

## Monthly Newsletter

July 3<sup>rd</sup>, 2019

*"Be humble for you are made of Earth. Be noble for you are made of stars."* — Serbian Proverb

*"Your enemy makes you wise"* — Italian Proverb

### Clues from Recent Asset Classes' Behavior

#### Macro: Signs of Weakness

#### Oil: OPEC Plus Agreement to Support Prices Amid Weak Demand

#### MENA: Investment Themes

### Introduction

Our investment journey continues through the second half of 2019 with a focus on a cluster of factors that include more regulation on big tech, geopolitical risk in the Middle East, rising probability of a no-Brexit deal, intensified protests in Hong Kong, OPEC and Russia's production cut agreement, and recurring trade skirmishes between Europe and the US. However, chiefs among the long list of factors are the US-China trade truce and the dovish bias by global central banks.

From this vantage point, the outlook for growth and inflation is still gloomy. Accommodative central banks will continue to support consumption and provide the liquidity pulse. The détente in the trade war between China and the US is a welcome de-escalation, but it is just a relief that does not eliminate the uncertainty around the trade dispute. Stimulus measures in China will cushion any slowdown in the economy. Although we might not see a recession given the supportive measures taken by policy makers, a positive reversal in data related to confidence indices, manufacturing indices, and global trade is not yet in sight. Moreover, the divergence between manufacturing and services sectors will likely continue which means that the economy is running on one leg and on support from central banks.

A combination of muted growth, subdued inflation, and uncertainty regarding the trade war despite the recent de-escalation at the G20 meeting last month means that sovereign yields will continue to be tamed. This explains the hunt for yield that was unleashed by the dovishness of central banks and the rise in negative yielding debt to a record of USD 13trn. Investors enjoyed the spread compression and are now squeezing the positive return contribution of accommodative monetary policy. Amid this environment, we believe that investors should not be complacent but should be ready to hunt as potential spikes in spreads could hit certain pockets. This will come through the credit or liquidity channel as working out a mountain of debt amid high refinancing needs in the coming years (corporate refinancing needs are estimated to be at USD 500bn next year), and low growth might affect margins and profitability and thus the debt service ratio.

Although we are not in an earnings' recession, most analysts have downgraded their forecasts for Q2 2019 and continue to see a muted growth in earnings for this year. Simultaneously, valuations of US equities are already at the levels of Q3 2018. This means that investors are expecting too much easing from central banks to support earnings unless results for Q2 surprise to the upside.

Amid a low real yield environment and expectations that emerging markets will ease their monetary policies, we continue to favor gold, high dividend paying stocks, domestic thematic plays and selective emerging market investments, while keeping a significant portion in cash to cushion our good first half performance for 2019 and to enjoy the tactical optionality to hunt opportunities with high premiums. Our biggest concern is to strike a balance between staying invested and having a good mix of uncorrelated assets.

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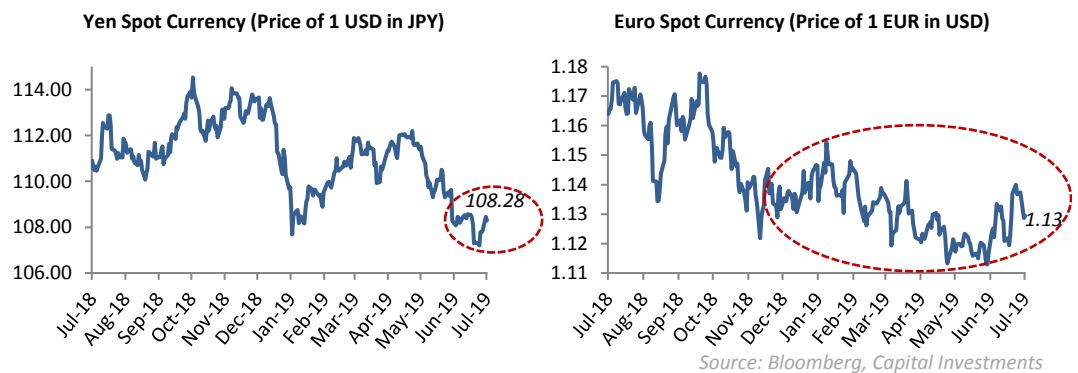
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## Clues from Recent Asset Classes' Behavior



