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From the Shah to the Strait: The US Gamble to Stabilize the Gulf

It has been nearly 50 years since the 1979 [Islamic Revolution toppled the Shah of Iran](#), replacing the Persian monarchy with a theocracy that sent shockwaves through the West. This upheaval triggered the decade's second major oil crisis and effectively dismantled Washington's "Twin Pillars" policy. By losing Iran as a strategic counterweight alongside Saudi Arabia, the United States saw its primary mechanism for regional proxy influence collapse — a blow compounded by the wave of oil field nationalizations across the Middle East from the preceding years.

Today, a new regional conflict has emerged as a definitive inflection point — one that could reverse decades of geopolitical momentum. Through [Operation Epic Fury](#), [the US and Israel](#) have launched a decisive campaign to dismantle the current regime's military and leadership infrastructure, signaling a bold attempt to usher in a new era for Middle East oil politics. While fraught with risk, this escalation presents a singular opportunity to reassert Western leverage and fundamentally reshape the regional balance of power.

In this report, we examine the geopolitical significance of Iran and what the current conflict could mean for US global influence. We also summarize the potential market ramifications, including the impact on bond markets, the US dollar, and equities.

The Fall of the Shah

To understand what is at stake today, it is essential to first revisit how Iran's modern political trajectory reshaped the regional order in the late 20th century. The roots of US involvement in Iran trace back to the British Empire's decline following World War II. As Washington urged London to dismantle its colonial apparatus in favor of democratic systems, a new political landscape emerged. This shift allowed Mohammad Mossadegh to rise to power in Iran. Once elected prime minister, he moved to reclaim Iranian independence and minimize foreign meddling, all while operating in the shadow of the reigning monarchy.

Tensions between Iran and the West reached a breaking point following [Prime Minister Mossadegh's decision to nationalize the Anglo-Iranian Oil Company](#). This British-controlled firm dominated the nation's energy sector and operated the world's largest refinery at Abadan, making its seizure a flashpoint for fierce opposition from London and Washington. When diplomatic and economic pressure failed to reverse the policy, a coup backed by the US and the UK overthrew Mossadegh, consolidating power in the hands of Mohammad Reza Shah Pahlavi in 1953.

While the relationship between the US and the shah was a strategic improvement over the previous administration, it was fraught with internal contradictions. The shah acted as a regional stabilizer, allowing the US and UK to secure oil prices and maintain a

presence without direct military intervention. However, he remained a consistent headache for Washington; his regime's record of human rights violations and his insistence on pursuing a nuclear program, against explicit US wishes, created deep-seated diplomatic friction.

The US also struggled to sustain the shah's authority as his regime became increasingly unpopular. Public resentment surged, driven by the monarchy's heavy-handed authoritarianism and a perceived policy of forced Westernization. Many Iranians felt this rapid modernization was a direct assault on their cultural identity, systematically distancing the nation from its deeply rooted traditions as a Shia Muslim society. This internal friction culminated in the 1979 Islamic Revolution, which dismantled the monarchy and established the current theocratic republic.

The Failure of the Twin Pillar Policy

The [fall of the shah created a strategic void in the Persian Gulf](#) that Washington has struggled to fill ever since. During the 1960s and 1970s, the US had relied on Iran and Saudi Arabia as the primary anchors of its Gulf strategy, [a framework later known as the Twin Pillars policy](#). By empowering both monarchies, US planners hoped each would serve as a counterweight to the other, preventing any single actor from dominating the region's oil and security architecture.

