

GCC Markets Monthly

January 2012

Summary

The EU agreement has disappointed and fallen short of expectations, failing to convince markets that any credible plans to tackle the Euro-crisis are in place

Economic growth in the GCC during 2012 will be driven by energy, infrastructure, and private sector investments and trading

This will be aided by any signs of a recovery in the global economic landscape that could drive oil prices higher

Despite relatively robust macro-fundamentals, direction for the GCC equity markets will largely be driven by trends in global markets, which appear increasingly vulnerable to swings

Continuing risk aversion and deleveraging is likely to contribute to more episodes of volatility in GCC credit markets

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Global Macro

Europe continues to disappoint

Outlook	ST (1-3M)	MT (3-6M)
Global Macro	↘	→

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Summary

- European credit crisis and political maneuvering at the forefront of the global stage
- Currently robust US Industrial Production remains at risk of decline if EU crisis extends
- Market uncertainty and inflationary pressures lend volatility to currency markets

Global Macroeconomic Developments

The latest EU agreement has disappointed and fallen short of expectations, failing to convince markets of the presence of any credible plans to tackle the Euro-crisis. Though the EU members agreed on measures in the first half of December, intended to communicate to the financial markets that they are working towards the goal of a common fiscal union, it remains to be seen if the latter will work out in practice.

While markets are not likely to test the resolve of the ECB and the EU until the beginning of 2012, evolving market reactions including the dip in performance point to continued tension and unresolved anxieties.

Rising yields of the weaker EU economies contrasts with the continued decline in the 10-year US treasury yield. Lately, yields on Italian and Spanish government bonds have ratcheted up, and the spread between French and German government bonds has widened on concerns about a potential French downgrade.

Meanwhile, the persistence of high unemployment rates is worrisome. There were still ~44.8mn unemployed people in the OECD area in Sep 2011, some 13.7mn more than before the crisis. UK unemployment rose to 2.62mn, the most since 1994, and the jobless rate climbed to a 15-year high of 8.3%. Unemployment among 16-24-year-olds rose by 67,000 to 1.02mn, the highest since comparable records began in 1992.

The November data on US industrial production looks robust, though the US still stands to lose if the Europeans fail to reach a substantive agreement to the EU crisis, for at least the following reasons. First, the US exports three times as much to the EU as it exports to China. Secondly, if the EUR is weakened substantially that would spell bad news for the ongoing attempts to fix US trade balances. Finally, many American businesses are located in Europe where they make hefty profits some of which gets recycled to the US.

Growth continues to remain robust in EM economies though it has moderated in the last few months largely due to the weakening external demand. This weakening demand along with slower growth will help EM economies such as China and India alleviate overheating pressures, through lower inflation rates. In turn, monetary policy in these countries continues to have room for further easing through a rate cut or a reduction in the required reserves ratio.

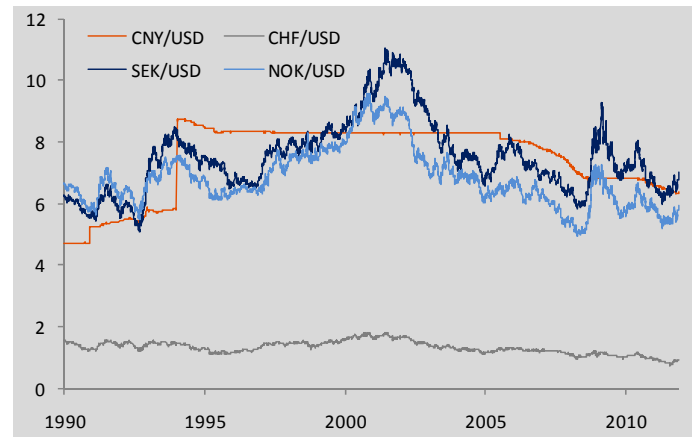
Volatility in FX Markets

During uncertain times, the foreign exchange market that is typically highly volatile in normal conditions becomes even more complex and difficult to ascertain. The long-term relationship, 1990-2011, between a set of currencies and the US is shown in the Chart below.