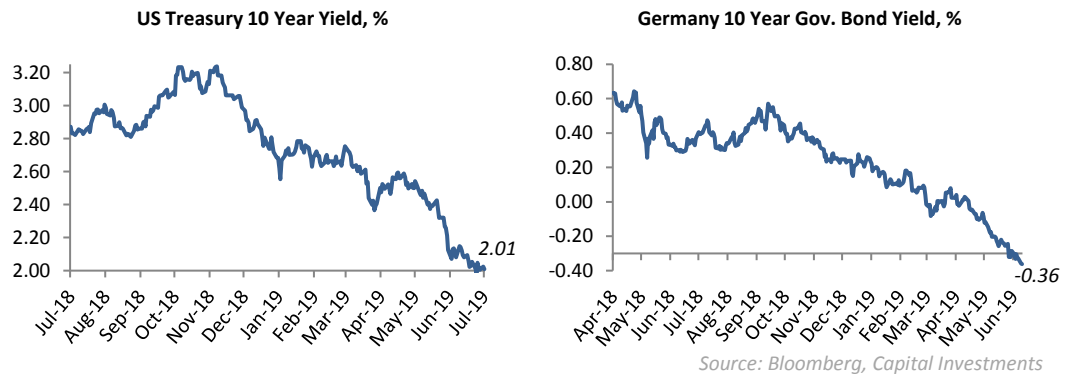
Source: Bloomberg, Capital Investments

A combination of escalating trade disputes between US and China along with rising expectation of potential easing by the US Fed contributed to the decline of the USD over the past two months. The USD represented by the DXY index jumped again above its 200-day trading average on the back of the trade truce achieved between the US and China during the G-20 meeting. On the other hand, the Chinese Yuan refrained from crossing the psychological barrier of 7 to the dollar and gained some of its lost ground. USD bears are not being cheered as dovish signs from other major Central banks in both emerging and developed markets are lending support to the USD.

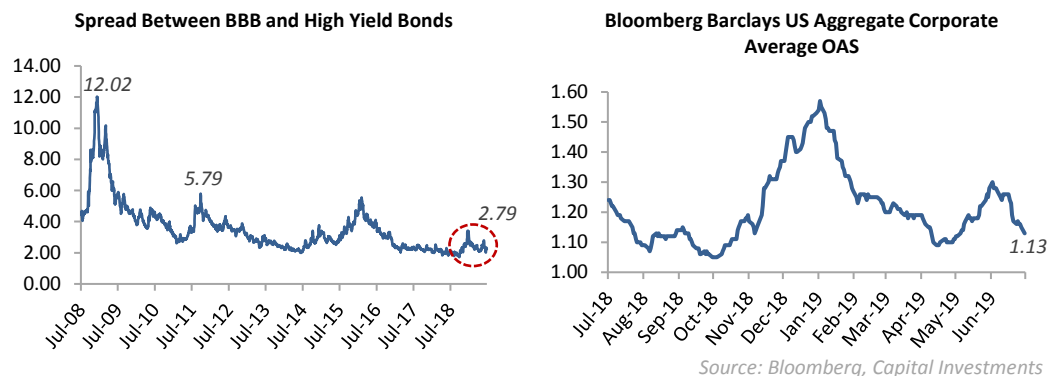


Source: Bloomberg, Capital Investments

The performance of the Japanese Yen is a mirror to that of the greenback as it acted as a safe-haven during the rising tension around trade, in tandem with other assets such as US treasuries and gold; this trend was reversed as illustrated in the chart above after the G-20 meeting. As for the Euro, it did not benefit from the dovish stance the Fed has taken as the ECB is adopting a more accommodative approach in terms of forward guidance and potential revival in quantitative easing which explains why the Euro was moving in a tight range for the past six months. It is obvious that a significant part of easing in Europe will continue to come through the currency channel as the ECB's toolkit appears to be limited.

