

War in the Middle East and the Potential Threat to Markets

Speaker Key:

DP David Pett

Gen. AL Lt. General (ret'd) the Honourable Andrew Leslie

KM Kevin McCreadie

GV Greg Valliere

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00:00:06	DP	The world's geopolitical climate continues to grow more dangerous following the recent outbreak of war in the Middle East. So why do investors seem relatively unfazed by the tragic events that are unfolding? On this episode of Inside Perspectives, Kevin McCreadie discusses the market's reaction to the beginnings of yet another devastating conflict with guests Greg Valliere and General Andrew Leslie. I'm your host, David Pett. Let's get into it.
00:00:37	DP	Normally, we'd do a bit of an icebreaker, but it just feels a little inappropriate, given the seriousness of our conversation today. So, General, let's start with you. And to the best of your knowledge and expertise, hoping that you can help describe the situation on the ground in Gaza as we speak.
00:00:59	Gen. AL	Based on Hamas attack on Israel, the Israeli government has now set itself three broad objectives. First and foremost, they want their people back, and they have a long-held policy of ruthless application of all the military might to rescue those who've been captured or kidnapped, and as well to follow and track down those who've engaged in the slaughter of Israeli citizens.
00:01:26		Their second objective is to attrit the Hamas leadership, and to what extent and how possible that might be remains to be seen. But of course, if they kill them, then they will be quickly replaced, they'll be martyred, and there's a huge population who have been radicalised over the last 15, 20 years in the Gaza Strip, which are pro-Hamas.

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		And the third objective is to neutralise, destroy the tunnels, which is going to be enormously complicated and difficult.
00:02:01	DP	Maybe we can get into a little bit more about the length of time that this may take to play out, from your perspective.
	Gen. AL	The last time the Israeli Army went into Gaza was in 2014. And it was tough fighting, but it wasn't nearly as complicated nor as populous as will be evident from the moment the Israelis cross in large numbers into Gaza City, which is a rabbit warren of tunnels and broken skyscrapers and house piled one on top of another. It's going to be incredibly difficult and sanguinary.
00:02:44	DP	So, Kevin, let me bring you into the conversation now, given what the general just said. Are you surprised at all at the reaction of markets today?
00:02:53	KM	It's initial reactions. Parts of it you would've expected. Oil quickly moved up 6 to 8%, gold quickly moved up 8%, right on. But the other things which you'd normally see as a safe haven, such as fixed income or treasuries, did not. So, parts of the market are looking at it, saying, okay, I want to have a little bit of a premium to maybe this event, so energy and gold.
00:03:27		But you haven't seen this real flush to run for the safest asset, government bonds around the world, which tells you that people are not maybe seeing this from a duration perspective or from what it could be outside of the specific issues within Gaza in terms of the region. And I think that's the bigger issue, is, what happens with the stability, or what was more benign stability to improving conditions in the Middle East broadly, to where we go from there.
00:03:58		That may have a greater longer-term impact on markets, energy markets, energy policy. It's a whole host of things that could, by the duration of this, if it spreads, that I think become more problematic.
	Gen. AL	So, if we shift slightly north, we still have Russia and their invasion of Ukraine, and the battles there are intense. Large-scale slaughter, tragically.

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00:04:23		With the two sides jockeying for position before the winter rains, which eventually lead to freezing in the snow and ice, are such that they're essentially immobile. And the world's attention has now shifted elsewhere to the Middle East. So, link what's going on in Palestine, the Gaza Strip specifically, with Hamas, who is supported by Iran, with Hezbollah in Lebanon, who's also supported by Iran.
00:04:52		Iran is rapidly becoming a fixed ally of Russia. Russia and China are increasingly forced together, or willing to work together, to create their own system of government, respect for the rule of law, compounded by a variety of other nations in the immediate Middle East, some of whom have decided to side with Iran and already tried to launch missiles against Israel. Which is why the United States moved two enormous carrier battle groups into the Mediterranean.
00:05:24		And they've already shot several incoming missiles which are aimed for Israel. United States is now deploying air defence systems and other technologies into Israel proper to assist and make sure that Iran and others can't meddle any more so than they've already done.
	GV	And to compound everything, to make it even more complicated, we have a shocking abdication on the part of many of our politicians in Washington. It's an embarrassment, in my opinion. And it is not sending a great signal, in my opinion, to our allies, that the assistance that they need, whether it's Ukraine or Israel, is being delayed by this dysfunction that we're seeing in our Congress.
00:06:11	DP	And Greg, just a little bit on... You're in Washington. That's where you live. We read about the dysfunction daily. What's it like to be there? Is it palpable in the streets? Is there outrage around that dysfunction?
	GV	There's no precedence for what is happening right now. There's always been disputes between the two parties. It's beginning to worry me that this could drag on well into the winter before any of this aid comes.
00:06:41	DP	Does this response that you're seeing in the US muddy waters a little bit from your perspective, General, in terms of the new war?

