Private Bank

Middle East Strategy

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Easier US Fed policy welcomed by Gulf policymakers

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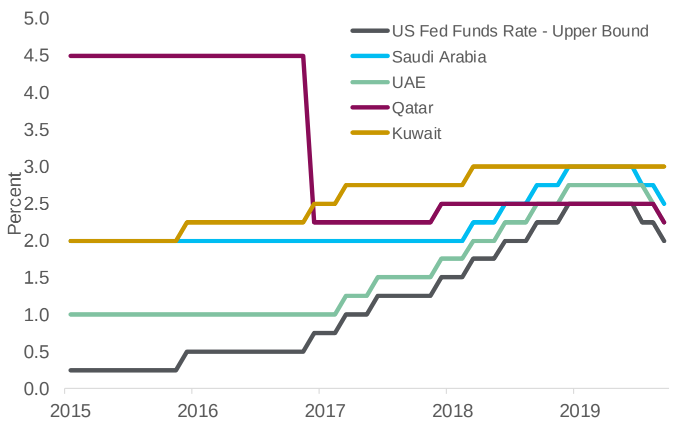
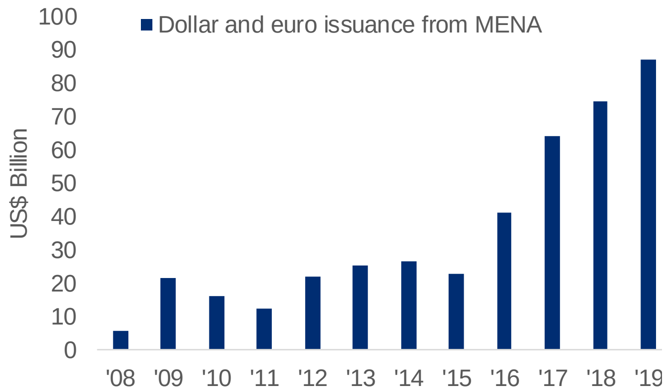
- **The hunt for yield remains a key theme for investors as central banks globally have turned more dovish**
  - We expect the Fed to cut rates another 25 basis points at its October meeting, and to continue its role to boost liquidity in markets
  - Lower interest rates have increased debt issuance in the Middle East
  - Sovereigns and companies in Middle East and North Africa (MENA) have raised around $85 billion in dollar and euro securities this year
- **Impact on oil markets following attacks on Saudi Arabia's oil infrastructure fades**
  - Investors turn focus on macro challenges afflicting the market
  - Saudi Arabia's non-oil GDP growth showing signs of pickup in 2Q'2019
  - Potential sign the economy is moving ahead once more after the effects of austerity measures imposed following the oil price slump in 2014

Figure 1: Gulf central banks easing in lock step with the US Federal Reserve



Source: Bloomberg as of October 8, 2019. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. **Past performance is no guarantee of future returns. Real results may vary.**

Figure 2: Surge in MENA borrowers tapping the eurobond market – data through Sept 26 for all years



Source: Bloomberg as of September 27, 2019. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. **Past performance is no guarantee of future returns. Real results may vary.**

Easier Fed policy is a welcome relief for Gulf central banks

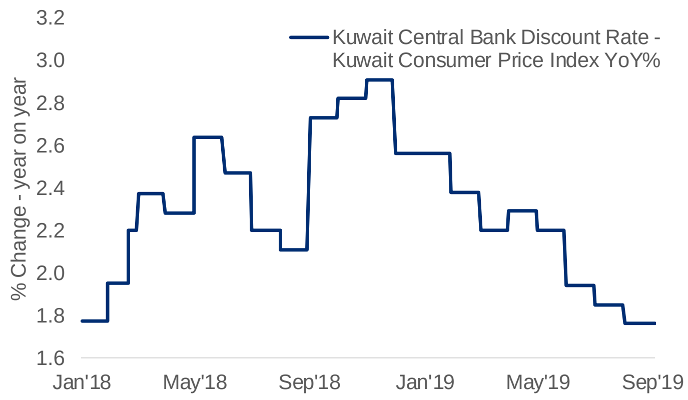
After a spike in economic uncertainty following the attacks on Saudi oil infrastructure on September 14th, monetary easing by the US Federal Reserve has come as a welcome relief for Gulf policymakers. Central banks in the Gulf Cooperation Council (GCC) member countries followed the US Federal Reserve by reducing key benchmark interest rates for a second time this year, albeit without committing to further easing in 2019. Saudi Arabia, the United Arab Emirates, and Qatar reduced their key interest rate by 25 basis points (bps).

