BofA FAQs: Five Answered Questions

Issue #7: How developments in the Middle East may move markets

Investment Strategy

25 October 2023

Equity
Global

The aim of this report is to look at market reactions to rising geopolitical tensions. It is not intended to be a prediction on how events unfold. We discuss various possible scenarios but do not consider the particular likelihood of them.

How vulnerable is the US economy to an oil price shock?

Given the US is now energy independent, this means it is a net exporter of petroleum products, so the headwind to US consumers from higher prices should be offset by profits for domestic producers. In an extreme scenario, if crude oil were to spike to $150/bbl, this might tip the US economy into recession, but it is not a given.

Could this lead to oil prices above $150/bbl?

The key question for energy according to Francisco Blanch is whether the conflict broadens regionally, and whether physical energy supplies are lost due to economic sanctions and/or military action. Scenarios range from the conflict being contained to Israel and Gaza with oil prices in the $90 to $95/bbl range, and LNG trading at around $15/MMBtu, to an extreme scenario where a regional conflict expands to target Middle East energy infrastructure, with the spike in prices reaching $130 or above. Supply losses of 2mn b/d or 2% of global supplies would likely push oil past $150/bbl.

What historically happens to USD when geopolitics rise?

If an escalation of the war in the Middle East leads to higher oil prices, this could lead to a stronger USD. If oil reaches $150, the USD could easily test and likely exceed its highs against several major currencies according to our FX Strategy team.

How do rising tensions overseas impact rates?

Mark Cabana's base case remains that US 10Y Treasury yields will peak in the 5% range and will be lower by the end of 2024. If oil does spike to $150, our view on the 10Y yield would be more limited. We would expect concerns about recession and geopolitics to lead to a flight to quality that would likely see UST rates fall amidst elevated macro uncertainty and risk of a consumption hit with higher oil prices.

How has the market reacted to spikes in energy prices?

S&P 500 peak-to-trough declines have been 7-8% on average during major macro shocks/geopolitical events, according to our US Strategy team, but more than fully recovered after 3 months. Energy is the most direct beneficiary of higher oil prices, while consumer sectors are negatively impacted. Labor is the big cost in most industries, while energy is 3% of costs.

Bonus Q: Should we expect more defense spending?

The US deficit is a real concern for defense spending, but national security has historically trumped absolute debt levels. We see the CAGR of global defense spending increasing from 1-3% and US defense spending increasing from 3-5% to 5-8%.

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LNG = Liquified natural gas

Refer to important disclosures on page 16 to 18.
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Timestamp: 25 October 2023 05:00AM EDT

Did you know?

- Saudi Arabia has $2mm b/d of spare oil capacity and could offset possible supply losses but probably not until prices exceed $100/bbl. (Blanch)
- The US is now energy independent so the headwind to US consumers from higher prices should be partly offset by profits for domestic producers. (Bhave)
- The extent to which US consumer spend would be impacted by an oil shock depends to what degree the consumer can reduce savings, with a longer oil shock more problematic. (Bhave)
- US defense spending relative to GDP is at an all-time low. (Bhave)
- An oil spike won't necessarily boost 10Y Treasury rates given what would likely be a flight to quality. (Cabana)
- Oil represents just ~3% of S&P 500 costs. (Subramanian)
- The S&P has been negatively correlated to oil prices when prices have risen on lower supply, but positively correlated when demand is driving oil prices higher. (Subramanian)
- History suggests that geopolitical dips should be bought, not sold. (Subramanian)

1. How vulnerable is the US economy to an oil price shock? What are the channels through which an oil shock would affect the economy?

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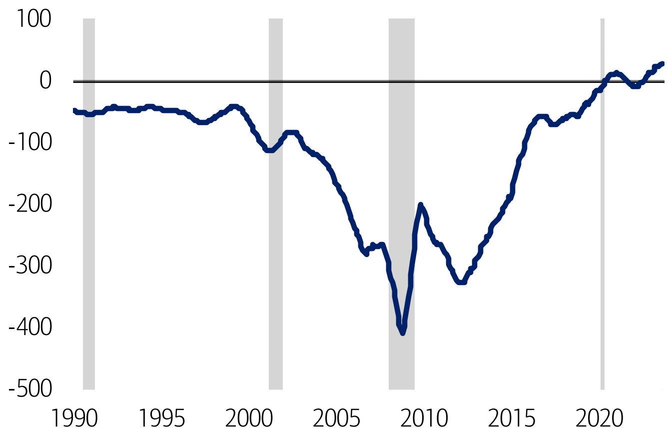
The US economy is a lot less vulnerable to an oil price shock than it was in the 70s, in 1990 or even in 2008. The US is now energy independent. It is a net exporter of petroleum products, so the headwind to US consumers from higher prices should be offset by profits for domestic producers (Exhibit 1).

Still, a large shock to oil prices is likely to be a net negative for the economy, at least in the short term. This is because producers probably will not deploy their windfall gains unless prices are expected to remain elevated for an extended period. Note that rig counts in the US were not very responsive to the increase in oil prices last year, possibly due to a shift in policy in favor of renewable energy (Exhibit 2).

Exhibit 1: US trade balance in petroleum products (12-month rolling total, $bn)
The US has become a net exporter of petroleum products



Source: Census Bureau, Haver Analytics

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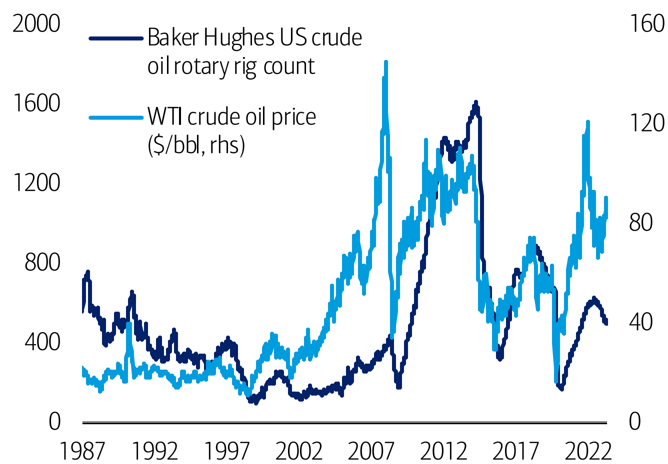
Exhibit 2: US rig count vs. oil prices
US production did not respond strongly to last year's surge in oil prices



