

New Shocks, Underlying Positive Trends Still Intact

A body in motion stays in motion at a constant speed and in a straight line unless acted upon by an external force.

– Sir Isaac Newton, *Philosophiæ Naturalis Principia Mathematica* (1687)

February brought many developments to capital markets. For well-diversified investors, it was another strong month: global stock markets outside the U.S. rose – some sharply – and bonds also rallied. All this now feels distant, given the dynamic situation in the Middle East as March begins.

Iranian conflict

Capital markets have a long history of looking past geopolitical events. An initial, swift risk-off reaction is often followed by a recovery when investors return their focus to fundamentals and ask what the medium- to longer-term impact might be on global growth, corporate earnings, inflation and interest rates. This reaction function is getting milder and shorter, which reflects the increasing frequency of geopolitical upheavals and surprises in recent years. Our [Special Market Update – Iran](#) provides greater insight to our market views of the Iranian conflict.

Moves in capital markets spurred by (seemingly) sudden events (geopolitical, economic, company/sector-specific) must be regarded in context. We need to factor in whether and to what degree the markets anticipated an event – and thus what was already priced into affected assets. The early days of the Iran conflict brought some movements in capital markets that might seem counterintuitive – stocks sold off briefly on the Monday opening after the start of the conflict, but recovered. By the end of the day, North American markets had made small gains, while bond yields rose slightly. The U.S. dollar, considered by some to no longer hold its safe-haven status, did play its traditional role. Examining price movements across all of late February and early March, we conclude that capital markets continue to function well and are moving appropriately to incorporate new risks. Although volatility is high, reactions in energy markets, equities, bonds and currencies are less acute than might be expected under the circumstances. Intraday price

action that starts on the manic side eventually gives way to what we might call the “gravitational pull” of the constructive fundamental backdrop for growth, corporate earnings, inflation, central bank policy, and bond yields that predated the conflict – and will likely continue post-conflict.

Energy impact

In the Middle East, oil and natural gas prices are the obvious catalysts of volatility and uncertainty for global economies and markets. Oil prices are coming off five-year lows from back in December; prices began to rise in 2026 on expectations of stronger global growth (a positive signal) and spiked after Iranian hostilities. This behaviour was not out of the ordinary. So far, the spike is manageable, and oil infrastructure hasn’t been targeted to date. The world has managed oil shocks before, most recently during Russia’s war on Ukraine and last June’s 12-day war involving the U.S., Iran and Israel. Oil prices will stay volatile. Still, a short-term spike doesn’t threaten the key fundamentals, i.e., the solid path of global growth and corporate earnings.

Higher oil prices can lift inflation, but again the current levels are manageable, and investors can look past a short-term spike. A quick return to lower oil prices is likely once stability returns.

Bond yields rose in early March only because they had previously fallen on safe-haven demand before hostilities, and the scope of the conflict looked less severe than feared. Over the full February-to-early-March period, bonds have provided ballast to portfolios.

Analysis from BMO Economics ([Conflict With Iran: Economic Implications](#)) outlines three oil shock scenarios that project varying price increases and durations, none of which are severe enough to send the U.S. economy into recession. They model oil price increases from 25% to 80% relative to their prior baseline forecast. Outcomes from the various scenarios range from a

negligible impact on U.S. economic growth through to a more severe oil shock that would dent U.S. economic growth but not drive a recession. Growth still manages to climb between 1% and 2% in 2026. U.S. inflation scenarios range from adding 0.2% to inflation to the more serious scenario where inflation potentially comes in 1.6% higher than it otherwise would have been (i.e., in the 3% to 4% range). In the latter scenario, further Federal Reserve interest rate cuts are unlikely. The effect on Canada in these scenarios is generally equal to or less than the effect on the U.S., given offsets from a heavier weighting of energy production in Canada's GDP.

Bottom line: since inflation is expected to remain in check, central banks can maintain an accommodative stance, keeping bond yields stable and minimizing the need to reprice other assets on this basis. The key takeaway is a continued supportive environment for financial markets. Equity markets are digesting the potential significance for global economic growth, which is uncertain in these early stages of a fluid situation, so the primary impact on stocks is one of risk appetite and sentiment.

It's possible that weakening the Iranian regime will mean more stability for the region. That would be a positive outcome for global growth and oil prices – and hopefully also for the people of the Middle East.

