Short Brief from the Chief Investment Officer

March 2, 2011

Update on the Stress in the Middle East

Riots, civil war, protests, toppled governments…the Middle East is going through some major sea changes that are likely to have profound effects on the region and, potentially, the world both geopolitically and economically. While this region has been subject to a constant state of some form of instability for decades due to the imposition of artificial sovereign boundaries and identities, today we are faced with the highest amount of uncertainty regarding the complexion of its governing bodies and their impact on the global economy. Surprisingly, the financial markets have proven resilient and have handled the turmoil relatively well with most developed markets still in positive territory year-to-date. However, given the importance of these developments, we attempt to provide some insight on a very fluid and evolving situation.

Overview

We have witnessed the overthrow of two governments (Tunisia and Egypt), riots in Bahrain, Oman, and Yemen, and what appears to be a developing civil war in Libya. The primary catalysts for these uprisings are:

- Demands for democratic reforms. Most of these countries have suffered decades of frustration living under the oppression of autocratic and corrupt governments.

- Poor economic conditions affecting the broad population. While the global economic recovery appears moderate but healthy, the great majority of the people residing in these countries has not participated and, in fact, has experienced rising costs of living and high unemployment. The masses are demanding measures to alleviate the stress of higher food and energy prices on consumers who, in many cases, spend more than 50% of their income on those items.

While many of the protests have been relatively peaceful with the exception of the brutal suppression in Libya, some have ignited sectarianism that could result in protracted conflicts, possibly additional civil wars and contagion into countries such as Algeria and Saudi Arabia. In the most optimistic scenario, longer term, we can hope these movements result in the introduction of self-sustaining democracies in these countries. However, in the short term, there is a real risk of new authoritarian and potentially extreme fundamentalist regimes filling the power voids which could lead to continued uncertainty from a geopolitical standpoint and, as such, more volatility in risk assets due to the risk of a severe reduction in oil supplies.

Key Country Updates

Libya

The situation in Libya is expected to get worse before it gets better given Gaddafi’s intransigence and all-or-nothing stance. He has lost the Eastern provinces representing the bulk of the oil reserves but he has the means to maintain a power struggle. Reports indicate he has hired Russian and African mercenaries to suppress protestors. Adding to the uncertainty around any potential resolution to the situation, there appears very little cohesion between the various protestors with many having radical tendencies. A vacuum of leadership could be created if Gaddafi leaves or is forced out of power. News reports indicate the U.S. has started to reach out to Libyan opposition groups to get a better understanding of their needs and intentions.

From an economic perspective, Libya represents 1.9% of the world oil production or approximately 1.6 million barrels per day, Saudi Arabia has reportedly backfilled nearly half the disruption in the oil markets (approximately 700,000 barrels/day) and has stated it can increase that amount if needed.

Egypt

The situation in Egypt appears to have stabilized with banks open again and the government announcing a stimulus package aimed at getting the economy back on its feet after losing several billion dollars due to an economy paralyzed by protests. Markets are scheduled to reopen on March 6, 2011.

Bahrain and Saudi Arabia

While the uprising started with 100,000 people in streets marching peacefully in Bahrain, today, the Saudis are reportedly sending tanks to Bahrain to ensure the protests remain peaceful. Based on our contacts with analysts plugged into Washington D.C., we understand the U.S. government believes there is a low probability of unrest and instability in Saudi Arabia itself.

