Kuwait Financial Centre "Markaz"
RESEARCH

Geopolitics influences GCC Markets in September, Oil turns volatile

Concerns of global economic slowdown weigh on regional stocks

October 2019

Research Highlights
GCC Economic and Market Commentary for September, 2019

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GCC markets ended the month of September in negative territory, losing 0.7% for the month, dragged down by volatile oil prices and negative performance in Kuwait markets. Oil witnessed one of the most volatile months in decades, after a devastating attack on Saudi Aramco oil refineries intensified concerns about growing instability in the world's most important crude-producing region. Saudi Arabia, Oman, Dubai and Qatar ended the month of September on a positive note, whereas Kuwait, Abu Dhabi and Bahrain declined. Kuwait's All Share Index fell for the second consecutive month, falling by 4.4% in September, suffering from the profit booking since the MSCI EM index inclusion announcement in July.

We see the following issues as key developments during the month of September:

1. **Impact of Kuwait's emerging market upgrade on foreign ownership of banks -** The attractiveness of the Kuwait market has improved over the years due to various capital market reforms. Subsequently the decision to include Kuwait into EM index by FTSE and MSCI have led to wide spread interest from foreign investors to increase their holdings in Kuwait equities, with banks occupying the centre stage in the investment mix.

2. **Equity Risk Premium of GCC countries - Have they been falling? -** Equity risk premium (ERP) is an important indicator of risk associated with investing in a market. While ERP of some GCC countries have declined, indicating investor confidence, some have not followed the trend.

3. **Boursa Kuwait Witnesses Rising Liquidity Levels:** Liquidity levels in Kuwait has improved dramatically in 2019. Kuwait has introduced several capital market reforms in order to attract global attention. The subsequent MSCI upgradation has resulted in peak investor interest towards the Kuwait capital markets.

4. **GCC Bond issuances witness an uptick in H1 2019:** Bond markets in the GCC witnessed a pick-up in debt issuances during the first half of 2019 after a subdued close in 2018. As oil prices have been volatile throughout 2019 due to demand and supply side shocks, GCC countries, which have proposed expansionary budgets to boost economic growth, are expected to tap the bond markets in the subsequent quarters as well.

5. **Why Kuwait is not following the Fed? :** Central Bank of Kuwait last increased its discount rate in March 2018, aligning with the U.S Fed rate hike. Since then, the U.S Fed has hiked rates thrice and cut rates twice. However, Central Bank of Kuwait has maintained its policy rate unchanged citing reasons related to economic growth, deposits growth and currency strength.

GCC Market Commentary

GCC Market Trends – September 2019

Index	M. Cap (USD Bn)	Last close	2018 %	Sep -19	YTD %	S&P correlation**	ADVT* (USD mn)	P/E TTM	P/B TTM	Div. Yield
S&P GCC	893.6	111	8.4	-0.7	3.7	0.121	N.A	14.8	2.0	3.4
KSA	508.8	8,092	8.3	0.9	3.4	0.065	832.6	17.3	1.9	4.0
Abu Dhabi	140.9	5,057	11.7	-2.1	2.9	0.095	41.5	12.7	1.4	5.0
Qatar	138.8	10,367	20.8	1.3	0.7	0.093	61.3	14.1	1.4	4.2
Kuwait	108.2	5,679	5.2	-4.4	11.8	0.010	112.1	13.4	1.3	3.7
Dubai	77.2	2,781	-24.9	0.8	9.9	0.120	59.0	7.3	0.9	4.4
Bahrain	24.9	1,517	0.4	-1.1	13.4	0.044	2.3	10.2	0.9	4.6
Oman	13.2	4,018	-15.2	0.3	-7.1	-0.006	4.3	8.2	0.7	7.1

Source: Reuters, Zawya, Note: * Average Daily Value Traded ** - 3-year daily return correlation with S&P 500 index

The S&P GCC composite index fell by 0.7% for the month, dragged down by volatile oil prices and negative performance in Kuwait markets. Among the positive performers, Saudi Arabia, Oman, Dubai and Qatar increased by 0.9%, 0.3%, 0.8% and 1.3% respectively. Bahrain, Abu Dhabi and Kuwait decreased by 1.1%, 2.1% and 4.4% respectively. Qatar was therefore the best performing GCC market and Kuwait was the worst performer for the month of September.

