

Portfolio Managers Outlook 2011

Asset Allocation 2011:

As the commentary below states, we enter 2011 in a state of confusion. The Bond markets appear to be pricing in prospects of a robust recovery with an increasing threat of inflation while the equity markets, particularly the regional equity markets are much more benign about growth prospects. Having said that global equity markets have made a strong comeback in December from a weak November, but overall we feel there is still a slight disconnect between the equity and the bond markets.

Overall we fall in the camp of the bond market bears. We believe that we have seen the lows in interest rates (high in government bond prices) and that 2011 onwards is likely to see a slow and long lasting increase in rates. i.e. the Bond market is most likely entering a period of secular decline. This however does not bode ill for all bonds, we believe that credit sensitive bonds (i.e. High Yield bonds) will continue to have attractive high single digit returns in 2011. It is in the government bond and high grade bond space that the risks are very high. Indeed, if economic recovery is as strong as the bond market seems to be implying High Yield returns maybe even more attractive than just high single digit. Overall our asset allocation scenario for 2011 would be as follows:

Regional Equities	20%
Global EM Equities	20%
Global Dev Mkt Equities	10%
Regional High Yield Debt	10%
EMG High Yield Debt	20%
Other Risk assets (commodities etc.)	15%
Cash/High Grade Bonds	5%

Outlook 2011: Disconnect

We often go to great lengths to point out the short sightedness of market participants; the lack of focus on the long term, exaggerated reactions to news, etcetera. Strangely, at present, at least one group of market participants appear to be focusing on trends that are not likely to emerge for several years. We refer to the disconnect between global equity and bond markets at the moment. This disconnect is perhaps evidence of a deeper uncertainty about the likely outcome of unconventional policies being employed by major developed economies. How this uncertainty is resolved, will probably determine how 2011 pans out for different asset classes. That much is at clear; sadly, it gets increasingly confusing from here on.

The source of confusion is not so much about the eventual outcome, but rather the path to that outcome. Given the rather short time frame under discussion here (1 year for an asset class with a duration of close to 30 years is rather short) there are several possible scenarios that could play out over the next 12 months. Despite having exhausted our arsenal of qualifiers so far, one outcome is rather likely; emerging markets will continue to outperform on a relative basis. Whether that translates into attractive absolute returns or not is not so clear.

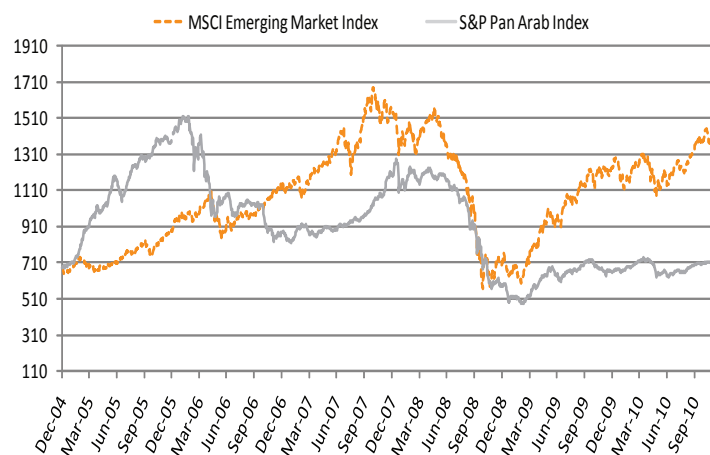
As always, the global backdrop will be important for navigating the regional capital markets with success. The majority of market participants still appear confused between structural and cyclical trends. The consumption bust in the US and the debt burdens of several European economies are structural and not cyclical issues. Hence despite the normal ebb and flow of economic data, these issues will take a long time to be addressed. More importantly, emerging economies will continue to comfortably outperform their developed counterparts in terms of economic growth. Despite current investor concerns about inflationary pressures in the US, the sheer magnitude of the output gap, combined with the time needed to close this even on the most optimistic assumptions would strongly suggest that inflation in the world's largest economy is headed firmly lower in the medium term. The slack in the labor market means disposable incomes and hence consumption will remain subdued, dampening the overall growth in GDP, for several years to come. Not a pleasant backdrop for risk taking in the biggest

stock market in the world. Across the Atlantic in Euroland, things are perhaps in worse shape. Suffice to say that it will take some doing to address the debt burdens of weaker members of the Euro.

