



Global Markets: A Tale of Two Bulls



Global Markets:
The risk of recession
is mispriced

Hot Topic:
The active versus
passive debate

Middle East Equities:
Positive developments
in the GCC

Investment Theme:
Opportunities in
EGYPT

Contents

Global Markets:

The risk of recession is mispriced Page 2

Hot Topic:

The active versus passive debate Page 10

Middle East Equities:

Positive developments in the GCC Page 18

Investment Theme:

Opportunities in EGYPT Page 24

Welcome to the 26th edition of Perspectives.

For much of this year, risk assets have enjoyed a healthy climb, helped by a dovish tilt from major central banks and hopes of a trade deal between the US and China. But as we entered May, volatility came back with a vengeance. Both global and Middle East equity markets gave up some of their year-to-date gains while bond yields continued to surprise on the low side.

In the first part of this publication, we try to assess what is currently priced by the market in terms of global recession risk. At the time of our writing, the U.S 10-year treasury yield is trading at 2.1% and the three-month to 10-year curve is slightly inverted, which seems to indicate that the market is priced for recession. *We don't buy the current bond market panic and explain why we believe investors should keep some exposure to risk assets.*

In the “Hot topic” section, we make the case for Active management, arguing that asset allocators should balance their portfolios between passive and active instruments in a smart way.

In the second part of this June edition of Perspectives, we shift our focus towards investment opportunities in the Middle East. While our regional equity markets were not immune to the broader global risk-off sentiment that prevailed in May, recent weeks have seen several developments both globally and locally which have largely gone unnoticed yet are likely to emerge as positive catalysts for the GCC investment climate through the second half of 2019 and 2020.

The Investment theme of the month is Egypt, a country which has been an overweight position in our Middle East and North Africa equity portfolios for some time now.

We hope you will enjoy this issue.

Disclaimer. This document is provided to you by Al Mal Capital PSC (“AMC”) for informational purposes only, and contains proprietary information that may not be publicly distributed to, or used by you, or any third parties without AMC’s prior written consent. All figures and numerical representations appearing in this document have not been audited and any references to AMC and returns are indicative only. Although all information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, no representation or warranty, express or implied, is made by AMC as to its accuracy or completeness. AMC and any of its affiliates make no guarantee, assurance, or representation what so ever as to the expected or projected success, profitability, return, savings, performance, result, effect, consequence, or benefit (either legal, regulatory, tax, financial, accounting, or otherwise) of any instrument, product, strategy or service described here in this document.

Global Markets: A Tale of Two Bulls



2018 proved to be a very challenging year for asset allocators. Indeed, as nearly 95% of asset classes recorded negative returns, the median performance for diversified strategies was around -5%. So far, 2019 proves to be a very different year. At the time of our writing, a naïve strategy invested 50% in long-term U.S Treasuries and 50% in the S&P 500 would have returned around 12% year-to-date, not a bad result when you consider all the negative news which have been dominating the headlines over the last few months.

There is indeed a tale of two bull markets.

On one hand, U.S Treasuries 10-year yield is trading around a two-year low and is nearly pricing in a recession. Indeed, the 3 month - 10 year US Treasury yield curve is slightly inverted and the futures prices imply 65 basis points of expected Fed easing during 2019 and an additional 30 bps of easing during 2020, reflecting a total of 4 rate cuts by the end of 2020 (see GS chart below).

Futures market pricing Fed easing (source: Factset and Goldman Sachs)



Meanwhile, the universe of negatively yielding bonds across Global Bond Markets has expanded further to \$11.3tn, the highest level since 2016.

The drop in bond yields and the inverted yield curve haven't triggered any panic on the equity market. Quite the contrary as the S&P 500 has been recovering much of its May pullback and is hovering close to its all-time high (see chart on the next page).

S&P 500 versus U.S Treasuries 10-year bond yield



As we get opposing signs from bonds and equities, which market will ultimately be right?

Before jumping to a conclusion, let's try first to understand what is currently priced in on both sides.

When it comes to the **bond market**, U.S Treasuries seem to be pricing in that the U.S-China trade war will dent US and global growth and force the Fed (and other central banks) to ease rates very aggressively.

Recent macro-economic numbers such as PMI surveys or U.S job market seem to indicate that global growth is slowing down significantly and that it would take more than a pause in the rate hiking cycle to extend the current economic expansion. This explains why the odds of a July rate cut in the U.S are close to 80%.

Major central banks are indeed ready to ease rates. We gathered some evidences from Fed Chairman Jay Powell early June when he owed to “act as appropriate” to maintain the current economic expansion. The ECB also mentioned (indirectly) early June that they are ready to cut rates. In an interview with Bloomberg, Bank of Japan governor stated that the G-20 has

room for additional stimulus. Australia has already cut, so has India. China is stimulating its domestic economy as well.

The **equity market, on its side**, is pricing in both policy support and trade hopes.

Basically, global money supply is rising and pushing up stock prices despite weak macro numbers. “Bad economic news” are even becoming “good news” again. As explained in the previous edition of Perspectives, next year is an election year in the U.S and both fiscal and monetary policy are expected to be supportive – i.e the stock market expects both monetary and fiscal easing ahead of 2020.

The drop in bond yields is also fueling expectations of a new wave of share buy-backs in the U.S (through cheap financing on credit markets) and some improvement in the housing markets thanks to lower mortgage rates.

But the equity market is not only betting on Fed easing; it also expects some kind of trade deal to happen.

During the month of May, global equity markets adjusted to the reality of no immediate fix to the trade war. US-China trade talks broke down on May 5. After that, tensions worsened with US export controls on Huawei. The risk of a multiple-front trade war rose, with US threats of tariffs on Mexico in June. The Mexico tariff threat—aimed at getting Mexico to tighten up on flows of Central American migrants—came as a potential game-changer, in signaling that tariffs can

be used as a weapon to address any problem. It pointed to a post-WTO world without reliable rules of the game.

But now that investors' expectations on trade have been reset lower, market participants are expecting a Trade war "truce" (instead of a great deal) to be signed by the U.S and China slightly after the G20 meeting which will take place in Osaka by the end of June.

What is our take on the above? Are the bond and equity markets being both over-optimistic?

On our side, we believe that while one or two rate cuts by the Fed in 2019 are likely to happen, the bond market might have gone a little bit too far in terms of rate cut expectations. **We would thus not buy the bond market panic and continue to avoid U.S Treasuries at this stage.**

On the **equity side**, we believe that **two things need to happen for main indices to progress further:**

First, the Fed should at least match investors' expectations in July and thus start easing at the next FOMC meeting. Based on history, 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. However, should Powell and the Fed disappoint markets, be prepared for a major equity market pullback. Indeed, since 1988, on 13 occasions the futures market expected a cut in the funds rate the day

prior to a scheduled FOMC meeting – and all 13 instances, the Fed cut rates. In other words, the Fed has always cut interest rates when the market priced a cut on the day prior to a FOMC meeting. The bar has thus been set very high.

A second condition for equity markets to rise further should come in the form of tangible signs that global growth is in the process of stabilizing. A strong signal would come from a kind of Trade deal between the U.S and China. It does not need to be a "perfect deal" as it was expected at the start of the first quarter. What the market needs is negotiations resuming after June's G20 summit, leading to a deal in late 2019 / early 2020. Should it happen, investors will look beyond earnings hit this year and start to anticipate an improvement in 2020. This should help the equity market to record moderate gains. But in the case of negotiations failing and U.S/China entering into a full-blown Trade and Tech war, business and consumer confidence are likely to collapse with dramatic consequences on earnings expectations – and thus stock prices and credit spreads.



On our side, we believe that while one or two rate cuts by the Fed in 2019 are likely to happen, the bond market might have gone a little bit too far in terms of rate cut expectations. **We would thus not buy the bond market panic and continue to avoid U.S Treasuries at this stage.**

INVESTMENT IMPLICATIONS

Our base case is for global economic growth to slow down though economic expansion remains intact. Corporate earnings are expected to rise very modestly but central bank easing and some kind of trade deal should help investors to look beyond 2019 earnings disappointment. We still expect modest gains for equities with higher volatility given ongoing trade tensions and uncertainty about Eurozone growth.

In terms of regional equity preferences, we continue to favor U.S. equities versus the rest of the world. The fall of bond yields has made equities more attractive on a relative basis and might trigger a new wave of share buy-back.

Sentiment is still too pessimistic and earnings expectations are not exaggerated (although the fourth quarter expectations might still be too high). The U.S. is less trade dependent than most countries and has more fiscal/monetary policy space. Domestic economy is still expected to do reasonably well – especially the U.S. consumer who enjoys a low unemployment rate, wage growing by 3% yoy, declining gasoline prices ahead of the summer and lower mortgage rates. That being said, with weaker US growth and absolute valuations still elevated, drawdown risk has increased – hence a modest overweight stance.

We remain cautious on European equities. For sure, sentiment is too pessimistic and global asset allocators remain underweight (both are positive from a contrarian perspective). Absolute valuations are in-line with history and are cheap relative to bonds and international equities. Still, there is a long list of headwinds. First, the Eurozone equity market is going through an earnings recession and we still need to see downward earnings revisions stabilizing. European companies are among the most impacted by the Trade war and further pain could come if the U.S. starts to impose tariffs on European cars exports. While the ECB recently hinted that they could lower rates if growth continues to weaken, the dovish stance is negative for European banks, which are still a decent weight in the index.

The eurozone is also constrained by its fiscal straitjacket, so with high trade dependence and little monetary or fiscal room for maneuver, European growth is vulnerable.

Last but not least, political risk remains high. The Brexit outcome is still highly uncertain and continues to weigh on

business confidence. The Italy risk is here to stay. The European Commission, which is tasked in part with upholding EU treaties, recommended legal action against Italy after it broke the EU's debt rules last year and is likely to do so in 2019 and 2020. The commission stated that Italy hasn't made enough progress in reducing its debt, with officials in Brussels expecting Italy's debt to rise to 135% of gross domestic product (GDP) in 2020 from 133.7% this year. Eurozone governments are mandated to limit debt levels to 60% of GDP. The European Council will now consider whether to start an excessive deficit procedure against Rome, which may eventually result in billions of euros in fines. We believe further escalation between Italy and the EU is very likely later this year, when the Italian government presents its 2020 budget. Italian authorities plan to cut taxes, while the EU will likely request fiscal consolidation for Italy to stay compliant with fiscal limits. Missing budget targets could trigger negative credit rating actions and a widening of sovereign credit spreads later this year.

