

Monthly Newsletter

December 6th, 2018

"No man was ever wise by chance." — Seneca

"After a certain number of years, our faces become our biographies." — Cynthia Ozick

Clues from Recent Asset Classes' Behavior

Macro: Weak Economic Outlook

Oil: Would the OPEC Meeting Deliver a Bullish Sentiment?

MENA: Few Words on UAE and Saudi Arabia

Introduction

After a tough October and a volatile November, potential end of year rebound is in the card although major headwinds have not gone away completely, and important macroeconomic issues that have weighed on markets have not faded. Global economic growth is plateauing, emerging market economies are facing some challenges, China is experiencing slower growth, the socioeconomic outlook in Europe appears fragile, from Brexit, to the Italian budget saga, and to the Yellow Vests movement in France.

Given that negative expectations are well anchored and are dominating the investment scene, investors should pay attention to market signals to determine tactical movements or material inflection points.

From a geopolitical perspective, the cease of fire between the US and China in relation to the international trade policy if materialized will provide markets with some room to breathe till the end of Q1 2019. While investors would be looking for the details of the trade negotiation and its path, easing trade war rhetoric will have a positive implication on global economic activity and growth projections, supply chain dynamics, and world trade flow. This would be supported if coupled with some flexibility in the serious and tough negotiations regarding Italy's budget, the Brexit path and outcomes, and finally, the suspension of the gasoline tax by the French government.

From a macroeconomic perspective, the Chinese authority is taking various targeted measures that aim at calibrating economic growth in 2019 amid a slowdown in activity. In the US, softness is being felt and the one-off effect of the tax cut is fading slowly, which may prompt both parties controlling the congress to avoid a political gridlock by extending the debt ceiling deadline and by agreeing on an infrastructure spending program in the range of USD 200bn to lubricate a peaking economy.

Moving to the global monetary policy, it is getting clearer that the general theme is a hawkish stance delivered in a dovish tone and a gradual approach to ensure stability in the financial system. Three major central banks including the US Fed, the ECB, and potentially BOJ, will be withdrawing liquidity through quantitative tightening measures, where the US Fed will be withdrawing around USD 600bn in 2019. However, recent remarks from the Fed indicate that it may pause its rate hike cycle in 2019 by adopting a more gradual and data-dependent approach, which will be elaborated further after the Fed meeting end of December. As for the ECB, which is due to phase out its asset purchase program by end of 2018, we think that memories of the 2011 tightening mistake are still present. Thus, we expect that various accommodative measures will stay in place while economic developments in key countries such as Italy, Germany, and France, will shape these policies. The Bank of Japan is still committed to a negative interest rate policy despite some technical tweaks to its asset purchase program.

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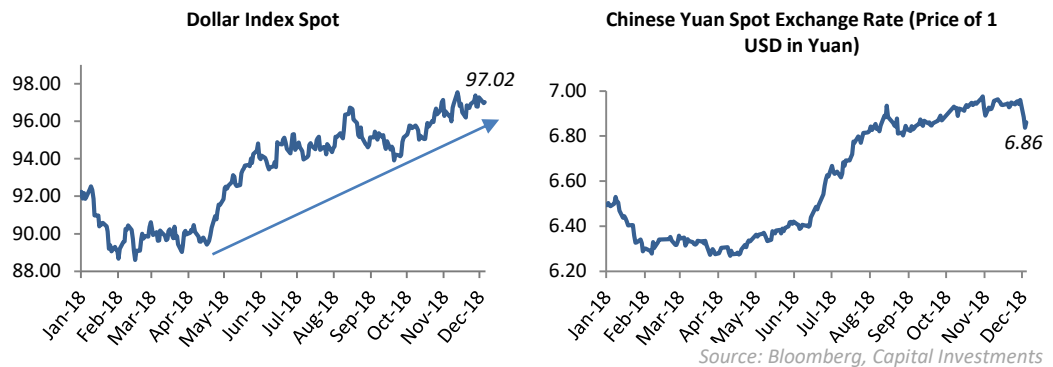
From this vantage point, a breeze of optimism could flow into markets. Slowing US monetary policy tightening and a framework for trade negotiations will express themselves through a softer USD and a resilient Yuan. This shall prepare the ground for a rebound in US equities that would serve to do damage-repair and rebalancing and would translate into inflows to emerging markets and commodities, notably gold, while a potential deal between OPEC and Russia on oil production cuts this month will provide oil prices with a much-needed lift.

