

RANDOM WALK

A new world order?

For once, the year has gone according to script. The region has sold off marginally, with wide dispersion between the best and worst performing markets.

Country	Index	YTD Change	Market Cap (USD mn)
MENA Region	MXARM Index	-6.38%	1,472,032
Oman	MSM 30 Index	25.30%	27,863
Abu Dhabi	ADSMI Index	8.80%	125,223
Dubai	DFMGI Index	-8.20%	103,777
Saudi Arabia	SASEIDX Index	-15.30%	474,244
Qatar	DSM Index	23.80%	141,701
Kuwait	KWSEIDX Index	23.10%	208,566
Bahrain	BHSEASI Index	3.80%	30,936
Egypt	Hermes Index	-7.60%	121,342
Jordan	JOSMG NPR	31.00%	55,363
Morocco	MCSINDEX Index	13.00%	90,051
Tunisia	TUSISE Index	17.00%	6,506

Source: Bloomberg

YTD: December 31 2007 up to June 30 2008

One interesting aspect of the performance above (though the period under review is quite short) is that the top performers among the bigger markets are all beneficiaries of high energy and commodity prices. Saudi Arabia is a clear exception, where lack of access to non-regional investors perhaps seriously limits the impact of global asset allocation to provide any impetus to the market, as yet.

Moving on to individual stocks, a somewhat similar tale emerges, with none of the worst performing stocks being beneficiaries of the commodity boom (Saudi Banks) or in major oil producing markets (Dubai Stocks).

S No.	Top Performers	YTD Return
1	Jordan Phosphate Mines	342.5%
2	Arab Potash Company	102.1%
3	Barwa Real Estate Company	95.8%
4	Aamal Holding	67.6%
5	Qatar Islamic Bank	62.0%

S No.	Top Losers	YTD Return
1	Saudi Investment Bank	-36.3%
2	Samba Financial Group	-35.6%
3	Emaar Properties PJC	-31.2%
4	Riyad Bank	-30.7%
5	Deyaar Development	-30.1%

Source: Bloomberg

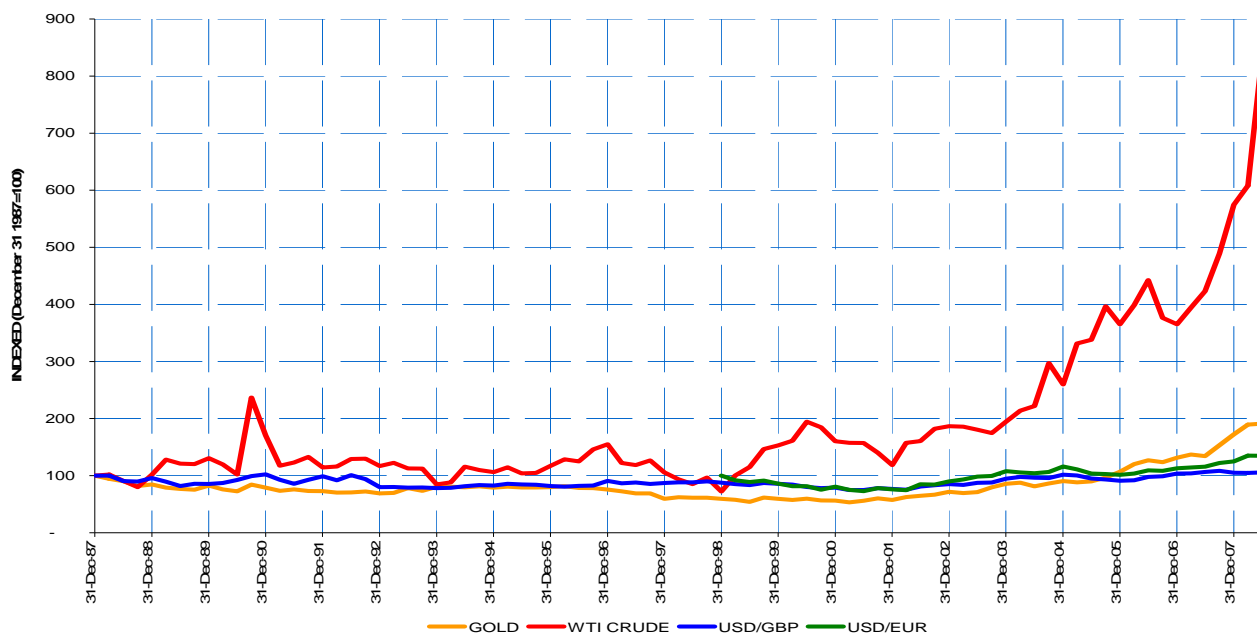
YTD: December 31 2007 up to June 30 2008

Although performance for regional markets thus far has been a bit of a mixed bag, compared to other emerging markets, the region as a whole has been a stellar performer.

