

# The Arabian Markets

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## Highlights:

- The overall returns on a diversified international portfolio since the start of 2014 has been negative — risk for no reward!
- Concerns are not so much at the scale of any possible downside but the lack of a significant upside catalyst.
- This year may be the first in a generation in which all three main asset classes (bonds/equities/real estate) will register a synchronised annual decline.
- It's almost certain that the region will suffer a double whammy from tightening fiscal & monetary policies.
- One supporting factor is that oil may be in the final stages of a prolonged bottoming-out process.

## Austerity Arabia



Market Commentary — a product of Sales and Marketing and not Investment Research or Advice

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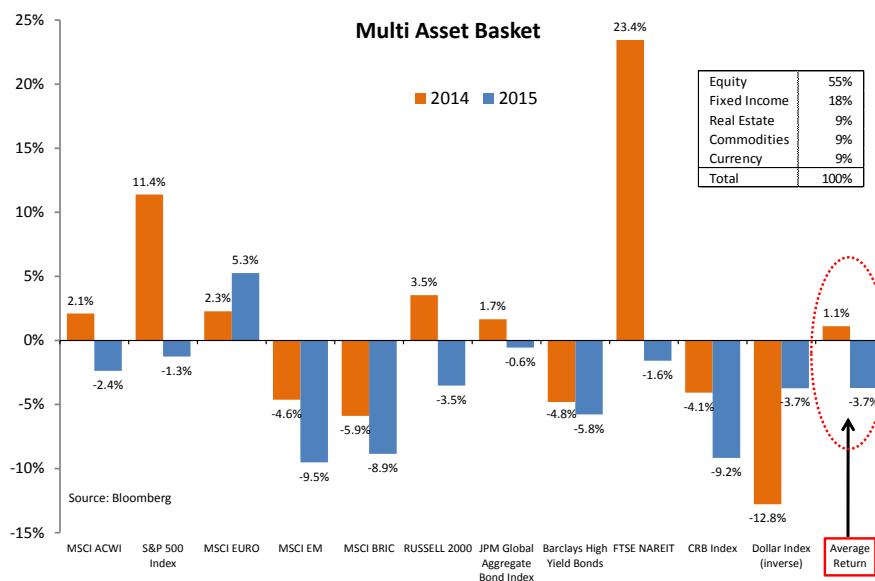
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## International Snakes & Ladders

The S&P500 index has endured a moderate correction and investors seem unsure whether this will simply end up being an overdue wobble or if it signals the start of a more sinister decline.

One indisputable fact, however, is that for all the buying and selling, the huffing and puffing, the overall returns on a well diversified portfolio since the start of 2014 has been negative — risk for no reward!



But even this analysis is distorted by the large developed markets (US/Europe/Japan) that have benefited from massive asset purchases by price insensitive and valuation agnostic buyers, such as central banks.

For the rest of the world it has been a pretty miserable year with the majority of stock markets declining in dollar terms and economies struggling under the weight of sluggish growth and a commodities bust.

The chatter this year has been about the Federal Reserve raising interest rates but there have been literally dozens of rate cuts by central banks around the world desperately trying to keep their economies afloat.

The European Central Bank and the Bank of Japan are pressing pedal to the metal in a frantic attempt to avoid a slowdown but the Eurozone is projected to grow this year by 1.5% and Japan by a measly 0.6%.

With the IMF downgrading global growth forecasts there are murmurings of another round of quantitative easing to which the markets have responded positively given the effect of previous rounds on asset prices.

The continuation of the same failed policies will eventually test the patience of investors and the credibility of central banks, if not today then tomorrow, and calls for new solutions will only grow louder.

There has been a sharp increase in bets on a tail risk event and while the view here is not as bearish the presumption is that the equity markets will drift lower with occasional upside volatility and a modest net change in prices over the next few months, maybe even years.

