

Monthly Newsletter

September 3rd, 2020

"The wise pursue understanding; fools follow the reports of others." — Tibetan Proverb

"Be the change you wish to see in the world." — Mahatma Gandhi

Clues from Recent Asset Classes' Behavior

Macro: The Rebound is Here... the Focus is on the Path of Recovery

Oil: Hurricane Laura Lent Some Support to Prices

MENA: Overview of GCC Banks 2Q20 Results

Introduction

Powell's speech at the virtual Jackson Hole meeting was the most influential event of August and a pivotal moment for financial markets as it laid down the foundations for a new paradigm in monetary policy. The Fed announced a shift to average targets for both inflation and employment, meaning that the FED is willing to let inflation overshoot beyond 2% without hiking short term rates. Despite clarifications provided in follow up statements by other Fed presidents, full details are still missing which makes the upcoming September meeting of the Fed's FOMC interesting.

The promise so far by the Fed to keep short term interest rates pegged to the lower bound near zero along with ample liquidity are supporting the overstretched valuation in stock markets.

Beyond the cushion provided by depressed yields, most equities look expensive even in the context of sequential improvement in macro figures across the board, upward revisions to earnings forecast for 2021, and sustained positive investor sentiment led by optimism regarding scientific progress on the vaccine front.

From this vantage point, investors should keep an eye for inflection points and should not be dragged by the foam of rising markets while missing the champagne when the moment of truth arrives, as gains may evaporate and losses stay and are guaranteed.

Clues or inflection point in our opinion may come from the VIX or the volatility or fear index in the market, and long-term US yield. Besides the key meetings for the Fed and the ECB in September, and as the Sino-US relationship appears to be on the backburner for "now", the two known unknowns that investors should deal with seem to be the uncertainty over the result of the US elections, which will have geopolitical implications and policy repercussions, and more importantly the approval of a new vaccine for covid-19 by regulatory authorities.

The decoupling between the VIX index and the stock market which are rising in tandem shows that many investors are doubtful of the sustainability of rally and that they continue buying protection as the market keeps its stubborn ascent. As for long-term yields, they will be driven by the pace of expansion and management of the Fed's balance sheet. We know so far that yield curve control is in the toolkit but not on the table as an active option.

The approval of a new vaccine for covid-19 may be a more influential event as it will mean that people can resume risky social activities from a health point of view and may indicate that we will exit the mask economy and move toward a normal economy. Therefore, the recent rebound in economic activity may lead to a sustained recovery in businesses, resulting in a sudden spike in long-term yields which will take down equities at least in the short term and would give some cyclical breath for a structurally weak USD.

We are participating in the rally while keeping our cautious stance by being long volatility and by holding some cash. We have added some position in the transport sectors and kept our exposures to mining, gold and silver. We are thinly exposed to the MENA and have played the theme of liquidity flows related to index inclusions recently.

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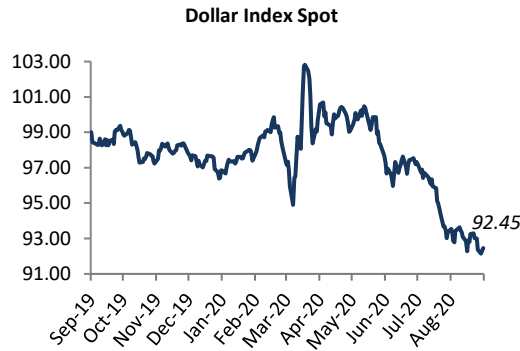
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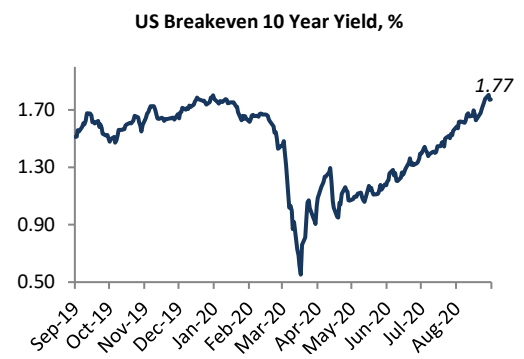
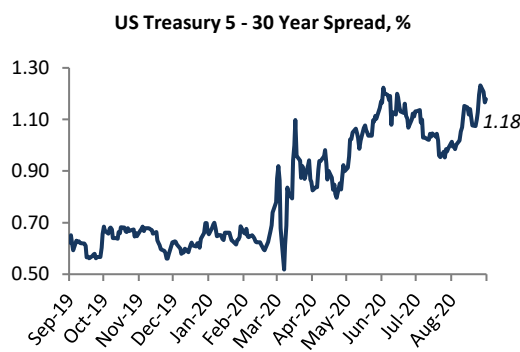
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Clues from Recent Asset Classes' Behavior



