Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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What Increased Geopolitical Tension Means for Stocks

Many readers are likely concerned about recent escalations between the United States and Iran. Geopolitical tensions and even war are, unfortunately, inevitable over time. An investor's job is to constantly assess and re-assess how each conflict may ultimately affect the global economy – or whether it will disrupt growth at all. In times when politics and geopolitics create 'crisis-like' narratives, I believe it is critical to tune out the noise redouble your focus on fundamentals.

A good place to start is by examining history in search of parallels and insights – knowing the past can often provide valuable information for how to view the present. Though the current situation appears to have de-escalated for now, ongoing tensions with Iran may feel dire and worrisome to many. But it's important to remember that the United States has been through much worse, and the economy and capital markets have a long track record of overcoming adversity.

Let's start with stocks. In the table below, I've laid out some provocations (and worse) throughout history that I think bear some resemblance to the current situation. I've also included stock returns in the year that the event occurred.

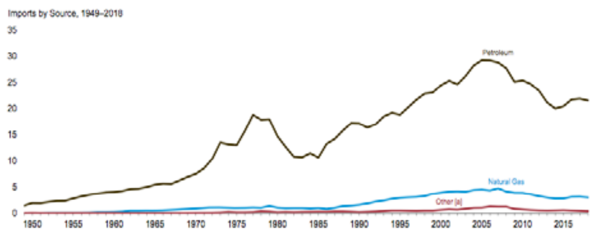
Year	Event	S&P 500 Return:
1950	Korean War	+30.81%
1953	Russia Explodes H-Bomb	-1.21%
1961	Building of Berlin Wall	+26.64%
1966	Escalations of Vietnam War	-9.97%
1990	Iraq Invades Kuwait	-3.06%
2001	September 11	-11.85%
2003	U.S. Invasion of Iraq	+28.36%

Source: Annual Returns on Stock, T.Bonds and T.Bills 1928-Current[1]

As you can see, there are some very significant, consequential events listed here. Market returns are mixed. In some cases, the declines were relatively modest, and in other cases, the upside was big. I believe the takeaway here is that geopolitical pressures and even war do not automatically imply weak markets. If the geopolitical situation gets bad, the Federal Reserve is tightening monetary policy (raising interest rates) to fight rising inflation, and oil prices are shooting higher, then maybe you get an outcome like 1990. Today, inflation is low, interest rates are low, the Fed is taking a neutralto-dovish stance while expanding their balance sheet, and GDP growth is expected to notch 2%.

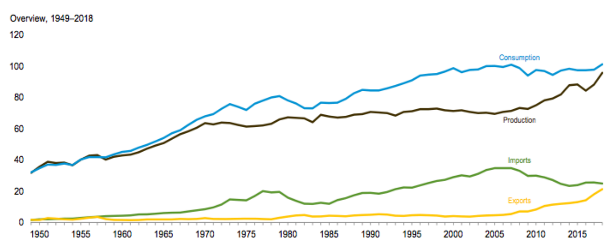
Geopolitics matter, but economic fundamentals matter more, in my view.

What about oil markets? When Iraq invaded Kuwait in 1990, oil was a key factor and rising crude prices put pressure on an already weak U.S. economy. But it is important to remember that in 1990, the U.S. was a major oil importer, and we were not a dominant energy producer on the global stage. Today, we are the world's largest oil producer and our reliance on imports has been in decline for years:



Source: Energy Information Administration[2]

Another key feature of the current energy market in the U.S. is that technological advancement and new efficiencies have allowed our energy consumption to remain relatively flat over the past decade. Fewer imports, more production, and level consumption mean less reliance on foreign oil.



Source: Energy Information Administration[3]

If Iran decides to disrupt oil markets perhaps by blocking shipping lanes in the Strait of Hormuz, for instance, I would argue the effects on the U.S. economy would be negligible. During the period of 'sustained high oil prices' in the chart below, the equity market did just fine and the economy continued to expand. Should oil prices go higher from here as tensions with Iran continue, I do not think we will see a material impact on growth fundamentals.

Source: Federal Reserve Bank of St. Louis[4]

Bottom Line for Investors

Other potential scenarios to consider are that further escalation – or war – could lead to more government spending, which may actually boost overall growth, in my view. Or perhaps increased risk aversion leads to more bond buying, putting downward pressure on yields. Again, outcomes are highly unpredictable.

