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A BULLISH POST-WAR SCENARIO

Topical Study #59

All important disclosures can be found on the back page.

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I. Very Ambitious Agenda

In his State of the Union address on January 28, President George W. Bush said, "There are days when our fellow citizens do not hear news about the war on terror. There's never a day when I do not learn of another threat, or receive reports of operations in progress, or give an order in this global war against a scattered network of killers." This explains why the President is so determined to fight both state-sponsored and free-lance terrorism.

His domestic agenda is equally as aggressive. To get it through Congress, he must succeed in quickly resolving his biggest geopolitical challenge, i.e. disarming Iraq and liberating the country from Saddam Hussein. If he succeeds, then he will have the leadership momentum to achieve his domestic goals. If he fails to do so, he will lose his credibility and the Congressional votes necessary to pass his programs. In my opinion, the President's success or failure will be total and should be either totally bullish or totally bearish for the stock market. I believe he will prevail.

Whether you agree or disagree with the President, you have to admit he is a very ambitious fellow. In his State of the Union address, he proposed the following domestic initiatives:

1) To stimulate economic growth, he is proposing that all the income tax reductions set for 2004 and 2006 be made permanent and effective this year. He wants to reduce the marriage penalty tax and to raise the child credit to $1,000 immediately, instead of slowly phasing-in these changes. Congress has already passed all of these for the next several years. But the President declared, "If this tax relief is good for Americans three, or five, or seven years from now, it is even better for Americans today."

2) The President wants to reform the tax code starting by eliminating the double taxation of dividends. He said, "To boost investor confidence, and to help the nearly 10 million seniors who receive dividend income, I ask you to end the unfair double taxation of dividends."

3) He proposes to reform Medicare by providing a choice of health care plans that provide prescription drugs. To help contain health care costs, he called on Congress to limit malpractice awards.

4) His energy independence program includes a national commitment to promote hydrogen as an alternative fuel to power cars.

The President already faces much resistance within Congress to his domestic program. Fighting the trial lawyers over medical tort reform could be tougher than toppling Saddam. However, in my opinion, the domestic resistance should be easier to overcome if the President succeeds in Iraq, as I expect he will. There are significant risks, of course. Saddam could launch WMDs against American troops and some of his neighbors, e.g. Israel and Kuwait. He might also set Iraq's oil fields ablaze as he did to Kuwait's fields in 1991. Another reign of terror unleashed by Al Qaeda could push the global economy into a severe recession.

II. Third & Fourth Reagan Terms

I believe that the Iraq issue will be resolved before the middle of this year. As investors, we need to formulate and to assess the probabilities of plausible post-war scenarios. My most likely "Target Scenario" is a relatively optimistic one with a 70% subjective probability and a big bet that President Bush will prevail both abroad and at home (Figure A). I have become increasingly impressed with his leadership abilities. He reminds me of President Ronald Reagan in many ways. The January 26, 2003 issue of *The New York Times* featured an article in the Sunday magazine section titled "Reagan's Son" by Bill Keller. Mr. Keller observed that many Republicans who have watched both Reagan and Bush at close hand see uncanny similarities between them:

> The presidents are alike in their outlooks and career paths, in their agendas of tax-cutting and confrontational deployment of American power, in the ideological mix of their advisers. (Whatever you read about the president's inheritance from his father and Gerald Ford, the Reagan DNA is dominant in the staffing, training and planning of the Bush administration.) More than that, there are important similarities of character and temperament. And both are simple men who have made a political virtue of being—in Bush's word—"misunderestimated" by the political elite.

Mr. Keller says that when he began his research for the article, he was inclined to think of Bush as "Reagan Lite." But his opinion changed:

> I ended my research more inclined to think that Bush is in a sense the fruition of Reagan, and that—far from being the lightweight opportunist of liberal caricature or the centrist he sometimes played during his own election campaign—he stands a good chance of advancing a radical agenda that Reagan himself could only carry so far. Bush is not, as Reagan was, an original, but he has adapted Reagan's ideas to new times, and found some new language in which to market them. We seem not only to be witnessing the third term of the Reagan presidency; at this rate we may well see the fourth.

For Ronald Reagan, the biggest threat was the "Evil Empire." For George Bush, it is the "Axis of Evil." This black-and-white, good-versus-evil approach to foreign policy can be criticized as dangerously simplistic. Or else, it can be viewed as a very effective way to lead the nation to pursue clear goals. So, for example, in the current administration's lexicon, disarming Iraq is about substance, not about the process of doing so. In many ways, it was Ronald Reagan who deserves much of the credit for winning the Cold War. Mr. Bush may get the credit for ending the so-called "Clash of Civilizations" before it truly becomes one.

Figure A: Ed Yardeni's Target Scenario (as of 1/30/03)

	S&P 500 Forward EPS	x	S&P 500 Forward P/E	=	S&P 500	DJIA
Jan 30, 2003	55		15		845	7945
Dec 2003	60		18		1100	10500

Scenarios: subjective probability and assumptions

Target (70% probability)

Economy continues to grow—no Double Dip—with inflation near zero, but positive—no widespread deflation. Consumer spending continues to grow as solid productivity gains boost real pay per worker. Housing industry remains strong. Home prices continue to rise providing positive wealth effect on consumer spending. Interest rates remain near current levels.

Earnings recover as profit margins rebound. Trend growth in earnings remains around 7%, though could be closer to 5%.

Iraq issue is resolved by spring. Oil price tumbles, boosting both U.S. and global economic activity.

Better (15% probability)

Geopolitics. Quick victory in Iraq stabilizes Middle East; Iranians peacefully force their anti-Western regime out of power. Israelis and Palestinians resume a peace process that is peaceful and lasting. Bullish consequences for global economy and stock markets are comparable to what happened after end of Cold War. In other words, U.S. won the Cold War, and now wins the "Clash of Civilizations."

Liquidity pours out of savings deposits into economy and stock market as consumer confidence rebounds.

Earnings rebound is stronger than expected as pricing improves on a cyclical basis.

