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FIRST ANALYSIS

News or events that may affect your investments October 2, 2024

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Perspective on new escalation in the Middle East

Key takeaways

- Iran attacked Israel on October 1, claiming retaliation for a number of blows against the leadership, communications structure, and weapons of Hezbollah, Iran's largest proxy force in the region.
- As each side learns more about the other's capabilities, each new round runs the risk that the two sides adapt their tactics to be more accurate and have greater impact, but miscalculations create a risk that an unintended escalation may occur.

What it may mean for investors

- We do not discount the possibility of more escalation and negative market surprises, but our investment guidance routinely takes steps to offset surprise events. Our recent guidance changes point out potential opportunities to hedge against risks arising from international conflict.

On October 1, Iran directly attacked Israel with a barrage of about 200 ballistic missiles. The strike came in response to Israel's increased targeting of Hezbollah and incursions across Israel's border with Lebanon. Iran claimed to have targeted military bases, but Israel reported damage to some homes in the Tel Aviv area due to shrapnel and shock waves. The Pentagon and Israeli spokespeople reported that air defenses destroyed most of the missiles and that casualties and damage on the ground in Israel were light. The Israel Defense Forces said that Israel would retaliate but did not specify when or how.

Iran's latest attack follows weeks of Israeli fighting against multiple Iranian-backed militias, particularly Hezbollah, which is Iran's largest proxy and operates in Lebanon. Israel turned its focus to Hezbollah after adding an objective to its war goals to return Israeli citizens to their homes in northern Israel, following months of Hezbollah rocket attacks from Lebanon.

Our perspective

Israel and Iran exchanged direct attacks on each other for the first time in modern history between April 13-19, 2024. We believe that crossing this historical red line itself escalated the tension in the region, but we now see a pattern of escalation in how the attacks have developed. Both the April and October 1 strikes came from a single direction (from Iran) and had to travel 1,000 miles to reach Israel. The long distance and single direction of attacks gave Israel and the U.S. time and opportunity to defend. U.S. positions in Iraq could block missiles relatively early in their path, and Israel has an extensive air defense system that intercepted many of the rest.

For its part, Hezbollah has been firing rockets into northern Israel since October 8, 2023, in support of Hamas' fight against Israel in Gaza. Israeli citizens living near the Lebanese border left their homes almost immediately. But Hezbollah targeted one of Israel's largest cities, Tel Aviv, with only one ballistic missile (on September 25), which occurred after Israel exploded Hezbollah pagers and walkie-talkies. Hezbollah may be taking care not to trigger a full Israeli invasion that could upset Hezbollah's political leadership in a fractious Lebanese political system.

Once Israel decided in September to clear the way for its citizens to return to their homes in the north, it began targeting specific parts of Hezbollah, aiming at the group's communication network (pagers and walkie-talkies), Hezbollah senior leadership, and rocket and missile launchers across Lebanon. Israel has claimed limited incursions into southern Lebanon to destroy weapons and eliminate any tunnels that cross under the border into Israel. And Israeli commandos conducted an unusual raid into Syria to destroy a suspected underground Iranian missile factory.

The problem for each side is that restraint doesn't necessarily achieve its objectives:

- Two Iranian missile barrages failed to break through Israel's air defenses materially, which begins to suggest that Iranian missiles might fail to deter Israel in the future. Larger, multi-wave and multi-directional attacks could reestablish the deterrence, but likely would spark retaliation in kind against Iran.

- Hezbollah's attacks into Israel have been just restrained enough to avoid a full-scale invasion of Lebanon, but at the cost of its senior leadership, disruption in its communication, and new risks to its missile supply line through Syria.

- Finally, Israel has troops on the border but could be hesitating to launch a full invasion because three previous incursions into Lebanon (1978, 1982, and 2006) were costly and inconclusive.

In sum, the constraints on the three sides still seem to be holding, but we see a clear risk of further escalation in the region. Predicting the timing and magnitude of the next escalation is challenging because, unfortunately, there are many historical examples in which antagonists throw off reason, ignore their constraints, and opt to escalate. One need look no further than Russia's invasion of Ukraine in February 2022. At the time, we wrote that Russian forces appeared ill-prepared, and the protracted human catastrophe that has developed since then bears out that observation.[1]

The U.S. has continued to move military assets into the region in an attempt to protect U.S. forces in the Middle East and to deter escalation. U.S. military hardware could continue to aid the Israeli air defense, in the event of a larger missile barrage from Iran or its proxies, but we doubt the U.S. will become involved in offensive operations.

Investment implications

As long as the constraints hold, capital markets may continue to look past the war as a conflict with low market impact. But if one side throws off its constraints and escalates to the point of significant infrastructure damage and loss of life, then the other side, retaliating in like degree, could affect the global economy (through oil prices) or

1. Prior to the invasion, Russia had assembled multiple armed forces units from across Russia's 11 time zones, and there was no indication that they had worked together, had adequate ammunition or had constructed medical facilities. For details, see "Russian military deployments likely aimed at diplomatic leverage", Janes, January 11, 2022. The resulting assault was forced to retreat and regroup by the end of 2022.

expand the war to other countries. The three sides are still showing restraint, but in our view, any new escalation is likely to move markets to react abruptly, as they did in April and again in early October — specifically, repositioning from equities into perceived havens. That is likely to lead to appreciation in the U.S. dollar, Japanese yen, and Swiss franc; higher commodity and 10-year U.S. Treasury note prices; and lower equity markets. In the latest case, these markets moved in these directions as the attack developed but partially reversed these moves later in the day, as the attack's impact was less than feared.

We do not believe these events indicate that investors should sell their equity exposure. Clearly, some recent headlines have ranged from disappointing to tragic — including after-effects from a major hurricane in the southeastern U.S., labor strikes, and material escalation of violence in the Middle East. At the same time, there are positive surprises, especially combinations of government spending and lower interest rates to stimulate the U.S. and other economies around the world. And we believe it's worth remembering that the S&P 500 Index marked its 43rd new record high in 2024 on September 30 and that the index had its best third-quarter performance since 2020.

Our overarching investment guidance is to maintain balance in portfolios. We don't see the war in the Middle East as a reason to abandon long-term investment strategies. But we do see some opportunities to reinvest short-term fixed income into somewhat longer maturities (3 to 7 years) and to add commodity exposure as a hedge against a worsening war and volatility from other headlines.

Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

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Definitions

[Include any index definitions for any indexes which have been utilized in the report]

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