Research @ Citi Markets Edition: The Middle East Conflict — Stagflation Risk

Recorded: March 30, 2026

Published: March 31, 2026

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Transcript:

Beata Manthey (0:00)

Welcome to Research @ Citi Markets Edition, where we break down global macro in 10 minutes. I'm your host Beata Manthey, Citi's Head of European Equity Strategy. Joining me today is our Senior Equity Strategist, David Groman. Welcome to the show, David.

David Groman (0:18)

Thanks, Beata. Great to be here.

Beata Manthey (0:20)

It's been only a month since the Middle East conflict has started. Brent is trading well above 100, dollar is up, while gold, rates and equities have sold off meaningfully. It is fair to say the conflict in the Middle East has changed the outlook for commodities, the global economy and markets in very many meaningful ways. So in today's discussion we want to unpack how the landscape has shifted and map out the scenarios investors should be thinking about from here.

David, maybe we begin with the economics. How have our economists already shifted their forecasts? And where do you think the risks are leaning now?

David Groman (1:01)

So our economists have trimmed our global growth forecast for 2026 to 2.7%, which is only a modest downgrade from what they were expecting last month. They've also boosted their global inflation forecast by around 50 basis points to slightly above 3% at this point. So for now our forecasts haven't shifted a ton, but the team has been very clear that the risks of the global economy have shifted dramatically to the downside and obviously the big swing factor here will be the path of oil and commodity prices.

Beata Manthey (1:31)

Of course that makes sense, so let's assume we end up in a more severe scenario with oil persistently above 100 a barrel for a few months from here. Where would our forecast land in this case?

David Groman (1:46)

So the impact obviously becomes much more significant. That type of scenario could push global growth down a full percentage point or so, below 2%. And at the same time global inflation — at least at the headline level — would jump by something like two percentage points to above 4%. So that's obviously well above what central banks would be hoping for.

I do think there's some good news here, which is that many economies are much more flexible and less energy-intensive than they used to be in the past. And that means that knock-ons from oil prices into growth might be smaller this time around. But the longer that this crisis lasts, recession risks, of course, will only continue to grow.

Beata Manthey (2:23)

So putting this all together, it seems like the main risk from here is stagflation, the combination of low growth and inflation. We've had few stagflationary shocks in the past, but the most recent one was of course 2022, kicking off around the conflict in Ukraine. Do you think this is a useful example? And would you say we are in a similar place to then?

David Groman (2:47)

So historical comparisons are always imperfect. I mean, especially as the war in Ukraine I think could potentially be viewed as more of a European-centric shock. But we did have a sharp rise in global commodity prices back then with lots of knock-ons globally. So, I think it's definitely worth thinking about. But there are obviously plenty of differences with this energy shock compared to 2022 as well.

I think most notably on the macro front, interest rates are in a very different place. Back in 2022, rates were much lower globally, and that led to a big turn in the rate cycle with many hikes coming through across the world. This time around, rates are relatively restrictive, right? And markets had at least been expecting interest-rate cuts, especially in places like the U.S., even just a few months ago.

But households this time around might not have as much of a buffer as they did following the rounds of post-pandemic stimulus back in 2022. There might also be less scope for fiscal-policy help than before. So I think lots to mull over in the weeks and months ahead.

But on that note, Beata, let me turn it back to you and we can talk in some more depth about our bread and butter, which is European equities. So if we try running some of these similar scenario analyses for equity-market fundamentals, where does that leave us?

Beata Manthey (3:59)

So yes, for context, bottom-up consensus has been forecasting around 12% EPS growth in Europe this year, which would be a pretty meaningful acceleration from flattish earnings growth last year. Now, even at the start of this year, our top-down models had been pointing to around only 8% EPS growth. Now, in a world where risks subside relatively quickly, EPS growth in line with our prior forecast still looks possible. But in a more severe case, we think that 2026 EPS growth could be fully eliminated.

Of course, this is when we exclude the positive impact on the oil sector that offsets the negatives elsewhere. But definitely some downgrades for more cyclical sectors to come through going forward.

David Groman (4:55)

Great, that's clear. So, seemingly skewed toward the downside with some risks around how big the downgrades could ultimately be. But Beata, one pushback that we get is that European equities have already fallen around 10% from recent highs. So does that mean that bad news is already priced in, that these downgrades are potentially already reflected in current prices?

Beata Manthey (5:14)

The market moves have been meaningful, but we are not completely sure that we can say downside risks are really being reflected quite yet.

Firstly, yes, the market is down 10%, but the market trajectory into the crisis was much more bullish than in any other path into previous geopolitical crises. So usually the market sees problems ahead and starts pricing them in. It wasn't the case this time around: The market was up, not down, before the crisis.

Secondly, we've entered this crisis with the highest valuations across all the previous ones. It's true for Europe, but it's also true for any other major equity market around the world.

And final, most important point: Our “what's priced in for EPS” model was suggesting that European equities, but also many others across the world, were pricing in significant EPS upgrades to already-bullish consensus. And the recent sell-off has brought the expectations closer, but still above the analyst expectations. So that would imply that risks are still skewed to the downside here, especially if we get into these more-adverse economic scenarios we've discussed earlier.

David Groman (6:31)

Makes sense. So I'm sure positioning might also be playing a role here. How has this been shifting and where do things stand now?

Beata Manthey (6:39)

Our quant team produces a very useful positioning model. And according to them, positioning on most equity indices, except from the U.S., was very bullish before the conflict had started. This has now mostly unwound. That's why in the initial phase of the sell-off, whatever has gone up the most beforehand has gone down the most. We've now moved from the de-risking phase to short-positioning build-up phase.

So the net positioning is now negative in Europe and in the U.S., but not yet very bearish. In some Asian indices, like Korea or Japan, positioning is actually still net long. Now gross positioning has finally started to come off, but it is far from low.

So bottom line, the before-crisis excesses have now been priced out, but if the news flow doesn't improve, there is still scope for more negative buildup.

David Groman (7:40)

So to wrap this all up, how do we navigate equity markets for now? How are you thinking about it?

Beata Manthey (7:46)

We find that the equity indices have really followed closely the previous conflict's performance path. So the most exposed regions like Japan, Europe, EM, Asia have sold off the most, while the less exposed like the U.S. or the UK have done somehow better but have also felt the market pressure.

Now, sector-wise, while most sectors have traded in line with the 2022 playbook, we find that some defensives still have scope to do better if the news flow doesn't improve.

Now, if a quick resolution comes through, it is still possible we go back to more pro-cyclical price action. But the longer this goes on, the knock-ons on supply chains, growth, inflation gets greater, and it will be hard to go back to the previous market trends.

So, David, there is plenty to look out for, but let's wrap up here. Thanks for being here today.

David Groman (9:06)

My pleasure.

Beata Manthey (9:07)

Thank you for joining us today. This episode was recorded on the 30th of March and I'm your host, Beata Manthey. Our next Research @ Citi Markets Edition will be hosted by Dirk Willer, Citi's Global Head of Macro. Thanks for tuning in. Goodbye for now.

Disclaimer (9:24)

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