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FX Insight

FX Amid the Middle East Conflict

Analysts

Saktiandi Supaat
(65) 6320 1379
saktiandi@maybank.com

Shaun Lim
(65) 6320 1371
shaunlim@maybank.com

Fiona Lim
(65) 6320 1374
fionalim@maybank.com

Alan Lau
(65) 6320 1378
alanlau@maybank.com

Background

The recent escalation of the situation in Israel and Gaza which started on 7 Oct is a complex and longstanding political and territorial dispute between Israelis and Palestinians and runs the risk of further escalation which would have likely implications on currencies. In this piece, we delve into some possible scenarios and the likely effects on currencies via the oil and output growth channels.

Three Conflict Scenarios and Implications

The possible scenarios surrounding the current situation revolve around the theme of conflict escalation. As it stands, Israel and Hamas are currently in an outright war. The status quo that the most likely outcome is for a limited escalation of the conflict, where it is contained within the Gaza Strip and involves the current two belligerents, namely Hamas and Israel (Scenario 1). We have preliminarily observed that volatility in bonds, oil and equities has risen although FX volatility remains relatively stable.

Should the situation escalate to a broader regional conflict that involves more parties such as Iran or the US, there would likely be greater volatility across all asset classes and for safe-havens to outperform (Scenario 2). Of note, we would expect a further and more sustained rise in oil prices, which would have knock-on effects on FX. In the most extreme case of this scenario (with very low probability now), where a more involved global situation akin to a more involved global war occurs, all bets would be off and we would expect extreme volatility in currencies that arise from economic instability, growing fiscal deficits, trade disruptions and inflation.

Lastly, if a peaceful resolution to this conflict can be found within the next month or so (Scenario 3), we would expect the volatility to normalize across most asset classes, for oil prices to then come off and for the USD to depreciate, albeit gradually, against other currencies.

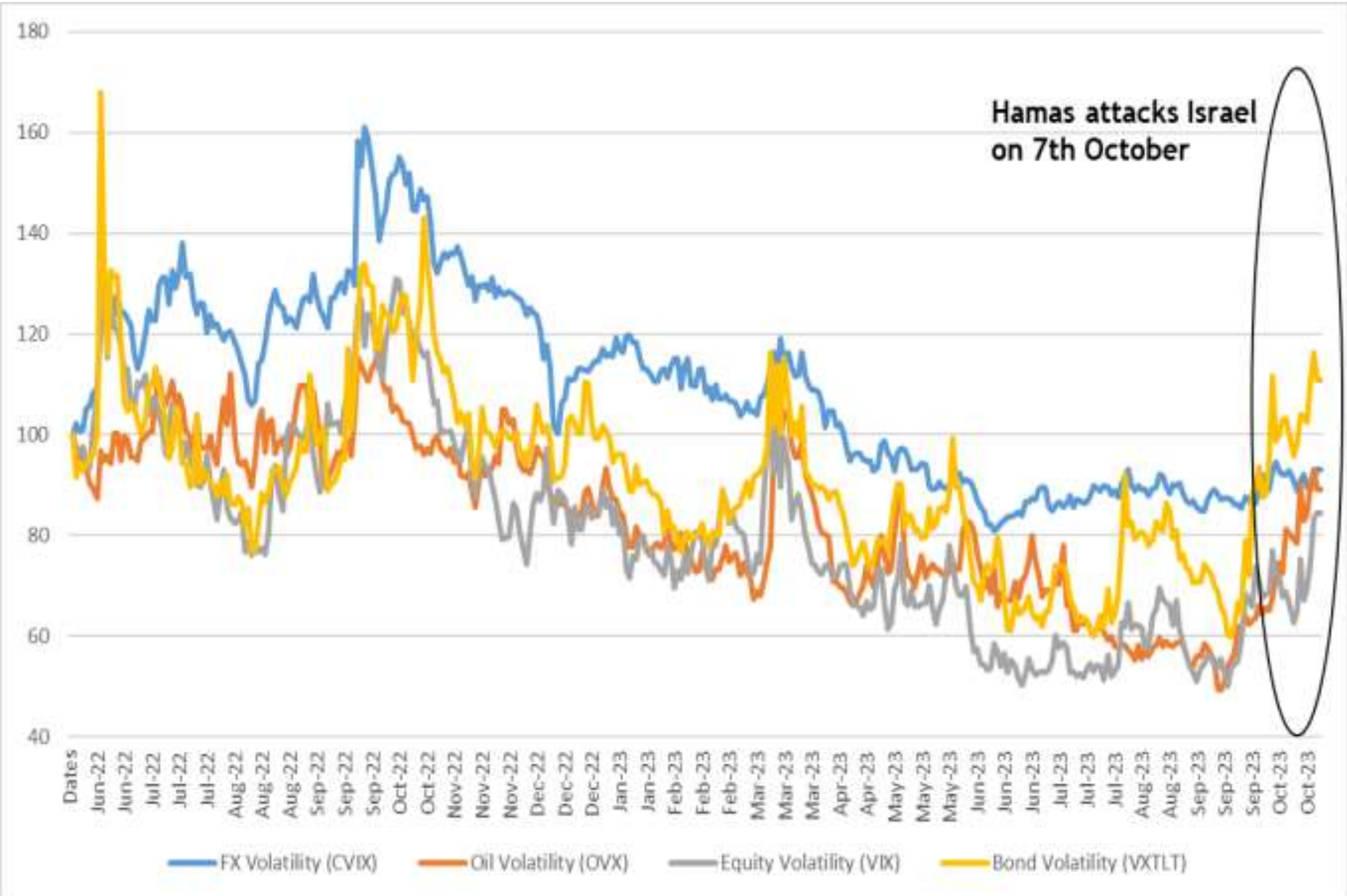
We would caution that we attempt to simplify the impact of a complex issue and the situation is one that remains highly fluid and volatile.

