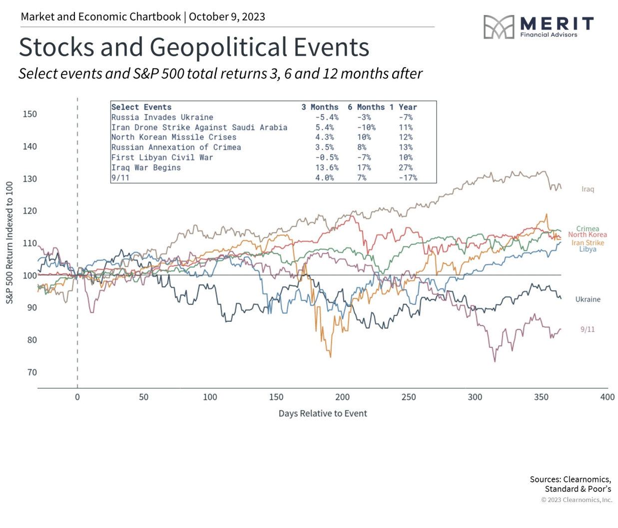
How Middle East Conflicts Have Historically Impacted Markets

Merit Financial Advisors Investment Team | October 9, 2023

On the morning of Saturday, October 7, Hamas launched a surprise attack on Israel killing hundreds and plunging the region into further conflict. Israel immediately declared war on Hamas, responded with air strikes, and called up 300,000 army reservists. The U.S. and many U.N. Security Council members have condemned the attacks by Hamas, which is designated a terrorist organization by many major countries, and are providing assistance to Israel including the positioning of a U.S. aircraft carrier in the Eastern Mediterranean. The situation is evolving and we all hope for a return to stability in the region, and especially for the continued safety of civilians and any friends and family that might be impacted.

The impact of regional wars on markets depends on the economy

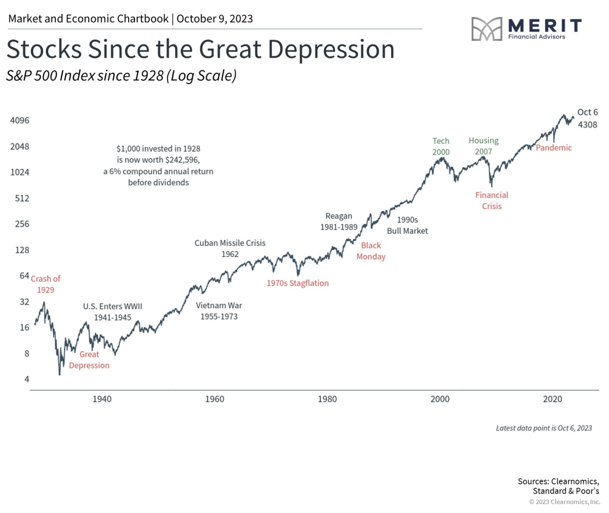


Without minimizing or trivializing the severity of this conflict, especially the humanitarian consequences, many investors will naturally have questions and concerns about the impact on markets in the coming weeks. What does history tell us about regional wars and their implications for markets and the economy?

Unfortunately, for long-term investors, geopolitical risk is unavoidable. Headlines on regional and global conflicts are alarming since they involve violence and the loss of life, and are therefore unlike the typical flow of business and market news involving earnings, valuations, and mergers and acquisitions. These events are also difficult to analyze and their outcomes challenging to predict. As a recent example, many of the predictions around Europe's access to oil and gas following Russia's invasion of Ukraine, fortunately, did not play out. So, while short-term traders may be tempted to guess the direction of oil prices, the S&P 500, and interest rates, it's often better for long-term investors to hold a properly diversified portfolio and stay level-headed as events unfold.

Calling the history of the Middle East complex would be a vast understatement, making the current situation even more difficult for investors to analyze. Many diplomats have spent their entire careers attempting to broker peace, countless volumes have been written on the subject, and decades, if not centuries, of ethnic and religious history complicate relations between the region's nation-states. At the risk of oversimplifying matters, the numerous attempts at achieving peace by the U.S. since the mid-twentieth century have been largely unsuccessful. While the Camp David Accords in the late 1970s and the Oslo Accords in the 1990s did improve relations and helped to end conflicts at the time, violence has erupted many times over the past decade.

