The Gloom, Boom & Doom Report

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Of War Cycles and their Economic Consequences

> History: "A collection of the crimes, follies, and misfortunes of mankind."
>
> *Voltaire*

INTRODUCTION

A war in Iraq in order to remove Saddam Hussein — unquestionably an undesirable, vicious, and dangerous head of state — is almost a certainty. The United States (under a rather dangerous president as well, I might add) has got itself into a position where retreat at this stage is almost impossible unless Saddam were suddenly to pack his bags and go into exile or be assassinated by someone in his inner circle. But even in the event of the sudden removal of the Iraqi leader, it is likely that the US would still invade Iraq in order to play a significant role in choosing the country's next leader and have some "control" over the country's economic and political destiny. Therefore, investors should assume that war is about to break out.

We can also assume, but with less certainty, that the US will win the battle and that Saddam Hussein will be removed. I mention this because, if there is one consensus today, it is that the invasion of Iraq will be relatively easy and that Saddam's armed forces are no match for the US. I agree with this assessment, but we don't know for sure that Saddam won't get assistance from another country — Russia or Iran, say. Even if he doesn't get assistance from anyone — he doesn't seem to have a very wide circle of friends in the Middle East, or anywhere else — it cannot be ruled out that the countries which surround Iraq, or any of several ethnic tribes within Iraq, will move militarily against a US occupation force. (See the enclosed article by Nicholas Kristof about the Kurds, which illustrates the complexity of the problem.)

Equally, we know little about what will follow the successful removal from power of Saddam Hussein. Will democracy be introduced successfully in Iraq within a short period of time without destabilising the rest of the region? Will US forces return home, leaving behind them significantly improved geopolitical conditions in the Middle East and oil prices reduced to below US$20 per barrel? I think that only those people who believed three years ago that the Nasdaq was still a good buy at over 5,000, and who wrote books about the Dow heading straight to 36,000, would be naïve enough to assume that such a rosy outcome is realistic. In fact, we are dealing with an extremely delicate situation — one which the US administration is approaching with great fanfare and all the tact of an elephant in a porcelain shop.

First, the fact that this war has been so well advertised eliminates entirely the element of surprise, which in warfare is a very crucial strategic advantage. In addition, the long-lasting preparations for war have led to millions of people around the world and numerous governments voicing their opposition to the operation on all manner of grounds. Had the US launched a surprise attack on Iraq, much of this foreign criticism of and hostility towards America would not have arisen, or it would have been overshadowed by the speedy conclusion to the hostilities and the removal of Saddam Hussein. I am not suggesting that the US should already have attacked Iraq, or that it should do so now (I oppose the war), but if warfare against Iraq was decided on by this administration some time ago, as seems likely, then a surprise attack at that time could have destroyed overnight all of Iraq's military installations and sites of weapons production. Of course, the disadvantage of such a course of action would have been that the heroic actions of the American military against an impoverished country that is in every respect infinitely inferior to the US would not have been captured on camera by the likes of CNN, which has already deployed a battalion of producers and supporting staff to the Middle East. After all, it must be one of this administration's policies to boost the president's flagging popularity and distract the American public from the financial market hangover and impending economic misery by airing the forthcoming nightly fireworks and strikes against Iraq — a country which cannot be described as anything but "militarily handicapped".

There is another issue concerning the war with Iraq that seems to be generally misunderstood. Every time the stock market has declined in recent months, the bullish camp, whose string of erroneous forecasts has just celebrated its third anniversary since the Nasdaq peaked out at 5,049 on March 10, 2000 and the S&P at 1,527 on March 24 of the same year, has argued that the market was weak because of uncertainty about the war. I don't think for a minute that the threat of war was responsible for the market declines in January and February. A deteriorating economy, combined with the realisation that corporate profits have not only continued to be doctored, but are in fact far lower than what companies are reporting, is, in my opinion, the reason for the poor performance of the stock market. Moreover, the public must realise by now that economic statistics, and financial and political "news", can be trusted less and less under an administration and special interest groups whose sole purpose is to boost the stock market and dismiss deep-rooted economic problems while aggravating the existing financial imbalances.

I am very sceptical, therefore, of the consensus which believes that with the onset of the war, or once the war is successfully brought to an end, the stock market will enter a long-lasting bull market. The stock market has rallied in the last few days simply because the market had become massively oversold. When this oversold reading coincided with Bush's ultimatum to Saddam Hussein, the impending war was perceived as triggering the rally, in very much the same way that the earlier market weakness was explained away by the "uncertainty" about the war. I shall attempt below to show that a war will not remove the present malaise in the financial markets. The "war cycle" is turning up, and geopolitical uncertainties are likely to persist for the foreseeable future. The problems don't only centre on Iraq, but on the entire Middle Eastern region, on Central Asia and on North Korea, which was visited recently by my friend Nick Harbinson, managing director of the Asian equity desk of Merrill Lynch in Singapore, who has contributed to this report a short account of his trip (see pages 9–10). Nick's report should give our readers a good idea of the potential threat posed by North Korea. In addition to continued geopolitical tensions in the future, the global economy — with the exception of a few bright spots (China, India, and Vietnam) — is, in my opinion, performing far worse than official statistics would indicate, and therefore, with or without a war, stock prices are unlikely to enter a lasting bull market anytime soon.

At the end of this report, I have the pleasure of enclosing a report on the art market in the US, contributed by my friend Kenny Schachter. Manfred Schoeni's article on Chinese contemporary art (see GBD report of December 31, 2002) prompted an angry e-mail from a subscriber who pointed out how treacherous art investments are. I fully agree that no one should buy art for the sole purpose of achieving capital gains; however, having recently met a few art dealers and collectors who have had the pleasure not only of enjoying their collections but also of seeing their net worth increase substantially, I didn't want to give up on the idea of art as an asset class, which, like commodities, will likely continue to appreciate in an economic environment where paper money depreciates in value.

Schachter, an artist and writer, was the recipient of a Fonca grant (principally funded by the Rockefeller Foundation) in 1997–1998. He has taught in New York City at the School of Visual Arts, the Fashion Institute of Technology, Parsons, New York University, and Columbia University. He is a regular contributor to numerous art magazines and has appeared on TV and radio. He recently established an experimental exhibition space in New York City designed by renowned artist/architect Vito Acconci. In a recent *New York Times* interview, he explained that an integral part of his program was "to work outside the confines of the art world, to cross-pollinate with architects, fashion designers, dance groups and musicians". According to Schachter, his new gallery, conTEMPorary, located on Charles Lane near the Hudson River, "is like a small incubator for nurturing ideas, for working with disparate groups of people and becoming an integral part of people's lives if it's presented in a human way".

WAR CYCLES

In his book *Cycles* (New York: 1971), Edward Dewey devotes a chapter to "The Patterns of Wars". His research was inspired by an Index of International War Battles and Civil War Battles, which had been created by Raymond Wheeler in the 1930s. (Wheeler had been a professor of psychology at the University of Kansas and president of the Kansas Academy of Sciences, and became well known for his studies into climate cycles.) According to Dewey,

> … the War Index was used by Professor Wheeler to show a relationship between shifting temperatures in the earth's climate and man's proclivity for war. Warm periods, he noted, were the time of dictators and international wars, while cold periods produced civil unrest and democracy. His compilations were made without any preconceived notions of cycles, but he did note that there were recurrences of drought and civil war at approximately 170 years intervals and that every third of these drought–civil war periods was more pronounced, thus creating a longer cycle of 510 years. He also observed shorter rhythms, especially one of approximately 23 years.

