Ashmore

# Oil prices and the GCC: The resilient and the less so

By John Sfakianakis

**Earlier this year we published a paper to describe the investment opportunities in the Middle East.[1] We touched on the significant developments in the region, especially in the areas of social reform, economic development and even conflict. We also talked briefly about the implications for oil prices on the economies and stock markets. Given recent price moves in oil, we would like to provide you a more specific view on what the 'new normal' oil price levels mean for the region.**

The Gulf economies have experienced the longest period of economic growth and prosperity since the advent of oil. The third economic boom lasted longer than the first oil boom in the early 1970s and the second one in the early 1980s. With oil prices down to levels observed in 2007, many have questioned the sustainability of growth in the Gulf economies. Our view is that oil prices have been exaggerated on the downside and will begin to recover in 2015 and beyond, as Emerging Markets (EM) economies make a strong comeback, the US and China continue to show solid growth prospects and Europe and Japan recover. The downtrend in oil prices has actually found most Gulf economies in a strong fiscal situation; however, some are more resilient than others. Qatar, Saudi Arabia, the UAE and Kuwait are able to withstand short and medium term pressures due to high fiscal reserves and assets. For Qatar, Saudi Arabia and the UAE we don't expect any of the announced and undertaken mega projects to be delayed in the foreseeable future. Most of these projects have received generous allocations that will offset any oil price decline in the short term. Fiscal spending would be sustained for some time as it provides necessary confidence and multipliers for the private sector.

Reserves would serve the purpose of stimulating capital expenditures just as both Saudi Arabia and the UAE did in 2009. For the less resilient economies such as Oman and Bahrain, a reduction in capital expenditures is not expected immediately, but what is more likely is for some outlays to extend over longer periods of time. The issuance of debt is an option both states would take given that credit markets are still attractive. Regional equities have been highly correlated recently to declining oil prices and all equity markets in the Gulf have been correlated to each other. Policy makers will keep in mind that any extreme cuts in fiscal spending could have negative effects on regional equity markets – particularly as Qatar and the UAE are now part of the MSCI EM Index and Saudi Arabia is expected to open its market to foreign investors in the first half of 2015. Policy makers are also cognisant that investor confidence is of paramount importance and although they will all try to apply some sort of fiscal discipline, actions are likely to be measured and gradual. Budgets are an obvious gauge for the business communities of each state and some will have to curtail spending over time, albeit enough to cause significant declines in output.

## In the face of lower oil prices, we believe GCC equity markets will present compelling investment opportunities once the dust settles

Downside risks to headline growth numbers could be impacted if the Gulf oil producers institute oil production cuts. We believe this is something they seem less inclined to do at the moment, though it could prove essential for an upward movement in 2015. For example, in the short term, Saudi Arabia naturally reduces its oil output in the winter months as electricity demand falls. However a more meaningful output reduction would impact real GDP figures.

The currencies of the Gulf States that are pegged to the USD (except Kuwait, which follows a restricted floating policy which in itself closely follows the greenback) are currently net beneficiaries. A stronger USD translates into stronger purchasing power, albeit along with lower state oil revenues. Issuing debt is an option that could be coupled with tapping into reserves. The option of debt issuance is important as it diversifies the options of budgetary financing and also doesn't burden the liquidation of reserves and/or regional Sovereign Wealth Funds. Interest rates are still opportune and the macro-fiscal environment in the region is conducive. Credit markets have remained solid despite the sharp decline in oil prices. Bond yields and credit default swap prices in Saudi Arabia, the UAE, Kuwait and Qatar have not risen sharply, suggesting little stress on financial systems. As opposed to 2008, moves in foreign exchange forwards markets do not indicate major pressure on Gulf economies' currency pegs to the dollar, in our view.

Privatisation and greater deleveraging of the state from the economy is an ongoing policy shift which is encouraged. Broad based changes in energy and fuel subsidies are important and recent upward price moves in Abu Dhabi as well as Qatar and Kuwait are on the right path. Saudi Arabia continues to review its future energy regime as costs outweigh any long term benefits.

