

Market Pulse - The Middle East conflict

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Highlights:

- The Middle East conflict pushes equity premiums higher; fundamentals still sound for materials, industrials, defence, energy, and tech
- US Treasury yields rise on inflation worries but remain within normal range; Stay positive on short-duration bonds
- Quality US tech stocks remain resilient, with strong cash flows; South Korea, Taiwan tech structural growth stay intact

Equities

The Middle East conflict has created uncertainties in global financial markets, driving up the equity risk premium. What will arise from this evolving situation largely depends on whether the crisis escalates, how various countries respond, and how long the Strait of Hormuz remains closed.

The Strait of Hormuz, which accounts for about 20% of the world's seaborne oil trade, is currently blocked by Iran. Oil prices may experience short-term volatility as energy supply faces disruptions. However, a prolonged blockade is unlikely. About 90% of Iranian oil is exported to China, and both sides have strong incentives to ensure supply remains steady. Moreover, OPEC members can increase production to partly offset the impact, easing the shock on markets. Furthermore, the US will hold its midterm election this year, with inflation being a key determining factor. An extended closure of the strait would significantly push up oil prices, rekindling inflation. Hence, it is reasonable to expect the Trump administration would want to see a quick end to the conflict. As a result, although uncertainties may put pressure on the energy market in the short term, the aforementioned reasons suggest that the probability of a sustained energy crisis is limited.

Markets are impacted by the war to different extents. US technology and AI sectors, which are trading at relatively higher valuations, could come under greater pressure. Market fears that higher oil prices could reignite inflation, prompting interest rates to remain higher for longer and increasing borrowing costs for companies. However, we believe high-quality growth technology firms have strong balance sheets and stable cash flows, providing them with a measure of resilience.

In Europe, countries in the region rely more heavily on energy imports than the US, and therefore the impact they face is greater. The closure of the Strait of Hormuz would send natural gas and oil prices higher, potentially squeezing the industrial margins of European firms. Moreover, declining tourism demand in the region could also weigh on the luxury and consumer sectors.

In Asia, Japan's heavy reliance on energy imports means that rising oil price would increase costs for companies. Iran, OPEC's fourth-largest oil producer, has close ties with China. Since Iran sells a lion's share of its oil output to China, the country will also feel the impact of the war. Our focus in South Korea and Taiwan stocks is primarily on sectors with long-term structural growth prospects, such as tech and AI. While the crisis may have a limited impact on the fundamentals of these sectors, we will closely monitor the stability of supply chains.

Currently, we remain optimistic about the materials, industrials, defence, energy, and technology sectors, whose fundamentals have not been altered by the latest developments. We are less focused on consumer discretionary, communications, property, and financials. Our investment strategy continues to combine defensive and growth-oriented stock selection, aiming to balance return and risk.

Bonds

Following US and Israel's military action on Iran, US Treasury yields rose about 10 bps across the curve. The attack on Middle East oil facilities and the closure of the Strait of Hormuz pushed oil prices higher, prompting investor concerns about resurgent inflation. For now, the market is pricing in fewer than two rate cuts this year, with the first cut delayed to July or September. Should inflation rebound and the labour market perform better than expected, the rate-cut timetable could be pushed back even further. Ahead of the conflict, we had already moderately reduced US duration.

Despite US Treasury yields moving higher, they are still broadly trading within the normal range. Before the crisis broke out, equity corrections, coupled with worries about the longer-run impact AI may have on the labour market, market had already driven funds into US Treasuries, prompting yields to hover near the lower end of the range. Another supporting factor resulted from the bankruptcy of UK mortgage lender Market Financial Solutions, which sparked concerns about the health of private equity and credit markets.

On corporate bonds, credit spreads of long-term bonds widened by about 5 to 10 bps following the crisis, while short-term bonds did not exhibit any noticeable impact. Looking ahead, we remain constructive on short-end duration bonds and plan to increase exposure to short-term corporate bonds once volatility eases.

Investment involves risks, including the possible loss of the principal amount invested. Past performance is not indicative of future performance.

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