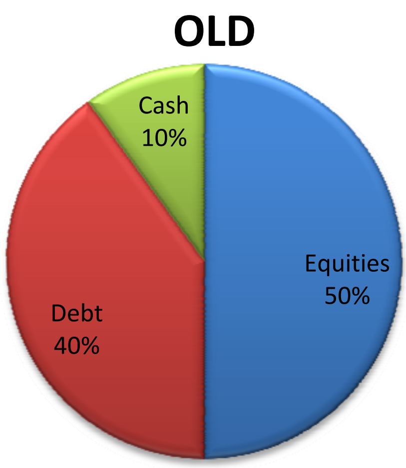
Portfolio Managers Outlook

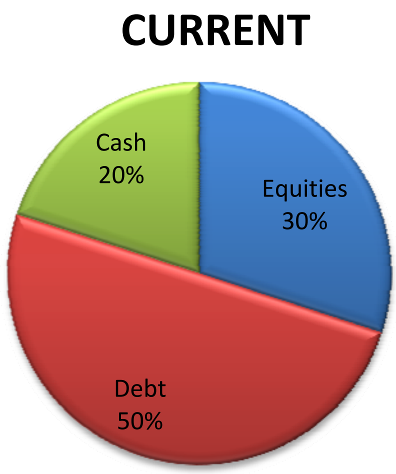
Quarter 2, 2010

Overview:

Our asset allocation call for the 2nd Quarter turned out to be a touch too aggressive as the equity markets in the region significantly underperformed the debt markets. On the debt side returns were helped by a booming US Treasury market which took prices higher even if credit spreads were unchanged. On the equity side the regional markets appear to be exhibiting one sided correlation with the global markets, unfortunately that correlation is on the downside rather than the upside.

For Q3 and going into Q4 our outlook is much more benign. As our Equity Portfolio Manager discusses below, risks to global growth have risen significantly and the market is once again looking to the US Federal Reserve to act in a market friendly manner. While we expect they will, we do not believe that now is the time to be super bullish regional equities, while we would maintain some exposure to regional equities, we would reduce as the charts below show:





Equity Outlook

QE II:

Unlike the forgotten star of the Cunard Line berthed in Dubai since 2008, we refer to the next move by the US monetary authorities. The timing and extent of the next phase of Quantitative Easing will determine the short term path of equity and other asset class returns. But before a more detailed discussion of the future, a quick recap of the year thus far.

Still high on the after effects of QE I, we were quite bullish on equities when we last wrote. In hindsight this optimism was completely off the mark, as the regional MSCI Benchmark sank over 9% from May through July. Among our market views, Egypt at neutral/underweight was spot on, as the market underperformed the regional benchmark by about 6%. All other large markets performed more or less in line, with our preferred overweight in Qatar slightly adding value. The smaller markets were standout performers again; Tunisia rose during the period and Morocco outperformed by about 4%. Our home favorite, the UAE, did not add any value at all, with the MSCI UAE index underperforming by 5%. Going a bit more granular, our perennial favorites (yes we are beginning to bore ourselves as well) Almarai, Jarir Marketing, and Savola were significant outperformers over the period. Most large commodity plays (SABIC, Saudi Kayan, and Yansab) underperformed, with SAFCO being a notable exception. Thankfully, on a bottom up basis we seem to be doing better than our market calls!

Given the view here regarding the likely path of US economic growth and the corresponding policy response, investors are really faced with two choices. Remain invested through the slowdown and get the full benefit of a rally on the back of aggressive quantitative ease (after round one of USD 1,250,000,000,000 round two is not going to have any less zeroes). Or, wait on the sidelines and go long after the fact. Our suggestion is firmly leaning towards the latter, as the underlying fundamentals make this a purely tactical call in our opinion. We do not find compelling values in equities globally, and long return prospects for passive strategies are modest right now. Hence any attempt to capture a quick gain on the back of a policy action is a tactical maneuver which should not take away from the strategic asset allocation decision. We were at 50% equities last time out, and are happy reducing that to 40%. The relative risk return profile of fixed income is clearly superior at the moment.

A quick word about earnings for the second quarter. Almost without exception, most banks came out with numbers that highlighted the following:

1. More provisions (with trends being uniform on a market wide basis)
2. Hardly any growth in assets
3. Continued attempts to improve liquidity

In a nutshell, the financial sector is still firmly in recovery mode, with no signs of a return to the days of double digit growth. The read across for the real estate sector regionally is hence not that bright either, as the woes of several UAE real estate companies indicate. After posting a second quarterly loss in succession, Aldar sank over 37% in the period. For the year, the stock is down over 50%; good luck being bullish Abu Dhabi real estate.

