# Risk of energy price shock

Just under a week after the start of the Iran war, there is no end in sight. Due in part to the military superiority of the US and Israel, a relatively short war remains our baseline scenario. However, there is a significant risk that the conflict will continue for longer. We analyze the consequences of such an alternative scenario for the global economy and financial markets.

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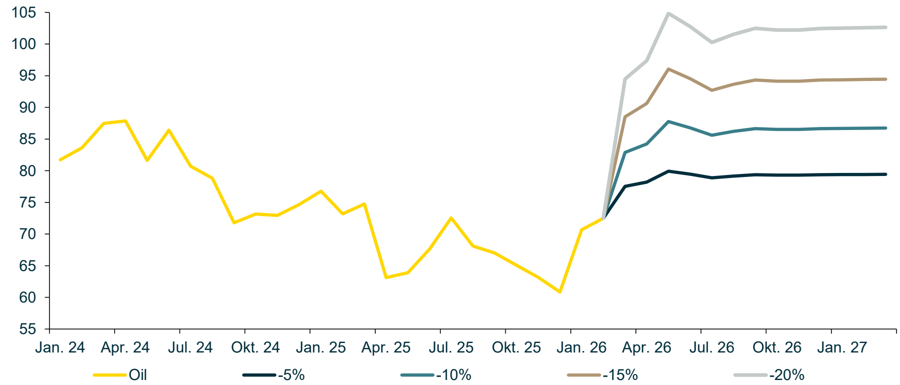
## If the war drags on, ...

How much will the war in Iran weigh on the global economy and financial markets? Obviously, this depends largely on how long the war lasts and how severely it disrupts oil and gas supplies. In our baseline scenario, we continue to assume that the war and the resulting disruption to shipping in the Strait of Hormuz will end in a few weeks. However, given the US and Israeli governments' repeated statements about their goal of “regime change,” there is a risk that the attacks by the US and Israel will drag on for several months, thereby disrupting oil and gas transportation for a longer period of time. In an extreme case, this could prevent one-fifth of global production of both oil and liquefied natural gas from reaching the world market.[1]

## ... the price of oil could rise to $100

Even in the event of a prolonged conflict, there would probably be no shortage of oil and gas (see box), but the reduced supply would certainly cause the price of oil to rise. According to a VAR model we have estimated, a 20% reduction in supply – with all other conditions remaining unchanged – would cause the price of oil to rise to USD 100 (Chart 1). The price of LNG could also rise further in such a scenario.

Chart 1 - 20% reduction in supply causes oil price to rise to $100
Historical oil prices and possible price paths for various supply disruption scenarios (5%, 10%, 15%, 20%), based on a VAR model, in USD per barrel



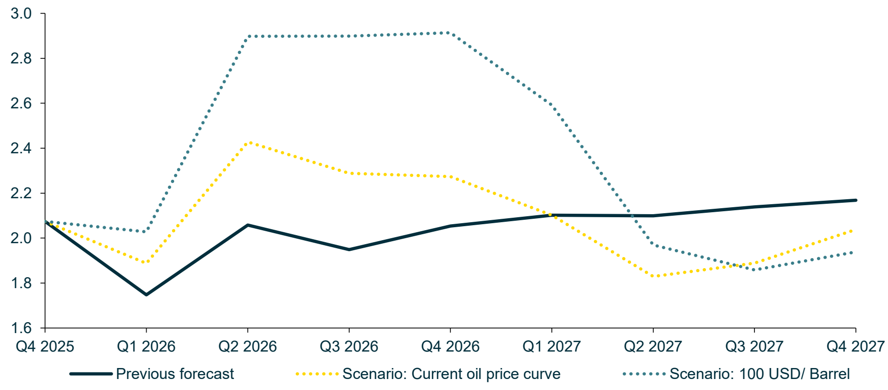

Source: Bloomberg, Commerzbank Research

## Eurozone: Inflation at 3%, economy even weaker

Such a sharp rise in energy prices would drive inflation up significantly. The higher oil price would very quickly be reflected in gasoline and heating oil prices, pushing the inflation rate up towards 3 percent (Chart 2). Added to this would be the effect of higher natural gas prices, which would, however, appear in the statistics with a certain delay, as gas and electricity suppliers would first have to adjust their tariffs. Overall, the inflation rate would probably exceed 3% for much of this year. In the longer term, the higher oil price would also be reflected in higher core inflation, as companies would pass on their higher energy costs to their customers.