The Fed reduced the federal funds rate target by a quarter-percentage point to a range of 1.75% to 2% during its September 18 meeting. We expect the Fed to cut rates another 25 basis points at its October meeting and to continue its role to boost liquidity. During the period of Fed tightening, Gulf central banks were unable to lower borrowing costs to help their countries weather the effect of lower oil prices on their economies.

Most central banks in the Gulf region follow the Fed's moves on key interest rates in order to maintain exchange rate stability. This is because their currencies are pegged to the US dollar, with the exception of Kuwait, whose dinar is linked to a basket of currencies. Kuwait's banking regulator said it is keeping its discount rate unchanged at 3%.

Kuwait's decision to hold steady is an effort to preserve the dinar's appeal in the region. With consumer prices rising at their fastest rate since 2017, the real rate of interest has fallen to 1.85%, less than half of that of Saudi Arabia – **figure 3**. Kuwaiti inflation for 2019 is estimated at 1.5%, which is more than double the pace of 2018. A cut in interest rates by the Kuwait Central Bank would have exacerbated the matter.

Figure 3: Kuwait's real interest rate is at the lowest level since early 2018



Source: Bloomberg as of October 3, 2019. Data through August 31, 2019.

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Although small in magnitude, the monetary easing will give regional economies a helpful boost, as growth has yet to recover from the 2014 oil price decline. And while a looser monetary stance is certainly welcome, fiscal policy continues to be the traditional driver of growth in the region and plays a primary role in terms of determining the economic outlook.

Leading Gulf economies Saudi Arabia and the UAE continue to face slower growth in the face of regional geopolitical challenges and external headwinds. The latter include the trade war, lower oil prices, slower global growth, and exchange rate appreciation. Lower interest rates are expected to reduce cost of funds and boost borrowings to support sluggish GDP growth.

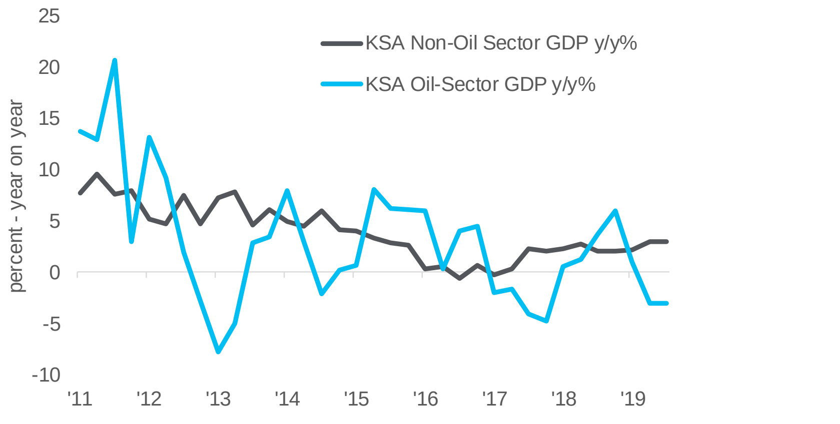
Saudi Arabia's non-oil economic growth accelerated in the second quarter of 2019, This was a potential sign that the economy is moving ahead once more after the effects of austerity measures imposed after the fall of oil prices in 2014. Non-oil GDP expanded almost 3%, the fastest pace since 2015 - **figure 4**. Oil GDP shrank, partly due to over-compliance to the OPEC+ agreement reached late last year. This involved cutting production in an effort to stabilize supply in oil markets. Real GDP fell during the second quarter to 0.46% year on year, as the cuts in oil production marginally outweighed non-oil expansion.