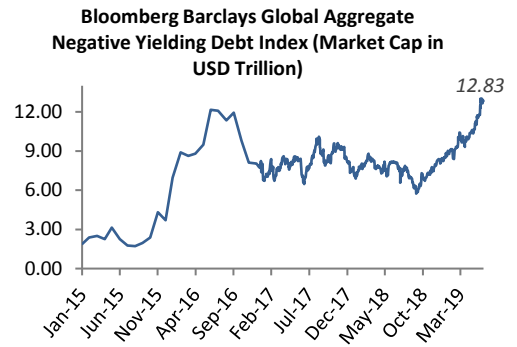
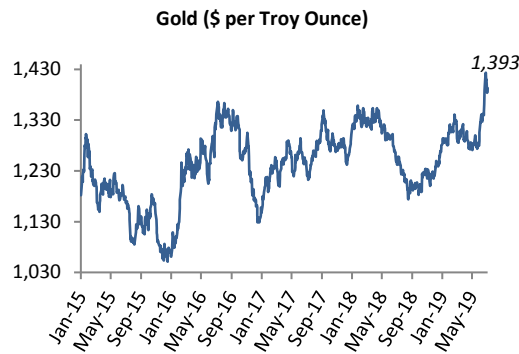


The pause in the trade dispute between the US and China played a major role in stabilizing the yield on US treasuries as a gloomed economic outlook and potential easing from central banks pushed investors to fly to quality. The drop in German bund yield to a record low and the plunge in the Swiss yield curve below zero for maturities less than 30 years exercised additional gravitational pressure on US yields and incentivized investors to reach out for yield in anticipation of a synchronized global monetary easing which compressed spreads across the globe.



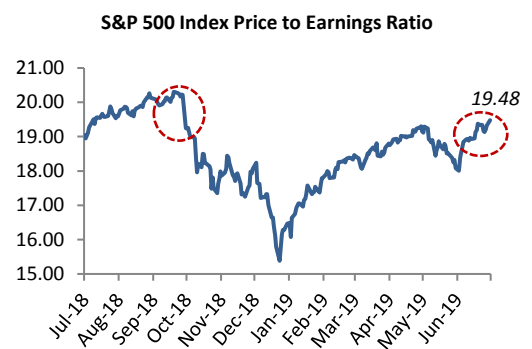
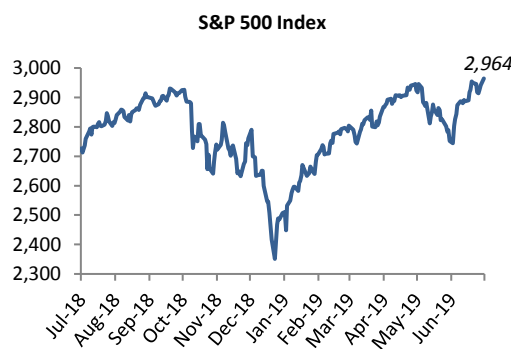
The US credit market has given us many signs over the years of where to find relative value for each credit rating; it serves as a general benchmark for spread analysis. Looking at the US corporate aggregate average Option Adjusted Spread (OAS), we see major tightening in the spread due to the market pricing in a Federal Reserve interest rate cut. This makes it harder to find value among bonds of all ratings.

To zoom in on the general picture highlighted above, we are currently observing the winnowing spread between BB (Best of high yield) and BBB (Worst of investment grade). The oil price rally is a big contributor as explorers and producers have a much higher weighting in the High Yield index than Investment Grade. Moreover, the rise in the volume of outstanding negative yielding debt has fueled demand for yield, and therefore migration down the credit spectrum. This implies that BB and BBB bonds have become less attractive as their spread tightens to cycle lows.



