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Macro Insight
Geopolitics and investment markets

History tells us that most geopolitical events have short-lived effects on markets

But the risk comes from how much recent events have damaged the economic scenario, and how policy makers will, or can, respond

Our views

As event risks dominate the current market environment, a defensive and selective asset allocation makes sense

We favour quality and value in DM equities, income opportunities in fixed income and inflation protection in commodities, infrastructure and other alternatives

HSBC Asset Management

The crisis in the Ukraine puts geopolitical risk back on the radar for global investors. The investment outlook, which was already "unusually uncertain", has become even more complicated. This note looks at what geopolitical shocks mean for investment markets, using the lens of asset pricing theory.

History tells us that most geopolitical events have short-lived effects on markets. Our event-study analysis corroborates that idea. But the risk comes from how much recent events have damaged the economic scenario, and how policy makers will, or can, respond.

Recent events mean that the "stagflation tone" to economic data is set to persist for longer. A defensive stance to asset allocation is, therefore, prudent but we need to stay invested and take a granular approach by leveraging different regional, style, and inflation-hedging exposures to build a robust portfolio allocation.

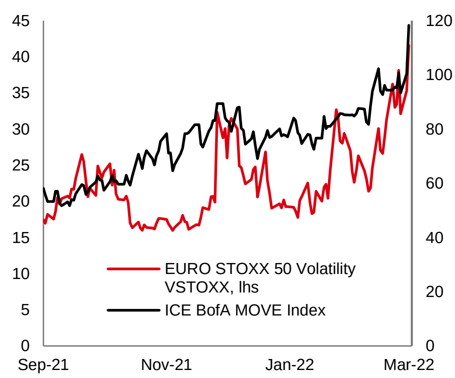
The geopolitical risk premium

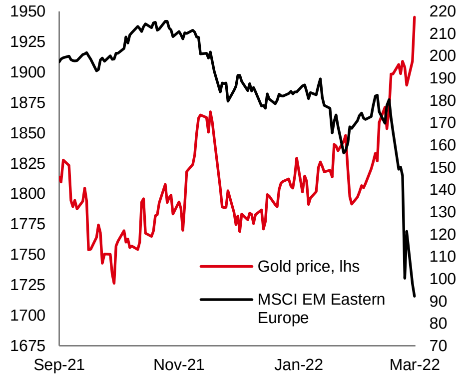
The so-called "present value relationship" links an asset's future cash-flows and a discount rate to determine today's market price.

That perspective implies that geopolitical uncertainty can impact markets as: (i) a direct shock to discount rates (i.e. pushing higher the premium for bearing risk); (ii) a shock to expected cash-flows through how it affects the economic regime; or (iii) both. Our thesis is that what combination of these elements we get matters, because it determines the size and length of the market drawdown.

Typically, geopolitical shocks – and a higher geopolitical risk premium – mean spikes in market volatility (figure 1), higher correlations among risky assets, and risk-off moves favouring safe-havens (figure 2). That's precisely what we have seen in markets in recent days.

Figures 1 and 2: Market volatility measures spike; Risk off- EM Europe vs Gold





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How persistent will this risk premium be? If it is short-lived, then recent volatility creates opportunities in risk assets. On the other hand, if event risks linger, then a more cautious investment strategy is warranted.

The question is particularly pertinent in the current market context. A number of risk asset classes have behaved in surprising ways. US stocks, for example, rose last week, despite the turmoil. And some emerging market currencies, usually viewed as more sensitive to market risk, have also been impressively resilient.

