

### It takes two to taco

*President Trump's blockade on traffic through the Strait of Hormuz is a high-risk, high-stakes strategy for the negotiating table. That means risks for markets too.*

Unsurprisingly, events in the Middle East continue to dominate the headlines. Back in the days when I more often picked up a physical newspaper, I'd start at the back with the sport and reverse my way through the content via the financial section to the 'news'. It wasn't always less stressful, though!

The back pages on Monday would have focused on Northern Irish golfer Rory McIlroy's addition of a second Masters' Green Jacket to his wardrobe. A chart of his first three-and-a-half days' performance at the event reflects this year's stock market moves: a very strong start, despite having to extricate himself from a few sticky situations, followed by a nasty wobble born of poor decision-making and bad execution. All exacerbated by spirited counterattacks from his rivals.

But that's where the analogy ends for now. There's no march to victory in the air just

#### Quick take:

- Market volatility continues in light of the continued conflict in Iran.
- Higher global inflation and weaker growth could be on the cards if the Strait of Hormuz remains closed.
- However, US first quarter earnings are expected to be good, driven by strong tech sector growth.

yet. With US President Donald Trump imposing a blockade on all traffic traversing the Strait of Hormuz, the trickle of oil that had started to pass through is once again reduced to nothing. This is high-stakes poker. The plan seems to be to reduce Iran's revenue to the extent that it has no option but to capitulate.

However, we've already seen that the country is willing to tolerate a lot of pain. The longer cargoes remain trapped in the Gulf, the greater the probability of not only higher global inflation but also much weaker growth as various commodities beyond oil itself become not just expensive but impossible to obtain.

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We (and the majority of investors) continue to judge this escalation as an integral part of the negotiating process, however dangerous it appears to be. Thus, we continue to see relatively muted market reaction to the latest developments.

Last week we saw another example of how markets react when the news turns for the better. The announcement of a two-week ceasefire and talks between the US and Iran in Islamabad – another example of ‘Trump always chickens out’ (taco), his tendency to pull back from the brink – were greeted with an instant mark-up of most financial assets. The rally wasn’t as pronounced as on 23 March, when President Trump first announced the beginning of the end of the war, but there is a visible gap higher on the charts.

Once again, we’re reminded that waiting for the good news to break before committing to the markets means leaving returns on the table.

As long as we believe that all logic leads to an agreement in the not-too-distant future, we’re staying fully invested but always cognizant that there’s no guaranteed outcome. And there are at least two parties (the US and Iran) that have to agree to terms. If Israel also agrees, the path to peace would be smoother.

### Clues in the bounce

A few things have been revealed by the nature of the market bounce since the beginning of the month. There seems to have been a bit more support for large-cap technology companies in the US than before the war started. We’ve detected some improvement in sentiment regarding the adoption of AI tools as the tools themselves appear to have become more effective. Even bigger rallies were seen in memory chip stocks (Samsung, SK Hynix) in South Korea, which had suffered a big shakeout from speculative peaks made in February. Even so, the performance gap between IT hardware and software & services companies opened up again, with the former outperforming the latter by close to 10% in April so far. Investors are still struggling to sort out software winners and losers.

### Europe’s energy vulnerability

We also note that, having fallen by more than global aggregate indices in March, European equities have failed to recapture the ground they lost, relative to global indices. Two factors are at work here. First, Europe is vulnerable to energy price increases and/or product shortages owing to its lack of domestic supplies. Second, if improving sentiment towards AI ‘spenders’ is justified, then European indices have limited exposure to the theme. In recognition of these handicaps, we

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became more cautious about European equities in March.

It's not all bad news, though. The defeat suffered by Prime Minister Viktor Orbán in Hungary's parliamentary elections on Sunday removes a blockage to some of the EU's policy ambitions. Crucially, it potentially permits a €90bn loan by EU member states to Ukraine, which will keep it funded through 2027. That might reduce the threat of further damaging escalation from Russia.

The final observation is that sovereign bonds failed to recover much lost ground either. Having sold off alongside equities in March owing to concerns about higher inflation and fiscal deficits, the threat of structurally higher and more volatile inflation continues to hang over them. Investors are demanding higher yields as compensation.

### **The acid test for equities**

There are really only two things that define equity returns: how much they earn and what investors are willing to pay for those earnings. The latter is all over the place at the moment as the risk-free rate – the rate of return on an investment with no risk of loss – moves around rapidly and the tolerance for risk falls and rises with the latest news from the Middle East. But, as we head into the first quarter earnings

season, we should get a fair view of corporate earnings power – even if what comes next is less certain.

