

Monthly Newsletter

May 30th, 2019

"Someone is sitting in the shade today because someone planted a tree long time ago" — Warren Buffet

"The expected never happens, it is the unexpected always" — John Maynard Keynes

Clues from Recent Asset Classes' Behavior

Macro: Signs of Weakness

Oil: Caught Between the Spectra of Supply Disruption and Trade War

MENA: Saudi Arabia's Inclusion into the MSCI and FTSE EM Indices

Introduction

President Trump's tweet on the 5th of May reignited the trade war with China. The escalation in the standoff with China moved into technology as President Trump curbed Huawei's access to US markets and US suppliers, along with movement to curtail US visa issuance to Chinese students. An appeasement for the time being in trade negotiations with Japan, EU, Canada and Mexico did not save the moment. All this coupled with renewed sanctions on Iran, the rise in geopolitical tensions in the Middle East and the Korean Peninsula, along with the roaring wave of populism in Europe and rising nationalism tone in China cemented the risk-off themes.

The initial casualty in this trade war seems to be financial markets, as consumers and producers are yet to pay the price, while challenges and dislocations in supply chains are yet to reveal themselves. The trade war is taking its toll on global trade which has been decelerating, and it is expected to shave off from global GDP growth.

Some residual expectations about a potential truce or agreement regarding the trade war with China ahead of the G20 meeting in Osaka-Japan at the end of June, along with dovish central banks are keeping financial conditions accommodative and thus providing some support to markets, which seem to be on pause as they search for direction after the steep drop over the past weeks.

In fact, the positioning in markets is already defensive. Powered by the overall risk tone, long-term sovereign yields are dropping to two-year low levels. The US 10-year yield of 2.23% is below the Fed Fund rate of 2.38%. The size of negative yielding debt soared again to USD 10.8trn, a figure last seen in 2016. CDS levels are rising, leading to some widening in credit spreads and investors are casting out high yields. The currency market is telling an ugly story as investors are moving towards the USD and Japanese Yen as safe haven, while the decline in GBP and Yuan are contributing to the rise in uncertainty and volatility, which has been spiking amid various asset classes, notably equities, oil, and US treasuries. Declining oil and copper prices coupled with negative macro readings in terms of industrial production and PMIs are adding some gloom to global growth especially that the Atlanta GDP Now Q2 forecast for the US economy is at an estimated annual growth of 1.3%, down from 3.2% and far below the long-term trend growth in US of 2%.

While markets are looking for direction, investors are facing binary scenarios. The probabilities of deals in relation to Brexit and the trade war are unclear. The outcome of the OPEC meeting with its allies in July seems ambiguous as Russia and OPEC appear to be divided. All market participants are pricing in weakness in the economy and a potential interest rate cut by the Fed. Investors would have to keep an eye on the Fed's communication and on negotiations between the Democrats and Mr. Trump regarding the USD 2trn infrastructure package, as in a late cycle economy this might set wage growth on fire. As the U.S. presidential election season is expected to commence soon, we think that the stock market performance will affect the tone, tactics, and actions of U.S. trade negotiators as a falling market will spark negative sentiment. In China, authorities will keep injecting stimulus to avoid big concessions in the trade deal and to keep unemployment in check.

From this vantage point, we prefer to keep a substantial portion in dry powder to hunt for selective plays with adequate risk premium, while benefiting from the expected volatility to execute tactical trades.

