MARMORE
MENA INTELLIGENCE
A المركز MARKAZ Subsidiary

MACRO & MARKETS: GLOBAL & GCC

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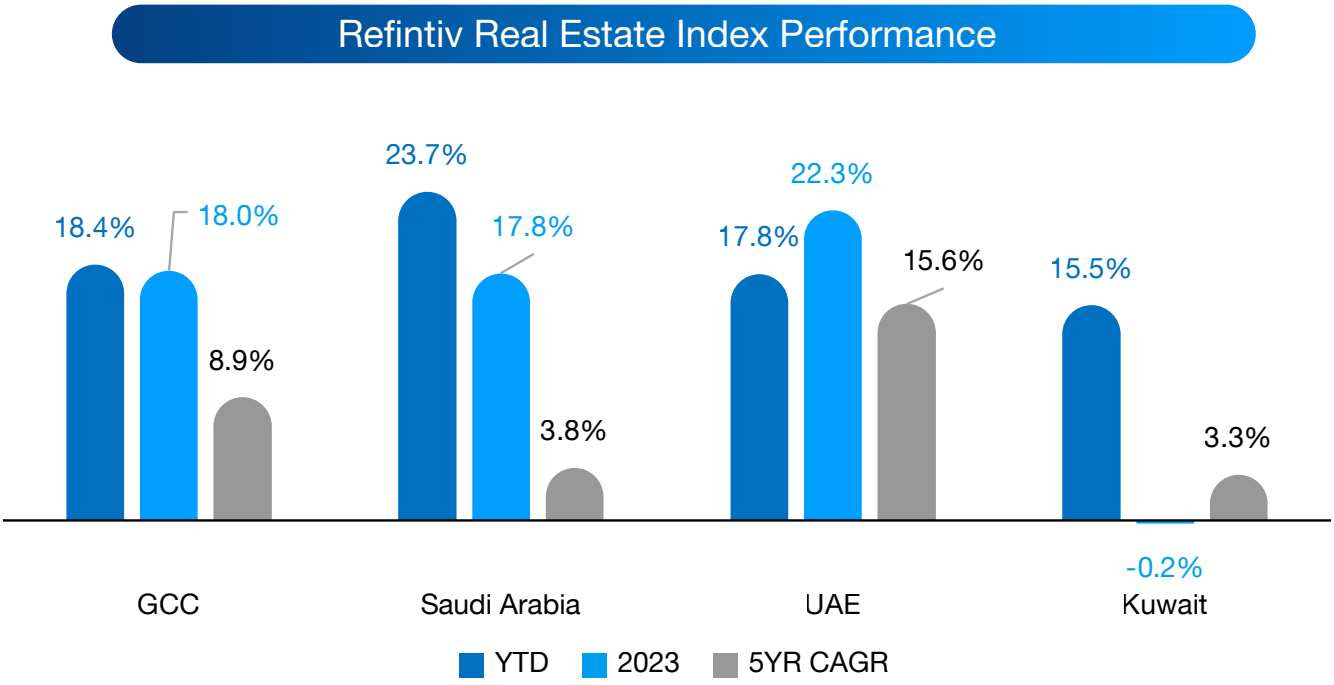
Highlights

- MENA markets surged ahead in September despite heightened geopolitical risks, thanks to the Fed's audacious 50 bps cut in interest rates. Among MENA markets, Saudi Arabia appears excessively valued, with its current P/E being well above its 5-year median.
- Real Estate stocks in Saudi Arabia, UAE and Kuwait outperformed their respective broader markets, backed by a strong rebound in property prices and rental yields. Notably, the 5-year CAGR for the UAE Real Estate index stood at a staggering 15.6%.
- The Fed reduced interest rates by 50 bps (from 5.25% to 4.75%) as against the expectation of 25 bps, marking the beginning of the monetary easing cycle. Global equity markets welcomed the move, extending their yearly gains further.
- Fed's bold conviction to reduce interest rates comes from the assumption that the U.S. economy has achieved soft landing and inflation would gradually reduce to less than 2%. However, there is an alternate scenario that could play out involving a combination of inflation not reducing much, along with increase in unemployment number, which can cause Fed to retract. Hence, markets are walking on a tight rope and any small economic jolt can cause huge shocks to the market.

