

Monthly Newsletter

October 4th, 2018

"Life must be understood backwards; but it must be lived forwards." — Soren Kierkegaard

"I don't play the game by a particular set of rules; I look for changes in the rules of the game."

— George Soros; Soros on Soros

Clues from Recent Asset Classes' Behavior

Macro: Mixed Global Picture

Oil: Prices Crossed the Key Resistance of USD 80 per Barrel

MENA: Putting Rising Oil Prices into Perspective

Introduction

It is the US midterm elections season, and the markets' trajectory is set to be defined by the dynamism of the run up to the event and by the outcome of the polls.

Putting Iran aside, de-escalation is a general theme that markets are factoring in ahead of the Election Day on November 6th. Markets are pricing in a resolution of trade tensions, Canada joined the new NAFTA deal along with Mexico under a new name called the US-Mexico-Canada Agreement, or the USMCA. The new tariff of 10% imposed by the US administration on USD 200bn of Chinese imports was less than expected. Meanwhile, China seems to be committed to not using its currency as a weapon in trade skirmishes, and the PBOC is so far honoring a line in the sand at 7 to the Dollar, which the Yuan is not crossing. This is a sign that China does not wish to escalate the trade war further, while obviously postponing any serious talks about trade till after the elections and possibly until the G 20 meetings in December. Regarding the North Korean issue, all relevant parties are acting in ways that keep hope alive.

As a result, de-contagion as a sub-theme is gaining pace around the globe. The USD which appears to have peaked in mid-august vis-a-vis major currencies continues to be relatively weak despite the noise in Europe in terms of Brexit negotiations, and discussions between Italy's populist government and the bureaucrats in Brussels over the former's budget deficit. In fact, emerging market currencies boosted by hawkish central banks are still holding the ground, the large players in asset management have turned, once again to buying battered emerging market equities, while commodity prices are either stabilizing or picking up.

As such, the USD side of the equation is priced for perfection. The economy is running at a healthy pace, unemployment at record low, and an obvious picture of a late cycle behavior which warrants modest expectations for the continuation of solid growth. On the other hand, investors may need to review their assessment of the Eurozone outlook. The recent performance of the Euro and sluggish sentiment indicators, not to mention the political turmoil, are pricing in a perpetual deterioration. However, unemployment in Europe is falling, household loans are growing, and sentiment and PMI would improve once political challenges ease as such, weakness in the Euro would persist over the short term. China continues to re-calibrate its growth path through reforms and a mini-stimulus, which would set the tone for many emerging market countries. These countries, along with China, represent around 60% of global GDP, a critical mass that is difficult to ignore.

We place a cautionary note concerning the tide reversal for two reasons. On the macro front, leading indicators are still encouraging in the US which means that the economy is set to do well for the foreseeable future. The convergence in growth for Europe and emerging economies will take time to materialize, although we believe that the pendulum is shifting as emerging economies resolve their issues concerning higher debt burden, deteriorating fiscal conditions, and slower growth over the coming quarter. The other reason is related to the global monetary stance. For instance, the volatility was cushioned so far by ample liquidity provided by major central banks, but investors are aware that starting Q4, the pace of quantitative tightening by the US and ECB along with a potential tapering by the BOJ would intensify. Thus, a significant amount of liquidity would evaporate at the beginning of next year which will prove challenging for all asset classes in general.

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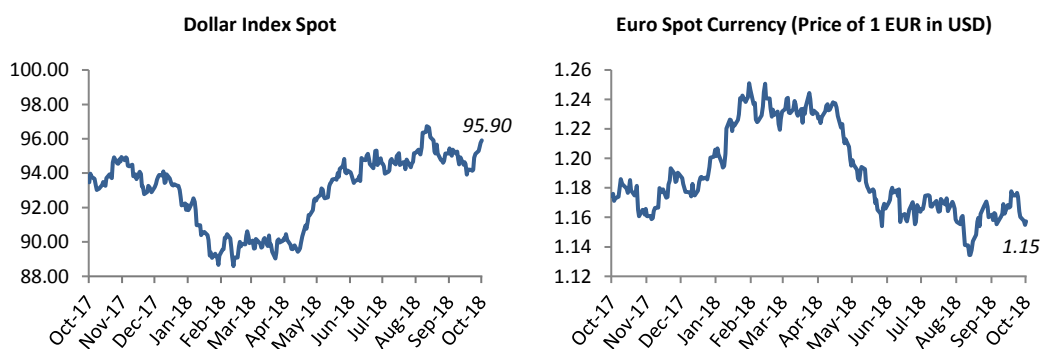
This would expose vulnerabilities and excesses such as high leverage and overvaluation in the system and create shocks. While emerging markets are classic victims, ballooning corporate leverage and overstretched US markets valuation shall be under the radar.

Through the lenses of financial stability, we try to approach the recent outcomes of the US Federal Reserve meeting. Although the Central Bank sounded dovish by keeping the path of its dot plot as it is and by removing the word accommodative, we think that the Fed tried to inject some uncertainty as it is worried about declining risk premiums generated by the certainty of the forward guidance provided. This is keeping investors running in the yield chasing game, as epitomized by the narrowing spreads of junk bonds to historical levels.

