

Monthly Newsletter

February 5th, 2020

"Plan your work for today and every day, then work your plan." — Margaret Thatcher

"Every exit is an entry somewhere else." — Sir Tom Stoppard

Clues from Recent Asset Classes' Behavior

Macro: The Coronavirus Dented Global Growth Outlook

Oil: Demand Caught the Coronavirus Infection...Would OPEC Save the Moment?

MENA: A Perspective on the Saudi Petrochemicals Sector

Introduction

The past month was an eventful one, to say the least, as the start of our investment journey in 2020. We closed "phase one" on different global fronts and we opened Pandora's box of "phase two". This includes trade compromise between China and the US, Brexit negotiation between Britain and the EU during the transition period for the coming 11 months. In the Middle East, "phase two" consists mainly of the newly announced peace plan by Mr. Trump in relation to Israel and Palestine, along with rising geopolitical tensions in the eastern Mediterranean basin on the back of gas discoveries and pipelines and, last but not least, rising tensions between the US and Iran.

"Phase two" was a known unknown, in fact the tail risk or the "unknown unknown" that took markets by surprise was the outbreak of the Coronavirus in China. This viral infection has hit almost 25k persons as of the time of writing and led to the quarantine of many Chinese cities and the disruption of supply chains and the socio-economic activity in China and other parts of the world. This prompted the World Health Organization to declare a state of emergency. As a result, the negative implications for the global economy and markets were deeply significant and could be illustrated into four trends.

First, in a flight to safety mode, the short end of the US yield curve moved into inversion while the 30-year US yield dropped below 2%, darkening global economic outlook prospects. While the yield curve reaction may have some dovish assumptions embedded in terms of further easing by the monetary authority, it has dented the global economic growth for 2020.

Second, as the global manufacturing PMIs were exhibiting signs of bottoming out and upticks over the past 3 months on the back of optimism related to the trade narrative between the US and China along with monetary easing around the world, the outbreak of the virus is challenging the trend and the reflationary trade lost steam as commodities that are sensitive to China's growth, such as copper and oil, went on a free fall, pressuring inflationary expectations.

Third, a lower USD in 2020 is not a valid thesis anymore, while the Chinese Yuan may weaken past the threshold of 7 to the dollar. Fourth, we are posed to face a world with lower growth that will hopefully be cushioned by extravagant monetary policies globally.

We expect 2020 to be a volatile year in terms of markets' behavior. Thus, it would warrant frequent tactical positioning and portfolio rebalancing. We are expecting action from OPEC and its allies to balance the oil markets and extra stimulus from major governments, notably China, in terms of tax cuts and liquidity injections. In the MENA, we are not big fans of the banking industry as profits from loan growth recovery is dented by Net Interest Margin (NIM) contraction, and we are shying away so far from petrochemicals and focusing on plays related to domestic spending power in Egypt and KSA. In emerging markets, we like Indonesia and Philippines to mention a few.

Asset Management Team:

Wassim Jomaa, CFA
VP, Head of Asset Management
Wassim.Jomaa@Capitalinv.com

Raed Al Momani
Portfolio Manager
Raed.Momani@Capitalinv.com

Sarah Elawi
Financial Analyst
Sarah.Elawi@Capitalinv.com

Zina Rajjal
Financial Analyst
Zina.Rajjal@Capitalinv.com

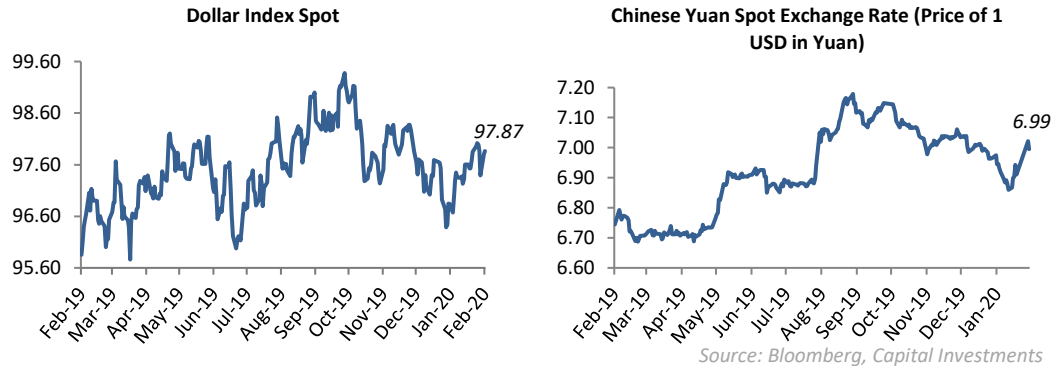
Ghaleb Mihyar
Financial Analyst
Ghaleb.Mihyar@Capitalinv.com