MENA markets forged ahead in September on the back of global optimism thanks to Fed's bravo of 50 bps cut in interest rates. The positive performance of GCC despite oil price retreating by 8.7% and heightened geopolitical tensions (Israel's bombardment of Lebanon) is indeed surprising. The power of Fed clearly triumphs everything else. Dubai (+4.1%) and Qatar (+4.0%) were clearly the performers of the month followed by Abu Dhabi (+1.5%) Saudi Arabia (+0.7%). Among MENA markets, Saudi Arabia looks excessively valued with its current p/e of 24 plotting far above its median value of 18 and is clearly now more than +1 standard deviation above mean (a good indication of excess valuation).



Source: Refinitiv; YTD as of Sep 2024 end; Returns indicated above are Total Returns

Among the sectors, there is one sector that is worth focussing i.e., Real Estate. We notice a second successive year of outperformance for the Real Estate sector in Saudi Arabia and UAE while for Kuwait, there is an outperformance for 2024. The 5-year CAGR for the UAE Real Estate index is a staggering 15.6%!

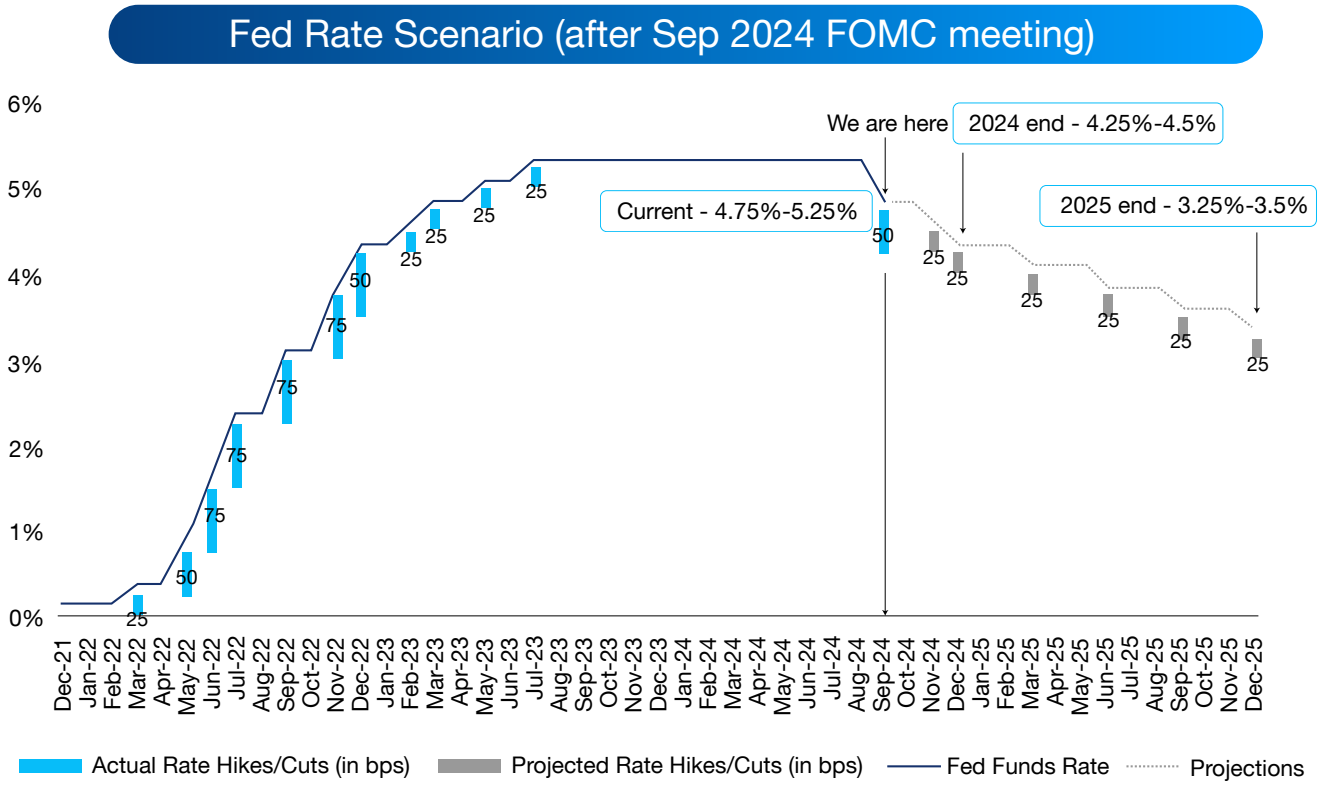
The fabulous performance is backed by a strong rebound in property and rental rates. Dubai housing prices were up by 20.7% in Q1 2024 YoY, Riyadh housing prices up by almost 8% and average Grade B rents for offices in Abu Dhabi grew 9.7% in the same period. Kuwait's commercial sector sales surged 16.9% YoY in Q1 2024. This has resulted in good earnings numbers, which propped up the share price of real estate stocks. The revival of tourism and therefore the hospitality sector can keep up the momentum provided geopolitics does not spoil it.

