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Ashmore

Middle East braced for lower oil prices

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We focus on the impact of the recent fall in oil prices on the Middle East. It's not a straight-forward picture and we explain why. We report on other major changes across the Emerging Markets (EM) universe and also discuss the very negative sentiment in the global markets. Poor market sentiment, weaker growth in Europe and other negative events increasingly call into question the stated commitment by the Fed to raise rates.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	985	–	-2.46%
MSCI EM Small Cap	1,032	–	-2.99%
MSCI FM	684	–	-1.79%
GBI EM GD	6.60%	–	0.41%
ELMI+	2.97%	–	0.20%
EMBI GD	5.35%	302 bps	0.32%
EMBI GD IG	4.43%	206 bps	0.52%
EMBI GD HY	7.46%	531 bps	-0.05%
CEMBI BD	5.22%	315 bps	0.05%
CEMBI BD HG	4.31%	222 bps	0.32%
CEMBI BD HY	7.24%	520 bps	-0.53%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1906	-2.94%
VIX Index	21.24	37.39%
5 year UST	1.53%	-16 bps
10 year UST	2.28%	-14 bps
US HY	6.51%	-1.05%
European HY	5.21%	-0.53%
EURUSD	1.2677	0.65%
USDJPY	107.46	-1.35%
Brent	88.21	-4.28%
Copper	313.61	1.50%
Gold	1229.19	1.76%

Additional benchmark performance data is provided at the end of this document.

Emerging Markets

When oil prices drop, the obvious question is: how will the Middle East fare?

The short answer is that differentiation is essential, because not all countries in the region feel the same revenue pinch. But the full answer is more complex. Oil importers, for example, are also affected.

Starting with the oil exporters – Kuwait, Qatar, Saudi Arabia and the UAE are fiscally robust. Within this group, some require a higher break-even price (oil revenues minus annual expenditures) than others. For 2014, we estimate that Qatar has the lowest break-even price at USD 58 per barrel (Brent crude), followed by Kuwait at USD 68 per barrel, UAE at USD 86 per barrel and Saudi Arabia at USD 92 per barrel. Still, Saudi Arabia will sustain a respectable surplus in 2014. At the point of writing, Brent crude is trading at USD 88 per barrel.

The next consideration is fiscal buffers. The Gulf oil exporters sit comfortably on very strong balance sheets in the form of large Sovereign Wealth Fund (SWF) assets. Saudi Arabia's foreign reserves cover an estimated 35 months worth of imports. The traditional 'rule of thumb' for reserve coverage is the equivalent of 3 months of imports.[1] All central banks and SWFs have accumulated substantial foreign reserves, mostly invested abroad, that would provide secure income for future generations.

In recent years, substantial domestic investments to raise physical and human capital capacity have been implemented. It is often forgotten that since the early 1980s and through the early 2000s, the level of domestic investment was low due to low oil revenues. Much of the capacity building has been compressed within a decade to 'catch up'. To outside observers this may appear to be profligate and inter-generationally disruptive spending, but domestic investment across all the Gulf oil exporters has been a very important and deliberate strategy to diversify economies. The mandate of one of Abu Dhabi's government agencies to help diversify its economy is a good example: the focus is to manage long-term, capital-intensive investments intended to deliver strong financial returns and tangible social benefits for the country.

Many are ready to ring the fiscal alarms unwittingly, but few take sufficient account of the role of policy makers and institutions. The region possesses both the knowledge and institutions to manage lower oil prices. Lower oil prices will be a boon for those policy makers who have over the recent past been calling for greater efficiency and prioritisation in spending.

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[1] See for example http://www.imf.org/external/pubs/ft/survey/so/2011/POL040711B.htm

Emerging Markets

Now is the time for regional policy makers to 'walk the talk' about fiscal discipline. We expect sensible responses if the drop in oil prices becomes more protracted. Policy makers are likely to gradually slow down the pace of fiscal expansion while tapping into reserves. The most probable direction of travel – and the most prudent – would be to contain fiscal outlays. Reserves will only be used during the really rainy days of substantially lower oil revenues for the Gulf oil exporters.

