White Paper
Multi-Asset Solutions

March 2024

How to Position for Geopolitical Shocks in 2024

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Executive Summary

Multiple wars and an unprecedented number of global elections should imply a higher geopolitical risk premium in 2024. Most risk assets, however, seem to be pricing in a benign macroeconomic environment. We examine the most appropriate and easily implementable portfolio strategies for investors who believe that these calm market conditions inadequately reflect the balance of risks.

What Risks are We Thinking About?

To identify the right strategies, we need to first specify the prevailing geopolitical risks. We believe they can be grouped into two categories:

Global Supply Shock Scenario

A material supply shock would be similar to the 2022 development when the Russia-Ukraine war triggered a stagflationary shock by upending global energy and food supply. The most likely candidate scenarios are again linked to energy disruption and therefore found in the Middle East. Currently, the most compelling threat would arise from a flare-up in the conflict between Israel and Hezbollah on the Lebanese-Israeli border. A full-blown war could draw in Iran and the United States, with a sizable chance of disruptions to Gulf shipping (leading to reduced maritime oil shipping), or even to actual oil production if Iran or its proxies were to disrupt production in the region.

Regional Crisis Scenarios with Risk-off Spillover

Regional crisis scenarios are events where actual supply disruption is avoided, but markets become skittish and quickly reprice downside risks of such a disruption. The consequence would be a large rotation of capital out of risk assets into safe assets. There are multiple plausible scenarios that could set off such a dynamic.

In Asia, for instance, it is conceivable that North Korea induces a crisis that exceeds previous stress episodes. Less likely, one could imagine tensions in the Taiwan Straits breaking with precedent, threatening trade or production in semiconductors. Outside of Asia and the Middle East, a confluence of simultaneous crises in less economically central regions (e.g., Venezuela-Guyana and other smaller oil producers) could engender a similar effect.

Odds of these happening are higher given the backdrop of the US election, which raises the incentives of global actors to time initiatives in 2024. Here the macroeconomic transmission would matter less — as there would not actually be a material supply disruption. Rather, it would be financial market dynamics that would sharply reprice risk premia upwards across the board, with currencies moving first and to the strongest extent.

Such big price moves would then set off some knock-on effects that would concentrate in certain markets, both across the globe, or in risk pockets within larger developed markets. The magnitude of any financial ripples could be great, especially given that some risk scenarios could directly affect valuations of the "Magnificent Seven" stocks, due to their reliance on hardware supply chain from regions such as Taiwan (notably NVIDIA, Apple, and Amazon).

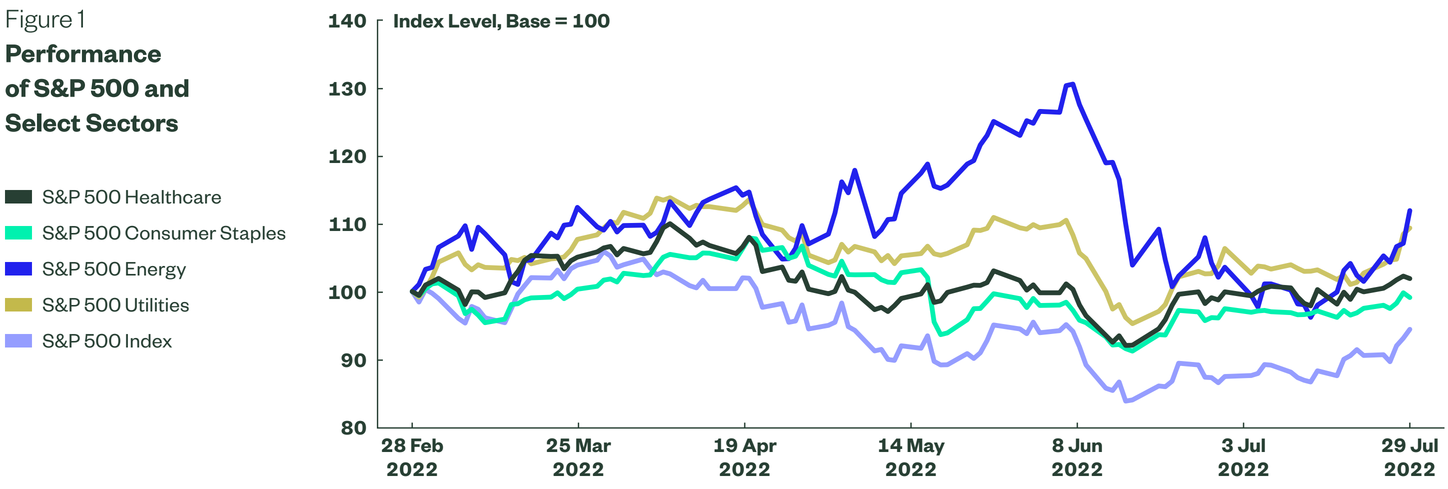
Suitable Portfolio Strategies Given the Context

The choice of tools to put in place in the context of the above scenarios varies in complexity. At the simpler end of the spectrum, overweighting currencies and related assets and sub-asset classes is the easiest way to implement. In the foreign exchange (FX) market, the classic safe-haven currencies led by the US dollar, Japanese yen, and the Swiss franc tend to outperform in periods of stress. The associated government bonds may not rise in the same way though — a stagflationary impulse tends to raise long-term rates, which means the nature of the crisis matters for bonds.

