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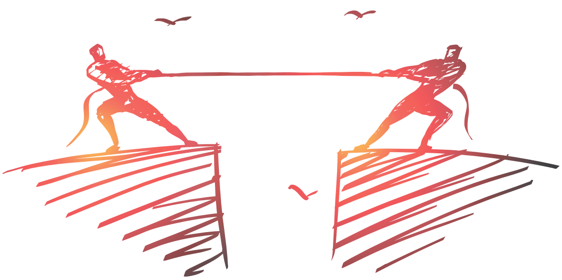
The Diplomatic Standoff: Qatar



On June 05, 2017 The Kingdom of Saudi Arabia (KSA), the United Arab Emirates (UAE), and Bahrain, along with Egypt (a member of the Arab League), cut diplomatic ties with Qatar, on charges of promoting terrorism and instability. They closed air and sea connections with the peninsular country and also prohibited their nationals from traveling to Qatar.

Given the close trade and deep geographical links with the rest of the GCC, the severance of diplomatic relationships did have economic repercussions for Qatar. Let's look at it from five viewpoints: Broader economy; Trade (export and import); Investments (FDI's); Currency; and Capital Markets.

Broader economy

First up, if sanctions remain in force for long, many things were predicted to happen.

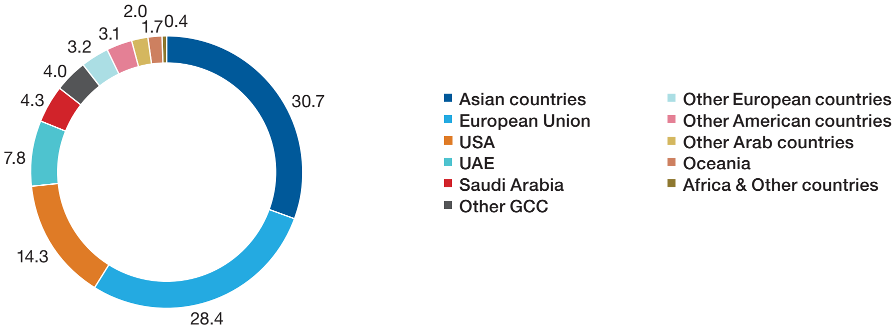
For one, GDP was expected to nosedive. The Institute of International Finance (IIF) estimated that Qatar's GDP growth could decline from 2.3% in 2016 to 1.2% in 2017 as a result of lower non-hydrocarbon growth. However, the GDP remained resilient resulting in an overall real GDP growth of 2.1% in 2017. Following the diplomatic standoff, foreign financing (nonresident deposits and inter-bank placements) and resident private sector deposits fell by about US$40 billion; but this decline has been offset by liquidity injections by the central bank and private sector deposits. In fact, the diplomatic rift has probably acted as a catalyst to speed up the structural reform agenda to improve the business environment.

Trade exposure

Import

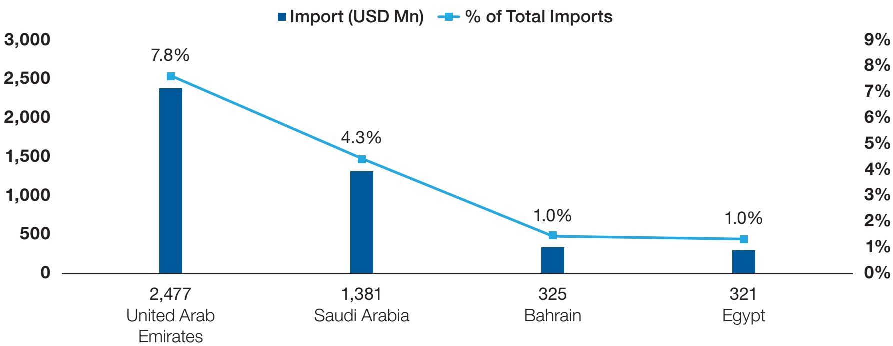
A majority of imports (73.4%) consisting of machinery and manufactured items arrive from Asia, Europe, and the USA. Qatar receives most of the essentials from its neighbours. About 80% of food supplies are from UAE and Saudi Arabia. All this is now going to take a hit.

