

Perspectives

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Walking the Tightrope



First Half Global
Markets Review: Ten
stories to remember

International Markets
Outlook: Walking the
Tightrope

Middle East Equities:
The first half of 2019
in the rearview

Special Focus: Kuwait
MSCI Inclusion puts
spotlight on non-oil
economy

Welcome to the 27th edition of Perspectives.

The first half of 2019 is one of the most memorable on record with strong returns across all asset classes. Confronted by weaker economic data, risks to the trade outlook and still low inflation, central banks came to the rescue by opening the door to further monetary stimulus. Bad economic news became good news for financial markets as equities and credit rallied alongside traditional safe-haven assets such as government bonds and gold.

In the first part of this publication we review the 10 stories to remember from this eventful first half of the year. We then share our views for the third quarter and beyond – we believe that the path for risk assets is becoming narrower but maintain a positive stance on risk assets.

The second part of this edition of Perspectives is dedicated to our regional markets. Middle East equities posted decent returns in the first half of this year although they lagged U.S and Emerging Markets equities. We believe there are still some secular and cyclical reasons to be positive on MENA going forward. The special focus of the month is on the Kuwait MSCI Inclusion which puts spotlights on non-oil economy.

We hope you will enjoy this issue.

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First Half Global Markets Review:

Ten stories to remember

10

The everything bull market.

Six months ago, markets were coming off a rough end to 2018 and many investors were expecting a very difficult year ahead. Halfway into 2019, there's certainly been a lot of major stock market news to digest, and almost none of it went the way Wall Street expected.

After a weak month of May, major central banks came to the rescue of financial markets at the end of the quarter. Confronted by weaker economic data, trade jitters and low inflation expectations, the Federal Reserve and the European Central Bank hinted at more monetary stimulus to come. As such, bad economic news became good news for financial markets. Global bond and stock markets added \$4.5 trillion to global wealth in June as a bullish monetary policy offset lower EPS expectations, weak macro data and geopolitical tensions. Global stocks (MSCI World) just had their greatest June performance in history. The Dow Jones index had its best June since 1938 while the S&P 500 saw its best June since 1955. As it was already the case in January of this year, all asset classes' returns were positive. According to a report by Goldman, January and June of this year are the only months in the last 150 which have seen all assets posting a positive total return.

June's strong performance has made it a very decent second quarter as the S&P 500 gained 3.8 per cent and International ex-US equities 2.7 per cent. We note however that Long-term US Treasuries (20y+) outperformed equities with a 5.7 per cent gain as the long end of the curve flattened on the back of record low inflation expectations. But the best performing asset of the quarter was Gold (+9.1 per cent), which benefited from a weaker dollar and the dovish stance adopted by major central banks (more on Gold later in this section).

The strong performance of financial markets during the second quarter is coming on top of a very strong first quarter – consequently, the first half of 2019 proved to be exceptional for multi-asset managers as the 15 asset classes monitored in the chart below posted positive performance during the first half of the year.

In fact, stocks have recorded one of their strongest rallies in recent times. The S&P 500 has gained more than 17 percent

since the start of the year, its best performance in the first six months of a year in more than two decades. The Dow Jones rose 14 percent, and the Nasdaq 21 percent.

Outside the U.S., stocks gained as well with a 12.4 per cent advance for International ex-US equities and 9.2 per cent for Emerging Markets equities. European equities were among the best performers with a gain of 17.4 per cent for the DAX Index. Within Emerging Markets, China CSI 300 index was up 27 per cent over the first half. Russia was the best-performing stock market globally with a gain of more than 28 percent in dollar terms.

In Fixed Income, the yield on the U.S 10-year Treasury note plunged below 2 percent several times this year, for the first time since President Trump was elected. Yields on government bonds have been falling fast — everywhere. Australia, Britain, Germany, France, Japan and the U.S. have all experienced it, and the value of negative yielding bonds around the world hit \$13 trillion at the end of the quarter. The U.S yield curve (3m10Y) have been inverted for 26th straight day between May and June.

Credit performed relatively well as U.S high Yield bonds gained nearly 10 per cent while Emerging Markets Bonds (in \$) returned 9.4 per cent.

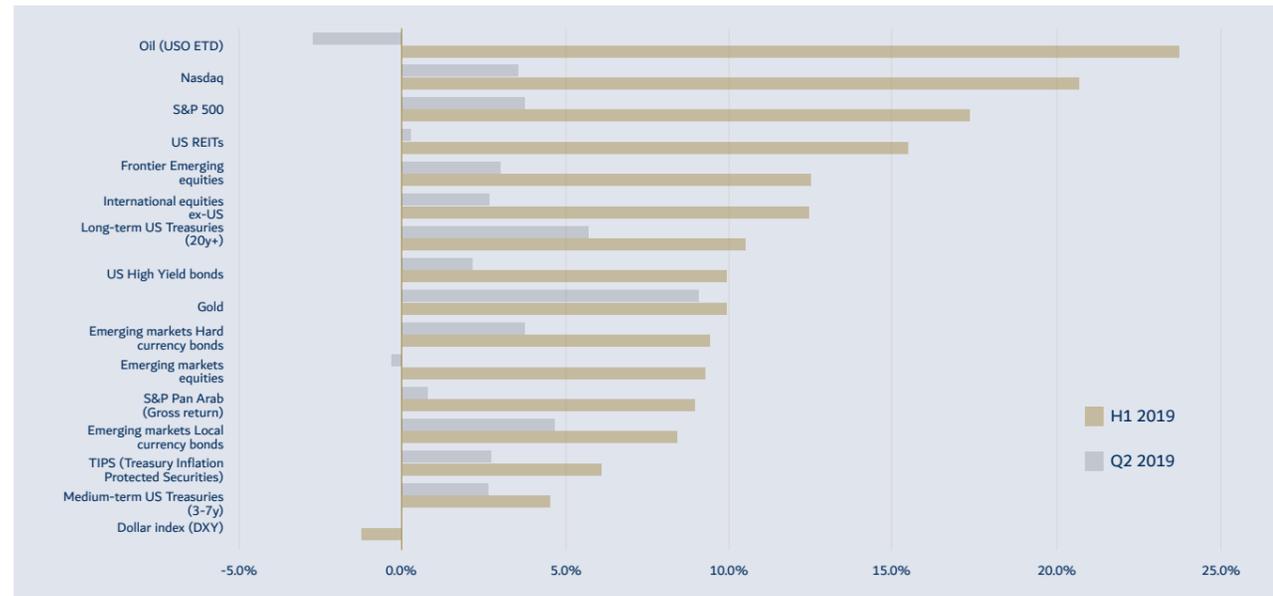
On the currency side, the dollar index ended the first half of the year flat after weakening in June (-1.6%), its worst month since January 2018.

In commodities, Oil prices tumbled more than 20 percent between late April and late May due to growing fears that demand would be weaker than expected as the global economy slows. But oil recovered part of the drawdown in June and remains the best performing asset class in the first half of the year with a gain of roughly 23 per cent.

But one asset (absent from the chart on the next page) which outperformed them all was Bitcoin. The highly volatile cryptocurrency rose about 180 percent so far this year, approaching the \$14,000 level at the end of the first half.



H1 and Q2 2019 returns (in \$) for selected asset classes



Below we look in more details in what we consider to be the 10 most relevant financial market stories of the first half of the year.

Story #1: Central bank policy is all what matters

As mentioned earlier, Middle East tensions and weaker macro data didn't stop the S&P 500 to climb to new highs as monetary policy was indeed the main driver of risk appetite during the first half of the year. Among all the superlatives in

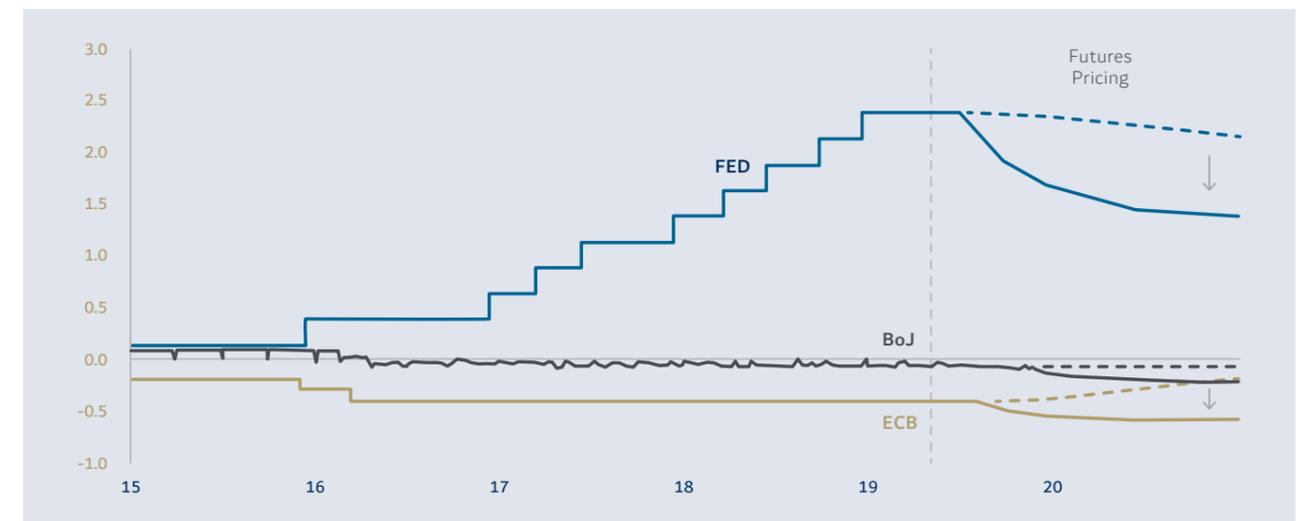
markets, June saw US Macro data collapse most since April 2017. But since June, there has been a second dovish wave with increased expectations for more ECB easing post Mario Draghi's Sintra speech and the June FOMC meeting.

Central bank policy is all what matters



As shown on the chart below, pricing of central banks has turned more dovish across regions throughout the first half of this year. On an aggregate basis, we have moved from a tightening bias to an easier stance in less than 3-months.

Central banks' discount rates; dotted line represents market pricing at the end of 2018



The market is now pricing roughly 3 rate cuts by the Fed and similarly investors have priced further ECB easing. As a result, both equities and bonds rallied and had one their best starts of the year since the 80s. This is not unusual after dovish monetary policy shifts, e.g. when the Fed starts cutting interest rates; actually 1989, 1995 and 1998 were strong years for equity and bonds.

Story #2: The "jaws of death"

On the back of dovish central banks, the dichotomy between global stock prices and global bond yields is reaching extreme levels. As equities soared, U.S Treasury yields tumbled further

in June (and notably the long-end). The U.S 10-year bond yields dropped below 2.00% to end the month - the lowest monthly close since Oct 2016.

Global bond yields are collapsing as global stocks are back to record highs



In the latest University of Michigan consumer confidence report, expectations for long-term (5-10y) inflation dropped to a fresh all-time low of 2.4%, hinting that the Fed is on the verge of losing the war against unanchored inflation expectations. In Europe, the 5-year inflation swaps have dropped from 1.7% at the start of the year to 1.3% as of the end of June (see chart below).

Investors have a point - comparing the CPI inflation trajectory for each business cycle since 1879 clearly shows that this business cycle is different from others, which means that CPI and bond yields could stay lower for longer, hence pushing asset prices to even more stratospheric levels.

US & Eurozone medium-term inflation expectations (source: Bloomberg)

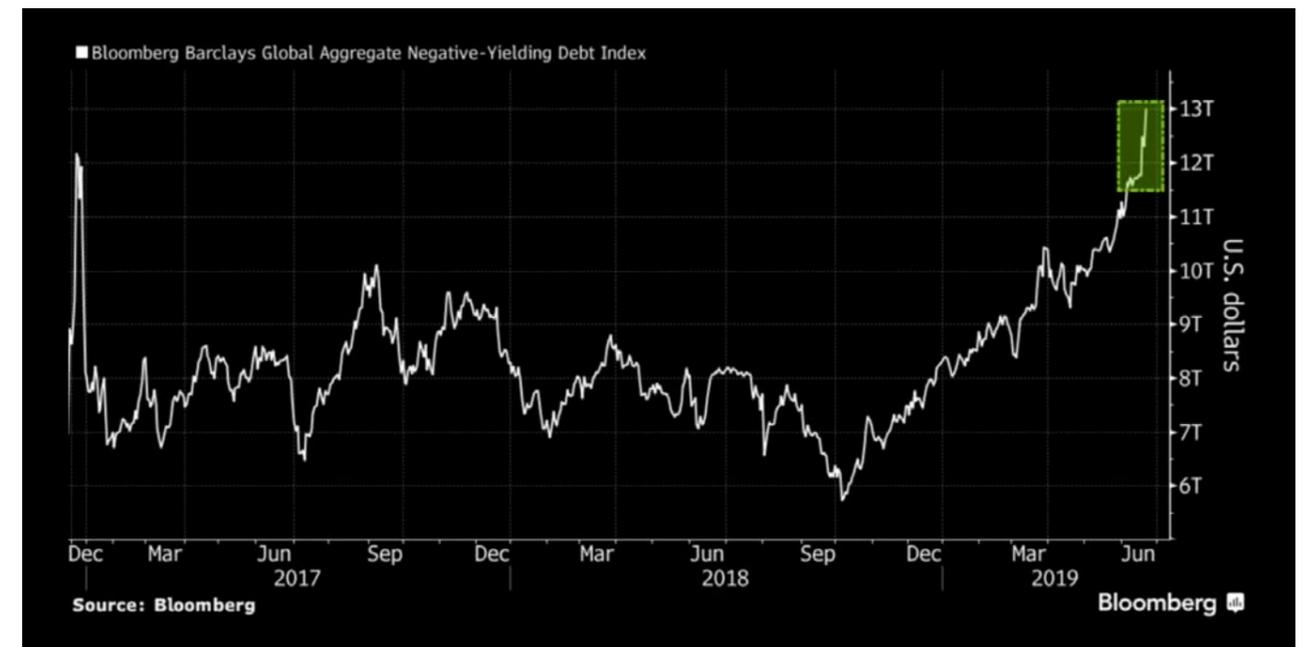


Story #3: Negative Yields and Global Yield curve inversion

A direct consequence of macro-economic data weakness, lowered inflation expectations and central bank dovishness has been an inversion of the U.S yield curve and record amounts of negative yielding debt. Indeed, yields collapsed around the world. Germany's 10-year government bond yields

slipped further into negative territory (-0.3%) and the French 10-year yields fell to zero for the first time. In Switzerland, 96% of the yield curve is now trading in negative yielding territory. As of the end of June, \$13 trillion of bonds around the world were yielding below-zero – an all-time high.