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	Gen. AL	The immediate effect on some of the international crisis points we're dealing with, the immediate effect of some of the international crisis points we're dealing with is the aid bill that was supposed to get through Congress for roughly \$50 billion plus of equipment and funds has not gone through.
00:07:02		And of course, if the House should stagger a bit more, then we could get default on debt, whatever that means. And I'm certainly not an expert in that. Having said all that, the United States is dealing with multiple levels of complexity. And to what Kevin was getting to earlier, a degree of difficulty in international circumstances which I have not seen in multiple decades. It has never been this complicated or this dangerous.
00:07:29	KM	If you were just describing the Middle East today, not the Middle East of a month ago, the current picture, what you described, is troubling.
		You've thrown in the fact that there is Ukraine and Russia now in the back pages, but still equally troubling. And the world is looking away to the Middle East. And as you pointed out, winter is coming and we're now going into the second year come next February or March. And the resolve around the world, not just in the US, to keep funding this without progress, is starting to wane.
00:08:00		And especially as this other hotspot has emerged, and is going to be very, very complex and very, very destabilising. And so, if you are Russia in this, or if you are the Ukraine, you have very different views of what just happened. If you're Zelenskyy, this is the last thing you needed, especially after the US was already having this public debate about funding your efforts. Now, you're competing for weapons. You're competing for ballistics and missiles and shells with another ally.
00:08:37		And I think if you're Russia, you're looking at this and saying, this is actually a pretty good sign. This is probably something that landed in my lap. Because this may get you to your endgame that you want of something, whatever that is.
	Gen. AL	It's so complicated and dangerous right now, that I'm going to pick up on something Kevin talked about a few

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		minutes ago, which is the reaction of the markets, which I'm certainly not going to offer an opinion on.
00:09:01		But I'm just going to say that, seeing how the markets have responded, which is with a degree of calmness and maturity, is exactly the right response. Because when everything is going to hell around you, if you panic, you make poor decisions. And you never get rewarded for poor decisions. So, whatever they're doing, somehow, it's maintaining that stability for now.
00:09:23	KM	The ones I worry about are the next shoes to drop. These are early days. So, think about it. You've had between Israel and Jordan, between Israel and Egypt, between Israel and actually Saudi Arabia, almost, a true throng of... If we had gone back three or four decades, the Middle East felt like a much stabler place, putting the issue at hand aside.
		You throw into this mix a few weeks from now, if one of those regimes falls, whether it be Egypt or Jordan, you all of a sudden have turned the Middle East into something that three or four weeks ago was very different.
00:09:57	GV	The key factor here is, what if? What if a lot of scenarios come true? Especially Iran. How great a threat do you think Iran is right now?
	Gen. AL	Iran has been gleefully meddling in this part of the world for a very long time. Actually, for millennia. This is the most recent manifestation.
00:10:18		The fact that they're supporting both Hezbollah and Hamas, and of course that they have no real desire to see Saudi Arabia flourish, it's no coincidence that Hamas attacked Israel a short while ago, just as Saudi Arabia was about to sign a recognition and normalisation of relations with Israel. Who'd have thought that could've happened, to Kevin's example?
00:10:45		So, there's timing here. There is a sense of strategy which is not yet fully apparent, but you can see that there's a guiding hand behind a lot of this. And right now, we have the Israeli Armed Forces massed on the border with Gaza City, population at 2.1 million civilians, who are desperately in need of humanitarian supplies, and you

