RANDOM WALK

The Next 5 years

During the first half of the year, markets have been mixed. The MSCI Arabian Index rose 10.1% though to the end of June, marking a good first half for the region, at least on the surface.

However, a closer look highlights some curious divergences. First up, the rise in the index was not broad based.

	Number	Market Cap
Outperforming Stocks	**78**	**38.5%**
Underperforming Stocks	**96**	**61.5%**

The above highlights a point made here in the last issue, regarding the search for alpha as opposed to the earlier trend of merely capturing beta. Amongst the top 20 performers during the period, there are 2 members from the largest 20 companies in the region. Extending the analysis further, 7 of the 50 largest companies in the benchmark made it into the top 20 performers. Combined, these top 20 accounted for 84% of the increase in the regional MSCI Benchmark, but represent 12.8% of the market cap.

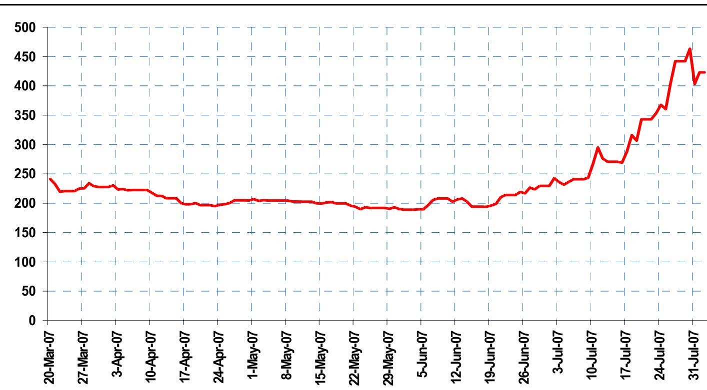
Market action during the first half of the year clearly points to a speculative element. Second, it also highlights the lack of ownership for the nascent rally. Hence it will not come as a surprise to see regional markets retrace the gains made during the first half.

The Great Unwind

Liquidity, over the last decade and a half, has supposedly been the underpinning of phenomena ranging from equity market returns, growth in the size of alternative investments, to the unprecedented boom in M&A activity across the globe. Various definitions of liquidity abound, perhaps the simplest is it measures the supply of capital. Hence, higher the supply of capital, higher the liquidity and vice versa. What follows from this simple explanation is that liquidity is also a function of the price of risk; the lower the price of risk, the higher the liquidity available, and crucially, vice versa. In recent weeks, credit markets have witnessed a sharp increase in the compensation for risk being demanded by providers of debt capital, with credit spreads widening sharply and US treasuries rallying.

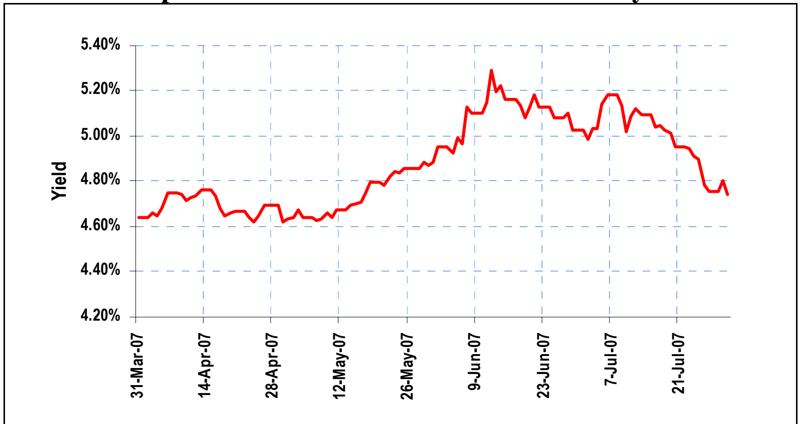
Graph 1: Crossover Index

iTraxx Crossover Index



Source: Bloomberg

Graph 2: 10 Year US Government bond yield



Source: Bloomberg

Any regional fallout of the ongoing market gyrations in the US and Europe (quite likely) represents a gigantic buying opportunity in the long term. The reason is two fold; aside from meeting the energy demand of the rest of the world, MENA has limited exposure to global growth (it primarily exports energy products, where demand has proven to be price inelastic). Also, the tightening of monetary conditions in the US lowers the probability of interest rate increases in the near future, with actual easing more than likely before rates ultimately head up. The regional economies will be beneficiaries of easier liquidity conditions, as governments will be able to ease in line with the US.

MENA economies as a whole are capital rich, and in an environment where capital supply tightens (and consequently returns on capital rise), the region should benefit. However, this only holds for the region as a whole, and for the providers of capital, and not consumers of the same. On a micro level, both at a market and corporate level, the situation will be different. Countries looking for investment from abroad (Egypt for example) will be negatively impacted, and will have to deliver more for investors than they have in the past. Capital available for corporates will also tighten, as the postponement of Dana Gas' sukuk issue already shows.

