It's time for investors to plot war strategy

U.S. equity markets have typically done well during wartime

Sam Ali
Newhouse News Service

It is hard to believe the Dow Jones industrial average was flirting with 9,000 a little more than a month ago and that every armchair investor was predicting the end of the three-year bear market.

What a difference five weeks makes.

"There are two things to kill a stock market," said David Edwards, president of Heron Capital Management. "One is the Fed raising interest rates, and the other is the anticipation of war."

Wall Street hates uncertainty, and all the anxiety is about war these days. Whether played out through diplomatic channels or on the battlefield, concerns about Iraq will continue to drag down stocks as investors wait and wonder. But if history is any guide, investors who plan to beat a fast retreat the minute bombs start falling should take note: War is generally good for U.S. equity markets, but only after investors decide they are on the winning side. In fact, macabre as it may sound, sending troops to battle has often signaled a great buying opportunity.

"In times of great uncertainty, financial markets all over the world have a cycle that has repeated in all cases: shock and stabilization," said Daniel Sharp, publisher of the quarterly SharpInvesting.

Take a look at the first Gulf War.

The S&P 500 plunged more than 13 percent in the three months after Iraq's 1990 invasion of Kuwait. But once the bombs started pounding Baghdad, the market's mood changed. The S&P soared nearly 16 percent in one month after the U.S.-led assault in January 1991 -- and more than 28 percent by January 1992.

During World War II, the market declined 17 percent in the five months after the attack on Pearl Harbor in in the five months after the attack on Pearl Harbor in December 1941. But between January 1942 and 1943, the markets gained 13 percent. They had more than doubled by 1946.

Since World War I, there have been six wars, and Sharp said all have followed a similar pattern. The average initial negative shock to the market is about 12 percent. But just one month later, the markets are generally up 2 percent from prewar levels. Within three months, they're up 5 percent, and six months into war, the average pop has been 6 percent.

Market strategists expect the same this time.

A decisive military victory or an unexpected abdication by Iraqi President Saddam Hussein would trigger a major buying spree in the market.

"We think the market will take off like a rocket," said David Kotok of Vineland, N.J.-based Cumberland Advisors, the money management arm of Ryan Beck & Co. "The firepower is there."

Trillions of dollars are on the sidelines, idly waiting for the geopolitical fog to lift. Corporate chieftains are sitting on their hands and postponing building factories, rolling out new marketing strategies and hiring staff. And investors are hanging on to their wallets.

"Stocks are too cheap to sell at current valuations, but no one wants to buy in advance of the war," Kotok said. "If Iraq falls quickly, as we saw in the first Gulf War and in the war in Afghanistan last year, stocks could rally 15 to 20 percent pretty quickly."

All of this does not mean investors should rush in blindly.

The big question market strategists struggle with these days is what to do during the turbulent and volatile prewar phase.

"This is a frustrating point for me and my clients right now," said Tim Villano, publisher of TradersFocus, an investment newsletter based in Connecticut. "The price patterns are very negative right now, and I think we are going for a test of October lows in this prewar posture."

Complicating matters, bonds and U.S. Treasuries are considered equally unattractive options right now.

considered equally unattractive options right now, Villano said, voicing a sentiment expressed by many strategists.

"When you are making 40-year lows in yields, it's not a great time to be buying bonds," Villano said. "Right now, everyone is piled into the bond market, just like three years ago everyone was piled into the stock market. You don't want to make the same mistake twice."

So what's an investor to do?

When questioned, several market strategists came up with plays they think will fare well from here to Baghdad and beyond.

Oil-field services A war could cause the price of crude, now around $36 a barrel, to spike to $60 or higher, driving up the stocks of big oil companies such as ExxonMobil or ChevronTexaco, Heron Capital's Edwards said. But a swift end to the war could drop prices just as quickly, meaning stocks of those companies would probably fall back as well.

As an alternative, Edwards suggests looking to oil-field services companies. That makes Baker Hughes International an attractive play.

