From the Desk of the
Chief Economist

BANK ISLAM

Economic Research

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Imran Nurginias Ibrahim | Chief Economist | inurginias@bankislam.com.my
Farah Zazreen Zainudin | Economist | fzazreen@bankislam.com.my
Nor Lyana Zainal Abidin | Economist | nlyanaz@bankislam.com.my
Khayrin Farzana Fazli | Economist | kfarzana@bankislam.com.my

INTENSIFYING GLOBAL HEADWINDS AS U.S.-ISRAEL AND IRAN COLLIDE

- Over the past five days, the U.S. and Israel have struck an array of military and infrastructure targets across Iran. Iran's Supreme Leader Ayatollah Ali Khamenei was killed along with many other senior leaders. Iran retaliated against US military assets in the region, Israel and other infrastructure assets across the region, including Dubai's airport. President Trump has stated that combat operations will "continue until all of our objectives are achieved", without elaborating beyond an initial projection of "four to five weeks". Comments from Israeli Prime Minister Benjamin Netanyahu also alluded to military strikes increasing in intensity in "coming days".

RAPID ESCALATION AND HORMUZ BOTTLENECK

- The U.S.–Israel attack on Iran and Iranian response has disrupted shipping in the Persian Gulf and spiked oil prices. The all-important Strait of Hormuz is basically closed to oil, LNG and container trade. A few ships have reportedly been hit, and existing insurance policies have been revoked. Even if this proves short-lived, high insurance costs could prevent any quick resumption in transit. The conflict has also shut all air traffic across the region, affecting global passenger travel and freight. The broader economic impact is highly uncertain, depending on how long the hostilities last and whether there is lasting damage to transport infrastructure.

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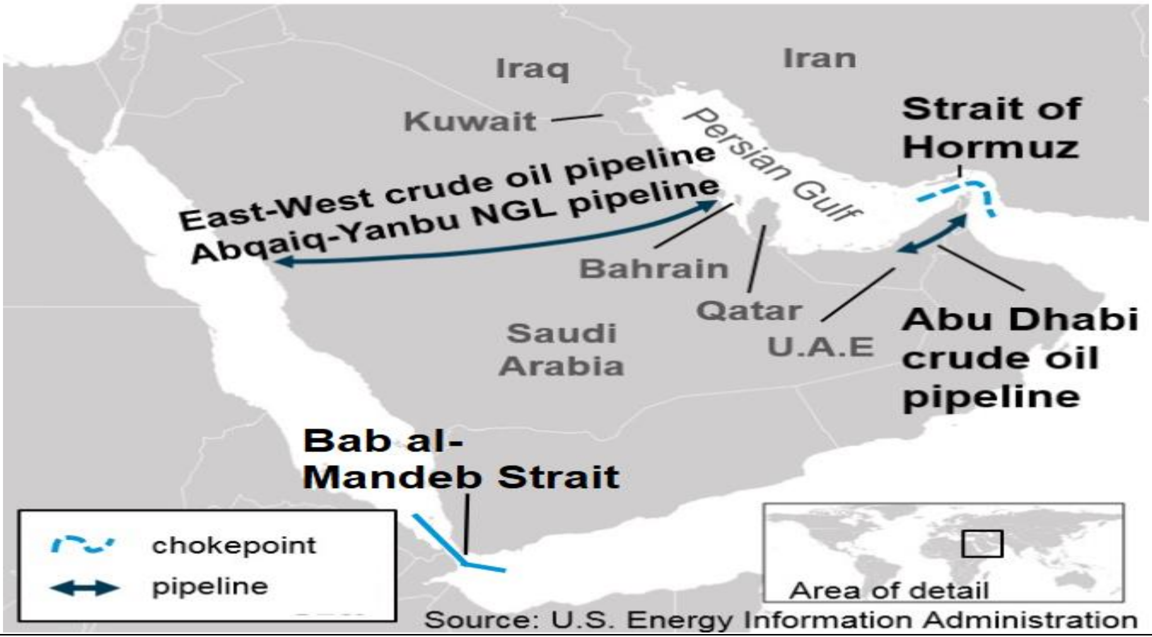
- A rapid escalation in U.S.–Iran hostilities has raised the probability of severe disruption at the Strait of Hormuz, the main sea exit from the Persian Gulf, directly affecting producers of crude, condensate, refined products, and LNG. The large and sudden oil and gas production losses like the 1978–79 Iran Revolution, 1990 Gulf War, and 2022 Russia-Ukraine can tighten energy markets and trigger nonlinear price movements due to: 1) short-run oil demand and supply being inelastic; 2) limited inventory and spare capacity; 3) risk premium due to uncertainty over escalation.

