

The Global Impact of Unrest in the Middle East

SOCIAL AND POLITICAL UNREST ACROSS THE MIDDLE EAST and North Africa has amplified uncertainty in global markets and set a new obstacle for the continuing global recovery in the form of sharply higher oil prices. In a roundtable discussion, portfolio managers and analysts from across the firm offered their perspectives on the short- and long-term consequences of the recent turmoil and resulting market volatility. Speakers included Equity Portfolio Manager Vera Trojan; Fixed Income Portfolio Managers Julian Dwek, Anthony Small, and Jim Valone; Global Industry Analyst Jay Bhutani; and Macroanalyst Robert Scherfke.

Q: How is unrest in the Middle East affecting investment opportunities in the region?

Trojan: In the short term, we are seeing an impact on stock performance in emerging markets that reflects the ties that different countries and companies have to the areas in turmoil. Some construction companies in Turkey, for example, are meaningfully exposed to the Middle East, and thus are seeing a decline in their stock prices. The effects of political unrest go beyond regional and developed/developing market boundaries, however, and so companies in places like South Korea and India that have established businesses in the region over many years are experiencing the negative effects of political

instability. Quite plainly, if a company's business contracts were signed with a government that gets replaced, that could easily lead to contract renegotiations, delays, and lost business.

Q: Specifically in terms of Egypt, what is your perspective on the effects of the change in government?

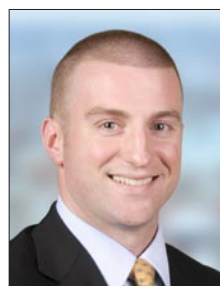
Trojan: In Egypt itself, our view is constructive. From what we've seen so far, the Egyptian military has made a commitment to follow a timetable in preparing for elections, and that appears to be unfolding as well as could be expected. A new cabinet has been appointed. What's more, banks are open for business. One of the largest Egyptian banks reported to



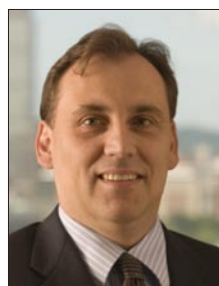
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us that there was no flight of capital during the turmoil. In fact, after the first couple of days, banks experienced a net inflow of deposits — a positive sign of confidence that tells us there was not wholesale panic among the population. Of course, it's not clear that other governments in the Middle East would have as orderly a transition, should they fall. Each country must be evaluated on its own merits as events unfold. Also, even in Egypt the economic impact of transition will be negative in the short term, with higher fiscal deficits and lower tourism and investment. Longer term, it matters very much whether and how a country like Egypt actually transitions to a more open system. If it does, then I think it will be good for growth in that country, and could potentially lead to new business formation and more integration and growth in the region as a whole.

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— Vera Trojan, Equity Portfolio Manager

Valone: From my perspective as an emerging market debt investor, I agree that it is difficult to generalize about the outlook for the region as a whole, as each country faces a very specific set of circumstances and because we expect it will take several years for the current political uncertainty to be resolved. However, I do believe that, over the near term, political turmoil in the Middle East will act as a drag on economic growth in the region, as tourism and investment spending are negatively affected by the uncertainty. Governments in many countries are likely to follow the recent examples of Saudi Arabia and Bahrain and attempt to address the concerns of their populations by increasing wages, subsidies, and public sector employment. This increase in government spending will likely cause debt levels to rise and credit fundamentals to deteriorate in these countries.

However, the Middle East and North Africa represent a very small part of the broader market for emerging market debt, and many other emerging market countries do not share the same combination of undemocratic governments presiding over economies that suffer from high levels of unemployment, rising inflation, and pervasive corruption. The broader market may demand higher risk premiums as compensation for elevated political uncertainty, though.

Q: How susceptible are developed markets to events in the Middle East?

Valone: As we have seen, the political uncertainty has destabilized energy markets and sent the price of oil higher. We believe the threat of disruption to energy production in the region, which accounts for one-third of global crude oil supply, will continue to exert pressure on energy prices. This could impede global growth and exacerbate inflationary concerns in emerging markets.

Trojan: Rising oil prices affect developed countries more than they do emerging market countries, as the former are far bigger consumers of energy on a per capita basis. Among developing countries, industrialized economies are the most vulnerable, particularly those with no energy resources of their own, such as South Korea. Also, many developing country governments, such as India, subsidize energy costs and hence higher oil prices will lead to higher budget deficits.

Small: In terms of the impact of recent events on Europe, it's a telling fact that the Middle East has been a more important export destination for Germany than China. Therefore, prolonged uncertainty in the Middle East could have a dramatic impact on Germany's ability to continue to drive the economic recovery in the eurozone. The ramifications of energy price inflation, furthermore, may be that interest rates across the entire eurozone are pushed higher, making the funding pressures for countries facing financing challenges like Ireland, Greece, Portugal, and Spain more problematic.

