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Oil is a Political Commodity

by Brian J. Friedman, CFA

The Arab revolutions over the past two months remind us that oil is still a political commodity. Since late January when former Egyptian President Hosni Mubarak was forced from power, oil prices have climbed by approximately $20 per barrel. Since then unrest has spread to other Arab countries including oil exporters such as Libya, Saudi Arabia and Bahrain. Earlier periods of political instability such as the aftermath of the 1973 Arab-Israeli war, the 1979 Iranian revolution and Iraq's incursion into Kuwait in 1990 saw oil prices jump dramatically for a period of time.

Middle Eastern affairs are a personal and academic interest of mine. I spent a year studying the history, politics and economics of the Middle East at the University of Tel-Aviv in Israel. In addition to regular return visits to Israel, I have also visited the Palestinian Territories, Egypt, Turkey, Morocco and Pakistan, in some cases more than once. Over the years I have had numerous discussions with Middle Easterners from a wide variety of backgrounds, countries and political affiliations. Since political risk is such an important part of the energy markets, we thought it might be useful to outline certain political risk factors that are often ignored by the media.

Arab Politics Seems Alien and Peculiar to Westerners

Arab politics seem to operate according to a peculiar and alien logic. As Westerners, we are often confused by the choices made by their people and political leaders. A number of Arab countries are still ruled by absolute monarchs wielding powers that would inspire jealousy in medieval European kings. Others are ruled by Presidents that act like kings. Until the U.S. military installed a democratic, albeit troubled, regime in Iraq, Israel was the only country in the Middle East where Arabs could vote in a free and fair election.

"National" Identity is new to the Middle East

As Westerners, we often make assumptions that do not readily apply to Arab countries. For starters, our national identity as Americans (or French, British, Spaniards, etc.) is clear and widely shared. The history of the United States is punctuated by conflicts over expanded political rights, but since the Civil War our identity as "Americans" was never superseded by regional, tribal or religious definitions.

For several centuries, identity in the Middle East was also quite well defined. If you asked an Arab his/her nationality prior to World War I to the extent the question was even understood the most likely answer was "Islam." By our hierarchy of self-definition, Islam is a religion which is separate from our concept of nationality. In the Arab world, however, this separation was unnaturally foisted upon them both by their own leaders as well as their colonial masters in the aftermath of World War I. Prior to this time Arabic was primarily a language and only secondarily an ethnicity. The Arabs were for many centuries proud citizens of the Islamic Empire ruled from Istanbul, Turkey.

Alternatively many Arabs might also have described their "country" according to their tribe or clan affiliation, but very few understood themselves to be "Syrian," "Iraqi," "Jordanian," or "Libyan." For most people, these were artificial political boundaries imposed by outsiders to keep Arab Muslims divided and weak. A few intellectuals and other members of the political elite possessed Western notions of an Arab nation. They promoted this concept to the masses and it grew throughout the 20th century. As this concept spread it became amalgamated with competing ideas such as Islam, tribe, clan and, initially most weakly, the state. As a result, Arab countries never truly became "nation-states," a concept we largely take for granted in the West.

Lack of Identity Breeds Illegitimacy

The newly created Arab states faced a daunting challenge throughout most of the 20th century. Not only did their citizens not identify with a coherent national identity, but they also viewed their states as inherently illegitimate. By extension, their rulers were also viewed as illegitimate. Large segments of society worked to overthrow these new regimes to establish political entities more in accord with their self-definition. For the most part this led to pan-Arab or pan-Islamic political movements which threatened existing rulers, and resulted in periodic revolutions over the years.

Arab states worked against these revolutionary pressures in four major ways:

- Political and economic repression for the masses while promoting patronage for loyal and powerful elites
- Manipulation of the media and educational system to create a new state-centered identity (often mixed with a leadership cult)
- Attempts to co-opt Islam and Arab nationalism into state-centered loyalties
- Promoting conflict with scapegoats such as Israel and subjugated Christian, Shiite and Kurdish populations

By the 21st century most Arab countries had successfully used these tools to craft new national identities with the state at least as important, and perhaps slightly more important, than competing alternatives such as Islam or pan-Arabism. Despite this transformation, national identity in the Arab world is still quite muddled and large segments of society, such as the Islamists, espouse alternative definitions.

The inherent illegitimacy of Arab governments is at the very core of Middle Eastern politics. Various governments pursue different methods to establish their legitimacy or, failing that, to keep their populations politically quiescent. Arab governments rely on a mix of fear, bribes and identity building to maintain their power. Most maintain multiple levels of secret police and onerous regulations that prevent alternative sources of non-governmental power. Most importantly, Arab governments seek to bestow economic privilege on groups loyal to the regime while preventing all others from amassing capital or organizing in almost any other manner.

It was not an accident that the recent revolutions were sparked by the self-immolation of a street vendor harassed by the Tunisian police for selling produce without a license. His frustration was shared by the majority of Tunisians. The dictatorial regime of Zine El Abidine Ben Ali granted family members and close allies access to monopoly businesses while preventing competition economic and political from almost everyone else. This situation is common throughout the Arab world, as is the tendency toward political nepotism. Fears that aging current rulers would perpetuate this system by installing their sons or close relatives in power also helped ignite popular anger.

