

# The Fear and Reality of Geopolitical Risk

Every so often, geopolitical turmoil rears its ugly head and spooks the markets. The most recent geopolitical situation creeping back into the markets is the rhetoric between North Korea's leader, Kim Jong Un, and President Trump. Fear that rhetoric may escalate into a full blown war has the markets on edge, as some individual investors are allowing their emotions to influence selling into the unknown. Polaris Greystone will remain disciplined and clinical with its decisions, acting on fact, not "what might happen."

There is a very low probability that a war will breakout on the Korean peninsula. I think both sides know that a war would be absolutely devastating to all involved. Kim Jong Un knows that any military conflict with the United States would most likely end in his death or his removal as the leader of North Korea. The United States, on the other hand, knows that any attack on North Korea would be met with an all-out counter offensive, putting millions of civilians' lives in harm's way. Even a surgical strike could end up turning into a full-fledged world war, with China and Russia potentially coming to North Korea's aid. The hope is that both political leaders fully understand that the stakes are far too high to risk a war and that the risks far outweigh the rewards.

According to The Washington Post's reporting on August 8, 2017, the US Defense Intelligence Agency has calculated that "up to 60 nuclear weapons are now controlled by North Korean leader, Kim Jong Un." This is significantly higher than the 10 to 20 nuclear weapons the Stockholm International Peace Research Institute estimated in July. Kim Jong Un knows that any use of these weapons, regardless of where, would result in an immediate counter attack by the United States, South Korea, and Japan. "The North Korean leadership is not suicidal. They are not seeking martyrdom," former Secretary of Defense William Perry wrote in HuffPost on March 10, 2017. "They want to stay in power, and they understand that if they launch a nuclear attack, their country will be destroyed, and they themselves will be killed — it would end the Kim dynasty."

Any preemptive attack made by the United States would be met with an all-out retaliation from the North Koreans. While the first waves of a U.S. led attack would do significant damage, there is no possible way to eliminate a North Korean counter attack. North Korea could strike U.S. bases in South Korea, Japan, and perhaps Guam. This could be done using their large arsenal of conventional weapons, or worse yet, nuclear weapons missed in the initial U.S. led attack. They could also turn their sights on civilian targets in South Korea and Japan, putting millions of innocent people in harm's way. There is also the possibility of China or Russia entering the war if North Korea is attacked, upping the ante of the conflict and turning it into a full-fledged world war.

We have examined fifty-three crisis events that have occurred from 1907 to present, in an effort to understand their impact on the markets overall. These crisis events ranged from the start of wars, terrorist attacks, political upheaval, and market turmoil. As you can see from the chart below, initial reaction to the crisis event is negative, 80% of the time. Once the clouds have lifted, however, the markets turn positive most of the time (historically more than 75% of the time), recovering their loss relatively quickly.

	Reaction	% Gain Days after Reaction Date			
	Date	22	63	126	253
<b>Mean</b>	<b>-6.6%</b>	<b>3.8%</b>	<b>5.4%</b>	<b>9.0%</b>	<b>14.2%</b>
<b>% Time Positive</b>	<b>20.0%</b>	<b>83.0%</b>	<b>75.5%</b>	<b>81.1%</b>	<b>75.5%</b>

Source: Ned Davis Research, Polaris Greystone Financial Group

## This Isn't a Crisis (yet)!

Rhetoric with North Korea is a far cry from a full blown crisis. Just try to think back to the Russian intervention in Ukrainian civil war, Russia seizing Crimea, or Israel invading and occupying the Gaza Strip. How about the Ebola outbreak? In each incident, we received countless calls and emails from concerned clients convinced that this news would take down the markets. You can look back at our educational emails over the years, properly guiding clients to remain calm, ride out the short-term "blips" in the market, and to not react. Many individual investors allowed their emotions to get the best of them and sold at exactly the wrong time.

## What if Things Get Worse?

Polaris Greystone is constantly weighing the risk in the markets to determine if the reward is great enough to remain fully invested. Our investment team runs "if, then" scenarios so that we are prepared to act (not react) if needed. "If" war broke out with North Korea "then" we would reduce the equity exposure in all of our portfolios because we believe the markets would react negatively for weeks or even months after the first shots were fired, depending on how the conflict was progressing. In this case, we have already put together a game plan (in advance of the crisis event). We have already prepared the list of the most volatile positions and those most exposed to the crisis event. If war were to break out, we would remove the investments that would be most susceptible to decline, holding defensive positions and investments that would benefit from the crisis (like the aerospace and defense industry). Lowering our equity exposure would reduce the impact of a major correction in the market due to a military conflict.

Reducing our equity exposure during a market correction is only half of the equation. Our goal is to limit the losses in our portfolios when the markets are going down and to capture as much of the upside as possible when they recover. Obviously this is a challenging goal. Tactical investing requires us to reenter the markets, typically at a time when few people are willing to risk their money in the market. Our risk assessments and technical research help us make clinical decisions when most investors are investing based upon emotion. Again, we have a prepared game plan of investments that we would love to own at a cheaper price. We would methodically add exposure to strategic areas of the market that we felt gave us the best balance of risk and return.

Polaris Greystone remains ever vigilant in the management of your portfolio. We are very experienced navigating tricky markets and don't see any reason that this current geopolitical situation will be any more trying than the markets we have navigated in days past. We don't say this out of arrogance but rather a strong confidence in our clinical, process-driven, technical manner in which we invest on behalf of our clients.

As always, I welcome your comments and questions.



**Sincerely,**

**Jeffrey J. Powell**

Managing Partner