Market Analysis, Research & Education
A unit of Fidelity Management & Research Company

Libya Update: Risks Rise, But Economic Recovery Not Yet Jeopardized

Fidelity research provides insight on the potential impact to energy stocks

The following analysis contains input from Fidelity's market analysis, asset allocation, emerging-market and energy research teams.

The North African countries that have undergone the greatest political unrest so far—Libya, Egypt and Tunisia—collectively account for only a miniscule slice of the global capital markets and economy. However, ongoing developments in the region can impact the global financial markets in a variety of ways, particularly through their influence on crude-oil prices and the geopolitical risk premium for financial assets.

Assessing crude-oil prices and supply/demand imbalances

While turmoil in Tunisia and Egypt put upward pressure on global crude-oil prices, the negligible petroleum production from those countries meant there was little impact on the global supply/demand balance for crude oil. However, Libya accounts for roughly 2% of global oil production and 3% of world oil exports.[i] With reports that significant amounts of Libya's production have gone off-line, there is likely some fundamental impact from the region's unrest on the global economy.

Losing Libya's production from the global crude-oil markets, however, is not likely to be a traumatic event because the world is reasonably well supplied with oil and has some supply cushions that could help prevent near-term disruptions of this magnitude. Crude-oil inventories held by the 34 countries that are members of the Organization for Economic Cooperation and Development (OECD) are at above average levels, with nearly 58 days of supply on hand versus an average of 53 days from 2005-2008.[ii] Spare production capacity, primarily in Saudi Arabia, is estimated to be more than twice the size of total Libyan production, and Saudi has already brought a portion of this online. In addition, several countries, including the United States, maintain strategic petroleum reserves that could be utilized as well.

From a fundamental supply/demand standpoint, the outlook for higher crude-oil prices in 2011 was already expected, with prices having moved up 12% in the fourth quarter of 2010 due largely to the strengthening U.S. and global economies.[iii] At this point, however, the majority of the increase in crude-oil prices in recent weeks has been due to an increased "risk premium" for the commodity, which reflects the possibility of political unrest spreading to additional and particularly larger crude-oil producers in the region. Since Egypt's "day of rage" on Jan. 25, 2010, the per-barrel price of U.S. crude oil has risen to almost $98, from $85, while European crude-oil prices spiked above $110, from $96.[iv] If any additional producers from the Organization of Petroleum Exporting Countries (OPEC) were to experience supply disruptions, such as Saudi Arabia and Iran—which together account for roughly 20% of global exports—it could cause a far greater spike in crude-oil prices (see Exhibit 1, page 2). *[See page 3 for further commentary on the energy sector from John Dowd, portfolio manager of Fidelity Select Energy Portfolio and Fidelity Select Natural Resources Portfolio.]*

KEY TAKEAWAYS

- **Turmoil in the Middle East has pushed up crude-oil prices and geopolitical risk premiums, but it has yet to significantly alter the solid economic fundamentals underpinning the global economy.**
- **Although there is the potential for unrest to spread to other major crude-oil producers beyond Libya and for oil prices to rise further, so far oil markets generally have remained well supplied.**

Perspective on rising geopolitical risks and the threat to riskier financial assets

Stock and bond markets in the Middle East and North Africa are small by global standards, but the potential for the spread of political instability can have an impact on the risk premium for financial assets around the world. So far, the biggest impact on performance has been to securities in countries most directly affected, with Egypt's stock market down about 20% in 2011 before it was suspended in late January, and the prices of its dollar-denominated government bonds declining about 10%.[v] Emerging-market assets as a category have gotten off to a choppy start in 2011, though much of this can also be attributed to inflation pressures and other investor concerns that were apparent before the recent political turmoil. The longer the political upheaval lasts and the farther it spreads, the more potential it has to increase risk aversion and act as a headwind for emerging-market stocks and other assets. So far, the detectable damage has not been extensive.

