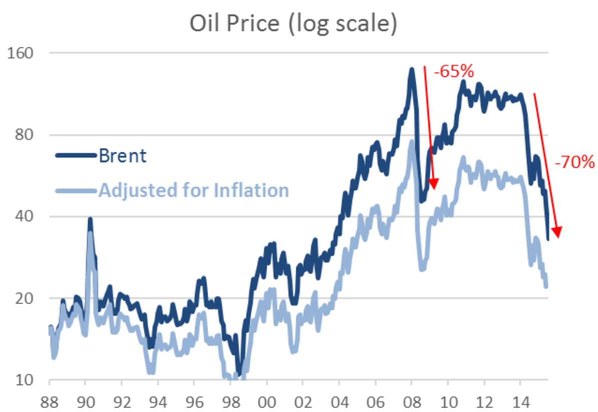
Is this the "New Normal" for the GCC?

January 2016

Equity markets (both global and regional) and oil have started off 2016 on a very weak note. This comes after a weak 2015 when oil was already down -45% and GCC equity markets by around -15%. With recent declines, a barrel of Brent today sells for less than during the 2008 global financial crisis.

As can be seen on the oil price chart below, the current nominal price of around US$ 30 per barrel of Brent is low compared to history, and even more so when adjusted for inflation. So the question is: when will oil price recover and how far can it recover?

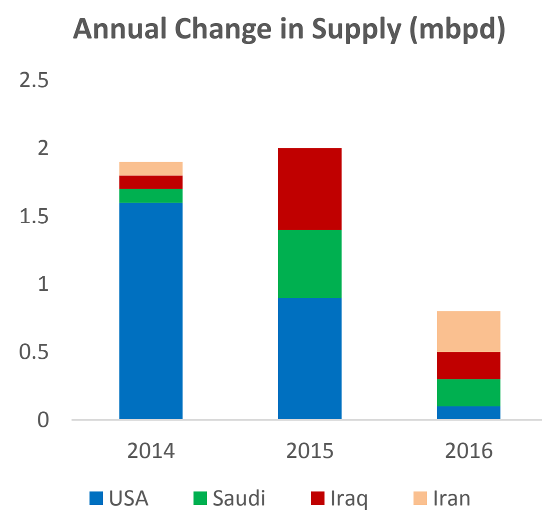


Source: Amwal, Bloomberg.

Understanding Crude Oil Supply

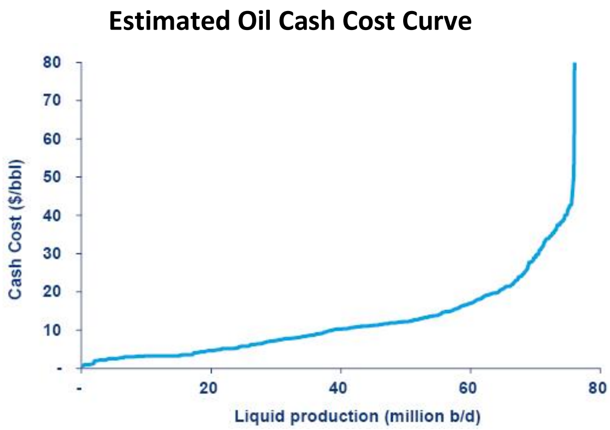
As with any commodity, crude oil's price is driven by demand and supply. Oil's demand growth has remained in a predictable 1 to 1.5 mbpd range over the past several years, with a slowdown currently expected due to a weakening Chinese economy. On the other hand, supply growth has proven far harder to forecast, driven as it is by OPEC policy, fast changing technology particularly related to shale oil, geopolitics and capex cycles.

The chart below highlights key countries that contributed to recent supply increases, and the consequent oil price drop. In 2014, when oil price was still high, the primary increase in global supply came from the US, driven by rapid advances in shale extraction technology. In 2015, OPEC's decision to defend market share contributed to an increase in Saudi Arabia's supply, and the resulting oil price drop slowed down the pace of US supply growth.

