PICK OF THE WEEK

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Hassi R'Mel

Soon to be a headline

The financial services industry breeds armchair experts. 25 years ago, few could place Iraq or Afghanistan on a world map. Now there are legions of pundits on the Kurdish problem in Tikrit, or Pashtun support for the Taleban in Kandahar and Helmand. More recently, these experts have developed instant opinions on how the population of Homs regards Syria's minority ruling Alawites, and the strategic importance of one-horse towns such as Misrata or Sirte in Libya. Such expertise about previously insignificant parts of the globe is not surprising when a sudden crisis erupts where the potential impact reaches far beyond their borders. But it is of minimal value to the investor because he should be operating quite differently.

The adage "if it's in the news, it's in the price" remains a truism. Therefore investors should analyse, and thus anticipate likely future headlines, using current widely available data to draw logical conclusions; they should act rather than react. Hassi R'Mel fits these criteria admirably: today a fly-blown and woebegone oasis in the Sahara desert, its destiny is soon to enjoy its own fifteen minutes of fame. For if, as we expect, local politics rapidly deteriorate further, then the lights flicker off in Madrid and Lisbon, Rome, Athens and Istanbul. As traders and pundits are blissfully unaware of Hassi R'Mel's very existence, the market surprise will be significant.

The next domino?

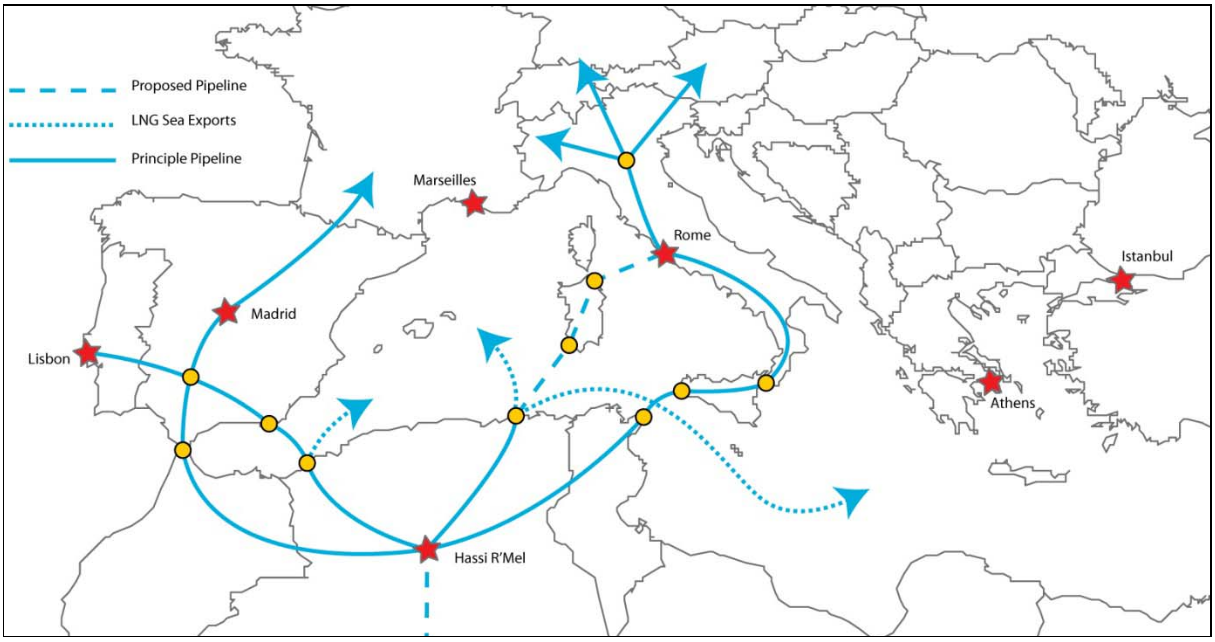
When late in 2010 the Tunisian street vendor Mohamed Bou'azizi committed suicide after continuous police harassment, the world watched quizzically at the speed at which a once irremovable dictatorship crumpled - for Tunisia is unimportant to most people except Tunisians. The subsequent explosion of civil unrest in Egypt did generate mild interest, not because of its economic significance (0.65% of World GDP in 2010) but because, with 84 million people, it is the most populous country in the Middle East & North Africa region (MENA), and has long been a crucible of new ideas and subsequent changes across a wider area. Once its despot had also fled after a final murderous spree, it too is being relegated as news filler on a slow day.

