

Monthly Newsletter

May 8th, 2019

"A wise man will make more opportunities than he finds" — Sir Francis Bacon

"Nobody got anywhere in the world by simply being content" — Louis Dearborn L'Amour

Clues from Recent Asset Classes' Behavior

Macro: A Fragile Recovery

Oil: Supply Shortage and Timid Demand

MENA: Focus on Domestic Plays Amid Trade War Rhetoric

Introduction

After a dire fourth quarter in 2018, the economic performance during the first quarter of 2019 has been one of a welcome relief. The three major global players-the US, China and Europe-registered decent growth in their economic activity for the beginning of 2019. Because of this performance, global Central Banks led by the US Fed, Bank of England and Bank of Canada shifted their policy tone from a dovish stance into a more neutral one, while future moves will be dictated by incoming data, notably inflation, which was recently muted across the board.

Despite this rosy start, the outlook seems somewhat challenging. For instance, the improvement in economic growth in both China and the US was of poorer quality. Growth in the US was driven by inventory buildup while in China it was mainly driven by domestic consumption. This means that the trade component was the weakest which explains the softer activity in Europe and emerging markets.

This lackluster growth is coupled with an increase in oil prices and a tight labor market in the US, which will lead to some pick up in core inflation down the road and potential pick up in yields.

Moving to markets, their performance was robust since the beginning of the year driven by easiness in global financial conditions, on the back of less hawkish Central Banks rather than earnings growth. Risk appetite revived, and volatility reverted to its mean after the panic sale at the end of last year. However, several signs continue to flash red, warranting a cautious approach from investors, as, even though the fear of missing out (FOMO) effect drove markets higher, the risk-reward equation does not seem reasonable given the year to date performance since the beginning of the year.

This cautious stance is valid as many vulnerabilities are still present and these range from fragile economic growth to weak earnings trends, which may affect corporate quality, not to mention high leverage in the global financial system along with currency and maturity mismatch.

These vulnerabilities were recently exposed through the tweet of Mr. Trump about the trade negotiations with China by stating that tariffs will increase to 25% from 10% on \$200bln worth of goods and threatened to impose new tariffs on around \$325bln worth of Chinese products, which led to a panic sale in markets across the board as investors sought haven in gold and the Japanese Yen. This proved that markets cannot rise only on the back of optimism regarding trade negotiations and dovish Central Banks. It is obvious that a high level of complacency was reigning over the investment environment.

In addition to the potential escalation in trade war and protectionism, other factors could expose these vulnerabilities and rattle markets, which include a negative re-assessment of the global economy or a sudden tightness in financial conditions. We have noticed lately that volatility, indicated through the VIX index, is becoming volatile itself which illustrates the high level of fragility in an overstretched market.

We prefer to adopt a cautious approach, raising cash, looking into domestic plays in the MENA region and looking after opportunities with attractive risk premiums, without ignoring the positive effect of international index inclusions on liquidity flows, notably in Saudi Arabia and Kuwait.

