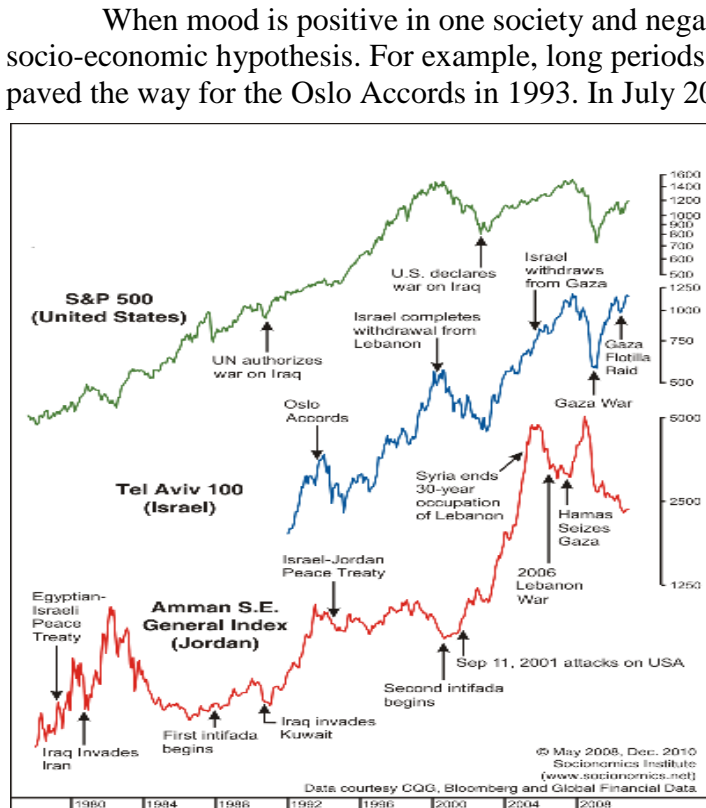


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### THE MIDDLE EAST, OIL, AND THE GLOBAL ECONOMY

With the recent conflict in the Middle East, which has led to a large dip in indexes around the world because of the loss of surety, many may wonder what the short and long-term effects will be, particularly towards their investments in equities. Based on historical evidence, it is somewhat simple to predict what the movement of markets will be in the coming months and in the year ahead. Mark Twain says it best: “History may not repeat itself, but it sure does rhyme.” When looking at data on conflict over the last 35-40 years, trends are more than abundant. While conflict in the Middle East does bring declines in the S&P 500 and other respective indexes, the S&P 500 has not reacted in tandem with Middle Eastern markets in times of peace. For example, the Egyptian-Israeli Peace Treaty, signed in 1979, brought a 8% upward spike in the Amman S.E. Index (the largest, oldest, and most-traded index in the Middle East). This had relatively no effect on American markets. Contrary, 2 years later when Iraq invaded Iran, both the Amman S.E. and S&P 500 saw large declines. However, these declines were followed by very sharp upturns in the following years, bringing both indexes to all-time highs. Again, in 1989 when Iraq invaded Kuwait, both indexes saw declines, followed by nearly all-time highs within 1 or 2 years. Here is a chart showing relative performance between the S&P 500, the Amman S.E., and Israel’s Tel Aviv 100 (introduced in the early 90’s):



When mood is positive in one society and negative in another, the results are also compatible with the socio-economic hypothesis. For example, long periods of rising social mood in both Israeli and Arab societies paved the way for the Oslo Accords in 1993. In July 2000, the leaders of Israel and Palestine held a similar summit at Camp David in the United States. But, this time, the Amman S.E. was still in a two-year bear market (the low end of an eight-year trading range), and the two sides walked away without shaking hands...one month later the Tel Aviv 100 ended its five-and-a-half year bull market run. Comparatively, the S&P 500 saw a constant decline over the next two years in tandem with the Tel Aviv decline.

