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The Economic Domino Effect

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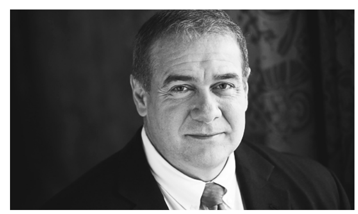

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The democratic movement erupting across the Middle East and North Africa (MENA) reminds me of the historic political changes that occurred the early 1990s when the Berlin Wall fell, the Cold War ended, and a series of revolutionary events led to the dissolution of the Soviet Empire.

When the populist revolution broke out in Egypt, I happened to be in Moscow speaking at the Troika Dialog Russia Forum. I must admit, being at the scene of the Russian revolution 20 years later made the events transpiring in Egypt feel all the more historic. One morning I watched images of Egyptian protestors standing on tanks in Tahrir square in Cairo, and at a dinner that evening I listened to first-hand accounts of when Boris Yeltsin stood on a tank outside the Russian White House during the 1991 revolution.

While my Russian colleagues recounted the winds of change that brought the collapse of communist regimes in the early 1990s, I could not help but reflect on how the political transformations of that period also precipitated turmoil in the financial markets and severe recessions.

The unification of Germany in late 1990, for instance, led to the European currency crisis in 1992-1993 and essentially plunged the entire continent into a deep recession. This crisis was a particularly vivid experience for me because at the time I was running European fixed-income trading for Morgan Stanley. Similarly, the 1991 collapse of the Soviet Union was followed by a severe recession and hyperinflation.

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History teaches us that the revolutionary road is lined by economic shocks and currency instability. As the events play out in the Middle East and North Africa, I believe the turmoil in the region will perpetuate an economic domino effect that may result in dramatic shifts across the investment landscape over the course of the next year.

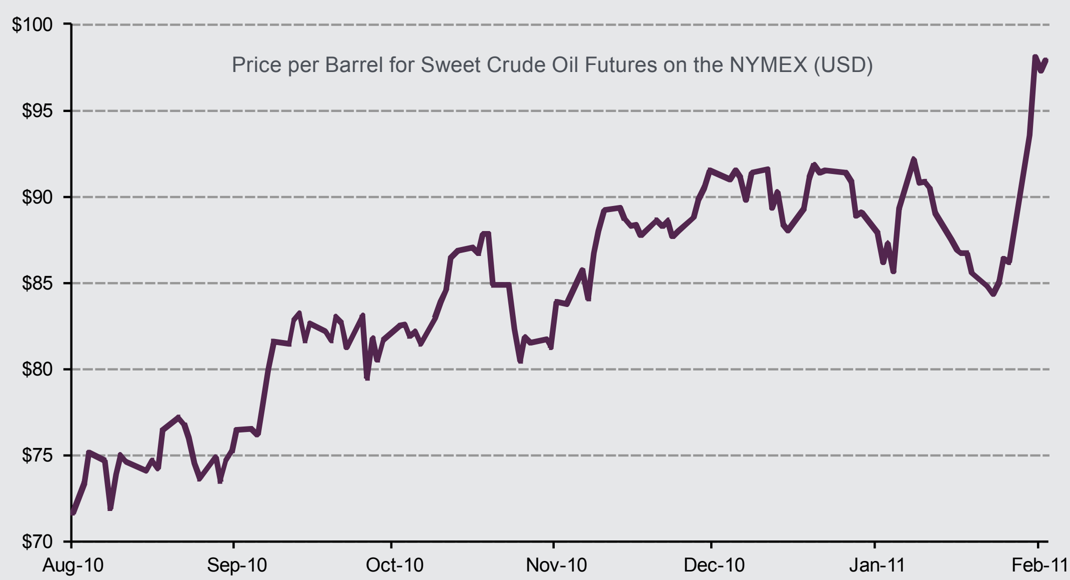
The Global Cost of Turmoil: Higher Oil Prices

As we have already begun to see, the mere threat of a disruption to the world's oil supply has caused the price of crude oil to spike. The extent and duration of the spike in oil prices will depend largely on whether the threat extends beyond smaller oil producers like Libya, Algeria, Yemen, and Bahrain, and into larger players like Saudi Arabia and Iran. Keep in mind that oil prices spiked 15 percent on the *perceived threat* that Libya's production of 1.6 million barrels per day might be in jeopardy. Imagine what may happen to prices if investors perceive the possibility of an interruption to Iran's production of 3.7 million barrels per day, or Saudi Arabia's 8.6 million barrels per day.

In terms of how high crude oil prices may rise, the summer of 1990 may provide some perspective. During the early stages of Operation Desert Storm, crude oil prices rose

SHOCK AND OIL

In recent weeks, the threat of a disruption to the world's oil supply has caused the price of crude oil to spike. As democracy spreads across the MENA region there is a very real prospect that crude oil prices could hit $125 or higher. Short of a threat to Iran or Saudi Arabia, however, oil at $200 per barrel is not likely in the near term.



Source: Bloomberg. Based on data through February 25, 2011

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141 percent over a three-month span. It was another five months before prices returned to pre-crisis levels, which meant that for more than eight months oil prices were, on average, 40 percent higher than pre-crisis levels.

