

Greg Valliere Monthly Commentary

Update as of 9/29/2009



Greg Valliere
Chief Political Strategist
Washington Research Group

GREG VALLIERE: Well, hello, everybody. It's Greg Valliere from the Washington Research Group recording on September 29th, at the end of quite a quarter. A quarter in which optimism finally returned and the market obviously did quite well. So on today's call I'm going to be a killjoy and talk about what might go wrong in the fourth quarter after all of this optimism.

First of all, I think you've got to say that the assumption of a decent economic recovery is fully baked into the market, and I continue to worry that the consumer is not going to spend very robustly, that we'll have a statistically good second half in terms of GDP, with inventory building producing maybe 3% growth in the second half. But the jury is out in the first part of 2010, with consumers still pretty scarred by what's happened with foreclosures, with unemployment producing more anxiety, as the jobless rate in all likelihood goes a bit higher. It's entirely possible that the consumer, who accounts for about two-thirds of the U.S. economy, will move very, very slowly to return to normal shopping habits.

So with that kind of outlook, I guess the good news is that the Fed is prepared to keep the funds rate at zero for maybe another year. There's been new speculation about how aggressively the Fed eventually might take away the punch bowl, but that's still a long, long way off. I think the risks still are that the economy is weaker than we hope for, rather than the economy really blasts off.

But that's not the biggest concern. I continue to feel, as I've said on these calls during the course of this year, that the really big risk is geopolitical. For President Obama, Afghanistan represents a political risk in his own party. The growing anxiety on the left over committing more troops has presented Obama with his first big challenge politically. And, intriguingly, he's got some growing uneasiness with people on the right wing, with people like George Will arguing that Afghanistan is really not worth fighting for, that we can do much of our work against the Taliban through drones, these airplanes that are unmanned, can spot encampments of the Taliban and take them out. On both the right and left, there seems to be a feeling that Obama has not perhaps pursued the right policy, and I think this is going to be a real albatross for him as we get into late 2009.

The big story, though, the one that really concerns me, and I think eventually will begin to concern the markets, involves Iran. And many of you have heard me say for the last couple of

years that the Iranian nuclear facilities represent the greatest threat to the world, and I continue to believe that. I mean, obviously, some rogue domestic terrorist could commit some horrible act, and you can't dismiss how barbaric the Taliban and Al Qaeda are, but I think the one story that is going to start getting people's attention, obviously, is what's going on with Iran. My conclusion is a depressing one, and that, of course, is that eventually the Israelis are going to have to act on their own, and it could be a very messy process taking out these Iranian nuclear facilities. I would point to four developments over the last week or so that will probably convince the Israelis that they're going to have to act on their own.

The first development is, of course, the decision by the U.S. to toughen sanctions. Well, I know sanctions sound tough, and the U.S. is now talking about perhaps going after the insurance companies and reinsurance companies that underwrite the shipments of Iranian goods around the world. But you've got to ask the question: Do sanctions really work against dictatorial governments? They haven't worked against Fidel Castro. They haven't worked against Kim Jong-Il. If anything, sanctions provoke those despots. And I think you've got to also say that sanctions perhaps will make life more miserable for ordinary citizens in Iran, but the prospect of an uprising against the Ayatollahs, in my opinion, has no better than a 20% chance of succeeding. The Revolutionary Guards and all these goons have the guns, and the students and the dissidents don't. And I think that, unfortunately, the repression will succeed in Iran.

A second factor that has to be weighing on the Israelis is that two of the key players in winning United Nations support for sanctions, Russia and China, seem to be wavering. Maybe we'll get Russia to go along with some modest sanctions because of our decision to abandon missile defense in central Europe, which undoubtedly pleased Putin and Medvedev. But the Chinese, who have extensive business dealings with the Iranians, I think, are not inclined to go along with any kind of tough sanctions. And, again, I think you've got to ask the question, even if the U.N. agrees to sanctions, does anyone seriously believe that sanctions would dissuade Iran from its nuclear ambitions?