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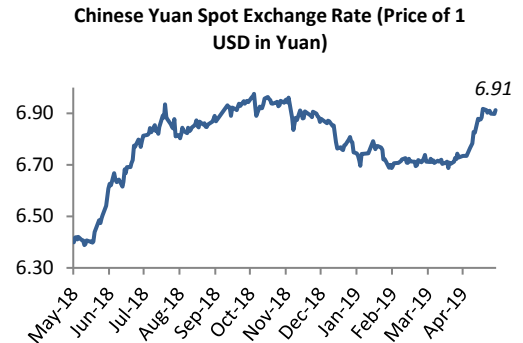
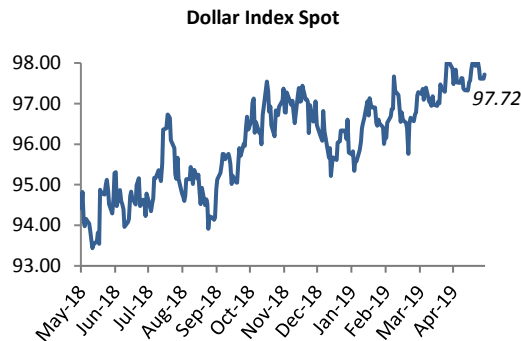
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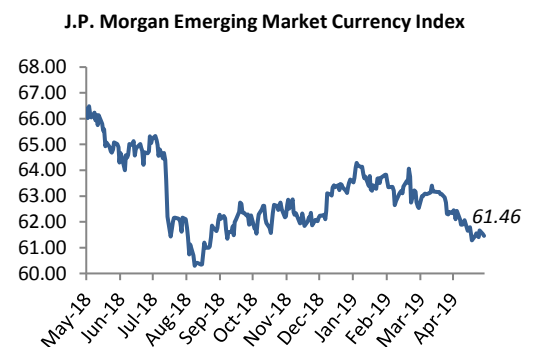
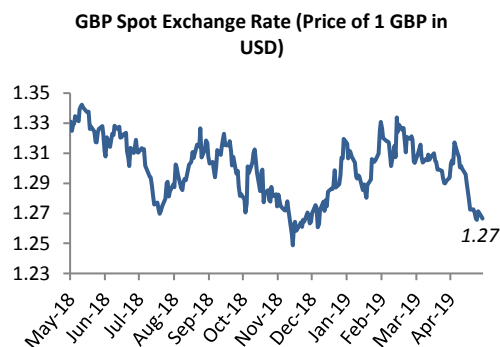
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Clues from Recent Asset Classes' Behavior

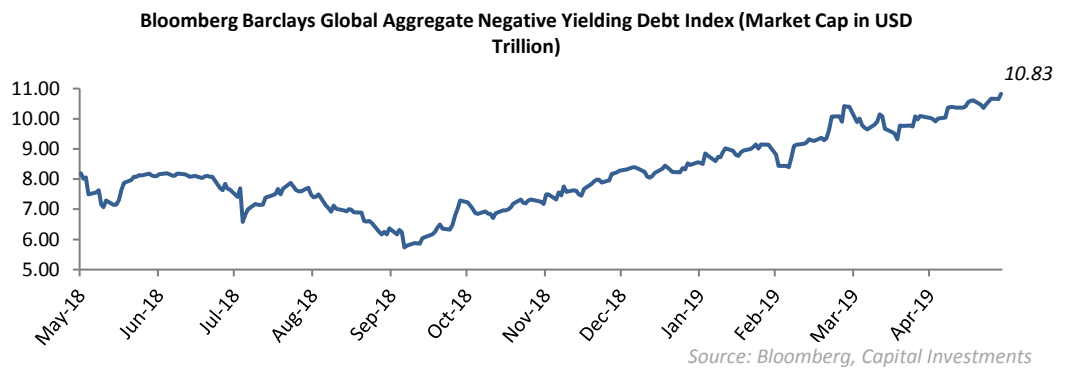
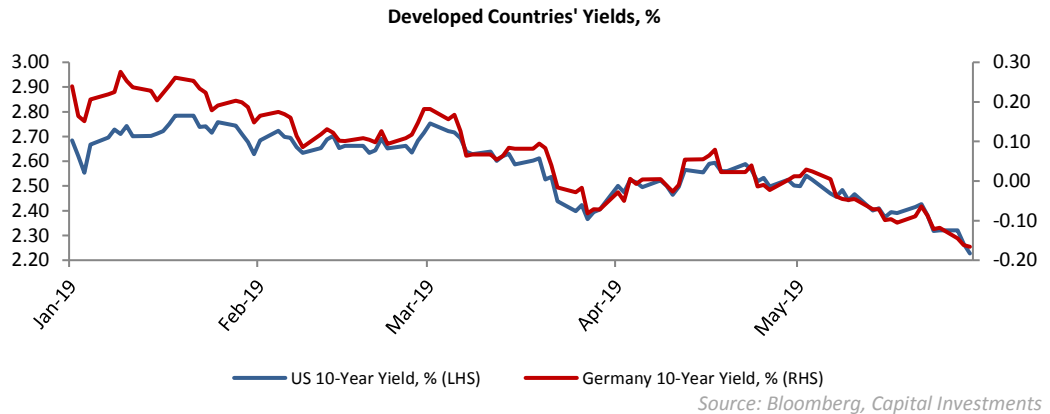


