

DoubleLine Statement on Israel-Hamas Conflict/War

October 13, 2023



On October 7, 2023, the Palestinian militant group Hamas launched a surprise attack on Israel from its base in the Gaza Strip, posing the most significant security challenge to Israel in recent history. The attack was unprecedented in scale and scope, involving an incursion of armed militants across the border by land, air and sea under the cover of a barrage of thousands of rockets launched from Gaza. At the time of this writing, militants infiltrated towns and communities across southern Israel, killing over 1,300 Israelis and taking more than 100 people as hostages back to Gaza, according to news and official reports. Over 1,350 Palestinians have been reported killed in retaliatory attacks so far.

With the ongoing fighting to resecure Israeli territory and conducting retaliatory airstrikes on Gaza, the Israeli Defense Forces is preparing for the next phase of its response, which is likely to involve a broader air and ground operation. The conflict is certain to escalate and needs to be monitored for its impact on global markets. The risk is that the conflict expands to multiple fronts along Israel's border and/or across the region, particularly to Iran, could have wider impacts and requires monitoring.

To that end, we are focused on the following issues:

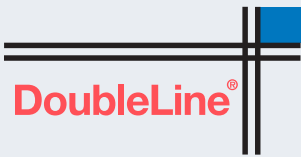
What will be the extent of the Israeli response?

What is the risk that the conflict expands to multiple fronts (e.g., the West Bank, Lebanon, Syria)?

What is the potential for the conflict to expand to involve Iran?

What is the outlook for Israel's economy and domestic politics?

What is the potential impact on global markets, particularly for energy?



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What will be the extent of the Israeli response?

Israel is likely to launch an extensive ground invasion of the Gaza Strip in coming days or weeks, marking a significant escalation of the conflict. While Israel has not publicly stated that it will send ground troops into Gaza, senior Israeli officials have warned that Israel will significantly expand its initial airstrike response. Israel has since ordered a “complete siege” of Gaza and has cut off supplies of water, food, fuel and electricity to the territory. It has also called up more than 300,000 military reservists and is reportedly building a base next to the Gaza border to accommodate tens of thousands of soldiers in preparation for further military action. The operation will likely be more extensive than previous ground invasions of Gaza in 2007 and 2014, as Israel will feel the need to respond aggressively given the severity of the Hamas attack, suggesting that the conflict will be prolonged and involve mass casualties. As a point of reference, the 2014 incursion lasted seven weeks and led to more than 2,000 Palestinian deaths and 66 Israeli deaths.

The initial goals of the Israeli military response will likely be to degrade Hamas’ infrastructure and military capabilities, re-establish deterrence and showcase Israeli military strength. It is not yet clear if Israel will pursue additional objectives, including a possible attempt to remove the Hamas leadership from governing Gaza, where it has ruled since 2007, and/or attempt to temporarily reoccupy the territory (Israel withdrew from its formal occupation of Gaza in 2005). A permanent occupation is unlikely given the well-understood difficulties involved in administering over an extremely dense, urban territory of more than 2 million people, most of whom would be hostile to an Israeli occupation. The pursuit of these additional objectives would likely prolong the conflict by many months.

The presence of over 100 reported Israeli hostages taken to Gaza complicates Israel’s ability to conduct a full-scale invasion and points to the possibility of a multiphased approach. Hamas likely plans to use the hostages to deter Israel from launching a full-scale invasion and/or from eliminating Hamas leadership. Israel, which has a long track record of prioritizing the recovery of hostages (often paying a high price in prisoner exchanges) might choose to engage in hostage negotiations as a first step to retrieve as many hostages as possible. Israel has said it is not negotiating for hostages, but recent reporting has suggested that external mediators, possibly Egypt, the United Arab Emirates or Qatar, have started reaching out to facilitate a potential prisoner exchange. Any negotiation process could delay a full ground invasion. The airstrike campaign is likely to intensify before the invasion to reduce risks soldiers might encounter on the ground.

