

# Market Impacts: Iran Conflict

Joint U.S.-Israeli attacks on Iran over the weekend have sparked a conflict that could draw in much of the Middle East. Explore the short- and long-term implications for investors.

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## Key takeaways

- **Investment risks:** The escalation underscores that potential energy-supply disruptions, particularly through the Strait of Hormuz, remain the primary market risk, with prolonged conflict increasing pressure on Gulf-exposed issuers. Additionally, indiscriminate Iranian missile and drone strikes targeting Gulf-country infrastructure introduce a new set of risks.
- **Fixed Income:** Heightened Middle East conflict has increased uncertainty, prompting a flight to quality in bond markets, with oil prices, inflation dynamics, and central bank constraints likely to be the key drivers of yields, spreads, and risk appetite as events evolve.
- **Equities:** Market impact is expected to be limited on most global equities for now, with potential risks emerging only if it becomes prolonged or expands—primarily through higher oil prices that could pressure certain industries and consumer sentiment without materially altering U.S. monetary policy.

## Investment Risks to Consider

In February 2023, we first mentioned the possibility of a military strike against Iran. We have been actively monitoring the Middle East for investment risks; the events of this past weekend have not changed our view that energy supply and energy prices will be the main mechanism of influence for global markets. If military actions occur in the Persian Gulf, it is less likely that oil tankers will continue to travel through the Strait of Hormuz. That has the potential to limit the supply of both oil and natural gas in the market, leading to a short-term spike in prices.

Iran's indiscriminate missile and drone strikes across the UAE, Saudi Arabia, Bahrain, Qatar, and Kuwait have introduced new investment risks, with attacks hitting military bases, airports, hotels, apartments, and financial centers. Gulf nations can rebuild if the strikes are brief, but we believe a prolonged campaign would increase financial pressure on corporate and sovereign issuers reliant on energy, tourism, and financial services. We recently enhanced our investment risk monitoring of exposures in those areas.

## Fixed Income Implications

### Bond Market Dynamics: Iran-Israel-U.S.

The situation in Iran remains highly fluid as the country's supreme leader, Ayatollah Ali Khamenei along with several other leaders, has been killed while both sides continue to exchange attacks.

At this juncture, it is difficult to fully assess the economic consequences of these actions and the total impact on bond markets. The depth, breadth, and duration of the conflict will ultimately drive behavior, and it's just too soon to tell. Recent comments from President Trump suggest the bombings could last a week or longer.

Nevertheless, we can make some broad assessments about possible market reactions based on prior military conflicts and the current cyclical position of economies and markets. Being nimble and able to actively manage risk in these types of markets can be critical as conditions can—and often do—change rapidly.

As with most political conflicts, a flight to quality and liquidity is typically the first response in financial markets, followed by higher commodity prices, led by oil. Oil is often considered the transfer mechanism of conflict into the global economy. Sharply higher oil prices could prove to be a stagflationary shock, if growth stalls and prices rise. With a U.S. economy highly dependent on the wealth effect from elevated stock prices, and stock prices dependent on low bond yields, and bond yields dependent on stable inflation expectations, it's easy to see how an energy price shock could quickly unravel markets. But again, it's still too early to tell.

## **Bond Market Roadmap**

### **Oil**

We believe oil is the lynchpin and could be a meaningful barometer for risk. In this respect, WTI trading prices may need to climb north of \$80 per barrel and remain there for several weeks to months to be considered a meaningful tax on growth. However, recent comments suggest OPEC+ (Organization of the Petroleum Exporting Countries) is committed to providing additional capacity, and the U.S. has the option to temporarily tap its Strategic Petroleum Reserve to buffer any price spikes.

### **Central banks**

Central banks remain poised to provide liquidity if financial markets seize up but may be somewhat constrained by ongoing inflationary pressures, especially if oil prices rise. Futures markets continue to expect the Federal Reserve (Fed) to remain on hold until mid-year, then reduce rates by about 50 basis points in the second half of 2026.

### **Global government bonds**

A flight to quality is a typical reaction to heightened geopolitical risks with global government bonds benefiting, led by the U.S. The first indicator we believe many investors will watch is how the bellwether U.S. 10-year Treasury bond trades as the conflict in the Middle East continues to unfold.

