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Israel-Gaza Conflict Views & Potential Implications

Summary

After years of geopolitical developments altering the direction of the global economy and financial markets, the conflict in Israel and Gaza has the potential to further disrupt economic and financial markets trends. In this report, we provide perspective on the possible implications—geopolitical, economic, markets and political—of military conflict between Israel and Hamas.

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Hamas' attack on Israel marks another major geopolitical challenge permeating across the globe. Arguably, geopolitical developments have had the most material impact on the global economy and financial markets in recent years. U.S.-China tensions and Russia's invasion of Ukraine have been the most consequential; however, increased Chinese military incursions in Taiwan, military coups in Africa, the Nagorno-Karabakh conflict in Armenia and Azerbaijan as well as renewed violence between Kosovo and Serbia have all contributed to a worsening global geopolitical environment and present risks to the economic outlook. Military conflict in Israel contributes to and elevates this geopolitical uncertainty. Predicting the evolution of the Israel-Gaza conflict is difficult; however, Prime Minister Netanyahu's declaration of war against Hamas and subsequent rhetoric seem to suggest a speedy deescalation is not on the horizon. Regional escalation—in the form of intensified Israel-Iran proxy battles, direct Israel-Iran military conflict or the military involvement of other influential actors such as Saudi Arabia and Qatar—would shift the global geopolitical climate in an even less favorable direction. While the likelihood of an escalation to a regional conflict is outside our scope, broader military conflict in the Middle East would likely result in reduced oil supply and a spike in crude prices. As evidenced during the initial phases of the Russia-Ukraine conflict, rising oil and natural gas prices can inflict severe damage on select economies around the world, particularly G10 countries and key emerging market nations that contribute materially to global growth, such as China and India. In the coming days and weeks, we will be watching for evidence and/or rhetoric that implicates Iran as a hostile actor in the attack on Israel. Should proof be presented that Iran knew about, coordinated or outright supported Hamas' aggressions by supplying resources, Israel's military offensive could extend beyond Gaza and toward Tehran. Direct Israel-Iran conflict would worsen the geopolitical backdrop significantly and would have direct economic implications around the world via higher oil prices and deteriorating sentiment. In the event of regional escalation, safe-haven assets such as the U.S. dollar and U.S. Treasuries would likely outperform, and we would adjust our forecasts to reflect more greenback strength and more risk-sensitive currency depreciation at least through the end of this year.

The Israel-Gaza conflict is likely to compound and exacerbate deglobalization. We have touched on deglobalization multiple times this year and how the interconnectedness of the world's economies is in decline. Our latest report highlights the role of geopolitics in deglobalization and how geopolitical hostilities have already resulted in the fragmentation of the global economy and will likely be the driving force of further economic fractures. Prior to the Israel-Gaza conflict, relations in the Middle East were on an improving trajectory. Saudi Arabia and Iran tentatively restored diplomatic ties, while the United States was making progress toward brokering formal ties between Saudi Arabia and Israel that would have included Palestinian concessions. The latest Israel-Gaza conflict likely ends the near-term possibility of Saudi Arabia recognizing Israel as a sovereign state, diminishes chances of Israeli concessions to Palestine, and creates new impediments to regional peace. Recent improvements in regional relations are now likely to backtrack, and a reset of Middle East relations could begin to materialize. Should these fissures take shape in the Middle East, globalization will take yet another hit. More broadly, major geopolitical players, not just in the Middle East but globally, will need to take a stance on either voicing explicit support for Israel or taking another position. As these geopolitical fault lines set in, alongside already existing geopolitical barriers, deglobalization could pick up pace. To gauge sovereign sentiment toward Israel and where geopolitical fault lines could be erected or reinforced, voting in the United Nations General Assembly (e.g., to "condemn" the attack on Israel) will provide the most insight. We will be paying particular attention to how regional stakeholders vote as well as countries that previously abstained or voted against condemning Russia's invasion of Ukraine. Should countries with economic influence or political sway not vote in unison with Israel, geopolitical borders could be redrawn and new forces of deglobalization could be applied.