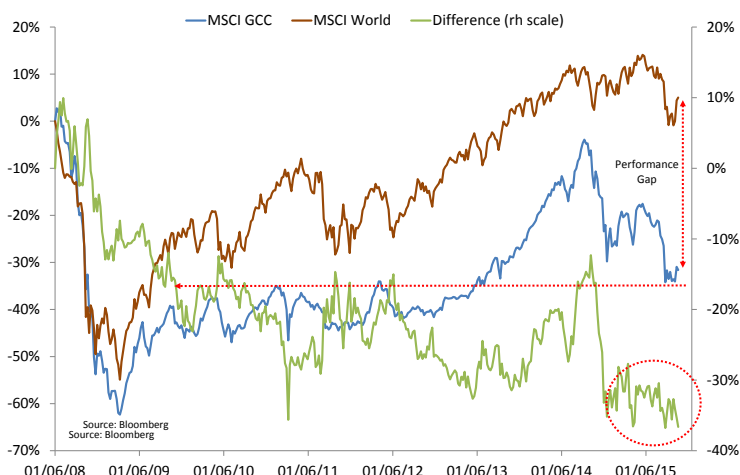
In the meantime investors will need to remain vigilant and nimble, accept the increased volatility, and focus tactically on absolute return strategies and strategically on longer time horizons.

## Regional Market Developments

Pessimism across the regional markets has led to a substantial sell-off that reflect expectations of a decline in corporate earnings with portfolio values down by around a quarter over the past year.

Indeed stock prices are barely higher than after the global financial crisis and the performance gap between the MSCI GCC index and the MSCI World index at -37% is at it's widest levels.

Investors appear anxious about a lack of clarity in the macro-economic outlook and the limited tools available to governments constrained by factors beyond their control such as oil prices, US monetary policy and regional security.



The good news is that valuations have improved and that the bad news may be partly baked into prices with dividend yields appearing particularly attractive at current levels.

	Index	Current Valuations		
	Current	PER	PBR	Div Yield
Saudi TASI	7,784	16.6	1.8	3.3
Dubai DFM	3,708	12.8	1.2	6.7
Abu Dhabi ADX	4,556	12.5	1.4	5.0
Kuwait KSE	5,754	14.7	1.0	4.5
Qatar DSM	11,772	12.0	1.4	4.3
MSCI Europe	1,068	18.2	1.5	3.6
S&P500	2,033	18.1	2.7	2.1
<b>MSCI GCC</b>	<b>507</b>	<b>14.0</b>	<b>1.6</b>	<b>4.3</b>
MSCI GCC ex-KSA	499	12.6	1.5	5.4
MSCI EM	865	12.6	1.4	2.9
MSCI Asia	529	11.7	1.4	2.8

Valuations at 18th October

Source: Bloomberg

The price to earnings multiple in Saudi Arabia has fallen from over 20x in June to 16.6x and the MSCI GCC average has declined from nearly 17x to 14x — and 12.6x excluding KSA.

This is comparable to peer emerging markets that began their earnings adjustment phase last year.

Whether valuations are sufficiently appealing will depend on the extent to which earnings eventually decline and the capacity for multiples to expand.

From a top-down perspective it continues to be difficult to identify pockets of value as investors have been relatively efficient in reacting to macro-economic developments and adjusting their portfolios accordingly.

Defensive sectors with steady earnings and reliable dividends including consumer non-cyclicals, communication and utilities that ought to be attractive at this point in the cycle have already performed well and trade at premium multiples.

Conversely, sectors that have performed poorly and that seem reasonably valued such as energy (year-to-date -22%) and consumer cyclicals (-16%) are comparatively more risky and require meticulous attention in stock selection.