Monthly returns heat-map of S&P GCC Composite index

S&P GCC	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
2014	3.40%	3.70%	2.70%	2.80%	3.20%	-7.40%	8.10%	6.40%	-1.40%	-6.80%	-10.9%	-4.40%	-2.6%
2015	2.80%	4.40%	-6.90%	10.10%	-2.30%	-3.50%	0.10%	-13.2%	-1.10%	-2.70%	-2.30%	-2.40%	-17.3%
2016	-10.7%	3.70%	1.90%	5.70%	-5.10%	1.10%	-0.10%	-1.20%	-3.90%	2.20%	7.90%	4.20%	4.3%
2017	1.60%	-0.80%	-1.50%	-0.40%	-1.40%	3.20%	-0.40%	0.90%	-0.60%	-2.70%	-1.50%	3.40%	-0.4%
2018	5.30%	-2.50%	3.40%	2.90%	-0.40%	1.10%	2.20%	-2.50%	0.20%	0.10%	-2.00%	0.70%	8.4%
2019	6.80%	-1.00%	2.77%	4.40%	-5.60%	2.50%	1.10%	-5.80%	-0.70%				3.7%

Source: Reuters

Oil witnessed one of the most volatile months in decades after a devastating attack on Saudi Aramco oil refineries intensified concerns about growing instability in the world's most important crude-producing region. Brent futures leaped a record USD 12 per barrel. on 16 September, before settling just above USD 69 per barrel registering the biggest one-day percentage gain since the start of the contract in 1988. Prices have since reverted back as the government of Saudi Arabia has reacted promptly and restored production capacity at pre-attack levels within 10 days of the attack. Brent crude ending the month of September rising 0.5%.

Kuwait's All Share Index fell for the second consecutive month, dropping by 4.4% in the month of September, suffering from the profit booking since the MSCI EM index inclusion announcement in July. Saudi Arabia, Oman, Dubai and Qatar ended the month of September on a positive note, whereas Kuwait, Abu Dhabi and Bahrain declined. Kuwait's Blue Chip companies ended the month in the red as investors have been perturbed by geopolitical uncertainties in the region, leading them to book profits. All the top five blue chips registered a loss during September, however their year to date gains remain positive. Kuwait Finance House and Zain were the top losers among the blue chips, falling by 9.8% and 4.8% respectively. While majority of the sectoral indices in Kuwait posted a monthly decline, Insurance index increased by 3.2% to become the top performing index for the month. Technology sector was the worst performer for the month, declining by 11.2%.

Among the GCC Blue Chip companies, Emirates NBD was the top gainer for the month with a rise of 12.1%. Kuwait Finance House was the top loser, declining by 9.8%. Saudi Basic Industries Corporation (SABIC), the largest company by market cap among GCC countries also declined by 7.9% bringing its year-to-date loss to -20.8%, making it the worst performing blue chip company in 2019. Mesaieed Petrochemical Holding Co on the other hand increased by 4.9% in September making it the most profitable blue chip company among its GCC peers in 2019, with yearly gains surging by 98.3%.

Global Market Trends – September 2019

Equity	Last close	MTD%	YTD%
S&P GCC	111	-0.7	3.7
MSCI World	2,180	1.9	15.7
S&P 500	2,977	1.7	18.7
MSCI EM	1,001	1.7	3.7
MSCI FM	552	-2.3	6.6
Commodities			
IPE Brent	60.8	0.5	12.9
Gold	1,472.0	-3.1	14.8

Source: Reuters

The impact of the Fed reducing the interest rates was finally visible as the US S&P 500 and the MSCI World indices ended the month of September with gains of 1.7% and 1.9% respectively. However, the fast-moving scandal involving President Donald Trump and allegations that he pressured Ukrainian President Volodymyr Zelensky to investigate his political rival Joe Biden and his son, has toppled politics in Washington DC, turning Democrats toward an impeachment investigation. This has wiped out most of the gains from the US markets seen earlier in the month when the S&P 500 breached the 3000 mark.

Gold has decreased by 3.1% in September as easing of concerns of an escalation in the US-China trade war took some shine off the safe-haven. Gold has witnessed a rally of 14.8% so far in 2019.

Impact of Kuwait's emerging market upgrade on foreign ownership of banks

Kuwait's stock market is dominated by banking sector stocks. Listed banks in Kuwait represent nearly 58% of the weight as measured by market capitalisation. The total market cap of 175 listed securities on Boursa Kuwait is approximately KD 32.3bn. There are 10 local banks in Kuwait that are listed on Boursa Kuwait with a combined market cap of KD 16.5bn. In addition, Boursa Kuwait has two more cross-listed banks from Bahrain, taking the total market cap of banking sector to KD 18.7bn.

FTSE Russell was the first to announce the inclusion of Kuwait to its Secondary Emerging market within the FTSE Country Classification scheme, with inclusion happening in two stages, commencing from September 2018. Out of the 12 stocks that were added to FTSE index, 5 were banks. The holdings of banks by foreign entities have been continuously increasing over the course of a year since, with Gulf Bank leading the rest in terms of increase in foreign ownership. National Bank of Kuwait, however remains the most preferred choice of foreign investors with an ownership of 13.5% by foreign investors.

