

RANDOM WALK

After consecutive years of dramatic market returns, the major markets in the Middle East stand where they began 24 months ago. A giddy sense of euphoria in 2005 and abject despair in 2006 were extra bonuses for investors who came along for the ride.

Table 1: Regional Stock Market Returns

Market Return	FY2004	FY2005	FY2006
Abu Dhabi	75%	69%	-42%
Dubai	152%	195%	-44%
Qatar	65%	70%	-35%
Oman	24%	44%	14%
Saudi Arabia	85%	104%	-53%
Bahrain	33%	24%	1%
Kuwait	38%	79%	-13%

Judging by the growth in activity across all markets during this period, the numbers of passengers on this ride has been significant.

Table 2: Trading Activity in Regional Markets

Value Traded (USD in bn)	FY2004	FY2005	FY2006
UAE	18	139	114
Qatar	6	28	21
Oman	2	3	2
Saudi Arabia	473	1,104	1,403
Bahrain	0	1	1
Kuwait	53	100	62
Total	553	1,374	1,603

Source: ADASM, DFM, DSM, MSM, Tadawul, KWSE, BHSE

Effectively, investors have precious little to show for 2 years of investment. While there have been plenty of explanations put forth as to why the markets crashed (50% is not a correction - time to call a spade a spade!) in 2006, after going into overdrive a year earlier.

Table 3: Capital Calls in the Region

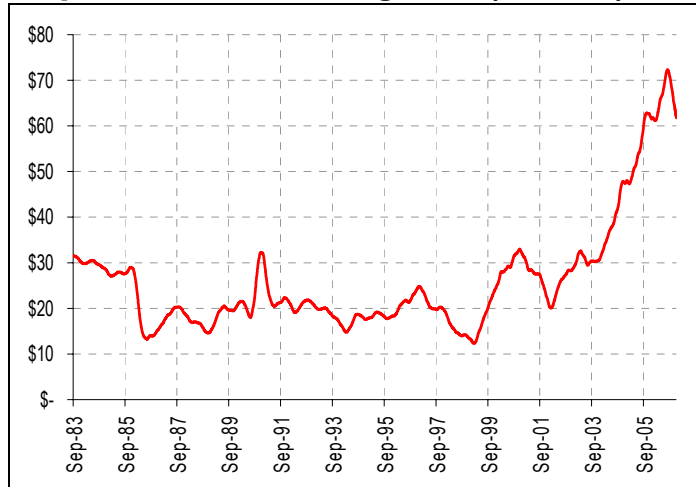
(USD in mn)	FY2004	FY2005	FY2006
UAE	758	10,374	3,556
Qatar	-	4,786	4,137
Oman	67	824	84
Saudi Arabia	347	221	1,230
Bahrain	708	3702	7,278
Kuwait	400	2,249	5,349
Total	2,280	22,157	21,634

Source: Zawya

So, while markets were rising rapidly, companies were net sellers-both in the primary and secondary markets. The belief here is that this extra supply acted as the catalyst that unraveled the whole upward spiral.

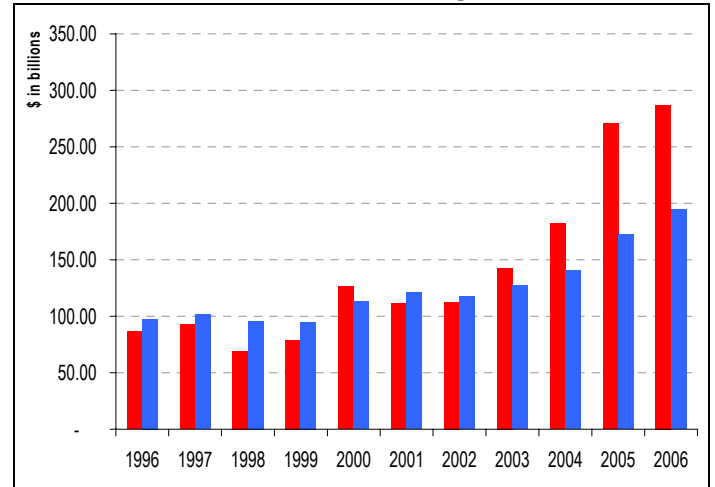
The perspective here is that though it is useful to dissect the last couple of years, what is much more useful, and indeed should prove rewarding, in forming an investment strategy for 2007. However, it is not possible to do so without first understanding fully the dynamics of the bull market in the Middle East over the past few years, and the subsequent pull back (one crash per newsletter only).