Bloomberg GCC200 Index	PER	PBR
Basic Materials	14.2	1.7
Consumer Cyclicals	17.7	2.3
Consumer non-Cyclicals	20.7	2.6
Communications	17.5	2.0
Diversified	19.3	1.2
Energy	10.5	1.6
Financial	11.8	1.4
Industrial	14.3	1.7
Utilities	NA	1.5
<b>Index</b>	<b>14.2</b>	<b>1.6</b>

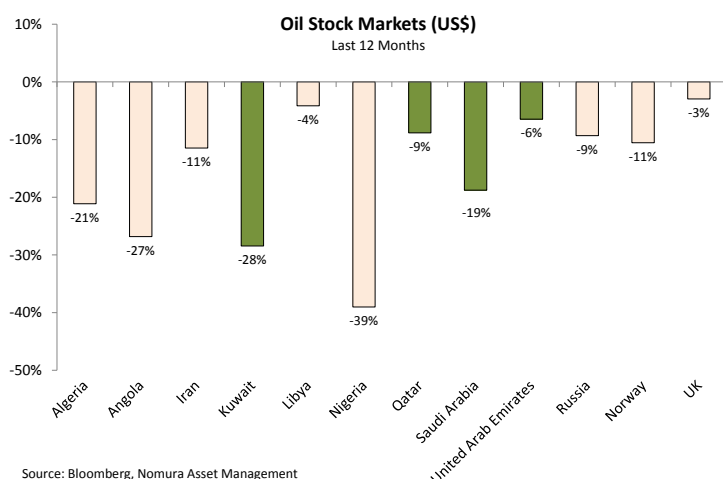
Source: Bloomberg

The financial sector offers scope for positive surprises on the basis that valuations may reflect excessive concerns over asset quality given the strength of their underlying businesses and capital adequacy.

## The Oil Connection

The performance of the Saudi stock market since the introduction of the Qualified Foreign Investor (QFI) program on June 15th has been disappointing. The Tadawul All Share Index has fallen 18% in four months.

Hopes that foreigners would rush to buy stocks directly have been overshadowed by the deteriorating prospects for the economy and the worsening outlook for corporate profits.



In fairness the weakness in the energy industry has contributed to a generally poor performance in most oil-related stock markets around the world.

Oil dependent equities from Algeria and Angola to Nigeria, Norway and Russia have all suffered steep losses.

The decline in the UAE has been more muted due to an overstated perception that its economy is more diversified and hopes for a revival in trade with Iran.

Slackening global demand suggests that oil prices will remain low for a prolonged period and Nomura's assumption is that the upside is capped at \$60 as key OPEC members seem willing to increase output in order to protect market share and shutter high cost producers.

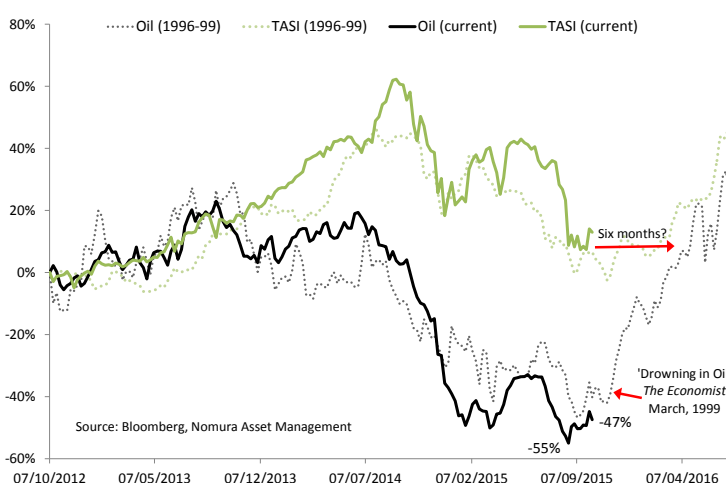
But the price of oil is notoriously difficult to predict and it is hard to know exactly when sentiment will turn or policy might shift and what the catalyst for a possible rally might be.

Recent warnings of \$20 oil have parallels with the infamous *Economist* cover story titled 'Drowning in Oil' in March 1999 which predicted that oil could collapse to \$5 just as prices were set to rebound.

The dotted lines in the chart (right) show the performance of oil and the nascent Saudi stock market between 1996 and 1999 superimposed on real time prices since 2012.

Oil fell from \$26 in 1997 to around \$10 within two years sending the stock market down in sympathy.

