

Unrest in the Middle East and North Africa Leads to Volatile Oil Price: Factors Impacting Investment Strategy

by James Spencer, Senior VP/Chief Investment Officer
Ryan Hanna, VP/Investment Officer

March 2011

During the past few weeks a wave of protests among Islamic peoples has spread across the Middle East and North Africa, most recently toppling the governments of Tunisia and Egypt. This area is home to the major OPEC oil producers, including Libya, where retaliation by its ruler Colonel Muammar el-Qaddafi pushed the price of West Texas intermediate oil over \$100 per barrel on February 24 and the S&P500 Index down nearly 2% for that week. The unrest has spread quickly, unnerving both politicians and investors as its turbulence has engulfed more countries such as Yemen, Iraq, Algeria, and Bahrain. The outcome is uncertain and rests uncomfortably on any number of unknowns, including the stability of Saudi Arabia and any policy response from interested parties such as the U.S., Iran and Israel. In the short-term, oil prices are likely to remain above their average of about \$75 per barrel since 2005. It is fair to say, as did BCA Research in a Special Report dated February 24, 2011: “Nobody saw this coming...”

Call it humility or common sense, but we find little basis for believing that one can predict with any degree of confidence oil prices or the ultimate governing policies of each of these countries. However, an investment strategy should make a determination

of the likely direction of these events and the consequences of a further significant move in the price of oil – in either direction. The following factors should play a role in this analysis:

1. The twelve OPEC countries produce nearly 40% of the 88.0 million barrels per day (mbpd) of oil consumed globally. OPEC countries have approximately 5.0 mbpd of spare capacity; Saudi Arabia controls two-thirds of all OPEC spare capacity. Though Russia and the U.S. produce slightly more oil than Saudi Arabia, non-OPEC countries have virtually no spare capacity at the present time (Energy Information Administration: Short-Term Energy Outlook, February 8, 2011).

As a result of the ongoing battle with its people, Libya’s production has been reduced by nearly 1.0 mbpd to about 0.5 mbpd. Saudi Arabia has indicated its willingness to make up this difference, further reducing its spare capacity. (The vast majority of Libyan oil is exported to Europe, principally Italy.) Adding to the challenge, as of February 10, 2011, the International Energy Agency was projecting a 1.5 mbpd increase in global oil demand in 2011, on top of a 2.8 mbpd gain in 2010.

Unrest in the Middle East and North Africa Leads to Volatile Oil Price: Factors Impacting Investment Strategy *Continued*

Countries such as Iraq and Brazil have promising opportunities to expand oil production over the next ten years. However, these opportunities in Iraq are dependent on the maintenance of political stability, in order to attract and retain foreign investment. In Brazil, expansion of production depends on success at drilling in a very deep and difficult offshore environment. Venezuela, an OPEC member and eighth-largest global oil producer, produces just over 2.0 mbpd and has been increasing its outstanding debt at a dangerous rate in support of social programs. Another OPEC producer of similar size, Nigeria, will hold elections on April 9. According to Barclays Capital, “previous Nigerian elections have been accompanied by considerable violence, particularly in the oil region” (Barclays Capital; Energy Flash, Libya and beyond: the escalating risks, March 1, 2011).

The U.S. government lifted the ban on Gulf of Mexico drilling at over 500 feet in October 2010. However, it took until February 28, 2011 to issue the first permit, as regulators have been reviewing new spillage containment systems. Improved technology for enhancing the production of U.S. natural gas should allow this energy source to increase its penetration of non-transportation fuel markets. New technology is also reinvigorating U.S. production in certain oil formations in states such as North Dakota. Furthermore, all 28

countries comprising the International Energy Agency are supposed to maintain a strategic oil reserve amounting to 90 days of the prior year’s net imports. (Bank of America Merrill Lynch: Oil shock economics 101, February 24, 2011)