We would also favor Japan over Europe. For sure, Japan is trade dependent as well and the World Bank recently cut Japan's growth forecast for 2019 to 0.8% from 0.9%, citing the U.S.-China trade dispute as the main reason for the downward revision.

However, the domestic situation remains decent - Japanese unemployment is still low, labor force participation is on the rise, and the services sector appears healthy. Japan equity valuations remain cheap and we note 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. Companies have an abundance of cash, largely owing to ultra-loose monetary policy, but businesses are reluctant to make large capital expenditures. All things being equal, stock repurchases boost a company's per-share earnings and dividend yields.

When it comes to Emerging markets, the impacts of trade war on specific economies depend on two variables: 1) Trade dependence: economies which are highly dependent on trade (and China supply chain) are likely to suffer from a long-term trade war; 2) Policy space: economies with more room to adjust via fiscal, monetary and exchange-rate policy will be more resilient in case of prolonged trade war impact.

Corporate earnings are expected to rise very modestly but central bank easing and some kind of trade deal should help investors to look beyond 2019 earnings disappointment.

So who are the potential winners / losers within EMs? The trade dependence of Emerging Markets varies widely. China's trade dependence has fallen over recent years to 35%, leaving it relatively less vulnerable. Moreover, China can adjust fiscal, monetary and currency policy to maintain growth above 6%.

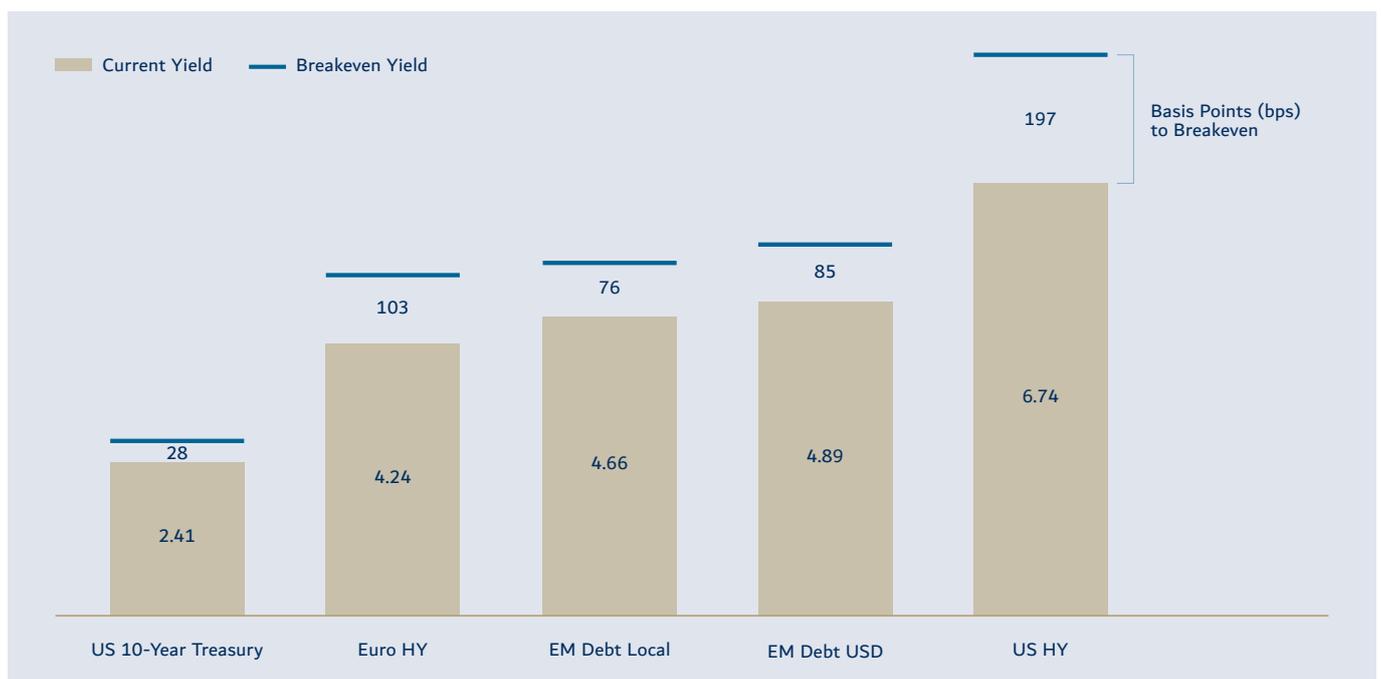
However, the smaller, open economies of East Asia are highly exposed to any slowdown in global trade resulting from the US-China trade war. Countries with strong balance sheets may find the most supportive policy is to allow their currencies to weaken, which helps to explain the recent depreciation of the Korean won and Taiwan dollar. The big question for the rest of EM Asia is the renminbi's trajectory. For now, CNY/USD is stable at 6.9, but the PBOC will not spend reserves to defend a level. If the US carries out threats to tariff all Chinese imports at 25%, some depreciation of CNY/USD past 7 is likely. This will bring broad EM pain.

We note that GCC equity markets should prove resilient in the current context. They are much less trade dependent than most emerging markets and would benefit from weaker dollar and U.S rates cuts (through their dollar peg). Moreover, they have room to adjust fiscal policy.

Within Fixed Income, we avoid U.S government bonds. As mentioned earlier, we believe that the recent drop in long-term bond yields is exaggerated. For hedging purposes, we would favor cash or ultra-short term bonds over long-term treasuries. They offer less duration risk and higher yields than the long end of the yield curve.

In the current benign rate environment, the coupon income from credit asset classes is looking particularly attractive. For instance, rates or spreads would need to rise more than 197 basis points to generate negative total returns in U.S High Yield (see below).

Current Yield versus Breakeven Yield (%) in selected segments of Fixed Income





We note that GCC equity markets should prove resilient in the current context. They are much less trade dependent than most emerging markets and would benefit from weaker dollar and U.S rates cuts (through their dollar peg).

Within **commodities**, tight fundamentals supported **oil prices** through mid-May. But escalating trade wars and weaker activity indicators have finally caught up with the oil market sentiment. The magnitude and velocity of the move were further exacerbated by growing concerns over strong US production growth and rising inventories as well as technical factors. As explained earlier, we do not believe in the recession scenario which means that oil demand should remain decent going forward. Meanwhile, the supply situation remains positive: OPEC is reluctant to increase supply, Venezuela's power outages not only hit its population but also oil production, Iran restrictions remain a positive for oil and instability in Algeria (a big oil & gas supplier to Europe) continue to weigh on the market as well. As such, we believe that Brent oil could potentially move back to \$70-75. But as the US is going through a soft patch, we would be

surprised to see oil moving back quickly to this level. Futures were trading in backwardation early May and the curve is now flat. We expect a move back to backwardation in the near-term.

In Precious metals, rising macro and geopolitical uncertainty, dovish central banks, lower real yield and weaker dollar all acted as tailwinds for **gold price** which is now approaching the \$1365-\$1395 resistance level. We note that it has been a line in the sand for gold for a few years – a significant trigger is thus needed for Gold to break this resistance.

When it comes to **currencies**, the dollar has recently started to weaken. Over the last two years, the dollar has been the winner by default, i.e the U.S economy fundamentals are less than rosy but it is much worst elsewhere. However, there are now some reasons to be more cautious on the dollar:

#1: The Fed is likely to decrease interest rates. As the market is pricing in several rounds of rate cuts in the U.S, the impact on the dollar will depend on what the other central banks do;

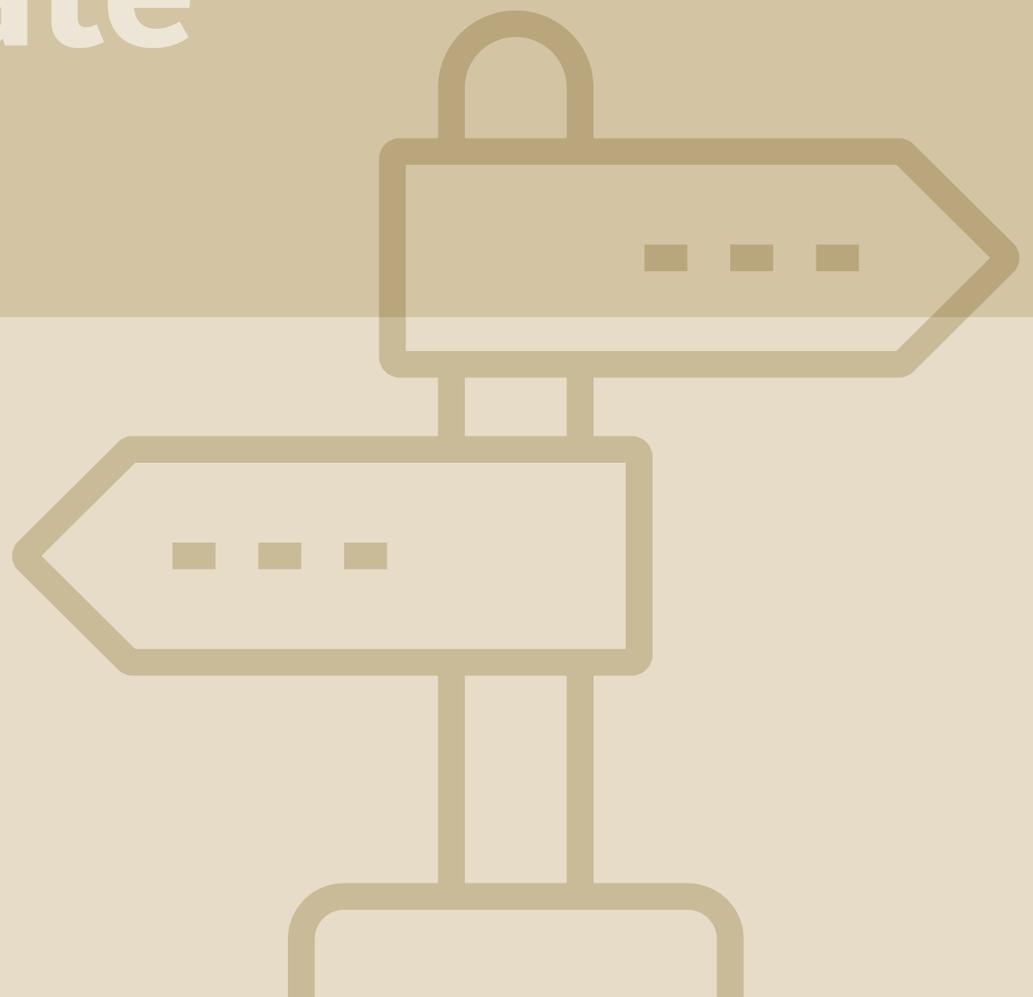
#2: The dollar is over-valued on a PPP basis (this is not a valid timing tool but it does increase downside risk);

#3 Over-optimism: as highlighted in the May edition of Perspectives, speculators increased their net long U.S. dollar bets in April to the highest level since December 2015, according to calculations by U.S. Commodity Futures Trading Commission data released late April. This is exacerbating the downside risk;

#4 Negative divergence: While the dollar index was flirting with new highs at the end of May, it was interesting to see that the dollar bull-run in 2019 has been very different from the one which took place in Q2 and Q3 of last year. This time, dollar highs are 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. The lack of breadth in the dollar advance should thus be interpreted as a negative signal for the greenback.