Global negative-yielding debt exploded in June and now stand at a record \$13 trillion market-value



The deal of the Century

A world of negative yield is opening the door to all sort of extreme situations. At the end of June, Austria launched a Euro 1.25 billion tranche of the 2.1% 100-year deal it launched two years ago. It was apparently 4 times oversubscribed – over 100 investors put in orders for \$5.5 billion of the century bonds. The new deal was priced to yield 1.1712% - meaning investors are paying a price of 154% price today to get back 100% in 98 years...

In the U.S, the drop of long-term yields resulted in a partial inversion of the yield curve as the 10-year yield traded below the 3-month Treasury bill for the first time since 2007, prompting warnings that the U.S. is headed for recession later this year or in early 2020. That's because, historically, such

"curve inversions" have tended to precede major economic slowdowns by about a year.

The U.S yield curve inversion is not an isolated event. It is actually getting worse in the rest of the world as 15 economies now have 30-year yields lower than LIBOR overnight rates.

Story #4: Negative earnings revision

The S&P 500 may have just enjoyed its best June in 84 years but not because of rising corporate profits and earnings. Quite the contrary: according to Goldman, while the S&P 500 rose 7% from its trough on June 3, valuation expansion accounted for 90 per cent of the rally in response to the Fed's becoming "impatient" and signaling an easing cycle has begun.

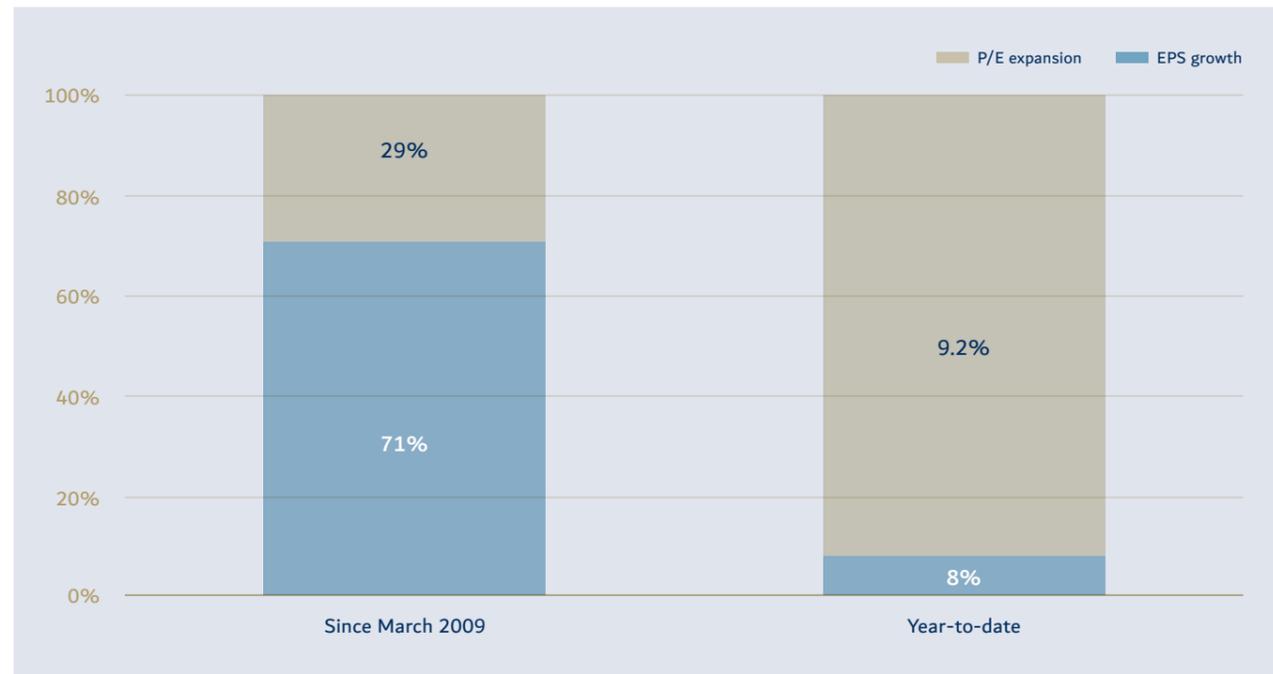
Indeed, consensus for S&P 500 bottom-up 2019 EPS estimates has resumed its downward trend following a brief reprieve during Q1 earnings season. The consensus has lowered its estimate of 2019 EPS by \$1 to \$166 (+2 per cent growth year/year) during the last six weeks of the month, with Goldman noting that since the start of 4Q 2018, 2019 EPS growth expectations have declined from +10 per cent to +2 per cent.

The number of S&P 500 companies issuing negative guidance has jumped to 87, the second highest on record.

So with 2Q earnings season kicking off in earnest on July 15, consensus expects aggregate EPS to decline by 1 per cent year/year, and if realized, this would be the first year/year decline in quarterly EPS since 2016.

No doubt, tariffs are hurting some businesses. FactSet found that companies that generate more than 50 per cent of sales domestically are expected to report an average earnings' increase of just 1.4 per cent in the second quarter. But companies with more than half of sales outside the U.S. should see a 9.3 per cent drop in earnings.

The vast majority of S&P 500 gains so far this year has been coming from P/E expansion, instead of earnings (source: Goldman Sachs)



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Story #5: Growth and Large Caps continue to lead

Taking the U.S. as reference, the "Growth" style continues to outperform "Value" by a wide margin. The outperformance was around 250 basis points in the second quarter (+5.1 per cent for Growth versus +2.5 per cent for Value) which brings the year-to-date outperformance to nearly 800 basis points (+21 per cent versus +13.2 per cent) - this is almost as wide as the outperformance for the full 2017.

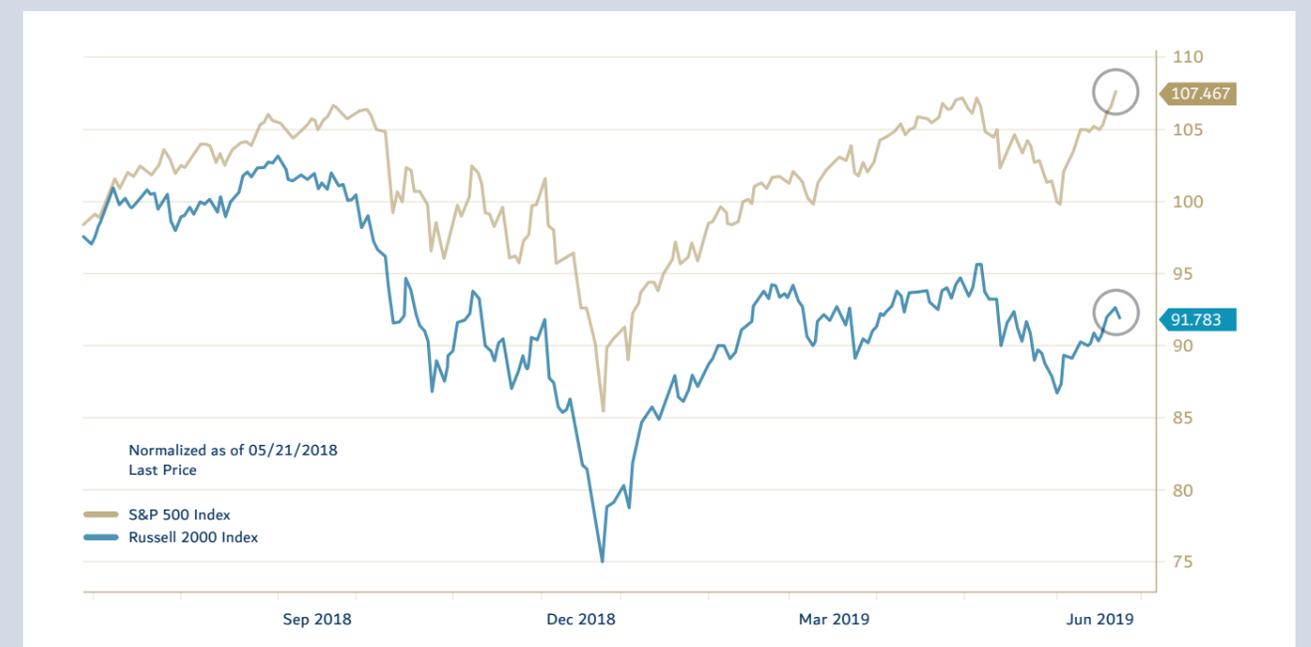
Looking at the first half of the year, the Technology sector is once again leading the market with a 26 percent gain despite the trade war and growing regulatory and political pressure.

Shares of Facebook were the best performers among the largest tech firms, with a gain of 47 per cent. Microsoft's 31 percent rally pushed its market value to \$1 trillion, making it the most valuable company.

Looking at the size effect, it is worth noting that small cap stocks are diverging from S&P 500 by over 15 percent in the last year. The Russell 2000 index is way off its highs and is not confirming a breakout in the S&P 500. This is a bearish divergence that could spell trouble ahead.

Looking at the size effect, it is worth noting that small cap stocks are diverging from S&P 500 by over 15 percent in the last year.

U.S small Caps have been underperforming the S&P 500 by 15 per cent over the last 12 months (source: Crescat Capital)



Story #6: Many investors missed the equity rally

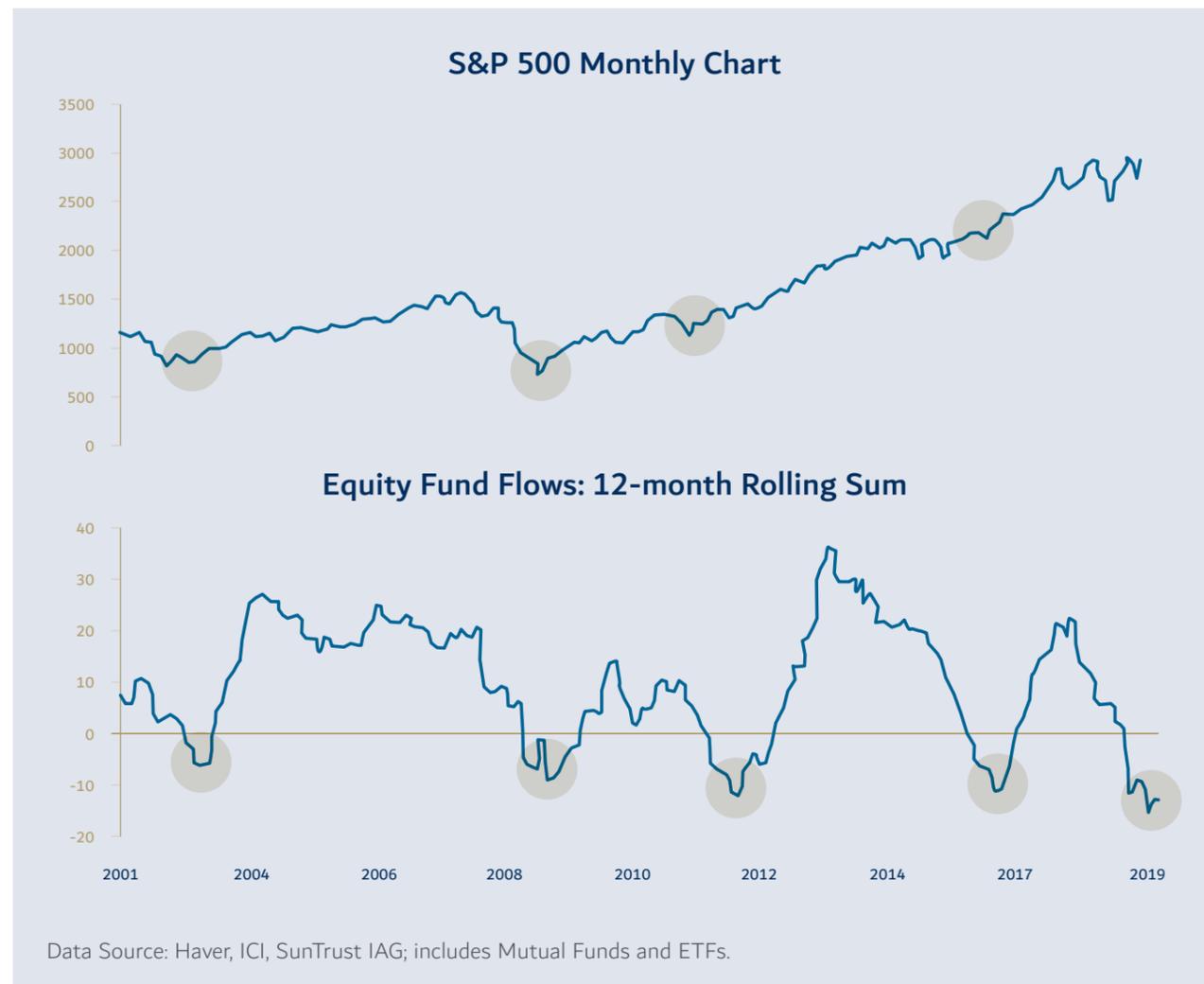
Another remarkable observation is the fact that the average investor didn't seem to trust the epic stock rally which took place during the first half of the year.