Clearly, a significant portion of the apparent variations can be explained largely by inflation differentials and the use of USD or Swiss Franc (CHF) during turbulent times. Lately, the Swiss CPI fell 0.5% YoY in Nov 2011, as the strong Franc pushed the cost of imports down 2.7% YoY to offset higher energy and accommodation costs. In turn, this risk of deflation has weakened the CHF/USD and other major currencies.

The weakness in the USD appears to be structural and is likely to remain for a prolonged period as long as the US twin deficits, the budget and the current account deficits, continue to widen.

Major Currencies vs. USD



(Source: Board of Governors, US Federal Reserve)

GCC Macro

2011 Oil price marks historic average

Outlook	ST (1-3M)	MT (3-6M)
GCC Macro	↗	↗

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Summary

- Oil prices remain supportive given the underlying economic conditions.
- OPEC's current production quotas look increasingly geared towards a lower price level.
- Continuing recovery in global demand would help GCC countries to sustain an expected 27.5% rise in their oil export revenues in 2010

Economic Growth

Amidst the global chaos, the GCC economies continue to fare well, thanks to a combination of forces including the firmly high oil prices and the continued expansive fiscal policies. The latest of such policies is the UAE announcement of USD 2bn in additional spending through a wage-hike.

Economic growth in the GCC during 2012 will be driven by energy, infrastructure, and private sector investments and trading. A global recovery, if it materializes, will drive the oil prices higher, thus having a further positive impact on the region. However, oil production in most of the GCC is unlikely to increase significantly, as they are bound by OPEC quotas. The two exceptions are Oman and Bahrain who are non-members.

A surge in oil prices to their all-time high average of ~USD 115/bbl for 2011, is likely to have generated ~USD 305bn in Revenues for the GCC region, and pushed the current account surplus to a record high. Consequently, the combined GDP of the six-countries would have risen from ~USD 1,075bn in 2010, to nearly 1,380bn at current prices for 2012. This would mark the highest level ever and significantly above the previous peak GDP of USD 1,138bn in 2008.

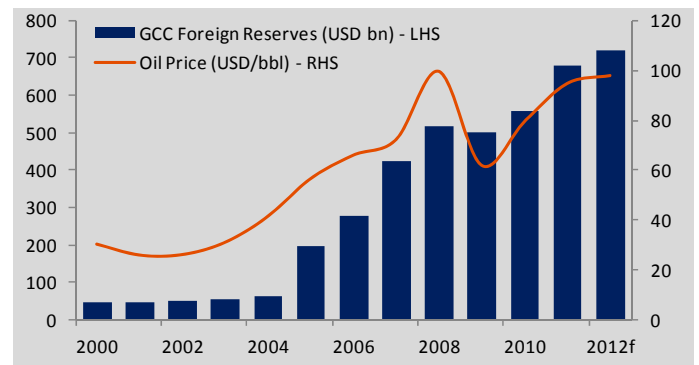
As oil exports constitute the bulk of exports in the GCC region, there is a high tendency for total exports to mirror changes in oil prices. Growth in exports was mostly prominent in 2005 with 40% YoY growth, matched by a 36% increase in Oil prices. As a case in point, the financial crisis had severely eroded exports for Kuwait and Saudi Arabia in 2009 by 41% and 39% respectively, as average Oil prices fell by 38%. However, going forward, the differential in growth in exports and oil prices may increase as oil prices are expected to rise in the near future by 19% versus a lower increase of 37% in exports.

Throughout the years, Qatar and UAE have successfully managed to decrease the dependency of their economies on

hydrocarbon revenues through diversification of their resources. Qatar relies much more on gas exports which largely accounts for the drop in the share of its oil exports from 56% in 2000 to nearly 19.8% in 2011.

As a sign of continued progress, GCC companies have been raising their employee force by a steady margin, and plan to raise salaries. A recent survey published by the HR consulting firm Mercer, of more than 300 firms across all industries in Saudi Arabia, Qatar and the UAE showed that most companies in Qatar and Saudi Arabia plan to raise salaries by ~6%, while UAE companies expect are likely to raise salaries by ~5.5% next year.