Israel's focus to shift away from local political divisions and toward geopolitical risk management. Israel's financial markets have come under pressure this year in response to the Netanyahu administration's pursuit of judicial reforms and social backlash to the perceived weakening of Israel's institutions. The focus of the current administration has been on implementing the reform package, either unilaterally or in cooperation with opposition parties; however, with the larger risk to Israel's sovereignty and institutions now geopolitically driven, local political divisions are not likely to be a focus of financial markets nor the administration for the time being. If any silver lining exists, the attack on Israel's sovereignty could be a catalyst for local political cohesion, at least in the near term or over the course of the conflict. Along with the announcement of a large Bank of Israel (BoI) FX intervention program designed to stabilize the shekel, easing local political divisions could be a source of stability for the shekel following the initial depreciation after markets reopened from the weekend. With that said, the shekel—along with other Israeli financial assets such as sovereign debt, equities and measures of sovereign default risk—are likely to remain on the defensive, and we do not anticipate an ILS rebound at this time. The shekel has already sold off around ~15% against the dollar since judicial reforms were announced in late January. Even so, in our view, the more likely ILS path is further depreciation, albeit at a gradual pace, in the months ahead. This view stems from our FX vulnerability analysis, which is designed to gauge potential currency depreciation in an exogenous shock or global risk-off scenario. Our framework suggests the shekel could weaken as much as 20% on a peak-to-trough basis under shock circumstances. While Israel's fundamentals are sound (current account surplus, an educated and diversified economy and adequate FX reserve coverage even with the latest BoI intervention program), as the current shock scenario continues to unfold, combined with broad-based U.S. dollar strength on investors' desire for safe-haven assets, we believe another 5% ILS depreciation could still be forthcoming by the end of this year and into early 2024. Shekel depreciation is likely to be smoothed by the Bank of Israel, and we now expect the USD/ILS exchange rate to trend toward ILS4.15 by early 2024. Risks are, however, tilted toward a sharper and quicker depreciation as uncertainties are abundant and other actors becoming involved in the conflict is still a real possibility.

Geopolitics can play an outsized role in many of next year's elections. 2024 is likely to be a year defined by elections, and we expect geopolitics to be a point of contention for voters as many developed and emerging market countries host general and legislative elections next year. We have already seen geopolitics cause political fracturing in the United States with additional funding for Ukraine a sticking point that nearly caused a government shutdown earlier this month. U.S. politicians will discuss appropriation bills again in November with no bi-partisan longer-term resolution on additional Ukraine support since the short-term funding deal in early October. Ukraine aid will likely still be a source of dispute in November, and with Israel already a large recipient of U.S. aid, conversations will now likely include increasing support to Israel as well. Federal spending plans could play a role in determining voter intentions during the U.S. election cycle next year, especially as aid fatigue has started to set in. Similar sentiment could spread around the world and could result in more protectionist and domestically focused policy platforms gathering momentum internationally. Not only could new protectionist policies result in additional deglobalization forces, but unorthodox policy platforms could also disrupt local financial markets and economic activity. Israel and Ukraine will likely be a topic of debate leading into the 2024 U.S. election; however, geopolitics can also be a theme in Narendra Modi's campaign for another term as prime minister of India, President Putin's re-election bid in Russia and Taiwan's presidential election. Many African nations will also host elections in 2024. Africa has become a geopolitical hotspot not just because of recent military coups, but also due to most of Africa signing up for China's Belt and Road Initiative (BRI) as well as China being a major sovereign creditor to many debt-distressed countries in Africa. African nations can benefit from China's BRI-related infrastructure plans, but at the same time, have had difficulties restructuring sovereign debt with China as a majority bondholder. Should policy platforms across the continent shift toward developing closer relations with the U.S. as opposed to China, Africa could become the next source of global geopolitical tensions.

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