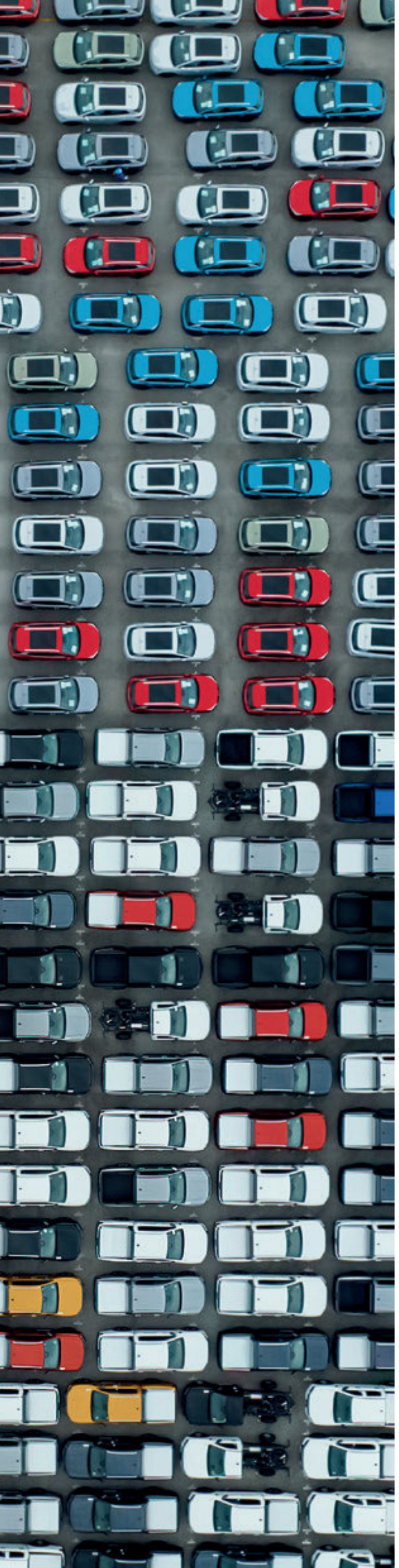
RATHBONES

PEACE OF MIND IN A DANGEROUS WORLD

You can't predict the future when investing, but you can prepare for it by thinking about geopolitical risks



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Written by
Oliver Jones
Head of asset allocation

FOREWORD

In introducing this report we want to both acknowledge that uncertainty is a real and genuine concern for our clients – especially when it comes to things like big geopolitical risks that are far removed and outside of our control – and offer what we hope will provide some genuine peace of mind when it comes to your investments.

Sadly, as recent events have shown us, the destruction of human life from geopolitical events can sometimes render the impact on financial markets trivial in comparison. But we still have a responsibility to consider the investment implications, prepare for and monitor them.

We know that these risks, and the great uncertainty that can stem from them, are one of the biggest financial concerns that keep our clients awake at night. And this report is an opportunity to shed what we hope will be some reassuring light on our approach to protecting your investments from these risks.

Ed Smith
Co-chief investment officer

Last year's escalation of the Ukraine war to a full-scale invasion was a reminder of how much difference hard-to-foresee geopolitical risks sometimes make to investors. The war was an important reason why even the most sophisticated forecasters grossly underestimated how much inflation would rise, how much equity markets would struggle and how bonds would suffer their worst year in decades.

This won't be the last geopolitical ruction to roil markets. It's important to be realistic about our ability to foresee such events – acknowledging the existence of what one-time US Secretary of Defence Donald Rumsfeld once called the 'unknown unknowns'. But that's no reason to bury our heads in the sand – there's still much we can do to prepare.

It's worth monitoring the biggest geopolitical risks on the horizon and then putting plans in place, should any of these risks turn into reality. We hope that having a framework for how we will identify, monitor and respond to these risks can give our clients some peace of mind about their investments.

This report sets out our systematic approach to doing just that, illustrated through what we think are four of the most significant threats.

Charting choppy waters: navigating geopolitical risks

We need to answer three questions:

- Which risks should we consider?
- How can we monitor whether these risks are about to occur?
- How should we respond if they do happen?

Our framework is therefore split into three parts: identifying, monitoring and planning responses to major geopolitical risks.

