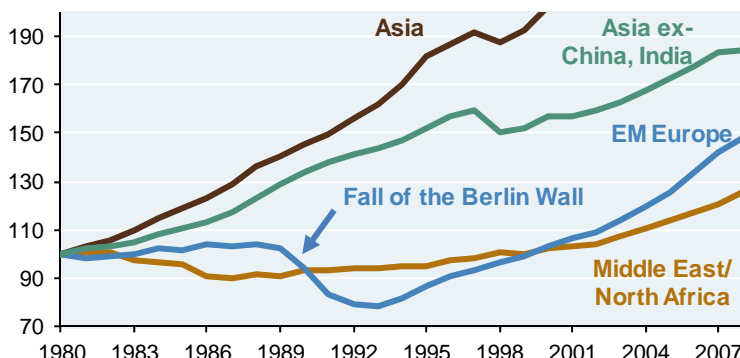


Topics: Events in the Middle East

One of the most frequent questions I have been asked over the last decade goes something like this: “*How do I manage around geopolitical risks in my portfolio?*” Before 2001, this question was not asked very much. The 1990’s were an oasis of geopolitical calm, following the collapse of the Berlin Wall and a decline in US military spending to its lowest level since the 1930’s¹. By the end of the 1990’s, Francis Fukuyama’s “*End of History*” was all the rage, proclaiming the triumph of liberal democracies, and with them, free markets, rule of law and separation of powers. Like the 1930’s however, the calm of the 1990’s was temporary, after which a variety of historical forces re-emerged with a vengeance.

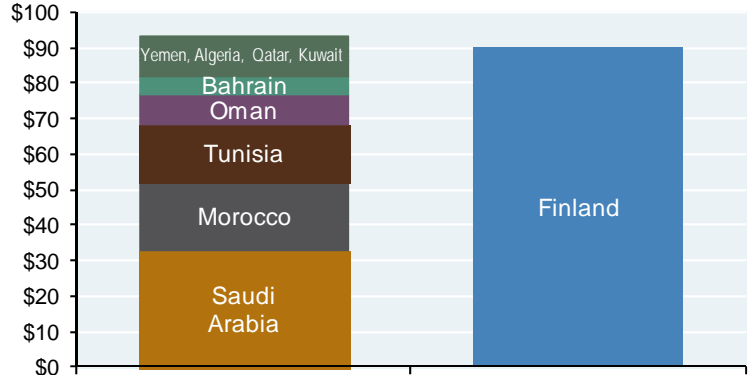
A couple of years ago, I spent time with **Princeton’s Bernard Lewis** to discuss his views on the Middle East. One of the more revealing comments he made at the time: we should plan for a lot more instability in the region, since most of its countries are not sufficiently converting oil wealth into jobs, growth and progress. As one indication of this, he claimed that the energy exporting countries have made little progress in growing non-energy exports², and were in aggregate lower than Finland, a country with 5% of the Middle East’s population and which is located at the outer edges of the Arctic Circle. Broadly speaking, he’s right. As shown below, per capita GDP in the Middle East/North Africa (MENA) only recently began to grow after 20 years of stagnation, while other parts of the world are making faster progress, particularly after the fall of Communism in Eastern Europe. Regarding the non-energy sector, much of the Middle East is still an *Infertile Crescent*; energy-exporting countries do in fact trail Finland. Both of these developments are part of the macroeconomic backdrop in which unemployment is high, economic dynamism and labor mobility are low, and intense subliminal frustrations lay just below the surface.

MENA per capita GDP: Trailing the field
Index, 1980=100



Source: "Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD", Angus Maddison, University of Groningen.

Exports excluding energy: MENA vs. Finland
Billions, USD



Source: International Trade Centre, 2008.

Bernard Lewis (born 1916) is the Cleveland E. Dodge Professor Emeritus of Near Eastern Studies at Princeton University. He is widely acclaimed as one of the most influential postwar historians of Islam and the Middle East, and was the source of the phrase “Clash of Civilizations” used by Samuel Huntington in his 1993 essay. Professor Lewis obtained his Ph.D. from the University of London, specializing in medieval Islamic history and also contemporary Middle Eastern affairs.

