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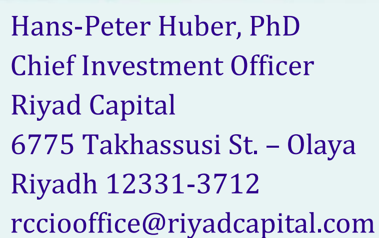
Global Investment Perspectives

First Quarter 2019



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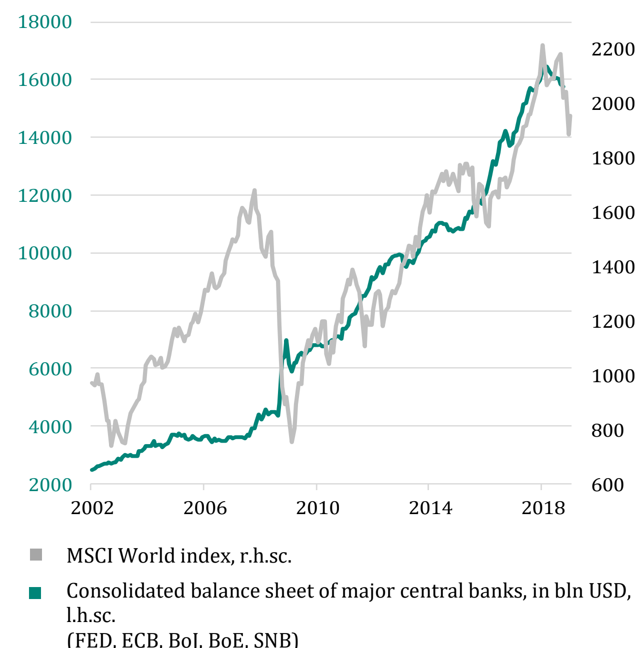
A Re-Synchronized Global Growth Slowdown in 2019

- **The growth slowdown of the World economy, which began in the second half of 2018, will continue to unfold in 2019. Uncertainties related to the US-Chinese trade dispute additionally cloud global economic prospects.**
- **The growth acceleration of the US economy in 2018 has been transitory as most recent macro indicators point towards a notable slowdown in 2019. Hence, the US economy will synchronize again with the global business cycle after last year's temporary divergence.**
- **The US Federal Reserve has most recently taken a softer stance on the back of the latest economic indicators. We expect two final rate hikes in the course of this year before US rates will have reached their peak in the current interest rate cycle.**
- **Growth of the Saudi non-oil economy will further accelerate in 2019 supported by an expansionary fiscal policy. The overall economy will witness a gradual growth slowdown due to a lower growth contribution by the oil sector in view of the expected output cuts.**
- **Global equity markets are adapting to the normalization of monetary policy after years of excessive liquidity creation (see figure below). Although the medium-term outlook remains subdued, a gradual recovery after the strong corrections seems likely in the short term.**
- **We expect the Saudi equity market to perform well in 2019. This is based on a solid single-digit earnings growth projection for this year. On top, we expect the inclusion process in major EM indices to lead to some valuation multiple expansion in the course of the year.**

Equity Markets Driven by Global Excess Liquidity



MSCI World index, r.h.sc.

Consolidated balance sheet of major central banks, in bln USD, l.h.sc. (FED, ECB, BoJ, BoE, SNB)

source: Bloomberg

Over the past 10 years, a key driver for global equities has been the unprecedented liquidity creation by major central banks in the framework of their quantitative easing programs.

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Part 1: Global Economy

A Global Growth Slowdown in the Making

Recent economic data illustrate that the global economy experienced a considerable growth slowdown in the second half of 2018. While global GDP growth, based on our estimates, had reached a cyclical peak of more than 4.0% by mid of last year, it slumped to 3.6% in the third quarter (see figure 1). This deceleration in growth was geographically broad-based, affecting the Eurozone, Japan and Canada among the developed economies and countries such as China, India, Russia and Korea among emerging markets.

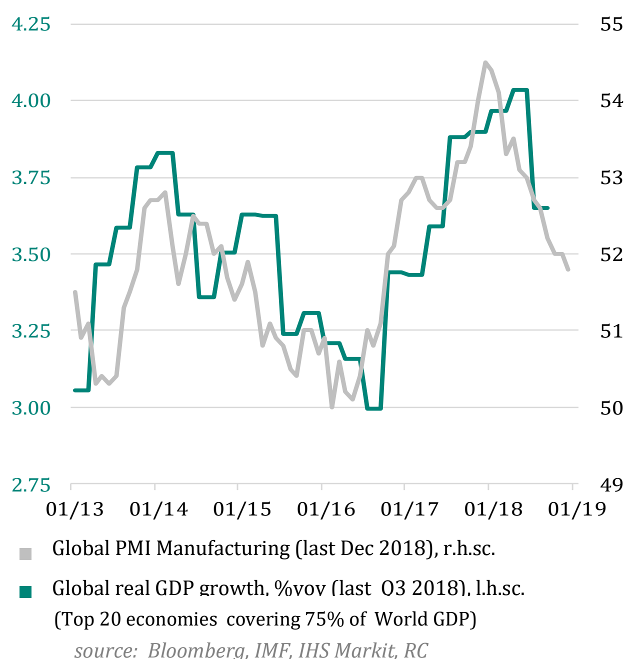
Various indicators of global economic activity point towards further weakness by the end of last year and into 2019. Based on global PMI Manufacturing, World GDP growth has most probably slowed to approximately 3.5% by the end of 2018 (see figure 1). For 2019, forecasts have notably been revised downwards in recent months. Bloomberg business economists' consensus expects global economic growth of 3.5%, compared to 3.7% just a few months ago (see table 1).

In past issues of this report, we have already referred to the reasons for the cyclical upturn of the global economy over the last two years and anticipated the scenario of a significant growth slowdown in the course of 2018 at an early stage. From our point of view, the key growth drivers of recent years have been positive fiscal stimulus in most economies, a highly accommodative monetary policy of major central banks, an overly positive environment on global financial markets and, in particular, a benign development of most real estate markets. The positive impulses of these factors have already weakened considerably for some time, or even developed into negative ones, thus indicating a clear slowdown in global economic growth at an early stage.

In addition to these economic factors, increased political issues could potentially further exacerbate the macro slowdown. In the first place, this applies to the US-China trade dispute. As both countries have already imposed punitive trade tariffs, the first consequences of this restrictive trade policy for the respective domestic economy are already becoming apparent towards the end of 2018. The outcome of renewed negotiations during the first quarter 2019 remains highly uncertain.

In addition, Europe is another area of political uncertainty. First, the possibility of a hard Brexit, the UK leaving the EU without a contractual framework, could have lasting negative effects for the UK and Europe. In addition, disputes between some national governments and the EU, as in the case of the Italian fiscal budget, could further intensify with negative repercussions on financial markets. Against this background, we consider the current consensus forecast of 3.5% for global growth in 2019 to be rather optimistic and see risks rather biased to the downside.

Figure 1:
Global Growth Weakening in H2 2018



source: Bloomberg, IMF, IHS Markit, RC

Table 1:
Global GDP Growth Forecasts

	2016	2017	*2018f*	*2019f*
World	**3.2**	**3.7**	***3.7***	***3.5***
Advanced Economies	**1.7**	**2.4**	***2.3***	***2.1***
USA	1.6	2.2	*2.9*	*2.6*
Euro Area	1.9	2.4	*1.9*	*1.6*
Japan	0.6	1.9	*0.9*	*0.9*
United Kingdom	1.8	1.8	*1.3*	*1.5*
Emerging Economies	**4.4**	**4.9**	***5.0***	***4.9***
China	6.7	6.9	*6.6*	*6.2*
India	7.1	6.7	*7.3*	*7.3*
Russia	0.3	1.6	*1.7*	*1.5*
Brazil	-3.3	1.1	*1.3*	*2.5*
Saudi Arabia	1.7	-0.9	*2.4*	*2.1*

Bloomberg economists' consensus forecasts, KSA: RC forecasts

source: Bloomberg, RC

US Economic Divergence Turning to Slowdown Convergence

Last year, the US economy experienced a growth acceleration to almost 3.0%, diverging from the global trend. This was mainly due to the tax reform introduced by the Trump government at the beginning of 2018. However, recent economic data suggest that this effect is slowly fading and that the US economy will grow at a lower rate in 2019 as well. A particularly worrying signal came from the ISM Manufacturing PMI, which slumped no less than 5.2 points month-on-month in December. A drop of this extent had last been seen 10 years ago amidst the Great Recession. But also other economic indicators, such as durable good orders or retail sales, are increasingly pointing to a slowdown in growth.

Against the backdrop of a slowing US economy it is important to note that the fiscal scope of the US government to stimulate the economy is quite limited at this juncture. In particular, the tax reform introduced last year has already left a clear mark on the fiscal budget. The federal deficit has expanded to 4.3% of GDP by end of 2018, after having been close to 2% of GDP back in 2016.

