Navigating Geopolitical Risk

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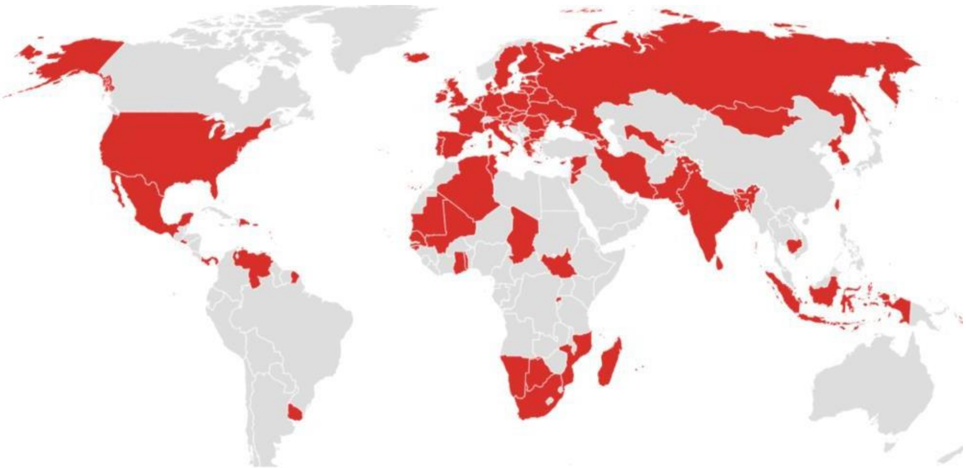
This year has been particularly turbulent on the global stage. Many analysts believe we have entered a new era of geopolitical tension, and 2024 has only intensified this with the election supercycle, trade wars, and the potential escalation of already volatile conflicts. In this document, we will explore the significant risks currently shaping the global landscape, including the global election supercycle, ongoing geopolitical conflicts such as the US-China trade tensions, the Russia-Ukraine war, and the escalating situation in the Middle East. We will also discuss how these risks are measured, the potential future trajectory of these tensions, and the importance of maintaining a disciplined investment approach amidst such uncertainties. While no one can predict the future with certainty, understanding these dynamics may help ease some apprehension and reinforce the value of staying the course.

Election 'Supercycle'

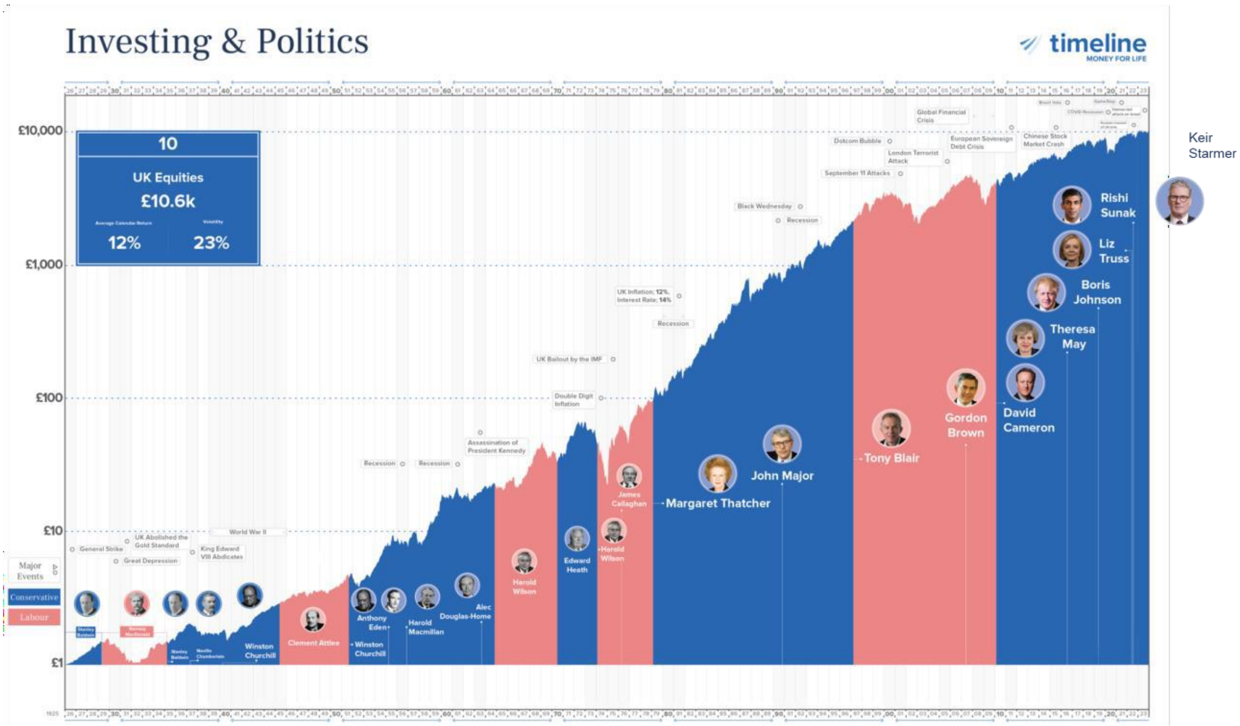
2024 is certainly a year for history books, with the Olympics, men's football (almost) coming home, and Murray's peaceful retirement from the world tennis stage. The other events that have graced the newspapers this year seem to be the never-ending elections playing out across the globe. This is a historic year for democracy, with 40% of the global population, which contributes to 50% of global GDP[1], heading towards the polling stations at some point in 2024, all highlighted in red below. According to Timeline's calculations, this equates to just over 80% of global market capitalisation. With this in mind, what will be the impact on the markets?



