Allianz Global Investors

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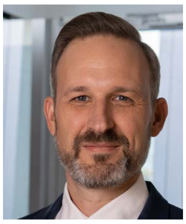
Israel-Iran: what next?

Iran's direct action on Israel over the weekend has led to fears of further escalation. But in the absence of a full-blown crisis in the region – which is not our base case – we think the impact on financial markets will be contained.

An Iranian strike on Israel would have been unthinkable six months ago. But the weekend's attack was a consequence of months of bloodshed that have hardened old battlelines in the Middle East. The fear is that Iran's action could lead to a further dangerous escalation in the region, justifying an increase in the probability of a full-blown crisis. But there are some "reassuring" indications that any retaliation could at least be measured, and we expect both sides to step back from the brink of war:

- Iran's mission to the United Nations announced after the strike that "the matter can be deemed concluded", showing that Tehran may try to calm the situation in the coming months.
- Both damage to US and Israeli interests and human casualties were very limited, at least according to first reports, suggesting that the road to a potential de-escalation can be found.
- Israel and its allies seem to have managed to shut down a large majority of the incoming drones and missiles, which should deter Tehran from a renewed attack.



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KEY TAKEAWAYS

- Iran's attack on Israel has raised fears of a wider conflict but a broader war in the region is not our base case scenario.
- We see "reassuring" indications that any response from Israel could at least be measured and the US, Israel's most important ally, has said it won't participate in any retaliation.
- Commodity markets may see the most direct transmission of the tensions, and we expect prices for oil and its derivatives to spike even higher in coming weeks.
- The conflict may help create entry points in equity markets, while US Treasuries may also benefit from their safe-haven characteristics in times of geopolitical tension.

Israel's success in countering the multi-wave attack will be an important lesson learned.

- With Israel and Iran approximately 1,000km apart, an Israeli air strike is difficult without the support of its allies and neighbours. Iran also seems to have avoided using its more lethal ballistic missiles.

Given this backdrop, we see some potentially important though contained impacts for the global situation and financial markets:

Geopolitics: global ripples but not a broader war

Iran's attack will further complicate President Biden's pre-election situation. To shore up support from the US Muslim electorate he leant on Israeli Prime Minister Benjamin Netanyahu to open food aid to Gaza. But the attack from Iran will force him to reaffirm US commitment to Israel.

Russia may benefit as global attention moves from Ukraine to the Middle East, stretching Western military support. Higher oil prices will also help President Vladimir Putin stabilise the Russian budget.

China has in recent years become increasingly assertive in the region, a position it will want to further reaffirm given fast-moving events in the region. But it also needs to ensure things do not get out of control, as it is itself fighting economic issues and needs cheap oil and open commercial routes.

Commodities: oil provides a hedge for turmoil and gold should benefit

Amid tensions in the Middle East, Brent crude had already risen to over USD 90 a barrel, and we expect prices for oil and its derivatives to spike even higher in coming weeks. This fits well with our long position on the commodity complex. Our fundamental view remains constructive as we think oil offers a good hedge against renewed inflationary risks while profiting from the Chinese recovery and solid US economy.

After a strong rally recently, also triggered by geopolitical tensions, gold should continue to profit from its status as a diversifier and safe haven, with emerging markets investors buying into the yellow metal. An exogenous increase in headline inflation coupled with flights into safe haven Treasuries could support gold, as real interest rates will trend lower.

The only risky factor is how the US dollar responds to the crisis: as a safe haven, the dollar tends to profit from such situations, which would be a negative for commodities.

Inflation: price pressures should remain under control

Further escalation could complicate central banks' effort to bring inflation under control as higher oil prices creep into core inflation. Nevertheless, we believe that unless we have a full blow-up of the regional crisis, the impact should remain under control.

In the US, the key issue is excess demand while its large domestic oil production allows it to be more immune to external shocks like the present one. On the contrary, price rises could be more broadly felt in Europe at a time when the economy just started reaccelerating, especially as gas prices have recently crept up following Russia's attacks on Ukrainian facilities.

All in all, after the recent rise in US Treasury yields, the US Federal Reserve (Fed) could move back to its "natural" cautious stance in cases of uncertainties and maintain its pace to lower interest rates in the second half of the year.

Financial markets: potential entry points may emerge

Equity markets remain fundamentally solid thanks to better-than-expected economic data and solid earnings. In the medium term, we therefore remain constructive on stock indices, and we think short-term corrections might offer good entry or re-entry points.

However, we are also fully aware that short-term momentum was already slower in April before Iran's strike, as unexpectedly high inflation data in the US led to higher-for-longer interest rate expectations, with US Treasury yields ending last week above 4.5%.

In this environment, higher oil prices could – largely for psychological reasons – exacerbate fears of longer-term inflation stickiness and receding chances of central bank rate cuts.

Equity positioning and sentiment has grown increasingly positive in recent months without straying into bubble territory. Fallout from the weekend's events may help limit any market exuberance. Even before this latest twist in the Middle East conflict we were anticipating further volatility in both bond and equity markets, and for certain types of portfolios in March we added hedges in the form of option strategies and retained our positions in gold.

As higher oil prices are an exogenous shock, it will be a hard trade-off for the Fed between higher imported inflation through energy prices and lower economic growth and increased market volatility.

US Treasuries will certainly continue to be mostly impacted by strong inflation data, but they will also likely profit from their safe-haven characteristics in times of geopolitical tension. At actual yield levels, we could see some renewed interest from longer-term investors who need to rebuild bond portfolios.

In initial trading following the attack, markets took consolation from a lack of sustained damage to Israel and a call from Saudi Arabia for restraint, with S&P 500 futures up 0.4%, the EURO STOXX 50 up 0.47%, EUR/USD barely changed at 1.0659, and Brent crude up slightly (+0.5%).