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TAKING STOCK: ARE WORRIES ABOUT GEOPOLITICAL RISK HURTING YOUR INVESTMENT PERFORMANCE?

By Nino Boezio

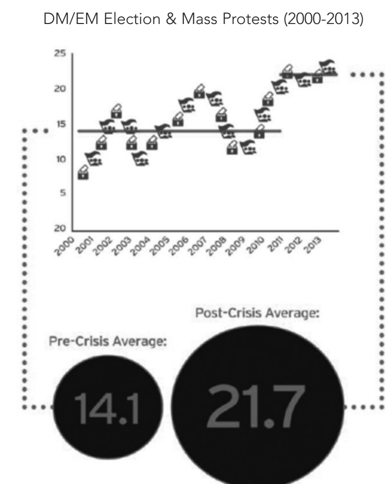
We have seen more than our fair share of geopolitical risk in recent years. Major headlines in 2013 and 2014 included tensions from North Korea, the potential financial collapse of Cyprus, the unrest in the Ukraine, conflict and instability in North Africa and the Middle East, Scotland's referendum to stay in the United Kingdom and the Ebola virus. Citi in a report released in May 2014,[1] concluded that geopolitical events (that include election risk, mass protest risk, referendum risk and geopolitical risk, which Citi classifies all together under the label of *Vox Populi* risk) occurring in this decade, i.e., the period spanning 2011-2013, are running 54 percent higher than the prior decade (see below):

Citi measured the impact of various recent events on financial performance as shown in the following table[2]:

However, investors who in recent years adjusted their investment strategy to reflect concerns over geopolitical risk likely suffered in investment performance. Anyone watching the news headlines would have noticed a major disconnect between the ominous periods of global unrest and the corresponding financial market reaction, especially after a few days or weeks had passed. It was as though nothing had happened. Financial markets have tended to shrug off any fear and to bounce back quickly.

Ironically, I have noted that many recent negative events were viewed as positive developments if they resulted in temporary market dislocations, for they created buying opportunities for those who were willing to take on

FIGURE 1: The Yearly Average of Elections and Mass Protects in Major Markets has Jumped 54% in the Post-Crisis Enviroment



Source: Citi Research

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Figure 6. Liquidity Aside, Politics Still Matters. Many Of The Top One-Day VIX Moves Since QE Began Correspond to Political Events.

Date	%Change in VIX	%Change in S&P	Political Events	Financial/Macro Events
2/25/2013	38.7%	-1.83%	Italian election	
8/8/2011	30.1%	-6.59%	US downgrade	
8/4/2011	28.9%	-4.77%		ECB, BoJ actions, slowdown fears
5/6/2010	26.7%	-3.11%		Flash crash
4/27/2010	25.8%	-2.17%		Greece downgrade
1/28/2011	25.7%	-1.79%	Tahrir Square	Japan downgrade
5/7/2010	25.0%	-1.43%	UK election, Greece riots	
10/30/2009	23.9%	-2.74%		End of month
1/22/2010	22.6%	-2.13%	US policy uncertainty, Fed	
1/24/2014	21.3%	-2.01%		China fears, US earnings miss
1/21/2010	19.8%	-1.95%	Obama calls for bank regulations	
3/16/2011	19.3%	-1.76%		US housing data, Fukushima disaster continues
3/1/2011	19.2%	-1.68%	Libyan civil war	
2/20/2013	19.2%	-1.24%		Fed communication

Source: Chicago Board of Exchange, Bloomberg, Associated Press, CNN Money.com. Citi Research

the risk, or for those who wanted to add to their investment positions.

I would concede that the majority of negative global geopolitical events never materialized into something considered significant (even though they may have spiked market volatility for a short time), but I would still have expected the markets to price-in some sort of visible and persistent risk premium. Of course, by their very nature, unforeseen geopolitical occurrences are characterized as low probability "tail risk" events and are therefore expected to inflict pain on financial markets infrequently. However, there is a sense today that even when such events do become apparent and the risks are visible they are still being mispriced—such events are ignored because they are considered irrelevant and it is believed that they will play out gradually without any adverse consequences to financial markets.

