



# Navigating a World with Increasing Geopolitical Risks



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## Navigating a World with Increasing Geopolitical Risks

Over the last few years, the world has been shaken by the revival of several geopolitical conflicts that have reminded humanity of the different motives behind the decisions taken in the realm of politics and international relations.

Seven months ago, we witnessed the revival of a conflict that has always been present, albeit dormant. It occurred on October 7, when Hamas led attacks in Israel, which in turn led to a response from Israel in the Gaza region. This conflict quickly developed into a crisis that has shaken the Middle East and the world alike. Ever since, the situation has remained fluid and ever-changing, with other international actors stepping onto the scene to, hopefully, play a part in ending a conflict that has brought pain and tragedy to humankind.

The latest developments registered at the end of April, and at the time of this writing, included the evasive hopes of striking a deal between Israel and Hamas,

after the latter claimed it had accepted the terms of a truce deal, while civilians in the southern city of Rafah were ordered to evacuate due to escalating airstrikes in the zone. The latest escalation occurred when the Israeli military said it had sent tanks into Rafah while taking over the Gaza side of the border that the zone shares with Egypt. The response from Israel comes as backlash to a rocket launch from Hamas at a border crossing between Gaza and Israel that killed Israeli soldiers. Both sides continue to blame each other for the lack of a truce, with little apparent willingness to come to the negotiating table.

Ultimately, what we have been witnessing are two hot wars and one cold one. Ukraine and Russia, Israel and Hamas, the United States and China. Geopolitical uncertainty, especially to the extent that it is currently being experienced around the globe, can create countless risks. These risks can range from transitory to severe, from supply chain disruptions and inflation to open conflict. Let us be fair, open conflict between two superpowers would meaningfully affect all markets, unlikely to discriminate by asset class. In this piece, we are not addressing a conflict of that magnitude. What we are addressing, however, is a series of relatively

more contained conflicts, any of which could ignite the powder keg of a broader conflict.

For now, the cold war between East and West continues to be fought through a series of proxy wars, as was the case during the first cold war between the United States and Russia. That is not to minimize these conflicts. Needless to say, any war, whether through a proxy or not, exerts a costly toll on human life. Some of the actors in these scenarios are different, some are the same, but the deep-rooted differences between many of these players remain a major source of conflict. On one hand, China, Russia, Iran, and, to a lesser extent, North Korea seek to expand their spheres of influence in their respective regions. On the other hand, the United States and its allies seek to maintain the status quo in these regions. Cooperation between the countries on either side of this global clash is evident across its various hot zones. It is not a coincidence that Russia is using technology and weapons from China, Iran, and North Korea in its battle with Ukraine. At the same time, it is also not a surprise that Ukraine and Israel are using Western technology.

In Europe, Vladimir Putin appears intent on expanding Russia's sphere of influence in the region, arguably attempting to revive some version of the previous Soviet empire. Ukraine's inclusion in the NATO alliance would derail this process and is something that Putin is vehemently opposed to. In the Middle East, Iran and Israel are clearly at odds; however, a dynamic that is often overlooked is that Iran is also at odds with its other regional nemesis, Saudi Arabia. The famous phrase "The enemy of the enemy is my friend" is clearly at play here, as the Abraham Accords had set in motion a plan that would bring the United States, Israel, and Saudi Arabia closer, a degree of rapprochement that Iran clearly opposes. In fact, the United States and Saudi Arabia appear close to signing a defense pact, something that was recently publicly confirmed by US Secretary of State Antony Blinken and Saudi Foreign Minister Faisal bin Farhan. Israel joining this pact is key,

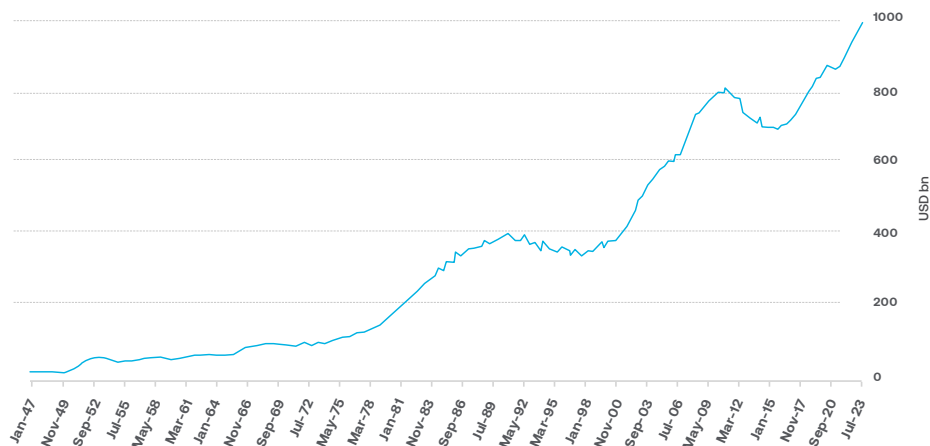
— “...the **worst move an investor can make** is to be overtaken by fear and liquidate his or her investments to hide in cash.”

