Bianco Research L.L.C.

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Perception Versus Reality: War And Markets

Conference Call Package

March 19, 2003

Long-Term Interest Rates - 1900 to 2003

Why The Gulf War 1 vs. Gulf War 2 Overlay Does Not Apply

Gulf War 1 Quotes

A week before the United Nations deadline for the withdrawal of Iraq from Kuwait, President Bush's envoy, James Baker, was to meet face to face with President Hussein's closest adviser, Tariq Aziz. The meeting was to take place on neutral territory at a hotel in Geneva on 9th January 1991. If full scale war was to be averted, this is where the diplomatic solution to the crisis had to be found. . . .

We filed out one door, they filed out another. We then went back up to the Secretary's set of rooms in the hotel. He made a call back to the White House and gave a report on the meeting. And then we sat down to figure out what his opening line and opening statement should be. And to prepare him for the various questions and answers that we thought would come during the course of probably the most watched press conference in quite some time.

> ***The message that I conveyed from President Bush and our coalition partners was that Iraq must either comply with the will of the international community and withdraw peacefully from Kuwait, or be expelled by force. Regrettably ladies and gentleman, I heard nothing today that, in over six hours, I heard nothing that suggested to me, any Iraqi flexibility whatsoever.***

And someone told me* [Baker] *afterwards that the first word I used was 'regrettably' and when I said 'regrettably' there was a, that there was a, a tremendous amount of market activity in the various markets around the world, world markets and stock markets and so forth. And everybody concluded just from that one word, that, that things were not going to work out politically that we probably would end up at war in the Persian Gulf.

Seven nights later, war began.

Frontline - Voices In The Storm: The Brink Of War

Gulf War 2 Quotes

March 17 (Bloomberg) -- The U.S. and U.K. withdrew a resolution that set today as a deadline for Iraq to disarm, signaling the end of efforts to get United Nations backing for military action against Saddam Hussein's regime.

``We have worked very hard in the last few days in a final effort to seek a council consensus,'' U.K. Ambassador Jeremy Greenstock told reporters before the Security Council met. ``We have to conclude council consensus will not be possible.'' He said the two countries ``reserve the right'' to disarm Iraq by force.

Bloomberg – March 17, 2003

Gulf War 2 - Perception vs. Reality

Gulf War 1 Quotes

"At some point, you're going to have to do something with those dug-in troops," says retired Gen. Edward C. Meyer, a former Army chief of staff. And a head-on fight, he estimates, could cause ***10,000 to 30,000 U.S. casualties****. "Against Iran, the Iraqis were very good at defensive warfare," he warns.* - The Wall Street Journal, November 15, **1990**

Lite Industries factory in Paterson, NJ, is one of several companies working to meet Defense Dept's order for body bags, called 'human remains pouches' by Pentagon; ***Pentagon ordered 16,099 body bags in contract let on December 11, [1990]*** --The New York Times, January 16, **1991**

Gulf War 2 Quotes

*The nation's top military officer said today that the Pentagon's war plan for Iraq entailed shocking the Iraqi leadership into submission quickly with an attack "****much, much, much different" from the 43-day Persian Gulf war in 1991****.* – The New York Times, March 5, **2003**

Everybody knows the uncertainty over war is slowing the economy, but what happens once we win? Imagine, for a moment, that oil prices have sunk to $20 a barrel. Capital spending is once again steaming along, and optimism has seized the stock market. – The Wall Street Journal, March 5, **2003**

