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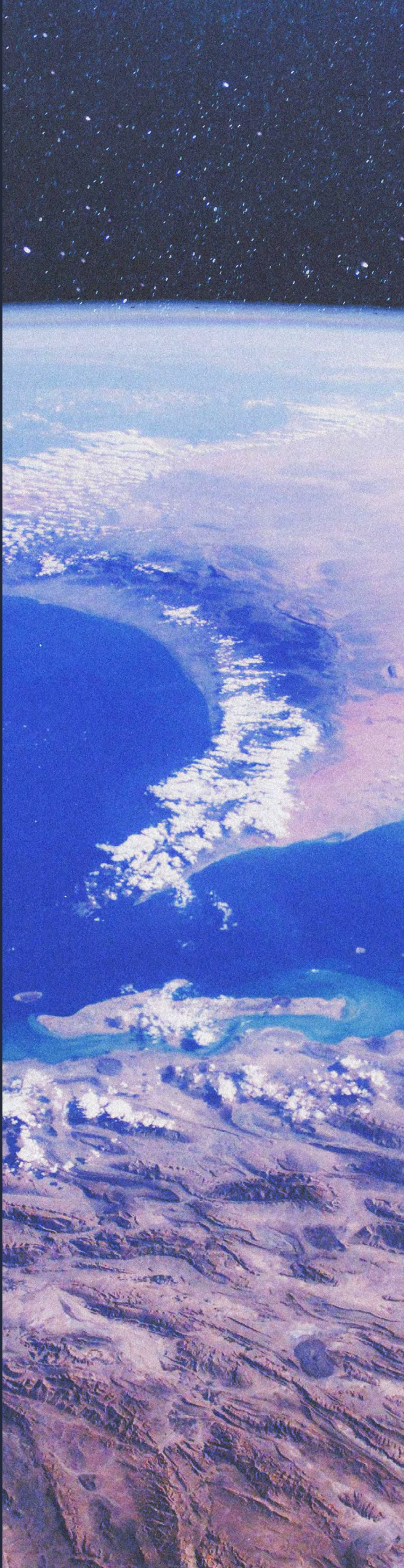
CIO Outlook - Q2 2026

Navigating the Strait of Hormuz



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FROM DR DAN APPLEBY
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Dan joined Blackfinch in 2018 and was previously Head of Research, and has held Senior Analyst and Investment Manager roles within Blackfinch for our Multi-Asset and Adapt AIM portfolios. He also sat on the investment committee for the VCT and EIS portfolios. Dan holds a PhD in nanoelectronic research and is also a CFA Charterholder.

Markets began the year on a high, supported by a Goldilocks mix of public and private spending and hopes of central bank rate cuts. That spending story remains intact, with the US's One Big Beautiful Bill now in force and heavy investment in artificial intelligence (AI) infrastructure continuing at pace.

Yet, rate cuts now look less likely as geopolitical tensions have revived the threat of a supply-side inflation shock via energy markets. The last time this happened was after Russia's invasion of Ukraine, which forced Europe to reconfigure its natural gas supply chains. After a combined US-Israel attack on Iran at the end of February, attention is fixed on a narrow waterway connecting the Persian Gulf to the rest of the world's oceans.

That is the Strait of Hormuz, a maritime gateway between Iran and Oman, through which much of the Gulf's exports reach world markets. Its significance lies in the sheer volume of traffic that passes through it. Around a fifth of global oil consumption and a similar share of liquified natural gas (LNG) trade move through the strait, making it a key route not just for the region, but for global energy pricing. Saudi Arabia and the UAE have some pipeline capacity that bypasses the strait, but not enough to offset a serious interruption. The importance of Hormuz also extends beyond energy. Gulf states are major exporters of nitrogen-based fertilizers and their feedstocks, which are critical to global food production.

That means the Strait of Hormuz is not only a choke point for the fuels that power the global economy, but also for inputs that help feed it. Most of the energy exports moving through the Strait of Hormuz go to Asia.

The Energy Information Administration estimates that in 2024, 84% of the crude oil and condensate and 83% of the LNG transiting the strait went to Asian markets, with China, India, Japan and South Korea the main destinations for crude flows. When it comes to fertilizer, exports are less concentrated than energy flows. For example, World Bank data for 2024 shows that Saudi Arabia's fertilizer exports went mainly to India, the United States, Thailand, Brazil and Australia.

Therefore, the global significance of this strait is apparent, and any prolonged disruption would have consequences well beyond oil, adding to inflation pressures and making the path back to lower interest rates more difficult.

