FORSTRONG
GLOBAL

ASK FORSTRONG
THE ISRAEL-HAMAS CONFLICT: IS CASH NOW KING?

TYLER MORDY
CEO & CIO
Forstrong Global Asset Management Inc.

Key Takeaways

- Looking back at market reactions to past geopolitical crises, the pattern is typically the same: stocks fall as investors assess risk but recover strongly within a few months.
- Crises provide important signals about shifting investment dynamics. The key signal today is that Western bond markets have lost their effectiveness as a market hedge.
- A new set of "safe haven" assets are taking hold, led by commodities and emerging market bonds. Cash is set to dramatically underperform.

Ask Forstrong: What impact will renewed tensions in the Middle East have on financial markets?

Not since the 1970s has the investment climate seemed so turbulent. The globalizing impulse that has defined the world economy for over two decades is now in rapid flux. New economic barriers between countries are choking the free and frictionless trade that once flowed across national borders. Fragmentation has instead become today's buzzword. In financial markets, American government bonds are experiencing their second largest continuous drawdown in history. Elsewhere, a sputtering Silicon Valley, that former techno-capitalist machine fueled by easy funding rounds, has led to a thrashing in private market valuations. Other instabilities are being revealed as interest rates rise.

All of this is what Nassim Nicholas Taleb calls "fragility", with each problem provoking the other in a mobius loop of global dysfunction. Now, the tragic outbreak of conflict between Israel and Hamas only further entrenches the pattern. Given that the Middle East accounts for 32% of world oil production, the stakes could not be higher.

The main risk is that the Gaza conflict spills into a wider war, dragging in other regional forces such as Hezbollah and potentially Iran. The latter would likely entail Israel seeking to destroy Iran's nuclear capability, prompting Iran to block the all-important Straight of Hormuz and seize the flow of oil to global markets. In that scenario, market tremors would undoubtedly echo the 1970's oil shocks.

How should investors respond? The issue is that traditional financial modelling has no predictive ability for these types of events. Black swans, by definition, take everyone by surprise. Rather than trying to predict one of the many outcomes that may unfold — an impossibility — investors would be better served to look back at the track record of major events and their impact on markets. Here, history is quite clear: geopolitical crises almost always create buying opportunities.

Rummaging through past cross-border conflicts produces a long list of stellar market returns. Stocks almost always fall as markets assess risk but recover strongly within a few months. This is the classic pattern of "buy the rumour, sell the news", where geopolitical threats increase uncertainty and downside risks (and therefore result in market declines), while actual events resolve uncertainty and prompt protective policy responses (which create recoveries). The Cuban Missile Crisis in October 1962 was a 13-day confrontation between the US and the Soviet Union, widely considered the closest the Cold War came to full-scale nuclear warfare. However, after the crisis subsided, the Dow went on to gain more than 10% that year. Or take the Korean War, when the North invaded the South. This conflict lasted from June 1950 — July 1953. During that time, the Dow was up an annualized 13.6%. History is brimming with similar examples.

Revisiting The Safe Asset Shortage Thesis

Geopolitical crises also provide important signals about shifting market dynamics. Several signals have surfaced in the current crisis. Most conspicuously absent is the usual rush into the safety of Western bond markets. In fact, bond markets, along with other risk assets, have continued to sell off since the conflict started on October 7th. This is new territory and exactly the dominant fear during the 2010s: with record low bond yields across the developed world, investors agonized over a "shortage of safe assets". If government bonds couldn't do the job, which assets would?