Source: Bloomberg, Baker Hughes, American Automobile Association

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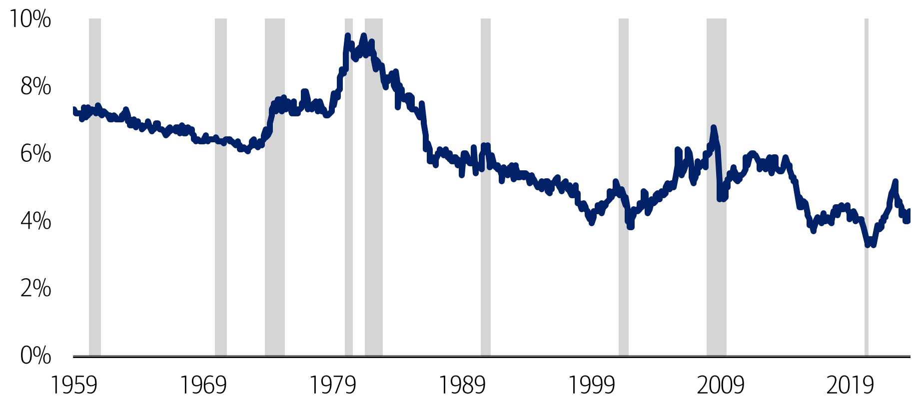
Meanwhile, real consumer spending should be quickly impacted by an energy price spike. But even on this front we would note that i) the share of energy goods and services in the consumer wallet is very low by historical standards (Exhibit 3), and ii) the strength in household balance sheets means that consumers can, to a degree, respond an energy shock by saving less instead of spending less on other items.

In an extreme scenario, what if crude oil were to spike to $150/bbl? Briefly, this might tip the US economy into recession, but it is not a given. Based on historical patterns, we estimate that energy prices would spike 25-40%, which would amount to 1.0-1.5% of consumer spending. We think consumers could probably offset around 50bp of the shock by lowering savings in the near term. That might not be sustainable if the shock turns out to be persistent, but the prospects for a long-lasting increase in oil prices of this magnitude seem limited given its expected deleterious impact on global demand.

So, we would likely be looking at a 0.5-1.0% shock to consumer spending, which would translate to a 1.4-2.8pp headwind to q/q annualized GDP growth, in case the full impact of the shock is felt in one quarter. This headwind would be partially offset by the gains for energy producers. Still, if the pass-through from oil to energy prices is at the higher end of our estimates, or if consumers are less willing to dis-save than we assume, there is risk of a quarterly contraction in GDP.

Whether that would turn into a recession would depend partly on the Fed response. In our view, the Fed prefers not to lean against an exogenous energy shock if the other components of inflation are moving in the right direction. But if higher energy prices lead to a de-anchoring in inflation expectations, the Fed might be forced to hike further or at least stay on hold indefinitely. The knock-on effects of even higher rates for even longer could trigger a recession.

Exhibit 3: Energy goods and services as a share of consumer spending
The share of energy in consumer spending is low by historical standards



Source: BEA, Haver Analytics

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1a) What are the scenarios around the direction of oil and LNG prices if tensions escalate?

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The ongoing turmoil in the Middle East quickly brings to mind the concept of energy fragility. However, Israeli-Palestinian conflicts post 1973 have had a limited impact on energy prices because they were mostly contained. So, the key question for energy is whether the conflict might broaden regionally, and whether physical energy supplies could be lost if economic sanctions were imposed and/or military action were taken.

We break this out into 4 simplified potential outcomes for energy markets:

1. Under a scenario where war is contained to Israel and Gaza and eventually eases, we would expect oil prices to trade in a $90 to $95/bbl range over the coming months and LNG to trade at around $15/MMBtu.

2. If the conflict does not broaden substantially and if the US were to enforce Iranian oil sanctions and global oil supply is curbed by 1-1.5mn b/d in 2024, Brent prices would likely jump above $100/bbl and LNG above $20/MMBtu.

3. Should the conflict expand beyond Gaza to engulf Iran, we believe crude prices could quickly climb above $120-$130/bbl to account for the potential risk of a Persian Gulf shutdown. Note that a spike of this move would likely occur without any actual production losses.

4. If an unfolding regional war expands to target Middle East energy infrastructure, the spike in prices could range between $130 to $250+/bbl. Supply losses of 2mn b/d or 2% of global supplies (equivalent to the production of Qatar or half of the UAE output) would likely push oil past $150/bbl. At the extreme end, if shipments through Hormuz, a choke point for nearly 20% of the world's oil and LNG, were to shut down for a meaningful period, oil could spike above $250/bbl and LNG could surpass $50/MMBtu.

1b) Are there any automatic price stabilizers?

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While Saudi Arabia has >2mn b/d of spare capacity and could make up for lost Iranian barrels, recent signaling suggests Saudi is unlikely to do so unless oil exceeds $100/bbl. Middle East-North Africa economist Jean-Michel Saliba's analysis of Saudi fiscal breakeven oil price suggests general government funding requirements are met around US$95/bbl (see the report Emerging Insight: Saudi Arabia – eyeing US$100/bbl oil 28 September 2023)

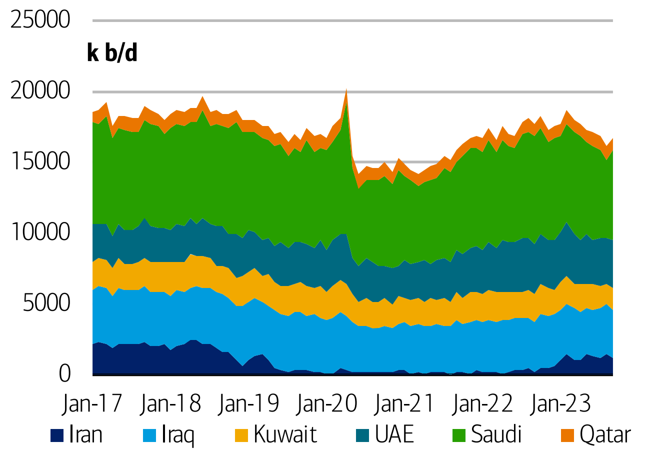
Saudi energy policy decisions are likely to finely balance OPEC (Organization of the Petroleum Exporting Countries) members' funding needs, the impact on oil demand, internal group cohesion considerations, reliability as a major oil supplier, and public perceptions (both domestically and internationally).

