Iran: An update on a moving target

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Unless you have been hiding under a veritable rock, or out in the garden enjoying this glorious weather, you won't have missed the missile barrages being launched between Iran and Israel.

The situation: On Friday 13th, Israel launched a salvo of missiles into Iran under operation "Rising Lion". It appears the Israelis' target was Iran's plutonium enrichment facilities. Targeted to slow or halt Iran's progress to becoming a nuclear power and potentially further destabilising the world order.

What we saw in response was a predictable retaliatory strike from Iran using hundreds of drones and ballistic missiles. Israel's potent defense system, the "Iron Dome", caught a fair amount of the barrage with only a few of the missiles from Iran finding their targets. From then to now both nations have been firing missiles at one another in well documented salvos.

Research is showing elements of Israel's Rising Lion operation has been years in the planning. Combining a massive force of arms with clandestine activities within Iran causing catastrophic damage to Iran's senior military leadership, military infrastructure and retaliatory capability. As a result, Israel has almost total air superiority over Iran with jets striking Iranian targets with impunity. Iran's dramatically reducing ability to retaliate has been noted in the dwindling number of ballistic missiles which is now in the teens as opposed to last week when it was in the hundreds.

Israel's efforts seem, at this juncture, to be both primary and secondary. Primary is clearly an attempt to remove Iran's ability to make a nuclear bomb. Secondary, and arguably far more influential, seems to be a very carefully planned attempt to destabilise the Iran powerbase and increase the possibility of uprising and regime change in Iran. Either way one looks at it, we remain dramatically closer to a regional Middle Eastern war than we were a week ago. Normally one would look to the US to step in and mediate a ceasefire. However, Trump's immediate comment was that the two nations would likely have to "fight it out" for the time being. Trump left the G7 meeting in Canada this week to "do something big" which saw the USS Nimitz carrier group breakaway from training exercises in the South China sea and steam headlong into the conflict zone along with numerous US refueling jets. This has all sparked rife speculation that the US might be willing to get involved in the military campaign to accelerate Israel's Primary objective, and highly likely its secondary objective as well.

The market's reaction: the prescribed knee jerk response to any Middle Eastern conflict is played out in the oil market as investors panic that global oil supply becomes disrupted, prices rise to the benefit of oil producers, refiners and holders of oil and its derivatives. Oil has rallied some 10% since the 13th and puts the black stuff at $76.84 a barrel at today's market open.

Broadly speaking, the average price of Brent Crude, going back to the 70's, sits at around $77 a barrel so today's price is a clip below what most would consider the 'average' price of oil. A lower oil price remains something key to central banks around the world as oil represents a major component of headline inflation. So, when it is trading cheaper than its historic average, it's having less inflationary impact on broad inflation. This in turn helps keep inflation subdued to enable central banks around the world to reduce the level of interest rates they set, in turn helping to stimulate the global economy.

Many in the market believe one of Trump's goals behind the "drill baby drill" comments he made on the campaign trail was not, as many think, to cement the US's place as the worlds biggest oil producer, but to increase global oil supply to decrease its price and its pressure on inflation. This in turn allows central bankers to cut US interest rates to boost the economy. Combine this with the notion that lower oil remains a boon for the everyday consumer with lower prices feeding into what we pay at the pump. Should interest rates indeed come down as a result of lower oil then this would induce lower interest rates on credit cards and mortgages which in aggregate, increases consumers' disposable income, driving up consumption and eventually business and job growth.

So, flip all of that on its head for a second, with oil on the rise we can loosely observe that benefits from a decline in price turn into drawbacks from a rising price and the market action we have seen as a result certainly underpinned this fear.

On Friday, as the first missiles were launched, the stock market predictably sold off with oil being the bright star in an otherwise red stock market. Stocks usually do this because investor appetite tends to sour when the potential for war escalates. Usually, they parse this with a move into the safety of government bonds like US Treasuries. However, US treasuries ended that first day in the red. Why? investors feared a rising oil price would indeed cause inflation to rise, therefore potentially limiting the US Federal Reserve's ability to cut rates in the way they have been pricing in. This comes at a time when the market is also very nervous about a US recession. Should inflation begin to rise at a time when growth is stalling, this would classify as a 'stagflationary' scenario which would certainly cause the stock market some serious concerns. The other two haven stalwarts, gold and the dollar, both rallied 2.5% and 0.5% respectively on the day showing investors were indeed on the hunt for a safe port in the storm.

