جدوى للإستثمار
Jadwa Investment

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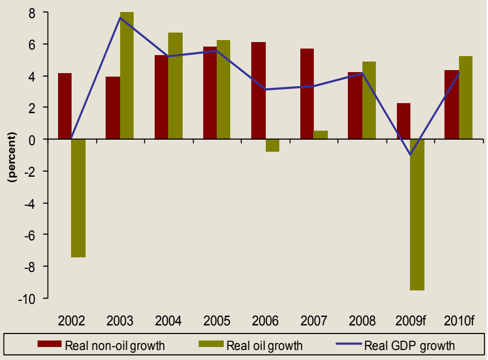
Saudi economy: On the brink of recovery

Real GDP growth



It has been a tough year for the Saudi economy. Global recession hit hard through the early part of 2009 and as the external environment began to improve local business confidence was set back by high-profile troubles at two local companies. Recent data suggest that the worst is now over for the economy and based on our assumption that external conditions will continue to get better, then barring any other major public financial events at family businesses, we expect a sustainable recovery to take hold in the fourth quarter.

Government spending is the key source of dynamism within the economy. Expenditure seems to be above budget and is likely to pick up further as implementation of those projects recently signed or retendered begins. In contrast, many private sector businesses face problems accessing finance. Given the caution within commercial banks only modest growth in lending is expected over the near-term. SAMA has made the environment conducive to lending once banks become less risk averse and interest rates are expected to stay very low. With oil prices likely to be in excess of the budgeted level, we expect only a very small budget deficit despite the anticipated overspending. The deficit on the current account will be larger, but is not a concern.

Inflation has fallen sharply this year as the external factors behind its surge over the previous few years have all reversed. Food and commodity prices have dropped, bottlenecks have eased and exchange rate movements have been favorable. There is sufficient slack in the economy to prevent domestically-driven inflation outside of the rental market for some time, but with commodity prices rising and the dollar slipping as global economic growth resumes, we do not expect inflation to fall much lower than its current level of 4.2 percent over the remainder of the year.

The difficult economic environment has hit the financial performance of listed companies. Earnings per share for the first half of the year were 24.3 percent lower than for the same period of 2008. Earnings growth should be positive over the second half of the year owing to the improved economic situation and the very weak performance in the final quarter of last year. Stronger earnings should lift the TASI. After a period of moving in line with global markets broke down in mid-May, the market has traded sideways, missing out on the gains most other emerging and developed markets have recorded. We expect the market to break out of its current range and move higher in the final quarter and maintain our fair value projection for the TASI of 6,200 at the end of the year.

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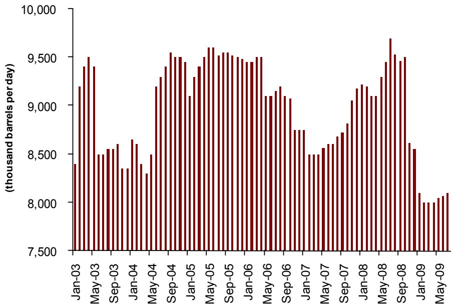
Economic growth

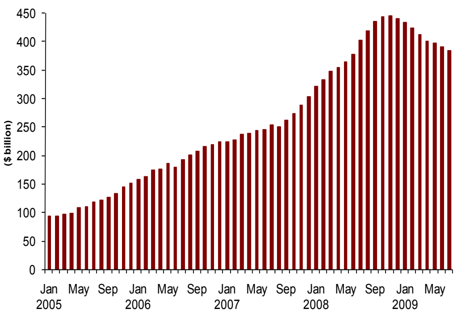
Data for the year to date make clear that it has been a difficult period for the Saudi economy. Although there are some contradictions in the data, the themes that emerge are the weakness of consumers and private sector businesses, the essential role played by government spending and a lower contribution from the oil sector. While recent data suggests that the worst may be over, we do not yet see consistent signs of improvement and think that problems with some family business have pushed back the prospect of recovery into the fourth quarter.

The Saudi economy can be broken down into three sectors; the oil, non-oil government and non-oil private. Assessing the performance of the first two of these sectors is reasonably straightforward. Growth in the oil sector is largely determined by oil production. Oil production averaged just over 8 million barrels per day (b/d) in the first eight months of this year, compared to 9.3 million b/d in the same period of last year, a decline of 13.4 percent. Production has risen modestly in the last few months, but with Opec not expected to adjust output quotas this year, it is likely to remain well below the elevated levels of last year. The non-oil government sector has grown by around 3 percent per year for the last decade irrespective of what has been happening elsewhere in the economy and we see no reason for this to change in 2009.

