CIO PERSPECTIVES

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Middle East conflict: our analysis and investment implications

The attack on Israel and the new conflict with Hamas raises the odds of a wider conflict in the Gulf, particularly at a time when relations between Saudi Arabia and Israel were normalising. Market reactions appear so far relatively restrained, with oil gaining 4% Monday, equities marginally lower in Europe. US equities ended the session in positive territory, as some FED policy-makers sounded cautious on the next rate moves.

Why is this violence happening?

Here is a quick overview of what has happened so far with the caveat that it is almost impossible to summarise in a few lines the situation in the region given its complexity and its historical roots. Geopolitical risks are always difficult to predict, risks of escalation are significant and multiple complex scenarios can arise.

1. Iran is trying to hinder Saudi-Israel normalisation.

- Arab-Israel normalisation: the Abraham Accords signed in 2020 between Israel and United Arab Emirates signalled the start of the normalisation between some Arab countries and Israel. Saudi Arabia is said to have been in talks to join the agreements as well this year.
- A Saudi-Israel normalisation may pose a significant threat for Iran. The normalisation could have extended into regional security agreements including the US, which would have left Iran isolated.
- Iran has significant leverage over radical militant groups surrounding Israel and the attack by Hamas is said to have been supported by Iran, with the ultimate goal of making a Saudi-Israel rapprochement harder and reminding the Saudi's of the power Iran wields in the region.

2. Hamas is shoring up its militant credentials given its weakened domestic political position.

- As a militant organisation with little interest in securing peace with Israel, Hamas also has an interest in preventing any Saudi-Israel normalisation in which the Saudi's would have accepted a 'fudge' as a solution to the Palestinian issue.

3. Israel's usually sophisticated security surveillance and response failed.

- This is most likely because of internal divisions resulting from Benjamin Netanyahu's judicial reform, which saw growing divisions between the government and the security services.

What are the geopolitical implications?

- The Hamas attack increases the risk of an Israeli attack on Iran.
- It also will likely lead to a deterioration of US relations with Iran, reversing recent improvements.
- The conflict, and Israel's expected heavy-handed response, will complicate Saudi Arabia and Israel's (and Israel's and Turkey's) rapprochement.

- Israel's domestic discourse will shift further to the right, making it even harder to find a solution for the Palestinian issue.
- The developments also undermine Joe Biden's hopes for good headlines ahead of the US elections; they could also undermine improving Saudi-US relations.
- However, this is not to say that Saudi-Israel rapprochement is now hopeless, or that US-Saudi relations will deteriorate – the point is that they are now facing new and significant risks.
- The scale of the security threat in the region, could further threaten Western support to Ukraine, simply by shifting away the focus and by reminding the West that there may be other conflicts requiring military and financial support. The death of US citizens in Israel, and the allegations that some hostages are US citizens, will lead to calls in the US that there may be more imminent concerns to US security than Ukraine.

How are financial markets reacting?

- **Oil on the rise:** prior to the attack, oil prices had declined by more than 10% from the September peak. They jumped by more than 4% on Monday as investors fear that the attack on Israel could lead to further escalation between Saudi Arabia and Iran. Given the number of Israeli hostages, the tension is unlikely to ease in the short-run in the region and this could put a floor on oil prices. The ongoing relaxation of US sanctions on Iranian oil sales will become much harder. Israel is now more likely to decide, in coming months, once the immediate conflict is under control, that now is the time to attack Iran's nuclear capabilities, with the possibility of a larger regional conflict erupting.
- **Equities muted:** elsewhere, the market impact has been more muted. Equity futures were down less than 1% across the globe except for Israel and Middle East stock exchanges. Note however that Monday was a public holiday in the US which often limits liquidity and we could thus see the market impact spreading across a few days. Equity volatility has increased to reflect the current geopolitical tensions but the VIX index remains below 20, well below the 80+ level it experienced in March 2020 at the start of the Covid-19 crisis. The S&P 500 actually ended up on Monday, after some FED policy-makers sounded cautious on the next rate moves.
- **Safe haven wanted**: bond yields in Europe were down more than 10bps reflecting the demand for safer assets, on the reopening of US bonds, yields dropped by 15bp at the time of writing. Gold prices were supported too, jumping back to 1850 USD and should also benefit from a floor as long as tensions continue.