(See also Michael Zahorchak (ed.), *The Raymond Wheeler Papers*, "Climate, The Key to Understanding Business Cycles" (NJ: Tide Press).

Based on the data that had been compiled by Professor Wheeler, Dewey then found war cycles of durations of 142, 57, 22⅓ and 11⅓ years, which in some instances coincided with climatic cycles such as the 12.18-year cycle in tree rings and the 22.1-year cycle in the minima of the record of Nile flow (the latter going back to AD 662; see also Michael Rampino, *Climate, History, Periodicity and Predictability* (New York: 1987)). Concerning the 22⅓-year war cycles, Dewey noted that "the continuous presence of a cycle of this length for 2,500 years explodes the idea that wars come when a new generation that does not know the horror of war grows up". Dewey was also "fascinated" by one aspect of the cycles of war:

> International battles clearly have their counterparts in *both* biological and economic cycles. By "biological" cycle I mean one that expresses itself predominantly in biological phenomena, such as animal abundance. By an "economic" cycle I mean one that expresses itself predominantly in economic phenomena, such as prices and production. It is rare indeed for a phenomenon to evidence both kind of cycles, *but war does*…. As international war is sensitive to cyclical forces that are normally responded to only by animals and also to cyclical forces that are normally responded to only by men in their economic capacity, we may think of it as both an economic *and* biological phenomenon. This is most interesting and unusual…. How should we interpret these war cycles? In my own mind I picture the space in which we live as filled with forces that alternately stimulate and depress all human beings — make them more or less optimistic, or make them more or less fearful. These forces do not *control* us, they merely *influence* us. They create a *climate* that is sometimes more favorable to war and sometimes less favorable. War will come without the stimulus of these forces and wars will be avoided in spite of these stimuli, but, *on the average,* the probabilities for war are greater when the "climate" is right. The evidence suggests that one of the major causes of war, if not the major cause, may be mass hysteria or combativeness, which occurs at reasonably regular rhythmic intervals.

The historian Arnold Toynbee also believed in a war-and-peace cycle as a consequence of a "Generation Cycle in the transmission of a social heritage". He noted that:

> The survivors of a generation that has been of military age during a bout of war will be shy, for the rest of their lives, of bringing a repetition of this tragic experience either upon themselves or upon their children, and … therefore the psychological resistance of any move towards the breaking of a peace … is likely to be prohibitively strong until a new generation … has had the time to grow up and to come into power. On the same showing, a bout of war, once precipitated, is likely to persist until the peace-bred generation that has been lightheartedly run into war has been replaced, in its turn, by a warworn generation.

(Arnold Toynbee, *A Study of History* (London: 1954).)

I am not sure whether there are war cycles with a precise periodicity such as 142, 57, 22, or 11 years, as Dewey and Wheeler have suggested, but the observation that a peace-bred generation will more lightheartedly start a war than a war-worn generation is plausible. (For the record, both the 57- and 22-year war cycles are still trending down until the 2005–2010 period, when both will turn up.) Moreover, I agree with Dewey's observation that wartimes occur when a certain "climate" or belligerent mood among people exists. In this respect, it is interesting that Kondratieff empirically established that the periods of the rising wave (which are characterised by a rise in commodity prices and interest rates) "are considerably richer in social upheavals and radical changes in the life of society (revolutions, wars) than are periods of downward waves". According to him,

> … the upward movement in business conditions, and the growth of productive forces, cause a sharpening of the struggle for new markets — in particular, raw materials markets. On the one hand this makes for an expansion of the orbit of the world market and the involvement of new countries and regions in the trade network. On the other hand, it makes for an aggravation of international political relations, an increase in the occasions for military conflicts, and military conflicts themselves. At the same time, the rapid growth of new productive forces, intensifying the activity of the classes and groups within that have an interest in that growth, creates the prerequisite for sharpening the struggle against socioeconomic relations that are obsolescent and hinder development. It creates the prerequisite for big internal upheavals.

(Nikolai Kondratieff, *The Long Wave Cycle* (Richardson & Snyder, 1984).)

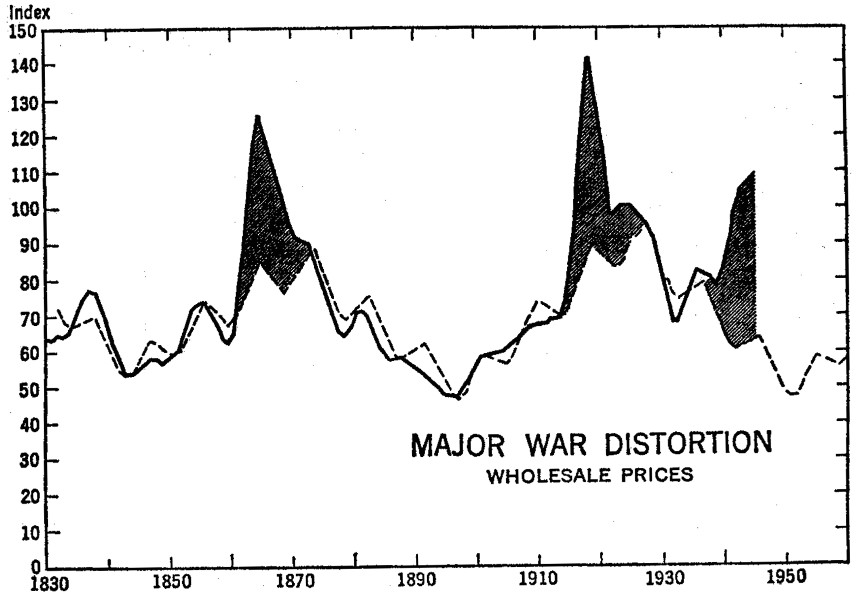
I may point out that major conflicts such as the Napoleonic Wars, the Crimean War (1853–1856), the American Civil War, the Franco-Prussian War (1870–1871), the Sino-Japanese War (1895), the Spanish-American War, the Russo-Japanese War (1905), the First World War, the February Revolution in Russia (1917), the Second World War, and the Vietnam War all occurred in periods of the rising Kondratieff wave. And although the Kondratieff cycle is now only bottoming out, the increase in commodity prices we have seen over the last 18 months does suggest that the long wave has probably already started to turn up — at least as far as commodity prices are concerned. So, if I combine the war cycles of Dewey, which are shortly going to turn up, and the rising wave of the Kondratieff cycle, we should be prepared for a more hostile and bellicose world in the years to come, regardless of how the conflict in Iraq will be settled. Moreover, while a rising Kondratieff wave has in the past led to a more belligerent mood, wars then also had the effect of creating "upside distortions" in commodity and wholesale prices (see Figure 1).

