

Market Tranquility and Geopolitical Risks in 2014

By Donna Gilding

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Geopolitics and political economics typically have a lot of impact on the financial markets. Given all of the recent turmoil, it's therefore surprising that the markets remain unfazed by the growing instability around the world. Of note, we have looming civil war in the Ukraine, Cold War rhetoric between the West and Russia, territorial tensions in Asia and populist nationalism in Europe. A Dutch columnist recently wrote: ".....If anything characterizes recent history, it is the degree to which the 19th century, unexpectedly and to the astonishment of many, makes itself felt in the 21st century..."

The financial markets seem to believe that the credit crisis is being diffused slowly, but surely. At the same time, international developments threaten to undermine the economic recovery. All in all, global geopolitical risks could, in fact, derail the world recovery.

The Resilient Capital Markets – Thus Far

Tranquil markets have tended to underprice geopolitical risks. Financial markets have been sanguine about geopolitical risk for several years and have taken a very relaxed approach to the recent Ukraine crisis. It's like watching a slow chess game with a maniacal master manipulating the board. We do not know what the master is going to do. Perhaps he is considering the reunification of Russia.

The markets have brushed aside these and previous geopolitical concerns, whether in Iran, Iraq, North Korea or Syria. More recently, the markets have been similarly relaxed about the Turkish government's tensions, Venezuela's volatile situation and Thailand's struggles to restore socio-political calm.

However, geopolitical risks have gotten a fair amount of attention from World Economic Forum, the International Monetary Fund, as well as the Council of Foreign Relations (CFR). The CFR has identified 33 of the largest geopolitical risks for 2014 and the impact they would have on the US. The top ten risks are listed below. The first five represent the greatest likelihood of occurring. The last five represent the high impact risks that could directly threaten the US. These are also the risks that would most likely trigger US military action and/or threaten the supply of critical US strategic resources.

- *Strengthening of al-Qaeda in the Arabian Peninsula.* The Arabian Peninsula is considered the most dangerous al-Qaeda affiliate to US national security. More than two dozen US diplomatic facilities in the area have shut down because of terrorist threats. The US has continued to escalate its drone counterterrorism campaign in the region.

- *Political Instability in Jordan.* The kingdom's political stability and economy are severely threatened by the influx of Syrian and Palestinian refugees. The United Nations has estimated that Jordan will need \$5.3 billion by the end of 2014 to handle its refugee crisis.
- *Sectarian Violence in Iraq.* According to the CFR, if sectarian violence continues, Iraq may plunge into a deeper state of chaos and potentially into civil war.
- *Rising Security Threats in Pakistan.* The withdrawal of US allied forces from Afghanistan after 2014 could increase instability by allowing anti-state militants from Pakistan to establish a terrorist safe haven in Afghanistan.
- *Increased Violence and Instability in Afghanistan.* Failure to sign a security pact could undermine the efforts of US and allied forces to improve security in Afghanistan. The reestablishment of al Qaeda cells throughout Afghanistan is one possibility if the agreements are not consummated.
- *Terrorist Attack on the US Homeland.* Another attack on the scale of 9/11 is plausible, according to the CFR. The White House has warned that al-Qaeda in the Arabian Peninsula "poses the greatest potential threat."
- *Iranian Nuclear Crisis.* The prospect of breakthrough in the nuclear standoff with Iran has recently improved. A lasting settlement, however, is still uncertain. The possibility of military strikes cannot be discounted, according to the CFR.
- *North Korean Crisis.* The risk of conflict on the Korean peninsula remains fairly high. There are continual efforts by North Korea to develop nuclear weapons and long-range missiles, despite UN Security Council resolutions condemning these actions. The execution of North Korean leader Kim Jong Un's uncle on treason charges has increased the potential for political instability in the country.
- *Civil War in Syria.* Ongoing civil strife threatens the stability of US allies, particularly Turkey and Jordan. Increased regional instability could create another safe haven for extremist groups active in Syria, like al-Qaeda affiliates, Hezbollah and Islamic State of Iraq.
- *Cyber Attack in US Infrastructure.* The increasingly sophisticated nature of cyber attacks, such as an attack on critical infrastructure, could be very disruptive or potentially devastating. Energy is the most vulnerable industry and therefore, a large-scale attack could temporarily halt the supply of water, electricity, gas, transportation, communication and financial institutions.

The CFR also identified 23 other threats including violence in South Sudan, Egypt, Lebanon, Bangladesh, Myanmar, and the political crisis in Venezuela as well as the drug-related violence in Mexico.

Smaller Is Safer

With all this happening, why does tranquility about geopolitical risk continue?

- First, as most of the recent turmoil has occurred in countries that are small when measured by traditional indicators such as:
 - Relative size in the global economy
 - Cross-boarder trading
 - Sophisticated financial networks
 - Market impact
- Second, markets feel that there are sufficient internal circuit breakers that would limit the risk of geopolitical over-reach. Experts believe that no one country or region is economically and politically strong enough to impose its will on others.

- Third, North America and Western Europe have been gradually improving after the prolonged economic slowdown caused by the global financial crisis. Even Japan has done better.
- Fourth, markets continue to have faith in central banks' ability to insulate them from weaker fundamentals, whether economic, financial, or political.
- Finally, markets love consistent trends, and the pattern of quickly fading geopolitical disruptions has been profitable for an extended period of time.

Evolving Political Crises

To date each of the geopolitical shocks has been insignificant on a standalone basis. In aggregate, however, they are starting to affect a more meaningful part of the global economy; few if any can be resolved easily. Leaders in Europe and the US will come under increasing domestic pressure “to do something”.

The World Economic Forum advocates collaborative multi-stakeholder action because businesses, governments and civil society do not have the tools and the authority to tackle systematic risks. In addition, they believe global governance is key to addressing global risks, such as climate change or cyber attacks.

Global cooperation alone does not appear to be the way to diffuse most of the current geopolitical tensions. The reality is that multilateral institutions are hampered by national politics and have not been particularly effective.

Complacency seems to be dissipating, as underlying geopolitical tensions around the world are building. Should this continue, it would quickly become evident that many markets are, indeed, underpricing geopolitical risk.

Donna Gilding is an investment consultant with more than 30 years of institutional investment experience.

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