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The Investment Implications of the Crisis in Egypt

In 1974, while in their early 20s, my parents picked up and left their native country of Egypt for North America. Having grown tired of Egypt's corrupt political system and religious oppression, they left their friends and family, along with everything they had, in the hopes of creating a better life for their future family. Three years later, my sister was born, and four years after that, I was born.

Watching the events of the past week unfold in Egypt evokes mixed emotions for all Egyptians, both those living in Egypt and abroad. In one corner, there's hope. Perhaps this really is the end of the autocratic regime that has ruled Egypt for decades and, as a result, the beginning of a democracy. In the other corner, there's fear. Over the course of one week, the country has completely fallen apart, and there appears to be little, if any, law and order. Over the past few days, I've reached out to several relatives living in Egypt, and despite Internet and cell phone service being shut down, I was able to connect with them. The following is based on conversations with them, along with some broader perspectives on the implications, and potential implications, of the Egyptian crisis for markets and investors.

Boiling over

In a sea of confusion, one thing is clear: Egyptians have grown tired of Hosni Mubarak and the National Democratic Party. By way of background, the National Democratic Party is only democratic by name, as Egypt has been in a "State of Emergency" since 1967, which has given the president unilateral control.

While Egypt is rich in history, it is beset by problems in the present, the culmination of which ultimately led to these protests. With an official unemployment rate of around 10% (many argue the real number is significantly higher), it is estimated that approximately 20% of Egypt's population of 80 million live below the poverty line. In talking with people in Egypt, their perception and belief is that the real figure is about twice that. Moreover, Egypt's GDP per capita is around \$6,200. To put this in perspective, U.S. GDP per capita is approximately \$46,000 and even Mexico's is \$13,200¹. A number of studies put Egypt's literacy rate (defined as people over the age of 15 who can read and write) at a very low 60%-70%². What makes all of this even worse is that there appears to be no catalyst for change and, therefore, no hope.

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¹CIA - The World Factbook

²U.S. Department of State: <http://www.state.gov/r/pa/ei/bgn/5309.htm#>

With all of these issues growing and compounding, there was bound to be a breaking point. So what was it? While the successful protest movement that ousted the Tunisian dictator, Ben Ali, in mid-January 2011 may have been the immediate spark for the riots, Egypt was already at the boiling point as a result of last November's Parliamentary election. Once again, Hosni Mubarak's party managed to gain over 80% of the seats in Parliament through what was supposed to be a democratic vote. After growing tired of corruption and rigged elections, the youth of Egypt (the median age in Egypt is 24 years old) decided it was time to retake control of their country. Through the use of social media outlets like Facebook and Twitter, the youth organized demonstrations beginning on Tuesday, January 25, 2011, that drew more protesters each day.

While the underlying issues in Egypt would seemingly affect poor Egyptians more than the wealthy, the call for Mubarak to resign comes from a unified Egypt - the voice of all social classes, ages and religions. Perhaps that's what makes this movement so powerful; not only are students out in the street protesting, but doctors, lawyers and business owners are standing by them, voicing the same demands. Word of these organized protests spread like wildfire, and by Tuesday, February 1, 2011, these demonstrations had grown so large that they were referred to as the Million Man March.

In the meantime, much of the country's normal business has come to a standstill. The stock market is closed, businesses are shut down and the classrooms are empty. Since the police disappeared for a few days (the rumor is that Mubarak disbanded the police to create chaos in an attempt to end the protests), civilians were forced to arm themselves in an effort to protect their homes and businesses. One person I spoke with hired Bedouins from the deserts of Egypt to come guard his warehouse with swords. The jails have been raided, and many criminals have been released. Civilians have set up two to three checkpoints on every major street and are searching people when they are found driving after curfew. If the driver appears suspicious or carries a weapon, the civilians tie the suspect to a light post until the army can come arrest him. Stores are running low on food and water, ATM machines are limiting cash withdrawals and the situation is quickly deteriorating. What makes it even worse is that Mubarak pulled the plug on Internet and cell phone services, which only makes life that much more difficult.

