Capital Markets Strategy

Essential inCights for the C-Suite

Chart of the Day

We provide below a very brief review of markets one week after the attacks launched in Israel on Saturday, October 7th, during the Jewish holiday of Simchat Torah, and exactly 50 years (+ one day) after the surprise attacks on Israel in the 1973 Yom Kippur War.

Given the very early stages of the military response, and uncertainty around the significant behind-the-scenes diplomatic discussions underway between US and regional leaders, we focus more on the variables that can impact markets than on scenario analysis at this time.

Generally speaking, global markets have been remarkably resilient in the first week following the crisis; in particular, in USD credit markets where issuance last week exceeded median forecasts and spreads tightened. Across asset classes, the concurrent jump in EU Natural gas prices and tightening in USD HY credit spreads were the most notable moves on the week. **However, fundamental and technical dynamics continue to outweigh geopolitics as the primary driver of most markets at this early stage.**

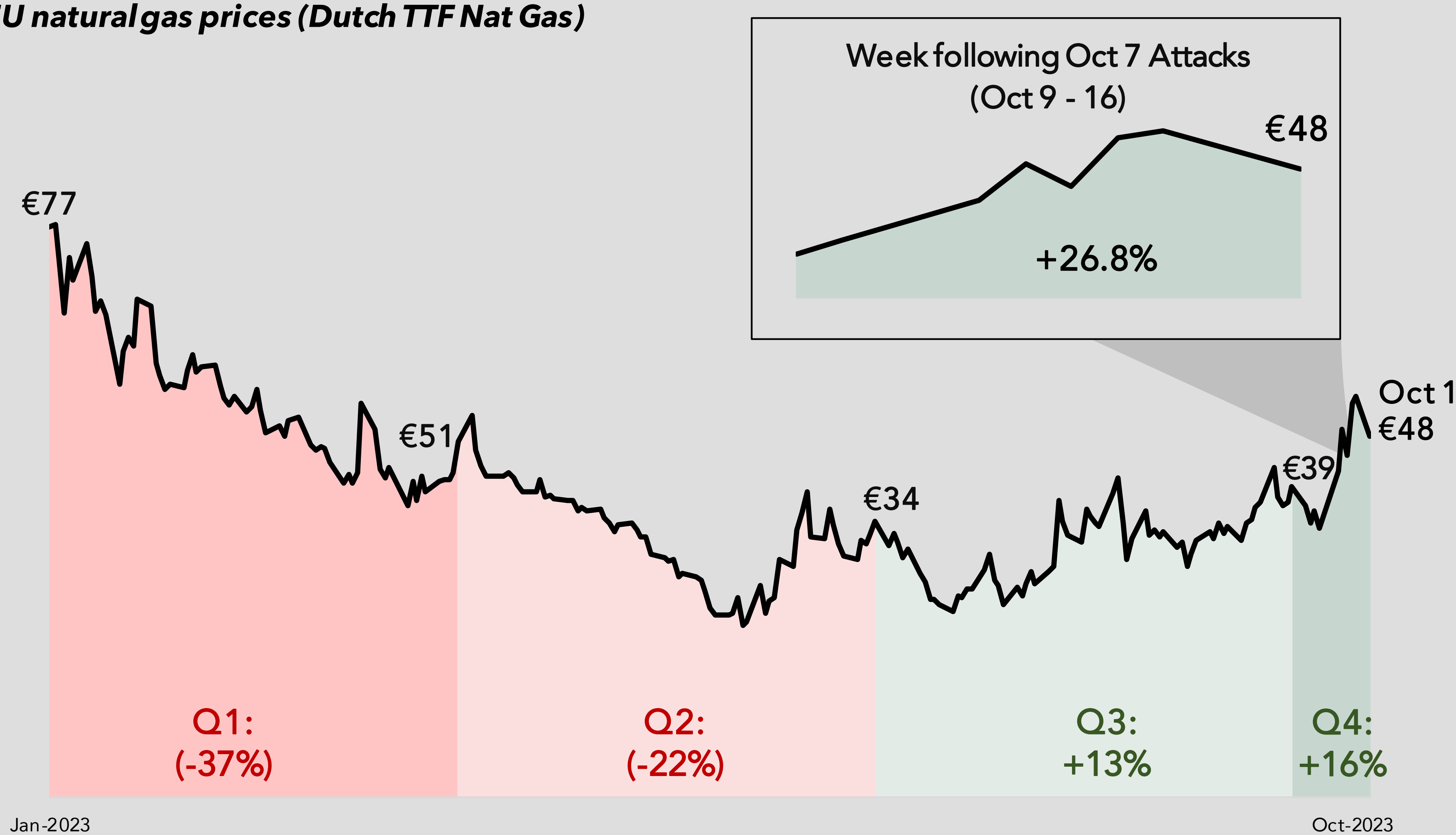
While the resilience thus far has been impressive, it is important to emphasize the very early stages of the crisis, and the tenuous nature of current market stability. In escalation scenarios, look for energy prices to be the most direct and rapid channel of contagion to the real economy.

