GCC markets at tempting valuations after the crash

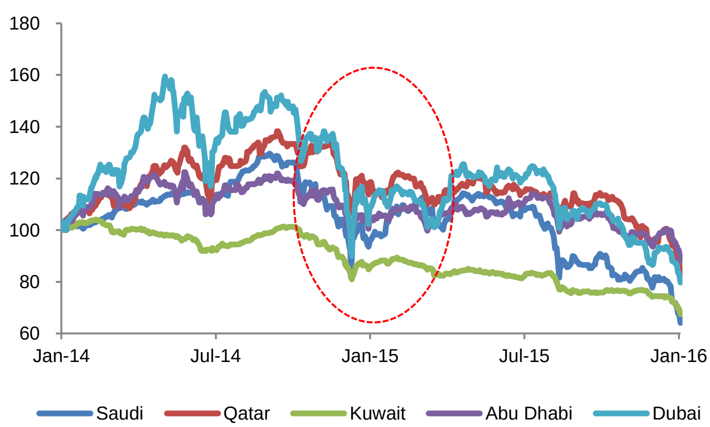
- **Falling oil prices pull the rug out from under the GCC markets**
- **Unlike the past two major market crashes, this time it's all about Oil**
- **Prevailing low oil prices leads to spending cuts/subsidy removal**
- **Crude prices expected to stay at low levels in the near future**
- **GCC Markets trading at multi-year lows; attractive in terms of multiples**

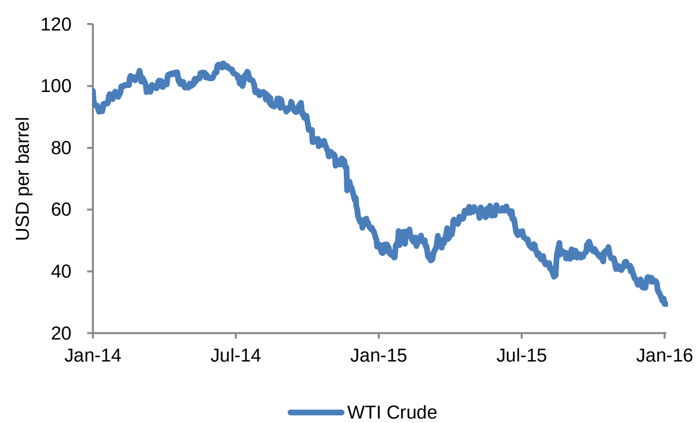
2016 starts on a depressing note

Since the beginning of 2016, GCC markets are experiencing a huge selling pressure due to fall in oil price. Till date, amongst all GCC markets, TASI has been the biggest loser with a 16.9%YTD fall, followed by QSE (-13.8%YTD), DFM (-12.2%YTD), KSE (-10.3%YTD), ADX (-9.7%YTD), MSM30 (-7.9%YTD) and BSE (-3.3%YTD). However, GCC markets experienced a much awaited relief rally yesterday (19th January) as pessimism over China eased. Saudi, Qatar and Dubai all rallied by more than 3.0%.

The Kuwaiti market has reached a low of 5,095 points – back to the 2004 levels. Qatar market witnessed a low of 8,527, somewhere near the index's 2006 levels. Saudi Arabia has touched a low of 5,397 in 2016 and DFM index plunged to a low of 2,641 points – somewhere near 2004 and 2006 levels, respectively. Lifting of Iranian sanctions has put further pressure on oil prices as Iran has already announced its intention to increase its exports by 0.5mn barrels per day. UAE is one of the countries which are set to benefit from lifting of sanctions on Iran due to its trading links. However, it also saw a steep drop of 4.64% on Sunday (18th January) as prospects of sustained low oil prices outweighed any positives from increase in trade related activities.

