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Developments in Israel:
A sustained market impact?

Seema Shah, *Chief Global Strategist*

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Following the horror of the Hamas-led attacks in Israel this weekend, global investors are contemplating the potential impact on broad investment markets. Although challenging, during a rapidly developing geopolitical conflict, investors are best suited to stay level-headed, considering that fundamentals ultimately drive long-term investment returns.

In general, while geopolitics typically has a short-lived direct market impact, the indirect impacts via inflation, confidence, and economic growth can be more persistent and, ultimately, more damaging.

Investor consideration—Oil prices

The critical macro concern lies with the oil market reaction. Brent crude prices have risen around 5% so far, heading toward the $90 per barrel mark. This increase only partially unwinds the 11% drop in oil prices last week, but there is strong potential for a further rise in prices, although the extent is subject to significant uncertainty.

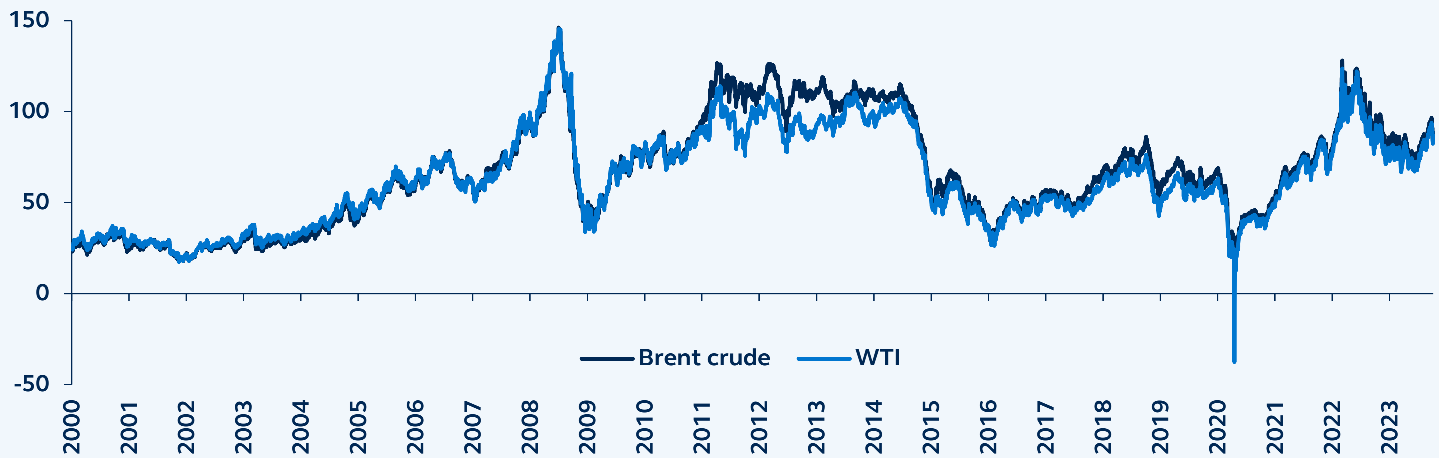
It is worth pointing out that, despite the obvious parallels to the 1973 Yom Kippur War and the ensuing Arab oil embargo, which sent oil prices soaring, one key difference today is that the U.S. is a net oil exporter. As a result, the U.S. economy is significantly less vulnerable to spiking oil prices. In addition, the U.S. holds vast resources of fossil fuels, which should subdue any potential price increase. For investors, a surge in oil prices toward the all-important $150 p/b mark would likely require a significant escalation in tensions, including potential strikes on Iran's nuclear facilities.

Investor consideration—Global growth

Rising oil prices would pressure the U.S. consumer but, provided oil prices do not spike above the $150 p/b mark, the broad market impact should be contained. Although the U.S. consumer is already facing headwinds from eroding fiscal support and diminishing excess savings, household balance sheet strength is robust and so should be able to withstand additional modest pressure from oil prices.

Global oil prices

WTI and Brent crude, oil price in USD, January 2000–present



Source: Principal Asset Management. Data as of 3:00pm ET, October 9, 2023.

Investor consideration—Inflation

In today's economy, with global central banks having tightened monetary policy aggressively over the past 18 months and inflation still above target, the inflation risk is the most pertinent.

While central banks will likely look through these developments in the near term, higher energy prices can work their way into core inflation and inflation expectations if sustained. Indeed, in the 1970s, soaring oil prices ultimately drove surging inflationary pressures and a deanchoring of inflation expectations, prompting aggressive Federal Reserve monetary tightening.

Investor consideration—Bond yields

With the U.S. bond market closed on Monday, it is difficult to parse the reaction. Markets are already nervous about the inflation outlook. If price pressures re-emerge, threatening to undo the disinflation progress made over the past year and prompting additional monetary action from policymakers, that could ultimately threaten a further bond rout. However, at least in the near term, a flight to quality will likely benefit U.S. Treasurys, alongside gold and the U.S. dollar.

Investor consideration—Equity markets

Elevated uncertainty is rarely a supportive backdrop for risk assets. However, as equity markets have been wholly preoccupied with the direction of bond yields, a bond market rally may even stabilize the recent downward trend in equity markets.

Today's conclusion…

Risk assets are currently priced for perfection, making them susceptible to any further economic or geopolitical strains and uncertainties. In light of the situation in Israel, it is prudent for investors to maintain a diversified portfolio across different asset classes, with a particular emphasis on defensive sectors. Safe havens like U.S. Treasurys and the U.S. dollar, along with exposure to energy stocks, are preferred for well balanced portfolios today.

Market reaction to geopolitical crises

S&P 500 performance in past geopolitical shocks

Events	Key dates	S&P 500 selloff starts*	Days of selloff	Days to recover from bottom	Selloff	30 days from key date	90 days from key date	180 days from key date
Cuban missile crisis	10/14/1962	10/15/1962	8	10	-7%	7%	15%	22%
1973 Arab–Israeli War (1st oil crisis)	10/06/1973	10/12/1973	46	2246	-14%	-11%	-13%	-19%
Iran hostage crisis	11/04/1979	10/05/1979	33	75	-10%	5%	12%	4%
Soviet–Afghan War	12/24/1979	12/17/1979	17	7	-4%	7%	-5%	7%
Iraqi invasion of Kuwait	08/02/1990	07/16/1990	38	174	-17%	-11%	-10%	5%
September 11 terrorist attacks	09/11/2001	09/11/2001	10	34	-12%	-2%	4%	5%
2003 invasion of Iraq	03/19/2003	03/21/2003	10	22	-5%	5%	12%	14%
Military intervention in Libya	03/19/2011	03/08/2011	8	14	-5%	3%	1%	-9%
Annexation of Crimea	02/27/2014	03/07/2014	7	18	-2%	-2%	4%	8%
Ukraine/Russia conflict	02/24/2021	02/25/2021	12	3	-4%	3%	-14%	-15%

Source: Bloomberg, Principal Asset Management. *Peak level around key dates. Data as of October 9, 2023.

Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Equity investments involve greater risk, including higher volatility, than fixed-income investments. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful.

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