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MIDDLE EAST SCENARIOS BULLETIN

Deal reached but risks remain two side

Key points

- A US–Iran deal has been agreed, extending the ceasefire and opening the door to the reopening of the Strait of Hormuz. If upheld, it will see shipping increase. However, we still expect the recovery in shipping and Gulf production to take time and, as temporary buffers fade, current price optimism to unwind, leading to higher prices and more volatility ahead. We forecast Brent to average US$87 in Q4 2026, gradually easing to an average US$68/bbl in Q4 2027.
- We see two sided risks around what the reopening of Hormuz will mean in practice for shipping, production and prices. In the benign scenario, to which we attach greater probability, a faster normalisation sees prices return toward US$60/bbl by end-2027.
- While petrol prices rise in Q3 as the fuel excise tax is reimposed, prices then ease falling back below $2.00/l in early 2027 with diesel prices down below this level by H2 2027. Headline inflation falls but the impact on Trimmed Mean inflation is modest given existing cost pass through already in the pipeline to businesses and consumers. For New Zealand, a sharper fall in headline and core inflation provides a stronger boost to economic activity.
- In an adverse scenario, constrained shipping and prolonged supply disruption see oil prices rise above US$155/bbl this year and remain above US$100/bbl into end-2027
- This drives diesel and petrol prices to around $3.07/l and $2.68/l by year end and with a broader lift in prices globally, Australian headline inflation lifts to nearly 6%yr in Q4 and economic activity takes a significant hit. The impact on New Zealand is more pronounced.

Strait of Hormuz reopens but path to normal uncertain

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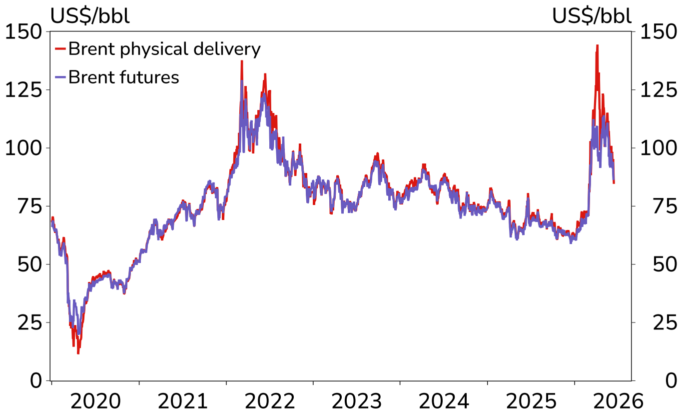
Head of Business & Industry Economics

A deal between the US and Iran was finally agreed on the 15th June. This follows months of repeated claims that a deal was imminent, following the 8th April ceasefire, and intermittent US–Iran and Israel–Iran clashes. Assuming the deal holds, it will be the first step in reaching a longer-term permanent agreement and unwinding the energy shock. It extends the ceasefire by 60 days and is set to see the reopening of the Strait of Hormuz, which has been closed for around 15 weeks.

As we anticipated would occur following a deal, oil prices sold off sharply on the news. Brent has fallen to around $83/bbl, down sharply from $141/bbl price for Dated Brent recorded in March. A deal reduces the 'war risk premium', and if upheld, will see shipping recover, as it reportedly already has, reinforcing downward pressure on prices.

Brent Crude oil price



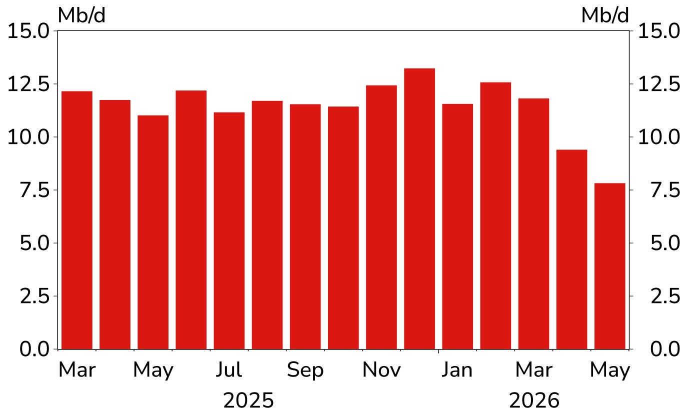
Source: Macrobond, ICE, EIA, CME Group, MODS, Macrobond, Westpac Economics

