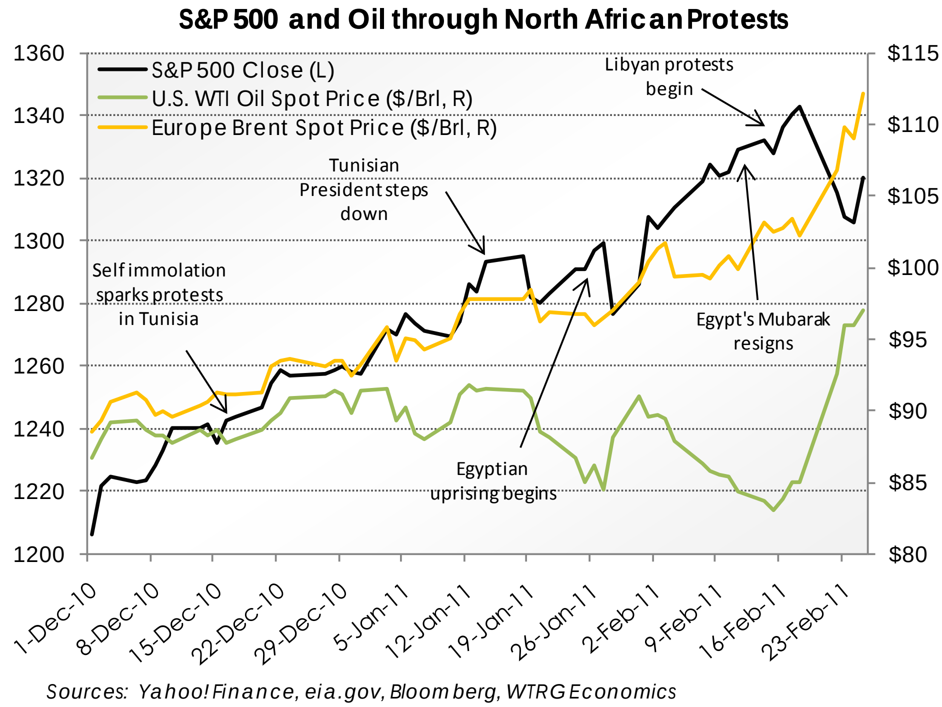
The world has witnessed an incredible series of events over the last few months. In mid-December, a young vegetable vendor in Tunisia, frustrated by a dearth of economic opportunities, set himself on fire in the public square. This tragic but isolated event proved the ember to ignite a simmering frustration with high unemployment, rising food prices, government corruption and lack of personal freedoms across North Africa and the Middle East. Escalating protests finally forced the Tunisian President, who had ruled for 23 years, to flee the country less than a month later. News and images of the civil unrest spread quickly through the region on the back of social media sites, and soon Tunisia's success in toppling its long-ensconced ruler set off a domino effect throughout the region. Egyptian President Hosni Mubarak, a U.S. ally who had ruled his country for 30 years, was driven from power after only a few weeks of protests and replaced by an interim military-led government. The most violent uprising currently is taking place in Libya, and threatening the 41-year reign of Colonel Muammar Qaddafi.

The organic rebellions have ushered in a degree of change in just a few weeks that numerous wars and countless billions of dollars have been unable to accomplish for decades. The implications of the dramatic shifts in power will not be known for some time, but several factors that contributed to the protests are noteworthy. The degree to which access to technology has enabled the uprisings is remarkable. People in far-reaching corners of these countries were able to learn of the protests, voice their opinions, and mobilize by communicating through sites like Facebook and Twitter. Technology allowed disparate groups of people to organize anonymously, and obtain critical mass before the governments could fully suppress the disturbances. Another significant factor is the role that economic opportunity has played in the unrest. Many westerners think of people in the Middle East and Northern Africa as highly focused on religious concerns, but in reality, religion has had almost nothing to do with the uprisings. In fact, much of the dissent has been focused on high unemployment, rising prices, and the enormous societal gaps between the haves and the have-nots. These are issues that Americans understand all too well.

In this month's piece we explore some of the potential investment and economic repercussions of the unrest in the Middle East. We believe that the uncertainty in one of the world's most important oil-producing regions will cause market volatility in the short run, but the long-term implications could emerge a net-positive for the global economy.

