Equities off to a flying start in 2019

GCC markets gear up for additional foreign inflows

February 2019

Research Highlights
GCC Economic and Market Commentary for Jan, 2019

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GCC equity markets greeted its investors in celebratory fashion, recording its highest monthly gains in over two years. Investor sentiment was bullish, as the influx of foreign funds, uptick in oil prices and expansionary budget policies are all expected to support corporate earnings growth in 2019. The story was no different in the global markets, as equities continued to be the flavour of the month among investors. The U.S. and Emerging Markets witnessed a reversal in fortunes, putting the misery of 2018 behind them. A recovery in oil prices was also underway, as U.S and China take steps to resolve the trade dispute while Saudi Arabia affirms its commitment to avoid a supply glut.

We see the following three issues as key developments during the month of January:

1. **GCC State Budgets 2019 – Still in expansionary mode:** Indications from GCC countries largely seem to suggest that they are gearing up for another year characterized by spending to revive economic growth. Development of non-oil sectors continues to be the common theme among GCC budgets, as GCC economies remain upbeat regarding revenue inflows, with oil prices projected to increase in 2019.

2. **Saudi Arabia's debt outperforms peers – What to expect from GCC fixed income markets in 2019:** GCC fixed income markets were handed a boost when J.P. Morgan announced that they would be including GCC countries into their Emerging Market Bond Index. Post-announcement, Saudi Arabia's sovereign debt outperformed similarly rated instruments from other countries. Despite these developments, we expect issuances in the GCC region to fall considering the limited upside potential in the environment of increasing rates.

3. **Why Index inclusion is not a cure all solution for the GCC:** In the wake of index inclusion announcements pertaining to GCC markets, foreign inflows have seen a sharp uptick in recent months. With the impending inclusion of Saudi Arabia into MSCI EM index and GCC countries into J.P Morgan's emerging market bond index expected to take place during the year, GCC countries are well poised to see a huge influx of foreign funds. While undoubtedly being a positive sign, GCC countries must not be carried away by the passive inflows and focus on pursuing further reforms to ensure the sustenance of foreign capital and development of the economy.

GCC Market Commentary

GCC Market Trends – Jan 2019

	M. Cap (USD Bn)	Last close	2018 %	Jan'19 %	YTD %	S&P correlation**	ADVT* (USD mn)	P/E TTM	P/B TTM	Div. Yield
S&P GCC	893.6	114	8.4	6.8	6.8	0.093	N.A	14.75	1.97	3.40
KSA	540.1	8,560	8.3	9.4	9.4	0.029	826.68	16.25	1.90	3.63
Qatar	143.0	10,720	20.8	4.1	4.1	0.081	56.26	14.83	1.46	3.91
Abu Dhabi	137.7	5,045	11.7	2.6	2.6	0.070	37.82	12.53	1.32	5.17
Kuwait	97.1	5,795	7.8	2.5	2.5	0.028	91.63	15.68	1.28	3.55
Dubai	70.0	2,568	-24.9	1.5	1.5	0.076	31.90	7.08	0.87	5.88
Bahrain	22.2	1,391	0.4	4.0	4.0	0.054	3.99	8.93	0.82	5.48
Oman	12.9	4,166	-15.2	-3.6	-3.6	-0.016	4.39	8.91	0.79	6.96

Source: Reuters, Zawya, Note: * Average Daily Value Traded ** - 3-year daily return correlation with S&P 500 index

The S&P GCC composite index, a comprehensive benchmark that covers stocks from all GCC countries, recorded its best start to a year in recent times. The index gained 6.8% for the month, boosted by the strength in Saudi stocks. Saudi Arabia led the list of gainers, rising up by 9.4% in January. Qatar, Bahrain, Abu Dhabi and Kuwait also ended the month positively, gaining 4.1%, 4.0%, 2.6% and 2.5% respectively. Dubai market, which was the biggest loser of 2018, witnessed a rise of 1.5%. Oman was the only drag on the index, losing -3.6% for the month.