Source: Bloomberg, Capital Investments

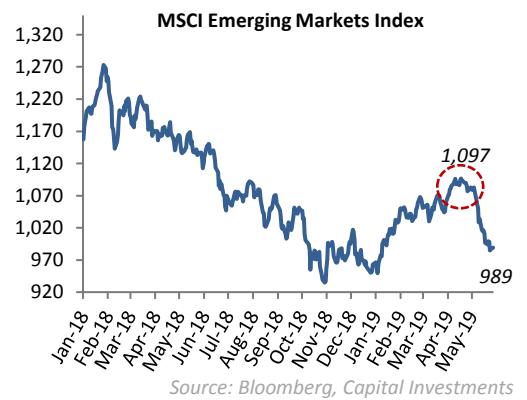
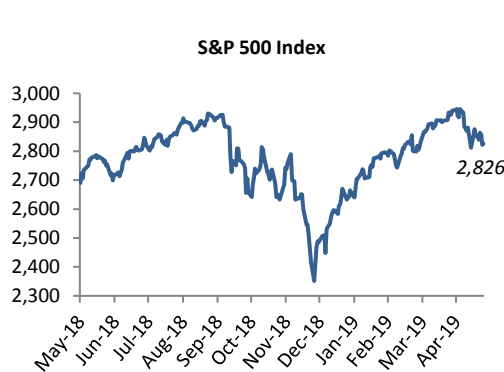


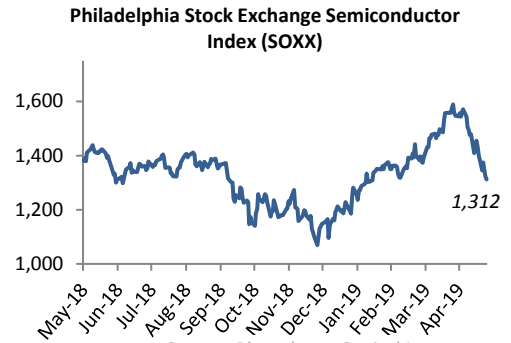
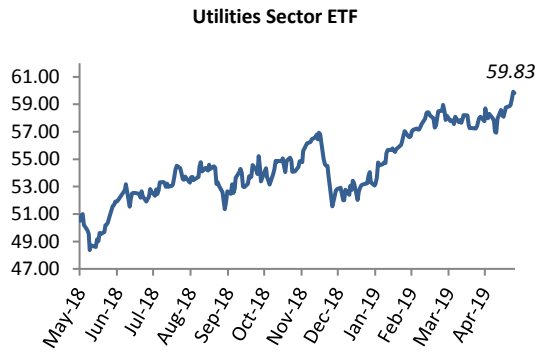
Source: Bloomberg, Capital Investments

Currency markets are sending some worrying signs. The defensive positioning among investors is epitomized through a strong USD and Japanese Yen, while the fall in the GBP is warning loudly about the rising risk of a no deal Brexit. The Chinese Yuan is in a tug of war; the country's corporates have a large stock of foreign currency denominated debt that cannot withstand a sharp drop in the currency, while at the same time, a depreciating currency boosts exports. Most emerging market currencies were victims of the escalation in trade war, whether the economy is based on commodity exports such as Brazil or on manufacturing exports such as Korea and Turkey. The Egyptian Pound was odd to the trend.



