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Pricing the Shock: Oil, Volatility and Portfolio Resilience

March 25, 2026

Key Takeaways

- ▶ The Strait of Hormuz disruption is a classic information-rich shock, driving extreme oil volatility and forcing markets to reprice growth, inflation and recession risk as the duration of the supply shock becomes clearer.
- ▶ Markets are still pricing a relatively quick resolution, but forward curves are shifting higher, suggesting oil is unlikely to revert to prior levels and that prolonged disruption would materially increase stagflation and recession probabilities.
- ▶ Our portfolio positioning has proven resilient and is tilted toward energy and real assets, where upside from supply shocks and improving fundamentals provide both diversification and attractive forward return potential.

Calibrating Surprise Through Oil

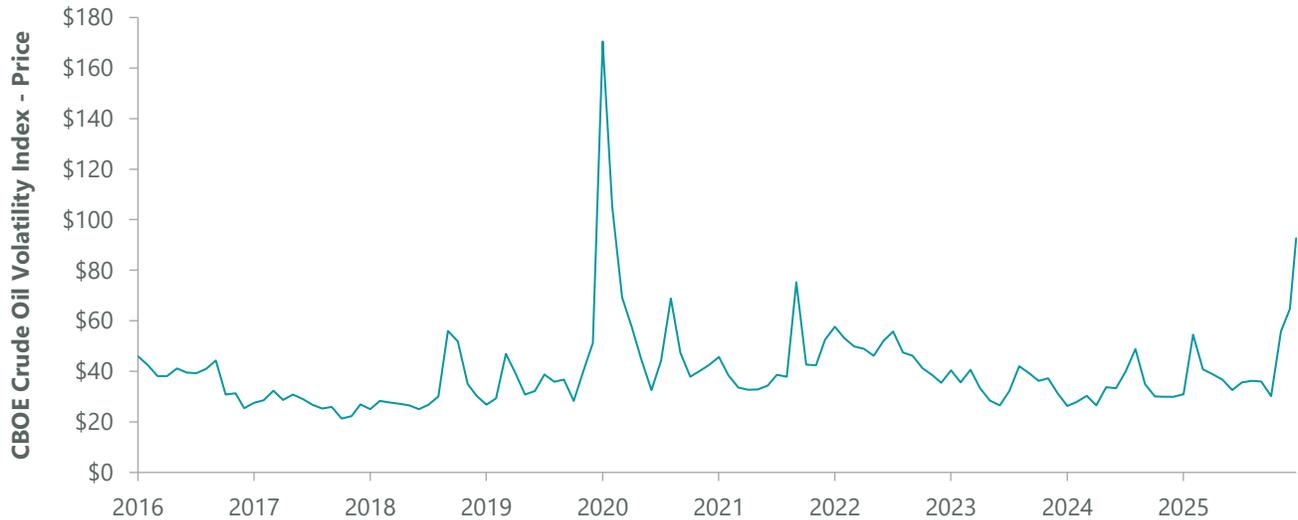
The current conflict with Iran, and the effective closing of the Strait of Hormuz, is the year's first big "information-rich" event — a surprise that introduces a shock of uncertainty the market must price over time as new information reduces uncertainty. The defining characteristic of these events is a large spike in volatility, which will ultimately result in price discovery at a level that reflects the new information.

Information-rich events are typically good tests of portfolio construction and often require some level of adaptation. They also create new opportunities, typically in the form of exploitable risk premiums and behavioral errors resulting from overreactions or underreactions. Our portfolio construction has held up as designed following some recent portfolio adaptations and, although we are observing some elevation in risk premiums, the market's underreaction to changes in energy and commodity markets offers attractive forward return opportunities.

The best way to measure surprise events is with volatility. With the latest Hormuz crisis, the best gauge is the oil volatility index (OVX), which has registered the second-largest oil volatility event on record, surpassed only by the demand collapse during COVID when oil briefly hit negative levels in Spring 2020. At its peak, the OVX reached 120, implying daily moves in oil price of roughly 8%. This level of volatility is not sustainable and has already begun to fall as uncertainty has waned (Exhibit 1).