Source: Bloomberg, Capital Investments

In a world where negative yielding assets are at record high, as illustrated by the chart above, gold is not at a disadvantage anymore. This is supported by a lower USD and lower real yields, as well as the reintroduction of the easing bias by major central banks. We continue to be constructive on the yellow metal and we think that the rally may need to consolidate in anticipation of the potential Fed rate cuts. Although the rally in gold was in line with that of other quality assets, we continue to believe that gold will be supported by lower yields. Gold also looks cheap when compared to the Dow index, as the Dow to Gold ratio currently stands at 19, whereas in 2011 when gold reached 1900, it cost 8 ounces to buy the Dow index.

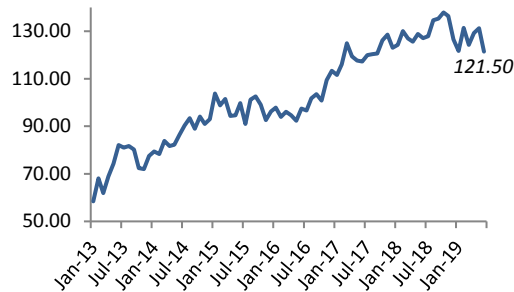


Source: Bloomberg, Capital Investments

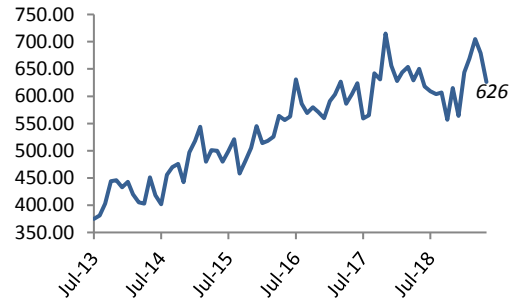
The S&P 500 Index has so far registered a triple top, benefiting from the anticipated easing of the Fed along with resumption of trade talks between the US and China. It is worth mentioning however that the valuation at a P/E of 19.4 is back at levels last seen in September 2018. Amid a deterioration in consumer confidence indices, which are leading signals for a potential pull down in the market, further advancement in stocks should be validated through growing bottom lines and require evidence of macro data stability.

## Macro: Signs of Weakness

Conference Board Consumer Confidence Index

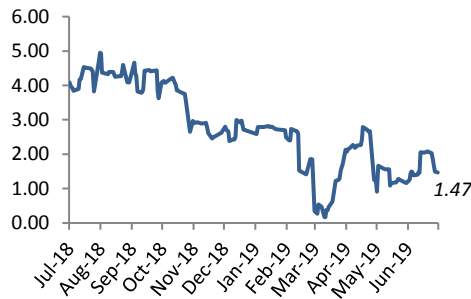


US New Home Sales (in Thousands)



Source: Bloomberg, Capital Investments

Atlanta Fed GDPNow Forecast



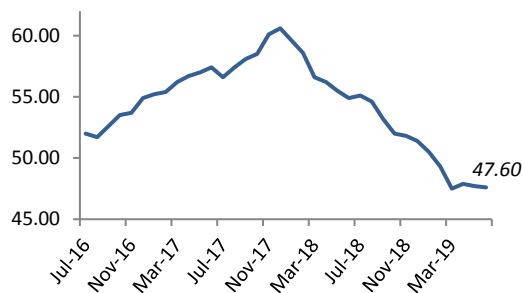
US Citi Economic Surprise Index



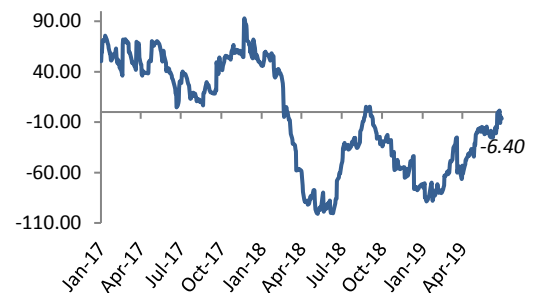
Source: Bloomberg, Capital Investments

The coming few months will tell whether the trade truce will help reflate consumer confidence in the US. A combination of weak housing data and deteriorating manufacturing figures across the different regions in the US has led to a drop in the US Citi Economic Surprise Index and a revision in the Atlanta Fed GDP forecast for Q2 2019.

