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Israel-Iran Military Conflict Views & Takeaways

Summary

Middle East tensions have escalated following Iran's strike on Israel this past weekend; however, we continue to believe a broader regional conflict is not imminent. In this report, we offer takeaways and perspective from the latest escalation, and also highlight that our global economic, monetary policy, and financial market outlook has not changed as a result of the most recent geopolitical developments in the Middle East.

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Iran's retaliatory strike on Israel is an escalation of Middle East tensions, but not necessarily a pre-cursor to broader regional conflict. Events over the past few weeks in the Middle East, more specifically this past weekend, reinforce that the global geopolitical landscape remains tense and that finding a steady state in the Israel-Hamas war remains elusive. As far as significance, Iran's aerial assault marks the first attack on Israel launched directly from Iranian territory as opposed to the use of foreign proxies. Also, even while retaliatory in nature, military strikes directly from Iran and not through international proxies represents an escalation in the Israel-Hamas war. This escalation brings the Middle East closer to full-scale regional military confrontation, a conflict that could ultimately draw in the United States given its strategic alignment with Israel. With that said, while Iran's retaliatory strike on Israel is notable, in our view, recent hostilities do not necessarily mean a broader regional military conflict is now imminent. Iranian retaliation was seemingly transparent and telegraphed in advance to allow Israel and Israel-aligned nations to prepare defense capabilities. To that point, almost all Iranian drones and missile strikes were intercepted by Israel and allied defense partners before hitting Israeli territory. Those that got through defense systems caused no material infrastructure damage and inflicted no casualties. Also, some solace can be found in the fact Iran targeted Israeli military sites and not civilian centers nor U.S. military assets. Targeting civilian populations or U.S. military sites would likely have prompted an intense Israeli Defense Force and/or the United States military response. These characteristics of the Iranian attack lead us to believe Iran's retaliation was more symbolic and a face-saving technique rather than an explicit attempt to inflict maximum damage on Israel.

The next stages of the conflict are uncertain, but will be guided by Israel's response. Given our assessment of Iran's attack on Israel, we continue to believe military conflict will remain contained and not expand into Tehran or the broader Middle East on a sustained basis. We say “sustained basis” in that temporary flare-up's similar to the latest escalation could be repeated, but ultimately we do not believe Iran nor Israel are actively seeking a wider scale conflict or confrontation with each other. However, we do not have an excess degree of conviction in the future direction of the conflict and sentiments could change rapidly. We may get clarity in the near future as Israel's war cabinet, formed in October 2023 to dictate the war against Hamas, is currently discussing response options. As of now, no decision has been made as the three-member war cabinet is seemingly divided on whether to respond with a degree of restraint and signal no need for escalation, or react more forcefully and seek targets inside Iran's borders. In the event Israel does choose to react with a show of force, the Israeli Defense Force (IDF) could target government, military and/or civilian targets. The worst case scenario would likely involve IDF preemptive strikes on Iran's nuclear facilities as well as civilian populations in addition to stepping up hostilities against Iranian proxies and immediately expanding its military offensive into Rafah. Before any decision is made, Israel will likely try to be swayed toward deescalation by international diplomacy efforts. Diplomatic attempts at deescalation are already underway as the United Nations Security Council called an emergency meeting to communicate a need for restraint from all stakeholders. While the UN Security Council is likely to gather frequently to discuss deescalation options, any messaging or official communications are symbolic and not legally binding. In fact, any UN Security Council attempt to release a joint statement or resolution condemning Iran or Israel would likely be vetoed by Russia and China, permanent UN Security Council voting members and allies of Iran, or the United States, also a permanent voting member and Israel ally. Institutional diplomacy is likely to continue, but ultimately may not have significant influence over how Israel decides to proceed as Netanyahu's government must continue to be perceived as committed to war efforts in the Middle East and limiting any future aggressions from Iran. In that sense, back channel talks and bilateral negotiations between governments may be the most effective approach at achieving deescalation.

Our views on the long-term direction of the global economy and financial markets have not changed. Under the assumption that conflict in the Middle East does not escalate, we do not anticipate any disruptions to global economic activity, the shift to more accommodative monetary policy from major central banks, or our view that the U.S. dollar will enter a period of trend depreciation starting from late 2024. Sentiment and oil prices are the most likely channels through which the global economy, monetary policy and financial markets could be interrupted. Should containment or deescalation indeed materialize, sentiment is likely to be unaffected and political risk premium currently embedded into oil prices should recede. If political risk does get removed from oil prices, the global economy should not experience any renewed inflationary pressures and central banks including the Federal Reserve, European Central Bank and Bank of England can continue along their respective paths toward interest rate cuts in the coming months. Geopolitical developments will continue to be a risk factor for FX markets; however, for the time being, we continue to believe monetary policy trends will be the driving force of the U.S. dollar's long-term performance. In that sense, we believe the dollar can strengthen into Q3-2024, and once the Fed begins easing policy and global financial conditions ease, then depreciation pressures can build on the greenback toward the end of this year and into 2025. In our central scenario for the evolution of the global economy and monetary policy, the Israeli shekel can strengthen over the long-term aided by dollar weakness, and we maintain our 12-month ahead forecast for the USD/ILS exchange rate to fall to ILS3.62 by Q2-2025. However, we believe the shekel is currently more vulnerable than any time in recent history. Economic fundamentals have come under pressure due to the conflict, while local political risk associated with the Netanyahu administration was elevated pre-conflict and remains heightened. In the event of a risk-off scenario, originating from events in the Middle East or elsewhere, the shekel could be more sensitive and experience more pronounced corrective weakness than the shekel has typically been accustomed to. Risks to our long-term shekel outlook are tilted to the downside (i.e. less shekel appreciation than we currently expect) to reflect the uncertainties related to the ongoing confrontation with Hamas and the risk that a prolonged Israel-Iran conflict touches off in the near future.

Since the start of the Israel-Hamas conflict in October 2023, we have published periodic updates on developments in the Middle East. For additional insight and for how our views have evolved, please refer to the below publications.

Middle East Travel Takeaways: Published November 2023

Israel-Gaza Conflict Scenario Analysis: Published October 2023

Israel-Gaza Conflict Views & Potential Implications: Published October 2023

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