THE CLOSURE OF THE STRAIT OF HORMUZ

- The Strait of Hormuz is one of the world's most critical energy chokepoints, connecting the Persian Gulf to the Indian Ocean, with Iran to the north and the UAE and Oman to the south. Although the waterway is almost 100 miles long, it narrows to roughly 21 miles at its tightest point, with shipping lanes in each direction only about two miles wide. Its shallow depth makes vessels vulnerable to naval mines, while its proximity to land exposes shipping to shore-based missiles, drones, fast patrol boats, and helicopter interdictions.

Chart 1: Strait of Hormuz



Sources: EIA, Bank Islam

- From an energy perspective, the strait is indispensable. In 2025, tankers transported an estimated 16.7 million barrels per day (mb/d) of crude oil and condensates through Hormuz, primarily from Saudi Arabia, Iraq, Kuwait, the UAE, and Iran. The strait is equally critical for natural gas markets: nearly one-fifth of global LNG supply, largely from Qatar, transited the same route.

- The Strait also holds high importance in containerized trade traffic, with over 30 million TEU of containerized port traffic travelling within the route, according to the United Nations Conference on Trade and Development (UNCTAD), signaling large transshipment activity in the waterway. There is no comparable alternative sea route capable of absorbing this volume in the event of prolonged disruption.

- The economies most exposed to Hormuz disruption include:
    - **Asia:** China, Japan, South Korea, and India—highly dependent on Gulf crude and LNG.
    - **Europe:** Particularly LNG-importing nations relying on Qatari supply.
    - **Emerging Markets:** Energy-importing economies with limited fiscal buffers.

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IMPACT ON OIL PRICE

Chart 2: Volume of Total Flows through the Strait of Hormuz, million b/d

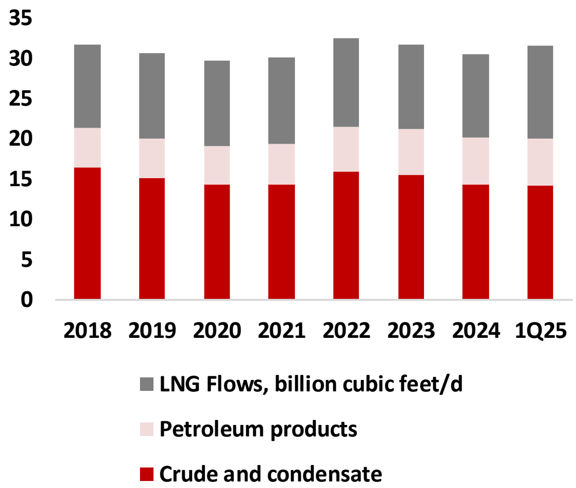

Table 1: Volume of Total Flows through the Strait of Hormuz

	2018	2019	2020	2021	2022	2023	2024	1Q25
Total Oil Flows, million b/d	**21.4**	**20**	**19.1**	**19.4**	**21.4**	**21.4**	**20.3**	**20.1**
Crude and condensate	16.5	15.2	14.3	14.4	16	15.5	14.3	14.2
Petroleum products	4.9	4.9	4.8	5	5.5	5.8	5.9	5.9
LNG Flows, billion cubic feet/d	**10.3**	**10.6**	**10.7**	**10.7**	**11**	**10.5**	**10.3**	**11.5**

Sources: EIA, Bank Islam

- **The intensity is high and the endgame uncertain.** Oil prices will largely depend on the duration and severity of the conflict, particularly whether it leads to disruptions in production or shipping through critical energy routes. If the conflict proves short-lived, similar to the brief flare-up in mid-2025, oil prices would likely retreat quickly after the initial spike and return close to their pre-escalation average of around USD65 per barrel. Under such circumstances, the broader global economic impact would likely be limited, with only negligible effects on trade, inflation, and financial markets.

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- However, recent developments suggest the risk of a more prolonged escalation, which could alter market expectations. If tensions intensify or persist for several weeks, investor anxiety would likely rise, and a geopolitical risk premium could push Brent crude toward the USD90–USD100 range. In this environment, global equities and pro-risk currencies would likely come under pressure, while inflation risks could re-emerge due to higher energy costs.

- Given the uncertainty surrounding the conflict, three illustrative scenarios can help frame potential outcomes:
  1. A disruption limited to Iranian oil production could lift Brent prices to around USD90–USD100 per barrel. In this case, market pressures may prove temporary as inventory drawdowns, the potential release of strategic petroleum reserves, or increased output from other producers help offset supply losses. The effects on LNG markets, container shipping, and air transport would likely remain short-lived.
  2. If shipping through the Strait of Hormuz were disrupted for up to one month, Brent prices could spike to around USD120 per barrel, reflecting the strategic importance of the route through which roughly a fifth of global oil and gas flows.