We think that long/short investors can manage the volatility generated by the normalization of monetary policy around the world, but in our case as long only investors, we need to keep a buffer in cash along with safe fixed income investments to get the benefit of optionality, and to weather any oscillation, which may intensify down the road as markets feel the effects of the tightening cycle.

In the MENA region, rising oil prices are set to boost the coffers of GCC nations, which is positive in general, especially that this is coupled by reforms and well drafted expansionary preliminary budgets for 2019 by two important countries: Saudi Arabia and UAE. On the political front, turmoil in Syria is shrinking and calm is relatively restored in most of the country, and there are talks that the border with Jordan may open soon which would be positive for both countries. In Iraq, the constitutional and political process related to the election of the country's president and the formation of a government is finally moving forward. All these are good indicators for the region.

Clues from Recent Asset Classes' Behavior

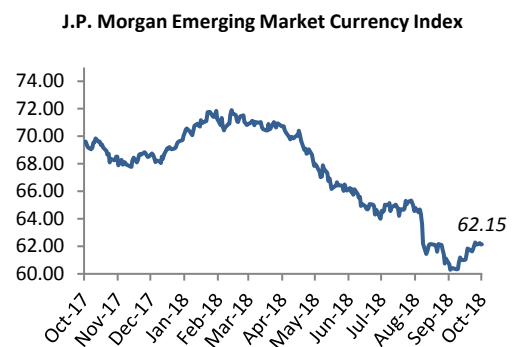
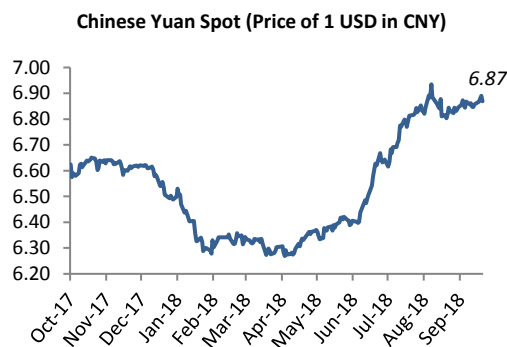


Source: Bloomberg, Capital Investments

Many factors explain the relative weakness in the USD. First of all, the divergence in monetary policy is narrowing in our opinion, as many emerging economies starting from Argentina, passing by Russia, South Africa, to Philippines and Indonesia are hiking interest rates. In advanced economies, tightening is the mode now as seen in Norway and ECB. Meanwhile, China seems to be still committed to not devaluing the Yuan which has been moving in a stable range since August. Easiness in trade tensions, and most probably, a deceleration in the rate of cash repatriation by US corporates on the back of the tax cuts initiated at the beginning of the year will lead to weakness in the USD.

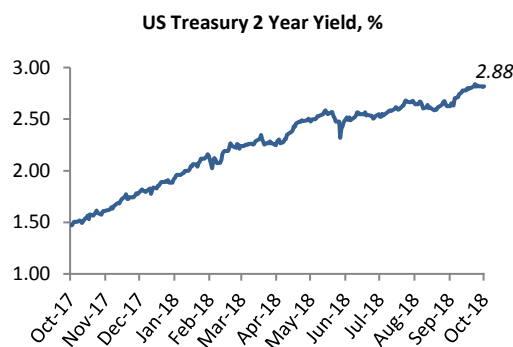
Other explanations include, in our opinion, a revival of appetite for risky assets, highly concentrated long positions in the USD mirrored by large short positions in the Euro. From a long term perspective, we continue to believe that the US budget and current account deficits are set to widen further which would reduce the appetite of investors for US assets, especially that the country is running such deficits at a late cycle stage while in theory, budget deficits should correlate with unemployment rates. As a result, any rally in the USD on the back of hawkish comments from Fed members or encouraging macro data should persist over the short run but the longer term view is still biased toward a weaker greenback.

On the Euro front, we think that far from the political pressures, the currency will be supported by the ECB's actions as Mr. Draghi mentioned that labor markets in Europe are tightening while a pickup in wage growth and domestic price pressures will continue. Concurrently, Mr. Coeure, another ECB official, mentioned that policy normalization has started but gradually. As such we think that weakness in the Euro is toward its end.



Source: Bloomberg, Capital Investments

Moving on to emerging markets, the JP Morgan Emerging Markets Currency Index has been rising, indicating that investors are gaining confidence in local central bank actions and confirming that the advantage of monetary policy divergence in favor of the USD is shrinking although rising US sovereign yield may pose some headwinds.

