



Research Note

Equity Strategy: Approach in Turbulent Times

- Our goal in this report is to provide some insight into the conditions currently facing global equity and credit markets and provide some historical perspective for what is currently taking place in the markets.
- **“Deleveraging” is the New Catchphrase:** This process will be painful economically, as both banks and consumers shrink debt levels. The US and other government responses have been to bring bad debts from the private sector into the public sector, effectively making them “collective” bad debts. Though we expect this response to assist a recovery, we do not believe it will be possible to avoid a significant recession in the US and European economies.
- **Looking to credit markets for relief:** Global credit markets have frozen up and the key to any near term rebound will be an easing of interbank rates that have risen over 250 basis points in the last three months in the EU, US, and UAE.
- **A historical perspective:** US corporate earnings have declined nearly 39% from their peak last year. During the prior two market corrections (early 1990’s and early 2000’s) earnings declined 44% and 54%, respectively. We feel the current challenges facing the global economy are more severe and may indicate that earnings have much further to decline than experienced in previous earnings declines.
- **Impact on regional markets:** In the near term local equity markets should continue to be driven by global events. However, from a longer term perspective we see several key factors that point to a relatively stronger economic foundation in the MENA region. We feel that the region’s relatively small exposure to the toxic debt instruments, continued current account surpluses, and substantial wealth reserves will provide a catalyst for growth beyond the near term crisis.

Robert McKinnon
 +971 4 360 1117
 robert.mckinnon@almalcapital.com

Downtown Burj Dubai
 Emaar Square
 Building 4, Office # 302
 Sheikh Zayed Road
 P. O. Box 119930
 Dubai, United Arab Emirates
 T +971 4 360 1111

	S&P 500	DFM	ADX	TASI	DSM	KSE
Price	899.22	3025	3133	5814	7029.9	12558
P/E	17.23	7.36	7.85	12.9	8.76	14.46
52wk High	1565	6320	5159	11697	12637	15668
52wk Low	840	2991	3062	5640	7007	11270
Δ % YTD	-39%	-49%	-31%	-47%	-27%	-6%
P/B	1.7	1.3	1.6	2.2	2.0	2.0
P/Sales	0.9	2.7	2.8	3.6	3.8	3.3

Equity Strategy: Approach in Turbulent Times

Our goal in this report is to provide some insight into the conditions currently facing global equity and credit markets and provide some historical perspective for what is currently taking place in the markets. We will also attempt to give some guidance for how investors should approach investing in this environment and the outlook for the impact on regional markets.

“Deleveraging” is the New Catchphrase

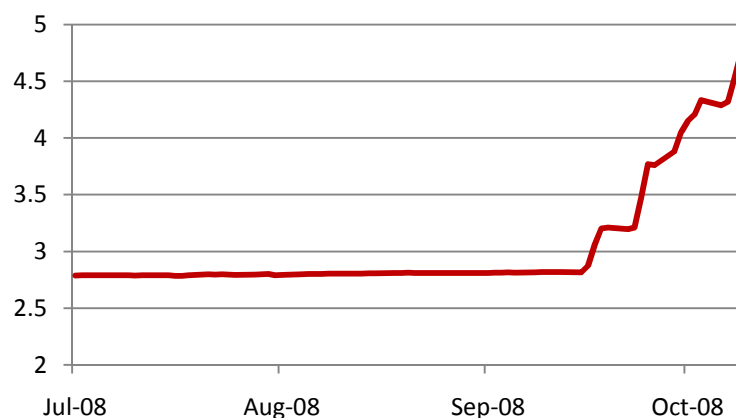
Most investors have recently heard that the global banking system is in the midst of a major deleveraging process. What does this mean? At the risk of being too simplistic, essentially many banks had grown their loan books to levels that were unsustainable and, in search of more growth began to target more high risk lending practices. In some cases institutions were leveraged over 30x equity. Now the banking system has reducing the size their balance sheet.

In order to deleverage, a lender must either increase the equity in the business by selling assets, a capital injection, or off-loading portions of its loan book. Unfortunately, in the current market environment nearly all financial institutions are looking to deleverage at the same time, diminishing the value they can obtain for their assets or their shares in the case of a recapitalization. It is a simple case of very few buyers and many sellers.

Interbank Lending is Frozen

The resulting downward pressure on prices of assets in the banks’ portfolios has further pressured interbank lending as the uncertainty of asset values to back up interbank lending has increased substantially.

US\$ 3mo. LIBOR



Source: Bloomberg

As illustrated by the chart above, US\$ LIBOR rates have responded by increasing substantially over the last 4 weeks. Higher rates for LIBOR indicate the risk that banks perceive when lending to each other.

Government Treasuries to the Rescue

The recent response by governments across the globe has been to essentially recapitalize and pump liquidity into the banking system to encourage lending to resume. Central banks across the world have cut interest rates in an attempt to add liquidity and encourage banks to open up lending activities. In our opinion, this has been somewhat futile as the banks are approaching the current environment as a preservation of capital period, rather than a return on capital period. Hence higher interest rate spreads have not loosened credit conditions.