### **Yield curves**

Yield curve movements are difficult to generalize. If the Fed is constrained by persistent inflation, then flatter yield curves may result. However, a major financial shock may require the central bank to respond to disorderly markets, resulting in a steeper curve. At this juncture, a flatter yield curve seems most likely, as a straightforward flight to quality drives longer-dated bond yields lower.

### **Credit**

Credit spreads typically widen and credit-rating curves tend to steepen during bouts of geopolitical risk as a flight to quality ensues. Within credit sectors, Energy and Commodities may benefit, while Banks could prove to be the relief valve as investors attempt to pare risk. However, the depth and breadth of the conflict will likely prove to be the ultimate determinant of spread changes.

## **Securitized**

Interest-rate volatility may increase if bond prices rally sharply and curves steepen, then flatten. This may put some pressure on mortgage-backed securities (MBS) spreads. However, given the high-quality nature of MBS and their liquidity, demand tends to normalize fairly quickly, as the sector typically benefits from a flight to quality.

## **Municipals**

Municipal bonds may provide diversification away from geopolitical concerns. The use of basic services, such as paying taxes, using roads, attending schools and buying electricity from utilities, continues to march along regardless of the geopolitical backdrop.

## **Emerging markets (EM)**

EM bonds could be quite volatile in the near-term depending on the breadth and duration of the conflict. Countries most closely involved in the conflict (both geographically and politically) may experience weaker prices and higher yields, while those farther removed and strategically positioned to benefit may rally. Spreads for countries in the Gulf Cooperation Council, both sovereigns and corporates, as well as Israeli-based entities may likely move wider, while other regions may suffer general widening with the broader risk-off trade.

## **Allspring Fixed Income Platform View**

Most of Allspring's fixed income investment teams have been moving up in quality over the past year or so to seek to reduce cyclical risk and improve liquidity. As a result, we believe our teams are well-positioned to take advantage of the volatility resulting from conflict in the Middle East and will do so as events unfold.

It's important to remember that our investment decisions are not made in isolation. The unfolding conflict in the Middle East needs to be assessed in conjunction with a recent upsurge in credit issues in private credit, the broadening impact of artificial intelligence across the U.S. and global economy and changing dynamics at Fed and other central banks around the world.

Optimistically, the global economy, led by the U.S., appears to be expanding modestly while disinflation slowly unfolds. Unemployment is low in several developed countries around the world, corporate profitability is high, and the balance sheets of many publicly traded companies are in good shape.

In summary, a cautious approach to opportunistic risk taking in bond portfolios seems appropriate at this time.

## **Equity Implications**

### **Special Global Equity**

The conflict is in early stages, and the level of economic and market impact is likely to be manageable. That said, we will need to recalibrate that perspective if the duration of the conflict drags on for more than a couple of weeks or if other nations join the battlefield in support of Iran.

The economic impact directly on the U.S. is likely to be minimal and limited for the time being. The most likely impact would be through an increase in the price of oil if the Iranians are successful in choking off the Strait of Hormuz, which the Iranians have stated they intend to attempt. This would put upward pressure on inflation, but it is likely to be "looked through" by the Fed and won't impact future interest rate policy.

Although the Fed is keen to brush aside inflation due to a (likely temporary) increase in the price of oil, real companies and consumers will have to deal with it. A handful of industries within the Industrial and Materials sectors are likely to be most impacted through an increase in the cost of goods sold (putting downward pressure on margins), including chemicals, packaging, machinery and transportation.

Consumer pocketbooks are likely to get incrementally pinched; consumer sentiment might be impacted more. The conflict could create more uncertainty for individuals who are coping with persistently high prices and the uncomfortableness of the unknown impact of Artificial Intelligence on job security.

## **Growth Equity**

From a market standpoint, the key question is whether this remains a headline risk or spills into the real economy through Energy and Logistics. The focus is less on oil prices and more on whether there is sustained disruption to physical flows—shipping, insurance, or routing—that raises delivered costs.

If that happens, we believe the market impact is more likely to show up through confidence and financial conditions than through monetary policy. In equities, this argues for dispersion: companies with pricing power, high margins, and limited energy exposure should hold up better. Conversely, energy- and transport-intensive businesses may face faster margin pressure. For consumers, sentiment is the swing factor, even if spending holds up initially.

