

Monthly Newsletter

March 1st, 2019

"Today a reader, tomorrow a leader" — Margaret Fuller

"A perfect unit is the Earth. Why do you persist in disremembering her with swords and boundary marks?" — Mikhail Naimy

Clues from Recent Asset Classes' Behavior

Macro: A Small Uptick in Data

Oil: OPEC and The Tweet

MENA: Egypt's Economy and Reforms on the Right Track

Introduction

For the past couple of months, the narratives of Brexit, US-China trade negotiations, dysfunctionality of US politics, divergence among the hawk and dove camps of the Fed, decelerating corporate earnings, and a normalization or slowdown in global economic growth in 2019 seem to be well recognized by investors.

As a result, a wave of optimism reigned supported by the tailwind of relatively low oil prices, tamed inflation and bond yields, stable USD and potential impulses from the targeted Chinese stimulus measures which may lift corporate profit in the second half of the year.

The optimism grew further around an improvement in the trade negotiations between the US and China. Market participants are aware that the issues will not be resolved fully and that the devil lies in the details, however continuous discussions are a positive engagement. In this context, analysts are talking about a potential "Mini-Shanghai Accord 2" in allegiance to the previous agreement achieved in 2016, which generated tacitly a less hawkish US monetary policy, as well as a stable Chinese Yuan and supportive economic policies by China. This time, it will also include a set of memoranda of understandings between the two powers in relation to key trade issues and a framework to reduce the US trade deficit with China.

In addition, the flock of dovish central banks led by the US Fed is casting its spell over the markets, keeping investors' animal spirits bubbly and pushing markets in an upward direction.

From this vantage point, it is worth concentrating on whether markets have overshot to the upside or not? In our opinion, we prefer to de-risk equities, while improving our asset allocation accordingly and holding a portion in dry powder. Given that some sort of a trade deal is in sight, the earnings season is coming to an end, and the Fed has expressed its views, markets will have to consolidate or re-test some lows as we cannot see much juice to squeeze, especially that the wide risk premia that were available in the last quarter of 2018 are closing.

As we move forward in our investment journey in 2019 we prefer to keep looking over our shoulders. We deeply believe that any unexpected events or data would cause some risk aversion however we think that investors should curb some of their greed for a variety of visible reasons and thus avoid the waiting game until the next shock explodes.

Despite the dovish tone adopted by major central banks and amid a potential pause in interest rate hikes by the US Fed, we continue to believe that the general bias of monetary policy is relatively hawkish. Most central banks' balance sheets including that of the Bank of Japan have almost peaked or are declining meaning that liquidity drainage is still in place until further notice. The latest market rally has shown how investor sentiment and central banks are the major driving force of volatility. Amid tight banking regulations in relation to proprietary book trading, and given the spread of algorithmic strategies and passive strategies, markets were exposed as the only marginal buyers were central banks and no one dared to step in and buy the dip, only until central banks and notably the Fed turned the needle. In markets that are dependent on easy liquidity, vulnerabilities rise and spread compression in credit, or multiples expansion in equities are not sustainable.

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We are closely watching the growing risks from populist movements and geopolitical tensions. We took notice of the OECD warning about the high level of low rated corporate leverage as the disconnect between this mountain of debt and depressed default rates is masked by low global interest rates. General uncertainty about global trading is weighing negatively on global capital expenditure. In addition, cross national divergences along with established macro imbalances and instability are risks that could not be ignored.

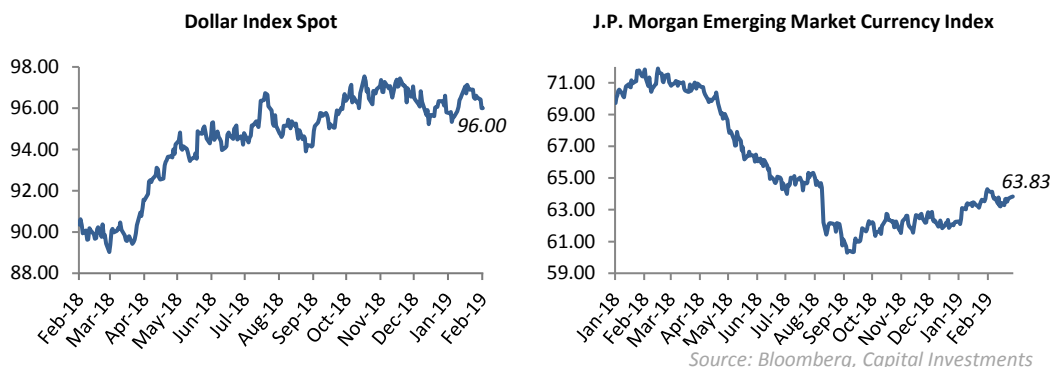
We continue to be constructive about the MENA in general amid recovery in oil prices, targeted fiscal measures adopted by many governments, along with potential international indices inclusion for key countries such as Saudi Arabia and Kuwait.

