

Schroders Talking Point



Middle East Update

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There have been two main arguments for investing in the Middle Eastern markets over recent times. Firstly, the much more productive use of oil reserves has led to a transformation of the economies which have been successfully diversifying, growing strongly and have very strong fundamentals. Secondly, these markets have historically had a very low correlation with both the developed and emerging stock markets.

In the face of the global credit crunch and set back in stockmarkets generally, the Arabian markets have outperformed but have not provided the degree of protection that would have been expected.

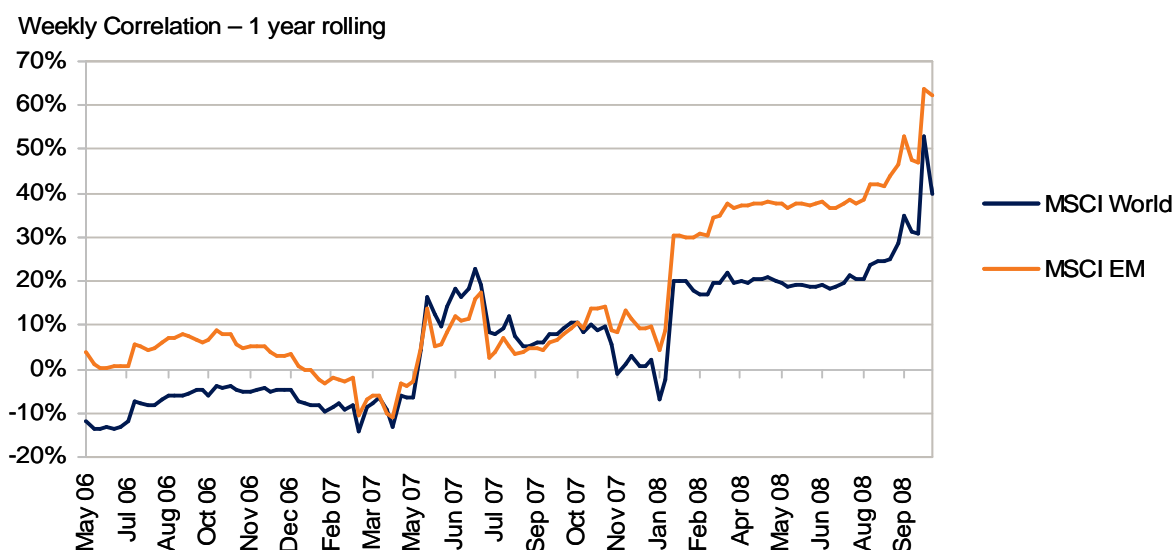
The following table shows the performance of these markets compared to the MSCI emerging and World indices.

	QTD %	YTD %	12m %
MSCI Emerging Markets	-24.8	-51.5	-52.1
MSCI Arabian Markets	-11.1	-36.9	-25.5
MSCI World	-16.3	-36.5	-37.9

Source: FactSet, MSCI Net dividends reinvested USD, 30 September 2008

The increased correlation can be seen in the chart below.

MSCI Arabia Weekly Correlations - 1 year rolling



Source: FactSet, MSCI Net dividends reinvested

The historic low correlations have significantly increased during the course of this year. There are several reasons for this, none of which undermine the low correlation argument. Before examining what has been driving market performance in recent weeks it should be noted that from a purely statistical point of view, correlation calculations are only meaningful if long run data is used. The fact that markets move in the same direction for short periods is not statistically significant.

The increased correlation is not altogether surprising. During crisis periods markets often detach from fundamentals and trade together. When risk appetite falls sharply investors tend to sell equities indiscriminately. In addition the impact this has had on the Arabian markets has been exacerbated by the seasonally low volume in the regional markets due to Ramadan and Eid coinciding. Finally, although there has been a lot of long-term international investment there is no doubt that the region has attracted a certain amount of 'hot' money over the last 12 months. Hedge fund activity has also increased during this time which has resulted in a certain amount of forced liquidation due to the tight credit conditions. Although within the region there has been a significant range of performances between countries.