Conclusion

Given the current state affairs, investors looking to protect their portfolios should consider increasing exposure to the various traditional safe-havens such as gold, CHF or the JPY. The latter is especially interesting, given that at this point it remains one of the most fundamentally undervalued currencies as it comes under pressure from rising US yields.

Background
The roots of the Israeli-Palestinian conflict stretch back quite far and a more recent driver in part attributes it to the late 19th century and were significantly influenced by the Balfour Declaration of 1917. Following the war, the League of Nations granted Britain the mandate over Palestine, further intensifying tensions between Jewish immigrants, who saw the mandate as a pathway to statehood, and the Arab population, who viewed it as a betrayal of their national rights. Jewish immigration increased under British rule, leading to escalating clashes between Jewish and Arab communities. The situation worsened in 1947 when the United Nations proposed a partition plan, dividing Palestine into separate Jewish and Arab states. The plan was accepted by Jewish leaders but rejected by Arab leaders, leading to the declaration of the State of Israel in 1948 and subsequent military conflicts between the newly established state and neighbouring Arab nations. This declaration marked the formal beginning of the Israeli-Palestinian conflict, which has endured for decades, marked by wars, peace attempts, and ongoing disputes over territory and statehood.

Chart 1: Asset Class Volatility Rises on the Middle East Conflict



Source: Bloomberg, Maybank FX Research & Strategy
Note: Volatility indices were indexed to 100 as of 1 Jun 2022.

Since Hamas attacked Israel on 7 Oct, and the subsequent escalations by Israel, we have seen an increase in volatility across asset classes (Chart 1). G10 FX volatility has been relatively calm, possibly as the USD trades at levels that are stretched to the upside, leaving markets rather cautious about how much further the USD can strengthens. Across the other asset classes however, volatility while somewhat elevated remains off recent highs of the past year. Notably, oil prices have risen some 7.5% since the onset of the conflict (Table 1) and we expect oil prices to rise further and more sustainably so on further escalation of tensions that could lead to a spill-over to a wider regional conflict.