For further information and to discuss possible investment opportunities, please contact:

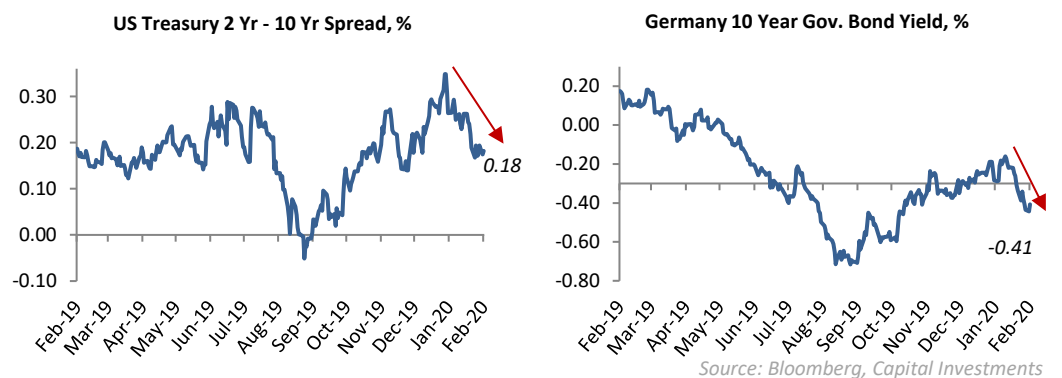
Asset Management Department
Tel: +962 6 5200330
Ext. 2494 and 2373
AssetManagement@Capitalinv.com

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Clues from Recent Asset Classes' Behavior

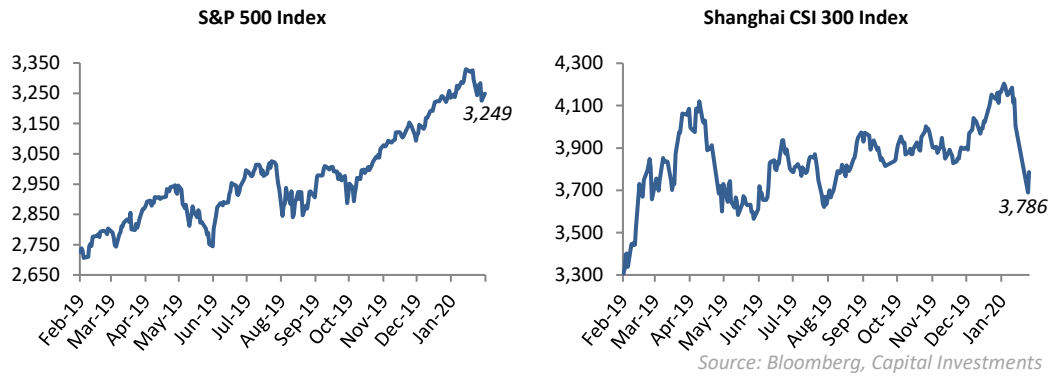


Before the outbreak of the Coronavirus, the world’s socioeconomic system was benefiting from a détente between the US and China on the back of the signing of the Phase One trade deal and enjoying the tailwind provided by easing global monetary policy. The USD was on a downward trend and the Chinese Yuan was following a relatively stable pattern. However, this trend has reversed as the world is factoring the substantial economic price that China will pay due to the viral outbreak, especially that when SARS erupted in 2003, China’s economy constituted 4% of the global economy and now it is around 18%, with more sophisticated transportation lines and logistics and supply chain effects. As a result, the Yuan weakened while the greenback gained strength, hurting commodities and the reflation trade.