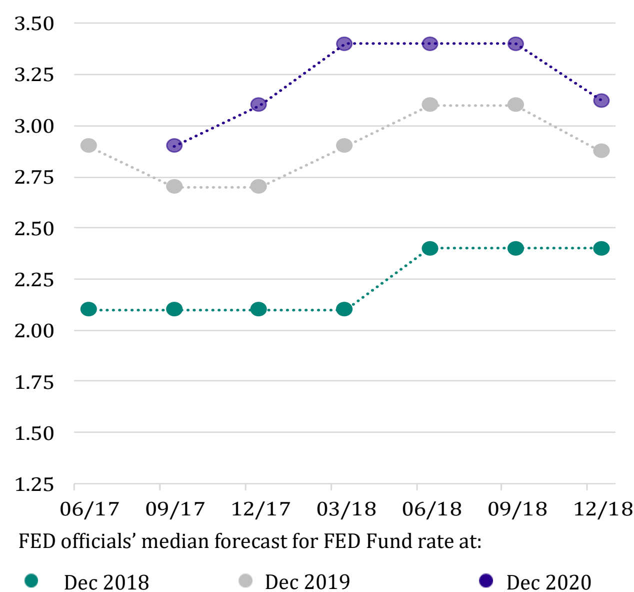
A Softer Stance by the US FED

The increasing signs of a notable growth slowdown in the United States have also impacted the economic assessment of the US Federal Reserve. In December, the FED officials reduced their quarterly projections for future interest rates in 2019 and 2020. The US central bank officials now expect two rate hikes over the course of 2019, while three interest rate hikes were still forecasted back in summer 2018. For 2020, the projection of a single additional increase in policy rates remains unchanged (see figure 2). In our view, this reduction to two projected rate hikes for 2019 is a realistic scenario against the background of the expected slowdown in growth. On the other hand, we do not expect any further interest rate hikes in 2020, which means that the FED Fund rates should peak at 3.0% in the course of 2019.

At the same time, the FED will continue to taper its balance sheet in 2019 along the path determined and initialized in Q4 2017. The FED balance sheet had been significantly inflated as a result of several quantitative easing programs over the last 10 years (see figure 3). Although FED Chairman Powell has expressed some flexibility in implementing this strategy, we expect the US Federal Reserve to broadly stick to its plan to continuously scale down its balance sheet under normal macro and market conditions.

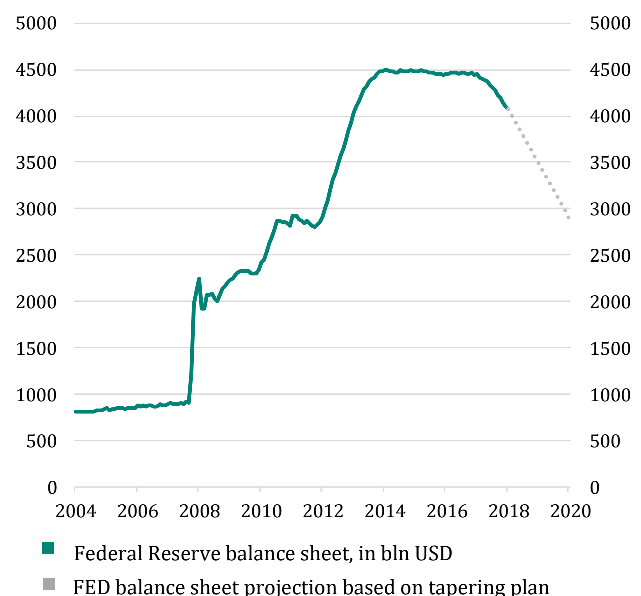
This balance sheet reduction indeed marks a turning point in monetary policy. This also applies to other major central banks, which in the past carried out quantitative easing programs resulting in ballooning central bank balance sheets. Meanwhile, the European Central Bank (ECB) suspended its bond purchases at the end of 2018 and is currently holding its balance sheet at a constant level. A balance sheet reduction may be envisaged at a later stage, although timing and execution are not yet determined at this point. Other central banks are at a similar stage in this process. Finally, the Japanese central bank, the only central

Figure 2:
Federal Reserve Officials' Interest Rate Forecasts



source: Federal Reserve

Figure 3:
FED Sticking to its Balance Sheet Tapering Plan



source: Federal Reserve

bank still maintaining a buying program, has notably reduced its monthly purchases since 2017. Overall, this normalization of monetary conditions and gradual absorption of excess liquidity by major central banks will have significant implications for global financial markets in the medium term.

Chinese Growth Deceleration and a Fading Current Account Surplus

The global economic slowdown also affects the Chinese economy. Some indicators point even toward an accelerated slowdown in China towards the end of 2018. Official PMI Manufacturing data for December, for example, fell below the 50 mark to 49.4, indicating even an output contraction, while industrial production rose only 5.4% year-on-year in November, a trough in growth last time observed 10 years ago during the Great Recession (see figure 4). On the back of this most recent development, the Chinese government has started to gradually counteract by allowing a slightly higher budget deficit for 2019 and by moderately easing monetary conditions. Notwithstanding, the consensus of the business economists forecasts a notable growth slowdown from 6.6% to 6.2% in 2019. In view of this rather fragile macroeconomic situation, the Chinese government definitely has a vital interest not to further escalate the trade war with the US.

In terms of the external balance, an interesting observation could be made in 2018. For the first time in over 20 years, a quarterly current account balance turned out negative (see figure 5). Although this may be an outlier in the short term, it does point to the medium-term trend of a dwindling current account surplus— a surplus which had reached no less than 10% of GDP 10 years ago. This vanishing current account surplus is not the result of the trade dispute with the US, but rather a consequence of China's structural transformation from an export-driven role model to a domestic demand-driven economy.

The medium-term implications of a balanced or even negative current account balance in China are significant for China as well as for the rest of the world. For many years the massive capital inflow as a result of this current account surplus has served as a buffer helping to stabilize the domestic economy and the external value of the Chinese currency. Without this capital inflow the Chinese government will have less flexibility to react to economic shocks. The consequences in the medium term may be higher business fluctuations of the Chinese economy and an increased volatility of the Chinese currency as the Chinese authorities will have fewer tools to counteract global shocks and managing the currency will become increasingly difficult.

At the same time, the fading current account surplus will translate into a lack of Chinese capital exports to finance major deficits elsewhere in the World. This, in particular, also applies to the US. In fact, China is currently the largest holder of US treasuries. Hence, a growing supply of US government bonds as a result of higher fiscal deficits in the coming years will potentially face a structurally lower demand with possibly considerable implications for US government funding costs.

Figure 4:
Chinese Industrial Slowdown

source: Bloomberg

Figure 5:
China Current Account Surplus Fading

source: Bloomberg

Part 2: Oil Market

A Rollercoaster Ride on Global Oil Markets

Global oil prices went through a real rollercoaster ride in the past 12 months. From March to October 2018, the Brent oil price was driven from less than 70 USD to above 85 USD (see figure 6). This happened in the face of growing fears that the supply outage of Iran as a result of the re-imposed sanctions could not be entirely compensated by other producer countries, thus leading to a global supply shortfall. In the fourth quarter of 2018, however, against the general market expectation, oil prices fell sharply by about 40%, in the case of Brent to a level of 50USD.

In our view, two factors were the main drivers of this massive price correction. First, just prior to the sanctions on Iran at the beginning of November, the US government granted a temporary waiver to selected countries, permitting them to import Iranian oil. Secondly, the remaining OPEC members expanded their production to an extent that OPEC output increased by about 1.0mbd from May to November, although in the same period Iran had already recorded an output decline of over 700k bd (see figure 8 and 9). The bulk of this increase came from Saudi Arabia, which expanded its output by 1mbd to over 11mbd (see figure 10). Combined with a concurrent massive supply expansion of about 700k bd by US shale oil producers, this caused a considerable oversupply on the global oil market in Q4 2018. Prior to this the market had been characterized by a substantial supply shortage pushing oil prices up. These changing market conditions are also reflected in the futures term structure of oil prices. The longer dated futures prices were still well below the spot prices (backwardation) in spring, which usually indicates a market shortage. With the massive output expansion by November, spot prices fell below futures prices (contango), typically a constellation suggesting a supply overhang (see figure 7).