Over long periods of time, markets have recovered from geopolitical conflicts



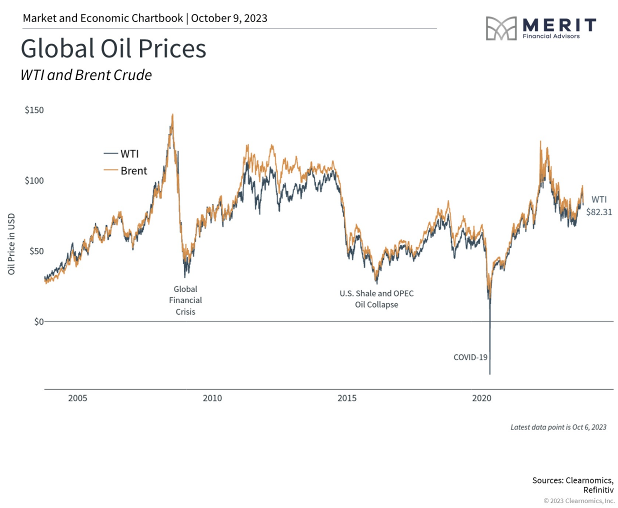
From the perspective of investors, it's always important to separate feelings and beliefs around politics and global matters from portfolio decisions. As the first chart above shows, the impact that wars have on markets varies depending on the business cycle. Some events such as 9/11 and the ensuing wars in Iraq and Afghanistan were met with market declines. This was because these events coincided with the dot-com crash which, while unrelated, required years to stabilize.

In contrast, most of the conflicts since the 2010s, including wars in the Middle East, the annexation of Crimea by Russia, and the on-going nuclear threats in North Korea and Iran, were against the backdrop of an expansionary economic cycle. While some of these periods experienced market declines over the following three to six months, economic growth tended to lift markets higher over longer time horizons despite geopolitical uncertainty. The history of strong bull markets in the 20th century across World War II, the Vietnam War, and the Cold War further underscores this point.

Of course, last year's invasion of Ukraine by Russia is still ongoing and, so far, markets have not yet recovered their previous peaks. Again, this is largely due to the interaction with other economic forces, namely rising inflation, supply chain disruptions, and elevated market valuations following the pandemic.

One direct impact of the Ukraine war and uncertainty in the Middle East is on energy prices. Oil prices did jump following the recent attack on Israel, with Brent crude rising from $84 per barrel to above $87, partially reversing the decline over the past two weeks from a high of about $97. However, this pales in comparison to the sharp rise in oil last year when prices approached $128. There was little direct impact on oil when Russia annexed Crimea in 2014, and even the 2019 drone strikes against Saudi Aramco by Iran and others, which knocked out 5% of global oil production overnight, saw only a short-lived reaction in oil markets. Thus, the impact on energy prices from Middle East conflicts is far from a sure thing.

Oil prices have risen following the attack on Israel



Perhaps the broadest implication for investors is the idea that markets depend on global stability, the rule of law, and business/consumer confidence. Regional conflicts, especially those that involve the United States and its allies, increase the "risk premium" on financial assets because the future becomes more uncertain. This uncertainty is the idea that even the possibility that markets and businesses could be affected is enough to hurt investor confidence. This is why many investors tend to focus on questions around global dynamics as the world shifts from the U.S.-centric, unipolar world since World War II to a multipolar one.

Many of these issues are deeply challenging and often theoretical. As such, their impacts on markets, the economy, and corporate activity are far from certain. History shows that it's a mistake to make dramatic shifts in portfolios in response to geopolitical crises. Properly diversified portfolios, especially those built around long-term financial plans crafted in partnership with a trusted advisor, are designed to handle exactly these periods of uncertainty.

None of this is to dismiss or detract from the severity of the conflict in Israel, especially from a humanitarian perspective. While the situation will be closely watched as events unfold, investors should avoid overreacting with their portfolios.

