

## Monthly Newsletter

December 5<sup>th</sup>, 2019

*"Don't be afraid of hard work. Nothing worthwhile comes easily." — Gertrude Belle Elion*

*"Art is not what you see, but what you make others see." — Edgar Degas*

### **Clues from Recent Asset Classes' Behavior**

**Macro: Some Signs of Potential Stability...But Some Hiccups in China**

**Oil: Slowing Shale Boom and OPEC Decision to Support Prices**

**MENA: Infrastructure Spending to Pick Up after Aramco's IPO**

### Introduction

The spirit of happiness powered by optimism around Brexit and trade negotiations brought healing to the ailing stock markets as they climbed to a new high from the low recorded during October. The easing angel of financial conditions supported the ascension of markets as dovish central banks played the liquidity music dispelling the darkness of an inverted yield curve and resurrecting yields from their nadir. Then the reality check came into play and the ghost of the trade war returned to haunt the markets casting long shadows over their path and the economic outlook, reminding everybody that after the Thanksgiving joy you get the Black Friday discount in both main street and wall street.

Key statements by Mr. Trump that casted doubts about the possibility of a "phase one" trade deal with China and that re-heated the trade war narratives with Argentina, Brazil and France pierced the positive momentum balloon which lost altitude quickly.

The faltering of the rally shows that it was flying on the wings of positive sentiment. The recent turn in data especially in manufacturing PMIs around the world which started to become less contractionary stoking reflationary hopes proved to be not convincing enough. Market participants were seeking clarity regarding the US-China trade relationship and they were looking for sustainable data that translate into brighter expectations in relation to growth and inflation.

In fact, as markets recorded new peaks in the US and valuations re-rated higher to levels seen in 2018 amid a decline in earnings growth and margins indicated that the recent rally is exhibiting signs of exhaustion. This was illustrated by a lack of a deep sell-off in safe haven assets such as gold or treasuries and a curtailed shift to aggressive risk appetite.

The recent shake off in markets as our investment journey in 2019 is coming to an end proved that, in terms of the economic environment, growth is muted and thus a rise in idiosyncratic risk would be a theme in 2020. While fiscal stimulus is expected in China, Germany and possibly in the US, further easing of monetary policy in 2020, especially by the Fed, might be the surprise. More importantly the year of 2020 appears to be pegged to political developments from the trade war rhetoric, passing by Mr. Trump's impeachment process and not to mention the investment implications of the US presidential election. As such, there is a need to focus on quality and fundamentals to play volatility tactically and to mitigate unknown company specific risks and pockets of illiquidity traps.

Turning to the MENA region, we are hoping that Saudi Arabia uses the proceeds from the Aramco IPO to spend on infrastructure projects domestically and to boost the economy. More importantly, we are noticing a positive change in the air of the geopolitical atmosphere in the GCC as a resolution to the conflict in Yemen and the Qatar embargo seem probable given various positive measures and statements from various key players.

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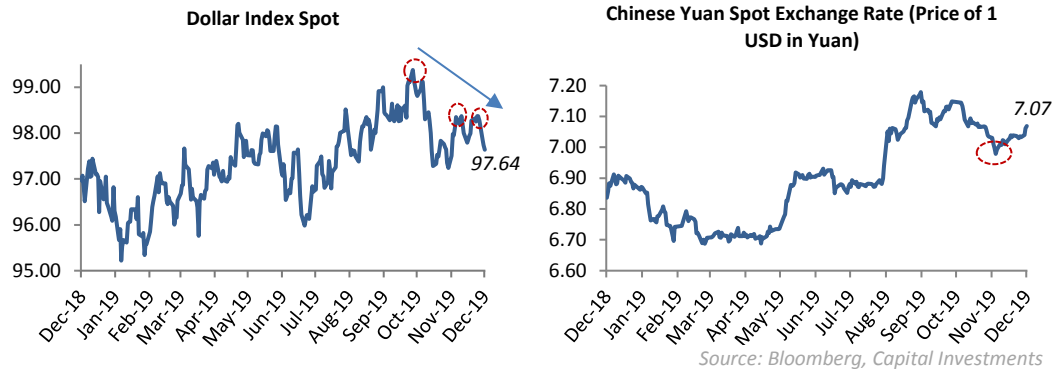
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**This report must be read with the disclaimer at the end of the report.**

