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The war in the Middle East takes a turn for the worse

By Angelo Katsoras

Following the October 7 attack on Israel by Hamas, we have witnessed a steady intensification and expansion of the conflict in the Middle East in the following order:

- Israel responded with airstrikes and an invasion of the Gaza Strip.
- Hezbollah and the Israeli army have regularly exchanged heavy fire along the Lebanese border.
- Houthi rebels began targeting maritime traffic in the Red Sea, prompting U.S. and British naval and air forces to strike their bases in Yemen.
- Israel has intensified its bombing of Iranian military installations in Syria and Lebanon. Iran financially supports and arms Hamas, Hezbollah and other regional militias hostile to Israel.
- Repeated attacks on U.S. military bases in Syria, Iraq and Jordan have resulted in numerous injuries and three deaths. The United States has carried out significant retaliatory strikes in response.

On April 1, tensions escalated dramatically when Israel destroyed an Iranian consulate building in Damascus, killing Brigadier General Mohammad Reza Zahedi, a senior Islamic Revolutionary Guard commander, and several other senior officers.

On April 13, Iran retaliated with direct missile and drone attacks on Israel. Although Iran signaled its intentions well in advance, giving Israel and its allies ample time to bolster their defences and avoid casualties, the operation broke the long-standing rule of engagement that direct large-scale military attacks on their respective countries were to be avoided. This event marks a dramatic shift in strategy and increases the likelihood of direct military confrontation between the two sides.

How will Israel respond?

Israel could heed the advice of the United States to refrain from hitting Iran directly and, instead, continue to target Iranian-backed militias. For instance, immediately after the attack, Israeli forces responded by bombing a Hezbollah weapons manufacturing facility. However, early indications are that the Israeli government is considering a more direct strike.

Potential targets include the missile base used by Iran for its attacks, arms manufacturing facilities, or energy-related infrastructure. Announcing the attack in advance, as Iran did, could help limit casualties. However, as this would constitute Israel's first direct attack on Iran, it could be perceived as an escalation by Iran and provoke a counterstrike.

This, in turn, could draw the United States further into the conflict by continuing to help Israel intercept Iranian missiles and drones. This would also increase the risk that its military bases would again be targeted by missile and drone attacks by Iranian-backed militias.

What about the oil sector?

While there have been disruptions to shipping in the Red Sea owing to attacks by Iranian-backed Houthis, these incidents have not yet had a significant impact on oil shipments. However, there is a risk that Iran could partially block traffic through the Strait of Hormuz by stopping certain oil-carrying vessels bound for the West. This, in turn, would force the United States and its allies to patrol both the Red Sea and the Strait of Hormuz.

If oil prices were to rise significantly as a result, inflation could remain higher for longer, thus delaying rate cuts by the Federal Reserve.

Bottom line: Even if the Israeli response is considered restrained, it would continue the trend of increasingly aggressive tit-for-tat responses that is already smudging the red line which, if crossed, would lead to a sustained, direct conflict between Iran and Israel. The longer the war in Gaza drags on, the greater the risk that this scenario will play out. This would not be good news for the global economy and financial markets.



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