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## **War's length, oil prices key to economy Post panelists see jobs as another major factor**

**By Aldo Svaldi**  
**Denver Post Business Writer**

**Sunday, March 23, 2003** - Prewar jitters weighed heavily on investors in the first quarter, driving stock prices lower after a promising start to the year.

Once war became a certainty, markets rallied, although they didn't leap on the first day of fighting like they did during the 1991 Persian Gulf War. [see graphic](#)

The Denver Post asked four panelists to discuss what happens to markets in times like these, and whether victory on the military front might help a softening economy.

Panelists included: Andrew Clark, senior research analyst, Lipper Inc.; Philip Dow, director of equity strategy at RBC Dain Rauscher; Chris Johnson, chief executive, Capital Investment Counsel Inc.; and Thomas Landau, chief investment officer, SectorQuant Capital Management.

### **Post: How will war with Iraq shape the economy and the stock and bond markets?**

**Clark:** If it's short, and I'll use Mr. (Defense Secretary Donald) Rumsfeld's measure of "short" as six weeks, and if it's successfully prosecuted, the war premium will definitely come out of the market. It will be good for equities, and on the bond side, it will be good for corporate bonds, but probably not so good for treasuries. If it's a longer war, measured in months with an uncertain outcome, the effect on the economy could be quite severe, especially if the price of oil goes up.

**Landau:** The war has created this discontinuity in the market, putting everything else on hold. The war will be short and sweet, due to overwhelming U.S. firepower. After it ends, the market will start playing its usual game of winners and losers. There's still a chance that something could go wrong with the war - Murphy's Law. There's also the possibility of terrorist retaliations on the United States.

If a rally starts, it will be sustained and result in a good year for the market, probably with the averages being 10 percent to 15 percent higher from last year.

**Johnson:** The fundamentals of a continued slow-growth economy are in effect whether there's war or not. We may have a different fight than we did in 1991. We're going in on their turf, and if we have to go block to block and dig this guy out, we could see problems. Otherwise, it will be a short war.

A resolution in Iraq will create excitement and a rally in the stock market. However, economics and the future price of oil will determine the sustainability of that rally.

**Dow:** I don't see many investment books that tell you to alter your investment discipline based on a war or the outcome of a war. If the



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**Chris Johnson,**  
**CEO of Capital**  
**Investment**  
**Counsel Inc.**

war is prosecuted successfully, then you'll see a return in strength in the dollar, U.S. stocks and securities, which were a little bit overcooked on the downside.

One key metric to watch is business capital spending. We've seen industrial production and factory orders look a little bit better of late. If we could get some kind of an uptick in businesses taking risks, that could be a positive. We suspect a positive year, but more in the area of a stock market up 6 percent.

**Post: High energy prices are seen as a reason for the current softening in the economy. Do you see oil prices going down or staying high?**

**Johnson:** We have never seen oil go above \$32 a barrel without an economic slowdown or a recession that followed. After a resolution to the crisis in Iraq, oil prices should be lower, and they're already responding that way.

The real question is whether we ultimately settle in at \$15 to \$25 a barrel, or \$25 or \$30 a barrel. That will dictate economic activity. I think \$25 to \$30 is more likely. With a lot of the other uncertainty beyond Iraq, we'll probably see oil prices a little higher than we've seen historically.



**Dow:** Our analysts feel that after the war we're going to be looking at oil prices in the area of \$22 to \$25 a barrel. If prices are significantly higher, it could be a problem. But the economy is less dependent on oil than we were in 1974-1975.

**Landau:** I view the impact like a regressive tax, in that it takes away money consumers might spend on other things. Take the guy who doesn't own a home, who may also have been laid off, and with sub-prime credit. This kind of consumer is in trouble, whereas the lower-middle-class and upscale consumers who have lower mortgage payments would continue to be in good shape even if oil prices remain high.

**Clark:** I watch oil prices because inflation affects the bond markets. Inflation is a concern further out, and it's not just on the energy side, it's on the food side as well. The Federal Reserve will have a challenging year with rising inflation and a soft economy.

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**Thomas Landau,  
CIO, SectorQuant  
Capital  
Management**

**Post: Looking beyond the war, consumer confidence is weak, retail spending is down, layoffs are rising. Do you see this as a soft spot, or do you see consumers retrenching?**

**Dow:** To bet against the consumer has been a bad bet for a long time. If you look at debt levels versus take-home pay, they're not as concerning as the bears would have you believe. The bearish case that we're in a secular bear market and going to double-dip is overly pessimistic right now. We will have slower growth in the first quarter, and may be up a little bit in the second quarter. But for the year, we would easily see 3 percent growth in gross domestic product, GDP. This economy could be poised for a reasonably strong recovery of some duration.

**Clark:** Output is actually doing just fine, whether it's measured by GDP or capacity utilization, or other factors, and is picking back up. The weakness is actually on the jobs front. This is what the folks at the National Bureau of Economic Research keep on pointing to, and why they haven't called the end to the recession yet, because they're still seeing a very mixed picture.

