CITY OF LONDON
Investment Management Company Limited

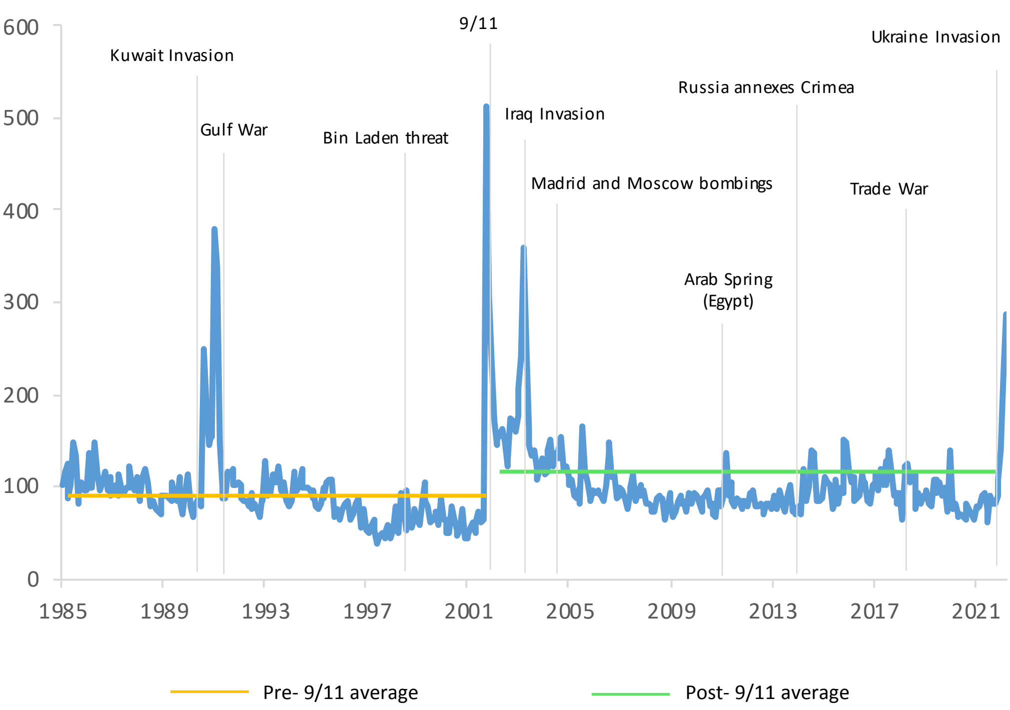
Investment Lessons from Recent Geopolitical Shocks

April 2022

The CLIM Approach

Geopolitical shocks have long been a feature of investing in emerging markets, as illustrated by the Russian invasion of Ukraine. In this paper we explain why our Macro analysis argued for a neutral stance in Russia prior to the invasion and discuss potential solutions to mitigate future geopolitical risks. Most often, but not always, geopolitical shocks are propagated by sharp swings in commodity prices. The CLIM country allocation framework takes these risks into account in two ways. First, as part of our quantitative analysis, we rely on three pillars: 1) Politics and Institutions, 2) Macro Fundamentals and 3) Market Fundamentals. The first pillar builds on indicators of governance, corruption, rule of law, regulation etc. One of the six indicators we consider in the first pillar relates to "political stability and the absence of violence". However, the first pillar (Politics and Institutions) accounts for only 25% of the country scores we construct for frontier markets, 10% of the score for emerging markets and 5% for developed markets. The weight of the "stability and violence" sub-component thus forms a relatively small part of our quantitative assessment. However, geopolitical risk also enters the second stage of our analysis, the qualitative assessment, which focuses on trans-national factors and the risks and opportunities lying ahead.

Chart 1: A New Geopolitical Landscape



Source: Caldara, Dario and Matteo Iacoviello (2022), "Measuring Geopolitical Risk," American Economic Review, April, 112(4), pp.1194-1225.

