Tiemann
Investment Advisors, LLC

April 3, 2003

War, Uncertainty, and the Markets

Introduction

Disciplined investors try to emphasize long-term planning over short-term swings in the markets. Now and then, however, an event arises with so much emotional power and such immediate influence on the direction of the market that even the most disciplined investor must pay attention. Surely the war in Iraq qualifies as such an event.

As members of the public, we do not really know whether the war is going according to plan. The generals like to point out that wars never do. Even with the amazing depth of television coverage we have had in this war (the *New York Times* dubbed it "Iraq around the clock"), we still have only a fragmentary picture of what is actually happening there. But while the war may or may not be going according to the script, the market's reaction to it surely is.

Buy the rumor; sell the news

An old Wall Street traders' saying runs, "Buy the rumor; sell the news." Like many adages, it is not always good advice, but underlying it is an important truth. Investments are risky because the future is uncertain. The riskier the investment, the greater the potential reward investors should (and generally do) demand to compensate for the risk. If uncertainty increases but upside potential does not, the market usually falls. The daring may treat the drop as an overreaction, creating a buying opportunity. If a rumor creates uncertainty, it may create buying opportunities: Buy the rumor. When the news comes that resolves the uncertainty, the stock or market may move up or down with the news, but after that it is likely not to be so cheap any more: Sell the news.

Actually, when dramatic news occurs, it can increase or decrease the public's perception of the risk in the market. In the long runup to the war, with

165 University Avenue Palo Alto, CA 94301 (650) 566-0200 Office (650) 566-0210 Facsimile

the gathering of US forces in the Persian Gulf, the debates in the United Nations, and the weapons inspections in Iraq, every passing day made the situation seem more precarious. The markets responded accordingly. Based on the S&P 500 index, the US stock market fell –2.74% in January, another –1.70% in February, and a further –4.81% from March 1 to March 11.[1]

After times of uncertainty, once the picture becomes clearer the market often recovers. So it was as the war began. As the final diplomatic drama played out in the second week of March, war came to seem increasingly inevitable. From March 12 to March 21, as US forces geared up for their initial assault, as the first missiles hit Baghdad, and as the first troops crossed into Iraq, the market rose +11.9%. The early war news seemed particularly encouraging. The resolution of uncertainty (yes, there would be a war) and the early news (coalition forces seemed to have the upper hand) set the market's tone.

In hindsight, Friday, March 21 would have been a good day on which to sell the news. That weekend we learned that Iraqi resistance was stronger than anticipated, and the campaign might be difficult after all. That Monday, March 24, the market fell by –3.52%. It recovered +1.72% the following day, but slid for the remaining four trading days of the month. In the end, having traversed a range from –4.8% to +6.5% during the March, the market closed the month with a gain of just +0.84% .

What about the real world?

War news seemed to dominate the market during March, and since the war itself began, the market seems to have reflected its progress, to the exclusion of everything else. This effect was perhaps most dramatic on Wednesday, April 2. That day the war news was encouraging, but the economic news was weak. The Factory Orders report for March was off –1.5%, compared to a consensus estimate of –0.8%. Apparently, good war news trumped the weak economic report, and the market rose +2.61% for the day.

For the time being, the market seems to be doing little more than handicapping the outcome of the war. When things look good in Iraq, the market rises; when they look bad, it falls. This is not so unusual. Other wars have produced strong market reactions as well. Early in World War II, from December 31, 1940 to April 30, 1942, the S&P 500 index lost more than –30% of its value. But over the next twelve months, to April 30, 1943, the war began to turn toward the Allies, and the S&P 500 rallied by +61%. The Korean War was broadly similar. North Korea invaded South Korea in June 1950, and in that month the index fell –5.5%. It then rose 70% during the rest of the war through

[1] Source for market data: see end note.

July 1953. In the first Gulf War, from Iraq's invasion of Kuwait in August 1990 to the ceasefire at the end of February 1991, the S&P 500 returned just over 5%. It fell about –14% (August-October) while the US organized the armed response, and then more than retraced (November-February) when the response was successful. But war does not automatically boost markets. The Gulf of Tonkin resolution authorized US military intervention in Vietnam in August 1964. That conflict dragged on for some ten years before the desultory conclusion President Nixon dubbed "peace with honor." During that period (9/1964-8/1974), the S&P 500 returned just an annualized +2.1% (a cumulative +22.6% for the total period). The progress and outcome of a conflict are factors in returns.

Economic life goes on during and after war. The economic figures, the weakness or robustness of our economy, the size of the federal budget deficit, the effect of fiscal and monetary stimulus, and a host of other factors still matter. The uncertainty leading up to the war may have depressed market valuations, and the resolution of the uncertainty may ease these jitters' dampening effect on valuations. But once the war ends, other, more normal factors will resume their place at the front of traders' minds. A rally marking a successful conclusion to the war would not necessarily forecast economic strength in its wake. It may (if it occurs at all) instead be a short-term, positive overreaction to geopolitical events, temporarily overshadowing the underlying economic reality.

Conclusion

We have likely been in a market depressed by war fears and the associated uncertainty. As the uncertainty recedes, this drag on the market may ease. The speed with which this happens will be related to the progress of the war, and in the meantime the market's ups and downs are likely to reflect the conflict's. Nevertheless, while this uncertainty persists, the market may be "cheap" compared to where it would have been without those fears. The history of the impact of wars on our market would indicate that if the war effort proves successful, then those investors that see it through may be rewarded. Still, once the war is done, we can expect the market to go back to its usual business of pricing the activity of real businesses in the real economy.

– Jonathan Tiemann
Palo Alto, California

Source for returns: 2003: Standard & Poors. 1926-1981: Roger G. Ibbotson and Rex A. Sinquefield, Stocks, Bonds, Bills, and Inflation: The Past and the Future, Financial Analysts Research Foundation, 1982. 1982-2002: BARRA. Some calculations by TIA.