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Asset Management

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Portfolio Managers Outlook

A tale of two halves

So far, the year has been all systems go. If it traded, it generally went up, significantly. Across developed, developing and emerging markets, risk assets have risen sharply. Our value focused brethren have been crying foul at the lack of fundamental underpinnings of this rally, but a 7.7% YTD return for the MSCI World Index is tough to argue with, fundamentals or no fundamentals. True to form, most of the MENA region has lagged these impressive returns, with the S&P Pan Arab index gaining less than 3% YTD (MSCI Emerging Markets Index has gained 14.4% YTD). Egypt is the exception, up a roaring 26.9% for the same period. Dubai deserves an honorable mention as well, which is up by 9% during the same period.

Clearly, the risk trade is firmly on across the globe. It would appear that a bulk of this is in response to two main factors: continuing aggressive accommodation by the Fed and ECB and some positive US economic data. Of the two, the central bank actions are likely to endure for a longer period of time, while, it is still debatable how sustainable the US economic rebound is. Although regional factors like Egyptian politics and Iran's nuclear program threaten to impact markets, we firmly believe this is a global risk trade at the moment, and global factors will continue to dominate. Recent precedent has shown that cheap central bank liquidity has been primarily used to buttress bank spreads, with limited to zero follow through in credit growth. Given the highly leveraged state of European financials and their reliance on whole sale funding, the impact of continued cheap funding from the central banks will not likely have a different impact going forward (this in other words, is a liquidity trap). Hence, in our opinion, the most crucial variable for global sentiment in the short term is likely to be developments in the Europe. Politicians and bureaucrats are generally a fatal combination for sane and rational behavior, and this time around in the Europe may not be any different. The consequences of a mismanaged default in or exit from the Euro zone will be dire for equity markets, MENA included. Hence, though this rally may lack valid fundamental legs, the European crisis driven reversal promises to be large enough to allow investors an opportunity to change course. For now, it is all systems go.

In our own backyard, developments are more or less as expected. Saudi banks continue to build reserves, telecoms continue to report decent growth and Qatar's GDP growth remains among the highest in the world. In our opinion, the best proxy for global risk appetite in the region is Egypt, which has been on fire this year. This is despite the Muslim Brotherhood dominating the elections and with no clear sense of what policy direction the new government will take. Though the prospects for a further advance in Egypt are bright, the setup is just too speculative for us to try and participate. Our favored markets of Saudi Arabia, Qatar and Dubai continue to offer significant upside participation, while clearly possessing good defensive characteristics. We remain more or less fully invested and hope to participate meaningfully in any market strength, though chances of matching a furiously rising market remain modest. We see no reason to try and resist the current market strength, while still recognizing that speculative merit dominates any investment merit for being long at the moment. Though our focus on earnings quality and sensible valuations means that we miss out on Arab Tec's 100% bounce, we remain confident of adding value relative to market performance across complete market cycles. We wish all our readers a happy and prosperous 2012.

Fixed Income

Regional and global fixed income markets have performed very well for the first six weeks of 2012. The outlook, however, is far from clear as we look out over the remainder of the year. We are monitoring four factors closely: first the European Debt crises, second Chinese GDP growth, third US Economic growth and finally, the regional geopolitical situation. Of these, the ones likely to have the greatest impact on Middle East bond spreads, are Chinese GDP growth and regional geo-politics, particularly the Iran situation.

On balance, we are positive for regional fixed income markets because, we believe that all the four factors mentioned above will play out more or less favorably for our region. We think that the European risk has for the most part, been priced in and unless there is a complete meltdown of the Euro (unlikely in our view), we do not believe that the on-going negative news out of the Europe will have a huge impact on regional bonds. For China, we expect a soft landing on GDP growth in the range of 7.5-8%, which we feel would be supportive for the region's economies. We also believe that US economic growth will be in excess of 2% and unemployment will slowly continue to trend down. Finally, we do not expect a major geo-political event in the region although rhetoric will remain.

Keeping these factors in mind, we have positioned our portfolios with a positive bias, but we are being conservative in our security selection and staying very nimble by keeping investment sizes low and only in the most liquid names. We prefer strong corporate names like DP World, Qtel, Emaar and large quasi sovereign banks like Emirates Islamic, Qatar National Bank and the longer date Qatar sovereign bonds. We also believe that, where our mandates allow, we are diversifying out of the region into good quality Asian, Russian and other Emerging Market bonds.

Overall, we expect this to be a 4-6% return year in the fixed income space. With bias to the upside of the range, however, should one or more of the factors mentioned above play out negatively for the region, this number could well be 0 or even negative. Hence, we continue to recommend a conservative and flexible approach for investing in regional bonds this year.

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