Large OPEC spare capacity could allow for an offsetting increase in its market share in response to a potential drop in Iranian oil exports, but likely gradually and in a controlled fashion. (Press reports suggest potential tightening of enforcement of US secondary sanctions on Iran.)

In terms of potential impact of higher energy prices globally, we note resource-poor Europe and Japan would likely suffer most. US energy independence means America is less sensitive to an external energy price shock, although the US SPR has been greatly depleted during the Ukraine war. Higher oil prices would stoke US inflation too. As the world's biggest energy importer, China may also be hurt, but their growing strategic oil stockpiles likely could help them temporarily cope with minor Middle East supply disruptions. In contrast, Russia would likely improve its geopolitical leverage as the world's largest net energy exporter in the case of an expanding regional conflict.

Exhibit 4: Middle East crude oil exports

Middle East crude oil exports have been averaging ~16.5mn b/d in recent months and represent about 17% of world supplies



Source: Bloomberg

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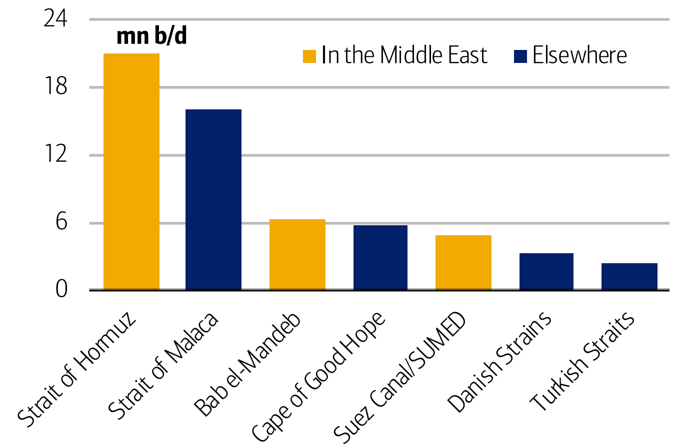
Exhibit 5: EIA chokepoints

There are multiple energy chokepoints across the Middle East, including Hormuz, Suez, Abqaiq, or the Ceyhan pipeline plus plenty of countries at risk



Source: EIA (estimates as of 2019), BofA Global Research

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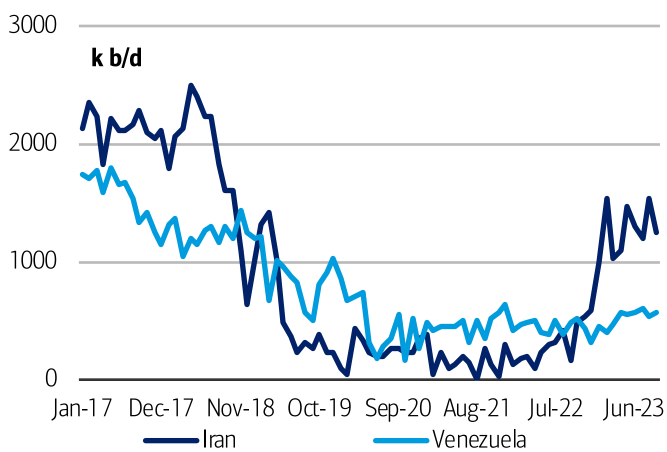
Exhibit 6: Crude oil exports from Iran and Venezuela

Iranian crude oil exports have increased during the past few months as the US government reduced pressure on sanctions



Source: Bloomberg

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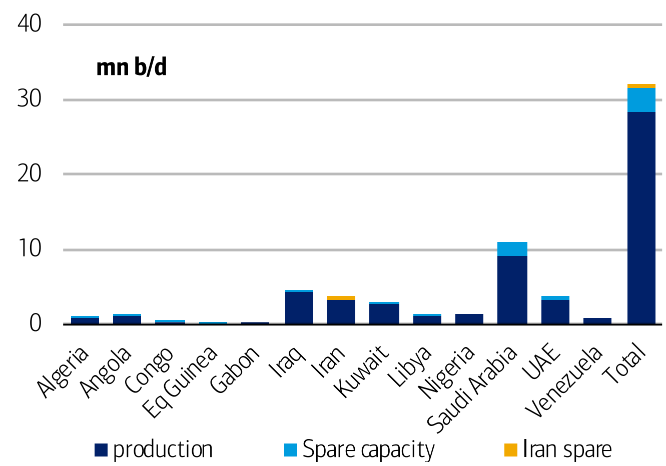
Exhibit 7: OPEC production capacity

Still, armed with 3.3mn b/d of spare production capacity outside Iran, there is a lot of room to put a lid on oil prices if other volumes are lost elsewhere



Source: IEA, BofA Global Research estimates

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1c) If the US were to get directly involved in the conflict in the Middle East, should we expect a major drag on the US economy?

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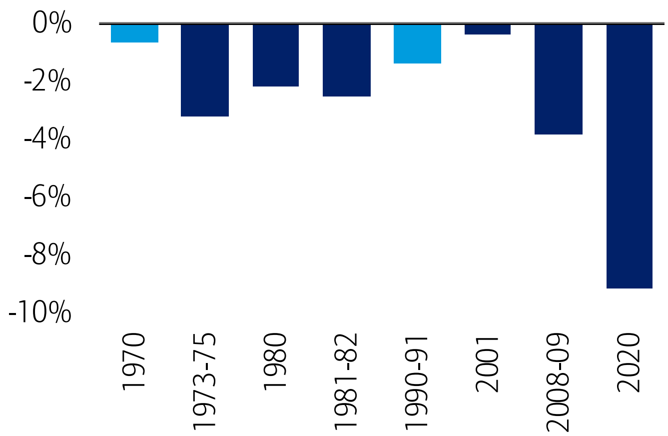
There are only a handful of examples of direct US involvement in military conflicts ("boots on the ground") since WWII. US involvement in Vietnam spanned multiple business cycles. The shallow 1970 recession happened in the aftermath of the peak of the conflict (late 60s). The recession was driven by both Fed tightening to combat a growing inflation problem, and fiscal consolidation after a few years of deficit expansion to fund defense spending.

The Gulf War happened towards the end of the short 1990-91 recession. The recession was triggered by the oil price shock due to Iraq's occupation of Kuwait, rather than the US military response. Tight Fed policy also played a part. It is worth noting that the 1970 and 1990-91 recessions were mild by historical standards (Exhibit 8).

