CAPITAL CREEK STRATEGY REPORT– OCTOBER 2023

Israel at War

Investment Implications from the Middle East Conflict

Scott T. Slayton, CFA

About Scott

Partner, Chief Strategist

Scott is a partner of the firm and Chief Strategist. Before joining Capital Creek, Scott was the Head of Asset Allocation at UTIMCO, where he served on the firm's Management, Investment, and Risk Committees. Scott has 35 years of investment experience as a strategist, portfolio manager, and asset allocator. Scott spent most of his career in New York, working at Kidder Peabody, Morgan Stanley, and Tudor Investments. Scott studied at the University of Texas at Austin, where he received a BBA in finance in 1988. Scott is also a Chartered Financial Analyst, CFA.

About Capital Creek Partners

A Private Investment Firm, Founded by Families.

We are an investment partner organized to serve the needs of family offices, foundations, endowments, and private investment companies. Established in 2018, Capital Creek Partners was founded as a boutique multi-family office to serve a small number of prominent families. Our firm's culture is rooted in *Integrity, Humility, and Excellence*.

CAPITAL CREEK PARTNERS

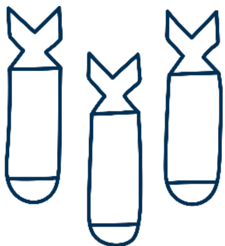
"Highly Confidential. This presentation is provided for informational purposes only and does not constitute investment advice, tax advice, a recommendation, or an offer of solicitation. CCP does not represent that the information contained herein is accurate or complete, and it should not be relied upon as such. Opinions expressed herein are subject to change without notice. Certain information contained herein (including any forward-looking statements and economic and market information) has been obtained from published sources and/or prepared by third parties and in certain cases has not been updated through the date hereof. While such sources are believed to be dependable, CCP does not assume any responsibility for the accuracy or completeness of such information. CCP does not undertake any obligation to update the information contained herein as of any future date. Any projections, targets, or estimates in this presentation are forward-looking statements and are based on CCP's research, analysis, and assumptions made by CCP."

"Middle Eastern wars rarely stay in the Middle East."
Thomas Freidman

Hartford, CT - October 13, 2023

We are shocked and horrified by the senseless violence that was visited on the State of Israel beginning on October 6th, 2023. Our thoughts and prayers are with those who have been impacted by this tragedy. Beyond the humanitarian disaster, major geopolitical developments are relevant to global financial markets, and so, as strategists, we are compelled to attempt to analyze how these events in the Middle East may impact prices, volatility, and investment flows across assets.

The global complexities of war



Wars are unpredictable and often morph into much more complicated and long-lasting affairs. The ongoing Russia/Ukraine war is a prime example of this concept. Military history is replete with examples of wars that started out contained but ultimately spread to involve multiple parties. The other fact we know from history is that wars tend to last longer than most participants or analysts expect at their onset. Unfortunately, the modern tendency has been for major conflicts to grind on into "forever wars." This historical fact is especially true for proxy wars with well-funded backers on both sides. The American involvement in Vietnam from 1958 through 1975 is a prime example. Will the Hamas-inspired attack on Israel remain contained to Israel and Gaza, or will it spread to involve Lebanon and Syria by way of Hezbollah joining the fight? Will Iran become directly implicated in helping Hamas launch its attack? Will the war turn into a proxy war pitting Iran, Russia, and possibly China against the U.S., Israel, and other Western democracies? These are the key questions, and market direction could hinge upon the answers.

War-driven inflation

Wars, by their very nature, are inflationary. The world has an inflation problem, which is impacting most major countries except for China. At the margin, this new war could result in higher rates of inflation, especially for the countries that may become involved. If the war escalates, it could materially impact global central banks in their ongoing fight against inflation. The key transmission mechanism would be via the price of crude oil. If Iran becomes directly involved in this conflict, we could see oil prices explode higher. In an eerie echo from fifty years ago, Iran has now called for an oil embargo against Israel. The good news is that OPEC does have spare capacity, as does North America. Higher oil prices will bring on

additional supply, but there could be a dicey period where oil prices remain well above $100 per barrel. We know that energy prices have an outsized impact on inflationary expectations in developed economies such as the U.S. and Europe. Higher energy prices could also present a major headwind for President Biden's re-election campaign, adding to future policy uncertainty. The U.S. Strategic Petroleum Reserve has been run down to its lowest levels in forty years. This key reserve may now provide little cushion in the event of a true energy crisis.

U.S. funding challenges

Can the U.S. fund two major wars on different continents simultaneously while running massive budget deficits and lacking a functional Congress to pass spending bills? The debt downgrade by Fitch was dismissed by Treasury Secretary Yellen as inconsequential, but it did refocus markets and U.S. adversaries on the unsustainable U.S. fiscal trajectory. The paralysis in the U.S. House of Representatives further highlights U.S. political dysfunction and emboldens U.S. adversaries. Lacking a Speaker of the House could become a serious hurdle to passing even a Continuing Resolution to fund the government beyond November 17th. Both Ukraine and Israel will need additional funding from the U.S., and the bond market may be less willing to take down the additional U.S. paper without higher interest rates. The bond vigilantes are back with a vengeance, and their reward is higher interest rates on longer-duration U.S. Treasury paper. In my view, risk assets are bound to struggle in the face of even higher long-term interest rates.

Iran's involvement in Gaza

There are conflicting reports about the level of involvement by Iran in this tragedy. The Wall Street Journal came out quickly with a detailed article about Iran's direct involvement in supplying, strategizing, and giving a "green light" to Hamas to attack. However, the White House is strongly denying the story and claiming that there is no clear evidence of Iran's direct involvement. The Administration appears to be working hard to prevent this conflict from escalating beyond the Israeli and Gaza borders. The entire world (outside of Russia) has strong incentives not to let this conflict spread throughout the Middle East and become another major proxy war. I am reluctant to place probabilities, but the risk of the conflict spreading is still material, in my opinion.