Fear & Greed Over Time

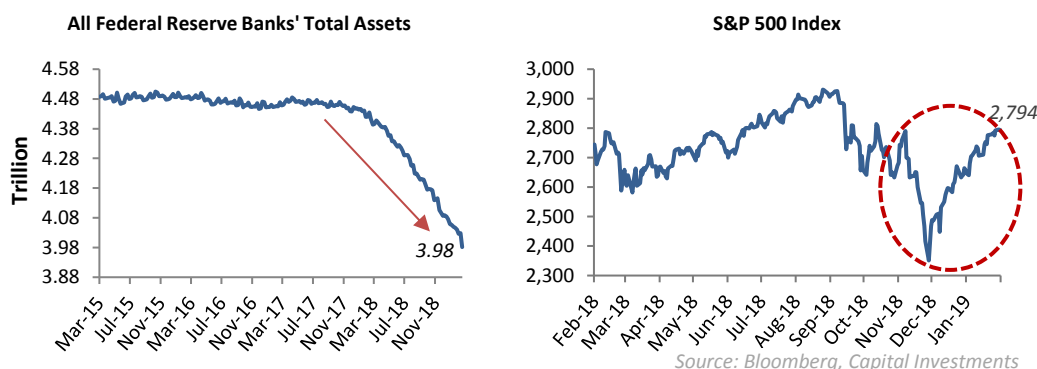


Source: CNN Business

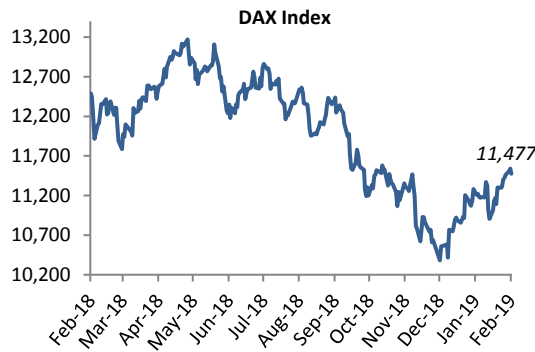
Clues from Recent Asset Classes' Behavior



Despite a dovish US Fed rhetoric and an expected pause in interest rate hike, the USD is still resilient and did not weaken. In fact, the dollar index (DXY) is still trading in its stubbornly high range above its 200-day moving average at around 95.5. We prefer to see the USD breaking below such support. Stalling eurozone activity and a weak Euro are contributing meaningfully to the strength in USD despite a deceleration in US economic activity and an expected higher budget deficit. In the same context, many emerging market currencies lost their allure after a boost post the Fed meeting at the end of January. A potential trade deal between the US and China along with a gradual recovery in Europe will lead to a weakening USD and a stable Yuan which may prove positive for well positioned emerging market countries.

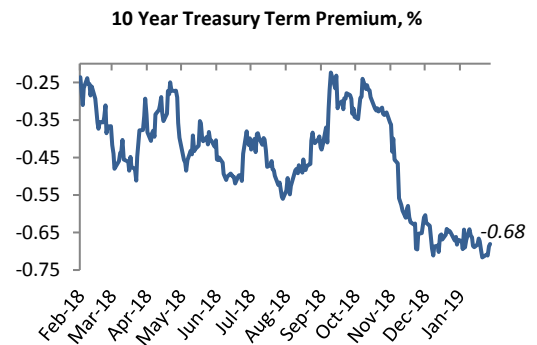


We believe that the V-shaped recovery in US equities is driven mainly by a risk-on mood on the back of the patient approach towards monetary policy tightening that the US Fed decided to adopt, along with the optimism over trade negotiations. However, we prefer to adopt a cautious stance as the divergence between the US Fed balance sheet and market reaction is not sustainable especially that the US Fed is still expected to rain in USD 600bn from its balance sheet this year. In addition, investors should assess the Fed's movement carefully as its members are divided between hawks who would like to resume the tightening cycle once an improvement in data is registered, and doves who would prefer inflation to overshoot before tightening again, while details in relation to the balance sheet action plan are still not clear although markets participants expect the Fed to stop shrinking its balance sheet by the end of Q3 2019.



