



Post Attack Environment

The meeting in the Azores between the three key members of the Coalition of the Willing is now history. There is a certain Greek Classic quality to this unfolding drama. First, will come the final appeals, probably falling on deaf ears. If the Chirac interview last night was a preview, we know how the French will react--with charm and deceit. Chirac has painted himself into the corner where only outright distortions can grow. When asked whether he believed that Iraq had any WMD, Chirac hid under a thick blanket of mendacity, by claiming he 'was not sure,' buttressing his innocent denial with the spin that knowing that was the purpose of the inspectors. But, he clearly knows that the inspectors have found evidence of chemical and biological agents, and what they have not found was the required evidence of the destruction of those biochemical agents. Even Chirac's beloved inspector chiefs, Blix and Eilbaradei have noted that. UNMOVIC found far too little of the Iraqi WMD assets, or the world would be in a different position entirely. An appeal to 'sweet reason' will gain support from those opposing swift and harsh justice, but it will only confuse those who have not paid attention to what Blix and Company have actually said and written.

The last phase of diplomatic staging is occurring and then the dogs of war will be loosed. It could all begin this week, or it could drag on a few days more, with the final resolution still unchanged. Dragging-on, however, seems less a function of paying homage to public opinion than of logistical considerations having to do with what equipment the Coalition has in place now and what will arrive shortly. The FT's story today that much of the "heavy stuff" has yet to arrive is a bit disorienting, but one does not know how much 'disinformation' is in the news pipeline. The Turks now seem 'out of it,' and the U.S. has lost its northern conduit for at least heavy equipment. To us, it was dismaying to read that Vienna blocked movement of heavy equipment through Austria. Vienna is very much "Old Europe," to use the incendiary terminology of our current Defense Secretary. Time and further delay will only increase uncertainty for investors, but will they get relief from the first few days of fighting? What's the likely environment for investors when the live fire begins?

Every analyst purveys a favorite scenario. It is the apex of pre-game strategizing, which unfortunately has a very poor predictive history. Generals are said to fight the last war, but journalists are much worse because their training as military historians and students of strategy and tactics are woefully deficient. Some are so young that they don't even have the 'last war,' to practice on! We confess to our own difficulty in constructing a clear scenario analysis of this epochal event. And, without one, it is hard to give clarity to investors. Many analysts are satisfied with their pithy observation that they know how it will begin, but have no real clue as to how it will end, or more importantly, when it will end. We are not even sure how it will begin. Still, scenario analysis depends upon Robustness. Are there any themes that stand out irrespective of the operative drivers?

Environmental Scanning: many analysts operated on the theory that outright attack would bring a sharp rally. This seems less clear to us because of the strong upward performance of the past two days. Since we began to sketch this note last night, the market has opened to the upside once again. We think the market is 'buying the rumor,'" and drawing on the parallel of 1991. But, an old adage intones that 'the market never does it to you the same way twice,' and we believe that is sound advice in this circumstance. This time, the market may well have much less upside potential. Why? Precisely because the options open to Saddam include germ or biological warfare; a 'Stalingrad' type defense with large numbers casualties; and, not the least, a long rebuilding campaign via occupation by a foreign military power. The latter "phase" of the war is the building of a democratic Iraqi state, and no one assumes this is a short-term phenomenon.

In 1991, the show of decisive military power meant the market reduced its worries about an adverse outcome. Baghdad had evidenced poor defenses. Second, there was the long interval during which bombing reduced



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Iraq's defenses, exposing fixed positioned armor in the sights of a highly armed, highly mobile adversary. Then, markets must have sensed it was all going to be over for Iraq rather quickly. And even though the bombing campaign was a long one, before the 'wheel to the west,' it seemed clear that Iraq had no defense. Few considered that Saddam Hussein would still be in power to do his 'thing' once again when the fighting had stopped.

This time, we start from a different history. Saddam Hussein outlasted us all. He is still there. This time, however weakened his military is, it will still possess a lot of capability---perhaps even to loose chemical and biological weapons despite President's Chirac's lack of information. Saddam has been caricatured as an eternal optimist. He believes he will live to fight another day and that time is on his side. What happens when he learns he has no exit? Will he let loose his WMD?

