

## A PiratInvestor.com SPECIAL REPORT:

# WHAT HAPPENS TO STOCK MARKETS AFTER NATIONAL SECURITY IS THREATENED

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By Steve Sjuggerud, Ph.D.

*“Nothing is more troubling to financial markets than uncertainty... And nothing creates more uncertainty than war, the most unpredictable of all human activities.”*

–John Steele Gordon, “The Great Game”

What happens to stock markets after national security is threatened? Well we only have a few instances from this century to draw from. But the almost unanimous answer this:

1. Stock markets fall at first, in shock, and mass uncertainty sets in.
2. The uncertainty is resolved, and stock markets roar higher than where they began.

**Ultimately, buying after the period of mass uncertainty, and around the time that some resolution of the uncertainty appears imminent, has traditionally been an excellent way to make money in stocks.**

Let’s take a quick look at the following shocks to national security and their effects on the U.S. stock market:

- World War I as it began in 1914, and what followed
- World War I when we entered it in 1917, and what followed
- World War II in 1940 when Hitler took France, and what followed
- World War II when Japan bombed Pearl Harbor in 1941 and what followed
- The Korean War as it began in 1950 and what followed
- The Cuban Missile Crisis as it began in 1962 and what followed
- The Gulf War

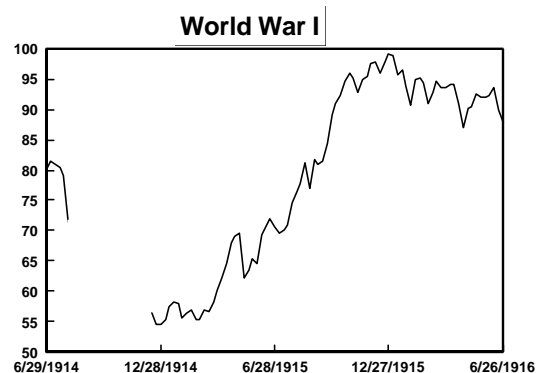
## WORLD WAR I

### When it began

Archduke Ferdinand was assassinated on June 28, 1914 in Sarajevo by a Serbian political dissident. This set off a chain reaction that culminated with Germany declaring war on Russia on August 1, 1914. But, in the month leading up to the formal declaration of war, uncertainty was building in financial markets.

On the July 27<sup>th</sup>, stocks dropped sharply on Wall Street, and the price of gold soared. The situation was spiraling out of control, and pressure was high on Europeans to mobilize their forces. The next day Austria-Hungary declared war.

The volume on the stock exchange reached 1.3 million shares, the highest level since the panic of 1907. The heavy trading was a sign of panic: stocks fell dramatically. General Motors, for



example, fell almost 34%, from \$58 7/8 to \$39 that day.

The panic grew too strong to manage and a decision was made to close the New York Stock Exchange, indefinitely. It stayed closed for 4 1/2 months.

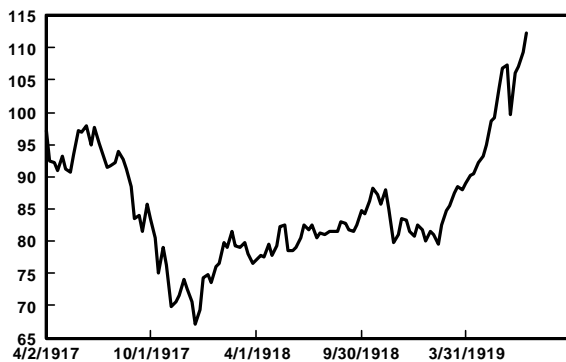
Surprisingly, trading was dull when the market reopened during the war. In fact, the last day of 1914 had the lowest volume traded in the 20<sup>th</sup> Century, at less than 50,000 shares.

By September of 1915, after panicking at the outbreak of war, Wall Street found itself in the grips of a great bull market. It had become clear that 1) the war of movement on the Western front was over, and the battle in the trenches had begun, 2) that the flow of gold out of the U.S. had stopped, and that 3) the U.S. was benefiting handsomely as a supplier to the war.

