MARKET
SIGHT*LINES*

Coercive Diplomacy: The Managed Off-Ramp Is Proving Bumpy

By **Michael O'Keeffe, CFA**
Stifel's Chief Investment Officer

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When it comes to the Middle East, investors may be learning military escalation is really part of a negotiation strategy. Coercive diplomacy uses force, economic pressure, and the threat of additional action to influence the terms of an eventual agreement. This is likely to be President Trump's approach in dealing with Iran: Be deliberately vague, signal that the United States is ready to escalate, but then pause and give diplomacy room to work. In March, we outlined **four potential paths for the U.S.-Iran conflict**, favoring a Managed Off-Ramp. That scenario appeared to materialize in June, but the agreement broke down and direct strikes resumed. This latest pause has opened another diplomatic window, but the recent strikes, continuing blockade, regional proxy activity, and threat of renewed attacks show the path will not be smooth. In this Sight|Lines, we discuss coercive diplomacy and consider why a Managed Off-Ramp, although bumpy, may remain the most likely outcome.

THE TAKEAWAY: ESCALATION AND NEGOTIATION ARE NOT MUTUALLY EXCLUSIVE

While current conditions remain unstable, a return to negotiations may well bring us back to a bumpy Managed Off-Ramp. In summary:

- Our **four scenarios** remain useful, but the final end state will likely differ from the current environment.
- A Managed Off-Ramp briefly emerged in June, but its breakdown showed the journey will be rough.
- While direct U.S.-Iran strikes have paused, the blockade, regional proxy activity, and threat of renewed attacks reinforce the risks of escalation.
- Military, economic, and maritime pressure are tactics intended to improve U.S. terms in negotiations.
- Trump's deliberately ambiguous rhetoric is part of the strategy, preserving uncertainty over whether the next step will be negotiation or renewed escalation.
- The original U.S. motivations – "munitions, markets, and midterms" – continue to favor an eventual off-ramp, even if pressure is used to improve negotiating leverage first.
- U.S. incentives may favor a negotiated outcome, but Iran, Israel, and regional proxies all have different objectives and can make the path challenging.
- We are placing less weight on a smooth off-ramp and more on the risks of a Shadow War and a Severe Tail, but a negotiated ending – the Managed Off-Ramp – remains the most likely outcome.

IN-DEPTH: WITH COERCIVE DIPLOMACY, ESCALATION AND NEGOTIATION ARE TIED TOGETHER

Coercive diplomacy can make the current conditions unstable, but the strategy appears intended to revive negotiations that may well bring us back to a Managed Off-Ramp, but it will be a bumpy ride from here. Going deeper:

- In March, we defined four scenarios that still frame the range of potential outcomes and their related probabilities:
  - 50% to a Managed Off-Ramp, 25% to a Shadow War, 15% to a Severe Tail, and 10% to a Regime Change.
  - The environment feels like a Shadow War, but we still see the Managed Off-Ramp as the most likely outcome.
- The June 17 memorandum showed that de-escalation was possible, but not durable:
  - The agreement had 14 points and 60 days for negotiations, easing oil prices, inflation worries, and market concerns.
  - A future agreement will need clearer terms, stronger enforcement, and greater confidence in compliance.
- After U.S. strikes over 13 nights, the current pause, while not a formal ceasefire, creates room for diplomacy:
  - The U.S. paused strikes and Iran suspended retaliation, but the White House says it retains all military options.
  - The blockade remains, Hormuz traffic is constrained, and Houthi-Saudi hostilities continue – conditions more consistent with a Shadow War than peace.
- U.S. officials have linked continued pressure to the pursuit of better negotiating terms:
  - Rubio said Iran was requesting talks, but the U.S. would keep raising the cost until Tehran was prepared to honor an agreement.
  - Sanctions, the blockade, and the threat of renewed strikes preserve U.S. leverage while Iran reassesses its position.
- Trump's rhetoric continues to be deliberately vague, making it more important to focus on U.S. actions:
  - Trump can describe the military as "locked and loaded" while maintaining that serious negotiations are underway.
  - We are watching mediator activity, military targeting, U.S. demands, and whether the pause continues as talks progress.
- With a focus on "munitions, markets, and midterms," an open-ended conflict will have military, economic, and political costs:
  - Critical munitions have been materially reduced and must be rebuilt, potentially constraining future readiness.
  - Prolonged energy disruptions raise risks, while a path to peace would be politically constructive ahead of the midterms.
- There are many continued risks to this coercive diplomacy approach:
  - Iran wants sanctions relief, oil exports, and regime security, yet Houthi attacks can widen the conflict.
  - Tuesday's Trump-Netanyahu meeting may clarify what Israel may want to support an agreement.
- We continue to see the Managed Off-Ramp as the most likely destination, but risks remain:
  - A bumpy road to a smooth off-ramp can feel like a Shadow War or a Severe Tail.
  - We are monitoring mediation, pause conditions, shipping, military targeting, oil markets, and the Trump-Netanyahu meeting for signs that support or weaken this view.

WHAT WE THINK

Coercive diplomacy makes the path to peace intentionally difficult to read, and recent events show why escalation and negotiation can be components of the same coordinated U.S. strategy. We continue to see a Managed Off-Ramp as the most likely outcome, with our view still anchored in U.S. incentives around "munitions, markets, and midterms," as well as Iran's need for sanctions relief and oil exports. But the pause remains quite fragile, other parties can disrupt this path toward peace, and miscalculation could push the conflict toward a Shadow War or a Severe Tail. We will continue to remain focused on negotiation strategies – even coercive ones – and their impact on oil, inflation, rates, growth, and volatility.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
StifelInsights.com

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