Markit Eurozone Manufacturing PMI SA



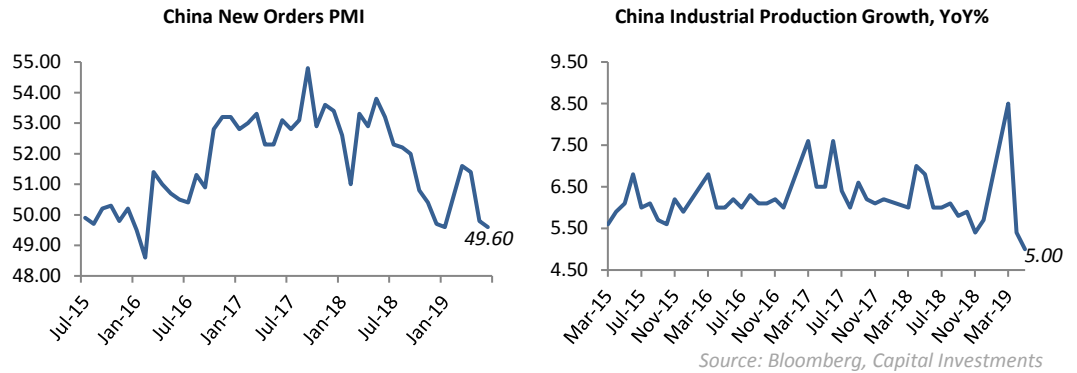
Eurozone Citi Economic Surprise Index



Source: Bloomberg, Capital Investments

Data from Europe is showing some signs of stability especially at the level of the manufacturing sector, and private consumption continues to be decent in the Eurozone. However, the impulse of credit expansion is still muted and not reflected in the GDP despite the measures taken by the ECB,

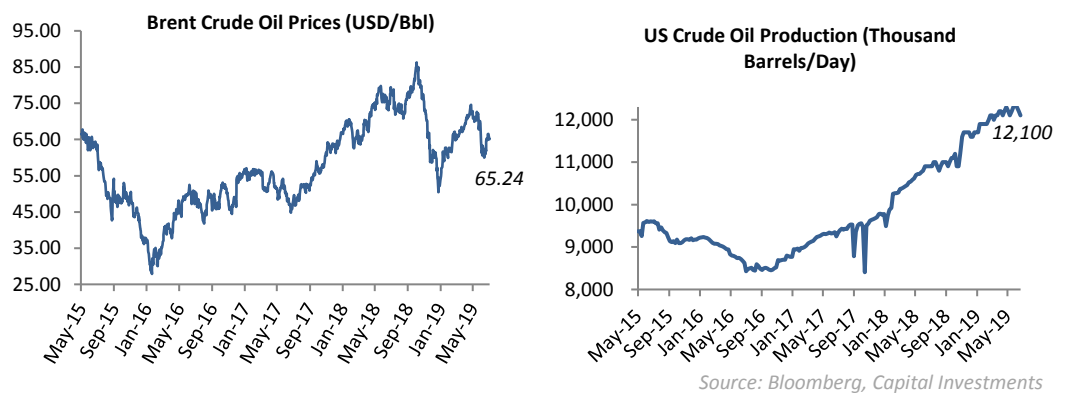
notably the TLTRO program (Targeted Longer-Term Refinancing Operations) which aims at boosting the availability of liquidity for lending through the banking system.

