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Global

Equity Research

Other

Industry Overview

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ISSUES WHICH KEEP ME AWAKE AT NIGHT

Sector View:

New: 0-Not Rated

Old: 0-Not Rated

Investment Conclusion

- Both geopolitical risk and "local" politics stand to weigh more heavily on markets in 2008 than has recently been the case, with rising protectionism (including in response to sovereign wealth funds) adding to concerns.

Summary

- Overall, markets remained relatively relaxed about political risk from mid-2006 (when they discounted the probability of early military action against Iran) until late 2007. But, consistent with markets' broad increase in risk aversion, the latter part of 2007 saw an increase in political risk awareness, especially insofar as there was perceived to be a potential effect on oil – witness the mid-October 2007 "spike" related to rising concern over a possible Turkish military incursion in northern Iraq. We expect this pattern to continue in 2008, especially given tighter financial conditions globally and weaker global growth.

1. The Middle East – Iran, Israel, Lebanon, the Palestinian Territories, Syria (1)¹

We judge that since early 2006 market perception of the probability of military action against **Iran's nuclear programme** – by either the US or Israel – has been the biggest single political influence on the oil price. That pattern looks set to continue in 2008 even though we still assess the probability of military intervention as low. Consider:

- While there are conflicting assessments of Iran's progress, most experts estimate that the Iranians are still some years away from being able to build a nuclear weapon. This was highlighted earlier this month by the release of a US National Intelligence Estimate (NIE) Report, which stated with "high confidence" that Iran had suspended its weaponisation programme in 2003 and with "moderate confidence" that it had not restarted it since (although the latter point was contradicted by Israeli defence minister Ehud Barak who stated that Israel believed Iran had restarted weaponisation);
- Despite difficulties reaching agreement in the UN, the diplomatic process is continuing (notwithstanding disappointment on the part of EU negotiators over what they see as continued procrastination on the part of the Iranians). The US and its European allies had hoped to reach agreement on a third round of international sanctions this month; but both China and Russia are now indicating that they may leverage the NIE Report to block agreement in the UN Security Council. Nevertheless, there are signs that non-UN financial sanctions are having an effect on decision-makers in Tehran;
- The downside risks of military action to the global economy stand to weigh heavily, especially in a US election year.

Against this backdrop, senior US military personnel – including Admiral William Fallon (Commander, US Central Command) – are consistently playing down the prospect of military intervention (while being careful not to take the option off the table).

Within Iran, internal power struggles are deepening in the run-up to the March 2008 *majlis* (ie, parliamentary) elections – and may do through to the mid-2009 presidential election. The root cause of these may lie as much in disagreements over economic policy as in how to respond to the international community's concerns over Iran's nuclear programme – consistent with opposition to President Mahmoud Ahmadi-Nejad appearing to be rallying around reformist former president Mohammad Khatami. Candidate registration for the 290 *majlis* seats opens in early January, with the reformists predicting possible widespread disqualifications by the powerful

¹ The order reflects our subjective judgement of the current importance of the issue to market participants, and the numbers in brackets the ranking of each issue in our previous (August 2007) update.

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Guardian Council (as occurred before the 2004 election). That said, even if supporters of Mr Ahmadi-Nejad do suffer a setback, there is no guarantee that Iran would rein in its nuclear ambitions – or even suspend its enrichment programme.

The US-hosted **Middle East Peace Process** (MEPP) conference held at Annapolis on 27 November produced a commitment to further talks by Israeli Prime Minister Ehud Olmert and Palestinian President Mahmoud Abbas. These are due to continue in Jerusalem on 12 December. But expectations of an early breakthrough are low given the weak position domestically of both Mr Olmert and Mr Abbas, which may restrict their scope for deliverable compromise. Furthermore, major Arab countries – notably Saudi Arabia and Syria – seemingly remain at best ambivalent about the US initiative. That said, there is broad agreement that the “regional context” – ie the perceived threat posed by Iran and the “Shia crescent” – offers a window of opportunity for a breakthrough. And the ultimate shape of a workable agreement is well understood.