Worse (15% probability)

Iraq is defeated after a very messy war. The U.S. wins, but the Middle East becomes even more unstable. Oil prices remain over $30 a barrel.

Deflation becomes a big problem for profits as consumers reduce spending and home sales fall. Consumer and business credit problems mount.

Earnings are flat or down in 2003 and growth now trends around 3%, or less than half the trend since 1960.

III. Future Of History

Francis Fukuyama wrote a controversial article in the Summer 1989 issue of *The National Interest* titled, "The End of History?" He argued that the ideological battle between capitalism and communism was over. The clear winner was capitalism. The clear loser was communism. To the extent that history consists mostly of epic struggles between opposing forces, the triumph of capitalism also marked the end of history.

On August 1, 1989, I wrote a Topical Study titled, "The Triumph Of Capitalism," in which I argued that the triumph of capitalism over communism was wildly bullish for stocks and bonds. On September 4, 1991, I continued to beat the drum with a study titled, "The Collapse Of Communism Is Bullish." My thesis worked out very well during the 1990s and so did my Dow 5000 and Dow 10000 targets.

In the Summer 1993 issue of *Foreign Affairs*, Samuel Huntington wrote an article titled, "The Clash of Civilizations."[1] He dismissed the end-of-history thesis, arguing instead:

> Civilization identity will be increasingly important in the future, and the world will be shaped in large measure by the interactions among seven or eight major civilizations. These include Western, Confucian, Japanese, Islamic, Hindu, Slavic-Orthodox, Latin American and possibly African civilization. The most important conflicts of the future will occur along the cultural fault lines separating these civilizations from one another.

9/11 and the subsequent war on terrorism supported Huntington's view of the future of history as a clash between Western and Islamic civilizations. President Bush seemed to respond to 9/11 with an immediate instinctive understanding of what was at stake and has responded accordingly.[2] The Bush administration's game plan seems to be to attack the Islamic fomenters of such a clash. Winning in Iraq could prove to be the endgame for the state-sponsored and free-lance terrorists who are striving to trigger a clash between the West and Islam, in my opinion. If so, then the bullish consequences could be comparable to what happened after the end of the Cold War.

Admittedly, this scenario may be too naïve. We may not have to wait much longer to find out. If the Iraqi people respond to American soldiers as liberators, then the optimistic post-war scenario would be more credible. In his State of the Union, the President told the Iraqi people, "Your enemy is not surrounding your country— your enemy is ruling your country. And the day he and his regime are removed from power will be the day of your liberation." Of course, a smooth regime change in Iraq could have a very positive domino effect in Iran. It might even convince the Israelis and Palestinians to follow a road map to peace. Of course, a democratic regime change in Iraq could destabilize Saudi Arabia.

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[1] The article can be found at http://www.alamut.com/subj/economics/misc/clash.html

[2] See Bob Woodward, *Bush at War*, Simon & Schuster (2002). Also see my September 6, 2002 commentary, "The Causes & Consequences of 9/11," http://www.prudential-yardeni.com/subscriber/a_090602.pdf

IV. Star Wars & Hydrogen

In the long run, Mr. Bush's endorsement of hydrogen as an alternative to crude oil may be even more destabilizing for Saudi Arabia, as well as the other oil producers. Ronald Reagan promoted the "Star Wars" missile defense shield as a way to tilt the balance of nuclear terror in our favor. The prospect of such a shield frightened the Soviets and may have contributed to their willingness to adopt a less hostile approach toward relations with the United States. As the Soviets became more reasonable, they also became more vulnerable to internal upheaval, which turned out to be remarkably effective and peaceful when the Evil Empire finally crumbled in the late 1980s.

President Bush's hydrogen plan to shield Americans from our dependence on foreign oil is a warning to oil producers that their scarce resource may become much less scarce in the future. It gives them a great incentive to keep the price low to discourage consumers from pursuing alternative energy technologies. If hydrogen does develop into a competitive alternative to petroleum, then the prospects of unlimited cheap energy could transform the global economy in a very bullish way.

V. Greatest Leap Forward

Before I get too carried away, however, let me stay on the planet Earth as we know it. If there is no hydrogen revolution, then the demand for oil is bound to soar in coming years as China continues to boom. The Chinese seem intent on impressing the world by 2008 with their latest Great Leap Forward. During the summer of 2008, they will host the Olympic Games. In my opinion, this one event is the Big Driver for the Chinese economy, as well as for the global economy. The Chinese are building superhighways everywhere. They are expanding their regional airports and ordering more jets. They are encouraging their people to trade in their bicycles for cars. Currently, roughly 70% of their energy comes from domestic coal, which is highly polluting. The Chinese are scrambling to acquire more oil from Russia. They are doing the same for liquefied natural gas from Australia and Indonesia.

Obviously, oil and gas are not the only commodities China needs more of. If the Chinese get to have the same car ownership rates as in the United States today, the total number of cars on the planet Earth would double! That would require a great deal of copper, steel, rubber, platinum, plastics, leather, and semiconductors. In other words, one of the most obvious ways to play China is to buy commodities and commodity producers. This is Marc Faber's investment thesis and I agree with it.[3]

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[3] Mr. Faber's views were summarized in the January 20, 2003 issue of *Barron's*. He also has a new investment book out, *Tommorow's Gold: Asia's New Age of Discovery*. For more information, see his website at http://www.gloomboomdoom.com/

Chinese demand for commodities may already account for some of the recent strength in the CRB raw industrials spot price index and its metals component. I favor this index because it includes the spot prices of 13 raw industrial materials, but not gold or any energy or lumber commodities.[4] Interestingly, the price of gold tends to lead both this overall index as well as its metal component (Figure 1). The strongest price components have recently been copper, steel, and rubber (Figure 2). Chinese demand for technology is also booming and accounts for much of the rebound in worldwide semiconductor sales last year (Figure 3).

VI. Tech Is Cheap

While China is likely to put upward pressure on many commodity prices, it is also likely to be a major source of deflationary pressures. Both the U.S. trade deficit with China and imports from China already slightly exceed our trade deficit with Japan and imports from Japan. However, imports from China are equivalent to only 3.1% of U.S. manufacturing shipments, though this is up from only 0.9% ten years ago (Figure 4).