Chart 2 - The oil price jump increases inflation

Headline inflation in the euro area in %; Current oil price curve calculated from futures contracts




Source: Bloomberg, Commerzbank-Research

The burden on businesses and private households caused by higher energy prices would also slow growth in the euro area. According to our model estimates, if oil prices remain high at $100, economic growth in the eurozone would be around 0.4 percentage points weaker than in our baseline scenario of a short war. This would roughly halve the growth rate we expect for 2026 (0.9%), meaning that there would be little sign of a recovery.

## The ECB would probably hold steady

This would put the ECB in an uncomfortable position. After all, the weaker economy would argue in favor of lower interest rates, while an inflation rate of more than 3% would be an argument for higher interest rates. The markets seem to assume that the ECB would consider the inflation risks to be more significant, with recent statements by ECB Chief Economist Philipp Lane possibly playing a role in the desire to “take no risks with regard to inflation.” The financial markets now expect the ECB to raise interest rates in the coming months with a probability of around 20%, whereas at the end of last week they had even considered an interest rate cut possible.

However, we assume that the ECB would leave key interest rates at 2% even in our risk scenario. This is because central bankers would probably argue that the ECB is committed to its medium-term inflation target of 2%, which would not be jeopardized by a temporary rise in inflation driven largely by energy prices. In addition, the ECB's tolerance threshold appears to be quite high. During the last episode of high inflation, it took inflation of over 8% for the ECB to respond with an initial interest rate hike, and even in our risk scenario, the inflation rate would not rise anywhere near that level. In addition, an economy weakened by the energy price shock would argue for lower inflationary pressure in the medium term.

## US economy in a more comfortable position

The outlook for the US economy would be significantly better in our risk scenario. Although higher oil prices are likely to push inflation up at a similar rate to the eurozone, the effect of natural gas prices is likely to be significantly lower. Gas prices in the US have risen much less sharply than in Europe in recent days.

The impact on gross domestic product is also likely to be very limited. After all, the US has been a net exporter of energy for several years. Higher oil prices may initially weigh on the economy because the negative effects (higher prices at the pump reduce consumers' purchasing power) occur more quickly than the positive effects (such as higher investment and dividends in the oil industry). In the medium term, however, the effect on economic growth is likely to be minor.

## Fed interest rate cuts in the second half of the year questionable

At the US Federal Reserve, the discussion has so far revolved around when and to what extent interest rates will be lowered further. In our baseline scenario, we expect interest rates to be cut by a total of 100 basis points from June onwards after Kevin Warsh takes office as the new Fed chair, with 75 basis points of these cuts coming before the end of the year. If the inflation rate rises significantly due to more expensive energy, while growth remains solid and the unemployment rate relatively low, interest rate cuts would probably be questionable, at least to this extent. However, a complete change of course toward interest rate hikes is also unlikely. This is because the Trump administration would once again intensify its already considerable pressure on the Federal Reserve and possibly describe interest rate hikes as unpatriotic or even, against the backdrop of the war, as “high treason.”

## Higher bond yields, ...

Yields on government bonds have already risen since the start of the Iran war. Even falling stock prices have not driven investors into high-quality government bonds. Unlike in previous crises, investors clearly no longer view US Treasuries and German government bonds as safe havens. If the war drags on, yields will certainly rise further. Higher inflation, lower expectations of interest rate cuts and, possibly, costly fiscal measures to cushion the impact of an energy price shock would create a poor environment for bonds.