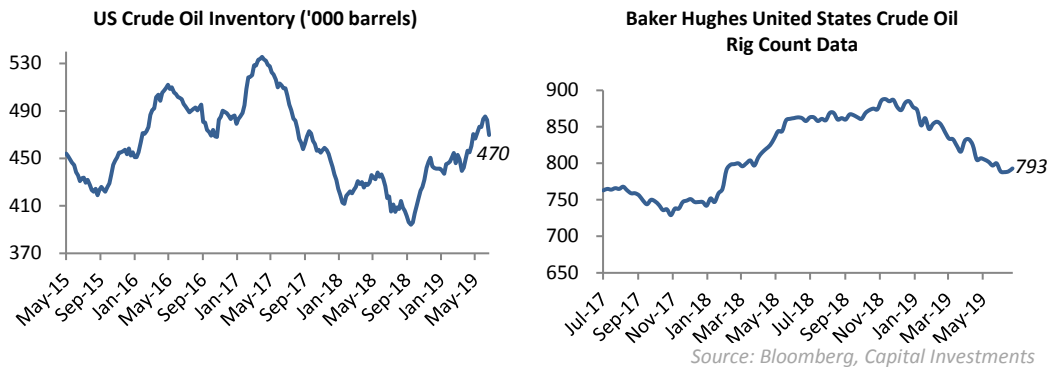


We believe that China will enhance its stimulus measures to cushion the negative backdrop of the trade war. Such measures could include further reserve requirement cuts at the level of the banking system and more targeted infrastructure spending as the VAT cut that took place over the past two months did not bear fruit yet. The PMI data, especially those related to new orders, are not encouraging as we enter the third quarter of the year.

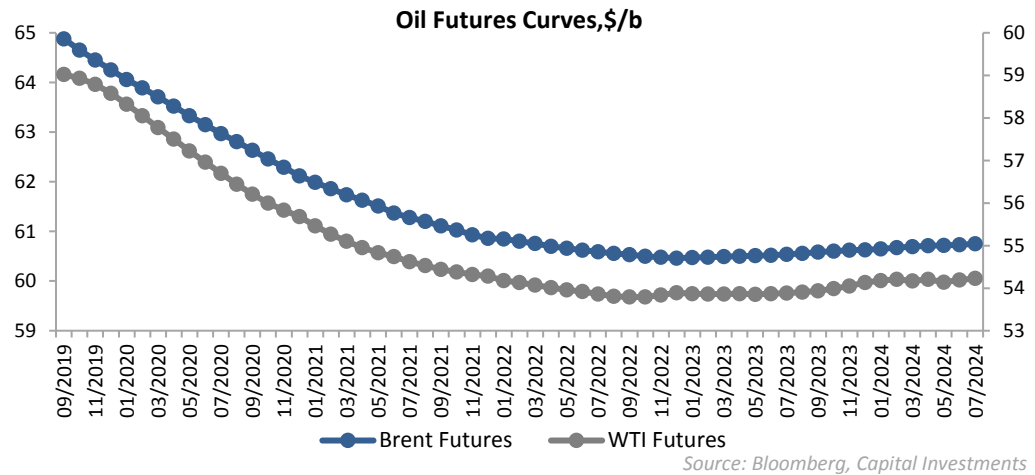
### Oil: OPEC Plus Agreement to Support Prices Amid Weak Demand

Supply and demand fundamentals are putting oil prices in a tug of war, and we believe that the market will continue to alternate between a deficit and surplus. On the one hand, OPEC and its allies have agreed on extending output cuts until March 2020 in an attempt to keep oil prices buoyant. Additionally, the driving season in the US should provide some support to oil prices. On the other hand, the IEA has revised its 2019 demand forecast downward from 1.3 million b/d to 1.2 million b/d. Moreover, despite the supply disruptions, there is limited downside remaining to the production from Venezuela, Iran, and Libya as the bulk of the supply has already been lost. Therefore, we believe that oil prices will continue to trade in a range unless the trade dispute is resolved.





Nonetheless, it's worth noting that both the WTI and Brent futures curves are in backwardation now (only Brent was in backwardation before), as rising inventories in the US due to maintenance of refineries played a big role in the shape of the curve in Q2 2019.



