Zenith INVESTMENT PARTNERS

Market Update: Israeli-Hamas War

Considerations for inflation, bond volatility and portfolio construction

In the wake of the sudden and well-coordinated attack by Hamas on Israel, the resulting conflict has not only led to a tragic loss of human life but has also reverberated across the geopolitical landscape. At this time, we have a responsibility to analyse the far-reaching implications of these events for our client portfolios and to pinpoint the focal points of risk as the situation unfolds.

There has been an immediate market reaction that was consistent with our expectations. Safe haven assets like government bonds, the US dollar and gold rallied as investors sought protection from the spike in volatility. The rally in these assets was relatively modest, perhaps due to the market becoming increasingly desensitised to ongoing geopolitical tensions.

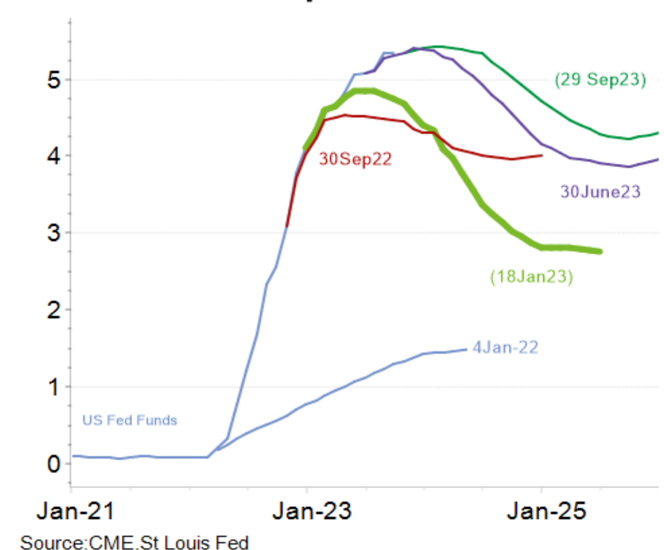
The more significant move to note, however, was a sharp rise in the oil price. While Israel and the Palestinian territories are not significant oil producers, the conflict could lead to wider regional instability, noting that the Middle East accounts for approximately one-third of the global oil supply.

Notably, Iran, which is widely regarded as an influential backer of both Hamas and Hezbollah, could become entangled in the conflict, potentially disrupting oil production and transportation. Iran's control over the passage of tankers through the Strait of Hormuz adds to this concern, as a blockade would likely place additional upward pressure on oil prices.

Alert but not alarmed...the backdrop of rising bond yields

The prospect of an escalation in the conflict and elevated oil prices poses a substantial challenge for central banks, including Australia's RBA, in their efforts to combat inflation while also attempting to achieve a 'soft-landing'. The evolving situation underscores the intricate link between geopolitical events and global macroeconomic dynamics.

Over recent months markets have been struggling under the weight of the 'higher for longer' interest rate outlook and higher bond yields. Interestingly, events over the past week have partially reversed, although perhaps temporarily, the lift in bond yields. Prior to the conflict, the US 10-year government bond yield briefly pierced 4.8%, representing a new post-GFC high. Markets, which had been expecting the Fed to cut rates significantly in 2024-25, were no longer confident that growth and inflation would allow that. Several factors are responsible for the curious confluence of falling inflation and rising bond yields.



The most salient explanation that we can point to is the surprising resilience of the US economy, despite 500 basis points of monetary policy

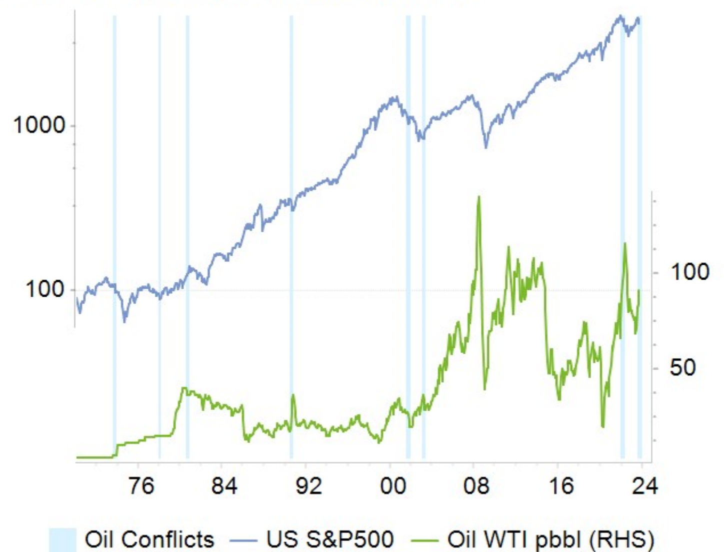
tightening. And although policy makers are signalling that the hiking campaign is over, the change in rhetoric has prompted the market to reassess expectations for rate cuts in 2024-25.

The rise in bond yields is also a function of the continued growth over the last year of the US fiscal deficit which has doubled from approximately US$1 trillion to US$2 trillion (8 per cent of GDP). This deficit expansion continues to fan the inflationary flames, particularly amidst a backdrop of an overheating economy. Consequently, the debt issuance required to fund this expansion and lingering concerns around a government shutdown has exacerbated the bond sell-off.

Past is prologue

Markets typically struggle to interpret geopolitical shocks given the underlying drivers of conflict are often idiosyncratic. However, it's important to highlight that markets generally look beyond the initial volatility and are relatively adept at pricing in longer-term fundamentals.

Whilst history is a useful guide, we must be wary of additional crosscurrents such as heightened recession risk due to the rapid increase in interest rates, poor consumer sentiment and the potential for an oil price shock, should relations in the Middle East deteriorate further.



Source:IRESS,S&P

The chart above highlights previous conflicts that directly impacted oil prices (1973, 1978-80, 1990, 2001-03 and 2022) and the market's reaction. As demonstrated, it's clear that sharply rising oil prices can be problematic in economies and markets, through exacerbating inflation and catalysing further central bank tightening. Although we don't currently believe these risks necessitate portfolio changes, understanding the market's reaction to similar historical regimes is important when considering risks to the economy and portfolios.

Push and pull forces

In uncertain times like during war, we expect markets to overshoot to the up and downside, which is why we remain focussed on delivering strong long-term returns for our investors, whilst remaining alert to emerging risks and opportunities. This involves managing a diversified set of portfolio return drivers with a keen focus on the tapestry of geopolitical, economic and market related developments as they arise.

Written by Calvin Richardson and Martin Kofoed. Zenith Investment Partners October 2023.

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