GCC Foreign Reserves vs. Oil Prices



(Source: EIU, EIA)

Proportion of Oil Exports to Total Exports

(%)	2002	2004	2006	2008	2010	2011
Bahrain	68.4	70.8	72.5	76.6	70.7	82.0
Kuwait	91.5	92.0	94.2	95.0	92.1	95.1
Oman	66.6	67.8	66.6	58.0	56.9	63.3
Qatar	51.3	45.6	46.9	35.7	20.5	19.8
Saudi	76.0	73.7	76.1	78.8	74.5	78.6
UAE	32.0	32.6	39.9	35.7	28.3	30.3

(Source: EIU)

GCC Equities

Global volatility sways markets

Outlook	ST (1-3M)	MT (3-6M)
GCC Equities	→	→

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Summary

- GCC markets showed lackluster performance as the debt overhang in Europe continues stalemate
- Qatar’s QE index remained the only GCC benchmark index with positive net returns for the year
- Overall direction for the GCC markets will be driven by trends in global markets, which in turn appear increasingly vulnerable to swings

Review

With the overhang of the debt crisis in Europe and rising pessimism about a swift resolution of the situation adding pressure on global equities, the GCC markets exhibited rather lackluster performance during December.

Although some GCC equities experienced a turbulent month, Saudi, Qatar and Oman managed to stage a recovery that pushed the S&P GCC index to a gain of +2.85% for the month, its best performance since April 2011. However, the late-year surge proved insufficient to offset the losses sustained during most of the year, and the benchmark index closed the year with a net loss of -4.47%.

Saudi Arabia’s Tadawul index ended the month as the best performing index in the region, with a net gain of +5.14%, following regulatory indications of market reform towards foreign investment in the equity markets. The heavyweight Petrochemicals sector was the biggest beneficiary, but ceded ground thereafter, while the Investment and Cement sectors emerged leading performers for the month.

Oman’s MSM 30 emerged the second best-performing index during December, adding +5.07% with gains across the board, led by the Industries and Banks & Investments sectors. A 12% increase in spending outlay for the 2012 budget served as a sentiment lifter for key stocks in Oman.

Qatar’s QE index closed the month with a net gain of +2.17%, remaining the only GCC benchmark index with positive YTD returns of +1.12%. Industrial and Banking sectors were the key pillars of the gains.

The UAE markets continued their decline, extending the sharp losses recorded during November, dragged largely by the Real Estate sectors in both markets. Dubai’s DFM index shed -1.85%, with the Services, Investment and Real Estate sectors contributing the most to the decline. In Abu Dhabi, sharp declines in the Real Estate and Telecom sectors caused the ADSM index to shed -1.74% for the month.

Losses on the Industries, Services and Banking sectors dragged Kuwait’s KWSE (Weighted) index down by -1.01% for the month. Meanwhile Bahrain’s BSE index remained the worst-performing GCC index for the year, as a net decline of -1.67% during the month stretched the YTD loss to -20.15%.

The other key laggards for the year were the DFM index with -17.00%, Kuwait’s KWSE index with -16.22% and Oman’s MSM 30 index with -15.69%. The Saudi Tadawul fared better with losses for the year being restricted to -3.07%.

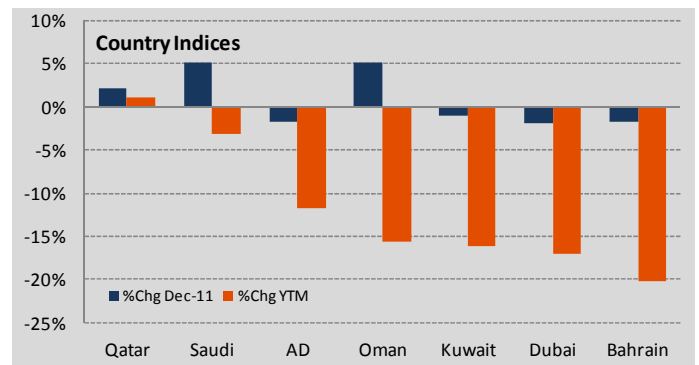
Outlook

Despite the volatility that has engulfed global markets, Oil prices recorded their highest historic average price during 2011, leading to an improvement in economic activity for the region. Though downside risks remain for oil prices in the short-term, consensus points towards strength in prices in the medium to long-term.