What if the Fed is wrong again!

Fed surprised pundits when it reduced interest rates by an audacious 50 bps (from 5.25% to 4.75%) as against the expectation of 25 bps heralding the beginning of monetary easing and paving way for future interest rate cuts. According to the Fed dot plot, interest rates will reach 3.25% by the end of 2025.

When interest rates go down, equity markets tend to do well as per economic logic as the

cost of capital comes down. Truly reflecting this trend, MSCI World and S&P 500 went up by 2.6% each, post the rate cut, which was on top of the yearly gain of 14.5% and 17.8% respectively until the September Fed meeting. It is another question that equity markets did well even when interest rates were going up thanks to copious liquidity showered from the helicopter to manage COVID stress!



However, we have another important dimension here which is the inverted yield curve. Back in 2007, when yield curve was inverted for 19 months followed by great recession, Fed started its first rate cut. Post that, S&P 500 fell nearly 57% in the next one year while unemployment climbed to over 5%. Coincidentally the current yield curve inversion has also finished 19 months, though we notice that the yield curve has straightened from being inverted though it is yet to slope positively. Also, 8 of the last 12 easing cycles were accompanied by a recession while 4 of them witnessed soft landing.

Fed's act is predicated on easing inflation (from 7% to 2.5%) and hence the bold conviction that interest rates can now be reduced. When Fed increased interest rates nearly two years ago, many were anticipating recession which normally is the case when interest rates move up. However, strong economy meant that recession never showed up while inflation eased despite low unemployment rate. This combination is very unusual and has rarely been observed in the long economic history of the U.S.

Let us see some scenarios from this point forward:

1. **Soft landing:** This narrative is the most dominant one where we don't expect any economic recession and inflation to slowly melt back to Fed's 2% target. The labour market will remain tight though with low unemployment.

2. **Hard Landing**: The high interest rates that worked in the economy for the last one year might trigger a recession while inflation, after a brief deceleration, may start accelerating. The labour market tightness may continue.

Fed, along with analysts, are nearly convinced that we have now achieved soft landing and hence the case for reducing interest rates by 50bps.

However, the second option is not done and dusted. It all depends on how well Fed is reading the print on inflation and unemployment. It looks like Fed is not worried about inflation anymore but may be more concerned about unemployment increasing (through job losses). If that happens, it will show up in low consumer spending and therefore a recession. Fed wants to pre-empt this.

Fed should get two things right from this point forward. Inflation should be benign, and unemployment also should be low. Famously, Fed got the inflation print wrong earlier terming it as "transitory" when inflation was rising. Inflation turned out to be "sticky" and hence Fed had to reverse course and increase interest rates in record time to bring the inflation down. While the goods inflation came down swiftly, thanks to easing of supply chain bottlenecks, the services inflation continued to be sticky and high. If decreasing interest rates start reigniting inflation (through higher demand) once again, then it becomes hugely difficult to contain inflation as inflation is normally shaped more by expectations (called anchoring) than actual data. If people collectively believe inflation will be higher in future, inflation will tend to move up purely based on this expectation. That is why central banks are normally extra cautious before they embark on monetary easing.
Regarding unemployment (job losses), high interest rates during the last one year will have its effect on increasing job losses, which may hurt consumer spending. Though Fed wants to prevent that from happening, it may still happen forcing the Fed's hand for retracing.

Of course, if Fed senses that inflation is not coming down as expected and unemployment is increasing, it can always pause further rate cuts and be in that pause mode till it gets the conviction but that will shake market confidence.

