Wars and markets

Why contrarian market wisdom doesn't necessarily apply to international conflicts.

BY EUAN SINCLAIR

Buy to the sound of cannons, sell to the sound of trumpets.
— Lord Nathan Rothschild, 1810

> Analysis of 440 international crises between 1918 and 2002 found geopolitical conflicts reduced stock returns by approximately 4% annually.

The unfortunate recent events in Ukraine have many traders wondering about war and its effects on the markets. Obviously every geopolitical conflict is different, but that's true for any type of event. Clearly a war involving Iran will have greater impact on the oil market than one in the South Pacific, for example.

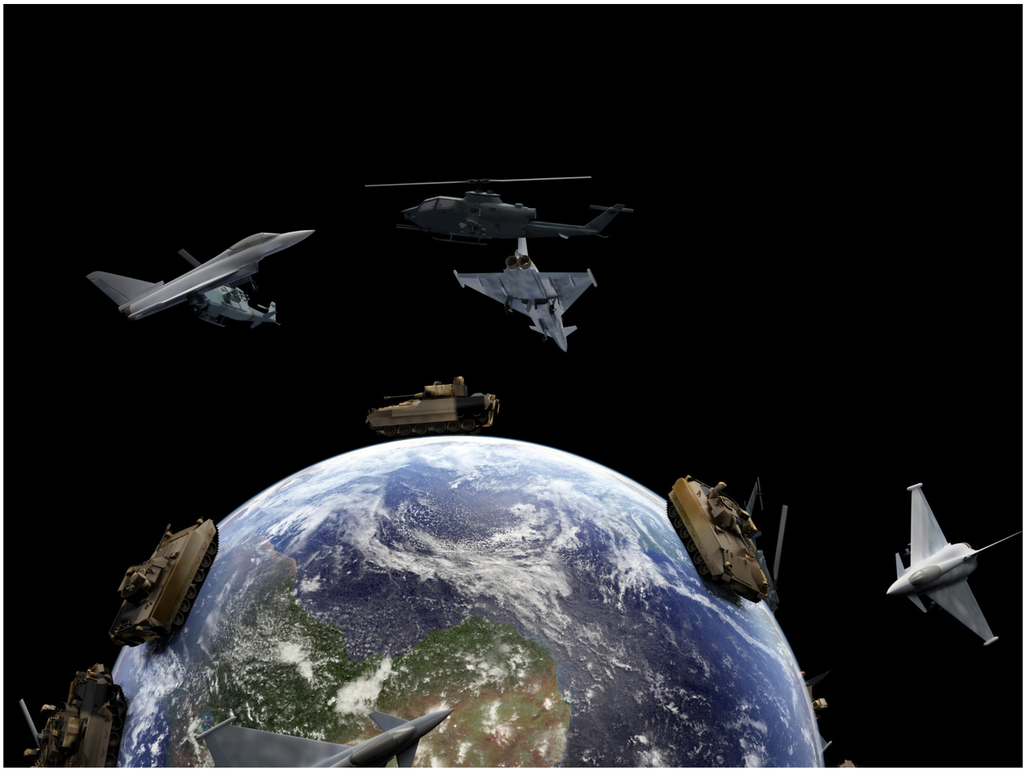
But exactly what kind of effect? Do wars and other disputes between countries have any common characteristics in the ways they move stocks? Simply, are wars a time to buy or a time to sell?

Myth, reality, and Rothschilds

In the early 19th century Mayer Amschel Rothschild and his five sons had solidified the banking empire that made them one of the world's richest families. In 1815 they were rumored to have made a fortune when they used a carrier pigeon to send the result of the Battle of Waterloo (which was "a damned nice thing — the nearest run thing you ever saw in your life" according to the victorious general, the Duke of Wellington) from Belgium to London. Having the news before his rivals gave Nathan Rothschild (who helped finance Wellington's army) an edge over his competitors on the floor of the London Stock Exchange.

This is a good story. It isn't true, but it's a good story. It's true the Rothschilds were known to use pigeons to communicate (an 18th century version of high-frequency trading), and stressed the importance of timely information, but in this case the messenger was a human who got the result from a Dutch newspaper and then took a boat to England. Lord Rothschild got the news, sold bonds to create a panic, and then scooped them up as other traders interpreted this as a sign the British had lost the battle. This true story seems just as good as the apocryphal one.

Given he was a legendary (literally, in regards to the pigeon story) trader, it's difficult to argue with Lord Nathan's quote at the beginning of the article. The idea behind the phrase is that during times of war investors panic and sell their stocks. This selling lowers prices to the point where they are a bargain. In contrast, when the war ends people start to buy as their perceived risk is reduced. This increase in buying causes stock prices to rise, making it an attractive time to sell. This idea is really just a special case of being a contrarian: buying on bad news and selling on



good news because in both instances the market overreacts.

