

## Monthly Newsletter

July 2<sup>nd</sup>, 2020

*“Paradoxically, the man who has failed and the one who is at the peak of success are in exactly the same position. Each must decide what he will do next.” — Kano Jigoro*

*“What is life without honor? Degradation is worse than death.” — Stonewall Jackson*

### Clues from Recent Asset Classes' Behavior

**Macro: The Question is Where the Recovery in Data is Going to Settle**

**Oil: Price Recovery Depends on Shrinking Inventory in Crude and Transportation Fuels**

**MENA: Saudi Arabia... Austerity and High Valuation imply a Cautious Stance**

### Introduction

Markets ended the second quarter of our investment journey in 2020 on a positive note. The reopening of economies across the world and the promising scientific progress in identifying a vaccine or a treatment played a major role in shoring up sentiment. Generous fiscal stimulus supported household income and cushioned the aggregate demand amid a rise in jobless rates. Moreover, an expansionary monetary policy played a role in narrowing the gap between the stock market and the economy as recent data releases recovered from their nadir recorded in April.

Moving into the second half of 2020, the confirmation of key trends related to the virus, the macroeconomy, and the policy response are crucial to keep the sentiment tilted to the positive side and volatility movement within tolerable norms.

As new infection cases are on the rise again in the U.S., containment efforts need to succeed otherwise reopening developments will be reversed; this is evident in key US states such as Texas, Florida, California and Arizona. An uncontrolled viral curve along with a pressure on hospitalization capacity will take its toll on investors and consumers moral, along with implications on economic activity.

On the data front, improvement in high frequency indicators such as mobility data, and encouraging progress in macroeconomic indices are imperative for an analyst to raise earnings expectations for 2021 and are the only way to confirm that such potential growth justify high valuation amidst rock bottom interest rates.

Turning to policy response, the European next generation fund is in the making along with large stimuli enacted by key European countries notably Germany. This might be a game changer for Europe and the Euro, as we think that a relative mutualization of debt in the old continent is vital for the latter. The Congress's decision by the end of July regarding the extension of the relief program and the businesses' ease of access to second subsidized loans is key in the US. On the monetary front, liquidity is the name of the game and is key for asset prices appreciation; recent tapering in the Fed's balance sheet will impact the stock market rally.

On a separate note, we continue to think that markets dislike uncertainties especially around policies or security risk. Thus, we need to keep an eye on developments related to international trade relationships especially between the U.S. and other global economic players with a focus on China. Markets are also keeping an eye on the U.S. presidential election trends as they have significant impact on policies.

After the market rally, we continue to adopt a cautious approach and we hold a relatively decent exposure to gold and silver. Also, we are focusing on companies that benefit from the social distancing trend. We tactically trade companies that could be classified as cyclical or recovery plays, some of which are in the mining industry. In the EM, we had a focus on China, Korea and Egypt which all paid off well. We are still focusing on companies that can grow their market shares or benefit from certain corporate events and are able to sell at attractive valuations. We park some allocation in cash to benefit from volatility opportunistically and keep a cushion for downside risk.

