



# GLOBAL PERSPECTIVES

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## GEOPOLITICAL RISK — THE FEAR AND REALITY FOR FINANCIAL MARKETS

Given the threat of geopolitical risk, it is reasonable to question why global financial markets remain so buoyant. The answer may partly be the constant nature of geopolitical risk. Consider the French proverb “plus ça change, plus c’est la même chose” (the more things change, the more they stay the same). It only takes a cursory search to find quotes from ancient philosophers dealing with the certainty of uncertainty. For example, Pliny the Elder is credited with the phrase “In these matters the only certainty is that there is nothing certain.” It has always been difficult for investors to construct a portfolio which allows for the small probability of one of these geopolitical threats escalating into a crisis that significantly affects market returns. Therefore, the more important question may be, “Has the nature of geopolitical risk changed thereby increasing the probability of disruption to markets?”

### Today, geopolitical risk takes many forms

To analyze an issue, one must first define it. A common definition of geopolitical risk is the risk of one country’s foreign policy influencing or upsetting domestic political and social policy in another country or region. Unfortunately, this definition does not fully encompass the scope of today’s geopolitical risk. Some risks fit this definition (e.g., Russia’s annexation of Crimea and support for separatists in the Ukraine, China and Japan’s dispute over various islands, Iran’s support of Hezbollah), while others do not. A growing number of groups are aligned with an ideology rather than a traditional country, e.g., Boko Haram in Nigeria, Islamic State in the Levant (ISIL). These groups represent significant geopolitical risk. Furthermore, as a collector of old maps, I see constant reminders of how unstable countries and their spheres of influence can be. The creation and subsequent collapse of the world’s great empires involved changing political structures and, more often than not, armed conflict. Wars may but do not necessarily impact markets. Pronounced and prolonged market reaction appears to depend on where the war occurs, whether it spreads, and/or how much it impacts globally significant commodities such as oil.

### Geopolitical risk scales with the global influence of the countries affected

Our analysis suggests that regardless of the level of bloodshed, armed conflicts confined to areas remote from significant world economic activity and which do not threaten oil supplies tend not to impact markets. It should be noted that there may be a brief nervous reaction from investors while these criteria are assessed. The ability of conflict to spread to areas of greater economic activity or rather the fear of spread appears to be affected by the involvement of a “superpower” or “superpowers.” The definition of a superpower and the type of superpower involvement are pertinent to answering the question, “Has the nature of geopolitical risk changed?” To be a superpower, it appears that a country/region/group needs to meet three criteria:

1. Control or influence approximately 20% of global GDP
2. Have a significant military capability
3. Have the ability to project that military power globally

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The U.S. is the only country that controls 20% of global gross domestic product (GDP) but the European Union (EU) as a whole controls/influences more and China is getting close. Russia does not have sufficient control or influence, but their attempts to reassert the level of influence the Soviet Union enjoyed is clearly a source of geopolitical risk. All have significant military strength, but EU coordination of the use of their member state military is limited and China lacks the ability to project power due to their relatively small naval presence. It is difficult to act as a global superpower without naval and air power that can be projected globally. Consequently, the U.S. is the only current major power meeting all three superpower criteria. It is evident in their actions that Russia and China are unwilling to accept the status quo. Both countries are clearly seeking to assert more influence in the territories adjacent to their homelands but also on the broader global arena. We must expect China to significantly expand its naval presence, which in turn will create the potential for greater tension with the U.S. In the interim, China is confined to but increasingly assertive in its territorial claims in the South China Sea, etc. Although regional in scope, these actions create potential global geopolitical risk by increasing tension with several neighbors including Japan, Vietnam and the Philippines. Both Japan and the Philippines are likely to call on U.S. naval support if the tension with China escalates to armed conflict.