Source: Bloomberg, Capital Investments

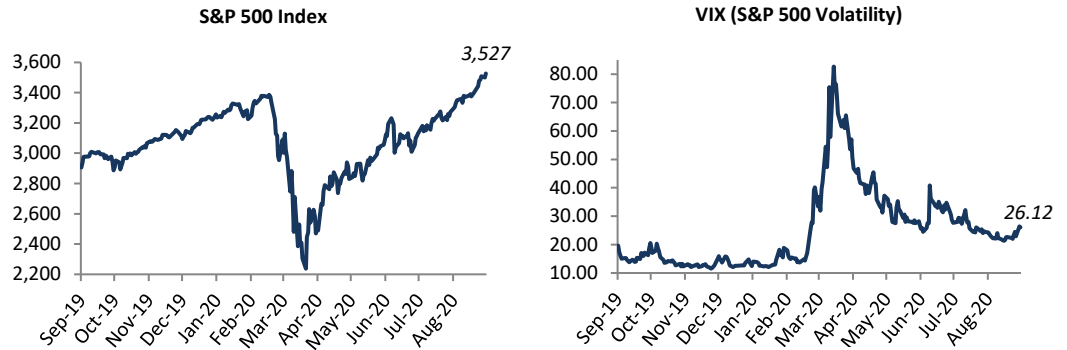
The green back is failing to gain ground against major currencies notably the Euro and the GBP. The Euro seems to be holding ground as it flirted with the 1.2 level vis-a-vis the USD backed by an improvement in the real rates differential and better outlook in relation to fiscal positioning. The USD may benefit from its safe haven status or rally on the back of the potential announcement of a vaccine. However, the USD is structurally and fundamentally on a downward trend benefiting emerging markets and commodities. This is being helped by a strengthening Chinese Yuan which is enjoying an advantageous yield differential when compared to the US as the Fed is adopting a much looser monetary policy.



Source: Bloomberg, Capital Investments

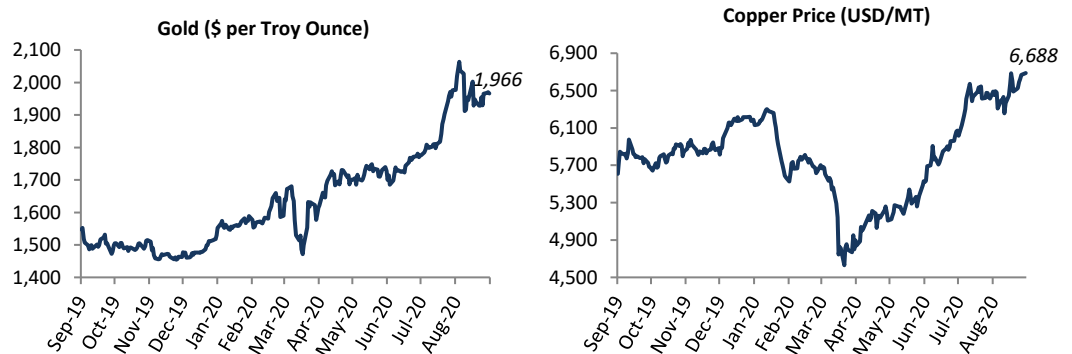
The tolerance of a higher target for inflation rate by the US Fed prompted traders to start factoring in a term premium across the curve. The influence of the Fed's announcement is obvious on the steepness of the US yield curve as illustrated by the 5-year 30-year US yield spread. It is worth mentioning that equity markets were going up along with breakeven rates which shows that investors are seeing equities as a hedge for inflation. While nominal yields were moving recently in a range between 0.5% to 0.7%, it was the real yield that was going deeper into negative territory. This explains the rise in breakeven rates (nominal yield minus real yield = breakeven rate) and