In my opinion, the overarching point here is that while there are myriad potential outcomes, investors should consider the possibility – or even the probability – that geopolitics, economics, and markets often move in different lanes. While the geopolitical situation worsens, the economy can still grow and markets can still thrive. It's an investor's job to continually take the good with the bad, and to weigh the impact of a geopolitical dust-up versus the impact of macroeconomic forces. The latter, in my view, is almost always more important.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Federal Reserve database in St. Louis (FRED), January 5, 2019. http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

[2] U. S. Energy Information Administration / Monthly Energy Review December 2019 https://www.eia.gov/totalenergy/data/monthly/pdf/sec1_2.pdf

[3] U. S. Energy Information Administration / Monthly Energy Review December 2019 https://www.eia.gov/totalenergy/data/monthly/pdf/sec1_2.pdf

[4] U.S. Energy Information Administration, Crude Oil Prices: Brent - Europe [DCOILBRENTEU], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DCOILBRENTE, January 7, 2020.

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- How could tensions between the U.S. and Iran impact the markets?
- Will the conflict impact oil prices?
- The top two cocoa producers in the world join forces
- What of the state of trade between the U.S. and China

U.S. – Iran Geopolitical Pressure Builds, Then Subsides

Tensions were high this week as the U.S. and Iran engaged in tit-for-tat military provocations, with many fearing the crisis could spiral into war. By week's end, the pressure had subsided, but the situation remains on high alert as outcomes in geopolitics – particularly ones that involve Iran – tend to be unpredictable, in our view. For their part, the equity markets largely shrugged off the escalation and continued ticking higher even as bombs were falling.[1] Throughout history, geopolitical pressures and war are (unfortunately) common occurrences, but, in our view, they do not automatically imply weak markets. In our view, a geopolitical event is rarely influential enough to end a bull market or economic expansion on its own. Other factors like weak growth, rising interest rates, falling earnings, low liquidity, and/or asset bubbles (euphoria) must be present as well.

Oil Prices Ticked Higher, But It May Not Matter

Oil prices ticked higher at the first sign of conflict, though not significantly. Some investors were concerned about comparisons to 1990, when Iraq invaded Kuwait and oil prices shot higher, triggering a recession. In 1990, the U.S. was a major oil importer, and we were not a dominant energy producer on the global stage. Today, we are the world's largest oil producer, and our reliance on imports has been in decline for years. Though Iran has the capability of disrupting oil markets, the impact of doing so may not be as significant as many believe. Oil prices are already up 20% from early October, which corresponded with a strong performance period for the S&P 500. What's more, when oil prices were sustained above $100 a barrel in the first half of the last decade, stocks managed to continue climbing higher.[2]

The OPEC of Chocolate?

The top two cocoa producers in the world – Ivory Coast and Ghana – are banding together to form a 'coalition of cocoa,' where they can wield more control over the world's cocoa prices. The two countries combined account for nearly two-thirds of global cocoa production, which in 2018 generated $107.3 billion in sales. Cocoa farmers in both countries often live at or below the poverty line, so the hope is that putting a premium on cocoa prices can enhance their standard of living. The partnership, which may be dubbed "COPEC," is set to go into effect this October, with an expected $400 per metric ton price increase (+18%) scheduled.[3] Consumers might reasonably expect that by Christmas this year, the chocolate stocking stuffers and the chips for Santa's cookies may end up costing a little more.

The State of Trade

New tariffs aimed at Chinese imports that landed in Q4 caused a slide in U.S. imports in November, but we also saw imports increase in exports in the same month. The end result was an objective that the Trump Administration has long sought – pushing the trade deficit to its lowest level since

October 2016. The tariffs on consumer goods like footwear and electronics spurred the decline in imports, but because of the "Phase 1" trade deal reached at the end of the year, $120 billion of Chinese imports are about to see tariffs cut in half – from 15% to 7.5%.[4] Many expect this tariff cut to result in positive contribution to U.S. GDP going forward, where it was a drag in the back half of 2019.

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[1] The Wall Street Journal, January 9, 2019. https://www.wsj.com/articles/irans-supreme-leader-issues-more-threats-at-u-s-after-missile-attack-11578480435?mod=hp_lead_pos1

[2] The Wall Street Journal, January 6, 2020. https://www.wsj.com/articles/oil-extends-climb-on-threat-of-iraq-sanctions-11578316490

[3] The Wall Street Journal, January 5, 2020. https://www.wsj.com/articles/new-cocoa-cartel-could-overhaul-global-chocolate-industry-11578261601?mod=djem10point

[4] The Wall Street Journal, January 7, 2019. https://www.wsj.com/articles/u-s-trade-gap-narrowed-8-2-in-november-11578403976

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