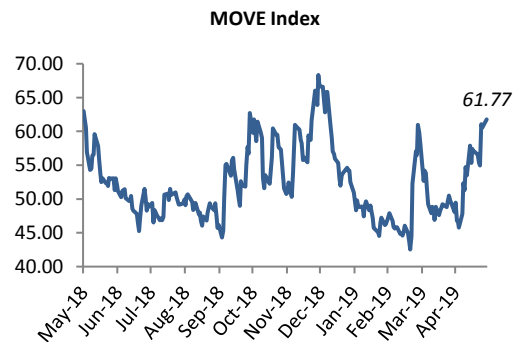
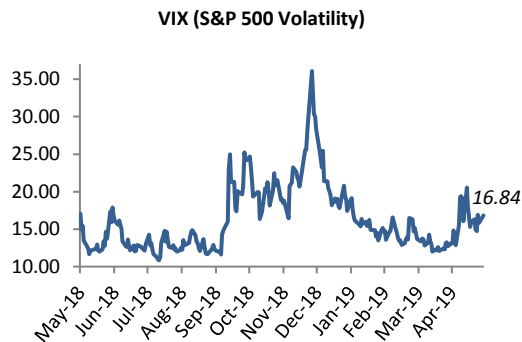
The defensive positioning was obvious in sovereign bond yields which declined sharply, and the size of negative yield debt soared, signaling potential weakness in the economic outlook and pricing in further easing from Central Banks. Amid a worsening macro environment, companies may face lower margins and earnings. In addition, concerns regarding the global corporate debt mountain re-emerged, and credit spreads started to widen reflecting high leverage ratios.





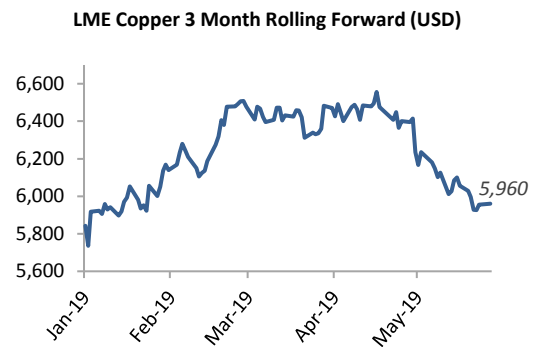
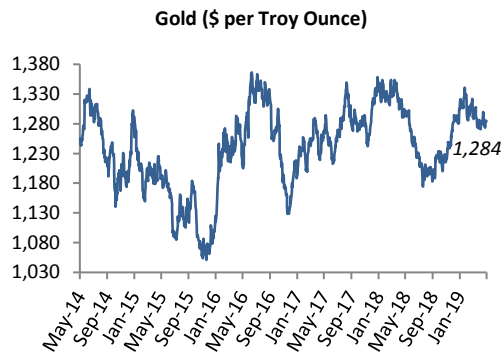
Source: Bloomberg, Capital Investments

The correction was felt heavily across equity markets, notably in EM, which suffered more than their US counterparts, who are not factoring in fully the uncertainty surrounding the trade negotiations. Rotation from cyclical and trade-related sectors such as autos, tech and industrials into defensive plays such as utilities, consumer staples and REITs was obvious. On a separate note, the US Fed revealed in its latest survey of senior loan officers that demand for credit is falling across all categories and banks are tightening their lending standards. In addition, reports from Citi showed that the credit impulse in China is decelerating. This, combined with escalating trade tensions, might indicate that earnings will weaken in the coming quarter.