Import by origin (% of Total Imports) - 2016



Source: Ministry of Development Planning and Statistics

Import from diplomatic conflict countries - 2016



Source: Ministry of Development Planning and Statistics

In the short term, other import countries will see challenges related to logistics and banking. It may be noted that shipping operators use Dubai's Jebel Ali hub to discharge Qatari-destined cargo and then forward it to smaller vessels into the Doha port. Now, the Jebel Ali hub has banned all ship destined or arriving from Qatar. The ban means a rerouting of traffic leading to increased cost and time. If the current blockade of essential goods from the neighbours continues, Qatar will be forced to align with new partners like Turkey, Iran, and India. It is not clear how the trade with these potential partners would pan out in the long run.

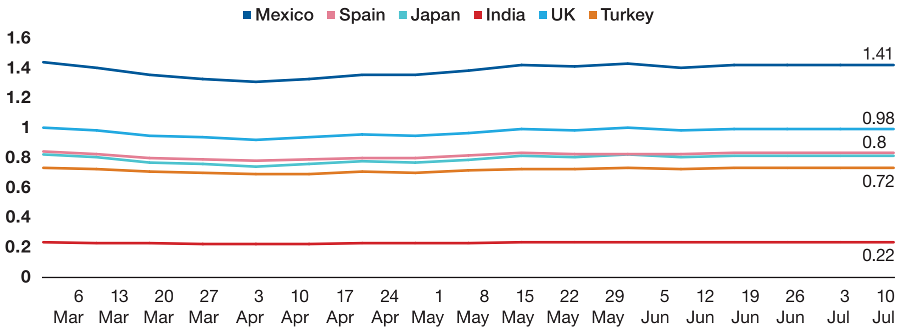
Export

Qatar is the world's biggest seller of liquefied natural gas and exported 30% of global supply in 2016. A majority of the gas export is to the Asian countries, and only 8% is to GCC of which exports to UAE were 5.8%. Qatar's exports to UAE are mostly gas (LNG), and UAE has so far avoided shutting down the pipeline supplying gas from Qatar. Abu Dhabi-based Dolphin Energy Ltd., which operates the gas pipeline, pumps around 2 billion cubic feet of gas daily to the UAE. Moreover, though the diplomatic dispute could close the gas pipeline to the UAE, Qatar has decided against it.

Qatar's exports of oil and gas are unlikely to be affected, as its main sea routes through Omani and Iranian waters are still accessible. Further, its biggest trading partners Japan, India, China, and South Korea (JICS), which buy more than 70% of natural gas from it are outside the politically volatile Middle East. So, it is unlikely that O&G exports from Qatar will take a hit.

The International Energy Agency (IEA) has warned increasing diplomatic tension between Qatar and its Arab neighbours is leading to operational problems in the region. While there have been some logistical issues, Marmore data suggest that this hasn't increased the transportation cost of LNG to crucial trade partners yet.

Qatar freight (USD/MMBTU) 2017



Source: Marmore Research

FDI, currency, and rating

What are the implications on FDI inflows, which are so central to the growth of the economy? Has the embargo hurt the Qatari Riyal (QAR)? What has been the cumulative impact on the sovereign rating?

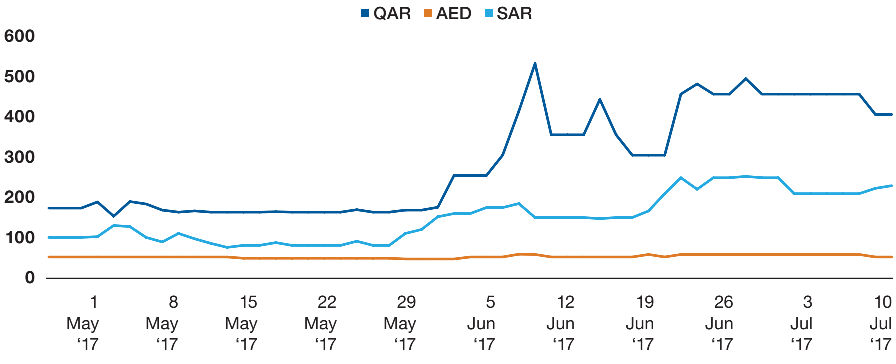
Foreign direct investment

Although a range of large capital projects related to construction and transport are being lined up, FDI inflows in Qatar has been meagre. Besides, historically, more than 90% of the FDI in Qatar has been from USA (20%), European Union (30%), other American Countries (35%) and Asia-excluding GCC (5%). The impact of the ongoing crisis on the FDI inflow will be insignificant.