A third factor that I think the Israelis have to be looking at is that rather than any sign of conciliation, the Iranians are ratcheting up the tensions. As I record this, right after the very solemn Jewish holiday, we've had 48 hours of Iranian missile testing, and the Iranian defense minister said, in what I thought was a shockingly provocative statement, that they're getting ready to destroy Israel. I would like to think that perhaps this coming Thursday when they meet in Geneva, the U.S., the Iranians, and some other countries, that maybe something constructive could come out of that meeting, but I sure wouldn't bet on it.

And then, finally, I think maybe the most important factor of all is that the U.S. Defense Secretary, Robert Gates, has indicated both publicly and privately that the U.S. is not inclined to strike Iran, and there have been similar remarks from people in the Obama Administration. And that leads me to conclude one of three things: either, one, the U.S. is sincerely convinced that such strikes would be futile, that the Iranians would just rearm, or that it could lead to a much bigger war. Or, number two, the U.S. is simply trying to distance ourselves from an inevitable Israeli strike, saying, in effect, you know, 'We don't want to have our fingerprints on

it.' Or, third, maybe the U.S. is simply encouraging the Israelis to go it alone, saying, in effect, 'You guys do it.'

There's little doubt in my mind that the Israelis are prepared to move. There have been leaks in many newspapers in the last couple of years. The most impressive leak came over this past weekend in *The Wall Street Journal Weekend Edition*. If you didn't see it, I highly recommend it. It was written by Anthony Cordesman, who is among the leading military strategists in America, and I know he talks to the Israelis all the time. You know, he listed in great detail what the Israelis are planning to do. That would include midair refueling of the F-15s and F-16s, and the use of very sophisticated bunker-busting bombs. Cordesman points out there are challenges. It's not easy. It certainly isn't like what Israel has done in the past, which was pretty neat and clean. But the plans are, I think, in place, and I do feel there's a growing chance the Israelis will have to act by winter.

Well, finally, what would happen if the Israelis strike? I think these strikes would last for several days, and I think they would prompt a ferocious retaliation from the Iranians. Ahmadinejad has promised to place mines in the Persian Gulf and in the Strait of Hormuz. Obviously, the price of oil would rise dramatically. Ahmadinejad has vowed to launch terror squadrons around the world, and, sadly, I take him seriously. And he's got a huge supply of missiles that have the range to hit Tel Aviv and other cities, as the Iranians demonstrated just a couple of days ago. You know, whether those missiles could penetrate Israeli air defenses is unknown. I think in a brief but very ugly war like this most countries, including the U.S., would publicly condemn the Israelis, but in private, I think most countries, maybe even including Saudi Arabia, would welcome an attempt to halt Iran's drive for hegemony throughout the Middle East.

I think there are some positives that could arise from this, from destroying the Iranian nuclear capacity, and maybe putting them in their place. But I think the potential negatives are immense, because Iran and the Ayatollahs in Iran and many of the fanatics in that part of the world do have a suicide mentality, and no one could be certain of what types of unconventional weapons they may have.

So on that somber note, again, I hate to be a killjoy after a very nice quarter, I think that we have to worry more about geopolitics. And as the year comes to a close, my fear is that this story, the Iranian story, will be a dominant one hanging over all of us.

That's it for this month. I look forward to talking to you again soon.

This commentary occurs monthly. The information provided through the Greg Valliere commentary is for general informational purposes only and represents the views of the speaker, but may not represent the views of Schwab, its affiliates, or any of their employees or officers. Nothing in this commentary should be considered as a solicitation or a recommendation by Schwab to buy, sell or continue to hold securities or other investments, or open an account. The information in the presentation is from what is considered a reliable source; however Schwab does not guarantee the accuracy, completeness or reliability of the information. Some of the statements

in this presentation may be forward looking and contain uncertainties. There can be no guarantee of future performance. Changes in economic or market conditions as well as other factors may affect the relevance of the views and opinions expressed.

(1009-11181)