



Equity Market Commentary

7 February 2011

Summary

Unrest in Middle East & North Africa

In recent weeks, violent protests have rocked Egypt, with demonstrators demanding the ouster of the country's strongman Hosni Mubarak.

The protests predictably rattled Egypt's financial markets, even though responses across the other markets were fairly muted. Meanwhile, oil hovered above US\$92 as the power struggle there raised the risk of disruptions to Suez Canal – a major shipping lane for oil tankers to Europe and North America.

There have been reports of similar demonstrations breaking out in Algeria, Jordan and Yemen, with thousands of people calling for a change in their countries' political systems.

Besides a suppressive regime, one of the main drivers of this social unrest has been the poor economic performance of these economies. In particular, these countries suffer from the evils of high inflation, high unemployment and high poverty levels.

In summary, we maintain a cautious view of the North Africa market, as it is difficult to predict the political end-game at this stage. Although we currently have some exposure to some Gulf states such as Qatar, Kuwait and Dubai, we are still comfortable with those investments and do not see the risks of political turmoil in these markets, as the governments have plenty of financial resources.

We expect that the impact on other developed and emerging markets will largely rest on the potential of a destabilizing or radical political environment that could have lasting effects on oil prices.

We expect to maintain our current allocations of overweighting equities and commodities, and will continue to monitor the risks of political contagion.



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Market Uncertainty Heightens as Egyptian protests persist

In recent weeks, violent protests have rocked Egypt, with demonstrators demanding the ouster of the country's strongman Hosni Mubarak. The latest round of violent unrest in Egypt followed years of political repression and economic mismanagement that resulted in high unemployment and inflation.

Tension rose further when Mohammed El Baradei, the former head of the United Nation's nuclear watchdog, was placed under house arrest for challenging the legitimacy of the Mubarak's administration.

The protests predictably rattled Egypt's financial markets, even though responses across the other markets were fairly muted. Meanwhile, oil hovered above US\$92 as the power struggle there raised the risk of disruptions to Suez Canal – a major shipping lane for oil tankers to Europe and North America.

To global investors, the key issue is the economic significance of this development, the contagion risk and its implications for global emerging market funds.

To address this issue, it is worth bearing in mind that Egypt is a key ally of the US in the region, and it controls the Suez Canal which contributes approximately US\$5 billion to its national coffers and remains a key shipping route connecting the West to the East. So far, there has been no report of disruptions in the Suez Canal – which carries an estimated 8 per cent of global sea trade and (together with the Sumed pipeline) about 2.5 per cent of global crude oil supplies.

The country is also the second highest recipient of foreign aid from the US after Israel and has a peace treaty signed with Israel (Jordan is the other Arab country with a peace treaty with Israel). Therefore, there are plenty of questions over Egypt's political fate, and especially its relations with the US and Israel, should the protesters successfully topple the current administration.

Also, there's the question of who would lead Egypt after Mubarak. El Baradei has presidential aspirations and he has loosely allied himself to the Muslim Brotherhood. Meanwhile, the Muslim Brotherhood has caused some investors to become nervous as it was originally a radical Islamic organization, out of which grew Hamas. However, they have long since renounced violence and are now seen as a reasonable face of Islam.

In Egyptian politics, the military plays a very important role. The army is widely respected by the population and is regarded as being a stabilising factor. Should the negotiations between the opposition and the government fail to reach a compromise, it remains unclear which side the army is on. The Egyptian army has so far adopted a fairly neutral stance by deploying troops in all major cities and avoiding any engagement with the demonstrators.

Egypt's economy is dependant on tourism, receipts from the Suez Canal, and foreign aid. Tourism accounts for 11.3 per cent of Egypt's GDP and employs 12 per cent of its workforce. While the Egyptian economy is relatively well diversified, the continued demonstrations and a sharp fall in tourism might weigh heavily on the economy.



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Needless to say, most aspects of the economy will deteriorate from prolonged political instability – inflation will likely increase due to disruptions, growth will decline, and the government finances will likely need to be stretched in order to stabilize and rebuild the country.

What is the contagion risk?

There have been reports of similar demonstrations breaking out in Algeria, Jordan and Yemen, with thousands of people calling for a change in their countries' political systems.

COUNTRY	Population (m)	Median Age	Unemployed (%)	Below poverty line	Internet Users (m)
Algeria	35	27	10	23	5
Egypt	81	24	10	20	20
Jordan	6	22	13	14	2
Lebanon	4	29	na	28	1
Libya	6	24	30	33	0
Morocco	32	27	10	15	13
Saudi Arabia	26	25	11	na	10
Syria	22	22	8	12	4
Tunisia	11	30	14	4	4
UAE	5	30	2	na	4
Yemen	23	18	35	45	2

Besides a suppressive regime, one of the main drivers of this social unrest has been the poor economic performance of these economies. In particular, these countries suffer from the evils of high inflation, high unemployment and high poverty levels.

However, the richer Gulf Cooperation Council (GCC) countries are in a better position to manage against the uprising due to their vast financial resources – oil revenues, large foreign reserves and smaller populations. This month, Kuwait approved an increase in food subsidies of US\$4 billion, which will be valid until March 2012. In this context, the countries that are more susceptible to contagion risk are Yemen, Jordan and Algeria.

Cautious on North Africa

In summary, we maintain a cautious view of the North Africa market, as it is difficult to predict the political end-game at this stage. Although we currently have some exposure to some Gulf states such as Qatar, Kuwait and Dubai, we are still comfortable with those investments and do not see the risks of political turmoil in these markets, as the governments have plenty of financial resources.

We expect that the impact on other developed and emerging markets will largely rest on the potential of a destabilizing or radical political environment that could have lasting effects on oil prices. The resurgence of global growth had already driven up the price of oil in the fourth quarter of 2010 and an energy supply shock could destabilize the fragile recoveries in the developed markets. We expect to maintain our current allocations of overweighting equities and commodities, and will continue to monitor the risks of political contagion.



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