Boom time in the Middle East?

Geopolitical outlook and review

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Our geopolitical crystal ball worked well in 2011, correctly predicting rising tensions in Iran, deterioration in Iraq, Qaddafi's fall in September, shifts in Egyptian elections and relative stability in hydrocarbon majors amongst others.

2012 may be even more eventful and we touch upon the key potential developments for each country inside, as well as reviewing our calls for last year.

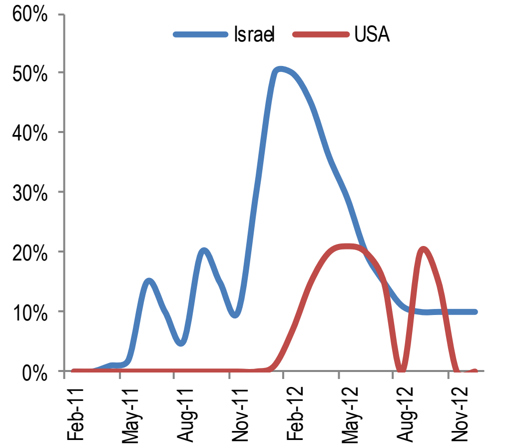
Notable unpleasant highlights include:

- **Iran:** Fig 1 shows our expected probability of an attack on Iran, with the US line dependent on elections there (currently < 1%). We were amongst the first to highlight this as one of the major consequences of the Arab Spring and the escalation in tensions has proceeded as predicted, with the chance of Iran giving up its nuclear program close to 0 and diplomacy dead. We note that popular perception has now shifted to viewing this as a possibility if not a probability and the chances of something dumb happening from any of the sides are now higher than ever, with the focus moving inexorably to regime change from nuclear weapon prevention.
- **Iraqi civil war:** We maintain our view that the Iraqi government will fall apart this year and sectarian violence will escalate. Given Iraq is expected by the IEA to contribute 80% of OPEC's incremental capacity through to 2016, this may make the oil market even tighter than currently expected
- **Sub-Saharan jihadists:** The politicisation of jihadist groups is a worrying trend and we see them getting a stronger foothold in Africa. We will return to this topic, but the most immediate threat is in Nigeria, where Boko Haram may well ignite a sectarian war with Southern Christian militia in the next few months, raising fears over disruptions to Nigerian oil and bidding up Brent.

Pleasant highlights include:

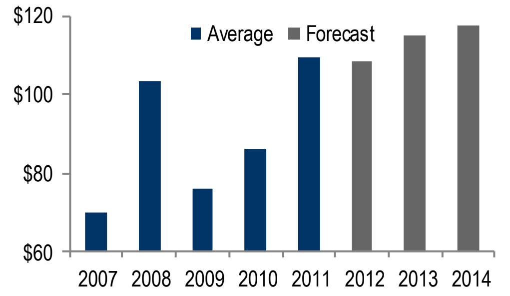
- **North African momentum:** We are positive on the march to democratisation, with Tunisia leading the way and real power transfer finally on the cards in Egypt after the populace realised the army was not that different to Mubarak. We are particularly positive on Libya and envisage a rapid return to stability (although not normalcy, militias will take time to disarm and there will be skirmishes), with oil output back up fully by the end of the year and elections progressing relatively smoothly.
- **A financial boom:** The permanent bid under the broken oil market should keep oil prices high (Fig 2), transferring huge levels of wealth into the oil producers from the rest of the world. This has traditionally been saved, but is now being deployed internally to reinforce social contracts and keep populaces happy, as well as secure interests abroad. Given the basic nature of these petro-economies, there is also a strong chance of asset-bubble formation, which are typically fun while they last
- **Everyone could just kiss and make up:** Fig 3 is from 2007, showing Sultan Qaboos of Oman, King Abdullah of Saudi Arabia and President Ahmedinejad of Iran. A trade bloc of MENA states, Turkey, Russia, India and China would be formidable and almost self-sufficient. Which is perhaps why it is unlikely to happen

1. Probability of attack on Iran



Source: RCML Research

2. Average Brent prices and consensus forecasts



Source: Bloomberg

3. Happier days

Source: Reuters

An interesting 2012 after an intriguing 2011

Geopolitical prognostication is tough, particularly as a call for smooth sailing, stable governments and no real issues are a bit dull unless the country in question is in dire straits. This is in contrast to market strategy, where the inherent bias is to be bullish unless one adheres to the curious religion of permabearishness (with some notable exceptions).