Currency

On 12th June 2017, 12-month forward contracts for the Qatari Riyal (QAR) jumped to a record 525 basis points. This jump is an indication of increased bets on Qatar devaluing its currency, currently pegged at 3.64 per dollar.

USD-QAR 1Yr forward swap



Source: Reuters, Marmore Research

However, the possibility of Qatar abandoning the peg is remote as the Qatar Central Bank has USD 34.5bn of net foreign reserves. While the sanctions imposed on Qatar is exerting pressure on the QAR, the drop in oil prices is having a similar impact on the Saudi Riyal.

Credit rating

The severed diplomatic ties have adversely affected Qatar's credit rating. Standard & Poor lowered its long-term rating on Qatar by one notch to AA-minus. There can be further downgrading if the crisis deepens. These have had a contagion effect on Qatari companies, resulting in a subsequent decline of corporate ratings of biggies like Industries Qatar and Qatar National Bank. We are likely to witness similar trends in other banks and companies as well.

S&P credit rating

S&P Rating Scale	Qatar	Industries Qatar	Qatar National Bank	Qatar Insurance	Doha Insurance	Doha Bank	Qatar Islamic Bank
AAA							
AA+							
AA	Pre-crisis						
AA-	Post-crisis	Pre-crisis					
A+		Post-crisis	Pre-crisis				
A			Post-crisis	No-change			
A-					No-change	No-change	No-change
BBB+							
BBB							
BBB-							
BB+							
BB							
BB-							

Source: Reuters, Marmore Research

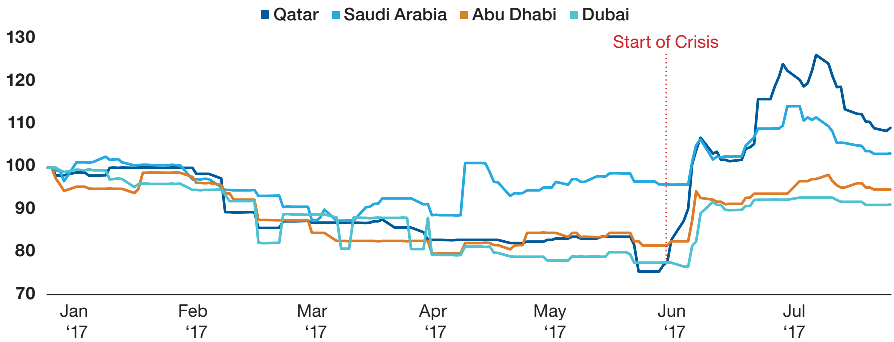
Capital market impact

Debt market

Qatar's external debt is 114% of its GDP, marking it as the second amongst GCC nations. The external debt saw a sharp increase in 2016, primarily on account of a sharp rise in commercial banks' foreign liabilities to $123 billion (81% of GDP) from $85 billion the year before. Qatar Government has an outstanding external sovereign debt of USD 35.8bn as of July-2017; a majority of this got issued in 2016. Consequently, the external vulnerabilities for Qatar are more substantial than for highly rated regional peers. As the chances of the ongoing dispute being resolved appear bleak, the cost of debt is expected to increase, and the balance sheet would deteriorate further. The rising global interest rates will accentuate the crisis.

