Market Insights
April 2024

MFS EMD Team Views on the Situation in the Middle East

The current geopolitical environment in the Middle East remains tense. The situation in Gaza remains a humanitarian disaster that continues to fuel tit-for-tat attacks between Hezbollah and Israel along the northern Israeli border with Lebanon as well as attacks on Red Sea shipping by Houthi rebels in Yemen. Both Hezbollah and the Houthis receive support from Iran and are considered proxies for the Iranian regime. Israel and Iran have been engaged in a low-level conflict for some time. This "war in the shadows" recently became more overt and dangerous with Israel's targeted bombing of an Iranian diplomatic building in Damascus, killing a high-ranking Islamic Revolutionary Guard Corp general and other senior officers. This act precipitated a retaliatory attack on Israel from Iran. Neither country appears to want to escalate their conflict, but both nations have both domestic political and military reasons for not wanting to appear weak. More broadly, other countries in the region have a variety of reasons for wanting a cease-fire in Gaza, followed by a political framework that provides some path for a longer-term solution to Palestinian aspirations for self-governance and a state. Many of these governments must contend with populations that are more sympathetic to the Palestinian cause than are the governments themselves (all of which are unelected). Jordan's Hashemite monarchy rules over a large Palestinian population that it seeks to placate while also maintaining a constructive relationship with Israel. Some Gulf governments have normalized relations with Israel and, given normalized relations with Iran, are playing a part in diplomatic efforts to urge Iranian de-scalation. Egypt's government has sought to balance its population's anger towards Israel's heavy-handed retaliation in Gaza for the October 7 attacks by Hamas with its desire to play a constructive role in some sort of resolution of the broader Palestinian issue. The West, and China in a more limited way, is seeking to limit escalation in the region.

Where does this complicated, multi-faceted Mideast landscape leave our positioning? Broadly speaking, we are underweight the region. We had reduced our exposure in Israel before October 7 given the extremist nature of the Netanyahu government and the risks to stability that it posed both internally and externally. Post October 7, we further reduced remaining positions in Israel but also reduced positions in the region more broadly where political and security risks didn't appear to be adequately discounted by the market. We took down Jordanian bond positions, for example, since market prices don't reflect the complicated risks of a country that borders the West Bank — not to mention Syria and Iraq — and has a large Palestinian population angered by Israeli actions in Gaza and the West Bank, and would almost certainly feel the spillover effect of any broader regional conflict. We've had no exposure to Lebanon for some time, given the country's political dysfunction and economic deterioration. The Gulf petrostates trade at very tight levels (between 40 to 80 basis point spreads to US

Treasuries) and, while they might benefit from the higher oil prices arising from increased regional tensions, they are also vulnerable to the spillover effects of a more wide-spread crisis. In our view, the risk/reward attributes of these countries' bonds are relatively unattractive. Egypt is the one country in the region where we have increased our positions. This is due to the government's recent commitment to meaningful adjustment measures and reforms supported by a new IMF program, expanded funding by other multilateral and bilateral lenders as well as new and substantial investments by key Gulf countries. The Sisi government appears to have adroitly used the crisis in Gaza and its criticism of Israeli actions to distract and placate (to some extent) a population that is feeling the economic pain associated with past misguided policies and now current corrective measures. Of course, given Egypt's poor record of sticking to reforms, we are carefully monitoring this situation.

The risk of a broader Mideast crisis has broader global implications that we factor into our portfolios. The higher oil prices resulting from Mideast tensions (as well as other factors) have informed broader portfolio exposures, incrementally favoring certain oil exporters outside the region as well as being a considering factor in certain oil importers with already fragile credit metrics. A major Israeli/Iranian conflict (not our base case, but a possibility) would roil global markets, generally. Towards that end, we did buy some relatively low-cost insurance via out-of-the-money put options in order to provide some broad portfolio offset to a meaningful market sell-off.

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