Saudi oil production



SAMA net foreign assets



To estimate the performance of the non-oil private sector we look at the following data:

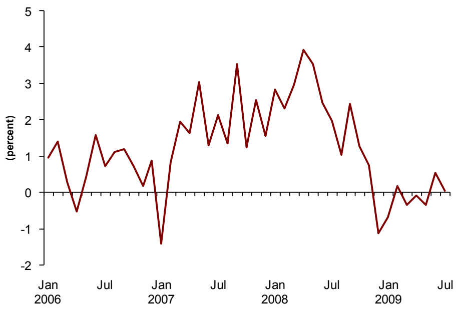
- **SAMA net foreign assets** fell by $56 billion over the first seven months of the year. Deposits in foreign banks were down by $42 billion and investments in foreign securities were $15 billion lower. The government is drawing down its foreign reserves in part to finance spending, but the extent of the decline is surprising (see Government Finances). Over June and July SAMA net foreign assets fell by $13.3 billion, even though oil prices were well in excess of the level we estimate is required to balance the budget.

- **Cement sales** are up by 17 percent in the first six months of 2009 compared to a year earlier. This points to a greater volume of work taking place on construction projects. Growth picked up in recent months due to the conditional lifting of the export ban; in June cement sales were up by 21 percent in year-on-year terms.

- **Imports via the Kingdom's ports** over the first five months of 2009 were 18 percent lower than in the same period of last year. Imports of construction materials fell the most, by 29 percent; those of consumer goods were down by 12 percent. In month-on-month terms imports through the ports rose by 0.7 percent in May.

- **Exports via the Kingdom's ports,** excluding oil and gas, were down by 1 percent over the first five months of the year compared to the same period of last year, with only petrochemicals showing growth. Exports of all other goods were down by over 30 percent. The month-on-month data also shows a continued fall, with total exports through the Kingdom's ports down by 0.9 percent compared with April, and non-oil and gas exports down by 1.8 percent. Lower exports reflect the impact of the global recession on Saudi exporters.

Bank lending to the private sector
(monthly change)

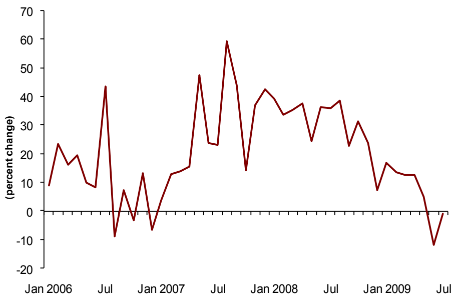


- **Bank lending to the private sector** has declined in four of the first seven months of the year and in absolute terms is SR6 billion below its end-December level. Lending rose in June and July, but in year-on-year terms it is at a nine-year low.

- **Point of sale terminal data** is the closest approximation to retail sales. Annual growth in the value of point of sale transactions was 6.9 percent over the first seven months of the year. The growth rate has declined in five of the seven months, but rebounded from -11.7 percent in June to -0.9 percent in July (seasonal spending trends distort the month-on-month comparisons). Note that there was an 11 percent increase in the number of point of sale terminals in the year to July.

- **The value of commercial and personal cheques cleared by local banks** is down by 9 percent over the first seven months of 2009 compared with the same period of last year. The July total was the highest so far this year and the year-on-year decline was just 1.6 percent.

Point of sale transactions



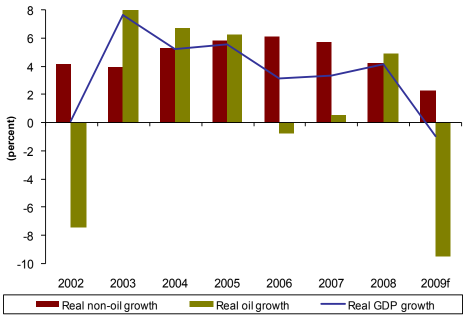
- **Government contracts** worth around $140 billion have been awarded so far this year, of which around $110 billion were for non-oil projects. There is generally a significant time lag between the award of a project and the commencement of work on that project, so we think these commitments will have little immediate impact on the economy. Similarly, the $75 billion of private sector projects cancelled or put on hold so far this year will have minimal impact as it is unlikely that many of these had got beyond initial plans.

- **The number of employment visas issued** in the first half of Hijri year 1430 (corresponding to December 28, 2008 to June 23, 2009), was down by 29 percent. With 52 percent of visas issued for workers in the building and construction sector, this suggests the growth in the pace of project implementation has slowed compared with last year. Data on those exiting the country is not available, but it seems likely that there was a large net inflow in the first half.

