

## GULF WAR: ARE FINANCIAL MARKETS SLEEPWALKING?

Asset prices have been moving in unusual ways since the onset of the Gulf War (no safe havens, limited dollar rally and de-risking). Do financial markets know something we don't, has something fundamentally changed in the way asset prices reflect economic expectations, or are they simply malfunctioning and about to swing wildly as things normalise? Unfortunately, it is impossible to know for sure, and what's more, these hypotheses are not mutually exclusive. So far, markets appear to expect an inflation spike, met with a firm central response, with limited damage to growth, and a relatively swift return of inflation to target range. That may turn out to be correct. But far worse outcomes are also very plausible. Not seeing them priced in to a greater degree helps limit damage to growth in the near term, but could cause trouble if this changes abruptly.

Markets around the world have had one overwhelming driver since reopening on March 1: the price of crude oil on exchanges (Brent and WTI). Not physical oil (the one delivered by pipelines and tankers), nor oil products like fuel, diesel, or petrol, whose prices have skyrocketed and which arguably matter a lot more for economic outcomes. Just "paper" oil (*i.e.*, financial contracts), the price of which has fluctuated wildly on an intraday basis, based on the ebb and flow of hopes and fears about the severity and length of this energy shock. Stocks, bonds, and non-dollar currencies have all exhibited a tight negative correlation to oil contracts. In other words, markets have been bouncing around based on little more than war communications from all belligerent parties.

Overall, one month into the war, oil was 55% more expensive, global stocks down 8% and gold down 15%; markets moved from expecting cuts from major central banks to expecting multiple hikes, and global yields were several decimal points higher, reaching levels not seen since the late 2000s in some cases (*see table and chart for more details*)<sup>1</sup>. None of this is crazy *per se*. But look deeper, and some inconsistencies and other oddities appear.

### NO SAFE HAVENS

Stocks and bonds have sold off jointly. So has gold. While the latter is highly unusual, the former is, in fact, quite common in response to an inflationary shock, but these shocks were so rare from the 1980s to the 2020 pandemic that we had collectively forgotten about them. Indeed, a joint bonds-stocks selloff is exactly what happened in 2022. As inflation risks rise, central banks are expected to tighten monetary policy by increasing policy rates. This then pushes up short-term interest rates and depresses growth expectations. Ordinarily, capital would then flow to the relative safety of long-term government bonds (leading to a flattening and even often an inversion of the yield curve), and perennial stores of value like gold. Of course, this may yet happen, as markets move to worry more about growth.

But, this time, the flattening has been relatively muted, *i.e.*, long term rates have not been bought as much as they typically would. There could be two reasons for this, not mutually exclusive: an inflation risk premium, and real rates. But market-based expectations of inflation in 10 years have not moved up meaningfully (unlike shorter term ones). That leaves real rates. Why would real rates have gone up since the start of the war? The most likely explanation is that markets expect higher government deficits. This makes sense considering the large deficits incurred by most advanced countries' governments in 2022-23 to help cushion the shock from higher energy costs (between over 3% and over 5% of GDP in Europe's largest economies).

<sup>1</sup> Numbers refer to the prices of Oil Brent spot contracts and the All Countries World Index (ACWI) from market close on 27/2/2026 to 27/3/2026.