Scherfke: I would add that consumers around the world are at risk. Before we had an oil price spike, we had steeply rising agricultural commodity prices. On both sides of the developed/developing world divide, large populations of the poor were already struggling as a result of higher food prices, and so the layering on of additional inflationary pressure from energy markets will take its toll on consumers virtually everywhere. Rising commodity prices are often taken as a symptom of a stronger growth environment, but this time around they threaten to destroy some measure of global growth momentum.

Q: What do you expect in terms of the global policy response to the inflationary impact of rising oil prices?

Small: In Europe, there will be increasing pressure to raise rates. As an inflation-targeting entity, the European Central Bank (ECB) has been willing to hike rates in the past — as it did in 2008 before the collapse of Lehman. The ECB has a single needle in its compass — to keep inflation anchored — and if that needle drifts off course, the ECB will likely act, despite continued sovereign credit concerns in Europe.

In the US, the rise in the oil price will likely embolden the Fed's regional governors to push for a tightening of monetary policy and higher interest rates. Foreign exchange markets seem to have assumed thus far that the Fed will keep policy loose while other central banks will tighten, but I'm not sure how long this can be sustained if higher oil prices increase domestic inflationary pressures in the US.

Trojan: Across the emerging markets, elevated oil prices will complicate the battle against inflation. Governments will fight it with their own pocketbooks — with food and fuel subsidies, for example, but also by asking refiners to exercise caution in how they price their products. The battle against inflation will therefore be fought through fiscal measures as well as by individual companies in critical product areas like energy and agriculture. In places like Russia, by contrast, the situation represents a positive condition given their prominence in the global energy markets.

Q: Jay, as the global industry analyst covering the oil sector, what are your thoughts on energy disruptions — both in the short and long term?

Bhutani: Disruptions of oil and gas could get worse if chaos widens. In Libya alone, the oil and gas fields are geographically scattered and under the control of different clans, and export routes from these fields could fall into the hands of competing factions. Other flash points we've seen include Bahrain, which is strategically important to Saudi Arabia. With the spread of political unrest, we are on the edge of a world in which fundamentals do not matter, and where market technicals dominate the direction of the oil price.

Thinking longer term, political upheaval and regime change in the Middle East could cause a paradigmatic shift in the way energy resources are priced and supplied on a global basis. The defining aspect of the post-World War II oil market has been that the Gulf States have promised to supply ample amounts of oil

to the West at reasonable prices, in return for assurance of their security. Over time, the Gulf States have taken more and more control of their resources, and the definition of a reasonable price has risen, but the quid pro quo remains the same. This is a tenet of US energy supply security, and has occasionally been punctuated by the need to go to war in the Gulf to protect it. It is possible that this very basic tenet of supply security is now at an end. Therefore, it is worth considering what the right price of oil is in a world where supply security is not assured and where the presence of surplus oil capacity in the Middle East is not a given. Supply security in the future may have to be assured by diversification, both in the variety of energy sources used (i.e., oil, gas, coal, and nuclear) and geographically, where Western nations will need to forge new alliances with diverse energy suppliers who could become more reliable energy exporters.

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— Jim Valone, Fixed Income Portfolio Manager

Q: What are the other potential implications for the global capital markets?

Dwek: The strongest conclusion I reach is that Middle Eastern government savings rates will fall, and the cost of capital will go up globally as a result. Traditionally, Middle Eastern governments saved a very large share of their oil revenues. It's hard to see a scenario where this process doesn't slow, or even reverse. Going forward, I expect most Middle Eastern governments will spend their reserves on domestic spending (Saudi Arabia?), arms (Libya?), or both. Even a peaceful transition to democracy (Egypt?) implies much more political competition, more redistributive fiscal policies, and therefore much lower government saving.

Reserve accumulation by countries in the Middle East has been a key element of the “global savings glut” that has kept real yields low. If this reserve depletion is large enough, the cost of capital could go up for everyone, from other emerging market countries to US corporations.

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— Jay Bhutani, Global Industry Analyst

Q: How are you positioning your portfolios in light of the turmoil?

Valone: In fixed income portfolios, we have been careful not to alter portfolio positioning based on headlines, but the increase in political risk has prompted us to adopt a more cautious outlook for the Middle East and North Africa, and we are positioned more defensively in the region as a result.

Trojan: In terms of emerging market equities, we are carefully assessing the risk profile of individual companies based on their exposure to the region, and the potential impact of turmoil on their business. I would hasten to add that a clear outlook for the Middle East and North African region is difficult to articulate, given how much depends on the types of regimes that come into power and the degree to which energy resources continue to flow to the rest of the world. There are positive signs, like those mentioned in connection with Egypt, but uncertainty for now — and possibly for some time to come — will continue to put pressure on stocks connected to the region, keeping volatility high.

Jay Bhutani is responsible for managing global natural resource portfolios for institutional investors, and is based in Wellington Management’s Singapore office. He is also a global industry analyst, conducting fundamental research on the energy sector.

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