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Beyond the Portfolio - Assessing the Market Impact of the Middle East Crisis Transcript

Mike Miranda:

Over the past several days, global markets have been reacting to a rapidly escalating conflict in the Middle East. Since late last week, the United States and its allies have launched coordinated military strikes against targets in Iran, and those actions have already triggered retaliatory missile and drone attacks across the region. The result is a sharp rise in geopolitical risk and renewed questions around energy markets, global stability, and the potential ripple effects for the global economy and financial markets.

Welcome to Beyond the Portfolio. I'm Mike Miranda, head of investments for BMO Private Wealth North America. In each episode, we'll bring you expert analysis from BMO's top strategists and economists to help you navigate market conditions and stay informed. Moments like this are a reminder that markets don't operate in a vacuum. Geopolitics, economics, and investor psychology often intersect, and when uncertainty rises, it becomes ever more important to step back and understand the bigger picture.

Today, I'm joined by three experts who have been here before, Brent Joyce, chief investment strategist in Canada, Carol Schleif, Chief Market Strategist, and Dan Phillips, Chief Investment Officer of the US. And together, we're going to unpack several key questions. Where the global economy and markets stood before this conflict escalated, how markets have reacted in the early days of the conflict, and most importantly, what investors should be watching now across macro conditions, energy markets, and portfolio positioning.

Our goal today is not to predict headlines, but to bring context, perspective, and discipline to a moment when uncertainty is rising. So Brent, let's start with you. Can you provide an update on the recent market action since the US-Israel strike on Iran and your higher level observations on how markets have reacted so far?

Brent Joyce:

Yeah, thanks, Mike, and thanks for having me on again. This developed on the weekend when markets were closed, and so there was time to get a little bit of digestion. And then the initial reaction this week is, I think, largely in the context of the conflict not being worse than maybe people imagined. There's been some surprising developments early on on Monday that have sort of shaken themselves out. I want to take a step back because what's important here is some of the concepts around diversification and this podcast theme of Beyond the Portfolio really gets to the point of staying away from what's happening tick by tick, or even day by day and saying, "Is what I believe in from a portfolio construction standpoint working for me?" And so we have a situation where equity markets are down modestly given the extent of the shock that we're witnessing in the Middle East.

The notion that bonds are not doing their job, I would debunk that. So yes, bond yields have risen a little bit this week, but it's because they were declining in the latter half of February. And so if you step back and think about it on a year-to-

date basis to the end of trading yesterday, you have a US equity market, the S&P 500 that's basically flat, maybe down about a half a percent. This global growth theme, more cyclical environment that was driving certain sectors in the US and certainly non-US markets continues to be intact. If you looked at just this week, you would see some of the biggest damage in European markets and non-US markets, but it's because they had gone up the most in January and through February. And some of that is people taking profits and getting defensive from areas that have done the best in their market.

And then on the bond front, yeah, a little bit of higher yields this week, but on a year-to-date basis, US aggregate bonds are still delivering over 1%. That's the kind of ballast and protection that we would expect from well-diversified balanced portfolios. And so I would try to stay away from the day-to-day movements. It's a fast-moving, fluid situation, and markets are trying to incorporate all of these new developments and step back and say, "Well, how has my portfolio performed on a more week-to-week, month-to-month basis?" And that will hold true in the weeks and months to come, I think.

Mike Miranda:

Great perspective, Brent. I appreciate that. And certainly great to think about it from a balanced portfolio construct. Dan, let's bring you in because here we're recording this podcast on Wednesday morning the 4th, and if we rewind back to the first couple days of the week, Brent touched on them a little bit, but markets were fairly calm on Monday, but then opened dramatically lower yesterday. What was behind that drop from your perspective?

Dan Phillips:

When thinking about the last couple of days, the second day I would say is where the uncertainty really started to hit investors because of the so called FAGA war, which extends into, especially in this day and age, into information flow, whereby investors were increasingly having to sort out what was fact from what was propaganda, which was, and it does take more time during war environments. And especially with the markets having done so well coming up to this point, certainly since Liberation Day last April, there was a bit of a shoot first and find out the answers to these questions later.

