MENA EQUITIES
OUTLOOK
By Sagar Patel and Ahmad Banihani

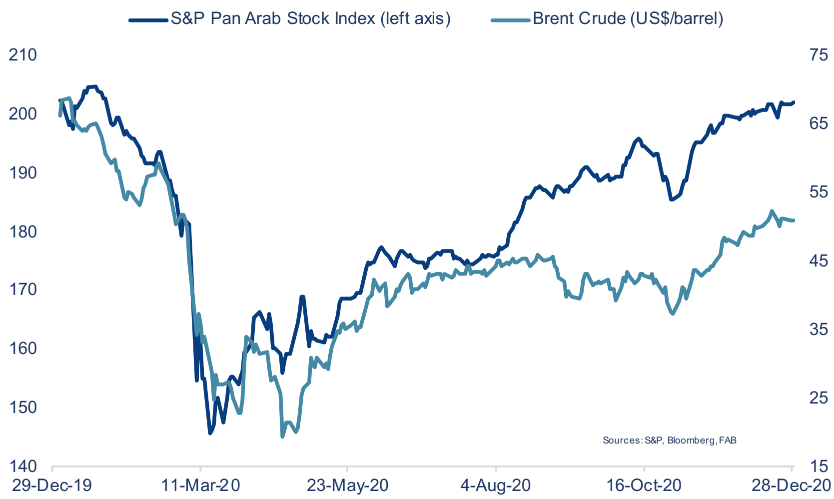
The MSCI Emerging Market Index is the embodiment of emerging market equities. The UAE and Qatar entered it in 2013, Saudi Arabia in 2019, and Kuwait in late 2020. These countries now total about 4.6% of the index, and global allocators are having to take notice of them, although in truth their full realization of what constitutes MENA equities as a class remains at an early stage.

Global investors may not yet understand the significance of recent historic reforms (particularly in the UAE), or the numerous potential benefits of Israel beginning to come in from the political cold. Nor are they yet willing to believe that Brent crude could recover to an average of US$65/barrel in 2022 (which is FAB's house view), compared to US$55.99 on 8 January.

Regional Gulf Cooperation Council (GCC) governments and sovereign wealth funds are looking beyond hydrocarbons, and more toward their own stock exchanges. Oil is still important, but with ongoing industrial diversification it is becoming less so. Hydrocarbons have been the starting-point, but prescient local rulers know the world is changing. Within the world of EM equities, MENA equities represent a genuine value proposition, and very often offer attractive dividend yields.

Fiscal stimulus has proven paramount in the region's economies in the response to the coronavirus pandemic, and has helped them cope with it. According to Fitch Ratings, off-budget stimulus has amounted to nearly 30% of GDP in Bahrain and Oman, more than 10% in Kuwait, Qatar and the UAE, and in excess of 7% in Saudi Arabia. This injection of liquidity has already shown a direct and positive impact on economic data coming out of the GCC nations, while also being supportive of local equity markets. Having said that, the S&P Pan Arab Composite LargeMidCap Index lagged the MSCI All Countries Index by about 15% last year. However, this could be a buying opportunity in absolute and relative value terms.

While the GCC nations did all they could by way of stimulatory spending during 2020, these countries are constrained by their still relatively high fiscal breakeven prices for crude oil. The region is, however, gradually becoming less dependent on hydrocarbons. Hence, selected stocks in



the GCC region provide strong cases for value-driven investment, as well as potential growth stories. Also, just as Kuwait entered the MSCI Emerging Market Index last year, MENA equities are likely to command a growing percentage in that index.

FAB's Asset Allocation Committee expects emerging market assets to do well in 2021, and that includes MENA equities, specifically driven by the further rollout of policy reforms, and successful economic diversification. Visitors to the delayed EXPO 2020 later this year will see this first-hand. However, by then, asset prices may have already begun to move upwards.

The S&P Pan Arab Composite LargeMidCap Index is trading at 15.5x 2021E earnings. Over the last ten years, MENA equities as a class have tended to trade in a range of about 13x-15x forward earnings, with a peak of 20x and a trough of 12x. For 2021, the Bloomberg consensus is for earnings to recover substantially, by 29.3%, helped by the base effect. Heading towards mid-2021 investors will be looking at prospective 2022 corporate earnings, with the Bloomberg consensus assuming earnings growth of 18.1% for that year, underwriting a prospective 'very good value' P/E ratio of 13.1x, and an attractive PE-to-Growth (PEG) ratio of 0.73x.

The house view is optimistic regarding a return to robust global growth by the second half of 2021, and upward revisions in MENA earnings are looking more possible. While such an outcome would be helped by favourable oil prices (Glenn Wepener is forecasting Brent to average US$58/barrel in 2021, and US$65 for 2022), the GCC oil & gas producers' economies are successfully evolving away from hydrocarbons. As noted, reform efforts are instrumental in this.

