DC ADVISORY

Weekly round up (Week 13)

We are now four weeks into the Iranian conflict, which began on February 28. What makes this episode particularly difficult to assess—both in terms of duration and ultimate economic impact—lies in two structural characteristics that distinguish it from more recent market shocks.

Let's consider the dynamics of how these previous crises were resolved. The "Liberation Day" tariff shock, despite its severity, actually had only one control point—and therefore only one point of resolution. A single individual, Donald Trump, held the political lever and could adjust it in one direction or the other. The markets understood this, which explains why volatility quickly dissipated as soon as the rhetoric began to shift.

The COVID-19 pandemic, by contrast, constituted a true humanitarian and economic shock. Yet it sparked an extraordinary level of institutional coordination. Governments, central banks, the International Monetary Fund (IMF), the World Health Organization (WHO), and other global bodies acted with a common goal and a shared sense of urgency. The scale of the disruption was immense, but the cohesion of the response was equally so.

The Iranian conflict possesses none of these stabilizing characteristics. It cannot be resolved by a single decision-maker, and there is no coherent alignment—neither around a rapid military resolution nor around a coordinated economic safety net. This brings us to the second challenge: distinguishing the signal from the noise, given that communications from all sides are designed as much to project a posture of strength as to foster a settlement.

Last week's flow of communications was—to put it charitably—deeply contradictory. On the U.S. side, the rhetoric has shifted significantly, moving from language of acceleration and escalation to talk of de-escalation, negotiation, and a way out of the crisis. Reports of a 15-point U.S. framework covering the dismantling of Iran's nuclear facilities, the reopening of the Strait of Hormuz, and a broader regional settlement offered markets a constructive scenario to build upon. New momentum came from the announcement of a planned summit between Donald Trump and Xi Jinping in Beijing on May 14 and 15. Following the delays imposed by the conflict itself, this development reinforced a growing sense that the U.S. administration is convinced a diplomatic framework is beginning to take shape.

This, however, does not align well with the operational reality on the ground. Self-imposed escalation ultimatums remain on the table, and the significant movements of U.S. military personnel in the theater of operations do not resemble the posture of a party preparing to withdraw. The Iranian position is no less opaque. Official military statements have been categorical: they deny any interest in a ceasefire and any contact regarding it. However, this position appears to have softened conditionally when the Iranian government acknowledged its fundamental demands regarding security guarantees and formal recognition of its authority over the Strait of Hormuz. Adding to the complexity, reports from Reuters indicate that Iran has since insisted that Lebanon be included in any ceasefire framework, thereby linking this conflict to a broader regional settlement.

If we try to filter out the noise by observing the Iranian conflict from a very high vantage point—imagine a weather satellite in space, above the storm clouds—a clearer picture begins to emerge.

From this perspective, it is clear that markets are now in the eye of the storm. The windows are rattling. Our preferred sentiment indicator, the VIX, has surpassed 30 points—a classic signal that uncertainty has increased. At the same time, bearish sentiment has surged. The American Association of Individual Investors (AAII) survey, which tracks retail investors' expectations over a six-month horizon, has shifted decisively from optimism to pessimism over the past four weeks.

In commodity markets, energy prices have continued to rise but remain broadly in line with our supply shock scenario. Food prices have also risen, highlighting the risk that fertilizer shortages may begin to weigh on future harvests. Precious metals, however, tell a different story. Gold recorded its worst month since 2008, while silver lost more than a quarter of its value. This pattern is not unusual: gold often strengthens during periods of heightened event risk, but once the event materializes, it is frequently used as a source of liquidity—either to finance losses on risky assets or to meet margin calls.

In the bond markets, the adjustment has been just as pronounced. Since the start of the conflict, government bond markets (with the exception of Japan) have seen an aggressive flattening of the yield curve. Two-year yields have risen sharply: UK gilts by about 100 basis points (bp), German Schatz bonds by 68 bp, and US Treasuries by 57 bp. This repricing reflects the markets' reaction to central bank communications aimed at anchoring inflation expectations. The Monetary Policy Committee (MPC) and the European Central Bank (ECB) are now expected to tighten policy by approximately 75 bp, while investors estimate a 40% probability that the Federal Open Market Committee (FOMC) will raise rates by 25 bp this year.

Breaking down the 2-year U.S. Treasury note, its inflation component rose from 2.81% to 3.27%, suggesting that over the next two years, the conflict could add about 0.5% to consumer prices.

However, this inflation is viewed as temporary; at the 10-year point, inflation rises by only 7 basis points and remains unchanged at the 30-year point at 2.19%. This suggests that central banks have successfully anchored inflation expectations and that the conflict is limited in duration.

Corporate market spreads have widened, although the moves have been relatively moderate compared to previous episodes of event-driven tensions. Credit spreads have widened slightly more in Europe than in the United States. In terms of total return, investment-grade securities underperformed, mainly due to rising underlying bond yields; in other words, the longer the index's duration, the greater the decline. U.S. credit thus appears to be the worst performer among investment-grade securities, while emerging-market sovereign debt underperforms corporate debt.

An important nuance lies in the behavior of real yields. Across the entire US yield curve, real yields (growth) have risen; at the 10-year end, they have gone from 1.68% to 2.11%. This suggests that markets do not anticipate a significant deterioration in growth, but rather the opposite. This could explain the limited widening of credit spreads, which are generally more sensitive to growth expectations, while reinforcing the idea that this conflict could be short-lived.

The view from our weather satellite is nuanced but consistent. It appears that this event is viewed as a localized inflationary geopolitical shock, rather than the start of a broader economic slowdown. Implicitly, markets seem to be anticipating a scenario in which the conflict would be resolved within a limited timeframe of 4 to 8 weeks and, perhaps more controversially, that a resolution could eliminate longer-term geopolitical risks and could therefore, ultimately, be economically beneficial.

It is also worth noting that, according to our weather satellite, the Iranian conflict is not the only storm cloud on the horizon. The private credit storm is forming silently. This is a liquidity storm that will unfold over the next 12 to 18 months. Meanwhile, on the distant, vast, and ever-forming horizon, the supercell of AI-driven disruption looms. It is the largest system in the sky, an order of magnitude greater, but it remains distant, its true scale difficult to estimate. Its force is expected to be felt in labor markets, entire sectors, and capital allocation; this is a thematic storm that will unfold over the next 3 to 5 years.

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