The critical unknown variable is the duration of the Strait closure. This is important as the closure has the potential to be the largest oil supply shock in history. Currently, an estimated eight million barrels per day (mmb/d) are offline according to the International Energy Agency, largely a function of storage filling behind the Strait. Analysts estimate the supply shock could approach or exceed 10 mmb/d within weeks, a disruption that cannot be offset by Strategic Petroleum Reserve (SPR) releases — which could optimally cover roughly four mmb/d — or a quick supply response.

Exhibit 1: Hormuz Closure Results in Historic Volatility



Source: Bloomberg. As of March 18, 2026.

If this situation is not resolved within the next couple weeks, global oil inventories will decline toward historic lows and prices would need to rise to induce demand destruction. The critical level is when global consumption exceeds 4% of global GDP, roughly \$150 oil, which would raise recession probabilities materially, increasing U.S. recession odds from approximately 20% pre-Iran and the roughly 31% we are currently observing.

The market is not pricing a drawn-out crisis. Both the oil forward curve and volatility curve remain in steep backwardation — reflecting a sharp spike in spot prices with expectations for normalization later in 2026. However, the forward curve continues to move higher as the closure persists, signaling oil is unlikely to revert to \$60 levels, but will instead settle higher depending on the timing of a resolution.

Positioning to Persevere Through Volatility

We are evaluating three scenarios as events unfold:

1. **Near-term resolution (~30% probability, declining):** Strait reopens within two weeks, cumulative draw down of supply of 20 million to 40 million barrels, minimal structural damage, and oil settles in the \$70–\$75 range in the second half of the year.
2. **Extended disruption (~60% probability):** Closure lasts four to eight weeks, drawing 300 million to 500 million barrels, exhausting the SPR and pushing inventories to multiyear lows. Oil stabilizes in the \$80–\$95 range into 2027 with signs of structural damage.
3. **Tail event (~10% probability):** Conflict extends into early summer or beyond, resulting in structural damage, continued closure and cumulative draws exceeding one billion barrels. Oil spikes toward \$200, forcing demand destruction, with prices remaining above \$100 for an extended period as markets rebalance.

Probability-adjusted outcomes suggest oil prices settle above \$70 but quickly escalate as a function of time.

These dynamics are increasingly central to portfolio construction. We have been adapting the portfolio to be more resilient to volatility spikes, which have recently been characterized by extremely fast ascents and equally fast normalization, with limited expansion in exploitable risk premiums. Our approach has been to reduce exposure to high-volatility, high-correlation names that consume a disproportionate part of our risk budget, lowering downside during spikes and allowing us to play offense more quickly.

This positioning has worked as intended. During the recent episode, the VIX reached 28 — a one standard deviation move — and the portfolio declined roughly 80 basis points relative on a gross basis, in line with or better than peers, without requiring defensive repositioning. In fact, we added to select names we believe are well-positioned when the crisis abates.

At the same time, the opportunity set is evolving alongside commodity markets. We believe market leadership will continue to broaden and that the ongoing bull market in real assets will be reinforced by this crisis. Our portfolio reflects this with an active overweight of over 800 basis points in energy and materials. One of the key benefits of this positioning is that commodity return tails are symmetric — downside from demand shocks like COVID and upside from supply shocks like Hormuz — providing diversification against the structural left-tail skew from long equity exposure.

Energy fundamentals are also improving meaningfully, with cash flow and earnings estimates seeing positive revisions. We expect energy to continue to lead the market in 2026. However, the most constructive outcome for energy equities is a quicker resolution, as energy stocks typically perform better when prices stabilize at higher levels — the most likely current outcome -- rather than during acute price spikes.

If stagflation risks become more embedded, energy and health care have historically been two of the few areas of outperformance. We have used recent health care weakness to add exposure while remaining fully positioned in energy. Despite this, risk premiums remain compressed and we are still positioned defensively relative to history, maintaining dry powder to act more aggressively when we are better compensated for risk.

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