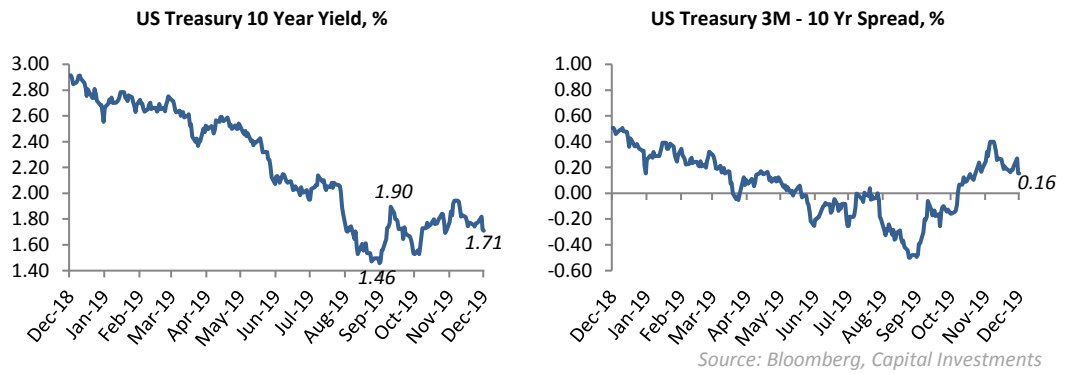
## Clues from Recent Asset Classes' Behavior



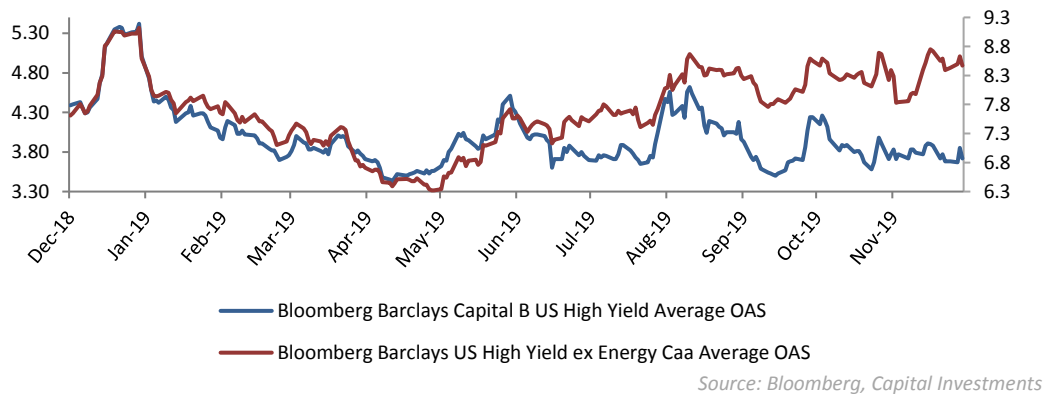
Since reaching a peak in September, the dollar index is following a downward trend and had only registered lower highs so far. The decline in the USD could be attributed to the receding trade war tensions between the US and China along with relative optimism in relation to a potential “phase one deal”. We think that the decline in the green back is also attributed to a dovish Fed that has restarted its printing press and it is, in our opinion, a reflection of weaker economic performance in the US that is set to reveal itself during the coming months and thus forcing the Fed to ease further.

Another factor that may contribute to the weakness in the USD and thus may have positive investment implications on commodities and emerging market could be a decisive stance by the US administration to cheapen the currency to control its trade deficit.

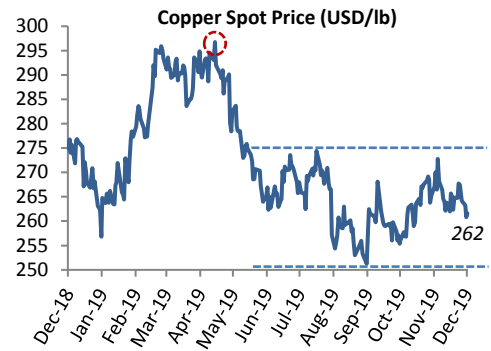
The Chinese Yuan was trading in mirror to the USD and at the peak of optimism about a trade deal, it dropped below the key psychological barriers of 7 to the dollar. However, we do not think that this is sustainable as China’s data is not assuring so far despite a recent pick up in PMIs which may warrant further easing or a currency depreciation.



The major sell-off in sovereign yields appears to be behind us as the US 10-year yield retrenched from a peak of just below 2%. Given that central banks have anchored interest rates at a lower gear and that inflation and growth expectations are so far muted and trade negotiation evolution lacks clarity, the inflation risk premium is not present. As long as there is no aggregation of positive factors that may change this landscape related to growth and inflation meaning a global synchronized fiscal stimulus and trade war resolution, nothing is in sight to push yields beyond 2% or 2.25%, while the pre trade war 10-year US yield level of 2.5% seems a far goal.

