

Global Asset Allocation Team

When does an energy shock become a macro scenario?

The defining investment question today is not whether energy prices are high. It is whether the shock remains confined to commodity markets or begins to alter economic behaviour.

Markets have spent much of the year reacting to headlines from the Middle East and the resulting increase in oil and gas prices. Yet history suggests that the initial shock rarely determines the final outcome. What matters is the transmission mechanism. A temporary rise in energy prices can affect inflation expectations and market sentiment without materially changing growth. A persistent shock, however, can trigger a broader adjustment in consumption, investment, hiring and credit conditions. However, the distinction is not simply a matter of time. It depends on whether the shock begins to alter economic decisions.

For that reason, our focus is on monitoring the transmission channels that connect market developments to real economic activity. Our scenario framework is built around transmission channels rather than market moves. The key question is not where oil trades next month, but whether higher energy costs become restrictive enough to materially tighten financial conditions and weaken demand.

Our central scenario remains one of resilient expansion. In this environment, the energy shock persists but remains contained. Higher oil prices keep headline inflation elevated and encourage central banks to maintain a restrictive stance for longer. Growth momentum slows somewhat, but the transmission stops there. Consumption remains resilient, corporate earnings continue to expand, investment broadens beyond technology-related spending and credit remains available at attractive conditions. Financial conditions stay supportive despite higher policy rates, allowing the global economy to continue expanding around potential. The shock acts as a headwind on activity, not a catalyst for contraction.

Base

Resilient Expansion

Contained but persistent energy shock → restrictive-for-longer policy → slower momentum → resilient demand, earnings and credit → **continued expansion**

The upside scenario emerges if energy uncertainty begins to normalise. The important development is not simply lower oil prices, but a reduction in the inflation constraint. As energy pressures fade, headline inflation moderates without requiring weaker demand. Central banks gain greater flexibility to pause tightening, policy uncertainty declines and confidence improves. This improvement in confidence becomes a powerful transmission channel, supporting a broader recovery in investment and earnings across sectors and regions. In this scenario, expansion strengthens not because demand suddenly accelerates, but because one of the main constraints on growth is gradually removed.

Upside

Goldilocks Expansion

Energy normalisation → lower inflation pressure → reduced monetary-policy constraint → improving confidence → **broader earnings and investment**

The most relevant downside risk is not a traditional demand-led recession. Instead, it is a policy-driven slowdown. In this scenario, energy prices remain high enough to keep inflation uncomfortable but not high enough to create a severe physical supply shortage. Concerned about inflation persistence, central banks maintain restrictive policy for too long relative to underlying demand conditions. The transmission chain becomes progressively more damaging: higher real rates weaken confidence, weaker confidence slows consumption and investment, capital expenditure plans are revised lower, hiring slows and earnings expectations deteriorate. Credit spreads gradually widen and financial conditions tighten. The economy eventually slows not because energy prices directly destroy demand, but because policy restraint progressively transmits through the real economy.

Downside

Restrictive Policy & Slowdown

Persistent inflation pressure → policy remains too restrictive → confidence and demand weaken → earnings, capex and hiring revised lower → **tighter financial conditions**

The tail scenario is fundamentally different. Here, the shock originates from a sustained physical disruption to energy supply rather than from elevated risk premia. Extreme energy prices generate simultaneous pressure on household purchasing power and corporate margins. Central banks remain constrained by inflation while real incomes decline. The combined effect produces a sharp tightening in financial conditions, deteriorating credit dynamics and a severe slowdown in activity. Importantly, this is not a permanent stagflation outcome. The sequence is inflation first, demand destruction second and eventual disinflation later.