We feel the recent news that the UK and US will recapitalize the banking system directly with funds from government treasuries will prove to be more affective, especially taken in combination with the coordinated global rate cuts. The UK government has announced a plan to directly (through equity injections) recapitalize the system and the US Treasury has announced the TARP rescue plan to recapitalize the banking system through buying US\$700 billion riskier mortgage assets from the banking system. This past weekend US Treasury Secretary Hank Paulson has announce that they will also create a plan to directly inject equity capital into the system as the UK has announced.

How Much Damage Has Already Been Done?

The question going forward is going to be how much damage has already been done to the economy and what might be the unintended consequences of the rescue responses? We can draw parallels to other financial crisis, but our view is that the scale of the problem and relative uniqueness of the government responses make the current situation very much unlike other financial crisis.

We expect that at some point the poor conditions in the credit markets will subside. However, reluctance to expand lending and take on risk will continue for some time. The implication of this is that credit will flow to the least risky areas of demand. A portion of the economy (lower quality consumer and less stable corporate borrowers) will continue to be starved for credit. We expect this will be seen in both rising unemployment and slower consumption over the next 12 months in the US, UK, and Europe.

Is the Consumer Tapped Out?

The problem also exists that consumers, especially in an environment of deflating home prices and rising unemployment, will not have the capacity to draw credit from a rehabilitated banking system. The government responses, thus far, have done little to help deleverage the

“consumer balance sheet.” We expect that a period of relatively higher savings rates will be needed to replenish already stretched finances.

The weakness of the consumer implies that when economic growth does return, the long term trend for growth will be less than historical levels. The added impact is that lower long term earnings growth rates should keep equity valuations constricted relative to historical levels.

Historical Perspective

Though we feel that the problems currently facing the global economy are unique when compared to other instances in the past, there are some parallels that can be drawn for investors. We have taken a look at other recessions/market corrections to hopefully get an idea of what to look for to signal markets may be coming out of this malaise. We looked at early 1980's, 1987, early 1990's and 1998/2001. Because of a lack of data we have excluded 1929.

Recent Market Corrections - Data for S&P 500

Period	Market Bottom	Earnings Bottom	% Earnings Decline	% Equity Decline
Early 80's	2Q82	4Q83	-34%	-19%
1987	4Q87	3Q87	-21%	-25%
Early 1990's	4Q90	1Q92	-44%	-13%
Early 2000's	3Q02	1Q03	-54%	-46%
Current	?	?	-39%	-42%

Source: Bloomberg

1) Markets Are Forward Looking

In all cases, with the exception of 1987, equity markets began to recover before actual earnings recovered. The key to take away from this is that the market tends to be a leading indicator. As for the current market correction, we expect earnings declines (peak to trough) will surpass that of the early 2000's. Most of the 39% decline to date has come from the banking sector and we expect earnings pressure to continue to pass through to other industries in the coming 6-12 months.

2) PE Multiples look Deceptively Cheap Early in a Correction and Expensive in the Later Stages

The market is usually slow to adjust expectations downward in the case of a slowdown. The volatility in the earnings (the “E”) portion of the PE multiple can make equities seem cheap early on in a market correction. However, as seen in the table above, earnings can very easily decline over 50% peak to trough.

At the market peak in 2000 the S&P 500 traded at a TTM PE of 30x. After declining by nearly 23% as of the 1st quarter 2001 the PE was at 24x. However, in the 2nd quarter 2002 (one quarter before the market saw

a bottom) the PE stood at 41x. The best time to buy would have been at the point that the TTM PE was at its highest, not its lowest level. We certainly do not think high PE multiples are a buying signal. The point to take away here is that when looking for value in this type of environment make sure to be clear that multiples can be deceptive.

Deleveraging Process Could Lead to More Extreme Impact on Corporate Earnings

Unlike the previous market corrections that we have looked at, the current deleveraging process could lead to more extreme and prolonged earnings declines in both the US and Europe. During the two relatively “painless” corrections of the early 1990’s and 2000’s US earnings declined 44% and 54%, respectively. During both instances the consumer was relatively strong throughout process. In our view, the consumer is less capable to maintain expenditures in the current environment. We have already seen earnings decline 39% and our view is that further significant declines are probable in the 4th quarter and 1st quarter of next year.

Government Response Could Speed up the Process of Recovery

The governments’ response to recapitalize the system and transfer bad assets from the banking system to government balance sheets should soften the blow, but it is unclear when asset values (in particular homes) will begin to find a bottom. The relatively large government response should help the asset values find a bottom quicker than if no help had been given. However, we have not seen any signs yet of a bottom in asset prices.