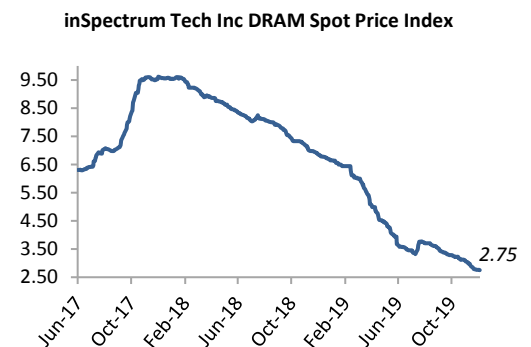
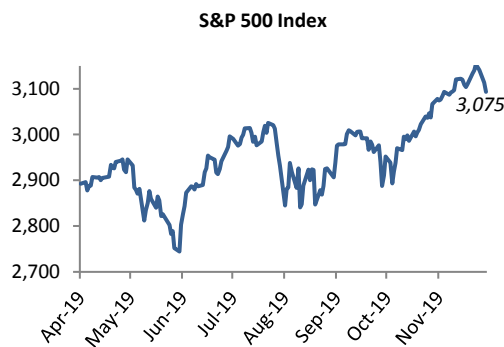


Amid muted growth expectations and a lack of expansion in earnings, the divergence between spreads on C-rated and B-rated bonds is eye catching. Even after adjusting for the energy sector, the C spectrum has raised the warning flags and suggests that as the slowdown extends, we will see some falling angels joining the C league from the B-rated segment. This warrants some caution in credit and equity markets and indicates that a focus on quality is preferred, while pockets of volatility and illiquidity risk will be a theme in 2020. Spread compressions that occurred over the previous months could not be attributed to credit risk improvement but to liquidity chasing yield amid declining interest rates.



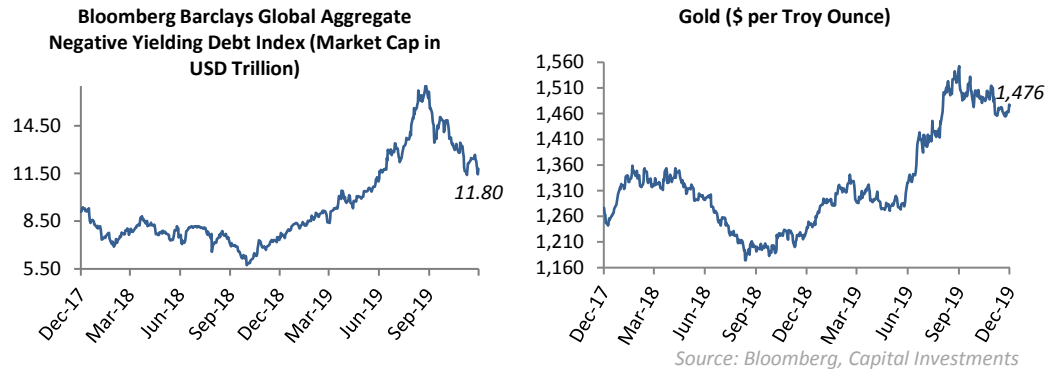
Source: Bloomberg, Capital Investments

We have been constructive on China and our investment in the ETF paid off but what is striking is that, despite all stimulus packages taken by the authorities, results are not being seen in the economic data or in domestic aggregate demand. The two charts above of copper prices and the Shanghai CSI 300 index show a similar picture that the local players are not buying the stimulus story. Yet this indicates that further measures are in the works especially that the trade war path with the US is not showing any decisive de-escalation.



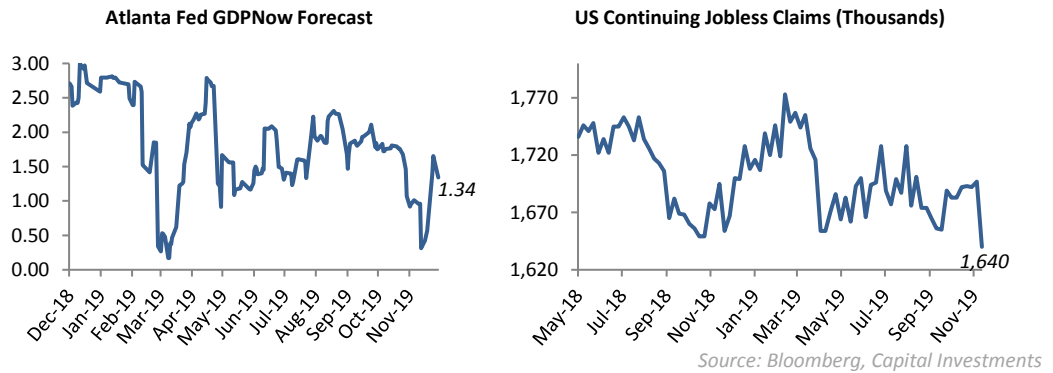
Source: Bloomberg, Capital Investments

The S&P 500 index increased by almost 25% since December 2018 while EPS growth was disappointing which means that at the time of writing the market is trading near a forward P/E of 18. This clearly indicates that the valuation is overstretched and that a lot of good news is baked into equity prices. On a separate note, we have noticed that prices of memory chip are reaching a nadir and may be bottoming which warrants some further assessment for potential investments in Korea, Taiwan and Singapore especially in fields related to the semiconductors industry.

