



Flash

Geo-political tensions – an ongoing influence on financial markets

The world has at least 50 trouble spots. While tensions in Africa mostly concern local power struggles, conflicts in the Ukraine, the Middle East and the China seas involve the major powers and, hence, “world order”. They are termed “geo-political”. For the time being, the risk that the Ukrainian conflict spills into other countries seems limited. But the Middle East is a breeding ground for terrorism and a destabilization of Saudi Arabia could have catastrophic consequences. At present, we do not hedge our portfolios against geopolitical risks.

The world has at least 50 trouble spots. Many of these have only local significance.

The “International Crisis Group“, which is headquartered in Brussels, is a non-government organization whose objective is to prevent war-like conflict. Its monthly publication, “Crisis Watch”, currently lists more than 50 trouble spots. The majority of these are in Africa and are mainly local power struggles involving specific border territories. The conflicts involving the Ukraine, the Middle East and the China seas are different in scale. They involve the major powers and, hence, “world order”.

The Ukrainian situation looks as if it can be contained, at least over the near term.

Since Russia staged an almost bloodless coup to grab the Crimea in early 2014, the dispute over East Ukraine has spread and developed into armed conflict. The pro-Russian separatists, whose moves are orchestrated by the Kremlin, want their so-called Peoples Republics of Donetsk and Lugansk to be separated from the rest of the Ukraine. On military terms this is a war which Ukraine’s government in Kiev cannot win. Moreover, some commentators view the conflict as posing a broader threat to the West. What President Putin might do is difficult to assess. In the absence of significant military resistance, his determination to return Russia to her former status seems only to become more forceful. As the West remains unable to coordinate a response to events in the Donbass region, we believe that troubles in the Ukraine are likely to escalate. It is quite possible that Russia will recognize Donetsk and Lugansk as independent states just as it recognized Abkhazia and South Ossetia in 2008. In recognizing those two breakaway regions from the Georgian republic Russia led a very select group of just four countries, the others being Nauru, Nicaragua and Venezuela. So far as the current Ukrainian situation is concerned, Russia might make a start by declaring an official separation of Donetsk and Lugansk from the rest of the Ukraine. So long as matters went no further, the present crisis looks limited in terms of its potential to ignite trouble elsewhere. In the medium term, the West must confront Moscow’s ambitions in a credible way, which might need to include an element of military threat. At all events, geo-political risk remains elevated as a result of strained relations between Russia and the West.

The Middle East is a breeding ground for terrorism which is threatening the West.

There is a frightening instability in much of the Middle East and North Africa. The latest eruption is in Yemen. The Shiite Houthi militia have taken control there, threatening an implosion of the state. In Libya the internationally recognized regime, based in Tobruk, is at war with an opposition based in Tripoli. The Islamic State (IS), taking advantage of the chaos, has infiltrated the country and has publicized its presence very effectively by beheading 21 Coptic Christians on shores of the Mediterranean that face Italy. In Egypt, President al-Sisi is brutally re-

pressing his political opponents and his army is struggling to cope with IS-led insurgents in Sinai. With its new power base in Libya, IS can now threaten Egypt from a second direction. In Syria, President Assad is trying desperately to hang on to power, but a large part of his country is now under the control either of IS or of other rebel forces. The Islamic state made international headlines last summer when it rapidly overran vast chunks of Iraq. IS and Kurdish forces are now in a bitter battle over much of Northern Iraq as well as in parts of Syria. Failed states in the Middle East and in North Africa are a breeding ground for terrorism, which has already had a significant impact on the West and threatens its social and economic structures.

Big challenges confront Saudi Arabia

The fact that the Arab spring of 2011 did not reach into Saudi Arabia might suggest that the desert kingdom is relatively stable. Moreover, the regime change that followed the death of King Abdullah passed off without incident. But Saudi Arabia faces big challenges. It views all regional troubles through the prism of never-ending Sunni-Shiite conflict. Thus the Shiite regime in Iran is the arch-enemy of Sunni house of Saud although Qatar and Turkey can also be counted as regional rivals. A thawing of relations between Iran and the US has led to tensions in Saudi's long standing relationship with the US. The cooperation with Sunni rebels in Syria and in Iraq was ill-advised. IS undermines the authority of the Saudi regime at home and threatens the country from the North. In Yemen, Saudi's allies have been driven from power while in Bahrain the Shiites remain troublesome despite the Saudis having sent troops to bolster the regime there. Saudi society has significant frictions. Half of the population is under 25 and increasingly demands more freedoms. Up to now the Saudi royal house has been able to buy off these demands. This policy will probably continue even though it is harder to finance at today's lower oil prices. For now, we assume that Saudi Arabia will remain a relatively stable factor in the investment environment but we recognize that instability in that country could wreak terrible damage on markets.

The territorial status of the islands in the East and South China seas remains disputed.

The islands in the South and East China seas are no longer making headlines but are still disputed. Tension between China and Japan concerning the Senkaku islands could explode at any time. Given the military alliance between the US and Japan, conflict over the islands could develop into a power struggle involving China and the US.

It's difficult for investors to insure themselves against these geo-political tensions.

"Geo-politics" are an ever-present uncertainty so far as financial markets are concerned. Right now, Russia's aggression and developments in the Middle East are in the spotlight. At present, we do not hedge our portfolios against geopolitical risk.

Aquila & Co. AG, 23. February 2015