When all was said and done, the stock market had nearly doubled in 1915, and the reopening of the exchange would have been a great buying opportunity.

Note: the initial panic following the onset of a

#### U.S. enters war, April 1917



conflict is always over-done and panicky. Don't be surprised if the market falls strongly when it reopens tomorrow.

#### When we entered the war

The U.S. entered the war in April of 1917. The concern on Wall Street was that the government was borrowing unprecedented amounts of money. But, by the time the war ended on November 11, 1918, it was clear that the only

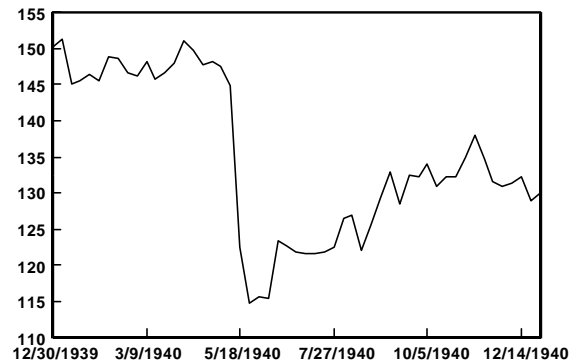
real victor was the U.S. Russia and Austria were in pieces, and even though Britain and France were victorious on the scorecard, they were wiped out, their power never to return at its old strength again. In this case the end of the war should have been the end of the uncertainty. But it took a few months for the market to realize it, and it rallied more than 50% from its lows.

## WORLD WAR II

### Hitler Takes France

On May 9, 1940, the Dow stood at 148. The very next day on May 10, Hitler stormed the "Benelux" countries (Belgium, Netherlands, and Luxembourg), causing havoc and uncertainty in

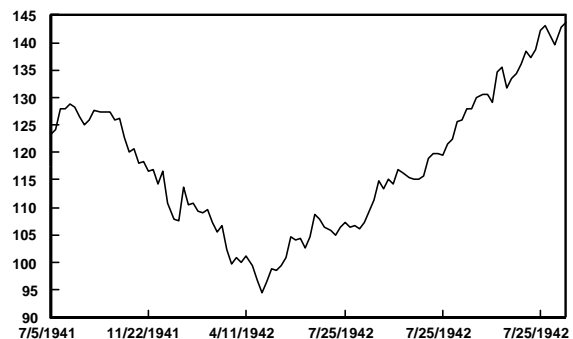
#### Hitler Takes Paris



the financial markets. In two weeks time, the Dow would be down by 23%. The worry was justified: t Hitler took France, occupying Paris on June 13, 1940. Wall Street and all of America feared that England could be next.

Then, on December 7, 1941, the Japanese bombed Pearl Harbor in a surprise attack, dragging the U.S. into World War II. Mass uncertainty set in again, and the Dow spiraled lower for five months from around 120, bottoming out at 92.92.

#### Pearl Harbor



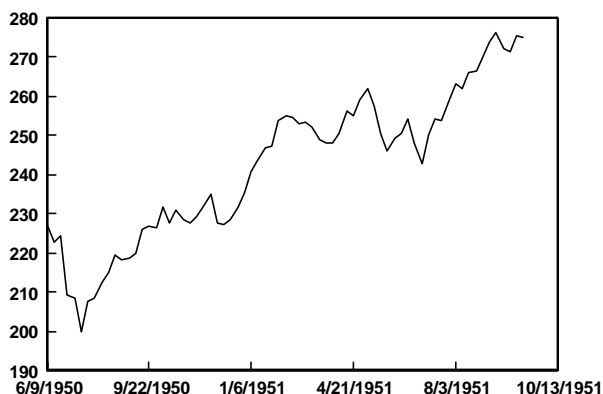
But on April 18, 1942, General Doolittle bombed Kobe, Tokyo, and Yokohama, and that was followed by the Battle of Coral Sea. This was the first sign of real certainty – America had entered war and had successfully attacked the enemy. By 1945, the war ended, and the Dow had risen to 193.