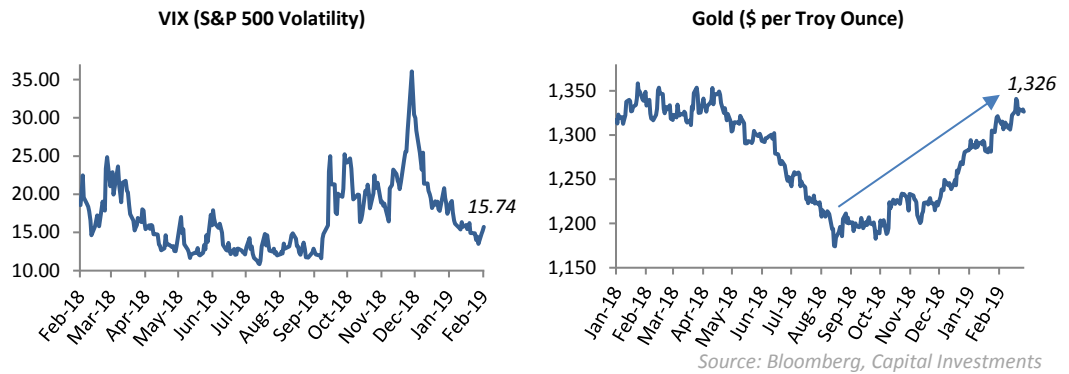
Source: Bloomberg, Capital Investments

Progress over trade negotiations, coupled with stimulus measures taken by the Chinese authorities, along with a potential inclusion into the MSCI index are driving the Chinese equities higher. Although we expect some volatility in markets, Chinese equities will be supported by the action taken by the government which will start to show positive results in the coming months. Our attention turns to Germany which has delivered negative data over past months, and this explains the muted recovery in its stock market relative to China or the US, however, if the economies in Europe in general, and Germany in specific, gain track, we think that investing in the Dax is worth considering.



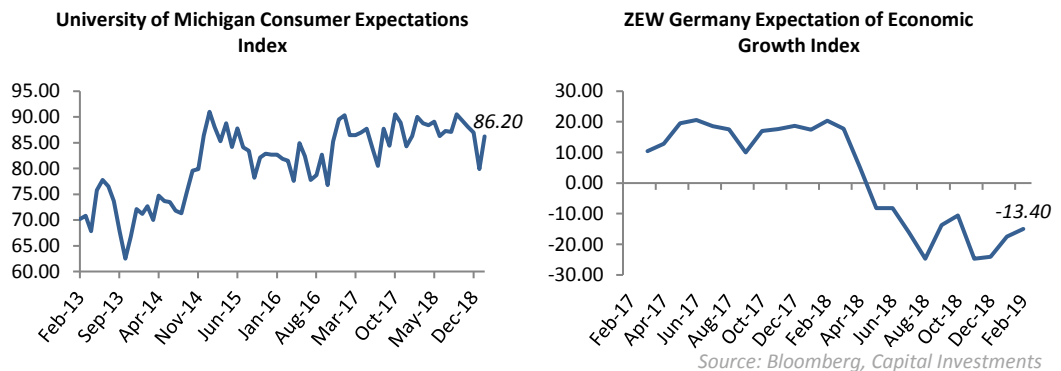
Source: Bloomberg, Capital Investments

A disinflationary wave due to falling energy prices, muted global economic activity coupled with a flight to safety reaction has kept bond yields at bay, although we started to notice steepness in the long end of the curve which means that investors are expecting the Fed to end its hiking cycle soon, and most probably, they are expecting much more clarity regarding the shrinking of the Fed's balance sheet. We think that cyclical inflation will pick up in coming months as oil prices and some other commodity prices are recovering, in addition, few soft economic data are suggesting that economic activity is gaining some ground which will lend support to yields and may push them higher. In this context, we would like to alert investors on the deep compression in spreads and the significant narrowing in the term premium, which raises some warning flags regarding complacency when it comes to fixed income investing. We prefer to tap the market selectively as wide spreads are not available.