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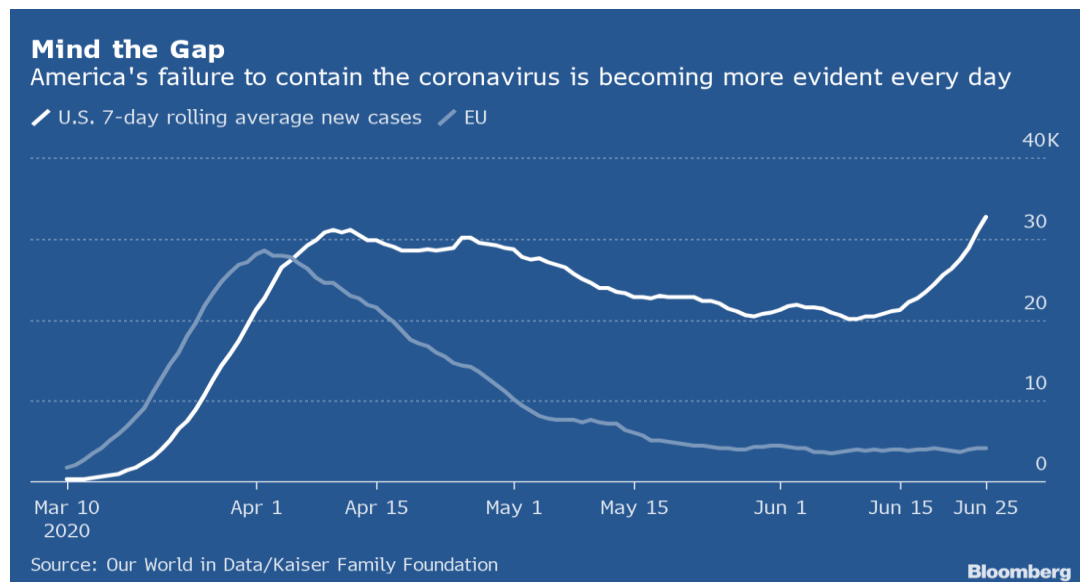
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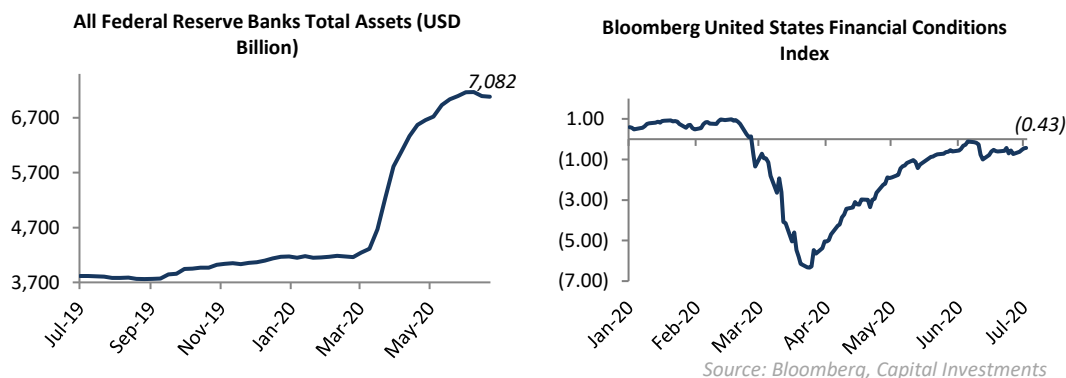
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### Clues from Recent Asset Classes' Behavior

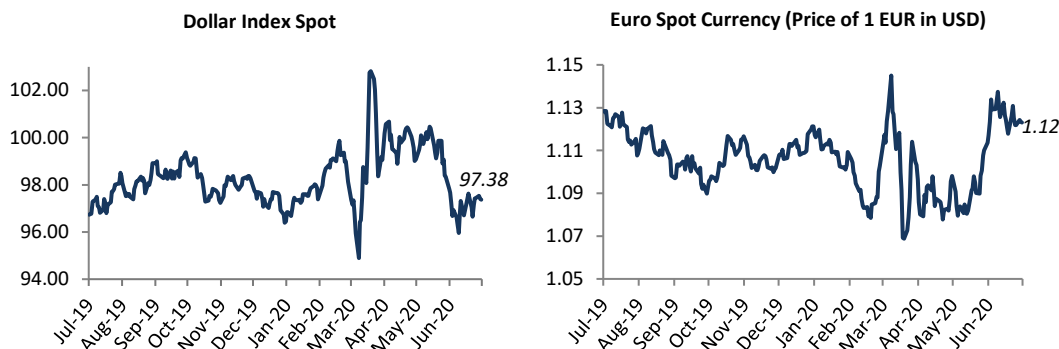


The fall in the number of infections in key countries coupled with a decline in mortality rates, along with serious progress on the scientific front, in terms of finding a cure or vaccine, has relieved substantial pressure. However, the re-emergence of a second wave in the US is creating a substantial risk to the reopening process and to economic activity. Only significant news related to positive progress on treatment or vaccines could save the moment.



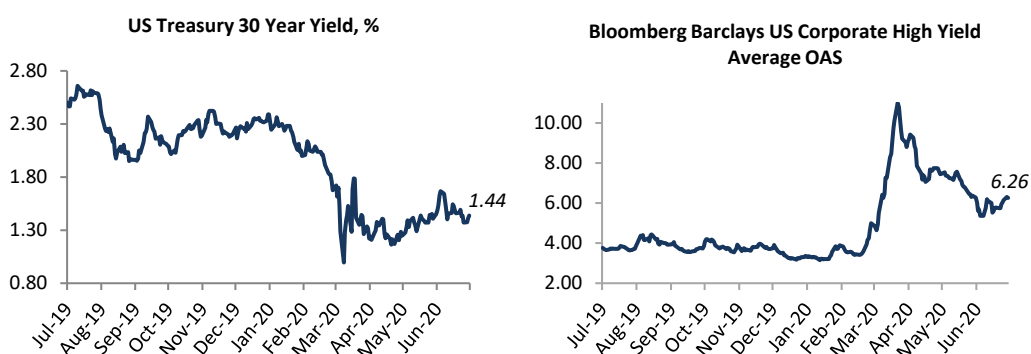
Substantial liquidity injections by major central banks and expansion of asset purchase program to include single corporate bonds in the case of the Fed played a major role in the equity market rally. The liquidity injection made any recent news look good which pushed asset prices up. Investors appear to be looking for the next liquidity shock in order to get direction. The Fed balance sheet is showing some signs of tapering, and the Fed has raised the repo rate in its open market operations and dialed back some swap lines with global central banks. The Bloomberg US financial conditions

index illustrated above shows clearly that the Fed was able to defuse pressure from the funding market but we are not yet out of the woods as the index is sensitive to risk averse behavior resulting from flight to safety, negative macro news, or undesirable viral curve developments.