According to BofA ML Global Fund manager survey, the overweight position in cash by fund managers is at its highest level since January 2009. We view this as a positive from a contrarian perspective.

\$71 billion of withdrawals for EU equity funds in the first half and \$41 billion of redemptions for U.S equity funds over the same time period. We also view this as a positive as it signals that there is a lot of dry powder to be reinvested in the stock market.

Meanwhile, equity fund outflows are near record levels with

Despite new highs, Equities outflows are at record high



Story #7: Dollar is breaking its 200 days moving average

As mentioned in the introduction, the dollar index ended the first half of the year flat after weakening in June (-1.6%), its worst month since January 2018. Most notably, the dollar dropped below its 200 days moving average and this was the biggest

penetration of the 200DMA since May 2017. As already discussed in the June edition of Perspectives (“Will the dollar continue to smile?”), there are reasons to be cautious on the dollar – a topic we also cover in the market outlook section of this edition.

The dollar index broke down its 200 days moving average



Looking at global currencies leadership, this year has been so far a great one for investors looking for carry (see chart below). Year-to-date, Egypt is the world's best carry trade. It

may stay that way for a while longer if the government gets its wish and strikes another deal with the International Monetary Fund.

Best carry trades since the start of the year

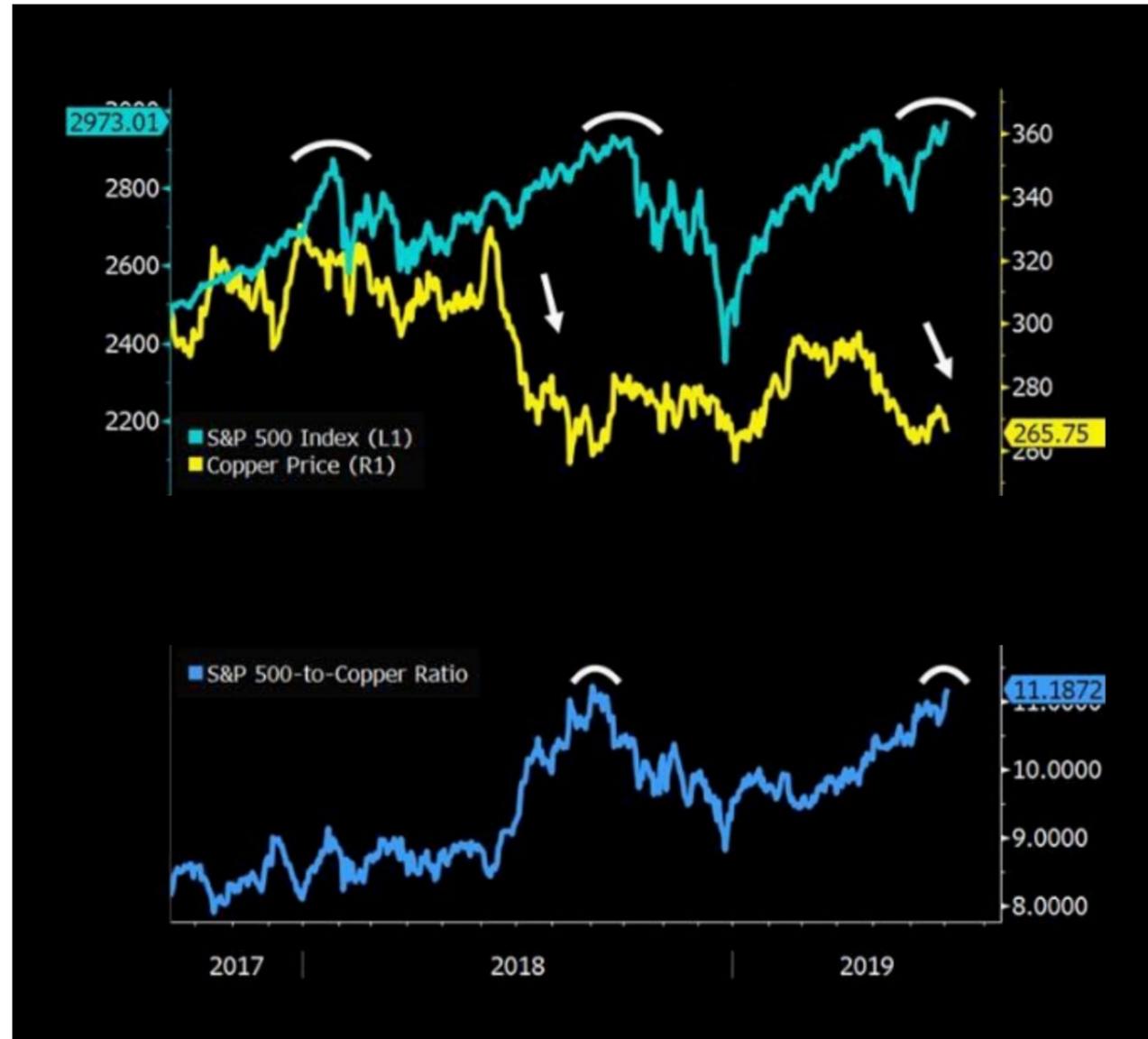


Story #8: Dr. Copper is diverging from the equity bull market

Copper prices have been weakening on the back of disappointing macroeconomic data and trade war fears. It is interesting to note that Copper is now diverging from the S&P 500 by over 35%. Copper is seen by many as a leading indicator for the global economy – hence the nickname Dr Copper.

The last time this distortion reached similar extremes was at the September 2018 market peak.

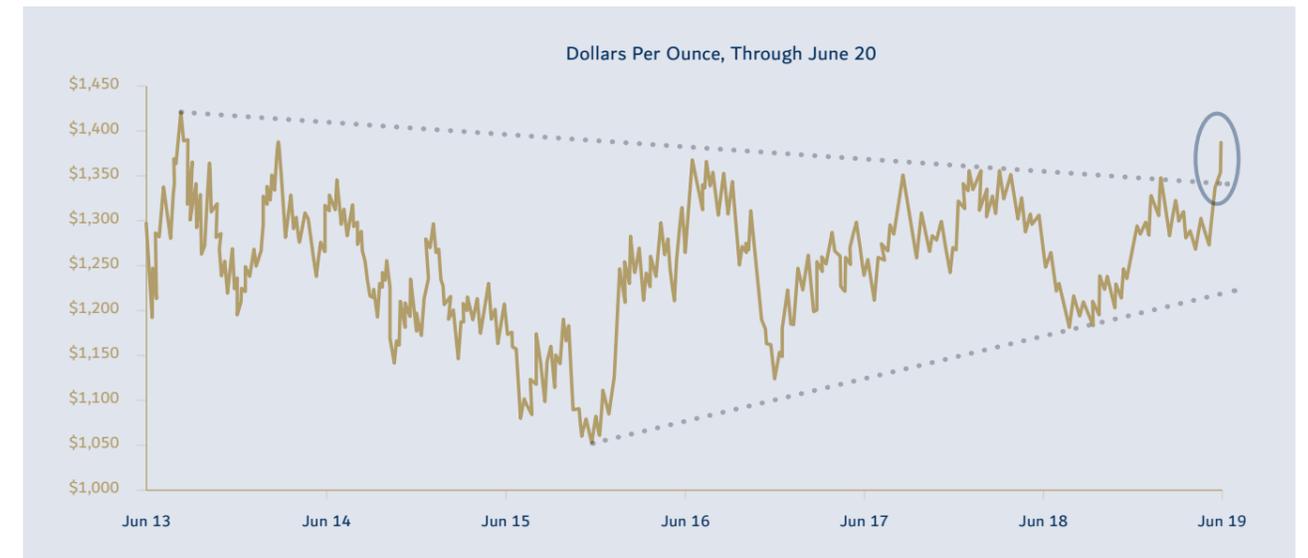
S&P 500 versus Copper (source: Bloomberg, Crescat Capital)



Story #9: Gold is back

Gold has surged in June as the U.S. Federal Reserve's amazing turn from hawkish at the beginning of the year to dovish today has finally shifted investor expectations. Investors now anticipate that they will have ultra-low to negative real rates for long into the future, which is a bullish tailwind for gold.

Gold broke out its 5-year trading range in June (Source: LBMA, Global Investors)



Story #10: Bitcoin is up +180% in the first half

In case you hadn't noticed, Bitcoin has made a major comeback this year. After falling below \$4,000 for much of 2018, the price reached almost \$14,000 in June, before retreating to \$12,000 at the end of the quarter.

Most crypto currencies soared in June, Q2 and H1 with Litecoin recording the largest gain with a 300% year-to-date performance.

Increased acceptance is part of the catalyst, with companies like AT&T now accepting BTC payments and Fidelity offering trading. A flurry of entrepreneurial activity should also start supplementing the ecosystem with great new tools and services. Facebook Libra announcement and further printing by major central banks also helped.

Bitcoin is up 180 per cent year-to-date (Source: zerohedge)



International Markets Outlook: Walking the Tightrope



In our 2019 Global Outlook (“Navigating Choppy Waters”), we shared our positive view on risk assets despite all of the looming macro/geopolitical risks and the profound technical damages caused by the 2018 correction. Our base case was that the Q4 pullback was the corrective phase of a secular bull market – and thus advised our readers to remain long equities in a selective way.

As highlighted in the first section of this edition of Perspectives, risk assets came back with a vengeance in the first half of 2019 posting strong returns across the board. To be honest, the amplitude and breadth of the rebound during the first 6 months of the months went beyond our most optimistic expectations.

The key question for investors is whether the “goldilocks” conditions which took shape throughout the last two quarters will prevail for the rest of the year. Indeed, risk assets are evolving within a very narrow path. The global economy needs to be strong enough to avoid sparking recessionary fears and

weak enough to keep policy makers on hold. Any decline in U.S or global growth expectations could spur recession fears. But should the Federal Reserve and/or ECB disappoint market expectations in the coming months, this could create some market panic as well. Meanwhile, any geopolitical tensions such as trade tensions or oil price “melt-up” could further dent investors’ sentiment. As we highlighted previously in our Global 2019 outlook, the later stage of the economic cycle is very often characterized by higher macro-economic volatility – and thus higher market volatility. We would thus caution investors to not extrapolate the smooth first-half equity rally through year-end.

As we are entering into the second half of the year, we review below the weight of evidence for risk assets and equities in particular. On an aggregate basis, the global context remains favorable to risk assets – but we expect more corrections and volatility down the road.



Global equities outlook: The weight of the evidence is slightly bullish



Macro Fundamentals (Bullish)

While uncertainties are elevated, the global economy is still expanding at a moderate growth rate and a recession looks unlikely at this stage. While manufacturing is struggling (see Global PMI chart below), nominal wage growth is expanding at 5% in the U.S and 3% in the Eurozone. This is important as consumer spending makes nearly up to 70% if the US and over 50% of the EU's economy. Significant direct effects of the trade conflict between US and China on economic growth will not materialize before 2020 when the ongoing adjustments

on global supply chain will finally weigh on productivity.

We expect the global economy to gather momentum in the second half of 2019 as income growth in the developed markets should shift domestic demand. We also believe that monetary and fiscal impulses from the Chinese government and the expected widening in the eurozone budget deficit will unlock further growth potential. We see annual growth rates increasing towards 2.5-2.7% in the U.S and 1.2%-1.4% in the Eurozone in H2 2019.

JP Morgan Global Manufacturing PMI



Monetary Policy (Bullish)

Virtually all major central banks have indicated their will not to choke the still fragile growth. While the general direction of global policy rates was up until 2018, this has changed in 2019 so far.

In the U.S, to cut or not cutting rates is no longer the question. Now the question is the quantity, magnitude and timing of rate cuts for the rest of the year. As shown on the table on the top of next page, the market expectations are very high. True, the recession probability is higher today than it was in either of instances when the Fed was already cutting rates and the Fed

has not yet started the rate cutting cycle. This indicates that the Fed needs to act sooner rather than later and probably to a degree that is larger in magnitude than their base case calls for. The 2Y to Fed Funds yield spread currently stands at -72bps. By this measure the Fed is substantially behind the curve and should act by cutting rates by at least 25bps in July and perhaps another 25 basis points in September or October (depending on economic data and global financial conditions). All in all, we expect some rate cuts but less than the market is currently pricing in.

Cumulate interest rate probabilities relative to current Fed Funds rate

	-25bps	-50bps	-75bps	-100bps
July 2019	100%	20%	0%	0%
September 2019	100%	83%	16%	0%
October 2019	100%	89%	38%	5%
December 2019	100%	94%	62%	21%
September 2020	100%	99%	74%	51%

Note that the S&P 500 has typically generated strong returns at the beginning of Fed cutting cycles. An analysis of equity returns during the past 35 years following the start of 7 Fed cutting cycles shows that the index climbed by a median of 2% and 14% during the 3-and 12-month periods following the start of a Fed cutting cycle, respectively.

