Research @ Citi Podcast Markets Edition: Middle East Developments Escalate to De-Escalate

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Transcript:

Opening Teaser: (0:00)

Research @ Citi Markets Edition.

Beata Manthey (0:06)

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.

Over the past few weeks, a sharp escalation in the Middle East has injected a fresh risk premium across global asset classes, with Brent trading above $100. For equities and cross-asset investors, the core question is whether this marks a transient geopolitical flare-up or a sustained supply-side shock capable of altering the global inflation and the rates path.

Joining me today to unpack the catalyst, channel risks, and price scenarios is Max Layton, Citi's Global Head of Commodities Research.

Max, welcome to the show.

Max Layton (0:48)

Thanks, Beata.

Beata Manthey (0:50)

So let's start with the immediate triggers. What specific developments over the last few weeks have driven this rapid repricing in energy and rate markets? And how does your team map out the potential timelines from here?

Max Layton (1:05)

After the memorandum of understanding broke down, President Trump has moved to a full economic blockade of Iran, or as full as possible. From the U.S.'s perspective, sanctions have been put on, there's a blockade of oil exports. And this is resulting in Iran feeling, “Well, the economy has been hit by this, the currency's depreciated significantly, there's obviously the revenues not coming in.” So, Iran is in every way, in my opinion, incentivized to escalate here. And that's what they've been doing. So that's not a prediction as much as it is factually what's been happening over the last two weeks. And they're escalating through a number of different paths, some of which many didn't expect. And I think they're going to continue to escalate.

The prediction we have is they're going to continue to escalate until any number of paths result in either the breaking of the blockade or in some form of diplomatic solution. I do think that if I focus on some areas like the regional disruption that's going on, that looks unsustainable. The region will likely get together — there's some early attempts at that this week. And it's not just the Middle East producers in the region — it's Azerbaijan, Turkey. They don't want the worst-case scenario to happen and issues with potential migration from Iran. China doesn't want it. In my opinion, they don't want it to get to the worst-case scenario. And so I do think we're going to escalate for as long as it takes from the Iran side of things to get that diplomatic solution or break the blockade.

Beata Manthey (2:38)

Thanks, Max. Many investors have viewed the U.S. midterm elections as a potential turning point for the conflict. Is that still relevant? And how long could the situation persist if tensions remain elevated?

Max Layton (2:50)

Look, it's certainly a factor. I'm not sure that it's a particularly important factor. You know, there's at least two main parties to this conflict. From Iran's perspective, as I spoke about before, they're incentivized to act now. So they're going to be acting now and raising the pressure in every way that they can now. And that's regardless of the midterms. Now, it looks like President Trump, at least publicly, he's saying that this conflict can go on until around the midterms. And he's predicting it will end slightly before or slightly after the midterms. I'm not sure on what basis that is made, but it certainly looks like it's going to get worse before it gets better.

Beata Manthey (3:32)

Understood. Now, maybe let's bring China to this discussion. China has maintained a degree of insulation earlier this year, but recent developments appear to challenge that balance. With an upcoming high-stakes meeting between President Trump and President Xi on the calendar, how significant is the China factor here? And do you expect the Middle East to feature on the agenda of that meeting at all?

Max Layton (3:57)

I think ultimately Iran's going to make its own decisions, and so is President Trump and the administration. Having said that, China has a potentially very important role to play here — they have a number of different incentives. I don't tend to predict what President Xi is going to do exactly, but what I can observe is that they don't want mutual energy infrastructure from an economic perspective in the region — they don't want it to escalate to that point. And to the degree we look at that as a possibility over the coming days and weeks, they, I expect, will be trying to talk both sides down and potentially even mediate both sides away from that outcome.

Because of the fact that if you look through from an economic perspective, there's a couple of different channels that China's exposed to — not just Iran, but the Middle East as a whole. In fact, most people focus on the China-Iran axis, but China has five to 10 times the cumulative foreign direct investment in the Middle East outside of Iran, and a similar kind of magnitude of exposure to energy exports from the Middle East ex-Iran. So, they're actually dramatically more exposed economically to the countries surrounding Iran. And for these reasons, I think that they're going to get more involved.

