

A Review of Geopolitical Conflicts and Stock Market Performance

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Abstract

Geopolitical risk has become one of the important factors contributing to uncertainties in global financial markets by influencing investments, market stability, and economic growth. This research study provides an overview of the effect of geopolitics on stock market performance, stock market volatility, investor behavior and financial system resilience. Conceptual models are used to describe the impact of geopolitical risk and macro-financial propagation mechanisms. The presented analysis explores the methodologies used in analyzing the influence of geopolitics ranging from traditional econometric models to advanced GARCH, TVP-VAR, network and quantile models and provides a comparative analysis of different regions' vulnerability to geopolitics, sector responses to geopolitical risk, and risk propagation. At the same time, research gaps in integrating macro-financial perspective, behavioral economics, and sector approach in studies of the effects of geopolitical risk on stock market dynamics are also presented. This study highlights the effect of geopolitics on risk management practices and investment decisions to ensure a better financial interconnectedness.

Keywords: Geopolitical Risk, Stock Market Volatility, Financial Markets, Investor Behavior, Spillover Effects, Risk Transmission, Macro-Financial Risk.

1. Introduction

Geopolitical risk remains as one of the most significant determinants of the operation of financial markets in the current global environment. Continuous wars, political unrest, trade conflicts and economic sanctions have made the world experience more uncertainty and as such the financial markets are becoming more susceptible to external shocks. These are the

geopolitical occurrences that have a direct impact on the performance of the stock market, investor confidence and the stability of the entire financial system. Consequently, the role of geopolitical risk has become imperative to investors, policy makers and researchers.

The current financial markets are much interconnected and this has enabled financial shocks experienced in a given region to rapidly be spread to other parts of the world. The recent world wars have demonstrated clearly that geopolitical unrests can cause interruptions in trade, supply chains, and cause abrupt changes in stock prices. The result of these conditions is more volatility and uncertainty in the market and makes it hard to make informed and stable decisions by investors. In those cases, the markets tend to respond, not only to real geopolitical events, but also to anticipations and perceived risks.

These economies are more susceptible as they have poor economic structure and more reliant on externalities, whereas the developed economies are more stable and interdependent in their responses. Simultaneously, various sectors of the economy respond in a different manner to geopolitical shocks. Sectors like energy, defence and shipping are specifically impacted since they are directly connected to global trade and resources, but financial and sustainable sectors react according to long-term outlooks and alterations in policy.

Another factor that affects investor behaviour is the geopolitical risk. When uncertainty is high, investors are had to behave in an emotional manner and this results in behaviour such herding, where market participants are engaged in following the general trend, instead of acting independently. This action leads to more market instability and enhances the effect of the geopolitical events. Moreover, due to the high level of interconnectedness of international financial markets, the spillover and contagion effects occur, i.e., risks are not only transmitted between countries and regions but also between large economic blocks like the G7 or BRICS.

Despite a number of recent studies that investigated the effects of the geopolitical risk through a variety of models and methods, there is a gap to develop a comprehensive understanding that incorporates the regional, sectoral and behavioural levels. Thus, the objective of this paper is to summarize recent research to understand the impacts of geopolitical risk on stock market returns, volatility, and investor behaviour in financial markets around the world. The research also aims to establish general trends, methodology, and important lessons that can be used to make more effective risk management and investment decisions in an ever-evolving uncertain global environment.

2. Geopolitical Risk Transmission Framework

Geopolitical risk is external risk factors such as conflict, instability, dispute, sanctions, and diplomatic problems which are uncertain in the world of financial markets. Geopolitical risk impacts economic outcomes through several inter-related pathways of trade, financial market, and financial institutions.