Saddam's prospective defeat leaves most forecasters sure that he will not survive in office, but that does not tell us how the end game will play out. Part of that end game is the rebuilding of Iraq and the prevention of more assistance to terrorist groups. Part of it is the oil scenario. Will the Iraqi fields and terminals and pipelines be destroyed or at the least, badly damaged, interrupting Iraqi oil exports for a long time? Part of it is the dismemberment issue. Will Iraq break up into three (somewhat) hostile smaller states (Kurds, Shia's and Sunni's)? What will be the collateral damage to the Iraqi population? How will the rest of the world react? Perhaps, more importantly, how will the Arab Street react? What about Israel? Will the Iraqi's hit Israel with some form of WMD and if so, can Israel be kept out of the fight? What will be the response of various terrorist organizations toward the U.S., both abroad and here at home? Finally, with a squabbling NATO alliance now in shambles, how will the evolution of Iraq's political economy take place? A U.S. "spoils of war" approach or a return to multilateralism? The bottom line, no matter what positive outcome is forecast is **very high uncertainty. It is hard to see the Geopolitical Clouds merely lift when the fighting is over.**

The direct costs of the war are unknowable until the war ends and the costs of building a durable and democratic Iraqi state are simply not definable at this moment. One thing for sure. The costs will be higher than the original estimates. This has some adverse implications for our current cyclical disturbance. In the absence of a sharing of these costs by a wide array of countries around the world, the U.S. will have an ongoing burden of restoring the oil sector in Iraq; rebuilding the communications, transportation and utility grids that will be disrupted by the battle; and, delivering humanitarian aid to those most affected by the war just to name a few of the priorities. This means manpower and monetary resources will be needed and these will be largely U.S. responsibilities. While some offsets may arise via a revived oil industry, they cannot be known now. Furthermore, it is almost certain that a high degree of domestic security will have to be maintained entailing even larger public expenditures.

A continued drain on the American budget will impact the conduct of monetary and fiscal policy in the U.S. The Fed meets tomorrow and our speculation is that at least some strong language suggesting the possibility of an interim move will show up in the Fed's announcement. The Bush tax plan is still a 'work in progress.' Thus, the combination of monetary and fiscal stimulus that will occur is very much in doubt. The recent macro data all point to a more intensified slow "patch." While Industrial Production rose a nominal 0.1% that is hardly an offset to new order, shipment and backlog data from the Empire State survey that all point to contraction, at least for that region. On the basis of past performance, this suggests that the other business sector surveys (e.g. Philadelphia) as well as the next ISM manufacturing survey will show slowing industrial performance. Consumer confidence fell again last week and at some point the "CNN Effect" is likely to hold spending down. In that environment, business reluctance to spend may be more enhanced, widening the potential output gap further.

The two fundamental "conditions," are the Coalition does its thing easily, quickly and with a minimum of collateral damage, the extreme case being the resignation and exile of Saddam Hussein. Under that



circumstance, the rally could continue...provided that the ongoing obligations now taken on by the U.S., are not seen as Act II of a long term War in the Sand, or a precursor to wars with Iran and Korea. But, consumer anxieties and the need to rebuild balance sheets will still be there. The depreciation of the dollar will continue to help, but in our view, under the "optimistic" situation, the Congress will prove more reluctant to pass an aggressive tax bill. Sooner or later, the market will come to evaluate the post war environment and begin to deal with the on-going issue of nuclear (and/or other mass destruction) proliferation. Some geopolitical risks will lift, but hardly all of them at once.

The other 'condition,' is that something quite unexpected develops in the war and peace scenario which emphasizes how fragile are security conditions around the world. Any number of 'bad news' scenarios could play, the least of which is extensive collateral damage.

