Middle East, Markets and Cash

November 23

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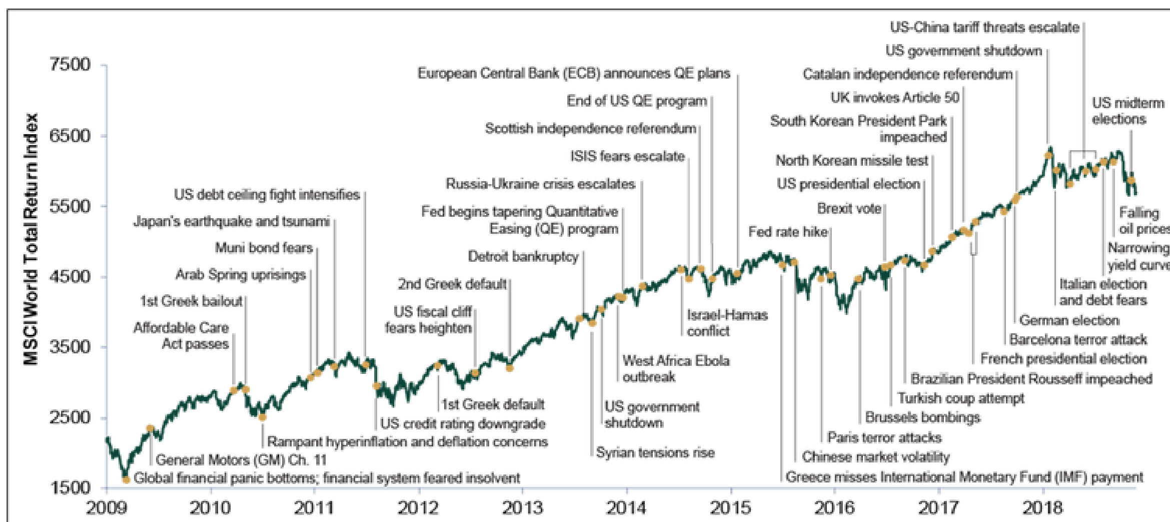
During periods of market volatility, when the interest rates on cash are looking enticing and are competing with short-term investment market returns, it's common to feel uneasy and contemplate transferring your funds out of the market and into these alternatives. The notion of having instant access to your money and the false sense of security it provides may be alluring. However, it's important to recognise that this strategy carries substantial risks that can negatively impact long-term portfolio returns and investor outcomes.

Numerous years of extensive academic research conducted worldwide consistently demonstrates that doing this, even for a short period, then attempting to time re-entry into investment markets is extremely challenging, if not impossible, and poses a risk to long-term returns.

Markets generate growth despite the "Wall of Worry"

Markets are well known for climbing the 'Wall of worry', that being persistent in achieving long-term economic progress in the face of adversity. Markets react to new information often before regaining momentum in their prior direction, unless events are set to bring about a 'new normal'. But if you look for reasons to sell, you must also look for reasons to buy.

The Wall of Worry – reasons to sell or not to buy



Source: FactSet, as of 7/6/2017. MSCI World Total Return Index Level (Net) from 12/31/2008 – 6/30/2017. Presented in US dollars. Currency fluctuations between the US dollar and pound may result in higher or lower investment returns.

The latest event that investors are focused on is the Middle Eastern conflict between Palestine and Israel. Sadly, conflict has persisted within the region for multiple decades and capital markets have equally digested that news across the same period, still managing to grow by multiples despite these circumstances.

An unfortunate fact is that conflict is a regular occurrence within the region, whilst usually limited to smaller scale events than the one we see today. The current war is said to be the fiercest since the Yom Kippur War in 1973, when Egypt and Syria invaded Israel with the aim of persuading it to negotiate better terms for the Arab countries.[1] That conflict lasted for only 19 days but produced deadly consequences for thousands of people. The current war has produced the same although the duration is currently unknown.

What does this mean for investment markets?

The economy of Israel can be fairly represented by the 125 Israeli companies present in the iShares MSCI Israel Exchange Traded Fund, which is down by 21% year-to-date.[2] Importantly, the index was already down by 9.55% on the eve of the 2023 conflict between Israel and Hamas. Whilst direct investment in the region is the most impacted, the Israel ETF accounts for just 0.2% of the global index, meaning that the immediate financial impact will not be felt by global investors.

How will oil and energy from the Middle East be impacted?

So far, energy markets have only moved moderately in price terms, with Natural Gas up 4% since the conflict started whilst Brent Crude (London) Oil has risen by 2.68% and WTI (American) Oil has fallen by -0.40%.