AI apocalypse

Although markets are currently fixated on the Iranian conflict, other developments have been moving capital markets. The narrative on Artificial Intelligence is in flux. AI has gone from market darling and amazing technological advance to destroyer of worlds and everything it touches. Weakness in U.S. equity markets last month stemmed from the view that those building out AI – the hyperscalers – are overspending on the buildout. Fears mounted that those who potentially benefit from deploying AI (e.g., everything from software enterprise companies to trucking companies) will be eaten by AI. Add to this the notion that AI will kill so many jobs that the whole thing has now devolved into an AI apocalypse.

While exact outcomes remain uncertain, our research and industry conversations suggest a nuanced perspective: AI's impact will likely be evolutionary rather than revolutionary. The transition will bring both challenges and opportunities, transforming certain industries and jobs while creating new ones. All past technological innovations have featured this powerful and historically positive creative destruction – not apocalypse. Recent high-profile job cuts in the technology sector are often company-specific headlines and have more to do with rightsizing previously inflated hiring than AI job replacement. In fact, some companies are being accused of scapegoating AI to mask these realities. Investors who maintain diversified portfolios and regularly take profits can navigate through and benefit from advances in these technologies.

Global growth upside surprise

Declines in some sectors affected by the shifting AI narrative (most notably software) have been in the minus 20% range year to date. Yet the S&P 500 Index was up 0.5% through the end of February as sector rotation churned beneath the surface.

In our view, this is a healthy development. It represents a passing of the baton from the narrow leadership that characterized the S&P 500 for several years to broader-based participation from a wider variety of companies that are more sensitive to cyclical economic growth versus the secular-themed stories associated with AI.

Very economically sensitive sectors that were lagging performers for more than a year are perking up. Top performers included real estate, energy (even before the conflict-driven jump in oil prices) and consumer staples. The outperformance of these economically sensitive sectors mirrors the ongoing advance of non-U.S. equity markets, which are also heavily weighted toward global growth. Continuing to deliver are Canada, Japan and emerging markets ex-China. To these geographic moves, add smaller companies in North America where small- and mid-cap stocks continued to outperform large-cap companies. Share-price movements in these areas aren't new, but they are no longer just sentiment driven. Underlying global economic momentum is improving. Corporate earnings results and analyst upgrades are justifying these sectors' outperformance over the past several months.

Tariffs turned down – and private credit shudders

Two other developments we want to mention briefly (in our view both are well understood but still headline grabbing) are the U.S. Supreme Court striking down IEEPA tariffs and turmoil in some areas of private credit.

On tariffs, the U.S. administration has other means besides the IEEPA to levy them. There will be legal back-and-forth on how refunds may – or may not – play out. The use of tariffs as a broad cudgel now has some restraints. This development is welcome, but we don't see it as the endgame. Companies are resigned to tariffs for the foreseeable future; they continue to adapt and move on.

As for private credit, negative headlines target only a subset of players; such episodes are not new to this asset class. It does not mean all private credit is bad. We do not believe it is widespread rot, nor is it causing contagion. Echoing what happened when regional banks like Silicon Valley and First Republic failed in 2023, shares of publicly traded private-credit asset managers are being broadly shunned until the dust settles.

Bottom line: investors have plenty to digest, capital markets remain resilient. They are adjusting to new developments and functioning well overall. Despite a steady diet of alarming headlines, not all news points to negative outcomes.

The last word: Not enough to knock things off course

Capital markets have handled many challenges over the last 18 months. We expect that the current situation will follow a similar path. We believe economic expansion remains intact, and after the near-term volatility, the equity bull market will resume.

The global economy is buoyed by reasonable levels of inflation, supportive financial conditions, decreased trade uncertainty, productivity gains, fiscal stimulus and upgrades to corporate earnings, plus capital expenditures in AI, defence and infrastructure, and signs that employment, manufacturing and housing activity are exiting their recent soft patch. The energy shock is the external force; however, we don't believe it's capable of knocking the global economy off its path. Our upside growth scenario could be dented by a prolonged conflict that restrains access to global energy supplies; even here, we don't see derailment. If we get a reasonably quick stasis, it would reinforce our view that global economies are set for solid growth in the year ahead, which will take equity markets to new highs.

A strengthening global economy is the body in motion that stays in motion. Through it all, we rely on the classic tenets of diversification: exposure to a broad range of global equities and sectors while bonds provide an important cushion.

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