Israel began producing natural gas from offshore fields in the Mediterranean in 2004, accounting today for approximately 2% of global production. Two-thirds of Israeli production is consumed domestically, while the remaining one-third is shipped by pipeline to Egypt and Jordan. Following the attacks on October 7th, Israel shut down its Chevron-operated Tamar offshore gas field for security reasons, given the proximity of its pipelines to the Israeli city of Ashkelon, which has been directly impacted by the attacks. Production at Israel's Karish and Leviathan gas fields is still ongoing.

Israel's offshore natural gas fields

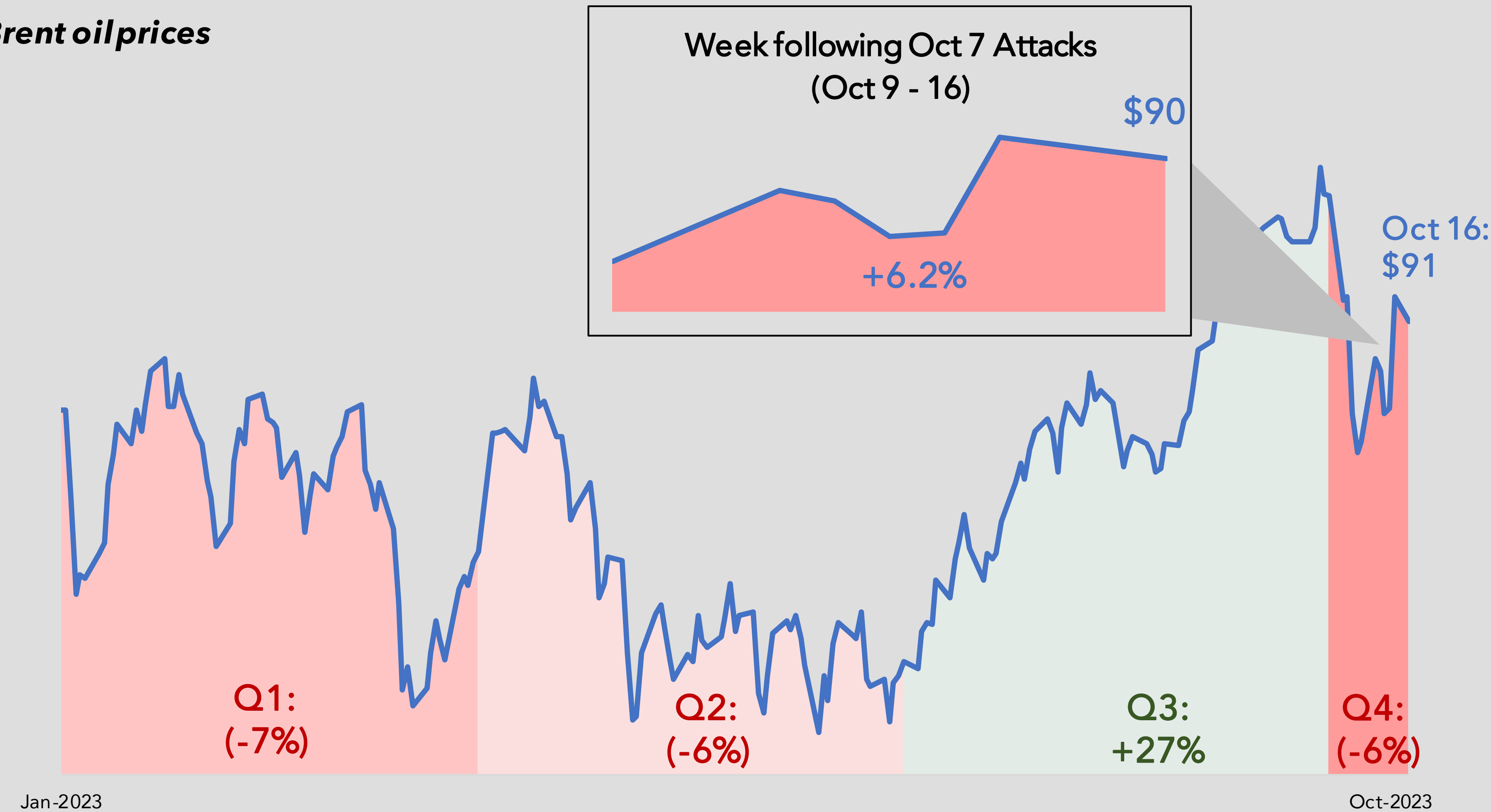
Closure of Israel's Tamar offshore gas field has put significant upward pressure on European nat gas (TTF) prices at a time when competition for LNG supplies is more intensive than a year ago given China's emergence from a two year COVID lockdown. Damage to a pipeline in Finland last week also contributed to the surge in prices. To the extent a counter-offensive in Gaza and regional conflict remains contained, Israel's low percentage of global production, as well as Europe's high nat gas storage rates (> 90%), should soften the risk premium in gas markets.