Graph I: WTI Brent Closing Price (USD/Bbl)



Source: Energy Information Administration

GRAPH 2: GCC Revenues & Expenditures

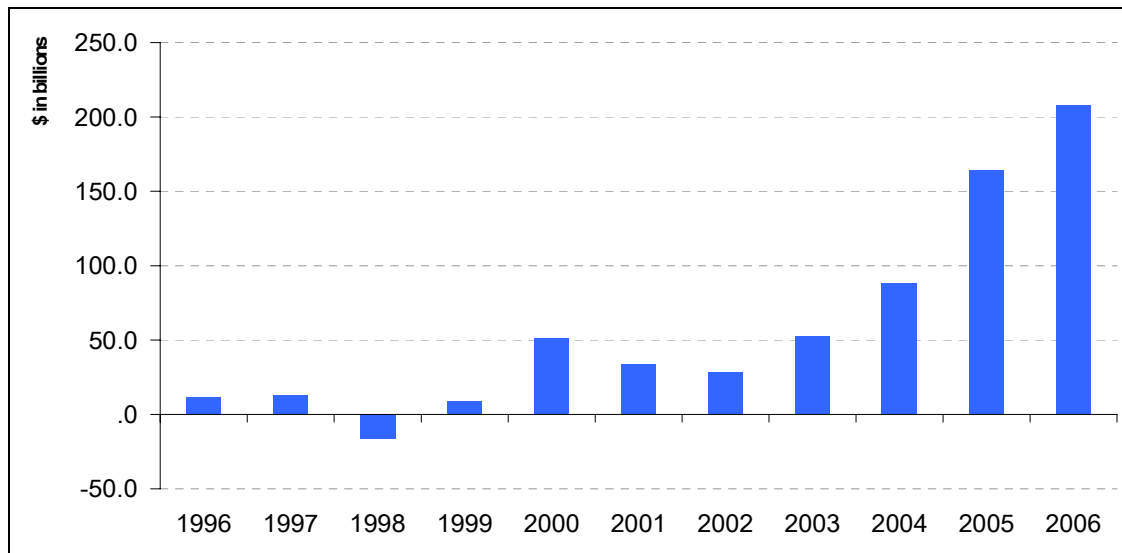


Source: Business Monitor International, IMF

The primary driver has clearly been firm oil prices, which in turn have boosted government revenues and spending, as shown above.

The swing has been decisive, with the Gulf Cooperation Council (GCC) states running substantial surpluses from 2003 onwards, after years of persistent deficits.

GRAPH 3: GCC Current Account Balance



Source: Business Monitor International, IMF

Clearly, the one major driver for the region has been higher oil prices. Significantly higher oil revenues have provided fiscal space to regional governments (primarily Saudi Arabia) to cut domestic public debt, and increase spending, without crowding out the private sector. This is quite evident from the rapid increase in private sector credit in the region, as participants in the economy

have geared up to execute government spending plans. While it is true that fiscal discipline across the board has been impressive, government spending has continued to underpin higher economic growth.

Most GCC countries have ample room to maintain current spending without going into deficit even if oil prices weaken substantially from the current mid 50s (WTI Brent). The interesting bit is the medium term outlook for oil prices, given the investment boom in the sector over the past few years. The lead time for energy sector investment is fairly long (a modern oil refinery takes anywhere from 5 years or longer to become fully operational, depending on configuration details) and we are now approaching the period when some additional capacity is likely to start coming on stream over the next couple of years.