GCC market relative performance over the past two year vis-a-vis oil price movement





Source: Bloomberg

Markets adjusting to the "new reality"- re-rating across sectors

Unlike 2008, governments across GCC have carried out fiscal reforms to deal with the prevailing low oil prices. The reason is simple i.e. to deal with higher absolute budget spending levels compared to 2008. Oil prices have been driven down by excess supply and competition rather than demand destruction as was the case in 2008. With oil prices expected to stay low for the foreseeable future, markets are pricing in for further measures the governments might take for e.g. complete removal of subsidies in Saudi or imposition of taxation in various forms such as VAT and corporate taxation across all GCC countries. In addition, spending cuts/slowdown has spooked investors. We are witnessing re-rating of all the sectors. However, in the medium-long run, the fiscal reforms will improve the attractiveness of the GCC markets as it will reduce their reliance on oil and related products.

A look at the previous crises

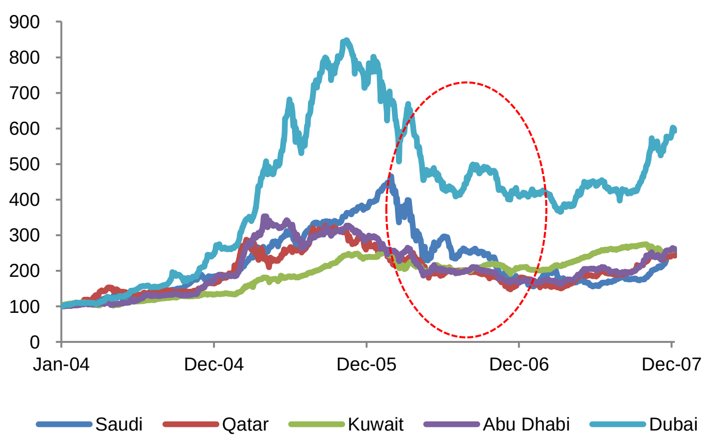
GCC markets witnessed sharp downfalls several times in past ten years. The markets are closely related to the performance of crude oil, which is still the largest revenue contributor to the region. Over the past decade, markets recorded three sharp plunges: in 2006, 2008 and the beginning of 2016. The first two were not directly related to oil; however, over the last year, downfall of the GCC markets has been closely linked with the oil price movement.

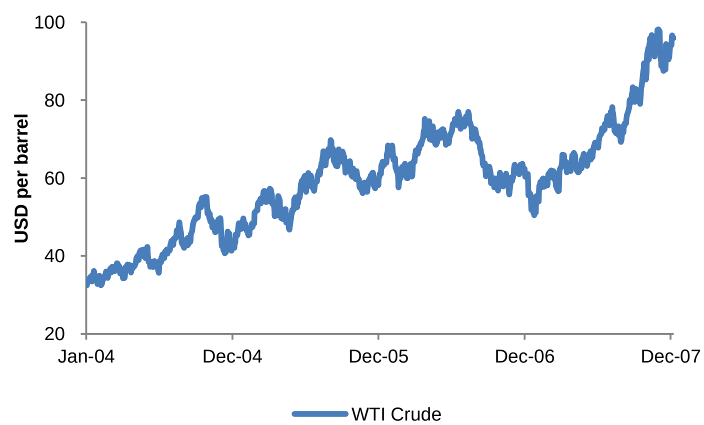
2006 crash

In 2006, GCC markets experienced a sharp collapse as the market ignored fundamentals and traded at unjustified valuations. Saudi Arabia was the major reason for the market crash in 2006. The long-standing dominance of retail investors led to considerable volatility in the Saudi bourse. The market saw a vertiginous run-up over 2003–06. This was due to several factors, but key among them was a huge influx of small first-time traders, attracted by a number of underpriced IPOs. (Under-priced IPOs encourage investors to sell part of their existing holdings to raise capital to invest in new issues, thereby fueling volatility.) Between 2003 and its peak in February 2006, the Saudi index gained 700%, with market capitalization soaring to USD800bn — around two-and-a-half times the nominal GDP. At its peak, the Tadawul was the world's 10th largest stock market by value, despite having just 78 listed stocks, many with a limited free float. During that period, TASI touched 20,967 points, which was the highest till date; however, post crisis, the market touched a low of 4,313 points – almost 1/5th of the index high.