EU natural gas prices (Dutch TTF Nat Gas)



Fifty years ago, following the October 1973 attacks on Israel during the Yom Kippur war, oil prices quadrupled as Middle East producers cut production and imposed an embargo on oil exports to the US in retribution for its support of Israel during the crisis. By comparison, the geopolitical risk premium in oil prices has been more contained in the current crisis as the US and regional leaders (i.e., Saudi) from today's well diversified markets have embarked on an active behind-the-scenes diplomatic effort to contain regional escalation. In the event of a regional escalation that included Iran, oil prices closer to $150 and a global recession with global growth < 2% would likely follow. A potential strengthening in the Iranian sanctions regime should also be watched closely.

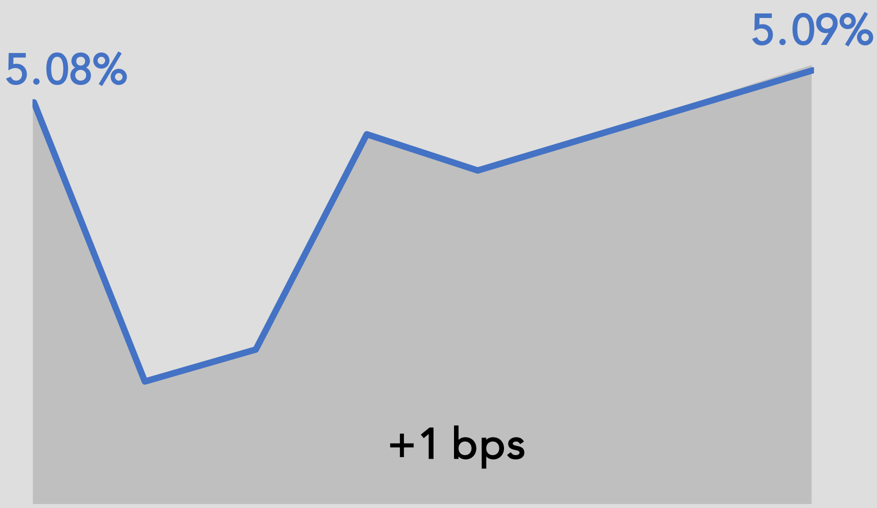
Brent oil prices