Construction expanded for a second quarter, after more than three years of declining activity, rising to 4.9% y/y (vs. -2.9% for the same period in 2018). This has been supported by increased government spending on infrastructure under a four-year SR200bn (US$53bn) fiscal stimulus program launched in 2017.

Purchasing Managers' Index (PMI) survey data showed a slowdown in non-oil sector activity in the UAE in August, with the index falling to 51.6, from a 2019 high of 59.4 in May. Softer Q3 readings follow stronger second quarter data reflected in higher export orders and a boost in household spending over Ramadan.

Household consumption is likely to remain constrained in the UAE. Official data published by the central bank showed only marginal growth in private sector jobs in 1H2019 and declining average salaries across all job categories. The pressure remains on the government to boost spending and investment to support growth in the non-oil sectors.

Figure 4: Saudi Arabia's Non-Oil GDP Growth



Source: Bloomberg as of October 3, 2019. Data through Q2'2019. KSA = Kingdom of Saudi Arabia.

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Lower rates boost debt issuance by Gulf economies

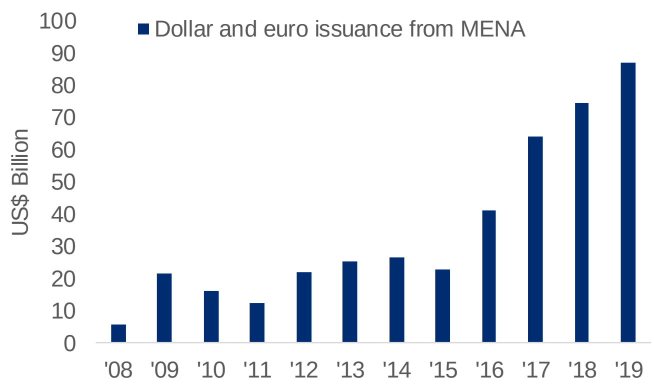
The hunt for yield remains a key theme for investors as central banks globally have turned more dovish. Record eurobond issuance comes amid a sudden surge in debt sales by frontier and emerging sovereigns after the cost of borrowing declined. Middle Eastern and North African borrowers are seeking to take advantage of some of the lowest funding costs experienced.

Sovereigns and companies in MENA have raised around $85 billion in dollar and euro securities this year – **figure 5**. The average yield on Middle Eastern governments' dollar debt dropped 4.2% from the end of December 2018 to a record low of 4.43% last month – **figure 6**.

Abu Dhabi raised $10 billion in a three-part deal with the longest note maturing in 2049. Bahrain issued $2 billion of bonds in a two-part deal about a year after it secured a bailout package from its Gulf neighbours. The island kingdom sold dollar-denominated Sharia-compliant securities due 2027 and a conventional bond maturing in 2031.

However, compared to emerging-market peers, Gulf bonds are underperforming, with the extra yield that investors demand to hold dollar bonds from the Gulf Co-operation Council members has risen 33 basis points since September 14 – **figure 7.**

Figure 5: Surge in MENA borrowers tapping the eurobond market – data through Sept 26 for all years



Source: Bloomberg as of September 27, 2019.

