



April 2026

Reflections & Insights

“If there’s anything more important than my ego around, I want it caught and shot now.”

“Anyone who is capable of getting themselves made President should on no account be allowed to do the job.”

– DOUGLAS ADAMS, THE HITCHIKERS GUIDE TO THE GALAXY

Frenetic is a word which has to do some heavy lifting to match the events of the last quarter. With it comes the knowledge that writing reviews like this is a hiding to nothing. By the time each paragraph is written, something else has happened, and the lines between truth and lie, fact and delusion are almost impossible to untangle.

Ordinarily, this wouldn’t matter terribly. These musings have had the luxury of being able to express views on geopolitics without worrying unduly about their effect on markets. There was a brief scare over tariffs a year ago, but after the realisation that TACO was not a foodstuff, it’s been *comme ci, comme ça*. Markets and the economy underpinning them have been broadly fine.

The question now is whether that cosy consensus is under threat. Reviews like this are supposed to take a position, and there will be practitioners of the art who do so and are correct, not because of unique analytical ability, but through having been in the right place when the weather changed.

What is going on could have profound implications for growth and inflation across the world, but equally, it may not. Which way the cookie crumbles doesn’t depend only on how long hostilities in the Middle East last, but also on the character of whatever peace emerges.

Rather than attempt to predict what will happen in the immediate future, this review will attempt to think about some of the long-term issues which have been thrown into relief by the conflict.

Firstly, attempting to bomb ‘back to the Stone Age’ a sophisticated society of 90 million people with a long history and embedded institutions, however repellent, is not going to work without committing war crimes and killing on an industrial scale. However many bombs the U.S./Israeli coalition drops, if Iran can use a single cheap drone to knock out shipping in the Strait of Hormuz, the conflict is more equal than it appears. Iran has also understood its power in ways it has previously doubted.

The same has been true of the conflict in Ukraine. On paper, the result was obvious, yet here we are, four years later, and the Ukrainians have rewritten the rulebook on asymmetric warfare. The implications of this are profound. Muscle-bound military might with expensive, inflexible hardware is not as useful as it seems. It can terrify people, but it can also lead to a quagmire, which holds political risks.

This has been compounded by a bewildering smorgasbord of supposed 'war aims' in Iran, which have been inconsistent and incoherent. If you are going to start a war, you need to know how to end it, without leaving an unholy mess. All of this means that the world is adjusting to the concept that the U.S. hegemon is neither invincible nor reliable.

A BROADENING OF ALLIANCES

Second, the breach between the U.S. and its democratic allies (as well as with those in the Gulf) will be very hard to repair. Ignoring the offensive rhetoric, the E.U. and the U.K. need to focus on their backyard. The strains on NATO, combined with U.S. unilateralism, will push the U.K. back towards the E.U., will accelerate the development of a credible arms industry and reinforce the need to support Ukraine. European tolerance of fifth columnists in its institutions (Hungary) will end, and populist right politicians will need to distance themselves from Trumpism. U.S. interference in European politics will be particularly unhelpful to those whom U.S. politicians wish to see in power. All this points to a drive for greater resilience, a broadening of alliances and a rapprochement with China.

Third, it is ironic that the country that has caused the spike in oil and gas prices is the least affected, because of its energy self-sufficiency and distance. While U.S. policy remains focused on fossil fuels, the interruptions to supply and huge price hikes can only accelerate the transition to a sustainable supply of energy in countries which are net importers. Of course, fossil fuels will continue to be part of the mix for years to come, but betting against solar, wind, and nuclear does not look like a good idea.

Energy is not the only area where the conflict has disrupted supply. Fertiliser, helium (used in both tech and medical settings) and many other industrial commodities have been affected by the closure of Hormuz and by Iranian attacks on Gulf infrastructure. Markets seem to expect supply to revert to normal when Trump calls a halt to proceedings, but that is not going to happen. Qatar has explained that the damage to the world's largest LNG plant will take several years to repair.

Central banks have generally thought that price hikes, which result from a temporary interruption of supply, do not require a muscular monetary response. This is an area where U.S. and EU policy is likely to differ, with a greater tolerance for inflation in the U.S. than in the E.U. The inflation shock is also going to affect prices across the supply chain, including food, packaging and a host of intermediate effects. As ever, the real pain will be felt by the weakest, and this may have political ramifications.

Fourth, while China is following the Napoleonic dictum of not interrupting its enemy while it's making a mistake, it is reliant on oil from the Gulf. Despite large reserves at home, it needs a resolution to the conflict in the medium term. The country is positioning itself as a reliable partner and a clear alternative to U.S. hegemonic ambition. In the geopolitical sense, China is on the right side of history in this conflict. This will have long-term consequences for Asia, but will also help to pull the rest of the democratic world more into the Chinese orbit. Some of this draw is through choice, some through necessity, given Chinese leadership in renewable energy and EV's. India's star will also rise.

RESILIENCE AS AN INVESTMENT THEME

Fifth, resilience will become one of the major investment themes of the next decade. Events have shown that a higher degree of independence among like-minded nations is essential. The complex interdependence which has characterised the globalisation of recent decades is now being questioned. In the aftermath of tariffs, global trade has not shrunk, but has shifted as manufacturing aligns with the signals given by what are, in essence, arbitrary taxes – for example, India's trade with the U.S. has exploded because iPhones are now made there. These shifts will continue, even as coalitions of countries seek to ensure the security of supply of key goods closer to home. In this context, the U.K. has no choice but to get closer to Europe.

Sixth, don't write off the U.S. from an investment perspective. As we have observed, nobody knows what will happen in the Middle East, whether the next target is Cuba or if Greenland is no longer on the menu. Despite all the uncertainty, the political winds are indicating change, perhaps as soon as November, when the mid-term elections take place (assuming they do). The U.S. remains a dynamic, flexible economy with many of the most impressive companies on the planet. In many cases, these are global businesses which just happen to be based in the USA. Current economic conditions are just about okay there, but the truth is that nobody knows how significant the inflationary (and monetary) impact of the Iranian war will be, or whether it will tip a somewhat fragile economy into recession. If it does, that recession will be mitigated by the vast capital spending which supports the AI industry. At the same time, earnings growth has been excellent and valuations, while still high, are back in touch with reality. It is noteworthy that the PE on NVIDIA is now lower than Exxon's.

Seventh, the implications for markets elsewhere are more complicated. Europe and Japan are more vulnerable than the U.S. to supply shocks and generally have stretched fiscal positions. Bond markets will not be forgiving if governments or Central Banks show signs of letting inflation rip, but we already see signs of political pressure to 'do something' about energy costs. Emerging markets are heterogeneous, with some cruelly exposed and others insulated. All in all, a mixed bag.

If we weren't writing about the current mess, we would probably be focusing on risks in private credit markets, whether AI investment is going to produce a return for its backers and the risks to the tech giants of their 'Big tobacco' moment. The conclusions would probably be to advise caution, but to say that the investment weather is broadly okay.

Of course, we aren't doing that. Instead, it may be very boring, but when you look across the confusion which reigns today, there is only one investment approach which makes sense.

Diversification. This is not just about diversification across equity markets, but also the need to put in some inflation protection (TIPS or index-linked gilts), and to make sure that your advisers are thinking not just about AI but also about resilience. The war in Iran is a wake-up call which throws a number of lazy assumptions into relief. While it would be wonderful if the combatants packed up their kit and went back to what they were doing before, it is becoming clear that when the fog lifts, the landscape is going to look different.

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