September 2017

RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Geopolitical wake-up call

With high-stakes geopolitical risks back to the fore, what does this mean for equity markets and portfolio decision-making?

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All values in U.S. dollars and priced as of August 31, 2017, market close, unless otherwise noted.

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Markets are facing a simmering geopolitical pot as the U.S. and North Korea ramped up the rhetorical brinksmanship this summer. We revisit how equites reacted to past geopolitical crises, and discuss how to factor a wide range of outcomes into portfolio decisions if the showdown escalates into something more ominous.

After a multiyear hiatus, geopolitical risks are back on the table amid aggressive rhetoric between North Korea and the U.S. along with related missile tests and fresh economic sanctions.

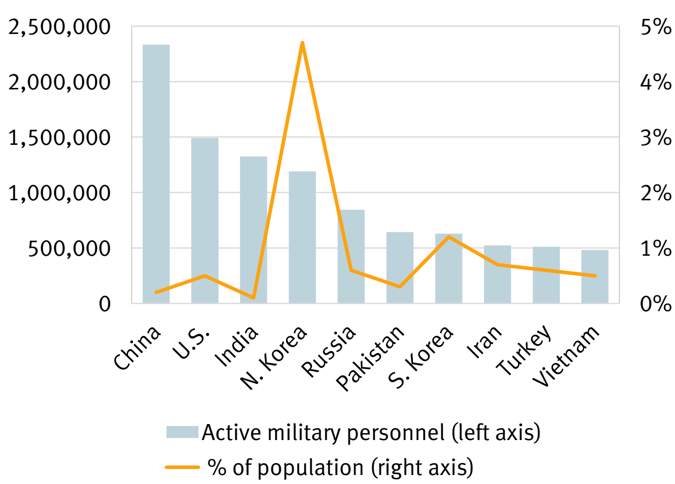
Factoring this or any credible geopolitical threat into investment decisions can be challenging given the wide range of potential outcomes, some with high stakes.

Add to that, there is an unpredictable, young leader on one side squaring off with an unpredictable, new president on the other side who campaigned on a non-interventionist foreign policy platform but is increasingly making interventionist moves in multiple regions of the world. Then there are the vital interests of South Korea along with the roles of neighboring China, Russia, and Japan.

The North Korea situation comes at a time when equity markets are sitting just beneath all-time highs and the global economy and corporate earnings continue to show signs of buoyancy. In other words, markets have good reasons to look past the geopolitical risks, as long as they don't escalate to a dangerous level.

We examine how previous geopolitical incidents impacted equities, highlight the proverbial "canaries in the coal mine" related to North Korea, and discuss rules of thumb about factoring geopolitical risks into portfolio decision-making.

The world's 10 largest militaries by active personnel



North Korea has one of the world's largest militaries, and the biggest force as a % of population.

Source - RBC Capital Markets, RBC Wealth Management, World Bank, OECD

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Tension and release

Historically, equity markets have reacted to military clashes in a more muted manner than one may think.

The S&P 500 fell 6.3%, on average, in 17 post-WWII military conflicts listed in the table below. The market's reaction lasted an average of only 30 days. At times equities weakened during the run-up to the conflict as tensions were mounting, and recovered soon after it began.

But like any small sample size, there were notable deviations. Markets were not immune from volatility and losses. Some events sparked 10%+ corrections and negatively impacted the economy.

For example, the S&P 500 dropped 15% when the U.S. bombed Cambodia during the Vietnam War, and it declined 16% when Iraq invaded Kuwait. The 9/11 terrorist attacks brought about a decline of almost 12%. Each of these events occurred

S&P 500 responses to select acts of war and terrorism since WWII

Events	Start date	# trading days to trough	% change to trough	# trading days back to even
Acts of war				
U.S.				
U-2 spy shot down; cover unwound	May 7, 1960	2	-0.6%	4
Bay of Pigs invasion	Apr 15, 1961	6	-3.0%	14
Cuban Missile Crisis	Oct 16, 1962	6	-6.3%	13
Gulf of Tonkin incident (Vietnam)	Aug 2, 1964	4	-2.2%	29
Tet Offensive (Vietnam)	Jan 29, 1968	25	-6.0%	46
Cambodian Campaign (Vietnam)	May 1, 1970	18	-14.9%	86
U.S. invades Grenada	Oct 25, 1983	11	-2.8%	15
Lead-up to U.S. Panama invasion	Dec 15, 1989	2	-2.2%	8
Lead-up to Gulf War: Desert Storm	Jan 1, 1991	6	-5.7%	13
U.S. spy plane captured in China	Apr 1, 2001	3	-4.9%	7
War in Afghanistan	Oct 7, 2001	1	-0.8%	3
Lead-up to Iraq War	Feb 5, 2003	24	-5.6%	28
External				
N. Korea invades S. Korea	Jun 25, 1950	15	-12.9%	56
Lead-up to Six-Day War (June 6)	May 14, 1967	15	-5.6%	20
Yom Kippur War / Arab oil embargo	Oct 6, 1973	42	-16.1%	6 years*
Soviet-Afghan War	Dec 24, 1979	7	-2.3%	10
Iraq invades Kuwait / oilfields seized	Aug 2, 1990	50	-15.9%	131
Average		14	-6.3%	30
Terrorism				
U.S. Embassy seized in Iran	Nov 4, 1979	3	-1.0%	6
U.S. Marines killed in Lebanon	Oct 23, 1983	12	-2.5%	15
Oklahoma City bombing	Apr 19, 1995	1	-0.1%	3
U.S. Embassy bombings in Africa	Aug 7, 1998	5	-2.5%	7
WTC, Pentagon, airplane attacks	Sep 11, 2001	5	-11.6%	19
Madrid train bombings	Mar 11, 2004	3	-1.7%	5
London Underground bombings	Jul 7, 2005	no S&P decline; FTSE -1.4%		
Paris Bataclan, restaurant attacks	Nov 13, 2015	1	-1.1%	2
Nice Bastille Day attacks	Jul 14, 2016	1	-0.1%	2
Average		4	-2.6%	7

* Other economic and monetary policy factors negatively influenced the number of days it took the market to get back to even; this is not counted in the average number of trading days back to even.
Source - RBC Wealth Management, RBC Global Asset Management, Wikipedia, The National Security Archive at George Washington University, U.S. Naval Institute. Data attempts to capture any pre-event impact.