Table 1: Oil and FX (vs USD) % Changes amid Key Geopolitical Events

Dates: Event Start to Peak Oil Impact	Event	Oil (Brent)	Gold	USD (DXY)	EUR	SGD	MYR	IDR	THB	PHP
7 Oct 2023 – Ongoing (% impact as of 23 Oct)	Middle Eastern Conflict: Israel vs Palestine	7.5	7.6	-0.6	0.2	-0.5	-1.4	-2.2	1.4	-0.4
24 Feb 2022 - Ongoing (% impact as of 8 Mar)	Russia-Ukraine War; Potential Embargo on Russian Oil	32.2	7.7	3.0	-3.6	-1.4	0.1	-0.4	-2.8	-1.9
13 to 24 Feb 2021	Texas Winter Storm	7.4	-1.1	-0.3	0.4	0.4	0.0	-0.6	-0.5	-1.2
14 Sep to 16 Sep 2019	Attack on Saudi Oil Infrastructure	14.6	0.7	0.4	-0.7	-0.2	-0.2	-1.0	-0.1	-0.8

Source: Bloomberg, Maybank FX Research & Strategy Estimates

We note that the potential for oil prices to rise on further escalation is the key question for financial markets with regards to the conflict and we set out below (Table 2) three possible scenarios and our assumption for oil prices in each of them. We then highlight our expectations for currencies in each of the scenarios to provide investors with suggestions for how to position themselves in the context of possible scenarios for the conflict.

Table 2: Possible Scenarios for the Conflict

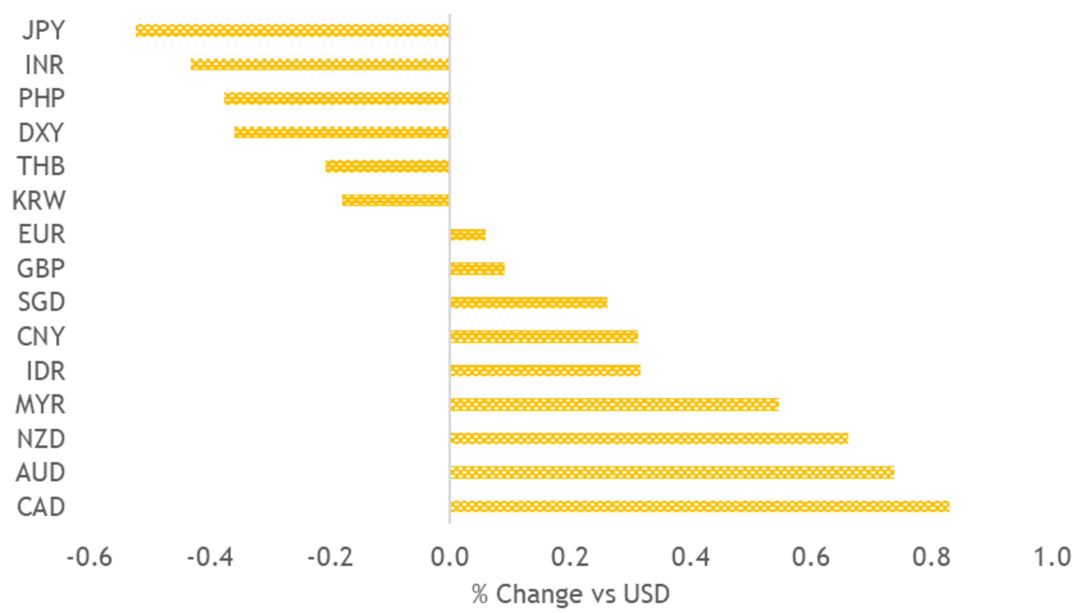
Scenario	Event	Oil (Brent)	Gold	Expected Currency Movement
Limited Escalation (Scenario 1)	Status quo where the conflict remains contained between Israel and Hamas. No further implications for oil beyond what is priced.	Between $80 to $100/barrel	Between $1900 to $2100	Supportive for USD and CHF. Risk currencies to be capped.
Further Escalation (Scenario 2)	Further escalation of the conflict such that it becomes and involves more parties (Iran/US). Extreme cases could lead to World War 3. Oil supply is significantly impacted.	Above $120/barrel	Above $2100	Gold and CHF to outperform. USD to remain supported. JPY probably to follow, although oil could weigh. Negative for risk currencies -INR/PHP.
Peace (Scenario 3)	Peaceful resolution of the conflict, perhaps brokered by the US or China. Some easing of oil prices as conflict resolves.	Below $80/barrel	Between $1800 to $2000, potential for gradual appreciation	Gradual decline of the USD against most currencies.

