

RANDOM WALK

May he live in interesting times...

It is not known if this was indeed a Chinese curse or proverb. Like it or not, investors have been blessed (cursed?) with interesting times. Since 2004, investors are yet to experience a “stable” year.

Index	2004	2005	2006	2007	4 Year CAGR
Saudi Arabia	85%	104%	-53%	41%	26%
Dubai	152%	195%	-44%	44%	56%
Abu Dhabi	75%	69%	-42%	52%	27%
Kuwait	38%	79%	-13%	25%	28%
Egypt	105%	132%	11%	51%	68%
Bahrain	32%	24%	1%	24%	20%
Qatar	65%	70%	-35%	34%	25%
Oman	24%	44%	14%	62%	35%

The current year, which will be the year of the rat (!) according to the Chinese calendar, could potentially make the recent past look stable by comparison. Global capital markets are becoming increasingly interlinked, including the Middle East. A myopic investment outlook is the main pitfall to avoid.

Talk of an impending recession in the US is gaining recognition and perhaps states the extent of the economic challenges facing the US.

The nature of economic realities in the US is relevant for the rest of the world, a structural bull market in emerging markets notwithstanding. The US accounts for about a quarter of global oil consumption, and is still a bigger consumer than the next four largest oil consumers (China, Japan, Russian Federation, and Germany) combined. Together, the top 5 account for 45% of global consumption.

As the extent of economic headwinds in the developed world becomes clearer, oil prices will become susceptible to tactical weakness. According to data prepared by British Petroleum, the inflation adjusted average price of oil is USD 26.1 per barrel, over the last 145 years. It is unlikely that global growth patterns are likely to see a profile that has not been witnessed over the last 15 decades. Such a long term average has little utility over the relatively short term horizon of one’s investing horizon; however it illustrates the fact that current price levels of oil are vulnerable to tactical weakness. We would be quite surprised if the current bull market in commodities did not experience a significant correction, without changing the overall bullish view. After only one negative year over the last decade, while the price itself went up almost 10 times, a 30% correction will be a mere blip on the long term chart.

The overall bullish view remains intact because the growth story in China and India is set to extend into the foreseeable future. For the first time in history, two emerging markets, China and India, were the biggest level contributors to global growth at a country level in 2006. We remain comfortable holding a long term bullish view on commodities in general, and oil in particular.

The forest and the trees

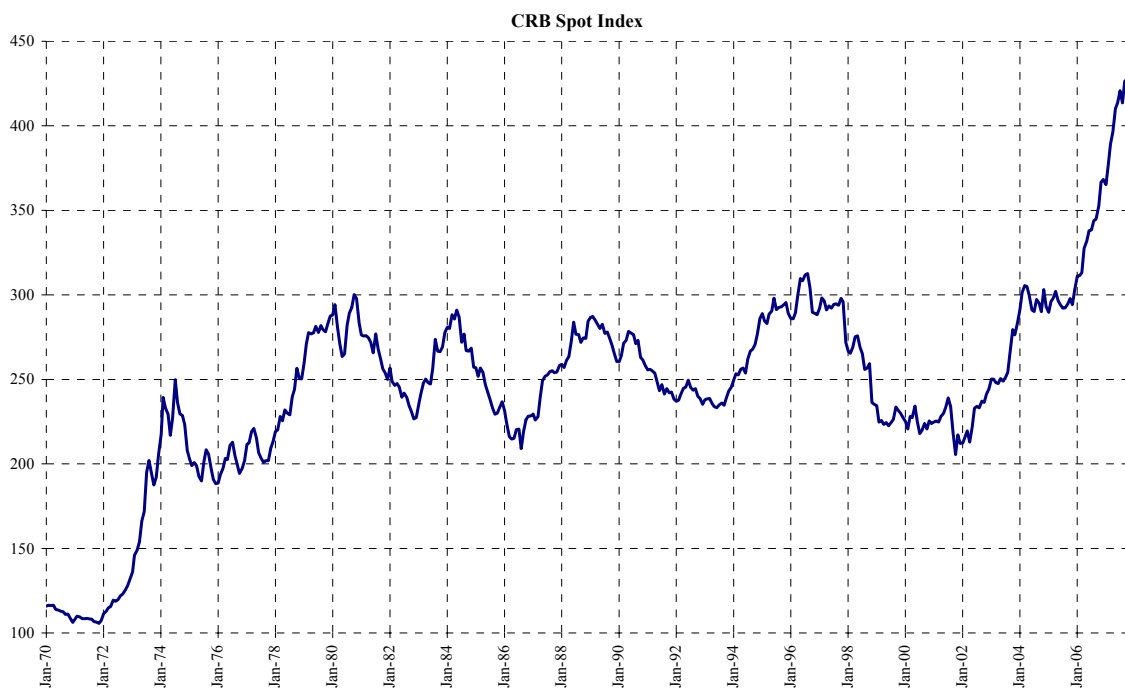
Focusing back home, the outlook for oil prices is a significant medium term factor. The region's reliance on oil revenues is well documented and understood. Oil prices appear vulnerable because of the emerging global growth scare. The consensus view has moved from complacency about emerging market growth momentum to some concern about the impact of sluggish US economic performance on the rest of the world. Combined with a dramatic increase in investment across the value chain of hydrocarbons, emerging growth concerns may trigger a sharp correction in the price of oil. Increased speculative activity in the commodity by new players like hedge funds will only serve to increase any downside momentum.

