Measuring geopolitics' impact on markets

Good news discriminates, bad news is impartial

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In Alexandre Dumas's 1844 novel The Count of Monte Cristo , news of an impending revolution in Spain creates financial panic among French investors. Some sell Spanish bonds at a great loss, only to see the price bounce back after the news proves to be erroneous.

In the light of rising protectionism and the apparent dismantling of the postwar global order, geopolitics continues to matter a great deal to markets in 2018. But, as in Dumas's tale, it can be hard for investors to know how to react to such uncertainty. In a recent study, State Street Global Advisors assessed the impact of geopolitics on markets and found identifiable patterns of market responses to geopolitical events.

In search of real-world laboratory conditions, we selected markets with sufficient liquidity, well-functioning financial systems, (at least partially) floating exchange rate regimes, non-commodity economies and markets exposed to chronic geopolitical risk. Only four emerging markets met these criteria: India, Israel, South Korea and Turkey. We compiled a subjective list of 71 distinct geopolitical events stretching back to the late 1980s, and categorised them as either 'positive' or 'negative', measuring market reactions along different time intervals. The invasion of Kuwait by Iraq in 1990, the 1999 Lahore Declaration the start of Turkey's European Union accession process in 2005 are examples of the events studied for this research.

For currency markets, the effects were fairly consistent. Negative events led to an instant depreciation, on average at minus 0.64% within two trading days. Positive events barely registered a market reaction. To add context, the long-term average monthly performance of the four currencies is minus 0.66%, meaning that after a negative event currencies undergo their expected monthly fall in only two days. After this initial shock, currency trade reverts to normal patterns, but does not necessarily reclaim the original loss.

For equities, we opted for MSCI indices to analyse the impact of geopolitical events on local markets, as they are constructed on a consistent basis across countries and provide the longest data series. On average, 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 higher degree of anticipation for these events compared to currency markets. Weekly and monthly results are pronounced both in absolute terms and in relation to historical returns. For instance, one month after a negative event, equity indices tend to be on average 2.02% below their pre-event levels.

The three-month results are critical to understanding the length of the event impact. On average, indices recover in nominal terms to pre-event levels, the gap between the performance after negative and positive event collapses, and performance begins to revert to the mean for both positive and negative events. Therefore, it seems the effects of geopolitical events last somewhere between one and three months.

In addition to the impact on returns, we used a preferred equity metric – specifically, the average correlation between 20-day returns of every possible pair of stocks in the index – to measure the 'beta' effect of geopolitical events. Equity markets deem adverse events to be beta events, with correlations shooting up and markets performing broadly negatively. However, for positive events, there is a mild fall in correlations. One reasons is that, while there are few winners from negative events (such as the defence industry), the gains of positive events may be distributed less evenly. For example, a regional trade agreement can make protected industries suffer. Simply speaking, bad news hits everybody alike, but good news discriminates.

The research suggests that geopolitics is a discernible factor in financial markets. All four markets considered are emerging markets, though comparatively advanced ones. Deeper and more liquid developed markets could experience those events with different magnitudes, but one can expect the same general direction.

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