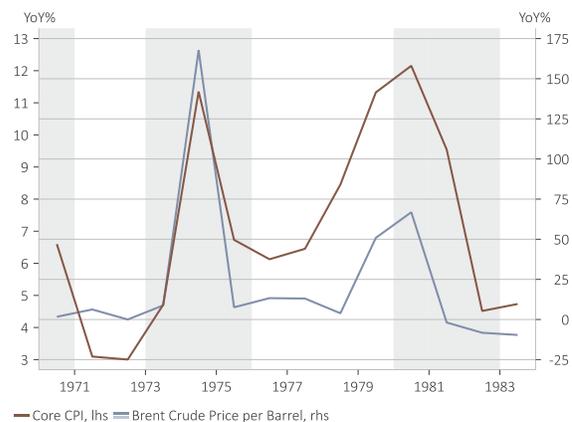
The revolution in Iran triggered a regional crisis. Not only did disruptions associated with the revolution trigger a second Middle Eastern oil shock (see Figure 1), but the new Islamic Republic's aim to export its revolution terrified the surrounding Sunni monarchies and Iraq, and these tensions erupted into the bloody Iran-Iraq War in 1980. The conflict quickly became a theater for Cold War competition, with the US and

the Soviet Union providing support to opposing sides — not to secure a decisive victory for their proxy, but to ensure their own strategic interests and guarantee the continued flow of oil. Concurrently, both belligerents pursued nuclear and strategic capabilities, fueling fears of a broader cascade of proliferation.

Figure 1

Middle East Oil Shocks Fueled US Stagflation

BLS and OECD



The fear of Iran acquiring weapons of mass destruction and regional dominance would later help drive the US invasion of Iraq and shape Washington's pressure campaign to constrain Iran's nuclear program. Under President Obama, [the US briefly revived elements of the old Twin Pillars](#) logic through the Iran nuclear deal, which aimed to reintegrate Tehran into a managed regional order — an experiment that ended when the Trump administration withdrew from the agreement in 2018.

Abraham Accords

Since returning to office, President Trump has pursued a fundamentally different strategy to fill the enduring void left by the shah's fall. His administration now seeks to reshape the [Middle East by positioning Israel, Saudi Arabia, and key Gulf States as](#)

[the core of a pro-US regional bloc](#). This new framework aims to bridge longstanding differences among these nations through expanded trade, investment, and diplomatic engagement — an approach formalized and expanded by the Abraham Accords. In exchange for this alignment, the US has provided military assistance and, in certain cases such as Qatar, extended explicit security guarantees to bolster regional stability.

The Accords have played an important role in reshaping the Middle East in the US's favor. By narrowing the political gap between Israel and several Arab states, they laid the groundwork for deeper security cooperation against Tehran. Iran's deepening ties with US rivals like China and Russia, its support for regional proxy groups, and its ongoing nuclear and ballistic missile advances have cemented its status as the central target of this reconfigured US strategy. Meanwhile, Israel has consistently sought to disarm Iran following years of threats and provocation.

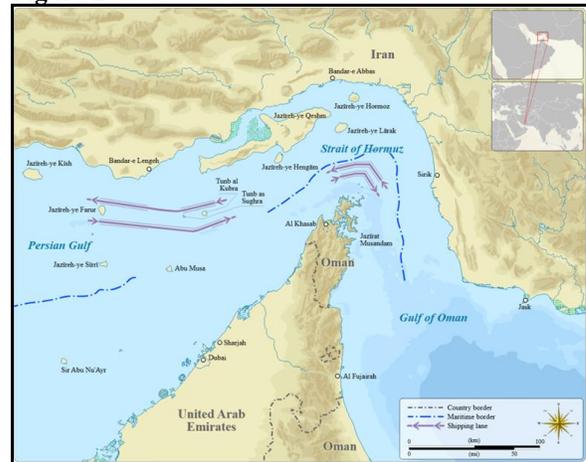
When Tehran continued its nuclear enrichment and rejected negotiated limits, Washington ultimately shifted from diplomacy to force, [striking key nuclear sites in 2025's Operation Midnight Hammer](#). That campaign has since broadened into Operation Epic Fury, targeting Iran's military, missile, and command infrastructure in a decisive move to cripple the very capabilities that have menaced the region and driven the search for a new, more durable security order since the shah's fall.