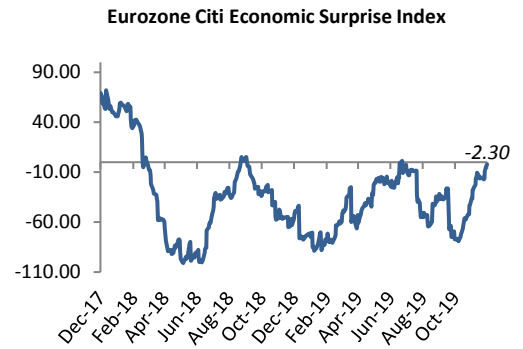


As illustrated in the charts above, gold price has been retreating as the size of negative yielding debt dropped from a high near USD 17 trn to around USD 11.8 trn coupled by an increase in real yield. However, uncertainty surrounding key policy making decisions around the world and a weaker USD are lending support to the yellow metal.

### Macro: Some Signs of Potential Stability...But Some Hiccups in China

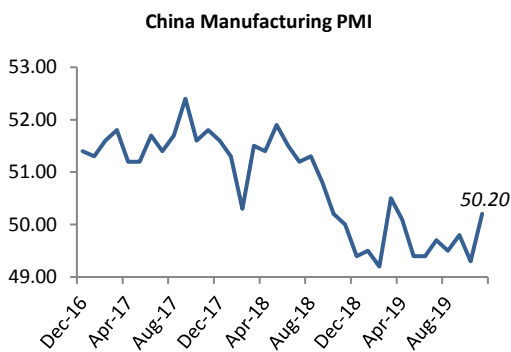


Despite the recent improvement in the continuing jobless claims data, the GDP forecast for Q4 2019 continues to be muted. Usually, jobless claims numbers continue to climb despite stabilization in PMIs or some soft data such as sentiment indices. We think that the slowdown may continue into next year which will prompt the Fed to ease further or the US administration to seek approval for a new tax cut law that aims at boosting income for the middle class.



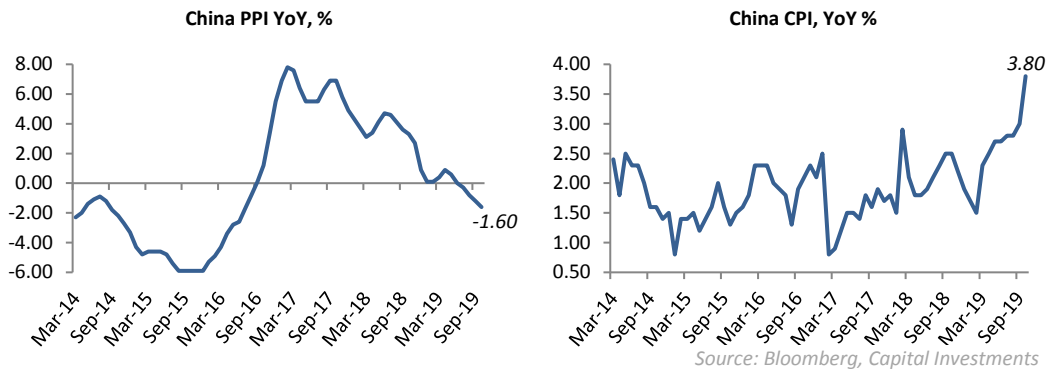
Source: Bloomberg, Capital Investments

German growth data showed that the economic engine of Europe avoided a recession and the consumer index is showing some signs of improvement especially since Europe benefits from easing in the trade skirmishes between global players and is ready to benefit from any cyclical upswing. The Citi economic surprise index for the Eurozone is improving as it benefits from a low probability of a 'No Deal' Brexit and the dovishness of the ECB. Further confirmation is needed in terms of improvement in hard data related to corporate lending indicators or key macro figures such as employment which started to recover in Germany.



Source: Bloomberg, Capital Investments

The improvement in China's PMIs was an encouraging sign over the past month however we are not sure if it was due to the long lunar holiday that occurred in October which dictated a rebound in November or due to factories front loading production ahead of US tariffs in December, especially that industrial production and profit were on a downward trend along with key data related to retail sales and fixed income investments which were disappointing.



Worrying enough in China is the deflationary trend in the factory gate prices illustrated by the PPI data, which in our opinion would push the authorities to take extra stimulus measures on the monetary front in terms of Reserve Requirement Ratio cuts or interest rate cut (which was for the first time since 2015 when a deflation in PPI occurred) and potential enhancement in infrastructure spending. On a separate note, a rise in consumer inflation due to rising food prices mainly pork, may dent aggregate domestic demand by curbing consumers’ purchasing power. Although we are constructive on China, we will adjust our stance tactically depending on macro developments.

