جدوى للإستثمار
Jadwa Investment

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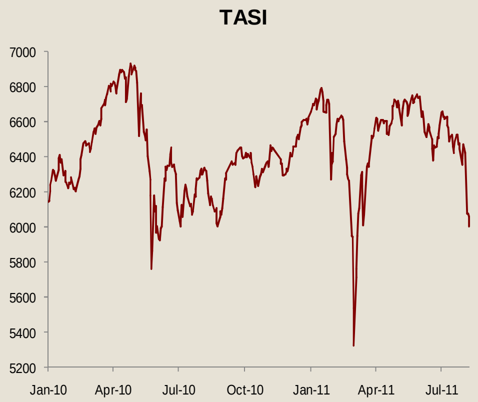
Debt, downgrade and Saudi Arabia

August has so far been a very volatile month for financial markets, with fears rising that the world will return to recession, a debt deal in the US proving insufficient to prevent a downgrade of the government's credit rating and an escalation of debt problems in the Eurozone. The chances of a new global recession have risen, though the more probable outcome is a period of low economic growth. It is likely that the Kingdom's stock market will remain volatile, but oil prices are still at a level that will support the high government spending that will drive the Saudi economy.



Late on Friday credit ratings agency Standard and Poor's (S&P) cut the rating of the US government. Prior to this the US's credit rating had always been at the highest level available (a rating of AAA). A credit rating is a measure of the creditworthiness of a borrower; the lower the rating, the more likely that a borrower will default. S&P's move was triggered by disappointment about the recent deal to extend the ceiling on the amount of debt the US government could issue. Although the deal was concluded before the debt ceiling was hit, which meant that the US government was able to make all scheduled payments, S&P considered that the deal did not go far enough to tackle the debt problems the country faces. It also highlighted that the political climate in the US, which was the main barrier to extending the debt ceiling, complicated the prospects for a long-term debt deal.

Another factor contributing to the volatility is mounting concern about the spread of the debt problems in the Eurozone. Specifically, Italy and Spain were forced to pay much higher rates to borrow through financial markets owing to weak economic growth, continuing budgetary stresses and political uncertainty. The new framework established by EU institutions to deal with the debt problems in Greece, Ireland and Portugal in late-July would be overwhelmed if it were extended to cover Italy and Spain given the far greater size of these countries' debts (total financing needs for Italy and Spain over the final five months of 2011 are around €245 billion ($350 billion), greater than the value of Greek debt maturing over the next six years before it was restructured).

Fears that EU institutions were not being bold enough to confront this problem were heightened last week when the European Central Bank (ECB) choose only to purchase (and thereby lower borrowing costs) only Greek, Irish, and Portuguese bonds. European policymakers held emergency meetings over the weekend, and on Sunday the ECB signaled that it would start buying Italian and Spanish bonds in an attempt to blunt the spreading crisis. In addition, Italy announced plans to reduce its budget deficit late last week. Nonetheless, serious Eurozone debt problems remain.

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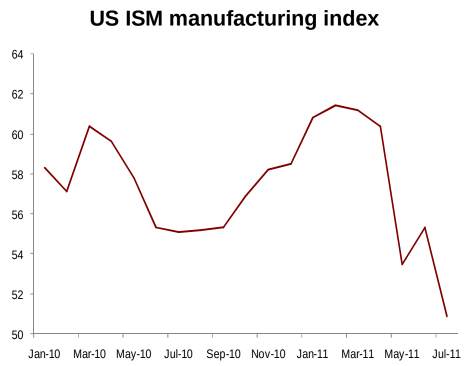


In addition, investors have been unnerved by a flow of economic data showing that the global economy is struggling. In the US, data released in the past two weeks on economic growth, housing and manufacturing have all pointed to a slowing economy. Data from elsewhere in the world has also generally been weak. Some of this can be attributed to the impact of the natural disaster in Japan, which is now fading more rapidly than had been feared, and to high commodity prices, which have recently begun to fall. However, there are longer-lasting factors that are becoming more prominent. Recent steps to tackle debt problems across leading economies through cutting spending and raising taxes will hold back economic growth. In emerging markets, growth is slowing in response to rises in interest rates and other policy measures to tackle inflation. Furthermore, general economic uncertainty and falling share prices are hitting consumer and business confidence throughout the world.

Market reaction to these developments has been aggressive. Stock markets and most commodity prices have dropped, gold has surged and, despite the downgrade, the price of US government debt has risen. Global stock markets were battered on Monday, with the US S&P500 falling by 6.7 percent, its worst daily performance since December 2009. It is down by over 16 percent in the last 10 trading days, the largest drop since the recession shook the markets in late 2008. Many of the main European markets are down further.