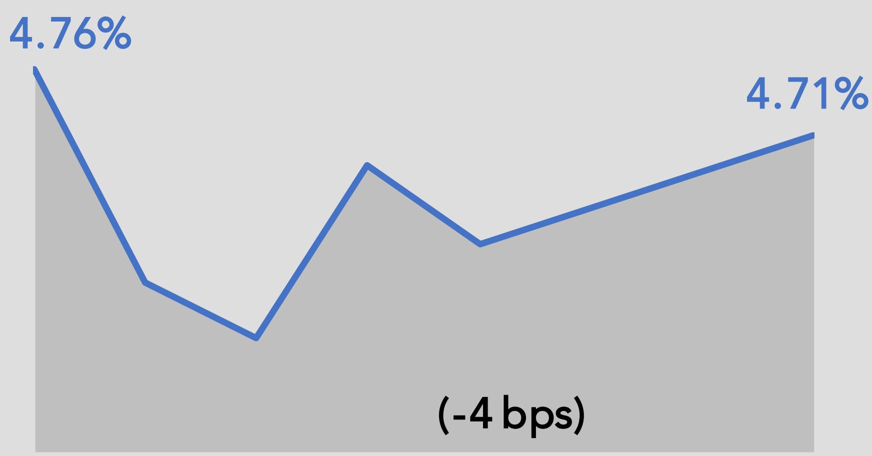
Initially, markets responded to the Oct 7th attacks with a bull flattening of the yield curve as LT rates moved lower on safe haven flows and lower expectations of an additional Fed rate hike. However, one week later, the bear steepening that preceded the Gaza crisis has reasserted itself, as the challenge of absorbing US Treasury supply outweighs geopolitical risk for now. Realization that an Israeli-Hamas war will take longer to play out has also dampened flight-to-quality (FTQ) flows. However, we would expect a resumption of bull flattening following either a significant escalation of the ground offensive in Gaza, or a broader contagion of the crisis to Hezbollah and Iran.

Benchmark US Treasury yields

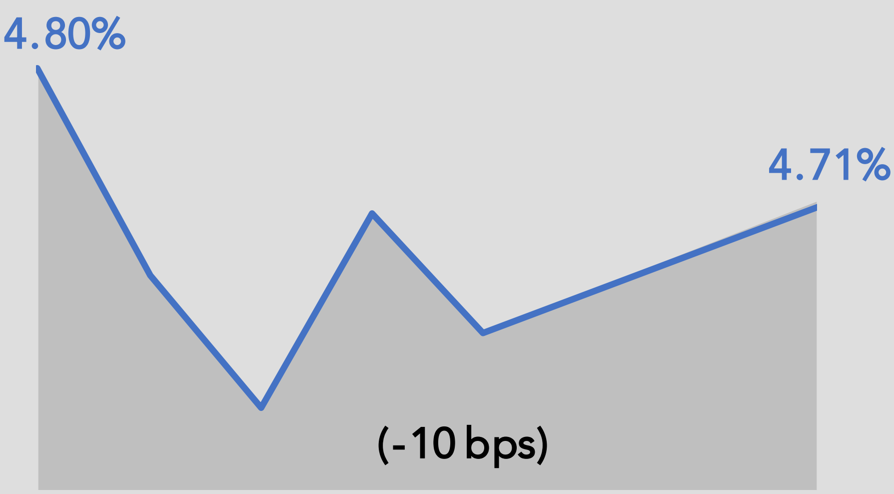
2 year UST (Oct 9-16)



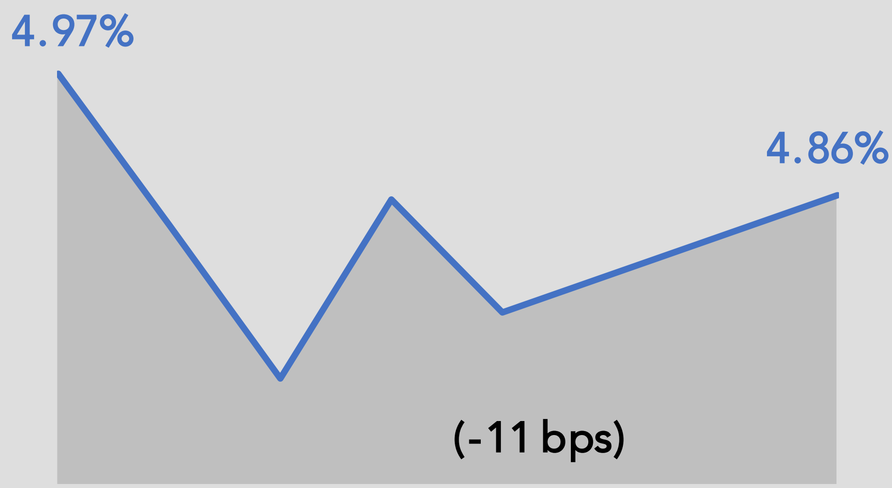
5 year UST (Oct 9-16)