Unsurprisingly, valuations became increasingly stretched; with the average price-to-earnings ratio reaching a high of 47.0x in late February 2006 (the ratio exceeded 100.0x for a number of companies). Expected corporate profit growth began to run ahead of actual results; this was compounded by annual reporting displaying that many companies had invested heavily in the stock exchange and booked unrealized stock market earnings. The correction, when it came, was severe, with the TASI losing half its value in less than three months, ending the year more than 53% below where it began. This pattern was repeated, to varying degrees, across most other GCC states. Abu Dhabi, Qatar and especially Dubai witnessed tremendous surges in stock prices in 2005, before experiencing equally abrupt (and in some cases even steeper) falls.

GCC market relative performance during 2006 crisis vis-a-vis oil price movement





Source: Bloomberg

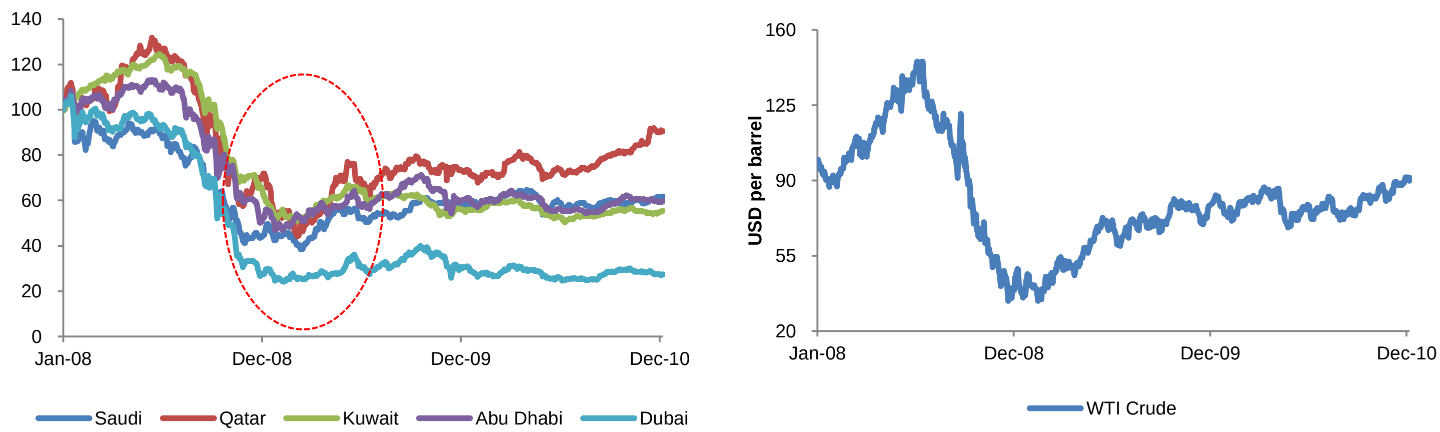
2008 Global financial crisis

2008 Global financial crisis started with sub-prime mortgage crisis in the US and subsequently spread throughout the world. The crisis pushed the world economy into a recession which consequently led to oil demand destruction which in turn led to the collapse of oil prices by more than 50.0%. GCC markets also fell down drastically with the world markets. However, after the Global Financial crisis the GCC countries did not resort to any drastic fiscal reforms due to heavy build-up of reserves and lower budget spending at that time. In addition, oil prices recovered fairly quickly in 2009 and 2010.

UAE experienced a big negative impact due to the crisis. The stock market boom in UAE was fueled by the Real Estate sector. Following the passage of the long-awaited foreign property ownership law in the UAE in March 2006, a deluge of foreign money came in, creating a market for Dubai's unparalleled ambition of creating a skyscraper city, and numerous reclaimed land projects. Property prices skyrocketed since then. In 2007, UAE markets witnessed some setbacks due to a holdup in rising property prices. This was followed by the 2008 sub-prime crisis, when a huge downfall was experienced across major world markets. GCC, due to its dollar-peg, also faced the heat. As Dubai and Abu Dhabi were sitting on huge real estate debt, the markets witnessed a huge crash post the 2008 crisis.

