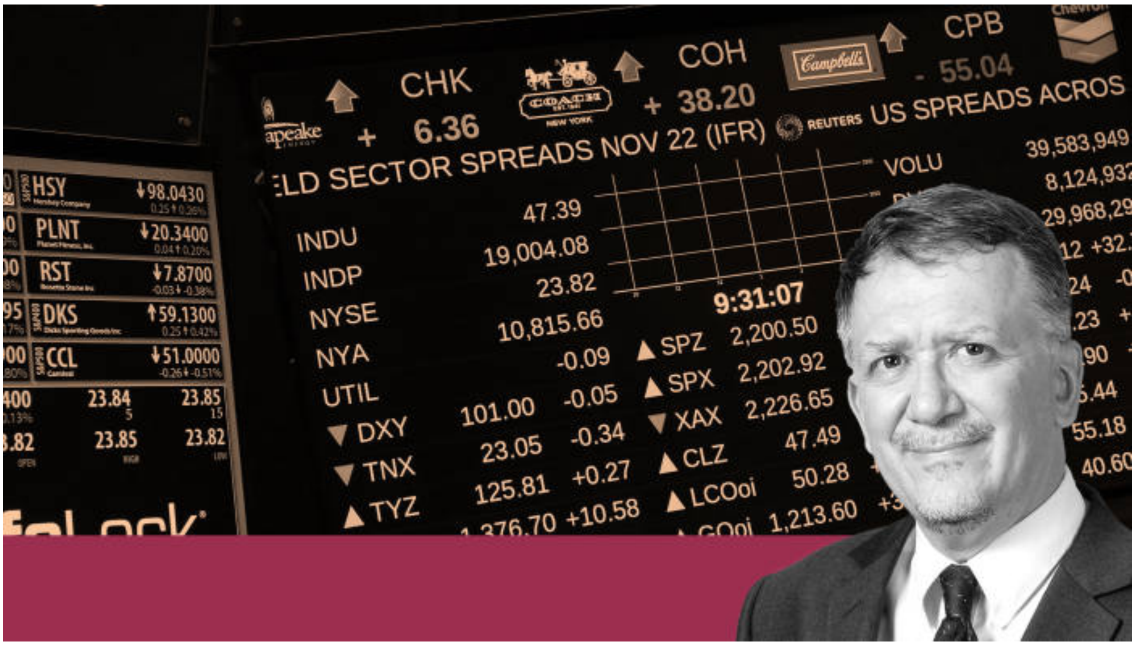
Markets

Authers' Note: War – what is it good for? Premium

The FT's newsletter on the world of investment

Authers' Note



7 HOURS AGO by: John Authers

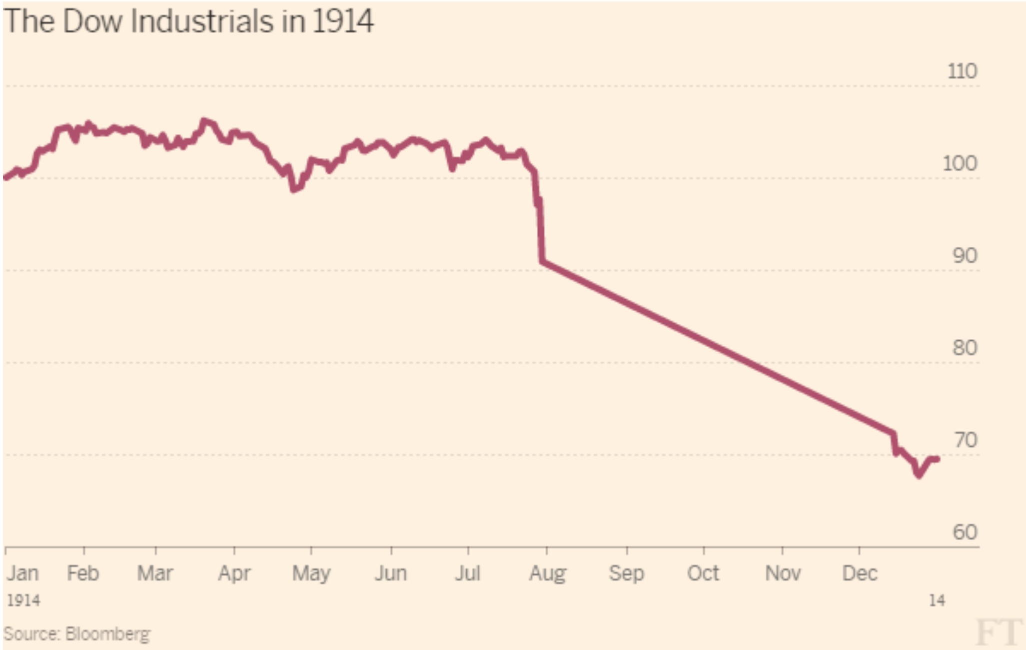
One comment from a reader on my latest Smart Money column, on the lessons from history, averred that the clearest lesson from history is, and I quote, "that wars are a positive for US stocks. If Trump sends in the troops the S&P 500 would be a good wartime haven for investors."