While all the points mentioned above should be seen as serious headwinds for the dollar, we are not forecasting a major period of weakness for the greenback at this stage. Indeed, for the dollar to decline meaningfully, the following should happen: 1. Global growth should be robust and more evenly distributed; 2. Risk appetite needs to be solid and; 3. Global USD liquidity should rise thanks to improving global trade. As discussed earlier, we are not there yet.

Hot Topic: Solving the Active vs Passive Management Debate



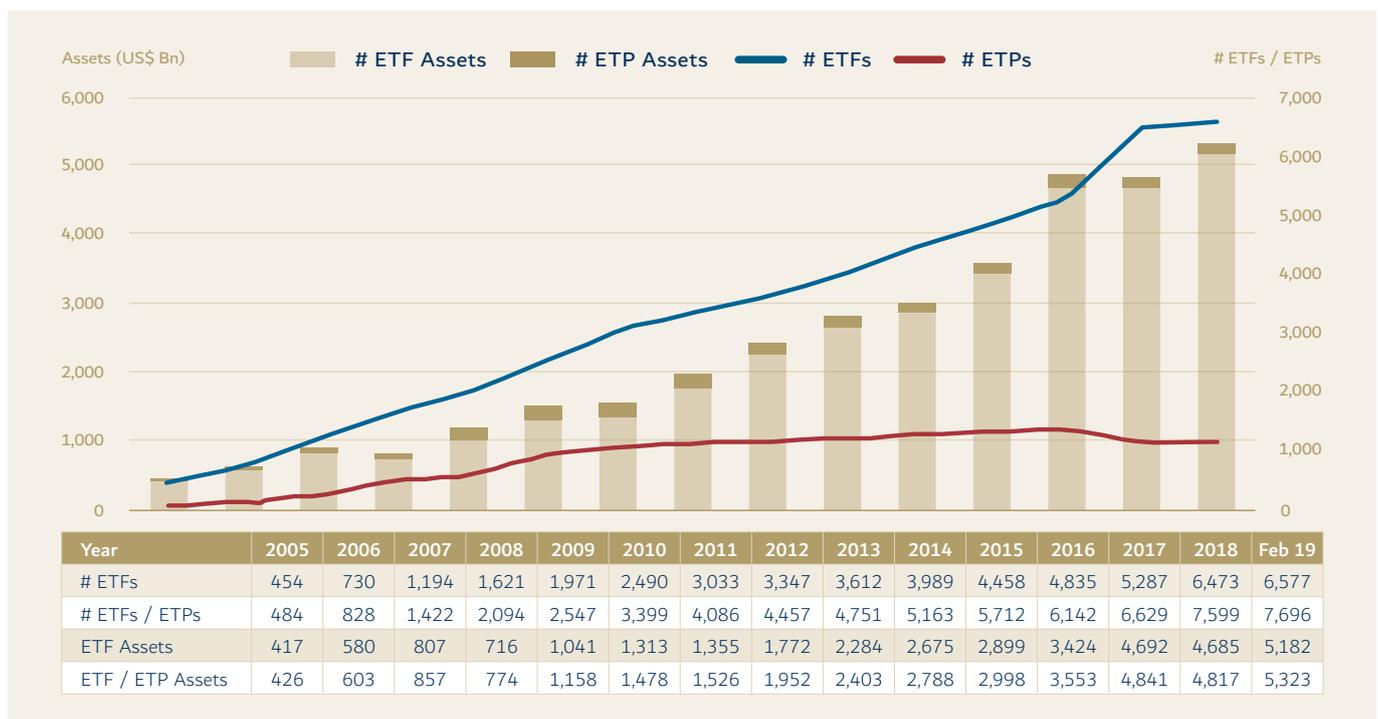
Ever since index funds – also known as passive investments – have existed, there has been an endless debate about their merits versus active management.

Proponents of active and passive investment management styles have made exhaustive and valid arguments for and against both approaches. At Al Mal Capital, we do not endorse one style over the other. Rather, our goal is to understand and define the characteristics of each approach in order to determine which best suits to our client needs.

The basics of active and passive management

The proliferation of passive management strategies in recent years is well known and evidenced by the exponential growth of ETFs or Exchange Traded Funds. As shown on the chart below, as of the end of February 2019, there were almost 7,000 ETFs traded while assets in passive instruments have grown from \$774 billion in 2008 to more than \$5 trillion, a 20% compounded annual growth rate (CAGR).

10 Year ETF & ETP CAGR: 20.1%



Passive investment management attempts to replicate as closely as possible the return on an index (e.g the S&P 500), typically by purchasing the majority or all the securities in the same weighting as the index. The intellectual basis for passive investment management is the belief that over the long term, an active investment strategy cannot achieve returns in excess of the market. This is due to market efficiency and the impact of higher turnover, which leads to higher capital gains taxes and trading costs.

Active investment management does not attempt to replicate an index, but rather purchases securities in different weights than the index in an attempt to outperform the index or some other benchmark. The intellectual basis for practitioners of active money management is a belief that the market is inefficient and individuals who are proficient at stock or sector selection can add value through increased returns above a benchmark index like the S&P 500.

Active and Passive management – pros and cons

<p style="writing-mode: vertical-rl; transform: rotate(180deg); font-size: 2em; font-weight: bold;">PROS</p>	<p>ACTIVE MANAGEMENT</p> <ul style="list-style-type: none"> • Allows managers to exploit inefficiencies • Not forced to own the "bad" stocks • Can be more defensive during market turmoil 	<p>PASSIVE MANAGEMENT</p> <ul style="list-style-type: none"> • Low fees / Low turnover • High certainty of getting the market rate of return • Easier to understand
	<p>CONS</p> <ul style="list-style-type: none"> • Typically higher fees than passive • Mistakes do happen as managers make bad decisions • It is challenging to find managers that beat the market 	<ul style="list-style-type: none"> • Pro-cyclical (most heavily invested in recent winners) • Some ETFs are exposed to counterparty risks • No managerial control exercised during market turnover

As the Table above shows, there are tradeoffs between the costs and potential benefits of the two approaches. Passive management will maintain exposure to the market, but not offer any potential for above-benchmark returns (or down market protection). Active management offers the potential for above-market returns, but comes with the chance that the manager won't beat the stated benchmark.

Historical evidence

Proceeding from the conclusion that both active and passive management are valid strategies, the question becomes where and when is one more appropriate than the other?

At the end of 2009, Baird & Co made an interesting study. They examined several major asset classes to identify which of them are conducive to active management and which are best suited for passive management. To do so, they measured the frequency that the median mutual fund in a given asset class was able to provide excess return above its benchmark (see second column in the Table below). In column 3, they

defined the degree of efficiency of each asset class. Market efficiency is the degree of which asset prices reflect all available information.

As the Table shows, active management probability of success does depend on the degree of efficiency of a market. In efficient markets such as U.S Equities - large caps value or fixed income, the percentage of periods median fund produces excess return is quite low. On the other hand, less efficient markets such as Emerging markets or U.S small caps growth offer high probability of success to active managers.

Active and Passive management – historical evidence (source: Baird)

Asset Class	% of Periods Median Fund Produces Excess Return	Efficient (favouring passive) or Inefficient (favouring active) Asset Class	Market Assets (% Active / % Passive)
Tax-Exempt Fixed Income	4%	Highly Efficient	99% / 1%
Large Value	28%	Efficient	92% / 8%
Taxable Fixed Income	29%	Efficient	79% / 21%
High Yield	35%	Efficient	96% / 4%
Mid Value	40%	Efficient	94% / 6%
Mid Core	43%	Mixed	59% / 41%
Small Value	50%	Mixed	82% / 18%
Large Core	54%	Mixed	46% / 54%
Mid Growth	55%	Mixed	96% / 4%
International	57%	Mixed	69% / 31%
Large Growth	67%	Inefficient	93% / 7%
Small Core	70%	Inefficient	67% / 33%
Commodities	72%	Inefficient	47% / 63%
Emerging Markets	75%	Highly Inefficient	48% / 52%
Small Growth	80%	Highly Inefficient	89% / 11%
Real Estate	90%	Highly Inefficient	63% / 37%

The Baird study caused them to **question whether the marketplace recognizes that some asset classes are more efficient than others** and, therefore, have a distinct bias towards active or passive management. A way to measure that was to determine what percentage of assets in an asset class is invested in active or passive managers (4th column of the table). Surprisingly, some of the most efficient asset classes

are dominated by active management (e.g. in U.S. equities Large and mid-caps value, both over 90% active assets) and many of the least efficient asset classes have a bias towards passive management (e.g. Emerging Markets and Commodities, both over 50% passive assets). This is counter-intuitive and leads to the conclusion that **many investment portfolios are not optimally constructed**.

A pragmatic use of active and passive funds

Our open-architecture philosophy enables us to use active and passive management in a pragmatic way, i.e. we use active management where it has the best chances of success while passive management is used to round out the asset allocation. This approach may lead to optimal portfolios that play into

the strengths of the different investment options. Unlike what most of the industry is doing, we aim to emphasize passive management in the most efficient markets (e.g. government bonds) while active management is usually favored in the less efficient asset classes (e.g. emerging markets).

Top-quartile funds improve the case of active management

On the basis of the poor results experienced by active managers on the most efficient markets, one could argue that active management should be avoided in some markets such as US equities or High Yield bonds. But this hasty conclusion fails to take into account that the results showed in the previous section focused on the performance of the median

mutual fund. Indeed, this outcome changes dramatically when looking at the performance of the top-quartile funds (i.e. performance that ranks in the top 25th percentile of the peer group universe). For example, the average performance of the top quartile fund within U.S. equities - large caps is clearly above the index performance. Here, the success of top quartile

HOT TOPIC

funds greatly improves the case for active management.

