

## A More Treacherous Phase

### Key points

- As the conflict in the Middle East moves into its fourth week, we take the opportunity to lay out our key views and forecasts.
- Clearly the situation continues to evolve, and so while the forecasts presented in this note represent our modal forecast set, we should be mindful that the tails around these forecasts are fatter than would usually be the case.
- We made some revisions to our forecasts to the Australian economy last week, revising down GDP forecasts for this year and next, and lifting our inflation and unemployment rate forecasts. We continue to expect the RBA to deliver a 25bp rate hike in May.
- In addition, we have also made downward adjustments to our global growth forecasts for 2026 and 2027.
- In foreign exchange, we continue to forecast AUD/USD at USD0.72 by mid-year and 0.73 in H2 2026. However, we see the distribution of risks to the \$A as asymmetric at present; that is, more downside risk than upside.
- Term yields have moved higher in the past week, with a significant repricing taking place in the front-end of yield curves. We view this move as overdone.

### A shifting backdrop

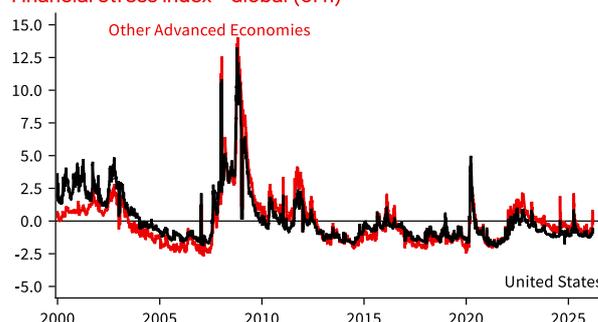
**The macro-economic outlook appears to be transitioning towards a more treacherous phase.** It is now possible that the impact of a large shock to the oil price will be amplified by tighter financial conditions (equity market declines, wider credit spreads, higher term yields). **As forecasters, this development leaves us worried about downside risks to growth.**

**However, it is also clear – particularly from our conversations with customers – that price rises are already starting to impact the final price structure of many goods and services.** Indeed, one of the features of the post-COVID economy seems to be much faster price adjustments and pass through. In this instance, the speed of price adjustment is also compounded by the magnitude of supplier price rises – they are simply too large to be absorbed by margins.

**This set of outcomes presents challenges for policy makers, as it potentially embeds under-performance against both price stability and full employment mandates.** Markets remain focussed on the inflation consequences of the disruptions in the Middle East and central bank expectations have repriced accordingly. Central banks are rightly concerned about the second round passthrough of cost pressures to broader wage and price setting, as well as the risk for inflation expectations. However, we expect that the growth consequences mean the monetary policy response is unlikely to match what is currently priced by markets.

**Outside of movements in fixed income markets, equity markets have moved lower,** responding to what is likely to be a softer earnings outlook. Locally, the ASX200 has declined ~8%, with the consumer staples, utilities and tech sectors out-performing. **Gold has declined,** a somewhat surprising development given its historical status as an investment for times of heightened geopolitical risk. However, recent declines should be viewed in the context of a 163% rally over the two years from January 2024. **Measures of realised volatility in financial markets, such as the VIX Index, have risen but remain low relative to other periods of elevated geo-political stress.** Generally speaking, broader measures of financial stress remain well contained to date.

Financial Stress Index – Global (OFR)



Source: National Australia Bank, The Office of Financial Research (OFR), Macrobond

**It is clear that the duration of the conflict is the most consequential variable when thinking about the potential impact on the economy and financial markets,** and recent damage to energy infrastructure raises the possibility of a longer supply shock.

**But we should also acknowledge that the starting point for global growth is stronger than most forecasters believed even just a few weeks ago**, thanks largely to better-than-anticipated outcomes in US and Chinese economic data of late. Moreover, the global economy has proved resilient in recent years despite a number of shocks in the past 5 years (COVID, disrupted supply chains, high inflation, Russia-Ukraine conflict, central bank tightening cycles etc.) Indeed, many of the factors helping to support global growth through these shocks remain in place, such as ongoing fiscal support (China, US and Europe), strong private sector balance sheets and tailwinds from tech-related capex spending.

**There are many forms of geo-political risk, but those that often matter materially for economic growth and financial markets are geo-political events that are consequential for the supply and pricing of energy.** The current episode clearly ranks as one such event, and our forecasts for Australia now reflect an uncomfortable combination of lower GDP growth and higher inflation as we account for the impact of higher energy prices. Low supplies of refined petroleum product are a potential vulnerability for the domestic economy.