IT'S WORTH MONITORING THE BIGGEST GEOPOLITICAL RISKS ON THE HORIZON AND THEN PUTTING PLANS IN PLACE, SHOULD ANY OF THESE RISKS TURN INTO REALITY.

IDENTIFYING THE MOST RELEVANT RISKS

It's not possible to monitor every conceivable geopolitical risk, so as investors we need a way of pinpointing the most important ones. As a starting point, we've used the Preventive Priorities Survey, published annually by the Council on Foreign Relations, a US international relations think tank. The survey asks hundreds of US foreign policy experts, academics and government officials to rank geopolitical threats by both likelihood and potential impact.

We consider only the 'Tier 1' events identified in the survey – those with the highest combined scores based on considering these two criteria. We then apply our own judgement to filter that list. This leaves us with four key risks, which we set out below.

The advantage of this approach is that it is repeatable annually and has previously been impressively prescient: for example, it flagged the full-scale invasion of Ukraine as a 'Tier 1' risk before it happened. We can also add any geopolitical risks not covered by the survey in the future if necessary. Using this approach, we identify four important risks.

CHINA—TAIWAN CRISIS

By this, we mean a lasting military blockade or outright invasion of Taiwan by China. The Chinese Communist Party has a long-term goal of reunification, and President Xi Jinping has refused to rule out the use of force to achieve it. Far from it – Ely Ratner, US assistant secretary of defence for Indo-Pacific security, recently declared that China's army "is likely preparing for a contingency to unify Taiwan with the PRC by force".

China has been increasing the pressure on Taiwan through a mix of political interference, cyberattacks, breaches of its airspace, and live-fire military exercises around the island – particularly since 2022. To protect Taiwan, the US supplies it with defensive weapons, including a $1 billion package due to be transferred directly from Pentagon stockpiles for the first time this year.

It also maintains what experts call a 'strategic ambiguity' on whether it would intervene militarily if the island were attacked: it doesn't explicitly say it would fight China but it doesn't say that it wouldn't fight China. By doing this, it hopes to prevent an invasion by presenting China with the risk that any battle over Taiwan could be long and costly.

ESCALATION OF THE UKRAINE CONFLICT

This could involve the war spilling over well beyond Ukraine's borders – for example, through an attack on a NATO country. Escalation could also mean the use of nuclear weapons. The risk is that Russia, faced with defeat or humiliation, lashes out. Russia maintains a large stockpile of tactical nuclear weapons, which President Putin has threatened, not very obliquely, to deploy if the country's "territorial integrity" is threatened.

