

FOCAL POINT

Oil: after the geopolitical tensions, mind oversupply

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Our Focal Point series explores topical issues on macro, markets and investment

- Uncertainty on oil prices has significantly increased with the Israel-Iran tensions. Prices rose after a slide that was triggered by oversupply concerns. The tentative cease fire has brought risks into better balance. The risk distribution appears increasing bimodal, with high probability of supply disruption temporarily raising inflation or a return to an oversupplied market.
- Given our pre-crisis baseline of prices hovering at below US\$ 70/bbl, we modelled three risk scenarios to assess the impact of oil price volatility on growth and inflation. In a higher price scenario (to around US\$ 90/bbl for a couple of quarters) stemming from renewed geopolitical tensions, the negative GDP impact would be larger on DM countries than for EMs. Regarding inflation, the increase would be more protracted and significant in EM than in DM.
- A downside scenario foresees prices dropping temporarily to US\$ 55/bbl until year end and would see global consumers and EM manufacturers (Asia, Turkey) benefitting. Gulf Cooperation Council (GCC) countries like Saudi Arabia might only benefit in the long run from this costly move, if price cuts drive out US shale producers, which would be among the biggest losers. In the short run, however, the price decrease would add further strain to the fiscal and current account deficits of Saudi Arabia conflicting its Vision 2030 diversification plan.

Oil prices have experienced large directional swings year-to-date with initially a steady decline of the Brent to US\$60/bbl that was quickly reversed by the conflict between Iran and Israel¹. The news related to a ceasefire has led to market relief but still with a pending risk of resurgence of the conflict, given the increasingly precarious political situation in Iran. Oil prices are stuck between the risk of increase oversupply compounded by the Saudi Arabia's strategy and the risk of sudden flare ups due to further geopolitical tensions. In the following, we review the latest drivers of oil prices and present the results of upside and downside scenario for the oil prices,

with the impact on growth, inflation and an assessment of potential winners and losers.

Oil price stuck between geopolitical risk and fears of oversupply

The sudden rise in Middle East tension following the renewed conflict between Israel on Iran, a major oil and gas producer, and the risk of retaliation have raised fear of repercussions on oil facilities leading to higher energy prices. Yet in the past only a few episodes of elevated geopolitical risk led to sustained price rise. They did when a big energy producer

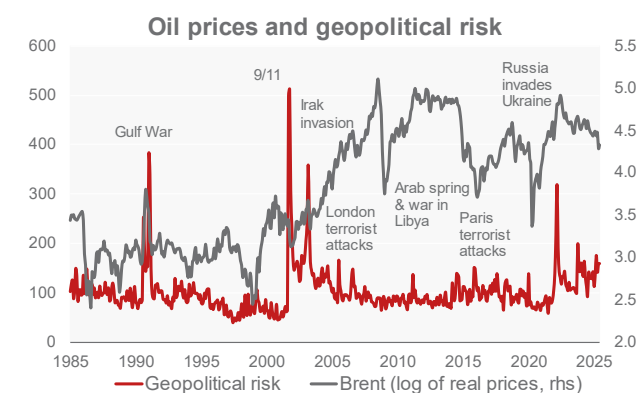
¹ We have dealt on the broader consequences of the conflict and their market implications [here](#).

was involved, either as the invaded country, such as Kuwait in the first Gulf war of 1990-91 or Russia in 2022. In all other cases, the negative supply shock was either too short lived to persistently affect prices, or the following demand destruction due to a business cycle downturn eventually pushed down oil prices².

At the time of writing tensions have declined with the late announcement of a cease fire (Brent somewhat below US\$ 70/bbl), but doubts remain on how long it will hold. The fears of an uncontrolled escalation have receded but given the fluid situation we do not rule out renewed tensions that would push oil prices higher again. The main risk would be an Iranian retaliation that would affect energy infrastructure of neighbouring oil countries directly or indirectly via its proxies like the Abqaiq-Kurais attack in 2019 or a blockade of the

fundamental driver of prices in the coming months. Indeed, since the beginning of the year Saudi Arabia and seven other leading members of the OPEC+ have decided to reverse their previous oil cut strategy and increased production above the level initially imposed by the quotas. This had several motivations, from increasing market share at the expense of US shale producers, to punish higher production cost OPEC members which systematically cheated on production quotas (Kazakhstan, Iraq) and possibly to appease persistent President Trump by showing a willingness to keep oil prices low. Whatever the reasons, OPEC spare capacity remains extremely elevated (at 88th percentile considering the last 40 year) and oil inventories are not particularly low, at least in developed countries.