The Fed is not the only central bank within developed markets likely to move to a dovish stance. After its June meeting, ECB President Draghi vowed to keep policy rates ultra-low and

then mentioned the central bank might be inclined to do even more. Inflation expectations in the Eurozone have dropped significantly since the start of the year and this could spur more action from the ECB in the months to come. In Japan, core consumer inflation rate declined in May and factory manufacturing activity is expected to fall in June, putting pressure on Japan's economy and the Bank of Japan (BoJ) to broaden its already aggressive stimulus program, possibly as early as July.

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Sentiment (Bullish)

Looking at various surveys and portfolio positioning, it looks like many market participants have missed the strong run in risks assets which took place in the first half of this year. From a contrarian point of view, we view this as a positive.

As highlighted in the first half 2019 market review section,

the average cash overweight position within mutual funds is at its highest level since January 2009. Other surveys show that investor positioning has been decoupling from equity performance to an unprecedented extent. This indicates that investors have some dry powder to be reinvested into risk assets.

The average cash overweight position within mutual funds is at its highest level since January 2009.

After years of outperformance by U.S equities versus the rest of the world, a more dovish Fed and some weakening of the dollar could act as triggers for some outperformance by emerging market.

Valuations (Neutral)

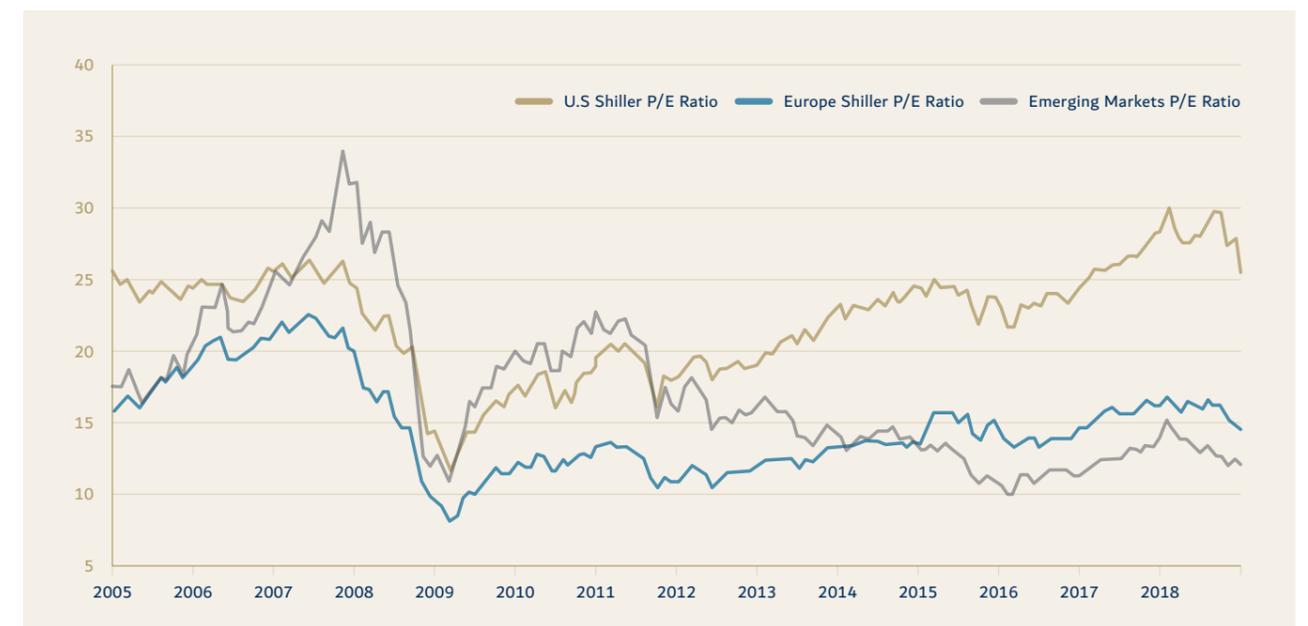
From an absolute perspective, U.S equities are expensive. On a 12-month forward basis, the S&P 500 currently trades at 16x earnings. The Shiller P/E ratio came slightly down but still stands at 25x, which is above the long-term average.

However, we note that valuations are not all equal across sectors and style. For instance, cyclicals are currently more attractively valued than defensive stocks. The latter were buoyed by recent drop in bond yields while the former have been pricing in a slowdown in global growth. Some improvement in economic momentum in the second half should lead to some upward earnings revision for cyclical

stocks and thus improve even more their relative valuation attractiveness. It should also be highlighted that U.S equities remain attractive versus bonds, especially in light of the recent drop in the U.S 10-year Treasury bond yield.

Looking at the rest of the world, it is interesting to note that Europe and Emerging Markets equities are trading at a significant discount to U.S stocks. After years of outperformance by U.S equities versus the rest of the world, a more dovish Fed and some weakening of the dollar could act as triggers for some outperformance by emerging market.

Shiller P/E ratios for U.S, Europe & Emerging Markets equities (source: Litman Gregory)



Seasonality and other market cycles (Neutral)

As discussed in the May 2019 edition of Perspectives (“BEHAVIORAL FINANCE: Seasonality and other stock market cycles”), equity markets seasonality (which is also known as the “one-year cycle”) divides the year into 2 parts: winter (from November 1st to April 30th) and summer (1st of May to October 31st). Historical cumulated performance clearly shows that the best season of the year to be long the stock market has been the winter season instead of the summer season. As such, stocks have now entered the less favorable period of the year.

But the one-year cycle is not the only one to be considered. For instance, the 4-year cycle (or “presidential” cycle) refers to

the effect of the US presidential 4-year term on the stock market, real estate, bonds and commodities. The theory about this cycle states that economic sacrifices are generally made during the first two years of a president's mandate. As the election draws nearer, administrations have a habit of doing everything they can to stimulate the economy so that voters go to the polls with jobs and a feeling of economic wellbeing. This seems to be playing out again as monetary and fiscal stimulus in the U.S are currently helping the economy gathering speed ahead of the 2020 U.S presidential election. As such, the 4-year cycle pattern seems to indicate that equity markets have further to run.

Technicals (Neutral)

From a U.S equity market perspective, we note that market participation has been less than robust during the most recent up leg. First, large caps have been outperforming small and mid-caps by a meaningful margin. The Russell 2000 index is way off its highs and is not confirming a breakout in the S&P 500 (see chart below). This is a bearish divergence that could spell trouble ahead.

Moreover, sector leadership came from health care, technology,

utilities, real estate and telecom – all areas with defensive characteristics be it quality (health care and technology) or low volatility (Utilities, Real estate and Telecom).

From a cross assets point of view, we like the fact that credit spreads have remained tight throughout the second quarter. However, the strong equity performance in June has not been fully confirmed by further spread tightening, which is a slight negative divergence.

Earnings Growth (Bearish)

As already discussed in the first half market review section, earnings have been the weakest link for equity markets so far this year.

A slowdown in global economic activity in part related to global trade weakness has been weighing on earnings growth expectations on a global scale. As shown on the chart below, global earnings downgrade outpaced upgrades by the most since January.

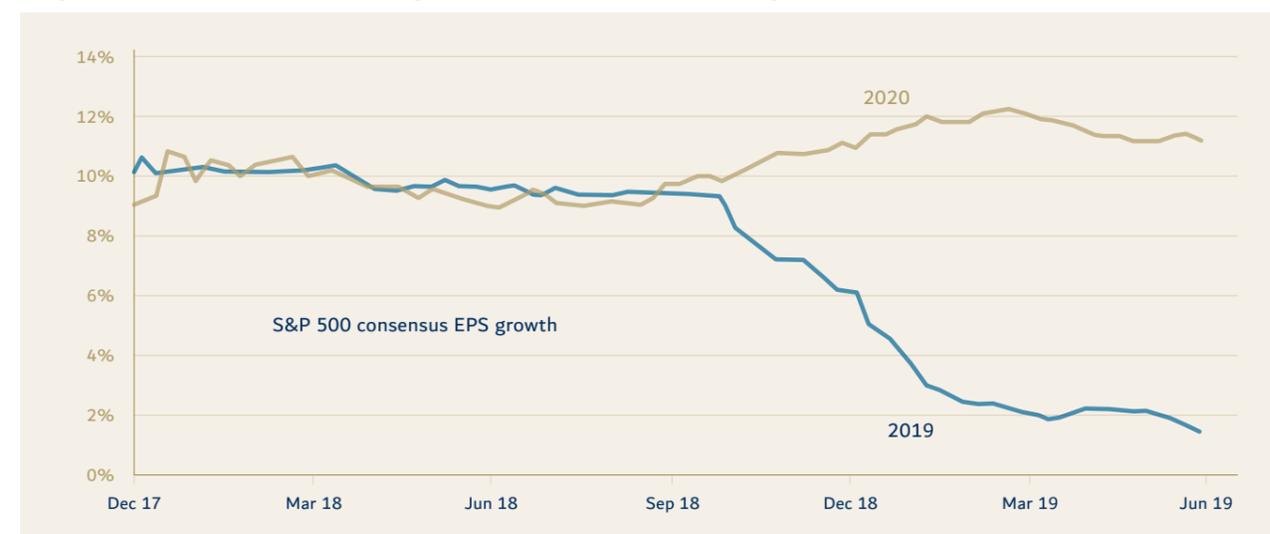
Global Earnings upgrade minus downgrade since the start of the year (source: Bloomberg, Citigroup)



Looking more specifically at the U.S earnings, we note that while the S&P 500 operating EPS was mildly up in Q1 (+2.5 per cent y/y), it is expected to decrease by 1.5 per cent y/y in Q2 and by -0.2 per cent y/y in Q3. A 6.8 per cent y/y rebound in Q4 is expected to lift the full year 2019e EPS to slightly positive territory (+1.9 per cent). This is way below the +10 per cent which was expected by consensus in early September 2018.

While the downward revision to 2019e EPS has been quite aggressive, we note that this has not been the case for 2020e numbers as the S&P 500 operating earnings are still expected to grow by nearly 12 per cent in 2020e (see chart on the next page).

Negative revisions to 2019 EPS growth, but not to 2020 EPS growth (as of end of June 2019)



At the time of our writing, the "worst case" trade war scenario was avoided at the G20 in Osaka as U.S President Trump agreed to restart trade talks with China President Xi Jinping, holding off new tariffs on Chinese exports, and signaling a pause in the trade hostilities between the world's two largest economies. While this has been taken positively by the markets, we believe that the G-20 summit delayed the escalation in trade tension, rather than solved the problem. It remains unclear how they can overcome differences that led to the collapse of a previous truce reached at the G-20 in November.

More importantly, we believe that the market will now shift its focus back to fundamentals - and second quarter earnings particularly. Expectations are now very low and negative

revisions have been aggressive – which leaves some room for positive surprises. But the guidance given by companies' management for the rest of the year might be even more important to watch. To our opinion, market participants might be able to look through this year disappointing earnings numbers provided they see signs that global growth is in the process of stabilizing. A strong signal would be come from of Trade deal – and the sooner the better. If it does happen, consumer and business confidence is unlikely to collapse. And even if macro and earnings numbers disappoint in the coming months, investors will look beyond earnings hit this year and start to anticipate an improvement in 2020. This couple with moderate support by the Fed should help the equity market to record moderate gains.

BOTTOM LINE: The weight of evidence remains slightly bullish and thus favorable for risk assets. While 2019 earnings growth do not look favorable for equity markets, moderate economic growth and dovish central banks should continue to support valuations. We also note that market sentiment is not overbought as many investors have missed the first half rally. Some cash might thus be deployed into equities before the end of the year. Moreover, the fall of bond yields has made equities more attractive on a relative basis and might trigger a new wave of share buy-back.

We thus continue to favor equities over fixed income but expect some volatility and mild corrections in the months ahead. Investors should prepare accordingly and avoid extreme tactical bets.

Below, we highlight our preferences for the main regional equity markets

U.S - NEUTRAL (FROM OVERWEIGHT) - A slowing but still growing economy is a positive macroeconomic context for U.S equities. We believe the potential for multiple expansion is capped but expect earnings growth revision to improve. We prefer quality companies with strong balance sheets in a late-cycle environment. Technology and Health care are among our favored sectors, although the valuation multiples for the former are rich. Should economic momentum gather speed in the second half, some cyclical stocks could be attractive as well.

We are moving from overweight to neutral as we believe that emerging markets equities currently offer more value, especially if the Fed becomes more dovish and if the dollar weakens further.

EUROPE: UNDERWEIGHT - Growth prospects in the Eurozone remain subdued. The old continent is dependent on global trades and is facing collateral damage from U.S-China trade jitters. Inflation expectations in the Eurozone have dropped significantly since the start of the year. During its June meeting, ECB President Draghi wowed to keep policy rates ultra-low and then mentioned the central bank might be inclined to do even more. The willingness of Mr. Draghi to cut rates is not the issue. The real question is effectiveness of these monetary policy at a time the European central banks are carrying so much of the policy burden to deliver macro-economic outcomes. Moreover, political risks (EU integration, Italy, Brexit, etc.) remain a strong headwind for European equities. And the ECB dovish stance is a negative for European banks. While the region is cheap on a relative basis, a catalyst is missing to unlock value.

JAPAN: NEUTRAL - Valuations are attractive and reforms continue to be implemented along with shareholder-friendly corporate behavior. Based on corporate announcements, the Nikkei reports that Japanese companies are on track to repurchase about ¥3.4 trillion (\$31 billion) worth of shares in Japan's fiscal year ending March 31, 2020, which would represent a 93% year-over-year increase. The dividend yield on the TOPIX Index has already risen to its highest level in almost seven years. Monetary policy remains supportive through central bank stock buying. Political situation is stable. The key risk for Japan equities is on the earnings side given the high operating leverage and sensitivity to global growth.