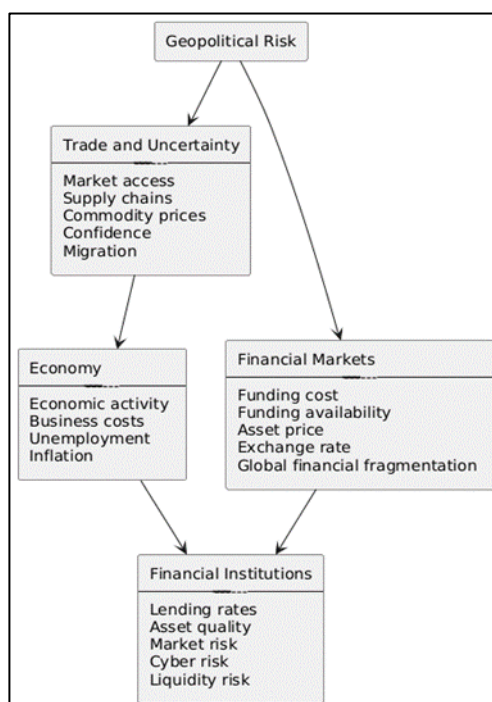


Figure 1. Transmission mechanism of geopolitical risk in the financial system

As shown in Figure 1, the impact of geopolitical risk starts by disrupting international trade and economic uncertainty through restricted access to the market, disruption in the global supply chain, increased commodity price volatility, reduced investor confidence, and migration impacts. The effects of these disruptions on the real economy include reduced economic activity, increased business cost of operations, higher rates of unemployment, and inflation.

Meanwhile, geopolitical shocks impact the financial markets directly due to higher financing costs, lower financing availability, variations in asset and exchange rates, as well as increased fragmentation of international financial markets. Such disturbances in the financial market impact the availability and the cost of financing and thus, have an effect on investment decisions and financial stability. The result of the two types of impacts on the economy and the financial market has an impact on financial institutions by creating more risks when it comes to lending activities, decreased quality of assets, market risks and liquidity risks, as well as

operational risks such as cyber risks. Hence, geopolitical risk transforms from being a purely political risk to a financial risk.

3. Macro-Financial Transmission Channels of Geopolitical Shocks

The influence of geopolitical shocks on financial stability takes place through various interrelated transmission mechanisms, which at the same time impact the markets, economy, and institutional capacity. It is crucial to comprehend these mechanisms to provide an explanation of how the local geopolitical shocks cause macro-financial effects.

