INVESTMENT STRATEGY RESEARCH

RBC Capital Markets

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Geopolitical Problems

Is it time to call the World Police?

- Tensions between the US and North Korea have reach a heightened level that appears to have roiled markets over the past few days.
- We offer no view on how this may play out, as we are not geopolitical experts; however, we think investors can take some guidance from the geopolitical events of the past six decades to gain some understanding of how markets have typically dealt with "dislocations" such as this.
- We acknowledge that this time could be different, as most events that we will use for comparison's sake do not involve the threat of nuclear war (although some have).
- The seven events that we have identified for comparison are the Cuban Missile Crisis, the Six-Day War, the Tet Offensive, the Yom Kippur War, Gulf War I, 9/11, and Gulf War 2. We acknowledge that none of these may be comparable to the current situation, especially with the threat of nuclear conflict bandied about; however, we think there are some interesting takeaways nonetheless.
- Our key takeaway would be that the impact on stocks is far greater in the lead-up to conflict (S&P/TSX average drawdown of 8%, S&P 500 10%) than it is when the bombs begin to fall.
- In fact, the actual beginning of conflict has often marked "the beginning of the end" in terms of poor market performance, with both the TSX and the S&P 500 generating modest average gains when risks are arguably at their greatest. We add that some have been followed by prolonged bull markets, while others have helped to prolong ongoing bear markets.
- We also look at the performance of gold during most of these events. The bottom line is that gold generally performs as expected, providing a worthwhile hedge against geopolitical risks.

All values in Canadian dollars unless otherwise noted.

Priced as of prior trading day's market close, ET (unless otherwise stated).

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Mobilizing the World Police

Tensions between the US and North Korea are running high. We are not geopolitical experts and thus we will not weigh in on how this conflict may play out; however, we think that history can provide some guidance as to how markets might perform in the lead-up to and during major conflicts.

We note before starting that the base case probably remains that one or both sides will back down and that conflict will ultimately be averted. Thus, this piece should not be viewed as predicting that conflict will occur, but rather as providing some guideposts in the event that it does.

For the purposes of this piece, we will focus on seven events that have taken place since 1960. They are:

1. **Cuban Missile Crisis (October 1962):** Arguably the closest parallel to the current situation. The Soviet Union attempted to deploy ballistic missiles in Cuba in response to the US's deployment of missiles in Europe as well as the failed Bay of Pigs invasion during the prior year. Over a 13-day period, both sides refused to back down, and it is commonly viewed as the closest the world has come to global nuclear war.
2. **Six-Day War (June 1967):** War between Egypt, Syria, and Jordan on one side and Israel on the other. A proxy for the Cold War, with Soviet-supported Egypt, Syria, and Jordan in full conflict with US-supported Israel. The conflict was resolved quickly, with major losses on the Arab side, which was forced to cede control of major territories to Israel, including Jerusalem, the Golan Heights, the Sinai Peninsula, and the Gaza Strip.
3. **Tet Offensive (1968):** A major offensive conducted by the Viet Cong against South Vietnamese and US forces. Viewed by many as the turning point in the Vietnam War in favour of the North.
4. **Yom Kippur War (October 1973):** A surprise attack led by Egypt on Israel and much of the territories it had gained in the Six-Day War. After initial success, the Arab forces were eventually swiftly defeated by Israel; however, the events of the War and the US's support for Israel touched off the OPEC oil embargo, which contributed to a vicious bear market that had begun early in 1973 and would last until the end of 1974.
5. **Gulf War 1 (January/February 1991):** Iraq's invasion of Kuwait in early August 1990 led to the first Gulf War, which pitted forces led by the US against the armies of Iraq. The rapid rise in oil prices as a result of the War is credited with contributing to ongoing economic malaise in the US and the eventual loss of incumbent President George H.W. Bush in the 1992 election.
6. **9/11 (September 2001):** The hijacking of four US airlines by Al Qaeda operatives. Two of the planes crashed into the World Trade Center (destroying both towers) and one crashed into the Pentagon (causing major damage). Contributed to an ongoing bear market, which had begun in early 2000 and would extend to October 2003; it was also the root cause of the invasion of Afghanistan by US-led forces.
7. **Gulf War 2 (March to May of 2003):** The US-led invasion of Iraq brought about by Iraq's refusal to allow proper inspections of its suspected WMD program. Often credited in part with marking the end of the 2000–03 equity bear market.

We acknowledge that this list may not be comprehensive and some might cite other events that took place over the past six decades. However, for our purposes, our view is that these are either most analogous to what might unfold should conflict occur between the US and North Korea or at least give a flavor as to how markets have typically reacted when faced with periods of heightened uncertainty.

Key Takeaway: The lead-up is often worse than the event

Our work suggests that the actual onset of conflict generally marks the beginning of the end in terms of poor performance by stocks. That is, the lead-up has often been far worse than what took place when the bombs started to fall. Furthermore, gold has consistently provided a worthy hedge to growing tensions, although we note that this is somewhat skewed by one outlier.

Exhibit 1: Markets are generally hit ahead of the event

Drawdown of the S&P/TSX and S&P 500 in the lead-up to various geopolitical events vs. the performance of gold

Event	Dates	S&P/TSX	S&P 500	Gold
Cuban Missile Crisis	10/16/62 to 10/28/62	-18%	-9%	N/A
6-Day War	6/5/67 to 6/10/67	-4%	-7%	N/A
Tet Offensive	1/30/68 to 9/23/68	-12%	-5%	N/A
Yom Kippur War	10/6/73 to 10/26/73	-11%	-8%	76%
Gulf War 1	1/16/91 to 2/28/91	-11%	-18%	8%
9/11*	09/11/2001	-8%	-9%	8%
Gulf War 2	3/20/03 to 5/1/03	6%	-13%	9%
Average		*-8%*	*-10%*	*25%*

Source: Haver Analytics; Bloomberg; Trend & Cycle; RBC CM Canadian Equity Strategy. *Performance for 9/11 is measured over the ensuing 30 days

Compare the above to the performance during the actual conflict, which has been positive in several instances, with both the TSX and S&P actually generating positive averages despite ongoing tensions.

Exhibit 2: The “during” is often muted

Performance of the S&P/TSX, the S&P 500, and gold during various geopolitical events

Event	Dates	S&P/TSX	S&P 500	Gold
Cuban Missile Crisis	10/16/62 to 10/28/62	8%	-2%	NA
6-Day War	6/5/67 to 6/10/67	3%	4%	NA
Tet Offensive	1/30/68 to 9/23/68	15%	10%	NA
Yom Kippur War	10/6/73 to 10/26/73	-11%	1%	-3%
Gulf War 1	1/16/91 to 2/28/91	-2%	4%	-5%
9/11	09/11/2001	-8%	-9%	6%
Gulf War 2	3/20/03 to 5/1/03	1%	5%	3%
Average		*1%*	*2%*	*0%*

Source: Haver Analytics; Bloomberg; Trend & Cycle; RBC CM Canadian Equity Strategy.

In closing, we note that the resolutions of the above crises were in some cases followed by prolonged bull markets (the Cuban Missile Crisis, Gulf War 1, and Gulf War 2) and in some cases helped to contribute to ongoing bear markets (Yom Kippur War, 9/11).

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