American policy makers have repeatedly emphasised that a war against Iraq has nothing to do with gaining access to Middle Eastern oil and with increasing Iraqi production in order to depress oil prices. I am inclined to give them the benefit of the doubt, but it is clear that in the years to come the demand for oil will grow dramatically should the living standards in emerging economies — in particular, in China — continue to rise. I was recently in Vietnam, a country with an annual GDP per capita of approximately US$300. I was stunned by the sight of what seemed to be millions of motorcycles crowding the streets of Hanoi, Ho Chi Minh City, and the coastal city of Danang, where five years ago there were very few! This was especially surprising, since there is not yet a consumer credit system in Vietnam.

In China, passenger car sales soared by 56% in 2002 and motor vehicle sales now exceed one million units per annum. Indeed, it is a fact that with rising incomes and higher standards of living, people in emerging economies do gradually shift from using bicycles to small motorcycles and then to cars. And if this trend continues, which in my opinion is inevitable, then energy consumption in emerging economies with their large consumer markets that are far from reaching any saturation point will continue to increase very substantially. From Figure 2 (courtesy of Barry Bannister of Legg Mason Wood Walker Inc.), which I have used previously in GBD report of December 31, 2002, entitled "Get Back in the Market???"), we can see how oil consumption per capita soared in Japan between 1950 and the early 1970s; the same pattern occurred in South Korea between 1965 and 1995, as its industrial production jumped. In both cases, annual per capita oil consumption rose from around one barrel to around 17 barrels within a period of less than 30 years — a 17-fold increase! I would not be surprised, therefore, if China's oil consumption more than doubled every six to ten years for the next 20 to 30 years. (It has doubled over the last seven years.) And since China became a net importer of oil in the mid-1990s, such an incremental demand would have to be met by imports.

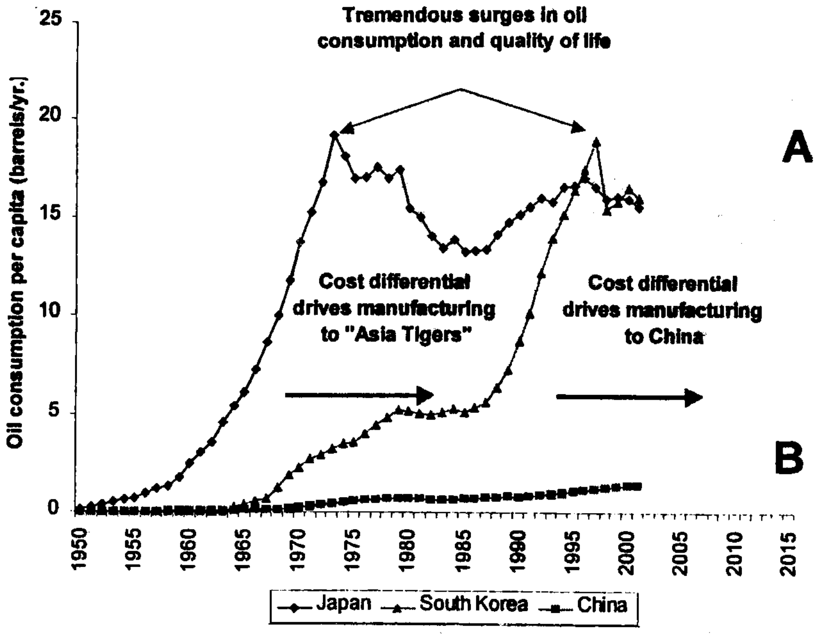
The rising thirst for commodities isn't limited only to China and to oil, but is visible in every other emerging economy that is rapidly industrialising and for all types of commodities. In particular, I should

Figure 1 **War-time Distortion, 1830–1950**



Source: Edward Dewey, *Cycles, The Science of Prediction* (New York: 1947)

Figure 2 **Oil Consumption per Capita for Japan, South Korea, and China, 1950–2001**



Source: Barry Bannister, Legg Mason Wood Walker Inc.

like to mention that in India and Vietnam, where economic reforms have begun to stimulate the domestic economies, the demand for commodities should also rise considerably in the years to come. Oil aside, the consumption of other commodities is poised to rise as well. Let's take China's consumption of copper as an example. Its consumption as a percentage of total world consumption has increased from 6% in 1990 to 12% in 2000 and 16% in 2002, and is expected to reach 29% in 2010 (statistics provided by Simon Hunt of Simon Hunt Strategic Services, simon@shss.com). Thus, we should assume that commodity prices — near-term profit taking aside — are poised to move up much further in the years to come. This would be particularly true if there was a war — now or sometime in the next ten years or so. From Figure 2, we can see that in the past, major wars produced significant temporary upside distortions for wholesale prices. (For a detailed analysis of war cycles, I also recommend Joshua Goldstein, *Long Cycles, Prosperity and War in the Modern Age* (Yale University Press, 1988).)

THE ECONOMIC AND FINANCIAL CONSEQUENCES OF WAR WITH IRAQ

There is one important point investors should be aware of, which may have been overlooked during the peaceful and financial bubble years of the 1990s. Wartimes are common in the history of the world; it is times of peace that are the exception. According to the historian Will Durant, "war is one of the constants of history, and has not diminished with civilization or democracy. In the last 3,421 years of recorded history only 268 have seen no war." Or just look at the period between 1895 and 1918. During this brief span of years there were continuous conflicts around the world, including the Russo-Japanese War (1895), the war between Turkey and Greece over Crete (1897), the Spanish-American War of 1898, the Anglo-Boer War of 1899–1902, the military expeditions of the great powers in China in 1900, the Russo-Japanese War (1904–1905), the Russian Revolution of 1905, the Turkish Revolution of 1908, the French military expedition in Morocco (1907), the military conflict between Italy and Turkey over Tripoli (1911), the First Balkan War (1912), the Second Balkan War (1913), the Chinese Revolution of 1911, the First World War (1914–1918), the February Revolution in Russia (1917), the October Revolution and the Russian Civil War (1917–1921). According to Durant,

> … the causes of war are the same as the causes of competition among individuals; acquisitiveness, pugnacity, and pride; the desire for food, land, materials, fuels, mastery. The state has our instincts without our restraints. The individual submits to restraints laid upon him by morals and laws, and agrees to replace combat with conference, because the state guarantees him basic protection in his life, property, and legal rights. The state itself acknowledges no substantial restraints, either because it is strong enough to defy any interference with its will or because there is no superstate to offer its basic protection, and no international law or moral code wielding effective force.