Purchasing Managers Indices (PMI) (2017-2018):											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
Global Manufacturing	50.7	50.6	50.5	50.4	49.8	49.4	49.3	49.5	49.7	49.8	50.3
Global Services	52.6	53.3	53.7	52.7	51.6	51.9	52.5	51.8	51.4	51.0	51.6
Global Composite	52.1	52.6	52.8	52.1	51.2	51.2	51.7	51.3	51.1	50.8	51.5
US Manufacturing	56.6	54.2	55.3	52.8	52.1	51.7	51.2	49.1	47.8	48.3	48.1
US Services	56.7	59.7	56.1	55.5	56.9	55.1	53.7	56.4	52.6	54.7	53.9
US Manuf. New Orders	58.2	55.5	57.4	51.7	52.7	50.0	50.8	47.2	47.3	49.1	47.2
EU Manufacturing	50.5	49.3	47.5	47.9	47.7	47.6	46.5	47.0	45.7	45.9	46.9
EU Services	51.2	52.8	53.3	52.8	52.9	53.6	53.2	53.5	51.6	52.2	51.9
EU Composite	51.0	51.9	51.6	51.5	51.8	52.2	51.5	51.9	50.1	50.6	50.6
China Manufacturing	49.5	49.2	50.5	50.1	49.4	49.4	49.7	49.5	49.8	49.3	50.2
China Services	54.7	54.3	54.8	54.3	54.3	54.2	53.7	53.8	53.7	52.8	54.4
China Manuf. New Orders	49.6	50.6	51.6	51.4	49.8	49.6	49.8	49.7	50.5	49.6	51.3

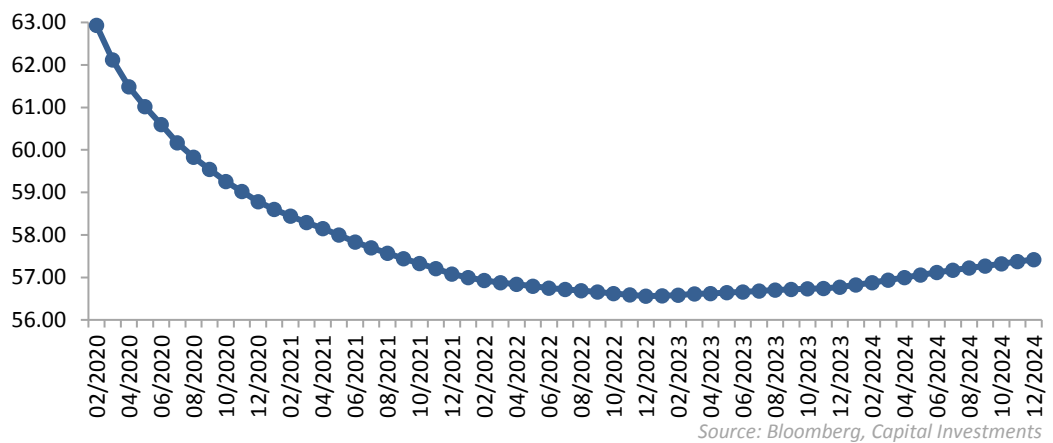
\* PMI reading above 50 indicates economy expansion  
 \* Red points displayed within the lines above indicate highest point in the range  
 \* Figures in green indicate acceleration from previous month, while red indicate deceleration

Source: Bloomberg, Capital Investments

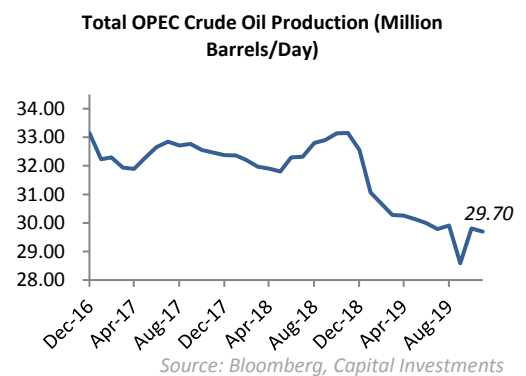
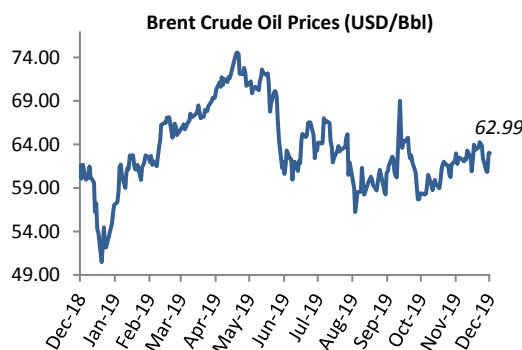
### Oil: Slowing Shale Boom and OPEC Decision to Support Prices

Although the IEA has painted a gloomy picture of global oil demand, we believe that supply side factors will continue keep the oil market tight, as evidenced by the oil curve that is, once again, in backwardation. While the IEA believes that global oil demand will plateau in 2030 as the use of more efficient cars and electricity rises, the following factors will continue to support prices.