It is worth remembering that the current oil price environment merely takes us back to two years ago, not to the dark ages of the early 2000s when oil prices were below USD 25 per barrel.

The bottom line is that even with oil averaging USD 80 per barrel, the robust Gulf oil exporters will do well. Instead of concentrating all capital expenditure in a few years, most Gulf economies will spread spending over longer periods which allows for efficiency and productivity gains.

Fiscal spending for various social programs was scaled up in response to the 2011 Arab Spring. We don't expect any social spending (e.g. unemployment benefits, nationalisation of the workforce, social housing, SME financing) in response to the 2011 Arab Spring to be curtailed in Saudi Arabia or in any of the Gulf countries. In Saudi Arabia's case, the money for social spending has already been allocated from a budgetary perspective. We don't believe that there will be any shift in the Gulf countries ability to combat Islamic State or their commitment to root it out from the wider region.

Away from the Gulf, the Middle East oil exporters who are most exposed in an environment of declining oil prices are Algeria, Iran, Iraq and Libya. None of these countries possess deep fiscal buffers to make necessary corrective moves in due course. With the exception of Algeria, none possess sizeable foreign assets to tap into. In Algeria, the fiscal balance as a percentage of GDP has been negative since 2009. This is also the case for Iran since 2011. Libya's fiscal deficit is estimated to be the largest in the Middle East this year, and Iraq is expected to have a deficit in 2014, the second in a row. Break-even prices range from USD 140 per barrel in Iran to USD 108 per barrel in Libya. Not all of them are equally vulnerable at the end of the day. Political instability and lack of institutional depth in Iraq and Libya could put a dent on fiscal resilience and create wider centripetal pressures. The role of the state in both Libya and Iraq is at best tenuous. Historically, Algeria and Iran have demonstrated greater resilience during previous times of crisis.

Fig 1: **Break-even oil prices and foreign assets**

Country	Break-even oil price in USD	Foreign assets as a % of GDP
Saudi Arabia	92	98
Algeria	125	105
Iran	140	45
Iraq	111	3
Kuwait	68	165
Qatar	58	105
UAE	86	145
Libya	108	145

Source: IMF, Ashmore Group

The Middle East also has a substantial number of oil importers. For those economies, lower oil prices are fiscally positive in some ways and will improve current account balances too. But the picture is not entirely unambiguous. Most oil importers have benefited from the 'windfall' in the Gulf oil exporters by receiving bilateral aid and grants (particularly in Bahrain, Egypt, Jordan, Lebanon, West Bank and Gaza, Sudan, Morocco and Yemen). There have also been substantial private investments and remittances into the oil importing states from the Gulf. We estimate that some USD 34bn was remitted in 2013 from Saudi Arabia, while in percentage terms Qatar's remittances abroad as a share of GDP were among the highest in the world. We estimate that since 2011 more than USD 25 billion was disbursed in financial assistance to non-oil exporting Middle Eastern countries from Saudi Arabia, the UAE and Qatar. Hence the dependence of the non-oil exporters on the oil exporters in the Middle East is vast. It is important to recognise these linkages: Some oil importers struggle with weak confidence, which hampers growth and job creation. Thus, growth in the Middle East oil importers was only running at a rate of 3% in 2013, which is substantially below their trend growth rate of 5%. To the extent that commodities prices soften more broadly, this will also adversely impact countries such as Jordan (via lower potash and phosphates mining revenues) and Morocco (phosphates).

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Emerging Markets

EM snippets:

- Brazil: Several polls released over the past week point to a growing lead for opposition Senator Aecio Neves ahead of the 26 October presidential election. Polls early in the week showed a small lead for Neves over Rousseff – 46% of total votes for Neves compared to 44% for Rousseff – but polls released later in the week showed a larger lead of 52% versus 37%. Vanquished first-round contender Marina Silva threw her weight behind the Neves campaign over the weekend. She consistently polls in the low 20s.