Residential property prices in Dubai, measured by the proprietary property price index of Morgan Stanley, dropped 25% in 4Q08 from the previous quarter. High-end apartments and villas were the worst hit, with prices falling 35% in 4Q08 from their peak in 2Q08. Almost half of all the construction projects in the UAE, worth around AED1.1tn (USD582bn), were either put on hold or cancelled in response to the falling demand and deteriorating market conditions. All GCC markets witnessed similar pressure during 2008 and 2009, when oil too plunged to its lowest level due to the global economic slowdown. In 2008, Dubai witnessed the highest fall (-72.4%YoY), followed by TASI (-56.5%YoY), ADX (-47.5%YoY), KSE (-38.0%YoY) and QSE (-28.1%YoY).

GCC market relative performance during 2008 crisis vis-a-vis oil price movement



Source: Bloomberg

The current crash and its impact

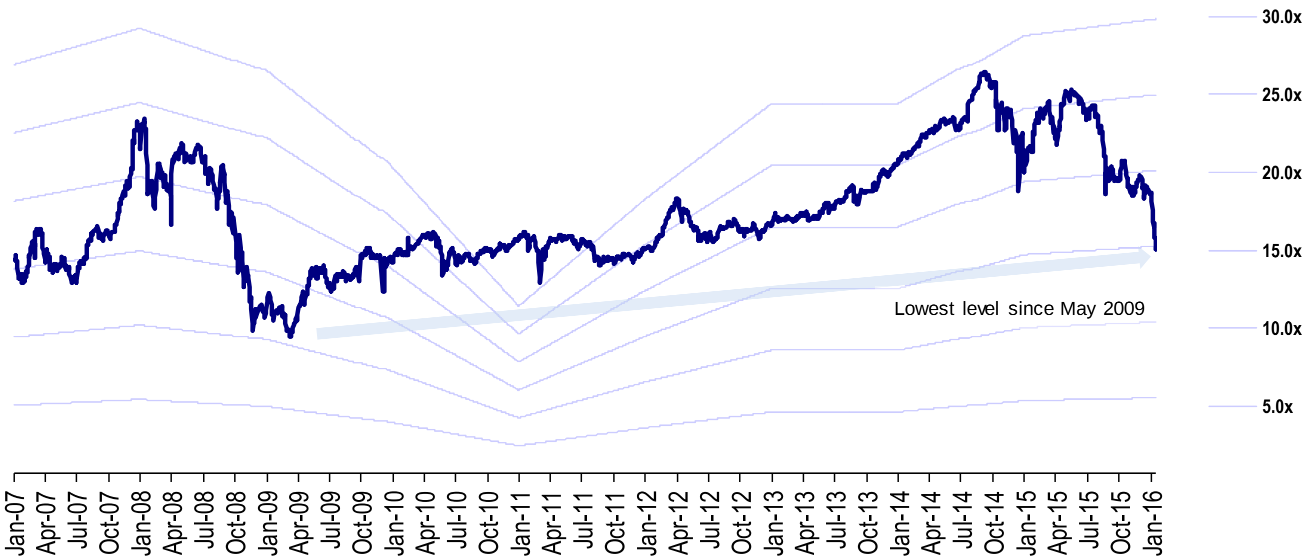
GCC markets were severely affected in 2015 due to a sharp plunge in oil price. Since oil is the key revenue source of most of the GCC nations, a more than 50% drop in oil price disrupted the fiscal balances of the oil-rich GCC players. During the end of the year, Saudi Arabia's decision to maintain oil output to retain market share added to the negative sentiment, and led to another set of declines in crude prices. During December, Qatar and Saudi Arabia published their 2016 budgets, which included spending cuts and a projected fiscal deficit.

Saudi Arabia's decision to cut energy subsidy and increase feed stock prices would negatively impact petrochemical stocks. Furthermore, Qatar and Saudi Arabia took several initiatives to increase their non-oil revenue by raising taxes, fees, retail gasoline prices etc. These measures will impact the disposable income and consumers and hence their spending power.

