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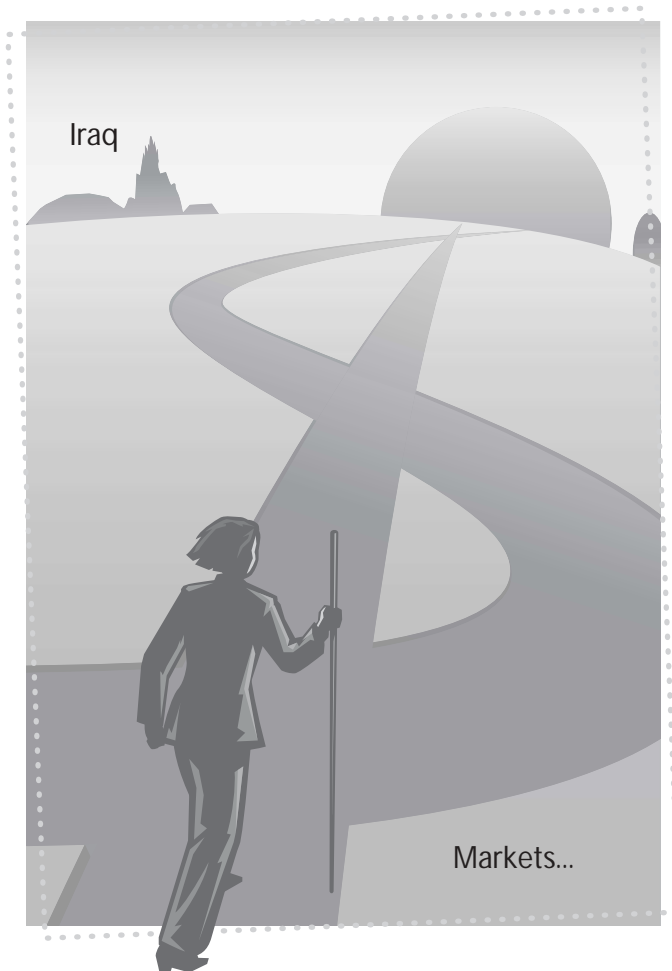
What The Markets Should Reflect From The Victory In Iraq

A Candian's Perspective

by Nino Boezio

Now that the war in Iraq is over (and it was considered a major success), we are all wondering what its implications will be for the equity markets. Based on what we have seen from history, we can make certain assertions as to what to look for in the near-term economic climate, and the resulting market performance.

- *Relative peace and prosperity for the next 10-20 years.* After past wars, it has been difficult for a new challenger to rise up anytime soon there after, so we can expect the United States to continue to dominate the world scene for some time. Peace endures when there is only one superpower. This should help create a healthy



stock market, even though it could also foster an overshoot in equity valuations, as it did in the 1990s.

- *Declining uncertainty as time passes.* The end of the war now reduces uncertainty. The only other major concern is fear of another terrorist attack. This terrorism fear will continue to factor into equity performance, but time will eventually erode this extra risk premium. We do note however, that just before the actual Iraq conflict took place, stock markets around the world no longer had major and prolonged declines the way they did prior to last fall. So there is more confidence that the market is on a sure footing and that the world economy is recovering.
- *More interest in helping the Third World, even if it results in deficits.* Some see terrorism to be partly rooted in poverty, ignorance and religious fanaticism. Hence there is more incentive to help the Third World rise out of poverty and to better understand the Western world. How much money will actually go to poorer nations remains to be seen, but if it is viewed in part as a preventive measure against future terrorism, then there will be more justification for shelling out large sums of money. Hence government deficits will become more likely, resulting in more government bond issues than previously anticipated.
- *A greater focus on technology.* The U.S. victory in Iraq was in large part due to advanced technology. Technology is now proving to help win wars (and also save lives), not just to make life more convenient. And as President Bush stated in a presidential address, advanced warfare can now target a troublesome leader, without destroying much of the infrastructure in the process. Hence there will be more interest than ever before on the part of all world governments, to promote and encourage technological development. This could help once again create some bubbles in certain sectors of technology, where the tangible results are still unproven and speculative.
- *A re-test of OPEC.* It is hard to see Iraq being in a position of independence from the U.S. anytime

soon. Iraq will also need money to rebuild from the current war and to catch up from 10 years of economic sanctions. In order for Iraq to sell enough oil to generate sufficient revenues for rebuilding, other OPEC nations will have to cut their own output to keep the price of crude at the target of \$22-\$28 per barrel. It will be interesting to see if other OPEC nations are willing to forego some of their own additional wealth and prosperity in order to help Iraq, or instead try and cheat one another once again to get an edge on revenues.

