CLARO ADVISORS

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Claro Market Insights – Geopolitical Risk

Today's Russian invasion of Ukraine is no doubt alarming. It also is not completely unexpected as the threat had been signalled for weeks. However it certainly adds to the already growing list of concerns for investors. Some of these concerns include; the ongoing recovery from Covid and recent Omicron surge, supply chain disruptions, inflation fears, rising commodity prices, expectations of interest rate hikes and stock market volatility.

So far we've witnessed a pretty classic selloff from riskier assets into safe havens. Yields fell across the curve as investors have flocked to treasuries. Safe haven currencies increased as the US Dollar, Swiss Franc and Japanese Yen all experienced inflows. The price of gold rose above $1,900 an ounce and is up 6.5% YTD. Oil prices jumped above $100 per barrel for West Texas Intermediate crude (WTI) and have risen +30% YTD.

Meanwhile, the major indices have entered correction territory down greater than 10% from their highs…

- S&P 500 -12%
- DJIA -10.25%
- Nasdaq -16%
- Russell 2000 -13.5%
- MS ACWI -9.5%

"History doesn't necessarily repeat itself, but it often rhymes", a saying attributed to Mark Twain, can be quite useful when analyzing market reactions during times of crisis. The following are some geopolitical events that occurred over the past seventy years that have affected the markets in the near-term and how they recovered over the following year.

Stocks typically recover from sudden Geopolitical Events[1]

Event	Date	1-week %	6-month %	1-year %
Korean War	June-50	-7.6%	4.9%	11.2%
Suez Canal Crisis	October-56	1.6%	-1.4%	-11.5%
Cuban Missile Crisis	October-62	-1.9%	24.5%	32.0%
Iranian Hostage Crisis	November-79	-1.0%	3.0%	25.9%
Soviet-Afghan War	December-79	0.3%	6.4%	25.7%
Falkland Islands War	April-82	2.1%	5.8%	34.5%
Beirut Barracks Bombings	October-83	-1.6%	-5.5%	0.8%
Libya Air Strike	April-86	3.1%	-0.6%	17.7%
Iraq Invasion of Kuwait	August-90	-3.3%	-2.1%	10.2%
Gulf War	January-91	4.4%	20.6%	32.3%
US Embassy Bombings Africa	August-98	-1.4%	14.6%	19.3%
9/11 Attack	September-01	-4.9%	6.9%	-16.7%
Iraq War	March-03	-0.5%	17.4%	8.4%
Lebanon War bombings	July-06	-2.8%	11.0%	19.4%
Russia/Crimean Crisis	February-14	0.8%	8.3%	14.7%
*S&P 500 performance following geopolitical events				

[1] Index and eocnomic data sourced from YCharts, event and dates sourced from Wikipedia

Geopolitical crises are often alarming for investors. As you can see most events had an initial negative shock to markets, as they likely should. It's natural to be concerned for the well being of those involved and to think how it will affect our own daily lives. But as time passes and geopolitical pressures abate, investors tend to refocus their attention to the health of the domestic economy and overall corporate profits.

With regards to our economy, the bigger risk very likely lies with the Federal Reserve's ability to navigate a soft-landing. How will the central bank's shift to a more restrictive monetary policy be received without stifling investment and dampening consumer demand? Following decades of accommodation, the Fed now has to deal with accelerating costs and persistent inflation likely through a series of rate hikes and by shrinking their balance sheet. Removing money from the economic system is not easy, particulary during times of crisis, so the Fed has to be mindful of how much it can do to alleviate pressures without dampening sentiment.

Inflation is also a threat to corporate profits and the ability of companies to maintain robust earnings growth. Corporate earnings rose above $210 per share for the S&P 500 index in 2021 and are expected to increase another 8% this year to $225 and even to $250 in 2023.[2] With rising wages and increasing input costs, margin pressures could weigh on these lofty earnings expectations. At the recent low of 4,115 on the S&P 500, that would put the current price-to-earnings ratio (PE) at 19.6x trailing earnings and 18.3x forward earnings. From a valuation perspective, that is not unreasonable considering the health of corporate balance sheets and the insatiable demand of U.S. consumers. However, if earnings are at risk and sentiment becomes muted then the denominator to the PE ratio could be adversly afftected and company valuations might appear a bit stretched.

The Bottom Line

Corrections are typical in any cycle and sometimes they are exacerbated by geopolitical events. However, investors should be aware that the recovery after a selloff can be equally as swift. The bigger risk may be the Fed's ability to navigate policy without becoming too restrictive. A flat yield curve could result in potentially crowding out investment and stifling demand. This could slow or even contract the economy. Yet we believe that should not be the case here as consumer and corporate balance sheets are healthier than they've been in decades, consumer sentiment and demand is high, leading economic indicators continue to be robust, and corporate earnings remain strong.

Even as we face near-term risks, the mid to long-term prospects for growth remain intact. This will especially be valid as economies reopen globally, provided we can get beyond the geopolitical tensions. Trade relationships and supply chains should improve, technology should help keep downward deflationary forces on prices, infrastructure spending and demand for labor should remain supportive of employment, and consumers will continue to spend money on goods and services. Rest assured, investors over the long-run will be rewarded through higher profits as the economy grows.

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[2] https://www.yardeni.com/pub/yriearningsforecast.pdf