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The Geopolitical Paradox: Dangerous World, Resilient Markets

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OVERVIEW

Bottom Line: Markets are paying more attention to political risk, but are still pricing resilient global growth. A faltering European economy remains the biggest threat to this benign scenario.

One of the confounding stories of the year has been the apparent disconnect between rising geopolitical risks on the one hand and well-performing global markets on the other. That may be changing. Increasingly, market analysts are debating whether political developments—including the Russia-Ukraine conflict, turmoil in the Middle East, and rising tensions in Asia—pose a systemic threat to markets. Though their answer generally is “no,” they are increasingly highlighting the downside risks. Central banks have followed suit, and even the normally inwardly focused Federal Reserve sees “spillovers from developments in the Middle East and Ukraine” as a risk to U.S. growth.

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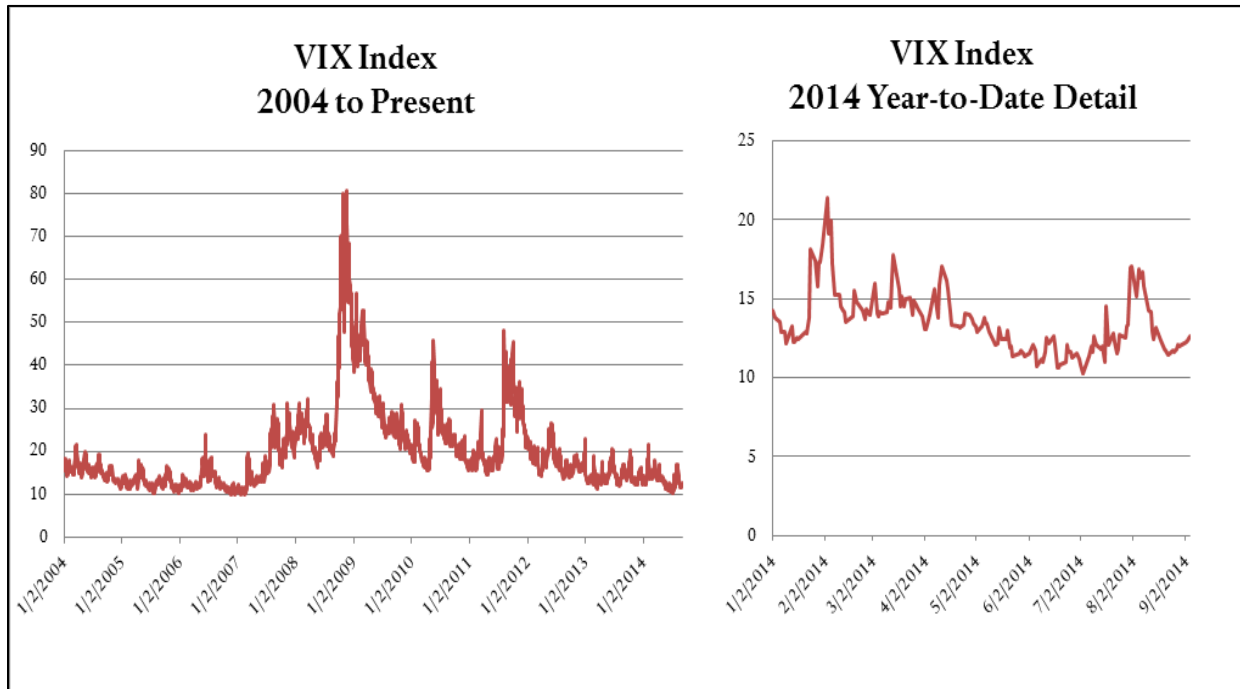
But while the conversation has changed, particularly following the downing of Malaysian Airlines Flight 17 in mid-July, markets have not moved substantially and still appear to be pricing a benign global outlook. Figure 1 shows the Chicago Board Options Exchange Market Volatility Index (VIX), most analysts’ favorite indicator of risk appetite. Market volatility has risen, but according to this measure, it remains at relatively low levels and well below the peaks associated with recent shocks, including the global financial crisis, Greece’s economic collapse, and the threat to the euro. The VIX is far from a

perfect measure of investors’ desire for insurance against geopolitical risks, and there are other indicators suggesting investors may be becoming more cautious, but the VIX index suggests that market participants are less worried about geopolitical risk than political analysts. Global equity markets remain at elevated levels, risk premia continue to fall, European periphery bond spreads remain near postcrisis lows, and even Greece is issuing new debt. Is there a disconnect? It seems so, but there are at least three possible explanations.

FAR AWAY AND UNCORRELATED

Much of the market commentary to date has stressed that the risks that most worry political analysts may not be central to global growth and markets. Although conflict in Syria or Ukraine represents a material political threat, the argument goes, these are small pieces of the global economic mosaic. An Ebola pandemic, though devastating for Africa, may be easily contained in the major industrial countries. In Asia, China-related turmoil seems uncorrelated with other global risks. Certainly there is concern about a hard landing in China, given the country’s outsized effect on global demand. But tensions between China and its neighbors, or concerns about internal instability, are unlikely to upend the Chinese economy given the sizeable economic buffers that the Chinese have to offset any shock. Admittedly, should any of these risks break out, the transmission will likely be rapid and chaotic. For now, though, most of these political risks may seem far away for all but the most exotic of investors.