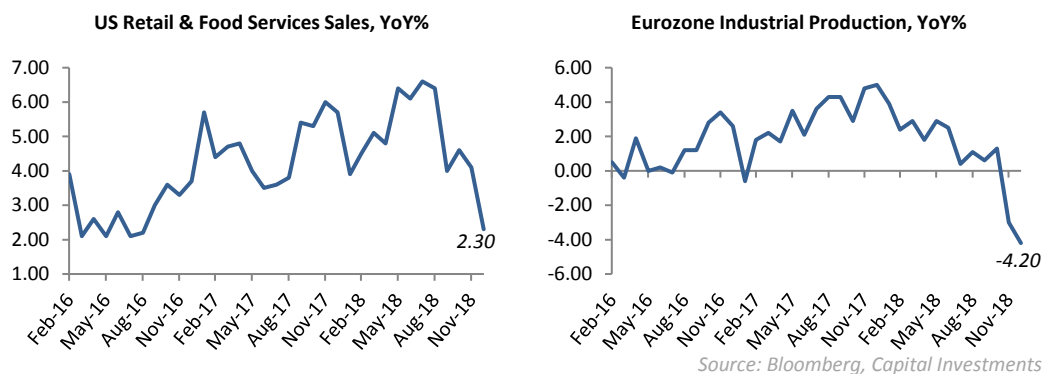


We continue to see gold prices as a warning signal from the woes in the global economy and an early indicator that the monetary policy is about to shift, which explains the recent rally in the yellow metal amid a relatively strong USD. As for the VIX index, which is the gauge of fear in the market, is approaching its recent lows. Although equities might have some room to run due to an improvement in soft data and a potential easiness in trade talks and Brexit negotiations, the VIX index is telling investors to start de-risking and to avoid any complacency.

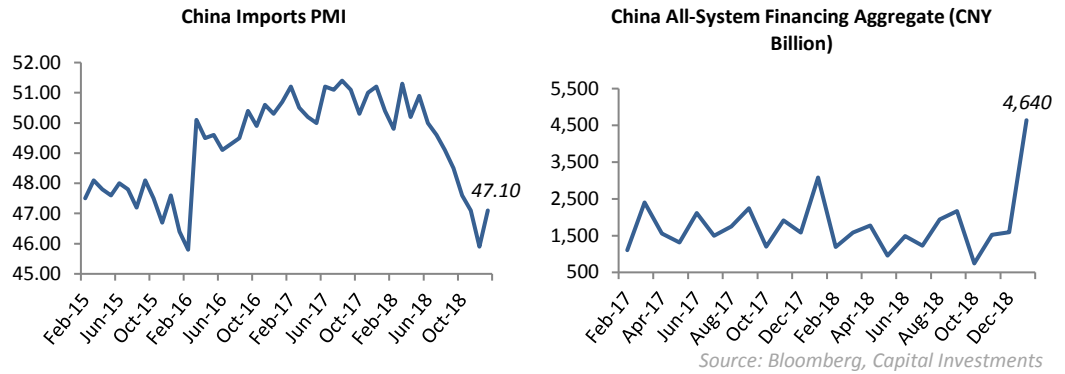
Macro: A Small Uptick in Data



The Fed’s dovish tone and optimism regarding the US-China trade negotiations have led to an uptick in consumer expectations, as shown in the graphs above, which might reignite a positive sentiment and stimulate consumer spending going forward.