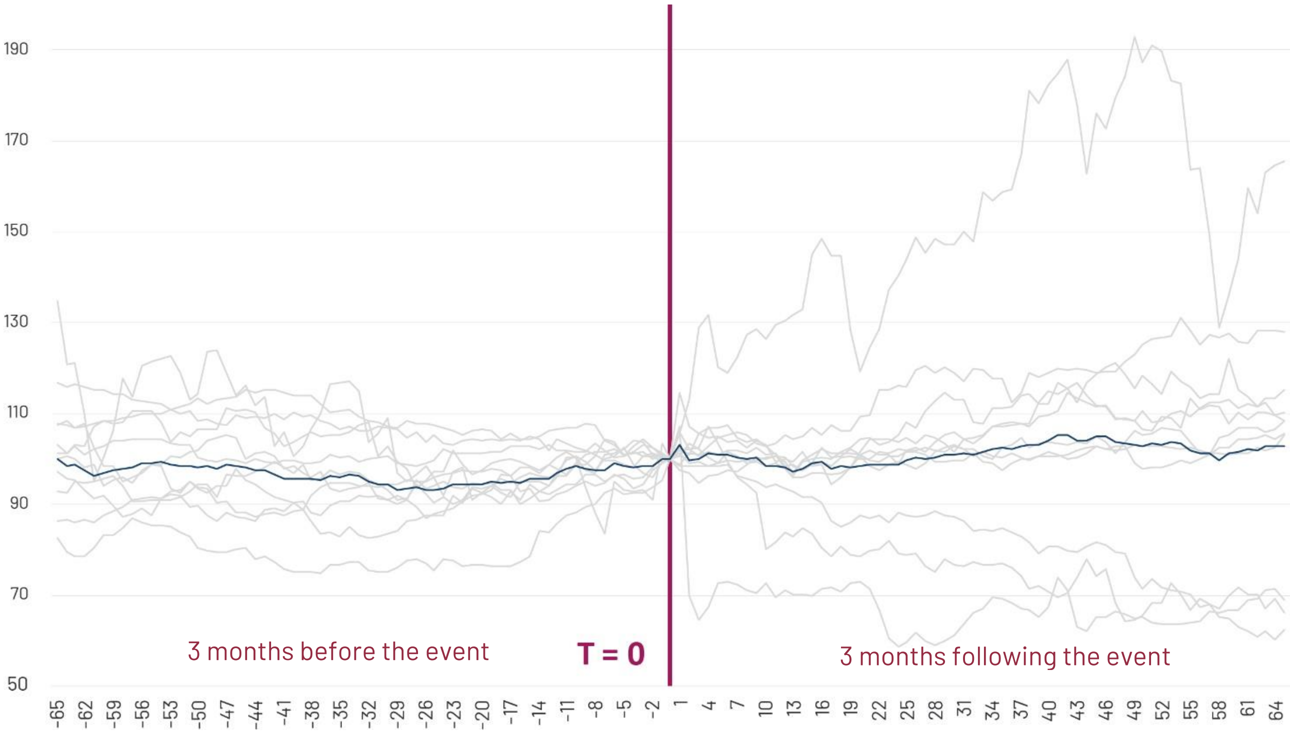
What could happen if the situation escalates further?

- **Oil:** oil is always the most affected asset class when tensions arise in the Middle East and the current Israeli crisis should be no exception. The US has already sent a US carrier in the region and tension between the US and Iran could push oil prices above 100 USD. As shown by Table 1, past geopolitical events have usually led to a rise in oil prices, especially when those events were related to Middle East.

