Geopolitical risk - implications for portfolio construction

Dominic McCormick | Select Asset Management | 08 July 2014

Do geopolitical events involving potential or actual military conflict really matter in the constructing of investment portfolios? On the one hand, we can clearly point to major geopolitical events in history that have been associated with very poor returns from equities and other assets. These include the two world wars (particularly for the losers). But are events of this catastrophic nature just so rare that they can be largely ignored? And can they be anticipated and hedged against, in any case?

The experience of the last couple of decades seems to suggest that geopolitical conflicts don't really matter much for markets or the world economy. While one can list numerous significant geopolitical conflicts since 1990, it is hard to come up with any that have a major and/or sustained impact on markets and the global economy (albeit that the local economic and humanitarian impact on many smaller countries has often been devastating).

Perhaps this can all be traced back to the reaction to the first Gulf war in 1990/91. It was initially a major concern with higher oil prices sparking fears of, and some actual, economic slowdown. Shares sold off, oil and gold rose. Perhaps the biggest issue was fear of the unknown given that the US had not had a major military engagement since the failure in Vietnam 15 years before. However, when the bombs started dropping on Baghdad in January 1991 and it was clear Iraq's army in Kuwait would offer little resistance, sharemarkets rallied strongly while oil and gold fell. Iraq, as a major issue for markets and the global economy, has largely been ignored since despite the enormous humanitarian and monetary cost of the second Iraq invasion and occupation from 2003.

It almost seems as if markets have taken Iraq as a blueprint for dealing with geopolitical risk ever since. Essentially, as long as the conflict is not between major powers (or at significant risk of becoming so), it is largely met with a yawn from markets. Perhaps the only exception is when the supply of a strategic commodity is threatened for an extended period (yes, I am mainly talking about oil). However, even the carnage in Iraq over many years has not resulted in major extended supply disruptions although any disintegration of the country with the latest threats could be a different matter.

Stepping back, how should we expect major geopolitical conflicts/events to impact markets?

If we ignore the consequences of the total destruction of a capitalist system that occurred in Russia during the Russian revolution of 1917 for example (and resulting 100% losses), the risks to investment come from these events' impacts on:
1. Economic growth;

2. Inflation/resource scarcity/pricing; and,
3. Risk premiums.

Let's take each of these in turn.

Obviously, war is generally negative for an economy experiencing it directly given the devastating impact on business activity and destruction of productive capacity. On the other hand, it can be stimulative for certain countries supplying weapons and personnel if they are sheltered from most of the direct effects. With minor countries bearing the brunt of the destruction and major countries benefiting most from the supply of arms, is it any surprise that the impact of most geopolitical events over the last few decades on markets and the global economy has been minor?

Secondly, war can create inflation either because it impacts the supply of a strategic commodity(s) or because government debts built up to finance the war effort result in pressure for higher inflation as a means to more easily finance such debts.

The third factor is the one that is least tangible, unpredictable and most often ignored. Many investors assume that unless such geopolitical events have a direct impact on fundamentals – e.g. economic growth or inflation – then we don't need to worry about them. However, one of the biggest drivers of asset markets is simply changes in risk premiums – that is, the return demanded by investors as compensation for risk in various asset classes.

While it is true that some part of the change in risk premiums can be related to concerns that fundamentals will change in the future, this explanation often fails to explain many big moves over time. Part of changing risk premiums can be rational while part is often irrational with a significant tendency to overshoot in times of uncertainty. This is particularly a concern if the starting point for markets is low risk premiums and high levels of complacency, such as now. In such circumstances, it may take less of an event to spark fear and increased risk premiums.

Of course, currency markets can also be impacted by the three aspects described above.

What are the characteristics of geopolitical events that markets should most worry about? In my view, it is those conflicts that are either between, or are at risk of developing between, major countries OR, alternatively, conflicts that can develop in ways that threaten supplies of key commodities (mainly oil). Markets need worry little about civil wars in small countries without strategic resource importance, conflicts between minor nations or conflicts between a major nation and a small nation that have little potential to develop into conflicts between major powers.