This wave of optimism should be taken with a word of caution. Besides the trade negotiations between the two largest economies in the world, the economic developments in Europe, and the path of the monetary policy, an important economic question is being raised amid this sea of regime shifts: are we moving from a late cycle stage to an end of cycle stage?

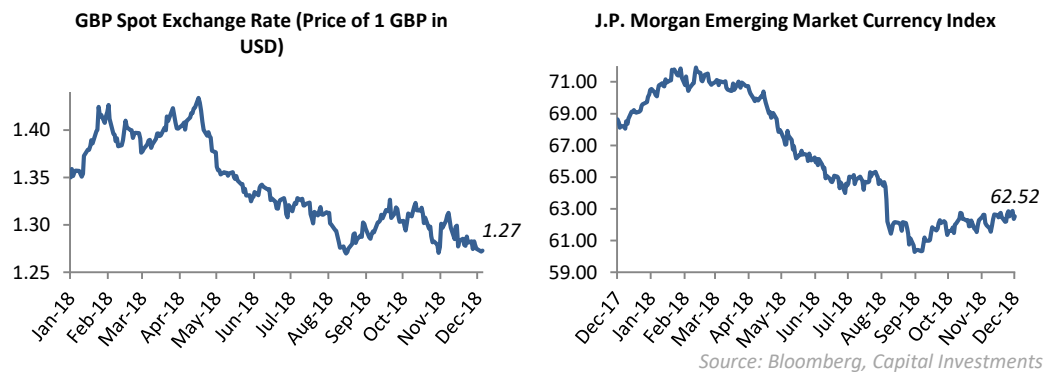
Many indicators suggest that we are approaching the end of the cycle. With the absence of cheap liquidity and rising short term borrowing rates, the search for yields is diminishing, and markets are, once again, reflecting a realistic risk premium. Moreover, financial conditions are getting tighter, earnings are peaking, economy is slowing, and marginal returns from leverage are retrenching and exposing highly leveraged corporate balance sheets. For instance, idiosyncratic risk is popping up; GE and the latest bankruptcy of Sears, are good examples of a tighter liquidity situation and turning tides. Consumer confidence is overstretched, and as economic data start to show more weakness, economic growth will gradually decelerate, margins will shrink, and P/E ratios shall not expand amid tighter liquidity especially in the US. As a result, volatility may intensify, and investors should be ready for a rough ride especially in US equity markets where the concentration of capital has been accumulating over the past decade.

In the MENA region, potential easing of geopolitical tensions, notably in Yemen, coupled with stable to rising oil prices and expansionary, or less austere, fiscal policies for GCC countries amid potential global indices inclusion for key markets, such as Kuwait and Saudi Arabia, will be supportive for equity markets going into 2019.

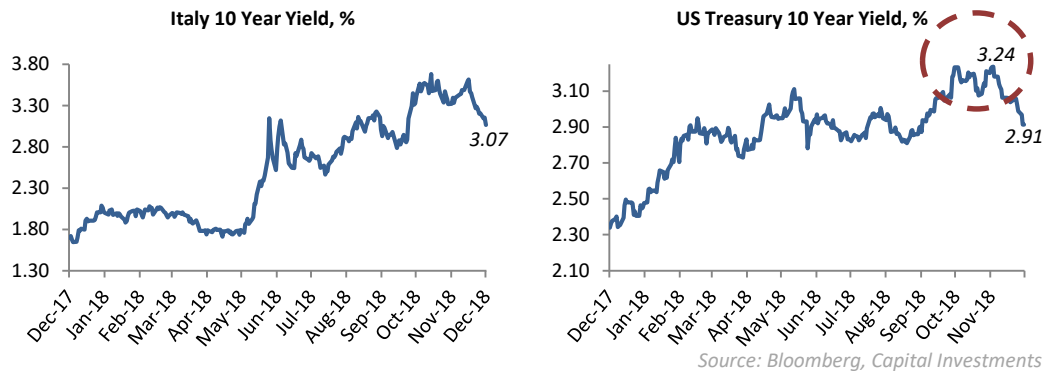
Clues from Recent Asset Classes' Behavior



The USD continues to be stuck in a stubbornly strong range and the strengthening shift was confirmed after a series of key events took place in May 2018. These include the announcement of new sanctions on Iran, the formation of the “populist” government in Italy, and the U.S.’s rejection of a framework for trade negotiations proposed by China. Now, after the passage of almost 6 months, some of these factors seem to be easing. The G20 summit in Argentina opened the door for trade negotiations between the US and China, the Italian government is showing some signs of flexibility in the negotiations with the EU, while the US implicitly reduced the impact of sanctions on Iran through providing waivers to eight countries. While the path of Brexit seems to be uncertain as indicated by the weak behavior of the GBP, the factors that were behind the USD’s strength in general appear to be abating awaiting full confirmation. This is in addition to the fact that China signaled a tougher management of the Yuan as the PBOC cut its pledge to allow market supply and demand to play the biggest role in directing the exchange rate, which means that the Chinese authorities are taking steps to ensure the stability of the Yuan.