**But on the positive side, Australia is a net energy exporter and will ultimately benefit as our terms of trade move higher thanks to higher LNG prices.** Moreover, policy makers have plenty of flexibility to respond appropriately to developments and the starting point from an economic perspective – with the exception of inflation – is positive: low unemployment and above trend GDP growth. So while the outlook is both uncertain and challenging in the near term, it is also important to acknowledge the relatively favourable starting point for the Australian economy.

## A summary of our key views

### Australia

As outlined in our most recent *Forward View* publication ([see here](#)), **we have made some downward revisions to our forecasts for Australian GDP growth for this year and next.** We now expect GDP growth of 1.8% (year-ended) in 2026 and 2027. This compares to prior forecasts of 2% for both years. The main drivers of our downward revision to GDP have been a weaker outlook for growth in household consumption and modestly softer forecasts for business investment growth as corporate profits come under pressure amid a more uncertain backdrop.

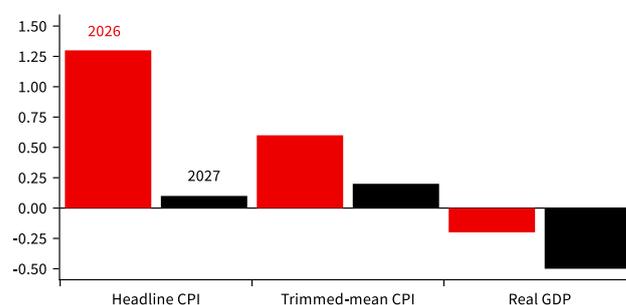
**On inflation, we now expect headline inflation to reach an annual rate of around 5% in Q2 2026.** While this primarily reflects a retail fuel price impact, we are also cognisant that other impacts will accumulate relatively quickly. For example, higher airfares will flow through into official price data from April for domestic and May for international flights. The passthrough of higher costs through fuel and other inputs across transport, logistics, fertiliser- and fuel-intensive agriculture, petrochemical-based packaging and components, and electricity-intensive manufacturing and

construction materials will be evident over coming months. Upward pressure on food prices is likely to be among the earlier and more responsive CPI categories. The extent and persistence of this supply driven inflation pressure remains uncertain, but a material impact has already been realised.

Indeed, **we have added a cumulative 30bp onto our core inflation forecast** over the next three quarters to reflect both the mechanical short term fuel impact and the second-round impacts of pass-through of cost pressures, and now expect the trimmed mean measure to print at 0.9% qoq for both Q1 and Q2 of this year. This will see core CPI peak at an annual rate of 3.75% yoy in the June quarter.

The chart below shows the magnitude of our forecast changes relative to where they were in mid-December, which reflects both a more aggressive policy rate forecast and the impact of higher oil prices.

NAB Forecast Revisions\*



Source: National Australia Bank  
Notes: Bars show the change in NAB's forecasts, calculated as March 2026 minus December 2025, for year-ended December growth in 2026 and 2027.

**Slower growth in the economy will mean that the unemployment rate will peak at a higher level than we previously expected.** We now see the unemployment rate climbing to 4.75% in 2027 (prior forecast was 4.6%). This will deliver some spare capacity in the labour market.

**We have not made any changes to our RBA forecast and expect the RBA to deliver another 25bp rate hike in May, taking the cash rate to 4.35%.** While the current outlook is challenging for central banks (higher inflation and weaker growth), the starting point for the RBA compares unfavourably on inflation, but favourably on growth (~60bp above trend growth rate as at December 2025). This suggests that at the margin, the RBA should have relatively more tolerance for a tightening of financial conditions and weaker growth.

However, **we are mindful that there is another five weeks until the RBA's next meeting and a lot could change in this time.** Indeed, there are a number of developments that could see the RBA pivot quickly. Should the conflict continue to a point where Australia's fuel reserves are compromised, rationing of petrol could possibly drive abrupt changes in consumer and business behaviour. These developments could warrant a considerable reassessment of the outlook. Alternatively, it is possible that if the conflict concludes soon, the RBA will be left with a more challenging inflation outlook but easing worries about the growth outlook.

