



Global Spotlight on Efforts to Avoid Escalation of Israel-Gaza Conflict

Energy markets face limited impact, while regional bond markets remain sensitive to events.

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Diplomatic efforts are taking place to contain the conflict in Israel and Gaza, which continues to inflict a heavy humanitarian toll in the affected areas. The situation remains highly fluid, with various potential geopolitical outcomes. Although the possibility of the conflict spreading to other parts of the region cannot be discounted, in our view it is likely that it will remain largely contained to Israel and Gaza, possibly extending to a limited engagement between Israel and Hezbollah on Israel's northern border.

Below, we summarize what we believe to be four potential scenarios, in order of likelihood, followed by implications for energy and bond markets.

1. The conflict remains restricted to Israel and Hamas in Gaza

Active international efforts continue to prevent the conflict from escalating and spreading into other countries. A widening of the conflict is neither in the interest of regional powers (Israel, Iran, Türkiye, and Saudi Arabia) nor of global powers ahead of key elections. The U.S. will play a key role in restraining Israel's response and is already on a regional tour seeking to de-escalate the situation. This is the highest-probability scenario in our view.

2. An opening of a new military front with Hezbollah in north Israel

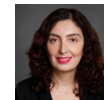
There have been flare-ups on the border between Israel and Lebanon in recent days, and Lebanon's Hezbollah has warned that it is fully ready to fight Israel. However, the exchanges so far have been limited in nature, restricted to the typical "rules of engagement." Pressure on Hezbollah to act will rise if Israel invades Gaza. One potential restraining factor is that a renewal of hostilities with Israel would not be popular in Lebanon, particularly as Hezbollah is currently actively lobbying in the Lebanese presidential election. We believe there is a lower probability of this scenario than the conflict being contained to Israel and Hamas, but there is a material risk of Hezbollah becoming involved.

3. A wider regional conflict and the potential involvement of Iran

There have been some indications that Iran may have provided support to Hamas in its attack on Israel, although U.S. officials noted that they have not yet seen evidence of Iran's involvement. If Israel's response to Iran was restricted to hitting proxies in Syria, Lebanon, and perhaps covert action in Iran, that would fall under the normal "rules of engagement." However, if Israel decided to strike at Iran directly, that would be a clear escalation. This would not be



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a desirable outcome, and the U.S. would seek to prevent it, making this a low-probability event in our view.

4. A further spreading of the conflict across the Middle East, including Egypt, Türkiye, and the Gulf countries

Countries in the region have already issued statements condemning one side or the other or calling for restraint. Besides Hezbollah in Lebanon, no other entity in the region has an interest in becoming directly involved in the conflict. We view this outcome, therefore, as a low probability.

Other factors to consider include the potential impact on relations between Israel and the Gulf Cooperation Council (GCC) countries. While Saudi Arabia condemned the attack by Hamas, it blamed Israel for the dire situation in Gaza. It also has paused talks to normalize relations with Israel. Other countries in the region, such as Türkiye, Egypt, and Qatar, may be able to use their relationship with Hamas to position themselves as mediators, potentially enhancing their relations with the West.

Risk to Energy Markets Remains Low

The potential impact on energy markets derives primarily from any potential escalation or de-escalation of the crisis rather than to anything fundamental in those markets. Although the short-term rise in prices was an understandable reaction to the attack on Israel, we would not regard higher energy prices as inevitable. The upsurge in oil and gas prices typically fades following geopolitical events.

The scenarios discussed in the previous section imply a high probability of a benign outcome for global energy markets, with prices likely settling down in line with tensions. The implied much lower probability of a broader conflict would introduce greater “event risks” and the potential for price spikes, but these would be dependent on how the conflict progresses.

Currently, direct risk is higher in gas markets than in oil markets, but neither risk is particularly acute. Israel produces gas that is liquefied and exported, primarily through Egypt. But there is very little risk to global gas markets. European gas storage is at the highest seasonal levels in the past eight years, which should provide an ample cushion even if the weather turns more severe over the winter.

Israel is not a meaningful oil producer. The proximate risk to oil supply comes from the possibility that further sanctions might

be imposed on Iran if it is found to have supported the Hamas attack. However, the Organization of the Petroleum Exporting Countries’ (OPEC) spare capacity is such that it should be able to comfortably blunt the impact of any potential new sanctions against Iran.

In summary, there is little potential for a first-order disruption because Israel is not a major energy producer and there is a mechanism to manage a second order disruption if further sanctions are imposed on Iran. Fears of oil prices spiking well into the USD 100s per barrel imply a third-order disruption of more drastic Iranian action or more direct involvement from Saudi Arabia and other OPEC nations.

Bond Markets Likely to Remain Stable

Following the Hamas attack, the Israeli shekel (ILS) sold off against the U.S. dollar, crossing the threshold of ILS 4 per dollar for the first time since 2015. However, the depreciation was less dramatic than during the previous crises of 2012 and 2014–2015, when the ILS depreciated by 10% and 18%, respectively. On both previous occasions, the USD/ILS reached the 4.05–4.10 area before stabilizing, and the sell-offs in Israeli local government bond prices were relatively modest. We expect a similar reaction in bond markets this time.

The conflict has jangled nerves in the debt markets of neighboring countries. Yields on Egypt’s and Jordan’s dollar-denominated bonds have risen as investors have priced in more risk for owning the debt. Egypt’s debt was already under pressure before the conflict because of its inability to unlock vital funding from the International Monetary Fund (IMF), but the conflict has highlighted the country’s strategic importance. Although Egypt will likely resist accepting refugees from Gaza, it may have a role in de-escalating the conflict and negotiating a humanitarian corridor.

Jordan does not border Gaza and is under less direct pressure than Egypt from the conflict. It has established itself as a bastion of stability in a challenging part of the Middle East. Its tourism industry has posted a record year, and the country continues to enjoy strong support from the IMF and the U.S. Nevertheless, Jordan’s debt will come under more pressure if the conflict escalates.

Our analysts continue to monitor the evolving situation to evaluate implications for financial markets.

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