Bianco Research L.L.C.
An Arbor Research & Trading Affiliated Company
Independent · Objective · Original

Volume 14, No. 7 | 1113 West Armitage, Chicago IL 60614 | www.biancoresearch.com

Commentary

James A. Bianco, CMT (847) 304-1511
March 6, 2003

Perception vs. Reality: Will Everything You Know About This War Be Wrong, Too?

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**

In the last few days "war talk" has become almost palpable. Much of this talk revolves around the markets' reaction to the start of "Gulf War 2."

Naturally many are looking at the start of "Gulf War 1" in 1991 as a model. That model shows that stocks soared, oil prices plunged, and bond yields collapsed following the news of the first "air sorties" on January 17, 1991 (live on CNN from room 906 in Al Rasheed hotel in downtown Baghdad). As the second "Gulf War 2" quote suggests, many are arguing (hoping) the same will happen again.

What has become foggy is **why** the markets reacted violently to the start of "Gulf War 1." As the "Gulf War 1" quotes say, the expectation was that war would cost tens of thousands of American lives (and presumably take several months). This was confirmed by such authoritative sources as the former Army Chief of Staff. Furthermore, a cold chill went down everyone's spine when it was reported that the Pentagon ordered tens of thousands of body bags, as war was about to begin. Contrast this to the second "Gulf War 2" quote which suggests a massive strike to start the war that will end it almost as soon as it begins.

Simply put, **most every prediction about Gulf War 1 was wrong!** The perception of several thousand dead gave way to the reality that only a few hundred American soldiers were killed (with over half coming from accidents or friendly fire). The perception of a ground war lasting 100 weeks gave way to the reality of a ground war that lasted only 100 hours (4 days). The perception of a battle-hardened Iraqi army slugging it out toe-to-toe with coalition forces gave way to the reality that hundreds of Iraqi soldiers surrendered to an unarmed Italian camera crew.

When the markets realized the perception they priced in was wrong, prices were adjusted – and adjusted quickly. In fact the market's perception was so far from reality that many markets immediately changed course (trend) in moves that, in some cases, lasted several years.

It wasn't the start of the war that caused the markets to react violently; it was the fact that market perceptions were so far off base.

Perceptions vs. Reality: Y2K?

"Gulf War 1" was not the first time the marketplace's perception did not square with reality. Remember the great "ATM run" that was suppose to take place in December 1999?

Back in late 1999, the Federal Reserve believed that Americans were going to "protect themselves" from a potential Y2K problem. In doing so, they were expected to withdraw about two weeks of spending money ($1,000), buy groceries, generators, flashlights, batteries and other such "survival gear."

The Federal Reserve was so concerned that 100 million households were going to withdraw $1,000 each ($100 billion of currency) from ATMs in short order that they sprung into action. Their fear was many of these ATMs would run out of cash thus creating a panic among those left cashless as the millennium turn came.

To head off this problem, the Federal Reserve "flooded the banking system with money" and created a special borrowing facility to insure those financial institutions that needed cash would have it.

The reality was the perceived ATM run never materialized. Cash withdrawals were only slightly above average for that time of year. So, the perception of an ATM run did not square with reality.

What happened to all the liquidity the Fed pumped into the banking system? Many have argued that it instead found its way into the NASDAQ and helped fuel the most speculative part of the bubble. The Fed perceived a potential problem with ATM's running out of money and, in reality, they may have helped fuel the final leg of the great 1990's stock market boom.

What Perception Is Being Priced In Now?

So, what perceptions are being priced in about "Gulf War 2?" This is a tricky question to answer as it depends on whom you talk to. That said, **we believe** the markets are expecting the following:

- A military campaign that will take anywhere from four days to four weeks. In other words, a military campaign that will take no **more** "effort" than "Gulf War 1."
- An "occupation" that could be dicey. The market fears how the Iraqi people will react to "occupation." How will the Kurds in Northern Iraq react? How will the Arab world react and how will our European allies respond?
- Finally, the marketplace worries about potential terrorism in response to any military action in Iraq.

In other words, the market expects an "easy" or "smooth" military action, but has serious concerns about any "occupation" thereafter. How reality differs from this perception will largely determine the reaction in the marketplace to "Gulf War 2."

Surely this perception will be closer to the mark than in 1991 (when the perception could not have been more wrong). Haven't we learned from 12 years ago and the market will now price in a perception much closer to the actual reality? Maybe, but then again how many people were looking for a lone sniper in a white box truck in the D.C. area last fall? How close was that perception to reality?

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).

Bianco Research L.L.C.

1113 West Armitage, Suite 4
Chicago IL 60614

Phone: (847) 304-1511 Fax (847) 304-1749
e-mail: research@biancoresearch.com
http://www.biancoresearch.com

For more information about the contents/ opinions contained in these reports:

President (847) 304-1511
James A. Bianco jbianco@biancoresearch.com

Research Analysts (847) 304-1506/1534
John J. Kosar jkosar@biancoresearch.com
Greg Blaha gblaha@biancoresearch.com
Scott Mikkelsen smikkelsen@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 876-1825
Fritz Handler fritz.handler@arborresearch.com
Patrick Lovett pat.lovett@arborresearch.com
Peter Forbes peter.forbes@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595
e-mail inforequest@arborresearch.com
http://www.arborresearch.com

For more information about Arbor Research & Trading and its services:

Director of Fixed-Income Sales (800) 876-1825
Daniel Lustig dan.lustig@arborrersearch.com
Director of International Sales (847) 304-1560
James L. Perry james.perry@arborresearch.com
Anne Schultz anne.schultz@arborresearch.com

Arbor Research & Trading (UK) LTD

75 Cannon Street London England EC4N 5BN
Phone 44-207-556-7309 Fax 44-207-896-1887

For more information:

Director of Arbor (UK) 44-207-556-7309
Neil Tritton neil.tritton@arborresearch.com
Sean Fletcher sean.fletcher@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com