Concern over Libya has been on a wholly different scale. Again, not because of its economic significance, given it accounted for 0.13% of world GDP in 2010, and it has a population less than a tenth of Egypt. Nor is there a sudden revulsion against brutal dictators by politicians in the leading democracies; for they understand the real limits on their power and the many constraints on what they can achieve abroad. Moreover, as was evidenced by very slow and confused reactions at the beginning of the "Arab Spring", tame dictators on the payroll are usually preferred by democracies to serve their self-interests, rather than the inevitable unpredictability of new democratic governments. Hence the leading powers were embarrassingly eager to forgive Colonel Gaddafi for his many brutalities at the slightest opportunity, and even now are quietly praying that President Assad will stop his murderous campaign against Syria's people so he can be forgiven too. In Syria, the West will do nothing, as in Egypt and Tunisia. Herein lies the key to the angst over Libya: oil/gas supplies.

With pre-revolution production of 1.7 million barrels of oil per day, Libya accounted for only 2.1% of the total world production of 82 million barrels per day. However, its oil is a particularly light, impurity-free type, vital for blending with more common heavier oils and especially important to European refiners. This explains the political imperative for

Europeans to act with unusual alacrity (as well as massive US support below the radar screen).

The Arab Spring has already caused significant change, but capital markets and politicians are operating reactively, and then only to energy threats. Hence a general lack of interest or news on the broiling unrest in other MENA countries such as the Yemen, Bahrain or Morocco. And because this new-found expertise is also reactive, then it is easy to foresee that the next major surprise will come from the most obvious problem country of them all - Algeria.



Since 1945 Algeria's history has perhaps been one of the most woeful of any MENA nation. For three centuries a province, then an almost independent part of the Ottoman Empire (essentially Turkey), France invaded on a weak pretext in 1830 to become the colonial ruler. However, the French then fell deeply in love with the area, so increasingly considered and legislated that Algeria was part of France itself. Thus independence was only achieved in 1962 after a prolonged and visceral series of overlapping civil wars, between regional, tribal and ethnic groups and the 20% of the population which was French. Algeria then settled into a post-colonial pattern similar to many other MENA nations. Three presidents - varying only in the degree of their brutality - followed one another, each dependant on the support of an increasingly powerful and murderous military. The watershed came in 1991, when the last of these surprisingly held what can only be described as the first reasonably fair election. The result was that in the initial rounds of both the local, then the national, ballots during 1990 and December 1991, there was overwhelming support for the Islamic Salvation Front (FIS) which won over 50% of all votes cast on a high turnout. Not only was this deeply unpopular with the army, whose entrenched political and wide financial interests across all aspects of the economy were at risk, it was greeted with nothing short of horror by the leading democracies, particularly America and France. Despite FIS then having a modest social programme and a desire for a secular Islamic state, its huge victories coincided with a raft of terrorist attacks elsewhere, such as the Lockerbie and Templehof air base bombs. In the western mind, Islam and terrorism were becoming synonymous, hence in public there were few official complaints when the results were over-turned, with another army appointee becoming president.

Enter the obscure Mr Bouteflika

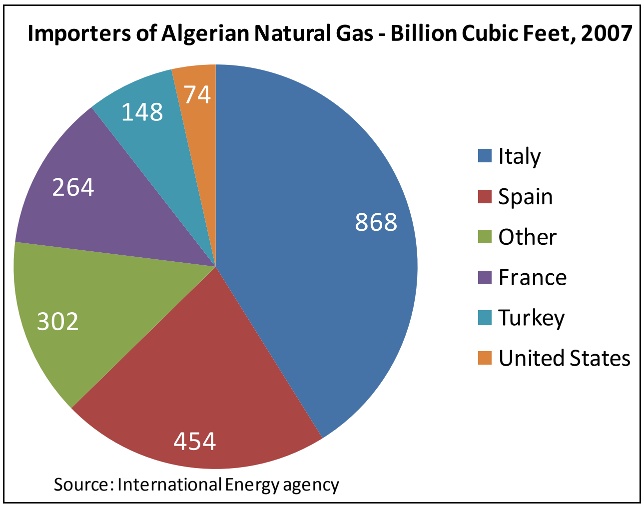
Since 1999 the president has been Abdelaziz Bouteflika. To Algerians he is a tyrant; to politicians and investors he matters for only one reason: oil/gas.