but its inclusion would revolve around some form of truce or closure to the conflict in Gaza. This pact would erode Iran's influence in the region, which increases that country's incentive to oppose it, something it is doing by providing assistance to its proxies, Hamas and Hezbollah. To be fair, faced with internal discontent, it can be argued that both Iranian and Israeli leaders have incentives to keep the conflict in the region going. History is witness to the countless number of instances when leaders, faced with internal dissent, turn to foreign conflicts to divert problems at home.

Geopolitical risks do not appear likely to ebb any time soon and are likely to rise over time. In light of this backdrop, what are investors supposed to do? Most importantly, the worst move an investor can make is to be overtaken by fear and liquidate his or her investments to hide in cash. Decisions driven by emotional reactions are some of the worst corrosives to a sound investment framework. The key is to keep a level head and be driven by facts, not emotions. To this point, exercising a degree of prudence is most likely the correct approach. Again, by prudence we do not mean running for the exits. Thinking about a strategy that mixes in a degree of "offense" and "defense" into an investment portfolio would be the right start.

"Offense" in this context would constitute investments in industries and companies that would have a positive correlation with increased geopolitical risk, more specifically, companies that would see increased

**The U.S. Defense Spending has not stopped growing**



Source: Federal Reserve Bank of St Louis

demand for their products as the risk of conflict rises. A prime example of this subset would be the aerospace and defense industry. The conflicts in Europe and the Middle East led to increased defense spending from countries in these regions, as well as countries that supply weapons to them. For example, the proposed defense budget for the United States for 2024 rose 3% from the previous year, reaching its current level of USD 842 billion. This number includes the largest budgetary request by the Pentagon in history, as can be seen on the graph above.

Astonishingly, this record number might not be large enough to keep up with the spending needed to adequately modernize the country’s armed forces to the levels required to meet today’s uncertainty around the world. In what appears to be a response to counter China’s attempts to expand its sphere of influence in the South China Sea, the 2024 budget proposal seems to be focused on modernizing the United States Air Force and Navy. This has led to increased spending on programs like the newest version of the stealth bomber, Northrop Grumman’s B-21 Raider, as well as the F-35 Lightning fighter/bomber aircraft. In addition, the Navy is also upgrading its submarine and surface warfare vessel fleets. Companies like Northrop Grumman (NOC), Lockheed Martin (LMT), L3 Harris (LHX), and GE Aerospace (GE) stand to benefit from the modernization of the Air Force, while General Dynamics (GD)

and Huntington Ingalls (HII) benefit from increased naval spending. At the same time, increased expansion of the country’s newly created Space Force also benefits companies like Boeing (BA). Needless to say, increased focus on automated warfare through drones and artificial intelligence will benefit many of the companies mentioned above.

There are other dynamics at play that would also create tailwinds for many companies in the defense industry, mainly increased spending to resupply weapons to Ukraine and defensive weapons to Israel. The U.S. government recently passed a resolution approving a military aid package for Ukraine and Israel totaling USD 75 billion. The bulk of the package is earmarked for Ukraine and aims to resupply munitions for equipment such as the HIMARS missile system as well as the Javelin anti-tank missile, increasing demand from manufacturers like RTX (RTX) and Lockheed Martin. Given the fact that Israel manufactures a large share of its defensive weapons, such as the Iron Dome and David’s Sling domestically, the US aid package would benefit the country’s domestic defense industry. However, Israel works closely with companies like RTX to run its Iron Dome program, as well as Boeing and Northrop Grumman to manufacture and upgrade its existing fleet of F-15 Eagle and F-35 Lightning aircraft.