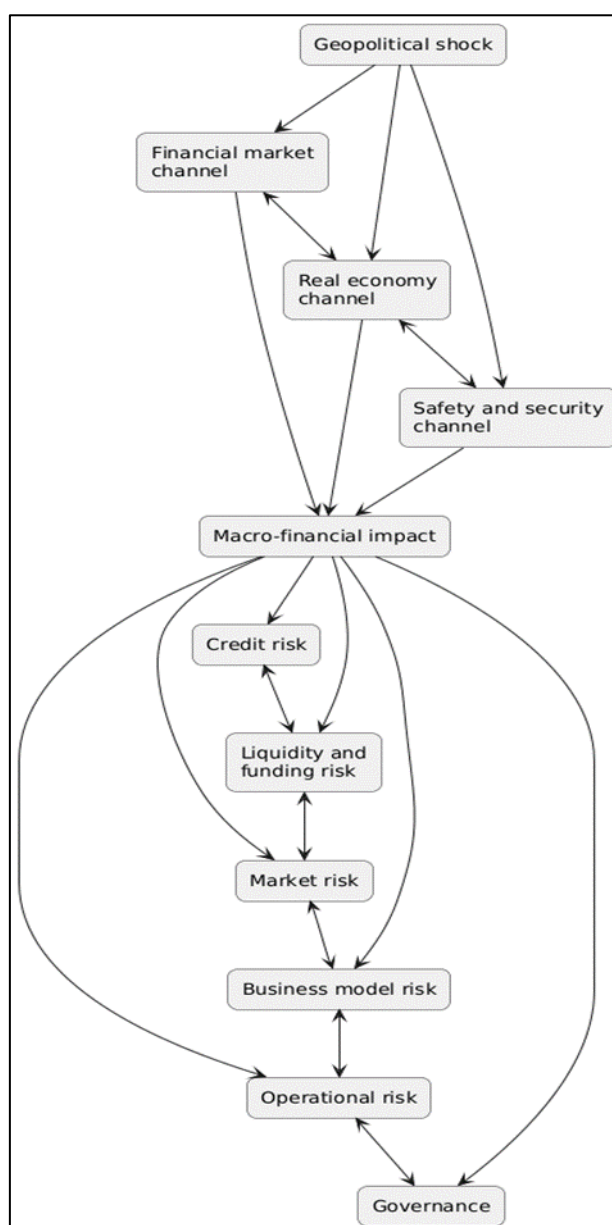


Figure 2. Transmission channels of geopolitical shock and macro-financial risks

As shown in Figure 2, the impact of the geopolitical shock occurs first through three basic transmission mechanisms: financial market mechanism, real economy mechanism, and safety and security mechanism. The financial market mechanism considers immediate changes in stock prices, exchange rates, liquidity, and investor confidence. The real economy mechanism includes disruptions to production, trade, investments, employment, and economic growth, whereas the safety and security mechanism considers higher military spending, political instability, infrastructure disruption, and national security issues.

These interrelated channels give rise to a macro-financial effect, which then translates into several types of financial risks. There is an increase in credit risk due to weakened borrowing abilities. Liquidity and funding risk result from tightened financing and lesser liquidity in the market. Increased market risk is caused by greater volatility in equity, commodities, and foreign exchange markets. Long-term geopolitical uncertainty can also transform the business model through changes in supply chains, international trade, and investments, leading to increased business model risk. Operational risk also increases due to disrupted supply chains and cybersecurity.

4. Existing Methodologies

The role of geopolitical risk in financial markets has attracted a lot of interest over the past few years due to the current global conflicts, trade tensions as well economic uncertainties. The recent research literature indicates that geopolitical events have a strong impact on the stock market behavior, which can be observed in terms of volatility and returns. According to Hasyim et al. [1] and Sayed [2], recent wars like the Russia-Ukraine war have caused sudden changes in the stock markets, indicating the uncertainty and sudden changes in the investing behaviour. On the same note, Lamine and Zribi [5] stated that there will be always be a long-term negative impact of geopolitical risk in stock returns and augmented volatility in global markets.

Recent literature also highlights that the influence of geopolitical risk is not similar in all economies. Nasouri [3] mentioned that geopolitical shocks are more sensitive to emerging markets because they are structurally weak and are reliant on the external factors. This observation is substantiated by Panazan et al. [7], who have noted that volatility was different in the SAARC countries, and Panazan and Gheorghe [9], who have pointed out that there was a high level of interdependence among G7 markets in the state of geopolitical stress. Moreover,

Eissa and Al Refai [16] showed that the Middle East and African markets reacted differently to geopolitical risks based on whether the risks are threat or event-based. Ayadi and Ben Mbarek [17] also revealed that geopolitical risk also reacts with other uncertainties like oil price and monetary policy and results in time-dependent effects on stock market returns.

On the methodological side, recent research used superior econometric methods to gain a more insightful view of the dynamic aspect of geopolitical risk. Maimaitijiang et al. [4] applied time-varying parameter and demonstrated that the impact of geopolitical risk varies over time and in various industries. Lamine and Zribi [5] used GARCH models and established volatility persistence, whereas Hu et al. [10] observed the tail-risk correlations and revealed robust cross-dependences between global markets. In more recent research, Enescu and Szeles [24] applied quantile-based techniques and found that geopolitical risk has various results in a bullish and bearish market, which are nonlinear and regime-dependent.

Sectoral researches also indicate that geopolitical risk does not have an equal response in all sectors. As emphasized by Boyuket al. [6] and Agbede et al. [18], energy markets are prone to geopolitical events by disruptions in supply and changes in regulations. As demonstrated by Marobhe et al. [19], shipping sector is adversely impacted in case of geopolitical conflicts as there is disruption in international trade routes. Conversely, Chatziantoniou et al. [21] discovered that various sectors in the US stock market respond differently on the nature of the geopolitical risk, whereas Helmi et al. [22] found that sustainable and green markets respond variably based on the time period and extents of risk.