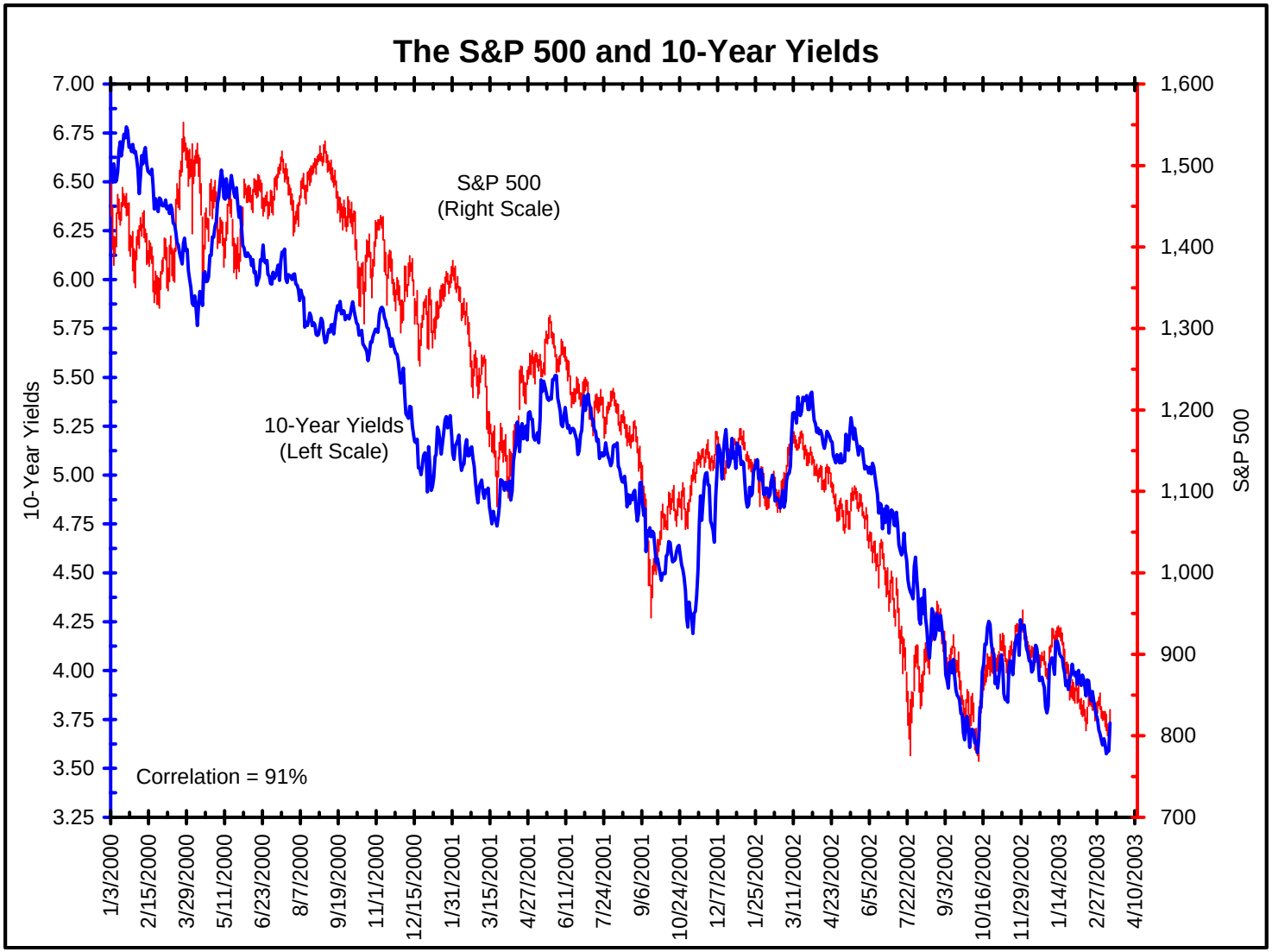
Conclusion

Market perceptions and real-world realities are not the same thing. For the markets to have a volatile reaction, or start a new/different long-term trend, reality must diverge from the market's perception when war starts. The further reality diverges, the stronger the reaction will be. **Should the war go as expected, it is very possible that the markets will not exhibit a large reaction.**

Will perceptions diverge from reality? Probably. How will they diverge from reality? We could go on and on for hundreds of pages offering our "expert military analysis" as we are qualified to pontificate on this subject (not!). We could offer hundreds and hundreds of links to others "expert analysis" (and, in fact, we have in our newsclips product). But in the end, does anyone really know? None of the "experts" in 1991 knew.

The best course of action is to understand what the market expects and then watch to see how this "squares" with reality in the coming days. When divergences develop (going "better than expected" or going "worse than expected") look for the markets to adjust accordingly (and probably rapidly).

Stocks And Bonds



War Premium or Inflation?