The Chinese are certainly likely to contribute to the ongoing commoditization of technology. In the United States, constant dollar tech spending by both businesses and consumers rose 19% last year, while current dollar spending was up only 4.5% (Figure 5). Unit sales growth is strong because tech has become so cheap. In many industries, cheap information technologies are boosting productivity and helping to offset deflationary pressures. However, at the same time, cheap technologies are a source of deflation by allowing companies operating in highly competitive global markets to lower their prices.

There have been six major failed rally attempts in the S&P 500 Tech stocks since March 2000. I've missed them all because I was not convinced that the outlook for earnings was likely to improve as expected by the bulls. I am still not convinced that a solid recovery is around the corner. If so then, valuation multiples remain too high (Figures 6 and 7). Tech may be cheap, but the stocks are not. The latest CIO Tech Poll suggests that the outlook for tech spending remains very modest (Figures 8, 9, 10, and 11).

Clearly, while I see a potential for a bullish post-war scenario, I am not especially bullish on technology stocks. My number one favorite sector is Health Care.[5] I like Financials because I expect that credit quality will improve this year. I am still very positive on Home Builders. I would add Media and Cable to my list of likely out performers. All of the above are immune to competition from China. And, of course, Materials would be a good way to participate if the global economy gets a big boost from China's Great Leap Forward.

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[4] For more on this, see "My Favorite Indicator," December 17, 2002, http://www.prudential-yardeni.com/weain.asp
[5] For more on why I am bullish on Health Care, see my January 21, 2003 commentary, "Smoking Gun," http://www.prudential-yardeni.com/subscriber/a_012103.pdf

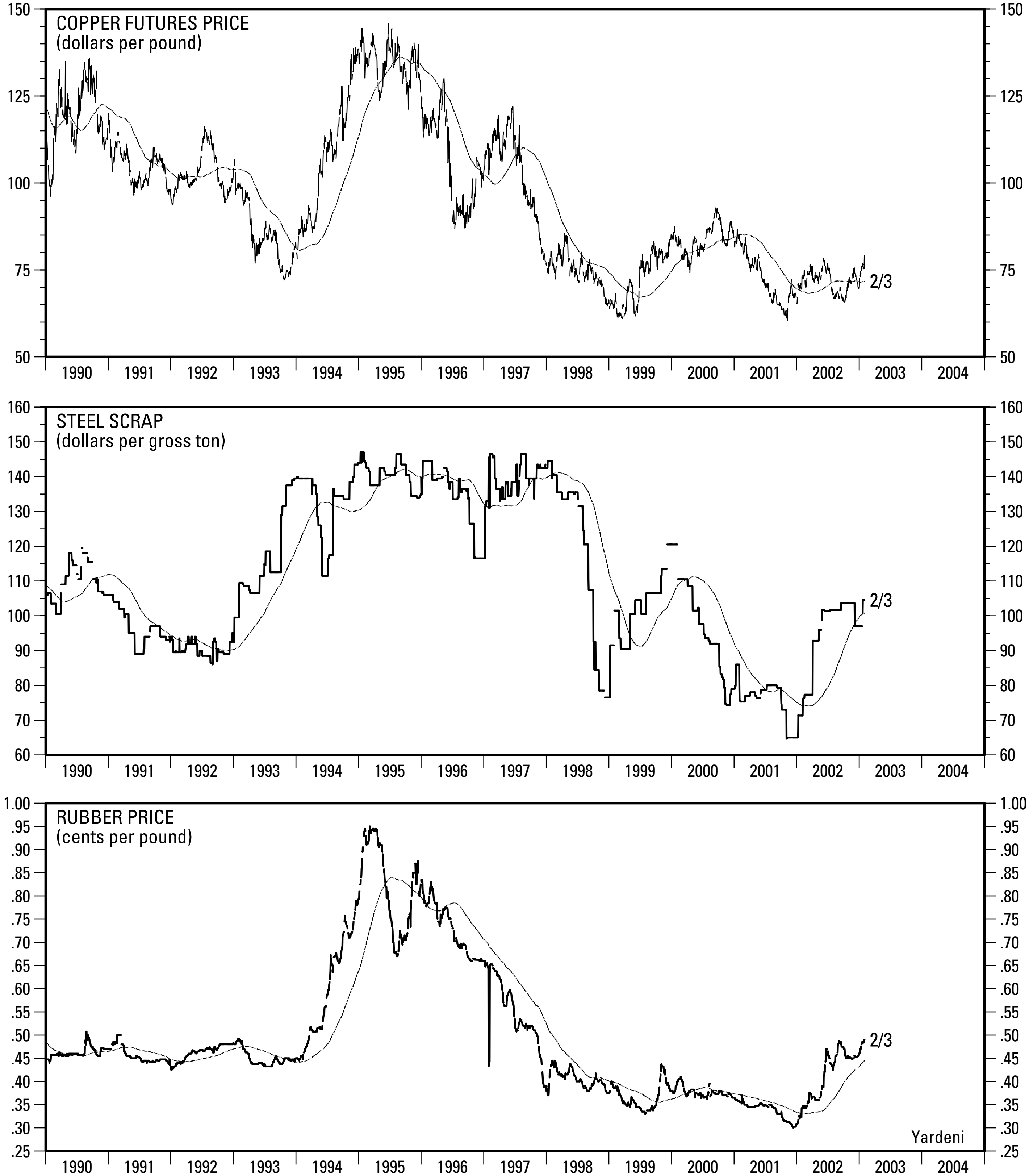
Commodity Prices

Figure 1.

—— 200-day moving average.
* Includes copper scrap, lead scrap, steel, tin, zinc, burlap, cotton, print cloth, wool tops, hides, rosin, rubber, and tallow.
** Includes copper scrap, lead scrap, steel scrap, tin, and zinc.
Source: Commodity Research Bureau.

Commodity Prices

Figure 2.