In the Short Run

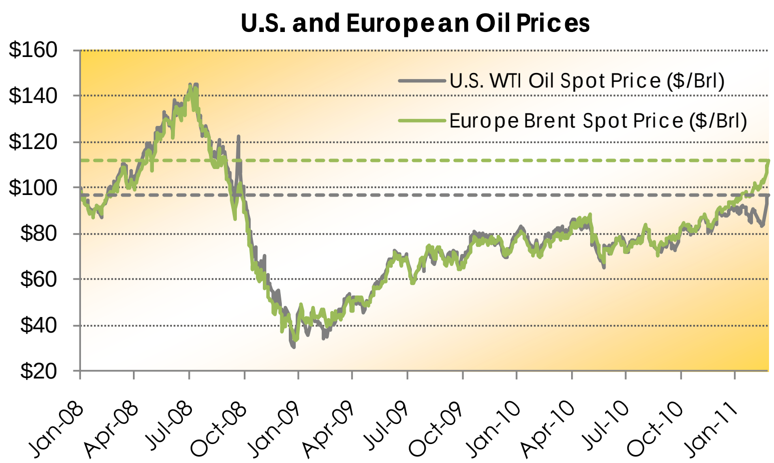


Until the protests reached Libya, the uprisings had only a minor impact on U.S. financial markets. Although European Brent crude prices began to creep up after protests began in Tunisia, the price of West Texas Intermediate crude actually fell until Libya erupted. Even the ousting of Egypt's Mubarak, a backer of U.S. policies and Israel's only regional ally, did little to roil U.S. equities. Upheaval in a nation that is part of OPEC (Organization of the Petroleum Exporting Countries), however, caught the attention of investors as oil flows were interrupted and the price of crude began to rise more sharply.

Violence Shuts Down Production

The violence marring the Libyan protests was a departure from the comparatively-tame Egyptian stand-off. Qaddafi's aggressive counter-attack against his people has prompted major oil companies like Italy's Eni, France's Total and Spain's Repsol to curb production and evacuate employees. Much of Libya's oil production facilities are located in the eastern part of the country, which has most aggressively defected from Qaddafi's control. Less than 2% of the world's oil comes from Libya, with only 5% of that amount making its way to the U.S., but despite the relatively-small contribution to global oil supply, prices have shot up. Fear of protracted supply reductions is partly to blame, but *quality*, not just *quantity*, is also a contributing factor, according to the Energy Policy Research Foundation.

At this point, *quantity* of supply is adequate. Saudi Arabia has promised to tap its spare oil capacity - equivalent to more than double Libya's total production - to replace any reductions; however, most of this oil differs in *quality* from the kind that Libya produces. Saudi oil is largely high-sulfur "sour crude" and cannot easily replace the Libyan "sweet crude" necessary for the production of various types of fuel for transportation, particularly diesel fuel used in Europe. Oil experts believe that if Libyan production is shut down for more than several weeks, European sweet crude refiners will be forced to turn to Algeria and Nigeria - key suppliers to the U.S. - for the sweet crude that produces diesel. This could push up the price of gas for Americans despite the fact that the U.S. has little reliance on Libya.



Source: eia.gov, Bloomberg, WTRG Economics

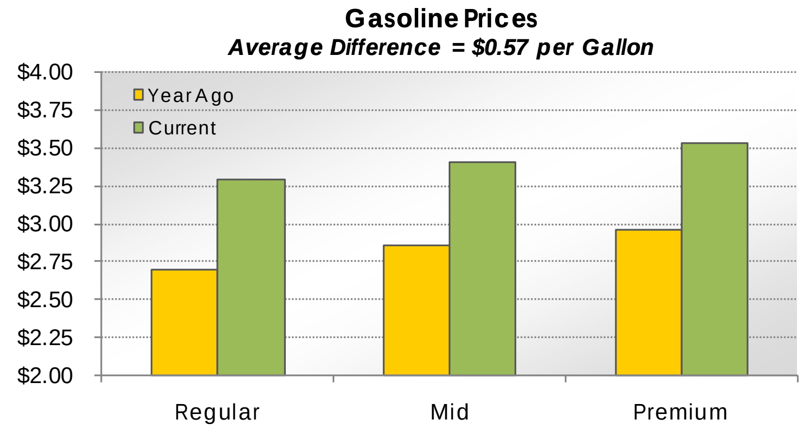
Brent crude, the global benchmark for oil, closed above $112 per barrel on Friday while U.S. West Texas Intermediate crude finished just under $97 per barrel. Prices this high have not been seen since the fall of 2008 as prices made their way down from the $140 per barrel levels reached the previous summer. If the unrest spreads to key producers like Algeria, there is the potential for oil to again reach the highs of mid-2008. Algerians have mounted erratic protests against food inflation and unemployment, but an organized uprising has not been sustained.

