Perspectives

April **2020**

Quarterly Investment Outlook:
The Day After

Global Markets: 10 stories to remember from The Corona Crash

Investment Strategy: The Day After

Middle East: The 1st quarter in the rearview

MENA Equity Outlook: Q2 2020 and beyond

Hot Topic: Are GCC pegs at risk?

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Welcome to 34th edition of Perspectives.

The first quarter of 2020 has by no means been an easy one for investors. As COVID-19 evolved from a Chinese epidemic to a Worldwide pandemic, the debate shifted from whether or not there will be a recession this year to how deep and long it will be. As markets moved to reflect this new reality, global stocks lost a record $19.6 trillion from peak to trough as equities underperformed fixed income by a magnitude not seen since the depths of the Global Financial crisis in 2008.

In the first part of this publication we highlight the 10 stories to remember from the "Corona Crash" which took place last month. We then share our global market outlook for the second quarter and beyond. After reviewing the weight of evidence from a fundamental and technical standpoint, we explain why we are turning more cautious on risk assets following the strong rebound which has been taking place since March 23rd.

The second part of this edition of Perspectives is dedicated to our regional markets. We look at the first quarter in the rearview and share our current investment strategy. In the "hot topic" section, we discuss how the COVID crisis and low oil prices could threaten the dollar-peg of some GCC countries.

We hope you will enjoy this issue.

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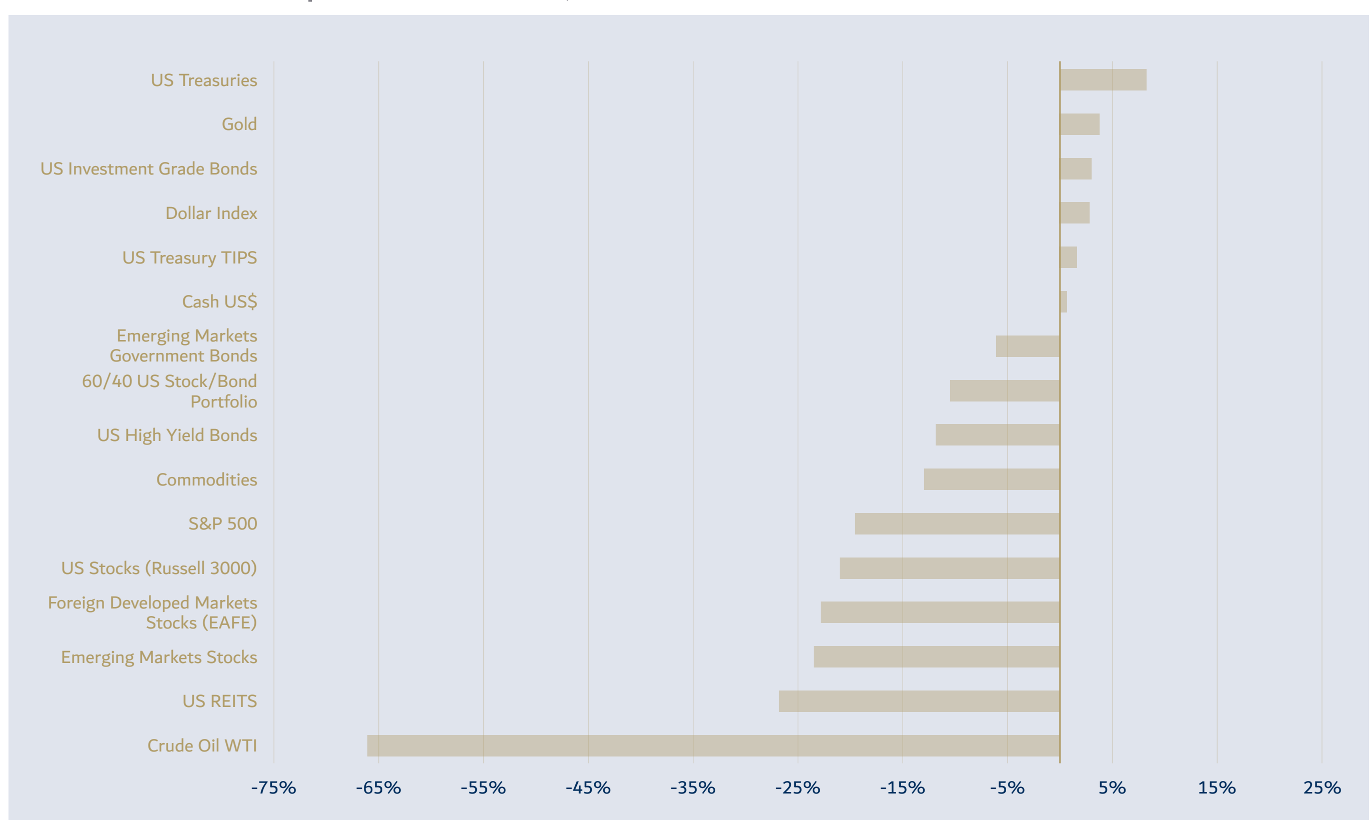
10 stories to remember from The Corona Crash

Upbeat fourth quarter earnings, improving business sentiment and a phase 1 U.S-China trade deal propelled risk assets higher to begin the year — until the global spread of coronavirus brought a swift and sudden reversal.

Concern over the human and economic toll has prompted the world's biggest quarterly market capitalization loss (in bonds and stocks) ever, with bonds adding a modest $1.1 trillion while stocks lost a record $19.6 trillion. Equities underperformed fixed income in Q1 by a magnitude not seen since the depths of the Global Financial crisis in 2008.

Selected asset classes performance over Q1 2020

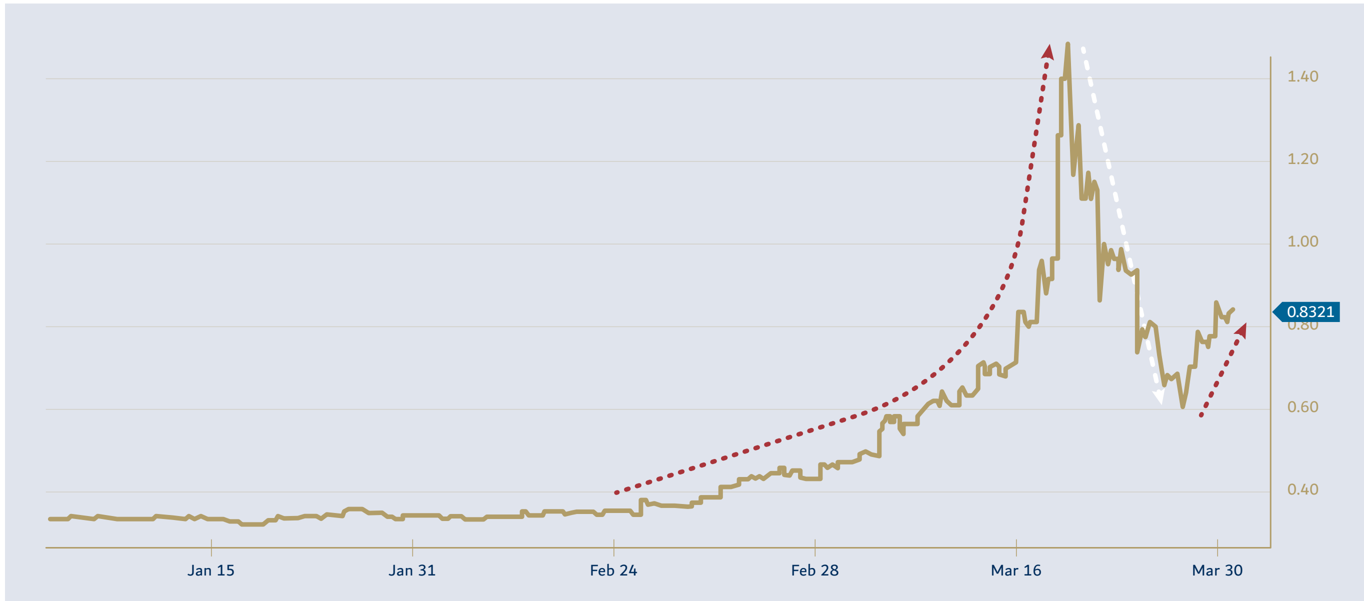


This quarter has by no means, been an easy one for global investors. As COVID-19 evolved from a Chinese epidemic to a worldwide pandemic, the debate has now moved on from whether or not there will be a recession this year, to how deep and long it will be. As markets moved to reflect this new reality, equities have fallen sharply, with the worst returns coming in March.

Within US equities, the S&P 500 was down -19.6%. The Russell 2000 was the biggest (major) index loser in Q1 (down around 31%) with Nasdaq being the relative winner (down around 13%).

Directly-virus-affected sectors such as airlines (-50%), hotels & cruise lines (-58%), restaurants (-34%) were a bloodbath in Q1 while food and drug stores massively outperformed as shown on the Covid-19 long-short trade on the next page.

The "Virus Fear" Trade (long Food, short Leisure) *Source: Bloomberg.*



US bank stocks suffered their second worst quarter ever, crashing 41% (Q1 2009 was -44%) with Citi and Wells Fargo hit worst. US REITs – often perceived as a defensive sector - were down -27%.

Pan-European stocks were hit as hard as US stocks were in Q1 (-25% to -30%) led by UK's FTSE index.

Emerging Markets equities were down -23.6% as emerging local currencies tumbled against the dollar which is up +2.8% on a trade-weighted basis.

While Covid-19 started in China, the Chinese stock market did well on a relative basis. The tech-heavy and small cap ChiNext Index ended the quarter with a positive performance (over 4%) while the rest of the Chinese stock market fell albeit relatively modestly (e.g -9.8% for the Shanghai Composite).

Within Fixed Income, Credit markets collapsed at a record pace in Q1 as US and EU High Yield spreads surged by an average of 400 basis points over the quarter as concerns about the effect of the shutdowns on corporate profits have led to credit spreads widening. As one should expect, riskier, junk-rated corporate bonds have fallen by more than investment grade rated companies, with high yield energy bonds, the worst hit by the collapse of oil prices. US Investment Grade ended in positive territory (+3.1%) thanks to the Fed program of buying US corporate bonds. Investor appetite still seems to exist, as US Investment Grade issuance reached a new record of $260.7 billion in March 2020, bringing the year-to-date to $509.7 billion, the fastest ever start to a year. We also note that US Investment Grade credit has dramatically outperformed Europe since The Fed promised to start buying.

The defensive part of fixed income portfolios has performed as expected with government bonds rising in price, as central banks cut interest rates and restarted quantitative easing. It is however noteworthy to mention that US Treasuries markets exhibited unusually high volatility (see dedicated section). However, it did emerge as the winning asset class of the quarter with an 8% gain as US 10 Year Treasury bond yield ended April at a again of around 60 basis points. Meanwhile, Emerging Markets Government bonds tumbled 6%.

As described later in this article, return dispersion within Commodities was huge with oil collapsing by 66%. Oil was caught in a perfect storm with an agreement between OPEC and Russia to constrain supply breaking down just as the outlook for demand fell. Meanwhile Gold was volatile but still managed to deliver quarterly gains (+3.8%).

While US Treasuries recorded strong gains, the magnitude of the equity decline led most multi-assets funds to record one of their worst quarter ever (as shown on the performance table, a 60/40 stock/bond portfolio is down -10.5% over the quarter). Hedge funds performance was mixed; Trend-followers and Macro strategies were slightly up, Market Neutral and Merger funds were down around -8% while Equity hedge funds were down almost -15%.

A Quarter to Remember:

DOW JONES' WORST Q1 EVER

This was the **Dow Jones' worst 1st quarter ever** and worst overall quarter since Q4 1987. Within the Dow Jones Industrial Index, only 1 stock (Microsoft) recorded a positive performance over the quarter;

WORST Q1 FOR THE S&P 500

This was the **S&P's worst 1st quarter since 1938** (and worst quarter since Q4 2008) and March was the worst month for the S&P 500 since October 2008;

BIGGEST SPIKE EVER FOR THE VIX

The 1st quarter also saw the **biggest quarterly spike in the VIX index ever**;

BIGGEST CRASH FOR THE US 30Y YIELD

The US Treasury 30 Year Yield fell in all three months in the 1st quarter. This was the **biggest 1st quarter crash in the 30 Year** Yield since 1986;

BIGGEST DROP FOR THE US 2Y YIELD

The US Treasury 2 Year Yield plunged 136 basis points in the 1st quarter (down 6 quarters in a row) – this was the **biggest yield drop since Q1 2008**;

GAINS FOR GOLD

This was the 6th straight quarter of **gains for gold**;

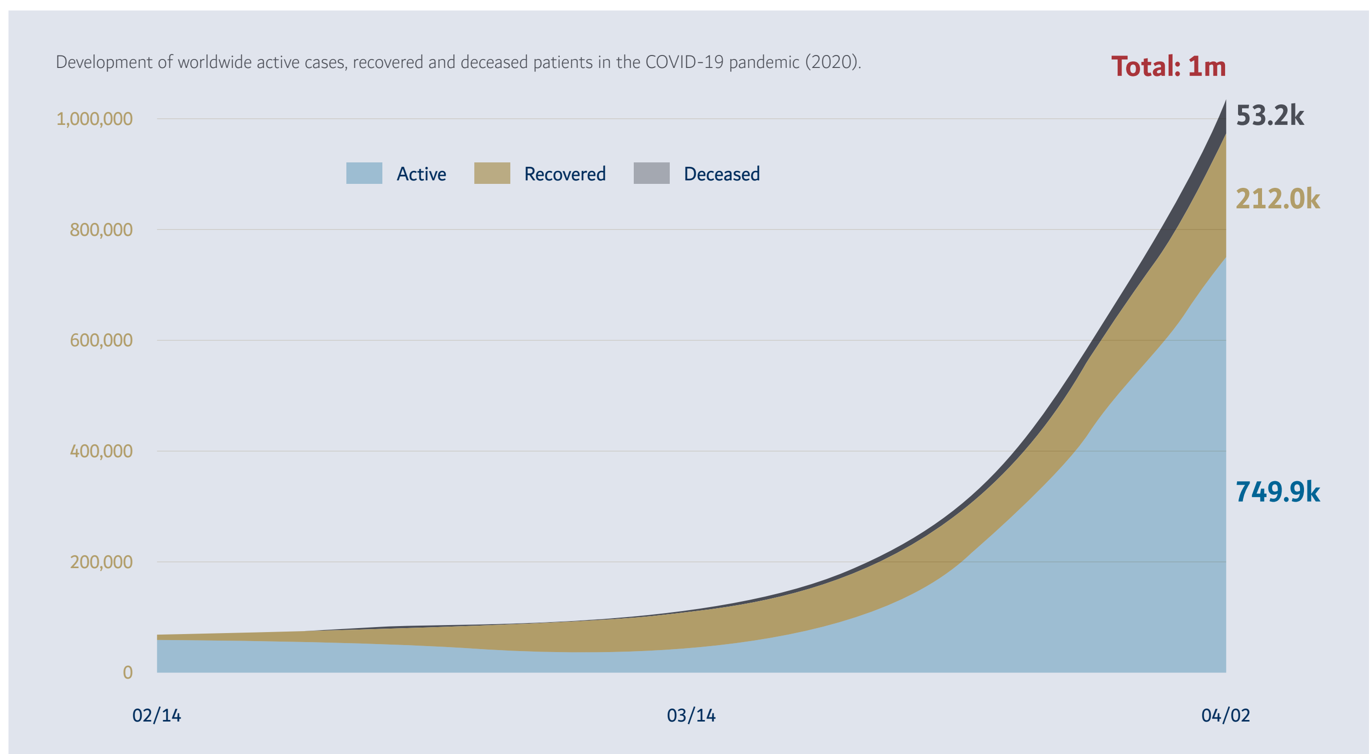
66% CRASH IN CRUDE OIL

The 1st quarter 66% crash in WTI Crude Oil was the **worst quarterly drop ever**.

STORY 1: From Wuhan Coronavirus to Covid-19 Global Lockdown

At the time of our writing, the Covid-19 virus has infected more than 1 million people across the world, a milestone reached just four months after it first surfaced in the Chinese city of Wuhan. More than 51,000 have died and 208,000 recovered in what has become the biggest global public health crisis of our time.