To finance deficit, the governments issued bonds, created provisions and decided to promote the private sector. Among other GCC countries, Dubai released a zero deficit budget in 2016, as oil accounts for just 6% of the Emirates' total revenue. We expect the overall scenario of the GCC to remain subdued in the near term; however, markets are expected to recover in the longer run once oil price stabilizes and investors jump in for value buying.

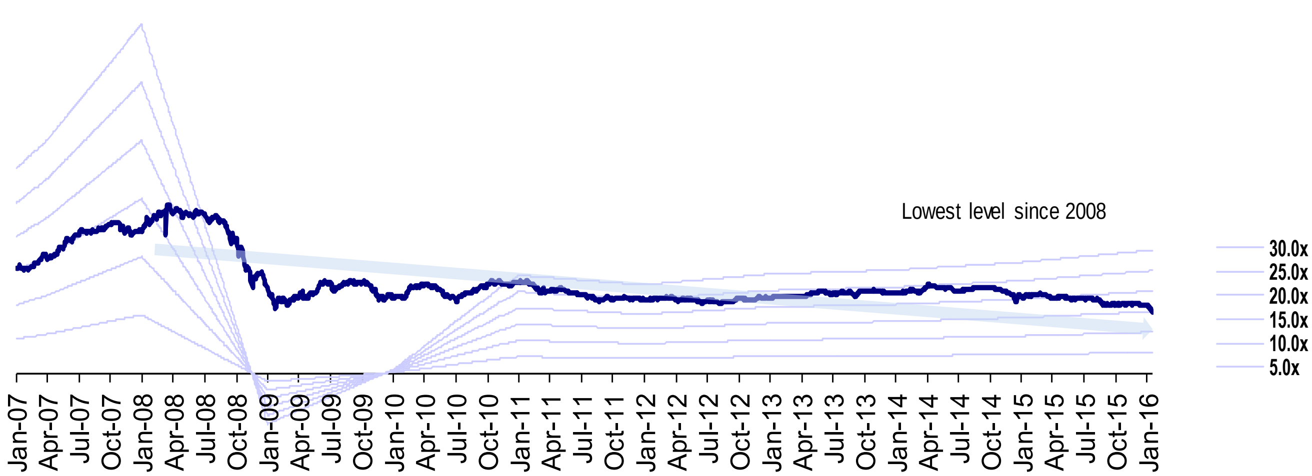
PE Band

Saudi Stock Market (Tadawul)