The Strait of Hormuz

The most commonly discussed concern about Iran would be its acquisition of a nuclear weapon. Iran has (or had) a robust nuclear enrichment program, with several sites containing centrifuges designed to

enrich uranium. Foreign governments, most notably the US and Israel, have actively tried to discourage or disrupt these installations. Even so, despite all the concern about nuclear weapons, Iran's most potent leverage remains its proximity to the Strait of Hormuz, the narrow passage between the Persian Gulf and the Gulf of Oman (see Figure 2).

Figure 2



(Source: Wikipedia Commons)

The [Middle East region generates](#) about 30% of the world's crude oil production, and, more importantly, about 75% of excess oil capacity rests in the area. Roughly 20 million barrels per day of crude oil pass through the strait. There are pipelines that go around the strait: one to the Gulf of Oman, and another that transverse Saudi Arabia to the Red Sea.

Liquefied natural gas has become an increasingly important product in world energy markets. Qatar is home to QatarEnergy, which is the world's largest LNG producer, and about 20% of global LNG supplies pass through the strait.

Less known is that the region also generates other important products. Almost 50% of global urea, a component in fertilizer, is produced west of the strait. Similarly, 50% of global sulfur exports originate from the

same area. Saudi Arabia is one of the four largest producers of phosphates, another key component of fertilizers. Finally, [about a third of the world's helium supplies come from Qatar](#). Besides its use in filling balloons and raising the pitch of one's voice, this inert gas is used in the manufacturing of semiconductor chips as it insulates the silicon wafer during etching and is used in industrial cooling processes.

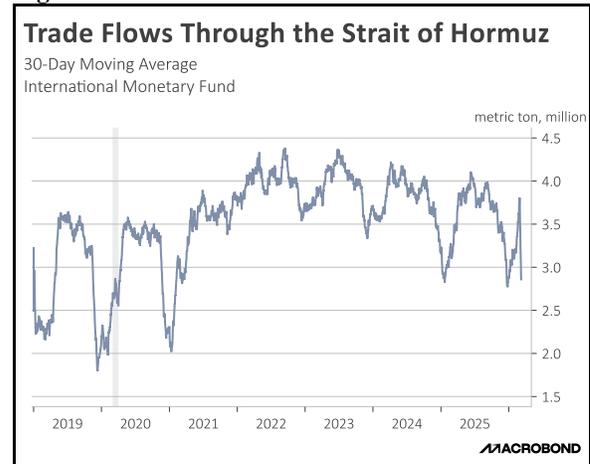
Since the 1979 Iranian Revolution, there have been several incidents where Iranian forces have attempted to affect shipping in the Strait of Hormuz. When Iraq attacked Iran in September 1980, both nations attacked each other's shipping capabilities. These attacks escalated after 1984, eventually leading to the US Navy escorting shipping through the strait. By the end of the war in 1988, the US had destroyed about 40% of Iran's navy, reducing Tehran's ability to affect Persian Gulf shipping. In the mid-1990s, Iran installed shore-to-ship missiles along its coastline at the strait.

A Point of Failure

Although closing the Strait of Hormuz is a serious threat, it has several drawbacks. First, as our description above shows, the waterway is very important to the global economy. Closure would be expected to bring a coordinated response against Iran and thus would not be implemented except under the most serious of circumstances. Therefore, it has been often threatened, but never really implemented...until now. Second, Iran's economy is just as dependent on open shipping through the strait as its neighbors, so closing it means economic problems for Tehran as well. Finally, once this region's shipping is meaningfully disrupted, the world will know that supplies from the region are insecure. Although demand will eventually return, consumers will likely diversify, resulting in a

weakening of the region's economies. After all, if shipping is closed, producers eventually run out of inventory and are forced to shut in production. Restarting production can take months.

