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Discussion Draft

Managing Geopolitical Risk in Investment Decision-Making

Summary

Financial market wariness of geopolitical risks has risen in 2014. And with good reason. Virtually nothing can slam an economic outlook and investment portfolio more quickly than adverse geopolitical developments.

The post-Cold War bliss has been erased in the shards of 9/11, in the sands of Iraq, in the valleys of Syria, in the mountains of Afghanistan, in the plains of Ukraine, and the seas of East Asia. The perceived backpedaling of the U.S. from its global leadership position has invited multiple entities to pursue enlargement of their influence and even territories. The world geopolitical order appears to be in the midst of yet another vast realignment, with no certain outcomes clearly discernible in 2014.

Recidivist ideological, ethnic, tribal, and religious animosities have been unleashed from time capsules. Ancient boundaries have been re-asserted in the Middle East and East Asia. The supremacy of Western liberal democracy has been challenged. Privacy fears escalate in the face of burgeoning security concerns and the growing abilities of new technologies and big data techniques.

Foolproof geopolitical risk detection and remedies do not exist. The outcome of elections often will surprise as will the subsequent course of policymaking. Coups, fires, hurricanes, cyclones, tornadoes, and earthquakes randomly strike without warning. In a world of 7.2 billion people, an infinitesimally small slither can resort to heinous terrorist activities in an attempt to further their cause. Already, the battlefield of the 21st century has been expanded to include cyberspace. Reminiscent of the Cold War, daily jousting among major powers has become commonplace. These "official incursions" have been supplemented by the activities of rogue hackers seeking to solve mighty cryptographic puzzles and by criminal entities in pursuit of ill-gotten gains. Target, Home Depot, and certain banks are among many firms to have been technologically breached.

This paper defines geopolitical risk in a broad manner, looks at the current and strategic assortment of geopolitical risks, and addresses investment decision-making in light of geopolitical risks.

Introduction

At least on the timing of adverse geopolitical developments, the great American writer and humorist Mark Twain was wrong.¹ There really is a worst time of year: July through September.²

In line with this seasonal tradition, the third quarter of 2014 found the “ISIS/ISIL Caliphate” rapidly absorbing large chunks of Iraq and threatening extinction to non-believers. The cease-fires in Gaza between Hamas and Israel collapsed again and again, prolonging this tragic conflict. Relations between Russia and the West continued to deteriorate as Russian troops massed and then crossed the Ukrainian border, to render “humanitarian assistance” to Russian separatists inside Ukraine. Reciprocal sanctions escalated, with Russia considering a ban on Western airliners’ overflight permission. The international community continues to fret about Iran’s pursuit of nuclear weapons, North Korea’s behavior and intentions, and disagreement over territorial claims in East Asian Sea. Scotland even contemplated a divorce from the U.K. The Ebola virus enveloped more and more African nations threatening to achieve pandemic status. And friends and foes alike ceaselessly patrolled the internet in search of new vulnerabilities.

Most of these adverse situations do not look amenable to instantaneous resolution. This assortment of geopolitical developments may overhang markets for many months and years to come in our opinion.

Brief Tour of Geopolitical Risk History

By their nature, geopolitical events are often sudden and unexpected. On the brink of World War I in July 1914, few if any diplomats, let alone investors, envisioned the end of the Russian, German, Austria-Hungarian, and Ottoman monarchies in just a few years.

The existing World Order, a nebulous concept anyway, proved more fragile than commonly perceived. Massive armies are not needed to trigger geopolitical events. A single individual or a small group can effect history-altering change through assassinations and coups.³

Operating in an adjacent but inter-related realm, capital markets often appear complacent to outright indifferent about geopolitical risks. Again and again, capital markets’ chaotic reactions to familiar geopolitical problems puzzle. Although 9/11/2001 surprised all, Muslim extremists operating in Taliban-controlled territory declared their intent to strike the West in 1996 and 1998, with some form of an attack anticipated by experts. For example, the front cover of Foreign Affairs in the November/December 1999 issue cited two articles, “The Taliban: Exporting Extremism” by Ahmed Rashid and “Kashmir: Fundamentalism Takes Root” by Jonah Blank. And Marshall Goldman presciently commented on “Putin’s Power Grab” in the November/December 2004 Foreign Affairs.

¹ “October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February.” – Mark Twain

² Consider the following examples over the past century: World War I began in early August 1914; World War II started on September 1, 1939 in the European theater; the Korean War commenced on June 25, 1950 (almost July); Iraq attempted to annex Kuwait on August 1, 1990; Boris Yeltsin halted a near Russian coup in August 1991; the Asian Financial Contagion began in early July 1997 (a quasi-geopolitical risk event); and in August 1998, President Clinton’s government was threatened by revelations about his personal conduct, Russia devalued and defaulted, and LTCM collapsed.

³ Gavrilo Princip’s assassination of Archduke Franz Ferdinand and his wife in June 28, 1914 sparked the Great War.

Under different terms, the concept of geopolitical risk has been around for millennia. In ancient Greece, Mediterranean merchants would have been familiar with the risks of trading among different city states. As Marco Polo and his adventurous family knew in the 13th century, the prosperity of traders along the famed Silk Road varied by location. For example, trading practices in Bukhara and Samarkand, now part of modern Uzbekistan, were dictated by local authorities.

As synthesized in Adam Smith's "An Inquiry into the Nature and Causes of The Wealth of Nations" in 1776, economists have long endeavored to seek policies that promote prosperity. Drawing upon this tradition, comparative international economics has been a core discipline of the economic profession for the past three centuries.⁴

Almost two centuries ago, European capital assumed geopolitical risk by helping build some of the 19th century infrastructure of the United States, especially the canals and railroads, and in parts of Latin America and Asia as well.

And economists have regularly crossed directly into the political theatre, perhaps most famously by John Maynard Keynes in his searing critique of the 1919 Paris Peace Conference in "The Economic Consequences of the Peace."

The term, "geopolitical risk," has been bandied around a lot in the wake of 9/11. First coined by the Swedish political scientist, Rudolf Kjellén in 1916, to consider the role of geography in international relations, the term has expanded in the early 21st century, certainly among capital market practitioners, to include domestic political events like elections and policymaking, health crises like SARS and Ebola, and even natural disasters such as hurricanes and earthquakes. The political response to natural calamities can exacerbate (New Orleans' Hurricane Katrina, Japan's Fukushima) or mitigate the after-effects.

Conceptually, GPR is now used in some quarters to describe almost any event where politics or policy might disrupt efficient economic or market function. Acknowledging this progressive conceptual enlargement of geopolitical risk, a better term to characterize these extraordinary, often exogenous shocks, might be Market Exogenous Risks or MERs.

Geopolitical events seep into the markets through multiple channels. For example the propellant of rapid oil price increases is often found in geopolitical events such as regional conflicts in the Middle East (e.g. Arab Oil Embargo, 1973) or episodic deterioration in diplomatic relations between the East and West.

The globalization of the capital markets resumed accelerating after World War II and increased the need for sound geopolitical analyses. By the late 1970s, many equity investors had increased their allocations to non-local markets and firms. And sovereigns began to aggressively market debt beyond their borders. For example, foreign ownership of OECD government debt increased from 10% in 1980 to 41% in 2010.

The end of the Cold War in 1989 sparked the freest movement of people and capital in at least a century and this augmented the need for many businesses and investors to operate in a global context mindful of geopolitical risk. In the spirit of post-Cold War triumphalism, the exciting,

⁴ Even today in the 21st century, much of comparative international economics ignores the real essence of geopolitical risk in the way of wars, crises, and national security. Comparative political economy considers issues like political party impact on economy, but geopolitical risk is usually exogenous in international economics as taught today.

almost intoxicating promise of global capitalism was heralded in popular treatises such as Tom Friedman's "The Lexus and the Olive Tree" (May 2000) and during the 1990s as well as the early Oughts. In addition to raising living standards, the celebrants of global capitalism claimed liberty and democracy as collateral benefits. But as seen in the Asian Financial Crisis of 1997-1998, these rapid capital movements ironically were destabilizing and contributed to heightened geopolitical risk from cultures accustomed to a slower pace of change.

Geopolitical Risk in the Early 21st Century

In his masterpiece, *The Structure of Evolutionary Theory*, the late Stephen Jay Gould argued for the application of his concept of "punctuated equilibrium" to economics and political science (p. 977). The "Global Order" in the Teens now exhibits rapid change in search of the next relative steady state consistent with the theory of punctuated equilibrium.

In the early 21st century, great geopolitical risks abound. Cyber-attacks border on acts of war. Vital natural resources, such as oil and fresh water, are concentrated in unstable areas. Governments and global organizations will have to proceed wisely to avoid conflicts. Like Britain from the Victorian era through the onset of World War I, the U.S. holds a hegemonic geopolitical leadership position. This position carries many responsibilities (e.g., see the Middle East) in an increasingly multipolar world.

The stakes are high. Walter Russell Mead wrote in 2007 "With God on Our Side: American Apocalypse and the Mall at the End of the World," "As the twenty first century progresses, fears of mass destruction and the end of the world will become more prevalent even than during the Cold War. There will be more and more actors capable of wielding more and more weapons of mass destruction."

Mead's not a doomsayer: "Just as the 20th century unleashed good and evil beyond the ability of 19th century humanity to comprehend or cope with, so too the twenty first century will witness unimaginable blessings and horrors. With bodies and even souls remade by the marvels of genetic engineering and the fusion of the biological and mechanical kingdoms, our descendants may inhabit mental and physical universes only dimly imagined today." (p. 25)

The U.S. and key allies may have the means to head off a possibly problematic course in world affairs. But in so doing, the U.S. and like-minded nations must guard against the perception of hegemonic hubris, a concern shared even by some of the staunchest European allies of the U.S. Rather than seeking unilateral solutions, the greater geopolitical good might be better served by improved multipolar cooperation

Geopolitical Risk Analyses

Especially since the late 1970s, the explosion of capital market globalization spawned the formation of sovereign analytical teams by investors, broker-dealers, rating agencies, independent research boutiques (typically operating in either economic, equity, or credit arenas), and specialist insurers. Historical economic, political, demographic, and quality-of-life statistics were parsed.