Indicators compiled by private providers suggest that geopolitical risk has risen in stepwise fashion following 9/11 and the subsequent invasion of Iraq (see chart 1). This measure also correlates positively with market volatility as expressed by the VIX. Are there fundamental reasons to believe that geopolitical risk has permanently increased and will play an increasingly important role for markets? We believe so. When the tectonic plates of geopolitics shift, frictions naturally arise: approximately 30 years ago, the US and the West experimented with opening their semi-globalised system to the rest of the world following the collapse of the Soviet Union and the early market reforms that took place in China. It also aimed to address the multiple economic crises that plagued Latin America, Turkey, India and Africa in the 1980s and early 1990s.

The experiment succeeded in many respects, introducing greater competition, openness and productivity to previously heavily regulated or planned economies, culminating in China's accession to the WTO in 2001 and Russia's in 2012. Yet, the associated increase in capital flows, which met with remaining rigidities (e.g. fixed or managed exchange rates) still led to recurrent financial crises across the emerging world. In the wake of the 2008-09 Global Financial Crisis, the public began to develop greater sensitivity to the costs of unbridled globalisation and winner-takes-all competition. Politicians in turn began to pander to these shifts in sentiment, encouraging a retrenchment from globalisation (re-shoring), increased trade protectionism and support for flailing domestic manufacturing activity. While the end of the Cold War granted the US a short-lived unipolar moment in history, the ascendancy of China quickly developed into a new rivalry, euphemistically labelled "strategic competition" by the US. But this rivalry is not only a race for global market share and economic heft, it also represents competition between different political and economic systems. Indeed, both Russia's invasion of Ukraine and China's increasingly fervent claim on Taiwan can be interpreted as illustrations of such a 'systems competition'.

The present conflict in Ukraine has uncovered another channel through which geopolitics affect economies and markets: the weaponisation of finance. In a first among G20 countries, the West has frozen Russia's reserve assets held abroad and curtailed the use of the SWIFT messaging system (other countries previously subject to such actions include Syria, Iran and North Korea). This will call into question the wisdom of erecting a 'fortress economy' and force other countries with similar designs to adapt their economic and geopolitical strategy. One long term possibility is that this move will undermine the attractiveness of the US dollar as a reserve currency. For the moment, an alternative payments system and currency are not in sight, but movements towards them could be accelerated as a result.

The Market Evidence

A review of market behaviour over a period of more than eighty years shows that geopolitical shocks are most powerful (in terms of generating at least a double-digit market loss) when they either provoke a strong commodity price shock or occur on US territory and/or involve US personnel elsewhere. Except in rare cases, the period of the market sell-off is limited to less than a month. Conversely, the recovery (to the pre-event price level) is swift and only occasionally does it exceed 100 days (see chart 2).

Emerging market equities typically fare somewhat worse, understandable given their more vulnerable economies, dependent as they are on foreign goods and capital. While the effect on the asset class may be limited in general, that on individual markets can be dramatic as the recent exclusion of Russian equities from the investable universe demonstrates. In all cases, volatility spikes sharply in the short term.

Chart 2: Geopolitical Events & Market Impact

Event		S&P 500			MSCI EM		
		Size of Selloff (%)	Duration of Selloff (Trading Days)	Duration to Recover (Trading Days)	Size of Selloff (%)	Duration of Selloff (Trading Days)	Duration to Recover (Trading Days)
Ukraine Invasion	Feb-22	-9	20	16	-18	24	na
Iranian Gen. Airstrike *	Jan-20	-1	2	5	1	3	4
N. Korea Missile Crisis	Jul-17	0	4	6	[illegible]	2	3
Bombing of Syria	Apr-17	-3	32	17	-2	11	4
Arab Spring (Egypt) *	Jan-11	-2	2	3	-5	21	22
Iraq War	Mar-03	-5	7	17	-4	7	6
9/11 Terrorist Attack *	Sep-01	-12	10	15	-15	10	39
Kosovo Bombing	Mar-99	-4	4	10	-2	4	5
WTC Bombing *	Feb-93	0	1	2	1	3	4
Gorbachev Coup *	Aug-91	-2	2	3	-5	2	4
Gulf War/ Operation Desert Storm	Jan-91	-6	7	8	-6	9	3
Kuwait Invasion *	Aug-90	-17	52	85	-31	119	101
USSR in Afghanistan	Dec-79	-4	14	6	na	na	na
Iran Hostage Crisis	Nov-79	-10	24	54	na	na	na
Yom Kippur War/Oil Embargo*	Oct-73	-17	28	1523	na	na	na
Six-Day War	Jun-67	-7	21	41	na	na	na
Vietnam War	Aug-64	-3	15	37	na	na	na
Kennedy Assassination *	Nov-63	-3	2	3	na	na	na
Cuban Missile Crisis *	Oct-62	-7	7	9	na	na	na
Suez Canal Crisis *	Oct-56	-7	19	137	na	na	na
Korean War	Jun-50	-13	18	44	na	na	na
Pearl Harbour	Dec-41	-11	18	207	na	na	na
Average		-6	14	102	-7	18	18