Foreign Ownership of Kuwaiti Banks

Banking Stocks	M. Cap (KD Bn)	Foreign Ownership % as of			Change in Ownership levels, % (3-1)
		9-Aug-2018 (1)	25-Jun-2019* (2)	18-Sep-2019 (3)	
NBK	6.07	9.44	13.25	13.49	4.05
Gulf Bank	0.84	1.46	11.52	11.12	9.66
KFH	4.44	4.27	6.22	6.86	2.59
KIB	0.28	6.33	5.06	4.65	-1.68
Burgan Bank	0.80	3.17	2.10	3.83	0.66
Boubyan Bank	1.56	1.55	3.26	3.39	1.84
Warba Bank	0.37	0.94	2.95	3.00	2.06
AUB	0.63	0.28	0.42	0.65	0.37
CBK	1.00	0.23	0.45	0.45	0.22
ABK	0.48	0.10	0.13	0.12	0.02

Source: Reuters, Boursa Kuwait; Note: * - MSCI inclusion announcement date

While the FTSE had set the wide spread interest from foreign investors in motion, the anticipation of Kuwait's inclusion in MSCI EM index also contributed in stimulating active foreign investors to increase their holdings. The announcement was made in June 2019 by MSCI to reclassify the MSCI Kuwait Index to EM status. However, it is still subject to availability of omnibus account structures and same National Investor Number (NIN) cross trades facilities for international institutional investors which Boursa Kuwait has already planned to implement by November 2019.

The Vanguard Group ownership in various Kuwaiti listed banks

Bank	Ownership %		Value Held (USD Mn.)	Shares O/S (Mn.)
	Sep-2018	Aug-2019		
NBK	0.79%	3.16%	673	6,524
KFH	0.79%	1.73%	298	6,976
Gulf Bank	0.00%	1.93%	58	3,048
Boubyan Bank	0.44%	1.02%	56	2,884
Warba Bank	0.81%	2.02%	25	1,500
KIB	0.73%	1.88%	18	1,079

Source: Reuters

Historically, foreign passive investors increase their positions in a particular market around the implementation date while active investors typically preposition themselves before the announcement of upgradation and implementation. To substantiate, The Vanguard Group, a US based asset management company is among the leading player that has been increasing its positions in Kuwaiti listed banks since Sep 2018. Some of the other mutual fund players such as Schroder, Blackrock, Templeton, Norges bank have also increased their holdings in Kuwaiti listed stocks in particular banks that will be among securities to be included in the emerging market.

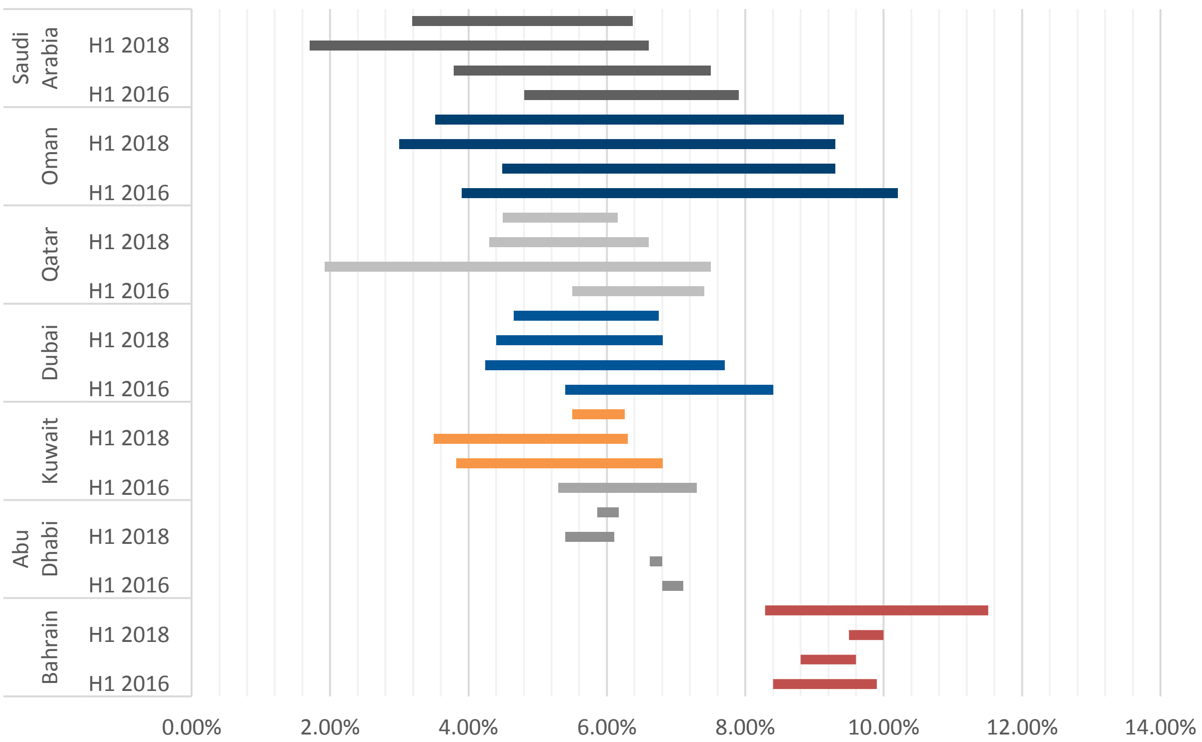
Over the years, the attractiveness of the Kuwaiti market and its securities has improved dramatically due to various factors including higher liquidity, attractive valuation and earnings growth, enhanced transparency and improvement in corporate governance practices. This is driving the various mutual fund managers to increase their holding in Kuwaiti listed securities with banks occupying the centre stage of the investment mix.