The 9/11 tragedy in 2001 elevated capital market focus on geopolitical risk. In the aftermath, many capital market institutions privately fretted about the possibility of the deployment of weapons of mass destruction. Little noted, the desire by official economic policymakers to

combat this geopolitical gloom in the early Oughts through generous monetary accommodation arguably contributed to the depth and breadth of the ensuing Great Recession of 2007-2009.

At the top of the global business expansion in the mid-Teens, geopolitical considerations again have moved to the forefront of macro market analysis. Russia's seizure of Crimea in 2014 could potentially reignite the Cold War and rival focus on central bank activities. Exhausted from decade-long engagements in two conflicts, Iraq and Afghanistan, and committed to incapacitating the ISIS terrorist group, a war-weary United States pivots toward the embrace of a world inclined to share the global policing burden.

Geopolitical Risk Biologically and Systemically Inherent

In our Darwinian world, all living things compete and evolve. This fundamental natural law spurs progress. The same process governs the evolution of nations and institutions. In this perpetual contest for winners and losers, competitive tensions will surface.

According to the United Nations, 193 nations span the globe in the early 21st century. An even greater number of political ideologies and religious beliefs shape the conduct of nations, institutions, groups, and individuals.

Disagreements among distinct factions regularly occur. On the nation level, such disagreements can spark diplomatic rows and even ignite armed hostilities. On the group level, societal outliers may express their ignored opinions through terrorist actions.

Given the large set of competing opinions, high-tension hotspots almost continuously exist somewhere in the world. Fortunately, most of these hotspots are relatively small and have little effect on even local economies and markets. But with disturbing frequency, more substantive tensions may spill over into regional and global markets approximately every several years.

Overlaid on this turbulent geopolitical landscape, shifting demographics present a challenge. Populations in many developed countries are shrinking or growing at low rates. Meanwhile, the developing world from Africa to the Middle East to South Asia is experiencing population explosions. The maintenance of stability in the face of rapid population growth has historically proved difficult and probably is too much to hope for in the best of circumstances in many of these areas.

Despite the chronic threat of sudden disruption, many capital market practitioners regard geopolitical risks as interesting but unavoidable fuzzy background noise. The disciples of this hands-off approach argue that even national intelligence agencies frequently fail to anticipate major geopolitical shocks. Other than to discard negatively-affected sovereigns and their main debt and equity issuers, clear portfolio doctrine-avoid has not been devised on how best to cope with geopolitical risks. Moreover, institutions less inclined to actively follow geopolitical risks argue that even semi-efficient markets largely price in geopolitical perturbations. In their view, compelling anticipation and post-event reactionary strategies may not exist. Our accompanying figures suggest there may be some reason to revisit that position.

There has been little formal consideration of geopolitical risk in the Journal of Portfolio Management, Financial Analysts Journal, or the Journal of Finance. And yet, the commonplace eruptions of geopolitical risk often affect markets and portfolios.

Despite similarities, no two business cycles are perfectly congruent. The excesses of systemic financial leverage, partially manifest in novel and imperfectly-designed structured products that catapulted the global economy into the Great Recession of 2007-2009, unlikely will serve as the main tripwires for the next major world economic contraction in our view. As this young 21st century unfolds, geopolitical risk ascension seems more likely to become the next economic derailment.

In our opinion and even without impossible-to-attain perfect prescience, close attention to geopolitical risks can improve portfolio performance and mitigate overall institutional sensitivity to adverse market outcomes.

Portfolio Policy

Governments, institutions, and individuals can do much to mitigate their exposure to geopolitical risks by embracing the following suggestions;

- 1. Formalize geopolitical risk consideration:** If heads of state can begin each morning with a review of geopolitical risks, then the consideration of such risks should be on the agenda of every weekly investment committee and risk committee.
- 2. Regular business continuity plan reviews:** Thirteen years after 9/11, some organizations only circulate group contacts and provide limited information on alternative worksites.
- 3. Event Contingency/Scenario Planning:** Although exact events are not forecastable, generic classification characterizations can be devised. For example, the consequences of a dirty radiological bomb detonation in proximity to a major equity exchange should be well understood.
- 4. Monitoring:** As always the case in the knowledge industries, the efficacy of a geopolitical risk mitigation program hinges mainly on the quality of the staff devoted to this crucial task. Their modus operandi should be: read; visit; analyze; and network. Despite their fine quality, cutting-edge geopolitical risk evaluators will not be content to merely read and watch the financial media. And while incrementally helpful, the additional coverage afforded by subscriptions to geopolitical risk services and even rating agency sovereign analysis will be insufficient. There is no substitute for regular visits by “boots-on-the-ground” investment decision-makers. The random man/woman interviews in the street can sometimes shed unique light on local economic and political conditions. Geopolitical risk teams must also network into the political, economic, corporate, and investor habitat of the local market under study. Numerous think tanks serve the international community. And many local intelligence agencies willingly provide overviews upon request.
- 5. Maintain portfolio diversification:** Usually a good idea anyway, diversification can also help protect a portfolio from geopolitical risks as crises or events usually weigh on specific markets or assets. Oil, gold, and bonds often rally as risks elevate. Diversification offers an additional advantage as uncertainty rises. Geopolitical events often generate binomial or bifurcated market predictions as the outlook with and without a geopolitical event can vary widely. A typical mid-cycle prediction and allocation would call for an overweight in risky assets like equities and an underweight of fixed income as interest rates presumably rise. This perfectly reasonable call could turn out to be completely wrong should a significant geopolitical event unfold as investors look for safe assets. The understanding of how escalated geopolitical tensions might impact current predictions is a primary technique to manage risk. There are no immutable rules about

how investors should build in defensive diversification, or when to do so. In part, the solution depends on particular investing strategies and goals, but geopolitical risks should be part of any discussion on diversification.

6. **Variable reaction function by asset class/time:** Like acts of nature, geopolitical shocks vary widely in intensity. Although horrific, a terrorist bombing that tragically inflicts dozens of casualties cannot be ranked in the same magnitude as the onset of a major war that affects millions. Events that are localized are less likely to spillover to global markets, but there can be significant moves in the relevant local asset classes. Markets often price in geopolitical events over days or weeks, following an initial reaction. In part, this is driven by the information flow, when there is less available at the outset. As information becomes available, markets re-price the risk and target the assets most likely to be impacted. This provides active or short-term managers opportunities on both the down- and up-swings. Long-only and long-term investors may be able to benefit from defensive positioning and the opportunity to acquire undervalued assets.
7. **Psychological reluctance to capitalize on GPR events:** Another example of behavioral economics influencing market activity and decision-making. A study published in The Journal of the American Medical Association in 2002 found that Americans, even those not directly impacted by the attack, could take six months or more to cope with a national traumatic event like September 11. Anecdotal evidence suggests that investors who were short the market on 9/11/2001 reported feeling regret for profiting from the disaster. While many market participants try to avoid losses as geopolitical events weigh down markets, profiting is often a different matter. Inertia is a powerful force that can prevent market participants from adding or shedding risk at the right time. Nonetheless, some of history's greatest investors did just that. Nathan Mayer Rothschild, who funded the British government during the Napoleonic wars, received news about the Battle of Waterloo a day before official channels and was granted permission to trade on the information. J.P. Morgan, whose career began in the early 1860s by cleverly speculating on Union military needs during the American Civil War, also profited from buying assets cheap while helping bailout the U.S. government during the Panics of 1893 and 1907. But, these are exceptions.

Framework for Managing Geopolitical Risk in Investment Decision-Making

Four Dominant Themes

- Search for New World Order
- Globalization versus fragmentation (Quebec, Scotland, Venice, Catalonia, California, Texas, Alaska, Silicon Valley)
- Return of multipolar system with reduced American global footprint
- Proliferation and accessibility of weapons of mass destruction

Definition of Geopolitical Risk for Capital Markets

- Putting the "Political" back in front of "Economy": It's back to "Political Economy" and time for "Geopolitical Economics"
- Modern capital market connotation of geopolitical risk: any international event (incident, war, threat of war, disruption of major trade flow (oil), revolution, terrorist action, coup, assassination, health crisis) that adversely affects global commerce and capital markets
- Sharper definition: "sudden geopolitical shocks" vs. long-term strategic
- Realignments - end of Cold War and this unfolding "Clash of Civilizations"

The Late 20th/Early 21st Century View of Geopolitical History

As the late U.S. Ambassador Richard Holbrooke to the U.N. noted:

- First half of 20th century will be remembered for defeat of fascism
- Second half of 20th century will be recalled for defeat of communism

So too, we believe that:

- First quarter of 21st century, and hopefully in less time, will be recalled for the containment of terrorism and political turbulence in the Middle East, resolution of East Asian tensions, rise of BRIC nationalism

A Longer View of Geopolitical History

- Technology and information have accelerated the pace of world history
- Geopolitical specialists grapple with defining this new era
- Fukuyama's *The End of History* (1989)
 - History follows universal reason
 - Horizontal analyses looking at the forces operating across all regions
 - Era where Western liberal democracy is recognized as best form of government
- Huntington's *The Clash of Civilizations and the Remaking of World Order* (1996)
 - History flows from "irrepressible conflicts and irreconcilable logics" (see latest Hamas/Israel conflict in Gaza in 2014)
 - Vertical analyses of world politics, shaped by region and culture
 - Cultural differences will persist and conflicts will continue to occur along those fault lines
- Mead's *With God on Our Side: American Apocalypse and the Mall at the End of the World*
 - Proposes a third way, an integration of the Fukuyama and Huntington theses
- Yergin and Stanislaw's *The Commanding Heights* (1998)
 - Proclaims political triumph of free market ideology over statist economic models in the last quarter of the 20th century

