MARKET COMMENTARY

Rising tensions in the Middle East

Thomas Hempell

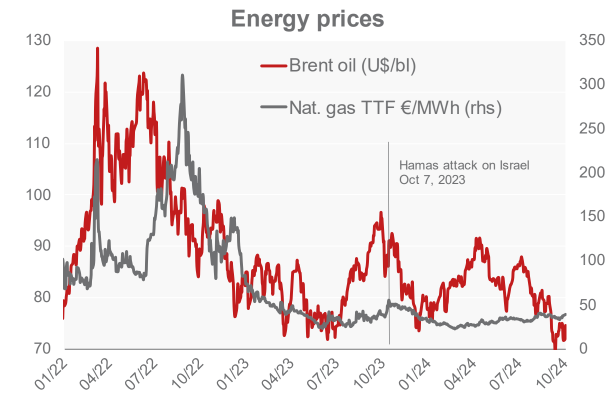
2 October, 2024

- **Following Iran's massive overnight attacks on Israel, the risk of an escalating direct confrontation between the two countries has been rising strongly and may have tremendous consequences for the region.**
- **From a global market perspective, the biggest signpost to watch in the near term is the risk of disruption of oil supply, with attacks on Iranian production facilities and intensifying Houthi attacks in the Red Sea well possible, and the tail risk of a closure of the Strait of Hormuz in case of a severe escalation of the Iran/Israel conflict.**
- **A sharp rise in the oil price may reignite inflation worries. Compared to a year ago, however, the level of energy prices come from a lower level while the disinflation process is much more entrenched. This could mitigate the stagflationary threat from a sharper spike in oil prices.**
- **Oil prices have risen amid the renewed tensions and equity markets have pared some of earlier gains, though the overall reaction has thus far been muted.**

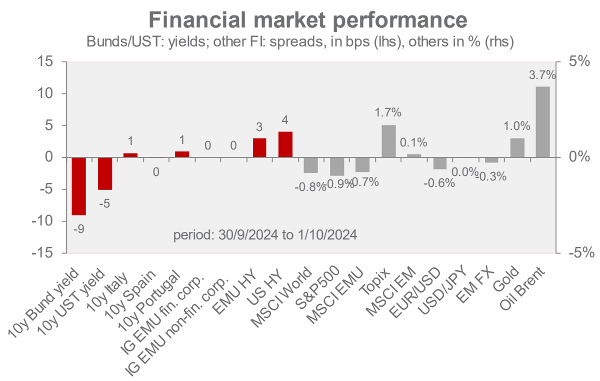
The events in the Middle-East are very worrying and fluid. Following Iran's massive attacks on Israel overnight, **the risk of an escalating direct confrontation between the two countries has been rising strongly** and may have tremendous consequences for the region.

From a global market perspective, the **biggest signpost to watch in the near term is the risk of disruption of oil supply**. Retaliation strikes by Israel may hit Iranian oil production sites. The pro-Iranian Houthis in Yemen may intensify attacks in the Red Sea, further disrupting global trade and oil transport specifically. And in an extreme (tail risk) case, Iran may attempt to virtually close the Strait of Hormuz – through which about 20m barrel of oil and oil products (~20% of global supply) transits. Such an event would have the potential to significantly drive up oil prices on supply concerns. **Rising oil and energy prices may spark fresh inflation worries and could slow the further normalisation of monetary policy.** Unsurprisingly, the recent tensions have already sent oil prices higher, extending the recovery started by Chinese stimulus announcements. Equity prices have pared some of recent gains while safe-haven bids have been adding to downside pressures on Bund yields following benign euro area inflation prints released yesterday for September.

Mind, however, that a **sluggish Chinese economy** and a **renewed slowdown in global industrial production** have been **weighing on energy prices over the summer** (left chart below). Furthermore, Saudi Arabia's recent strategy turn (abandoning its unofficial 100$/bl price target and raising production to regain lost market shares) keeps weighing on the oil price. As a result, **the oil price is coming from much lower levels than last October** (despite this week's bounce, Brent oil is still 18% cheaper than before last year's Hamas attack on Israel). Furthermore, the overall **disinflation process in the advanced world is better entrenched** than a year ago, leaving the economies and inflation expectations less exposed to the stagflationary knock-on effects from higher energy prices. This may help explain the thus far relatively muted market reaction to the severe escalation of the conflict (right chart).



Source: Datastream, GenAM



Source: Datastream, GenAM calcuations