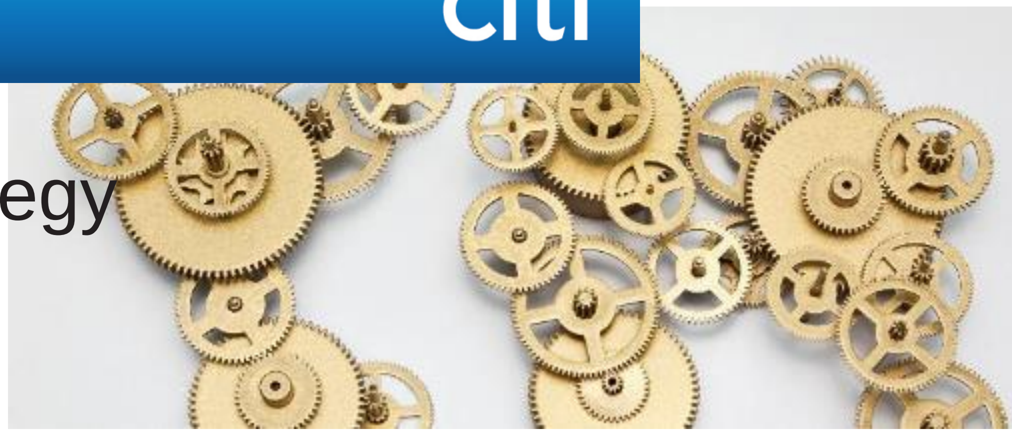
Private Bank



Global Strategy Bulletin

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Markets Falter On US/Iran Escalation – But Take the Lessons of History

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- **News**: US/Iran tensions took a major turn toward escalation after the US killed the head of Iran's "Quds force," the foreign wing of Iran's Revolutionary Guard, which is designated by the US as a terrorist organization.
- After the strike in Baghdad, the US said General Qasem Soleimani "was actively developing plans to attack American diplomats and servicemen in Iraq...and approved the attacks on the US embassy" on December 27. Press reports carried vows of "hard revenge" from Iran's supreme leader.
- Near-term crude oil futures jumped 4.5% on the news while US equity futures dived more than 1%. Global bond yields fell and gold surged 1.5%.
- **Comment**: An intermittent escalation has been clear since the US resumed oil sanctions on Iran in mid-2018 following its pullout from the "comprehensive plan" that restricted Iran's nuclear development.
- Markets will now be left to speculate on a wider range of possibilities for the conflict between the US, Iran and regional proxies.
- To a significant extent, we believe investors need to separate this security concern and tragic impact on many innocent lives in the Middle East from global economic developments. Investors should recall the immediate, severe concerns that followed the September 14, 2019 attack on Saudi Arabia's key oil infrastructure, another chapter in the escalation. The impact on oil markets was erased in 11 days and just 26 days in global equity markets.
- As a more chronic example, we recall the many concerns about world economic growth from 2003-2007 on the US invasion and occupation of Iraq. The war had long lasting and wide consequences, but driving recession was not one of them.
- The latest news has for the moment broken an unusually strong upward momentum in financial markets which rallied sharply on the first day of the new year. This context is important for investors, but one needs to note that 18 of 20 geopolitical or political shocks we identify since World War II had no lasting, independent consequence for financial markets. What if the current conflict is not akin to one of those 18? For that, we diversify across both low- and higher-risk investments in our asset allocation and tactically overweight gold as a direct risk hedge at present (please see our Outlook 2020 for discussion).

Markets Falter on US/Iran Escalation – But Take the Lessons of History

As the headlines above can attest, a major new escalation has come in the conflict between the US and Iran, which has already involved deadly force in numerous places away from the two nations. As we have seen before, financial markets will immediately brace for the potential for a wider engagement.

This has devastating impact on lives in the region and beyond, and we are at pains to discuss investment impact in the same breath. We must, however, responsibly advise investors not to make harmful portfolio mistakes reactively on such news. They should also be careful in extrapolating alarming analysis of Middle East security to wider global economic issues.