More Regulation is a Certainty

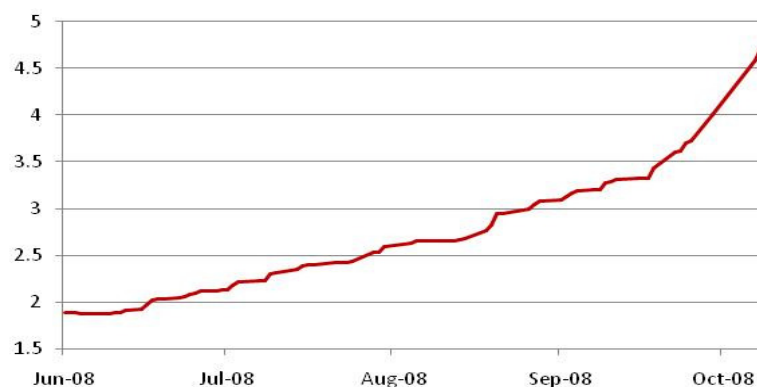
Governments throughout the world are going to spend the next few years trying to introduce regulation that will reduce the systematic risk in the future. While additional regulation is needed, it will add some uncertainty in the near term. In our view the uncertainty is over the potential for unintended consequences and over-regulation that may suffocate growth and innovation. At a minimum the banking system will be less leveraged offering more stability, but at the same time less fuel for economic expansion. A trade-off most will be willing to take in the current environment.



How Does This Impact Regional Markets?

Unfortunately the stress in the global capital markets has had a significant impact on both regional equity and credit markets. EIBOR rates have increased over 250 basis points since June and equity markets have lost over between 30% and 50% across the region. Clearly local markets have not decoupled.

3mo. EIBOR Rates



Source: Bloomberg

In our opinion, MENA economies are much better positioned to weather out the storm in global markets over the long term. However, in the near term, events in global markets will be the main driver for local markets.

Key Fundamental Differences in Regional Markets

While the near term pressure on regional markets should continue, there are four key differences for the regional economies that point to a stronger long term outlook for MENA economies.

1) Current Account Surpluses to Continue

The oil driven current account surpluses in the region are estimated continue even with oil in the US\$45 range. Therefore, at current levels of US\$77 there is still a substantial buffer to capital inflows to the region.

2) Not Capital Constrained

There have been signs recently that the regional banks are constrained in their ability to grow loans. However, we feel regional governments has sufficient reserves to recapitalize the banking system if needed. We do expect loan growth to slow from the 49% yoy level seen in the first half of this year, but we still expect loan growth to continue into 2009.



3) Little Exposure to the Global Bad Debt Instruments

With the exception of a few regional entities, it seems that exposure to the toxic debt instruments that are wreaking havoc on the global banks is limited in size.

Where is the Relative Safety for Investor?

Nearly every sector has been hit in recent months. As we expect uncertainty to continue, the real estate and banking sectors should continue to be volatile until investors can assess the impact to both sectors. Additionally, with expectations for global growth declining, we expect pressure on energy and petrochemical equities to continue. Valuations are very attractive in all three sectors, but near term volatility should continue.

We feel investors should be targeting the consumer goods and telecom sectors in the region. Both sectors are less exposed to potential volatility in reported earnings during this period and are supported by strong recurring cash flow. These would include companies like Etisalat, Qtel Zain, and STC, in the telecom sector and Almarai and Savola in the consumer sector.

Some Guidelines for Investing in Difficult Times

With valuations at incredibly attractive levels in the region, it can become very tempting to try and pick the bottom. However, as we pointed out earlier, valuations are not the driver during market corrections. If investors are patient and have a long term time horizon, we feel these markets do offer value. So how do you deal with the worry of missing a great buying opportunity, but at the same time protecting your savings? Here are some recommendations:

- 1) Stop using leverage until markets calm – Leverage makes the investor more susceptible to market volatility. The key is to be able to wait out the storm to gain when valuations come back to a fair value. Don't let volatility compounded with leverage force you to miss the opportunity.
- 2) Manage position size – spread your risk among several companies and sectors.
- 3) Enter positions in stages – start small and add to your positions in increments. Put less capital at risk initially.
- 4) Add to positions on strength not weakness – Along the lines of rule #3, set a stop loss. Hence exit on weakness. Add in increments to your position as the market improves and move the stop loss up with the stock. **DO NOT AVERAGE DOWN.**

Conclusion

We expect trying times to continue globally. Regardless of the fundamental economic strength in the region, global issues will continue to impact region markets. This is a time to worry about preserving capital, rather than making trading gains.

This does not mean that investors should avoid the market completely. I firmly believe that 2 or 3 years from now we will look back at the next six months as one of the best buying opportunities the region has seen for years. However, in the near term the key will be to manage risk.

Al Mal Securities Group**Managing Director**

Tamim Refai +971 4 360 11 30

Institutional Sales & Trading

Hassan El Salah +971 4 360 11 09

Khamis Shinnawi +971 4 360 11 10

Tareq Hamdan +971 4 360 11 06

Homam Maghalseh +971 4 360 11 07

Reza Kiani +971 4 360 11 13

Portfolio Advisory

Akram Annous +971 4 360 11 12

All Desks Number +971 4 360 11 00

Al Mal Capital Research**Managing Director**

Robert McKinnon +971 4 360 11 17

Equity Research Analysts

Irfan Ellam +971 4 360 11 53

Bobby Sarkar +971 4 360 11 68

Deepak Tolani, CFA +971 4 360 11 52

Mala Pancholia +971 4 360 11 54

Prerna Sharma +971 4 360 11 56

Arun Ramachandra +971 4 360 11 57

Katherine Lynn, ACCA +971 4 360 11 66

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