Manulife Investments

INVESTMENT NOTE

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Investing in Uncertain Times – The Korean Peninsula

By Macan Nia

Tensions between the global community and North Korea have increased after North Korea successfully tested an ICBM [intercontinental ballistic missile] that experts believe could 'theoretically' hit the U.S. mainland. Tensions increased further when the US military announced that it believes North Korea has the technology to 'miniaturize' a nuclear weapon to *potentially* fit onto one of their ICBMs. Questions remain regarding whether a North Korean ICBM targeted at the US could successfully re-enter the earth's atmosphere after launch and its precision when locating targets. Successful re-entry is extremely complex due to the heat generated which can damage electronic systems and demolish the missile. Add the exchange between Donald Trump and Kim Jung-un and you can see why tensions have run high.

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We have received requests from clients asking for our views on the matter and its implications for capital markets going forward. We want to stress, we are not political strategists. Rather, we are investment strategists who will look at the current situation through an investment lens.

We believe there would be nothing to gain from a military campaign for any of the parties involved from a humanitarian, economic or sustainability perspective. Should the situation escalate, North Korea, South Korea, Japan, China and the United States would all be drawn into the conflict, in some manner.

From a humanitarian perspective, even a non-nuclear conflict could cause tragic loss of life. North Korea has the world's 4th largest active army[i] and its ballistic missiles can easily hit Seoul and Tokyo which have populations including the greater area of 24 and 38 million people respectively[ii]. The upheaval in the Korean peninsula would flood China with refugees [North Korea has a population of 26 million] and would require both China and the U.S. to engage in nation building at a time when there is very little appetite. Kim Jung-un could potentially be replaced and the family dynasty could end.

From an economic perspective, military conflicts are detrimental to a nation's economy. The war in Syria has resulted in at least a 60% drop in GDP while the Korean War (1950-1953) which was the most destructive war since WWII led to 1.2 million Korean deaths and saw an 80% decline in GDP. Today, South Korea's GDP is the 11th largest in the world and accounts for approximately 2% of the global economy. An escalation between the U.S. and North Korea would likely draw South Korea into the conflict exposing the South Korean economy. Using history as a guide, a war would likely paralyze the South Korean economy resulting in a 1% decline in global GDP. However, the biggest disruption would be on the global supply chains. The critical role that exports play in the country's economy also gives South Korea an outsized role in international trade. South Korea is the world's 5th largest exporter and is a major exporter in many diverse products including: ships, appliances, cars, refined petroleum products, computer chips, apparel etc. It is not just this diversity, but the importance of its trading partners that matters. About 60% of its exports are to the four largest economies in the world; the US, China, Japan and Europe, making it a great bellwether for global economic growth. Months after the Thai floods in 2011, electronics and automotive factories across the world were reporting shortages. To put this in perspective, Thailand is the world's 22nd largest exporter while South Korea is the 5th largest exporter. Clearly, a South Korean disruption would prove much more challenging. One example of the possible disruption could be in the global smartphone market – South Korea is the biggest producer of liquid crystal displays in the world [40% of the global trade] and the second biggest of semiconductors [17% market share]. It is also a key automotive manufacturer and home to the world's three biggest shipbuilders. A military conflict in the region would guarantee a global recession as three of the top five largest exporters [China at 1, Japan at 4, South Korea at 5] would likely be drawn into a conflict.

And financially, a military escalation would hit the wallet. Per the U.S. Department of Defense, direct spending and interest cost for the 2003-2010 Iraq war was approximately $1.0 trillion dollars. The current economic and political climate in the US will be challenged if the country racks up the expense of a war while at the same time pushing through tax reform, a much more popular priority at home.

It is unlikely that a military option can adequately overthrow Kim Jung-un without resulting in humanitarian and economic disaster. Thus, it is in everyone's best interest to come to a diplomatic solution. While the headlines were quoting both leaders, it has been reported that United States and North Korean delegates were using back channels to work towards a diplomatic solution. We believe that the likelihood of military escalation is very low [less than 5%] and believe that a diplomatic solution is much more likely given the potential consequences.