While there is no certain way to identify and invest strictly in top-quartile managers, the success rates of average versus above-average managers makes a strong case for trying to identify the best managers. We believe that by conducting thorough research on due diligence on investment managers, it becomes easier to identify which of them exhibit the characteristics associated with consistent, long-term success.

It is by the way interesting to note that performance dispersion (and sustainability) is much more pronounced in the less efficient asset classes than in the more efficient ones (see chart below). This means that identifying the best asset managers in the less efficient asset classes would lead to a higher performance impact – hence the importance of thorough due diligence in this segment of the market.

Alternative asset returns exhibit significant performance dispersion (source: Daily Alas)

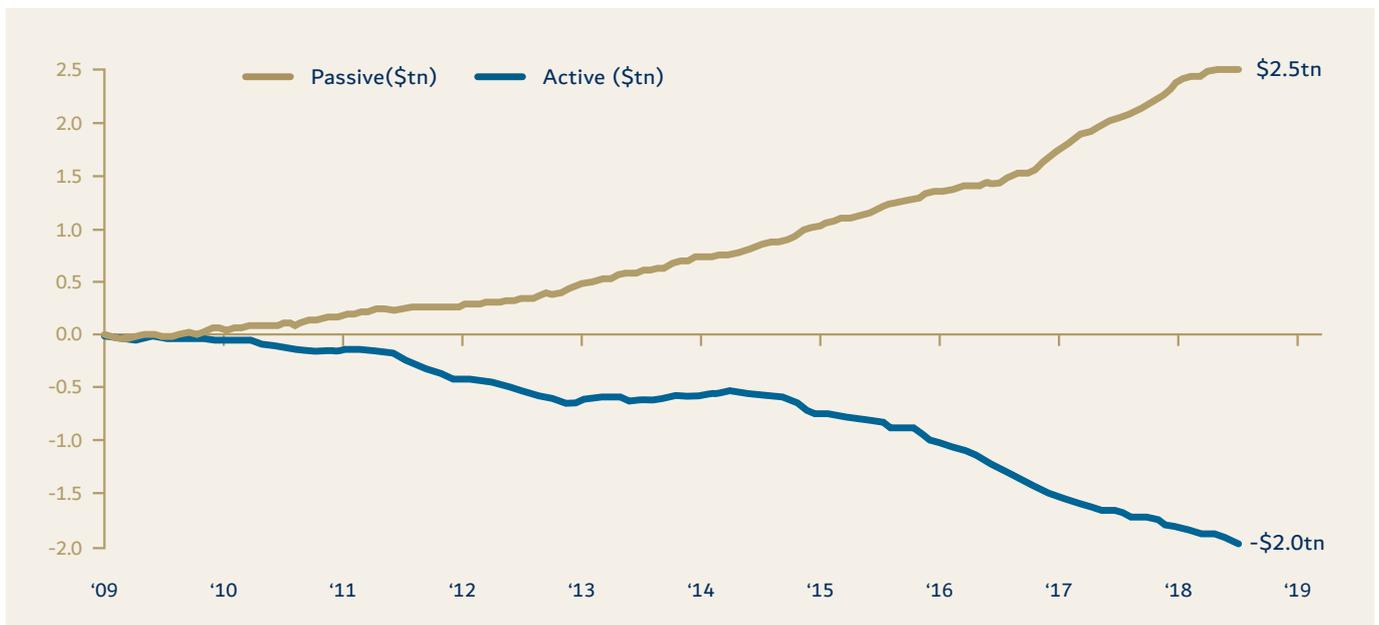


The risks (and opportunities) related to the boom of the ETF industry

As mentioned earlier, the Global ETF industry has indeed grown tremendously over the last 10 years. But the success of “passive” investing has happened at the expense of actively managed funds. As shown on the chart below, US equity passive funds

(ETFs) have recorded massive inflows since 2008 whereas US equity actively managed funds (mutual funds) have endured major outflows. In the U.S, ETFs now account for 50% of the total assets under management for equity funds versus 25% in 2009.

Active vs. Passive equity flows since 2009

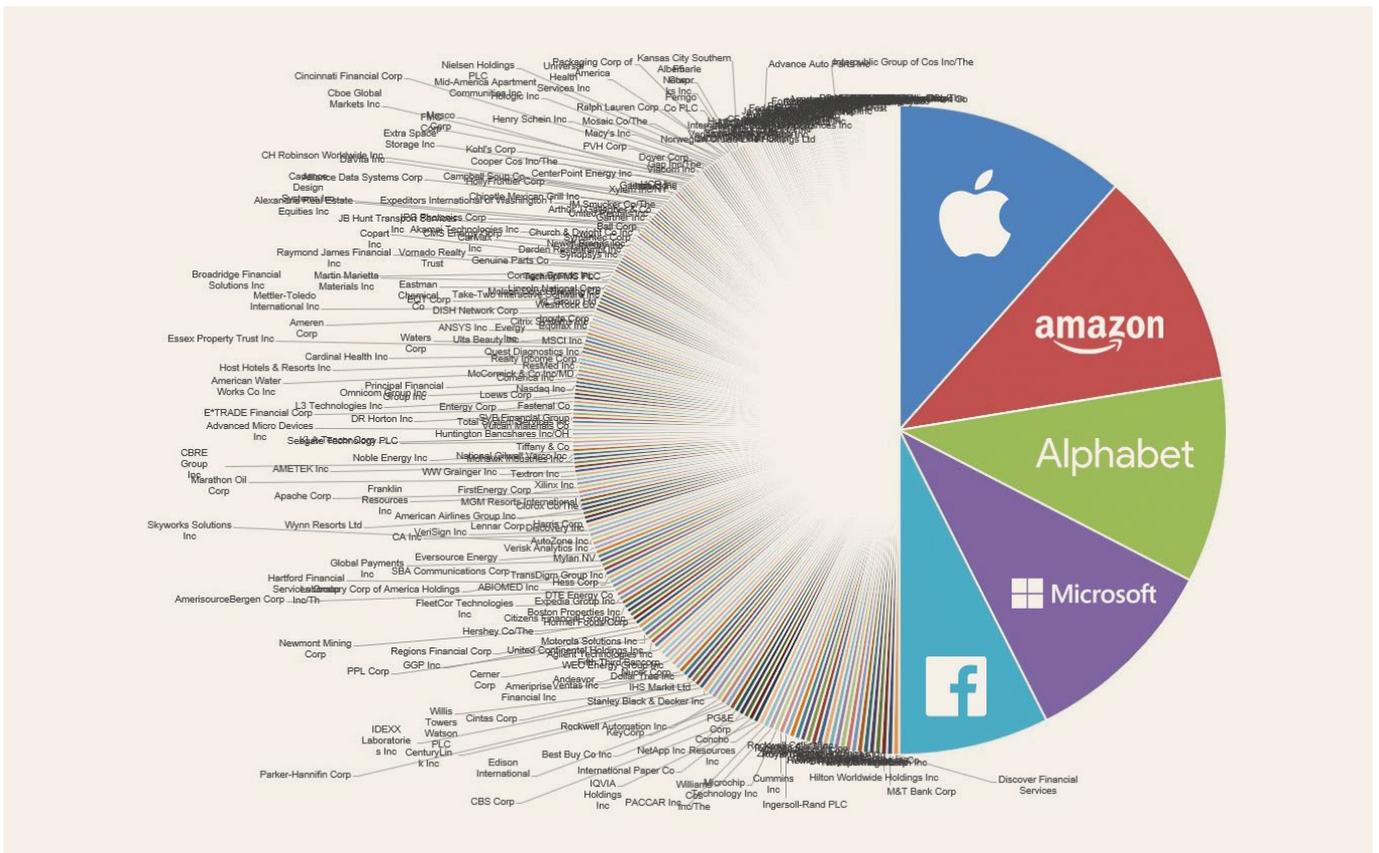


The trend movement from active to passive strategies has largely benefited the large, liquid stocks that have a high representation in the market-capitalisation weighted indices which passive fund managers adopt.

That movement can be exacerbated when important themes develop. For example, the group termed 'FAAMG' (Facebook, Amazon, Apple, Microsoft, and Alphabet's Google) have received attention because they magnify what is perceived by

investors as the strength of large, innovative technology-centered companies. Over the recent years, the FAAMG have strongly outperformed the S&P 500, a phenomenon which is similar to the popularity of the 'Nifty Fifty' in the 1960s and 1970s. As a consequence, their weight in the index is now disproportionate. Indeed, the combined market capitalization of these 5 stocks is now as big as the combined market cap of 282 members of the S&P 500.

The five largest S&P 500 stocks have a market capitalization equal to the bottom 282 S&P 500 stocks (source: The Irrelevant Investor)



As with any strong trend, there are risks but also opportunities attached to it for investors. Let's first have a look at the downside risks related to the boom of ETF investing.

Risks for ETFs investors

The rapid rise of ETFs is raising questions about whether the industry has built a giant on top of a structure designed for something much smaller. In other words, are ETF managers able to provide investors with instant liquidity, when what goes into their products is often much harder to buy and sell?

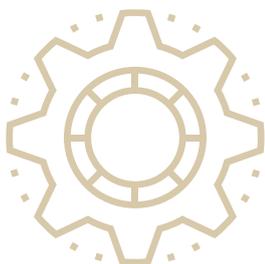
Let's take one example. In 2013, Ben Bernanke, then chairman of the Federal Reserve, prompted panic among investors into emerging markets with the so-called "Taper Tantrum". That day, the price of iShares Emerging Markets Equity ETF known universally as EEM, its ticker symbol, changed hands for 2.6% less than the value of the securities in the MSCI emerging markets index it attempts to track. At the time, during the US afternoon, two-thirds of those underlying securities were not available to trade. By the next day, however, the discount had all but disappeared.

Another day of stress related to ETF investing was August

24, 2015, where declines in Asian bourses snowballed at the Wall Street open and wild trading ensued. Some 1,278 securities, mostly ETFs, were halted for sharp moves, some ETFs widened to big discounts and some electronic market makers backed away from the market.

By and large the system has worked. In heavily traded ETFs, such as those offering exposure to the gold price or the S&P 500, flows of buyers and sellers produce a deep market where even big trades are unlikely to create waves that significantly move prices.