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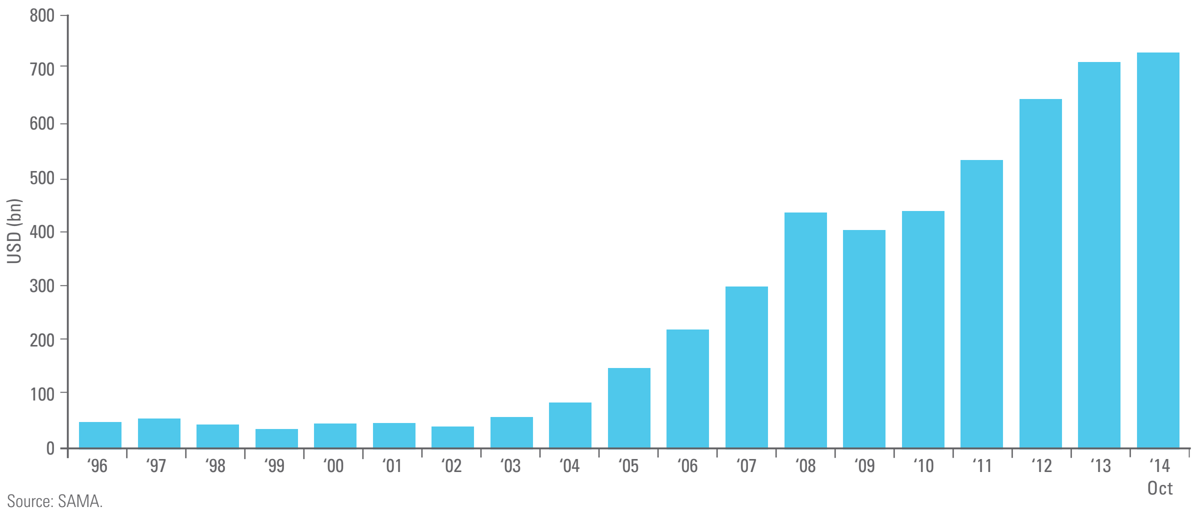
[1] *Saudi Arabia: A USD 560bn opportunity*, Occasional View, 5 August 2014.

## Saudi Arabia

Saudi Arabia has the highest budget breakeven price amongst the resilient Gulf economies and, at USD 101, the breakeven price is not sustainable in 2015 even if oil prices are exaggerated on the downside. Since 2005, budgetary outlays have increased by an average of 12% which pushed breakeven prices higher. However, Saudi Arabia has the fiscal buffers and official reserves (at USD 734bn) to sustain a deficit for 2015 even if its fiscal breakeven is in the low USD 90s.

Figure 1: **Saudi Arabia foreign assets**



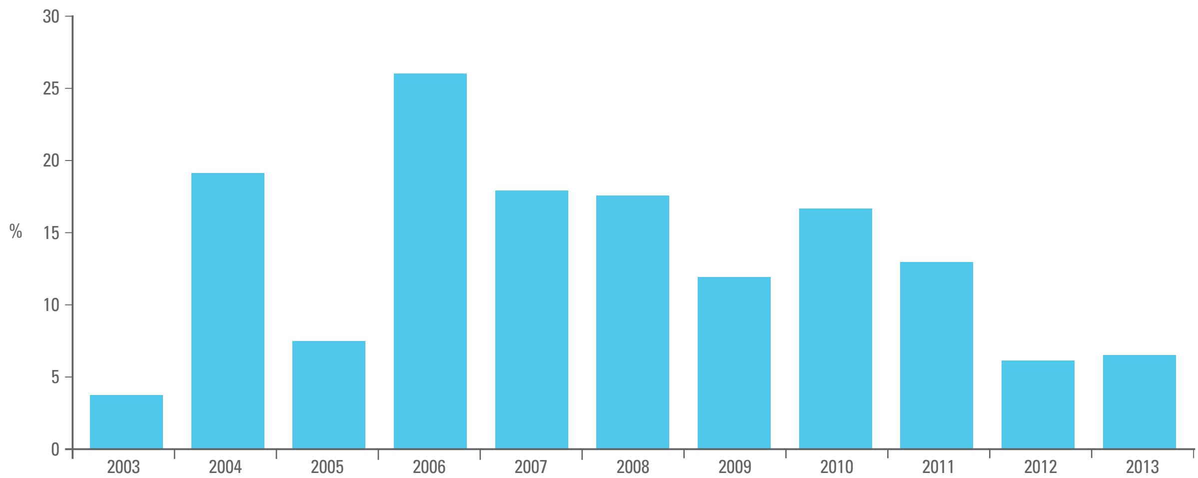

Source: SAMA.