One conclusion that can be drawn from both fundamental scenarios is that much more Government will be in the GDP equation as an aftermath. Given any level of the current account deficit, that has to mean a relatively smaller private sector. Inevitably, that adds "weight" to the drag of this recovery, even if some might argue that higher fiscal expenditures will restore aggregate demand. More than likely, we will get substantial substitution

Secondly, however the war and subsequent peace-making efforts, there will be the issue of how the war-peace transition is financed. Surely, it means more government debt. The increase in debt has two aspects: cyclical and structural. The market may think it likes the cyclical positive, but it will come to be afraid of the structural side of the equation.

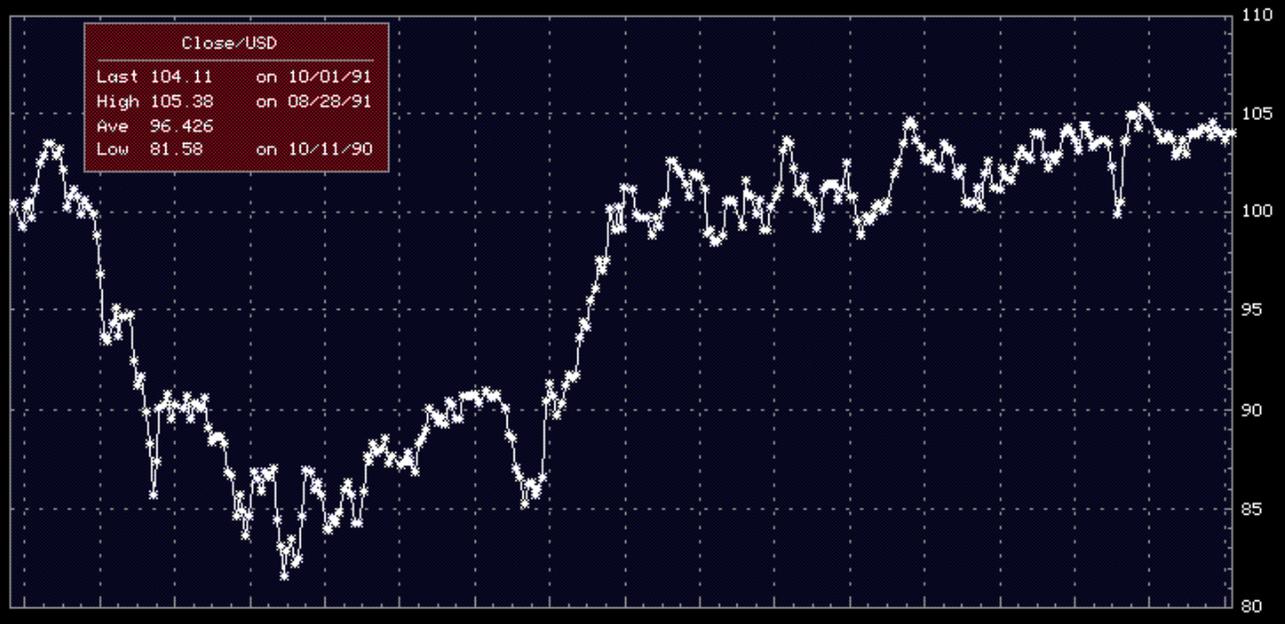
Wars as events in public finance always lead to inflationary pressure, because no politician wants to levy the taxes necessary to finance the war. Why will this one be different? It won't, even if we can't see the end game at this moment. This incipient inflationary pressure may relieve the Fed from its deflationary nightmare, but if the weight of government slows economic growth, Stagflation may once occur appear.

At 8063 (1:40 PM EST), the Dow is now up some 7% since the close on March 11th, the SPX is up almost the same amount and the CCMP over 8%. How much more of this upside breakout is there left? If it is a 'buy the rumor, sell on the news' situation, then what we may be observing is all the pre-war optimism that reflects the assumed post-attack rally of 1991. From August 1990 onward, the market fell until the rally began on January 17th. It rose some 25% back to the levels current just before Iraq invaded Kuwait. On that model, the Dow would go to over 9000, another 11 or 12% more, until the 'correction' is over. Our guess is that will not be the case. This rally began before hostilities have commenced, and there is always market learning. Traders that got in 'earlier,' may also depart earlier.



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