Special market update – February 15, 2022

Investors often think that investments are tied to geopolitical events – which is interesting because geopolitical events rarely have a meaningful or lasting impact on the markets.

The current tensions between Russia and the Ukraine have many investors questioning what, if any, market impact may hold should there be military action. While there are many valid reasons to be concerned about escalating geopolitical tensions, market performance is rarely one of them.

It is hard to think of a year where there hasn't been some sort of geopolitical event. However, it is rare that a non-financial event has any meaningful or lasting impact on the markets. Yet, many investors immediately turn to their portfolios in the face of exogenous events.

As we can see in *Chart 1* below, there have been a multitude of events that we can point to over the last 100 years that certainly were worrisome. Yet, only when we look closer and focus on the sharper, more prolonged equity downturns or bear markets (*Chart 2*), do we see that they are typically associated with economic recessions. And while some geopolitical events can lead to recession – the COVID-19 global pandemic being the most recent one – in most cases, it is a financial disaster or the end of the economic cycle (with the two being inter-connected) that leads to bear markets and recessions.

Energy markets

We wouldn't suggest that the threat of a Russian invasion of Ukraine doesn't hold any market consequence. The most meaningful impact to financial markets would likely be centred around the energy markets. Crude oil is Russia's single largest export. Additionally, Russia is a major supplier of natural gas to Europe. Russia is the world's third-largest oil producer, and approximately half of Russia's federal budget comes from oil and gas. Military action against Ukraine would no doubt trigger sanctions, rocking an already tight oil market.

Speculation has crept into oil prices with crude breaking above US$90/bbl in recent weeks. Certainly, any disruption in global energy supplies could see prices climb higher and complicate the inflation outlook. Nonetheless, a diplomatic compromise appears to be underway. Given the economic consequences of sanctions to Russia, a longer-term conflict appears to be a very low probability. More to the point however, history would suggest that while there could be market volatility caused by geopolitical events, these tend to be shallow and short and rarely trigger losses consistent with a bear market.

Would the conflict impact consumer spending?

As we can see in *Chart 2*, deep and prolonged equity market volatility tends to coincide with economic recessions. The reason for this is simply that equity investors care more about earnings and valuation than they do about politics and conflict. As investors, we need to ask ourselves how a conflict in Ukraine would impact the spending habits of American consumers, for example. Economic weakness leads to a drop in corporate sales and profitability and therefore triggers a commensurate adjustment in value – **geopolitics does not**.

To be fair, there have been four bear markets that fell outside of recessions, 1946 – the Margin Shock, 1962 – the Kennedy Slide, 1966 – the Flash Crash (or Baby Bear), and 1987 – Black Monday. However, neither of these bear markets coincided with a recession, nor any specific geopolitical event. And therefore, in the absence of an unpredictable event or events, we would suggest that the risk of recession, and consequently, the risk of a bear market in today's environment is quite low.

To conclude, while the current events may be worrying, from a perspective of a diversified portfolio, we find little cause for concern.

Chart 1 – Is it geopolitics or economics that drive equity markets?

