

Context of Events

COMMENTARY
March 2022

One correctly could suggest the world entered a darker phase over the past week. One also correctly could observe that the skies have proceeded to darken since the dawn of the post-Soviet era. The breadth of those two observations reflects a proper range of thinking regarding geopolitical risk and investment management. Though the thrum of growth generally masks these ever-present risks, they sometimes break through and volatility surges. That in mind:

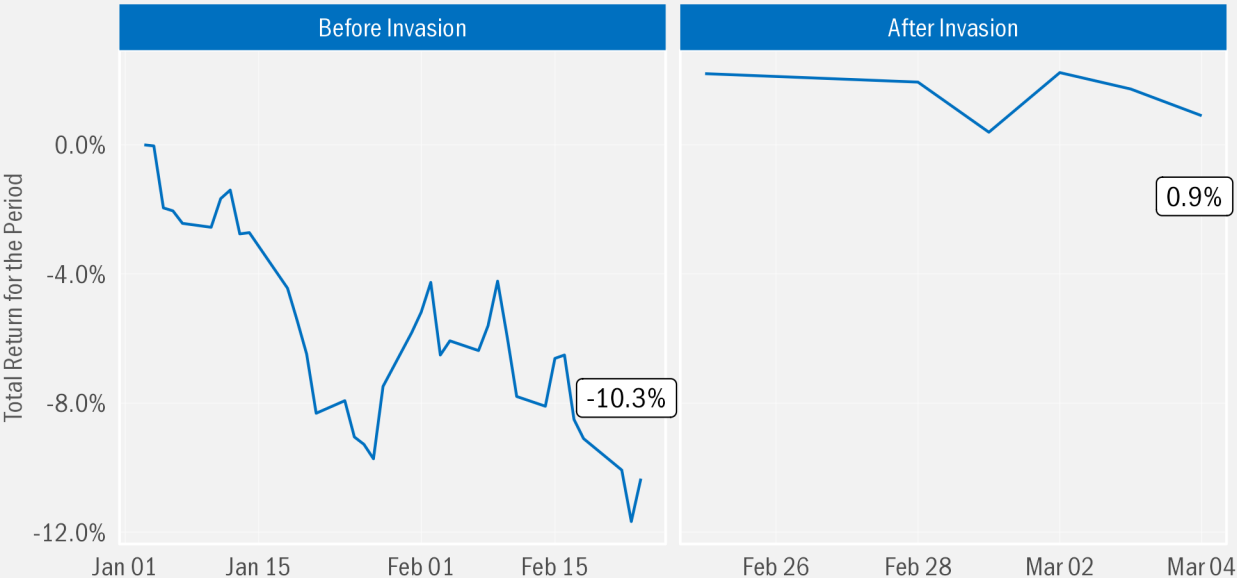
- Markets don't like or dislike uncertainty. Rather, markets "price" uncertainty
- The greater the uncertainty, the higher the cost of that uncertainty, the larger the discount to assets exposed to that uncertainty
- We think investors are wise to maintain both a deliberate short-term interest in and a positive long-term bias regarding potential impacts of an uncertain future on portfolios

A War Begins

Geopolitical risk generally remains in the back of the minds of most investors. Without specific incident, however, those thoughts don't as often translate into specific positioning. If they did, the investor response might be a permanent "risk off" stance. But when such risk becomes acute—when geopolitical action forces investor reaction—investors generally seem to make their fears known pretty quickly, selling off risky assets in favor of cash and risk-free bonds. Markets tend thereafter to rebound as resolutions are found and risk subsides. What's surprising to us, then, is the relative calm equity markets have demonstrated in the face of the continued escalation of and the potentially grim consequences of the conflict in Ukraine.

Figure 1: Performance of the SPDR S&P 500 ETF Trust (SPY)

The domestic equity market had been reflecting a combination of fears that included the potential impacts of shifts in monetary policy and the likelihood of a Russian invasion in Ukraine. Now that the war has begun, markets have been relatively flat, challenging explanations



From 01.03.22 through 03.04.22. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. SOURCE: SRCM using data from Bloomberg

Markets Await

We often hear the phrase, “markets don’t like uncertainty.” It’s better said that markets don’t care one way or the other. Rather, markets “price” uncertainty: the greater the uncertainty, the higher the cost of that uncertainty, the larger the discount to assets exposed to that uncertainty. In “normal” times, geopolitics are merely one component of the broader set of risks investors consider, their *potential* effects discounted in a non-specific manner. But such risks occasionally become more specific, and investors seek greater protection as a result.

Through that lens, we could argue that investors may have long assigned a non-trivial probability to a potential surge in geopolitical tensions involving Russia. But, given the lack of specific pressure, investors may have thought the risks deserved no more detailed consideration. As Putin gathered military assets on Ukraine’s border earlier this year, however, investors arguably began to sell riskier assets as they priced in the heightened potential for war.