Source: Maybank FX Research & Strategy Estimates

Three Possible Scenarios and Implications

We discuss the three possible scenarios in greater detail with the focus of the discussion centred around the possible currency moves in relation to changes in the price of oil. We have estimated the sensitivity of various currencies to a 10% increase in oil prices (Chart 2), price changes of oil equity, UST yields and global GDP growth in previous episodes of Middle Eastern conflict (Table 3), FX sensitivity to yield/equity changes (Chart 3) and actual vs predicted FX moves (Chart 4) to set the stage moving forward.

Chart 2: Estimated FX Sensitivity to 10% Increase in Oil Prices



Source: Bloomberg, Maybank FX Research & Strategy Estimates
Note: Figure for DXY is est. raw beta relative to Brent

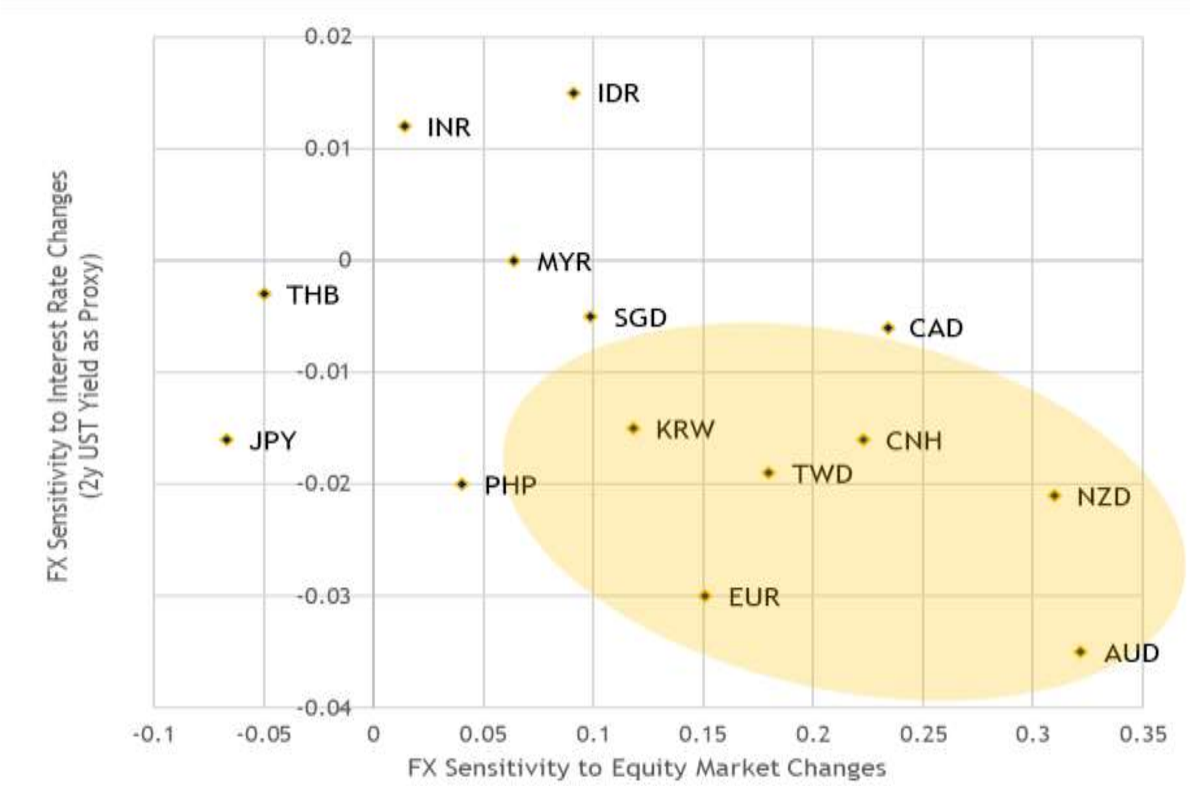
Table 3: Oil in Previous Instances of Middle Eastern Conflict