The bottom line? While the hope is for stability in the Middle East, investors should maintain perspective when it comes to their portfolios. History shows that it's often better to hold onto a diversified, properly constructed portfolio than to try to time the market due to geopolitical events.

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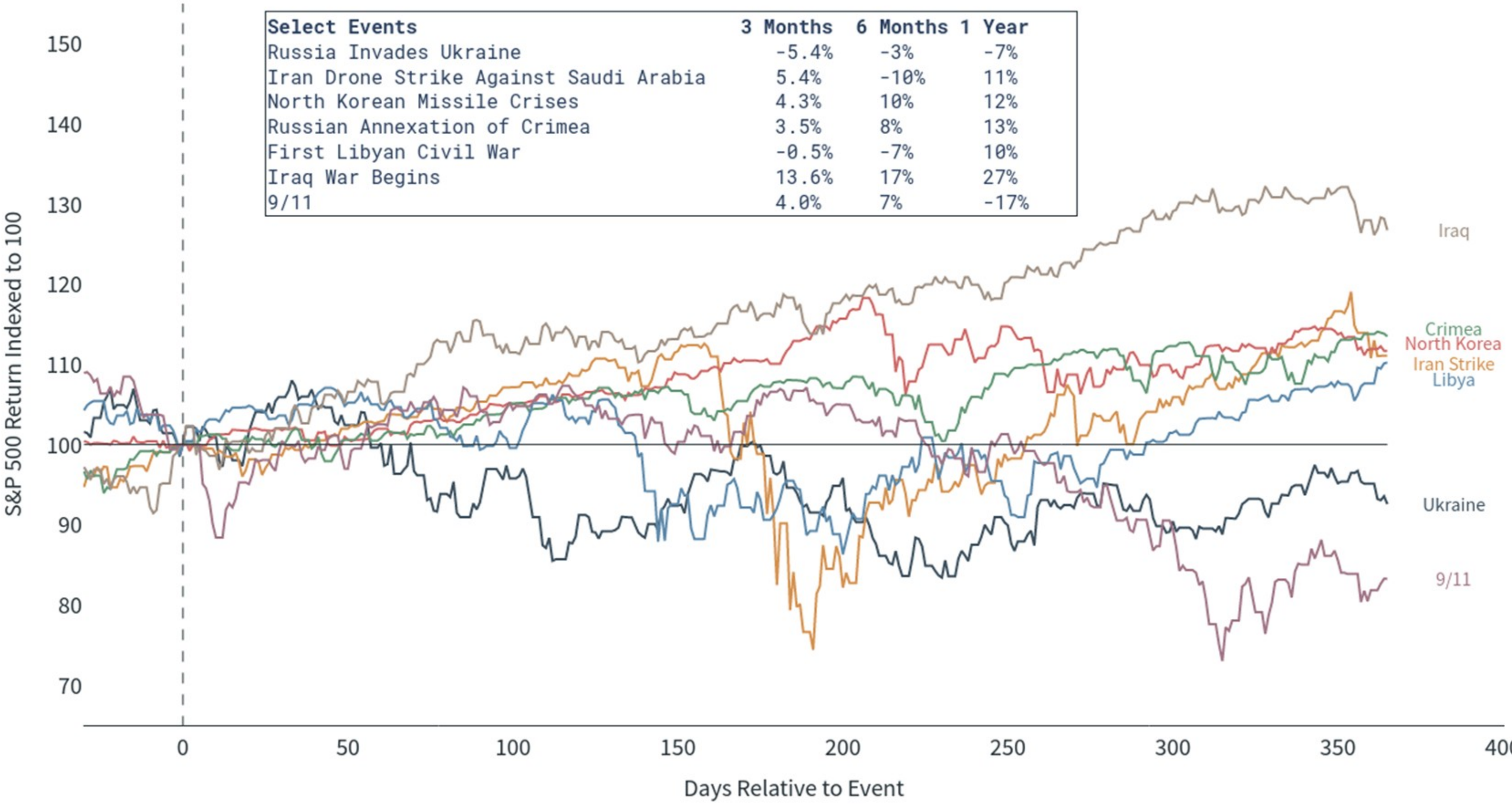
Stocks and Geopolitical Events

