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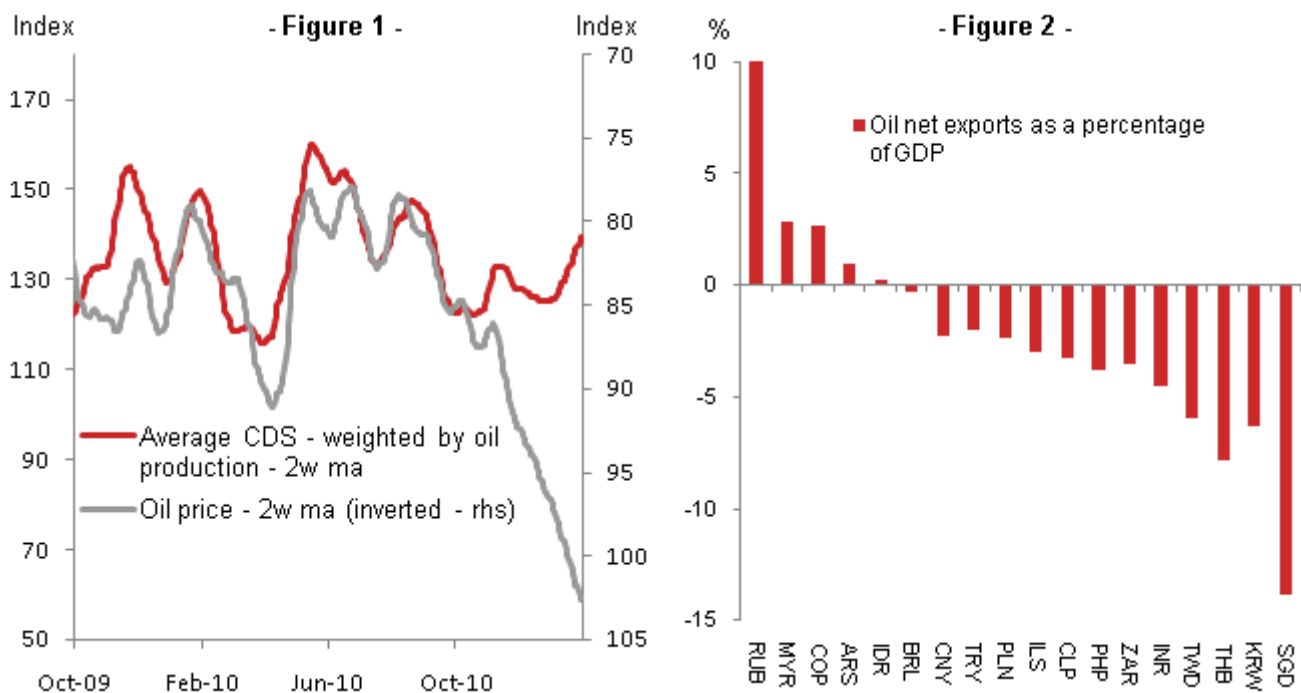
Macro Strategy

Chart of the day: Tracking the spill-over effects of the Middle East crisis

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Yesterday's market response to the rising crisis in Libya suggested that Middle East tensions were spilling over into global markets, with the key focus being the impact on oil prices. Although the average Middle East CDS (weighted by countries' share in oil output) has widened over the past days, the price action has been relatively contained, highlighting Libya and Egypt's limited share of world output. More broadly, looking at net exports of oil as a percentage of GDP, Asian markets, bar Malaysia and Indonesia, together with Turkey and Poland, appear to be most vulnerable to higher oil prices, while Russia stands to be a major beneficiary. Our EM team recommends selling Russia CDS vs buying Poland.



