The GCC – Opportunities in the Newly Emerging Market Status Countries

The Gulf Cooperation Council Countries (GCC) are being upgraded to the status of Emerging Markets by major indices, creating a new region for investors in the EM arena to focus their attention. GCC countries are different from the other countries in the EM universe to date, as they are oil-exporting, their currencies are pegged to the dollar, they enjoy high foreign currency reserves and very low debt-to-GDP. Momentum investing in GCC stock markets has proven to be quite lucrative for traditional Emerging Market investors of late. Dr Ryan Lemand, Senior Executive Officer for ADS Investment Solutions & Global Head of Wealth and Asset Management for ADS Securities addressed delegates at the Investment Solutions Forum to highlight the opportunity.

LEMAND INTRODUCED HIMSELF AND THE ADSS GROUP, which he explained is a group of privately-owned companies in Abu Dhabi in the United Arab Emirates with a presence also in London, Hong Kong, Singapore.

"My mission today is to highlight some of the investment opportunities for Asia's HNWIs in the Gulf Cooperation Council countries, which is better known as the GCC region." He said he could only touch on some key insights in a brief talk, but that the overall picture was one that wealthy investors should take a good look at as a diversification in the EM universe.

He began by focusing on oil revenues, reserves and CapEx in the oil sector. He first showed how Saudi Arabia's foreign exchange reserves had peaked in the 2013-2015 and had been declining rapidly since then, partly driven by historic lows for the price in the years after the global financial crisis.

"When looking at these charts," he said, "many people had assumed that this trend will continue forever, and Saudi Arabia will later go bankrupt. But oil has recovered more than doubled from its lows and in late September was trading at around USD64 and with replacement CapEx in the oil sector at about 80% of total spending, and global demand for oil rising, there is a considerable supply shortage going forward."

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The OPEC deal came in to stabilise the market, he reported, and not only helped keep the price elevated and at a sweet spot, but most importantly decreased the volatility, with historical vol dropping from 66% to 13%, and implied vol from 65% to 22%. "So," Lemand reported, "Saudi is actually building forex reserves again and has also been using its foreign currency reserves to fill in certain gaps."

Oil, he continued, is controlled by a cartel called the OPEC, itself controlled by the majority of the oil-producing countries around the world, with a key purpose to balance out the market to sustain a certain price.

"The conclusion of all this data I am highlighting today," Lemand explained, "is to explain why we are so positive on oil prices." He went on to explain how oil supply is largely dependent on capital expenditures, so, for example, an oil well dries up within six months to maximum one year. He reported that as 80% of CapEx in OPEC countries is just replacement CapEx, and because there is lower CapEx due to lower oil prices in recent years, there is not enough replacement CapEx today to sustain the production over the long term.

"The result," he warned, "is that we might see an oil supply crunch potentially in the medium term, which of course means higher oil prices." This, he said, was further borne out by oil stocks representing 47 days of world consumption currently, which is an all-time low. And with risks such as the attacks on Saudi Arabia recently, that could drop even lower.

He further warned that electric cars are no panacea. "If you look at the number of appliances you have at home that are made of plastic, there are literally numerous consumer items requiring oil as the base product. And the world is still using charcoal, amazingly, with demand and supply still going up."

Leman then zoomed in on the six GCC countries, the United Arab Emirates, Saudi Arabia, Qatar, Bahrain, Kuwait and Oman. "Typically," he reported, "these countries have their currencies pegged to the dollar, they are net importers of goods, so a strong dollar is beneficial. Second, they sell oil and benefit when prices are going up. Most of these countries have recently been reclassified to EM and most importantly, the UAE and Saudi Arabia are now part of the MSCI and FTSE Emerging Market Indices, which means that all of the passive managers will have to include these two countries in their portfolio; otherwise they can have a tracking error."

He turned then to the assets of the central banks and sovereign wealth funds, which he said represent multiples of their respective GDP. He explained that with extremely low debt, high foreign exchange reserves and investments, largely positive

fiscal balances, and diversifying economies, the outlook is very encouraging."

The UAE, he explained, was created in 1971 and at the time oil was 90% of its GDP. "Last year that figure was just 30%," he reported, "so they have been dynamically diversifying their economy. Saudi Arabia's strategic plan 2030 is following the same path."

He then noted that GCC stock markets are not really fundamental markets, they are mainly momentum driven, and dominated by retail investors and increasingly foreign institutions.

To access the markets, he advises smart beta, noting that already out of the USD5 trillion ETF market globally, some 20% is already smart beta and for asset owners of less than USD1 million today the adoption rate is more than 40%. Moreover, the trend is accelerating - he noted that 2017 was a breakout year for smart beta, with over USD55 billion of global inflows in smart beta strategies, and with the global market capitalisation of USD80 trillion roughly, there is plenty of room for growth.

"This is simply because, in downturns, smart beta saves you money," he reported, "you don't lose as much money when using a smart beta strategy. I can concede that, as yet, this is not proven in the GCC, but we are seeing more managers use smart beta there."

He then highlighted one of ADSI's flagship strategies which invests into Saudi Arabia stock market, by simply using the Tadawul Index, which is the Saudi Arabia index and using the smart beta strategy. He showed how from September 2012 to April 2019 it had realised a gain of 79% versus 70% actual index performance, while the Sharpe ratio is higher, the standard deviation is lower, the maximum drawdown is lower, thereby offering investors benefits from all levels just using a plain vanilla smart beta strategy.

Lemand also agreed that geopolitics today have pushed the risk premium of the GCC into the red zone, but he said that was driven by lack of knowledge of the region and fear. "But," he said on closing, "the opportunities in the GCC are there for all to see." ■