### Market expectations for policy rates across major central banks: Number of hikes or cuts by year-end 2026

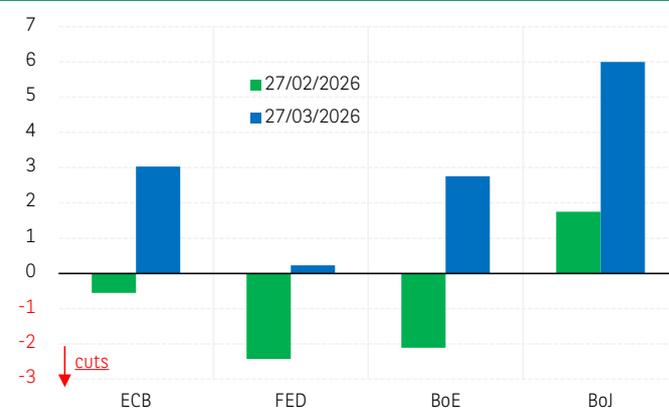


CHART 1

SOURCE: BLOOMBERG, BNP PARIBAS

### Markets overview Feb 27 – March 27

	in % change				
	27/03/2026	1-Week	Since Feb 27	Year to date	1-Year
S&P500	6368.9	-2.1	-7.4	-7.0	+11.9
Nasdaq Composite	20948.4	-3.2	-7.6	-9.9	+17.7
Euro STOXX 50	5505.80	+0.1	-10.3	-4.9	+2.3
CAC40	7701.95	+0.5	-10.2	-5.5	-3.6
Bloomberg World Index	2239.14	-1.5	-8.5	-5.0	+14.2
Nikkei 225	53373.07	+0.0	-9.3	+6.0	+41.2
Hang Seng Index	24951.88	-1.3	-6.3	-2.6	+5.8

	in bps				
	27/03/2026	1-Week	Since Feb 27	Year to date	1-Year
OAT 10Y (%)	3.83	+7.9	+61.6	+27.0	+36.6
Bund 10Y (%)	3.09	+5.1	+45.1	+23.9	+32.1
US Tr. 10Y (%)	4.43	+4.8	+49.0	+26.1	+6.8
JGB 10Y (%)	2.39	+11.1	+26.8	+32.2	+79.9
Gitl 10Y (%)	4.97	-2.0	+74.1	+49.5	+19.1

	in % change				
	27/03/2026	1-Week	Since Feb 27	Year to date	1-Year
EURUSD	1.15	-0.5	-2.6	-2.0	+6.6
DXY Index	100.15	+0.5	+2.6	+1.9	-4.0
Brent (\$/bbl)	112.57	+0.3	+55.3	+85.0	+52.1
Dutch TTF Price (€/MWh)	54.18	-8.6	+71.4	+83.8	+31.8

TABLE

SOURCE: BLOOMBERG, BNP PARIBAS



However, precisely because of the legacy of these large deficits, there is much less room for maneuvering this time. That is why most governments' responses to date have been far more targeted, time-limited and restrained. If it stays that way, markets may therefore revise term premium down; but ongoing concerns about large fiscal deficits could keep it high or even push it higher in individual countries. The under-performance of US Treasuries, UK Gilts and Italian BTPs are noteworthy in this respect. So are the unusually poor trading conditions in US Treasuries in the last week of March, with three bond auctions (2Y, 5Y and 7Y) showing unusually low demand.

For now, the rise in long-term real rates could help explain the counter-performance of gold. Another likely explanation is gold's parabolic performance in the run-up to the war, which made it a preferred asset to sell for any holder (including central banks) confronted with liquidity needs.

### LIMITED DOLLAR APPRECIATION

The dollar index is up 2.65% over the month. This is directionally what would be expected in the face of an energy price shock, which is a positive terms-of-trade shock for the US (and other energy exporters), and a negative one for all other countries. Moreover, the dollar has historically been a safe haven, rallying in times of heightened risk and risk aversion. But last year already provided a number of opportunities to see this pattern much weakened. The market moves of the past month have shown likewise, with currency moves in both developed and emerging markets being only about 2/3 of what previous patterns would predict. Nevertheless, should energy prices continue to escalate, we would expect the dollar to strengthen further, possibly with non-linearities along the way. In some countries, central banks may then be compelled to step in to alleviate selling pressure on their currencies that would intensify inflation and financial stability risks.

### MUTED DE-RISKING

In recent days, stock markets have started registering somewhat more meaningful losses; however, this is largely linked to issues unrelated to the war impacting tech stocks, which had until now acted as safe haven. Despite US and, to a lesser extent global stocks, being richly priced before the war, only one major index (the NASDAQ) has corrected by more than 10% from peak to trough. Corrections of around 8% in a single month have happened roughly every 2.5 years on average since 2000. The VIX, the so-called "fear index" of expected S&P500 stocks volatility has been hovering between 25 and 30 (versus a long-term average around 20, and spikes above 50 last April in the wake of "Liberation Day"). Earnings expectations have not been downgraded meaningfully. And many stock analysts are holding on to their pre-war year-end targets for US indices. Surveys of global investors indicate they have not derisked their portfolios very much, with cash holdings remaining far below what we saw after last year's "Liberation Day" shock, let alone after the full-blown Russian invasion of Ukraine in 2022. This suggests global investors are not expecting the war and associated energy shock to cause meaningful damage to growth. The OECD and central banks that have published revised forecasts in recent weeks would seem to agree<sup>2</sup>. However, these forecasts were based on scenarios for the size and duration of the energy shock that are already out of reach given developments in energy markets and on the ground since then (see graph below).