A HIGHLY DISRUPTIVE CYBERATTACK

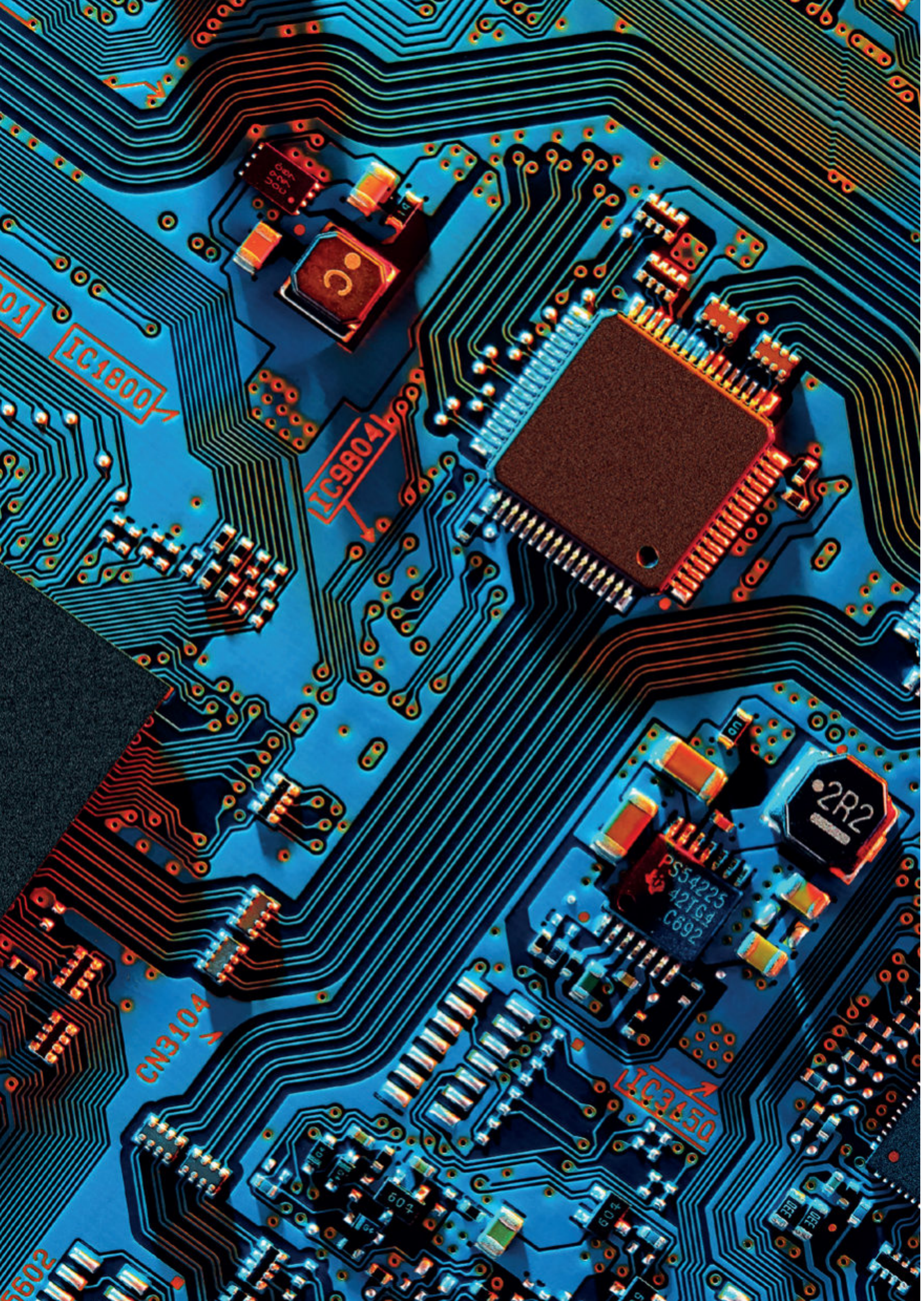
We're talking here about an attack with much more damaging and longer-lasting consequences than any we've seen so far. Even the most severe attacks to date, such as the Russia-linked 2017 NotPetya incident, have had only a minimal impact on the global economy and markets. We worry about this risk because cyberattacks have become far more regular and sophisticated recently – more than doubling in frequency since the invasion of Ukraine, on some counts. Moreover, several states are reportedly developing a new generation of advanced cyber weaponry.

DIRECT MILITARY CONFRONTATION BETWEEN ISRAEL AND IRAN

Iran and Israel have been engaged in a shadow conflict involving cyberattacks and assassinations for years. Iran also supports Hamas, which is responsible for the recent horrific attacks on Israel, though the precise extent of its involvement is not yet clear. A longstanding issue, and potential trigger for direct conflict, is Iran's nuclear programme.

Iran has been adding to its uranium stockpiles since the nuclear deal it struck with the US and other major powers broke down in 2018. To be used for a nuclear bomb, uranium has to be enriched to 90% purity; experts believe Iran is not far off this. Moreover, Iran has reduced cooperation with the International Atomic Energy Agency, which is trying to monitor Iran's nuclear programme.

Iran says this is for civil rather than military use, to develop nuclear energy. However, some Israeli officials think Iran wants a nuclear bomb, and they view a nuclear-armed Iran as an existential threat. Responding to this, Israel has threatened strikes on Iran if uranium is enriched to bomb-grade.