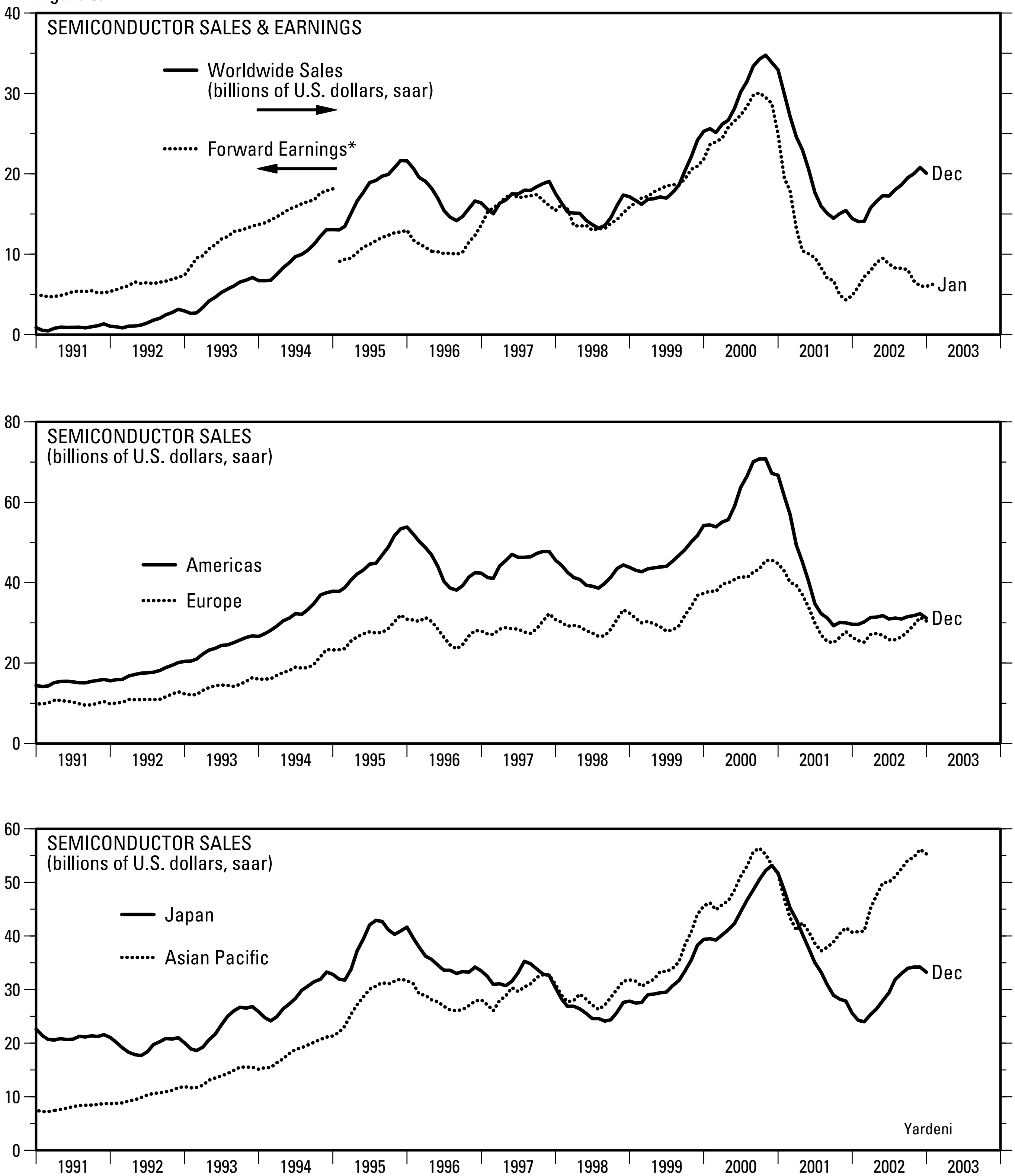


—— 200-day moving average.

Source: Commodity Research Bureau and Comstock Commodity Exchange Inc.

Semiconductor Sales

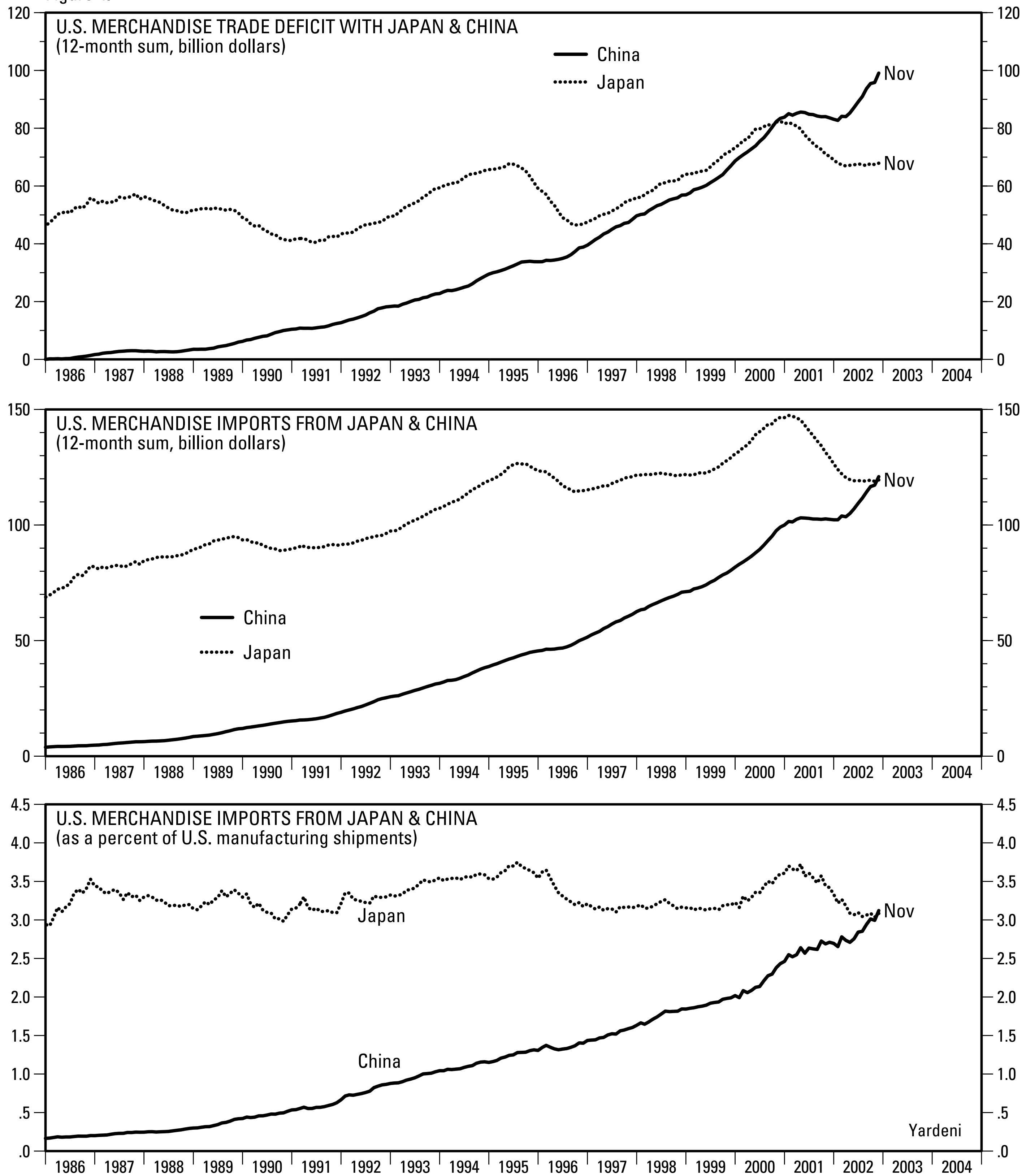
Figure 3.



