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# GEOPOLITICAL STRATEGY IN BRIEF

October 4, 2024

# The Middle East: Major Escalation Is Likely, Either Now Or Later

- We expect major escalation in the Middle East over the next 6-9 months (60% probability).
- The worst-case scenario: a sustained Israel-Iran conflict, disrupting Persian Gulf energy shipments.
- Investors should hedge by buying fossil energy-related assets from outside the region.

We are reiterating our call that the key geopolitical risk to watch is the escalation of conflict in the Middle East.[1] With Israel moving against Hezbollah, and Iran launching over 180 ballistic missiles at Israel on October 1, how close are we to it?

Pinpointing the exact start of a major war is difficult. Yet, all signs are concerning.

Iran likely miscalculated its October 1 missile strikes, justifying them as "deterrence". Tehran claimed the attack was in response to the July 31 assassination of Hamas leader Ismail Haniyeh in Tehran and Israel's successes against Hezbollah, including killing its leader, Hassan Nasrallah. However, Iran's attack on Israel's territory goes beyond simple deterrence. For whatever Israel has done, it has not staged any overt *en masse* missile attacks on sovereign Iranian territory. Iran's missile attacks (first in April, but especially now) set a new and dangerous precedent. RETARDED TAKE

**Table 1** The Israel-Hamas War Is Likely To Become A Larger Regional War

| Outcomes | Scenarios | Probabilities | | | | Market Impact |
|---|---|---|---|---|---|---|
| | | Current | Apr. 14, '24- Aug. 16, '24 | Dec. 22, '23- Apr. 13, '24 | Oct. 19, '23- Dec. 21, '23 | |
| **Major Escalation (60%)** | 1. Major Regional Escalation, But No Sustained Israel-Iran War | **30%** | 30% | 20% | 10% | Markets Start To Price-In Geopolitical Risks |
| | 2. A Sustained Israel-Iran Direct Conflict | **30%** | 30% | 20% | 20% | Sustained Global Risk-Off, Oil Price Shock (i.e., back to the 1970s scenario) |
| **No Material Escalation (30%)** | 3. Gaza Strip War, With No Major Regional Escalation | **30%** | 40% | 60% | 70% | Market Neutral Outcomes + Occasional Headline Risk Volatility (i.e., status quo) |
| **Long-Term Truce (10%)** | 4. Lasting truce | **10%** | - | - | - | Marginally Lower Energy Prices, Positive For Regional Assets |

1 Alpine Macro *Geopolitical Strategy* "Para Bellum: Should Investors Get Ready For A Bigger Middle East Conflict" (May 8, 2024), "Israel May Hold Its Fire For Now, But Escalation Is Likely On The Horizon" (April 15, 2024) and "Notes From The Road" (September 26, 2024).

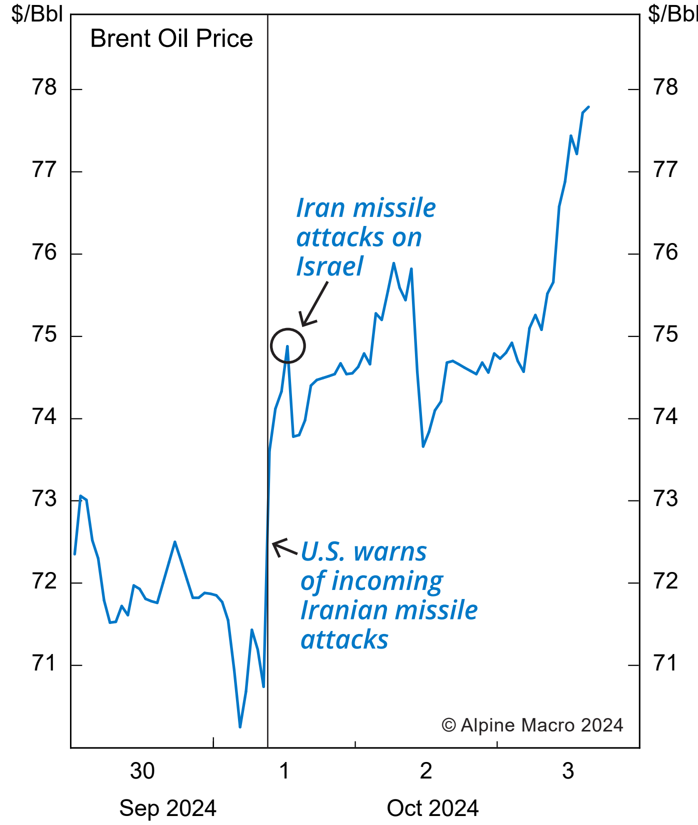
Iran's overreaction stems from a regime in crisis, using external power to maintain its domestic grip by appealing to nationalism. It likely felt compelled to act after Israel's recent surprising gains against Hezbollah, its strongest proxy, to avoid the strategic humiliation threatening its domestic stability. Meanwhile, Israel sees ongoing threats from Hamas, Hezbollah, and Iranian missile strikes as existential, and cannot tolerate them, creating a zero-sum game with few de-escalation options (though some remain, as explained below).