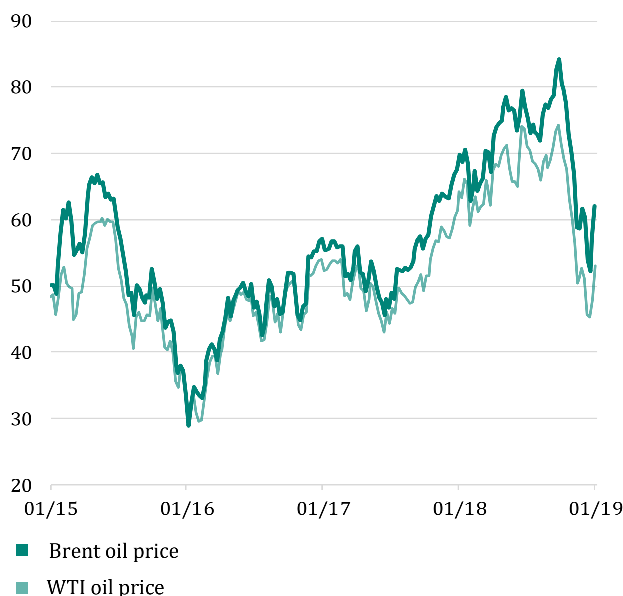
These market imbalances also affected global oil inventories. The OPEC output cut agreement of 2016 and the resulting market shortage caused OECD oil inventories to fall from 3.1 bln brl to 2.8 bln brl in the period from spring 2017 to summer 2018 (see figure 11). The subsequent supply expansion in the second half of 2018 led in turn to an increase in inventories of around 100 mln brl by November of the year.

The Necessity of A Renewed OPEC Output Cut

Against this backdrop, OPEC producers and their affiliate partner countries agreed at the end of November on another production cut of overall 1.2 mbd and started to implement already in December (see figures 8 and 10). This supply reduction has already affected oil prices with the Brent price rallying from 50 USD to 60 USD in the course of January.

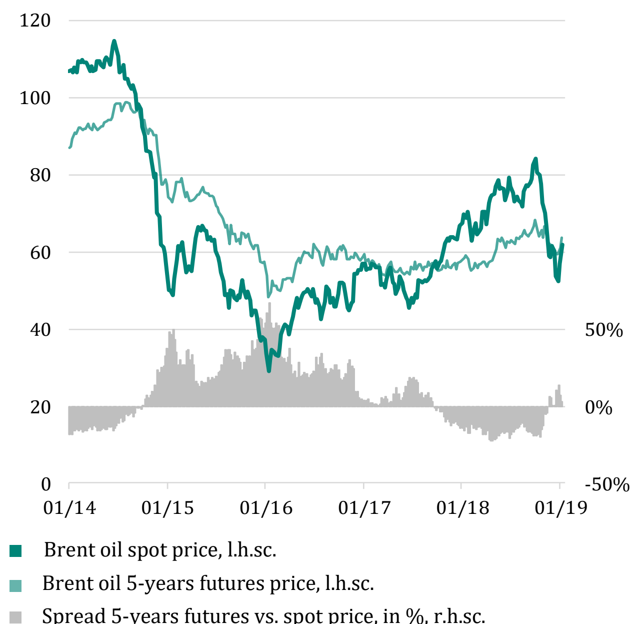
In our view, this output cut is in fact required to rebalance the market in the course of 2019. Based on the latest projections by the International Energy Agency (IEA) global demand should grow by 1.4 mbd

Figure 6:
Oil Market Rollercoaster



source: Bloomberg

Figure 7:
Oil Market from Backwardation to Contango

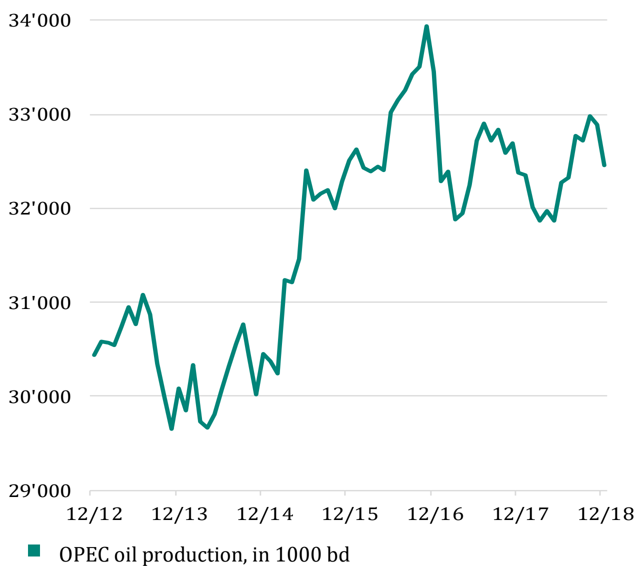


source: Bloomberg

this year. On the other hand, Non-OPEC supply is expected to increase by another 1.5 mbd. This estimate has most recently been reduced by 0.4 mbd due to Russia's participation at the OPEC output cut agreement and an expected production cut in Canada due to logistical problems. Given an estimated supply overhang of about 600k bd throughout 2018, the envisaged output cut by OPEC should be sufficient to broadly balance the market in 2019. This baseline scenario additionally assumes that the waivers on Iranian sanctions granted by the US government to some countries will not be renewed in May of this year which will further reduce output and, hence, support the market.

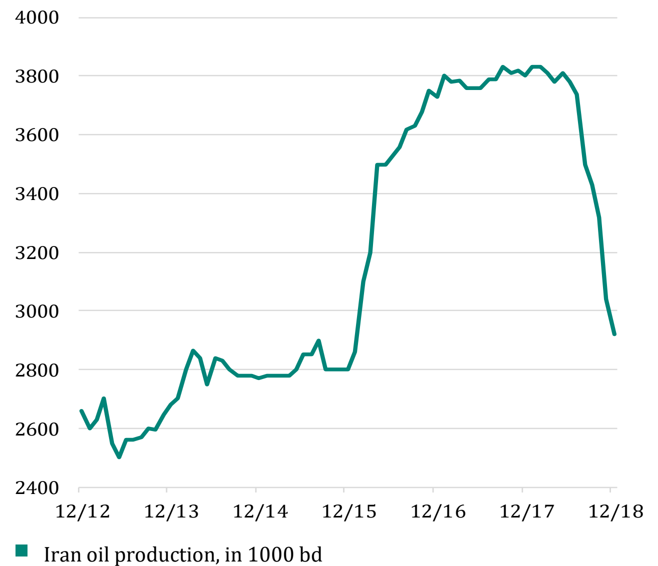
Under this baseline scenario we expect Brent prices to broadly fluctuate in the 60-70 USD range and forecast an average Brent price of 65 USD. For WTI we expect an average oil price of 57 USD in 2019.

Figure 8:
OPEC Expanding Output until November



source: Bloomberg

Figure 9:
Iranian Oil Output Dropping Ahead of Sanctions

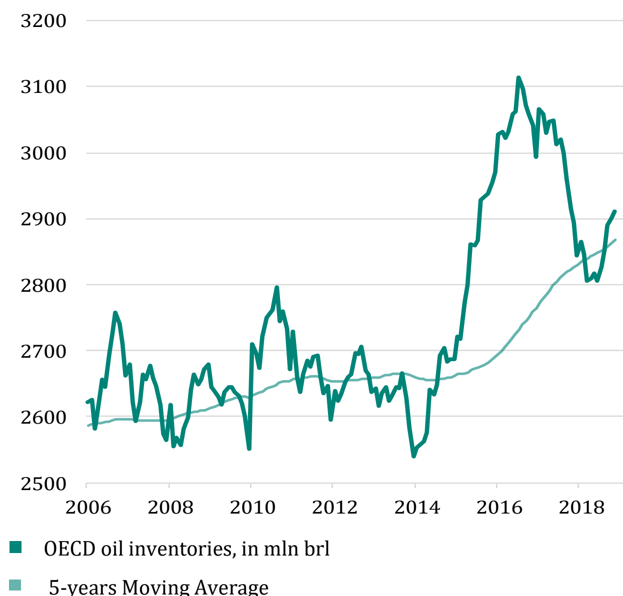


source: Bloomberg

Figure 10:
Saudi Arabia Cutting Output after Expansion

source: Bloomberg

Figure 11:
OECD Oil Inventories Increasing Again



source: Bloomberg

Part 3: Saudi Arabian Economy

GDP Growth Acceleration in H2 2018

In the course of 2018 the Saudi economy has clearly recovered from the recession in 2017. Based on recently released data, the non-oil private sector grew by 2.0% year-on-year in Q3 2018 (see figure 12). Our GDP tracker model suggest that this growth should pick up to 2.5% in Q4. For the full year 2018, we, therefore, expect a non-oil private sector growth contribution of 1.8%. The oil sector experienced a strong recovery to 3.6% yoy in Q3 and this growth rate should further accelerate to about 6.4% in Q4 according to our model estimates which incorporate the massive oil output expansion to 11.0 mbd in the last quarter. For the full year 2018, the oil sector is forecasted to grow by 3.0%.

Accordingly, the growth rate of the overall economy is expected to accelerate to 4.3% in Q4 2018 (vs. 2.5% in Q3) which translates into a full year growth figure of 2.4% (see figure 13).

