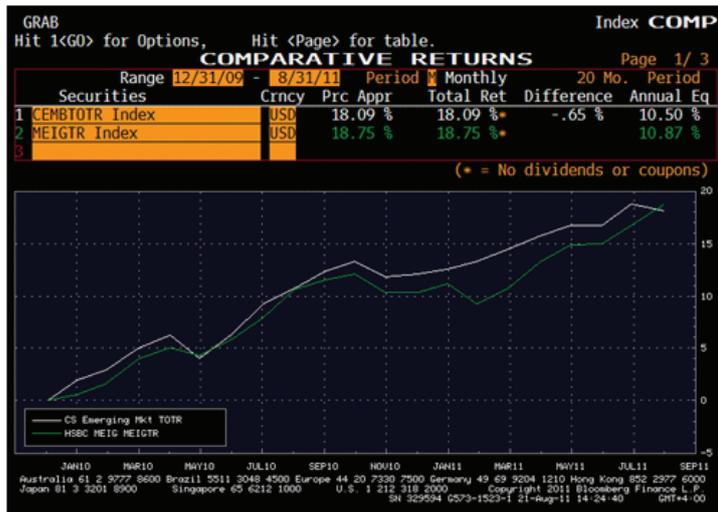


Portfolio Managers Outlook

FIXED INCOME: Middle East, The New Safe Haven!



Source: Bloomberg

The chart above tells a very interesting story. After having underperformed global Emerging Market bonds for much of the last 2 years and longer, the HSBC Middle East Index has dramatically caught up in the last 2 months, and particularly in the last few weeks as market volatility has increased. The HSBC index is dominated by High Grade names from Qatar and Abu Dhabi and these names have benefited tremendously as global markets have unraveled. Investors looking for a safe place to earn a decent premium on US Treasuries have flocked to names like Qatar, ADGB, IPIC, Qatari Diar, Mubadala and others. We believe that in the near term, this trend is likely to continue, the only risk being if we were to get large scale redemptions from Emerging Market Mutual Funds which may cause temporary weakness in the sector.

How Are We Positioned?

In our flagship Makaseb Income Fund we have dramatically reduced our risk profile. High grade, utilities and quasi-sovereigns now make up almost 60% of the fund, up from about 33%. While we are not concerned about any specific credit event within the Middle East bond space, we believe the global market volatility means that it is more prudent to increase exposure to safer names. We believe that the US is very close to a recession if not already in one, in our opinion, what started out as a "soft patch" in June-July turned into much more, thanks to the political gamesmanship surrounding the debt ceiling debate in the US, which led to an S&P downgrade. We believe that while some policy options are still available to the US, their impact is not very clear. Hence, we would recommend a defensive stance in the regional bond market by staying in top quality paper. 3-4% may not seem to be very exciting yields but in this environment we believe they represent the lowest risk and best option.

EQUITY: Attractive, but need to be Selective!

The first half of the year was dominated by the Arab Spring. Clearly the political, economic, and social implications of the change in political weather (from autumn?) in the Middle East will be felt over a long period of time. The initial market reaction has been volatility and sharp sell offs, while the policy response has been populist and expansionary, on balance. At last count, Tunisia and Egypt have thrown out the incumbent regimes while Libya and Syria remain in chaos. Bahrain faced a serious spell of strife, which for the time being has tapered off following the mobilization of a GCC force led by Saudi Arabia. There were protests in Oman as well, which led to a series of government actions aimed at appeasing the public.

In this backdrop, it is perhaps not surprising to see the regional scorecard through to August 20.

Index	YTD %
Saudi Arabia	-10.3
Dubai	-10.90
Abu Dhabi	-6.00
Kuwait	-17.1
Qatar	-6.70
Egypt	-29.00
Oman	-18.70
Bahrain	-10.70
S&P Pan Arab	-13.9
MSCI EM	-15.7

Living up to its mostly frontier market characteristics, the region as a whole has again significantly underperformed the broader Emerging Market universe. This continues a rather depressing long term trend, where since 2005, the MSCI EM Index has risen 11.9% annually, while the S&P Pan Arab Composite is down 8 basis points a year. Put another way, while emerging markets have risen 110%, MENA markets are down 0.50%. This is over a six and a half year period, which is a reasonably long period to evaluate performance. However, over the last decade, MENA markets have risen 11.6% annually (as measured by the Dow Jones Arab Titans 50 Index) while Emerging Markets have posted 14.2% annual returns. Adjusting for the narrow focus of the Dow Jones Index would most likely result in broadly comparable results for the two regions.

