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A fragile equilibrium

- Earnings positivity remains dominant in the tussle with inflation worries. However, oil markets warrant close monitoring given the ongoing risk they reach a tipping point where inventories can no longer cushion against supply disruptions.
- Overweight global equities but look to broaden exposure across sectors and regions.
- Favour Emerging Market (EM) bonds but limit long maturities. Long maturity bonds remain most at risk from any renewed inflation worries. Oil inventories help balance inflation worries

Corporate earnings and oil prices are two key themes dominating the narrative for financial markets. Year-to-date (YTD), positivity around the earnings growth outlook has dominated, helping drive global equities close to double-digit gains. However, renewed US threats of military action in the Middle East are starting to return the focus to oil prices and the resultant risks of inflation.

Some perspective on oil and its impact on macroeconomics may be helpful at this stage. The Strait of Hormuz closure and damage to energy facilities in the Middle East have thus far reduced global crude oil supply by approximately 20%. However, the impact on oil prices and market expectations of inflation has been more muted than feared at the start of the Middle East conflict. This is likely due to (i) oil prices holding at lower levels in inflation-adjusted terms relative to past oil price shocks, (ii) steadily improving energy efficiency in recent years and decades and (iii) tactical policymaker use of inventories to help bridge the supply gap since the start of the conflict.

Confidence can be drawn from these three factors that a much worse energy impact (i.e., one that results in a significant impact on inflation) can be avoided as long as the Hormuz strait closure is relatively limited in length – with the length defined by how long crude oil inventories can continue to offset lost output from the Middle East.

Gold remains in a long-term uptrend

In the very short term, gold has once again become sensitive to bond yields, falling when bond yields rise to reflect the opportunity cost of holding the non-yielding metal. In the long term, however, data shows EM central bank demand for gold remains intact, and history shows gold can perform well in stagflationary environments. Key to remain Overweight in gold.

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