Q&A with Investment Strategy
Israel-Iran Conflict Resurfaces

June 13, 2025
Larry Adam, *Chief Investment Officer*
Tracey Manzi, *Senior Investment Strategist*
Pavel Molchanov, *Investment Strategy Analyst*

WILL THE OIL PRICE SPIKE BE SUSTAINED? THE KEY ISSUE IS RISK TO SUPPLY

Israel launched airstrikes on Iranian targets last night, marking a significant military escalation between the region's two most powerful militaries. In response, oil prices surged to their highest levels since January, global equities declined, and the dollar strengthened as investors sought safe-haven assets. As with all geopolitical events, the situation remains fluid. Our core message to investors: stay focused on your long-term strategy, rather than reacting to headlines. History suggests that, like previous crises in April and October 2024, this will likely be short-lived—neither side appears to want full-scale war.

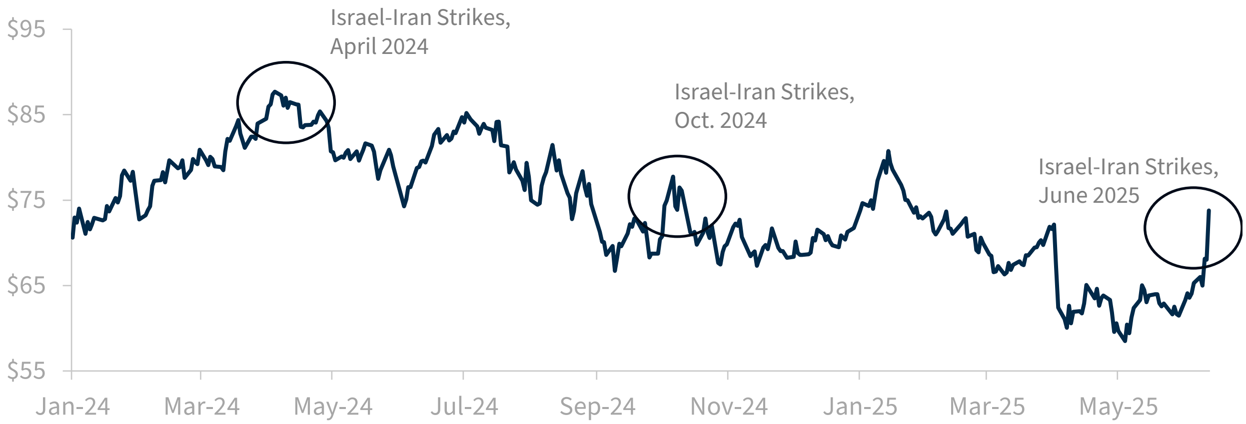
WHAT HAPPENED LAST NIGHT?

Israel's airstrikes targeted Iran's nuclear enrichment infrastructure, which has been at the center of international controversy for more than two decades. Also targeted were senior military officers. The two sides are offering different perspectives on how much damage was caused. Israel's intent appears to have been two-fold: 1) slowing Iran's progress toward developing a nuclear weapon; and 2) sending a signal that more attacks could come if Iran continues to reject a negotiated settlement. The strikes came less than a day after the UN nuclear agency declared Iran out of compliance with its obligations, and amid a lack of progress in US-Iran talks that have been trying to reach a deal. While the timing of the strikes was earlier than expected, there had been speculation for several days that Israel was looking at military options.

HOW DOES THIS AFFECT THE OIL MARKET?

As of this writing, oil prices are up 7% on Friday morning, the largest one-day gain since October 2024. That historical comparison is *not* a coincidence. It was in October 2024 when Israel and Iran exchanged missile strikes—a re-run of what happened in April 2024 as well. This latest crisis bears a close resemblance to the two episodes that occurred last year, though it is fair to say that the scope of Israel's current military action is broader than it was last year. Israeli Prime Minister Benjamin Netanyahu said attacks will continue "until the threat is removed."