The follow-up support for this assertion, from the poster, who goes by the moniker Frictionless Splendid Isolation, was as follows: "Actually most wars have worked out well for the US economically, John, and have led to a stocks value boost. Sure there may be some shorting . . . but in the long run war works well for western superpowers economically. As for data . . . just look at US stock market returns. Big crashes did not occur during US wars."

As the possibility of US involvement in a war is being discussed more openly than in a long time, this is a topic worth discussing. There may be something to be said for our commenter's point of view. Plainly victory in the second world war worked out very well in the long run for US assets, and a war can be a great form of Keynesian stimulus. But on balance the notion that wars are positive for US stocks is wrong. Bear with me while I try to set out the arguments. Thankfully, there have not been that many wars, so there is a problem with small sample size, but I think the lessons are clear.

A first important point is that wars at their outset are not welcomed by markets. This is the

Dow Jones Industrials in 1914 (rebased):



The day the market reopened was the worst in history, in percentage terms. Plainly the outbreak of what was then a distant war was not well received. Here is how the Dow fared over the entirety of the first world war, from outbreak to Armistice:

Average annualised return over this period was 3.6 per cent, according to Bloomberg — nothing exciting, and the market reacted negatively to the deployment of US troops. The first world war was not particularly beneficial to asset prices. (It is a little embarrassing to write that sentence about one of the greatest human catastrophes in history, but it is my job to analyse markets.)

Now, on to the second world war. We will start with the outbreak of war in Europe (in September 1939), and go through to Victory in Japan Day six years later. This is how the Dow did:

It should surprise nobody that Hitler's Blitzkrieg of 1940 was bad for US stocks. Neither is it surprising that Pearl Harbor was poorly received. After the onset of the war provoked a savage bear market, the US war effort and growing military success propelled a rebound, although the cumulative annualised return over the period was still barely over 2 per cent, and would have dropped below that level but for the ecstatic market reaction to the news of the atomic bombs on Hiroshima and Nagasaki. This is the only precedent of any kind for the threatened nuclear confrontation in North Korea, but it should not be taken too seriously; back then, the advent of the atomic bomb meant that the war ended far sooner than expected, while another nuclear attack now would have no such silver lining.

For another example of a much shorter war, this is how the S&P fared during the First Gulf war, from the invasion of Kuwait through to the end of US hostilities.

It should be wholly unsurprising that the market reacted negatively to the news that Kuwait had been invaded, and that western troops were likely to be pulled into a war. The news helped bring stocks, already weak, into a brief but nasty bear market. It is also unsurprising that news that the war was going well was treated positively.

Now, what of wars that do not go well? The fact of winning the second world war, after much bloodshed and destruction, was plainly very positive for the world. If we take a look at Vietnam, by general consent the least successful foreign war for the US to have completed so far, then the picture is different.