investors' rush to gain a dividend yield and benefit from a rise in equities rather than end up with a negative yield from bonds.



Source: Bloomberg, Capital Investments

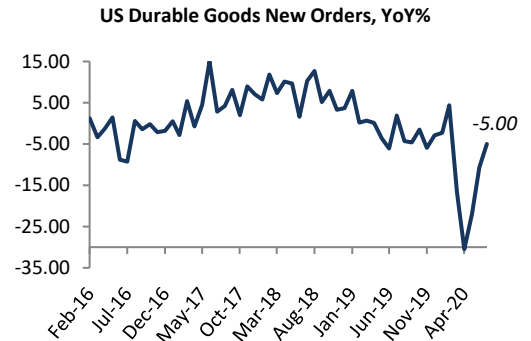
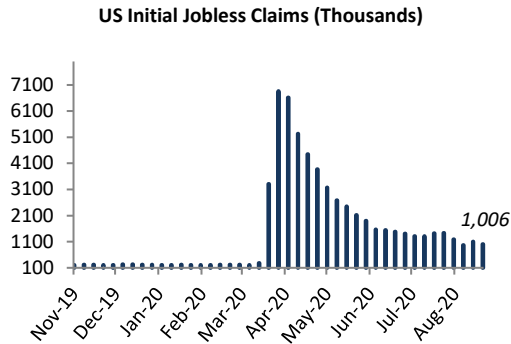
Since the beginning of August, there has been a decoupling between the stock market and the VIX index which resumed its upward trend after hovering around the 20 level. We take the rise in VIX seriously as it means that investors are buying protection given that they face a market priced for perfection, rising uncertainty around US election results and a potential spike in yields.



Source: Bloomberg, Capital Investments

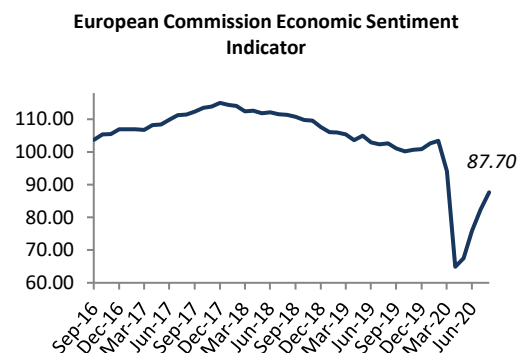
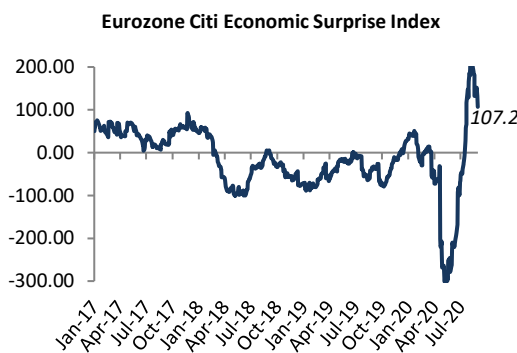
We continue to like gold and silver and are invested in the miners, and so far, we are comfortable that gold price is consolidating above key support levels and above its 50-day moving average. As for copper, we are constructive on the metal as supply may move into deficit due to some mines disruption and prices may be supported by infrastructure spending in China.

