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## **Investment Implications of the Israel-Hamas Conflict**

For investors, geopolitical risks today center on the Great Power competition involving countries like the United States, China, and Russia. Nevertheless, terrorism by non-state actors can still be destabilizing, as shown by the October 7 attacks on Israel by Hamas, the Palestinian terrorist group that controls the Gaza Strip. The attacks resulted in the largest mass killing of Jews since the Holocaust and the seizure of over 200 hostages, prompting the Israeli government to launch military reprisals aimed at destroying Hamas as a political and economic power and raising the risk of a broader regional conflict. This report discusses how the Israeli-Palestinian fighting could play out in the coming weeks and months and what the implications are likely to be for investors.

### **Roots of the Conflict**

After centuries of anti-Semitic persecution that culminated in the Nazis' mass murder of Jews during World War II, the return of peace and the waning of Britain's colonial power in the Middle East prompted waves of Jews to immigrate into what they saw as their ancient, rightful homeland. In 1947, the United Nations moved to create separate Jewish and Palestinian states in what is now Israel. However, the Palestinians and regional Arab states resisted. After the state of Israel was created in 1948, the Arabs attacked, only for the Israeli forces to push them back even beyond the borders of the UN-proposed Palestinian state. Some

700,000 Palestinians were displaced into the Gaza Strip, along the Mediterranean coastline, and into the West Bank of the Jordan River. Large numbers of Jews moved into the formerly Palestinian areas.

Even after a UN-sponsored armistice in 1949, the Arab countries didn't recognize Israel. In 1967, the militaries of Egypt, Jordan, and Syria began massing troops on Israel's border for a new war, but the Israelis launched a preemptive strike that devastated them in just six days and further expanded the territory controlled by Israel. In 1973, Egypt and Syria launched yet another war on Israel. They again failed to dislodge the Israelis, although a UN-brokered peace agreement led to Israel ceding control of the Sinai Peninsula back to Egypt and accepting UN peacekeepers in areas like the Golan Heights region.

In the 1980s and 1990s, a wave of protests against Israel's occupation of Gaza and the West Bank and violent terrorist pressure led to negotiations and a peace deal known as the Oslo Accords of 1993 and 1995. Those accords created the Palestinian Authority to govern Gaza and the West Bank, but they stopped short of creating a Palestinian state. Many Palestinians rejected those accords and continued calling for Israel to be dismantled so they can form their own state on what they see as their rightful, ancestral lands. Various Palestinian terrorist groups have arisen over the years to attack Israel, including Hamas in Gaza and Iran-backed Hezbollah in Lebanon. Shortly after the Israelis pulled out of Gaza in 2005, Hamas was voted into power there, pushed out the Palestinian Authority, and gradually created

a kind of terrorist state that regularly launched attacks on Israel. To manage the threat from Hamas, Israel adopted a policy of strictly limiting movement in and out of Gaza and responding to Hamas attacks by launching retaliatory airstrikes on the enclave.

The Israeli-Palestinian conflict has always involved political, ethnic, and religious factors. Islamic states in the region have long resisted Israel, but some ethnically Arab states have gradually come to terms with it. Egypt established full diplomatic relations with Israel in 1979, and Jordan did so in 1994. Bahrain, the UAE, Sudan, and Morocco did so in 2020 under the U.S.-led Abraham Accords. In recent months, the U.S. was negotiating for Saudi Arabia to recognize Israel in return for U.S. security guarantees, assistance with nuclear energy, and other benefits. However, ever since its Islamic Revolution of 1979, the ethnically Persian state of Iran has remained dedicated to the destruction of Israel, often sponsoring terrorist attacks on Israeli interests and developing a nuclear weapons program to threaten Israel and build its power in the region.

### The October Attacks

According to [press reports](#), the Hamas attacks of October 7 [relied on extensive, sophisticated preparations, possibly involving the assistance of a state actor such as Iran](#). Illustrating how meticulous the planning was, maps and orders found on killed attackers showed detailed knowledge of the Israeli military's most vulnerable facilities and capabilities. The attackers operated in highly organized units with specialized capabilities, and the units carried orders to achieve specific, coordinated goals, including killing civilians and taking hostages. Attacking by land, sea, and air (using paragliders), the units were able to

kill approximately 1,400 of Israel's citizens, most of them civilians. They also seized more than 200 hostages of various nationalities.

Figure 1



The attackers' sophisticated planning, use of large missile barrages, and [incorporation of advanced weapons like drones](#) was a surprise not only to the Israeli military, but also to the U.S. and other militaries that monitor the situation around Israel. Press reports say U.S. and Israeli intelligence services [were aware that Hamas was planning something big](#), but they apparently had no good information on the specific date of the attack or how it would unfold.

This "intelligence failure" has important implications for the rest of the conflict and beyond. It serves as a reminder that advanced, technology-oriented intelligence services like those of the U.S. and Israel still struggle with understanding the deep motivations and intentions of their adversaries' leadership.

- Indeed, reliance on high technology like satellite imagery and intercepted communications can give a false sense

of knowledge. They may show a lot about an adversary's order of battle, manpower, and resources, but they can't "get into the head" of adversarial leaders to know what they plan to do in secret.

