Weekly Market Flash

Geopolitics and the Indifference of Markets

October 13, 2023

The financial world is full of timeless bits of advice veterans of the system give to those just coming on board. One such hoary old saw is to pay no attention to geopolitics. While wars, terrorist attacks and the like dominate the lead stories on the nightly news, they rarely make much of an impact on financial markets, and any such impact is usually short-lived.

That's the advice, and there is some pretty solid historical data to support it. Consider this past week. Last Saturday, Israelis woke to the deadliest terrorist attack in their country's history, with a known death toll now exceeding 1,300. The brutal terrorist attack by Hamas, and Israel's subsequent declaration of war on the group that has controlled the Gaza Strip since 2007, will likely reverberate throughout the Middle East for a long time to come in ways that we can't fully comprehend today. It will be yet another major foreign policy headache for a world already dealing with the war in Ukraine, the ever-present threat of crisis in Taiwan, and unsteady domestic politics in much of the developed Western world.

Business As Usual

Yet financial markets have barely registered any reaction at all to the events of October 7. US stock and bond markets have remained focused on their usual themes this week, with interest rates and Fedspeak at their customary top of the list. Bond yields fell significantly after some seemingly dovish comments by a few Fed officials suggested that the recent rise of intermediate and long-duration yields might be doing the Fed's work for them and thus reduce the urgency for another rate hike when the FOMC meets at the beginning of next month. A mostly in-line but slightly hotter than expected inflation report on Thursday took some of the enthusiasm out of that dovish narrative. The stock market this morning is mixed, with optimism concentrated in the banking sector where the first batch of third-quarter earnings reports from heavyweights like JPMorgan Chase, Citi and Wells Fargo has received a warm welcome. Even oil markets, which could be expected to be much more reactive to events in the Middle East, have not gone crazy.

The Fog of War

Why are markets so blasé about geopolitics? There are two main reasons, one of which is perfectly rational and the other of which is potentially past its expiration date. First, the rational explanation. It is very hard to translate a geopolitical crisis into a set of known or highly probabilistic outcomes to which a tangible value can be attached. If we consider those three major flashpoints in today's world – Ukraine/Russia, China/Taiwan and Israel/Hamas – there is much more fog than clarity about (a) how the conflicts might be resolved and (b) what the downstream knock-on effects of any such resolution might be. This is a vastly different problem from, say, mapping out valuation scenarios for growth equities in the technology sector following a one-percent change in interest rates. "When in doubt, leave it out" is another one of those old chestnuts shared around securities firm trading floors.

The second reason for the market's usual indifference to world events stems from a longstanding, and by now in our opinion outdated, assumption that the background scenery of the global political order doesn't change at anything more than a glacial pace. This assumption is rooted in the so-called "Washington Consensus" that gained popularity back in the 1990s – the belief that free movement of capital, light-touch regulation, free trade and globalization-friendly political systems under the benevolent leadership of the United States was and would continue to be the way of the world. That assumption is no longer relevant, but it is entirely unclear what is going to replace it.

Wall Streeters often talk of a "wall of worry" when listing things that, while individually perhaps not packing much of a punch, pose a threat to asset price trends when added together. We would add geopolitical uncertainty to whatever else is piling up on investors' wall of worry, and are not inclined to dismiss it as irrelevant. We remain comfortable with where our portfolio positioning is today, but at the same time we are prepared to expect more, rather than fewer, surprises in the year ahead.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research