Goldman Sachs The Markets

How geopolitical instability is affecting markets

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Sam Grobart: As geopolitical instability increases, what does that mean for the global economy? This is The Markets.

Hi, I'm Sam Grobart. Today I'm joined by two guests, Jared Cohen, president of global affairs and co-head of the Office of Applied Innovation here at Goldman Sachs and Sam Morgan, global head of Fixed Sales in Global Banking & Markets and co-head of One Goldman Sachs. Jared, Sam, thanks so much for joining us today.

Jared Cohen: Thanks for having us.

Sam Morgan: Great to see you.

Sam Grobart: Jared, over this past weekend in Jordan, there was a drone strike on US troops from an Iran-supported militia. What does this mean for the continuing conflict in the Middle East?

Jared Cohen: Since October 7th, what we've seen Iran do, and by the way, I should say Iran's the only country that has an easy brief in this war, all they have to do is destabilize. Everybody else has the burden of stabilization. And so, what you see Iran doing is they're showcasing for the world where they have proxy activities. They have the Houthi activities in Yemen. They have Hezbollah in Lebanon. They have five different Shia Arab militias in Iraq and so forth.

What they're doing with each of these proxy groups is they're creating a new normal around what these groups will do today, what these groups will do in the future. And they're basically busting through any perception that there are meaningful red lines to constrain them.

If you look at the attacks on the US servicemen and women and Jordan, this, to me, is just an escalation of what Iran has been doing. The area where they attacked is where Syria, Jordan, and Iraq all meet. Very important land corridor for them getting resources and weapons to Hezbollah in Lebanon and some of their proxies in Syria. Jordan said the attack happened in Syria. The Iranians denied the attack altogether. And so, this kind of fog of war that is largely born out of a combination of all of this playing out on social media and just the lack of visibility on the ground just adds additional complexity to it.

Sam Grobart: Sam, this widening crisis in the Middle East, how are markets reacting to this?

Sam Morgan: Markets have consistently shrugged off geopolitical tensions in the Middle East and Ukraine believing them to be localized in nature. The specific events that you referenced were an example of this. Oil jumped a few dollars, but quickly reversed. And the moves in treasuries in other key markets were also temporary and small in nature.

The market does focus on political and geopolitical risks. But these really focus on the US election and the nature of the US/China relationship. And more broadly, the market focus is squarely on macro topics. The growth in inflation picture. Monetary and fiscal policy. And particular, Fed policy and the differences in the outlook between US, Japan, Europe, China, and the UK.

Sam Grobart: Let's stay here on the Middle East for a moment. And Jared, I'll start this question to you. We've seen this widening conflict in the Middle East. We've seen, along with what happened last week, Houthi attacks on global shipping routes in the Red Sea. While this is all happening, oil prices remain comparatively low. What are the implications of a low oil price in this context, geopolitically?

Jared Cohen: Well, look, low oil prices are good news for Europe. You know, it's troubling news for some of the OPEC+ countries that want oil prices to be high enough to get the upside benefit, but not too high that it impacts demand. And so, as we think about escalation, one area of escalation has been increasing the attacks in the Red Sea through proxies. A second area of escalation would be you do have some kind of direct confrontation between the US and Iran. It increases the likelihood of a Hezbollah front opening up much more significantly.

Now, it's unclear if that would have an impact on shipping. The tricky thing about the Houthis is the Iranians don't have as much control over what the Houthis do day to day. But they continue to flood them with weapons and continue to flood them with resources.

As a terrorist organization, they're very difficult to deter. And it's very difficult to degrade their capabilities. Not to mention the fact that the missiles and capabilities that they're deploying are much less expensive than those that are required to take them out of the sky. And so, the Houthis sort of stumbled into this strategic advantage in the Red Sea that they weren't anticipating. And now that they've noticed it, now that they've embraced it, I see them doing everything possible to continue to push.

Sam Grobart: Sam, any thoughts there about the price of oil in this geopolitical context?

Sam Morgan: It's an important question. But this sensitivity of the US economy to oil on growth side has actually reduced substantially over the last few decades due to the growth of a domestic energy production. So, in reality what happens is the impact of higher oil prices on real income and consumption is offset by the impact on domestic energy production.

In the last few years, the shell sector's been a little bit more conservative about changing production aggressively when prices rise or fall. But still, the shell sector does provide this offsetting impact to consumer impacts.

The impact on inflation, however, is significant. Our rules of thumb are that $10 changed in the price of bread and oil changes headline PC inflation by around 20 basis points or headline CPI inflation by around 25 to 30 basis points. And so, I say net-net, the impact on growth has some puts and takes. But the impact on inflation, and particularly headline inflation, could be quite significant.

Sam Grobart: Sam, let me ask you another question on the macro scale. From time to time, perhaps even a little bit more recently, we hear about potential challenges to the supremacy of the US dollar, whether it's the euro, the yuan, the ECNY. Can anything realistically, at this point, dislodge the dollar as the world's reserve currency?

Sam Morgan: You're right, there are some threats to the dollar's status as the world's reserve currency. And there are certainly some countries, geopolitically, that have a desire to diversify their holdings away from dollars. However, I'm not a big believer that the dollar's place in the world financial system and its status as a reserve currency is going to be under sort of imminent, significant threat. And the real reason for that is just the depth of US capital markets.

If you're going to hold substantial amounts of dollars, you need to be able to deploy them. You've seen instances in recent years of some countries trying to settle trade in non-dollar terms. For example, Russia has sold some of its oil to India and that's been sold in rupees. But there are challenges deploying those rupees as effectively as you would the US dollar.

So, will we see some desire for diversification into other currencies and into gold and other assets? 100 percent. But is the dollar's imminent place at the center of the financial system under significant threat? I would say not at this stage. Not given the US's place in financial markets and the depth of dollar-dominated capital markets.

Sam Grobart: And final question for you both. What's the biggest issue in your world that isn't being talked about enough? Jared, let's start with you.

Jared Cohen: I worry that there's this axis of destabilization that is developing between Iran, North Korea, and Russia. Three countries that have very few allies and very little to lose. Their brief is to just destabilize the world. And if you look at North Korea, which we've gotten used to as a geopolitical threat, I worry that North Korea is starting to get into the proxy game the same way as Iran, and what that means for this dangerous axis.

Sam Morgan: Well, I think the biggest issue that's not being talked about enough is the level of US debt. Federal [UNINTEL] debt as a percent of GDP has almost tripled since just before the financial crisis. It was around 35 percent of GDP in 2007. And it's around 100 percent in 2023. And similar, when you look at other measures of debt, including state and local debt.

And the rise in this debt stock maybe even understates the problem because we also now have primary budget deficits that are unusually wide relative to the cyclical state of the economy. So, historically, in good economic times, the government would pay back debt. In bad economic times or the times of crisis, they draw down. And that's not been the case recently.

It's not just the US either. Many other countries are suffering significant increases in their debt levels. It's unclear what the catalyst will be for the market to focus its attention heavily on this again. I do worry about debt sustainability. I worry about the impact on bond markets. And these sorts of developments, from a longer-term perspective, have the ability to constrain the fiscal priorities of future generations.

Sam Grobart: Jared, Sam, thank you so much.

Before you go, I want to let you know about a new special podcast miniseries on our Goldman Sachs Exchanged feed that you should definitely check out. The Future of Four Wheels is a four-part exploration of how the auto industry is rapidly and radically changing in an age of electrification and automation. Go to the Goldman Sachs Exchanged feed to listen.

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I'm Sam Grobart. Thanks so much for listening.