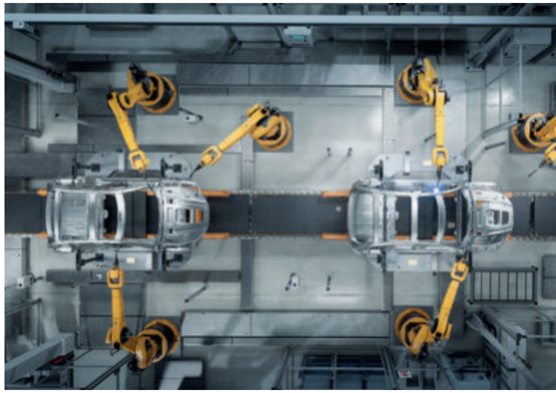
MONITORING MAJOR RISKS

We're not in the business of trying to forecast geopolitical risks far in advance. Why not? Academic research shows that even the judgements of geopolitical experts (which we're not) about how such events will play out over more than a few months have historically performed poorly. One remarkable study of more than 80,000 forecasts from hundreds of experts over two decades found that their projections were no more use than random guesswork.

Even so, we see value in identifying 'red flags' – markers that the risks we've identified may be imminent, or at least much more likely to be realised. There is some academic evidence that identifying red flags significantly improves prediction, making it worthwhile to forecast geopolitical risks over shorter time horizons. The full market impact of the kind of risks we've flagged typically unfolds over some time, rather than being felt immediately, so even warnings that appear only a little before the event should still be useful.

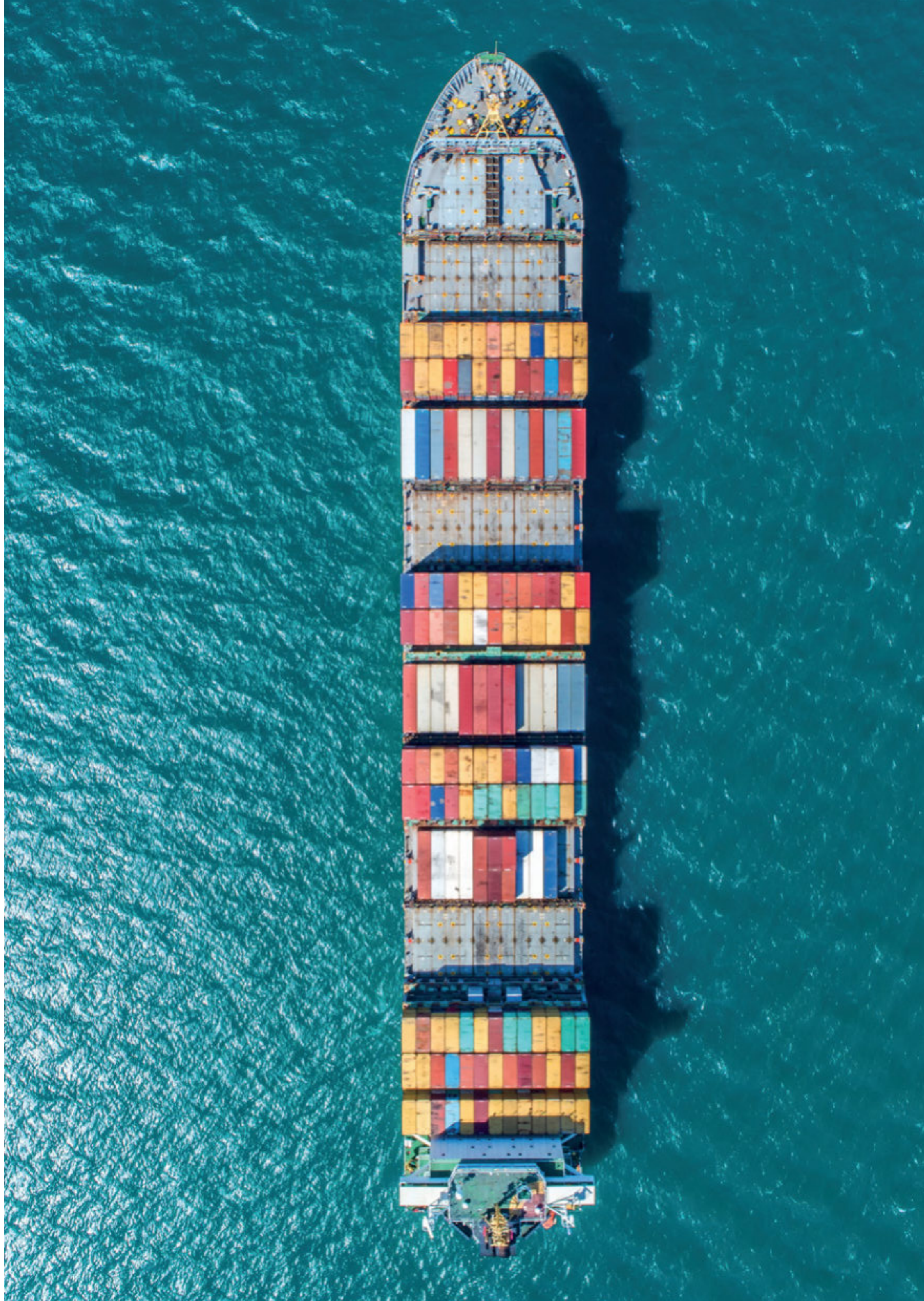
To help us identify and monitor relevant red flags for each of the events identified above, we've partnered with the geopolitical risk team at BCA Research. They've helped us fill out the table on page 10. It lists red flags for each of the geopolitical risks on our list. BCA is continuously monitoring those red flags for us, as well as suggesting changes to the list where necessary.