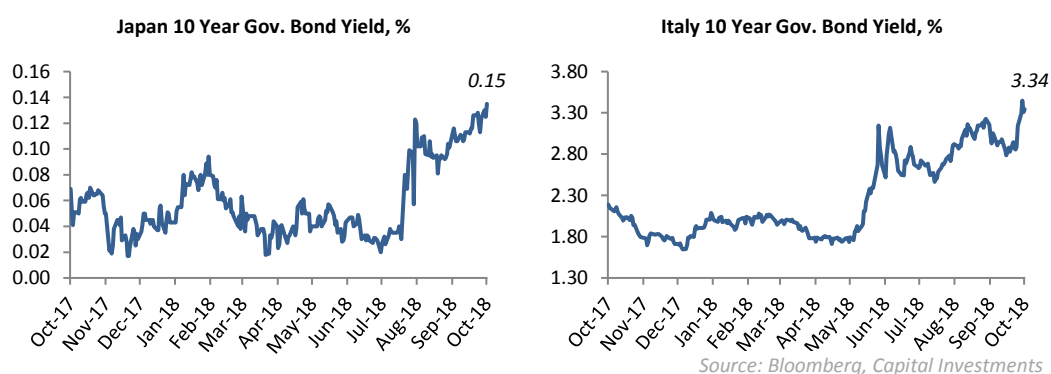


Source: Bloomberg, Capital Investments

In the US, the 2 year sovereign yield continued to climb albeit in a slower manner which means that investors continue to see the Fed hiking interest rates. We are monitoring the 2 year yield as it is now around the high of 2008 and its peak may signal the end of the economic cycle.

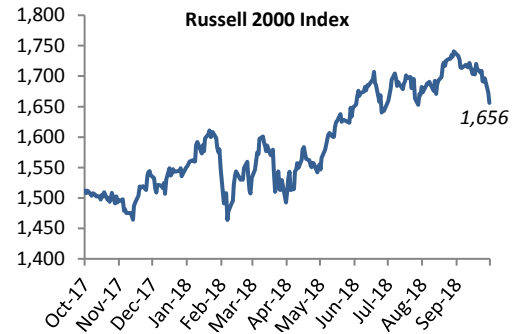
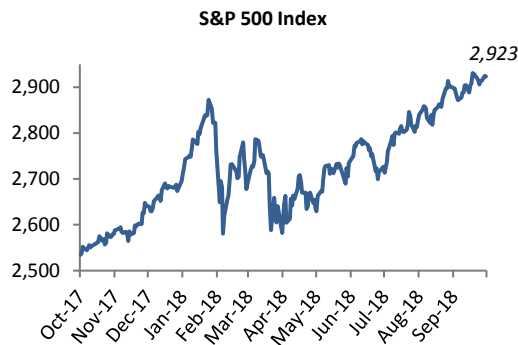
On the other hand, we are also observing the spread between the 1 year US T-bill and the Fed fund rate, which is shrinking to relatively 35bps. This indicates that investors are seeing the tightening cycle approaching its end, and is a pattern worth monitoring.

The US 10 year yield was moving in a tight range until it broke its recent top of 3.13% touching a high of 3.21%, at the time of writing, on the back of strong economic data namely related to ADP data on jobs creation, and the fact that Amazon started to raise the wages of its employees which is a sign of a tightening job market. We think that the two important drivers of the upward movement in yields are yet to materialize and these are rising inflation and a widening US deficit. The US 10 year yield will face a strong resistance at around the 3.25% level, which if broken the yield may climb even higher probably 3.5%. Until then, we will keep monitoring the data and adopting a wait and see approach in relation to long duration, unless spreads are juicy and credit risk is validated.



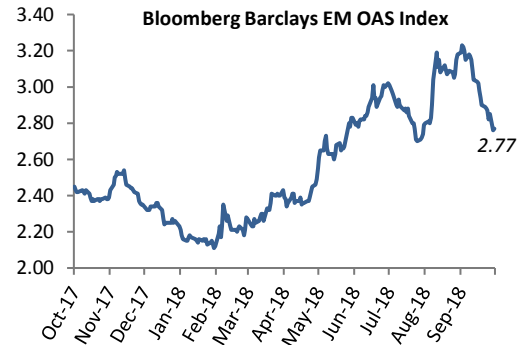
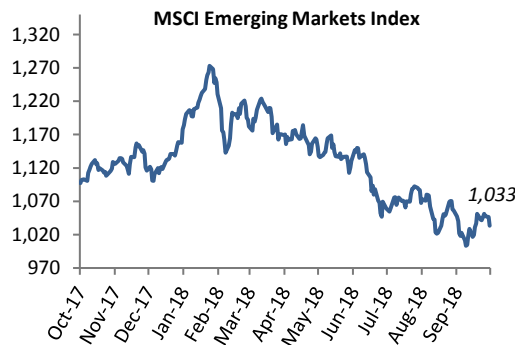
The relationship between the European Commission officials and the Italian government is the opposite of the Romeo and Juliette type. The tug of war between the two over the nation's budget, which put Italy's deficit at 2.4% of GDP, had a big impact on markets as equity fell, Italian yields spiked while Germany benefited from a classic flight to quality. Market participants' worries are well grounded especially that the ECB was the main buyer of Italy's sovereign bonds lately as foreigners were shying away. We believe however that both parties will find a workable solution as indicated by recent media reports and the behavior of the Euro which did not fall significantly.

