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ECONOMIC TALKING POINTS

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**Two years after the great financial crisis, we now face
another ominous shock.**

Will the latest geopolitical eruptions slow U.S. economic growth? Yes!

We've been on the road meeting with clients the past two weeks and the number one topic on everyone's mind, not surprisingly, has been the unfolding events in the Middle East and North Africa. All essentially posed the same question: How will the turmoil half way around the world affect the U.S. and international economy?

We did not hesitate in our response: It will slow the economic recovery this year, as both consumers and businesses look on with concern and begin to reconsider their spending plans.

What is occurring geopolitically is an absolute game changer. The uprisings across North Africa and Persian Gulf represent a momentous inflection point in world history --- one that will prove to be hugely consequential for the international political system and the global economy.

For the foreseeable future, however, the violence and instability will not end in the next few days, or weeks, or perhaps even this year. As a consequence, oil and gasoline prices will remain elevated throughout 2011. The higher cost of fuel, along with more

expensive food, and rising interest rates later this year, will take considerable steam out of the recovery.

Having said that, we do not see any greater risk of a double dip recession (except under two scenarios which we mention below). But GDP growth for the US and much of the international community will be slower than had been forecast just two months ago.

How much slower? We have revised downward our projection for growth this year from 3.5% to 3.2%, and even the latter estimate may be on the high side.

Why the change?

Investors and business leaders will have to adjust to a prolonged period of uncertainty on how these uprisings will be resolved. While we can easily sympathize with protestors who demand greater political freedoms and a better quality of life, there is at the same time a palpable undercurrent of angst, since no one quite knows how it will all play out. This is, after all, a vitally important region of the world, producing nearly 40% of the planet's oil. It is also a geography that has suffered from bitter wars, deep tribal rivalries, and frequent acts of terrorism. It is no surprise that neither the Persian Gulf nor North Africa has any history of producing a successful democracy. (Algeria in the 1990s did have free elections and it led to a major victory for Islamic fundamentalists. But once in power, this group worked to pass laws that would undermine the democratic process. The military eventually intervened and took over. When the Shah of Iran was overthrown in 1979, the country had a democratic vote but the government ultimately devolved into a brutal, cleric-led theocracy.)

The fundamental question at this stage is whether the protestors, army, political institutions, and in some cases the monarchy, can work together to overcome the historical dynamic that has so far prevented a transition to a viable democracy. If not, we could see many countries in the region stumble from one autocratic leader to another, or succumb to tribal fragmentation and anarchy. We will probably not know the answer to this question for quite some time.

What is certain is that whole swaths of countries are undergoing tectonic changes, so much so that the entire strategic equation of US foreign policy for this region is itself in a state of flux.

The main near-term risk?

The big threat economically is that we are potentially looking at the greatest oil shock to hit the international community since the mid-1970s, when a disruption in supply led to an exponential increase in the price of crude and triggered the longest recession (1973-1975) since the great Depression. Oil prices have been marching higher in recent days. The price of Brent oil, which we believe is a more accurate barometer of supply and demand pressures than West Texas Intermediate (WTI), now stands above \$107 a barrel, the most in more than two years. Even WTI crossed the triple-digit threshold, to \$100. A

general rule of thumb is that every \$10 increase in the price of oil reduces GDP growth by half a percentage point within two years.

Needless to say, the timing of this upheaval couldn't be worse. Remember, we just barely survived a devastating financial crisis and the recovery is less than two years old. Certainly the job market has not made much of a comeback. Yet here we are facing another ominous event that could potentially derail the current recovery.

So what should one be looking at right now?

While more than a dozen countries have seen violent protests, here are the ones that can have a major long-term impact on the US and international economy.

Egypt: Not a major oil producer. The big danger is if the Muslim Brotherhood occupies a dominant role in the next government. If so, tensions between Israel and Egypt will increase.

