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THE DEAL DESK

GFMC Newsletter

The Geopolitical crisis and its effects on the global economy and stock markets ~ *Shripriya Narayanan*

The global stock markets have experienced extremely volatile trading over the past several months, which might have stemmed mainly from the current global macroeconomic events. In the recent past, investors have tackled the inflationary environment and the expected monetary tightening cycle that has stirred a vast market sell-off. Additionally, the war between Ukraine and Russia has significantly disrupted the already stumbling global supply chain. Evaluating a few of the more significant geopolitical crises in the recent past helps us stay abreast and gear up to take the required potential actions. Our analysis reveals that the impact of such geopolitical events has conventionally been short-lived, and the global economy has swiftly bounced back to normalcy.

Russia and its influence on the Global Economy

Russia is the 11th largest economy in the world, the largest exporter of natural gas, and a significant exporter of fossil fuels, including crude and refined petroleum and coal. The country is also the single largest wheat exporter and has a significant market share in exporting aluminum products and precious metals such as gold, platinum, and palladium, which are some of the critical inputs for the global economy. The weight of the Russian markets on the MSCI All Country World Index is a little below 0.4%, whereas the US market is just under 60% of the same index. However, The Russian invasion of Ukraine pushed crude oil prices to a 14-year high and had a similar impact on European gas prices.

Key Takeaways

- Underlying economic factors are usually more significant drivers of the markets than geopolitical events. Thus, investors should closely monitor oil prices, inflation, and actions by the central bank.

- Gold has been considered a "safe" asset in the bear market playbook, along with cash and US treasuries. However, during the geopolitical crisis, gold did not move much.

- The impact of geopolitical events on equity markets has historically not been too bad. Stocks tend to bounce back to normalcy, usually within 6 to 8 months after the crisis.

- The shortage of food and energy, supply chain disruption, and the continued impact of COVID has formed a 'stress nexus,' which is aggravated by the continued impact of climate change, thus, increasing the risks to the global economy.

Ukraine and its influence on the Global Economy

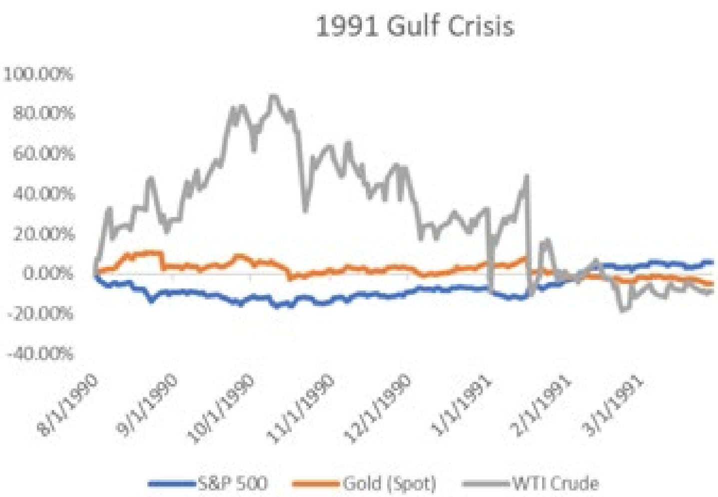
Ukraine is a relatively minor country when compared to Russia. With a GDP of $155.30 Billion, the country is ranked 56th in the world economic rankings. Regardless of its size, the country has vast geographical advantages, with mostly fertile plains and plateaus, making it the sixth-largest wheat exporter, accounting for 9% of the world wheat trade. The country is also a leading exporter of maize, barley, sunflower oil, and rapeseed.

What does history say about geopolitical events?

Historically, geopolitical events like the Russia-Ukraine war have had a short-term impact on the US Stock markets, as observed when analyzing global conflicts over the past several years.