China, Russia, and Iran

The emerging Beijing, Moscow, and Tehran alliance is formidable and will be implicitly backing Hamas and Hezbollah. So far, the backing has been silent and not overt. If this changes, watch out because we could be headed down the wrong path toward another major conflict. The good news is that China, Russia, and Iran are all facing economic difficulties that do not look to be resolved anytime soon. Another proxy war would only add to their difficulties. The US economy is already contending with high inflation, high-interest rates, an inverted yield curve, negative leading economic indicators, a commercial real estate recession, and the return of student debt payments. Another major war demanding heavy U.S. involvement could shock the US consumer and be the straw that breaks the current post-Covid economic expansion's back.

Monitoring the markets for conflict impact

I am watching the dollar, oil, gold, U.S. Treasury bond, and equity markets for direction near-term. Markets can be good leading indicators for where future conditions are headed. The dollar is flat since the war started, while 10-year U.S. Treasury bond yields continue to soar to new cycle highs above 4.90%. This is odd behavior for the world's two premier safe haven assets, which have historically rallied on serious geopolitical tensions. Gold, another haven asset, has surged by 7.2% since the start of the war on October 6th. The global benchmark, Brent Crude Oil, is also up over 8% since the beginning of the conflict. Additional risk premium is being built into the oil price as markets must discount some increased likelihood that Iran becomes more overtly involved in the conflict. The S&P 500 Index appears to be discounting the war remaining contained as it now trades 2.3% higher than when the conflict began. To sum up, asset prices have moved relatively modestly so far, and the message seems to be that this conflict has a good chance of remaining contained within Israel/Gaza. My belief is that global equity markets will likely buckle if the Israeli ground invasion goes badly and the war expands significantly.

The 1973 Yom Kippur War

The 1973 Yom Kippur War analog warns of a potential delayed negative reaction for equities. I went back to study the S&P 500 Index price action during the 1973 Yom Kippur War, which occurred exactly fifty years before the recent Hamas attack on Israel (see Exhibit 1). The 1973 war was distinct in containing numerous state combatants allied against Israel. These included mainly Egypt and Syria, but also included Saudi Arabia, Morocco,

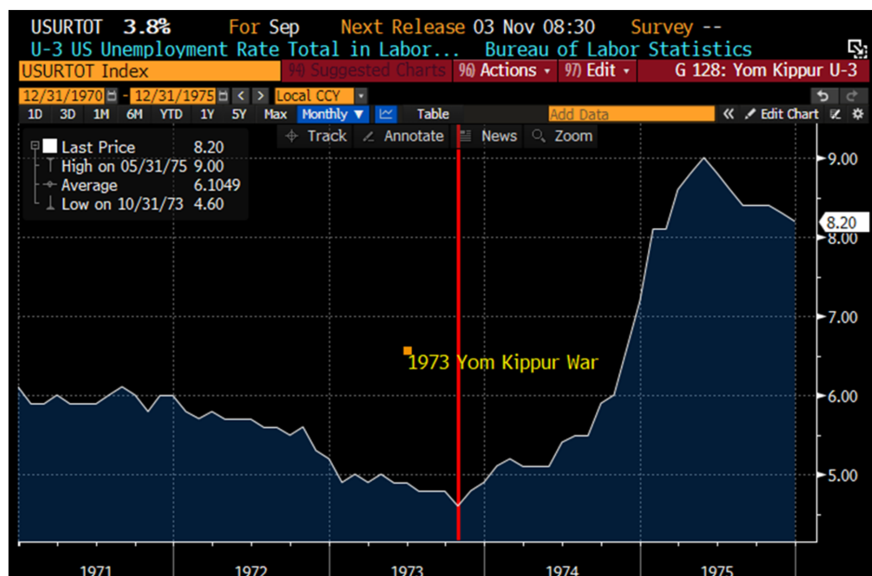
Iraq, and Jordan. Virtually the entire Arab League was unified against Israel. The former Soviet Union, Cuba, and North Korea overtly backed the Arab countries, while the U.S., Canada, and Japan decisively backed Israel. The current war is very different, with Hamas attacking Israel with apparently far less pan-Arab support, both militarily and politically. However, the 1973 S&P 500 analog does give us some sense of what could happen if the war begins to spread. The SPX was flat to up during the first two weeks of the war and then plunged over 17% in a month as oil prices began to surge higher on the Arab oil embargo that was used to punish the U.S. and other countries for supporting Israel during the war. Oil prices more than tripled in six months, and the U.S. economy plunged into a deep recession in 1974, along with sharply rising unemployment (see Exhibit 2).

Exhibit 1: 1973 Yom Kippur War SPX analogue

Source: Capital Creek Research, Bloomberg

Exhibit 2: U.S. unemployment rate soars on war PI oil embargo

Source: Capital Creek Research, Bloomberg



The new investment era

The Israel/Hamas war is another brick in the wall against free market "globalization." It underscores our view that we are in a new investment era where Great Power countries are more focused on politics and national security than they are on growth and corporate profits. In our view, the geopolitical risk premium for global equity markets just went up another notch. At the margin, the Israel/Hamas war makes us more cautious toward equities and reinforces our tactical underweight toward the equity asset class. In the current environment, we continue to favor cash, Treasury Inflation Protected Securities (TIPS), and private credit. All three asset classes should provide positive real returns irrespective of the path of equities.