Last year's decline from above \$100 to the \$40 level is comparable to that episode and has led to a similar sell off in the Tadawul index.



In terms of scope and scale history suggests that we could be in the final stages of a bottoming-out process even if the recovery in prices might be less robust than its precedent suggests.

## Austerity Arabia

Talk of austerity in Arabia sounds ridiculous but it is increasingly certain that next year will see a slowdown in economic activity due to the double whammy of tightening fiscal and monetary policies.

With budget deficits swelling and foreign currency reserves shrinking governments have indicated that they will trim spending and the private sector has started to lower its capital investments accordingly.

The IMF has cut its growth forecasts for Saudi Arabia to 2.2% next year amid a record fiscal deficit and estimates that its foreign exchange holdings will last only a few more years at current levels of spending.

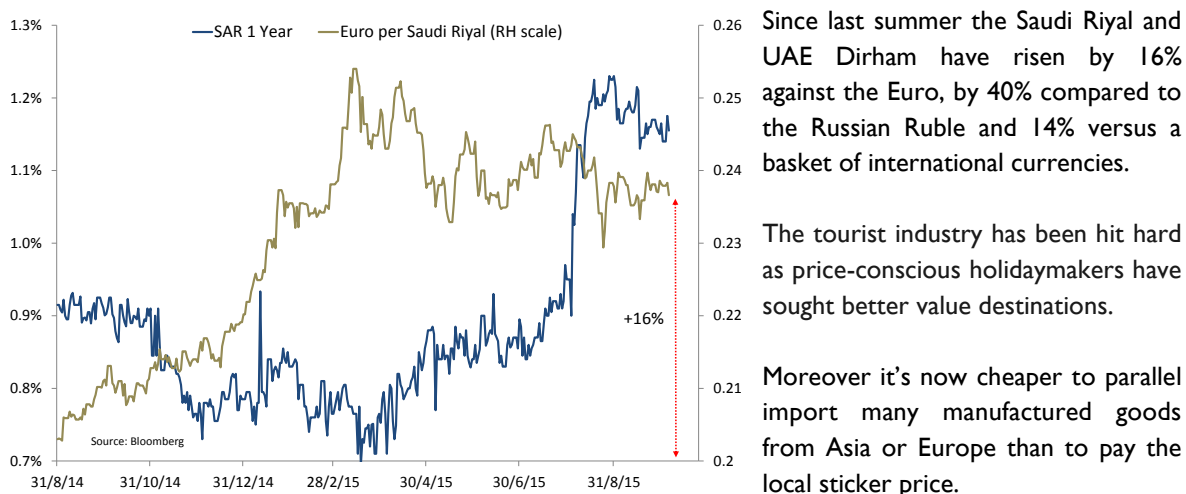
Standard & Poor's and Fitch have also revised their long-term outlook on Saudi Arabia to Negative from the current rating of AA- and AA respectively and a credit downgrade appears inevitable.

The cash cushion will buy a little time but most governments have been slow in seeking ways to raise revenues and chosen to rely on their diminishing reserves or borrowings to sustain expenditure levels.

In the UAE higher utility rates and housing fees as well as cuts in fuel subsidies are among the measures taken to help balance the books while food subsidies are being reduced in Bahrain.

These actions are necessary but their budgetary impact is limited and the timing unfortunate given the uncertain economic climate that is squeezing households and inhibiting discretionary consumption.

Meanwhile strong local currencies, courtesy of the US dollar peg, have led to an effective tightening in monetary policy that is hurting the competitiveness of local enterprises.



The strength of regional currencies is being compounded by interest rates that have edged higher with forward rates reflecting slowing deposit growth and fears of a US interest rate hike.

Rising interest rates and strong currencies combined with the prospect of reduced government spending and higher taxation is exactly what the regional economies don't need at this point in the business cycle.

Companies are already feeling the effects of this multiple tightening phenomenon and it is now likely that GCC firms will experience a profit recession over the next few quarters.

