

What's War Good For?

When it comes to the economy and the markets: absolutely nothing

BY ERIC J. SAVITZ

TWITCHY INVESTORS HAVE the stock, bond, and oil markets gyrating wildly on every new tidbit about the war. Good news from Basra, stocks tick higher. Troubling word from Karbala, they head back down. Iraq has become the most important business story by a wide margin, and for good reason. If combat drags on for more than a few weeks, a possibility even the White House has raised, the damage to the economy and the financial markets could be considerable.

"The war has paralyzed the economy," says Mark Zandi, chief economist at Economy.com. "It already was struggling prior to the commencement of the conflict. The economy probably contracted in February, and again in March. If it lasts more than four to eight weeks, the war will push the economy into a full-blown recession."

Zandi isn't the only one who fears another downturn. "The long war scenario pushes us back into recession," agrees Campbell Harvey, a professor of finance at Duke University's Fuqua School of Business. "The way it plays out is this: the longer the war goes, the worse it gets." Tom Gallagher, Washington-based political analyst for the investment research boutique ISI Group, has similar worries. "We're likely to take Baghdad—no one doubts we will," he says. "The question is the costs in terms of casualties, dollars, and confidence. The longer it takes, the longer the war remains a depressive factor on the economy."

Certainly, economists think so. A survey of 223 economists by the National Association for Business Economics, released last week, found that 41% of respondents now consider war and homeland defense the biggest dangers to the domestic economy. That's up from just 3% in a comparable August survey. Likewise, the International Monetary Fund warned last week that the financial markets had priced in a short and decisive conflict—and that "any departure from this scenario could weaken confidence further." The IMF added that "prolonged uncertainty could keep risk aversion at a high level, depress financial markets and reinforce the headwind against global economic recovery."

Already, the war's impact on the domestic economy has been widespread. The airline industry has warned that a lengthy conflict could result in widespread bankruptcies—American Airlines parent AMR late last week was reportedly days away from filing for Chapter 11. In the war's first week, according to the Air Transport Association, the airline industry eliminated more than 10,000 jobs; domestic bookings for travel in the next 60 to 90 days are down 20%, while transatlan-

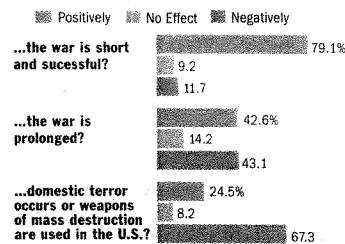


A British soldier fires a wire-guided missile at an Iraqi position last week.

Peace Dividends

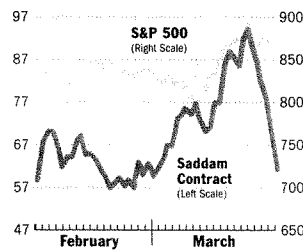
► Financial Executives International and Duke University's Fuqua School of Business asked more than 200 CFOs how revenues at their companies would be affected by the war. If the war is short, the survey found, most companies expect sales to grow in the next 12 months. But many see sales shrinking if the war drags on. And the use of weapons of mass destruction in the U.S. or large-scale domestic terror attacks would crimp sales.

How Would Your Revenues React If...



► TradeSports.com, an Irish wagering site, makes a market in "Saddam futures," priced from 0 to 100. Buying the April contract is a bet that Saddam will be out of power by the end of the month. If that happens, the contract closes at 100. If he's still in power at month's end, it closes at zero. Last week, as the S&P 500 slid, the April contract was in the low 60s, suggesting a better-than-even-money chance that the dictator will be gone before May.

Betting Against Saddam



tic bookings are off more than 40%. The spike in oil, meanwhile, will hurt earnings at a wide range of energy-intensive companies. And corporate jitters about the war could slow a nascent pickup in tech spending.

"It's touching every corner of the economy, every sector, every single business," Zandi says. "And it is undermining sales. Business spending is declining." The data support his view. The Commerce Department last week reported a 1.2% drop in February durable goods orders; non-defense durable goods orders, not including aircraft, fell 2.8%.

Unfortunately, some reports suggest consumers are pulling back, as well. The Conference Board last week said its consumer-confidence index had fallen to its lowest level since 1993. A study by J.D. Power & Associates found that auto sales slid 8% in the first four days of the war; ShopperTrak said that U.S. retail sales dropped 9.9% in the same period. Likewise, hotel

occupancy rates fell 4.8% in the war's first week, reports Smith Travel Research. Meanwhile, February new-home sales tumbled 8.1%, to the lowest level since August 2000, according to the Commerce Department.

Higher energy prices are taking a toll on many sectors. While crude prices retreated at the start of the war, oil has since moved higher again, and remains far above its level a year ago; it's now about \$30 a barrel, rather than \$20. Zandi notes that higher petroleum prices are hurting a wide range of energy-intensive manufacturers, such as steel, paper, rubber, plastics and glass companies. Also hit hard will be the transportation sector: railroads and truckers, in addition to the airlines. Last week, for instance, Union Pacific warned that first-quarter earnings would miss expectations, due to higher fuel costs and weaker demand resulting from the situation in Iraq.

