

As Pharaohs Fall: What Changes in the Middle East Mean for Investors

So far Tunisia and Egypt have seen their leaders leave office. Libya's leader vows to be carried out and will probably get his wish. Other countries such as Bahrain have witnessed strife reminiscent of Ireland of thirty years ago. Iran shows its colors by suppressing its dissenters in a manner not practiced by the Shah. No doubt other countries in the area will follow this trend in time.

If cable news organizations had been around to cover the signing of the Magna Carta in 1215 or the reformation in Western Europe, the comparisons with today might be more obvious. As they were not, the parallels need to be explained.

Civilization's first attempt at government came from Egypt. It was hardly democratic. It was rule by the Pharaohs, whose grip on the state was legitimized by the religious leaders of their day. Still, the ideas of state administration, infrastructure creation, organized defenses, taxation and the like came from the need to organize to protect the Nile Valley and its agricultural output from predators. At this stage religion and government were one and the same.

Europe evolved in a similar fashion. However, first with the English rebellion against its King which set up the two Houses of Parliament, then with the Protestant reformation which had the effect of challenging the concept of state supported religion, Europe began to evolve away from the idea that government and religion were one and the same. The evolution was further evidenced by the creation of the United States Constitution, which for the first time formalized the separation of religious sanction from the role of government.

In contrast to the West, the Middle East has taken a route of warring tribes, religious competition and despots. This is much like the European Middle Ages. Tribal warfare prevents the evolution of society by obstructing the creation of institutions necessary for economic growth and development. Religious competition increases the size of the tribes and their capabilities. Despots can bring order to religious and tribal chaos at the cost of wealth distribution, as was the case of Egypt and Libya. Of all the Muslim countries in that part of the world, only Turkey has been able to institute a secular democracy. Even there, secularism is treated as a religion in itself.

The current trend of uprising and rebellion against non-democratic regimes has great potential for political and economic progress. Thus far only the conflict in Bahrain has religious overtones. Even there the grievance has more to do with economic discrimination than religious persecution. For other countries such as Egypt, the complaints revolved around access to economic tools and participation in the growth of the country.

With some of the lowest average ages for populations in the world, the Middle Eastern countries are experiencing great pressure for economic opportunity from a generation which in some cases is well educated but unemployed. A more generally beneficial distribution of energy wealth should go a long way to addressing this situation. Despots generally skim the wealth of the country for their own ends. However, even Switzerland has announced that such family assets will be frozen until legitimate ownership can be verified.

Of all the countries in the region, the one to most feel the heat is Iran. After the fall of the Shah, the country has not delivered on its potential for economic development. Its nuclear program intimidates the world while providing nothing to its citizens. If other countries transition to secular democracy, the burden of proof will then be on Iran to show cause why they should not do the same. In this same boat is Syria and for somewhat different reasons, Jordan, Kuwait and Saudi Arabia. The former country has its own despot while the latter three provide well for their people but do not encourage political freedom. However, the experience of China shows that people will tolerate narrow political options if economic options are wide. More problematic are countries that provide neither.

Looking askance on these trends is Israel. The Jewish state is alarmed in the short run at the potential for more countries becoming like Iran. An equal threat would be if the countries turn out to be like Turkey. While Israel has democratic institutions, it has a policy of favoring Jews over non-Jews. If other countries adopted a policy of accepting its citizens without regard to religious affiliation, it would put pressure on Israel to do the same. Such a course would have a profound effect on the country's character.

With energy wealth, education, youth and opportunity, the Middle East can become a key contributor to the world's economic growth. It will not be a smooth transition, nor will it be free of setbacks along the way. However, with so much of the Middle East tied into the rest of the world already with the Internet and other information technologies, it does not appear there is any going back to the past. The Pharaohs served a purpose in the evolution of the world. They are not the future.

The Economy

Economic activity is keeping a measured pace. The growth rate is slow for this stage of economic development. This is mainly due to the absence of housing demand. However, there is no expectation of the economy sliding back into a recession. While much of the Government stimulus funds are due to expire in the second half of the year, the reduction of the payroll tax for workers is providing for a second wave of stimulus spending.

State spending is very much in the news with the talk of re-negotiating retirement benefits of public workers. Like housing, public spending by states and municipalities has been a drag on the economy. With so much of state revenue being tied to property values, there does not seem to be a chance for the trend to reverse itself in the near term.

Interest Rates

Interest rates are reaching an inflection point. While various Treasury programs can suppress interest rates for awhile, the ability of the Government to keep interest rates down over an economic cycle is problematic. There is an increasing chance for an interest rate increase before year-end. 2012 should see a continuation of the trend unless there is meaningful progress on reducing the deficit.

Inflation

Inflation in food and fuel costs is becoming ongoing. These costs are not avoidable and fall most heavily on the lower class, who must devote a larger share of their incomes to these items.

While food cost increases may be temporary due to weather-related factors, energy costs seem to be more related to world demand. Only conservation measures will shelter users from the effects of energy price increases. Prices that reflect tensions in the Middle East should reverse themselves with time.

The Stock Market

After churning up almost without interruption since last September, stocks declined sharply after the turmoil in the Middle East hit Libya, a major oil exporter.

A second but less obvious trend is that of the revenues and earnings of some companies coming in below forecasts. While certain industries like manufacturing continue to experience strong trends in sales and profits, other areas like technology are having hiccups in revenue projections.

These trends may lead to the next market advance being less broad-based than the current one. This will be especially true if interest rates firm up. Many a company is being supported by low interest rates. Higher rates will translate into lower profit margins.

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February 24, 2011

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