Breakout Briefings
Our Worldview in Charts

BREAKOUT CAPITAL
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Rockefeller Capital Management

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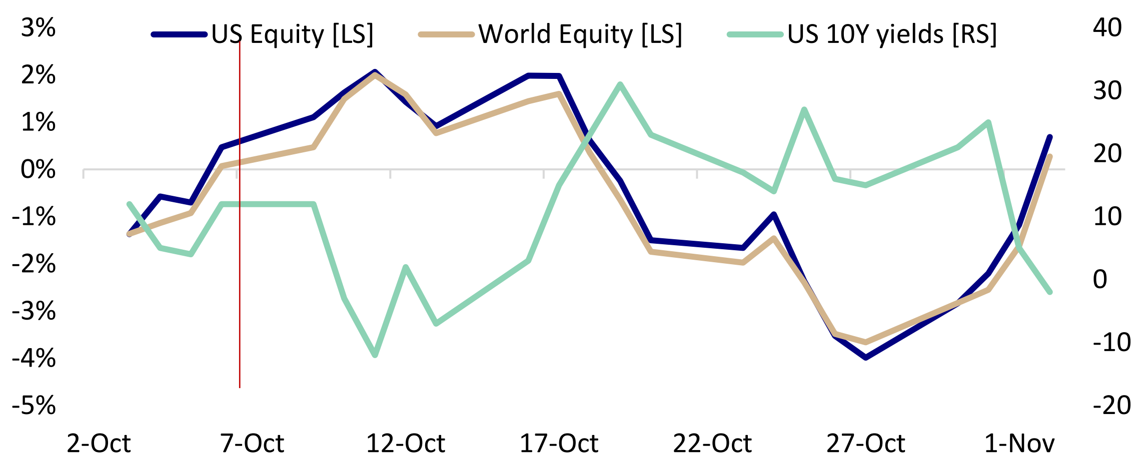
Why Markets are Calm in the Face of War

War in the Middle East has put geopolitical risks back at the forefront of the global conversation, and the media is often quick to link moves in the market to action on the battlefield. Only markets are not like pundits, they react not to worst case scenarios but to most likely scenarios, and so far have been quite calm amid the fighting between Hamas and Israel. In fact, since the conflict began with the attack on October 7, markets appear to be reacting more to interest rates than military events.

Markets Have Responded More to Rates Than War

Though serious voices call this the most dangerous time in living memory and suggest that an “axis” of autocratic powers including Russia, China, Iran, and North Korea is stirring up trouble in the Middle East, the markets seem to be waiting for evidence on the geopolitical front. As the chart below shows, the US and global equity markets are broadly unchanged since October 7. The volatility in the US (and global) markets, in fact, has been driven more by global macro-economic trends. Renewed worries about US fiscal deficits led to a sharp increase in US 10-year bond yields by more than 40 bps from the 10th to the 20th of October, which contributed to a drawdown of almost 6 percent in US equities. In the last few days, the trend has reversed with a sharp decline in global yields and a recovery in global risk assets. The key takeaway: global markets continue to respond to rates and not war.

Chart 1. Change in Global Equity Markets and US 10 Year Yields
(Percent, Basis points)

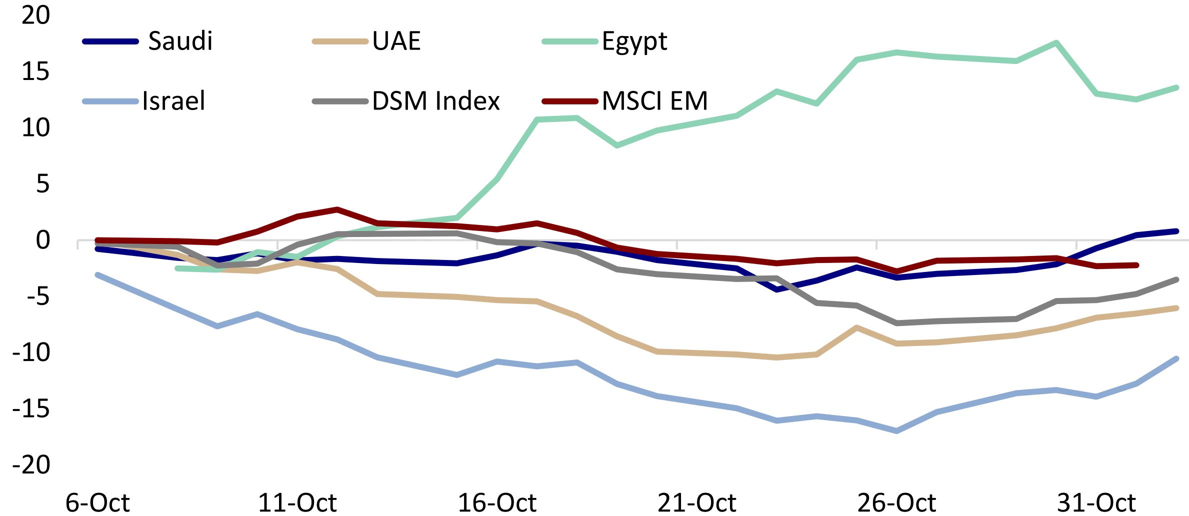


Source: Bloomberg, Breakout Capital Calculations. LS= Left Scale, RS= Right scale