However, overall direction for the GCC equity markets is likely to be driven by trends in global markets, which appear increasingly vulnerable to swings given the uncertainties that surround the resolution of the European credit crisis.

The impending results season is being closely watched by investors and analysts, and could be the key catalyst in a market that has been devoid of any local triggers for an extended period of time. With Saudi Arabian entities usually the first in the line to disclose results, the earnings trend in Saudi stands a good chance of influencing the short-term direction for its other GCC peers.

GCC Equity Returns



(Source: Bloomberg)

GCC Equity Strategy

	MoM Returns	YTM Returns	ST Outlook	Key Considerations
Saudi Arabia	+5.13%	-3.07%	→	<ul style="list-style-type: none"> - Continued global economic concerns could exert downward momentum through demand and pricing worries for the Petrochemical sector - Markets will be swayed by trend in earnings announcements for FY 2011
Kuwait *	-1.01%	-16.22%	→	<ul style="list-style-type: none"> - Political factors continue to overshadow fundamental considerations and remain at the forefront for investors - Lack of tangible progress regarding the Government projects and spending plans hinders visibility
UAE – Dubai	-1.85%	-17.00%	↘	<ul style="list-style-type: none"> - Possible European sovereign ratings downgrade could have regional impact - Ongoing restructuring of Dubai corporate and GREs will impact sentiment - Outlook for credit growth likely to remain weak in the short-term
UAE – Abu Dhabi	-1.74%	-11.68%	↘	<ul style="list-style-type: none"> - Cut-backs in spending will have strong medium-term impact on credit growth - Real-estate slowdown could stretch the provision cycle for Banks - Possible European sovereign ratings downgrade could have regional impact
Qatar	+2.17%	+1.12%	→	<ul style="list-style-type: none"> - Anticipated success of new Sovereign bond issue will be key sentiment driver - Attractive yield through high dividends may attract investors. - Expectations of robust earnings from key companies will have an impact
Oman	+5.07%	-15.69%	→	<ul style="list-style-type: none"> - MSM appears to be close to a technical bottom, that could trigger a recovery - 2012 budget expects a 12% rise in spending. This could be a driver for Bank credit growth and corporate profits
Bahrain	-1.67%	-20.15%	↘	<ul style="list-style-type: none"> - Political instability continues to hamper investor sentiments - Civil disruptions adversely affect domestic Tourism and Retail segments.

* Kuwait's performance is represented by the KWSE Weighted Index

GCC Sector Strategy

	ST Outlook							Key Considerations
	SA	KW	DU	AD	QA	OM	BH	
Banks	↗	→	↘	→	↗	→	↘	<ul style="list-style-type: none"> - Visibility for UAE banks hampered by continuing provisions - Expectations of healthy growth for Saudi and Qatar banks will support investor sentiment
PetChem	→	→	-	-	→	-	-	<ul style="list-style-type: none"> - Limited downside as global economic concerns and oil volatility priced in - Hike in Saudi feedstock prices unlikely to have significant profit impact
Retail	↗	-	-	→	-	-	-	<ul style="list-style-type: none"> - Expectations of positive earnings growth could be key driver - Sector favored by defensive investors targeting earnings sustainability
Real Estate	→	↘	↘	↘	↘	-	-	<ul style="list-style-type: none"> - High investment exposure continues to drag profitability in Kuwait - Large supply pipeline for 2011-12 could pressure prices in UAE