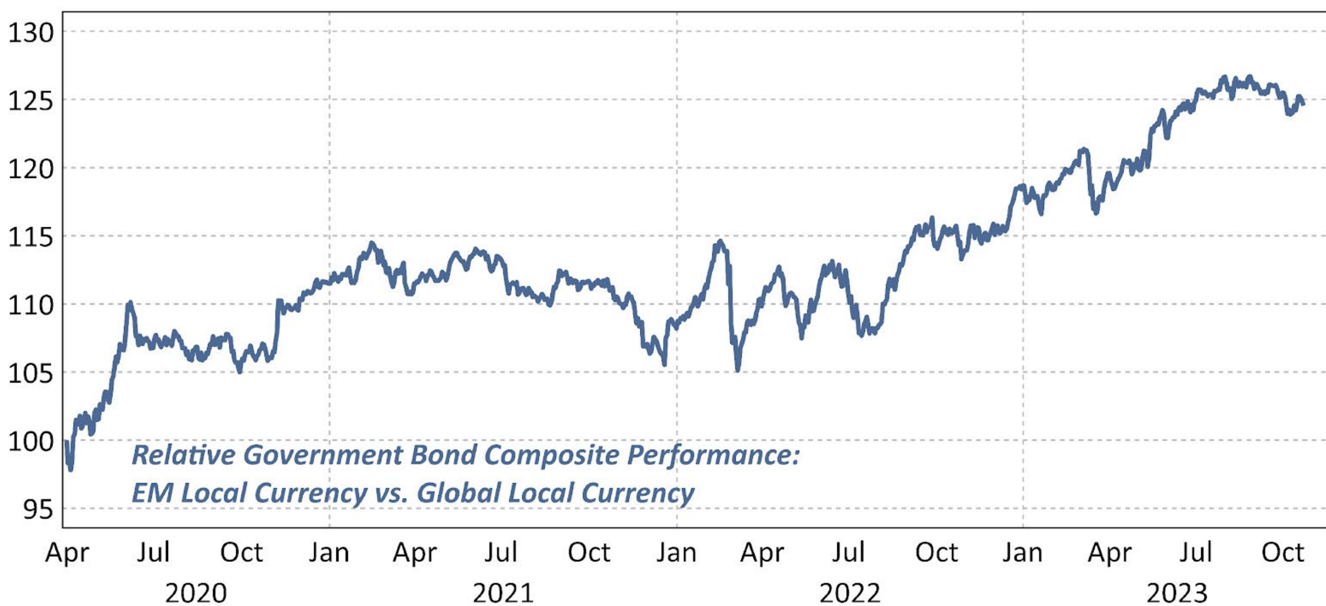
Today, a new set of "safe haven" assets are taking hold. The most obvious is commodities. In a world of chronic supply shocks and the associated inflationary pressures, bonds become ineffective hedges while commodities become highly effective ones. Investors shouldn't be surprised that resource-rich stock markets closest to the battle zone, from Saudi Arabia to Egypt and other Gulf states, have only experienced moderate pullbacks.

But a less obvious safe haven is emerging market bonds, which have dramatically outperformed developed market bonds. This is also a departure

from the past. In previous crises, EM bonds and their local currencies always underperformed Western ones, as investors fled to the safety of the developed world.

That is now changing and is the direct result of policies put in place during the pandemic. Less stimulus and more proactive central banks in EM have led to lower inflation. And, in fact, these dynamics extend a long narrative of EM economies improving their balance sheets and pursuing structural reform, as a result of lessons learned from the shocks over the last few decades. Stronger sovereign, corporate and household fundamentals have lowered external vulnerabilities. To borrow Taleb's words again, EM nations have increased their "anti-fragility".

Meanwhile, most Western nations continue to struggle with a series of self-inflicted wounds: soaring deficits, high sovereign debt levels, and, most notably, over-stimulating during the pandemic (and entirely missing the inflationary impulse afterward). Higher-for-longer inflation remains the central challenge there.



With inflation largely under control in most EMs, many of their central banks will diverge from Fed policy and start cutting rates. In fact, several have started, most notably in Brazil, Chile, China, Peru and Poland. Others, including Colombia, Indonesia and Mexico, will soon follow. This is also new territory as EM central banks have always lagged the Fed in easing cycles to avoid currency depreciation and re-igniting inflation pressures. Not this time. Looking ahead, the triple tailwind from higher real yields, rising local currencies, and looser monetary policy will support continuing outperformance for EM bonds — acting as both a safe haven and risk-on asset.

Investment Implications

At a time when nearly every newsfeed reveals the world to be a dark place — whether by rising rates or the coverage of the Israeli-Hamas conflict — investors are running for the hills. Data from flow tracker EPFR shows investors pouring more than USD $1 trillion into global money market funds so far in 2023.

Part of this is understandable. Cash looks tempting. With interest rates for Canadian cash hitting 22-year highs, why not avoid the volatility that comes with other risk assets?

But investors should fight this temptation. Now, as much as ever, cash is unlikely to be king. Why? First, cash rarely outperforms over any medium-term period. In fact, it is the worst performing asset class over all long-term periods you care to examine. Trying to time geopolitical threats by hiding in cash is also fraught with risk. In fact, this narrow focus on one type of risk is speculative at best, and hinges upon achieving two near-perfect tactical portfolio actions. One is getting out at the right time; the second is to get back into the markets at the right time. The first decision is difficult at best. The second step is often overlooked.

Secondly, cash typically underperforms once central bank rate hiking cycles end. We are near this point for many of the world's central banks. Finally, broad investor sentiment is completely washed out. We are again at a period where the world can deliver upside surprises. Cash often feels like a safe bet. But the prospective returns for a globally-balanced portfolio, with its lower valuations and higher yields, has not looked this compelling in decades. When things are falling apart, they are often falling into place for long-sighted investors.

Tyler Mordy, October 2023