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MARKET SIGHT LINES

Middle East War: Risks of Further Escalation, Higher Inflation, and Economic/Market Fallout

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My team and I regularly update our Geopolitical Risk Dashboard, which aims to identify and assess the likelihood of key geopolitical risks that have the potential to create market volatility over the next three to five years. One such risk, *Middle East War*, describes a prolonged Israel/Iran conflict that could escalate to involve the U.S. and may now be unfolding. In this week's Sight|Lines, we delve into the unfolding developments, briefly explore their historical context, and then turn to the economic and market implications going forward.

THE TAKEAWAY: ISRAEL ATTACKS UNSURPRISING, BUT ESCALATION WOULD MEAN TROUBLE

Given history, Israel's attacks are unsurprising, and escalation from here will spell further trouble for the economy and markets. In summary:

- As far back as 1970, there have been treaties designed to limit Iran's nuclear effort.
- More recently, evidence surfaced about Iran's blatant violations of the most recent deal, even as the U.S. has tried to strike a new deal with Iran.
- Israel launched strikes just days before the start of additional talks, signaling Israel's intent to derail any prospects of a new nuclear deal.
- Israel has sought to degrade Iran's nuclear program, eliminate its military leadership, and weaken its missile capabilities.
- While Iran's counterstrikes have been mostly ineffective, the risk of escalation — including the involvement of Iran's allies, like the Houthis — is real.
- The most direct impact, and potential for more impact, relates to oil, given Iran's production and the region's strategic importance to oil markets.
- Equity market volatility has increased, reflecting worries about energy security, higher inflation, and potential disruptions to global economic growth.
- Monitoring these risks, and the potential for peace, will be important going forward.

IN-DEPTH: ISRAEL ATTACKS WERE NOT A SURPRISE, BUT FURTHER ESCALATION MAY CAUSE ECONOMIC AND MARKET TROUBLES

Given history, Israel's attacks should not have been a surprise, and escalation from here creates the risk of higher inflation, a slower economy, and volatile/weak equity markets. Going deeper:

- There have been numerous treaties designed to limit Iran's (and the world's) nuclear effort. However, more recently we've learned of blatant violations even as the U.S. has tried to strike a new deal with Iran:
    - In 1970, Iran ratified the Nuclear Non-Proliferation Treaty but violated it in the early 2000s.
    - In 2015, Iran agreed to the Joint Comprehensive Plan of Action, but President Trump withdrew the U.S., and Iran began breaching its commitments in 2019.
- The timing and scope of Israel's strikes were strategic and influenced by the October 7 terrorist attacks:
    - For years, Israel has viewed Iran's nuclear ambitions as an existential threat.
    - The timing of the strikes signaled Israel's intent to derail any prospects of a new nuclear deal.
    - The strikes have been designed to degrade Iran's nuclear program, eliminate its military leadership, and weaken its missile capabilities.
- While Iran's counterstrikes have been mostly ineffective, a greater risk is escalation:
    - Iran has hinted at activating regional proxies, including the Houthis, to expand the conflict.
    - Such action could destabilize the broader Middle East and invite U.S. involvement.
- Given Iran's production and the region's strategic importance, oil markets are in focus:
    - Oil prices jumped 7% last Friday as the conflict began.
    - About 30% of the world's oil shipped by tanker passes through the Strait of Hormuz every day, so maintaining stability in the region is important.
- Continued troubles could be negative for the economy and the markets:
    - Higher oil prices can lead to higher inflation and more subdued global economic growth.
    - Equity market volatility has increased, but threats to the world's energy security, the potential for higher inflation, and an impact on global economic growth could mean even more volatility.
- Monitoring these risks, and the potential for peace, will be important going forward:
    - At the recent G7 meeting, leaders called for de-escalation, emphasizing the need for diplomacy.
    - U.S. President Donald Trump has signaled potential deeper involvement, urging Tehran to negotiate while supporting Israel's actions.

CONCLUSION

The Stifel Geopolitical Risk Dashboard aims to identify and assess key geopolitical risks that have the potential to create market volatility over the next three to five years. In the report, we identify one such risk, *Middle East War* – a prolonged Israel/Iran conflict that could escalate to involve the U.S. Over the last week, with Israel's attacks on Iran, and Iran's counterattacks, there's an increased risk of a sustained conflict and U.S. involvement. Higher oil prices can lead to higher inflation, slower economic growth, and equity market volatility. Monitoring these risks, and the potential for peace, will be important for investors going forward.

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