In general, investor behaviour changes in times of geopolitical uncertainty. In a study by Blasco et al. [23], the herding behaviour is stronger in the initial phases of geopolitical crisis, especially in the emerging markets. This action creates coordinated trading activities and adds to the further instability of the market. Medhioub [14] also noted that high degree of uncertainty usually leads to irrational investment decisions that are motivated by fear and panic.

Moreover, recent works underline the existence of spillover and contagion effects in the global financial markets. Hu et al. [10] and Gong et al. [12] demonstrated that geopolitical shocks augment the market interconnectedness, which enables risks to be transmitted speedily across regions. NguyenHuu and Oersal [8] and Shawon et al. [15] also connected geopolitical risk to financial stress, which means that its effects are not just on the stock markets, but on the financial system in general.

Table 1 summarizes the reviewed studies by research category, representative references, methodological approaches, and the principal findings reported in the literature.

Table 1. Summary of reviewed literature

Category	Studies [Ref]	Methods Used	Key Findings
Volatility & Returns	[1], [2], [5], [25]	GARCH, Event Study	Increased volatility, negative returns
Regional Analysis	[3], [7], [9], [16], [17]	Panel, MGARCH, LP	Emerging markets more sensitive
Dynamic Modeling	[4], [10], [11], [24]	VAR, TVP-VAR, Network	Time-varying and interconnected risk
Sectoral Impact	[6], [18], [19], [20], [21] [22]	Mixed Econometric Models	Different sector responses
Investor Behavior	[13], [14], [23]	Behavioral, CSAD	Herding increases instability
Spillover & Contagion	[8], [10], [12], [15]	VAR, Network Models	Strong global risk transmission

5. Comparative Analysis

The studies reviewed reveal a broad variety of methods and results related to how geopolitical risk affects financial markets. There is both a definitive difference and similarity, according to a comparative analysis of studies, regarding the methodology used, the regional focus and sectoral impact and behavioural response.

Methodologically, previous research primarily builds on conventional models including GARCH and event study models to study volatility and short-term market responses [1], [2], [5], [25]. These techniques are useful in determining the short-run effects but poor in establishing dynamic associations. More recent studies, by contrast, employ more advanced methods like VAR, TVP-VAR, network models and quantile-based methods that offer a more insightful view of time-varying, nonlinear, and regime-dependent effects [4], [5], [10], [11], [15], [24]. The comparison reveals a distinct move towards more active and diversified models of analysis as opposed to the previous, more passive models.

Regarding the analysis of the region, we can see a uniform pattern in the literature. Research on the emerging markets suggests that geopolitical risk is more sensitive since the economic structures are less established and the economies are more reliant on the external

factors [3], [7], [8], [16], [18]. Conversely, the developed markets are comparatively stable in their reaction but very interdependent and the spill over effects are high [9], [10], [15], [16]. Comparative analysis of the regions shows that the extent of impact varies, but none of the markets is perfectly immune to geopolitical shocks.

The comparison of the sectoral effects shows that geopolitical risk does not impact the industries equally. The energy, defence and shipping industries are identified to be affected more directly as these areas are closely linked to the global trade, resources and conflict induced demand [6], [19], [20]. Conversely, financial and sustainable industries show ambivalent reactions with respect to policy expectation, investment horizon and the market [21], [22]. This difference suggests that it is valuable to analyse the sector-specific effects when determining the overall effect of geopolitical risk.

In recent studies, it is observed that geopolitical unpredictability enhances herding behaviour particularly in the initial stages of conflict [13], [23]. Emotional and trend-following behaviour is stronger when compared to fundamental-based investment decision making, and magnifies market volatility [14]. Most studies are conducted on the behavioural aspects in isolation, without incorporating them with market structure and macro-financial risks.

The contagion effects analysis reveals that there is a close interconnectedness in global financial markets. Empirical research based on network and correlation techniques demonstrates that the geopolitical shocks in one market are transmitted to other markets, especially across major economies, including G7 and BRICS. Table 2 presents a comparative view of traditional and recent studies on geopolitical risk in financial markets.