Select events and S&P 500 total returns 3, 6 and 12 months after

Select Events	3 Months	6 Months	1 Year
Russia Invades Ukraine	-5.4%	-3%	-7%
Iran Drone Strike Against Saudi Arabia	5.4%	-10%	11%
North Korean Missile Crises	4.3%	10%	12%
Russian Annexation of Crimea	3.5%	8%	13%
First Libyan Civil War	-0.5%	-7%	10%
Iraq War Begins	13.6%	17%	27%
9/11	4.0%	7%	-17%



Sources: Clearnomics, Standard & Poor's

Stocks Since the Great Depression

S&P 500 Index since 1928 (Log Scale)

Latest data point is Oct 6, 2023

- The stock market has performed extremely well since the Great Depression - a nearly century-long period.
- This occurred despite problems along the way throughout the 20th and early 21st century.
- Investors should focus on the long run in order to benefit from growth.

Sources: Clearnomics, Standard & Poor's

Global Oil Prices

WTI and Brent Crude

Latest data point is Oct 6, 2023

- Oil prices have swung wildly over the past two decades due to OPEC and the U.S. shale revolution.
- Oil spiked due to the war in Ukraine and are once again beginning to climb.
- This increased the cost of energy for consumers and businesses, especially in Europe.

Sources: Clearnomics, Refinitiv

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Definitions and Methodology

The **S&P 500** is a market capitalization-weighted index of large cap U.S. stocks. U.S. **mid cap** and **small cap** are the S&P 400 and S&P 600, respectively. **Value** and **growth** are the corresponding Standard & Poor's value and growth indices.

MSCI EM is an index of emerging market stocks. **MSCI EAFE** is an index of developed market stocks. **MSCI ACWI** is an index of global stocks.

The **forward P/E** is a ratio of the current market price of an index divided by an estimate of earnings over the next twelve months. The **Shiller P/E** is based on Robert Shiller's cyclically adjusted price-to-earnings ratio.

The **AAII Investor Sentiment** index is based on a weekly survey conducted by AAII.

Unless stated otherwise, **earnings** and **valuations** data are from Refinitiv indices.

The **LEI**, or Leading Economic Index, is produced monthly by the Conference Board.

Consumer sentiment indices are based on surveys conducted by the University of Michigan Surveys of Consumers.

Asset Class Performance and Asset Classes Relative to U.S. Stocks charts: The EM, EAFE, Small Cap, Fixed Income and Commodities are these indices, respectively: MSCI EM, MSCI EAFE, Russell 2000, iShares Core U.S. Bond Aggregate, Bloomberg Commodity Index.

Fixed Income Performance: All sectors are represented by the Bloomberg Barclays bond indices except for EMD USD and Local which are the JPMorgan EMBIG Diversified Index and JPMorgan GBI-EM Core Index, respectively.

The Balanced Portfolio is a hypothetical 60/40 portfolio consisting of 40% U.S. Large Cap, 5% Small Cap, 10% International Developed Equities, 5% Emerging Market Equities, 35% U.S. Bonds, and 5% Commodities.

The **Bloomberg Commodity Index** is a broadly diversified basket of physical commodities futures contracts.

The **DXY** is a U.S. dollar index based on a basket of currencies, including the Euro, Yen, Pound, Canadian Dollar, Swedish Krona and Swiss Franc.

Portfolio Risk/Reward and Portfolio Drift Since 2009 charts: stocks and bonds are the S&P 500 and iShares Core U.S. Bond Aggregate, respectively. Each portfolio represents a hypothetical stock/bond asset allocation.

The **MSCI Factor** indices are created and maintained by MSCI to capture factor returns. They cover various factors including Quality, Size, Momentum, Volatility, Value and Yield. The Multi-Factor index tracks the performance of Value, Momentum, Quality and Size.

The **MSCI USA** index tracks large and mid cap U.S. stocks.

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