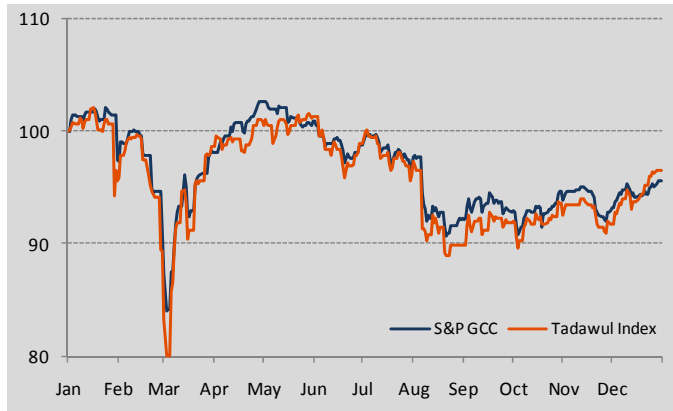
Investment Ideas/Theme Watch

Investment Theme	Investment Rationale
Retail & Consumer Non-Durables	<ul style="list-style-type: none"> - Demographic fundamentals remain intact - Low-beta exposure and dividend plays increase appeal for the sector given near-term uncertainties
Banks	<ul style="list-style-type: none"> - Backed by strong macro fundamentals and improving credit quality - Banks in Saudi and Qatar are candidates for strong out-performance in the medium-term
Telecom	<ul style="list-style-type: none"> - Increased appetite for Telecom stocks as 'defensive' and dividend plays



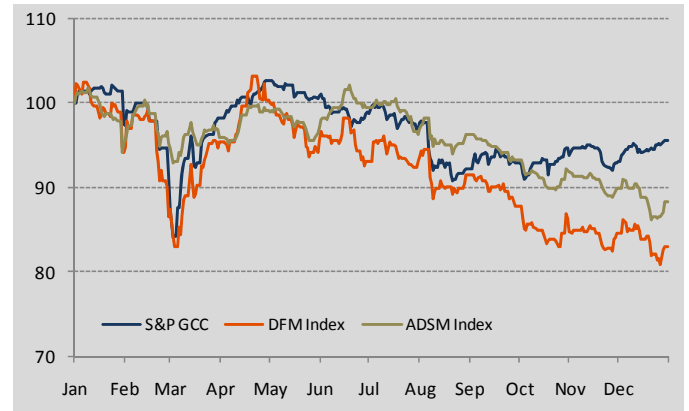
GCC Market Watch

Saudi Arabia



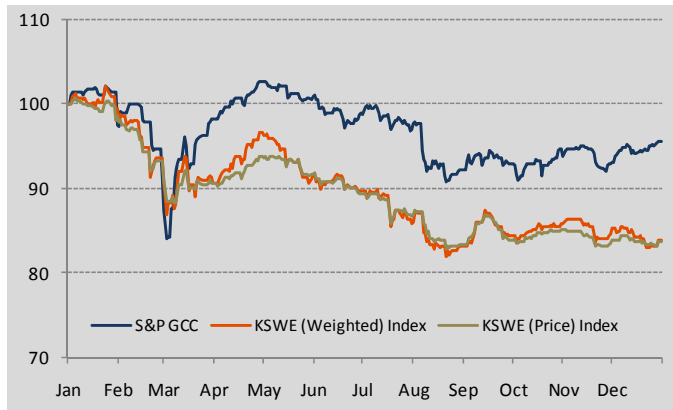
(Source: Bloomberg)

UAE



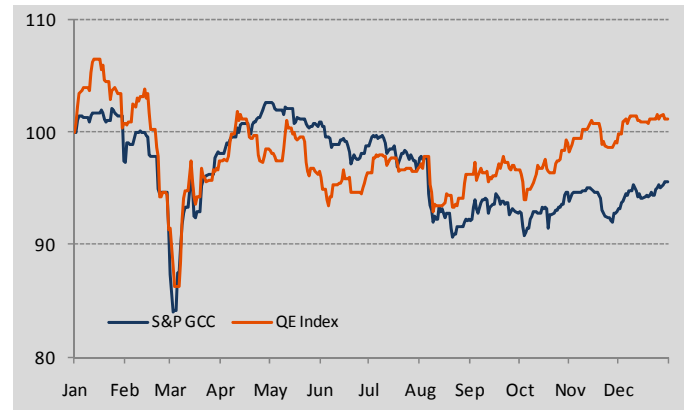
(Source: Bloomberg)

Kuwait



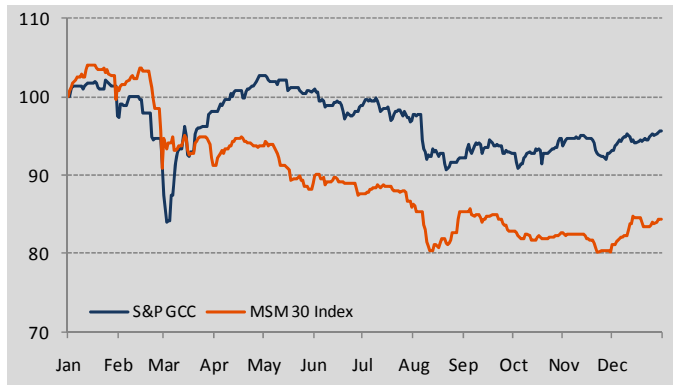
(Source: Bloomberg)