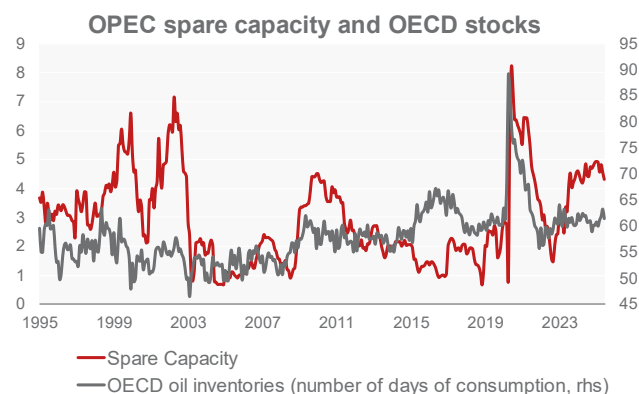
Likewise, the rebound in the Chinese economic activity will have a less marginal positive effect on oil prices than before. Over the past three decades, China has accounted for half of the world's oil demand, but China's crude oil imports are now gradually declining. It fell by 1.9% in 2024, making the first annual decline in 20 years (except for the COVID period). It is related to multiple factors like the growing share of services in the economy that counts now for more than 50% of GDP, the rising sales of EVs but also the growing internal oil



Source: Caldara & Jacoviello (2022), Ox. Economics, Datastream, GenAM

Hormuz Strait that would be the most significant tail risk. Indeed, it is a critical oil choke point as c. 20% of the global oil consumption flows through the Strait. 84% of it went to Asian markets in 2024. 20% of LNG also transited, primarily from Qatar. It would lead to a sizeable and prolonged disruption. Political consideration makes such an extreme event unlikely, as it would inflict serious harm to Iran itself. According to the U.S. Energy Information Administration (EIA), in 2024, approximately 84% of Iran's crude oil and condensate exports were transported through the Strait of Hormuz. Moreover, a closure of the Strait would significantly harm Saudi Arabia and all the Persian Gulf strait as a very large part of its supply would be blocked. This would unwind the recent efforts to restore relationship with the GCC, something that, in bad need of allies, would be highly detrimental for Iran. By the same token, a closure of the Hormuz Strait would alienate China, the receiver of around 80% of Irani oil output.

These renewed tensions should not overshadow the weaker market fundamentals and the oversupply concerns that have emerged earlier this year and which we think will remain a

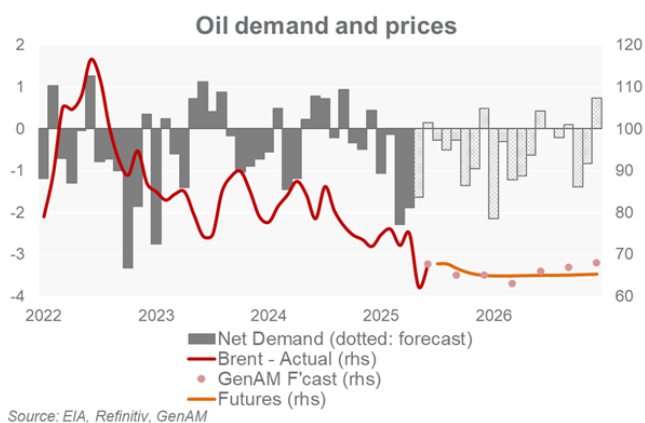


Source: EIA, OECD, GenAM

production that has reached c. 4.6m bpd. In addition, the China's National Energy Administration said it was likely that demand for fuels in China peaked two years ago. China is now close of being the 5th largest oil producer in the world and strategically will continue to boost its domestic oil production. All this is consistent with a weak underlying price dynamic; it is worth noting that, even at the peak of tensions, the spot Brent price did not rise above the US\$ 83 /bbl peak seen in mid-January. Without political tensions the market would remain oversupplied and oil prices hover in the US\$ 65-70/bbl range over the coming months, with demand-supply imbalance posing downside risks, broadly in line with what futures show.