While Russia has significant naval and air resources, it is not clear to what extent they need to be modernized/upgraded. Russia has embarked on a campaign of reasserting economic and political influence over the former Soviet Republics. Until recently, the principal tool used to unlock resistance was energy. The virtual regional monopoly Russia enjoys in the marginal supply to gas to Europe via Gazprom allowed it to surreptitiously reassert influence. However, the escalation of events in eastern Ukraine has raised the visibility of Russian intentions and raised the risk of the spread of conflict. Russia is clearly testing NATO and EU responses but we do not believe they intend to engage in a war. More likely, we will see increased "Cold War" activity which has global consequences for the levels of defense spending. The risk to financial markets may not be through an escalation of armed conflict in Ukraine, but rather through a diversion of economic resources toward defense which may not have the same multiplier effect on global economic growth as other forms of investment. A significant fear for investors is the lack of momentum in global economic growth, and anything that undermines confidence in increasing expansion may impact valuations.

## Changes in foreign policy are reshaping geopolitical risk

Recent geopolitical events have illustrated how the nature of geopolitical risk is changing. The nature of U.S. military involvement in various crises is a key change. The U.S. continues to demonstrate its willingness to commit naval and air resources. However, as first seen during the civil war in Libya, again in Syria and in combating ISIL, the U.S. has become less willing to commit troops to resolve global conflicts, which is forcing others such as Japan and the EU to reconsider their role in resolving conflicts. In a similar vein, Saudi Arabia has become less willing to be the swing producer to resolve oil supply gluts, which may force Russia and Iran to reconsider how they cooperate to resolve the issue. In a recent study from the Brookings Institute (*The Sultans of Swing? The Geopolitics of Falling Oil Prices*, by F Gregory Gause, III), the author points to the following possibility after an analysis of previous severe oil price declines:

*"In all of these cases, despite serious geopolitical tensions between Saudi Arabia and Iran, lower oil prices led the two countries to cooperate in the oil arena to try to put a floor under falling prices and push those prices up. So far, in the current oil price collapse, the Iranians have not been willing to accept production cuts. However, given their past practice and the severity of the strains the fall in prices is placing on the Iranian economy, it would not be at all surprising to see Tehran reconsider its position and begin dealing with Riyadh over some kind of production cut agreement within OPEC, even if that cut is not proportional to the reduction Riyadh takes on. There are already some signs that the Russians are reaching out to the Saudis in search of some kind of production cut arrangements that would include OPEC and non-OPEC states."*

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## **Risk can be transformed, but it rarely disappears**

Part of the problem in analyzing geopolitical risk is the word “risk.” It is clear that geopolitical risk also creates opportunity. The fall of the Berlin Wall and the collapse of the Soviet Union raised significant uncertainty, but ultimately ushered in an enormous economic peace dividend. While we can debate how appropriately the dividend was shared and how lasting it will prove to be, it is hard to frame it as a negative. Of course, risk is similar to matter; it can be transformed, but it rarely disappears. Markets tend to overreact to the end of a crisis assuming it is over. In most cases the risk has simply been transformed. The fall of a tyrant in Libya has led to increased conflict among the factions previously forced together by the dictator. We witnessed the same thing in the Balkans after the disintegration of Yugoslavia. While few mourn the loss of Muammar Gaddafi, Josip Tito or Saddam Hussein, we can trace several of the current geopolitical risks to the overthrow or death of these dictators and the volatile change that occurred subsequently.

## **Investors are rational actors when assessing geopolitical risk**

The ugly truth about investor attitudes to geopolitical risk is that we are amoral in our assessment of the impact on our portfolios. If we consider the death toll in the civil war in Syria, estimated to exceed 200,000, or the Rwandan Genocide during which an estimated 500,000–1,000,000 Rwandans were killed in a 100-day period, markets have been largely unaffected. I do not wish to imply that investors as individuals are not deeply affected by these tragedies. However, the narrow part of our conscience we use as investors is focused on the impact to the revenue and profits of the corporations we invest in, not the loss of life, injury or dangerous living conditions people affected by the tragedy are enduring. In our view, investor reaction to geopolitical risk can be summed up as:

## **Change in Value of Markets = Change in Expectations of Growth/Change in Expectations of Risk to Growth**

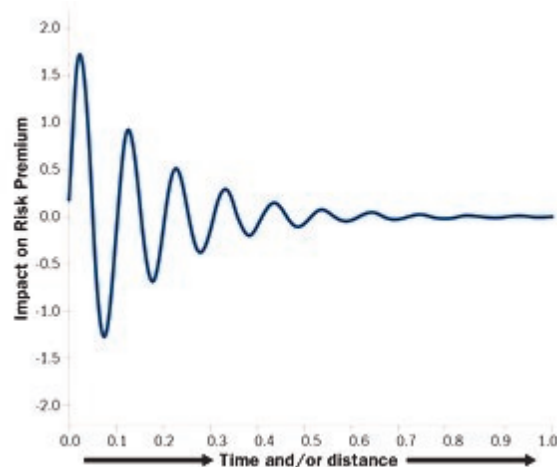
This formula is not intended to represent a real mathematical relationship, but to illustrate how investors appear to assess geopolitical risk. The most important element is the focus on items that are material to investment valuation and the absence of moral judgment. While the emergence of new geopolitical risk is often met with a spike in the risk denominator causing markets to fall, this is usually short lived as investors assess the impact of the risk on their assumptions of earnings and cash flows. If the event is localized and unlikely to spread or impact global economic growth, the risk premium dissipates quite quickly. The dissipation of the additional risk premium appears similar to the dissipation of a wave in a pool of water caused by dropping a pebble onto an otherwise calm surface. The size of the wave or risk premium is significant at the source of the event but as we move away from the source in either time or distance the wave dissipates quite quickly.



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Exhibit 1 attempts to illustrate the same point as the photograph above. Unless the energy of the crisis is reinforced by items that threaten global economic growth such as the involvement of a superpower (increased risk of a greater conflict and a loss of consumer confidence), a risk to oil prices (increased input/transport costs to industry and a loss of consumer spending power), or risk to the global financial system (the resulting reduction in lending leads to a reduction in economic activity), the risk premium reduces quickly.

**Exhibit 1: Impact on investor risk premium of most geopolitical events**



Source: Columbia Management investment Advisers, LLC

## Central bank intervention has muted investor reaction to geopolitical risk

Therefore, most geopolitical events do not lead to significant or persistent global market reactions. That may be in contrast to the extent of media coverage or the level of emotion that we as empathetic humans exhibit. However, investors cannot ignore these events as a few do escalate. We have already mentioned the most likely escalation factors. However, we should also note that the nature of a crisis is chaotic so the degree to which it may escalate is hard to predict, especially given the interconnected conflicting ambitions and sometimes historic antipathy of the antagonists. Furthermore, the current level of central bank intervention is unprecedented. The various experiments with quantitative easing (QE) have created enormous liquidity pools designed, in part, to dampen shocks to growth from any cause. Therefore, the muted investor reaction to the current plethora of geopolitical risks may be encouraged by the confidence investors have that central banks will do whatever it takes to dampen the impact of the possible escalation/spread of current threats. If QE ever ends then investor sensitivity to potential shocks may rise. Citi Research in their study *War & Peace: Shale, Central Banks Underpin Investor Indifference to Geopolitics* notes, "Market indifference may also have unintended consequences; while the presence of these buffers limits market disruption and damage to the global economy, it could be contributing to a variation of moral hazard for foreign policy, exacerbating the crises at the regional level and raising the threshold for international action."

## Geopolitical risk rarely threatens major markets, but often creates opportunities

If the reality is that geopolitical risk rarely poses a significant persistent threat to the broad financial markets, why do we spend so much time trying to analyze it? Clearly, the human element will always attract attention, but the most intriguing element of geopolitical risk to investors is the opportunity it creates. There have always been and there will always be investors who overreact to events, and that volatility creates opportunity for those with cooler heads. More importantly, geopolitical risk may lead to change. While general market indices rarely show significant reaction, there may be an opportunity in specific asset classes and sectors. If our assumption that the conflict in Ukraine will lead to a return to

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Cold War conditions, what is the opportunity for investors? Defense spending in the U.S. is not evenly spread across all states. Will municipal bond investors in the states where defense spending is more concentrated benefit? These are the types of questions we should focus on when considering geopolitical risk.

## Disclosure

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