The World is Falling Apart – Will Markets Follow?

Over the past six months, geopolitical risk has intensified in Eastern Europe and the Middle East, with the Russian invasion of Ukraine, the fighting between Israel and Hamas, and the ongoing ethnic cleansing by ISIS in Iraq beginning to threaten the stability we have enjoyed in financial markets since 2012. Thus far, equity markets have remained fairly calm and collected - but could that change? In this month's MAInsights, we will discuss our views on the market's resiliency so far and why we believe the path of the Russian/Ukrainian conflict is critical for investors to watch going forward.

The Market's Resiliency

If one had to guess the market's return for the year by reading only world headlines in 2014, they would almost surely expect equities to be in negative territory for the year. In our view, the fact that the global markets are solidly positive for the year indicates the continued influence of the central bank liquidity backstop and the willingness of investors to bet that peace will ultimately prevail, as it usually does. While the Federal Reserve is "tapering" their asset purchases and the European Central Bank seems to be doing more talking than acting, on the other hand, the Bank of Japan is growing their balance sheet at an unprecedented rate, purchasing nearly $500B of assets (including Japanese equities) so far in 2014. With this huge amount of firepower supporting global financial markets, taking the opposite side of the central bank trade is still not a comfortable position to be in, regardless of what is going on geopolitically. Although equity markets, broadly speaking, have not endured significant losses, it is worth mentioning that bond markets are displaying more of a "risk-off" mentality. U.S. and German bonds, the safe havens in times of de-risking, have been in high demand in recent months, with the U.S. 10-year treasury falling below 2.35% and the German 10-year bond yield plummeting to an all-time low of 1.00%. As such, when it comes to the economic risks associated with these conflicts, we may be seeing a more rational reaction in the bond market than we are seeing in the equity market.

The Crisis to Watch

Going forward, we believe the Russian/Ukrainian crisis represents one of the greatest risks for investors due to its impact on the already fragile European economies. Since Russia initially invaded the Crimea region of Ukraine in February, the West (U.S. and Europe) has traded sanctions with Russia to attempt to dissuade any further escalation. As Russia's largest trading partner, it appears Germany's export-driven economy is bearing the brunt of the impact of those sanctions after the EU halted exports of military hardware and oil equipment to Russia and the Kremlin retaliated by banning food imports from Europe. As a result, German economic sentiment declined to lows not seen since December 2012 and other EU countries have begun to show similar signs of stress. Just as worrisome, the financial markets in Russia and Europe are now becoming strained after the EU banned their citizens from providing capital to any Russian state-owned bank, leading to significant declines in both Russian and European bank stocks over the past several weeks. The longer this continues, the more likely it is that Europe and Russia will slide back into recession and jeopardize the broader global recovery.

The worst near-term scenario for financial markets would likely be an escalation in the conflict causing Ukraine to cut off shipments of oil and gas supplies from Russia to Europe. Europe currently imports 30% of their natural gas from Russia, 15% of which is piped through Ukraine. With Ukraine already considering a sanction on Russia to cut off this gas supply through their country, Europe is at risk of seeing much higher gas prices and a further dent in their economy. Although we would not put anything past Vladimir Putin, based on the steep economic consequences Russia would face by losing half of their European-bound oil and gas, we think the likelihood of a long-lasting sanction on their energy exports is still fairly low.

Investment Implications

Interestingly, we believe all this turmoil could ultimately turn into a net positive for the U.S. energy sector as it should incentivize Europe to wean off Russian energy and look to the U.S. for imports of our abundant, low-cost gas supply. This adds to our conviction that investors should have exposure to the vast build-out of U.S. energy infrastructure needed to support this growing export opportunity. As we have discussed at length in previous commentaries, we are primarily investing in this theme through the midstream MLP asset class which offers visible growth, attractive yield, and a geographic concentration in North America that should insulate their cash flows from the current geopolitical risks.

Apart from our position in MLPs, we believe a broadly diversified portfolio that conforms to the client's risk objectives is the best means of protection from these unpredictable events. When market volatility rises, it is important for conservative investors to own assets within their portfolios that are uncorrelated or even negatively correlated to equities. In many cases, allocations to high-quality fixed income can offer a great deal of this protection as the recent surge in Treasury bond prices has shown, but we continue to seek out alternative assets that can fill this need for uncorrelated returns without the same level of interest rate risk. As for equities, although they have been resilient so far this year, we would not be surprised to see a 5-10% market correction in the next six months. To put this type of pullback into perspective, the S&P 500 has averaged a 14.4% intra-year correction on an annual basis going back to 1980, which may be surprising to investors who have enjoyed a relatively smooth ride in recent years. In this context, a 5-10% correction from here would only be normal for the market and would likely create an attractive buying opportunity for long-term investors.

Please send your questions, comments and feedback to: info@mai.capital. Any statistics mentioned have been obtained from sources we believed to be reliable, but the accuracy and completeness of the information cannot be guaranteed. Any statement non-factual in nature constitutes only current opinion of this author which is subject to change without notice. Neither the information nor any views expressed should be considered as investment advice or constitute as a recommendation to buy or sell any security, strategy or product nor should it be considered as a forecast of future events or a guarantee of future results.

THIS IS NOT A RECOMMENDATION TO BUY OR SELL ANY SECURITY.