Predicting geopolitical events is never easy, particularly regarding the ongoing conflict in the Middle East. This is where long-term investing and a diversified portfolio helps mitigate the shorter-term volatility. Nevertheless, given the potential economic significance of the strait, we should assess the initial market reaction and conclude what is the most likely outcome.

The Conflict So Far

On the 28 February, the US and Isreal launched a wave of strikes on Iran, targeting its nuclear programme, ballistic missile infrastructure, and military leadership. The opening salvo killed Supreme Leader Ali Khamenei, triggering an immediate and wide-ranging Iranian response. Iran fired hundreds of drones and ballistic missiles at Israel and the US military bases across Bahrain, Jordan, Kuwait, Qatar, Saudi Arabia and the UAE, pulling these countries into a conflict that most did not want.

By the end of the first week, oil prices had surged in a similar way to what was seen at the onset of the Russian invasion of Ukraine, stoking supply-side risks from disrupted energy supply chains. The Strait of Hormuz is now effectively closed (Figure 1), as commercial shipping avoids the route while Iran uses the strait as part of its retaliation.

Source: Bloomberg

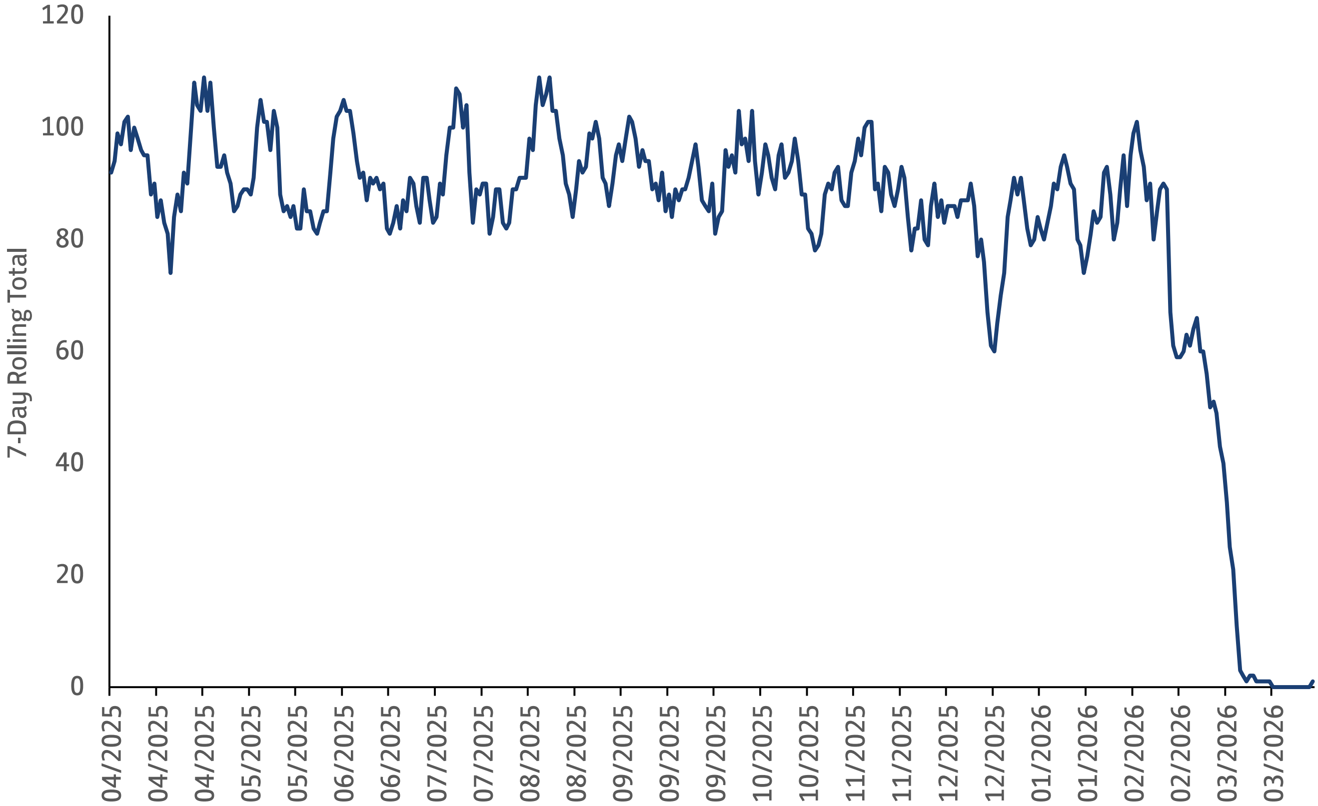

Figure 1: Estimated number of vessels transiting the Strait of Hormuz, a critical choke point in the global energy trade.

