STELLAR CAPITAL MANAGEMENT, LLC

Economic & Market
Commentary

Iraqnophobia

The potential military conflict with Iraq grabbed the headlines throughout most of the first quarter. In the background there were rumblings about North Korea as well as the difference of opinion at the United Nations Security Council. The potential changes to both the tax code and regulations in the telecom industry filled the gaps in the news coverage. The combination of these issues cast a cloud of uncertainty over our budding economic recovery during the quarter. Only in the last half of March did speculation about Iraq give way to reality as U.S.-led military forces attacked Iraq.

The equity markets responded to this by climbing more than 10 percent from the 48-hour deadline speech through the first day of spring. On the other hand, interest rates rose faster than the stock market as money left the safety and security of the bond market and found its way back into stocks. In addition, gold, oil, and other commodities fell sharply as the U.S.-led troops met with little resistance in the first few days of the attack. The initial euphoria based on expectations of a short conflict has faded quickly and the markets have sobered up a bit as the reality of the conflict has set in.

Is war the "all clear" signal we've been waiting for? It has removed one uncertainty from the minds of corporate chiefs and investors, but more still remain. Uncertainty, the main symptom of Iraqnophobia, has kept capital investment subdued over the last few months. It has had an impact on some of the most recent economic reports and will likely haunt the economic data for the next few months as well. If the confrontation goes smoothly (*read "our way"*) and ends quickly, these reports should be received in stride, as post-war cost forecasts will likely be reasonable and global stability will be enhanced. If that is the case, a return to healthier consumer and corporate confidence levels should be close at hand. Should this become a more drawn out conflict, confidence levels will be volatile, and the markets will likely follow the lead of the battle for a time.

Looking ahead, which has been tough to do with the onslaught of "war news," businesses are still in business all over the globe and domestic policy makers are still "taking all measures" to avoid deflation. While we have some hurdles to overcome, we seem to have the building blocks in place to clear the hurdles. Corporations will still have to prove to the world that they are not "out for the count" by practicing good business ethics and producing good financial results. State governments will still have to balance their spending with expected revenue, and the Federal Government will have to work through a few years of deficit spending. These are not tasks to be taken lightly, and it will take a well-balanced approach to pull it off successfully. The good news here -- once military issues are in the background, we should see more focus and effort on the domestic economic agenda.

We are still approaching the bond market with caution and keeping maturities shorter than normal as we believe that interest rates could rise if the safety premium unwinds further and demand for money picks up. We appreciated the recent surge in the stock market, but are still approaching the stock market with a philosophy focusing on total rate of return (income + long-term appreciation), and harboring cautious optimism for the long-term health of the economy and the equity markets.

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