Source: Bloomberg, Capital Investments

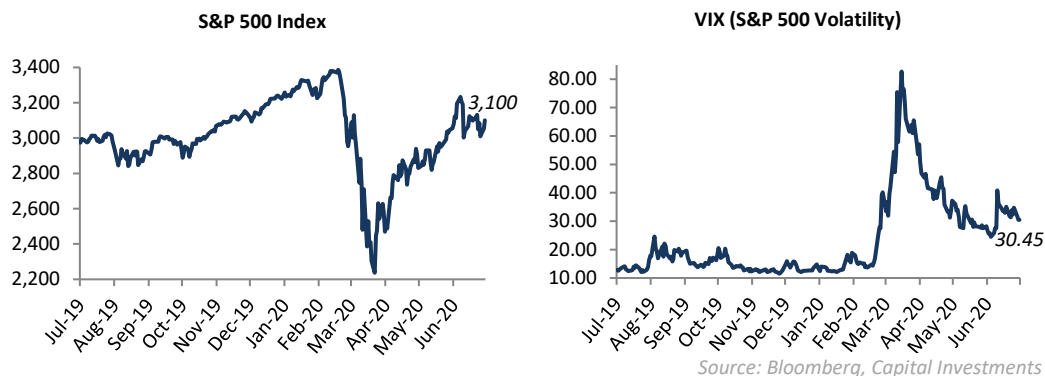
We subscribe to the theory that the USD will weaken over the medium term. The uncertainty surrounding global economic outlook is providing the USD with the privilege of the safe -haven status. However, the ambitious European plan backed by France and Germany- that may lead to a relative mutualization of the old continent 's debt through the planned next generation fund of Euro 750bn- is, in our opinion, a game changer that will cause the greenback to lose ground vis a vis the Euro and other currencies. In addition, a gradual global economic recovery along with the excess liquidity injected by the Fed will lead to softness in the USD. We have not yet taken a constructive bet against the USD in our portfolio, but as we progress and get more validation for our hypothesis, we will look further into emerging markets and commodity linked investments set to benefit from a weak USD and an infrastructure spending spree in major global markets, mainly China.



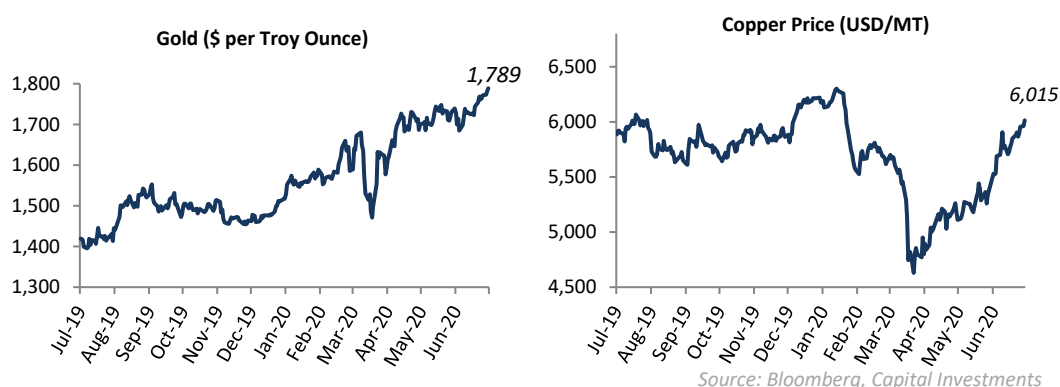
Source: Bloomberg, Capital Investments

Fears over the rise in new infection cases in the US along with their potential repercussions on the economic activity revived the flight to safety plays. As a result, the yield on US 30-year treasuries declined although the retreat was not substantial or alarming. Meanwhile, indicators of credit spreads ticked up as illustrated by the High Yield Bond Option Adjusted Spread Index in the chart

above. This shows that some investors are concerned about the effect of rising infection rates on the reopening of the economy, upcoming macro data, and oil consumption.

