GCC risk from a MENA perspective

A Report by Daman Asset Management, March 2011

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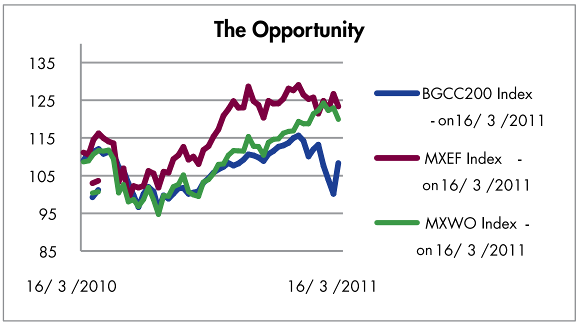
Executive Summary

These are truly momentous times in the MENA region with the spontaneous uprising in Tunisia and the now dubbed "Jasmine Revolution" leading to the ouster of the previously well entrenched president Zein El Abdine Bin Ali and igniting a domino effect which has rapidly spread throughout the middle east with revolutions and people's defiance abounding and leading to the resignation of the formerly impregnable Hosni Mubarak, as of the time of writing Kaddafi's regime in Libya is looking increasingly fragile. The spill over effect of the events that are being vividly played out in the media in as far a field Morocco, Libya and closer to home Bahrain and Oman are both a game changer and a major paradigm shift. It is important to note that the seeds of the unrest are due to a economically disenfranchised populous rather than any political/subversive factors per se. Investors are fleeing MENA markets en masse, given that their calculus of risk has changed and a renewed focus on political risk has emerged.

The events in Egypt and MENA region in general question one of the major tenants of emerging markets investing, specifically that large populations with a youthful working age demographic are positive for GDP growth. However, what has become readily apparent is that this is clearly not a given when GDP growth is outpaced by labour force growth. With the conclusion being that equitable income distribution should be a more important factor than blind policies to pursue GDP per capita growth alone. The fact that Egypt now faces a prolonged period of political uncertainty is a given and any new regime that comes into power is likely to follow more populist policies (potentially increasing fiscal spend, inflation, currency weakness,…etc) which would imply an increased equity risk premium and a higher cost of capital when discounting investment opportunities in the Egyptian market.

It is important to note that Egypt was the only MENA market in the global MSCI (Morgan Stanley Capital International) Emerging Market (MXEM) Index.

Fig 1



Source: Bloomberg

We believe that the above mentioned market dislocations have created very attractive opportunities within the GCC markets and as such are advocating a shift from North African markets into specific GCC markets. At this juncture it is important to draw a distinction between Bahrain and the rest of the GCC countries. The seeds of the current unrest within Bahrain have been fomenting for a while at the root of which lies the sectarian divide between the minority Sunni population of which the ruling family belongs to and the Shiite majority. This demographic is unique to Bahrain within the GCC. Hence, Bahrain was always going to be susceptible to the contagious tremors being felt throughout the region.

In a bid to quell the social unrest GCC countries pledged $20 billion in financial aid to both Bahrain and Oman with $10 billion going to each country to upgrade their housing and infrastructure in the next ten years. The package amounts to over half the Bahraini economy and nearly 22% of Oman's GDP as at fiscal year 2010 numbers and provides an important fiscal stimuli to the regime. Failing the financial nostrum, the Bahraini royal family asked for the help of the peninsula shield force to come to its assistance, which led to Saudi and UAE troops to be deployed, thereby escalating the risk level further by adding the military dimension.

