

Monthly Newsletter

October 2nd, 2019

"It is better to fail at originality than to succeed in imitation" — Sir Francis Bacon

"No, your job as a leader is to inspire and to galvanize, not to share your distraught thoughts. You make your people dispirited" — Lee Kuan Yew

Clues from Recent Asset Classes' Behavior

Macro: Green Shoots Do Not Look Sustainable

Oil: The Aramco Factor

MENA: Egypt's Macro Story Still Resilient

Introduction

The last quarter of our investment journey in 2019 has officially started amid negative outlook reviews for the global economy. Both the World Bank and the OECD are seeing weak economic growth as tariffs will dent real consumer income, weaken business and consumer confidence, and curb capital expenditures.

Purchasing Managers Indices for manufacturing and industrial output around the world confirm that we are already suffering from a global manufacturing recession. Concurrently, if Germany, Japan, South Korea, China and recently data from the US, serve as a good barometer then we get a confirmation that the industrial sector around the globe is not in good shape.

In this context, we continue to think that the global economy is sliding towards a weak growth trajectory, and expectations for growth and inflation are muted despite some positive noise from a few macro releases during the month of September. This situation seems to be persistent as there is a lack of global political determination to launch a fiscal stimulus so far despite some encouraging signs from a few countries such as China, India, France, Denmark and Netherlands. Simultaneously, global central banks are reacting with a lag especially in the US.

Amid a hesitant and divided Fed, investors may ask whether global interest rates are being set in Frankfurt or Tokyo, especially that the recent reduction in interest rates by the Fed did not significantly affect the US yield curve and the US 10 -year yield was moving in sync with news about the US-China trade negotiations rather than the US Fed's measures. On the other hand, a significant liquidity squeeze was felt in the US funding market as indicated by the soaring repo rate and other money market rates, which prompted the Fed to inject liquidity to alleviate the stressed situation and thus pave the way for another round of Quantitative Easing.

A combination of low interest rates, a mountain of global debt, and stories of failing IPOs or bankruptcies and liquidity issues along with muted global growth expectations, despite dovish central banks, put us on a cautious and skeptical mode.

The delay in raising US tariffs on Chinese imports gradually till mid-October and December might be only a postponement of bad news. The talk of a potential interim trade deal between the US and China appears to be a distraction from the impeachment inquiry launched by Democrats regarding Mr. Trump. We continue to see any enthusiasm regarding the resolution of the trade dispute as a trial balloon until concrete evidence is provided, either through a positive lead from the face to face negotiations expected to take place in Washington in mid-October or through a potential meeting between President Trump and President Xi during the APEC summit in Santiago in November. Meanwhile, we are a bit worried that the trade war is taking different tracks- one related to technology and the other related to finance as some news erupted stating that the US may curb investments in China in addition to trade issues.

Beyond the trade tensions, the Brexit saga, and protests in Hong Kong, we are carefully observing signs of disruption in the food supply chain due to the alignment of many factors including China's swine fever, and extreme weather conditions such as drought in Europe, Australia and China, and floods in the US which may impact the grain and protein markets in the coming quarters.

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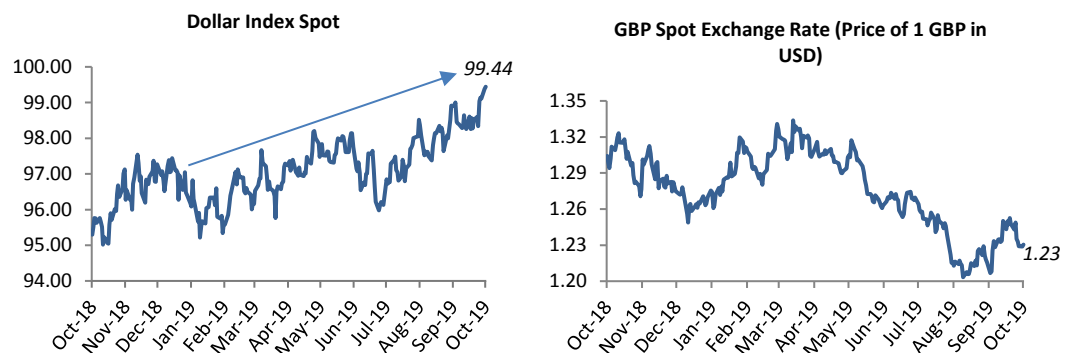
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This report must be read with the disclaimer at the end of the report.

