

6 March 2026

Imran Nurginias Ibrahim
Chief Economist
inurginias@bankislam.com.my

Khayrin Farzana Fazli
Economist
kfarzana@bankislam.com.my

INTENSIFYING TENSIONS IN THE MIDDLE EAST BLEED INTO GLOBAL CURRENCY MARKETS

Conflict spread across the Middle East following U.S. and Israel's attack on Iran. On 28 February, Israel kicked off its Roaring Lion campaign with a pre-emptive strike on Iran with the U.S. joining the fray soon after. Dubbed the Operation Epic Fury, the first wave of strikes was targeted towards Iran's Islamic Revolutionary Guard Corps (IRGC) command-and-control nodes, missile infrastructure, and senior leaders. The strikes were swiftly met with retaliation as Iran launched a series of counterattacks across numerous U.S. military bases across the Middle East, including ones in Bahrain, Qatar, United Arab Emirates (UAE), Kuwait, Jordan and Saudi Arabia. Within hours of the coordinated U.S.–Israel strike, several senior Iranian leaders were reportedly killed, including Ali Khamenei, Mohammad Pakpour, Aziz Nasirzadeh and Ali Shamkhani, among others. The immediate aftermath triggered widespread disruption across regional aviation networks. Within hours, thousands of flights were grounded or prevented from departing across parts of the Middle East, while incoming aircraft were diverted or delayed as multiple countries closed their airspace in response to the rapidly deteriorating security environment. Beyond the targeted strikes on military installations, there were also widespread reports of damage to civilian infrastructure, alongside significant civilian casualties and injuries. However, amid the barrage of missiles lighting up the sky, these reports were slower to surface and be verified. As of 2 March, the Iranian Red Crescent informed that 555 people in 130 locations had been killed in Iran with more than 150 people, including children, were killed in a strike on a school in southern Iran close to an IRGC base. On the other side, six U.S. servicemen were killed, and eighteen others were injured while official Israeli spokesperson confirmed nine civilian deaths.

Global currency markets experienced sharp movements and heightened volatility amid escalating tensions between the U.S. and Iran. At the market open on Monday, investors rapidly shifted toward safe-haven assets as risk sentiment deteriorated. Gold (XAU), which had previously been consolidating around the USD5,100–USD5,200 range, surged to approximately USD5,419 as demand for defensive assets intensified. At the same time, the USD strengthened broadly, with the USD Index (DXY) decisively breaking above the key 98 resistance level. The move reflected a classic flight-to-quality response, as global investors sought liquidity and safety in dollar-denominated assets. Other traditional safe-haven currencies initially benefited from the surge in risk aversion, although much of the early gains faded in subsequent sessions as the USD emerged as the dominant safe-haven beneficiary.

In the week since the initial escalation, the conflict has broadened in scope and begun to affect critical regional infrastructure and global trade routes. The Strait of Hormuz—which sees around 20% of global oil trade flows—has been shut off. Commercial flights are limited and shipping companies reroute their trips to avoid the region. Governments worldwide have issued travel advisories urging citizens to avoid the region, while consular authorities have initiated coordinated evacuation efforts to ensure the safe departure of their nationals. Following

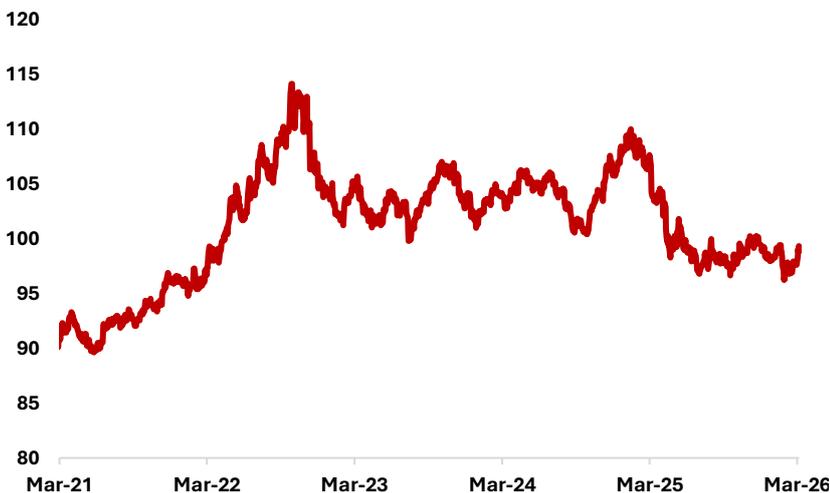
strikes on the U.S. embassy in Riyadh, the U.S. has suspended its operations as well as those in Kuwait and Lebanon.

