Q2-2016

Update

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Global Economy

The turmoil fueled by UK's vote to leave the European Union (EU) engulfed financial markets in the second quarter and darkened the outlook for the global economy. The decision took investors by surprise and has ushered in a period of further uncertainty for Britain's economic outlook and its political future. The fallout from the Brexit vote caused investors to take refuge in safe haven assets such as government debt, the Japanese Yen and precious metals.

In addition to concerns surrounding the impact of the Brexit vote, a weaker jobs report in the US has severely dented the outlook for interest rates in the nation. Other advanced economies continue to face pressures in sparking price growth. Consumer prices in the Eurozone remained negative before rising slightly in June, while Japan's efforts to spur price growth have proved futile. Among developing economies, especially China, a transition toward a more consumer-driven economy is facing challenges. India has been a bright spot among emerging markets after a faster than estimated pace of expansion in the first quarter of the year.

Looking forward, financial markets are likely to continue to witness volatility in the backdrop of UK's decision to end its EU membership. A number of firms are readying plans to relocate their Britain-based operations to other places, putting a large number of jobs at risk. Moreover, UK's trade flows are also expected to be hit in the short to medium term. While the implications of the 'Leave' vote would be felt majorly on the European side of the Atlantic, the impact of the resulting risk-off sentiment and deferment of investments are likely to be felt in the US as well. Speculations have increased that the US Federal Reserve is unlikely to raise interest rates this year and other central banks could step up easing measures. While concerns about a financial panic similar to the one witnessed during the financial crisis seem farfetched for now, downside risks to the global economy have increased.

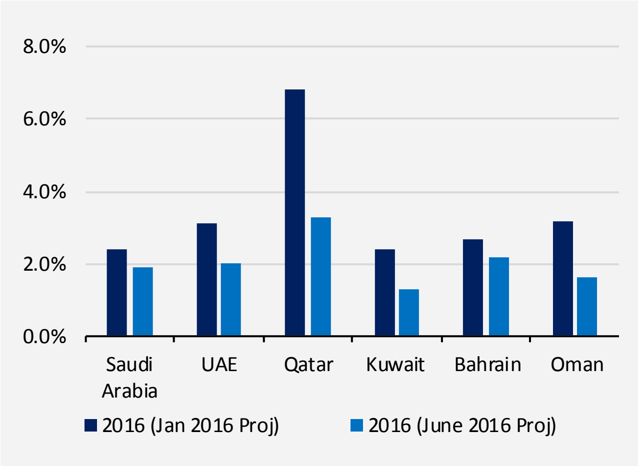
GCC Economy

Since the beginning of the year, the oil-exporting countries of the GCC region have introduced a string of reforms ranging from spending cuts, rationalizing of subsidies, to increasing taxes and fees to weather the shrinking oil revenues. In addition to tightening fiscal policies, most GCC countries are resorting to measures such as privatizations and divestments. The Gulf nations have also expressed their commitment to introduce a number of reforms and implement Value Added Tax by 2018. Saudi Arabia's Vision 2030 and National Transformation Plan (NTP) 2020, a key part of the blueprint to prepare the Kingdom for the post-oil era took center stage during the quarter. The Kingdom also announced the implementation of 2.5% tax on the value of any white land, i.e. undeveloped residential and commercial plots within urban boundaries. Meanwhile, in Kuwait the government increased domestic fuel prices, while Qatar moved to a market linked fuel pricing system.

The other key feature of the quarter under review was the increase in borrowings by Gulf countries. Apart from domestic borrowings, Abu Dhabi, Qatar and Saudi Arabia, have raised a combined USD 24 billion of international debt since late April. The increase in debt levels and lower oil revenues resulted in many rating agencies downgrading their outlook and ratings for several GCC countries. In line with these developments, the average cost of credit-default swaps and domestic borrowing costs in GCC countries have also surged.

We expect low oil prices and tightening fiscal policies to weigh on the economy in the near term, as lower infrastructure and consumer-discretionary spending will impact growth in the private sector. The World Bank, in June this year, lowered its 2016 growth forecast for the GCC nations to 2.0%, the slowest pace since 2009 compared to a 2.9% growth in 2015. Nevertheless, the reforms initiated by the GCC nations are likely to help these economies realign their strategies for lower dependence on hydrocarbons in the long run.

