

SPOTLIGHT ON VALUE

economic and market ideas and how they may benefit our investors

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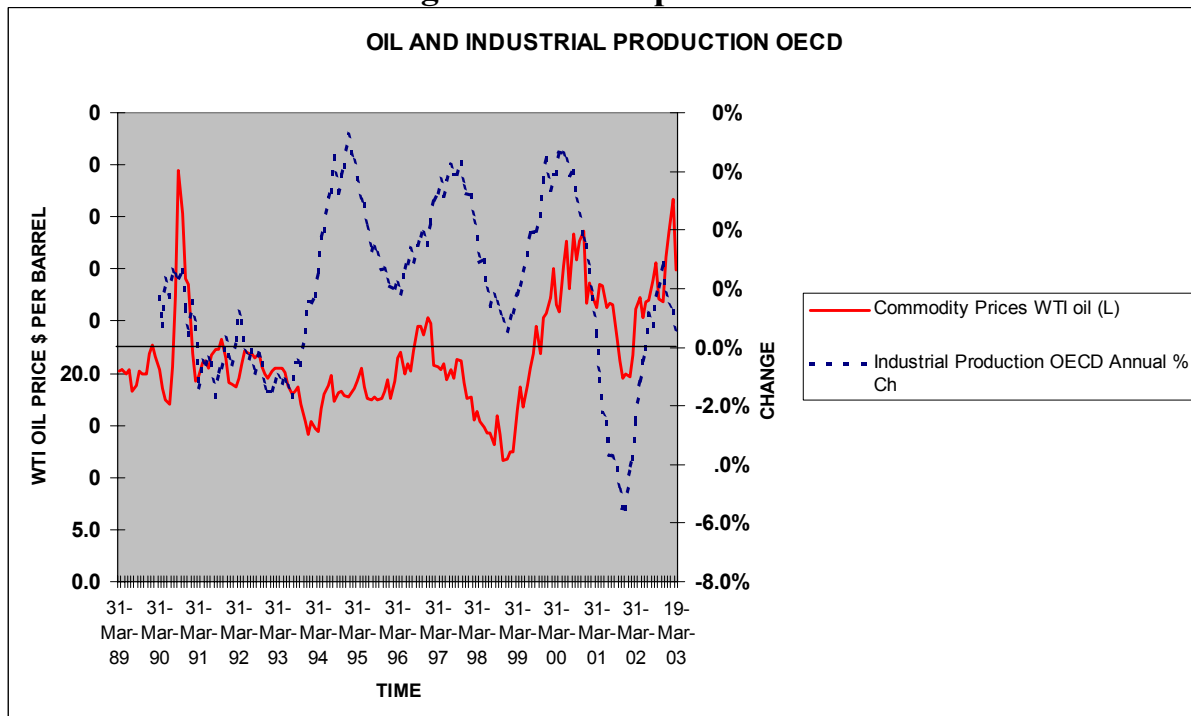
Equity Analysis
Asset Management Advisory
In-depth financial modelling
and consulting

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Oil, Iraq & Market Prospects

At the time of writing the equity market is profoundly unsettled. While it has come off its most recent lows, there is little doubt that it is struggling to find a new direction. We have been bearish on the market prospects for some time. On the basis of our valuation models though, the market is beginning to look attractively priced – assuming that business conditions continue to be “normal”. By that we mean a low inflation, positive growth environment, and no recession. Clearly, were the world economy to move into recession, then the current market valuation would continue to look on the top side – unbelievable though this sounds.

Chart 1: Are we heading for double dip ?



So What About the Oil ?