Equity Risk Premium of GCC countries - Have they been falling?

Structural reforms, fiscal consolidation measures, better economic growth prospects and increase in oil prices have resulted in GCC countries attracting investor attention during recent times. In this context, this article studies the trend of Equity Risk Premium (ERP) associated with the individual GCC countries for the past 4 years. ERP refers to the excess return that investors demand for investing in equities over the risk-free rate. The value of the equity premium varies depending on the level of risk associated with the market. ERP has been calculated based on three methods – credit ratings, CDS spreads, implied ERP.

The risk premium of Saudi Arabia, Abu Dhabi and Kuwait have consistently declined over the past four years based on credit ratings and CDS Spread methods. This decrease could be explained by the increase in average oil prices from 41.20 $/bbl in H1 2016 to 66.14 $/bbl in H1 2019 as this would increase the revenues of the country and improve their position to service debt and in turn reduce the risk. The positive investor sentiment on the back of index inclusions of the GCC bonds by JP Morgan have also contributed to the decline in ERP.

Equity Risk Premium Range for GCC countries (in %)



Source: Marmore Research; Note: Chart denotes the ERP range obtained from CDS, Rating and Implied ERP methods

Qatar suffered a ratings downgrade in 2017 from Aa2 to Aa3. This has been due to increase in its external debt and concerns about the sustainability of its growth model which rests more on government led investments. Since 2017, with its ratings unchanged at Aa3, increase in oil prices and index inclusions, the ERP has decreased.

Bahrain's rating has been downgraded from Baa2 in 2016 to Ba2 in 2017, B1 in 2018 and B2 in 2019. This has increased its equity risk premium. The reasons for the recent downgrade, as cited by the ratings agency, are increase in liquidity risks, slow implementation of fiscal reforms and high gross borrowing needs of the government.

In October 2018, financial aid of USD 10 billion was promised to Bahrain by the neighbouring countries Saudi Arabia, UAE and Kuwait. The first tranche of it, USD 2.3 billion for 2018 was received by Bahrain. While this has been perceived favourably by the markets and has led to narrowing of CDS spreads, this has not resulted in reconsideration of ratings by the rating agency.

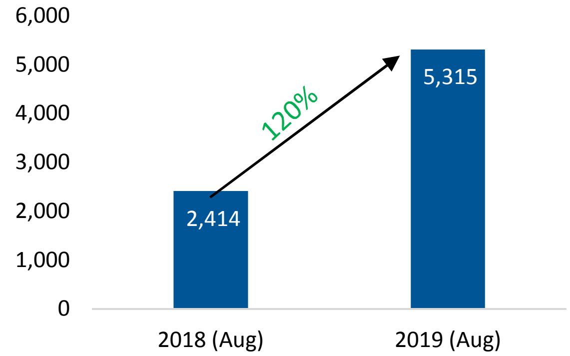
Oman's rating has been a downgraded to Baa1 in 2017 to Baa3 in 2018 and Ba1 in 2019. The rating agency cited persistently wide fiscal and current account deficits and Oman's dependence on external financing as reasons for the downgrade. For 2018, though there had been a downgrade, the risk premium has not increased. This is because the increase in default spread was offset by the decrease in the U.S equity risk premium.

Except for Oman and Bahrain, other GCC countries have seen a decline in their equity risk premium because of favourable factors such as better economic growth and structural reforms. While IMF's projections of slowing global growth and oil price volatility could lead to increase in ERP of GCC countries, more investor friendly reforms and better regional growth could lead to further decrease.

