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Geopolitics is the Elephant in the room

Highlights

- Global markets were up in July, but M7 stocks have corrected sharply after soaring to record highs. Is the AI (tulip) mania finally being questioned?
- GCC markets gained positive momentum on the back of good Q2 2024 earnings. However, falling oil prices could be a cause for concern as OPEC+ is caught between maintaining the production cuts to support oil price vs. demand headwinds from China.
- GCC markets should also be worried about the continued underweight by global fund managers, which could stem from ineffective storytelling of GCC's macroeconomic strengths, significant risk premium assigned due to geopolitical tensions and heightened valuation.
- The world is full of geopolitical hot spots, and they all evolve over time in terms of risk progression. While it is important to model and manage the geopolitical risk, it is certainly far more complicated.
- Fixed income yields have started coming down in anticipation of the much awaited first fed rate cut in September.
- Geopolitical events, oil price response, recession fear and Fed will shape the fortunes of global and regional markets going forward.

I am not too sure how to read the markets for July. At a market level, MSCI World (which is now 70% US!) was up 1.7% while S&P 500 edged up by 1.1%. However, what should worry investors is the rapid descent of M7 stocks, which was led bravely by Nvidia. M7 stocks lost $2.6 trillion between July 10th and month end with Nvidia correcting by 23% and Meta by 18% from the highs of July 10th. The analysts are associating this with rotational trade though some smart sellers are seeing the froth more clearly than others. The M7 combined is more than the next six countries (Japan, UK, Canada, China, France and Switzerland) combined! The AI (tulip) mania is finally being questioned at several levels including productivity gains and economic impact. The massive ramp up of project spending by almost all technology companies in AI will certainly increase the overall industry cost but the benefits may cancel out and then everyone will be left holding trophy projects.

Despite oil price dropping by 6.6% for the month, S&P GCC composite index was up by nearly 4%, thanks mainly to Dubai and Kuwait while Saudi Arabia and Abu Dhabi supported to an extent. GCC markets gained positive momentum on the back of good earnings coming out so far. Banking and Real estate continue to be sector picks. Oil production cuts are eating into GDP growth, and this forced IMF to cut the GDP forecast for Saudi Arabia by nearly 1% point to 1.7% for 2024. OPEC+ is caught between maintaining the nearly 5 million barrels per day of production cuts to support oil price vs. demand headwinds from China. Though it announced that starting October, they will start unwinding the production cuts, it will depend on economic data coming from emerging markets including China and India. I wonder if not for this massive production cuts, where would the oil prices be ($40/bbl probably!)

GCC markets should also be worried about the continued underweight by global fund managers. A sample of 75 active EM managers analysed by EFG Hermes shows that EM managers exposure is about 50% in Saudi Arabia and UAE, while Qatar and Kuwait ranks even lower at say 20-10% of theoretical weights in the MSCI EM Index. Why are active EM fund managers underweighting this much when GCC story as an emerging market should be far better than other emerging markets? Maybe it has to do with ineffective storytelling, a significant risk premium assigned due to geopolitical tensions and high valuation. Historically, GCC market valuation (measured by P/E ratio) has always been higher compared to the broader EM index though it has levelled off recently.

This brings us to the discussion about geopolitics. Though I am not a political analyst, I worry about geopolitics from the context of how it impacts market. Israel's double attack on Beirut and Iran certainly opens the possibility of things getting out of hand. The response and counter-response will certainly escalate the tensions and impact markets. Hence, modelling geopolitical risk and hedging them is key though we enjoy spending more time analysing Fed.

There are too many moving parts though there may be only two parties to a war. Diplomatic back channels will be busy both at formal and informal levels where several interlocutors and negotiators are drafted to find a way out.

The world is full of geopolitical hot spots, and they all evolve over time in terms of risk progression. Here are the key phases to such progression in my reading:

1. **Eruption Phase:** This is when the dispute started, and it can date back several decades. (Like India Pakistan over Kashmir)

2. **Simmering Phase:** Geopolitical conflicts do not result in immediate explosion. Rather they simmer for a very long time (South China sea), and it is almost impossible to predict their blowout.