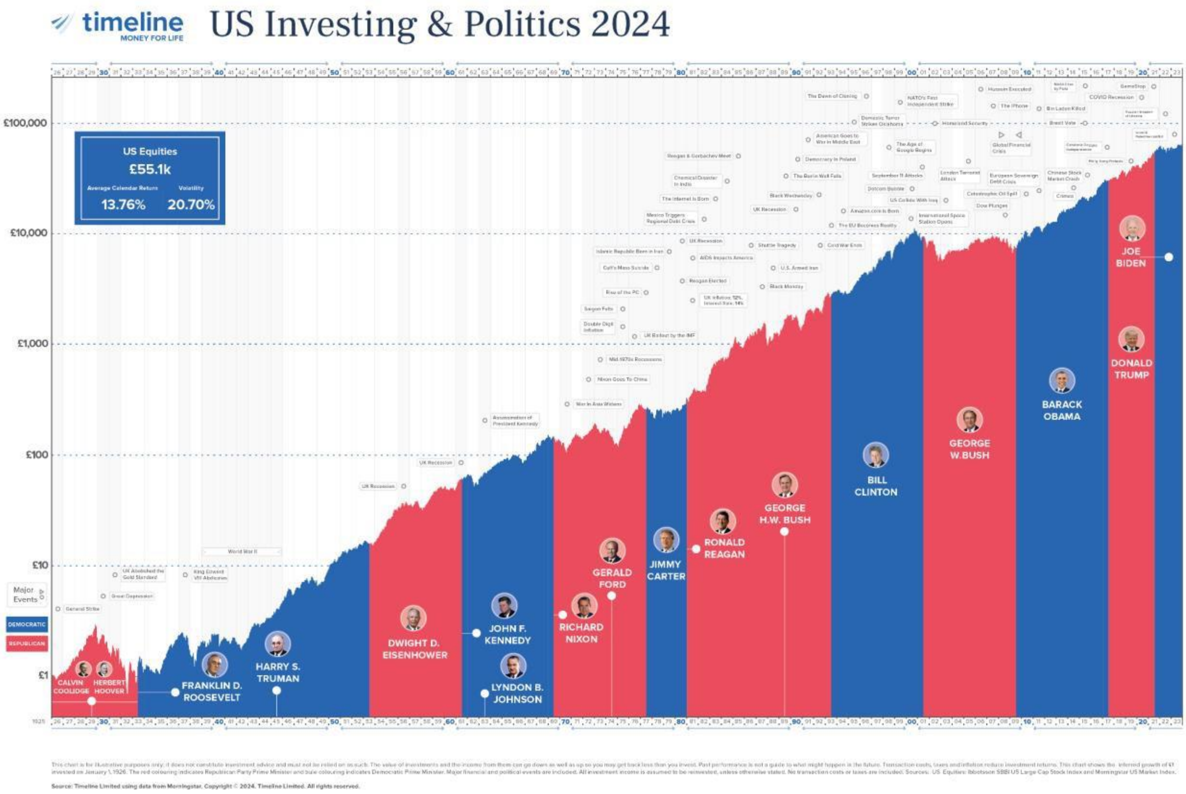
Source: Timeline (2024)