Timing the US involvement in Vietnam is difficult. Covert involvement began in 1954, but was on a small scale and was little discussed. US stocks did very well during the Eisenhower years of the late 1950s, but it is hard to see how Vietnam had anything to do with this. The following chart starts with the Tonkin Gulf resolution in 1964, which gave President Lyndon Johnson the power to make a huge build-up in troops, and ends in 1975 when the Americans left Saigon.

Over the course of that dreadful decade for the US, the S&P was almost flat. But this ignores the prime consequence of the attempt to go to war without funding it, which was an inflationary spiral, including even the decision to leave the Bretton Woods link between the gold price and the dollar in 1971. This is how the S&P did in real terms, adjusted for US CPI, during the Vietnam years:

An unsuccessful war, it should be no surprise, is disastrous (among other things, and a long way down the list, for stock markets).

Broadening the discussion, let us look at the most prominent losers of the most prominent wars of the past century. The first world war destroyed the Austro-Hungarian empire. And it did not do much good to Austrian stocks. It took them 97 years to get back to where they had been before the war, according to the annual yearbook of investment returns compiled by Elroy Dimson, Paul Marsh and Mike Staunton. Their summary of Austrian financial history is worth reading:

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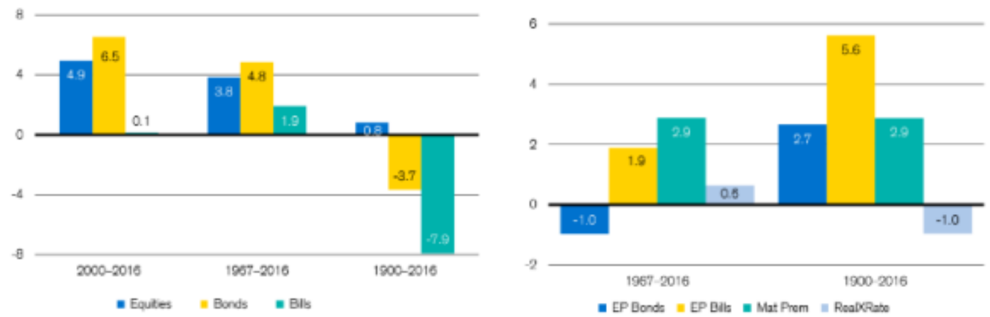
Austria ranks top in the 2015 Family Life Index, an InterNations survey that reports the best places in the world to bring up children. The Economist Intelligence Unit, in a study of 80 countries, reports that Austria is the best country in which to be born today. But what were the origins of the best place to be born?

The Austrian Empire was reformed in the 19th century into Austria-Hungary, which, by 1900, was the second-largest country in Europe. It comprised modern-day Austria, Bosnia-Herzegovina, Croatia, Czech Republic, Hungary, Slovakia, Slovenia, large parts of Romania and Serbia, and small parts of Italy, Montenegro, Poland, and Ukraine. At the end of World War I and the break-up of the Habsburg Empire, the first Austrian republic was established. Although Austria did not pay reparations after World War I, the country suffered hyperinflation during 1921–22. In 1938, Austria was annexed by Germany and ceased to exist as an independent country until after World War II. In 1955, Austria became a self-governing sovereign state again, and was admitted as a member of the European Union in 1995, and of the Eurozone in 1999. Today, Austria is prosperous, enjoying a high per capita GDP.

Bonds were traded on the Wiener Börse from 1771 and shares from 1818 onward. Trading was interrupted by the world wars and, after the stock exchange reopened in 1948, share trading was sluggish and there was not a single IPO in the 1960s or 1970s. The Exchange's activity expanded from the mid-1980s onward, building on Austria's gateway to Eastern Europe. Still, over the last 117 years, real stock-market returns (0.8% per year) have been lower for Austria than for any other country with a continuous record from 1900 to date.