* 12-month forward consensus expected operating earnings per share for S&P 500 Semiconductors sector.
Data from 1995 forward for earnings based on new Global Industry Classification Standard.
Source: Semiconductor Industry Association.

U.S. Trade with Japan & China

Figure 4.

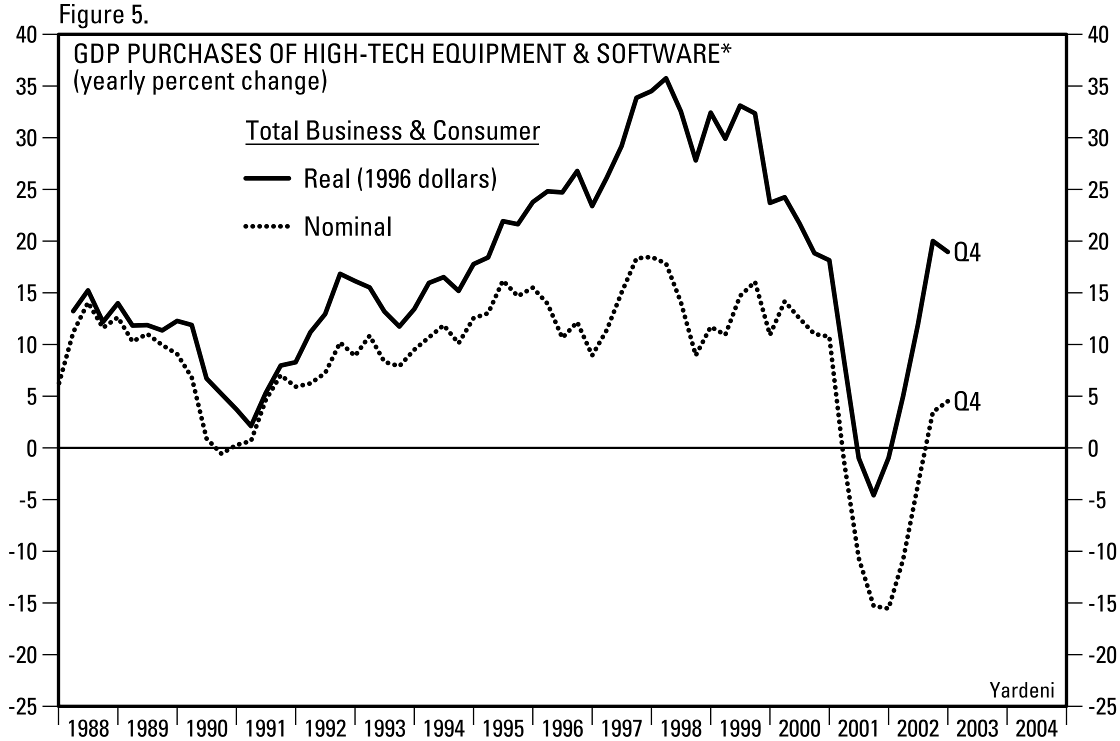


Source: Bureau of the Census.

High-Tech GDP

Total tech spending in GDP is recovering, with both nominal and real measures up from a year ago.