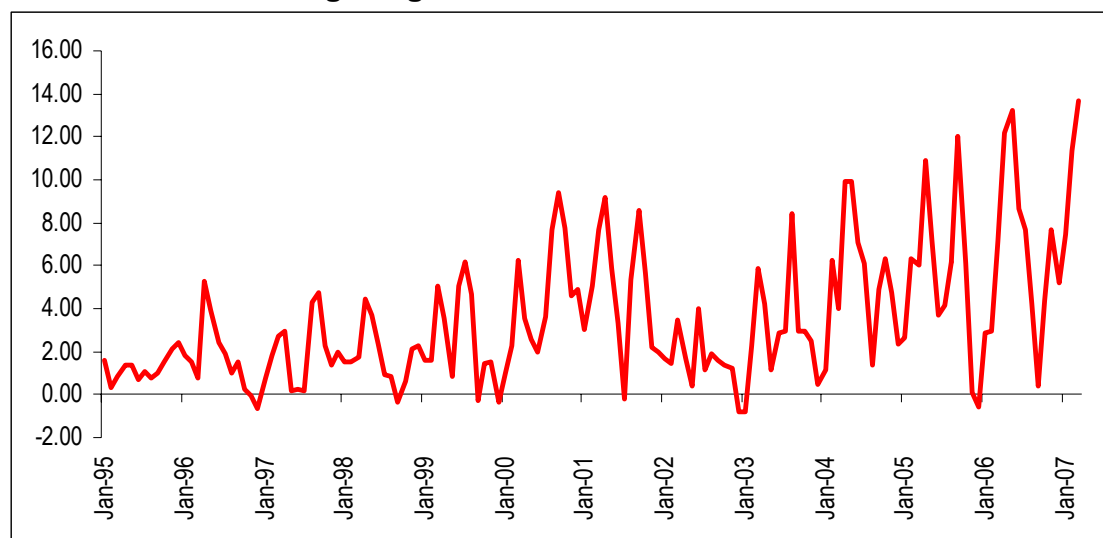
Table 4: Oil & Gas Investment in the Region

Country	No. of Projects	Value of Projects (USD in bn)
Kuwait	19	14.04
Saudi Arabia	70	91.97
UAE	30	31.81
Oman	18	12.73
Bahrain	1	0.30
Qatar	25	25.10
Total	163	175.95

Source Zawya

The belief here is that oil prices generally have moved sharply in response to supply shocks, rather than demand. A case in point is when oil prices hit bottom around 1998, at a time when the global economy was doing very well, and demand growth had been robust. The current oil bull market has been on a slow boil for several years principally because of a rapid slowdown in energy sector investment resulting in a tight supply situation eventually. A case in point is the strength of refining margins in the recent past, indicative of bottlenecks in the supply chain.

Table 5: Gross Refining Margins



Source: Energy Information Administration
Based on ANS USWC (Cracking)

As the supply situation eases with the commissioning of incremental capacity in the supply chain, the base case here is that oil prices are perhaps well poised to stabilizing at current levels over the medium term. However, some domestic issues in major producers like Kuwait and Iran may result in a deteriorating fiscal situation. Kuwait in the past has demonstrated a tendency to try and address domestic challenges by loosening fiscal discipline (case in point being the KWD200 handed out to every Kuwaiti

recently; the predominance of current expenditures in the Kuwait budget also limits fiscal space). Going forward, there is a fair probability of economic growth tapering off from the torrid pace of the past few years.

This brings us to the most interesting bit-wither capital markets from this point on?

2007 and beyond

One of the enduring mysteries of the past year has been the severe beating taken by almost all markets, in the backdrop of still strong economic performance. What happened?

Actually, this is more or less par for the course-the correlation between economic performance and stock market returns is close to zero, using the data for the USA over the past 50 years. Hence the mystery is a non starter after all, as the historic record clearly indicates that such a relationship does not exist in the short run. On to earnings then-how come the markets fell sharply while earnings were still growing?

The correlation between the annual change in earnings of the S&P500 index and its annual return is zero! The relationship only becomes statistically significant and hence meaningful over longer periods of time, say 5 years or beyond.