Egyptians came out in huge numbers to overthrow President Mubarak largely because he was unable to improve their economic welfare. Nearly half of the country's youth are out of work and food prices are soaring. Protestors are demanding a better quality of life, more jobs, an improved economy and a more representative government. The politically powerful army seems sympathetic. The great unknown is whether free elections will also give the Muslim Brotherhood a key role in the next government. If so, this radical group can lurch the country toward a more adversarial relationship with Israel. Not only could Egypt's peace treaty with Israel be in jeopardy, Egypt may choose to look the other way as weapons entering Gaza increases, further arming and emboldening Hamas terrorists. Israel is unlikely to tolerate the flow of new arms and may counter by retaking control of Gaza, or launching destructive air raids near the Egyptian – Gaza border. It's a dangerous scenario that could escalate into a wider conflict.

Libya: Significant supplier of oil to Europe. Ghadaffi's brutal regime is about to fall. But don't expect oil to flow soon after.

The country produces 1.8 million barrels a day (about the same the U.S. produces in the Gulf of Mexico), with much of it going to Europe. But the riots and bloodbath unleashed in Libya threatens to shut down production. Foreign oil companies operating in the country have ordered employees to leave. Ghadaffi is desperately trying to retain power even if it means committing genocidal warfare against his own people. Incredibly, he has ordered his soldiers to use their rifles, machine guns, helicopter gunships, and jet fighters to attack protestors. (Be grateful he gave up building nuclear weapons a few years ago.) An estimated 1,000 people have so far been killed.

We believe Ghadaffi's rule is in its final death throes. It's only a matter of days or weeks before he is deposed or disposed. The question is what happens next? There is no clear opposition leader. Political parties have been banned. Libya is also badly splintered

by tribal groups that do not work well together. Moreover, unlike Egypt, the Libyan military does not have a political power base. Thus the risk of unrest and civil war will remain even after Ghadaffi's demise, with different tribal factions likely to make a grab for the country's richest oil fields.

Libya is thus very much a wild card and that has all sorts of implications for the European economy. If oil production grinds to a halt, Saudi Arabia can pick up the slack since they have about 4.5 million barrels of spare capacity. But that doesn't leave much left in the event of another major reduction elsewhere, like in Iran or Kuwait.

Saudi Arabia: Clashes with Shiite minority will increase, but the Saudi Kingdom will prevail.

The country possesses 20% of the world's oil supplies and is thus a pivotal player in the global economy. Saudi authorities have been successful in quashing previous Shiite uprisings and continue to go after Al Qaeda cells. Furthermore, by spreading its huge oil wealth around the country, the Kingdom has been able to keep the country fairly stable. What is worrisome, however, is that Saudi Arabia is now completely encircled by regimes that face more serious uprisings. There's the Shiite-majority Bahrain in the north, Yemen (with its Al Qaeda base) to the east, Jordan with its civil unrest to the west, and of course Egypt right across the Red Sea. The two most problematic for the Saudis are the riots in Bahrain and Yemen.

Bahrain; Geographically critical for the U.S. and Saudi Arabia. A collapse of the Bahrain monarchy can turn the country into an Iranian puppet.

Though not an oil producer of any significance, it is Bahrain's location that puts it at the nexus of any tensions in the Persian Gulf. The country has seen lots of violence in recent days as the Shiite majority demand more political freedoms, jobs, and greater representation in government which the minority Sunni -led ruling party has either ignored or moved too slowly.

What's the outlook? The long-time Al-Khalifa monarchy could be in danger of falling if it doesn't allow for greater Shiite participation. Yet giving the Shiites more power would be unsettling for the U.S. and Saudi Arabia. Bahrain sits in the Persian Gulf right across from Iran. Its strategic location is so important that the US has its Fifth Fleet based there to assure maritime traffic flows freely in the Gulf and through the Strait of Hormuz without Iranian interference. More worrisome is if the Shiite majority succeeds in overthrowing the Al-Khalifa monarchy, for then Bahrain could turn into an Iranian satellite. Iran would also be able to use Bahrain as a gateway to infiltrate Saudi Arabia through a causeway that links the latter two nations. Events in Bahrain thus deserve especially close monitoring.

