Yardeni Research

March 10, 2026

Morning Briefing

On Iran, Central Banks, South Korea, & AI

Executive Summary: The Middle East war is throwing central banks around the world for a loop as they try to chart monetary policy paths for their economies amid new stagflation and supply-chain risks. William examines what the war might mean for the Fed, the ECB, the BOJ, and the PBOC. … Also: The war sent Korea's Kopsi index on its biggest plunge ever, as the Korean economy is extremely reliant on oil imports and vulnerable to surging oil prices. There's risk that the geopolitical chaos will squelch investors' AI enthusiasm. Might Korea be a canary in the AI coalmine?

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Central Banks: Iran War Has Policymakers in a Whirl. Everything the globe's top central bankers thought they knew about 2026 is changing at warp speed. Making matters even worse for officials in Washington, Frankfurt, Tokyo, and Beijing is that they don't know what they don't know about a Middle East crisis propelling the price of oil well above $100 per barrel or possibly higher.

Without a sense of how long the Strait of Hormuz will be effectively closed, how many fresh bombing raids US President Donald Trump and Israeli Prime Minister Benjamin Netanyahu will order, and how much Iran might retaliate and where, economic forecasting is in a fog that's thickening by the day.

Here in Japan, for example, the financial markets suffered the next leg of the global stock swoon Monday morning, with the Nikkei 225 Stock Average *plunging* as much as 7%. At least 95% oil imports into Asia's No. 2 economy go through the Strait of Hormuz. This has words like "*Iranflation*" and "*warflation*" flying around in Japanese cyberspace.

Yet what's really trending at central bank headquarters around the globe is discussion of stagflation risks and this decade's latest supply shock. From the Covid-19 pandemic to Russia's invasion of Ukraine to the trade war to triaging the implications of AI on the fly, the 2020s have kept central bankers on their feet. Now comes a Middle East war that's increasing risk of a global recession with rising inflation in a hurry.

Let's take a look at what the war might mean for the globe's four most powerful central banks:

(1) *Federal Reserve*. With just over two months left in his tenure as Fed chair, Jerome Powell could be excused if he's ecstatic about passing the gavel to someone else at such a precarious moment. Presumably, it will fall to nominee Kevin Warsh *after May 15* to decide which of the Fed's dual mandates to prioritize as Trump offers critiques via social media in real time.

The Fed is almost universally expected to hold rates steady at the March 17-18 policy meeting. Even after news that nonfarm payrolls fell 92,000 in February, Polymarket.com assigns rough 85% odds that the Fed will stand pat on April 29, too. That means that if Warsh, assuming he's confirmed, tries to push for rate cuts in line with Trump's preference, he may face strong pushback. The minutes of the January Federal Open Market Committee indicated that "*several*" members thought rate hikes might be needed. The hawks are gaining power as fallout from the war in Iran mounts.

The real decider may be the bond market. As the US national debt careens toward *$39 trillion*, the combination of a budget-busting war and oil-driven inflation might limit the Fed's latitude to ease. Its flexibility may also be limited if the dollar gets wobbly or if Trump gets creative on imposing new tariffs.

(2) *European Central Bank*. At ECB headquarters in Frankfurt, policymakers are mulling how to respond as the Iran war upends the central bank's "*good place*" narrative. The ECB, admits President Christine Lagarde, has no "preset" response to an energy shock layered on top of already elevated inflation and tepid growth. The issue now is that "*stagflation risks* have risen," warns Henry Cook at MUFG Bank.

Heading into 2026, the ECB reckoned that Eurozone inflation rose 1.9% y/y this year, just below the 2.0% target. In its risk assessment, the ECB noted that a *14.2% y/y increase* in oil prices and a 20.0% y/y rise in the price of natural gas would push inflation upward by 0.5ppts. Costs of both have surged far more than that in recent days. And the ECB's stress tests didn't consider broader supply-chain disruptions or a weaker euro.