Monthly returns heat-map of S&P GCC Composite index

S&P GCC	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2014	3.4%	3.7%	2.7%	2.8%	3.2%	-7.4%	8.1%	6.4%	-1.4%	-6.8%	-10.9%	-4.4%
2015	2.8%	4.4%	-6.9%	10.1%	-2.3%	-3.5%	0.1%	-13.2%	-1.1%	-2.7%	-2.3%	-2.4%
2016	-10.7%	3.7%	1.9%	5.7%	-5.1%	1.1%	-0.1%	-1.2%	-3.9%	2.2%	7.9%	4.2%
2017	1.6%	-0.8%	-1.5%	-0.4%	-1.4%	3.2%	-0.4%	0.9%	-0.6%	-2.7%	-1.5%	3.4%
2018	5.3%	-2.5%	3.4%	2.9%	-0.4%	1.1%	2.2%	-2.5%	0.2%	0.1%	-2.0%	0.7%
2019	6.8%											

Source: Reuters

Kuwait's market was off to a strong start in 2019, after disappointing in the fourth quarter of last year. The index performance was led by banking stocks, which were boosted by the decision to lift the foreign ownership cap of 49% on domestic banks. National Bank of Kuwait and Boubyan Bank gained 4.1% and 3.4% respectively for the month. In January, Kuwait Financial House tabled a merger offer to Ahli United Bank that presents a 17% premium on AUB's share price. Ahli United Bank subsequently accepted the offer and the final decision is now subject to the completion of due diligence and regulatory approvals. Predictably, the news invoked mixed response from shareholders of both banks. Shares of Ahli United Bank soared by 13.7% for the month while Kuwait Financial House witnessed its share price go down by 0.5% in the same period.

Saudi Arabia outperformed both the GCC markets and the Emerging market index during the month of January. Rise of Saudi Arabia's index was led by the rally in large cap stocks that are expected to be part of the MSCI EM benchmarks after the inclusion of Saudi Arabia into the EM indices. Rebound in oil prices, inflow of foreign funds and the increase in capital expenditure projected in the budget were all positive triggers that helped the country's equity markets. Qatar was the next best performer, extending its positive performance of 2018 into the New Year.

Among Blue Chips, Ezdan Holdings, Al-Rajhi Bank and Samba Financial Group were the top gainers, rising by 20.4%, 15.7%, and 15.6% respectively for the month. Samba, Saudi Arabia's third largest bank by total assets, witnessed an uptick in prices after reporting a rise in yearly earnings. Al-Rajhi Bank's prices also went up as Malaysia's Central Bank gave the nod for Malaysian Industrial Development Finance (MIDF), a state-backed Malaysian lender, to conduct negotiations with Al Rajhi Bank over a potential merger deal.

Global Market Commentary

Global Market Trends – January 2019

Equity	Last close	MTD%	YTD%
S&P GCC	114	6.8	6.8
MSCI World	2,028	7.7	7.7
S&P 500	2,704	7.9	7.9
MSCI EM	1,050	8.7	8.7
MSCI FM	944	4.3	4.3
Commodities			
IPE Brent	62	15.0	15.0
Gold	1,321	2.9	2.9

Source: Reuters

Global equities were off to a flying start in 2019, with several major markets gaining sharply. The month started on a positive note for the U.S. markets, before weak earnings of selected blue chip stocks partially erased the gains in due course of the month. Federal Reserve Chairman Jerome Powell brought cheer to the markets after stating that the Fed will be flexible in its plan of hiking interest rates. The softening stand from the Federal Reserve was perceived positively by the markets. After the announcement, the Dow soared by 3.3% on Jan 4, its fourth biggest single-day rally of all time. The S&P 500 index gained 7.9% for the month while the MSCI World Index gained 7.7% during the same period. Europe showed signs of volatility throughout the month, as the markets keenly observe the developments surrounding the Brexit deal. European markets received a lift after Theresa May's Brexit deal was rejected by the Parliament. Germany's DAX index gained 5.8% during the month while UK's FTSE index closed with gains of 3.6%. Asian Markets remained mixed as China and Japan outperformed India. India's SENSEX closed with modest gains of 0.6% in January, as concerns over general election weighed on investor sentiment. The MSCI EM index witnessed a sharp rebound, gaining 8.7% in January after shedding nearly 17% in 2018.

Oil markets witnessed a sharp rebound after a subdued close to 2018. Oil prices rose by 15.0% during the month, snapping a three-month losing streak. Volatility in the oil markets refuse to die down as production cut announcements, concerns over demand and fresh sanctions caused the prices to fluctuate. Saudi Arabia's commitment to production cuts supported the oil price while China's slowdown in manufacturing sector acted as a minor drag in January. Oil prices surged further towards the close of the month, reacting to the U.S. sanctions on Venezuela's crude exports.

We see the following three issues as key developments during the month of January:

1. GCC State Budgets 2019 – Still in expansionary mode

The year 2018 was positive for GCC economies, as the rise in oil prices during the first three quarters of the year eased the strain off their fiscal and current accounts. It was earlier anticipated that the risk of rising interest rates and the mismatch between growth cycles of the U.S. and the GCC countries would affect the economies and result in a slowdown. However, the uptick in oil prices allowed GCC countries to pursue capital expenditures without losing control over their deficits. Some of the GCC countries witnessed a drop in external borrowings in 2018 compared to the previous year, as the increase in oil revenues reduced their need to proceed with further sovereign issuances.

