

Saudi Arabia - new cornerstone to emerging markets

Saudi Arabia is the biggest and most influential member of the six-member Gulf Cooperation Council (GCC) that was created back in 1981 and whose member states' currencies are pegged to USD. In total roughly 50 mln people live in the GCC, around 700 companies are listed on the local stock exchanges and aggregate market caps stack up to roughly \$1 trillion with Saudi Arabia making up around 40% of that.

During the last couple of years Saudi Arabia has grabbed a lot of attention. Let me bring out 5 more important ones in the chronological order:

1. Firstly, orchestrating OPEC's all-out oil production war starting from September 2014 which later on resulted in the collapse of oil prices and the resulting demise of US shale oil with US losing 1 mln barrels/day of oil production. Two years later they have switched sides in this battle by strongly advocating for agreeing on first OPEC oil production cuts in the last 8 years during OPEC's next official meeting on November 30th. They have even gone as far as trying to include non-OPEC members like Russia, Brazil and Mexico in these talks.
2. Secondly, Saudi has been active militarily-wise both in Yemen and in opposing Assad's regime in Syria and regional-wide ISIS activity. At the same time tensions with its arch rival Iran have seemed to ease somewhat as Iran came out of international sanctions in the beginning of 2016.
3. Thirdly, Saudi Arabia has swiftly adopted National Transformation Program 2020 (NTP 2020) with the ultimate goal of greatly reducing its dependence on oil exports, increasing non-oil revenue at least 3 times and achieving a balanced budget even in the environment of today's depressed oil prices. Budget break even oil price has very quickly dropped from around \$100/barrel to around \$60/barrel.
4. Fourthly, in October Saudi Arabia successfully issued maiden \$17.5 bn of international debt (largest ever issue for an emerging market), which was almost 4 times oversubscribed, enabling them to reduce domestic liquidity crunch and pave way for additional debt issuances down the road and warm up investor relations for the impending IPO of 5%-10% of Saudi Aramco that's supposed to come to the market some time in 2017 or 2018 with total proceeds somewhere around \$100 bn for that stake sale making Saudi Aramco potentially the first trillion dollar public company in the world. Since Saudi's debt level is very low and forecasted to rise from 8% of GDP to somewhere around 30% by 2020 then investor interest has naturally been high for that debt.
5. Fifthly, Saudi Arabia has taken steps to standardise (moving settlement cycle to T+2 from current T+0 some time in 2017) and open up its stock market for all foreign investors and to become an important part of MSCI Emerging Market Index. The list of actual reforms (including implementation of GCC-wide VAT tax from 2018, cuts in subsidies and cancellations of one-off payments etc) goes on but I'll stop here right now.

Oil production and (re-)unification of OPEC

Most important development for Saudi Arabia and the whole of GCC is right now the reunification

process of OPEC oil cartel. it's pivotal that oPEc follows through on its promise to formally announce production cuts during their November 30th meeting. Despite abundant skepticism that OPEC is „dead“, unable to agree on production cuts and without any control over the oil markets I hold a different view. When it comes to an oil cartel that controls 1/3 of global energy markets one should never underestimate its true pricing power, especially when they're starting to feel the effects of low energy prices in their everyday activities and finances.

Even without any cuts to oil production the oil market has by now almost entirely worked through the market overcapacity and declining energy sector capex for the third year in a row almost guarantees higher prices to come due to underinvestment. But right now it seems that oPEc and Saudi Arabia are keen on hastening the oil market balancing process and re-rating of energy prices to some extent.

MSCI Emerging Market index

Most likely Saudi Arabia will be put under review for MSCI Emerging Market classification during MSCI's semi-annual review in May 2017. If equity market reforms proceed as planned then it's very likely that this review will end with a positive decision in May 2018 with inclusion becoming effective in June 2019. Saudi Arabia will likely form ca 3%- 5% of MSCI Emerging Market index depending on new listings to come in between and the degree of openness for the entire Saudi stock market. Since Qatar and the United Arab Emirates are already in the MSCI Emerging market index with a total combined weight of roughly 1.7% then in 2.5 years the GCC will start to form more than 5% of global emerging markets resulting in huge both active and passive investor fund inflows.

SEF-LHV Persian Gulf Fund

Luxembourg-domiciled SEF-LHV Persian Gulf Fund has been investing in GCC equity markets since 2008. The fund is long-only and fully hedges USD currency risk to get the underlying equity markets performance in EUR terms.

The main objective of the fund is to benefit from the long-term trend of energy rich GCC countries pumping out their energy reserves and investing it back into the diversification of their local economies - therefore the bulk of fund's investments are in financials, industrials and business services companies. GCC countries own 45% of world's oil reserves and 20% of world's natural gas reserves.

As of end of October fund portfolio's single investments traded at weighted average of just 9.2x twelve month forward looking earnings, 1.1x trailing book value and offered 4.7% dividend yield. Valuations haven't been this cheap in the region since the financial crisis of 2008/2009. This means that any return of investor confidence in the region will likely result in meaningful rally in GCC across all risk assets.

Picture: (c) Andrew-V-Marcus—shutterstock.com