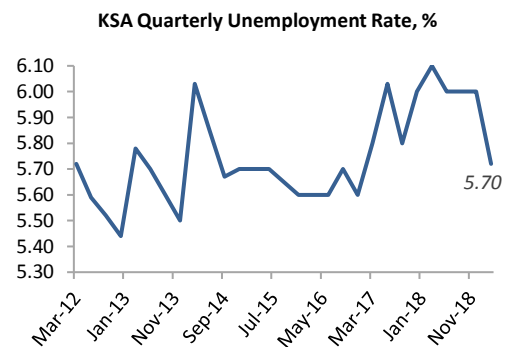
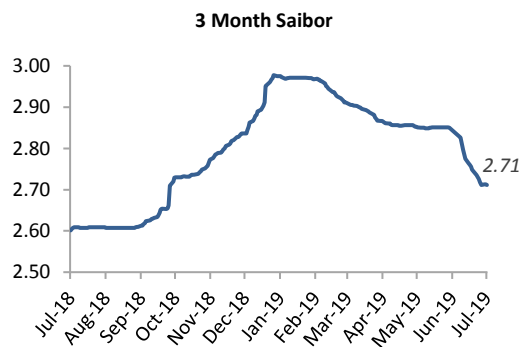
### MENA: Investment Themes

Several global factors are currently influencing investment decisions; a trade war truce between the US and China, the extension of the OPEC agreement to curb oil production, uncertainty over growth, dovish central banks of both developed economies and emerging markets, muted inflation, and a global manufacturing recession as indicated by falling PMIs. Considering these conditions, investors need to be strategically positioned to enhance investment performance.

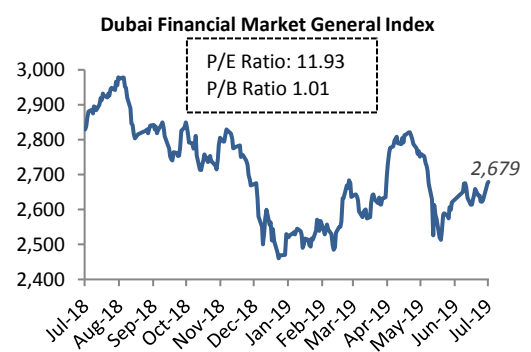
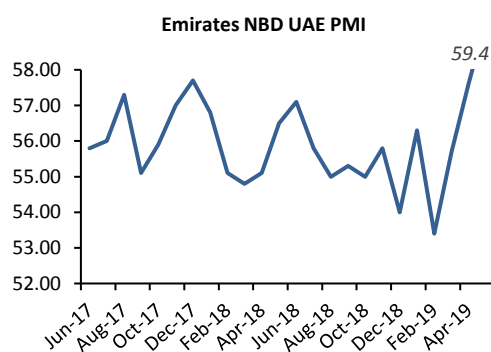
In relation to banks, net interest margins (NIMs) will be problematic going forward and thus we should look at banks experiencing one or more of the following four factors beyond NIMs; a peak in

provisioning, a recovery in corporate lending, and growth in retail lending and mortgages. The latter is highly evidenced within Saudi Arabian banks whereby, according to SAMA data, the number of mortgages awarded in Saudi Arabia surged 212% YoY in May. The fourth factor is sector consolidation and event driven investing which is currently observable within UAE banks.

In addition, to insulate portfolio performance, we should look at stocks benefiting from higher domestic consumption in the region and sector consolidation. For example, in Saudi Arabia the Saudization of jobs and the enforcement of health insurance for Saudis working in the private sectors are creating some opportunities in the retail and insurance sectors. In addition, real estate stocks should benefit from potentially lower interest rates going forward, and investors should continuously look for high dividend paying stocks and any bottom up plays, along with other thematic plays benefiting from the Expo 2020 in Dubai, which is expected to increase the number of tourist arrivals into the UAE and thus spending in the country.