As such, Team Lagarde could face heightened risks of a deepening recession. "Higher *energy prices* act like an additional tax, dampening consumption and investment," notes Daniel Stelter, founder of the Beyond the Obvious think tank. "Already weakly industrialized countries such as Germany will slide deep into recession—the entire eurozone into at least a technical recession."

Last week, when ECB council member Pierre Wunsch *said* that if the energy surge persists, "then we will have to run our models and see what happens," the subtext sounded like "we don't have a playbook for this."

(3) *Bank of Japan*. On a list of monetary policymakers whose 2026 is going terribly awry, BOJ Governor Kazuo Ueda's name deserves a spot near the top as Japan's inflation risks surge and *GDP flatlines*. This makes the upcoming March 18-19 board meeting a *stagflation* brainstorming session. Ueda finds himself in a place where even good news on Japan's economy can be bad. In January, real wages rose for the *first time* in 13 months—by 1.4% y/y.

The biggest increase since May 2021 will surely cheer Prime Minister Sanae Takaichi. Base pay *climbed 3%* y/y, the biggest gain in 33 years. Yet with oil prices surging, the sudden appearance of wage growth in an economy struggling with *low productivity* complicates the BOJ's job. So does a *weak yen*, which increases the odds of importing inflation.

In these upside-down times, the yen isn't playing the usual safe-haven role in times of international turmoil. Takaichi's sweeping plans to cut taxes and boost government spending are also *unnerving* the bond market. All this leaves the BOJ trapped on hold.

(4) *People's Bank of China*. Even before Iran became a war zone and complicated China's year, PBOC Governor Pan Gongsheng was engaged in quite a juggling act. China ended 2025 with its slowest GDP growth rate in *nearly three years*—4.5% y/y. That was thanks to Trump's tariffs colliding with a domestic property crisis and weak household demand.

Yet Pan's institution has been limited in its ability to ease policy by President Xi Jinping's political priorities—namely, propping up the yuan. A weaker exchange rate might increase the odds of giant property developers defaulting on offshore debt and of a clash with Trump World. If the US thought Beijing were depreciating its currency to boost exports, retaliation could be harsh.

Now, add the odds of imported inflation to the reasons the PBOC is reluctant to ease. Before the war, *at least 90%* of Iran's oil went to China. And like Japan, any prolonged closure of the Strait of Hormuz could cause an inflation shock for which the PBOC hadn't planned. The PBOC's ability to defeat deflation once and for all may depend on how quickly Team Xi can replace its oil supply from both Iran and Venezuela.

South Korea: Seoul Stocks—Canary in the AI Coalmine? Perhaps no major stock market has had a wilder ride so far in 2026 than South Korea's. And the two main drivers of the extreme volatility—AI and the Iran war—make Seoul a cautionary tale for what may be to come globally.

Prior to the US and Israeli strikes on Iran, which began on *February 28*, Korea's Kospi index was on a record run, turning more and more heads in Asia's fourth-biggest economy. President Lee Jae Myunghad was delivering on promises made when he assumed office on *June 4*.

Lee said that, unlike the last five Korean leaders since the mid-2000s, he wouldn't just talk about ending the "Korea discount"—he would end it. He campaigned on a pledge to *more than double* the Kospi index to 5,000 within five years (it was below 2,500 at the time). Thanks to the global AI trade, it took just five months.

In fact, prior to bombs' falling on Tehran, the Kospi topped 6,000—a 139% y/y gain in late February. The rally brought Korea's overall market capitalization to about *$3.76 trillion*, making it the No. 9 market globally. The market cap of Korean equities was suddenly larger than that of much bigger economies like France and Germany.

Yet the war quickly brought financial mayhem to Seoul's trading pits—and raises questions about the underpinning of the AI investment boom.

Let's explore why Korea has been hit so hard and what it might portend more broadly:

(1) *Extreme volatility*. Last week, in the first two trading days after the war began, the Kospi *lost 18%*, the *biggest plunge ever*. Lee called a hastily arranged cabinet meeting. Bank of Korea Governor Rhee Chang Yong convened policymakers for an *emergency meeting* as the won fell to a 17-year low. The immediate worry is Korea's extreme reliance on imported oil.

