

## A primer on geopolitics and investing

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Angela Ashton | PortfolioConstruction Forum | 28 January 2015

"A Primer on Geopolitics and Investing" by BCA Research, August 2014

Most people have never heard of BCA Research. It tends to be very quiet, but it produces some of the most consistently good quality market and economic analysis of any research group in the world. [Stephen Poloz, now the Governor of the Bank of Canada, is a past Managing Editor of BCA Research – Ed.]

In 2012, BCA Research expanded its investment-focused economic and market analysis services to formally include geopolitics. Their research suggested most of their clients thought geopolitics was important to investment decision making, but did not strictly or consistently include it in their decision making framework.

In this paper, BCA Research provides a broad framework on how to think about geopolitical risk and relate it to investment. The approach to geopolitical analysis assesses risk as the chance of deviation from an expected outcome, either good or bad. It uses three frameworks:

- Overstated and understated risks – media tend to distort geopolitical risk perceptions. Often, risks are overstated or misinterpreted (red herrings). Other, more important risks, are often ignored or understated (leaving the potential to blindside).
- Exogenous and endogenous risks – Many investors believe geopolitics are exogenous from investment markets. But, often, geopolitical risk is endogenous, as it underlies assumptions in how countries will behave.
- Scenario analysis – Geopolitical strategy considers all forecasts as probabilistic. It looks for probabilities of outcomes, catalysts and implications.

In BCA Research's view, the world is currently moving into a multipolar state – that is, we're entering an era where there are a number of great powers in the world, as the global dominance of the US alone begins to diminish. Now, there are a number of countries that can pursue independent and globally relevant foreign policy. Multi-polarity can be balanced or unbalanced and, according to BCA, the world now approximates an unbalanced multi-polar world.

Multi-polarity is often associated with global volatility and is more likely to cause military conflict, depending on the type of multi-polarity. Both World Wars took place during periods of unbalanced multi-polarity. But this could be transitory.

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BCA Research argues that we'll see three main trends over coming years as a result of these changes in global power balances:

- The return of Europe as a united bloc – this may occur as the US buck-passes on military issues in the environ of Europe (such as Syria);
- A paradigm shift in Japan as the US wanes and China's power grows – Japan will strengthen ties with the US and will also rally other China-wary countries in the region; and,
- A China-Russia alliance – They may be pushed into each other's arms as the Euro/US/Japan bloc becomes more strongly aligned.

This rebalancing of geopolitical positioning will also mean geopolitics will become much more important for markets than it was.

BCA's geopolitical analysis also suggests that inflation may no longer be the focus of monetary policy, as it has been for the past 50 years or so. That mandate may be quietly changing amongst central banks. BCA Research points to the examples of Japan explicitly attempting to create inflation, Germany lifting wages and Fed Chair Janet Yellen's rhetoric hinting that the Fed is focusing on economic growth and American's prosperity. All of these indicators suggest that keeping inflation low is not the policy anchor it once was.

If this is the case, implications include, BCA Research argues:

- An easy global monetary policy, which will be broadly supportive of equities;
- Inflation will remain low due to excess capacity and a global savings glut, meaning interest rates can remain low;
- Due to low interest rates, high levels of government debt levels will be sustainable.

[Read "A Primer on Geopolitics and Investing"](#)

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