On the petrochemicals side, SABIC disappointed relative to consensus (which is too optimistic) with profits dropping sequentially as well. Industries Qatar beat consensus, but is still likely to show a drop in full year profits compared to last year. With major capacity expansions ramping up in the Middle East and China, any bullishness on margins would appear to be misplaced. Autos and Housing have been the two biggest drivers for chemicals demand in the past decade, and both sectors are in firm retreat in the US, hitherto the biggest chemicals market globally. In our opinion, increasing capacity reduction in high cost geographies (parts of Europe, for example) will signal stability in margins. We are not there yet. Our sector strategy is to be strategically underweight until we see compelling value emerging; until that time we are happy to try and get some juice out from the tactical side.

Coming back to the US economy, a lot of soft data points are pointing to rapidly slowing momentum. The US economy is relevant for the region for several reasons:

1. Currency peg links monetary policy directly to the US
2. Commodity and energy demand; US is still the largest consumer
3. Sentiment, and the resulting impact on fund flows

Most leading indicators with an impressive record of predicting the trend of US economic growth are indicating rapid slowdown (or dip into negative territory) around the end of the third quarter this year. The US equity market obviously does not agree, though the bond market is not painting a pretty picture with the 10 Year US Treasury yielding about 2.80%. Hence the setup is one of a rapid change in expectations for equity market participants over the next couple of months. In the ensuing adjustment in valuations, pro cyclical plays are likely to bear the brunt; our region is viewed by many investors as a big bet on global/emerging market growth and as growth expectations get recalibrated markets closer to home may suffer as a consequence.

We are happy staying defensive both on asset allocation as well as portfolio construction. We continue to favor domestic plays, and would continue to stay away from sector exposed to global growth or suffering from excess capacity. Within markets, Egypt perhaps is a standout in terms of vulnerability to external flows, combined with a simmering political succession issue that is yet to be resolved. Despite under performing in the period since our last comment, we continue to remain underweight the land of the pharos. The resilience of the smaller markets, with no support from valuations defies logic, and us; we remain underweight. Saudi Arabia is the market where we find the most interesting bottom up stories, and on an overall basis we remain neutral despite being bearish on the biggest petrochemical plays. We continue to believe that the UAE has the highest proportion of negative news already discounted, but struggle to find names to excite us; at best we would suggest being neutral. Qatar is likely to perform poorly leading up to any policy action in response to falling US economic growth, and hence goes to underweight.

Market	**Relative to Benchmark**
Saudi Arabia	Neutral
Kuwait	Underweight
Qatar	Underweight
UAE	Neutral
Egypt	Underweight
Oman	Neutral

Assuming a massive QE comes through a bit early (due to a faster than expected economic slowdown) we would shift to being overweight Egypt (benefit from improving expectations of global growth driving flows to risky assets), Qatar (commodity bounce), and the UAE (energy prices for Abu Dhabi, tourism and logistics for Dubai). However, we are happy crossing that particular bridge when we do come to it.

<u>Debt Outlook</u>

Our earlier calls for overweighting Dubai and over weighting duration both have paid rich dividends so far. Making both the Makaseb Income Fund and the Mashreq Al Islami Sukuk fund one of the top performing fixed income funds in the region on an YTD basis. We believe that Dubai has rallied enough now and is more fairly valued. As such we would no longer be overweight Dubai in our portfolio. However on the duration side we continue to feel that interest rate risk is muted and hence would be long duration in out portfolios, in this regard we like the Qatar and Egypt 2040 which are some of the longest duration bonds in the region.

Overall we believe that the debt market in the region has rallied strongly particularly in July and we would not expect this performance to continue into the 3rd quarter, particularly for some of the lower rated issuers in the region. Hence, we are currently getting more defensive in our portfolios in terms of credit quality, but we are looking to increase yield by continuing to extend duration. We expect total returns in regional fixed income to still be attractive but driven more on the back of interest rate movements rather than credit spread contraction, at least through the 3rd quarter. If we were to get some evidence of a stronger economic recovery globally we may change that outlook. We believe Issuance from the region will grow following Ramadan and expect new issues out of the GCC, the Sub-Continent and Egypt. Should this new issuance materialize we would expect it to be a net positive for the regional debt market in terms of increasing liquidity the market.

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