(2) *Cooling AI investments?* The Kospi 5,000 goal, of course, was a little too easy for Lee as startling rallies in chipmakers *Samsung*, SK Hynix, and other tech giants at the center of the AI data center boom sent the broader market higher. But a longer-term risk is dawning on Korea Inc.: What if Iran war fallout *cools AI investment* for a prolonged period?

Korea's *$1.9 trillion economy* is highly vulnerable to surging commodity prices. So, its terms of trade should deteriorate as oil and gas costs rise. Korea has managed to partly offset that dynamic thanks to strong exports of AI chips, maintaining a surplus.

(3) *Chips weakness*. The main global concern is that geopolitical chaos and rising oil prices are dampening investors' enthusiasm for AI. That's why the sudden weakness of Korea's chip production and facility investment could augur poorly for stock markets around the globe.

Only time will reveal whether this most "old-economy" spoiler can upend the ultimate "new-economy" trade, which has lifted stock markets everywhere beyond the reach of Economics 101. But Korea's travails are worth monitoring at a time when many global investors find themselves at an AI crossroads.

(4) *A bigger problem*. The challenge now for Lee is to ensure that financial reforms catch up with the Kospi index in a hurry. To be fair, Korea's National Assembly is beginning to act. It just approved a long-debated measure forcing companies to cancel so-called *treasury shares*. They don't receive dividends or voting rights, but the family-owned conglomerates, or *chaebols*, that tower over all else in Korea use such shares to avoid hostile takeovers. Eliminating this tactic has long been key to ending the Korea discount.

Yet the problem is much bigger. Lee's finance minister, Koo Yun-cheol, must *act faster* to rein in the *chaebol t*hrough bold, transparent antitrust enforcement. *Chaebols* are notorious for monopolistic behavior and prioritizing family connections over merit in hiring and promoting. They also tend to hog economic oxygen that would be better spent enabling startups to disrupt Korea Inc. and create high-paying jobs.

(5*) Reform needed*. Also, Lee's economy is terribly behind the curve in cutting bureaucracy, modernizing labor markets, increasing productivity, supporting a startup boom, empowering women, and creating the conditions for small and mid-size companies to raise wages and take bigger risks.

The financial system needs a bit of shock therapy. On June 24, 20 days into Lee's term, index giant MSCI did what it had done for *11 years*: It rejected Korea's request for an upgrade to developed-market status. In fact, Seoul didn't even get on MSCI's watchlist for markets on the move.

The classification matters greatly for global institutional investment flows. Goldman Sachs *reckons* that an MSCI upgrade would pull another $30 billion of foreign capital into Korea's financial markets. Yet MSCI remains unimpressed by Seoul's barriers to foreign investor access, regulatory inconsistencies, underdeveloped market infrastructure, and limits on the number of trading hours per day for the won.

Korea also has a ways to go to reach Lee's goal of becoming a top-three AI leader or to justify the huge gains in the market. Here, too, the economy's over-reliance on large firms is a demerit. Korea needs better Silicon Valley-style academic-industry integration to produce the *talent* and the venture-capital ecosystem it needs.

In the meantime, though, Korea Inc. is grappling with Iran war-related shockwaves—and trying to avoid the dubious honor of being a canary in the AI coalmine.

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the March 5 week, forward earnings rose to record highs for LargeCap and MidCap, but SmallCap's ticked down for the first time in 13 weeks. Still, SmallCap's forward earnings (1.6% below its record high in June 2022) has soared 14.3% y/y and is improving at its fastest rate in 40 months. That's more than *double* MidCap's slower gain of 6.2% y/y (still a 12-month high) and compares to LargeCap's strengthening gain of 17.5% y/y (44-month high).

