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Hilary Kramer
President, A&G
Capital Group

 Email Author

 Biographical

War and Your Wallet

By Hilary Kramer

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In the bars, the malls, and baseball stadium bleachers, every investor asks the same question: When the United States invades - liberates? - Iraq, what will be the consequence, and the price? Note the "when," not the "if." President Bush and his national security team have made it plain: Saddam Hussein must go.



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Clearly, investors and all Americans are nervous. The stock market is flirting with the Dow's post-9/11 low of 7702 on July 23rd; White House economic adviser Larry Lindsey told *The Wall Street Journal* that a war could cost \$100 to \$200 billion.

Of course, those costs must be compared to the cost of another terrorist attack. And in the long term, of course, asserting strong American leadership in the world, freeing the planet from state-sponsored terror, and improving the political economy of the Middle East will be bullish factors for international investment and growth.

But let's not get ahead of ourselves. Let's talk instead about the short term, when the U.S. might actually be engaged in hostilities in Iraq. Such a period could prove difficult, of course, and it could hurt some companies and sectors. But even so, I see selected investment opportunities ahead, especially in two key areas: oil and defense stocks.

First, oil. An attack on Iraq today will probably not have as much affect as did the Iraq-provoked crisis of 1990-1991. In the days immediately after Saddam's conquest of Kuwait, in August 1990, oil prices nearly doubled, to \$41 per barrel. Why? Traders were concerned about the safety of Saudi Arabia's reserves. But once the United States and its allies launched the war in January 1991, big exporters rapidly increased production and prices fell back to the low-20's. Nevertheless, the oil-price-spike helped push the U.S. economy into the 1990-1991 recession.

But the oil situation is different - and better - today. In the past 12 months, oil prices, currently closing in on \$30 per barrel, have risen less than 10%. Why? One reason is President Bush's strong leadership; politicians around the world may criticize him, but investors and oil traders show their confidence in him by restraining their speculative frenzies. Another reason is that more non-OPEC producing countries today produce oil. Chief energy analyst, James Williams of WTRG Economics in London, Arkansas, says that, since 1994, Russia has increased its production from 5.9 million barrels per day to 7.3 million barrels per day. While China, in that same time period, increased production from 2.9 million to 3.3 million. Canada's production increased from 1.7 million to 2.3 million. In fact, in these past eight years, Non-OPEC countries have increased production from 35 million to 40.5 million barrels per day. So while a war will push prices upward, the overall price-effect - especially if the war goes as well as we can reasonably expect - should be small.

Still, since oil is the major ingredient in nearly every industrial and consumer product, many companies are going to struggle to improve, or even maintain, their earnings. The airline industry is a good example; jet fuel prices doubled in 1990-91, helping to kill off such proud carriers as Eastern and Pan Am. Today, the airline industry is facing a new Gulf War even as chronic mismanagement problems have it suffering its worst losses in history. So the industry will likely lose a horrendous \$7 billion this year, even assuming that the skies stay absolutely safe from

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terrorism.

Most likely, the Organization of Petroleum Exporting Countries will continue to try to maximize its profits. OPEC ministers have gathered in Osaka, Japan trying to decide production quotas. The cartel's self-imposed production ceiling of 21.7 million barrels per day is already the lowest since 1991. Even with the cheating on those quotas that produces another three million or so barrels per day, there is some concern in the oil-traders' pits about the potential loss of oil during an Iraqi war. But if the war goes well for the US - as it did in Afghanistan - there will be likely be good news about oil: What news? Iraq itself. That country has the second-largest reserves in the world, some 112 billion barrels, and yet it only pumps out 700,000 barrels per day - less than 1/5 of its 1990 production level. Once Saddam is toppled, more of that production should come on-stream, helping push down prices.

For investors, forewarned is forearmed. And so for savvy investors, forewarned could also mean foreordained gains. With this increase in oil production and prices, investors should not miss out on the opportunity to buy select oil and gas exploration companies like *Anadarko Petroleum* (NYSE:APC) and *Marathon Oil* (NYSE:MRO) These two companies should profit from higher prices which will provide them with more money for exploration.

Anadarko is one of the fastest growing companies in the "oil patch" with operations primarily in Texas, Louisiana, Alaska, and the Gulf of Mexico. After acquiring Union Pacific Resources in 2000, Anadarko is also one of the largest independent oil and gas companies in the world; Anadarko has 2.3 billion equivalent barrels of oil and natural gas reserves. The stock is currently trading in the low \$40's but with the impending war bringing elevated prices, and oil production expected to step-up in the U.S. The stock should be trading at \$60 per share within the next 12 months.

