

# No solution in sight: What do we expect next from the Gulf?

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**Japan Equity Research Team**
SMDAM

We are one of the largest investment management companies in Japan, offering discretionary investment management, investment trusts and advisory services to a range of institutional investors, pension funds, government agencies and retail investors worldwide.

### Executive summary:

- **Still no breakthroughs:** Diplomacy remains deadlocked while Houthi attacks continue to keep the region on edge, leaving global energy markets vulnerable to fresh shocks.
- **Oil risks are here to stay:** Export flows have partially recovered, but shipping disruptions and security concerns continue to keep upward pressure on crude prices.
- **Japan and Asia are directly exposed to these risks:** Heavy reliance on Middle East energy means higher oil prices quickly translate into stronger inflation and rising costs for businesses and consumers.
- **More hawkish rates backdrop is rapidly emerging:** Persistent energy-driven inflation strengthens the case for further policy tightening, even as higher oil prices create winners and losers across the Japanese equity market.

Efforts to end hostilities between the U.S. and Iran remain at an impasse. Reports suggest Iran proposed reopening the Strait of Hormuz and resuming nuclear negotiations in exchange for measures including the unfreezing of assets. However, U.S. President Trump rejected the proposal on 26 September, and little progress has been made since. Both sides continue to use military pressure as a negotiating tool, with no clear path to compromise emerging.

At the same time, clashes between Saudi Arabia and Yemen's Iran-backed Houthi movement have intensified. The Houthis have targeted Saudi airports and energy infrastructure, prompting retaliatory action from Saudi Arabia. Continued attacks risk further disruption to shipping in the Red Sea. As a result, even if the U.S. and Iran move towards a ceasefire, broader regional tensions are unlikely to fade quickly, leaving oil markets sensitive to further developments.

For Japan, which imports almost all of its crude oil and relies heavily on Middle Eastern supply, any disruption to regional energy flows has direct implications for energy costs and corporate profitability.

## A dangerous cocktail – identity and geopolitics

Religious and political factors remain closely intertwined across the Middle East.

While Saudi Arabia is predominantly Sunni and Iran predominantly Shia, the region's instability cannot be explained solely through sectarian differences.

The Houthis, whose roots lie in the Shia Zaidi tradition, receive support from Iran and remain engaged in conflict with Yemen's Saudi-backed interim government. However, the current tensions also reflect wider regional security concerns and competition for influence.

Based on developments to date, a lasting reduction in tensions would likely require several steps. These include a halt to military attacks, guarantees for safe passage through the Strait of Hormuz, renewed nuclear negotiations, and a gradual easing of U.S. sanctions. Reducing conflict in neighbouring areas and establishing independent verification mechanisms would also be important. Given the complexity of these issues, a durable agreement is likely to be difficult to achieve.

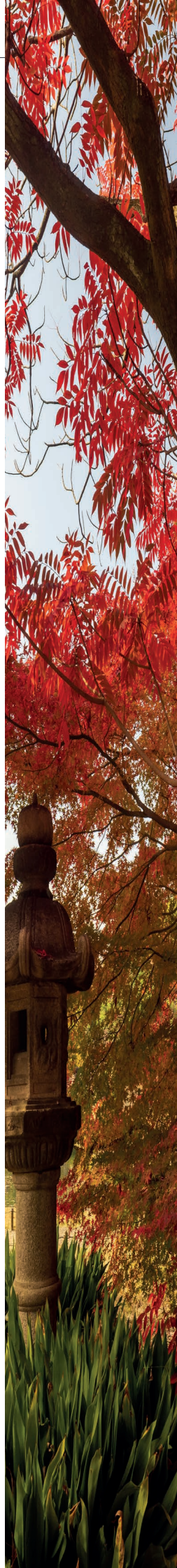
## Higher oil prices mean further hikes are more likely

On 14 October, the International Energy Agency (IEA) estimated that crude exports from Gulf producers had recovered to around 75% of pre-conflict levels.

However, shipping costs and insurance premiums remain elevated as attacks on vessels around the Strait of Hormuz continue. With significant obstacles still standing in the way of a broader agreement, supply concerns are likely to persist, keeping upward pressure on energy prices and inflation. This is particularly relevant for Japan, where higher import costs tend to feed through quickly into producer prices and household energy bills, adding to inflationary pressure.

Against this backdrop, we have revised our annual average Brent crude oil assumption from US$86 to US$98 per barrel for this year and from US$84 to US$85 for next year. We have also incorporated an additional 25bp rate hike in both Japan and the U.S. in March next year. In Japan, we have brought forward a previously expected January rate increase to December this year. Should oil prices rise further, additional policy tightening may be required, underscoring the importance of closely monitoring developments across the Middle East.

While higher energy prices present a headwind for consumers and many businesses, they may provide support for parts of Japan's energy, trading and resource sectors, highlighting the uneven impact across the economy and equity market.





## Figure 1: Possible steps toward ending the U.S. – Iran conflict

| STEP | KEY POINT | SPECIFIC MEASURES |
|---|---|---|
| 1 | Agreement to halt mutual attacks and ensure safe navigation. | The United States and Iran agree to cease attacks. Ensure safe passage through the Strait of Hormuz and lift the naval blockade. |
| 2 | Resume nuclear negotiations and gradually lift economic sanctions. | Freeze highly enriched uranium production and conduct inspections. The United States partially lifts oil-related sanctions after verifying compliance. |
| 3 | De-escalate fighting in surrounding areas. | Address conflicts involving Saudi Arabia, the Houthis, and others. Separately coordinate security and ceasefire terms for each party. |
| 4 | Reach a long-term comprehensive agreement and verify compliance. | Impose long-term limits on nuclear development and lift economic sanctions. Have third countries verify compliance. Establish security guarantees and procedures for investigating violations. |

Note: This summarizes the steps generally considered likely.
Source: Prepared by Sumitomo Mitsui DS Asset Management based on various sources.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