# Middle East - The Reform and Index Upgrade Story

## April 2019

On 1st December 2017 we wrote a thought piece entitled "Is this the Riyal Deal?" on the potential for a sustained market friendly reform process in Saudi Arabia following the clarification of political secession and the subsequent announcements of the Saudi Vision 2030 and the National Transformation Plan. The stated goal of these changes was to reduce the Saudi economy's reliance on oil by enabling the non-oil economy to grow through reforms to the economic and social structures within the country. Needless to say we were very optimistic at the end of 2017 and the subsequent stock market performance numbers have justified our optimism so far:

### EQUITY MARKET PERFORMANCE
### 1st DECEMBER 2017 to 31st MARCH 2019

| | USD | EUR |
|---|---|---|
| **Saudi Tadawul** | **22.04%** | **30.75%** |
| S&P 500 | 6.01% | 13.58% |
| MSCI EM | -8.66% | -2.14% |
| MSCI FM | -14.02% | -7.89% |

Source: Bloomberg, as at 31 March 2019

Whilst the economic and stock market reforms have continued at pace in Saudi Arabia, there are very significant positive events going on in the rest of the region as well, specifically in Kuwait which we will also examine in this report.

Starting with Saudi, we will examine both the impact of economic reforms, and the impact of associated stock market reforms and their potential to continue to drive stock market performance.

Saudi has, for the last 18 months, gone through some of the most radical economic and cultural reforms in the country's history. I think we can safely say that three years ago the overwhelming majority of Saudi citizens would not have forecast (or even dreamt in most cases) that three years later women would be able to drive, men and women would be eating at the same restaurant tables, cinemas would exist and foreign workers would be leaving in their millions. From the depths of the oil price fall in 2015, the Saudi budget deficit has been cut to below 5% of GDP from above 15%, with a reduction in subsidies such as fuel and electricity and reduced expense allowances for government workers leading the way. With very low government debt levels and a now strong oil price environment the budget deficit can be taken back into balance in a controlled manner and the focus can be returned to economic growth.

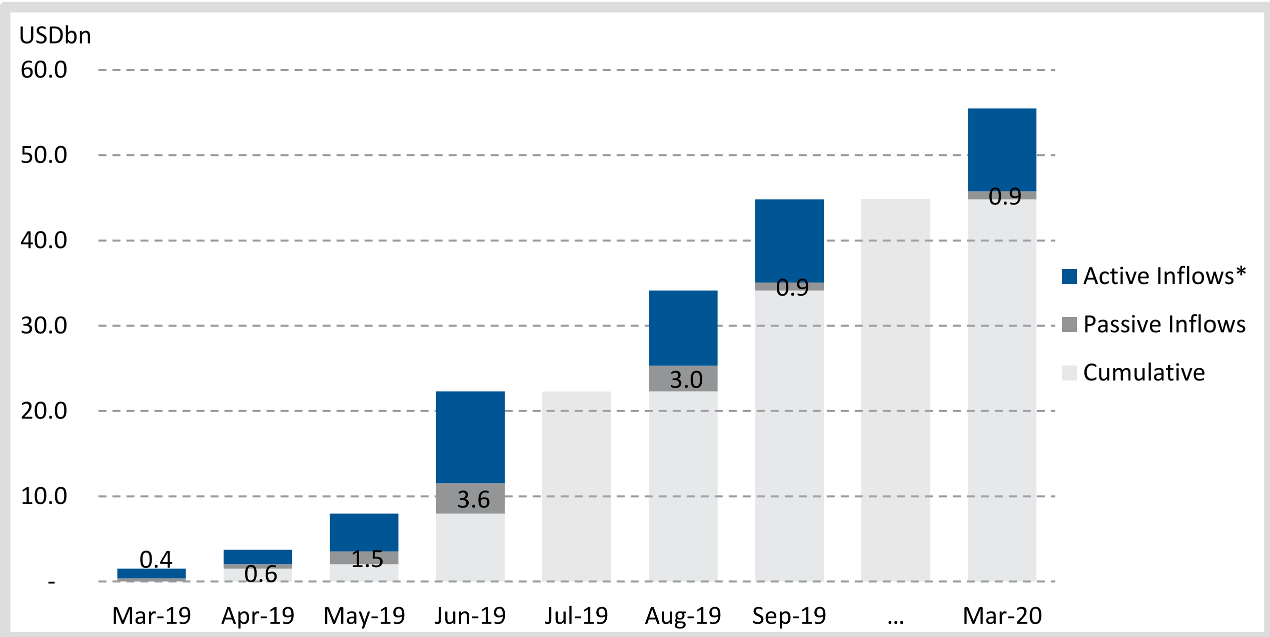
Any major economic reform process will create severe economic dislocations in the short term, the key is having the political will and power to see them through and therefore propel the economy into the upswing of the J –curve. The impact of 1.5 million expats leaving the country has certainly caused many consumer companies to suffer, particularly those that cater to the less affluent parts of the population, but this "Saudization" has resulted in huge market share gains for the strongest companies in their sectors. Healthcare companies are benefiting from a government push to increase private participation in the industry, entertainment and leisure companies are enjoying much greater cultural freedoms (we have invested in the largest private gym company in Saudi) and insurance companies look set to benefit from both the proposed enforcement of mandatory motor insurance and the move towards private medical cover.