Boursa Kuwait Witnesses Rising Liquidity Levels

Liquidity levels in Kuwait has improved dramatically in 2019 with Kuwait all shares index cumulative turnover value till the month of August increasing by 120% from KD 2,414 million in 2018 to KD 5,315 million in 2019. The basic materials sector witnessed the highest increase in turnover value at 131% and the consumer goods sector recorded the lowest figures at -63% over the same period. The month of July witnessed the highest turnover value in 2019 at KD 979 million.

Kuwait All Shares Index – Total Value Traded (KD Million)

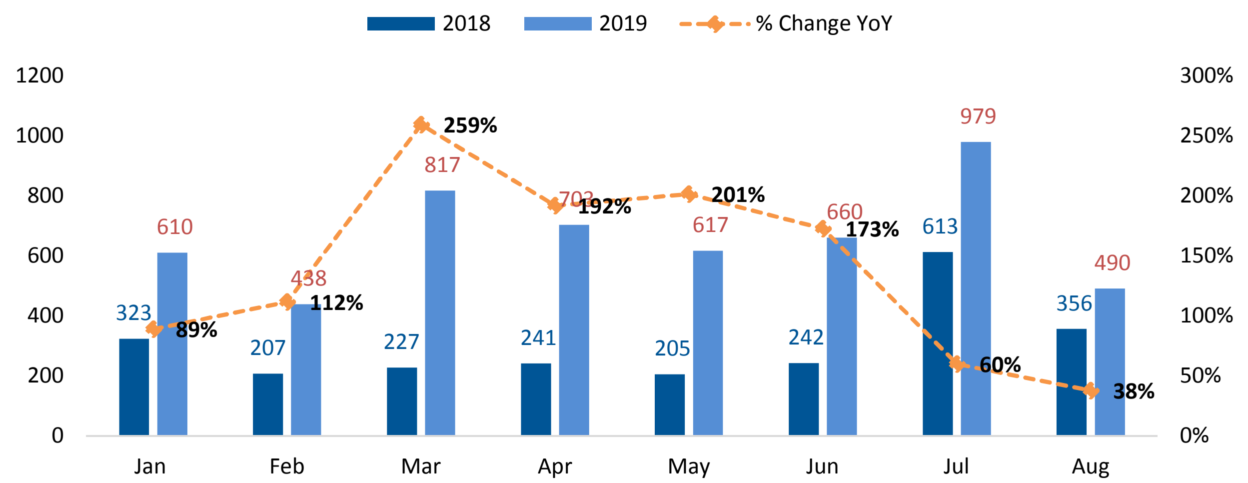


Source: Reuters; Note: Value traded is for the period from January to August of the respective year

Since 2017, Kuwait has introduced several capital market reforms in order to attract global attention. These efforts have greatly paid off as global index providers namely MSCI, FTSE Russell and S&P Dow Jones Global Benchmark Indices reconsidered their stance on Kuwait, upgrading it to their respective emerging markets index. On September 2017, FTSE announced its plans to classify Kuwait as an emerging market and on December 2018, S&P Dow Jones Global Benchmark Indices did the same.

The year 2019 has especially peaked investor sentiments as the world's largest index provider, MSCI, with over USD 1.8 trillion in capital under management, announced in its semi-annual index review in June of 2019 that it was upgrading Kuwaiti equities to its emerging markets index. In the days leading up to this potential announcement by MSCI, domestic and international investors poured capital into Kuwait markets which has seen a sustained rise in traded volume and turnover values throughout 2019. As a result, the Kuwait All-Share Index and Premier market Index have provided stellar returns of 17% and 24% respectively as of August 2019.