Events (Dates)	% Oil Price Change (Absolute Change)	% Change in Gold	% GDP Growth (Global)	% Change in Equities (SP500)	Change in 10Y UST
Gulf War (1990-1991)	135 ($17/barrel to $40/barrel)	+5% to 10%	-0.1% to -0.5%	-10%	-100bps
Iraq War (2003)	60 ($25/barrel to $40/barrel)	+15% to +25%	-0.2% to -0.5%	-15%	-100bps
Arab Spring (2010-2012)	71 ($70/barrel to $120/barrel)	+10% to 15%	-0.1% to -0.3%	-10%	-50bps

Source: Bloomberg, Maybank FX Research & Strategy Estimates

We observe that periods of Middle Eastern conflict are where global growth tends to be slower, oil prices tend to rise, equity prices tend to fall and UST yields tend to fall (Table 2).

Chart 3: FX Sensitivity to Yield/Equity Changes



Source: Bloomberg, Maybank FX Research & Strategy Estimates
Note: Regression analysis between FX/USD on 2y UST yield and S&P500 over a 2Y Dec-2019-21 daily log levels sample period

Chart 4: Actual vs Predicted FX Moves (4 Oct to 23 Oct 2023)

Source: Bloomberg, Maybank FX Research & Strategy Estimates
Note: Predicted Weakness is estimated using FX return beta to a 2% sell off in S&P 500, 25bps fall in UST 10y yield and 8% fall in Crude Brent Oil.

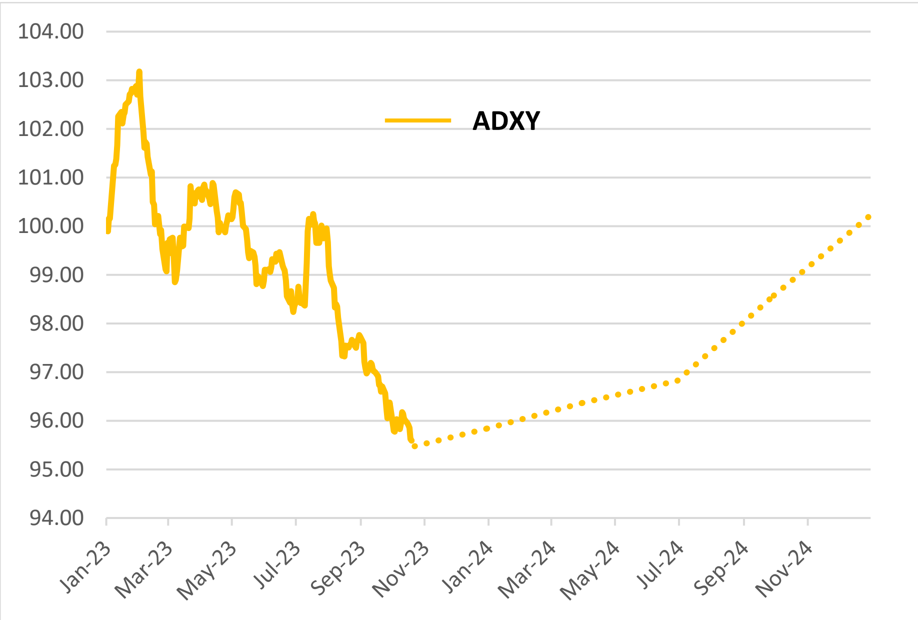
Scenario 1: In this scenario, there is limited escalation of the conflict beyond the status quo and the war is largely contained between Israel and Hamas. Oil is likely to remain within current ranges and is unlikely to trade above $100/barrel as there is limited impact of disruption to the global oil supply in this scenario. The ongoing conflict is likely to be supportive of safe havens such as gold, USD, and the CHF. The JPY is likely to be trickier to call given that the tremendous yield disadvantage that it is currently at against the rest of the world. In addition, JPY has the highest sensitivity to increases in oil prices and this should be another factor that weighs on the traditional safe-haven status of the JPY. Risk currencies such as the regional ASEAN currencies (with exception of SGD and gold linked THB) and the AUD and NZD are also likely to be capped in this scenario given the ongoing uncertainty and possibility that this scenario could further escalate into Scenario 2. We do not expect too large a drag on global growth in this particular scenario. These expectations are largely in line with the already observed market movements (Chart 4), with notably the MYR and IDR underperforming. Meanwhile, the PHP was kept stable on warnings of a possible off-cycle central bank hike. Notably, actual outturns for both the SGD and the CHF were relatively in line with the predicted moves, which suggests that both currencies could be a fairly attractive proposition for investors looking to be more hedged against risks.