Rising probability of Middle East countries switching into offensive. With Iran's strategy of offense geared towards crippling U.S. military bases in the Middle East, its neighbouring countries bear the brunt of its attacks. These countries have thus far been on the defensive lines, but prolonged and intensified attacks could potentially draw them into retaliatory strikes, culminating into a broader regional confrontation.

While traditional U.S. allies such as the United Kingdom (UK) and the European Union (EU) have so far appeared reluctant to support a full-scale war, a further widening of the conflict could place increasing pressure on them to adopt a clearer strategic position. Within the EU in particular, member states remain divided on the appropriate course of action, complicating efforts to forge a unified and coordinated response. On one end of the spectrum, Germany has signalled stronger alignment with the U.S. position. German Chancellor Friedrich Merz stated that Germany shares U.S. interests in curbing Iran's terror regime and preventing further development of "its dangerous nuclear and ballistic armament." Meanwhile, the UK and France have adopted a more cautious middle ground, emphasising the importance of diplomatic engagement and de-escalation. Spain holds a firmer stance, decisively rejecting the attacks and evicting U.S. military aircrafts from its bases.

The conflict appears to be expanding in scope, with little indication for a de-escalation on either front. What Trump estimated to be a four-week offensive has been extended to potentially over eight weeks, according to U.S. Defence Secretary Pete Hegseth. As of today, Israel has announced the next phase of attack while Iran remains steadfast. With the possibility of a prolonged confrontation, risk averse sentiments are expected to continue dominating investor portfolios. Safe haven holdings will be the favoured option while appetite for emerging market assets and more volatile holdings gradually becomes more subdued.

Table 1: USD Index (DXY)



Sources: Bloomberg, Bank Islam

US Dollar index climbed above 99.00 on multiple tails

Throughout the first two months of the year, the USD was under pressure as policy volatility and rising U.S.-specific risk premia turned investors away from the currency. Multiple attempts to break above the key resistance zone at 98.00 failed.

The Fed Factor: Nevertheless, expectations of the Federal Reserve (Fed) staying pat on its Federal Funds Rate (FFR) has kept the currency anchored above the 97.00-level. A consistent theme in the Fed's policy path is that the

central bank will do best in adopting a cautious and well-paced timing of cuts. This stance provided crucial guidance for investors amid the extended policy volatility, broader macro uncertainty and shifting balance of risks, maintaining the consensus that the Fed will likely pause in March. Incoming data then pointed towards a job market deterioration that is less severe than expected, albeit job growth still trending below average. The full conviction came from the January Federal Open Market Committee (FOMC) minutes where policymakers raised persistent inflation as the focal risk. Notably, the Core Personal Consumption Expenditure (PCE) inflation – the Fed's preferred gauge of underlying price pressures – has floated above 2.0% since March 2021, reinforcing the need for sufficiently restrictive rates to bring it down. Several policymakers believed that rates should be maintained unless there is clear evidence that inflation is firmly entrenched while some even voiced the possibility of rate hikes. The hawkish signals solidified investors' expectations that the Fed will extend its pause for longer. The final nail in the coffin was the official PCE inflation figures released just days later, with the core reading surprising to the upside (Jan 2026: 3.0% vs. Dec 2025: 2.8%). Following the back-to-back hitters, the probability of no cuts in March is fully priced in and a cut in April appears increasingly unlikely. As such, the USD gained modest support, keeping it anchored above the 97.00 after a brief slippage to the 96.00 zone on 11 February.

Revival of safe haven status: Following the sharp escalation of tensions in the Middle East, markets immediately flocked towards safe haven assets as risk aversion grew. Despite Trump's unpredictability and contradictory moves previously eroding the greenback's status, the renewed jitters overshadowed the earlier hesitance for USD holdings. From a technical standpoint, the USD approached the key resistance level at market open on 2 March, breaching decisively past 98.00. Following the breakout, the greenback proceeds to the next immediate resistance. Despite several attempts, the DXY fails to sustain above the 99.00. Nevertheless, with the possibility of a broader conflict and heightened expectations of a higher for longer Fed, the USD may yet generate enough bullish momentum to top the level. The currency is last seen trending around 98.95.