- India: RBI governor, Raghuram Rajan, stated for the first time the government's intention to remove foreign investment limits to the Indian bond market. The expected timing is related to the economic cycle: India will try to open the bond market once the economy has returned to equilibrium (the economy is experiencing an upswing). Services activity rose to 51.6 in September from 50.6 in August. This follows a rise in manufacturing PMI as well in the month of September. India's cyclical upswing is aided in part by optimism about removal of bottlenecks in the economy by the government. Still, once this becomes more pronounced India will need to address deeper structural impediments to growth.

- Ukraine: Fears in some quarters that Ukraine would not provide Dollars for Naftogaz to repay a maturing bond proved unfounded. Naftogaz paid in full. Three way talks over gas between Russia, Ukraine and the EU are set to take place in Berlin on 21 October. Rebels in Eastern Ukraine stated that they were ready to sign an agreement to establish dividing lines between them and Ukrainian government troops in Donetsk.

- China: Services PMI sustained a healthy pace in September, though the pace moderated somewhat from August. HSBC's services PMI was 53.5, well into expansion territory, compared to 54.1 in August. Manufacturing is more sensitive to cycles in final demand than services due to the larger role of inventories. Exports rose strongly in August to 15.3% yoy, while the pace of imports also rose strongly at 7% yoy. High levels of both imports and exports point to healthy levels of economic activity overall. It was announced over the weekend that the European Central Bank is considering adding RMB to its list of reserve currencies. The ECB actually holds very few reserves; they are mostly held with member central banks. Even so, we expect China's currency to become one of the major global reserve currencies within a small number of years.

- Philippines: CPI inflation moderated sharply from 4.9% in August to 4.4% in September. Base effects should now kick in and bring down inflation more decisively during the remainder of this year. Falling oil prices are also having a powerful positive effect on inflation. The target range for inflation of 3-5% is now easily achievable. Next year the target narrows further to 2-4%. The central bank is likely to maintain a moderately hawkish stance to achieve this target. Exports rose more than expected in September: 10.5% yoy versus 8.1% expected.

- Malaysia: Both imports and exports rose more than expected in August. Exports were up 1.7% yoy (vs -1.4% yoy expected) and imports rose 7.65 yoy (versus 0.4% expected). Strong imports signal healthy domestic demand and the composition bodes well for growth: capex related imports rose 26.3% mom sa. Better exports suggest that Malaysia has a competitive edge versus other countries in the region, particularly in the energy sector. Industrial production in September rose 6.5% yoy versus 5.1% yoy expected. Unlike many other countries in the world, Malaysia's government last week upgraded its estimate for GDP growth in both 2014 and 2015.

- Russia: Foreign holdings of Russian OFZ bonds have proven extremely resilient despite the political row between Russia and the West over Ukraine. Foreign holdings of OFZs fell by less than 1% between 1 July 2014 and 1 August 2014. Russia announced that it moving forward with a 40-year accord for supplying gas to China. President Putin on Saturday ordered the withdrawal of more than 17,000 troops from drills in the region near the Ukraine border.

- Turkey: The government formally launched its medium term economic program. The program envisages lower growth in both 2014 and 2015, but embeds expectations of a strong pickup in consumption and investment next year. This seems reasonable. President Erdogan is focused on generating a landslide victory in next year's parliamentary elections in order to be able to effect constitutional changes that can vest more power in the presidency. Also realistic therefore is the massive upwards revision of the inflation target from 5.3% to 9.4% for 2014, though there is a healthy dose of optimism embedded in the expectation of just 6.3% inflation next year. As discussed last week, the program also envisages reforms, but puts the bulk of them after next year's election, when arguably they would be more useful if they had been implemented yesterday. Industrial production rose 5.2% in September versus 5.7% expected.

