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Dr. Manoranjan Sharma
(Chief Economist)

ECONOMIC DIGEST

HEIGHTENING GLOBAL GEOPOLITICAL TENSIONS - SEEN FROM INDIA'S PRISM

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INTRODUCTION

A day after the 50th anniversary of the Yom Kippur war (i.e., October 7, 2023), Gaza based Hamas, an Islamist group, launched 7,000 rockets on Israeli targets heightening global geo-political tensions. These are times of great challenge and turbulence. We already had the Russia- Ukraine war for close to two years. Now we also have a global flashpoint in Israel and Palestine. There are lurking fears that things could take a turn for the worse in China and Taiwan. So, all this needs to be placed in the backdrop of the COVID-19 pandemic, which is widely considered to be one of the most severe economic and medical emergencies in the last hundred years.

The nearest comparisons are the Spanish flu of 1919 and in terms of the hit to income, output and employment; it was also seen as the most severe debilitating crisis, much more than the Global Depression, the Global Financial Crisis of October 2008 and even the Great Depression of 1929. No wonder, then, the World Economic Forum's Global Risks Report 2023 characterised the present situation as 'polycrisis' to stress that "present and future risks can also interact with each other to form a 'polycrisis' - a cluster of related global risks with compounding effects, such that the overall impact exceeds the sum of each part".

Aspects of polycrisis include the Russia-Ukraine war, recovery from the COVID-19 pandemic, geopolitical tensions and fragmentation, international financial architecture, industrial policies, climate change, etc. In this context, the Marrakech Principles for Global Cooperation, which include reinvigorating inclusive and sustainable growth; building resilience; supporting transformational reforms; and strengthening and modernizing global cooperation assume great significance.

India recovered well post the pandemic and multilateral institutions like IMF, RBI, World Bank, ADB and OECD are agree that India is on a steady growth path of 6 to 6.5%. But one size does not fit all. What worsened matters was that in several countries, particularly in advanced economies like the US and the UK, inflation was very close to double digits, 9%, 10% also, in case of US and UK which was a 40- or even a 50-year high. Things were coming slightly on track but there are also fears of stagflation with the inflationary spiral and slackness in GDP growth.

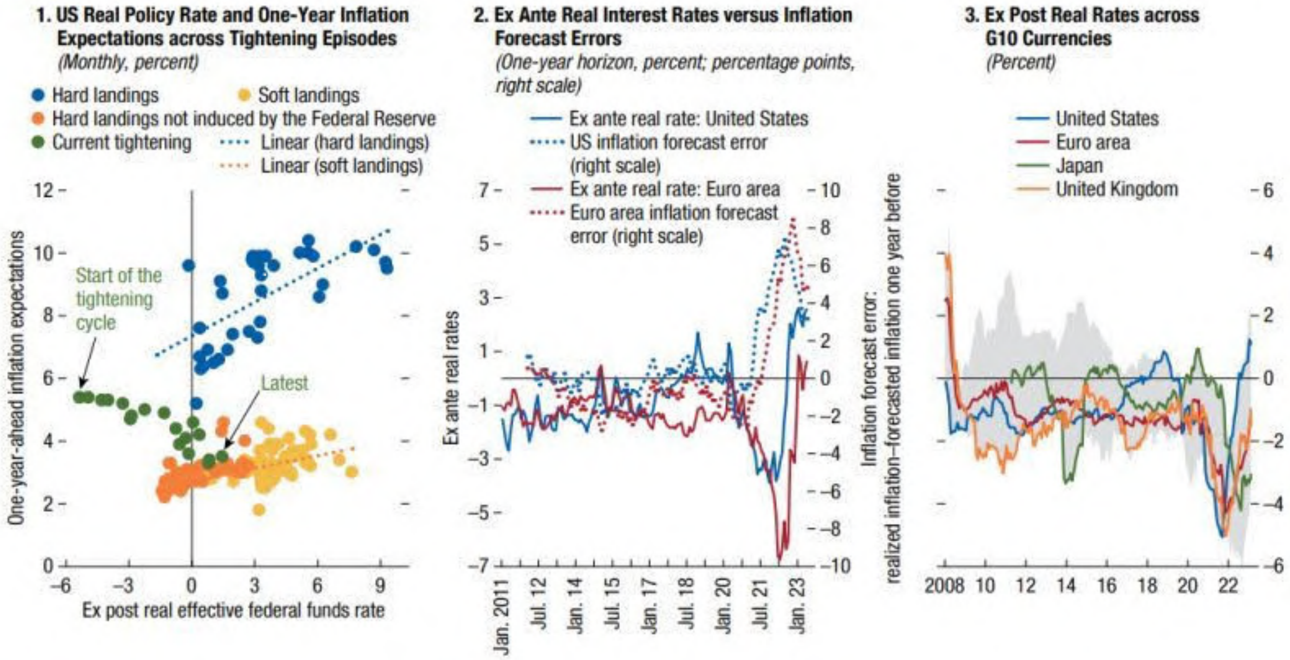
The surprise Israel-Palestine war has wide-ranging ramifications and repercussions across geographies, economies and sectors. There is volatility in the bond and equity market albeit temporarily. Bond yields will harden, cost of credit may go up for companies, crude price will rise if it spills over to the Middle East. There can be a sustained reduction in oil supply. Surging crude oil could impact domestic inflation and interest rates could remain persistently high for a prolonged period. The disconcerting mix of war risk, spurt in US bond yield to record highs and volatile crude support the safe-haven dollar. Technically, the greenback is still in an uptrend and the upcoming correction could be the normal retracement. Gold may become a safe haven.

