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ASSESSING GEOPOLITICAL RISK

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The United States' airstrike January 3, 2020, near Baghdad, Iraq, that killed a top Iranian military general was a major escalation in Mideast tensions. Iran's retaliatory strike January 8 sent a message, but additional responses can't be ruled out. We discuss what this conflict might mean for stocks and assess ongoing risks.

STOCKS AND GEOPOLITICS

These latest developments in the Middle East understandably have many investors on edge. As market strategists, we face the difficult task of separating the human toll from the economic and financial toll—never easy when lives are lost in times of geopolitical conflict.

For investors, the good news is the stock market has a long history of shrugging off significant and unsettling geopolitical events. As serious as this escalation and the prospect of war with Iran are, previous experiences

FIGURE 1. Geopolitical Events and Stock Market Reactions

Geopolitical Events And Stock Market Reactions

Market Shock Events	Event Date	S&P 500 Index		Calendar Days To	
		One-Day	Total Drawdown	Bottom	Recovery
Iranian General Killed In Airstrike	1/3/2020	-0.7%	?	?	?
Saudi Aramco Drone Strike	9/14/2019	-0.3%	-4.0%	19	41
North Korea Missile Crisis	7/28/2017	-0.1%	-1.5%	14	36
Bombing of Syria	4/7/2017	-0.1%	-1.2%	7	18
Boston Marathon Bombing	4/15/2013	-2.3%	-3.0%	4	15
London Subway Bombing	7/5/2005	0.9%	0.0%	1	4
Madrid Bombing	3/11/2004	-1.5%	-2.9%	14	20
U.S. Terrorist Attacks	9/11/2001	-4.9%	-11.6%	11	31
Iraq's Invasion of Kuwait	8/2/1990	-1.1%	-16.9%	71	189
Reagan Shooting	3/30/1981	-0.3%	-0.3%	1	2
Yom Kippur War	10/6/1973	0.3%	-0.6%	5	6
Munich Olympics	9/5/1972	-0.3%	-4.3%	42	57
Tet Offensive	1/30/1968	-0.5%	-6.0%	36	65
Six-Day War	6/5/1967	-1.5%	-1.5%	1	2
Gulf of Tonkin Incident	8/2/1964	-0.2%	-2.2%	25	41
Kennedy Assassination	11/22/1963	-2.8%	-2.8%	1	1
Cuban Missile Crisis	10/16/1962	-0.3%	-6.6%	8	18
Suez Crisis	10/29/1956	0.3%	-1.5%	3	4
Hungarian Uprising	10/23/1956	-0.2%	-0.8%	3	4
N. Korean Invades S. Korea	6/25/1950	-5.4%	-12.9%	23	82
Pearl Harbor Attack	12/7/1941	-3.8%	-19.8%	143	307
Average		-1.2%	-5.0%	22	47

Source: LPL Research, S&P Dow Jones Indices, CFRA, 01/06/20

All indexes are unmanaged and cannot be invested into directly.

Past performance is no guarantee of future results.

The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

have shown us these developments may not have much impact on U.S. economic fundamentals or corporate profits. That means any resulting stock market volatility may be fleeting, as was the case last week.

We've included a table that shows how stocks have performed after 20 significant geopolitical events dating back to World War II [Figure 1]. On average, stocks had fully recovered losses within 47 calendar days (less than seven weeks) after an average maximum loss of 5%, according to a study conducted by Sam Stovall at CFRA. The stock market's track record of recovering quickly from these events can be reassuring. Accordingly, we want to be careful not to overstate the potential impact of geopolitical events, no matter how unsettling they might be.

But we must keep in mind that geopolitical stability in the Middle East region unfortunately has always been temporary. We cannot dismiss the risk that this latest episode could escalate further into a broader conflict. Neither side wants all-out war, so we are hopeful for a lasting cease fire.

WHERE DO STOCKS GO FROM HERE

The S&P 500 Index has jumped more than 10% since the start of the fourth quarter of 2019, which means investors priced in a lot of good news late last year—a U.S.-China trade deal, stabilizing global growth, and the pause in Federal Reserve (Fed) rate hikes are at the top of the list. As a result, we think some potential 2020 gains were probably pulled forward into late 2019, perhaps limiting the upside for 2020. Regardless of how the Iran conflict plays out, we may see stocks get repriced over the next several months as investors wait for the economy and corporations to deliver against those loftier expectations that are accompanying higher stock prices.

To be clear, we are not calling for an immediate stock market correction. In fact, we still think stocks will move higher between now and the end of the year. Higher earnings could potentially push stocks well beyond our fair value target that we outlined in our [Outlook 2020](#) publication. In the meantime, the wait for the fundamental improvement that has been priced in could be accompanied by increased market volatility. We know bull markets historically have tended to include several pullbacks of 5–10% in a typical year, and we should be braced for that. Hopefully, stock market “repricing” will come more from growing corporate earnings than falling stock prices.

There are several geopolitical and economic risks to stocks to monitor besides those in the Middle East. Geopolitically, phase-two trade negotiations with China could stall, which may lead to re-escalation in U.S.-China tensions. North Korea remains a threat. Economic risks include a potential pickup in inflation that could trigger renewed fears of Fed rate hikes, as well as the possibility of deteriorating growth in Europe and Japan. Finally, domestic politics carry the potential to disrupt markets, including possible fallout from the impeachment process and policy uncertainty ahead of what most likely will be a highly charged U.S. election.

FOCUS ON FUNDAMENTALS

While heightened geopolitical uncertainty can be unsettling for investors, we will continue to focus on the fundamentals supporting gross domestic product, inflation, employment, interest rates, and corporate profits when making investment decisions. We would not be sellers of stocks into weakness related to the U.S.-Iran conflict, given stocks have weathered heightened geopolitical tensions in the past. Our focus on fundamentals served us well last year, and we believe it will again in 2020.

We do recognize that such strong stock market performance in late 2019 may have pulled forward some gains from 2020. While the strong market performance of 2019 may limit the magnitude of potential market advances in 2020, we still anticipate stock market gains this year. A Fed committed to keeping interest rates at current levels and progress on trade may improve prospects for business investment and productivity growth, and support growth of corporate profits. We believe this likely will be the key driver of stock market gains in 2020.

WEEKLY MARKET PERFORMANCE REPORT

Please see our new [Weekly Market Performance](#) report with insights on major asset classes.

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