Finally, US involvement in Iraq and Afghanistan also spanned multiple business cycles. The peak of the conflict, in the mid-2000s, corresponded with the housing boom. Again, there is little indication that the economy was negatively impacted. So, in conclusion, history suggests that, should it occur, direct military involvement in the Middle East would be unlikely to weigh meaningfully on the domestic economy.

Exhibit 8: GDP contraction during US recessions, peak to trough

The 1970 and 1990-91 recessions were mild by historical standards



Source: Bureau of Economic Analysis (BEA)

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2. What typically happens to the USD when geopolitical tensions rise, especially during energy shocks?

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To the extent that an escalation of the war in the Middle East were to lead to higher oil prices, we expect this would lead to a stronger USD. The USD should do well against high beta currencies because of risk-off. The USD should also do well against EUR and JPY, as the US is energy independent, while the Eurozone and Japan import the most energy in G10 as a share of their consumption. High oil prices should also be a stagflation shock, forcing the Fed to keep rates high or even higher for longer, despite weaker growth, in turn supporting the USD.

This is consistent with the FX price action in the months after the war started in Ukraine. Oil prices increased sharply, and the USD appreciated to a 20 year high, with EURUSD well below parity.

Where would the USD trade in case oil rallies to $150?

We would think the USD could easily test and likely exceed its highs against several major currencies. As seen in Exhibit 12, the relationship between the USD and oil has changed over the years, with the sign of the correlation with EURUSD having flipped from + to -. This has to do in large part with US energy independence and the terms-of-trade shock that a supply driven oil price rise of that level would have on the European economy.

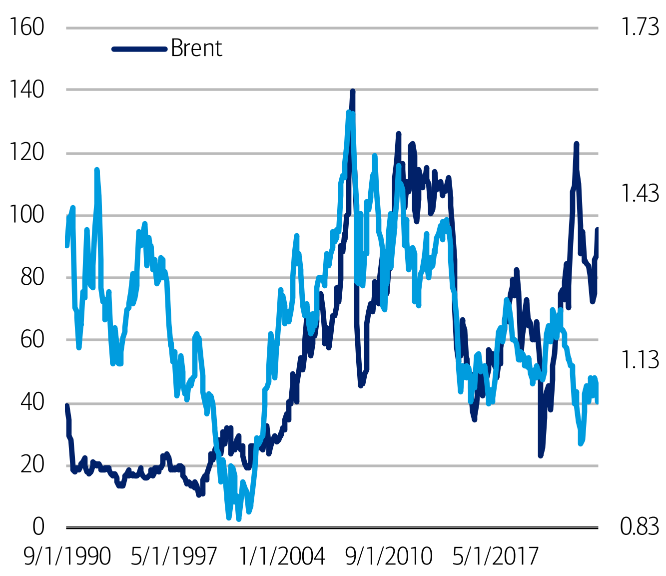
The start of the Russia/Ukraine war saw Brent almost touch ~$140/bbl. EURUSD traded to ~$.98 /EUR and USDJPY also eventually traded around Y150/USD, and was likely held back to an extent because of FX intervention in Japan.

If Brent crude traded back to the $140-$150 level, we could envision EURUSD in the mid/low-.90s, and USDJPY maybe getting above Y160 (though would likely again be smoothed out via VX intervention). This would likely be the initial move, but these extreme levels would likely moderate to an extent at some point.

Our FX team recently wrote (Liquid Insight: Oil supply shock and FX 03 October 2023) on the relationship between crude oil and the USD a few weeks ago. Among the findings, it shows USD tends to be supported on supply-driven oil price shock (+24% USD NEER correlation to oil Supply shock, highest across all major currencies)

Exhibit 9: Brent vs. EURUSD

The relationship between the USD and oil has changed over the years, with the sign of the correlation with EURUSD having flipped from + to -.



Source: Bloomberg

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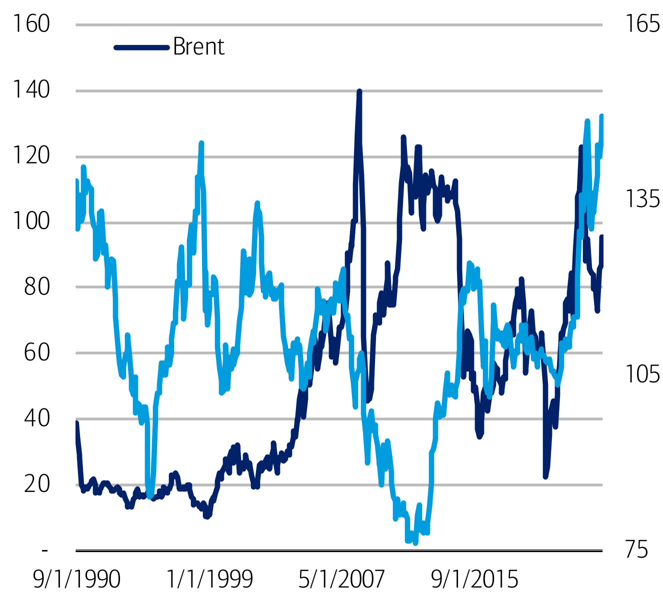
Exhibit 10: Brent vs. USDJPY

USDJPY maybe getting above Y160



Source: Bloomberg

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3. How much could US interest rates be impacted by geopolitical tensions? What is your forecast for US rates if tensions escalate and energy prices rise?

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Geopolitical risk and higher oil prices likely would mean at least two things for the UST market: (1) wider front end breakeven inflation rates with higher oil (2) a flight to quality bid at UST back end (see the report: Global Rates Weekly: Real spooky rates 13 October 2023). Our prior analysis suggests 10Y rates have historically declined 5-10bps in the week after previous geopolitical conflicts (Exhibit 14). We think this is a reasonable estimate for the potential impact at the UST back end.