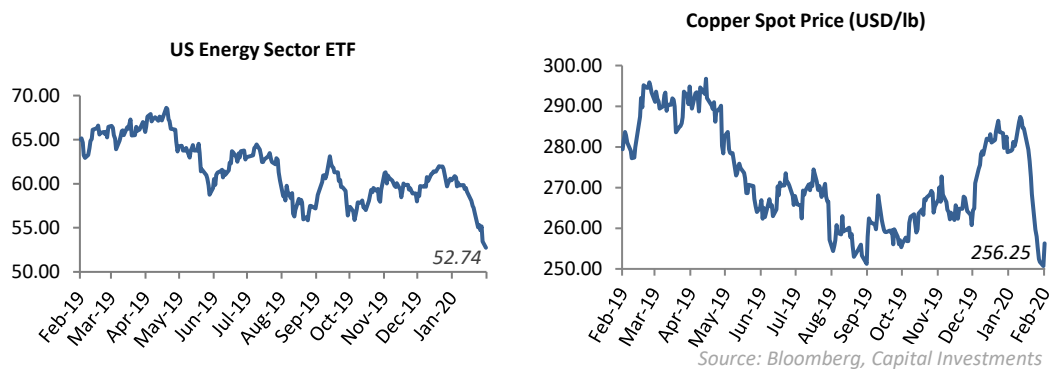


The reversal in the reflation trade was clearly illustrated as the US yield curve spreads between 3M and 10 year and between 2 year and 10 year either turned negative or contracted. The deep decline in Germany’s 10 year into the negative territory illustrates the same picture. This year is packed with global events, from the Olympic games in Tokyo to the EURO football cup to the Expo in Dubai, and any viral outbreak, if not contained quickly, will put global growth at risk. These negative

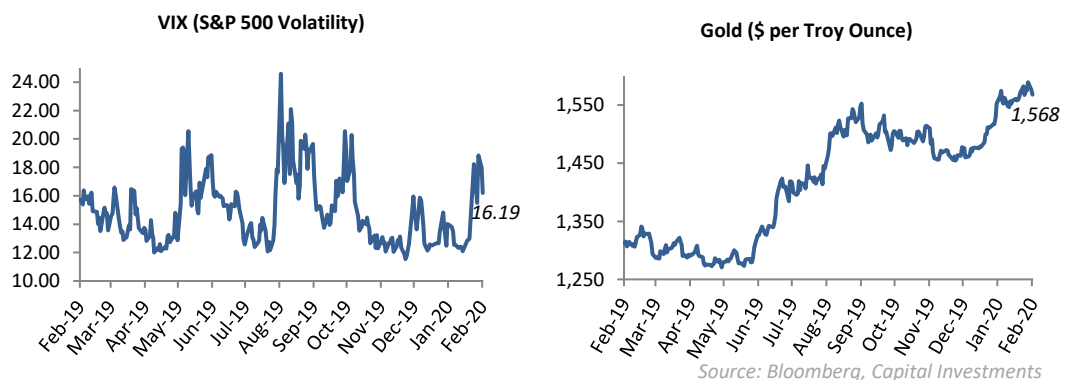
implications explain the reaction of bond traders and raises expectations of potential further stimulus.



The pullback in global markets, which were relatively overstretched amid decelerating earnings growth, did not come on the back of spiking inflation due to the pumped liquidity by global central banks since the summer of 2019, but due to the negative revision in global economic outlook because of the developments in China.