World Bank Lowers Growth Forecasts for GCC Nations

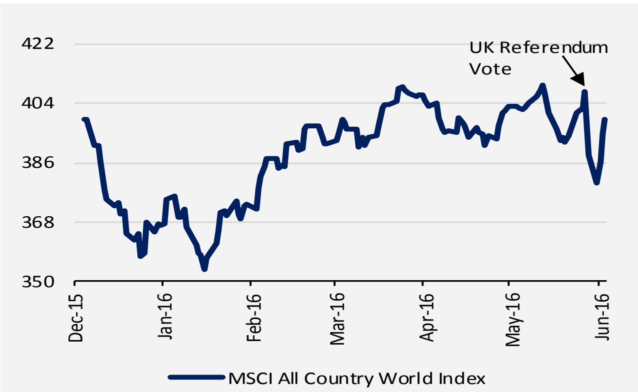


Source: Bloomberg

Equities

Global equity markets staged a notable recovery at the beginning of the second quarter of 2016, amid a recovery in commodity prices, waning fears of a global recession and easing concerns about China's currency devaluation. However, markets failed to hold on to their gains and ended in negative territory before the end of the second quarter, after UK citizens voted in favor of a 'Brexit'. Investors reduced their exposure to riskier assets and flocked to safe haven assets, causing a large outflow of funds from equity markets. In terms of market cap, the MSCI World Index lost approximately USD 1.2 trillion by the end of the second quarter of 2016 from USD 37.5 trillion, the peak level during the quarter. Forward valuations for the MSCI World Index also dropped, with the PE multiple hovering near 16.8x towards the end of Q2 2016, 1.4% lower on an annual basis, but still 0.8% above on a QoQ basis. We expect uncertainty and volatility to rule global stock markets in the second half of the year as investors assess the consequences of the Brexit. However, speculations have increased that major central banks will ease monetary policy in the aftermath of Brexit, which could lend support to equities and riskier assets.

Global Equities Witnessed a Steep Decline Post 'Brexit'



Source: Bloomberg

In the US, the S&P 500 index reversed its earlier gains and finished 2Q16 1.1% lower, following Britain's decision to exit the EU. The Fed is expected to resort to a cautious approach in raising interest rates, considering the developments in Britain and the recent downside surprises in US nonfarm payroll numbers for April and May. However, domestic macroeconomic fundamentals in the nation broadly seem more balanced compared to the other developed countries, which make us believe that US equity markets might be able to retain investors' interest. Meanwhile, delayed expectations of a rate hike in the US resulted in the greenback trading weaker against major counterparts for most of the quarter, until the Brexit vote. In light of the US Dollar's weakness in the first half of the year, profits amongst the S&P 500 companies are also projected to decline at a more moderate rate of 5.1% YoY in 2Q16 compared to the fall of 7.1% YoY in the first quarter of 2016, marking five consecutive quarters of earnings declines in the S&P 500 benchmark.

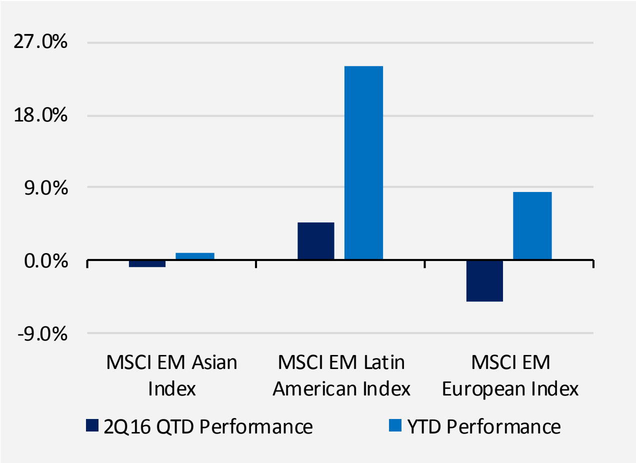
In terms of valuation, the S&P 500 is trading at a one year forward PE multiple of 17.6x, higher than the 10-year historical average of 14.9x. Going forward, we expect market participants in US equity markets to remain on their toes ahead of the US Presidential elections near the end of this year. Moreover, following Britain's referendum, we expect a stronger US dollar and increased volatility to weigh on investor sentiment, while expectations of a delay in an interest rate hike could support equity markets.