Most of our clients will be very aware of our next charts, but they are pivotal in reiterating our philosophy: markets don't care who sits in the Oval Office or at Downing Street, they continue onwards. It is a reminder not to let politics dictate your portfolio, the engine driving your financial future.

[1] Charles Stanley, 2024



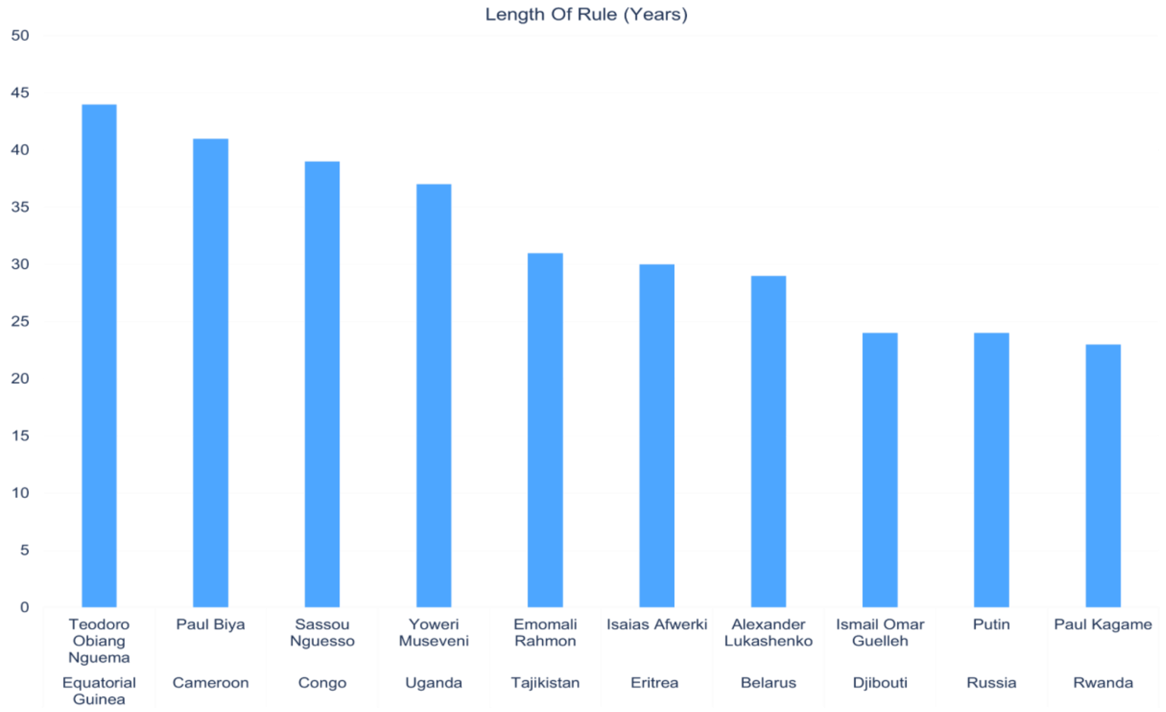
Source: Timeline (2024)



Source: Timeline (2024)

One key observation from the two above graphs is the healthy alternation between the parties in power. It is natural for people to fear the worst if their preferred party loses an election, however history has shown that these fears are often unfounded. Markets tend to continue their upward trajectory regardless of which party is in power. The ability to transition between governments in a peaceful manner should be seen as a hallmark of a robust democratic system, reflecting the evolving needs of the electorate. This process allows markets to flourish in response to a system that adapts to change.