Expansionary Fiscal Budget for 2019

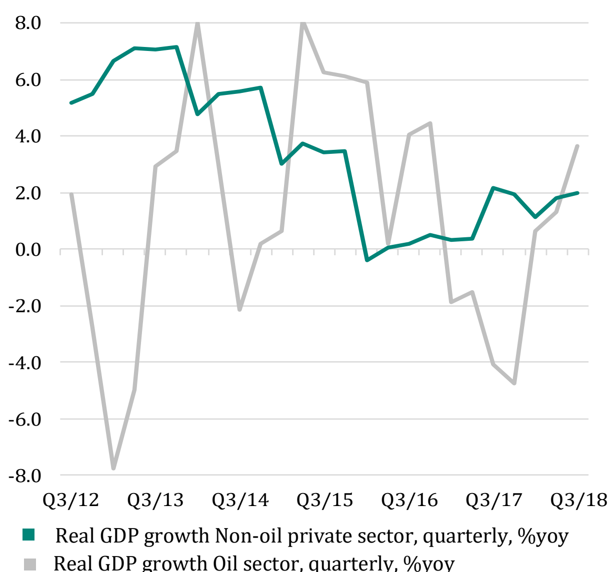
For 2019, the Saudi government has released an expansionary fiscal budget aimed at spurring the domestic economy. Fiscal expenditure is targeted to expand by 7.4% to 1106 bln SAR (see figure 14). More than half of this increase is allocated to capital spending which is expected to be raised from 205bln SAR in 2018 to 248bln SAR. The large-scale projects thus funded are intended to have a particularly stimulating effect on the domestic economy, especially in sectors which have not yet participated in the general economic rebound, such as the construction sector which has still been in recession in 2018 (Q3 2018 growth -3.6% yoy).

On the revenue side, the budget shows an increase of 8.9% to 975bln SAR (see figure 15). This applies on the one hand to the non-oil revenues, which are expected to rise from 288 bln SAR to 313 bln SAR, and on the other hand to oil revenues with an increase from 607 bln SAR to 662 bln SAR.

In the case of non-oil revenues, the increment is mainly due to additional income from the fiscal measures introduced a year ago. The lion's share falls on the expat levy, which is forecasted to double from 28 bln SAR in 2018 to 56.4 bln SAR. This is a quite ambitious target since these fee rates are raised but not doubled in 2019 and, in addition, the number of expats will probably continue to decline this year after the departure of already 1.1 mln expats from the beginning of 2017 until mid of 2018.

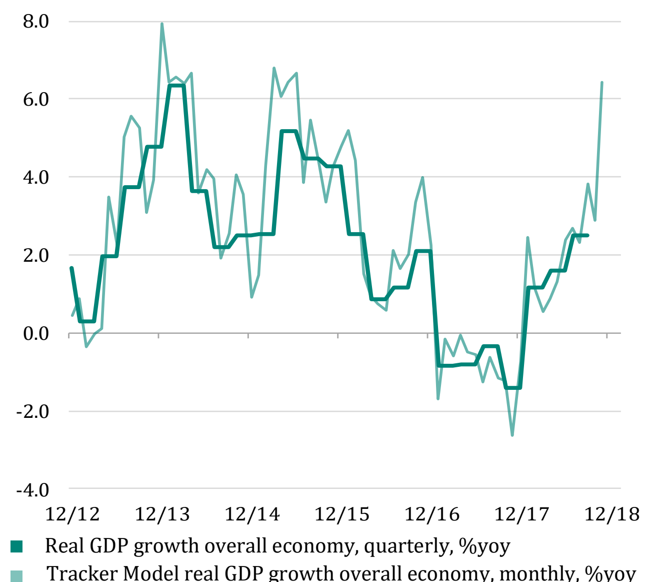
The increase in oil revenues by 80bln SAR also seems somewhat ambitious given our oil price scenario. Our forecasted Brent average price of 65 USD represents a 10% reduction from the average price of 72 USD in 2018. The decline in the Saudi export price is likely to be in the same range. In addition, on the back of the recent OPEC agreement on production cuts, substan-

Figure 12:
GDP Growth Oil- and Non-Oil Economy



source: GASTAT

Figure 13:
Overall GDP Growth Strong Rebound in H2 2018



Source: GASTAT, SAMA, Bloomberg, RC estimates

tial oil output and export increases cannot reasonably be expected. On the other side, the fiscal transfer ratio (fiscal oil revenue as % of total oil revenues) will most probably be higher this year, as the transition to the new Aramco tax regime with the introduction of regular dividend payments resulted in one quarterly dividend payment missing at the beginning of last year.

Overall, we, therefore, expect fiscal revenues to be gradually below budgeted levels in 2019. On the other hand, we assume that the government will broadly adhere to its expansionary fiscal stance in order to stimulate the domestic economy. Hence, we expect the government to accept a gradually higher fiscal deficit for this year. Based on our estimates, we forecast a fiscal deficit of -179 bln SAR or 5.7% of GDP compared to an official budgeted deficit of -131 bln SAR or 4.6% of GDP.

Peaking Interest Rates and Substantial Capital Inflow in 2019

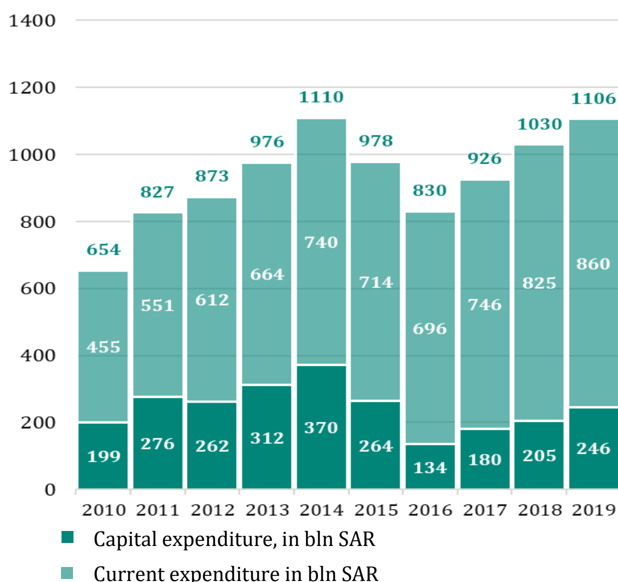
On the back of our expectations for monetary policy in the US, SAMA is also expected to raise official interest rates twice by a total of 0.50% over the course of the year. As a result, the official repo rate will be 3.5% at the end of 2019 and the reverse repo rate at 3.0%. The 3-month SAIBOR is expected to be around 3.3%. In analogy to the US, we assume that this will be the peak of the current interest rate cycle. In our view, this represents a moderate further increase in funding costs which can generally be absorbed by the Saudi economy. Accordingly, we expect private sector loan growth in the range of 3-5% this year.

The government will also rely on credit markets to finance its fiscal deficit. New sovereign borrowing for 2019 could gradually exceed the 120 bln SAR which the government targeted in its budget announcement, given our somewhat higher deficit projection. We expect the government to equally split its bond issuance between local and international capital markets. A first international tranche of 7.5 bln USD has already been successfully issued in January.

International sovereign funding will positively affect the balance of payment. This also applies to the expected inflow of foreign investors' capital in the context of the inclusion of Saudi equities in major Emerging Market indices during 2019. This foreign inflow is estimated at 30-40 bln USD. Finally, as an important premiere, Saudi Aramco is supposed to tap international debt capital markets for the first time to finance its acquisition of a majority stake in SABIC. Given the size and standing of the company, this could raise substantial capital on global financial markets. Overall, this considerable foreign capital inflow should largely benefit domestic liquidity in 2019.

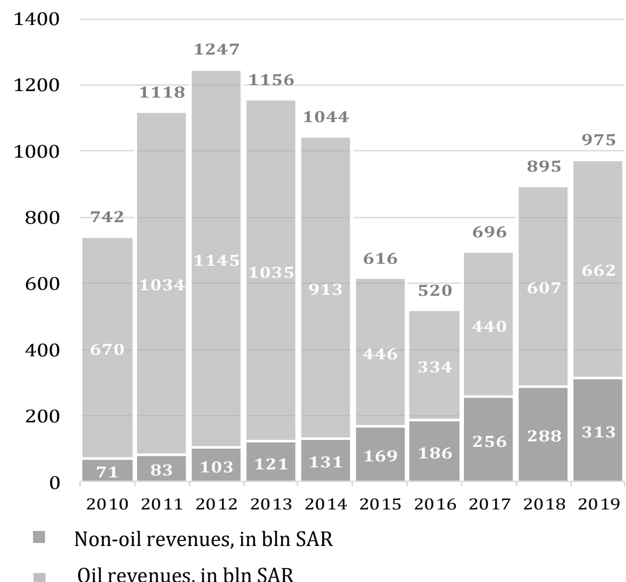
Based on this fiscal and macro assessment, we expect growth of the non-oil private sector to further accelerate from 1.8% in 2018 to 2.2% this year. By contrast, growth of the oil sector is forecasted to slowdown from 3.0% to 2.1% due to the impact of the recent OPEC output cut agreement. As a result, the growth rate of the overall economy is projected at 2.1% for 2019, gradually lower than last year's rate of 2.4%.