ONE REMARKABLE STUDY OF MORE THAN 80,000 FORECASTS FROM HUNDREDS OF EXPERTS OVER TWO DECADES FOUND THAT THEIR PROJECTIONS WERE NO MORE USE THAN RANDOM GUESSWORK.



THE RATHBONES RED FLAGS

China / Taiwan crisis	Ukraine conflict escalation	Highly disruptive cyberattack	Israel / Iran military confrontation
Surging Chinese imports of arms and stockpiling of critical goods.	Oil prices well above current levels, enabling greater Russian aggression.	Could be little or no warning. However, may be more likely ahead of major elections (Taiwan, Russia, Ukraine and US in 2024), or after major policy change (e.g. crippling sanctions hitting a country with a history of aggressive use of cyber capabilities).	Evidence that Iran has enriched significant quantities of uranium beyond 60%, Israel's stated red line.
China repatriates funds held overseas and/ or imposes capital controls.	Significant increase in Western supply of advanced weapons to Ukraine.	Intensification of smaller- scale/ unsuccessful cyberattacks targeting critical infrastructure or institutions, especially if a clear pattern of targeting is visible.	Evidence that Iran has enriched uranium to 90% (weapons grade) or tested a missile that could carry a nuclear weapon.
Specific warnings from intelligence services/ militaries.	Russia faces defeat — Ukraine retakes territories annexed in 2014, especially Crimea.	Further deterioration in the West's relations with Russia/China/ Iran/North Korea.	Intensification of shadow or proxy conflicts, especially involving Iranian nuclear sites and critical infrastructure in Iran or elsewhere in the Middle East.
Large build-up of Chinese forces opposite Taiwan.	Ukraine increases attacks on Russian territory.		Specific threat of an attack by either side.
Taiwan holds an independence vote.	Russia's invasion has made no further progress by run-up to 2024 US presidential elections.		More domestic unrest in Iran, which includes worker protests across the country or leads to divisions within armed forces/the top ranks of government.
China occupies outlying islands in Taiwan Strait (Kinmen, Matsu, Penghu).	Specific threat of a nuclear attack.		Specific warnings from intelligence services/ militaries.



PLANNING OUR RESPONSE

To plan how to adjust our portfolios should it become clear that one of the key risks that we've identified is imminent, we've taken the following steps:

- Charting the key channels through which each risk might affect the global economy
- Assessing the possible impact on global economic growth and inflation
- Identifying any effects specific to particular regions, sectors or commodities
- Translating the economic effects into implications for different asset classes
- Analysing the possible consequences for equities in different sectors.

You can find out more about the possible effects of each risk in the section starting on page 19. That said, some features apply to most, if not all, of our key risks.

WHAT DO GEOPOLITICAL RISKS HAVE IN COMMON?

The biggest geopolitical risks are mostly wars and commodity supply shocks. These are typically inflationary since they tend to reduce the supply of goods and services more than the demand for them. Some may even create additional demand, through big increases in military spending.

