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What the fog of war clouds: transition risks, inflation dynamics and spillovers

Ceasefires may not end the story: transition risks, inflation and the transmission to rates and valuations

By Naomi Fink, Chief Global Strategist and Chief Economist

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Since the US and Israel launched coordinated strikes against Iran in late February, markets have only paid partial attention to the evolving state of the conflict and its potential resolution. Instead, markets appear to see the various risks stemming from the conflict as temporary—more a distraction than a lasting driving factor—especially amid the ongoing capex boom surrounding AI investment.

Since the beginning of the hostilities in February, the temptation has been to reduce the question to whether the conflict will come to an imminent end. Markets have repeatedly suffered disappointment when such expectations have not been met, and focus has shifted quickly back to other matters, such as the ongoing AI investment boom. The pattern suggests headline fatigue, where markets repeatedly reset their focus instead of updating their underlying assumptions.

Repeatedly resetting their focus, however, may have led the markets to overlook an important insight: valuable information may be gleaned not only from outcomes, but from failed transitions. Understanding these failures may allow us to better assess the path for future transitions.

A framework for understanding the conflict

To do this, we developed a game-theoretic model consisting of five possible “states” (or scenarios) between which the conflict can transition, with markets repricing accordingly:

- **Scenario 1 — credibility-driven escalation**: The US escalates because maintaining deterrence and credibility is judged more important than near-term economic or market costs.
- **Scenario 2 — war-risk dominant coercion:** Both sides keep pressure high and preserve escalation options, while avoiding full-scale kinetic commitment.
- **Scenario 3 — mutual off-ramp:** Both sides move toward ceasefire or negotiation, but this state is only stable if concessions and enforcement are credible.
- **Scenario 4 — inflation-constrained de-escalation:** Inflation, oil prices, bond yields and domestic market pressure constrain policymakers and push them toward de-escalation.
- **Scenario 5 — hawkish political pressure:** Domestic or political pressure pushes leaders toward a tougher posture, making compromise harder and escalation risk higher.

We then designed a replicable news filter that allows us to gauge the relative likelihood of which state is in effect at any given time, and which scenario it is likeliest to transition towards, conditional on the current state. This framework also helps identify what events could confirm or disconfirm the current state, such as a ceasefire/mutual off-ramp or escalation. We share below what we learned from running the news filter, which could help us understand the state of the conflict at any given period and the potential transitions ahead.

Key insights from the framework

1. Think in terms of "transition risk"

Market pricing is typically scenario-dependent. As a result, most of the repricing tends to occur between states rather than within them. Therefore, failed transitions—such as unsuccessful off-ramps and unanticipated reversions—may yield comparatively more information. These moments may reveal the constraints and incentives facing policymakers, which are otherwise difficult to directly observe. Once a new state becomes obvious, much of the repricing has already been completed.

2. Attention is focused on the "ceasefire" headline rather than whether the transition is credible

Markets have shown that they tend to focus on headlines, especially those about the prospect of a ceasefire, without fully assessing if such a state can be reached. By focusing on the headline, markets may miss the necessary conditions of a durable transition—notably, whether both sides have incentives to follow through. In their absence, there is a likelihood of a reversion to the "attractor" state, identified as Scenario 2 (war-risk dominant coercion).

3. Is it an equilibrium or a transition state?

We have observed that markets tend to misread transitional phases between states as a new equilibrium. We learned this by observing the number of failed transitions from "sticky" Scenario 2 (war-risk dominant) to Scenario 3 (mutual off-ramp). A mutual off-ramp/ceasefire remains fragile and is not durable unless it is supported by concessions from both sides. In the absence of credible concessions, we have witnessed repeated reversions to Scenario 2.

4. The risks extend beyond oil prices

As we have outlined in prior insights, markets initially greeted the conflict with disbelief, then framed it in terms of a conventional oil shock. However, such a perspective is incomplete. The spillover risks are broader and connected. Foremost, the risks extend to inflation; they also touch financial markets (and the adjustments they have to go through), macroeconomic policy and politics. These channels all feed back into each other. As a result, focusing just on energy prices risks underestimating the systemic nature of the shock caused by the conflict.

5. The most important overlooked channel may be fixed income, not equities

An important and potentially overlooked channel is the impact on fixed income markets and interest rates, rather than equities. The rise in global yields reflects the combination of uncertainty over inflation and central bank policy and historically high levels of indebtedness among developed economies. The potential for central banks to raise policy rates to deal with inflation, in turn triggering a further rise in global yields, has significant implications for required returns on capital and hence asset valuations.

6. If investors focus only on the ceasefire, they may miss the inflation-forcing mechanism

Finally, investors may be underestimating the role of inflation as an active driver of outcomes. In Scenario 4, inflation serves as a factor that forces policymakers to seek an off-ramp. However, this does not necessarily resolve underlying inflationary pressures, particularly those linked to energy and supply chains. In this scenario, political sensitivity to inflation both in the US and Iran becomes a driving factor shaping decisions. The scenario focuses on inflation as a mechanism constraining both sides; political concessions are a precursor (and confirmation of) a mutual off-ramp. If investors ignore this mechanism and instead focus only on the ceasefire, they may miss the "forcing" nature of inflationary forces in the US, which may not disappear even after the transition to a "mutual off-ramp" has been achieved.

Conclusion

Our analysis suggests that markets may be overly focused on outcomes—such as ceasefires—while overlooking the transitions between states and their broader economic implications.

In particular, inflation can be seen as both a consequence of the conflict and a constraint on its further evolution. Rather than fade quickly once a ceasefire is reached, inflationary pressures may persist and continue to influence policymaking.

A more robust framework therefore requires us to track not just “what happens,” but how and why transitions succeed or fail.

In this context, we expect transition risks and spillovers—particularly via inflation and interest rates—to be key to understanding both market pricing and future developments.

For long-term investors, the implication is that reacting to short-term headlines, such as ceasefire announcements before the transition is confirmed, may be unnecessarily costly. In the absence of clear concessions, enforcement mechanisms or other evidence that both sides have incentives to complete the transition, market rallies linked to off-ramp expectations may be vulnerable to reversal. Waiting for confirmation may therefore be less about missing the first move and more about avoiding repeated repricing around failed transitions.

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