Saudi Arabia can sustain high spending at above USD 90 with an annual budgetary increase of 5% and would still take a decade and a half to deplete its foreign reserves. We find this as a highly unlikely scenario as policy makers are aware of intergenerational equity issues. More importantly, most of the mega capital projects have been offset from previous surplus budgets and pose much less of a front-loaded challenge. The main risk is a prolonged downswing in oil prices at USD 30 over many years, which we find highly improbable.

## Qatar

With the government's fiscal breakeven for FY 2015 at USD 65 and enough firepower to withstand medium term price shocks, Qatar is one of the most fiscally resilient countries in the region and continues to benefit from very high growth.

Figure 2: **Qatar GDP growth rate**




Source: International Monetary Fund, World Economic Outlook Database, October 2014.

Around 50% of Qatar's hydrocarbon revenues are derived from the gas sector and liquefied natural gas (LNG) exports. As a result, Qatar is over the short term less vulnerable to oil price risks as long as Qatar's LNG continues to be sold on long-term contracts. As part of the country's '2030 National Vision' as well as gearing up for the FIFA World Cup in 2022, capital expenditure has been rising in 2014. We don't believe that a drop in oil prices will delay the completion of any of its infrastructure projects, at least through 2017, as most are part of the country's 2030 vision and at an advanced completion stage. Qatar's non-oil fiscal balance as a share of non-oil GDP has been falling since the global financial crisis and today stands at an estimated -45%. The Qatar Central Bank (QCB) can inject enough liquidity into the financial system – as it did during the height of the global financial crisis – through its daily repo operations and the government could achieve the same goal by managing allocations from its public enterprises and its wealth funds.

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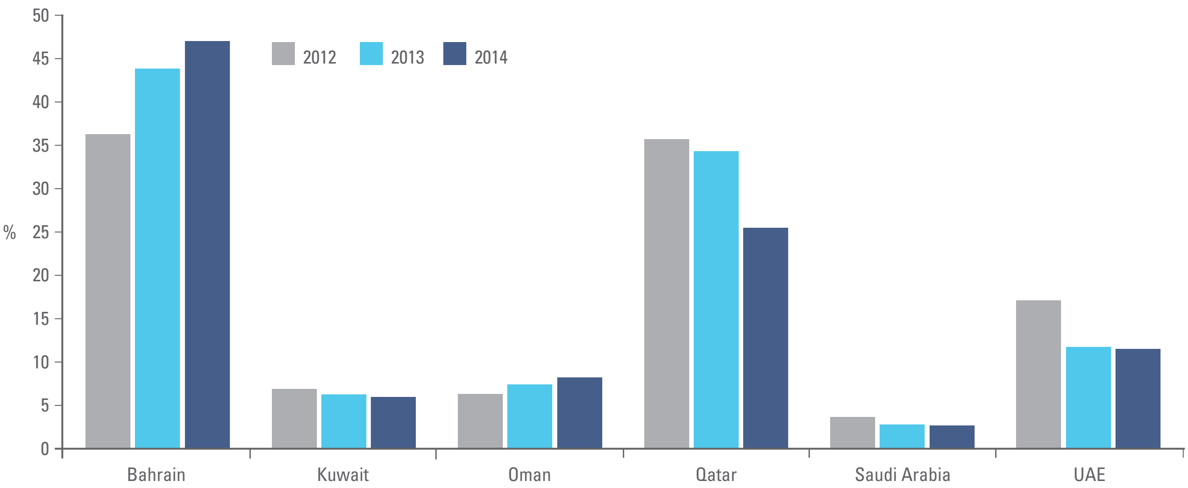
## Oman

In our view, Oman is among the least resilient Gulf economies in a downtrend oil price market as hydrocarbon revenues comprise 75% of total government revenues and expenditures have increased steeply over the past few years. Oman's breakeven oil price increased from USD 62 in 2008 to an estimated USD 101 in 2014. A sustained low oil price could force Oman to restrain spending in the short term as it would otherwise risk generating large fiscal and current account deficits. Import coverage stands at around five months – adequate over the short term but involving significant risks if oil revenues further decline from this point onwards. In 2015, Oman will likely post a fiscal deficit of around 5% which we believe is manageable over the short term through a combination of debt issuance and expenditure cuts of around 20%. Its debt to GDP ratio stands at 7.3% as at 2013 which allows it room to expand over the short term.

The government has stated officially that it could tap the Islamic bond market to cover any fiscal deficit in 2015.