More recently, in 2008 when Hamas attempted to take over Gaza (leading to a snowball effect resulting in what we now call the Gaza War) all three indexes saw very sharp downturns. Even smaller events, such as Gaza Flotilla tirade, are backed by downturns. These have been much smaller in comparison, but are downturns nonetheless. And again, these were quickly followed by upswings within just a few months.

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With all this being said, it is more important to

seek out what this means for our future. We may not be able to see the political future for the Middle East, but it is important for investors to understand the nature of the economic and financial risks. These largely come from two sources: (1) The potential for oil prices to rise sharply if supplies from the region are disrupted and (2) The potential for rising geopolitical tensions to cause a general flight out of risk assets.

Subjective reports suggest that Libya's oil production has basically shut down as a result of this recent crisis. Libya only accounts for a whole 2% of world-wide oil output, which isn't a big deal. However, this is occurring when oil inventories as a whole are already low and Libya is a major supplier of light sweet crude to Europe that cannot be easily replaced by others in the industry. On top of this, oil prices are already under upward pressure because of critical demand/supply levels. If Libya is the only country to lose its production for a while, then there really shouldn't be too much of an impact in the large scope of things. But that is where most of the fear is subsiding: in the belief that other producers in the region could also become involved in their own disorder. Algeria (1.6% of global production), Bahrain and Yemen are also small producers in the region. Iran is responsible for 4.6% of global supplies in itself. Finally, there is the threat to oil transportation through the Straits of Hormuz.

It is true that oil prices have risen continuously over the past two years, but they have not been a problem for the economy on a global scale. The majority of disciplined research shows that it normally requires oil prices to double before the world economy hits a harsh bear market. Economic models propose that a \$10 per barrel rise in crude prices reduces economic growth by 0.1-0.2%. That is not a huge effect. But, if prices were to rise to \$150, this would theoretically cut 1% off growth, which would be quite disastrous given that most developed countries are still getting the ball rolling after 2008.

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A rise in oil prices of this magnitude would be a deflationary rather than inflationary surprise. There is little chance that companies would be able to pass on the costs into higher prices or that workers would be able to secure higher wages. In other words, it would represent a massive relative price shock, squeezing spending on other goods and services. In that sense, it would be equity bearish, and eventually bullish for government bonds. Equities have been looking overextended for a while, and this has provided the perfect excuse for an expected correction, which is exactly what we saw during the trading sessions of February 21-25. Think of this as simple profit-taking. Stocks have been up so much over the last year and a half that investors need a time to cash out, but don't want to miss out on the continually rising share prices. They got their excuse and the market saw its minimal correction last week.

The bigger question is whether the cyclical equity bull market remains intact. Absent a further major spike in oil prices, we expect that the global economic recovery will remain intact. Moreover, recent developments will keep central banks on hold – even policy hawks would agree that tightening in the face of a geopolitical/oil shock would be madness. Thus, the two main drivers of the bull market – rising earnings and low interest rates – should stay in place for a while longer. Although the inclination of many investors will be to take some money off the table in the face of heightened geopolitical risk, the broad strategy should be to buy on dips. Today, we reiterate this recommendation. Also, although the VIX has risen, it may still be worth buying some VIX contracts. In the past, the U.S. dollar has risen during periods of extreme political and economic uncertainty, but that has not occurred this time. The U.S. monetary and fiscal policy stance troubles investors and the economy is perceived as more vulnerable than most to a rise in prices. Thus, the Swiss franc, yen and gold are seen as more appealing safe-haven plays. We would agree with this assessment.

A final and important point is that the current events highlight yet again how unstable it is for the world to have so much dependence on oil supplies from the most politically unstable region on Earth. This puts a premium on oil supplies from other areas such as Canada's oil sands. Investing in companies with exposure to non-Middle East oil would be a good strategy. This is an enduring and rapidly-evolving story making it impossible to derive any hard conclusions. Right now, we would not alter our basic view of expecting a sustained global economic recovery that should allow risk assets to outperform government bonds and cash over the next year or so.