10 year UST (Oct 9-16)

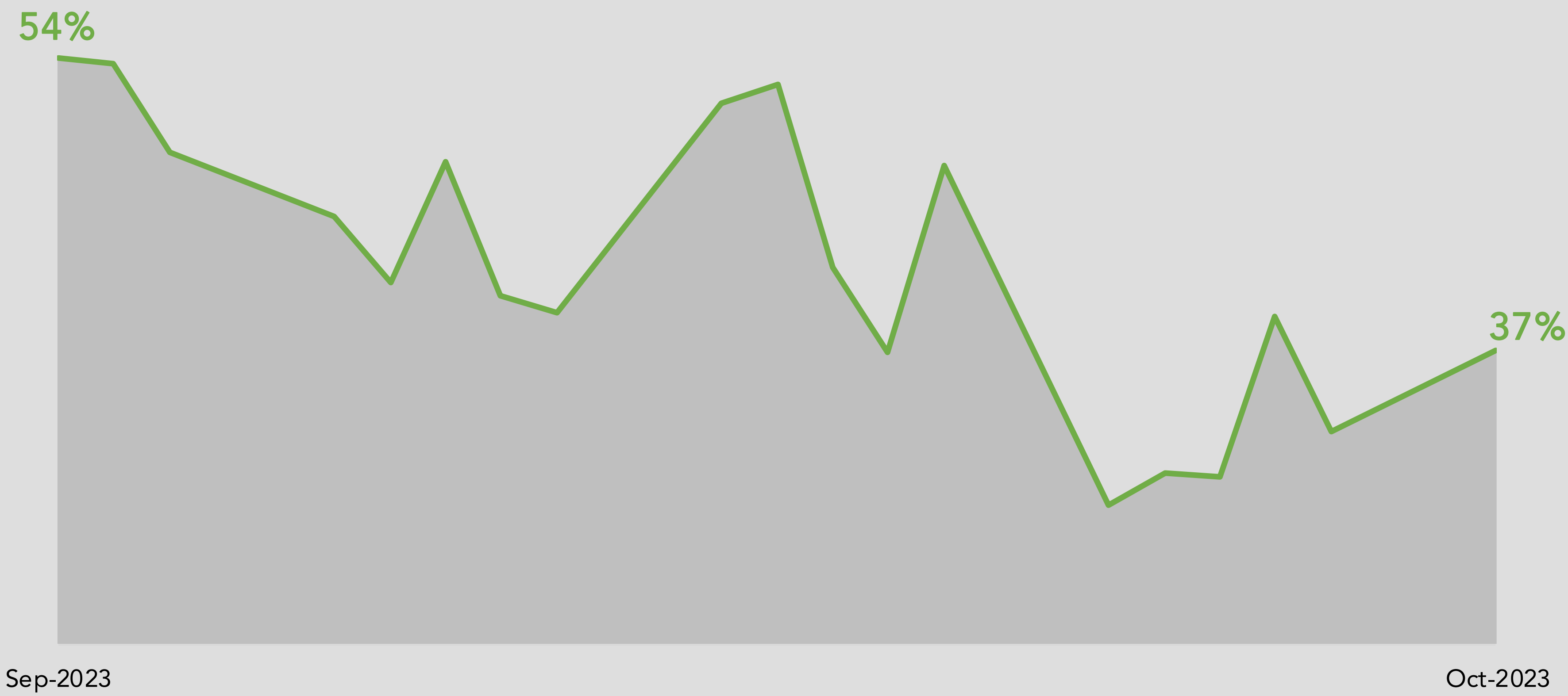


30 year UST (Oct 9-16)