## Evolutionary Strategies

Given that oil prices are expected to remain subdued for the foreseeable future, the spectacular economic development since the turn of the century can no longer be fueled by petrodollars.

A new paradigm, likely to be moulded by a combination of spending cuts, revenue increases and deep economic reforms is required to propel economies towards the next stage in their development.

Unfortunately the window of opportunity to reshape economies during the oil-led boom is now firmly shut and tough decisions will have to be taken under less favourable circumstances.

Compromises must be made but there is considerable scope to cut wasteful expenditures and to *spend smarter* with a focus on *qualitative* rather than quantitative growth.

Additionally, governments can limit their role in the economy and allow the private sector to satisfy any slack or fill gaps in the markets on commercially viable terms.

These adjustments should provide private companies, particularly SMEs, the opportunity to enter sectors in which it had been difficult to compete or from which they had been excluded.

From a revenue raising perspective the IMF has recommended the application of duty on cars and value added taxes in order to help stabilise government finances.

However, and unlike the removal of subsidies, increasing revenues through the introduction of any form of taxation raises the delicate issue of accountability and transparency in spending.

Higher taxation will lead to an increase in the cost of living and should be offset by deregulatory steps that reduce excessive pricing and allow economies to remain competitive — UAE inflation in August was 4.9%.

Telecom tariffs in the region, for example, remain too high while the protective agency laws and archaic company ownership rules preserve inefficiencies and sustain prices at elevated levels.

In other sectors, such as real estate, there is latitude to ease regulations, improve access to mortgages, extend residency rights to foreign buyers and offer better legal protection to international investors.

Many industries across the region remain highly fragmented with subscale operators that benefit from barriers which sustain inefficiencies and discourage consolidation and cross-border mergers.

The recent royal directive to open the Saudi Arabian retail and wholesale markets to full foreign ownership should reduce uncompetitive practices and allow international firms to operate without costly intermediation but the devil is in the detail that is yet to be revealed and in the implementation process.

Policymakers must not shy away from bold initiatives that offer an opportunity for economic renewal, can invigorate entrepreneurial spirits and raise the aspirations of ambitious companies.

Charles Darwin wrote, “it is not the strongest of the species that survives nor the most intelligent. It is the one that is most adaptable to change.”

To prosper the Gulf economies must adapt or risk undoing the gains of the past decade.

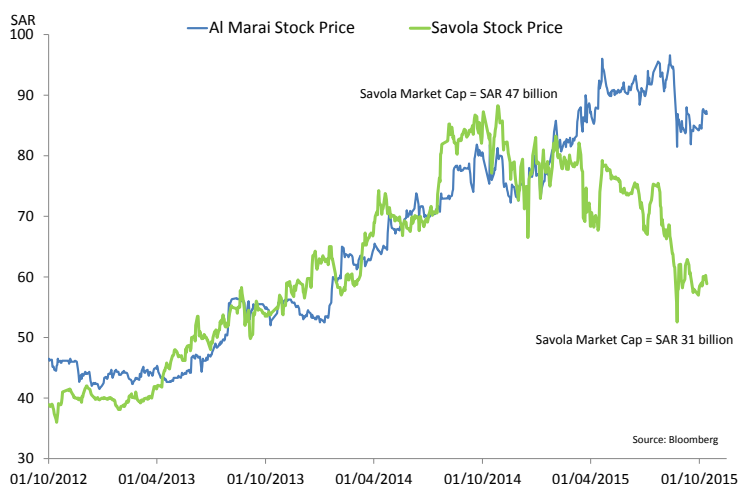
## Trading Places

On the basis that the upside to stock markets may be limited investors will need to become increasingly creative to generate returns, relying on tactical trading rather than buy-and-hold strategies.