And specifically, the focus yesterday was around the Strait of Hormuz. We've talked about this. It's the pathway by which about 20% of the world's oil flows out of the oil producing Gulf States, and there was increasing news around that strait being shut down. And so it seemed like the kinetic war, if you will, and the Israeli and US strikes were really on track in the more conventional sense, but there was growing concern around the Iranian desire and ability to shut down the straight, either through mines, placing mines throughout the straight and/or just deterring individual oil tankers from being able to make it through via drones, et cetera.

And so in this sort of true shoot first and find out answers later, the insurance companies, which insured the risk of passing through the straight, started to pull back providing that insurance to the oil transport companies. And without that insurance, the economics of going through the straight didn't make sense to them. And so we started to see those be pulled back, that news hit, and oil prices moved up above the \$75 per barrel level that we saw with the first Iranian strike last summer. And so we are now sitting at elevated oil prices, and of course that impacts different markets in different ways and to different extents. The likes of the US and Canada, for instance, are less exposed to oil supply

shocks because of the domestic oil production that they both have, including in Canada, especially as it relates to production versus domestic demand.

But other areas of the markets are more exposed. So think about EFI, in other words, and basically Europe and Japan equities, both Europe and Japan being major importers and have major dependencies on external energy sources, and then also emerging markets, which you can think of China, India, Korea, all major importers of oil. And those markets were hit especially hard yesterday because of this concern around oil supply as it related to oil flow through the Strait of Hormuz. So at the end of the day, we did have a bounce back from opening lows as more information was digested, but ultimately we had North American markets, US, Canada down in the case of the S&P 500 down ultimately less than 1%, but those more dependent economies and equity regions such as EFI down more like 3% and then emerging markets down around 5%.

Mike Miranda:

All right. Thanks for that perspective, Dan. Certainly markets have been choppy and trying to dissect the news flow for sure. Let's bring in Carol. Carol, we've written a number of pieces over the last weeks on the market health and fundamentals, and certainly we had a client piece out earlier this week on the specifics of the escalation with Iran, but I'd love your perspective maybe on where we came in from a market backdrop, maybe the health of the global economy and financial markets. Brent made some good points at the outset about anchoring towards fundamentals. So I'd love your perspective first, elevating as to amidst this conflict, what did things look like coming in from a fundamentals perspective?

Carol Schleif:

Sure. Good morning. And thanks, Mike, for having us on again. Really appreciate it. I'm really glad you asked that question because it is so important to remember that we came into this shock or surprise, if you will, from a very sound fundamental standpoint. In the US, if you look at the S&P 500 earnings, we're just wrapping up the earnings season. And in aggregate, those companies generated 10% top line growth and 15% bottom line growth. You have global GDP growing above where expectations had been a year ago, particularly in the US, but other places as well holding in a lot better, even given all of the shocks that they faced in terms of supply chains and a variety of issues last year. So we were stepping off on very strong footing and we've had more data that confirmed that even this week, you had a couple of key retailers report, they came in above expectations and the stocks rallied even in a down market earlier this week.

And then just this morning, you had more favorable ADP employment numbers, and you also had some really positive news out of the ISM services. So there's a lot of strength going into this, meaning that markets, economies are very resilient and able to withstand and have time to sort through additional challenges that might be thrown at them. So it's really as important as we're taking that breath and stepping back and looking at portfolio positioning to understand why we remain towards that front foot growth perspective, because we do think markets and economies will be able to absorb this once we get a bit more clarity.

Mike Miranda:

Yeah, I think that's a helpful perspective. The starting place is always important once you bring some sort of new information and new shock. And I think your points about underlying fundamentals being strong is a good one and dovetails with some of the comments Brett made at the outset about thinking about fundamentals as well. Carol, let's stay with you maybe and just think about bigger picture. We've written a few times and talked about it from a thematic perspective of a global pivot. So how do these recent developments in the Middle East fit with our global pivot expectations and the broader geopolitical landscape we've been discussing?