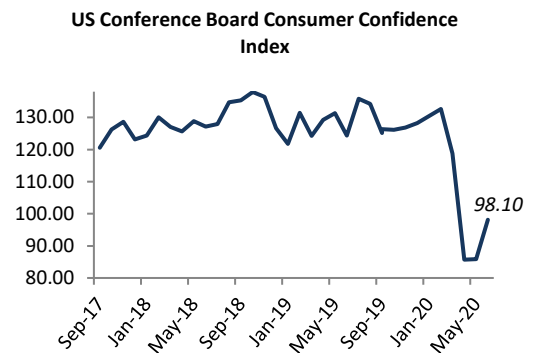
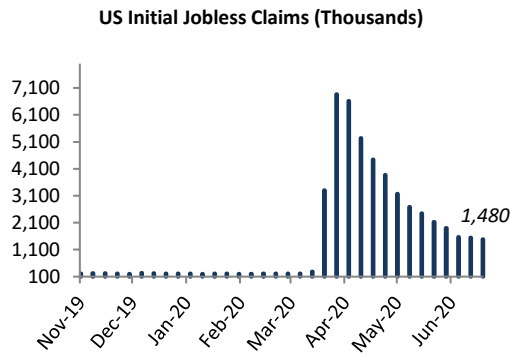


The momentum of the rally in equities seems to be losing steam. Markets took notice of a potential second wave, they need more clarity regarding key policy issues related to global trade, are searching for validation that the Fed’s input will offset the potential repercussions of the rise in new infections and that the pandemic relief payments that are set to expire at the end of July are set to be extended by the US Congress, which may remove a major fiscal uncertainty. Another important question would be to what levels will investors take their equity exposure as we are approaching the US presidential elections given the policy/regulatory implications. On the upside, the S&P 500 index is hovering around its 200- day moving average around the level of 3040 with a technical floor in case of a retreat at the level of 2700 near its 200 -week moving average. The behavior of the VIX index, or fear factor, is remarkable as its spike is being muted. We prefer to keep rebalancing our portfolios tactically to benefit from the sector rotation that is taking place in the market while keeping a decent portion in cash as the market valuation is overstretched.



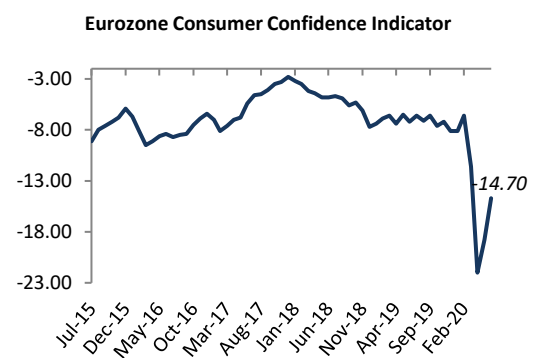
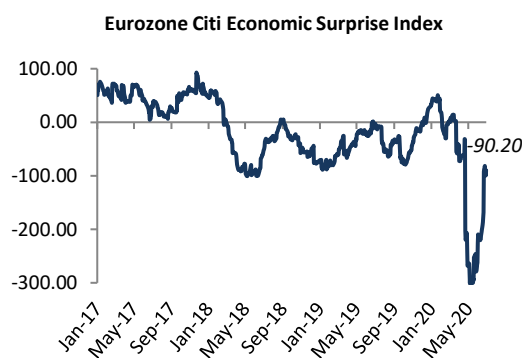
The yellow metal is gaining on the back of safe -haven trades despite a strong USD. We are invested in gold and silver miners and looking at plays related to copper and lithium as the former is benefiting from shutdowns of mines in Latin America while the latter seem to be forming a bottoming base.