In contrast, there are countries where leaders have maintained power for decades, as shown in the chart below. These long-standing governments may not be considered by most people as free and fair societies. The lack of regular, fair elections in such contexts can result in perceptions of limited rights and suppression of political opposition. This highlights the importance of democratic processes in supporting both societal freedom and economic stability.



It is important to recognise that even in well-functioning democratic systems, elections can cause market noise - a small side effect of democracy. As a general rule, markets tend to react negatively to periods of uncertainty. Perhaps this is most evident during US elections, which account for 62% of the global equity market capitalisation and play a significant role in shaping both internal and international policies. During a recent investment webinar, a poll suggested that many advisers believed that Trump was likely to re-enter the White House. Whilst it is impossible to predict the actual winner, there are realistically four potential outcomes: a Republican landslide, a Democrat landslide, a divided government with Trump in charge, or a divided government with Harris in charge. At present, it is uncertain who will end up in the White House, but the worst outcome from a market perspective may be a contested victory, which could lead to a period of uncertainty and vulnerability. Yet, based on historical data, this should only result in volatility for a matter of months rather than any prolonged impact on markets. In election years, there is generally heightened volatility at the start of the year; however, as a clear winner emerges, returns typically normalise and reach non-election year heights. Essentially markets react well to certainty.

Source: BlackRock (2024) BlackRock Fundamental Equities

What is Geopolitical Risk, and How is it Measured?

The word 'geopolitical risk' is thrown around liberally by the media and investment professionals alike. But what do these words mean for our clients and in the context of their portfolios? The CFA definition of 'geopolitical risk' is:

> 'The risk of tensions or actions between actors that disrupt the normal and peaceful course of international relations. This risk can include the threat, realisation, and escalation of adverse events such as wars, terrorism, and tensions between states and political actors.'

Geopolitical risk tends to be measured consistently by a Geopolitical Risk Index (GRI). This is constructed from news articles present in major worldwide news publications based on keyword searches of an extensive library of terms that denote "risky" actions. These include, but are not limited to, invasions, blockades, threats, and terrorist activity. The index measures risk as the share of these news articles containing and addressing these terms at a given point in time.

This is something to flag, as geopolitical risk may decrease on a GRI without any solution to the events that caused a spike. As we all know, the news cycle can be a fickle thing, and as events progress over time, they end up losing momentum and falling out of public consciousness. As new stories come into the newspapers, previous ones are reported on less, especially those that carry on for a prolonged period of time. Therefore, GRIs, whilst useful, only provide part of the picture.

Current Geopolitical Risks and Hotspots

Writing about geopolitics comes with the inherent challenge of its ever-shifting nature. By the time this document is released, some information may be outdated, or events may have escalated. Nonetheless, these are the key players and events as they stand at the time of writing.

East-West Tensions

Recent poll shows that many respondents are concerned about the risk of escalating global conflicts. While this is a significant worry, many analysts argue that the growing tension between the East and West, particularly as trade restrictions increase, is of even greater concern. US-China relations remain a contentious issue despite appearing relatively stable compared to previous years. The upcoming election in the US could be a turning point where this relationship may face further strain. Trade tensions between the US and China escalated in 2018 when the US imposed tariffs on Chinese imports to reduce its trade deficit.

This triggered a prolonged trade conflict that has significantly impacted global trade. Although negotiations were attempted, they broke down in May 2019, and the issue remains unresolved. Whether Trump or Harris ends up in the White House, this will likely be a leading topic for the next four years.

The Russia-Ukraine Conflict

The ongoing Russia-Ukraine conflict continues to be a significant geopolitical risk as we move into 2024. This conflict has sparked a long-term humanitarian crisis and heightened risks to capital flow, international trade, and global markets. Geopolitical tensions between NATO and Russia have been high since the annexation of Crimea in 2014, and Russia's invasion of Ukraine has brought these tensions to levels not seen since the Cold War.

Economic sanctions imposed on Russia, coupled with NATO's continued financial and military support for Ukraine, have only deepened the rift. Although neither side appears to seek an escalation, the heightened tensions bring the risk of accidental or intentional escalation, which could lead to a full-blown global conflict with catastrophic consequences. Given this backdrop, a ceasefire remains unlikely in the near term.