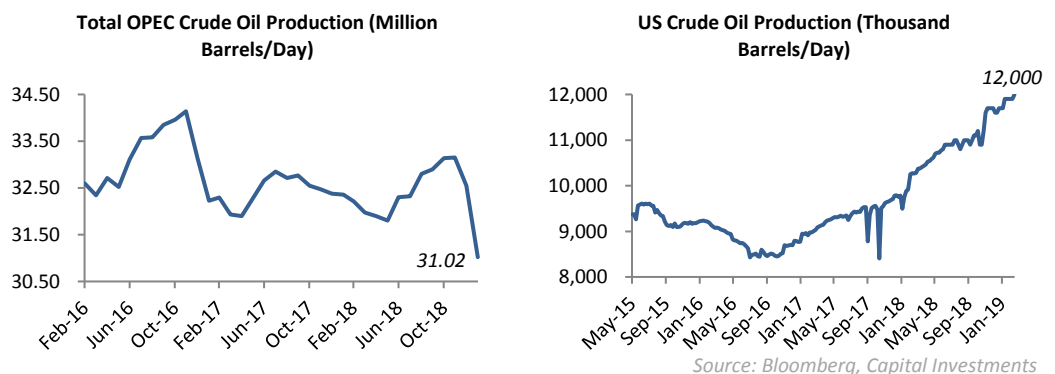
However, hard data remains weak- US retail sales recorded the weakest growth since August 2016, not to mention The Federal Bank of New York data which is showing signs of delinquencies in car loans and credit card payments. In addition, industrial production in Europe is still under pressure, especially with the weakness in China’s economy over the past months. We need to see data confirmation that the sentiment is turning into actual economic activity.



The good news is that the fiscal and monetary stimulus in China is starting to materialize albeit modestly, and we will monitor PMI data to get a confirmation that the uptick in the data is sustainable especially in relation to trade figures. In addition, credit expansion has resumed in China, as shown in the graph above, which means that recent measures are starting to bear fruit. China is trying to rebalance its economy towards private consumption and thus it has lowered taxes for low income workers, and in addition, it has lowered the reserve requirement ratios for banks to make funding available in the economy and to lower borrowing costs. We think that the effect of all these measures will come with a lag.

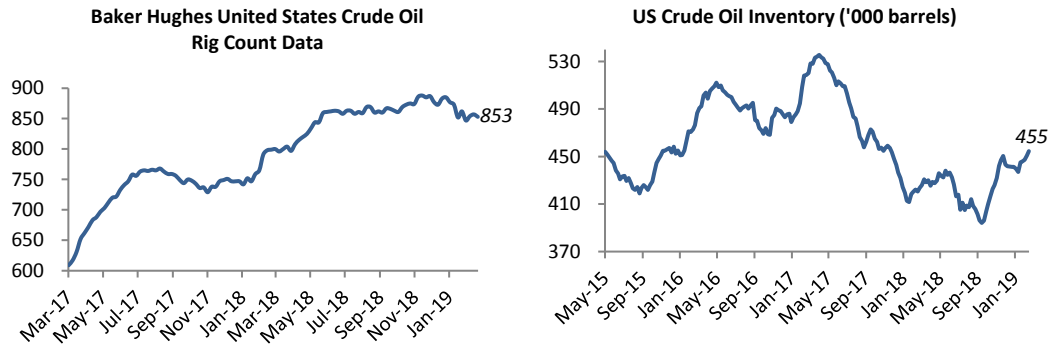
Oil: OPEC and the Tweet

While Trump’s tweet against OPEC weighed negatively on oil prices, it’s important to note that the market’s fundamentals remain intact. According to the IEA, the market is undergoing a gradual rebalancing process as it works off the surpluses built in H2 2018.



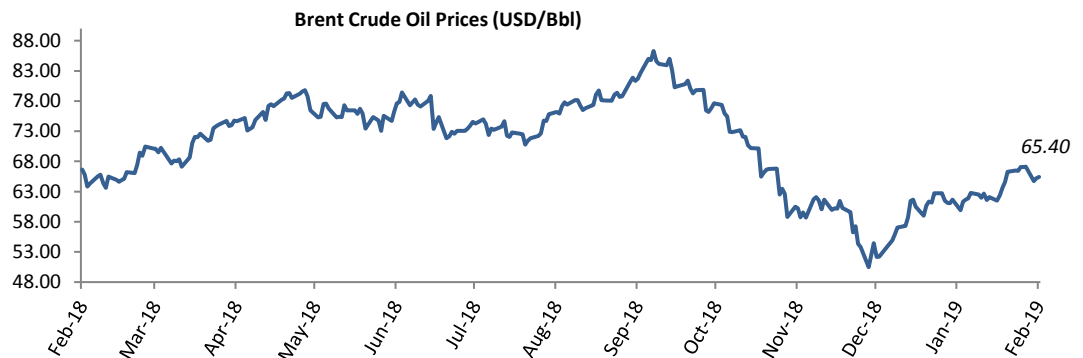
The IEA has maintained its optimistic global demand growth forecast for 2019 at 1.4mln b/d, while Al-Falih the Saudi Energy Minister has stated that oil demand is expected to start to recover in Q2 2019. On the supply side, loss of output continues from Libya, Venezuela, and Iran, while the

elections in Nigeria pose a geopolitical risk which could disrupt production. In the US, rig count continues to trend relatively lower. Moreover, Saudi Arabia has pledged even deeper oil cuts, bringing its output to 9.8mln b/d in March, and Al-Falih has stated that reducing the glut driven by increasing US crude inventories is their main target.