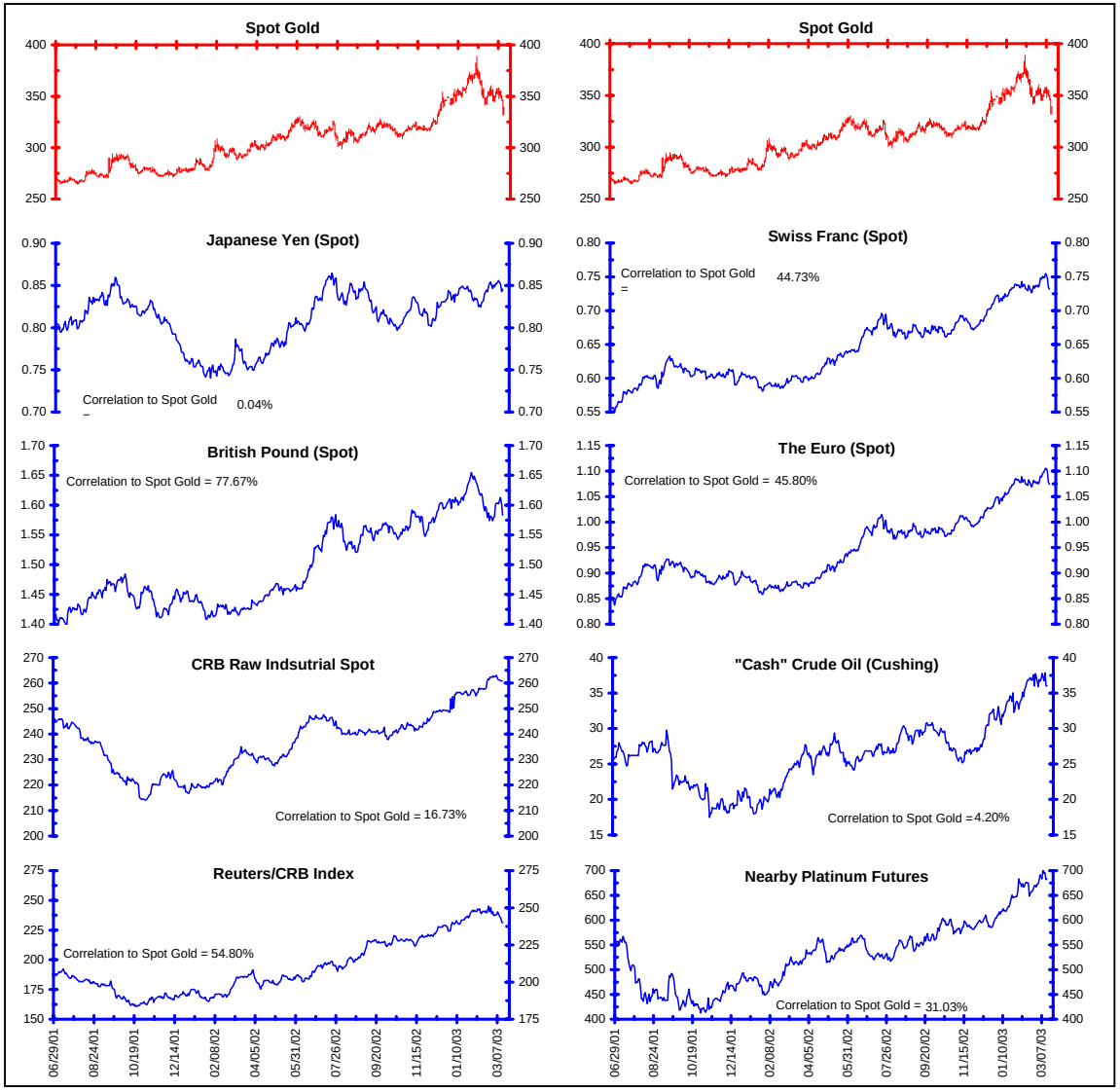
The war has not started so we still do not know what "reality" looks like. However, market perceptions have changed in the last few days. We base this assessment on more than yesterday's big rally in stocks and the collapse in bonds. Let us explain.

While stocks and bonds are also caught up in the "war trade," they have powerful crosscurrents like repealing dividend taxes, preannouncement season, deflating "the bubble," the convexity trade, and the ballooning Federal deficit.

These crosscurrents make reading the "war trade" difficult. The commodity and currencies have fewer crosscurrents; therefore, we believe it makes them a "better read" on the "war trade". To measure the effects of the "war trade," we constructed the charts below.

