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by portfolio manager
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*“Bliss was it in that dawn to be alive,
But to be young was very heaven!”*

- William Wordsworth

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Abstract

The upheavals in North Africa have now affected one of the world's significant oil producers. There are fears that this could spread to other nations in the Middle East and possibly to other emerging markets. We believe that this is a problem specific to the Middle East where the current economic model and wealth distribution offers few prospects to the rapidly growing and young populations in the region. A possibly unexpected aspect, to Western eyes, is the fact that it is economic issues rather than religious matters that are driving events; it is more about human progress thwarted rather than turning away from so-called western values. The concern for investors and governments alike is the sharp rise in the price of oil on fears that a major producer such as Iran or Saudi Arabia might succumb. We believe that every \$10 rise in the average price of a barrel of oil for 2011 will drag down developed market economic growth by 0.1% to 0.2% and that in Asia, with its large manufacturing base and higher oil dependency, the effect could be as much as 0.5% off growth. The energy factor adds another layer of complication for central banks in the US and Europe who are trying to find ways of supporting growth while seeking to prevent inflation expectations from breaking out, which might force a monetary tightening that the fragile recovery could ill-afford. This paper seeks to understand the background to recent events, to assess the likely economic impact on developed and emerging economies and likely responses, and finally, to provide some ideas for investors.