Figure 14:
Fiscal Expenditure (2019 Budget)



source: MoF

Figure 15:
Fiscal Revenues (2019 Budget)



source: MoF

Part 4: Global Financial Markets

Challenging Market Environment

The year 2018 was a bad year for all types of risky assets. This applies in the first place to equity investments. Measured by the MSCI World index, global equities lost -8.2% on a total return basis, i.e. including dividends (see figure 16). Emerging Markets were hit especially hard with a minus performance of -14.5%. But in the course of the fourth quarter, the developed equity markets, which had been remarkably resilient until then, were also pulled down by the general negative trend (see figure 17). The exception to the generally negative trend in 2018 were the GCC equity markets. Saudi equities gained +12.1%, while the rest of the GCC markets advanced by + 11.8%.

In the field of fixed income, all assets exhibiting higher credit risk, i.e. high yield and emerging market bonds, performed negatively, while bonds from high quality borrowers achieved at least a flat performance.

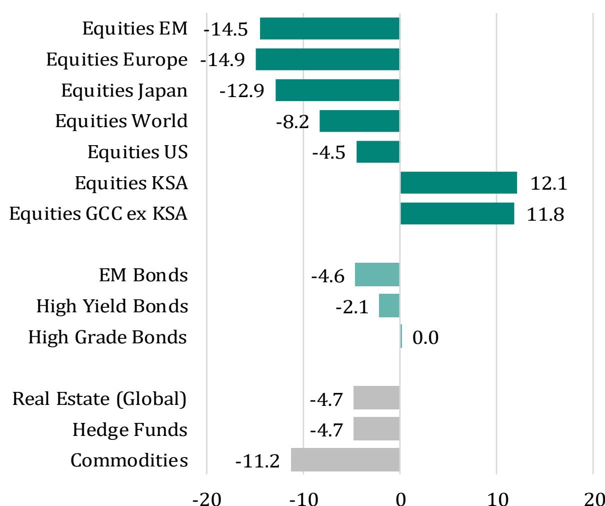
Despite the significant corrections in recent months, the long-term bull market for developed equity markets, which had started in March 2009, has not yet been broken in terms of the MSCI World index (see figure 18). The downturn in Q4 2018 amounted to -18.1%, hence, less than the -20% mark which typically defines a bear market.

This long-term bull market of global equities over the past 10 years can, in our view, be explained by two factors. First, we have experienced one of the longest periods of economic expansion for the majority of industrialized countries by historical standards. Accordingly, this has also translated into sustainable growth of corporate profits. Earnings per share for the MSCI World rose by nearly 80% during this period, which corresponds to an annual growth rate of approximately 6%.

Second, the simultaneous expansion of valuation multiples, which drove the market beyond its earnings growth path, is mainly a result of the unprecedented expansionary monetary policy of major central banks over this period. Not only were key policy rates kept at record low levels over the entire period, but central banks also generated massive excess liquidity. Thus, the consolidated balance sheet of the main central banks quadrupled over the last 10 years (see figure 19). However, this additional liquidity did not flow primarily into the real economy, which would have led to significant inflationary pressures, but found its way onto financial and real estate markets, leading to asset inflation there. Besides, the ultra-low interest rates also implied extremely low financing costs and, thus, additionally inflated global corporate profits.

This phase of excessive liquidity creation by major central banks may have come to an end, as already mentioned in part 1. As a result, an important tailwind, which has boosted global financial markets over the last 10 years, is fading (see figure 19). This clearly affects the medium-term outlook for global

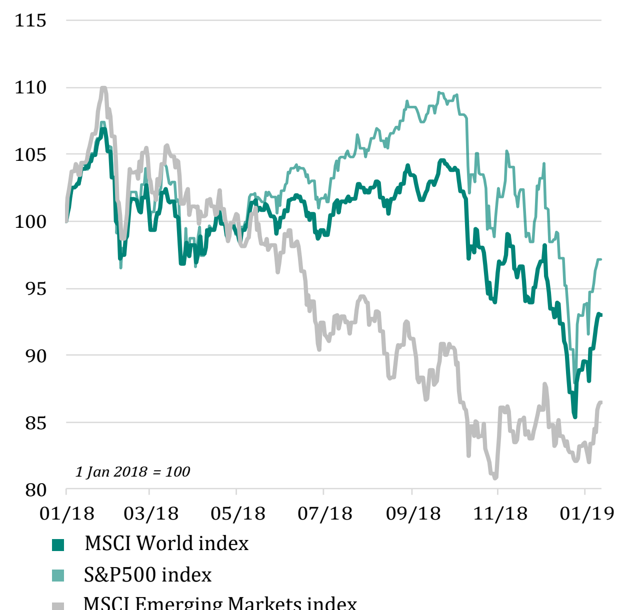
Figure 16:
Asset Class Performance 2018 (in %)



Remarks:
- All return figures in USD
- Equity performance = total return (including dividend pay-

source: Bloomberg

Figure 17:
All Equity Markets Negatively Affected in 2018



source: Bloomberg

equity markets for the coming years.

With the corrections of the recent months, global equity markets have taken this new environment partially into account. Valuation multiples have normalized accordingly (see figure 20). In historical comparison, global equity markets, however, cannot be considered as outright cheap. The forward PE-ratio for the MSCI World dropped from 16.9 prior to the correction to the current figure of 14.0. This, in turn, is still well above the low of 9.9 10 years ago. A similar picture characterizes emerging markets, with a current PE-ratio of 11.0 compared to a figure of 12.9 before the recent correction and a low of 7.7 back in 2008.

However, equity markets are not driven primarily by valuation at this time, but by the changing earnings prospects over the next 12 months. As a result of our cautious macro outlook, we, therefore, expect downward earnings revisions, which makes markets vulnerable over the next 12 months. In the short term, however, we wouldn't rule out a gradual extension of the recent recovery after the strong corrections in Q4 2018. This assessment is based on the current more dovish stance of the FED and a more pro-growth attitude by Chinese authorities in the short term - both factors being especially supportive for emerging markets.

In our asset allocation, we, therefore, tactically increase emerging market equities from underweight to neutral. This results in an overall neutral stance towards international equity markets. At this point, we do not have any regional preference and keep local and regional equity markets at their strategic quotas.

US Rate Hikes in 2019 Completely Priced Out

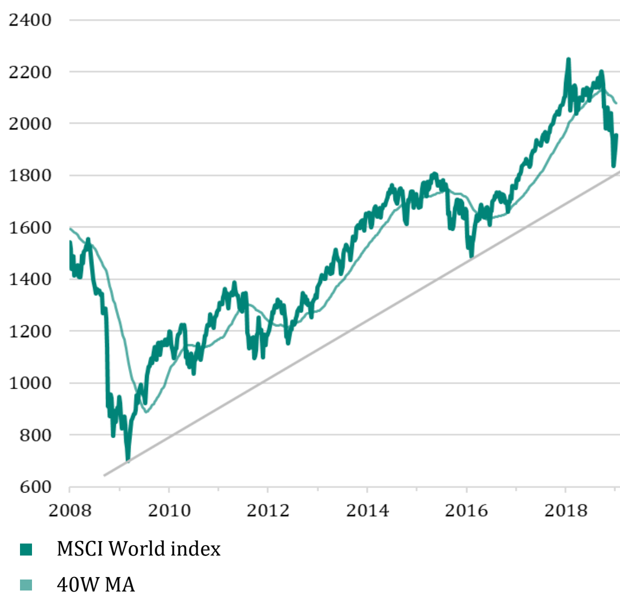
In analogy to the equity market, 10-year US treasury yields rose sharply from 2.5% to 3.2% until October 2018 and, subsequently, were subject to a considerable correction down to 2.55% by end of the year (see figure 21). At this point, as a consequence of the most recent slide, no single FED rate hike is priced in anymore at the front-end of the yield curve. FED fund futures for December 2019 are trading around 2.5%, the prevailing level of FED fund rates (upper boundary).

This reflects an overly pessimistic view on monetary policy and, hence, on the US economy for 2019. Given our baseline scenario of two additional rate hikes in the course of this year, we, therefore, see some upside for bond yields along the curve and expect 10-year treasuries to approach again the 3.0% level in the coming months. As a conclusion, we recommend to keep the duration of US government bonds and high-quality corporate bonds rather short respectively underweight high-grade bonds as an asset class.