[1] https://www.nytimes.com/2023/10/07/world/middleeast/israel-gaza-conflict-timeline.html
[2] iShares.com 02/11/2023

The nations directly involved in the conflict produce little in the way of oil. The World Bank has forecast oil to average $90 per barrel in the current quarter, before declining to an average of $81 a barrel next year as global economic growth slows. Overall, commodity prices are projected to fall 4.1% next year.[1] The bank has three scenarios under which oil prices could rise should conflict in the region escalate:

Small disruption which would see oil supply reduce by the equivalent of the same seen during the 2011 Libyan Civil War and an increase in the oil price of between 3-13% ($93 to $102 per barrel).

Medium Disruption (equivalent to the Iraq war of 2003) would see a reduction of oil supply to the tune of between 3-5 million barrels per day, driving oil prices up by between 21-35% ($109 to $121 per barrel).

Large-scale disruption (comparable to the Arab oil embargo in 1973) would shrink oil supply by 6 million to 8 million barrels per day. That would drive prices up by 56% to 75% initially—to between $140 and $157 a barrel.

But the basis for the scale of the disruption is vague at best and based on a comparison to previous levels of conflict seen in the Middle East. Importantly, the World Bank states that “initial spikes in oil prices often reversed rapidly in earlier episodes”.

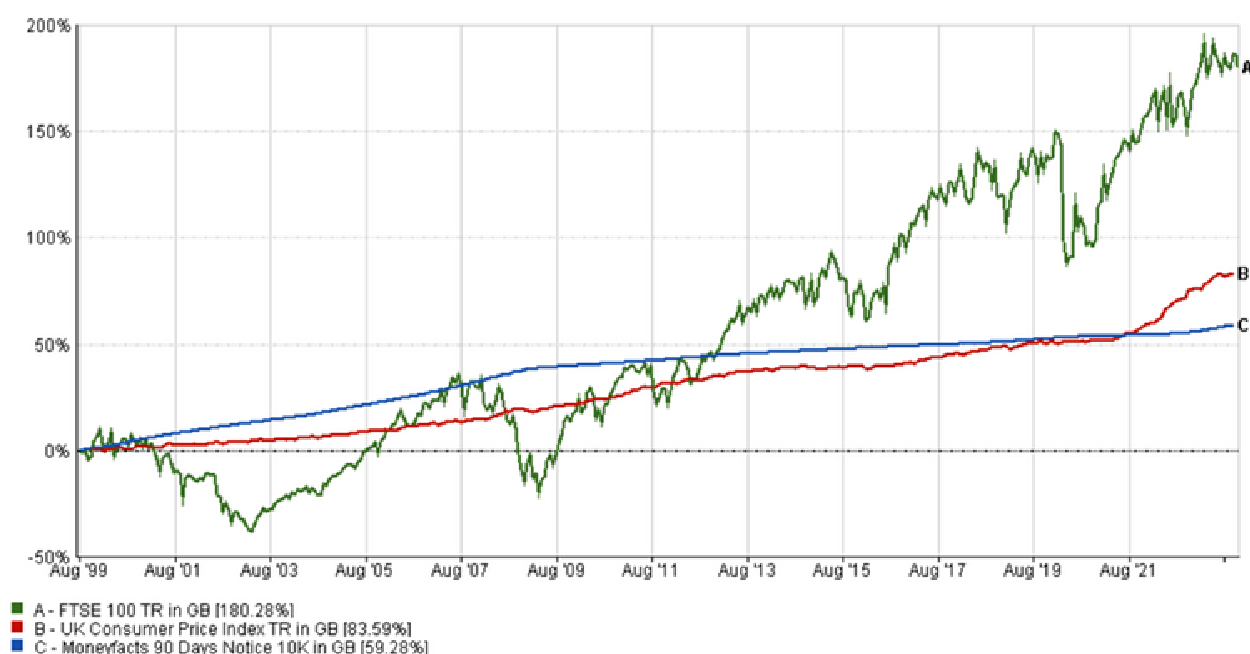
What impact does the oil price have on investment markets?

Put simply, any increase in the price of oil may cause inflation to be “stickier” for longer and could see interest rates remaining elevated, until central banks are more confident in the direction of inflation. The price of oil also impacts input costs for companies which effects corporate earnings. Again, the key point to note is that spikes in oil prices, caused by conflict, can reverse rapidly. There is a variety of media speculation around what escalation could mean, particularly if the US and Iran engage in further sanctions. But at this stage, it is just speculation.

Cash as a long-term asset class?

Cash has a place in every portfolio, but not as the main investment vehicle. When charting the performance of cash compared to inflation and the stock market, there is a clear winner. And although there are times when cash can outperform inflation, it ultimately doesn’t keep pace with it, meaning that cash saved becomes worth less over time (rather than growing in value). In fact, this is such an issue that the Financial Conduct Authority (FCA) have even issued guidance to investors over concerns that they are holding too much in cash in their portfolios .[4]

[3] https://www.worldbank.org/en/news/press-release/2023/10/26/commodity-markets-outlook-october-2023-press-release



The other factor to consider is what will happen when the Bank of England cuts interest rates. This is a certainty as the bank will look to boost economic growth again in the future.