TABLE 1: IMPACT OF PAST GEOPOLITICAL EVENTS ON BRENT CRUDE OIL (FROM 1990), %

DATES	EVENTS	1 DAY	1 WEEK	1 MONTH	3 MONTHS
02.08.1990	Iraq's invasion of Kuwait	5.53%	18.99%	37.26%	61.30%
16.01.1991	First Gulf War	7.13%	-27.07%	-39.55%	-32.53%
11.09.2001	US terrorist attacks	5.87%	-0.66%	-18.18%	-33.70%
11.03.2004	Madrid Bombing	2.63%	3.56%	4.22%	10.78%
05.07.2005	London Subway Bombing	0.60%	1.52%	3.76%	3.76%
25.01.2011	Arab Spring in Egypt	-1.41%	5.31%	15.27%	29.52%
15.04.2013	Boston Marathon Bombing	-2.64%	-2.64%	0.55%	6.10%
14.03.2014	Ukraine conflict	1.10%	-0.44%	1.26%	5.17%
22.09.2014	Intervention in Syria	-1.44%	-4.90%	-13.90%	-37.30%
28.07.2017	North Korea Missile Crisis	2.00%	1.81%	0.99%	18.28%
16.09.2019	Saudi Aramco Drone Strike	14.61%	7.56%	-1.33%	9.76%
	AVERAGE	3.09%	0.28%	-0.88%	3.74%