Swap traders are divided on the chances of another Federal Reserve rate hike by December, pricing in roughly 50% likelihood after the nonfarm payrolls report showed employers quickened the pace of hiring.

The Federal Reserve warned of escalating geopolitical risks to global financial system with Middle East conflict and war in Ukraine threatening ‘spillovers’ to markets amid heightened risks of higher inflation and slower growth. The Fed said “the global financial system could be affected by a pullback from risk-taking, declines in asset prices, and losses for exposed businesses and investors, including those in the US”.

Soft-Landing Scenario: How Likely Historically?

Current conditions portend a soft landing, but this tightening cycle began late and monetary policy may not be tight enough to return inflation to targets.



Sources: Bloomberg Finance L.P.; Federal Open Market Committee; Federal Reserve Bank of St. Louis; Haver Analytics; JPMorgan; Blinder 2023; and IMF calculations.

Note: In panel 1, ex post real effective federal funds rate is measured using year-over-year core personal consumption expenditure inflation. Episodes of monetary policy tightening are identified as in Blinder (2023), using real GDP, the civilian unemployment rate, and the NBER business cycle dates. A hard landing is defined as an episode during which GDP declines by more than 1 percent or there is a NBER recession for at least a year after a Federal Reserve tightening cycle. Hard-landing and soft-landing episodes are defined as in Blinder (2023), using the definitions of soft and soft-ish landings in Table 1. Each dot does not correspond to a landing episode but rather a monthly observation in either hard- or soft-landing episodes. One-year-ahead inflation expectations are derived from the Surveys of Consumers, University of Michigan, University of Michigan: Inflation Expectation, retrieved from Federal Reserve Economic Data (FRED), Federal Reserve Bank of St. Louis. In panel 2, ex ante real rates are based on expected inflation over the next 12 months (that is, a one-year period) from current date. Real rates shown for advanced economies are computed using one-year inflation swaps, whereas inflation forecast errors are calculated using the difference between year-over-year CPI inflation and the forward annual inflation as priced in one year prior. In panel 3, nominal one-month money market rates are adjusted by headline inflation. The shaded area denotes maximum and minimum real policy rates across G10 currencies. CPI = consumer price index; G10 = Group of 10; NBER = National Bureau of Economic Research.