The rise in Japan's long term government yields indicate that the BOJ is paving the way for less intervention in terms of yield curve control and in terms of buying fewer longer term bonds. This will help banks and more importantly insurance companies that benefit from rising rates. In this context, we think that the Yen will strengthen vis-a-vis the USD and US equity to fall as money will flow back.



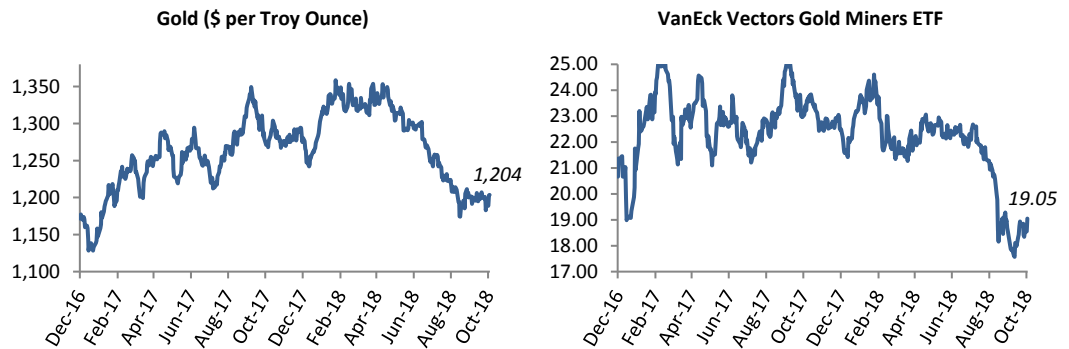
Source: Bloomberg, Capital Investments

With regards to the S&P500 Index, it is worth noting that each time it approaches the upper bound of its upward channel we notice a retreat in the index. Moreover many companies are giving out negative earnings guidance while analyst are turning cautious about corporate profitability which may indicate that profits are peaking. It is worth mentioning that a significant portion of the profit generated by the companies forming the S&P500 index is generated outside the US which might be at the mercy of a rising USD, the trade war narrative and any slowdown in China and emerging economies. We would like to highlight the decline in the Russell 2000 index- which is more representative of the companies that generate their profit domestically in the US- as a good indicator that trade tension is receding.



Source: Bloomberg, Capital Investments

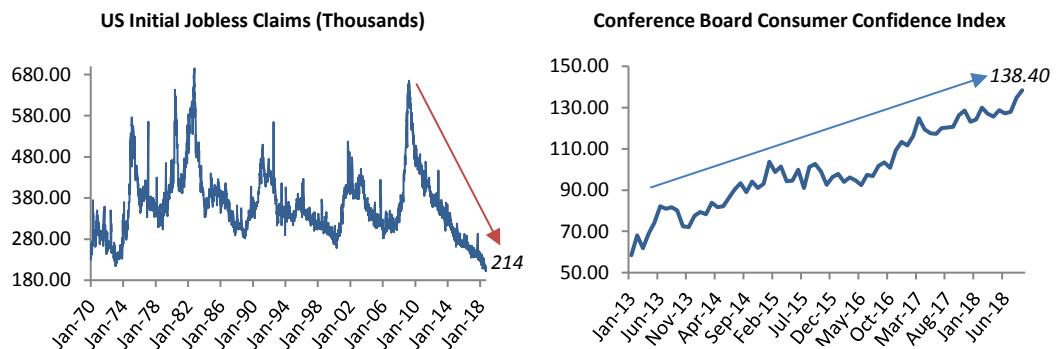
The charts above illustrate the rebound that is taking place across emerging market assets. The MSCI equity index appears to have turned the corner while the Barclays EM USD Aggregate Average OAS has been shrinking, indicating that the pricing of emerging markets bonds has been improving and the re-emergence of investment appetite as investors are testing again the water of emerging markets with their toes before having a full plunge.



Source: Bloomberg, Capital Investments

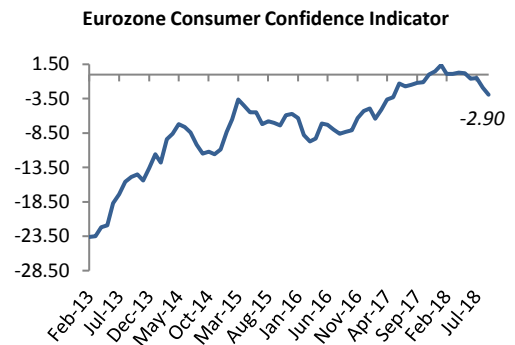
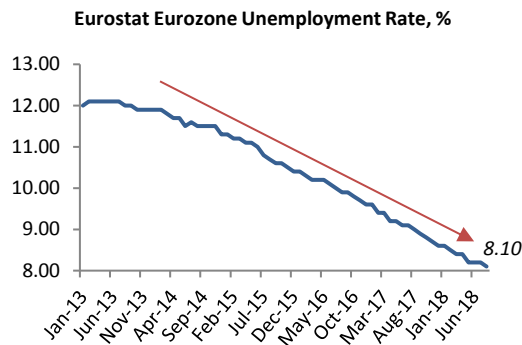
The Dow to Gold ratio is standing at around 22 at the moment in comparison to around 8 in 2011 when gold prices reached USD 1900 per ounce. This means that adding some exposure to gold may act as a diversifier amidst a potential rise in inflation as oil prices are soaring. Gold continues to track the USD and potential weakness in the greenback would be an important catalyst for gold to rally. We may look into the Gold Miners ETF (GDX) as it has been falling while gold prices have been relatively flat for the past month. In addition, when gold prices appreciate, mining stocks usually bounce further.

