



Winds of Change in Saudi Arabia's Investment Climate

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The winds of change are blowing in Saudi Arabia, carrying the potential to dramatically shift the investment climate there. One of the most anticipated financial events in the Middle East region seems as if it could finally come to pass in the near future — the opening of the Saudi Arabian stock market to foreign investors.

The origins of Islam trace back to Saudi Arabia, a place where the world's Muslims seek spiritual refuge in the holy cities of Mecca and Medina. The country has been considered by many as impenetrable in the past due to its harsh, dry desert with extreme temperatures. The investment climate may become more hospitable though to foreign investors after the Kingdom's financial regulator, the Riyadh-based Capital Market Authority (CMA), announced foreigners would be able to buy and sell shares on Saudi Arabia's Tawadul All Share Index starting in 2015. Until this landmark decision is implemented, investors from outside the six-nation Gulf Cooperation Council (GCC) now have only indirect market access — namely through swaps and exchange traded funds.

Saudi Arabia's accession into the World Trade Organization (WTO) in 2005 helped lay the groundwork for opening the Kingdom to wider foreign investment, encouraging the Saudi Arabian government to continue engaging in economic reform and diversification.

From my point of view, the CMA's announcement is a game-changer for the region. The US\$745-billion¹ Saudi economy dwarfs many others in the region, and its market is well-capitalized and mature. Trading liquidity in the Saudi Arabia stock market is the highest in the region, and Saudi Arabia has the strongest pipeline of initial public offerings (IPOs) in the region as well. Some pundits are speculating that Saudi Arabia could receive an emerging market classification from index provider MSCI within the next two years, leapfrogging the "frontier" classification and likely drawing more investor interest as a result.

Saudi Arabia is the Organization of Petroleum Exporting Countries' (OPEC) biggest producer. Oil has been a huge driver of government revenues as well as GDP. However, in our view the Saudi economy has more to offer investors than just its oil riches. We have found the management of many Saudi companies to be impressive, and not only within the energy sector. We favor banks as well as consumer-oriented companies, like retailing or food and beverage, that cater not only to the Saudi market but also the wider Middle East market. There are a lot of potential opportunities in Saudi Arabia, in our view, and we are eagerly seeking them out. Important for us—particularly in light of the market excitement the news of potentially allowing foreign direct investment generated—is finding shares at attractive prices too. Over the medium term, we would expect foreign investor interest to steadily rise in preparation for Saudi Arabia's likely eventual inclusion in global indices. However, there could be some speculative excess akin to what we saw in the United Arab Emirates and Qatar when MSCI announced these markets would be moved up from frontier to emerging market status, both of which subsequently experienced sharp corrections. Hopefully, the Saudis will work to help prevent that type of market volatility with the proper framework for investors and perhaps a more gradual foreign integration.

Saudi Arabia saw a strong current account and fiscal surplus in 2013 as a result of high oil revenues – both production and price-led. There has been robust government spending in recent years on a number of projects to diversify its economy and to encourage economic growth. In our view, Saudi Arabia is in a strong position to continue to spend, with foreign exchange reserves currently above 100% of GDP.² The country's growth rate has been impressive as well; GDP growth has averaged above 6% in the past four years, although for 2014 the pace of growth looks to be a little slower.³

Challenges in Saudi Arabia

While the economic and investment climate appear positive to us, a few clouds hang over the country, particularly the high rate of youth unemployment. The median age of Saudi Arabia's population is 26.4⁴, and as of 2010, there were roughly 8.5 million expatriate workers in the Saudi economy, nearly a third of the total population.⁵ You can thus see why employment has been an important issue among its locals. Officials have been attempting to address the challenge; the government has helped promote job training and education by launching the King Abdallah University of Science and Technology. In my chats over the past couple years with Saudi officials, it seems there has been an increased focus on training and hiring efforts aimed at its large youth population, which generally lack the education and technical skills the private sector needs. In the short- to medium-term, a mismatch between the output of the national education system and the requirements of the private sector could continue.

Overall, we think more private sector employment is needed; two-thirds of Saudi citizens work in the public sector. And, in our view, the youth need more incentive and training to work in a wider variety of skilled jobs the economy needs. Interestingly, the Kingdom of Saudi Arabia's Ministry of Labor recently announced it has teamed up with Harvard University and the Massachusetts Institute of Technology to launch an online education venture in the country this fall. The effort includes a unique pilot program directed to Saudi women, youth, the disabled and citizens in rural communities, who have often had less access to education and employment opportunities.

Of course, geopolitical concerns are an ongoing issue in the region. The Arab Spring, a pressure point for some countries in the Middle East, saw limited calls for protests in Saudi Arabia. This was partly due to the strengthening economy and overall rise in living standards, along with the popularity of the King and his reforms. More recent tensions in the region so far haven't had a significant impact on Saudi Arabia's economy, other than perhaps creating some oil price volatility.

We view Saudi Arabia a good proxy for growth in the Gulf region, and think increased investor interest in Saudi Arabia is likely to have a spillover effect. We are optimistic more foreign investment could bring long-term benefits to the country and region, and are excited about the potential opportunities this watershed event could provide us as investors.

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1. Source: WorldBank, 2013, GDP (current US\$).

2. Source: IMF World Economic Outlook database, April 2014. © by International Monetary Fund. All rights reserved.

3. Ibid.

4. Source: CIA the World Factbook, 2014 est.

5. Source: Information Office of the Royal Embassy of Saudi Arabia in Washington, DC, 2010 Census.