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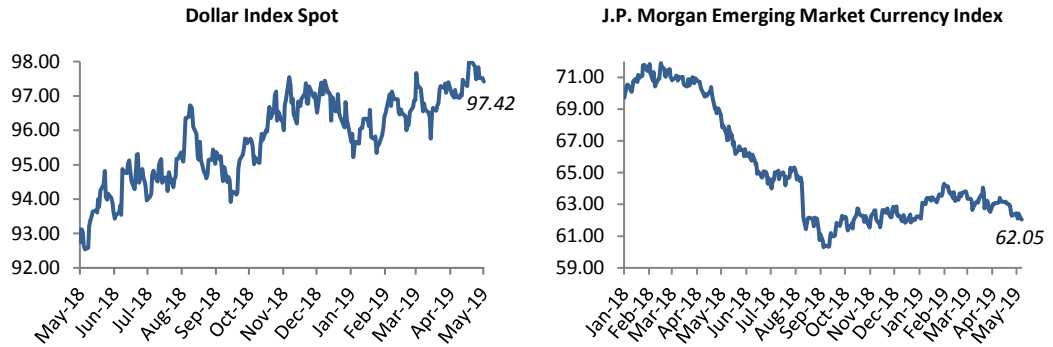
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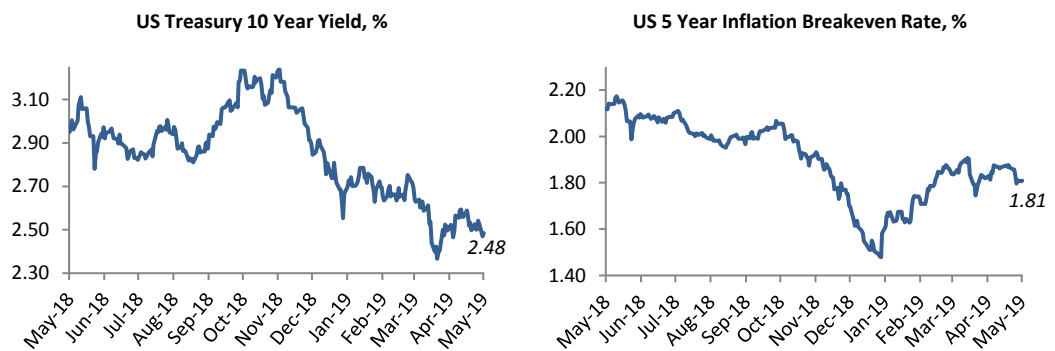
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Clues from Recent Asset Classes' Behavior



Source: Bloomberg, Capital Investments

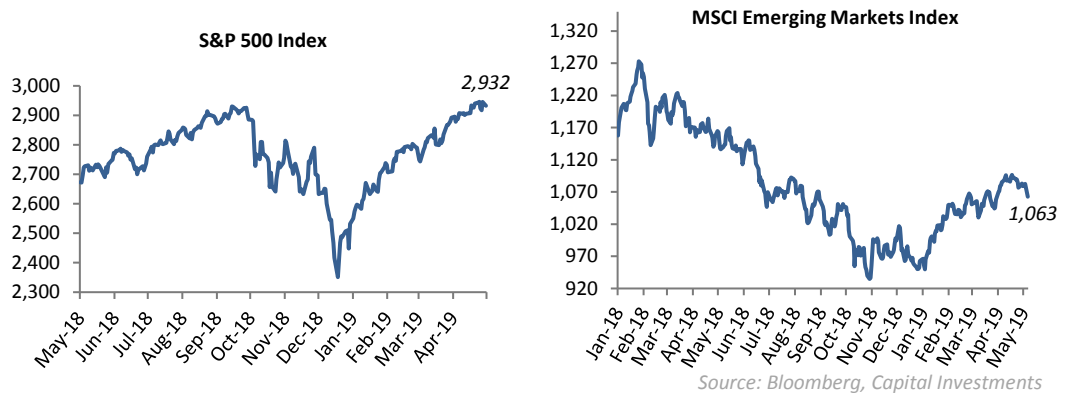
The USD maintained its strong level vis-à-vis major currencies in the world notably the Euro and various emerging economies currencies. The USD, which was supported by a less dovish US Fed, lost some steam despite maintaining its stubbornly high range. In fact, weaker than expected wage inflation coupled by poor US GDP growth in Q1 capped gains in the green back. Internationally, a potential deal between the Conservative and Labor parties in the UK regarding a compromise over the Brexit process, and some improvement in the economic activity in Europe also played a role in taming the appreciation of the USD, which has taken its toll on emerging market currencies and commodities.