- Hong Kong: Pro-democracy protest leaders and government officials in Hong Kong began formal negotiations on Friday.

- Poland: The central bank surprised the market by cutting rates by 50bps to just 2%. Central bank governor Belka did not rule out further cuts. The Polish 10yr bond now trades at yields below the level that prevailed just before last year's Taper Tantrum. Of course, the situation is somewhat different. US treasury and Eurozone yields are now much lower than last year, testament to the market's failure to appreciate the underlying

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Emerging Markets

weaknesses in the US and other developed economies and therefore over-reacting to the tapering announcement. Within EM the situation is also different. The JP Morgan GBI EM GD index today trades at a yield of 6.6%, far above last year's level, and above the average yield level that has prevailed since 2009, indeed close to the levels that prevailed before the Greenspan Bubble burst (and at spreads that are nearly twice as wide).

- **Venezuela:** ICSID, the World Bank's arbitration panel, ruled against Venezuela in the ExxonMobil nationalisation case. In a verdict that some might say screams "crime pays!", Venezuela was ordered to pay a mere USD 1.2bn (including interest, money already paid, etc.) compared to ExxonMobil's original claim of USD 16.5bn.

Global backdrop

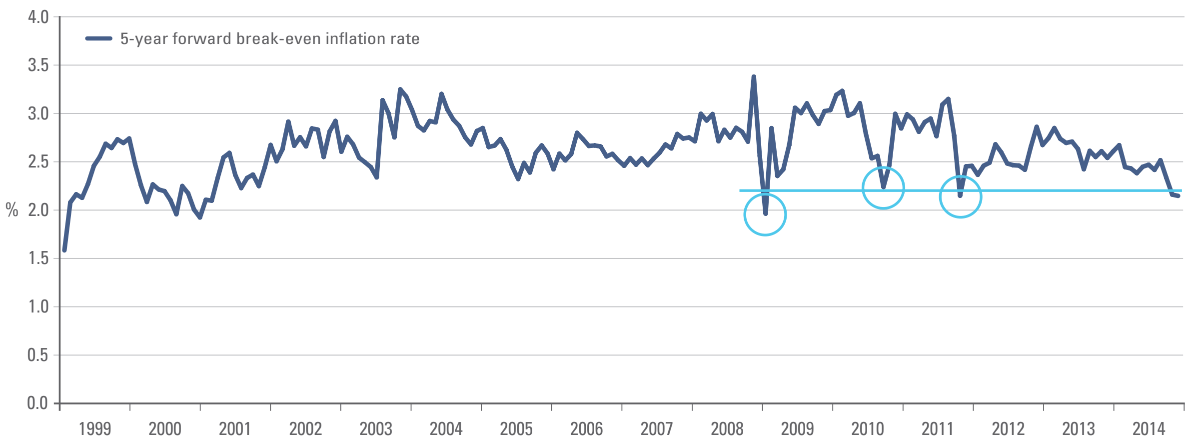
Fed officials spent the last week reiterating their intentions to hike rates next year and the market responded accordingly: The economy is nowhere near being able to handle tighter money, and, besides, hot money has been the major driver of asset price inflation since 2008/2009. Hence, it is fitting that asset prices in developed economies should fall when the main source of upside – easy money – is at risk of going away.

This year's market dynamic has some similarities with last year's attempt at tapering. Last year it was mortgage markets that caved in. This year it is the stock markets and US high yield markets that have taken the brunt of the pain.

What are the odds of a softening of the Fed's policy stance? Pretty high, in our view. Every time US inflation expectations have dropped below 2.2% since the bursting of the Greenspan Bubble the Fed has eased as the chart below slows. The specific occasions were late 2008/early 2009, when the Fed gave us QE1, late summer 2010, when we got QE2, and in autumn 2011 when the Fed launched 'Operation Twist'.