The lesson seems to be that when military aggression or wars are significant on a geopolitical scale, it does not necessarily mean equity markets will automatically sell off sharply.

during recessions and likely extended or exacerbated the periods of economic weakness.

It may seem surprising the market did not react more sharply to the Cuban Missile Crisis or the Six-Day War Israel faced given their gravity. The lesson seems to be that when military aggression or wars are significant on a geopolitical scale, it does not necessarily mean equity markets will automatically sell off sharply. Numerous circumstances shape market performance at any given time.

In the case of the Cuban Missile Crisis, the S&P 500 had already plunged 26% months ahead of the confrontation. This "flash crash" had far more to do with extremely high equity valuations, the unwinding of market excesses, and trading mechanics than the prevailing geopolitical strains. The drop may have muted the subsequent selloff during the Cuban Missile Crisis.

It goes without saying that local equity markets could be affected more dramatically by military clashes or a major terrorist attack if the civilian population and infrastructure are seriously impacted.

Stress tests

The canaries in the coal mine of any forthcoming stress on the Korean Peninsula would likely be gold, South Korea's government bond market, and select currencies.

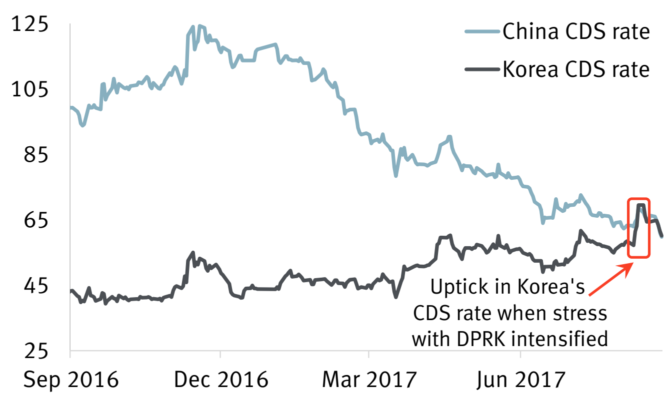
Gold is typically the go-to safe haven when trouble hits. Bullion bounced 5% when North Korea recently tested longer-range missiles and the related rhetoric escalated. If tensions re-emerge gold would likely benefit, but otherwise faces some near-term headwinds (see page 21 for more).

South Korea's bond market is on guard, as the 10-year government yield now trades at a modest yield premium to the comparable U.S. Treasury yield, erasing a long-standing discount. We think the premium would increase if risks of a military conflict flare up again, as South Korea bond yields would likely rise while Treasury yields could fall (and bond prices would do the opposite).

Credit default swap rates are another important risk measure. The cost of insuring 5-year South Korea government bonds against default jumped 22% in just three

Credit default swap (CDS) rates for 5-year sovereigns

(in USD basis points)



The cost to insure Korean and Chinese bonds against default is now roughly the same.

Source - RBC Wealth Management, Bloomberg; data through 8/25/17 days when the prospect of a North Korea-U.S. military clash increased. By this indicator, the risk of South Korea sovereigns is now nearly equal to that of Chinese government bonds.

Among currencies, South Korea's won qualifies as an obvious canary. It declined 2.7% against the dollar during the recent wave of stress. In contrast, the Swiss franc and Japanese yen are often viewed as safe havens. They rose against the dollar when the verbal confrontation intensified.

What's your comfort level?

More broadly, the North Korea uncertainties raise a pertinent question for equity investors: How should geopolitical risks be factored into portfolio decisions?

The difficulty in budgeting for geopolitical risks is that they are often unquantifiable and include multiple, complex scenarios that can be outside of the market's ability to recognize or grasp. Geopolitical events can occur unexpectedly, such as the 9/11 terrorist attacks. At other times, global markets may overreact like they did when Iraq invaded Kuwait.

As geopolitical events play out, the market ultimately gauges the potential economic implications.

In determining equity allocations, investors would be prudent to assume that significant geopolitical risks can crop up from time to time that could push the equity market into a temporary 5%–10% pullback or even a longer-lasting correction of greater magnitude.

If an investor's current allocation to equities cannot be sustained through these types of declines then there may be a mismatch between the equity weighting and liquidity needs, risk tolerance, or time horizon that should be addressed. Funds earmarked for equities should be long-term allocations given the steep swings the equity market can (and usually does) have.

As geopolitical events play out, the market ultimately gauges the potential economic implications. Indicators such as consumer and business confidence, retail sales, and manufacturing activity, along with commodity prices, tend to be the arbiters of whether a geopolitical event will have a transitory or longer-term impact on markets and economies.

Maintenance check

The North Korean flare-up is a reminder that it's always the right time for investors to assess whether their equity exposure is appropriate given their full financial profile and if equity allocations are properly calibrated to match one's liquidity needs, risk tolerance, and time horizon, among other factors.

With or without the escalation of concerns around North Korea our recommendation would argue for leaning against risk by scaling back equity allocations, or sector exposures or individual security positions that may have ballooned during the recent rally. The amplified geopolitical risks underscore this message.

Research resources

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