Dividend cuts that occurred in 2020 are firmly in the rear-view mirror, with prospective dividend yields on our regional benchmark showing an attractive 3.53% for 2021, and 4.05% for 2022. Certainly a yield in excess of about 4% begins to make this asset class attractive from the point of view of the global hunt for yield.

Lastly, whereas earnings forecasts for the MSCI All Country Index for 2022 bottomed in early June 2020, estimate revisions for the MENA benchmark for the same year did not bottom until the end of September. The intervening period was one during which the price of Brent crude was essentially flat, while the prices of most other risk assets were improving. Accordingly, although the bull arguments for MENA equities include the non-oil factors mentioned, it appears that a better oil price between now and into 2022 would be a bonus, making the asset class even more attractive. MENA equities should indeed play catch-up with their global peers.

The Kingdom of Saudi Arabia

According to the IMF, the country's GDP is expected to have contracted by 6.8% in 2020. However, as global growth regains traction, and as the potential for an increase in oil production begins to improve, we anticipate a solid economic recovery in line with the IMF's projected 3.1% growth outlook for 2021.

The Saudi Arabian Ministry of Finance estimates the fiscal deficit for 2020 to be 298 billion riyals (12% of GDP). Government spending is forecast to rise by 1% in 2020, and to fall by 7% in 2021 and 4% in 2022. It may well be that headwinds remain in the form of essential fiscal adjustments. Having said that, the government has taken drastic measures to curb spending and increase revenues via capital expenditure suspensions and an increase in taxes with the objective of navigating the structurally-lower oil prices prevalent since 2014. These measures will play a significant role in stabilizing and restoring the government's fiscal position.

Net interest margins in the important Saudi banking sector are expected to correct with the lower interest rates, although pandemic vaccine solutions should help normalize activity levels, eventually moving rates higher and supporting the sector. In the meantime, an increase in housing starts and mortgage issuances should support retail credit growth. We expect pandemic-related provisions are likely to be to be staggered, and to be capital-neutral based on central bank and Basel guidance.

Saudi Arabia's Tadawul index outperformed its neighboring markets in 2020 with a return of 3.58%. While select stocks might seem relatively expensive compared to their emerging market peers, the positive momentum in the largest equity market in the GCC cannot be ignored. Investors should concentrate on company-specific factors (e.g., in consumer goods), social reforms (e.g., in insurance), and other selected growth opportunities (e.g. in cement) when stock-picking in KSA.

The United Arab Emirates

The UAE has already started to see a significant improvement in tourism. There is considerable pent-up demand for travel, and Dubai and Abu Dhabi should greatly benefit. As mentioned, the EXPO towards the end of this year should provide major positive impetus. Indeed, it will showcase the considerable achievements of the UAE's leadership and visitors will see what an attractive place the UAE is to live. Increasing fiscal spending, an improvement in credit and employment metrics, and the stabilization of the real estate market should help real non-oil and gas GDP growth to recover as 2021 proceeds.

UAE economic activity recovered partially in the third quarter of 2020. The Central Bank of the UAE (CBUAE) recently projected total real GDP growth for 2020 in the region of -6%, with non-oil and gas GDP expected to have declined by around 5%. For 2021, CBUAE expects real total GDP to grow by 2.5%, and non-oil by 3.6%. We would also note that in the medium-term, improved growth should result from the recent very well-received reform initiatives, making the UAE even more attractive to expatriate and retiring professionals.

We are recommending an overweight position in UAE stocks. Stock allocation is mainly focused on sustainable dividend opportunities, and on companies that have the financial flexibility to weather economic weakness. The remainder of the overweight logic largely relates to attractively-priced banking names that have potential to fully participate in the UAE's expected economic recovery. Lastly, we expect normalized relations with Israel to result in mutually-beneficial joint ventures, and would not be surprised to see some related new market listings.

Kuwait

While an overview of Kuwait equities may show signs of expensive valuations relative to potential earnings growth, the MSCI inclusion of that market in its EM index will go a long way to provide underlying support to this sub-class, and to raise the bar on the potential country growth outlook. However, investors will want to be sure of policy normalization after the recent change in the country's leadership, and any positive changes in Kuwait's fundamental outlook will be heavily contingent on that.

Egypt

Egypt offers diversified sectoral exposure, and good scope for stock selection. Post-pandemic normalization and favourable base effects are expected to drive 25-30% earnings growth for Egyptian companies in 2021. Investment capex is likely to be supported by rate cuts totaling 400 basis points in 2020, with further rate cut expectations of 150-200 basis points in 2021. We will continue to be highly stock-specific in Egypt, and with due regard for liquidity. While the banking and real estate sectors are likely good ways to play a macro recovery there, investors should be able to find attractive and specific opportunities in the healthcare, fintech, energy, and consumer sectors.