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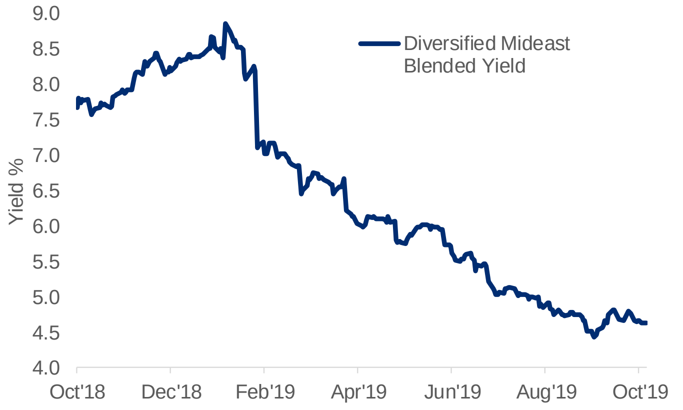
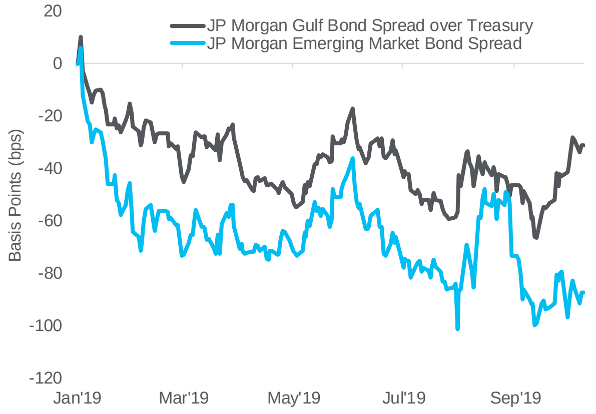
Figure 6: Average yield on Middle Eastern governments' dollar debt falls to a record low, however…



Source: Bloomberg, JP Morgan Emerging Market Bond Indices as of October 4, 2019. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. **Past performance is no guarantee of future returns. Real results may vary.**

Figure 7: …Gulf bond spreads are increasing following surge in new issues along with the decline in oil prices



Source: Bloomberg, JP Morgan Emerging Market Bond Indices as of October 9, 2019. Normalised as of 01/01/2019. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. **Past performance is no guarantee of future returns. Real results may vary.**

Impact of Attacks on Saudi Arabia Oil Facilities Fades

Crude oil prices have normalized following a spike higher in the immediate aftermath of the September 14th attack on Saudi Arabia's oil facilities. Price gains have evaporated, reflecting macro challenges troubling the market and expectations of weaker global demand growth ahead – **figure 8**.

Following the attacks that instantly disabled around half of Saudi output, global markets watched closely as the kingdom managed to restore oil production and exports ahead of its self-imposed deadline. Saudi Aramco has reportedly restored production to 9.9 million barrels a day. However, output was 15% lower in September compared to August's levels.

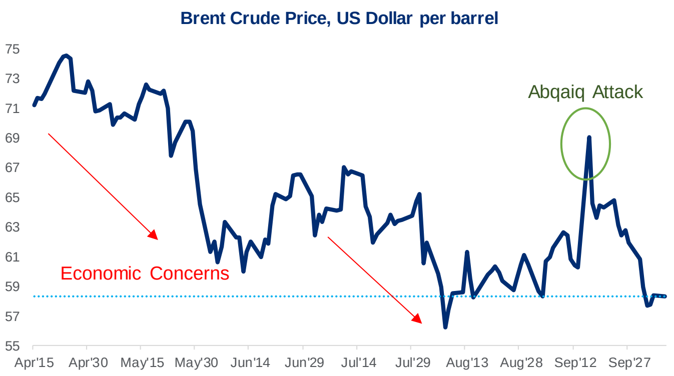
As we've discussed in previous publications (Middle East Investment Strategy, September 16, 2019), such episodes suggest that a significantly larger impact is priced initially, which then fades as information becomes clearer. We saw this in the initial 20% surge in the intraday price of Brent crude that quickly abated.

Since the attacks in September, very little progress has been made in resolving tensions in the Middle East. Even with a thaw in US/Iran relations seeming quite unlikely for the visible future and Saudi Arabian oil infrastructure directly targeted, the global oil price has still fallen back below $58 – **figures 9 & 10**.

Ratings agency Fitch has downgraded Saudi Arabia's credit rating to A from A+, with 'Stable' outlook citing rising geopolitical tensions in the Gulf following the attacks in mid-September on the Abqaiq and Khurais fields, as well as a deterioration of the Kingdom's fiscal and external positions. The Saudi finance ministry responded that it was disappointed with the move as it did not reflect its response to the strikes on September 14th or its capacity to handle adversity.

