INVESTMENT MANAGEMENT

Morgan Stanley

COMMENTARY

Morgan Stanley Saudi Equity Fund

September 2018

Launch Date:
January 6, 2009

Portfolio Management:
Najmul Hasnain, CFA

Location:
Riyadh, Saudi Arabia

Base Currency:
Saudi Riyal (SAR)

Benchmark:
Tadawul All Share Index "TASI". Free float adjusted all share Index

PERFORMANCE REVIEW

During the last 12 months, the Fund returned 19.4% (net of fees), while the benchmark (TASI) rose by 9.8%. Since inception (6 January 2009), the Fund has returned 269.1%, outperforming TASI by 217.9% (cumulative), net of all fees and expenses.

MARKET REVIEW

The JP Morgan Global Composite PMI declined to 52.8 in September compared to 53.4 in August (the lowest reading over the last 12 months). The manufacturing PMI was slightly higher, but the services sector was weaker month-on-month (similar to the previous month's trend).

The IHS Markit U.S. Composite PMI declined month-over-month. The IHS Markit U.S. Composite PMI came in at 53.9 in September versus 54.7 in August. The services sector PMI fell to 53.5 in September compared to 54.8 in August, while the manufacturing index rose month-over-month. In September, total non-farm payrolls registered an increase of 134,000, which was below the market expectation of 185,000. The unemployment rate, though, declined to 3.7%, the lowest rate since 1969. Average hourly earnings rose at an annualized rate of 2.8%, in line with expectations.

The pace of economic activity in the euro area was marginally lower versus the previous month. The IHS Markit Eurozone Composite PMI stood at 54.1 in September versus 54.5 in August. Among the eurozone's largest economies, output growth declined in Germany and France, while Italy showed a sequential increase.

The Caixin China General Composite PMI improved slightly to 52.1 in September, recovering from a five-month low of 52.0 in August. The Services PMI increased to 53.1 compared to 51.5 in August, while manufacturing fell marginally to 50.0 in September compared to 50.6 in August.

U.S. economic conditions remain strong and that has provided further confidence that the U.S. Federal Reserve (Fed) will continue to increase interest rates. As mostly expected, the Fed increased interest rates in September. Many analysts expect one more interest rate increase in 2018 (December). However, global trade tensions and Chinese tariffs were a cause of concern, which may alter these expectations.

Geopolitical risks and trade war fears continued to dominate the business news flow. Emerging markets came under pressure due to rising U.S. interest rates, economic slowdown in China and the impact of trade war.

PORTFOLIO ACTIVITY AND PERFORMANCE ATTRIBUTION

During the latest quarter, we increased exposure to the hotels, restaurants & leisure sector in specific names which we believe offered compelling valuation. We also increased our exposure to the banking sector on continued improvement in interest rates, which remains positive for the sectors margins. On the other hand, we reduced the overweight to the health care sector on margin deterioration and relatively weaker demand growth. We also reduced exposure to the oil, gas and consumables sector on valuations that look full.

STRATEGY AND OUTLOOK

For the Saudi market, after a weak August, September has started to show some signs of stability. Earlier, a host of factors were attributed to the market decline including weakness in emerging markets, some local political noise and summer doldrums.

In terms of earnings expectations for the third quarter of 2018, the banking sector may show high single-digit growth. On the other hand, petrochemical sector earnings in aggregate are expected to register a quarter-over-quarter decline due to lower product margins. We are expecting a mixed set of results from retail/consumer stocks.

Oil prices continued to strengthen. On the oil front, all eyes are on the implementation of the new U.S. sanctions on Iran and the impact on supply. The U.S. administration is looking to have Iranian oil exports down to 'zero' from the current export at ~3 million barrels per day (bpd). Various estimates put ~1 million bpd of decline in Iranian exports, and this may increase as the oil sanctions come into full force by 4 November. Saudi Arabia has offered to fill the gap if the Iran oil exports decline.

Saudi Arabia's Non-Oil Private Sector PMI declined to a four-month low of 53.4 in September compared to 55.1 in August. Output, new orders and employment registered slower growth.

Other key local economic indicators have been fluctuating. Inflation has remained relatively subdued, consumer spending was up (based on point-of-sale/ATM withdrawal data) and, with increasing oil prices, government finances and the budget deficit are in a much better position.

The government's drive to increase employment among locals is continuing. The government identified several new sectors that would be required under the new regulations to employ a higher proportion of Saudis. The impact on the businesses, especially smaller companies, will be negative as operating costs would rise. News flow around announced government projects remains positive. However, most of these projects are still in the planning or very early implementation stages. On the ground impact is expected over the next two to three years.

We are overweight to the banking and petrochemical sectors. In the petrochemicals sector, due to rising oil prices and better plant operations, we expect improvement in earnings. Near term, we believe petrochemical sector profitability would be under some pressure due to a decline in margins. For 2018, the overall retail sector outlook is weak due to a decline in consumer spending and an increase in operating costs. However, industry consolidation is helping the larger/organized retailer at the cost of smaller operators. Hospital sector earnings are facing headwinds in the short term, but we are positive on the longer-term prospects.

For further information, please contact your Morgan Stanley representative.

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