If the war goes well, Edwards said Baker Hughes, Schlumberger and Halliburton are the kind of companies best equipped to help Iraq rebuild its aging oil extraction infrastructure. If the war goes badly, oil prices may well remain elevated, perhaps above $40, for a while.

"If so, oil fields that are currently not economical to exploit may well be developed, which would also increase demand for Baker Hughes' services," he added. Although all three companies will see increased business, Baker Hughes is the cleanest play. Halliburton is dealing with asbestos litigation, which will drag on the stock price indefinitely, and Schlumberger is losing money.

Oil War rhetoric has escalated, and tensions in the Middle East have simmered for more than a year. After the recent surge in oil and natural gas prices, however, is it too late to buy into energy stocks?

Hardly, strategists said.

Standard & Poor's recommends investors increase their exposure to the sector.

Shares of giant oil companies such as BP, ChevronTexaco and Royal Dutch have touched or skirted 52-week lows, even though the earnings outlook for 2003 look pretty good. Why the disconnect?

Investors fear a sharp drop in crude prices will hammer oil stocks. After all, that is what happened at the end of the first Gulf War.

Still, Sharp is bullish on companies like ChevronTexaco, regardless of how the war plays out in Iraq. He said the company is cheap, trading at 10 times 2003 earnings, and it has a solid dividend yield of 4.4 percent, which is among the highest in the sector.

"It stands to benefit from the U.S. plan to put Iraq oil fields in trust for the Iraqi people," he said. "But even if there is no war, the company will show increased profitability from 2001 merger cost savings between Chevron and Texaco, which will aid the bottom line starting in 2004."

Gold Expectations of war in Iraq, weak equity markets and a dollar dropping against the euro have fueled a surge in the price of gold, which has traditionally been viewed as a safe haven in turbulent times.

After falling as low as $255 per ounce in April 2001, gold hit $388.50 earlier this month, its highest level since September 1996.

Many gold bugs think the price will hit $800 -- double the current price -- in the not-so-distant future. The ranks of such true believers are starting to swell.

The bullish view on gold reflects a common belief that the precious yellow metal is in the early stages of a bull market that could last for the next 10 to 12 years. (Gold hit a historical high of about $850 in January 1980.) Villano, the publisher of TradersFocus, cautions investors to wait until the market is in the throes of its wartime relief rally before snapping up gold.

"If you buy gold ahead of the war, it could be a terrible mistake," he said. "We really are firm believers that the long-term prospects for gold are good, but if the

the long-term prospects for gold are good, but if the war effort diffuses, prices are going to come down, and that would be a better time to buy it."

Security Many strategists believe security companies will be the next big wave in growth stocks and that growth in this industry will be as robust as that in the technology sector in the early 1990s. Congress already has appropriated a $40 billion Emergency Response Fund to address the nation's security needs.

One benefactor of the homeland security trend is California-based OSI Systems, one of the few profitable explosive and contraband detection companies, said Kenneth Reid, senior financial analyst at Spear's Security Industry Analyst.

Heightened concern about the safety of American ports since Sept. 11, 2001, has forced the United States to start paying more attention to what cargo is loaded onto ships entering this country's waters and who serves on crews, he said.

Intelligence agencies are setting up databases to track cargo, ships and seamen, Reid said. OSI stands ready to profit from the move. Unlike traditional X-ray equipment used in airports -- technology now considered archaic -- OSI's gamma-ray inspection system is considered state-of-the-art.

"We get millions of containers coming in every year, and those things are going to have to be inspected quickly, and OSI has the equipment to do it," Reid said.

Technology If you have a Trimble Navigation chip in your cell phone or the car you drive has a global positioning system, you can be pinpointed and found -- any time, anywhere, Villano said.

When field crews were trying to locate debris following Columbia's disintegration over Texas, they used GPS receivers from Trimble Navigation.

"It's an essential new technology, and it's going to be pervasive," he said. "I like the technology and the company's prospects for growth."

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