On a sector basis, the most obvious impact of a higher cost of capital has to be on real estate, which is perhaps most sensitive to interest rate movements, at par with financial services. As the cost of capital rises globally, the cost of capital for real estate players in the MENA region will also rise-capital is a fully fungible asset in today's integrated global financial system and risk adjusted returns regionally will always be in line with risk adjusted returns available abroad. Real estate companies in the region still looking to raise capital (especially offshore) to fund projects may find it challenging to successfully close funding at prices prevailing earlier. Over time, the combination of costlier capital and emerging infrastructure bottlenecks will soften the hectic pace of real estate development in the region.

The rising cost of capital will tend to favor businesses which have demonstrated the ability to grow organically as opposed to buying growth via purchases, or expansions funded by fresh capital. This clearly is likely to result in a bit of a shift from recent history in the region, where commodity plays have ranked among the top performers. The MENA region is in the middle of a multi year structural bull market, and leadership of the bull-run shifting from cyclicals to domestic demand plays in the future is a natural evolution of the bull-run. The prime beneficiaries in the future will be sectors like housing (think developers with the right long term strategy), retailing (think consumer staples), business enablers (think office supplies, logistics), and media (think publishing, entertainment). Some stock picks among these sectors are Savola, Research and Marketing, Jarir Marketing, Olympic Group, Pachin, Aramex, Orascom Construction, Orascom Hotels, and Agility. Telecom operators with the correct strategy (in order to combat the price erosion that is inevitable) will also benefit (Orascom Telecom is a good example). Saudi

Arabia and Egypt look like the best placed markets, as they offer the maximum upside if the view expressed above is correct.

Taking a quick look at the last few years, the shift to domestic demand plays will represent a significant change in return patterns seen thus far. During the last 5 ½ years, equity markets in the MENA region have gone up 116.0%, at a CAGR of 18.7%. The return attribution over the period highlights the leadership of cyclicals (represented by Banks and Commodity Chemicals).

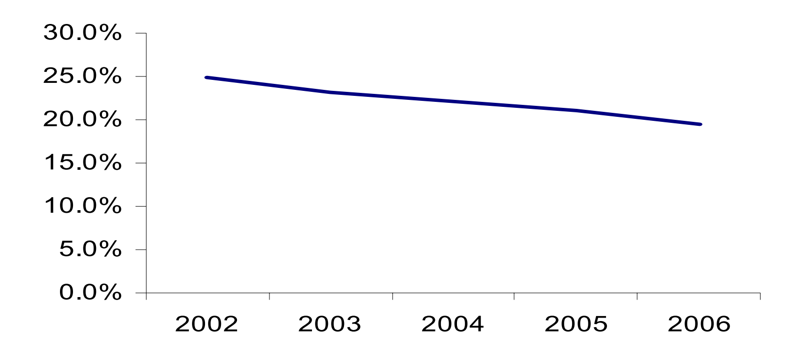
Sectors	Return attribution
Banks	39.6%
Commodity Chemicals	20.3%
Building Materials & Fixtures	6.8%
Real Estate Holding & Development	6.6%
Specialty Finance	6.2%
Fixed Line Telecommunications	5.5%
Investment Services	4.7%
Mobile Telecommunications	4.1%
Telecommunications Equipment	4.0%
Heavy Construction	2.9%
Food Products	2.4%
Transportation Services	2.1%
Electricity	1.6%
Diversified Industrials	1.5%
Steel	1.2%
Others	6.5%
Total	116.0%

A return attribution of the universe of listed stocks reveals that stocks in the petrochemicals sector (represented by Commodity Chemicals) were among the top return generators, despite being grossly under represented in the universe of listed securities (Hydrocarbon and related industries account for 40% of GDP, while representing only 15% of aggregate market capitalization). In effect, the stellar performance of commodity chemicals over the last 5 ½ years is under stated, as proportional representation in the capital markets would have resulted in even higher returns.

The under representation notwithstanding, returns have been spectacular-a portfolio of publicly listed MENA commodity stocks over the period would have earned an annualized return of 44.0%, beating even the returns from crude oil – a position in OPEC basket of crude oil would have generated 33.5% annually over the same period.