Emerging Market Bond Spreads Widening

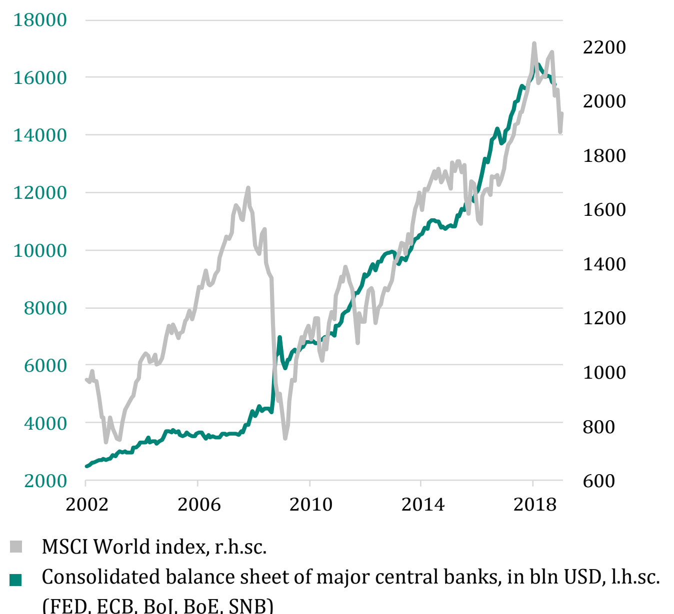
As mentioned above, credit risk was repriced in the course of 2018. As a consequence, emerging market debt instruments also went through a correction which caused yield spreads to US treasuries to widen. For the JPMorgan EMBI+ index this yield spread widening amounted to about 130bp from 3.1% to 4.4% (see figure 22). For USD-denominated sovereign Saudi bonds, which exhibit a higher credit quality compared to the average of the JPMorgan EMBI+ index

Figure 18:
Long-term Equity Bull Market Not Yet Broken



source: Bloomberg

Figure 19:
Equity Markets Driven by Global Excess Liquidity

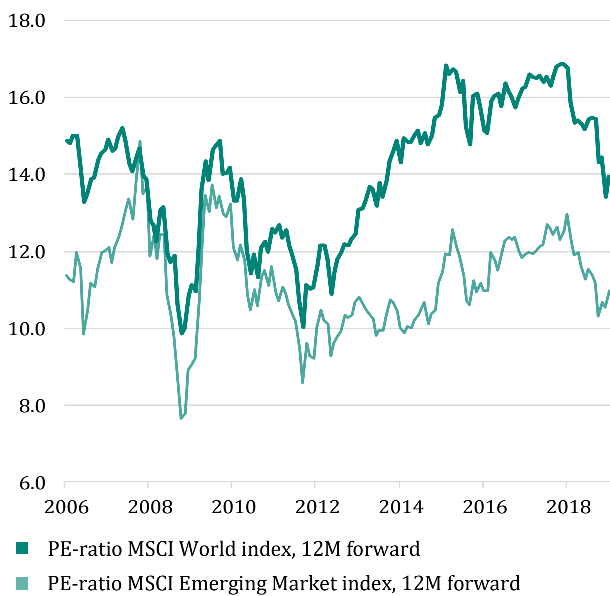


source: Bloomberg

(A+ vs. BBB-) and hence, offer a lower spread to US treasuries, this widening was clearly lower with about 60bp (from 1.1% to 1.7%). Saud sovereign bonds may additionally benefit from a gradual spread tightening as they will soon be included in the widely used JPMorgan EM bond indices.

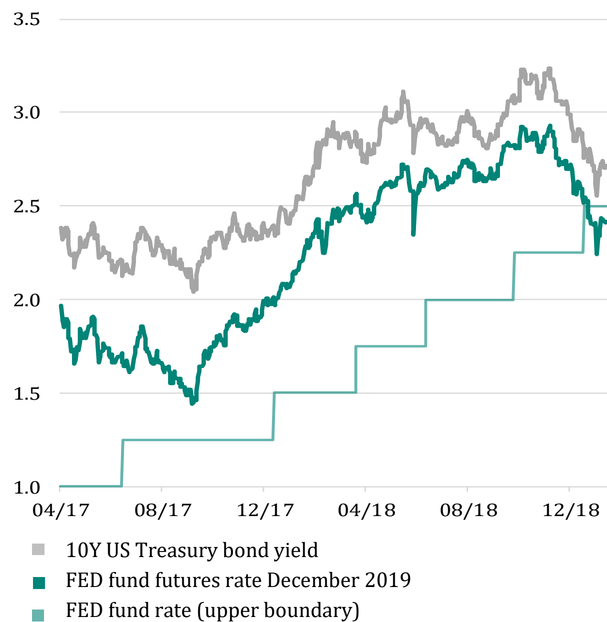
Finally, commodity investments were also subject to significant corrections during 2018 which were broad based affecting all major commodity areas. The most pronounced downturn could be observed in the energy sector with about -30%, while metals dropped by -23% and agricultural products by -12%. The development of commodity prices is closely linked to emerging markets (see figure 22), as both depend on the cyclical pattern of the global economy. Hence, our tactical upgrading of emerging markets also implies a corresponding move for commodity investments from underweight to a neutral weighting.

Figure 20:
Equities Less Expensive but not Outright Cheap



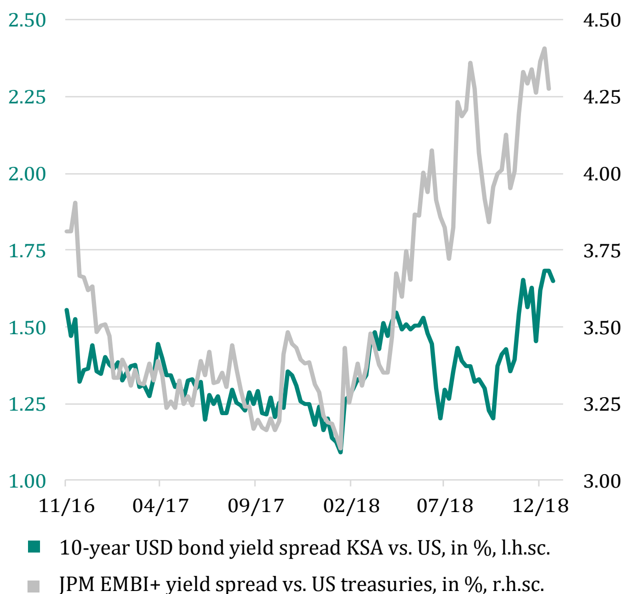
source: Bloomberg

Figure 21:
Market Pricing Out Any US Rate Hike in 2018



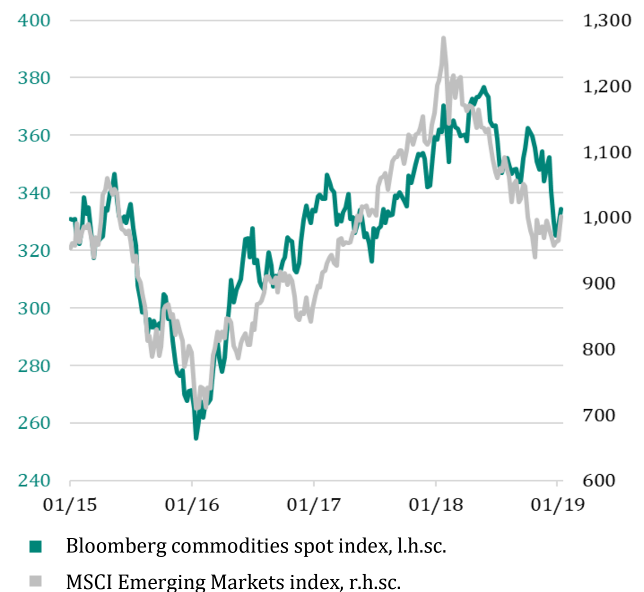
source: Bloomberg

Figure 22:
Emerging Market Yield Spread Widening in 2018



Source: Bloomberg, JPMorgan

Figure 23:
Commodities Linked to Emerging Markets



source: Bloomberg

Part 5: Saudi Equity Market

Strong Outperformance in 2018

Despite an adverse global market environment, the Saudi equity market achieved an excellent performance in 2018 (see part 4). Especially in the first half of the year, TASI recorded substantial gains on the back of positive decisions by MSCI and FTSE regarding its inclusion in their emerging market indices. In the second half, however, the Saudi market was subject to temporary corrections with a partial recovery towards the end of the year. Meanwhile, TASI has started the year 2019 on a very positive note with initial gains of no less than 7% by mid-January (see figure 24).

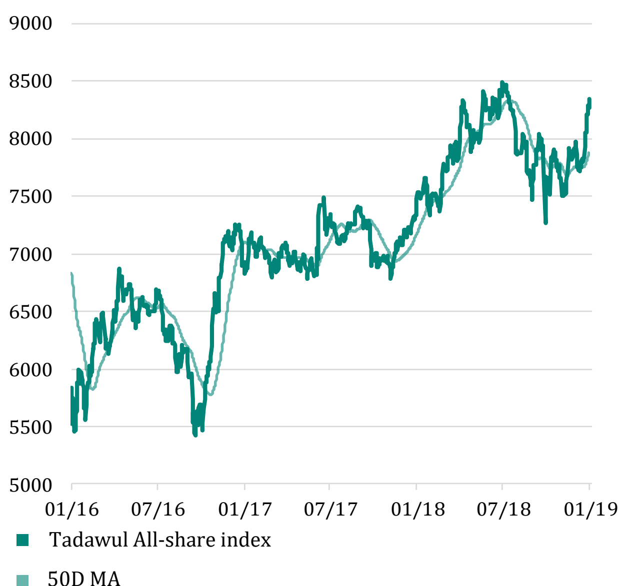
Foreign Investors Returning to the Market

A key driving factor for the market over the last 12 months has been the inflow of foreign capital due to the index inclusion in the course of 2019. In H1 2018 foreign institutional investors purchased Saudi equities to an amount of 12.4bln SAR. Part of this was subsequently unloaded in the course of the general market correction during H2 2018. Meanwhile, however, foreign investors have started to return to the market. In the first three weeks of 2019, net purchases by foreign institutional investors already sum up to 2.7bln SAR (see figure 25). Nonetheless, the net amount of Saudi equities acquired so far by foreign institutions over the last 12 months (approx. 8.0 bln SAR) constitutes only a fraction of the total capital inflow expected with a view of the index inclusion in 2019 (approximately 110-130 bln SAR). Hence, a still substantial amount of foreign capital is supposed to enter the Saudi market in the next 6-9 months, certainly impacting the price discovery process of Saudi equities throughout this period.