In the Middle East, limited protests in Egypt initiated some volatility in the market amid a robust macro story. The main focal point continues to be the war in Yemen and the recent attack on Aramco's facilities which disrupted 5% of global oil supply. However, we think that global powers, chief among them the US, does not want to see an uncontrollable conflict in the region and thus signals from all parties indicate that a window for negotiation may open.

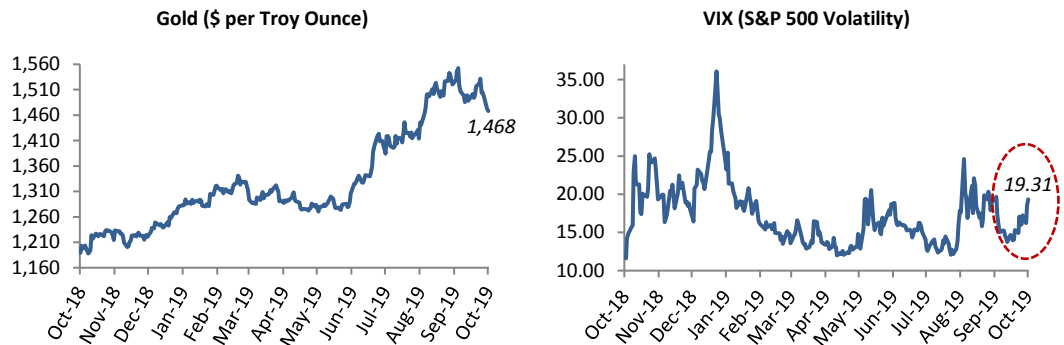
We still hold a significant portion in cash to be tactically deployed as we keep investing in gold and highly rated government papers while looking at bottom up stories and companies with strong cash flow generation and sustainable dividends.

Clues from Recent Asset Classes' Behavior



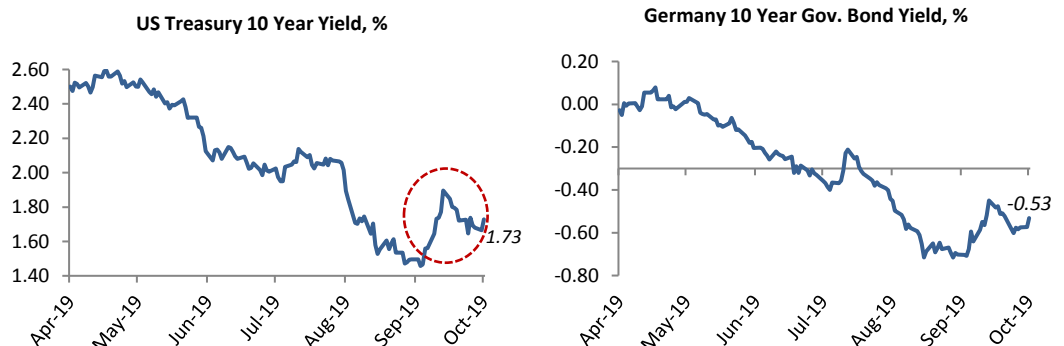
Source: Bloomberg, Capital Investments

A combination of factors continues to support the strengthening bias in USD vis-a-vis other currencies, these include higher US yields in comparison to other advanced economies coupled with a hesitant and flexible Fed policy, not to mention that the US economy is still enjoying a relatively stronger cyclical story than other big economies while the haven status of the USD will keep backing the greenback. The USD is set to weaken if fiscal stimulus kicks in actively in other nations, so their cyclical recovery boosts their currencies, or if the Fed swings clearly into an easing mode. Turning to the GBP, we continue to think that it is undervalued despite its recent downward trend and it may recover quickly if the uncertainty surrounding Brexit fades, as illustrated through the rally early September.



