"If history repeats itself, and the unexpected always happens, how incapable must Man be of learning from experience."

- George Bernard Shaw

As tensions and rhetoric around North Korea have escalated over the past few months, many clients have asked us how we believe this translates to market risk. This question and similar ones about geopolitics are presently more common than at any time since the financial crisis. With the backdrop of elevated international tensions, we find this an opportune time to share our perspective on the market risks presented by macro and geopolitical incidents.

While there are likely no greater number of major economic, political, or environmental events of significant scale that occur today than in the past, one factor is definitely true: we are more globally connected as a society. Whether the occasion at hand is an election, coup, earthquake, hurricane, terrorist attack, currency collapse, or deadly virus, the coverage and commentary from traditional and social media is both immediate and ubiquitous.

Given that we are presented with a virtually unavoidable barrage of disturbing images and sound bites from world events, it is understandable that these would subsequently capture more of our consciousness today vs. a less "connected" era. While it would seem logical that this "mind-share grab" would affect trading patterns, sentiment, and confidence, we have not seen an overall increase in downward market moves following disastrous or alarming situations.

One way to think about the stock market is as an open forum of thousands of buyers and sellers who collectively set the price for each stock by evaluating the present value of the company's stream of expected future earnings. This process incorporates all the risks that these multitudes of traders perceive and applies a discount for the myriad of uncertainties.

After 9/11 some investors believed that the market began to embed a new "terrorism" discount to all financial assets, due to this previously unrecognized risk. Since 2001, we have witnessed a steady stream of troubling terrorist attacks and natural disasters across the globe. As these events occur on a semi-regular basis, it is reasonable to assume that the market's discounting methodology now includes a broader range of external dangers.

If we look at some cases of the market's response to "crises" over the past several years, we can see that selloffs have historically been followed by a relatively rapid return to prior levels. Most recently, the market declined by 2% following North Korea's past two missile launches, but recovered almost immediately.

		Market Performance %		
Crisis (Event)	Year	1 Month Prior	Day of Event	1 Month After
Pearl Harbor	1941	2	-4	-1
Cuban Missile Crisis	1962	-3	-2	11
JFK Assassination	1963	-2	-3	6
Nixon Resigns	1974	2	-1	-15
Gulf War	1990	-1	-1	-8
LA Race Riots	1992	1	2	-1
WTC Truck Bombing	1993	1	0	1
Oklahoma City Bombing	1995	2	0	4
9/11/2011	2001	-8	-5	4
Iraq War	2003	3	0	2
Hurricane Katrina	2005	-1	0	0
Hurricane Sandy	2012	-1	0	0
Boston Marathon Bombing	2013	2	-2	7
Brexit	2016	3	-4	6
Hurricane Harvey	2017	-2	0	3

These historical observations, some of which have included horrific costs in terms of human tragedy, suggest the negative impact to the stock market is relatively contained. The reason may be that stock exchanges react principally to the disruption of national or global economic activity and profitability. While fifty inches of rain in Houston has enormous personal and financial consequences for the local economy and its inhabitants, the broader economic impact is considered limited in terms of scope and duration.

So is it truly possible that the S&P 500, trading at 18x forward earnings, is accurately reflecting the risks of a conflagration on the Korean peninsula? We believe the stock market, to the best of its ability and using all current information available, reflects: 1) Expectations for a continued low interest rate environment, 2) Ongoing revenue and earnings growth, and 3) Some probability that geopolitical events or natural disasters will disrupt economic activity.

The key drivers of stock valuation are the underlying earnings trajectories of the public companies in which we invest. This is where we spend the majority of our time. Rather than focusing on the potential, and in most cases limited market effect of exogenous, unpredictable events, we need to be most concerned with the outlook, risks, and valuations of stocks in our portfolios. This does not make us immune to unexpected external shocks, but history suggests that investors are best served weathering the turbulence that follows in their wake.