Inside **Israel**, Mr Olmert’s domestic position may be further weakened by ongoing alleged corruption investigations and by publication – expected imminently – of the final report of the Winograd Commission investigating the 2006 Israel/Hizbollah conflict. Nevertheless, we expect his government to continue to survive for the time being, not least as polls indicate that the main opposition right-of-centre Likud party would be the biggest winner in a general election and therefore stand to form the next government.

There are signs that **Syria** could be prepared to engage seriously with Israel over a peace agreement – which some commentators judged to be key to a wider Middle East settlement. But any breakthrough in peace talks would probably require a commitment on Syria’s part to disarm **Lebanon**-based *Hizbollah*, which may be beyond Damascus’s capability. And the international community would likely have to drop its investigations into the 2005 murder of the then Lebanese prime minister Rafik al-Hariri.

That said, while there are still hurdles to be overcome, a possible compromise over the vacant Lebanese presidency could be reached in Beirut shortly following preliminary agreement to amend the constitution to allow General Michel Suleiman, the army chief of staff, to be elected. One sticking point could be opposition insistence on the appointment of a “neutral” prime minister, which has so far been resisted by the government of Fouad Siniora.

2. Pakistan (2)

Pakistan looks set to continue to be mired by terrorist attacks, civil unrest and political uncertainty irrespective of the outcome of the 8 January general election. Arrests of political opponents, proposed election procedures and President Pervez Musharraf’s caretaker government appointments have sparked concern over whether the election will be “free and fair”, even though the state of emergency is now due to be lifted on 15 December.

A political deal with former prime minister Benazir Bhutto, which Washington had tried to broker, now looks less likely, at least before the elections; and her earlier apparent willingness to deal may have damaged her Pakistan People’s Party’s (PPP) election prospects. Former prime minister Nawaz Sharif’s return to Pakistan adds further uncertainty to the election outcome, although he has now stated that his PML(N) party will compete the elections after he and Ms Bhutto failed to reach agreement over a boycott. Mr Sharif himself was barred from standing by the election commission earlier this month.

PML(N) has stated that it will campaign on the single issue of demanding restoration of the supreme court judges deposed by Mr Musharraf in November to fend off possible challenges to his re-election as president.

Mr Musharraf’s removal of his uniform on 28 November – the day before he was sworn in for his new presidential term – has done little to mollify his opponents in Pakistan and may in the medium term weaken his grip on the army, now under the command of a close Musharraf ally and former head of the intelligence service, General Ashfaq Kiyani. Nevertheless, Mr Musharraf appears to remain the preferred option for the US and close allies in the context of both Afghanistan and in the pursuit of *al Qa’ida*.

3. US Elections (-)

Opinion polls continue to suggest that Hillary Clinton will emerge as the winner of the Democrat Party primary and Rudi Giuliani as the winner of the Republican. But other candidates in both parties – notably Barack Obama (D) and Mitt Romney (R) – appear bent on causing an upset based on winning early momentum in the 3 January Iowa caucus and the 8 January New Hampshire primary on the road to the 5 February “Super Duper Tuesday” covering 22 states. Polls – especially for two key potential swing states, Florida and Ohio – also suggest that Senator Clinton is favourite to win the White House; but that Mr Giuliani is the Republican best placed to beat her.

November 2008 will also see all the seats in the House of Representatives up for re-election, with the Democrats expected at least to retain a majority. The Democrats may additionally increase their current 51 seats (including two independents) in the Senate, where the Republicans are defending 22 of the 34 being contested.

4. Trade Frictions (-)

Although negotiations continue, prospects for bringing the WTO’s Doha Round to a successful conclusion in the near-to-medium term look increasingly slim to us. Failure to reach agreement has highlighted concerns about possible swelling of protectionist sentiment generally – and especially in the US in the run-up to the 2008 elections. Such sentiment could seek to exploit recent safety concerns

over Chinese products – ranging from toys through toothpaste to pet food – which have resonated strongly with US voters. And China's actions barring some meat imports from the US risk being seen as "tit-for-tat" even if the health concerns are well-founded.

