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IMPLICATIONS OF GEOPOLITICAL INSTABILITY FOR INVESTORS: SPOTLIGHT ON THE MIDDLE EAST

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By Nino Boezio

Any major geopolitical event will affect investment performance. Investors with diversified portfolios are not immune from the repercussions. Among the recent developments worth noting are the crisis in Ukraine and, in our hemisphere, unrest in Brazil and Venezuela. We have also seen unrest in Asia stemming from tensions between Japan and China and threats from North Korea.

Tensions can spread quickly, with potentially explosive results, such as major conflicts. The region that has demanded perhaps the greatest attention is the Middle East, which has been volatile for decades. Lately, Egypt, Iran, Iraq and Syria have all been in the headlines. Exploring financial data from the region can give us a good indication of how severely financial markets can react to any geopolitical crisis.

For investors, the Middle East is of particular interest because the region is still the main source of oil, which keeps the global economy running. The price of oil and the uncertainty of accessing this vital commodity affects equity markets all over the globe. When the price of oil increases dramatically, it can push economies into recession, as high fuel costs pressure consumers and businesses to curtail other expenditures.

This Investment Insight examines data related to past major events in the region to provide insight into the magnitude of their impact on financial markets. It also outlines steps investors can take to protect themselves from geopolitical instability.

THE INVESTMENT IMPACT OF PAST GEOPOLITICAL EVENTS IN THE MIDDLE EAST

Segal Rogerscasey Canada has analyzed the performance of a range of investments during and just after six key events in the Middle East, starting with the 1973 Arab oil embargo. The results of that analysis are summarized in the table on the next page.

Based on the data in the table and considering how markets have responded to risk in the past several years, if any prolonged and major crisis were to occur, Segal Rogerscasey Canada believes the following consequences are likely:

- North American equity prices (and by extension, equity markets globally) could decline significantly in the short term as economic expectations are severely diminished due to the event.
- Prices could rise for safer fixed-income securities, particularly those issued by the government of Canada and the U.S. Treasury, unless inflation expectations rise dramatically, which can then factor into higher interest rates. These investments are considered safe, liquid and often produce positive rates of return during major crises.
- As we saw with the recent global financial crisis of 2008-09, the value of the U.S. dollar could increase compared to other currencies because investors would prefer more liquid U.S.-based assets. Many global transactions and investment vehicles including derivatives use the U.S. dollar as the medium of exchange. As global risk increases, more activity in these products would be expected, resulting in more demand for the U.S. currency.

EXPLORING FINANCIAL DATA FROM THE REGION CAN GIVE US A GOOD INDICATION OF HOW SEVERELY FINANCIAL MARKETS CAN REACT TO ANY GEOPOLITICAL CRISIS.

Performance of Various Investments[1] During and in the Months Following Six Key Events in the Middle East

		Event and Reaction Dates					
Investment Performance		Arab Oil Embargo (10/16/73 – 12/05/73)	Iranian Revolution (1/16/79 – 12/1/79)	Iraq Invasion of Kuwait (8/02/90 – 8/23/90)	Persian Gulf War (1/17/91 – 2/28/91)	U.S. Iraq War (3/20/03 – 4/9/03)	Libyan Civil War (Arab Spring) (2/18/11 – 5/2/11)
Canadian Stocks[2]	During the Event	-5%	30%	-5%	9%	-1%	-1%
	Next Six Months	-8%	19%	5%	4%	20%	-11%
U.S. Stocks[3]	During the Event	-16%	6%	-13%	12%	-1%	2%
	Next Six Months	-2%	9%	20%	23%	21%	-8%
Oil[4]	During the Event	287%	119%	34%	-10%	1%	33%
	Next Six Months	-13%	22%	-45%	13%	7%	-18%
Gold	During the Event	4%	109%	9%	-4%	-4%	11%
	Next Six Months	44%	32%	-8%	-2%	15%	13%
Canadian Bonds[5]	During the Event	2%	1%	0%	4%	2%	1%
	Next Six Months	-5%	4%	11%	5%	4%	6%
U.S. Bonds[6]	During the Event	-2%	-2%	-4%	2%	-1%	-3%
	Next Six Months	-6%	3%	11%	6%	2%	-1%

[1] Some return estimates are approximated based on monthly data. Returns for U.S. stocks, oil and gold are expressed in U.S. dollars; otherwise, the returns are expressed in Canadian dollars.

[2] Canadian stocks are represented by the S&P/TSX Composite Index.

[3] U.S. stocks are represented by the S&P 500 Total Return Index.

[4] Oil is represented by the price of West Texas Intermediate, as supplied by Thomson Reuters.

[5] Canadian bonds are represented by government of Canada bonds with a maturity greater than 10 years prior to 1980 and the DEX Universe Bond Index thereafter.

[6] U.S. bonds are represented by 20-year U.S. government bonds.

Source: Segal Rogerscasey Canada

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- The price of gold and other precious metals would increase. Precious metals are often viewed as "safe-haven" investments. They can sometimes function as pseudo-currencies and may be preferred relative to other investments in times of crisis, due to their intrinsic and tangible value. Certain economies (particularly those in the developing world) will lose confidence in their local currencies in times of global instability.