Incidence of Geopolitical Risk: 1900-September 2014

The 1990s Were an Atypical Calm Exception; Commonplace Historically

- For global capital markets, major geopolitical event occurs about once every decade and a half: World War I (1914-1918); World War II (1939-1945); Korean War (1950-1953); Cuban Missile Crisis (1962); Vietnam War (1965-1973); Arab Oil Embargo (1973); Iranian Revolution (1979); Gulf War (1990-1991); 9/11/01; Afghanistan War (2001-2014); Gulf War II (2003-2011)
- Minor incidents are more frequent, a sample includes: Berlin Blockade (1948); Hungarian Revolution (1956); "Suez Crisis" (1956); "Cultural Revolution" in China (1965); Soviet tank invasion of Prague (1968); Pueblo incident (1968); Watergate denouement (1974); U.S. hostages in Tehran (1979); U.S. invasion of Grenada (1983); U.S. invasion of Panama (1989); Tiananmen Square (1989); potential Russian Coup (1991); World Trade Center Bombing (1993); Chinese missile testing over Taiwan (1996); India and Pakistan nuclear testing (1998); bombing of *USS Cole* (2000); U.S. reconnaissance plane in China (2001); revolutions in Eastern Europe (2002-2004); Bali nightclub bombing (2002); Madrid train bombings (2004); London subway/bus bombing (2005); Trios of Hurricanes led by Katrina (2005); North Korea conducts nuclear test (2006); Bagram U.S. Air Force

base attack in Afghanistan (2007); South Ossetia incursion (2008); Mumbai LeT attack (2008); “Arab Spring” begins (2010); Wikileaks (2010); Syrian Civil War begins (2011); Earthquake and Fukushima meltdown (2011); “Occupy Wall Street” movement (2011); Benghazi attack (2012); Hurricane Sandy (2012); French intervention in Mali (2013); Boston Marathon attack (2013); Snowden NSA leaks (2013); Egyptian coup (2013); Syrian chemical attack (2013); Ebola outbreak begins (2014); Ukraine/Crimea (2014); extremist insurgency in Iraq (2014); potential Iranian nuclear deal (2014) (1983 marine barracks bombing in Lebanon, Oklahoma City domestic terrorism, bombing of Marrakesh market in 2011, Nigerian abduction of girls in 2014, Kenya mall (September 21 to September 24, 2013) and U.S. embassy (August 7, 1998) in Nairobi, Kenya, and almost too numerous to count, near daily bombings in Iraq and Afghanistan)

- Expect higher frequency of geopolitical events in a more integrated world of 193 U.N. member nations

Major Geopolitical Risks: 2014-2024

Dispute Framework: *“Old” Problems, “New Old” Problems, “New” Problems*

“Old” Problems

- Liberal capitalism, with attendant “creative destruction” or kinder “socialist recidivism”
- Religious tolerance or “Clash of Civilizations”
- Lack of compromise among sovereigns and ideological factions
- Corruption
- Global health issues and pandemic threats
- Demographics

“New Old” Problems

- Climate change
- Role of terrorism as a tool to engender geopolitical change
- Political and economic convergence to regional aggregates (Eurozone) or nationalist-fueled unraveling into smaller units (Balkans)
- Shift in the global balance of power
- Distributionist policies: trade, technology, information, healthcare, wealth
- Modernization of Bretton Woods institutions: World Bank and IMF
- Radical Muslims struggle to renew the Arab world through conflict with the West

“New” Problems

- Proliferation and potential use of weapons of mass destruction
- Reduced barriers to substantive terrorist operations thanks to technology
- Reduction in the efficacy of nation-state borders due to the enormous trade, information, and population flows increased by economic globalization
- Cyber sabotage
- Genetically-modified food
- Intellectual property rights

Regional Risks

East Asia

- Rising influence of China; its political/economic stability; Taiwan question; territorial and resource ambitions
- Japan's economic recovery and potential veer to nationalism
- Korean unification; North Korea activities and nuclear program
- Religious extremism, terrorism, and insurgencies
- Indonesian unbundling
- Singapore's role

South Central Asia

- India/Pakistan conflict potential
- Pakistan's nuclear weapons and proliferation risk; violent extremism within Pakistan
- Economic liberalization vs. traditionalism
- Afghanistan's stability post-2014 U.S. withdrawal

Middle East

- Arab Spring aftermath
- Resolution of the Palestinian question
- Iraq: survival or fragmentation; ISIS/ISIL
- Syria: civil war and risk of an extremist state (Caliphate) spilling into Iraq
- Iran: moderation of theocracy and resolution of nuclear issue
- Future of Saudi monarchy, Egypt, Jordan, and other "moderate" Arab states: a turn toward the West or fundamentalism
- Potential power vacuum should the rogue Middle Eastern states implode: Iran, Libya, Syria
- Turkey: stability; West or East
- Increasing intra-regional terrorism risks
- Proliferation and risk of regional arms race

Europe

- Expansion of the EU; possibility of British exit from EU
- Economic integration offsetting political differences vs. rejection of capitalism and embracing of populist economics and right-wing politics
- Support current U.S.-based order or advocate for new global order
- Russia's role: domestic social and economic stability amid resurgent nationalism and uncertainty about ultimate aims
- Separatist agitators: Basques, Ireland, Balkans, Catalonia, Venice, Scotland
- Future of NATO

Latin America

- Democracy, capitalism, populism, or authoritarianism
- Mexico: risk from transnational criminal organizations, corruption, and extent of reform
- Argentine devaluation/default redux
- Venezuela: which political model
- Brazil: which political model
- Columbia: making progress with insurgency and economic reforms

Africa

- Mainstreaming the “lagging continent”
- HIV epidemic and Ebola outbreak
- Will the wealth, health, technology, and education divide narrow or widen
- Addressing “state failures”
- Terrorism risks in North, East, and West Africa

North America

- Will the U.S. amend its superpower role by taking either a unilateralist or multilateralist route
- Polarization of domestic politics
- Immigration and issues along the Southern border
- Continued U.S. activist role in fining foreign banks
- U.S. domestic energy renaissance amid outdated infrastructure
- Vulnerability to cyber-attacks

Geopolitical Risks Contribute Directly to International Financial Crises

- Between 1980 and 2000, the Council on Foreign Relations reported that at least 125 countries experienced some banking problems, with half becoming insolvent (*“Financial crises are nothing new. In the past 20 years alone, more than 125 countries have experienced at least one serious bout of banking problems. In more than half these episodes, a developing country’s entire banking system essentially became insolvent.”*)
- Global interconnectivity has never been higher. World exports represented 20.9% of global GDP in 1980, 18.3% in 1990, 24.1% by 2000, and 31.3% in 2013
- Global economic system racing to incorporate quickening technological changes will frequently fall on the cusp of deflationary excess supply - a natural breeding ground for political instabilities

Decision-makers, perhaps guided by their subscriptions to country risk rating services, assign probabilities to the menu of geopolitical risks. In the past, most experts have made up “subjective” or “heuristic” risk probabilities for quantitatively-inclined clients. These euphemisms cannot camouflage the “back-of the envelope” nature of such “probability inventions.”

For example, the probability of Korean unification looks high (80%-90%) over the next 25 years. But the when or how cannot be stated with any precision. Users should be cautious of such probability inventions. The temptation to rely on such probability figures can engender complacencies. As often learned the hard way, the sudden emergence of low-probability events can be far more unsettling than the occurrence of a perceived high-probability event. Think independently, view all risks as high, and be ready for the unexpected.

Major Potential Geopolitical Risks as of September 2014

Although comprehensive, the following list of geopolitical risks cannot cover all the possibilities. In the same vein as black swan risks, some geopolitical risks, by definition, are unknowable in advance. Moreover, the configuration of risks will change through time.

1. **North Korea:** This rambunctious, de facto vassal state of China occasionally reaches outside of its self-imposed cloister to pursue international aid in exchange for another round of broken promises to behave like other nations. Three main scenarios face the “Hermit Kingdom”: reunification with South Korea; escalation of belligerence and the sale of arms, including weapons of mass destruction; and status quo. In our view, the status quo scenario seems most likely.
2. **China – Japan:** China has pursued a military buildup to reasonably reflect its rising status in the world. Japan has benefited from a strong alliance treaty with the U.S. limiting its military to modest self-defense capabilities, but that is changing. Historical animosity and current disputes in the East China Sea raise the probability of a misstep. Three likely outcomes: Status quo with rising tensions; low-level or field-command military decision increases the likelihood of conflict with the U.S. stepping between; an incident leads to rapid escalation and naval conflict. While status quo is most likely, an accidental low-level military incident is an increasing risk.
3. **China – Southeast Asia:** China is a critical trading partner for the nations of Southeast Asia, creating a sense of reassurance and worry simultaneously as China’s regional power increases. China claims sovereignty over the South China Sea creating tensions with others in the region. Possible future trajectories include: China successfully uses its regional influence to secure its goals without violence; small-scale sea skirmishes increase potentially followed by economic sanctions or embargoes; diplomatic agreements pave the way for sharing resources; status quo persists with disputes left unresolved with occasional small skirmishes. The most probably outcome is that China will achieve its goals using influence, though tensions will persist.
4. **India – Pakistan:** These South Asian nuclear neighbors fought three full-scale wars (1947, 1965, and 1971). The Kargil War in 1999 entailed Indian military response to alleged infiltration by Pakistani troops across LOC (line of control) into Indian Kashmir. Border skirmishes are common. Kashmir remains a source of contention. Nuclear deterrence nullifies superiority of Indian armed forces and reduces the chances of an overt conflict. Possible further deterioration of internal security in Pakistan could be an issue given the country’s nuclear capability. Status quo most likely outcome, but extremist ideology in Pakistan and existence of violent sub-state groups like Lashkar-e-Taiba could play the role of spoiler at any time.
5. **China – U.S.:** Perhaps the most-important bilateral relationship in the world. The U.S. and China linkage is best characterized as stable, punctuated by moments of great power friction. The two countries have constructive dialogue on many issues, but tensions remain over cyber activities, Taiwan, currency, climate change, China’s naval buildup, and human rights issues. The friction points most likely to spark military conflict include disagreements over Japan, Taiwan, and cyber activities. Neither country is eager to confront the other, so China-Japan tension will remain a source of uncertainty, China will continue using economic tools to bring Taiwan into its orbit, and the real wild card is the possibility of intentional or unintentional cyber catastrophe.
6. **Taiwan:** The independently-governed territory is a thorn in China’s side, a democratic partner to the U.S., and the issue that could still trigger a direct conflict between U.S. and China in the Straits. Taiwan has a solid economy, and the population has a strong tendency to elect free-market leaders occasionally antagonistic to China. China has focused on building economic ties in the hope of peacefully regaining the island in the future. We believe that the Chinese will continue along this strategy for some time to come. Other courses remain possible: Taiwan could antagonize China into launching either a cyber or military strike; China could lose patience with the economic strategy and turn to other measures; the U.S. decides to provide military assurance to Taiwan, which

would be antagonistic to say the least. While this is a major global fault line, the outlook is status quo for now.