## THE MODERN THREATS TO NATIONAL SECURITY

### The Korean War

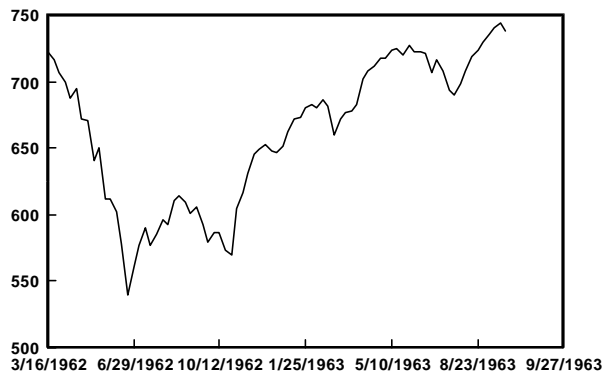
The North Koreans invaded South Korea on June 25, 1950. When the 38<sup>th</sup> Parallel was crossed, the U.S. seemed uncertain how to respond. The North was under the watch of the Soviet Union, and South Korea was under U.S. watch.

Korean War



In less than three weeks, the Dow fell 12% to under 200. Later that month, General Douglas MacArthur had taken command of the U.N. forces assisting South Korea, resolving the uncertainty, to an extent. The Dow rose dramatically over the next year.

Cuban Missile Crisis



A truce in July 1953 ended the fighting, and the Dow soared. In 1954, the Dow finally passed its 1929 highs, nearing 400.

### The Cuban Missile Crisis

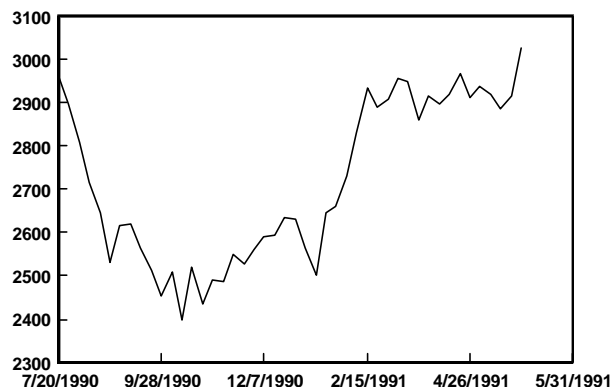
As Soviet ships headed toward Cuba in late October of 1962, fears mounted that Armageddon was near.

Before the month of October had ended, Khrushchev agreed to withdraw the missiles, resolving the uncertainty, and the Dow rose nearly 40% over the next 12 months.

### The Gulf War

Iraq invaded Kuwait on August 2, 1990. While President Bush said the invasion “cannot stand”, it was unclear what America would do. Stocks tanked by 20% in two months. By mid-

Gulf War



January, after Bush began to attack, eliminating uncertainty, the Dow started roaring ahead. It was up 20% in just a few months, and the bull market ultimately continued for nearly 10 years.

## THE PATTERN IS CLEAR

Markets bounce back from financial crises, and they actually do so with remarkable gusto. The pattern is: a sell-off as the news breaks, a (generally short) period of uncertainty, and then (generally) a remarkable rally as the uncertainty is removed.

Let’s hope this time is no different than the others – a short period of uncertainty followed by a remarkable rally after the uncertainty is removed.

## HOW COMMODITY PRICES REACT TO THREATS TO NATIONAL SECURITY

When national security is threatened, history suggests that oil prices only rise if the opponent poses a threat to the world supply of oil. So let's start with oil...

During the Korean War, oil prices fell in inflation adjusted terms. During the year of the Cuban Missile Crisis, oil prices fell adjusted for inflation. And as we steadily became more involved in Vietnam, oil prices fell from 1965-1972 adjusted for inflation. In these situations, the oil supply was not at risk. So if the world supply of oil is not at risk, the price of oil is not at risk.

