The Wealth Report

Conflicts that arise among Middle East countries tend to threaten global oil supply. This time around, however, it's America involved in a tense standoff. What does this mean for investors?

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POTENTIAL IMPACT OF U.S. TENSION WITH IRAN

Overview

Today, Iran is the seventh-largest crude oil producer in the world. It is reported to possess about 13% of the world's oil reserves and currently generates more than 4 million barrels per day. However, that represents only 4% of the world's total production. The sanctions that President Donald Trump re-imposed on the country last year continue to hamper Iran's ability to ramp up oil production.[1]

However, Iran is a member of the Organization of Petroleum Exporting Countries (OPEC); the U.S. is not. OPEC is the reigning body with the power to increase or limit production by member countries. Production levels are what determine the price of a barrel of oil — when supply is lower than demand, the price increases; when there is excess supply, the price drops.

Therefore, despite its limited production capacity, Iran does wield a level of power that the U.S. can offset primarily through its own independent oil production. Over the past decade, the U.S. has become an efficient producer of domestic oil through the increase of shale production and other processes.

"The U.S.-Iran conflict [is] unlikely to be a 'one-and-done' event."[2]

U.S. Conflict

In January, a U.S. airstrike in Baghdad killed the top military commander in Iran, Gen. Qasem Soleimani. This was a preemptive measure to thwart perceived plans to attack American diplomats and service members in the region.

However, the attack intensified already strained U.S.-Iran relations and ratcheted up the potential for elevated military conflict and geopolitical turmoil. In terms of the initial market response:[3]

- Oil prices jumped 3%.
- The S&P 500 dropped by about 0.7%.
- The Dow Jones Industrial Average lost 0.8%.
- Investments were redirected into defensive assets like gold and Treasurys.

Less than a week later, Iran retaliated with a comparatively muted attack on two Iraqi air bases housing U.S. forces, yielding minimal damage and casualties. However, the threat of subsequent attacks by Iran via covert and/or diplomatic action remain a top concern.

Market Volatility

While stocks ended 2019 on a high note, the New Year has been plagued with uncertainty as the markets await any further retaliation from Iran and subsequent disruption in global oil markets. Investment analysts have cautioned that the stock market's exuberance, paired with expectations of further action from Iran, could lead to increased volatility and a 7% to 10% correction in global equity markets.[4]

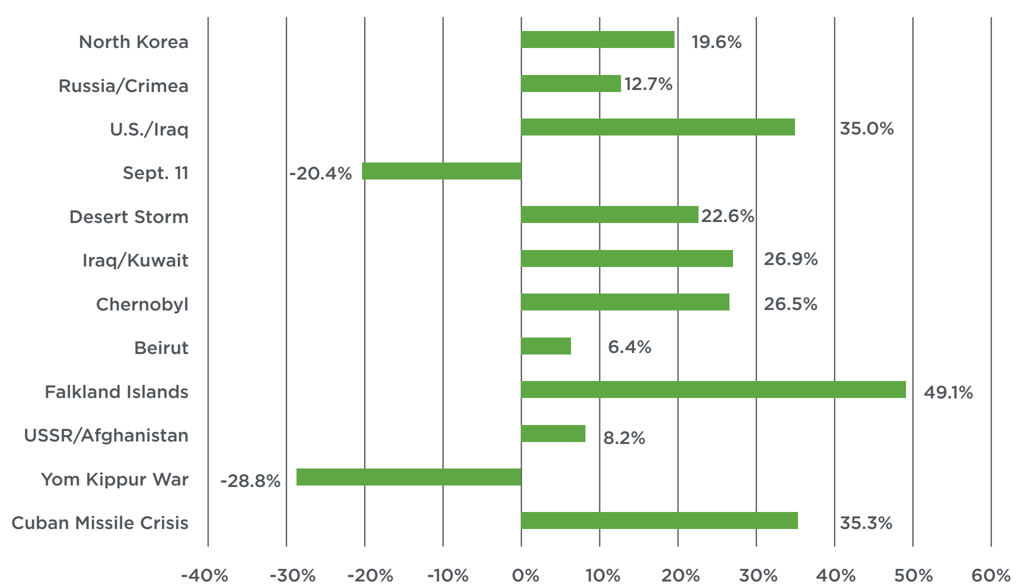
However, with that said, history shows that conflicts impacting oil prices are often short-lived. According to an analysis by CNBC, in the months following a crisis in the Middle East, stocks and oil tend to outperform safe haven assets like gold and Treasurys.[5]

Long-Term Prognosis

One of the fortunate components to our modern economy is that the U.S. is far less reliant on fossil fuels as a contributor to gross domestic product than back in the 1970s, when the high price and low supply of gas created a national crisis.

The increase in shale production has catapulted the U.S. as a major global oil exporter, and domestic production means that higher oil prices have less impact on our economy. From a historical perspective, even military conflicts do not tend to have a long-term impact on U.S. business and market cycles. As demonstrated in the accompanying chart, market returns have been generally positive in the 12 months following a major geopolitical event.[6]

S&P 500 Returns 12 Months After the Peak of a Major Geopolitical Incident[7]



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Despite these positive long-term results, it's important not to underestimate the impact of short-term oil price shocks. According to an economist at Credit Suisse, a sharp increase in oil prices preceded five of the past six recessions.[8]

Rocket Man and the Dotard: Additional Geopolitical Risks

Bear in mind that Iran isn't the only country that has expressed ire against the U.S. in recent years. Exchanges between North Korean leader Kim Jong Un and President Trump have been threatening, accompanied by ongoing missile tests. During the initial round of contentious barbs traded between the two leaders, the markets responded with a major sell-off in global stocks and a 1.1% decline in the Dow Jones Industrial Average.[9]

There is, however, an interesting market dynamic when it comes to U.S. military conflicts. The stock market does not like uncertainty. Concern over what might happen makes growing businesses reluctant to expand and hire, while a less stable employment environment causes consumers to delay making big purchases and investors to refrain from buying stocks (or selling them as a precaution).