3. A prolonged disruption lasting three months or more could push Brent prices above USD150 per barrel, significantly amplifying the economic impact. Such a scenario would likely trigger broader supply-chain disruptions, given the interconnected nature of global trade, manufacturing, and energy logistics.

- Importantly, these scenarios assume temporary supply disruptions without permanent damage to oil and LNG production facilities or freight infrastructure. A lasting loss of production capacity would extend the shock and deepen its economic consequences, not only through higher energy prices but also through persistent supply shortages across multiple sectors.

- From a policy perspective, such developments would primarily represent a temporary supply shock, raising price levels rather than creating sustained inflation. Central banks typically look through short-term energy shocks. However, if elevated oil prices persist, policymakers would need to carefully balance the risk of rising inflation expectations against the potential drag on economic activity. Authorities would also closely monitor the degree of cost pass-through into broader inflation, as prolonged energy price pressures could reinforce the risk that global inflation remains higher for longer.

IMPACT ON GLOBAL MACROECONOMIC CONDITIONS AND FINANCIAL MARKETS

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Chart 3: Global Growth, y-o-y%

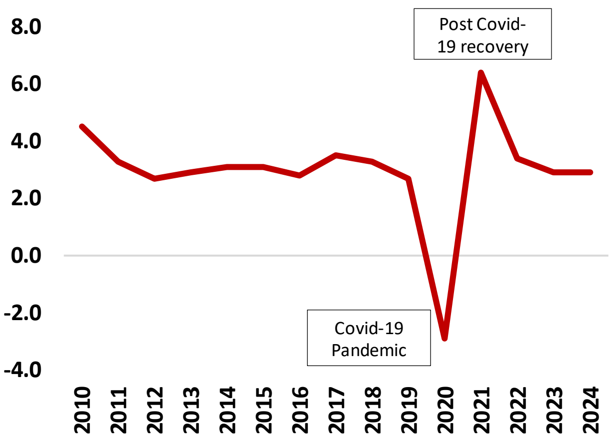
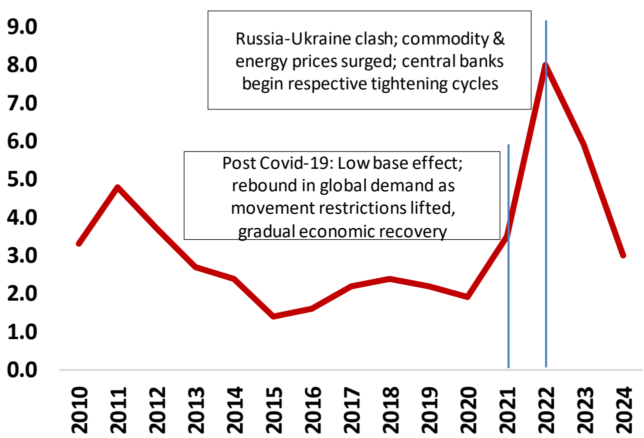


Chart 4: Global Inflation, y-o-y%



Sources: World Bank, CEIC Data, Bank Islam

- The escalation of conflict between U.S./Israel and Iran risks delivering a meaningful shock to the global economy, which is already contending with the effects of earlier tariff increases. Higher oil prices would feed quickly into headline inflation through petrol and transportation costs, while also exerting indirect pressure through energy-intensive goods and services. Elevated inflation would erode real household disposable income, dampening consumption, while rising input costs could weaken corporate profitability and investment. At the same time, slower global growth would weigh on external demand and exports, with any decline in imports providing only a partial offset to the broader drag on economic activity.

- More broadly, a prolonged conflict in the Middle East could generate a stagflationary impulse by simultaneously lifting inflation while weighing on global growth. Higher energy prices would exert upward pressure on near-term inflation, while increased uncertainty, weaker purchasing power, and rising production costs would constrain economic activity. Ultimately, the scale of the macroeconomic impact will depend critically on the breadth and duration of the conflict, particularly whether disruptions to energy supply and trade routes become sustained.

- One of the most notable shifts has occurred in financial market expectations for monetary policy. Traders have begun scaling back expectations for interest-rate cuts by the Federal Reserve as the conflict raises concerns about a renewed inflation impulse driven by higher oil prices. The prospect of a "war-induced" inflation spike has led markets to reassess the likelihood of near-term easing, with futures pricing now indicating a higher probability that the Federal Reserve will keep rates unchanged rather than proceed with earlier anticipated cuts. This reflects growing caution among policymakers, who may find it more difficult to look through energy-driven inflation if it risks unanchoring inflation expectations.