Turning towards Europe, the conflict between Russia

and Ukraine has provided powerful motivation for many countries in the region to modernize their armed forces. Germany finds itself in a major push to modernize its tanks and mobile artillery assets, while it continues to supply its famous Leopard tanks to Ukraine. The United Kingdom, France, Spain, and Sweden continue to spend heavily in upgrading their air forces, some through upgraded American aircraft like the F-18 Hornet and F-35 Lightning, others through home-grown aircraft like the EuroFighter, French Rafale and Swedish Grippen fighter jets. Spending on these products is benefiting both American companies like Boeing, Lockheed Martin, and Northrop Grumman, as well as European defense companies like Airbus (AIR FP), BAE Systems (BA LN), and Dassault Aviation (AM FP). Investors with the appropriate risk tolerance could consider gaining exposure to the aerospace & defense industry directly through these companies or through ETFs such as the U.S.-focused iShares U.S. Aerospace and Defense ETF (ITA) or the European-focused VanEck Defense UCITS ETF (DFNS LN).

Regarding fixed income, we have maintained a conservative, more defensive approach for the last couple of months. Aside from the geopolitical factors mentioned above, we also need to pencil in the volatility of global monetary policy, together with the fears of the most expected recession the market has seen in a while, which remains. Therefore, our stance continues to lean towards favoring quality over yield, preferring issuers that exhibit solid and strong fundamentals alike. Furthermore, against a backdrop of tight spreads between investment grade corporates and sovereigns, together with the fact that bonds are starting to look relatively more expensive than at the beginning of the year, we continue to stress the importance of choosing sound companies that exhibit healthy cash flow generation, together with adequate leverage levels. Some issuers we have favored lately, specifically because of the reasons mentioned above, are Coca-Cola, NextEra Energy, and General Motors, whose bonds we have highlighted in our Focus List.

In the context of our “offense and defense” strategy, the “defense” portion would involve investing in commodities such as oil and gold to hedge against rising geopolitical risk, as these commodities tend to rise in times of conflict. In our view, both commodities have favorable backdrops regardless of geopolitical risk, with the latter creating an additional catalyst. The supply and demand dynamics of oil remain favorable, as supply remains constrained due to an underinvestment in drilling and transportation infrastructure, particularly in the United States, coupled with self-imposed supply constraints from OPEC+, namely Saudi Arabia. At the same time, demand, particularly in countries like China and India, appears to be rising. Combined with constrained supply, this dynamic is creating a relative floor for oil prices. The other piece of the “defense” puzzle is gold. This precious metal tends to increase in price because of its traditional role as a “store of wealth” asset in investors’ portfolios. Moreover, the central banks of large countries such as China are buying the commodity in very large quantities, a dynamic that is diminishing its already limited and finite supply. Investors looking to get exposure to the oil or gold industries could consider doing so through ETFs such as the Energy Select Sector SPDR Fund ETF (XLE) and the SPDR Gold Shares ETF (GLD).

Whether a truce between Israel and Hamas, or even Ukraine and Russia, is reached in the future, it is hard to deny that geopolitical risks are rising across the globe. Considering this reality, investors with the appropriate risk tolerance could potentially benefit from tactically allocating an equally appropriate portion of their portfolios to a strategy that considers some elements of “offense and defense,” such as the one we mentioned above. If you need more information or would like to discuss these or other potential ideas in more detail, please do not hesitate to contact your financial advisor.■

# House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
<b>Global Asset Allocation</b>		
Equities	NEUTRAL	NEUTRAL
Fixed Income	OVERWEIGHT	OVERWEIGHT
Cash	UNDERWEIGHT	NEUTRAL
<b>Regional Breakdown</b>		
US Equities <sup>1</sup>	OVERWEIGHT	OVERWEIGHT
European Equities	NEUTRAL	NEUTRAL
Japanese Equities	OVERWEIGHT	OVERWEIGHT
Emerging Market Equities	NEUTRAL	UNDERWEIGHT
Chinese Equities	NEUTRAL	UNDERWEIGHT
US Treasuries <sup>2</sup>	OVERWEIGHT	OVERWEIGHT
Investment Grade Fixed Income	NEUTRAL	NEUTRAL
High Yield Fixed Income	NEUTRAL	UNDERWEIGHT
Emerging Market Sovereign	OVERWEIGHT	NEUTRAL
US Dollar	NEUTRAL	OVERWEIGHT
Energy <sup>3</sup>	OVERWEIGHT	NEUTRAL
Precious Metals	UNDERWEIGHT	OVERWEIGHT

<sup>1</sup>Relative to global equities in USD

<sup>2</sup>Relative to aggregate fixed income markets in USD

<sup>3</sup>Relative to an overall commodity allocation

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