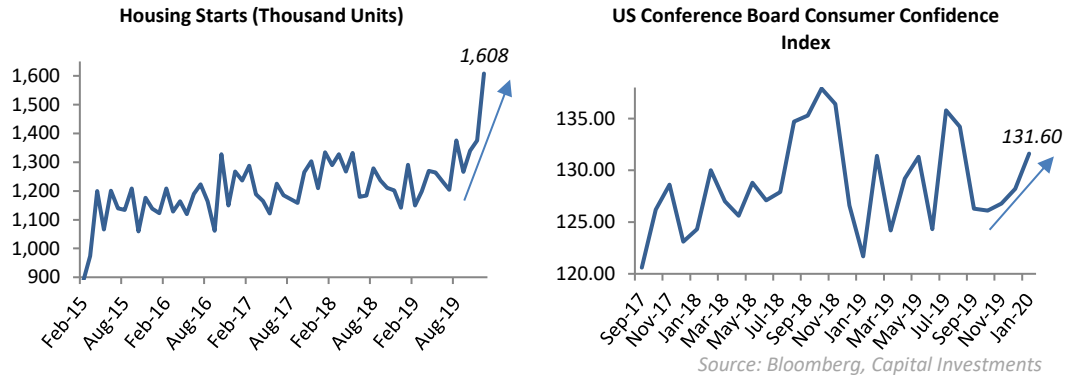


Obviously, cyclical sectors as illustrated in the graphs above are suffering the most.

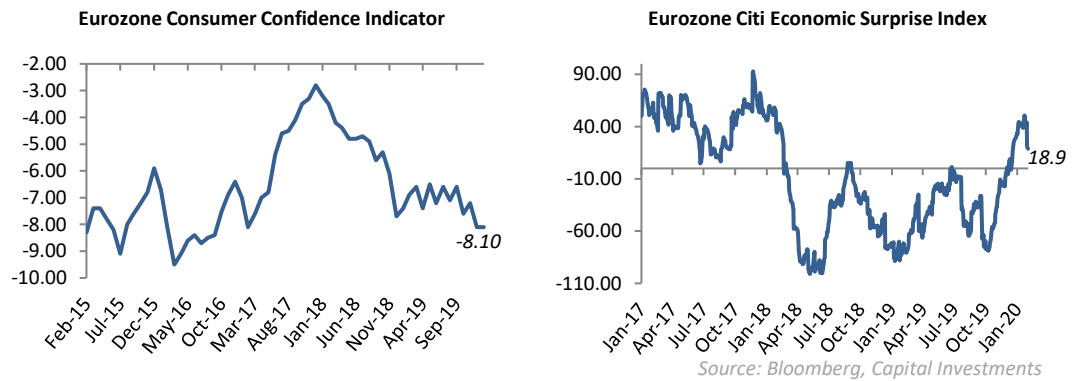


The VIX index, which is a gauge of fear, spiked significantly, touching the level of 20 at a certain point in time, while the gold price rally was tamed by the rise in the US dollar.

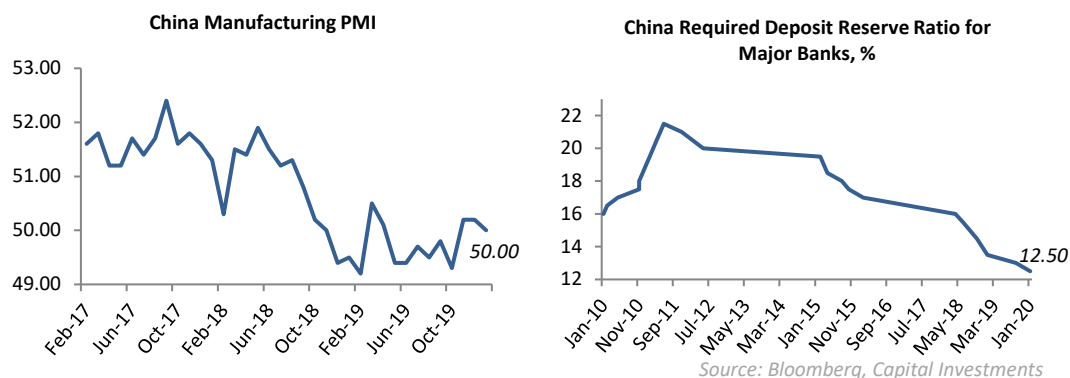
Macro: The Coronavirus Dented Global Growth Outlook



The US economy delivered an encouraging set of data recently as confidence indices are gaining track, the housing sector seems to be finally picking up on the back of lower interest rates and Purchasing Managers' Indices showed signs of stability. Encouraging recovery was priced into 2020 however the outlook may be revisited once the implications of the coronavirus on the global economy are clear.