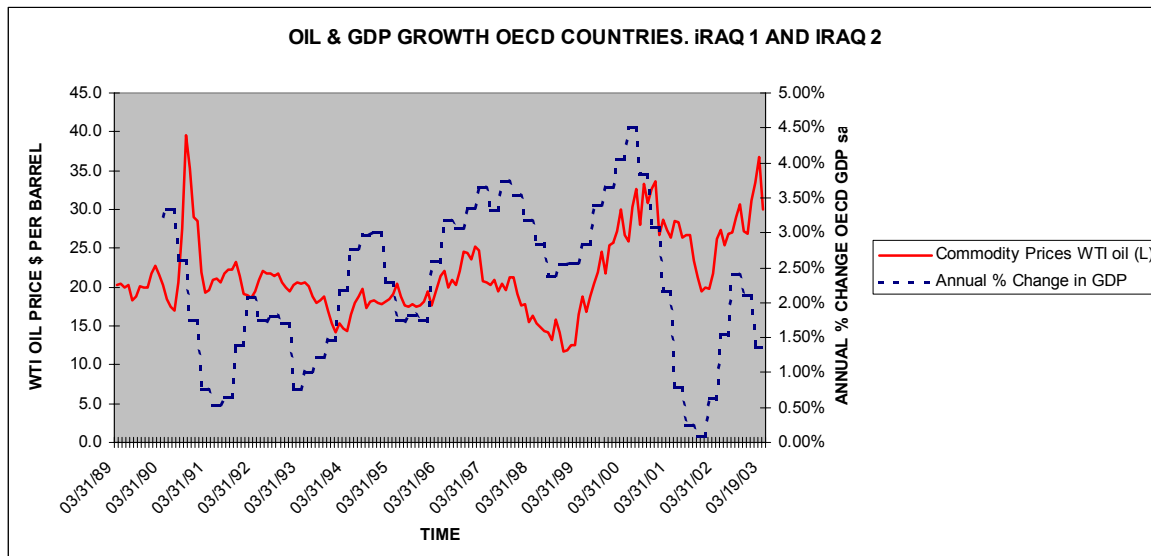
Chart 1 is disturbing. It shows that after oil price spikes, industrial production in the OECD countries tends to head south, and fall. We have plotted events since the 1991 Iraq war, when oil prices spiked at nearly \$40 a barrel. This was followed by a 2 year period of negative OECD industrial production growth. As oil prices subsided in the mid to late 1990's, so this helped underpin industrial output, which rose relatively rapidly in the OECD area. But look what happens when the oil price spikes again in 2000. It is followed by a shrinkage in industrial production. This has only just started to recover again, before we are confronted by another oil price peak.

On its own, this suggests that industrial production would be negative in the OECD region for the next 6 to 9 months.

And GDP Growth ?

If Industrial production looks weak, what about GDP ? Chart 2 shows that the outlook here is not wonderful either.

Chart 2: OECD GDP Growth and Oil prices

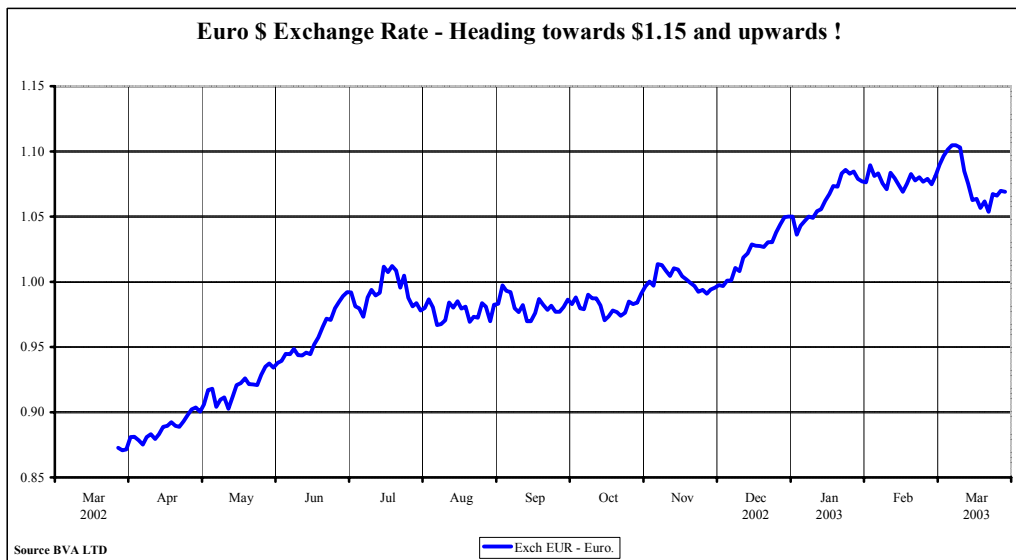


GDP follows a similar, but less volatile pattern than industrial production. As oil prices go up, so GDP growth tends to zero. Bearing in mind that this is the situation for the whole of the OECD, there are some countries here that are in recession..

In our view, the recent sustained oil price rise that has occurred largely because of the Iraqi oil situation (Nigeria and Venezuela have played a role here too) is going to trigger off a period of economic weakness and recession in the OECD area. This is likely to last from 2003 Q 3 through to early 2004, or so. Purchasing power will be diverted into meeting oil demand, and this will weaken the outlook for retail sales and consumption elsewhere. It is not exactly encouraging for investment either. It could bring forward the time when consumer resilience in the UK and the US finally capitulates to wider economic and political forces.