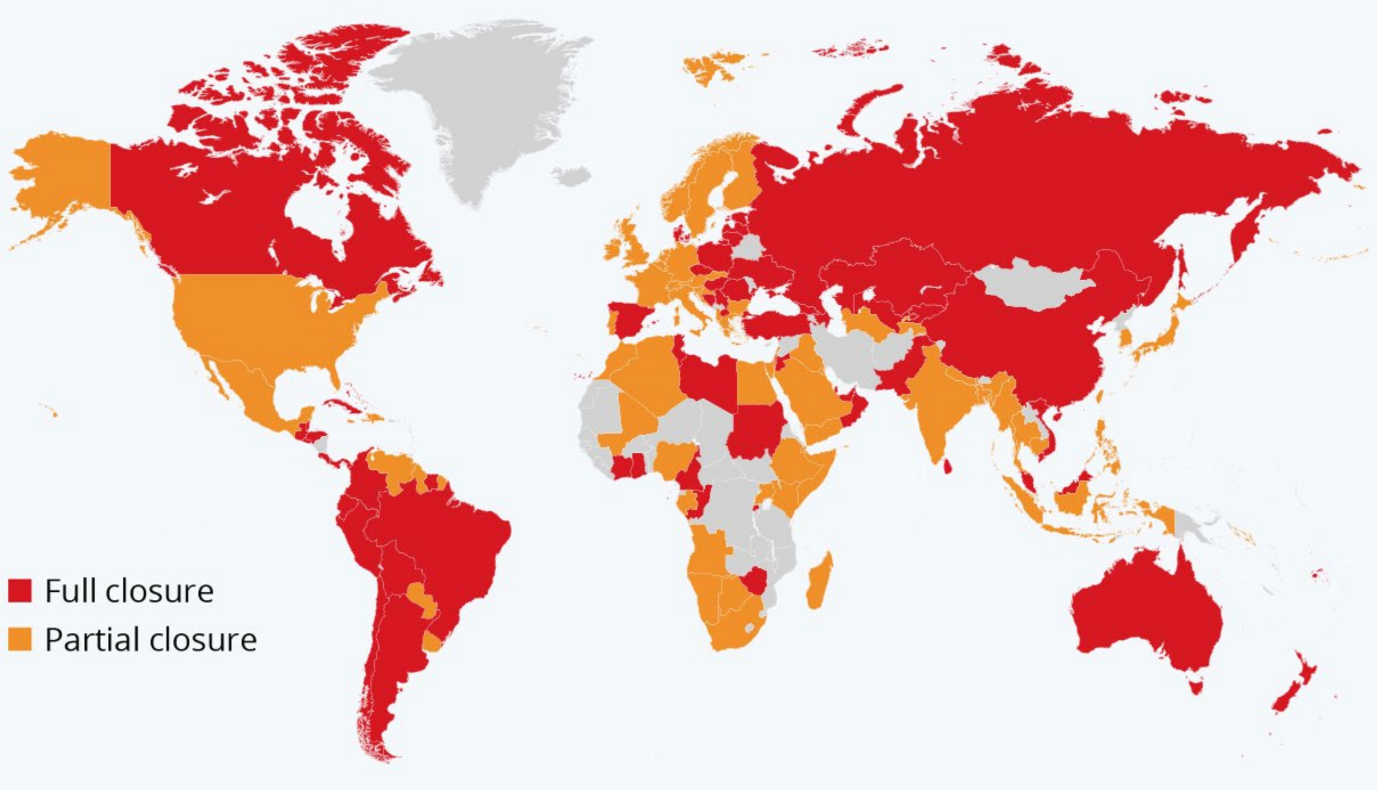
The Global Rise of the Coronavirus: *Source: Statista/Johns Hopkins University.*



Half of the world population is now in lockdown and an immense majority of countries have closed their borders to non-residents and non-nationals either fully or partially.

Investors hate uncertainty and suddenly had to face 2 major unknows: 1) A major and global health crisis; 2) The short and long-term impact of the global lockdown on the economy.

Border Closures: Countries that have closed borders to non-citizens and non-residents (as of Mar 31, 2020). *Source: Bloomberg.*



As discussed in our previous edition of Perspectives, investors hate uncertainty and suddenly had to face 2 major unknows: 1) A major and global health crisis for which the length, extent and potential recurrence are still unknown; 2) The short- and long-term impact of the global lockdown on economic activity.

Indeed, one doesn't need to wait for traditional economic data to be released to appreciate the scale of the hit to the economy, which is emanating from the virus containment measures currently in place across much of the world. A few select data points demonstrate the magnitude of the shock.

For example, car sales in China fell about 80% in February. Data from the restaurant booking app Opentable show that bookings are down close to 100% in nearly every country that they operate in. In one week in March, over three million people signed up for jobless benefits, more than four times the previous record since 1967. Clearly, this is not just a normal recession, but a sudden shock to the economy that is unprecedented among developed economies in the post-war period. US CBO (Congressional Budget Office) estimates that US GDP growth will be down -28% quarter-on-quarter in Q1 while US unemployment rate will jump to 10%.

Car sales in China fell

80%

in February

Restaurant bookings are down close to

100%

in nearly every country

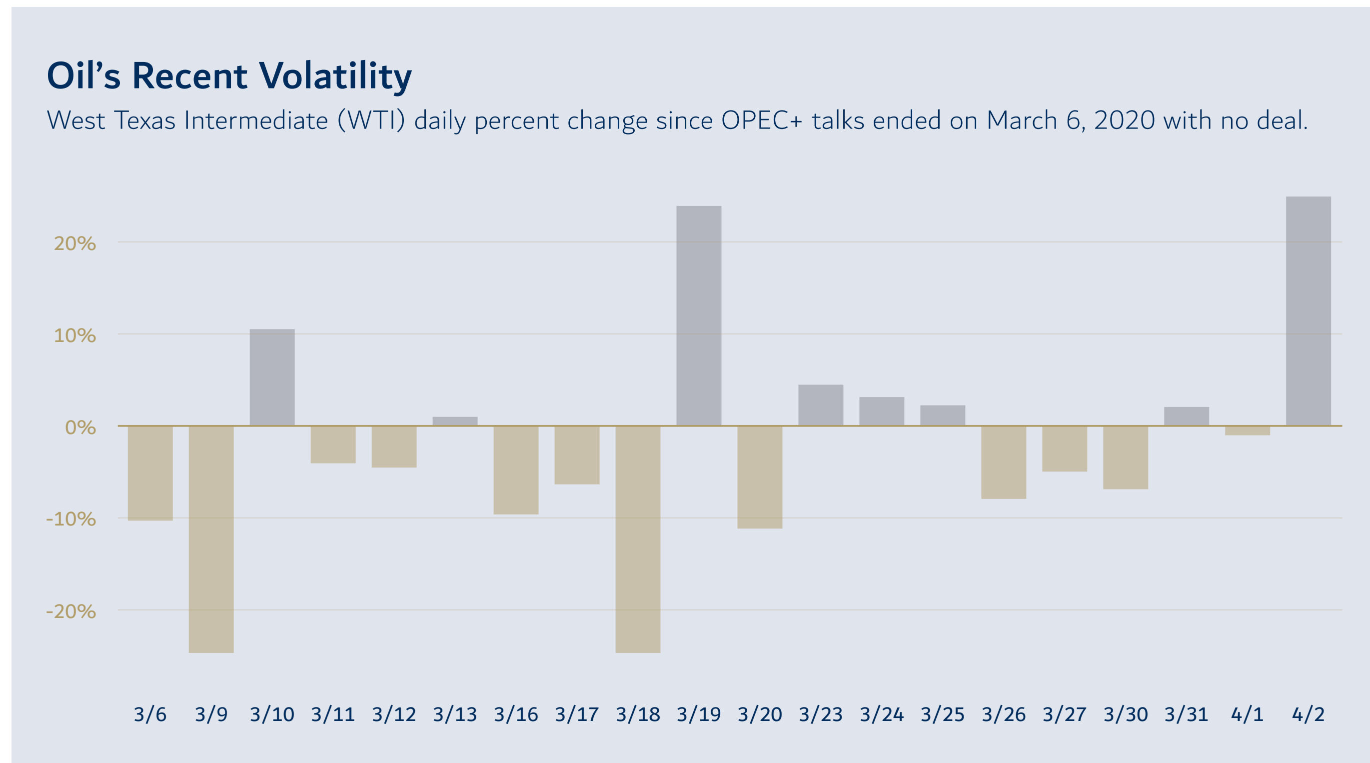
US CBO estimates the US GDP growth will be down

-28%

quarter-on-quarter in Q1

STORY 2: The Oil Crash

As mentioned in our March edition of Perspectives, the first "blackswan" (an economic shock spurred by COVID-19) collided in early March with an oil crash after a three-year pact between OPEC and Russia ended in acrimony in Vienna after Moscow refused to support deeper oil cuts to cope with the outbreak of coronavirus. OPEC responded by removing all limits leading the Oil market to face a perfect storm: on one hand, demand is collapsing by between 30 and 35 million barrels a day due to the COVID-19 dislocation; on the other hand, OPEC+ failure to extend/deepen production cuts bring extra oil into the market. Consequently, global storage capacities are reaching their limits with dramatic consequences on oil prices (-67% year-to-date). Hopes for a potential deal between OPEC, Russia and US/Canada contributed to record high volatility in March (see chart below).

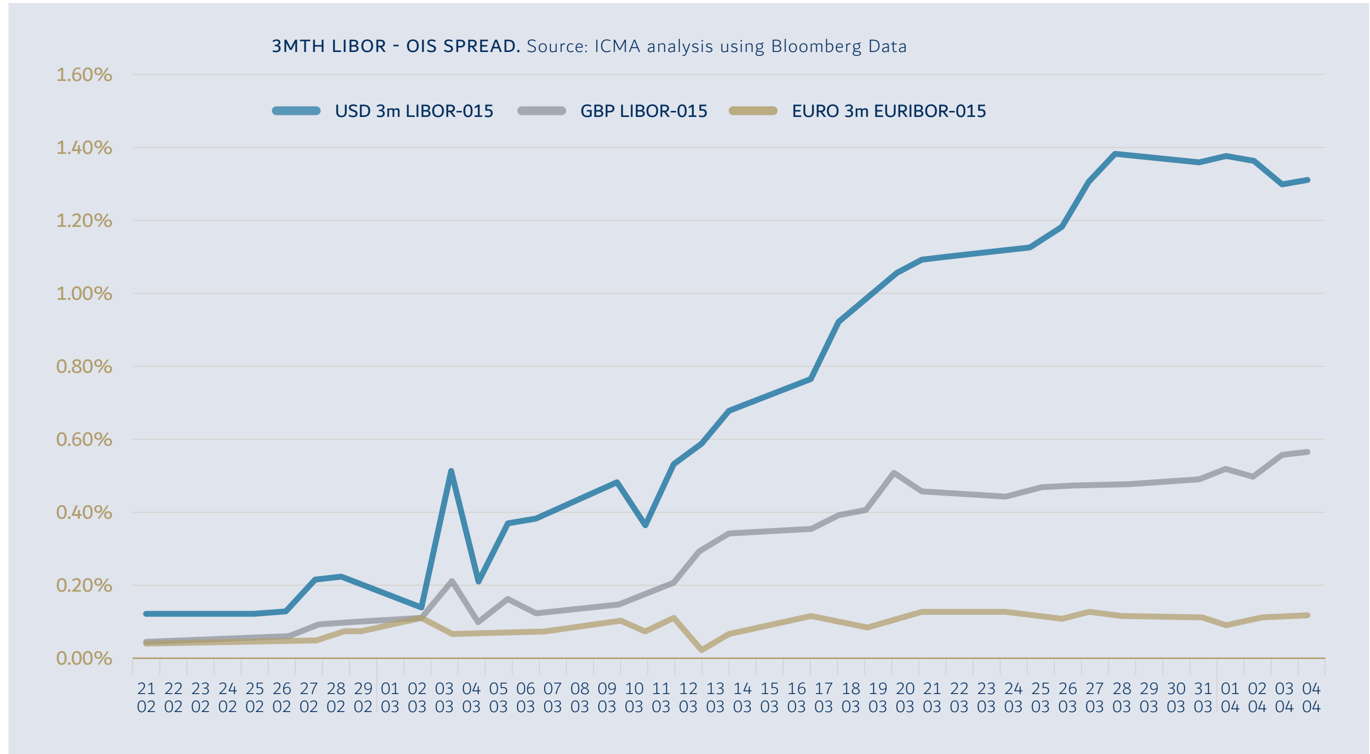


Global storage capacities are reaching their limits with dramatic consequences on oil prices.

STORY 3: Financial Contagion

The collusion of two Black Swans (Covid-19 and the Oil crash) led to the occurrence of another Black Swan: dysfunctional capital markets. Indeed, signs of financial contagion started to abound from mid-March, e.g:

- **High volatility in the us treasury market (more on this in story 5);**
- **Treasury cash / swap basis surging;**
- **LIBOR-OIS spread surging (see chart below);**
- **Huge discount to NAV on fixed income ETFs;**
- **Credit spreads widening;**
- **Cross asset correlation surging suggest a huge global marging call (e.g Gold sell-off);**
- **Trade-weighted dollar was appreciating despite rate cuts because of a dollar shortage (see story 6).**

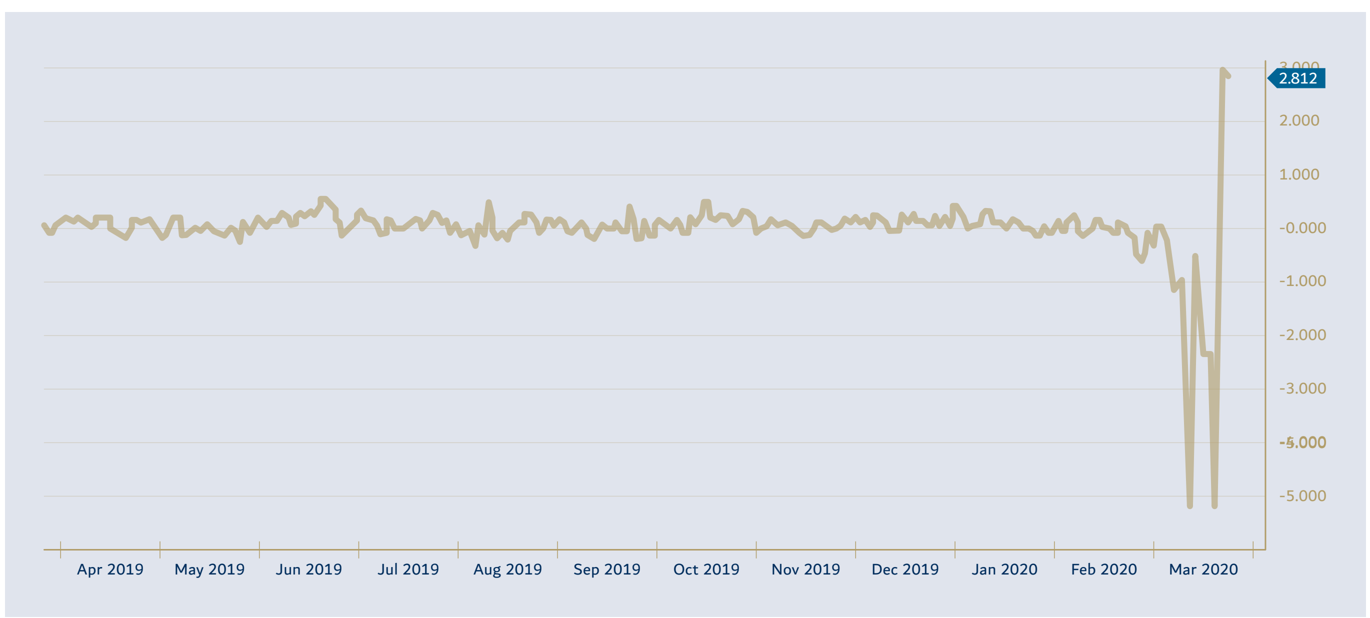


The accumulation of these warning signs and fears that central banks and policy makers were losing control of capital markets led to some panic selling on the markets, triggering the activation of circuit breakers in Wall Street for the first time since the Global Financial Crisis in 2008.

