RATHBONES

Weekly Digest

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Flash to bang

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The longer the Strait of Hormuz stays closed, the greater the disruption to the global economy. Recognising this risk, we're continuing to build resilience into portfolios.

Quick take:

- Traders are building a bigger risk premium into oil prices.
- Damage to infrastructure could complicate restarts to production.
- In spite of this, global equity indices are close to their all-time highs.

The 'flash to bang' time is a handy method for assessing how far away a thunderstorm is. With sound travelling at roughly one mile every five seconds, just count the seconds to see how immediately you need to take shelter. More alarmingly, there's a misleadingly calm hiatus between the blinding flash of the detonation of a nuclear bomb and the arrival of its shockwave.

A swell of thunder from Hormuz?

If the first US-led strikes of the present Iran conflict at the end of February were the 'flash', where's the 'bang'? For most of us in the West, the only real signs of disruption are higher fuel prices and the odd cancelled long-haul flight. But the longer the Strait of Hormuz remains shut and the world is deprived of important supplies of oil, gas, and related products, the more we'll notice. German airline Lufthansa might represent the thin end of the wedge: it cut 20,000 scheduled flights last week. While this represents just 1% of its total capacity, it's part of a trend that has seen around a 3% global reduction in flights so far. Many of those began in, or transited through, hubs in the Middle East. There are other signs of behavioural change. Barclays reports that US gasoline consumption is down around 5% from a year ago.

More encouragingly, and unlike a nuclear explosion, much of this destructive force can be put back in the bottle if the Strait is reopened. So we return to the thorny issue of diplomatic negotiations. The mood has shifted both ways in the last few days, with the current one being a little more constructive. Fittingly, much seems to hang on whether the sides come to some

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agreement over Iran's nuclear ambitions. The good news is that talks are still taking place.

Even so, traders are building a bigger risk premium into the oil price, with Brent crude back over $100 per barrel. We should also note the difference between futures prices and those for immediate physical delivery – commonly called the 'spot price'. There was virtually no difference before March between the spot price and front-month futures contract for Brent – the price for delivery (or, more often, just financial settlement) a month ahead. However, a premium for immediately available supplies has been evident since the war broke out – particularly in early April, when shortages pushed the spot price above even the peak after Russia's full-scale invasion of Ukraine. An even bigger premium than the current one would suggest tightening supply conditions.

We must also consider the fact that the longer the Hormuz closure runs, the longer it might take to restore deliveries to previous levels. Apart from the existing damage to Gulf infrastructure, once storage facilities are full the only viable option is to shutter production.

Unfortunately, restarting it involves more than just turning the taps back on. There's a risk that, for example, water will have built up in the well, and you might also lose the natural pressure that previously brought the oil to the surface. Older wells can suffer degradation due to a loss of pressure. The oil itself can solidify in the pipes and need to be cleaned out. There's also the not insignificant matter of removing any cap that might have been applied. It could be that for every extra day the Strait is closed it might take two or more days to restore production.

Markets continue to take the pragmatic, logic-driven view that there will be an imminent return to something that looks more normal. Hence the big increases in share price indices we've seen on days when the riskier outcomes seem to be ruled out. But we have to acknowledge that these riskier outcomes may yet occur, so we continue to build resilience into portfolios. One recent example includes recommending US equities over European (since the US market seems to be less affected). Another increasing exposure to index-linked gilts over conventional ones to provide greater inflation protection.

A bolt from the Bank

Another big flash emanated from the Bank of England via the BBC last week. Sarah Breeden, one of three Deputy Governors on the rate-setting Monetary Policy

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Committee, was quoted as saying, “stock markets are too high and set to fall.” This isn’t the sort of thing one expects from Bank officials who are usually more intent on calming nerves, not shredding them. The content of the article was somewhat less alarming, which makes one wonder how much ‘clickbait’ was added to the hook before publication.