In the wake of these positive developments, indications have been clear that GCC countries are willing to pursue with further spending to support economic development. Budget statements revealed by Saudi Arabia, Kuwait and Oman show that they forecast a budget deficit for 2019.

Summary of 2019 GCC State Budgets

Country		Oil & Gas Revenues (USD Bn)	Other Revenues (USD Bn)	Current Exp. (USD Bn)	Capital Exp. (USD Bn)	2019f Nominal GDP (USD Bn)	2019 Oil Price Assumption (USD/bbl.)	2019 Projected surplus/deficit (USD Bn)	2019 Projected surplus/deficit (% of GDP)
Saudi Arabia	2019 Budget	178.74	84.51	232.20	66.42				
	2018 Budget	163.89	47.52	208.71	55.35	795.6	-	-34.9	-4.4%
	% change	9%	78%	11%	20%				
Kuwait	2019 Budget	48.14	6.18	62.00	12.70				
	2018 Budget	44.21	5.88	60.50	10.88	152.4	55	-25.2	-16.5%
	% change	9%	5%	2%	17%				
Qatar	2019 Budget	56.97		32.67	25.25				
	2018 Budget	47.28		31.00	26.30	204.3	55	1.2	0.6%
	% change	20%		5%	-4%				
Oman	2019 Budget	19.43	6.93	30.21	3.46				
	2018 Budget	17.70	7.10	29.06	3.56	86.5	58	-7.3	-8.4%
	% change	10%	-2%	4%	-3%				

Source: Marmore Research, Respective Budget statements, GDP data - IMF

Saudi Arabia has proposed an expansionary budget for the second year in succession, characterized by heavy spending that focuses on reviving the economy and improving the unemployment situation of nationals. Despite the expected pickup in capital expenditure, majority of the expenses are focused towards reforms and welfare schemes targeted towards nationals. This primarily boils down to fixing the issue of high unemployment among Saudi citizens, which peaked at 12.9% in 2018. The government also proposed to continue its public assistance program that provides monthly payments to low and middle-income families to help soften the impact of taxes and subsidy cuts on nationals. The total expense of this program in 2018 is estimated to be between USD 8.5-13 billion. The budget deficit of USD 35 billion is expected to be plugged through external borrowing and drawing down of reserves.

Kuwait's state budget involved a greater deficit, which amounted to 16.5% of its GDP. Kuwait has now posted deficit in each of the past four years ever since the oil prices began to slide in mid-2014. This is in contrast to budget surpluses recorded for 16 successive years prior to that. The major uptick when compared to the previous year was in capital expenditure, which increased by 17% compared to 2018. As with the case of Saudi Arabia, current expenditure formed a large portion in the expense side, where wages and salaries alone amounted to 71% of the total expenditure. Out of the total revenue generated, 10% or KD 1.6 billion (USD 5.3 billion) of the revenues will be transferred to Kuwait's sovereign wealth fund. The budget deficit is expected to be around KD 7.7 billion (USD 25.4 billion) following the allocations for 'Future Generations Fund' (FGF).

Oman's budget for 2019 was along similar lines to that of that of the previous year, focusing primarily on economic diversification. The budget aims to achieve revenue diversification through government expenditure while keeping the deficits at a manageable level. The proposed introduction of new taxes, outsourcing government services to private sector, investment programs are some of the steps that are expected to boost job creation and economic development. The budget deficit is projected at 8.4% of the GDP, and is expected to be funded through foreign borrowing (72%), local borrowing (14%) and drawing down of reserves (14%).

Qatar's budget for 2019 factored a sharp rise in revenues when compared to previous year's budget. The 20% increase in revenues was attributed to the higher oil price assumption, which stands at USD 55/bbl. in 2019, higher than the USD 45/bbl. assumption in 2018. With major projects related to the 2022 World cup being close to completion, the country expects capital expenditure to reduce mildly by 4%. The government also stated that it does not expect to implement VAT in 2019, as it would increase the cost of living for its citizens. As a result, Qatar is expected to post a budget surplus of 0.6% of its GDP in 2019.