EMERGING MARKETS - OVERWEIGHT (FROM SELECTIVE) - Economic reforms and policy stimulus support EM stocks. A dovish Fed and weaker dollar in the second half could provide further tailwinds for Emerging Markets equities. Overall, macro fundamentals are stable, economic growth rates are solid, debt to GDP ratios have fallen and current account balances are generally rising. Within EM, China is our favorite market as it the least correlated to US equities thanks to a large internal economy fueled by a growing middle class. The China market is too large to ignore (30% of MSCI EM). Earnings growth expectations have found a bottom and even turning positive. The Chinese government is actively supporting the economy via a loosening of monetary conditions and increased government stimulus.

Our views on the other asset classes



FIXED INCOME

We believe that the drop in long-term bond yields observed during the first half of the year has been exaggerated. Looking at U.S Treasuries, the 10-year yield dropped below 2% in June as the bond market is nearly pricing in a recession. Indeed, the 3 month-10 year US Treasury yield curve is slightly inverted and the futures prices reflect around 70 bps of expected easing during 2019 and an additional 30 bps of easing during 2020, reflecting a total of 4 rate cuts by the end of 2020.

Our take is that the bond market is right to price in one or two rate cuts but it might have gone a little bit too far – we would thus not buy the bond market panic and avoid U.S Treasuries at this stage. Even for diversification purposes, we would favor cash. Going forward, we expect the coupon (income) to be the main contributor to bond returns.

Within Credit, a dovish Fed should keep High Yield spreads relatively tight at a time when default rates continue to decrease. We thus expect High Yield to outperform Investment Grade bonds. **We are also positive on Emerging Markets bonds (hard currency and local currency), especially those issued by countries with sound liquidity, manageable leverage and access to founding. This is particularly the case in the GCC region.**



CURRENCIES

The U.S. dollar story so far this year has had two sides. Yield differentials have reasserted themselves as a key driver, with the greenback rising against the lower-yielding euro, yen and Swiss franc, but declining against most higher-yielding Emerging Markets currencies.

Going forward, we believe there are reasons to be cautious on the dollar:

1. The Fed is likely to decrease interest rates. While other developed markets central banks are also moving to a dovish stance (ECB, BOJ), they have much less ammunition ta hands than the Fed. This is thus bearish dollar;
2. Over-valuation on a PPP basis (not a timing tool but it increases downside risk)
3. Negative divergence: While the Dollar index has been flirting with new highs over the first half, it is interesting to see the dollar behaving very different in 2019 than last year. During the first half, the dollar highs were not confirmed by a large number of currency lows. With the euro accounting for 57% of the dollar index weight, euro weakness has been a major contributor to the dollar strength. However, and unlike in Q2/Q3 of 2018, emerging market currencies are not making new lows. Indeed, some emerging market currencies have been performing decently well against the dollar since the start of the year. This is especially the case for high yielding Emerging Markets currencies such as the Russian Rubble or the Mexican Peso. The non-confirmation of last year lows is not a phenomenon restricted to emerging market currencies. While the Swiss Franc and the Swedish Krona have been trading in a similar way than the euro, the pound, yen, the Canadian and the Australian dollar all remain above the lows reached at the end of last year or later. Last but not least, Gold price pattern is also creating a negative divergence. The yellow metal, which historically correlates negatively with the dollar, has been able to slightly appreciate in price so far this year. The lack of breadth in the dollar advance should thus be interpreted as a negative signal for the greenback.
4. Deteriorating long-term fundamentals: While US. Economy superior real GDP growth rate is a short term positive for the dollar, some of U.S long term fundamentals continue to deteriorate. Based on S&P Global Economists' analysis of tax cuts and increase in government expenditures in the pipeline, the U.S. fiscal deficit will likely expand to \$991 billion by 2020. According to S&P review, the current account deficit, a broader measure of trade, will be \$700 billion by 2020. Since the U.S. consistently spend more than it saves, Uncle Sam will likely become more reliant on foreign capital inflows to fund its deficit. While deficits aren't necessarily bad, the debt necessary to finance the deficit may create large and persistent imbalances, increasing risks of reaching unsustainable levels. This vicious circle should be seen as dollar negative, particularly if the U.S find it more difficult to attract foreign flows. Indeed, central banks around the world plan to diversify their foreign currency reserves away from the dollar in order to increase their exposure to the yuan, the euro or gold.

While all the points mentioned above should be seen as serious headwinds for the dollar, they do not give much hint regarding the direction of the dollar in the near-term. The dollar is currently the winner by default, i.e the fundamentals are less than rosy but it is much worst elsewhere. For the dollar to meaningfully weaken, we need to see decent macroeconomic improvements in China and eventually also a pick-up in the Euro-area. As such, despite some serious challenges ahead, the U.S dollar is unlikely to collapse. We are thus moving our stance on the dollar from BULLISH to NEUTRAL.

In the rest of developed markets, the Swiss Franc and the Yen could very well play their safe haven roles during the time of crisis. The British Pound remains deeply undervalued against the dollar (on a PPP basis, GBP/USD should be trading around 1.80) but a positive outcome on Brexit is needed for the Cable to progress further. In-line with our constructive view on emerging markets, we move our stance on emerging markets currencies from BEARISH to BULLISH.



OIL

Despite concerns of slowing demand for oil and rising U.S oil production (12 MM barrels per day in May), seasonal factors tend to be relatively supportive of oil prices, as eyes turn towards the US driving season. Our view since the start of the year has been that oil market looks more broadly balanced in 2019 than in 2018. The slowing, but growing, global economy is likely to underpin oil prices this year. Supply issues remain (Iran sanctions, the shaky political situation in countries such as Venezuela and Algeria and constrained by OPEC+ discipline). Regarding the later, Russia has agreed with Saudi Arabia at the G20 to extend by six to nine months a deal with OPEC on reducing oil output. Thus, oil prices could be on a firmer footing throughout Q3. However, with the US economy going through a soft patch, we would be surprised to see oil quickly moving back to \$70-\$75 level.



GOLD

Rising Macro and geopolitical uncertainty, dovish central banks, lower real yield and weaker dollar are tailwinds for Gold price. As of the end of June, Gold broke its \$1365-\$1395 resistance level, which has been a line in the sand for gold for a few years. We are turning BULLISH on Gold.

Key takeaways and our asset allocation recommendations

(one year time horizon)

Heading into the second half of 2019, we continue to favor **equities over fixed income**. We expect moderate but positive returns for **equities** on a one-year time horizon. While valuations are more demanding than at the start of the year, earnings momentum is expected to re-accelerate in the second half of the year. Financial conditions remain supportive and sentiment is far from overbought.

While we remain positive on equities, increased selectivity is needed. We also expect volatility to make a come-back in the near future. As mentioned earlier, the later stage of the economic cycle is usually characterized by higher volatility.

As shown in the asset allocation matrix on the next page, we now favor Emerging Markets equities over U.S and Japan.

While we are still underweight Europe, there might be attractive trading opportunities at a micro level within countries and sectors, especially in case of some resolution on the ongoing trade disputes.

We continue to be cautious on **Fixed Income**. With \$13 trillion of bonds still trading in negative yield territory, the asset class remains too expensive. We favor US high yield debt as well as Emerging Markets debt. We also continue to

favor alternative fixed income such as trade finance funds.

Amid so much geopolitical and policy uncertainty, investors should consider being more opportunistic. We are at the stage of the cycle where investors need to add flexibility to portfolios and take advantage of alpha opportunities through actively managed funds.

Within **real assets & illiquids**, we are constructive on real estate as the search for yield is likely to stay intact. We also believe that hedge funds will deliver better returns going forward as they should take advantage of the rise in volatility and a more selective context. Private equity has become overcrowded with the amount of “dry powder” reaching record levels. Nevertheless, there are some attractive direct co-investment growth opportunities. Gold should be considered as useful portfolio diversifier in the current context.

On the **currency** side, we believe that the dollar will be under pressure but is unlikely to decline meaningfully. Emerging Markets currencies are expected to perform well – but the “Fragile 5” needs to be monitored closely. The Swiss Franc and the Japanese Yen can be used as a portfolio diversifier, i.e. it should do relatively well in case of market turmoil.



Heading into the second half of 2019, we continue to favor equities over fixed income. We expect moderate but positive returns for equities on a one-year time horizon.

In the next section, we review our favorite themes for 2019 as well as the Top 30 risks for the rest of the year.

Asset Allocation Matrix

	Asset Class View	Bullish	Neutral	Bearish
Equities	Overweight	Emerging Markets ▲	US large caps ▼ US small & mid caps ▼ Japan	UK Europe
Fixed Income	Underweight	Trade Finance US High Yield ▲ Emerging Markets debt (in \$) Emerging Markets debt (in local currencies) ▲	US Investment Grade Corporates ▼	Sovereigns
Real Estate/ Illiquids	Neutral	Real Estate Gold ▲	Hedge Funds Energy Industrial Metals	Private Equity Agriculture
Cash		Emerging Local currencies ▲	US \$ ▼ Yen Swiss Franc Euro ▲	British Pound

An UPDATE on our 2019 Investment Themes



THEME 1: Equity versus Fixed Income

As mentioned earlier, we do not see the US and other developed economies heading into recession in 2019. We do not believe that a financial crisis similar to 2008/9 is in the cards. Moreover, a rise in inflation triggering excessive monetary tightening does not look likely either. As such, we expect decent economic growth with moderate inflation in 2019, a context which is usually favorable to equities.

Equity valuations are more attractive than Fixed Income as illustrated by the risk premium (e.g around 350 basis points in the U.S, a level historically consistent with 10%+ 12-months returns for U.S equities).

UPDATE: Our call to overweight equities over fixed income proved to be right in H1. However, maintaining an overweight stance to equities after such a rally is never an easy task. We however stick to our preference for equities over fixed income but warn investors that volatility (and the likelihood of correction) is likely to increase going forward. This will be the price to pay to be allocated to equities in 2019.



THEME 2: High free cash flow yielders

As liquidity is drying in the market, the key is to avoid illiquid instruments as much as possible. When it comes to allocating to equities and credit, the focus should be on companies with strong balance sheets and generating sustainable, high free cash flows.

We do like in particular global stocks trading at an attractive high free cash flow yield. In a world of high debt levels, we also feel that avoiding companies with high leverage will pay off over time.

High quality free cash flow yielders can be found in all sectors but are more frequently represented in Healthcare, Technology and Consumer sectors.

UPDATE: This theme worked well in H1. Our call is intact.



THEME 3: Growth stocks

With growth slowing down, investors will pay a premium for growth – we thus expect US growth stocks to perform well in this context.

At the end of 2018, Large Cap Tech stocks were looking cheaper as the FAANGs lost more than a \$1 trillion of market capitalization in Q4 2018. Short-term forecasts are challenged but the long-term thesis is intact.

Within defensive growth, Large-caps Pharma and Medtech continue to offer attractive growth rates at a reasonable price and will most likely be favored by investors looking to get exposure to equities without being too much exposed to the macro-economic cycle.

UPDATE: Growth outperformed value during H1 and the FAANGs performed strongly. We do believe that valuations of growth stocks look stretched now and fund flows are pointing towards some over-optimism for this theme. Some caution is thus warranted but we believe that pull-backs are buyable.



THEME 4: Opportunities in trade war casualties

Trade war was among the main culprits behind the rise in market volatility last year and remains investors' biggest concern.

Our base case is for the US to back down on some of the measures that have been taken in its trade war with China. In turn, China will be willing to make concessions on intellectual property rights, technology transfer and foreign ownership of Chinese companies.

As a lot of bad news on Trade have already priced in, any good news on Trade could trigger a re-rating of some of the "Trade war" casualties. This includes Asia-ex Japan equities – and Chinese domestic stocks in particular.

But European stocks have also been suffering from the rise in Trade tensions. For instance, the DAX index lost 22% in 2018 and companies such as German cars could benefit from any relief on the Trade war front.

UPDATE: While there is still no firm resolution on the U.S-China Trade war front, the market is starting to price in some kind of agreement between the two super-powers. As anticipated, China equities are benefiting from this renewed optimism. For sure, any disappointment on the Trade war front would lead to a brutal correction in Chinese stocks. But as mentioned earlier, we expect some progress and this should continue to support the theme.



THEME 5: Pro-growth policies

The pro-growth policies implemented by President Trump in the U.S are creating some "neighbor envy". As the European continent is facing structural economic issues and 9-10% unemployment rate, anti-establishment movements came back with a vengeance in 2018. In March, Italy kicked off the move with the rise to power of the populist Five Star Movement and The League. In Germany, Angela Merkel will step down in 2021. France and UK have their own problems. Ultimately, we believe that European politicians will try to buy off voters with more fiscal stimulus.

In a certain sense, President Trump's economic policies may be exported not only in Europe but also elsewhere – e.g China recently announced that they are targeting a fiscal policy stimulus of 1% of GDP in 2019. Following the path of the U.S already happened before – e.g when the US slashed its tax rate in 1986, everyone followed afterwards.

The implementation of pro-growth policies in Europe and China could trigger a rebound of these two under-performing markets.

But the implementation of pro-growth policies could also continue to take place in the U.S. For instance, infrastructure spending has been much slower to materialise than many expected, but this could well be a key element of President Trump's growth strategy ahead of the 2020 elections. In such scenario, U.S Industrial stocks would benefit.

UPDATE: We haven't seen much progress on that front as monetary policy easing took the front seat in H1. We still expect to see some positive developments on the "pro-growth policies" theme later this year.



THEME 6: GCC bonds

2018 was a bloodbath for Emerging Markets bonds. While they tend to trade at tighter spread than US high yield this has been reverted at some point in 2018. Within EM bonds (in dollar), we do like GCC issuers for the following reasons.