Perhaps, it is a good time to remind clients of a key tenet of Investment 101, which is <u>not to allow geopolitical risks to question or alter an investment strategy.</u> Geopolitical risks are nothing new, this is not the first time that North Korea has hit the news wires. Three prior US presidents have dealt and failed in controlling North Korea's nuclear ambitions. Allowing geopolitical events to question an investment strategy is a losing one. As the table below highlights, geopolitical events cause a sell off from the initial reaction. However, markets are often positive 1 month and 1 year after that initial reaction.

S&P 500 percentage gain/loss after last reaction

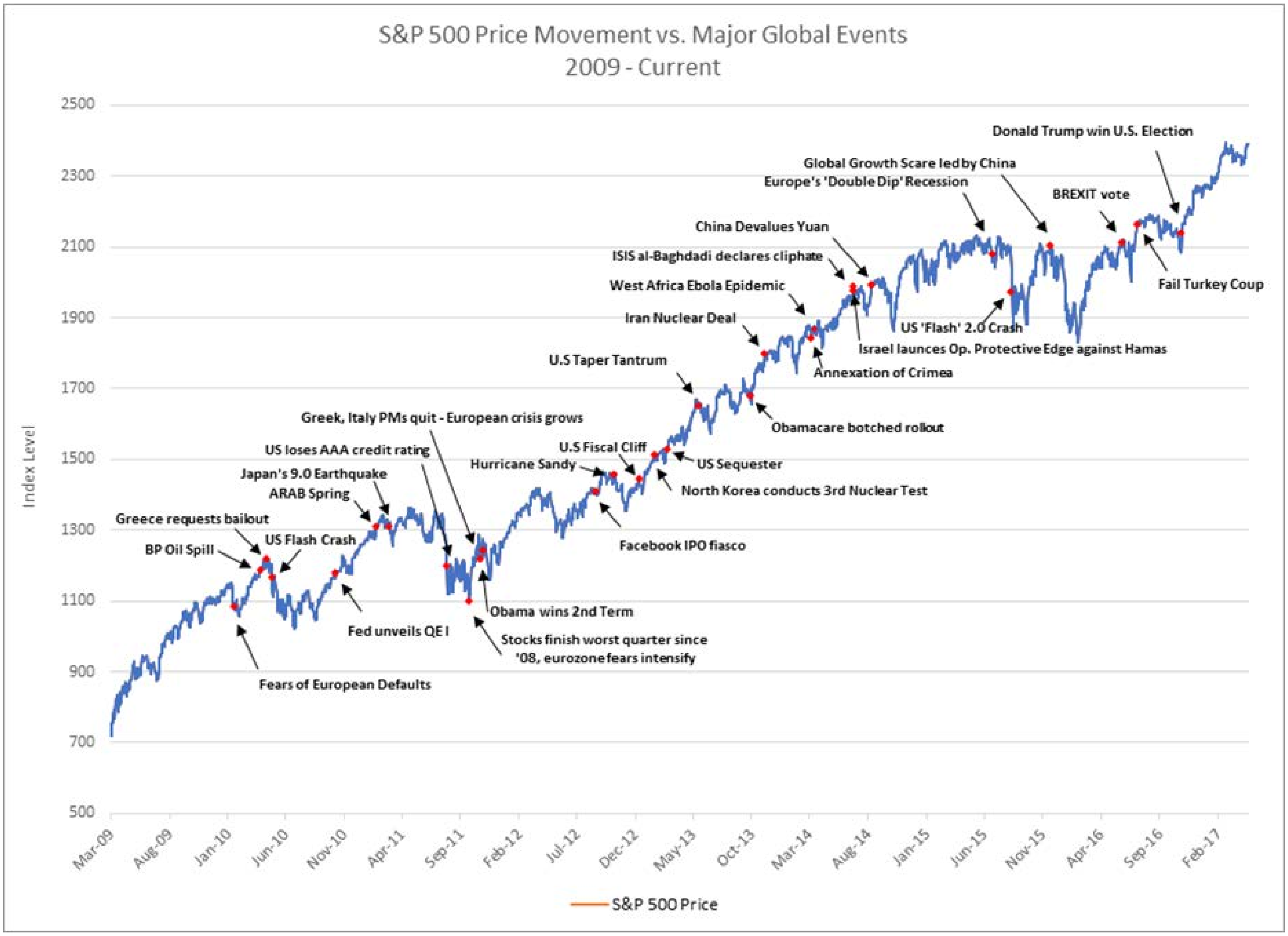
Event	Reaction Dates	% of Gain/Loss During Event	1 Month later	1 year later
Attack on Pearl Harbor	12/06/1941 - 12/10/1941	-8%	2%	16%
Outbreak of Korea War	6/23/1950 - 7/13/1950	-12%	10%	42%
Cuban Missile Crisis	8/23/1962 - 10/23/1962	-10%	16%	41%
U.S.S.R invades Afghanistan	12/24/1979 - 01/03/1980	-2%	10%	37%
Gulf War Ultimatum	12/24/1990 - 1/16/1991	-4%	17%	37%
Gorbachev Coup	8/16/1991 - 8/19/1991	-2%	3%	15%
September 11 terrorist attacks	9/10/2001 - 9/21/2001	-12%	11%	-11%
U.S. Invades Iraq	3/18/2003 - 03/31/2003	-2%	8%	35%
	Average gain/loss	-6%	10%	26%
	Median gain/loss	-6%	10%	36%

