HB Markets

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In this report we examine some of the more important events and possible ramifications, and look in detail at what is a highly mobile and fluid situation.

As 2010 drew to a close, few market observers could have predicted such a widespread wave of "people power" protests from North Africa and the Middle East, and the manner in which these events would dominate the headlines and shape the market movements to start 2011. Observers and pundits forecasting the usual ongoing stalemate over Israel and its immediate neighbours in the Middle East, will not only have been desperately trying to figure out the ramifications for previously "stable" regimes in Libya and Egypt, but also trying to second guess the next country in line for a popular uprising and almost inevitable overthrow of the incumbent administration.

Of particular note is the manner in which these new movements for regime change have been conducted, principally via the use of the internet and social networking websites, but more significantly through relatively peaceful but determined protests. This is all the more ground breaking when one considers that many of the nations involved are deeply conservative and authoritarian, as much as or even more than the old Soviet Union.

Most observers accept that we are probably still in the early stages of a sea change and shift in power for the entire region: changes that are creating new challenges for traders and investors in the stock market, and most of which are unique to the events currently taking place. When attempting to judge the outcome, it is important to take into account the lessons learned from previous turmoil in the regions involved, (such as the run up to independence in the 1950s and 1960s) as well as taking into consideration how since that era, Western economies and corporates are more closely intertwined and reliant upon the developing nations, and not only in terms of hydrocarbons.

Crisis background

One of the more significant aspects of the latest flare up in tensions in the Middle East & North Africa is that these events come at a time when the major upheavals and events of the last decade, (Iraq and Afghanistan) are arguably cooling off, perhaps not so much nearing closure and having delivered improved stability, but at least in terms of the greatest and most significant chapter involving the Allies. It is likely that for many Libyan and Egyptian nationals, the events in Iraq and Afghanistan regions in the immediate years after 2003 were a distraction in relation to their own domestic considerations.

Even so, there are many who will now argue that the events in Tunisia, Egypt and Libya are a belated reaction to the West's involvement in the region via an assortment of "friendly" caretaker autocrats, and with a new generation coming of age in countries with demographics skewed heavily towards the young, with poor economic prospects and high prices change is inevitable. The cost of living for the new generations may have been the deciding factor, even more than any craving for democracy or dislike for Mubarak, Gadaffi or assorted Arabian Peninsula Royal Families. Just as in the other great revolutions of the past century: Russia 1917, Iran in 1979 or indeed, the fall of the Soviet Empire in 1989, a kaleidoscope of events can be triggered by a common denominator that unites the majority.

Arguably the single, most compelling reason triggering the upheavals of 2011 to date is based on pure economics. The simple link between the falling U.S. Dollar, (the reserve currency in which all major commodities are denominated) and the soaring cost of agricultural commodities may have given the comparatively pampered West something to moan when added to the credit crunch, but this factor has had a disproportionate impact in the less developed parts of the World where agriculture plays a key role in driving economic growth. Of course, the big question here is whether the U.S. Dollar declined so sharply as a result of the fiscal stimulus efforts such as quantitative easing by the Federal Reserve, or would it have fallen as much anyway in the aftermath of the fall of Lehman Brothers et al? Another conundrum comes from the rate at which commodity prices are soaring, as demand from the new emerging superpowers such as Brazil, India, Russia and China has increased to levels that would have been unthinkable even 10 years ago. And while Federal Reserve Chairman Ben Bernanke would of course lay the blame firmly at the feet of the new kids on the BRIC nations block, other economists and Central Bank heads would no doubt say that hundreds of billions of dollars of stimulus (effectively a massive dilution and currency devaluation) in two separate tranches couldn't have made an already fraught prices situation any better.

Ironically, Crude Oil, the most economically important of all commodities is now in focus as a key determinant in whether the rebound from the Sub Prime recession could now reverse back into the dreaded double dip scenario. For countries like the UK, where there has been barely any recovery of note from the turmoil in 2007 - 2009, the cost of fuel may be the deciding issue for the rest of this year.