Across the Atlantic, European markets reversed early quarter gains after the UK voted to leave the EU, causing the Stoxx 600 index to end the second quarter 3.3% in the red. Key regional indices had received major support earlier during the quarter due to a rally in commodity prices and after Greece reached a milestone deal with its creditors to gain access to finance. However, markets surrendered gains in late June following the Brexit vote.

Meanwhile, on the macroeconomic front, Europe's 1Q16 QoQ GDP grew at its strongest pace since the first quarter of 2011. Domestic consumption and industrial production gauges have also shown signs of improvement recently. Resultantly, the Euro remained firmer against the greenback and a number of other key currencies for most part of the quarter, which is likely to weigh on export earnings of corporates this quarter. Furthermore, a challenged banking segment and headwinds from Britain's exit could dampen earnings in 2Q16, extending the decline in corporate profits for the last five quarters. In terms of valuation, European shares are cheaper than S&P 500, with the Stoxx 600 valued at 15.3x of one year forward earnings, while the S&P 500 is at 17.6x. Reforms to address structural issues would be welcome, particularly considering that over the long term monetary policy might not be sufficient in sustaining growth.

An upward rally in the MSCI Emerging Market (EM) Index lost momentum before the end of the second quarter, as the Brexit vote halted the recovery in EM indices. The MSCI EM index ended 5.1% down for the second quarter of 2016, with all three regional sub-indices registering a decline. Although positives such as delayed expectations of a rate hike in the US and easing concerns about China's economic health kept fund outflows from the EMs in check, weak global risk appetite following Britain's decision to leave the EU weighed on these markets.

European EMs were the Worst Performers in 2Q16



Source: MSCI

In Asia, the Malaysian exchange in particular was a weak performer as an international probe of the state backed investment fund, 1Malaysia Development Bhd, spurred large foreign fund outflows. While a challenging Chinese balancing act between short term stimulus measures and structural reforms continued to spook investors, India's commitment to bring more structural reforms along with signs of improving economic metrics and an above-average monsoon forecast could attract more investors. Among Latin American EM indices, the Mexican exchange plummeted 14.2% for the quarter following sharp weakening of the economic outlook, as lower oil revenues prompted the Mexican government to lower spending.

For the year ahead, EM investors are likely to keep a tab on the timing of a rate hike in the US, repercussions of Brexit and any additional accommodative monetary policy measures in a few other developed economies. We suggest investors to selectively tune their exposure to markets that are more committed to structural reforms and are less dependent on overseas markets for revenues.

GCC bourses finished mixed for the quarter, as investors weighed the impact of the rally in oil prices and rising interest rates on corporate performance. Equity markets in Saudi Arabia, Kuwait, Oman and Abu Dhabi ended in the green, while indices in Qatar, Bahrain and Dubai nudged lower for the quarter. Alongside other global equity markets, the Gulf exchanges witnessed a selloff near the end of the quarter, in the immediate aftermath of the UK.'s secession vote.

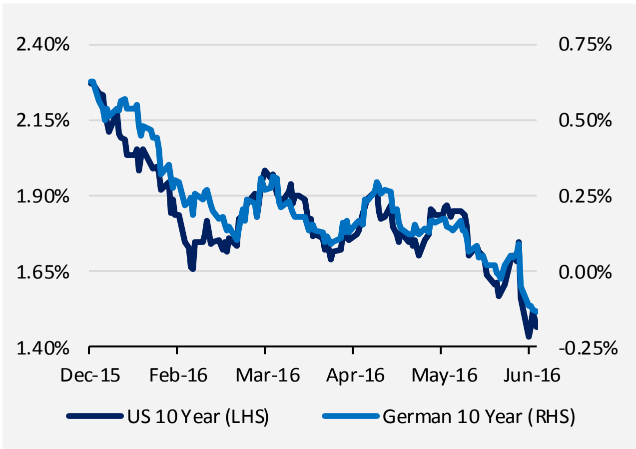
On the earnings front, corporate profits in the GCC continued to decline for another consecutive quarter in 1Q16, amid higher borrowing costs and deterioration in the Gulf region's economic landscape. Hiring pace among corporates continued to slow down, while some companies also downsized the number of employees. The Monster Employment Index, a survey measuring the health of the Middle-Eastern labor market, eased for the third consecutive month to 146 in June from 173 in December 2015. Meanwhile, GCC governments have introduced a number of reforms, including rationalization of subsidies, which might further influence corporate performance and discretionary income of individuals negatively in the short term. However, in the long term the impact will be positive.