In the next week to a month, Israel will retaliate. Severe responses could include: airstrikes on Iran's nuclear facilities, oil infrastructure, or leadership, which could spark a regional conflict and potentially draw in the U.S. or (far less likely) the GCC states. In this scenario, Iran's threat to close the Strait of Hormuz is a serious market risk.

**Table 1** outlines our scenarios. We still assign a 60% chance of major escalation in the next 6-9 months. Scenario 1 involves a war between Israel and Iranian proxies, primarily in Lebanon, with potential spillover into Syria and Iraq. This is arguably already unfolding, though not yet in a sustained way, as Israel's incursion into Lebanon still remains limited. Scenario 2, a sustained Israel-Iran conflict, is the most concerning.

Still, there's a notable chance of no further escalation – 30% for a war contained to Gaza and 10% for a lasting truce – due to Western pressure and the unpredictability of war, which both Iran and Israel may seek to avoid. Under U.S. pressure, Israel might opt for a more measured response, such as attacking Iranian airbases, that may not trigger a wider war at this point (though that risk will persist as long as the war in the Gaza Strip continues).

**Chart 1** Oil Prices Are Up ~10% Since Oct. 1 Iran's Attack On Israel




Source: Bloomberg Finance L.P.

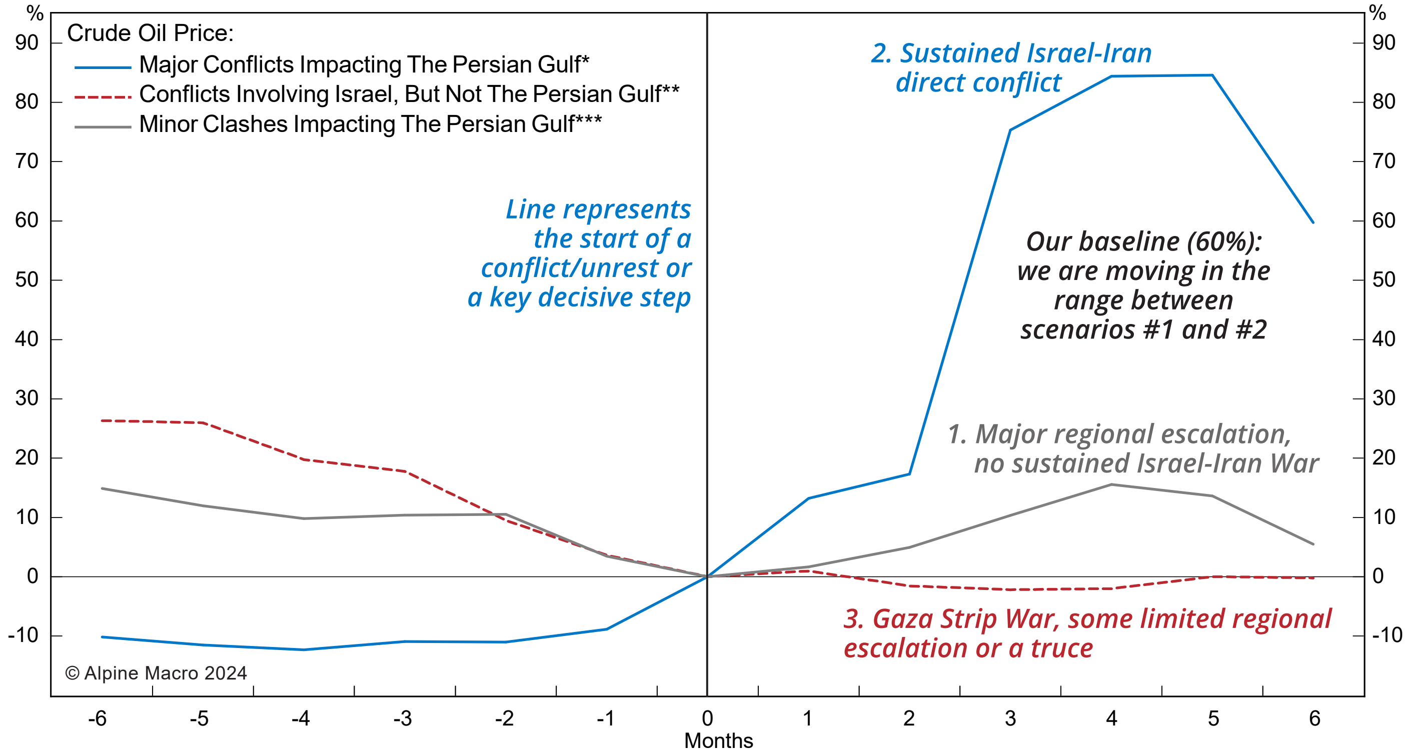
Two other wildcards to ponder:

- Will Iran accelerate its nuclear program and declare itself a nuclear power? A plausible but very risky move. Israel or the U.S. might strike Iran's nascent nuclear program, betting that Iran wouldn't risk nuclear escalation given its still-weak deterrent. This would be enormously destabilizing.

- Could the U.S. election outcome act as a conflict escalation catalyst? The Biden administration is trying to prevent conflict, but it is a lame-duck presidency. If Trump wins, Iran may escalate or attempt to cross the nuclear threshold before his inauguration, fearing a more hawkish U.S. stance. Conversely, if Harris appears likely to win, Israel might escalate before she takes office, fearing

Yeah right limited. Most retarded AM Report I have ever read

**Chart 2** Wars Impacting The Persian Gulf Are What Really Move Oil Prices




*5 events from 1973-2002
**7 events from 1982-2021
***6 events from 1988-2019
Note: This averages oil prices 6 months +/- from the start of conflict, with value indexed to 0 on conflict start date

her administration would push for a ceasefire. Escalation risks will remain high before the next president's inauguration (January 20, 2025).

## Market Implications

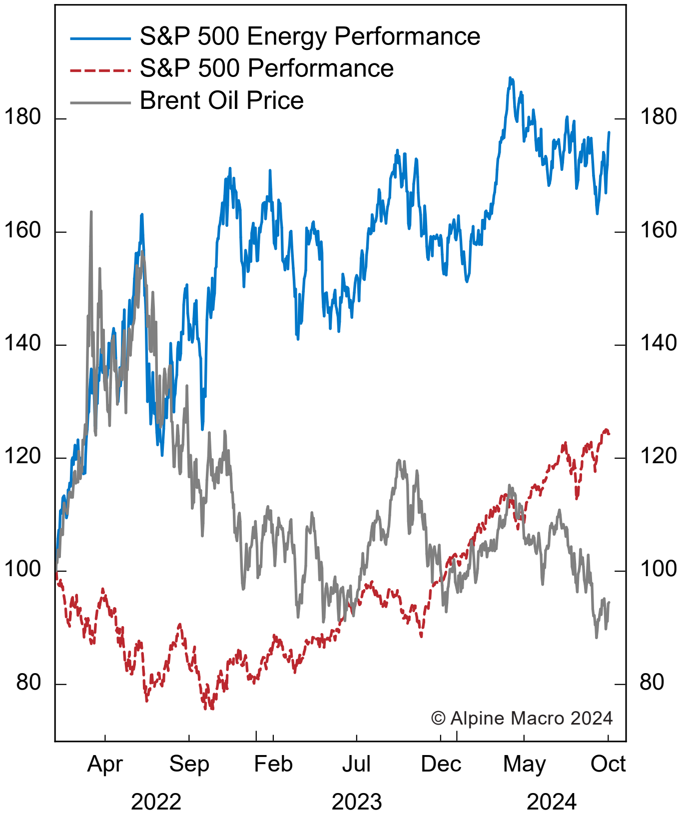
Since Iran's strikes on Israel on October 1, oil prices have risen about 10% (**Chart 1**). Markets hadn't been pricing in a geopolitical oil premium recently, and if the Israel-Iran conflict escalates, oil markets could become volatile. Whether this volatility is sustained depends on whether the conflict leads to a broader war or if it remains contained – then the risk premium would quickly wash out.

As we previously wrote, based on historical precedent, a broader and sustained conflict in Lebanon, Syria, and Iraq (Israel vs. Iranian proxies) could push oil prices up 10-20% over ~6 months. A sustained and direct Israel-Iran war could nearly double prices (**Chart 2**), as it would likely impede oil and gas shipments from the Persian Gulf. These scenarios are on a continuum (not necessarily distinct), and escalation in war is often unpredictable, so our baseline for the next 6-9 months is some form of escalation in this range (i.e. between Scenarios 1 and 2).