However, the expansion across more niche investments has created concerns that trading can become concentrated in an ETF, or the redemption process will exacerbate losses when markets for the underlying securities are far shallower, producing dislocations. Although the product was around during the financial crisis, it has yet to be tested in its current size and breadth in a market meltdown of such scale.



The rapid rise of ETFs is raising questions about whether the industry has built a giant on top of a structure designed for something much smaller. In other words, are ETF managers able to provide investors with instant liquidity, when what goes into their products is often much harder to buy and sell?



Opportunities for active managers

When investors buy an index fund such as the SPDR S&P 500 ETF, they buy all the stocks in the Index, whether cheap or expensive, and whether growth or value. As already highlighted in previous editions of Perspectives, the S&P 500 valuation looks stretched. While this is not a positive news as such, this however creates opportunities for active managers as valuations and earnings growth perspective of the different stocks constituents are diverging, which is a supportive environment for stock selection.

These “alpha” opportunities are even easier to identify in Emerging Markets. Take the example of Egypt stock market and the brutal devaluation of the Egypt Pound that took place at the end of 2016. This event provided a unique opportunity for active managers to differentiate between companies benefiting from the devaluation (e.g some exporters) and companies suffering the most from devaluation (e.g some importers). An index tracker can barely make this differentiation.

Connecting the dots

How can an asset manager or fund selector maximize the chances of generating high alpha? From the above, one can easily deduct that being able to select a top-quartile manager within a less efficient market (e.g Emerging Markets equities) can create outstanding alpha opportunities. This is precisely the move initiated some years ago by the large pension funds and endowments when it comes to use their “alpha budget”: they allocate more towards passive strategies within the most

efficient markets but commit a lot of due diligence efforts in order to identify the best managers within the less efficient markets such as Emerging Markets equities.

Moreover, we do feel that we are in the late phases of a passive index bubble. In the medium-term, this should create great opportunity for active managers to outperform passive managers. This should be even more valid in emerging markets, including our local markets.

Conclusion:

Active and passive management has each its own merits and inherent drawbacks. At Al Mal Capital, we do not endorse one style or another. Rather, we define the characteristics of each approach in order to determine which best suits to our client's needs.

On one hand, we believe that active management based on fundamental deep research can add value. This is especially

the case for our local Middle East equities markets.

On the other hand, when limited alpha opportunities are available or when the best managers available can only deliver average performance, passive investments are favored.

Understanding how to balance and leverage both active and passive management is crucial to realizing our client's investment objectives.

Middle East equities: Positive developments in the GCC

While regional equity markets were not immune to the broader global risk-off sentiment that prevailed in May, recent weeks have seen several developments both globally and locally which have largely gone unnoticed yet are likely to emerge as positive catalysts for the GCC investment climate through the remainder of H2 2019 and 2020.

An end to monetary tightening

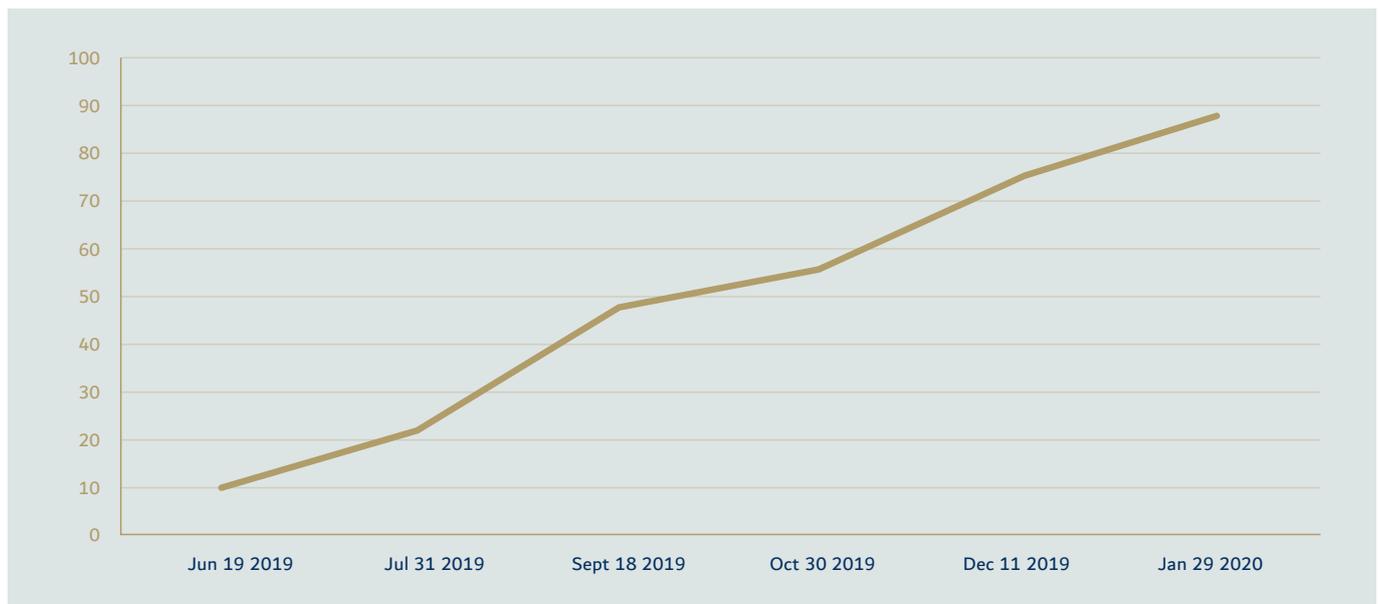
At the global level, increasing concerns surrounding the outlook for international trade have continued to fuel a reassessment about the trajectory of monetary policy from the U.S. Federal Reserve. There will be very few ‘winners’ around the world from a trade war between the U.S. and China, or the unexpected imposition of American tariffs on Mexican goods due to tightly integrated supply chains, however for the MENA region, the silver lining is found in the potential end to the monetary tightening cycle.

Pegged USD exchange rates have served the GCC well over the decades, and continue to act as an important anchor of financial market stability. The drawback, however, has been seen in recent years when the business cycles of the U.S. and the GCC fall out of sync, forcing central banks across this region to pursue a less-than-ideal policy. At a time of below trend non-oil growth, central banks in the GCC have followed the U.S. Federal Reserve in raising

interest rates, having tightened policy by 100bps in 2018.

Despite still healthy economic growth and a tight labor market in the U.S., financial markets are now increasingly pricing-in the probability that the next move by the FOMC will be an interest rate cut, rather than a hike. At the time of publication, the probability that the Fed would lower interest rates in an effort to support growth by December had risen to over 90% (see chart below). A lower interest rate environment in the GCC could prove to be a useful catalyst for regional private sector growth, helping to spur an acceleration in household spending, mortgage issuance, as well as business investment. At the very least, a more dovish outlook for the U.S. Fed will also help limit upward momentum in the US dollar, which will prove particularly beneficial for non-oil export sectors such as Dubai’s tourism industry.

Rate cuts (in basis points) currently Priced by the Market at Upcoming Fed Meetings (source: Eikon)



For sure, not all sectors would benefit from a dovish Fed. Indeed, the end of US monetary easing would hurt local banks, which have been benefiting from Net Interest Margin (NIM) expansion over the last few years given the large percentage of non-interest-bearing deposits. Banks as a sector is the largest weight in the index which means that disappointing earnings by the banks would negatively impact the performance of the S&P Pan Arab Index.

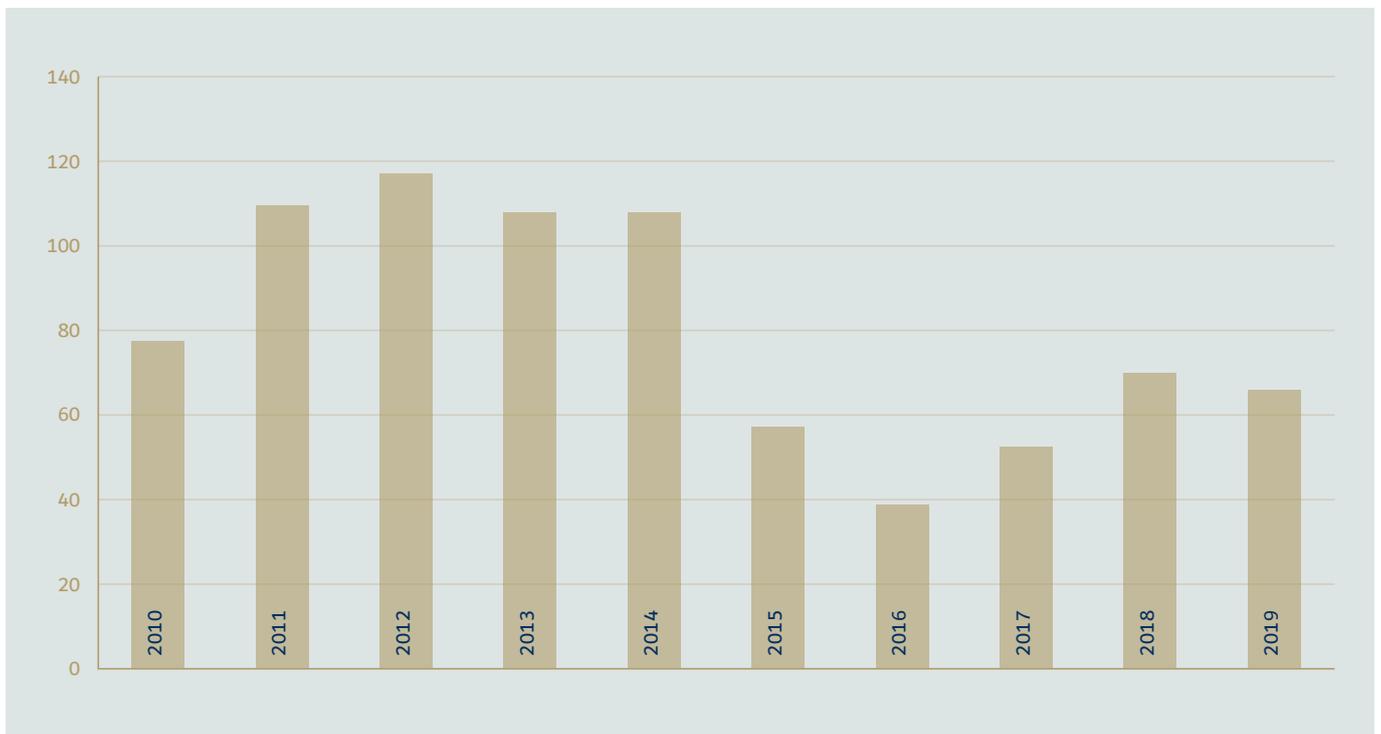
Oil prices in a comfortable zone

Oil prices ended the month of May at just under USD65/bbl, nearly 14% lower relative to their peak hit in late April. Media attention inevitably focuses on short-term moves in prices, but what is more important for the GCC is the longer-term trend, and in this regard, through the first five months of 2019, average prices for Brent crude were USD66/bbl, which is down only slightly on the USD70/bbl that was averaged in the same time period of 2018, and still well above the USD53/bbl and USD39/bbl seen in the first four months of 2017 and 2016 respectively (see chart below).