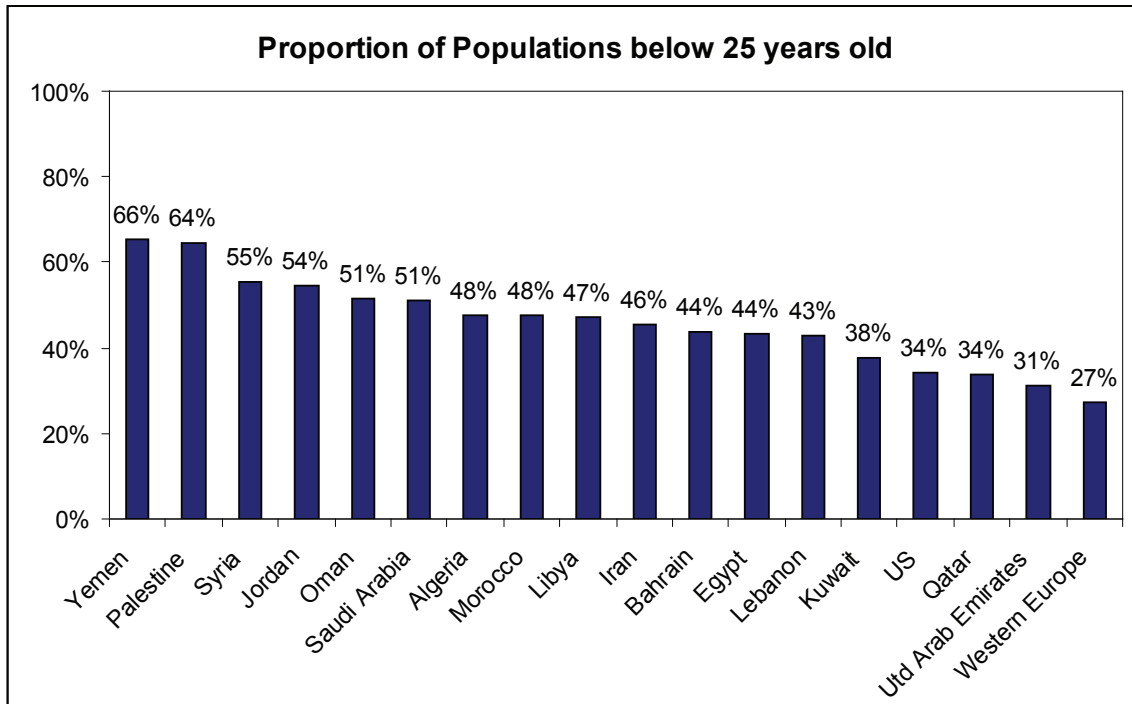
Context

The predominantly young populations in North Africa and the Middle East are finding their voice, and the political order that has held sway for the past 40-60 years is now under threat from all sides. Before these recent events, if we had been forced to guess what might be a trigger for upheaval we might well have guessed Islamic fundamentalism. This has been quite as much an issue for governments in the region as it has in the rest of the world. Indeed, it was a religious movement that was behind the overthrow of the Shah of Iran where a theocratic movement rebelled against the pro-western, 'culturally debauched' elite. This set the tone for political and cultural relations between Western and Middle Eastern nations ever since.

However, it is not religious or cultural forces that drive events today. The story is perhaps more profound and is one of human progress thwarted. The autocratic rule and sterile policies of the regimes in North Africa and the Middle East have nothing to offer their expanding and youthful population. Wealth, generated by production of resources has not translated into broader economic well-being but instead has been concentrated in the hands of a few. The story of human progress is best charted in the rise of China, which also has an autocratic system of government but which has decided its best course is the creation of what it calls the 'harmonious society'. Human progress here is measurable in terms of lower infant mortality, longer life expectancy, the rise of hundreds of millions out of poverty and the expectation of, rather than a hope for, a better life.

There are an estimated 335 million people in the Middle East and troubled areas of North Africa. Just over 50% of the population is under the age of 24 years. Only 6.3% of the people are over 60 years old, the median age is 24.75 years and the population has grown 2% a year on average for the last twenty years. The proportion of those under 24 is 43.5% in Egypt and 47.4% in Libya. In Iran the proportion is 45.6% and in Saudi Arabia it is 50.9%.

The age structure and growth of the population in this group is striking and stands in marked contrast to the developed world. In the US 34.3% of the population is under 24, 18% are over 60 years old, the median age is 36.6 years and population has grown at an average rate of 1.11% per year over the last twenty years. The picture in Western Europe provides an even greater contrast: 27.4% of people are less than 24 years old, 24.3% are over 60, the median age is 42.2 years and population growth over twenty years has been 0.34% per year on average.



Source: UNPD World Population Prospects: The 2008 Revision

It would appear that a demographic time-bomb has finally detonated. For years the political and military elites have kept a tight grip on power and wealth concentrating it in the hands of a few while simultaneously presiding over a period of rapid population expansion. An economic model that could accommodate this expanding group, with its rising expectations, and which could offer employment is entirely lacking. This, we believe, is at the heart of the social upheavals we have seen.

Nowhere is this more apparent than among the oil producing nations whose wealth, for a few, has expanded beyond the dreams of avarice since the oil crisis of 1973. The economies of such resource producing countries are characterized by highly capital intensive industries that employ comparatively few and technically specialized workers. The production of resources rather than manufactured goods or services lends itself to rent-seeking behavior. The owner simply awards a contract to a company to mine the resource and then sits back and collects his share of the revenues. The arrangement often results in corrupt practices, and as long as it lasts, removes almost any incentive to develop, broaden or deepen the rest of the economy. Innovation is stifled.

We have already seen a mixture of responses by governments. The awful scenes in Libya in pictures and reports capture the headlines. Elsewhere, governments are moving to increase subsidies for food and increase financial transfers to the population. We expect to see further efforts to appease restless populations by increased government spending that ought to increase consumption. Some governments will find this harder. Countries like Morocco, Jordan and Syria, as well as Egypt and Tunisia, are oil importers and already have substantial deficits and public debt burdens.

The effect of likely government spending plans in the region will probably be to crowd out private investment. Consumption will be boosted today at the expense of tomorrow while deficits will increase making future financing more expensive.

What's Next?

The non-humanitarian issue is now the price of oil and its likely impact on inflation and the economic recovery. While unrest was confined to Tunisia and Egypt, debt and equity markets were unmoved. Debt default in Greece was viewed as a greater concern than social unrest in North Africa. Now it has spread to Libya, an oil producer.