In fact, Goldman Sachs analyst Mark Meyer, rates Anadarko a "market outperform" as the company "continues its transformation from mid-cap domestic explorationist to global independent capable of generating competitive returns". Meyer further adds:

New CEO John Sietz's preference for returns over volume growth in 2002 suggests improved financial discipline is an attribute we believe will complement what we see as the sector's leading exploration franchise.

Marathon Oil, which sports a 4.1% dividend separated from US Steel in January 2002. The company has almost no political risk given its non-existent presence in the Middle East. Instead, the company does has well-diversified operations with exploration and development activities in 11 non-OPEC countries including the U.S., UK Canada, Gabon, Norway and Ireland.

Through Marathon Ashland Petroleum LLC, the company also refines, markets, and transports petroleum products in the United States. Trading in the low \$20's, the stock trades well below its fair value based on discounted cash flow projections. This makes Marathon one of the key acquisition targets in this rapidly consolidating sector.

Another area of opportunity is oil and gas services companies. The best of the group is Transocean (NYSE: RIG). Transocean is the largest provider in the world of offshore and inland marine contract drilling services for oil and gas wells. As a result of a string of mergers - including Sonat Offshore, Sedco Forex and Falcon - the company's revenues have grown by 400% in the past two years. Success in this industry comes down to size in the servicing sector and Transocean benefits from the scale that 160 mobile offshore and barge drilling units provides.

Transocean exceeded consensus earnings expectations in its last quarter for the second time in a row and is starting to rebuild investor confidence. Trading in the low \$20's, at its 52-week low, Transocean has upside to double within the next 18 months and surpass the \$40 mark where it traded in May 2002.

But of course, a key principle of sound investing in any market condition is to buy stocks that make products with wide profit margins that are *in demand and selling*. So, if the war costs \$100-200 billion, as the White House's Lindsey forecasts, then much of that money is going to end up at the Pentagon. My favorite defense stocks are Northrop Grumman (NYSE: NOC) and Raytheon (NYSE:RTN).

With missile defense climbing to \$9.0 billion in 2003, Northrop Grumman, which includes the recently acquired companies of Litton Industries, Newport News and TRW, is positioned to be the leading supplier to the deep-pocketed Pentagon. Northrop Grumman also makes the Global Hawk, an unmanned surveillance plane that is on the top of the Air Force's shopping list.

With Northrop Grumman's share price in the mid-\$120's, many investors have argued that the stock has already had its run and that it will be too daunting a task for the company to handle the cross-section of corporate cultures from all these recent mergers. However, on September 12th, Banc of America raised its rating on Northrop Grumman to market perform saying it believes potential integration issues are being resolved and that the troubled units are being turned around. But, with a price-to-earnings ratio or "p/e" of 25 and defense - especially communications-centric warfare tools - being the Pentagon's highest priority, the stock still has wings to climb another 15%.

Raytheon is also a winner. With a focus on missile defense, intelligence, surveillance, and reconnaissance, precision strikes and homeland defense, Raytheon is finding its products in strong demand - both home and abroad. I think of Raytheon as having both the offense and defense covered; that is, they make the tomahawk missile and the patriot missile.

Raytheon is the leader in defense electronics and a very big player in "homesection" - homeland security technology. After September 11th, the Feds deployed 1,100 large explosive detection machines one million dollars each. Raytheon is behind the hottest developments in facial, optical and fingerprint recognition devices. The company is also engaged in creating a computer software system to track citizens and non-citizens world-wide.

The key here is to take advantage of the depressed stock price, now at \$33.70 per share, which is due to disappointing sales in the corporate jet division. Even this area will "fly" again as corporate spending comes back and corporations begin to make big ticket expenditures again. Even if the stock rises only a 10% rise in the next 12 months, the 2.4% dividend provides an increased return and a chance to counter-act any volatility in the stock's price.

The bottom line in any war time environment is uncertainty. Lower stock prices have already reduced net wealth in the US by some \$7 trillion. That money's gone - the thing to do now is to look ahead, to companies that stand to do well in the next environment. Oil and defense are proven plays.

It's worth remembering that "uncertainty" is another word for "opportunity." So if, as Rudyard Kipling said, you can keep your head while others are losing theirs, you'll be a happy investor.

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