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Geopolitical risk events have become more frequent over the last decade

Measuring geopolitical risk

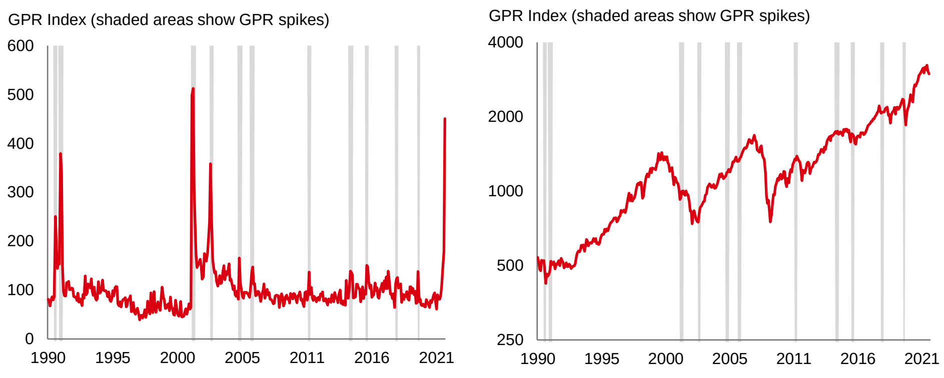
To start with, we need a way to track geopolitical risk. Two research economists at the US Federal Reserve, Dario Caldara and Matteo Iacoviello, have built an algorithm which trawls through international newspaper articles and measures the column inches devoted to geopolitical stories. The researchers initially built their model to start in the mid-1980s but they now have the data going back to the 1900s.

The result of their work – the Geopolitical Risk Index (GPR) – tracks how society perceives geopolitical risks. The index tends to be US-focused, but it has become a popular tool for economists to think about how much geopolitical risk is out there.

Figure 3 charts the index. The grey bars highlight some of the major risk episodes. The Gulf War and 9/11 stick-out as big spikes in the GPR, whereas more recent events – including the Russia/Crimea crisis in 2014 – create smaller spikes. It also appears that geopolitical risk events (albeit those of the smaller variety) have become more frequent over the last decade.

Next, we can tally those phases of big GPR spikes versus what is going on in markets. Figure 4 shows the global equity index, with the GPR spike periods highlighted in grey.

Figures 3 and 4: GPR Index; Global stock market performance



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These charts suggest that geopolitical risk has only a fleeting effect on global stocks. It seems to cause a wobble, but nothing to detract from a strategy of "stocks for the long run".

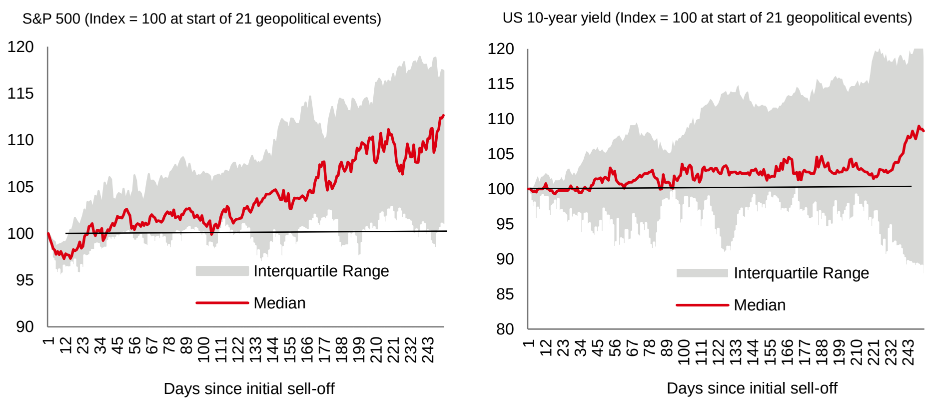
Our event study shows that events usually see a fast drawdown in markets, followed by a rapid recovery

Event study

In order to cross-check this finding, we ran an event study. Using the GPR index, we identified the most important geopolitical events since the 1960s, and then tracked subsequent stock market and bond yield performance. Figures 5 and 6 show how stocks and bonds behave - on average - in the aftermath of major geopolitical shocks.

The general pattern is clearest for stocks. We see a fast drawdown in markets, followed by a rapid recovery. Over the course of the year following the event, stock indexes are typically around 12% higher (in nominal terms). Caldara and Iacoviello come to the same conclusion. The balance of evidence points to the geopolitical risk premium as being fleeting.