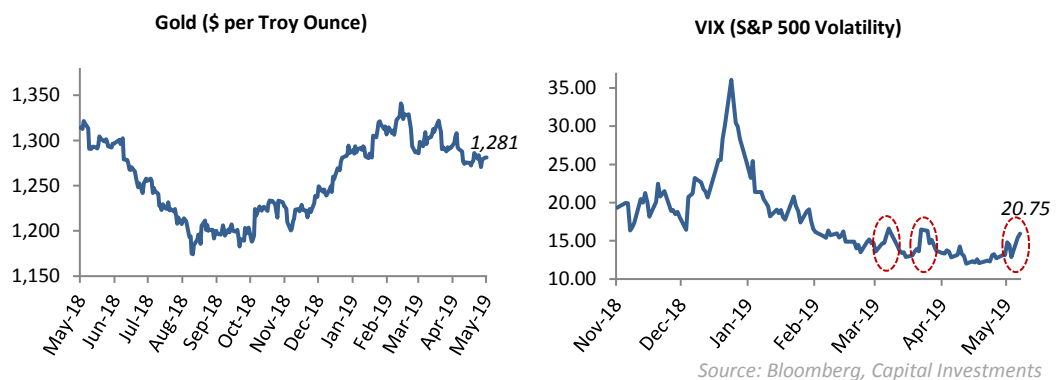
Source: Bloomberg, Capital Investments

Inflation expectations continue to be timid and below the US Fed threshold of 2% as indicated by the break-even rate in the bond market. While a mild inflation coupled with decent growth is welcomed by both equity and fixed income investors, we think that inflation will pick up once the rise in energy costs is reflected in core inflation through rising transportation costs. Wage inflation however is yet to express itself affirmatively amid a tight labor market. The US 10-year yield escaped the area of pessimism towards the end of March on the back of encouraging macro data and climbed to touch the level of 2.6% from a low of 2.37%. The recent retreat in yield was an expression of flight to safety on the back of the President Trump's Tweet that escalated the tension regarding the trade

negotiations with China. Further escalation in trade tension will impact negatively the global economic outlook and thus capping any rise in yields. Incoming macro data will be crucial for bond markets.



A combination of muted inflation and easing financial conditions along with optimism over the trade negotiations between China and the US contributed to the strong recovery in the US market which reached October 2018 levels. However, this rally seems to be over-stretched and fragile as the market dove significantly when Mr. Trump surprised markets with a tweet about raising tariffs on Chinese goods. As for emerging market equities, they have been pressured by a strong USD, weak economic data, and a set back in terms of reforms as is the case in Brazil, or noise due to heavy election season notably in Turkey, India, Indonesia, South Africa, and Argentina. We prefer to adopt a more cautious approach as the risk-reward prospect is not convincing after this stellar performance year-to-date amid weak earnings guidance and fragile economic growth.

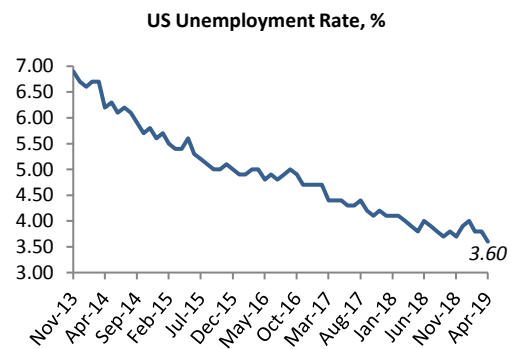
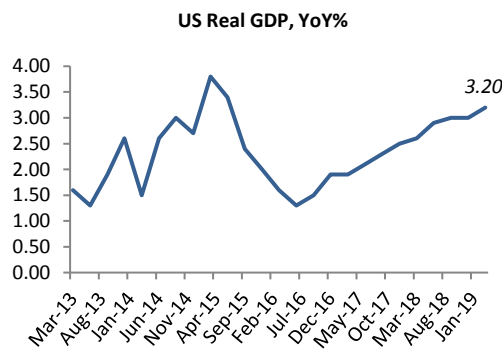


It is obvious that a combination of a strong USD and muted inflation kept Gold prices under pressure as they failed to cross the USD 1300 per ounce. It is not expected that central banks will turn aggressively hawkish, however they will follow a neutral approach which will keep interest rate levels relatively at bay and may lead to steepness in the yield curve. This would warrant the accumulation of Gold at current levels, while a weaker USD will confirm a rally in the yellow metal. The VIX index, which is an indication of volatility and a gauge of fear, has exhibited some interesting behavior. The

index which reverted to its mean started to show sudden spikes, indicating that there is a big sense of complacency rather than confidence in the financial and global economic systems, which means that a cautious approach and some hedging are appropriate now.