Fed Vice-Chairman Stanley Fischer said over the weekend that weaker foreign growth could lead the Fed to remove accommodation more slowly. Other Fed officials have also recently commented on the growth outlook and effect of a stronger Dollar on the US economy

Fig 2: **US 5-year forward break-even inflation rate**



Source: Ashmore, Bloomberg.

What would a Fed U-turn look like today? A softer message on hikes, change in dots? Perhaps even a pause in tapering? Hard to tell. One source of confusion is that the Fed's position now appears extremely confused. The 'dots' were unambiguously hawkish, but the FOMC minutes from Wednesday were clearly dovish. Where exactly do they stand? The market is less confused. And the negative momentum is being stoked by weaker German data, which prompted the IMF to pronounce a 40% chance of an EU recession. The German business cycle appears to be going through a trough with industrial production falling 4% in one month (August), which puts it nearly 3% lower than at the same time last year.

The silver-lining is that ECB does have a big arsenal, which it has not begun to use yet. Sure, policy rates are already zero and the ECB has announced it will buy EUR 1trn of ABS through targeted LTROs. But it has not actually started to buy yet. The only policy option available to western economies is to print more money to help push asset prices higher. But central banks cannot fix the economy. This requires political will, but there is none, because Western politicians are lame ducks, who have realised that there is more mileage in pursuing xenophobic policies and engaging in foreign policy than in doing reforms at home. Investors beware!

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Global backdrop

Ever more inflated assets prices in countries with weak fundamentals can be exciting for short-term gamblers, but does not offer value for long term investors who care about protecting the purchasing power of assets over longer time horizons.

Talking about weakness, the Bank of Japan revised down its forecast for the economy, particularly for industrial production and consumption. Smaller businesses have begun to express concern about the weak JPY, which increases the cost of imports.

As for EM, it merely gets pushed about by the changes in risk sentiment in the market, but EM bond markets have actually priced in most of what the Fed is likely to throw at the markets in the foreseeable future. Still, it is never fashionable to buy EM when it is cheap, even if it makes a great deal of sense. Thus, the global market place is still trading EM as if it depended on an easy Fed. This is fundamentally wrong. EM experienced the equivalent of a 200bps rate hike in last year's sell-off and withstood the shock very well (though investors were far more fickle than fundamentals, as always). Investors really ought to be more concerned about what monetary policy normalisation will do to the heavily indebted developed economies.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.9%	1.0%	0.3%	6.3%	3.7%
MSCI EM Small Cap	-2.9%	6.1%	5.5%	9.4%	6.1%
MSCI FM	-2.3%	19.5%	26.4%	17.1%	7.3%
S&P 500	-3.29%	4.78%	14.94%	19.38%	14.58%
GBI EM GD	1.02%	1.02%	-2.12%	1.44%	4.19%
ELMI+	0.06%	-1.65%	-2.69%	0.44%	0.73%
EM spot FX	0.10%	-5.48%	-8.29%	NA	NA
EMBI GD	0.54%	8.61%	9.13%	8.04%	7.77%
EMBI GD IG	1.11%	9.20%	8.87%	6.47%	6.61%
EMBI GD HY	-0.51%	7.57%	9.83%	10.65%	9.55%
5 year UST	1.18%	3.23%	2.30%	1.47%	3.55%
7 year UST	1.60%	6.14%	4.40%	2.25%	5.02%
10 year UST	1.98%	10.20%	8.00%	3.12%	6.02%
CEMBI BD	0.39%	6.66%	8.26%	8.43%	7.33%
CEMBI BD HG	0.69%	7.54%	8.70%	7.36%	6.96%
CEMBI BD HY	-0.23%	4.80%	7.34%	11.26%	8.50%
US HY	-0.29%	3.44%	6.49%	11.49%	10.95%
European HY	-0.30%	4.58%	8.17%	17.23%	12.99%
Barclays Agg	0.79%	2.44%	2.13%	1.31%	2.76%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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