Large-Cap Driven Market

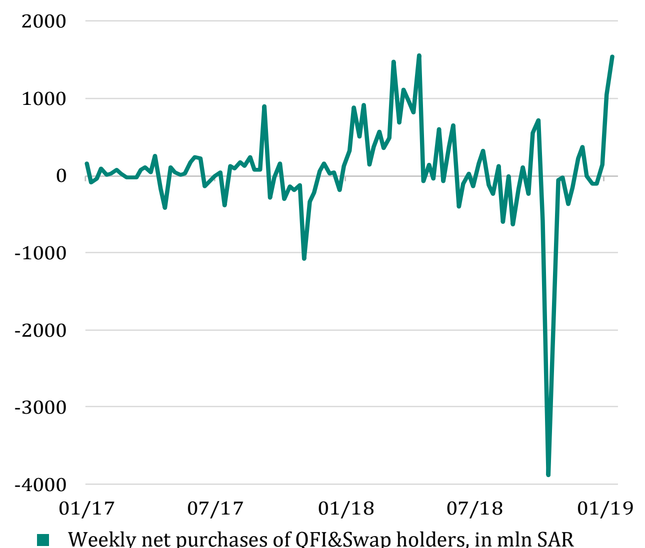
A more granular look into the market reveals that TASI has been essentially driven by large cap stocks (see figure 26). On the one hand, this can be explained by the upcoming index inclusion, which will mainly affect large cap stocks as the candidates for index inclusion. On the other hand, however, this can also be fundamentally justified, since the earnings development of these large cap stocks has been significantly better than the one of their small cap counterparts. Partly, this is due to the fact that the Saudi large cap segment is dominated by the banking sector, which has been characterized by sustainable earnings growth in recent years (see figure 28). Accordingly, the banking sector has clearly outperformed the market as a whole, lifting its weight in TASI to 45%. Nonetheless, banks continue to trade at a valuation discount to the overall market (see figure 27). From a longer-term perspective, a further reduction of this valuation discount seems to be justified, given the strong position of this sector and its solid earnings trend. In fact, we expect further high single-digit earnings growth of the banking sector in 2019, given our credit growth forecast (see part 3) and the margin expansion due to rising interest rates.

Figure 24:
TASI Strong Rebound after Weakness in H2 2018



source: Bloomberg

Figure 25:
Foreign Investors Returning to the Saudi Market

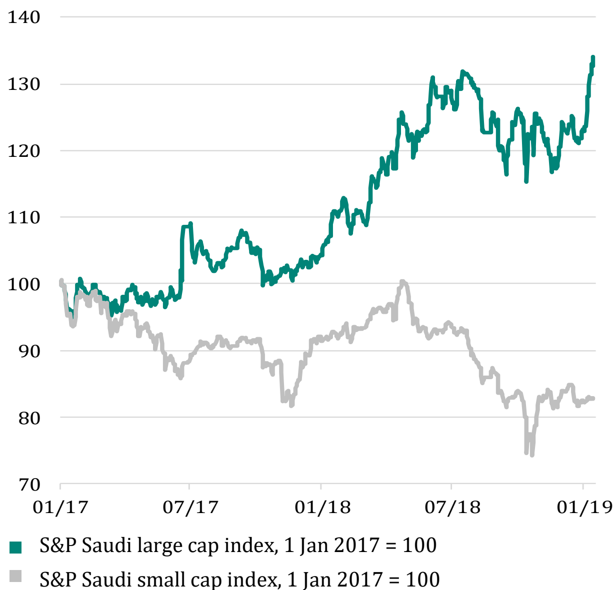


Source: Tadawul

At this stage, we take a more prudent stance towards the second sector we favoured throughout 2018, petrochemical companies. After significant profit growth in recent years, the sector will face a more challenging environment going forward (see figure 29). In the first place, we expect oil prices in 2019 to be on average 10% lower than last year. Next to this, an expected further production capacity expansion at a global scale may additionally weigh on profit margins. As a result, growth in the sector is unlikely to be positive for 2019.

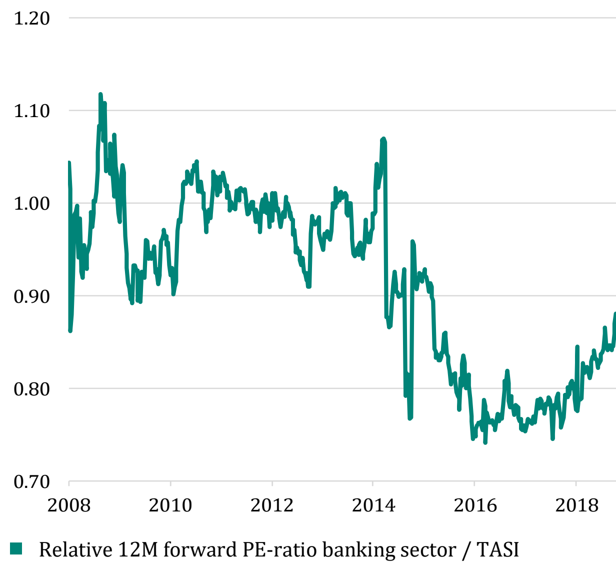
For the overall market, we, therefore, anticipate earnings growth for 2019 of 6% after 11% in 2018. Based on these projections and assuming a fair valuation multiple, the fundamental 2019 price target for TASI is in the area of 8760 points. With a view on the substantial foreign capital inflow to be expected over the coming months, we suppose that TASI will temporarily overshoot this fundamental price target. Hence, we stick to our overweight position of Saudi equities within our global asset allocation at this juncture.