Are these developments cause for concern? To a degree, yes. The absence of reliable hedges makes portfolio construction trickier by making it much harder to hedge risk. They also mean that this shock, if it persists or worsens, will inflict larger overall negative wealth effects (capital losses) than more traditional "risk-off" events. In countries like the US, where financial wealth effects contribute significantly to household consumption, it creates an additional downside risk to

<sup>2</sup> See March 2026 macroeconomic projections from the Fed, ECB, Banque de France and OECD. Our own work that milder scenarios for the evolution of the war deliver relatively limited growth impacts and transitory inflation increases. However, the now more likely adverse scenarios have more severe macroeconomic implications.

### TTF Gas Futures Prices, EUR/MWh

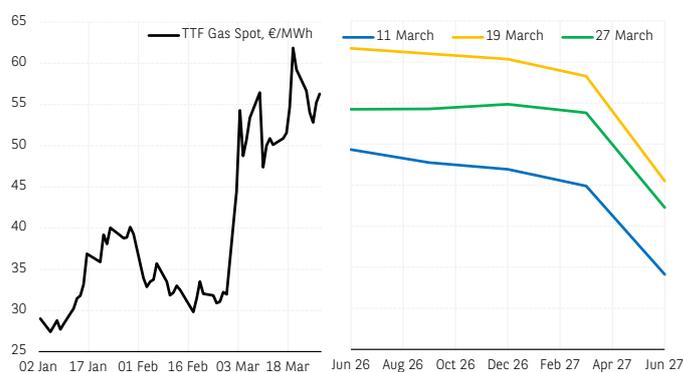


CHART 2

SOURCE: BLOOMBERG, BNP PARIBAS

### Brent Crude Oil Futures Prices, USD/bbl

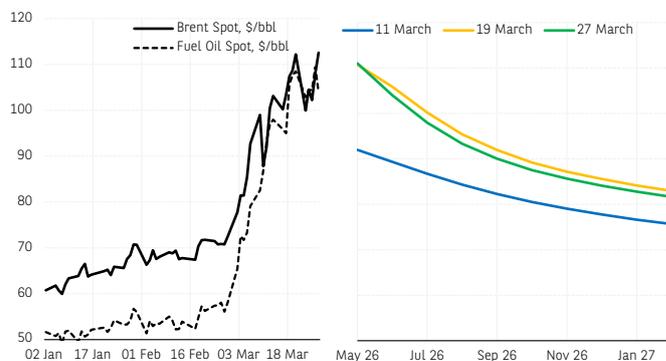


CHART 3

SOURCE: BLOOMBERG, BNP PARIBAS

growth. In Europe, for better or worse, this effect is insignificant in most countries, however.

The muted de-risking is also consequential, but not all negatively. As long as the possibility of scenarios that inflict only manageable growth costs persists, it is much preferable that financial markets do not amplify the headwinds from higher energy prices and more hawkish central banks. This would happen if we saw a spike in risk aversion that makes it prohibitive for corporates or sovereigns to access financing (or refinancing), and that pummels portfolios, potentially leading to systemic financial stability problems. Likewise, contracts for future oil prices have been assuming a relatively short-lived energy shock, and even spot prices have remained much below prices for physical delivery at key oil trading ports (see charts above). Given the overwhelming impact these prices have had on all other financial markets since the start of the war, this moderation is a good thing, a shock absorber of sorts.

Nevertheless, at some point, the future economic realities priced by markets and those delivered by facts on the ground will need to converge. At that point, we will either breathe a collective sigh of relief or have a rude awakening.

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