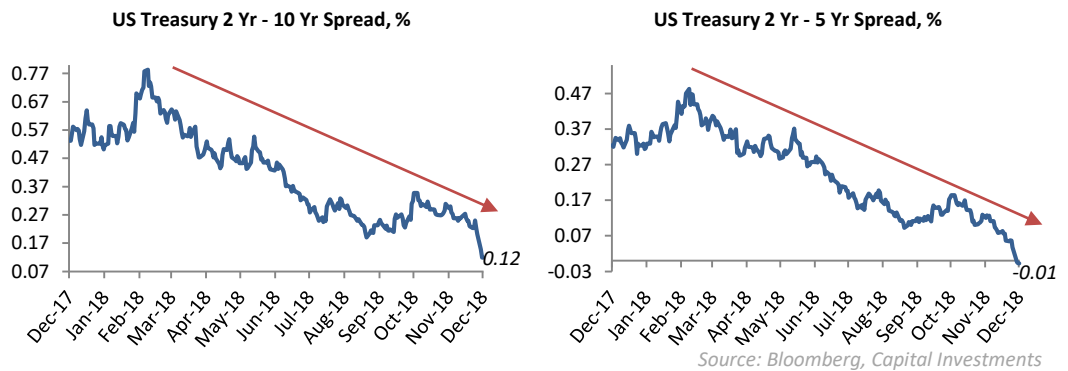


On another note, the trade in the USD is already crowded at a time the economy in the US is showing signs of a peak amid a Fed signaling that it may adopt a less tightening monetary policy in the coming year and widening current account and budget deficits in the US. Emerging markets, which saw their currencies collapsing during 2018, have adopted hawkish monetary policies and are showing signs of stability amidst these developments and are beginning to offer lucrative yields in papers denominated in their local currencies. The long-awaited weakness in the USD or the DXY (the Dollar index) should be meaningfully lower to ignite a rally in emerging markets equities and in commodities.



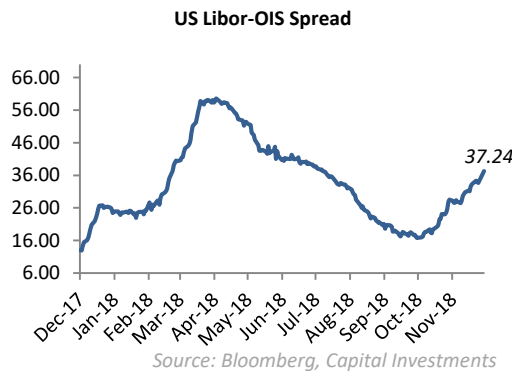
The decline in the Italian 10-year yield from a peak of around 4% is a positive lead for any developments in relation to the negotiations between Rome and the European Commission in Brussels regarding the Italian Budget. It is also encouraging news for the Euro and a potential indication that Europe may adopt a relatively loose fiscal policy notably in Germany and France to support a weakening economy and to tame the anger of the public.

The US 10-year yield appears to have formed an interim top by failing to break, for two times, the 3.20% to 3.25% range. Given that expectations are well anchored towards declining growth and tamed inflation in the near future, on the back of a strong USD and declining oil prices, a decline in yields might be persistent until investors face the reality of a rising US budget deficit in 2019 and a revival in economic activity, due to a potential pause in interest rate hike by the Fed and Trade war truce for Q1 2019. The negative outlook is indicated by the flattening of the US Treasury 2 year - 10 year spread, while in contrast, the 5year – 30year US treasury spread is still steep, the risk appetite is going down in stock markets.