However, as detailed in the June Market Outlook (13th June), we expect this optimism to be pared back, with prices to push higher as it becomes evident that the return of Gulf oil production will still take time. Even if shipowners' fears over security are allayed, with assurances around attacks or mines, vessels still need to be repositioned back to the Strait and contracts realigned. Insurance costs are therefore likely to remain elevated.

Oil fields will also need to be restarted after weeks of shut-ins driven by storage constraints. The pace depends on shipping flows and how quickly storage is freed up. Only then can production be brought back online, and even then reservoir pressure will take time to rebuild. Any damage to refining, export and storage infrastructure will also need to be repaired before Gulf production is fully restored.

At the same time, temporary buffers, cushioning the supply shock such as record US exports and very weak Chinese demand, will fade with inventories likely to continue to fall or remain close to critical levels in coming months.

China Crude Oil Imports



Source: GAC, Macrobond, Westpac Economics

As such, our base case still sees only a gradual normalisation in shipping through the Strait of Hormuz, with flows not returning to pre-conflict levels until mid-2027. At the same time, the conflict has highlighted the vulnerability of countries, particularly across Asia, and we expect a policy-driven push to rebuild reserves. As a result, while moderating, we forecast oil prices to remain above pre-conflict levels until late-2027. We expect spot prices to average US$85/bbl in Q4 2026, before easing to US$68/bbl in Q4 2027.

That said, much will depend on the durability of the US–Iran deal. As it stands, this is only a Memorandum of Understanding (MOU), allowing for the Strait to reopen while negotiations continue over the next 60 days towards a more permanent agreement.

The MOU reportedly includes the release of frozen assets, with the UAE having already unlocked $10 billion, and an easing in stages as conditions are met. However, key sticking points that have held back the reopening of the Strait remain, including Iran's nuclear enrichment. Israel has also not achieved its initial objectives. This was underscored by strikes on Lebanon just hours before the deal, and it has warned that hostilities with Iran would resume if it responds to any clashes with Lebanon.

As such, the deal could still be tested and prone to flare ups in conflict. There are also two-sided risks around what the reopening of Hormuz means in practice for shipping and production, even with a deal in place.

Using the Oxford Economics model, we assess a benign scenario where there is a faster normalisation in transit through the Strait and a quicker return of Gulf production this year, bringing energy prices back more swiftly to pre-conflict levels and lowering global inflation.

We also consider an adverse scenario, where the deal is tested and flare ups in the conflict persist. In this case, shipping through the Strait remains constrained, extending the energy supply shock well into 2027, with oil prices rising above US$155/bbl this year and remaining above US$100/bbl into end-2027.

Benign scenario: Faster rebound in supply

In the benign scenario we assume:

A faster normalisation of shipping and energy supply: The US–Iran deal proves durable, with constructive progress towards a more permanent agreement. While it still takes time for vessels to be rerouted, transits through the Strait resume more quickly than in the baseline, lifting to around 70 to 80% by the end of Q3.

The faster resumption of shipping eases storage constraints and supports a quicker recovery in Gulf production, with limited downtime as facilities are restarted. This is reinforced by higher non-OPEC supply, with the UAE boosting production above pre-conflict projections given it is no longer constrained by OPEC quotas.

At the same time, demand does not fully revert to pre-conflict levels, as some demand destruction and efficiency gains prove persistent, particularly in China. As such, underlying demand settles below the pre-conflict trend.