Note: Figures in this table measure a sell-off from when we believe it began to be priced in by markets. Events that were genuine surprises and were thus not anticipated by markets are marked by asterisks (*).

Source: Bloomberg

How to Respond to Increased Geopolitical Risk?

While the financial impact of geopolitical shocks is often not durable or systemic, they can still have significant effects on individual countries and their equity markets and/or require a wholesale portfolio adjustment. Our country reallocation favouring commodity exporters and penalizing large importers in the wake of the Ukraine invasion is a case in point. The episode also illustrates that commodity prices often provide the most powerful transmission mechanism of the initial shock.

One possibility for future analysis is to use additional, external indicators (e.g. those constructed by Eurasia Group or the Federal Reserve) that attempt to measure the risk of domestic and foreign violence and its economic impact. Given that these shocks are tail events ('black swans'), we are more likely to include such indicators in our qualitative assessment than subsume them in our quantitative analysis, where they may be insufficiently calibrated. If they are assigned a small weight, they could easily be outweighed by other factors, but if given a heftier weight, they might lead to an excessively risk averse posture.

An important caveat to this approach is that the ultimate effect of any shock on the market depends on a multitude of factors, including a country's position in the economic cycle, the government's and central bank's policy stance and the degree of freedom each has to accommodate the shock. In the same vein, it is important not to overreact to the current situation – territorial invasions are exceedingly rare and market prices reflect many other considerations too. While the strength of the most recent sanctions may act as a deterrent for some countries' territorial ambitions, they likely won't deter a truly determined regime. What is more, while the West appears united in its stance, the alliance is far from global: 81 of the UN's 193 member countries did not vote in favour of ejecting Russia from the Human Rights Council.

Our favoured approach in highly uncertain situations is to resort to scenario analysis. This allows us to map out all conceivable paths (however unlikely), attach subjective probabilities to them and draw out the market implications. In the run-up to the war on Ukraine, we established four possible paths: 1) a diplomatic resolution (10%), 2) a stealth invasion, fomenting insurrection, cyberattacks etc (25%) 3) a partial invasion e.g. establishing Donbas-Crimea land bridge (55%) and 4) a full scale invasion (10%). In other words, while we contemplated invasion as a possible outcome, we judged it to be unlikely. As a result, CLIM's Macro team recommended a neutral allocation to the Russian market given its exceptionally low valuations. However, the exercise also shows that the construction of mutually exclusive scenarios can be difficult as the Ukrainian government appears to hold and parts of both scenarios (3) and (4) now seem to be unfolding. What is more, low probability events may simply come to pass at times, reinforcing the case for pro-active risk management as much as for comprehensive analysis.