7. **Thailand:** The perpetual coup grinds on. After experiencing a coup in 2006, political crises from 2008-2010 and 2013-2014, and another military coup in 2014, Thailand's political system is fragile at best. Once viewed as a rising star in Asia, political challenges have dealt economic setbacks amid uncertainty. The military junta has shown pro-business leanings, but the political instability and potential for rapid leadership transition remains a challenge. There is also an active insurgency in the south of country, which is both poor and Muslim. Thailand could once again become an exciting international market, but significant political reform would be a welcome precursor.
8. **Indonesia:** Largely perceived as an emerging-market success, Indonesia has experienced economic growth and political stability. The country successfully countered the Jemaah Islamiyah terrorist threat, though separatist movements in the provinces of Aceh and Papua continue to present risks. Indonesia recently elected a new president, and reforms may lie ahead. Like many other countries, Indonesia may face renewed violence as foreign fighters return from Syria like when they returned from Afghanistan two decades ago. The outlook is stable though regional troubles elsewhere in Malaysia or Thailand could upset that prediction.
9. **Saudi Arabia:** Saudi Arabia's ruling regime leverages its natural resource base while managing internal social-cultural tensions, and pressure on either side could disrupt this balance. The country regularly confronts violent extremist threats emanating from within and outside its borders and faces a rival with growing regional ambitions in Iran. U.S.-Iran nuclear discussions potentially aggravate Saudi Arabia's security concerns. While Saudi Arabia is likely, in our view, to sustain its current course domestically and internationally other options include: major internal threat challenges ruling regime; increased tensions with Iran over Iraq and Syria drive a move from proxy conflict to direct confrontation and possibly an interest in building a nuclear capability; alternatively a U.S.-Iran nuclear deal drives Saudi Arabia towards further liberalization. Growth of an extremist state in Syria/Iraq also presents risk as Saudi rulers and energy infrastructure could be regional targets.
10. **Iran:** Perennial pariah of the international system may come in from the cold. Deep disagreements persist in the U.S.-Iran nuclear negotiations, but discussions continue. Resolution is likely to shift markets drastically in one direction or another. A nominally successful nuclear deal could gradually bring Iran (and its oil) back into the global economy. Failure would mean possible action against nuclear facilities becomes more likely in the future. Embroiled in the Iraq and Syria conflicts, Iran finds its interests with the U.S. allied in Iraq and opposed in Syria. Growing cyber capabilities also raises flags, as does the extensive Iranian threat network of Quds force and Hezbollah established to carry out attacks and facilitate financial transactions anywhere in the world. Internal meltdown of Iran seems unlikely soon; support of allies in Iraq and Syria increases likelihood of larger regional confrontation; equal odds on success and failure in nuclear negotiations.
11. **Iraq:** Holding together by a thread of nationalism, but more resilient than some might have predicted. The dissolution of this artificially contrived state into three components looks increasingly likely, but the pathway to that outcome remains uncertain. Iranian and U.S. attempts to roll back and degrade insurgents in the North could bring back an unstable status quo, reducing the likelihood of exit opportunity for Kurds. Continued success of insurgents in North Iraq and Southwest Syria would make return to status quo unlikely and leave a new controlled extremist state controlled by the Islamic State in the Levant (ISIL) in historically ungoverned territory. This would be frightening to almost all in

the region. Odds of holding together exceed breakup, but moving towards later. A major terrorist attack in the West emanating from Iraq could alter this trajectory.

12. **Syria**: Syria's civil war remains the fulcrum of the Middle East's future in many ways. Success of insurgents in Syria directly contributed to their recent insurgent success in Northern Iraq. Foreign fighter inflows also disconcerting globally as outflows present security risks. Assad regime has weathered the onslaught in part with help of stalwart allies Russia and Iran. Tide maybe turning back towards Assad as search for stability trumps freedom. Complicated set of outcomes include: complete stabilization within existing borders; partial disintegration separating Druze, Kurdish, Sunni, and Shia parts; complete overthrow and drawn out civil conflict. Partial disintegration with civil violence in the east seems likely with spillover effects in Jordan, Lebanon, and Turkey.
13. **Gaza**: Confrontations between Israel and Hamas are unfortunately regular occurrences. Challenging human rights situation and the international community appears stunned by Hamas' use of aid in its military pursuits. Possible resolutions: 5-10 week campaign followed by unilateral Israeli ceasefire; extended conflict as both sides seek upper hand potentially ensnaring regional powers; negotiated ceasefire through Egypt or the U.S. Reconstruction aid remains a questions mark, but a short conflict remains likely outcome.
14. **West Bank**: Palestinian Authority (PA) retains control of West Bank and has opted for a different strategy than Hamas in Gaza. Leadership in West Bank finds itself nonetheless in precarious situation. To gain credibility in Gaza, and potentially weaken Hamas, the PA must side with Hamas against Israel. While this chills Israel-PA relations, it is unlikely that violence spreads to West Bank on current path.
15. **Gulf States**: Greatest geopolitical risk from these major oil producers comes from inside their borders. Tensions between conservatism and modernism could exacerbate rifts that put ruling regimes in jeopardy. Countries like Oman, Bahrain, and Kuwait have already experienced civil protest. Modest changes in government followed. Rise of mini-financial hubs also bring tensions with Western governments on regulatory issues, which could impact markets and assets. Status quo remains the likely outcome, but possibility that one or more countries falls to more extremist populist movement should not be discounted completely.
16. **Yemen**: Country represents collision of resource scarcity and extremist ideology. Lacking the resources of Gulf neighbors, Yemen most importantly lacks water. This is one of the arenas where resource battles might begin playing out in short order. On top of that, local al-Qaida branch (AQAP) represented the greatest threat to U.S. homeland until recently. They also target Saudi Arabia. No stranger to civil war, Yemen's resource issues and extremists could generate spillover effects for Saudi Arabia and Gulf States.
17. **Egypt**: After three years of protest, unrest, democratization, rioting, and civil strife, Egypt is calming under President Sisi. Much rebuilding of economic and social-cultural foundations lies ahead. Big question is whether current leadership, adopting a more centralized approach to government, will have enough time to carry out plans before the already mobilized population loses patience. This means real risks persist in Egypt.
18. **Libya**: Quasi-failed state is awash with warlords, militias, and weapons. Oil might be flowing, but many western energy companies sold their interests given risks and instability. Any governance and reconstruction effort has much work ahead. The fate of Libya: persist as current quasi-failed state; disintegrate further; militias agree to ceasefires and negotiation with temporary government. Status quo likely persists, but real threat comes from spillover effects as arms flow across borders to Algeria, Egypt, Sudan, Tunisia, and Southern Europe.
19. **Turkey**: This NATO ally is in an increasingly tight spot with violence to the south, refugee flows, and a potentially weakening economy. Political arrangement that dominated for

decades with Turkish military as defenders of secular democracy has been undone in recent years. The authoritarian PM Erdogan will likely be the first popularly elected president on August 10, 2014. Political and economic stability will face continued and new challenges. After failed EU bid, Turkey struggles with the decision to focus its future westward (Europe, U.S.) or eastward (Middle East and China), while grappling with contravening forces of conservatism and modernity. Collision of ideologies will deepen the polarization in the society potentially triggering anti-government protests. Outlook is highly uncertain given internal tensions and the black hole of Syria to the south.