**Official data reflecting the early impact of the oil shock will not be available until the first half of April at the earliest, although this week has delivered sobering readings on consumer confidence, inflation expectations and the services PMI in Australia.** Until then, economic data will be useful for benchmarking the starting point for growth and inflation prior to the Middle East conflict.

**It is important to acknowledge that uncertainty around our forecasts has increased materially.** The economy entered 2026 in a strong position, having weathered global trade uncertainty through 2025. However, the impact of higher oil prices and related disruptions will have a much more direct (and faster) impact on the economy than previous shocks. The size of the shock is significant, but hard to quantify, and there are very real risks of a more material hit to growth than we have reflected in our baseline forecasts.

### Global Economy

**The conflict in the Middle East represents a negative but highly uncertain shock to the global outlook.** Its significance lies in the region’s central role in global energy supply. Our baseline assumes oil prices remain elevated in the near term but ease as disruptions partially unwind, with Brent settling around USD\$80 per barrel in coming weeks. Accordingly, we have made only modest changes to our forecasts for now, which also incorporate adjustments relating to the regular data flow but global growth, based on our baseline scenario, is now expected to be 3.2% in 2026 and 3.1% in 2027 (previously 3.4% and 3.2% respectively).

**It is important to recognise that the impact of higher energy prices is not felt evenly across the globe.** Net energy importers — particularly Japan, India and parts of Europe — face the largest growth headwinds, while energy exporters such as the US and Canada are better positioned, though still exposed as higher energy prices will still drag on many parts of their economies and via confidence, financial market and external demand channels.

**At a high level, potential exposure to this war is jointly determined by energy independence and intensity.** The heatmap below maps economies across these dimensions using a range of metrics. It indicates that net energy importers (Japan, EU, UK and India) on average are more exposed to the Iran war than their net energy exporter counterparts (US, Canada and Australia). Asian economies

### Energy security heatmap (ordinal rankings)

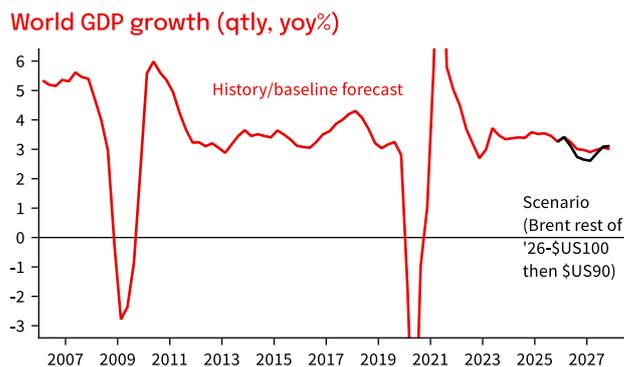
Metric name	JPN	EU	UK	IND	CH	US	CAN	AUS
Electricity production from oil and gas (% of total)	7	5	6	2	1	8	3	4
Energy intensity of GDP	4	3	2	5	7	6	8	1
Most recent energy weight in CPI	6	7	2	3	N/A	5	4	1
Net energy imports (% of energy use)	8	7	6	5	4	3	2	1
Effective days of oil reserves	4	5	6	8	3	1	1	7
Middle east crude oil imports in 2024 (% of total)	8	4	4	6	7	2	3	1
Middle east refined oil imports in 2024 (% of total)	7	4	4	8	6	3	1	2

Source: National Australia Bank, World Bank, BP, IEA, Energy Institute, Macrobond  
 Note: China does not publish an energy CPI weight. Middle east oil import figures do not delineate between EU/UK nor AU/NZ.  
 For all metrics except effective days of oil reserves, a lower number implies a higher rank.

such as Japan face the greatest downside given high energy intensity and dependence on imported energy, while Europe is less exposed due to its lower energy intensity.

We should note that these metrics aren’t perfect: US’ performance is undersold given its strong domestic gas production (and with US gas prices little impacted so far) while Australia’s is oversold given almost all oil products are sourced from the middle east indirectly via Asian refiners (with limited domestic refining capacity).

**Looking ahead, there is considerable uncertainty around any point forecast at this time, and risks are tilted to the downside for global growth relative to our baseline assumption.** The chart below illustrates how an extended period of oil prices at around \$US100/barrel might impact global growth. For this scenario we assume Brent trades at \$US100/barrel for the rest of the year before moving down to around \$US90/barrel in early 2027. Year average growth in this scenario is down a further -0.2 ppts to 3.0% in 2026. However, in quarterly yoy terms, there is a more pronounced dip in growth to a bit above 2.5%. If this scenario (and estimated impact) was realised it would be the slowest period of growth since the GFC (excluding the COVID shutdowns).



