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MENA Pulse

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KEY FACTS

- **Moderate tailwinds for GCC economies – weaker dollar and higher oil prices.**
- **Fiscal consolidation continues in the GCC**
- **Global market volatility is not yet a threat to GCC growth**
- **REITs will attract GCC investors despite some headwinds**

Welcome to MENA Pulse!

This is the first edition of our new monthly newsletter MENA Pulse, which focuses on the economies and financial markets of the Middle East and North Africa – the home market of Swicorp.

Because our customers expect independent judgement and top quality analysis, we have asked the renowned international economist Lars Christensen and his team at Markets & Money Advisory to produce the newsletter.

Besides being the founder and CEO of Markets & Money Advisory, Lars is a Research Associate at South Africa's Stellenbosch University and sits on the advisory board of Swicorp.

The fundamental idea of MENA Pulse is to give busy business executives and policymakers alike a quick overview of the key economic and financial trends in the MENA region – including macroeconomic and financial forecasts.

In this first issue, the focus on macroeconomic developments in the GCC countries and the relatively new and exciting local market in Real Estate Investment Trusts, which has grown rapidly over the past couple of years.

We hope you will enjoy MENA Pulse and look forward to discussing its content with you.

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From headwinds to moderate tailwinds

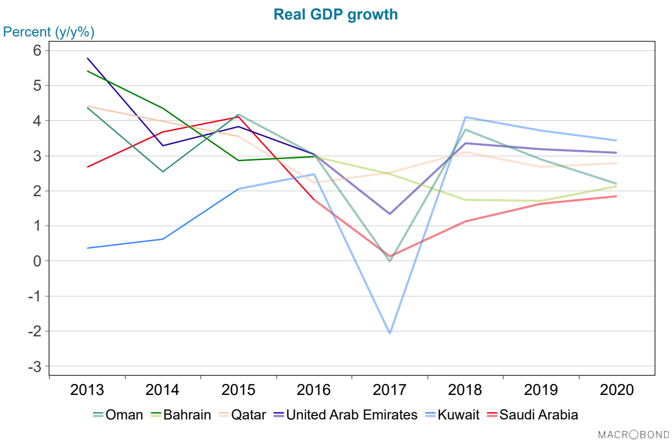
Over the past couple of years, the GCC economies have bucked serious headwinds – especially from sharply lower oil prices since 2014 and the stronger dollar, which brought a simultaneous appreciation of the dollar-pegged GCC currencies.

These factors caused a significant economic slowdown in 2015. In subsequent years, growth was further reduced by a necessary fiscal consolidation across the region.

However, these headwinds are now moderating as oil prices inch up once again. While they remain much lower than in 2014, the negative growth impulse that was initially so devastating has faded. Furthermore, after appreciating strongly from mid-2014 until the end of 2016, the dollar has weakened in recent months. Normally, that should be supportive of growth in the GCC economies.

That made 2017 a year in which growth stabilized. With any luck, 2018 could see a moderate pick-up across the region, as confidence indicators show clear improvement in the growth outlook.

Consequently, we expect real GDP growth in the GCC states to accelerate this year. Because this acceleration stems largely from the continued rebound in oil prices, and to some extent also from the weaker dollar, non-oil real GDP will not recover so quickly. Nonetheless, we can also expect moderate improvement in the non-hydrocarbon sector in 2018 as well.

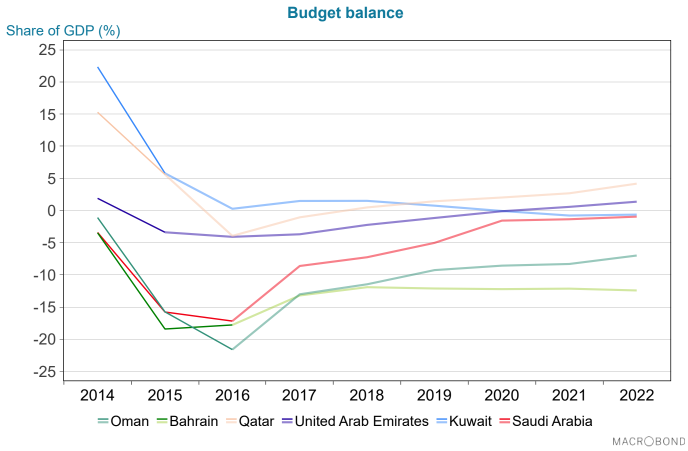


Fiscal reforms are progressing

The GCC countries have undertaken significant economic reforms in recent years. These reforms have particularly focused on reducing dependence on oil and gas income, both in terms of the overall economy and public sector revenue.