Source: *New York Times*, February 24, 2011

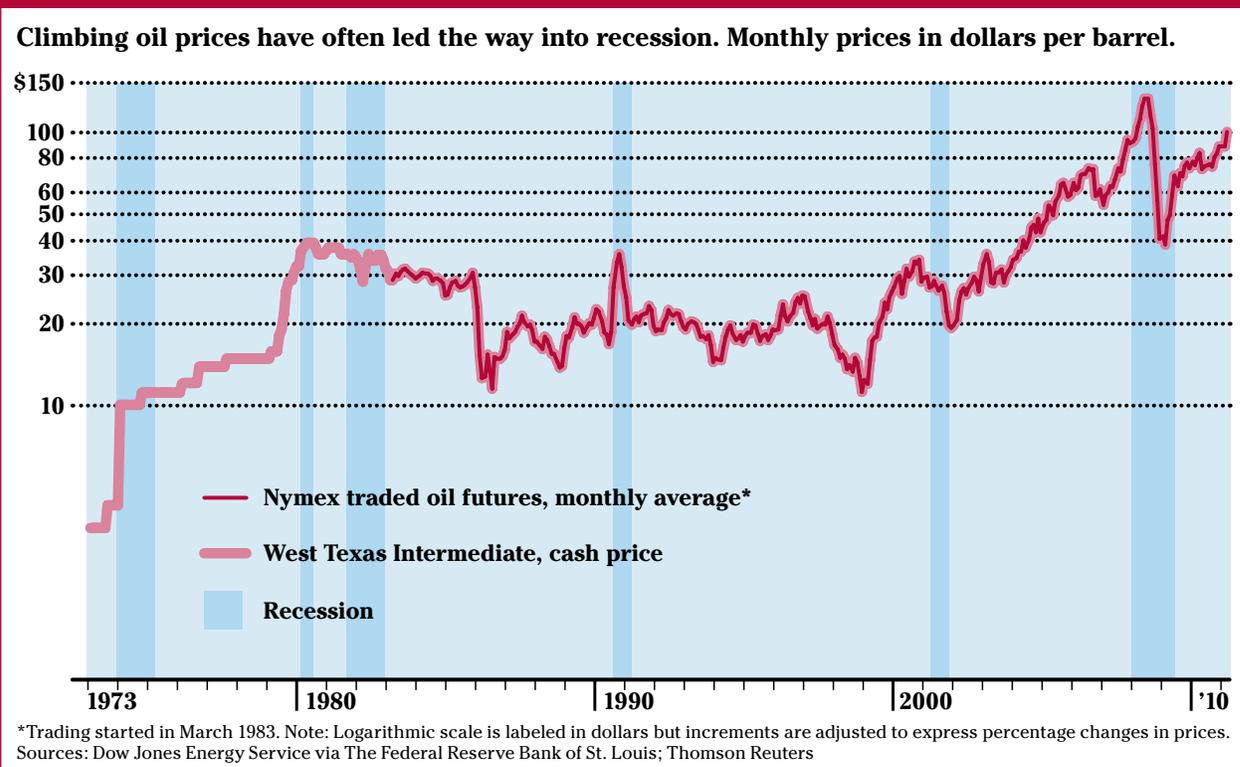
-
2. The turmoil that surrounds Saudi Arabia is a threat to its own stability. (See map: Yemen and Oman to the South, Egypt to the West, Iraq to the North, and Bahrain to the East. Bahrain is attached to Saudi Arabia by a fifteen-mile causeway.) Flowing between Iran and Oman, the Strait of Hormuz connects the Persian Gulf to the Arabia Sea, acting as a passage for over 15 mbpd of oil shipments. The Energy Information Agency terms this location the world’s most important “oil chokepoint.” As a preemptive balm, the Saudi government has just bestowed \$37 billion of new public spending on its citizens, including pay hikes for public employees, housing subsidies, and grants to unemployed students.

Unrest in the Middle East and North Africa Leads to Volatile Oil Price: Factors Impacting Investment Strategy *Continued*

The heightened unrest in the oil territories comes at a time when the global economic recovery is still fragile, having been buffeted by runaway debt and budget deficits in parts of Europe (Greece, Ireland, Portugal, etc.) and state budget challenges at home. Recent readings on U.S. consumer confidence, up to 77.5 in February from 74.2 in January, provide cause for hope but have yet to reflect the recent jump in oil prices. The governments of developed countries have nearly exhausted stimulus options, and political momentum has been shifting in the opposite direction.

The chart below shows that each of the past five recessions has been preceded by a sharp jump in the price of oil (early 1980s counted as one). Recent estimates suggest that each \$10 rise in the price of a barrel of oil results in a 0.2% reduction in GDP growth. In 2004, the Energy Information Agency had estimated this sensitivity to be 0.4%, but efficiencies have helped lower the impact over time. It may take a per-barrel price of \$140–\$150 (the last peak) before GDP is significantly affected, especially if the increase occurs over many months.

