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Geopolitics roil, but investors roll along

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AP
An image made from video of a news bulletin aired by North Korea's KRT on Monday, May 22, 2017, shows what was said to be the Pukguksong-2 missile lifts off as it is test-launched at an undisclosed location in North Korea. (KRT via AP Video)

by **Mark Zandi**

North Korea tests another nuclear missile. A suicide bomber kills more than a score of mostly young girls and their parents in Manchester, England, after a pop concert. A special prosecutor is appointed to investigate the Trump administration's links with the Russians.

This is a sampling of the disturbing geopolitical events rocking the world just in recent days — only the latest in what feels like a never-ending string of shocks. Recall last year's Brexit vote, or the even more seismic Trump election victory.

This seeming geopolitical chaos notwithstanding, financial markets are incredibly calm. Eerily so. One of the best measures of this is the so-called VIX. Also known as the fear gauge, the VIX captures investors' expectations of the volatility — the ups and downs — of the prices of stocks in the Standard & Poor's 500 index.

The VIX — officially, the Chicago Board Options Exchange Volatility Index — has been around since just after World War II, and it indicates that investors have never been as sanguine about the stocks they own as they are right now. Other financial markets, including bond, currency, and commodity markets, appear equally buoyant.

How do we square the geopolitical mayhem on the one hand with comatose investors on the other?

One explanation is that despite geopolitical concerns, investors are cheered by the economy, which is performing well and whose prospects are good. After a painfully long, dark decade, the economy has finally returned to full employment. The unemployment rate has fallen to lows only enjoyed in the best of times, and it is set to go much lower. A strong job market certainly makes any geopolitical news easier for an investor to digest.

Major global economies are also finally on the same page. Soon after the Great Recession, there was the European debt crisis, a nearly existential event for the eurozone. Then there were China's dizzying economic slump and recessions in many previously high-flying emerging economies that fell to earth under the weight of collapsing oil and other commodity prices.

But over the last year, Europe's economy has kicked into high gear, China has stabilized, and so too have commodity prices. Still-problematic economies such as Brazil, Russia, and Turkey are small fry and casualties of their own endemic corruption.

Investors finally feel as if no threat in some corner of the world will crater their investments.

The Federal Reserve and other major central banks also continue to push hard on the monetary accelerator, keeping interest rates near zero in many places, and negative in Europe and Japan. Investors aren't especially comfortable with the lofty prices of stocks, long-term bonds, and commercial real estate, and their instinct may be to sell on any bad news. But they don't, not knowing where to go with their money. They are effectively frozen in place.

There is also the possibility that investors are simply coping better with events that in times past would have freaked them out; they are becoming inured to bad news that is in their faces all the time.

It's instructive that the South Koreans, who have long dealt with craziness from the North, go about their business despite the real threat posed by Kim Jong Un. Terrorism is very scary, but Europe appears able to take each new attack a bit more in stride. Perhaps investors are getting to the same psychological place.

So what should we make of all this? Should we take solace in investors' confidence and assume they will insulate financial markets, and thus our personal financial futures, from geopolitical shocks? Or should we be nervous that investors won't?

I advise being nervous, and cautious. The one thing, and perhaps the only thing, we know for sure about financial markets is that they are what economists call mean-reverting. That is, if they are performing in an unusual way, that won't last for long, and they will go back to the way they have performed on average over history.

Thus, the current unprecedented low level of volatility in markets is sure to be broken. Stock prices have gone up and down and all around historically, and that hasn't changed. Financial markets will mean-revert. And those least cautious will be the most hurt.

The catalyst for this mean reversion is hard to foresee, but I wouldn't be surprised if it is a geopolitical event. The political perils of the president immediately come to mind. His numerous problems are like grains of sand being thrown on a sand pile. There's no telling which grain will cause the pile to crumble, but as the pile builds — and with the president this happens almost daily — it grows more unstable. It is time for all of us to buckle in.

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