

MARKET INSIGHT

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IMPACT OF MIDDLE-EAST TENSIONS ON ASIA

Risk assets have had a choppy start to the year with the escalation of the conflict between the US and Iran pushing oil prices higher. This development could negatively impact our outlook for Asian markets. Most countries in Asia are net oil importers, and higher energy prices not only impact discretionary consumption, but also leads to a deterioration of the trade balance and increases inflation, putting local currencies under selling pressure. This, in turn, forces Asian central banks to keep interest rates higher than they would otherwise have liked to defend the currency.

COMPARISON WITH SEPTEMBER'S SAUDI DRONE ATTACK

One of the reasons why we are positive on Asia for 2020 is because of our view that oil prices will range trade, but be capped on the upside. This thesis has to be re-evaluated in light of recent developments in the Middle East. In this regard, guidance could be taken from last September's drone attack on Abiqaiq, Saudi Arabia's largest oil production facility, which knocked out 5% of global oil supply. Oil prices initially surged over 20% in the immediate aftermath, but quickly reversed once it was determined that there was ample oil supply globally to take up the slack. A key reason for the quick adjustment is the fact that the development of the shale industry in North America has diversified global supply, helping to provide a buffer to stabilise energy prices.

US LOW APPETITE FOR WAR

Hence, the key question to answer is how much worse the US-Iran conflict could get, and whether it could materially knock out oil supply in the Middle East for a more sustained period. In our opinion, this would only materialise if a full-scale military conflict breaks out, stopping all exports from the Persian Gulf. Looking at it from the US perspective, such an escalation would mark a reversal of the current policy direction which has been to reduce US military presence in the region. The US' interest in protecting oil assets and maintaining peace in the Middle East has arguably diminished in recent years as the US has become self-sufficient in energy. After several failed campaigns in the region, the US appetite for war is also low, and it would take a brave President to go to war in a US presidential election year, though with President Trump, you cannot totally discount the possibility!

IRAN ALSO SEEKING TO AVOID WAR

Similarly, Iran would also rather avoid open conflict. Iran's modus operandi to increase its sphere of influence in the region has been to put in place proxies in various neighboring countries to do its bidding. The founding and continued funding of Hezbollah in Lebanon is just one example of how Iran has created the so-called "Shiite Crescent". Could Iran be pushed to take more assertive action as domestic unrest increases due to the effects of

economic sanctions? Ultimately, the leaders in Iran are pragmatic and recognise that it cannot win a conventional war against the US and its allies. Hence, Iran is likely to bide its time and continue to use covert operations to achieve its goals.

This all means that while tensions between the US and Iran should probably recede in the short-term, as with Brexit and the US-China trade war, this is merely a lull in proceedings and that there is every likelihood that this conflict will be ignited again in the near future.

STILL POSITIVE ON ASIA, BUT BE SELECTIVE

The low probability of a full-scale conflict in the Middle East suggests that our positive outlook for Asia can be maintained for now. Accommodative central bank policy, a greenback whose strength is likely capped, the signing of the Phase-One trade deal between the US & China, and the moderate improvement in economic growth globally, are all supportive factors that will help to support Asian markets. Investors concerned about the risk of oil prices potentially spiking, however, may want to be more selective in their exposure and avoid investing in countries like India, which is the Asian country most vulnerable to higher oil prices.

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