The Escalating Situation in the Middle East

The situation in the Middle East is another area of growing concern. The ongoing humanitarian crisis is catastrophic and could deteriorate further over time. However, from a market and global economy perspective, the situation in the Middle East remains relatively contained. The states currently involved have limited influence on global financial stability, with the main monetary impact likely to be on 'safe haven' assets such as gold and oil, which tend to see price increases during times of uncertainty.

Currently, there seems to be no imminent agreement for a ceasefire, with the conflict seemingly escalating. Additionally, there appears to be no clear plan for post-war governance and security in Gaza to help ensure long-term stability in the region. Military operations are likely to persist as the conflict escalates, displacing citizens on both sides. The situation in the region remains precarious.

The Growing Cybersecurity Threat

An issue that transcends regional boundaries is cybersecurity. As our lives and infrastructure increasingly move online, the potential for cyber-attacks grows. These attacks can take many forms, including corporate espionage, criminal extortion, and even international conflict. During a recent summit, Goldman Sachs reported that a cyber-attack occurs every 39 seconds. Not only are these attacks becoming more frequent, but they are also becoming increasingly costly. The average cost of a cyberattack has skyrocketed from $17.8 million in 2001 to $6.9 billion more recently.

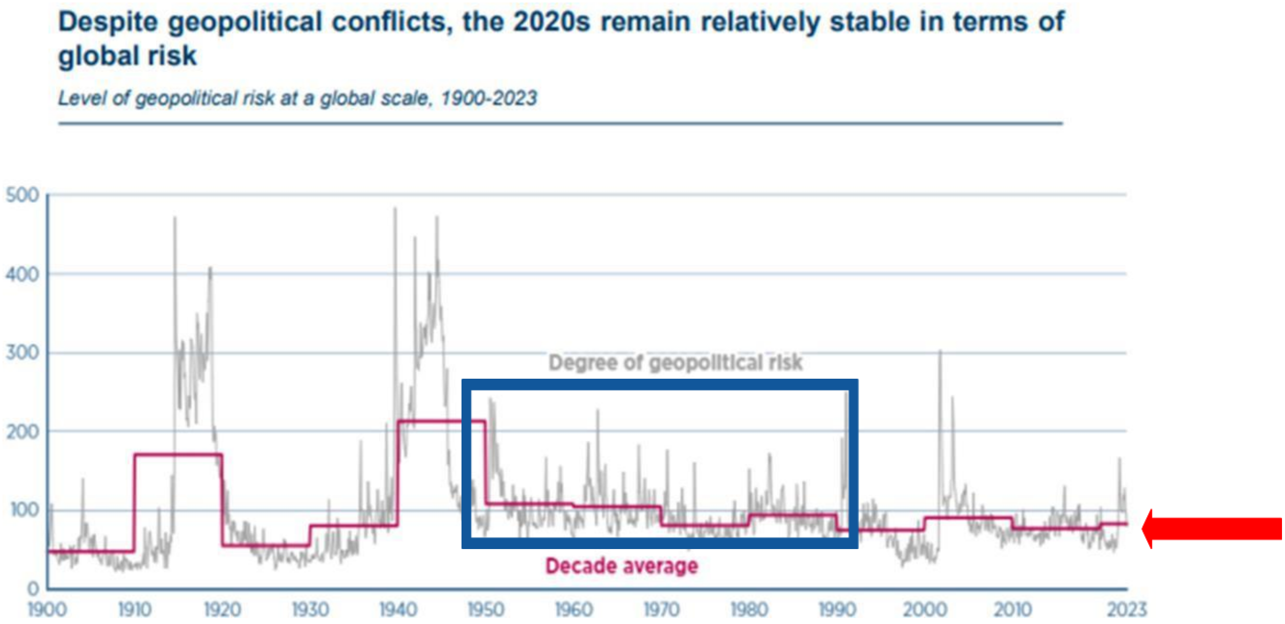
Cybersecurity concerns have no borders, with the US currently facing a widespread ransomware outbreak. The government is demanding stricter safeguards to protect against such threats. The digitisation of critical national infrastructure, including power grids, water supply networks, and transportation systems, makes these essential services increasingly vulnerable to cyber-attacks. A successful cyberattack on any of these systems could have severe consequences, including loss of life and significant economic damage.