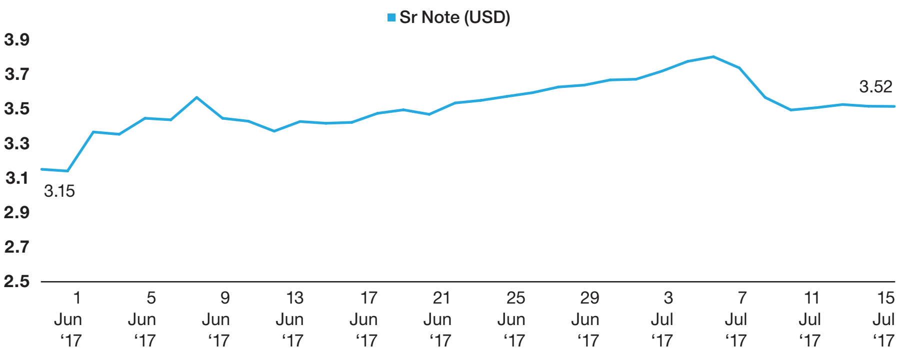
The diplomatic crisis has affected investor sentiment. For proof, look to the 5-year CDS or the cost of insuring risk, which increased from 57 bps in May-17 to 121bps in Jul-17. Similarly, the yield for the 10-year USD denominated bond issued by Qatar has increased 37bps. Investor sentiment is also gauged using the Equity Risk premium (ERP), which has risen.

CDS rebased to 100



Source: Reuters, Marmore Research

Yield on 10Yr USD bond issued by Qatar

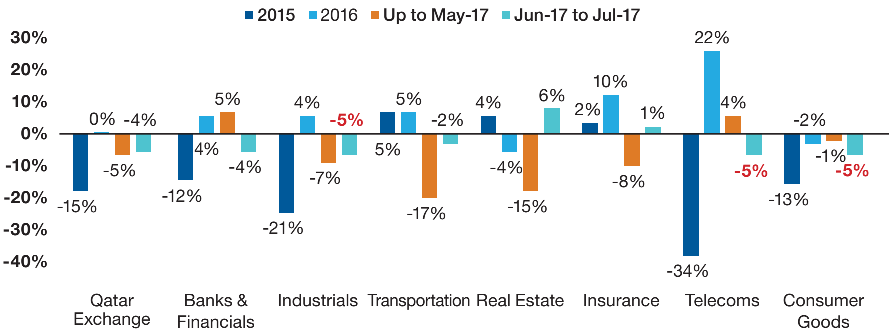


Source: Reuters, Marmore Research

The bottom line: Qatar's reputation as a financially sound, commodity-oriented economy, which could maintain high credit ratings is tarnished as a result of the ongoing crisis.

Equity market

Qatar's stock index tumbled 8.8% in June 2017, wiping out market capitalization equivalent to USD 11bn. As of July 20, 2017, the Qatar index declined by 4%. Except for real estate and insurance, all other sectors' indices have declined, with telecom, consumer goods, and industrials being the worst hit. However, it is not our case that Qatar's indices have been underperforming only due to the ongoing rift. The chart shows that most of them have underperformed during the 2015 and YTD May-17. The under-performance implies that most of Qatar's sectors were under-stress even before the rift and the current crisis acted as a double disadvantage.



Source: Reuters, Marmore Research

Some anomalies have been spotted with a few stocks rising unexpectedly. The notable ones were Ezdan Holding (up 13%) and Qatar Insurance (spiked 4%) during the period. Ezdan's positive performance since the dawn of the crisis can be attributed to the base effect, as the stock closed at the lowest level since 2015. Both these stocks, being heavyweights in their respective sector indices, contributed to the rise. The sharp decline of Industrials Index can be attributed to the decrease of the index constituents such as Industries Qatar and Qatar Electricity at 4% and 6% respectively, as these two stocks account for 67% of the index market cap.

The Qatar stock exchange witnessed a 25% increase in turnover in June 2017 as against the previous month. The increase in the volume of trading was due to institutional investors from the GCC bailing out of the country. Before the crisis, GCC and international investors held 9% of Qatar's stock market. Since then the GCC institutional investors have reduced their position in Qatari shares by USD 200mn. The Qatar Stock Exchange index was witnessing selling pressure since valuations based on which the investors had taken their respective positions no longer held right given the high level of uncertainty. Qatar is in the MSCI EM index, and a lower market cap and associated risks resulted in a reduction in weight. The decrease in weight might lead the passive fund managers to sell their holdings thereby exacerbating the issue.