Macro: The Rebound is Here... the Focus is on the Path of Recovery



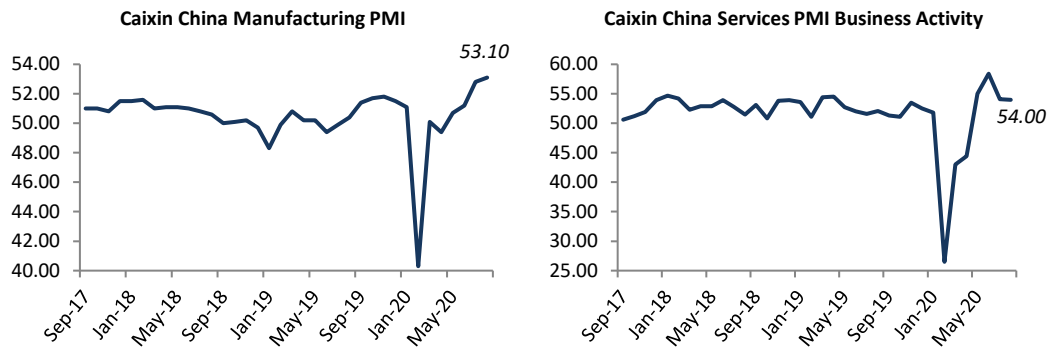
Source: Bloomberg, Capital Investments

The US continued to deliver relatively decent economic data despite the resurgence of the virus in many states in early summer. Data related to housing, durable goods and ISM manufacturing were encouraging, however, improvement on the jobs front seems to be decelerating in an indication that the economy is still in need of the oxygen of fiscal support to sustain the recovery.



Source: Bloomberg, Capital Investments

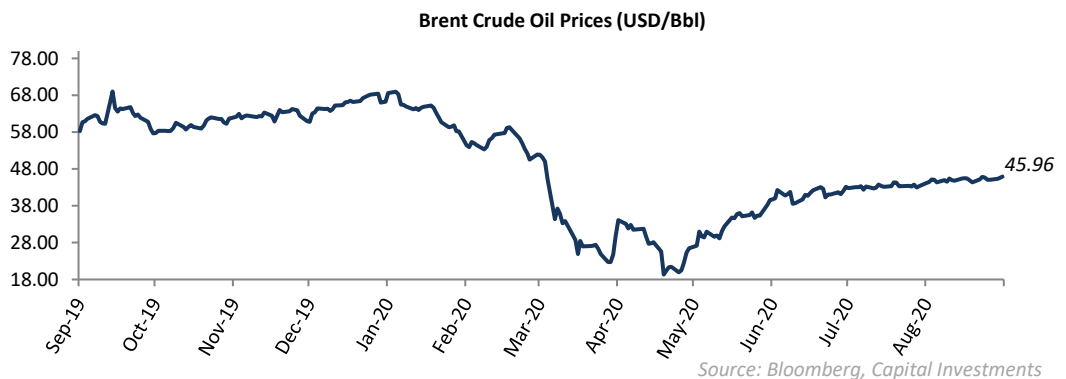
Europe was moving with confidence by registering sequential improvement since the lockdown was eased in late Q2 2020. However, the resurgence of the virus in key countries and the policy of targeted restrictions to keep the virus under control dented the rebound as indicated by the Eurozone Citi Economic Surprise Index.



Source: Bloomberg, Capital Investments

The Chinese authorities continued with their targeted fiscal and monetary measures to boost the economy with a focus on infrastructure spending. Although we expect further monetary easing in H2 2020, we have noticed that the intensity of the targeted fiscal stimulus is not significant which indicates that the intention is to spread it across a longer period of time to stretch its benefit. On a separate note, while the export sector is rebounding as indicated by the Caixin PMI, we have noticed some deceleration in services and a plateau in industrial activity in general.

