Mercer

Peering through the fog

Examining prior examples of the impact of geopolitics on financial markets in light of current market events

February 2022

A note of condolence

We are extremely saddened to learn about Russia's military aggression and the likely devastating humanitarian impact. Our thoughts and prayers are with the millions of Ukrainian people currently affected as well as any colleagues and clients who may have friends and family in the region.

A tragedy unfolds

Risk assets entered 2022 with rich valuations in spite of numerous challenges such as soaring inflation and tightening monetary policy in many countries. These challenges have acted as a headwind for financial assets, especially those with a long duration. Inflation and rising rates, however, were within macro-economic scenarios portfolio managers and economists typically lay out for markets. What is far less forecastable are the geopolitical conflicts with their inherently human nature, as we are currently witnessing between Russia and Ukraine. Compounding the economic with the geopolitical has contributed to year-to-date losses across both equities and fixed income. The S&P 500 has just entered correction territory (~-10%) and the longer duration Nasdaq has been deep in correction territory already (~-14%). Despite this, the US 10-year yield has risen by almost 45 basis points[1].

Russia's invasion of Ukraine has brought geopolitics to the forefront. While each geopolitical conflict is unique, including this one, the number of past events can teach us something about how markets respond to them. Even in the short two decades since the turn of the millennium, markets have faced 9/11, numerous military conflicts in the Middle East and Central Asia as well as instances of trade wars between the major powers. We cannot know how the conflict between Russia and Ukraine will play out, whether it will draw in other players, or how long it will last. However, by consideration of prior geopolitical events, and their impacts on markets, we may at least provide context on the possible impact of this event. Through these, we hope to help investors peer through the fog of market sentiment and stay the course during these times of geopolitically driven uncertainty.

Can investors position for geopolitical events?

Investors have good reason to wonder about portfolio implications when the news flow and market behavior is dominated by a geopolitical event. Not only do these events have the potential to cause far-reaching outcomes for the global economy and financial markets, but their inherently human component creates a level of uncertainty that is difficult to properly discount. This is why geopolitical events can often be catalysts for volatility spikes in financial markets.

[1] Source: Bloomberg, as of February 24, 2022.

In our view, investors can make portfolios generally more resilient against sudden shocks in the following ways:

- Maintain geographical, sector and return driver diversification in portfolios.
- Build portfolio resilience through strategic allocations to downside protection assets such as sovereign bonds, inflation-linked bonds, and gold.
- In the diversified alternatives space, some managers may have the necessary skillset and flexibility to navigate these kinds of crisis through dynamic and opportunistic risk expression and a more robust risk management toolkit.

However, now that we are in the midst of the event, is it advisable to realign a portfolio for what might eventuate? It is certainly possible to build scenarios around potential outcomes, but in many cases they can be inherently binary. A large scale conflict disrupting global energy supplies could trigger a stagflationary recession. Alternatively, a reduction in tensions could lead to a relief rally. In the former scenario, it would make sense to consider selling risk assets and buy gold and commodities, for example. In the latter, we might see a recovery in risk assets, while hedging assets like fixed income and gold suffering. How can we tell which scenario is most likely to materialize? The nature of many geopolitical events makes positioning for them a 'feast or famine' bet.

What can we learn from previous events like these? The past is by no means an exact guide to the future but when it comes to geopolitics and portfolio implications, it offers some valuable lessons. **Appendix 1** shows that over the last century geopolitical events have certainly led to notable drawdowns in the short term[2]. Germany invading neighboring countries at the onset of WWII or the Arab oil embargo stand out as particularly severe drawdowns. However, when looking at the whole series of events in the table, the typical sell-off lasted about a month and markets had fully recovered all losses after another month and half. There were of course exceptions to the rule. In some cases, it took years for markets to recover from the drawdown, especially when key economic variables such as oil were impacted, as was the case in 1973.

However, as pointed out above, it is difficult to tell how impactful a geopolitical event will be at the onset. When it happened, few would have thought that the Dredd-Scott decision would precipitate the US Civil War or that the assassination of an Archduke would trigger World War I. On the other hand, it was not unreasonable to fear at the time that the Cuban Missile Crisis would be the beginning of World War III. We always know more with the benefit of hindsight.

