

Investment implications of the evolving 'Jasmine revolution'

AT A GLANCE

- The 'Jasmine Revolution' in Tunisia has created a wave of regional democratic protest. Events are moving quickly with regime change in Tunisia and Egypt triggering democratic protests in Libya.
- Libya accounts for around 2% of total oil output. Domestic production has been significantly affected and ENI, Repsol and Total have all reported suspending operations.
- The momentum of democratic protest is shifting to the critical oil-producing region of the Middle East, raising investor fears.
- The outlook is governed by whether we see protests move in a significant way to the larger oil-producing nations of the Middle East, particularly Saudi Arabia. If this were to happen, we might see a large oil price shock that could have a stagflationary impact.
- The consensus view is that oil prices are likely to move higher as uncertainty persists, but the impact on supply should be not be significant enough to derail global growth.

"With global growth picking up and inflation starting to rise, commodities are vulnerable to upward price shocks, either due to oil supply fears or positive demand surprises. We are overweight commodities in our multi asset funds."

Trevor Greetham, Asset Allocation Director

Democratic protests in Tunisia and Egypt have forced regime change that has triggered similar protests in Libya, a nation that has laboured under the rule of Colonel Gaddafi for over 40 years. However, since Libya is a fairly significant player in the oil market, volatility levels have risen in financial markets and the oil price has surged to a 28-month high of \$119 USD a barrel.¹

As the locus of democratic protests moves closer to the critical oil-producing region of the Middle East, some investors fear we could see a 1970's oil price shock. That remains an unlikely outcome, although we may see elevated oil prices as long as uncertainty persists.

THE STORY SO FAR

Libya is the first major oil-producing state to be affected by the wave of popular revolts in the Middle East that begun with the Jasmine revolution in Tunisia. Libya is responsible for 2% of total oil output (1.6m barrels a day) and is a major exporting nation accounting for as much as 10% of Western European imports. Oil prices surged after Libya's two biggest producers, ENI and Repsol, halted production. As Total and other companies also suspended their operations, industry executives estimated that at least half the country's oil production has been shut down.

The price of crude oil has risen sharply despite the fact that OPEC (and Saudi Arabia in particular) has more than enough spare capacity to make up a total shortfall in output from Libya. This failed to calm market nerves partly because the OPEC supply is of lower grade than the high-quality Libyan crude, but more so because much of the price volatility reflects general market fears that there could be further supply shocks if the 'Jasmine Revolution' continues to spread.

WHAT IS REALLY DRIVING THE OIL PRICE?

While Libya is the first oil producer of note to be significantly impacted by the wave of democratic protest spreading across North Africa and the Middle East, the country is not a major player. Its 2% share of world output made it the 19th largest oil producing nation during 2010. OPEC and the International Energy Agency are both in a strong position to extend supply to the market and more than meet current levels of demand.

The rising oil price is not just about a few million lost barrels however. The real fear behind the upward price moves is that the larger oil-producing nations of the Middle East are drawn into this remarkable wave of democratic protest; it has already taken many observers by surprise in terms of its enduring momentum and its ability to cross borders.

TECHNICAL VIEW ON THE OIL PRICE

"After range trading for most of 2010 between roughly \$65 and \$90 per barrel, the price of Brent crude broke strongly above those highs in the first week of January, almost as if it anticipated the upcoming unrest in the Middle East. The next logical target is \$125, followed of course by the 2008 highs in the \$140's. Given that the current rally is very event and momentum driven, any easing of the present tensions in the Middle East could in fact see the Brent crude price correct down towards \$90/bbl without damaging the longer term positive uptrend."