Exhibit 14: Price changes around select geopolitical events in the past
Typical response to geopolitical events consists of lower rates, steeper curve & higher oil prices

		10y UST (bp)		5s30s curve (bp)		Crude oil (%)	
Event	**Date**	**Day After**	**Week After**	**Day After**	**Week After**	**Day After**	**Week After**
First Iraq War	1/17/91	-18.2	-6.9	--	--	-33.0	1.3
NATO bombing during Bosnian War	8/30/95	-2.6	-14.6	4.5	-10.3	-0.2	3.2
NATO bombing Kosovo War	3/24/99	0.0	8.6	-7.1	-0.3	-1.0	9.3
9/11 attack	9/11/01	-2.6	-10.2	33.4	21.7	0.5	-0.3
Afghanistan War	10/8/01	0.2	9.3	-1.4	9.1	0.3	-0.7
Second Iraq War	3/20/03	-3.1	-3.1	6.1	5.8	-4.3	6.2
Russia Invasion of Ukraine	2/25/22	-0.2	-23.1	-0.8	11.0	-1.3	26.3
Average		-3.8	-5.7	5.8	6.2	-5.6	6.5
Median		-2.6	-6.9	1.9	7.5	-1.0	3.2

Source: Bloomberg

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We believe that any flight to quality on the UST curve would initially result in a bull flattening, or a bigger decline in long end rates than in short rates, given the possibility of further Fed rates hikes. However, should the conflict broaden and oil move into the $150 range, we think the curve would eventually bull steepen due to the possibility of easier monetary policy. History suggests geopolitical risks typically see UST 5s30s bull steepening. The risk for higher oil prices also supports our 2s5s real curve steepener due to a widening of near-dated breakevens (see the report: US Rates Watch: The “real” case for steepeners 24 October 2023).

Our base case remains that US 10Y Treasury yields will peak in the 5% range and will be lower by the end of 2024. If oil does spike to $150, our view on the 10Y yield would be more limited. We would expect concerns about recession and geopolitics to lead to a flight to quality that would see UST rates fall amidst elevated macro uncertainty and risk of a consumption hit with higher oil prices.

4. What if oil hits $150?

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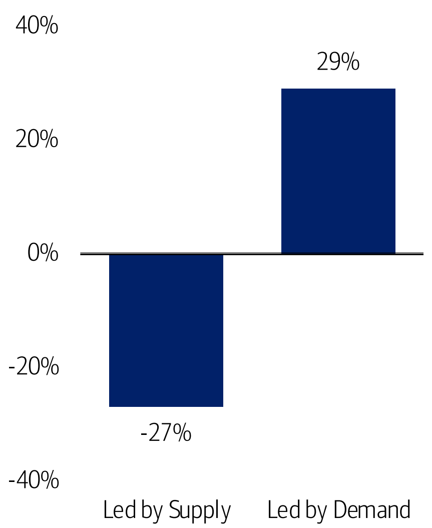
The risk of oil spiking to $150 or beyond is a tail risk worth considering if geopolitical conflicts escalate further, creating a supply shock superspike. Higher oil prices mainly driven by supply (as proxied by narrowing crack spread) have had negative impacts on the S&P 500 (-27% correlation), whereas high oil prices driven by demand (as proxied by widening crack spreads) have had positive impacts on the S&P 500 (+29% correlation).

Exhibit 12: Supply-driven oil spike = headwind for S&P 500

Correlation between S&P 500 QoQ return and WTI QoQ price change when higher oil prices are led by supply (narrowing crack spread) vs. demand (widening crack spread), 3/1986-9/2021



Source: BofA Global Research

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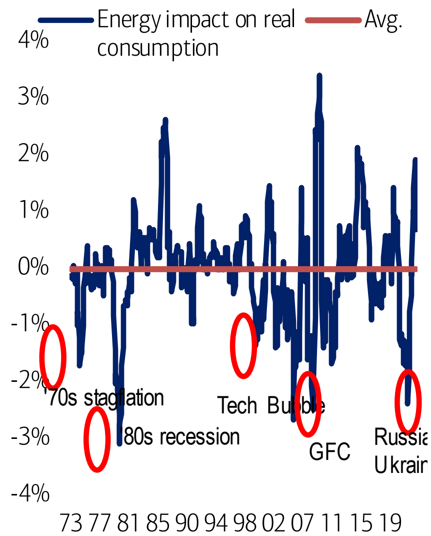
Exhibit 13: Lower oil added ~70bps to real consumption, higher oil could take it away

Spread between CPI ex. Energy and CPI YoY (1973-8/23)



Source: BofA US Equity & Quant Strategy, Haver Analytics

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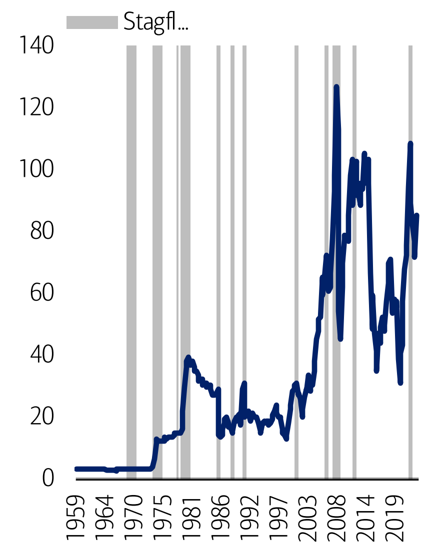
Exhibit 14: Key risk: stagflation

WTI oil prices vs stagflation (below-trend GDP growth, high & rising inflation; 1959-3Q23)



Source: BofA US Equity & Quant Strategy, Bloomberg, Global Financial Data which cites: Data from 1860 through 1897 are from The Derrick's Hand-Book of Petroleum, Oil City, PA: Derrick Publishing Co., 1898, Vol. 1. Daily data for oil prices was published in the same book in Vol. 1 (1897), 3 (1915), and 4(1919). Prices are for quotations in Oil City, PA. through 1919. Prices from 1920 to June 1941 are the price per barrel for oil in Pennsylvania based upon data from the National Bureau of Economic Research. From 1941 through 1968, the cost of a barrel of oil (equal to 42 US gallons) as collected by Platt's is used. From 1969 through December 1982, data from the Bureau of Labor Statistics is used, with the exception of the period from October 1973 through December 1982 when the US price of oil was fixed. During this period the landed costs of imports from the US Department of Energy is used. From January 1983 to present the price for West Texas Intermediate Crude Oil is used at 40 degree API, f.o.b. Cushing, Oklahoma.