The Gulf war 1991

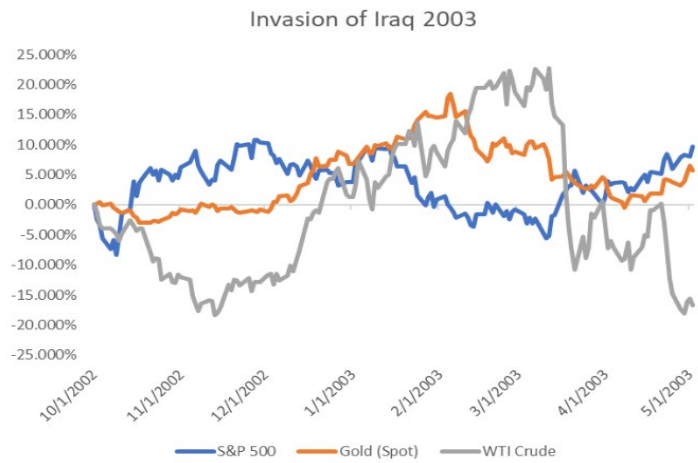
With the invasion of Iraq and subsequent annexation of Kuwait, the Gulf crisis began in mid-1990. By early 1991, coalition forces had started their operations, and Kuwait was liberated by the war's end in March 1991. The stock markets lost 16.9% of their value at the lowest point between Kuwait's invasion and liberation. However, the markets had almost fully recovered when the troops began to leave the region. "Oil" was one of the significant points issues during the conflict. At its peak, during the crisis, the US West Texas Intermediate Crude ("WTI") increased by almost 89%, but as the war began to wind down, the price of oil came down by 18.5%. By the end of the conflict, oil prices had declined by 8.9%.



Source: Refinitiv

Invasion of Iraq in 2003

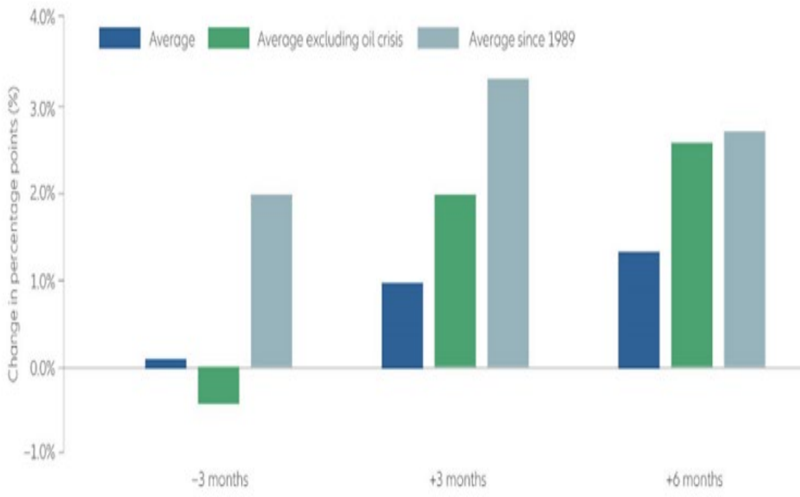
On October 2, 2002, the US Congress passed the Iraq Resolution authorizing the president to use "any means necessary" against Iraq. Also, by early October, the bear market stemmed due to the dot com collapse had ended. Within 49 days, from October 9 to November 27, the market had gained 20.8%. As the date of the invasion came closer, the stock markets started shedding and lost 14.7% from November 2, 2002, to March 11, 2003 (8 days before the invasion). However, the markets had almost fully recovered by the war's end. Oil prices were observed to be highly volatile initially but gained stability over a period, only to decline from over 30% peak to a low by the end of the period.



Source: Refinitiv

A few other crises where similar results were observed were the Cold War in 1953, 1956, 1962, 1982, and 1981; the Oil crisis in 1973 and 1979; Arab Spring 2011; Russian Military action in 2008 and 2014 and North Korean aggression in 2017. Several economic factors have influenced the market during these periods. Thus, one cannot draw precise conclusions about the effect of the global crisis on stocks, bonds, commodities, or currencies.

Stocks tend to bounce back after global crises – S&P 500 index performance



Source: Refinitiv

Post-crisis yields tend to rise as investors move away from "safe" assets – 10-year treasury performance (in basis points)

Source: Refinitiv

The reaction of the global markets to the Russia-Ukraine conflict

Since the beginning of the conflict, the markets have not seen outright panic, at least in the primary markets. The volatility index is currently at 28, which is well above its long-term average of 20, but far from the extreme values observed in recent years. The S&P 500 has almost lost 10% in value from its peak earlier this year, but the equity valuations are still high when compared historically. The effect of the war on the European markets has been less dramatic, while emerging markets have also seen lesser changes than expected. However, concerning oil prices, the story can be different. Energy prices have risen significantly, with Brent crude trading and West Texas Intermediate (WTI) trading above $100. The effect has the potential to disrupt economic growth. Historically, observations stated that a doubling of oil prices within two-three years has led to a recession. With this as the base, it would be fair to question if the US Federal Reserve would postpone the proposed normalization of monetary policy. They are because the rise in oil prices would lead to higher inflation rates. Additionally, corporations and households may continue to increase their inflation expectations because of higher energy prices, potentially driving higher inflation rates. Since late 2021, central banks have pointed to the underlying inflationary pressures and tight labor markets. Although we expect to see a decrease in the inflation rates, it will likely remain above the central bank's target of 2% shortly. Apart from monitoring the interest rates, the federal bank constantly aims to tighten the general financial conditions. A decrease in stock prices or an increase in market interest rates is not likely to change that. The global stock markets have experienced solid performance in the past several months; however, the Russia-Ukraine conflict may induce additional sell-offs in the near term. Keeping these in mind, investors need to remain cautious for the time being.

