Impact of the Iran-Israel conflict

15 April 2024

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- Iran launched retaliatory attacks on Israel on 14 Apr 2024
- Most immediate impact would be higher crude oil prices
- Most consequential risk is Iran blockading Strait of Hormuz
- US Strategic Petroleum Reserves deployment likely limited
- Rising inflation expectations could lead to deferred rate cuts
- Oil futures suggest market tightness should be short-lived
- Regional wars tend to not have lasting impact on markets
- Key level of Brent crude price to watch is USD 100/bbl.
- We reiterate our investment viewpoints for 2Q 2024

What happened over the weekend (14 Apr 2024)?

Over the weekend, there was an escalation in the ongoing Israel-Gaza conflict. After an Israeli airstrike on 1 April that destroyed the Iranian consulate in Syria and killed several senior members of the Islamic Revolutionary Guards, Iran retaliated by launching dozens of drones and missiles against targets in Israel. Those attacks have been intercepted by Israeli defence systems.

This event marked an escalation of the conflict that started with Hamas' attack on Israel and the subsequent Israel's ground incursion into Gaza. Iran's sponsored actors including the Houthis and Hezbollah contributed to several skirmishes which have avoided the direct involvement of Iran. Iran has stated that the attacks were specifically launched in response to Israel's attack on 1 April and the matter could be considered closed.

Market impact of escalating Middle East tensions

It is important to note this is an evolving conflict and further escalation is not inevitable.

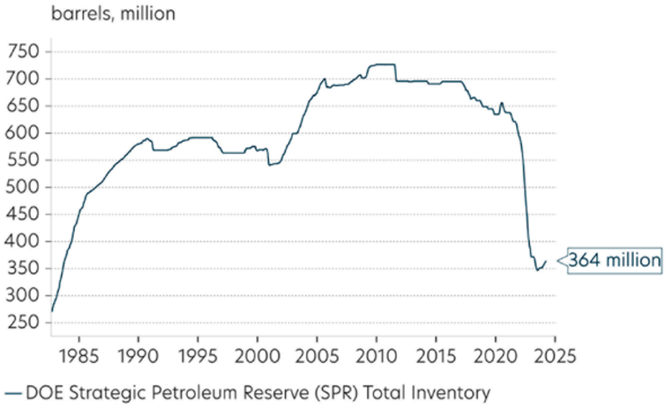
The most immediate impact is higher oil prices as oil supply from the Middle East could be disrupted. The most consequential risk is for Iran to blockade the Strait of Hormuz **(Fig. 1)**, which could potentially choke off 21m barrels per day (bbl./day), or approximately 21% of the world's consumption.

Figure 1: Strait of Hormuz blockade poses oil supply risks

Source: Google Maps

During the early days of the Ukraine-Russia conflict, the US government released 180m barrels from its Strategic Petroleum Reserves (SPR). However, SPR inventory levels have depleted to 364m barrels from a high of 700m barrels **(Fig. 2)** and hence, any deployment aimed at calming the oil market will be more muted.

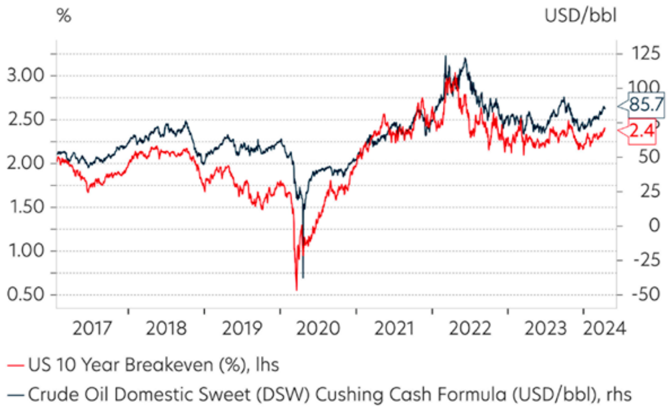
Figure 2: Huge declines in US Strategic Petroleum Reserve



Source: Bloomberg, UOB Private Bank

While oil prices have a limited growth impact on the economy relative to the 1970s, a sharp increase could raise inflationary expectations in the short term **(Fig. 3)**. This may lead to rising concerns that a Fed rate cut may be further deferred.