In order to stop the "bleeding", the US Treasury and the Fed brought in a "nuclear" arsenal in order to address markets dysfunctionality. The Fed decided to cut the federal funds rate down to zero and to launch (unlimited) QE4, which including massive purchases of US Treasuries, MBS and corporate bonds. Additionally, in a coordinated effort with five other major central banks, including the SNB, the Fed opened swap lines to smooth out disruptions in overseas Dollar markets. This announcement came after a 50 bps emergency rate cut and the giant repo operations ($5 trillion) the week before (more on the Fed in story 7). Such an unprecedented monetary policy action by the Fed had one key objective: STOP THE MARKET DECLINE. In case of further downside, margin calls and more involuntary liquidation would have accelerated, markets would have lost their ability to price securities, especially high yield bonds and emerging markets securities. Funds in those areas would have been unavailable for people to redeem because they wouldn't have had any prices, money would get trapped, corporate debt covenants broken forcing changes of control or restructurings, etc.

At the time of our writing, the Fed seems to have regained control of some parts of the market. For instance, credit spreads have tightened. etc., most bond ETFs discount to NAV have disappeared, etc. The most striking example is the LQD ETF (iShares US Investment Grade corporate bonds) which has now flipped and reversed from a 5% discount observed mid-March to a record premium of 3% a week later. The reason: with the Fed - via Blackrock - now buying the LQD ETF as part of its corporate debt bazooka, are not buying the single-name securities that comprise the ETF, investors are front-running the Fed's purchases.

LQD (iBoxx $ Investment Grade Corporate Bond) ETF Premium/Discount to NAV %

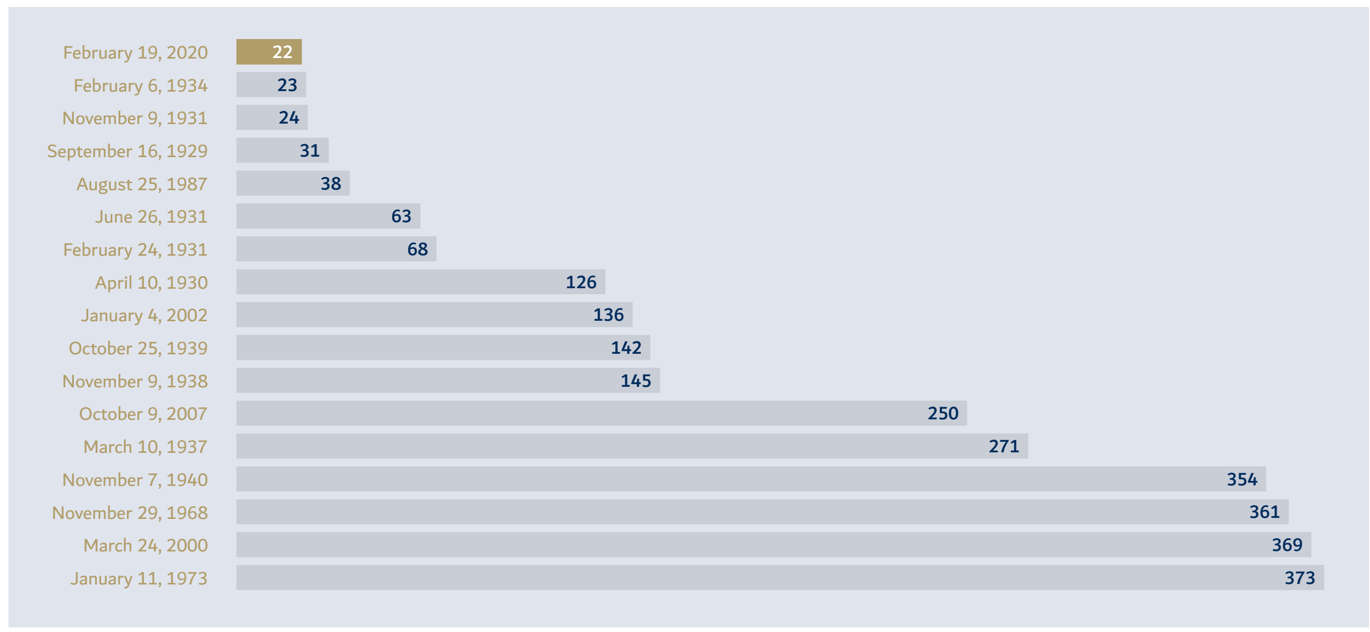


It thus looks like the FED has been able to avoid a full-blown financial crisis at the end of march. Their goal was to defend december 2018 lows and they were successful – but the risk is still there.

STORY 4: The fastest bear market ever

The collision of the three aforementioned crisis (COVID-19, oil crash and financial contagion) has led to the fastest bear market ever. As shown on the chart below, it took just 22 days for the S&P 500 to fall by 30% from peak compared to 250 days for the Global Financial crisis (2007-2008) peak to trough.

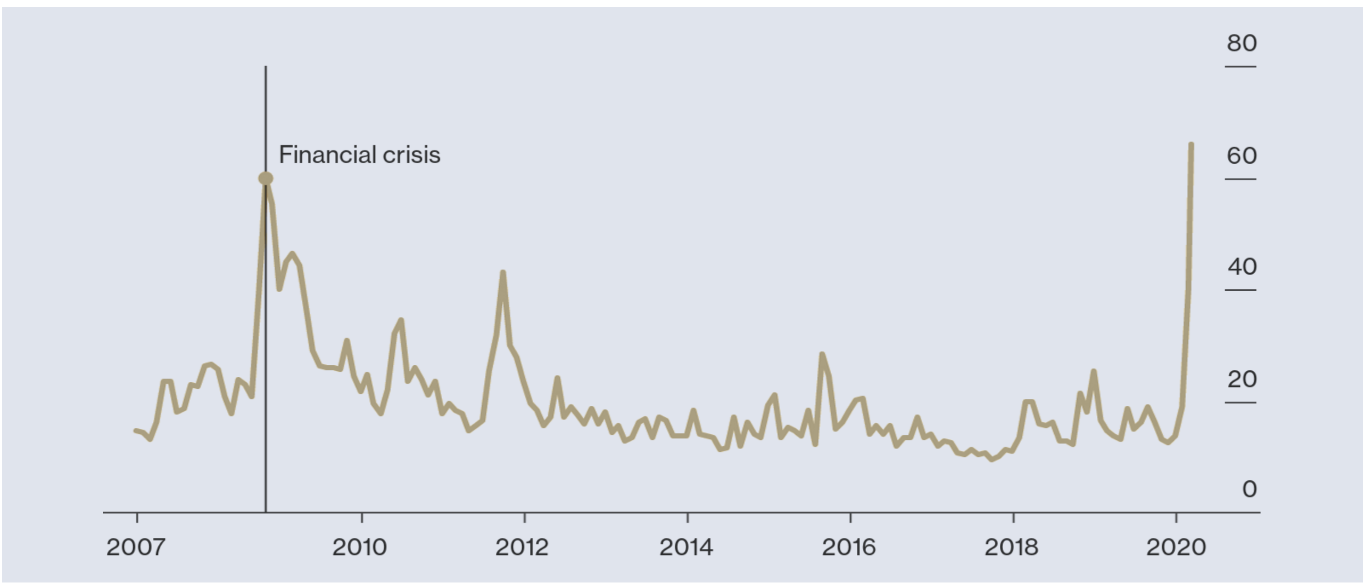
Stocks post fastest 30 percent drop ever. *Source: BofA Global Research*



STORY 5: A huge spike in volatility

During the 3rd week of March, the VIX Index, which reflects expected volatility on the S&P 500 over the next 30-days, notched its highest weekly close since 2008 amid the global financial crisis. The realized volatility was even higher, reaching its highest level since the Black Mondays in 1987 and 1929 (see chart below on the Dow 30-day realized vol).

CBOE Volatility Index (VIX) since 2007. *Source: Bloomberg*



But the spike of volatility was not only a US equity phenomenon. European, Asian and Emerging Markets volatility surged as well. Alongside the VIX Index, FX volatility is surging, which speaks to the rise in systemic risk amid the novel coronavirus outbreak and crude oil price war.

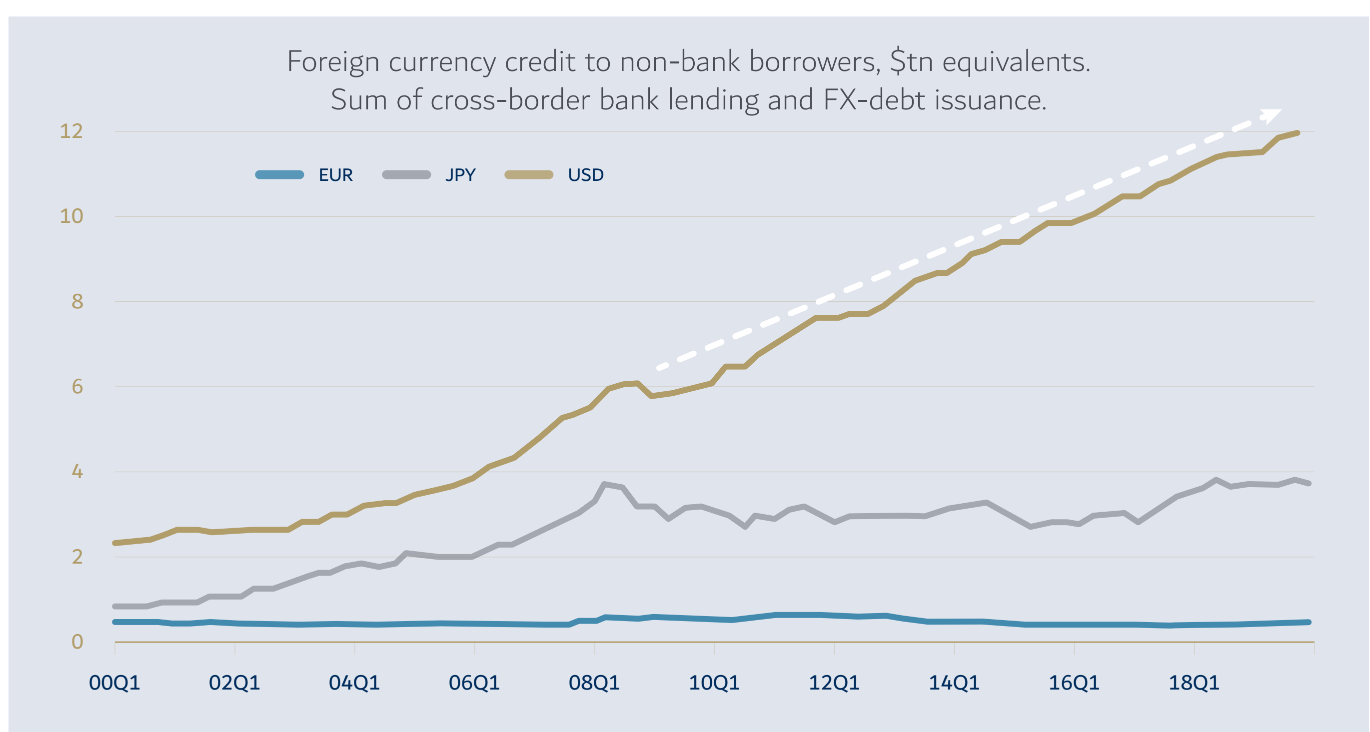
Surprisingly, the TYVIX index (US Treasury volatility) spiked as markets feared the Fed was losing control of the US Treasury market. As shown on the chart below, the FED was able to take out some stress as the TYVIX crashed during the last week of the month.

Treasury Volatility Index. *Source: Thomson Reuters*

STORY 6: The dollar shortage crisis

During the course of the first quarter, markets had to face a massive margin call due to what has been referred to as a giant dollar shortage. As highlighted by JP Morgan on several occasions, there is a $12 trillion demand for US dollars (safehaven) coming from overseas and there is currently no lender of last resort to match emergency needs. Hence the strong rally in the dollar during the month of March (including the biggest 7-day gain since Black Wednesday in 1992 when George Soros "broke The Bank of England") and a rise in cross-asset correlation (i.e all asset classes crashing at the same time) as clients are willing to sell any liquid asset to meet their margin calls. This dollar shortage is precisely the reason the Fed decided to set up swap FX lines with other central banks (ECB, SNB, BoE, BoJ) to provide dollars to them (so they can lend them to their banks). But this might not be enough and the Fed might have to extend these lines to Scandinavia, China and other Emerging Countries. As shown on the chart below, the dollar shortage is much larger now than in 2008.

The USD thrives on destress and deleveraging because three-quarters of cross-currency funding is undertaken in US dollar. That is a $12 trillion dollar short to be squeezed if the business cycle has ended.
Source: JP Morgan, BIS



There is a $12 trillion demand for US dollars coming from overseas and there is currently no lender of last resort to match emergency needs.

STORY 7: The largest fiscal stimulus ever

An unprecedented shock requires an unprecedented policy response. And that is what we have seen happening during the second half of March not only from central banks (see story 8) but also from a fiscal standpoint.

Most encouraging has been the policy response from the likes of the UK and Germany where governments have committed to pay a significant proportion of workers' wages during the shutdown to enable companies not to lay off staff despite the dramatic hit to sales. This is precisely, the right kind of policy to deal with this type of shock, to give those economies the best chance of rebounding sharply once the health situation is under control.

Government-backed loans should also help many companies to avoid otherwise inevitable cash flow induced bankruptcies. However, loans may not be enough for the hardest hit companies, some of which are likely to require grants or bailouts to survive a substantial loss of sales, at least part of which is likely to prove permanent.

In the US, a very substantial fiscal stimulus package has been agreed upon, worth about 14% of GDP (see table below), which will include some grants to small businesses. The package also provides government backing for credit to be provided by the Fed to investment grade companies (see story 8). This should ensure that large investment grade companies don't fail in the near term because of a lack of cash flow. However, again, some large companies may require grants or bailouts rather than just credit to survive this shock in the longer term.

In addition, while the US fiscal package significantly increases jobless benefits for the next few months, the policy appears less effective comparatively versus the UK or German policy where the policy is geared towards encouraging companies to hold on to staff. Overall, fiscal policy has already delivered a significant stimulus, multiplied by the impact of it being done globally. But further measures are still likely to be needed to deal with the size of this shock.

Debt and deficits in the Euro area and in the United States are expected to increase significantly.
Source: DB, Bloomberg.