Source: Bloomberg, Capital Investments

According to the IEA, supply growth outside of OPEC will stand at 1.8 mln b/d in 2019, bringing the total production from these countries to 64.4 mln barrels, which is 330k higher than forecasted. This means that the call on OPEC will be 30.7mln b/d, which is lower than their January production level of 30.8mln b/d. Nonetheless, Saudi Arabia and Russia are leading the group in curbing supply, and Al-Falih has expressed that OPEC isn't tied to its current level of cuts.



Source: Bloomberg, Capital Investments

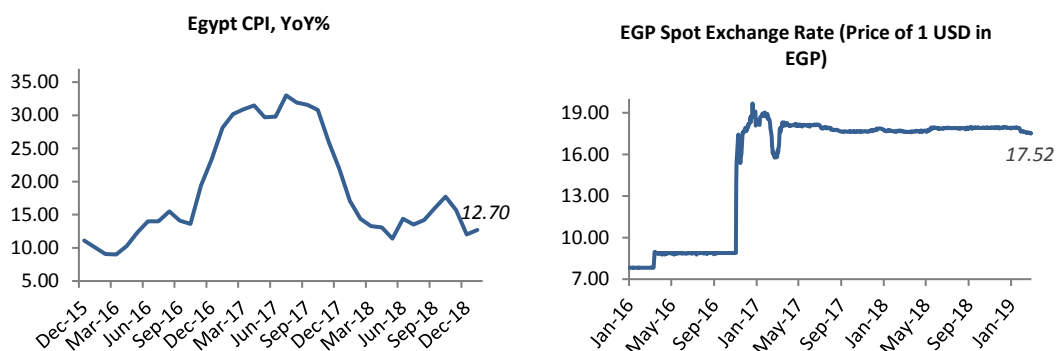
MENA: Egypt's Economy and Reforms on the Right Track

The Egyptian economy is set to benefit from a pick-up in domestic demand and an external recovery with GDP expected to grow by around 6%, while unemployment has reached the lowest point since 2011 at 8.9%. In addition, Egypt's debt/GDP is expected to decrease, which makes the economy more stable and balanced, and the current account deficit is expected to improve. Foreign investors have increased their investments in Egyptian T-bills by 30%, which has been driven by a softer rate cycle in the US, an increase in allocation to high yield funds, and an improvement in the external balance and current account, increasing the flow of money into the country.

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Unemployment rate, %	12.7	13.2	13	12.8	12.5	11.8	9.9	9.5	9.2	9
Primary balance/GDP, %	-4.4	-6	-4.5	-4.3	-5.4	-2.4	-0.3	1	1.2	1.3
Debt /GDP, %	74.6	84.7	86.2	88.4	96.8	103.2	92.6	89.2	87.1	84.6
Usable reserves (USD Mln)	15,556	14,960	16,710	20,104	17,570	28,707	41,661	44,960	50,395	52,510
Net FDI /GDP, %	1.4	1.2	1.3	1.9	2	3.3	3	2.8	2.7	2.4
Current account/GDP, %	-3.7	-2.2	-0.9	-3.6	-6	-6.1	-2.4	-2.5	2.4	2.3