	QTD %	YTD %	12m %
Bahrain	-23.2	-10.5	-1.9
Egypt	-27.5	-29.7	-12.7
Jordan	-13.2	0.0	24.1
Kuwait	-17.2	-10.6	-15.4
Lebanon	-16.1	29.3	55.5
Morocco	-21.8	2.0	4.0
Oman	-28.5	-11.4	15.2
Qatar	-22.4	0.2	21.0
Saudi Arabia	-24.9	-36.5	-7.4
Tunisia	2.5	15.6	24.6
UAE	-28.5	-33.8	-12.3

Source: FactSet, MSCI Net dividends reinvested USD, 30 September 2008

As can be seen from the above table, four of the stockmarkets have actually risen this year-end and one is flat. Once the stability of the global financial system is restored, and recent measures taken should go a long way to helping achieve this, then investor sentiment towards the Middle East and emerging markets in general should improve. This is primarily because the credit crisis will likely have a limited impact in the Middle East, economic fundamentals are extremely strong and valuations are attractive.

	C/A (%GDP) 2008e	Fiscal Bal (%GDP) 2008e	Reserves (%GDP) 2008e
Bahrain	14.6	8.1	149
Egypt	0.2	-7.1	23
Jordan	-18.5	-7.0	47
Kuwait	51.6	28.4	417
Lebanon	-11.0	-10.0	59
Morocco	0.3	-3.2	32
Oman	19.4	18.4	42
Qatar	45.1	23.2	144
Saudi Arabia	32.1	23.5	135
Tunisia	-3.5	-3.0	21
UAE	27.5	34.1	385

Source: Datastream, EFG-Hermes, August 2008

It is clear that the root cause of the credit crisis is the huge debt that has been built up in the developed world and it is the de-leveraging that is beginning in these economies that is responsible for the deteriorating outlook

for global growth. In contrast the Middle East is awash with large surpluses, due primarily to the high oil prices in recent years. For example the GCC* governments have accumulated a surplus of US\$750bn since 2001 and an oil price of US\$80 per barrel translates to surpluses of US\$250bn in 2008 and US\$130bn in 2009, or around 25% and 12% of GDP respectively. Even though the oil price has fallen sharply since its peak earlier this summer, there is still a comfortable buffer compared to the US\$50 per barrel used by governments to set their budgets.

This financial strength means the regional governments have plenty of room to support their financial sectors. Indeed, there has already been evidence of this. For example, the sovereign wealth fund in Qatar has announced its intention to inject additional capital into all local banks by acquiring 20% of their equity and the UAE government has injected \$34bn into local banks and guaranteed all deposits in the country. It is therefore clear that the global credit crisis is very unlikely to have a material impact on the financial institutions in the Middle East.

The regional economies are also expected to continue to deliver reasonably strong economic growth over the next several years even if the developed world experiences a recession. This is because government spending on infrastructure is likely to remain strong, as is growth in sectors such as services and consumption as windfall gains from the high oil price are increasingly being used to diversify the sources of growth.

Finally, once sentiment improves international investors should begin to focus on the regions' attractive valuations. The average PE is around 9x and earnings growth is expected to remain strong, possibly as high as +20% year on year. This is in contrast to the developed markets where the PE for the MSCI World index is also around 9x but earnings growth is forecast at 12%. Given the bleak outlook for economic growth in the developed world as the credit crunch and de-leveraging bite the earnings forecast of +12% is highly likely to be revised down substantially. There is also growing evidence of share buy back programmes being initiated and of the regions' sovereign wealth funds increasing their allocation to domestic equity markets.

This outlook is not without risks, of course. We would highlight three:

- Continued pressure on oil prices has a negative sentiment effect on markets. If oil reduced to average breakeven levels of \$50 per barrel and stayed there for some time, then the investment and infrastructure outlook for the region would deteriorate significantly
- Dubai has enjoyed a housing boom. It now looks as though there has been overbuild in certain segments. This puts some Dubai financial institutions at risk. However, across the UAE as a whole, loan to deposit rates in banks average just under 100%. Whilst this is high it is well below US & UK banks. Furthermore, there are the government reserves to easily support the financial sector in a crisis.
- A danger in the early part of the year was dollar weakness leading to inflationary pressures through the fixed currency regimes. After the worst of the credit squeeze is past in the US, dollar weakness could resume.

In conclusion, near term weakness has been caused by a combination risk aversion, low liquidity during the holiday period and forced liquidation by short term investors. Short term volatility is likely to remain high but over the medium to longer term we expect investors to refocus on the stronger economic fundamentals and correlation to remain low.

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