The combination of these demand and supply dynamics drives a faster rebuild in inventories. By year-end, inventories return to more comfortable levels, easing tightness in physical markets.

Short-term floor in prices gives way to a faster return toward pre-conflict: Markets reprice quickly on a credible reopening, with Brent falling sharply as risk premia unwinds. In the near term, prices find a floor around US$80/bbl in Q3, reflecting ongoing shipping and insurance frictions alongside inventories still need to be rebuilt.

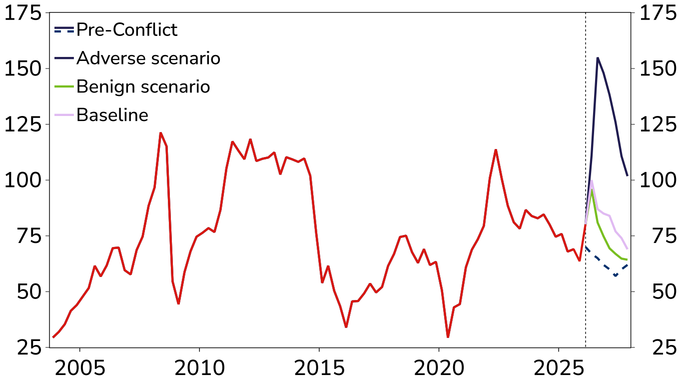
As stocks rise and the supply–demand balance improves, prices move below the baseline by end-2026 to an average US$75/bbl. With inventories in a stronger position, government replenishment is smaller and more gradual than in the baseline, reinforcing a softer price profile through 2027. By end-2027, Brent is back around US$60/bbl, broadly in line with pre-conflict levels.

The easing in refined product prices is more gradual and occurs with a lag. However, as supply improves and margins compress, the gap between crude and middle distillates narrows. Petrol prices still rise in Q3 as the fuel excise tax is reimposed, before easing below $2.00/l in early 2027, with diesel following by H2 2027.

Gas prices are also lower. Asian LNG benchmarks fall to around $15/MMBtu by end-2026 and US$12/MMBtu by end-2027, as the end to the conflict sees an acceleration in LNG flows, alongside higher oil supply lifting associated gas output and improving overall availability.

Oil Price Scenarios

Spot Brent Crude Oil, Quarter-Average, US$/bbl



Source: EIA, Macrobond, Westpac Economics

Economic impact

Lower energy prices see Australian headline inflation around 0.5ppt lower, at around 4.2% y/y by Q4 2026. While other commodity prices are also softer, the impact on the RBA's preferred Trimmed Mean inflation measure is more modest, given existing cost pass through already in the pipeline to businesses and consumers. With interest rates still elevated, the near-term lift to consumer spending and activity is limited in the short-term.

For New Zealand, a sharper fall in headline and core inflation, provides a stronger boost to economic activity with economic growth around 0.2ppt higher in Q4 2026 on a year-ended basis.

Adverse scenario: Deal tested, disruption persists

In the adverse scenario we assume:

Shipping through the Strait remains constrained: The gap between the parties remains too wide, keeping a durable and credible truce out of reach. This sees the deal repeatedly tested, with flare-ups in conflict. Israel's objective of Iran's complete nuclear disarmament and an end to its support for Hezbollah falls short and sees ongoing intermittent, short-lived attacks on Iran and Lebanon. While contained, these episodes add volatility and further complicate the path to de-escalation.

Prolonged production and supply shortfalls: Shipping through the Strait edges higher, with more vessels opting to go dark. Nonetheless, traffic remains only around 30 to 40% of pre-conflict levels or around 3 to 4.5 mb of Gulf crude oil supply, assuming 7mb/d of the 18mb/d that typically transits the Strait continues to be re-routed through pipelines. It also takes a further 6 months compared to our baseline before shipping is back to normal.