Chart 5: Monthly Gain/Loss of Major Equity Market, m-o-m%

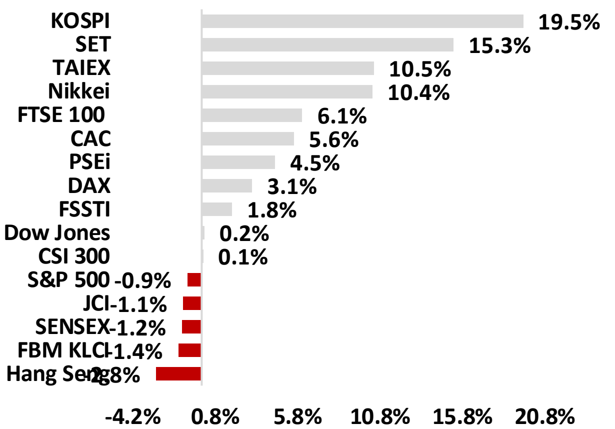
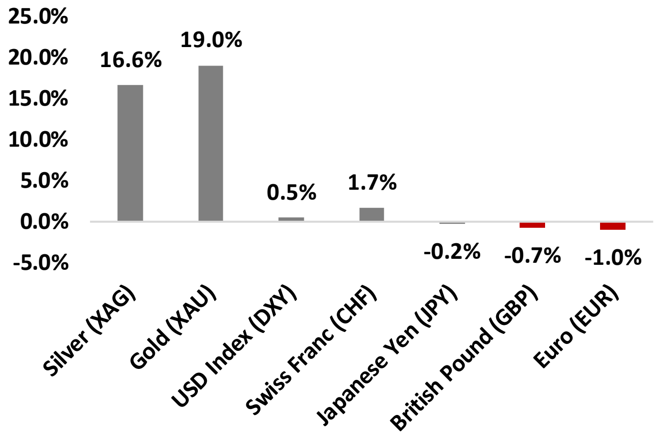


Chart 6: YTD Performance of Selected Currencies, (as of 4 March 2026)



Sources: Bloomberg, CEIC Data, Bank Islam

- Additionally, heightened risk aversion triggered by the conflict unsettled global markets, providing a catalyst for the USD to break above the immediate resistance level of 98.0 and sustain its rebound above that zone. The imminent inflationary risk would necessitate a higher for longer stance by the U.S. Federal Reserve (Fed), causing markets to swiftly recalibrate their policy expectations. According to the CME FedWatch tool, the probability of a Fed cut has been delayed to July at the time of writing. The heightening tensions, with the increasingly probable scenario of a broader regional conflict, and the hawkish Fed bets thus underpinned the USD's appreciation. Looking ahead, momentum now is skewed towards a bullish run, and the USD is expected to test the key resistance level at 99.00. Should the currency sustain above this level, the next immediate resistance appears around the 99.50 zone.

- Meanwhile, the gold price (XAU) has been on a roll since 2025, gaining bullish momentum on prolonged global policy uncertainties. Following the joint U.S.-Israel attack on Iran and the subsequent retaliatory strikes, XAU surged to the highest point since January (2 March: USD5,419). Nevertheless, it slid just a day later as it broke below the immediate support at 5,330 and fell through consecutive support zones. The drop effectively neutralized the immediate bullish momentum and the XAU slid past the crucial support of 5,000 to close at USD4,996.58 on 3 March. Despite the rising risk premia, the dominance of the USD won over the XAU. Looking ahead, geopolitical concerns will provide crucial support as investors continuously reassess and recalibrate their holdings amid the evolving situation.

- **Risk Assets:** Equities underperform, particularly in energy-intensive and consumer-facing sectors, as risk aversion grows.
- **FX:** USD strengthens on safe-haven flows; Similar appreciation will be observed across traditional safe-haven assets; EM currencies face depreciation pressures.
- **Bonds:** Short-dated government bonds benefit initially, but long-end yields rise as inflation premia increase.
- **Commodities:** Energy outperforms; industrial metals soften amid growth concerns.
- **Yield Curve Dynamics:** Financial markets would likely exhibit a two-phase response:
  1. **Initial phase:** Flight-to-safety supports short-dated government bonds.
  2. **Persistence phase:** Rising inflation premia and fiscal concerns drive bear steepening, with long-end yields rising more sharply.