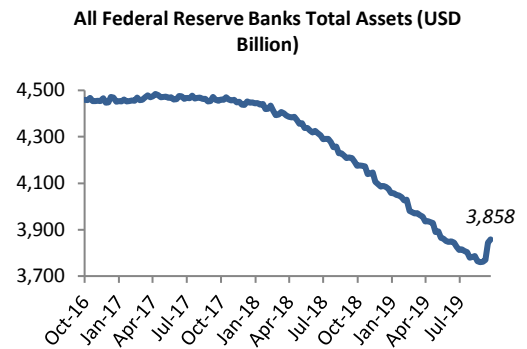
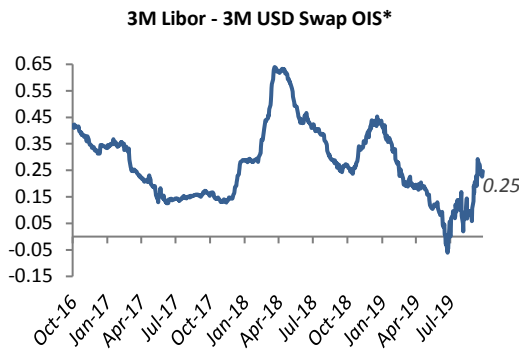
Source: Bloomberg, Capital Investments

Gold prices have been boosted by rising negative yielding debt coupled with an inverted yield curve and dovish central banks around the world. However, a stubbornly strong USD and a decline in the size of negative yielding debt led gold to retrench in the past few weeks before gaining some ground in the past few days. We continue to think that the retreat in gold left most investors unhedged and exposed to vulnerabilities, and we believe that amid low rates, muted growth expectations, financial markets' volatility, and geopolitical risks, the long-term case for gold is still intact. On the other hand, the behavior of the VIX index, which is a gauge of fear and volatility in markets, over the past few months clearly indicates that there is no room for complacency as volatility could suddenly materialize leading to sharp drops in the markets.



Source: Bloomberg, Capital Investments

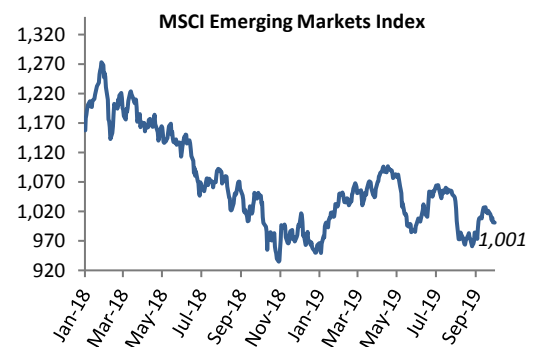
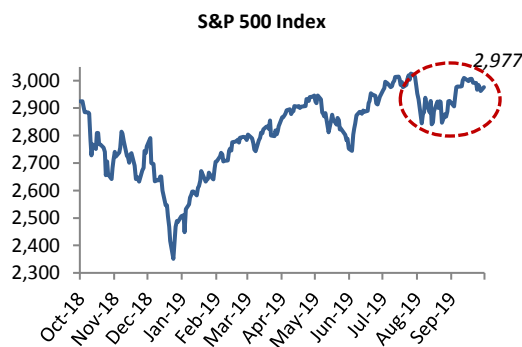
News related to trade negotiations is driving sovereign yields globally, and notably the US 10-year yield, while Germany's yields are being affected by the ECB's actions as well and by news about Germany's potential fiscal easing which might drive yields higher. Higher German and Japanese yields may affect both investment in fixed income and precious metal around the world, investors should keep watching any significant movement in them.



Source: Bloomberg, Capital Investments

*The LIBOR-OIS spread represents the difference between the 3 month Libor rate, the unsecured rate at which banks lend to each other, and the 3 month overnight index swap (OIS), which represents the central bank rate. It is a gauge of perceptions of risk in credit markets. Hence, when the gap widens it is an indication of perceived credit and liquidity risk.