First, GCC fundamentals are among the strongest in the world. GCC currencies are stable and pegged to the U.S dollar, GCC have low debt levels, ample foreign reserves and benefit from fiscal stability. This is in sharp contrast with many other emerging markets which are currently struggling with their currencies (due to the global dollar shortage situation), face widening budget deficit, depleting foreign reserves and rising debt levels.

4 out of 6 GCC countries are currently investment grade. According to the Net Foreign Assets methodology used by the IMF, these 4 GCC countries (UAE, KSA, Qatar and Kuwait) are among the wealthiest in the world, ahead of most G7 countries.

Before the oil crisis, GCC bonds suffered from very little interest by international investors. One explanation was the lack of issuance – indeed, that GCC sovereign and quasi-sovereign issuers didn't have to tap the bond market. Since then, the situation has evolved as GCCs are progressively issuing bonds.

Another reason for the low representation of GCC bonds in global portfolios was the fact that GCC bonds were not part of the JPM EM bond index given that the GCC average per capita income is much higher than EM. But this is changing as well as JPM has tweaked the classification. In January 2019, JPM EM bond index will start to progressively include GCC bonds which means that \$60 billion of passive and active flows should be expected. Over time, GCC is expected to be 18% of the index, on par with EM Europe and EM Asia.

Last but not least, GCC bonds are underpriced – in part because of the under-representation in indices as mentioned above but also because of a geopolitical risk premium. The spreads GCC bonds are currently trading at do not reflect the strength of the fundamentals and we believe that these spreads should tighten.

UPDATE: A GCC sovereign bond index returned roughly 10% in H1. While we don't expect similar capital appreciation going forward, we still like this particular segment of fixed income.



THEME 7: US Corporate Investment Grade bonds

The US corporate bond market posted negative returns in 2018 as falling prices within investment grade and high yield more than offset coupon income.

Over the last few months, investors have been concerned by the high levels of corporate debt in some sectors, the relatively high proportion of companies which are in the investment grade universe but at risk to being downgraded to the high yield universe and the rising risk of recession.

As discussed earlier, we do not expect a US recession and we think the extent of interest rate increases will be quite modest (maybe one 25 basis point increase in the Federal Funds rate in 2019 if any).

Furthermore, for investment grade companies, the degree of leverage is not particularly high by historic standards and the coverage of debt interest payments by earnings is comfortably high. The yield on US investment grade corporate debt, which increased to 4.4% in late 2018 looks attractive to us. We think that yield is a fair compensation for the risks involved and that yields will not rise significantly further in 2019.

We think that positive returns will be seen in 2019. Nevertheless, this is a market where investors need to be selective and we are thus recommending an active management and individual security selection approach.

UPDATE: The spread compression in H1 went beyond our expectations. The capital appreciation potential seems limited from current level but it is still possible to identify some attractive relative value opportunities.



THEME 8: Trade finance

As highlighted in previous edition of Perspectives, Trade finance loans represent a unique asset class that provides investors with decent income as well as significant portfolio diversification. The combination of floating rate income, collateral security and low duration means that trade finance loans can act as a shield against the possibility of rising interest rates in the current rate environment while at the same time offering the security of assets that are backed by collateral.

While they have been the preserve of commercial banks for many years, trade finance loans are now more easily accessible thanks to the deleveraging and greater syndication efforts from banks. Still, the biggest challenge remains the effort required from mainstream investors to climb an initially steep learning curve. To this end, specialized fund managers offer the best access to this compelling asset class.

UPDATE: The thesis remains intact

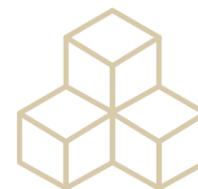


THEME 9: Multi-assets investing

2018 proved to be a very difficult year for asset allocators and multi-assets funds as 93% of the main asset classes ended in negative territory – the highest level ever. We do not expect such a scenario to repeat in 2019 and would thus advise investors to get exposed to the market through a diversified strategy. In this context, multi-assets funds can be a very useful instrument for those investors who do not seek to manage their asset allocations by themselves.

We believe multi-asset investing can offer our clients four key benefits: 1) Multi-asset funds can help you targeting specific and measurable investment outcomes (e.g a targeted return p.a); 2) Multi-asset funds are managed dynamically; 3) Multi-asset funds quickly adapt to markets using enhanced capabilities; 4) Multi-asset funds give you access to “best-in-breed” investment managers.

UPDATE: After a dreadful Q4, the first half of the year was outstanding for the multi-assets funds which stayed invested. Our diversification thesis remains intact



THEME 10: Blockchain

While 2018 was a bloodbath for crypto-currencies, blockchain technologies continue to be adopted. Indeed, the global blockchain market is anticipated to grow to over \$60 billion by 2024 as more companies adopt distributed ledger technology and mass-use cases appear. Very much still in the infancy stage, blockchain technology is currently being explored and adopted by global industry titans such as IBM and Softbank.

Additionally, thousands of innovative companies around the world are trying to solve market inefficiencies by leveraging the benefits that blockchain technology provides. These companies can be found in every industry, from content creation and transportation to financial services.

The blockchain ecosystem flourishes due to tokenized economies, developers, service providers and entrepreneurs who are breaking the mold.

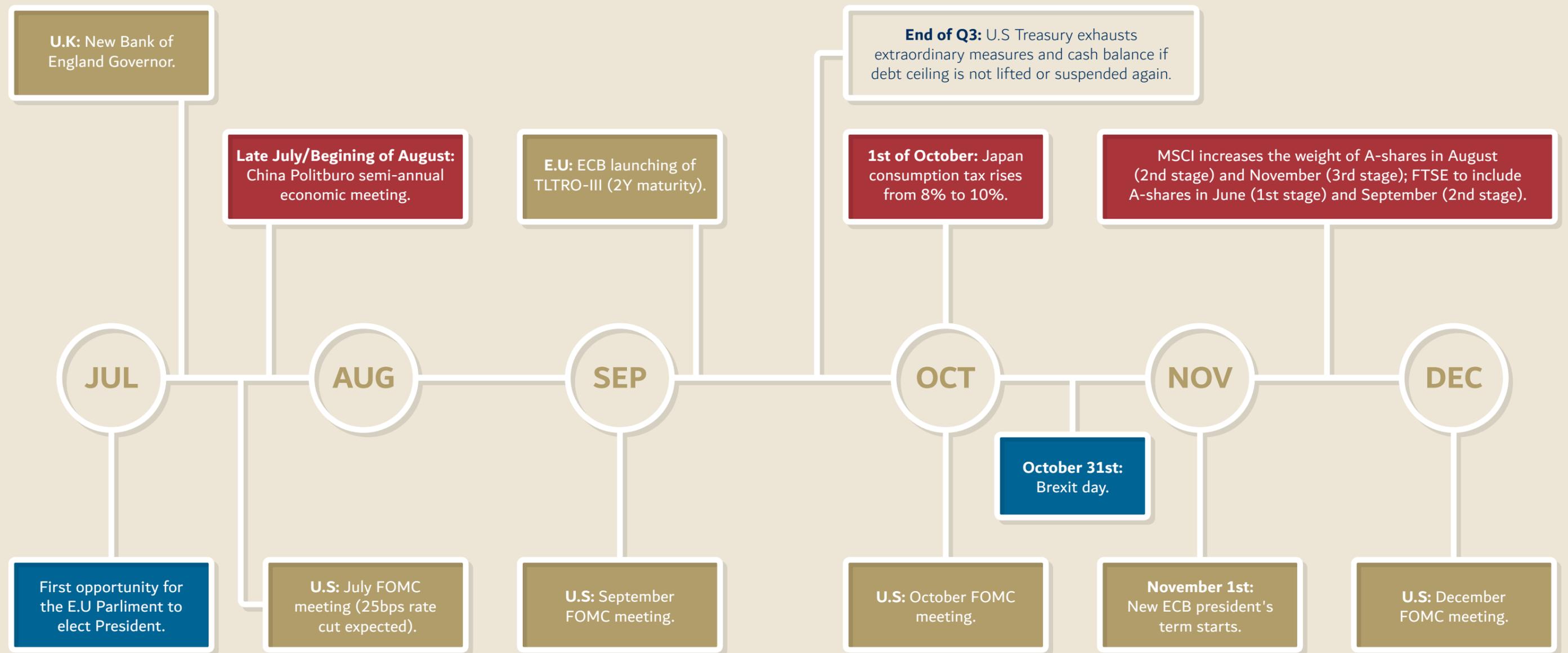
We are exploring ways to enable our clients to get exposed to this very promising theme.

UPDATE: The thesis remains intact – we are seeing very strong progress in terms of crypto-assets institutionalization and the range of products exposed to blockchain is expanding at a fast pace.

Key geopolitical risks to watch in H2 2019

Financial markets will have to climb a wall of worry in the second half of 2019. Below, we highlight what we consider to be the **TIMELINE OF KEY GEOPOLITICAL RISKS** to watch in second half of this year.

For sure, the highest risk is the “unknown unknown”. Another important point is that slowing down of global growth means that financial markets are more sensitive than before to any type of shock and this implies that volatility is here to stay.



Middle East equities: The first half of 2019 in the rearview

First Half & Second quarter Market review



MENA equity markets

At one point in the May selloff, the benchmark for MENA equity markets was down -4 per cent on a quarter to date basis but a rebound in June enabled the S&P Pan Arab Index to close the quarter in positive territory. Kuwait was the best performer in MENA this quarter, adding 7 per cent which brings its year to date gain to 20 per cent. The much-anticipated upgrade to 'Emerging Market' status was announced by MSCI, effective May 2020.

The smaller markets of Tunisia, Bahrain and Morocco came next with decent performances of around 4 per cent during the second quarter. Qatar managed to recover all of its first quarter losses and is now in positive territory for 2019.

Saudi Arabia – the biggest market in terms of index weight – closed exactly flat for the quarter. May saw the first phase

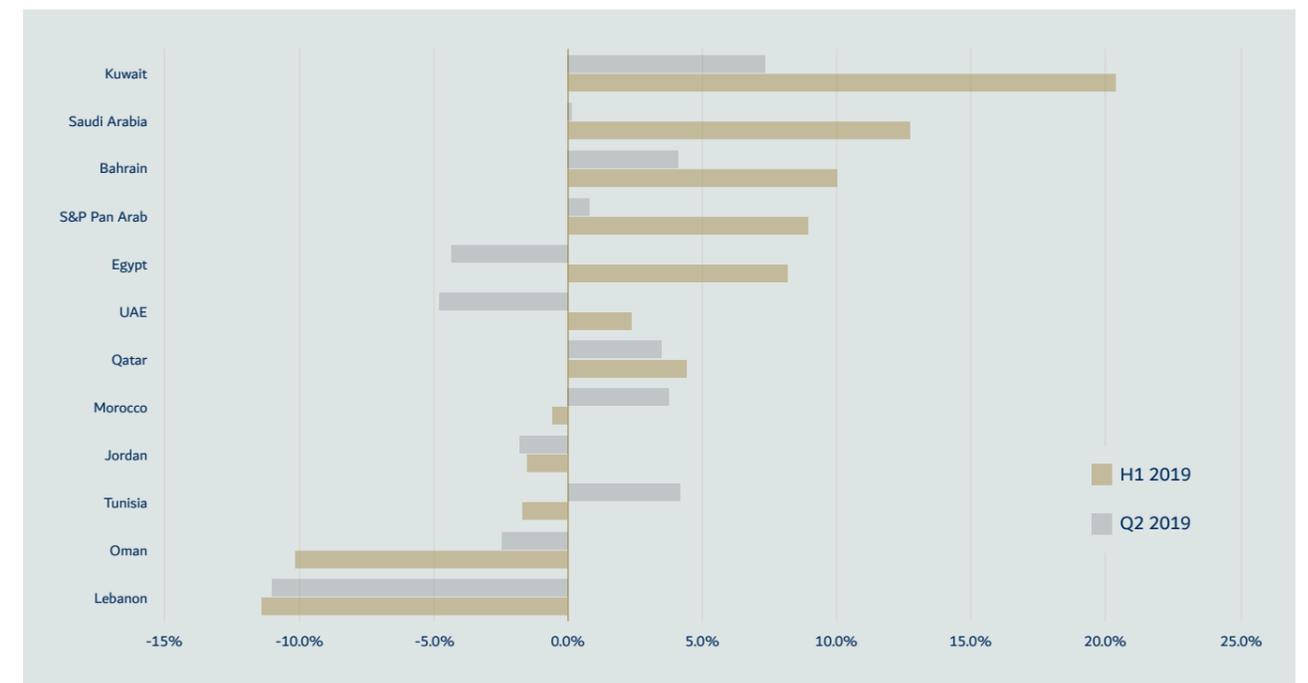
of passive money flowing in from MSCI trackers.

The UAE once again underperformed the wider S&P Pan Arab Index - however there were marked difference between Abu Dhabi and Dubai.

Egypt, which did very well during the first quarter gave back some of the gains (-4 per cent), as inflation stayed due to electricity price hikes and fuel subsidy reforms. The worst performing market in MENA in the second quarter and the first half was Lebanon.

On a year-to-date basis, the S&P Pan Arab was up 8.9 per cent. Kuwait was by far the best performing country with a 20.4 per cent gain ahead of Saudi Arabia (12.7 per cent). Egypt performed in line with the broad S&P Pan Arab while UAE underperformed.

MENA equity markets performance in Q2 2019 and H1 2019



Al Mal Mena equity fund performance in the second quarter and the first half

The fund performance in the second quarter was flat (-0.4%). The slight underperformance is a result of the underweight in the two markets – Saudi Arabia & Kuwait - which have continued their run based on non-fundamental factors. To our opinion, this beta rally is on its last leg.