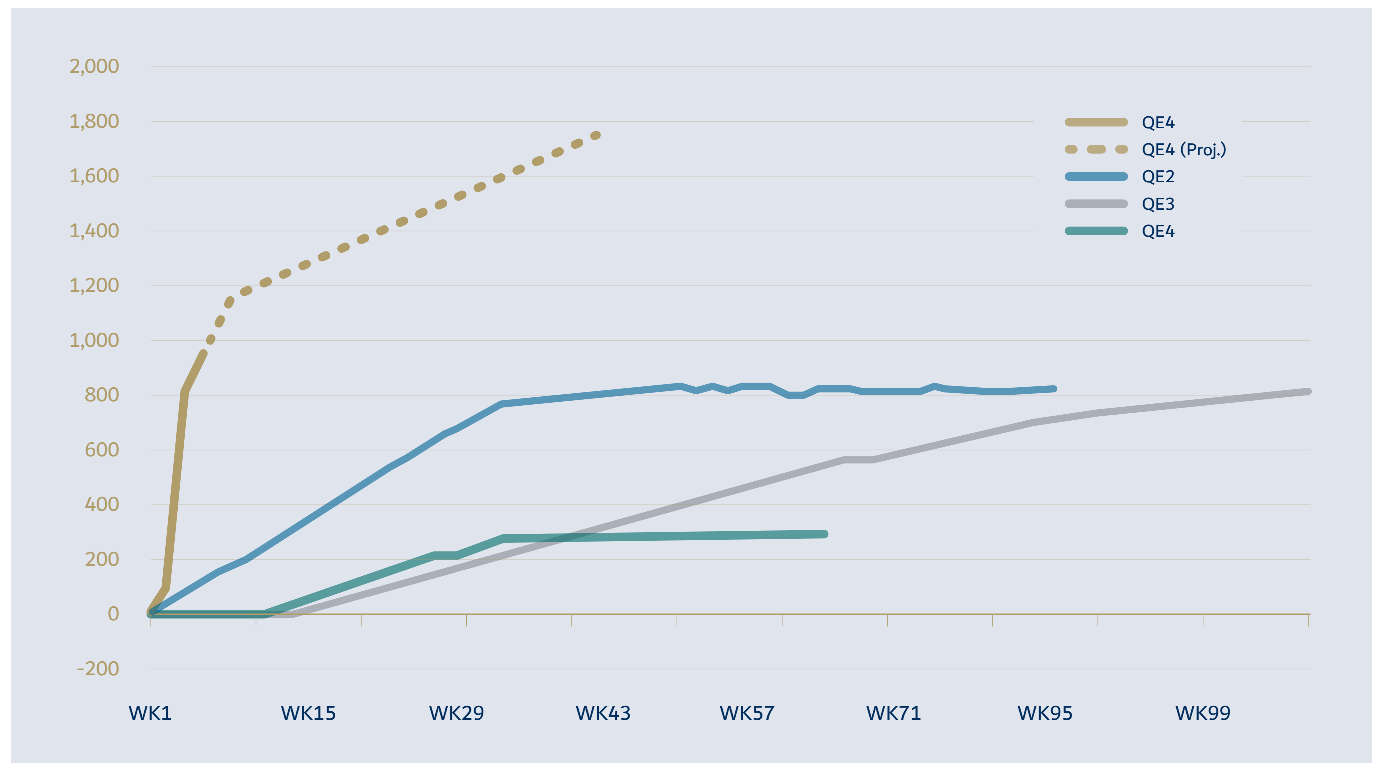
COUNTRY	FISCAL BALANCE % OF GDP		GROSS PUBLIC DEBT % OF GDP	
	2019	2020E	2019	2020E
GERMANY	1.3%	-7.3%	59.2%	68.3%
FRANCE	-3.2%	-9.5%	99.2%	114.4%
ITALY	-1.6%	-9.2%	135.6%	157.0%
SPAIN	-2.1%	-9.7%	96.0%	113.5%
US	-4.6%	-14.0%	79.0%	95.0%

STORY 8: Global central banks are going "nuclear"

As discussed earlier in this market review, Central bankers have been very pro-active during this crisis, cutting rates to their lower bound and restarting and expanding asset purchase programs (QE). The Fed's commitment to purchase as many government bonds as necessary is a substantial step, which should enable it to keep government borrowing costs low, despite the massive fiscal stimulus that is required to deal with the economic consequences of the virus. The Fed's corporate credit program should also prove a significant support for investment grade corporate bonds.

All in all, in the last 3 weeks of March, the Fed's balance sheet has increased by $1.6 trillion - the same amount as all of QE3 did over 15 months - and equivalent to 7.5% of US GDP.

QE4 Treasury purchase in perspective ($billion). *Source: BofA Global Research*



The European Central Bank along with the Bank of England haven't been quite as imposing, even though one can assume, their firepower is unlimited. They continue to focus on two major goals, keeping government borrowing costs low, and provide liquidity for investment grade corporates. In short, central banks, are doing all that can be reasonably expected of them, to fight the crisis.

The depth and duration of this recession will therefore depend on the extent to which governments fill in the gaps in their current fiscal responses, comforted by the support of the central banks, to ensure that unemployment is prevented from spiraling higher and bankruptcies of otherwise sound businesses are prevented. That being said, other questions be raised.

For instance:

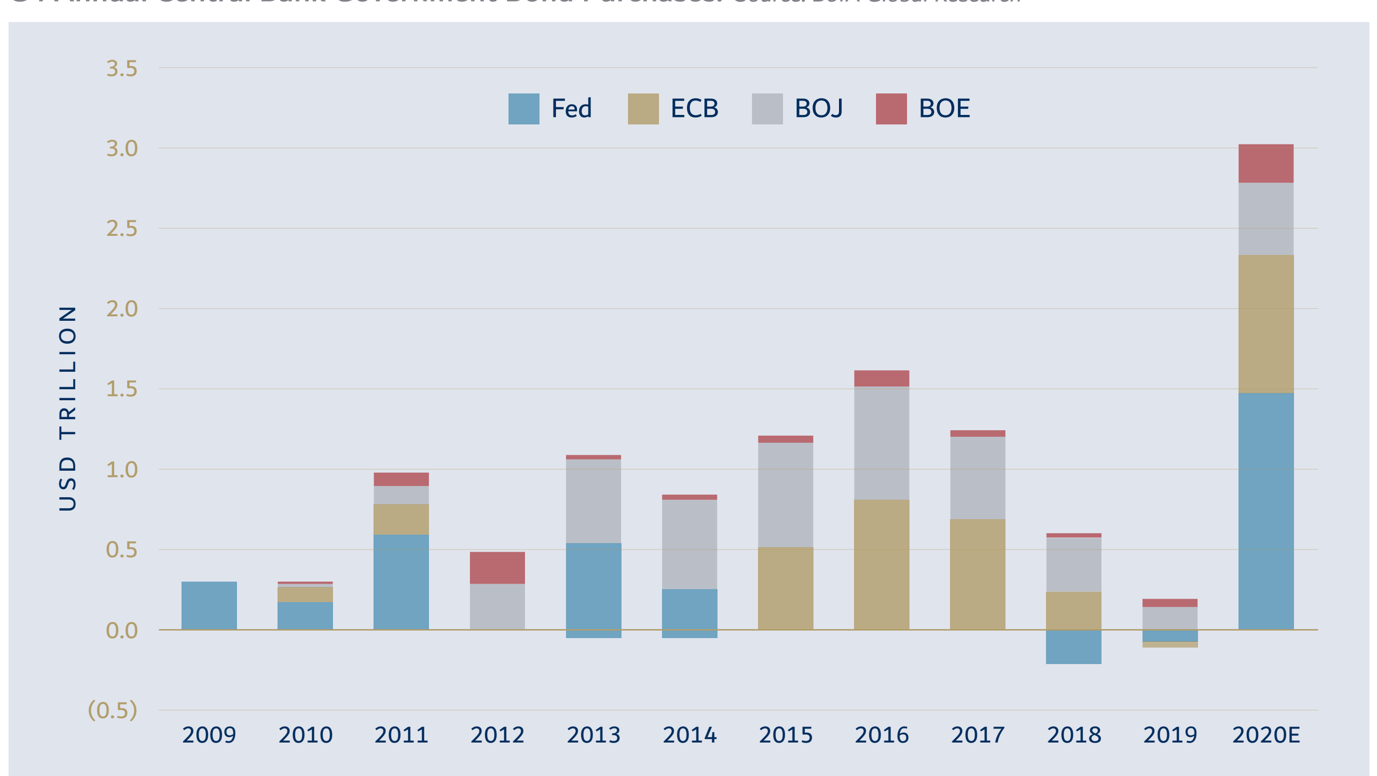
Will this massive liquidity injection ultimately create inflation or hyper-inflation?

While the Fed already owns more than 11% of the US Treasury market, at this pace of government-bond buying (see chart below), the Fed could own the entire market over a two-year time horizon.

Doesn't it create a massive moral hazard?

Is there an "exit plan"?

G4 Annual Central Bank Government Bond Purchases. *Source: BofA Global Research*

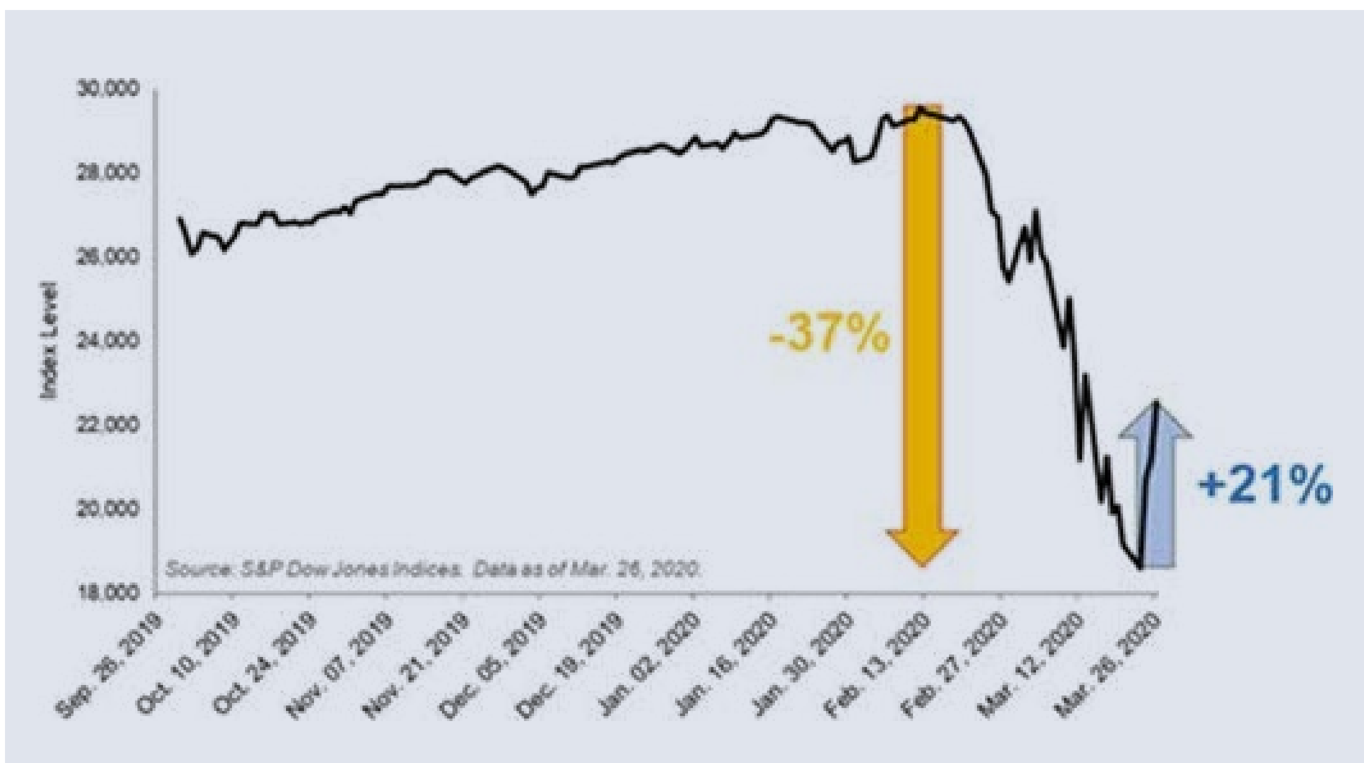


STORY 9: The fastest (cyclical) bull market ever

The pro-activeness of policy makers has been giving some support to "V-shape" bullish thesis, i.e the sharp market decline and economic contraction will be followed by a strong and quick economic and market recovery.

As the Fed went "nuclear" with QE4, the December 2018 low on the main US equity indices wasn't breached, attracting some "buy-the-dip" investors and triggering one of the largest short-coverings in history with the S&P 500 surging by 21% in a matter of 4 days (best week for US equities since 1933). As we will discuss in the outlook session, there is no guarantee that the bear market is over and that we have already seen the low.

From Fastest Bear to Fastest Bull: Dow Jones Industrial Average.



The "Bull thesis" works as follow: "The sharp market decline and economic contraction will be followed by a strong and quick economic and market recovery".

Gold is the second-best performing asset class over Q1 behind US Treasuries.

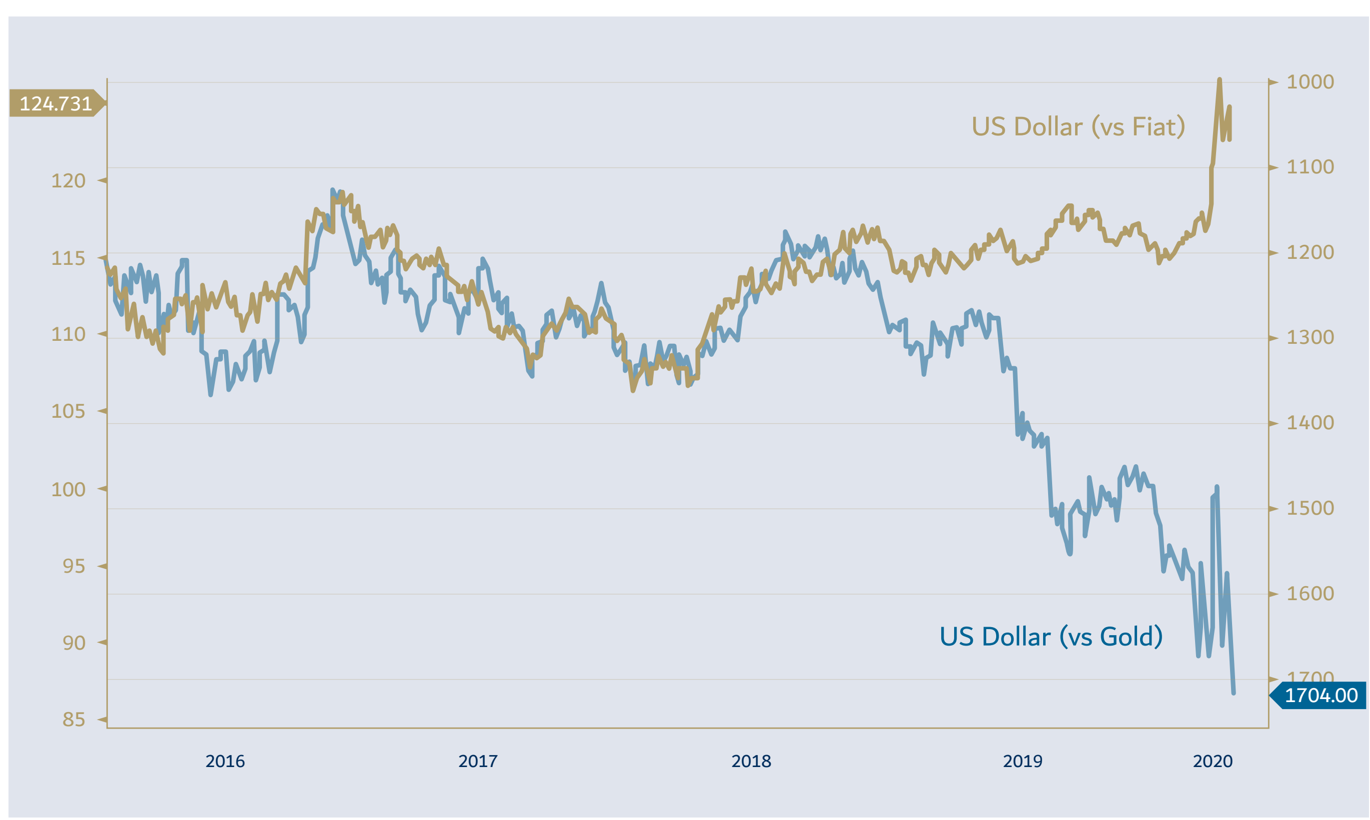
STORY 10: Gold is up 6 quarters in a row

Gold is the second-best performing asset class over the first quarter behind US Treasuries. It is now up 6 quarters in a row, up 42% since September 2018.

The yellow metal is seen by most investors as a “safe haven”. Historically, gold performed well during both deflationary and an hyper-inflationery environment. However, Gold exhibited unusual volatility during the month of March, recording a -14% drawdown between the 8th and the 16th of March. As explained in story 7 (“the dollar shortage”), investors faced some margin calls and any liquid asset (e.g Gold ETF) was considered as a valuable source of cash.

In light of the dollar appreciating against almost all (fiat) currencies, it is worth keeping in mind that the dollar continues to depreciate against Gold (“hard asset”). The massive money-printing by central banks could reinforce the attractiveness of Gold as a hedge against the de-basement of fiat currencies (including the dollar).

While the dollar continues to firm against other FIAT currencies (dollar shortage crisis), the greenback just hit a new low against GOLD (debasement risk). *Source: www.zerohedge.com, Bloomberg*



Investment Strategy: The Day After

At the time of our writing, the stock market has risen more than 25% over three weeks, highlighting the importance of staying invested, even as market conditions feel unsettling. This was the key message conveyed in our March edition of Perspectives which was published a few days before the March bottom.