Trends Were Mixed Even in Markets Close to the Crisis

The stock market in Israel is down around 10 percent since October 7, a relatively mild drop given the storm of controversy around its invasion of Gaza, and the reaction in the rest of the region is strikingly mixed. Egypt is up, Saudi Arabia is flat, the UAE is down only a bit. In short, idiosyncratic local factors appear to be having a larger impact on these markets than the threat of a wider war in the Middle East.

Chart 2. Performance of Select EM Equities and MSCI EM Index
(Indexed; Percent; In Dollar Terms)

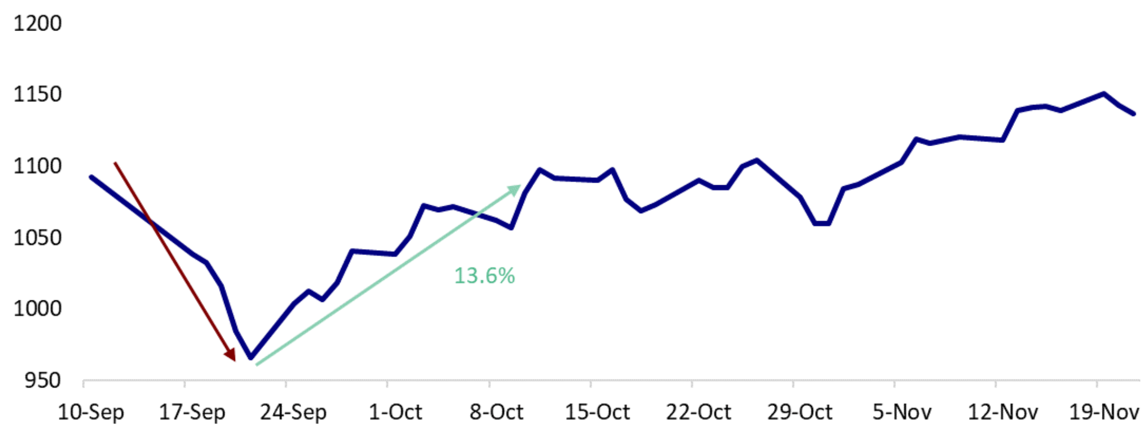


Source: Bloomberg and Breakout Capital Calculations. Normalised as of 05-October-2023;
DSM Index = Dubai Stock Market Index .

The Short Memory of Markets

The crisis most often compared to 10/7 is 9/11 in the United States, another terror attack that was widely seen as a portent of worse to come, and the market reaction then is instructive. The S&P 500 fell by 12 percent in just a week, the fall magnified, no doubt, by the fact that the US was six months into an eight-month recession. But that phase passed quickly — the S&P 500 would recover all of its losses by October 11.

Chart 3. S&P 500 Index During the 9/11 Crisis
(Index Level)



Source: Bloomberg

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How Markets Think About Geopolitical Crisis

In individuals, the mind tends to erase moments of pain, sanitizing memories over time, so that the latest crisis always stands out as especially dangerous. This is not irrational: in the heat of the moment, the outcome is always unclear. The collective mind of the market, in contrast, seems to recognize geopolitical risk as a historical constant, and to judge each new crisis on its own terms, not dwelling on the worst possible outcomes. That is what the historical pattern suggests.

The chart below shows the stock market reaction to 25 of the most significant geopolitical crises since World War II, including cross-border conflicts from Korea in 1950 and acts of terror from the first World Trade Center bombing in 1993. Many of these events took place in the Middle East or stemmed from conflicts in the region. On average, the S&P 500 dropped by around 4 percent and reached bottom in 15 days but recovered fully within about a month. Obviously, the next moves depend on events on the ground, but so far, the market reaction to the latest Middle East conflict has been typically calm.