Macro: Mixed Global Picture



Source: Bloomberg, Capital Investments

The charts above related to initial jobless claims in the US and the Conference Board Consumer Confidence Index clearly illustrate that the US economy is operating at a late stage cycle. In fact, jobless claims are almost at a 50-year low while the confidence index is near its record peak of 142 in early 2000. This, coupled with rising leading indicators and increasing consumer spending point that any cooling in the US economy is not imminent. In contrast, it is worth noting that mortgage rates are on the rise which is negatively impacting home prices, as evidenced by the S&P CoreLogic Case-Shiller Home Price Index cooling down and the falling US building permits. This weakness in the housing sector was clear through the decline in the iShares US Home Construction ETF by 20%.



Source: Bloomberg, Capital Investments

In our opinion, a confluence of factors is holding back the economic performance in Europe since the beginning of the year. These include bad weather conditions at the beginning of the year, coupled with a series of strikes in the second quarter, along with some political challenges including the most recent debate over the Italian budget which took its toll on consumer confidence. However, on a separate note, the unemployment rate is falling, and labor shortage is being noticed in some areas according to the ECB, inflation is gathering momentum, loan growth to households is picking up, and PMI data is gathering pace despite the latest softness. We think that growth will pick up in Europe and the economic activity in the old continent should not stay in the doldrums since the weakness is due to transitory factors.



Source: Bloomberg, Capital Investments

In China, the beige book is indicating that the manufacturing sector is already under strains and is feeling the repercussions of the trade war narrative. Revenues are declining along with profit growth. In fact, China's industrial production is flat while retail sales are slowing. In addition, slowing PMI data, especially those related to exports, are becoming concerning. While China's deceleration is a great threat to the global economic activity, we are comforted that the Chinese authorities have recognized the fundamental situation and are, since early Q3 of this year, taking some supply side reforms coupled with key deleveraging that aims at easing any potential structural risks.

Purchasing Managers Indices (PMI) (2016-2017):											
	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Global Manufacturing	54.0	54.5	54.4	54.1	53.3	53.5	53.1	53.0	52.7	52.6	52.2
Global Services	53.7	53.8	54.1	54.8	53.2	53.8	54.3	54.6	54.0	53.5	53.0
Global Composite	54.0	54.3	54.6	54.8	53.3	53.9	54.0	54.2	53.7	53.4	52.8
US Manufacturing	58.2	59.3	59.1	60.8	59.3	57.3	58.7	60.2	58.1	61.3	59.8
US Services	57.3	56.0	59.9	59.5	58.8	56.8	58.6	59.1	55.7	58.5	61.6
US Manuf. New Orders	63.9	67.4	65.4	64.2	61.9	61.2	63.7	63.5	60.2	65.1	61.8
EU Manufacturing	60.1	60.6	59.6	58.6	56.6	56.2	55.5	54.9	55.1	54.6	53.3
EU Services	56.2	56.6	58.0	56.2	54.9	54.7	53.8	55.2	54.2	54.4	54.7
EU Composite	57.5	58.1	58.8	57.1	55.2	55.1	54.1	54.9	54.3	54.5	54.1
China Manufacturing	51.8	51.6	51.3	50.3	51.5	51.4	51.9	51.5	51.2	51.3	50.8
China Services	54.8	55.0	55.3	54.4	54.6	54.8	54.9	55.0	54.0	54.2	54.9
China Manuf. New Orders	53.6	53.4	52.6	51.0	53.3	52.9	53.8	53.2	52.3	52.2	52.0

* PMI reading above 50 indicates economy expansion

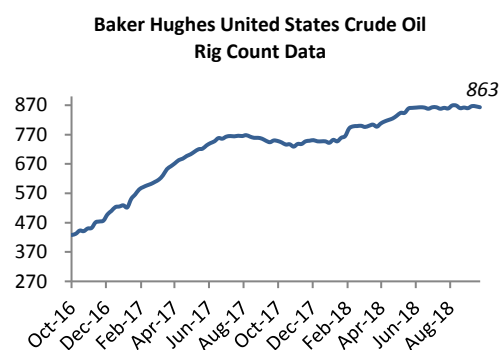
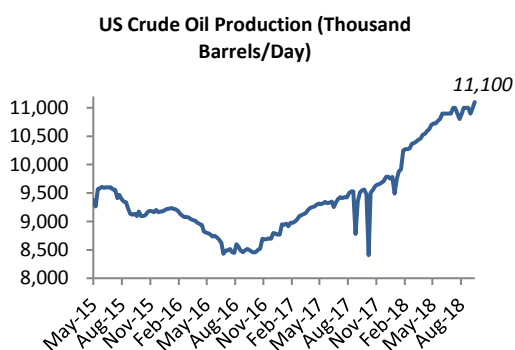
* Red points displayed within the lines above indicate highest point in the range