If earnings don't matter in the short run and neither does the economy, then what drives market returns? The answer is investor risk appetite, or the willingness to assume risk. The higher the risk appetite, the higher the valuations assigned to any particular stock, sector, market, or even region. Risk appetite is the single biggest determinant of short term market performance, since it can shift quite dramatically over a short period of time. Changing investor willingness to assume risk, and nothing else, explains the phenomenon of stocks in the region falling more than 50% while earnings have been strong, the region's economy has continued to do well, and the outlook still remains bright.

Table 5: Peak and Current Regional Valuations

GCC Markets	Peak PER (x)	Current PER (x)
Kuwait	14.3x	13.9x
Saudi Arabia	44.2x	15.9x
UAE	31.8x	12.7x
Oman	14.4x	11.3x
Bahrain	14.4x	10.2x
Qatar	33.4x	12.1x

Source: Bloomberg

It is more difficult to find out the reasons behind the decrease in risk appetite for regional equities. The prime suspect would appear to be the abundant use of leverage by market participants. Simply, 10% of X is half the size of 10% of 2X. For a leveraged stock bubble to keep bubbling, the requirement of leverage increases exponentially. Hence such a mechanism is unsustainable by definition, and is prone to imploding. And implode it did. Investor sentiment and short term market returns form a feedback loop, reinforcing each other in a rapidly progressing bull market, and working in the opposite direction in a bear market. This is the precise reason why markets historically overshoot on both the upside and the downside.

Historically, most major bear markets tend to take anywhere from 2 to 4 years to play out. The current phase is only one year old in the region. Any debate about the ultimate level of the bottom is superfluous and irrelevant as the only relevant variable for investors (and by extension, investment managers!) is valuation. Investors need to perceive that stocks (or markets, or regions, or asset classes) are priced to deliver attractive returns relative to the perceived risk. Here, there is value available regionally in pockets, particularly in businesses that are likely to continue benefiting from the dynamics of economic growth regionally. Elsewhere, there are still stocks that sell at expensive valuations, where the mistake of extrapolating past performance is likely to prove extremely costly.

Picks

The easy trade is now finally over. It will no longer pay to merely capture beta (up to 2005) or to avoid it (2006). Thankfully, for professional money managers (RW included), 2007 and beyond is almost guaranteed to be marked by a market environment quite unique in a regional context-one where in-depth analysis not only adds value, but is the only alpha generator. Truly, this is the year when the tide goes out and we shall find out how different players in the market are attired.

Across the region, the macro theme is still the same, with slowing but still robust economic growth, driven by ongoing fiscal stimulus. The coming year and beyond will witness a maturing of the economic expansion, as past rates of growth (both real, and more importantly for equities, nominal) are not sustainable indefinitely.

Random Walk is of the view that the current economic expansion has progressed enough to merit a slightly more cautious stance (only in terms of sector focus, equities are not suitable for the faint of heart in any case) by leaning towards higher margin, less commodity like businesses. This clearly implies a preference for higher value added players in the real estate sector-an Emaar, or an OCI is preferable to an Arab Tec for example.

Extending this note of caution a bit further, RW also favors businesses that have a certain degree of diversification, and scale. Scale is important, since the GCC and the Middle East is composed of several countries which lack sizeable domestic populations. Hence, domestic demand, one of the strongest themes in emerging markets elsewhere, is difficult to find in the region. This is where Saudi Arabia and Egypt stand out. Saudi Arabia is an even more interesting story, as not only does it have a relatively large population in a regional context, but also has businesses that are either expanding their reach regionally or are poised to do so. A great example is Al Marai, which is a good proxy on growing domestic populations, improving standards of living, and regional expansion, all for the price of one.