However, if the world oil supply is perceived to be at risk, oil prices will rise. During the Iran/Iraq conflicts of 1978-1980, oil prices more than doubled from \$14 a barrel in 1978 to \$35 in 1980. Also, oil prices spiked significantly higher when Iraq invaded Kuwait in 1990. But prices then quickly subsided to two-decade lows in 1994.

So, based on limited evidence, it seems clear that oil prices rise when the supply of oil is threatened in particular, not our national security.

Since Afghanistan is not a major supplier of world oil, the impact on world oil prices may be limited. However, if this becomes a greater Middle East issue, the situation could change drastically. That's probably stretching things though.

In particular, OPEC's Secretary General announced on the day of this crisis that OPEC will

do what everything possible to make sure the world is properly supplied with oil. At the same time though, President Bush will likely find many more friends than he had before in his push to drill in America.

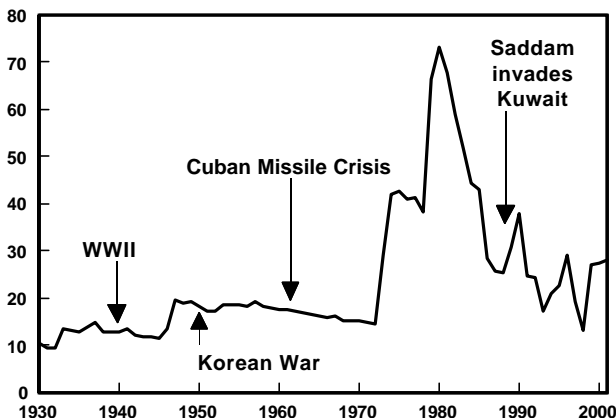
## BEYOND OIL

The best known commodity / store of value in crisis is traditionally considered to be gold. There are multiple reasons for this. First, countries traditionally print money wildly during wars to "finance" the war (note: a "whatever it takes" budget has already been approved for the current situation), making the paper currency less valuable. And second, brutally, if a country no longer exists one day, what are pieces of paper backed by its government worth? Not much.

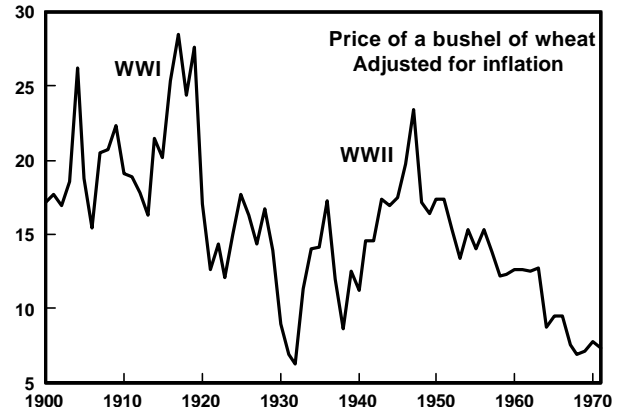
However, proving (mathematically not just anecdotally) that gold is a good store of value is hard to do. Its price has been controlled for nearly as long as data has been kept. But gold is always in demand in crisis. Historically, quality gold stocks like **Barrick Gold (NYSE: ABX)**, which has actually doubled in value over the last decade while gold has languished, are great portfolio insurance.

While the price of gold was controlled, the price of another commodity, wheat, was not. This chart of the price of wheat adjusted for inflation shows the spike in price during the wars – which shows the government printing of money at the time. Commodities, if they're good for anything, are a good crisis hedge.

### Price of Oil Adjusted for Inflation



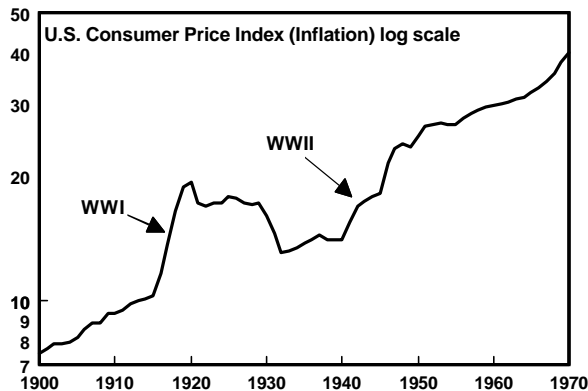
### Commodities Spike Higher During Wars



But with the clear rise in commodity prices, and the clear rise in inflation in times of war as the government prints money, the next logical step is higher interest rates. And this has traditionally been the case. But times may be changing...