The conflict also drew in Hezbollah, the Iran-backed Lebanese militant group and political party, which resumed hostilities with Israel from Lebanon, and now the Houthis, a similar Iran-backed movement in Yemen. An escalation with the Houthis risks a similar shipping disruption through the Bab al-Mandab Strait that connects the Red Sea to world oceans due to Yemen's proximity to this shipping lane.

Iran moved quickly to fill the political vacuum left by Ali Khamenei's death. His son was selected as his successor, a move widely seen as a bid to maintain regime continuity and to show that Tehran will not back down. Trump has claimed diplomatic talks are underway, but Iran has flatly rejected this, accusing the US of buying time before deploying ground forces to the region. Now a month in, it remains highly uncertain whether a ceasefire will be agreed, heightening the risk of a supply-side shock as the conflict extends into April. However, this remains a rapidly moving picture which is being felt in markets through elevated asset price volatility.

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Crude Oil's Response

Crude oil is almost always the first market to react when conflict begins in the Middle East, and this time is no different. With the Strait of Hormuz closed, Brent crude has surged from about $70 a barrel at the end of February to over $115 at time of writing, a rise of around 64% in a month. This is more than just an energy story as the crude oil price feeds into inflation expectations, central bank thinking, and broader risk appetite across global financial markets.

Figure 2 shows the price of crude oil with past Middle East conflicts marked as shaded regions. If there is one solace to take from past geopolitically caused spikes in oil prices it is that they are usually short lived.