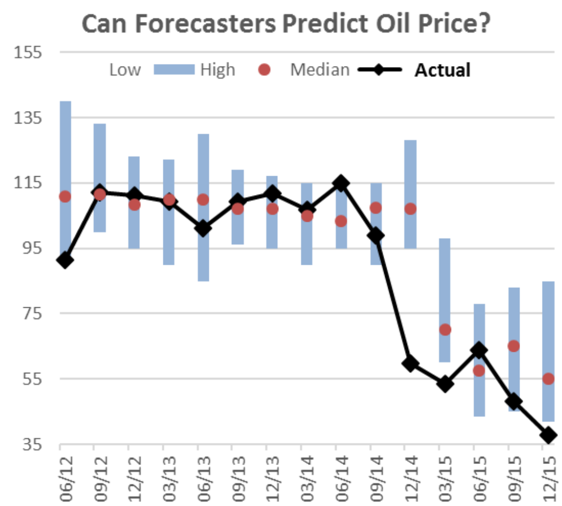


Source: IEA.

In 2016, three OPEC countries (Iran, Iraq and Saudi) are expected to be the primary contributors to supply growth. Iran's bullish statements indicate it could well surprise to the upside in 2016 and later. US supply is expected to stay largely flat in 2016, but this supply is sensitive to oil price both on the upside and downside. Several oil specialists are highlighting cash costs for some Shale producers above US$40 which indicate they may decide to shut down when prices are around US$ 30.



Source: BP, Wood Mackenzie Research.



What did forecasters get wrong?

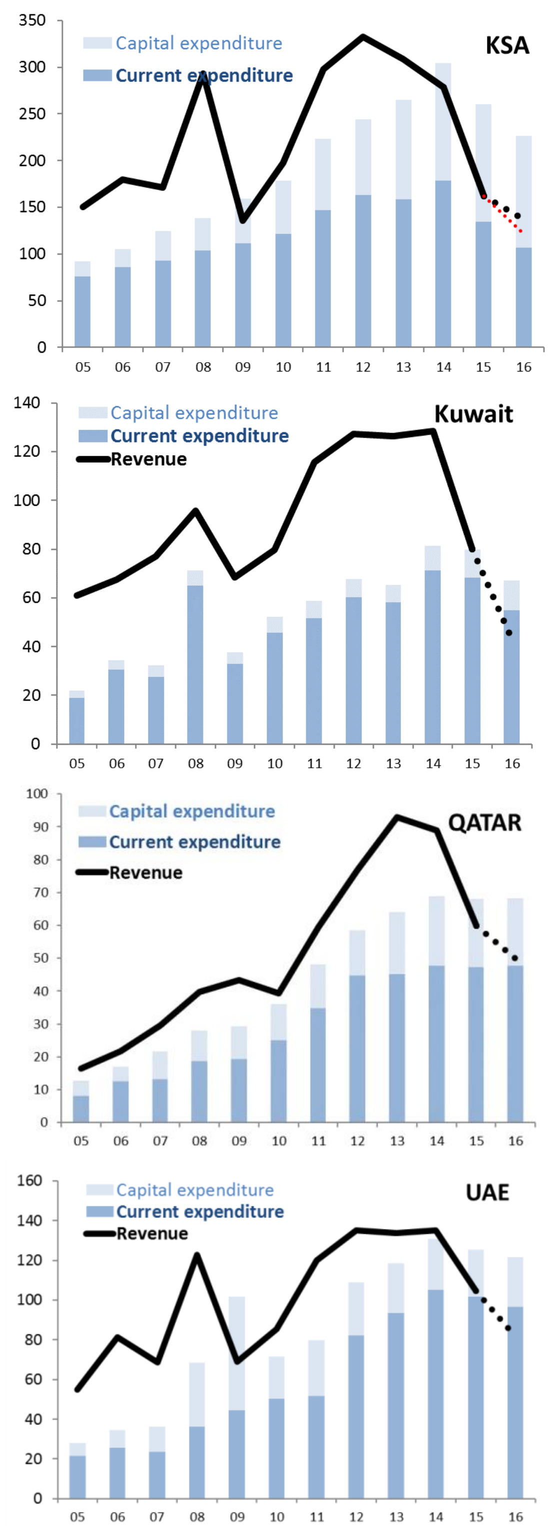
Comparing past analyst forecasts to actual subsequent oil price, we find that they missed to see the approaching drop in oil prices. For example, when prices started declining in early September 2014, the lowest forecast for yearend was US$ 90 per barrel of Brent versus actual yearend price of US$ 60. Similarly in 2015 even after a major drop, with rare exceptions, most analysts missed forecasting the initial drop to US$ 50 and then to US$ 30 per barrel. They revised their "forecasts" only after oil prices started to drop sharply, indicating that analysts are influenced by prevailing prices to a large degree. The question that follows is: if forecasters cannot predict oil, why do we pay so much attention to them? In our view what has been most difficult to predict was technological advancements which lowered cost of production and recent irrational moves by some producers to preserve market share at the expense of selling below costs. With oil price now below marginal producers cash costs, many industry experts now expect some producers to start shutting production.