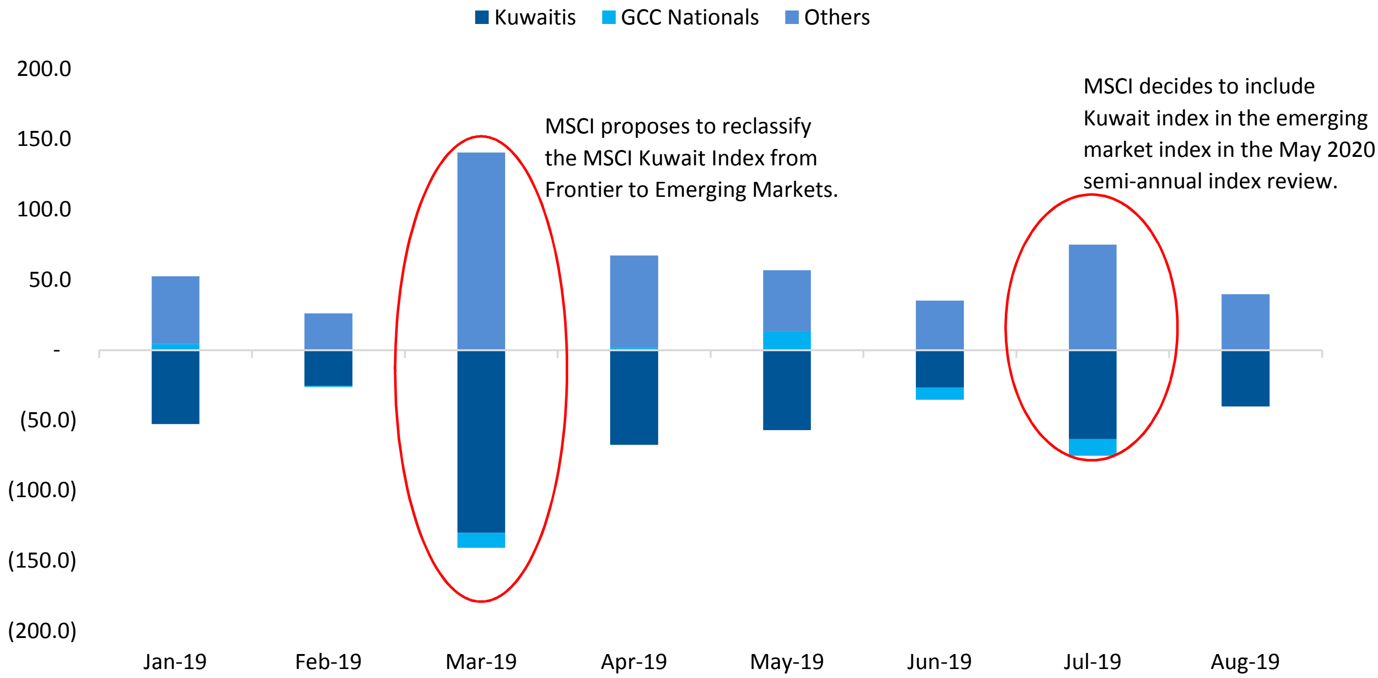
Monthly comparison of Total Value Traded (KD Million)



Source: Reuters, Marmore Analysis

In 2019, we see that turnover values have dropped nearly 50% between July and August. Even though this may indicate a substantial decline in the liquidity levels for in the month of August, we need to bear in mind that July witnessed a spike in liquidity figures due to the index inclusion announcement by MSCI on June 25th. Moreover, August had fewer working days as markets remained closed for five consecutive days for Eid Al Adha. However, when we compare the index turnover value of August with the same period in 2018, we see that there has been an increase of 38% year-on-year indicating that the MSCI announcement continues to have a positive impact on the Kuwait market liquidity levels.

Boursa Kuwait Traded Value by nationality (KD Million)



Source: Boursa Kuwait; Note: Values above the base line indicate net positive value traded while values below indicate net negative value traded.

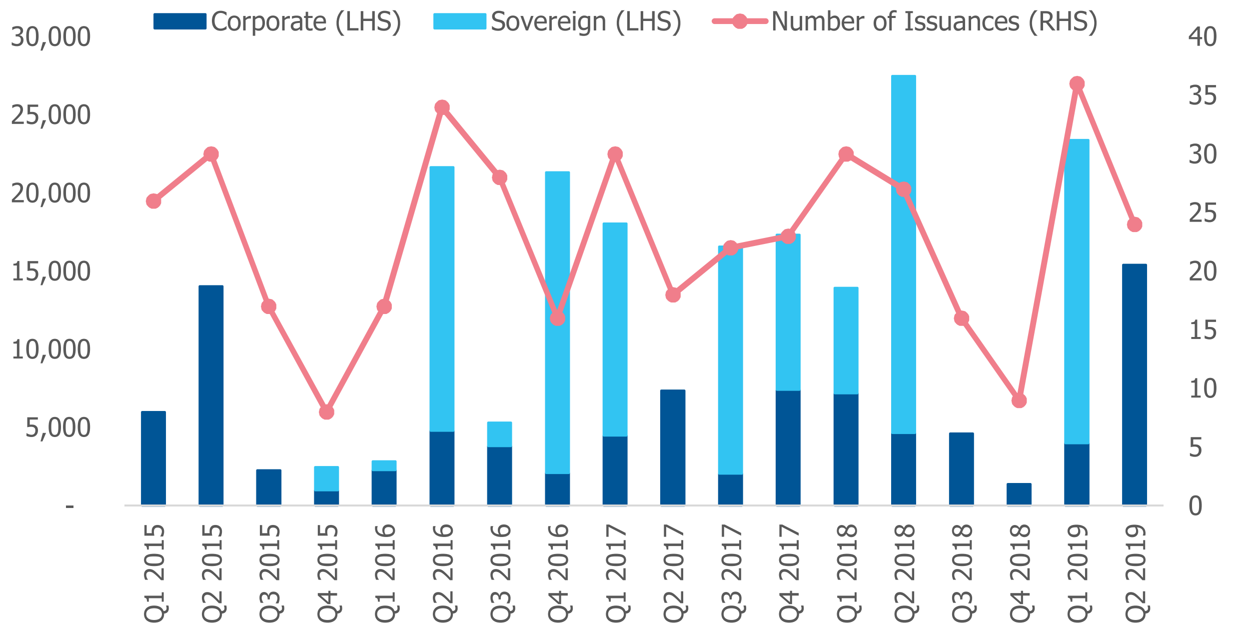
Looking at the trade value bifurcation by investor nationality for 2019, we see that the foreign investors (outside GCC) have been net positive buyers throughout. High levels of trade activity has been witnessed during March 2019 when MSCI proposed to reclassify Kuwait from Frontier to Emerging Market and on July when MSCI decided to finally integrate Kuwait into its emerging market index. Similar spikes in trade activity was also witnessed in 2018 when Kuwait was incorporated into the FTSE and S&P Dow Jones Global EM index.