We do not assume a renewed escalation in military targets on energy or port infrastructure. However, the recovery in Gulf production is slower compared to our base case, as the prolonged period of shut ins in the Gulf is assumed to have caused some damage to oil well infrastructure.

Meanwhile, the buffer from higher non-OPEC supply and a sharp pull back in demand fades. Notably, US exports fall from current record levels of around 6.9mbd, back and even below the average 3.9mbd recorded in 2025 as US commercial stocks and Strategic Reserves fall to critical levels. Chinese import demand also increases as their own domestic inventories decline.

This more prolonged stalemate also sees a longer-lasting loss of LNG exports given damage that the world's largest LNG export terminal, Ras Laffan in Qatar, has already sustained.

Oil prices lift to an average US$155p/b in Q3

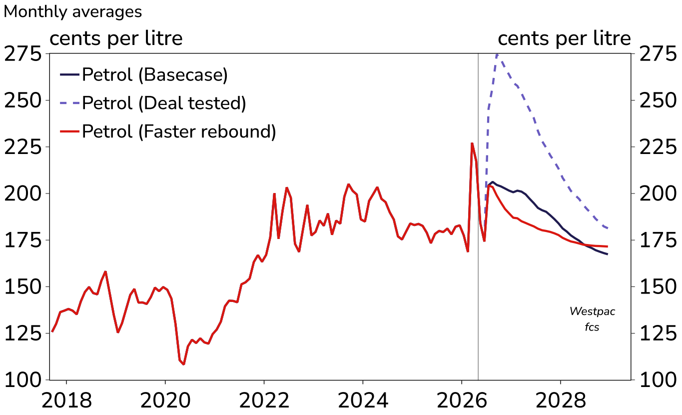
As supply tightens, competition for available barrels intensifies. Brent lifts sharply, averaging around $155/bbl in Q3, above the 150/bbl peak in 2008. While ongoing negotiations between the US and Iran see shipping increase gradually over the rest of this year, prices unwind more slowly.

By end-2026, Brent is still around $148/bbl, around $60 above our baseline. Moreover, it remains higher through 2027 as the sharp drawdown in inventories in 2026 brings forward demand from governments to rebuild strategic reserves. This adds a further layer of support to prices.

The prices of refined oil products like jet fuel and diesel, which have already seen larger spikes than crude oil prices, ratchet higher, amplifying the economic hit to activity, particularly for transport, aviation and other energy intensive industries such as agriculture and manufacturing. In Australia, diesel and petrol prices average around $3.07/l and $2.68/l by year-end, or 75cents and 65cents higher than in our basecase.

Gas markets also reprice higher with Asian LNG benchmarks reaching around $28/MMBtu in Q3 as fuel switching and competition for cargoes intensify.

Australia petrol price



Source: Bloomberg, Macrobond, Westpac Economics

Economic impact

Higher oil prices lift petrol and diesel prices and raise production and transport costs globally. Energy intensive goods such as plastics and fertilisers also rise further pushing up food and other prices. This drives Australian inflation to nearly 6% in Q4, albeit still lower than its 2022 peak. Underlying inflation also remains sticky at around 3.4% for most of 2027. The RBA faces a difficult trade-off of managing much higher inflation at a time when economic activity takes a significant hit.

In this scenario the Australian economy records several quarters of negative growth as higher inflation and interest rates further erode household disposable income and households pull back from spending on discretionary goods and services. Businesses defer or cancel new investments amid higher cost pressures, elevated interest rates and weaker demand. Weaker global growth across Australia's major trading partner economies also weighs on export growth, outside of LNG exports.

For New Zealand, the impact is more pronounced. Food and energy account for a larger share of the CPI basket, and the economy does not benefit from offsetting energy exports as in Australia. Headline inflation is around 1.5ppt higher relative to the baseline by end 2026 and economic growth is 0.8pt lower in Q4 2026 on a year ago basis, while the economy contracts in H2.

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