Although there was small movement in 2016 and 2020, the last time the Bank of England meaningfully cut interest rates to boost economic growth was in January 2008, as the base rate started its move down from 5.75% to just 0.50%, where it would stay for almost 8 years. Even from 2016 to 2021, the rate cycled between highs of 0.75% and lows of 0.10%, a savers nightmare.

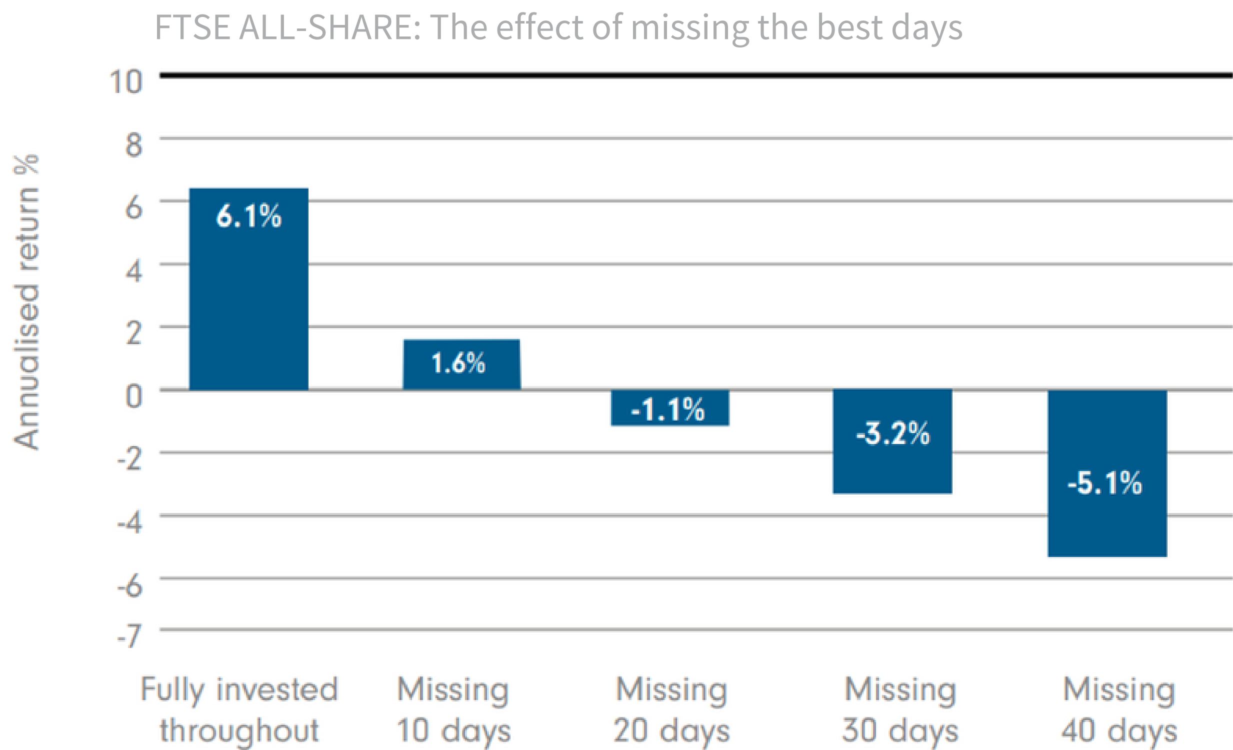
In 2003, the Bank of England gradually increased rates from 3.50% to 5.75% across the course of 4 years. The latest hiking cycle was completed in just 14 months and rates soared from just 0.10% to 5.25%, one of the fastest increases ever. Could the same be true for when the bank cuts interest rates? Perhaps, but one thing is for sure: the modern-day rate of change appears to be much faster than ever, owing to electronic trading and a globally connected economy.

So, savers could be caught short when the tide turns and the Bank of England changes tact and outside of tactical guesswork, the long-term trend shows that investing beats saving, by along way.

[4] https://www.ftadviser.com/regulation/2022/12/01/fca-tells-providers-to-warn-pension-holders-of-inflation-impact/

When doing nothing is best

Investment firm Fidelity is well-known for its piece entitled ‘When doing nothing is best’. As markets go through periods of volatility, they tend to be short-lived. Fidelity highlights how easy it is to miss the best days gains when trying to time the stock market and say that time, not timing, is the key to investing. They analysed the average annual return from the UK stock market over the last 15 years. As the chart shows, missing just the 10 best days over this period would have cut returns substantially:



Source: Refinitiv Data from 29/08/2008 to 31/08/2023 based on the annualised total return of the FTSE ALL_SHARE in GBP Termes.

Cash can seem an attractive investment at various points in the cycle, but the opportunity cost could be huge if it comes at the expense of missing the best days that the stock market has to offer.

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