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Conversations with Commerce Trust podcast
October Episode: Geopolitical Risks and the Rise
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David Hagee: Hello, and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today, we're discussing a number of rising geopolitical risks and their potential impact to markets with Scott Colbert, our Chief Economist and Director of Fixed Income Management, and KC Matthews, Chief Market Strategist here at Commerce Trust. Welcome to the podcast, gentlemen.

KC Mathews: Hey, good to be with you.

Scott Colbert: Hi, David.

David: We would be remiss if we didn't acknowledge the tragic events unfolding in the Middle East. The brutal attacks on Israel by Hamas in early October and Israel's response has caused untold suffering of thousands, and now threatens regional stability. Our hearts go out to all those affected by these events. Meanwhile, the war between Russia and Ukraine rages on with no end in sight. In addition, wildcards both domestically and internationally are also contributing to uneasiness around the globe. With geopolitical risks on the rise, we want to focus on the market impacts to these events. KC, what are your thoughts on some of the risks that we've mentioned in terms of market impact?

KC: Yes. Well, I think it's important to start with just setting the landscape that we have coexisted with a number of geopolitical tensions and military conflicts around the world for the last hundred years, if not longer, and I don't think that will change, unfortunately, going forward. Most investors today are aware of two major conflicts. As you mentioned, you have Hamas' invasion of Israel back in early October, but also Russia's invasion of Ukraine that takes us back to February of 2022. According to the Council on Foreign Relations, there's actually 32 ongoing conflicts around the world. We have drug wars, terrorist insurgencies, ethnic conflicts, and civil wars. As all this is going on, we realize that there's a significant impact to the local economies and markets, and a lot of tragedy locally, but a very small impact globally. What you find in global economies and the U.S. economy, these issues around the world, albeit tragic, have a limited impact on economic and market conditions.

History really shows us that about all these crises. There's so many of them but typically when you have a crisis when you look at the stock market using the S&P 500 as a proxy, there's a short-term negative reaction during the crisis. However, there's a swift recovery. I went back to 1960 and just took the median return of that S&P 500, 12 months after the conflict (major conflicts in which the U.S. was involved) started the return is actually 15.5%. You can see, we get through it, the market looks past it. The market knows they're not significant enough to the global economy and the U.S. economy to change the underlying fundamentals.

David: Thanks, KC. As we think about how this translates not only into the markets but also into the economy, Scott, what are your thoughts as to both the economic impact locally as well as globally of these crises. I'm also thinking about commodity prices related to both of those hot wars.

Scott: Certainly, with the Russian invasion of Ukraine, and then most recently the situation in the Middle East, they've certainly impacted commodity prices. They sent natural gas prices soaring for a while, which really put a dent in Europe's growth in 2022/ 2023. As KC suggested, they've faded now, and oil prices and natural gas prices have come back to pre-invasion-type levels.

At the same time, the stock market, while it was pushed around a little bit at first, it's basically been pretty flat through both the Israeli situation, as well as long term, almost within basis points of where it started back in February of 2022 (the Ukraine invasion.) We've had a fairly flat stock market, but it's certainly been somewhat inflationary with those commodity prices pushing up. It certainly forced our Federal Reserve (Fed) to push back more assertively and aggressively against inflation and its certainly dampened our economic cycle.

In the longest of runs, all of this stuff, as KC suggested, will probably fade. The impacts have been modest so far, and hopefully, it'll stay that way.

David: As we talk about the "shooting wars" (cold wars that escalate to armed conflict) it also bears some mentioning to discuss the rising global tensions out of China with their Eastern ambitions, and potentially Taiwan getting rolled into a shooting war as well. As we talk about those geopolitical tensions on the rise outside of the shooting wars, what's their impact on the global economy? Then, KC, about the markets as well.

Scott: Maybe I'll start with that. Now we're dealing orders of magnitude different. Let's face it, Russia is a modest emerging market, it only represented about 3% of the market capitalization of the emerging market stock index. It's literally only about 15% the size of China. Ukraine, on a relative basis to Russia, Ukraine's GDP (gross domestic product) was only about a tenth the size of the Russian GDP. Israel has a GDP of about $0.5 trillion, pretty similar to its neighbor, Egypt, but it dwarfs, Jordan and Lebanon, its two closest neighbors there.

