



EDMOND DE ROTHSCHILD ASSET MANAGEMENT

MARKET FLASH: ARE WE MOVING TOWARDS A REGIONAL WAR OF ATTRITION?

- **Tehran is maintaining a firm stance and seeking to rapidly increase the economic and geopolitical costs for its adversaries, targeting energy infrastructure and maritime routes as a priority.**
- **If the crisis persists, a sustained rise in energy prices could simultaneously weigh on household purchasing power, business costs, and margins.**
- **For now, the stock market reaction remains limited, but the rise in implied volatility (particularly for oil), the upturn in inflation expectations, and the persistence of a high geopolitical risk premium reflect growing concern.**

With Operation Epic Fury, a joint US-Israel attack on Iran, now in its 7th day, the likelihood of a brief, targeted and controlled intervention is fading. This was meant to be a surgical strike. It is now beginning to look like a protracted operation that could turn into a regional war of attrition, thereby reinforcing our fifty percent probability of a war that could drag on and culminate in Donald Trump finding an agreement with Ali Khomeini's successor. The US president could then boast about eliminating the former supreme leader and destroying Iran's military capabilities. If so, we could see a revival of risk appetite with oil prices falling back.

Nevertheless, the initial air strikes inflicted serious damage on the Iranian regime. Several top people were killed and part of the country's military installations were seriously damaged. And yet, technological superiority and devastating firepower alone will not neutralise a regime which is fully trained in asymmetrical confrontation. The Gulf's oil and gas infrastructure has already been targeted. The Strait of Hormuz, a strategic passage for global oil supplies, is still threatened with attack and is effectively closed due to the risk of missile strikes. Regional shipping lanes could be disrupted again.

This incident is a useful reminder that today's conflicts are not just settled in the early hours of a military operation. Success depends on the ability of warring sides to maintain pressure, absorb shocks and keep the initiative over the long term.

Tehran's official pose is to stand firm. The regime appears to be keen to jack up the economic and geopolitical costs for its enemies. This is why energy infrastructure and maritime routes have been targeted. The goal is clearly to transform a military confrontation into a systemic crisis for the region and all major oil-importing countries.

The regime has been weakened inside Iran but without signs of an imminent collapse. History tells us that authoritarian governments can cling to power despite intense foreign pressure as long as its security forces and the economic elite remain loyal. Political fragility does not automatically lead to an orderly or rapid transition as suggested in our Risk of Chaos adverse scenario (20% probability). This would translate into mounting tension

between political and ethnic factions and the risk of a Libyan scenario, i.e. lasting disruption to oil and gas flows and concerns over spiralling inflation.

In short, the chance of a prolonged war, with limited escalations followed by periods of latent tension, is gaining ground. This scenario is increasingly seen by a growing number of observers not as an extreme possibility but as the most probable outcome. The rapid regime change scenario would of course be very positive for risk assets but we now rate its probability at only 30%.

Financial markets initially viewed Operation Epic Fury as a temporary shock. Their first reactions suggested they thought disruption would be short-lived and that energy flows would quickly resume. The problem with this view is that the energy situation is changing. Oil prices have factored in a hefty geopolitical risk premium and prices of refined products like diesel fuel, heating oil and distillates are also rising as inventories are much lower than for crude oil. As a result, inflationary pressure has increased.

If the crisis lasts, several macroeconomic developments could be triggered simultaneously. Prolonged energy price rises will drive up costs for householders and hit company margins. Disruption to maritime transport is increasing freight costs and the system has already been hit by successive supply chain tensions. Mounting geopolitical uncertainty weighs on investment decisions, savings flows and confidence levels among economic actors.

It is estimated that a \$15 rise in oil prices could increase inflation by 1% in developed economies while shaving 0.3 to 0.4 points off global GDP growth. Today's shock thus looks like a negative supply shock, combining inflationary pressure with an economic slowdown.

For investors, this is a worst case scenario as it rekindles stagflation fears: rising prices are coupled with slowing growth so monetary authorities and governments have less leeway.

So far, market reactions have been subdued. Long US Treasury yields have only edged higher and tension has been more marked in the eurozone. The US dollar's appreciation is another token of its safe haven status but behind its limited rise deeper causes for concern are beginning to appear. Implicit volatility is up, especially for oil and inflation expectations have risen slightly. The geopolitical risk premium is still high, particularly for oil and shipping assets and for some emerging countries.

Apparently, investors have gradually adjusted their core scenario and are now factoring in the increased likelihood of a short term surge in inflation. The shift could continue for as long as US monetary policy remains unclear.