Marmore estimates the revenue at risk (USD 1.3bn) for listed companies. The estimate amounts to only 3% of the total earnings of those companies in 2016. Out of the USD 1.3bn of revenue that is exposed to the conflict countries, 90% is expected to be from UAE. Financial Services and Construction are the two major sectors that are likely to face challenges as an outcome of the ongoing blockade. For Qatari listed companies, a majority of the revenue comes from domestic business.

Blue chip performance

The performance of the blue-chip stocks has also been in sync with the performance of the indices. The five blue chips discussed below account for 56% of Qatar's listed company's market cap: and so turn to be the movers and shakers of their respective indices.

QNB and Qatar Industries declined by 1% and 13% respectively, up to May-17, and further decreased since the start of the crisis. Since SOEs own QNB and Qatar Industries, any event impacting the Qatari Government would trickle down to these companies. Factors such as rating downgrade of Qatar, followed by a decline of Qatar Industries to A1 from Aa3 by Moody's impacted the performance of these companies. Ooredoo performed negatively on the account that domestic operations, which account for 25% to 30% of the group's revenues, would suffer from the departure of residents of the countries severing ties with Qatar. Additionally, Ooredoo's Maldives-based subsidiary, which accounts for 1% to 2% of the revenue, would also suffer as a result of severed diplomatic ties with Qatar.

Name	Sector	Mcap (USD Bn)	2015	2016	Up to May-17	Jun-17 to Jul-17	Trend
Qatar National Bank	Financials	36	-18%	12%	-1%	-3%	
Industries Qatar	Industrials	17	-34%	6%	-13%	-4%	
Ezdan Holding	Financials	10	7%	-5%	-28%	13%	
Ooredoo	Telecom Services	9	-39%	36%	2%	-6%	
Masraf Al Rayan	Financials	9	-15%	0%	18%	-6%	

Source: Reuters, Marmore Research

Qatar's banking system has in recent years become more dependent on loans and deposits from Gulf and international banks. Because of the crisis, the Gulf banks have refused to extend matured deposits. It is not surprising that non-resident deposits declined from USD 40bn in August-2017 compared to USD 45.97bn in June-2017. The withdrawals could lead to liquidity issues and a consequential increase in the cost of funding. So, as a precautionary measure, Qatar's sovereign wealth fund has been pumping U.S. dollar deposits in local banks. Qatar Government infused deposit of close to 25bn into its banking system to cushion it from withdrawals by financial institutions. Factors such as a decline in the operating environment, loss of business confidence of the non-oil private sector, and external exposure of Qatari banks, could result in a spike in non-performing assets (NPAs). Despite the ongoing rift, according to the Qatar Central Bank, the Government and public sector deposits in Qatar's banking system have increased by around USD 11.5bn during June 2017, compared to the previous month, and reached USD 66bn.

The outlook for Qatar's insurance sector is positive as large-scale government investments in infrastructure and private sector construction projects are presenting substantial insurable assets for the Qatari insurance companies. The lower insurance penetration level also offers opportunities for the sector to grow. The ongoing conflict is not likely to impact the domestic telecommunications sector as it is envisaged to play a crucial role in helping Qatar progress towards its vision of becoming a knowledge-based economy. The short-term outlook is positive, supported by the resilience of the Qatari economy and the defensive nature of the telecommunications sector in Qatar given the non-discretionary characteristics of expenditure on telecommunication services. The tourism sector is one of the worst impacted sectors due to the ongoing conflict.

The hotels, which are usually full during the Eid Al Fitr holiday, witnessed low occupancy levels of 57%. The arrivals at Hamad International Airport dropped by 27,000 passengers a day compared to the same period last year. The drop in visitor arrivals is likely to force hospitality and real estate developers to re-evaluate their strategies, potentially causing delays to some of the ongoing tourism projects.

Conclusion

Given the close trade and deep geographical links that Qatar has had with the GCC, the ongoing blockade will hurt its economy in the short term. Also, if the embargo continues longer, it is possible to substitute the trade relationships with other countries. However, the sentiments and attractiveness of the country as a haven may deteriorate. Increase in food prices, erosion of Qatari fiscal balances, and a rise in borrowing costs are some of the real risks that Qatar will continue to face if the situation is not settled amicably soon.