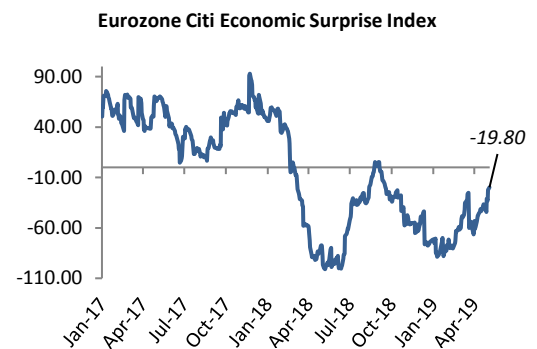
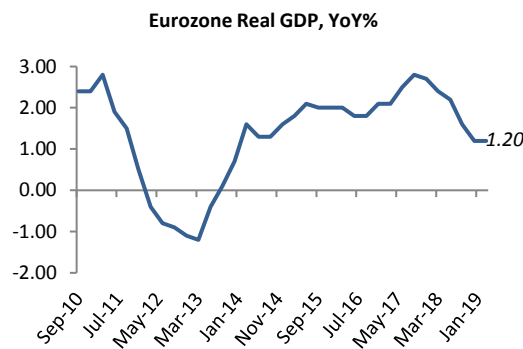
Macro: A Fragile Recovery

The series of charts below, illustrate clearly that the economic performance in Q1 for the three systemically important regions in the world was decent. However, this recovery continues to be fragile as global trade did not match the economic growth.



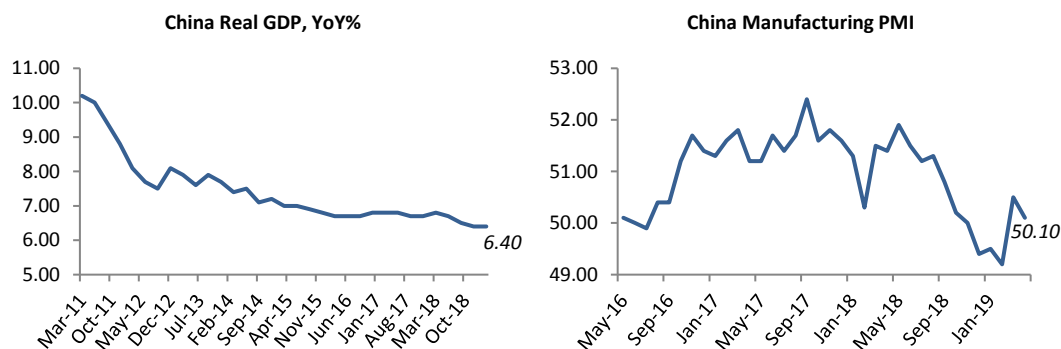
Source: Bloomberg, Capital Investments

The US grew through inventory buildup which is a bit alarming amid weak spending, and soft income growth, and a rising inventory to sales ratio, even though the unemployment rate is at a record low.



Source: Bloomberg, Capital Investments

The economic activity in Europe seems to be improving backed by the ECB's dovishness and various stimulus measures taken by many countries such as Germany, Italy, and France with the latter two seeing rising budget deficits. The pick-up in Europe requires much more confirmation as the weaknesses in confidence and PMI indices at the beginning of Q2 2019 are not encouraging.



Source: Bloomberg, Capital Investments

In China, economic growth is being supported by the targeted fiscal measures taken by the government, which aim at boosting local demand by reducing certain fees and VAT, and is being assisted by liquidity injections through the reduction in the reserve requirement ratio at the level of banks.