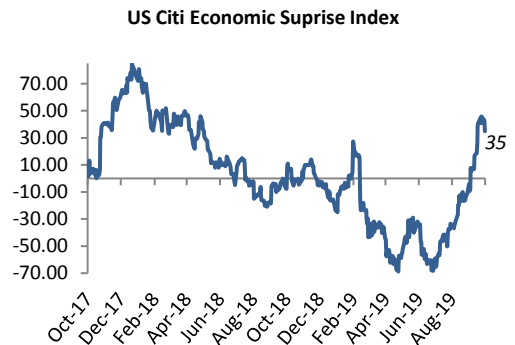
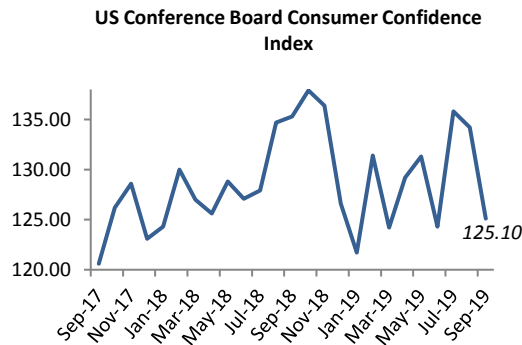
A liquidity squeeze was felt in the US funding markets as illustrated by the Libor-OIS spread chart above and by the US repo market. The latter saw its rate soaring to reach 10% at one point before the Fed intervened at the end of September and pumped almost USD 75bn daily and is expected to continue to do so till mid-October.



Source: Bloomberg, Capital Investments

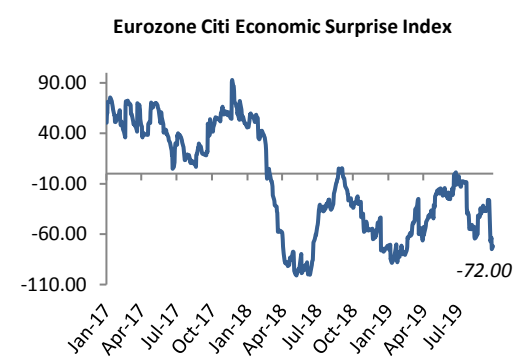
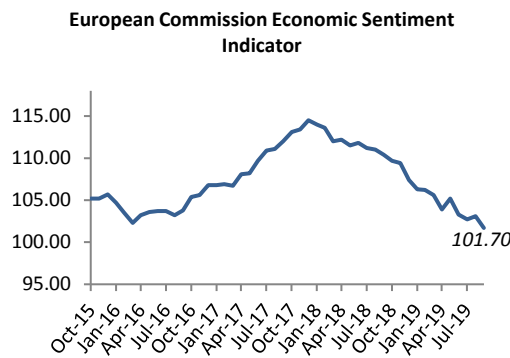
Despite the easing mode adopted by major central banks, we think that US equity market will move in a range bound with a negative bias unless a resolution to the trade dispute is reached or growth and inflation expectations are reviewed upward. We prefer to stay prudent and watch key technical levels especially the 200-day moving average. As for emerging markets, we think that they have a much better story as they are adopting both a fiscal and a monetary stimulus, but they need to be taken on a case by case basis. On a separate note, we are watching Germany carefully for a potential fiscal stimulus.

Macro: Green Shoots Do Not Look Sustainable



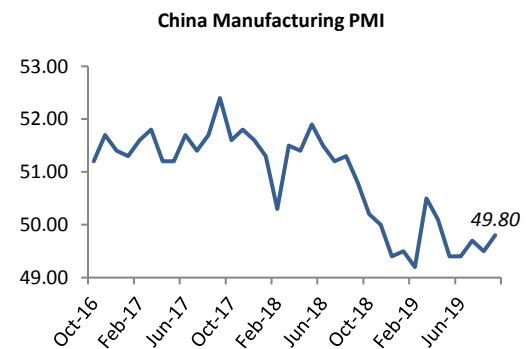
Source: Bloomberg, Capital Investments

The services sector in the US continues to show resilience supported by encouraging retail sales, low unemployment rate, and a recent pick up in the housing sector as indicated by the improving homebuilders' sentiment. However, the trade dispute is negatively impacting both business confidence and the manufacturing sector, which in our opinion will filter through other parts of the economy in the coming months and will lead to slowdown in hiring.



Source: Bloomberg, Capital Investments

In Europe, the economy is almost in a recession mode driven by key countries such as Germany and France, where recent data releases at the level of manufacturing sectors and confidence indices are not encouraging. The ECB's easing is so far driving growth in the narrow money supply (M1) but is not enough to drive economic growth if not coupled with a significant fiscal stimulus.