In terms of valuations, forward P/E ratios across the GCC markets are hovering above or very close to their long term averages. Moreover, the dividend yields in these markets are considerably higher than the developed market.

Fixed Income

Sovereign bond markets across the globe rallied this quarter, with yields on fixed income securities in advanced economies falling sharply amid a weakening global outlook and anxiety over the UK's EU referendum. The UK's eventual vote to exit the EU bloc accelerated the plunge in yields as investors sought shelter in safer assets. Yields on benchmark US 10-year notes fell to multi-year lows, and German, UK and Japanese bonds also plunged to record levels.

Sovereign Bond Yields Continued to Fall this Quarter

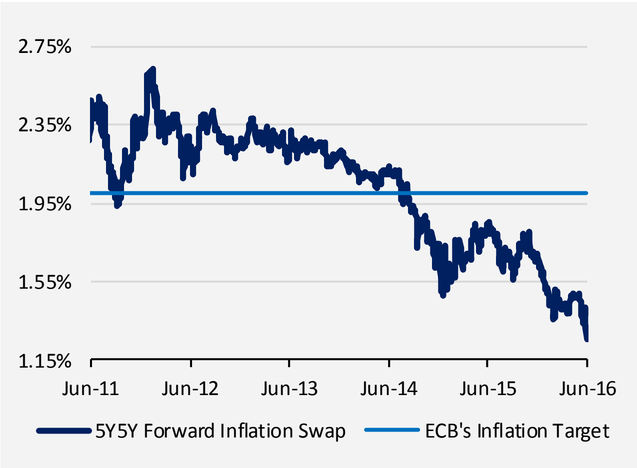


Source: Bloomberg

In addition to the UK's historic decision, US treasuries were also significantly impacted by the Fed's recent tone, with the yield curve shifting noticeably lower compared to the start of the year. Following the disappointing jobs data for May, the central bank held off raising rates as widely expected. However, the details of the Fed statement largely surprised markets as six officials now expect a single rate hike in 2016, compared to one official in March. Moreover, the central bank gave no time frame for increasing rates, a stark contrast compared to its previous stance when it expected higher rates "in the coming months". As a result of the weakness witnessed in labor markets, the odds for a rate cut have gradually gained steam. According to the CME Group's FedWatch tool, federal funds futures are indicating that the US central bank is more likely to cut rates than raise them by December. Coming to our outlook for the Fed's policy path, we believe that the Fed is likely to wait for further clarity on the global macroeconomic picture as well as the US political environment and hold off raising rates until later in the year. Bond yields are expected to remain at subdued levels and will be guided by Fed's tone on policy over the course of the year.

Across the Atlantic, the surge in German bunds has been fueled by central-bank action and Britain's EU referendum, with yields on government 10-year notes slumping into negative territory. Despite a strong start to the ECB's corporate bond purchases in June, the central bank's preferred gauge of inflation expectations, the five-year, forward inflation swap rate slumped to record lows last month and has remained below the ECB's 2% goal for almost two years now. The fallout from the 'Brexit' vote is likely to spur further risk aversion in the short-term and the ECB's expansionary polices are also expected to continue pressuring yields. However, bund yields have already fallen to all-time lows and the rally in German fixed income markets could slow and possibly subside once the implications of UK's vote become clearer over the coming months.