Fighting in the Middle East has a long history of causing oil prices to spike—there is nothing new in that. The key question from the standpoint of the oil market is whether this round of fighting could cause an actual disruption to oil supply. To be clear, Israel has *not* targeted Iran's oil industry infrastructure, either now or at any point in the past. Unless the situation were to reach the level of all-out war, it is highly unlikely that Israel would try to attack oil facilities. Likewise, it would make no sense for Iran to stop exporting oil, the most important part of its economy. Our base case assumption is that the two sides will step away from the brink of all-out war—just as they did twice in 2024—leading oil prices to cool down in the near future.



Source: FactSet

Crude Oil Price ($/bbl)

Iran is a member of OPEC and a sizable oil producer, though it exports less than many people might think. Iran's current production is 3.3 million barrels/day. Of that, Iran's domestic demand is around 1.8 million barrels/day—keep in mind, Iran has a population of more than 80 million. This means Iran exports around 1.5 million barrels/day, or 1.5% of global supply, putting it at #10 among the world's oil exporters.

Whenever Iran is embroiled in a geopolitical crisis, there is often speculation that it might try to block the Strait of Hormuz, through which approximately 20% of the world's oil passes. Iran has never done that, and we highly doubt that it would try. First, it would mean shutting off Iran's own oil exports, thereby halting a vital source of foreign exchange earnings. Second, it would likely lead to military intervention by the US and perhaps other major powers.

Looking ahead, geopolitical risks may cause short-term spikes in oil prices, but long-term market trends will be driven by supply and demand dynamics. With OPEC already increasing supply and global demand remaining sluggish, we remain confident in our year-end oil target of $65 per barrel.

WHAT ARE OUR LATEST THOUGHTS ON EQUITIES AND BONDS?

This crisis offers another reminder for investors not to become complacent. Following the ~22% rally from the April lows, we have cautioned that the equity market is vulnerable to volatility, particularly with valuations in the 93rd percentile relative to historical levels. Geopolitical crises have routinely triggered short-term volatility in equities. However, they have *not* derailed the market's long-term upward trajectory, with the S&P 500 averaging ~8% gains in the 12 months following such events over the past 30 years.

In this case, with the S&P 500 deriving less than 0.1% of its revenues from both Israel and Iran, the military action itself poses no fundamental risk to corporate profitability. The more relevant question is whether there could be a sustained rise in oil prices, which could fuel inflation and reduce expectations for future Fed rate cuts. As noted earlier, we currently expect the spike in oil prices to be short-lived. That said, let's not lose sight of other risks facing equities—slowing economic activity, stalled trade negotiations, and growing inflationary and economic pressures from tariffs, which, putting everything together, keep us cautious on the equity market in the near term.

Bond markets have remained relatively stable despite initial volatility. After an initial flight-to-quality, the sharp drop in yields quickly reversed, leaving the 10-year Treasury yield just modestly higher at 4.39% from last night's close. While bonds had rallied following the cooler than expected inflation data (CPI and PPI) this week, the latest Middle East developments have heightened concerns about the inflationary impact of prolonged oil price increases. While unlikely to affect the Fed's decision next week, it adds to policymakers' worries about upside inflation risks, especially given that inflation expectations, already elevated due to tariffs, are highly sensitive to oil price fluctuations. As long as these tensions are short-lived, this should not impact our year-end 10-year Treasury yield forecast.

THE BOTTOM LINE

Israel's strikes on Iran have reignited tensions in the Middle East, driving up oil prices and putting short-term pressure on risk assets. However, history suggests this crisis will likely be brief, as both sides appear keen to avoid full-scale war. If that holds, oil prices should retreat quickly, minimizing the impact on the economy, the Fed's outlook, interest rates, and the equity market. For context, our year-end 2025 forecast of $65 per barrel for WTI reflects weak global demand growth and a near-record number of new oilfields coming online this year. Given the fluid nature of this situation, we will continue to provide updates as developments unfold.

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PRODUCER PRICE INDEX | The Producer Price Index (PPI) is a measure of wholesale inflation, while the Consumer Price Index measures the prices paid by consumers.

CONSUMER PRICE INDEX | The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER
880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // 800.248.8863