Prices have risen for those assets considered safe havens. The main gainer has been gold, which is up by 7 percent since the start of August and by 16 percent since the end of June. The Japanese yen and Swiss franc have also been pushed up, despite intervention from both countries' central banks aimed at holding down the value of their currencies. Most notably, there has also been a rise in the price of US government bonds. This reflects the fact that the US is still considered a safe haven despite the downgrade of its credit rating.

Although one rating agency downgraded the US, it is still top-rated by the other two leading agencies, Moody's and Fitch, and neither has indicated that a downgrade in imminent. S&P rates the US in the twenty-fifth highest of the 26 categories of ratings it uses. The breadth, depth and liquidity of the US financial markets also support its safe haven status. No other financial market is of a comparable size or has the same variety of financial instruments as the US.

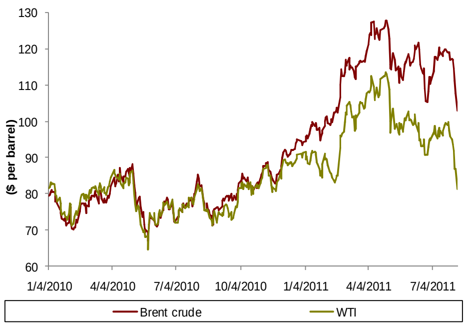
It is likely that markets will remain volatile in the near term. New economic data will be scrutinized closely, as will the actions of economic policymakers. This risk that the global economy slips back into recession has increased, but even if the economy does return to recession, it will be nothing like that of 2008/2009 because the global banking sector is in far better health. We think it more likely that a period of slow economic growth is ahead. This is in line with our long-held view.

Implications for the Saudi economy

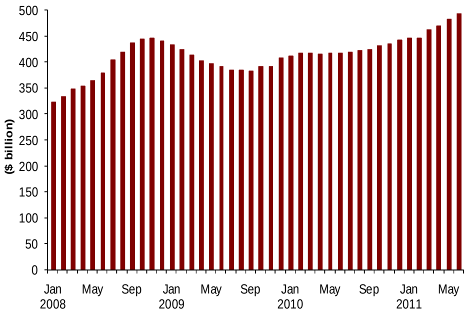
We do not think ongoing events will have too great an impact on the Saudi economy, as the growth momentum is coming from high government spending that can be afforded comfortably.

Oil prices remain the main link between the global economy and that of the Kingdom. Recent developments have pulled oil prices down by more than 15 percent in little over a week. Brent dipped below $100

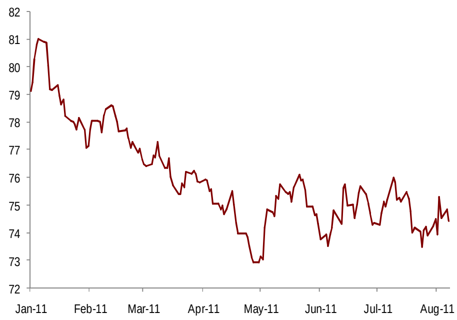
Oil price



SAMA net foreign assets



Trade weighted US dollar



per barrel for the first time since February and WTI hit its lowest level since November 2010. Nonetheless, prices remain above the $84 per barrel (Saudi export crude) we estimate is necessary to avoid a budget deficit this year. Indeed, the average for the year to date for Saudi export crude is comfortably in excess of $100 per barrel.

Further signs of a worsening global economic environment could well push oil prices lower. Should the US fall back into recession, it would be a more normal recession than in 2008, meaning the movement in oil prices would be much less severe. Rather than the spectacular drop in the second half of 2008, from almost $150 per barrel to just over $30 per barrel, prices could drop to between $50 and $60 per barrel. Even in this scenario, we do not think there would be much impact on Saudi government spending. Rather, the government would draw down its foreign assets to finance the spending, as it did in 2009. SAMA net foreign assets were $492 billion at the end of June, $49 billion above their 2008 peak.

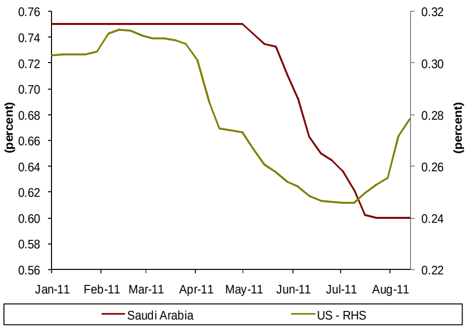
We think that US government bonds constitute the bulk of SAMA's net foreign assets. It is not possible to determine the exact amount as SAMA does not publish a breakdown of its holdings and US government data refers only to "oil exporters" and gives a total of just $221.5 billion at end-May, though this only captures direct purchases rather than those through foreign intermediaries and therefore understates the actual value. SAMA has publically referred to three criteria it uses to manage its portfolio of reserves: safety, liquidity and long-term returns. The downgrade has clearly called into question the first of these criteria. Nonetheless, no market outside the US offers the same level of liquidity, or the same array of financial instruments, so while SAMA will closely monitor the situation, we do not expect a major change in its asset allocation policy.