Figures 5 and 6: How stock and bond markets respond to geopolitical events



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However, some geopolitical events have resulted in much bigger-than-average stock market drawdowns, and several have had much longer durations

Rational expectations

Does that mean that a short-term effect on investment markets is all we should expect?

Figure 7 shows the data table of our post-1960 event study versus stock market performance. The median market reaction only tells part of the story. Some geopolitical events have resulted in much bigger-than-average stock market drawdowns, and several have had much longer durations.

Figure 7: Stock market performance following major geopolitical shocks since 1962

Event	Start of sell-off	Max drawdown	Duration of sell-off (trading days)	Days to recapture level (trading days)	Length of recovery (trading days)	1 week from bottom	1 month from bottom	3 months from bottom	1 year from bottom
Yom Kippur War	29-Oct-1973	-44.0%	237	1575	1338	0.4%	4.9%	24.0%	30.3%
9/11 attacks	10-Sep-2001	-11.6%	10	24	14	7.8%	11.1%	18.5%	-12.5%
Iran hostage crisis	05-Oct-1979	-10.2%	24	74	50	3.5%	7.7%	16.4%	29.3%
Invasion of Afghanistan	17-Dec-1979	-10.2%	12	17	5	4.0%	7.1%	18.1%	37.1%
Cuban missile crisis	15-Oct-1962	-7.6%	7	15	8	5.7%	15.0%	22.7%	36.5%
Syria intervention	18-Sep-2014	-7.4%	21	32	11	4.7%	9.5%	8.4%	9.1%
Nixon impeachment	30-Jan-1974	-6.6%	9	25	16	1.8%	9.1%	0.9%	-13.3%
Six Day Israel Arab war	08-May-1967	-6.5%	21	62	41	4.1%	3.3%	6.5%	13.0%
Libya intervention	18-Feb-2011	-6.4%	19	48	29	3.2%	5.0%	0.9%	11.7%
First Gulf War	01-Jan-1991	-5.7%	7	14	7	1.5%	15.4%	19.9%	34.1%
Shah of Iran exiled	26-Jan-1979	-5.6%	22	42	20	1.8%	6.6%	4.3%	16.9%
Brexit	08-Jun-2016	-5.6%	14	24	10	5.1%	8.3%	8.0%	20.9%
Iraq war	21-Mar-2003	-5.3%	7	23	16	3.7%	8.1%	14.9%	32.8%
Libya bombing	21-Apr-1986	-4.9%	20	27	7	3.7%	5.7%	6.2%	23.5%
Kosovo bombing	18-Mar-1999	-4.1%	4	13	9	3.1%	7.5%	5.6%	21.0%
Clinton impeachment	07-Dec-1998	-3.9%	6	10	4	5.4%	6.2%	13.4%	23.0%
Vietnam war mobilisation	17-Jul-1964	-3.2%	29	51	22	1.2%	3.6%	5.1%	7.2%
Assassination of JFK	21-Nov-1963	-2.8%	3	4	1	5.8%	6.3%	11.6%	22.7%
Syrian airstrike	01-Mar-2017	-2.8%	33	48	15	0.8%	2.7%	5.6%	14.1%
Arab spring	27-Jan-2011	-1.8%	2	4	2	2.7%	4.0%	6.6%	3.1%
Crimea conflict	07-Mar-2014	-1.7%	6	18	12	1.4%	-0.6%	5.2%	11.5%
Median	N/A-	-5.6%	12	24	12	3.5%	6.6%	8.0%	20.9%

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The 1973 Yom Kippur war stands out as a far-reaching and highly-impactful geopolitical event for investment markets

The 1973 Yom Kippur war stands out as a far-reaching and highly-impactful geopolitical event for investment markets. It is a very different geopolitical risk to the others in our sample, and different to anything investors have experienced since WWII.

In the language of asset pricing, that shock resulted in both a spike in market risk premia and sustained lower cash-flows. The shock tipped the world into recession in 1973-5, and toward a stagflation equilibrium, driven by the surge in oil prices following the OPEC oil embargo in the aftermath of the Yom Kippur war. This materially altered the economic regime, and the outlook for future cash-flows. Simultaneously, events (the war, a hawkish Fed) shocked perceptions of equity risk higher, and kept them there. P/E multiples moved into a lower regime.

