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The No-Peace Rally

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The war has moved from the UN to Iraq, and the fever of uncertainty has broken.

In one of those lucky coincidences that keep stock market analysts from hanging themselves, I wrote at 1:44 pm last Wednesday in "Luskin *Live!* on Rising Risks",

> "...the equity risk premium is now wider than ever. Markets don't stay stretched this thin for long -- without either unstretching, or breaking. At this point it's tempting to say that almost any form of resolution would be a positive for stock prices."

I missed the bottom by 8 minutes. From 1:36 last Wednesday the S&P 500 has tacked on 10.8% through yesterday's close, and is on its way today to posting more consecutive up days than we have seen in almost two years.

This rally has been confounding to those who have viewed war with **Iraq** as an unalloyed negative, and have chosen to interpret every uptick over the last two months as a "peace rally." Even late last week, after last Thursday's powerful rally coincided with a hardening of **US** and **British** resolve to dispense with the **United Nations** if necessary, the *New York Times* was still trying to force the market into the mold of the conventional wisdom, writing that "Investors bought beaten-down shares yesterday, as the United States expressed a willingness to delay until next week a vote on using force to disarm Iraq..." Make no mistake about it -- this is a "no-peace rally." This is all about finally getting down to business.

We've argued all along that war is indeed risky, but it's a risk with both an upside and a downside -- classic investment uncertainty. At the same time, we have worried that the downside compounded each day that the **Bush administration** pulled further on the loose thread of diplomacy -- enough pulling and the carefully knit structure of the western-democratic alliance for commercial globalization would come unraveled. The market turned around when Bush made it clear he was going to stop pulling on that thread.

Now the months of increasing incoherency and factionalism will resolve in the presence of a *fait accomplis* (if I may use a French expression). Globally, balking would-be allies are already taking initial steps to repair the damage. And domestically, the evidence is clear from the polling data in both the US and the UK, which show that deeply divided opinion *is* coalescing in favor of **Bush**, **Blair**, and war. That lowers the risk of wild-card policy changes, and induces those who must commit capital across long time horizons to get back in the game.

For example, consider the **Federal Open Market Committee's** post-meeting statement Tuesday in which they chose to "refrain" until "uncertainties abate" from declaring their so-called bias as to the balance of economic risks. This is remarkable coming from **Alan Greenspan**, who has spent much of the last decade being "often wrong but never in doubt." And it's ironic that Greenspan's capitulation to uncertainty comes at a time when the worst uncertainty actually appears finally to be behind us.

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But "refraining" was the right thing to do. As my colleague **David Gitlitz** pointed out Tuesday in "Gitlitz *Live!* on FOMC Meeting", rate cuts are not "an elixir for all economic ills." With monetary policy already entirely accommodative, applying that elixir to relieve the economy's military/political uncertainties would open the Pandora's box of inflationary risk for no good purpose. So backing off from the worst of last week's uncertainties could not have come at a better time -- if the FOMC meeting had been just one week earlier, fed funds futures were indicating that there was a 50/50 chance that the Fed would have made a very stupid and very serious error.

Where do we go from here? It's not going to be straight up every day like it has been for the last seven, but stocks remain deeply undervalued, uncertainty is rapidly dissipating, and the burden of proof has shifted decisively to the bears. Now it's **George W. Bush's** game to lose. And far more than just his war to win. His challenge is to manage expectations as war unfolds, and to reinvest his recovering political capital in pushing his tax-cut proposals through the unprincipled deficit-phobia of his opponents, just as he pushed his war through their unprincipled unilateralism-phobia. TM