2. Saudi Arabia's debt outperforms peers – What to expect from GCC fixed income markets in 2019

Saudi Arabia's sovereign debt outperformed similarly rated instruments from other countries after J.P. Morgan announced their decision to include Saudi Arabia and four other countries into their emerging market bond index. Geopolitical concerns and the sharp decline in oil prices weighed down on Saudi's fixed income markets in the fourth quarter of 2018, as the option-adjusted spreads of Saudi Arabia's 10-year sovereign bonds that were due in 2026 widened by 53 basis points since early October until the end of the year. In comparison, similarly rated Chile's bonds rose only by 39 basis points.[1] However, investor confidence returned in 2019 after J.P Morgan's announcement and the stabilization of oil prices. Yield to maturity of Saudi Arabia's 10-year issuance is higher than similar issuances made by Chile and Israel.

Performance of 10 Year sovereign bonds

Country	Long-term Foreign Currency rating (Moody's)	Issue Date	Maturity Date	YTM
Saudi Arabia	A-	26/10/2016	26/10/2026	**4.00**
Chile	A-	21/01/2016	21/01/2026	3.45
Israel	A-	01/01/2016	01/01/2026	3.66

Source: Reuters

Saudi Arabia tapped the debt markets in January, issuing international bonds worth USD 7.5 billion, raising the tally of their U.S. Dollar denominated issuances to USD 60 billion since 2016. According to their budget statement for 2019, the country's public debt stood at USD 149 billion in 2018 and is forecasted to USD 181 billion in 2019, meaning that Saudi Arabia could issue bonds worth USD 32 billion this year to finance their deficit. Saudi Arabia's finance minister also hinted that they might consider issuing bonds in foreign currencies other than the U.S. Dollar.

J.P. Morgan's emerging market fixed income indices are widely tracked by several institutional investors across the globe. Therefore, any alterations in the benchmark constituents and weightages could result in sizeable change in fund flows within, into and out of emerging markets. Kuwait, Saudi Arabia, UAE, Bahrain and Qatar will join Oman, which was already part of the index. The five GCC countries will have a weightage of 0.8%, 3.1%, 2.6%, 2.1% and 2.6% respectively, taking their combined tally to 11.2%. They are expected to bring huge passive inflows of between USD 30 billion and USD 60 billion. The process of inclusion is expected to begin from Jan 31 and conclude by Sep 30 of 2019.

Overall issuances in the GCC region is expected to go down in 2019 due to concerns over rising interest rates and market volatility. With the issues pertaining to trade war and two more interest rate hikes still lingering, the cost of raising capital for issuers in expected to increase. Therefore, corporates might turn to bank loans as against corporate issuances. Considering the limited upside potential in the environment of increasing rates, global fixed income investors are anticipated to reduce credit risk and shift to developed market issues in 2019.

[1] Bloomberg

3. Why Index inclusion is not a cure all solution for the GCC

A gradual shift from active investing to passive investing has been playing out in the last decade. In Asia, the share of assets in passive equity funds has risen from a meagre 16% in 2007 to nearly 48% in 2018. The case has been similar in other markets across the world. The market for index or passive funds has grown to an extent that they have found a prominent role in shaping investment strategies worldwide. As the affinity of investors grows towards passive funds, it becomes imperative for markets to associate themselves to globally tracked indices that have assets worth trillions of U.S. dollars tracking them.

In the wake of index inclusion announcements for GCC markets, foreign fund inflows into the GCC has seen a sharp uptick. The inclusion of five GCC countries (ex. Oman, which was already part of the index) into the JPM EMBI indices alone is expected to bring in cumulative inflows of close to USD 30-60 billion into the GCC region. These index inclusions did not happen overnight. It involved a systematic approach to rectify shortcomings and develop the domestic capital markets. Without disputing the fact that it is a step in the right direction, the index inclusion cannot be deemed as a cure all solution for GCC markets.

Overview of GCC countries in global indices

Country	MSCI	FTSE	S&P	JPM EMBIGD
UAE	Added to the MSCI EM Index in 2014	Weightage in Index - 1.0% No. of companies in index - 20	Weightage in Index - 0.8% No. of companies in index - 24	Included in 2018 review with a weightage of 2.6%
Saudi Arabia	Will be included into MSCI EM from May 2019 with an expected weightage of 2.6%*	Will be included into FTSE EM from March 2019 with an expected weightage of 2.7%	S&P has a standalone index that captures 80% of KSA's local Mcap.	Included in 2018 review with a weightage of 3.1%
Kuwait	Has 23% weightage in MSCI FM Index. Part of market reclassification watch list for 2019	Weightage in Index - 0.6% No. of companies in index - 7	Will be included into Emerging Market indices from Sep 2019. Currently has a weightage of 16.9% in Frontier BMI index with 36 companies.	Included in 2018 review with a weightage of 0.8%
Qatar	Added to the MSCI EM Index in 2014	Weightage in Index - 1.3% No. of companies in index - 18	Weightage in Index - 1.2% No. of companies in index - 22	Included in 2018 review with a weightage of 2.6%
Bahrain	Part of the MSCI Frontier Market Index	Classified as Frontier Market but is not part of the FTSE Frontier Index Series	Weightage in Index - 3.4% No. of companies in index - 14	Included in 2018 review with a weightage of 2.1%
Oman	Part of the MSCI Frontier Market Index	Weightage in Index - 3.7% No. of companies in index - 17	Weightage in Index - 2.5% No. of companies in index - 16	Already part of the index with a weightage of 2.7%