The point of the above is to highlight the importance of starting valuation points to long term returns. Valuations at present appear broadly in line between MENA and Emerging Markets, based on trailing earnings; this is where it gets interesting. Saudi Arabia, Bahrain, Abu Dhabi, and Dubai have negative earnings growth over the last 5 years. Kuwait as a whole has lost money since 2009, while Oman has been basically flat over the same 5 year period. No wonder the performance of regional markets over the last 5 years has been terrible (Qatar and Egypt the notable exceptions; Egypt basically flat earnings, Qatar decent growth) as valuations were sky high in 2006, and growth subsequently collapsed. Markets tumbled as the simple strategy of extrapolating exponential growth in the future came up short; it is this very strategy of extrapolating negative growth that is creating a monumental long term (next 5 years) buying opportunity. Historically trailing valuations peak at bear market bottoms; subsequent earnings growth acceleration results in valuations falling, and prices play catch up. Over the next 5 year cycle, MENA markets as a whole appear poised to eliminate the performance gap with Emerging Markets. Superior relative performance, which may or may not be significantly positive in absolute terms, should achieve this. Given the classic bear market pattern thus far, a significant positive absolute performance for MENA markets over the next 5 years appears the odds on bet.

Sadly most of us do not have the luxury of figuring out the long term and comfortably ignoring the present. The immediate term through to the end of the year appears mostly unremarkable regionally; slight political flare-ups seem like the most significant regional factor likely to impact markets significantly. Most other factors like global risk appetite and commodity prices including energy are global and impact the region equally as other risk assets. Regional politics is increasingly becoming discounted in valuations, though Egypt perhaps has some more adjustment left. This is simply because the political picture is still settling down, and in our opinion most investors are too optimistic about a smooth transition in Egypt which crucially manages to appease the public. Elsewhere, unfortunately the chaos in Libya and Syria does not impact the region much economically, and hence is most likely already fully discounted. As long as the major energy producers in the region (Saudi Arabia, Kuwait, Abu Dhabi, and Qatar) maintain the status quo, a political event causing a market swoon through to December is unlikely.

The exogenous factors are however a bit tricky; petrochemical producers have been on a tear, with most reporting record interim earnings so far. (as a side note, It is a measure of the extent of overvaluation in the last market peak that *Sabir trades more than 50% below its 2006 peak, while its earnings per share are up almost 45%*). Although a secular bull market in petrochemicals may very well be under way, a cyclical slowdown would put a dampener on a large sector in the region. Such a slowdown will be triggered in part by capacity additions running to higher utilization rates in the region and some demand softness out of China. Recent market action in the US and Europe related to growth and debt concerns respectively merely reaffirms structural issues and is not necessarily new. However, the risks of a double dip recession in the US are now significantly higher compared to the first half of the year, and are in the process of being quickly discounted in the markets. The capitulation from some sell side strategists would seem to suggest that this bout of market weakness is close to running its course. Timing the market being the eternal challenge, we would suggest increasing risk exposure gradually as a sharply slower US growth outlook or outright recession becomes mainstream consensus. Perhaps the first use of the D (deflation) word in this round of economic Armageddon predictions could be used as a cue to start buying risk again. In any case, significant volatility is almost assured through to the end of the year. Given the virtual freefall in some markets, any relief rally backed by some reasonable catalysts (most likely a coordinated policy response globally) promises to be fast and furious.

MSCI continues to play hide and seek with Qatar and UAE. Now the Emerging Market status review has been extended through to December of this year. The consensus view is that an upgrade for the UAE is a done deal, while Qatar will be a function of foreign ownership limits being enhanced. An upgrade would be positive, but does not alter the investment thesis for the region or these two markets. In any case we remain confident that ultimately Emerging Market status will come through; genuine investors should be welcoming the opportunity to buy the region cheaply for a slightly longer period of time thanks to the delay.

After a long time we believe Kuwait is on the cusp of becoming interesting. We have already started the search for good opportunities in the Kuwaiti market, which is languishing at multi year lows. We are prepared to be patient for a while longer in order to find the right opportunities in Kuwait. We firmly believe Egypt is likely to disappoint on balance in the short term, simply because the political atmosphere does not look encouraging. Qatar remains a good investment, though not one likely to run away in the short term. Saudi Arabia's banking sector is showing initial signs of life and we stand prepared to invest soon in the sector. Saudi consumer stocks remain our firm favorites; retail franchises are top of the list. Oman is also at an interesting valuation point, though we struggle to find any major short term catalysts. The UAE, and specifically Dubai, remain our firm favorites for outperforming the region over the short and medium term. Valuations, the trough in the earnings cycle, and the gradual unwind of the credit excesses of the past 5 years or so have positioned the UAE to deliver strong returns over the medium and long term in our opinion.

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