The downgrade is negative for the dollar and therefore the riyal, but it should not trigger a significant short-term fall. In the first few days of trading after the downgrade, the dollar was fairly stable. There are three reason for this that are likely to linger. First, other leading economies also face serious problems; second, countries with stronger economic fundamentals or those that are considered safer than the US are intervening to stem the rise in their currencies and third, the US continues to be viewed as a safe haven, Given the problems elsewhere in the global economy we think it likely that emerging market currencies will rise the most against dollar.

We do not think the downgrade will have an impact on the exchange rate peg between the riyal and the dollar. At the moment, the peg makes sense for the Kingdom for economic reasons including the reliance on dollar-denominated oil revenues and the potential damage to non-oil competitiveness and foreign investment any adjustment would cause. In addition, it is backed by a strong strategic commitment. We think it would take a serious decline in the dollar sustained over several years for there to be any reconsideration of the peg.

A fall in the dollar will add to inflationary pressures in the Kingdom. In 2010, 46 percent of the Kingdom's imports were from emerging markets, and these currencies are likely to climb the most against the dollar. The Korean, Indian and Brazilian currencies are all up by over 2 percent against the dollar since the start of August. However, we think the inflationary impact of a weaker dollar will be offset by lower commodity prices. In addition to the sharp fall in oil, which

Three-month interbank rates



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lowers the transportation costs of imported goods, prices of foods and construction raw materials have also dropped. The Reuters commodity price index is down by over 7 percent so far this month.

The exchange rate peg means that interest rates in the Kingdom are closely linked to those in the US. It is conventional wisdom that the downgrade should cost a government in terms of higher interest rates on its bonds, perhaps as much as 100 basis points (1 percentage point) over time, as investors demand higher compensation for the risk they are taking. However, prices of US government debt have risen in the last few days. This is not a surprise given the safe haven status the US retains; indeed, Japan has experienced several debt downgrades (its credit rating is two notches lower than that of the US), but still pays among the lowest interest rates in the world on its bonds. In addition, the foreign holders of US government bonds (mainly the central banks of Japan, China, and Opec members) do not have sufficient alternatives.

US interbank rates have risen in August, though they are still well below where they were earlier in the year. Saudi interbank rates followed US interbank rates down over the past few months, but have stayed flat at all-time lows since mid-July. With the banks very liquid (excess deposits at SAMA were SR71 billion at end-June), we do not foresee a notable rise in Saibor unless US interbank rates surge, which looks unlikely given the liquidity within the US banking sector. Indeed, the interest rate outlook for the Kingdom could well be more benign given that the weakness of the US economy has pushed back the likelihood of an increase in the US Fed Funds rate and therefore of the Saudi repo or reverse repo rates.

Implications for Saudi investors

The Saudi stock market has followed global markets in selling off sharply. It dropped by 5.5 percent on Saturday, when it was the first market open after the downgrade, and was a further 0.8 percent down today, bring the loss to 6 percent so far in August. The petrochemicals sector has led the falls as it is the most exposed to the global economy. The declines have pulled the market’s price-to-earnings ratio to around 12, which is a relatively attractive level, particularly as we think government spending will not be affected and will ensure that the economy continues to perform well. Nonetheless, further volatility driven by moves on global markets is likely and sharp falls cannot be discounted.

In this environment of heightened uncertainty and a volatile stock market that is closely linked to global markets, the real economy offers an attractive option for Saudi investors. The government has the financial resources and publically made the commitment to huge investment spending, particularly in housing. The huge volume of work required means that it will be challenging for the existing construction companies to cope, creating opportunities for other firms in construction and related industries. Industries that supply the construction sector with key inputs will be major beneficiaries of government spending. The huge planned construction work will also generate the need for a vast amount of raw materials.

Investors also have opportunities to gain from the likely increase in consumer spending, particularly of those on low incomes. The impact of the introduction of the minimum wage and unemployment benefit and the extension of social insurance payments will last longer than the recent short-term boost to spending triggered by the two-month salary bonus, as the payments will be regular. In addition, the house-building program will cause a further influx of expatriates that have their own requirements. Those on lower incomes tend to spend a greater proportion of their earnings than those on higher incomes. This should benefit retailers and producers of goods such as foods, clothing and some electrical items.