## Macro: The Question is Where the Recovery in Data is Going to Settle



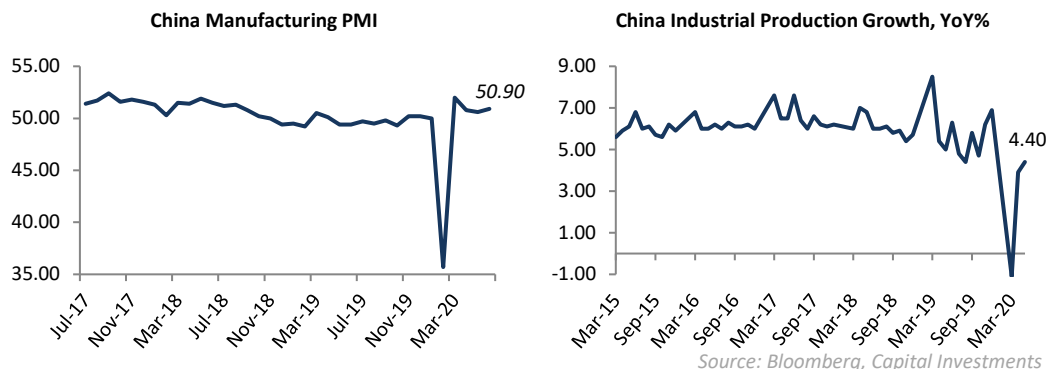
Source: Bloomberg, Capital Investments

Support from governments and reopening of the economies was expected to lead to a recovery in economic data. The question now is where are we going to settle after the recent recovery? especially that the IMF painted a bleak outlook in its recent update and many scholars are stating that the economic output will need few years to come back to pre-coronavirus levels. Despite the recent improvement in sentiment indicators, we noticed that progress on the employment front has stalled with the jobs report in the US due early July is important to set direction as it will have implications for the fiscal policy.



Source: Bloomberg, Capital Investments

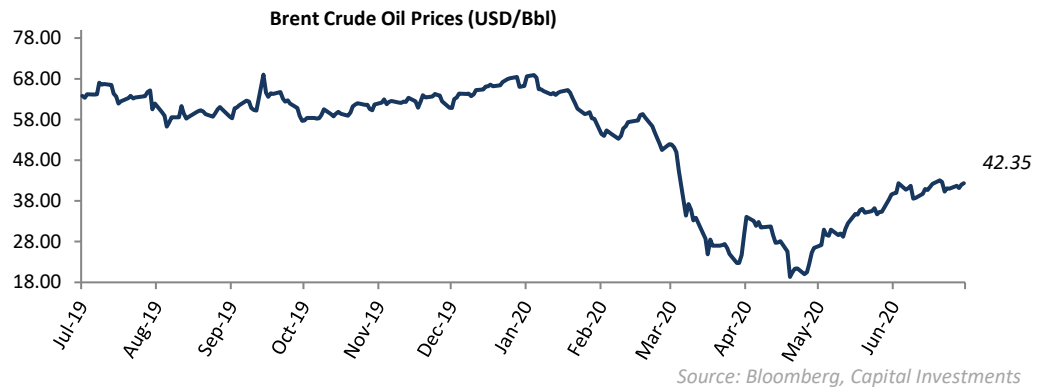
The recovery in Europe appears to be lagging other parts of the world especially that the reopening process started late and the lockdown was stricter. We are constructive on Europe provided governments press forward with the stimulus plan and the European recovery fund, and we think that European companies offer a cyclical exposure.



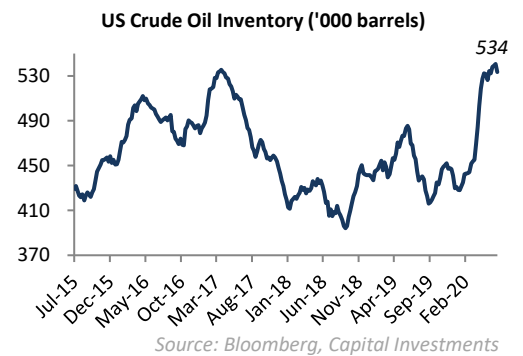
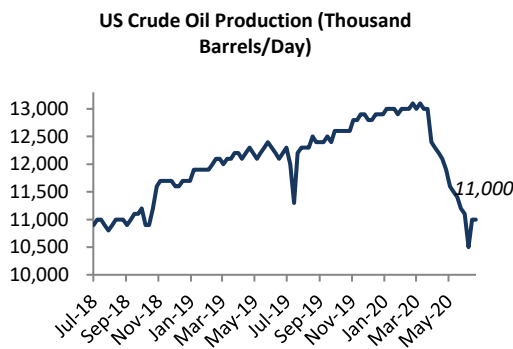
China's economic activity is showing signs of progress driven by fiscal measures and expansion in credit and this is validated by economic data. We are interested in the fiscal plan passed by China which is targeting the new economy infrastructure such as data centers, UHV power transmission and 5G along with measures that will help in boosting commodity prices, which we are noticing in copper.

