Azimut – ME Conflict Impact

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Azimut Middle East

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Heighted geopolitical conflict in the Middle East: Impact on Sukuk markets

We expect limited impact on the fundamental credit profile of Gulf Cooperation Council (GCC) sukuk issuers from the heightened conflict between Israel and Iran. At the same time, we expect near term weakness along with higher volatility/risk premia on GCC assets since we do not foresee a near term resolution to the conflict. Having said this, a ceasefire in the Hamas/Israel conflict can immediately cool down the regional geopolitical risk temperature. Under the worst-case scenario, which is not our base case, a full-scale war between Iran and Israel can cause material weakness in regional assets as the fallout from a high intensity conflict is hard to predict and will adversely impact the GCC. We assign limited probability to the worst-case scenario as in our view, external powers have a strong interest in preventing further escalation. Major attacks by Israel or by Iran will likely cause a significant jump in oil prices which will negatively impact the electoral prospects of the incumbent US president in the upcoming elections at the end of 2024. We also think that the Chinese government, which is currently dealing with a negative fallout arising from the collapse in property prices, will act to prevent an oil shock. The Chinese government has already demonstrated a desire to achieve stability in the Middle East by arranging a reproachment between Iran and Saudi Arabia. In our view, China will influence the conflicting parties to act in a manner which does not impact global economic stability.

The attack by Israel on the Iranian embassy in Damascus and Iran's response has occurred in a backdrop of on-going Hamas/Israel conflict and thus did not come entirely as a shock. The conflict in the region has spread since it started in October 2023 and has involved multiple countries and caused shipping disruptions in a key global trade channel. After every escalation, the key actors have acted in ways that indicate a desire to avoid a full interstate war. However, a prolonged conflict increases the possibility of a miscalculation that can lead to deeper conflict.

Despite elevated regional risks over the last six months, GCC economies have been able to sustain economic momentum as sectors such as tourism, trade and foreign investment have not been impacted. Iran's direct involvement in the conflict does significantly increase the threat level in the region which will likely have some impact on sectors such as tourism and trade. This impact to a certain extent will be negated by the recent jump in oil prices which will boost domestic economies.

Moreover, GCC economies have been experiencing an economic boom driven by elevated oil prices and sustained economic reforms. These countries have built up sizeable fiscal and external buffers and thus are in a strong position to support domestic economies should the Iran/Israel conflict have unforeseen consequences. In addition, GCC banks are well capitalised and have ample liquidity to support sukuk issuers in the unlikely event of a shutdown of global financial markets for GCC borrowers.

GCC: key data and comparison (IMF 2023)						
Gulf Cooperation Council	**Avg. 2000-2020**	**2021**	**2022**	**2023**	**2024F**	**2025F**
Real GDP (percent change, year-over-year)	3.8	3.8	7.8	0.5	2.7	4.6
Current Account Balance	12.1	8.9	16.1	9	7.4	6.9
Overall Fiscal Balance	5.4	0.7	7.9	3.7	3.2	3.3
Inflation (percent change, year-over-year)	2.2	2.2	3.3	2.5	2.3	2
Emerging market and middle-income countries1						
Real GDP (percent change, year-over-year)	4	3.7	5.1	3.1	2.9	4.1
Current Account Balance	–4.0	–4.8	–4.7	–2.8	–4.3	–3.4
Overall Fiscal Balance	–5.9	–6.6	–5.7	–5.4	–8.9	–8.1
Inflation (percent change, year-over-year)	7.1	7	11.1	22.6	25.6	19.8

For the time being we prefer to take a defensive positioning on GCC assets due to the elevated geopolitical risks. Nevertheless, we plan to add risk should we see significant weakness. We believe the fundamentals of GCC countries will continue to be supported by robust non-oil sectors, strong buffers, a low-inflation environment and improved investor sentiment highlighted by Microsoft's USD 1.5bn investment in G42, an Abu Dhabi based artificial intelligence and cloud company. The GCC region produces nearly a third of the global oil supply while it straddles key global trade and shipping routes. In our view, global powers will actively seek to ensure regional stability to prevent major disruption to the global economy which has recently shaken off the impact of a global pandemic. As recent history indicates, commodity supply disruptions caused by geopolitical shocks can severely disrupt the global economy and have a long-lasting impact, and are difficult to reverse. We expect global powers to act in a manner which prevents this scenario.

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