

MLC Viewpoint

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Middle East Update The Winds of Change



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At a time when most market and media attention alike is firmly fixated on the terrible aftermath of the Japanese earthquake and tsunami and the ongoing nuclear reactor drama there, events in the Middle East are continuing to evolve with potentially a much greater medium term impact for the global economy.

The UN Security Council has affirmed, by a 10-0 vote (with 5 abstentions), a resolution allowing “all necessary measures” by member states, short of a commitment of troops on the ground, to protect Libyan citizens from attack by the Gaddafi Government. We have witnessed days of missile strikes on Libyan government assets. This has been justified on humanitarian grounds, although a likely significant “behind the scenes” rationale for this action is to assist rebel forces in the removal of a regime deeply unpopular in the West.

At the same time, events in Bahrain have heated up with the influx of security forces from neighbouring states (namely Saudi Arabia) aimed at preventing a popular uprising by the majority Shia citizens overthrowing the reigning al-Khalifa monarchy. Opposition party leaders have been arrested and the civilian death toll has escalated with the rising tensions.

Whatever comments might come to mind regarding the possible contradiction inherent in the differing Western response to these parallel events, it is clear that there are winds of change blowing strongly in the Middle East at present. Is it a genuine desire for democracy and greater freedom of speech, as suggested in many media reports, or simply a demand for the basics of humanity – employment, food, education - driving popular uprisings in Tunisia, Egypt, Libya, Bahrain and many

other countries in the Middle East - North African (MENA) region?

Whatever the underlying rationale, these winds are blowing cold enough to create a shiver for Western governments – at the heart of the concern lies oil. What makes the recent developments in Libya and Bahrain (as opposed to Egypt and Tunisia) more significant for the West is the significance of these countries to the flow of oil. Prior to the outbreak of civil war Libya was producing around 1.6 million barrels per day of oil, of which around 1 million bpd was being exported primarily to the European market. That makes it a moderate oil producer in the region. Bahrain on the other hand, is a relatively small oil exporter (40,000 bpd) having tapped out much of its reserves in the past few decades. However, it does have substantial gas reserves.

Of much greater strategic significance however, is Bahrain's close alliance with its neighbour Saudi Arabia. They are separated by only a 25km road link, the King Fahd Causeway, named after the previous Saudi King. This is the same causeway over which columns of armoured vehicles have passed into Bahrain in recent days in support of the royal family. The closeness of the two countries, geographically, strategically and demographically, makes the current strife in Bahrain particularly worrying for the West.

Like Bahrain, Saudi Arabia also has a Sunni ruling class sitting over a



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significant Shia population. Amongst this Shia underclass exist similar problems of high unemployment and political disenfranchisement as seen in Bahrain. However, unlike Bahrain, Saudi Arabia is the largest oil producer in the world at around 9 million bpd. It literally floats on a sea of oil with 20% of the world's proven reserves. At its current rate of production it still has a further 80 years before its known reserves would be exhausted.

That makes Saudi Arabia economically and strategically vital to the West. And, as a result, what happens in Bahrain potentially represents the "thin end of the wedge". If the Bahraini ruling family were to be toppled by a popular uprising then what might stop the Saudis experiencing a similar fate? Not surprisingly in the face of this turmoil, oil prices have surged over recent months as events have unfolded. The benchmark Brent oil price has risen 36% from US\$ 85 bbl (per barrel) at the end of November 2010 to US\$ 116 bbl as of 18 March 2011.

The actual disturbance in the supply of oil to the West has been moderate thus far – it is true that Libyan oil production and exports have been significantly hit by the civil war but other OPEC states have sought to compensate by boosting their own production. However, the rise in the price of oil

has as much to do with the potential threat to global supplies if Middle Eastern instability were to extend to Saudi Arabia. At 9 million bpd, Saudi output represents approximately half of the daily consumption needs of the US or about the total oil demand of China. Any actual disturbance to Saudi oil supplies or even an increased threat to them could send oil prices sky high.

The magnitude of the rise in oil prices thus far, if maintained long enough, could modestly undermine global GDP growth in 2011 and would temporarily boost inflation measures. It would be unlikely however, to undermine the global recovery currently underway. The modest correction in global equity markets over recent weeks suggests that investors have already moved to price in this environment to some extent – the relative underperformance of Asian equity markets reflecting the greater oil sensitivity of many economies within the region.

However, a worst case outcome which saw oil prices rise a further 40-50% would have a significant and depressing effect on global growth if sustained for any length of time. This scenario would likely have a very negative effect on global equity markets with higher investor risk aversion and lower earnings expectations undermining expected returns. Overall, this

seems a less likely scenario, but it is not one that can be truly discounted given the twists and turns of Middle Eastern politics.

However, equally we should not discount a more benign scenario which sees these winds of change blow themselves out over coming months as tensions ease naturally. What the rise in oil prices in recent months has done to strip investor confidence could easily be handed back in a scenario of oil prices reverting to \$80-85 bbl on easing tensions in the region.

The sheer unpredictability of the events in the Middle East and Japan in recent months highlights the importance of investors maintaining well diversified portfolios that aim to reduce not just the possible impact of forecastable risks on their returns but also those risks that by their nature are completely random or unexpected.

In the MLC Horizon 4 Balanced Portfolio (within Superannuation and Pension), exposure to the Energy sector within the equity portion of the portfolio as at 31 December 2010 was 2.65% through global equities, and 2.10% through Australian equities. Both of these exposures are slightly below their relevant benchmarks.

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