Portfolio Manager Insights

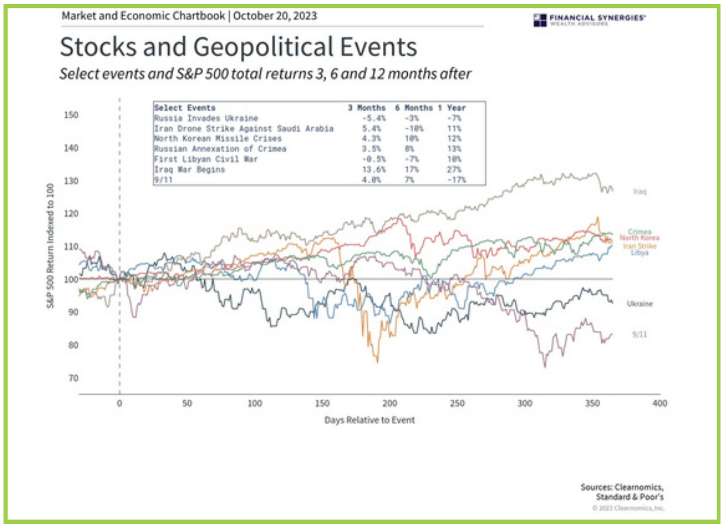
How Middle East Conflicts Have Historically Impacted Markets

Mike Minter, CFP®, CFS® | October 24, 2023

On the morning of Saturday, October 7, Hamas launched a surprise attack on Israel killing hundreds and plunging the region into further conflict. Israel immediately declared war on Hamas, responded with air strikes, and called up 300,000 army reservists.

The U.S. and many U.N. Security Council members have condemned the attacks by Hamas, which is designated a terrorist organization by many major countries, and are providing assistance to Israel including the positioning of a U.S. aircraft carrier in the Eastern Mediterranean. The situation is evolving and we all hope for a return to stability in the region, and especially for the continued safety of civilians and any friends and family that might be impacted.

THE IMPACT OF REGIONAL WARS ON MARKETS DEPENDS ON THE ECONOMY



Without minimizing or trivializing the severity of this conflict, especially the humanitarian consequences, many investors will naturally have questions and concerns about the impact on markets in the coming weeks. What does history tell us about regional wars and their implications for markets and the economy?

Unfortunately, for long-term investors, geopolitical risk is unavoidable. Headlines on regional and global conflicts are alarming since they involve violence and the loss of life, and are therefore unlike the typical flow of business and market news involving earnings, valuations, and mergers and acquisitions. These events are also difficult to analyze and their outcomes challenging to predict.

As a recent example, many of the predictions around Europe's access to oil and gas following Russia's invasion of Ukraine, fortunately, did not play out. So, while short-term traders may be tempted to guess the direction of oil prices, the S&P 500, and interest rates, it's often better to remain level-headed as events unfold.

Calling the history of the Middle East complex would be a vast understatement, making the current situation even more difficult to analyze. Many diplomats have spent their entire careers attempting to broker peace, countless volumes have been written on the subject, and decades, if not centuries, of ethnic and religious history complicate relations between the region's nation-states.

OVER LONG PERIODS OF TIME, MARKETS HAVE RECOVERED FROM GEOPOLITICAL CONFLICTS

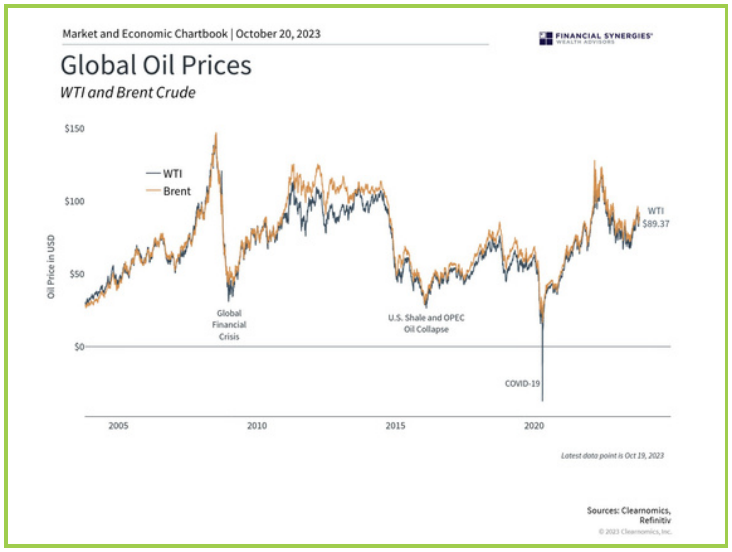
At the risk of oversimplifying matters, the numerous attempts at achieving peace by the U.S. since the mid-twentieth century have been largely unsuccessful. While the Camp David Accords in the late 1970s and the Oslo Accords in the 1990s did improve relations and helped to end conflicts at the time, violence has erupted many times over the past decade.

From the perspective of investors, it's always important to separate feelings and beliefs around politics and global matters from portfolio decisions. As the first chart above shows, the impact that wars have on markets varies depending on the business cycle. Some events such as 9/11 and the ensuing wars in Iraq and Afghanistan were met with market declines. This was because these events coincided with the dot-com crash which, while unrelated, required years to stabilize.

In contrast, most of the conflicts since the 2010s, including wars in the Middle East, the annexation of Crimea by Russia, and the on-going nuclear threats in North Korea and Iran, were against the backdrop of an expansionary economic cycle. While some of these periods experienced market declines over the following three to six months, economic growth tended to lift markets higher over longer time horizons despite geopolitical uncertainty. The history of strong bull markets in the 20th century across World War II, the Vietnam War, and the Cold War further underscores this point.

Of course, last year's invasion of Ukraine by Russia is still ongoing and, so far, markets have not yet recovered their previous peaks. Again, this is largely due to the interaction with other economic forces, namely rising inflation, supply chain disruptions, and elevated market valuations following the pandemic.

OIL PRICES HAVE RISEN FOLLOWING THE ATTACK ON ISRAEL



One direct impact of the Ukraine war and uncertainty in the Middle East is on energy prices. Oil prices did jump following the recent attack on Israel, with Brent crude rising from $84 per barrel to above $87, partially reversing the decline over the past few weeks from a high of about $97. However, this pales in comparison to the sharp rise in oil last year when prices approached $128. There was little direct impact on oil when Russia annexed Crimea in 2014, and even the 2019 drone strikes against Saudi Aramco by Iran and others, which knocked out 5% of global oil production overnight, saw only a short-lived reaction in oil markets. Thus, the impact on energy prices from Middle East conflicts is far from a sure thing.

Perhaps the broadest implication for investors is the idea that markets depend on global stability, the rule of law, and business/consumer confidence. Regional conflicts, especially those that involve the United States and its allies, increase the “risk premium” on financial assets because the future becomes more uncertain. This uncertainty is the idea that even the possibility that markets and businesses could be affected is enough to hurt investor confidence. This is why many investors tend to focus on questions around shifting global dynamics.

Many of these issues are deeply challenging and often theoretical. As such, their impacts on markets, the economy, and corporate activity are far from certain. History shows that it’s a mistake to make dramatic shifts in portfolios in response to geopolitical crises. Properly diversified portfolios, especially those built around long-term financial plans, are designed to handle exactly these periods of uncertainty.

None of this is to dismiss or detract from the severity of the conflict in Israel, especially from a humanitarian perspective. While the situation will be closely watched as events unfold, investors should avoid overreacting with their portfolios.