Table 2. Comparative analysis of geopolitical risk studies

Dimension	Traditional Studies	Recent Studies	Key Observation
Methodology	GARCH, Event Study (Short-term focus)	VAR, TVP-VAR, Network, Quantile Models	Shift from static to dynamic and nonlinear analysis [1], [2], [4], [5], [10], [24].
Market Focus	Single market / region	Global, multi-region (G7, BRICS, SAARC)	Markets are interconnected, no isolation [3], [7], [9], [10], [16].

Market Type	Limited comparison	Emerging vs Developed comparison	Emerging markets more sensitive to shocks [3], [7], [9], [16], [17].
Sectoral Analysis	Isolated sectors (Energy, Shipping)	Multi-sector comparison	Sector responses vary significantly [6], [18], [19], [20], [21], [22].
Investor Behavior	Less focus	Herding and behavioural analysis included	Emotional behaviour increases volatility [13], [14], [23].
Risk Transmission	Basic correlation	Spillover, contagion, network-based analysis	Strong global risk transmission [8], [10], [12], [15].
Nature of Impact	Linear, short-term effects	Time-varying, asymmetric, regime-dependent	Impact depends on market conditions [4], [5], [10], [17], [18], [24], [25].

6. Research Gap

Despite the numerous advances made in the comprehension of the geopolitical risk and its impact on the financial market dynamics, there still exist several shortcomings that need to be addressed. Firstly, most of the available literature focuses on separate features of the geopolitical risk including volatility, contagion effect, sector performance, and investors' behaviour, whereas the interaction between all those features and their joint effects on the market dynamics have not been thoroughly studied yet [3], [5], [9], [10], [15], [23], [24].

Moreover, there exists an imbalance between the developments in the methodologies and their use for solving the practical issues. The use of such sophisticated econometric models as GARCH, TVP-VAR, network and quantile regressions has improved the understanding of the dynamics and non-linearity of the relations; nevertheless, their use for financial risk management and investments has been quite limited so far [4], [5], [10], [24], [25]. Moreover, there is a lack of cross-country studies comparing both developed and emerging markets [3], [7], [9], [16], [18].

The literature at the sectoral level also highlights differences in responses to geopolitical events, but cross-sector analyses of energy, defence, shipping, financial, and sustainable markets have been scarce [6], [19], [20], [21], [22]. Also, behavioural literature has

concentrated on herding behaviour without sufficient connection of investor psychology to financial risks [13], [14], [23].