Source: Bloomberg, Capital Investments

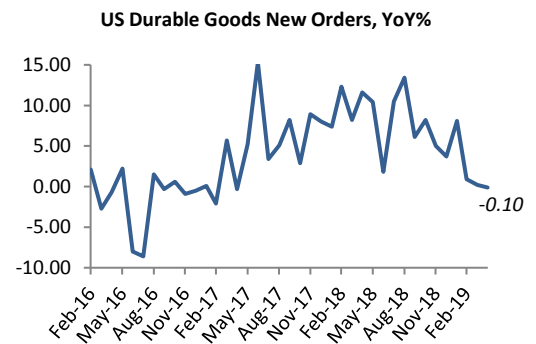
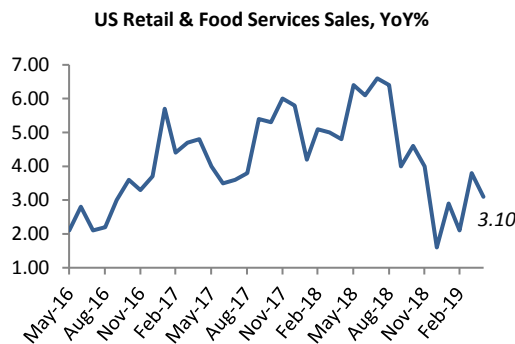
Volatility is spiking again across the board giving a no breather to investors. The pause in the VIX index, which is a gauge of fear in the equity market, after its recent spike, is a mirror to the tentative consolidation in equities after the sharp drop. While the MOVE index, which reflects volatility in US treasuries, is showing that investors are nervous.



Source: Bloomberg, Capital Investments

Despite falling interest rates, gold is trapped by a strong USD and a falling Yuan. As such, it failed to break the USD 1,300 per ounce level. The expected deficit in copper did not save the industrial metal from weakness in the economy, as it dropped along with oil, confirming the worries expressed in sovereign yields.

Macro: Signs of Weakness



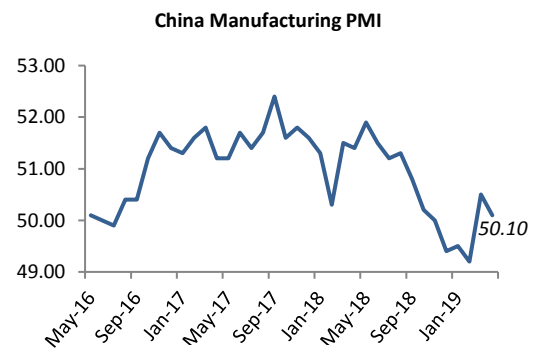
Source: Bloomberg, Capital Investments

The improvement in the Eurozone and Chinese economies during the first quarter of the year was mainly due to resilient domestic consumption amid an inventory buildup, notably in Germany and the US, and supportive services sector, while the manufacturing and trade contributions were not encouraging. It seems that stockpiling is going to be a drag on Q2 performance, while the slump in manufacturing is affecting the services sector which is losing steam, and decelerating global trade is not supportive.



Source: Bloomberg, Capital Investments

In the US, weakness is apparent in many indicators- industrial production is falling, capacity utilizations are on a downward trend, while retail sales and durable goods new orders are not printing good figures amid a sluggish housing sector, which explains the downgrade of the GDP forecast for Q2 2019. In Europe, the domestic demand appears to be resilient supported by looser fiscal policy and an accommodative ECB. This, however, is offering little assurance as the trade war impact is starting to filter through manufacturing and business expectations in Germany.