About the Author

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MSF Graduate

Shripriya is a full-time MSF graduate who enjoys reading and spends most of her time in the quiet corridors of the library. She is a trained Carnatic vocalist and enjoys playing the violin in her free time. She aims to bank on her previous professional experiences and explore an asset management career after graduation.

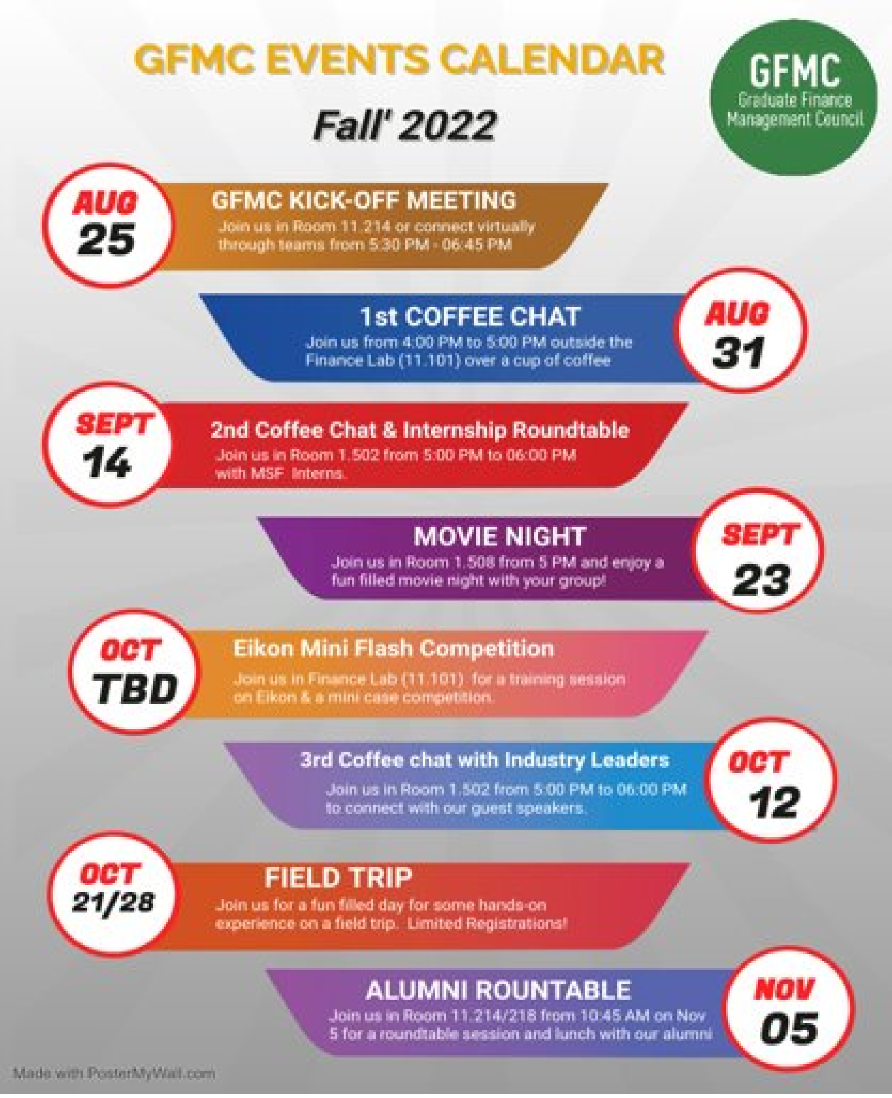
Alumni Spotlight

Sakshi Srivastava,CFA
Fall -21, MSF

By –Pranjal Bhatt

Sakshi did her bachelor's from Delhi University and MBA-Finance from Institute of Management Technology, Ghaziabad in India before pursuing MS in Finance at UTD. Sakshi graduated in Fall 2021 and has been working as a Investment Banking Associate at Société Générale in the Advisory Financing Group based out of New York. Her job responsibility at Société Générale involves providing integrated financing and debt advisory services to clients with an emphasis on structured lending. Sakshi has recently passed the CFA L3 examination and holds the CFA charter holder as well as the FINRA Series 63, Series 79 and SIE licenses.

About GFMC



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GFMC Officers

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