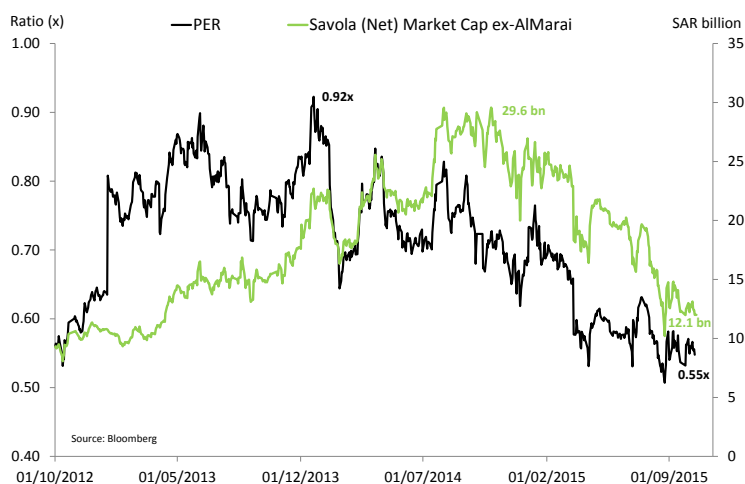
One idea is to play the established trading ranges in selected markets, buying the dips and selling the rallies. Another is to identify stocks that deviate from their expected paths or from underlying relative valuations.

The price chart for two of the largest companies in Saudi Arabia — AlMarai and Savola shows that the latter has underperformed over the past few months as its profits have disappointed.

This outcome is to be expected when firms experience a divergence in their operating performance but what makes this particular observation interesting is that Savola owns approximately 36% of the outstanding shares in AlMarai and can be considered as a partial proxy for the dairy company.



Savola's stock price and market capitalisation has dropped by 32% from SAR 47 billion in October last year to SAR 31 billion but *excluding* the market value of its stake in AlMarai the *net* capitalisation has fallen by 57% from SAR 29 billion to SAR 12 billion (see chart below, right hand scale).



One way to measure the extent to which valuations have discounted the disparity in operating performance is to examine the relative changes to price to earnings ratios (PER).

The ratio of Savola's PER to AlMarai's PER (left hand scale) has fallen from a high of 0.92x two years ago to 0.55x.

This lower valuation suggests that investors may be in the process of discounting Savola's weaker outlook.

As the deviation in stock prices has increased, the lower net market capitalisation of Savola's operating units and the stock's reduced valuations might make the shares comparatively appealing to investors that expect a recovery in its commercial operations.

This rudimentary analysis does not account for factors such as accounting practices and capital gains taxes but serves to simply illustrate some of the trading strategies that investors may have to adopt in order to succeed in a challenging market environment.

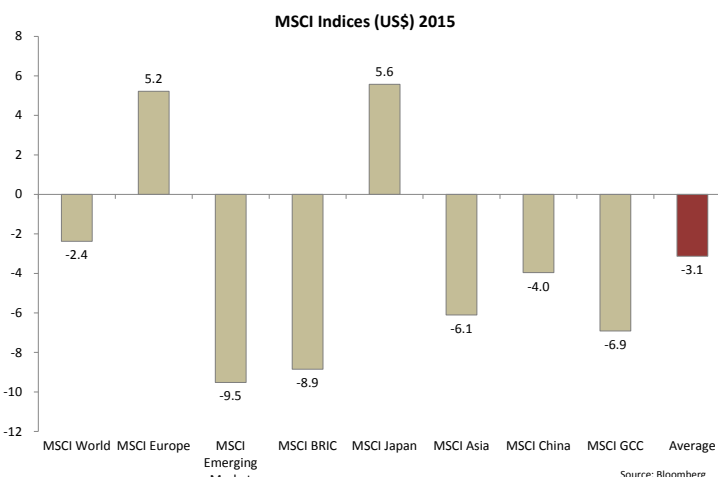
## Mapping Markets

The cautious approach to global and regional equities this year has been vindicated and stock markets have been characterised by price volatility and currency swings from which there have been few places to hide.

The MSCI World index is down 2.4% with the Emerging Markets and BRIC performing particularly poorly.