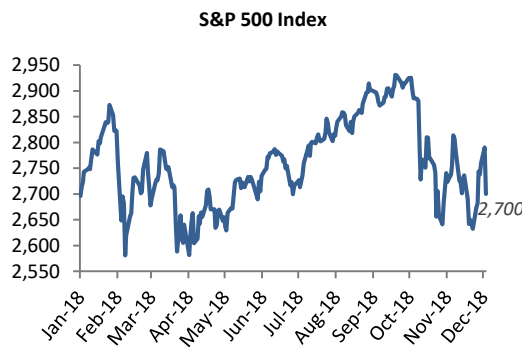


Warning macroeconomic signs coupled with a potentially slower and gradual pace of rate hikes by the Fed, investors increased the demand for the belly of the yield curve, which led to an inversion in the US treasury 2year - 5year spread. Investors might have considered the potential pause by the Fed as an indication that the monetary authority may allow an overshoot in inflation amid a strong job market. Given that the Fed officials signaled that they have approached the “neutral” level of interest rates, this means that they are willing to slow the tightening process amid a less certain economic path, which led investors to buy the belly of the curve, around the 5 year maturity, as a flight to safety and as a sign that the Fed rate hike cycle will level off soon. This is being confirmed by

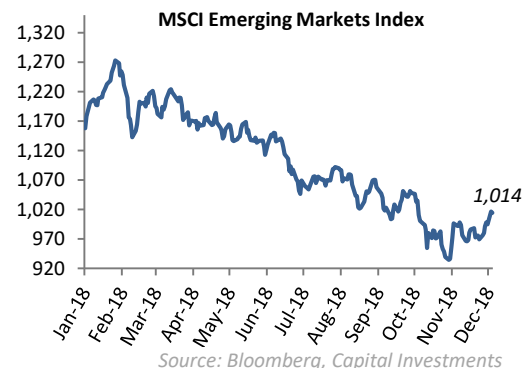
the implied yield on the Fed Fund Future contracts for 2020, and by the forward OIS curve which started to dip beyond the second half of 2019.



The Libor-OIS spread is a barometer of the credit conditions in the market, because it shows if funding is abundant or scarce for banks to borrow. Generally, a widening spread means that funding conditions are challenging. As such, the rising spread reflects tight USD liquidity outside the US mainly and is an indication that short term rates are on the rise and funding would become scarce.



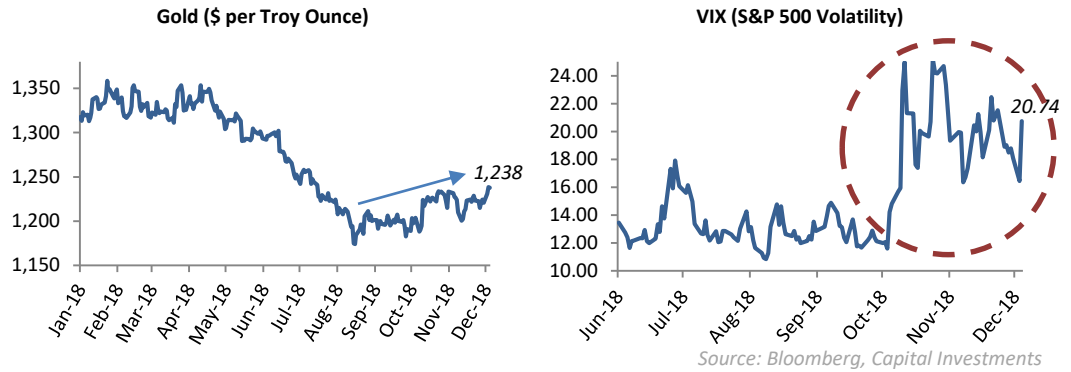
Cyclically Adjusted P/E Ratio is 27.01



Cyclically Adjusted P/E Ratio is 16.46

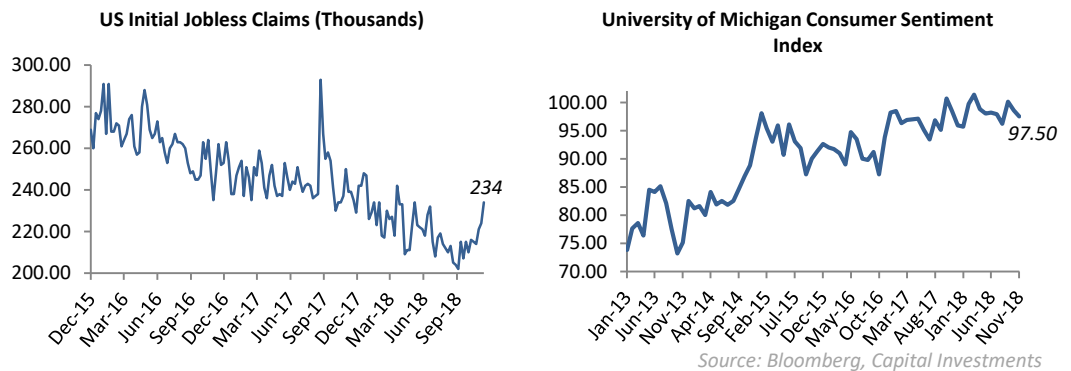
We continue to have a long term bearish view of US equities and the chart above clearly shows that, over the past decade, a significant concentration of capital has been built in the US. This concentration in capital usually occurs amid rising short term interest rates, tightening financial conditions, peaking business confidence, deterioration in interest sensitive sectors (such as auto and housing), but more importantly, amidst companies' guidance regarding slower top line growth, peak in margins and earnings because of rising costs and weaker sales. As market participants start to realize the realities related to the matrix of macro headwinds, increasing margin pressures, and peaking EPS, multiples will start to contract. Should such factors be coupled with a rising US deficit and weakness in USD, foreign investors, notably the Japanese, would start repatriating capital leading to an appreciation in both the Yen and the Japanese equities. Any relief rally that may result out of the trade truce would be an opportunity for investors to rebalance their portfolios especially when it comes to the technology sector which is subject to high regulatory scrutiny and is facing a weak outlook. From a long-term perspective, we continue to believe that the US market is entering a bear market and thus investors should apply the strategies and tactics of declining markets well by riding the volatility and by being quick in following price action. In the same context, market