There are a lot of things in flux right now, and it’s hard to predict how they will turn out. In some ways, Egypt is the least worrisome, with former Mubarak Foreign Minister Amr Moussa emerging as a potential compromise candidate. Bahrain is more worrisome, as there is increasing pressure on the monarchy from the Shi’ite majority, while the Saudis appear inclined to support the Sunni monarchy (Bahrain is the base of the US 5th fleet). Libya looks like it will fall into a cauldron of Civil War, with Khaddafi threatening to sabotage the country’s oil facilities. France appears to be backing the regime in Algeria, but the situation is highly uncertain, given the country’s history of internal factionalism and violence. Yemen is a volatile mix of highly armed tribes with ties to a variety of potentially destabilizing forces. As for Saudi Arabia, the generational challenges of the ruling family are well known; how they will play out in the context for demands for more political and social freedoms, less so. A Facebook page is calling for a Saudi “day of rage” in mid March. Meanwhile, the Saudi government announced large increases in domestic spending, with King Abdullah doubling the budget of a development fund that helps Saudis buy homes and start businesses. In addition, government workers will receive a 15 percent cost of living adjustment, and youth unemployment assistance was extended.

¹ As highlighted in a recent note from the Council on Foreign Relations, the decline in US military spending as a % of GDP from 1985 to 2000 was mostly a function of military spending being held constant while GDP grew.

² Countries include Algeria, Bahrain, Egypt, Kuwait, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, Yemen and the United Arab Emirates. The UAE is excluded from the bar chart, for reasons related to large discrepancies in its reported export data. To be clear, the **UAE has made the most progress in the region** on diversification of its economy away from energy-related production and exports.

Topics: Events in the Middle East

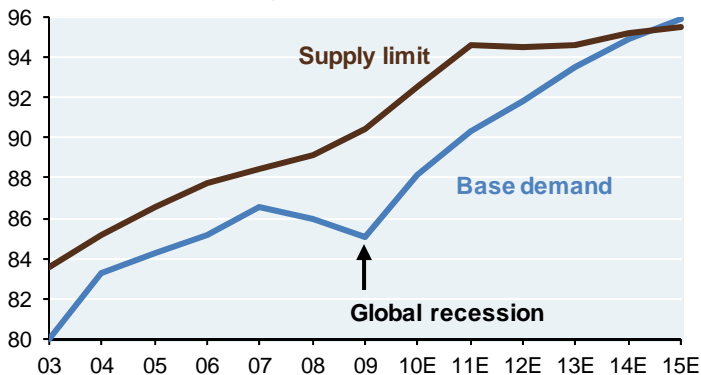
Energy risks

We are not ruling out much higher oil prices over the next 2-3 years as a consequence of sovereign risks, depletion of older fields, higher marginal costs, growing demand and gradually dwindling new finds. A few points on near-term risks:

- According to press reports, Libya's Nafoora oil field stopped producing because of an employee strike. Reuters reports that Shell stopped operations in Libya while Total, Statoil and Wintershall are suspending operations and are in the process of evacuating international staff. The country's biggest oil producer, Eni said production is continuing, although some reports indicate it is evacuating non-essential staff and family members of employees.
- Libya and Algeria oil exports each represent roughly 1/3 of current spare capacity, estimated at around 5.2 mm barrels per day. The Saudis are assumed to be willing and able to provide whatever supplies are needed to offset shortfalls due to disruptions elsewhere. But it is not clear at what price level the Saudis would be willing to do this. If Libya and Algeria shut down temporarily, that could reduce global spare capacity to 2 mm barrels per day, a level similar to the 1990-1991 Gulf War, when oil prices rose 140%.
- The recession temporarily put concerns about oil scarcity on the back burner. But as shown in the chart below, spare capacity is now estimated by Macquarie Research to fall back to around 2 mm barrels per day by 2012, even before the current turmoil in the region. These projections leave little margin for geopolitical problems, and are consistent with the period of 2003-2006 when oil prices were rising sharply.
- Asia is highly energy-dependent, particularly Japan, Korea, Singapore, Thailand and the Philippines, whose net energy imports are 40%-80% or more of total energy use.
- The good news: OECD stockpiles are at the high end of where they've been over the past 4 years, and can be released to deal with short-term supply disruptions. The IEA claims to have around 90 days worth of demand cover; the last major draw was after Hurricane Katrina. Unfortunately, according to JPMS, the emerging world's demand is driven by diesel, not US crude, so the current configuration of OECD oil stocks is not ideal for them. This is why China continues to grow its own strategic stocks; their crude imports were 1 million bpd above trend in Sep-10 and Jan-11.