However, the smart money is of the opinion that the macro risk will be contained to the North African markets, Bahrain, and Oman within the GCC and that there is a clear bifurcation between the North African economies and the rest of the GCC markets which are characterized by stable regimes with strong hydrocarbon resources, current account surpluses, extensive public spending plans, and hence a more contented population. The crude distinction to be made here is between the net oil exporters and the net oil importers, if we take hydrocarbon reserves per capita as a proxy for

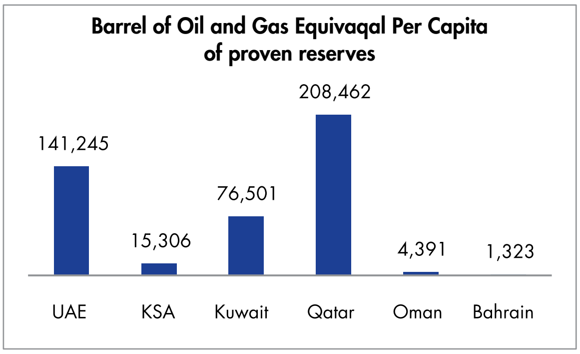
Change in political landscape is a major paradigm shift

Equitable income distribution more important factor

Capital as well as troops being deployed to quell unrest in Bahrain

the ability to provide welfare services Qatar and UAE are the highest followed by Saudi Arabia.

Fig 2



Source: CIA Factbook and Daman Estimates

This short paper will outline some of the key factors for investing in the GCC ex-Bahrain and give some empirical basis and opinion as to why we believe now is the time to be switching from North African Investments into the GCC.

Dispelling the Oil Myth

It is a commonly held belief that our markets are highly correlated to the price of oil; however upon closer scrutiny, this does not hold up.

Fig 3

Security	CLH1	INDU	SX5P	MXAP	BGCC200
CLH1	1	0.593	0.548	0.373	0.233
INDU	0.593	1	0.681	0.277	0.156
SX5P	0.548		1	0.426	0.327
MXAP	0.373	0.277	0.426	1	0.459
BGCC200	0.233	0.156	0.327	0.459	1

Bloomberg Ticker	Description
CLH1	WTI Crude Future March 11
INDU	Dow Jones Industrial Average Index
SX5P	STOXX Europe 50 Index
MXAP	MSCI Asia Pacific Index
BGCC200	Bloomberg GCC 200 Index

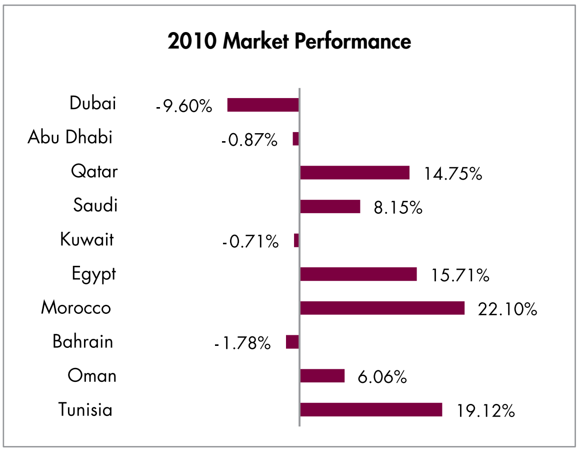
Source: Bloomberg

From the table above it can be seen that the GCC is far more correlated with what happens in the Asian markets, and the correlation with oil is a weak one at best.

Nuanced Performance

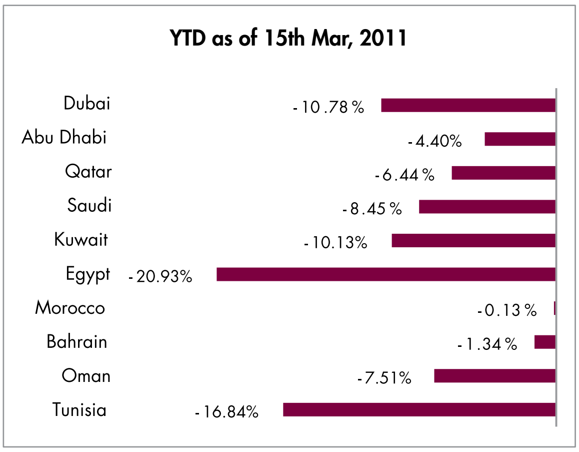
2010 was the year where the strongest market performance was registered by Qatar and the North African markets of Tunisia and Egypt. However, given the above mentioned elevated macro risks; both Tunisia and Egypt have been major laggards this year and all of the MENA markets to a certain degree have sold off given the heightened macro risk levels prevalent within the region.