What would change our view: prolonged disruption to energy or shipping lanes, a meaningful shift in inflation expectations, or a broader tightening in financial conditions. Separately, we are watching rising friction between frontier artificial intelligence (AI) model providers and U.S. defense procurement—not a near-term earnings issue, but an early signal for how control and governance may shape the next phase of AI adoption.

## **Intrinsic Emerging Markets Equity**

Early market reactions in the Gulf region point to heightened volatility, with Saudi and Egyptian equities falling sharply as investors braced for conflict, while other regional markets will remain closed over the next few days.

From an EM standpoint, we view the latest escalation involving Iran primarily as a source of near-term volatility rather than a fundamental shift in the EM investment backdrop. Historically, geopolitical shocks of this nature tend to reprice risk temporarily through energy markets and sentiment, but they rarely alter the medium-term earnings or balance-sheet trajectories that ultimately drive equity returns.

We expect dispersion across countries and sectors to increase rather than a broad-based derating of EM equities. Markets with large external imbalances and high energy import dependence are more vulnerable in the short run, while energy exporters and select commodity-linked businesses may see partial offsets.

The risk to the above expectations is that markets were quite bullish on emerging market equities and consensus going into the weekend was that any attack would be short-lived. Should the conflict drag on, investors may begin to question their bullish stance on EM and risk assets in general.

We see three key markers of well-known risk: Oil, the dollar and gold.

- The oil price appears set to jump, although this may be cushioned by planned increased production by OPEC+ members. Further, the U.S., China and other key oil consuming nations will be able to tap their strategic reserves if necessary. A key risk is that Iran is attempting to close the Strait of Hormuz, which accounts for approximately 20% of global oil transport.
- The U.S. dollar is another key barometer of risk, and we would naturally expect a flight to the dollar in the near term. Indeed, the dollar moved broadly higher in early Asian trading. Again, the key driver will be the extent and duration of the Iranian conflict. In the near term, a stronger dollar will be a headwind to EM equities.
- We believe gold should extend its rally, and any outsized effect from geopolitical tensions may be short-lived.

Under normal circumstances, a stronger dollar and higher oil prices would typically be a tailwind for Gulf markets, but that seems unlikely in this case.

EM investors will naturally ask how this will affect China as the heavyweight emerging economy. While higher oil prices are a modest headwind at the margin, we believe that the more important drivers for Chinese equities remain domestic policy, earnings recovery, and confidence stabilization rather than Middle East geopolitics. China's diversified energy supply, policy flexibility, and limited direct exposure to Iran reduce the risk of a sharp macro spillover. From an equity perspective, we think any impact is more likely to come indirectly through global risk sentiment or export demand, rather than through corporate fundamentals. As such, we do not view the Iran situation as a central determinant of Chinese equity performance relative to the more consequential domestic factors shaping the investment outlook.

While China and Iran are politically close, and China is the largest purchaser of Iranian crude, but their economic ties remain limited. China maintains no formal alliance with Iran and will likely seek to remain neutral in the conflict. However, the Gulf has attracted a significant amount of outbound foreign direct investment from China in recent years (primarily to Saudi Arabia, Egypt, Iraq, and the UAE). Successful regime change in Iran could change the calculus for China, but the implications are difficult to predict.

We remain focused on bottom-up fundamentals, valuation discipline, and balance-sheet resilience. Many high-quality EM companies today are entering this period with conservative leverage, strong cash generation, and limited direct exposure to Iran-related trade flows. Unless tensions escalate into a sustained disruption to global energy supply, we believe the market impact is likely to be episodic rather than structural. Periods of heightened volatility have historically created opportunities to add to durable franchises at more attractive prices, particularly where headline risk obscures company-specific fundamentals.

**OPEC+** is a coalition of the member countries of the Organization of the Petroleum Exporting Countries (OPEC) together with a group of non-OPEC oil-producing nations, including Russia and several others, formed to coordinate and manage global oil production levels in order to influence market stability and prices.

The **Gulf Cooperation Council (GCC)** is a regional intergovernmental organization that promotes political, economic, and security cooperation among six Middle Eastern countries bordering the Persian Gulf: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE).

The U.S. **Strategic Petroleum Reserve** is the nation's emergency stockpile of crude oil, created to protect the United States against major disruptions in global or domestic oil supplies.

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