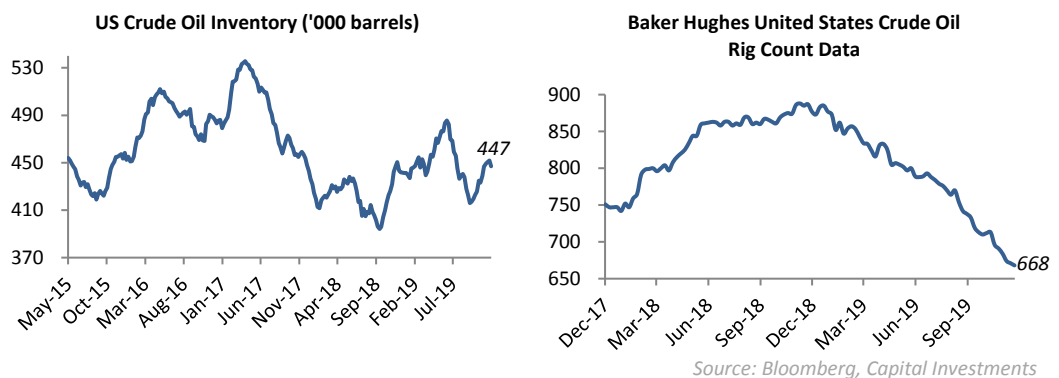
**Brent Oil Future Curve (USD/Bbl)**



For starters, OPEC and its allies continue to curb production, with their output down by 110,000 bpd MoM in November. Moreover, OPEC may agree to deepen cuts in its upcoming meeting as rising PMIs from China suggest stronger demand. This offered some support to oil prices although the IEA stated that the cartel and its allies are unlikely to change their output policy this week.



Meanwhile in the U.S., the oil rig count has declined for a record of 12 consecutive months, bringing the total count to 668- the lowest figure since April 2017- due to the shale slowdown that was highlighted in last month's newsletter. Additionally, according to the EIA, U.S. inventories decreased by a surprising 4.9 million barrels for the week ending Nov. 29 versus analyst expectation of a decrease of 1.5 million barrels. Moreover, as Aramco's IPO approaches, Saudi Arabia aims to create 9 million bpd of additional long-term oil demand globally by avoiding the conventional market and creating new ways of using oil and gas such as petrochemicals.



## MENA: Infrastructure Spending to Pick Up after Aramco's IPO

Saudi Aramco's long-anticipated IPO comes as a kickoff to the Kingdom's Vision 2030 to overhaul its oil-dependent economy. Aramco is floating 1.5% of its shares at a valuation of USD1.7tn and is therefore expected to raise around USD25bn, which makes up around 3% of Saudi Arabia's GDP. The Public Investment Fund (PIF), the seller of Aramco, is expected to use the proceeds to undertake local investments to diversify the economy, increase the non-oil sector's contribution to GDP growth, and generate domestic employment. Thus, we hope the PIF invests in the Kingdom's mega projects such as Neom, Qiddiya, and Red Sea Resorts which will stimulate economic growth through the multiplier effect. In addition, further spending on entertainment, tourism, manufacturing and technology will lead to a domestic consumption boom as various consumer business opportunities are emerging, including cinemas, restaurants, and gyms.

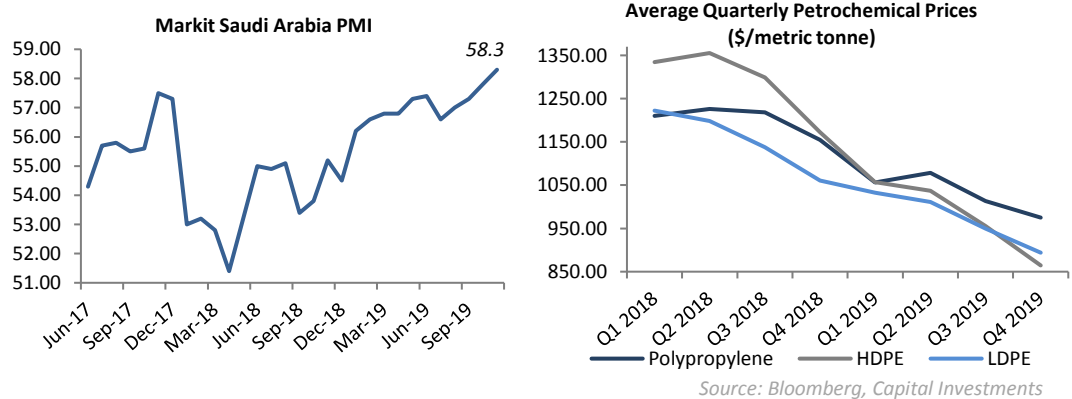
We link investing in Saudi Arabia to the optionality concept; we believe that some sectors' prevailing fundamentals are improving as evidenced by the recent ramp up in cement sales and growth in mortgage loans. This provides investors with the optionality since the expected increase in government spending post the IPO will create certain investment opportunities in sectors related to

