Investment insight

Current geopolitical risks and the parallel universe of financial markets

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"In financial markets, monetary policy and macroeconomics trump geopolitics – at least for the time being."

Not surprisingly, geopolitical risks are front of mind for many investors right now. News headlines and television coverage are truly frightening. In particular, hopes that the Arab spring would lead to a flowering of secular democracy across the Middle East, which were always optimistic, now look appallingly naïve. And yet, from the behaviour of the world's financial markets, we could be forgiven for thinking that investors operate in a kind of parallel universe: markets just don't seem too concerned by the global ructions.

Investment managers often find geopolitical risks difficult to manage – while history is some help in modelling and analysing their impact, every crisis is different and unpredictable. At MLC, our investment approach includes geopolitical crises among the wide range of possible scenarios, both favourable and unfavourable, that we consider when determining our portfolios' asset allocations.

The world faces an elevated level of geopolitical risk

In the Ukraine, the battle between Russian-backed separatists and Ukrainian forces continues unabated. Any hopes that the horrific shooting down of MH17 would encourage either side to take a backward step have come to nothing. Tensions between Russia and the western democracies have risen to levels not seen since the end of the Cold War.

In the Middle East, conflict between Israel and Hamas in Gaza shows little sign of easing, despite mounting international pressure for a durable ceasefire. Three years after the toppling of the Gaddafi regime, Libya is in turmoil as rival factions battle for control. The heavily armed militias that were responsible for overthrowing Gaddafi refuse to surrender either their weapons or influence to a central government. Libya is at risk becoming a failed state.

The civil war in Syria has spilled over into Iraq. Large swathes of Iraqi territory, including a slice of Iraq's oil-producing capacity, are in the control of extreme Islamist forces now operating under the banner of the Islamic State. There is a very real prospect of Iraq dividing along largely sectarian lines: a Kurdish north east, a largely Shia south, and predominantly Sunni west potentially governed by the fanatics of the Islamic State.

And tensions between China and her Asian neighbours – Japan, the Philippines, and Vietnam – over China's territorial claims in the South China Sea continue to simmer while the attention of the world's media is elsewhere.

What's been the impact on markets?

While geopolitical concerns have had an impact on financial markets in 2014, so far that impact has been limited. Markets seem to believe that in the geopolitical hot spots common sense will eventually prevail, and have shown they are willing to be discerning. For example, markets appear to have taken the view that Russia is the biggest potential loser from the conflict in the Ukraine, and that the economy of the European Union (EU) will be relatively unscathed. The Russian rouble has weakened against both the US dollar and the euro, prompting Russia's central bank to increase official interest rates in a bid to defend the currency. While Russian share prices are around 10% off their highs for the year, share prices in Europe have posted modest gains.

Globally, markets seem have remained fairly calm. Share markets haven't suffered a major setback, gold (usually seen as a safe haven investment) has lost a good portion of this year's gains, and bond markets have not sold off in response to any heightened inflation risk. And despite the possible threats to Iraq's oil supply (more on this later), oil prices are nowhere near their record highs of above $145 a barrel or higher – they are below $110. Oil prices are always something MLC is concerned about, not least because a sharp and sustained rise in oil prices could be a trigger for least two plausible, and very negative, scenarios: a 1970s-style stagflation or an inflation shock. Both of these are scenarios we model and analyse carefully.

What are the possible investment implications of these geopolitical risks?

Conflict over the Ukraine could disrupt energy supplies to Europe

While limited (though tightening) sanctions have been imposed on Russia, the western democracies' apparent reluctance to take a tougher stand reflects the fact that around 40% of the EU's oil and 22% of its gas supplies come from Russia. Any disruption to Europe's energy supply, possibly as a result of Russian retaliation against tougher EU sanctions, could derail the eurozone's tentative and fragile economic recovery.

However, Russia's economy is highly dependent on oil and gas exports, and supply disruptions would likely harm the Russian economy significantly more than it would hurt the EU. Markets may well be correct in assuming that President Putin is well aware of this and will ultimately act accordingly. On the other hand, Putin is playing to an overtly nationalistic audience at home, which makes dignified retreat extremely difficult, so there is surely some chance that the markets' assumption could prove too complacent. And even if energy disruptions detract only modestly from eurozone growth, they may be all it takes to drive the continent back into recession.

Iraq's civil war could seriously impact oil prices

If we look to the Middle East, despite the tragic human cost, there are good reasons to believe that the conflict in Gaza will not widen beyond Gaza, and the conflict is not likely to feature prominently on investors' radar screens. The possible ramifications of the conflict in Iraq, however, are a different matter.

While estimates vary, Iraq has the fifth-largest known oil reserves in the world. Two of the world's five most important oil fields are in Iraq: the Rumaila and West Qurna-2 fields. Both are located in the country's Shia-dominated south. Iraq's other major fields – the so-called 'supergiant' fields with more than 5 billion barrels in reserve – are either in the south or in the Kurdish-dominated north east. While the Islamic State now controls a significant share of Iraq's land area, the oil fields and facilities in these areas are not among Iraq's largest. Though this is something of a relief, Islamist forces do pose a real threat to the major Kurdish fields, at least one key oil pipeline, and they are close enough to Baghdad to threaten the East Baghdad field, with reserves of around 8 billion barrels. But once again, markets seem to be hoping for the best.

It may be that markets are right to be fairly relaxed. After a poor start, Iraqi government forces are now doing a much better job of taking the fight to the Islamists; certainly the Kurdish forces to the north have had considerable success against them. Even if Iraq collapses and divides along sectarian lines, whoever is in charge still has an overwhelming incentive to keep the oil – and export revenue – flowing.

Of course, there is a risk that the conflict in Iraq intensifies, potentially widens to include Iraq's neighbours (Iran and Saudi Arabia, between whom there is very little love lost) and the oil price climbs to levels that threaten global economic growth and inflation However, current pricing in oil and other markets don't give that much credence.

Why do markets seem complacent?

The willingness of financial markets to understate and perhaps under-price the current geopolitical risks is best explained by an improving global economy and the ongoing effects of quantitative easing. The US economy appears to be gathering steam after a poor (weather-related) start to 2014. Employment is growing reasonably solidly, unemployment is declining, credit is flowing, and key business surveys are consistent with solid economic growth and the emergence of a long-awaited recovery in business investment.

China's economy has recently shown signs of stabilising at a growth rate that remains the envy of the world. Fears that Japan's economy would be severely impacted by a consumption tax hike in April have so far been unfounded. In Europe, where economic conditions remain the most fragile of the world's major economies, fears that the eurozone could still fall into deflation prompted further monetary policy easing steps by the European Central Bank (ECB) over the year. They have also raised hopes that the ECB may embark on its own large-scale quantitative easing program, although there are some practical impediments to this. That hope has clearly helped boost share markets in the eurozone in the face of the Ukraine crisis.

The bottom line is that in the parallel universe that is the financial markets, monetary policy and macroeconomics trump geopolitics – at least for the time being.

Despite this, the unpredictable geopolitical environment is one of many reasons why MLC's multi-asset portfolios are defensively positioned at present. This is particularly true of the MLC Inflation Plus portfolios, which are required to consistently control risk exposure.