S&P Global Ratings

Credit Conditions Update October 2023

War In Middle East Compounds Global Geopolitical Risks

Oct. 18, 2023

This report does not constitute a rating action

Key Takeaways

- The eruption of war between Hamas and Israel in the Middle East puts further upward pressure on our global assessment of geopolitical risk that we already view as elevated and worsening. This compounds the strain on international relations caused by the Russian invasion of Ukraine and the tense relationship between China and the U.S.
- While not underestimating the severity of the human tragedy unfolding in Israel and Gaza, our current base case is that the conflict will likely be largely contained to Israel and Gaza, limiting the geographic and credit impact of the conflict.
- The risks of escalation involving the opening of a second front with full military engagement of Lebanese militant group Hezbollah remain material, but we think it less likely that Iran would become directly involved.
- A key risk in the event of escalation would be the potential for an energy supply shock, which could underpin inflation and weigh on economic activity.

Editor's Note: This report provides an interim Credit Conditions commentary following the attack on Israel by Hamas on Oct. 7, 2023. S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Emerging Markets, North America, and Europe). Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers.

The attack on Israel by the militant group Hamas on Oct. 7 has reopened old wounds in the Middle East and created further geopolitical fissures in an increasingly fragile and uncertain world. We recognize that this remains a rapidly evolving situation, fraught with danger, and one that will take several weeks, if not months, to stabilize. Yet, it will inevitably shape relations in the region for many years to come. We see some potential repercussions, both short and longer term, as well as latent risks regionally and globally.

Contained Spillovers In The Short Term Are Still The Most Likely Outcome

For now the economic and credit impact is largely being contained to Israel, Gaza, Egypt, and Jordan, even though recent developments present a real threat to stability in the wider Middle East and add to already heightened geopolitical concerns globally**.** The immediate focus is centered on Israel's military response to the Hamas atrocity, which needs to be carefully calibrated both to minimize the number of civilian casualties in Gaza and to attempt to safeguard the large number of Israeli hostages.

Our current base case is that the conflict will likely be contained to Israel and Gaza, with limited spillovers to other countries. The modest reaction in traditional market barometers of financial stress also point in this direction. Safe havens, such as the U.S. dollar are marginally higher since Hamas' attack on Israel on Oct. 7, while gold is just over 4% higher. Brent crude, at $90.6 per barrel, is 7% above the Oct. 6 close, although to put this in context it is still 7% lower than it reached two weeks ago. Oil prices nevertheless remain volatile and we expect upward pressures will remain while tensions in the Middle East persist and the risk of Iran becoming more directly involved in the conflict remains.

The price of natural gas is seeing a bigger impact. In part, the Israeli government-mandated closure of the Tamar offshore platform has contributed to the almost 30% surge in Title Transfer Facility (TTF) prices back to March/April 2023 levels at around €49 per megawatt-hour. But for reference, only 35% of Tamar's 10 billion cubic meters per annum current production can be exported to Egypt, so even if Egypt were to cut its modest and erratic liquified natural gas (LNG) exports by that amount, it would only amount to 1% of Europe's annual supply (and less than 1% of the global LNG market). So it is not very material in the bigger scheme of things.

Nonetheless, this war between Israel and Hamas acts as a further dampener on global business and consumer confidence that is already weak, while muddying the waters for advanced economies' central banks in their fight against inflation. The disruption to Israel's economy will be more material, not least due to the rapid call-up of 360,000 reservists between the ages of 18 and 40, comprising 6.2% of the 18-64 working-age population. Israel is a service-led economy, with the computing and information services sector the largest export contributor to the country at 5.6% GDP in 2021.

At the same time, travel and tourism could suffer amid concerns the conflict will spill over to other regions or that terrorist attacks could take place in other large cities. In particular, given the proximity of Sharm el-Sheikh to Gaza, Egypt's tourism sector could suffer. Moreover, fears of additional incidents could put a dampener on the return-to-office movement that many companies have advocated, given the ability of many employees to work remotely--thus weighing on economic activity in urban areas.

Another Geopolitical Fault Lines Reopens

The longstanding issue of the future of Palestine has been restored to center stage, in our opinion, beyond what could be a drawn-out war in Gaza carrying huge uncertainty and risk as Israel acts to restore confidence in its own security in the region.

More broadly, this crisis reopens another geopolitical fault line that could shift priorities, notably in the U.S., away from Ukraine and toward providing military and diplomatic support for Israel. This represents a challenge for Europe to step up military support for Ukraine in addition to the financial and humanitarian support it already provides. At this stage, it is not clear that the EU can be fully committed to providing the level of support that will be necessary to allow Ukraine to continue to build on its offensive capabilities.

Escalation Is The Critical Risk

A top risk is escalation/contagion should Hezbollah launch a full-scale second front in the North of Israel or should Iran get directly involved.

This crisis has reawakened latent sympathy for the Palestine cause in many countries and communities, which could become manifest in demonstrations and protests from Palestinian-supporting groups across the globe. There is little visibility about where and how this tension could translate into severe violence, but depending on how any Israeli ground offensive in Gaza progresses, these disturbances could grow across the globe.

We think that any likelihood of direct escalation involving Iran seems relatively low at this stage. The main reason for this is that Iran has already achieved its overarching objective, namely derailing the rapprochement between Israel, Saudi Arabia, and the U.S. that seemed close to being agreed in coming months but is now likely set back for many years. Consequently, Iran has little further to gain and quite a lot to lose if it provokes a broader conflict that could result in further sanctions and military engagement, including potentially with the U.S.

Similarly, Russia could indirectly benefit from this crisis. U.S. foreign aid support for Ukraine may be downsized as attention turns toward Israel. Furthermore, while Russia has been building closer relations with Iran, it has also traditionally maintained good relations with Israel, partly as many Israelis have dual Israeli-Russian nationality. The risk, of course, is that Russia becomes more likely to retain captured Ukrainian territory and continue to act as a destabilizing influence in the region.

A key risk in the event of escalation would be the potential for an energy supply shock. While full-scale involvement of Hezbollah, would likely significantly increase risk premiums and volatility in financial markets, any potential oil supply disruption caused by sanctioning Iran and cutting off the exports of Iranian oil—currently about 2 million barrels per day (mbd)--might be offset by Saudi Arabia given it has sufficient spare production capacity (about 3 mbd). But this is not certain, as Saudi Arabia also wants to see a relatively strong global oil price.

The extreme tail risks for energy relate more to the possibility of Iran impeding transit through the Strait of Hormuz, the supply route for about 30% of the world's seaborne oil and one-fifth of global LNG supplies (mostly from Qatar) in a tight market. India (which imports one-half of its LNG from Qatar alone) and other APAC markets would be physically the heaviest affected. Yet, Europe also receives one-fifth of Qatar's exports (about 5% of the total European market) and its supply/demand balance has been very tight since Nordstream 1 closed in Sept. 2022.

Nevertheless, even in the absence of a material energy supply shock, the evident sensitivity in energy prices to recent events indicate that some inflationary pressures could persist through the Northern Hemisphere winter, particularly if supply disruptions of natural gas and LNG to Europe become more widespread.