ECB's Preferred Inflation-Outlook Gauge Dropped to Record Lows



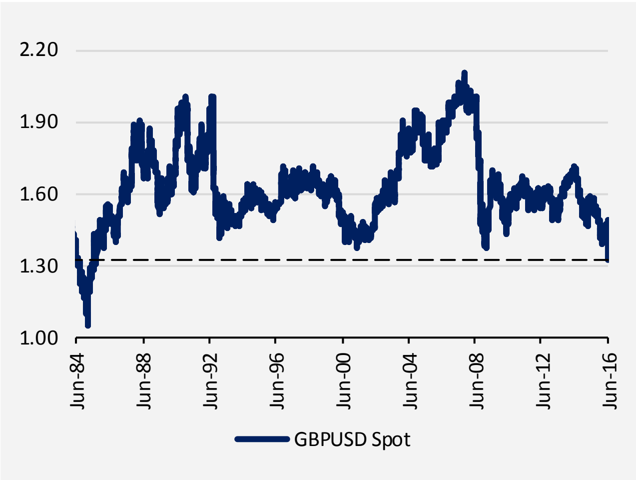
Source: Bloomberg

In contrast to Germany's fixed income markets, peripheral bonds slumped following the UK referendum, with the spread between Spanish and German 10-year notes rising to the highest level since the ECB first commenced its asset purchases last year.

Currencies

Currency markets were among the most volatile asset class following the UK referendum, with the British Pound plunging to the lowest level against the US Dollar since 1985. In addition to substantial economic implications that are expected in the fallout of the vote, repercussions are also being felt in Britain's political landscape, with Prime Minister David Cameron resigning from his position and Scottish leaders pressing for a second vote on independence from the UK. The aftershocks of the vote are expected to continue pressuring the currency, with the UK first needing to trigger Article 50 of the Lisbon Treaty, which would set in a two-year window for formal talks within which the nation would leave the EU. However, the resignation of Mr. Cameron implies that it is likely that Britain won't leave the EU until a new Prime Minister is in office. The post-Brexit confusion in the political space has increased uncertainty, which does not bode well for the Pound. Moreover, it is now expected that the Bank of England would likely be in easing mode to mitigate the impact of the 'Leave' decision. Taking cognizance of the economic and political forces in play, we expect the British Pound to weaken further over the coming months.

Sterling Slumps to a Three-Decade Low After 'Brexit' Vote



Source: Bloomberg

The UK referendum also had a considerable influence on other currencies across the world. The US Dollar encountered increased selling pressure in the run up to the referendum and rebounded sharply in response to the UK's vote to exit the EU, while economic cues from the US were mixed. Overall economic activity in the US appeared to be gaining some momentum in the second quarter following a weak start to 2016, however, payroll additions dropped sharply in May mainly due to the workers strike at Verizon that trimmed payroll additions by at least 35,000. Separately, the domestic unemployment rate fell to the lowest level since 2007 and consumer spending also recorded its biggest increase in more than six years in April. Going forward, better economic prospects in the US and a cautious investor outlook are expected to broadly support the greenback in the coming months.

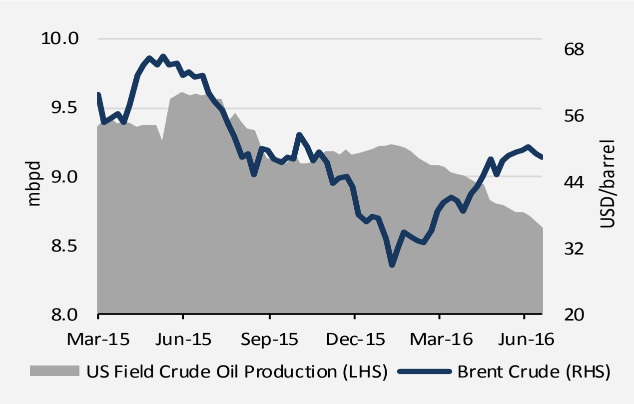
The Euro showed remarkable resistance against the US Dollar this year despite the ECB's negative interest rate policy and increased asset purchases. The Fed's recent dovish stance supported the Euro against the US Dollar. While the ECB has lifted growth and inflation forecasts for the region this year, downside risks for the common currency persist. The negative sentiment from UK's exit is expected to spill over to the Eurozone, potentially affecting overall economic activity. Additionally, price growth in the region continues to remain a challenge, with the ECB Chief Mario Draghi acknowledging that inflation in the region remains "rather subdued". Against this backdrop, the central bank has reiterated the potential for further stimulus in the region that could cap any significant upside in the common currency.

