STATE STREET GLOBAL ADVISORS

2019
Global Market Outlook

Not Over
Until It's Over

Geopolitical Outlook

Geopolitics Drives Uncertainty and Downside Risk

The trend toward monetary tightening should continue and further unilateral sovereign actions promise more surprises.

Elliot Hentov, PhD
Head of Policy and Research

After years of indifference, in 2018, markets responded strongly to geopolitical events. Two simultaneous developments drove the change.

First, global central banks (led by the Federal Reserve) reversed years of monetary easing after peak liquidity in 2016–2017. While the pace remains unclear, the trend toward further tightening should characterize 2019 and may make markets more sensitive as liquidity declines further.

Second, geopolitical risk has increased as the world order continues to undergo a transformation. International organizations, treaties and laws have gradually begun to cede influence to the unilateral actions of major countries, based on raw political power. The lack of transparency around these unilateral decisions by executive administrations is likely to lead to regular market surprises. Volatile price moves are the natural consequence but may present opportunities, as well as risks, for investors.

US Policy Impact

In both instances, these developments are led by the United States. While the US has been the main source of monetary and geopolitical volatility, US markets have been the beneficiary relative to the rest of the world. We believe this pattern will continue throughout most of 2019.

Trump's "America First" has upset the status quo on issues where a strong domestic constituency is lacking. As a result, there have been a number of geopolitical triggers in 2018 that could have further implications for investors in 2019. In Figure 1, we highlight several examples of geopolitical price action based on US policy moves.

Figure 1
Market Impact of US Policy

Geopolitical Trigger	Market Effect
US-China Trade Tensions	Renminbi depreciation > 10%
US Withdrawal from Iran Deal	Crude oil prices rose >12%
US-North Korean Summit	Korean won appreciation >3%
US-Turkish Rift	Exacerbated currency crisis, with Turkish lira depreciating near 40% and Turkish rates jumping from 8% to 24%
US imposes further sanctions on Russia	Russian rouble decouples from oil prices

Source: State Street Global Advisors Research, 2018.

These moves are likely to have secondary and tertiary effects, for example, on companies within complex supply chains or those with specific regional exposures that may have to alter their business models or absorb additional costs.

Hotspots for 2019

Other areas of the world are also likely to be affected by geopolitics in 2019. In the map below, we pinpoint the hotspots for geopolitical activity that could have an impact on markets in 2019.

High

Moderate

Low

Washington DC

Global trade and security risks

Damascus

Baghdad

Civil war and Kurdish secession

Moscow

Russian cyber, political and military interventions abroad

Beijing

US trade hostility and Belt & Road initiative

Caracas

Economic meltdown

London

Brussels

Rome

Brexit impasse & EU budget negotiations

Tehran

Coping with US sanctions

Pyongyang

Declining risk of conflict

Source: State Street Global Advisors as of October 2018.

At the global level, we expect the US–China dispute to continue as there is presently no obvious exit strategy for either country. Equally, Russian interventions in conflicts and external elections continue, and reciprocal sanctions are unlikely to ease.

In the Middle East, the confrontation with Iran is likely to loom large, with proxy theaters in Yemen and Syria. In a worst-case scenario, we could see provocations in international waters or inside Gulf countries—all of which could have an impact on oil prices.

Venezuela, too, is likely to continue to be a factor in commodity markets. It appears to have passed a point of no return from an economic perspective, triggering the largest refugee crisis in Latin America, and having spillover effects on Colombia. Further escalation of this situation could invite intervention from external actors, such as the US.

With regard to Korea, we expect the détente to last until 2020, assuming that there are no inflammatory moves by either side.

Finally, the European Union is strained on three levels:

1. **Brexit.** The need for the EU to maintain unity and strength as a trade/regulatory bloc while ensuring the UK meets its outstanding liabilities.

2. **Italy.** Ensuring the credibility of monetary union (the trajectory is either repeated bouts of economic crises or erosion of monetary orthodoxy).

3. **Poland/Hungary/Romania.** Facing down challenges to the legal and political order, with a sharp reversal of country fortunes possible with the renegotiation of the EU budget cycle.

Any resolution of these geopolitical themes could trigger re-ratings in the markets they affect and should be monitored over the coming months.