Government bonds play an important role in our portfolios as protection against typical disinflationary economic downturns. However, since geopolitical shocks tend to be inflationary, government bonds are often not much use when these happen. In a classic downturn of falling inflation, long-dated government bonds (those that mature seven years or more in the future) typically deliver strong positive returns and outperform other fixed income assets. In contrast, an inflationary geopolitical shock, like the full-scale invasion of Ukraine, would tend to cause long-dated bonds to sell off, and short-dated inflation-protected bonds to deliver positive returns.

WE FOUND THAT DEFENCE STOCKS TEND TO OUTPERFORM THE OVERALL STOCK MARKET WHEN GEOPOLITICAL RISK RISES.

Tracking investment returns

Gold has a track record of benefiting from geopolitical risk. Several academic papers use an index of geopolitical risk created by the Federal Reserve to show this. Ingeniously, the index is based on the proportion of newspaper articles analysed that mention relevant words and phrases. We've replicated and extended the analysis of one of those papers.

We found that defence stocks tend to outperform the overall stock market when geopolitical risk rises. One might expect the same for the prices of energy and agricultural commodities – geopolitics can affect their prices by disrupting production and distribution. But there's no consistent relationship: their prices do very well in some instances, but they're not a catch-all hedge against this type of risk.

The US dollar also tends to perform well at times of heightened geopolitical risk. Admittedly, some emerging market central banks have sought to diversify their reserves away from the dollar since the invasion of Ukraine, which resulted in Russia's dollar-denominated assets being frozen, and the country locked out of the global dollar system.

However, this didn't stop the dollar appreciating – it's still stronger than before the invasion. The dollar remains the world's primary reserve currency. In any case, there's no correlation between changes in its share of central bank reserves across the world and dollar strength.

DIVERSIFYING STRATEGIES

Lastly, so-called trend-following strategies, which seek to identify and capitalise on pricing trends in various asset classes, may help to offset the effects of large geopolitical shocks. Such strategies typically struggle at turning points – when prices stop rising and start falling because of a big event, for example.

But trend followers can in principle deliver positive returns when both equities and government bonds sell off. This is because of their flexibility to invest in other asset classes and to take what are known as short positions, which can provide a return from falling asset prices.

Their ability to deliver positive returns when both equities and bonds are sliding was illustrated last year in the aftermath of the invasion of Ukraine. Unlike most of the asset classes we invest in, trend-followers' returns have historically tended to do well when economic growth and inflation are volatile – and volatility usually increases following major geopolitical shocks.

TREND FOLLOWERS CAN IN PRINCIPLE DELIVER POSITIVE RETURNS WHEN BOTH EQUITIES AND GOVERNMENT BONDS SELL OFF. THIS IS BECAUSE OF THEIR FLEXIBILITY TO INVEST IN OTHER ASSET CLASSES AND TO TAKE WHAT ARE KNOWN AS SHORT POSITIONS.

FINANCIAL AND ECONOMIC IMPACT

CHINA—TAIWAN CRISIS

A lasting blockade or outright invasion of Taiwan could have two significant direct effects on the global economy. First, the global supply of semiconductors, vital to virtually all electronic devices, could be severely disrupted. Taiwan is the world's largest producer of chips, supplying more than 90% of the most advanced models. Chip foundries take years to build, require precisely controlled environmental conditions and depend on a highly skilled workforce.

That makes the potential for disruption in a war high. TSMC, Taiwan's dominant chip supplier, has announced some high-profile new facilities in the US, Japan and Germany, but building capacity overseas reportedly still accounts for less than 10% of its total capital investment. Second, global shipping could be threatened. More than 40% of the world's container fleet passed through the Taiwan Strait last year. For the largest vessels, this was as high as 80%.

RUSSIA AND UKRAINE TOGETHER ACCOUNT FOR LESS THAN 2% OF GLOBAL GDP, AND RUSSIA IS ALREADY INCREASINGLY DISCONNECTED FROM GLOBAL TRADE.

The indirect effects of an invasion could also be very significant if it resulted in disorderly decoupling, where major advanced economies rapidly reduce economic and financial ties. An abrupt decoupling with Russia occurred after the invasion of Ukraine, but China is a much more important part of the global economy. It is the world's largest exporter and a vital part of supply chains for IT/electrical equipment, many metals, chemicals and clothes.