Assuming prices remain within a rough range of USD60-70/bbl

over the course of the year, we believe this is a comfortable level for much of the region. At these levels, prices are sufficient to cap any large widening in fiscal and external deficits, while also not being so low as to raise the possibility that governments could respond to cutting spending (similar to what occurred in 2015/16). In addition, prices are not high enough as to provide any incentive for governments in the region to slow much needed reform momentum. As a result, from a macro perspective, the combination of steady government spending alongside supply-side reforms will undoubtedly be positive for the investment climate in the months and years ahead.

Average Brent Crude Oil Prices, USD/bbl, Jan-May (source: Eikon)

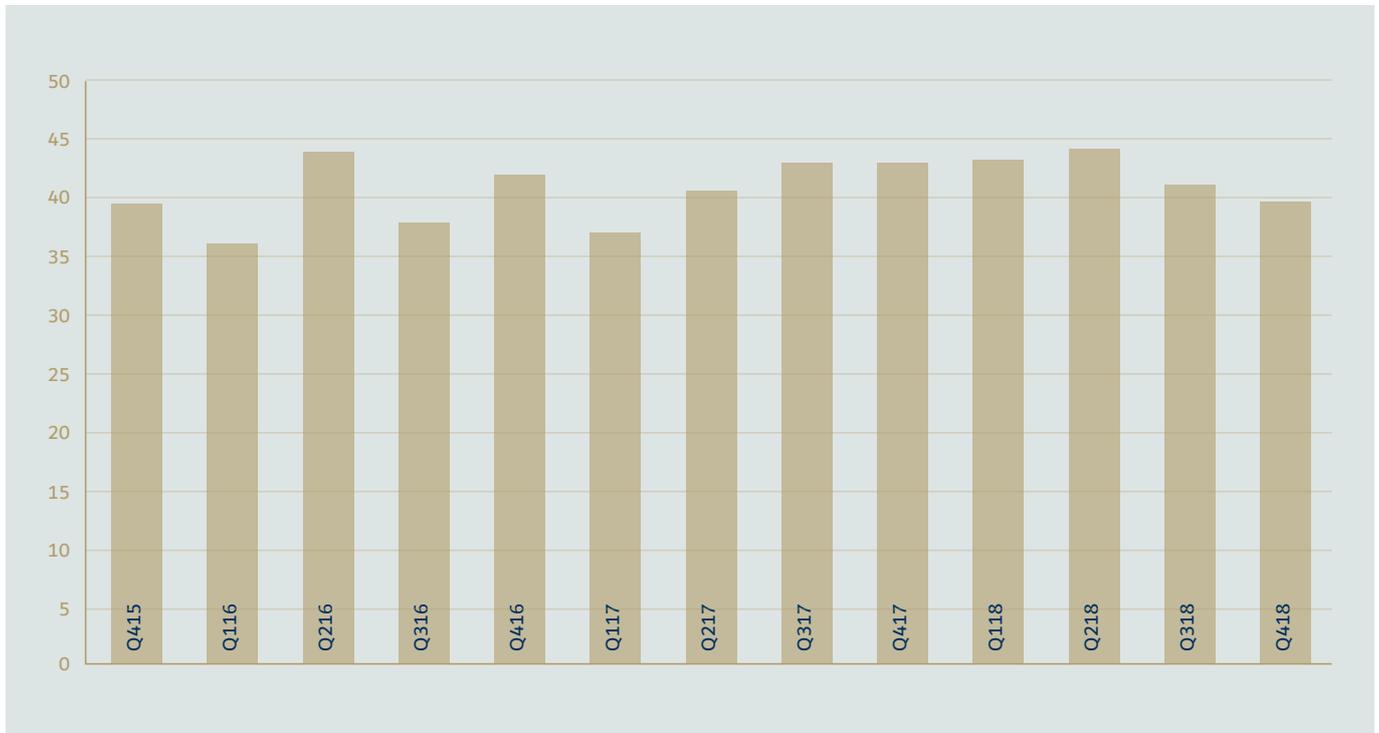


Reform momentum continues apace

The past month has also seen a continuation of reform momentum in several key economies in this region, highlighting how governments are using the levers which they have under their control to boost near-term growth and improve the long-term investment climate. The most high-profile of these reforms came out of the UAE, where it was announced that through a 'Golden Card' system, nearly seven thousand permanent residency visas were to be offered to a select group of entrepreneurs and investors. This follows on from decisions last year in which longer-term visas were offered to foreigners with large locally based investments.

The residency reforms are important for several reasons. First, by incentivizing foreign residents to invest more of their capital in the domestic economy, the policies should, at the margin, help attract greater investment (mostly focused on the residential real estate sector for the time being). The unique nature of the UAE's labor market wherein 90% of the workforce are expatriates, has always been a structural economic weakness, as much of the wages that are paid out are eventually sent back to home countries (see chart on the next page). To the extent that these reforms help retain some of these wages and profits within the UAE's borders, the impact will be positive for the local economy.

UAE Remittance Outflows, AEDbn (source: Central Bank UAE)



More important however is the symbolism behind these reforms. Residency is one of the most contentious issues across the entire GCC, and while economic policy in some markets is currently focused on boosting levels of national employment, and overturning the traditional development model that has relied on importing foreign labor, the UAE is

doing the opposite, and appears to be striving to ensure that it remains a magnet for highly educated overseas workers. In this context, a willingness to reform the residency model serves as a useful indicator that reform in other areas is likely to keep pace with the evolving needs of an economy that wants to remain globally competitive.



The residency reforms are important for several reasons. First, by incentivizing foreign residents to invest more of their capital in the domestic economy, the policies should, at the margin, help attract greater investment. More important however is the symbolism behind these reforms.

As the bulk of monthly incomes are spent on housing in the GCC, falling real estate rents in particular do, in fact, have the added benefit of acting as a boost to real incomes for the vast majority of the workforce that do not own their homes.



Good time to be a consumer

Much of the GCC has officially remained in deflation through the first five months of 2019, as a result of the combination of base effects from last year's introduction of VAT, and more importantly, ongoing declines in residential real estate prices. This highlights one of the more interesting aspects of the local investment climate, wherein regardless of the below-trend pace of job creation (seen through monthly surveys such as Purchasing Managers'

Indices), it has never been a better time to be a consumer. As the bulk of monthly incomes are spent on housing in the GCC, falling real estate rents in particular do, in fact, have the added benefit of acting as a boost to real incomes for the vast majority of the workforce that do not own their homes. Theoretically, this should help support local consumer spending patterns in 2019, and provide a boost to the regional retail sector.

UAE Inflation, % Y/Y (source: Datastream)



All eyes on Saudi Arabia

As the largest regional economy, macro and market trends in KSA often play a defining role in the GCC's investment landscape. To this end, the first five months of 2019 have been defined by what has come to be known as the 'Index Inclusion Story', as the Tadawul gradually becomes integrated into several key benchmark global emerging market equity indices. Foreign investment into KSA equities hit record highs through May, and now account

for over 6% of total market ownership, up from 4% at the start of 2019. Foreign investors have also been net buyers on the market for 21 consecutive weeks. We see this influx in foreign capital as not only a necessary condition of the market's ongoing development, but also as a supporting catalyst that should eventually boost local sentiment once the current bout of risk-off sentiment stabilizes.

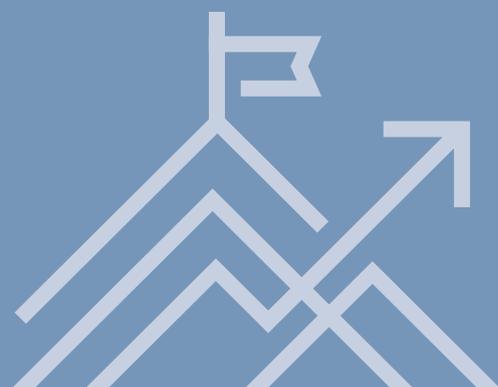
Foreign Buying on KSA's Tadawul, SARbn (source: Tadawul)



Investment Theme: Opportunities in EGYPT

Egypt is part of our Middle East and North Africa equity investment universe and has been an overweight position in our portfolios for some time now.

Indeed, as highlighted in our Q2 Investment outlook, we continue to find very attractive bottom-up opportunities in Egypt with PEG (P/E to growth) ratios often way below 1.