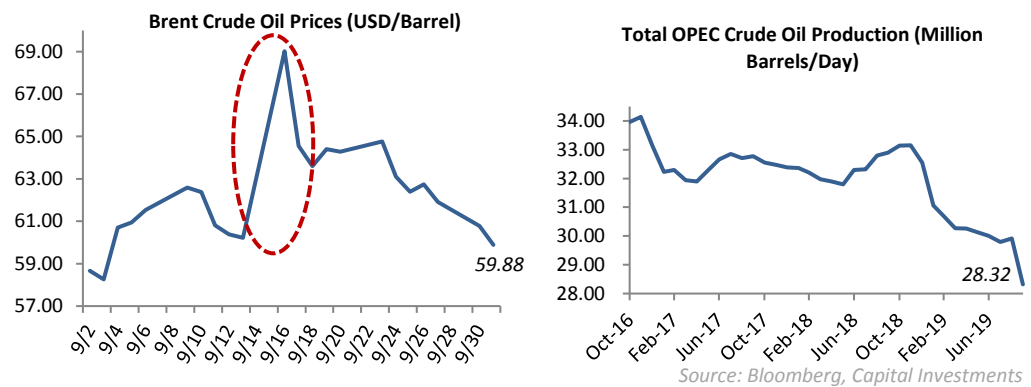


Source: Bloomberg, Capital Investments

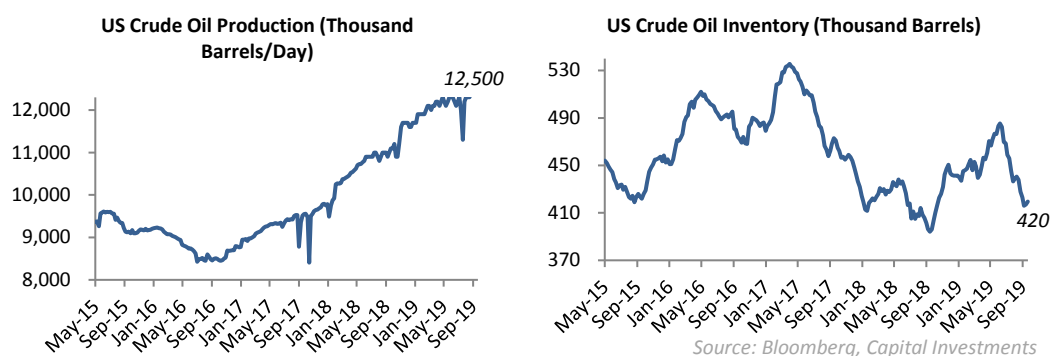
Despite recent stabilization in China’s manufacturing indices, further confirmation is still needed in the coming months. It is obvious that the Chinese stimulus steps taken in Q2 2019 are cushioning economic activity, although authorities admitted that the country cannot grow at 6% p.a. We think that even a slight weakness in China would affect global growth, and although it is facing a tough trade dispute with the US, we believe that China will roll out more stimulus and reforms to bolster the economy and boost investors’ confidence. These measures could come in the form of reforms to State Owned Enterprises, reduction in business fees, and construction of new infrastructure projects.

Oil: The Aramco Factor

We had highlighted in our September newsletter that the trade war was overshadowing the geopolitical tension in the MENA region, and the unprecedented events that unfolded in the month of September attested to that. Saudi Arabia’s oil production was cut by half after explosive drones attacked Aramco’s Abqaiq plant, suspending around 5.7m barrels per day of output, equivalent to 5% of global production. Gas output was also disrupted, with 2bn cubic feet in daily output, about half of normal production, stopped by the attack. Global oil prices surged the most on record after the strike, which was the single-biggest disruption to oil markets.



Saudi Aramco vowed to recover production by the end of September and was able to successfully deliver on its promise. Aramco produced more than 9.9 million bpd on the 25th of September, restoring its full production output.



Nevertheless, Aramco's faster than expected recovery, easing political tensions in the region following the attack, as well as demand concerns due the trade war and slowing economic activity weighed on oil prices, with Brent returning to its pre-attack levels. Q3 was oil's weakest quarter since last year, with Brent futures slumping 8.7% since the end of June. Moreover, the IEA has stated that it might cut its global oil demand estimates for 2019 and 2020 should the economic conditions deteriorate further, while the EIA reported that U.S crude supplies rose by 2.4 million barrels for the week ended September 20 vs. analyst expectations of a 190,000-barrel draw.

