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# Understanding War Risk

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**Yes, the markets fear the risk of war -- but it's a risk with both a downside and an upside.**

It's almost painfully clichéd to attribute the last several weeks of stock market decline to "war jitters." The fashionably contrarian view seems to be that "it's the economy, stupid" -- concerns about war with Iraq are just a smokescreen concealing deepening economic weakness. This may be one of the times when we have to side with the conventional wisdom. But the conventional wisdom may well be correct for the wrong reasons.

For many months now we have written about the economy's "muddle-through" recovery and dismissed fears of a double-dip recession, focusing on the gains that will accrue from **the Fed's** finally having ended its six-year siege of monetary deflation and moved to a truly accommodative stance (see "Gold's Wild Ride" December 20, 2002; and "The Too-Big Easy?" January 31, 2003). We are encouraged by the possibility of strong pro-growth shifts in tax-policies (see "Born-Again Growth Advocacy" January 8, 2003). And we see the beginnings of a recovery in capital investment and in the technology sector of the economy (see "Luskin *Live!* on Cisco and Tech's Earnings Season" February 5, 2003 and "The Brightening Capex Outlook" February 11, 2003).

Within the context of our view of a stable and improving economic backdrop, the market decline of the last several weeks would seem to be all about Iraq -- all about a heightened sense of increasing economic *risk* in the sense of a widening dispersion of possible outcomes both good and bad, but *not* about a lowering of the mean expectation about which those outcomes are dispersed.

This view of war risk as symmetrical uncertainty entailing both good and bad outcomes -- as opposed to a deadweight cost or a break-even at best -- has been borne out by the continuing resiliency of the riskiest sectors of the capital markets during the broad market's decline. Stocks overall have delivered negative returns year-to-date, but high-yield bonds have moved higher. And within the equity market, the Information Technology sector has been astonishingly resilient, frequently declining less on down days and rallying further on up days than the broad market (see "Beyond Iraq" January 27, 2003).

The conventional explanations for an "Iraq effect" have to do first with strictly negative concerns about the direct economic consequences of war -- the cost of the war itself, of possible disruption of oil supplies, and of post-war reconstruction, and so on. Such costs would be negative on the face of it -- a tax on the global economy. But if we assume the likely scenario that a war would be brief and successful, then these costs are both forecastable and small in the grand scheme of things. The downside risk is that the war will become a Vietnam-like quagmire.

But there is an upside, too. While we dismiss "broken windows" stimulus arguments about war spending, it may well be that bearing the costs of war will raise the net present value of the world economy considerably. A world without **Saddam Hussein** and his weapons of mass

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destruction would be a better place in which to do business for years to come. While "doing nothing" always seems intuitively to be the less risky course, the market in its wisdom may in fact be worried about precisely *that* possibility -- perhaps the real risk is that we *don't* go to war with Iraq.

A special case of the concern for costs has to do with the possibility of terrorist retaliations on US soil. It's easy to let one's imagination run wild on this, with escalating scenarios of increasingly awful potential events, starting with suicide bombers in malls and going all the way up to a nuclear bomb in a major city. The felt intensity of these imaginings may be out of all proportion to their small likelihood -- but each of them surely has *some* likelihood, and these must be downside risks that are already impounded in market prices. But it's not at all obvious that staying out of war would decrease these risks. In fact, the putative purpose of going to war is precisely to decrease them.

In our view the most important risk of war with Iraq is political. The prestige and influence of **President Bush** is intimately connected to the war on terrorism in all its aspects. As the war has evolved from the crisis atmosphere following the terrorist attacks of September 11, 2001 to today's seemingly endless, Hamlet-like decision process on Iraq, Bush's enormous approval ratings have steadily declined. Before his State of the Union address two weeks ago they had fallen back to within 10% of their pre-9/11 levels. With the increasing sense of resolve following the SOTU and **Colin Powell's United Nations** address last week, Bush's poll numbers have ticked up markedly.

Bush's opponents understand very clearly that the best way to undermine him is to draw out today's state of anxious waiting. The last thing they want is a war-time President -- and probably a *victorious* President -- pushing for the growth initiatives that could strongly turn the US economy around by the elections in 2004. As long as the Iraq decision remains unmade, it can be used to crowd out all other initiatives while Bush's popularity deteriorates. Once it is made, Bush will be -- for at least a time, and perhaps for a long time -- politically invincible. With the kind of pro-growth initiatives that are on the table today, such an outcome would be extremely bullish.

So the domestic political risk, then, is a distribution with very fat tails. The downside is two more years of a muddle-through economy while the **Democrats** block Bush's economic initiatives, and then another hanging-chad election with Bush running as a beaten man. The upside is a popular war-time president who can end the double-taxation of corporate income, slash top personal income tax rates, and reform Social Security.

The market has declined in order to embed a risk premium appropriate to these uncertainties. But these uncertainties will resolve, and soon. Remember, President Bush is, to a large extent, in control of the timing decisions -- and it's not in his interests to wait much longer. The deep risk premium in markets, then, may be one that investors will be able to capture fairly quickly. And beyond that, we could see a political environment that will be extraordinarily favorable in terms of robust economic growth. TM