In this section, we attempt to assess both the exceptionally sharp sell-off as well as the more recent rally and present our key recommendations in terms of Strategic Asset Allocation (SAA).

As forewords, we would like to summarize the key arguments of the bull and the bears with regards to the equity outlook.

Reasons to be Pessimistic

01 17 million people have already filed for US unemployment insurance. The jobless rate in the US could reach 20% this year and is expected to jump on a worldwide basis;

02 According to the most pessimistic, US GDP growth is poised to fall by an unfathomable 34% in the second quarter of 2020 (Q/Q, annualized), with the steepest drop expected in April. European countries are also expected to face the sharpest contraction of their modern history;

03 Goldman Sachs believes that S&P 500 earnings could fall to $110/share in 2020 with 2Q20 EPS estimated to be down 123%. GS now forecasts a 25% decline in S&P 500 dividends;

04 Supply chains are intertwined in this world such that even the recovery in China is struggling to maintain purchasing in the most secularly advantaged sector;

05 The US High Yield credit market is poised to potentially absorb an additional $555bn in Investment Grade downgrades as a huge swath of BBB-rated companies are re-evaluated in the corona-crisis;

06 Following the recent market rebound, next 12-month market P/E for the S&P 500 is higher than when US equities prices peaked. As such, the market can not be seen as cheap. And it is way more expensive than the P/E usually observed at secular troughs;

07 The current bear market and recession are taking place at a time where the global macro-economy was struggling with secular headwinds such aging demographic, a heavily indebted economy, a decline in exports (trade war), sub-par economic growth rates, weak industrial sectors, declining productivity levels, over-valued assets, etc. The Covid-19 pandemic is seen my many as the needle that popped the "everything bubble" which means that we could have very well entered a long-lasting depression cycle;

08 The global lockdown and ensuing recession could have ripple effects on many segments, especially those with high levels of leverage (commercial real estate, credit cards, student loans, etc.);

09 While the lockdown could soon come to an-end, there could be new waves of the pandemic. Moreover, "normal-life" is unlikely to resume any time soon as social-distancing, travel bans, isolationism and cautious business and consumer sentiment are likely to be in play for some time;

10 While developed countries are bailing out their domestic economies, who will be the buyer of last resort for the rest of the world (e.g commodity-exporting emerging markets with low forex reserves and high dollar-denominated debt)?

Reasons to be Optimistic

01 Monetary stimulus has been swift, targeted, and appears to be almost unlimited. Liquidity is a key market driver and such levels of central bank balance sheet expansion is unprecedented. In the short-term, the Fed is massively increasing the liquidity of banks (excess reserves) through the various "QE" facilities to stave off a second "financial crisis." Given the banks do NOT want to loan out any funds not guaranteed by the Federal Reserve, the excess liquidity flows into asset markets. Don't fight the Fed! Its balance sheet is infinitely bigger than yours.;

02 As the Fed's new mandate now allows the purchase of both corporate investment grade and junk bonds, they are basically suppressing the risk. We can thus expect a virtuous circle where tightening credit spreads trigger another wave of "risk-on" positioning;

03 While GDP growth and earnings growth are expected to collapse in the first half of this year, most of the negative news seem to be priced in. Investors are likely to look beyond 2020 and focus instead on the strong recovery in 2021. Price often leads earnings, especially at major inflection points. During both the GFC and the dot-com bear market (2000–2002), prices and valuations bottomed many weeks before earnings did;

04 Only a few weeks into the crisis we have already had an unprecedented, coordinated fiscal/monetary response (for a peacetime economy). During the financial crisis it took months for policy makers to do what has taken only a few weeks this time around. As of now, an unprecedented amount of Fiscal stimulus is now in place to support individuals who are losing their jobs, incentivize companies to keep people employed, and provide a financial backstop to corporates. This is in place in most developed countries and in some emerging markets (e.g China, GCCs, etc.). Unlike a "normal" recession, the strong level of support will allow companies and individuals to resume normal activity and spending once the lockdown is over;

05 There is a large amount of cash on the sidelines. Hedge funds have dramatically reduced their gross exposure while large US Pension funds have kept their re-allocation to equities on hold;

06 While investor sentiment has reached oversold extremes, corporate insiders seem to be taking the other side, as they often do at extremes. The ratio of insider sales to buys has now reached the levels seen at most major bottoms.

07 In China, activity has already begun a nascent recovery, providing a lens for US investors on how things may look once the impact of virus mitigation efforts begins to wane;

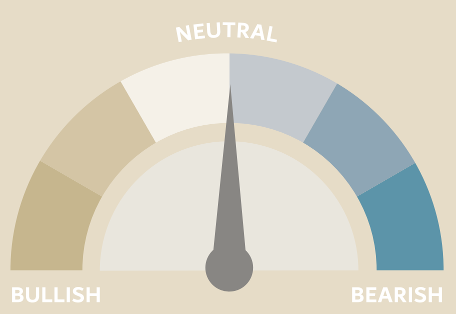
08 Pharmaceutical companies remain focused on developing vaccines and treatments for the virus;

09 The end of the Pandemic could trigger a "euphoria" move by consumers who have been forced to save money during the lockdown and who will thus be eager to spend once the crisis is over;

10 This is a Presidential year in the US. With Mr Sanders not running in the Democrat convention anymore, markets will start to price-in a pre-election rally.

On our side, the strategic view on risk assets (and equities in particular) is guided by the changes and developments in what we call the weight of the evidence. On the following pages, we present the key takeaways from both fundamental indicators (macro-economy, monetary cycle, earnings growth, valuation) and market indicators (sentiment, market cycle, technicals).

Global Equities Outlook: The Weight of the Evidence is Neutral.



Macro Economic Cycle (Bearish)

Economic Fundamentals are bearish. We have moved from the prospects of improving global growth at the start of the year to a discussion of a rapidly evolving recession (and even depression in a worst-case scenario). For example, in the span of two weeks, US initial jobless claims moved from near 50-year lows (near 200,000) to their highest level on record (almost 17 million in 3 weeks).

The silver lining in this period is the pro-activity of policy makers in terms both fiscal and monetary stimulus, as mentioned in the "10 stories to remember" section.

Still, at this stage, it is very difficult to estimate what will be the short-term and long-term impact of the global lockdown the economy is currently facing.

In a perfect world, once the economy starts to open back up, a "V" recovery would take hold. That may be wishful thinking other than for certain high-demand areas of the economy. For now, we are experiencing an "I" (straight down). Looking ahead, we may see a number of different letters; including "L" (think cruising perhaps), "W" (especially if we suffer COVID-19 setbacks/re-eruptions) or "M" (the dreaded upside-down "W"). But one letter may be the best one to illustrate the broad economy: "Y."

A "Y" may be apt because there were already fault lines seen in the economy before the COVID-19-related economic implosion. More than one-third of Russell 2000 small-cap companies had negative pre-tax income. Manufacturing was already suffering recession-type weakness last year courtesy of the trade war and tariffs; and had only stabilized before the virus hit. Once the economy begins to open back up, we could experience a short-term surge in growth (especially in relative terms); but that's unlikely to be sustained (hence the "Y" shape).

On the positive, US households are in a better shape compared to the GFC-era. Indeed, household debt as a share of disposable personal income (first chart below) has declined significantly since the debt bubble peak; and now sits below even the pre-housing bubble trendline. Furthermore, households' debt service ratio is historically low, thanks mainly to lower debt levels, but also record-low interest rates. Still, US consumers are likely to suffer from one of the greatest hits to disposable personal income in history. Yes, the CARES Relief Act will help cushion the blow but it is still estimated that more than half of US small businesses cannot survive a three-month shutdown and that more than half the American households have no emergency savings. It is also likely that the Covid-19 episode is likely to bias consumers toward savings over consumption—another reason to be skeptical of a full-blown V-shaped recovery.

A month ago, our view was for the Global economy to (barely) avoid a recession in 2020. Given the breath and duration of the lockdown on a global scale, we now believe the global economy will not escape a recession this year as global growth is likely to hover between -0.5% and -1.0% this year. We expect US real GDP growth to be around -2% followed by a shallow recovery of around 1% 2021.

Euro area authorities have reacted quickly to covid-19, although stimulus remains disunited and unevenly distributed. We expect a gradual recovery in H2 but believe that real GDP growth to be between -2% and -3% this year with considerable risks to the downside.

The coronavirus damage to the Chinese economy is proving greater than expected. Still, they should be able to grow this year between 1% and 2% and then rebound strongly (>10%) next year. Japanese growth on the other hand, is likely to be

Recession Recovery Shapes

negative this year (between -1% and -1.5%).

Emerging Markets ex-China remain a big question mark. A persistent oil glut will continue to put downward pressure on the Brent oil price, before it drifts back to its equilibrium price of around USD30-35 at year's end. We thus expect oil and other commodity exporters to remain under pressure. We also note that emerging markets currencies have been under considerable pressure in March as the dollar shortage crisis put considerable strain on many emerging markets. We expect a lot of economic performance within this heterogenous universe.

For sure, expectations for the global economy are being ratcheted lower, and that provides some opportunity for data to continue to exceed expectations. Still, we expect incoming economic data in the next few months to be as volatile as stocks have been over the past few weeks.

Monetary Policy (Bullish)

Federal Reserve Policy is bullish. As already discussed in the first section, in the face of economic weakness and credit market strains, the Fed has stepped up in its role as lender of last resort. It has cut rates to zero and re-established a number of lending and liquidity programs last seen in 2008. This reaction by the Fed reflects a simple truth about liquidity – when it flees in the face of trouble it is hard to re-capture.

On one hand, central bankers' proactive efforts should be praised as history shows that recessions become depressions when central banks fail to provide liquidity. Given the magnitude of the Fed intervention (QE infinity), that seems unlikely to be an issue in the current case. Stable bond spreads and the drop of the MOVE index (bond volatility) seem to vindicate the Fed's bold move.

And the Fed is unlikely to stop its efforts as the Fed's balance sheet could potentially grow to $10 trillion. Indeed, it has already grown from $4 trillion to $5.8 trillion in a matter of months, and the Treasury will be issuing trillions in new debt likely to be absorbed by the Fed.

During WWII, the Fed increased its balance sheet 10-fold as the central bank monetized war debt and engaged in quantitative easing (QE) to enforce its price caps (around 2.5%). Given that we are now looking at wartime level deficits and furthermore a Fed that will likely be monetizing those deficits, the parallel is not far-fetched. Modern Monetary Theory (MMT) is here. This is raising some eyebrows as many economists believe that the Fed is progressively nationalizing financial markets hence bringing an end to free capital markets.

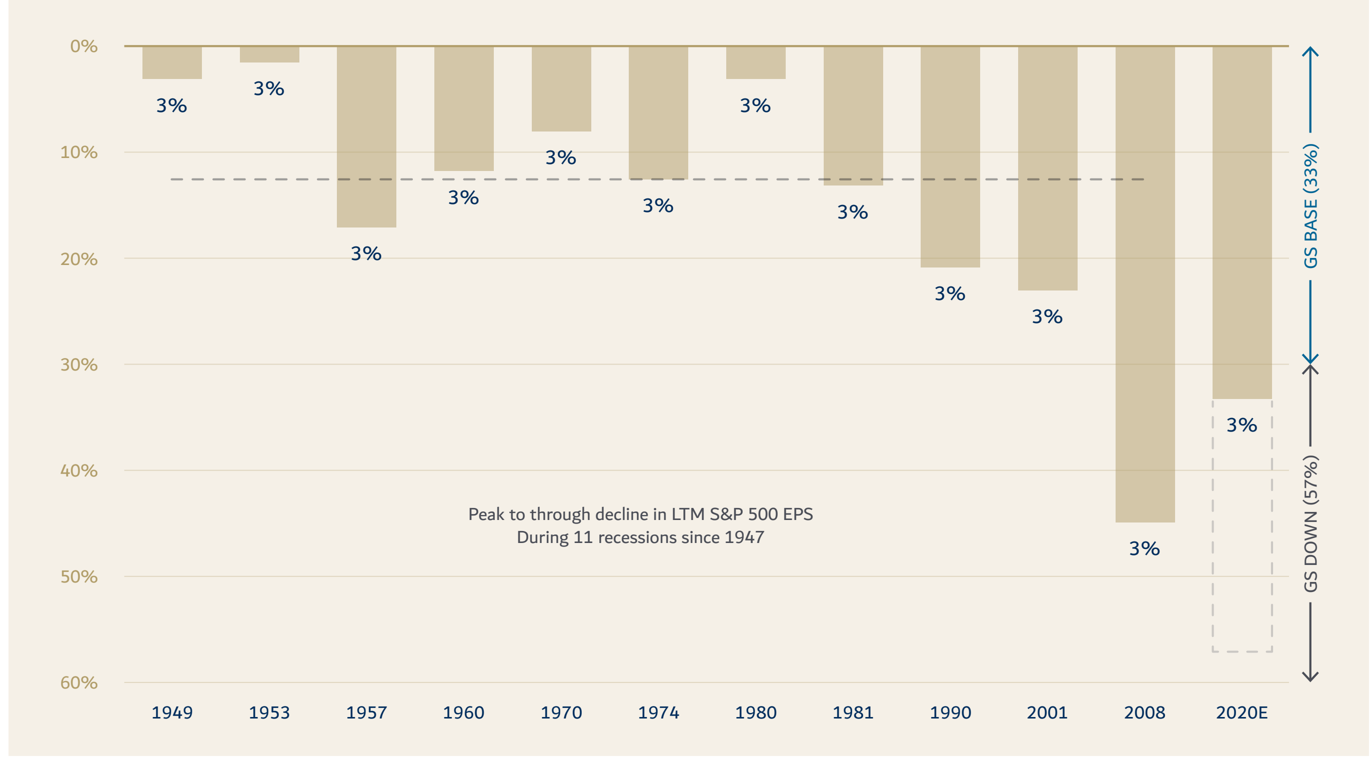
The "Fed Put" played a key role in avoiding financial contagion and a full-blown liquidity crunch last month. Going forward, it will be of utmost importance for the Fed and other G4 central banks to preserve their credibility. Our "bullish" stance on monetary policy could therefore become a "bearish" one at some point.

Earnings Growth (Bearish)

As is the case for global economic growth, estimating the impact of Covid-19 on 2020 earnings is an equation almost impossible to solve. As we are entering earnings season, it will be interesting to hear what companies have to say, although we expect them to offer very little guidance about the upcoming quarters. In the US, the earnings estimates have been marked down a lot already (with the Q2 growth estimate now at −16% and the 2020 estimate down to −6%). However, the S&P 500 dividend futures contract (next 12 months) is pricing in a hit from $62/share to $40/share which means that the hit to earnings might be much higher than what the consensus is pricing in so far. Similarly, Goldman Sachs expects (in its base case scenario) S&P 500 EPS to fall 33% (see chart below). Their worst-case scenario anticipates a -57% yoy decline in earnings, a decline which would be far more pronounced than in 2008.

We thus expect a "rocky" earnings season not only in the US but also in Europe and the rest of the world – hence our "bearish" stance on earnings. To grow more constructive on this in the near term we would like to see stability emerge in earnings estimates. We want to see this downward revision cycle run its course before leaning too heavily on earnings estimates.