How does this oil price outlook affect GCC economies?

Oil revenues on average make up around 75-85% of government revenues in the region. With revenues rising sharply over the past 10 years (ex 2015) leading to both higher current spending as well as investment spending by governments (between 2-4x) during this period. Now after the sharp decline in oil price, governments are starting to adjust their future spending plans.

We think after experiencing such a sharp fall, most GCC governments will take a much more conservative approach towards future spending, even if we see a partial recovery in oil price.

GCC Budgets in Charts (US$ bn)



Source: IMF, Central banks

Saudi was the first to adjust with announcements both in spending cuts and revenue increases in the form of reduced energy subsidies. This is already visible in 2015 public finances, and is expected to accelerate in 2016. Other countries have not yet announced any formal measures although the rhetoric points in that direction. Plans to introduce a GCC region wide VAT are finding increasing mention in the press.

Expect pain not capitulation

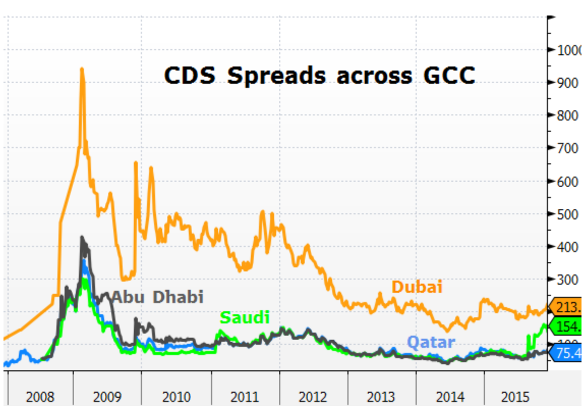
Most governments are making new budgets assuming an average oil price of US$ 45. Accordingly, there will be large deficits across all countries in 2016. Saudi government expects a deficit of around US$ 90bn, which will likely be around US$ 105bn if prices averaged US$ 35. Based on US$ 45 oil price assumption, Qatar's deficit will be US$ 15bn, UAE's around US$ 40bn and Kuwait's around US$ 15bn in 2016.

At US$ 45 oil price, Qatar and Saudi will have sufficient revenues to cover their current spending. UAE and Kuwait will be able to cover current spending budgets too with marginal adjustments. At sustained low oil prices, all the countries will need to make material adjustments to even current spending. Although we currently do not expect current prices to persist for long, one should not rule out structural changes that either make production cheaper or reduce dependency on oil.

In our view the most noticeable immediate impact of lower oil prices will be on investment appetite, both public and private. Once governments complete the committed and essential investment in infrastructure over the next few years, we expect them to (1) materially reduce capital spending, and (2) restrict such spending to only projects that make strong economic sense. We expect governments to focus initially on weathering the short term financing gap and then on increasing savings buffers for future sustainability, and corporates on international diversification. The investment burden may shift more to the private sector, and it remains to be seen how governments encourage private capital and risk taking.

Will governments withdraw deposits from local banks?

Another key question in our view is how short term government funding needs will be met. Governments have in the past deposited part of their budget excesses with local banks which currently account for between 12-40% of total deposits. So one immediate source could be these deposits. Additionally, there has been talks of issuing debt, and some of the assets in the sovereign wealth funds could be liquidated. We estimate total savings in Sovereign Wealth Funds to be in excess of US$ 2 trill in total compared with around US$ 200bn budget deficit in 2016. While a mixture of these are more likely, depending on oil prices, the amount needed could have an impact on local liquidity and interest rates.



Source: Bloomberg

What does all this mean for stocks?

While having an oil price outlook is an important first step, we believe it is crucial to accurately quantify the impact of this "new normal" oil price and future government budgets on company profits and stock valuations. These changes in turn will also affect consumer and business confidence over time.