Scenario 2: In this very low probability scenario, the conflict escalates and involves more parties, notably the most likely of which could be Iran and the US. Iran provides substantial financial, military, and ideological support to Hezbollah, viewing the group as a strategic ally and a means to project its influence in the region. Hezbollah, in turn, has been involved in several conflicts, notably with Israel, and its military capabilities have been significantly bolstered by Iran's support. In turn, Israel and the US are key allies and Iran joining the conflict could then prompt US action. Taken to the extreme, this could start an extended global war akin to "World War 3". In this scenario, we expect a disruption of the global oil supply and for oil to trade above $120/barrel. We would expect UST yields to fall tremendously, for equities to sell off and for a global contraction in economic growth. In terms of impact on currencies, we expect safe havens to outperform. Gold and the CHF should outperform in this situation. Should the US get involved in the conflict, we should observe US yields coming off and the outlook for gold, a non-yielding asset should improve. The USD is likely to remain fairly supported, although the expected fall in yields should make it difficult for it to outperform. The JPY continues to be tricky to call given the high drag that the increase in oil prices could have on it, although if yields could come off by enough, the JPY's safe haven status could once again come to the forefront. We do see the possibility of the JPY outperforming should the yield disadvantage factor swing sufficiently. Risk currencies should do poorly in this scenario. In particular, the INR and PHP should do poorly given the high drag from the expected rise in oil prices. The AUD and NZD, while traditionally risk currencies, could be somewhat supported by higher oil prices as suggested from the sensitivity chart.

Scenario 3: This scenario sees a peaceful resolution to the current conflict. Possible brokers for peace could be the US (important ally to Israel) or China, who have been touting for peace in the region. The latter had earlier brokered a deal to restore relations between Saudi Arabia and Iran and have sent an envoy in the Middle East to promote peace talks between Israel and Hamas. In this situation, we would expect our base case forecasts to hold and for the USD to gradually decline against most currencies. Global growth outlook should continue to be one of a gradual recovery. Asian currencies in particular, remain stretched against the USD, and could outperform in such a situation. If we look at the Maybank ADXY chart (Chart 5), we see that Asian currencies are trading at year-lows against the USD and there could be potential for a rebound. The dotted line implies our expectations for these currencies going forward should a peaceful resolution to the conflict be found. The resulting easing in oil prices should be particularly positive for the PHP and KRW given the high drags that oil has on them. The INR is trickier to call because of RBI's current stance of leaning against the wind to reduce volatility. Gains in the INR could easily be offset by intervention to weaken the INR. While there are limits to intervention to support the currency because of the drawdown in foreign reserves, these limits do not apply to intervention in the direction of weakening in a currency since foreign reserves would be accumulated instead. The INR has remained exceedingly stable this year, and we suspect this is largely due to RBI's preference.