Oil: Hurricane Laura Lent Some Support to Prices

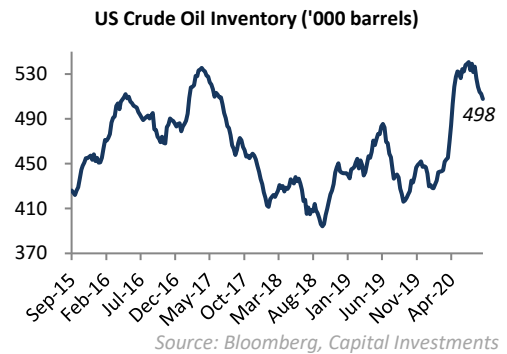
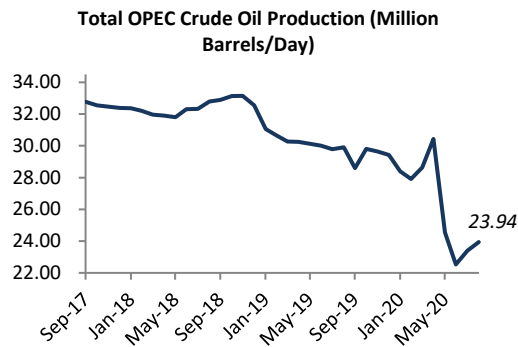


Source: Bloomberg, Capital Investments

Oil prices finally pushed higher in August and broke the \$45/barrel mark after struggling the past couple of months to do so as ongoing uncertainty over the trajectory of the demand recovery as well as OPEC+ pumping more barrels to the market kept gains in check.

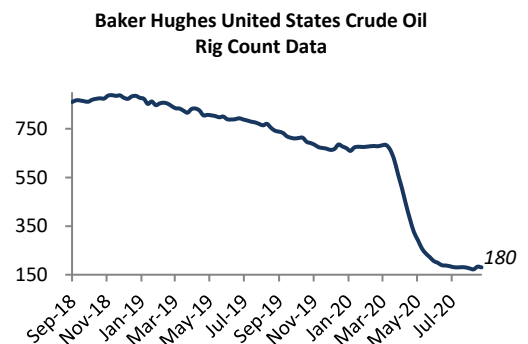
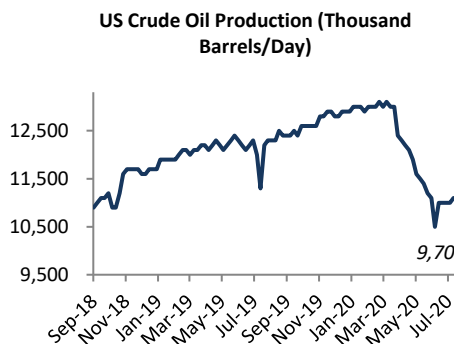
Brent reached its highest in 5 months in anticipation of disruptions to production and refining in the Gulf of Mexico caused by Hurricane Laura. More than 80% of oil output in the Gulf of Mexico and almost 3 million b/d of refining capacity had been shut ahead of Laura’s landfall. The Hurricane also

disrupted energy flows, with trans-Atlantic shipping rates rising and the movement of more than 60 oil and refined product tankers put to a halt.



Source: Bloomberg, Capital Investments

Although prices reversed some of their gains as the Hurricane passed without causing any widespread damage and companies quickly began to restart operations, prices were further supported by Abu Dhabi’s decision of a 30% cut in crude supplies. Abu Dhabi National Oil Company announced that it will reduce October supplies by 30%, up from a 5% cut in September, in order to meet the country’s OPEC+ commitment. This decision however comes after the country exceeded its quota in August. Collectively, OPEC pumped 24.27 million bpd in August, up 950,000 bpd from July. August also marked Iraq’s highest level in compliance in recent years.