Goldman Sachs expects EPS to fall 33% in the United States (base case scenario). *Source: Goldman Sachs*

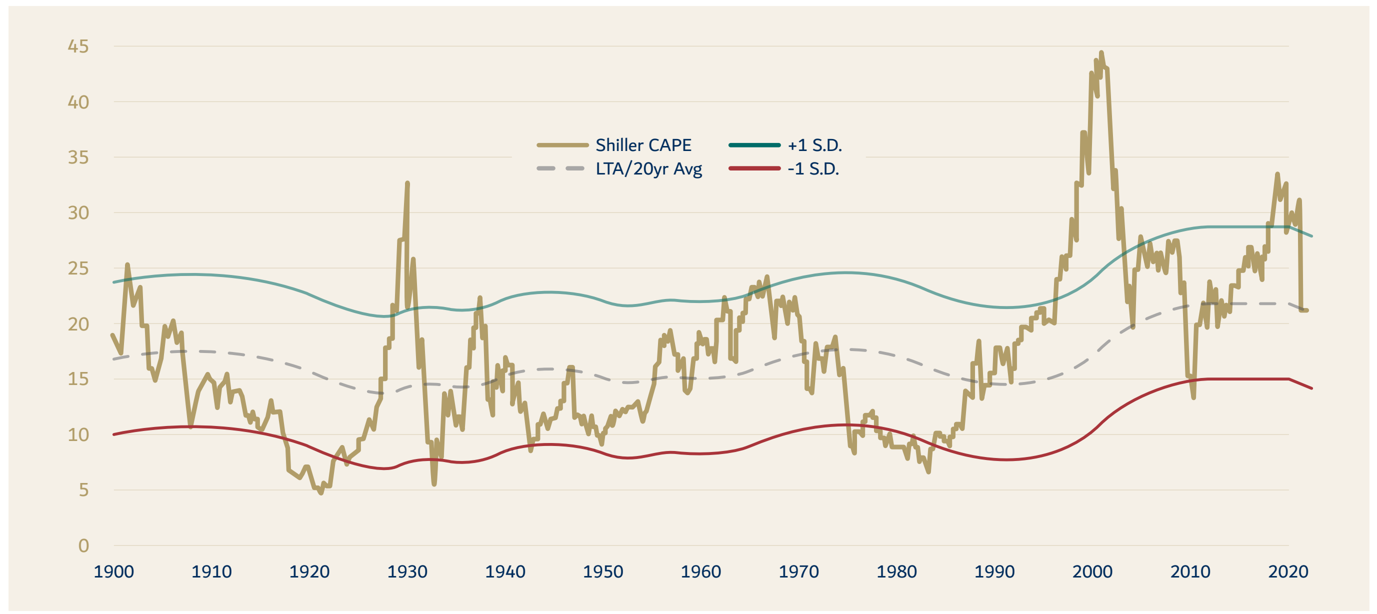


We would like to see stability emerge in earnings estimates. We want to see this downward revision cycle run its course before leaning too heavily on earnings estimates.

Valuations (Bullish)

Looking at US equities, Price/earnings ratios that look at trailing earnings have dropped and are approaching their long-term averages. However, 12-month forward P/E for the S&P 500 is now more expensive than it was when equity prices peaked. The same apply to Eurozone stocks which do not look cheap on an absolute basis as they trade at a much higher level than 2008/2009. It is also important to keep in mind that estimates are untrustworthy at this point, given the very high level of uncertainty surrounding this crisis.

Shiller S&P 500 back to long-term average. *Source: Topdown charts*



From a cross-asset pint of view, relative valuations are supportive for stocks (see chart below) as the equity risk premium for the S&P 500 has been that attractive only at two previous occasions: in the mid-70s and at the trough of the Global Financial crisis.

Overall, valuation levels are bullish for equities.

Equity risk premium 1960-2020. *Source: SunTrust Private Wealth*

Investors Sentiment (Neutral)

We view Investor Sentiment as neutral. Following the waterfall decline in the S&P 500 off its February 19 high (a 34% decline over the course of 23 trading sessions), Investors Intelligence data shows more bears than bulls for the first time since early 2019. The bull-bear spread is its most negative since 2016 and bears are at their highest level since 2011.

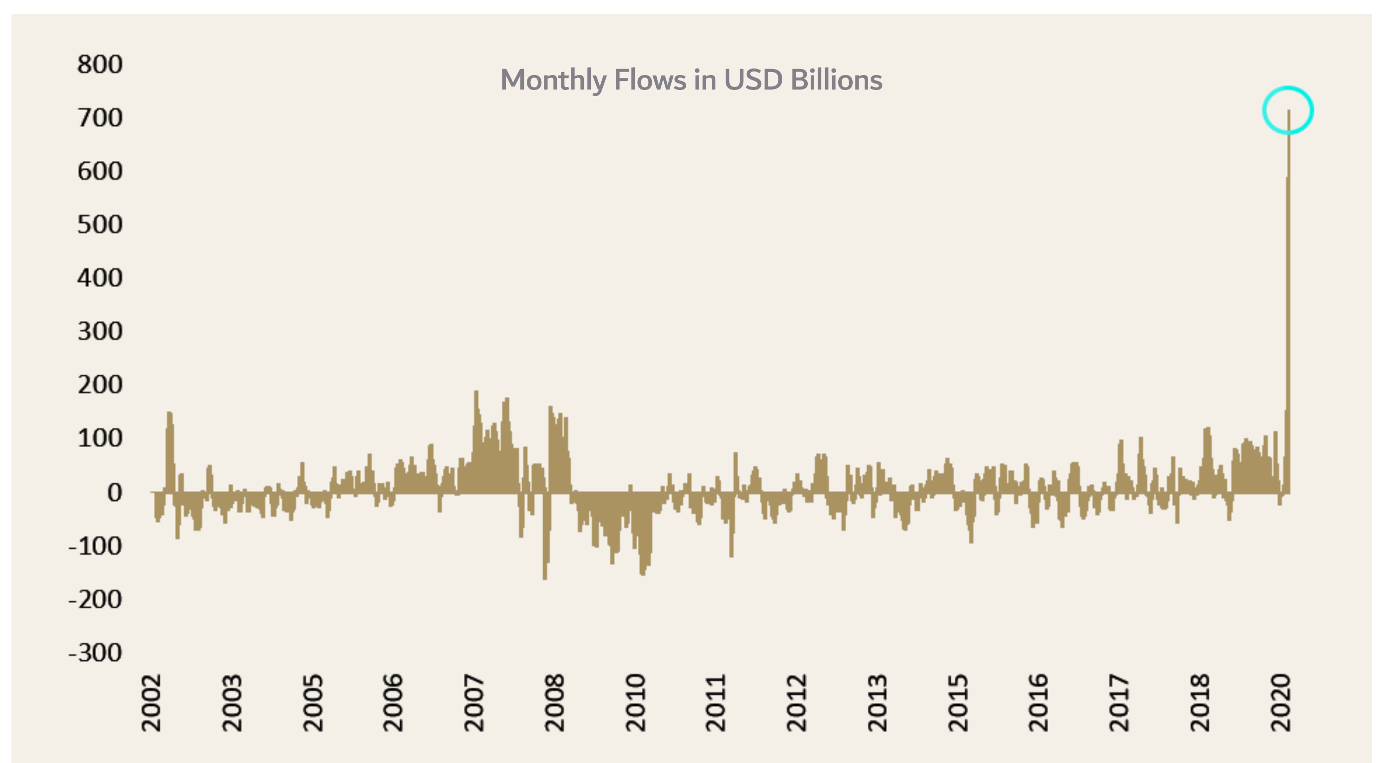
From a fund flow perspective, the picture is roughly the same with equity funds seeing $60 billion of outflows over the past four weeks (only December 2018 saw more outflows). Total assets in money market funds shot up to a record $4.4 trillion – there is thus a lot of dry powder on the sidelines, ready to be re-invested when sentiment improves.

However, we note that retail investors didn't panic in the same way they did during past crisis. For instance, a recent US survey of 401k investors show that 73% of them have no plan to sell their investments or to cash out. Similarly, online brokers are facing a record number of new account openings as many retail investors want to grab the opportunities created by the "Corona-crash".

From a contrarian perspective, the signals are thus mixed. Some surveys have reached extreme levels while others do not show the same capitulation observed at previous troughs.

Online brokers are facing a record number of new account openings as many retail investors want to grab the opportunities created by the "Corona-crash".

Market mutual funds just shot up to a $4.4 trillion record. *Source: ICI, Bloomberg*



Seasonality and Other Market Cycles (Bullish)

Seasonal Patterns and other market cycles remain bullish. Recent events have been boosting Donald Approval rating to 49% (the highest of his Presidency so far). If history repeats itself, election year patterns tend to be bullish when incumbents get re-elected.

While seasonality is likely to become a headwind in late April, the combination of the 1-year, 4-year and 10-year cycle seems (Cycle composite) seems to indicate that stocks should do well after a volatile 1st half (!).

Cycle composite for the S&P 500 in 2020. *Source: S&P Dow Jones Indices*

When it comes to the S&P 500 pattern following a market crash, the evidence is mixed. Indeed, the S&P 500 has closely followed the charts during the crash of 1987, as well as the crashing phase of the Global Financial Crisis (GFC) in 2008. In both instances, from their respective trading lows on October 20, 1987, and October 10, 2008, the S&P 500 gained 20% in short order and then failed. From that point on, however, there was a big fork in the road and the 2 analogs diverged.

Following the crash in 1987, the bull market resumed 2 months later.

In 1987, the market successfully retested the lows on December 4, and gradually regained the losses in the following months and quarters. It took almost 2 years to make new price highs, in August of 1989, in what was a slow but consistent resumption of the secular bull market of 1982–2000.

Following 2008, the bull market resumed in 2013.

In 2008, on the other hand, the market was far from done in terms of the decline. After gaining 20% to 1,008, the S&P 500 fell another 27% to a new low of 741 on November 21, only to rally another 27% to 944. Following that rally the index fell another 29% to its final low of 667 in March 2009. It wasn't until 2013 when the index finally hit a new high. That was the secular bear market of 2000–2013.

At this stage, both patterns are possible. We would thus not "bet" on one scenario over the other.

Technicals (Bearish)

Breadth is bearish. The crash from February highs has been accompanied by extreme levels of volatility, intense selling pressure and rapid deterioration beneath the surface. While the initial downside pressure may be yielding to a period of rallies and re-tests, an important and healthy development would be a decline in volatility and the wide price swings that come with it.

The underperformance of small & mid-caps vs. large-caps as well as the underperformance of cyclical vs. defensive is not a positive signal either.

Over the past four weeks, the S&P 500 has experienced both two of the top 10 single-day gains and two of the top 10 single-day losses since 1950. In addition to seeing volatility ebb, we are looking for evidence of improving trends beneath the surface. For instance, we would expect to see renewed cyclical leadership and other evidence that longer-term trends are improving.

Bottom line: The weight of evidence was bullish throughout 2019 and has been deteriorating, recently being downgraded to a NEUTRAL stance on risk assets (see summary below).

Indicators Review Summary (Neutral)

Fundamental Factors (Leading Indicators)	Market Factors (Coincident Indicators)
MACRO ECONOMIC CYCLE: **BEARISH (-1)**	INVESTORS SENTIMENT: **NEUTRAL (=)**
MONETARY POLICY: **BULLISH (+1)**	SEASONALITY & OTHER MARKET CYCLES: **BULLISH (+1)**
EARNINGS GROWTH: **BEARISH (-1)**	TECHNICALS (Trend, Breadth, Credit Spreads, Etc.): **BEARISH (-1)**
VALUATIONS: **BULLISH (+1)**	

The current bear market has entered a period of brutal rallies followed by frustrating re-tests that can challenge investor patience. We expect volatility to remain elevated in developed equity markets, and therefore, absent a more bullish message from the weight of the evidence, we would generally discourage chasing rallies.

Rather than thinking about putting new money to work at this juncture, investors should consider using the rally to reposition away from cyclical laggards and towards structural growth leaders within sectors such as healthcare, the internet and public infrastructure. Technology stocks, especially big internet stocks, are now trading at low valuations despite a relatively resilient earnings outlook. Managed care and pharma companies have also been holding up well.

Generally speaking, we favor cash-rich "quality growth" companies able to navigate the looming global recession.

This may also be a time for a renewed focus on global diversification and leaning toward those areas that are showing relative strength. While we believe that US equities (especially large caps) might be more resilient than most other geographies, some countries have been improving in terms of relative strength. This is especially the case for North Asia (and Chinese equities in particular), a region where the virus seems to have been brought under control.

We would however be very selective within Emerging Markets ex-China as many countries are looking particularly exposed to the fallout from covid-19 and the collapse of energy and industrial commodity prices.

Within fixed income, The Fed's massive intervention could help contain any strong rise in US Treasury yields (it may even be tempted by a form of yield curve control). ECB measures should help curb spreads on peripheral debt but eurozone dislocation risk is likely to come back with a vengeance once the Pandemic is over.

We remain cautious on credit overall, remaining tightly focused on high-quality paper on the short end. While central banks are supporting investment-grade bonds (and some junk bonds), we expect to see a wave of fallen angels in the months ahead.

The combination of equity market weakness and credit market stress is putting a new emphasis on portfolio liquidity and appropriate levels of cash. We thus recommend an overweight stance on liquidities and gold.

On the currency side, the rush for US dollars provoked by market turmoil and the dollar shortage crisis seemed to have been calmed by central bank action. We believe the US dollar's recent surge is unsustainable, especially as the growth and rate differentials previously driving dollar strength have deteriorated. Although we could see further short-term spikes, we have a medium-term negative view of the greenback. We are now overweight the euro, Swiss franc and yen against the US dollar. A near-term resurgence of Brexit uncertainties and further signs of economic weakness could lead to renewed pressure on sterling. The second half could see support for sterling grow, as long as Brexit-related issues are resolved.

Within Alternatives, we believe that the current market context will benefit various hedge fund strategies as short-duration arbitrage and active management opportunities are plentiful. An upturn in defaults will provide opportunities in the credit space.

Asset Allocation Matrix

	Asset Class View	Bullish	Neutral	Bearish
Equities	Neutral	China U.S Large Caps ▲	U.S Small and Mid Caps ▼ U.K	Emerging Markets ex-China ▼ Europe ▼ Japan ▼
Fixed Income	Neutral	Trade Finance U.S Investment Grade Corporates ▲	U.S High Yield ▼ Emerging Markets Debt ▼ (in $) Sovereigns ▲	Emerging Markets Debt ▼ (in local currencies)
Real Estate/ Illiquids	Neutral	Gold Private Equity ▲ Hedge Funds ▲	Agriculture Real Estate ▼	Industrial Metals ▼ Energy ▼
Cash	Overweight	Euro ▲ Yen ▲ Swiss Franc ▲	U.S $ ▼ British Pound	Emerging Local Currencies ▼

Middle East Equities: The 1st Quarter in the Rearview

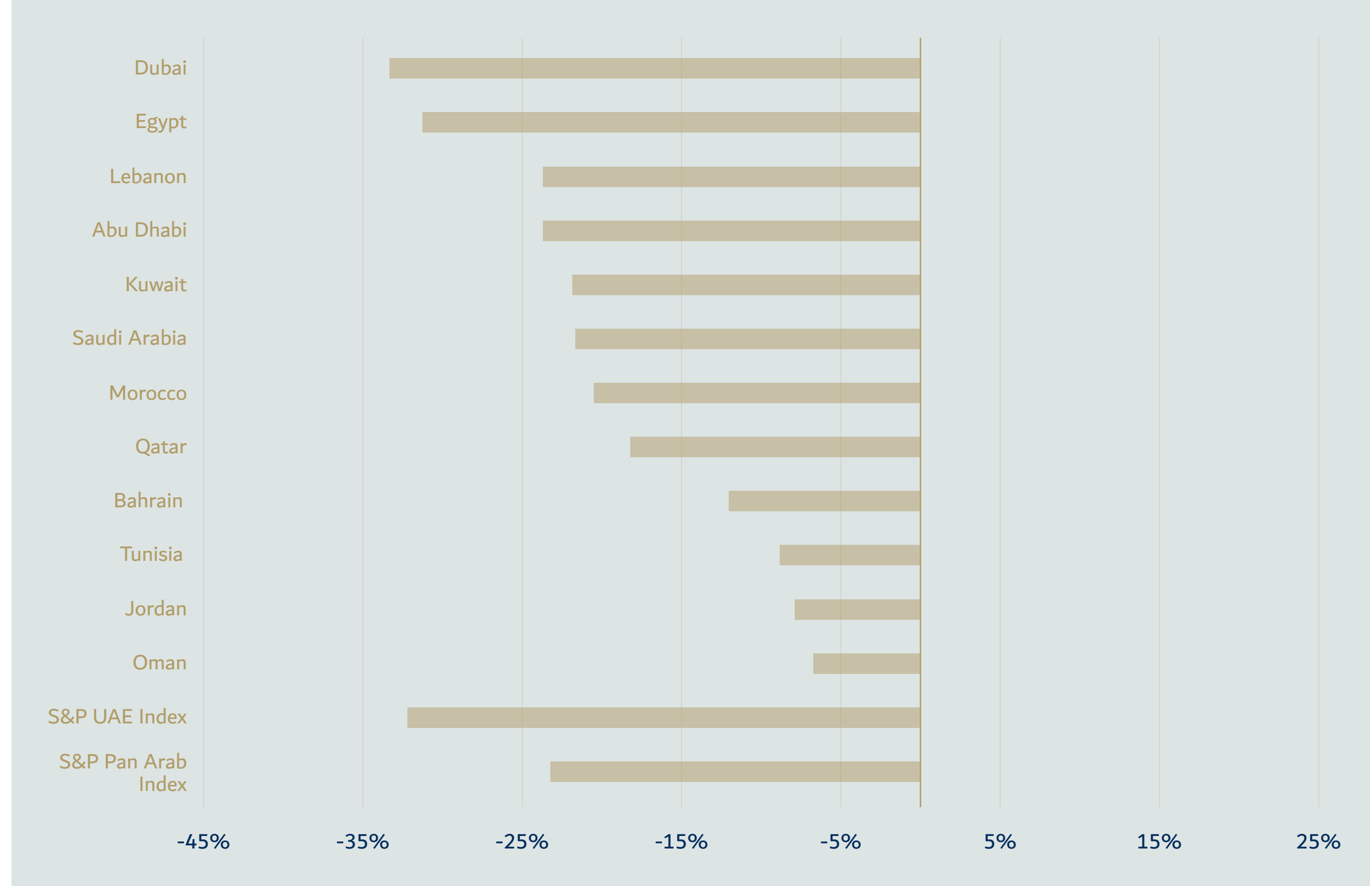
Markets Performance

Middle East equity markets have been particularly hit by a perfect storm of tumbling Oil prices and the major adverse economic impact from the outbreak of COVID-19.