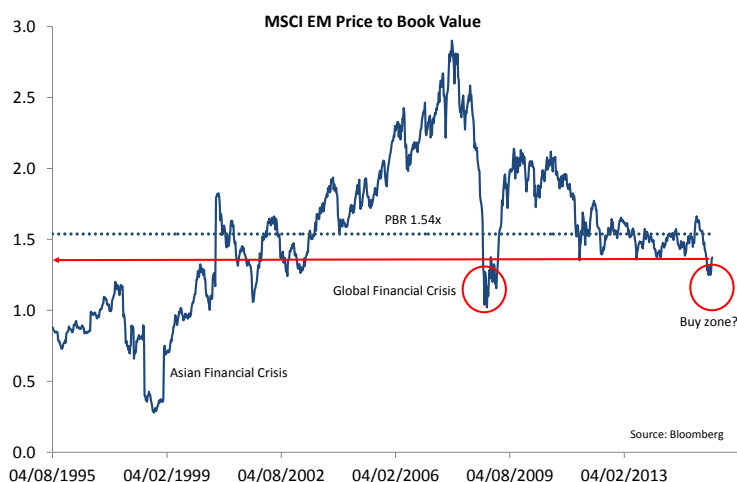
Japan +5.6% has been the stand out performer followed by Europe +5.2%.

Commodity driven economies have been especially hurt by the US dollar's strength and investment outflows that have triggered widespread price dislocation and left stock valuations at historically depressed levels.



The outlook for China is a key issue for EM but also the world economy generally and the consensus considers the risks manageable given the country's huge foreign reserves, scope to cut interest rates and ability to boost fiscal spending. This may be true in the short term but the idea that a Marxist politburo can indefinitely manage a large and globally integrated economy away from any serious downturn is nonsense.

China constitutes about a fifth of the MSCI EM index which comprises twenty-three important economies including BRIC but also Taiwan, South Korea, Mexico, South Africa, Turkey and Poland.



Based on price to book — a favoured valuation metric in times of earnings uncertainty — the current MSCI EM index ratio at 1.37x is below the twenty year average of 1.54x and has been lower only during chaotic periods (Asian and the Global financial crisis).

There is a wide dispersion of valuations across EM and even within individual markets so stock picking is essential in identifying attractive equities that have largely discounted the negative news.

Investors that have reservations about the ominous developments in China might consider another proxy for the emerging markets or take a more selective investment approach.

Warren Buffett's advice is to be "greedy when others are fearful" and while the suspicion is that there is another leg downward to come, distress in markets can be a good buying opportunity.

Dipping into the EM space is not without risk or for the faint hearted but a sensible strategy of *gradual accumulation* in robust businesses and oversold stocks over the next twelve months should be rewarding.



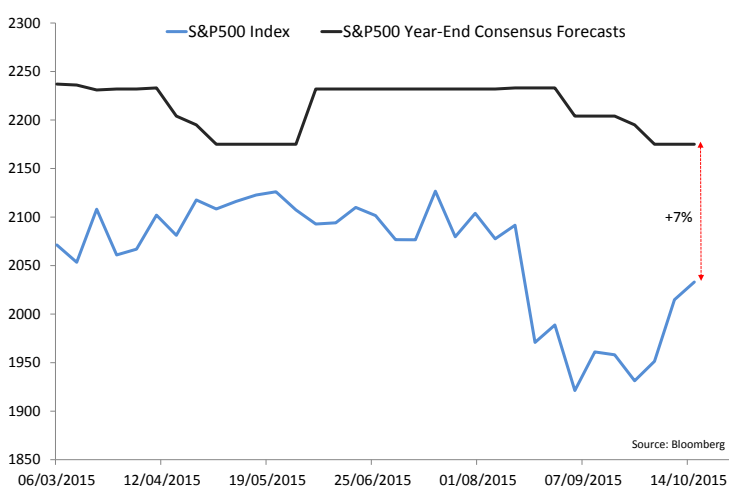
## Forest from the Trees

Despite the market volatility and ongoing growth scare, strategists remains relatively sanguine about the outlook for the developed stock markets, and particularly the United States.