valuations excluding the US are much more attractive but are hostages of either a strong USD or political turmoil.

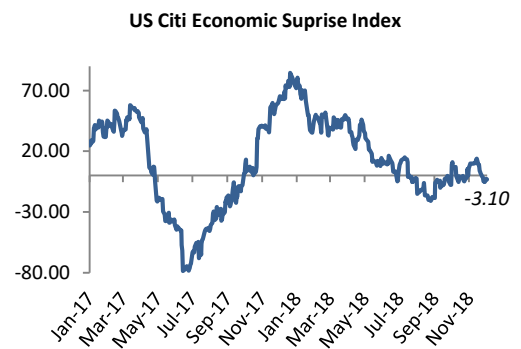


It is worth mentioning that the ETFs backed by gold increased their holdings by over USD 1bn in the recent period which may signal a bullish shift in investor sentiment towards the yellow metal. Investors are seeking to hold gold to achieve portfolio diversification and to improve their risk adjusted return amid significant jumps in the VIX index (or fear gauge) as shown above.

Macro: Weak Economic Outlook



A couple of natural disasters, including hurricanes and wildfires, took their toll on the US economy as jobless claims have been on an upward trend since September, and consumer and business confidence indices appear to be peaking although the Fed’s Beige book continue to see modest or moderate pace in economic expansion across the US. Interest sensitive sectors such as housing and automotive continue to show signs of weakness, while cyclical sectors along with the technology and consumer sectors seem to be pressured by the recent trade war narrative. In addition, the tightening credit conditions are weighing on the economy as epitomized by small caps company which have weak balance sheets.



Source: Bloomberg, Capital Investments

The situation is murkier in Europe. Germany’s GDP contracted in Q3 2018 on weak export demand while the Citi economic surprise index continues to decline, and business confidence indices are falling along with PMIs. ECB’s President Mario Draghi warned about the trade war risk and highlighted that external risks to the Euro economy are rising and may put a halt to investments. Meanwhile, the conservative German Bundesbank announced that the ECB will take a long time to fully end its stimulus program and normalize monetary policy. This reflects the challenging economic conditions in the old continent amid socioeconomic turmoil and rising populist movements from Spain to Italy passing by Germany, and recent protests in France, not to mention the issue of Brexit whose path remains unclear, but its consequences are highly damaging for the UK’s economy.



Source: Bloomberg, Capital Investments

Although China’s PMI export orders are falling, and its industrial output is growing at a slower pace, the recently announced measures and the dovish monetary policy, epitomized by reduction in reserve requirement ratio for banks, is starting to take some effect as the growth in infrastructure spending is encouraging and key data such as rail freight and electricity consumption are still resilient. China is seeking to cushion the weakness in its economy through targeted tax cuts and investment incentives, and by providing more credit to private sector companies and to local governments which look to invest up to USD 194bn in infrastructure. Moreover, China’s policy makers are expected to increase the budget deficit next year from 2.6% to 3% of GDP.