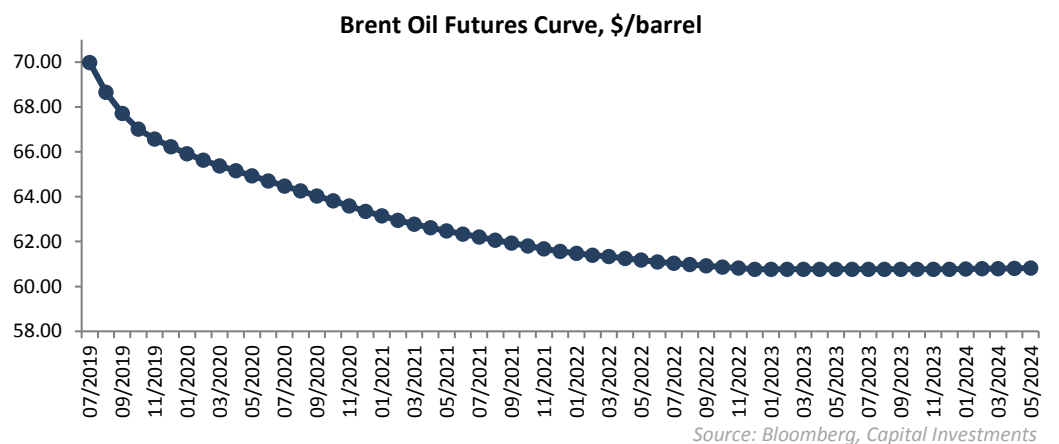
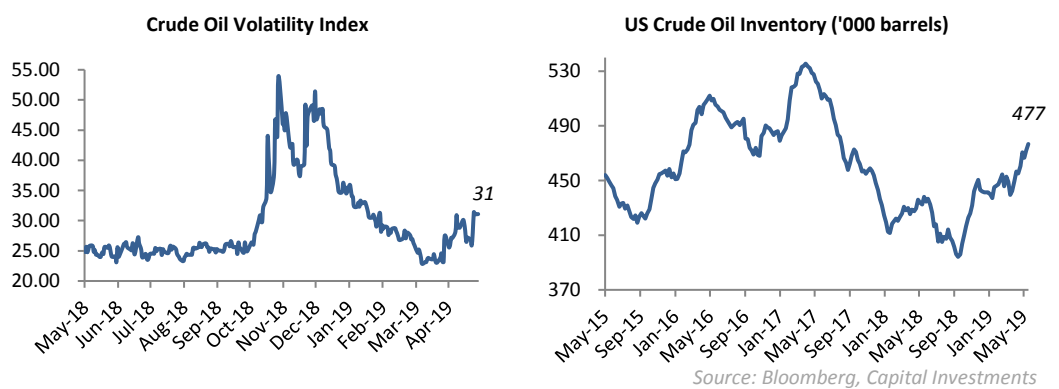


Source: Bloomberg, Capital Investments

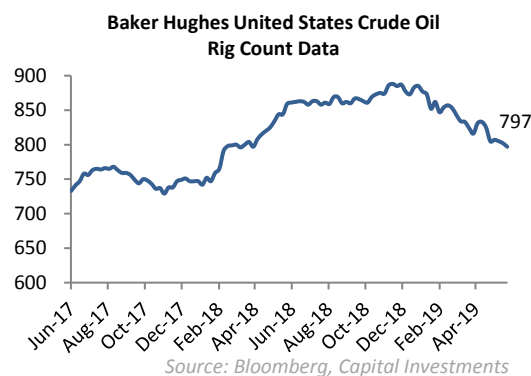
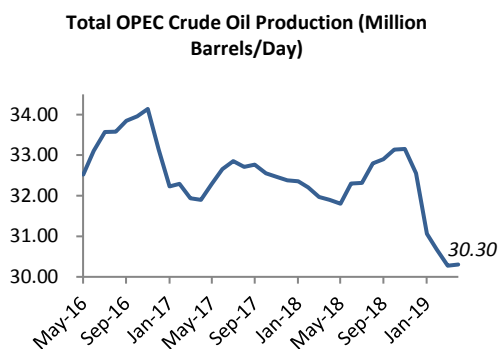
China appears to have lost its steam since April as data related to retail sales, industrial production, industrial companies profit, and fixed asset investment were on a downward trend. Many Chinese stimulus measure are due to kick in, along with the injection of liquidity through a reserve requirement cut. Investors are awaiting a confirming trend in data to set the direction.

Oil: Caught Between the Spectra of Supply Disruption and Trade War

Even though the IEA cut its oil demand growth estimate for 2019 by 90,000 bpd to 1.3 million bpd and although U.S. inventory levels have increased, we believe that supply-side factors will support prices. Inventory drawdown as the driving season kicks off in the US, as well as the disruptions in supply outlined below will keep the oil market tight, as evidenced by the oil futures curve, which remains in backwardation.



