Special Commentary — November 20, 2023

Middle East Travel Takeaways

Summary

International Economics spent time in the Middle East recently, meeting with local market participants, corporates as well as peer economists and researchers. The majority of our discussions centered around the current regional geopolitical landscape, and how a deteriorating global geopolitical environment could be a key source of influence over the global economy in the years to come. Our conversations also touched on the unintended consequences of military conflict and elevated geopolitical tensions such as the impact on upcoming elections and the reserve status of the U.S. dollar. We also gathered local perspective into the outlook for individual economies across the MENA region. In this report, we highlight key themes and takeaways from our conversations with Middle East counterparts.

Economist(s)

Brendan McKenna
International Economist | Wells Fargo Economics
Brendan.McKenna@wellsfargo.com | 212-214-5637

Middle East Travel Takeaways

- **Israel-Hamas military conflict is top of mind for regional market participants; however, the consensus view is that a broader regional conflict is unlikely.** While geopolitics have always been a concern across the region, recent events have pushed geopolitics to the forefront of corporate and investor risk assessment practices. Risk mitigation strategies have been pursued and initiated by all institutions we spoke with; however, most believe no broader escalation of the conflict will materialize, a view we broadly agree with at this time. In our scenario analysis report designed to gauge deescalation vs. escalation, we set triggers that if breached, would signal to us the evolution of the conflict. These triggers included humanitarian corridors, peaceful mediator countries such as Qatar negotiating hostage releases and attempts at a cease fire, and no intelligence updates that indicate actors such as Iran played a role in the attack on October 7th. All agreed deescalation thresholds had been tripped, while our triggers for escalation had yet to be fully breached. In addition, most highlighted that regional countries, specifically Iran, had little incentive to escalate the war. U.S.-Iran tensions have tentatively cooled with a recent prisoner swap agreement, and a direct Israel-Iran confrontation or more aggressive proxy battle would risk a snap back to more hostile relations. The most likely scenario is a contained and limited two-front conflict on the border of Lebanon with Hezbollah; however, most felt a suppressed second front would not be enough to materially change the direction of the conflict. With our deescalation triggers being hit and limited escalation thresholds breached, we now believe the Israeli shekel will not reach the top end of our shock scenario FX depreciation range, and our ILS4.15 target is now too pessimistic. While the currency did approach our target, we will project a more stable shekel in our next formal FX forecast update in the November International Economic Outlook publication.
- **All agreed that geopolitics will be the driving force of further deglobalization and a fragmented global economy is a distinct possibility.** In all of our public forum speaking engagements and one-on-one conversations, we brought up deglobalization and the fragmenting of the global economy along geopolitical borders. Audiences and peers all agreed that deglobalization has been underway for some time, and that conflicts in Russia & Ukraine as well as the Middle East will create new forces that reduce the interconnectedness of world economies. While all agreed deglobalization was happening now and will continue, most noted that fragmentation (i.e. the dividing of the global economy into separate and distinct blocs) is a longer-term trend that may have started, but has not yet become clearly visible. We shared our U.S-China blocs fragmentation scenario, which all agreed was entirely plausible in the decades to come; however, many felt "regionalization" would occur before full U.S.-China bloc fragmentation, or in lieu of a U.S.-China bloc split. Regionalization could take the form of Latin America, Middle East, ASEAN etc. blocs or "Global North" nations (mostly advanced economies) divided from "Global South" (mainly emerging economies) nations. In a "North vs. South" split, the Global South would likely be most negatively impacted due to less economic diversification, creating a larger wealth disparity between the developed and developing world.
- **Many highlighted that while fragmentation will likely occur along geopolitical ideologies, multiple "geopolitical swing states" that will carry significant influence and be courted by the U.S & China are becoming apparent.** While all agreed our fragmentation framework designed to model how the world may fracture is logical and conceivable, a minority of peers believed alignments have changed as a result of the Israel-Hamas war. Select peers we spoke with believed more countries will opt for neutrality, and a neutral stance can be a way to improve respective status' on the global pedestal and/or receive concessions from world superpowers. The geopolitical swing states we heard mentioned most often included India, but also regional Middle East commodity exporting superpowers Saudi Arabia, Qatar and the UAE. Our fragmentation framework identifies India and Qatar as neutral already, and recent actions, in our view, reaffirm that neutrality. As of now, our analysis highlights Saudi Arabia and the UAE as leaning toward a China allegiance; however, with oil and natural gas supply a global concern, each country may shift toward unaligned status in an effort to secure concessions that can aid future economic diversification plans and improve regional and individual soft power. Over time, we would expect the U.S. and China to make attempts to pull existing neutral countries and potential unaligned nations into their respective orbits to strengthen future blocs. These attempts can include defense guarantees, enhanced trade relations, intelligence sharing as well as other concessions that improve economic and security prospects.

