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Navigating geopolitical risk: Investment insights amid Middle East escalation

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Kim Catechis of Franklin Templeton Institute hosted a discussion with two of our investment leaders in the Middle East to review the financial market implications of the US Operation Epic Fury targeting Iran and the escalation of the conflict in the broader region.

Key takeaways for investors

- This conflict is already quite different from other geopolitical crises in this region during recent decades. First, there is a question or possibility of regime change in Iran. Second, Iran has attacked several Gulf Cooperation Council (GCC) countries and damaged critical infrastructure like airports and seawater desalination plants. Third, the Strait of Hormuz is closed to shipping traffic.
- To this point, markets have had a mostly measured reaction. Bond yield spreads in the GCC markets have been well behaved. But moving into the second week of the turmoil, the market movements are getting bigger. Oil markets moved as much in the past day as they had moved in the entire week prior.
- Higher oil prices should benefit GCC credit markets. At the start of the fighting, GCC balance sheets were quite strong. They are in a strong position to deal with the financial fallout of the conflict.
- Right now, our base case is that this conflict will remain relatively short, in the range of two weeks to a month. Still, markets have to price in multiple scenarios, including shorter or longer time frames.
- The initial inclination for investors in this type of situation is (unsurprisingly) to reduce risk. But we also see signs of a rotation into sectors where prices may increase, such as materials and energy, as well as in some of the defensive sectors. On the other hand, sectors that face greater business risk, such as tourism, hospitality and real estate, are starting to see investment rotate away.
- Countries that experience less direct impact or that are more diversified may be a bit better off. For example, Saudi Arabia has a large, diverse equity market, not to mention access to Red Sea ports.
- The key risk we see is that this is uncharted territory, primarily because this is the first time that the Strait of Hormuz has closed. Also, Iran, despite experiencing heavy attacks, is still able to respond. Markets may price in a longer conflict if Iran proves to have staying power. Equity valuations could change a lot in a week.
- Looking globally, US markets appear to be more removed, and US natural gas prices have not risen nearly as much as European gas prices. The bond yield curve in Europe quickly priced in inflation and a change in monetary policy stance. US Treasuries have been very well behaved. The Federal Reserve may still be disposed to do another rate cut.
- The US dollar initially strengthened because investors have begun moving out of emerging markets. However, if future inflation months from now is higher, and interest rates are lower, the dollar should go back toward a weakening trend.
- Questions are turning to how much damage will happen across the region, and what will come after the fighting stops. US objectives may shift. With the costs rising higher for everyone, there may be an incentive to find an exit. In the meantime, expect more volatility and further rotations.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal. Large-capitalization companies may fall out of favor with investors based on market and economic conditions. **Small- and mid-cap stocks** involve greater risks and volatility than large-cap stocks.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets.** To the extent the strategy invests in companies in a **specific country or region**, it may experience greater volatility than a strategy that is more broadly diversified geographically.

Commodity-related investments are subject to additional risks such as commodity index volatility, investor speculation, interest rates, weather, tax and regulatory developments.

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