Source: MSCI, FTSE, S&P and JPM; Note * - Saudi Arabia is currently a standalone index in the MSCI, ** - EMBIGD – Emerging Bond Index Global Diversified

Legends: Emerging Market Frontier Market Standalone Index

Market liquidity has been one of the major pain points for the regional markets. The influx of foreign funds through index inclusions would undoubtedly help in this regard. Kuwait has been witnessing a steady inflow of foreign capital into its market owing to its inclusion in FTSE EM index and the potential inclusion of MSCI EM index. Saudi Arabia has witnessed a similar trend, barring the period when investors had concerns due to various ongoing geopolitical issues. However, this trend cannot be sustained without broader improvements. Taking cue from their neighbours UAE and Qatar, the benefits of the inclusion could be short-lived. Liquidity conditions received a temporary boost during 2014, when MSCI upgraded both Qatar and the UAE to emerging markets. However, the situation was back to square one, a few years later.

Turnover ratio of UAE and Qatar equity indices

Year	UAE	Qatar
2011	16%	18%
2012	19%	12%
2013	38%	13%
2014	75%	29%
2015	25%	13%
2016	23%	9%
2017	17%	14%
2018	11%	11%

Source: Reuters; Note: Stock turnover ratio is computed as total value traded of the stocks for the year divided by the average market capitalization for the period.

Another way of looking at these inflows is that a large portion of them is index driven passive inflows. It is skewed towards countries that are safe havens with oil wealth and may leave behind the ones that have pursued diversification efforts. Index inclusion should be followed by broader diversification reforms. The dependence of GCC economies on the Oil and Gas industry is still heavy and further initiatives need to be undertaken to overcome this dependence. In addition to passive inflows achieved through capital market development, emphasis must be laid on improving the business environment to attract more foreign direct investments. GCC governments must continue to stimulate the growth of non-oil industries and the private sector. Consistency in policy from the Government and the Central Bank is also of paramount importance to retain foreign investors in the capital market, as it ensures stability and transparency. Therefore, GCC countries must not be carried away by passive inflows into their economy and must continue to pursue further reforms to ensure the sustenance of foreign capital and development of the economy.

Appendix

MENA Market trends

Index	M. Cap (USD Bn)	Last close	2018 %	Jan'19 %	YTD %	S&P correlation**	ADVT* (USD mn)	P/E TTM	P/B TTM	Div. Yield
S&P Pan Arab Index~	106.7	134	-7.6	4.6	4.6	0.072	N.A	13.34	1.28	4.70
Saudi Arabia	540.1	8,560	8.3	9.4	9.4	0.081	826.7	16.25	1.90	3.63
Qatar	143.0	10,720	20.8	4.1	4.1	0.029	56.3	14.83	1.46	3.91
Abu Dhabi	137.7	5,045	11.7	2.6	2.6	0.070	37.8	12.53	1.32	5.17
Kuwait All Share	97.1	5,256	7.8	2.5	2.5	0.028	91.6	15.68	1.28	3.55
Dubai	70.0	2,568	-24.9	1.5	1.5	0.076	31.9	7.08	0.87	5.88
Egypt	43.1	1,358	-11.1	6.3	6.3	0.078	52.6	12.35	1.91	4.57
Morocco	61.4	11,351	-8.3	-0.1	-0.1	0.049	N.A	17.76	2.63	4.02
Jordan	22.1	3,873	-5.7	2.4	2.4	-0.005	N.A	14.24	1.28	4.74
Bahrain	22.2	1,391	0.4	4.0	4.0	0.054	3.99	8.93	0.82	5.48
Oman	12.9	4,166	-15.2	-3.6	-3.6	-0.016	4.39	8.91	0.79	6.96

Source: Reuters,

*Note: * Average Daily Value Traded ** - 3-year daily return correlation with S&P 500, ~ S&P Pan Arab Composite Large Mid Cap Index*

Disclaimer

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