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IMPACT ON MALAYSIA

- For Malaysia, the economic impact is likely to remain contained provided the conflict does not become prolonged or materially disrupt key shipping routes. Nonetheless, near-term financial market volatility cannot be ruled out. Market participants are expected to remain highly sensitive to movements in Brent crude prices, geopolitical developments, and shifts in global risk appetite. The direction of the ringgit, in particular, will depend on the relative dominance of opposing forces: higher oil prices, which could support Malaysia's external position, versus broader risk aversion and US dollar strength. Much will hinge on the duration and intensity of the conflict.

- Additionally, Malaysia's diversified trade portfolio and entrenched trade corridors across major markets provided a crucial buffer against bilateral trade tensions, enabling the country to benefit from trade diversion. Thus, despite the broadening conflict in the Middle East, export flows remain anchored in other regions which would help Malaysia to withstand the transmissions of trade shocks. Malaysia's trade performance held firm in 2025 despite mounting external pressures, underscoring the country's deep integration within global supply chains and competitive strengths in electronics, advanced manufacturing, and technology-driven exports.

Chart 7: Share of Exports to the U.S., %

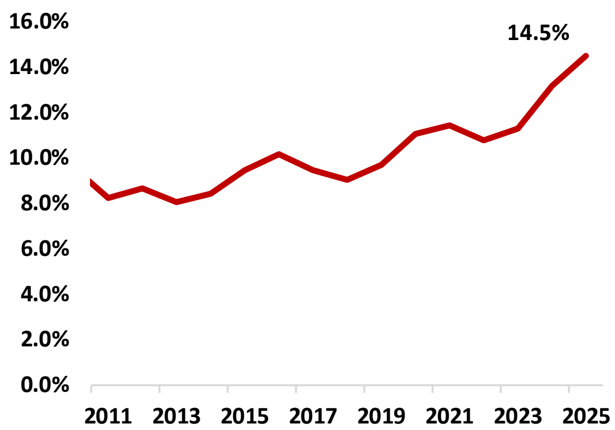
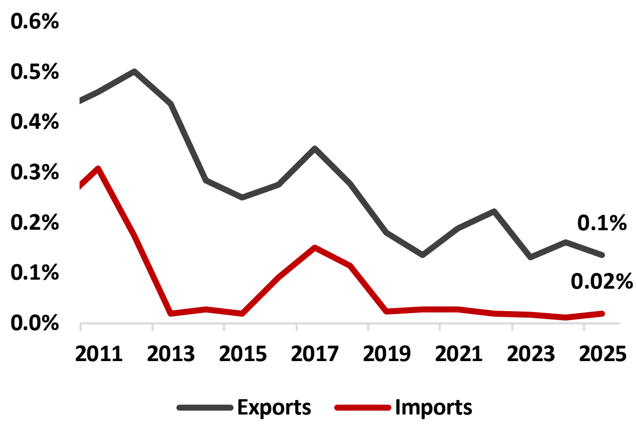


Chart 8: Share of Exports and Imports to Iran, %



Sources: Department of Statistics Malaysia (DOSM), CEIC Data, Bank Islam

- Nevertheless, Malaysia's openness also poses as a potential risk, making it vulnerable should the conflict deteriorate further or extend for longer than expected. Disruptions of trade flows and regional unrest would spill over into deeper global supply chain disruptions. Another key risk emerges from potential U.S. trade barriers against countries trading with Iran. To date, U.S. President Donald Trump has signed an executive order that could impose a 25% tariff on countries that "directly or indirectly purchase, import, or otherwise acquire any goods or services from Iran."

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- As of 2025, Malaysia's imports from Iran remain relatively limited at RM279.3 million, accounting for less than 0.02% of all imports. Although the composition is marginal, it still places Malaysia on the radar at the receiving end of potential U.S. tariffs.

- Given the limited clarity surrounding the proposal, it remains uncertain whether the tariff would be layered on top of existing duties, including the current 19% tariff on selected Malaysian goods. Additionally, with the Supreme Court ruling against the reciprocal tariffs, Trump had enacted a global 10% tariff in its place, later to be raised to 15%. Nonetheless, little clarity has been given regarding the implementation of the measure and how it will interact with existing bilateral trade agreements, in which the previous tariff rates were already negotiated and agreed upon. Thus, coupled with the prolonged uncertainty, the potential U.S. trade sanctions could significantly weaken demand for Malaysia's exports.