3. **Blowout Phase:** This is when the conflict is out in the open in terms of aggression or war (Russia and Ukraine). Again, there is no standard formula to predict how long this phase will last.

4. **Engagement phase:** After the blow out phase, the parties to the war may engage (hostile) for a certain time before there emerges a victor and loser.

5. **Conclusion Phase:** This is where global interlocutors may structure a deal acceptable to both the warring parties. (rarely happens)

Geopolitical Risk Progression

Phases	Eruption	Simmering	Blowout	Engagement	Conclusion
Market Reaction	Negative ↓	Indifferent —	Negative ↓	Indifferent —	Positive ↑

In all these phases, we can have severe posturing with sudden action taking everyone by surprise. Geopolitical events can also be categorized from a frequency vs intensity point of view. There are conflicts that are frequent but less intense and some rare but with huge intensity (Hiroshima). Geopolitical events have turned from the traditional to digital warfare thanks to technology.

As investors and analysts, we are more worried as to how geopolitics will impact markets. Historically, while some events (like 9/11) can result in sudden market crash, unlike economic events (like the global financial crisis), markets get up quickly, dust off and march ahead most of the time while dealing with geopolitical events. When a particular geopolitical event unfolds, the market may exhibit negativity but quickly will turn indifferent during the simmering phase. However, the market may again turn negative during an actual hostility (blowout phase) but will again turn indifferent if the engagement becomes prolonged (like the Russia Ukraine conflict). When a particular geopolitical event concludes (which rarely happens), the markets of course cheers. Geopolitical risk is the elephant in the room clearly and ignoring it will be unwise.

In the fixed income market, Fed has just celebrated the anniversary of its last rate increase. Yields have started coming down in anticipation of the much awaited first fed rate cut in September. Market has discounted that in price but is unable to discount any other things apart from this. For e.g., the market analysts are still divided on how deep and how long the cuts could be. If the anchor point is the zero interest rates from where the rates started climbing, then the rationale is that the cuts could be deep. But what if the neutral rate (a theoretical level of borrowing costs that neither stimulates nor slows growth) has moved up to say 2.75% or 3%, then the current rate of 5%+ may not be as restrictive as people suppose it is. Yield curve correction has shown some interesting trends where the market still favours the short end at the expense of long end. The long-end yield (30 years) is up 50 bps in the last one year while the short-end (1 year) is down 58 bps. The reason for scepticism over the long end is the continuing worries about fiscal indiscipline which is spiking global debt. For now, people are happy on the short side as they reap higher YTM as well. The 1year-10-year spread is also down by 30 bps and is at its tightest level.

In summary, geopolitical events, oil price response, recession fear and Fed will shape the fortunes going forward.

Equity & Commodities	Close	Returns		
		July 2024	YTD-July 2024	2023
Global Equities				
Global (MSCI World)	3,572	1.7%	12.7%	21.8%
USA (S&P 500)	5,522	1.1%	15.8%	24.2%
Japan (TOPIX)	2,794	-0.5%	18.1%	25.1%
GCC Equities				
GCC (S&P GCC Composite)	147	3.9%	-0.3%	6.2%
Saudi Arabia (TASI)	12,110	3.7%	1.2%	14.2%
Abu Dhabi (FTSE ADX General Index)	9,339	3.1%	-2.5%	-6.2%
Dubai (DFM General Index)	4,268	5.9%	5.1%	21.7%
Kuwait (Boursa Kuwait All Share PR)	7,239	4.4%	6.2%	-3.1%
Commodities				
Oil (Brent Crude in USD/bbl.)	80.7	-6.6%	4.8%	-10.3%
Gold (in USD/oz.)	2,448	5.3%	18.7%	13.1%

Fixed Income	Yields	
	July 2024	2023-end
U.S. Treasury 10Y Sov.	4.09%	3.88%
Saudi Arabia 10Y Sov.	4.76%	4.39%
Abu Dhabi 10Y Sov.	4.52%	4.32%
Kuwait 10Y Sov.	4.77%	4.34%