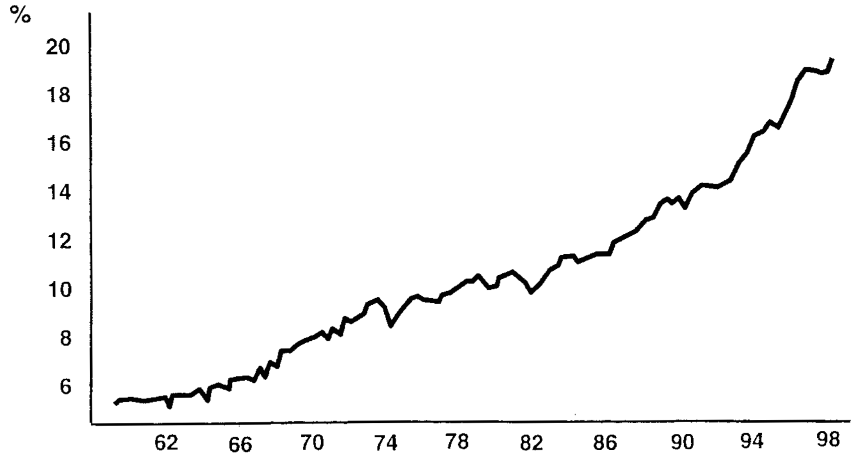
(Will and Ariel Durant, *The Lessons of History* (New York: 1968).)

I leave it to the reader to ponder on the causes of the impending Iraq war….

I am not necessarily suggesting that the next 20 years will be as turbulent as the first 20 years of the 20th century, but we must realise that the late 1980s and 1990s were extremely unusual from a historical point of view, since, aside from some minor conflicts, there were no major wars or revolutions. So, purely from a probability point of view, investors should not expect the relatively peaceful time that has followed the Korean War, and especially the peace dividend we have enjoyed over the last 15 years or so, to continue forever. The peace dividend that followed the end of the cold war was certainly a contributing factor to higher stock valuations around the world (declining interest rates and rising profits aside). If the world is now moving into an era of increased tensions, then this will be an additional negative factor for equity valuations. Moreover, during the relatively peaceful 50 years that followed the Second World War, trade as a percentage of GDP increased rapidly and peace allowed a truly global capital market to be created, both of which factors were favourable for economic development around the world. As can be seen from Figure 3, trade as a percentage of the world's GDP increased from around 5% in the 1950s to over 20% at present.

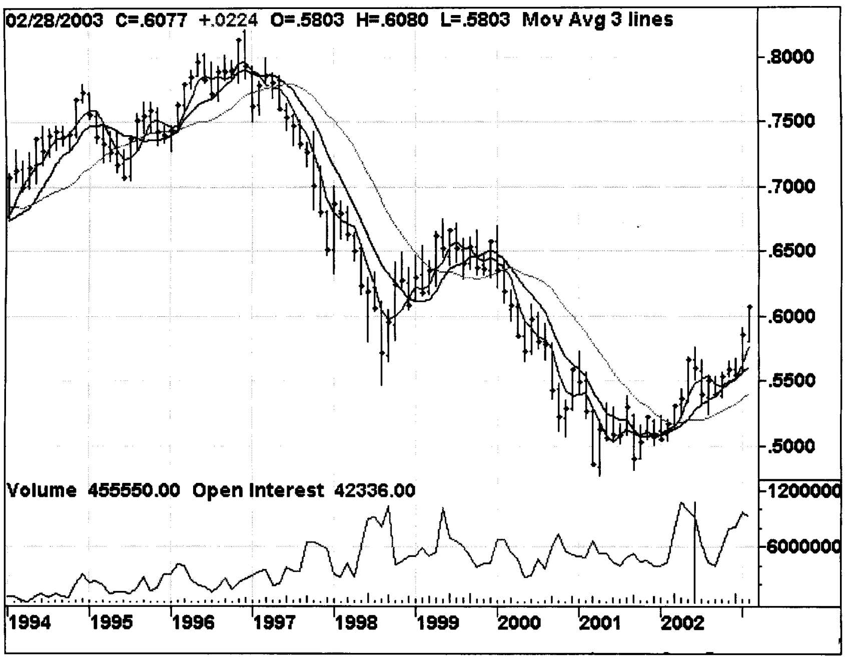
Moreover, since the creation of a truly global capital market in the late 1980s, international capital flows financed the investment boom in the emerging economies in the early 1990s, and have in the last few years financed the excessive consumption in the US, which is reflected by the growing American current account deficit. If we assume, therefore, that rising global trade and an increase in global financial flows had something to do with peace around the world in the 1990s, we should also assume that in the case of increased geopolitical tensions and, especially, a major conflict, there could be some interruption in these favourable trade and financial trends. In the worst case, severe geopolitical tensions could lead to an interruption of free trade or of international financial flows and bring about supply shortages, trade embargos or outright trade wars, the imposition of foreign exchange controls, and even the freezing of assets held by foreigners or, in an extreme case, their outright expropriation. In short, if political tensions around the world continue to escalate and lead to a major conflict somewhere, then the financial markets and financial

Figure 3 **International Trade Relative to World GDP, 1960–1998**



Source: www.BigCharts.com

Figure 4 **Australian Dollar, 1994–2003**



Source: TFC Commodity Charts

intermediaries would seem to me to be particularly vulnerable, since they have become so disproportionately large in comparison to the real economy. One point is clear to me. In the next major conflict in the world, the derivatives market is most likely to cease to exist, since financial institutions throughout the world hold derivative positions. Therefore, if one major player somewhere in the world doesn't settle or fails altogether, a vicious chain reaction could follow, with the result that the markets will be closed.

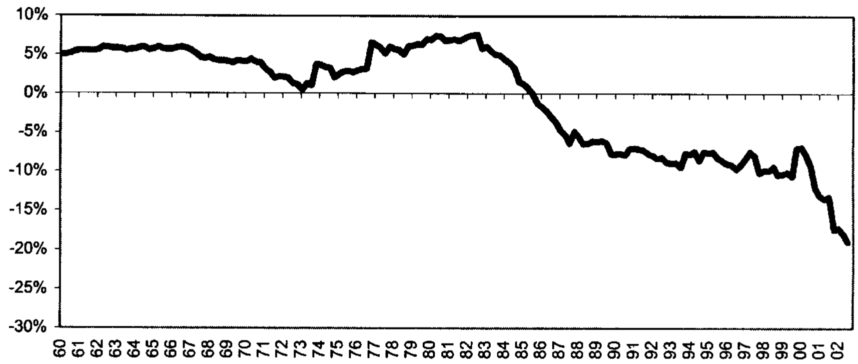
It is not my intention to sound alarmist, but I think that investors who grew up during the last 50 years have no idea of what unpleasant financial and economic consequences might result from a major conflict. Throughout history, asset freezes, the imposition of foreign exchange controls, and expropriations have been very common, and I have no doubt that sometime in the future we shall experience such emergency measures once again. Therefore, investors should seriously consider diversifying not only their assets, but also how they hold those assets. To hold all of one's assets in one country with just one financial institution may be imprudent in an age of rising risks of international conflicts. **Consequently, an investor may want to hold some of his assets in the US, but also consider the ownership of assets through a foreign bank or the holding of real estate in a foreign country. In terms of real estate investments, I would consider Australia and New Zealand to be relatively immune to international turbulence**, which may be (rising commodity prices aside) a reason for the recent strength in their currencies (see Figure 4). In particular, I would be concerned as a foreigner about holding very significant financial assets in the US (foreign central banks, insurance companies and pension funds, and high net worth individuals), since, given the dependence of the US on foreign capital flows, the imposition of foreign exchange controls at some future date would seem to be, in my opinion, quite a probable event. In this context, it may be useful to glance quickly at the net investment position of the US.