If we apply a price appreciation experience similar to the Gulf War in 1990 to the average crude oil price one month prior to the protests in Egypt (approximately $90 per barrel for sweet crude oil futures on the NYMEX), we arrive at oil reaching as much as $215 per barrel. If we apply a lower percent increase, say the average increase of 40 percent during the 1990 conflict, crude oil would still exceed $125 per barrel. With crude oil futures currently trading around $98 per barrel, this means it would be possible to see oil prices rise another 25 percent increase from present levels.

Short of a threat to Iran or Saudi Arabia, oil at $200 per barrel is unlikely; however, as the democracy movement spreads across the MENA region, I believe there is a very real prospect that crude oil prices could hit $125 or higher.

> "Restrictive monetary policy will lead to economic slowdown in the emerging markets in 2011. Since it's seldom a good bet to fight against central banks, emerging market equities are not the place to be for the next few quarters."

Higher Energy Prices Mean Pressure on Emerging Markets

If energy prices linger at such elevated levels, the next domino will be heightened inflationary pressures around the world, but particularly in the emerging markets. Central bankers in Brazil, Russia, India, and China (the "BRIC" countries) are already wrestling with runaway food prices. Surging energy prices are likely to trigger even tighter monetary policy decisions in the near term. The hawkish European Central Bank could even be convinced to move toward a rate hike as well.

But of all the economies impacted by higher energy prices, China may be in the worst position. Recently, China surpassed Japan as not only the second largest economy in the world, but also the second largest consumer of oil in the world. The possibility of a sustained, dramatic increase in energy prices should finally convince the People's Bank of China that it has a significant inflation problem and is meaningfully behind the policy response curve. With inflation already at 4.9 percent but real interest rates at -1.9 percent, China is facing the triumvirate of price pressures: food, wages, and now energy.

But China is not alone. The other BRIC countries – Brazil, Russia, and India – also need to take dramatic policy measures to cool off overheating markets and fight inflation. We've already seen this in Russia, where a surprise rate increase was announced on February 25. This surprise move helped lift the ruble to its highest level in more than two years. Across the emerging markets, exchange rates (including the Chinese RMB) may be valued significantly higher to quash domestic inflation and calm the growing social unrest that has resulted from rising food prices.

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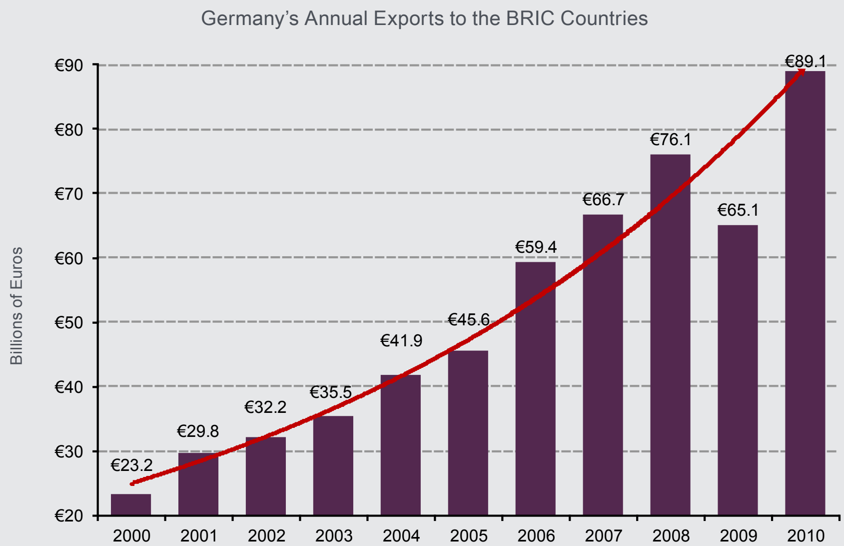
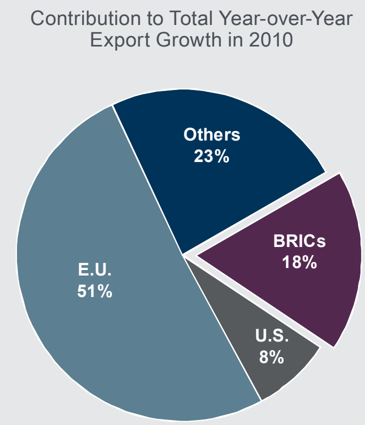
FUELED BY THE BRICS

Any economic slowdown in the BRIC countries – Brazil, Russia, India, and China – would be especially painful for the German economy. In 2010, German exports to the BRICs grew by 37 percent. From 2001 to 2010 the compound annual growth rate exceeds 14 percent. Currently, China accounts for more than half of Germany's exports to the BRICs.





Although Germany's exports to the BRICs account for only 2% of GDP on a nominal basis, the fast-growing category accounted for 18% of incremental export growth in 2010.