The picture is clearly one of an economy that has slowed. Virtually all indicators show that the private sector was weaker in the first half of this year than one-year earlier. The clear bright spot is the contribution of the government. Government spending looks to have been well above target, which is providing a vital boost for some private sector contractors. Government activity is not stimulating the import of raw materials because stockpiles that have built up since the final quarter of last year are being drawn down. Private sector operators that do not have government contracts are being affected by a lack of access to finance, export-oriented manufactures are having a particularly tough time and consumer-led sectors such as retail are also suffering.

There is a lack of clear signs of recovery in recent data. This is despite the fulfillment of the following key preconditions for a revival in the economy; improvements in the global economy, oil prices more than double their recent lows (and above $60 per barrel since mid-May) and share prices up around 40 percent from their March lows. We think this is because of concerns about the financial health of family businesses. Problems at one prominent local family business and an associated businessman have been highly publicized and it seems that several other family groups are stressed financially. Owing to worries about family business and their own exposures, banks have become more cautious in extending credit to the whole of the private sector (see our July 2009 *Monthly Bulletin* for more information).

Real GDP growth



Business activity traditionally slows during the summer and Ramadan (although consumer spending picks up notably during the latter) and we think that the economy is in the midst of a period of consolidation during which confidence should improve. Government has been aggressive in its policy response to the slowdown and the increasing visibility of new infrastructure and construction projects should help to boost sentiment. Provided external conditions continue to get better (the global recovery gains traction, oil prices hold above $60 per barrel and share prices make modest gains) then barring any other major public financial events at family businesses, we expect a sustainable economic recovery to emerge in the fourth quarter. Real GDP growth is forecast at -1.0 percent this year, with real private sector non-oil GDP slipping to a 10-year low of 2.3 percent.

Outlook for the global economy

Growth has resumed in much of the global economy, albeit at a very sluggish pace and reliant on unsustainable government stimuli. Confidence is rising and growth should pick-up modestly over the remainder of the year. A move to a stronger, more sustainable pace of growth is not expected in 2009 and there are many challenges ahead for the global economy.

The economies of Japan, Germany and France all grew in the second quarter and the US is expected to return to growth in the third quarter. Growth in key emerging markets, particularly those in Asia, has also bounced back. While this is clearly encouraging, there are some concerns about the quality of this growth, which was primarily driven by government stimulus policies that are not sustainable over the long term as they are unaffordable and risk stoking inflation. Private sector consumption and investment generally continues to fall.

Nonetheless, we anticipate a modest pick-up in growth over the remainder of the year. Movements in consumer and business confidence have generally been positive and there are encouraging indicators that the US housing market has bottomed and labor market conditions are improving. Health is also returning to parts of the financial sector, though serious issues remain.

The recovery will be fragile and vulnerable to setbacks. With consumers likely to continue to reduce debt, rather than spend, unemployment is expected to stay high for some time. In addition, great care will be required in withdrawing stimulus programs in order for this process not to undermine the recovery. We therefore do not expect that the recovery will precede a rapid return to a growth rate in line with the long-term trend.

Inflation

Inflation has fallen sharply this year as the external factors behind its surge over the previous few years have all reversed. Food and commodity prices have dropped, bottlenecks have eased and exchange rate movements have been favorable. Rents remain the main source of inflation, though they have also slipped owing to the provision of more housing and lower building material costs. With commodity prices picking up and the dollar weakening, we do not expect inflation to fall much lower over the remainder of the year.

Year-on-year inflation averaged 5.8 percent over the first seven months of the year and stood at 4.2 percent in July, its lowest level since July 2007. Inflation in each of the components of the cost of living index has fallen so far this year. The most pronounced decline was for foodstuffs, where inflation stood at 1 percent in July compared to 11.3 percent in December. Rental inflation stood at 13.5 percent in July. While this remains very high, it has fallen in each of the last 12 months after hitting a high of 19.8 percent in July 2008.

The following factors explain the fall in inflation so far this year:

- **Lower food prices:** International food prices plunged from record highs in the middle of last year owing to a combination of the global recession, much better than expected harvests and the relaxation of some barriers to food exports introduced earlier in the year by some countries. In July, food prices were 24 percent lower than their peak last June, as measured by the IMF food price index. This decline has not been fully passed on by retailers in Saudi Arabia—the food price component of the inflation basket is down only 5 percent from its high—but this is likely to reflect retailers rebuilding margins, as they did not pass the full extent of the food price rises during the previous two years on to consumers either.

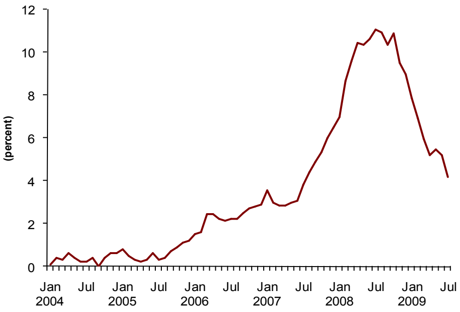
- **Stronger exchange rate:** The financial crisis triggered a dramatic strengthening of the US dollar as investors slashed their risky bets and instead put money in the relatively safety of the large and liquid US financial market. Given the riyal's peg to the dollar, this appreciation cut the cost of imports from outside of the US in riyal terms.