Source: Ned Davis Research
* Start Date [start of event] - End Date [lows in markets]

Market recoveries following geopolitical events are often quick, leaving those investors who had altered their investment strategy behind. Market sell-offs of more than 5% can be put into two distinct buckets: those that occurred during a recessionary environment and those driven by sentiment [geopolitical]. From our team's perspective, any near-term pullback would likely be the result of the latter. The global economy, led by the world's largest economies [United States, China, Europe and Japan] is currently experiencing economic growth, which has led to a healthy trade, corporate earnings and employment. In the United States, there have been 87 instances of pullbacks of greater than 5% driven by sentiment factors – 90% of the time, the S&P 500 was positive 1 year later. We believe that this time will not be different, and any pullback due to sentiment will be very short term in nature.

In the history of recorded time, there has always been a geopolitical component of concern and this trend is likely to continue as long as we inhabit earth. Therefore, we shouldn't be alarmed when an event arises.

The chart below shows the S&P 500 and all the 'risks' since the Great Recession. Despite the many more recent 'headline risks', the S&P 500 returned 14.7% annualized since 2008. There have been countless 'headline risks' over the past 30 years and despite this, the S&P 500 has returned 7.6%, 7.0% and 9.3% over a 10, 20 and 30-year time frame[iii].



Source: Bloomberg, Capital Markets & Strategy

Since all military options will likely prove inadequate and can result in severe humanitarian and economic destruction - we believe that a political resolution to the current situation is much more likely. We believe any short term sell-off in markets caused by geopolitical fears will be short lived. For the markets, fundamentals, corporate earnings and valuations will be the biggest drivers of returns over the upcoming year. As of today, global economic fundamentals are positive and we believe this will lead into strong corporate earnings throughout the remainder of 2017. With valuations at reasonable levels and supported by strong earnings, we believe that a new dollar invested today will be positive on a one year forward basis. We remind investors not to be swayed by headline news but rather to remain focused on their investment objectives.

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[i] 2017 Edition of 'The Military Balance' – International Institute for Strategic Studies
[ii] Wikipedia – City of Seoul, City of Tokyo
[iii] Bloomberg