Another significant example is 1979/1980 (Iran hostage crisis). This time, the equity market multiple didn't change too much over the crisis period. The market volatility wasn't related to changes in the risk premium or investor beliefs. Instead, the longer market draw-down was a consequence of adverse shifts in economic fundamentals. Again, the challenge came from a spike in oil prices with the 1978 Iranian revolution leading to a slump in oil exports from the country.

The implication of this is that **to fully understand how the current crisis impacts the market outlook, we need to think about what it does to future fundamentals**, especially the growth/inflation mix.

Some events can alter the economic regime and lead to long-lasting effects

Key factors are the impact on commodity prices and economic confidence

Recent news flow increases the “stagflation tone” in current economic data

There are parallels with 1973 today but the key difference today is that monetary policy is unlikely to be as restrictive

Economic effects

There are two main ways that the global economic situation is affected by recent events in the Ukraine.

Firstly, rising commodity prices (and especially the oil price) will affect the macro-economy. Figure 8 shows nominal and inflation-adjusted oil prices. Brent oil prices are up around 15% since the start of February, and above the psychological level of $100. Real oil prices are a bit lower than in previous episodes over the last decade, but still show a large spike. Recent trends are inevitably going to create some economic pain.

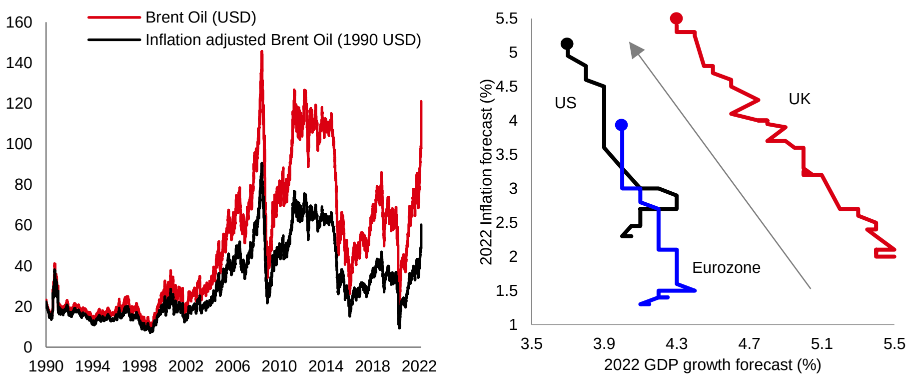
Economic models typically suggest that a $10 spike in the oil price lifts inflation by 0.4-0.5% points in the main economies, and reduces global growth by 0.1-0.2% points.

An important assumption, however, is how long-lasting an oil price spike will be. A key difference from 1973 is that the US and China have significant strategic reserves of oil and other commodities that could cushion the impact of supply disruptions. Meanwhile, December oil futures contracts are considerably lower than spot; in other words, the oil curve is in strong backwardation. That may suggest a short-lived price spike. Our research assumes the oil futures curve is a best case scenario, with other risk scenarios pointing to higher-for-longer oil prices.

The second important economic factor will be the “confidence channel”. Do recent events stall-out consumer spending and pause corporate investment? Damaged animal spirits could be a material downside risk for growth but, at this stage, it is hard to gauge how large this effect could be.

Nonetheless, recent news flow means that a combination of intensified inflation pressures and greater downside risk to growth increases the “stagflation tone” in current economic data. Growth downgrades and inflation upgrades have been the story of 2022 so far – especially in the main western economies (see figure 9). That trend looks set to persist. Meanwhile, the economic effects of higher oil prices will be globally-uneven, with the heaviest burden to growth and inflation on Central Europe, parts of MENAT, and oil importers.

Figures 8 and 9: Oil prices; forecast growth & inflation mix



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Policy puts

Financial markets have already removed some expected policy tightening for 2022 (Figure 10). Typically, in response to geopolitical events, central bankers will look through high inflation and focus on fighting recession risk. And in doing so, they provide an important “put” to investment markets.