FIGURE 1: VIX INDEX (VOLATILITY OF THE S&P 500) WITH 2014 DETAIL



Source: Chicago Board Options Exchange

Far away does not mean inconsequential. As I have argued in the case of Western sanctions against Russia, the disruptions that will result depend not only on the size of the markets affected but also on the leverage, integration, and interconnectedness of Russian institutions in global financial markets. Russia's continued efforts to destabilize Ukraine may ultimately lead to comprehensive financial sanctions, which could cause substantial economic dislocations.

A SEA OF GLOBAL LIQUIDITY

The dominant driver of economic returns in recent years has been central bank policy and there is little doubt that the highly accommodative monetary policies of the United States, eurozone, United Kingdom, and Japan have provided an important firewall against geopolitical risk. With interest rates at or near zero in the major economies, inflation muted, and growth steady if uninspiring, economic fundamentals create strong incentives for risk-taking. An excessive down-weighting of risk has become an unintended consequence of monetary policy aimed at providing support for a still-fragile recovery. But that may be changing. The Federal Reserve is beginning the process of normalization and is expected to begin lifting rates in mid-2015. We saw last year that even talk of interest-rate normalization could create a “taper tantrum,” where markets became hypersensitive to weaknesses in economies that had been long ignored. The Fed's efforts to communicate its new policy course could trigger similar sensitivities about political risk.

Foreign exchange markets in particular may be vulnerable.

While the Fed prepares to normalize, the European Central Bank (ECB) and the Bank of Japan are preparing to move in the other direction, introducing or expanding quantitative-easing (QE) programs in the face of low

inflation and weakening demand. As a result, global liquidity will remain ample. Still, the divergence of monetary policies, after a long period of synchronization, creates conditions for increased market volatility. Foreign exchange markets in particular may be vulnerable, as history suggests these markets are often bellwethers of divergent monetary policies. In this environment, geopolitical news could have greater effects.

CONFIDENT OIL MARKETS

Europe is the channel through which political risk could reverberate in the global economy.

It is often noted that the vast majority of postwar recessions have been associated with energy shocks. Rising turbulence in the Middle East has raised the prospect of a long-term disruption in the region, where national borders could be rewritten through violent upheavals. The threat of a Russian cutoff of gas to Europe also hangs over markets. Consequently, it is surprising that energy markets, and oil markets in particular, do not ask for a premium in futures markets for secure energy supplies. At present, current oil contracts are higher than longer-term futures contracts, and though there are technical reasons for this downward trend

(“backwardation”), it hardly is suggestive of disrupted or anxious markets. There are many good reasons for such comfort. A stable and moderate global expansion that has limited demand, as well as the revolution in fracking and other technologies, has allowed Saudi Arabia to maintain substantial spare capacity, thereby limiting the potential for a supply disruption to roil markets in the near term (though the longer-term buffering effects on market prices from these developments can be overestimated). But there also seems to be a notion that, whatever the political turmoil in the Middle East, the incentives to pump oil will stabilize supply. Even so, it is hard to imagine that if borders are to be rewritten through conflict, oil supply will remain stable and predictable. It would not be surprising to see rising geopolitical risk reflected in oil markets.

EUROPE AS THE WEAK LINK

There are a number of reasons why Europe is the channel through which political risk could reverberate in the global economy. Europe is most vulnerable to disruptions in trade and financial relationships with Russia, though I have argued elsewhere that these costs may be small relative to the costs of inaction. Weak growth in China and elsewhere in the emerging world could significantly affect exports, particularly in Germany. Significantly, though, Europe also faces these challenges at a time of economic stress and limited resilience. Growth in the region has disappointed and leading indicators have tilted downward. Further, concern about deflation is beginning to weigh on sentiment and investment. The persistence of low inflation—well below the ECB’s goal of around 2 percent—is symptomatic of deeper structural problems facing the eurozone, including an incomplete monetary union, deep-seated competitiveness problems in the periphery, and devastatingly high unemployment. Homegrown political risks also threaten to add to the turmoil, as rising discontent within Europe over the costs of austerity is undermining governing parties and fueling populism. The result is a monetary union with little capacity or resilience to defend against shocks. The ECB has responded to these risks with interest-rate cuts and asset purchases, and is expected to move to quantitative easing later this year or early next, but the move comes late, and is unlikely to do more than address the headwinds associated with the ongoing banking reform and continued fiscal austerity. Overall, a return to crisis is an increasing concern and political risks could be the trigger.

THE PARADOX REMAINS

In sum, it is hard not to conclude that markets are still too sanguine about the risks that geopolitical turmoil could upend global growth. A return to the economic crisis conditions that we saw in Europe from 2011 to 2012 remains the most likely potential catalyst for these shocks. The economic remedy calls for far more ambitious and growth-oriented policies in Europe. That may be the hardest scenario to imagine.

Looking Ahead: Kahn's take on the news on the horizon

The sanctions game

Europe seems to be inching toward harsher sanctions against Russia, focusing on state-owned oil companies, and the United States is expected to follow suit.

QE Europe

The European Central Bank is expected to embrace quantitative easing, but is dampening expectations of a September move.

A Scottish jolt

The polls suggest a close vote on Scottish independence, which could rattle European and British markets.