What happens next?

The situation in Egypt changes almost hourly. That said, based on the latest events, it appears this situation could play out in one of three ways:

- 1) Mubarak resigns and turns power over to the Egyptian people immediately and, through some type of international support, Egypt holds its inaugural truly democratic election, ending the protests.
- 2) Mubarak maintains that he will not run for office in September, but wishes to complete his term - this eventually appeases the public and the protests end.
- 3) Mubarak maintains that he will not run for office in September, but wishes to complete his term - the public is unhappy and continues to protest until he resigns.

While it seems clear that Mubarak's rule will soon come to an end, the bigger question is what happens next? One result of the long suppression of opposition movements in Egypt is that this is particularly unclear.

Although it seems unlikely, a change in power from one dictator to another would certainly be a step in the wrong direction. However, for the West, it's probably even a bigger problem if the new government is hostile to the West.

The U.S., in a tough political spot, obviously wants to encourage democracy, yet has been dependent on the Mubarak administration to provide some stability in an always volatile Middle East region. America has also paid for this stability, providing Egypt with nearly \$2 billion in military and economic aid.

The risk to oil

However, if stability turns to instability, what does it mean for the global economy?

The first concern is the production and distribution of oil. Here the direct effects should be relatively minor. Egypt is not a significant oil producer, ranking only 29th in the world in oil production. Nor is the Suez canal that crucial a trade route for oil, as it is too narrow for the largest supertankers. Moreover, unlike the Straits of Hormuz at the mouth of the Persian Gulf, goods that can't get through Suez always have an alternative route.

However, the issue of contagion is a far more significant risk. Egypt is not the only nation in the region marked by autocratic rule and great income inequality. If a revolt in Egypt becomes a revolution that encourages similar revolutions in the states that surround the Persian Gulf, the result could be a temporary, but serious, disruption in oil supply to the world. Even concerns about such an eventuality could lead to a spike in oil prices.

And nothing is more chilling to the global economy than a surge in oil prices. According to a 2004 study conducted by the International Energy Agency, even a \$10 per barrel increase in oil prices has the potential to cut U.S. real GDP by 0.3%³. Oil is currently trading around \$92 per barrel, a modest jump from the high \$80s we saw before the demonstrations in Egypt began. If these issues continue to escalate and the price of oil were to rise, for example, to \$145 per barrel (where oil peaked in 2008), the U.S. economy would take a hit of approximately 1.5%. To put things in perspective, the U.S. economy grew at a rate of 2.8% in 2010. A sharp increase in oil prices to \$145 per barrel would have knocked off about half the economic growth we saw last year. An even bigger shock to oil prices would obviously have an even larger impact on the economy. Imagine the cost of gasoline rising to \$10 per gallon? How about \$20? In theory, it would literally cripple the U.S. and possibly the global economy.

³International Energy Agency: Analysis of the Impact of High Oil Prices on the Global Economy, May 2004

A few final thoughts

While these fears may never materialize, and we don't expect them to, it is clear why this issue in Egypt and, ultimately, stability in the Middle East, remains critical. The Egyptian crisis has not yet reached a level that changes our overall view of the U.S. economy, global economy or the relative valuation of assets. However, it does remind us that despite the strong recovery in corporate profits, attractively valued equity markets and a strengthening global economy, it's important that investors maintain a balanced approach to risk in their portfolios.

While I sincerely hope these issues are resolved in a peaceful manner, I'm also hopeful that Egypt's government will make a true change for the better. As someone in Egypt told me yesterday, "It's not the person that needs to change, it's the system." I hope the government makes the appropriate constitutional changes to truly reflect a democratic system; a system that allows the freedom of speech, freedom of religion and a system that creates opportunities. I personally thank today's Egyptian youth for standing up for what they believe in and hope they eventually see the positive changes that they are fighting for. Additionally, I hope that today's generation of young Egyptians and the generations after them, unlike my parents' generation, aren't forced to leave their country in hopes of creating a better life for their own future families, but can instead build that better life in their native land.

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