I decided to investigate further. Nowhere did the story refer to the source material for the comments, which was a speech Ms Breeden had made at a conference a few days earlier, which was published by the Bank. It’s a very sensible one, fully in tune with her title of Deputy Governor for Financial Stability. In it she looks at past examples where a combination of speculative, misguided and inappropriate behaviour led to market dislocation. She goes on to focus on the main risks that she’s monitoring today. All of these have been firmly on our radar and are key topics for discussion in our sector and asset allocation meetings. They’re private markets, leverage in government bond markets, and elevated asset valuations in selected equity markets.

It’s not so much that she thinks any of these factors in isolation will cause a crisis, more that there could be cross-asset contagion and liquidity problems – with problems in one market potentially causing problems in another. I think we’d justifiably be more shocked if she *wasn’t* on the lookout for such risks and stress-testing the system against them. This is where I thought her comments were relatively constructive. She alluded to the much more strongly regulated and capitalised banking system than before the Global Financial Crisis. She also mentioned stronger private sector balance sheets and more tools at the Bank’s disposal to provide support if required.

Furthermore, Breeden made it abundantly clear that she’s “not predicting the next crisis”. She refers more to the potential “fragility” of markets, especially if there are numerous overlapping faults. I have previously referred to such situations as the “dry tinder” for a conflagration. But it does require a match to light it. That could be a policy error (often, ironically, by a central bank). It could an external event (which the war in Iran would qualify as – one reason why we’re monitoring developments very closely).

How long till the ‘bang’?

Turning back to the BBC article, Breeden says: “I'm not saying it will happen today, tomorrow, in 12 months' time.” That’s pretty indeterminate. Unfortunately for investors, market timing doesn’t follow the laws of physics. There have been innumerable

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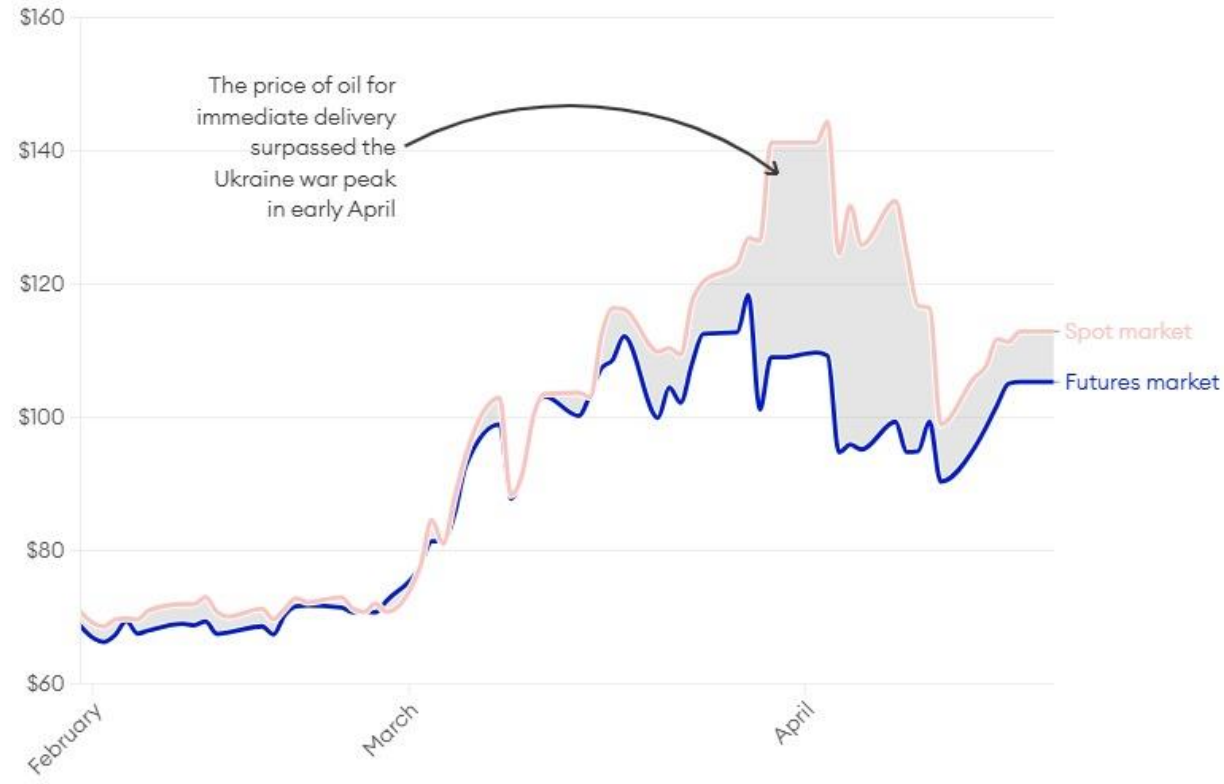
opportunities to panic and cash in investments in recent years, and yet here we sit with global equity indices within a hair's breadth of their all-time high. That's not to say we won't take more evasive action if we see fit. But for now, we continue to remain fully invested, while covering risks with appropriate hedges where we are able. We've seen the flash and are protecting our portfolios, as best we can, from the potential 'bang'.