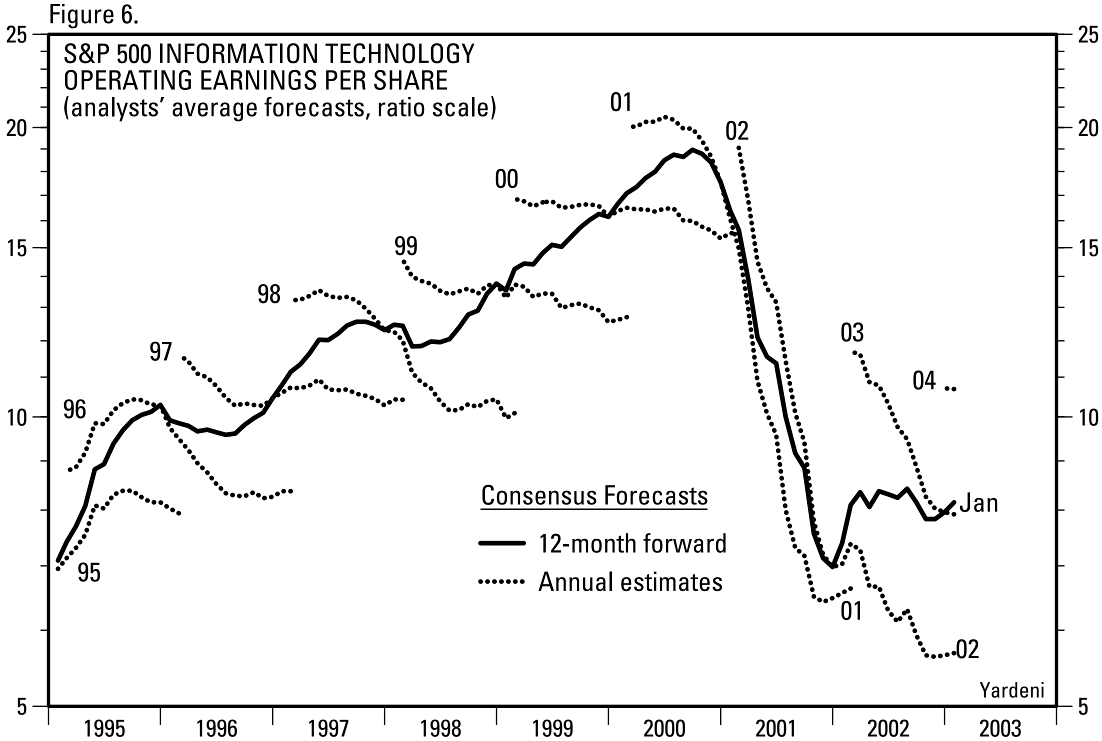
Figure 5.



* Includes computers and peripheral equipment, software, and communication equipment purchased by businesses and consumers.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The recovery in Tech forward earnings has stalled after briefly rebounding early last year. 2002 earnings were down 20% from 2001. 2003 earnings are expected to be up 40%, but only back to 1995 level.

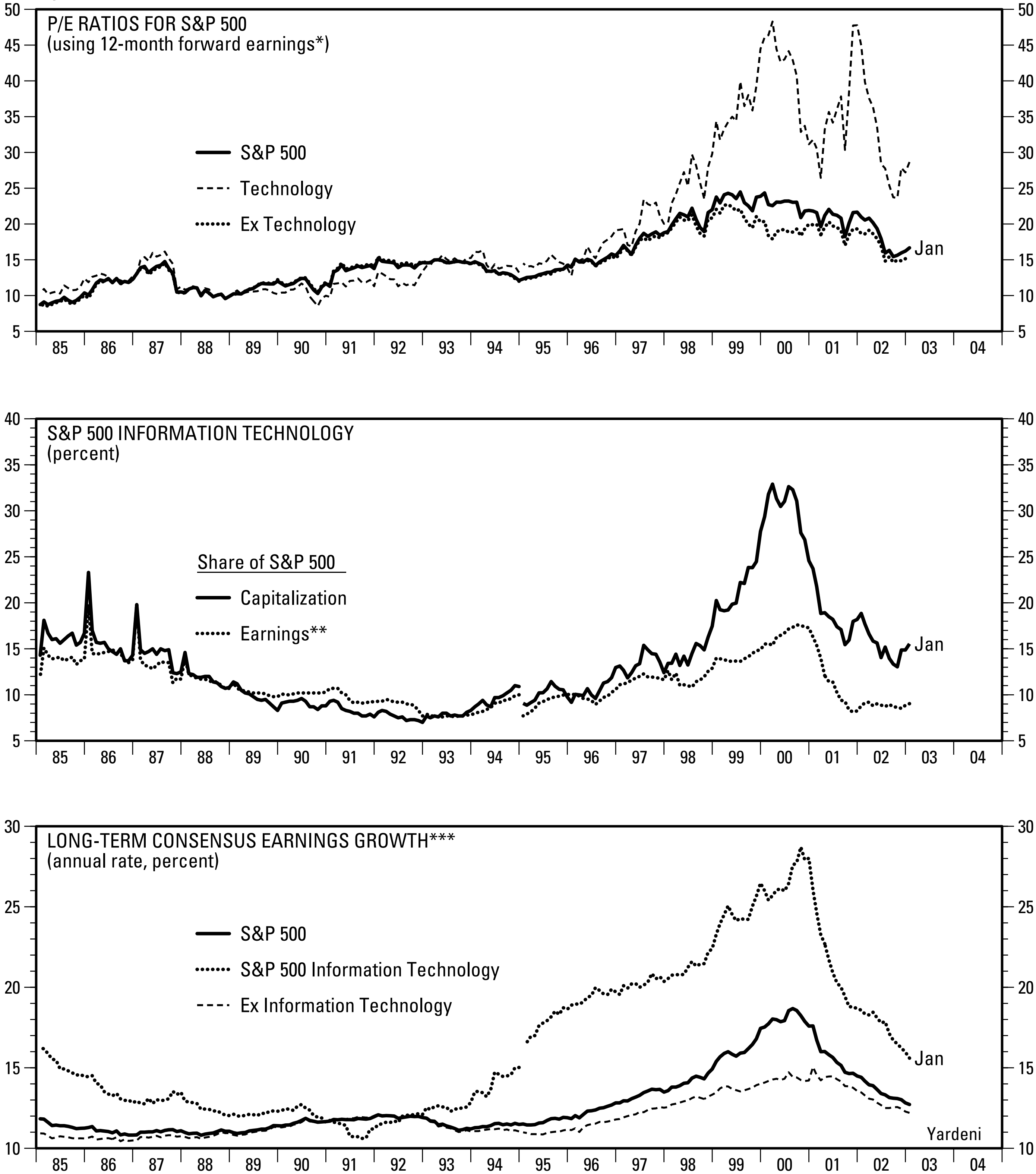
Figure 6.



Source: Thomson Financial.

Technology Valuation

Figure 7.

