FROM CONFLICT TO CALM

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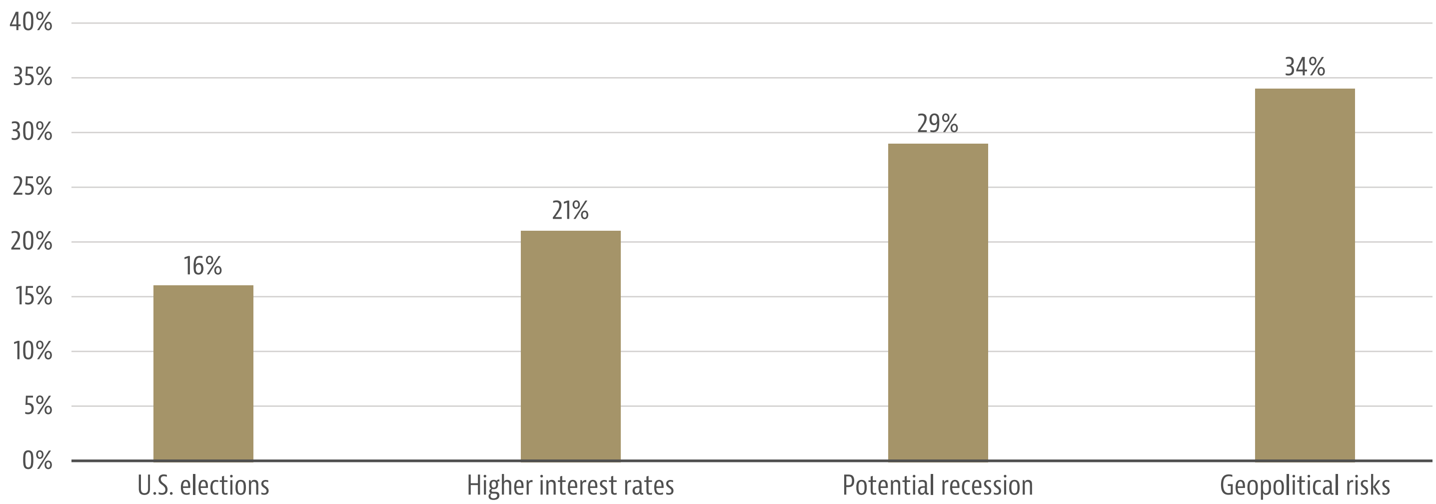
The Stock Market's Surprising Resilience During Wars

"I am overwhelmed by the possible risks in the world today," said one of my clients as we reviewed market events. It's a statement that reflects the concern many investors feel. While there are numerous investment concerns, geopolitics seems to top the list. It's easy to get frightened by the negative ramifications and possible escalation of the ongoing wars in Ukraine/Russia and Israel/Gaza. But it's critical to remember that wars have unfortunately been all too common in the last 80 years since World War II, yet investors have still enjoyed strong equity returns.

WHAT POTENTIAL INVESTMENT RISK ARE INVESTORS MOST WORRIED ABOUT IN 2024?



Source: J.P. Morgan Private Bank. Data as of December 31, 2023.

Investors often consider a multitude of short-term factors while making investment decisions, including economic indicators, corporate performance, valuations, and geopolitical events. Geopolitics such as wars/conflicts could be significant disruptors as the outcomes are hard to predict. However, contrary to popular belief, historical data reveals that the relationship between wars and stock market returns is largely uncorrelated, and this article aims to help demystify this complex relationship.

Wars affect global economies, as we live in a highly integrated world. Supply chains get disrupted, commodity prices increase, and inflation levels are affected everywhere. Central banks worldwide must factor this into their models while making policy decisions. For example, commodity prices have been driven higher due to the war in Ukraine, as the world isn't using Russian oil and natural gas freely. Geopolitics complicates matters for the Bank of Canada as it tries to cut rates to support economic growth while also trying to combat inflation.

In today's ongoing wars, major powers are largely staying out of any direct conflict. It is very unlikely that these wars escalate to a point where they will turn into a global affair. While investors should not ignore geopolitics, history shows that geopolitical events do not have lasting effects on a globally diversified portfolio of stocks and bonds.

Global economics and investment returns in most major economies have been very strong despite periods of active war. However, the negative ramifications on regional markets and specific subsectors can often be substantial.

In the table below, we use the U.S. stock market benchmark, the S&P 500, as a proxy for global markets, as over 40% of revenues generated by the S&P 500 are from outside the U.S.. While the short-term implications are more mixed, the table confirms that 12 months after the geopolitical event started, 75% of the time the S&P 500 has posted positive returns. The average return has been over 8%. For more extended periods, like 3 and 5 years, there is a 92% probability of a positive return with an average gain of ~34% and 61%!