Asset allocations reflect a wait-and-see stance. Until the situation becomes clearer, we believe tactical caution is advisable. There is still a real risk of energy prices rising further, either because of damaged infrastructure or production stoppages because exporting is impossible with the Strait of Hormuz closed. Nevertheless, once geopolitical risk eases, we will increase our risk asset overweight and especially for equity indices. First, global economic momentum is robust so upside should broaden out. Second, fiscal stimulus is on the agenda. Third, there should be less AI risk outside the US. In fixed income, we are taking profits on our government bond overweight until there is improved visibility on commodity markets.

EUROPEAN EQUITIES

Markets focused on the rapid escalation in the Middle Eastern conflict. Energy prices soared, especially after the Strait of Hormuz was blocked. Meanwhile, inflation in the eurozone rebounded to 1.9% in February. A potentially protracted rise in energy prices and a rebound in inflation naturally rekindled fears of stagflation in Europe. The market is now expecting the ECB to raise rates before the end of this year. The AI theme was pushed into second place this week but it remained a market driver. Fresh worries appeared over circular financing with news that OpenAI was planning another fund raising. But there were also positive signals after Broadcom's strong results lifted European players like **STMicroelectronics**.

Companies exposed to the Middle East and higher energy prices were naturally under fire over the week. **Wizz Air** cut guidance due to cancelled flights, operating disruption and higher fuel costs. **Adidas** also fell due to what was considered cautious guidance and the group's significant exposure to the troubled Middle East. Investors unsurprisingly bought into defence stocks like **BAE Systems**, **Leonardo** and **Dassault Aviation** although profit taking occurred at the end of the week. Thanks to mounting geopolitical tension in recent months, **Dassault Aviation** reported a results beat and said prospects were robust. **Thales** also surprised on the upside with cash flow 30% higher than expected. However, the group remained cautious on the outlook. Thanks to growth in Germany and a string of acquisitions, results at **Spie**, European leader in multi-technical services, showcased record profitability and strong cash flow. Results at **ASML** were also upbeat with better-than-expected gross margins and convincing guidance for 2026. **Prada's** results were in line but consolidating **Versace** is expected to drag on results this year.

US EQUITIES

This week, the S&P 500 shed 0.70% and the Russell 2000 1.78%. But the Nasdaq Composite managed to gain 0.36%, as large cap growth stocks outperformed small caps and highly speculative sectors.

Implicit volatility stayed high. The VIX hit 28 at the beginning of the week before falling back. Government bond yields rose across the board with 10-year Treasuries at 4.10%. Markets are now starting to factor in a scenario of more protracted inflationary pressure. The US dollar appreciated further. WTI jumped from \$71 to 80 in only a few days, its biggest move since 2020 and its first close above \$80 since mid-2024.

AI and technological regulation remained centre stage. **Nvidia** announced massive investments in photonics but there were concerns fresh restrictions on US AI chip exports could be introduced. The Pentagon officially rated **Anthropic** as a supply chain risk. **OpenAI** launched new models and its search for advertising partnerships, notably with **Trade Desk**, lifted optimism on monetisation potential but also fears of an AI capex squeeze for some companies. **Oracle** was among tech companies to lay off staff. Inratech dispersion was also high. Software and cybersecurity plays rebounded sharply as the Long Semis/Short software trade began to unwind.

Sector shifts naturally reflected energy shock concerns and increasing nervousness. Energy (+0.84) led gains as WTI soared to above \$80 and visibility on oil majors improved. Consumer discretionary managed to gain 0.52% thanks to some retail and e-commerce stocks performing well mid-week. Financials dipped 0.40% but did better than the market. High interest rates continued to underpin banks and some credit companies.

In contrast, some traditionally defensive sectors tanked. Consumer staples led falls with a 5.18% plunge on some disappointing figures and switches into energy stocks. Healthcare lost 1.98% and utilities 1.77% as interest rates rose and investors took profits. Cyclical and segments exposed to the global cycle also came under pressure. Materials tumbled 5.36%, industry was off 2.87% and listed property ended 1.24% down, a reflection of growth concerns from any prolonged oil shock. Communication fell 1.02%, despite resilience from some internet and media majors.

EMERGING MARKETS

The MSCI EM index was down 6.64% in USD as of Thursday's close. Korea, Mexico, Taiwan and Brazil, China and India lost 13.53%, 6.89%, 6.21%, 6.06%, 4.91% and 2.65%, respectively.