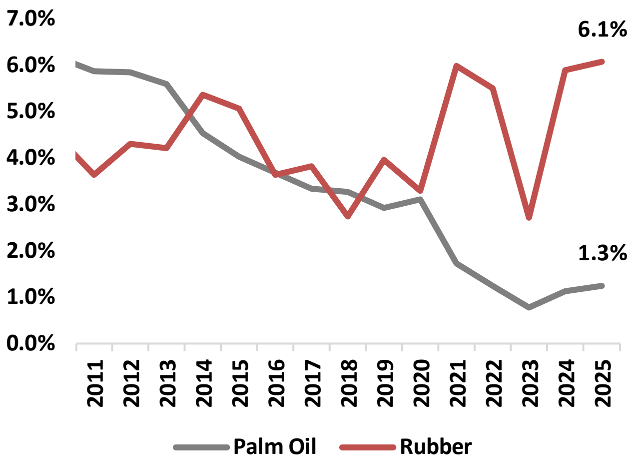
- Beyond trade barriers, the direct military confrontation would materially disrupt core economic operations in the U.S. and across regional economies, eroding both consumer and business confidence to undermine overall demand. The U.S. has solidified its position as one of Malaysia's top export markets over the past decade, with its composition of total exports rising to 14.5% from 9.5% between 2015 and 2025. Of this, machinery and transport equipment and miscellaneous manufactured articles account for the largest share. As such, easing external demand would in turn weigh on Malaysia's manufacturing and technology-intensive sectors, dampening business confidence and heightening downside risks to industrial production growth.

Table 2: Export Composition

Composition of Exports to U.S.	RM billion	% Share
Machinery and Transport Equipment (MT)	158.6	68.1%
Miscellaneous Manufactured Articles	45.5	19.5%
Manufactured Goods	14.7	6.3%
Food and Live Animals	4.7	2.0%
Chemicals	4.5	1.9%
Animal, Vegetable Oils and Fats	3.2	1.4%
Crude Materials Inedible	0.9	0.4%
Mineral Fuels	0.7	0.3%
Others	0.2	0.1%
Beverages and Tobacco	0.0	0.01%
Total	**233.1**	**100.0%**

Sources: DOSM, CEIC Data, Bank Islam

Chart 9: Share of Commodity Exports to the U.S, 2010-2025



- Meanwhile, Malaysia's exposure to Iran has been steadily diminishing (2015: 0.3%, 2025: ~0.1%), which places less severity on Malaysia's trade outlook from a deterioration in demand from Iran. Nevertheless, the key risk on this front remains from disruptions to trade flows through the Strait of Hormuz, which would spill over into Malaysia's economy through commodity price shocks and global demand dynamics.

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- Nevertheless, the most immediate consequence of a prolonged escalation involving the U.S.-Israel and Iran is a significant surge in global oil prices, with effects passing through the global economy, including Malaysia. These elevated energy costs would directly increase transportation and logistics expenses, which are likely to be passed on to consumers. The spillover effects, including higher food and goods prices are expected to intensify inflationary pressures within Malaysia.

- This transmission effect could push the overall inflation rate above 2.0% for the year, compounded by additional factors including the impact of import tariffs, the full implementation of the Sales and Services Tax (SST), and a low base effect. Should inflationary pressure accelerate beyond expectations and the domestic economy demonstrate sufficient resilience, there is a likelihood of a 25-basis point interest rate hike to contain inflationary pressures while supporting sustainable growth.

Chart 10: OPR vs. CPI Inflation

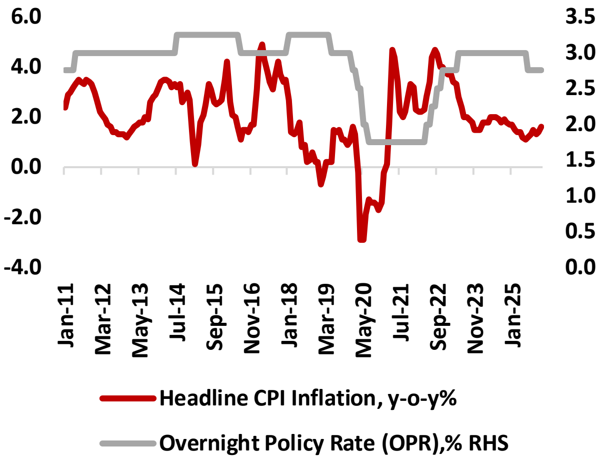
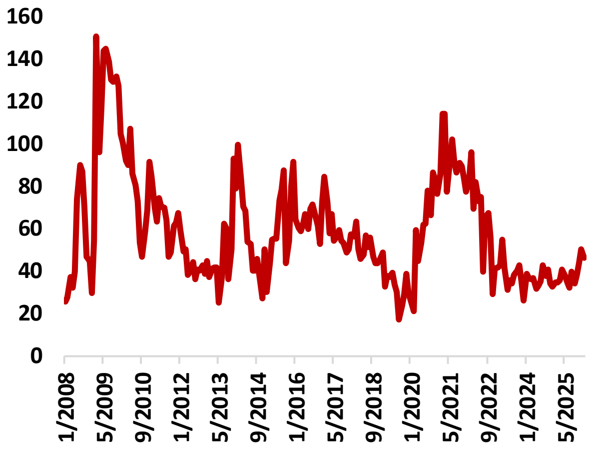