GEO-POLITICAL EVENTS AND S&P 500

Date	Geopolitical/military events	1 month later	3 months later	6 months later	12 months later	3 years later	5 years later
12/07/1941	Pearl Harbor	-3.40%	-12.70%	-9.10%	0.40%	44.82%	63.88%
10/31/1956	Suez Canal Crisis	-2.80%	-3.80%	-0.10%	-11.50%	26.20%	50.11%
10/20/1962	Cuban Missile Crisis	8.70%	17.70%	25.10%	32.00%	66.99%	73.64%
10/17/1973	Arab Oil Embargo	-7.00%	-13.20%	-14.40%	-36.20%	-7.73%	-6.69%
11/03/1979	Iranian Hostage Crisis	4.20%	11.60%	3.80%	24.30%	40.43%	64.43%
12/25/1979	USSR in Afghansitan	5.60%	-7.90%	6.90%	25.70%	31.91%	54.72%
08/03/1990	Iraq Invades Kuwait	-8.20%	-13.50%	-2.10%	10.10%	30.28%	62.04%
01/17/1991	Gulf War	15.20%	23.50%	20.60%	33.10%	44.31%	85.52%
08/17/1991	Gorbachev Coup	0.00%	3.00%	7.00%	8.90%	23.56%	76.70%
02/26/1993	World Trade Center Bombing	1.20%	2.50%	4.00%	6.40%	46.70%	135.22%
09/11/2001	9/11	-0.20%	2.50%	6.70%	-18.40%	8.38%	25.52%
03/20/2003	Iraq War	2.20%	15.60%	17.40%	28.40%	49.04%	48.28%
Average		**1.30%**	**2.10%**	**5.50%**	**8.60%**	**33.73%**	**61.11%**
% position		**50%**	**58%**	**67%**	**75%**	**92%**	**92%**

Source: Truist and Yahoo Finance**

For more recent data points, since Russia invaded Ukraine on February 24th, 2022, the S&P 500 has returned 8.7% annualized (16.87% cumulative). Since the start of the Israel/Gaza war on October 7th, 2023, the S&P 500 has returned 23.1%, which supports the fact that fundamental earnings and economic factors (and valuation expansion) are driving markets, not wars.

Moreover, a study by Mark Armbruster, published in the Financial Analysts Journal*, examined stock returns during wartime and peacetime from 1926 to 2003. The research revealed that the stock market has generated returns above historical averages and with less risk during periods of war, reinforcing the notion that wars and stock market performance are largely uncorrelated.

So, what contributes to the stock market's resilience, and how can we protect portfolios during periods of conflict?

*Mark Ambruster Study: https://www.armbrustercapital.com/stock-markets-at-war/
**Data is as of June 25, 2024.

1. **Economic Fundamentals:** Economic growth, corporate earnings, and interest rates are the primary drivers of stock market performance over long periods. Even during wars, these fundamental factors continue to play a critical role. For instance, technological advancements and increased production during World War II boosted economic growth, positively impacting the market.

2. **Governments and Companies Adapt** to wartime conditions, finding ways to sustain and grow:

   a. **Government Interventions:** Governments and central banks frequently implement policies to stabilize economies during conflicts. These interventions, such as fiscal stimulus and monetary easing, can cushion the stock market, fostering faster recovery and growth with positive long-term implications.

   b. **Market Anticipation and Adaptation:** While companies' management teams have a tough time predicting the outcomes of war, they anticipate geopolitical events to the best of their abilities and adjust their operations accordingly. This forward-looking nature helps in absorbing shocks.

3. **Regional Impact:** The S&P 500 is a globally diversified set of companies with little exposure to war-torn areas. Therefore, there is generally little impact on a global scale. However, if an investor was exposed only to those regional investments, they would likely see larger negative ramifications on their investment portfolio.

4. **Diversification:** Diversified portfolios tend to better weather geopolitical storms. Diversification is most effective when implemented geographically and by sector. While certain sectors may suffer during conflicts, others, such as defense, technology, and energy, often benefit, proving to be a ballast to portfolios. This diversification helps mitigate the overall impact on the stock market and portfolios.

WHAT SHOULD INVESTORS DO?

During times of war, it feels like risks are rising and sources of positivity and hope are declining. They undoubtedly influence investor sentiment and can induce market volatility. However, investors should remember that their long-term impact on investment returns is typically limited. Investors should consider the steps outlined below to get through these dynamic markets:

- **Stay Informed but Calm:** While staying abreast about geopolitical events is important, it is equally crucial to remain calm and avoid making impulsive investment decisions based on short-term market movements or emotions. Taking hasty actions like liquidating portfolios due to fear of escalation of war can permanently impair long-term returns. Time in the markets is typically much more beneficial to generating strong long-term returns than trying to time the market.

- **Focus on Fundamentals:** The single most important factor of long-term returns is investment fundamentals. Investing in companies with strong economic fundamentals, robust earnings, business moats, and sustainable growth prospects is a great way to protect portfolios, as these companies are more likely to withstand geopolitical shocks and deliver good long-term performance.

- **Invest in a Well-Diversified Portfolio:** Ensure that you are always invested in a well-diversified portfolio, as a lack of concentration in any one region, asset class, or sector can help mitigate risks.

- **Focus on the Long-Term:** Financial plans are built for the long term and account for your cash flow needs and market volatility. Ensuring that your financial plans are current and meet your long-term financial objectives is a great defense mechanism to overcome short-term market volatility.

- **Seek Professional Guidance:** Navigating market uncertainties can be challenging. Seeking guidance from a financial advisor or investment counsellor can help, as they can provide personalized advice tailored to your financial goals and risk tolerance. They can help you develop a comprehensive investment strategy that aligns with your objectives, ensure you are not taking excessive risk, and provide a well-diversified portfolio to help you stay on track during turbulent times.

Geopolitical events will always be a source of concern, but despite potential disruptions, historical data and economic fundamentals demonstrate that stock market performance remains largely uncorrelated with such conflicts. Investors can manage these fears by investing in portfolios that are diversified by sector, asset class, and geography; working with a trusted advisor, focusing on the long term, and keeping financial plans current.

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