Country	Index Name	PX_LAST	YTD
Brazil	Brazil Bovespa Stock IDX	IBOV Index	-7.5%
Russia	Micex Index	INDEXCF Index	-11.1%
India	BSE Sensex 30 Index	SENSEX Index	-33.3%
China	CSI 300 Index	SHSZ300 Index	-46.0%
Hong Kong	Hang Seng Index	HSI Index	-21.2%
Korea	KRX 100 Index	KRX100 Index	-15.1%
Vietnam	Ho Chi Minh Stock Index	VNINDEX Index	-53.0%
Thailand	Stock Exchange of Thaiindex	SET Index	-14.9%
Philippines	PSEi - Philippine SE IDX	PCOMP Index	-33.3%
Indonesia	Jakarta Composite Index	JCI Index	-16.1%

Source: Bloomberg
 YTD: December 31 2007 up to July 7 2008

The price of oil has defied all expectations of an impending correction (including our view) and has risen 51% for the year at the time of writing. It appears as if the world is shifting to a new store of value, namely the energy and precious metals complex. That said, we still believe oil prices at current levels will lead to wide scale demand destruction in developed economies globally, and an intermediate correction remains over due.



Source: Bloomberg

While subsidized demand in the major emerging consumers (China and India) has undoubtedly played a role in the sustained rise of the price of oil, even the removal of these subsidies over time will not result in more than a temporary blip in this structural shift. A structural bull market in oil and gold remains intact, and is likely to continue for several years.

The implications of this structural shift are clear and well documented. Wealth distribution from commodity consumers to commodity producers has accelerated in recent years, creating competition among various asset classes and geographies for attracting these fast accumulating pools of wealth. Closer to home, the Middle East

region has commenced on an ambitious infrastructure build out, worth close to a trillion dollars over the next decade.

Country	Project Name by Country	Estimated Cost (USD mn)
Kuwait	City of Silk	171,150.00
UAE (Dubai)	Dubai Waterfront	40,000.00
Kuwait	Khairan Residential City	27,000.00
Saudi Arabia	King Abdullah Economic City	26,600.00
UAE (Dubai)	Business Bay	20,000.00
UAE (Dubai)	Burj Dubai (Downtown Dubai)	19,877.47
Oman	Blue City	15,000.00
UAE (Abu Dhabi)	Mina Zayed Port Development	15,000.00
UAE (Abu Dhabi)	Al Raha Beach	14,700.00
UAE (Dubai)	Palm Deira	12,500.00
UAE (Dubai)	Dubailand	10,000.00
UAE (Umm Al Quwain)	Al Salam City	8,300.00
UAE (Dubai)	Palm Jebel Ali	7,500.00
UAE (Abu Dhabi)	Shams Abu Dhabi	6,800.00
UAE (Abu Dhabi)	Reem Development	5,500.00

Source: Zawya

Implications for investment strategy are clear; focus should remain firmly on the biggest beneficiaries of energy and commodity boom, coupled with careful security selection to avoid potential victims of populist policies aimed at alleviating significant inflationary pressures.

Inflationary pressures and the subsequent policy responses were highlighted as challenges for investors in our earlier issue. This hazard is firmly emerging as the most important determinant of investment returns over the medium term. Starting from the macro level, economies with little fiscal space to absorb the cost of subsidizing domestic consumption coupled with low export surpluses of commodities stand to lag the region significantly.

Country	Budget Deficit (\$ bn)	Net Exports (\$ bn)	Current Account (\$ bn)	Inflation	Domestic Debt/GDP
UAE	25.1	91.5	64.2	11.1%	22.9%
Bahrain	0.1	2.7	2.9	4.1%	9.3%
Egypt	(6.9)	(15.8)	2.7	6.9%	86.1%
Jordan	(0.8)	(6.3)	(2.6)	5.8%	108.7%
Kuwait	19.0	41.9	49.1	5.0%	7.8%
Lebanon	(2.5)	(7.5)	(2.4)	9.3%	171.1%
Morocco	(1.7)	(14.5)	2.2	2.0%	56.5%
Oman	2.6	13.9	7.6	8.3%	10.2%
Qatar	7.4	26.3	16.8	13.8%	11.7%
Saudi Arabia	56.7	170.8	109.9	6.5%	23.3%
Tunisia	(1.0)	(3.9)	(1.4)	5.3%	55.4%

Source: Global Insight, BMI, Reuters

Markets like Egypt, Jordan, and Lebanon (possibly Morocco as well) emerge as potential laggards. Policy makers in these economies will face a severe test of skill and strength of character—the reaction thus far from Egyptian regulators is a copy book case of what can go wrong. Faced with a rising incidence of inflation, Egypt

responded with a series of ill advised moves-public sector employees received a 30% pay hike (inflationary), industrial zones had their tax exemption status significantly modified, and the sale of BDC was also pulled out after the bidding, despite a bid worth 3.8X book value. Somebody, somewhere, needs a quick reality check. We will not be surprised if the rest of the region also follows suit with policies that do nothing to alleviate inflation.