Chart 4. Market Reaction to Geopolitical Crises

#	Geopolitical Event	Date	S&P 500 Total Drawdown	Days to Bottom	Days to Recovery
1	N Korea attacks S Korea	25-Jun-50	-13%	23	82
2	Hungarian Uprising	23-Oct-56	-1%	3	4
3	Suez Crisis	29-Oct-56	-2%	3	4
4	Cuban Missile Crisis	16-Oct-62	-7%	8	18
5	Gulf of Tonkin Incident	2-Aug-64	-2%	25	41
6	Six-Day War	5-Jun-67	-2%	1	2
7	Tet Offensive	30-Jan-68	-6%	36	65
8	U.S. bombs Cambodia	29-Apr-70	-15%	27	121
9	Munich Olympics	5-Sep-72	-4%	42	57
10	Yom Kippur War	6-Oct-73	-1%	5	6
11	U.S.S.R. Invades Afghanistan	24-Dec-79	-2%	15	15
12	U.S. Bombs Libya	14-Apr-86	-1%	18	21
13	Iraq invades Kuwait	2-Aug-90	-17%	71	189
14	WTC Bombing	25-Feb-93	0%	4	5
15	U.S. Embassy Bombings Africa	6-Aug-98	-2%	8	12
16	U.S.S. Cole Yemen Bombing	11-Oct-00	-3%	1	2
17	US Terrorist Attacks	11-Sep-01	-12%	11	31
18	Iraq 2003 war	19-Mar-03	-3%	12	14
19	Madrid Bombing	11-Mar-04	-3%	14	20
20	London Subway Bombing	5-Jul-05	0%	1	4
21	India Israel and Lebanon Bombings	11-Jul-06	-3%	3	17
22	Boston Marathon Bombing	15-Apr-13	-3%	4	15
23	Russia Attacking Crimea	7-Mar-14	-2%	7	25
24	Bombing of Syria	7-Apr-17	-1%	7	18
25	North Korea Missile Crisis	28-Jul-17	-2%	14	36
	Average (25 events)		-4.2%	15	33

Source: LPL Financial Research and Breakout Capital Calculations

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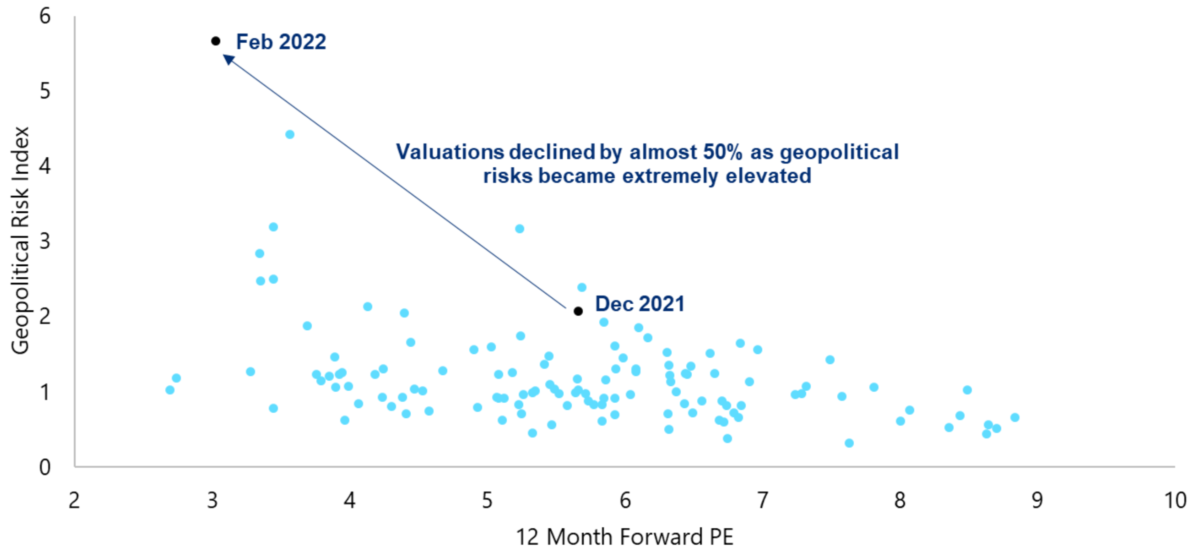
Research from Citi suggests that markets start to react to geopolitical risk only when the risk becomes extremely severe; it measures severity based on risks stemming from war, military escalation, or acts of terror. This pattern was repeated in the case of China during the 2017-18 crisis and North Korea during Aug 2017 crisis when missiles were fired over Japan. The chart below shows how the pattern unfolded during the Russian invasion of Ukraine; as the invasion approached in late 2021, the market did not react at all and Russian stock market valuations were still in line with the historical average. As Russian troops moved into Ukraine, risk started to reach "extreme levels" and crossed the 5.0 mark in February 2022. As a consequence, valuations declined sharply, by almost 50%, to reach historically low levels.

Chart 5. Geopoplitical Risk Index (Current vs 5Y Avg) and 12 Month Forward Valuations (P/E) (%) for Russia



Source: Citi Research, MSCI, Breakout Capital Calculations.

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