As the US/Iran conflict brews, we recall being asked routinely, if intermittently between 2003-2007 how it could be that the US economy would keep growing when it was engaged in a foreign war in Iraq. The growing housing bubble was only a tangent issue at the time. The US war in Iraq has had lasting, complex consequences beyond the scope of our discussion here, but driving recession was not of them.[1]

More easily, investors can look to the recent events of September 2019 to assess the possibilities for making mistakes over the current, building escalation. On September 14, Saudi Arabia's oil output was halved by drone attacks for the very first time. Crude oil immediately surged 15% only to lose the entirety of that gain in a mere 11 days (see figure 1). Global equity markets followed the path in reverse, but with much less amplitude.

This year, we don't see crude oil markets in quite the same weak state after price declines and forthcoming production cuts. Global equity market valuations have also advanced, and quite rapidly of late. However, the same underlying story of reduced global vulnerability to oil supply shocks on elevated US output remains (see figure 2).

Figure 1: Daily Crude Oil Price

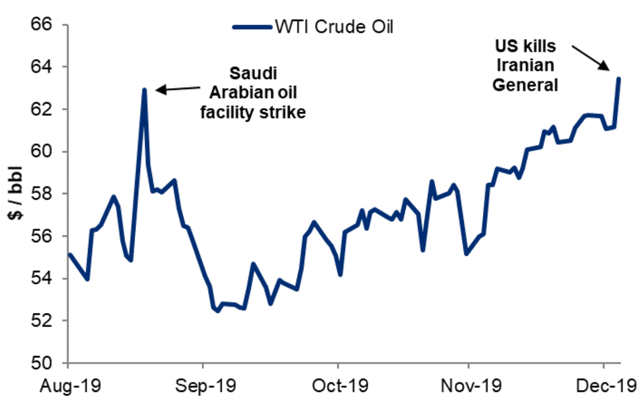
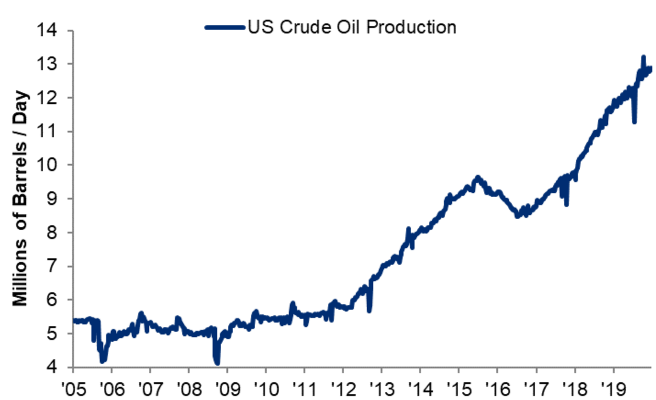


Figure 2: US Weekly Crude Oil Output



Source: Haver Analytics as of January 3, 2020.
Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

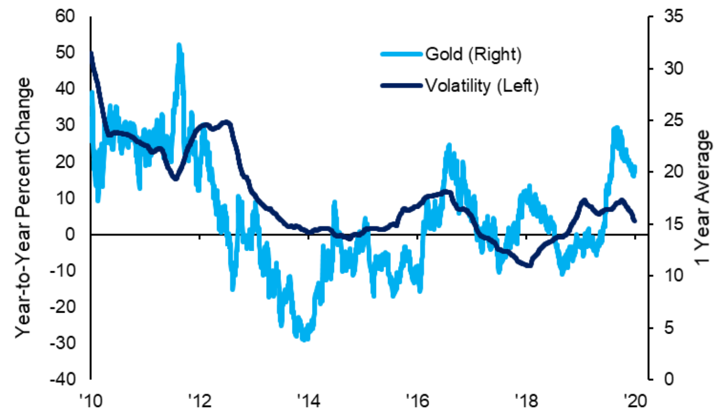
As we discuss in Outlook 2020 diversified investors should build portfolios they can comfortably live with under all adverse scenarios. While we are 4% underweight global fixed income amid history's highest bond valuations (the underweight is in non-US developed markets), we maintain a small position in gold as a direct risk hedge (see figure 3). Gold is surging this morning, but may come under pressure in certain positive economic scenarios, as would high quality bonds.

Most fundamentally, we see a low probability for geopolitical events to drive lasting turning points in the wider world economy. There are just two such cases of this happening since (and including) World War II (see figure 4). Many analysts on today's news shows will instead focus on worst-case military outcomes with no regard for that precedent. What happens in the much longer pauses between new negative events is not today's business for world media.