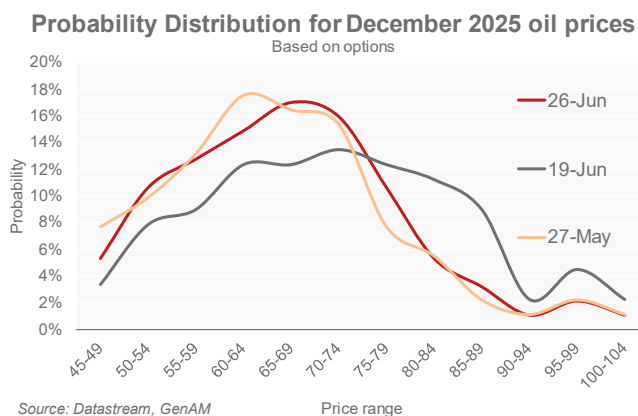
² The ECB has recently carried out a [quantitative analysis on the impact of geopolitical shocks on Energy markets](#), finding a

limited effect and only if troubles arise in large energy producers.



Scenarios point to the risk of a sharp but temporary inflation rebound

Tensions are leading to sharp shifts in market expectations as markets weight the likelihood of different outcomes of the crisis. In periods of tensions options pricing were consistent with a non-negligible probability of prices returning to above US\$80/bbl, but the implied probability of a drop to below US\$ 60 /bbl has remained high.

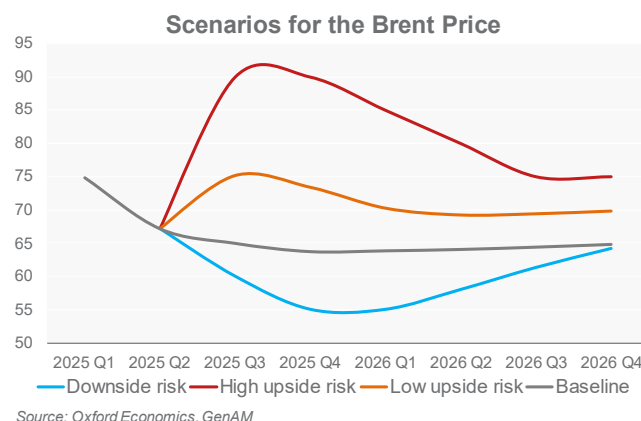


To quantify the economic fallout of these oil price movements, we modelled three scenarios, using the Oxford Economics Global Model. We considered the following:

- A downside scenario for oil prices, in which Mid-East tensions de-escalate quickly and the forces that drove prices down in the first part of the year take the lead, in the form of lowered demand following a more negative impact of tariffs on the global cycle, and the collapse of the OPEC+ cartel exacerbates oversupply. Brent then falls to US\$ 55 /bbl by year end and go back to baseline by the end of next year.
- Low risk scenario: The cessation of the Israel-Iran attacks softens concerns about a significant

reduction in oil supply. Nevertheless, the US enforces stricter sanctions on Iran, which reduce global oil production by 0.7 million barrels per day (bpd), around 1% of the global supply. Brent price then escalates to US\$75/bbl and is projected to remain at just below US\$ 70/bbl for the next few years.

- Medium risk scenario: Israeli attacks and Iranian retaliation continue. Air attacks on Iran's oil infrastructure leads to a stop of exports, cutting global supply by around 4%, but the Hormuz strait is not closed. This pushes the oil price to around US\$90/bbl, where it remains through to the end of 2026, afterwards³.

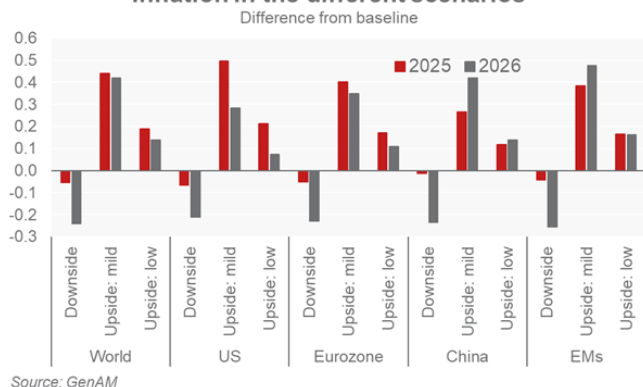


The riskiest scenario would see a sharp rise of inflation. In the US it would be short-lived but would occur in tandem with the spike in the core rate we expect from tariffs, this would badly be affecting mood and add to uncertainty. The shock would be roughly similar in the euro area (0.4%pp above baseline), but with a limited carryover to the core rate. Model simulations shows that the inflationary impact on EM would increase next year, as the passthrough from oil to retail prices is strongest and economies are less flexible. On the opposite, the slide in oil prices assumed in the downside scenario would have a broadly similar impact across countries, concentrated in 2026.