The move by Fitch may add challenges to Saudi Arabia's plans to diversify itself away from oil as it prepares for a potential sale of US dollar denominated Islamic bonds. Saudi Aramco was subsequently downgraded by Fitch given that the rating is capped by that of the sovereign to A from A+.

Figure 8: Fading impact of attacks on Saudi Arabia in oil markets as prices fall to below pre-strike levels



Source: Bloomberg as of October 7, 2019.

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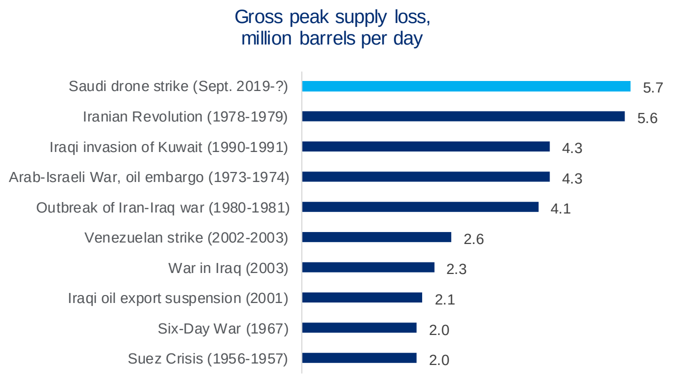
Figure 9: Saudi attack vs other historical episodes of oil disruptions



Source: Bloomberg as of September 2019.

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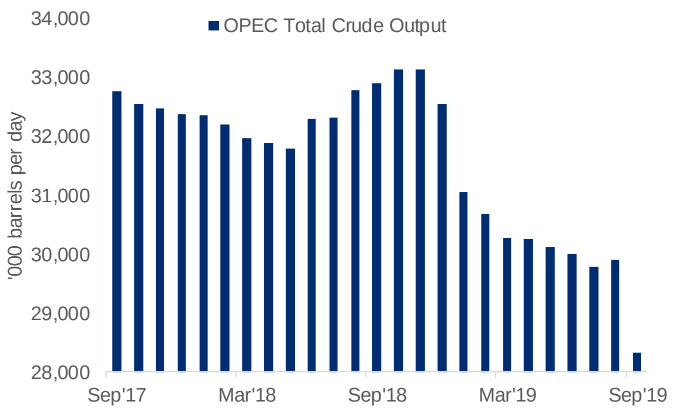
Figure 10: OPEC's output down to 28.3 million barrels a day (mbd) in September



Source: Bloomberg as of October 7, 2019.

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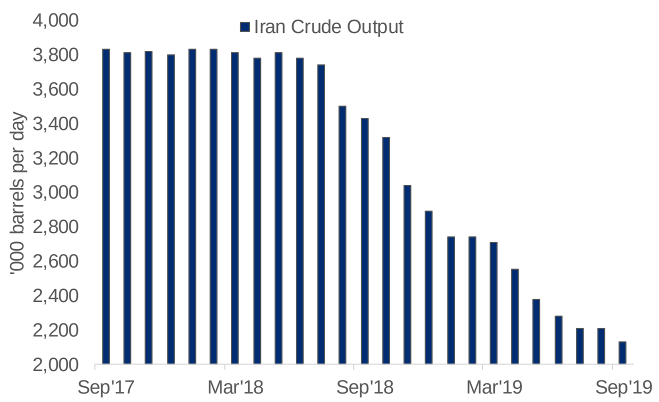
Figure 11: An unlikely chance that relations with Iran thaw could see almost 1.7 mbd of supply restored in oil markets



Source: Bloomberg as of October 7, 2019.

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Asset allocation definitions

Asset classes	Benchmarked against
Global equities	MSCI All Country World Index, which represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.
Global bonds	Bloomberg Barclays Capital Multiverse (Hedged) Index, which contains the government -related portion of the Multiverse Index, and accounts for approximately 14% of the larger index.
Hedge funds	HFRX Global Hedge Fund Index, which is designed to be representative of the overall composition of the hedge fund universe. It comprises all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.
Commodities	Dow Jones-UBS Commodity Index, which is composed of futures contracts on physical commodities traded on US exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The major commodity sectors are represented including energy, petroleum, precious metals, industrial metals, grains, livestock, softs, agriculture and ex-energy.
Cash	Three-month LIBOR, which is the interest rates that banks charge each other in the international inter -bank market for three-month loans (usually denominated in Eurodollars).