Likely geopolitical ramifications and other regional developments

Just as the freeing-up of the former Soviet bloc was arguably a significant influence on the great 1990s bull market for shares, in the months ahead a smooth transition and outcome to the crises in North Africa and the Middle East will be vital for the markets. Even in Egypt, the initial euphoria at the (peaceful) departure of an unpopular leader has given way to the obvious frustration of dealing with the interim military rulers who have taken his place. Unless or until democracy replaces the current hiatus, the celebrations in the countries involved and consequential relief for the stock markets could prove to be premature. This is particularly the case for the Western companies based operationally in the countries involved. Gold miner **Centamin Egypt (CEY)** has effectively become a stock market barometer for the situation, not only in that country but also for the whole wave of change seen across the region. Its shares still languish near range lows of 120p despite the latest hopes for a dialogue between rebels and the incumbent regime in Libya.

What Next?

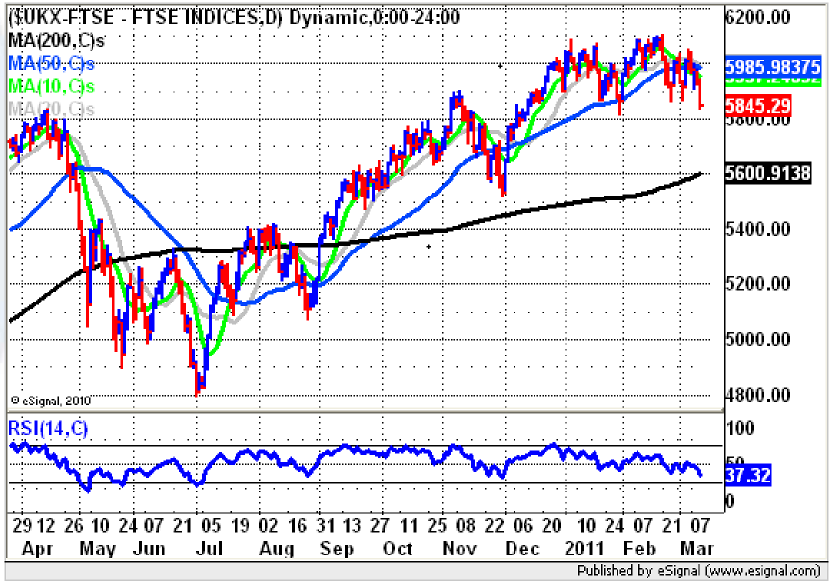
Just like the liberation domino effect of former satellite nations of the Soviet Union at the end of the 1980s, there are many who expect a similar sequence of events to pan out in the Middle East. The problem is that to date, only the most liberal regimes within this group of nations that have experienced peaceful transitions. Should the changes continue and extend to the deeply conservative and authoritarian nations, the world will most likely see a very different sequence of events, with progressively more difficult transitions, and in the worst-case scenarios, civil war. Presidents of all varieties may come and go, but it is likely that those regimes backed by monarchy will prove to be far harder nuts to crack. The Emirates, Saudi Arabia, Morocco and the politically and strategically sensitive Jordan not only have Royal Houses, but cultures combined with deeply entrenched and historical religious backing. Making matters more complicated is the very fine line between the monarchies in question and the governments attached to them. It would be almost impossible for meaningful change to take place in these nations without the effective dismantling of centuries old political systems and traditions. “Let them eat cake” measures such as public sector wage increases or other sweeteners and subsidies for the masses are now unlikely to be seen as more than delay tactics to long suppressed citizens with a thirst for liberation.

Just to complicate matters further at a time when Islamic issues of all kinds are in the frontline on the world stage, there is also the matter of sectarian tension between predominantly Sunni and Shia communities. Ruling Sunni houses in the Arabian peninsula could unwittingly disturb this hornet's nest, much to the ire of the Shia nation of Iran – already regarded as one of the region's most dangerous players.