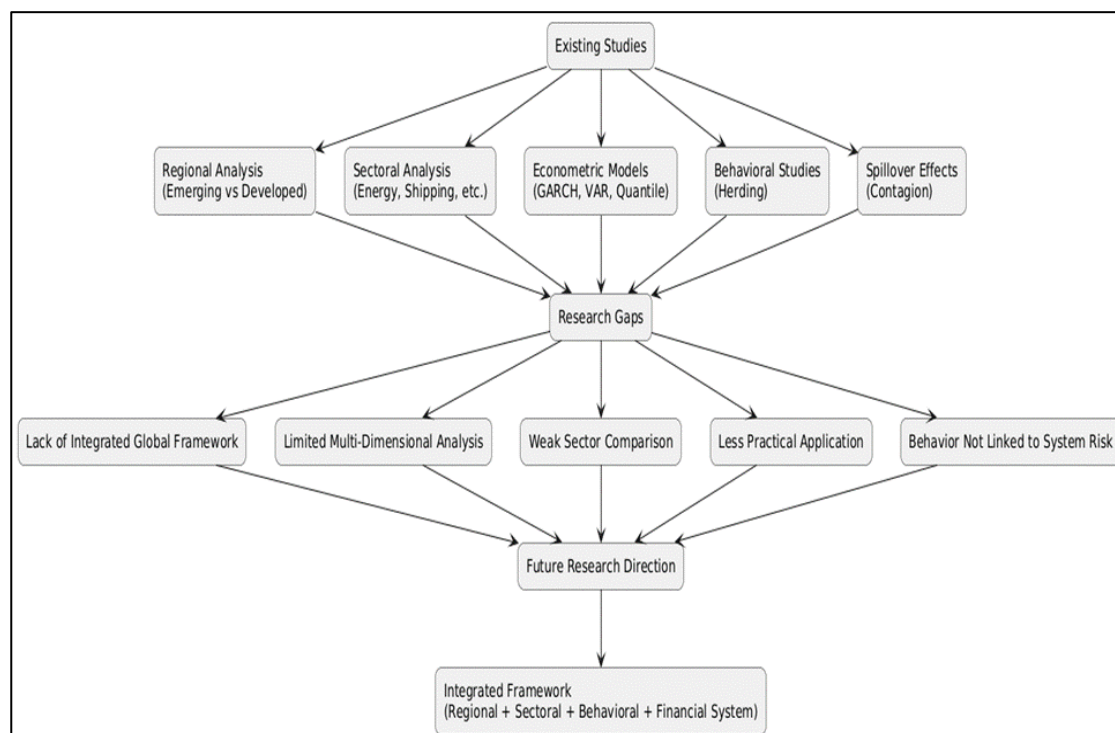


Figure 3. Integrated research gap and future research framework

Figure 3 provides an overview of the research gaps observed and suggests an integrated research framework by combining the aspects of the regional, sectoral, behavioural, and macro-financial approaches. Such an integrated perspective would enhance the study of the geopolitics of risk transmission and would give better foundations for further empirical analysis and financial risk management.

7. Motivation for Future Research

The rising prevalence of geopolitics, sanctions, and trade disruptions further underscores the need to conduct more thorough research into their effects on global finance. While the literature has already contributed greatly to understanding financial volatility, spillovers, and investors' behaviour, most of the evidence is still fragmented in terms of specific regions, industries, and methodological aspects. Thus, future research needs to be more focused on creating an integrative model that considers all macroeconomic, financial market, sector-specific and behavioural variables in order to understand geopolitical risks better. One more area of potential development is the practical use of econometric models. While modern

econometric methods like TVP-VAR, network, and quantile models make it possible to measure the process of dynamic risk transmission more accurately, there is a lack of research in applying the findings to practical purposes such as investment decisions and policy-making. Moreover, the growing financial interconnectivity requires more attention to cross-market risk transmission and resilience, especially in terms of major economic groups such as the G7 and BRICS. Table 3 provides a summary of potential directions for future research.

Table 3. Summary of future research directions

Research Area	Current Limitation	Future Research Direction
Integrated Framework [3], [7], [9], [24], [25]	Studies are fragmented	Combine regional, sectoral, behavioural analysis
Methodological Approach [4], [5], [10], [24]	Focus on theoretical models	Develop practical and applied models
Regional Analysis [7], [9], [10], [16]	Limited global integration	Study cross-market interactions (G7, BRICS)
Sectoral Analysis [6], [18], [19], [21], [22]	Isolated sector studies	Multi-sector comparative frameworks
Investor Behaviour [13], [14], [23]	Studied separately	Integrate behaviour with market and system risk
Risk Transmission [8], [10], [12], [15]	Basic spillover analysis	Advanced network and dynamic models
Data & Modeling [4], [10], [24], [25]	Static and historical analysis	Real-time and adaptive modeling approaches

8. Conclusion

This research study provides a comprehensive overview of recent research contributions that analyse the effect of geopolitical risks in financial market performance. According to the research outcome, geopolitical events affect financial markets by means of economic and financial channels of transmission, which lead to higher volatility, contagion effects, and changed investor behavior. The study also showed an evident shift from traditional econometric approaches to more advanced dynamic models of financial market reaction. Moreover, the comparative analysis shows that emerging markets are relatively vulnerable to geopolitical risks, while developed countries suffer from contagion effects due to financial globalization. Heterogeneous reactions of financial markets to geopolitical events are observed

in energy, defence, shipping, finance, and sustainable sectors. However, despite the obtained results, current research efforts on this issue are quite fragmented with regard to region, sector, behaviour, and methodology. Thus, this research study has identified the need for an integrated approach to analyzing geopolitical risk transmission by combining macro financial, behavioural, and sectoral aspects.

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