

MARKET SIGHT LINES



Market Reaction to the Israel– Hamas War ... and Left Tail Risks

By Michael O'Keeffe, *Chief Investment Officer*



In our **Geopolitical Risk Dashboard**, we've been discussing *Middle East Tensions* as an important risk to monitor. Such a risk just became a reality, with Hamas invading Israel and a war breaking out. Of course, before we consider the market implications and investment risks, we must first focus on the human tragedy. To quote Stifel's recent statement:

"The recent attacks against Israel are horrific and represent a clear violation of human values. We must never tolerate violence or acts of terrorism. Our hearts go out to all of those experiencing loss, and we pray for the quick release of those taken hostage. It is imperative that we find a way to achieve lasting peace throughout the region. The world is watching."

In this Sight|Lines, we discuss the market reaction to, and left tail risks from, the Israel-Hamas war.

THE TAKEAWAY: MINIMAL MARKET REACTION, BUT GREATER DOWNSIDE RISKS.

The immediate market reaction from the invasion and early days of the war appears minimal, but the downside, or "left tail," risks have increased. In summary:

- Oil prices, a logical initial focus, have risen modestly since the attack.
- Stock markets have generally risen through the week, with some negative pressure on Israeli stocks.
- The 10-year Treasury yield has fallen, one sign of a "risk-off" trade common at the start of a war.
- The region has been shaken, and investors are focused on escalation as a key market risk.
- An escalation would impact the flow of oil, including the movement of oil through the Strait of Hormuz.
- And more broadly, in a multipolar world, world powers may "pick sides," increasing tensions globally.
- Finally, these events will reinforce pockets of deglobalization, a potential driver of higher inflation and a headwind for markets.

IN-DEPTH: SO FAR, MARKET REACTION HAS BEEN MINIMAL, BUT WORRIES ABOUT ESCALATION INCREASE DOWNSIDE, OR "LEFT TAIL," RISKS MATERIALLY.

The immediate market reaction from the invasion and early days of the war appears minimal, but the downside, or "left tail," risks have increased. Going deeper:

- Oil prices are a logical initial focus and have risen about 4.7% since the start of the war.
- Stock markets have been well behaved this week:

- The S&P 500 is up 1.0% through Thursday. The MSCI EAFE Index, which captures other developed markets globally, is up 2.4%. And emerging markets, as measured by the MSCI Emerging Markets Index, is up 2.7%.
- The Israel stock market, as measured by the MSCI Israel Index, has fallen 8.0%.
- The 10-year Treasury yield fell from 4.80% last Friday to 4.6% following the invasion.
 - Some investor “risk-off” shifts may be contributing to this decline, as increased demand for bonds can drive yields lower.
 - But market participants may also be responding to comments from Federal Reserve officials signaling that rising yields can act as a substitute for further tightening of monetary policy. The 10-year is still 0.75% higher since the last rate hike in July.
- While the region has been shaken, investors are even more focused on escalation:
 - Israel’s priority will be to respond to the attacks, work to free the hostages, and neutralize Hamas.
 - However, there is the potential for this conflict to escalate into a broader war which may involve the Middle East as a whole.
 - Iran has a history of supporting terrorist groups like Hamas and Hezbollah, a militant group in Lebanon, to undermine stability in the region. Any involvement of Hezbollah and/or Iran – past, present, or future – would represent a meaningful escalation.
- An escalation involving Iran would impact the flow of oil and oil prices and lead to higher inflation:
 - Each day an amount equivalent to about 20%-30% of the world’s oil consumption passes through the Strait of Hormuz, a waterway between Iran and Oman.
 - Iranian oil production has increased to about 3.15 million barrels per day, despite sanctions. Any disruption will decrease supply and put upward pressure on oil prices and inflation.
- We live in a multipolar world, with the U.S. and China as the two major economic and military world powers with which other countries can align:
 - Iran and China have a friendly relationship and are more than two years into a 25-year cooperation agreement designed to strengthen their political, strategic, and economic relations.
 - So Israel and its allies, most notably the U.S., will be monitoring China’s response.

CONCLUSION

Our **Geopolitical Risk Dashboard** highlights *Middle East Tensions* as an important risk to monitor, and the Israel-Hamas war, a human tragedy, illustrates why. While market reactions have been somewhat muted, the invasion and resulting war bring into focus greater risks of an escalation which would broaden the human impact and have even more serious market and investment implications. Our base case is for the conflict to remain locally contained, but to again quote part of Stifel’s recent statement: “The recent attacks against Israel are horrific ... It is imperative that we find a way to achieve lasting peace throughout the region. The world is watching.”

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The S&P 500 Equal Weight Index is the equal-weight version of the widely regarded Standard & Poor's 500 Index, which is generally considered representative of the U.S. large capitalization market. The index has the same constituents as the capitalization-weighted S&P 500, but each company in the index is allocated a fixed weight of 0.20% at each quarterly rebalancing. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The MSCI Emerging Markets Index captures large and mid-cap representation across 26 emerging markets countries, covering approximately 85% of the free float-adjusted market capitalization in each country. The MSCI Israel Index is designed to measure the performance of the large and mid-cap segments of the Israeli equity market, covering approximately 85% of the free float-adjusted market capitalization in Israel. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options.

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