- *The American experiment.* President George W. Bush after the fall of the World Trade Center twin towers, remarked that he did not understand why many people and nations in the world hated the United States. Therefore there will be a tremendous temptation by the U.S. to make Iraq a model of American generosity, prosperity and an example of the good aspects of the U.S. way of life in order to silence many of the critics. In addition, Afghanistan should also receive added benefit, in order to counter the claims of critics that "the Iraqi war was all about oil." So we will likely see a large amount of money devoted to the region, in an effort to counter the negative elements that speak out against U.S. foreign policy. On the other hand, it will also be tempting for the U.S. to look for ways that such generosity can pay for itself, through economic and financial benefits being realized on behalf of American companies. So we should see more of an interdependence developing between North American energy and development companies, and foreign aid. The Middle East will also be encouraged to develop its own stock markets and share wealth. The Middle East will continue to be a major focal point for the world in general, as it has a long history of instability; yet it supplies the world with much needed energy. So we will even see many countries trying to jockey for position in the region, not just the U.S.
- *More confidence for the U.S. to get involved in world affairs.* Success in Iraq 1, Iraq 2 and Afghanistan, encourages involvement in the next one. In one sense the U.S. has now gotten momentum to clean up what it considers to be world problems, as long as the human and financial costs remain low. If the stock market continues to rebound, and if George W. Bush's approval rating and popularity remains high, then there will be more interest in doing this again under a future president (no one wants to deviate from a winning formula). This could help promote defense stocks as an investment alternative (the fall of the USSR in 1989 did not alleviate

the need for a strong military). However, the U.S. has dealt a disastrous blow to the United Nations, which it in large part helped to create.

- *Europe is becoming a dangerous ally.* One cannot tell whether the European Community (EC) in general, dislikes the U.S. or the Islamic world more. The EC has already set goals to build an economic, military and political system that will be equivalent to, or will surpass the U.S.. Various European voices imply that the U.S. is dangerous, which is rather ironic given that the U.S. has been the major factor that saved Europe a number of times from its own self-destruction, and also was the nation that afterwards provided substantial financial support for Europe to rebuild. So we will see the major economic and military competitor against the U.S. to be Europe. If this is realized, then there should be fewer hurdles to permitting U.S. companies to merge in narrow industries, such as airlines, defense and technology.
- *Market performance can be subdued in the short-run.* We know that financial markets tend to oscillate between extremes, which some characterize as fear and greed. The late 1990s may be characterized by greed and excess, the last few years could be characterized as one of fear and depression. The only time we see the middle ground is when the markets travel from one extreme to another. However, it takes time to get out of one mind-set and go to another, so it will take a few years for investors to lose their fear and be once again comfortable with stocks. So we can expect the next few years not to have dramatic equity returns, even though this year may be an exception, as we bounce off very depressed prices.

Overall, we do see a backdrop for prosperity and economic development to once again embrace the world. Of course, if any unforeseen events occur of a non-economic nature (such as a nuclear incident, a natural disaster or a health epidemic that gets out-of-control) then all bets are off. But in the meantime, it looks like we have a number of positives that were also present in the early 1990s, which can help foster a healthier stock market and better economic growth. Even though some cite persistently high P/E ratios as an indication that equity valuations are still high, this does not mean that all stocks in a particular group are unattractive. So there should be opportunities for equities to do well, even though there is always the fear that we can be in a market malaise for years, as occurred in the 1970s. Right now that latter assessment is too pessimistic. **♣**



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