**Johnson:** It's a soft spot that could remain for a while. Sixty-five percent of the economy is consumer led, and although consumer confidence is weak, we shouldn't put a lot of confidence in sentiment surveys during the war period. However, the slowdown is worldwide. We can't ignore the slower pace of sales, the lack of pricing power and the fact that production is only running at about 75 percent of capacity.

**Landau:** The loss of 380,000 jobs in February led some economists to think we're slipping into a double-dip recession. Of course, a laid-off worker is not a good consumer. Lower interest rates and mortgage refinancing put money in homeowners' pockets. The government is going to stimulate the economy as part of the overall, economic tax-cut package. Monetary policy will remain highly accommodative, and housing wealth is continuing to rise, which is critical for consumers.

**Post: Trading volumes in the stock market are down, and the latest personal finance books talk about buying businesses and income-generating assets. Are we seeing the death of the equity culture in this generation?**

**Johnson:** Millions of first-time investors entered this market at the peak, and were burned very badly. They may not come back to the equity market for quite a while. But the long-term investor looks at values today and will be more forgiving, because they understand the cycles. We are definitely not seeing the death of equities. Low trading volume is a result of economic uncertainty and diplomatic bickering. As these factors are resolved, and they will be, investors will return.

**Post: Are we going to see a greater emphasis on dividends then?**

**Johnson:** Historically, 40 percent to 50 percent of the rate of return in the stock markets has come from dividends. In the last decade, the income generated from equities wasn't that great. With the elimination of double taxation on dividends, you're going to see more of an emphasis of corporate America increasing dividends, or for the first time, paying dividends.

**Post: Mr. Landau, which sectors do you think are vulnerable and which are promising in this environment?**

**Landau:** Some sectors are vulnerable, just like some consumers are vulnerable. The obvious examples are the telecommunications and airline industries. Many had faulty business plans and erected a lot of debt.

Some of the defensive, value-oriented industries that have done well in the downturn, like food, tobacco and beverages, will probably fall as we go back into another growth cycle.

Demographic trends will help certain industries such as health care, with the aging of the baby-boom generation. That includes medical supplies, medical devices, pharmaceuticals, biotech. Those stocks got overpriced three years ago, and the sector got clobbered. Those stocks have returned to reasonable levels, and they're ready to go forward again.

Also, technology should benefit from the next round of corporate capital expenditures, and I see basic materials doing well in this cycle.



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**Philip Dow, director of equity strategy at RBC Dain Rauscher**



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**Andrew Clark,**  
**senior research**  
**analyst at Lipper**  
**Inc.**

**Post: Mr. Dow, can you give us some specific stocks to consider?**

**Dow:** An area appropriate now would be health care. We would lead the list with a company like Medtronic, which is the largest of the medical device companies, the most diverse and the highest grower, probably capable of 15 percent earnings growth the next three years. I own the stock, and we do not have a banking relationship.

The second name would be Pfizer, the 800-pound gorilla in pharmaceuticals. The current yield is only 1.9 percent on a dividend of 60 cents a share. Five years ago the dividend was 23 cents a share. Plan on that dividend doubling - or growing pretty dramatically over the future. I own Pfizer, and we don't have a banking relationship.

To a lesser extent, you need to be positioned in biotech. This year is one of the first you've been able to use "earnings" and "biotech" in the same sentence. The leader is Amgen. I do not own Amgen, and we do not have a banking relationship.

The other area that we think is attractive would be energy. Focus more on natural gas companies. For the first time in my career, you no longer have a surplus in natural gas. Apache would be an ideal way to play it. We do have a banking relationship with them. I do not own the stock.

The final area would be media, which will probably benefit in an economic recovery. The names there would be Viacom and ComCast, the leader in cable. I own ComCast. I do not own Viacom. We do not have banking relationships with either.

A note of caution. The fundamentals are deteriorating pretty dramatically within the U.S. banking system, where cuts in the Fed funds rate have severely impacted net interest margins. That pressure is going to cause the financial group to have declining earnings for the year. They're not going to get killed, but they're overvalued. If you've had a good time in financials, you may want to lighten up this year.

**Post: We've seen some renewed interest in the big technology names again. Is that trend worth chasing?**

**Dow:** Well, techs went from 10 percent of the S&P 500 to 35 percent, and now they're back down to 14 percent or 15 percent. One should have at least a 14 percent or 15 percent exposure, and the good news is, you don't have to be a rocket scientist to figure out who the survivors are. They're the great big names with positive cash flow, that have a battleship-like balance sheet with billions in cash.

**Post: Mr. Clark, are you at all worried that mutual fund investors are piling into bond funds late, similar to what they did in 1999 with equities?**

**Clark:** If they're doing it for diversification purposes, the answer is no. It's a perfectly fine move. If people are doing it to chase returns, it's probably not the best thing to do. The bond market will probably do OK this year, and you may make 5 percent or 6 percent on clipping your coupon.

If you're doing it to diversify, that's great. The last three years have taught that bonds are actually good things to own at times. To stray from your strategy, you'd better have a good reason. War is not one of them, probably. And the fact that the equity markets are down is not necessarily one, either. It's better to be diversified.

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