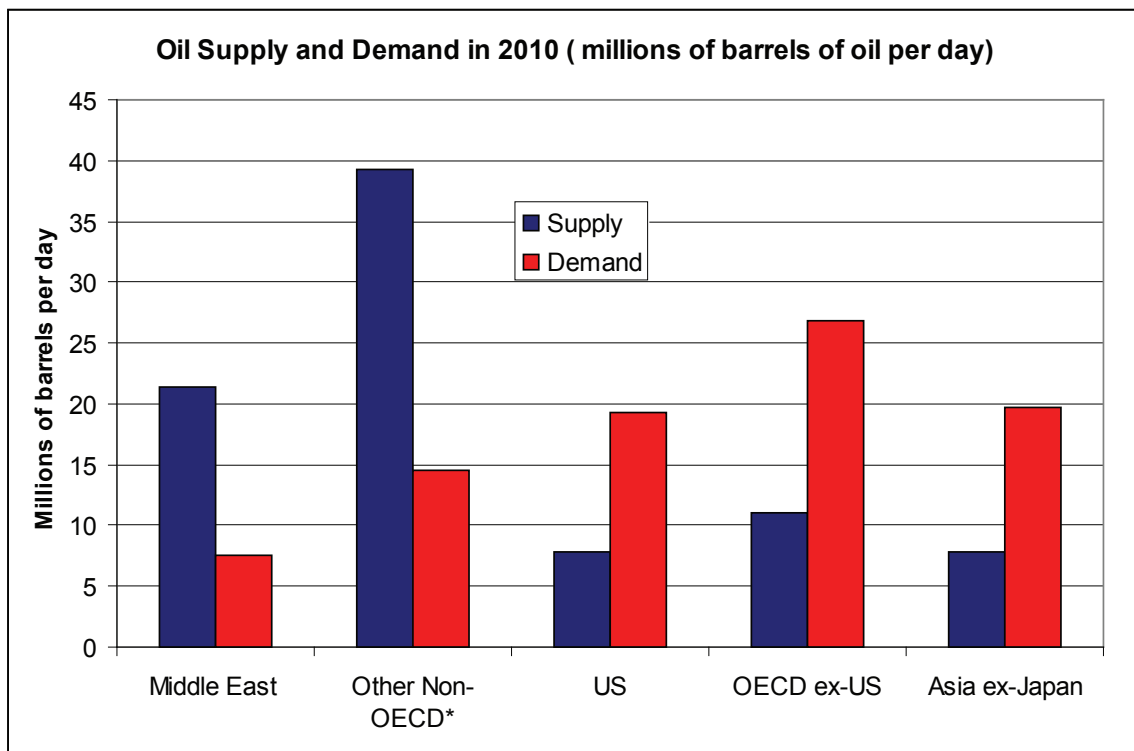
The Organization of Petroleum Exporting Countries (OPEC) excluding Iraq, the OPEC-11, has agreed to an aggregate daily production quota of 25 million barrels per day but is in fact producing 26.8 million barrels. The cartel has not acted to stem this excess production because of the already high oil price and steady increases in forecast oil demand. In 2011, the Middle Eastern members of OPEC-11, are expected to produce 20.3 million barrels of oil per day or 23% of the world's total daily production of 89.3 million barrels. Libya produces 1.6 million barrels each day, which is 1.7% of world production.

Matt Simmons and others have argued that Saudi reserves are overstated and that they are actually producing flat out. However, we do know that OPEC-11 was producing 29.5m barrels each day in July 2008. Some commentators have forecast a “super-spike” in the oil price to over \$200 per barrel which we believe is unlikely in the current conditions. But if unrest spread to Iran with its daily production of 3.7 million barrels or Saudi Arabia with potential production capacity of 11.5 million barrels, then the situation would look very different.