The key geopolitical risks today are probably the following:
1. Ukraine
2. China island disputes

3. North Korea
4. Iraq/Syria

I won't discuss any of these in any detail here. However, it is worth noting that none of these have had any real impact on markets so far and, perhaps, for good reasons. None have so far involved clashes between major powers and while the oil price has increased on the latest Iraq issues, supplies of oil have so far been largely unaffected.

However, I think the first three risks are potentially dangerous because they have some chance of developing into conflicts between major nations. The fourth is dangerous because the Iraq situation has some risk of resulting in the disintegration of that country (and the risks of a wider Middle East conflict) that would almost certainly significantly impact oil supply and prices.

Why are markets so complacent about the risks of these events developing into much more serious issues? Simply because, as noted above, markets have been trained in recent decades not to worry about them. Why would these current events be any different? The thinking is totally understandable and could well be proven correct – but it has probably led many investors to not even spend time on considering whether, why, how, and when these developments could turn into much more serious issues for markets and the global economy.

One related concern as flagged above is that current market valuations are elevated and investors are complacent, soothed by many years of easy monetary support from central banks. Overall, this is a cocktail for dramatically increased risk aversion at some point. It may or may not be a geopolitical event that sparks such a change, but it certainly should not be ruled out.

I think the current attitude of markets therefore has certain implications for investors in relation to geopolitical events.

Firstly, it suggests that when major geopolitical events develop, it may take markets some time to price in the implications of these.

Secondly, the elevated valuations/complacent position of most markets means that the downside risks are more significant if a major geopolitical event were to spark greater risk aversion.

The first point suggests that while perhaps major geopolitical events cannot be predicted in advance, investors may have some time to react as markets may be slow to price in the events that really matter. The key is understanding which types of events are ones that will significantly impact markets and why.

The second point suggests that the downside risks in the current investment environment are significant and growing and some permanent hedging/diversification for such major geopolitical risks may be appropriate for portfolios, despite the ongoing costs of such "protection" if the environment remains benign.

So what investments/strategies can be used to hedge such geopolitical risks?

Historically, gold has been seen as a geopolitical hedge and has often spiked higher on such events only to quickly give these gains back. I do believe gold makes sense as part of a portfolio, but other drivers are much more important to its long-term pricing (e.g. real interest rates, inflation, debts levels, confidence in central banks, currency volatility, etc.). Buying gold only in response to every geopolitical event that hits the media headlines is likely to result in poor returns.

We can also buy protection and/or specialist funds that are "long volatility". This can make particular sense now when volatility across many asset classes is at low levels and this "insurance" is relatively cheap. Trend-following managed futures can also have a role here, despite concern over recent poor returns.

More generally, we should recognise that periods of major market conflicts are often inflationary, either during or after the event. Therefore, despite the complacency over current low inflation levels (with some fearing deflation instead), inclusion of inflation hedging assets can make sense (e.g. gold, commodities, inflation-linked bonds). Specific exposure to energy/energy companies can also be appropriate, particularly if the greater risk geopolitical events are focused on energy supplying areas.

Have the risk of major geopolitical events increased or decreased in recent times?

Some commentators believe that greater global integration and communication suggests that risks of a major military conflict have decreased. However, it seems that an overstretched US - under domestic, global and fiscal pressure - is withdrawing somewhat from its role as global policeman, increasing global tensions. In addition, the growing wealth and accumulation of, and access to, increasingly powerful weapons across the world - and emergence of more military superpowers such as China or India - is providing more potential for conflicts and trouble spots globally.

While geopolitical risk has not been a significant driver for investment markets in recent decades, it may be a mistake to extrapolate this same view forward. Risks of major conflicts have grown and highly valued and complacent markets could mean that the impact of such events could be even more dramatic than otherwise. Some permanent hedging should be part of well-constructed portfolios, although investors need to be cognisant of the ongoing "insurance" costs of this. The likely slow reaction of markets to major geopolitical events could enable investors to employ a more dynamic hedging component, dependent on an assessment of the particular characteristics of various geopolitical risks and conflicts.

Importantly, investors need to avoid kneejerk reactions to every geopolitical event that come along and be willing to be more discerning and fully alert to the risks (and opportunities) that these events bring.

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