* Figures in green indicate acceleration from previous month, while red indicate deceleration

Source: Bloomberg, Capital Investments

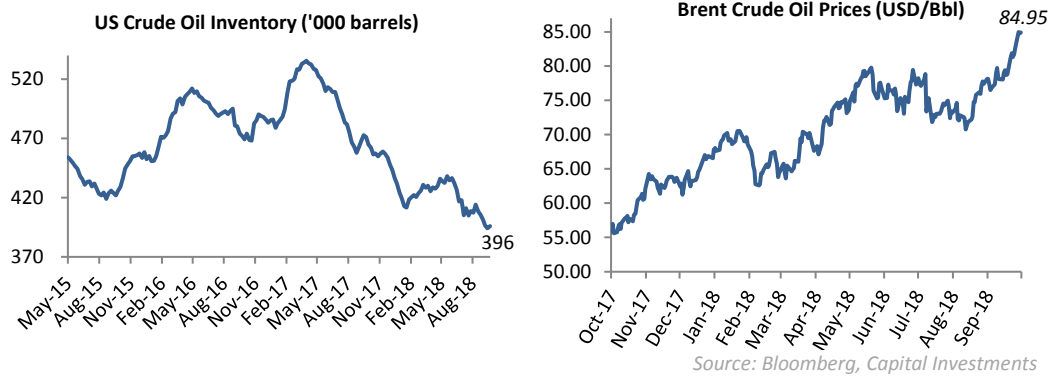
Oil: Prices Crossed the Key Resistance of USD 80 per Barrel

A combination of factors are supporting the upward trend in oil prices after the recent breakout above the key resistance of USD 80 per barrel. Chief among them is the expected supply disruption due to the looming sanctions on Iran, which saw its oil exports falling by around 1mIn barrel a day since April. In addition, loss of production in Venezuela, while production from Libya, Angola, and Nigeria continues to be fragile are supporting the upward trend.



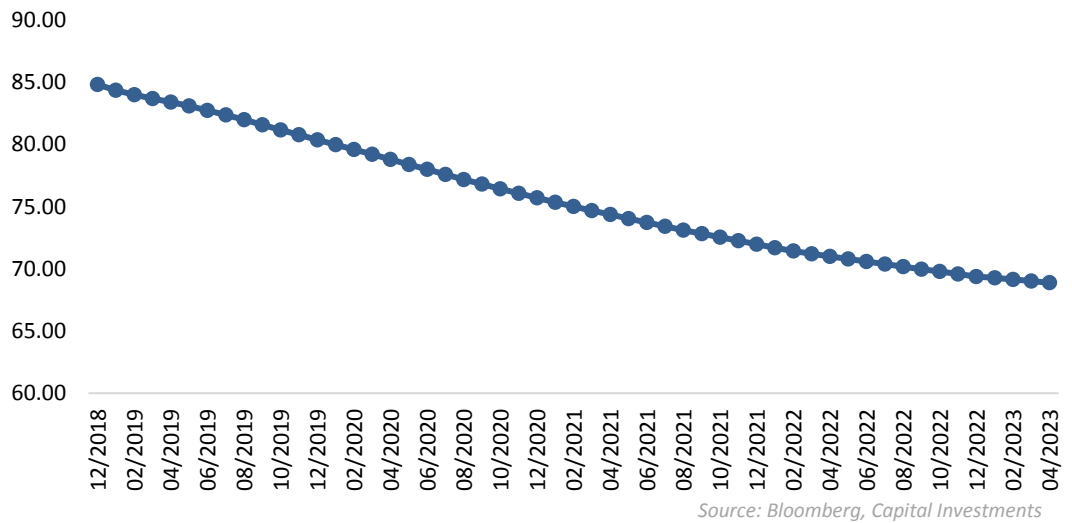
Source: Bloomberg, Capital Investments

The US production could compensate for this shortfall as it is expected to add around 500k barrels of export capacity in 2019 if the pipeline bottleneck is solved, especially that US production has relatively reached a plateau in terms of production, as evidenced by the rig count being stable with a slight downward bias despite the recent spike in oil prices.



