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Navigating Oil Shock Risks: Emphasizing Quality and Global Diversification

Disciplined positioning matters regardless of the market environment. A global multi-asset framework can help.

Historically, oil shocks have coincided with equity market drawdowns, particularly in the S&P 500, which has tended to enter correction territory within three months after major oil price shocks while commodities have outperformed. However, the current macro backdrop differs meaningfully from prior episodes such as the inflationary shocks of the 1970s and the 2022 global inflation surge when central banks were forced to aggressively tighten policy following prolonged periods of monetary easing.

Today, monetary policy has already normalized across most developed economies. As such, the likelihood of a sustained policy tightening in response to higher oil prices is significantly reduced. While volatility may increase in the near-term, conditions for a prolonged and systemic drawdown in risk assets may be less pronounced than in prior cycles.

Oil dynamics further reinforce this view. The forward curve for Brent crude remains in substantial backwardation, with near-term prices elevated relative to longer-dated contracts. This typically reflects short-term supply concerns rather than expectations of sustained structural shortages. Notably, six-month forward prices remain well below levels observed during 2022, indicating that markets are not pricing in a prolonged oil shock scenario. At the same time, implied volatility in oil markets appears to be peaking, which may precede stabilization across broader assets.

In fixed income, some sovereign bonds have not been an effective hedge during oil-driven volatility regimes. Instead, we favor a more selective approach by widening the opportunity set. We favor sovereign issuers characterized by low inflation and stable policy frameworks, including China and Switzerland. In Switzerland's case, the strength of the Swiss Franc has played a key role in anchoring inflation and limiting upward pressure on yields.

Across the Middle East, real estate remains vulnerable, with approximately 15% of the region's dollar-denominated property debt entering distressed territory and a growing maturity wall approaching the end of the decade. These assets are inherently illiquid and therefore susceptible to sharp price swings during times of stress. That said, certain markets like Dubai may benefit from strong pre-sale activities and large revenue backlogs.

Saudi Arabia remains heavily concentrated, with performance driven by a small number of dominate names, including Saudi Aramco and Ma'aden. While these companies have benefited from higher oil and gold prices, broader market participation has been limited, with equal weighted performance remaining relatively flat YTD. We work with colleagues to create multi-factor strategies that aim to achieve more stable local returns alongside global multi-asset exposures.

We continue to view the Middle East as an important hub for global capital markets. Significant pools of capital, particularly sovereign wealth funds, have been deployed across the world, supporting innovation, infrastructure, and private investments (particularly in the US tech sector). These cross-border flows remain a key driver for both regional and global economic resilience.

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