Source: Standard and Poor's

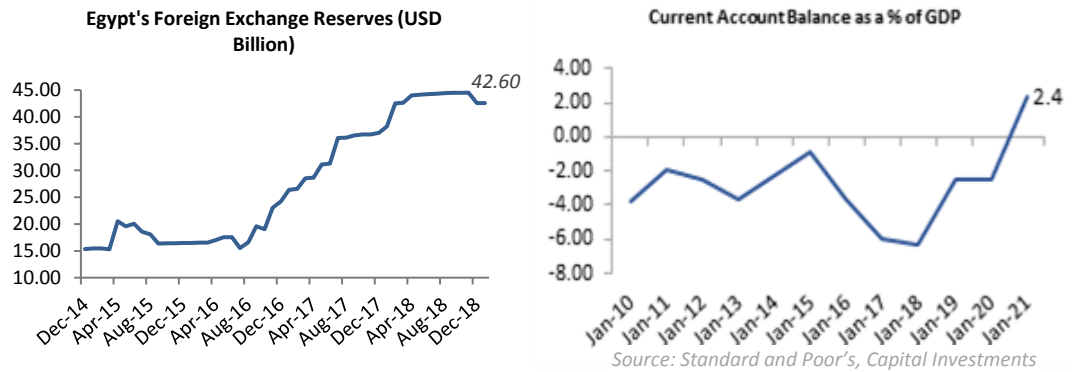
Inflation has been following a downward trend to reach 12% recently, and in line with the disinflationary trend across the globe. We see a spike in inflation as a major risk especially that oil prices are recovering gradually, not to mention that Egypt's inflation is affected by other domestic and global supply constraints, especially when it comes to food prices as agriculture products prices have been relatively on the rise.



Source: Bloomberg, Capital Investments

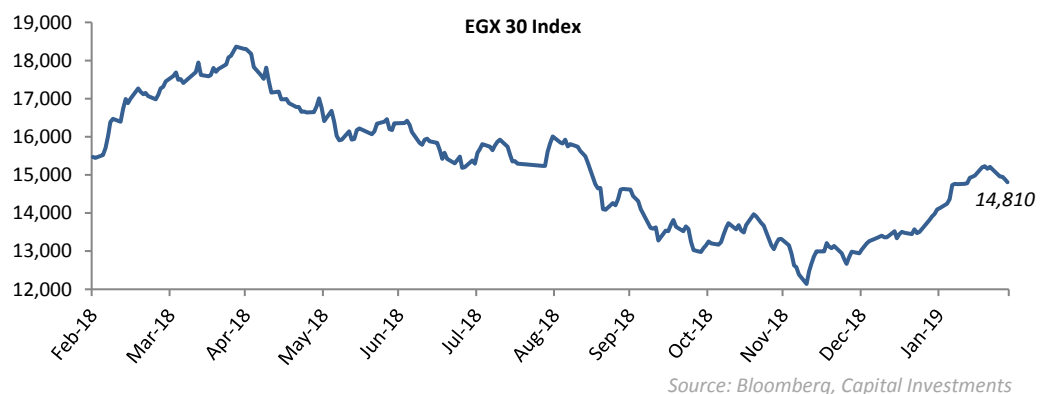
Egypt still has ample foreign currency reserves in the range of USD 42.5bn enough to cover 7.34 months of imports, and although the country has around USD 14.5 in short term external liabilities, it will be able to generate around USD 20bn through the balance of payments mainly by the receipt of remittances and tourism, which has been recovering at a high rate. This is in addition to savings made by lower oil prices and the gas production of the Zohr field, which is due to reach 2.1 bcf/day, according to the Ministry of Petroleum, without mentioning potential FDI and revenue from the Suez Canal. More importantly, Egypt is due to receive the two last tranches of the IMF program with USD 2bn each (one of them is already confirmed) and the second one is expected in July. Egypt issued

successfully USD 4bn international bonds this year. All this combined is sufficient to cover short term external liabilities and current account needs which are at 2.5% of an expected GDP for 2019 of USD 298bn. On top of that, we have noticed that the carry trade has resumed as foreign inflows, which dropped by around USD 10bn from a peak of USD 21bn in early 2018, are increasing again as the US Fed is adopting a dovish tone.



It is worth noting that the Central Bank of Egypt has abolished its repatriation mechanism as this was seen as a disguised intervention in the FX market. With the absence of this, any inflow of foreign money will go through the interbank system thus affecting the currency positively and the same would apply in the case of any outflow. The EGP is expected to be volatile with a plus/minus 5% range but will be supported by the factors mentioned earlier. Moreover, after 7 consecutive meetings, the CBE MPC has finally started the easing cycle on the 14th of Feb 2019. The 100 bps cut shows reflects the Central bank's confidence in the Egyptian economy despite global turmoil. The decision is backed by an improvement in FX, capital flows, and relatively lower inflation. Finally, we expect more cuts between the first quarter and the 4th quarter of 2019 of around 2%.