The S&P Pan Arab Index lost 23% over the quarter with high beta markets such as Dubai and Egypt tumbling while the smaller (and relatively less liquid) markets held up better.

The bulk of the decline was in March although markets stared to stabilize towards the end of the month.

First quarter MENA equity markets performance



The bulk of the decline was in March although markets started to stabilize towards the end of the month.

COVID-19 – surging cases lead to lockdowns

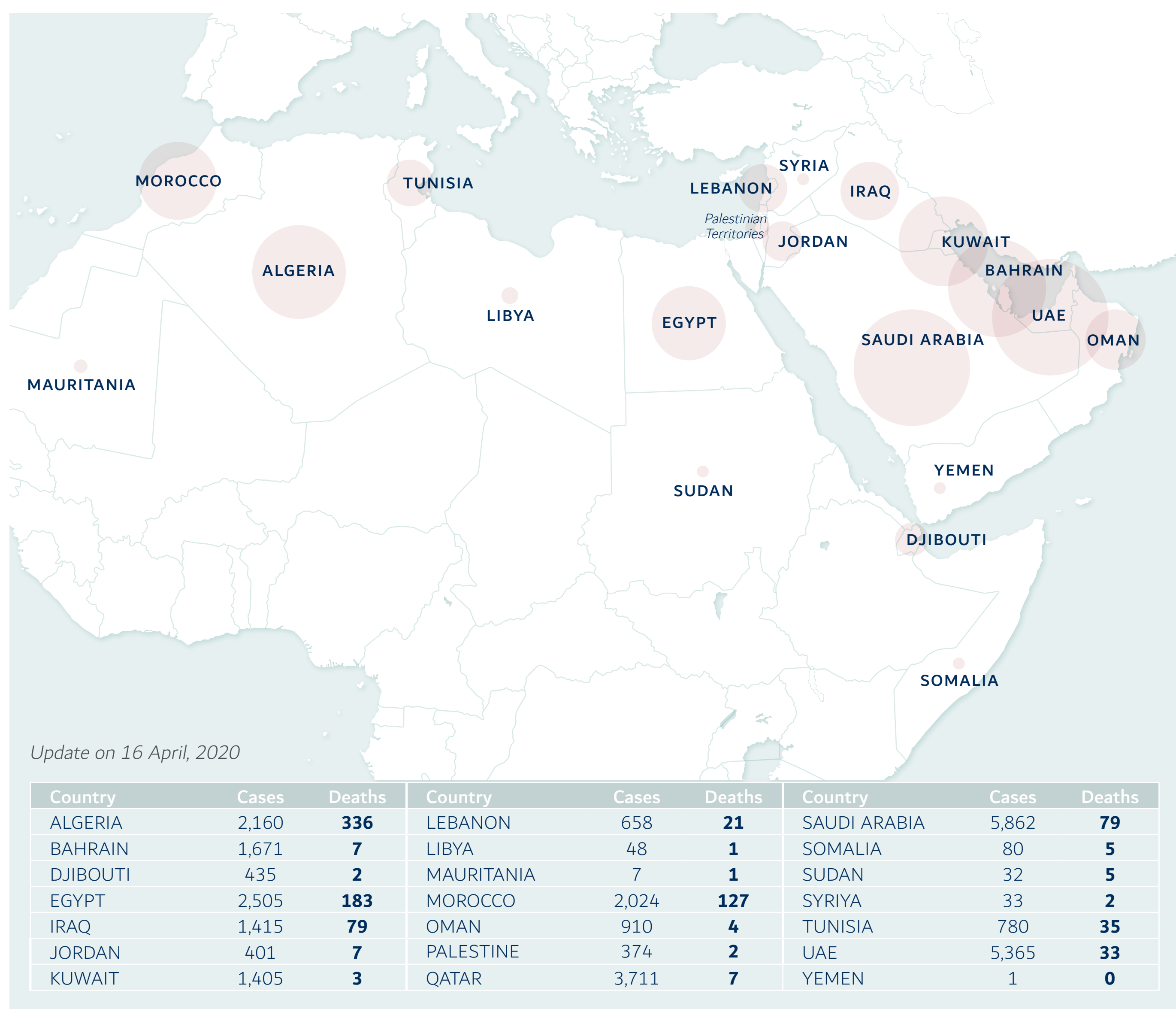
Governments around the globe are grappling with how to stop the spread of the virus by implementing border closures, travel restrictions and lockdowns.

Countries in the Gulf have taken unprecedented moves. Every country began with their own varying levels of travel restrictions, from wholesale halting of all commercial flights in Kuwait, to Saudi Arabia banning travel to 39 countries – by the end of the month all travel came to a complete halt. Most have imposed curfews ranging from 10 to 15 hours of the day.

In Saudi Arabia, lockdowns were imposed in Riyadh, Makkah and Medinah, and residents were banned from leaving and circulating between the Kingdom's 13 regions, until the end of the 21-day curfew between 3pm and 6am. The Kingdom has suspended Umrah pilgrimages, stopped prayers at mosques, shut all but essential jobs and closed off the eastern province of Qatif.

Kuwait declared the period of March 12-26 an official holiday. All governmental entities and ministries will cease operations. Iran, the worst hit, has asked for an emergency $5 billion loan from the International Monetary Fund to combat the outbreak. Qatar reported a massive jump in cases in the middle of the month. In Bahrain confirmed cases rose by nearly 70% after new cases were confirmed on a returning flight of Bahrainis from Iran. The UAE has suspended entry for many, moved many to work from home and implemented widespread monitoring of cases.

COVID-19 Outbreaks in Arab Countries. *Source: Nature Middle East*

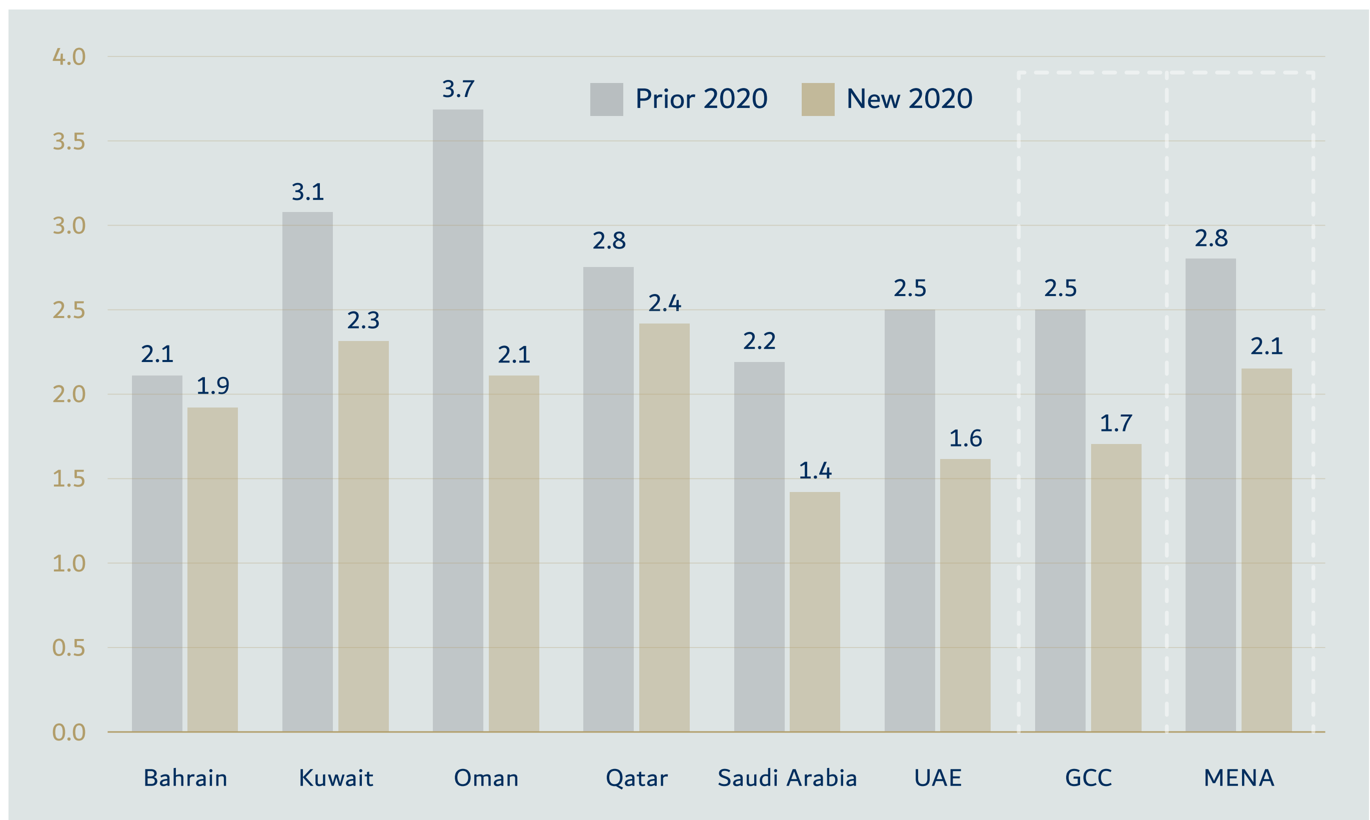


Country	Cases	Deaths	Country	Cases	Deaths	Country	Cases	Deaths
ALGERIA	2,160	**336**	LEBANON	658	**21**	SAUDI ARABIA	5,862	**79**
BAHRAIN	1,671	**7**	LIBYA	48	**1**	SOMALIA	80	**5**
DJIBOUTI	435	**2**	MAURITANIA	7	**1**	SUDAN	32	**5**
EGYPT	2,505	**183**	MOROCCO	2,024	**127**	SYRIYA	33	**2**
IRAQ	1,415	**79**	OMAN	910	**4**	TUNISIA	780	**35**
JORDAN	401	**7**	PALESTINE	374	**2**	UAE	5,365	**33**
KUWAIT	1,405	**3**	QATAR	3,711	**7**	YEMEN	1	**0**

Economic Impact

The economic impact of coronavirus on GCC economies and wider Middle East and North Africa (Mena) could be much bigger than originally anticipated, according to economists. MUFG Bank estimates point to MENA regional real GDP growth of 2.1% in 2020 from 2.8% previously and for the GCC region, real GDP to register 1.7% this year from 2.5% previously. We believe there is strong downside risks to these estimates.

GCC and MENA regional real GDP growth in 2020 (%). *Source: MUFG MENA Research*



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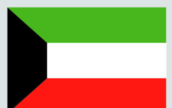
The economic impact of coronavirus on GCC economies and wider MENA could be much bigger than originally anticipated

Dubai has announced an economic incentive package for its free zones, consisting of five parts - including postponing rent payments for six months and cancellation of some fines for companies and individuals.

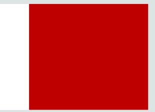
Stimulus Measures

Authorities in the region announced a series of stimulus measures as economies came to a grinding halt. To prevent companies from laying off their staff, Saudi Arabia's King announced the government will cover a portion of private sector salaries in the industries most impacted. The economic stimulus valued at over 9 billion riyals will pay 60% of those salaries for the next three months.



Kuwait has approved a package aimed at maintaining private- and public-sector jobs and stabilizing prices for food and medical supplies.

The government will put in place a mechanism to secure minimum income for contract workers affected by the crisis and will help owners of small and medium-sized businesses by postponing payments funded by the National Fund.



Dubai has announced an economic incentive package for its free zones, consisting of five parts - including postponing rent payments for six months and cancellation of some fines for companies and individuals.

Other Developments

A raft of macro news flow from the Kingdom, which has not got its due attention.

Aramco has announced the development of the Jafurah – the largest non-associated gas field in the country with volume of gas resources estimated at 200 trillion cubic feet.

The company will invest USD 110bn to develop this field with a length of 170km and a width of 100km. Saudi Aramco has also begun early preparations for an International listing. Though we think it is unlikely anytime soon, given market conditions and a weak outlook for commodity prices. Then, we have Saudi Entertainment Ventures Company (SEVEN), a PIF subsidiary announcing plans to build 20 entertainment destinations, 50 cinemas and 2 large theme parks across the country. Finally, KSA will hold its biggest sporting event next month, with 6,000 athletes expected to participate. The 'Saudi Games' to be held in Riyadh in the last week of March will feature 40 sports, including swimming, athletics, archery, badminton and basketball, that will be open to men and women.

The crisis in Lebanon further deepened with the parliament deciding that debt restructuring was the best solution for the looming Eurobond maturities.

A team of IMF experts met the Prime Minister to advise on tackling the economic crisis, which spiraled last year as capital flows into the country slowed and protests erupted against the ruling elite over decades of corruption and bad governance.

The Expo 2020 organizers are in discussions for a possible opening delay of up to a year due to the global coronavirus pandemic.

Organizers haven't ruled out the scheduled late-October start and any final decision would have to be made by member states of the Paris-based Bureau International des Expositions (BIE), which awards the event.

MENA Equity Outlook: Q2 2020 and beyond

Looking at the region from a macro-economic perspective, one of the first consequence of declining oil revenues and the economic effects of Covid-19 will be deteriorating fiscal situation across the GCCs.

Budget deficit in Oman is expected to widen to -11.0% of GDP, Bahrain to -9.1%, UAE -4.3% and -9.2% in the Kingdom of Saudi Arabia. But these are optimistic figures as they are based on an average Brent Oil price at USD 52.7/bbl in FY 20e. Moreover, the demand destruction from the coronavirus is likely to be shouldered largely by the GCC as Russia appears unwilling or unable to further reduce its supply, which could further pressure oil revenues for the GCC and real GDP growth. There is always a possibility that a deal gets signed, but such a deal would require a minimum of 10mn barrels/day to be removed from the market. Even 10mn barrels a day might not be enough as some oil analysts believe that the oil market could be up to 20mn barrels oversupplied.

We believe such a cut will be very hard to implement and different players in the market will break this agreement in fear of bankruptcy. Hence, we believe oil prices will remain at suppressed levels through out this year and budget deficits are thus likely to be worse than the aforementioned numbers.

We continue to favour Egypt as the country equity market has a large pool of interesting, undervalued and resilient ideas.

Going forward, we expect fiscal consolidation to pick up in Oman and Bahrain, but assume the gradual reduction in Saudi budget deficit to continue (3% pa, which is equal to 1% GDP headwind for the Kingdom), excluding any off-budget spending by PIF out of the capital raised from the Aramco IPO. We see further room for equity markets in the GCC to correct, given their c.30% historical correlation to oil prices.