Key Milestones in 2019

Date	Event	What to Watch
January / February	US trade: China tariffs and automobile imports	Does the US impose a 25% tariff on a wide swath of Chinese imports on January 1? What is the result of the Section 232 investigation into auto imports, due on February 17?
February 16	Nigerian presidential elections	Stability and outlook in the largest African nation and OPEC member.
March 29	Brexit—UK leaves EU	Nature and duration of transition period; tail risk of UK hard Brexit.
May 9	EU agrees new 7-year budget (2021–2027)	Levels of economic transfers granted to Poland and Hungary; measures of support for struggling southern European states.
May 23	EU Parliamentary elections	Performance of populist parties; constellation of majority bloc in EU Parliament; ripple effect on national politics in Germany, Italy and France.
May	Indian elections	Re-election of Modi or emergence of new national figure.
June 29	G20 Summit	Status of trade and geopolitical disputes among largest nations.
May–August	South African elections	Potential first loss of African National Congress majority.
October 27	Argentinian elections	Electoral test of economic liberals and new International Monetary Fund (IMF) regime.
October	Polish elections	Success of incumbent government and test of anti-EU sentiment.
November 1–December 1	New EU leaders of the European Central Bank (ECB), European Commission and Council	Political center of gravity in EU institutions; future of monetary policy and crisis-fighting ability of the ECB; relations among EU governments (especially North–South).

What to Do as an Investor

To understand how investors might factor geopolitics into their investment decisions, we studied how emerging markets have reacted to geopolitical events over the past 30 years.[1] We found clear patterns in currency and equity markets but no consistent outcomes in bond markets.

For currency markets, negative events led to an instant depreciation, on average of -0.64% within two trading days, whereas positive events barely registered a market reaction. To add context, we note that the long-term average monthly performance of the currencies in the study was -0.66%. So in the wake of a negative event, currencies undergo the majority of their expected monthly fall in just two days. After this initial shock, currency trading reverts to normal patterns, but does not necessarily reclaim the original loss over the subsequent 12 months. As Figure 2 shows, currency performance normalizes, but even one year later, positive events have led to a 2% outperformance relative to the historical average.

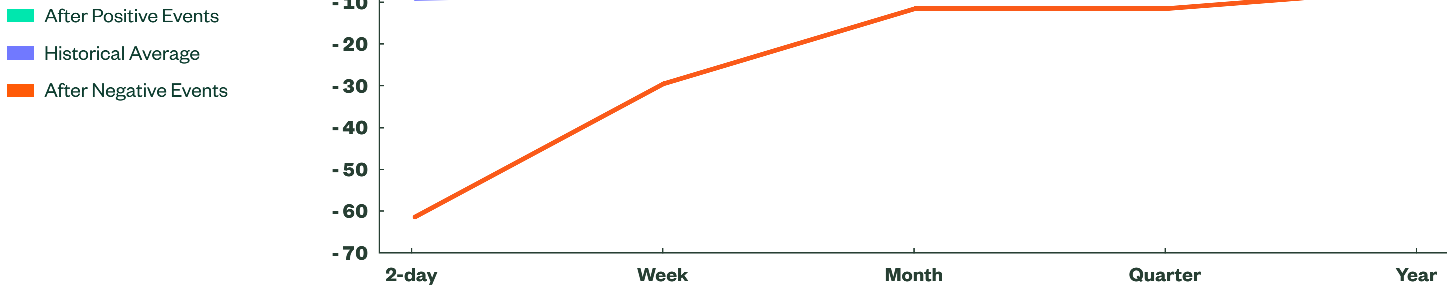

Figure 2
Annualized Currency Performance[2]

Source: State Street Global Advisors Research, 2018.

For equity markets, Figure 3 shows the effect of geopolitical events on returns for stocks within local MSCI indices. This chart illustrates the rolling monthly equity performance relative to historical averages. Instant reactions reflect the positive or negative nature of any event and are far more symmetrical than those in currency markets. Higher frequency data suggest that equity markets display a somewhat higher degree of anticipation for those events than currency markets. Weekly and monthly results are pronounced, both in absolute terms and in relation to historical returns. In other words, positive events lead to a consistent outperformance. For instance, one month after a negative event, equity indices tended to be, on average, 2.02% below their pre-event level.