It is worth highlighting that the S&P Pan Arab index now stands at 800 points which is just 3% shy of the 4-year high,

achieved at a point when oil prices were much higher.

At a PEG ratio of 1.6x, the focus should soon shift away from the 'index inclusion' theme to pure stock picking stories.

On a year to date basis, the Al Mal Mena equity fund is up 7.5 per cent against 8.0 per cent for the benchmark (last NAV date in the first half is as of 26th of June).

Macro Highlights: Signs of Divergence

With most markets in MENA having now reported their Q1 GDP results, a better picture is emerging on the trajectory of the regional economy as we start the second half of 2019. When looking back over H1, we can see clear signs of a divergence in local business cycles. Encouragingly, some of the largest regional economies – including Saudi Arabia, the UAE and Egypt – are all showing signs of an acceleration in consumption and investment. In contrast, the picture is less flattering for the rest of the non-GCC universe, as several of MENA's smaller economies, such as Morocco, Tunisia and Lebanon have all shown signs of a softening in activity.

A rebound in the GCC's two largest economies...

Saudi Arabia's Q1 GDP growth came in at 1.6 per cent y/y, which was slower than the 3.5 per cent and 2.4 per cent rates of expansion that were posted in Q4 and Q3 2018. Growth in the oil sector slowed sharply to only 1.0% y/y in Q1 from 5.9 per cent in Q418, and with OPEC having recently announced an extension to its production-cut agreement through the end of 2019, the sector is likely to remain a headwind on the broader economy this year.

That said, it can certainly be argued that while the overall pace of growth has slowed, the quality of Saudi Arabia's economic recovery has actually improved. In particular, non-oil private sector growth came in at 2.3 per cent y/y in the first three months of 2019, representing the fastest pace of expansion since the fourth quarter of 2015. Looking at the data from an Expenditure perspective, it is also encouraging that government spending was not the main factor driving consumption and investment higher, but rather, it was household spending and business investment. When seen within the wider context of a host of high-frequency macro data (including trends in private sector credit, POS data, new mortgage lending, etc.), it becomes

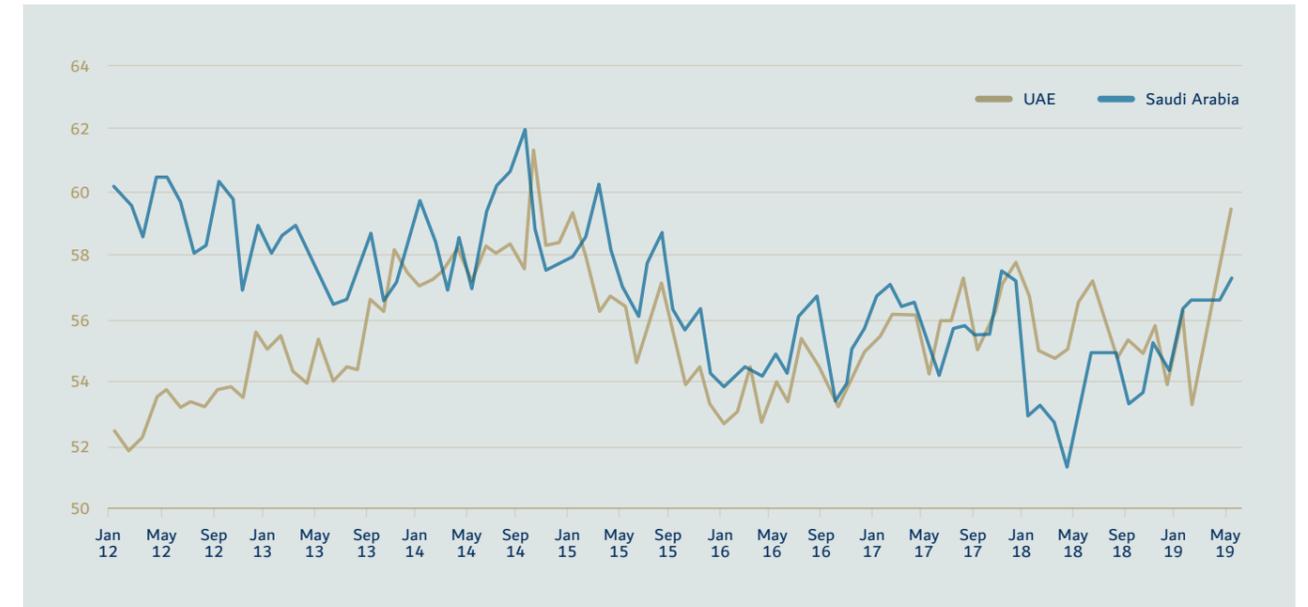
increasingly evident that a recovery is gradually taking hold within the Saudi consumer sector, and likely accelerated through Q2 and into the second half of the year.

A similar turnaround in the business cycle of the UAE has also become evident in recent months. Leaving aside the oil sector which, like Saudi Arabia, will be slight constraint on overall GDP growth, the Augmented Economic Coincident Indicator which is calculated and published by the central bank showed growth in the non-oil economy rising to 1.6 per cent y/y in Q1, compared to only 0.5 per cent in Q418 and Q318 respectively. This pace of expansion is below historical trend, but also indicative of an economy on the mend. Particularly encouraging from our point of view was the strong rebound in employment growth in the first three months of 2019, as there was a net +60k new jobs created in the UAE's private sector in this time period. Other data, including the UAE's Purchasing Managers' Index, have similarly pointed to an uptick in business activity, with the PMI having registered its second-highest reading on record in May (59.4), while the H1 average rose to 56.7 from 55.9 in H118.

UAE non-oil augmented economic coincident indicator



Purchasing manager indices

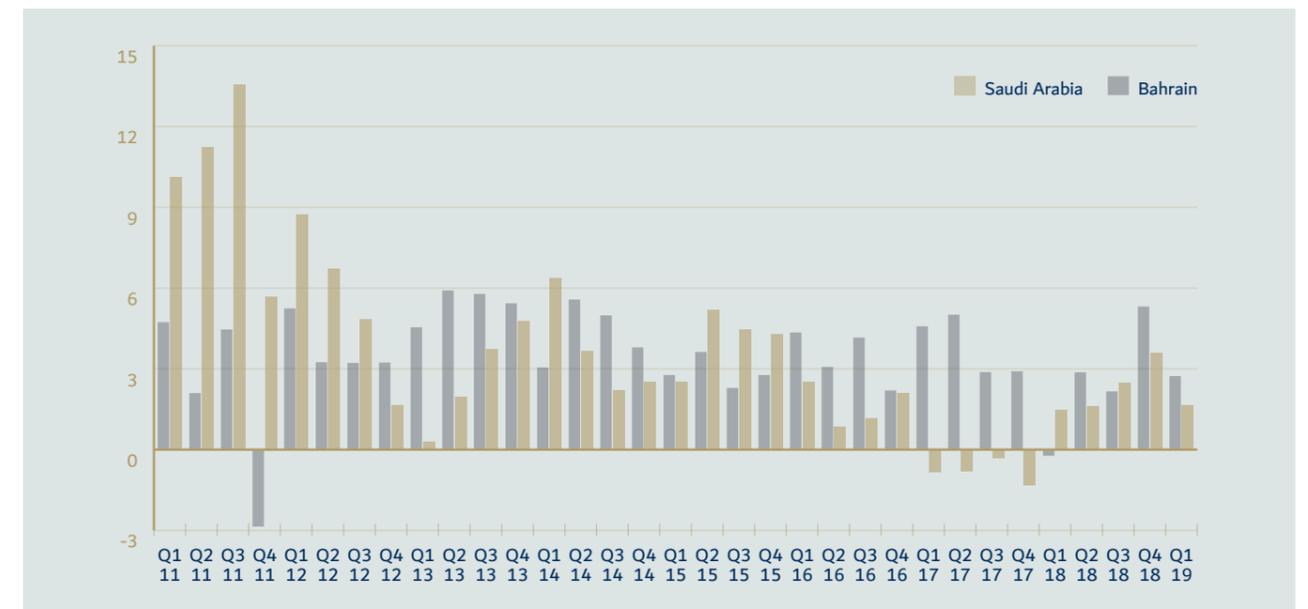


A more nuanced picture in the rest of the GCC...

It is encouraging that the GCC's two largest economies are showing signs of recovery, however the macro picture in the rest of the region is slightly more nuanced. Domestic demand trends in Bahrain stand in contrast to those in Saudi and the UAE, as the country posted real GDP growth of 2.7 per cent y/y in Q1, however this was driven predominantly by the

hydrocarbon sector which expanded 9.2 per cent y/y in real terms, compared to slower growth in the non-hydrocarbon sector of only 1.5 per cent. To the extent that fiscal policy is restrained as part of Bahrain's efforts at containing its budget deficit, slower government spending could continue to pose a downside risk to the non-oil economy in the near term.

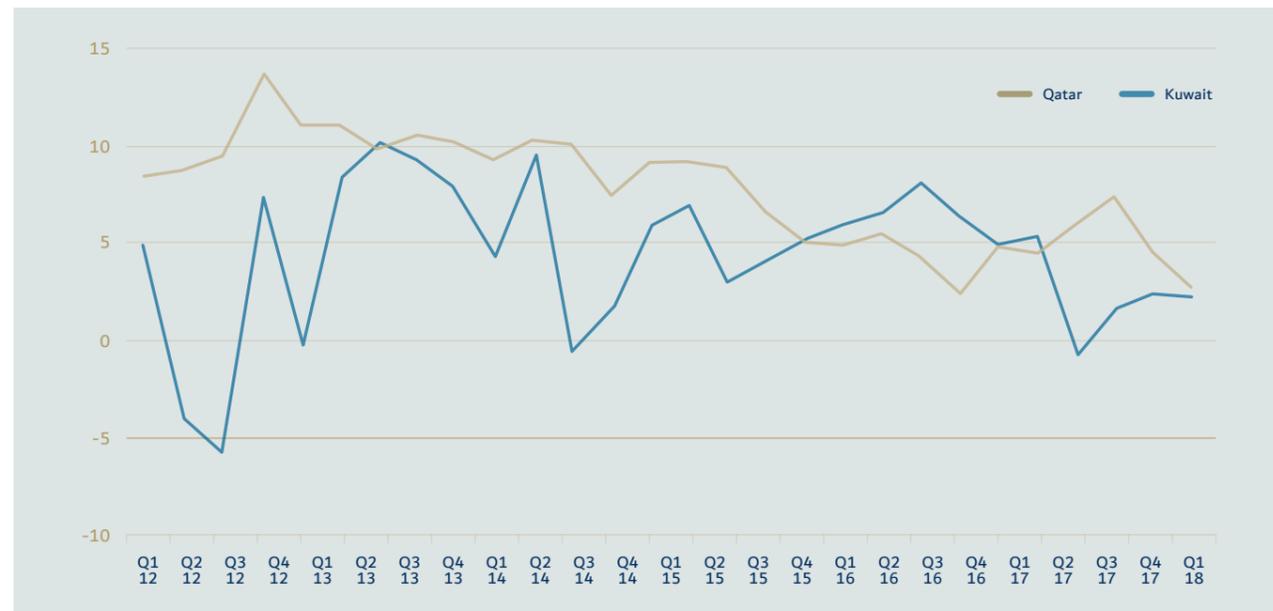
Real GDP growth, % y/y



As we highlight in our Country Spotlight this month, Kuwait's non-oil economy is also expanding at a roughly similar pace of 2 per cent, while Qatar's non-oil economy, having outperformed its regional peers throughout much of the downturn since 2016, is showing signs of slowdown, as the stimulus provided by the

multi-year construction-led boom gradually fades away (at the time of publication Qatar's Q1 GDP data was set to be released). Oman does not release quarterly national accounts data, however the majority of high-frequency data from this economy also tends to indicate a pace of non-oil growth in the low single-digits.

Non-oil GDP growth, % y/y



Non-GCC is underperforming, with the exception of Egypt.

Outside of our immediate vicinity, the picture for much of the non-GCC MENA region is less bullish. Economic growth in Tunisia, for example, slowed to only 1.1 per cent in Q1, representing the weakest pace since the first quarter of 2016. Looking ahead, while a weaker currency is helping the external sectors of the economy such as tourism, it is unclear if significant progress on reform momentum can be achieved in the second half of the year as parliamentary elections are set to take place. Similarly, in late June the governor of the central

bank of Lebanon told an investment conference in Beirut that the economy would likely have zero percent growth in 2019, although he also pointed to the tourism sector as a potential bright spot.

Morocco stands somewhat apart in this regard, as while real GDP growth was only 0.4 per cent y/y in Q1, this was driven in large part by declines in the agricultural sector (which is still mostly dependent on unpredictable rainfall patterns) and lower public spending.

When looking at some recent developments that are not currently captured by the official Morocco GDP statistics – such as the opening of the largest port in the Mediterranean, as well as ongoing investment by European automakers who are keen on using Morocco as a base for export-oriented manufacturing – then the picture for Morocco becomes more encouraging, particularly beyond the short term.

Real GDP growth, % y/y



There is a notable exception to this trend, however. As we highlighted in our Country Spotlight in our June Perspectives, the Egyptian economy's recovery has been stellar, with headline GDP growth running between 5.0-5.5 per cent currently. There is a lot to like in the Egyptian investment story at the moment, particularly as the combination of the EGP devaluation and ongoing policy reforms support an increase in exports and fixed investment (please see last month's Perspectives for a more detailed analysis).

What about MENA (PT)...