### **Oil: Price Recovery Depends on Shrinking Inventory in Crude and Transportation Fuels**

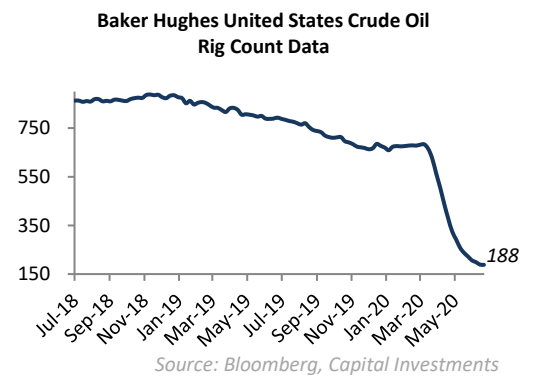
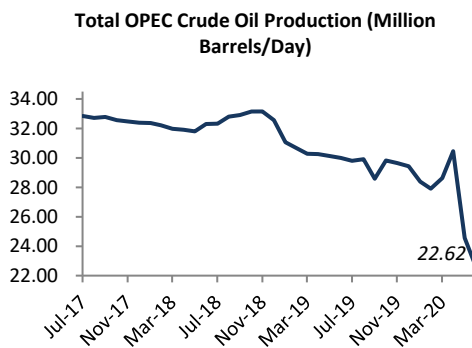
Ever since the unprecedented negative oil prices we witnessed in mid-April, oil prices have been on the rise. However, prices are struggling to break upwards due to fears over a second wave of COVID infections. The negative sentiment in the market due to the new outbreak in Beijing and the rising infection rates in the U.S indicate that oil demand is not expected to pick up anytime soon. In fact, global demand for crude is expected to drop by 8.1 million barrels/day in 2020 according to the IEA. In addition, Asian nations, unlike China, are unable to recover rapidly and this is evident in the slow activity at the Indian refineries. On another note, the International Monetary Fund adjusted their forecast to predict a deeper recession than what they anticipated two months ago. Likewise, the Federal Reserve warned that the economic damage of the pandemic will stick to the American economy for a while.



On the other hand, a few signs of recovering demand have started to emerge. China’s manufacturing data for June beat estimates, showing that the recovery there is intact, whilst in the U.S, housing data came in better than expected. Saudi Arabia as well as some oil trading companies are also seeing some recovery.



In the U.S, crude stockpiles were on an upward trend and reached record highs in June, and there is a risk that U.S. shale producers could start bringing back output as oil prices recover from their lows. Nevertheless, U.S. crude inventories fell by the most since December last week, but the draw was eclipsed by swelling stockpiles of refined products, according to the EIA.



OPEC and its allies' efforts to curb production have helped keep prices buoyant. The cartel pumped 22.62 million b/d in June, down 1.92 million b/d MoM and the lowest level in two decades. Moreover, the group agreed on a one-month extension of its output cuts and have stated that any member that does not implement 100% of its production cuts in May and June will make extra reductions from July to September to compensate for their shortcomings. This will make total cuts in July 9.6 million barrels, 100,000 barrels a day lower than the reduction in June. OPEC's efforts have also been supported by a falling rig count in the U.S., which has reached its lowest level in over a decade.

The swelling U.S inventory underscores the difficulty facing OPEC and its allies in their efforts to balance the market and explains why the oil's future curve was only in backwardation for only 3 days before it went back into contango again. The resumption of production in Libya will also pose a challenge to OPEC++. We believe that recovery in prices is subject to a drop in these stockpiles and increased demand for transportation fuel.

### **MENA: Saudi Arabia... Austerity and High Valuation Imply a Cautious Stance**

Saudi Arabia, the world's largest oil exporter, is searching for ways to rein in a ballooning fiscal deficit on the back of the crude-market turmoil and extra spending required by the coronavirus pandemic. It has announced a slew of austerity measures to protect fiscal and economic stability in the short and long term. The measures include tripling the value-added tax to 15% starting July 1, ending a monthly cost-of-living allowance paid to government workers, cancelling or delaying some operational and capital spending, and reduced spending on some programs under "Vision 2030" economic transformation plan. In addition, Saudi Arabia's government has frozen hiring until the end of the year to further cut down on spending and the Saudi Cabinet said customs duties on some commodities will be imposed. The latter move came as the current applicable tariff is 5% on all commodities, while the WTO's ceiling rates reach up to 20%. While the increase in prices as a result of the higher customs is not likely to be too sizeable, the decision combined with the VAT increase, will weigh on the already suffering private consumption on the back of lower disposable income due to Covid-19, with discretionary retailers getting impacted the most.

The number of coronavirus cases in Saudi Arabia has exceeded 190,000, with around 1,700 deaths, following a rise in new infections over the past two weeks. Expats will most likely feel the economic fallout from the Covid-19 outbreak. As many as 1.2 million foreign workers could leave Saudi Arabia

this year, according to a report from Jadwa Investment Company, which will also have an impact on demand and consumption in the economy. In addition, the halt of tourism (10% of GDP) will impair business activity in several sectors, including restaurants, travel agencies, airlines, and mobile phone companies. Official data show Saudi Arabia earns around \$12bn a year from the haj and the lesser, year-round pilgrimage known as umrah, Reuters reported saying some 2.5 million pilgrims typically visit the holiest sites of Islam in Mecca and Medina for the week-long haj. Saudi Arabia will bar arrivals from abroad to attend the haj this year due to the coronavirus, allowing only a limited number of Saudi citizens and residents to make the pilgrimage with social distancing measures enforced.