GCC Bond issuances witness an uptick in H1 2019

Bond markets in the GCC witnessed a pick-up in debt issuances during the first half of 2019 after a subdued close in the last two quarters of 2018. The rise in oil prices during the first nine months of 2018 boosted the oil revenues for GCC economies, reducing the need to tap the bond markets. Consequently, Sovereign issuances dried up in the second half of 2018.

Since the start of 2015[1], the UAE and Saudi Arabia have been the most active in terms of bond issuances among GCC countries, accounting for 34.3% and 31.9% of the total issuances by value. Sovereign issuances formed a major part of total debt issued by Saudi Arabia during the period while the case was opposite for the UAE, where Corporate issuances were much larger in value.

GCC Bond Issuances Q1, 2015 – Q2, 2019 (USD Mn.)



Source: Reuters; Note: All non-sovereign issuances are considered as corporate issuances

Sovereign issuances in the GCC region surged after 2016, as the fall in oil prices prompted GCC countries to resort to external borrowings for funding their government expenditure. Saudi Arabia leads the GCC countries in terms of sovereign issuance since 2016, raising more than USD 60 billion through international bond issuances. However, Qatar was the major issuer among sovereigns in 2019 so far, raising USD 12 billion dollars through an international issuance in March 2019. Saudi Arabia and Oman were the other sovereign issuers during the year, with the former raising USD 7.5 billion through an international issuance in January and EUR 3 billion through a Eurobond issuance in July while the latter raised USD 3 billion in July. Oman's sovereign issuance came after Moody's downgraded the country's credit rating to junk territory, much like S&P and Fitch, who also downgraded Oman's rating to junk category earlier.

Corporate issuances witnessed their best quarter since the start of 2015 during Q2 2019 in terms of value of bonds issued, boosted by Saudi Aramco's maiden bond issuances worth USD 12 billion during April. Notably, Saudi Aramco received orders worth USD 100 billion, highlighting strong investor interest towards

[1] As of 23rd Sep 2019

the company before its impending IPO. Excluding Saudi Aramco's issuance, UAE corporates have been the most active issuers during 2019 in terms of both number and value of issuances.

The total outstanding debt in GCC countries as of Q2 2019 stands at USD 501 billion, of which approximately USD 43 billion is scheduled to mature in the second half of 2019.[2] Rollover of maturing debt is likely to result in further issuances during the rest of the year. As oil prices have been volatile throughout 2019 due to demand and supply side shocks, GCC countries, which have proposed expansionary budgets to boost economic growth, are expected to tap the bond markets in the subsequent quarters as well. Saudi Arabia in particular is expected to lead the activity as it plans to raise USD 31.5 billion for the full year of 2019 to fund its expenditure.

[2] NBK report.

Why Kuwait is not following the Fed?

Central Bank of Kuwait (CBK) has last increased its discount rate in March 2018, aligning with the U.S Fed rate hike. Since then, the U.S Fed has hiked rates thrice and cut rates twice. However, CBK has maintained the discount rate unchanged at 3%. The recent Fed action happened on 18th Sep 2019 where rates were cut by 25 bps. UAE, Qatar and Saudi Arabia followed through immediately.

Interest rates are one of the key variables in an economy. Market participants keenly follow interest rate movements. It is an indicator of how the economy is performing, a signal of what could be expected and a tool to minimise impact of externalities. As the lending and deposit rates of financial institutions are based on them, they have an impact on economic growth and consumer spending.

