THOUGHT FOR THE WEEK

# CAN NORTH KOREA IMPACT YOUR NEST EGG?

Global Financial Private Capital

## SYNOPSIS

- President Trump's "fire and fury" remark this week that targeted North Korea injected volatility into a stock market that has otherwise been relatively quiet this summer.
- Any military response will most certainly cause volatility to rise in global equity markets, but the risk of material impact to the U.S. economy is very low.
- Investing in stocks can be tough at times because to be successful over the long run, an investor must learn to become comfortable with uncomfortable investments.

## NORTH KOREA

President Trump's "fire and fury" remark this week that targeted North Korea injected volatility into a stock market that has otherwise been relatively quiet this summer.

Given the amount of media attention this conflict has recently received, investors are now asking how an escalation with North Korea could impact the future for stock prices and the broader U.S. economy.

North Korea is roughly the size of Pennsylvania, and its economy is even smaller. Over 90% of its trade is done with China, which consists of mostly iron ore, coal, and black market (illegal) services. From an economic perspective, if the country disappeared tomorrow, the world would barely notice.

It's unknown if they have the ability to conduct a direct attack on the U.S. mainland, but even if they do, it's likely that our defense systems would intervene before they could cause any real damage.

The only legitimate threat they pose is to neighboring countries, particularly South Korea. They represent around 2% of world GDP, so if their economic output were to fall by 50%, then the global economy may slow by 1% (2% x 50% = 1%).

However, South Korea does play a big part in the global supply chain, particularly in technology. They are currently the biggest producer of liquid crystal displays (40% market share) and the second biggest of semiconductors (17% market share). The country is also a key automotive manufacturer and home to the world's three largest shipbuilders.

> *"Long-term success in equities requires an investor to become comfortable with uncomfortable investments."*

If there was a catastrophic attack on South Korea, this supply chain could be severely disrupted. Since nearly every company in every sector relies on technology, the U.S. economy would most certainly feel the impact.

For example, U.S. spending on electronic items, including smart phones, cameras, tablets and computers account for roughly 1% of the consumer price inflation basket. If this supply chain were to be disrupted and caused prices to rise, inflation would follow.

Another potential consideration would be the added cost to support U.S. military action. Fighting wars can get very expensive very fast, and the increased level of government debt to fund any involvement may influence interest rates and the Fed's monetary policy.

Financial market impact will be more immediate. Markets have proven over time that they hate uncertainty, so the fear of the unknown will fuel volatility, particularly in stocks. It's hard to say just how volatile the stock market would get, but investors should expect to feel some pain.

However, this will be temporary because emotions fuel volatility, but volatility does not derail $19 trillion economies. For scale, the chart on the following page shows the market reaction over the coming weeks after September 11, 2001.


*Source: Bloomberg*

This was the worst attack on U.S. soil since Pearl Harbor, yet it was not enough to drive our economy into a recession. In fact, those who bought into the panic when the market eventually reopened participated in one of the best buying opportunities in the history of the stock market.

To summarize, any military response to North Korea will most certainly cause volatility to rise in global equity markets, but the risk of a longer-term drawdown or material impact to the U.S. economy is low.

## WHAT ARE THE ODDS?

The next step is to determine the odds of this conflict escalating past the tipping point. Admittedly, this is tough because data, logic, and reasoning are poor tools to assess a situation predicated upon politics, ego, and obligations for governments to protect its citizens.

All we can do is assess the facts and try to understand the incentives and motivations of the governments involved in the conflict. Within this context, I firmly believe that the odds of a major conflict with North Korea are quite low for three reasons.

The first is the U.S. military. Despite the rampant dysfunction that plagues our government, the one thing our country does extremely well is defense. There is not a country in the world that comes close to our technology, training, and firepower. Any involvement from our armed forces would most likely be quick and effective.
The second is China. Since China controls so much of North Korea's trade, they can exert a tremendous amount of force. The last thing China wants is to disrupt their control over the region, and they continually show the world that they will do anything in their power to keep the U.S. from expanding their presence in the region.