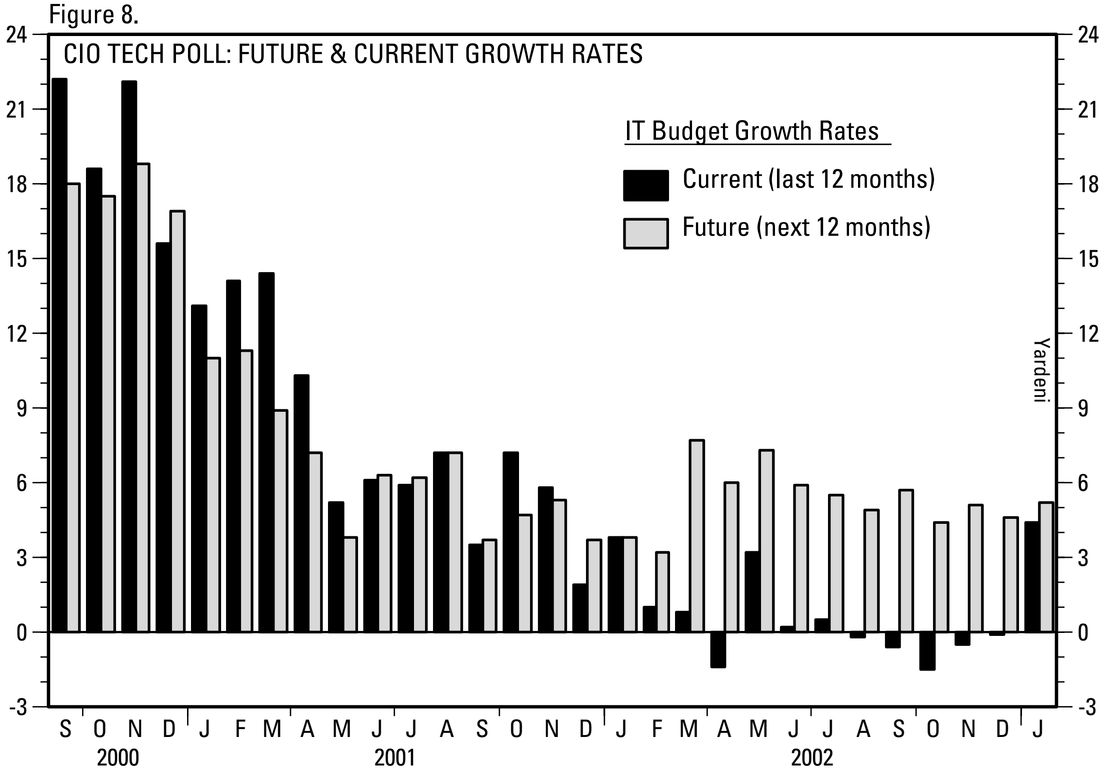


* Price divided by 12-month forward consensus expected operating earnings per share using mid-month data.
** Using consensus 12-month forward earnings forecasts.
*** Five-year forward consensus expected S&P 500 earnings growth.
Data from 1995 based on new Global Industry Classification Standard.
Source: Thomson Financial.

CIO Poll

The CIO Tech Poll shows that 12-month projected IT spending growth remains subdued.

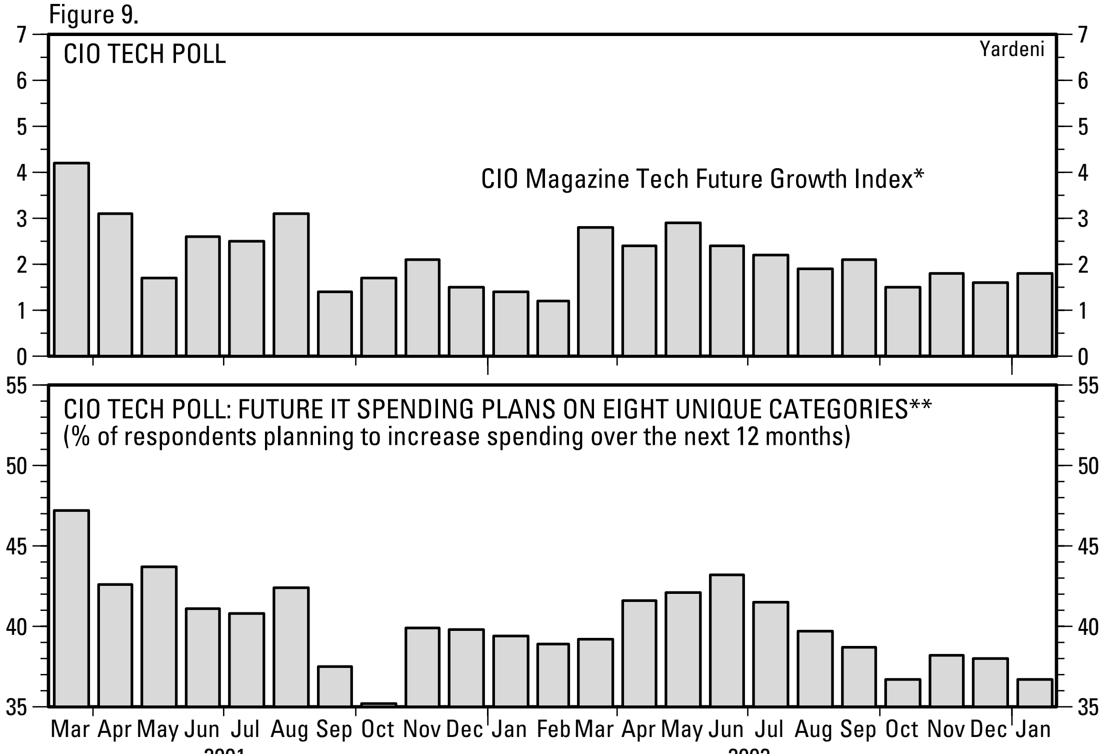
Figure 8.



Source: CIO Magazine Tech Poll.

The percentage of CIOs planning to increase spending remains below 40%.

Figure 9.