How could investors hedge against this risk? We still believe the best approach is to invest in oil-related assets from outside the Middle East. If Mideast oil production is disrupted, these assets would benefit from both higher oil prices and their availability. Some

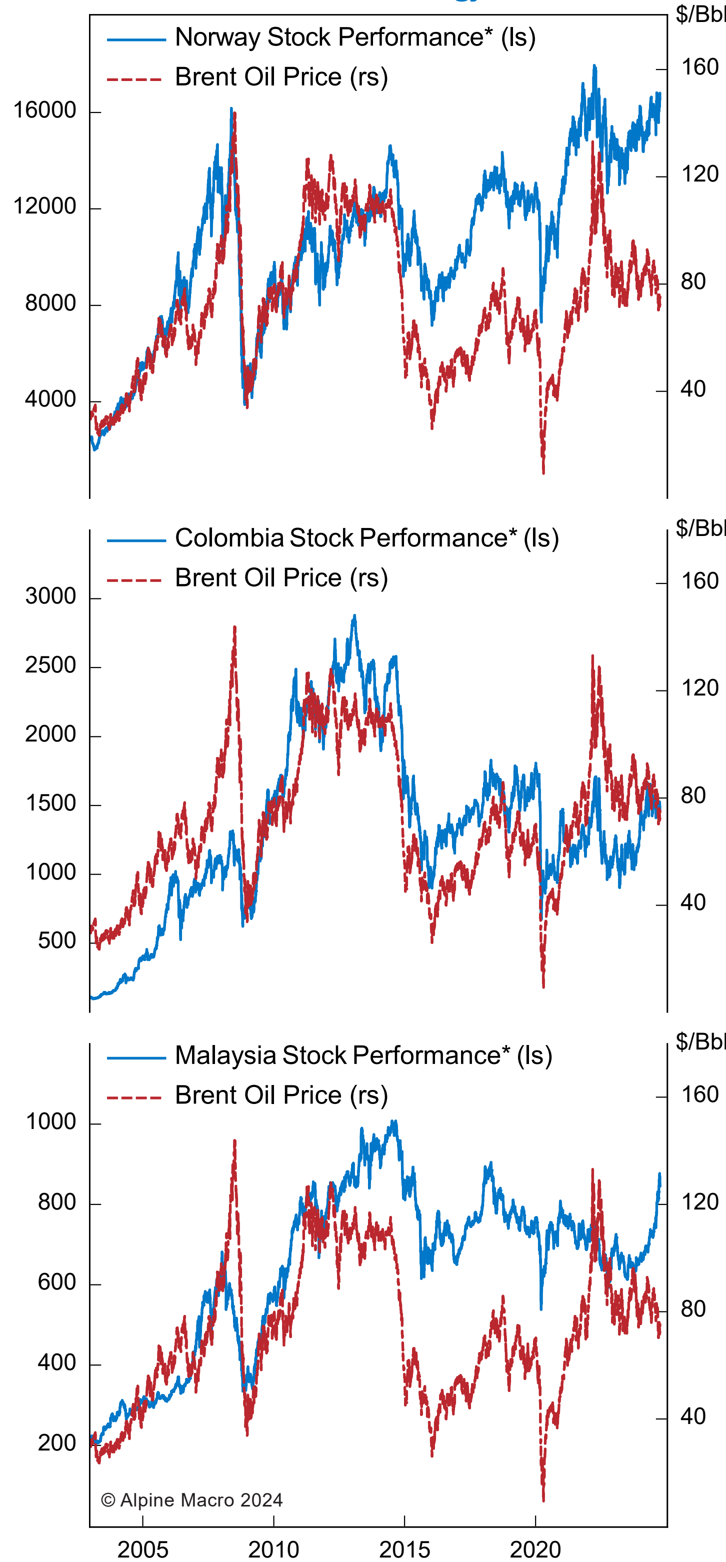
  

**Chart 3** U.S. Energy Assets Are A Potential Hedge Vs. Mideast Conflicts




Note: All series are rebased to Jan 2022=100

**Chart 4** Another Mideast War, Hedge: Other Non-Mideast Energy Producers' Assets




*Source: MSCI Mid & Large cap

examples include assets like U.S. energy (**Chart 3**) or equities from oil-producing countries (**Chart 4**). While these have their own cyclicality, from a geopolitical standpoint they seem like solid bets.

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