#### Tadawul Index: Sectors' Sales and Profitability in Q1 2019 Vs Q1 2020

Sector Index	Q1 2019 Sales (SAR Mn)	Q1 2020 Sales (SAR Mn)	YoY% Change	Q1 2019 Net Income (SAR Mn)	Q1 2020 Net Income (SAR Mn)	YoY% Change
Energy	280,730	233,169	-17%	83,691	62,183	-26%
Chemicals	53,688	45,275	-16%	3,075	(1,604)	-152%
Materials	2,328	3,032	30%	647	1,050	62%
Industrials	2,409	2,365	-2%	(22)	(21)	3%
Capital Goods	2,328	2,552	10%	(74)	(78)	-5%
Banks	30,029	29,994	0%	12,242	11,184	-9%
Insurance	6,493	7,019	8%	119	108	-9%
Health Care Equipment and Services	2,790	2,990	7%	445	453	2%
Commercial and Professional Services	724	647	-11%	81	1	-99%
Transportation	1,560	1,482	-5%	154	(23)	-115%
Consumer Durables and Apparel	985	868	-12%	(11)	(41)	-266%
Consumer Services	1,685	1,528	-9%	132	1,171	785%
Media and Entertainment	546	510	-6%	81	66	-19%
Retailing	5,918	6,525	10%	517	529	2%
Food and Staples Retailing	2,374	2,845	20%	59	107	81%
Food and Beverages	9,985	11,161	12%	372	654	76%
Pharma, Biotech, and Life Sciences	445	479	8%	(22)	46	310%
Diversified Financials	886	748	-16%	180	(41)	-123%
Telecommunication Services	18,785	19,670	5%	2,924	3,116	7%
Utilities	11,891	11,926	0%	(1,397)	(2,408)	-72%
Real Estate Management and Development	2,175	1,586	-27%	196	(374)	-291%
<b>Total</b>	<b>438,751</b>	<b>386,374</b>	<b>-12%</b>	<b>103,388</b>	<b>76,078</b>	<b>-26%</b>

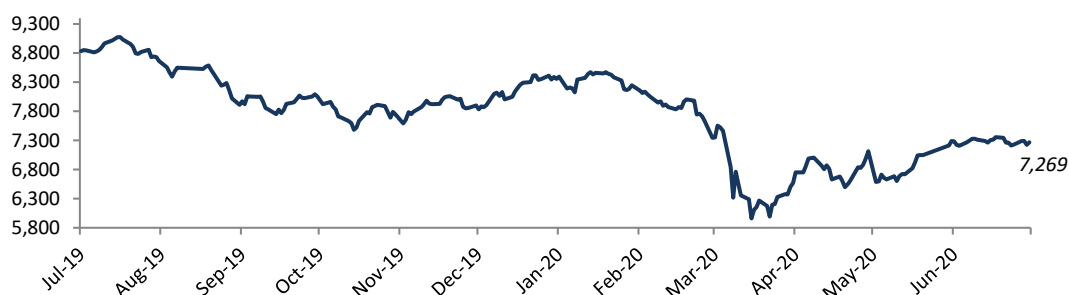
\*Excludes REITs

Source: Bloomberg, Capital Investments

According to the table above, which displays the profitability of the different sectors of the Tadawul index, most sectors such as banks, energy, chemicals, utilities and real estate experienced a

deteriorating performance YoY in the first quarter of 2020 noting that chemicals, utilities and real estate registered a loss. While the expansion in the materials sector was due to a positive quarter for cement companies which we do not think is sustainable as the government cuts back on spending. The spike in the consumer services sector is related to a one-off gain registered at Seera (Altayyar previously). Resilient sectors continued to be food and beverage, part of retailing and telecom. Companies are expected to report even worse results in Q2 due to the restrictions to curb the increasing Covid-19 cases in the country. However, the Saudi market is up 22% from the lows it reached in mid-March on optimism related to reopening and recovering oil prices. However, we cannot take all sectors and companies as a one concept model which shows that the broad rally highlights the disconnect between the economic reality and the performance of the market. In addition, when comparing the Price-to-Earnings Ratio of Tadawul to the one of the emerging markets index, it shows Tadawul’s expensive valuation which is not backed by improving fundamentals. Thus, we have a cautious and selective stance on the Saudi market as we might see a correction from current levels despite the bullish momentum embedded in the index’s chart.