A slowdown in the US economy coupled with dollar depreciation could see protectionist sentiment against China spread, absent accelerated renminbi appreciation. Notably, there are clear signs of the EU gearing up to impose "countervailing duties" where the European Commission judges that Chinese products are benefiting from "unfair" subsidies.

5. Sovereign Wealth Funds (-)

2007 has seen sovereign wealth funds (SWF) come squarely onto the political radar thanks to burgeoning oil revenues, the emergence of funds in China and Russia and the quest by SWFs to diversify their holdings. The move by G7 to commission work at the IMF – on a voluntary code to encourage greater transparency – and at the OECD is encountering pushback from officials in fund-owning states.

Related national security concerns – legitimate or otherwise – stand to fuel protectionist sentiment in Europe and the US. And efforts to evolve a common transatlantic response may be stymied by differences in the principal preoccupations of Washington and of Europe; and by lack of agreement within Europe itself. But, even absent potential barriers to investment in Europe and the US, SWFs may look increasingly to opportunities in Asia, where additional capital inflows could bring significant benefits but could also complicate management of the recipient economy.

6. Taiwan (6)

Campaigning for the 12 January parliamentary elections is under way, with President Chen Shui-bian's struggling DPP looking to shore up support by successive appeals to pro-independence sentiment. But Beijing's reaction is likely to be muted in the hope of a KMT victory, followed by a win for KMT candidate Ma Ying-jeou in the March 2008 presidential election (over the DPP's Frank Hsieh, who recently committed to set aside the issue of formal independence if elected).

KMT wins should see some easing of cross-strait economic constraints but are unlikely to lead to a major political shift, as was underlined by recent changes to the KMT charter diluting its commitment to unification.

7. Thailand (10)

Although the August referendum on the new constitution resulted in a "yes" vote, low turnout meant that it was supported by less than one-third of the electorate despite the army's efforts to bolster the vote.

Former prime minister Thaksin Shinawatra's supporters have regrouped for the 23 December elections within the People's Power Party (PPP), which the military – favouring a coalition led by the Democrat Party that polls show coming second in the election – will hope to keep from power. Pre-election tensions therefore appear set to escalate. And even if elections pass peacefully, the new constitution looks like a reversion to managed democracy in the hands of the political classes, which could encourage further political turmoil downstream.

8. Russia (3)

As expected, President Vladimir Putin's personal popularity has secured a big win for the *United Russia* party (with Mr Putin himself heading the party list) in the 2 December *Duma* (lower house) election. Redistribution of votes from parties falling below the 7% threshold to enter parliament should give *United Russia* a majority of over two-thirds (and the pro-Putin *Fair Russia* party stand to deliver a further 8% of the *Duma* to the Kremlin). A two-thirds majority would allow *United Russia* to amend the constitution to allow Mr Putin to continue to exert authority – whether as prime minister (as he has intimated) or in another capacity.

United Russia is now expected to announce its presidential candidate at its 17 December party congress – with, we judge, Mr Putin's backing for that candidate more or less guaranteeing electoral success.

Mr Putin's apparent indecision of his future role appears to be causing unease within the Kremlin where his supporters are anxious to ensure a smooth transition around the 2 March 2008 presidential election. But whatever Mr Putin decides, effective power in Russia is expected to remain within the current leadership, with no significant post-election policy shifts – bearing in mind signs which analysts believe indicate some loss of influence by economic liberalisers in the Kremlin.

Both the US and the EU (especially the French EU presidency in 2H08) hope for post-election improvements in relations. But major obstacles to that – notably **Kosovo** (where a UN deadline for reaching agreement on the province's future expired on 10 December), potential Russian suspension of the Conventional Forces in Europe (CFE) agreement and missile defence – may remain.

9. Korea (7)

Although opinion polls are close and **Republic of Korea (RoK)** politics remain volatile, the main opposition GNP's candidate Lee Myung-bak is favourite to win RoK's 19 December's presidential election. If elected, his first priority will be to ensure a GNP victory in the 9 April 2008 parliamentary elections. Pro-business Mr Lee is expected to put significant emphasis on economic growth; but his policies may (a) stand primarily to benefit the *chaebols* (eg, making it easier for them to take stakes in domestic financial institutions), (b) slow moves to improve corporate transparency and (c) do little to check growing domestic economic nationalism.