Oil supply and demand dynamics

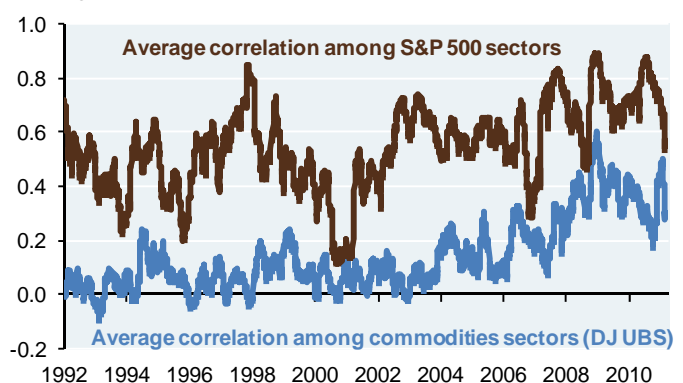
Millions of barrels per day



Source: Macquarie Capital.

Commodity sectors generally less correlated than equities

Average correlation



Source: Bloomberg, J.P. Morgan Private Bank.

Dealing with geopolitical risks in portfolios over the last decade

There was a time when the kind of parallel growth now taking place in the US, China and Germany would have suggested a portfolio on Autopilot, with equity exposures as high as investment mandates and risk tolerance would allow. But in this brave new world of competing ideologies, natural resource scarcities and historical grievances, it's not that simple. We are generally running with less outright equity exposure than we did in prior decades and with more allocated to hedge funds, which with the notable exception of 2008, have done a good job in our portfolios generating returns per unit of risk they take.

And of course, having commodity exposure has paid off handsomely over the last decade, with commodities³ substantially outperforming equities. The idea is not that one should own commodities *instead* of equities, but *in addition* to them, where appropriate. To obtain commodity exposure, we use a wide variety of means: spot, forward and option transactions; commodity-linked notes, some of which include partial principal protection; bonds issued by commodity countries and companies; commodity stocks and mutual funds; and actively managed hedge funds. As shown above, the correlation amongst different commodities is considerably lower than for S&P sectors, leaving substantial opportunity for active management to add value. So far, our early experiences with active commodity management have been positive.

³ This is true for commodity returns whether measured by the Commodity Research Bureau, or indices computed by S&P and Dow Jones.

Topics: Events in the Middle East

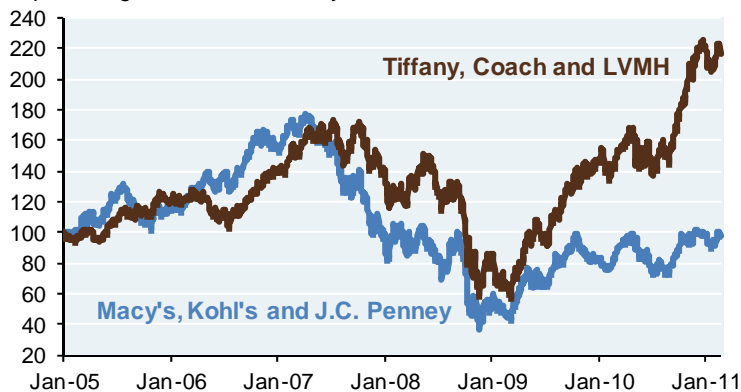
Developments in the Middle East coincide with visible improvements in the US economy