Source: Bloomberg

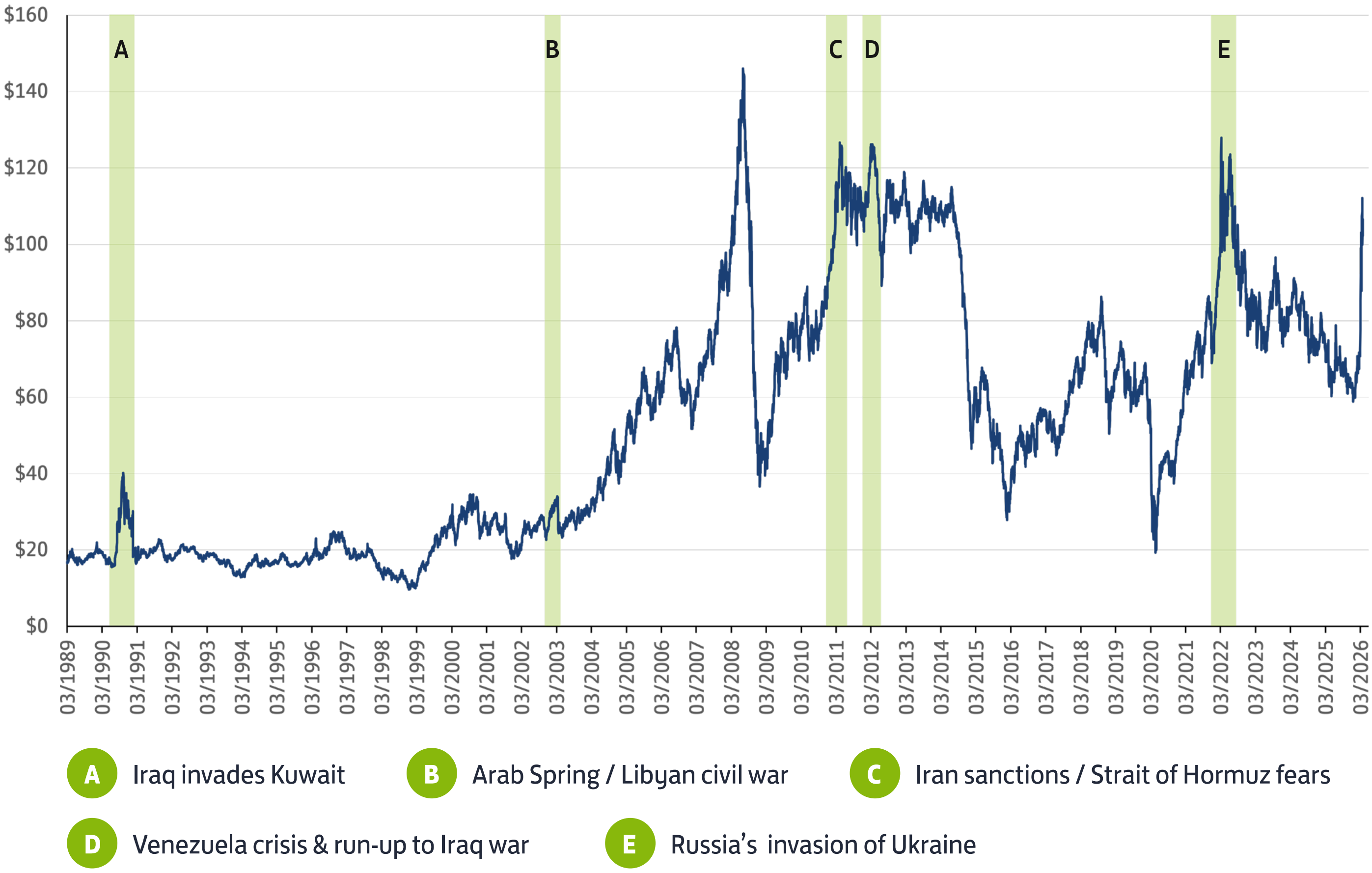

Figure 2: Historical price of a barrel of Brent crude oil marked by previous geopolitical events.

Amongst these previous geopolitical events, the sanctions on Iran in 2012 leading to fears of the Strait of Hormuz being closed is the most pertinent to today's situation. Crude oil rose to $125 in early March 2012 as the US and Europe sanctioned Iran over its nuclear weapons development. This raised fears that Iran would disrupt energy flow through the strait in retaliation, very much now a precursor for today. However, crude oil prices quickly reversed as US production rose while a slowdown in the global economic outlook led to concerns over lower demand.

For a commodity such as crude oil, this supply/demand balance is the usual structural driving force that determines price. Indeed, the largest rise in crude oil shown in the chart from 2007/08 was mostly due to a tight supply and strong demand backdrop. At the time, there was very low spare production capacity when global economies were running hot in the lead up to the Global Financial Crisis.

Before the current conflict started, the Energy Information Administration (EIA) reported that global oil inventories would build by 3.1m barrels per day in 2026, implying a supply-over-demand imbalance. This capped any rise in the oil price, resulting in an EIA forecast for Brent crude at $56 per barrel across 2026. However, reports are now that the war has cut at least 8m barrels of oil from production per day; demand for oil is also reducing, just not at the same magnitude as the loss in production.

The key takeaway is that this was a structurally oversupplied market pre-war, but the conflict has added a cyclical shock which has significantly reduced supply. If we see a quick resolution, energy markets should reverse as the geopolitical premium in current pricing is removed. The EIA has revised its expectation for Brent crude in 2026 to $79 per barrel, while futures contracts for oil deliveries in December stand at c. $84. Both prices suggest a short-term resolution to the conflict.

How to Position Portfolios

A quick resolution to the ongoing conflict is the key factor for markets in the second quarter and beyond. If this transpires, and crucially energy exports through the strait resume at similar levels, then markets should recover at pace. This is very much the bullish view of the coming quarter.

But time is running out. A prolonged closure of the Strait of Hormuz will create a significant supply shock and lead to inflation, with central banks likely responding by raising rates. The issue is that tighter monetary policy works by suppressing demand, not by fixing supply, and therefore risks pushing an economy into recession. It is a balancing act as the alternative would be to allow inflation to spiral out of control and damage longer-term economic stability. Hence the difficult decision for central banks in supply-side inflation shocks is to take the recessionary hit in the short term to prioritises price stability and protection of its currency over the long term.

> **Why this geopolitical conflict is that much harder to predict is due to the unpredictability of President Trump. His social media posts seem to turn at a moment's notice, from progress on a ceasefire, to escalating the war by targeting non-military infrastructure. In March, the only certainty in markets has been volatility, and this is set to extend at least into April. Making tactical calls to change portfolio allocations, in turn, risks being thrown off by short-term market swings as sentiment changes on a tweet.**

As is often the case, the right call is to maintain allocations to diversified asset classes and investments. For the long-term investor, cyclical falls in asset prices also present opportunities to top up holdings. There will be a great buying opportunity at the other side of this war. February ended with a bullish backdrop of public and private spending stimulus, and this still remains the case.

IMPORTANT INFORMATION