MENA REGION

The “Halo Effect” of Saudi Arabia’s Emerging Markets Arrival

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Saudi Arabia’s inclusion in the MSCI Emerging Market Index marks a significant milestone for the MENA region, according to Salah Shamma, Franklin Templeton Emerging Markets Equity’s Head of Investment, MENA. He explains the “halo effect” from this move that mirrors that of other prominent index providers, and shares why the region is becoming much harder for global investors to ignore.

Saudi Arabia’s inclusion in the MSCI Emerging Markets (EM) Index[1] is another huge win for the Kingdom’s capital markets and a significant milestone for the entire Middle East and North Africa (MENA) region. The “halo effect” of MSCI’s move, following similar upgrades by index providers FTSE Russell and S&P Dow Jones earlier this year, will be felt on trading floors across the region as MENA becomes an investment destination that global investors can no longer ignore.

In many ways, Saudi Arabia's new emerging market (EM) status should be viewed as another important step in the evolution of its equity market. We expect further economic expansion and increasing levels of foreign investment to support its ambitions of a deeper and more dynamic stock market.

Saudi Arabia's elevation to EM status resulted from a number of capital market modifications and improvements made to its equity market infrastructure. On top of this, we're impressed at the pace of domestic reforms unfolding inside the Kingdom. Like other small EMs, we've seen a host of significant social and economic changes.

While Saudi Arabia's economic fundamentals remain strong, there have also been numerous developments since the beginning of 2019 that lead us to believe the Kingdom is in the middle of a recovery. For example, the success of both Saudi Aramco and the government's recent international bond issues highlight the ability of Saudi Arabia to attract capital, and with that rising levels of foreign investors. Government projects inside Saudi Arabia have been reinstated and consumption numbers such as electronic point-of-sales data, as well as total credit card transactions, are also on the rise. All of these factors have helped alleviate investors' concerns and support overall market performance.

Promotion to the MSCI EM Index, in our view, is the next transformative liquidity event for Saudi Arabia. With this in mind, we continue to like sectors that are exposed to the Kingdom's exciting recovery story, including banks and companies within the consumer discretionary sector.

We anticipate a likely significant increase in foreign flows resulting from Saudi Arabia's inclusion in the MSCI EM index. More than US $8.6 billion has already found a home in the market this year from international institutional investors, including passive flows through exchange-traded funds (ETFs) of over US $2.5 billion. In total, we anticipate US $6.5 billion in flows are likely to initially come into the market on MSCI's first inclusion date on May 28, and US $40 billion overall (because of Saudi Arabia's 2.7% inclusion weighting in the MSCI EM Index).[2]

Should Saudi Aramco's initial public offering (IPO) go ahead in 2021, as some media reports suggest, then the Kingdom's representation in the MSCI EM index could almost double. Foreign ownership levels in the Saudi stock market are now at a record high of 3.2%, excluding strategic stakes, which is encouraging, but still low compared with emerging market peers.

Going forward, we believe the "halo effect" of Saudi Arabia's MSCI EM inclusion will reverberate across stock exchanges in MENA, making the region's growing allocation sizable enough for international investors to sit up and take notice. In short, we believe the MENA region will become much harder for global investors to bypass. To date, the MENA region has accounted for approximately 1.8% of the MSCI EM Index, through the United Arab Emirates (UAE), Qatar and Egypt.

With Saudi Arabia's inclusion, that share of the index will increase significantly to around 4.5% after the second phase of inclusion in August. What's more, there is a strong possibility that Kuwait will be upgraded to emerging market status by MSCI next month. Expectations of such a move have already spurred recent gains in Kuwaiti stocks. Should an upgrade be forthcoming, we expect more than US $2 billion in passive inflows (and up to US $10 billion in total) could find its way into the Kuwait market.

We believe significant liquidity events like upgrades by index providers such as MSCI, FTSE Russell and S&P Dow Jones make the argument for owning MENA stocks a much more attractive one. With representation in gauges like the MSCI EM Index now rivalling the likes of Brazil, South Africa and India, the MENA region has truly arrived on the global investment stage. We think the "halo effect" for investors will likely be felt far and wide.

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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.

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1. 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.

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