Capital Markets Brief

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Uncertainty & the Economic Costs of War

Historically, the US economy has shown extraordinary resilience during times of great upheaval and uncertainty. Economic growth boomed after WWII, survived the Vietnam War, weathered the short conflict with Iraq in 1990 and, more recently, has remained stronger than most had expected. The US economy continues to grow despite several setbacks, including the burst of the tech bubble, slump in business investment, the September 11 attacks and corporate scandals. Many now worry that the US economy is vulnerable to another crisis — the possibility of war with Iraq. In addition, the recent news that North Korea has been building weapons of mass destruction, in violation of the treaty they signed in 1994, has only added to the uncertainty.

Stock markets do not like uncertainty. However, the US capital markets have shown that, although uncertainty may have a short-term effect on market behavior, investment fundamentals typically outweigh uncertainty as a long-term market driver. Short-term returns are a reflection of investors reacting to uncertain news such as the possibility of war and terrorism. Long-term returns in stocks are a reflection of corporate profits. There is uncertainty surrounding the real possibility of war with Iraq and concern that the costs may tilt the US economy back into recession. I believe the most likely outcomes are a short-lived spike in oil prices and/or a slight increase in interest rates.

The worst-case scenario would be if we entered into a long-term conflict in Iraq without the support of our allies. This would involve significant casualties and require large outlays of capital. I think this is unlikely. I believe that the most likely scenario is one where the conflict is short and the economic impact, nil. Under such circumstances, oil prices would spike initially, then revert back to price levels that reflect the underlying fundamentals of supply and demand. Stock and bond markets would suffer short-term declines, then recover to reflect underlying fundamentals. Consumer and business confidence would initially decline, and then quickly rebound once a sure victory was at hand. The actual cost of war could place upward pressure on interest rates in the short term as the US government increased its activity in the Treasury market.

Higher oil prices translate into a higher tax on consumption and investment spending, with the most severe effect felt by countries who import a majority of their oil. When Iraq invaded Kuwait in August of 1990, oil prices escalated from $18 to $36 per barrel. Today, however, many estimate that the current price of crude oil, at $30 per barrel, already reflects a $5 per barrel “war premium”. If and when stepped-up military operations in the mid-East become evident, the price of crude could go as high as $50 per barrel. If the conflict is short (less than 8 months), the per-barrel price would quickly revert back to the $25-28 range. For a “short” war, the economic impact would be about a 0.4% deduction from real GDP growth in 2003. A longer conflict and a sustained increase in oil prices could eventually shave 1.0% off of GDP growth, but we find this scenario improbable.

The US is less oil-reliant than it was in the 1970s and even the early 1990s. Today, the US uses 20% less crude oil than it did ten years ago (inflation adjusted). To mirror the same impact that rising oil prices had on the economy a decade ago, oil prices today would have to rise to nearly $67 per barrel — again, highly unlikely.

An expensive conflict without the financial assistance of our allies could put upward pressure on interest rates. The US government would then have to raise funds in the Treasury market thus triggering higher rates. However, the additional government outlays and the stimulus from such outlays could help offset the negative effects of higher oil prices.

Don Robinson
Lockwood Advisors, Inc. and Consultiva Internacional, Inc.