In the banking sector we have witnessed very low or non-existent loan growth for the last three years, due both to an uncertain outlook for corporates (imposition of VAT, anti-corruption process, removal of subsidies and impact on disposable incomes) and a lack of government capital spending due to the focus on other more urgent reforms. We now expect banking loan growth to accelerate over the next two years as companies become confident in the new economic environment. For example, the Purchasing Managers' Index, a gauge of the performance of the non-oil private sector, rose to its highest level in more than a year in January 2019, reflecting rising output and new orders. More tellingly, business optimism about future output was the highest in more than five years. In addition we believe the government will start to actually develop many of the proposed major infrastructure projects (airports, railway lines, roads, tourist resorts, both religious and entertainment), and the rapid growth of the nascent mortgage and consumer lending markets will start to become significant.

The fourth quarter of 2018 showed the first tangible signs of these economic policies as GDP grew by 3.6% versus the fourth quarter of 2017(the quarter most impacted by economic change) and credit growth to the private sector started to rise after two years of stagnation. To highlight the change in economic behaviour of the consumer due largely to the cultural reforms, point of sale transaction numbers in the restaurant and hotel sector increased by 68% in February 2019 versus February 2018!

To add to the economic story in Saudi, one of the key pillars of the National Transformation programme has been reform of the Saudi stock market. The result of the progress being made regarding foreign ownership allowance, settlement cycles and custody requirements all being elevated to international market norms is that Saudi has been upgraded by both FTSE and MSCI to Emerging Market status. The actual inclusion into these indices is ongoing. The following chart shows the expected inflows into the market this year.

### FTSE AND MSCI ACTIVE/PASSIVE INFOWS (e) (USDbn)




*The forecasts are based on analyst reports by Goldman Sachs on average "Possible Inclusion of the MSCI Emerging Market Index: What to Expect on June 20" and JP Morgan "Saudi Arabia Upgrade to EM".

Source: Citi Bank as at 12 Jan 2018

To put these numbers into perspective, the whole equity market currently trades around USD750m per day. Foreign portfolio holdings currently total only 2% of the market (around USD10bn), way below the next least owned Emerging Market, Qatar, with 8.2% foreign ownership. With Saudi's elevation directly from stand-alone status to EM index inclusion, and with the recent changes to foreign ownership laws, in our 30 years of emerging market experience, we cannot recall such a large, liquid stock market being so under owned by foreign investors.

Moving on to another very exciting inflow story, Kuwait was upgraded by FTSE to Emerging Market status last year and we are very confident that MSCI will follow suit in June this year, for implementation in June 2020.