Tail

Energy Shock & Recession

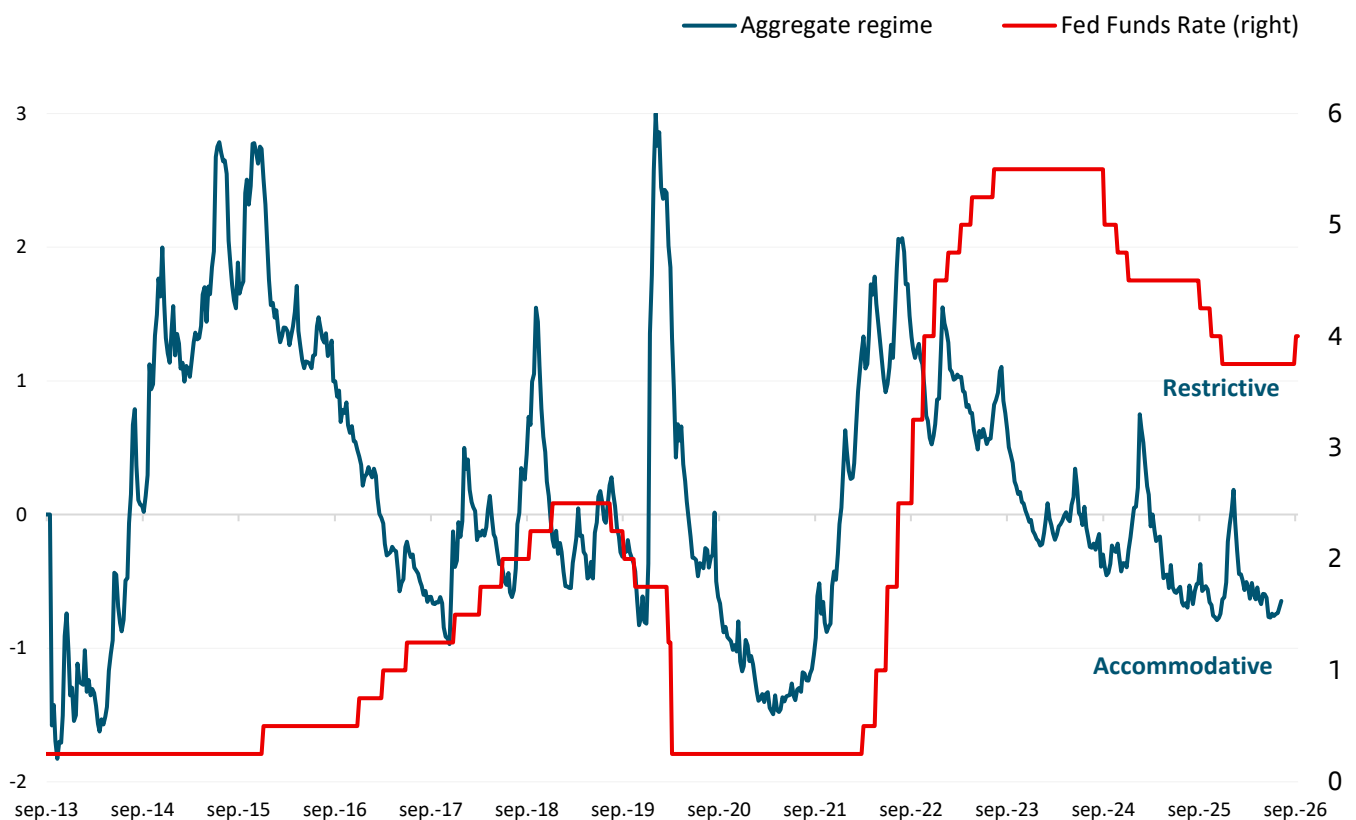
Physical supply disruption → extreme energy prices → real-income and margin shock → sharp tightening in financial conditions → **severe slowdown and later disinflation**

The distinction between these scenarios therefore lies not in the initial shock, but in how far the shock travels through the economy. We monitor a specific set of indicators to assess whether transmission is occurring: earnings revisions, capital expenditure intentions, hiring trends, credit availability and broader financial conditions. These variables sit at the critical intersection between markets and the real economy. They tell us whether a supply shock is remaining a market event or becoming a macroeconomic process. For example, despite higher policy rates and rising bond yields, financial conditions have remained broadly accommodative, helping support economic activity and earnings.

Graph 1. Central Banks' tightening does not imply a direct tightening of financial conditions

Aggregate financial conditions vs. the Fed policy rate

Source: Santander Asset Management & Bloomberg



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