Equities	
Developed market large cap	MSCI World Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in 23 developed markets. Large cap is defined as stocks representing roughly 70% of each market's capitalization.
US	Standard & Poor's 500 Index, which is a capitalization -weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.
Europe ex UK	MSCI Europe ex UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in each of Europe's developed markets, except for the UK.
UK	MSCI UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in the UK. FTSE 100 Index: Capitalisation weighted index of the 100 most highly capitalised companies traded on the London Stock Exchange FTSE 250 Index: Capitalisation weighted index of the 250 most highly capitalised companies outside of the FTSE 100 traded on the London Stock Exchange
Japan	MSCI Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in Japan.
Asia Pacific ex Japan	MSCI Asia Pacific ex Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the performance of large cap stocks in Australia, Hong Kong, New Zealand and Singapore.
Developed market small and mid-cap (SMID)	MSCI World Small Cap Index, which is a capitalization-weighted index that measures small cap stock performance in 23 developed equity markets.
Emerging market	MSCI Emerging Markets Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure equity market performance of 22 emerging markets.

Bonds	
Developed sovereign	Citi World Government Bond Index (WGBI), which consists of the major global investment grade government bond markets and is composed of sovereign debt, denominated in the domestic currency. To join the WGBI, the market must satisfy size, credit and barriers-to-entry requirements. In order to ensure that the WGBI remains an investment grade benchmark, a minimum credit quality of BBB–/Baa3 by either S&P or Moody's is imposed. The index is rebalanced monthly.
Emerging sovereign	Citi Emerging Market Sovereign Bond Index (ESBI), which includes Brady bonds and US dollar -denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It is composed of debt in Africa, Asia, Europe and Latin America. We classify an emerging market as a sovereign with a maximum foreign debt rating of BBB+/Baa1 by S&P or Moody's. Defaulted issues are excluded.
Supranationals	Citi World Broad Investment Grade Index (WBIG)—Government Related, which is a subsector of the WBIG. The index includes fixed rate investment grade agency, supranational and regional government debt, denominated in the domestic currency. The index is rebalanced monthly.
Corporate investment grade	Citi World Broad Investment Grade Index (WBIG)—Corporate, which is a subsector of the WBIG. The index includes fixed rate global investment grade corporate debt within the finance, industrial and utility sectors, denominated in the domestic currency. The index is rebalanced monthly.
Corporate high yield	Bloomberg Barclays Global High Yield Corporate Index. Provides a broad-based measure of the global high yield fixed income markets. It is also a component of the Multiverse Index and the Global Aggregate Index.
Securitized	Citi World Broad Investment Grade Index (WBIG)—Securitized, which is a subsector of the WBIG. The index includes global investment grade collateralized debt denominated in the domestic currency, including mortgage -backed securities, covered bonds (Pfandbriefe) and asset -backed securities. The index is rebalanced monthly.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
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(MLP's) - Energy Related MLPs May Exhibit High Volatility. While not historically very volatile, in certain market environments Energy Related MLPS may exhibit high volatility.

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Real Estate Investment Trusts (REITs) are subject to special risk considerations similar to those associated with the direct ownership of real estate. Real estate valuations may be subject to factors such as changing general and local economic, financial, competitive, and environmental conditions. REITs may not be suitable for every investor. Dividend income from REITs will generally not be treated as qualified dividend income and therefore will not be eligible for reduced rates of taxation.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

Past performance is no guarantee of future results.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

The information contained herein is not intended to be an exhaustive discussion of the strategies or concepts mentioned herein or tax or legal advice. Readers interested in the strategies or concepts should consult their tax, legal, or other advisors, as appropriate.

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