Jeff Hochman, Director of Technical Analysis

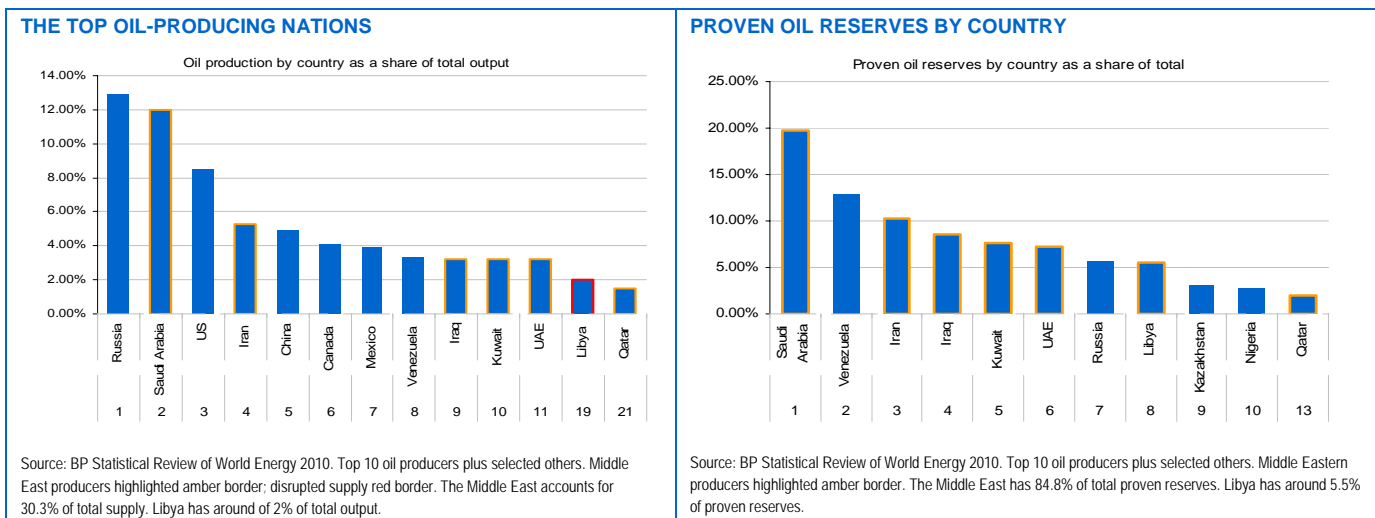
THE OIL PRICE HAS SURGED OUT OF ITS TRADING RANGE



Source: Datastream, as at 23.02.11.

'The Middle East has over 80% of proven oil reserves'

The Middle East is the 'end game' in terms of oil price sentiment. The overall region is responsible for over 30% of world output but that does not really begin to reflect its strategic significance, given OPEC quotas on production. The Middle East has over 80% of total proven global reserves, with Saudi Arabia alone sitting on top of nearly 20% of the world's oil stores.



HOW FAR WILL THE JASMINE REVOLUTION RUN?

The potential for democratic protest to spread into key oil states such as Saudi Arabia cannot be dismissed out of hand. Indeed, the cost of insuring against a default on Saudi Arabian debt has spiked sharply, reflecting generalised fear in financial markets. There are anecdotal reports that hundreds of Saudis have signed up to a Facebook campaign calling for a 'day of rage' on March 11 though it remains to be seen if such protests will materialise. Unemployment in the country remains above 10% and much of that is youth unemployment.

'Saudi Arabia... high youth unemployment...'

'and some resentment at lack of a trickle down effect from oil wealth.'

Saudi Arabia is not immune to popular protest and the uprising in Bahrain's Shia community has triggered genuine concern among the ruling elite. So much so that King Abdullah has announced a range of financial support measures worth an estimated \$36 billion USD, which are designed to appease the less enfranchised and boost non-oil sectors of the economy. The measures include a pay rise for public sector employees, reprieves for imprisoned debtors and financial aid for students and the unemployed. The fact that these concessions are being made illustrates how seriously Arab governments are taking the evolving threat to their sovereignty.

ECONOMIC IMPLICATIONS OF AN OIL PRICE SHOCK

While the leaders in Tunisia and Egypt fell only days after vowing to fight on, we cannot be certain of that outcome in Libya. Moreover, the momentum of democratic protest seems set to continue. Libya might be something of a tipping point in that regard, inspiring youth protesters in other countries. Unfortunately, Libya also marked a significant watershed in terms of the level of military response – a change in the regional dynamics that has not been lost on nervy financial markets.

'for every \$20 per barrel the oil price rises, the global economy would forego 1% of GDP'

If we were to see significant demonstrations in key oil states such as Saudi Arabia that introduced the potential for regime change, it would raise the possibility of a significant 1970s style oil price shock. History shows that significant shocks in the oil price tend to have a damaging stagflationary impact on the global economy. Analysts at Soc Gen estimate that for every \$20 per barrel the oil price rises from current levels, the global economy would forego 1% of GDP.

HISTORICAL COMPARISONS

Every oil spike is different but the previous spike in 2008 gave us an indication of the pain threshold the world economy has for oil prices. During this episode, oil prices stayed above \$100 a barrel for several months before peaking at \$145 in July 2008. The global economy fell into a deep recession less than 6 months later, however, the impact of oil is difficult to isolate from the credit crisis that was gripping the financial economy.

The 2008 rally in the oil price was essentially driven by economic factors, such as surging Chinese demand. Current events fall into the camp of a geo-political shock. How would China now react to a price hike? The 1970s experience shows geo-political shocks tend to be more chaotic as speculation and panic hoarding exacerbate an already bad situation. Prices tend to over-shoot.