In **China**, NBS Manufacturing PMI fell to 49.0 in February from 49.3, missing the consensus estimate of 49.1, due to the extended Lunar New Year holiday (the longest on record at nine days). Non-Manufacturing PMI edged down to 49.5, or slightly below the 49.7 estimated. In contrast, the private-sector Caixin (RatingDog) Manufacturing PMI surged to 52.1, the highest reading since December 2020, driven by the sharpest rise in new export orders since September 2020.

In **Taiwan**, manufacturing PMI rose sharply to 55.2 in February from 51.7 in January, the highest reading since December 2020. Output and new orders grew at their fastest pace in over four-and-a-half years. **Hon Hai Precision's** revenue rose 21.6% YoY in the first two months of 2026 to a record NT\$1.33 trillion.

In **India**, manufacturing PMI in February was 56.9 vs 57.5 in January, driven by the fastest factory output expansion in four months and solid domestic demand. Services PMI was 58.1 vs. the previous reading of 58.7, taking the Composite PMI to 58.9. The US issued a temporary 30-day license allowing Indian refiners to purchase Russian oil loaded onto vessels before March 5.

In **Mexico**, President Sheinbaum called for a return to multilateral diplomacy and condemned invasions as the US-Iran conflict escalated. The government suspended import permits for 350 steel companies after detecting alleged irregular activities

In **Brazil**, fourth-quarter GDP rose 0.1% quarter-on-quarter, meeting estimates, with full-year 2025 growth at 1.8%. The Senate approved the Mercosur-EU trade agreement, concluding the ratification phase in Congress. **Petrobras** surpassed profit expectations after robust oil production and record exports helped cushion weaker crude prices

CORPORATE DEBT

Yields on Germany's 10-year Bund surged from around 2.65% last week to above 2.87%. The rise was due to fresh fears over inflation from Middle Eastern turmoil and the direct impact on Brent crude and gas prices. Despite disappointing retail sales, markets are applying a higher inflation risk premium as the situation lowers hopes for an ECB rate cut over the short term. Markets are, in fact, now factoring in a rate hike this year! The rebound in the risk-free rate hit total returns this week even if spreads were resilient. Naturally, government bonds and long investment grade, the most rate-sensitive segments, fell the most. With the Eurostoxx index down 6%, government bonds lost 1.5%, IG 0.8% and HY 0.5%.

But IG only widened by 3bp and HY by 8bp, a remarkably resilient performance. Investors hedged positions with derivatives like the Main (+5bp) and the Xover (+20bp) but refrained from selling elsewhere. Investors generally have large cash balances and defensive positions which is why cash segments outperformed derivatives over the week.

At the same time, markets became more selective over cyclicals. Energy-intensive sectors like chemicals saw profit taking. However, inflows stayed positive thanks as IG all-in yields moved back to close to 4%.

The overall sentiment remained cautious but still positive. Carry is still the main performance driver but sovereign debt repricing could be triggered by energy shocks. In the near term, the focus will be on upcoming eurozone CPI and the market's ability to absorb new issues without any significant spread widening.

GLOSSARY

- Investment Grade: bonds rated as high quality by rating agencies.
- High Yield: corporate bonds with a higher default risk than investment grade bonds but which pay out higher coupons.
- Senior debt benefits from specific guarantees. Its repayment takes priority over other debts, known as subordinated debt.
- Debt is considered to be subordinated when its redemption depends on the earlier payment of other creditors. To offset the higher risk, subordinated Senior debt has priority over other debt instruments.
- Tier 2 / Tier 3: subordinated debt segment.
- Duration: the average life of a bond discounted for all interest and capital flows.
- The spread is the difference between the actuarial rate of return on a bond and the rate of return on a risk-free loan with the same maturity.
- The so-called "Value" stocks are considered to be undervalued.
- EBITDA: Earnings before Interest, Taxes, Depreciation, and Amortization.
- CTA: quantitative strategy which uses futures to invest in a wide range of financial assets, including equity indices, short-term and long-term interest rates, currencies, and commodities.
- The PMI, for "Purchasing Manager's Index", is an indicator of the economic state of a sector.
- AT1s belong to a family of bank capital securities known as contingent convertibles or "Cocos". Convertible because they can be converted from bonds to shares (or depreciated entirely) and contingent because this conversion only occurs if certain conditions are met, such as the issuing bank's capital strength falling below a predetermined trigger level.
- RT1s: perpetual bond issues with early redemption possible after 10 years. Coupon payments are discretionary and non-cumulative.

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47, rue du Faubourg Saint-Honoré 75401 Paris Cedex 08
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AMF Registration number GP 04000015
332.652.536 R.C.S. Paris