Russia has been forced to reduce exports due to the contamination of its major pipelines. Meanwhile, sanctions on Iran and Venezuela, along with political upheavals in Libya and Nigeria have also caused supply disruptions. Although some spare capacity is available in Russia, Kuwait, KSA and the UAE, it will not be released due to elevated inventory levels. It's also worth noting that OPEC has decided to move its next policy meeting to July 3-4 from June 25-26 as they await further clarity after the G20 meeting.



MENA: Saudi Arabia’s Inclusion into the MSCI and FTSE EM Indices

MSCI, one of the world’s largest index providers, announced the results of its May 2019 Semi-Annual Index Review (SAIR), and changes are effective as of the close of May 28, 2019. MSCI generally selects stocks for its equity indexes that are easily traded, highly liquid, and have active investor participation. Saudi Arabia’s phase 1 inclusion in the MSCI Emerging Market Indexes is the main highlight in the MENA region with around USD7bn of expected passive inflows. 30 Saudi Arabian securities will be added at half of their Foreign Inclusion Factor (FIF)-adjusted market capitalization this review, representing a total weight of 1.42% in the MSCI Emerging Markets Index as shown in the table below. The 30 stocks have a free float of around USD200bn and an inflow of 7bn represents a considerable 3.5% of this float. Phase 2 will be the final phase of the inclusion and will take place in August 2019, adding another USD7bn of inflows. In addition, FTSE phase 3, 4, and 5 will take place in June 2019, September 2019, and March 2020, respectively, adding around another USD4.5bn of passive inflows.

Fortunately, the inflow of liquidity will take place until March 2020 but the market will certainly experience volatility in that period. Beyond the MSCI index inclusion, which mainly focuses on large caps, it is worth looking at midcap banking stocks and certain thematic plays in Saudi Arabia such as healthcare and building materials, if government spending materializes, as they are laggard.

Table: Constituents of the MSCI Saudi Arabia EM Standard Index

Ticker	Company Name	Weight
SABIC AB	Saudi Basic Industries Corporation	0.21%
RJHI AB	Al Rajhi Bank	0.21%
NCB AB	National Commercial Bank	0.17%
STC AB	Saudi Telecom Company	0.11%
SAMBA AB	Samba Financial Group	0.09%
RIBL AB	Riyad Bank	0.08%
MAADEN AB	Saudi Arabian Mining Company	0.06%
BSFR AB	Banque Saudi Fransi	0.05%
ALINMA AB	Alinma Bank	0.05%
YANSAB AB	Yanbu National Petrochemical Company	0.04%
ALMARAI AB	Almarai Company	0.04%
SECO AB	Saudi Electricity Company	0.03%
SAFCO AB	Saudi Arabian Fertilizer Company	0.03%
JARIR AB	Jarir Marketing Company	0.02%
ALBI AB	Bank Albilad	0.02%
KAYAN AB	Saudi Kayan Petrochemical Company	0.02%
SABB AB	Saudi British Bank	0.02%
SAVOLA AB	Savola Group	0.02%
EEC AB	Etihad Etisalat Company	0.02%
BJAZ AB	Bank Aljazira	0.02%
SIIG AB	Saudi Industrial Investment Group	0.01%
APPC AB	Advanced Petrochemical Company	0.01%
NIC AB	National Industrialization Company	0.01%
ALARKAN AB	Dar Alarkan Real Estate Development Company	0.01%
SACCO AB	Saudi Cement Company	0.01%
PETROR AB	Rabigh Refining and Petrochemical Company	0.01%
TAWUNIYA AB	The Company for Cooperative Insurance	0.01%
EMAAR AB	Emaar The Economic City	0.01%
CATERING AB	Saudi Airlines Catering Company	0.01%
BUPA AB	Bupa Arabia for Cooperative Insurance Company	0.01%

