



# PERSPECTIVES

A REPORT FOR CLIENTS OF TD PRIVATE CLIENT GROUP - PRIVATE INVESTMENT COUNSEL

## On The Brink Of War

*What Conflict in Iraq Could Mean for Your Portfolio*

The story currently dominating both the headlines and airwaves is, of course, the potential war in Iraq. Not surprisingly, the same issue has become a key focus in global financial markets of late.

### More Market Turbulence

After enduring a sharp decline in the six-month period extending from April to September of 2002, precipitated in part by the Enron debacle and resulting erosion of investor confidence, investors appeared to refocus on improving fundamentals in October. Corporate earnings for the quarter ending September 30th were generally in line with or better than expectations and investors responded accordingly. The U.S. market's S&P 500 rose 15.21% in the two months of October and November while the TSX Composite and EAFE\* indices advanced 6.55% and 13.21%, respectively.

In December, as the rhetoric heated up and U.S. troop deployment in the Middle East increased, global financial markets began to reflect rising anxiety. Gold, fulfilling its traditional role as a safe haven in times of crisis, rose 11% from \$ 320 (U.S.) in early December to \$ 356 at the time of writing (see Chart 1). Similarly, crude oil has increased by 33% on world markets from \$27 (U.S.) to \$ 36 (see Chart 2). Meanwhile, the S&P 500 fell 11%, wiping out most to the gains of October and November (see Chart 3).

### What Are Financial Markets Telling Us?

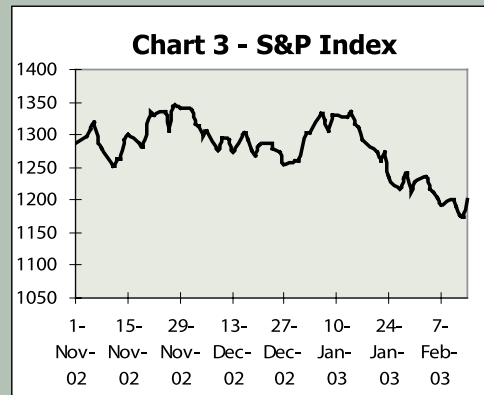
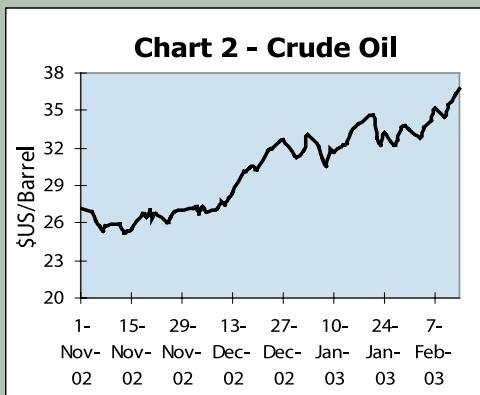
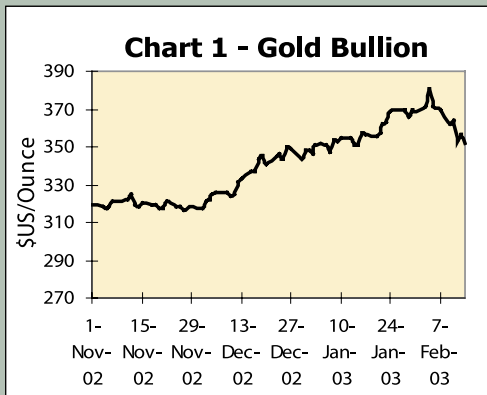
As Charts 1 – 3 illustrate, the recent path of stocks is the mirror image of gold and oil – stocks down, gold and oil up. The trends displayed in all three charts are the product of investor uncertainty.