Chart 11: 10y/3y MGS yield spread, bps



Sources: Bank Negara Malaysia (BNM), Ministry of Finance (MoF), DOSM, Bank Islam

- **Financial markets:** Heightened global risk aversion could pressure the ringgit, increase market volatility, and tighten financial conditions.
- **Yields:** MGS curve likely experiences bear steepening, with long-end yields rising faster than the short end due to inflation and fiscal concerns. As for now, the 10y/3y MGS yield spread is still at a manageable level despite a very slight uptick in recent months.

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HOW HIGHER OIL PRICES COULD IMPACT MALAYSIAN GOVERNMENT FINANCE?

- Historically, Malaysia's fuel subsidies have proven highly sensitive to such price shocks. In 2022, fuel subsidies in Malaysia surged to RM52.0 billion when global crude oil prices surged above USD100/barrel, driven by a combination of post-pandemic demand recovery and reduced global oil supply, particularly amid geopolitical tensions between Russia and Ukraine. This amounted to 74% of total subsidies for the year. At the time, the average subsidy per litre for RON95 and diesel was RM1.34 and RM1.29, respectively.

- Based on this historical precedent, a sharp surge in oil prices above USD 100 per barrel, well above the government's official projection of USD 60-USD 65 per barrel for 2026, would likely exert significant pressure on government finances. In particular:
  - Increased fuel subsidy burden: Subsidy expenditure could rise substantially, potentially undermining the government's fiscal deficit target of -3.5% of GDP.
  - Pressure on policy measure: The government may face difficult trade-offs between containing inflation, maintaining social support, and safeguarding fiscal sustainability.
  - Revenue volatility: With oil-linked revenues and export receipts potentially rising in parallel with price spikes, fiscal planning becomes more uncertain, affecting debt management and allocation for development priorities.

Chart 12: Trend of Subsidy Outlays, 2000-2022

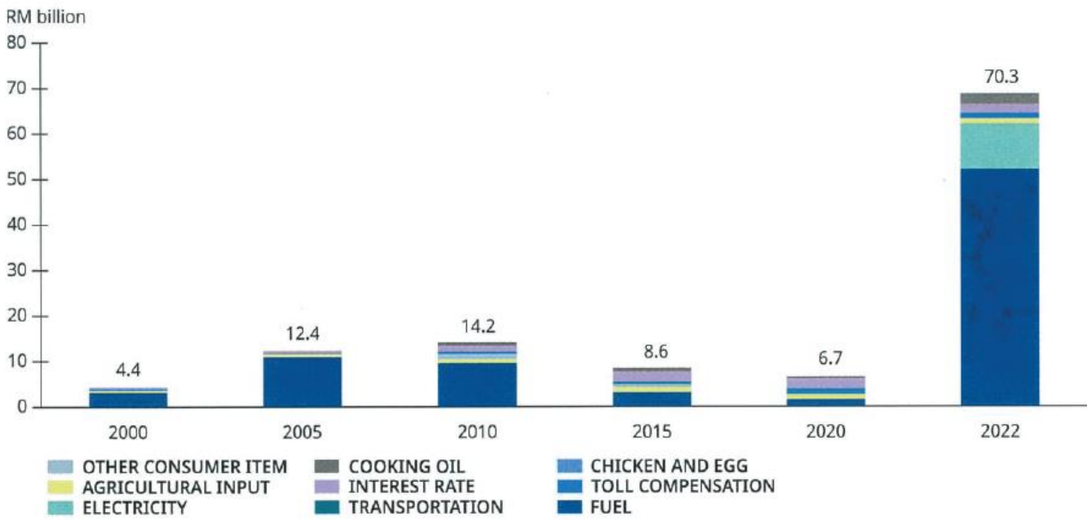
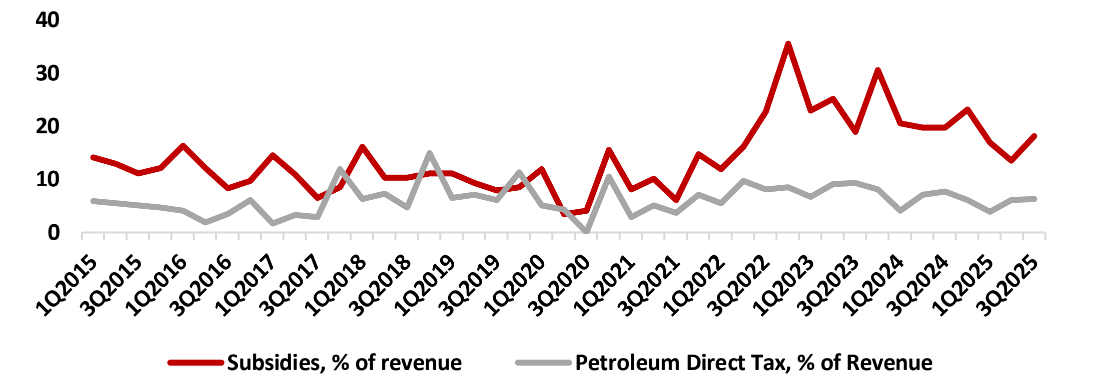