Purchasing Managers Indices (PMI) (2016-2017):											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
Global Manufacturing	54.4	54.1	53.3	53.5	53.1	53.0	52.8	52.6	52.2	52.0	52.0
Global Services	54.1	54.8	53.2	53.8	54.3	54.6	54.0	53.5	52.9	53.4	#N/A N/A
Global Composite	54.6	54.8	53.3	53.9	54.0	54.2	53.7	53.4	52.8	53.0	#N/A N/A
US Manufacturing	59.1	60.8	59.3	57.3	58.7	60.2	58.1	61.3	59.8	57.7	59.3
US Services	59.9	59.5	58.8	56.8	58.6	59.1	55.7	58.5	61.6	60.3	#N/A N/A
US Manuf. New Orders	65.4	64.2	61.9	61.2	63.7	63.5	60.2	65.1	61.8	57.4	62.1
EU Manufacturing	59.6	58.6	56.6	56.2	55.5	54.9	55.1	54.6	53.2	52.0	51.8
EU Services	58.0	56.2	54.9	54.7	53.8	55.2	54.2	54.4	54.7	53.7	53.4
EU Composite	58.8	57.1	55.2	55.1	54.1	54.9	54.3	54.5	54.1	53.1	52.7
China Manufacturing	51.3	50.3	51.5	51.4	51.9	51.5	51.2	51.3	50.8	50.2	50.0
China Services	55.3	54.4	54.6	54.8	54.9	55.0	54.0	54.2	54.9	53.9	53.4
China Manuf. New Orders	52.6	51.0	53.3	52.9	53.8	53.2	52.3	52.2	52.0	50.8	50.4

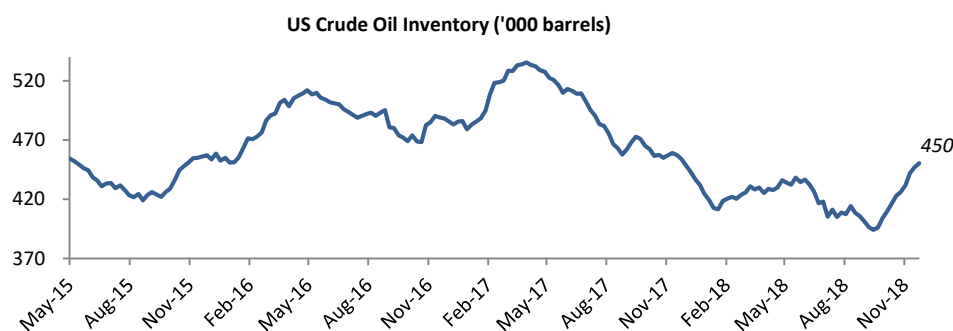
* PMI reading above 50 indicates economy expansion

* 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: Would the OPEC Meeting Deliver a Bullish Sentiment?



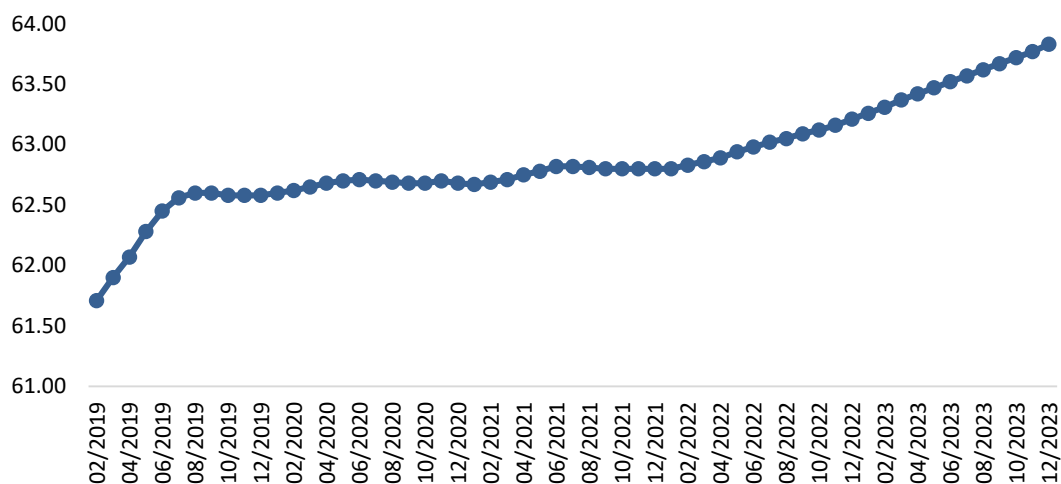
Source: Bloomberg, Capital Investments

Bearish sentiment dominated the oil market throughout the month of November with the oil curve flipping into a bearish contango shape for the first time in over a year. The steep decline in oil prices, by over 20% in November, was on the back of Saudi Arabia producing more than 11mln barrels a day in a move to cushion the market from the US sanctions on Iran. This came amid rising oil inventories over the past 10 weeks, US oil production rising to a record 11.6mln barrels a day, weak economic prospects, and from a different angle, a series of tweets by President Trump which took aim at OPEC plans to cut oil production. On a separate note, Goldman Sachs went further in explaining why the decline in oil prices was harsh by stating that dealers sold futures to cover producer hedges. For instance, producers lock in their price exposure through the purchase of put options from investment banks. As prices decline to the levels where the options pay out, then the banks providing the hedges are forced to sell large quantities of futures to cover their own risks.