Europe showed signs of stability as indicated by stabilizing PMI data and improving economic surprise indices on the back of more clarity regarding Brexit and less tension regarding the trade narrative between the US and China, coupled with a dovish ECB which has been providing a tailwind for the economy. Now, given that Europe is mainly tilted towards cyclicals and exports, further assessment would be required to measure the impact of the possible slowdown in the Chinese economy.

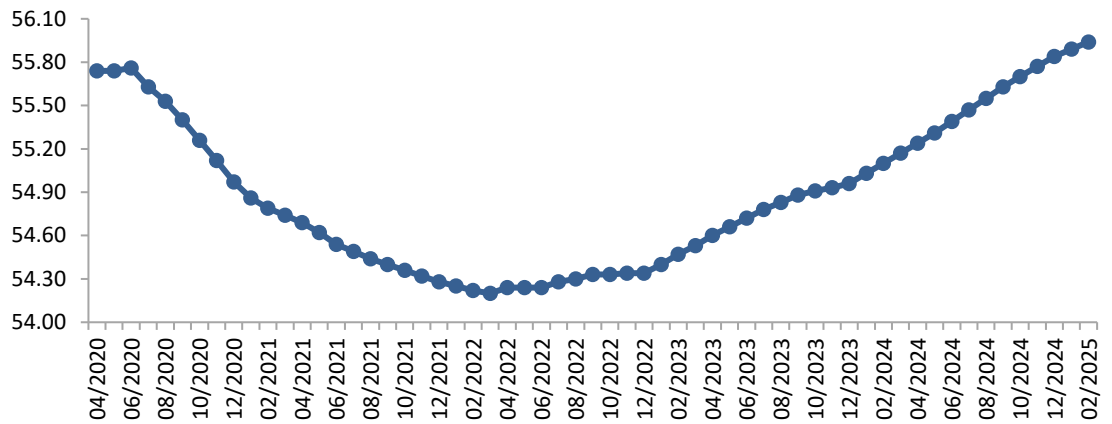


Quarantines, travel restrictions and closures of factories are all negative shocks to the economic activity in China. As such, the deterioration in data is yet to be revealed in the coming months although stock markets are quick at discounting the negative effects. China already reacted with a positive stance by injecting more than USD 174bn into the system and may be most probably planning further fiscal stimulus in terms of taxes and fees reduction to ensure the socio-economic stability of the country.

Oil: Demand Caught the Coronavirus Infection...Would OPEC Save the Moment?

We had entered 2020 with a constructive view on oil prices owing to heightening geopolitical tension, tightening OPEC supply, and slowing shale drilling. The outbreak of the coronavirus in China, however, has overwhelmed all these bullish factors. Brent prices have fallen more than 15% since Jan 20, when financial markets first took notice of the magnitude of the health crisis in China. As the virus continues to spread further, fears of lower oil demand and weaker economic growth prospects are growing. It is estimated that Chinese oil demand has dropped by about 3 million barrels a day, equivalent to 20% of total consumption. In response to this epidemic, OPEC and its allies are considering cutting their oil output by a further 500,000 barrels per day and will be holding an early meeting in Vienna to figure out ways to offset the demand shock from China. The market's bearish sentiment is also reflected in the oil contracts' forward curve, which has moved out of backwardation and into contango.

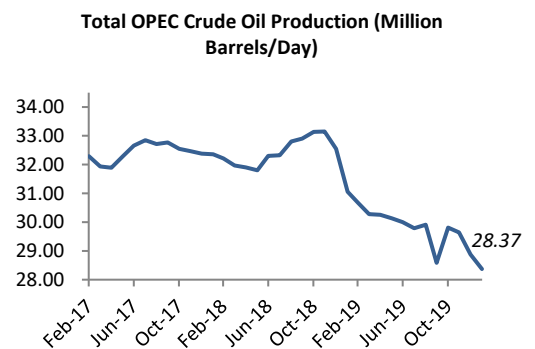
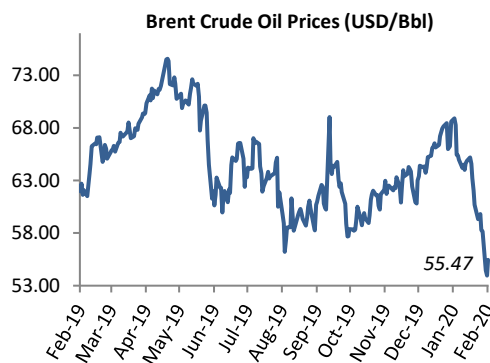
Brent Oil Future Curve (USD/Barrel)