Kuwait's discount rate, which is its policy rate, and deposit rate are influenced by U.S Fed interest rate moves. But it does not always mirror the changes. This is because Kuwait has its currency pegged to an undisclosed basket of currencies, in which US Dollar is expected to have a dominant position. The slower pace of rate increases were aimed at supporting economic growth.

Weak global growth and trade tensions have been cited as reasons for the recent Fed rate cut. Other GCC countries' interest rate moves mostly mirror that of the U.S Fed interest rate, as their currencies are pegged to the dollar. UAE, Saudi Arabia and Qatar followed the Fed's trajectory of rate cuts. Saudi Arabian Monetary Authority has stated that the recent cut was in line with its objective of maintaining monetary stability.

According to the CBK, reasons not to follow Fed trajectory includes the following:

- **Support non-inflationary growth in the non-oil economic sectors**
  Inflation in 2018 was at 0.7% due to decreasing housing rents, easing food prices, and a strengthening dinar. It is expected to pick up to 2.5% in 2019-20 as the deflationary factors unwind.[3] Maintaining policy rate could be CBK's attempt to reduce the upside risks to inflation.

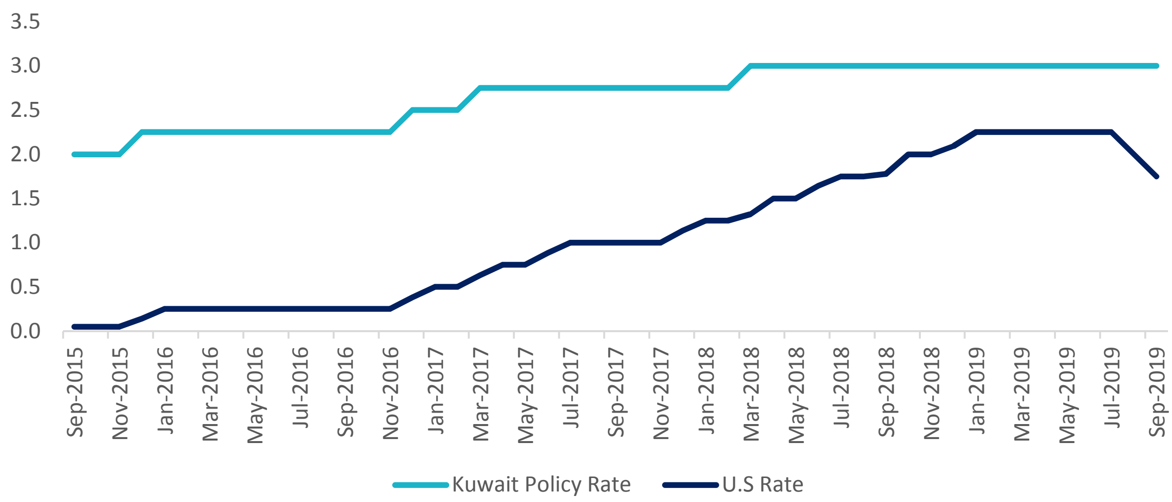
- **Enhance the competitiveness and attractiveness of the local currency for domestic savings**
  By retaining higher interest rates, CBK reduces the degree of outflow of funds, thereby maintaining the strength of the currency.

- **Boost returns on dinar deposits**.
  CBK has responded to U.S Fed rate hikes by increasing deposit rates almost in tandem. The deposit rates were increased to sustain fund flow into the region. This has resulted in weighted average return on KD deposits inching up from 1.61% in 2017 to 1.81% by the end of 2018. On the other hand, weighted average rate on KD based credit posted a much smaller increase, edging up to 4.83% by the end of 2018, compared to 4.75% a year earlier.[4]

  If CBK lowers policy rate, as most bank loans (corporates) are based on floating interest rates they are priced down quickly reducing banks' interest income. However, the rate banks pay on time deposits would lower only at the time of renewal of these deposits, leading to high interest expense for some time before it could also decrease. Hence, there is a narrowing of interest rate spread for the banks in the interim. To avoid this, and to continue delivering high returns on deposits, CBK could have maintained the policy rate.

[3] IMF Country Report on Kuwait April 2019
[4] Central Bank of Kuwait Financial Stability Report 2018

U.S Interest Rates vs. Kuwait Interest Rates (in %)



Source: Reuters

CBK bases its decisions on the data of the general economic performance, the indicators of local liquidity, the movements of savings and bank credits, and the interest on Kuwaiti dinar and the world's major currencies, notably the US dollar. Kuwait's policy action in future is also expected to reflect these parameters instead of mirroring the trajectory of U.S. Fed rates.

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