I am dreading the combination of inflation not reducing much, along with increase in unemployment number, which can cause Fed to retract. If premature lowering of interest rates reignites inflation, then it can cause

recession that can technically be termed as stagflation. Though analysts are assigning a low probability to such a scenario, it is something that can still happen.

So far what has panned out is a dream scenario (low inflation, strong economic growth and low unemployment). Even if one of the three gives in say for e.g. a recession or resurfacing of inflation or labour market loosening, all assumptions will be thrown out of the window.

Markets are walking on a tight rope and any small economic jolt (like the famous Bank of Japan increasing rates by 25 bps) can cause huge shocks to the market. The current Fed action will be more consequential than BoJ given the reserve currency status of the U.S. Dollar.

While the dot plot by Fed FOMC members give a good idea of things to come, it is bound to change as new data arrives. Many argue that artificial intelligence induced productivity gains will make sure that inflation will be contained, or unemployment may not spiral out of control. But these are early untested days where the jury is still out as to whether, artificial intelligence will result in overall productivity gains.

It is instructive to note that if recession happens and unemployment starts shooting up, unlike what happened during post-covid time of 2019, the U.S. government does not have much of dry powder to throw as fiscal stimulus. The U.S. government has run up $9 trillion in debt in the last four years due to which interest on debt is now more than national defence expenditure! With US government lacking fiscal flexibility (especially in election times), the personal balance sheet of individuals will also turn cautious with consumers holding back on discretionary spending. The slower consumption and investment growth will mean a dent in GDP growth, all to be expected and factored in our analysis.

While fed has technically inaugurated the easing cycle, neither the size nor the speed is clear to the market as of now. Fed is a group of very intelligent people, and they see and analyse more data than folks like us. However, if Fed makes a mis step, all of us will pay dearly!

Benchmarks matter

In the world of benchmarks, it is common to see the Total Return (TR) index preferred over price return as it includes dividends and hence is a total representation of asset class performance than just price returns. Due to the power of compounding, the differential performance of TR index is indeed staggering.

As they say, the devil lies in the details. TR index is basically calculated assuming that dividends are reinvested in the same asset class/stock on the ex-dividend date. This is where this turns into a theoretical concept. Many a times the dividend reinvesting will result in fractional shares and many markets