Internationally, Mr Lee would look to mend relations with Washington and to take a firmer but constructive line with **North Korea** at a critical time in the six-party talks as they move towards the dismantling of the Yongbyon nuclear plant and, ultimately, North Korean nuclear disarmament. However, North Korea has still to produce a list of its weapons programmes and periodic significant setbacks to the six-party process cannot be ruled out.

10. South Africa (8)

The African National Congress (ANC) is due to elect a new leader at its 16-20 December party conference, with precedents suggesting that that leader would then be the party's candidate for the 2009 presidential election when the current president, Thabo Mbeki, must stand down. While it is still not entirely clear who will stand for the ANC leadership, early balloting in the region is pointing to victory for former deputy president Jacob Zuma. Despite reassurances from Mr Zuma, this could unsettle investors who would see potential for damaging economic policy shifts were he then to succeed Mr Mbeki as president too. On the other hand, a third term as party leader for Mr Mbeki would likely also unsettle markets by protracting uncertainty over the presidential succession.

It remains to be seen whether Mr Zuma's candidature will be handicapped by renewed corruption investigations, which his supporters claim are politically motivated.

Emerging Issues – Six Of The Rest

In alphabetical order, we judge that the following six issues could break into our "top ten" during the year:

Egypt – Governance: Constitutional amendments passed earlier this year and the conduct of June's upper house elections have raised further question marks over commitment to democratic reform, which may boost support for the Muslim Brotherhood (which already effectively controls 88 seats in the lower house following the 2005 elections, despite being officially banned). Political tensions could come to a head, in due course, around the presidential succession.

India – Upcoming Elections: Although the current Congress-led government's term of office does not expire until May 2009, Prime Minister Manmohan Singh may call an election in the second half of 2008 (even if an ongoing disagreement with Congress's communist allies over ratification of India's nuclear agreement with the US does not precipitate an election even earlier). Opinion polls suggest that Congress will emerge from the next election as the largest single party and therefore form the next government. But coalition negotiations before and after the election and associated political uncertainty may unsettle markets.

Indonesia – Upcoming Elections: President Susilo Bambang Yudhoyono's fragmented ruling coalition is likely to come under significant strain as its members prepare themselves for parliamentary elections due in April 2009 and the presidential election due in July 2009. Mr Yudhoyono himself enjoys considerable public support (even though his Democratic Party holds only 10% of the seats in the legislature); but if he is to establish a strong platform for 2009 he may need to make more progress with key 2004 election pledges on poverty eradication, attracting more foreign investment, job creation and eradicating corruption. His predecessor in the presidency, Megawati Soekarnoputri (whose Indonesian Democratic Party-Struggle is the second largest in the legislature) has already said she will run for president again. The largest party in the legislature, Golkar, will choose its candidate by nationwide polls to be completed by February 2009.

Malaysia – Upcoming Elections: Despite a recent run of popular protests against the government and the possibility of early elections in the first half of 2008, we judge that significant policy shifts are unlikely – and even less so a change of government.

Saudi Arabia – Terrorism: Last month's announcement by the Saudis that they had detained over 200 suspected militants was a reminder of the potential scale of the terrorist threat there – including against key oil installations – despite a string of counter-terrorism successes since 2003. Additional concern revolves around the possibility of Saudi nationals believed to be with Sunni militia in Iraq returning home in due course.

Turkey/Northern Iraq: Provisional approval by the Turkish parliament in October for military action against PKK bases in Iraqi Kurdistan triggered an up-tick in oil markets. Since then, US/Turkey co-operation to counter the increase in PKK attacks has deepened; but, with the government recently endorsing approval for military action, significant Turkish strikes still look likely.

The "Known Unknowns" – Terrorism

The second half of 2007 saw several reminders of the global nature of the terrorist threat, with incidents as far apart geographically as the Philippines, India, Pakistan, the UK, Germany, North Africa and Chile. Expert US assessments of *al Qaeda's* capabilities concede that the organisation/franchise has recently been growing in strength. We believe the risk therefore remains significant of a **successful major terrorist attack** on a Western target.

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