At the global level, recently, the IMF has placed in public domain a very comprehensive report on this issue which demonstrates that a 10 point basis hike by the US Fed which will reduce commodity prices by 0.5% to 2.5% with a lag of 18 to 24 days and there are larger effects for highly storable and industrial goods. Accordingly, there could be some kind of a divergent stance between central banks of different countries depending on their peculiar circumstances and distinctive conditions.

GLOBAL SPILLOVERS

There could be a further flashpoint in the Middle East and the Israel-Palestinian war may well spill over to Iran. With some unconfirmed reports indicating that China could also have some part to play in it, the US bringing two of its warships in close proximity to the hotspot and China also parking its warship in the troubled waters, the situation is evolving and it is difficult to foresee how things will pan out. If the war is localised, then we do not see things going beyond manageable proportions. But if Iran is also affected and there is some kind of a major flashpoint with China, then things could spiral and go out of hand. In this kind of a doomsday scenario, all bets would be off.

Iran is contextually significant because of the crude oil output of almost 3 million barrels per day (mb/d) i.e., about 3 % of the global production but more importantly, 20 % of the total crude oil production passes through the Persian Gulf.

INDIAN SCENARIO

In the case of India, this war would have multiple macroeconomic impacts and also have several implications for the financial and banking sector. Bond yields will go down -- as interest rates would rise further, oil prices would go further up. This would impact the Indian capital market, the banking sector and the triple deficits- trade deficit, current account deficit and also to a limited extent, fiscal deficit.

FIIs are continuously selling due to higher bond yields and high crude oil prices could add more issues. India and the rest of the world are now tackling the bigger, higher threat of inflation. In this grim overall setting, the breaking out of another war, besides the on-going Russia-Ukraine war and the lingering impact of the pandemic makes the transition growth pathway uneasy and the ascent to growth difficult and uneven. This leads to the fears of the central banks around the world launching a fresh cycle of rate hikes to control inflation and the RBI will have to carefully straddle the growth-inflation trade-off. But in the case of India, we did not see RBI cutting rates prior to April 2024 next year. Now, this could delay things a little more.

All this depends on the severity of the Israeli counterattack and the duration- does it end swiftly with a crippling blow to Hamas or it drags into a long protracted war, e.g., Russia -Ukraine war? My sense is for a swift, bloody war and Hamas getting a debilitating blow. But this is an evolving situation and would further heighten geo-political tensions, which were already exacerbated by the Russia-Ukraine war and the posturing or worse in the Taiwan region.

SECTORAL IMPACT - A GRANULAR EXAMINATION

While surging oil prices have a cascading macro-economic impact across sectors and could trigger a risk-off in the market, oil-based sectors like automobiles, transportation, aviation, paints, tyres, cement and chemicals could take the greatest hit. So far, the market doesn’t seem to be unduly disrupted by the war-related risk because the supply-demand oil dynamics continue to be unfettered.
Some of Indian stocks with an Israeli connection include Adani Ports, which owns Haifa Port in Israel; Sun Pharmaceutical, which owns a majority stake in Israel’s Taro Pharmaceutical; Dr. Reddy’s and Lupin because of a potential impact on sector bellwether Tel Aviv-based Teva Pharmaceutical; NMDC and jewellers Kalyan Jewellers and Titan. Further, oil marketing companies could be adversely impacted and there are apprehensions that the war could impact India’s plan of building an India-Middle East-Europe Economic Corridor as reflected in the falling prices of railway stocks like IRCON, Jupiter Wagons, and RVNL in the wake of the Israel-Hamas war. The bearish Indian stock market is also attributable to the gradual downsizing of the Canadian Pension Fund, redemption pressure on FII’s for profit taking, high P/E ratio and overheated segments of the market, the US Fed and unassertive role of the LIC. But it is instructive to see how stocks perform after major events. Clearly, extensive pessimism is unwarranted.

How Do Stocks Do After Major Events?

