Geopolitical Tensions, Volatility, and Your Portfolio

Buckle in. Escalating geopolitical unrest, imminent rate hikes and a severe case of whiplash from the latest earnings season have descended on equity markets all at once, making it even more likely that we are in for a period of significant volatility.

On February 24, the day of the invasion, the initial knee-jerk reaction was a flight to safe-haven securities such as Treasury bonds and gold. However, Treasuries pared early gains with the 10-year yield finishing flat at 1.97%, while gold finished lower.

The risk-off sentiment that sent global equities lower at the beginning of the day also reversed. While international developed equities and emerging markets, (as measured by MSCI EAFE and MSCI Emerging Markets indexes) finished down by roughly 4%, U.S. equities staged an impressive comeback from earlier losses.

The rebound was partly due to investors taking advantage of oversold levels brought on by extremely bearish sentiment. But it was also because of increased expectations for a less aggressive tightening cycle by the Federal Reserve. Although higher energy prices may prove inflationary, the market quickly concluded that the central bank is less likely to front-load its rate hikes during the current geopolitical environment.

Although the S&P 500 fell further into correction territory on news of Russia's overnight attack, the index finished up 1.5%. The Nasdaq, meanwhile, came back from the brink of bear market territory to end 3.3% higher. Investors bought oversold technology stocks as fears of sharply higher intermediate and long-term rates subsided.

Russia's invasion is the most important geopolitical event since the fall of the Berlin Wall. War is first and foremost a humanitarian crisis, but it will also have far-reaching investment implications, including the possibility that energy security will take priority over the global fight against climate change.

Our views, however, are focused on what history tells us about significant geopolitical events, their impact on the fundamental drivers of stock prices, and how to position portfolios accordingly.

Risk-Off Reaction to Conflicts Often Short-Lived

The conflict between Russia and Ukraine has increased volatility in the short term, with markets uncertain about the impact rising energy prices will have on inflation, which is already at 40-year highs in the U.S.

But history shows that risk aversion around geopolitical events is often short-lived. The chart below illustrates that while the initial market selloff can be sharp, equity markets are typically higher three, six and 12 months later.

Geopolitical unrest can present potential buying opportunities for long-term investors, but only if the conflict doesn't materially impact economic growth.

Exhibit 1: S&P 500 Performance After Significant Geopolitical Events

	Start Date	+ 1 Month	+ 3-Month	+ 6-Month	+ 12-Month
World War II - Germany invades Poland	9/1/1939	13.2%	8.8%	6.7%	-7.1%
World War II - Pearl Harbor	12/7/1941	-3.4%	-12.4%	-10.2%	-0.2%
Korean War	6/25/1950	-10.0%	1.5%	4.9%	11.2%
Vietnam war	11/1/1955	7.3%	4.1%	13.9%	10.0%
Cuban Missle Crisis	10/16/1962	5.4%	13.3%	21.1%	27.8%
Arab oil embargo	10/19/1973	-8.6%	-13.3%	-14.9%	-34.4%
Iranian hostage crisis	11/4/1979	4.2%	11.6%	3.0%	25.9%
USSR in Afghanistan	12/25/1979	5.5%	-7.9%	8.4%	26.2%
Gulf war - Iraq invades Kuwait	8/2/1990	-8.2%	-11.3%	-2.4%	10.2%
Sept. 2001	9/11/2001	0.4%	4.0%	6.9%	-16.8%
US invades Afghanistan	10/8/2001	5.3%	9.2%	5.9%	-24.8%
US invades Iraq	3/20/2003	2.0%	13.7%	18.3%	26.7%
Russia invades Crimea	2/20/2014	1.8%	1.8%	8.0%	14.7%
	Avg.	1.1%	1.8%	5.4%	5.3%
	Median	2.0%	4.0%	6.7%	10.2%
	Max	13.2%	13.7%	21.1%	27.8%
	Min	-10.0%	-13.3%	-14.9%	-34.4%

Source: Bloomberg. As of 2/24/22

What to Watch

It's important that the focus remain on the impact these events have on the economy, inflation, and earnings – the fundamental factors that matter most to markets.

We don't expect the conflict to negatively impact the global economy overall, given that Russia only represents 3% of global GDP. However, we could see some of Russia's main trading partners (most notably Europe) being negatively impacted, as they are large importers of Russian gas and oil. This could occur if we see tougher sanctions imposed by NATO and the European Union, or if Russia cuts off energy supply to the West.

Also critical to growth will be the Fed's ability to engineer a series of rate increases to combat inflation in an economy that will naturally slow later this year. The Fed's task has been made even more difficult by rising energy prices due to the Russia-Ukraine dispute.

The Treasury yield curve, and specifically the yield or spread difference between two-year and 10-year Treasury notes, can give some indication of how the market sees short term versus longer term inflation levels, and give us a sense of whether the market is anticipating a potentially more dovish posture from the Fed down the road.

Our base case has been and remains that the Fed will increase the federal funds rate five times in 2022. Before Russia's attack the consensus was for six to seven hikes. The market is now forecasting less than six increases this year. We continue to expect Treasury yields will end the year between 2%-2.25% and that inflation will settle in a new range of 3%-3.5%, although inflation has the potential to surprise to the upside.

How We Are Positioned

Volatility was a major theme in our 2022 Outlook, and that is largely what we've experienced since trading began in January. Before geopolitical tensions escalated the market had shown resilience and a propensity for investors to buy on dips. We saw that again on the day the invasion occurred, as oversold conditions provided investors with some buying opportunities. More sharp swings in market levels are likely until we either get an easing of geopolitical tensions, relief for energy markets with the onset of new supply, or more clarity from the Fed.

Client portfolios are prepared for this period of volatility. At the start of February, we decided it was prudent to take some risk off the table by reducing our exposure to U.S. small cap stocks, a move which takes our overall equity weighting to neutral. Our U.S. exposure to small caps is now also neutral, down from a small overweight. We focused on small caps because it's an area of the market that has underperformed, where volatility tends to be worse than in large caps, and where earnings are more at risk. At the same time, we have recommended investors diversify into private equity, which is not correlated with public stocks and has offered higher returns.

Being nimble with tactical allocation shifts is one way to outperform in choppy markets, and is among the strategies we outlined in our January Investment Update for this year. The emphasis is on diversification, staying invested while buying on dips where appropriate, and seeking out companies that can grow earnings regardless of rising rates and inflation.

This is also a time when investors need to consider all factors that impact their wealth, and not just investments, to ensure they are pulling all levers to preserve and even grow their wealth during challenging markets.

Most of all, avoid making emotion-driven investment decisions. If you're feeling uneasy, revisit your investment plan with your wealth manager. Volatility, while unnerving, can work for you, as long as you avoid following daily market gyrations and stay focused on your long-term investment goals.

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