Any move that China makes and any problems we have with China, with China being the 30%, representing 30% of the market cap of the emerging market stocks and 16% of the global GDP, are likely to be much more material and much more impactful, and of course, use up a lot more of our time, energy, and resources. It feels like we're expending a lot just in the Ukraine-Russian situation. I think that would pale in comparison to probably how much capital and resource would tie us up with a shooting war in Taiwan of any sort. Even a non-shooting war, just an embargo or any move on China attempting to take over Taiwan.

KC: David, can I jump in. Just adding on China, what's interesting when you put a little meat on the bone, all these issues, conflict in the South China Sea or the New Silk Road, which is the Belt and Road stimulus infrastructure spending in China, conflict with India, they've existed for quite some time. Yet they just reported their third quarter GDP, which is up 4.9%.

In the U.S. we're about to report our third quarter GDP, which will probably be somewhere between 4.5% and 5% with all these issues, that are not new. Some of these things, we're just going to have to coexist with and hope they never escalate. If they do, do another podcast.

David: That's right.

Scott: Yes. I can't imagine it possibly being positive in any way, shape, or form, but it also might end up doing exactly what KC suggested, all the other conflicts have done. With a stock market that goes towards, risk aversion, stock prices fall, people move towards bonds. Over time, we work through and absorb the situation from a geo-economic perspective.

David: Let's pivot from global geopolitical tensions back into the U.S. It's been an eventful fall for us. We had a speaker get ousted, we've had three weeks of turmoil surrounding a new speaker being installed, that happened today. Then we also are on the doorstep of the 2024 U.S. elections. Around all this turmoil in the U.S. and a pending election, historically what have market reactions been to that, KC?

KC: Well, any type of uncertainty the markets don't like. When it comes to politics, again some of these things the market will look through. They won't change the underlying fundamentals of the economy or impact corporate earnings. Therefore, you get short-lived uncertainty and then it's back to the cyclical drivers, high-interest rates, consumption, things like that end up being the drivers. I do think, obviously, we have some issues with keeping the government open. We went through that, it cost the speaker his job. We got a new one. We're going to have to deal with this again in 45, or less than 45 days. There's a high probability that you get a government shutdown. Government shutdowns have happened before, they've been short-lived, they're terrible for all those families involved. Looking through it, through the economic and market lens, we get through it and markets end up moving higher. I don't think that is going to be a driver. It's more of the noise in the marketplace.

Now, if we move on to the presidential election cycle, typically, in an election year, that'll be next year, what you see is a flat choppy to down market for the first half, and then as you get clarity with the election, markets start to move higher. At the end of the day, again it doesn't end up being a sustainable driver to markets because we've had good markets with Democrats in the White House, good markets with Republicans in the White House. What works pretty well, believe it or not, unfortunately for our country, is gridlock. When you just get a bunch of politicians arguing about things, but they can't damage the country or the economy, and lo and behold, markets do just fine.

David: Scott, what about economic impacts here on all this turmoil inside the U.S. political scene. As well as this pending presidential election, as well as just a, probably a fairly contentious primary season coming up?

Scott: As KC suggested, if there's a four-year cycle to the presidential cycle, the stock market is pretty much flat. It has worst year going into an election, and then once the certainty of the election, if there's any certainty, and we might not have any certainty with this election until after the election, but then usually the market is relieved and then makes forward progress.

We didn't mention this, but in general, the Fed Reserve tries to stay out of politics. It may play into them getting through their interest rate hiking process a little bit sooner, and so there might be a silver lining there for the economy. As far as the primary season, I wouldn't expect much fireworks because right now, Trump is by far the clear (Republican) frontrunner, and Biden is the unchallenged Democratic incumbent, but surprises happen along the way. We'll see.

David: Definitely an interesting political environment that we're in. As we look at the markets today, there's the backdrop of the Fed probably concluding their rate hiking cycle. You have these geopolitical tensions that over the long run smooth out but become very volatile in the moment.

Thanks for the interesting discussion, gentlemen. If you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from. Thank you for joining us today on *Conversations with Commerce Trust*. I'm David Hagee. We'll talk again soon.

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