S&P 500 Index Performance After Geopolitical And Major Historical Events

		S&P 500 Index Returns			
Market Shock Events	Event Date	1 Month	3 Months	6 Months	12 Months
Germany Invades France	5/10/1940	(19.9%)	(12.7%)	(4.5%)	(18.7%)
Pearl Harbor Attack	12/7/1941	(1.0%)	(11.0%)	(6.5%)	4.3%
N. Korean Invades S. Korea	6/25/1950	(10.0%)	1.6%	4.1%	11.7%
Hungarian Uprising	10/23/1956	(2.1%)	(2.8%)	(1.3%)	(11.7%)
Suez Crisis	10/29/1956	(4.4%)	(3.6%)	(0.0%)	(11.6%)
Cuban Missile Crisis	10/16/1962	5.1%	14.1%	20.7%	27.8%
Kennedy Assassination	11/22/1963	6.8%	11.9%	15.5%	23.2%
Gulf of Tonkin Incident	8/2/1964	(1.6%)	1.9%	5.3%	2.7%
Six-Day War	6/5/1967	3.3%	5.9%	7.5%	13.5%
Tet Offensive	1/30/1968	(3.8%)	5.1%	5.2%	10.2%
Penn Central Bankruptcy	6/21/1970	(0.1%)	7.2%	16.8%	28.6%
Munich Olympics	9/5/1972	(1.0%)	5.7%	2.3%	(5.8%)
Yom Kippur War	10/6/1973	(3.9%)	(10.7%)	(15.3%)	(43.2%)
Oil Embargo	10/16/1973	(7.0%)	(13.2%)	(14.4%)	(35.2%)
Nixon Resigns	8/9/1974	(14.4%)	(7.0%)	(2.8%)	6.4%
Reagan Shooting	3/30/1981	(0.9%)	(1.8%)	(14.0%)	(16.4%)
Continental Illinois Bailout	5/9/1984	(3.1%)	1.0%	6.4%	12.8%
1987 Stock Market Crash	10/19/1987	8.1%	10.9%	14.7%	22.9%
Iraq's Invasion of Kuwait	8/2/1990	(8.2%)	(13.5%)	(2.1%)	10.1%
Soros Breaks Bank of England	9/16/1992	(2.5%)	3.0%	6.8%	9.9%
First World Trade Center Bombing	2/26/1993	1.7%	2.0%	4.0%	4.7%
Asian Financial Crisis	10/8/1997	(3.7%)	(1.8%)	14.1%	(1.5%)
U.S.S. Cole Yemen Bombing	10/12/2000	2.7%	(0.9%)	(11.3%)	(19.6%)
U.S. Terrorist Attacks	9/11/2001	(0.2%)	2.5%	6.7%	(18.4%)
Iraq war started	3/20/2003	1.9%	13.6%	18.7%	26.7%
Madrid Bombing	3/11/2004	3.5%	2.7%	1.5%	8.4%
London Subway Bombing	7/5/2005	3.3%	1.8%	5.3%	5.5%
Bear Stearns Collapses	3/14/2008	3.6%	5.6%	(2.8%)	(41.5%)
Lehman Brothers Collapses	9/15/2008	(16.3%)	(26.2%)	(34.8%)	(11.7%)
Boston Marathon Bombing	4/15/2013	6.3%	8.4%	9.7%	17.9%
Russia annexed Crimea	2/20/2014	1.5%	2.6%	8.0%	14.7%
BREXIT	6/24/2016	6.5%	6.2%	11.0%	19.7%
Bombing of Syria	4/7/2017	1.8%	3.1%	7.6%	12.8%
North Korea Missile Crisis	7/28/2017	(1.1%)	3.6%	14.8%	13.4%
Saudi Aramco Drone Strike	9/14/2019	(1.4%)	5.4%	(8.8%)	12.5%
Iranian General Killed In Airstrike	1/3/2020	1.9%	(23.1%)	(4.2%)	14.4%
U.S. Pulls Out of Afghanistan	8/30/2021	(3.7%)	2.8%	(4.9%)	(12.0%)
Russia invades Ukraine	2/24/2022	5.9%	(7.2%)	(2.1%)	(7.1%)
	Average	(1.2%)	(0.2%)	2.0%	2.1%
	Median	(1.0%)	2.2%	4.0%	7.4%
	% Higher	42.1%	63.2%	57.9%	63.2%

