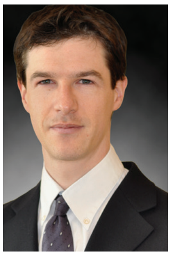
Global Investment Insights

The geopolitical economy

Speed read
Fund managers now report geopolitical crisis as the biggest tail risk. The main threats are the conflict in Ukraine, and the arrival in the Middle East, amid interrelated conflicts, of the militant group Islamic State. Spare capacity in oil markets is worryingly low, and Russia could threaten to withdraw gas supplies to Europe. Votes on geopolitical change in the European Union could add to the uncertainty.



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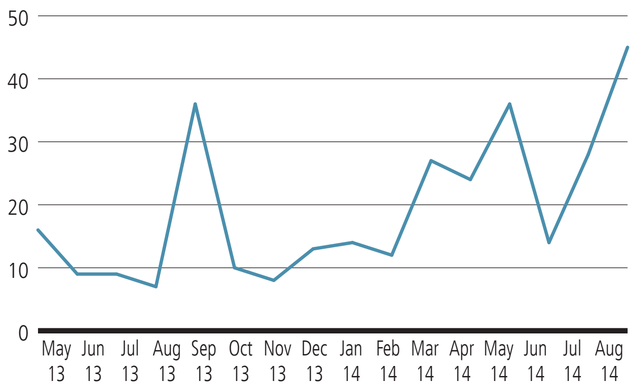
Investors, like the rest of humanity, are appalled at the violent conflicts unfolding in the former Soviet Union and the Middle East. Even the names of the conflict zones are in dispute. Separatists in the Ukrainian provinces of Donetsk and Luhansk claim they are no longer part of Ukraine, just as Russia now claims and occupies the former Ukrainian province of Crimea. The worst scenario would be further expansion of the conflict to other parts of Crimea, or even to other countries from the former Soviet Union that also border Russia and have sizeable Russian minorities.

In the Middle East, there are even more extensive disputes over which country holds sovereignty in which tract of land, with potential for overlapping conflicts to spread and feed off each other. The conflicts and shifting alliances are complex, rapidly changing, and negotiated partly in secret. There is probably nobody in the world who sees the entire picture. The dimensions of the conflict include relationships between secular and religious authorities; between Islam and other religions; between and within the Sunni and Shia branches of Islam, neither of which is homogeneous; between ethnic groups; between periodically feuding clans within ethnic groups; and, last but not least, relationships between nation states. While the situation is exceptionally complex, it should not be ignored by investors – above all because of its humanitarian impact, but also because of its potential impact on financial markets.

Geopolitical risk is rising up the investment agenda, judging by the monthly fund manager survey conducted by Bank of America Merrill Lynch. A geopolitical crisis is now by far the most common response when fund managers are asked to name the biggest tail risk, as shown in Figure 1.

Figure 1: The big new worry

Percentage of fund managers reporting geopolitical crisis as the biggest tail risk



Source: Bank of America Merrill Lynch

A recent example of the effect these concerns have on markets came on Friday, 15th August. News was reported that Ukrainian government forces had fired on a Russian military deployment, as opposed to pro-Russian paramilitaries, in Ukraine. This would have represented a significant escalation in the conflict. Within minutes, equity indices in the US and Europe lost 1% of their value – an unusually rapid drop representing the loss of tens of billions of dollars. Equity markets subsequently recovered the losses, amid Russian denials of the reported news and more positive developments in negotiations between Russia and Ukraine.

More broadly, recent sell-offs in risk assets could be attributed to geopolitical concerns – but only to a limited extent. Other possible causes include expectations that the Federal Reserve could start raising interest rates sooner rather than later, default by Argentina, falling GDP in some of the Eurozone's largest economies, and perhaps lower volumes in equity markets amid the summer holiday season, which can amplify the effect of bad news on prices.

Give peace a chance

How should investors make sense of geopolitical risks? Certainly they should not underestimate them – particularly in a context where spare capacity in oil markets is at its lowest levels since mid-2008, when a shortage of spare capacity contributed to a spike in oil prices that was followed by global recession. The impact on energy markets could be particularly acute in the winter months if Russia wields the threat of withdrawing gas exports to Europe. On the other hand, investors should remember that geopolitical news, just like economic data, can get better as well as worse – and that this is particularly the case when the news seems overwhelmingly bad.

What good news can reasonably be hoped for? In the Middle East, defeat of the militant group Islamic State, or IS, is a necessary but not a sufficient condition for a gradual return to peace and stability. IS is a movement so violent and uncompromising that it was effectively expelled from Al Qaeda for being too extremist. It has surprised even hardened specialists in Middle East conflicts with its ability to achieve short-term military victories. In the short term, the best that can be expected is the containment rather than comprehensive defeat of IS. In the longer term, however, the movement's brutality may prove its undoing. Its forerunners in Iraq were eventually defeated by a US-led surge after their atrocities lost the support of moderate Sunni leaders.

In Ukraine, an agreement between the Ukrainian and Russian governments would be the best outcome, but it could be hard to achieve. There are big disagreements, not least on the question of whether Crimea is part of Ukraine or part of Russia. Perhaps the most realistic prospect for peace is a "frozen conflict" in which parts of Ukraine come under Russian control without being internationally recognised as part of Russia, similar to Abkhazia and South Ossetia following the Russo-Georgian war of 2008.

Redrawing the map of Europe?

Geopolitical states of flux can unsettle investors even when they stop short of violent conflict. So without being unduly phased, investors in Europe should keep their eye on three upcoming votes. First, on 18th September Scotland holds a referendum on whether to leave the United Kingdom. Second, the government of Catalonia plans a referendum on 9th November to decide whether to leave Spain – but unlike the Scottish referendum, the Catalan one is not certain to go ahead since it has not been agreed with the Spanish government. Third, the next UK general election will be held on 7th May 2015, unless Parliament orders an earlier election. The Conservative party – the main partner in the current coalition – has promised to hold a referendum on leaving the European Union in 2017 if it wins the election. The opposition Labour party enjoys a lead in opinion polls, but it has been shrinking.

Geopolitical uncertainty therefore looms in Europe. European risk assets face further sources of volatility from upcoming results from the Asset Quality Review of Eurozone banks, the approach of expected interest rate rises by the Bank of England and the Federal Reserve, and the possibility of lost Russian gas supplies.