

Iranian attack builds momentum for conflict expansion

Market volatility likely to increase in the coming days, with much depending on Israel's response

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FLASH NOTE

SUMMARY

- Scale of Iranian attack appeared larger than expected, raises Mideast tensions
- Israel's reaction will be crucial; the US is trying to de-escalate the situation
- We expect increased volatility in markets in the coming days

IRANIAN ATTACK ON ISRAEL STOKES MIDDLE EAST TENSIONS

Iran launched a missile and drone attack on Israel on April 13, the first such strike from its own territory, in retaliation for a suspected Israeli strike on the consular section of Iran's embassy in Damascus earlier this month. That attack killed several Iranian commanders.

Although an Iranian retaliatory move had been widely anticipated, the scale of the assault appeared larger than expected and the move raises tensions in the wider Middle East, where the probability of a ceasefire between Israel and Hamas in Gaza has decreased. Egypt, Qatar and the US have mediated talks aimed at securing a ceasefire in Gaza but, even prior to the Iranian attacks, those negotiations had struggled to close in on a deal.

Iran said after its assault, which allowed it to save face, that it considered the retaliatory measures finished. "The matter can be deemed concluded," Iran's mission to the United Nations said in a statement on the social network X. "However, should the Israeli regime make another mistake, Iran's response will be considerably more severe."

Israel's reaction will now be crucial. The Israeli military said 99 percent of the Iranian barrage had been intercepted, but there are calls from some quarters in Israel for a robust response. There is some convincing of Israel to be done by the US, China and regional powers in the Middle East to de-escalate the situation.

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US President Joe Biden urged Israel to show restraint as its war cabinet met after the assault. It is noteworthy that Biden reportedly told Israeli Prime Minister Benjamin Netanyahu: “You got a win. Take the win.” Media reports also indicate Biden told Netanyahu the US will not take part in a counter-offensive against Iran.

Biden, seeking re-election in November, does not want a wider regional conflict – or for the US to be dragged into one. By acting decisively to shield Israel, the US and other Israeli allies have prevented the escalation risk being bigger than it would otherwise have been.

However, the chances of a wider regional conflict have increased to around 30 to 35 percent even though such a scenario is in the interests of no party. The shadow war between Israel and Iran has been brought out into the open. Even if escalation is avoided now, the escalation burden will be much lower in the future.

Underlining the risks to the world economy of a wider conflict, Iran seized an Israel-linked cargo ship in the Strait of Hormuz, one of the world's most important energy shipping routes, on April 13, before the missile and drone attack later the same day. The move showed Iran’s capacity to disrupt shipping through the Strait of Hormuz, through which a third of all oil cargoes pass.

We will watch events closely in the Middle East, and also on the Russia-Ukraine front, where the Russian military is replacing battlefield losses faster than expected. Russia also said on March 20 it would bolster its military by adding two new armies and 30 new formations by the end of this year.

MARKETS VIEW

We expect increased volatility in financial markets in the coming days. The first reaction to Iran’s assault came in crypto trading, which saw a correction. However, Saudi Arabia’s benchmark Tadawul All Share Index closed almost flat.

Depending on Israel’s response, we could yet see a bigger response in markets – such as a correction in equities, and outperformance in oil, the USD and other safe havens such as gold. Fixed income assets could see some near-term gains but these may be muted should Middle East tensions fuel inflationary pressures. We have advocated playing volatility, as the price for protection has been low.

Fundamentally, the first quarter earnings season has just begun and we expect, given stronger economic growth so far, that corporate results will overall beat expectations and companies will project improved earnings going forward. However, we will watch events closely as geopolitical risk has increased after Iran’s attack on Israel.

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