

Iran must respond to the events of January 3, and could potentially do so in a number of ways:

- Hard response: i.e., major attack on U.S. facilities, not necessarily/exclusively based in Iraq. Authorities have hinted at attacks at military establishments/personnel and not at civilian ones but collateral damage cannot be ruled out. Such action would bring about a severe counter-retaliation on the part of the US, potentially putting the stability of the current regime at risk.
- “Soft” response: i.e., attack on U.S. proxies (Saudi Arabia, blockade of the Strait of Hormuz), frequent minor/medium attacks on U.S. facilities in Iraq whilst plotting a larger attack. Cyberattacks would very likely be part of this strategy.
- Diplomatic/political action: ask/convince the Iraqi government to expel “Western” forces from Iraq; revamp the nuclear program.

Longer term, the question is if this regional crisis evolves into a global crisis. The longer the world expects/perceives that “something big” will happen, the longer the uncertainty potentially affecting the world economy negatively. Oil prices would likely spike up in case of an escalation but the oil market is now in an excess supply situation and the OPEC+ agreement limiting oil production could be revoked quickly, if needed.

Should the Iraqi government decide to expel the US troops, we believe Iraq will have lost an important military and diplomatic anchor and a counterbalance to the Iranian designs on the country. Such a decision would increase the risk of either renewed civil war or a splintering of the country as neither the Sunnis nor the Kurds would willingly accept Iraq being a satellite state of Iran. On top of that, the US admin may impose sanctions on Iraq, adding economic pain to an already tense social and political situation.

From an investment perspective, no doubt the events of late in the middle east and aftershocks or escalations that may occur can drive a risk off / flight to quality scenario of wider spreads, strong dollar, yen and swiss franc, as well as lower Treasury/bund/JGB yields. Long term, however, we would expect markets to continue to be driven by the overarching fundamental backdrop of muted economic expansion and central bank accommodation, which would be unlikely to change significantly as a result of what we’ve seen so far in terms of this situation and its larger consequences. Therefore, we will remain flexible in approach, and try to maintain a balance in the portfolios between our economically sensitive trades. As of now, that remains a portfolio strategy of long credit spread product based on our expectation for a prolonged economic expansion, and overall long duration based on expected profit from term premium, secular rate decline, and potential to gain in the event of economic slowdown, but again we will remain flexible, and this could change as the valuations and circumstances evolve.

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