The outlook for profits, employment, capital and consumer spending, home sales and bank lending continue to improve. How serious a dent might \$100+ oil put in the recovery? A lot depends on what happens to U.S. interest rates. A “free money” policy (when short term interest rates are below the rate of inflation) can offset a lot of pain from higher oil prices. But how long should the Fed continue with this approach? It is already being blamed for setting in motion a regressive chain of events which raise both financial asset and commodity prices, eventually reaching the life of a street vendor in Tunisia⁴. The first chart below compares the stock prices of Kohl’s, JC Penney and Macy’s to Tiffany’s, Coach and LVMH. As a crude progress report on US monetary stimulus; it is a complicated picture. Employment needs to show up faster than inflation does.

The prior *Eye on the Market* scanned for inflationary pressures around the world, and found a few⁵. Most commentary we read suggests that since core inflation and wages are not rising, the coast is clear. Perhaps. I’ve included a chart of what inflation and wages were doing in 1993, at the onset of the Fed’s major monetary tightening campaign. If this is what you were looking at back then, you were blindsided pretty badly. Currently, Fed Funds futures markets are pricing in the probability that the Fed does not raise rates this year and only raises them to 1.5% by December 2012. We think there’s a risk it will sneak up on the Fed more quickly than this, and have prepared portfolios for a rockier ride than 2009 or 2010.

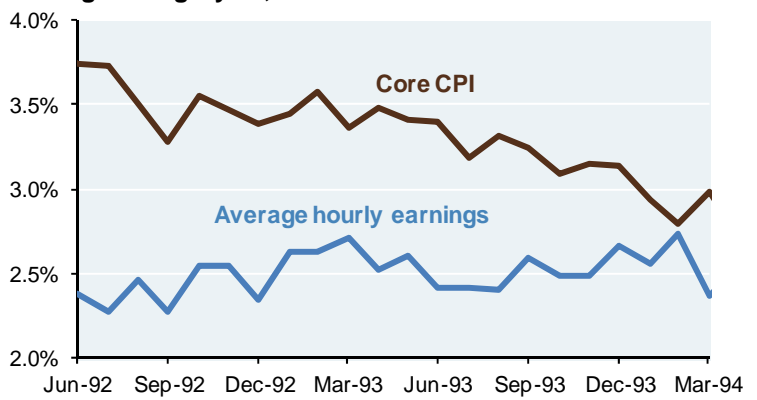
US monetary policy report card

Equal-weighted index, January 2005 = 100



Source: Bloomberg.

Average hourly earnings and core CPI leading up to 1994 Fed tightening cycle, Percent - YoY



Source: Bureau of Labor Statistics.

Michael Cembalest
Chief Investment Officer

More from Bernard Lewis. When I pushed Bernard for optimism regarding the political process in the Middle East, he offered this. Before WWII, many countries in the Middle East enjoyed more tolerant and open-minded governments. During the Vichy period of the Second World War and during the subsequent Cold War, Germany and Russia successively exported their own forms of dictatorship into the region. So it is not inconceivable that over time, regimes based on greater direct representation re-emerge in the region. This would not be unprecedented; transitions of post-war Japan and Germany are two remarkable examples which took place over years rather than decades. In recent notes, we have also highlighted Indonesia, which after decades of clan-based leadership, pursued constitutional reforms in 1999 which led to the first freely elected national, provincial, and regional parliaments in forty years.

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⁴ In good company with the Fed as contributors to higher food prices: zero rate policies of many developing economy central banks; abnormally terrible weather (see EoTM January 24, 2011); biofuel policies; financial flows into agricultural commodities.

⁵ In Europe, recent readings for manufacturing and service sector input and output prices are at their highest levels in a decade.