We do not expect oil prices to fall off the cliff, though a 25% to 30% correction is quite probable. Such a scenario would first and foremost represent a great buying opportunity for regional equities for the long term (meaning a complete market cycle of roughly 5 years). Investors should be wary of chasing beta at the moment and focus on avoiding grief in the event of a market sell off on the back of weaker oil prices.

Cyclical plays should be avoided for the time being, until at least some signs emerge of the anticipated correction in the commodity complex having run its course. This correction has not yet begun. The structure of the MENA region here is an issue, as the listed universe here as measured by the MSCI Arabian Index is dominated by cyclicals.

Industry Group	MSCI Arabian Index
Banks	34.9%
Materials	22.5%
Telecommunication Services	12.3%
Diversified Financials	7.2%
Capital Goods	7.1%
Real Estate	6.0%
Transportation	2.9%
Energy	1.8%
Food Beverage & Tobacco	1.7%
Utilities	1.2%
Consumer Durables & Apparel	0.9%
Insurance	0.6%
Consumer Services	0.4%
Pharmaceuticals, Biotechnology	0.3%
Food & Staples Retailing	0.1%
Retailing	0.1%

Materials and Banks alone account for almost 60% of the index-and this is after the stunning decline in several regional names lately. Our major concern at the moment is weathering the coming turmoil with minimum damage. Rather than hitting the panic button at the first opportunity, investors should watch out for strength on the back of coming easing in the US, and possibly the rest of the developed investment universe as well. This will be a good opportunity for short term investors (a turbulent year is meaningless for longer term investors) to alter their portfolios away from cyclicals like materials and banks, and more towards domestic demand plays like telecoms. For materials, it is obvious that a correction (which still leaves the bull market intact) in the commodity space will raise concerns about final demand and hence hurt sentiment and valuations. In an extreme (which is always a relative term!) move, oil could possibly retrace all the way back to USD 60 per barrel and still leave the bull trend intact.



Clearly, such a reduction in the oil price would dent sentiment and focus attention on the health of external accounts and sustainability of fiscal surpluses across the region. Market weakness, along with substantial volatility is the likely outcome.

Adding further confusion to the picture are the off shore fund flows that several regional markets have benefited from. Historical evidence suggests that such flows bring with them volatility, and higher correlations with the rest of the world. It is unclear how these offshore investors will react in the face of further stress in their domestic markets. Will they reduce exposure to a frontier market like the Middle East or increase allocations to gain diversification benefits? Only time will tell although we suspect that ultimately fund flows to the region will remain stable, and strong. Ultimately is the catch word here, and volatility in the interim is perhaps the only outcome that is certain at present.

Towards the latter part of 2007, regional currencies pegged to the US dollar were the subject of revaluation rumors. The rationale behind the rumors was that rising inflation in the region was a function of undervalued currencies. Many analysts have called for a currency revaluation (or abandoning USD pegs) as a means of fighting inflation. We believe this rationale is suspect at best, and completely off the mark at worst.

The conventional analysis in our opinion has thus far not focused on the major variables here. Taking a look at the evolution of inflation in the worst hit countries in the GCC thus far, it is obvious that the bulk of the inflation is either structural or due to a negative term of trade shock.

Evolution of Inflation by Category - Qatar	2002	2003	2004	2005	2006
Food, beverages & tobacco	1.20%	-0.30%	3.30%	3.10%	7.30%
Clothing & footwear	-1.70%	-1.60%	8.10%	-2.70%	12.40%
Rent, fuel & energy	1.80%	18.00%	16.20%	26.30%	25.90%
Furniture & furnishing	-2.90%	1.50%	3.30%	4.50%	4.20%
Medical services	-2.20%	2.60%	-1.40%	4.50%	1.20%
Transport & communications	1.10%	-8.40%	3.70%	3.90%	1.90%
Education, culture & recreation	-4.10%	3.60%	2.90%	-0.10%	2.30%
Miscellaneous good & services	5.20%	0.70%	4.10%	4.10%	13.60%
CPI	0.20%	2.30%	6.80%	8.80%	11.80%

For Qatar, Rent, fuel, and energy is the major category which has seen price levels rise substantially. Energy prices are a function of price strength globally; rent increases are structural due to limited supply, while food prices are again due to higher prices globally.

