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POLITICAL PULSE

Lifting the Fog of War

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Markets are not comforted by deferring the decision to go to war -- markets want resolution, and that's probably not far away.

The media echo chamber was nearly deafening yesterday with the universally accepted story line that equities extended their rally and gold plunged on signs that the three-day weekend's burst of diplomacy and global protest meant that war with Iraq would be delayed or perhaps even averted. Those "signs," however, appeared visible only to those wearing special -- perhaps French-made -- glasses. Even as that story was being retailed far and wide, light sweet crude oil -- the commodity more sensitive than any to the risk of war with Iraq -- was rising to new 29-month highs of nearly $37 per barrel. At the same time, **President Bush** made it abundantly clear that neither **United Nations** wrangling nor a weekend of anti-war demonstrations had weakened his resolve. In mid-afternoon comments yesterday, Bush told a group at the White House that while war remains a last resort, "the risk of doing nothing is even a worse option as far as I'm concerned."

Today's moderate reversal suggests the danger -- as always -- in making straight-line extrapolations based on any single factor. But understanding the nature of the market's response to the latest moves on the global geopolitical chessboard could also provide useful insights into what might be expected once the "fog of war" is lifted from the landscape

If the war-risk premium discounted by the markets is -- at root -- attributable to uncertainty about a range of potential outcomes, it's difficult to see how that uncertainty is lessened any by the typical explanations being offered. For one thing, delaying action in an attempt to secure broader UN agreement would seem more likely to *heighten* uncertainty than relieve it. If the market was placing some probability -- say 65% -- on war being initiated in the first week of March, would postponing military action until some unknown future date mitigate the uncertainty? Not likely. And as for the possibility that the play of events actually augurs against military force ultimately being deployed against Iraq, that would seem the most uncertain bet of all. Sure, a nonmilitary resolution would no doubt be the optimal conclusion to this episode. But the political capital invested by leaders like Bush and the **UK's Tony Blair** essentially dictates that no such conclusion would be possible unless Iraq agrees to total, verifiable compliance with its disarmament obligations. Again, not likely -- and even less likely that the market sees *that* as the probable outcome at this point.

From our perspective, the more logically satisfying rationale is that the markets have indeed taken a bite out of the available premium, but that the uncertainty is actually being resolved in *favor* of prompt military action, not against it. Here is what we see as the expected scenario most consistent with the market's behavior. Again, Bush and Blair have invested too much capital to bail out now, notwithstanding the disdain of UN bureaucrats and would-be French obstructionists. Recognizing Blair's domestic political concerns, the White House will seek another **Security Council** resolution finding **Saddam Hussein** in "material breach" of the previous 17 such resolutions. Bush and Blair, however, will not be held hostage by the intransigence of a few nations granted disproportionate power by a discredited institution. Last week's attempted glass-half-full justification for Iraq's non-compliance by weapons-inspector **Hans Blix**, and its steely refutation by **Colin Powell**, actually served to underscore the point in favor of military action. The "coalition of the willing" will not be bound by a UN unable and/or unwilling to enforce its *own* directives

For the equity markets this scenario is, on balance, a positive one because it implies that the sooner military action is initiated, the sooner it will be completed. That also suggests the market has reached a point where brighter prospects are visible "across the valley" once war uncertainty is taken out of the picture. In other words, the outsize risk premium that has been made available in equity valuations seems likely to present an increasingly attractive target as the inevitability of war -- and most likely a quick and decisive one -- becomes increasingly obvious. TM