Qatar



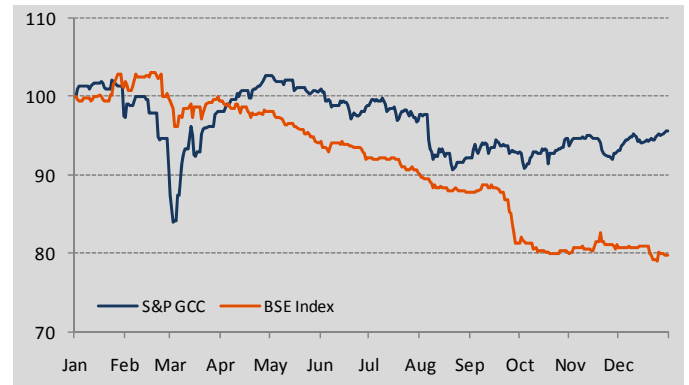
(Source: Bloomberg)

Oman



(Source: Bloomberg)

Bahrain



(Source: Bloomberg)

Note: The official indices published by the exchanges have been used as proxies for respective country performance in the above charts, while the S&P GCC Index has been used as a proxy for the GCC markets. The S&P GCC Index is constituted of ~270 companies from the 6 GCC countries, that have been screened on the basis of liquidity & size guidelines, and adjusted for free-float, with reviews conducted on a quarterly basis.

GCC Fixed Income

Europe, Far From a Happy Ending

Outlook	ST (1-3M)	MT (3-6M)
GCC Fixed Income	→	→

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Summary

- European credit crisis does not appear to be close to a amicable end
- Volatility in GCC credit continues on the back of global instability
- Taqa’s oversubscribed issue shows that investor appetite to regional bonds remain healthy

Review

December turned out to be yet another month of volatility and disappointment as global markets came to realize that EU leaders are still very far from an end to the region’s two-year debt crisis.

During their latest summit, the European leaders made some breakthroughs in the form of agreeing to structure a tighter fiscal union, expanding the region’s bailout funds, and tightening the rules to limit debts.

However, continuing disagreements regarding treaty amendments and capping the size of the bailout fund meant that a successful conclusion to discussions remained well out of reach.

Consequently, Fitch Ratings reduced the sovereign outlook for France and placed the grades of others including Spain and Italy on review for a downgrade. Furthermore, Moody’s Investors Service announced that it will review the rating for all EU countries. In parallel, riskier assets across the globe have retreated, while Treasuries advanced the most since early November.

Regionally, spreads widened across GCC bonds, as reflected in the HSBC-Nasdaq Dubai GCC Conventional Bonds Index. Regional CDS outperformed cash and stayed almost flat.

Abu Dhabi National Energy (Taqa) caught the markets’ attention during December on two occasions. First, through the successful issue of five and ten year bonds aggregating to USD 1.5bn; and secondly, through buying back USD 589mn of its 2012 bond.

Both events indicate that the company is working positively to manage its debt profile, causing investors to reward it by lifting its curve, and can be viewed positively in the context of the evolution of regional credit markets in terms of the sophistication of issuers.

On another note, officials in Saudi Arabia indicated that the Kingdom might issue a local currency sovereign Sukuk next year in a step that aims at building a yield curve.

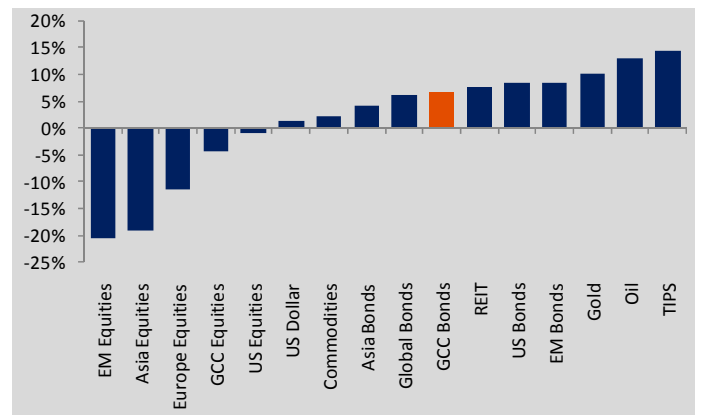
Outlook

Going forward, we expect both, risk aversion and deleveraging to continue, leading to more episodes of volatility. Therefore, we recommend limiting exposure to less quality names and longer maturity issues.