The Japanese Yen has been the best performing developed market currency this year, surging nearly 15% against the US Dollar and briefly strengthening past the 100 mark. Despite the negative interest rate policy adopted by the BoJ, external events namely the UK referendum decision and the Fed's scaling back of rate expectations have fueled gains in the currency. Given the UK's 'Leave' decision and continued inflation worries, the likelihood of the BoJ unleashing further easing measures have increased considerably. On the fiscal front, feeble economic growth has forced the Abe government to postpone a planned sales-tax hike until October 2019 and contemplate a fiscal stimulus package. Against this backdrop, we expect that the Japanese Yen is unlikely to mirror its H1 2016 strength in the latter half of the year. Though near-term shocks could fuel a surge towards Yen safety, we expect the currency to depreciate gradually in the coming months.

Commodities

Commodities extended their advance in the 2Q16, with oil prices ending the first half just under the USD 50/barrel level. Oil prices rose after violence in Nigeria pushed the nation's oil production to near-three decade lows and wildfires in Canada's oil sands field region wiped out nearly 1.5 million barrels of daily crude production. Moreover, US output also witnessed a steady decline, with oil rigs dropping to 341 near the end of Q2 2016 from 516 at the beginning of the year, thereby suggesting that the OPEC's strategy of maintaining output and squeezing high-cost suppliers was bearing fruit. On the opposite side of the spectrum, higher demand from a few emerging economies such as India helped in reducing the demand-supply gap, with IEA estimates indicating a near-equilibrium between demand and supply in global oil markets by 2017.

Falling US Production has Supported Oil Prices



Source: US Energy Information Administration, Bloomberg

At its recent meeting, OPEC decided against introducing a new output ceiling, though members expressed optimism of an improving oil market. However, we remain cautious of the returning Nigerian and Libyan output to the market and demand concerns post the 'Brexit' vote that could cap the uptrend in oil prices. Moreover, oil prices firming up near USD 50/barrel could result in low-cost shale producers to get back into the market, particularly amid early signs of a pick-up in the US oil rig count, which jumped by 11 on a weekly basis to 341 at the close of Q2 2016, registering the sharpest rise in a year.

Gold continued its ascent in 2Q16, with prices closing at a two-year high and well above USD 1,300/ounce in the fallout of the 'Brexit' vote. A cautious Fed outlook has also boosted appetite for the yellow metal which has been among the best performing assets this year. However, consumer demand for gold has been weak. Demand from China and India, the two largest consumers of gold, has declined 12% YoY and 39% YoY, respectively, in 1Q16, with demand in the latter being affected particularly by a jewelers strike in protest against a proposed excise duty. Meanwhile, demand prospects in India are also expected to remain soft, given the elevated gold prices, decline in value of the Indian rupee, and the near absence of the wedding season in the nation until the last quarter of the year. While the UK's vote to exit the EU creates the possibility for further gains in gold prices, we believe that the recent jump implies limited upside potential from current levels.

About Alkhabeer Capital

Alkhabeer Capital is a leading asset management and investment banking firm providing world-class investment products and services that endeavors to help institutions, family groups and qualified investors access to and/or allocate capital in ways that deliver real and enduring economic value.

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The asset management area provides investment opportunities through a large and growing portfolio of public and private funds in the areas of real estate, private equity and capital markets, while the investment banking area offers specialized Sharia compliant capital raising and M&A advisory services to businesses, private investors and families.

Alkhabeer Capital also provides advisory services on structuring Waqf entities and Waqf wealth management through its "Waqf" Program, which targets educational institutes, charitable foundations, family groups, high net worth individuals and other philanthropists who wish to establish Waqf entities.

Alkhabeer Capital has offices in Jeddah and Riyadh.

For more details on Alkhabeer Capital, please visit www.alkhabeer.com