Consensus forecasts for the S&P500 index show an expected upside of 7% by year end — an annualised return of around 40%!

Strategists argue that valuations are high but not excessive, that economies are growing and corporate profits increasing, albeit more slowly.

But this analysis ignores the context in which firms operate, the systemic risks and the shifting political winds.



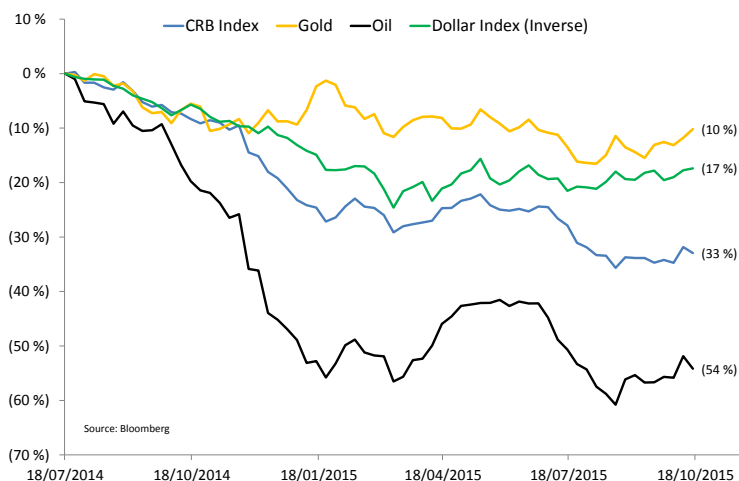
Central bank buying of government debt offers a temporary reprieve but is not a solution to the bulging mountain of IOUs, rising debt to GDP and the prospects of sovereign defaults or devastating monetisation.

Income inequality has been identified in some academic circles as a root cause of secular stagnation and is leading to radicalisation in the political landscape and a sustained rise of anti-establishment forces.

Syriza's consolidation on power in Greece, the election of a fervent socialist as Britain's opposition leader and the strong showing of unconventional presidential candidates in the US primaries are only the latest manifestation of social discontent and frustration with the political economy.

And no analysis these days is complete without a reference to the evolving geopolitical backdrop that has seen superpowers engage in proxy conflicts reminiscent of the cold war in the 1970s.

These developments may seem irrelevant to traders but a potential swing in the political pendulum has huge implications for economies, the capital markets and for the next generation of investors.



Gold may not have shone so brightly in the past year but it has been one of the best performing commodities and its non-US dollar price is actually up.

Gold typically moves inversely with the US dollar and while the currency has risen 17% since last summer the metal has fallen 10%, the CRB index is down 33% and oil has dropped 54%.

In this context gold has done a decent job in its advertised role as a protector of wealth in real (US dollar) terms.

## The Bottom Line

With interest rates set to remain low, cash plentiful and investor cautious it is difficult to make the case for a stock market crash in the absence of a black swan event (e.g. sovereign defaults, central bank missteps).

The concern is not so much at the scale of the downside but the lack of a significant catalyst to the upside and the prospects of sub-par financial returns for the next few years.

Indeed this year may be the first in a generation in which all three main asset classes (bonds, equities and real estate) will register annual declines — a synchronised bear market in which cash outperforms.

Most country specialists remain optimistic about China, and they may be right, but with corporate and household debt having doubled since 2008 the risk of a painful adjustment are substantial.

Meanwhile the European and Japanese economies are crawling higher and the Emerging Markets are facing significant challenges — can the US alone save the world?

The crystal ball is clouded but the end game is probably not increasing QE that serves the financially endowed but in an old fashioned Keynesian solution in which fiscal spending creates real jobs.

Regards

Tarek Fadlallah, CFA

Financial Market Trivia: Monday 19th October, 2015 is the 28th anniversary of *Black Monday* when the Dow Jones Industrial Average plunged by 22% in a single day. I was long UK equities in my first trade...!

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