How the Modern Stock Market is Affected by War

A look at investor attitudes to war and uncertainty in the modern era.

Lately, Russia has been building up its military presence on its border with Ukraine, a sign that Putin may soon invade--and drawing the U.S. and NATO into war. There is also the ongoing possibility of an armed conflict between the U.S., its allies, and Iran.

So far the U.S. has spent an estimated $6.4 trillion on wars post 9/11, a sizeable piece of the GDP. But how do wars affect the economy and stock markets? Security experts are weighing in, and only time will tell, but investing experts are sending out reminders that past wars didn't push U.S. equities lower long-term.

KEY TAKEAWAYS

- While war and defence spending can be a sizeable portion of the U.S. GDP, wars often have little sustained impact on stock markets or economic growth at home.
- Markets largely have ignored recent conflicts related to the Middle East and Iran.
- A war between Russia, Ukraine, and NATO allies, however, may have a more severe impact, especially on commodity prices.

Markets Often Shrugs it Off

As serious as this escalation is, previous experiences have indicated it may be unlikely to have a material impact on U.S. economic fundamentals or corporate profits. Stocks have weathered heightened geopolitical tensions in the past.

Geopolitical Events And Stock Market Reactions

Market Shock Events	Event Date	S&P 500 Index One-Day	S&P 500 Index Total Drawdown	Calendar Days To Bottom	Calendar Days To Recovery
Iranian General Killed In Airstrike	1/3/2020	-0.7%	?	?	?
Saudi Aramco Drone Strike	9/14/2019	-0.3%	-4.0%	19	41
North Korea Missile Crisis	7/28/2017	-0.1%	-1.5%	14	36
Bombing of Syria	4/7/2017	-0.1%	-1.2%	7	18
Boston Marathon Bombing	4/15/2013	-2.3%	-3.0%	4	15
London Subway Bombing	7/5/2005	0.9%	0.0%	1	4
Madrid Bombing	3/11/2004	-1.5%	-2.9%	14	20
U.S. Terrorist Attacks	9/11/2001	-4.9%	-11.6%	11	31
Iraq's Invasion of Kuwait	8/2/1990	-1.1%	-16.9%	71	189
Reagan Shooting	3/30/1981	-0.3%	-0.3%	1	2
Yom Kippur War	10/6/1973	0.3%	-0.6%	5	6
Munich Olympics	9/5/1972	-0.3%	-4.3%	42	57
Tet Offensive	1/30/1968	-0.5%	-6.0%	36	65
Six-Day War	6/5/1967	-1.5%	-1.5%	1	2
Gulf of Tonkin Incident	8/2/1964	-0.2%	-2.2%	25	41
Kennedy Assassination	11/22/1963	-2.8%	-2.8%	1	1
Cuban Missile Crisis	10/16/1962	-0.3%	-6.6%	8	18
Suez Crisis	10/29/1956	0.3%	-1.5%	3	4
Hungarian Uprising	10/23/1956	-0.2%	-0.8%	3	4
N. Korean Invades S. Korea	6/25/1950	-5.4%	-12.9%	23	82
Pearl Harbor Attack	12/7/1941	-3.8%	-19.8%	143	307
Average		**-1.2%**	**-5.0%**	**22**	**47**

Source: LPL Research, S&P Dow Jones Indices, CFRA, 01/06/20

When Markets Can Suffer

History tells us periods of uncertainty like we're seeing now are usually when stocks suffer the most. In 2015, researchers at the Swiss Finance Institute looked at U.S. military conflicts after World War II and found that in cases when there is a pre-war phase, an increase in the war likelihood tends to decrease stock prices, but the ultimate outbreak of a war increases them. However, in cases when a war starts as a surprise, the outbreak of a war decreases stock prices. They called this phenomenon "the war puzzle" and said there is no clear explanation why stocks increase significantly once war breaks out after a prelude.

After studying the period from 1926 through July 2013 and it is found that stock market volatility was actually lower during periods of war. Intuitively, one would expect the uncertainty of the geopolitical environment to spill over into the stock market. However, that has not been the case, except during the Gulf War when volatility was roughly in line with the historical average.

Capital Market Performance During Times of War

	Large-Cap Stocks	Small-Cap Stocks	Long-Term Bonds	Five-Year Notes	Long-Term Credit	Cash	Inflation
1926-2013							
Return	10.0%	11.6%	5.6%	5.3%	5.9%	3.5%	3.0%
Risk	19.0%	27.2%	8.4%	4.4%	7.6%	0.9%	
All Wars							
Return	11.4%	13.8%	2.2%	3.7%	2.8%	3.3%	4.4%
Risk	12.8%	20.1%	6.4%	3.5%	5.5%	0.7%	
World War II							
Return	16.9%	32.8%	3.2%	1.8%	3.0%	0.3%	5.2%
Risk	13.8%	21.0%	1.9%	0.8%	1.1%	0.0%	
Korean War							
Return	18.7%	15.4%	-1.1%	0.7%	0.3%	1.5%	3.8%
Risk	11.1%	12.7%	3.0%	1.7%	3.2%	0.1%	
Vietnam War							
Return	6.4%	7.3%	1.9%	4.7%	2.7%	4.9%	4.1%
Risk	12.1%	21.1%	8.1%	4.4%	6.9%	0.3%	
Gulf War							
Return	11.7%	-1.2%	12.5%	12.5%	12.1%	7.0%	4.7%
Risk	19.4%	27.5%	8.4%	3.8%	6.7%	0.2%	

In terms of the Iran conflict, however, investors have had a muted reaction to the headlines. 2019 taught us, it's that you have to try as best as possible to keep to your process and not get caught up in the headlines.

Part of the reason may be purely psychological. Today's investors have seen the stock market recover from both 9/11 and the Great Financial Crisis, arguably the greatest geopolitical and economic shocks of our time. This makes it easier for investors to shrug off other events.

A conflict with Russia can also cause volatile oil markets, as Russia is a key producer of crude oil and natural gas, with pipelines feeding many parts of Europe. If Russia were to shut off the spigot, or have its oil infrastructure damaged, it could lead to higher energy prices. Interruptions to the ports around the Black and Baltic Seas could also create even bigger shipping headaches and lead to food inflation as grains and other staples remain stuck at sea.

The Bottom Line

Over the last few years, markets have been conditioned not to overreact to political and geopolitical shocks for two reasons: first, the belief that there would be no significant subsequent intensification of the initial shock; and second, that central banks stood ready and able to repress financial volatility.

“We continue with our wait and watch. I strongly believe in our process of buying and holding for long term. Should there be an outlier event we will also be nimble to act’’, said Anish Agarwal, Principal Financial Planner, Northstar Wealth Management.

Reference: Investopedia. LPL Financial and CFA institute.

Northstar Wealth Management Pty Ltd
ABN: 83 641 887 149
Corporate Authorised Representative No. 001289121
Governor Phillip Tower
L 36, 1 Farrer Place Sydney NSW 2000
P 0466 181 535
E: anish@northstarwealth.com.au