GDP growth is currently running at roughly

5.5%

with a target to raise it over 6.0%

IMF is projecting a growth of

5.9%

in FY2019/20

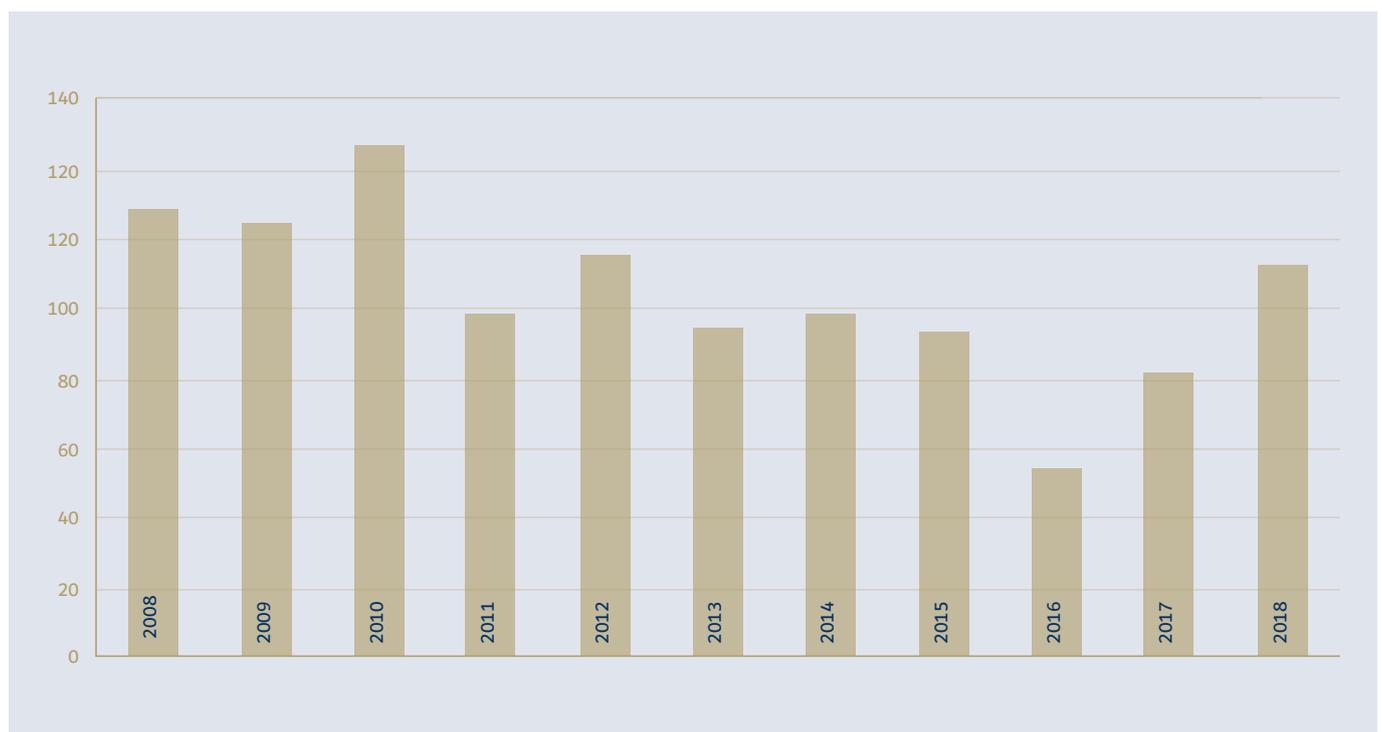
On a top-down basis, we believe that Egypt looks set to maintain its position as the fastest growing economy in the entire Middle East and North Africa in 2019 and 2020, as a significant amount of pent-up demand following several years of below-trend growth is finally released, and drives consumption and investment higher. Headline GDP growth is currently running at roughly 5.5% y/y, and the government is targeting to raise this already robust pace of expansion to over 6.0% in the upcoming fiscal year (beginning in July). Even the IMF, which is traditionally more conservative in its forecasts, is projecting growth of 5.9% in FY2019/20.

Reforms and EGP devaluation drive recovery

Several factors likely account for this macro outperformance, including ongoing reform momentum supported by the three-year USD12bn IMF Extended Fund Facility, as well as greater levels of political and policy stability, and the 2016 devaluation of the Egyptian pound. The change in the exchange rate regime has been particularly important, as it has been the main factor

helping to reduce some of the largest external imbalances in the economy, as well as boosting the performance of export industries such as tourism. Indeed, in 2018 Egypt welcomed a total of 11.3mn tourists, representing the highest level since 2012 (see chart below), while FX earnings from the sector jumped to USD11.6bn, compared to only USD7.8bn the year prior.

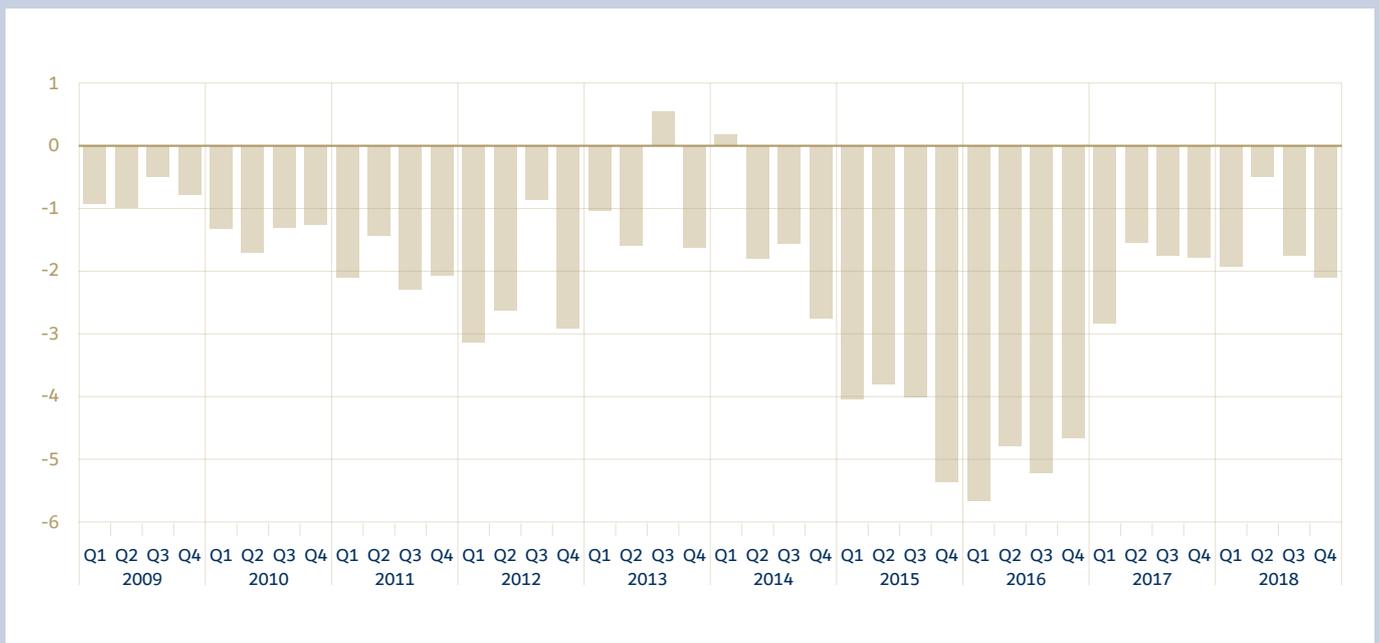
Tourist Arrivals, mn (source: Datastream)



INVESTMENT THEME

The economic rebalancing that has taken place has been pronounced, and has significantly reduced threats to underlying macro and market stability. The current account deficit, for example, narrowed to -2.7% of GDP in the last fiscal year, compared to a shortfall of -6.7% only one year earlier. Even as capital controls were removed as part of the country's IMF agreement, FX reserves steadily rose to record highs, and currently sit at roughly USD44bn, which represents a healthy seven months of import coverage.

Current Account Balance, USDbn (source: Datastream)



The current account deficit, narrowed to

-2.7%

of GDP in the last fiscal year

FX reserves steadily rose to record highs, and currently sit at roughly

USD44^{bn}

which represents a healthy seven months of import coverage

A bright spot in the region

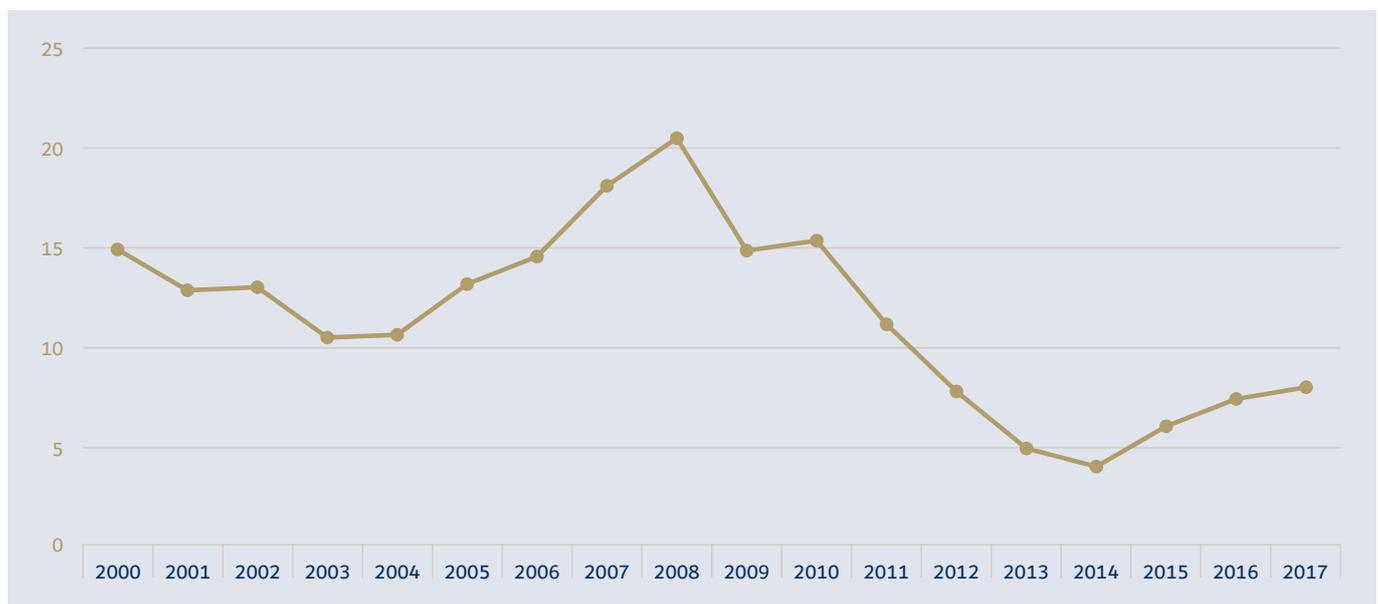
Stronger economic growth alongside a widening in the tax base, as well as repeated reforms to the domestic energy subsidy system have also helped narrow the budget deficit. In the upcoming FY2019/20 budget, authorities are targeting a fiscal shortfall of -7.2% of GDP, down sharply from the peak of roughly -13.2% hit in FY2015/16. Recent statements from government officials also highlight a commitment to maintain reform momentum, as average electricity prices are set to rise by an additional 15% this fiscal year, following on from hikes of 26% in 2018, 40% in 2017, and 30% in 2016. Although these reforms undoubtedly raise short-term costs for businesses and consumers, it is undeniable that they are necessary for longer-term sustainability and economic efficiency.