On the positive side, traders and investors are looking at the OPEC and its allies meeting on December 6 in Vienna, led by Saudi Arabia and Russia to get the direction of future oil production. President Putin and Crown Prince Mohammed Bin Salman paved the way for a potential deal to curb production with the details left for the relevant ministers to sort with the potential move by Russia

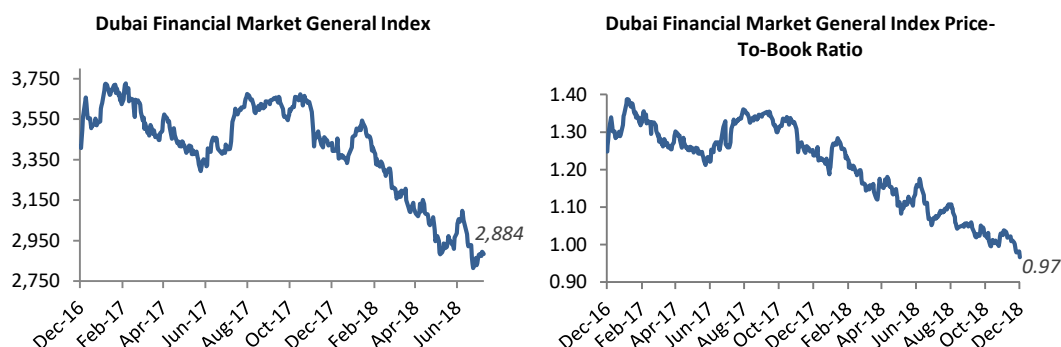
key to set the tone. The consensus range in cuts is between 1mln to 1.4mln barrels a day. On a positive note, the IEA said that global oil consumption will be solid next year partly due to lower oil prices with global consumption seen rising by 1.4mln barrels a day compared with 1.3mln barrels in 2018. Potential production cuts by OPEC and Russia shall restore oil prices to the USD 70 level per barrel.

Crude Oil Brent Future Curve (USD/Barrel)



Source: Bloomberg, Capital Investments

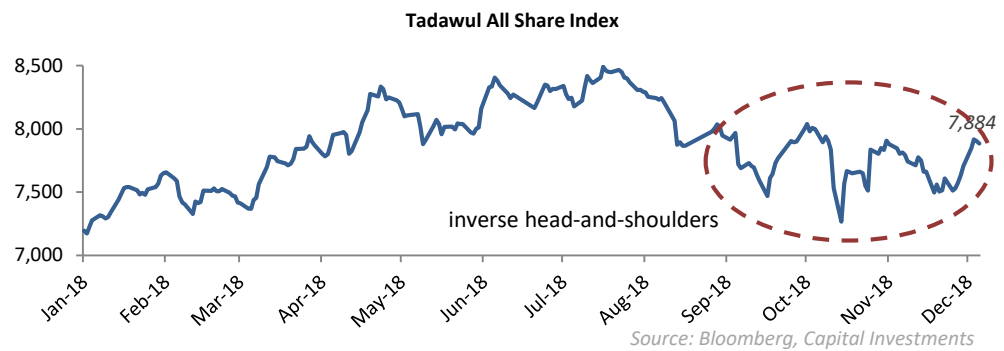
MENA: Few Words on UAE and Saudi Arabia



Source: Bloomberg, Capital Investments

Despite the recent recovery in oil prices, UAE equities continue to trade at a depressed level with price to book multiples near 1 and indices level at 3- year lows, making them the worst performers in the region so far. A combination of a strong USD and weakness in regional economies weighed negatively on the performance of the country notably on the tourism and real estate sectors. For instance, real-estate developer Damac stated that it sees a difficult year ahead for Dubai’s properties while the bellwether Emaar Properties sold 5 hotels to relieve a liquidity strain.

On the positive side, authorities in the UAE have been moving forward with key stimulus measures that include fees reduction, providing long term residency visas for specific categories of investors or employees, and more importantly, the central bank has removed a 20% cap on real estate loans while the government is stepping up its infrastructure spending for the Expo 2020. The IMF is optimistic about the growth prospects of the UAE which is expected to grow by 3.7% in 2019 compared to 2.9% in 2018.