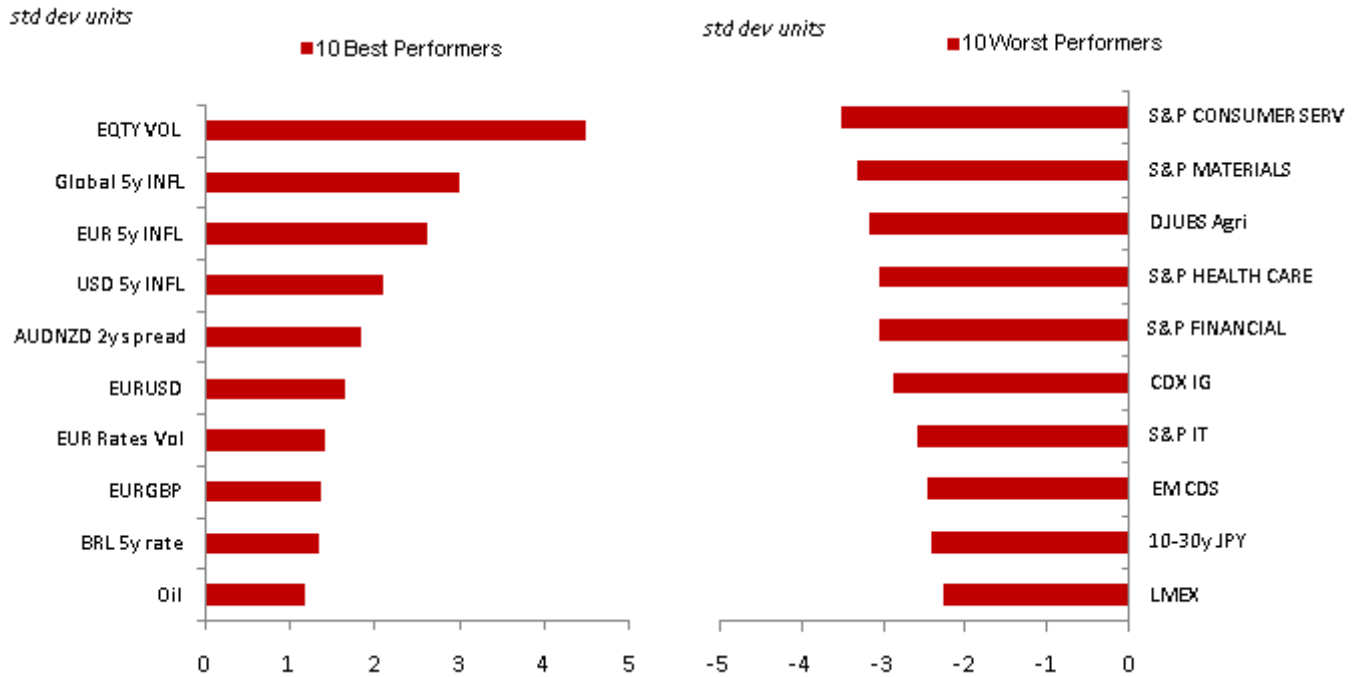
Source: Nomura, Bloomberg

Over the past few days the key question from investors has been whether ongoing tensions in the Middle East would spill-over into global markets. While Tuesday's market response to the rising crisis in Libya suggested Middle East tensions were spilling over into global markets, it is not yet clear whether we have entered a significant phase of risk aversion. The key focus, as is always the case with the Middle East, will be the impact on oil prices. This is especially true today as concerns around inflation have risen markedly in recent months. Figure 1 looks at the price of oil against a weighted-average CDS level for major oil exporters (weights are based on each country's oil exports as a % of world exports). A few points are clear. First, the current crisis is a uniquely Middle East affair. Normally, a rise in oil prices is accompanied by tighter Middle East CDS spreads as markets anticipate rising government revenues. This time, however, the opposite is happening. Oil is rising because of political tensions as markets fear significant supply disruptions. That said, the weighted-average CDS spread for oil exporters is not especially high, underscoring that up to this point countries where tensions have been concentrated represent a small portion of world oil output. Libya and Egypt's combined share of global output, for instance, is less than 4%.