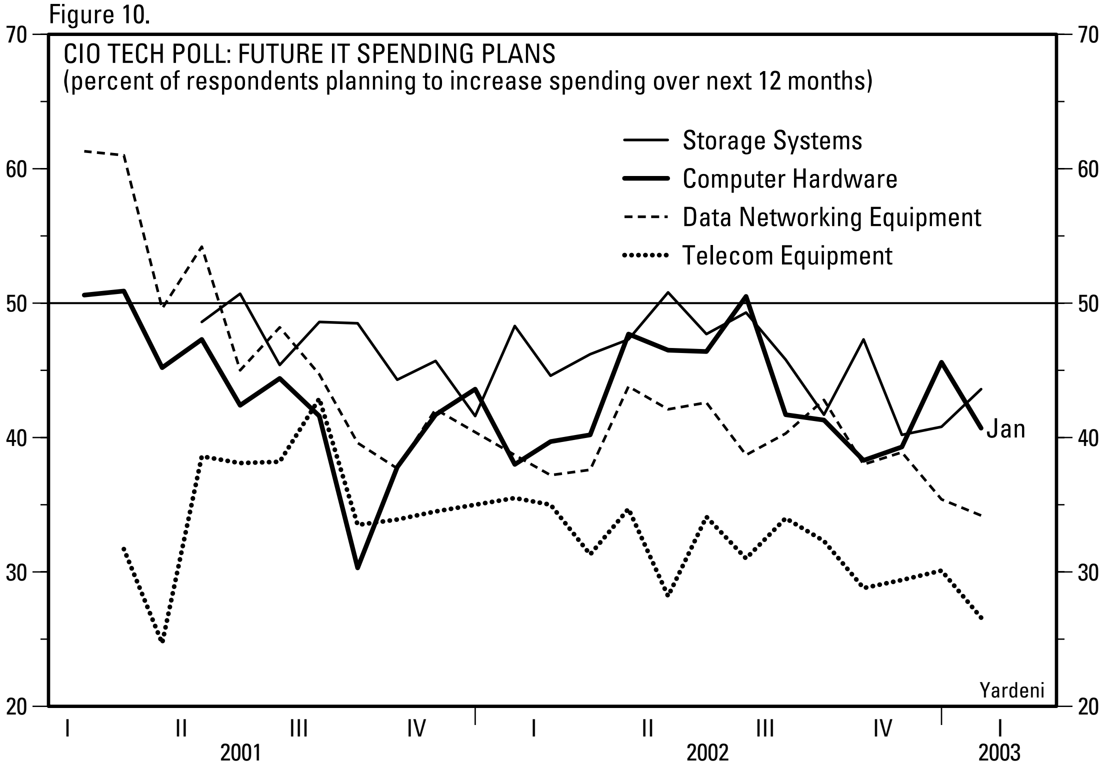
* Projected growth rate of IT budgets over the next 12 months, multiplied by the average percentage of respondents saying they plan to increase their spending in eight unique categories.

** The "plan to increase" responses are averaged together for the following categories: computer hardware, data networking equipment, telecom equipment, storage systems, outsourced IT services, infrastructure software, e-business software, and security software. Source: CIO Magazine Tech Poll.

CIO Poll

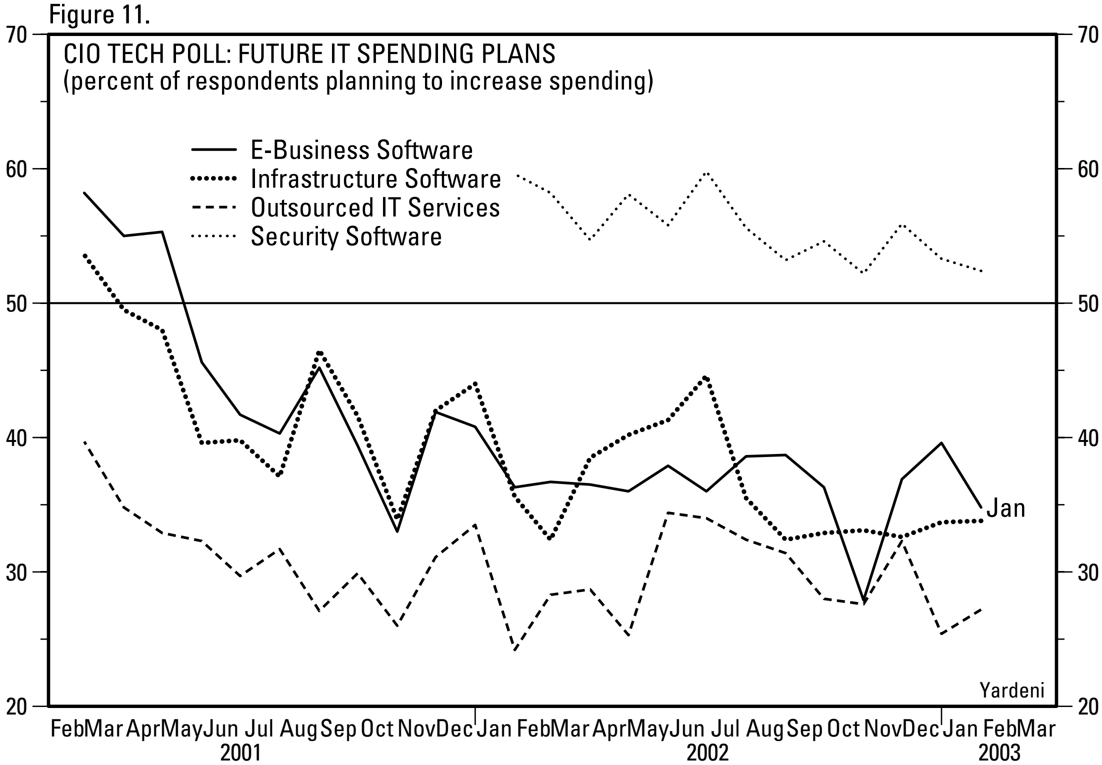
In January, CIOs planning to increase spending was above 50% for only one of eight major categories of IT spending.

Figure 10.



Source: CIO Magazine Tech Poll.

Figure 11.



Source: CIO Magazine Tech Poll.

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