- **Everyone we spoke with asked about the unintended and black swan consequences of military conflict in the Middle East, but also in Europe.** In all of our conversations we were asked about the possible ramifications of the Israel-Hamas war and Russia-Ukraine conflict on the U.S. election. While we mostly deferred on this question, we noted how providing aid to Israel and Ukraine has become a source of contention in U.S. political circles and "aid fatigue" is starting to set in. Our counterparts and peers shared a view that the regional war is likely to split voters on the left side of the political spectrum around the world, but seemingly most so in the United States, leaving the right as possible political beneficiaries. We also fielded multiple questions around whether geopolitical developments could facilitate a decline in the U.S. dollar's status as the global reserve currency. Our view has been that the U.S. dollar will not lose global reserve status any time soon, a view shared by all central bank FX reserves managers we spoke with. None of the FX reserves allocators we spoke with expressed a desire to shift away from the dollar or U.S. Treasuries. In fact, most said they have increased allocations to the greenback and USD-denominated assets as geopolitical tensions worsened due to safe haven characteristics of U.S. assets. With Middle East countries (Egypt, Iran, Saudi Arabia and the UAE) recently invited to join BRICS, we asked if a BRICS common currency would be a compelling alternative to the dollar or gain a share of FX reserve allocations. All expressed concerns with a BRICS currency bloc as intra-bloc geopolitical tensions (China & India, Saudi Arabia & Iran), economic competition (China & India, Brazil & South Africa), and the risk of secondary sanctions from perceived or actual doing business with Russia, would limit the rise and effectiveness of a new bloc currency. These conversations reinforced our view that the U.S. dollar will remain the world's preeminent reserve currency for the foreseeable future.
- **Regional Middle East economies are likely to remain on diverging trajectories for the time being; however, the shift away from hydrocarbon dependency is picking up pace for select commodity exporting countries.** We expressed our view that Middle East economies have wide gaps in relative economic prosperity, and at least in the short-term, this dynamic is unlikely to materially change. Sovereign default and catastrophe are likely to restrain Lebanon's economic prospects, Tunisia is likely to remain at high risk of default, while limited FX reserves, an overvalued currency, political influence and government intervention in private sector activities should prevent Egypt from fully achieving IMF goals and keep sovereign default an elevated probability. Other Middle East sovereigns such as Pakistan, Oman, Jordan and Bahrain are unlikely to achieve investment grade status over the medium-term. On the other hand, the Middle East is home to some of the most creditworthy sovereigns in the world. Saudi Arabia, Qatar, Kuwait and the UAE are all deep into investment grade territory and are unlikely to experience material deterioration to their respective balance sheets. All peers expressed excitement and optimism around economic diversification plans, particularly in Saudi Arabia, Qatar and the UAE. We spoke with many peers that highlighted each of these countries' momentum behind shifting away from hydrocarbon dependencies and how non-energy sectors will account for the majority of government revenues in the next five years. Our counterparts also expressed tentative optimism toward Turkey as well. Turkish financial markets have stabilized under a new cabinet, and while reaching investment grade status is a ways off, many felt conditions have improved and rating upgrades are now warranted. "Erdogan risk" remains intact, especially now that general elections are in the past, which should kept investors sidelined for the time being. However, many noted that Turkey is back on their radars under more orthodox economic policies and a longer track record of implementation could see capital deployment toward sovereign debt and lira-denominated assets over time.

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Grein	Economist	704-410-0369	Shannon.Grein@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	704-410-1437	Jeremiah.J.Kohl@wellsfargo.com
Aubrey George	Economic Analyst	704-410-2911	Aubrey.B.George@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

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