Source: Refinitiv, YTD and Yields as of Jul 31, 2024

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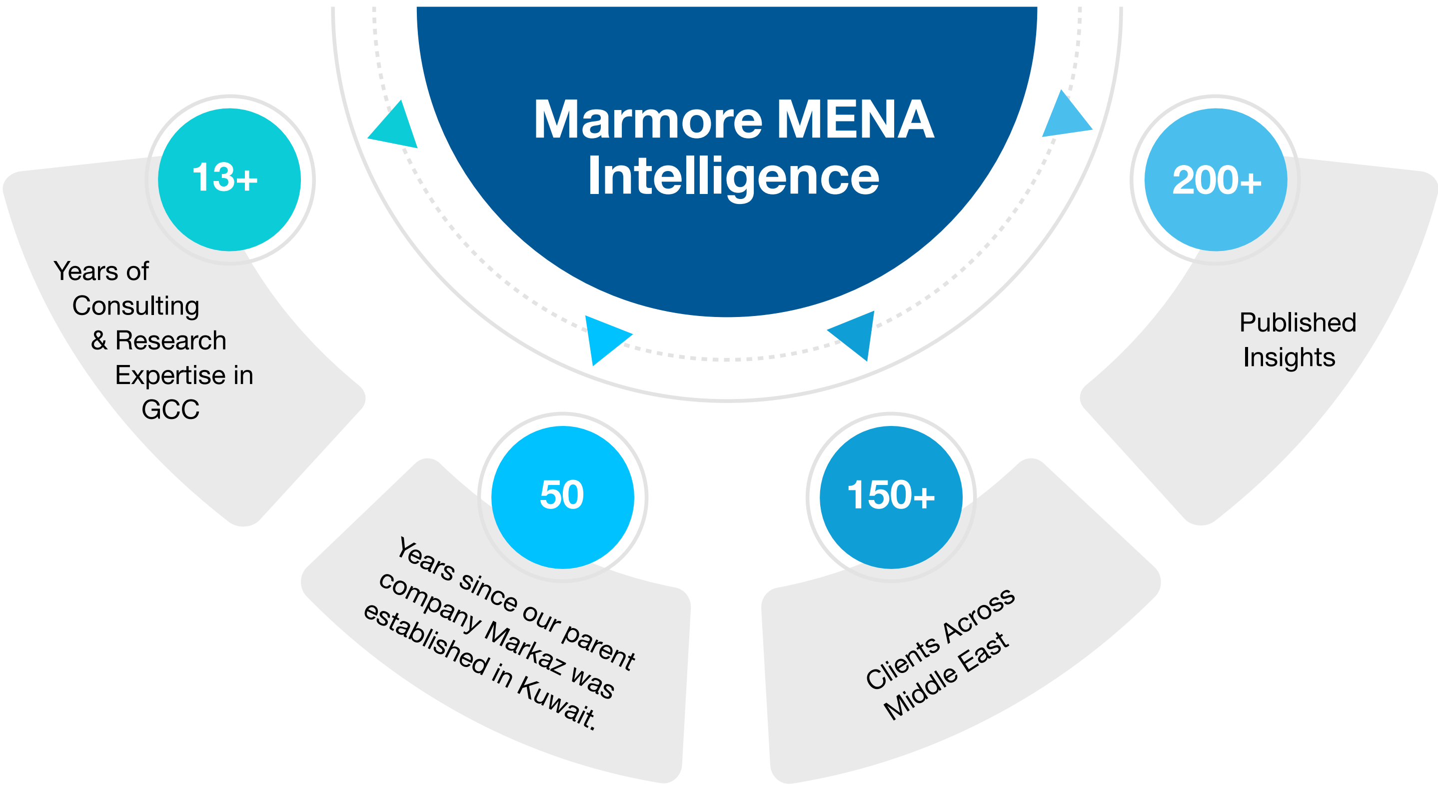

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