Another consequence of Covid-19 is supply chain disruptions in the electronics/whitegoods (also affecting the logistics sector), though with potential support for e-commerce and food producers/grocery retailers. The Telecom sector is not the safe-haven that investors expect it to be as CAPEX could be increased, WiFi usages increases while handset sales are expected to drop. As for UAE operators, pressure from the business community to allow data calls is likely to dampen their high margin international calls segment. We note that they have already allowed a few apps to operate free of charge.

The GCC banking sector (mainly Saudi and to a lesser extent UAE) is likely to suffer from Net Interest Margin compression after recent rate cuts. Kuwaiti banks enjoy 25bps lower repo rates that were introduced this month, which is helpful for cost of funds. Tighter liquidity could reduce asset growth of the banks. Moreover, significant increases in NPLs is expected due to poor business environment. Central banks have asked local banks to be lenient with corporates; for instance, in Egypt, the Central bank has asked banks to waive 6 months of payments for corporates and similar requests have been made to banks in Kuwait and Saudi.

The impact on healthcare sector and insurance sector is less clear but is most likely not going to be a major headwind or tailwind. The outlook for the Petro-chemical sector further deteriorates on lower demand/spreads, as a market equilibrium is pushed out. EMAAR's EPS could drop by 30% in FY 20e as Emaar hospitality could turn into losses on lower occupancy (given high operating leverage) and Emaar entertainment could lose 50% of sales

Our allocation has become more defensive, reallocating to companies whose business model are less vulnerable and holding unusually high levels of cash to be able to allocate opportunistically. We continue to stress test a variety or companies in our universe in order to allocate to significantly undervalued good quality names.

From a country perspective, we continue to favor Egypt as the country equity market has a large pool of interesting, undervalued and resilient ideas. We can't say the same thing in Saudi as the same names would be trading at 3x the valuations in Egypt and we do not believe the currency and/or the liquidity risk warrants such a discount.

DP World, a core holding for us, is going private. The parent company, which currently holds 80%, is offering a 29% premium (to the then stock price) for the rest.

The strategy is to transform the company from a global port operator to an infrastructure led global supply chain solutions provider. The Board believes that DP World is well placed to take advantage of the investment opportunities arising in the marketplace, thanks to its global footprint, high exposure to Origin & Destination cargo, ownership of key port assets and strong relationships with cargo owners. However, after a period of assessment, the Board concluded that the disadvantages of the company maintaining a public listing outweigh the benefits and believes a delisting is required for it to execute its medium to long term strategy.

Overall, even though the takeout price (USD 16.75) is much below our fair value estimate, we are happy with the ~25% return generated in less than a week.

Our Kuwait exposure has been very selective, mainly in the education sector. While our favorite investment in this sector (Humansoft) may face short term pressure on revenues due to the halt in education, once discounted, the company continues to present significant upside potential.

Our sector exposure favors, healthcare, consumer staples and consumer discretion, while our biggest underweight is in Financials and Materials where we see a significant drop and demand and no pricing power.

As for the cash levels, we have managed to raise a good cash buffer early in the quarter, which along with our defensive allocation managed to shield the fund from a significant hit. We plan to selective allocate to companies that may or may not be affected by what is happening and which will come out even stronger post crisis. We are also allocating to companies where we feel management is proactive and engaged with a plan. The current downturn has allowed us to take positions in names we felt were previously too expensive.

Hot Topic: Are GCC pegs at risk?

Historically, the GCC has maintained a currency peg to one regime or the other. The current system is a product of the Sterling Area collapse in the 1960s. Countries that came under this era chose greater flexibility with their own currency regimes, with some exceptions including GCC nations which opted for a stronger anchor in the form of the USD. By 1986, all countries within the GCC pegged their currencies to the dollar barring Kuwait, that pegged theirs to an undisclosed basket of currencies.

By anchoring their currency to the USD, these nations had to give up their ability to fully control their monetary policy, and to a certain extent, their capital market openness. Because of lower control of their monetary policy while maintaining interest rate parity, nations with varying business cycles are therefore induced to volatile inflation and growth figures. Another price to pay for the peg is the need for GCC countries to maintain large reserves of the currency, a difficult objective to fulfill when oil prices get weaker.

Why GCC countries need a currency peg

As mentioned previously, GCC countries chose to peg their currencies in order for the region to be anchored to a strong and stable currency denomination, in the form of the USD. However, the below reasons add further rationale for the GCC peg.

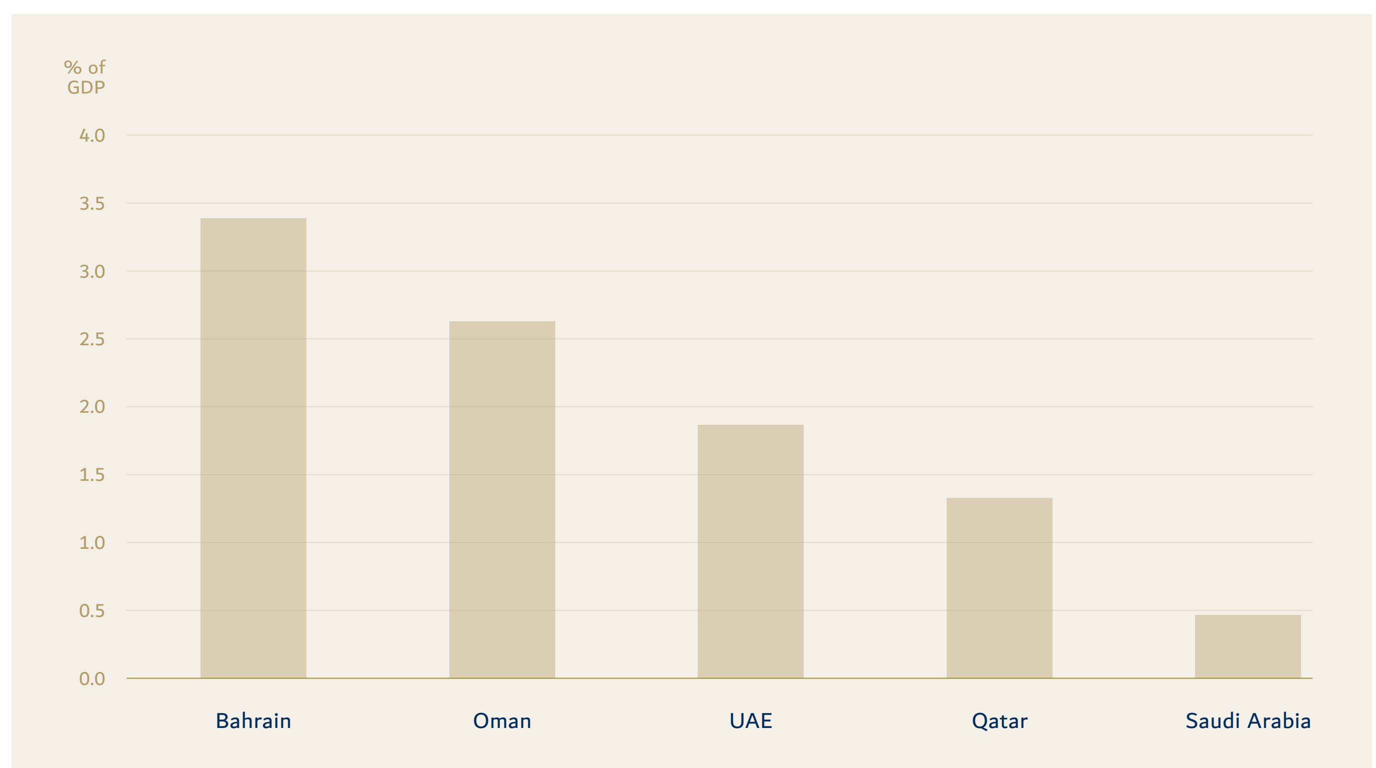
As a result of the GCC being large oil exporters, these states tend to have large current account surpluses, and a net positive international investment position thereby allowing them to withstand temporary deficits – at least this has been the case so far. Furthermore, the nationalized nature of business, also aides these states in many ways. As a result of assets being sovereign by extension, the liabilities firms owe, are also, sovereign by extension. Furthermore, governments and related entities have large positions in the deposits held within these nations thereby limiting the possibility of massive and insistent capital outflows. There exists also, a large supply of expatriate workers from Asia and thus, GCC labor markets avoid cost-push inflation as labor is relatively elastic in nature, curtailing at least part of the inflation problem monetary policy aims to cure. Domestic household too, whether made up of high mobility expatriate workers or a concentrated portion of naturalized citizens, have little sensitivity to real or nominal interest rates, compounded by underdeveloped and nascent financial and capital markets thus further minimizing the impact of monetary policy.

GCC countries chose to peg their currencies in order for the region to be anchored to a strong and stable currency denomination, in the form of the USD.

Risks to the GCC Peg

At this stage, there remains seemingly little risk to the GCC peg with nations reaffirming their stance. Saudi Arabia is looking to diversify their imports through Vision 2030 and the Central Bank of UAE is stressing the "continued and strong commitment to maintain the peg of the UAE dirham to the US dollar". As long as there is an overdependence on oil revenues, it is imperative for the peg to be maintained in order to ebb currency volatility as a result of oil price volatility. Not to mention, the peg aids to bring in capital inflows into the region. However, all of this comes at the cost of monetary policy limitations and other implications which are often overlooked. For instance, several GCC countries are looking at tourism as a source of diversifying the economy, and thus suffer from a strengthening USD as they lose, to some extent, their competitiveness within this space. Nonetheless, the countries facing the biggest risks of "de-pegging" are not UAE, Kuwait and Qatar as these three countries have relatively larger FX reserves. However, countries such as Oman, Bahrain and Saudi Arabia are seeing their fiscal positions deteriorating. Within these nations, government spending remains a large component of aggregate demand and have been notoriously less successful in their efforts to diversify revenue. The situation has been further complicated by the additional fiscal stimulus needed to combat the economic effects of COVID-19.

Estimates of monetary and fiscal support packages to counter impact COVID-19. *Source: IMF, ADCB estimates.*

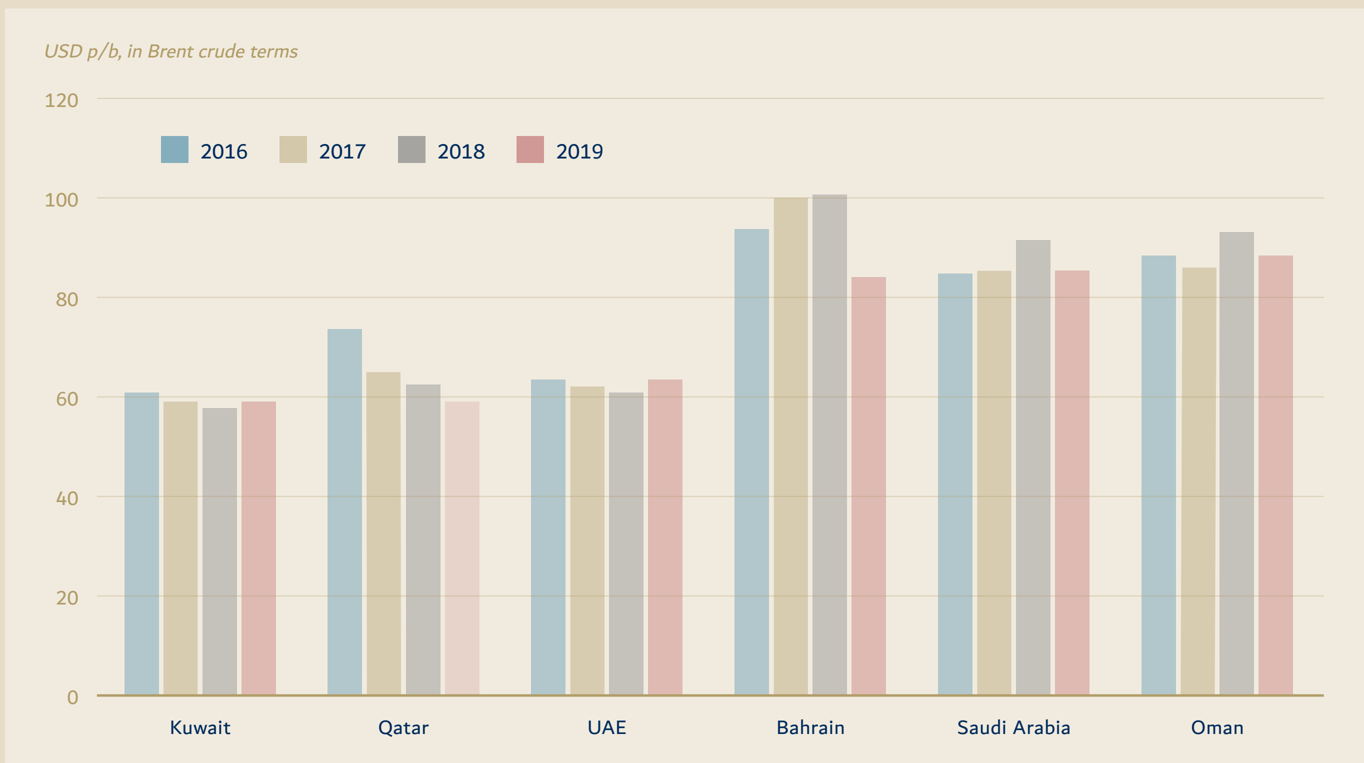


Fiscal stimulus is set to rise with lack of revenues from oil, combined with minimal fees, in order to boost trade and stagnant diversified sectors i.e tourism and real estate. There will be an imperative need to borrow large sums of money or drawdown on current reserves. With all of these complications, one can view the Break even point per barrel as the tipping point for oil prices, a level below which governments in the region will have to cut back their spending. GCC governments can increase their borrowings, but it is likely not the right environment especially as credit spreads widen (this will be especially the case for high debt nations such as Oman and Bahrain).

Notably, Oman did repay recently a 1.25 billion Eurobond and is likely to find aid from a recent GCC support package, perhaps more than any other nation receiving the same.

On the other hand, diversification efforts have come to a halt in Saudi, with oil prices dragging lower. The need for oil prices to rise has never been larger for Saudi as government debt is rising rapidly, compounded by weakening FDI into the nation. Saudi's tools to lower expenditures and reduce fiscal spending are limited, as their arsenal within this area comprises of mostly reductions in public sector wages and job cuts.

There has been some reduction in the BBE oil prices, although limited compared to the fall in oil.
Source: IMF, ADCB estimates.



Conclusion: A "Mexican peso" type of crisis looks unlikely for the GCC, at least in the near term. However, GCC governments need to ensure that they are in full control, at least to the best of their abilities, to maintain the peg. A de-peg, causing devaluation, would trigger ramping inflation, especially as most of the food within these regions are imported. Nonetheless, the peg does seem to be the optimal currency framework for the region as a devaluation is not likely to solve any of GCC nations' balance of payment challenges. These imbalances are likely to be better addressed through more pronounced, targeted, effective fiscal measures. There has never been a greater time, where these nations work together, to ensure not only that the peg is maintained, but also that fiscal and monetary measures are coordinated in order to prop up the lagging and weaker economies, and thus decrease the risk de-pegging.

Global equity markets have entered a period of brutal rallies followed by frustrating re-tests that can challenge investor patience. We expect volatility to remain elevated, and therefore, absent a more bullish message from our fundamental and technical indicators, we would generally discourage chasing rallies.

Rather than thinking about putting new money to work at this juncture, investors should consider using the recent equity rally to reposition away from cyclical laggards and towards structural growth leaders within sectors such as healthcare, technology and public infrastructure. We generally favor cash-rich "quality growth" companies able to navigate the looming global recession.

While we believe that US equities (especially large caps) might be more resilient than most other geographies, some countries have been improving in terms of relative strength. This is especially the case for North Asia (and Chinese equities in particular), a region where the virus seems to have been brought under control.

This may also be a time for a renewed focus on portfolio diversification. For instance, we believe that cash and Gold could be held for their own merits.

While our MENA equity strategies suffered during the first quarter, our cautious and selective approach enabled us to handsomely outperform the respective benchmarks. Going forward, we believe that our deep research bottom-up approach will help us to identify long-term winners within our region.

While our forecast and views are subject to changes, our commitment to serve our clients is not.

We remain at your full disposal for any specific issues you may like to discuss, so please do not hesitate to contact us.

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