Source: Bloomberg, Capital Investments

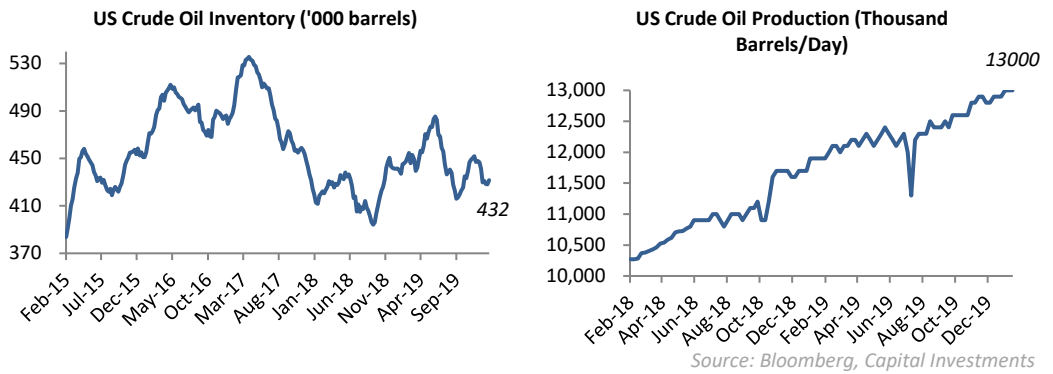
It will be difficult to truly assess the damage of this outbreak as trying to take guidance from the SARS pandemic in 2003 may not be truly meaningful. Although the new coronavirus seems to be milder than the SARS, China’s oil import needs were one fourth of what they are now. Moreover, at around the same time SARS was peaking in, the U.S. was launching the invasion of Iraq, which was able to keep oil prices afloat. We believe the picture will become clearer once the panic subsides and once the spread of the virus peaks.

Nonetheless, OPEC and its allies have been overdelivering on their production cuts, and their output fell in January to a multi-year low. The cartel pumped around 28.35 million barrels per day in January, down from 640,000 bpd in December. Production in January was also affected by disruptions in Libya and Iraq. Libya’s National Oil Corporation declared a force majeure after armed forces shut down a pipeline, and production averaged 760,000 bpd in January, down from 1.15 million bpd in December.



Source: Bloomberg, Capital Investments

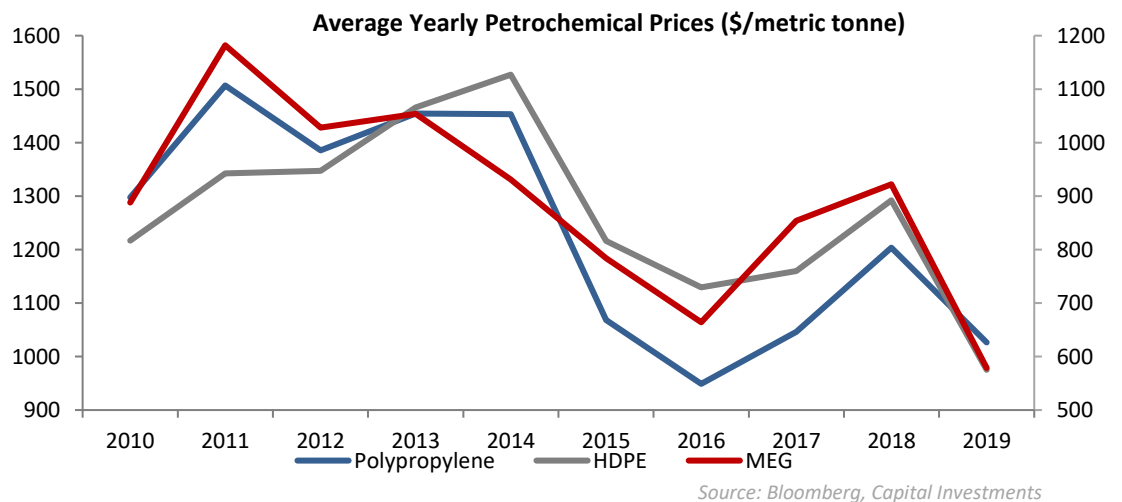
Meanwhile, US crude inventories increased by 3.5 million barrels versus of a forecast of 0.482 million barrels only for the week ending Jan 24. Moreover, according to Halliburton and Schlumberger, U.S shale oil fracking has already peaked and is in a period of sustained contraction.