Source: National Australia Bank, Macrobond. COVID extremes removed from y-axis

The impact on GDP for a given move in energy prices could become greater as prices move higher (i.e. the relationship is non-linear). Were prices to climb to a very high level– e.g. to \$120/barrel – which raises recession concerns, then risk aversion and financial market stress could become major headwinds, and any incipient weakening in activity self-reinforcing. The downstream risks of manufacturing disruptions and broader supply chain disruption also rise in this scenario.

**However, we should also be mindful that as noted above, the starting point for global growth is robust, and the global economy entered 2026 on a solid footing.** This will provide some cushion to growth downgrades and for now, centres our forecasts for global growth to an outcome that is softer relative to our earlier baseline, but not materially so.

### Foreign Exchange Outlook

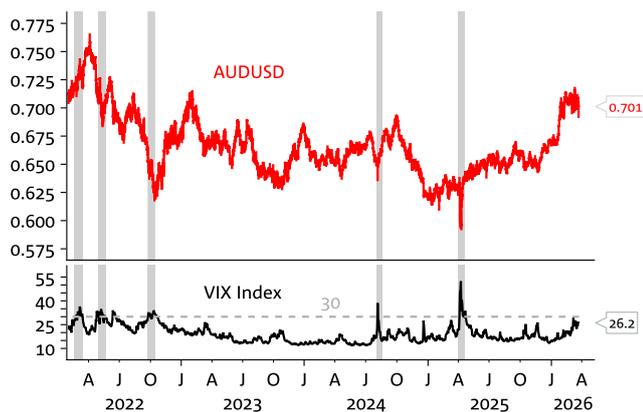
In the three months to the end of February, fundamental drivers of the Australian dollar had all run in the same

(supportive) direction, namely absolute as well as relative money market rates and bond yield considerations, positive risk sentiment and a step up in the pace of renminbi appreciation. Together they contributed to the run up in AUD from 0.6550 to 0.7150. **Since the start of the Iran war, key AUD drivers are no longer running the same way, such that the recent performance of and outlook for the currency is much more nuanced.**

Since the beginning of March, AUD/USD has made a new cycle high just shy of 0.72 (March 11) shortly after RBA deputy governor Andrew Hauser put markets firmly on the scent of a March follow up to the February cash rate rise. Yet on 8 of the 16 trading days in March to date, AUD/USD has dropped below 0.70.

The fact these drops back below 0.70 have so far proved temporary is superficially impressive given the magnitude of the geopolitical shock to which global markets are being subjected. Yet while risk sentiment has deteriorated, reflected in a fall of as much as 5.7% in the S&P 500 and 7.1% in the MSCI ACWI, there have so far been no individual days with outsized stock market selloffs and associated jumps in the likes of the VIX index to above 30 on a daily closing basis. It is such occasions that are historically associated with outsized falls in AUD.

### AUD/USD versus VIX index



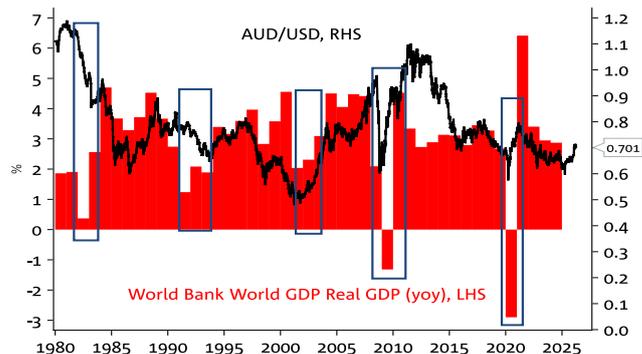
Source: National Australia Bank, Macrobond

**We are not proposing any FX forecast changes amid the current monumental period of geopolitical stress.**

But suffice to say, prevailing forecasts for AUD/USD back up at 0.72 by end Q2 and higher still in H2 certainly require some form of near-term US-Iran-Israel truce and an early resumption of oil and other commodity flows through the Straits of Hormuz. In its absence, the AUD faces more downside risk than upside potential in coming weeks. From an FX market perspective, we are watching leading indicators of global growth (such as copper, which has turned lower), oil prices in the forward markets as well as risk sensitivity measures such as the VIX index, alongside consumer and business confidence survey readings. Any significant sign of deterioration in these variables carries with it risk of a more sustained period of AUD under-performance.