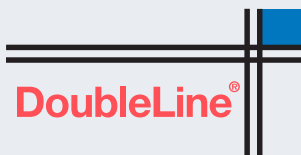
What is the risk that the conflict expands to multiple fronts (e.g., the West Bank, Lebanon, Syria)?

The risk that the conflict expands to multiple fronts along Israel’s borders is heightened. Various militant groups in neighboring Lebanon and Syria that are aligned against Israel, particularly Hezbollah, could use the current conflict to launch their own attacks. The risk from Hezbollah is particularly concerning because of the group’s reported large cache of precision-guided rockets that allegedly have the capability of reaching deep into Israeli territory. The risk is heightened by the potential for coordination among militant groups, given that many are actively backed by Iran. However, it is far from clear that Hezbollah would want to get involved at this stage in the conflict, as it might choose to preserve its military capability. As of writing, Israel had engaged in several episodes of limited artillery and rocket exchanges with militants in Lebanon and Syria at the start of the conflict. While clashes between Israel and Hezbollah on the borders with Lebanon and Syria are likely to continue, this activity appears somewhat contained so far.

The combination of Israel’s buildup of troops along its borders and a renewed commitment from the U.S. to boost support for Israel is intended to deter other militant groups from launching large-scale attacks. The U.S. said it was “surging” its support to Israel in the wake of the attack, including in the areas of air defense capabilities and munitions, and expediting shipment of military equipment. It also took steps to bolster its presence in the region, sending the USS Gerald R. Ford Carrier Strike Group to the eastern Mediterranean and adding fighter aircraft to local squadrons.

Despite the deterrence measures, the risk of attacks from other militant groups will require monitoring throughout the various stages of this conflict. An important flashpoint will be the anticipated invasion by Israel into Gaza, which could trigger a Hezbollah response. A worsening of the conflict over time, especially in the case of increasing casualties and extensive destruction in densely populated Gaza, could also prompt a response as the conflict evolves.

It will also be important to monitor the potential for a violent uprising in the occupied West Bank, where the Palestinian Authority has lost significant control of the security situation to the growing influence of militant groups. The West Bank, which has already experienced its bloodiest year in 2023 since the second intifada with more than 200 Palestinians killed, mainly in clashes with Israeli security forces, is particularly vulnerable.



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What is the potential for the conflict to expand to involve Iran?

It is possible that evidence will eventually emerge that directly links Iran to the Hamas attack, but an immediate conflict is unlikely. It is widely acknowledged that Iran has been and continues to be an active backer of anti-Israel militant groups across the region, including Hamas and Hezbollah, having provided them over many years with financial support, weapons and training. Meanwhile, recent media reports are alleging, with an uncertain level of credibility, various degrees of Iranian involvement in Saturday's attacks. However, Iran has denied any direct involvement, and neither Israel nor the U.S. has definitively implicated Iran. In the short-term, Israel is focused on the security crisis in Gaza; eliminating the threat from Hamas; and preventing an expansion of the conflict to multiple fronts, which could stretch its resources. An assessment of potential Iranian links is likely to come later. The U.S. seems intent on avoiding an expansion of the conflict to Iran in the short term, having acknowledged Iranian support for Hamas but saying that it has yet to find any evidence of direct Iranian involvement in the Hamas attack.

If evidence emerges directly linking Iran to the Hamas attack, the revelation could lead to a potential conflict with Iran, the nature and severity of which is uncertain. Israel could choose to retaliate by intensifying its ongoing "shadow war" in Iran, which has involved sabotage of infrastructure, cyber warfare, and assassinations of key security and scientific personnel. A more severe response involving targeted airstrikes on infrastructure and/or nuclear facilities would likely require U.S. involvement. There would likely be domestic pressure for the U.S. to tighten sanctions and/or join Israel in a military response.

What is the outlook for Israel's economy and domestic politics?