In other developments, Brazil will start talks on joining OPEC in July in Saudi Arabia but does not expect to achieve membership this year. Kuwait and Saudi Arabia have started preparation work to resume crude oil production from their jointly operated oil field, with initial output expected around the end of February.

MENA: A Perspective on the Saudi Petrochemicals Sector

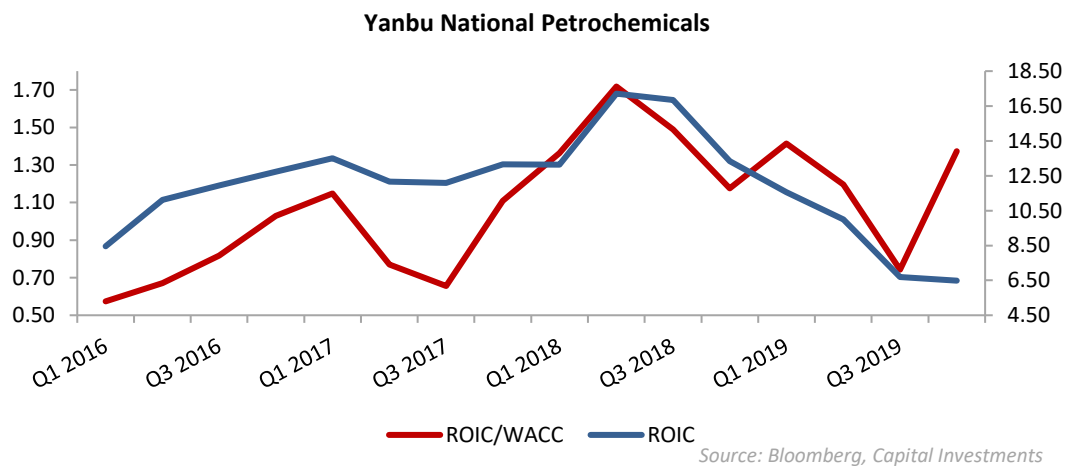
The petrochemicals sector has been under severe pressure for the past 3 quarters due to falling product prices -which have reached 9-year lows- compressing margins and negatively impacting profitability. Petrochemical stocks are subject to the dynamics of global supply and demand, and therefore the outlook for global GDP growth.



Going deeper into the MENA petrochemical sector, most of its constituents are characterized by clean and strong balance sheets, supported by low leverage and short cash conversion cycles. This has allowed them to maintain relatively stable dividends despite the pressure they've been facing

due to plunging product prices. Nonetheless, the sector faces capacity constraints due to the limited availability of feedstock from the government, as well as limited control over the feedstock price. This explains why the sector witnessed some consolidation, namely through the Sahara and Sipchem merger, and SABIC and SAFCO Agri units, while Advanced Petrochemicals continues to explore opportunities outside KSA.

With limited capacity and falling prices, the return on invested capital (ROIC) for the KSA petrochemical sector has been on a downward trend, while the ratio of ROIC/WACC has been increasing due to lower interest rates and thus WACC. This comes to show that it's the low interest rates that have been keeping the valuations of this sector overstretched, despite a weakening outlook and deteriorating petrochemical prices.



Given that KSA petrochemical companies are at the lower end of the global cash cost curve and that they have high operating leverage, the sector will greatly benefit should there be a substantial improvement in product prices. We anticipate recovery in prices to commence in Q2 2020, but due to the high uncertainty accompanying the coronavirus, we will continue to monitor them regularly for any signs of bottoming.

