Philequity Corner (January 31, 2011)
By Valentino Sy

What does Tunisia or Egypt have to do with Philippine stocks?

Why would a small country like Tunisia in the northernmost part of Africa affect the Philippine stock market? Why would Egypt which is so far away in the Middle East affect us?

Tunisia earlier this month forced the ouster of its long-time leader Zine El Abidine Ben Ali through "people power." Like our own EDSA revolution twenty five years ago, these popular revolutions can be very contagious. The Tunisian revolution has ignited similar moves against other authoritarian regimes in the region. Anti-government protests also erupted in recent months in Yemen, Algeria, Morocco, Sudan, and more recently, Egypt. Successful people power revolutions can embolden opportunists to make similar moves in the autocratic regimes like Saudi Arabia, Kuwait and the UAE which are the main sources of crude oil.

In Egypt, over 40 people have been reportedly killed and at least a thousand injured last week as protesters posed the biggest challenge to Egyptian President Hosni Mubarak's 30-year rule. Since Egypt is in the heart of the oil-rich Middle East, any political change or sociopolitical revolution is seen to be very explosive. Many fear that political turmoil in Egypt can be the tinderbox that may ignite violence to the historically volatile region.

Egypt controls the Suez Canal which considered is a chokepoint in the supply of oil going to Europe and to the US. Egypt is in the vicinity of Saudi Arabia which has the 2nd largest oil reserve in the world (267 billion barrels) and Libya which has the largest oil reserve in Africa and 9th largest in the world (41.5 billion barrels).

Stocks Plunge and Crude Oil Prices Jump

Global equities plunged the most since November, with the benchmark S&P 500 index declining 1.82 percent last Friday, and the iShares MSCI Emerging Market Index ETF (symbol: EEM) losing 3.26 percent after protesters in Egypt clashed with police, defying a curfew and setting fire to buildings. Concerns that the unrest in Egypt could spread in the Middle East caused the price of crude oil to jump by 4.4 percent to $89.49 per barrel.

Source: www.stockcharts.com

Supply Chokepoint

Stocks sold off and oil jumped because investors are worried that instability in Egypt could disrupt Middle East oil supply. Egypt controls the Suez Canal and its Sumed pipeline which connects the Mediterranean and Red Seas. The canal and pipeline is considered a significant geographic oil transit chokepoint, carrying more than 4 million barrels a day of crude oil or 4.7 percent of global output. But so far, traffic through the Suez Canal has not been affected by the protests in Egypt according to the Suez Canal Authority.

The Day the Internet Died

Amid widespread protests and civil disobedience, Egyptians authorities pulled the plug on the internet and cell phones, even as UN Secretary General Ban Ki-moon warned that "freedom of expression should be fully respected" in Egypt. Despite having one of the most advanced telecommunications markets in the Middle East and Africa, it was easy for the authorities to order the shutdown because there are only a handful of Internet Service Providers (ISPs) in Egypt. Around 16.6 million Egyptians use the internet as of end 2009 according to ITU, the leading UN agency for information and communication technology.

Emerging Market Shares Tumble

Emerging market stock funds experienced their biggest weekly outflow since the 3rd quarter of 2008 (during the week ending Jan. 26) according to EPFR Global. The rotation of investments from emerging markets towards developed markets which we first mentioned in our column two months ago (see *Is the Bull Market Over?*, November 14, 2010) continues.

The US economy is gradually recovering on the back of supportive monetary and fiscal policies, whereas emerging economies are confronted with rising inflation and tightening monetary policies. In fact, the US economy grew 3.2 percent in 4Q10 driven by the biggest gain in consumer spending in more than four years.

Meanwhile, rising geopolitical tensions in the Middle East and surging crude oil prices are generally bad for emerging markets especially those who are importing oil. As a result, the iShares MSCI Emerging Markets Index ETF posted its largest one-day drop in three months.

Inflation Worries

Although Philippine inflation remain in control, projected to range between 3.8 percent to 4.2 percent in 2011 by the Bangko Sentral, much of the unrest in Egypt and elsewhere in the oil-producing Middle East region have not yet been priced in. Higher-than-expected inflation rate this year may be detrimental to the government's efforts to achieve 7% - 8% GDP in 2011. This is also seen as a huge headwind for the Philippine stocks going forward, especially if crude oil prices breaches the psychological $100 per barrel level.

US in a Bull Market & EM in Consolidation Mode

All these uncertainties and political upheavals caused by Tunisia and Egypt have caused the market to correct. It is very likely that we will see further corrections in the market. But we believe that the US markets are in a bull market. With Bernanke at the helm of the Fed, the economies of the US and other developed markets have gotten stronger. Emerging markets are in a consolidation mode after the big run-up in 2009 and 2010. They still have to digest the big gains made the past two years before they can resume their uptrend. Nevertheless, we believe that these are just corrections in a long-term bull market.

Investors with long-term investment horizons should be taking these opportunities to buy, selectively, stocks with strong fundamentals. This is also the best time to buy using cost averaging. Of course there is always the risk that the downturn may overshoot, that is why we are advising investors to accumulate in a decisive and methodical manner.

Investors with shorter investment time frames should be quick and nimble like we said last week (see *Jack Be Nimble, Jack Be Quick,* January 24, 2011). They should take advantage of the volatility by buying during panic sell-offs and selling during rallies.

Those who are overweight stocks and those who are overleveraged should pare down their holdings to their comfort level. And those who are underweight stocks should take this opportunity to gradually increase your equity positions especially as valuations become more compelling.

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