

How Might War Impact U.S. Equities?

As global political uncertainty seemingly grows on a daily basis, equity investors are naturally concerned about how a war with Iraq or conflict with North Korea might affect an already fragile equity market and economy.

One course for considering the possible impact is to view the reaction following prior disruptive events. Of course, inherent differences between events make predicting the future based on the past difficult at best. Clear cause-and-effect linkages are difficult to establish in the real world. It is important to consider not only how a market-disrupting event affects the subsequent performance of stocks, but also what the market and economic climate were like in the period leading up to the event.

In this short paper, we take a look at the historical record in the hope that it can provide some insights that will be useful now.

Some Past Dramatic Events

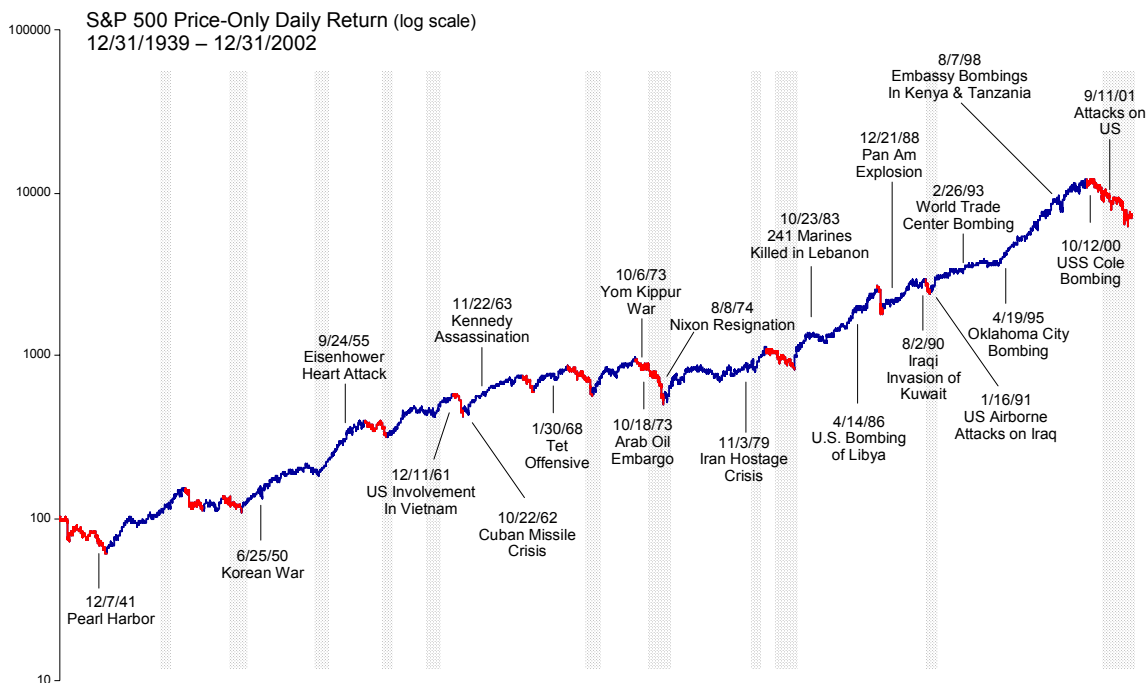
After the terrorist attacks of September 11, 2001, we examined the market's reaction (as measured by the S&P 500) to previous dramatic events in the following table, which we have updated here:

	Date	Return Day of Event	—Subsequent Return—		
			One Month	Six Months	One Year
Attack on Pearl Harbor	12/07/41	Sunday	-4.1%	-10.8%	-0.9%
Korean War	06/25/50	Sunday	-4.9	10.8	17.6
Eisenhower Heart Attack	09/24/55	Saturday	-6.0	7.0	1.7
First US Helicopters to Vietnam	12/11/61	0.5	-3.7	-13.0	-13.5
Cuban Missile Crisis	10/22/62	-1.1	12.0	26.1	32.8
Kennedy Assassination	11/22/63	-2.8	6.7	16.0	23.5
Tet Offensive	01/30/68	-0.5	-3.8	5.2	10.4
Yom Kippur War	10/06/73	Saturday	-4.8	-15.6	-41.1
Arab Oil Embargo	10/18/73	0.0	-5.6	-13.8	-34.3
Nixon Resignation	08/08/74	-1.3	-14.5	-3.6	5.5
Iranians Take U.S. Hostages	11/03/79	Sunday	4.6	3.7	26.7
241 Marines Killed in Lebanon	10/23/83	Saturday	0.6	-5.5	0.7
US Bombs Libya	04/14/86	0.6	0.1	-0.8	17.7
Pan Am Explosion Over Lockerbie	12/21/88	0.0	3.3	15.5	24.3
Iraqi Invasion of Kuwait	08/02/90	-1.1	-8.2	-2.4	10.2
US Airborne Attacks on Iraq	01/16/91	0.8	16.7	20.7	32.3
World Trade Center Bombing	02/26/93	0.2	1.0	4.0	5.1
Oklahoma City Bombing	04/19/95	-0.1	2.8	17.0	27.8
Kenya/Tanzania Embassy Bombed	08/07/98	0.0	-10.6	13.8	19.3
USS Cole Bombed in Yemen	10/12/00	-2.5	2.7	-11.0	-16.9
2001 Attack on US	09/11/01	Closed	0.4	6.6	-16.8

S&P 500 price-only returns are shown in table.