Yemen: Al Qaeda has launched numerous attacks in Saudi Arabia from its base in Yemen's rugged mountains.

This country is the poorest in the Arab world and the events in Egypt and Tunisia has sparked violent protests in Yemen as well. Anti-government protestors want to throw out country's long time president and install a new government that permit political reforms and improves economic conditions. Nearly half the population lives in abject poverty. The danger is that Al Qaeda, which has established a firm presence in Yemen's rugged mountains, has helped fuel this uprising by pressuring, bribing, and threatening tribal leaders to oppose the current government.

Al Qaeda's presence in Yemen also poses a clear threat to Saudi Arabia. It is from Yemen that Al Qaeda has organized attacks against the Saudi Kingdom. So while one may sympathize with those who legitimately seek a better life in Yemen, Al Qaeda forces are working feverishly to help overthrow a regime that has worked closely with the US and Saudi Arabia. At this time, we view the survivability of President Saleh as very low, which raises the question of what will follow? Will the army crackdown on protestors and violently end the uprising? Will southern Yemen secede altogether? Will we see a new government emerge and how will that affect Saudi Arabia?

Iran: So long as the military and the Revolutionary Guards side with clerical leaders, protestors have little chance of overthrowing the current regime.

The country's theocratic leadership will use all means to hold on to power. While the economic sanctions against Iran are hurting, it doesn't seem to be enough to bring about a regime change. The only way it will collapse is through a military coup and that is highly improbable given all available intelligence. As a result, any attempt to force change by Iranian citizens will continue to be met with violence, and now there is talk of arresting and executing leading opponents.

The threat of deadly violence has not intimidated the public from continuing their street protests. It's a tragic situation that will likely remain bloody. Iran is utterly impervious to international criticism. We do see a higher probability that Iranian leaders will try to distract the public by turning more belligerent towards Israel. The two Iranian warships that crossed the Suez Canal on their way to Syria may be the just the first wave of naval vessels Iran plans to send into the Mediterranean. That could ultimately provoke a confrontation with Israel. We also suspect that Iran hungers to retaliate against Israel on the belief that the Jewish state launched the Stuxnet virus, a computer bug that effectively crippled Iran's computers at key nuclear sites.

What impact will all these events have on the U.S. economy and the financial markets?

As we said earlier, economic growth has been revised downwards, along with gains in the major stock indexes. Here's a look at the factors that will cool the economy and profits.

(1) Expect the fear premium on oil to remain elevated with an additional \$10 to \$30 a barrel to the price. That brings the cost anywhere from \$110 to \$140 a barrel for Brent crude. (Of course, if Libya, Algeria, and Saudi Arabia all have trouble pumping oil because of social unrest, the price of could spike toward \$200 a barrel.)

As a result, we are looking at the retail price of regular gasoline to remain above \$3 a gallon the rest of the year, and it may even test the previous high of \$4.11, reached on July 17, 2008. Higher fuel costs will act as a major tax on consumers and business. For example, every one-cent increase in the pump price of gasoline takes \$1 billion out of consumer pockets during the course of a year. In just the past 12 months, consumers had to spend an additional \$50 billion to pay for gasoline, money that could have been spent elsewhere.

(2) Along with surging energy prices, the cost of food and other commodities have also soared. Rising demand from fast-growing emerging countries and a rash of floods and droughts this year have catapulted the price of corn by 94% in the past year and wheat 70%. As a result, the cost of corn feed escalated so much, farmers have been forced to slaughter more animals. The size of the cattle herd in the US has now dwindled to the smallest in half a century.

(3) Many Americans still vividly recall how the last recession devastated household finances. We are projecting that with the cost of food and fuel rising sharply, consumers may pull back on discretionary spending sooner than they have in past business cycles. They are less likely this time to take on new debt to offset the decline in purchasing power, especially if the economic climate weakens and job insecurity resurfaces. Consumers will thus remain quite frugal.