Natural gas trade movements 2010

Country	bn m³	% of World
Russia	199	23.4
Norway	100	11.7
Qatar	95	11.2
Algeria	56	6.5
World	851	52.8

Excludes cross-border movements between the US, Canada and Mexico. Includes both Pipeline and LNG movements. Source: BP Statistical Review 2011

With production of 1.8 million barrels a day, of which approximately 84% is exported, the country accounts for 2.2% of global oil supply; seemingly small but very significant at the margin for the oil market. It has the capacity to produce about half a million barrels more, but as a member of OPEC, is constrained by its quota. Thus Algeria is an important second division producer. In the gas market however, which is exempt from OPEC quota rules, Algeria is in the premier league, particularly as a European supplier. The gas is distributed both through a web of pipelines and LPG/LNG seaborne carriers. Most of it is used to generate electricity across southern Europe; any disruption in supply would have an immediate and significant impact first there, then globally.



Algerian gas imports as a percentage of total gas imports

Country	%
Italy	36
Spain	34
Portugal	29
Greece	26
France	13
Turkey	10

Source: BP Statistical Review 2011

Algeria is the sixth largest natural gas producer in the world. In European gas supply it is third only to Russia and Norway. Since the fall of the Berlin Wall in 1989, Russian energy policy has had the subtlety of a builder's wrecking ball. It uses supply threats to major European nations such as Germany and occasionally turns it off altogether to those considered within its sphere of interest, such as the Ukraine. As a result, the Europeans sought out more secure energy supplies (a view reinforced by both Gulf Wars) and to develop stable, safe alternatives - Algeria and Bouteflika the most popular. Therefore, even the mildest risk of regime change is of immediate interest and economic consequence, first to Europe, then America given the impact it would have on global gas prices. Recent developments in Algeria do not bode well.

The inevitable collapse of the regime

The unexpected result of the FIS winning the first clean national elections in December 1991 produced a swift reaction by the military. The result was cancelled; civil war ensued. Middle class FIS voters then slowly became radicalised. During his first term, Bouteflika was a weak president because, like his three predecessors, he depended on the army where he had few personal allies. In 2004 he took a gamble, running as an "independent" but with tacit military backing. All other candidates withdrew from the election prior to the vote from justifiable concerns over vote-rigging, fraud and coercion, all of which took place on a massive scale.

"Winning" 74% of the votes cast on the official count (with even heavier vote-rigging reported by independent observers), he then held a referendum on his new policies. This won 81% of the vote. Nevertheless, some key nations - especially America - declared both results free and fair, probably out of a fear that the FIS, now re-branded by Bouteflika as radical Islam, would be much worse. This second term was crucial. He divided the military then put his own satraps, owing loyalty to him alone, in key positions whilst consolidating his civilian power bases. The two-term rule for presidents was easily resolved by a change in the constitution; not surprisingly he won a third election in April 2009, now with 90% of the vote. Even old Stalinist politicians would have blushed with embarrassment. Algeria now has only three institutions: the Executive (all of whom Bouteflika appoints), the military (dependent on him) and the highly corrupt state oil company Sonatrach - entirely his own creature and the cash cow funding all his supporters. Bouteflika is Algeria.