This is the Dimson/ Marsh/Staunton breakdown of Austrian returns since 1900:

Chart 38: Annualized real returns on asset classes (l.h.s.) **and risk premiums** (r.h.s.) **for Austria, 1900–2016 (%)**



Note: Equities denotes the total return, including reinvested dividend income, on the equity market. Bonds denotes the total return, including reinvested coupons, on long-term government bonds. Bills denotes the total return, including income, from Treasury bills. All returns are adjusted for inflation and are expressed as geometric mean returns.

Note: EP Bonds denotes the equity premium relative to long-term government bonds; EP Bills denotes the equity premium relative to Treasury bills; Mat Prem denotes the maturity premium for government bond returns relative to bill returns; and RealXRate denotes the real (inflation-adjusted) change in the exchange rate against the US dollar.

Source: Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists, Princeton University Press, 2002, and subsequent research.

For one final example, let us go to Germany, the most conspicuous loser from the second world war. Few countries can ever have fared so well, at least in economic terms, from losing a war. Here is the Dimson/Marsh/Staunton summary:

In the first half of the 20th century, German equities lost two-thirds of their value in World War I and, during 1922–23, inflation hit 209 billion percent. In World War II and

World War I and, during 1922–23, inflation hit 209 billion percent. In World War II and its immediate aftermath, equities fell by 88% in real terms, while bonds fell by 91%. After World War II, there was a remarkable transformation. In the early stages of its "economic miracle," German equities rose by 4,373% in real terms from 1949 to 1959. Germany rapidly became known as the "locomotive of Europe." Meanwhile, it built a reputation for fiscal and monetary prudence. From 1949 to date, it has had the world's second-lowest inflation rate and its strongest currency (now the euro), and an especially strong bond market.

Once it was over, the second world war turned out to create a great buying opportunity in German stocks. In general, however, few investors should be hoping for a country in which they are investing to lose a war, to create a good new entry point. It is not a healthy way to try to make money. Over the entire period since 1900, according to Dimson/Marsh/Staunton, German stocks have returned an average 3.3 per cent per year, in real terms. Winning wars works out better, as US stocks returned 6.4 per cent. Keeping out of wars comes somewhere in between, with Sweden returning 5.9 per cent and Switzerland returning 4.4 per cent.

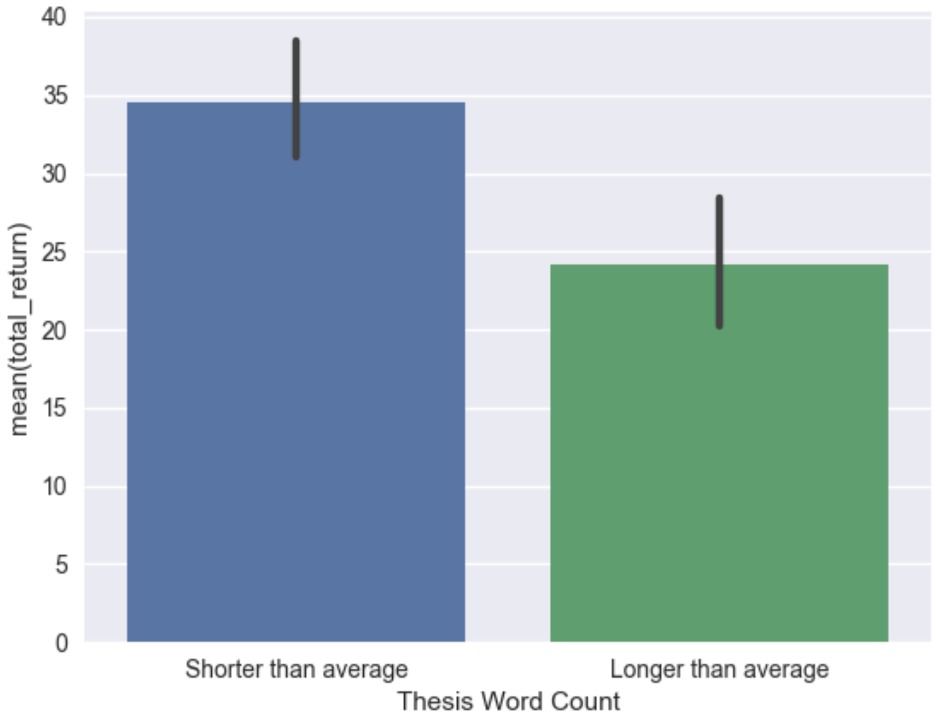
I think the case has been made, but I will return to a final point made in defence of the "war is good for stocks" argument by our commenter Frictionless Splendid Isolation:

Wars have an economic aspect to them, and the US superpower tends to win them. A simple, but effective, trading strategy is to bet at whatever short selling dip occurs at the start of a US war. Easy way to win long-term by betting on the Free World.

I understand this argument. My brief survey shows that the outbreak of a war can create a good entry point. But it is dangerous. The stock market is but one of many reasons why we should all hope that we can avoid a war. Ultimately, as someone said, war is good for absolutely nothing:

Sound of the Suburbs

Brevity is the soul of wit, said Hamlet. Condense your thoughts down into fewer words, and you crystallise your own ideas, organise and focus them. You are far more likely to convince others, and your ideas will in any case probably be better. For evidence, read this fascinating post on SumZero, It crunched through more than 10,000 investment theses that had been submitted to the site over the past decade, and found a clear link between the length of a thesis and its subsequent success. Shorter theses tended to lead to higher returns:



So, brevity is good for you. This ties in with one of the thorniest issues for modern news organisations, which I have already dealt with in my response to Frictionless Splendid Isolation: how should news organisations moderate comment threads? They are a staple of websites now. People expect to be able to interact with us, and to make a point. They can foster great debate, but also run the risk of turning our web pages into a forum for ugly and personal battles. By publishing comments which are factually inaccurate or offensive, or both, we run the risk of legal jeopardy. But the possibility remains that we can foster debate that advances knowledge. We do not want to lose that.

My colleague Lilah Raptopulous wrote a fascinating piece on this earlier this week. Meanwhile, I would like to focus on one of my own current dilemmas. A regular commenter on my columns goes by the online moniker of Sound of the Suburbs (I thoroughly approve), but writes always at inordinate length, in a style that is somewhere between Virginia Woolf and James Joyce. There is obviously something there, but I now find my eyes glazing over every time a Sound of the Suburbs comment appears. Here is an example:

> *The US has fallen into a trap laid by the early neoclassical economists.*
>
> *The cost of living = housing costs + healthcare costs + student loan costs + food + other costs of living*
>
> *The minimum wage must cover the cost of living.*
>
> *I am investing in Asia, US labour is too expensive.*
>
> *What a dump, I am going to have to cover their housing, healthcare and student loan costs in wages. Asian century coming up.*
>
> *The importance of the cost of living was known by Adam Smith and the Classical Economists but not now, what happened?*

They lived in a free trade world with a parasitic aristocracy, it was obvious to them.

The rentiers gains have to be paid by business in wages. The early neoclassical economists hid it at the end of the 19th Century and the beginning of the 20th Century.

The distinction between "earned" income (wealth creation) and "unearned" income (wealth extraction) disappears and the once separate areas of "capital" and "land" are conflated.

The problems with rentier activity in the economy are hidden in economics. These things disappeared so long ago everyone forgot about them, but a free trade world required a low cost of living to pay internationally competitive wages.

"Income inequality is not killing capitalism in the United States, but rent-seekers like the banking and the health-care sectors just might" - Nobel-winning economist Angus Deaton

The brighter economists in the 21st century are starting to realise what was hidden.

(Austrian aristocrats are going to be parasites too, they keep it hidden or are unaware it has been hidden. The Aristocracy are the traditional enemy of productive capitalism, Austrian economics could only ever be a joke).

He takes his moniker from a great late-70s post-punk pop song, which lasts three minutes and 14 seconds. That would be a great example to follow. Keep it brief, and you are more likely to make sense, and more likely to sway others.

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