Inflation Resurgence: Another significant tailwind for the USD emerges from the elevated oil price. The oil price skyrocketed in the past week, trending between USD80-85 bbl. Military activity in the region would raise the security premia for transportation, significantly constraining the flows of oil through key transport channels. Further exacerbating the situation, Iran has announced the closure of the Strait of Hormuz and threatening action on any vessels passing through. Amid the supply shock, oil price is anticipated to remain elevated which would feed into underlying price pressures globally. The resurgence of price pressures will raise costs for businesses, which could ultimately spill over to consumers and create an environment characterised by heightened inflationary risks. Major central banks, many of which had previously concluded their battle against inflation, may be forced to reassess their policy trajectories. In particular, higher inflation expectations could further delay the Fed's policy easing cycle. Markets have swiftly recalibrated their expectations, with the anticipated pause in rate cuts now extended to at least June. According to the CME FedWatch Tool, the probability of a rate cut in June has fallen sharply to around 30.0%, down from 40.5% just a week earlier.

At the current juncture, the USD is likely to sustain its bullish momentum with multiple tails supporting the uptrend. In the near term, the USD will likely test the 99.00 resistance. Should the currency sustain above this level, the next key resistance will emerge around the 100.00 zone.

Table 2: Gold (XAU)

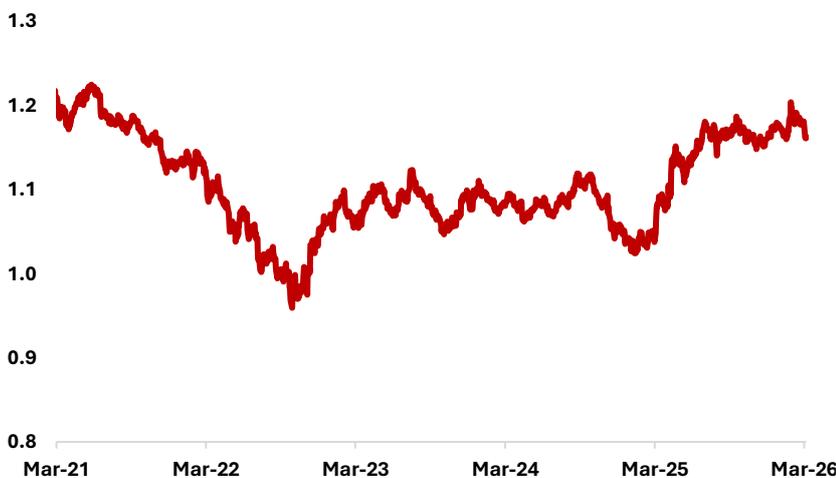


Sources: Bloomberg, Bank Islam

Gold price surged above USD5,400 before a sharp correction sets in

Similarly, gold price jumped on 2 March to close at USD5,419.11, the highest level since January 2026. However, the XAU experienced a deep correction just a day later as it opened lower at USD5,335 before breaking below the key support level at 5,300. With the crucial support broken, the XAU subsequently slid lower past consecutive levels, touching a low of USD4,996. In the following days, the XAU failed to regroup its bullish momentum, trading with a subdued bias between the 5,050-5,200-level.

Table 3: Euro (EURUSD)