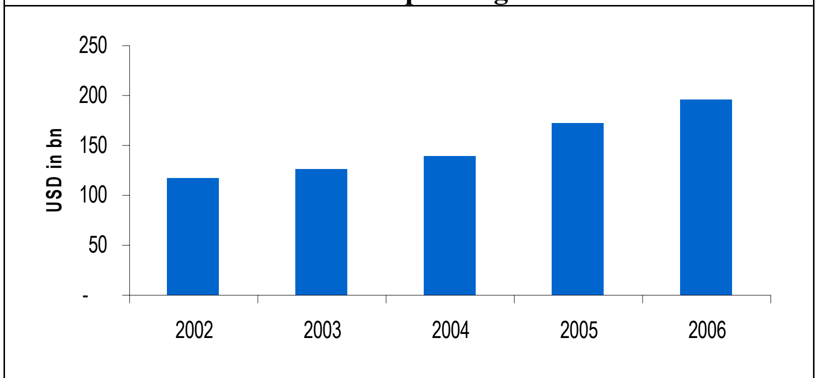
Unlike the last boom in oil prices, this time around governments in the hydrocarbon exporting nations of the Middle East have been judicious in spending this windfall. They have been paying down their domestic and external debt, increasing their education and healthcare spending and investing in infrastructure projects with the aim towards diversification away from hydrocarbon. This has resulted in crowding-in of the private sector at the time of increasing government spending. A corollary to this is employment creation both in the private as well as public sector.

Hydrocarbon exporter's stock of external debt % of GDP



Source: Economist Intelligence Unit

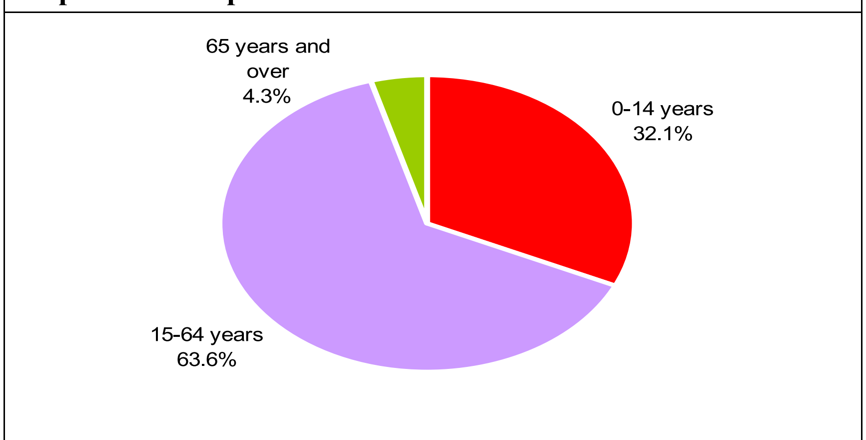
GCC countries Government Spending



Source: Business Monitor International

Going forward, over the next 3 – 5 years, the above ongoing structural changes and their impact on neighboring economies translate into higher disposable income, boosting domestic demand and private consumption. Domestic demand will further strengthen on the back of supportive demographic conditions in all countries in the region. With 32% of population below the age 15 years and both the government and private sector in expansionary mode, abundant employment opportunities will be created supporting disposable income level while giving boost to domestic demand.

Population composition in the MENA



Source: CIA

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Furthermore, hydrocarbon importing countries in the region are also benefiting from the structural transformation at their neighbors primarily through inward remittances. Countries like Egypt, Morocco, Jordan and Tunisia have historically been exporters of skilled and unskilled labor to their hydrocarbon rich neighbors. The huge influx of remittances has a positive impact both at the macro and the micro level of the receiving economy. The micro effect is more immediate, it results in higher stock of wealth which encourages increased consumption and results in an increase in domestic demand.

Over the last few years, capital markets in the region have discounted the rapid increase in earnings enjoyed by commodity producers and financial services. A similar pattern is unlikely to play out over the next market cycle.

Domestic demand plays are likely to be amongst the top performers over the next 5 years. The search for investment opportunities is not that simple. For starters, there are very few sizable direct plays on domestic demand. Firms operating in consumer discretionary, consumer staples and commercial services & supplies industries are ideal candidates. However, a quick search reveals that companies in these industries are on average small (less $100 in market capitalization) and largely illiquid. This leaves us with a fairly small investable universe. Luckily, some of the constituents of this investible universe have a regional footprint.

Conclusion

We believe the great unwind has commenced, globally. The era of cheap credit is coming to an end and the stellar returns enjoyed by asset classes benefiting from this easy supply are likely to mean revert. Being a capital and resource rich region, MENA is likely to benefit as global returns to capital rise.

Given supportive demographics and the current structural changes on the economic front, we expect domestic demand plays to be among the top performers in the next market cycle.

Real estate and commodity plays, some of the best performers in the last cycle, are likely to experience sub par returns over the same period.

Financial services however, will continue to perform well as a group due to their role of facilitators of capital mobility. However a slowdown in credit growth to more normal levels in the region (as well as globally) will perhaps result in weakness in the short term.

If we are correct in our view on the great unwind, the region is set for a period of sustained volatility, complete with furious counter trend market moves. Investors will be well advised to maintain a long term perspective during the ensuing mayhem, as trying to benefit from mere market noise in the short term can result in serious collateral damage. The tide has started to go out, and the beta trade is losing its luster across a variety of asset classes. Let the alpha hunt begin!

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