The widespread repercussions of persistent cyberattacks on entities can have a considerable impact on markets. As these threats continue to evolve, they will remain a critical concern for both governments and investors alike.

What Does the Future Look Like?

While it might not provide much comfort, the reality is that no one can confidently predict how these geopolitical issues will evolve. However, we can turn to historical data and current trends as a potential frame of reference.

In terms of historical geopolitical risk levels, we are currently at a relatively elevated point in the 2020s. In fact, today's levels are comparable to those seen during the Cold War, which spanned several decades. The first graph on the next page illustrates the degree of geopolitical risk over the past century. The blue box highlights the Cold War period, with the red arrow indicating our current geopolitical risk level.

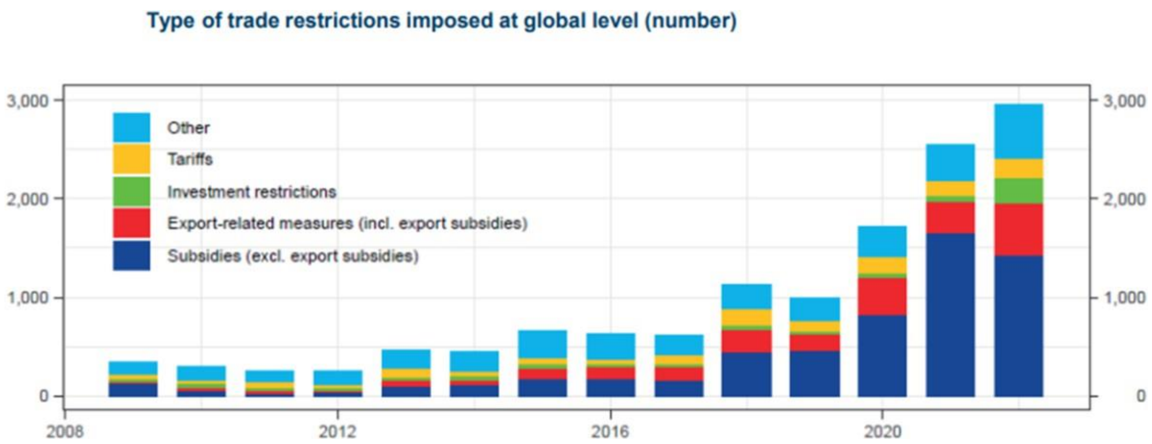


Source: Amundi (2024)

Despite ongoing geopolitical conflicts, the 2020s have remained relatively stable in terms of global risk when compared to some of the most tumultuous periods of the 20th century.

However, the term "Cold War 2.0" has been coined to describe the current climate of US- China trade tensions. The involvement of a growing number of global players, including Europe, has amplified the scale of tension and its potential repercussions.

When examining current trends, one clear indicator of the geopolitical landscape is the increasing use of trade tariffs and restrictions. These tools are often employed by countries to manage international dynamics and signal the level of tension. The second graph below demonstrates that the overall use of tariffs and trade restrictions has risen significantly since 2020. This pattern is not conclusive, but it suggests that we may expect heightened levels of trade tensions, which investors should be mindful of when considering the broader geopolitical context.