The Saudi equity market is forming an inverse head-and-shoulders pattern which should lay the ground from a technical perspective for a sharp rally. The conditions for this rally would be the stability and recovery in oil prices, expansionary fiscal policy for 2019, peak in expat departures which reached around 1.7mln persons since June 2017, some political breakthroughs in Yemen, large project awards by the government that would add some grease to the non-oil GDP activity, and a pickup in credit expansion to the private sector.

Major Indices	Status as of end		Performance	
	December. 2017	November. 2018	November.2018	YTD (30 November. 2018)
MENA				
Abu Dhabi	4,398.44	4,770.08	-2.69%	8.45%
Bahrain	1,306.03	1,328.81	1.07%	1.74%
Dubai	3,370.07	2,668.66	-4.16%	-20.81%
Egypt	15,016.97	13,319.50	0.52%	-11.30%
Jordan	2,132.17	1,863.13	-4.88%	-12.62%
Kuwait	4,793.47	5,317.81	1.60%	10.94%
Lebanon	1,142.60	981.68	-0.26%	-14.08%
Morocco	12,337.77	11,202.53	2.59%	-9.20%
Oman	5,047.14	4,412.06	-0.25%	-12.58%
Palestine	573.22	527.12	0.82%	-8.04%
Qatar	8,526.00	10,364.54	0.62%	21.56%
Saudi Arabia	7,230.61	7,702.99	-2.58%	6.53%
Tunisia	6,262.43	7,259.86	-1.89%	15.93%
S&P Pan Arab Composite	685.52	724.03	-1.71%	5.62%
Dow Jones MENA	523.44	553.47	-1.59%	5.74%
Americas				
Dow Jones Industrial	24,837.51	25,338.84	0.89%	2.02%
S&P 500	2,687.54	2,737.76	0.96%	1.87%
NASDAQ Composite	6,950.16	7,273.08	-0.45%	4.65%
S&P/Toronto Composite	16,221.95	15,194.04	1.11%	-6.34%
Europe				
EURO Stoxx 50	3,524.31	3,174.16	-0.73%	-9.94%
S&P Europe 350 Index	1,574.89	1,451.55	-0.83%	-7.83%
FTSE 100 Index/ London	7,622.88	7,038.95	-1.25%	-7.66%
FTSE MIB Index/ Italy	22,120.95	19,159.60	0.57%	-13.39%
DAX Index/ Germany	12,979.94	11,298.23	-1.30%	-12.96%
ASIA/Pacific				
NIKKEI 225/ Japan	22,783.98	22,262.60	1.56%	-2.29%
S&P/ASX 200/ Australia	6,088.14	5,758.42	-1.23%	-5.42%
BRIC				
Brazil/ Bovespa	76,402.08	89,709.56	2.61%	17.42%
Russia/ RTS	1,150.58	1,141.30	1.34%	-0.81%
India/ Bombay Sensitive	33,848.03	36,170.41	5.02%	6.86%
China/ Shanghai Composite	3,296.39	2,567.44	-1.36%	-22.11%
Hong Kong/ Hang Seng	29,863.71	26,451.03	5.89%	-11.43%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2017	November. 2018	November.2018	YTD (30 November. 2018)
Commodities (in USD)				
Brent Spot (Barrel)	66.39	58.94	-20.20%	-11.22%
WTI Cushing Spot (Barrel)	59.84	51.45	-21.22%	-14.02%
Natural Gas NYMEX (MMBtu)	3.06	4.65	40.70%	51.98%
Gold Spot (OZ)	1,295	1,224	0.78%	-5.46%
Silver Spot (OZ)	17	14.31	0.44%	-15.14%
Copper LME Spot (MT)	7,254	6,248	3.50%	-13.87%
Corn CBOT Active Month (Bushel)	3.95	3.73	-0.67%	-5.45%
Wheat CBOT Active Month (Bushel)	4.95	5.08	-1.60%	2.68%
Soybean CBOT Active Month (Bushel)	9.80	8.87	4.17%	-9.46%
Rough Rice Futures (USD/cwt)	11.66	10.92	3.17%	-6.35%
Currencies Spot Exchange Rates Against US Dollar				
Euro	1.19	1.14	0.72%	-4.61%
GBP	1.34	1.28	0.20%	-4.85%
CAD	0.80	0.75	-0.93%	-5.37%
Yen	0.01	0.01	-0.46%	-0.54%
CNY	0.15	0.14	0.47%	-5.88%

Source: Bloomberg, Capital Investments

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