20. **Nigeria**: The largest economy in Africa, a major oil exporter (#5), faces significant rebellion in the north. Boko Haram, the primary insurgent player, has shown capability and willingness to attack urban and energy targets, but most activities are focused elsewhere to include the kidnapping of 300 girls. It is unlikely that the insurgents can either overturn the government or breakaway, but making life miserable and disrupting economic flow may be a long-term strategy for the insurgents.
21. **Sudan**: An ongoing human rights challenge has constrained ability of natural resource-rich Sudan from participating fully in global economy. Violence levels have remained at a high level since 2011 following the Southern Sudanese independence referendum. Prior periods of violence in Sudan have normally ended in exhaustion, and this is likely to continue along the same lines.
22. **Somalia**: This failed nation state, breeding ground for terrorism and piracy, must be coaxed into formation of a reasonable government. The country has already split, with the semi-autonomous territory of Somaliland governing competently in the north. The primary al-Qaida linked insurgency successfully recruiting dozens of westerners to include U.S. increasing risks of homeland attacks. Violence in Somalia has spilled over into neighboring countries Uganda and Kenya in recent years, with incursions becoming more frequent. There is little evidence that Somalia will break out of its current cycle soon.
23. **Sub-Sahara Africa**: The realization of great economic promise collides with corruption, environmental, demographic, and cultural constraints. Tremendously large geographic expanse with young population and limited employment options as source of conflict going forward. Dividing line between North Africa and Sub-Sahara increasingly challenged as smuggling networks, violent ideologies, people, and weapons flow back and forth. Kidnap for ransom is also a problem in parts of Northern and Sub-Sahara Africa. The old regional construct breaks down as east, west, central, and south face significantly different challenges. Bright spots exist, but risks persist.
24. **Russia**: The seizure of the Ukraine's Crimean territory rekindles memories of the 1930s. Vladimir Putin has successfully controlled government since 2000, and could constitutionally do so for another 10 years. Tail end of tremendous extractive industry-fueled economic growth, providing leverage over Western Europe through the energy sector in particular. Sub-state issues like organized crime and cyber activities also create tensions. Potential future flashpoints include the Baltics, Middle East, and central Asian states. Sanctions against Russia, of limited impact so far, may remain modest. Tail risk in Russia exists should sanctions really bite (targeting business operations or ownership), but seems unlikely beyond U.S. imposed sanctions. Likely outcomes: Putin recognizes long-term tensions unproductive and relents; Russia seeks negotiated settlements on outstanding issues without triggering crisis; continued use of violence, nationalism, and economic coercion in pursuit of state goals. We hope to be wrong, but expect more of the same despite recent Eastern Ukraine negotiations which may be way of creating time and space to reinforce insurgents.

- 25. Ukraine:** New tinderbox of Europe is full of contradictions. Ukraine's history since the end of the cold is clouded in organized crime and corruption; making NATO membership unlikely anytime soon. Russia's land grab in Crimea and Eastern Ukraine puts West in precarious situation. Possible trajectories include: status quo marked by continued fighting in eastern Ukraine with Russians on the borders; an escalation whereby Russia claims intervention is necessary given humanitarian concerns or the absence of Ukrainian control; energy starved Europe come winter coalesces to Russian will in Ukraine; Russian led peace negotiations to include financial compensation for giving up eastern Ukraine and Crimea. Without further Western intervention, it will be difficult for Ukraine to hold together, but we believe that Russia may hasten this outcome with direct intervention as they appear to be searching for justification. The West's response has been modest and focused on sanctions thus far. We believe this will continue, as will the crisis, for some time.
- 26. Baltic States:** Although these nations are members of NATO, Russia may seek to restore part of its "near abroad" in former territories with ethnic Russian populations. This would represent Russia's greatest direct challenge to the West, and leave the West with a stark set of choices. It is less likely that Russia would target the NATO allies while Ukraine remains unsettled, though not impossible if Russia believes it provides additional leverage. The U.S. has committed additional military spending to the Baltics as a warning signal. While the threat to the Baltics is likely to persist as a threat rather than materialize into a reality for the medium-term, the trajectory of the crisis in Eastern Europe suggests that unfortunately anything is possible.
- 27. Poland:** Strategic player centrally located at the crossroads of Eastern and Western Europe is established as a Western nation, perhaps to the chagrin of those in the east. Immediately after the fall of the Soviet Union, Poland transformed the Communist Party headquarters into the stock exchange. Already a well-regarded NATO ally after meaningful contributions to the Afghanistan campaign, Poland's recent decision to condemn Russia's move into Ukraine drew sanctions against Polish fruit imports to Russia. Geopolitical risk is generally towards the positive side; but Poland could face pressure from an increasing disagreement with rejuvenated Russia.
- 28. Western Europe:** Modern liberal democracy clashes with Islamic fundamentalism in certain nations like France and the Netherlands. The scars of the Great Recession have persuaded certain U.K. political elements to consider a national referendum to leave the European Union. Voters in Scotland, Venice, and Catalonia have expressed independence desires. Meanwhile, the strategic continuity of the euro currency cannot yet be fully assured given disconcerting structural unemployment, especially for youth, and the rightward nationalist tilt of some sovereigns like France.
- 29. Hungary:** Like some others that attempted to transition towards liberal democracy and capitalism following the fall of the Soviet Union, Hungary remains in a sort of limbo. Leadership seems to prefer following a Russian course, partially rejecting liberal capitalism. Policies that include price caps and sectoral taxes are hurting the business community, and the possibility of nationalization remains a possibility. Hungary could change course and move towards liberal capitalism, but trajectory change appears unlikely soon.
- 30. Latin America:** Competing ideologies of capitalism and socialism collide with nationalism and populism. Debate over governance models and values continue as the region charts a course for the future. Major regional conflicts, such as Brazil-Argentina, are contained as the region focuses on domestic politics. Risks from transnational criminal organizations (TCOs) in Central America remain palpable as violence, largely tied to narcotics trade, remains high and the financial system finds itself in a precarious

situation. Members of former Peruvian socialist terrorist organization Sendero Luminoso, who mounted a decade-long violent insurgency, are completing their prison terms and getting released. Kidnap for ransom in some countries remains a concern. Likelihood of major incident in the region remains low, but corruption and violence tied to TCOs and domestic political uncertainty will continue to limit economic growth and generate risk for individual countries and markets.

31. **Mexico:** The tale of two states. On the one hand, Mexico is a thriving emerging market with sound economic fundamentals and tremendous growth opportunity, due in part to geographic proximity with the U.S. On the other hand, it is a society plagued by narco-violence and systemic corruption, due in part to the drug flows up to the U.S. Squaring the contradiction is challenging. While violence levels have dropped with the new administration, the TCOs remain deeply entrenched. The country is focused on internal growth and reforms, but criminal elements persist and strengthen. Mexico may well be able to meet the internal challenges to security and governance with time, but risks of resurgent violence and internal turmoil remain. Good expected to outweigh bad, but bad provides meaningful tail risk.
32. **Brazil:** Vibrant country with potentially bright future, challenged by populist politics that make market-oriented reforms difficult. Brazil has experienced riots in both 2013 and 2014, triggered by policies ranging from World Cup spending to train fare. With the upcoming Presidential election on October 5, 2014, more riots are possible in the short-term. Dilma Rousseff's reelection is likely, unless some major event shifts the political winds. Over the long-term, the populist politics will continue generating headwinds. A sharp turn to socialism, while possible, remains unlikely as the benefits of free-markets and foreign capital proves powerful. Nuclear weapons ambitions and arms race with Argentina ended in 1991, and relations have been positive since. Status quo is most likely.
33. **Argentina:** Plagued by ongoing issues tied to the debt default in 2002, country remains on the outskirts of the global markets. Despite the constraint, Argentina has weathered the storm and brighter days probably lie ahead. Like others in the region, populism, socialism, and capitalism will continue to clash in the domestic political sphere and there is always the possibility of disruptive riots. Debt deal and economic reforms would be a positive shock to geopolitical outlook, and continued failure to resolve the issue would be viewed negatively.
34. **Colombia:** Turning point seems to have arrived after a multi-decade long struggle against insurgents and narco-traffickers. While Columbia still has work ahead, its law and order intelligence-led campaign has spawned positive results. Rebuilding and governance policies seem to be taking hold, potentially setting the country on a positive trajectory. Nonetheless, risks to the downside remain with a potential resurgence of FARC or narco-militias and a strand of socialist ideology that advocated violent resistance. Kidnap for ransom remains an issue, though declining, and that will deter some foreign investors. U.S. aided in Columbia's turnaround and should remain a strong supporter if things turn in the wrong direction. Downside risks remain, but geopolitical events point towards the upside.
35. **Venezuela:** Perhaps the greatest challenge in South America, as the exit of Hugo Chavez has not brought the rapid policy change some expected or hoped for. Chavez's 21st century socialism plan has not really borne fruit and dried up much of the foreign investment that was left in the country. Plagued with a series of problems to include violent crime, politicized military and police, weak government institutions, and an overreliance on the petroleum industry. Much of the geopolitical risk exists to the upside as any political action would likely be aimed at removing the current government. Despite

economic weakness and systemic issues, current government seems relatively well situated. Status quo remains likely outcome to almost everyone's detriment.

36. **Cuba:** Castro regime of almost 60 years will pass after outliving the terms of 10 U.S. Presidents. Despite political rift with the U.S., Cuba has remained a destination for European and Canadian travelers, so not entirely closed off to the world. Economy remains relatively underdeveloped and agrarian, but that could change rapidly if Cuba begins a process of liberalization and reformation. The transition would likely be slow and managed, which might be the best course of action after 60 years of socialist rule. The geopolitical risk points to the upside, but liberalization also raises the possibility of riots and populist politics. Our bet is that Cuba will be a good news story given the tourist money and investment likely to enter the country, but our view is far too early to tell for sure.
37. **United States:** Porous southern borders and domestic political extremists could produce a series of low-level shocks. War-weary population increasingly hesitant to play an activist role in global affairs. Vulnerability to cyber-attacks, particularly the electric grid and financial centers, remains a significant concern. Small groups will continue to advocate for the succession of certain counties from their parent state (e.g. California) and even the succession of Alaska and Texas from the United States. Privacy, climate change, healthcare, role of sovereignty, immigration, gun control, and other issues will continue to polarize politics.
38. **Al-Qaida, Offshoots, and Associated Entities:** Temptation to declare victory of al-Qaida after the death of Osama bin Laden was strong, but would have proved premature. The violent ideology he advocated and the groups that grew out of his enterprise remain the stone in the global community's shoe. An attack can happen virtually anywhere at any time, and this gets the attention of highest government officials around the world. Rather than recede, the number of groups has metastasized since 2010. Al-Qaida and offshoots exist in Afghanistan, Algeria, Iraq, Libya, Mali, Mauritania, Pakistan, Somalia, Syria, and Yemen. Adherents have come from over 100 countries. While the ideology and associated organizations has done well in the wake of the Arab Spring, the threat against has ironically receded slightly. Political turmoil opened up space for the organizations that operate locally, often referred to as focusing on the near enemy, and so emphasis on far enemy (U.S. and Western Europe) is less relevant. Markets have generally priced in modest terror risk, but large attack or an attack with a weapon of mass destruction (WMD) would be a game changer. Unfortunately, risks of WMD attack are increasing.
39. **Taliban/Afghanistan:** U.S. withdrawal from Afghanistan in 2014 will be a significant event, and there is no clarity on the type of force that is likely to remain. Complete U.S. withdrawal would likely throw the country back into civil war with competing factions and a strong Taliban ready to try and reassert control. These risks, of course, undermine attempts at attracting investments for the country's vast mineral deposits. Heavy mining machinery makes for an easy and attractive target. It is unclear, after 13 years of war, whether the Taliban would be content with having the U.S. leave or whether they would want to strike back at the U.S. While they might prefer to focus internally, it is unlikely the Taliban will be able to control the border of Pakistan, which is the real source of the violent ideology interested in striking the West. U.S. withdrawal probably means increased risk from this border territory.
40. **Cyber-Attacks:** With an increasingly connected global information architecture, the cyber domain represents a new geopolitical domain for nations, sub-state actors, and individuals. Cyber-attacks range greatly in their tactics and objectives, from a basic denial of service to large-scale theft to crashing infrastructure systems. A cyber-attack can limit access, change, or take information. The future of war will certainly have a