This all sounds good in theory. But is it actually true? It may have been the case during the Napoleonic Wars (or perhaps Rothschild was trying to fool us), but we shouldn't take the idea on faith. We can test it. And by testing it, we are forced to be specific in what we mean. How do we define when the war starts? How long after do we wait to buy stocks? How long after the war ends do we sell them? Does it matter who is in the war, or where it is? Does it matter who wins?

Quantifying conflict

Again, every situation is different. For example, at the start of World War I the New York Stock Exchange closed from July 31 to December 12, 1914 after large numbers of foreign investors started selling assets to raise money for the war, and for general security. Even though America did not enter the war until 1917, the huge level of uncertainty caused the Dow Jones Industrials to drop 24% when trading resumed, at the time its largest decline. The London exchange reopened at the start of 1915, although 1,600 traders and exchange employees had already enlisted in the newly formed Exchange Battalion of the Royal Fusiliers.

However, the start of World War II was handled very differently. The London Exchange closed for six days in 1939 and for one more day in 1945 when the building was hit by a V2 rocket (trading resumed the next day in the basement). The New York Stock Exchange didn't close at all.

But it's pointless to focus on the specifics of each conflict before we know about the commonalities. That should give us a starting point, when we think about how to position ourselves. Further, when the news channels get hold of a story, the specifics will dominate the coverage. We need to have a high-level view first.

It's fairly easy to look back at U.S. involvement in the major conflicts of the 20th Century and see how the Dow reacted over the next year (Table 1). These outcomes seem to support the bullish case, albeit in a very small sample.

TABLE 1: DOW PERFORMANCE IN YEAR AFTER U.S. ENTRY INTO A CONFLICT

Date	Event	Next year's return
April 6, 1917	U.S. enters WWI	-16.6%
Dec. 7, 1941	Pearl Harbor	2.2%
June 25, 1950	North Korea attacks the South	15%
Aug. 7, 1964	Tonkin Gulf Resolution	6.4%
Jan. 17, 1991	Desert Storm begins	24.5%

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But each of these conflicts had different lengths, so one year is not the holding period that corresponds to "selling to the sound of trumpets."

Redoing the simple analysis to correspond with the end of U.S. involvement is also straightforward (Table 2). Again these results look slightly promising. But does it make sense to just look at the date when the U.S. became involved? In the cases of the World Wars and Vietnam the conflicts considerably pre-dated American involvement.

It would be helpful to have a more comprehensive study. Luckily, two New Zealand based academics, Henk Berkman and Ben Jacobsen (the latter coauthored the study on seasonal stock market tendencies referenced in "The persistent calendar anomaly" from the April issue of *Active Trader*) have studied the effects of war and other international crises on stock market returns.

They looked at a database that contained 440 international crises between 1918 and 2002 and found such events reduced stock returns by approximately 4% per annum. Most of these negative returns occur in the first month after the beginning of the war, but subsequent periods during the crisis also have below-average returns, and there is only a partial recovery when peace returns. Volatility also increases (by around a third) during crises. These effects are global but impact the countries directly involved the most. Here's a summary of their results:

- World Market Index, average annual return: 3.96%
- First month of war (annualized): -5.23%
- During war (annualized): -1.69%
- First month after war (annualized): 3.2%

All but the last of these numbers is statistically significant at the 5% level.

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Some incidents have worse effects than others. When a crisis begins with abrupt violence or when major world powers are in direct conflict, the negative effects are larger. However, I would caution traders about deciding whether an incident is "major" or not. There is a good chance that by the time an incident comes to the attention of the general public, it is major. For example, in March the Ukrainian-Russian conflict was clearly major, but how would one classify the Papuan dispute that has been ongoing since 1963? It has claimed more than 400,000 casualties, but only seven so far this year. Sadly, wars are going on all the time, and most of them escape our attention.

What is it good for

The broad conclusion a trader should draw from this extensive and careful study is that wars are bad for markets and increase volatility. I'm not a Rothschild, so no doubt some people will choose to believe Lord Nathan. But you don't need to believe me, believe the numbers.

I won't criticize the trading skills of a Rothschild, but it seems what he said is no longer true, if it ever was (there's a fairly good chance he may have known that all along).

Instead we should probably listen to the most famous strategist of all time Sun Tzu, from *The Art of War*:

> *There is no instance of a nation benefitting from prolonged warfare.* ◆

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TABLE 2: DOW PERFORMANCE DURING THE PERIOD OF U.S. INVOLVEMENT

Entry date	Exit date	Event	Return	Annualized
April 6, 1917	Nov. 11, 1918	WWI	-5.4%	-3.4%
Dec. 7, 1941	Aug. 9, 1945	WWII	46.2%	12.6%
June 25, 1950	July 27, 1953	Korean War	25.5%	8.3%
Aug. 7, 1964	Aug. 15, 1973	Vietnam War	5.4%	0.6%
Jan. 17, 1991	Feb. 28, 1991	Desert Storm	11.9%	103.4%