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When I wrote my commentary last week, we were breathing a sigh of relief because the United States was able to avoid a government shutdown. But today, the near-shutdown is far in the rearview mirror — the Israel-Hamas War has shocked the world and brought geopolitical risk to the forefront of the global conversation.

## Two paths to consider in the Israel-Hamas War

Over the weekend, Hamas launched a surprise attack on Israel, killing civilians and taking hostages, in what seems to be a reaction to the Israel-Saudi peace plan that is in the works. Israel has declared war and appears to be preparing for a wide-scale invasion of Gaza. Part of the Israel-Saudi peace deal was a pre-condition of Israeli concessions to Palestinians. This seems unlikely to happen in the current environment, which suggests the peace deal may be derailed. The Wall Street Journal has reported that Iran was involved in Hamas' attack; if this is confirmed, that risks other countries being pulled into the conflict.

There are many possible ways this crisis can evolve from here, but for the purposes of simplicity, I would suggest two possible paths for macro/market observers to consider: 1) the situation remains contained, or 2) other countries join the conflict.

- **If the situation remains contained**, we can look to the 2014 Gaza war for some historical perspective on what could happen going forward. That war was very short-lived (it spanned July and August of 2014) and had a temporary negative impact on retail sales that rebounded once the war ended. In this scenario, the price of oil is likely to rise modestly, as is often the case when Middle East geopolitical risks rise. I would also anticipate the price of gold to rise somewhat, and for US Treasury yields to fall slightly as investors show a mildly increased preference for "safe haven" asset classes. In this environment, based on the stock market performance we saw during and after the Gaza War, I would not anticipate any material negative impact to US stocks or even global stocks beyond the short term.
- **If the situation is not contained and other countries join the conflict**, the ramifications could be far worse — likely more similar to the Yom Kippur War of 1973. This would be a significant "risk off" environment as Iran's oil production comes under scrutiny. In recent months, Iranian oil production has increased substantially, and the US and other governments have turned a blind eye because it has eased price pressures caused by OPEC+ production cuts. This would likely not continue, which would place more significant upward pressure on oil prices. And if Iran were to become directly involved in the war, it could impact the flow of Gulf exports because of its proximity to the Strait of Hormuz. Gold prices and US Treasury prices would likely rise more substantially than in the first scenario as investors flock to 'safe haven' asset classes. In this scenario, I wouldn't be surprised to see a sell-off in global stocks and even US stocks.



## Israel-Hamas War

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## "Dot plot" fears

The September "dot plot" from the Federal Open Market Committee triggered fears that the US Federal Reserve would keep interest rates "higher for longer."

## "Golden Week" dims

China's "Golden Week" holiday — which usually sees a strong boost in tourism spending — saw better but less-than-expected results, underscoring China's uneven economic recovery.

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Now Treasury yields could rise if we see a significant resurgence in inflation caused by the events in the Middle East, but it seems unlikely that we would see a major impact to global inflation. First, the real price of oil is already elevated, and it is hard to imagine anything like a tripling from today's level (in 1973, prior to the Yom Kippur War, West Texas Intermediate oil was around \$28 a barrel in today's prices<sup>1</sup>), the global economy is far less oil intensive than it was at that time, suggesting the inflationary impact of any oil price rise is now proportionately less.

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### Markets react to “higher for longer” fears

In other news, the further rise of long bond yields is also worrying investors. The September “dot plot” from the Federal Open Market Committee (FOMC) triggered fears that the US Federal Reserve would keep interest rates “higher for longer,” which in turn placed upward pressure on long bond yields. Recent better-than-expected US economic data has added to that upward pressure on yields, resulting in downward pressure on stocks.

However, as I have said before, it appears markets are overreacting to the dot plot and the data. That's because:

- **The Fed's dot plot can be very inaccurate in its predictive abilities.**  
As I've mentioned before, the December 2021 dot plot anticipated a median fed funds rate of 90 basis points at the end of 2022. Instead, we got a fed funds rate of 440 basis points at the end of 2022.
- **The disinflation narrative continues.** Yes, US economic data has been quite strong, but we continue to see data that supports our disinflation narrative. For example, the US jobs report for September<sup>2</sup> positively surprised, with far higher non-farm payrolls than expected (336,000 jobs were created). August non-farm payrolls were also revised upward materially. However, average hourly earnings were tame at 0.2% month-over-month and 4.2% year-over-year. (By way of comparison, Canada's jobs report for September also showed a much larger job gain than expected. But unlike the US, average hourly earnings were hot at 5.3% year-over-year, up from 5.2% in August.<sup>3</sup>) Further, other employment data suggests a less robust US labor market. The Institute for Supply Management's non-manufacturing survey weakened, including the employment component, and the ADP number was also a lot weaker. And the US economy is likely to moderate from here as excess savings are depleted and the lagged effects of monetary policy tightening materialize.
- **The copper/gold ratio suggests interest rates may peak.**  
Historically, there has been a strong relationship between the 10-year US Treasury rate and the copper/gold ratio — an economic indicator that divides the price of copper (which is driven by industrial demand) by the price of gold (which is seen as a “safe haven” asset). Interest rates and the copper/gold ratio have tended to rise in tandem and vice versa. But recently, a divergence has emerged. The copper/gold ratio has generally been declining, likely in expectation of upcoming weaker economic growth, while rates have spiked. This trend may be suggesting that interest rates may soon be nearing a peak.
- **Yields have tended to ease quickly after tightening ends.** It is important to note that in recent history, the 10-year US Treasury yield has typically been quick to ease following the end of the tightening cycle. History suggests that even if the yield on the 10-year US Treasury moves higher, it is unlikely to remain there for long. We expect elevated bond yields of 4.5% to more than 5.0% to be a temporary phenomenon.