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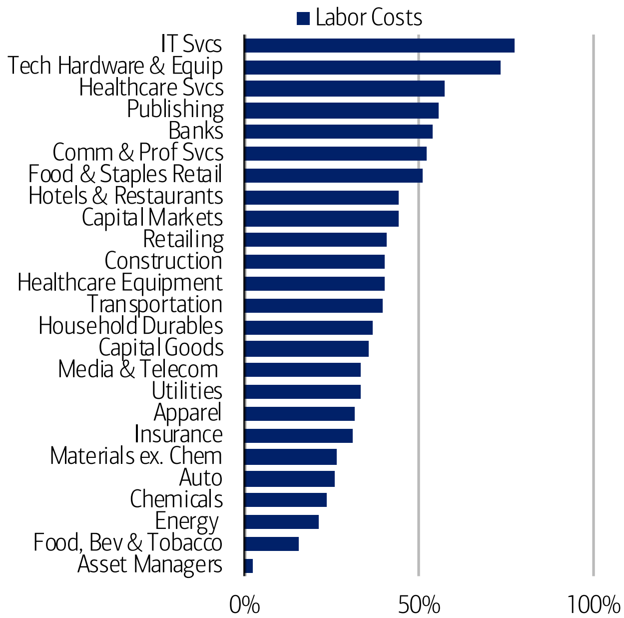
Manageable cost pressure from rising oil and gas

From a cost pressure perspective, the impact is manageable: the S&P 500 is more tethered to energy producers than to feedstock beneficiaries. Oil represents just ~3% of S&P 500 costs. Easing wage pressures (40% of total costs) should more than offset the impacts of higher oil. Even transports and airline companies have higher gearing to wages than fuel costs. Wages represent $5-6tn of S&P 500 costs, and with wage inflation proxied by average hourly earnings having decelerated by almost 2ppts since Q1 of 2022.

Fuel costs would need to increase by 20-30% to offset easing labor costs since Q1 2022, all else being equal.

Exhibit 15: Labor Costs are biggest cost in most industries
Labor Costs as % of Total Operating Costs by Industry (the use of commodities by industries; as of 2020)



Source: BEA, BofA US Equity & Quant Strategy

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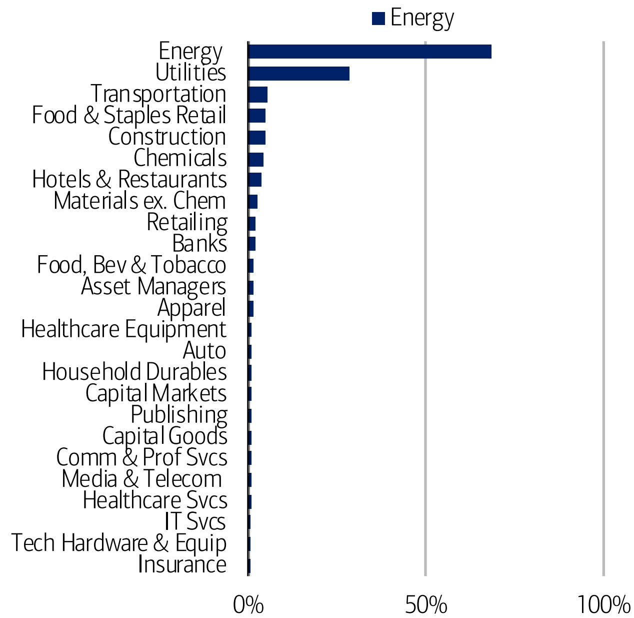
Exhibit 16: … Energy costs are insignificant in most industries
Energy Costs as % of Total Operating Costs by Industry (the use of commodities by industries; as of 2020)



Source: BEA, BofA US Equity & Quant Strategy

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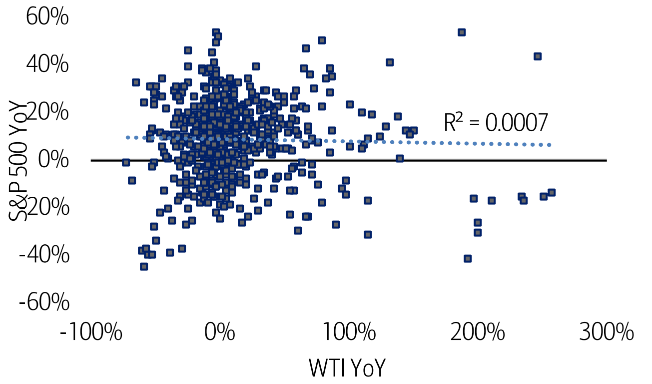
t represents over 100bn in alleviating cost pressure.

Regressive tax of higher oil impacts lower price point retailers

The consumption tax represented by higher oil and gas prices impacts the lower income consumer most given that these costs represent a bigger share of the wallet. The impact to total US consumption is more manageable given the smaller contribution of lower income consumers to aggregate numbers. Moreover, the sales impact is most acute at lower price point retailers like grocers and drug stores, big parts of the S&P 500 Consumer Staples sector. We are underweight Consumer Staples in part because of the regressive tax from higher oil and gas.

Exhibit 17: No correlation between stocks and oil
S&P 500 YoY vs. WTI YoY (1973-9/23)



Source: Bloomberg, BofA US Equity & Quant Strategy

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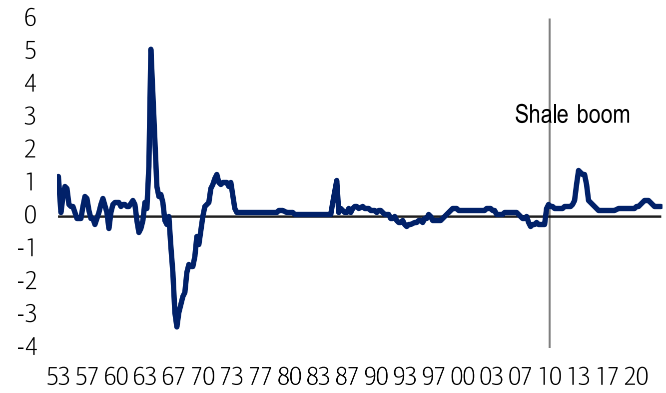
Exhibit 18: Higher oil has been a tailwind to earnings, especially after US shale revolution
WTI 5-yr rolling beta to S&P 500 earnings based on a multivariate regression using WTI and GDP vs. S&P EPS (1953-2Q23)



Source: Haver, FactSet, BofA US Equity & Quant Strategy

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4a) How does the equity market react to rapidly rising oil prices?