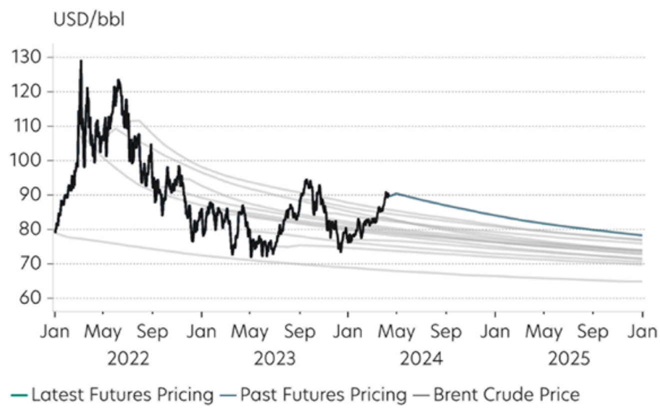
Figure 3: Oil prices are correlated to inflationary expectations



Source: Bloomberg, UOB Private Bank

The cumulative impact of the Middle East conflict has so far been well-contained, with the oil futures curve remaining backward dated **(Fig. 4)**; this suggests that investors consider any near-term tightness in the oil market to be short-lived.

Figure 4: Brent oil futures in backwardation



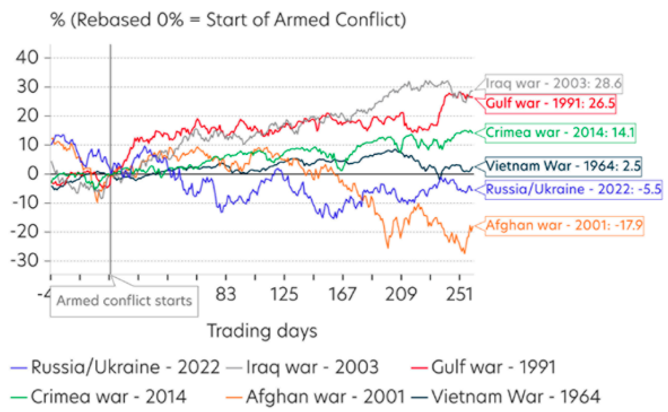
Source: Macrobond, UOB Private Bank, Intercontinental Exchange (ICE)

In the event of a further escalation, it is conceivable that Iranian crude oil could be sanctioned. Currently, Iran supplies 3.1m bbl./day, or 12% of the OPEC's supply. Excluding Iran's spare capacity, the total spare capacity in OPEC is 6m bbl./day; they will be more than sufficient in making up for Iran's supply.

A blockade of the Strait of Hormuz by Iran will be considered as a declaration of war, which will bring Israel and the Western nations into the conflict. This would effectively legitimise their efforts to change a regime that is experiencing waning domestic support at Iran.

It is important to note that the impact of regional wars tends to not have a lasting effect on the markets, using S&P 500 as a reference. This was observed in the case of the ongoing Ukraine conflict as well as most other conflicts over the past few decades including the Iraq war, the Gulf war, the Crimea war, and the Vietnam war **(Fig. 5)**.

Figure 5: S&P 500 performances in recent conflicts



Source: Macrobond, UOB Private Bank, S&P Global

Investment implications

An escalation of the conflict, especially if it involves nations including the United States, would inevitably trigger a short-term sell-off in stocks. The key level of Brent crude price to watch is USD 100/bbl. and higher. The USD will stay firm with long-end treasury yields likely declining and gold prices firming. However, if the escalation stays regional, the sell-off is likely to be short-lived and fundamentals will re-assert themselves again.

We continue to recommend switching out of growth stocks which have outperformed, to those in sectors that have lagged including energy, commodities, industrials, and financials. Rising inflationary expectations could catalyse short-term profit taking in stocks and sectors with relatively higher valuations.

Higher oil prices are like a tax on consumption which may exert downward pressure on long-term interest rates. Having an allocation to investment-grade bonds is still relevant in portfolio construction. They act as important portfolio stabilisers in an environment of heightened geopolitical tensions.

Maintain an allocation to alternative assets which have relatively lower correlation with traditional assets.

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