With monetary policy exceptionally loose in the US to force the Dollar lower, and likely to remain so for the foreseeable future, all other major economies will continue to try and fight the appreciation of their own currencies. Sadly all countries cannot have weakening currencies at the same time, hence there will be some economies which will need to bear the brunt here. For emerging markets, efforts to prevent rapid currency appreciation will generally be supportive for risk taking and will ensure that capital markets remain well bid.

However the current level of stock markets globally, whether in the developed or emerging world, generally have inbuilt growth assumptions that may be too optimistic in some cases. This is perhaps truer for the developed world as opposed to Emerging Markets. Over the course of the year, given the rich valuations (in our opinion) for the S&P 500 Index, a period of rather weak returns is probable in response to any renewed weakness in economic data. Here it is important to bear in mind that the current recovery in the US remains exceptionally tepid by normal post World War II standards, which is significant given the unprecedented level of monetary and fiscal stimulus that has been provided. Although emerging markets are likely to outperform in such a scenario, returns may very well turn out to be negative. Chinese growth and the success of current Chinese policy measures aimed at addressing some domestic speculative activity will be a crucial factor in determining the extent of EM outperformance.

The global backdrop sets up the MENA region rather nicely for the medium term, including 2011. The MENA region has lagged the broader EM universe significantly over the last 5 years, 3 years, and 1 year.



Source: Bloomberg

As a whole, the region has reasonable (though certainly not compelling) valuations. It has all the favorable characteristics of the EM universe (positive demographics, healthy fiscal balances, big infrastructure spending) without the participation of the broader EM universe investor base. With a few notable exceptions (UAE and Kuwait), banking sectors are healthy, well capitalized, and do not have excessive leverage.

Last but not least, the region is home to some of the world's largest energy reserves. Commodity prices are likely to remain strong due to a combination of EM demand (mainly China) and fiat currency debasement. With most of the region on some form of a Dollar peg, the most likely outlet for currency appreciation pressures (despite rock bottom interest rates) will be asset price inflation. In the last round, regional real estate markets were the focus; this time round equity markets are more likely to act as the conduit for alleviating upward pressures on regional currencies.

Another supportive factor for capital market prospects in the region is the likely gradual improvement in banking sector liquidity over the next few quarters. Private sector credit growth has been rather anemic recently, and the public sector has taken up all of this slack. Banks have been building up their provisions over the past few quarters and this process is likely to run its course over the next quarter or so (with the exception of UAE and Kuwait). Post Q1 2011, we expect a gradual pickup in private sector credit growth on the back of continued government spending.

The principal downside risk over the next 12 months is likely to be a growth scare from China; this would result in commodity weakness and be generally quite negative for risk assets globally, and in EM in particular. To a lesser extent, inflationary pressures in the emerging economies are likely to garner increasing attention going forward, and some policy actions to address the same could result in market weakness. Politics and economics are also likely to increasingly mingle, and some political actions (trade barriers, capital controls etc) may result in increased market volatility.

Within the region, our preferred markets are Qatar, Saudi Arabia, Egypt, and the UAE. Despite recovering this year, Kuwait does not offer any compelling fundamental value at the moment. Qatar has perhaps run ahead of itself a little bit following the successful world cup bid, but until and unless flows into EM funds abate, Qatar will remain well bid. Saudi Arabia offers middle of the road valuations, favorable demographics, supportive fiscal and monetary stances, and one of the most diverse investment universes in the region. Egypt is progressing well as an economy, though it is a bit difficult to find good value at the individual level (again thanks to strong flows from EM investors keeping stocks firm). The UAE figures on our list simply because it has the cheapest valuations in the region, even after accounting for higher uncertainty and risk. We believe most of the bad news about UAE (more so Dubai) is known, and the probability of negative surprises is quite low. The bear market in Dubai has been one of the most brutal on record (the index is down 81% from its November, 2005 peak) and has demonstrated the typical overshoot in both directions (trading at a high of 6.2 times sales in 2005, to a low of 1.4 times sales earlier this year). Simply by virtue of the starting point of valuations at this point, the UAE is poised to be among the best performing markets in the region over the next 3-5 years.

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