As an investor, I always find it hard to compute why the direction of US interest rates is considered more of a market moving event than the loss of human life but I suppose one must then conclude the reaction is emblematic of just how seriously the direction of US interest rates is going to be in 2025, and how influential inflation is going to be on that interest rate trajectory. Buckle up.

So where to go from here?: Well Iranian oil pumps crude at circa 3mn barrels a day which is a little over 3% of the daily oil production globally. This is not insignificant but represents a daily amount which the Saudis could offset with an increased production almost instantly. Given this, we expect the spike in oil on supply fears to calm back down with the oil price retreating from where it trades today. Good news for those worried about inflation. However, a wild card remains the Strait of Hormuz which is one of the world's shipping choke points. Iran possesses the ability to close this which would significantly disrupt global supply and cause more rises in oil.

A counter to this threat is China. China, a loose supporter of Iran, buys around 90% of Iran's oil which makes it the biggest Iranian Crude client. Further, around 12 – 20 million barrels of oil pass through the Strait of Hormuz each day, of which 80% is bound for Asia and most of that to China. It is therefore highly likely China would pressure Iran not to shut the Strait and also likely Iran would want to listen to that message from its biggest client.

So back to oil and markets, in line with our loose outline to how oil versus inflation versus interest rates interact, we can then extrapolate a stock market, under a lower oil price, quickly recovering its poise. The propensity for the stock market in 2025 to bounce back would suggest investors' risk appetite remains healthy and therefore their willingness to 'buy the dip' is still alive and kicking. However, a clear topic to finish on would be the market's reaction to the US getting involved militarily in the campaign against Iran which would, we think, put a different spin on the market's movements from here. Yesterday, the closure of the Strait of Hormuz was the flashpoint, 12 hours later and a few Truth Social announcements from Trump and speculation is on the probability of the US joining in the fight.

Why would they do that? Most assessments point toward a unified goal of eliminating Iran's ability to make nuclear weapons, which Israel is attempting to do without the US right now. However, most assessments also make clear that this can't be achieved without destroying the Iranian enrichment site at Fordow which is 20 meters underground. Presently, the US MOP bombs (Massive Ordnance Penetrator) are the only ordnance capable of getting through 20 metes of rock to level the facility. Ergo, if the unified goal is to eradicate the Iranian nuclear threat, you need US bombs coming from US planes to finish the job.

We know Trump's approach to Iran has always taken a harder line than those of his predecessors so this is certainly something he would entertain. Further, if Trump wanted to take this option, then there has not been a better opportunity with a more hamstrung Iran, than now. Conversely, joining the fight would create some polarization of opinion in the US and potentially do more damage than good to his already dwindling approval weighting. The market's reaction to this would be volatile in both directions and would certainly create some upward pressure on oil prices north of $80 in the short term, weaker stock markets and stronger gold as safe havens are sought. Treasuries would also be volatile as investors parsed their desire to use them as a haven but also weary of their interest rate implications against a rising oil price.

A more likely route would be Trump using the threat of US military involvement to rattle the Sabre enough to bring the Iranian regime to the point of abandoning its nuclear intentions. Don't forget, one of the core goals of an autocracy is to survive. The US stepping into this conflict and the potential for the Iranian people to rise in revolt might just be something the supreme leader wants to avoid more than having a nuclear weapon.

Right now the Iranian people remain focused on seeing Israel as the aggressor over its own leaders so the ability to engineer a coup is far from concrete. Regardless, this Sabre-rattling theory certainly chimes with Trump's "art of the deal" in how to complete a successful negotiation which would also avoid dragging the US into a conflict he promised on the campaign trail, he wouldn't do.

The market's reaction to a resolution on the conflict, the voluntary deconstruction of Iran's nuclear apparatus without a single US bomb being dropped would be bullish with equities and treasuries rallying, oil price decline, gold selling off and investment positivity further underpinning the equity market into the second half of the year. Trump's lap of honor would also be something to behold. TAM remains aware of both the bull and bear case and the rapidly shifting narrative. TAM stands ready to increase its potent defensive investments should the market take a dive but currently has its investments in stocks intact on the increased probability that a non-military resolution can be sought.

If you would like to speak with us about anything in this note, or to discuss our discretionary investment management services in general, please get in touch with our UK business development manager David Terry today.

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