(4) If, as we expect, the stock market starts to lose altitude in the coming months, the decline in equity asset values will cut into household net worth. Any diminution in household wealth has a negative psychological impact on consumers and will cause them to retrench.

(5) Businesses will also back pedal on capital spending plans as fresh worries mount on how rising energy and food costs will affect sales and revenue growth in the future. One big concern is the likelihood employers may further delay hiring plans, which will have a detrimental impact on consumer confidence in the months ahead.

(6) Efforts by Congress to slash spending and regain control over the budget will serve as an additional drag on growth should such a measure pass. While it is impossible to quantify at this time how much Congress and the President will agree to cut (if they do!), less official spending at a time when the private sector may do the same poses another risk for the economy.

(7) With the second round of the Fed's quantitative easing coming to an end in June, Bernanke will face a major uphill battle within his own ranks if he chooses to proceed with QE3. If there is no QE 3, the absence of fresh liquidity could drive interest rates higher and throw another wrench into the recovery.

(8) The ECB has already sent signals it is prepared to raise interest rates given that Eurozone inflation has now consistently run above the 2% target. Should the central bank tighten later this year, it will certainly slow growth across Europe and add more hardships to the ailing economies of Ireland, Greece, and Portugal --- and by extension, U.S. exporters.

(9) We already have seen numerous emerging countries (Brazil, India, China) raise interest rates to cool inflation pressures. With energy and food prices climbing globally, these additional steps to ease growth will eventually lower demand for US products.

What does it all mean?

As a result of these factors, we have downshifted GDP growth from 3.5% to 3.2% this year, and from 3.8% to 3.5% in 2012.

As for consumer expenditures, we cut our forecast from a 3.8% increase in 2011 to 3.2%, and reduced it from 3.5% to 3.3% in 2012.

Year-end forecasts on the major stock indexes have also been lowered:

DJIA to end 2011 at 12,677 (instead of 13,077)

S&P 500 = 1,409 (vs. 1,485)

NASDAQ = 2,813, (vs. 2,963)

Russell 2000 = 847 vs. (887)

What of the prospects of a double dip recession?

We have not changed the odds of a double dip recession; it remains around 15%. But we will be closely monitoring two situations:

1. What if civil unrest and violence dramatically increases and destabilizes Saudi Arabia?

If the House of Saud comes under grave threat, or the country falls victim to Iranian influence and/or Al Qaeda terrorists, it would be catastrophic for the world politically, economically, and militarily. However, we believe US and NATO forces would aggressively intervene to prevent such an outcome. Though Saudi Arabia is a devout Islamic and insular nation, its strategic importance to U.S. national security cannot be overstated.

The probability of a collapse of the Saudi monarchy is thus less than 10%.

2. The second major risk is the outbreak of a military confrontation between Israel and Iran. Whatever triggers this war, it would almost certainly expand to include the participation of Hamas and Hezbollah, the two main terrorist proxies for Iran. Here, too, the stakes would be sufficiently high as to warrant the involvement of US forces. Such an event will rapidly kick up oil prices to above \$125 a barrel for WTI. The question then becomes how long will crude prices remain at these lofty levels. By our estimate, the economy will likely tip into recession if WTI oil holds at \$135 a barrel for two months, or if gasoline prices exceed \$4.50 a gallon.

We have assigned about a 15% probability for such a scenario.

Bottom line:

The political dynamics now in play in the Persian Gulf and across North Africa are truly unprecedented and that makes it unusually difficult to formulate conclusions. The uncertainty here is profound given how important this region is to the world. In fact, the events of the last few weeks raise even more chilling questions than we noted above. For instance, what if the civil unrest spreads to China? (Spotty protests have already broken out in some cities out of sympathy for the Arab uprisings, but Chinese authorities smothered them at lightening speed.) Here's another. What if the contagion spreads to the troubled European countries, like Greece and Ireland? (Strikes have turned violent in Greece this morning.) The outcome of all these protests is so nebulous and speculative, it has motivated an increasing numbers of money managers and individual investors to play it safe and repatriate their funds, keeping them for now in the US.

And this is only the beginning.

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