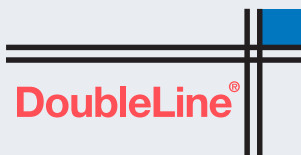
A "rally 'round the flag" effect in Israel will foster national unity in the short term and support the formation of a new emergency government coalition to manage the security crisis. After many days of speculation, the government announced on October 11 the formation of a temporary unity government, which includes key opposition leader and former Defense Minister Benny Gantz. The development is expected to strengthen the credibility of the government as it manages the security crisis by enhancing the decision-making body overseeing the military operation. As part of the coalition government deal, which will only last until the end of the war in Gaza, no bills or government decisions will be advanced that do not concern the conduct of the war. This implies that a controversial judicial reform program launched earlier this year by Prime Minister Benjamin Netanyahu's right-wing government, and which heightened political polarization and social tensions, is likely to be delayed and possibly discarded, which would be constructive for the outlook.

The impact on Israel's economy will ultimately depend on the length and intensity of the conflict, which remains uncertain at this time. Disruption to economic activity is expected, particularly in the short term and especially in the communities of southern Israel, which were most impacted by the Hamas attack. It is possible that Israel will swiftly secure its borders and enhance its defenses, which could allow economic activity to swiftly recover. However, the significant call-up of military reservists might lead to a further tightening of the labor market for the duration of the conflict, putting upward pressure on inflation. A deterioration on the fiscal front is expected, given the need to ramp up defense spending. However, overall government debt levels are expected to remain relatively well contained over the medium term, limiting potential downward ratings pressures. The Bank of Israel (BOI) has responded by announcing it would provide up to \$45 billion in liquidity support to the foreign exchange market to manage shekel volatility.

What is the potential impact on global markets, particularly for energy?

The impact of the Gaza conflict on the energy market should remain relatively contained for now, but oil prices could be driven by headlines related to a potential expansion of the conflict to Iran. In coming weeks and months, questions and claims of Iranian links to the attacks will be publicly explored and debated, with media reports potentially driving market reactions amid fears of a potential conflict between Iran and Israel or the U.S. Iran is a key oil exporter, having recently ramped up production to over 3 million barrels per day (and exports to just under 2 million barrels per day) but is also a key player in energy markets given its proximity to the Strait of Hormuz, through which around 20 million barrels of oil moves per day. Iran could potentially retaliate to any future attack by threatening or attempting to block the strait. Iran also has a demonstrated capacity to attack oil infrastructure in the Persian Gulf via proxies (including a high-profile attack in 2019 on Saudi Arabia's production facilities). A growing consensus that Iran is implicated in the attack could also involve a renewed crackdown by the U.S. on Iran's oil exports.

The current Gaza conflict could also have implications for the local energy market in the eastern Mediterranean if disruptions to gas production are sustained. Israel ordered the shutdown of its Tamar gas field on October 9, citing safety concerns amid the Gaza conflict. The shutdown, if sustained or expanded, is likely to result in reduced shipments to key export partners Jordan and Egypt. Energy implications beyond the eastern Mediterranean are limited – although Egypt re-exports Israeli gas as LNG to markets in Europe, increased domestic consumption in Egypt has recently weighed on those exports.



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The impact of the conflict on general market risk sentiment is likely to fade over time unless the conflict expands to Iran. The market reaction in the initial days of the conflict marked a flight to safe-haven assets and a jump in oil prices, though both of those effects have largely faded as investors became increasingly convinced that the conflict would remain localized and that impacts on energy markets are limited for the time being. As previously mentioned, news flow regarding links to Iran and a potential disruption to oil supplies in the case of an Israeli and/or American retaliatory strike could drive price action and requires monitoring.

An additional risk worth monitoring is if this conflict emboldens other geopolitical actors to take advantage of resources and attention being turned to this conflict. Russia remains engaged in its war in Ukraine, which is being supported by Western countries. This could provide an opportunity for Russia to make gains in Ukraine as resources, funding and attention get diverted to the Israel conflict. Similarly, China has maintained the open position that it eventually would like to reunify with Taiwan and make more territorial claims in the South China Sea. The conflict in Israel could be viewed by China as an opportunity to advance its ambitions of being the regional superpower. ■

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