Far outside of our immediate universe, the picture is more concerning. Indeed, the Turkish and Pakistani economies have been showing signs of a sharp macro slowdown as both grapple with emerging balance of payments crises. The recent signing of an IMF agreement should be the catalyst to start Pakistan's multi-year recovery, with the hope being that Fund-mandated policy reforms help stimulate foreign private sector capital inflows (i.e. reduce the reliance on foreign aid), while a weaker currency can help rebalance the current account.

Turkey's economic recovery prospects for the second half are more encouraging, as we suspect the sharpest slowdown in domestic spending (both at the consumer and business level) was seen in the first half. Real GDP growth in the first quarter declined -2.6 per cent y/y, following on from a contraction of -3 per cent in Q418, largely as a result of weaker confidence following the sharp sell-off in the lira in 2018. Notwithstanding ongoing political risks, with the currency recently stabilizing and inflation gradually normalizing, we suspect consumer and business sentiment will gradually improve through the end of this year, while the weaker TRY will continue to support an export-led recovery.

Kuwait MSCI Inclusion Puts Spotlight on Non-Oil Economy

In late June index compiler MSCI announced that it would be upgrading Kuwaiti equities to ‘Emerging Market Status’, a decision which is likely to result in billions of dollars of new inflows into the local stock market. Given the positive role that the ‘Index Inclusion Story’ has played in Saudi Arabia’s investment profile over the past year, MSCI’s decision to move forward with including Kuwait into the index is one of the rare events in this region that can truly be considered as ‘game changing’. With foreign investor interest in the Kuwaiti equity market only set to grow in the years ahead, it will be increasingly necessary to capture an accurate picture of local macro and sector-specific trends, particularly given the relative scarcity of high-frequency data that is available on this market compared to the rest of the MENA and GCC region.

When formulating a view on the wider Kuwaiti economy, taking into account the hydrocarbon sector is clearly a necessary starting point. Whether measured as a percentage of GDP (47%) or share of export receipts (90%) and fiscal revenues (90%), there is little denying the overwhelming role of the oil sector. Through the first half of 2019, oil output was effectively flat in year-on-year terms, having averaged 2.7mn b/d. With OPEC + Russia having agreed at the end of June to extend, but

not deepen, their production cut agreement through 2019, it appears that the oil sector will only be a slight drag on the economy this year. Assuming crude output in H2 remains at current levels, which is already slightly below Kuwait’s quota as part of last year’s agreement, then overall production in 2019 will decline by an estimated -1.0 per cent. This is a headwind on the economy, but not one which would result in a fundamental reassessment of the country’s investment profile.

Kuwait oil production, mm b/d

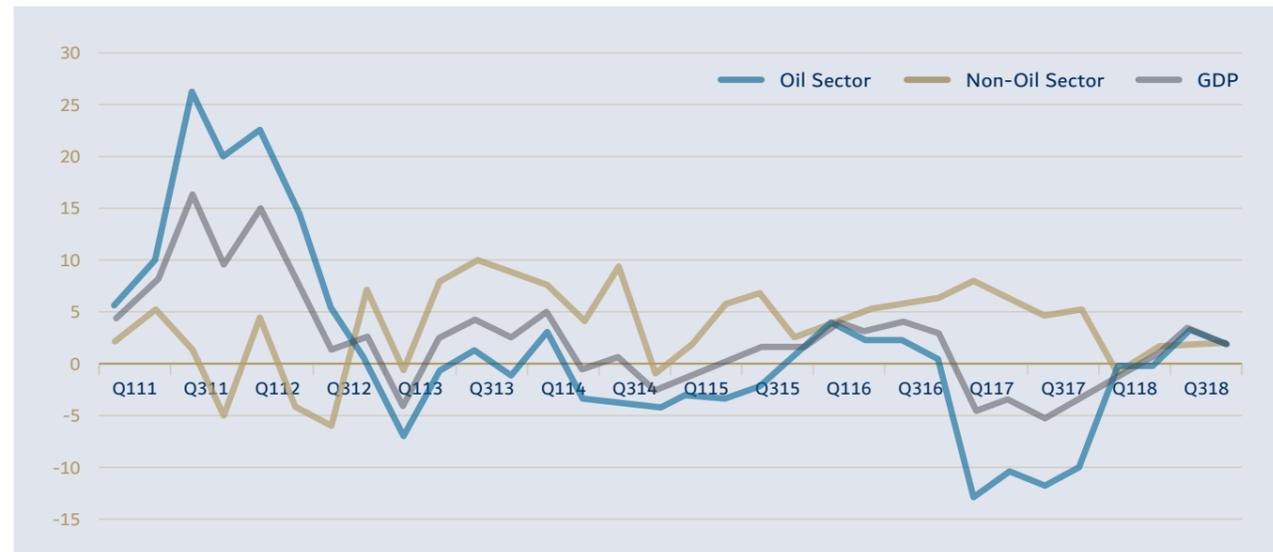


Non-Oil Growth Matches Regional Trend...

Within the non-oil economy, growth momentum has slowed over the past year, although the pace of expansion is broadly similar to what we have witnessed across the rest of the GCC. Indeed, non-oil GDP expanded 1.2 per cent y/y in 2018 (and 2 per cent y/y in Q4), compared to an estimated 2 per cent and 1.3 per cent in Saudi Arabia, and the UAE. That said, if we lengthen our time horizon back to when the decline in global oil prices began in 2015, it is clear that Kuwait's economy was a relative outperformer, having notched non-oil growth of 5.3 per cent and 6 per cent in 2016 and 2017 respectively.

The largest contributor to non-oil growth in recent quarters has been found within the 'Other Services' sector of the economy, which accounts for 11% of GDP, and expanded by an impressive 14.4 per cent y/y and 10.3 per cent in Q4 and Q3 of 2018. Growth of over 10 per cent was also posted within the 'Hotel & Restaurant' sector last year, although the industry only accounts for roughly 1 per cent of the economy at this stage. The second half of 2018 also saw an encouraging rebound in the Construction sector, which grew 6.2 per cent y/y in real terms in Q4, and points to a potential acceleration in fixed investment.

Kuwait real GDP growth, % y/y



More up-to-date figures are somewhat encouraging. Private sector loan growth is currently running around 5 per cent y/y, which is the fastest level in two years. Unlike other central banks throughout the GCC, policymakers in Kuwait did not follow the U.S. Federal Reserve in 2018 and refrained from tightening monetary policy (a higher base rate of 3 per cent mitigated risks associated with potential capital outflows),

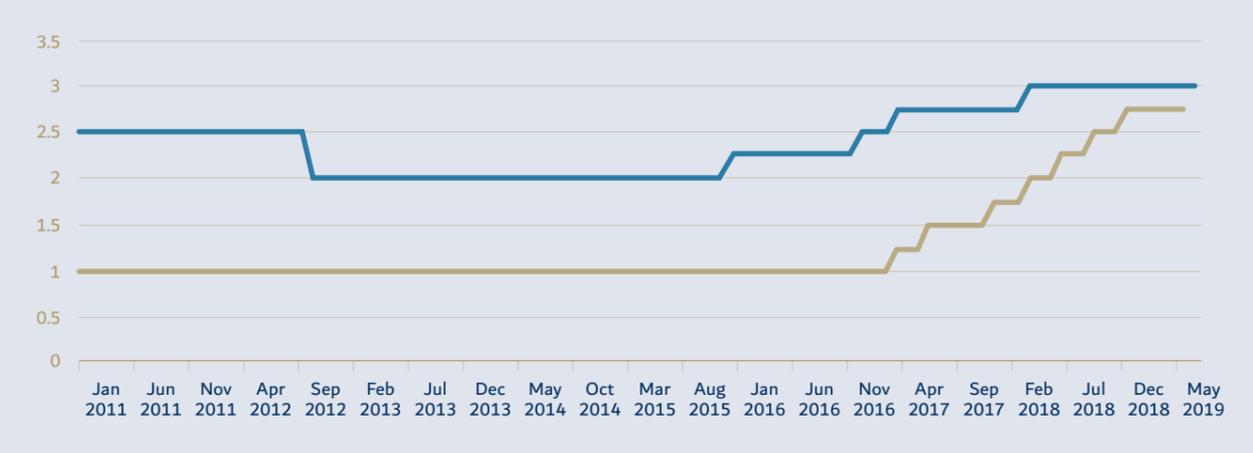
and that appears to be paying dividends now through stronger loan growth. In addition, through the first four months of 2019, remittance outflows to Pakistan and the Philippines rose by a combined 10 per cent y/y to a three-year high of USD531mn, indicating a potential strengthening in the non-oil economy given the large share of expatriate labor.

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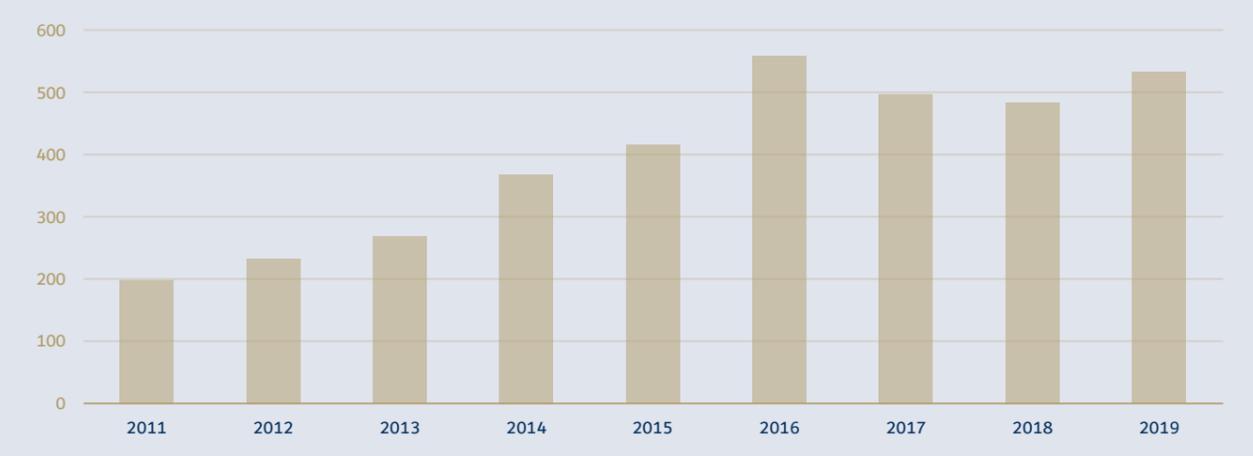
Kuwait claims on private sector, % y/y



Key Policy Rates, %



Remittances to Pakistan and Philippines, USDmn, Jan-Apr



Diversifying Revenue Streams is a Challenge...

Despite recent volatility in oil markets, global energy prices remained stable in the first half, having averaged USD66/bbl, compared to USD71/bbl in the first half of 2018. The lack of diversification in export and fiscal revenue streams undoubtedly leaves the economy more exposed to swings in global oil prices. Theoretically however, even in a worst-case scenario of lower-for-longer oil prices, Kuwait would have little difficulty in raising financing given still low levels of government debt (estimated at 15 per cent of GDP), as well as an extremely robust sovereign

credit profile (see discussion below). The challenge, in our view, will not be found in foreign investor appetite for financing any potential fiscal or external shortfalls, but rather, in the potential for a lack of domestic reform momentum. Indeed, Kuwait's parliament has yet to pass a new debt law which is necessary for issuing new sovereign paper, which has forced authorities to cover short-term financing shortfalls by drawing down on funds accumulated within their General Reserve Fund (which is managed by the KIA).

General Government Gross Debt, % of GDP



Sovereign Wealth Assets are a Strength and a Weakness...

Difficulties in passing a new debt law, which in the broader context of possible economic reforms can be considered relatively straightforward, is important as it might also signal the potential for slower progress in other reform areas. Indeed, unlike the UAE, Saudi Arabia or Bahrain, Kuwait has not yet implemented a VAT, while recent plans put forward by the eldest son of the Emir to construct an economic free zone (known as 'Silk City') that would have administrative, legal and judicial independence similar to Dubai's DIFC, appears to be facing stiff opposition from parliament. With one of the highest levels of GDP per capita in the world and large pools of national savings, the main economic challenge for Kuwait is perhaps a lack of urgency.

Despite the challenges associated with implementing a wide-

ranging diversification agenda, the FX earnings that have accrued over the years from hydrocarbon exports have been so large as to mitigate the very risks that are often associated with commodity-based economies. Since global oil prices began to fall in 2015, sovereign credit ratings throughout the GCC have dropped in tandem, and this has included numerous downgrades for Bahrain and Oman (both of which are now classified as 'non-investment grade'), but also Saudi Arabia (e.g. S&P has downgraded KSA's rating by three notches). In contrast, Kuwait – despite being amongst the most dependent on hydrocarbons to generate FX earnings – has not had its sovereign credit rating downgraded once throughout this period and retains one of the highest ratings in the region alongside Abu Dhabi at AA/Aa2.

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FINAL WORDS

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Late-cycle expansions are often associated with elevated equity valuations, tight credit spreads, and financial excesses. While these conditions can create vulnerability, history also demonstrates that late-cycle equity returns can be very decent – albeit volatile.

In our view, the second half of 2019 is unfolding much like a funambulist walking a tightrope. The path for risk assets to move higher is becoming narrower with considerable risks attached to it. However, it remains manageable and best addressed through a diversified and selective portfolio management approach.

One very positive development on our side last month was the launch of our UCTIS Luxembourg fund co-branded with Azimut, one of the leading European asset managers. Al Mal Capital is the sub-adviser of this fund which follows the same investment process than our highly successful Middle East equities strategy.

While our forecasts 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 like to discuss, so please do not hesitate to contact us.