Chart 13: Subsidies and Petroleum Tax



Sources: Bank Negara Malaysia (BNM), Ministry of Finance (MoF), DOSM, Bank Islam

- Last year, under the BUDI MADANI (BUDI95) programme, which targets subsidies only to Malaysian, the government allocated approximately RM11 billion at USD70/barrel to cushion the difference between the subsidized pump price of RM1.99/litre and the market price (~RM2.60/litre).

Table 3: Estimated Unsubsidised Fuel Prices and Government Subsidy Burden

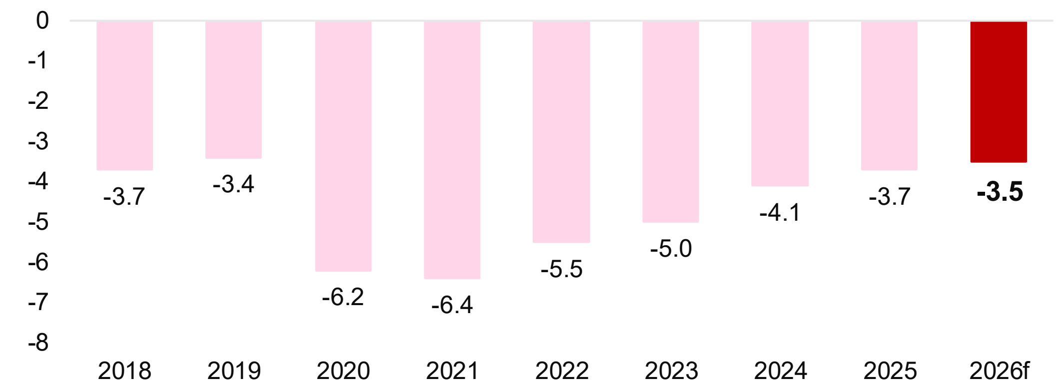
Brent Price (USD/bbl)	Unsubsidised Price (RM/litre)	Subsidy per Litre (RM)	Total Subsidy (RM Billion)
70	2.60	0.61	11
120	4.45	2.46	44

Sources: MoF, Bank Islam

- Assuming the unsubsidised pump price moves proportionally with Brent crude, estimated at RM0.037 per litre for every USD1 increase in Brent, a rise in global oil prices to USD120/barrel due to a prolonged U.S./Israel and Iran conflict in the Middle East could increase the subsidy requirement under BUDI95 to around RM44 billion. This would represent roughly a fourfold increase compared with the allocation when Brent is at USD70 per barrel.

- Although higher crude prices would normally boost petroleum-related revenues, particularly from PETRONAS dividends, the sharp increase in oil subsidies may offset these gains, exerting significant pressure on the government's fiscal deficit target of -3.5% of GDP and constraining resources available for development priorities.

Chart 14: Malaysia's Fiscal Deficit, % of GDP



Sources: BNM, MoF, Bank Islam

- Additionally, elevated energy costs would be transmitted through transportation and logistics channels, increasing the price of goods and intensifying inflationary pressures, potentially exceeding 2% for the year. Policymakers may therefore face challenging trade-offs between maintaining subsidies to protect households, containing inflation, and ensuring fiscal sustainability, highlighting the vulnerability of Malaysia's government coffers to sustained oil price shocks driven by geopolitical tensions. Moreover, long-term dependence on PETRONAS dividend is neither sustainable nor without risk, particularly as the global energy market increasingly shifts toward renewable sources.