CHART 1: CRUDE OIL (BRENT) – GEOPOLITICAL EVENTS FROM 1990



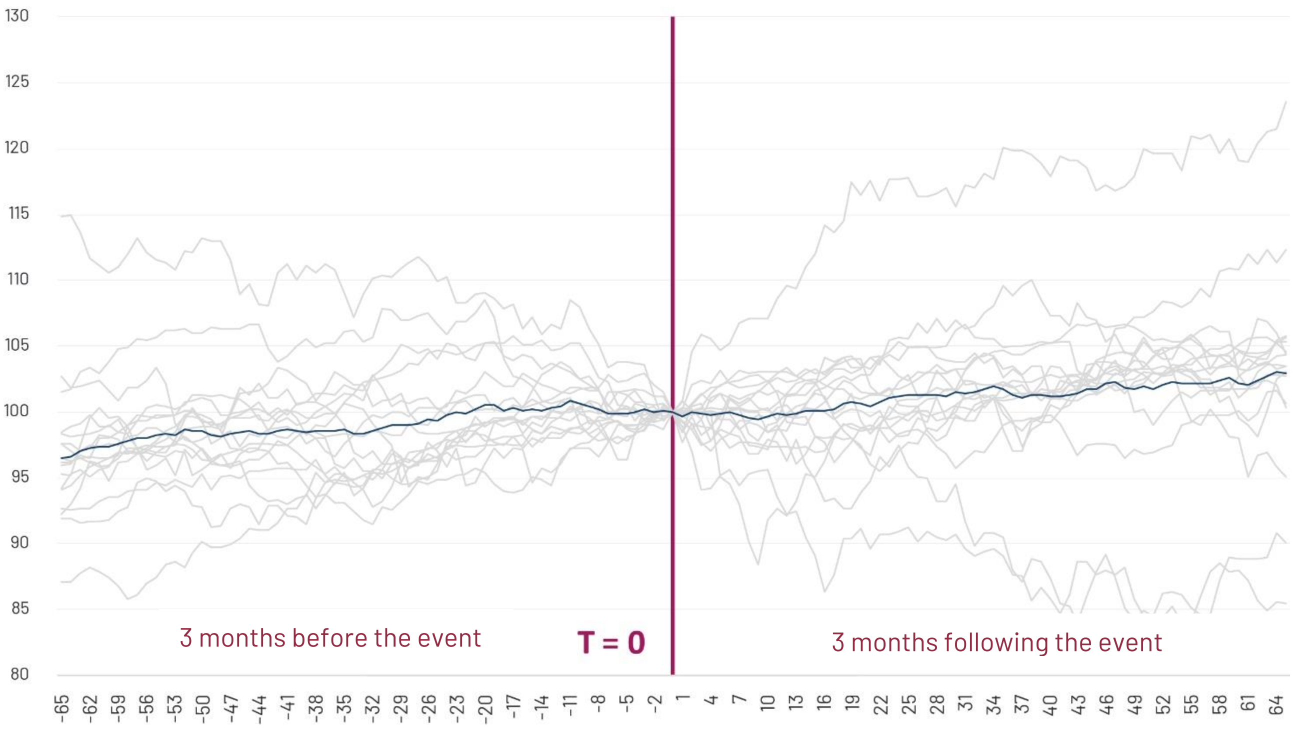
Source: Indosuez Wealth Management

- **GDP growth:** higher oil prices are a negative for big oil importers such as Europe, India or China. Higher oil prices for longer could have an impact similar to that experienced in the 1970s. Several academic studies though point a weakening relationship between GDP growth and oil prices. This may due to more service-led economies and a lower share of oil in production among other factors. However, if oil prices were to stay above 100 USD for a sustained period of time, we could revisit our GDP growth expectations for 2024 across the globe.
- **Inflation:** higher oil prices would mechanically increase headline inflation. However, core inflation may not be much affected by higher oil prices as the negative impact on economic activity could be bigger than the impact of higher oil prices themselves.
- **Central banks**: if oil prices and other commodities prices were to rise and stay much higher for a prolonged period of time, this could push central banks to combat inflation threats and raise rates further. But the odds of this happening are low in our view, as financial conditions have tightened significantly and central banks may step back and see the impact of the economy first. If, instead, the global economy were to move into a recession, central banks could actually ease their monetary policy instead and lower their respective reference/target rates.
- **Equities:** previous major geopolitical events have led "on average" to negative returns in the first few days, being more muted returns in the months following the event as shown by Table 2 but the impact has strongly varied from one event to another. Markets tend to recover from short-term pain, but volatility is likely to remain higher during the initial phase of the conflict, as there is little visibility and multiples scenarios that are difficult to forecast.

TABLE 2: IMPACT OF PAST GEOPOLITICAL EVENTS ON S&P 500 (FROM 1967), %

DATES	EVENTS	1 DAY	1 WEEK	1 MONTH	3 MONTHS
05.06.1967	Six-Day War	-1.51%	2.51%	1.75%	4.92%
05.09.1972	Munich Olympics	-0.25%	-2.73%	-2.35%	5.83%
08.10.1973	Yom Kippur War	0.35%	0.18%	-3.69%	-12.50%
05.11.1979	Iranian hostage crisis	-0.67%	0.98%	4.62%	11.85%
24.12.1979	Soviet invasion of Afghanistan	0.07%	0.33%	5.44%	-7.81%
15.04.1986	Bombing of Lybia	0.19%	2.17%	-1.20%	-0.96%
02.08.1990	Iraq's invasion of Kuwait	-1.14%	-4.38%	-9.27%	-12.28%
16.01.1991	First Gulf War	0.78%	5.25%	17.64%	23.82%
11.09.2001	US terrorist attacks	-4.90%	-5.47%	0.45%	4.08%
11.03.2004	Madrid Bombing	-1.52%	-0.14%	1.90%	1.12%
05.07.2005	London Subway Bombing	0.88%	2.32%	3.47%	0.16%
25.01.2011	Arab Spring in Egypt	0.03%	1.30%	1.18%	5.02%
15.04.2013	Boston Marathon Bombing	-2.30%	-1.66%	4.40%	5.50%
14.03.2014	Ukraine conflict	-0.28%	1.09%	-0.18%	4.95%
22.09.2014	Intervention in Syria	-0.80%	-1.62%	-4.14%	3.57%
28.07.2017	North Korea Missile Crisis	-0.13%	0.06%	-1.18%	3.94%
16.09.2019	Saudi Aramco Drone Strike	-0.31%	-0.52%	-0.59%	6.16%
	AVERAGE	-0.68%	-0.02%	1.07%	2.79%

CHART 2: S&P 500 – GEOPOLITICAL EVENTS FROM 1990



Source: Indosuez Wealth Management

Is this the end of the goldilocks scenario?

Investors have lately contemplated a goldilocks scenario characterised by a resilient economic growth combined with lower inflation. This scenario could be put into question by a number of factors and an escalation of Middle East tension is definitely one of them. However, it is way too early to consider that the attack on Israel as the event that will derail global economic growth. For the time being, financial markets tend to consider that the impact will be limited as equities were so far muted.

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