More broadly, the political and economic uncertainty has the potential to act as a headwind for riskier assets. The week ending February 25 featured the largest negative returns of any calendar week for the U.S. stock market in 2011. However, the 1.7% loss to the S&P 500 Index was a relatively minor pullback in the context of the 16.6% rise during the past five months. While safe haven assets such as Treasury bonds and gold rose, whether risk aversion continues to increase will likely depend significantly on whether the events in the Middle East pick up steam or begin to stabilize.[vi]

EXHIBIT 1: A significant portion of the world's production of crude oil comes from countries in the Middle East and Africa region.

Global Crude Oil Production and Exports (2009)			
	Country	% of Global Production	% of Global Exports
Top 5 Producers	Russia	13%	13%
	Saudi Arabia	11%	15%
	U.S.	7%	0%
	Iran	6%	5%
	China	5%	0%
Other OPEC Members	U.A.E.	3%	5%
	Iraq	3%	5%
	Kuwait	3%	3%
	Nigeria	3%	5%
	Angola	3%	4%
	Algeria	2%	3%
	Libya	2%	3%
	Qatar	1%	2%

Source: Energy Information Administration, Haver Analytics, FMRCo (MARE) as of 12/31/09.

How Fidelity is Monitoring Developments in the Middle East and North Africa

At Fidelity, our portfolio managers gauge the potential direct and derivative impacts of geopolitical risks by tapping a broad array of research and analysis from our experts in the region, energy sector analysts, and other global investment professionals. From a geopolitical perspective, our sovereign debt team provides scenario analysis concerning risks, outcomes, historic similarities and important differences to evaluate the contagion risk. From an economic perspective, we gauge the impact of potentially higher crude-oil prices and the possibility of negative impact on global growth. We evaluate this risk primarily at the company level; for example, by analyzing whether the industry is highly sensitive to a global slowdown, how much risk is priced in, the downside protection of current valuations, whether earnings expectations are reasonable, and whether the company's customers or costs are highly influenced by changes in crude-oil prices.

With respect to potential investment opportunities in the Middle East and North Africa region, the weak political systems in many countries had led us to place very high risk premiums on many of the equity opportunities prior to the recent upheaval. It is possible a structural change may be taking place that could ultimately be positive for the investment climate in the Middle East and North Africa, but it will take time to sort out the long-term political trends given current uncertainties.

Outlook on contagion, crude-oil prices and the global economic recovery

The potential for political upheaval to spread to other crude-oil-producing nations is inherently unpredictable and unquantifiable. The countries that have experienced unrest so far have shared a few common traits, some of which are held in common with other oil-producing countries in the Middle East. These include high levels of unemployment and poverty, a population with a high percentage of young adults, and leaders who have exercised power for decades with regimes widely recognized for corruption and repression. However, even the largely non-violent spontaneous demonstrations in Egypt look very different from the armed conflict in Libya. So while many key oil-producing countries, from Algeria to Iran to Saudi Arabia, have something in common with these economic and political backdrops, they all have dramatic differences in key areas that may make them less vulnerable to civil strife.

Ultimately, the most direct and lasting impact on global financial markets would be if higher crude-oil prices change the trajectory of the economy. On the one hand, the more than 150% oil price increase since February 2009 is the kind of abrupt, short-term spike that historically has often precipitated a recession in the United States.[vii] Higher crude-oil prices act as a tax on consumer spending and business operations, taking money away from consumer discretionary purchases and squeezing corporate profit margins.

On the other hand, the U.S. economy is much better positioned to weather crude-oil prices settling above $100 per barrel than during mid-2008, when petroleum prices hit record levels amid a U.S. recession. The U.S. economy re-accelerated in the second half of 2010, and recent strength in leading economic indicators suggests a continued broadening of the expansion. Though crude-oil prices are up sharply from the $34 per barrel daily low set in February 2009, consumers have already experienced $100 per barrel oil before, and the brief revisiting of sub-$50 oil prices in 2009 probably did not change the expectation that crude-oil prices would move higher over time.[vii]

From a global standpoint, if oil remains at about $100 per barrel in 2011, oil expenditures would represent about 5% of global economic activity. Given the continued strong growth in developing economies and solid global expansion overall, this level appears to be manageable. If crude oil increased to $120 per barrel and stayed at that level, oil expenditures would increase to 6% of global GDP—a level not seen since the early 1980s.[viii] Above this price level, pressures on consumers and businesses would probably increase substantially.