³ We do not present the result of an extreme (and unlikely) scenario in which the closure of the Hormuz Strait brings oil prices to US\$120 between now and the end of the year. Global

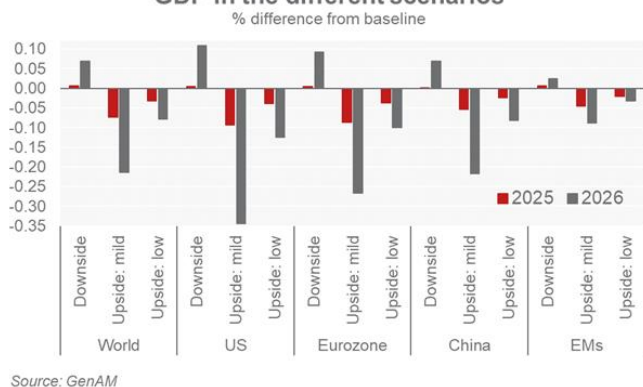
inflation would rise by 1ppt, but the model results suggest a relatively muted impact, with expected 2025 growth slowing from 2.8% to around 2.5%.

Inflation in the different scenarios



The hit to GDP of the mild upside risk scenario would be concentrated in 2026, with the US being affected more than the rest of the world as consumption would suffer from the drop in real disposable income⁴, more than offsetting the improvement in the trade balance as US is a net exporter of oil. This could add to the uncertainty that we expect to keep US growth subdued next year too. The drop in oil prices would have a positive, but mild effect on activity, nowhere near the size needed to offset the adverse impact from tariffs.

GDP in the different scenarios



Central banks' reaction to this shock is unclear a priori. Theory states that just for any adverse supply shock, a central bank should look through the price level rise and then cut to cushion the impact on activity. However, to avoid second round effects due to higher inflation expectations, accommodation may be more limited than what theory and model simulation would suggest.

All in all, a deterioration of the Israeli-US-Iranian confrontation as per our medium-risk scenario, provided it does not spill over to the rest of the region and the world, would provide a temporary and manageable hit to the economy. Therefore, a contained and limited crisis would likely give way to a situation in which oil returns to the US\$ 65-70/bbl range. Such a level

would benefit consumers but harm Gulf producers and the US shale industry.

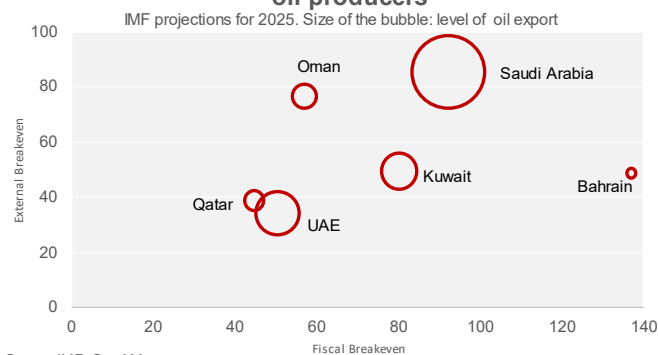
Heterogeneous impact on EM countries, Saudi Arabia under pressure if prices fall further

The impact of higher or lower oil prices is heterogeneous across EMs. While EMs are usually seen as beneficiaries from higher oil prices, the reality is more nuanced. EMs could benefit from higher oil prices if it is driven by higher global activity but not by a supply shock. Moreover, the countries where oil revenues are more than 50% of exports earnings, only represent c. 3% of the world GDP. At the EM level, if we consider the IMF oil producer classification, the weight of oil producers in the EMBIGD (the main EM fixed income benchmark) is only 24%. A vast majority of EMs remain large oil importers, negatively impacted by a prolonged rise in oil prices related to a supply shock.

In our downside scenario for oil prices will affect significantly GCC producers, as GDP would decline from -0.5 pp in the worst case for Saudi Arabia to a tiny -0.02pp for Qatar while large oil importers like Turkey would see only a marginal GDP boost.

