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INVESTMENT ADVENTURES IN EMERGING MARKETS

MENA REGION

Why the MENA Region Appears to be on Firmer Footing

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As Middle East and North Africa (MENA) economies adapt to the reality of sustained lower oil prices, Dino Kronfol, chief investment officer, Franklin Templeton Global Sukuk and MENA Fixed Income, and Bassel Khatoun, managing director and director of portfolio management, Frontier and MENA, Franklin Templeton Emerging Markets Equity, outline why they believe regional economies are on a more sustainable footing. And, they explain why the current landscape could prove to be fertile ground for potential opportunities in both fixed income and equities in the region.

The Middle East and North Africa (MENA) region has been unpredictable over the past year. Several Arab countries maintained a blockade against Qatar, regional tensions with Iran escalated and Saudi Arabia and Egypt continued to implement busy reform agendas.

In the midst of all of these geopolitical developments, we believe regional economies are on much more stronger footing today. More than three years after the 2014 oil price collapse, government spending has declined, deficits have troughed and a wave of structural reforms—which have targeted everything from spending and taxes, to economic and social reforms—appears to have picked up momentum.

On the back of these observations and other potentially positive developments, we believe the current environment could prove to be fertile ground for potential opportunities in both Gulf Cooperation Council (GCC)[1] fixed income and MENA equities—both of which we consider to be overlooked asset classes.

However, some issues remain over several MENA economies, such as Bahrain’s recent credit downgrade over unclear government strategies to tackle government deficits, Oman’s inability to curb its government wage bill and the economic impact of the aforementioned Qatar blockade.

And though we expect Saudi Arabia’s capital market to likely continue to develop and open up to foreign investment, the future of Saudi Arabia looks unclear as we wait for the long-term impact of its recent reforms to manifest. Egypt has also been executing an ambitious reform agenda involving cutting interest rates and the further removal of subsidies this summer.

However, with recent structural reforms continuing at a very encouraging, and almost unprecedented pace, our outlook for both fixed income and equity markets remains constructive.

In our view, the last two years have highlighted how the “right” response to weakening petroleum prices is much more important than the price per barrel. Most GCC sovereigns for example have significant financial buffers, which allows them ample time to think about, and implement, the appropriate policy response during changing oil price environments. The oil price plummet in 2014 was a serious wake-up call for GCC governments to address their heavy reliance on high oil prices, source non-oil revenue and cut bloated costs. We continue to see governments maintain and execute these reform programmes to put their economies on more sustainable footings.

Capital markets in GCC economies have developed faster than many observers expected on the back of a government reprioritisation of spending when oil prices declined. This is largely because the policy response to oil prices has been targeted and effective, in our view.

And from a fixed income point of view, it may have gone unnoticed to some investors, but the GCC region is a significant issuer of emerging-market sovereign debt, which is becoming an increasingly relevant component in global bond markets.

We've been beating this drum for some time. As GCC economies diversify their economies away from a traditional reliance on fossil fuels, it clears a path into the international debt market. With more than US$320 billion in total outstanding debt, and 87% of total issues denominated in major foreign currencies—mainly the US dollar—we believe the GCC bond market is an exciting investment area.

Focus Returns to Growth

We've seen GCC governments continue to adapt to the changing economic and political environment. Saudi's potential inclusion in the MSCI Emerging Markets (EM) Index[2] and Saudi Aramco's initial public offering (IPO) give us plenty of reasons to be optimistic about the road ahead.

Equities in the MENA region are currently trading at 12.5x this year's earnings,[3] which puts them at a discount to their own historic valuation levels. And while Saudi isn't part of an emerging market index just yet, MENA equities are trading at a discount to emerging market valuations to which they have historically traded at a premium.

However, Saudi's upgrade to emerging-market status is dependent on whether Saudi's equity market is compliant with international trading standards. In our view, Saudi's inclusion in the index could be a key criterion for a successful initial public offering of state-owned Saudi Aramco oil company, which makes some exciting prospects for the region. Like most emerging market upgrades, the preceding 1-2 year period to gaining official emerging-market status could drive foreign inflows to Saudi's equity market, while a successful listing would underscore MENA's transition from the peripheries of emerging market investment to the mainstream.

We are optimistic that further reforms will continue to bolster investor sentiment in the GCC region and drive corporate earnings.

Taking stock of the investment landscape across the MENA region, it is clear to us that the region has hit an important inflection point. And even though some countries in the region are not entirely out of the woods yet, a higher and more stable oil price, ongoing reform measures and an improvement in earnings are giving us reasons to be optimistic about the road ahead.

In our opinion, the key to truly setting the region on a path towards unbounded economic growth will be the approval of Saudi Arabia's inclusion in the MSCI EM Index, which we are confident will take place this year. We think 2018 will be a milestone year for the region, and arguably the wider global economy as a whole.

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What Are the Risks?

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline.

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1. The Gulf Cooperation Council is an alliance between six Middle Eastern countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates (UAE).

2. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-markets countries. MENA representation in the index currently includes Qatar, United Arab Emirates and Egypt. Indexes are unmanaged and one cannot directly invest in them. They do not reflect any fees, expenses or sales charges. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com.

3. MENA region earnings refer to market capitalisation weighted averages of 2018 estimated price-to-earnings ratios of respective Standard and Poor's country indexes of 10 countries: Saudi Arabia, UAE, Kuwait, Qatar, Bahrain, Oman, Egypt, Morocco, Jordan and Tunisia, and MSCI country index for Lebanon. Indexes are unmanaged, and one cannot directly invest in them. They do not include fees, expenses and sales charges There is no assurance that any forecast, projection or estimate will be realised.