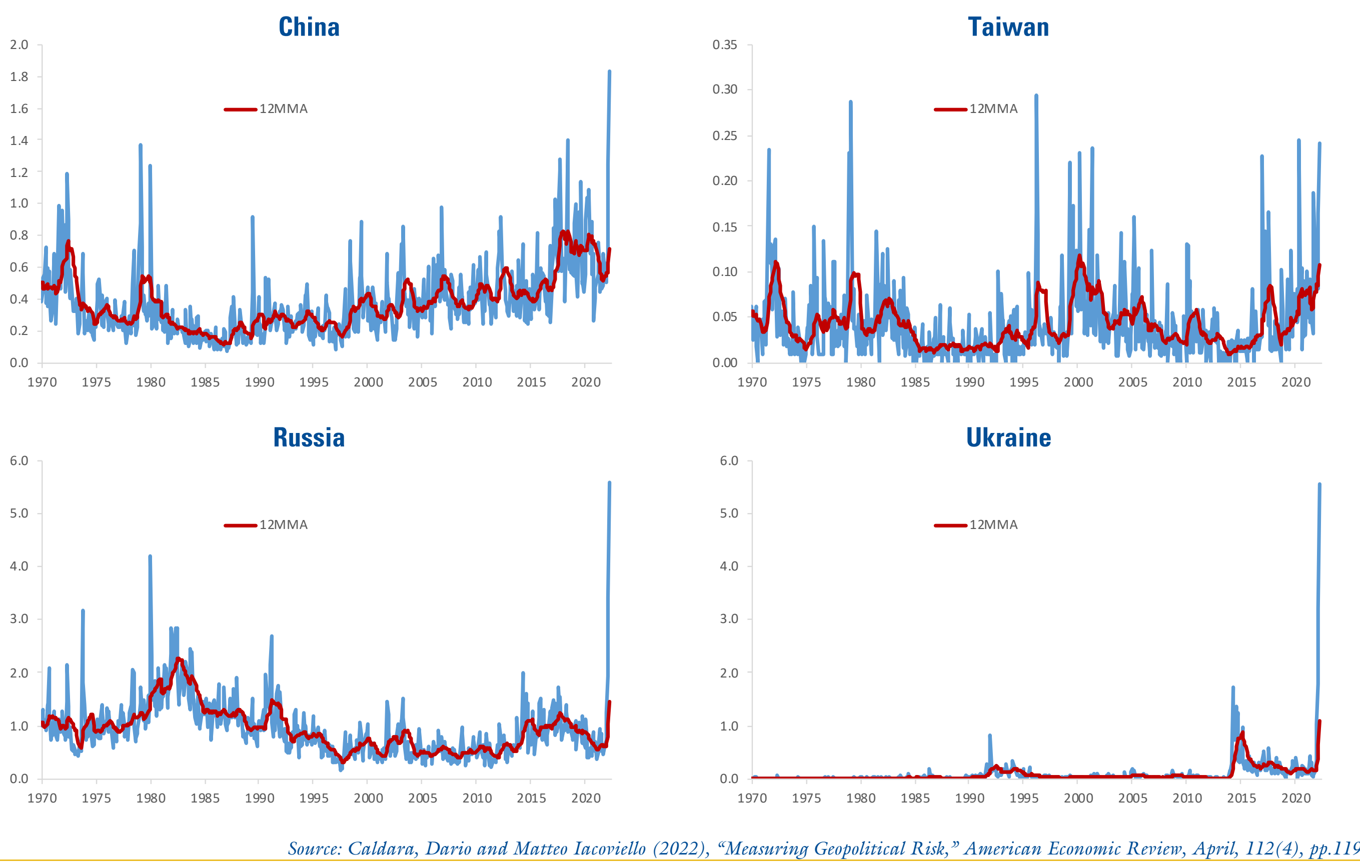
Conclusion

In our view, a better incorporation of geopolitical risks into our framework is required given the changing world order and the new 'systems competition' we identified. We will continue to review our process and evaluate additional resources and metrics that can provide original and timely insight into these issues.

Timely, consistent indicators are notoriously difficult to construct. The Federal Reserve index shown in Chart 3, which relies on the number of phrases relating to military acts and threats found in US, UK and Canadian newspapers, demonstrates how challenging and potentially misleading such measures can be. However, if an adequate, predictive indicator could be found, it would enhance our analysis. Even then, it is important to remember that markets respond to a multitude of factors and that public policy can mitigate or amplify any such effect.

We will also invest more time in scenario analysis, which – while not sure-proof – provides the best tool to appreciate the implications of a range of possible outcomes. Most situations don't lend themselves to binary outcomes as the present case has shown. Similarly, China's claims on Taiwan can materialize in a variety of ways other than outright military attack, e.g. through blockades, infiltration, cyberattacks, or via financial markets to name a few. The same holds for Iran's ambitions in the region and North Korea's strategy vis-a-vis its southern neighbour. We aim to explore these global flashpoints in greater detail and employ courage and creativity to ascertain the likelihood of unexpected scenarios going forward.

Chart 3: Geopolitical Risk Indicator by the Federal Reserve



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