Regional expansion is another strong emerging theme, so far most evident in the Telecom and Banking sectors. However, there is no reason why other sectors will not join in, as the absence of scale for most domestic players makes such an expansion a necessity. Here companies with the most cost strategy will benefit, as past experience in other regions has shown that it is easy to pay uneconomical prices for acquisitions. The recent award of the third Saudi Mobile license is a case in point. At a price tag of USD 6.1 bn for the license itself, it will take some doing for the MTC led consortium to earn attractive returns on their Saudi operations. Assuming that the MTC led group will make attractive returns at the price paid, then Etihad Etisalat appears to offer much better value-the price tag for the third license and capex of at least USD 1 bn to be up and running accounts for 92% of the current stock price of SAR 59. With less than 10% of the stock's current market price attributable to a rapidly growing business, Etihad Etisalat appears to offer ample room for outperforming the market. Among established players, Orascom Telecom has hit upon a winning formula with the focus on its core markets; unless things go dramatically wrong in some of its markets, with the company expected to turn free cash flow positive this year, the strength in EBITDA numbers seen recently will start flowing through to the bottom line as well.

A gradual softening in the Real Estate sector in Dubai seems the odds on medium term outcome at the moment. This does not imply that there is no speculative activity in the sector, for there is plenty of it. However, the major underpinning factor is the rapid growth in the region's population. As long as the current growth phase continues, real estate valuations will have a floor.

Elsewhere, including adjoining markets like Abu Dhabi, potential demand still appears well ahead of current supply, and the sector should continue to do well. However, the replication of the past performance of Emaar by players based elsewhere in the region is unlikely, primarily as the scale of projects announced (and being implemented) by new players is very big, and most of the benefits (but not all of the risks) are already discounted in prices. Due to the outlook for Real Estate in Dubai, mortgage financiers appear vulnerable, and a large valuation discrepancy between the current players suggests that Amlaak is likely to under perform, barring a change in its ownership. Regionally, Orascom Hotels and Developers has a good value accretive model, which over time should benefit from the trends of population growth and improving living standards.

In the banking sector, Islamic banks appear attractive, though competition is likely to increase many fold in the very near future. At present it is more of a land grab phase, with existing players (with a clear strategy) scrambling to grow rapidly in order to combat the rapid rise in competition. Among this segment, DIB has shown the most promise in terms of progressing on a high growth trajectory, and is likely to remain a major player in the future, more competitive landscape as well.

Longer term, it is important to have exposure to proxies for economic growth in a regional portfolio. Here Random Walk favors business enablers (logistics providers like Agility), and suppliers to business consumers (Saudi Research & Marketing Group, Jarir). Well managed companies in this particular space are poised to do well for a number of years as business activity remains strong in the region.

One note about the bigger markets in the region. Saudi Arabia has rallied off its recent lows, and there is talk of a significant rebound this year. Broadly, the market is still not cheap, banking stocks are still expensive, and speculative stocks still dominate

trading volumes (generally). RW believes that the most tell tale sign of a sustainable bottom for the Saudi Market will be a gradual decline in liquidity in the speculative stocks in the Saudi markets, though the absence of this factor will not preclude investment in fundamentally sound counters at the right valuation.

Caveats

The regional political situation regarding Iran is threatening to spiral out of control. The rhetoric on both sides continues to get more aggressive, and the danger of this escalating into an armed conflict is quite real. However the precedent of North Korea provides some comfort, where a lot of saber rattling ultimately only resulted in a peaceful resolution (as of now).

Logically, it would appear that given the recent US experience in Iraq (a country much more ethnically fragmented than Iran) a similar misadventure in Iran is unlikely. Contrary to the situation in Iraq where rival groups (ethnic, religious and political) are vying for supremacy and control, any conflict with Iran will be much more clear cut and hence potentially more problematic for the aggressor. The view here is that a conflict will be avoided, though the situation is likely to get a bit worse before settling down. As of now, no impact of such a strike is being accounted for in the investment view being propagated here.

Final Note

Overall, 2007 is shaping up to be a very interesting year. The big swings of the recent past are unlikely to be repeated, with fundamentals reigning supreme. Dispersion between the leaders and laggards this year will be extreme, with a well managed active portfolio likely to significantly outperform passive market portfolios. The tide is well and truly going out; RW will endeavor to remain dressed during the process.

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