It is tempting to suggest that the combination of favourable interest rate differentials and the fact that the spike in oil, gas and coal prices is a positive term of trade shock for Australia, in contrast to most of the APAC region and Europe, can continue to limit AUD downside risk. **We are sceptical AUD can continue to display as much resilience as it has if risk asset prices suffer bigger convulsions than witnessed so far this month.** This is especially so if any such selloffs are associated with material downgrades to global growth expectations for 2026 and beyond. These have consistently proved to be the enemy of AUD, regardless of what has been happening to the terms of trade at the time.

### AUD – vulnerable to material global growth downgrade



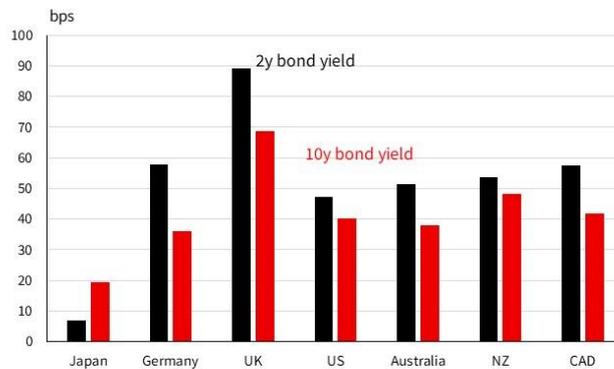
Source: National Australia Bank, Macrobond

### Interest Rate Outlook

**There has been a meaningful re-pricing in rates markets since late February as investors re-think the path of monetary policy in response to the energy supply shock** (and so re-position). Excluding Japan, front-end yields have led the move higher as central banks (BoE, ECB, Fed) signalled that rate cuts are off the table and that, if inflation expectations become unanchored, higher cash rates are likely. This is particularly the case for Gilts and Bunds given that the ECB and BoE are single-mandate central banks.

While a shift in cash rate expectations is the correct reaction to an energy price shock, the magnitude of the move recorded post last week’s BoE meeting was overdone, and at the time of writing has partially been unwound. If the energy shock is significant enough to cause inflation to move meaningfully higher, the demand destruction of such a move will also be significant, doing some of the central bank’s work.

### Change in bond yields since late February



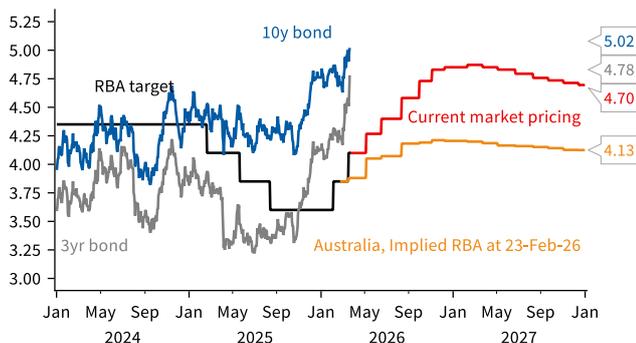
Source: NAB, Bloomberg

The complicating factor for the Australian rates market was that yields were heading higher well ahead of the US-Israel conflict with Iran, as the RBA pivoted from easing policy in 2025 to tightening in 2026 to address capacity pressures and upside risks to inflation. While the re-pricing in yields since late last year can be well explained by this pivot from the RBA, the shift higher in the past week has predominantly been driven by the directional move in global yields rather than domestic factors.

NAB is forecasting one more rate hike for 2026 which will take the cash rate to 4.35%. In contrast the OIS curve prices the cash rate at 4.75% by year end, the 3-year bond yield is close to 4.70% and the 10-year bond is close to 5.05%. The front end is looking stretched.

For longer-dated yields, the global backdrop still matters: investors are likely to demand a higher return for extending duration given elevated uncertainty and the risk that fiscal positions deteriorate. That would imply more sovereign supply to be absorbed by an investor base that is becoming increasingly price sensitive.

### RBA cash rate expectations and AU bond yields



Source: National Australia Bank, Reserve Bank of Australia, Macrobond Financial AB, Account in-house, Bloomberg, Macrobond

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