[1] While distortions to economies occur in war time, economic growth has generally been the rule, rather than the exception during foreign wars.

As global equities surged 2.7% in December and entered 2020 with a vault to new records, events of the past day will drive sobering headlines. At the same time, we remain fundamentally optimistic on the health and prospects for the global economy which has merely been held back by acute policy-related drags on growth during the past two years. Over the course of 2020, we'd expect that to be the more important news development.

Figure 3: Change in Gold Price vs Change in the VIX



Source: Haver as of January 3, 2020
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Figure 4: Geopolitical Events and Shocks – Impact on Financial Markets over Short and Long Periods

Geopolitical Event	Date	S&P 500 (% since event date)			Nikkei (% since event date)			MSCI World ex USA (% since event date)			DXY Dollar Index		
		Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days
Pearl Harbor	12/7/1941	-6.87	-2.90	-12.02									
Cuban Missile Crisis	10/19/1962	-3.78	7.61	17.16									
JFK Assasination	11/21/1963	-2.81	3.06	8.28									
US Bombs Cambodia	4/29/1970	-15.30	-6.43	-4.94	-15.93	-12.49	-7.64	-10.45	-17.01	-16.07	-0.20	-0.23	-0.51
Arab Oil Embargo	10/18/1973	-16.23	-8.45	-13.04	-1.81	-1.44	-4.47	-14.68	1.96	-18.53	7.48	5.28	14.04
USSR Invades Afghanistan	12/24/1979	-2.27	5.37	-7.78	0.57	2.63	0.68	3.94	3.94	11.85	-1.06	-0.71	5.91
US Bombs Libya	4/15/1986	2.95	-1.39	0.16	3.09	3.73	16.08	0.00	6.19	8.16	-4.15	-4.80	-5.30
US Invades Panama	12/15/1989	-2.06	-3.73	-3.43	0.63	-3.71	-14.63	0.00	3.67	-7.04	0.31	-1.69	-0.44
Gulf War	12/24/1990	-4.16	0.09	12.10	-6.95	-4.43	10.47	1.75	1.75	15.97	-0.21	-3.61	4.90
World Trade Center Bombing	2/26/1993	-0.31	1.67	2.04	-0.44	12.36	23.00	0.00	8.52	18.62	0.18	-1.15	-4.79
911	9/11/2001	-11.60	0.45	4.34	-6.28	1.48	3.68	-8.48	3.24	5.48	-1.08	0.29	1.85
US Invasion of Iraq	3/20/2003	2.49	2.06	15.57	4.77	-1.02	12.94	1.53	4.58	22.05	0.84	-1.85	-7.89
North Korea Related													
Korean War	6/23/1950	-12.80	-8.67	1.20									
Operation Paul Bunyan	8/18/1976	-3.15	1.64	-4.32	-0.75	-0.21	-4.52	0.00	-0.26	-7.60	0.07	-0.57	-0.12
2009 Nuclear test	4/25/2009	-1.28	5.09	13.05	-2.46	6.92	14.20	-2.32	12.28	21.21	0.52	-5.54	-7.04
2016 Nuclear test	9/9/2016	-2.55	-0.81	2.97	-2.03	0.39	10.65	-2.06	-0.81	-0.72	-0.01	1.36	6.05
2017 Escalation	8/7/2017	-0.24	-0.64	4.44	-0.30	-3.89	12.43	-0.26	-0.49	3.60	0.23	-1.22	1.62
Political Events													
Nixon/Watergate	3/15/1974	-1.72	-7.28	-8.04	-1.80	1.05	4.42	0.00	-2.57	-6.12	-1.04	-1.57	-2.12
Clinton/Lewinsky	8/20/1998	-12.30	-6.20	5.59	-8.34	-11.66	-6.74	-12.75	-12.75	-6.37	-1.76	-5.18	-6.58
Brexit	6/23/2016	-2.30	4.30	3.72	-6.93	3.50	4.62	-5.31	-0.37	1.70	1.85	4.00	2.46

S&P 500	Initial Impact %	30 days %	90 days %
Average all events	-4.8	-0.8	1.9
Average ex WW2	-4.7	-0.6	2.6
Average ex WW2 and Oil Embargo	-4.1	-0.2	3.5

Source: Bloomberg as of January 3, 2020
Note: last 2017 event refers to North Korean nuclear and long-range missile tests.
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