Historical Graph

In the graph below, we chart the daily return for the S&P 500 price index and plot each of the important events shown on the previous page. The shaded bars represent periods of economic contraction, while the red portions of the return line represent bear markets for the index.



A Few Caveats

- First and foremost, our list of important events is subjective. While we tried to include as many significant events as possible, reasonable people might have included others or excluded some of those we chose.
- The impact of significant market events is impossible to precisely determine. Each can have short- and long-term economic consequences, can affect consumer confidence, can benefit or harm specific industries and/or companies, and can have far-reaching political implications. Some — like the 2001 terrorist attacks or the assassination of President Kennedy — can affect the nation’s long-term psyche and morale.
- Likewise, existing market and economic conditions can either exacerbate or minimize the impact of a dramatic event.

Some Observations From The Graph

Perhaps most apparent from the graph is that these political and economic events, while important, have had little long-term impact on the return of the S&P 500. Equities have exhibited a strong upward trend over this 63-year horizon. The bulls clearly have the edge.

Further observations:

- The “normal” state of the equity market is rising, and the “normal” condition of the economy is expansion. While bear markets and economic contractions are not rare, they have been noticeably shorter than the corresponding positive environments.
- Significant events, in isolation, rarely cause an expanding economy to contract, or a rising market to fall. (Obviously, one can speculate on events that *could* cause such effects, but they are without precedent.)
- In general, the stock market has weakened while anticipating war, but rebounded as fighting proceeded. The S&P slid nearly 8.0% in the three weeks after the Korean War started, but rallied as fighting progressed for a gain of 21.7% on the year. The 1990s bull market got its start while the U.S. was fighting the Gulf War. One exception was the stock market’s 13.5% drop during the year following the increased U.S. involvement in the Vietnam War.
- Some of the biggest recent events — the 1993 World Trade Center bombing, the 1995 Oklahoma City bombing, and the 1998 embassy bombings in Kenya and Tanzania — all occurred during one of the longest economic expansions and strongest bull markets on record.
- The subsequent-year return for the S&P following prior dramatic events has been negative on only four occasions prior to the two most recent events (the USS Cole bombing and the 9/11 terrorist attacks). Two of those — the Yom Kippur War and the Arab Oil Embargo — occurred virtually simultaneously in October 1973. Importantly, the equity market was already declining prior to these events. The third prior event with a negative subsequent-year return was the attack on Pearl Harbor, which occurred near the end of a difficult bear market. One year after the attack, the S&P was down just 0.9%. The final dramatic event with a subsequent-year decline began when the U.S. increased its involvement in the Vietnam War in December 1961. That was accompanied by a bear market that lasted just over six months. For the year following the arrival of U.S. helicopters in Vietnam, the S&P was off 13.5%.
- The current economic contraction is significantly longer than any of the ten other post-1939 recessions. While the average length of prior recessions is 11 months, the current recessionary period has lasted 23 months. (Note that our definition of a contraction comes from the National Bureau of Economic Research, which typically does not identify peaks or troughs until several months after the fact. Thus, it is possible that the duration of the current recession may turn out to be somewhat less than stated.) The current recession has been accompanied by the longest bear market for the S&P 500 in the post-World War II era.

A Closer Look at the Persian Gulf War

The most obvious comparison to the current geopolitical situation is Iraq's invasion of Kuwait in 1990 and the subsequent Persian Gulf War. This graph shows the same data as the earlier one, but begins on July 31, 1989 (one year prior to the Iraqi invasion) and ends February 28, 1992 (one year after the liberation of Kuwait). Again, the shaded area represents an economic contraction, while the red line indicates a bear market for U.S. equities:



Observations:

- Just prior to Iraq's invasion of Kuwait in August 1990, equities had turned the corner into a bear market, and the economy had begun a recessionary period.
- Interestingly, the 1990-1991 economic contraction is one of the shortest on record, just eight months. The average (not including the current period) for other post World War II recessions is 11 months.
- In the year preceding the invasion of Kuwait, the S&P had returned 2.9% price-only. In the year following the liberation of Kuwait, the index rose 12.4%.
- Over the course of the conflict, from the initial invasion of Kuwait to its liberation seven months later, the S&P returned 4.6%.

Only time will tell if history repeats itself and the stock market bounces back this time, and if so, to what extent. And, of course, non-financial impacts and the potential loss of life from a possible military conflict cannot be quantified. Nonetheless, some perspective from past market-disrupting events may be useful as we consider the current market environment.