The top two red panels show gold. The eight blue panels under gold show four major currency markets (the Japanese Yen, Swiss Franc, British Pound, and the Euro) and four commodity sectors (the CRB Raw Industrial Spot Index: industrial commodities, Crude Oil: energy, the Reuters/CRB Index: agriculture, and Platinum futures: precious metals).

Also shown is the rolling three-month correlation between gold and these eight currency and commodity markets. That is, each day we re-calculate the correlation over the previous three months.

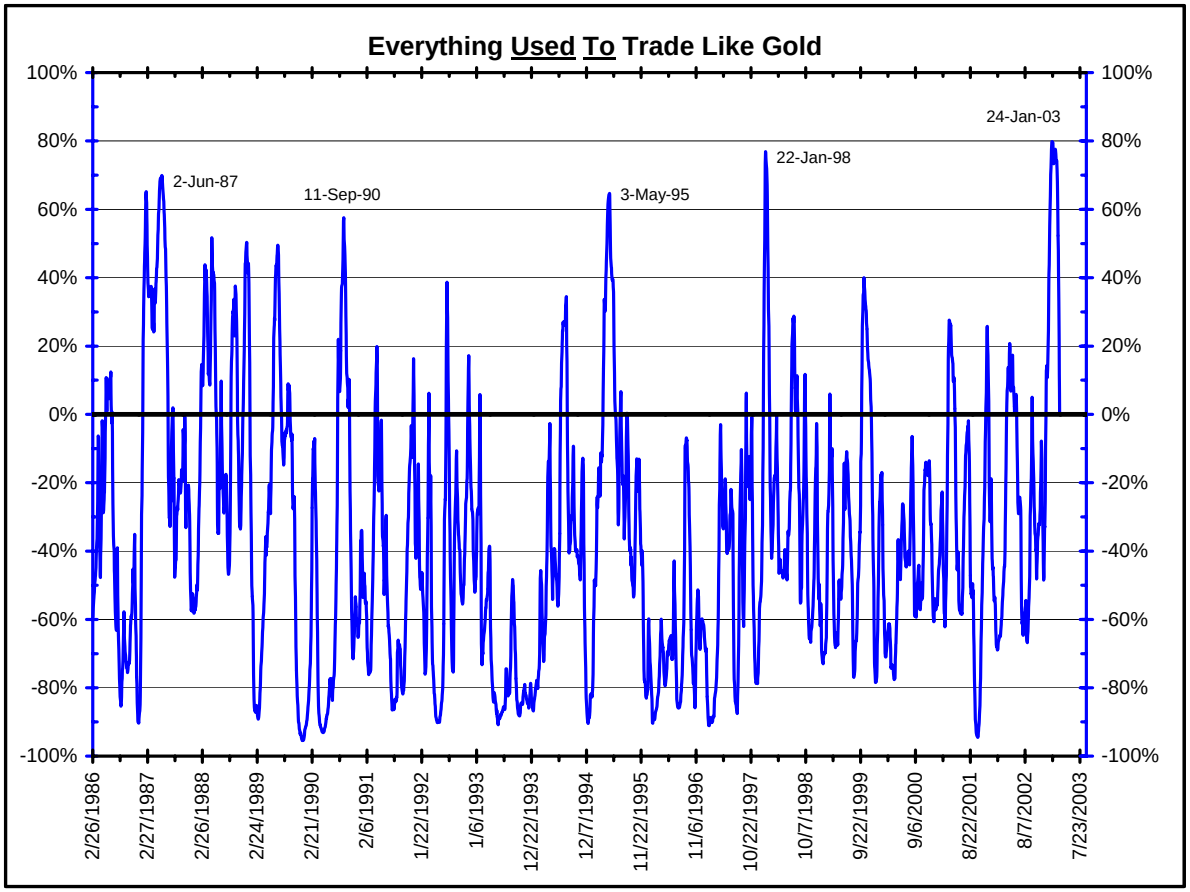


War Premium or Inflation? - 2

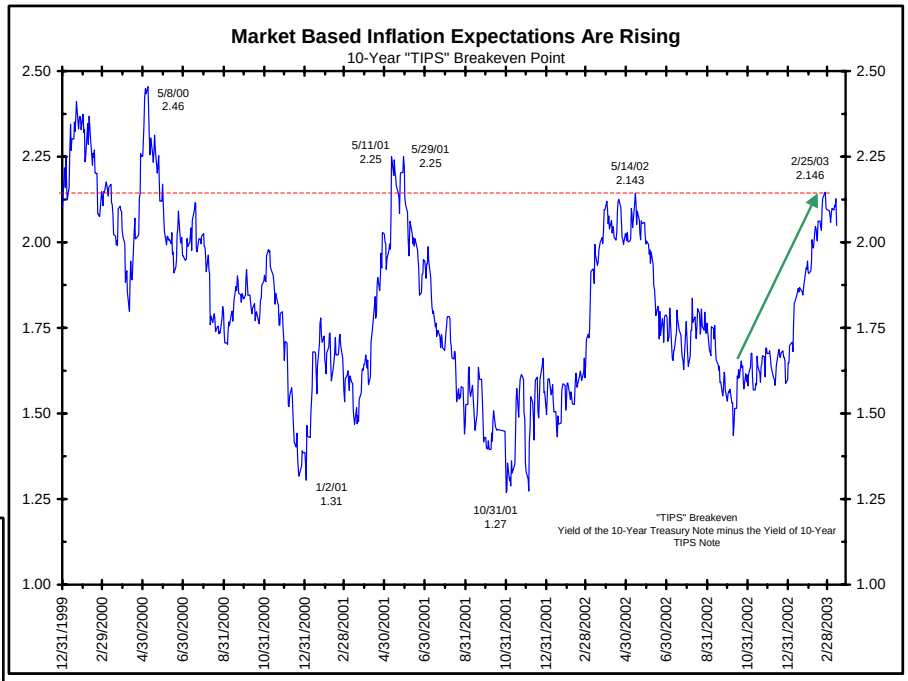