Prior to December, crude oil prices had fluctuated within a \$ 24 – \$ 31 per barrel range for most of 2002. Crude's subsequent rise can be said to reflect three factors. First, a strike by the Venezuelan oil industry cut that country's oil exports by as much as 90%, upsetting the global balance between supply and demand. Second, the threat of war in Iraq raised the understandable concern that Iraqi crude exports could be curtailed, further reducing global supplies. Third, possible war raised the spectre of reduced oil exports from the rest of the Middle East. In short, concerns about Iraq have resulted in a "war premium" being built into oil prices, accounting for most of the rise from \$ 27 to the current \$ 36 level.

Interestingly, while commodity markets, focused on the short term, have pushed oil prices up sharply, longer-term investors in the shares of oil companies clearly have a different view. Those share prices have not risen in line with crude oil. In fact, most oil companies' shares trade at levels suggesting that crude oil's longer-term, sustainable price is in the mid - \$ 20's. At their current prices, oil companies' shares suggest that the

Since the end of November, Gold & Oil up... Stocks down

Source: Bloomberg L.P.



price of oil will return to its previous level once the current issues in Iraq have been resolved.

Similarly, gold bullion prices had crept up gradually from January to November 2002, rising from about \$ 300 to \$ 320. As gold is priced in U.S. Dollars, the sliding greenback was automatically reflected in higher gold bullion prices. Like oil, the price of gold spiked upward from December to the present, and at the current price of \$ 356, likely reflects a sizeable war premium.

Just as uncertainty has helped pushed up the prices of oil and gold, that same uncertainty has aided in pushing equity markets down. It appears that gold and oil prices currently reflect a war premium while stock prices suffer from a political risk discount. Uncertainty, and its presence or reduction, will likely play a major role in determining prices of all three in the coming months.

### Lessons From the Gulf War

Winston Churchill once wrote that the only thing predictable about war is that it is unpredictable. Put another way, history does not repeat precisely though it can be instructive.

When Saddam Hussein invaded Kuwait in August 1990, stock markets around the world fell (see "Leading Up To War" column of Chart 4). The S&P 500 dropped 10.2% between August 2, 1990 and January 16, 1991, when western forces engaged the Iraqi army in Kuwait. During the same period, the TSX Composite declined 9.7% while oil and gold rose 38.5% and 8.7%, respectively.

During the 40-day Gulf War, investors, sensing a marked reduction in the level of uncertainty, pushed equity and key commodity prices in opposite directions. The S&P 500 and TSX Composite jumped 17.6% and 9.4%, respectively, while the prices of crude and gold fell 42.6% and 10.8%. (see "Gulf War" column of Chart 4).

**Chart 4 - Gulf War Investment Environment**

Index/Commodity	Leading Up To War (Aug.2 '90 - Jan.16 '91)	Gulf War (Jan.16 '91 - Feb.26 '91)	The Next 12 Months (Feb.26 '91 - Feb.26 '92)
S&P/TSX Comp. TR	-9.7%	9.4%	8.6%
S&P 500 TR	-10.2%	17.6%	18.1%
Gold (Spot)	8.7%	-10.8%	-0.3%
Oil (Nymex Crude)	38.5%	-42.6%	0.5%

Thereafter, in the year following the Gulf War, equity markets resumed their advance while oil and gold were static (see "The Next 12 Months" column of Chart 4).

While historical parallels are always imprecise, the common denominator is that a reduction in investor uncertainty should result in a shrinkage of the political risk discount assigned to stocks and the war premium imbedded in crude oil and gold prices.

### Looking Ahead

Should geopolitical uncertainty diminish in the coming months, the financial backdrop will likely improve. Stock prices ultimately reflect corporate earnings growth and, while less robust than past cycles, Canadian and U.S. company earnings are recovering. We are modestly overweight in equities in your portfolio, favouring companies with solid earnings and prospects. Where appropriate, your bond holdings emphasize high quality corporate issues to increase your income and global bonds to take advantage of the appreciating Euro currency.

The long, deep bear market of the past three years has represented one of history's most difficult periods for investors. While challenges remain, the coming years should be more fruitful.

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