- Moreover, intelligence analysts are always at risk of becoming wedded to their established understanding of a situation. Whether you call such a situation "narrative capture" or perhaps a "failure of imagination," it can blind an analyst to the possibility of new or unexpected actions from the adversary. Even when the intelligence analyst thinks outside the box and imagines a new, surprising action from the adversary, the intelligence agency may not have the information or processes needed to test the theory.

### **Risks for Israel and Gaza**

As of this report's date of publication, the Israel Defense Forces have amassed around Gaza and have begun what most observers expect will be a large ground attack supported by air, naval, and cyber assets. The Israeli government initially said its aim would be to destroy Hamas as a political and military force, although that rhetoric has softened somewhat more recently. Israel could well decide on a more limited aim, such as the severe degradation of Hamas. Whether that happens will be determined in large part by the domestic Israeli political pressure on Prime Minister Netanyahu to exact revenge and/or make sure such an attack doesn't happen again. Netanyahu will also be under pressure from the U.S. and other allies to minimize civilian casualties. Finally, military considerations may call for a more limited approach, especially since Gaza's complex urban environment and the usual advantage to defenders could result in massive casualties on each side.

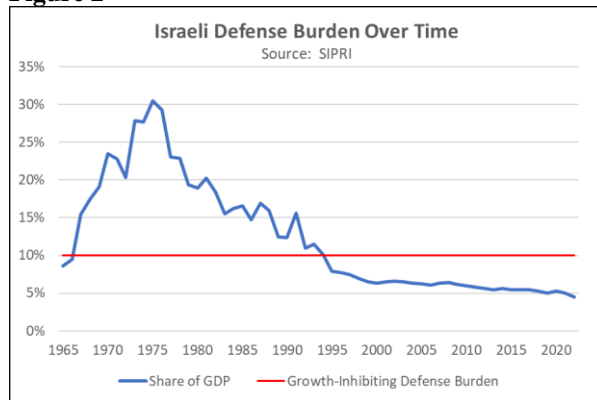
Israel faces a number of different risks as it contemplates its next move. Militarily, a large-scale incursion into Gaza would not only run the risk of high casualties in the near term, but given the continuing frustration and anger of the Palestinians, Israel could also face a long, expensive counter-insurgency conflict like the U.S. faced in Vietnam, Iraq, and Afghanistan. Whether the Israeli operation is short or extended, it could also undermine the country's strong economic growth in recent decades, especially if investment slows and the country's innovative technology firms move operations elsewhere. The conflict could affect domestic politics by exacerbating frictions over the military exemptions granted to ultra-orthodox Jews or by requiring budget adjustments to shift more resources toward the military.

- As we have written before, CIA analysis and our own replication of that analysis indicates that a country's military spending can rise as high as 10% of gross domestic product before it starts to inhibit economic growth. As shown in Figure 2 (next page), Israel's defense burden is currently less than half that level, meaning it has plenty of economic capacity to hike defense spending if necessary.
- Nevertheless, a rapid hike in defense spending could worsen consumer price inflation. It would also likely entail the politically difficult decision to shift at least some funds from civilian programs such as healthcare, education, and infrastructure.

Finally, a destructive, bloody incursion into Gaza would likely present big diplomatic risks for Israel. The expected destruction and civilian casualties could undermine sympathy for Israel in the U.S. and other key countries. They could also engender more

foreign support for Hamas. Indeed, China and its geopolitical bloc have already issued statements that seem tilted in favor of the Palestinians. Greater foreign support for Hamas could encourage the Palestinians to continue fighting the Israeli forces and help encourage other groups, like Hezbollah, to attack Israel from the north.

**Figure 2**



### Risk of Regional Conflict

[More broadly, the bigger risk is that the conflict will spread beyond Israel and Gaza, potentially encompassing the entire region and beyond.](#) At the very least, a large-scale, destructive Israeli attack on Gaza that leads to many casualties among Palestinian civilians would likely prompt attacks on Israel from the numerous Iran-backed Islamist groups in neighboring territories. Indeed, Hezbollah fighters have already been launching missiles into Israel from their base in southern Lebanon. Other Islamist groups in Syria could also join the fray. In addition, unrest among West Bank Palestinians could worsen.

To date, Israel's retaliatory attacks on Gaza have already prompted the ethnically Arab Islamic states in the region to distance themselves from Israel, pushing the momentum of the Abraham Accords into reverse. Saudi Arabia has announced that it is suspending its participation in the talks to normalize relations with Israel. If fighting

between the Israelis and Palestinians worsens, there is a risk that the region's Arab leaders would feel compelled to step up their support for the Palestinians, which would further throw the peace process between Israel and the Arabs into reverse. That would be even more likely if Islamist groups on Israel's northern and northeastern borders step up their attacks on Israel and the Israelis ratchet up their counterattacks.