Expectations going into the season are good, especially in the US. Investment strategists, on average, are looking for earnings to have grown 12% since last year, and for the same pace for the whole of this year relative to 2025. Aggregated forecasts from individual stock analysts are looking for an even punchier 17% annual growth rate... And then the same again in 2027!

### **US tech tailwind**

The US benefits from strong growth from the technology sector, a tailwind unavailable to most other markets. Indeed, Goldman Sachs calculates that no less than 87% of the first quarter's earnings growth will have been generated by the technology sector, with almost two-thirds of the total coming from just seven AI-related stocks (with chipmaker Nvidia alone accounting for 35%). There have been signs that earnings participation is broadening out, but it's still top-heavy.

Goldman has provided a range of earnings forecasts for the S&P 500 in 2026 under different scenarios for the situation in the Middle East. The base case is for \$312 of earnings (+12%). A mild oil shock reduces growth close to zero (\$278). An oil

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shock-driven recession would cut earnings to \$239 (-13%) in their opinion. These look like reasonable estimates.

The biggest variable factors are the duration of the closure of the Strait of Hormuz and the consequent influence on commodity supplies. When they really get short, then economic problems will not be primarily because of high prices and spending displacement, but more about certain activities simply grinding to a halt.

The risks of more negative outcomes, which remain far from negligible, restrain us from increasing equity weightings in portfolios. But the sort of upside squeezes that we have already experienced illustrate the potential problem with reducing exposure. While we wait to see whether President Trump's high-risk strategy results in an eagle or a lost ball, we're maintaining a prudent balance between potential risks and rewards in light of the uncertainty.

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### Regional highlights

**UK.** UK data has been thin on the ground, but what we have seen confirms that the economy is barely growing – and that’s before the full impact of events in the Middle East are felt. The final PMI survey readings had the Composite measure at 50.3 in March (from 51 in February), barely above the 50 mark that defines growth from recession. The latest RICS House Price Balance survey fell to -23%, the lowest reading for two years. In any other circumstances, the Bank of England would almost certainly be cutting the base rate at this month’s meeting, as was expected before the war in Iran began. Futures markets are now pricing in a quarter-point increase in July. Much will depend on oil prices and inflation, but the Bank of England will remain cautious about leaving monetary policy too loose and so the bar for rate cuts is much higher now.

**US.** March’s inflation report saw headline CPI jumping from 2.4% to 3.3% on account of higher energy prices. Core CPI rose from 2.5% to 2.6%. Even so, both readings were slightly lower than consensus expectations. Translating this data through to the Fed’s favoured Core PCE reading of inflation, Goldman Sachs projects 3.1% for March, so still well ahead of the Fed’s target. This is consistent, at

the minimum, with no rate cuts for the foreseeable future, which is precisely what’s priced in. We’re still waiting for the prospective new Fed Chairman Kevin Warsh to come before the Senate for approval, and he is expected to push for lower rates eventually. But his approval is not necessarily a formality, with at least one Republican Senator, Thom Tillis, withholding his vote until the Department of Justice investigation into current Chair Jerome Powell is withdrawn. The University of Michigan sentiment survey hit an all-time low with inflation expectations rising. The US is not a happy ship, even with the stock market having rebounded to within 1% of its all-time high.

**Europe.** Europe is at the sharp end of the effects of rising oil prices owing to its reliance on imported energy. We have already seen a sharp decline in the economy’s performance as defined by Citigroup’s Economic Surprise Index. When the economy seemed to be picking up steam early in the year, the reading was a healthy +30, meaning that reported data was consistently beating economists’ expectations. It has since dropped to -21. Despite this reversal, traders are pricing in two quarter-point interest rate increases from the ECB by September, judging that

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the central bank will be more preoccupied by inflation risks than growth concerns. This echoes events of 2008, when the ECB, under Jean-Claude Trichet, tightened policy as the Global Financial Crisis was unfolding in response to the oil price's rise to \$148 a barrel, largely owing to China's growing consumption. Given that today's higher oil prices are a function of supply shortages and not excess demand, many believe that raising rates today would constitute a similar policy error on the part of the ECB.

**China.** While we wait for the Q1 GDP print this week, with the consensus estimate of 4.8% growth (which nobody really believes), the latest reports offer limited insight. March data will have been distorted by Chinese New Year and the early effects of the war in Iran. That was visible in the latest trade data, which showed exports growing by just 2.5% year-on-year, while imports were up 28%. At least the latest inflation reading remained in positive territory (1%), after deflation for much of last year. This suggests that China is slowly dealing with its manufacturing overcapacity problem.

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