Figure 3



For these reasons, Iran has tended to avoid the step of closing the strait. The general consensus has been that Tehran would not close the strait unless facing an existential crisis. Thus, its decision to close the strait would suggest Iran views the attacks it is suffering as existential. It isn't obvious that the US and Israel viewed their attacks in that manner. It appears the Trump administration was planning for a repeat of the Venezuelan solution, meaning a new leader in Iran that was amenable to the US but no wholesale change in governance. That may not have been Israel's position, but Washington showed no interest in regime restructuring like what was tried in Afghanistan and Iraq.

One of the factors that may have affected Iranian thinking about closing the strait is the development of drone technology. In the past, Iran could interdict shipping by naval mines, shore-to-ship missiles, and naval attacks. All three could be thwarted by the US Navy. The US can deploy minesweepers to clear the strait. Once a missile is launched, its "signature" can be seen by US

airpower and neutralized, and Iranian naval vessels can be attacked by the US Navy. Drones add another dimension. They are cheap to build, and they don't leave a signature when launched. Drones have become an effective way to not only deter shipping, but to give Iran the ability to attack oil installations in the region. So far, Iran's attacks on oil infrastructure have been modest, but the longer this conflict lasts, the higher the probability that Iran will expand its attacks on the infrastructure of its Arab neighbors.

Market Ramifications

So, where does this end? Our perspective is that the world has numerous potential "points of failure," or areas that bring economic vulnerability. For example, the semiconductor foundries in Taiwan are at risk to Chinese attack. China's dominance in the production and processing of rare earths is well known. The Strait of Hormuz is one of these points as well. Importantly, when the world has a dominant hegemon, economic actors around the globe feel a degree of confidence that these potential points of failure won't actually "fail." The current events in the Persian Gulf raise the possibility that the US is less able to protect these points of failure. If that fear becomes widespread, nations will tend to scramble to secure resources, leading to increased global friction and higher prices over the long term.

In the near term, we agree with the consensus view that the global economic and financial market implications of the Iran war will hinge on how long we see disruptions in the flow of oil, natural gas, and other commodities through the Strait of Hormuz. We believe that global investors have been remarkably sanguine about the length of the war. As of this writing, for example, US stock prices have only fallen a few percentage points from their levels right

before the war started. Other market moves have also been relatively muted, suggesting that investors expect the war to wind up quickly, allowing for a rapid normalization of shipping flows and a return to lower commodity prices. This is certainly one possibility. However, we think prudent investors should carefully consider the risk of a prolonged conflict that could scar global geopolitical, economic, and financial conditions over the longer term.

As our analysis above indicates, Iran could use its drones, naval mines, and missiles held in reserve to keep the strait largely shut down for an extended period, and the US and Israel may not be able to completely eliminate the threat. In addition, the Iranians could train their firepower even more directly on energy and shipping infrastructure throughout the region, in which case the resulting damage could slow the resumption of normal trade flows long after shipping can safely pass through the strait. As discussed above, an Iranian regime that believes it is facing an existential threat is more likely to adopt this kind of scorched-earth strategy.

If the war lasts significantly longer, the supply disruptions are likely to reverberate through the global economy for an extended period. While the global release of oil from the International Energy Agency's Strategic Petroleum Reserve System (SPR) should temporarily ease the oil shock, the released barrels could be used up in a matter of weeks. In addition, the SPR releases do nothing to mitigate the impact on global natural gas or fertilizer prices. A wide range of industrial and food products, therefore, will likely become more costly, weighing on global economic growth and asset prices. Given how Asia and Europe are so dependent on imported energy and other

products, they are likely to be more heavily impacted than the US.

In this worst-case scenario of stagflation (i.e., reduced economic growth with rapidly rising prices), some assets will likely do better than others. Energy, industrial metals, and agricultural commodity prices would likely rise as would the stock value of companies producing them. Although gold and precious metals prices have fallen since the start of the war, that probably stems in

large part from efforts to raise liquidity. In a more inflationary world, gold and precious metals prices could turn upward again. In contrast, longer-maturity bonds would likely lose value, driving up yields.

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This report was prepared by Thomas Wash and Bill O’Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

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