With regard to the pipeline for new issuances, we anticipate a healthy primary market next year as many issuers attempt to replace their maturing debt.

Another factor that might contribute to the size of the primary market would be the fact that European Banks, who play a big role in regional corporate funding, are restricting their lending due to exposure to EU peripheral names.

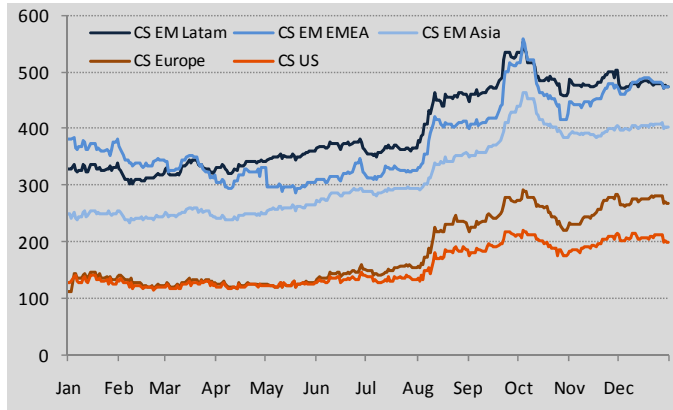
Returns across Asset Classes (YTD)



(Source: Bloomberg)

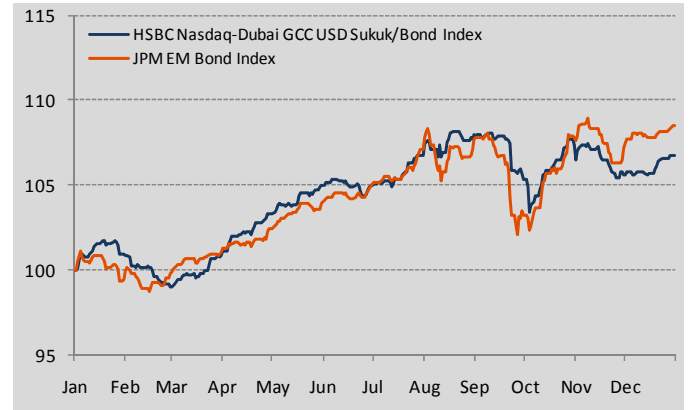
GCC Credit Snapshot

TR Swap Spreads



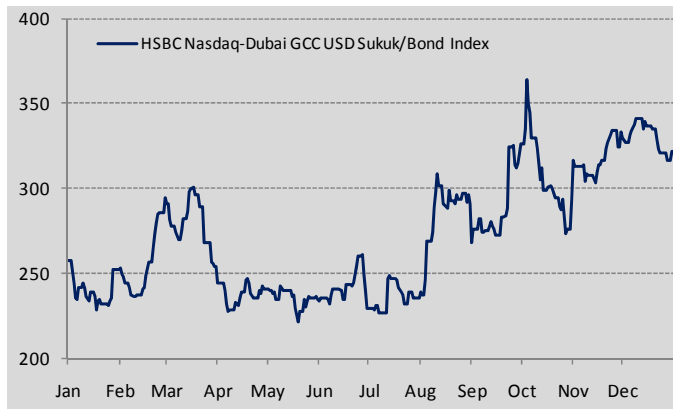
(Source: Bloomberg)