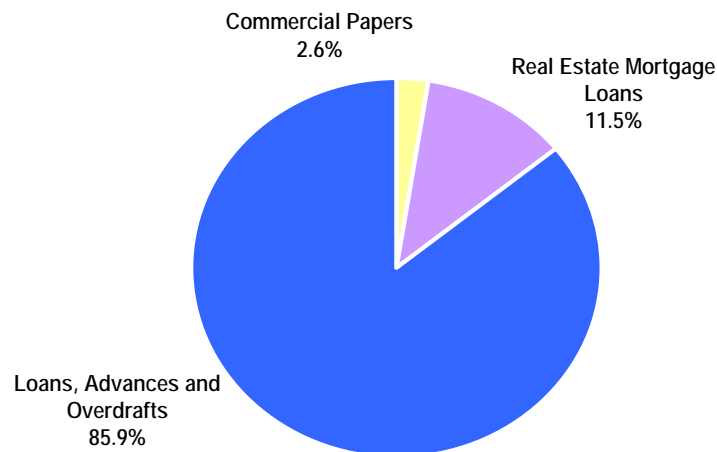
Inflation is not necessarily an evil to be avoided at all costs. The bulk of inflation in the region (Egypt again being a clear exception) is due to rising input costs globally, higher food costs and domestic demand that is benefiting from high government spending. In our view, the only incidence of inflation that can be tackled by sensible policies is that of domestic demand, which is evident in areas of strong real estate prices.

Country	Inflation Rate
Egypt	19.7%
Jordan	15.7%
Morocco	2.4%
Oman	5.0%
Saudi	10.5%
Tunisia	6.0%
Qatar	12.4%
UAE	10.0%
Bahrain	2.7%
Kuwait	9.5%

Source: Global Insight, BMI

Even focusing on strong real estate prices, policymakers do face a dilemma-price strength is attracting strong private sector demand, which is facilitating the rapid addition of housing stock in these markets. If policies aimed at cooling this demand succeed in arresting this growth and even reversing it, some of these markets (esp Dubai) will experience some degree of stress in the financial system.

UAE Banking Sector Credit Exposure



Source: Central Bank of UAE

We believe currency reform is not a viable solution for the bulk of the incidence of inflation in the region at present, as such a change will not impact input costs for construction or food. A good example of tackling

inflation via banking policy changes is Oman, where the regulatory authorities have moved to reduce the availability of credit to the private sector. This is being targeted by higher reserve requirements and reducing the maximum rate of interest that can be charged on personal loans. The net result of these changes is that it is less profitable for banks to lend on an incremental basis, thus reducing the rate of growth in these loans.

Moving on to the micro and business specific level, it is now increasingly important to watch out for losers of two kinds-policy victims, and margin casualties. Industries Qatar is a good example of the former, with the company announcing that prices of steel have been fixed for the next three years-although it is expected that the government will foot the bill, it is not clear how this mechanism will work. Air Arabia is a good example of the latter type, where the rapidly rising cost of fuel is likely to severely dent margins despite some cannibalization of traffic from conventional carriers. Financial service providers are also likely to generally struggle, as spreads continue to get squeezed and the cost of doing business keeps rising.

The ideal business in such an environment is one which has some component of fixed production costs, with no restrictions on selling prices. SABIC is a great example, with fixed production costs for some products, and no real restrictions on selling prices.

Telecom operators also have an ideal business model to thrive in such an environment, with a bulk of their costs accounted for by depreciation, hence fixing a significant portion of their operating costs. Well diversified operators trading at reasonable valuations should offer superior relative returns going forward.

Company	EBITDA Margin	EV/EBITDA	Leverage
Mobile Telecommunications Co.	41.20%	8.76	50.0%
Mobinil	29.90%	7.58	34.0%
Saudi Telecom	48.80%	7.32	20.0%
Bahrain Telecom	45.90%	8.22	26.0%
Etihad Etisalat	34.50%	11.26	43.0%
Orascom Telecom	45.00%	6.39	38.0%
Emirates Telecommunications Corp	39.80%	12.56	7.1%
Qatar Telecom	41.47%	7.59	43.0%
Telecom Egypt	50.19%	5.69	13.0%
Maroc Telecom	60.10%	9.86	6.0%
Oman Telecommunications	54.30%	8.53	2.0%

Source: Reuters, Company Reports

Final Note:

The latter part of the year is poised to be more fruitful compared to the first-the situation in Iran is the only curve ball in the equation, and is practically impossible to plan for. However investors may bear in mind that the riskiest period in this regard is perhaps prior to the next US presidential election, providing a rough timeline if an event is to occur.

Among the various markets, Saudi Arabia, United Arab Emirates, and even Qatar remain our top picks (due to commodity exposure, UAE partly due to valuations). Egypt, Lebanon, Morocco, and Jordan seem poised for underperforming due to fiscal problems combined with valuation in some cases. Investors should continue to favor fixed cost commodity producers (SABIC, SAFCO) and avoid margin (Air Arabia) and policy casualties. Happy investing.

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