More alarmingly, protests in Bahrain indicate that its neighbor, the kingdom of Saudi Arabia, may not be immune to the contagion. The Saudi royal family has moved to preempt an uprising through financial handouts. A $37 billion package for lower- and middle-income Saudis was announced last week, which included pay raises, unemployment benefit and affordable family housing. Experts in the region doubt that a financial offering will be sufficient to address the population's demands, with some calling it akin to a bribe. A call has been raised on Facebook for a March 11th "day of rage" in Saudi Arabia to demand an elected ruler, greater freedom for women and the release of political prisoners. If greater unrest erupted in the world's second-largest oil producer we would expect a much more severe market reaction.

Rising Energy and Food Prices Spark Inflationary Concerns

Rising energy costs, at a time when food prices already are a problem in much of the world, intensify inflation concerns. The Middle East is not the only region experiencing unrest due to the economic situation. Indian citizens are marching in the capital to protest skyrocketing food inflation. In Northern Ireland, recruitment of dissidents and terrorism are on the rise as the unemployment rate for people under 25 years old has reached 21% - its highest level since the 1998 Good Friday Agreement that brought an end to violence in the region.

Although the inflationary pressures stemming from energy and food are not rooted in excess demand emanating from the U.S., it does not mean that we are immune. In today's globalized world, no longer do commodity prices ebb and flow in line with the U.S. economy - we are price takers instead of price setters. Despite little disruption to U.S. crude supplies, gasoline prices have risen about 57 cents per gallon since a year ago.



Source: AAA Daily Fuel Gauge Report, as of 2/25/2011

The biggest concern domestically is that higher fuel prices will become a "tax" on Americans' already stretched disposable incomes. Consumers and corporations are still spending conservatively as they climb out of the deep hole left by the recession in 2007-2008. When oil hovered near $140 per barrel prior to the recession, many companies tried to pass higher energy costs down the supply chain in the form of delivery and fuel surcharges; attempting the same strategy today could serve to dampen end demand in the current environment. Any additional drag on spending, and the knock-off drag on consumer confidence, would likely slow economic growth later this year. Reflecting these concerns, U.S. stocks took a breather this week with the S&P 500 index posting its biggest multi-day losing streak in more than 3 months. We also believe that many investors who had concerns that the market's nearly-six-month winning streak had occurred too quickly used the upheaval as an excuse to take some profits. Volatility will likely continue as long as protests smolder in the region, but as we saw with the European fiscal crisis throughout 2010, equities like to climb a wall of worry. Signs of the unrest spreading to Saudi Arabia and Algeria could provoke more severe stock market gyrations, but in our opinion the U.S. equity market should fare better than both Europe and Asia as inflationary pressures slowly make their way from east to west during the rest of the year. Since emerging economies spend a greater proportion of income on food than their developed counterparts, food inflation is impacting these countries first. Central banks in Asia are already raising rates to contain prices and slow growth, and this tightening should slowly work its way through Europe and the U.S. by the second half of the year. The fiscal austerity path that Europe has chosen will only exacerbate the amount of drag on the global economy.

IN THE LONG RUN

The Demographic Shift

As the world's most advanced emerging markets like China, India and Brazil gradually transform into mainstream economic powers, investors have begun looking toward "frontier" markets as the next engine of growth. Up to this point, frontier markets have signified countries like Estonia and Vietnam, but legitimate governments in Northern Africa and the Middle East could boost countries in these regions to this economic tier. We believe that the financial markets did not react initially to the protests because the prospect of regime change in the region could herald more open markets in the years to come. More stability could mean structurally-lower oil prices as the geopolitical risk premium embedded in the commodity is reduced. When uncertainty is lessened, the financial markets usually smile on that asset.

We are not naïve enough to expect that these countries will introduce western-style democracies overnight, but greater economic opportunity could reduce structural unemployment, help alleviate extreme poverty, and reduce tendencies toward radicalism. This possibility is exceptionally important given the demographic makeup of most Arab countries. More than 60% of the population in the region is under 25 years of age. Data from the early 2000's indicate that the unemployment rate for people between 15 and 24 was 23% for men and 33% for women[1]. This "youth bulge" represents both a challenge and an opportunity. The challenge is to provide sufficient employment avenues and economic well-being for this population segment in order to transition them into productive world citizens in the years to come. The opportunity is the tremendous size of the working-age population itself, newly armed with the power of the internet. Currently, China is celebrating that its "one child" policy has left it with a relatively-small demographic of disaffected youth, but the country will experience a very unfavorable worker-to-retiree population ratio in the next several decades. The Middle East is the opposite side of that coin.