Egypt and Saudi Arabia: Exceptions that Prove the Rule

Egypt

Like other Arab countries, successive Egyptian governments struggled to establish legitimacy. Unlike other Arab countries, however, Egypt as a coherent political entity stretches back millennia. Egypt's population is clustered around the Nile river with wide deserts and an ocean separating Egypt from its neighbors (see map). As a result, state centered administration and a sense of nationhood are greater in Egypt than most other Arab countries. While Egypt remains firmly within the fold of the Arab governance model, successive Egyptian governments were able to obtain loyalty from the citizenry with somewhat less repression than other Arab governments and without oil wealth.

Due to Egypt's greater stability, President Mubarak embarked on a very gradual economic liberalization in the 2000's. While concentrating business opportunities among loyal elites such as the military and family associates, he nonetheless helped expand the Egyptian middle class to include approximately five to eight million people (out of a total population of 80 million). These are the same urban residents who filled the streets and forced Mubarak's resignation.

Access to economic opportunity is at the core of the Egyptian and Tunisian uprisings, but by the logic of repression in these countries all forms of organization economic or political were viewed as potentially existential threats to the incumbent regimes. Economic reform, we now know, let a genie out of its bottle as its beneficiaries demanded even greater opportunity. Calls for "democracy" therefore strike at the intimate connection between political and economic repression.

Mubarak held regular elections but simultaneously stifled the opposition. The next test will be whether democratic institutions will produce the outcome desired by the middle class. Chances are better in Egypt than in many other Arab countries, but greater democracy may open a Pandora's Box of dangerous political forces since the urban middle classes are at most 10% of Egypt's population.

Saudi Arabia

Since the uprisings began in late January the price of oil has shot up above $100 per barrel. Short-term fears related to supply disruptions through the Suez Canal (controlled by Egypt) or lost production from Libya (about 2% of global oil production) certainly contributed to oil's rise, but the ultimate source of investor anxiety revolves around potential instability in Saudi Arabia. The Saudi's supply 12% of the world's oil and sit on top of 20% of known global oil reserves.

The Saudi royal family enjoys greater legitimacy than most Arab rulers. For starters, their role in Arabian politics stretches back to the 18th century. As the premier tribe in central Arabia, the al Sauds were consistently independent of European colonial powers as well as the Ottoman Empire. When the Ottoman Empire dissolved after World War I the al Sauds moved to conquer all of Arabia, including the holy cities of Mecca and Medina. The basis of their legitimacy, therefore, is religion.

Even more than Egypt, the Saudi government has taken significant steps to liberalize the economy. Like all Arab regimes, the state maintains tight control over the economy and politics. Given its greater legitimacy among the people, the Saudi state relies less on repression (although this too is a matter of degree) and, of course, much more so on a sense of nationhood mixed with a healthy dose of spending largesse.

We know from world history that greater wealth generates rising expectations for improved economic opportunities and political participation from the citizenry. Saudi Arabia is much wealthier than Egypt and calls for a more inclusive economic and political system are gaining traction. In the shortrun the royal family can buy acquiescence from its people with a better distribution of oil revenues combined with threats of force. In the longrun, however, demands for political reform are likely to be answered. The question is whether reform follows a smooth transition to a British style constitutional monarchy or a more revolutionary path like Egypt. Given the legitimacy and resources of the royal family, the former is more likely but it ultimately depends on their ability to gracefully cede power.

Do Not Underestimate the Long-Term Political Risk in the Middle East

Arab governments are inherently unstable since their people do not readily share common beliefs regarding national identity. Efforts to establish new state-centered identities have generally been working, but do not enjoy exclusivity and rely on economic and political repression to maintain government control. Perhaps the recent revolutions sweeping the Arab world mark a turning point toward inclusiveness, but heightened instability is likely to remain a feature of Arab politics for many years to come.

Oil typically commands a price premium because of potential political instability in the Middle East. The markets are now demanding even greater premiums and our assessment is that recent revolutions are only the beginning of a long period of political uncertainty. Basic supply and demand factors remain the primary determinants of oil prices, but political risk in the Middle East should certainly not be ignored. Even the most seemingly stable Arab regimes such as Saudi Arabia and the Persian Gulf Emirates govern peoples that do not completely buy into their right to govern.