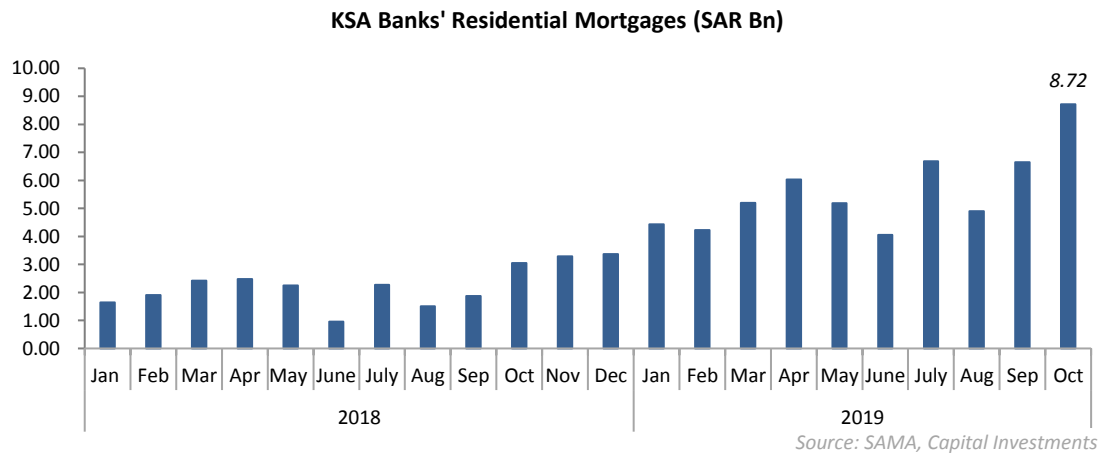
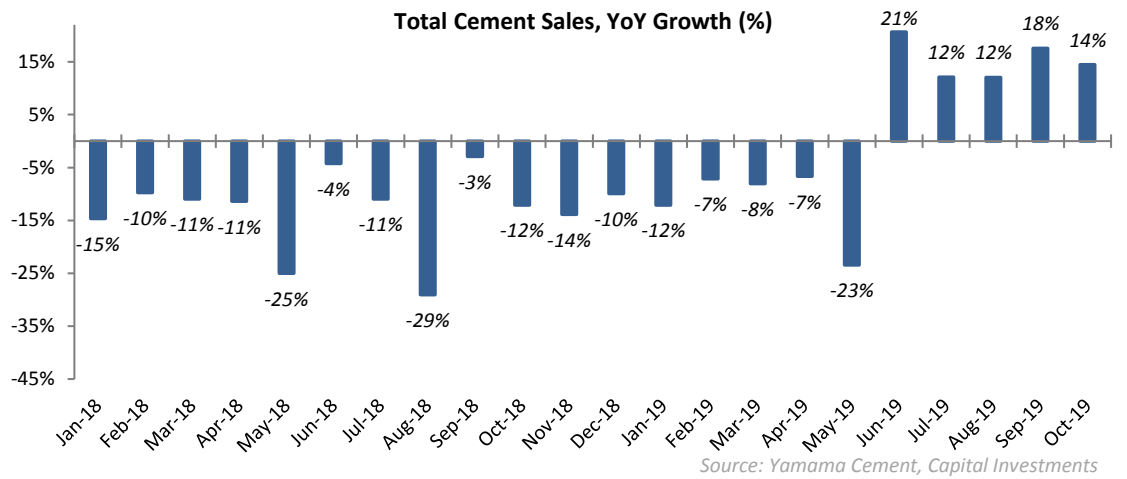
infrastructure spending, building materials, in addition to consumer discretionary goods as the significant pick up in mortgages will eventually lead to higher spending on furniture and home appliances.

However, in the petrochemical sector for example, playing the optionality is not worth it as current fundamentals are not supportive and we might need to wait another two-three quarters for prices to improve. Thus, investors should focus on companies with improving fundamentals and take investment decisions at the right valuation.