The chart below plots the “least correlated” market to gold back to 1986. In other words, every day we compare these eight rolling three-month correlations to gold. Then we take the “least correlated” market to make this series. The least correlated market can, and does, change from day to day.

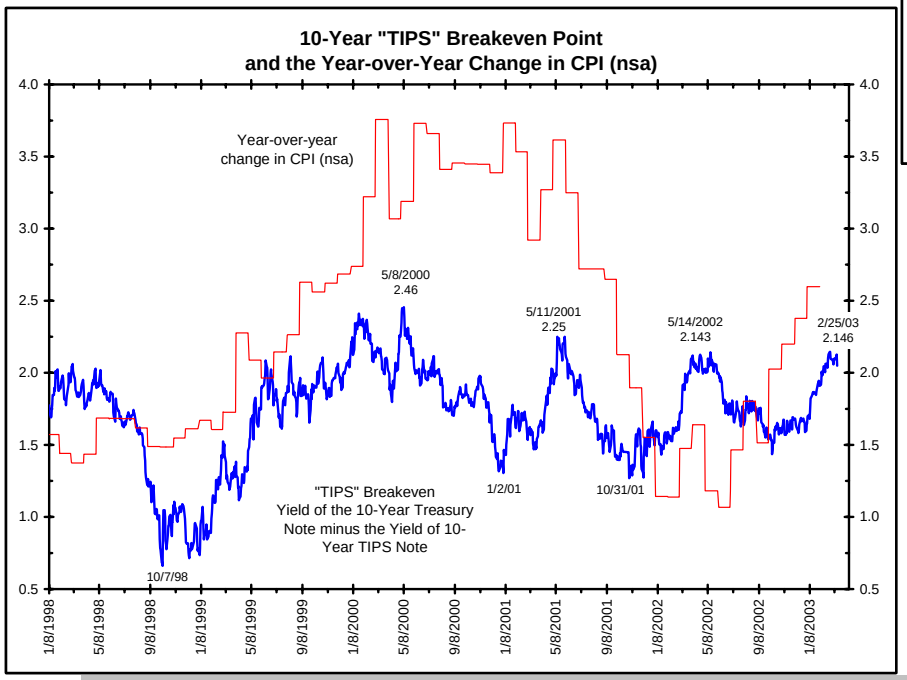
On January 24, the “least correlated” market to gold reached it highest level ever (the Yen at 79.9%). Furthermore, the least correlated market remained above 75% for 25 consecutive trading days – until February 25. Prior to the last few months, we have only seen three days above 75% in the last 17 years (all in January 1998). Only five days ago the least correlated market was still above 50%.