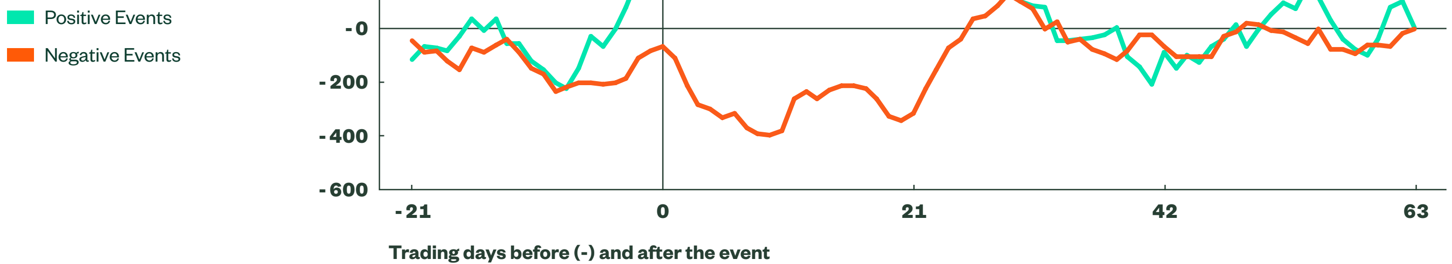

Figure 3
MSCI Local-Currency Monthly Rolling Returns, Basis Points[3] **Above/Below Historical Average**[4]

Source: State Street Global Advisors Research, 2018.

The three-month point after events is critical to understanding the length of the event impact. At this point, on average, indices return in nominal terms to pre-event levels. The gap between performance after negative and positive events collapses, and performance begins to mean-revert for both types of event. Therefore, the effects of geopolitical events typically seem to last somewhere between one and three months, but the differential performance during those initial weeks is not erased.

This historical performance suggests several investment actions during periods of heightened geopolitical risk:

1. **Consider currency hedges.** Since negative geopolitical events primarily transmit via currency, periods of higher risk could justify currency hedging, depending on the base currency. This can be abandoned once geopolitical tensions dissipate.

2. **Consider buying stocks on the dips.** Eventually, geopolitical crises settle into a new equilibrium and equity markets then tend to mean-revert to historical performance, albeit from a lower base. Similarly, although positive events are usually telegraphed in advance, investors can capture the tailwinds from the de-escalation of conflicts.

3. **Don't necessarily rely on bonds as proxies**. US Treasuries aside, resident and non-resident investors treat bonds differently when an event happens, due to different base currencies as well as differing perceptions about what constitutes a safe haven during periods of stress.

1 Petrov, Alexander; Hentov, Elliot; and Zumbo, Fabrizio. "How Does Geopolitics Affect Financial Markets?" September 2018.

2 Note: Averages across all positive and negative events where data is available, weighted equally across four markets; results annualized. Source: Bloomberg, State Street Global Advisors Research, 2018.

3 One basis point (bp) is equivalent to 0.01%.

4 Note: Averages across all positive and negative events where data is available, weighted equally across four markets; results annualized. Source: Bloomberg, State Street Global Advisors Research, 2018.

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Abu Dhabi
State Street Global Advisors Limited, Middle East Branch, 42801, 28, Al Khatem Tower, Abu Dhabi Global Market Square, Al Mayah Island, Abu Dhabi, United Arab Emirates. T: +971 2 245 9000

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State Street Global Advisors, Ltd., 770 Sherbrooke Street West, Suite 1200 Montreal, Quebec, H3A 1G1, T: +514 282 2400 and 30 Adelaide Street East Suite 500, Toronto, Ontario M5C 3G6. T: +647 775 5900

Dubai
State Street Global Advisors Limited, DIFC Branch, Central Park Towers, Suite 15 -38 (15th floor), P.O Box 26838, Dubai International Financial Centre (DIFC), Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority (DFSA). T: +971 (0)4-4372800

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Hong Kong
State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288

Japan
State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan, T: +81-3-4530-7380 Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association.

Ireland
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Switzerland
State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00

United Kingdom
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United States
State Street Global Advisors, 1 Iron Street, Boston, MA 02210 T: +617 786 3000

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