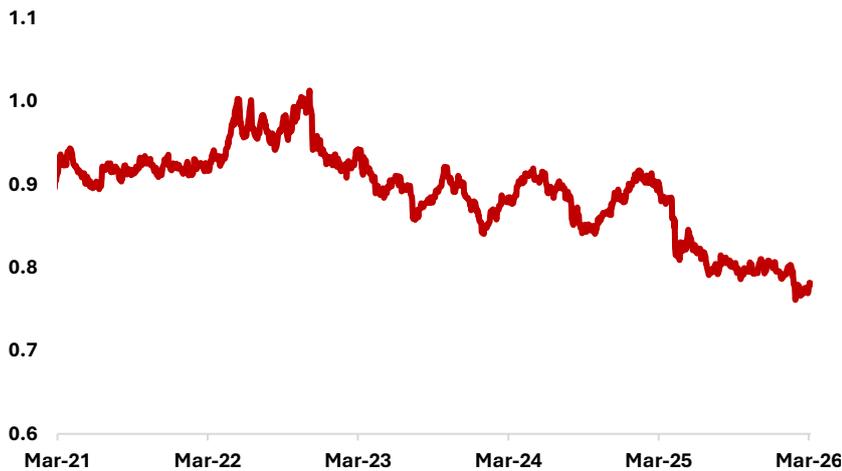


Sources: Bloomberg, Bank Islam

EUR depreciated against the USD appeal

It was a balancing act for most safe haven currencies, weighing between the USD strength and their own safe haven draw. The Euro (EUR) lost out to the USD with the EUR/USD currency pair slipping below the 1.17 support floor to close at 1.1688 on 2 March, the lowest since mid-January. On 4 March, the EUR broke the support floor of 1.16, briefly touching the lowest point of 1.1530. Beyond geopolitical concerns, the EUR was under pressure on expectations of a steady European Central Bank (ECB), taking cues from the moderating inflation and firm labour market conditions. However, the resurgence of inflationary pressures could necessitate additional tightening over the horizon. Be that as it may, any further rate hikes would likely materialise toward the latter part of the year, pricing in the lagged impact of higher oil prices and how it materializes into inflation. For the remainder of the week, the EUR traded within the 1.1550-1.1650 range. In the near term, the EUR/USD is expected to trade with a mildly bearish bias around the 1.15-1.17 range.

Table 4: Swiss Franc (CHF)

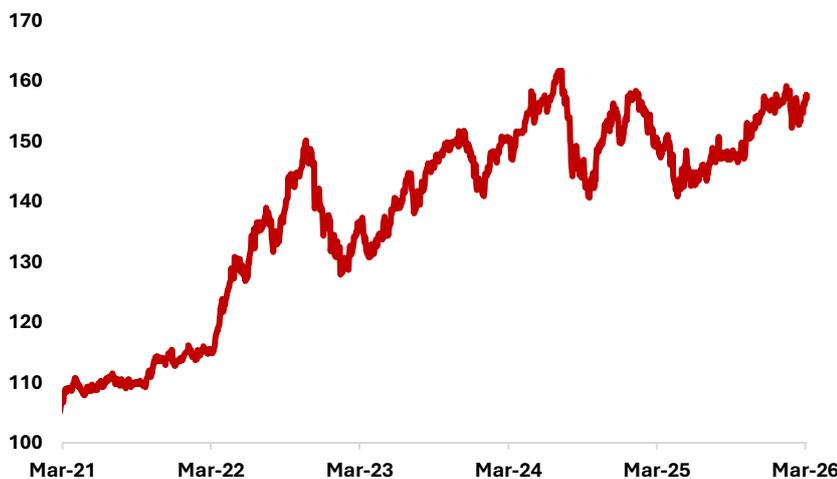


Sources: Bloomberg, Bank Islam

Swiss France depreciated

The escalation of U.S.-Iran tensions would traditionally narrate that safe haven flows support the Swiss Franc (CHF). However, as the conflict broke out, demand became increasingly skewed for the USD, exerting pressure on the CHF. The USD/CHF pair climbed above the immediate resistance around 0.77 on 2 March, sustaining above this level on the first trading day of the week. Nevertheless, the currency pair failed to maintain its break above the 0.78-level in the following days. Should the USD/CHF sustain a break above this level in the coming days, this would reinforce its bearish momentum.

Table 5: Japanese Yen (USDJPY)



Sources: Bloomberg, Bank Islam

JPY extended its bearish slide; oil supply disruptions to weigh on growth

USDJPY currency pair was more volatile, influenced by its dynamics of persistent weakness against Bank of Japan (BOJ) policy expectations and growing safe haven demand. The USD/JPY currency pair reached a high of 157.75 and a low of 155.85 on 2 March, highlighting the trade-off between heads and tails to the currency. Nonetheless, just a day later, the USD/JPY climbed decisively past the resistance level of 157 and sustained above this level. On one hand, the central bank appears ready to deliver further hikes as concerns of falling behind the curve of its peers weighed on discussions. While latest figures showed January headline inflation easing to 1.5%, snapping a 45-month streak of trending elevated above 2.0%, BOJ policymakers indicated that caution still warranted further hikes to ensure that the disinflation is entrenched. However, Japan's reliance on energy imports from the Middle East has overshadowed its appeal.

With Iran closing off the Strait of Hormuz and oil price spiking sharply, Japan would face significant supply disruptions while alternative options would be too costly. BOJ governor Kazuo Ueda warned that the conflict could significantly affect Japan's economy, signalling the possibility of the BOJ holding rates steady until further clarity on the impact of the conflict on its inflation and growth outlook. Coupled with the JPY's battle against its structural weakness in recent months, the USDJPY currency pair is likely to trade with a bearish bias in the near term, trading within the 156.50-158.00 range.