Until 1987, US investments in foreign countries exceeded foreign holdings in the US. However, over the last 15 years or so, the US net asset balance has deteriorated very badly, with the result that foreigners now hold more than US$7.3 trillion of US assets compared to US holdings of foreign assets of around US$5.3 trillion — which means a current imbalance of more than US$2 trillion, or 20% of GDP (see Figure 5, courtesy of Bridgewater Associates). Now let us assume that the current account deficit no longer grows, but stabilises at an annual rate of around US$500 billion. (The US current account deficit rose in the fourth quarter of 2002, 44% y-o-y to US$136.9 billion, or annualised US$547 billion.) In such a case (an optimistic one, in my view), the US net asset balance will continue to deteriorate and reach around 50% of GDP in about five to six years' time and 100% of GDP in approximately ten years' time! I am not suggesting that it would be impossible for foreigners to boost their assets in the US to 100% of GDP, but, obviously, the more US assets are held by foreigners, the more the US becomes vulnerable to the whims of foreign investors and not just in terms of the value of dollars, but also in terms of *all* asset markets, since foreigners hold approximately 30% of US Treasuries (excluding US Treasuries held by the Fed, foreign ownership is about 40%), 13% of US equities, and 23% of corporate bonds. I must say that I admire the US government's ambition to be or to become an empire with such a poor net investment position to start with! If the historian Barbara Tuchman were alive, she might include such an imperial ambition, at a time when the US has huge external imbalances, in her collection of "follies of history". Barbara Tuchman's *The March of Folly* (Chicago: 1984) is an excellent and highly readable account of history's major policy mistakes. Tuchman writes in her first chapter: "Wooden-headedness, the source of self-deception, is a factor that plays a remarkably large role in government. It consists in assessing a situation in terms of preconceived fixed notions while ignoring or rejecting any contrary signs. It is acting according to wish while not allowing oneself to be deflected by the facts. It is epitomized in a historian's statement about Philip II of Spain, the surpassing wooden-head of all sovereigns: 'No experience of the failure of his policy could shake his belief in its essential excellence.'" (This reminds me of Alan Greenspan.)

There is another point I should like to make about the financial consequences of a war in Iraq. If the US forces swiftly and painlessly achieve their objectives (the removal of Saddam Hussein without any US casualties, thanks to the US's vast air superiority), stock markets around the world may celebrate such a victory with a sharp rally. However, under a more careful analysis, such a victory would be a very mixed blessing, since it would act as an incentive for other nations, given the obvious US military superiority, to accelerate their nuclear programs and to acquire weapons of mass destruction in order to be in a better position to defend themselves against a foreign aggressor. Thus, the more the likes of CNN broadcast the terrific firepower of the US in battle, the more likely it is that "rogue" or other sovereign states that prefer not to dance to the tune of US foreign policies will acquire unconventional weapons.

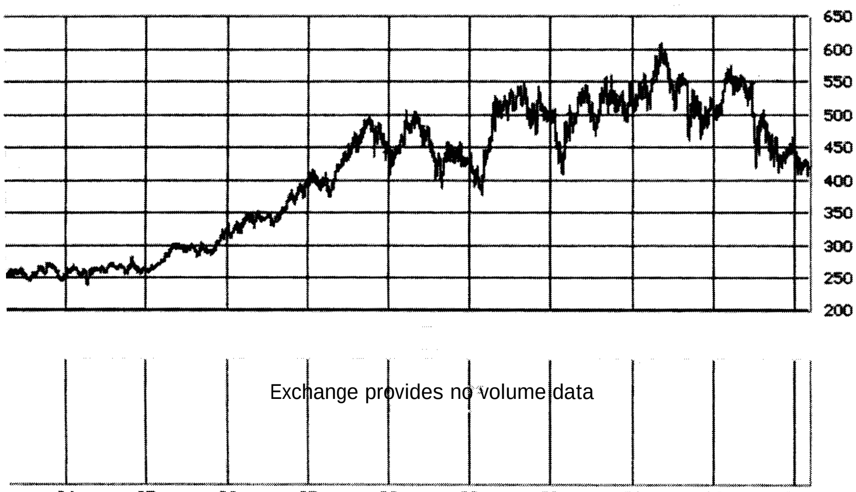
There is one other observation that may be relevant regarding the war. At present, investors' expectations are that the war will be a replay of the 1991 Gulf War. In other words, investors expect that following the war, oil and natural gas prices will tumble. This expectation is unquestionable, since it is so clearly reflected in the performance of oil and natural gas stocks compared to the price of oil and natural gas. Over the last 18 months, natural gas prices are up by 260%, yet the XNG Amex Natural Gas Index (a basket of gas companies) is down by 8%. And in the case of oil, prices are up by about 100% since late 2001, but the XOI Amex Oil Index is down by 13% (see Figure 6). Our readers will know that I pay a lot of attention to the performance of shares and tend to believe that the market is right more

Figure 5 **US Net Asset Balance % GDP, 1960–2002**



Source: Bridgewater Associates

Figure 6 **AMEX Oil Index, 1994–2003**



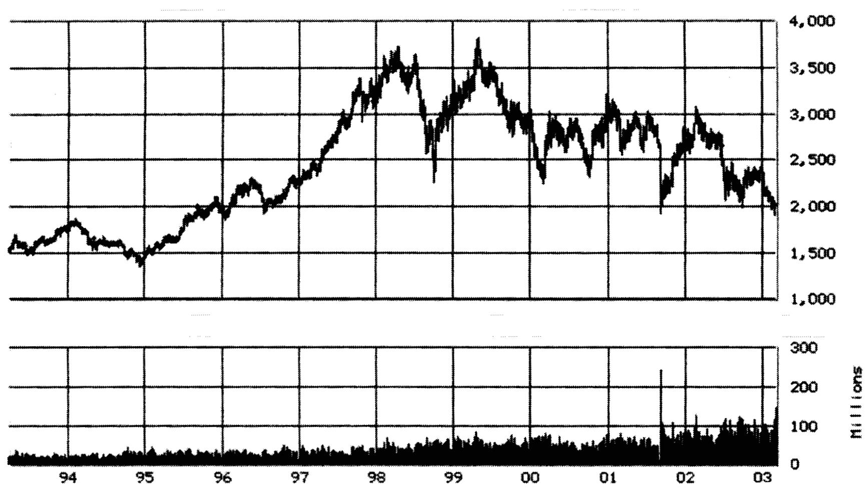
Source: www.BigCharts.com

often than the investment community. In other words, I am inclined to believe that when the news is positive and stocks decline (as is also the case now for home builders), then there is usually something fundamentally wrong. Equally, when stocks rally while the "news" is negative, it is usually a signal of an impending improvement in fundamentals. However, in the case of oil and gas, as well as mining companies, I wonder whether the market might not be wrong by not having followed their underlying commodities on the upside. The reasons for my doubts are that there is a widespread consensus that the coming war in Iraq will be a replay of the 1991 Gulf War and that, as was the case then, a year later the stock market was up 24%. I might add that the Korean War is also often cited as an example of where the stock market rose 18% a year after the war began.