Figure 26:
Significant Large Cap Outperformance



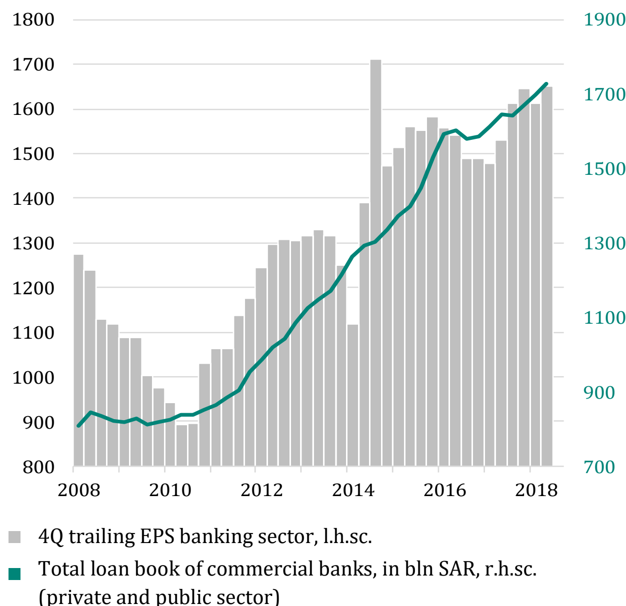
source: Bloomberg

Figure 27:
Banks Still Trading At Valuation Discount



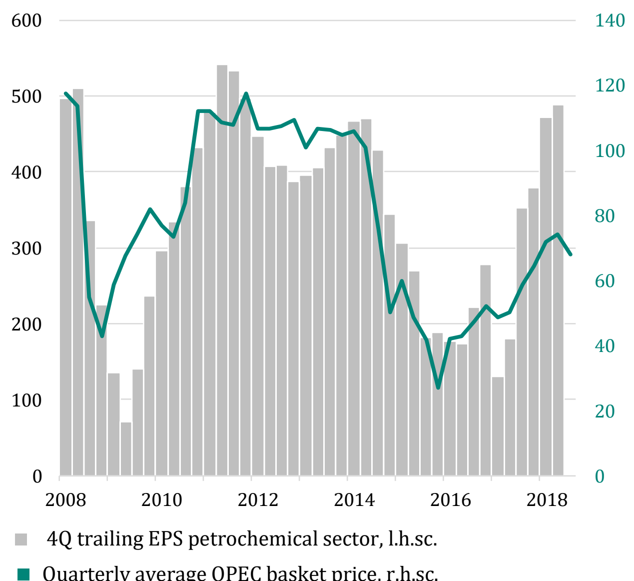
source: Bloomberg

Figure 28:
Sustained Earnings Growth of Banking Sector



Source: Bloomberg, SAMA

Figure 29:
Little Earnings Growth Potential for Petrochemicals



source: Bloomberg

Performance Equity Markets

	2015	2016	2017	2018
World (MSCI World AC)	**-4.3**	**5.6**	**21.6**	**-11.2**
Adv. Economies (MSCI World)	**-2.7**	**5.3**	**20.1**	**-10.4**
USA (S&P500)	-0.7	9.5	19.4	-6.2
Euro Area (EuroStoxx)	8.0	1.5	10.1	-14.8
Japan (Topix)	9.9	-1.9	19.7	-17.8
United Kingdom (FTSE100)	-4.9	14.4	7.6	-12.5
Emerging Markets (MSCI EM)	**-17.0**	**8.6**	**34.4**	**-16.6**
China (CSI300)	5.6	-11.3	21.8	-25.3
India (Sensex)	-5.0	2.0	27.9	5.9
Russia (Micex)	26.1	26.8	-5.5	11.8
Brazil (Ibovespa)	-13.3	38.9	26.9	15.0
Saudi Arabia (Tadawul)	-17.1	4.3	0.2	8.3

MSCI indices in USD, all other indices in local currency, price changes net of dividends

Valuation Equity Markets

	PE 17	PE 18	PB 18	RoE 18
World (MSCI World AC)	**20.6**	**13.9**	**2.0**	**9.6**
Adv. Economies (MSCI World)	**21.5**	**14.3**	**2.1**	**9.6**
USA (S&P500)	22.5	15.4	2.9	12.9
Euro Area (EuroStoxx)	19.6	12.8	1.4	7.0
Japan (Topix)	16.3	11.9	1.1	6.6
United Kingdom (FTSE100)	23.0	11.9	1.6	6.9
Emerging Markets (MSCI EM)	**15.7**	**11.3**	**1.5**	**9.3**
China (CSI300)	16.8	10.7	1.4	8.2
India (Sensex)	23.2	20.9	2.9	12.3
Russia (Micex)	7.2	5.3	0.8	10.7
Brazil (Ibovespa)	18.9	13.3	1.8	9.7
Saudi Arabia (Tadawul)	17.1	14.8	1.7	9.9

As of 31 Dec 2018
PE: price/earnings ratio, PB: price/book ratio, RoE: return on equity
all figures based on analysts' consensus estimates, Bloomberg

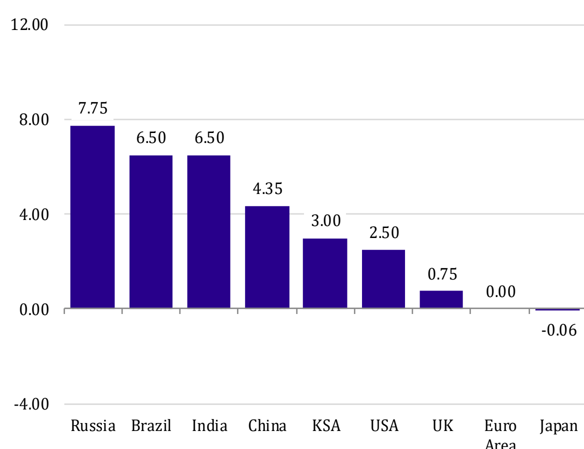
Central Bank Rates

	2015	2016	2017	2018
Advanced Economies				
USA	0.50	0.75	1.50	2.50
Euro Area	0.05	0.00	0.00	0.00
Japan	0.10	-0.10	-0.10	-0.06
United Kingdom	0.50	0.25	0.50	0.75
Emerging Market Economies				
China	4.35	4.35	4.35	4.35
India	6.75	6.25	6.00	6.50
Russia	11.00	10.00	7.75	7.75
Brazil	14.25	13.75	7.00	6.50
Saudi Arabia	2.00	2.00	2.00	3.00

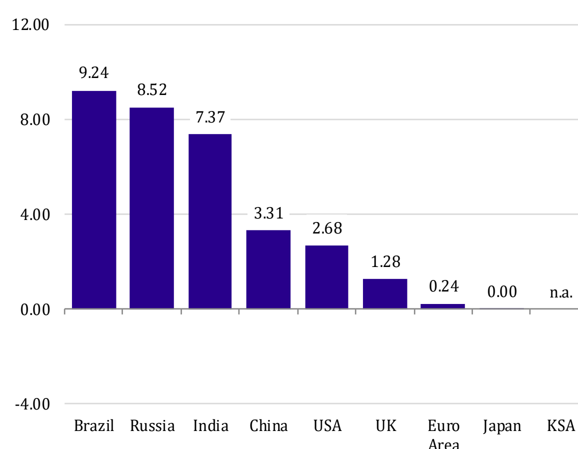
10-Year Government Bond Yields

	2015	2016	2017	2018
Advanced Economies				
USA	2.27	2.45	2.41	2.68
Euro Area	0.63	0.20	0.42	0.24
Japan	0.26	0.05	0.05	0.00
United Kingdom	1.96	1.24	1.19	1.28
Emerging Market Economies				
China	2.86	3.06	3.90	3.31
India	7.76	6.51	7.33	7.37
Russia	9.39	8.29	7.43	8.52
Brazil	16.51	11.40	9.80	9.24
Saudi Arabia	n.a.	n.a.	n.a.	n.a.

Central Bank Rates (as of 31 Dec 2018)



Government Bond Yields (as of 31 Dec 2018)



source: Bloomberg, RC estimates

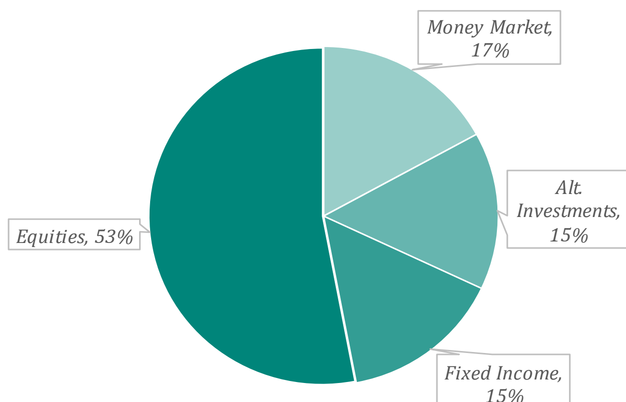
Part 6: Asset Allocation

Asset Allocation for Balanced Investor

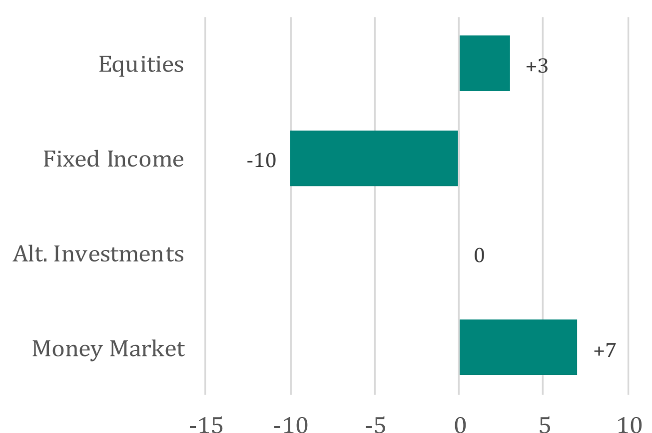
The following recommended asset allocation is tailored to an investor with a "Balanced" investment profile. This profile is reflected in the Strategic Asset Allocation which is an optimized portfolio structure based on the long-term risk/return-characteristics (i.e. more than 5 years horizon) of all asset classes considered. The Tactical Asset Allocation for the "Balanced" profile incorporates the short-to medium term investment view expressed in this document and translates into under- and overweights for each asset class compared to its strategic quota. Hence, these under- and overweightings reflect the relative attractiveness of different asset classes from a tactical perspective.

Asset Class	Tactical Allocation	Strategic Allocation	Over- / Underweight
Equities	**53**	**50**	**+3**
Saudi Arabia	28	25	+3
GCC other	5	5	0
USA	10	10	0
Europe	4	4	0
Asia/Japan	3	3	0
Emerging Markets	3	3	0
Fixed Income	**15**	**25**	**-10**
High grade bonds	5	15	-10
High yield bonds	5	5	0
Emerg. Market bonds	5	5	0
Alternative Investments	**15**	**15**	**0**
Hedge Funds/Private Equity	5	5	0
Real Estate	5	5	0
Commodities/Precious Metals	5	5	0
Money Market	**17**	**10**	**+7**
Cash SAR	17	10	+7
Total	**100**	**100**	**0**

Tactical Asset Allocation
(as of 31 Dec 2018)



Underweights / Overweights
(Tactical vs. Strategic Asset Allocation)



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