Conflict Update

02 October 2026

October volatility as markets gauge prospects for Iran War escalation

Key points

- Diplomacy between the US and Iran remains deadlocked.
- Crude oil transit through the Strait of Hormuz has recovered, but many other factors show normality is far from reached.
- An unstable equilibrium exists in which the Iranian regime will not accept peace without regime stability, whereas the US will not accept peace without regime compliance.
- US options for escalating military action remain limited only by our imagination and the Trump administration's track record for significant risk-taking and unpredictability.
- We believe renewed strikes are more likely to provoke large-scale Iranian retaliation against regional energy infrastructure and trigger a wider conflict rathern than to produce a deal, setting up October as a volatile month for markets.

In last week's note, we argued that the stage appears set for an escalation in the conflict if parties failed to accelerate the path to negotiations.

The diplomatic track between Iran and the US appears as intractable as ever. Last week's proposal by Iran, which effectively sought a accelerated version of the MoU, was quickly rejected by Preisdent Trump. And, after no discernible progress was made during weekend meetings between Iranian officials and Qatari mediators, the disagreements between Iran and the US even extended to the manner of the Iranian delegation left New York. US Secretary of State Marco Rubio ordered "on Monday that Foreign Minister Araghchi and his delegation had to leave New York immediately" according to the Associated Press. This was denied by the Iranian mission to the UN, which said that the departure had been planned well in advance.

A war by many means. This week has seen an attempted disruption at a US-run air force base in the UK as well as a suspected terrorist attack on a flight between the UAE and Israel. Meanwhile, traffic through the Strait of Hormuz (SoH) shows it reaching roughly two-thirds of pre-war levels. This has raised questions about whether Iran has lost its leverage in the SoH. But as long as tanker insurance costs - as well as the risk of escalating kinetic attacks - remain elevated, this should not be interpreted as a return to normality. Front-month Brent futures continue to hover around 100 $/bbl, and this does not take into account tanker freight costs, which have soared this year, or the even higher prices of oil product such as diesel.

The Iranian threat around the SoH remains persistent. Iranian attacks on commercial shipping in the SoH continue, and there have also been reports of injured US military personnel on a "maritime vessel". Broader attacks on US Navy warships have not been independently verified, but open-source investigators have noted that the US blockade line appears to have shifted from the mouth of the Gulf of Oman to further out into the Indian Ocean, presumably to avoid Iranian anti-ship ballistic missiles. While

this may not prevent the US from enforcing its blockade on Iranian shipping through the SoH transit, it does indicate a need to adjust to a more aggressive Iranian projection of military power in the region.

Recent events appear to have cemented the prevailing, and opposing, views of the US and Iran. The US, for the moment, appears satisfied with its current strategy under which they hope additional economic and military pressure will eventually force Iran to make significant concessions, if not capitulate outright. The Iranian regime has made clear such concessions will not be forthcoming. Instead, Iranian officials project the view that, by absorbing significant damage to Iran's economy, the US will ultimately face growing economic and political incentives to compromise. **This has led to an inherently unstable equilibrium in which the Iranian regime will not accept peace without regime stability, whereas the US will not accept peace without regime compliance.**

A post-midterm escalation? Several Iran analysts have been warning of another round of fighting, before or after the midterms on November 3rd (see for example these two recent podcast episodes with Hamidreza Azizi and Trita Parsi, respectively). The argument is that, freed from electoral constraints, especially if in the event of an electoral setback, the Trump administration could see stronger incentives to once more escalate the conflict in the hope of finding a lever with which to compel Iranian regime compliance.

'Titanic Fury' and other bad options. Reports of another possible round of escalation have fuelled speculation about possible targets, which could include renewed strikes on similar targets to those hit in March (military installations, deployed missile systems, and civilian infrastructure) or those struck in July (focusing more on military installations around the Strait of Hormuz). Another possibility is a strategic strike on nuclear targets like Pickaxe Mountain (which is reported to house some of Iran's remaining nuclear capabilities), an attempt to use special forces to extract highly enriched uranium (HEU), or an attempt to seize the oil terminals at Kharg Island. The Trump administration could also seek to dust off previously discarded options of arming the opposition, in particular Kurdish militant groups operating out of northern Iraq. The normally unthinkable scenario where the US could seek to use a tactical nuclear weapon on an Iranian target needs to be seen in the light of a US presidential administration whose Middle East policies have been plagued by poor planning, an overreliance on military force, rash and unpredictable actions, and a disregard for the strategic consequences of its actions. The combination of Trump's Nixonian 'madman theory' with the religiously and nationalistically infused ironclad resolve of the Iranian regime makes for a combustible mix in resolving conflict.

October volatility ahead as markets gauge prospects for renewed escalation. A best-case scenario is that renewed US strikes become a catalyst for more fruitful negotiations, ultimately leading to a diplomatic solution. Yet a more likely outcome is that they fail to coerce an already hardened regime with existential fears and a perception of the US as profoundly deceitful and untrustworthy. Iran may in turn retaliate against regional energy infrastructure in a manner consistent with previous attacks or worse. Such a move would then likely result in large-scale damage to Iran's own energy infrastructure, which could reduce the likelihood of Iran escalating first. Serious attempts at US-backed Kurdish interventions in Iranian territory could potentially lead to Iranian attempts to invade Bahrain and Kuwait. The conflict, already widened by the Houthi offensive in Yemen, could expand further to include Iran-aligned Iraqi Shia militant groups targeting either Iraqi Kurdistan or Syria. Even if the White House calculates that an energy crisis is an acceptable price to pay for Iranian regime compliance, the global economy will be left to suffer. This sets up October as a potentially volatile month, as markets gauge the prospects of renewed escalation.

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