Already school enrollment has risen markedly throughout the Middle East/North African region. Primary education is nearly universal, the gap between enrollment for boys and girls has shrunk at the secondary level, and higher education has grown in popularity. Fertility rates have also declined introducing new potential opportunities for women. Political, economic and social reforms will be the key to invigorating the private sector economies of these countries by opening up avenues for foreign investment and trade.

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[11] "Youth in the Middle East and North Africa: Demographic Opportunity or Challenge?," Population Reference Bureau, Ragui Assaad and Farzaneh Roudi-Fahimi, April 2007

Technology Leading the Way

Regardless of demographic shifts, technology has changed the face of the emerging world. Access to the internet has empowered people by giving them perspective on the outside world in addition to the traditional education they receive. Ways of life outside of their countries' borders are no longer such a mystery, and they are able to make comparisons between their existences and those of other young people abroad. Their parents' generation was largely ruled by the fear spread by authoritarian regimes that convinced the people they had few choices. The current generation of young, educated Arabs is well aware of the opportunities squandered by oppressive, aging leaders clinging to power.

The speed at which the protests are spreading is a testament to the power and efficiency of the internet. Internet usage has grown by more than 2,300% in Africa and 1,800% in the Middle East over the past decade, but user penetration rates are still relatively low at 11% and 30%, respectively. The potential for greater global connectivity is enormous, especially if increasingly-open markets enable the expansion of the region's technological infrastructure. This would likely lead to a virtuous feedback loop of greater foreign investment, better economic and educational opportunities, and less fertile ground for radical governments.

World Internet Usage

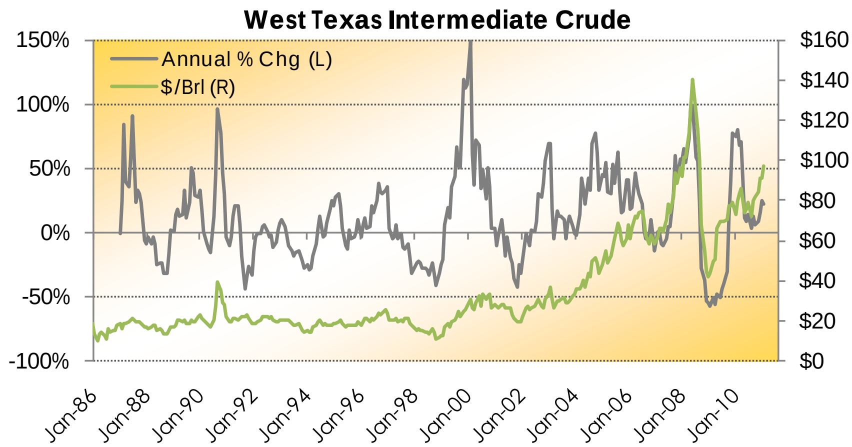
World Regions	Internet Users	Internet Users as % of World Total	User Penetration Rate*	Growth from 2000 to 2010
Africa	110,931,700	6%	**11%**	**2,357%**
Middle East	63,240,946	3%	**30%**	**1,825%**
Latin America/Caribbean	204,689,836	10%	35%	1,033%
Asia	825,094,396	42%	22%	622%
Europe	475,069,448	24%	58%	352%
Oceania/Australia	21,263,990	1%	61%	179%
North America	266,224,500	14%	77%	146%
World Total	**1,966,514,816**	**100%**	**29%**	**445%**

* Internet users as a percentage of population

Source: U.S. Census Bureau, Nielsen Online, www.internetworldstats.com

Moving Forward

We are concerned about the short-term financial market implications of sustained upheaval in one of the world's largest oil producing regions. Not only does the uncertainty pose a significant headwind for the markets, but the longer oil prices remain elevated, the more severe bite they could take out of consumer spending. Although the recent ***percentage change*** (gray line) in WTI crude is small relative to history, the ***price level*** (green line) at which we are starting is already elevated. Given the inflationary pressures the world is experiencing due to elevated food prices, it is likely that higher energy costs will feed consumers' inflation expectations and benefit our exposure to commodity-based holdings like the Agribusiness ETF and Canada.



Source: eia.gov, Bloomberg, WTRG Economics

If conditions threaten stability in a major producer like Saudi Arabia, we would likely move to reduce our portfolios' risk exposure significantly. In the long run, however, we think if more open and stable governments can be put in place in these markets, they will represent the next opportunity for investors in the emerging world.

February 28, 2011

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