He is now 74 and has no heirs, relevant to any careerist, as backing Bouteflika represents short term rewards only. His history is similar to many dictators: a criminal conviction over the proven theft in 1983 of 60 million dinars from Algerian embassies during his career as a diplomat; and many allegations of government sponsored murder. In February this year the "mysterious" death occurred of one of the few honest men still in a position of power, the head of the national police force, Ali Tounsi. Critical observers such as Amnesty International have long been banned. However, unlike some other MENA countries, there is minimal foreign criticism because he was a quick learner, using expressions such as "joining the war on terror" often enough, and occasionally attacking the few hard-line splinter groups, such as the tiny "Al-Qaeda in the Land of Islamic Maghreb". His oppression of all other citizens thus passes unnoticed.

During the early part of the Arab Spring, there was panic in Algiers that they too would be caught up. From late January 2011 many peaceful demonstrations commenced and continue, but have descended into alleged riots as a result of tactics used by the military. As elsewhere, food imports have been massively increased and been heavily subsidised, but to little effect; for so great is domestic corruption that much has been re-exported for profit by Bouteflika's cronies. For all practical purposes, such small economic activity that used to occur outside of the state-owned energy sector is grinding to a halt. Meanwhile, a long-running and occasionally violent dispute continues with Morocco and its occupied territory of the Western Sahara. Relationships with other neighbours can be described as odious: there has been an increase in border clashes in the last eight weeks with the new Tunisian regime, and these will soon follow with Libya's nascent government. Civil unrest and major suicide bombings have also accelerated.

Given Bouteflika's regime and background, it is wholly understandable why Algeria has become the haven for leading cronies of Colonel Gadaffi and, allegedly, members of his family.

The Algerian epicentre

Americans know of Cushing and Henry Hub, the British of Sullom Voe; all three are major pipeline crossroads. In terms of international importance, none compare with Hassi R'Mel, the most important single gas hub for Southern Europe. The region is sparsely inhabited and mostly Berber, historically antipathetic to any Algerian regime and particularly that of Bouteflika. It voted overwhelmingly for FIS. These factors are important locally, but nationally there are six reasons why the sand is running out for the current regime: i) the fall of Libya and Tunisia - the new governments will be hostile; ii) increasingly violent incursions from Morocco, sensing an opportunity to strike at an ancient enemy; iii) the coalescing of moderates and militants into an "Anything but Bouteflika" coalition; iv) his age and lack of an heir apparent; v) capital inflows have dried up; and vi) the Libyan example - Colonel

Gadaffi was wholly forgiven for the sake of his oil but simply went too far in his cruelty, forcing the West's hand.

Investment conclusions

The chances of the Algerian regime hanging on are small and diminishing. Maybe Bouteflika will walk quietly, or be murdered by the Army. Intelligent guesswork is required. It seems unlikely that he will go quietly and/or that any new incumbent will be untainted. Algeria wants FIS. Most international responses to the uprisings in MENA countries have been flat-footed and equivocal beyond occasional platitudes about freedom, with the exception of energy exporters, such as Libya. What, if anything, will NATO - or parts of it - do about Algeria? All that can be forecast with some certainty is denial followed by panic. This is not priced into energy markets. Throughout the Arab uprisings these have been remarkably sanguine, to the extent that even now, oil and gas reserves in the North Sea, Australia or Brazil are valued approximately the same as those beneath unstable MENA countries. Thus capital markets perceive no risk. Moreover, the majority of investment analysts and economists share a remarkable consensus that energy prices will fall, due to lower consumption amongst the slow-growth advanced nations, while demand from emerging markets rises at a sluggish rate. These latter two parts of the equation are probably correct, but markets are singularly failing to focus on the supply risks, which in Algeria's case are of immediate relevance to Europe. Thus any stock market rallies on the demise of Colonel Gaddafi or the largely popular disappearance of President Assad of Syria should be treated with extreme caution. Energy markets look very vulnerable; non-MENA gas companies very good value. Meanwhile, watch out for a new breed of armchair experts on the currently obscure Hassi R'Mel.

Regards

Bedlam Asset Management plc

Quiz Time

This issue's quiz is a two part question and as usual, the first three correct answers to both parts will receive a bottle of France's finest champagne if UK based; if overseas, a selection of thoughtful business books.

"25 years before the French invasion of the 'Barbary States' (now Algeria and Tunisia) which then small nation decided to embark on its own naval invasion and what percentage of its fleet was involved?"

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