Figure 2: S&P 500 Index Historical Drawdowns and Subsequent Performance

Dollar amounts show value of \$10,000 invested prior to drawdowns of 10% or more in the index

Initial Peak	Subsequent Low	Percent Drawdown	At Low	5 Years from Peak	5 Years from Low	10 Years from Peak	10 Years from Low	Peak to Present	Rank
01.02.1990	01.30.1990	-10.04%	\$8,996	\$14,890	\$15,210	\$52,246	\$53,805	\$234,830	21
10.05.1979	10.25.1979	-10.13%	\$8,987	\$18,865	\$19,285	\$49,679	\$53,072	\$1,184,618	20
10.07.1997	10.27.1997	-10.75%	\$8,925	\$8,548	\$9,779	\$18,569	\$20,515	\$69,310	19
03.24.2000	04.14.2000	-11.14%	\$8,886	\$8,287	\$8,228	\$9,175	\$10,715	\$43,116	18
10.10.1983	07.24.1984	-11.37%	\$8,863	\$19,558	\$24,102	\$38,042	\$43,155	\$619,601	17
01.05.1960	09.28.1960	-11.59%	\$8,841	\$16,479	\$17,874	\$21,362	\$22,244	\$4,484,164	16
07.16.1999	10.15.1999	-11.80%	\$8,820	\$8,355	\$8,444	\$7,913	\$10,511	\$46,814	15
04.28.1971	11.23.1971	-12.35%	\$8,765	\$11,677	\$11,931	\$19,720	\$21,006	\$1,789,560	14
09.12.1978	11.14.1978	-12.78%	\$8,722	\$20,139	\$20,421	\$39,399	\$45,690	\$1,306,587	13
12.31.1976	03.06.1978	-14.40%	\$8,560	\$14,785	\$19,788	\$36,584	\$48,991	\$1,413,003	12
02.13.1980	03.27.1980	-16.71%	\$8,329	\$19,912	\$19,569	\$43,012	\$53,469	\$1,092,604	11
07.17.1998	08.31.1998	-19.19%	\$8,081	\$8,875	\$9,132	\$12,509	\$15,798	\$56,742	10
07.16.1990	10.11.1990	-19.19%	\$8,081	\$17,627	\$18,357	\$51,732	\$58,014	\$224,831	9
11.28.1980	08.12.1982	-20.16%	\$7,984	\$18,314	\$31,868	\$34,277	\$59,503	\$881,260	8
02.09.1966	10.07.1966	-20.21%	\$7,979	\$12,286	\$12,865	\$15,023	\$20,074	\$2,374,305	7
12.12.1961	06.26.1962	-26.88%	\$7,312	\$13,420	\$15,080	\$18,743	\$28,607	\$3,522,062	6
11.29.1968	05.26.1970	-32.58%	\$6,742	\$10,577	\$10,522	\$12,760	\$24,253	\$1,885,750	5
08.25.1987	10.19.1987	-32.93%	\$6,707	\$14,511	\$14,689	\$36,781	\$56,409	\$272,936	4
01.11.1973	10.03.1974	-44.80%	\$5,520	\$9,176	\$12,305	\$19,510	\$42,636	\$1,479,976	3
09.01.2000	10.09.2002	-47.42%	\$5,258	\$8,706	\$11,599	\$8,558	\$22,699	\$43,083	2
10.09.2007	03.09.2009	-55.22%	\$4,478	\$10,291	\$13,827	\$20,190	\$49,970	\$37,145	1

From 12.31.59 to 03.04.22. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Given the growing intensity of the war, though, we might have expected markets to have experienced greater declines. But stock performance since the invasion presents yet another example of the difficulty in forecasting market moves. Further challenging the assessment of “what’s driving this stock market” are the effects of potential shifts in monetary policy going forward. The war has bolstered inflationary pressures, with energy and food prices seeing particularly intense gains. As global central banks have been keen to adjust policy to address persistent inflation by raising target interest rates, the war provides further reason to do so. But equity investors seem generally more fearful of rising rates, so the potential for higher rates than had been expected could be seen as a bad thing. So, too, would be the potential for weaker macroeconomic growth on account of the war, in particular in Europe. For these reasons and more, we should expect markets to remain volatile as the war continues and its impacts are more clearly observed.

Part of a Longer Chapter

But what of the longer term? An anecdote from history may be helpful. The Cuban Missile Crisis arose near the tail end of an episode in American/Soviet history that began with Cuba's establishment of diplomatic relations with the Soviet Union. America followed by severing diplomatic relations with Cuba and shortly thereafter attempted to overthrow the Castro regime in Cuba via an invasion at the Bay of Pigs. The Missile Crisis was the culmination of that eruption in tension, the easing of which may have led to the sharp rebound in the U.S. stock market after a drawdown of nearly 27% (ranked number 6 in Figure 2).

When placed into a broader macroeconomic, geopolitical and market environment, we see that geopolitical risk tends to clump across several major events, with some manner of resolution eventually leading to a rebound in the equity market. The depth of the drawdown can be read as an investor gauge of the severity of the various events. We can relate the length of the drawdown to the time it takes for that resolution to be found, or for whatever tensions were driving investor fears otherwise to subside. In the midst of the drawdown, then, investors should be cognizant of the fact that further escalation of the conflict, whatever form it takes, may lead to additional bouts of volatility and decline.

At the present, we cannot know how this war will end. We therefore want to remind readers that such uncertainty and the volatility that may rise around it can stymie efforts to meet short-term financial goals. Those with longer-term investment time horizons, however, may find that patience through such times of market declines and increased volatility tends to find reward in more positive outcomes over the long-term. Either way, we welcome any discussions you may wish to have regarding our understanding of the events as they are evolving in the context of your exposure to broad-market risk.

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