Fig 4 a



Source: Bloomberg

Fig 4 b



Source: Bloomberg

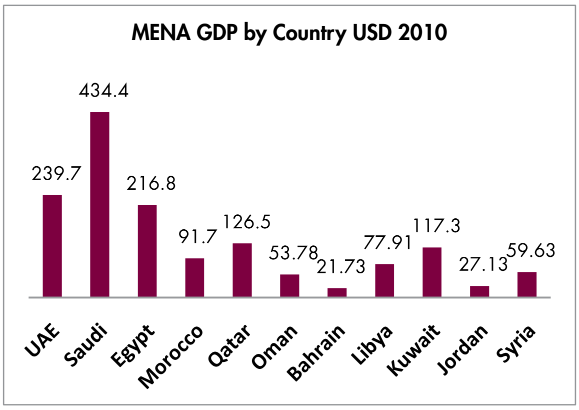
Distinction to be made between crude importers and crude exporters

GCC more correlated with Asia rather than oil

Putting Egypt into Context

As mentioned above Egypt is the only MENA market in the MXEM index; it is the third largest GDP producing country after Saudi Arabia and the UAE. It also has one of the most developed capital markets in the region, and has the highest debt as a percentage of GDP at 80% within MENA.

Fig 5



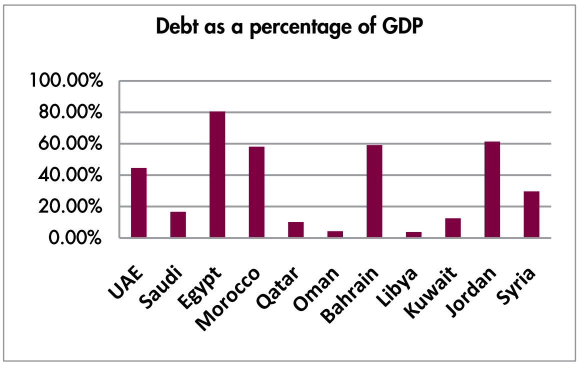
Source: Zawya and CIA factbook

Fig 6

Country	Stock Market Capitalization (As of Mar 15, 2011)
Saudi Arabia	$326 Billion
Kuwait	$117 Billion
Qatar	$114 Billion
UAE	$124 Billion
Morocco	$70 Billion
Egypt	$66 Billion

Source: As of Mar 15th, Daman Estimates and Bloomberg

Fig 7



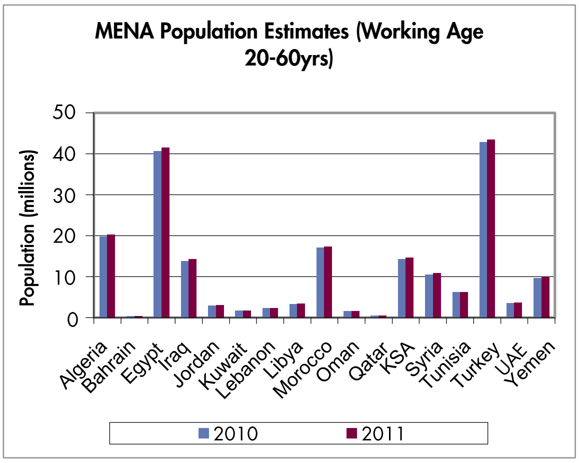
Source: Daman Estimates and Bloomberg

It is no surprise then that the ruptures in Egypt's capital markets are causing major dislocations in the broader MENA Markets.