Past Price Hikes Fed Recessions



Unrest in the Middle East and North Africa Leads to Volatile Oil Price: Factors Impacting Investment Strategy *Continued*

3. The Islamic countries undergoing revolt are characterized by one or more of the following social phenomenon: a median population age of 25 or less, compared with age 37 or higher for developed countries; population growth above the world average of 1.1% annually; significant political corruption; and above-average unemployment and inflation. (Food costs comprise a larger portion of the consumer price index in developing economies.) Indeed, newspaper accounts have quoted protesters as demanding better institutional services, such as health care, education and electric power. “In both Egypt and Tunisia, for example, only about 20% of 8th-graders score above 470 on the international TIMSS math assessment – a level consistent with basic numeracy skills – compared to two-thirds in the U.S. and 90% in South Korea” (BCA Research, *The Bank Credit Analyst*, March 2011 – Vol. 62 – No. 9). According to this report, the score for Saudi 8th graders is an abysmal 3%.

Conclusion: Impact on Investment Strategy

We believe a recovering global economy can co-exist with \$100 - \$110 per barrel oil. According to Brian Belski of Oppenheimer Asset Management, with the rise in gasoline prices over the past eighteen months, “consumers have become accustomed to elevated oil prices and have adjusted their spending habits accordingly” (Oppenheimer Asset Management Inc., *US Strategy Weekly; Impact of Middle East Upheaval on Markets*, February

28, 2011). On January 25, 2011, the International Monetary Fund raised its forecast for global GDP growth in 2011 to 4.5% from its October 2010 forecast of about 4.25%. At \$105 per barrel for oil, that forecast should perhaps be adjusted closer to 4.0%, still a healthy global GDP growth rate. However, the capital markets are juggling several crises at once, and there is little margin for error.

As a percentage of GDP, oil imports to China have recently surpassed those to the U.S. As defined by Bernstein Research, this oil burden on the Chinese economy is likely to worsen in the future. Recognizing this and other inflationary forces, the Chinese government has been taking steps to slow its GDP growth. On February 28, 2011, news agencies began reporting that China’s Premier Wen Jiabao had announced a reduction in its GDP growth target to 7.0% for the next five years from the previous five-year target of 7.5% (which turned out to be conservative).

Notwithstanding a 15% - 20% leap in the past three months, the price of crude oil has trailed the rise in the prices of other commodities, such as copper, silver, wheat and cotton, since the recession ended in 2009. On a year-to-date basis, the composite stock price of the energy sector has slightly trailed the price of oil, although up more than the overall stock market.

Cambridge Trust Company’s investment strategy as it relates to the impact of rising oil prices on

Unrest in the Middle East and North Africa Leads to Volatile Oil Price: Factors Impacting Investment Strategy *Continued*

relative performance has been as follows:

- Exposure to emerging markets has been reduced
- An overweight exposure to the energy sector has been maintained since September of last year in both our Total Return Equity Matrix and Equity Income Matrix
- Cash reserves have been built since the start of 2011, to be redeployed as selected opportunities arise

The direction of oil prices in the near-term should be dictated by global demand, political stability in the Middle East and North Africa, and Saudi Arabia's willingness and ability to replace any

reduced production from other OPEC members. OPEC producers are heavily dependent upon oil exports to support social services and have every incentive to keep the oil flowing. Protests have just escalated in Oman, and new governments in Egypt, Tunisia, and perhaps other countries, will take time to form. The following snippet from an editorial in the Saturday, February 26, 2011 Financial Times is most insightful: "The present uncertainty is political at heart; it will not abate soon. Oil prices depend not only on how much Saudi Arabia pumps, but on whether it keeps its people out of the Arab awakening."

CONTACT US

In Massachusetts contact: Robert MacAllister, 617-441-1599, robert.macallister@cambridgetrust.com ▶▶
or William Yates, 617-503-4041, william.yates@cambridgetrust.com ▶▶

In New Hampshire contact: Richard Simpson, 603-369-5104, richard.simpson@cambridgetrust.com ▶▶

For more Thought Series articles and podcasts, visit, www.cambridgetrust.com/thoughtseries ▶▶

All contents Copyright © 2011, Cambridge Trust Company.