Geopolitical risks on the rise – can markets remain complacent?

Cheap money and shale supplies have been helping to mask geopolitical risk

Financial markets remained largely impervious to politically-generated turmoil in 2014. Yet by any measure, 2014 was an eventful year in geopolitics.

Perhaps most dramatic development has been the seemingly sudden emergence of Islamic State of Iraq and Syria (ISIS), in which two countries it now controls a significant swathe of territory as well as oil-production revenues that are enabling it, according to numerous estimates, to become one of the richest and most powerful terrorist organizations in the world.

Meanwhile, there has been an escalation of the conflict between Russia and the West over Ukraine, which has prompted four rounds of trade sanctions and a revival of nuclear rhetoric. Other country risks such as the ultimately unsuccessful Scottish independence referendum and the ongoing Ebola epidemic in parts of West Africa have similarly failed to move markets. Indeed, the S&P 500 index has made new all-time highs in 2014.

Any market impact has generally been more localized. For example, global investors might see the Ukraine crisis as a reason to sell Russian assets. They might even see it as a reason to sell emerging-market assets more generally. However, they do not see it as a reason to sell America’s S&P 500 or the UK’s FTSE 100. If anything, volatility in riskier parts of the world seems to be increasing the desirability of assets in the more stable developed economies. Rapidly-rising London house prices may be evidence of that trend.

Why are markets treating political risk as a localized rather than a systemic issue? This might reflect the palliative effect of cheap money. Central banks have aggressively expanded their balance sheets and intentionally boosted asset prices that could otherwise have been damaged by higher political risk premiums.

For now, investors seem more interested in Janet Yellen’s next move on monetary policy than Vladimir Putin’s next move on Ukraine. Maybe this will change, but only when we have seen the end of near-zero policy rates and open-ended liquidity at extraordinarily low rates in developed markets.

The traditional way for rising geopolitical tensions to affect broader economies and financial markets is through the oil price. After all, every US recession in the past 30 years has been associated with a spike in oil – see figure 1. But, as of 1 December 2014, Brent crude oil prices have fallen below $70 a barrel despite the extensive list of geopolitical disturbances, many of which have materially impacted global oil supplies. Adding all of the various outages together brings the total amount of lost crude oil supplies to around 3.5m barrels a day.
The US shale energy revolution has significantly boosted the supply of crude oil while also reducing demand for it. The surge in US production has caused its net crude imports to drop by a weighty 8.7m barrels a day from their peak level in 2006, equivalent to the oil exports of Saudi Arabia plus Nigeria. Meanwhile, the wide spread between oil and gas prices is incentivizing a shift from oil to gas in transportation, petrochemicals and other oil-consuming sectors.

For now, then, it seems that shale oil production is having the same impact on oil price volatility that central banks are having on equity volatility. Just as cheaper money supports asset prices, so US shale and extra Saudi production help to suppress oil prices. Perhaps investors will take more notice of geopolitical tensions when and if these volatility dampeners are removed. The end of Quantitative Easing (“QE”) in the US and the turn in the US rate cycle – which we expect to occur in 2015 - could mean that markets will find it harder to ignore the headline news stories.

Geopolitical tensions are already hurting economic growth and this effect is not restricted to the ‘conflict zones’ themselves. We see the Russia-Ukraine crisis as having the most potential to become ‘systemic’, as Russia is both a large economy and a major commodity producer. Even with relatively mild sanctions, the “Russia impact” alone is estimated to cut Eurozone growth by up to 0.3% yearly, and an escalation involving, say, disruptions to gas supplies could throw the Eurozone economy back into recession.

With QE on the wane and future oil prices buttressed by the negative impact of geopolitics on future supplies, the potential for supply dislocations remains significant. We are cautious about whether central-bank action and shale supplies can continue to mask geopolitical risk indefinitely.

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