**Tadawul All Share Index**



Source: Bloomberg, Capital Investments

**Tadawul All Share Index P/E Ratio**



**MSCI Emerging Markets Index P/E Ratio**



Source: Bloomberg, Capital Investments

The IMF sees sharper than anticipated recession in Saudi Arabia as it said the economy will shrink by 6.8% this year, a sharper decline than the 2.3% contraction estimated in April, as low oil prices and the coronavirus pandemic have hit the economy. However, the IMF projects Saudi Arabia’s GDP to bounce back to 3.1% growth in 2021 as coronavirus restrictions are lifted and oil prices improve.

Major Indices	Status as of end		Performance	
	December. 2019	June. 2020	June.2020	YTD (30 June. 2020)
<b>MENA</b>				
Abu Dhabi	5,075.77	4,285.80	3.48%	-15.56%
Bahrain	1,610.18	1,277.61	0.63%	-20.65%
Dubai	2,764.86	2,065.28	6.18%	-25.30%
Egypt	13,961.56	10,764.59	5.33%	-22.90%
Jordan	1,815.20	1,603.04	-2.45%	-11.69%
Kuwait	6,975.96	5,607.07	3.37%	-19.62%
Lebanon	785.56	612.23	6.41%	-22.06%
Morocco	12,171.90	10,169.19	3.21%	-16.45%
Oman	3,981.19	3,516.00	-0.81%	-11.68%
Palestine	525.96	470.78	-0.99%	-10.49%
Qatar	10,425.51	8,998.56	1.74%	-13.69%
Saudi Arabia	8,389.23	7,224.09	0.15%	-13.89%
Tunisia	7,122.09	6,627.87	2.15%	-6.94%
S&P Pan Arab Composite	788.75	659.67	1.69%	-16.37%
Dow Jones MENA	605.23	504.33	1.81%	-16.67%
<b>Americas</b>				
Dow Jones Industrial	28,538.44	25,812.88	1.69%	-9.55%
S&P 500	3,230.78	3,100.29	1.84%	-4.04%
NASDAQ Composite	8,972.60	10,058.77	5.99%	12.11%
S&P/Toronto Composite	17,063.43	15,515.22	2.12%	-9.07%
<b>Europe</b>				
EURO Stoxx 50	3,745.15	3,234.07	6.03%	-13.65%
S&P Europe 350 Index	1,676.79	1,440.87	3.09%	-14.07%
FTSE 100 Index/ London	7,542.44	6,169.74	1.53%	-18.20%
FTSE MIB Index/ Italy	23,506.37	19,375.52	6.47%	-17.57%
DAX Index/ Germany	13,249.01	12,310.93	6.25%	-7.08%
<b>ASIA/Pacific</b>				
NIKKEI 225/ Japan	23,656.62	22,288.14	1.88%	-5.78%
S&P/ASX 200/ Australia	6,684.08	5,897.88	2.47%	-11.76%
<b>BRIC</b>				
Brazil/ Bovespa	115,645.30	95,055.80	8.76%	-17.80%
Russia/ RTS	1,548.92	1,212.63	-0.58%	-21.71%
India/ Bombay Sensitive	41,253.74	34,915.80	7.68%	-15.36%
China/ Shanghai Composite	3,050.12	2,984.67	4.64%	-2.15%
Hong Kong/ Hang Seng	28,189.75	24,427.19	6.38%	-13.35%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2019	June. 2020	June.2020	YTD (30 June. 2020)
<b>Commodities (in USD)</b>				
Brent Spot (Barrel)	66.42	40.89	11.63%	-38.44%
WTI Cushing Spot (Barrel)	61.06	39.27	10.65%	-35.69%
Natural Gas NYMEX (MMBtu)	2.32	1.75	-9.74%	-24.49%
Gold Spot (OZ)	1,517.27	1,780.96	2.93%	17.38%
Silver Spot (OZ)	17.85	18.21	1.91%	1.99%
Copper LME Spot (MT)	6,149.00	6,004.50	12.19%	-2.35%
Corn CBOT Active Month (Bushel)	4.01	3.42	3.48%	-14.84%
Wheat CBOT Active Month (Bushel)	5.69	4.92	-6.06%	-13.54%
Soybean CBOT Active Month (Bushel)	9.79	8.82	3.58%	-9.86%
Rough Rice Futures (USD/cwt)	13.14	14.51	-15.74%	10.43%
<b>Currencies Spot Exchange Rates Against US Dollar</b>				
Euro	1.12	1.12	1.20%	0.19%
GBP	1.33	1.24	0.47%	-6.46%
CAD	0.77	0.74	1.47%	-4.31%
Yen	0.01	0.01	-0.11%	0.65%
CNY	0.14	0.14	1.00%	-1.45%

Source: Bloomberg, Capital Investments

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