cyber component, and anyone targeting a great power is likely to use cyber as an opening salvo. Much cyber activity, however, happens below the nation-state level to include hacktivists, organized crime, and terrorists. Cyber-attacks originating in Eastern Europe and Asia are increasingly concerning. In escalation of cyber weaponry, the offensive has a distinct advantage. Building bigger walls is not sufficient to ensure a secure system, while increased computing speed and improved malware make it easier to break through. Environments where offense has the advantage over defense are always inherently unstable in the security space. Risk of cyber-attack against critical system, or the possibility of a cyber-attack that triggers contagion and complex failure is increasing. We see this risk rising steadily in coming years, but the target and nature of the attack will have a big role in determining the capital market response.

Geopolitical Events by 2025: High Impact and High Likelihood

High Impact:

1. Major conflict between U.S./Japan and China over territorial claim or cyber activities
2. Nuclear or biological terrorist incident in West
3. Cyber activity crashes financial, electrical, or communications systems
4. India-Pakistan nuclear exchange
5. Trade protectionism continues rising and new alliance blocks form
6. Saudi Arabia and Iran go to war over regional positioning
7. Russia continues territorial march risking conflict with Europe
8. North Korea triggers war with South Korea
9. Second nuclear arms race in Latin America
10. United Nations Permanent-5 structure abandoned as Russia continues expansion

High Likelihood:

1. North Korea folds and unites with South Korea
2. Iran gains latent nuclear weapon capability
3. Iraq-Syria borders change
4. China has several brief military incidents in support of its territorial claims
5. India-Pakistan relations falter
6. Washington becomes more conservative/isolationist in foreign policy
7. Europe remains stuck in low growth mode
8. Cyber-attacks escalate
9. Saudi Arabia stabilizes
10. Africa improves

Conclusion

Abetted by new technologies and the continuous transitions to new World Orders, geopolitical risks are on the rise in the early 21st century. The potential for their leakage into capital markets is significant. Capital market institutions would benefit from thorough coverage of geopolitical risks and development of thoughtful contingency planning. Unfortunately, history suggests that the distance between GPR events and episodic adverse market reactions will not be far.

Geopolitical risk analysis is an iterative process with strong feedback loops. In turn, per one veteran diplomat, “[Policy] is a continuously changing mix of people and ideas.” Policymaking

and decision-making are not equivalent. “Policy is a frame of mind, a strategy, or a sense of direction, whereas specific decisions define practical steps for moving in the desired direction.”⁵ This sage advice applies to asset management as well.

⁵ Saunders, Harold. “What Really Happened in Bangladesh.” *Foreign Affairs*, July/August 2014, p.41

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**Figure X. U.S. Equity Reactions to Key Geopolitical Events:
1914 through September 11, 2014**

Crisis Grade	Event	Market Reaction Dates	Cumulative Dow Jones Industrial Performance (%) After Reaction Dates*			
			Date Range Gain/Loss (%)	22 Days	63 Days	126 Days
Geopolitical Events						
A	World War I	7/28/1914 - 11/11/1918	14.92	-5.93	-6.70	0.86
A	Pearl Harbor	12/06/1941 - 12/10/1941	-5.94	1.79	-2.29	-10.04
A	Korean War	6/23/1950 - 7/13/1950	-11.99	7.70	13.68	15.96
A	Cuban Missile Crisis	10/19/1962 - 10/27/1962	-0.74	10.89	14.48	15.94
A	Gulf of Tonkin Incident	8/2/1964 - 8/7/1964	-1.42	1.20	5.90	4.24
A	Arab Oil Embargo	10/18/1973 - 12/05/1973	-17.86	7.95	4.61	7.03
A	Gulf War Ultimatum	12/24/1990 - 1/16/1991	-4.29	12.03	14.47	16.00
A	Attack on World Trade Center and Pentagon	9/11/2001-9/30/2001	-7.89	5.98	11.35	11.98
A	Egypt Coup d'état & Crackdown	7/3/2013-08/23/2013	0.15	2.44	3.73	9.78
A	Russia Invades Crimea	2/28/2014 - 3/4/2014	0.45	-0.77	0.03	3.12
B	Fall of France	5/09/1940 - 6/22/1940	-17.25	-0.80	2.23	6.97
B	Berlin Blockade	06/24/1948 - 05/12/1949	-8.47	-4.27	-0.64	4.27
B	France Falls at Dien Bien Phu	3/13/1954 - 5/8/1954	6.51	1.86	6.05	8.21
B	Soviet Invasion of Hungary	11/04/1956 - 11/10/1956	-1.04	-2.59	1.74	-2.26
B	Sputnik	10/03/1957 - 10/22/1957	-3.88	2.45	2.22	4.07
B	China Cultural Revolution	05/16/1966 - 10/06/1976	10.62	-0.74	0.37	-2.69
B	Six-Day War	06/05/1967 - 06/10/1967	3.20	-1.67	5.23	4.95
B	Soviet Tanks Invade Prague	8/20/1968 - 10/28/1968	7.77	0.94	-1.32	-5.13
B	Yom Kippur War	10/6/1973-10/25/1973	0.33	-8.53	-12.67	-11.69
B	Fall of Vietnam	04/30/1975 - 05/01/1975	1.17	0.11	4.91	0.88
B	Iranian Revolution	1/16/1979 - 2/11/1979	-1.58	0.60	5.85	2.54
B	U.S.S.R. Invasion of Afghanistan	12/24/1979 - 1/03/1980	-2.25	6.80	0.95	-0.62
B	Falkland Islands War	4/01/1982 - 5/07/1982	4.32	-5.71	-6.34	4.33
B	U.S. Invades Grenada	10/24/1983 - 11/07/1983	-2.73	5.96	5.88	-4.90
B	Invasion of Panama	12/15/1989 - 12/20/1989	-1.88	2.71	-3.88	-0.80
B	Iraq Invades Kuwait	08/02/1990 - 08/04/1990	-1.92	-9.85	-10.64	-7.81
B	Coup Attempt Against Gorbachev	8/16/1991 - 8/19/1991	-2.36	2.92	5.60	4.30
B	World Trade Center Bombing	2/26/1993 - 3/1/1993	-0.46	3.17	2.71	3.83
B	Oklahoma City Bombing	4/19/1995 - 4/20/1995	0.55	4.73	8.49	8.27
B	Kosovo War	02/28/1998 - 06/11/1999	22.76	6.18	4.61	-4.49
B	U.S. Invades Iraq	3/19/2003 - 12/21/2011	46.11	3.00	6.86	8.12
B	U.S. Invades Afghanistan	10/07/2001-06/22/2011	32.78	2.70	-6.52	-1.99
B	Battle of Baghdad	03/20/2003 - 04/15/2003	-17.52	1.88	10.96	12.22
B	Madrid Train Bombings	03/11/2004 - 03/12/2004	1.10	2.25	-2.22	-0.98
B	London Subway Bombings	7/7/2005 - 7/8/2005	1.43	1.84	2.20	2.27
B	Russo-Georgian War	08/07/2008 - 08/12/2008	1.85	-0.94	-20.03	-23.35
B	Mumbai Attacks	11/26/2008 - 11/29/2008	1.17	-2.83	-9.38	-9.19
B	Arab Spring (Tunisia)	12/17/2010 - 01/14/2011	2.57	2.59	0.60	6.15
B	Libyan Civil War	02/15/2011 - 10/23/2011	-3.42	2.29	4.11	9.94
B	Benghazi Attack	09/11/2012 - 09/12/2012	0.07	1.82	-5.72	1.33
B	Boston Marathon Bombings	04/15/2013 - 04/19/2013	-0.35	3.92	1.73	3.18
B	Bribe Chemical Attack Allegations	08/21/2013 - 09/26/2013	2.89	0.47	5.02	3.39
C	Easter Rebellion in Ireland	4/14/1916 - 6/30/1916	-2.24	-0.47	1.80	18.64
C	Bloody Sunday (N. Ireland)	1/12/1972 - 1/13/1972	3.99	-11.86	-0.74	0.16
C	U.S. Bombs Cambodia	4/29/1970 - 5/26/1970	-14.41	11.65	15.89	20.55
C	Beirut Barracks Bombing	10/23/1983-10/24/1983	0.01	-0.08	0.12	-5.53
C	U.S. Bombs Libya	4/15/1986 - 4/21/1986	2.56	-3.80	0.45	0.86
C	Argentina AMIA Bombing	07/18/1994-07/19/1994	-0.19	0.49	3.22	-1.88
C	Poison Gas Attack in Tokyo Subway	3/20/1995 - 3/21/1995	-0.27	3.07	8.93	15.76
C	U.S. Embassy Bombings in Nairobi and Dar es Salaam	8/07/1998 - 8/10/1998	-0.27	-8.72	-6.69	1.41
C	USS Cole Bombing	10/12/2000 - 10/13/2000	1.57	6.14	2.38	5.96
C	2002 Bali Bombings	10/12/2002-10/13/2002	0.00	9.19	7.43	0.75
C	Haiti Earthquake	01/12/2010 - 01/13/2010	0.50	-6.35	0.50	-2.21
C	Kenya Mall Attack	09/21/2013 - 09/24/2013	-0.75	0.26	4.81	3.87
C	Marakesh Market Bombing	04/28/2011-04/29/2011	0.37	-2.33	-1.78	-12.26
C	French Intervention in Mali	1/11/2013-Present				
C	Boko Haram's Abduction of Nigerian School Girls	04/14/2014-04/15/2014	0.55	1.57	3.36	4.04
C	2014 Hamas-Israel Conflict in Gaza	7/8/2014-Present				
C	Ebola Virus Outbreak	03/21/2014-Present				
Political/Economic Events						
1	U.S. Stock Market Crash of 1907	10/28/1929-10/29/1929	-11.73	4.85	8.00	18.88
1	JFK Assassination	11/21/1963 - 11/22/1963	-2.89	6.84	10.06	14.68
1	Kent State Shootings	5/04/1970 - 5/14/1970	-4.17	1.50	5.64	10.64
1	Nixon Resigns/Watergate	8/9/1974 - 8/29/1974	-15.50	2.12	1.32	-3.78
1	U.S. Stock Market Crash of 1987	10/02/1987 - 10/19/1987	-34.16	8.02	14.47	17.34
1	Orange County, CA Bankruptcy & Financial Crisis	12/06/1994 - 12/31/1994	2.36	0.91	4.05	13.27
1	Lehman Bankruptcy/Great Recession	09/15/2008 - 06/30/2009	-22.63	5.14	10.22	15.68
1	Wikileaks	10/28/2010-11/4/2010	2.89	-3.00	2.30	4.81
2	Earthquake in Tokyo	9/1/1923-9/15/1923	-4.10	-0.25	0.78	7.42
2	Truman Upset Victory	11/02/1948 - 11/10/1948	-8.34	-0.19	3.89	0.90
2	Riots and Labor Strike in France	5/6/1968 - 5/26/1968	-2.10	0.91	-0.76	4.30
2	Hunt Silver Crisis	2/13/1980 - 3/27/1980	-15.92	0.45	11.35	23.07
2	ERM U.K. Currency Crisis	9/14/1992 - 10/16/1992	-5.98	2.07	4.37	4.66
2	Mexico - Tequila Crisis	12/19/1994 - 12/31/1995	34.99	2.00	8.20	7.05
2	Terrorist Attack in Paris Metro	7/25/1995 - 7/26/1995	-0.16	-1.62	1.17	8.47
2	Asian Stock Market Crisis	10/07/1997 - 10/27/1997	-12.44	6.84	8.82	19.40
2	Russian LTCM Crisis	8/18/1998 - 10/08/1998	-11.28	11.13	14.35	21.10
2	South Ossetia War	08/07/2008-08/12/2008	1.85	-0.94	-20.03	-23.35
2	Occupy Wall Street Protests	09/17/2011-01/01/2012	6.16	4.02	6.22	6.72
2	Snowden NSA Leaks	06/05/2013-01/01/2014	10.80	-2.29	-1.31	-0.35
Overall						
Mean			-0.78	1.50	2.65	4.20
Median			-0.27	1.80	2.97	4.16
Geopolitical Events						
Mean			0.59	1.17	1.93	2.65
Median			0.00	1.80	2.22	3.15
Political Events						
Mean			-4.62	2.43	4.66	8.55
Median			-4.13	1.75	5.01	7.94
High Geopolitical Risk Events (A)						
Mean			-3.46	4.33	5.93	7.48
Median			-2.85	4.21	5.25	8.40
Medium Geopolitical Risk Events (B)						
Mean			2.38	0.73	0.28	0.73
Median			0.44	1.85	1.97	2.40
Low Geopolitical Risk Events (C)						
Mean			-0.61	-0.09	2.84	3.58
Median			0.00	0.09	2.09	1.13
U.S. Political/Economic Events (1)						
Mean			-10.73	3.30	7.01	11.44
Median			-7.95	3.48	6.82	13.97
Non-U.S. Political/Economic Events (2)						
Mean			-0.54	1.84	3.09	6.62
Median			-3.10	0.68	4.13	6.89