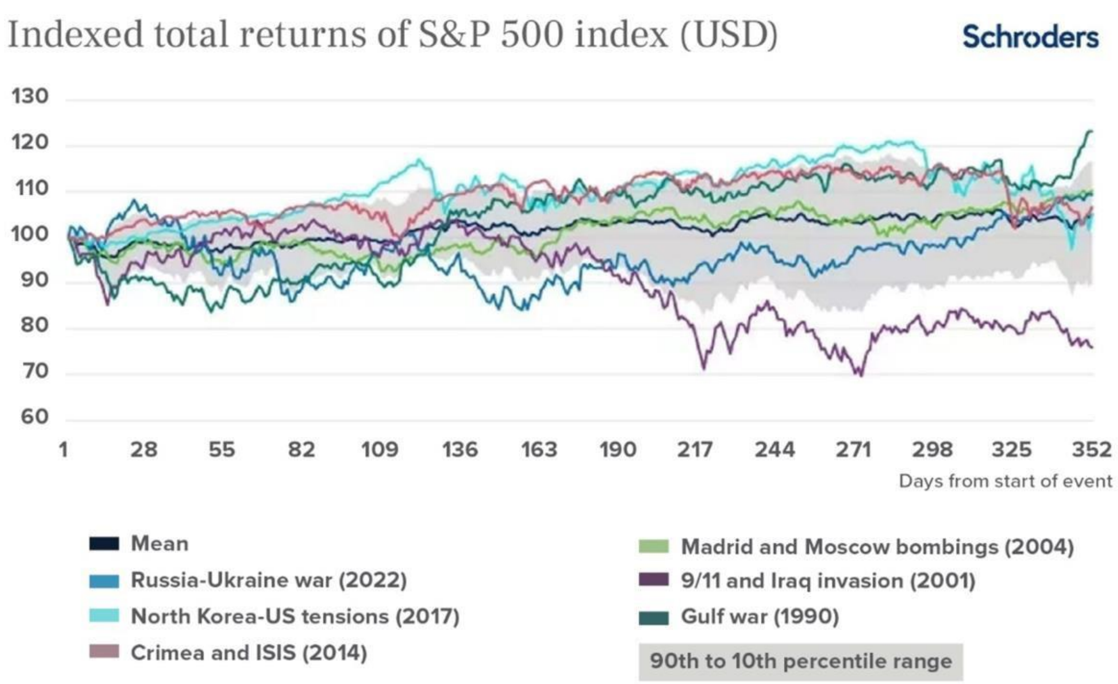


Source: Amundi (2024)

Easing Client Concerns?

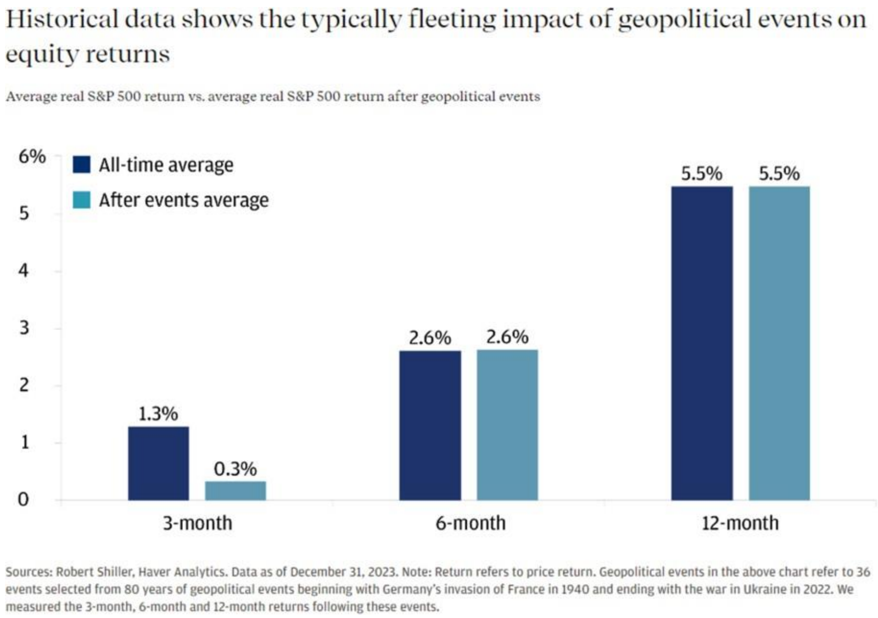
In times of uncertainty, it is natural for clients to seek increased guidance and assurance regarding their portfolios. Predicting the future is always challenging, however, we can find some clarity by looking at how markets have historically reacted to previous 'black swan' events.

Immediately following a geopolitical event, markets often experience a negative impact as they reassess the risks. The chart below illustrates the indexed total returns of the S&P 500 following various large-scale geopolitical events. It shows that markets typically do see an initial dip, but there is often a recovery over time. Most returns trend back toward the mean, with many rebounding to pre-event levels or higher within 12 months. This pattern demonstrates the inherent resilience of markets, even in the face of significant geopolitical challenges. While past performance is not an indication of future returns, this data highlights the importance of staying invested and avoiding reactive decisions during periods of heightened uncertainty.