MENA: Egypt's Macro Story Still Resilient

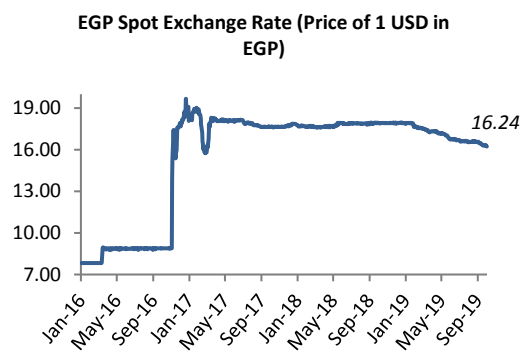
Egypt's macro picture remains resilient despite recent protests in the country which drove many retail investors and asset managers to sell their investments in the Egyptian T-bills and stocks in general. The Egyptian markets, however, rebounded after the fear of further escalation in the protests faded.

According to the central bank of Egypt, the Egyptian economy grew at 5.7% in Q2 2019 and is likely to grow at 5.6% in the fiscal year 2018/19. The country's budget deficit declined to 8.4% as a percentage of GDP in 2019 from 9.11% in 2018 and is expected to reach 7.4% in 2020, according to Bloomberg. Moreover, according to Reuters, the Egyptian government is targeting a primary budget surplus of EGP 124 bln in 2020 up from EGP 104 bln in 2019 which is around 2% of GDP. In our view, this is likely to stimulate the economy further. The central bank continued its easing stance since the beginning of the year and has recently cut interest rates by 100 bps leading to overnight and lending deposit to stand at 13.25%p.a. and 14.25%p.a. respectively which may recover lending for capital expenditures purposes. The main reason for this cut was that the annual headline and core inflation rates declined to 7.5% and 4.9% respectively, reaching the lowest levels in 6 years. The decrease in

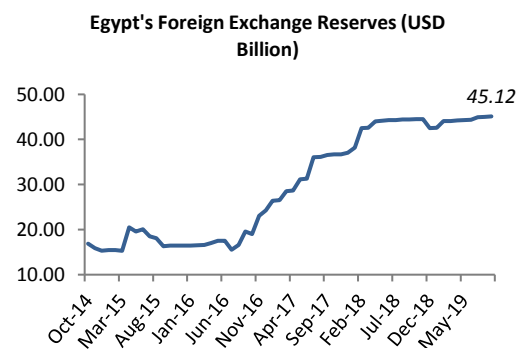
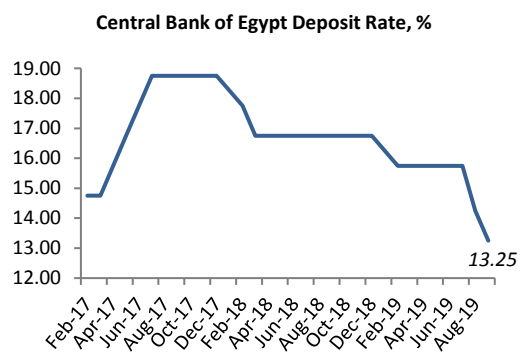
the interest rate is likely to reduce the budget deficit. For example, according to Bloomberg, every 100-bps reduction in interest rate will save the government around EGP8bn–EGP10bn per year.

Current account deficit as a percentage of GDP stands at 1.8% in August 2019, down from 2.4% in 2018. The main reason for the improvement is an increase in remittances and tourism revenue. Secondly, we contemplate that the improvement in the current account is because of more gas produced to reach 51.1 tonnes in the current year because of connecting the grid to the “Zohr Field”.

Finally, we expect the September PMI reading to improve as wage growth and employment were both positive in August and future expectations of manufacturing data rose to their highest level in more than a year. The Central Bank of Egypt (CBE) announced that the Net International Reserves reached USD 45.1bn at the end of September 2019 compared to USD 44.96bn and USD 44.91bn by the end of August and July 2019, respectively. On a sperate note Speaker of the House declared that Egypt will continue to pursue its political reforms agenda in tandem with economic reforms.