Evolution of Inflation by Category - UAE	2002	2003	2004	2005	2006
Foodstuff, Beverage & Tobacco	1.4%	2.2%	7.0%	4.5%	5.6%
Readymade Garments, Clothes and Footware	0.9%	1.6%	5.1%	2.5%	3.8%
Houserent and Related Housing Items	4.3%	5.2%	5.6%	9.3%	15.4%
Furniture & Related Items	1.8%	1.6%	2.4%	3.4%	2.4%
Medical Care & Health Services	7.3%	2.5%	1.5%	5.5%	3.3%
Transportation and Communication	1.8%	2.7%	4.6%	4.6%	9.5%
Recreation, Education and Cultural Services	4.5%	1.3%	2.1%	3.9%	2.4%
Other Goods & Services	1.3%	1.6%	6.9%	6.0%	6.1%
CPI	2.9%	3.1%	5.0%	6.2%	9.3%

The picture in the UAE is no different, with the bulk of the inflation coming from structural problems of supply bottlenecks. A currency adjustment will not be a panacea for the current bout of inflation in these countries. This inflationary spiral is the result of fiscal stimulus coupled with loose monetary policy.

Countries	Growth in Govt. Spending	Real GDP Growth	Inflation
UAE	7.5%	9.7%	10.1%
Saudi Arabia	11.0%	4.6%	2.3%
Qatar	22.3%	8.8%	11.8%
Oman	10.9%	5.9%	3.2%
Bahrain	8.6%	7.7%	3.0%
Kuwait	15.9%	5.0%	3.0%

Even without dropping the peg (and getting the flexibility to tighten monetary policy) it is possible to curb demand somewhat by reigning in fiscal stimulus. However, that goes against the objectives of developing infrastructure and economic diversification away from reliance on hydrocarbons.

The real problem facing the region is strong credit growth in the back drop of high inflation. Inflation essentially acts as a noise factor in the resource allocation process and results in misallocation of resources to sectors with the highest inflationary profits (where inflation essentially creates the illusion of growth and profitability). At the present time, a move to a more flexible exchange rate will not address the issue of high inflation. A more flexible exchange rate (simply adjusting the peg serves no purpose whatsoever) will result in sharply higher interest rates even if the aim is to merely move to marginally positive real rates. In a banking centric economy (as opposed to a capital market centric one), such a sharp rise in interest rates will constraint funding to all sectors of the economy significantly.

Flexible, market based exchange rate regimes are beneficial to the countries that use them, and do promote better resource allocation in the long run. There is no doubt that a more flexible regime is beneficial for regional economies, but it is not the solution for current inflation. Experts proposing (even encouraging) abandonment of the pegs as a solution to the current inflationary spiral are anything but. As the US Dollar inevitably weakens in the months ahead, ultimately currency regimes in the region will undergo a change. The best bet is the adoption of a reference currency basket for managing the domestic currencies. However, the instruments needed to move to a more flexible regime are not in place in all markets at present; the introduction of these instruments will give away the impending change before it actually happens.

Bottom Line

All of the above makes for an excellent setup right ahead. The much awaited volatility is upon us, as we participate enthusiastically in the gyrations of global capital markets. It will perhaps take a couple of quarters before the dust settles, and there are no bonus points for being a cowboy in the interim. The anticipated correction in the commodity complex (led by oil) should provide a great buying opportunity for equities in the region.

The fundamental story is intact, though sadly fundamentals count for little in the short run; sentiment reigns over daily, weekly, and even monthly moves. Investors are well advised to use market upticks (inevitable after the severity of the recent fall) to shift focus to plays on domestic growth and demand. The commodity players appear vulnerable as long as the focus remains on slowing economic growth in the developed world. Banks in the region present a challenge, as some players clearly are feeling the impact of a more risk averse world on their investments (even without exposure to sub-prime assets). Investors should focus on a limited number of well capitalized banks trading at the cheaper end of valuations (PE ratios for banks do not mean much-focus on book value). In terms of markets, Egypt is clearly vulnerable in the short run as its linkages with the emerging market universe are tighter than the rest of the region. Saudi Arabia is hostage to the oil price in the near term. If our view is correct on oil, then the Saudi market will present a better buying opportunity. Qatar on balance still looks interesting, though valuations are not that exciting.

Attempting to do the impossible and present a broad road map for the year, we believe investors should spend the next couple of quarters amending their portfolios before participating in market strength in the latter half of the year.

We wish all our investors a happy and prosperous 2008.

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