Carol Schleif:

It's really interesting to contemplate what potentially comes next. And it's important too, if you zoom out a little bit and look back to the start of last year, there's a lot of different things moving on on a political and geopolitical front. Markets tend to over time move pretty quickly through threatened wars and things like that. Markets tend to move pretty quickly beyond it, but there were some fundamental arc shifts or bends, if you will, that have happened recently. And so there's some interesting implications of what's going on in the Middle East, because if you get to the other side of this, depending on how the outcomes are, you can make an argument that perhaps we have more stability in the Middle East than we've been able to have before just from getting some of the more controversial players, if you will, there and everyone in a similar direction.

One of the other things in terms of second and third knock-on effects is to think through, you've got two major global powers now, especially as it relates to China and the US. And China and other large countries have been very dependent on inexpensive oil coming in to fund the economy. And so China has realized that the US has big sway, if you will, over global energy supplies. The globe on the other hand, including the US, has realized that China has big sway over rare earth. So you've got two big superpowers each with very keen understandings of the roles they play on a global basis, which actually could be very constructive as the US and China continue to work through their trade issues and come to a constructive conclusion, which we think both countries clearly want to get there, but it's delicate and it's difficult. And the negotiating position that they're both in is very constructive, which again, filters through and helps the whole world.

Stability and global trade, even if we've changed some of it and changed some of the rules of the game, if you will, over the last couple of years, that stability is really important. So there are a number of constructive scenarios you can paint about the geopolitical outcomes of this. And they do have bearings on economies, on markets, and will flow through to what the capital markets care about, which is earnings growth and inflation.

Mike Miranda:

All right. Thanks for that, Carol. Brent, let's bring you back in. Let's think about Canada a little bit more. So given Canada's status as a major oil and energy economy, how do we think the Canadian economy could be impacted if this conflicts leads to sustained changes in energy markets?

Brent Joyce:

Yeah, thanks, Mike. It's sort of myth-busting, I guess. The people think of Canada in that respect really because it's the contribution to our economic growth from energy that's out-sized, but that has more to do with the denominator than it does with the size of the energy patch here in Canada. The US produces twice as much oil as Canada does, but its impact

on the US economy writ large isn't as big because it's such a broad economy. And so for Canada, yes, the impact has some offsets because of higher energy prices, but energy prices don't really know any borders. We have some variation between Western Canada Select and Brent crude oil and WTI, et cetera, but higher energy prices certainly are going to pinch the mainstream of every economy. It's more acute for Asia and Europe, more levered to that Middle Eastern oil story. One of the things that we think about with Canada clearly is still the connectivity to our markets on a trading basis beyond just energy.

And the US remains with Canada highly integrated, those two economies, but it gets more to this story, I think for both the US and Canada, what Carol was talking about in sort of this upturn that we were anticipating and starting to see green shoots on of a bit of a resurgence in global GDP. And so some of the great work that our economics team has done is to try to quantify the impact here from an inflation standpoint and a growth dampening standpoint. And they've scenarioed oil prices ranging from going back down a little bit if we have some stasis in this conflict to upwards of oil moving into \$100 a barrel range. None of those scenarios upsets the apple cart in the US and tips it into a recession. And to your question about Canada, as goes the US, certainly goes Canada in terms of the North American economy.

And so importantly, that's a good stress test to try to put some goalposts around what this might look like. It does take that upside surprise in growth off the table and stocks would have to reprice for that, but we don't see that as a derailment of a good story. It's going to take away some of the upside that we might've been looking for further on in this year, but it's not an environment where inflation spikes so high that central banks have to be increasing rates dramatically. Maybe we don't get some further cuts from the Fed, but it's much more manageable, I would say, even under some fairly stressed oil price scenarios than people might imagine at the moment. And that also holds true for Canada, but you could take that to Japan and to European economies as well to some extent.

Mike Miranda:

All right, very helpful. Dan, let's close out with you then. Let's step back from the day-to-day and leave our listeners maybe with a view on the outlook for the US and international markets. How are we thinking about asset allocation more broadly in this environment? I think we started talking about that with Brent and the first question I'd love to close out there because ultimately I know our listeners are focused on what this means for markets and portfolios. So what's your perspective there?