The third is North Korea. Kim Jong-un has a really good life. He enjoys unlimited power and wealth in his country, and since they possess nuclear weapons, he can pretty much say whatever he wants with little fear of retribution.

However, the second he crosses the line, it all ends. Leaders in these positions are rarely willing to give it all up. They are just too self-interested.

That being said, I do expect the Trump administration to take North Korea more seriously than past administrations. I just do not see the conflict spiraling out of control to the point where the U.S. and/or global economy reverse course.

## IMPLICATIONS FOR INVESTORS

Think about all the geopolitical shocks, pandemics, terrorist attacks, central bank moves, and other sources of volatility that we have endured since the financial crisis.

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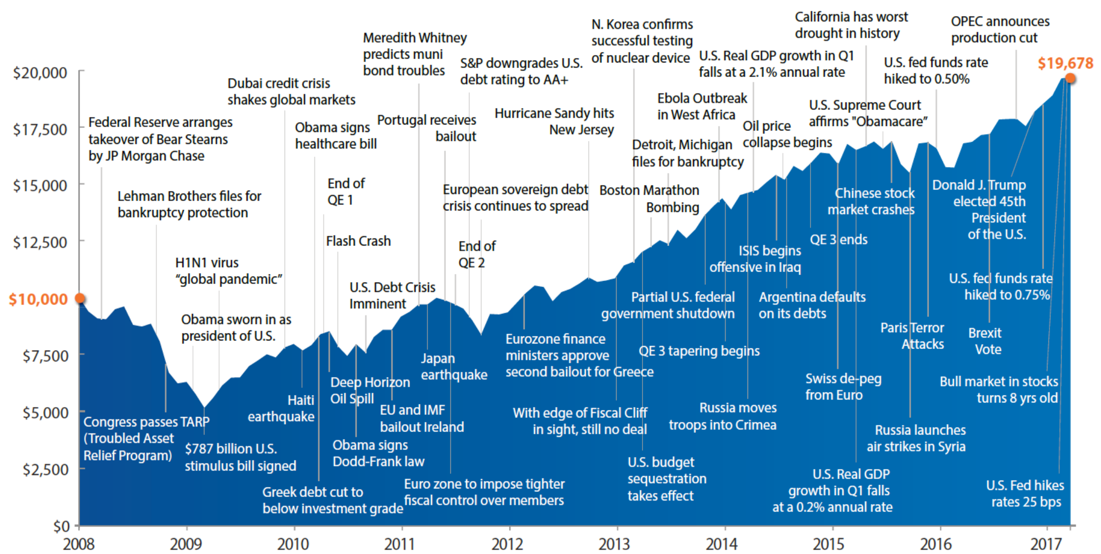
## S&P 500 INDEX: JANUARY 1, 2008 – MARCH 31, 2017

**The average annual total return of the S&P 500 Index for the period shown below was 7.59%.**




Source: First Trust Advisors L.P.

This chart is for illustrative purposes only and not indicative of any actual investment. The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. Stocks are not guaranteed and have been more volatile than the other asset classes. These returns were the result of certain market factors and events which may not be repeated in the future. Past performance is no guarantee of future results.

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The chart above shows that if an investor attached blinders, turned off the television, and ignored the events that transpired, an investor in the S&P 500 would have doubled their money by now.

Long-term success in equities requires an investor to become comfortable with uncomfortable investments, but simply ignoring events like the ones in this chart is not the answer.

Instead, gauge the severity of the situation and estimate any potential impact using analytics rather than emotions. Try to get a sense of what it would look like if things got really bad and then determine the odds of that happening. This is precisely what we have done with the North Korea conflict.

Another important rule is to always be honest with yourself on just how much volatility you can tolerate because no matter how well stocks are expected to perform, the inability to take the ride almost always ends badly. It is just not worth the risk of selling into panic.

*The bottom line* is that this conflict with North Korea will most likely become nothing more than another line on the chart above, and any further increase in volatility will not be an indication of a derailing U.S. economy.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer,
Global Financial Private Capital