The below table shows a weakening trend in PMI figures which shows that the economy is not on a solid path yet.

Purchasing Managers Indices (PMI) (2017-2018):											
	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Global Manufacturing	52.9	52.7	52.5	52.1	52.0	51.9	51.4	50.8	50.6	50.5	50.3
Global Services	54.6	54.0	53.5	52.9	53.4	53.7	53.0	52.6	53.3	53.7	52.7
Global Composite	54.2	53.7	53.4	52.8	53.0	53.2	52.7	52.1	52.6	52.7	52.1
US Manufacturing	60.0	58.4	60.8	59.5	57.5	58.8	54.3	56.6	54.2	55.3	52.8
US Services	58.7	56.7	58.8	60.8	60.0	60.4	58.0	56.7	59.7	56.1	55.5
US Manuf. New Orders	63.0	60.8	64.5	61.5	58.0	61.8	51.3	58.2	55.5	57.4	51.7
EU Manufacturing	54.9	55.1	54.6	53.2	52.0	51.8	51.4	50.5	49.3	47.5	47.9
EU Services	55.2	54.2	54.4	54.7	53.7	53.4	51.2	51.2	52.8	53.3	52.8
EU Composite	54.9	54.3	54.5	54.1	53.1	52.7	51.1	51.0	51.9	51.6	51.5
China Manufacturing	51.5	51.2	51.3	50.8	50.2	50.0	49.4	49.5	49.2	50.5	50.1
China Services	55.0	54.0	54.2	54.9	53.9	53.4	53.8	54.7	54.3	54.8	54.3
China Manuf. New Orders	53.2	52.3	52.2	52.0	50.8	50.4	49.7	49.6	50.6	51.6	51.4

* PMI reading above 50 indicates economy expansion

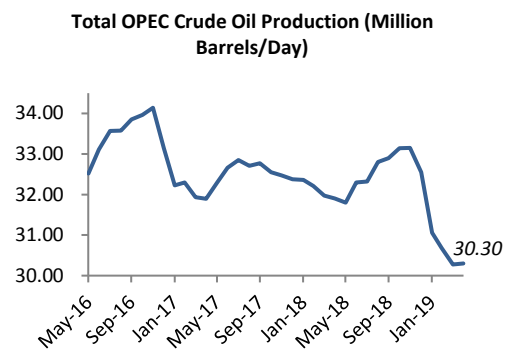
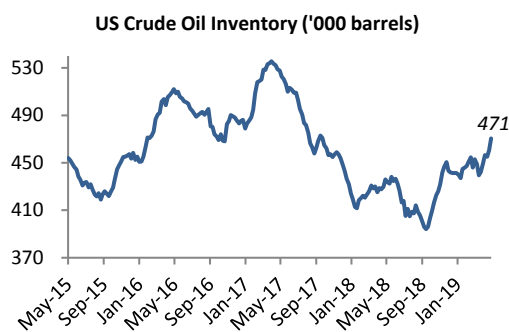
* Red points displayed within the lines above indicate highest point in the range

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

Source: Bloomberg, Capital Investments

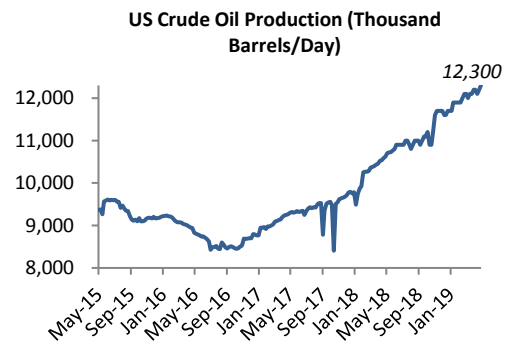
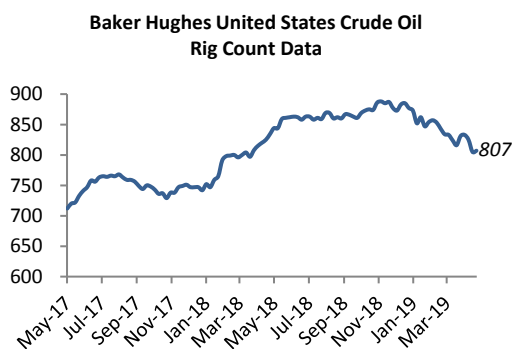
Oil: Supply Shortage and Timid Demand