We see a positive outlook overall for Saudi Arabia in 2020 especially as momentum grows behind efforts to end their five-year war with Yemen. Reports stated there was a nearly 80 percent drop in airstrikes nationwide in the last two weeks and strengthened cease-fire in the key port of Hodeida, in addition to positive statements by key players involved. This will restore stability and create a very positive sentiment in the region.

Furthermore, besides the incremental spending related to Aramco's IPO, there has been an improvement in PMI data in Saudi Arabia as the headline seasonally adjusted Purchasing Managers' Index rose to 58.3 in November, from 57.8 in October, the highest level in more than four years, which reflects stronger demand and operating conditions in the non-oil economy.





Major Indices	Status as of end		Performance	
	December. 2018	November. 2019	November.2019	YTD (30 November. 2019)
<b>MENA</b>				
Abu Dhabi	4,915.07	5,030.76	-1.51%	2.35%
Bahrain	1,337.26	1,526.95	0.24%	14.18%
Dubai	2,529.75	2,678.70	-2.48%	5.89%
Egypt	13,035.77	13,849.46	-4.87%	6.24%
Jordan	1,908.81	1,795.21	-0.28%	-5.95%
Kuwait	5,267.36	6,519.36	4.96%	23.77%
Lebanon	976.75	762.81	-0.13%	-21.90%
Morocco	11,364.31	11,822.32	2.94%	4.03%
Oman	4,323.74	4,064.14	1.61%	-6.00%
Palestine	529.35	521.53	0.39%	-1.48%
Qatar	10,299.01	10,147.88	-0.40%	-1.47%
Saudi Arabia	7,826.73	7,859.06	1.48%	0.41%
Tunisia	7,271.65	6,949.46	-0.58%	-4.43%
S&P Pan Arab Composite	728.72	746.59	1.11%	2.45%
Dow Jones MENA	556.65	574.14	0.97%	3.14%
<b>Americas</b>				
Dow Jones Industrial	23,327.46	28,051.41	3.72%	20.25%
S&P 500	2,506.85	3,140.98	3.40%	25.30%
NASDAQ Composite	6,635.28	8,665.47	4.50%	30.60%
S&P/Toronto Composite	14,322.86	17,040.20	3.38%	18.97%
<b>Europe</b>				
EURO Stoxx 50	3,001.42	3,703.58	2.75%	23.39%
S&P Europe 350 Index	1,367.94	1,644.01	2.57%	20.18%
FTSE 100 Index/ London	6,728.13	7,346.53	1.35%	9.19%
FTSE MIB Index/ Italy	18,324.03	23,259.33	2.49%	26.93%
DAX Index/ Germany	10,558.96	13,236.38	2.87%	25.36%
<b>ASIA/Pacific</b>				
NIKKEI 225/ Japan	20,014.77	23,293.91	1.60%	16.38%
S&P/ASX 200/ Australia	5,646.40	6,846.00	2.74%	21.25%
<b>BRIC</b>				
Brazil/ Bovespa	87,887.30	108,233.30	0.95%	23.15%
Russia/ RTS	1,066.13	1,438.45	1.09%	34.92%
India/ Bombay Sensitive	36,068.33	40,793.81	1.66%	13.10%
China/ Shanghai Composite	2,493.90	2,871.98	-1.95%	15.16%
Hong Kong/ Hang Seng	25,845.70	26,346.49	-2.08%	1.94%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2018	November. 2019	November.2019	YTD (30 November. 2019)
<b>Commodities (in USD)</b>				
Brent Spot (Barrel)	53.17	61.34	2.49%	15.37%
WTI Cushing Spot (Barrel)	45.41	55.17	2.03%	21.49%
Natural Gas NYMEX (MMBtu)	3.06	2.28	-13.01%	-25.53%
Gold Spot (OZ)	1,282.45	1,463.94	-0.57%	14.15%
Silver Spot (OZ)	15.50	17.03	0.21%	9.91%
Copper LME Spot (MT)	5,949.00	5,843.25	2.60%	-1.78%
Corn CBOT Active Month (Bushel)	4.07	3.81	-4.57%	-6.33%
Wheat CBOT Active Month (Bushel)	5.54	5.42	7.81%	-2.12%
Soybean CBOT Active Month (Bushel)	9.46	8.77	-4.65%	-7.30%
Rough Rice Futures (USD/cwt)	10.10	12.49	3.91%	23.68%
<b>Currencies Spot Exchange Rates Against US Dollar</b>				
Euro	1.15	1.10	1.09%	-3.92%
GBP	1.28	1.29	5.18%	1.34%
CAD	0.73	0.75	-0.30%	2.70%
Yen	0.01	0.01	-1.30%	0.11%
CNY	0.15	0.14	1.64%	-2.19%

Source: Bloomberg, Capital Investments

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