But **today’s policy makers are in something of a bind**. Energy prices come on top of already-high inflation rates. We still expect inflation to fall materially over the coming 12 months. But end-2022 inflation rates are likely to be stubbornly above target. Higher inflation today, and a slower fade back towards lower levels of inflation, make it a tricky situation for global central bankers. Despite recent events, we still anticipate five rate hikes from the Fed in 2022.

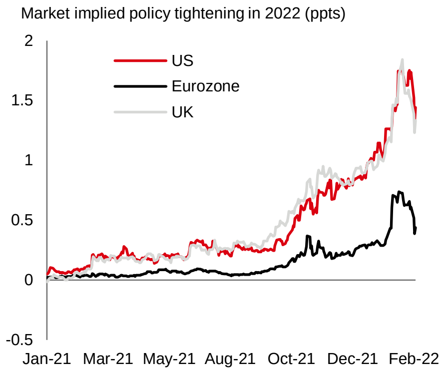
A combination of geopolitical shocks, high inflation, and policy hikes creates parallels with 1973. With it comes the risk of a much more sustained drawdown in asset markets. Could history repeat itself? The pre-conditions would seem to be an escalation of the Ukraine crisis, materially more inflation pressures, and a hawkish Fed.

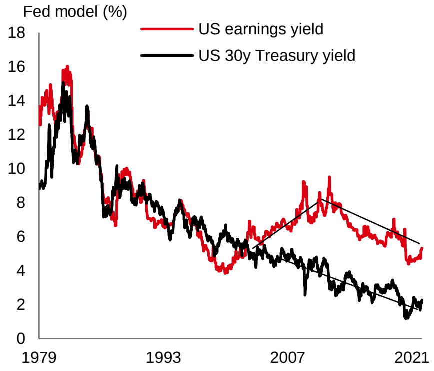
Despite the rise in oil prices, the market expects the recent spike to be short-lived

How geopolitical events play out from here is highly uncertain. But the big difference today versus 1973 is the reaction function of the Fed and the US political environment. We don't believe Fed strategy will look to squeeze inflation out of the system over the next year or so. Instead, the Fed's initial objective is to return policy to a more neutral setting after the large Covid-era policy stimulus. That implies a gradual and data-dependent profile of rate hikes this year, and some tolerance of inflation receding more slowly while geopolitical risks remain elevated.

We still expect inflation to fall materially over the coming 12 months. But end-2022 inflation rates are likely to be stubbornly above target

Figures 10 and 11: 2022 rate repricing; Fed model favours stocks over bonds





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Event risks mean the outlook is likely to remain unusually uncertain

Defensive asset allocation

Event risks dominate the current market environment. Geopolitical shocks, the Fed tightening cycle, and China macro uncertainty mean the outlook is likely to remain unusually uncertain, with volatile markets. We expect the macro-economic data to continue to have a "stagflation tone" for longer – at least until mid-year, and possibly until Q4.

That macro backdrop is a tricky one for many risk asset classes. Markets are likely to be choppy and investors need to have realistic investment return expectations. But while the temptation to run to cash might be high, high inflation and low interest rates make it an unattractive strategy. Relative valuations (Figure 11) still favour stocks over global bonds or cash. And it's important to remember – despite the current challenges – that **the typical impact of geopolitics on investment markets is short-lived**.

We think a defensive asset allocation should emphasise global relative value opportunities and active management

Instead, we think **a defensive asset allocation should emphasise global relative value opportunities and active management**. In particular, this means focusing on quality and value opportunities in developed market equities; on income opportunities in global fixed income; and on diversification and inflation-protection in commodities, infrastructure, real estate and other global alternatives.

Meanwhile, **parts of emerging markets have showed impressive resilience** to recent events, reflecting the fact that the asset class already took a lot of volatility last year. Cheap currencies and high real yields means that a selective approach, focusing on Latam and Asia, makes sense as part of our broad investment strategy.

Joe Little, Zac Tate and Hussain Mehdi, Global Investment Strategy Team

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