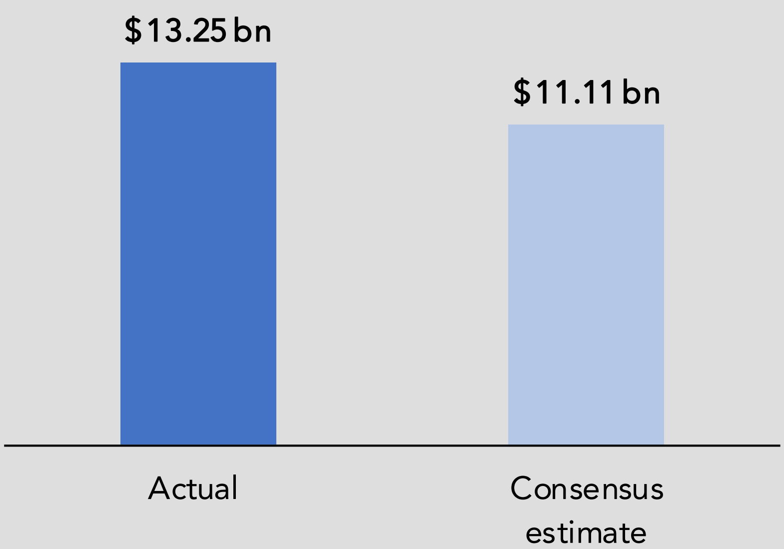
On Friday, October 6th, the evening prior to the Oct 7th attacks on Israel, markets were assigning nearly a 50% probability of an additional Fed rate hike by year-end. With two major geopolitical conflicts (Ukraine, Gaza), mixed economic data, and Fed QT, markets now believe that the Fed tightening cycle is likely complete. As several FOMC members have noted, financial markets are now doing the tightening.

Market implied probability of an additional Fed rate hike by year end 2023

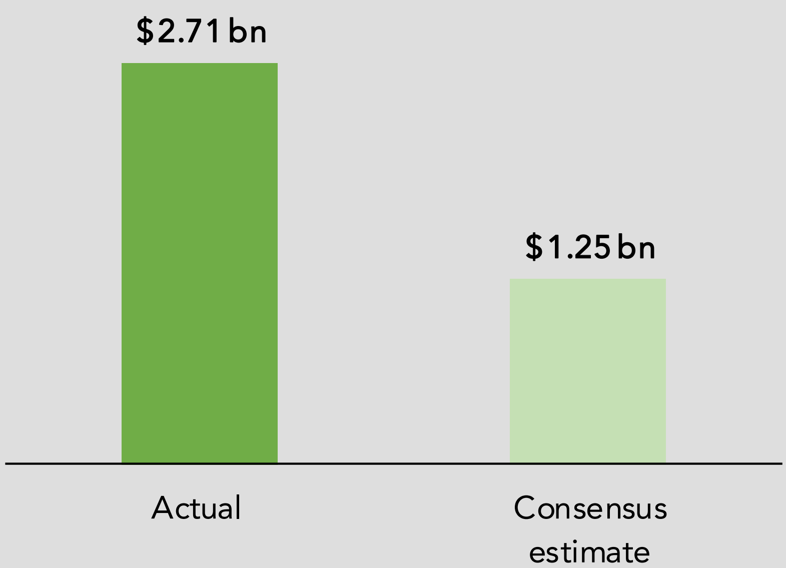


The remarkable resilience of USD credit markets was evident last week with higher issuance volumes and tighter credit spreads. USD IG issuance came in at $13.25 bn on the week, comfortably above avg estimates of $11 bn. With bank earnings nearly complete, and many corporates in earnings blackout, heavy IG supply from the bank sector is expected in the week ahead. In high yield, four issuers raised $2.71 bn, more than double median expectations for the week. Given the magnitude of geopolitical uncertainty, the 10 bps tightening in HY credit was notable.