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- **High rates are pressuring US debt servicing costs.** One aspect of higher yields that remains largely undiscussed is the impact on the US federal budget. Debt servicing costs have risen dramatically, becoming a very large line item among expenditures. Clearly the FOMC recognizes this, and likely doesn't want to see it continue for a significant portion of time, given its impact on the economy. While the economists Carmen Reinhart and Kenneth Rogoff published an exhaustive treatment of the impact of debt on economic growth (not surprisingly the higher the level of debt, the more downward pressure on economic growth), in my opinion they didn't give enough attention to the impact of rising rates, which I think is just as critical an issue in terms of the pressure on economies. The rise in debt over the last decade has not had a significant impact because rates were so low. Now it is becoming a source of real stress.

Finally, I take comfort from comments made by San Francisco Fed President Mary Daly last week. She conceded to the reality that the rise in the 10-year US Treasury yield is doing the Fed's work for it, which suggests the Fed can now be more dovish: "the need for us to take further action is diminished because financial markets are already moving in that direction and they've done the work. We don't need to do it more."<sup>4</sup>

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### Mixed economic data from the eurozone and China

Investors are also concerned about the health of various economies in the face of a global central bank-induced slowdown:

- **The eurozone:** Eurozone unemployment data improved for September, but Purchasing Managers' Index (PMI) data was mixed. The S&P Global Manufacturing PMI clocked in at 43.4, down slightly from 43.5 in August, marking the 15th consecutive month in contraction territory. The S&P Global Services PMI was 48.7, up from 47.9 in August but still in contraction territory.<sup>5</sup>
- **China:** The "Golden Week" extended holiday — which usually brings a boost in tourism spending — saw tourism increase significantly, but not as much as had been hoped for.<sup>6</sup> This underscores China's uneven economic recovery. In addition, the World Bank cut its 2024 growth forecast for China, from 4.8% to 4.4%, because of elevated debt levels and headwinds in the property sector.<sup>7</sup>

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### Dates to watch

Looking ahead, some of the most-watched data points this week will be the US Consumer Price Index (CPI), German industrial production, and German CPI. I will also be interested in the FOMC minutes, which will be released later this week.

Date	Report	What it tells us
Oct. 9	German Industrial Production	Indicates the economic health of the industrial sector.
Oct. 11	Minutes from September FOMC meeting	Gives further insight into the FOMC's decision-making process.
Oct. 11	German CPI	Tracks the path of inflation.
Oct. 12	US CPI	Tracks the path of inflation.

*With contributions from Brian Levitt and Paul Jackson*

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## Notes

<sup>1</sup>Source: Global Financial Data, Refinitiv Datastream, and Invesco Global Market Strategy Office

<sup>2</sup>Source: US Bureau of Labor Statistics, Oct. 6, 2023

<sup>3</sup>Source: Statistics Canada, Oct. 6, 2023

<sup>4</sup>Source: Reuters, "Fed officials largely sanguine about rise in US bond yields," Oct. 5, 2023

<sup>5</sup>Source: S&P Global/HCOB PMI Surveys, Oct. 2 and Oct. 4, 2023

<sup>6</sup>Source: CNBC, "China's domestic tourism is finally back to pre-pandemic levels," Oct. 9, 2023

<sup>7</sup>Source: The Wall Street Journal, "China's Economy Likely to Slow in 2024 as Headwinds Persist, World Bank Says," Oct. 2, 2023

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## Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector.

Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest. show less

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

The Eurozone (also known as the euro area or euroland) is an economic and monetary union of 18 European Union member states that have adopted the euro (€) as their common currency.

The federal funds rate is the rate at which banks lend balances to each other overnight.

Inflation is the rate at which the general price level for goods and services is increasing.

Tightening monetary policy includes actions by a central bank to curb inflation.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

PMI (formerly Purchasing Managers Index), a commonly cited indicator of the manufacturing sectors' economic health, is calculated by the Institute of Supply Management.

The Institute of Supply Management (ISM) non-manufacturing survey is an economic index based on surveys of non-manufacturing (or services) firms' purchasing and supply executives.

The ADP National Employment Report measures nonfarm private payrolls. It is published monthly in collaboration with Moody's Analytics.

West Texas Intermediate (WTI) is a type of light, sweet crude oil.

OPEC+ refers to the 13 members of the Organization of Petroleum Exporting Countries (OPEC) and 10 other oil-exporting non-OPEC members.

A basis point is one hundredth of a percentage point.

The opinions referenced above are those of the author as of October 9, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.