The stock market has bottomed after peaking in April 2018, and despite the recent rally, we believe that selective opportunities are still present. This lunch does not come for free however, and potential political uncertainty coupled with an unintended negative deviation from the current economic reform program are risks worth considering.



Major Indices	Status as of end		Performance	
	December. 2018	February. 2019	February.2019	YTD (27 February. 2019)
MENA				
Abu Dhabi	4,915.07	5,152.02	2.12%	4.82%
Bahrain	1,337.26	1,418.53	1.95%	6.08%
Dubai	2,529.75	2,675.80	4.21%	5.77%
Egypt	13,035.77	14,772.34	4.57%	13.32%
Jordan	1,908.81	1,990.07	1.97%	4.26%
Kuwait	5,267.36	5,538.96	2.00%	5.16%
Lebanon	976.75	937.64	-0.94%	-4.00%
Morocco	11,364.31	11,250.78	-0.88%	-1.00%
Oman	4,323.74	4,112.31	-1.30%	-4.89%
Palestine	529.35	540.77	1.82%	2.16%
Qatar	10,299.01	10,136.00	-5.45%	-1.58%
Saudi Arabia	7,826.73	8,472.50	-1.02%	8.25%
Tunisia	7,271.65	7,152.52	-1.51%	-1.64%
S&P Pan Arab Composite	728.72	770.30	-0.69%	5.71%
Dow Jones MENA	556.65	587.46	-0.66%	5.53%
Americas				
Dow Jones Industrial	23,327.46	25,985.16	3.94%	11.39%
S&P 500	2,506.85	2,792.38	3.26%	11.39%
NASDAQ Composite	6,635.28	7,554.51	3.75%	13.85%
S&P/Toronto Composite	14,322.86	16,074.30	3.43%	12.23%
Europe				
EURO Stoxx 50	3,001.42	3,282.77	3.90%	9.37%
S&P Europe 350 Index	1,367.94	1,507.99	3.89%	10.24%
FTSE 100 Index/ London	6,728.13	7,107.20	1.99%	5.63%
FTSE MIB Index/ Italy	18,324.03	20,498.79	3.89%	11.87%
DAX Index/ Germany	10,558.96	11,487.33	2.81%	8.79%
ASIA/Pacific				
NIKKEI 225/ Japan	20,014.77	21,556.51	3.77%	7.70%
S&P/ASX 200/ Australia	5,646.40	6,150.27	4.87%	8.92%
BRIC				
Brazil/ Bovespa	87,887.26	97,307.31	-0.09%	10.72%
Russia/ RTS	1,066.13	1,191.01	-1.93%	11.71%
India/ Bombay Sensitive	36,068.33	35,905.43	-0.97%	-0.45%
China/ Shanghai Composite	2,493.90	2,953.82	14.29%	18.44%
Hong Kong/ Hang Seng	25,845.70	28,757.44	2.92%	11.27%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2018	February. 2019	February.2019	YTD (27 February. 2019)
Commodities (in USD)				
Brent Spot (Barrel)	53.17	65.88	8.16%	23.90%
WTI Cushing Spot (Barrel)	45.41	56.95	5.87%	25.41%
Natural Gas NYMEX (MMBtu)	2.68	2.80	1.23%	4.32%
Gold Spot (OZ)	1,282.45	1,319.85	-0.10%	2.92%
Silver Spot (OZ)	15.50	15.74	-2.02%	1.58%
Copper LME Spot (MT)	5,949.00	6,546.00	6.42%	10.04%
Corn CBOT Active Month (Bushel)	3.83	3.74	-2.99%	-2.42%
Wheat CBOT Active Month (Bushel)	5.11	4.67	-10.54%	-8.57%
Soybean CBOT Active Month (Bushel)	9.08	9.17	-1.35%	0.99%
Rough Rice Futures (USD/cwt)	10.10	10.29	-3.06%	1.88%
Currencies Spot Exchange Rates Against US Dollar				
Euro	1.15	1.14	-0.68%	-0.85%
GBP	1.28	1.33	1.53%	4.35%
CAD	0.73	0.76	-0.24%	3.67%
Yen	0.01	0.01	-1.93%	-1.25%
CNY	0.15	0.15	0.20%	2.86%

Source: Bloomberg, Capital Investments

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