Across the region, we have seen the introduction of VAT and large cuts in food and energy subsidies. Government capital expenditures have also been slashed, especially in Saudi Arabia.

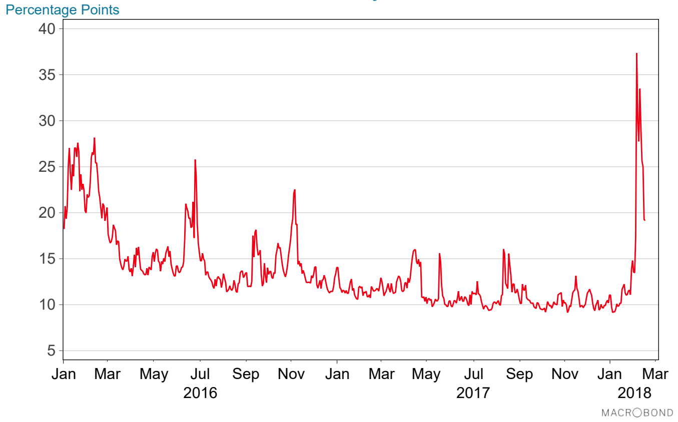
These measures have clearly helped consolidate public finances. But while such reforms are unquestionably necessary, they also suppress domestic demand and thus reduce growth. As public finances improve across the region, however, the need for fiscal consolidation grows smaller, allowing demand to recover. More importantly, fiscal consolidation should make the GCC economies more shock-resistant in the future.



Stock market volatility spikes

This year we have seen much more volatility in the global stock markets. Equity prices have fallen sharply after a prolonged period of growth and extremely low volatility.

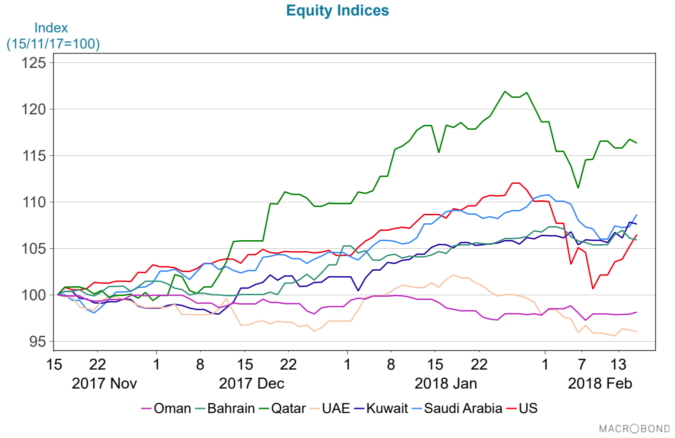
S&P 500 Volatility Index



There are many reasons for this decline, but at the core of the sell-off lies a combination of overvalued US stocks and rising inflation expectations on the heels of a weaker dollar. Higher inflation expectations, in turn, have caused investors to expect the Federal Reserve to be more aggressive than previously expected in tightening US monetary policy.

The sell-off has also spread to the GCC, where declines of share prices have been in line with those in the rest of the world.

Equity Indices



Falling stock markets are never good news for economic growth, and it is particularly worrying that US market fluctuations partly reflect expectations of aggressive interest rate hikes. To the extent that the Federal Reserve meets these expectations, the GCC countries will 'import' tighter monetary conditions due to their pegged exchange rate regimes.

The close relationship between interest rate hikes in the US and slower money supply growth in the GCC economies raises some concern about this year's growth outlook for the region.

