Research Note

Limited impact if Israel-Hamas war can be contained

20 October 2023

Steady markets, so far

In the first few days following the outbreak of the Israel-Hamas conflict, global markets were relatively calm. Israel and Gaza are of course no strangers to armed hostilities and investors hoped that the situation could be quickly brought under control. In fact, a few sectors that could potentially benefit including energy and defence companies saw price rises, helping to prop up the wider market.

But global equity markets weakened towards the end of the week. The US's S&P500 and Nasdaq indices fell by 0.5 percent and 1.23 percent respectively on Friday and this decline was mirrored in Europe and Asia. At the same time, 10-year Treasury bond yields climbed from a 4.53 percent low on Tuesday to 4.62 percent at Friday's close.

However, it appears that market fears are still limited, with most investors waiting to see how the conflict evolves. Other factors, including positive company earnings and growing likelihood of no more rate hikes this year are helping to counteract downward pressures.

Reasons to be circumspect

Looking forward, there are good reasons to be vigilant but not panicked by the current hostilities. While there is typically a knee-jerk market reaction to such events, in most cases the effect is short-lived. For example, Russia's invasion of Ukraine that started in February 2022 saw the S&P500 correct by 18 percent before starting to recover in September 2022. The index has since gained 22 percent.

Middle East conflicts also tend to result in a surge in oil prices. This current outbreak has already caused Brent crude prices to rise more than 7 percent to over US$90 per barrel. Higher oil prices, if sustained, is worrisome given the potential impact on already elevated inflation and slower growth numbers globally. However, the oil price rise has not been a steady one. Israel is not a big oil producer and prices are not expected to stay high unless supply from big oil players like Iran are disrupted.

Three possible scenarios

As such, much will depend in the days and weeks to come whether the war can be confined to the Israel and Gaza region. Should there be an escalation into a direct war between Israel and other Middle East countries such as Iran, the market response is set to become more pronounced, although it is important to remember that other factors remain at play.

Below, UOB Asset Management analysts outline three possible scenarios that could arise from the events of the past 10 days, and the implications for oil prices, equity markets and bond yields.

Figure 1: Potential scenarios relating to the Israel-Hamas war

Scenario	Details	Impact on oil prices	Impact on global equities	Impact on US Treasury yields
Confined war	• Ground invasion of Gaza • Limited regional conflict	Limited impact as markets have already priced in such a scenario		
Proxy war	• Multi-front war faced by Israel in Gaza, West Bank, Lebanon, and Syria • Unrest in wider Middle East (e.g. Arab Spring)	Significant rise of +$10-$20/bbl (ie similar impact as in 2006 & 2009)	Volatility rises leading to a drawdown in equities of -5% to -10% before recovery	Minor short-end sell-off slightly due to higher inflation fears Limited long-end rally driven by risk-off sentiment, but countered by higher inflation fears
Direct war	• Direct war between Iran and Israel	Extreme rise of +$20-$80/bbl (ie similar impact as in 1990-91 gulf war and 1973 Israel Arab war)	Volatility spikes, leading to a larger drawdown in equities of up to -20% (is similar to1973 Middle East war)	Significant short-end sell-off Long-end impact a balance of risk-off sentiment and higher inflation fears

Source: UOBAM

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