The extent of the economy's recovery is also increasingly evident in its gradually improving sovereign credit profile, as Egypt remains the only market in the wider MENA region to have received a credit rating upgrade so far in 2019. Since the start of this year, both Moody's and Fitch raised their credit ratings (to B2 and B+ respectively), while Standard & Poor's

led the way in raising its rating on Egypt to B back in Q2 2018. Over the coming years there is certainly scope for these ratings to gradually move higher, although the pace of improvement will largely depend on how successful authorities are at reducing the government debt burden.

One of the more encouraging trends in the macro environment is the ongoing rise in fixed investment that we have seen in recent years. For an emerging market at Egypt's level of economic development, increasing levels of fixed investment are key to helping propel longer-term sustainable growth, as basic infrastructure such as roads, ports and energy networks helps support broader economic activity. As a percentage of GDP, fixed investment in Egypt rose to an estimated 14.8% in 2017 (according to World Bank data), which is up over 2pp since 2014 (see chart below). This is still a low level by emerging market standards, but it is nevertheless heading in the right direction, and suggests to us that there are significant gains to be realized in the years ahead.

Gross Fixed Capital Formation, % of GDP (source: World Bank)



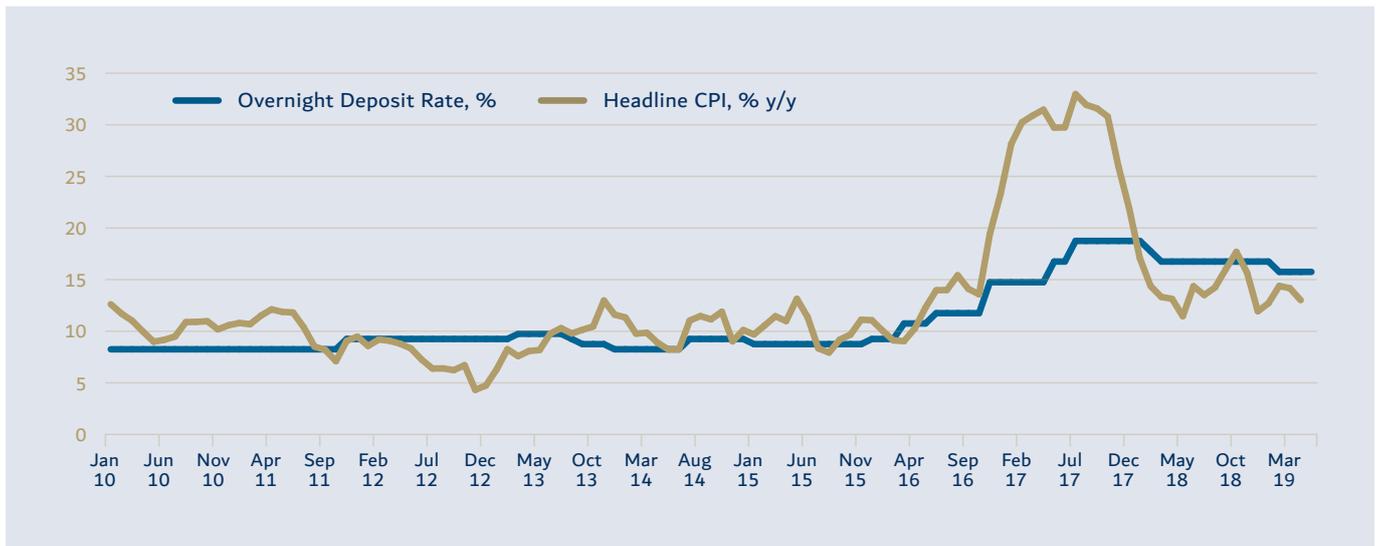
As the economic rebound appears to have been driven primarily by the export sector and public investment (the latter is most likely related to several of Egypt's 'mega projects'), a key challenge moving forward into H2 2019 and beyond will be in facilitating stronger private sector activity. In this light, the slow and steady monetary policy easing expected from the central bank will prove critical, as the combination of lower borrowing costs, a more stable political backdrop, and a stronger growth outlook eventually filters through into higher levels of business investment.

INVESTMENT THEME

Interest Rates Heading Lower

At its last meeting in May, the Central Bank of Egypt voted to keep interest rates unchanged, with the overnight deposit rate remaining at 15.25%. The bank has now kept rates unchanged at its last two meetings, following on from the 100bps rate cut delivered at its first meeting in 2019. The CBE’s inflation target is 9% ±3% by the end of 2020, which appears entirely within reach. Indeed, core inflation is running in the single-digits. And while inflation could spike in the short run due to a 20% increase in electricity prices and upcoming rationalization of fuel prices (indexation mechanism), we believe that the central bank target is within reach.

Monetary Indicators (source: Datastream)



The stability of the EGP should help underpin a more bullish Investment Thesis on the North African economy. Recent weeks have seen the currency appreciate to multi-year highs, even as other emerging market currencies came under downside pressure. Latest data from the CBE highlights how foreign investors have slowly returned to the domestic treasury bill market, and now hold 19% of outstanding EGP t-bills (as of March), compared to 0% in March of 2017. Given the aforementioned rebalancing in the economy’s balance of payments position and rise in FX reserves, there appears to be little downside risk to the currency in the near term, which should help facilitate stronger levels of foreign portfolio investment.

Foreign Holdings of T-Bills (source: CBE)



The stability of the EGP should help underpin a more bullish Investment Thesis on the North African economy. Recent weeks have seen the currency appreciate to multi-year highs, even as other emerging market currencies came under downside pressure.



Long-term growth opportunities abound

Looking beyond both the short-term challenges and opportunities, it is undeniable that Egypt possesses many of the necessary ingredients that can support a much stronger rate of long-term growth. First and foremost is the country's demographic profile, as a population of over 100mn represents the largest domestic market in the entire MENA region, which is increasingly well educated and thanks to the EGP devaluation,

cost competitive. This latter point is particularly important, as Egypt appears to be increasingly attractive as a source for outsourcing many service sector jobs (e.g. call centers). Combined with rising energy exports, steady remittance inflows, large infrastructure development needs, and low levels of financial penetration, the economy possesses the some of the strongest potential growth for the years ahead.

Current portfolio positioning

As of the end of May, our allocation to Egypt was 10% (versus 3.2% in the S&P Pan Arab index) and our main stock convictions were the following:

EGYPT KUWAIT HOLDING

Egypt Kuwait Holding is one of the MENA region's leading investment companies with a diversified portfolio of investments which includes fertilizers, petrochemicals, energy, and diversified Investments.

The Company is a play on liberalization of energy sector in Egypt with a portfolio of business which provides growth along with stability in cash flow.

What we like in the company:



STABILITY OF CASH FLOW

- **Sprea:** the company has shown resilience in terms of growth in top line and stability in margins as they control 85% of market share in Egypt and has the pricing power. The current utilisation stands at 80% and we expected this to go to 85% by 2020. The introduction of new line to export to Saudi will further improve the net income.
- **Alex Fert:** stable cash flows with utilisation levels of 105% due to no problems in supply of natural gas. They currently sell 30% of output in local market and we expect no reduction in this quota for foreseeable future.



POCKETS OF GROWTH

- **Nat Energy:** They have connected around 1.3mn households to the grid with another 1.7mn households to be added under their current concession and with current run rate they will need another 10-12 years to connect remaining houses to the grid while major growth is coming from Khobar power plant where they increased their capacity from 42MW in 2017 to 75MW and will further increase it to 115MW by 2020.
- **ONS (Onshore North Sinai):** This could be a source of massive growth they currently have 400 billion cubic feet (BCF) of P1 reserves while 218BCF of this has been developed and currently under commercial production. They have been working on new gas discovery in their current concession and have already done some preliminary study by Schlumberger which indicates around 1-2TCF of additional gas. They have already conducted a seismic study which confirms gas is now the last step to dig an exploratory well, which is expected to publish results by end of March 2019. If they are able to find this additional gas this could be worth USD 1bn (current market cap of company is around 1.3bn).



STRONG BALANCE SHEET

- The company has net cash of around USD 200bn (20% of market cap) this provides them strong edge vs competition as they can fund any new acquisition from this cash. They have been avoiding taking any leverage due to high interest rates in Egypt and eventually when interest rates will start to come down they will lever their balance sheet which will further improve their ROE's.

ORASCOM HOTELS

Orascom Hotels is an integrated developer of resort towns in Egypt. It develops residential units, hotels, and recreational facilities such as golf courses, town centers, and marinas. The company owns a land bank of 46 mn sqm and 24 hotels with a total of 4,300 rooms located on the Egyptian Red Sea coast, mostly in El Gouna.

What we like in the company:



TOURISM

Play on Egypt tourism; around 80% of Revenue is in USD as they mostly cater to foreigners.



NEW PROJECTS

Currently launching two projects every year (selling at EGP 39k per sqm) - at this pace this land plot will last for 20 years; Current NAV for this land is worth EGP 9 per share.



ASSETS

Sold non-core assets (Tamweel and some hotels in Makadi) which will help them to repay 1bn in debt (all EGP denominated debt) which will reduce their interest expense.



GROWTH

Next leg of growth to come from higher room rates (USD 65 per night vs USD 80 pre-Arab spring), monetization of land bank and reduced interest expense.

FINAL WORDS

FINAL WORDS

The natural trend for equities is to go up. And for as long as common stocks have existed (hundreds of years), this expectation has been met: stocks have had their ups and downs, but have trended steadily higher in value over the years.

There are many excuses to be fearful on risk assets. Indeed, the Trade war risk is a serious one and is unlikely to be solved any time soon. Some macro-economic indicators are pointing towards slower growth ahead and equity valuations are not cheap. Still, corporate earnings growth remain well oriented and we don't believe that a global recession is imminent. We thus maintain our overweight stance towards equities. We also believe that the U.S treasury market is too richly valued and thus recommend to hedge portfolios with cash instead.

While our regional equity markets went through a soft patch in May, we continue to stay positive on Middle East equities. As highlighted in this edition of Perspectives, some recent macro-economic improvements have gone un-noticed. Moreover, valuations remain attractive, particularly in the UAE and Egypt. Meanwhile, the ongoing inclusion of Saudi and other markets in the MSCI and FTSE Emerging Markets indices should be seen as strong tailwinds for Middle East equities.

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

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



Asset Management Team

Charles-Henry Monchau, CFA, CMT, CAIA
Managing Director – Asset Management
charles.monchau@almalcapital.com

Vrajesh Bhandari, CFA
Senior Portfolio Manager – MENA Equities
vrajesh.bhandari@almalcapital.com

www.almalcapital.com