[2] It should be acknowledged that in the real world, market movements are seldom driven by just one event, especially over longer periods. Appendix 1 needs to be seen in this context; each sell-off may be attributable to the named event to varying degrees.

Keep Calm and Carry On

In light of the above, our best advice to investors is therefore to stay restrained and not overreact. Positioning portfolios for the unfolding of geopolitical events whilst they are already developing requires an ability to see into the future. History has shown us that sell-offs driven by geopolitics can be so short-lived that even clairvoyant investors may struggle to time them.

On balance, the attempt to position for geopolitical events at this stage in the crisis is more likely to lead to the selling of risk assets after markets have already discounted the event. It is equally easy to miss the inflection point. Opportunity costs could be enormous in the long-term. Not being invested during the best 10 trading days over an entire 20-year period can cut cumulative portfolio performance in half[3]. Indeed, investors may be able to capitalize on temporarily elevated risk premia during periods of markets stress by rebalancing portfolios towards their long-term investment policy benchmark after a significant drawdown[4].

By using history to peer through the fog, for now, we suggest investors should prepare rather than predict and see through geopolitical turbulences whilst remaining vigilant of the situation.

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[3] See JP Morgan, '2019 Retirement guide': https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/retirement-insights/guide-to-retirement-us.pdf (slide 43) Accessed on February 23, 2022

[4] See Mercer, 'Rebalancing in troubled markets': https://www.mercer.com/our-thinking/wealth/rebalancing-in-troubled-markets.html Accessed on February 23, 2022

Appendix 1. **Equity market selloffs and recoveries around geopolitical events**

Event	Event date	Start of selloff	Duration of selloff (Trading Days)	Duration to recover prior level (Trading Days)	Size Of selloff (%)	1w from bottom	3m from bottom	12m from bottom
WW-II Germany annexes Czechoslovakia	15-Mar-39	10-Mar-39	22	108	-20.5	2.0	8.5	18.9
WW-II Germany attacks France	09-May-40	09-May-40	22	745	-25.8	10.6	17.1	9.2
WW-II Pearl Harbor	07-Dec-41	04-Dec-41	17	201	-10.8	6.2	-3.8	15.3
N. Korea invades S. Korea	24-Jun-50	22-Jun-50	17	43	-12.9	5.5	19.2	31.4
Suez Crisis	29-Oct-56	05-Nov-56	18	131	-6.8	3.3	-1.4	-6.0
Berlin Wall built	13-Aug-61	22-Aug-61	25	18	-3.9	1.4	8	-14.6
Cuban missile crisis	14-Oct-62	15-Oct-62	7	9	-6.6	2	22.7	36.5
Military operation in Vietnam	07-Aug-64	17-Jul-64	15	36	-3.2	0.5	4.8	5.8
Six Day Israel Arab war	05-Jun-67	08-May-67	20	40	-6.5	3.5	6.5	13
Israel Arab War/Oil Embargo[1]	16-Oct-73	29-Oct-73	27	1475	-17.1	6.3	5.6	-28.2
Iranian hostage crisis	04-Nov-79	05-Oct-79	24	51	-10.2	3.6	16.4	29.3
Invasion of Grenada	25-Oct-83	10-Oct-83	22	304	-6.3	2.8	-3.7	4.3
First Gulf War	16-Jan-91	01-Jan-91	6	8	-5.7	0.3	19.9	31.4
9/11 attacks[1]	11-Sep-01	10-Sep-01	6	15	-11.6	4.3	18.5	-12.5
Iraq war	20-Mar-03	21-Mar-03	7	16	-5.3	3.6	15.8	32.8
Intervention in Libya	10-Mar-11	18-Feb-11	18	29	-6.4	3.3	0.9	11.7
Ukraine (Crimea) conflict	14-Mar-14	07-Mar-14	6	13	-2	1.1	5.2	11.5
Intervention in Syria	22-Sep-14	18-Sep-14	21	12	-7.4	4.2	8.4	9.1
Brexit vote	23-Jun-16	08-Jun-16	14	9	-5.6	5.1	8	20.9
Airstrike on Syrian airbase	07-Apr-17	01-Mar-17	32	16	-2.8	0.6	5.1	4.2
Median			18.0	32.5	-6.6	3.4	8.0	11.6

Source: Deutsche Bank, Haver Analytics, Mercer. S&P 500 Index. [1]Event occurred around recessions.

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