Major Indices	Status as of end		Performance	
	December, 2019	January, 2020	January, 2020	YTD (31 January, 2020)
MENA				
Abu Dhabi	5,075.77	5,156.19	1.58%	1.58%
Bahrain	1,610.18	1,657.63	2.95%	2.95%
Dubai	2,764.86	2,790.42	0.92%	0.92%
Egypt	13,961.56	13,918.84	-0.31%	-0.31%
Jordan	1,815.20	1,867.90	2.90%	2.90%
Kuwait	6,975.96	7,033.48	0.82%	0.82%
Lebanon	785.56	704.29	-10.35%	-10.35%
Morocco	12,171.90	12,531.90	2.96%	2.96%
Oman	3,981.19	4,079.29	2.46%	2.46%
Palestine	525.96	522.29	-0.70%	-0.70%
Qatar	10,425.51	10,442.01	0.16%	0.16%
Saudi Arabia	8,389.23	8,246.59	-1.70%	-1.70%
Tunisia	7,122.09	7,080.15	-0.59%	-0.59%
S&P Pan Arab Composite	788.75	783.19	-0.70%	-0.70%
Dow Jones MENA	605.23	602.28	-0.49%	-0.49%
Americas				
Dow Jones Industrial	28,538.44	28,256.03	-0.99%	-0.99%
S&P 500	3,230.78	3,225.52	-0.16%	-0.16%
NASDAQ Composite	8,972.60	9,150.94	1.99%	1.99%
S&P/Toronto Composite	17,063.43	17,318.49	1.49%	1.49%
Europe				
EURO Stoxx 50	3,745.15	3,640.91	-2.78%	-2.78%
S&P Europe 350 Index	1,676.79	1,654.45	-1.33%	-1.33%
FTSE 100 Index/ London	7,542.44	7,286.01	-3.40%	-3.40%
FTSE MIB Index/ Italy	23,506.37	23,506.37	0.00%	0.00%
DAX Index/ Germany	13,249.01	13,249.01	0.00%	0.00%
ASIA/Pacific				
NIKKEI 225/ Japan	23,656.62	23,656.62	0.00%	0.00%
S&P/ASX 200/ Australia	6,684.08	7,017.22	4.98%	4.98%
BRIC				
Brazil/ Bovespa	115,645.30	115,645.30	0.00%	0.00%
Russia/ RTS	1,548.92	1,548.92	0.00%	0.00%
India/ Bombay Sensitive	41,253.74	40,723.49	-1.29%	-1.29%
China/ Shanghai Composite	3,050.12	2,976.53	-2.41%	-2.41%
Hong Kong/ Hang Seng	28,189.75	26,312.63	-6.66%	-6.66%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2019	January. 2020	January.2020	YTD (31 January. 2020)
Commodities (in USD)				
Brent Spot (Barrel)	66.42	56.33	-15.19%	-15.19%
WTI Cushing Spot (Barrel)	61.06	51.56	-15.56%	-15.56%
Natural Gas NYMEX (MMBtu)	2.16	1.84	-14.69%	-14.69%
Gold Spot (OZ)	1,517.27	1,589.16	4.74%	4.74%
Silver Spot (OZ)	17.85	18.04	1.07%	1.07%
Copper LME Spot (MT)	6,149.00	5,551.25	-9.72%	-9.72%
Corn CBOT Active Month (Bushel)	3.88	3.81	-1.68%	-1.68%
Wheat CBOT Active Month (Bushel)	5.59	5.54	-0.89%	-0.89%
Soybean CBOT Active Month (Bushel)	9.56	8.73	-8.69%	-8.69%
Rough Rice Futures (USD/cwt)	13.14	13.61	3.62%	3.62%
Currencies Spot Exchange Rates Against US Dollar				
Euro	1.12	1.11	-1.07%	-1.07%
GBP	1.33	1.32	-0.38%	-0.38%
CAD	0.77	0.76	-1.87%	-1.87%
Yen	0.01	0.01	0.25%	0.25%
CNY	0.14	0.14	0.84%	0.84%

Source: Bloomberg, Capital Investments

Capital Investments

Asset Management Department

Tel: +962 6 5200330 Ext. 2494 and 2373

AssetManagement@Capitalinv.com

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