Crisis Code Key
A-High Geopolitical Risk
B-Medium Geopolitical Risk
C-Low Geopolitical Risk
1- U.S. Political Crisis
2- Non-U.S. Political Crisis

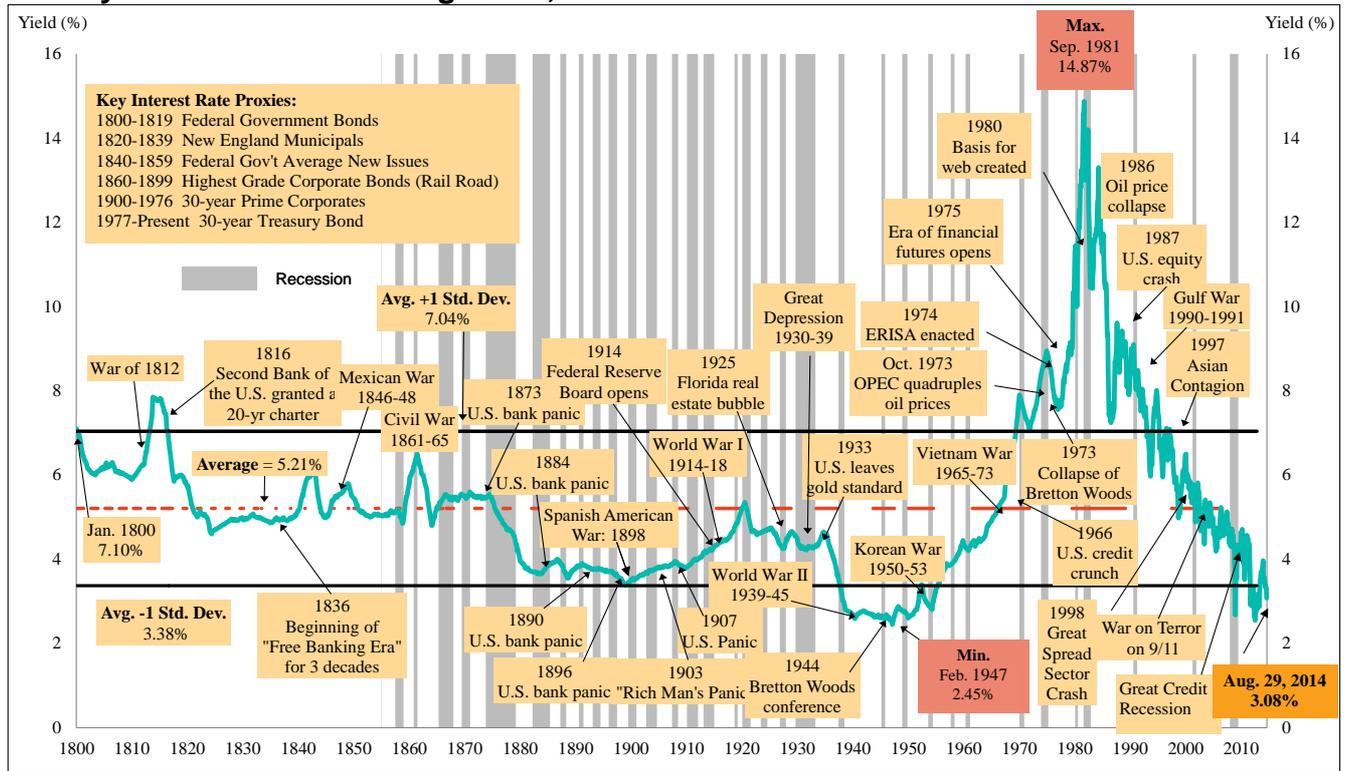
Source: BNY Mellon using data from Bloomberg

Figure XX. Historical Total Returns of U.S., U.K., French, German, and Japanese Bonds and Equities During Periods of War: 1812 to September 11, 2014