Inflation didn't rise on the Gulf War, partly because many countries helped foot the bill. And that may turn out to be the case again today.

### You Pay for Wars with Inflation



And since gold, while it may be a store of value, pays no interest, the other safe haven people chose during the Gulf War was government bonds.

Fortunately, there's an easy way to protect yourself from the risk of inflation, while still being paid a yield. You do this by investing in **inflation-adjusted Treasury bonds**. This is absolutely the safest place you can be. And considering that long-term inflation adjusted Treasuries are currently paying about 3.4% PLUS inflation (say, 2.5%), for a total yield of nearly 6%, with no inflation risk. (If inflation rises, the government is obliged to pay you back whatever it rises to).

### SO WHAT DO WE DO RIGHT NOW?

We have to break up our strategy for investing safely in this macro climate into two parts. The first part is uncertainty.

This period will be characterized by fear: we may not know who the enemy is and we may be unable to deliver a decisive blow. During this period, stocks will likely fall strongly.

I would advise you to shift your asset allocation to an extremely defensive position. Play it safe. If you do not already own **TIPS** (the Treasury Inflation Protected Securities I mentioned a moment ago) then contact your broker about how to buy these securities. These are the safest, highest yielding place you can be right now. If you don't have a broker, you can buy the **American Century Inflation Indexed Bond Fund (ACITX)**, a no-load fund, through most online brokers.

Additionally, I would immediately add defense contractors to my portfolio. Buy shares in **Lockheed (LMT), Boeing (BA), General Dynamics (GD), and Northrop Grumman (NOC)**. Whatever happens, national security will be a renewed priority for America, and these companies, after many years in the doghouse, will finally become prominent again. U.S. military spending is going to rise sharply, and will continue to rise for years. Buy all of these stocks and use a 25% trailing stop on these positions.

Finally, I would add shares of **Barrick Gold (ABX)** to my portfolio, and not sell it until you were absolutely certain that the crisis has been completely put to bed, or if it hits its 25% trailing stop.

So...my all-weather, war portfolio includes: inflation-adjusted U.S. Treasury bonds, which are commonly called "TIPS," the blue-chip defense contractors and Barrick Gold, the best managed gold mining firm in the world.

Keep in mind, this is a portfolio that would prosper until the military defeat of the United States. In other words, it's as defensive a portfolio as you're likely to ever hold. You will not want to own this portfolio after the uncertainty ends, as it will underperform in a bull market.

**And that's why you have to be ready to buy stocks aggressively once the U.S. had dealt the enemy a decisive military blow.**

Once it's clear that we're in the driver's seat, stocks will wipe out their entire loss quickly and move to much higher new highs. For example, if Bin Laden is killed or taken prisoner, it will be time to back up the truck and buy stocks. And you

won't have to necessarily buy risky growth stocks to make a lot of money at the end of the crisis. Just buy a handful of your favorite blue-chips.

Porter Stansberry would recommend stocks like **Applied Materials (AMAT)**, **Applied Biosystems (ABI)**, **National Semiconductor (NSM)**, **Diversa (DVSA)**, and **Antigenics (AGEN)**.

But I'd buy the stuff I understand and know best, things like the **Bank of Ireland (IRE)**, **The Irish Investment Fund (IRL)**, **Indosat (IIT)**,

**Singapore WEBS (EWS)**, and **Equity Office Properties (EOP)**.

The most important thing to remember is that the market's initial reaction to this crisis isn't the end of the world. It's the start of a great investment opportunity for you. And now you know exactly how to handle your portfolio.

Good investing.