The IEA sees global oil markets tightening in Q2 2019 as OPEC supply continues to fall and as the likelihood of an extension in production cut increases. Moreover, the renewed sanctions on Iran and geopolitical tension in the Middle East should support prices, along with the loss of output from Venezuela and Libya. Although inventories are currently on the rise due to turnaround in refineries, inventory drawdown is expected to start when the driving season kicks off in the US.

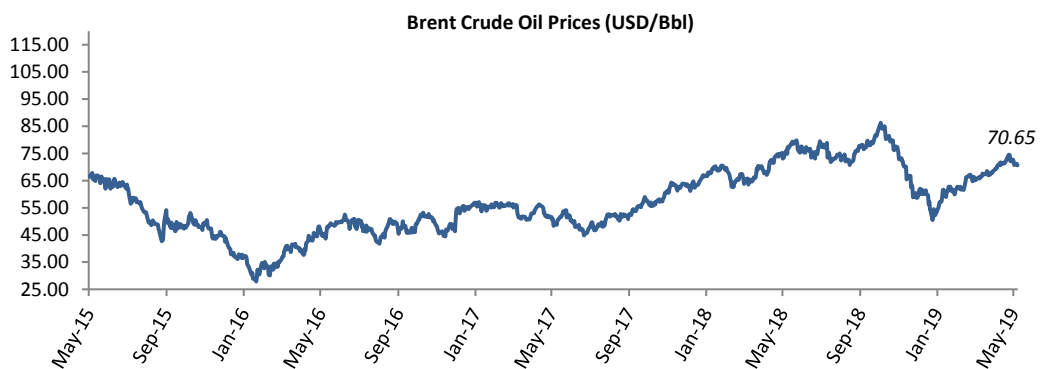


Source: Bloomberg, Capital Investments

The IEA has maintained its demand forecast at 1.4 mln b/d for 2019 but has warned that risks to demand are “currently on the downside”, exacerbated by the ambiguity regarding the trade war negotiations.



Source: Bloomberg, Capital Investments

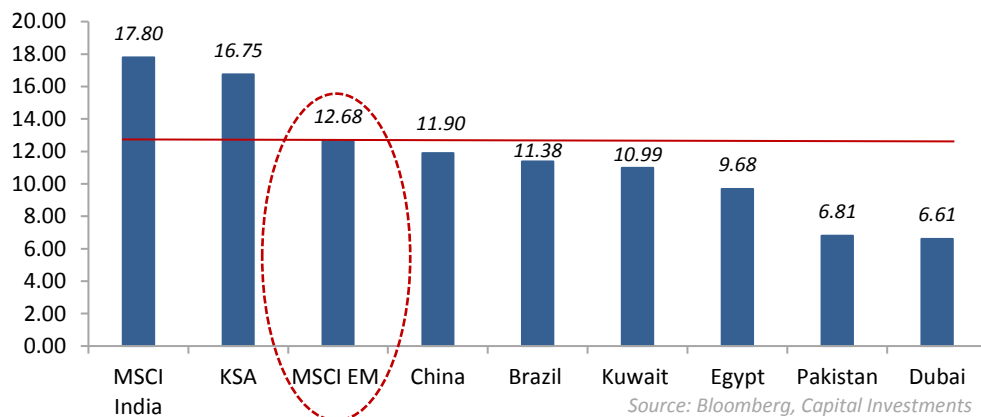


Source: Bloomberg, Capital Investments

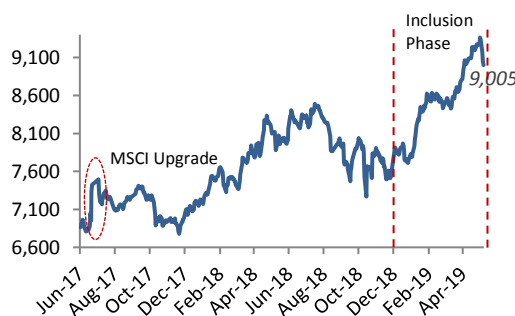
MENA: Focus on Domestic Plays Amid Trade War Rhetoric