None of this bodes well for the first-quarter earnings season, which starts in about two weeks. "First-quarter earnings? They're going to be poor, and second-quarter earnings will be a lot worse," Zandi says. "January was an okay month, but the trouble intensified in the second two months, after it became clear in mid-February that we were going to war."

Chuck Hill, director of research at First Call, notes that the pre-announcement season so far has been worse than any for the past five quarters, with the ratio of negative to positive pre-announcements running 2.8 to 1, compared with 1.6 to 1 at the same point last year.

Hill notes that the aggregate estimate from Street analysts now has S&P 500 earnings growing 8.4% in the first quarter. That forecast is down from 17.4% at Oct. 1, and 11.7% on January 1. Lately, he says, the figure has actually ticked up slightly, owing to a big jump in expected profits at energy companies that benefit from higher oil prices. Energy sector earnings are now expected to be up 168% from last year; at Jan. 1, forecasters were calling for a 90% increase. Meanwhile, for all S&P 500 stocks ex-energy, the forecast is for a more modest 1.9% gain for the quarter. The forecast for non-energy S&P stocks has ratcheted down from 14.2% at Oct. 1 and 8.4% at Jan. 1.

The tech sector, which has outpaced the broad market this year, could also suffer. In a Merrill Lynch survey of 100 U.S. and European corporate technology buyers just before the war, 17% of the respondents expected to slow their spending once the war started. In a similar vein, 67% of chief financial officers surveyed this month by Financial Executives International and Duke's Fuqua School said they were spending cautiously or holding off on capital investment in

the face of war-related uncertainty.

Let's keep all this in perspective. The war is still less than two weeks old. If it ends soon, the economy—and the market—could snap back smartly. "If the war is a brief one—if it's over in the next four-to-eight weeks—then I do think confidence will quickly rebound, and spending will rebound soon thereafter, particularly for business investment," Zandi says. "And it could be a substantive increase. There's growing pent-up demand for investment goods, IT products in particular. There's a replacement cycle waiting to be uncoiled once business confidence improves, and it gets more potent with each passing quarter."

Steve Leuthold, who runs the Minneapolis-based Leuthold Group, has moved his portfolios to maximum exposure to stocks. While he concedes that there could be several months more of war, Leuthold sees a big rally once the shooting stops.

"We'll emerge victorious, and then I think we'll have an explosion on the upside, a rally of at least 1,000 points on the Dow over a couple of weeks. This is the time when people ought to be building positions, unless they think we're going to lose this war," he says.

And yet, if the war drags on for months, Zandi continues, investors should brace for "a very debilitating, serious recession." One reason a downturn would be particularly difficult: a limited range of options for stimulating the economy. The Fed has little room left to lower short-term rates; Congress will find it hard to provide tax relief in the face of a war-inflated federal deficit. And Zandi fears that further job losses could exacerbate growing household leverage. "There are lots of signs of financial stress among households. We could see dramatic erosion in credit quality, resulting in rising personal bankruptcies and foreclosures." It would be a worse recession than the last one, the economist warns.

And for stocks? "It would be very dark," Zandi says. "During the 2001 recession, we lost 2 million jobs, and we could lose another 2 million. And last time we had unprecedented economic stimulus, which we can't... have again. The equity markets don't discount any of that."

Not even the Federal Reserve has any answers. Following its March 18 meeting, it said that "in light of the unusually large uncertainties clouding the geopolitical situation in the short run and their apparent effects on economic decision-making," it couldn't tell whether it should be more concerned about price stability or economic growth. Nonetheless, growing evidence of weakness suggests further interest-rate reductions. Montreal-based BCA Research last week advised that the odds are "good" that rates will be cut another half percentage-point at the Fed's meeting in early May, or possibly sooner.

The current situation in Iraq has been frequently compared to the 1991 Gulf War, Zandi notes. A big difference, however, is that by this point back then, "we had a pretty clear sense that the conflict was going to be over and we were going to be victorious at little cost. This time, it's painfully clear that it is not going to happen in the same way."

Duke's Campbell Harvey worries that there's another issue the market has barely considered—what happens when the war ends. "People are beginning to learn just how complex it is, with the Turks, the Kurds and Iranians. It could be very complex and costly," he warns. ■

Mistaken Identity

Metals, schmetals, Engelhard is really a tech company

BY RHONDA BRAMMER

ASK AN INVESTOR OR, FOR that matter, the proverbial man on the street, what Fortune 500 companies like Sherwin-Williams, Maytag and Estee Lauder sell and, like as not, you'll get a quick and informed reply. But ask about Engelhard, a company that last year ranked higher on Fortune's list than any of the aforementioned, and don't be surprised if even an old Street pro is a little tentative.