However, it is important to remember just why expectations of rate hikes have gone up. To the extent that markets are simply pricing in the weaker dollar and higher growth and inflation expectations, this does not necessarily bode ill for growth in the GCC economies. This is because dollar depreciation will support GCC growth, and because a weaker dollar typically goes hand in hand with higher oil prices.

Therefore, for the moment there is no reason for serious concern that the global stock market correction on its own will damage economic growth in the GCC. If the market sell-off were to deepen, however, and especially if it causes a sharp rally in the dollar, then economic growth could be threatened on a global basis. But we are not there yet, and this is not the baseline scenario.

Theme: REITS – a new way of investing in Saudi real estate

In 2017, we saw the introduction of a new and interesting way of investing in Saudi Arabia's real estate market – Real Estate Investment Trusts (REITs).

REITs are companies that own, operate or finance income-producing real estate. For a company to qualify as a REIT, it must meet certain regulatory guidelines. REITs are often traded on major exchanges like other securities and provide investors with a liquid stake in real estate. In Saudi Arabia, the REITs launched over the past year are traded on the Tadawul, or Saudi Stock Exchange.

A clear advantage of investing in REITs is that it gives investors the opportunity to buy an asset that is much more liquid than a 'normal' real estate investment. This significantly increases the investor base for real estate investments – another key advantage. Internationally, REITs have been known since the 1960s, but Saudi Arabia did not enact a legal framework for REITs to operate until 2016. This opened the door for the new investment vehicle, and we saw something of a boom in Saudi REITs last year.

The introduction of REITs is clearly positive for Saudi Arabia's economic development, since it encourages more private sector participation in financing real estate investments in the Kingdom.

Furthermore, the availability of REIT shares allows local investors to better diversify their portfolios. These securities are perceived as an attractive alternative at time when interest rates and bond yields are depressed and are expected to stay low going forward.

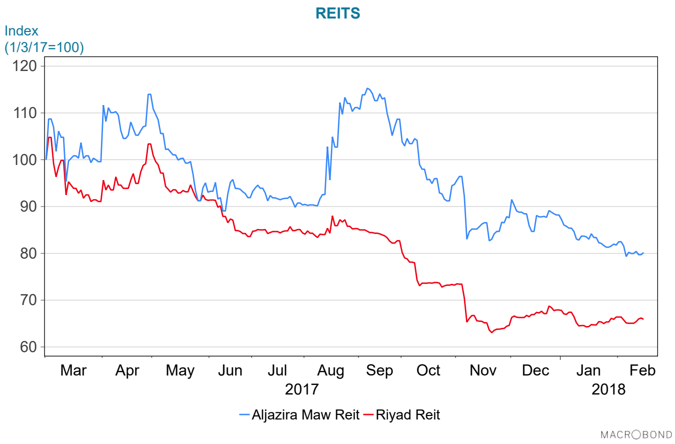
REITs in the region

REITs are quite a new phenomenon in the GCC (though unlisted real estate funds have been present for some time). The first was listed on the Nasdaq Dubai in 2014 (Emirate REIT). Last year, following enactment of the Saudi legislation, several REITs began trading in Saudi Arabia, Bahrain and the UAE. In the UAE, the legal framework for REITs has essentially been in place for a decade, but only recently has the market taken off. Oman has drafted new legislation that is expected to pass soon.

There is no doubt that the interest in REITs is a region-wide phenomenon. We are very likely to see more successful listings in coming years.

The honeymoon is over

First to be listed on the Saudi Stock Exchange was the Riyad REIT, which began trading in November 2016. Initially, its share price got off to a good start. But since March 2017, Riyad REIT has generally been trending downwards – a direction that applies to other Tadawul-listed REITs as well, as the graph below shows.



In general, Saudi REITs have underperformed the overall stock market. While the Tadawul All Share Index (TASI) posted a small gain (0.2%) in 2017, all locally listed REITs fell on the year.

There are several reasons for this rocky performance. To some extent, REITs were a victim of their own success. Investor interest was so huge in the early stages that many funds quickly became overvalued after their first listings. Some of their subsequent underperformance can therefore be ascribed to a natural adjustment towards more realistic valuations, reflecting the 'fair value' of their underlying assets.