On the other hand, once the U.S. is engaged in war, much of the reverse happens. There is no longer uncertainty; everyone knows that certain industries will thrive and thus investments, jobs and growth tend to thrive — as illustrated in the accompanying table.

Market Performance During Times of War[10]

	Large-cap stocks	Small-cap stocks	Long-term bonds	5-year notes	Cash	Inflation
WWII	16.9%	32.8%	3.2%	1.8%	0.3%	5.2%
Korean War	18.7%	15.4%	-1.1%	0.7%	1.5%	3.8%
Vietnam War	6.4%	7.3%	1.9%	4.7%	4.9%	4.2%
Gulf War	11.7%	-1.2%	12.5%	12.5%	7.0%	4.7%

Sources: The indices used for the total return of each asset class are as follows: the S&P 500 Index for large-cap stocks; CRSP Deciles 6-10 for small-cap stocks; long-term U.S. government bonds for long-term bonds; five-year U.S. Treasury notes for five-year notes; long-term U.S. corporate bonds for long-term credit; one-month Treasury bills for cash; and the Consumer Price Index for inflation. Returns for a wartime period are calculated as the returns of the index four months before the war and during the entire war itself. Past performance is not indicative of future results.

It is worth noting that the U.S. economy has changed significantly since the last major war. Historically, the economy was driven by the need for increased capital goods and natural resources. Since then, the U.S. has fostered a more service-oriented and "knowledge-based" economy with less reliance on industrials and manufacturing sectors. For better or for worse, what this means is that military demands in times of war are less likely to negatively impact domestic economic growth.

Final Thoughts

While it is true that markets hate uncertainty, it is perhaps that lack of confidence that has kept the U.S. economy in check for so long — when it might have otherwise overheated and caused higher inflation. The result is that growth remains in check, employment is steady, inflation is neutral and central banks have adopted accommodative monetary policies. All of these factors have contributed to the longest economic expansion in U.S. history.[11]

It is also important to recognize that while military conflicts will likely always trigger a short-term reaction in the markets, there is a wide range of factors that impact stock and bond market performance — including economic growth, earnings, valuation and interest rates. Tensions with Iran and North Korea are but pieces in a large puzzle that contribute to economic disruption. Isolated events are not likely to have a devastating or long-term impact.

In fact, one of the reasons financial advisors tout diversification is for situations just like Iran: When one portion of the market takes a hit, there are generally others that benefit. As always, we recommend you consult with an experienced financial advisor to help you structure an all-weather and wartime-resilient portfolio designed to meet your financial goals within your range for market risk.

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[2] William Watts. MarketWatch. Jan. 6, 2020. "What stock market investors need to know about intensifying U.S.-Iran tensions." https://www.marketwatch.com/story/what-stock-market-investors-need-to-know-about-intensifying-us-iran-tensions-2020-01-04/print. Accessed Feb. 3, 2020.
[3] Jesse Pound. CNBC. Jan. 3, 2020. "Here's what typically happens to the financial markets after major Middle East crisis events." https://www.cnbc.com/2020/01/03/heres-what-happens-to-the-markets-after-major-middle-east-events.html. Accessed Feb. 3, 2020.
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[5] Jesse Pound. CNBC. Jan. 3, 2020. "Here's what typically happens to the financial markets after major Middle East crisis events." https://www.cnbc.com/2020/01/03/heres-what-happens-to-the-markets-after-major-middle-east-events.html. Accessed Feb. 3, 2020.
[6] William Watts. MarketWatch. Jan. 6, 2020. "What stock market investors need to know about intensifying U.S.-Iran tensions." https://www.marketwatch.com/story/what-stock-market-investors-need-to-know-about-intensifying-us-iran-tensions-2020-01-04/print. Accessed Feb. 3, 2020.
[7] Ibid.
[8] Sam Ro. Yahoo! Finance. Jan. 7, 2020. "The Iran crisis could bring a bigger economic problem than surging oil prices." https://finance.yahoo.com/news/iran-crisis-could-bring-bigger-problem-than-surging-oil-prices-morning-brief-110442656.html. Accessed Feb. 3, 2020.
[9] Mark Armbruster. CFA Institute. Aug. 29, 2017. "What Happens to the Market if America Goes to War?" https://blogs.cfainstitute.org/investor/2017/08/29/u-s-capital-market-returns-during-periods-of-war/. Accessed Feb. 3, 2020.
[10] Ibid.
[11] Sam Ro. Yahoo! Finance. Jan. 7, 2020. "The Iran crisis could bring a bigger economic problem than surging oil prices." https://finance.yahoo.com/news/iran-crisis-could-bring-bigger-problem-than-surging-oil-prices-morning-brief-110442656.html. Accessed Feb. 3, 2020.