

# Israel-Gaza conflict: Oil prices surge amidst regional unrest

By <u>Izak Odendaal</u> 16 Oct 2023

The world has witnessed heart-wrenching scenes in Israel and Gaza in recent days. The fact that this is one of the longest unresolved conflicts in the world does nothing to diminish the horror.



Source: Pixabay

Thousands of lives have been violently changed forever, adding to the many lost over the years. It makes anything related to finance seem trivial, but this is an investment newsletter, and we must still ask whether these events can impact the broader world economy.

The roots of this conflict are deep and complex, and not for discussion here. It highlights how fortunate we are to have resolved our foundational conflict in 1994, accommodating the political aspirations of black and white South Africans.

Though economic equality remains distant, the constitutional dispensation is settled, and provides a framework for progress. In contrast, a peaceful and just settlement between Israel and the Palestinians now seems further away than ever. One can only hope some good will come of this somehow.

if it can escalate into something even bigger and damaging to the rest of the world?

It is important to note upfront that most regional or civil wars have little impact on world markets. The Russian invasion of Ukraine was different because of the outsized role those two countries play in food and energy markets. The October 1973 Yom Kippur War, when Egypt and Syria launched a surprise attack on Israel, had an even bigger impact on the oil price and the global economy.

### Oil upheaval

Therefore, whenever there is upheaval in the Middle East – and sadly, this happens regularly – the first thing investors look at is the oil price. It is through oil that this region matters greatly to the global economy.

Beyond oil, the collective Middle Eastern economy is relatively small. Israel's economy is about the size of the US state of Michigan, though it is bigger than South Africa's. Despite its oil wealth, Saudi Arabia's economy is about as big as Pennsylvania's. Iran is also an oil-rich country, but years of isolation and economic mismanagement means its economy is smaller than Wisconsin, despite its population being almost 15 times larger.

Indeed, the lack of economic development in many Middle Eastern countries is both a cause and consequence of political volatility. But it has also long been the scene of great power hostilities, from ancient empires to the modern European ones, the Cold War, and more recently, the rivalry between Saudi Arabia and Iran.

The Brent crude oil price rose immediately after Hamas launched its attacks, and fears of escalation drove it higher towards the end of the week where it closed at \$90 per barrel. This is an uncomfortably high level, but so far, the moves are small in the context of the volatility of the past four years and even the past few months.



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In contrast, 50 years ago Arab oil exporters instituted an oil embargo against Western nations sympathetic to Israel. The price of crude oil jumped from around \$4.50 per barrel to \$15.50, a near threefold increase.

This had devastating consequences across a global economy that was used to low and stable oil prices, and abundant supply. Oil was not just for fuelling gas guzzling cars, but also widely used for heating, generating electricity and running industrial processes.

The oil shock not only caused a recession in major economies, ending the long period of post-World War II prosperity, but also fanned inflation. The dreaded combination – called stagflation – crushed bond and equity markets and continues to haunt policymakers to this day. One of the reasons why central banks have been so aggressive in response to the recent inflation spike is to prevent an inflation psychology from taking hold as it did in the 1970s. Dislodging it can be very difficult.

While the embargo did not last long, the oil price remained high. Another oil shock hit the global economy at the end of the decade when the Iranian Revolution, and subsequent Iran-Iraq war, saw oil output fall and prices almost doubling.

As was the case 50 years ago, the big risk is a major disruption to oil supplies, either from damage to infrastructure or if Middle Eastern oil producers deliberately cut back production to pressurise Israel and its allies.

It seems unlikely that they will, though that probably depends on how far Israel pushes its retaliatory attacks. Iran is the one to watch given its long support of Hamas in Gaza and Hezbollah in Lebanon, but years of sanctions and underinvestment mean Iranian output is half of what it was in the 1970s.

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Exports had been increasing somewhat in recent months as the US and Iran resumed nuclear talks, and perhaps Iran will not want to jeopardise progress. Under US encouragement, Saudi Arabia and Israel were in the process of establishing diplomatic ties before the attacks. This process is likely to be disrupted, but the fact that it was underway makes it less likely that Saudi Arabia will suddenly wield oil as a weapon.

Saudi Arabia's approach to the oil market in recent years has generally been to try to stabilise the price at a level that is high enough to generate lots of income, but without being so high as to destabilise the global economy.

### Things have changed

Importantly, both the oil market and the global economy have evolved from the 1970s. Economic activity is much less energy-intensive today. Services form a bigger share of the economy, while industrial processes and transport are more efficient, requiring less energy for each unit of output or movement.

Economies are also more flexible and adaptable, and less heavily regulated. This means the global economy is less vulnerable to another jump in the oil price. The 1990 spike following Iraq's invasion of Kuwait had a limited impact on the global economy, though it was brief.

Oil and particularly gas prices shot up in the wake of Russia's invasion, causing great difficulty across the world, but not the economic devastation that Russian president Putin would have hoped for.

The oil market has also changed since the 1970s. Large and liquid spot and futures markets developed in the early 1980s, giving producers and consumers more options to hedge themselves against volatility.

Perhaps the most important change is much more recent. Thanks to the shale revolution, the US is once again the world's largest producer – as it was in the early days of the petroleum age. US crude oil production hit a record high of 13 million barrels per day recently, and the US has been a net energy exporter since 2019.

## Global powers and conflicts

The biggest economy in the world is now much less vulnerable to energy shocks. Despite remaining a staunch ally of Israel, the Middle East matters much less to US interests these days.

What about the other big powers? Without the involvement of big powers, regional conflicts do not usually escalate to globally significant ones. Russia has a history of meddling in the Middle East, and has been getting closer to Iran recently, but it is clearly tied up in a quagmire of its own making in Ukraine.

It did not intervene when Azerbaijan seized the Nagorno-Karabakh region from Armenia, right on Russia's doorstep. China has long supported the Palestinian cause, but apart from trying to undermine America's position in the region, it has little to gain from getting directly involved. That leaves the regional powers of Iran and Saudi Arabia, as discussed above, and Turkey (a Nato member) and Egypt.



Death toll adds up as journalists die in Israel and Palestine conflict

In summary, the tragic explosion of violence is likely to be a defining moment in the history of Israel and Gaza, but seems unlikely to have a major impact on the global economy. For markets, the ongoing strength of the US economy, and the implications for interest rates and inflation loom larger. US bond yields retreated somewhat in the wake of the attacks, a typical knee-jerk flight to safety, but higher-than-expected September consumer inflation data put upward pressure on yields again.

Nonetheless, there is no doubt that, geopolitically, we are in a very uncertain world. The post-Berlin Wall, pre-Covid environment of relative peace and prosperity, accelerating globalisation, and low and stable inflation and interest rates seem to be over.

But even as we look back with a certain nostalgia for this era, remember that it was punctuated by several episodes of turmoil: several civil and regional wars; 9/11 and the disastrous American invasion of Iraq; financial crises in 1998 and 2008; the Arab Spring; Brexit; and much more.

The future is therefore always uncertain, and since markets reflect and amplify the full range of human bias and behaviours, they are particularly unpredictable. Investors should therefore not panic when they read unsettling headlines.

It might cause short-term volatility, but the bigger drivers of market returns are usually more mundane things like asset-class valuations, inflation, and interest rates. And remember that despite our ability to inflict horror and cruelty on one another, it still makes sense to take a long-term bet on human ingenuity.

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