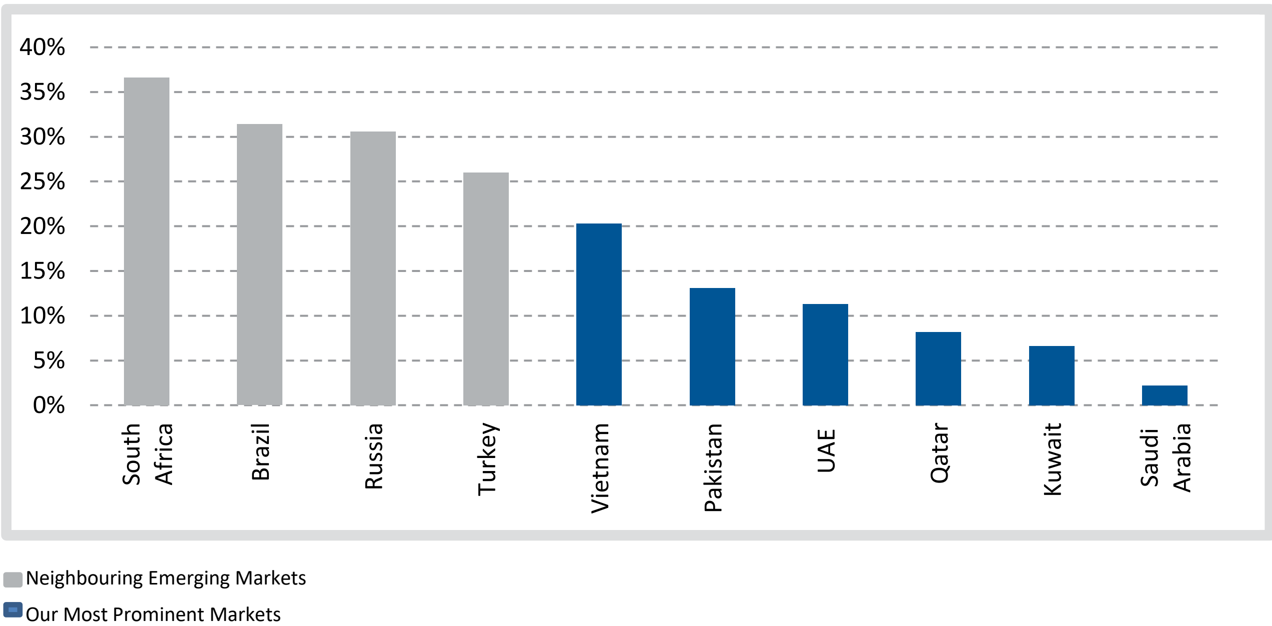
Kuwait, with a GDP per capita of above USD60,000, only falls into the Frontier markets classification due to its historically poor stock market infrastructure. The past year has seen substantial improvements and a strong convergence with international standards, certainly enough to meet MSCI Emerging Market requirements. As we have mentioned many times, Index upgrades alone are no guarantee of stock market performance, they need to be backed up by reform processes that will provide the hook for international investors to consider the country a worthwhile investment destination. Kuwait has a long history of government induced inertia as characterised by the quality of its infrastructure being inferior to many of its less affluent peers in the region.

Recent research trips to the 'Kingdom' have indicated that the political landscape is becoming more conducive to a rise in investment spending, supported by improving private sector credit dynamics among other factors. Credit growth reached 5% year on year in January of this year, the fastest growth in over two years, lifted in particular by stronger business credit uptake. We expect the non-oil sector will lead overall growth, expanding by 3% this year supported by better liquidity and improved sentiment, but as ever this hinges on the many infrastructure projects at the bid stage being actually tendered, something that we will be monitoring very closely. Underpinning this will be a further recovery in consumption, supported by low inflation and steady job gains which provide further encouragement for private investment.

Put in a reasonably volatile Emerging Market context, Kuwait offers one of the most stable technical and macro opportunities globally. A very stable macro outlook, backed by cheap stock valuations, with a strong earnings growth outlook and very low current foreign ownership of the stock market with significant inflow potential on MSCI EM inclusion provide a compelling investment case.

Focusing on the Index technical aspects, this May, Argentina will be upgraded from Frontier to EM status lifting Kuwait's weight in the MSCI Frontier Markets Index from 23% to 28%, while the expected merger between AUB and KFH would lift it further to around 31%. This could provide a significant tailwind to the MSCI upgrade trade. The chart below puts Kuwait foreign ownership in the context of some of the larger Emerging Markets, but also highlights the very low foreign ownership of the MENA region by including the Qatar and UAE stock markets.

### FOREIGN OWNERSHIP LEVELS




Source: Fiera Capital as at 31 March 2019

We estimate that Kuwait will be 0.57% of the MSCI Emerging Market Index post inclusion, driving around USD2.4bn of passive inflows to the market. Extrapolating the Saudi numbers to account for expected “active” money as well, gives a total inflow number of around USD10bn for Kuwait, in a market where turnover averages about USD80m a day.

## Conclusion

As fundamental bottom up investors we are looking to invest in companies with strong corporate governance, quality management, strong top and bottom line growth, attractive cash-flows and solid balance sheets. Companies are more likely to be able to generate strong top line growth in countries where GDP growth is strong, and strong economic growth correlates very closely with strong reform processes.

Index reclassifications are a natural outcome of these reform processes and provide the opportunity for stocks in Frontier markets to rerate to the more expensive Emerging Market valuation range. Combined with low foreign ownership in these equity markets, Kuwait and Saudi are currently providing us with the most attractive opportunities in our global frontier universe and account for 75% portfolio weight of our MENA strategy and 40% of our Global Frontiers strategy.

**Dominic Bokor-Ingram, Co-Portfolio Manager**
**Frontier and MENA strategies**

**April 2019**

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