LargeCap's rose for a 42nd straight week, its longest string of weekly gains in nearly 15 years! LargeCap's next milestone is the 46-week streak following the Great Financial Crisis (GFC) through the March 25, 2010 week. The SMidCap's forward earnings are also on solid uptrends too, with both indexes missing just a few of the w/w gains since Liberation Day last April.

LargeCap's forward earnings rose 0.8% w/w to its 40th straight weekly record high. MidCap's ticked up 0.3% w/w to its first record high since the January 29 week, which the index has posted in 14 of the past 19 weeks. During March 2025, MidCap re-entered the record-high-forward-earnings club, for just three weeks, for the first time in 33 months before tariffs sidelined the index for six months. SmallCap's took a small step back w/w to 1.6% below its June 2022 record. SmallCap's absence from the record-high-forward-earnings club has lasted longer than its post-GFC drought, 43 months now versus 36 months then.

These three indexes' forward earnings downtrends from mid-2022 to early 2023 during Big Tech's year of cost-cutting and again during Trump's Tariff Turmoil were relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the GFC. Powered by stellar growth from the Magnificent-7, LargeCap's forward earnings has soared 44.5% from its 54-week low during the week of February 1, 2023; MidCap's has slowly gained 15.2% from its 55-week low during the week of March 10, 2023; and SmallCap's has quickly rebounded 15.3% from its recent 42-month low during the May 23 week.

Analysts currently expect all three of these indexes to post double-digit percentage earnings growth in 2026 and 2027. Here are the latest consensus earnings growth rates for 2025, 2026, and 2027: LargeCap (12.6%, 15.9%, 16.1%), MidCap (-0.9, 17.5, 16.0), and SmallCap (9.2, 12.8, 18.1).

S&P 500/400/600 Valuation (*link*): Valuations tumbled across the board for all three S&P market-cap-style indexes during the March 6 week and at the fastest rate in 48 weeks. While forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018, they've been improving since October 31 and are closing the gap as LargeCap's weakens. LargeCap's forward P/E dropped 0.6pt w/w to a 10-month low of 20.6.

LargeCap's P/E of 20.6 remains 3.6pts above the seven-month low of 17.0 during the October 27, 2023 week. That compares to a 30-month low of 15.1 at the end of September 2022 and an 11-year low of 11.1 during March 2020. It's now down 2.2pts from a 25-year high of 22.8 during the October 31 week.

MidCap's forward P/E fell the most, 0.8pt w/w to 16.1, but only to a nine-week low. It's down just 1.0pt from a 64-week high of 17.1 during the February 20 week and is now 3.9pts above the 12-month low of 12.2 in October 2023. That compares to an 11-year low of 10.7 in March 2020 and a record high of 22.9 in June 2020 (when forward earnings was depressed).

SmallCap's forward P/E dropped 0.5pt w/w to a 15-week low of 15.1, just 1.1pts below its 14-month high of 16.2 during the February 6 week. It's 2.2pts above its 17-month low of 12.9 during the April 4 week and 4.5pts above its 14-year low of 10.6 in September 2022, but is now 2.0pts below its 41-month high of 17.1 during the November 29, 2024 week following Trump's election. That compares to a record high of 26.7 in early June 2020 when forward earnings was depressed and a record low of 10.2 in November 2009 during the GFC.

MidCap's P/E ticked down to a 19% discount relative to LargeCap's P/E from a three-year-high 20% discount a week earlier. That's up markedly from a 26-year-low 30% discount during the October 31 week. MidCap had last been at a 19% discount during the March 2, 2023 week, which then matched its best reading since October 14, 2021.

SmallCap's P/E was steady w/w at a 13-month high 26% discount to LargeCap's P/E. That's well above its 25-year-low 34% discount during the November 20 week. SmallCap had been at a 23% discount during the November 29, 2024 week, which was its best reading since the March 2, 2023 week.

SmallCap's P/E relative to MidCap's was also steady w/w, but at a 7% discount that matches the 18-month-low discount during the November 20 week. That remains well above its 20-year-low 10% discount in late 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above MidCap's, and both were above LargeCap's.

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