

## Iran war: where to from here, and what it means for New Zealand

We are now several weeks into the war in Iran, and the initial shock phase is giving way to a clearer assessment of the economic implications. What initially appeared as a geopolitical event is increasingly revealing itself as a macroeconomic one, with important consequences for growth, inflation, monetary policy and markets.

The most immediate transmission channel is energy. A meaningful share of global oil and gas supply has been disrupted, not just through constraints on shipping, but increasingly through direct damage to infrastructure. Even where capacity still exists, the ability to reliably deliver supply to market has been impaired.



Recent developments highlight how quickly this can escalate. The targeting of major gas infrastructure in the Gulf, including LNG export capacity, underscores that this

is no longer just about transport disruption. It is about the potential loss of productive capacity itself, with repair timelines in some cases measured in years.

The scale of the disruption is significant. The International Energy Agency has described the conflict as “the biggest crisis to hit global energy markets”, reflecting not just the magnitude of the shock, but the central role the region plays in global supply. Markets are no longer just pricing geopolitical risk. They are increasingly pricing physical disruption.

### Where to from here?

The range of outcomes is becoming clearer, even if the probabilities are not. The best-case scenario remains a contained conflict that de-escalates through diplomacy. In that world, the spike in energy prices proves temporary and the macroeconomic effects fade.

But the more realistic risk is a drawn-out conflict, not necessarily a full regional escalation, but a prolonged period of intermittent disruption. Recent developments point firmly in that direction. The targeting of energy infrastructure suggests supply itself is becoming a strategic lever, not just collateral damage.

This type of disruption is not easily reversed. Damage to export facilities and processing capacity can take years to repair. Even without further escalation, that alone is enough to keep a risk premium embedded in energy markets.

Layer on ongoing risks to shipping routes and the reluctance of market participants to fully trust supply chains, and the result is a world where energy prices are not just higher, but structurally more volatile.

Markets have shown again and again they can absorb a one-off shock. What they struggle with is persistent uncertainty.

## **Growth, inflation and monetary policy**

At a global level, the near-term macro impact is clear. This is a stagflationary shock. Higher energy prices act as a tax on households and businesses. Real incomes are squeezed, margins come under pressure, and confidence weakens. At the same time, headline inflation rises as fuel and transport costs feed directly into consumer prices.

What matters most, however, is the timing. In the short term, the shock is inflationary. Inflation prints rise and expectations become harder to anchor. In the medium term, persistently high energy prices erode demand, acting as a disinflationary force through weaker activity.

What makes this episode more challenging is the growing risk that supply disruption is not temporary. If damage to energy infrastructure proves persistent, the inflation impulse becomes less transitory and more embedded.

That tension is now front and centre for central banks, and it was evident in last week's policy meetings. The key takeaway is not what central banks did, but how they communicated. There is a clear reluctance to react mechanically to a supply-driven inflation shock, but also a growing unease about allowing another inflation impulse to take hold.

Central banks will typically look through the first-round effects of higher oil prices on headline inflation. The real concern is the potential for second-round effects, where higher energy costs feed into wages, margins and broader pricing behaviour. That is where inflation becomes more persistent.

Closely linked is the behaviour of inflation expectations. Policymakers may tolerate some near-term volatility, particularly if clearly linked to energy prices. But they will be far less comfortable if longer-term inflation expectations begin to drift higher, as that would signal a loss of credibility in the inflation-targeting framework.

The result is a more cautious tone. Central banks are signalling that while they are not rushing to tighten, they are also less willing to commit to easing. The bar for rate cuts has moved higher. This doesn't imply a renewed hiking cycle. But it does suggest the path to lower rates for those with room to move such as in the US, will be slower, more conditional, and more uncertain than markets had assumed.

## **Market implications**

Markets have focused on the immediate moves — higher oil prices, firmer inflation expectations, and a shift to safe havens.

The more important question is what kind of environment this creates if disruption persists. A prolonged period of elevated and volatile energy prices points to higher macro volatility and higher risk premia. It complicates the disinflation narrative and introduces greater uncertainty around central bank reaction functions.

The escalation into direct attacks on energy infrastructure also reduces the market's ability to "look through" the shock. When disruption shifts from potential to realised. And when repair timelines extend over years, pricing a quick normalisation becomes much harder.

That is not an especially supportive backdrop for duration. The idea that bond yields simply fall because geopolitical events are "bad for growth" is too simplistic. When the transmission channel is energy and inflation, the rates market can tell a very different story.

For equities, this is likely to be an environment of greater dispersion and less index-level clarity. Relief rallies on signs of de-escalation are likely to be met with renewed volatility when tensions flare again.

From an asset allocation perspective, this reinforces the case for selectivity. Energy and commodity exposures are obvious relative beneficiaries. Real assets and inflation-sensitive exposures become more relevant. By contrast, parts of the market reliant on falling bond yields or strong discretionary demand look more vulnerable.

Periods of sustained energy insecurity have historically accelerated shifts in energy systems. This episode may ultimately expedite the transition away from fossil fuels, as countries and firms look to reduce reliance on geopolitically sensitive energy supply.

## **What it means for New Zealand**

For New Zealand, the transmission channel is straightforward. We are a price taker in global energy markets and a net importer of fuel. Higher global oil prices feed quickly into domestic fuel costs, lifting headline inflation and squeezing household budgets.

What makes this particularly challenging is the starting point. The economy had been showing early signs of recovery, but inflation remains near the top of the RBNZ's target band and inflation expectations have been sticky.

The war arrives at exactly the wrong time. In the near term, the impact is stagflationary: higher inflation alongside weaker growth. Fuel costs rise, while households have less capacity to spend elsewhere.

The effects are also felt more broadly across the economy, including in the agricultural sector. Higher diesel prices lift on-farm operating costs, while energy-linked inputs such as fertiliser, particularly urea, also become more expensive. That represents an additional squeeze on margins in a sector that is central to New Zealand's export base.

But, as with the global story, the medium-term outlook is less straightforward. If higher energy prices persist, the drag on demand may ultimately dominate, creating a more disinflationary impulse over time. That leaves the RBNZ facing a difficult trade-off. It cannot ignore another inflation shock but tightening into a weakening economy risks compounding the slowdown.

The outcome is greater policy uncertainty. The war reduces the scope for near term cuts on economic weakness, but the immediately higher inflation does not provide a clear case for sustained tightening either. In fact, the subsequent disinflationary impact will possibly shift out the timing of the next hiking cycle we had assumed would start around the end of this year.

For a small, open, oil-importing economy like New Zealand, this is exactly the type of external shock that creates uncomfortable policy trade-offs.

## **Back to transitory vs persistent**

The real question is whether this proves to be a temporary disruption or the beginning of a more persistent period of instability across one of the world's most important energy-producing regions. If it is short-lived, much of the impact will fade. But if disruption to energy supply and infrastructure persists, the implications are more significant: weaker growth, more persistent inflation pressures, and more cautious central banks.

For markets, that means higher volatility and less confidence in a smooth disinflation process. For New Zealand, it means an external shock arriving just as the economy was trying to recover, and a much more complicated path ahead for monetary policy.

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