Source: Carson Investment Research, S&P Dow Jones Indices, CFRA, Strategas 10/09/2023
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VOLATILITY IN OIL

In case of crude oil prices, exacerbating two-pronged pressure stemmed from first Russia and now the Middle East. For natural gas, Europe reduced its dependence on Russia and then turned to the Middle East. This crushing war threw a spanner in the works and seems to have inordinately delayed things by disrupting critical supply chains. This has certainly rudely shocked investors across the world, including in India because oil is the basic catalytic agent. Oil prices in the last few days have dropped from $96 a barrel to $93 a barrel. At present, it is trading in a very narrow band of $87 to $89. But oil prices could breach the psychological barrier of $ 100 a barrel.

STRATEGIC OPTIONS AND CHOICES

A no-holds barred war is now on with Israel strongly pushing back to secure its borders with Gaza, ending the incursion of Hamas fighters into its territory, destroying the group's capabilities, and rescuing more than 200 Israeli hostages being held in Gaza. But whether it remains a localised conflict or the Iranian government also jumps in the fray going well beyond the pre-war direct and indirect support of the Iranian government remains to be seen. There could be some kind of a further flashpoint, it could spill over to Iran and China could also have some part to play in it. The US has also brought its warship very close to the hotspot as indeed has China. So the situation is evolving and it is difficult to foresee. But if the war is localised, then we do not see things going beyond manageable proportions. If Iran is also affected and there is some kind of a major flashpoint with China, then there could be a free fall.

Even if this kind of worst-case scenario does not materialise, there are distinct fears of a multi-front war in Gaza, the West Bank and Lebanon, especially as Iran is supporting Hamas, Hizbullah and a smaller group, Palestinian Islamic Jihad (PIJ). While gazing into the crystal ball and predicting the likely shape of things to come is fraught with uncertainties, there are not many chances of this conflagration degenerating into a wider regional war. News reports suggest that President Biden faces mounting pressure to strike Iranian proxies that have repeatedly attacked U.S. troops in Iraq and Syria this month. There is however, the manifest danger that this retaliation could well lead to a region-wide tempest-a tempest from which looking back may not be all that easy.

While Israel would eventually (our estimate is within 90 days) succeed in its military and territorial objectives, all parties to the war would be devastated. The post-war situation would also be characterized by continued insecurity and instability in daily life and the business environment in Yemen, Syria, Iraq, and Lebanon would be scarred for long. As my recent poem goes:
"…War triggered by land, women and riches.

And what does it lead to?
Flaming inferno
Bleeding streets
Rising miseries

Why do we go to war?
Who wins, who loses – catastrophes abound, devastation all round
The loser is shattered, the winner suffers tumultuous damages
Miseries surge, sufferings mount.

Shuddering groans, smouldering clouds,
Wailing widows, collapsing infrastructure
Make it a lose-lose and not a win-lose game
All parties to the war take a hit
Development imperilled
Bracing for tomorrow–banish fear and hatred
Join hearts and souls.

What is life, if full of strive
We have no time to resolve differences
Should this persist in the scramble for lives?
The fourth world war will be fought with stones and trees!"

Where do we go from here? Plans for fashioning even a fair measure of agreement have not made any headway because of seemingly irreconcilable differences among the parties to the dispute. The U.N. Security Council has so far been unable to arrive at a consensus on halting the carnage in the Middle East, with the United States and Russia vetoing each other's resolutions. While Russia insisted on a complete cease-fire, the USA made a case for "all measures, specifically to include humanitarian pauses". Clearly, in view of the intractable differences on the ostensibly endless Israeli-Palestinian conflict, there are no easy answers.

Concerns about Iran, broader geopolitical developments, shared economic interests and the perceived need to be on the right side of the US because of its financial might and clout will ensure on-going co-operation between Israel and some Arab nations. But given the trust deficit on both sides, the thaw in relations between Israel and Arab states will take some time and some doing.