Exchange Rate Turbulence anyone ?

Chart 3: The US giant has economic feet of clay



One interesting, and to some extent under reported consequence of the uncertainties surrounding Iraq and the Middle East has been the continuing weakness of the US \$. Well, perhaps this shouldn't be such a surprise after all. For how long could the US \$ continue to defy gravity, equipped as it was with such large external imbalances ? It may be that with higher short term rates in the Eurozone, plus a growing reluctance by foreigners to continue to finance the US deficit, that we are about to see an accelerated decline in the US \$. This is alarming for a number of reasons.

Firstly, it is clearly very deflationary. The US is the only significant part of the world economy that is absorbing exports from the rest of the world. In the absence of this effect, it is hard to see where the rest of the world's exports are going to go. Some will move into India, China and Russia, who thereby could become the saviours of the world economy for 2003. But their capacity and ability to absorb such large flows are limited.

A weaker US\$ will further weaken growth prospects in the EU, and also in Japan. Not a reassuring prospect.

Secondly, it hard to see how further deficit spending by the US government, whether this arises from the latest round of planned tax cuts, or through increased military spending, are going to be sustainable. Neither of them are beneficial to the US dollar. It is conceivable that US interest rates might have to move up a tick to provide investors with some kind of premium for holding dollars – a development that would be novel in the post WWII world, but one that would be unsettling for investment in the US.

Thirdly, it could well inflame an already tense trade situation between the US and the rest of the world, but particularly with the EU. It is at this point that failed diplomatic moves at the UN and elsewhere could have their heaviest sting. It also underlines why it is so important to try and restore some semblance of order to the UN/EU/Nato systems of international relations, if we are not to experience further destabilizing damage elsewhere in the world economic system.

And the impact of Iraq ?

We are struck by the confusion and inconsistency both in terms of how the “coalition” entered this war, and by the assumptions that seemed to have underpinned it. We are also concerned by the lack of weight given by both the UK and US governments to the weakening of other international agencies, that might be very helpful in the event of a prolonged global recession.

Fed by unduly optimistic views and assessments by the US/UK governments, the subsequent disappointment and let down felt by the markets is understandable. It is worth reflecting that the post Vietnam situation left an inheritance of markedly higher oil prices, very fast inflation, and almost zero growth in the US and the UK throughout most of the 1970's . It is wise to recall that a lot of the prosperity experienced in the 1980's and 1990's came from the impact of lower oil prices.

If the war is not to be ended particularly quickly, and if the peace is not to be a particularly “peaceful” one, then what other lessons can we draw from the past ? We are told that the UK/US cannot win the war. Sounds familiar to those who experienced Vietnam. Clearly if the political will is weak on the coalition side, then it is conceivable that the coalition can lose the war. If the war continues to be ineptly conducted, then the current crop of leaders may not be around to see it to a “successful” conclusion.

The Vietnam war created over 50,000 deaths in the US, and many, many more in Vietnam. Vietnam did not ultimately remain democratic or capitalist, despite US efforts to achieve that. Efforts to win this war without blasting Iraq to pieces may genuinely be unsuccessful. But winning the war through a Stalingrad or Grozny solution may also render a peace unworkable. A recipe for a stalemate ?

Unlike Vietnam though, Iraq possesses a lot of valuable real estate. On the upside is that most of the costs of the reconstruction will be paid for by the oil itself, whether in Iraqi, US or UK hands is an entirely different matter !! Unlike Vietnam, there are several other neighbouring countries whose attitude to the US will be decisively and negatively influenced in the event of a bloodbath.

Unlike Vietnam, there is the continuing issue of Israel-Palestine, which while being one of the root causes of the current situation shows no signs of being resolved.

Given all this, it is likely that the markets will remain unsettled for a while longer yet. The longer the war goes on, so the greater the danger of an unintended “spillage” into countries such as Iran, Turkey or Syria, not to mention Jordan, Egypt and Israel. No it isn’t a re-run of Cuba or the cold war, but it ain’t pretty.

As we view things at the moment, there is little sign of an early recovery in the world equity markets. It looks as if bonds continue to be the name of the game for the next month or two at the very least. However, for those brave enough to go “bottom fishing”, now might be the time to be getting out the angling gear. There are some attractively priced companies out there, and we would be pleased to tell you more about them !