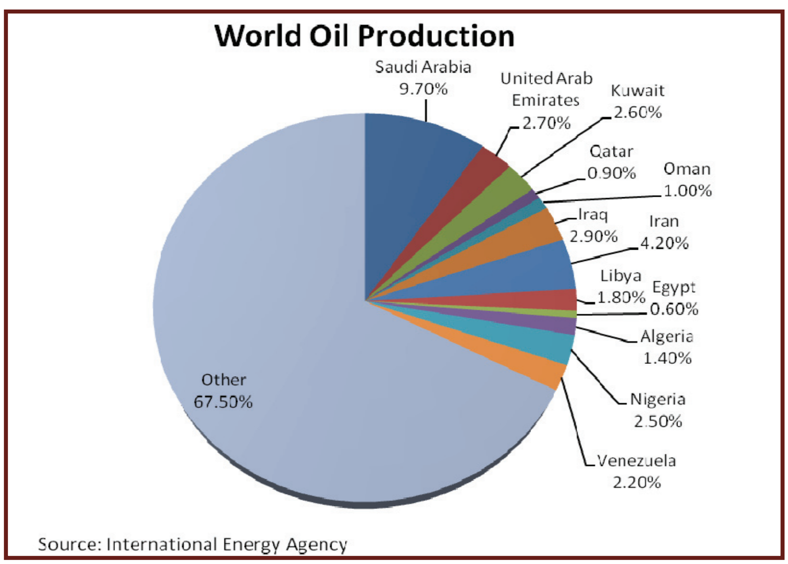
Others

Protests have gone on for the last four days in Oman while Yemen and Lebanon also are also experiencing unrest. Algeria has been able to contain its protestors but continues to face the risk of a spillover from its neighbors. While Nigeria has not had an uprising, the country's oil output represents approximately 2% of world supply and any uprising could put that at risk.

Potential Implications

Economic

The continued rise in oil prices remains the focus of concern and, an escalation and/or expansion of the conflicts will likely lead to higher prices staying elevated longer thereby jeopardizing the fate of the global economic recovery. While I have seen various estimates regarding the impact of higher oil prices on gross domestic product (GDP), the bottom line is the same. Here is a sampling of the various statistics:



- Every $10 rise in oil prices reduces GDP growth by about 25bps over the first year. If the elevated price persists over a second year, growth could be reduced by 1%. With world GDP growth expected to be just above 4%, this could mean nearly a 25% reduction in growth.
- Every $1 increase in oil reduces U.S. GDP by $100 billion per year and, as a corollary, every cent increase in the price of gasoline decreases U.S. consumer disposable income by about $600 million per year. Gas prices increased the last weekend in February to a new nationwide average of $3.37/gallon, an 8% increase over the previous month. The move in oil and gas prices in the last few weeks has, by all estimates, eliminated the benefits of extending the Bush tax cuts.

- Historically, the U.S. heads into recession after a two year surge in oil prices.

Portfolio

While the risks are clear, they are playing out against the backdrop of mixed U.S. economic data with a slight overweighting to continuing improvement. Regional and national business activity data has been strong, reflecting higher new orders and a marginal strengthening employment, while consumer confidence has reached a three year high. However, housing numbers continue to indicate stress in that sector, unemployment still exceeds 9% and consumer spending came in lower than expected. As such the recovery may be at risk depending on how events unfold.

Our risk-conscious philosophy based on broad asset allocation and extensive diversification should enable portfolios to mitigate the impact of the risks facing the global economy. Some key exposures to consider:

- Exposure to gold should help in the case of additional systemic shocks, general risk aversion and increases in inflation.

- U.S. Treasuries should also help reduce risk in portfolios if investors decide to seek safety in the face of more turmoil.

- Emerging market exposures could fare well for two reasons: (i) oil exporters can benefit from a continued rise in oil prices; and (ii) many of these countries, facing inflationary pressures, may finally allow their currencies to appreciate.

- High quality equities may experience an investor flight to quality.

- If energy prices remain elevated and end up acting more as a tax on growth (as opposed to providing inflationary pressures), companies may be able to adjust over the long term but may suffer in the short term; however, our core fixed income exposure should benefit in that scenario.

- Strategies exposed to other sources of energy, such as natural gas (which is in abundance in the U.S.), could also perform well.

- Hedge fund strategies may be able to take advantage of the volatility in risk assets through both their long and short books.

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