The same principle applies to gold. Gold works well as a geopolitical hedge as long as real rates do not rise. Within equities, classic defensive sectors do better, such as healthcare, consumer staples, and utilities. And of course, if the geopolitical shock is energy related, then the energy sector could outperform, too.

The late February 2022 macroeconomic shock had largely been worked through by financial markets by the summer, after Russia's cessation of gas supplies was confirmed. During those five months, the S&P 500 lost 5.6%, while energy, utilities, and healthcare gained 12%, 9.4%, and 2%, respectively (Figure 1). The US Dollar Index gained roughly 10%, too.

Figure 1
Performance of S&P 500 and Select Sectors



Source: Bloomberg Finance L.P., as of March 5, 2024. **Past performance is not a reliable indicator of future performance.**

Implementation Guide

1 **Long Commodities or Energy** Our base case view is a gradual increase in energy prices toward year-end due to recovering energy demand. However, any commodity shock could deliver a rapid price spike. There are plenty of other scenarios as well where commodities are less effective and there is demand destruction even. We, therefore, believe that going long commodity volatility may offer a better proxy exposure.

2 **Long Gold** In addition to a separate view on commodities, a singular exposure to gold can potentially help navigate macroeconomic risks. Historically, on average, in high volatility periods when the VIX Index rises, gold prices have outperformed other traditional risk mitigators such as bonds, Treasury bills, and defensive equities.

3 **Relative Value Defensive Equity Sectors** If macroeconomic risks arise and sector behavior reacts similarly as it did during past events, then focusing on defensive sectors while seeking to neutralize market beta can potentially be additive. As a result, a relative value macroeconomic sector position could be entered by going long defensive sectors (utilities, healthcare, and consumer staples) while shorting the broader overall market in either a dollar- or beta-neutral basis.

Ideas Involving Derivatives

For investors with access to more complex hedging tools, derivatives could prove to be compelling this year. Given the certain date of the US election, markets have a defined period to time options contracts. For example, the current VIX futures curve peaks in November and then subsides, and similar trends might be visible in other markets, too. Below are our views on derivatives strategies that reflect the distribution of risks:

1 **Vulnerable FX** The flipside of safe-haven flows is outflows from negatively affected currencies. The most attractive is EUR/USD among large US dollar currency pairs that are beta-positive to the global economy, given that Europe is centrally exposed to most risks. The euro options market also currently exhibits historically low levels of implied volatility and the forward curve remains favorable.

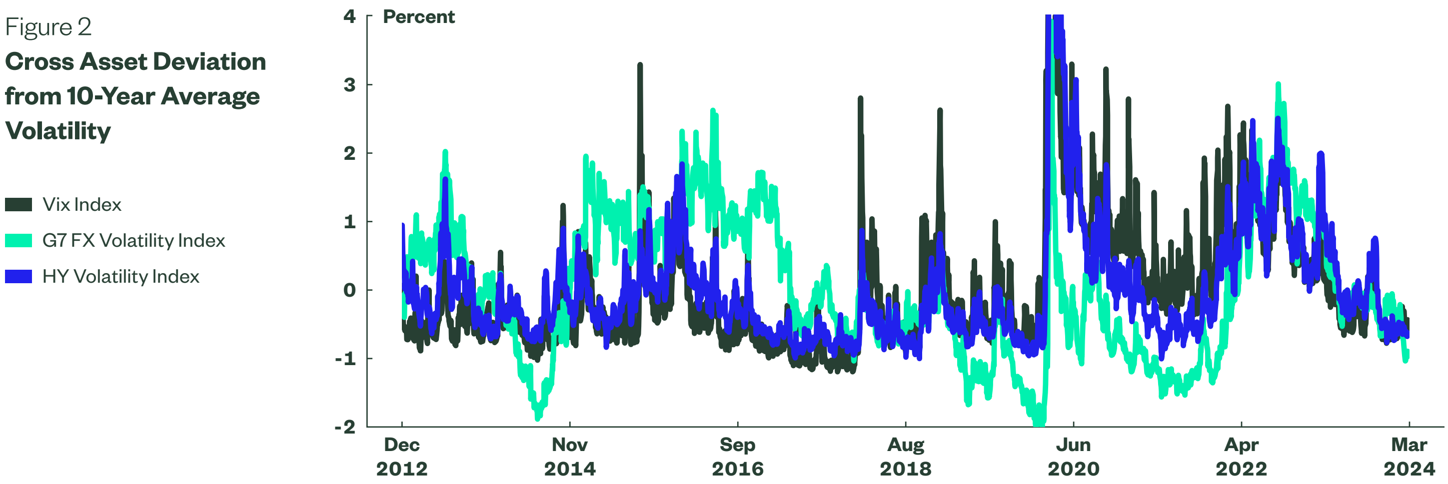
2 **Sovereign and Corporate Credit Default Swaps (CDS)** Sovereign CDS are relevant for geopolitically vulnerable countries, particularly those near conflict zones; large energy importers; or economies with a large beta to global economic growth. In the absence of a defined central risk scenario, the generic widening of risk premia is well captured here.