Investment implications

While political weakness in the region and the probability of higher crude-oil prices in 2011 were not surprises, the speed of political upheaval and the uncertainty about the political outlook have increased the risks more generally in the global financial markets. To this point, however, the positive momentum in the United States and global economic expansions has not been derailed. We will continue to monitor the situation in the Middle East and North Africa, with particular attention to the ability of recent developments to influence the world oil markets and geopolitical risk premiums. ■

Recent Middle East Turmoil and Its Potential Influence on Energy Stocks

By John Dowd, Portfolio Manager of Fidelity Select Energy Portfolio and Fidelity Select Natural Resources Portfolio

In my opinion, the reduction in Libyan crude-oil supply in and of itself is not sufficient to cause a shortage of crude oil. However, it clearly raises the susceptibility of the crude-oil markets to other potential supply shocks. In the past, every time spare OPEC capacity has dropped below 4.0 million barrels per day (mbd), crude-oil prices have risen. In January 2011, there was 4.7 mbd of spare crude-oil production capacity by OPEC countries, according to the International Energy Agency. Libya produces 1.6 mbd, so the removal of this country's capacity would bring the current spare capacity below the 4.0 mbd threshold that historically has led to a price spike. If political unrest were to spread across North Africa to Algeria, another 1.2 mbd of oil supply would be at risk (see Exhibit 1, page 2).

While these potential risks alone raise concerns for investors, there are two mitigating factors that should be considered. First, Saudi Arabia has the capability, and I believe the motivation, to produce more crude oil to contribute to global economic stability. OPEC's primary objective is to create stability in the global oil markets. Saudi Arabian officials have stated that they will offset any loss of Libyan production, and I believe they will. This spare capacity could dampen the potential for further crude-oil price increases and help ensure the global economic recovery remains on track. Second, higher crude-oil prices are likely to have some negative influence on consumption, effectively tempering demand and easing pressure on the supply challenges.

Geopolitical risks may linger

Regardless of how the political situation in Libya plays out, I don't expect to see the geopolitical risk premium on crude oil go away anytime soon. In a recent op-ed article in a major metropolitan daily newspaper, Saudi Arabian Prince Al-Waleed bin Talal wrote, "The winds of change are blowing across our region with force, and it would be folly to suppose that they will soon dissipate."[ix] I think Mr. bin Talal is right, and it's clear recent events have been a wake-up call—and not only for investors. During the past year or so, the world became complacent again. With our focus so much on economic risks, most people forgot about geopolitical risks. Investors have recognized that the supply of energy can be a constraint to economic growth. Historically when that has happened, energy stocks have outperformed. In recent weeks, consumers, business leaders, energy companies and governments around the world have been reacting to recent developments in the Middle ▶

East. This could impact not only crude-oil production in Saudi Arabia, but also the decision making on drilling in other areas, such as deepwater projects in the Gulf of Mexico. For example, I suspect the U.S. government may reconsider whether to continue its ban on drilling in the Gulf given the increased awareness of growing risk to the country's economic growth.

Outlook on energy stocks

Overall, I'm fairly optimistic on energy stocks. While crude-oil prices have reached a level that seems a bit expensive in the short-term, I believe there is further upside over the long term. Until a week ago, the vast majority of the upward move in crude-oil prices was driven by strong or improving business fundamentals, as opposed to speculation or geopolitical factors. The improving business backdrop was reflected by persistent upward revisions for crude-oil demand around the world. While there is a risk premium built into oil prices, I do not believe that risk premium is reflected in the current prices of energy stocks. Across the sector, many companies have free cash flow yields of 8% or higher, and their earnings-per-share estimates are rising. Valuations on average are reasonably inexpensive, and I don't think they reflect the upside potential from higher crude-oil prices.