If the Middle East crisis does spill over, another obvious question is which markets are most vulnerable. Figure 2 looks at net exports of oil as a % of GDP for a universe of EM currencies. Perhaps unsurprisingly, Asian markets are the most vulnerable to higher oil prices given their huge reliance on imports – Malaysia, and to a lesser degree Indonesia are the main exceptions. While short-term pressures from the spike in oil prices would almost surely be felt in Asian currencies, growing concerns over inflationary pressure in the region probably argues for more upside pressure in yields and downside pressure on equity prices. Eastern Europe, especially Turkey and Poland, are also vulnerable to higher oil prices, although given the significant sell-off already in TRY in the last few months, we believe downside should be reasonable well contained. On the flip side, Russia stands to be a major benefactor from the Middle East crisis – after all, it is one of the few major oil exporters not dealing with some level of political tension. One trade our EM strategy team likes is selling Russia CDS protection while buying Poland protection (see [Buy Poland 5yr CDS, while selling Russia](#)).

Macro Radar Screen*

Top 1-day macro market movers (vol adjusted using 60-day vol window)



Source: Nomura, Bloomberg,

*See note and table at the end of the document for explanations and conventions in asset performance

Our concerns that Libya's tensions would spill-over into broader markets looks well-founded after Tuesday's sharp spike in global risk aversion. Perhaps most notable, equity volatility surged to its highest level since early December. At the same time, some of the star performers of the generally supportive risk backdrop – notably developed market stocks – felt the bulk of the pressure in the past few days. That said, follow-through today has been relatively muted – most Asian stocks are well off their lows (China's markets actually closed up) while US futures point to a modestly positive open. Ultimately the pass-through of the Middle East crisis to broader markets will depend on what happens to oil – by now, the crisis is an important inflexion point, but oil prices have probably not yet risen enough to be a major, lasting threat to broader markets (see today's Chart of the Day). That said, the rise in oil is yet another factor driving up inflation pressures. Indeed, despite Tuesday's risk averse markets, most inflation breakevens managed to rally – with 5-year US and euro breakevens hitting new multi-month highs.

Elsewhere, the main story continues to be hawkish talk from ECB members and renewed flattening of European curves. Over the past week, EUR 2s10s has flattened nearly 20bp. In the UK, the flattening has been less severe, although today could be important. Coming on the heels of a solid public borrowing report (see [Public finances: A solid start to 2011 as receipts rack up](#)) today's Bank of England minutes will help shed light on whether the MPC is moving toward a rate hike as early as May – our economists think it is. This combination of monetary policy tightening alongside fiscal policy tightening is, for the moment, uniquely European and the reason we like flatteners in both the UK and the euro.

Research, trading notes and references

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*Note: The Macro Radar represents asset performance, not an asset's impact in terms of risk or economic performance. For most of the above categories, performance has been calculated in terms of prices of the underlying asset, i.e. a higher price entails a positive performance. For example, all outright interest rates are treated with respect to the value of an equivalent underlying bond, i.e. as yields fall the value of an equivalent underlying bond increases, therefore an outperformance of outright swap yields reflects yields declining. Equally, as credit spreads, such as iTraxx tighten, credit outperforms. Note that this treatment, when applied to outright inflation swaps, leads to rising inflation swap yields implying a positive performance, as would be observed in inflation-linked bonds. The exceptions to this rule are spreads, such as curve, fly, swap and cross-currency yield spreads, which are treated as assets in themselves, i.e. a steeper curve will be seen as a positive performance, a more convex curve will be a positive performance for the fly. The one-day performance refers to the last price available compared to the average price between 7am and 8am London time the previous business day.

Macro Radar Screen conventions broken down by asset class

	Quoted as	Move	Performance
FX	FX rate	up	positive
2y Rate Differentials	2y rates spread	widening	positive
EQ Subsectors	Index level	up	positive
Equities	Index level	up	positive
Credit	Index level	widening	negative
Vol	Vol level	up	positive
Curve	spread	steepening	positive
Fly	spread	up (more convexity)	positive
Rates	yield	up (price down)	negative
Inflation Swaps	yield	up	positive
Short End	yield	up (price down)	negative
Commodities	price level	up	positive
Libor-OIS	spread	widening	negative
Eqty/Bond ratio	ratio	up	positive

Source: Nomura

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