Source: Bloomberg, Capital Investments

The month of August saw some drawdown in US stockpiles. Crude inventories fell by 9.4 million barrels in the last week of August versus an analyst expectation of a 1.9 million drop. Although part the steep decline is attributed to Hurricane Laura, stockpiles had been declining since the beginning of the month. Total U.S. crude production dropped by 1.1 million barrels last week to stand at 9.7 million b/d. Meanwhile, US rig count continues to show signs of bottoming.

However, both the FED and OPEC expressed caution on the recovery of oil demand as the virus continues to spread across the globe, with India being the new epicenter. The FED said the pandemic

would weigh heavily on economic activity while OPEC+ also warned that the pace of the demand rebound was slower than expected.

While demand continues to weigh negatively on prices, the improvement in US stockpiles is an encouraging sign. Moreover, improving economic data in China and any clarity on the US stimulus package as well as an alleviation in trade tensions between the US and China will further lend support to prices. In addition, a weakening USD as a result of the FED's highly accommodative policy will also boost oil prices.

MENA: Overview of GCC Banks 2Q20 Results

GCC banks second quarter results revealed a clear impact on NIMs from the 150bps Fed interest rate cuts in March. On average, NIMs (calculated on average total assets) declined 23bps QoQ in Saudi Arabia, 43bps QoQ in UAE and 27bps QoQ in Kuwait. However, some banks, such as FAB, Riyadh Bank, Al-Jazira Bank and Gulf Bank, seem to be adjusting quickly to this headwind by actively managing their cost of funds during the quarter to offset part of the NIM compression. Most banks have guided to further NIM pressure in 3Q20, in addition, some banks mentioned their strategy to move towards high-quality low-yield lending due to Covid-19's impact on different sectors of the economy, which will further pressure NIMs going forward. Non-interest income also declined QoQ as lockdowns and fee holidays pressured revenues. While non-interest income may recover slightly from 2Q20 lows, several fee holidays will continue into 3Q20.

Across the banking space, the main positive trend from 2Q20 results has been the strong focus on controlling operating costs. Costs were down around 10-15% QoQ in aggregate across the sector as management teams actively managed the jaws amidst ongoing headwinds, with the biggest positive surprises coming from UAE banks which guided to further lowering costs in H2.

In 1Q20, significant increases in credit costs took place across GCC banks to accommodate for Covid-19's impact and this trend has continued into 2Q20 as banks also started adjusting their macro assumptions. Most banks (excluding UAE banks) witnessed 30-75% QoQ increase in provisioning, led by Saudi Arabia. UAE banks witnessed a decline of 40% in aggregate provisions mainly due to relatively low provisioning at ADCB and DIB, which may not sustain into H2. While 2020 overall

provisioning is largely dependent on the behavior of the moratorium accounts starting 3Q20/4Q20, guidance at most banks point to similar 2H20 provisioning vs 1H20 trends. The overriding uncertainty remains how big of an increase in NPLs the banks will see in this cycle, and this links to how quickly business activity will pick up to somewhere close to pre-pandemic levels. In Saudi Arabia, SAMA has extended the deferred payments program for Micro, Small and Medium Enterprises (MSMEs) for three months, until December 14, 2020. The extension of the program should help prevent a rise in credit costs in 2H20 and possibly defer the issue into 2021. However, it provides a relief to viable illiquid businesses still struggling with the Covid-19 crisis and could help moderate eventual NPL formation.

In 2Q20, loan growth across most banks in the UAE remained muted QoQ as lockdown measures in April and May severely impacted business volumes. In Kuwait, slight QoQ loan growth was boosted by Islamic subsidiary and/or international operations, while Saudi banks' slight lending growth was boosted by continued growth in mortgages, especially in June, in addition to increases in short term funding requirement from corporates. The question again is how quickly will business activity pick up and translate to higher lending growth.

Regarding dividends, regulatory risk on banks' dividend payments in 2021 is present as both banks and central banks may push for preserving capital, which will weigh on bank stocks' price performance. However, we believe 3Q20 results will give us more color on banks' provisioning trends and banks that are able to achieve higher loan growth to offset margin weakness. Banks with solid balance sheets, capacity to grow and a high NPL coverage will outperform weaker banks.