MENA equities have had a strong start to the year, driven primarily by higher oil prices, loosening fiscal policies, and most importantly by global index inclusions. The markets therefore seem to be overvalued, making them more vulnerable to external events and shocks. Such vulnerabilities include the trade war which is weighing negatively on global GDP outlook, as well as the geopolitical tension in the Middle East as the US renews its sanctions on Iran. Moreover, given the overstretched valuations, normal corrections should be expected. We advise investors to monitor the market for any corrections as they would provide a window of opportunity for rebalancing.

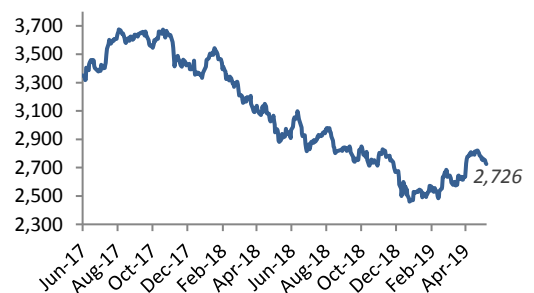
Emerging Markets Stock Exchanges' 2019 P/E Ratio According to Bloomberg Estimates



Tadawul All Share Index

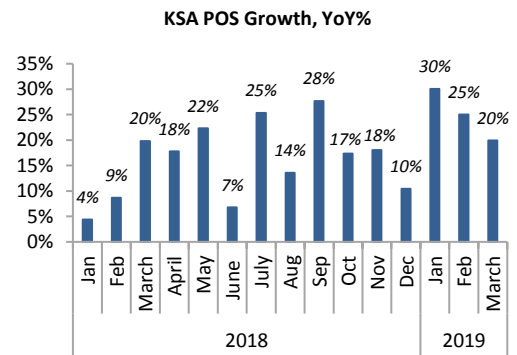
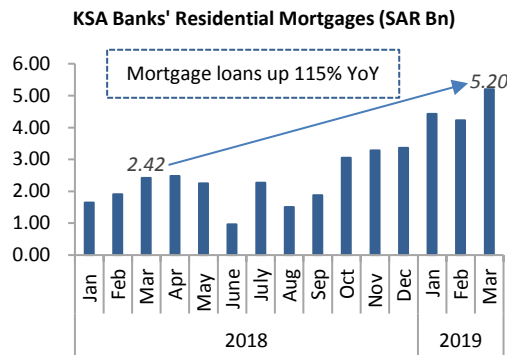


Dubai Financial Market General Index



Saudi Arabia will undergo a 2-phase inclusion—one in May 2019 and the other in August 2019 into MSCI EM index. Its weight in the index will be 2.8%. Inclusion into FTSE-RUSSEL index will continue until March 2020

We remain buyers of the index play which should last till May 2020, and we also see a few selective plays in the region that are shielded from the aforementioned vulnerabilities. In Saudi Arabia, non-oil GDP is recovering as unemployment amongst Saudis is decreasing, while private consumption is showing signs of improvement. This has been reflected in banking sector loan growth, including mortgage loans, which should eventually positively impact the retail and housing sectors. Nonetheless, infrastructure spending is still muted in the hopes that it will accelerate in the coming quarters after the Saudi budget recorded a surplus for Q1 2019. Additionally, the insurance sector is set to benefit from the enforcement of Medical Insurance for the uninsured Saudi citizens working in the private sector.