Source: Bloomberg & Global Research

Kuwait stock market

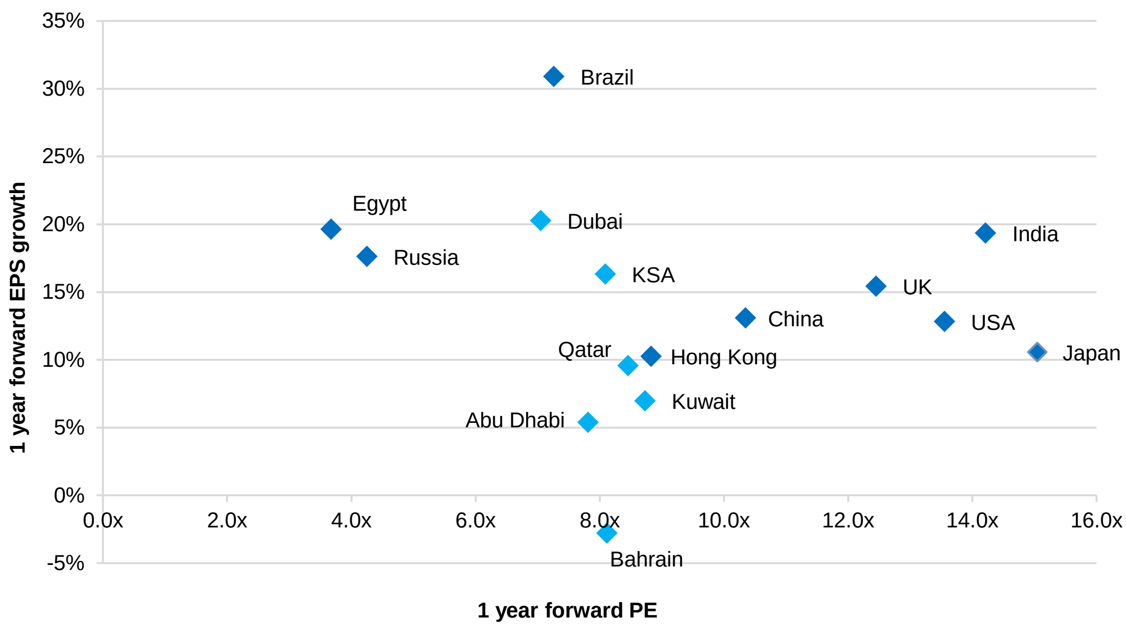


Source: Bloomberg & Global Research

Where are the markets trading now?

The one-year forward PE ratio of GCC markets stands between 7.0-9.7x, lower than that of its emerging market peers, which makes them attractive. In the past GCC markets such as Saudi used to trade at a premium to the emerging markets due to its dollar peg and subsidized energy costs. However, with prevailing low oil prices and removal of subsidies, it's hard to justify any premium going forward.

Comparative positioning of GCC and global markets



Source: Bloomberg

Catalysts

Inclusion in MSCI- Qatar and the UAE are already a part of the MSCI Emerging Markets Index, and Saudi Arabia is likely to be added to the index in 2017. The move will see passive and active money flowing into the Saudi market. Meanwhile, FTSE has upgraded Qatar to a secondary emerging market from a frontier market, which has made it more attractive to investors.

Rebound in oil prices- The consensus is against a quick rebound in oil prices. However if it happens it will provide boost to the sentiments and the markets. After the 2008 crash, oil prices recovered quickly in 2009. The consensus for oil prices was around USD40.0 per barrel at the start of 2009 and the actual prices for the year ended at USD61 per barrel.

4Q15 results – GCC companies have already started reporting their numbers. Better than expected overall results can act as a catalyst. However, positive sentiments will be limited by the fact that the true impact of subsidy cuts and other fiscal reforms will start filtering in from 1Q16. Drop in earnings is therefore more likely.

Reduction in geo-political risk- De-escalation of tensions between regional countries.

China- There has been a raft of bad news coming from China raising concerns over its economic growth and its impact on the world economy. If China starts showing better than expected numbers, it can act as a catalyst for regional markets as it is one of the largest consumers of oil and other commodities.

Oil price outlook

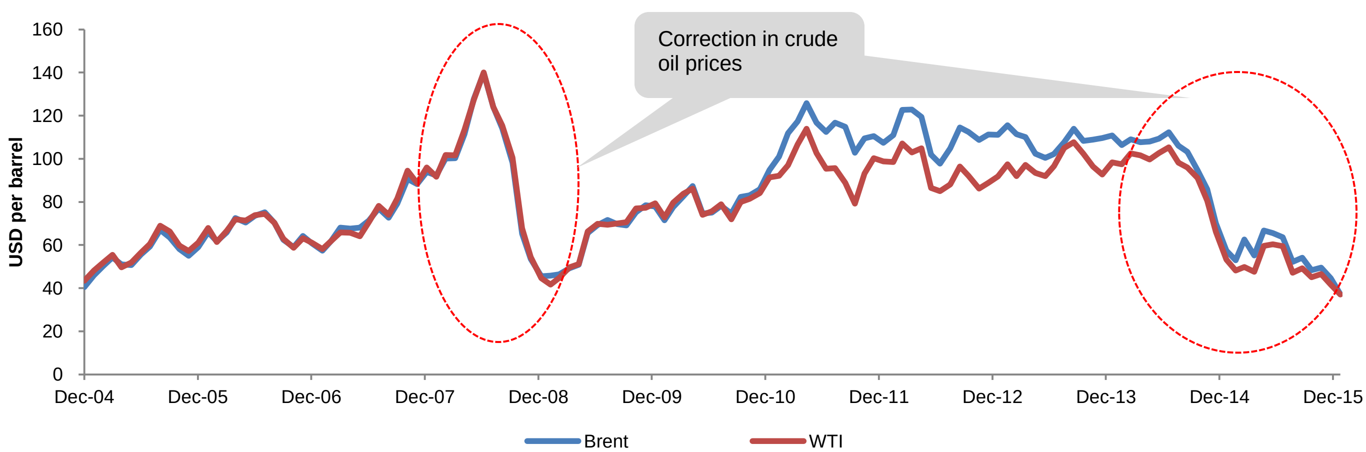
Oil prices expected to remain at low levels in 2016