- The price of crude oil would increase significantly as supply disruptions occur. As much as one quarter of the world's supply comes from the Middle East.

- By extension to the price increases in oil and gold, many energy-related equity securities would likely outperform other types of securities, a development that would favor many of the major Canadian equity indices over U.S. equity indices because the Canadian indices are more concentrated on energy. Companies that engage in energy production and extraction would enjoy higher prices for their products while having relatively fixed costs. Similar comments can be made for mining companies that specialize in gold or silver mining production.

It is also important to note the following:

- Oil prices were at low levels in the 1970s—below $4 USD a barrel early in the decade compared with near $100 USD a barrel at the time this publication was written. Oil was driven to almost $12 a barrel during the Arab Oil Embargo — a similar magnitude increase today would take oil to almost $400, which is likely too far a reach given the existence of Strategic Petroleum Reserves (SPRs) in many major countries today, which can help dampen any short-term spikes. In addition, oil prices were rather suppressed prior to the 1970s. However, oil prices reaching over $200 a barrel would not be unreasonable.
- Gold prices have tended to continue rising after a crisis ends, in many cases due to the inflationary impact of the event on the global economy. Central banks, for example, may engage in monetary stimulus measures to re-ignite economies that have stalled or retreated during the crisis.
- Given the world's growing dependence on energy, particularly in southeast Asia, it is quite possible a new Middle East crisis would affect the equity markets more than past crises did, although this could be mitigated somewhat by increasing global diversity of oil production and renewable alternatives.

STRATEGIES FOR INSULATING PORTFOLIOS FROM GEOPOLITICAL INSTABILITY

Even if an investor has a diversified investment program, any major geopolitical crisis will still likely have a negative effect on investment performance. However, investors should keep in mind that many geopolitical events de-escalate very rapidly into non-events. Therefore, a portfolio cannot always be positioned for a geopolitical crisis since it is uncertain if the perceived event will materialize into something larger.

However, as suggested above, certain sectors can perform well in troubled times. Energy-related equity investments can perform well relative to equities in general. Having parts of a portfolio invested in fixed income and dividend-paying securities can provide the cash flow needed to support the portfolio's financial obligations, despite any short-term market fluctuations that can occur. In addition, even though most portfolios will not include a direct exposure to precious metals, those that do or have an exposure to mining companies that are particularly focused on this sector may experience better relative performance. Gold has often been considered a safe-haven investment and a hedge against inflation, and as seen in the table on page 2, gold often performs well even after a crisis ends. For more sophisticated investors that can handle the volatility, an alternative could be to invest via oil and gold futures.

INVESTORS SHOULD NOT LOOK UPON NEGATIVE MARKET EVENTS ONLY WITH DESPAIR, BUT AS A CHANCE TO REVIEW PRIOR ASSET ALLOCATION DECISIONS WITH THE GOAL OF ESTABLISHING BETTER PORTFOLIO POSITIONING.

We would not suggest a heavy exposure to these categories given that many events do not materialize into full-blown crises and for many other reasons. Diversification should always be an important consideration. However, excluding these components in an asset allocation decision must be carefully weighed when evaluating the return and potential risk of the portfolio under review.

INVESTMENT OPPORTUNITIES DURING A CRISIS

It should be noted that any financial market dislocations would provide opportunities to shift back to investment categories that were previously considered expensive from a valuation point of view, assuming that financial conditions would return to some sort of normalcy within a short period. As demonstrated in the table on page 21, there would likely be an economic rebound once the crisis that triggered the repercussions ends.

Raising some cash from the equity portion of the portfolio or delaying some asset purchases in anticipation of a crisis can provide an opportunity to purchase equity securities at lower prices.

Also, previously idle cash can be deployed at that time to take advantage of new opportunities.

The portfolio can be rebalanced such that the asset allocation weightings can be returned to a previously-agreed-upon, long-term strategic weighting. In addition, alternative investments such as real estate and infrastructure can be introduced into the portfolio for the first time.

CONCLUSION

Geopolitical events are prone to cause fear and disrupt an otherwise well-thought-out long-term strategic investment strategy. Emotions can run high. Asset valuations become distorted and future market expectations can become radically changed. Advice on what to do is also not readily available in these fast-moving and disruptive investment climates.

A major financial market dislocation provides a great opportunity to revisit the asset allocation strategy of the portfolio. Segal Rogerscasey Canada has performed numerous asset allocation studies for its clients to reevaluate portfolio positioning based on existing, evolving or new global macroeconomic and market circumstances. We also have the tools to evaluate extreme market events and how these can impact the overall performance of a portfolio.

Investors should not look upon negative market events only with despair, but as a chance to review prior asset allocation decisions with the goal of establishing better portfolio positioning. A static asset allocation decision that only considers a small set of asset classes is not truly suitable for the needs of most clients and investors. As needs, return expectations and risks change, so too should portfolio positioning.

Nino Boezio, FSA, FCIA, CFA, is with Segal Rogerscasey Canada. He can be contacted at nboezio@segalrc.com.