Source: SAMA, Capital Investments

Major Indices	Status as of end		Performance	
	December, 2018	April, 2019	April, 2019	YTD (30 April, 2019)
MENA				
Abu Dhabi	4,915.07	5,258.05	3.61%	6.98%
Bahrain	1,337.26	1,433.92	1.46%	7.23%
Dubai	2,529.75	2,767.10	5.02%	9.38%
Egypt	13,035.77	14,920.15	1.24%	14.46%
Jordan	1,908.81	1,811.45	-5.37%	-5.10%
Kuwait	5,267.36	6,047.33	1.01%	14.81%
Lebanon	976.75	909.85	-6.46%	-6.85%
Morocco	11,364.31	11,192.06	2.56%	-1.52%
Oman	4,323.74	3,945.64	-0.95%	-8.74%
Palestine	529.35	527.56	-0.54%	-0.34%
Qatar	10,299.01	10,376.80	2.67%	0.76%
Saudi Arabia	7,826.73	9,304.20	5.50%	18.88%
Tunisia	7,271.65	6,885.12	0.34%	-5.32%
S&P Pan Arab Composite	728.72	819.93	4.12%	12.52%
Dow Jones MENA	556.65	624.27	4.16%	12.15%
Americas				
Dow Jones Industrial	23,327.46	26,592.91	2.56%	14.00%
S&P 500	2,506.85	2,945.83	3.93%	17.51%
NASDAQ Composite	6,635.28	8,095.39	4.74%	22.01%
S&P/Toronto Composite	14,322.86	16,580.73	2.97%	15.76%
Europe				
EURO Stoxx 50	3,001.42	3,514.62	4.86%	17.10%
S&P Europe 350 Index	1,367.94	1,582.81	3.13%	15.71%
FTSE 100 Index/ London	6,728.13	7,418.22	1.91%	10.26%
FTSE MIB Index/ Italy	18,324.03	21,881.33	2.80%	19.41%
DAX Index/ Germany	10,558.96	12,344.08	7.10%	16.91%
ASIA/Pacific				
NIKKEI 225/ Japan	20,014.77	22,258.73	4.97%	11.21%
S&P/ASX 200/ Australia	5,646.40	6,325.47	2.34%	12.03%
BRIC				
Brazil/ Bovespa	87,887.26	96,353.33	0.98%	9.63%
Russia/ RTS	1,066.13	1,248.39	4.20%	17.10%
India/ Bombay Sensitive	36,068.33	39,031.55	0.93%	8.22%
China/ Shanghai Composite	2,493.90	3,078.34	-0.40%	23.43%
Hong Kong/ Hang Seng	25,845.70	29,699.11	2.23%	14.91%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2018	April. 2019	April.2019	YTD (30 April. 2019)
Commodities (in USD)				
Brent Spot (Barrel)	53.17	71.85	6.43%	35.13%
WTI Cushing Spot (Barrel)	45.41	63.91	6.27%	40.74%
Natural Gas NYMEX (MMBtu)	2.72	2.58	-5.09%	-5.23%
Gold Spot (OZ)	1,282.45	1,283.55	-0.68%	0.09%
Silver Spot (OZ)	15.50	14.95	-1.14%	-3.52%
Copper LME Spot (MT)	5,949.00	6,426.75	-0.92%	8.03%
Corn CBOT Active Month (Bushel)	3.91	3.63	-1.02%	-7.23%
Wheat CBOT Active Month (Bushel)	5.19	4.29	-7.50%	-17.31%
Soybean CBOT Active Month (Bushel)	9.20	8.54	-4.87%	-7.20%
Rough Rice Futures (USD/cwt)	10.10	10.28	-5.30%	1.78%
Currencies Spot Exchange Rates Against US Dollar				
Euro	1.15	1.12	-0.03%	-2.20%
GBP	1.28	1.30	-0.02%	2.18%
CAD	0.73	0.75	-0.31%	1.85%
Yen	0.01	0.01	-0.52%	-1.63%
CNY	0.15	0.15	-0.34%	2.13%

Source: Bloomberg, Capital Investments

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