

Beyond the human tragedy: what war in the Middle East means for global markets

By Perpetual Asset Management

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The crisis unfolding in the Middle East will have broader ramifications for an already fragile world order, says Barrow Hanley's JAMES CARPENTER

MOST Australians will be rightly focused on the fate of innocent civilians caught up in the Israel-Hamas conflict.

The killing of more than 1000 Israeli civilians by Hamas gunmen and the subsequent shelling of the Gaza Strip is the most significant conflict in the region for 50 years.

Beyond the unfolding humanitarian crisis, there will be broad ramifications for regional stability and an already fragile world order.

The war poses challenges for central banks and policymakers trying to engineer a soft-landing for the global economy, says Barrow Hanley's James Carpenter.

The conflict carries direct implications for investors, including heightened uncertainty, increased energy prices, prolonged inflation and the potential for sustained higher interest rates potentially triggering a global recession.

"It's a tragic situation, which could have significant ramifications for markets," says Carpenter, a client portfolio manager at Barrow Hanley, a global value investing leader which is part of Perpetual Group.

"If the conflict does not de-escalate soon, the potential for it widening grows. This could hinder global oil supply in addition to other second derivative effects."

Impact on oil

The biggest ramification for investors lies in the region's importance to oil supply.

While the conflict does not directly affect oil-producing territories, the political implications of the attack are likely to see sustained upwards pressure on oil prices.

"We could easily see oil top \$100 a barrel in the near future," says Carpenter.

Key for investors is how the US responds, he says.

The US administration has recently been supportive of loosening sanctions on Iran to allow more oil supply into global markets.

This stance could now be under threat, raising the prospect of less oil in the system, higher energy prices and ultimately more inflationary pressure, argues Carpenter.

Iran, which has been allowed to supply an incremental 700,000 barrels a day into global markets, has denied involvement in the invasion — but has long provided financial support to Hamas.

"We're estimating that a risk premium could be \$5 to \$10 a barrel if the conflict spreads to other countries, especially to a direct hot war between Iran and Israel, which seems unlikely at this point."

The US administration has also been courting Saudi Arabia — partly in the hope of encouraging an increase in production — but this too is now under threat.

"More inflation means higher rates for longer — and whether it's one more hike or two more hikes isn't relevant.

"What people are not factoring in is persistent higher rates. They are expecting high rates to eventually come back down."

Inflation and rates

It's worth remembering that a multitude of factors have contributed to inflation, says Carpenter.

The initial catalysts were disrupted supply chains, a surge in food and oil prices following Russia's invasion of Ukraine, coupled with the effect of fiscal stimulus measures aimed at preventing a pandemic-induced economic downturn.

More recently, strike action and rising wages are also putting further upwards pressure on prices.

"There is this thought that central banks are going to be able to engineer a soft landing — that they are going to be able to land this thing.

"But this conflict likely presents a formidable challenge to that."

Complicating matters is the weakened ability of the US to step into to supply the world's energy needs.

The US Strategic Petroleum Reserve, a reserve of crude oil stored in underground caverns, has been heavily drawn down over the past 12 to 24 months, and replenishing stockpiles would be counterproductive to lowering oil prices.

"This time around, US shale oil producers will probably not be able to come to the rescue like they have in the past.

"The shale industry is mature — rig count (which represents new drilling sites for oil) has come down precipitously in the last 10 years," says Carpenter.

"So, if there is an energy shock, it may be difficult to unwind so long as the global economy continues to hum along.

"The big takeaway is we could be looking at turbulent times ahead just as global markets have entered into bull territory in the last year."



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