"Metals? Doesn't Engelhard do something with metals?"

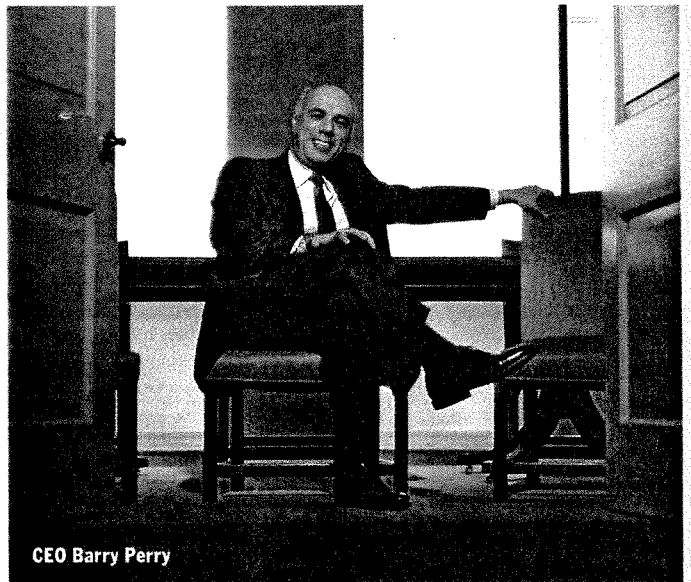
Which is certainly true. Roughly half of Engelhard's sales last year came from buying and selling metals, particularly precious ones such as platinum, palladium and rhodium.

And the company's long and rich history—over a century of it—is steeped in the lore of precious metals. Engelhard was founded as a metals fabricator in 1902 by Charles Engelhard, who pioneered uses of platinum for everything from light-bulb filaments to a catalyst for the mass production of nitric acid, which is used to make a slew of stuff, from fertilizers to dyes. And his son, the flamboyant and enterprising Charles Jr., gilded the tradition, reputedly serving as the model for Ian Fleming's Auric Goldfinger.

Today, however, Engelhard is no mere just a metals company than GE is just an appliance maker. For though half of its sales come from buying, selling, refining and recycling metals, that business—which Engelhard runs in order to secure a stable supply of raw materials for itself and its customers—last year chipped in a meager 13% of operating profits. The balance, a whopping 87%, came from its technology units, which provide a host of specialized products to niche markets where Engelhard ranks No. 1 or No. 2.

In truth, the right answer to the question "What is Engelhard?" is that it's a specialty-chemical company with a heavy technology bent, whose large metals component, the material-services unit, serves as a support operation for its customers and its own tech activities. It's a company that spends heavily on research and development and whose technological reach extends into areas loaded with potential, such as safeguarding the environment, nontoxic crop protectants and fuel cells.

In point of fact, Engelhard has long



CEO Barry Perry

demonstrated its prowess in tech. However, a new management headed by Barry Perry, a 22-year veteran of General Electric, who took up the reins a little over two years ago, has been forcefully melding the company's disparate businesses into an integrated enterprise focused on surface and materials science. Not the least of the virtues of the streamlining is that it fosters exchange of ideas and applications among the various and sundry parts of the company.

Engelhard commercialized the first catalytic converter for autos in the mid-1970s and is now a world leader in the field. In addition, it provides catalysts for the chemical and petrochemical industries, petroleum refining, food processing and pharmaceuticals. And it sells pigments and additives used in paper, plastics, inks, coatings and cosmetics.

Lively history, bright promise and sturdy performance have all been unavailable in keeping Engelhard's shares aloft: They're now at \$21 and change, down from a 52-week high of \$33.

The overall stock market, of course, until the past couple of weeks, has been in the pits. But Engelhard has had some special drags. It sells to businesses that are cyclical and, in a problematic economy, that scares investors. Moreover, its profits have stalled and the first quarter

seems all but certain to look punk stacked up against the year-earlier span, when electricity prices ran wild and touched off a boom in power-plant construction and soaring demand for Engelhard's pollution-control equipment.

Less tangibly, claims by a small West Coast company of a superior technology in catalytic converters, a key product line, have caused some unease. And investors with long memories warily recall that, back in 1995, Engelhard made quite a noise about PremAir, a catalyst system that promised not only to eliminate noxious emissions but also to gobble up ozone already in the air.

"PremAir wasn't a bust," insists Chief Exec Perry, noting that it's used today on Volvos and BMWs. But he concedes that the way Engelhard ballyhooed its prospects was a classic case "of letting your enthusiasm for your technology run out of control." No accident, then, Perry tends to be conservative when speaking of promising new products.

For example, he's obviously excited about Engelhard's position in fuel cells, but cautions that big commercial applications may be years away. Still, he stresses, the typical fuel cell uses eight material technologies and "Engelhard is the only company in the world that has a strong market position in all eight." In-