Geopolitical Risk Rises for Global Investors

By Brian Bremner and Simon Kennedy - Jul 29, 2014

Since the start of the year, conflicts in Syria, Gaza and Iraq have escalated, China has become more assertive in pursuing territorial claims against Japan, Thailand reverted to military rule, Russia annexed Crimea and separatists in Ukraine downed a civilian airliner.

These crises have had little lasting impact on major financial markets in the U.S., Europe and in Asia. Now Raj Hindocha, a managing director with Deutsche Bank Research in London, is warning that investors and money managers could be in for a rude awakening later this year.

Geopolitical risk is being underestimated and volatility suppressed, thanks in large part to the open monetary spigots at the U.S. Federal Reserve, European Central Bank and Bank of Japan, according to a recent report Hindocha co-authored.

“It’s the abundant liquidity that has numbed the markets,” he said in a telephone interview yesterday. “Nobody wants to bet against that firepower.”

Though it’s nowhere near the levels of 2011, when the U.S. recovery sputtered and Europe was in the grip of a sovereign debt crisis, volatility is starting to make a comeback. The Chicago Board Options Volatility Index -- which rises in times of market stress -- is up 8.56 percent so far in July and poised for its biggest monthly jump since January. And the U.S. and Europe agreed yesterday to escalate their pressure on Russia with a new set of sanctions targeting the country’s financial, energy and defense sectors.

September Surprise

Twenty eight percent of investors surveyed this month by Bank of America Corp. identified geopolitics as the biggest risk, up from 14 percent in June. Olivier Blanchard, economic counselor at the International Monetary Fund, said last week that “geopolitical risks have arisen, although they have not yet had global macroeconomic repercussions.”

Hindocha said the shift in market sentiment could come as early as September, when he expects the Fed to start to signal a move away from its current accommodative stand. “All of these risks that have been drowned out because of liquidity could be a trigger for people to take a more bearish view of the market.”
His thesis isn’t shared by Tai Hui, chief Asia market strategist at JP Morgan Asset Management, which oversees about $1.7 trillion worldwide. Hui points to positive economic data in the U.S., China and Japan.

The Standard & Poor’s 500 Index is up 7 percent this year, powered by strong corporate earnings and a drop in bond yields in the U.S. The yield on the Spanish 10-year bond has fallen below 2.5 percent for the first time in more than 200 years, according to data by Deutsche Bank.

**Country-Specific Crises**

As for oil, Wall Street analysts tracked by Bloomberg predict West Texas Intermediate will average $100 a barrel in the fourth quarter, down 5.1 percent from June 30, while Brent will drop 4.8 percent to $107.

“We are seeing a recovery in the U.S., a stabilizing Chinese economy and Japan is taking its tax hike with a strong recovery,” Hui said. “Investors are taking those more seriously than geopolitics.”

The crises in Ukraine, Russia and the Middle East are country-specific and fairly localized so far, according to Jan Dehn, the London-based head of research at Ashmore Group Plc, which has about $70 billion in emerging market assets.

“The market is rational in the fashion that it’s not lumping them all together,” Dehn said.

That outlook could swiftly change. “We’re still looking at a powder keg in Ukraine and if there’s a major escalation we’ll see the geopolitical risk premium rush back into the market,” said Gene McGillian, an analyst and broker at Tradition Energy in Stamford, Connecticut.

The run of negative geopolitical developments hasn’t yet moved markets in a big way “because there is a perception lag here,” Tina Fordham, a senior global political analyst at Citigroup Inc., said in an interview with Bloomberg TV.

“The last 25 years since the fall of the Berlin Wall have been extraordinarily peaceful and prosperous,” Fordham said, “and that’s what investors and money managers are used to working in.”

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