However, history may not replay itself in the same way. When the Korean War began, stocks were inexpensive, with the Dow Jones having at the time a higher dividend yield than bonds. And in the case of the 1991 Gulf War, stocks were also relatively inexpensive — certainly compared to stocks in Japan, where the Nikkei Index had just topped out at 39,000. (In 1991, the US also had a current account surplus.) Today, however, US stocks are not particularly cheap, unless it is a sector that has some deep-rooted problems, as is the case for the airline industry. For the record, the Dow Jones Transportation Average has now declined for five years in a row. It closed the year 1997 at 3,256 and has since closed every year at a lower level (see Figure 7). I mention this because some strategists argue that the market is most unlikely to decline for four years in a row. (The Dow Jones Transportation Average would be much lower if it consisted only of airlines, but trucking and rail stocks have kept it from reflecting the performance of airlines, which are, with the exception of Southwest Airlines, all at 15- to 20-year lows.) Moreover, in 1990 the global economy stood at the beginning of a business up-cycle, and we were in a secular bull market largely driven by declining interest rates. But now, it is far from evident that an up-cycle is about to begin; if anything, interest rates are more likely to move up from here than down. In fact, what concerns me most is that, despite close-to-record sales in the auto and housing industry, auto stocks such as Ford are at 15-year lows (see Figure 8) and building companies' stocks are "rolling over" (see also GBD of February 28, 2003, entitled "Many Questions, Few Answers").

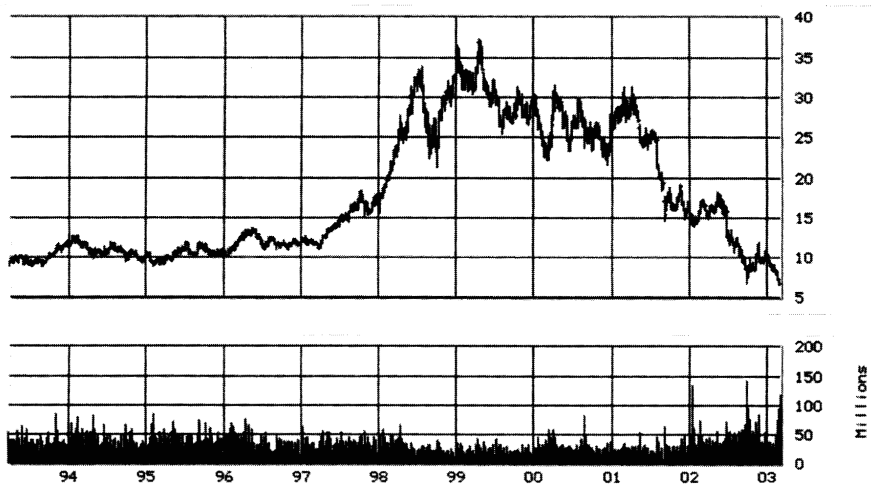
Finally, in 1990, financial stocks were extremely depressed; subsequently, as interest rates declined three years into the recovery (until late 1993), they soared. Today, however, financial stocks make up more than 20% of the stock market capitalisation and are rather expensive when compared to the rest of the market, given the potential problems in their derivatives trading position and consumer loans, where loan losses are escalating. Also, the technical position of financial stocks looks ominous. From Figures 9 and 10, we can see that both Fannie Mae and Bank of America don't appear to be at the beginning of a major advance, but rather in a position of having completed a major secular bull market which began in 1990.

Figure 7 **Dow Jones Transportation Average, 1994–2003**



Source: www.BigCharts.com

Figure 8 **Ford Motor Company, 1994–2003**



Source: www.BigCharts.com

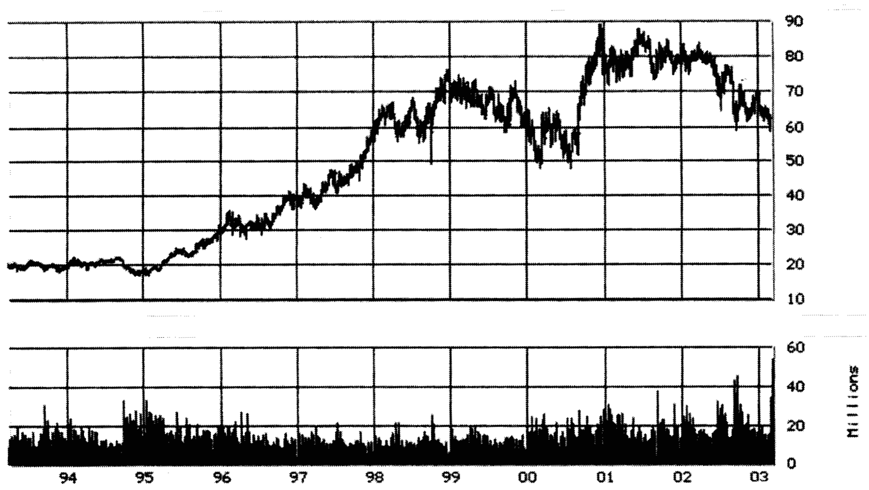
CONCLUSIONS

The war cycle will shortly turn up, and increased international tensions in the years to come will negatively affect stock valuations around the world.

An increased frequency of conflicts will be positive for commodity prices, but negative for international trade and for bonds. In particular, tensions could lead to a slowdown of international capital flows and, in the worst-case scenario, to the freezing of assets by some governments. The US is financially ill-equipped to finance its global leadership position, given the rising budget deficit and gargantuan and growing current account deficit.

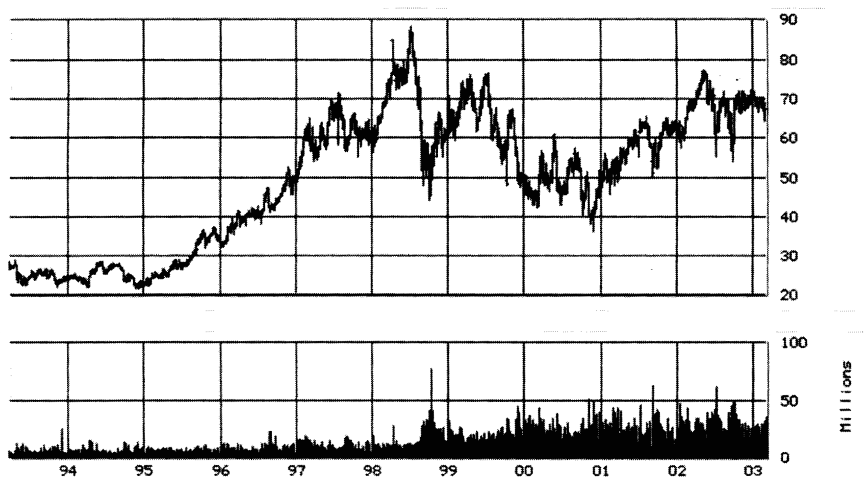
The present stock market and dollar rally may continue until late April or early May, since we are entering a period of seasonal strength. But once investors focus again on economic issues, the rally is likely to peter out and new lows later in the year or in 2004 should not be ruled out. In terms of sectors, **we like stocks of oil, oil servicing, and mining companies. We remain negative about financial stocks and housing companies. High-tech and telecommunications stocks, and the German Dax Index, seem to offer the best rebound potential, as short sellers may be compelled to cover their short positions.**

Figure 9 **Fannie Mae, 1994–2003**



Source: www.BigCharts.com

Figure 10 **Bank of America Corporation, 1994–2003**



Source: www.BigCharts.com

A Trip to North Korea, February 1–6, 2003

Nick Harbinson
Tel: (65) 9751-8816; E-mail: nick@harbinson.com.