More worrying for Saudi Arabia is the long-term ramifications on the fiscal and the current account deficit. It calls under question the recent decision to increase output, as it would lead to price levels persistently below the US\$ 95 /bbl fiscal breakeven. Before the latest output increase, the IMF estimated the 2025 and 2026 deficit to be at -4.9%. Back of the envelope calculations show that a US\$10/bbl change in oil price results in approximately a 2-pp swing in Saudi Arabia's deficit as a percentage of GDP. A wider deficit would increase the already large funding needs as Saudi Arabia alone is due to issue US\$17 bn of external debt this year. Fiscal adjustment would also conflict with the Vision 2030

Fiscal and External beakeven price for Gulf oil producers



diversification plan that entails large foreign funding needs.

⁴ In the US consumption is lower than the baseline by 0.2pp and 0.6pp in 2025 and 2026 respectively, against a 0.1pp and 0.3pp drop in the euro area.

US Shale producer to feel the burden of low oil prices

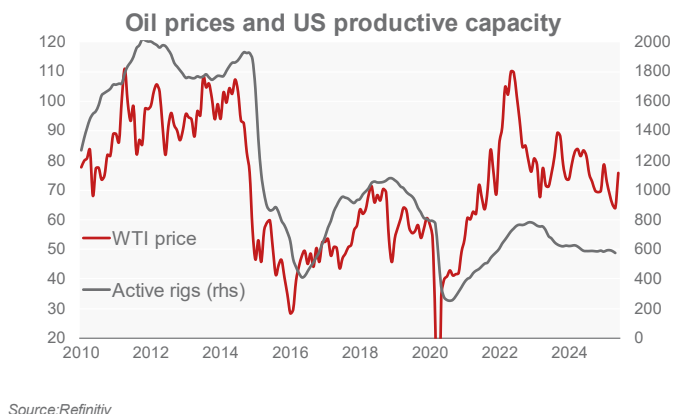
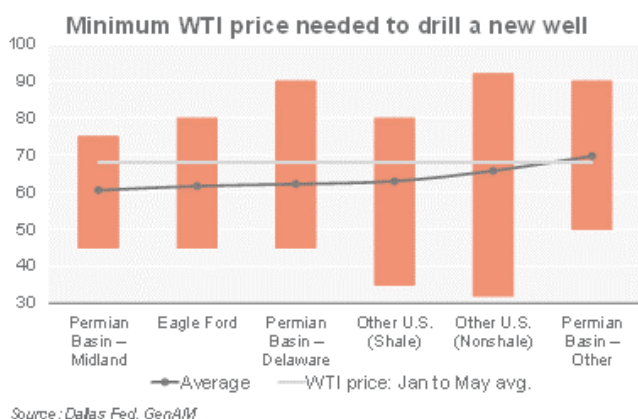
Oil remaining below US\$70/bbl will prolong the woes of the US shale sectors. In the US, shale producers will be challenged as the current price level makes higher supply hardly viable. The Dallas Fed Q1 2025 survey showed that already in March sentiment among US oil producers was negative and has likely worsened since, suggesting a contraction in drilling activity over the next year, also as oil executives expressed a conservative approach to capex.

Moreover, the breakeven price needed to increase production rose to US\$65/bbl, which in part factors in the cost push from the forthcoming 25% tariff on steel.

This will prove a challenge for planned rise in US oil production the administration seeks to achieve aim to alleviate consumer price pressures. The increase in US crude production over the past year was supported by WTI prices staying in the 70 to 75 range. If prices drop back to the mid-60 levels prevailing before the Middle East escalation, rig counts may decline, putting downward pressure on production.

Conclusion

The spike in oil prices following the Middle East tension only in part concealed the reality of a persistently oversupplied market. This remains our baseline scenario, resulting from prospects of weaker demand as US tariffs will hit especially strongly manufacturing and energy intensive countries while supply will remain elevated given the Saudi decision of increase production. This remains reflected in market perception of the distribution of risks. Alternative scenarios show that a spike of oil prices to around US\$ 90/bbl would have an overall manageable impact on the global economy, whereas a drop to US\$ 55/bbl would be particularly painful for large producers like Saudi Arabia, already confronted with a difficult budget outlook, and for US shale producers.





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