The Arab World

	Population (Millions)	Population Growth %	Median Age	% Urbanized	% Literate	GDP ($ Billions)	GDP per Capita	Oil Production Million Barrels/Day
United States	**313.2**	**1.0%**	**36.9**	**82.0%**	**99.0%**	**$14,620**	**$46,679**	**9.1**
North Africa								
Morocco	32.0	1.1%	26.9	58.0%	52.3%	$91.7	$2,866	0
Algeria	35.0	1.2%	27.6	66.0%	69.9%	$159.0	$4,543	2.1
Tunisia	10.6	1.0%	30.0	67.0%	74.3%	$43.9	$4,142	0
Libya	6.6	2.1%	24.5	78.0%	82.6%	$77.9	$11,803	1.8
Egypt	82.1	2.0%	24.3	43.4%	71.4%	$216.8	$2,641	0.7
Levant								
Palestinian Authority	4.2	2.5%	20.5	72.0%	92.4%	$6.6	$1,571	0
Jordan	6.5	1.0%	22.1	79.0%	89.9%	$27.1	$4,169	0
Lebanon	4.1	0.2%	29.8	87.0%	87.4%	$39.2	$9,561	0
Syria	22.5	0.9%	21.9	56.0%	79.6%	$59.6	$2,649	0.4
Persian Gulf & Arabia								
Iraq	30.4	2.4%	20.9	66.0%	74.1%	$84.1	$2,766	2.4
Kuwait	2.6	2.0%	28.5	98.0%	93.3%	$117.3	$45,115	2.5
Saudi Arabia	26.1	1.5%	25.3	82.0%	78.8%	$434.4	$16,644	9.8
Bahrain	1.2	2.8%	30.9	89.0%	86.5%	$21.7	$18,083	0.04
Qatar	0.8	0.8%	30.8	96.0%	89.0%	$126.5	$158,125	1.2
United Arab Emirates	5.1	3.2%	30.2	84.0%	77.9%	$239.7	$47,000	2.8
Oman	3.0	2.0%	24.1	73.0%	81.4%	$53.8	$17,933	0.8
Yemen	24.1	2.6%	18.1	32.0%	50.2%	$30.0	$1,245	0.3
Totals	**296.9**					**$1,829**		**24.8**
World Oil Production								**79.9**
Arab Countries %								**31.1%**

*Excludes Sudan which is 39% Arab, Israel which is 20% Arab and the small island of Comoros which is in Southern Africa.

Source: www.cia.gov

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Key Financial Ratios for Domestic Asset Classes

Asset Class	Price/Earnings 2011:Q1	P/E Benchmark	Over/Under Valuation	Price/Book Value 2011:Q1	P/BV Benchmark	Over/Under Valuation
Large-Cap Growth Stocks	17.2	27.0	-36.3%	3.6	5.7	-36.8%
Large-Cap Value Stocks	14.1	20.2	-30.2%	1.7	2.5	-32.0%
Mid-Cap Growth Stocks	24.3	24.8	-2.0%	3.4	4.5	-24.4%
Mid-Cap Value Stocks	21.3	19.1	11.5%	1.7	2.2	-22.7%
Small-Cap Growth Stocks	22.9	23.2	-1.3%	2.7	3.5	-22.9%
Small-Cap Value Stocks	33.5	18.2	84.1%	1.6	2.1	-23.8%

**Please note that the P/E data reported above are based on "as reported" earnings information rather than "operating" earnings. "As reported" earnings include one time write-offs whereas "operating" earnings reflect the profitability of a company as a going concern. We believe P/E's based on operating earnings are a better long-term valuation indicator, but Standard and Poor's does not report this information for the style indexes used in our calculations. Amid economic recession, declining earnings impact price-related ratios and "as reported" earnings can be significantly lower than "operating" earnings (particularly in the Value segment of the market) due to large write-offs. As a result, the P/E ratios listed above are higher than they would be using "operating" earnings for the denominator. To address this issue we have included Price to Book Value (P/BV) data, which are less affected by the impact of declining earnings and large write-offs.*

GHP Investment Advisors, Inc. benchmarks are based on proprietary discounted cash flow models. P/E and P/BV data provided by Bloomberg L.P. as of 3/31/11.

Returns by Index

Index	YTD*
DJIA Total Return	7.06%
NASDAQ	5.05%
S&P 500	5.92%
S&P 500/Value	6.81%
S&P 500/Growth	5.07%
S&P MidCap 400/Value	8.91%
S&P MidCap 400/Growth	9.84%
S&P SmallCap 600/Value	6.34%
S&P SmallCap 600/Growth	9.14%

DJIA & NASDAQ: Bloomberg L.P. as of 3/31/11.

S&P Returns: Standard & Poor's (April 1, 2011) Standard & Poor's Reports March Index Returns. Press Release.

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GHP Investment Advisors, Inc.
Registered Investment Advisor

1670 Broadway, Suite 3000
Denver, Colorado 80202
P 303.831.5000
F 303.831.5082

Invest@GHPIA.com **www.GHPIA.com**

Brian J. Friedman, CFA
President

Robert W. Hochstadt, CPA/PFS
Senior Principal

Steven I. Levey, CPA/PFS
Senior Principal

David J. May
Investment Analyst

Carin D. Wagner, CFP®
Financial Planning Manager

Sommer C. Vincent
Client Relations Manager

Mike Sullivan, CFP®
Financial Planning Associate

Christine Jerritts, PhD
Analyst

Deirdre McGuire
Client Relations Assistant

Ed Leone Jr., DMD, MBA, RFC
Associate

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