Beata Manthey (5:11)

Makes sense. Now, let's move to what you've been writing about in your many reports in the past months. So you've been emphasizing the cushion provided by global inventories and the strategic reserves. How much real buffer does the market actually have before physical tightness begins to bite more?

Max Layton (5:30)

So I try to compare this shock that's been going on at the level of inventories to what happened in the late 1970s, because obviously that had a pretty major impact on the global economy, not just the U.S. economy back then. So we're trying to find a bunch of different metrics to compare the two periods from.

I would say that inventories heading into the second oil shock and around the second oil shock were around 80 days globally — 70 to 80 days, depending on which metric you look at back then. Today, globally, they're around 100 days, around 95 to 100 days and going down. We were drawing around 3 million barrels a day. I think we're drawing more than that at the moment, considering the disruption to the east-west pipeline and the impact of the recent escalation on the Strait of Hormuz flows.

But in any case, to get down to those kinds of 1970s levels is going to take a long time. In other words, there is a lot of oil inventory around. Some of the products are tighter than others. The product market is tighter than the crude market. Within the product market, diesel is tighter than some of the others. But overall, there is a lot of oil inventory out there. And it's going to take, even at recent run rates, between one and two years to run inventories down to those 1970s levels. So, there is some time before we get to the kind of problematic levels we had back in the late 1970s.

I would say there's a couple of big differences between now and then. This is manifesting in more of a product-market shock at this time. And also there was a huge amount of hoarding reported back in the late 1970s, early 1980s. We haven't seen that hoarding this time around. I think actually the opposite is going to happen, at least for the moment. We are seeing governments de-stock their inventory. Probably China's de-stocking at the margin. Certainly the OECD countries are de-stocking. The OECD countries have another billion barrels of oil to sell into the market. And we have published that we expect the IEA and particularly the Europeans to release some product stocks over the coming weeks. And these kinds of cushions are hopefully going to smooth out this oil-price and oil-supply disruption over the coming months.

Beata Manthey (7:38)

Thanks, Max. So clearly there still is some buffer — so that's on the optimistic side. Now, just to wrap up, how would oil prices respond under the two extreme scenarios? So, number one, Strait reopening very quickly — let's say tomorrow — what do oil prices do from here? How fast do they normalize vs. the Strait remaining closed through year end?

Max Layton (8:02)

So I think they normalize very quickly. Indeed, I think that this is still, thankfully, largely a political issue rather than a damaged energy-infrastructure issue. And with that, oil came into this shock in a very large surplus. We think it's going to, on a reopening of the Strait, leave in an even larger surplus, because we expect Saudi and UAE and other countries are going to move to maximize production and use up as much of their spare capacity as they can to export as much as they can while the Strait is open. So we would expect both products and crude oil prices to collapse if that happens.

And then in terms of the Strait remaining closed through the end of the year, there's been a big move in prices in the last month. We'd expect them to remain roughly around these levels, maybe grind up a little bit from here.

Beata Manthey (8:52)

Thank you, Max. Clearly a lot more to discuss, but we are running out of time. So, to summarize our discussion today: Iran is incentivized to escalate, so it does get worse before it gets better. The central case is the Strait of Hormuz reopening during Q4, triggering lower oil prices.

Now, very quickly, from an equity-strategy standpoint, European equities and the broader economy are this time around far less vulnerable to gas price spikes than they have been during the 2022 energy crisis. Nonetheless, a severe re-escalation does pose clear downside risks for cyclical and energy-intensive sectors.

Max, thank you so much for joining us today.

Max Layton (9:36)

My pleasure. Thank you, Beata.

Beata Manthey (9:38)

And thank you all for tuning in to Research @ Citi Markets Edition. This episode was recorded on the 14th of September, 2026, 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 listening. Goodbye for now.

Disclaimer (9:57)