Mind the gap



Source: FactSet, Rathbones. Price of Brent crude.

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Regional highlights

UK. Headline UK CPI inflation reaccelerated in line with our expectations on the back of the Iran war, from 3.0% in February to 3.3% in March. The increase was, unsurprisingly, an energy price story. The price of energy switched from deflation (-1.0%) to inflation (+4.9%), almost entirely due to higher prices at the pump. We think headline inflation will probably have eased back to around 3% again in April as hikes from this time last year in other 'regulated' prices, such as water bills, road tax, and rail fares drop out of the year-on-year calculation. But it's worth recalling that before the conflict erupted, many were expecting inflation to be much closer to the 2% target in April. The outlook has changed materially. Government borrowing in the financial year ending March 2026 was £132.0bn (4.3% of GDP), vs the OBR's forecast of £132.7bn. The undershoot was the result of hefty downward revisions to the past data. Retail sales growth for March of 0.7% month-on-month delivered a hat-trick of positive news and was topped off by resilient purchasing manager survey results. But this might be as good as it gets for now with the full impact of the war in Iran yet to hit and the Bank of England currently seen as more inclined to raise than to cut interest rates, even with consumer confidence at its lowest since October 2023.

US. Economic data continue to defy concerns of a slowdown. Retail sales rose by 0.7% in March, well above expectations. Headline retail sales rose 1.7%, also above expectations and reflecting higher gasoline spending as a result of higher oil prices. Core retail sales growth was broad-based, with the largest increases at furniture stores (+2.2%), general merchandise stores (+1.0%), and non-store retailers (+1.0%). Higher petrol spending may have boosted general merchandise store sales because some of those stores sell petrol too. The S&P Global US services PMI increased in April to 51.3 (vs 49.8) but its underlying composition was mixed. The new business component declined but the employment component increased. The input prices and output prices components both increased – the latter reaching its highest level since July 2022. The S&P Global US manufacturing PMI also increased, slightly above consensus expectations, to 54.0 from 52.3. Its underlying composition was mixed-to-strong, with increases in the output and new orders components but a small

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decline in the employment component. The input prices and output prices components increased to their highest level since June 2025, reflecting new inflationary pressures linked to the war.

Europe. Not so rosy on the Continent. The Manufacturing PMI came in slightly better at 52.2 (vs 51.6) but services declined to 47.4 (vs 50.2), leaving the composite measure back in contraction territory at 48.6 (vs 50.7). The ZEW survey of sentiment regarding future economic growth fell from -8.5 to -20.4, the lowest reading since December 2022. In Germany, the ZEW survey of future expectations fell from -0.5 to -17.2, again the worst since 2022.

China. Profits at China's industrial firms grew at their quickest pace in half a year last month, adding to broader signs of an uneven economic recovery in the first quarter as we saw with the GDP data (+5%). Profits have grown by 15.8% over the past year.

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