We have done our best in a volatile year to use our duct-taped models based on a combination of qualitative and quantitative inputs to highlight what we see as significant, highly likely trends as well as low probability, high impact flashpoints. The latter can make predictions look silly due to their very nature (aka storm in a teacup syndrome), but it is our job to make a note of where we believe probabilities are being incorrectly estimated and for you to make your own informed decisions. Of course, they can also make you look silly if you don't highlight them, with the implications of the deployment of the Peninsula Shield Force in Bahrain and alleged DC assassination plot particular events that made us alter our views.

Having said the above, it's always nice to get predictions right and in 2011 we managed to call a number of significant developments scoring 3 out of four clover leaves overall.

Looking forward, several key themes emerged in 2011 that will shape events in 2012. There have naturally been other important trends such as the increasing democratization of information as we all get plugged into a giant infoweb and the decline of US influence and power in the region, but the below are the most important:

The regional Cold War

The deployment of the Peninsula Shield Force to quash the uprising in Bahrain was the first act of a rapidly developing regional Cold War and was the first market of what was to be an increasingly independent and assertive foreign and security policy from the GCC and Iran. We do not see this as an ideological conflict, although old prejudices die hard, but rather a political one between countries that have gone from being heavily indebted to rapid growth in just over a decade and are now looking to project their control in their region. Local populations have also been a significant factor in this and we have seen increased budgets and reinforcement of traditional social contracts to provide the groundwork for foreign policy, as well as a focus on muting any internal security threats. Finally, the fall of OPEC and rise of the GCC as the owners of spare capacity has been an important one for the oil market, the results of which we are likely to see come through later this year when the oil price comes under pressure.

Israel's increasingly fragile military hegemony and new arms race

Israel's position as the regional military hegemon will come under increasing pressure in the coming years as tens of billions of dollars of weapons enter the region to challenge the ascendancy of Iran. Should Iran reach nuclear capability, most GCC states will also build their nuclear arsenals even while pursuing independent foreign policies that actively speak out against actions they disapprove of.

Rise of neo-Islamism and adjustment of jihadism

The Islamist groups that were demoted to social functions under a number of thee deposed regimes have now come to the fore in democratic elections and the rise of a more pluralistic neo-Islamism once they find their feet could have significant implications globally. Jihadist groups have become increasingly decentralized and used for political ends, with African jihadist groups a particular concern with many regions fertile for recruitment

Oil through the roof

Nobody really believed that we were approaching the point of maximum oil production in 2008, but they do now. The shifting structure of the oil market and increased interference means that prices are now predicted to be above $110 for the foreseeable future, representing a huge wealth transfer into this region. This is not sustainable, but should last 3-4 years at least.

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Country by country analysis

Algeria – Quiet as expected, 4/4

We saw minimal chance of deterioration in Algeria when worries surfaced that Libyan violence might spread given the recent civil war and reasonably developed social infrastructure. Gradual reforms and economic stimulus were introduced by President Bouteflika and we expect he will be re-elected in 2014. 4/4 clover leaves.

Stability should continue with the new parliament gaining more power in 2012 and further constitutional amendments. The only real danger we see is a potential Tuareg uprising in Mali, augmented by Tuareg soldiers returning from Qaddafi's army and likely led by Iyad Ag Ghali, spilling over the border. This would likely not disrupt hydrocarbon production, but we would not be terribly positive for sentiment.

Bahrain – Coming to a boil after the invasion, 2/4

We were regrettably incorrect in assuming that security forces in civilized Bahrain would not use live ammunition on protestors and did not foresee the deployment of the Peninsula Shield Force to quash the protests. We were correct in our call thereafter that protests would remain muted until the end of the year and we would likely see the first evidence of terrorist activity in Q4, as we did with the alleged plot to blow up the Bahraini causeway and Saudi embassy. 2 out of four clovers for this one.

Going forward, a political resolution to the unrest in Bahrain is now effectively impossible and violent protest will increase this year with terrorist attacks likely, with the Bahrain Grand Prix on the 22nd of April a particularly dangerous date. Traditional opposition parties such as al Wefaq have lost support as the government has ignored them, with the amorphous February 14th movement, which sprung up at the outset of the protests, gaining traction. The current thrust of this group is small-scale, non-violent protest against repression and to highlight perceived human right violations. With no defined leadership structure, the response from the security forces will be increasing levels of collectivist punishment, which will cause elements to radicalize and violence to increase. The aims for the populace are also shifting from reform within the system to the removal of the ruling family. Even if the regime listened to calls for reform, their neighbours would not allow them to do so.