Perhaps the greatest spill-over risk is that of an Israeli-Iranian conflict. According to White House officials speaking shortly after the October 7 attacks, U.S. intelligence indicates that key Iranian officials were surprised by Hamas's actions, suggesting that Tehran was not actively involved. Nevertheless, new intelligence could still prove otherwise. In any case, Tehran's traditional support for Hamas, Hezbollah, and other Islamist groups could spur Israeli leaders to attack Iran overtly or covertly. For example, Israel could decide to launch the big air strikes that would probably be needed to take out Iran's budding nuclear weapons capabilities. In turn, Iran would almost certainly counterattack, potentially pulling the region's other Islamic states into the fray.

Another potential path to a regional conflict would be if a prolonged Israeli military operation in Gaza depletes Israel's ability or will to fight further. Whether it's accurate or not, perceived Israeli weakness could encourage intensified attacks by regional Islamist groups like Hezbollah or even Iran. In any case, this worst-case scenario would see a broad regional war that could ultimately draw in other powers as well, including the U.S. Especially dangerous is the possibility that Iran would use its large missile force to attack Israel or other states in the region, as shown in Figure 3.



Figure 3



### U.S. Considerations

The U.S. has been a key ally of Israel since its founding, so it wasn't surprising that a broad spectrum of U.S. officials expressed their outrage at the October 7 attacks and pledged support for Tel Aviv. To show his support, President Biden visited Israel and met with its leaders in mid-October, despite the risks involved in making a daylight trip into a war zone. Of course, given the U.S. electorate's generally strong sympathies for Israel, the president's support is good politics. That's true even though his Democratic party has become less supportive of Israel than in the past. However, we think that Biden's active involvement in the crisis also reflects broader economic and security concerns.

To back up the U.S.'s expressions of support for Israel, the administration has moved two aircraft carrier strike groups, two marine expeditionary groups, and numerous additional military aircraft into the region. Those assets certainly could be used to help Israel militarily, [say by providing additional intelligence to Tel Aviv or patrolling the air space around Israel's borders to free up Israeli fighter jets](#) for action in Gaza or elsewhere. [Nevertheless, U.S. leaders certainly don't want to be drawn deeper into an actual military conflict in Gaza or](#)

[elsewhere in the region.](#) The administration especially wants to calm the situation enough to be able to keep focusing on other global problem spots, such as Ukraine. Finally, the administration probably wants to calm tensions to reduce the risk of disruptions to the region's oil supplies. Any such disruptions would likely boost U.S. gasoline prices and hurt President Biden's chances of reelection in 2024.

Based on those considerations, a key issue will be what kind of deals the U.S. might strike with Israel or other regional countries amid the crisis. In return for U.S. support, the administration will almost certainly present the Israelis with a number of *asks*, such as moderation in their approach to the Palestinians or increased Israeli support for Ukraine. In the event that the situation broadens into a conflict involving Iran, the U.S. and Saudi leaders could strike a deal in which the U.S. military helps blockade Iranian oil exports in return for increased Saudi production and a commitment to maintain more forces in the region than Biden had previously preferred.

### Global Risks

Even today, when it still isn't clear whether the crisis will lead to a regional conflict, the Israel-Hamas situation has prompted fears that global oil supplies will be disrupted. That has pushed oil prices higher, which could exacerbate consumer price inflation around the world and prompt central banks to keep hiking interest rates and/or maintain them at high levels. Along with reduced business confidence as war risks rise, higher energy prices and interest rates could slow economic growth further, especially in Europe and other regions that rely on the Middle East for their energy supplies.

There is probably also some risk that China, Russia, and/or other members of the

Beijing-led geopolitical bloc could try to take geopolitical advantage of the situation, especially if they think the fighting has depleted the military resources of the U.S., Israel, or their allies. For example, the situation has probably increased the chance that Chinese President Xi would try to take advantage of the situation to seize control of Taiwan, although we haven't seen any evidence of that yet.

### **Investment Ramifications**

Whenever both sides in an international dispute maintain that they should have exclusive control over a territory, the dispute is likely to continue until both sides recognize and accept that one is more powerful than the other. In this dispute, the more powerful side is probably Israel, but many Palestinians and their supporters do not accept that conclusion. The dispute is therefore likely to fester even if today's immediate crisis passes and peace is restored.

For investors, the Israel-Hamas situation has many implications. As long as the crisis continues, or if it worsens, investors will bid up **oil and other energy commodities**, such as natural gas and uranium. We think investors will also be buying traditional **safe-haven assets such as gold**. Another

asset that we think is likely to benefit is the **U.S. dollar**, not only because it is a traditional safe haven, but also because the greenback has become positively correlated with global oil prices as the U.S. became a net energy exporter over the last decade or so. (Investors initially piled into Treasury bonds as well, driving their prices higher and their yields lower. However, as of this writing, that trade has already reversed amid continued concern about the Federal Reserve's interest rate hikes.)

Finally, concern about the Israel-Hamas crisis will probably continue to discourage stock buying in the near term, weighing on both international and U.S. equity prices. Israeli stocks are likely to struggle as long as uncertainty about the crisis remains. Still, we believe the risk of broader military conflict will drive up the value of global **defense industry stocks**, a theme that we have written about extensively in recent months.

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