Geopolitics and markets

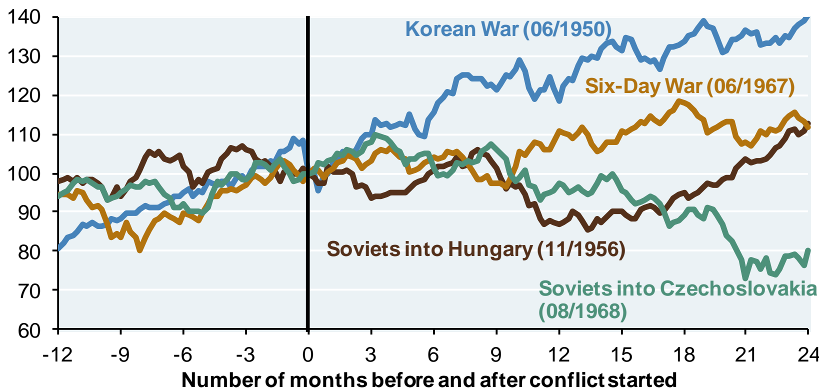
You can be forgiven for thinking that the world is a pretty terrible place right now: the downing of a Malaysian jetliner in eastern Ukraine and escalating sanctions against Russia, the Israeli-Palestinian conflict in Gaza, renewed fighting in Libya, civil wars in Syria, Afghanistan, Iraq and Somalia, Islamist insurgencies in Nigeria and Mali, ongoing post-election chaos in Kenya, violent conflicts in Pakistan, Sudan and Yemen, assorted mayhem in central Africa, and the situation in North Korea, described in a 2014 United Nations Human Rights report as having no parallel in the contemporary world. Only in Colombia does it look like a multi-decade conflict is finally staggering to its end. For investors, strange as it might seem, such conflicts are not affecting the world's largest equity markets very much. Perhaps this reflects the small footprint of war zone countries within the global capital markets and global economy, other than through oil production.

War zone countries as a % of total world...	
Population	11.7%
Oil production	9.0%
Foreign direct investment	3.8%
Gross domestic product	3.0%
Gross national product	2.8%
Trade	2.6%
Imports	2.5%
Gross capital formation	2.4%
Corporate profits	0.8%
Equity market capitalization	0.7%
Interbank claims	0.5%
Portfolio investment inflows	0.4%

Sources: IMF, United Nations, BP, MSCI, Bloomberg, BIS, World Bank, WTO. November 2014.

The (mostly limited) impact of geopolitics on US equity markets

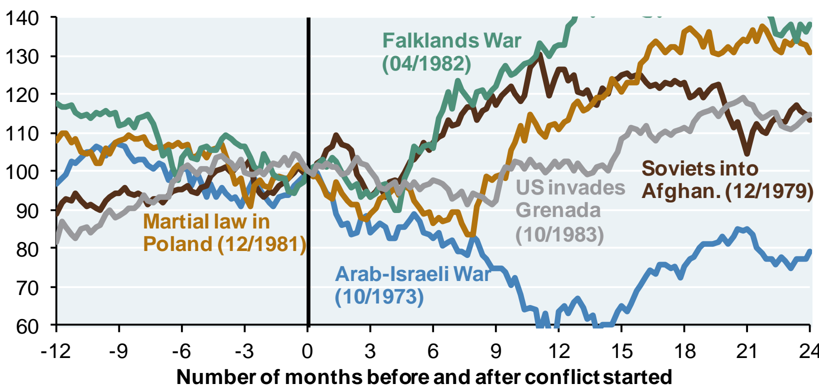
This is a broad generalization, but since 1950, with the exception of the Israeli-Arab War of 1973 (which led to a Saudi oil embargo against the US and a quadrupling of oil prices), major military confrontations did not have a lasting medium-term impact on US equity markets. In the charts below, we look at US equities before and after the inception of each conflict in three different eras since 1950. The business cycle has been a more important factor for investors to follow than war, which is why we spend so much more time on the former. While Russia emerged as a global risk factor in 2014, this is more a by-product of declining oil prices than of the conflict in the Ukraine (the Russian Ruble didn't collapse until oil did).



Source: Bloomberg. Equity index represents price returns.

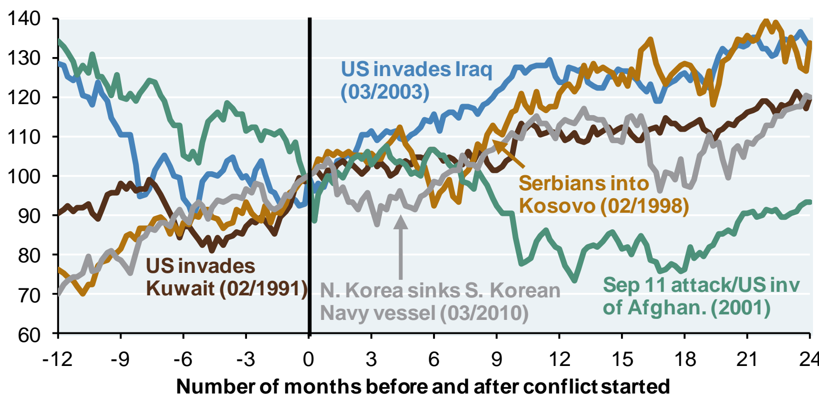
Soviet invasions of Hungary and Czechoslovakia did not lead to a severe market reaction, nor did the outbreak of the Korean War or the Arab-Israeli Six-Day War.

We did not include the US-Vietnam War, since it's hard to pinpoint when it began. One could argue that Vietnam-era deficit spending eventually led to rising inflation (from 3% in 1967 to 5% in 1970), a rise in the Fed Funds rate from 5% in 1968 to 9% in 1969, and a US equity market decline in 1969-1970 (this decline shows up at the tail end of the S&P series showing the impact of the Soviet invasion of Czechoslovakia).



Source: Bloomberg. Equity index represents price returns.

The Arab-Israeli War of 1973 led to an oil embargo and an energy crisis in the US, all of which contributed to inflation, a severe recession and a sharp equity market decline. Pre-existing wage and price controls made the situation worse, but the war/embargo played a large role. Separately, markets were not adversely affected by the Falklands War, martial law in Poland, the Soviet war in Afghanistan, or US invasions of Grenada or Panama. The market decline in 1981 was more closely related to a double-dip US recession and the anti-inflation policies of the Volcker Fed.



Source: Bloomberg. Equity index represents price returns.

Equity market reactions to US invasions of Kuwait and Iraq, and the Serbian invasion of Kosovo, were mild. There was a sharp market decline after the September 11th attacks, but it reversed within weeks. The subsequent market decline in 2002 was arguably more about the continued unraveling of the technology bust than about aftershocks from the September 11th attacks and Afghan War. As for North Korea, in a Nov. 2010 *EoTM* we outlined how after North Korean missile launches, naval clashes and nuclear tests, South Korean equities typically recover within a few weeks.

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