Source: Eurostat, Bloomberg, Guggenheim Partners

Looking ahead, I believe restrictive monetary policy will lead to economic slowdown in the emerging markets in 2011. Since it's seldom a good bet to fight against central banks, emerging market equities are not the place to be for the next few quarters. For investors looking at these markets, the next entry point should become apparent once there has been a material increase in interest rates and commodity prices begin to trend downward.

Cooling in the Emerging Markets Grinds on Europe

Any economic slowdown in the emerging markets will be especially painful for global economies that rely on exports to those markets for their livelihood in 2011. The prime example of this is Germany, the one economy that must remain strong for the sake of Europe.

Fueled by emerging market demand for autos, industrial products, and machinery, German exports to the BRICs rose 37 percent in 2010. This growth added as much as 1.1 percentage points to Germany's remarkable 3.6 percent GDP growth for the year. If Germany isn't able to expand its exports to the BRICs, which is entirely possible given last year's robust output and the potential economic cooling of the emerging market economies, then Germany's GDP could fall short of expectations by as much as a half of a percentage point.

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Last year, when the German economy was humming along at 3.6 percent, Euro Area GDP was a scant 1.7 percent. In 2011, the economies of Greece and Portugal are projected to contract. Ireland and Spain teeter on the verge of recessions as well. The European Commission is already projecting German GDP to fall to 2.2 percent in 2011. If German GDP falls to below 2 percent, which I think is highly likely, economic growth for the Euro Area will likely dip below 1 percent, or possibly begin to contract. This means the Euro Area could find itself on the brink of another recession and the European Central Bank would be forced into accommodative monetary policy.

The Ultimate Beneficiary: U.S. Markets

After all these dominos fall, global investors will likely find themselves in a world that looks like this: the Middle East is highly unstable, emerging market economies are slowing, and the crisis in Europe has been exasperated by shrinking exports, leading to a decline in the value of the euro.

Against this landscape, the U.S. economy and dollar-denominated financial assets will look increasingly attractive on a relative value basis. By the second half of the year I expect to

THE ECONOMIC DOMINO EFFECT

The turmoil in the MENA region is likely to perpetuate a global economic domino effect over the course of the next 12 months. As a result, the U.S. financial markets should prove to be one of the most attractive places to invest in 2011.

Turmoil in MENA region causes spike in crude oil prices

Scenario
Crude oil prices rise to $125+ per barrel due to real or perceived supply shock

Current Condition
Crude oil prices have already risen more than 15 percent since the outbreak of violence in Libya

Heightened price pressures cause emerging markets to further tighten monetary policy

Scenario
Accelerated interest rate hikes and higher reserve requirements are enacted to curb inflation; EM currencies appreciate

Current Condition
Negative real rates in Russia, China, and India. Surprise rate hike in Russia

Economic growth slows in the BRICs, currencies appreciate, exports decline modestly

Scenario
Strict monetary policy cools BRIC economic growth, possible revaluation of RMB in China to address rising food costs

Current Condition
The OECD leading indicators show a downward slope for BRIC economies

Slowing in BRICs hits Germany's export machine

Scenario
Germany's growth loses momentum, GDP misses expectations

Current Condition
In 2010, 1.1% of Germany's 3.6% GDP growth came from export growth to the BRICs. If exports remain flat, or grow only marginally, then 2011 GDP could dip below 2%

Fragile European economies face headwinds

Scenario
As German economic growth slows, it has a negative effect across Europe. ECB must loosen monetary policy

Current Condition
~ 50% of Euro Area growth comes from German growth;
~ 13% of other Euro Area exports were sold to Germany

Capital flows to U.S. markets

Scenario
With Europe faltering, BRICs slowing, and MENA in turmoil, the United States becomes the most attractive market for investors

Current Condition
$7.2 billion in capital fled EM equity funds during the week ended Feb 2, the most since Jan 2008

Source: Guggenheim

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see a rebound in the dollar, lower bond yields, and the outperformance of U.S. equities relative to Europe and most of the emerging market countries, with the possible exception of Russia. The flight to safety play will also be good for gold prices, which continue to be in a generational bull market despite the recent consolidation (which I view as healthy).

Going Back to the First Domino

Looking back to the beginning of economic domino effect, it's natural to think of the turmoil in the MENA region as the precipitating event – the hand that tipped over the first domino. But what may be most ironic about this entire scenario is that the dominos falling across the globe, from the Middle East to Asia and then Europe, ultimately end up back in the United States. I say "back" in the United States because the first domino that set these events in motion was actually the Federal Reserve's policy of quantitative easing.

By printing almost $2 trillion dollars and using them to buy assets, the United States created a rising tide of liquidity that has lifted all asset prices, including commodities, and more specifically agricultural products. Just as chronic food shortages were a major catalyst in the 1991 revolution in the Soviet Union, rising food prices have been a catalyst for the social unrest in the Middle East and North Africa, and it even appears to be spilling over into China under the banner of the Jasmine Revolution.

Regardless of who's to be blamed (or credited, depending on your perspective) for prompting the social unrest that has swelled into waves of democratic revolutions washing over the Middle East, the moral of the story for investors is that the U.S. financial markets should prove to be one of the most attractive places to invest in 2011.