Demographics: Dividend or Curse

It has become an investing maxim to assume that strong demographics are unequivocally good for a country. However, recent events have shown that if adequate jobs growth and a certain standard of living is not obtained for the working population; they can become disaffected and a powerful force for change in society. Outside of Egypt, Saudi Arabia has the largest employable population of the main MENA markets. The Saudi government is acutely aware of this and is thus engaging in government spending on truly epic proportions buoyed by the burgeoning current account surplus. In a carefully orchestrated move king Abdullah upon his return from abroad after a 3 month period of convalescence at the beginning of the month began distributing $37billion in social benefits. Housing is an acute problem and part of the fund is being used to help Saudis obtain housing loans; in addition to the expediting of the much delayed mortgage law. The Saudi government has been waxing lyrical about the period of prosperity under King Abdullah, for example one of the statistics quoted regularly is the fact that under his reign the number of industrial cities has doubled within the kingdom. With the implication being that Saudi economic prosperity is at the heart of the current regime. To a certain extent, this is the scenario that is playing out throughout the MENA/GCC region.

Fig 8



Source: Daman Estimates and CIA Factbook

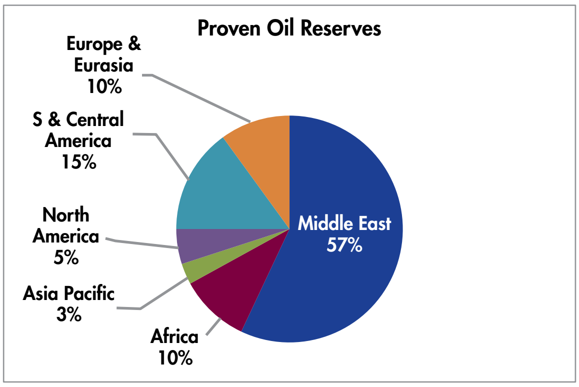
Egypt only Arab country in Morgan Stanley emerging markets index

Saudi engaging in government spending on truly epic proportions

The Winners of the Hydrocarbon Lottery-GCC

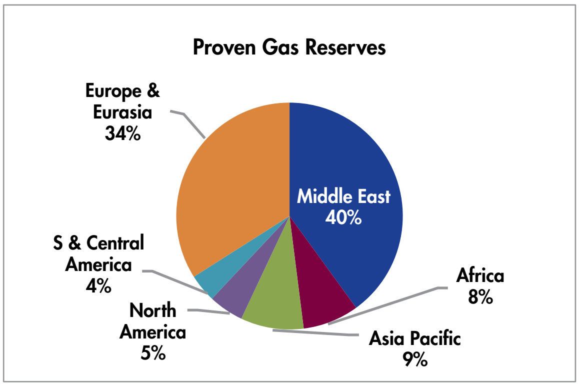
The Middle East owes its providence to being the most bountifully blessed region in the world with respect to proven oil and gas reserves, it comprises of 57% of all proven oil reserves and 40% of proven gas reserves.

Fig 9 a



Source: Daman Estimates and CIA Factbook

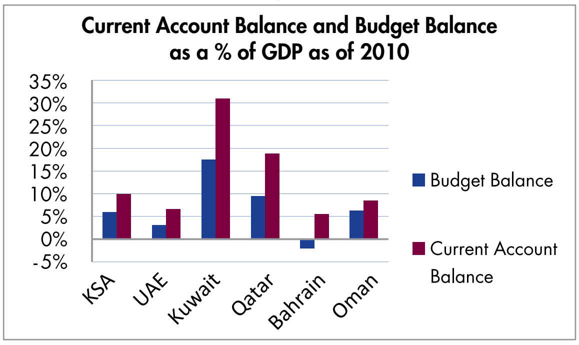
Fig 9 b



Source: Daman Estimates and CIA Factbook

Within the region it is clearly the GCC countries that control the bulk of these reserves.

Fig 10



Source: Daman Estimates and CIA Factbook

From figure 10 the distinction between Bahrain and the rest of the GCC countries becomes readily apparent that Bahrain was the only country to run a budgetary deficient during 2010 with the rest of the GCC countries running twin surpluses of both the Budget and Current accounts. The strong current and fiscal account surpluses are reflected in the sovereign credit rating of the GCC countries which are all investment grade in contrast to the North African markets of Egypt and Morocco which are clearly weaker.