This was a private trip and these are my personal notes and opinions.

Twenty kilometres north of the factories where You Eal turns out seventh-generation keypads for the global cellular market, the peasants in the fields around Kaesong lack running water, heat, and fuel. It is –12 °C, and under a dusting of snow the ground is solid. Apart from some sickles, hoes, and the odd bullock cart, there is no agricultural machinery. On the trip south from Pyongyang, 160 kilometres away, the only animals to be seen are a few goats and hens. The contrast in the countryside either side of the 38th Parallel is striking. The north is treeless, arid, and devoid of vegetation, anything larger than a shrub being gleaned as fuel by the peasants, who roam the hillsides tearing off anything they can find and transporting it on rudimentary cradles to their huts. Trench systems are a consistent feature on the barren hillsides, and the return journey up the deserted four-lane Reunification Highway (completed in 1989) provides a clearer view of rows of gun emplacements and pillboxes facing south. The military presence is omniscient.

In the countryside a few miles east of Kaesong we stopped to view the only original surviving burial mounds of one of the Korean dynasties. I opted to walk a portion of the way. Passed by stooped old women carrying bundles of twigs and leaves three metres long on their backs, I avoided a pile of human excrement. It was largely composed of what appeared to be straw.

In the Yangkakdo Hotel, the assortment of international guests (mainly East German steam engine fans) left the breakfast and dinner buffets embarrassingly untouched, and jostled each other at the fried egg stand. There is no milk, and bread made an appearance twice in five days. Hot water was supplied for four hours daily, although we had heat and some light. Our Korean minders, in another wing, had neither. In the basement, Stanley Ho runs Casino Pyongyang, which sports a massage parlour and karaoke lounge, staffed by Chinese and off limits to the Koreans. Unfortunately, similarities with Macau were few, but here I could defrost my feet and eat immoderately expensive fried rice, priced in Euros. In the city itself, crumbling concrete tenements with broken glass and plastic sheeting showed minimal light, and the chimney stacks were lifeless. The shops were predictably bare (no bread, fresh meat, or vegetables), with tinned goods and biscuits being the staple items. They were again unheated and poorly lit. In the many cavernous public buildings, we filed past huge murals of the Great Leader, hosted by whey-faced women in overcoats and gloves, and froze politely as we listened to the latest tale of American perfidy or of extraordinary sacrifice in the building of the nation.

The city itself is attractive, with wide, tree-lined boulevards, riverside walks and parks, leading inexorably to yet another war memorial or outsize statue of the generalissimo. The main public buildings are imposing, more so than those in the southern capital. There is no traffic other than trams and buses, and the occasional bicycle. Most people walk. Attractive young women in sky-blue uniforms and jackboots perform pirouettes as human traffic lights for the intermittent motorist. I wonder what they wear in summer. On the morning of my final day, sirens sounded at 10 am and within minutes buses stopped, streets and houses emptied, and the entire population disappeared into subway tunnels and bunkers to freeze for an hour in an air-raid drill. Driving through an abandoned city, attracting the hostile scowls of the few police and soldiers enforcing the curfew, was a surreal experience. One group stopped us and informed me through my translator that, as bombs didn't distinguish between foreigners and Koreans, I should be in a basement too.

Conditions are as bad, or worse, as anything I recall seeing in Eastern Europe, Russia, or Albania. But what I found significant was the stoical, almost jovial, acceptance of this lifestyle. In contrast to the apathy and cynicism of the Eastern bloc, the DPRK gives an impression of bustle, purpose, and self-belief that is very striking. I was particularly impressed with the absence of any form of public drunkenness.

This was not an encouraging trip. I came away with the strong conviction that if most of the Korean bulls (among whom I count myself) had any idea of what the world looks like on the other side of the DMZ they would be noticeably more cautious in their asset allocation. Granted: the bellicosity of the DPRK regime is long-standing, and the likelihood is that a visitor to this place would have come away dismayed by any visit in the last 20 years. What differs this time is the level of the stakes, the virulence of the rhetoric sparked by the "axis of evil" designation, and the palpable anger in the streets.

The DPRK's entire mythology is built around its history of defiance, struggle, and victory over the imperialist and capitalist powers, Japanese and American. They date a conspiracy to ensure their economic subservience to 1844, and to a motion in Congress authorising the opening of trade. The first attempt at commerce was made a few years later in 1866 when the USS *Sherman*, a Confederate blockade runner with a cargo of cotton and tin, reached Pyongyang. A decade earlier, on a similar mission, Perry had met with Japanese hospitality and Pinkerton his Cho-cho san. The Koreans were less receptive. The *Sherman* was burnt and its crew massacred, thus setting a door policy that many Seoul nightclubs continue to this day.

The DPRK see themselves as the heirs to the patriots of 1866, which is as vivid a part of their national consciousness as the *Pueblo* incident in 1968 or the shooting down of a US helicopter over the DMZ in 1994. The *Pueblo*, bullet and shrapnel holes emphasised in red paint, floats on the Taedong River on the site of the *Sherman*'s destruction, with the Woodward "apology" prominently displayed. School groups are led through this, and through museums of the Korean War that emphasise a history of US hostility and atrocities, including germ warfare and the first airborne delivery of napalm. These exhibits are essential props to a regime that defines itself in relation to a long-running aggression from the US and the West. A year ago, it looked as if tentative attempts at a market economy were being introduced, but this remains at heart a Marxist-Leninist state that rallies back to its roots when threatened.

In an aging Tupolev on the flight out to Shenyang, I brightened when an attractive young hostess engaged me in conversation. When would I be back, and how many of my friends would I bring with me? She was familiar with Moscow, Bangkok, Beijing, and Khabarovsk, but Pyongyang was far nicer, she said. She was determined to work hard for the Fatherland. Did I understand the basis of the "juche" idea? She was eager to enlighten me. (The Juche idea is Kim Il Soon's home-grown political philosophy — once beloved in much of Africa. It emphasises the paramount importance of the armed forces in government and the self-sufficiency of the state.) I smiled, realising that Dostoyevsky would be easier going, and opened my book.

Art Report

Kenny Schachter
E-mail: schachter@mindspring.com; Website: www.roveTV.net

Does your portfolio have the right balance of mutual funds, real estate investment trusts (REITs), and art funds? It should, says Michael Moses at NYU's Stern School of Business, who with Professor Jainping Mei created the Mei/Moses Fine Art Index (www.meimosesfineartindex.org). Although outwardly characterising art as an investment vehicle is a no-no in the art world, it is only a matter of time before such art-based funds become commonplace, according to Moses. Along with publishing papers with titles such as "Art as an Investment and the Underperformance of Masterpieces" and "Art, Wars and Recessions", the maverick academics have created a series of indexes tracking key categories of art (American, Impressionism, and Old Masters) against the Treasuries and the S&P 500.