Figure 3: **Debt to GDP**

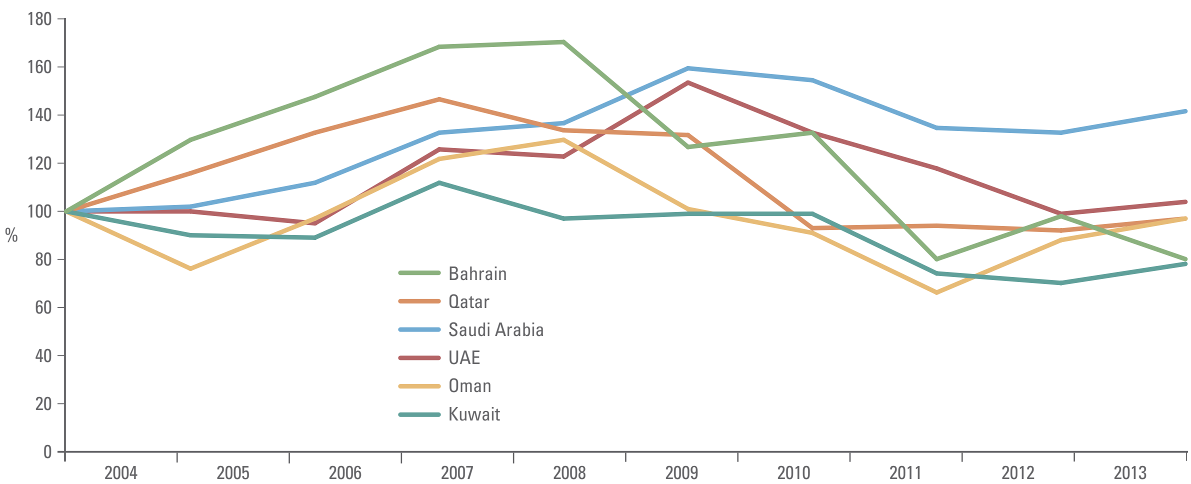



Source: International Monetary Fund, World Economic Outlook Database, October 2014.

## Kuwait

We believe that the country's fiscal resilience is among the best in the region. Kuwait's breakeven for the 2015-2016 budget has been targeted at USD 55, down from USD 75 in the 2014-2015 budget. The announcement of Kuwait's USD 20 drop in its fiscal outlays came at the midst of the recent oil price slump which highlights the country's flexibility. Historically Kuwait has been running large fiscal surpluses as expenditures on the capital side of the country's balance sheet have always remained moderate.

Figure 4: **GCC total investments as % of GDP (2004=100)**




Source: International Monetary Fund, World Economic Outlook Database, October 2014.

As a result, it has built a formidable foreign asset base over the last few years. Against the backdrop of falling oil prices, Kuwait in 2015 would still be in a position to sustain a fiscal surplus of 7% and a current account surplus.

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## Bahrain

At USD 125 fiscal breakeven, Bahrain remains in our view the most vulnerable and is less resilient to downside oil price pressures despite the fact that its GDP is almost two-thirds derived from non-oil economic activities. Government revenue on oil derived products is still high. Nevertheless, we expect that Bahrain will continue to be regionally supported, directly or indirectly, as it's too important to fail. Some USD 10bn of direct support has been promised to Bahrain via the GCC Fund. Given prevailing oil price conditions, we expect already a fiscal deficit of 5.7% for 2014 and 7.8% for 2015. As a result, we expect Bahrain to continue to push ahead with its diversification efforts in the wider services sector.