Ringgit retreated above RM3.93 amid potential delays to Fed rate cuts

Malaysia's currency outlook remains broadly supported by resilient macroeconomic fundamentals, steady repatriation flows and sustained investment inflows. However, a key driver that previously underpinned the Malaysian ringgit, the narrowing interest rate differential with the Fed's FFR has gradually faded as expectations for U.S. monetary easing are pushed further out. In contrast, Bank Negara Malaysia (BNM) is expected to maintain the Overnight Policy Rate at 2.75%, supported by stable inflation dynamics and resilient domestic demand conditions. The recalibration of global policy expectations has therefore strengthened the USD and limited near-term upside for the ringgit. Reflecting this adjustment, the USD/MYR pair has retreated toward the RM3.93 level, as markets reassess the pace of Fed easing and reprice global interest rate differentials.

The near-term trajectory of the MYR will be shaped primarily by two external drivers: global interest rate differentials and energy price dynamics.

1. Fed–BNM Rate Differential.

The widening policy divergence between the Fed and BNM has become increasingly important for FX markets. As geopolitical tensions push oil prices higher and reignite inflation concerns, expectations for policy easing by the Fed have been pushed further out. Futures markets now price a prolonged pause in the FFR, reinforcing a "higher-for-longer" global interest rate environment. With Bank Negara Malaysia expected to maintain the OPR at 2.75%, the policy gap relative to the U.S. remains substantial. This limits capital inflow momentum into emerging markets and reduces the earlier support that came from narrowing yield differentials.

2. Brent–Ringgit Sensitivity

Oil prices remain a key external driver for the Malaysian ringgit given Malaysia's status as a modest net energy exporter. Historically, higher prices for Brent crude support Malaysia's trade balance and fiscal revenues, which in turn provide underlying support to the currency. However, during periods of geopolitical stress, particularly disruptions affecting the Strait of Hormuz, the relationship becomes less straightforward. Oil price spikes driven by conflict tend to coincide with broad-based USD strength as global investors rotate into safe-haven assets, partly offsetting the positive terms-of-trade effect for Malaysia. Beyond the direct trade channel, elevated energy prices could generate broader macro spillovers. Sustained increases in Brent crude would raise logistics and production costs domestically while also placing pressure on Malaysia's fiscal position through higher subsidy expenditures. Based on our estimates, fuel subsidy costs under the BUDI95 scheme could rise to around RM44 billion if Brent prices reach USD120 per barrel, significantly higher than the government's current estimate of roughly RM11 billion, which is based on an assumed oil price of USD70 per barrel. Such an increase could complicate fiscal consolidation efforts and potentially weigh on investor sentiment, given that fiscal discipline has been a key anchor for confidence in Malaysian assets. The geopolitical shock could also have second-order effects on the real economy. Heightened regional tensions may dampen travel sentiment and disrupt tourism flows, potentially moderating the expected tourism rebound linked to the Visit Malaysia 2026 initiative. While the direct macroeconomic impact may be limited in the near

term, softer tourism receipts would reduce an important source of services exports and foreign exchange inflows.

The MYR has depreciated toward the 3.95 level amid heightened uncertainty surrounding the Middle East conflict, with elevated volatility expected to persist in the near term. A sustained breach of the 3.95 mark could see the USD/MYR test 3.98–4.00, reflecting intensified risk-off sentiment. The interplay of elevated Brent crude prices, geopolitical tensions, and a firmer USD suggests that the ringgit may trade within a wider range over the medium term. In a scenario where Middle East tension persist and oil prices remain elevated, we anticipate the USD/MYR could fluctuate between RM3.92 and RM4.10, as markets balance Malaysia's supportive macroeconomic fundamentals against global risk-off dynamics and shifting monetary policy expectations.

Table 6: Ringgit (USDMYR)



Outlook

Looking ahead, the broadening conflict will likely keep market sentiments subdued, providing modest support for safe haven assets. With the USD reestablishing its dominance in the currency market, we expect demand to significantly skew towards the USD, giving it the advantage over its peers. Furthermore, rising price pressures following the spike in oil prices will further delay the Fed's rate cut, providing additional tailwind to its bullish momentum. Similarly, major central banks policy paths were unanchored by expectations of a resurgence in inflation, granting modest support to the respective currencies. However, the supply shock also poses a key downside risk to growth, especially for countries heavily reliant on energy exports from the Middle East. Countries like Japan, South Korea and India will face slower supply, weighing on fuel-reliant sectors. On the other hand, China has scope to sustain its core economic functions as its diplomatic engagement with Iran ensures that Chinese vessels could pass through the Strait. However, the regional unrest and safety concerns would potentially see a slowdown in the number of shipments in the area. All in all, intensifying risks of a global slowdown and spillovers into broader economies would derail the growth outlooks across the board, especially in the event of a prolonged conflict. As such, investor sentiments will remain subdued, focusing their buying interest on countries with firm structural support, able to withstand the episode of volatility.