Table 1: GCC Banks 2Q20 Results – Key Ratios

Bank	NIMs (on Average Total Assets)	Cost to Income	CoR	NPL Ratio	NPL Coverage	Net Loans to Deposits	LCR
UAE							
Emirates NBD	4.04%	34.0%	139 bps	5.8%	117%	96%	153%
ADCB	3.44%	34.9%	107 bps	5.2%	73%	96%	129%
FAB	2.35%	25.8%	106 bps	3.9%	80%	74%	129%
DIB	3.67%	27.6%	123 bps	4.5%	76%	97%	89%
KSA							
Al-Rajhi Bank	4.03%	34.0%	65 bps	1.0%	253%	82%	164%
NCB	3.39%	32.1%	102 bps	1.8%	141%	83%	169%
Samba	1.42%	31.3%	122 bps	1.4%	158%	79%	242%
SABB	3.06%	41.8%	327 bps	2.3%	200%	81%	147%
Riyad Bank	3.53%	33.0%	129 bps	1.0%	194%	94%	160%
ARNB	3.23%	36.0%	114 bps	2.5%	123%	87%	206%
BSFR	3.17%	32.6%	181 bps	2.9%	102%	98%	168%
Al-Inma Bank	3.82%	38.3%	72 bps	2.6%	115%	96%	125%
Bank Al-Jazira	3.50%	53.5%	126 bps	1.3%	170%	84%	180%
KUWAIT							
NBK	3.27%	37.9%	171 bps	1.8%	186%	100%	156%
KFH	4.32%	35.6%	451 bps	2.2%	209%	68%	163%
Gulf Bank	3.55%	37.9%	186 bps	2.7%	325%	107%	206%
Burgan Bank	3.80%	49.2%	138 bps	4.8%	187%	103%	112%

Source: Bloomberg, Company Financials and Presentations, Capital Investments

Table 2: GCC Banks 2Q20 Results – Key Ratios

Bank	Equity T1 Capital	Total CAR	ROaA	ROaE	Dividend Yield*
UAE					
Emirates NBD	17.3%	18.4%	1.6%	14.1%	3.7%
ADCB	14.9%	16.3%	1.0%	7.7%	6.8%
FAB	15.2%	16.4%	1.3%	10.9%	6.5%
DIB	15.6%	16.7%	1.7%	13.0%	8.5%
KSA					
Al-Rajhi Bank	18.0%	19.0%	2.4%	19.3%	2.3%
NCB	18.0%	19.0%	2.2%	15.3%	6.2%
Samba	18.7%	19.1%	1.9%	9.0%	2.5%
SABB	18.1%	18.7%	-1.5%	-7.5%	4.4%
Riyad Bank	15.3%	17.8%	2.1%	14.6%	2.9%
ARNB	17.7%	19.7%	1.4%	8.8%	2.4%
BSFR	17.0%	17.9%	1.3%	7.5%	3.1%
Al-Inma Bank	18.5%	19.6%	1.5%	8.9%	-
Bank Al-Jazira	20.4%	24.2%	0.9%	7.4%	4.6%
KUWAIT					
NBK	14.9%	16.8%	1.0%	9.4%	3.9%
KFH	15.0%	16.5%	1.0%	10.1%	2.9%
Gulf Bank	13.4%	16.8%	0.8%	8.1%	5.1%
Burgan Bank	13.3%	16.2%	0.9%	8.5%	6.0%

Source: Bloomberg, Company Financials and Presentations, Capital Investments

*The sum of dividend per share amounts that have gone ex-dividend over the past 12 months, based on the dividend frequency. Price as at Sep 1, 2020.