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		have the international attention of the world focusing more and more on this, while of course we've got other fires literally raging.
00:11:14	KM	Yes, and I come back to the market issues. I think these become more market issues if one of these other regimes falls. Two, if you open a new front with Hezbollah on the northern front, which is a proxy for Iran. Or you do something in some of the straits where you depend on oil to be transited from. You've got a couple of carrier groups there now. Mistakes can happen. Accidents happen when people are, to your point, the fog of war.
00:11:42		So, those all have become market-troubling events if they were to play out. Some from a commodity standpoint, some from the fear of a larger engagement. But the fact is, to Greg's comment, I don't see how this ends quickly or soon, and how you don't deescalate this. It feels like that's a long way away from where we are today.
00:12:03	GV	Another what-if question that keeps me awake at night is, what if the Israelis don't do quite as well as we thought they would do? They suffer significant losses. And they start to think about the ultimate weapon. Is the use of any kind of nuclear weapon totally off the table, or is it a wild card?
	Gen. AL	It's, in my opinion, totally off the table. And the professional competencies of the Israeli Armed Forces should never be underestimated. A lot of nations have tried, and they've paid the consequences.
00:12:39		Having said that, it is going to be an extraordinarily brutal and slow and deliberate activity, because there are tunnels that go hundreds of feet underground, and they go for hundred and hundreds, if not thousands, of metres, some of them crossing under the Israel Gaza Strip border. It's going to be slow, patient work in pitch dark, with perhaps your own citizens being held as hostages inside, surrounded by radicalised youth who are probably willing to die to kill some of you.
00:13:15		It is, as I've said twice or three times now, going to be extraordinarily difficult, and it won't be over quickly. So, when and if the decision is made to go in, you have to start thinking, what does the Israeli government see as the

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		end state? What does victory look like, and at what price?
	KM	I guess I'd add one other thing to this, which is, the longer this goes on and the greater the civilian toll that is at play here, I think that the support issues from some of the Western countries will also...
00:13:46		And you're starting to see it today, early on, that people are asking for restraint. And if we're sitting here two months from now, that will get louder and louder and louder, and that complicates this again to another level.
00:14:00	DP	Given everything we've talked about, what is the best case? Because General, you're talking about a war that's not going to be over any time soon. This is going to be a protracted war, maybe as protracted as what we're seeing with the Ukraine war. What is the best-case scenario? First from a humanitarian aspect, but then maybe, Kevin, you can weigh in on the market aspect.
00:14:22	Gen. AL	It's a tough one to try and crystal-gaze. Having said that, Israel's suffered horrific loss and tragedies, and they're enraged right now. And they have as their objectives, well, those three items we've already talked about. Get their people back, they want to attrit and cause pain to the Hamas leadership. As a matter of fact, they said they want to eradicate it. It will never happen because it's an ideological movement now. And of course, they want to destroy the tunnels.
00:14:53		They're not going to be able to succeed in all three of those at the same time, because to do so would take so long that I doubt very much they have the will or the patience to see it through. Not because they're not willing to, but because of international criticism for the inevitable civilian casualties which will mount exponentially, because there's 2.1 million people in the Gaza Strip and they can't get out.
00:15:19		They can go north or south, but it's a relatively small portion of land. They can't get out. And if Hamas live amongst them, then how do you separate friend from foe? So, this could go on an extraordinarily long while. And I'll get back to my original question, what does victory actually look like? And how much will it cost in terms of blood and treasure?

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00:15:42	DP	And then, Kevin, we've talked about a spillover being not great for markets, at least adds a great deal of volatility. What is the best-case scenario from a market perspective?
	KM	Markets don't think the way that the General thinks, oftentimes. They'll look for anything that's deescalating as a positive, as a sign that we can go look over there again and get back to what we'd normally do without having to worry about something. So, anything that's deescalating. So, that would be a ceasefire, some type of, in the short term, a negotiation to get these hostages back. Whatever that is. Anything that amps it up is going to be market negative.
00:16:25		Having said that, what the General said at the beginning, I was actually quite surprised how sanguine markets were. Because as we were chatting earlier, when you look at the world, this has been one of a combination of things going on out there. People have some concern.
00:16:42	GV	Just a quick note from me, I was at a conference last Thursday outside of Toronto. There was a speaker before me who had a great theory. And that was, with all of the negative stuff, this is serious that we're talking about right now, Trump and Biden and all of these issues. But this speaker made a point. He said, you can still make money in this environment. Earnings are still good.
00:17:06		Yields, obviously, have moved up. But his premise was that we could still make money as investment professionals, even with all the terrible news.
	KM	And I think for now, that's right. I think one of the things when I think about this all, wars are inflationary. They really are. You have to run budget deficits to finance these things. We've been living a peace dividend for two, three decades.
00:17:34		Even put aside Afghanistan and what went on in Iraq, which were costly in terms of lives, a massive amount of lives lost. But for the most part, the last bunch of decades has been fairly peaceful. We haven't funded a lot of things. We're funding a lot of things right now, in a world where, post-COVID, every government in the world has already extended themselves. As so, I think the