## … a stronger dollar …

The dollar has already gained ground over the past week. We see three arguments in favor of continued dollar strength in the event of a prolonged conflict:

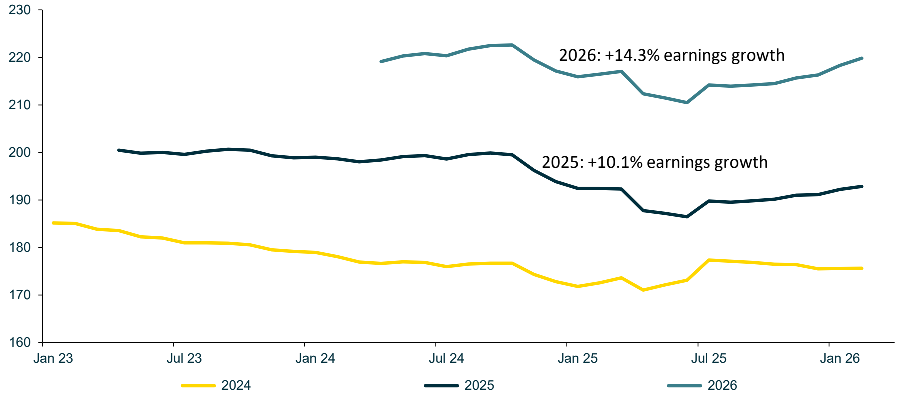
- In wartime situations, the US dollar generally benefits from its status as the world's reserve currency. This is because demand for the US currency rises in times of uncertainty in order to ensure solvency in the event of a worst-case scenario.
- An oil price shock is a burden for any economy. In general, however, it can be assumed that the US economy will prove more resilient to such a shock than the eurozone economy. This is because the US is a net exporter of oil and gas, while the eurozone is a net importer.
- Since the US exports more oil and gas than it imports, rising prices for these energy sources increase US net exports and thus demand for the dollar.

As a reminder, after Russia's invasion of Ukraine in February 2022, the price of oil rose from USD 100 per barrel to almost USD 140 and only began to fall sustainably again in the middle of the year. Meanwhile, the EUR-USD exchange rate fell from around 1.13 in February 2022 to as low as 0.95 in September of the same year.

## … and weaker stocks are likely

A prolonged war would make the environment for equities significantly less favorable. Analysts currently expect MSCI World companies to increase their 2026 earnings by an impressive 14% (Chart 3). We consider these assumptions to be somewhat too high anyway, and a long war would require an even greater adjustment downwards. A prolonged period of high oil and gas prices is likely to slow sales growth due to a weaker global economy, and high oil and gas prices would mean rising costs and falling profit margins for many companies. The stock market correction would then probably drag on for several months, and the MSCI World could lose 10% to 20% of its high in the meantime.

Chart 3 - War in Iran has become a key risk factor for optimistic 2026 earnings expectations
MSCI World: Trend of analysts' earnings expectations for the fiscal years 2024 to 2026 in index points




Source: LSEG Datastream market consensus, Commerzbank-Research

## Box: Are supply shortages looming?

Even if the conflict lasts for several months, there should be no shortage of energy. In particular, oil stocks have been replenished in recent months, creating a buffer. According to the International Energy Agency (IEA), global stocks have reached their highest level since spring 2021. In purely mathematical terms, this could cover a complete failure of supplies through the Strait of Hormuz for a year. In addition, Saudi Arabia and the United Arab Emirates could use spare pipeline capacity, which, according to the US Energy Information Administration, would extend the range of global oil reserves by another two months. Finally, if necessary, China and India could once again rely more heavily on oil supplies from Russia, which would ease the situation for other oil-consuming countries.

In the case of natural gas, the risk of a shortage would probably be greater if supplies from Qatar were to be interrupted for a longer period. After all, storage facilities in Europe are unusually empty. However, demand is set to decline significantly in the coming weeks as winter comes to an end, so supplies from North America and Norway should then be sufficient to meet demand.

> Apart from oil and gas, the disruption to the supply chains of European producers is likely to be limited. This is because most container ships trading goods between Europe and East Asia are still being routed around Africa via the Cape of Good Hope. This means that this important trade route remains largely unaffected by the war in Iran.
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> (back to the text)

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[1] The Strait of Hormuz is currently not being used by tankers, mainly because shipping companies are wary of the drastic increase in insurance premiums caused by the military conflict; there is currently no military blockade. In response, US President Trump has offered to provide escort protection for ships and to cover the higher insurance premiums. However, it is questionable whether this will persuade shipping companies to allow their tankers to sail through the strait again. (back to the text)

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