How and when OPEC would act is more difficult to pinpoint. The next formal meeting is June 2, 2011 in Vienna, but they could easily have a special meeting before then to discuss quotas. What we have seen over the last 2 years is OPEC gradually increasing production from 25 million barrels per day to current level of 26.8 million barrels per day as the oil price has recovered. They are actually producing around 2 million per day above their formal target, and we believe they are likely to continue to overproduce, while making reassuring noises that they will cover for Libya.

How much pain can the world economy take?

At some point the high and rising price of oil will become unsustainable. Price inflation will be forced higher and higher interest rates will be needed to counter it; company margins will be squeezed, growth will slow and demand for oil will fall. But predicting when this tipping point will be reached is far from easy.



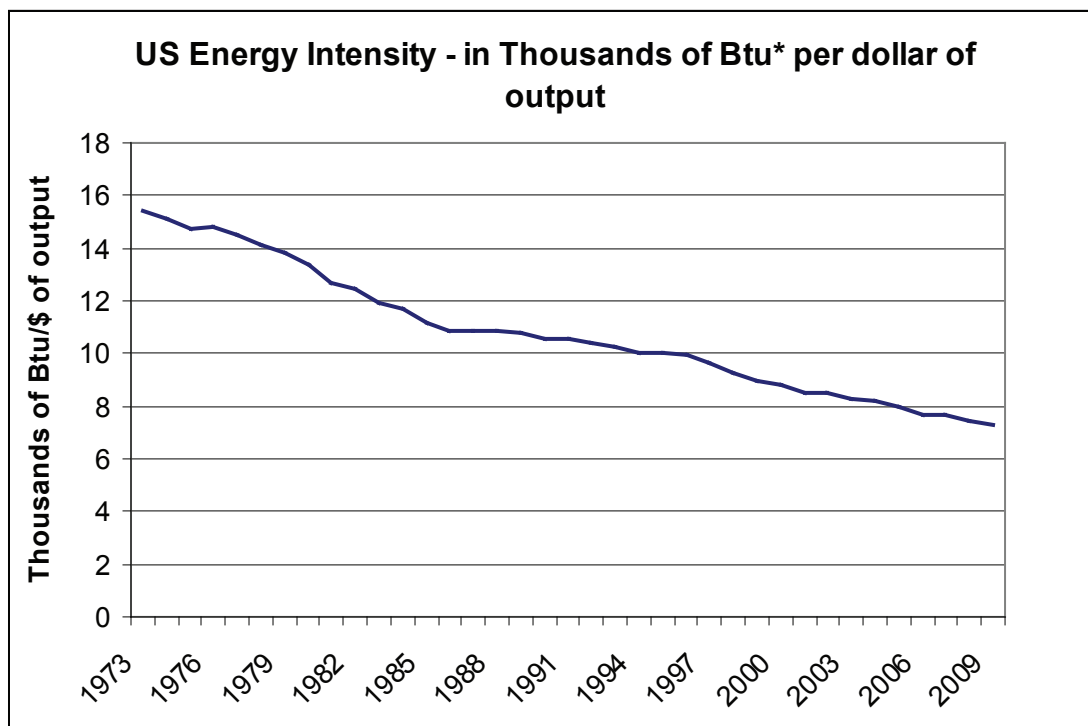
Source: IEA Oil Market Report, February 2011

* Other Non-OECD includes OPEC Natural Gas Liquids that are excluded from the formal production quota.

In 2008 world demand for oil ran at 86.1 million barrels per day and in 2011 this is expected to rise to 89.3 million barrels. The Organization for Economic Co-operation and Development (OECD) is an international organization founded in 1961 to further economic progress and world trade. Its members are mostly regarded as high-income, developed economies. Daily oil demand from the 34 member countries in 2008 was 47.6 million barrels and to meet this they were required to import 32.4 million barrels every day. In that year, when the oil price peaked at \$147, the average import price was \$97 per barrel. At that level the OECD was spending 2.78% of GDP on oil. The US, with its daily import requirement in 2008 of 12.95 million barrels, was spending 2.87% of its GDP.