Mohamed El-Erian (formerly CEO of PIMCO) while cautioning that certain geopolitical events could escalate to the point where they do matter to financial markets, cited four reasons why the markets have been ignoring geopolitical events: "the countries involved are less systemically important; there's little will from outside powers to get embroiled with these situations; the story of a recovering economy in developed markets has been a distraction; and extraordinary central bank support for markets has provided a layer of insulation."[3]

ARMIES OF ANALYSTS, AND FUND MANAGERS AT THE BIG MACRO FUNDS, MAKE A LIVING FROM ANALYZING GEOPOLITICAL TRENDS. ... INCREASINGLY, HOWEVER, IT LOOKS LIKE A WASTE OF TIME.

A financial news commentator (Matthew Lynn) offered up two similar credible explanations for the current market behavior:

> "firstly that there are not any wars or revolutions any more that can dramatically change the outlook for the global economy; and secondly, that the markets are so pumped up by quantitative easing, and easy money from the central banks, that anything else that happens pales into triviality by comparison. … Nothing that happens in the outside world matters to the markets right now. … Armies of analysts, and fund managers at the big macro funds, make a living from analyzing geopolitical trends, and moving their money around accordingly. Increasingly, however, it looks like a waste of time. Nothing that happens in the outside world matters to the markets right now. A war between China and Japan might change that. So could the collapse of the European Union and the single currency. But unless it is something that big—and those two examples both seem very unlikely—investors can stop worrying about the headlines from around the world. None of them are going to impact your portfolio."[4]

Citi in its report also cited monetary policy as a mitigating factor and made observations regarding the recent past which are worthy of note:[5]

> "So how do markets respond to Vox Populi risk? The answer appears to be, with remarkable calm, indeed hardly at all—for now. … This might reflect the palliative effect of cheap money as central banks have "come to the rescue" and boosted asset prices that would normally be hurt by higher political risk premiums. The extraordinarily low safe yields resulting from these same policies have created a hunger for yield among private investors that may have rendered them blind even to significant risks.
>
> The withdrawal of cheap money could mark a return to political risk, but for now markets are seemingly overlooking a confluence of developments that would, in a world with less liquidity, have likely prompted greater concern."

Citi's comments regarding "cheap money" and the related liquidity are worth exploring further. Central bank activity has helped buoy investment activity and performance regardless of the underlying backdrop and risk. We have also seen financial markets globally react strongly to the upside even though the underlying global economic fundamentals have been weak. Central bank activity has been encouraging risk-taking and has been offsetting the new risks emerging around the globe. However, there is an element of caution being expressed in Citi's report—once this liquidity withdraws as central banks change direction, we can witness more visible reactions to geopolitical risk once again, which is something we all need to keep in mind.

Citi also noted another type of decoupling recently, where global markets are no longer responding in unison to a geopolitical crisis, but rather are migrating to safer assets: "If anything, volatility in riskier parts of the world seems to be increasing the desirability of assets in the more stable DM (developed market) economies."[6] For example, the escalation of the conflict in the Ukraine in 2014 drove assets away from Russian equities into European or North American equities (i.e., hurting one while benefitting the other), whereas years ago such an event would have hurt all equity markets. Easy monetary policy by a particular central bank can therefore attract money to its domestic economy as its policy provides an aura of additional stability, and its financial markets can now function as a safe haven for investment assets, something that would have not occurred in prior crises. For many investors, this was an unforeseen consequence of easy money.

Another decoupling seems to be occurring when we look at commodity prices, which also suggests we are in somewhat of an artificial environment. The chart on page 6, for example, shows how the S&P 500 Index is moving in a