As a word of caution, we are attempting to simplify a complex decades-long geopolitical issue that goes beyond just Israel and Palestine. While we have reduced this to three scenarios, we would caution that there could be many other dynamics that could change the expected outcomes. The US continues to be hawkish on China, while a war continues in Europe between Russia and Ukraine and a higher for longer environment suggests a very fluid policy rate and yield situation. What is worrying to us that we are seeing a world that is increasingly fractious and we would urge investors to be cautious moving ahead.

Chart 5: Maybank ADXY Chart



Source: Bloomberg, Maybank FX Research & Strategy Estimates
Note: Asian FX Index is an equally weighted Asian FX index comprising of the performance of MYR, SGD, PHP, KRW, THB, IDR, CNY and VND against the USD. The solid line indicates the performance of the index year to date (as of 23 Oct 2023) while the dotted line indicates Maybank's forecast into 2024.

Conclusion

Given the current state affairs, investors looking to protect their portfolios should consider increasing exposure to the various traditional safe havens such as gold, CHF or the JPY. The latter is especially interesting, given that at this point it remains one of the most fundamentally undervalued currencies, although it remains under pressure from a tremendous yield disadvantage vis-à-vis the US and the rest of the world.

Other Asian currencies look to be stretched against the USD and could potentially rebound and perhaps even outperform should a peaceful resolution to the situation be reached. In the absence of a peaceful resolution, we see that the SGD could remain better supported in terms of it exhibiting safe haven properties and having a lower sensitivity to oil price changes. Indeed, the SGD has remained very firm on a trade-weighted basis year-to-date. SGDNEER currently trades at +2.00% above the mid-point of the band in our model.

Lastly, if we were to identify a single asset that would probably do well in all three scenarios, it would likely be gold. Gold is likely to do well in the event of conflict escalation as a safe haven. Moreover, gold is equally likely to do well in a situation of peace, when considering that US yields and the USD are at levels that are stretched and gold tends to do well as yields fall (as a non-yielding asset) and as the USD weakens. This makes gold one of the more compelling considerations for any investor looking to hedge or diversify at this point of time.

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Malayan Banking Berhad
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Foreign Exchange

Singapore
Saktiandi Supaat
Head, FX Research
saktiandi@maybank.com.sg
(+65) 6320 1379

Fiona Lim
Senior FX Strategist
Fionalim@maybank.com.sg
(+65) 6320 1374

Alan Lau
FX Strategist
alanlau@maybank.com
(+65) 6320 1378

Shaun Lim
FX Strategist
shaunlim@maybank.com
(+65) 6320 1371

Indonesia
Juniman
Chief Economist, Indonesia
juniman@maybank.co.id
(+62) 21 2922 8888 ext 29682

Myrdal Gunarto
Industry Analyst
MGunarto@maybank.co.id
(+62) 21 2922 8888 ext 29695

Fixed Income

Malaysia
Winson Phoon
Head, Fixed Income
winsonphoon@maybank.com
(+65) 6340 1079

Se Tho Mun Yi
Fixed Income Analyst
munyi.st@maybank-ib.com
(+60) 3 2074 7606

Sales

Malaysia
Zarina Zainal Abidin
Head, Sales-Malaysia, Global Markets
zarina.za@maybank.com
(+60) 03- 2786 9188

Singapore
Janice Loh Ai Lin
Head of Sales, Singapore
jloh@maybank.com.sg
(+65) 6536 1336

Indonesia
Endang Yulianti Rahayu
Head of Sales, Indonesia
EYRahayu@maybank.co.id
(+62) 21 29936318 or
(+62) 2922 8888 ext 29611

Shanghai
Joyce Ha
Treasury Sales Manager
Joyce.ha@maybank.com
(+86) 21 28932588

Hong Kong
Joanne Lam Sum Sum
Head of Corporate Sales Hong Kong
Joanne.lam@maybank.com
(852) 3518 8790

Philippines
Angela R. Ofrecio
Head, Global Markets Sales
Arofrecio@maybank.com
(+632 7739 1739)