Source: Schroders (2024)

Further studies, such as the one conducted by JP Morgan, align with these findings. Their research indicates that while there may be short-term underperformance (within the first three months), the negative impact on market performance typically dissipates by the six-month mark. Over the course of a year, markets often return to their previous levels, as illustrated in the graph on the next page.



Source: JP Morgan (2024)

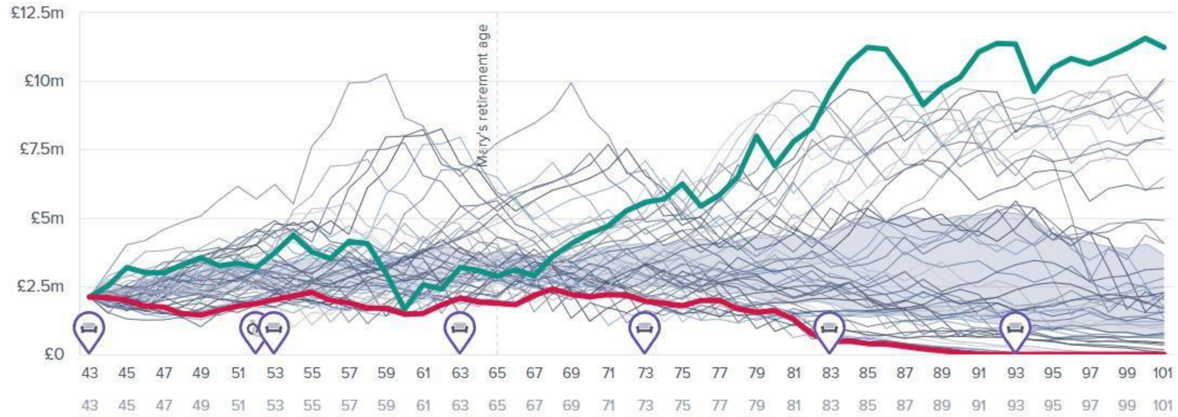
The key takeaway here is that, despite the short-term noise and potential volatility caused by geopolitical events, it is crucial to stay the course and maintain focus on long-term investment goals. Attempting to eliminate geopolitical risks entirely from a portfolio is not only impractical but can also lead to missed opportunities for growth. Globalisation has increased the interconnectedness of markets, meaning that the effects of shocks can be more widespread than ever before.

It is a fool's endeavour aiming to eliminate geopolitical risk from your portfolio altogether. In our interconnected world, globalisation has increased the likelihood that shocks will reverberate across borders more easily than ever before. Instead of trying to avoid all risks an approach that would also constrain potential returns – investors should focus on managing the risks that are within their control.

As Baroness Eliza Manningham-Buller, the former head of MI5, noted at a recent conference, some risks are simply unavoidable and must be managed rather than eliminated. She likened this to running a nuclear power plant: the potential for a catastrophic event is high, but the occurrence of such events is rare due to rigorous controls, including restricted access, security clearances, physical safeguards, and comprehensive screening processes. By effectively managing the components that can be controlled, the overall level of risk is significantly reduced, even though it can never be eliminated completely.

The same principle applies to investing. Although systemic risks are inherent in global markets, unsystematic risks can be mitigated through a well-diversified portfolio, spanning various asset classes and geographical regions. By focusing on what can be controlled and making informed, strategic decisions, investors can navigate uncertainties while positioning themselves for long-term success.

In conclusion, we cannot emphasise enough the importance of stress-testing our client's Financial Masterplans against a wide range of historical market scenarios. By simulating various potential outcomes, whether your investment journey began during periods of world wars, pandemics, or economic depression, we capture what could happen to your financial plan under extreme conditions. As illustrated below, this approach provides a comprehensive view of how a portfolio might perform over time across different market environments. This process ensures that our clients are well-prepared not just for favourable or average markets but also for potential downturns. Even in the worst-case scenarios, the stress testing shows that a well-constructed portfolio can endure challenging times, offering clients the reassurance that their long-term financial goals remain within reach. In a world of uncertainty, this level of preparation is essential for ensuring financial stability and peace of mind.



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