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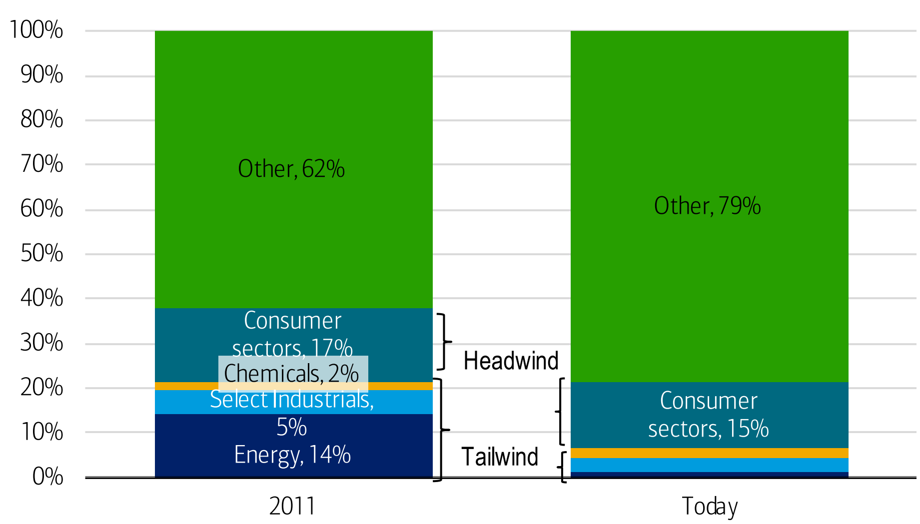
Higher oil prices have historically been a tailwind to S&P earnings, although it may be less of a positive today given the smaller contribution from earning of energy and energy beneficiaries.

Exhibit 15: Sectors that benefit from higher oil prices are much smaller now
% of S&P 500 earnings by sector



Source: FactSet, BofA US Equity & Quant Strategy
Note: Industrials with oil exposure includes Machinery, Industrial Conglomerates, Electrical Equipment, Construction & Engineering, and Trading Companies & Distributors

BofA GLOBAL RESEARCH

4b) What are implications if the conflict does not broaden?

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A larger regional conflict in the Middle East is a key risk to equities, but prior geopolitical shocks with no fundamental, long-term implications generally represented buying opportunities. Equities saw short, sharp sell-offs on the headlines, but enjoyed full recoveries within three months or less. I.e., history suggests that geopolitical dips should be bought, not sold (Exhibit 20).

Exhibit 20: S&P 500 peak-to-trough declines have been 7-8% on average during major macro shocks/geopolitical events, but more than fully recovered after three months
S&P 500 price changes around historical macro shocks and geopolitical events since 2010

Events	-1 month	-1 day	+1 day	+1 month	+3 month	Peak to trough	Trough to +3m after event	Trough days after (before) event
S&P downgrades Greek Sovereign Debt to junk/1st Greek Bailout	3.9%	-0.4%	-2.3%	-9.0%	-8.1%	-16.0%	9.0%	66
Arab Spring: "Beginning", Tunisian Revolution begins	3.9%	0.1%	0.3%	4.1%	2.8%	-1.6%	13.8%	-18
Arab Spring: Syrian/Libyan civil war begins	-2.4%	-0.6%	-1.1%	1.8%	-2.4%	-6.4%	8.5%	1
S&P downgrades US debt	-10.3%	-4.8%	-0.1%	-2.2%	4.4%	-18.8%	16.9%	59
US government shuts down	3.0%	-0.6%	0.8%	4.8%	9.9%	-5.4%	13.2%	7
Scotland passes referendum to vote on independence (voting date was 9/18/14)	3.6%	-0.4%	0.3%	2.8%	1.5%	-2.3%	11.7%	-24
Russia annexes Crimea	1.0%	1.0%	0.7%	0.3%	5.3%	-4.0%	7.8%	24
Swiss abandons cap on Franc vs. Euro FX rate	1.1%	-0.6%	-0.9%	4.3%	4.7%	-0.8%	7.3%	-30
Greece: misses debt payment to IMF	-2.3%	0.3%	0.7%	2.0%	-6.8%	-12.2%	6.8%	55
China: Devalues yuan	1.3%	1.3%	-1.0%	-6.8%	-1.4%	-12.2%	13.0%	14
S&P downgrades Japan credit rating	-5.4%	1.3%	0.9%	2.8%	4.8%	-11.2%	13.0%	-22
Turkey shoots down Russian plane for violating Turkish airspace	0.6%	-0.1%	0.1%	-1.2%	-7.5%	-13.3%	6.4%	79
Fed - 1st rate hike - increase interest rate 25bps	-0.5%	1.1%	1.5%	-8.0%	-0.8%	-13.0%	10.8%	57
Brazil: House votes to begin President impeachment trial	1.5%	-0.1%	0.7%	-1.6%	4.1%	-5.6%	8.3%	70
Brexit: UK votes to leave the EU	3.2%	1.3%	-3.6%	2.9%	2.4%	-5.6%	9.5%	4
Trump orders 59 Tomahawk cruise missiles to be fired at the Shayrat airbase in Syria	-0.9%	-0.3%	0.2%	2.0%	2.4%	-2.4%	5.3%	7
Trump fires FBI director James Comey	1.9%	0.0%	-0.1%	1.3%	3.1%	-1.2%	6.5%	-26
North Korea detonates a hydrogen bomb -its most powerful nuclear test ever	0.0%	0.2%	0.0%	2.1%	6.7%	-2.2%	9.2%	-15
Catalonia votes for independence from Spain	1.7%	0.4%	0.4%	2.4%	6.1%	-0.8%	9.5%	-26
The US announces imports of steel and aluminum threaten national security Under Section 232	-1.6%	1.2%	0.0%	0.8%	-0.3%	-10.2%	8.0%	-8
Trump administration releases initial list of Chinese products worth $50bn that are under consideration for tariffs	-4.1%	-2.2%	1.3%	1.9%	5.1%	-7.3%	7.9%	-1
Italian bond yields spike on budget concerns	0.6%	0.4%	-0.1%	2.1%	4.7%	-2.9%	8.7%	-14
Collapse in Argentina and Turkey's currency ignites concerns of emerging market currency crisis	1.6%	-0.3%	0.7%	1.4%	5.5%	-1.5%	8.9%	-18
US releases list of $200bn Chinese goods subject to tariffs	0.2%	0.9%	0.3%	1.8%	0.1%	-3.1%	8.6%	-13
Powell says we're "a long way" from neutral on interest rates	0.8%	0.0%	0.1%	-6.9%	-16.3%	-19.8%	6.8%	82
US government shuts down	-8.8%	-2.1%	-2.7%	8.9%	15.9%	-15.7%	21.4%	2
US Treasury designates China as a currency manipulator	-2.0%	-0.7%	-3.0%	1.5%	4.9%	-6.1%	8.4%	9
Drones were used to attack the state-owned Saudi Aramco oil processing facilities	4.1%	-0.1%	-0.3%	-0.6%	6.1%	-2.6%	12.1%	-24
Top Iranian military official killed by US airstrike	3.8%	0.0%	0.8%	-0.2%	-21.8%	-1.0%	17.6%	81
China puts Wuhan City, the center of the COVID-19 outbreak, on lockdown	3.0%	0.0%	0.1%	0.5%	-15.8%	-33.9%	28.5%	60
Russia/Ukraine conflict begins	-4.2%	-1.8%	1.5%	7.0%	-6.7%	-15.8%	1.9%	84
Average	-0.1%	-0.2%	-0.1%	0.7%	0.4%	-8.2%	10.5%	17
Median	0.8%	0.0%	0.1%	1.8%	2.8%	-5.6%	8.9%	4
Min	-10.3%	-4.8%	-3.6%	-9.0%	-21.8%	-33.9%	1.9%	
Max	4.1%	1.3%	1.5%	8.9%	15.9%	-0.8%	28.5%	
Average non-US	0.9%	0.1%	-0.1%	0.9%	-0.6%	-7.4%	10.3%	
% positive	61%	45%	61%	71%	65%			