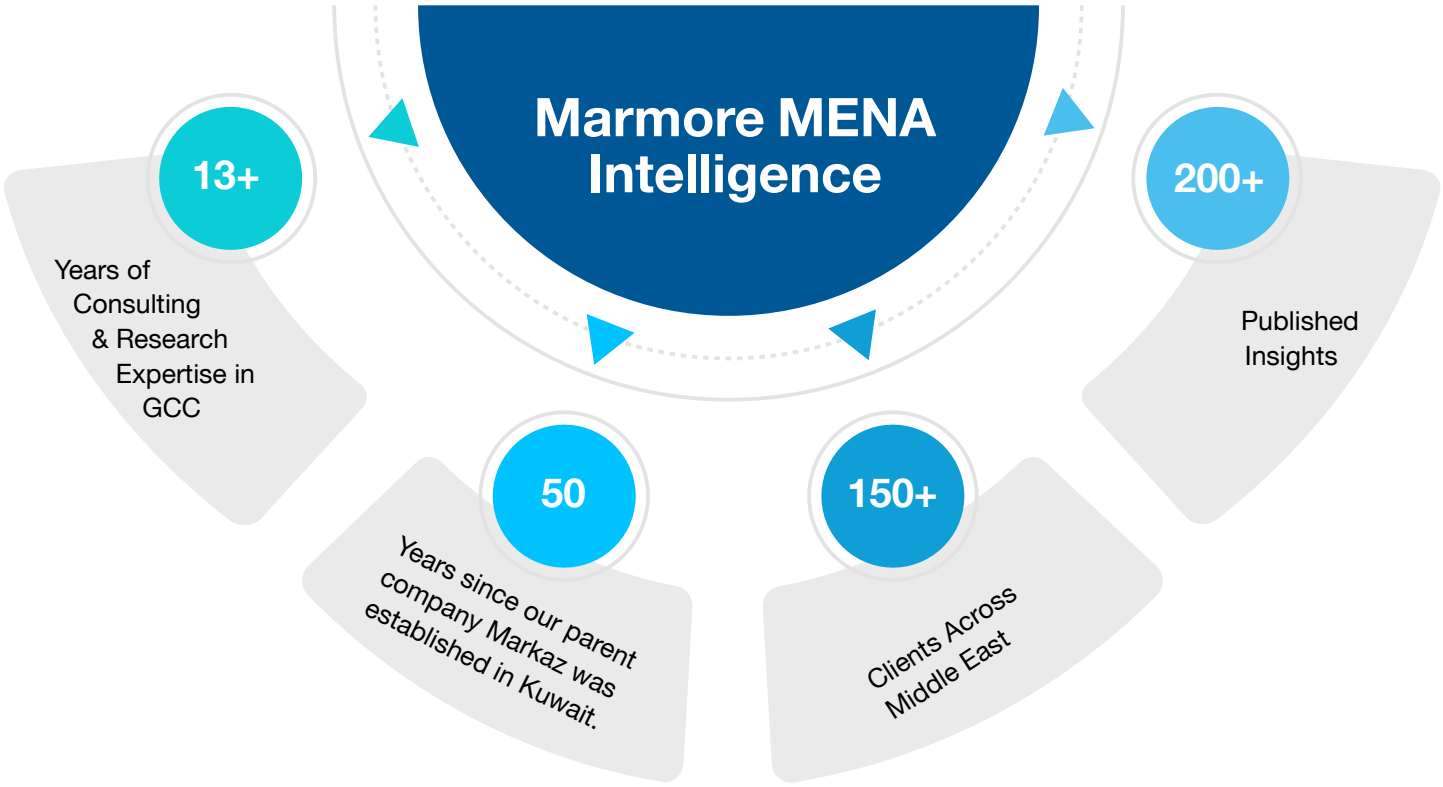
including developed ones do not allow for purchase of fractional shares. Also, there is a time lag between the date of dividend declaration (ex-dividend date) and the date when one receives the dividends. So, assuming reinvestment on the date of dividend declaration means that one should be having some cash back up to the extent of dividends. Due to these inefficiencies, many ETF's and mutual funds end up having higher tracking error. While we are on benchmarks, it is also interesting to note the role stocks entry and exit plays in the index. Stocks are regularly included and excluded from an index as a feature. A stock inclusion in the index attracts passive money post inclusion and active money even prior to inclusion in anticipation. Stock exchanges set up stringent criteria for inclusion of stocks in the index and therefore they should be good bets. On the other hand, stocks excluded from the index (due to poor performance or liquidity) tend to wither into oblivion over time. So goes the logic. However, a recent study challenges this conventional wisdom where stocks excluded from the index goes on to produce great returns. Do not take conventional wisdom at its face value!

Equity & Commodities	Close	Returns		
		Sept 2024	YTD-Sept 2024	2023
Global Equities				
Global (MSCI World)	3,727	1.7%	17.5%	21.8%
USA (S&P 500)	5,762	2.0%	20.8%	24.2%
Japan (TOPIX)	2,646	-2.5%	11.8%	25.1%
GCC Equities				
GCC (S&P GCC Composite)	150	1.3%	1.4%	6.2%
Saudi Arabia (TASI)	12,226	0.7%	2.2%	14.2%
Abu Dhabi (FTSE ADX General Index)	9,425	1.5%	-1.6%	-6.2%
Dubai (DFM General Index)	4,503	4.1%	10.9%	21.7%
Kuwait (Boursa Kuwait All Share PR)	7,136	-0.6%	4.7%	-6.5%
Qatar (QE Index)	10,614	4.0%	-2.0%	1.4%
Commodities				
Oil (Brent Crude in USD/bbl.)	71.8	-8.9%	-6.8%	-10.3%
Gold (in USD/oz.)	2,635	5.3%	27.7%	13.1%

Fixed Income	Yields	
	Sept 2024	2023-end
U.S. Treasury 10Y Sov.	3.81%	3.88%
Saudi Arabia 10Y Sov.	4.33%	4.39%
Abu Dhabi 10Y Sov.	4.05%	4.32%
Kuwait 10Y Sov.	4.08%	4.34%

Source: Refinitiv, YTD and Yields as of Sept 30, 2024

ABOUT MARMORE



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