At Amwal we group regional stocks into three categories based on their degree of impact from oil prices & future government spending:

(1) those directly impacted by oil such as chemicals, oil services, and transport;
(2) those impacted from likely change in future government spending such as banks, real estate and telecom; and
(3) those that are not much affected by either.

The tricky category is the second one which actually makes the bulk of the stock market, and require a more complex (likely a two or three stage discounted cash flow valuation) approach to valuation than a simplistic P/E valuation.

Chemicals are experiencing a double-whammy impact from lower oil price, directly with lower products prices and indirectly through government subsidy reductions in feedstock costs. There is limited rationale for the government to subsidize stock market investors at the expense of government budget which is now in deficit. On the positive side is these are all relatively easily quantifiable, so uncertainty over estimating future profits are lower after having a view on oil.

Banks: This is a relatively difficult industry to estimate full impact of lower oil prices, which in the GCC can be quite substantial. First, we expect loan growth to be lower as governments will cut spending. Additionally, there could be a liquidity squeeze if governments withdraw their deposits from banks. Regardless, interest rates will likely rise, hurting those banks that have a large interest rate mismatch (i.e. duration gap). Further ahead, after committed investment projects are completed, there will likely be materially less loan demand. On the positive side is, a bank's assets are liquid and can be re-deployed internationally, but risk-adjusted returns will likely be lower. The impact of these changes will vary by country. For instance, Saudi has low loan yields because they have cheaper deposit costs, so impact on them should be lower. Also Saudi banks have a lower loan to deposit ratio than other GCC countries. Other banks in the region will likely suffer a margin erosion unless they can diversify successfully. QNB for example has done a great job buying good assets at attractive valuations. Managing these acquisitions in countries materially different to Qatar and creating value will be a key challenge.

Telecom / real estate / logistics will see less demand as a slowdown in government spending will likely result in lower expat population, hence less customers, tenants and revenues. A key focus to us is estimating expat population working in government capital spending projects, who will likely leave the country once the projects are completed. UAE is likely better positioned with a sizable portion of their expat population there to stay beyond the building phase, although even they will likely see some impact.

Are any companies immune? Possibly a few but even they will be stress tested in such a low oil price environment, in our view. Some businesses which we thought had long term fixed contracts are seeing those contracts cancelled or renegotiated as customers are increasingly seeing low oil price akin to "force majeure".

At Amwal, our focus is on trying to accurately quantify the impact of this "new normal" environment on each stock in our investment universe, and then pick those that still hold value. Stocks have been on a declining trend for the last 18 months so several have priced in much of the lower profitability prospects. Also important will be to monitor government appetite for reforms. In our view governments could make material economic progress with reforms in productivity, keeping more spending in the country/region and by looking to produce more from the natural resources. For example, a recent McKinsey report on Saudi Arabia suggests only around 60% of natural resources are exploited in some segments. Additionally, we will be eyeing government intentions to make the region more attractive for tourism. Warm climate and sandy beaches are national assets waiting to be monetized to offset at least some of the negative impact of low oil prices.

About Amwal

Amwal LLC is wholly owned by Sheikha Hanadi Nasser bin Khaled Al Thani, founder of the first regulated investment company in Qatar in 1998. Amwal LLC is authorized by the QFCRA and is a leading independent asset management firm serving institutional clients, family offices and high net worth individuals. The Amwal group has pioneered the Qatar financial services industry for over a decade, with a number of firsts to its credit, including the first to offer financial planning and wealth management, first mutual fund, first Islamic mezzanine private equity fund and first money market fund.

Amwal has received awards for Best Asset Manager in Qatar from EMEA Finance for four consecutive years (2011-4), Best Investment Bank in Qatar from World Finance (2012), and Qatar Deal of the Year from Islamic Finance News (2008). Qatar Gate Fund, managed by Amwal, was ranked the #1 equity fund in the MENA region ranked by 3-year returns in a report prepared by MENA FM (April 2013).

Contact Information

Afa Boran, CFA
Head of Asset Management

Prashanth Uppuluri, CFA
Portfolio Manager

Amwal Tower, 22nd Floor
West Bay, PO Box 494
Doha, Qatar
+974 4452 7777
am@amwalqa.com