BRIEF MARKET INSIGHTS

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An Escalation of the U.S.-Iran Conflict:

The assassination of General Qassem Soleimani, a major figure in the Iranian regime, in a U.S. airstrike a few days ago had significantly raised the chances of an outright conflict between the U.S. and Iran. The Iranian response last night was to be expected, but the U.S. response is still uncertain. If there were to be a further response by the U.S., we fear that this would raise the ante. We've previously estimated that a U.S.-Iran war could shave 0.3% pts or more off global GDP, mainly due to a collapse in Iran's economy but also due to the impact from a surge in oil prices.

It's extremely difficult to know how events will play out from here. But Iran's Supreme Leader has promised "tough revenge" for the death of Mr. Soleimani. This could still come via numerous channels, including attacks on U.S. embassies in the region, assaults on neighboring U.S. allies (such as Saudi Arabia) - or strikes on U.S. military facilities in the Gulf though less likely.

Clearly, the major concern for the world economy is that events spiral out of control and the U.S. launches a full-blown military assault on Iran. We have focused our efforts in the past several months on the possible geopolitical and economic implications of a direct conflict between the U.S. and Iran. In summary, there are a few key points worth noting:

- First, the resulting collapse in Iran's economy could knock as much as 0.3% pts off global GDP – equal to our estimate of the damage from the U.S.-China trade war. The impact on the other MENA countries would ultimately depend on whether they get directly caught up in the conflict. Past experience suggests that they could actually come through relatively unscathed – many of the Gulf countries recorded rapid growth during the First Gulf War.

- Second, and more importantly for the rest of the world, oil prices would surge. In response to last night's events, oil prices have risen by more than 3% last night to $70 a barrel. But if Iran tried to close off the Strait of Hormuz, we've previously estimated that Brent crude would jump in response and confirms our current overweight position in portfolios through the first quarter of the year. The escalating conflict as described could push up inflation across the world, by as much as 3.0% pts in the OECD countries.

- Central banks in the developed world would likely not generate a monetary response. However, in Emerging Markets, those countries that are net importers of oil could result in inflation and affect higher interest rates.

- Third, there could also be negative side effects on investor sentiment and potential disruption to shipping routes in the region. Our current thinking is that the global economy could bottom out in the early part of this year and recover thereafter. But the outbreak of a war between the U.S. and Iran could put the recovery on ice.

Iran's options: Of all the options open to Iran's fanatical regime, instigating even more widespread chaos in the region may not be the most compelling one. They've been cornered by the U.S. administration's sanctions that have crippled their economy. They've been facing mounting protests at home against their expensive meddling in the affairs of other countries in the region, where protests against Iran have been occurring more often.

The most extreme military reaction by Iran could be to attack oil tankers passing through the Strait of Hormuz and once again to launch a major drone attack on Saudi oil facilities. At the same time, Iran might instruct its proxies in the region to engage American forces throughout the Middle East. In the most extreme scenario, Hezbollah and Hamas could fire thousands of missiles at Israel in support of Iran's maximum chaos campaign. In this extreme scenario, within a few hours of Iran's attacks, the U.S. and its allies (especially Israel and Saudi Arabia) would probably destroy much of Iran's oil infrastructure, nuclear facilities, missile installations, airfields, and other military installations. Presumably, that could be accomplished mostly with cruise missiles.

The Mullahs may be extreme radicals, but that doesn't mean they are crazy. Instead of a suicidal attack, they might opt for a more benign strategy. After all, they have more experience as terrorists than as conventional combatants. A cyberattack on U.S. interests would be the lowest level of escalation. We would expect limited attacks by their proxies may also be initiated. However, they are now facing a U.S. president who seems willing to respond disproportionately to any further instigation, especially if American lives are lost. In other words, they may be between a rock and a hard place.

In Summation: In terms of financial markets, equity and bond markets across the Middle East would probably come under some pressure in the near term, should the conflict escalate. We suspect that dollar pegs in the Gulf would remain intact. At a global level, a dent to risk appetite could cause risky assets to suffer in the shorter term – equities would fall and EM currencies could weaken – and safe haven assets to rally. In any event, it is unlikely that oil prices will soar to levels that will cause yet another global recession, as has happened in the past when chaos spread in the Middle East. If Middle Eastern oil supplies are disrupted, ample strategic petroleum reserves are available to mute any oil price shock. Higher oil prices would also stimulate even more oil production by U.S. frackers.