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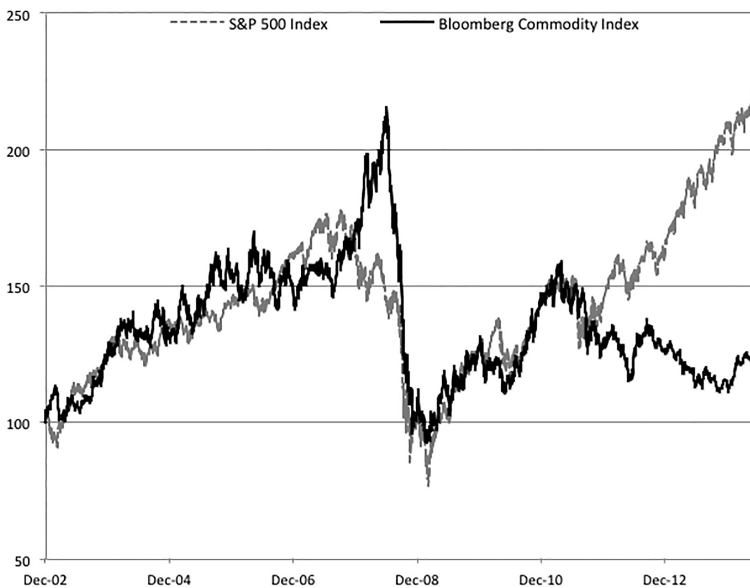
CENTRAL BANKS HAVE A NICE UTOPIAN WORLD TO OPERATE IN FOR NOW BUT THE CONSEQUENCE DOWN THE ROAD COULD BE DEVASTATING.

different and somewhat opposite direction to commodities, which some argue indicates we are out-of-sync globally:



Source: Bloomberg. Date Range: 12/31/02 – 6/30/14. Data was unitized with a value of 100 on Dec. 31, 2002. Bloomberg Index is the Bloomberg Commodity Index Excess Return. S&P 500 Index Ex Dividends.

If the global economy was growing, strong and healthy, we would expect the demand for commodities to be following a similar trajectory to equities, but this is not the case any longer. Unfortunately, even if financial experts agree that something appears amiss in the current financial environment, their ultimate response is to go along with the trend regardless, and hope to know when to alter the course at the appropriate time. The mantra "do not fight the Fed" or any other central bank for that matter, holds true if you want to have performance that closely tracks associated benchmarks, even if you are not in agreement with the underlying global fundamentals.

From a behavioral perspective, we are also likely seeing investors adopt an attitude of complacency, because they are getting used to the current upside trend. I have noted personally, that a "buy the dips" mentality is certainly taking hold in financial markets. Some of this can be warranted since if the global economy is gradually improving over time, equity markets can continue to reach higher levels even though the pace (not the magnitude) of price appreciation can be debatable. So why should we worry? Moreover, if things do fall apart, many today do expect central banks to ratchet up monetary policy to salvage the situation. However, as Alberto Gallo warns (a credit analyst from the Royal Bank of Scotland), this market insensitivity will not continue forever, and market participants "may be putting too much faith in central banks to rein in tensions and stabilize markets."[7] I would have to agree that the current global monetary strategy is going to fail eventually.

The U.S. Federal Reserve and Bank of England have ended their Quantitative Easing (QE) programs which should result in reduced liquidity, while the Bank of Japan has embarked on a brand of "super-QE" and the European Central Bank is expected to embark on a higher level of QE in the very near future. Overall, liquidity is still around and abundant, but one wonders whether several types of bubbles, market dislocations and/or inflation spikes may not be too far behind. With the current deflationary environment and excess industrial capacity, central banks have a nice "utopian" world to operate in—for now—but the consequences down the road could be devastating.

What about Natural Disasters?

The Citi report does not incorporate a discussion of environmental factors or natural disasters, but this too can weigh into any geopolitical risk assessment. Like geopolitical risk, an environment or natural disaster (like the Japanese Fukishima nuclear disaster in 2011 following a tsunami, which had elements of both types of risk) can hurt an economy.

The concerns over global warming have cooled off some-

what, especially given the "polar vortex" of last winter which inflicted the northeastern part of the North American continent with excesses of snow and abnormally low temperatures. In addition, the last few summers have generally been more moderate than that of 2012, which saw drought inflicting much of the grain producing states.

However, a U.S. Federal report issued in the spring of 2014 (http://nca2014.globalchange.gov/) continued to raise alarms about expected changes in weather that will persist for several decades to come. The report highlighted that temperatures will generally be higher and stay there longer—summers for example will be longer and winters shorter. Extreme weather will also occur which will result in more flooding, torrential rain downpours, drought, wildfires, higher sea levels and greater insect infestation.

