

## AN INVESTOR'S GUIDE TO THE WORLD'S REAL POLITICAL RISKS

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### HIGHLIGHTS

- For investors, most political risks are temporary shocks or simply "noise" but others may signal major tectonic shifts.
- The toxic dynamics of today's geopolitical landscape have heightened risks that bear close watching.
- When the next crisis hits, global crisis management will be much more difficult than it was 10 years ago.

As we enter year nine of the Great Recovery, there's a lot of loose talk about good economic numbers amid rising levels of political risk. But just how is the world so much riskier now than in periods around, say, the Cuban Missile Crisis or the remilitarization of the Rhineland? Besides, **not all political risks are alike, nor do they all have the same impact on investment strategies.**

Most of the politics that keeps investors up at night fits into one of three baskets: 1) the noise, which you should ignore; 2) the shocks, which are likely temporary; and 3) the tectonic shifts, which could threaten to bring the whole system down.

**Keep your eye on those shifts.**

Arguably, the risks that make us all the most nervous these days come from the unsettling headlines of our daily news feeds: vans driving into sidewalk pedestrians, cyber breaches of credit card data and more angry politicians promising to overturn the current order. It's all deeply troubling, but it's hard to price any of this noise into a discounted cash flow.

You shake your head, you shrug your shoulders and you move on.

**SHOCKS TO THE SYSTEM: S&P 500 INDEX DECLINES AND RECOVERIES SINCE WWII**

EVENT	DATE	DAYS TO MARKET BOTTOM	% CHANGE	DAYS TO RECOVER
JAPANESE TSUNAMI	3/11/11	3	-3.6	6
FLASH CRASH	5/6/10	1	-4.7	4
LEHMAN BANKRUPTCY	9/15/08	121	-46.0	285
MADRID BOMBING	3/10/04	10	-4.1	18
9/11 TERRORIST ATTACKS	9/11/01	5	-11.6	19
COLLAPSE OF LTCM	9/23/98	11	-10.0	9
IRAQ INVASION OF KUWAIT	8/2/90	2	-5.9	30
PROGRAM TRADING	10/19/87	33	-20.8	223
REAGAN SHOOTING	3/30/81	1	-1.2	4
NIXON RESIGNATION	8/8/74	39	-24.6	143
OPEC OIL EMBARGO	10/17/73	6	-1.9	10
JFK ASSASSINATION	11/22/63	1	-2.8	2
CUBAN MISSILE CRISIS	10/22/62	1	-2.7	5
PEARL HARBOR ATTACK	12/7/41	18	-10.8	257
<b>MEDIAN</b>		<b>6</b>	<b>-5.3</b>	<b>14</b>

SOURCE: CAPITAL IQ. PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

As for the potential shocks, they're even harder to factor into an investment strategy. Moreover, the historical record offers some grounds for comfort. Sometimes there are rate cuts or fresh government spending to cushion the blows. Sometimes the shock subsides and investors realize their portfolios don't look so bad after all. For example, stock markets recovered all losses within a month after September 11 and within two days of President Kennedy's assassination.

Current powder kegs range from the collapse of Venezuela to rising tensions between Iran and Saudi Arabia, to the unpredictable dynamics on the Korean peninsula. Odds are, these will all be on our list of worries for years to come. If one of them does blow, however, there would more than likely be emergency monetary and fiscal measures to cushion any spike in oil prices or bond yields. There would be diplomatic interventions to keep things from spiraling out of control. The brutal fact is that a regional humanitarian disaster is less likely to trigger systemic market crisis.

The real political risks to the global economy are far more insidious and less easy to track. They are to be found in the slow and unmistakable realignments of global power. While U.S. armed forces remain stronger than the next seven largest militaries combined (yes, *combined*), we still find it difficult to have our own way. Other countries, like China, are growing more assertive as Americans themselves are questioning the costs of global leadership. At the very least, the current administration's "America First" rhetoric and iconoclastic style have led friends and foes alike to re-examine their assumptions about the postwar order: Is the U.S. pulling back? Will the world fall into rival regional camps? Are we headed for a clash of civilizations?




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This is important for investors, because they need to assess the resilience of the global system when the next crisis comes. **We don’t know when that next crisis will come or what it will look like, but we do know we will need a massive and coordinated response to limit the damage.**

Indeed, since World War II, the world’s key economic summits have been among political or even military allies. The conversations were not always easy, but the United States, Europe and Japan were all bound together by a common political purpose. In 2008, when the Lehman collapse threatened a global depression, President Bush convened the leaders of the G-20, who immediately flew to Washington and rallied around a plan to restore market stability with a combination of fiscal and monetary support.

**Next time, as they say, will be different.**

In many ways, it may resemble the 1920s when the gold standard collapsed amid rivalry and carelessness, even when none of the world’s major economies wished for it. France resented the dominance of sterling and saw no need to help stem the flows of gold leaving Britain. Germany labored under the burden of postwar reparations and was too weak to act, while Russia was consumed by civil war and the United States had essentially withdrawn from global affairs following the Senate’s vote against the League of Nations.

When the G-20 convenes for the next crisis, its members will all want to avoid a collapse, but many will also be looking for an opportunity to throw an elbow among increasingly toxic relations with rivals. China might convince itself that it can withstand market turmoil better than the United States and focus on the stability of its regional partners. The U.S. might try to use the market pressures to extract trade concessions from Beijing. Europe is already asking serious questions about the future of trans-Atlantic relations, and cooperation will be far less automatic. Russia, while far less consequential economically, never misses the chance to throw sand in Western economic and political gears.

**Failure and collapse are by no means inevitable, but cooperative crisis management is much less likely today than it was 10 years ago.** If you are an investor with a time horizon that extends more than a few months, keep your eyes carefully focused on the uncertain chances of success.



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