Major Indices	Status as of end		Performance	
	December. 2019	August. 2020	August.2020	YTD (31 August. 2020)
MENA				
Abu Dhabi	5,075.77	4,519.32	4.98%	-10.96%
Bahrain	1,610.18	1,380.89	7.00%	-14.24%
Dubai	2,764.86	2,245.29	9.49%	-18.79%
Egypt	13,961.56	11,365.99	7.23%	-18.59%
Jordan	1,815.20	1,573.66	-0.52%	-13.31%
Kuwait	6,975.96	5,854.56	8.11%	-16.08%
Lebanon	785.56	597.46	0.03%	-23.94%
Morocco	12,171.90	10,134.80	-0.91%	-16.74%
Oman	3,981.19	3,771.89	5.71%	-5.26%
Palestine	525.96	445.96	-3.23%	-15.21%
Qatar	10,425.51	9,845.17	5.09%	-5.57%
Saudi Arabia	8,389.23	7,940.70	6.45%	-5.35%
Tunisia	7,122.09	6,769.22	2.81%	-4.95%
S&P Pan Arab Composite	788.75	710.39	5.86%	-9.93%
Dow Jones MENA	605.23	539.51	5.59%	-10.86%
Americas				
Dow Jones Industrial	28,538.44	28,430.05	7.57%	-0.38%
S&P 500	3,230.78	3,500.31	7.01%	8.34%
NASDAQ Composite	8,972.60	11,775.46	9.59%	31.24%
S&P/Toronto Composite	17,063.43	16,514.44	2.14%	-3.22%
Europe				
EURO Stoxx 50	3,745.15	3,272.51	3.09%	-12.62%
S&P Europe 350 Index	1,676.79	1,455.38	2.76%	-13.20%
FTSE 100 Index/ London	7,542.44	5,963.57	1.12%	-20.93%
FTSE MIB Index/ Italy	23,506.37	19,633.69	2.84%	-16.48%
DAX Index/ Germany	13,249.01	12,945.38	5.13%	-2.29%
ASIA/Pacific				
NIKKEI 225/ Japan	23,656.62	23,139.76	6.59%	-2.18%
S&P/ASX 200/ Australia	6,684.08	6,060.46	2.24%	-9.33%
BRIC				
Brazil/ Bovespa	115,645.30	99,369.20	-3.44%	-14.07%
Russia/ RTS	1,548.92	1,258.60	1.96%	-18.74%
India/ Bombay Sensitive	41,253.74	38,628.29	2.72%	-6.36%
China/ Shanghai Composite	3,050.12	3,395.68	2.59%	11.33%
Hong Kong/ Hang Seng	28,189.75	25,177.05	2.37%	-10.69%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2019	August. 2020	August.2020	YTD (31 August. 2020)
Commodities (in USD)				
Brent Spot (Barrel)	66.42	44.39	3.69%	-33.17%
WTI Cushing Spot (Barrel)	61.06	42.61	5.81%	-30.22%
Natural Gas NYMEX (MMBtu)	2.35	2.63	34.39%	12.11%
Gold Spot (OZ)	1,517.27	1,967.80	-0.41%	29.69%
Silver Spot (OZ)	17.85	28.14	15.39%	57.64%
Copper LME Spot (MT)	6,149.00	6,697.50	4.29%	8.92%
Corn CBOT Active Month (Bushel)	4.03	3.58	9.40%	-11.12%
Wheat CBOT Active Month (Bushel)	5.78	5.52	2.51%	-4.41%
Soybean CBOT Active Month (Bushel)	9.79	9.54	6.83%	-2.58%
Rough Rice Futures (USD/cwt)	13.14	12.49	7.72%	-4.91%
Currencies Spot Exchange Rates Against US Dollar				
Euro	1.12	1.19	1.34%	6.45%
GBP	1.33	1.34	2.18%	0.85%
CAD	0.77	0.77	2.79%	-0.44%
Yen	0.01	0.01	-0.05%	2.57%
CNY	0.14	0.15	1.85%	1.68%

Source: Bloomberg, Capital Investments

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