Until just a few days ago, these markets were trading in synch to a degree not seen in at least 17 years.

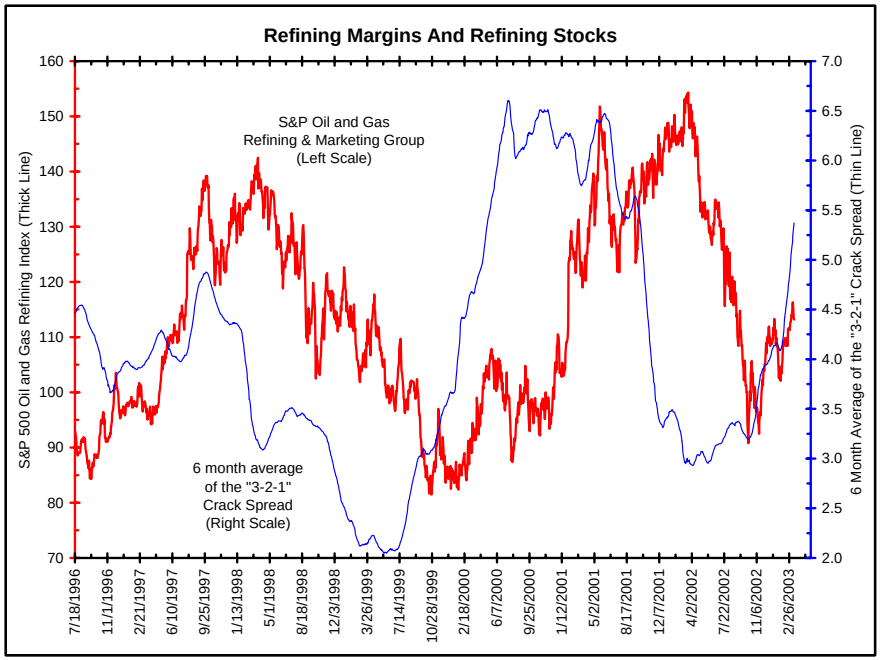


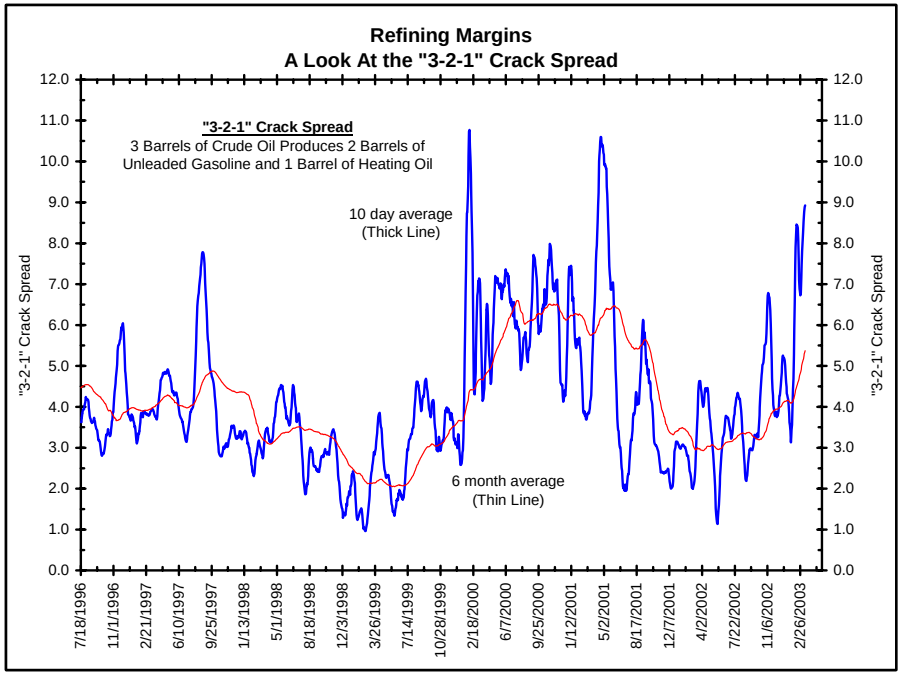
Tips Breakeven





Crack Spread

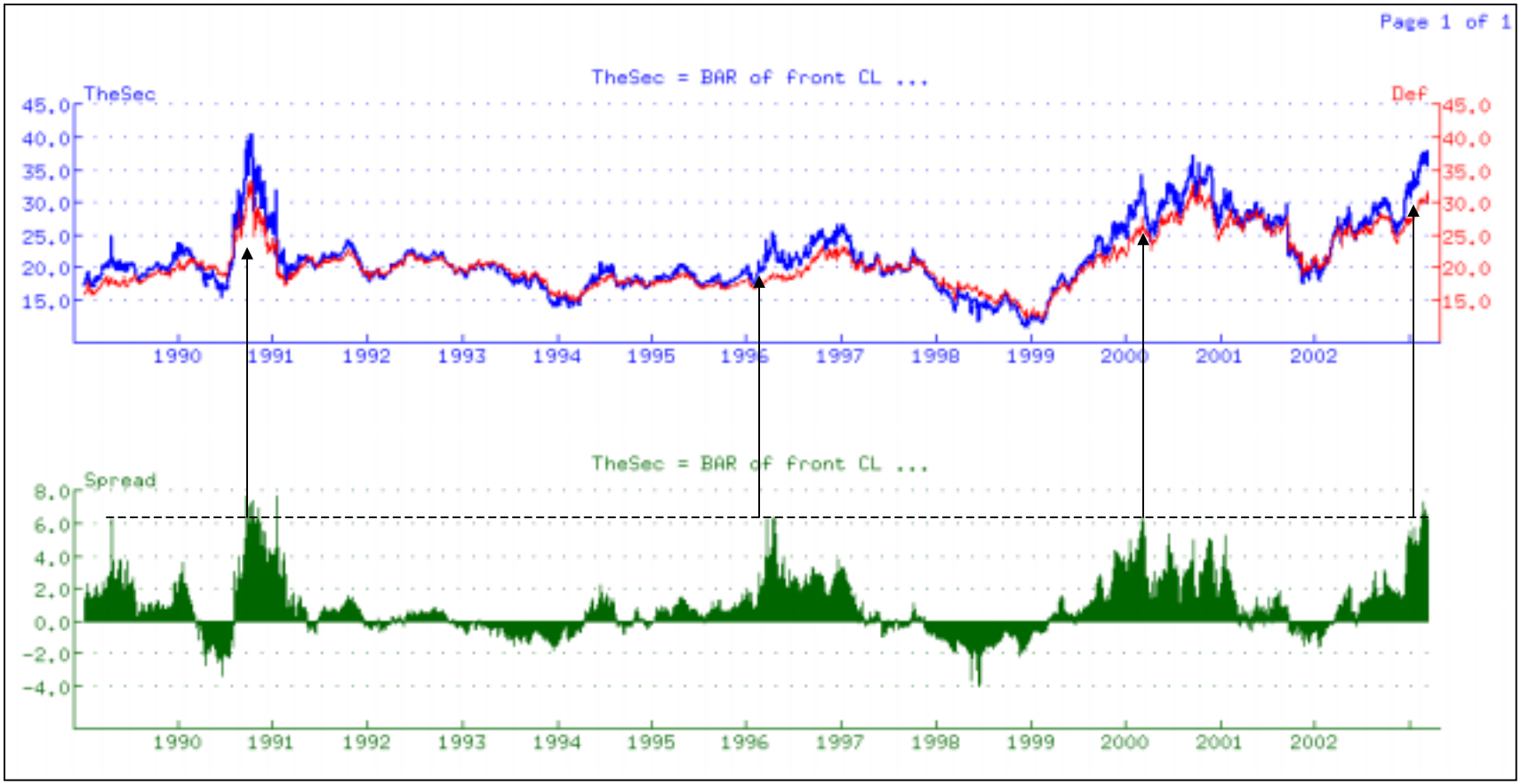




Crude Oil Futures

Top Panel
Blue Line = Nearby Crude Oil Futures Contract
Red Line = 6th deferred Futures Contract

Bottom Panel
Green Bars = Difference Nearby Crude Oil Futures Contract and 6th deferred Futures Contract



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