## UAE

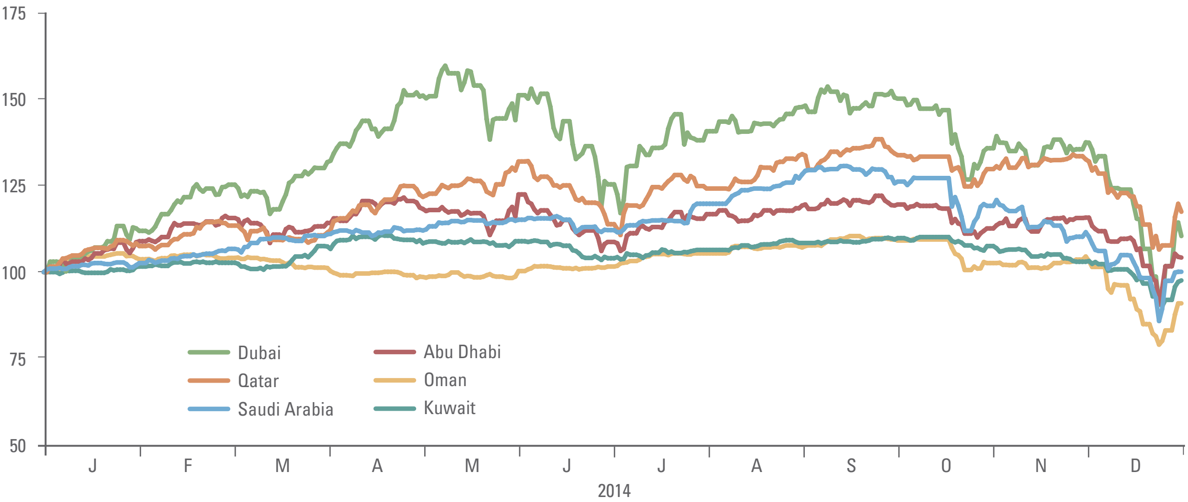
The UAE's breakeven point has been rising over the last few years mainly due to capital expenditures. The breakeven for 2014 is estimated to reach USD 82, and fall to USD 80 in 2015 as some fiscal discipline is applied over the short term. Large infrastructure spending which forms an integral part of Abu Dhabi's 2030 vision is expected to broaden the UAE's diversification efforts. However the UAE possesses substantial foreign reserves that we expect to provide ample cushioning over the medium term. Gross government debt is at 14% of GDP for 2014. Fiscal consolidation within the different emirates has been enhanced over the last few years which helps reduce the lack of coordination. Dubai continues its efforts to consolidate, which has helped to reduce its debt profile over time, given its successful diversification efforts. Due to various linkages, a prolonged slowdown in Saudi Arabia could spill over into certain sectors of the UAE economy, especially real estate and the hospitality business. We find such a scenario unlikely given Saudi Arabia's ability to withstand price shocks and apply counter-cyclical policies, as noted above. Given the UAE's position in the wider region, over-dependence on one source of income has diminished as its economy has been more global and broadly-based.

In summary, Oman and Bahrain are less fiscally resilient to oil price shocks. Qatar and Kuwait are the most resilient followed by Saudi Arabia and the UAE. The extent of the shock would depend largely on the fiscal discipline most of these economies will apply over the short to medium term and the price of oil. If this is a temporary shock, a view we believe in, the Gulf economies would all rise relatively unscathed. If not, some would have to take immediate steps and others over time. The region's efforts towards diversification would have to continue to advance. This would be a positive outcome arising from this latest slump in oil prices.

## What this means for equity markets

Markets in the GCC have corrected sharply in the last two months. Since its peak in early September this year, oil prices have fallen nearly 40%, and the GCC stock market has followed suit, down nearly 30% according to the MSCI GCC index. It's important to remember that, whilst sentiment towards equity markets in the GCC region has soured, some of this may be misplaced. Valuations are looking attractive with 2016 PE multiples trading at 11.3x, vs 13.8x and 16x for 2012 and 2013 respectively.

Figure 5: **GCC market performance**




Source: Ashmore, Bloomberg.

On that basis, we continue to find opportunities in Saudi Arabia, Qatar and the UAE where we expect a continued commitment to growth, especially in areas of social reform, housing, financing and consumer spending. In Saudi Arabia the majority of our exposure lies in direct consumer plays benefitting from resilient earnings in the face of declining oil prices, in areas such as education, health care and other areas benefitting from resilient demand. In the UAE we are finding banks that we believe have been significantly oversold and stand to benefit from a rapid price recovery once oil prices – and sentiment – stabilise.

In general, with recent market softness in the face of lower oil prices, we believe GCC equity markets will present compelling investment opportunities once the dust settles and the evidence of the region's resilience comes through.

## Contact

**Head office**

**Ashmore Investment Management Limited**
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

**Beijing**
T: +86 10 5764 2601

**Bogota**
T: +57 1 347 0649

**Jakarta**
T: +6221 2953 9000

**Istanbul**
T: +90 212 349 40 00

**Mumbai**
T: +91 22 6608 0000

**New York**
T: +1 212 661 0061

**Sao Paulo**
T: +55 11 3556 8900

**Saudi Arabia**
T: +966 11 486 8470

**Singapore**
T: +65 6580 8288

**Tokyo**
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**Washington**
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