It should also be noted that real estate prices are highly sensitive to interest rates and yields, which have been trending upwards in recent months. This would normally weigh on REIT share prices.

Furthermore, if we look at the North American market, US REITs had a rather challenging year in 2017. Prices basically flat-lined, and in recent weeks have taken a steep plunge as volatility spiked in the global financial markets and share prices fell. This sell-off also hit the Saudi market, though it seems that the share prices of Saudi REITs are proving more resilient than their American counterparts.

REITs are not going away

Whether the Saudi and GCC REIT shares go up or down in the next few months, there seems little doubt that the market is here to stay.

A legal framework for the REIT market is now in place across the GCC; we have seen successful listings, particularly in Saudi Arabia, with more in the pipeline; and investor interest remains high despite recent market turmoil.

The near-term outlook will very much depend on global market conditions, and especially on the extent to which interest rates and bond yields will rise. That said, GCC investors will still have to diversify their portfolios, and REITs can meet this need as the 'hunt for yield' and diversification continue.

Real GDP	Forecast			
y/y%	2016	2017	2018	2019
Saudi Arabia	1,7	-0,1	1,5	2,1
Kuwait	2,5	-2,3	4,4	3,6
UAE	3,0	1,3	3,4	3,3
Qatar	2,2	2,7	3,1	2,7
Bahrain	3,0	2,8	1,8	1,7
Oman	3,0	0,0	3,6	3,0

Gross fixed investments	Forecast			
% of GDP	2016	2017	2018	2019
Saudi Arabia	29,5	27,9	28,3	29,0
Kuwait	27,0	24,7	24,7	25,0
UAE	25,1	22,7	23,1	22,5
Bahrain	25,7	23,1	22,1	21,9
Oman	38,0	34,0	33,1	33,9

Exports	Forecast			
y/y%	2016	2017	2018	2019
Saudi Arabia	5,1	-3,8	2,1	1,1
Kuwait	1,1	-9,5	5,0	3,6
UAE	6,5	-2,1	4,5	2,0
Qatar	3,0	3,6	2,3	1,0
Bahrain	-0,8	9,1	3,7	2,0
Oman	-9,7	-2,3	3,5	6,2

Imports	Forecast			
y/y%	2016	2017	2018	2019
Saudi Arabia	-15,6	-8,1	1,6	-0,1
Kuwait	4,3	1,6	2,3	3,1
UAE	3,9	1,9	3,0	0,9
Qatar	13,0	-8,5	8,6	5,1
Bahrain	-4,6	16,8	7,3	6,9
Oman	-10,4	0,0	1,9	3,5

Inflation	Forecast			
y/y%	2016	2017	2018	2019
Saudi Arabia	3,5	-0,2	5,0	2,1
Kuwait	3,5	2,7	2,8	2,7
UAE	1,8	2,3	2,9	2,3
Qatar	2,7	0,6	4,6	2,0
Bahrain	2,8	0,9	3,2	2,1
Oman	1,1	3,1	3,4	3,7

Government balance	Forecast			
% of GDP	2016	2017	2018	2019
Saudi Arabia	-17,2	-8,7	-7,4	-5,0
Kuwait	0,3	1,5	1,5	0,8
UAE	-4,1	-3,4	-2,2	-1,4
Qatar	-3,9	-1,0	0,5	1,5
Bahrain	-17,8	-13,2	-11,9	-12,0
Oman	-21,6	-13,2	-11,7	-9,2

Current account	Forecast			
% of GDP	2016	2017	2018	2019
Saudi Arabia	-4,3	0,9	0,2	0,9
Kuwait	-4,5	-0,5	-1,1	-1,2
UAE	2,4	2,0	2,1	2,3
Qatar	-4,9	2,6	0,9	1,5
Bahrain	-4,7	-4,6	-4,2	-3,8
Oman	-18,6	-14,4	-13,2	-11,2

Source: Markets & Money Advisory and Swicorp.