Egypt – Headed to power transfer, 3/4

We stated from the outset that not that much had changed in Egypt as the army took control. Before the revolution, one of the key questions for Egypt watchers was who would take over after Mubarak died, his son Gamal, or the army. The revolution solved this issue as the army refused to kill (more) protestors. We noted that this would take time to be understood and could lead to further localized violence, but that elections would go largely smoothly and be delayed from September to November, with the Islamists doing better than expected. The Egypt-Israel gas pipeline was also continuously bombed as predicted. Our big mistake was in assuming promised aid would hit Egypt in the last few months of the year to help stabilize the economy, which it has not, so we dock a leaf for that leaving 3 out of the 4.

Into 2012 the new parliament and accelerated President will have a strong popular mandate in Egypt to start the painful process of economic recovery and restoring social order. We would expect a compromise to be agreed by the army and Islamist groups offering some sort of immunity and continued largesse in return for a less intrusive oversight of the democratic process. Foreign aid must come soon or we will also likely see a sharp devaluation of the Egyptian currency of 10-20% at least, which may reignite protests as food prices ramp up. We do not foresee significant shifts in foreign policy from the new leadership this year, but from 2013/14 onwards we may see a significantly different picture with some large obstacles ahead.

Iran – The Path to Persia, 4/4

Back in March we highlighted the Iranian nuclear issue coming to the fore once again as one of the key outcomes of the Arab Spring and correctly provided a roadmap for international action and escalating tensions in our notes over the last year. We also correctly called for no demonstrations to spread to Iran and provided an early indication of the increasing power of the conservatives, 4/4 leaves.

The probability of an attack on Iran is now higher than ever. The only solution to the current crisis, diplomacy, is off the table due to politics and the focus is now shifting to regime change. We see the probability dropping mid-year, although US elections could increase the probability of a US attack significantly (unless Ron Paul steams ahead), as will Iran's likely decision to move their centrifuges to reinforced facilities in Qom if not handled correctly (likely mid-year). We reiterate our view that the fallout may not be as bad as expected from an Israeli strike, horrendous from a US one. Aside from this hot button issue, we would expect continued Iranian support for Shia abroad and the Syrian regime, although we note that Hamas has increasingly been looking for alternative sources of funding and Hezbollah has had a sharp drop in the amount they receive. Sanctions will have their effect, but most of Iran's trade partners will adapt to circumvent them, with privileged elites becoming even richer. Another round of stimulus is likely to come in Q2, although protests may well start up in March/April.

Iraq – The next battleground, 4/4

We turned highly negative on Iraq last April, putting forward that it was highly unlikely that the government would survive past the summer of 2012 and that violence would into the summer, with another sharp pick up in sectarian attacks after the US troops pulled out in December and significant political deterioration. We were surprised to see Prime Minister Mailiki act so quickly, accusing Sunni Vice President Hashemi of organizing Sunni death squads (!), replacing the Sunni Iraqiyyah ministers and calling a vote of no confidence in his Sunni Deputy Prime Minister Mutlaq on the grounds that he didn't like him (particularly after he called Maliki a dictator). Terrorist attacks have also spiked against Shia in the last few weeks, as well as an assassination attempt on finance minister Rafie al-Esawi on Monday. 4/4 leaves.

The outlook for Iraq is bleak in our opinion and new elections will be anything but transparent and fair. True sectarian violence is likely to break out (see our December monthly for more background) and the nation's oil infrastructure is at significant risk, which is troubling as Iraq accounts for 80% of OPEC's incremental production as expected by the IEA through to 2013. Summer will be particularly dangerous, especially if Syria sees regime change by this point and the nature of the violence, focusing on well-funded, organized terrorist attacks rather than the firefights of the early insurgency will make it very difficult to control.

Jordan – Not the final frontier, 4/4

The announcement of the Star Trek theme park was a surprise, but our calls for increased integration with the GCC and relatively successful implementation of electoral reforms above and beyond those of Morocco were correct, as was our call that any protests would be small and dominated by Islamist groups, 4/4.

While introducing the most impactful reforms of any of the monarchies (in our opinion), progress in Jordan toward democracy will continue to be gradual. We do not see any big scares and if there are any protests (likely again from the Islamists), they will continue to be small. The economic situation with high energy and food prices is still a concern, but increased ties and aid from the GCC should start to filter into the real economy this year. With regards to why Jordan has been integrated into the bloc, we believe it is a combination of monarchical support, but also to provide military manpower to complement other GCC forces.

Kuwait – Democratic arguments, 3/4

The Kuwaiti political scene remained as strange as ever this year with repeated calls for new cabinets and votes of no confidence as expected, although we were surprised at fisticuffs in parliament a few months back. The issue of the stateless Bedoun continues to trouble with protests increasingly squashed, but the country has generally been peaceful. There has been some restriction of visas from countries with heavy Shia populations which we didn't note, along with more murmurings on local Shia. Three out of four for this one.