The current geopolitical turmoil in the Middle East and North Africa should serve as a reminder to investors that geopolitical risk ebbs and flows over time, and can have outsized effects on various financial assets. As such, investors should consider that having some exposure to commodities, such as energy and other natural resources, can help provide diversification benefits and inflation protection to a portfolio.

The **Market Analysis, Research and Education** (MARE) group, a unit of Fidelity Management & Research Co. (FMRCo.), provides timely analysis on developments in the financial markets.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.
Past performance is no guarantee of future results.

Investing involves risk, including risk of loss.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rate rise, bond prices usually fall and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk, or the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks. Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest-rate, currency-exchange-rate, economic, and political risks, all of which are magnified in emerging markets. The commodities industry can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.
Indices are unmanaged and you cannot invest directly in an index.

The Organization for Economic Co-operation and Development (OECD) countries include: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.
The OPEC member countries are: Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.
[i] Source: Department of Energy, Energy Information Agency, FMRCo. (MARE) as of 12/31/2009.
[ii] Source: Department of Energy, Bloomberg, FMRCo. (MARE) as of 9/31/2010.
[iii] U.S. oil represented by the West Texas Intermediate, Cushing (WTI) crude oil spot price. From 9/30/10 to 12/30/10, the price for WTI rose 12.3%. Source: Wall Street Journal, Haver Analytics, FMRCo. (MARE) as of 12/31/2010.
[iv] U.S. crude oil rose $11.69 (13.6%) from 2/18/2011 to 2/25/11. European oil represented by the Brent crude oil spot price, which appreciated by $9.02 (8.9%) from 2/18/2011 to 2/25/11. Source: Wall Street Journal, Haver Analytics, FMRCo. (MARE) as of 2/25/11.
[v] Egyptian stocks and bonds represented by the MSCI Egypt Index and the Barclays Capital Emerging Markets Egypt Bond Index, respectively. From 12/31/10 to 2/25/11 the MSCI Egypt Index and the Barclays Capital Emerging Markets Egypt Bond Index fell 20% and 9.9%, respectively. Source: FactSet, FMRCo. (MARE) as of 2/25/11.
[vi] From 2/18/11 to 2/25/11 the S&P 500 fell 1.7%. During the same period the 10-year government bond yield fell from 3.59% to 3.46% (yields move inversely to bond prices) and gold rose 1.4%. Gold represented by the London Gold Bullion, PM Fix price. Source: Standard and Poor's, Federal Reserve Board, Wall Street Journal, FMRCo. (MARE) as of 2/25/11.
[vii] U.S. crude oil prices rose 188% from a 2009 low of $33.98 on 2/12/09 to $97.89 on 2/25/11. Source: Wall Street Journal, FMRCo. (MARE) as of 2/25/11.
[viii] Source: International Energy Agency, International Monetary Fund, FMRCo. (MARE) as of 2/25/11.
[ix] Source: The New York Times as of 2/24/11.

The S&P 500 Index is a market capitalization–weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The MSCI Egypt Index – a free float-adjusted market capitalization index that is designed to measure equity market performance in Egypt.

The Barclays Capital (BC) Emerging Markets Egypt Bond Index is an unmanaged bond index that is designed to measure the performance of the government bonds of Egypt.

Before investing in any mutual fund, please carefully consider the investment objectives, risks, charges, and expenses.
For this and other information, call or write Fidelity for a free prospectus or if available, a summary prospectus.
Read it carefully before you invest.

Brokerage products and services and workplace savings plan products and services offered directly to investors and plan sponsors provided by Fidelity Brokerage Services LLC, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917
Fidelity Investments Institutional Services Company, Inc. 100 Salem Street, Smithfield, RI 02917. 576138.2.0