Source: Bloomberg, Arqam Capital, Capital Investments

Major Indices	Status as of end		Performance	
	December. 2018	May. 2019	May.2019	YTD (28 May. 2019)
MENA				
Abu Dhabi	4,915.07	4,791.42	-8.87%	-2.52%
Bahrain	1,337.26	1,427.59	-0.44%	6.75%
Dubai	2,529.75	2,607.01	-5.79%	3.05%
Egypt	13,035.77	14,028.00	-5.98%	7.61%
Jordan	1,908.81	1,810.61	-0.05%	-5.14%
Kuwait	5,267.36	6,153.91	1.76%	16.83%
Lebanon	976.75	866.32	-4.78%	-11.31%
Morocco	11,364.31	11,134.41	-0.52%	-2.02%
Oman	4,323.74	3,918.80	-0.68%	-9.37%
Palestine	529.35	525.17	-0.45%	-0.79%
Qatar	10,299.01	9,896.06	-4.63%	-3.91%
Saudi Arabia	7,826.73	8,550.90	-8.10%	9.25%
Tunisia	7,271.65	6,970.93	1.25%	-4.14%
S&P Pan Arab Composite	728.72	769.91	-6.10%	5.65%
Dow Jones MENA	556.65	587.49	-5.89%	5.54%
Americas				
Dow Jones Industrial	23,327.46	25,347.77	-4.68%	8.66%
S&P 500	2,506.85	2,802.39	-4.87%	11.79%
NASDAQ Composite	6,635.28	7,607.35	-6.03%	14.65%
S&P/Toronto Composite	14,322.86	16,297.46	-1.71%	13.79%
Europe				
EURO Stoxx 50	3,001.42	3,348.86	-4.72%	11.58%
S&P Europe 350 Index	1,367.94	1,520.33	-3.95%	11.14%
FTSE 100 Index/ London	6,728.13	7,268.95	-2.01%	8.04%
FTSE MIB Index/ Italy	18,324.03	20,260.98	-7.41%	10.57%
DAX Index/ Germany	10,558.96	12,027.05	-2.57%	13.90%
ASIA/Pacific				
NIKKEI 225/ Japan	20,014.77	21,260.14	-4.49%	6.22%
S&P/ASX 200/ Australia	5,646.40	6,484.84	2.52%	14.85%
BRIC				
Brazil/ Bovespa	87,887.26	96,392.76	0.04%	9.68%
Russia/ RTS	1,066.13	1,271.15	1.82%	19.23%
India/ Bombay Sensitive	36,068.33	39,749.73	1.84%	10.21%
China/ Shanghai Composite	2,493.90	2,909.91	-5.47%	16.68%
Hong Kong/ Hang Seng	25,845.70	27,390.81	-7.77%	5.98%

Source: Bloomberg, Capital Investments

	December. 2018	May. 2019	May.2019	YTD (28 May. 2019)
Commodities (in USD)				
Brent Spot (Barrel)	53.17	69.92	-2.69%	31.50%
WTI Cushing Spot (Barrel)	45.41	59.14	-7.46%	30.24%
Natural Gas NYMEX (MMBtu)	2.72	2.58	0.27%	-4.97%
Gold Spot (OZ)	1,282.45	1,279.35	-0.33%	-0.24%
Silver Spot (OZ)	15.50	14.36	-3.98%	-7.35%
Copper LME Spot (MT)	5,949.00	5,941.00	-7.56%	-0.13%
Corn CBOT Active Month (Bushel)	3.91	4.20	15.93%	7.55%
Wheat CBOT Active Month (Bushel)	5.19	5.05	17.73%	-2.65%
Soybean CBOT Active Month (Bushel)	9.20	8.56	0.23%	-6.98%
Rough Rice Futures (USD/cwt)	10.10	11.65	13.38%	15.40%
Currencies Spot Exchange Rates Against US Dollar				
Euro	1.15	1.12	-0.49%	-2.68%
GBP	1.28	1.27	-2.91%	-0.79%
CAD	0.73	0.74	-0.76%	1.08%
Yen	0.01	0.01	1.88%	0.22%
CNY	0.15	0.14	-2.54%	-0.46%

Source: Bloomberg, Capital Investments

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