For 2012 we see things continuing to remain calm, with the government maybe even staying together (Kuwait is the most progressive constitutional monarchy in the region). One area where there could be action is with regards to the Mubarak al-Kabir port that Kuwait is building at an extremely rapid pace just in front of Iraq's Umm Qasr port. Given the current political situation in Iraq we expect the reaction to become increasingly vociferous and Iraqi militants to take aim in due course.

Lebanon – Confessional confusion, 4/4

The confessional system in Lebanon whereby authority is delineated along the lines of the historical sectarian makeup of the country with protection of minorities is one of the more annoying ones to navigate. However, Lebanese politics have progressed as expected this year with Prime Minister Najib Mikati showing that was not one of their pawns (a few billion dollars in the bank helps with that) and the funding of the STL becoming an increasingly contentious topic. We thought it unlikely that Saad Hariri would return and make a meaningful challenge to the new coalition and indeed he did not. Four out of four.

The situation in 2012 could be a bit more muddled with Mikati threatening to resign if the funding is not approved. The March 8th coalition now has a sub-coalition of Amal, Hezbollah and the FPM pitted against Mikati and Jumblatt (at the moment anyway), something that was hinted at during the recent wage adjustment law discussions. We don't think the divisions will go too deep and don't see the government falling apart as Hariri's did, although if Syria falls apart things could get interesting. The major danger for Lebanon remains the aftermath of an attack on Iran, although we note the rather odd position of Hezbollah as a part of the government now, making any attack on Israel as retaliation extremely difficult, particularly in light of reduced Iranian funding.

Libya – Road to riches, 4/4

We got Libya spot on last year, predicting in March that Colonel Qaddafi would fight back out of Tripoli, arrive at the gates of Benghazi, be pushed back to Tripoli and then be deposed in September, after which elections would be called for June and rapid progress to restore Libya's oil would be made, with only occasional fighting as opposed to civil war. We did think more deaths in Benghazhi would be required for a no fly (and drive) zone to be implemented, but thankfully that wasn't the case. Four out of four.

We remain positive on the outlook for Libya as the construction of new social structures and an elected assembly gathers pace. There will continue to be isolated clashes as militia groups take time to disarm, but there is significant upside for all sides that will ensure that progress remains largely on track. We reiterate our view that Libyan oil exports will return to full output by the end of the year.

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Morocco – Graduality, 4/4

We saw any reform in Morocco as being moderate at best and that's how it turned out to be in our opinion despite the apparent power devolution of the new constitution. The February 20th movement remained small and peaceful as expected and the calls have not gone past reform with organized marches every Sunday. Four out of four.

The outlook for 2012 is also pretty quiet with no major upsets in the offing. The success of the Islamist Party of Justice and Development (PJD) in elections will be tempered by the continued control over all major functions by King Mohammed. The main coalition come and hold together, although it will be interesting to see if the King retains his current royal advisers, the appointment of whom has led to some controversy.

Oman – Nice and peaceful, 4/4

Given the popularity of Sultan Qaboos (also Prime Minister, Finance Minister, Defence Minister and Chairman of the Central Bank) we saw further violent protest such as the deaths in Sohar in February as highly unlikely, with small demonstrations and gradual reform. Government measures such widening the social security net and creating 150,000 new jobs have been effective and Oman remains quiet. Four out of four.

We do not see any issues with Oman as a largely content population are supported by further hydrocarbon investment and a gradual clean out of corrupt officials helps matters. The wild card remains the complete control of Sultan Qaboos over all decisions of import and the lack of a clear line of succession or training of deputies.

Palestine – On the World stage, 0/4

Happily there has not been the start of a third intifada as we expected, with only isolated Israeli strikes on Palestinian targets. After putting considerable pressure on international organizations with their push for statehood, the leadership of Palestine now appears to have shifted back to power-retaining mode, unwilling to stir the pot. Wrong on all counts here, 0.

Into 2012 we note that Hamas is suffering from a drop in financial aid from Iran and, given the increasing Sunni/Shia split in the region and rise of neo-Islamist groups, has actually started to move closer to Saudi Arabia. This is interesting as it provides more credence to their claims of ratcheting down the violence and being a proper leadership. Of course, that all may change in a heartbeat if Israel steps up attacks, but for now (ex a conflict with Iran/Hezbollah) we are going to suggest that this year may be quite peaceful (by Palestinian standards).