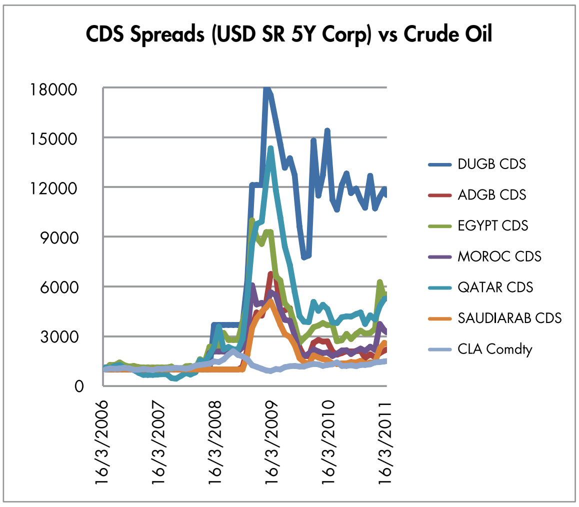
Fig 11

Sovereign Ratings		
Country	**Foreign Currency Ratings**	**Local Currency Ratings**
UAE*	AA/Stable/A-1+	AA/Stable/A-1+
Saudi Arabia*	AA-/Stable/A-1+	AA-/Stable/A-1+
Kuwait*	AA-/Stable/A-1+	AA-/Stable/A-1+
Qatar*	AA/Stable/A-1+	A/Stable/A-1+
Oman*	A/Stable/A-1	A/Stable/A-1
Bahrain	BBB/Neg/A-3	BBB/Neg/A-3
Egypt	BB/Neg/B	BB+/Neg/B
Morocco	BBB-/Stable/A-3	BBB/Stable/A-2

**Net Oil Exporters*

Source: Fitch, Moody's,

Fig 12



Source: Bloomberg

The recent tumultuous events have inflated the CDS spreads throughout the MENA region. With the biggest spikes clearly being in the Tunisian and Egyptian markets in contrast to the elevated levels of Dubai which have barely moved.

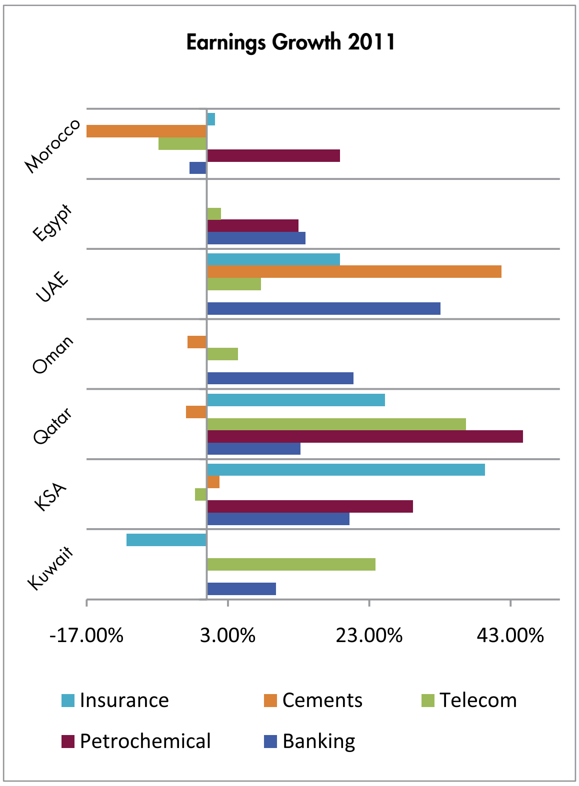
CDS spreads still remain at elevated levels

Bahrain only country to run a budgetary deficit in 2010

Strong Valuation Case

The UAE market stands out within the broader MENA Region as having the cheapest valuations multiples; the Egyptian multiples have contracted given the recent market related sell off. From a sectorial perspective, the UAE banking sector is set to show amongst the strongest earnings trends throughout 2011. Petrochemicals in Qatar and Saudi, and telcos in both Kuwait and Qatar are set to show strong double digit earnings growth.

