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Iraq - the outcome and its influence on markets

Perceptions regarding war against Saddam Hussein are currently the dominant short-term influence on stock markets.

Presently, we have fear of war plus uncertainty over the timing and outcome. Even though investors have lived with these concerns for several months, it is still difficult for stock markets to make upside progress against this background. Additionally, the near certainty of imminent war would weigh on stocks by removing most demand. Conversely, if war is perceived by a majority of investors as a diminishing or deferred risk, it is easier for stocks to rally, subject to other considerations. Even though most people expect war, perceptions wax and wane, with stock markets responding accordingly.

What happens to stocks if war commences? This would probably be bullish for most stocks, at least for the short term, because investors are likely to over discount military risks. So-called worst-case scenarios receive plenty of publicity, not least from those who most oppose war against Saddam Hussein. Deferred demand would return, given any evidence of military success by the US-led coalition. However, upside scope remains limited to a medium-term rally because stock markets are in secular bear trends.

What about bonds? Government bonds in Europe and North America have generally moved inversely to stocks for some time and this is likely to continue. Conversely, high-yielding corporate bonds are more likely to move in line with stock markets.

What about the dollar? Fear of war has weighed on the dollar, along with other considerations such as the current account deficit and Fed Governor Bernanke's much publicised comments. However short covering in the event of any military success against Saddam Hussein would lead to a technical rally by the greenback.

What about oil? The anticipation of war has influenced petroleum prices more than any other market. Against this background few traders dare short, while commercial suppliers and many energy-intensive industries are maintaining above average reserves and/or long positions in futures. Stories that Saddam might sabotage Iraq's wells have increased fears that petroleum prices could spike considerably higher. However even if installations are damaged, higher prices would soon reverse as oil-exporting countries announced production increases and hedge longs in futures were reversed. The price of crude oil could easily fall below $20 a barrel 6 to 12 months following a Gulf war.

What about gold? Fear of war can only have increased demand for gold. Therefore the onset of military action should lead to some profit taking. However the main factors behind gold's recovery are cyclical. Investors are certainly less enamoured with stock markets than in the 1990s. Also, they now suspect that deflation fighting by central banks will cause bonds and fiat currencies to be less reliable stores of wealth in future. Consequently downside risk for gold is probably limited to a small correction and an extended phase of ranging, before its new and most likely secular uptrend continues.

Best regards - David Fuller

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