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Economico Flash #27

Investment tactics & market timing: The world is ending - what now?

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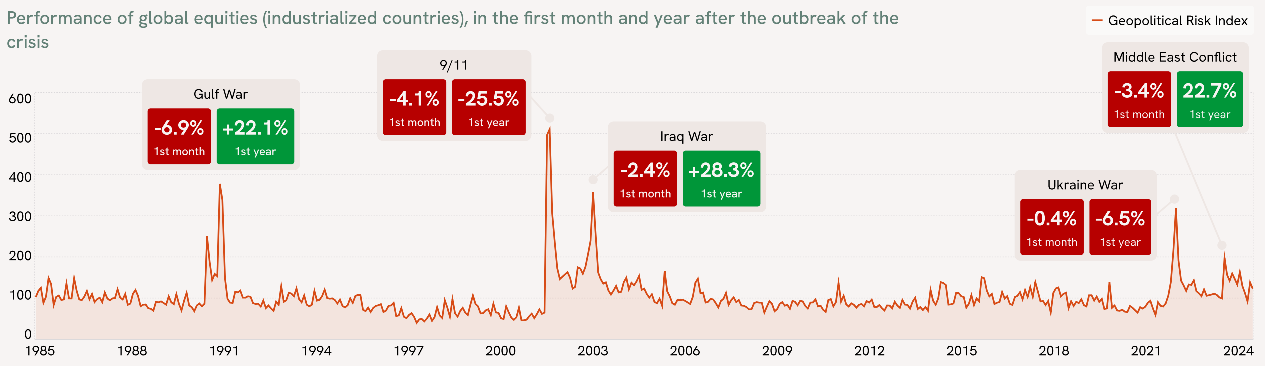
Chart of the week: Short and medium-term reaction of the global stock market to geopolitical crises



Sources; www.policyuncertainty.com; Refinitiv for MSCI World DC; VPS article Müller (2024) «Einfluss der Geopolitik auf Anlagerenditen»

Before we turn to the Economico core concern - the interest-preserving and cost-efficient implementation of the investment strategy - in Flashes 27 and 28, we look at the periodic adjustment or rebalancing of the investment strategy. Should this be done actively or passively based on rules? When - as is currently the case again - the prophets of the end of the world are booming, panic spreads on the global stock markets. Is this panic justified? In this Flash, we examine the relationship between the occurrence of geopolitical crises and the short to medium-term return behavior of the global stock market. The geopolitical crisis level is measured using the "Geopolitical Risk Index" (GPR) according to the Chart of the Week. This represents a consistent and near-real-time indicator of geopolitical events as perceived by the press, the public, investors and political decision-makers.

In the last five crises - with the exception of the war in Ukraine - the global stock market suffered severe losses within a month. However, with the exception of 9/11 and the Ukraine crisis, the global stock market turned positive again. It should be noted that 9/11 (Dotcom crisis) and the Ukraine crisis (rising inflation worldwide) were accompanied by developments in the real economy that had little or no intrinsic connection with the crisis event.

Market participants therefore appear to fundamentally overestimate crisis events, which leads to an overreaction on the markets, which subsequently is corrected again.

However, if a geopolitical crisis has real economic consequences - which is entirely possible in the current customs crisis - it can also leave lasting damage on the stock markets in the long term. Due to the observed tendency for markets to overreact, the rule of sticking to the investment strategy even during crises is to be advocated. When advising institutional investors, we recommend a rule-based rebalancing of the current allocation to the investment strategy if (generously defined) bandwidths are breached. This also keeps the transaction costs induced by rebalancing within narrow limits.

Providers offering in Economico are free to decide how they ensure ongoing rebalancing to the investment strategy in the asset management mandate. Most providers also use fixed rebalancing rules for this purpose. This is a topic that is worth discussing in more detail in the specific onboarding meeting with the selected provider.

Takeaways

- Equity markets tend to overreact in the short term during crises
- Disciplined strategy balancing with a focus on low transaction costs is advisable