Reaction to War in Israel

PGIM FIXED INCOME

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The following consists of the market reaction to the war thus far as well as a market outlook based on the situation. The market reaction and outlook is followed by the main scenarios that we see unfolding in Israel, the surrounding territories, and the region over the next three to six months. Indeed, much depends on whether Russia, China, and the U.S. can prevail upon Iran and Israel to avoid an escalation that engulfs the world's great powers in another proxy conflict. Our instinct is that just enough collective incentive exists to prevent a scenario of an uncontrolled spiral.

Regardless of the outcome, the episode serves as another grim reminder of a central thesis that underpins our forecasting: we have returned to a global backdrop of intense geopolitical competition—the shocks will just keep coming.

Market Reaction and Outlook

The Middle East crisis kicked off the interest-rate rally, but since then, the Fed comments to the effect that the recent increase in long-term rates circumvents need for further rate hikes appear to be the dominant market driver, pushing rates down, boosting stock prices, tightening credit spreads. The combination of the two market drivers – the Middle East crisis and prospects of a Fed dovish pivot – should help cap the U.S. 10-year yield below 5%, pending further clarifications on the economy's trajectory. Longer term though, the crisis highlights prospects for ongoing loose fiscal policy to meet the need for ongoing heavy defense spending to reload the various conflicts (those real and feared). Additionally, regarding energy prices, they were already firm, and developments in the Middle East will keep upside energy risks alive.

Looking ahead, credit markets appear to be overall biased "risk on." With isolated conflicts, it is not uncommon for markets to take a risk-positive stance (which seems likely to continue in the current instance) particularly on the heels of the recent relatively dovish Fed comments. In terms of the outlook for the yield curve, given recent significant increase in rates in Q3, significant further upward adjustments seem likely. Nonetheless, upward pressures on yields from heavy supply, continued growth, ongoing inflation risks, and the market's risk-on tone can keep rates in the higher end of the normal range (e.g., the 10-year Treasury yield in the 4.3-5.0% portion of the long-term normal 3.0-5.0% range). These underlying market drivers are likely to support a continued, yet slow, normalization in the shape of the yield curve (i.e., steepening) over the coming months and quarters. Bottom line, we see a 4.3-5.0% range for the U.S. 10-year yield, with yields biased towards the high side of that range through Q1 2024 and the lower end of the range as we proceed through 2024 as the economic data moderates.

Scenario Analysis and Respective Market Impacts

Long, drawn-out conflict limited to Gaza (55% probability): In this scenario, the conflict remains limited to Gaza. Israel faces significant resistance by Hamas operatives. Military operations stop short of maximalist aerial bombardment that would generate untold civilian casualties and lead to international condemnation. Iran opts not to call for multi-front war. Qatar and Egypt, despite the latter's decline of influence on Hamas, remain engaged. China pushes Iran not to escalate in a gesture of goodwill to Saudi Arabia and due to its own interest in avoiding another spike to oil prices.

Market impact: Temporary spike of Brent oil prices (~5%) and brief flight to quality in risk-free assets. No lasting impact on risk sentiment or central bank reaction functions.

Conflict metastasizes into proxy war (40% probability): Wounded by an intelligence failure of historic proportions, Israeli PM Netanyahu launches an unrestrained campaign of destruction in Gaza City, leading to thousands of Palestinian casualties. Israel's response is perceived as disproportionate and widely condemned, triggering Hezbollah to launch a second front in the war from Lebanon (and possibly a third front from the West Bank by Islamic Jihad). Furthermore, Hezbollah will monitor the concentration of Israel's military forces in the Gaza area and if there is a shift from concentration in the North. Israel is poised for counterstrikes on Iranian targets, and the conflict becomes yet another proxy battle between the U.S. and Russia. China and Saudi Arabia stand back, content in the sowing of chaos that further undermines U.S. hegemony and dents. Another foreign policy failure carries negative implications for President Biden's re-election prospects.

Market impact: Sustained spike in Brent oil prices (15-20%+) and bull steepening of fixed income curves in response to negative supply shock and rekindled risk of global recession. Additional cuts priced into interest rate forwards along with higher market-implied inflation breakevens.

Return to status quo ante (5% probability): Israel determines that rooting out Hamas as a military and political force in Gaza is futile; instead, it opts to harden its defenses and resume the normalization process with Saudi Arabia. The U.S., Russia, and China sponsor a multi-year mediation process.

Market impact: negligible.

Longer-term Geopolitical Perspective

Unfortunately, this episode of Middle East conflict serves as a grim reminder of the reality of the Great Power Competition. Taking it a step further, the shocks derived from this fragile backdrop will likely occur at greater frequency in the runup to the U.S. elections in November 2024. To the extent that revisionist powers (e.g., Russia, Iran, DPRK, and China) have an incentive for U.S. foreign policy to return to isolationism, they are more likely to "exercise their option" and sow chaos before the U.S. election when their leverage is arguably at a local maximum.

The spread of military conflicts with wide-ranging implications make export controls on any item with a military application all the more likely. Hence, it is less likely that political authorities will allow high tech to diffuse freely across borders for commercial purposes.

Beyond the proximate effects outlined in our summary of scenarios, there is a more speculative, second-order effect to consider. Indeed, discussions have turned to whether the U.S. defence industrial base has sufficient throughput capacity to back Ukraine, Israel, and possibly Taiwan with artillery and munitions in a simultaneous and extended conflict scenario. The unanimous and emphatic answer from experts is "no," which underscores the likelihood of a period of fiscal dominance in which deficits are mostly disregarded and interest rates must adjust to a higher equilibrium.

Why is this conflict different than the Yom Kippur War in 1973 and the resulting oil shock?

There are several reasons why the current war in Israel vs. Hamas is much different than the 1973 Middle East war and why its implications on the oil markets will be less significant. While the current war has a good chance to escalate to include other regional players, the makeup of the energy market and political arena is very different today.

Oil Production

The U.S. was largely dependent on OPEC oil in 1973. Today, the U.S. is the world's largest oil producer, followed by Saudi Arabia, Russia, and Canada. Furthermore, a war between Israel and Hamas will not see the Arab oil producing states unifying against Israel and the U.S. The current politics of the region see the Saudis more aligned with the U.S. and Israel than they are with Hamas, which is an Iranian supported terrorist organization.

Major oil producers, such as Russia and Iran, could destabilize the market, but they lack the unity of OPEC in 1973. While the conflict will surely destabilize oil pricing, an embargo on the magnitude of 1973 is unlikely given the broader regional conflict shaping up between OPEC members like Saudi Arabia and the UAE on one side and Iran on the other.

Implications in the Israeli and Palestinian Arenas

While there are broad implications that will come into view as the situation unfolds, a few conclusions can be made with a degree of confidence.

- With more than 360,000 reserves mobilized in 48 hours and more on standby, Israeli productivity and life is largely halted. The economic impact will be significant in the coming months.
- Long term, the Hamas attacks will have immense implications for Israel's political and military leadership. It will further destabilize an already political instable country.
- Israel will need to spend significant infrastructure and security resources to rebuild the south of the country to get Israelis to live there in the long run. This area is critical for the state to spread its population out of its densely packed central Tel Aviv metro area.
- What happens to Gaza's administration after/if/when Israel destroys Hamas as a viable political organization is a question that was probably not planned for. Israel cannot leave a vacuum for Iran to step in once again.

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