GCC vs. EM Bond Returns



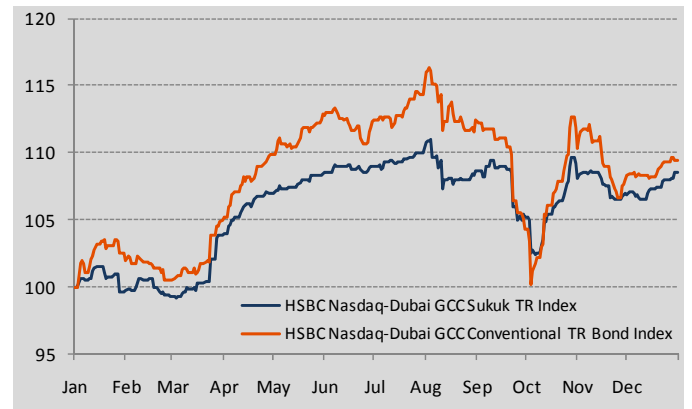
(Source: Bloomberg)

GCC Spreads



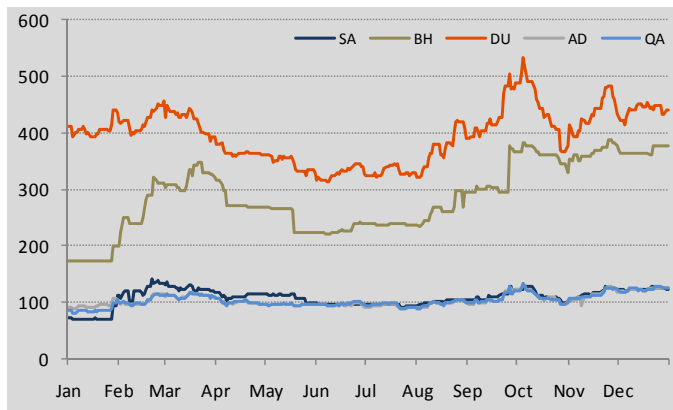
(Source: Bloomberg)

GCC Bond vs. Sukuk Returns



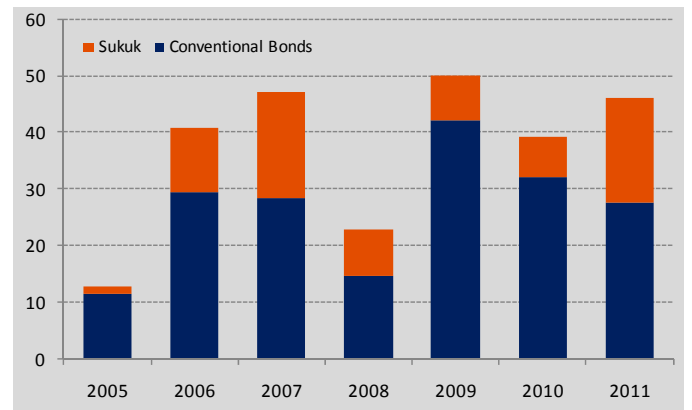
(Source: Bloomberg)

GCC Sovereign 5-year CDS



(Source: Thomson Reuters)

GCC Bond/Sukuk Issuances (USD bn)



(Source: Bloomberg, Zawya Sukuk Monitor)

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Indicators for Outlook

- ST** Short-Term; Indicates a time horizon of 1-3 months
- MT** Medium-Term; Indicates a time horizon of 3-6 months
- ↗ For Fixed Income, Alternatives, Commodities and Equities, this indicates a Positive Outlook, with expectations that the asset category shall deliver rising returns over the defined time horizon. From a Macro perspective, this indicates that economic growth over the defined investment horizon shall be higher than the current rate
- For Fixed Income, Alternatives, Commodities and Equities, this indicates a Neutral Outlook, with expectations that the asset category shall deliver flat returns over the defined time horizon. From a Macro perspective, this indicates that economic growth over the defined investment horizon shall remain in line with the current rate
- ↘ For Fixed Income, Alternatives, Commodities and Equities, this indicates a Negative Outlook, with expectations that the asset category shall deliver falling returns over the defined investment horizon. From a Macro perspective, this indicates that economic growth over the defined time horizon shall be lower than the current rate

Abbreviations used

- YTD** Year-to-Date
- ST** Short-Term
- MT** Medium-Term
- SA** Saudi Arabia
- KW** Kuwait
- DU** Dubai (UAE)
- AD** Abu Dhabi (UAE)
- QA** Qatar
- OM** Oman
- BH** Bahrain

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