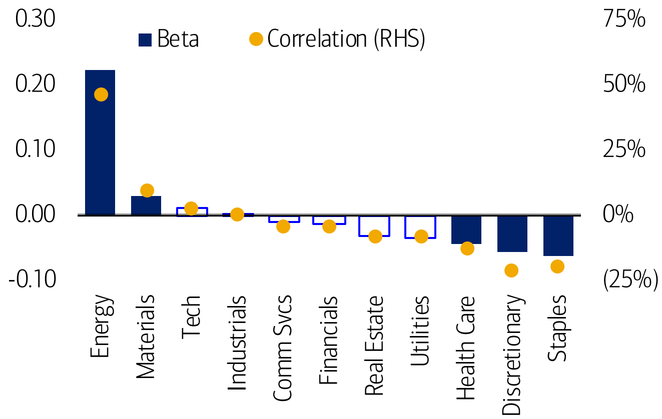
Source: BofA US Equity & Quant Strategy, FactSet, S&P

BofA GLOBAL RESEARCH

Top sectors & Bottom sectors for higher oil

Energy is the most direct beneficiary of higher oil prices. Materials has also historically benefitted from higher oil prices, which typically boost pricing power for Chemicals and commodities overall. On the other hand, Consumer sectors have historically been the worst performers. The low income consumer disproportionately spends more on oil as % of total spend, and discount retailers are typically hurt more by rising oil prices.

Exhibit 21: Higher oil: commodities benefit, consumers lose
S&P 500 sectors' relative performance (vs. S&P 500) vs. WTI oil (1972-present)



Source: BofA US Equity & Quant Strategy, Bloomberg, Global Financial Data

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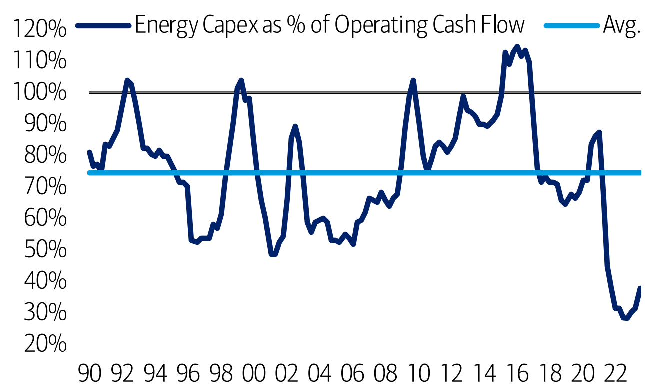
Exhibit 22: Supply discipline = higher oil prices
S&P 500 Energy capex as % of operating cash flow (1990-2Q23)



Source: BofA US Equity & Quant Strategy, FactSet

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5. Are we likely to see a boost to US defense spending even in light of already high deficits? What about the rest of the world?

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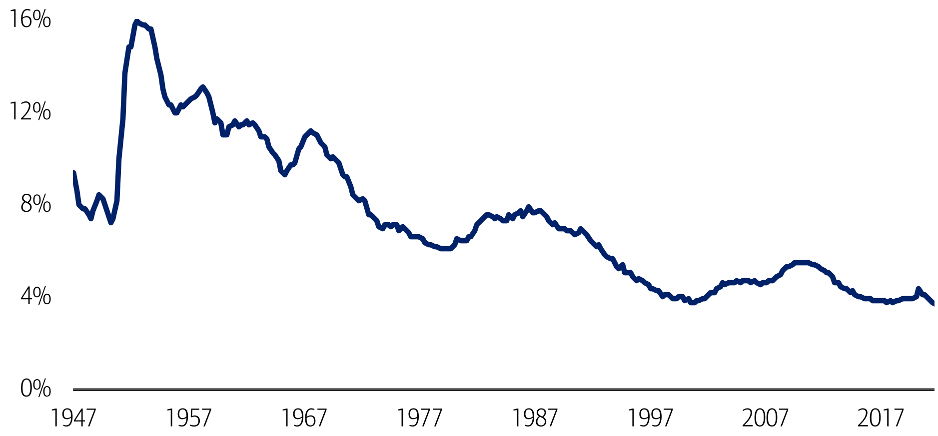
Defense spending is around an all-time low as a share of GDP (Exhibit 23). Given the ongoing conflicts in Ukraine and the Middle East, there is room for an increase in defense outlays. However, it remains to be seen whether there is appetite for further deficit expansion given growing concerns about the unsustainable trajectory of government spending.

Exhibit 23: Defense spending as a share of GDP

Defense spending is close to an all-time low as a share of GDP



Source: BEA

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While the deficit is a real concern for defense spending, our experience for the past 40 years has been that national security trumps absolute debt levels, so even though the current debt level is high, given increasing tensions in the world we do not think this will impact future spending in any way. We also view that Defense is not discretionary unless the US were to change its superpower status in the world. Countries in Europe have slowly been increasing defense spending.

We believe tensions in Asia, Europe and the Middle East will likely lead to defense spending globally going up. We think the CAGR of global defense spending is set to increase from 1% to 3% nominal globally but in the US we see it increasing from 3%–5% to 5%-8% nominal.

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Underperform	N/A	≥ 20%

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