In Dollar terms, in 2008 the nations of the OECD spent a combined \$1.15 trillion on oil; the US spent \$460 billion. We all know what happened next. The added strain on a system that was already heavily burdened by debt was too great and the world economy crashed. In the following year oil demand contracted by just over 1 million barrels per day, the oil price dropped down as far as \$30 per barrel and averaged \$58 for the year, reducing OECD oil spend to \$638 billion.

Now the oil price is back over \$100 per barrel (the price of Brent crude oil recently touched \$120 per barrel) at a time when economic recovery in the US is far from assured and when public debt is at new highs as governments try to support growth. The financial system in the Euro zone is especially fragile as the finances of European Union member states such as Greece, Portugal, Ireland and Spain come under increasing scrutiny. If oil should average \$95 per barrel for this year then not only will the economic growth forecasts of 2.2% in 2011 and 3% in 2012 be jeopardized, but oil spending at 2.5% of GDP in both the US and the OECD will rapidly approach crisis levels once again.



Source: US Energy Information Administration

*Btu: British thermal unit: a unit of heat equal to the amount required to raise one pound of water one degree Fahrenheit at one atmosphere pressure.

Since the oil crisis of 1973, the developed world has become much more efficient in its use of energy. The US, for example, has seen its use of energy per unit of economic output (energy intensity) fall by 52.7% between 1973 and 2009. This might well be ascribed to a decline in manufacturing and the growth of less energy intensive service industries over this period. But even in the period from 1999 to 2009 energy intensity in the US has fallen by 18.9% as improvements have been made in manufacturing processes, electricity production and transmission and more energy efficient products. In 2010, the US imported 11.75 million barrels of oil each day compared to 12.95 million in 2008. So there is hope, but sharp movements in such a key commodity will always result in economic dislocation and pain if the movements are sustained.

Lest there be any doubt, these high oil prices do not represent a conspiracy by oil producers to gain leverage over oil consumers. Such conditions will inevitably lead to slower growth and falling demand for oil, which could lead to lower oil prices. Consumers do not want to see sharply higher oil prices, and producers do not want to see a collapse in the price such as what was seen in 2008-9. There is little chance that companies, other than energy suppliers, could pass on such substantial price increases and thus this represents a squeeze on demand and prices for goods and services.

What about China?

There are some who question whether China ought to be worried about its stability given the well-known social pressures that exist and the authoritarian character of the government. We do not believe that China's situation is comparable to those nations in upheaval. The populations of the Middle East and North Africa are predominantly young, and as we have discussed, their economic prospects are limited. Hopes for a rising standard of living are poor under the present regimes and policies.

However, for the past thirty years Chinese economic policy has been wholly directed toward investment and a mass-industrial model designed to increase wealth and improve the standards of living for as many people as possible in the shortest possible time. The reasons for this are not wholly altruistic, of course; the Chinese ruling party have long been aware that to continue in power means improving the lot of the people - hundreds of millions of whom were living in poverty back in 1978.

The effectiveness of these efforts is beyond question. Life expectancy has risen from 41 years in 1950 to 73 years today. The population which was one of the most static in the world in 1980 is one of the most mobile. Wages in both urban and rural areas have risen significantly and a growing consumer market is evident. In 2010, for the first time more cars were sold in China (13.5 million of them) than were sold in the United States.

This is not to say that China's population is universally satisfied. Pressures exist and the government is highly sensitive to them. The prices of electricity, gasoline, diesel, staple foods and even the rate of interest paid on bank deposits are all tightly regulated in acknowledgement of the fact that there are huge divergences across China and within cities between income groups. The recent increases in minimum wages mandated by government serve two purposes: they address complaints from workers about exploitation and they raise disposable income to the benefit of the broader economy.