'The consensus view is that the rise in the oil price to date will not be enough to derail global growth'

"The unprecedented actions in the Middle East/North Africa (MENA) region have led to increased risk aversion and perhaps extended the rotation from emerging markets into developed countries, particularly among speculative investors.

"The uncertain geopolitical outlook has raised concerns about the potential re-pricing of risk and the impact on international oil and gas markets, which may affect sentiment in the short term. The long-term secular drivers of growth in EMEA and broader EM markets remain intact. Any near term market weakness may present an attractive buying opportunity."

Nick Price, Emerging Markets

'The Russian stock market could be expected to benefit from its energy bias'

Notes

1. Brent crude intraday price as at 24.11.01.

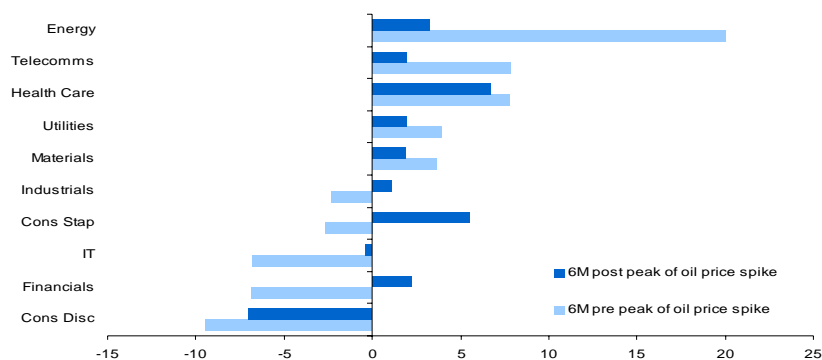
An important complicating factor is that other commodity prices are also in high gear. Metals and raw material prices are flirting with past peaks but it is food which is causing real concern. Food prices have risen beyond their 2008 peak according to the UN's composite Food Price Index, which recently hit its highest level since records began in 1990. Higher food prices, which fall heaviest on the poorest sections of society, are helping to spur the social unrest that we are seeing - making for a dangerously circuitous set of price drivers in the short term.

THE INVESTMENT IMPLICATIONS

Consideration of an oil price hike is justified but for the time being it remains unlikely. The more moderate, consensus view is that the rise in the oil price will not be enough to derail the global economy and oil supply is unlikely to be significantly impacted. The large oil-producing states in the Middle East have so far not seen the level of popular revolt in Libya and governments are at pains to avoid it. However, while uncertainty remains, we can expect a rising bias to the oil price.

There are a number of investment implications of a higher oil price. Given that it exerts further inflationary pressures on economies at a time when actual inflation has been rising, investors should certainly consider protecting their portfolios from inflation via an investment in inflation-linked bonds. Gold can also be expected to do well as a store of value in the context of global uncertainty. In the short term, we may see risk aversion that manifests itself within equities by extending the outperformance of developed over emerging markets.

RELATIVE SECTOR PERFORMANCE AROUND OIL PRICE SPIKES



Source: DataStream, Morgan Stanley, 24.02.11. Based on relative performance around 6 oil price spikes since 1970.

Within equity sectors, as the chart above indicates, energy is likely to be the biggest beneficiary (although the short term impact could be mixed if companies are forced to suspend operations, as was the case in Libya). Oil equipment makers have also shown a strong sensitivity to the oil price and could also be an attractive play. Russia could be a major beneficiary given its high weighting in energy stocks such as Gazprom and Rosneft. These companies also have a low level of participation in the Middle East compared to their global peers.

Elsewhere, the shipping and railway sectors tend to be beneficiaries, while airlines and autos tend to be negatively impacted along with consumer discretionary stocks. Consumer staples, telecoms, healthcare and utilities have historically performed well on a relative basis due to their less cyclical nature and defensive earnings characteristics.

Ultimately, investors should ensure they have a diversified portfolio; ideally one that includes inflation protection and exposure to energy and the shares of other real assets with pricing power.



This document has been prepared by Fidelity International. All views expressed in this document cannot be construed as an offer or recommendation.

Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same. Past performance and any forecasts on the economy, stock market, bond market or the economic trends of the markets are not necessarily indicative of the future performance. Prices can go up and down.

This document is prepared for information only and does not have any regard to the specific investment objectives, financial situation

and the particular needs of any specific person who may receive this document.

Fidelity / Fidelity International means FIL Limited, which is established in Bermuda, and its subsidiary companies. FIL Investment Management (Singapore) Limited (Co. Reg. No.: 199006300E) is the legal representative of Fidelity International in Singapore. Fidelity, Fidelity International, and the Pyramid Logo are trademarks of FIL Limited. SG11/094