Source: Bloomberg, Capital Investments



Source: Bloomberg, Capital Investments

Major Indices	Status as of end		Performance	
	December. 2018	June. 2019	June.2019	YTD (30 June. 2019)
<b>MENA</b>				
Abu Dhabi	4,915.07	4,979.95	-0.47%	1.32%
Bahrain	1,337.26	1,471.04	2.62%	10.00%
Dubai	2,529.75	2,658.63	1.46%	5.09%
Egypt	13,035.77	14,100.74	2.39%	8.17%
Jordan	1,908.81	1,880.11	4.07%	-1.50%
Kuwait	5,267.36	6,377.02	2.16%	21.07%
Lebanon	976.75	865.67	0.86%	-11.37%
Morocco	11,364.31	11,287.04	2.61%	-0.68%
Oman	4,323.74	3,884.91	-1.25%	-10.15%
Palestine	529.35	519.83	-1.07%	-1.80%
Qatar	10,299.01	10,455.67	1.78%	1.52%
Saudi Arabia	7,826.73	8,821.76	3.58%	12.71%
Tunisia	7,271.65	7,149.00	1.53%	-1.69%
S&P Pan Arab Composite	728.72	795.94	2.62%	9.22%
Dow Jones MENA	556.65	607.52	2.44%	9.14%
<b>Americas</b>				
Dow Jones Industrial	23,327.46	26,599.96	7.19%	14.03%
S&P 500	2,506.85	2,941.76	6.89%	17.35%
NASDAQ Composite	6,635.28	8,006.24	7.42%	20.66%
S&P/Toronto Composite	14,322.86	16,382.20	2.15%	14.38%
<b>Europe</b>				
EURO Stoxx 50	3,001.42	3,473.69	5.89%	15.73%
S&P Europe 350 Index	1,367.94	1,555.52	4.18%	13.71%
FTSE 100 Index/ London	6,728.13	7,425.63	3.69%	10.37%
FTSE MIB Index/ Italy	18,324.03	21,234.79	7.23%	15.88%
DAX Index/ Germany	10,558.96	12,398.80	5.73%	17.42%
<b>ASIA/Pacific</b>				
NIKKEI 225/ Japan	20,014.77	21,275.92	3.28%	6.30%
S&P/ASX 200/ Australia	5,646.40	6,618.77	3.47%	17.22%
<b>BRIC</b>				
Brazil/ Bovespa	87,887.30	100,967.20	4.06%	14.88%
Russia/ RTS	1,066.13	1,380.52	7.26%	29.49%
India/ Bombay Sensitive	36,068.33	39,394.64	-0.80%	9.22%
China/ Shanghai Composite	2,493.90	2,978.88	2.77%	19.45%
Hong Kong/ Hang Seng	25,845.70	28,542.62	6.10%	10.43%

Source: Bloomberg, Capital Investments

	December. 2018	June. 2019	June.2019	YTD (30 June. 2019)
<b>Commodities (in USD)</b>				
Brent Spot (Barrel)	53.17	64.43	2.38%	21.18%
WTI Cushing Spot (Barrel)	45.41	58.47	9.29%	28.76%
Natural Gas NYMEX (MMBtu)	2.76	2.31	-6.18%	-16.29%
Gold Spot (OZ)	1,282.45	1,409.45	7.97%	9.90%
Silver Spot (OZ)	15.50	15.31	5.11%	-1.17%
Copper LME Spot (MT)	5,949.00	5,982.00	3.03%	0.55%
Corn CBOT Active Month (Bushel)	3.98	4.32	-2.76%	8.55%
Wheat CBOT Active Month (Bushel)	5.28	5.27	3.43%	-0.19%
Soybean CBOT Active Month (Bushel)	9.35	9.23	2.02%	-1.31%
Rough Rice Futures (USD/cwt)	10.10	11.28	-1.57%	11.69%
<b>Currencies Spot Exchange Rates Against US Dollar</b>				
Euro	1.15	1.14	1.83%	-0.82%
GBP	1.28	1.27	0.53%	-0.45%
CAD	0.73	0.76	3.23%	4.16%
Yen	0.01	0.01	0.37%	1.60%
CNY	0.15	0.15	0.56%	0.17%

Source: Bloomberg, Capital Investments

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