We would argue that while there are many good causes for grievances against the government which are generally met with minimal tolerance, there is a general sense, absent in many countries in the Middle East and North Africa, that life in China is better than it was and is likely to get better still. We do believe that the Chinese political system will come under pressure in time. The government's rigidity and lack of transparency and accountability to the governed is not suited to the kind of market-based consumer economy it is seeking to create. Like the economic system over the past thirty years, the government will have to eventually embrace political change, but unlike the economy, it has shown little enthusiasm for doing so yet.

What should investors make of all this and what should they do?

Global Growth Impact

Every \$10 increase on a barrel of oil adds \$43 billion to the US oil import bill and \$38 billion to that of the European Union. Holding everything equal, this would represent a drag on economic growth of 0.27% and 0.26% respectively. For the OECD as a whole we estimate the import bill would increase by \$111 billion and that the drag on growth would be 0.27%, on a similar basis.

These growth figures do not take into account mitigating effects such as the fact the US produces 7.8 million barrels of its daily 20.6 million barrel requirement. Other factors such as cost pass-through and efficiency gains will also come into play. We believe that the actual growth drag is likely to fall in the range of 0.1% to 0.2% in the developed world for each \$10 move in the average price. In 2010 the average import price for a barrel of oil was approximately \$75. So far this year to the end of February the average price Brent crude oil has been \$99.89 per barrel.

For consumers in the developed world the impact will be obvious. Higher energy bills and higher costs of gasoline will equate to a higher tax rate or a higher interest rate on borrowings. As the oil price passed through \$100 a barrel, US gasoline prices approached \$3.25 a gallon. While this is still well below the peak of \$4.15 a gallon reached in July 2008, it is still the highest level in two years. In other words it is the equivalent to fiscal or monetary tightening which works against the Federal Reserve's policy of Quantitative Easing. It works to depress growth, and it is also inflationary if higher prices and continued monetary easing are sustained. The argument against such high oil prices being sustained is that demand for oil will fall, as it did in 2009, as people and companies become increasingly conscious of how much they are using and how much it is costing.

What should Investors do?

- ***China & Asia***

China and Asia look most vulnerable to an oil shock as it has a high dependency on oil imports, especially from the Middle East, and the economies are more manufacturing rather than services based. Oil consumption in Asia ranged from 4% of GDP in China up to around 6% in Korea and Taiwan in 2010. Each \$10 increase is estimated to increase that proportion by 0.4% to 0.7% of GDP.

Inflation in the region has been a growing concern for some time as a result of food prices. Food accounts for 20%-25% of the inflation basket (the basket of goods by which consumer price inflation is measured) in developed Asia, but in developing Asia it is much higher at 33% in China and over 45% in India. Therefore, higher energy prices are compounding Asia's inflationary problems and the concern is that this may result in more aggressive monetary tightening than is currently forecast by the market.

The long term growth story in China and Asia remains unchanged, in our opinion. Economic reform and liberalization accompanied by investment and rising wages are creating consumer markets in the world's most populous region. Higher oil prices inevitably hurt a region that is based so heavily on manufacturing and has a high dependency on imported oil, but we believe that this will not result in sustained damage to the economic model. The region's finances are strong both at the national and at the corporate levels. After good stock performance in both 2009 and 2010 we believe this could provide a good entry opportunity.

- **Energy & Alternative Energy**

Energy equities have under-performed the rise in oil so far this year with the price of Brent crude oil up 18.86% while energy stock prices have risen 12.24%. North American exploration and production (E&P) companies have done better than their European E&P counterparts, which have greater exposure to oil reserves in developing markets. So while high oil prices ought, on the face of it, to be good for the sector, investors appear to have concerns both about the security of oil production assets, preferring North American-based production, and about the impact high oil prices will have on demand.

Energy stocks have lagged the broad market by approximately 20% since the bottom of the equity markets in 2008. We estimate these stocks currently price in an oil price of \$60 - \$70 per barrel. We believe that the oil price in normal conditions will trade between \$75 and \$95 per barrel, and that even without the current unrest, this will trend higher over time. Thus, we believe that energy stocks represent good value and there may be an opportunity for investors.