Source: Bloomberg, Capital Investments



Source: Bloomberg, Capital Investments

Major Indices	Status as of end		Performance	
	December. 2018	September. 2019	September.2019	YTD (30 September. 2019)
MENA				
Abu Dhabi	4,915.07	5,057.32	-2.10%	2.89%
Bahrain	1,337.26	1,516.53	-1.08%	13.41%
Dubai	2,529.75	2,781.07	0.81%	9.93%
Egypt	13,035.77	14,257.75	-3.89%	9.37%
Jordan	1,908.81	1,827.74	0.36%	-4.25%
Kuwait	5,267.36	6,174.78	-5.41%	17.23%
Lebanon	976.75	795.69	-0.13%	-18.54%
Morocco	11,364.31	11,561.68	-1.27%	1.74%
Oman	4,323.74	4,017.69	0.32%	-7.08%
Palestine	529.35	517.65	-1.13%	-2.21%
Qatar	10,299.01	10,367.08	1.31%	0.66%
Saudi Arabia	7,826.73	8,091.76	0.90%	3.39%
Tunisia	7,271.65	7,051.03	-3.12%	-3.03%
S&P Pan Arab Composite	728.72	755.78	-0.87%	3.71%
Dow Jones MENA	556.65	579.56	-1.14%	4.12%
Americas				
Dow Jones Industrial	23,327.46	26,916.83	1.95%	15.39%
S&P 500	2,506.85	2,976.74	1.72%	18.74%
NASDAQ Composite	6,635.28	7,999.34	0.46%	20.56%
S&P/Toronto Composite	14,322.86	16,658.63	1.32%	16.31%
Europe				
EURO Stoxx 50	3,001.42	3,569.45	4.16%	18.93%
S&P Europe 350 Index	1,367.94	1,588.11	3.67%	16.10%
FTSE 100 Index/ London	6,728.13	7,408.21	2.79%	10.11%
FTSE MIB Index/ Italy	18,324.03	22,107.70	3.68%	20.65%
DAX Index/ Germany	10,558.96	12,428.08	4.09%	17.70%
ASIA/Pacific				
NIKKEI 225/ Japan	20,014.77	21,755.84	5.08%	8.70%
S&P/ASX 200/ Australia	5,646.40	6,688.35	1.27%	18.45%
BRIC				
Brazil/ Bovespa	87,887.30	104,745.30	3.57%	19.18%
Russia/ RTS	1,066.13	1,333.91	3.14%	25.12%
India/ Bombay Sensitive	36,068.33	38,667.33	3.57%	7.21%
China/ Shanghai Composite	2,493.90	2,905.19	0.66%	16.49%
Hong Kong/ Hang Seng	25,845.70	26,092.27	1.43%	0.95%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2018	September. 2019	September.2019	YTD (30 September. 2019)
Commodities (in USD)				
Brent Spot (Barrel)	53.17	59.85	1.10%	12.56%
WTI Cushing Spot (Barrel)	45.41	54.07	-1.87%	19.07%
Natural Gas NYMEX (MMBtu)	2.80	2.33	0.26%	-16.76%
Gold Spot (OZ)	1,282.45	1,472.38	-3.15%	14.81%
Silver Spot (OZ)	15.50	17.00	-7.51%	9.68%
Copper LME Spot (MT)	5,949.00	5,695.25	0.70%	-4.27%
Corn CBOT Active Month (Bushel)	3.98	3.88	4.94%	-2.39%
Wheat CBOT Active Month (Bushel)	5.43	4.96	7.19%	-8.62%
Soybean CBOT Active Month (Bushel)	9.35	9.06	4.26%	-3.13%
Rough Rice Futures (USD/cwt)	10.10	12.02	2.96%	19.02%
Currencies Spot Exchange Rates Against US Dollar				
Euro	1.15	1.09	-0.76%	-4.95%
GBP	1.28	1.23	1.09%	-3.65%
CAD	0.73	0.76	0.53%	3.01%
Yen	0.01	0.01	-1.68%	1.42%
CNY	0.15	0.14	0.11%	-3.78%

Source: Bloomberg, Capital Investments

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