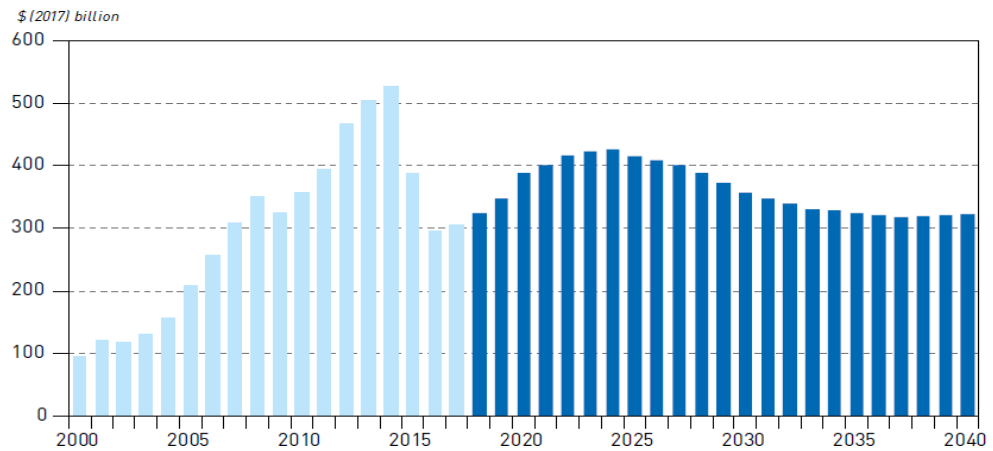
Moreover, oil inventories are at a 3.5-year low thus offering no substantial cushion for further shortfall in supply. The US will not tap its strategic oil reserves, while OPEC and its allies adopted a wait and see approach in their last meeting in Algeria given their limited spare capacity despite some media reports mentioning that Saudi Arabia and Russia are going to pump an extra 300k barrels per day to meet demand.

Crude Oil Brent Future Curve (USD/Barrel)



Crude oil Brent future curve is in strong backwardation while lack of capital expenditure on upstream over the past few years depicted in the chart below is amplifying the issue of shortage in supply.

Annual global upstream capital expenditure, historical and future requirements

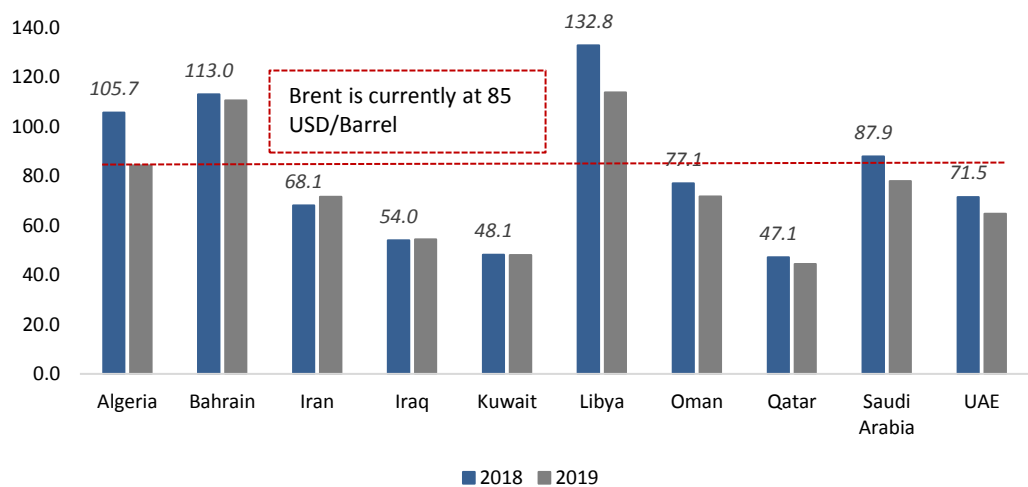


Source: Rystad Energy (historical, adjusted for inflation), OPEC (projection).

MENA: Putting Rising Oil Prices into Perspective

Despite various pockets of turmoil across the MENA region, some key developments are taking place. The steady rise in oil price over the past 12 months and its recent spike above USD 80 barrel is very positive for the balance sheets of the GCC nations and it is a good indication that a positive spillover effect in terms of economic activity, aid, and capital flow will materialize across the region. The chart below shows the fiscal breakeven oil prices for key countries according to the IMF World Economic Outlook 2018 data, and clearly demonstrates the potential improvement arising from the appreciation in oil prices.

Fiscal Breakeven Oil Price Projections (USD/Barrel)



Source: National authorities; and IMF staff estimates and projections, IMF World Economic Outlook data 2018

Saudi Arabia recently announced its preliminary budget for 2019. The figures indicate a shift toward an expansionary policy as the country's spending budget for 2019 has been increased by around 7% to reach USD 295bn or (SAR 1.1trn) while government revenue is expected to rise by around 10.8% to USD 260bn due to higher oil prices and the fiscal reforms initiated over the past years. Capital expenditure is set to rise by 15% Y-o-Y to reach USD 67bn. The government is expected to reduce its budget deficit to around 4.1% in 2019 from 5% in 2018 and plans to balance its budget by 2023. We think that this should bode well for the private sector which will give a boost for the non-oil GDP growth.

On a separate note, the UAE government announced a budget of \$16.4bn (AED60.3bn) for 2019, which represents an increase of 18 percent year on year. Approximately 42.3% of the budget will be dedicated to community development programs, while 17% and 7.3% will be allocated to education and health sectors respectively. This goes hand in hand with the targeted fiscal stimulus measures that have been announced since Q2 2018, which would boost economic activity ahead of the Expo 2020.