	Total Return (%) 1 Year Before				Annualized Total Return (%) During				Total Return (%) 1 Year After			
	U.S.	U.K.	France	Germany	U.S.	U.K.	France	Germany	U.S.	U.K.	France	Germany
Bonds												
War of 1812	06/19/1812	02/17/1815	1.34	9.76	4.39	6.52	4.74	6.52	4.39	6.52	4.74	6.52
Mexican American War	05/13/1846	02/21/1848	0.99	0.74	2.32	-3.65	8.92	-3.65	2.32	-3.65	8.92	-3.65
Crimean War	03/27/1854	02/25/1856	7.29	-14.17	2.65	9.54	5.67	9.54	2.65	9.54	5.67	9.54
U.S. Civil War	04/09/1861	04/09/1865	-5.56	3.09	9.28	4.22	6.02	-5.69	9.28	4.22	6.02	-5.69
France Prussian War	07/15/1870	10/28/1871	-0.74	7.54	-4.03	-38.31	7.31	12.96	-4.03	-38.31	7.31	12.96
Spanish American War	04/25/1898	12/10/1898	2.03	3.79	10.51	1.04	7.69	3.46	10.51	1.04	7.69	3.46
Boer War	10/11/1899	5/31/1902	5.52	0.98	6.37	3.27	7.66	0.55	6.37	3.27	7.66	0.55
Russo Japanese War	2/8/1904	9/6/1905	1.86	0.63	3.30	4.46	18.62	0.47	3.30	4.46	18.62	0.47
World War I	4/6/1917	11/11/1918	0.32	1.78	2.87	6.65	7.79	1.57	2.87	6.65	7.79	1.57
World War II	12/7/1941	8/14/1945	4.94	4.68	2.52	3.10	4.59	4.79	2.52	3.10	4.59	4.79
Korean War	6/25/1950	7/27/1953	1.91	0.96	-0.32	2.34	5.07	18.15	-0.32	2.34	5.07	18.15
Vietnam War	8/4/1964	1/27/1973	2.62	2.43	4.16	5.91	3.62	5.63	4.16	5.91	3.62	5.63
Arab Israeli War	6/10/1967	6/10/1967	4.90	8.89	-28.53	-4.36	-3.17	7.20	-28.53	-4.36	-3.17	7.20
Yom Kippur War	10/6/1973	10/25/1973	4.22	1.48	-1.87	-0.78	27.72	0.12	-1.87	-0.78	27.72	0.12
Falkland Islands	4/1/1982	5/7/1982	8.89	14.84	10.13	15.51	9.47	-6.74	10.13	15.51	9.47	-6.74
Gulf War	1/16/1991	2/26/1991	7.88	9.92	6.08	-1.49	-1.29	11.37	6.08	-1.49	-1.29	11.37
Bosnian War	4/6/1992	12/14/1995	11.67	12.37	13.28	12.28	17.02	10.89	10.64	12.37	7.57	9.56
Kosovo War	2/28/1998	6/11/1999	14.63	13.82	10.65	9.28	5.71	3.83	8.28	6.91	7.40	2.19
War on Terror	9/11/2001	present	12.72	7.48	9.99	12.45	6.15	21.82	10.98	7.64	14.80	3.42
Libyan Civil War	2/15/2011	10/23/2011	4.47	4.72	2.22	2.86	2.17	4.47	4.72	2.22	2.86	2.17
Syrian War	3/15/2011	present	4.81	5.06	2.14	1.61						
Average			4.60	7.22	3.74	7.22	5.43					
Equities												
War of 1812	06/19/1812	02/17/1815	-1.97	-0.20	4.75	9.33	6.82	0.82	4.75	9.33	6.82	0.82
Mexican American War	05/13/1846	02/21/1848	-0.22	-1.12	7.57	-1.72	0.54	8.52	7.57	-1.72	0.54	8.52
Crimean War	03/27/1854	02/25/1856	-4.09	-4.73	-9.37	2.22	11.64	4.79	-9.37	2.22	11.64	4.79
U.S. Civil War	04/09/1861	04/09/1865	32.97	5.99	22.23	5.10	11.58	2.97	22.23	5.10	11.58	2.97
France Prussian War	07/15/1870	10/28/1871	7.75	1.83	-1.46	5.17	15.42	5.91	-1.46	5.17	15.42	5.91
Spanish American War	04/25/1898	12/10/1898	15.14	8.51	10.59	9.93	9.90	-2.89	10.59	9.93	9.90	-2.89
Boer War	10/11/1899	5/31/1902	-17.40	-0.88	16.31	1.56	-6.76	0.23	16.31	1.56	-6.76	0.23
Russo Japanese War	2/8/1904	9/6/1905	7.47	0.42	25.00	-0.63	12.47	-0.36	25.00	-0.63	12.47	-0.36
World War I	4/6/1917	11/11/1918	4.02	33.28	169.46	7.00	23.17	-5.63	169.46	7.00	23.17	-5.63
World War II	12/7/1941	8/14/1945	1.65	1.98	19.54	8.52	11.53	14.85	19.54	8.52	11.53	14.85
Korean War	6/25/1950	7/27/1953	4.65	1.88	19.54	8.52	11.53	14.85	19.54	8.52	11.53	14.85
Vietnam War	8/4/1964	1/27/1973	2.04	0.99	-1.87	-0.88	14.19	43.26	-1.87	-0.88	14.19	43.26
Arab Israeli War	6/10/1967	6/10/1967	7.00	13.99	-7.85	-3.44	-11.12	24.26	-7.85	-3.44	-11.12	24.26
Yom Kippur War	10/6/1973	10/25/1973	0.98	-5.51	1.51	-21.53	13.33	54.15	-5.51	-21.53	13.33	54.15
Falkland Islands	4/1/1982	5/7/1982	-13.18	11.78	-2.53	8.45	-28.87	-54.88	-2.53	8.45	-28.87	-54.88
Gulf War	1/16/1991	2/26/1991	-3.10	-9.74	-23.53	-21.90	-39.53	25.40	-9.74	-23.53	-21.90	-39.53
Bosnian War	4/6/1992	12/14/1995	11.04	3.31	10.19	12.81	-27.62	15.98	3.31	10.19	12.81	-27.62
Kosovo War	2/28/1998	6/11/1999	26.91	25.31	24.37	46.30	-6.77	22.96	25.31	24.37	46.30	-6.77
War on Terror	9/11/2001	present	-24.39	-17.41	-26.66	-28.11	-26.21	7.25	-17.41	-26.66	-28.11	-26.21
Libyan Civil War	2/15/2011	10/23/2011	22.19	18.13	13.56	26.19	2.97	15.21	18.13	13.56	26.19	2.97
Syrian War	3/15/2011	present	22.57	17.02	17.37	29.90	8.47	15.21	17.02	17.37	29.90	8.47
Average			8.21	4.78	12.51	6.17	-8.85					
Bond Outperformance over Equities												
War of 1812	06/19/1812	02/17/1815	3.32	-1.14	-0.36	-11.14	-2.08	-11.14	-0.36	-11.14	-2.08	-11.14
Mexican American War	05/13/1846	02/21/1848	1.21	1.21	-5.26	-5.26	8.38	-5.26	1.21	1.21	-5.26	8.38
Crimean War	03/27/1854	02/25/1856	11.38	12.02	12.02	12.02	-5.97	12.02	12.02	12.02	-5.97	12.02
U.S. Civil War	04/09/1861	04/09/1865	-38.53	-12.95	-12.95	-12.95	-5.56	-5.56	-12.95	-12.95	-5.56	-5.56
France Prussian War	07/15/1870	10/28/1871	-8.50	-2.56	-2.56	-2.56	-8.11	-8.11	-2.56	-2.56	-8.11	-8.11
Spanish American War	04/25/1898	12/10/1898	-13.11	-6.80	-6.80	-6.80	-8.89	-8.89	-6.80	-6.80	-8.89	-8.89
Boer War	10/11/1899	5/31/1902	-19.48	-7.03	-9.66	-9.66	4.85	4.85	-9.66	-9.66	4.85	4.85
Russo Japanese War	2/8/1904	9/6/1905	19.26	-1.85	-22.87	-11.97	-12.01	-12.01	-22.87	-11.97	-12.01	-12.01
World War I	4/6/1917	11/11/1918	-7.15	-11.14	-11.14	-11.14	-18.40	-18.40	-11.14	-11.14	-18.40	-18.40
World War II	12/7/1941	8/14/1945	12.96	-28.60	-162.58	-162.58	-3.05	-3.05	-162.58	-162.58	-3.05	-3.05
Korean War	6/25/1950	7/27/1953	-39.74	-1.02	-4.48	-4.48	-16.55	-16.55	-4.48	-4.48	-16.55	-16.55
Vietnam War	8/4/1964	1/27/1973	-21.37	-10.64	17.66	1.75	-3.18	-6.28	-10.64	17.66	1.75	-3.18
Arab Israeli War	6/10/1967	6/10/1967	-2.14	9.88	10.38	25.69	6.07	25.69	9.88	10.38	25.69	6.07
Yom Kippur War	10/6/1973	10/25/1973	3.25	6.99	-3.39	-9.23	-23.98	-25.45	6.99	-3.39	-9.23	-23.98
Falkland Islands	4/1/1982	5/7/1982	22.06	3.06	11.68	6.87	7.28	27.73	-0.97	-18.51	47.13	-23.57
Gulf War	1/16/1991	2/26/1991	10.98	19.65	29.61	20.41	38.24	-88.21	-73.01	-65.12	-45.88	-95.18
Bosnian War	4/6/1992	12/14/1995	0.63	9.06	3.09	-0.52	44.64	-4.19	-6.43	9.02	0.07	5.85
Kosovo War	2/28/1998	6/11/1999	-12.28	-11.49	-13.72	-37.02	12.48	-24.97	-6.00	-24.57	-7.15	-7.98
War on Terror	9/11/2001	present	37.11	24.89	36.65	40.56	32.36	23.21	15.50	26.81	32.08	21.86
Libyan Civil War	2/15/2011	10/23/2011	-17.72	-13.41	-11.35	-23.33	-0.79	-10.38	-20.97	-11.54	-7.86	-15.07
Syrian War	3/15/2011	present	-17.76	-11.95	-15.22	-6.86						
Average			-3.60	-0.30	-8.03	1.32	14.65					
Avg. Bond Outper.			12.22	12.26	18.18	22.64	21.40					
Avg. Equity Outper.			17.98	12.85	23.76	19.99	5.63					
Frequency of Bonds Outperforming Equities			48%	50%	38%	50%	75%					

Indices used for Bonds: USA 10-year Government Bond Total Return Index, United Kingdom 10-year Government Bond Total Return Index, Germany 10-year Government Bond Total Return Index, France CAC All-Tradable Total Return Index, Japan 10-year Government Bond Total Return Index, S&P 500 Total Return Index, UK FTSE All-Share Return Index, Germany Deutscher Aktienindex (DAX-30) Return Index, Japan Nikkei Total Return Index. Indices used for equities: S&P 500 Total Return Index, UK FTSE All-Share Return Index, France CAC All-Tradable Total Return Index, Germany Deutscher Aktienindex (DAX-30) Return Index. Source: BNY Mellon using data from Global Financial Data

Figure XXX. A History of Long-Term U.S. Interest Rates, U.S. Recessions, and World Military Conflicts: 1800 to August 29, 2014



Source: BNY Mellon using data from Global Financial Data, Bloomberg

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