The report also provided some insight into the economic ramifications of such events including: the expectation for higher insurance rates or no insurance at all in some regions; higher demands for energy; more pressure on agriculture (in general lower crop yields); more health concerns; decreasing water supply; and a major change in ecosystems which can affect our wildlife and fishing industries. Most of these may not be large immediate impacts, but some events could—we still remember Hurricane Katrina in 2005 and the devastation it caused in parts of Louisiana and particularly in the city of New Orleans.

Even though this federal report may have completely frightened you, fortunately this change in weather should be gradual so that our North American economy can adjust, even if there are some major weather events in isolated areas. Nevertheless, much of the world will face similar pressures to the United States and Canada, and we have not even touched on the financial impact of events that can include earthquakes, hurricanes and tornadoes that can also be expected to escalate. In addition, as the global population continues to grow, the risk of an event affecting a large number of people becomes elevated.

Given the supposed success of central bank activity since the global financial crisis (even though we still do not know what the ultimate consequences will look like down the road) we can now expect central banks to get more directly involved in response to any environmental or natural crisis to compensate for the perceived economic impact. Central bank intervention is now being seen as the panacea to any financial dislocations occurring domestically or around the world regardless of the cause, which is becoming a very strange strategy to say the least. This is certainly not something that would have ever occurred if we had stayed faithful to debt limits or even a gold standard.

SUMMARY

Geopolitical risk can be a very interesting subject to debate. However, because such risks are very subjective, are hard to measure, and many events are hard to predict in advance, a geopolitical risk discussion can sometimes be very uncomfortable to engage in and can be highly speculative. Observable and reliable data may also not be available. As a result, geopolitical risk may often be ignored or improperly reflected in any risk analysis because of the difficulties associated with quantifying it. In addition, if something arises on the world scene that is very detrimental to a portfolio's performance, the portfolio manager can provide the defense that the event was unforeseen and therefore not the result of faulty investment management.

Nevertheless, geopolitical events can have a very important and significant impact on investment performance when they do tip into "real crisis" territory, and therefore should not be dismissed outright. Sensitivity analysis and other forms of risk assessment should be taken into consideration (that do not always need to be numerical in nature) which can result in better financial outcomes. We should never assume geopolitical risk is gone forever, but keep it in mind when establishing our investment outlook.

In addition, we should not always expect central banks to be there to nullify any future market dislocations, especially if inflation begins to rise substantially. Monetary policy may

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have to change course once deflation is no longer the positive underlying backdrop behind global economic activity. The absence or change in the currently stimulative monetary policy to a policy that results in less liquidity, could lead to greater market volatility and higher sensitivity to geopolitical events as we lean into the future.

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ENDNOTES

[1] Tina M. Fordham, Matthew P. Dabrowski, Willem Butler, Robert Buckland, Edward L. Morse, Taking It to the Streets: What the New Vox Populi Means for Politics, the Economy and Markets, Citi GPS: Global Perspectives and Solutions, May 2014, page 8.

[2] Ibid, page 16.

[3] Eisen, Ben, "El-Erian: Markets should be worrying about Ukraine," <http://www.marketwatch.com/> [path: http://blogs.marketwatch.com/thetell/2014/03/24/el-erian-markets-should-be-worrying-about-ukraine/]

[4] Lynn, Matthew, "Why the Markets Brush Off Horrific World Events," <http://www.marketwatch.com/> [path: http://www.marketwatch.com/story/why-the-markets-dont-care-what-happens-in-the-world-2014-07-23]

[5] Fordham, "Taking It to the Streets," page 9.

[6] Fordham, "Taking it to the Streets," page 31.

[7] Watts, William. "This is why markets shrug off Ukraine plane crash, Gaza and other geopolitical flashpoints," <http://www.marketwatch.com/> [path: http://blogs.marketwatch.com/thetell/2014/07/21/this-is-why-markets-shrug-off-ukraine-plane-crash-gaza-and-other-geopolitical-flashpoints/]