Previously, they found that fine art trailed the S&P 500 over the long haul, though barely. That is not the case any longer. Their latest, yet-to-be-published study shows that the art market has outperformed the stock market for the last 40 years, and dramatically outpaced it over the last five years, when art brought an average 12.9% return, and stock, zilch. Plus, the duo concludes, collecting art offers more by way of glamour than piling up stocks and bonds. In the words of Moses (Mike, that is), "Art may serve to humanize the barbarians, but the barbarians will never admit to its investment value since that would negate its non-barbarian status." Translation: art for art's sake is a surprisingly good investment.

As if touting artworks as an investment wasn't seditious enough; the findings of Mei/Moses are even more eye-popping and contradictory to previous beliefs. Namely, that masterpieces underperform the market, as opposed to typical art dealer advice to buy the very best (i.e. most expensive) artworks a client can afford. Mei/Moses determined that it was not clear that the highest-quality art has the highest financial returns. Another finding of note is that the art market does not correlate to the stock market (but probably does mirror the real estate market to an extent) and is not as volatile as previously thought — thus, the key benefit of art can be for purposes of diversification.

Strangely enough, Moses comes to this economically reductive way of analysing art through the traditional transcendental notion that art can change a person's outlook of the world, and that certain images stay with the viewer for life. But, before you log on to the Art Index to gauge the future performance of your budding art portfolio, Mei/Moses are not quite ready to prophesise the next (inevitable?) downturn — not yet, anyway!

An interesting historical note on the art and investment front was the case of the British Railways Pension Fund, which undertook an unorthodox foray into the art market in the mid-1970s. In an effort to combat high inflation, a faltering London stock market, weak property levels, and a high dollar, the Railways Pension Fund invested in art and other collectibles, seeking portfolio diversification, long-term capital appreciation, and profits. To consider such a scenario today for what is essentially a public trust seems unthinkable. Yet, the fund, which invested in Old Masters, Impressionist, Chinese, and European art (and antiquities), did remarkably well over the course of a 20-year period. The initial cash outlay of £40 million reached £168 million by the end of the project in the late 1990s, which equalled an 11.3% cash rate of return, or 4% per year above the movement of the Retail Price Index. Strangely, in 1999, after the successful run of the Railway Pension Fund's experience with art, it was determined to invest in other vehicles such as equities rather than reinvest in art. Looking back a couple of years later with hindsight, British Railways would be wise to dip back into the art market and get back on track!

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Author & Publisher
DR MARC FABER

Research Editor & Subscription
LUCIE WANG

Copyeditor
ROBYN FLEMMING
E-mail: robynfle@bigpond.net.au

Subscriptions and enquiries
MARC FABER LTD
Suite 3308–3310, The Center
99 Queen's Road Central
Hong Kong
Tel: (852) 2801 5410 / 2801 5411
Fax: (852) 2845 9192
E-mail: contrary@pacific.net.hk
Website: www.gloomboomdoom.com

Design/Layout/Production
POLLY YU PRODUCTION LTD
Tel: (852) 2526 0206
Fax: (852) 2526 0378
E-mail: pollyu@netvigator.com

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Iraq and Turkey ▪ *By* Nicholas D. Kristof

Kurds are about to be betrayed — again

BATMAN, Turkey

A middle-aged Kurd took me on a lonely hillside near here to point out the isolated police station in whose basement he had been beaten, subjected to electric shocks and sexually humiliated. We stood half a mile away as he recounted his tale, and then the police spotted us — and a tank rushed toward us.

I fled. But the Kurds in Turkey cannot flee, and many here worry that the war in Iraq will set off more of the savagery that marked the 1980s and 1990s in "Turkish Kurdistan" — a phrase that, if I were Turkish, might lead to my arrest. The world has turned its back on the Kurds more times than I can count, and there are signs that America is planning to betray them again.

The United States was so desperate to bribe Turkey into its coalition that it was willing to allow tens of thousands of Turkish troops into Iraq's Kurdish areas. And Washington still seems ready to acquiesce in this.

The Turks, having broken the back of Kurdish resistance within their borders, plan to expand their efforts and "disarm" Iraq's Kurds to block their control of oil fields. How can America allow this? Aside from the sheer immorality of presiding over what is in effect a Turkish invasion of peaceful Iraqi Kurdistan, such an incursion risks warfare between Kurds and Turks that could spill into Turkey as well.

"The Turkish government has been far worse to the Kurds than Saddam has," one well-educated Kurd said bitterly. His comment stunned me, for Turkey never used poison gas or conducted mass executions as Saddam did, but one Kurd after another said the same thing. They described past Turkish military techniques like raping wives in front of husbands, or assembling villagers to watch men being tied and dragged to their death behind tanks, and they noted that Turkey had been less tolerant of Kurdish language and culture than Saddam.

President George W. Bush is motivated to invade Iraq partly, I believe, by a deeply felt horror of Saddam's repression. But if American claims to be acting on behalf of the people of Iraq are to have credibility and moral legitimacy, Washington must try to stop Kurds from being slaughtered not only by its enemies in Baghdad, but also by its friends in Ankara. And America should certainly not acquiesce in such steps as a Turkish invasion of northern Iraq, which could trigger a new spiral of clashes and repression in Turkey.

How could a warm and friendly country like Turkey, which has made genuine progress on human rights and deserves a place in the European Union, be so harsh to its Kurds? Turkey's horror of a flourishing Kurdistan derives from its "Sèvres syndrome," named for the French city where Western powers tried to dismember Turkey after World War I. Ever since then, Turkey has seen accommodation as a slippery slope toward national disintegration. There had been progress toward reconciliation in recent years, but now the prospect of war in Iraq has revived old suspicions and hatreds.

While Bush has been eager to take note of Iraqi atrocities against the Kurds, the West has never been so outraged by similar Turkish atrocities. More than 30,000 people died during the years of fighting between the Turkish government and the guerrillas of the Kurdistan Workers Party; both sides were brutal, murdering civilians and engaging in torture and terrorism. Turkey also forced at least 500,000 Kurds to leave their villages at gunpoint. Excellent reports on Turkey by Human Rights Watch say that some refugees who have tried to return to their homes recently have been shot by government-armed thugs.

Southeast Turkey still feels like a police state. I traveled to one remote town to interview a Kurdish man who had been beaten by the police in front of neighbors, doused with gasoline and then set on fire — he survived. His family was so terrified to see a foreign reporter and risk another police nightmare that they sent me packing.

Only one Kurdish man was not afraid to be named: Abdurrahim Guler, 37, who has endured repeated bouts of torture and death threats. In one brutal session, he says, the commander called out, "Bring in the stick," used to rape men. "You can use your stick," Guler says he shouted back. "I still won't talk even if you use a minaret!"

Now something even grimmer is bearing down on the brave Kurds: Turkish tanks, like the one that sent me fleeing, but waves of them. I feel sick at the thought that America is about to betray the Kurds, again.