Recent events have also reminded governments of the importance of energy security and issues presented by a heavy reliance on oil, an increasing proportion of which is being produced in less stable parts of the world. Alternative energy solutions are now back on the agenda. In the recent global financial crisis alternative energy policies had taken a lower priority, but we believe that there will be renewed support. Solar, wind and hydroelectric technologies are the most advanced, and we expect to see greater investor interest in the sector.

- **Innovation**

We believe that truly innovative companies are those that can adapt themselves to changes in external conditions, to competition and to technological change. They can sustain product development and, in doing so, maintain a return on the capital they have invested that is well above the average over time. Those companies that are innovative, efficient in their use of energy and are able to generate higher productivity are the kinds of companies that will do better in this environment.

This may seem like an obvious point to make, but it offers investors a different slant to suggesting a broad switch into technology, telecoms and healthcare, all of which do not rely so heavily on the price of oil in their businesses. There will be many who recommend this and money is already switching. We would suggest this more thoughtful approach: looking across all sectors there are businesses that at first might appear to be vulnerable but have demonstrated their ability over the past ten years to generate returns on investment, even through the difficult years of 2008/9.

Conclusions

The social upheavals we have seen in Tunisia, Egypt, Bahrain and Libya have at the root sizeable and growing young populations that have been economically dispossessed by unresponsive autocratic governments. There is therefore, a real risk that this could spread across a group of nations where religious and cultural similarities exist alongside similar economic deprivation.

As a consequence, governments across the region are moving quickly to effect transfer payments through subsidies and handouts to appease people that are growing restless. The violence that has taken place in Libya has been especially sobering. We believe it is likely that the nations in the main oil producing region (for that, in truth is the West's overriding concern) will do enough in the short term to ensure stability. The seasons will also help: as the summer months approach, temperatures can reach 110°F, making street protests unbearable.

However, this will only provide a short breathing space. Governments will need to do much more to justify their position in power, and until they do, a risk premium on oil prices is likely to remain. Our oil price forecast this year was for oil to trade in a range of \$75 to \$95 per barrel. We would expect the average price for the year to come in the \$85 to \$95 range.

For developed markets this will mean added pressure on consumers already trying to pay down debt and will further complicate the work of Central Banks trying to navigate their way through inflationary and deflationary forces to support a recovery that still looks uncertain. We believe that for the US Federal Reserve fear of a deflationary spiral as in Japan is an overriding concern. Consumers paying down debt and spiking oil prices are both deflationary, and the temptation therefore is to sustain or increase monetary easing. If demand weakens, oil prices will come back down again, but weaker demand will have other unpleasant side-effects. If demand is sustained and higher oil prices are sustained then inflation and inflation expectations could take hold. The Federal Reserve is already taking a gamble between growth and inflation, and the stakes just got higher.

In Emerging Markets where food price pressures have already appeared in headline inflation, the concern is that these price pressures remain higher for longer. This, compounded by higher energy costs may prompt more widespread and aggressive monetary tightening.

Events such as these present investors with a wealth of uncertainty and risk. But at times like these there are also opportunities. Good quality companies see their share prices hit along with the bad, and those who can look through it will find value. The region will eventually stabilize, oil prices will come down again and policy makers around the world will have been reminded once again of the importance of developing alternative sources of power to the hydrocarbons that have powered us so far.

For those willing to look beyond today's headlines, the events in the Middle East could prove to be uplifting. Those that currently benefit significantly from the Middle East's engagement with the global economy are numbered in thousands, yet there are 335 million people in this region (compared to 317 million in the US and 188 million in Western Europe). This is a movement driven by secular matters not religious issues, and there is no reason to suppose that a theocratic system is an obvious alternative to the present system of government. If these events result in governments that pay more heed to the governed, become more accountable and offer greater chance of employment wealth and a rising standard of living then this could be another significant step in the tale of human progress.

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Commentary for our views on Asia, Alternative Energy and Energy markets is available on our website. Please [click here](#) to view.

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