As far as corporate bonds are concerned, credit spreads tightened across both investment grade and high yield (HY) during 2023, bringing both to the low end of their historical ranges. Within HY specifically, a strong preference for quality has driven higher-rated debt spreads (BB and B) near 20-year tights, while lower-rated CCC spreads hover slightly below their 20-year average. The combination of BB and B spreads hovering at historic levels of tightness and the increased beta in CCC debt leaves HY spreads particularly vulnerable in a risk-off event.

3 **Volatility** We are near historically low levels of implied volatility in most asset classes, which could mean current calm market conditions could reset at a higher floor. Past experience also suggests that volatility moves sharply, not incrementally, in the event of a regime change (Figure 2).

Figure 2

Cross Asset Deviation from 10-Year Average Volatility

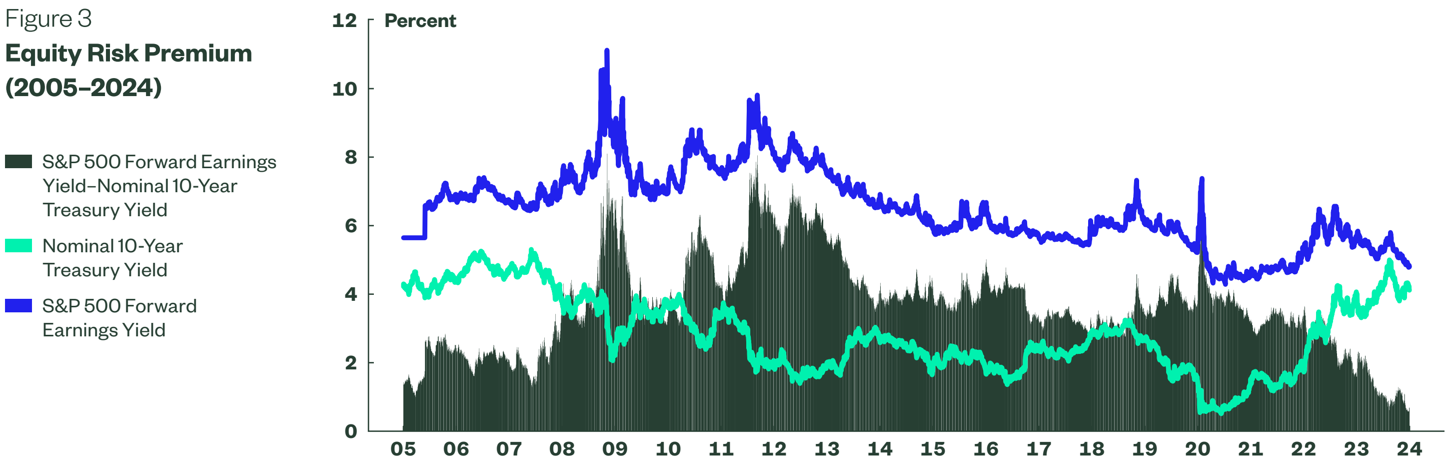


Source: Bloomberg Finance L.P., as of March 8, 2024. **Past performance is not a reliable indicator of future performance.**

4 **Considering "Renting" Versus "Owning" Equities** While we have a favorable base case for equities, valuations look stretched not only in isolation but also from a cross asset perspective. Equity risk premium, measured across several metrics, is roughly two standard deviations tighter than its 20-year average (Figure 3). Additionally, the next twelve-month price-to-earnings (P/E) ratio for the S&P 500 is about 21, which is both near the top end of its range and above its average since 2000. Given that equities are near all-time highs, valuation is rich, implied volatility is low, and geopolitical risks are elevated, one idea would be to "rent" and not "own" equities and substitute cash equities with long call structures given attractive pricing across developed markets (S&P 500, EURO STOXX 50, and Nikkei 225).

Figure 3

Equity Risk Premium (2005–2024)



Source: Bloomberg Finance L.P., as of March 8, 2024. **Past performance is not a reliable indicator of future performance.**

The Long and the Short of it

As 2024 unfolds, there are several global and regional risk scenarios that may throw cold water over the benign macroeconomic environment that markets seem to have priced in for the year. History also suggests that benign market conditions frequently experience sudden market regime shifts. Given this context, the spectrum of strategies, ranging from the simple to the complex, that we have illustrated above should provide a healthy choice for investors in the event of a risk-off environment.

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* Pensions & Investments Research Center, as of December 31, 2022.
† This figure is presented as of December 31, 2023 and includes approximately $64.44 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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ID2064092-6471612.1.1.GBL.INST 0324
Exp. Date: 03/31/2025