USD IG issuance for week of Oct 9

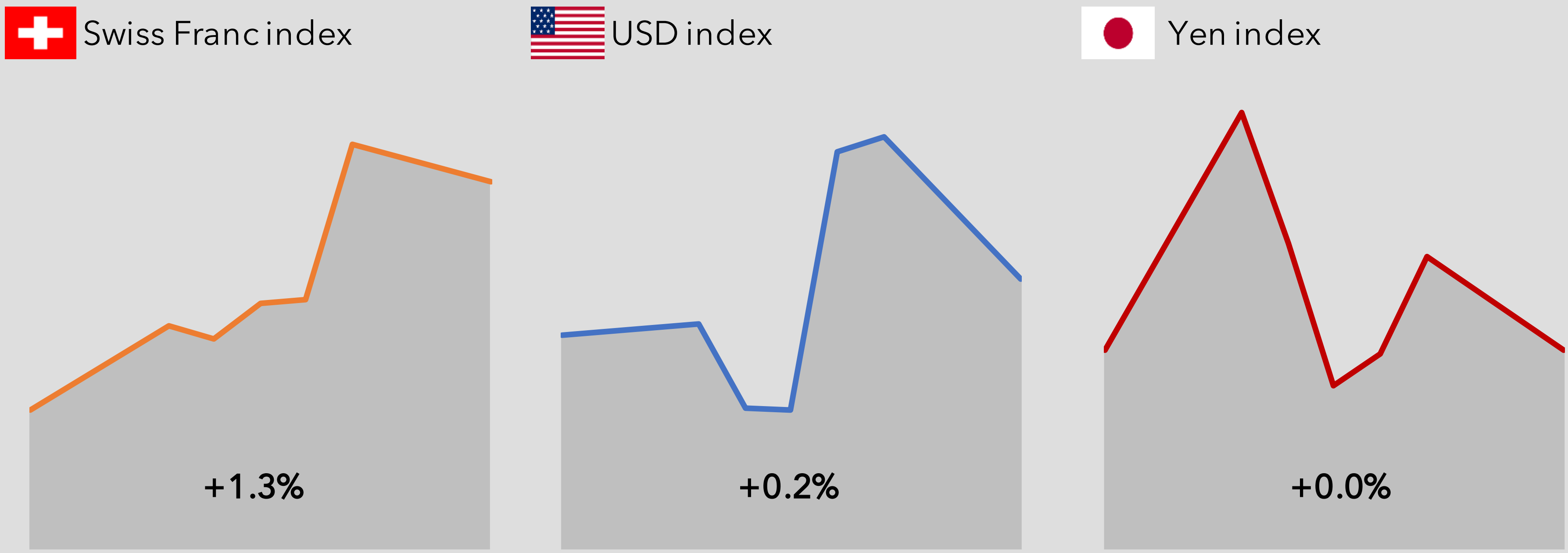


USD HY issuance for week of Oct 9



Geopolitical risk aversion has driven flows into the traditional big three safe haven currencies - Dollar, Yen and Swiss Franc (CHF) - with CHF the greatest beneficiary thus far. Broader contagion to EMFX has been reasonably contained since the crisis began.

Currency markets (Oct 9 - 16)



One week after the Oct 7th attacks on Israel, markets have been remarkably contained and resilient, with USD credit spreads actually tightening on the week. Across asset classes, the concurrent jump in EU Natural gas prices and tightening in USD HY credit spreads have been the most notable moves on the week. The "magnificent seven" tech stocks also rose to new highs vis-a-vis the S&P 500. Look for energy markets to be the primary channel of contagion for any regional escalation in the weeks ahead.

Market performance by asset class (Oct 9 -16)

Commodities	
Brent	+6.3%
WTI	+4.9%
EU Nat Gas	+26.8%
US Nat Gas	**(-6.5%)**
Gold	+5.0%

Credit Markets	
10 year UST	(-10 bps)
HY spreads	(-10 bps)
IG spreads	(-1 bps)

Equities	
Dow Jones	+1.8%
S&P 500	+1.6%
NASDAQ	+1.0%
MSCI Global Equities	+0.6%
Russell 2000	+0.1%

Currencies	
Swiss Franc index	+1.3%
USD index	+0.2%
Yen index	+0.0%

Source: Bloomberg. Data as of October 16, 2023. CFR. MUFG. JPY and CHF are trade weighted indices.

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"Macro stability isn't everything, but without it, you have nothing."