

Conflict in the Middle East



On Saturday 28th February Israel and the United States launched preventative airstrikes against Iran. It follows extensive build up of US military in the Gulf (highest presence since 2003) and a second round of nuclear talks between the US and Iran which concluded without a deal on the 17th February. During the initial strikes Iran's Supreme Leader Ayatollah Ali Khamenei was killed, along with other senior members of the Islamist regime. This looks to be a large and ongoing operation aimed at generating regime change in the State whilst also significantly impacting its military capability and nuclear ambitions.

Iran has retaliated with extensive missile and drone attacks against Israel and US regional assets across the Gulf, including attacks across eight countries (including Kuwait, Bahrain Saudi Arabia and the UAE). Latterly, Lebanese militant group Hezbollah have launched rocket and artillery at Northern Israel, escalating the conflict outside of Iran. Air defence systems have neutralised many of the attacks, but clearly there is significant damage and loss of life, and this represents a substantial escalation of geopolitical risk in the region. At the time of writing, the conflict remains active and fluid, with no sign of an imminent ceasefire.

The near-term market reaction to date has been as expected. Oil prices have risen sharply whilst equity markets have declined. The price of gold has advanced, and the US dollar has also strengthened. Bond yields have ticked higher, with investors recognising the potential inflationary impact of a sustained move higher in energy prices.

Wars and conflicts have been a constant throughout history, however recent events might cause us to look at how the stock market has performed during past times of war. The chart below shows the S&P 500 Index level since 1927 and several of the major wars and conflicts since then. Though uncertainty may temporarily shape the market, we believe seeing the market's overall resiliency can help maintain a long-term perspective.



Source: S&P CapIQ, Bloomberg. Monthly index levels from 12/31/1927 - 3/28/2024. Past performance is no guarantee of future results. This chart is for illustrative purposes only and not indicative of any actual investment. The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

Source: Baird

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History shows in most cases regional conflicts tend to have a limited medium to longer-term effect on asset prices. Over the longer-term, military conflicts appear as small blips on a long-term chart of market performance, despite the significant market noise they generate in the near-term. This is because they typically have limited impact on the underlying fundamentals to the global economy.

Turning to this conflict, the key transmission mechanism to the global economy lies in the energy space and is therefore the key area we are watching. The Straits of Hormuz is the World's most important oil route, moving over 20m barrels a day of petroleum liquids from Iran, Iraq, Kuwait, Qatar, Saudi Arabia and UAE to global markets. At present, the Straits are effectively closed, principally due to higher insurance costs and vessel operators voluntarily holding back transits in these early days of the conflict as a precaution. If access was restricted for a sustained period, it would likely put further upward pressure on energy prices.

Beyond the transport of energy supplies, the Gulf states are one of the world's largest oil-producing regions. Iran themselves account for around 4% of global oil output, and it is unclear at this stage whether this production is at risk during the current power vacuum, or under new leadership. To date, Iran's attacks have not impacted production capacity in other Gulf states, but this remains a potential source of risk.

Ultimately, the duration of this conflict and its impact on energy prices will dictate its impact on the global economy – higher energy prices can act as a drag on the global economy, with businesses and consumers impacted by higher costs, whilst also putting upward pressure on inflation. This in turn could alter the outlook for interest rates.

How long this conflict lasts remains unclear at this point, although we can expect that the US President would not want it to become a talking point for the mid-term elections. The prolonged attacks we are seeing on Iranian military assets will at some point weigh on their ability to retaliate, but they may see some leverage in disrupting flows through the Straits of Hormuz. Iran also finds itself in a power vacuum, and potentially on the cusp of a generational shift in leadership, the implications of which are unclear at this stage. For these reasons, market volatility could remain elevated in the near-term.

For now, we continue to monitor the conflict closely and to see no need to alter our asset allocation views or portfolio composition. Our base case scenario remains intact – a constructive fundamental backdrop underpinned by resilient US growth, steady activity across other major economies, solid corporate earnings momentum, and ongoing fiscal support globally. That said, we do acknowledge an increase in tail risks, particularly linked to upward pressure on energy prices.

Our direct investment exposure to the Middle East is minimal. During periods of elevated market volatility and headline risk, maintaining a disciplined, long-term investment horizon and robust diversification remains critical. These principles continue to anchor our portfolio construction and risk management framework.

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