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		culmination of war being inflationary, it also means that you're going to be running deficits higher, which they're going to squeeze out the private sector.
00:18:04		There's a whole bunch of things here that will be market events over the longer term that will show up in terms of interest rates, inflation, government pushback on just spending.
	DP	Does this show up in the Fed's next announcement as a risk? Presumably it does, given what you've just said, right?
	KM	I think it's probably one of the many, many things that are on the periphery of things. I think that they're data dependent right now in the Fed, which is, is the labour market loosening?
00:18:34		Is the economy slowing down to a place where it will take deep pressure on demand for things? Particularly labour, but also goods. To the extent that these higher rates that have just jumped up, without the Fed doing anything, the market worrying about much more supply of things to fund deficits, maybe because of funding these wars. That's raised a fair amount of interest rates from where we were in the summer. And that's doing the Fed's work for them, too. Mortgage market works off the ten-year bond.
00:19:03		It doesn't work off when the Fed raises rates a quarter of a point or not. That's not what creates the housing problem with the cost of housing. So, I'd say they'll take all of these things into consideration. Clearly, a market-moving event which, if you drop the equity market 10 or 15%, will have a wealth effect. They would take that into effect. So, anything from these geopolitical events that translates backwards into a negative market event would be something they'd look at. But I'd say they're keeping probably it in many of a smaller set of things. Not the biggest thing on their mind.
00:19:35	GV	Are we learning just to live with higher inflation? Is it now an environment where we just have to look the other way as inflation stays higher than what the Fed had hoped for?
	KM	So, we've talked about this a lot over the last couple of years. Coming out of COVID, we had thought that the world was going to go back to something more normal.

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		And we'd find that normal wasn't the world we left in March of 20.
00:20:00		That normal was probably something that looked like March of 2006 before the great financial crisis and all of the artificial ways of keeping rates low, and that a zero interest rate was probably not normal. We're going back to a world where probably a ten-year bond, or bonds themselves, have about a 2% difference between the inflation rate, which is what history was. So, if you've got a 4% kind of ten-year bond, you probably have 2% inflation around you. That's kind of where we're tracking right now. We're closing in on 5, and inflation's 3.
00:20:32		So, I think longer term, yes, Greg, I think we're looking at just structurally because of some of the changes, the world is less global. We've brought supply chains back to every place. Those are more expensive. When you're in a less global world, you're competing against fewer people. Pricing is easier. So, a lot of the impacts of some of this stuff are being felt. And we're not even talking today about China-US relationships, we're probably at an all-time low. And that's not getting any better any sooner. And the Chinese are planning to broker everywhere around the world.
00:21:02		They're a broker with Russia and Ukraine, they're a broker in the Middle East now in terms of trying to create peace. And sort of ironically, at the same time, they've named their own Muslim population that wants to separate as terrorists. But yes, I think US-Chinese relationships are probably at an all-time low and are going to get lower. So, that, too, is inflationary.
00:21:25	DP	How does the war, specifically in your mind, General, impact that relationship between China and the US in terms of what they might end up doing around this war?
	Gen. AL	Near-peer competitors is how China sees themselves. Actually, from their point of view, they see themselves as superior to the US. They're not, by the way. Never underestimate the US military capacity and capability, and they're extraordinarily good war fighters.
00:21:54		Having said all that, I think Kevin's tour de force in terms of the linkages between the markets and the current

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		activities of either terrorism, or wars, or both combined, is one which is unprecedented in our times in terms of the dangers and the potential dangers for international peace and security, because let's not forget why Russia went into Ukraine.
00:22:23		Let's not forget why Hamas was able to attack Israel. Let's not forget that China was able to intimidate Taiwan for several years in a row because the West's attention wasn't focused there. Now, you've got a multiplicity of points of focus, and it's going to be an interesting future.
	KM	And not from a market perspective, David, but from a policy perspective, both the end of the Trump administration and the Biden administration had really wanted to pivot away from the Middle East. They really wanted to pivot to China and that region. And this is, I think, I can't see how that happens any time soon with what has just occurred. This feels like the policy issues in the Middle East are going to dominate for quite some time here.
00:23:06	DP	Well, I think I'm going to end the conversation there. Obviously, a very sobering topic and I appreciate your time today and we will see you again very soon.
00:23:23		For a full transcript of today's episode, visit agf.com/podcast . And don't forget to subscribe to hear more from us at Apple Podcasts, Spotify, Stitcher, Podcast Addict and Pocket Casts.
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