Fig 13



Source: Daman Estimates

Banking Sector Highlight					
Country	**NII YOY**	**Profit YOY**	**Loans YOY**	**Deposits YOY**	**CDS bps**
Oman	7%	21%	9%	15%	N/A
Qatar	14%	13%	22%	22%	106.6
UAE	7%	33%	9%	10%	444.5/107.2 Dubai/Abu Dhabi
Kuwait	5%	10%	9%	9%	N/A
KSA	8%	20%	11%	9%	119.7
Egypt	8%	11%	23.3%	10.7%	422.4
Morocco	10.4%	11%	16.6%	4.4%	213

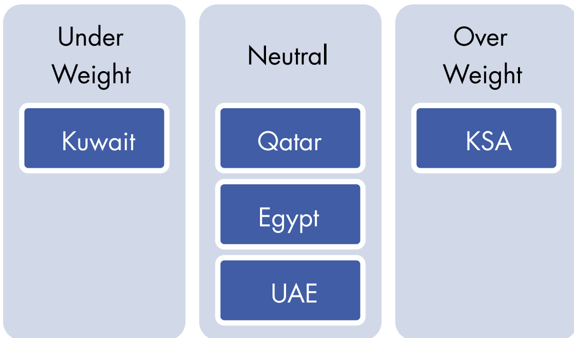
Source: Daman Estimates

Portfolio Asset Allocation

Asset Allocation	Aggressive Suggested %	Balanced Suggested %
Equity	70%	50%
Fixed Income	20%	40%
Cash	10%	10%

Given the recent market selloff, we would be aggressively weighting our asset allocation towards equities for a short term tactical perspective of 3-6 months and moving to a more balanced allocation from a long term perspective.

Portfolio Country and Sector Allocation



Kuwait: Despite the recent economic stimulus plan, lots of structural problems remain

Qatar: Continued double-digit growth, given recent sell off valuations are becoming more attractive

Egypt: Threat of currency depreciation and further political destabilization

UAE: Despite the slow recovery, Low valuation will attract long term investors

KSA: Largest government expenditures & excess reserves

Aggressive tactical overweight in equities for the next 3-6 months

UAE has the cheapest valuation multiples

Saudi biggest overweight with sectoral overweights in building & construction, logistics, petrochemicals and banking

Neutral

- Telecom
- Real Estate
- Cement

Over Weight

- Building & Construction
- Shipping & Logistics
- Banking
- Petrochemicals

Cement: High Dividend yield

Telecom: Defensive that benefits from organic growth and supportive demographics

Real Estate: More damage to come and slow to recover, yet value will be the main driver

Building & Construction: Benefits from the expansionary fiscal policy and the huge spending on infrastructure projects

Shipping & Logistics: Favorable supply demand dynamics and a play on global trade

Banking: First beneficiary from GDP growth and well capitalized to weather possible credit shocks

Petrochemicals: Despite an expected oversupply, oil will provide the necessary hedge

Political uncertainty has become a major factor to be considered when appraising investment opportunities within the MENA region and will remain so for both the short and medium term. However, given the strong economic factors of the GCC coupled with a strong valuation case we are advocating a strong overweight in Saudi Arabia, however we are cognisant of the fact that the Saudi stock market will be volatile in the near term and our suggested investment strategy in Saudi Arabia is biased towards sectors with solid long run growth prospects, and a play on the Saudi domestic market with strong fundamentals. Our sectorial overweights are banking-Saudi banks have minimal exposure to other GCC markets, Telcos, consumer, and Petrochemicals, and would be neutral on Saudi Real Estate until the Saudi mortgage law is fully promulgated.