Trusting the Markets Among Rising Middle East Tension

I hope everyone had a happy and heathy holiday! The older I get, the more I realize that we don't get do overs in life. Let's all strive to make 2020 the best year yet.

The new year started out with some rocky and even scary international developments. Our present conflict with Iran has caused some quick profit taking and reallocation of assets. Some of this is simply the result of an over-bought stock market while some is the result of reasonable concern over how widespread and violent this situation may get. Gold is hitting highs we have not seen since 2013, as investors move to safe haven assets. The stocks of defense contractors like Lockheed-Martin are seeing significant buying as well. Interest rates have dropped as investors assess the impact on economic growth here and abroad. So, just how bad could a war (declared or not) be for our investment portfolios?

The best we can do is look to history for some guidance. Military conflict over the past one hundred years has generally been good for the U.S. economy - at least over the short to medium term. Over the long term, there is strong evidence that war leads to increased debt, lost opportunity cost as money is directed toward select industries and away from everything else, inflationary pressures and taxes—not to mention the cost of human life. World War I, World War II and the Korean Conflict all resulted in GDP improvements and large jumps in manufacturing output during and shortly after the conflict. The first Gulf War kick started the nineties and the bull run in stocks. The same can be said of the second Iraq conflict following 9/11. U.S. equity markets bottomed in 2003 right as the U.S. military invaded Iraq. The one glaring exception is Vietnam. That conflict resulted in the U.S. stock market being mired in a recession throughout much of the 1970s. During that time, inflation was rampant leading to interest rates nearing 20%.

I am not smart enough to figure out all the reasons for these differences and won't try. What I do know is that markets are good at figuring out if anything (even war) is helpful or harmful to companies' ability to increase earnings, and then compare those earnings to receipt of bond interest - all relative to inflation (commodities). It is this ongoing process that leads to the valuation of asset classes. To me, this basic concept of investing is comforting. No matter the current news or state of world affairs, we only need to look for the fundamental data and it will eventually show up in the price of the assets that we follow and invest in.

Right now, corporate earnings are continuing to grow albeit at a slower rate. Currently the growth rate is around 8% year over year. Interest rates are historically low, and the yield curve is no longer inverted. Commodity prices are also low, although the price of oil is certainly in play. This favorable data is reflected in the strong equity markets that we continue to enjoy.

Last week's commentary can be found here.

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