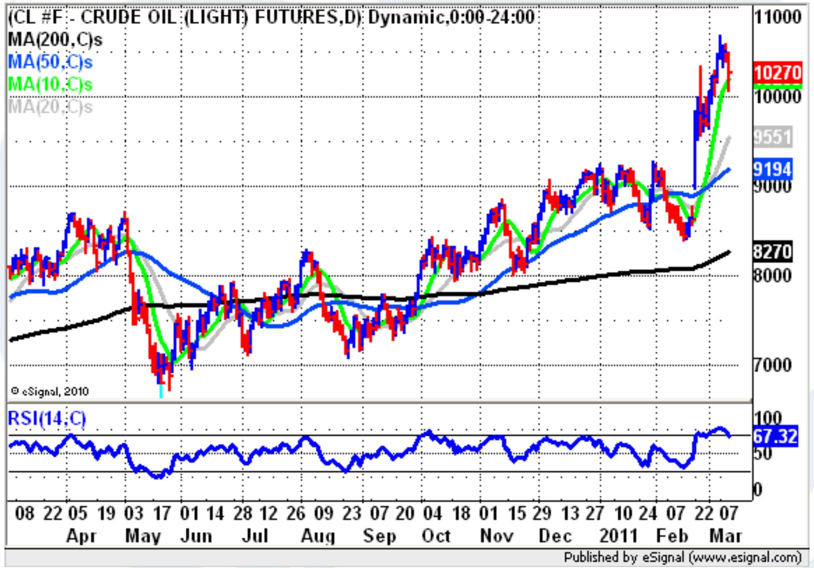
In short, the odds on all these variables panning out in an orderly manner by the end of the year are very long indeed. Perhaps even more critical at the moment is the fact that the UK stock market at more or less 6,000 is already assuming a positive outcome.

Consequences for the traders and investor, threats and opportunities

As a general rule, geopolitical strife is a "buy the dip" opportunity in stock market parlance. While it may mean leaving one's morals at the door, buying to the sound of cannons and selling to the sound of trumpets in the manner of 19th century financier Nathan Rothschild still rings true today. The best example of this was seen in March 2003, when the second Iraq invasion produced the "Baghdad Bounce," the start of one of the biggest rallies in stock market history until the bubble burst in summer 2007. Winding forward to 2011, similar reactions from markets and prices have been seen so far. Whenever there has been a hiccup in proceedings in Egypt, Libya, Bahrain et al, the down day of 50 - 100 points has been followed by keen buying interest. Of course, a break of post December support near 5,800 on the FTSE-100 may prove a bridge too far for this particular historical precedent, but the principal remains nonetheless.



Individual events for the stock market have if anything been just as fascinating on a sectoral basis. The headlines in recent weeks, even in the mainstream press have focused on the soaring price of crude oil, clearly putting oil & gas stocks under the spotlight. Surprising though, with the commodity they produce trading at a premium, to date we have yet to see a great feeding frenzy on the part of investors for sector favourites such as **BG Group (BG.)** or **Tullow Oil (TLW)**.



The other obvious ports of call at times of great geopolitical uncertainty are Gold and mining stocks. Likely fears of a competitive devaluation of paper currencies through QE is probably the reason for a somewhat pedestrian start to 2011 for FTSE 100 mining stocks since the Middle East crisis began. Sector giant **Rio Tinto (RIO)** is still 100p down on its January start, while even larger rival **BHP Billiton (BLT)** is off nearly 150p.

Just as the market as a whole looks to be in denial over the downside from prolonged geopolitical problems, it seemingly also has yet to appreciate the idea of gaining exposure to precious metals, both in terms of their representation of real value and exposure to demand for them from the emerging market economies.

Due to the ongoing lack of buying interest at the time of the spikes in the underlying commodities, on this occasion we are sidestepping the idea of buying resources stocks. Even though these shares could be viewed as great value, on balance too much of the bull argument is already factored into this crowded area of the market, a point which those buying now may find out the hard way, especially if as we hope there is a "happy" resolution to the current North Africa and Middle East crisis.

Summary

While the situation in the North Africa and the Middle East represents one of the most dangerous geopolitical events for a generation, thus far the uprisings have played out too fast and too peacefully (relatively speaking) to significantly unsettle the financial markets. There has been no significant net downside for stock indices apart from in local markets such as Saudi Arabia, and just for a change the total absence of the usual rush to the U.S dollar in time of crisis also serves to indicate generally positive expectations for the outcome. Perhaps rather luckily for bulls of Gold there has been enough U.S. Dollar weakness and financial markets uncertainty to take the metal to new record highs above $1,430, but even here unless there is a significant deterioration, such as an event involving Allied forces, a plateau rather than a new spike is indicated here.

The $64,000 question is how the stock market as a whole will be affected from this point on?

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