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Emerging Markets Spotlight

What a China-Taiwan conflict would mean for stock markets

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There has been a significant amount of speculation in the media and in investment commentary about the potential for hostilities between China and Taiwan (and, by implication, involving allies of either.) This note does not examine the claims and motivations of the different actors in the dispute, nor does it attempt to imagine how any conflict might play out. Rather, we examine the question 'what might such a conflict mean for emerging (and global) equities?'

Despite the rich thirty-plus year history of emerging market investing, there aren't many data points for what military conflict looks like, and certainly nothing on the scale of a potential China-Taiwan conflict. A China-Taiwan conflict would impact EM equities both through involving the two largest country constituents of the MSCI EM Index, with weights of 34.0% and 14.7%, respectively (as at 30 September 2021). It would impact EM equities through potentially major disruptions to the flow of critical goods, including semiconductors and other electronic components, as well as refined materials such as petrochemicals, plastics and metals. And it would impact EM equities through the heightened risk that would likely see investors around the world aggressively de-risk their portfolios.

The obvious comparison is Russia-Ukraine in February 2014, but even that has limited relevance given the absence of material support provided by the West to Ukraine. From the start of hostilities on 27 February 2014, to the low in December 2014, MSCI Russia fell 50.5% in US dollar terms, while with the economic impact dragging on, MSCI Ukraine fell 66.4% in US dollar terms to the low in January 2016. For both, currency weakness was a significant part of the observed decline. It is also important to note that MSCI Russia fell 11.7% in US dollar terms on Monday 3 March 2014 as the scale of the conflict became apparent.

Another conflict, and one that saw significant economic damage, was the Israel-Hezbollah/Lebanon conflict in July-August 2006. MSCI Israel fell 10.5% at the start of fighting, but then performed well in the remainder of 2006 and in 2007, while the local Lebanese stock index fell 20.5% in US dollar terms in the first few months and then stabilized.

Given the potential for a China-Taiwan conflict to draw in other superpowers, we can also look at the Turkish shooting-down of a Russian military aircraft in November 2015. This period saw a rapid 18.8% fall in MSCI Turkey in US dollar terms, although this was in the context of a broad downtrend in Turkish assets from wider political and economic stress.

From a Taiwanese end, we can examine episodes of violent changes of power and serious amounts of unrest, particularly the Arab Spring in 2011 and Hong Kong street protests in 2019. The timing of events in the Arab World in 2011 is complicated, but the calendar year saw the MSCI Egypt price index fall 48.9%, while the Bahrain bourse local index declined 20.5% and the Tunisian local index declined 11.9% having been down 19.0% in the first few weeks of the year (all in US dollar terms). In Hong Kong, the period of the greatest unrest, from March to October 2019, saw an 18.0% decline in MSCI Hong Kong in US dollar terms.

It is impossible to predict how China-Taiwan hostilities could play out, geopolitically, economically, or otherwise. Significant economic damage and/or a change in government would likely cause a sharp decline in Taiwanese equities. A US economic response would also hit Chinese assets, although it is worth noting that some sanctions have been applied by the US to selected Chinese companies and equities, so this risk is presumably priced in, to some degree.

One point that can't be made too strongly, is that these localized conflicts had minimal impact on global risk appetite, but a serious conflict, bringing in regional allies and/or the United States, would be more likely to hurt risk assets everywhere.

Perhaps a better proxy for a geopolitical shock of this scale is 9/11, which saw a rapid 15.0% fall in MSCI EM index and a 13.1% fall in MSCI World index (the developed market benchmark). Again, a caveat would be that this came after a major fall in global equities following the tech bubble bursting in developed markets and various major economic crises in emerging markets, so the shock arrived with markets well below their recent highs, which is not the case at present. It is perhaps the case that the dislocation of economies and markets in September-October 2008 or March-April 2020 would be other comparisons.

As for asset allocation within emerging market equites, the obvious markets to avoid are China and Taiwan. Historic correlations would suggest that a hard fall in those markets could also be expected to spread to Korean equities, while the historically higher beta markets of Latin America, South Africa, Russia and Turkey would also be expected to be among the worst performers. Realistically, though, this would be likely to be an 'all correlations go to 1' market crisis.

In conclusion then, although precise forecasts are impossible, a few points can be made:

- Significant military conflict and unrest has been associated with rapid 10-20% declines in equity markets.
- Weaker economies are generally harder hit, but that does not apply to Taiwan or China.
- With MSCI Taiwan up 82.98% in US dollar terms since the start of 2019, and only 8.4% below its February 2021 high, the market is clearly pricing in a lot of good news and a limited amount of risk.
- MSCI China is up only 28.5% since the start of 2019, and is down 29.5% since its February 2021 high, suggesting the consensus is much less optimistic. China has also been subject to limited financial sanctions since 2020. However, the US dollar continues to dominate global financial flows, and tighter sanctions could hit Chinese equities (particularly H-shares) hard.
- Despite historic vulnerabilities to risk-off events, the likely relative winners in EM would be US allies with large economies and limited trade exposure, which might be India and Mexico, and US allies with large external surpluses, like Saudi Arabia and smaller Gulf states.
- Serious geopolitical stress is bad for risk assets, including emerging market equities, and it is very much to be hoped that a peaceful and constructive outcome can occur.

Source for all data JOHCM/Bloomberg (unless otherwise stated)

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