The overall result would probably be weaker global growth and higher inflation. The stocks most affected would be those in cyclical sectors, with significant supply chain or revenue exposure to China, and with a dependence on advanced semiconductors. Defence stocks might outperform. Within fixed income, short-dated inflation-linked bonds might do best. Finally, Chinese assets might be subject to sanctions and/or capital controls.

ESCALATION OF THE UKRAINE CONFLICT

Russia and Ukraine together account for less than 2% of global GDP, and Russia is already increasingly disconnected from global trade. However, further escalation could still cause considerable damage to the global economy through its impact on commodity supply.

Ukraine is a major exporter of agricultural commodities. Before Russia's invasion, it accounted for 12% of global corn exports, 9% of wheat and 17% of barley – and nearly half of sunflower oil. Ukraine has still exported these commodities despite the war, though in lesser volume. There's also increased uncertainty about future exports, as Russia has recently reneged on a UN-brokered agreement to allow Ukraine to export grain. Moreover, its agricultural exports might halt altogether following a nuclear escalation if countries impose even stricter sanctions.

Russia's gas exports to Europe have all but ended, so that shock has already happened. But Russia continues to export oil. Tracking data from Bruegel, a Brussels-based economic think tank, shows that its share of global exports has hardly changed since the war began. As a result, disruption to Russia's oil supply is still possible.

The EU continues to import some Russian oil by pipeline, for example, while more than 50% of tankers carrying Russia's global seaborne oil exports are still EU-insured and more than 25% are EU-owned. If relations with the EU worsen this insurance could be cut off.

What effect would a ratcheting up of the Ukraine conflict have on economies and asset prices? The result would be a commodity shock, which would weaken growth and aggravate inflation. Investors in these commodities would benefit if the prices of energy and agricultural commodities surged. As to stock markets, energy firms, some food producers and defence companies could do well. However, cyclical and growth stocks would probably underperform. Within fixed income, short-dated inflation-protected bonds would probably fare best.

HIGHLY DISRUPTIVE CYBERATTACK

There's much more uncertainty about the impact of this risk than of the other three we've identified – we have few meaningful historical parallels to work with. Insurers' estimates of the likely damage caused vary wildly depending on the assumptions used. The impact could be very different depending on which sectors are affected: the range of those targeted recently has been very broad. Since the invasion of Ukraine it has included, for example, communications, financial services, healthcare and utilities. This risk could also coincide with any of the other three if it were state-sponsored.

Given the enormous uncertainty around the effects of a major cyberattack, in our analysis we've primarily treated it as a generic 'risk-off' event, acknowledging that in practice the implications could vary considerably depending on the precise nature of the attack (see the appendix for more detail). The stocks of those cybersecurity providers not compromised by an attack could benefit.

MILITARY CONFRONTATION BETWEEN ISRAEL AND IRAN

Both Israel and Iran are small economies by global standards, so the primary global economic threat is disruption to global energy markets – either accidental or deliberate. Iran is adjacent to the Straits of Hormuz, a chokepoint for global energy shipping, through which a third of global seaborne oil trade and quarter of global seaborne natural gas trade pass every year.

Iran itself also accounts for around 4% of global oil production and 6% of natural gas. There are clear parallels to the two oil shocks of the 1970s. The first, in 1973, was caused by Opec's response to Western support for Israel. The second, in 1979, was sparked by falls in output linked to the Iranian Revolution. Both Iran and Opec account for a smaller share of global oil production than they did in the 1970s, but they're still significant.

In equity markets, cyclical and growth stocks would probably suffer most, while energy and defence stocks would do best. Within fixed income, short-dated inflation-protected bonds might again be the best performers.

FOREWARNED IS FOREARMED

We know we live in a world full of geopolitical risk. Moreover, the world has probably become more dangerous over the past few years, with escalating tensions between the US and China, the world's two superpowers, and more recently Russia's full-scale invasion of Ukraine.

The future is unpredictable, but there are things we can do to prepare for the unknown. We hope that having a plan for how we will identify, monitor and respond to these risks can give our clients some peace of mind about their investments.

If you have any follow-up questions, please get in touch with your investment manager, call us on 020 7399 0000 or email enquiries@rathbones.com.