Qatar – Power projection, 4/4

Peaceful as one would expect in a county with a GDP/capita of over $100,000 and double digit real GDP growth. We noted the prominent role that Qatar would play in the Libyan uprising, which has led to somewhat of a backlash in recent times, but the foreign policy remains to leverage its soft and economic power as much as possible, particularly in support of neo-Islamism. Four out of four.

The internal situation in Qatar remains completely safe (60-120% local pay rises last year) and the economy will continue to grow at a furious pace as the government spends aggressively to diversify its economy. Qatar's foreign policy will continue to be to acquire strategic assets abroad and look to control Islamism through media and financial support. The recent opening of the Muhammad ibn Abdul Wahhab Mosque in Doha and speeches by Shaykh Qaradawi is also intriguing given the increased focus on Salafism in Saudi Arabia, as is the opening of a Taliban office in Doha.

Saudi Arabia – Splashing cash, 4/4

Internally Saudi Arabia remained stable with isolated Shia protests as we expected. Externally, we did not anticipate the overt deployment of Saudi security forces into Bahrain, but did note that this was the start of a regional Cold War that we have seen develop over the year and predicted an increasingly aggressive and independent foreign and oil policy. The reform process remained gradual, stimulus increased and oil kept flowing. Succession proceeded in line with our expectations with Prince Nayef next in line and Prince Salman third. We dock a leaf for not spotting the incursion into Bahrain, so three out of four overall.

We see more of the same in 2012 with the main spending packages coming through and heightened control on oil production with their GCC associates. Prince Nayef's renewed focus on Salafism will also become more apparent with more support for the clerical class and exporting of ideology. The situation with the Shia in the Eastern Province remains delicate with more arrests recently, but we believe it will remain largely under control and reiterate that even if we do see more violence Saudi oil supplies will remain stable. After the alleged DC assassination plot and other related actions relations are strained with Iran, but we do not see any overt deterioration, with proxies instead utilized. We also note that diplomatic channels are still open, unlike between Iran and the USA, highlighting the oddness of the current situation.

Syria – Toward a Post-Assad Syria, 2/4

Our initial position at the start of March that the significant Syrian security apparatus would quash any organized protest was woefully incorrect. We shifted our position at the end of March to one that foresaw continued violence, deaths, and economic malaise, but no overthrow of the regime, who we believed would have to start some real reforms in December to appease increasingly angry Sunnis. These reforms did not come through, so 2/4 it is.

The Arab League "observers" are unlikely to stay in Syria for much longer and we anticipate that if President Assad does not put out some real power sharing that the level of violence is poised to increase dramatically as external factors pile on the pressure in combination with increasing internal divisions. The economy probably has three or four months left before the government targets their historic support in the mercantile classes and the budget deficit could exceed 20% this year. Regrettably, civilian deaths will continue and terrorist attacks increase.

Tunisia – Ticking along, 3/4

Nahda surprised us by winning 41.5% of the vote versus our expectations of 25-30% and as a result have a reasonably popular mandate to construct what we believe will be a successful coalition. We saw the situation in Tunisia into the elections in a similar manner to Egypt after some scuffles in the interim and this is how it turned out to be. Three out of four.

As with Egypt, the economy now needs to be the focus with international aid required, but unlike Egypt, Tunisia is further along the path to stabilization and the development of a solid power base with which to make the tough decisions. 2012 should be a positive year.

United Arab Emirates – No change, 4/4

We didn't see the violence spreading to the UAE with increased government handouts and reinforcement of the social contract being the order of the day, with any dissent quashed. Pay rises of 35-100% for government employees and a pickup in government spending duly came through. Four out of four

2012 doesn't bode much change on the geopolitical front, although Abu Dhabi is likely to step up oil production capacity to help control the oil price.

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Yemen – Sticky Saleh, 3/4

We saw President Saleh likely leaving in 2012, which now appears to be the case (although you never know with him), which was a hit and the army staying together, which was a miss as General Ali Mohsen al-Ahmar stood to the side (maybe angry at Saleh trying to have him bombed). Al Qaeda seems to have gained a foothold in the middle of Yemen and the tribes are lining up for control after any power handover. Three out of four.

2012 should be the usual chaos, with the Ahmar family in prime position to take over control, although Saleh's son Ahmed Ali still retains control of the Republican Guard and will need significant incentives to relinquish this. The patronage network that Saleh built will also take time to dismantle, with significant strengthening of state institutions required. Saudi Arabia now appear to be backing all main groups and this may help in the process.

Finally, thank you for your support in 2011 and have a splendid 2012!

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