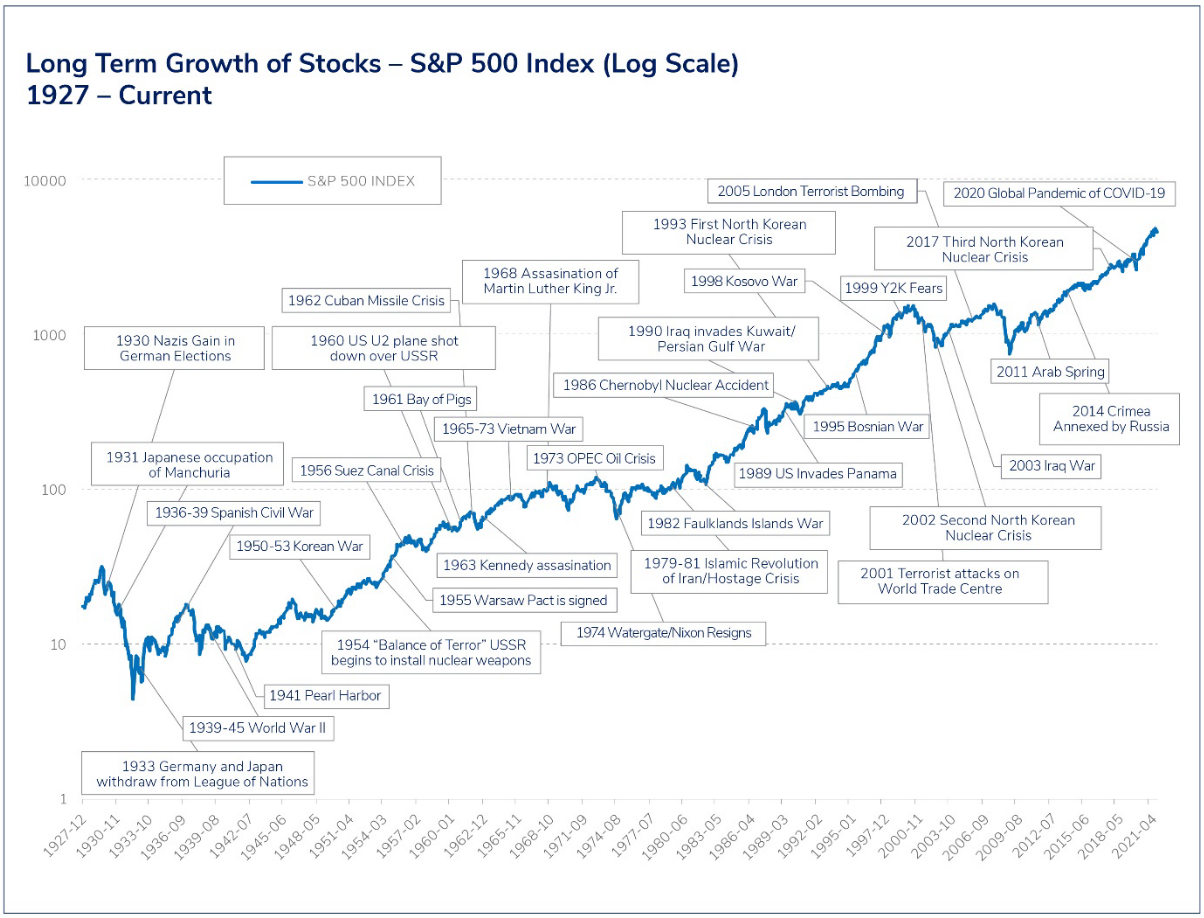
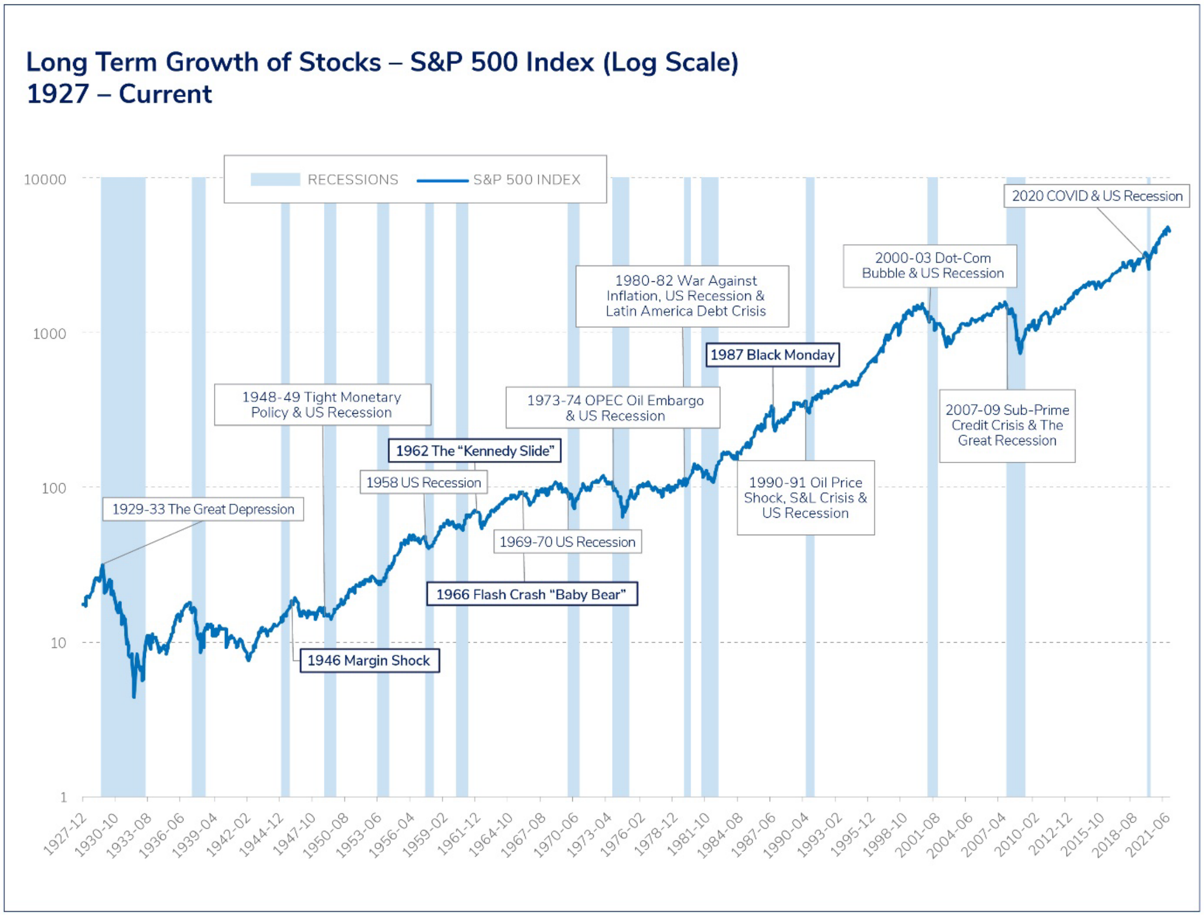


Chart 2 – Equity downturns (bear markets) are typically associated with economic recessions



Source: IG Wealth Management, Bloomberg as of February 2022

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