Dan Phillips:

Yeah, and so we came into this with an overweight to equity markets fairly broadly across the different regions, largely driven by what Carol nicely articulated earlier on with respect to the fundamentals we're seeing of continued growth, perhaps even accelerated economic growth, inflation that at worst is capped at around a two and a half-ish level and possibly will continue to come down once we get through this disruption we're seeing in the Middle East right now. And then earnings season showed continued earnings growth, but perhaps more importantly, spreading growth beyond just technology into the more cyclical areas of the market like infrastructure, energy, et cetera. And so we retain that overweight allocation and constructive outlook on the markets even at the present point and would certainly recommend that our clients resist the urge to sell into the weakness that we've seen over the last couple days.

As Carol also noted in talking about the longer term themes, specifically the theme of global pivot that we have, there's this real opportunity for this event to be positive for markets in the grander scheme of things, really centered on the prospects of bringing Iran back into the global economy, if you will. It's a country that has the second or third-largest oil reserves in the world. Investment into Iran could probably help squeeze a lot more oil out, bringing down energy prices, of course, but they're also a country of 90 million people, highly educated, young, very young demographics, which could really add a lot of demand to the global economy as well. And so that prospect of Middle East peace is something that could really drive markets. So that's the longer term potential positive here.

We still need to get through what we're going through right now, of course. As I noted, the Strait of Hormuz is the focal point right now. The insurance companies, as I also noted, have pulled back on that insurance that they're providing for those oil tankers, but developments more recently suggest a bit more of a positive backdrop whereby the US Navy is now apparently going to start escorting the oil tankers through the Strait of Hormuz.

And then the US is also stepping in to provide that insurance that some of the private players have moved out of on an attempt to get that oil flowing again because I think the administration knows as well as anyone how vital that is to economic functioning. And so we're going to follow that pretty closely. Otherwise, as it relates back to the more traditional or the kinetic war going on, it does seem like the US and Israel have been hitting all of their milestones or their targets. We've seen, for instance, I think a good stat as it relates to the effectiveness of the Iranian defense right now is the number of ballistic missiles they've been launching. So they, on day one, for instance, launched 350. On day two, it was an estimated 175, day three, 120, day four yesterday, 50. So you're seeing this exponential drop in the amount of launches they're able to get off, which is in large part, of course, due to the strikes on missile launchers, the depots of the missiles themselves.

And so if that can continue, then the US and Israel will have a much better time and easier time executing on their goals and targets. And we have seen that through the fact that it seems like at this point, the US and Israel have a complete air supremacy, if not outright complete air dominance, whereby they can now fly the skies above are in completely unburdened and seek out their remaining targets, et cetera. So that's hopefully a way to get this war to an end. The risks are still there, of course. The big thing is the drones. The drones are much cheaper than ballistic missiles. They're much harder to find and stop from being shot out in the first place. And so that's going to be a big focus here in addition, of course, to getting the straight hormones safely opened again.

But all said at where we're at today, it seems like the worst perhaps has passed and that this operation could come to an end sooner than later. And once that does, then I think the markets will be ready to reassume their positive trajectory.

Mike Miranda:

All right. Thank you all three of you for some wonderful insights there. As we wrap up today's discussion, it's clear that, as I said at the outset, geopolitical events can move markets quickly, but they rarely operate in isolation. What matters just as much as the starting point of the global economy, corporate earnings, central bank policy, investor positioning, those fundamentals ultimately shape how resilient markets can be in the face of shocks. And I think we touched on many of those points through the questions here.

While the situation involving Iran and the broader Middle East will continue to evolve, history reminds us that markets tend to differentiate between short-term volatility, which is what we're experiencing right now, and longer-term

economic impact, which is what we certainly remain anchored towards. For investors, the key is staying focused on fundamentals, diversification, and long-term discipline rather than reacting emotionally to fast-moving headlines. We'll continue monitoring developments closely and sharing insights as the situation unfolds. Thanks for joining us on Beyond the Portfolio, and thank you to Carol, Brent, and Dan for their perspectives today.

Thank you for listening to Beyond the Portfolio. You could follow us on Apple Podcasts, Spotify, or your favorite podcast app. Until next time, I'm Mike Miranda.

Speaker 5:

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