Crude oil prices are expected to remain low for some time amid continued higher output from Saudi Arabia, strengthening of the dollar and rising output from Iran as the US and EU have lifted economic sanctions against the country. According to analysts, crude oil prices may fall further during the first half of 2016 and recover in the second half of 2016. There has been constant downward revision by analysts on their crude oil price expectations. The forecasts now range from USD30-50 per barrel.

Sustained low oil prices has led to spending cuts

Rising oil price post-2009 boosted the GCC markets' performance and led to building up off a huge fiscal surplus. However, crude oil price started to decline from 2014 when it declined by 45.0% and in 2015 by 16.2%. In 2016, oil price is down 24.0%YTD to below USD30 per barrel. Initially in 2014, the GCC markets were late in reacting to the fall in oil prices. However, the recent crash seems to have priced in low oil price and spending cuts initiated across GCC. Continued decline in oil price prompted GCC countries, particularly Saudi Arabia to introduce major spending cuts in their budget along with removal of subsidies.

Crude oil price movement over a decade



Source: Bloomberg

Salient points from IMF January 2016 WEO update

- Global activity expected to be more gradual than expected in the previous update in October 2015 WEO especially in developing markets and developing economies. 2016 World GDP growth revised down to 3.4% compared to 3.6% in the October 2015 WEO.

- Slowdown and rebalancing of the Chinese economy, lower commodity prices, and strains in some large emerging market economies will continue to weigh on growth prospects in 2016-17.

- Improvement in growth rates expected in countries currently in economic distress, notably Brazil, Russia, and some countries in the Middle East.

- Growth in emerging market and developing economies is projected to increase from 4.0% in 2015, the lowest since the 2008–09 financial crises, to 4.3% and 4.7% percent in 2016 and 2017, respectively.

- Growth in Saudi economy revised down by 1.0% to 1.2% for 2016. The GDP growth for 2015e is 3.4%.

Global Investment House
Website: www.globalinv.net
Global Tower
Sharq, Al-Shuhada Str.
Tel. + (965) 2 295 1000
Fax. + (965) 2 295 1005
P.O. Box: 28807 Safat, 13149 Kuwait

Research
Naveed Ahmed, CFA
(965) 2295-1280
nahmed@global.com.kw

Wealth Management
Rasha Al-Qenaei
(965) 2295-1380
alqenaei@global.com.kw

Global Kuwait
Tel: (965) 2 295 1000
Fax: (965) 2 295 1005
P.O.Box 28807 Safat, 13149 Kuwait

Global Bahrain
Tel: (973) 17 210011
Fax: (973) 17 210222
P.O.Box 855 Manama, Bahrain

Global UAE
Tel: (971) 4 4477066
Fax: (971) 4 4477067
P.O.Box 121227 Dubai, UAE

Global Egypt
Tel: (202) 24189705/06
Fax: (202) 22905972
24 Cleopatra St., Masr El Gedida, Cairo

Global Saudi Arabia
Tel: (966) 1 2994100
Fax: (966) 1 2994199
P.O. Box 66930 Riyadh 11586, Kingdom of Saudi Arabia

Global Jordan
Tel: (962) 6 5005060
Fax: (962) 6 5005066
P.O.Box 3268 Amman 11180, Jordan

Global Wealth Manager
E-mail: contactus@global.com.kw
Tel: (965) 1-804-242

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