APPENDIX: IMPACT ON DIFFERENT EQUITY SECTORS

For clients interested in more detail, in this appendix we've used a combination of quantitative and qualitative criteria to identify sectors to downgrade/upgrade should each risk be realised. One arrow represents a small downgrade/upgrade, two arrows represent a large one. A blank space represents no change. In each case, our starting point was ranking sectors quantitatively by their sensitivity to a couple of relevant factors, applying downgrades to those with the highest combined rankings. We then applied additional downgrades based on the cross-checks described in the tables, before finally making qualitative adjustments. These assessments are our opinion – the actual effects of these geopolitical events may be different – so you shouldn't rely on this for any personal investment decisions.

	China / Taiwan crisis	Ukraine conflict escalation
	Combined rankings for cyclicality and revenue exposure to China. Cross-checked with information about supply chain dependency from OECD modelling and qualitative judgement	Combined rankings for cyclicality and growth. Cross-checked with performance after initial invasion, regression on supply-driven oil price moves and qualitative judgement
Technology	↓↓ China revenue/supply chain dependency	↓↓ Growth exposure
Telecommunications		
Health care		
Banks	↓ Cyclicality	↓ Hit hard after invasion
Financial services		↓ Sensitive to supply-driven oil price moves
Insurance	↓ Middling cyclicality and China revenue exposure	
Real estate		↓ Cyclicality
Automobiles and parts	↓↓ Cyclicality, China revenue/ supply chain dependency	↓↓ Cyclicality/growth exposure
Consumer products and services	↓ China revenue exposure	↓ Growth exposure
Media		↓↓ Cyclicality/growth exposure
Retail		↓ Sensitive to supply-driven oil price moves
Travel and leisure	↓ Some cyclicality and China revenue exposure	↓ Sensitive to supply-driven oil price moves
Food, beverages and tobacco		↑ Some producers benefit from higher food prices
Personal care, drug and grocery stores		
Construction and materials	↓ Cyclicality	
Industrial goods and services	Upgrade defence, downgrade rest	Upgrade defence, downgrade rest on cyclicality
Basic resources	↓↓ Cyclicality, China revenue exposure	↓↓ Cyclicality
Chemicals	↓↓ China revenue/supply chain exposure	↓ Some cyclicality/growth; but fertilisers could do well
Energy		↑↑ Beneficiary of higher energy prices
Utilities		↑ Some benefit from higher energy prices

	Highly disruptive cyber attack		Iran / Israel military confrontation	
	Combined rankings for cyclicality and beta — used beta to reflect generalised uncertainty following major cyberattack. In practice effects will vary depending on specific nature of the attack.		Combined rankings for cyclicality and growth. Cross-checked with average performance in three previous oil shocks, regression on supply-driven oil price moves and qualitative judgement.	
Technology	↓	Cyclicality/beta, possible target. Security providers benefit	↓↓	Growth exposure
Telecommunications		Possible target — not especially vulnerable otherwise		
Health care		Possible target — not especially vulnerable otherwise		
Banks	↓↓	Cyclicality/beta, possible target		
Financial services	↓↓	Cyclicality/beta, possible target	↓	Sensitive to supply-driven oil price moves
Insurance	↓	Cyclicality/beta		
Real estate	↓	Cyclicality/beta	↓	Cyclicality
Automobiles and parts	↓↓	Cyclicality/beta	↓↓	Cyclicality/growth exposure combination
Consumer products and services			↓	Growth exposure
Media	↓	Cyclicality/beta	↓↓	Cyclicality/growth exposure combination
Retail			↓	Sensitive to supply-driven oil price moves
Travel and leisure			↓	Sensitive to supply-driven oil price moves
Food, beverages and tobacco				
Personal care, drug and grocery stores				
Construction and materials	↓↓	Cyclicality/beta	↓	Underperformed in past oil shocks
Industrial goods and services	↓	Cyclicality/beta		Upgrade defence, downgrade rest on cyclicality
Basic resources	↓↓	Cyclicality/beta	↓↓	Cyclicality
Chemicals	↓	Cyclicality/beta	↓	Some cyclicality/growth exposure
Energy		Possible target — not especially vulnerable otherwise	↑↑	Beneficiary of higher energy prices
Utilities		Possible target — not especially vulnerable otherwise	↑	Some benefit from higher energy prices

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