On the other hand, many media reports are confirming that the GCC nations led by Saudi Arabia and UAE are set to provide an aid package to Bahrain of up to USD 10bn, while Jordan is set to receive around USD 2.5bn.

Rising oil prices, however, may negatively impact the budget and trade balances of Egypt. It is worth noting that the Egyptian economy is doing well and is expected to grow by 5.6% in 2019 according to the International Institute of Finance. Moreover, Egypt's current account deficit has narrowed by 58.6% Y-o-Y to USD 6bn in FY 2017-2018 according to the Central Bank of Egypt. Additionally, the flow of the three big sources of capital inflows- i.e. remittances, tourism, and Suez Canal revenues- were rising and contributing positively despite a deceleration in FDI and despite foreign capital outflow from the local T- bills market.

Major Indices	Status as of end		Performance	
	December. 2017	September. 2018	September.2018	YTD (30 September. 2018)
MENA				
Abu Dhabi	4,398.44	4,947.92	-0.78%	12.49%
Bahrain	1,306.03	1,348.60	0.78%	3.26%
Dubai	3,370.07	2,825.76	-0.51%	-16.15%
Egypt	15,016.97	14,632.40	-8.60%	-2.56%
Jordan	2,132.17	1,979.14	-0.34%	-7.18%
Kuwait	4,793.47	5,345.74	1.59%	11.52%
Lebanon	1,142.60	971.12	-2.89%	-15.01%
Morocco	12,337.77	11,377.24	-1.47%	-7.79%
Oman	5,047.14	4,523.82	2.37%	-10.37%
Palestine	573.22	532.15	-0.88%	-7.16%
Qatar	8,526.00	9,784.31	-1.03%	14.76%
Saudi Arabia	7,230.61	7,898.68	-0.62%	9.24%
Tunisia	6,262.43	7,801.67	-7.33%	24.58%
S&P Pan Arab Composite	685.52	735.22	-1.00%	7.25%
Dow Jones MENA	523.44	561.87	-1.01%	7.34%
Americas				
Dow Jones Industrial	24,837.51	26,439.93	1.83%	6.45%
S&P 500	2,687.54	2,914.00	0.43%	8.43%
NASDAQ Composite	6,950.16	8,041.97	-0.83%	15.71%
S&P/Toronto Composite	16,221.95	16,204.62	-0.36%	-0.11%
Europe				
EURO Stoxx 50	3,524.31	3,449.79	1.68%	-2.11%
S&P Europe 350 Index	1,574.89	1,560.16	1.32%	-0.94%
FTSE 100 Index/ London	7,622.88	7,545.44	1.52%	-1.02%
FTSE MIB Index/ Italy	22,120.95	21,511.07	6.13%	-2.76%
DAX Index/ Germany	12,979.94	12,435.59	0.58%	-4.19%
ASIA/Pacific				
NIKKEI 225/ Japan	22,783.98	23,796.74	4.07%	4.45%
S&P/ASX 200/ Australia	6,088.14	6,181.22	-2.19%	1.53%
BRIC				
Brazil/ Bovespa	76,402.08	80,000.09	4.33%	4.71%
Russia/ RTS	1,150.58	1,187.88	8.75%	3.24%
India/ Bombay Sensitive	33,848.03	36,324.17	-6.01%	7.32%
China/ Shanghai Composite	3,296.39	2,791.78	2.44%	-15.31%
Hong Kong/ Hang Seng	29,863.71	27,715.67	-0.62%	-7.19%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2017	September. 2018	September.2018	YTD (30 September. 2018)
Commodities (in USD)				
Brent Spot (Barrel)	66.39	81.46	5.59%	22.70%
WTI Cushing Spot (Barrel)	59.84	72.12	3.32%	20.52%
Natural Gas NYMEX (MMBtu)	2.84	3.06	3.98%	7.49%
Gold Spot (OZ)	1,295	1,183	-1.54%	-8.66%
Silver Spot (OZ)	17	14.25	-2.00%	-15.50%
Copper LME Spot (MT)	7,254	6,182	3.59%	-14.78%
Corn CBOT Active Month (Bushel)	3.86	3.65	-0.07%	-5.38%
Wheat CBOT Active Month (Bushel)	4.83	5.13	-5.96%	6.21%
Soybean CBOT Active Month (Bushel)	9.73	8.55	1.36%	-12.10%
Rough Rice Futures (USD/cwt)	11.66	9.79	-9.65%	-16.04%
Currencies Spot Exchange Rates Against US Dollar				
Euro	1.19	1.16	0.34%	-2.53%
GBP	1.34	1.31	0.92%	-2.71%
CAD	0.80	0.77	0.00%	-3.63%
Yen	0.01	0.01	-2.07%	-0.46%
CNY	0.15	0.15	-0.85%	-5.16%

Source: Bloomberg, Capital Investments

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