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It's Not the End of the World -- Just "As We Knew It"

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Six weeks since the September 11 terrorist attacks, most of the well-known equity market indices have rebounded to challenge their pre-attack levels. The Wilshire Total Market Value Index, the S&P 500, the NASDAQ Composite, and the NASDAQ 100 all traded higher last Wednesday morning than their September 10 closes. Of the marquee indices, only the Dow Jones Industrial Average and the Russell 2000 Index of small-cap stocks failed to achieve that level of recovery.

But for *all* the indices, attainment of that level was short-lived. As Wednesday's news revealed a widening anthrax scare and the unraveling of potential diplomatic initiatives between **Israel** and the **Palestinian Authority**, the exploration of pre-attack levels in the equity market was abruptly turned back.

It's strange how clearly the market speaks to us sometimes… last week the market was saying that, while the world didn't end on September 11, the world *as we knew it* did.

When I say "the world didn't end on September 11," I mean that there were four catastrophic risks -- none of which have eventuated so far, and all of which have been significantly alleviated -- to which the market had to assign some probability when it re-opened on September 17. Let's take a careful look at them one a time -- the evolution of events with respect to these risks is all that matters right now.

The first risk was that the attacks of September 11 were merely the leading edge of a prepared program of continuing large-scale terrorism designed to disrupt the economy of the industrialized world. Happily, it appears that the terrorists have expended all their ammunition: since September 11 there have been no further attacks.

The second was that the attacks would goad the United States into precipitous and extreme military action in the Middle East that would trigger a meltdown of global diplomatic, military and economic relationships. Unsophisticated interventions that could have polarized the world into pro-US and anti-US camps might have triggered anything from an OPEC oil embargo to a broader war, potentially drawing in nuclear-capable combatants. Happily, it appears that the US is bending over backwards to win friends and influence people, and to isolate narrowly defined terror vectors as the focus of attack.

The third risk was that the global financial panic in the wake of the attacks would trigger large policy errors by central banks in the US and around the world. Indeed, for a while there, it looked like **Alan Greenspan** and the **Federal Reserve** had lost control of events (see "Alan Greenspan's Perfect Storm," September 19, 2001). But happily, it seems that we have come out of the panic in a monetary position no worse than the one in which we entered it.

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The fourth risk was that the paralysis of global consumer and business economic activity after the attacks would lead to a sudden and severe economic contraction. Happily, so far the figures suggest surprising resiliency in both consumer activity and corporate earnings.

Okay, so the world didn't end on September 11. But when I say that it did end *as we knew it*, I mean that we are by no means out of the woods with respect to those four risks.

Before September 11 we were already sliding down a slippery slope, with an economy flirting with recession. The attacks blasted us off that slope, and for a while it looked as though they would hurl us into a bottomless pit.

But the good news is that we landed on a tight-rope, and so we haven't fallen into the pit -- yet. The bad news is that now we have to walk that tight-rope without falling off into the pit. And if we *can* stay on the tight-rope, we can work our way all the way back to that slippery slope we were blasted off of, and then try to climb up it. Fun, huh?

We'll fall off the tight-rope if *any one* of those four risks ends up eventuating. Let's look at them again with this in mind.

With respect to further terror attacks, the fact is that we may be in the middle of one right now. Last Wednesday, when the market failed in its attempt to rally above its September 10 levels, it was just as the anthrax scare had amplified to the point of shutting down the operation of the **US House of Representatives**. Is this a second-wave terror attack? It began weeks ago in Florida, and the authorities started out not even treating it as a criminal matter. Then a week went by and it became a criminal matter. Then another week went by and **Health and Human Services Secretary Tommy Thompson** started talking about it on television as a terrorist event. Is it or isn't it? Nobody seems to know -- and for me, that makes it worse.

With respect to the conduct of our military actions in the Middle East, there is always the risk that at any moment we will do something really aggressive or really stupid -- or just that someone standing near some kind of red button will simply make a mistake and set his coffee mug down on it and trigger heaven only knows what. But that's the least of our problems; at least there we are generally in control of events. The real risk in this domain is that other players in the game do something aggressive or stupid, or make a mistake. Last Wednesday, at the same time as the market was absorbing the Washington anthrax scare, it was dealing with the breakdown in the Israel/Palestinian peace process triggered by the assassination of **Rehavam Zeevi**, and pledges by **Ariel Sharon** of "war to the bitter end." And now there have been renewed hostilities between **India** and **Pakistan** in the disputed area of **Jammu-Kashmir**. It's sad to admit, but we have come to a state in which when someone in Jammu-Kashmir sneezes, someone on Wall Street gets a cold.

With respect to the risk of large-scale monetary errors by the Federal Reserve, there's probably not much danger at this point. Alan Greenspan has already made them all. And now that the financial panic in the immediate wake of the attack has passed, the danger is even less. But now the spotlight of risk simply moves to other policy-makers -- the ones in the **US Congress** who determine tax, spending, regulatory and trade policy. Here the good news is that all the locks are off all the lock-boxes, and the obsession with deficit reduction and debt-retirement has been set aside. The bad news is that all the congresscreatures now have their law-writing shoes on, and who knows what mischief they will now create in the name of the war on terrorism? It seems that we don't have to worry about the risk of a capital gains tax cut. But if I were a big pharmaceutical company like **Bayer AG** I'd be plenty worried that my patents on the weapons in the war against bio-terrorism -- such as the antibiotic **Cipro** -- would be seized for public use without the niceties of just compensation required under the "takings" clause of the **Fifth Amendment of the Constitution**. In general, large American companies with lots of political clout can expect to come out well in this. Foreign companies like Bayer, and smaller US companies who can't afford enough legislative influence, may not fare so well. Perhaps that's one of the reasons why the Russell 2000 Index of small-cap stocks has lagged in its recovery post September 11 -- I'll be writing more on this over the next few days.

With respect to the risk of sudden economic contraction, all I can say is that I simply don't buy the seemingly good news we've seen on this so far. I have no doubt that people will buy lots of cars when **General Motors** bribes them sufficiently to do so. And I have no doubt that many large American companies can squeeze out a "beat" this quarter when called up for patriotic economic duty (see "Uncle Sam Wants You… To Make Your Quarter!" October 19, 2001). But this market has been in recession-denial all year, and I say it still is. Nothing has gotten better. A lot has gotten worse. Those chickens will come home, and those chickens will roost.

It's not the world as we knew it anymore. And until we get to know it again, and get control over it, the equity markets are going to have a very hard time.