- **Lower transportation costs:** Fuel prices and the volume of global trade have fallen significantly since the world fell into recession, with the Baltic dry freight index down by over 70 percent over the year to date compared with the same period of 2008. Given the Kingdom's reliance on imports, these reduced costs have made a helpful contribution to lowering inflation.

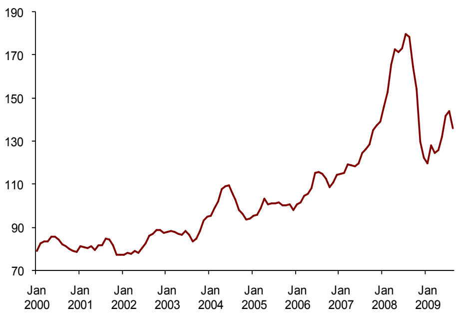
- **Lower inflation in the Kingdom's trading partners:** A study by the IMF found that inflation in trading partners was the key determinant of inflation in Saudi Arabia. According to IMF data, average inflation among advanced economies is forecast to fall to just 0.1 percent this year from 3.4 percent in 2008.

- **Lower demand:** The economic slowdown has allowed bottlenecks to ease and lowered prices. Prices of construction raw materials dropped quickly as private sector activity eased, causing stockpiles within the Kingdom, ultimately resulting in

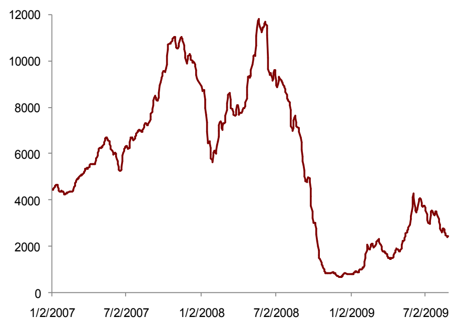
Inflation



IMF food price index

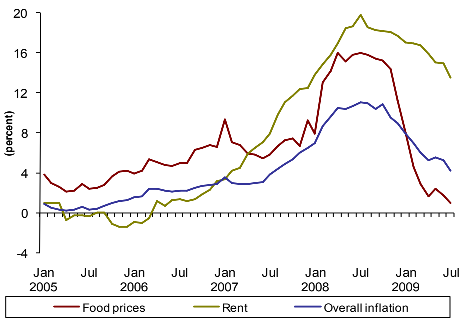


Baltic dry freight index



lower prices. The seizing up of projects elsewhere in the region reduced the cost of skills and equipment needed for infrastructure and industrial projects. The effect of these changes is clear in wholesale prices, which fell by 2.5 percent in year-on-year terms in the first quarter of 2009 (latest data) compared to an average rise of 10.9 percent in year-on-year terms over the first three quarters of last year. More recent data show that local steel prices were 55 percent lower in June than one year earlier, for cables, wood and cement the declines were 37 percent, 28 percent and 7 percent, respectively.

Inflation breakdown



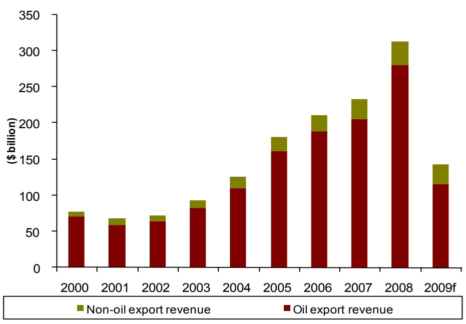
We do not think that inflation will fall much further this year. Commodity prices have risen and the riyal has weakened in recent months owing to signs that the global economy is starting to recover. In addition, the positive impacts of plunging prices in the final quarter of last year will drop out of the annual comparison. For example, the IMF food price index is currently 24 percent below its peak of June 2008, but is actually 10 percent above the average for the final quarter of last year. Ramadan will also push up food prices. Over the past seven years the rise in food prices in the first month of the Gregorian calendar that Ramadan falls in has been over four times greater than the average monthly rise in food prices for the rest of the year.

In normal circumstances, the large monetary and fiscal policy stimulus being injected into the economy would stir inflationary pressures. At present we do not think this will be the case. The government has taken these measures to stimulate the economy and to revive confidence in the private sector, but the response has so far been sluggish. Even when bank lending picks up and activity in the private sector accelerates, there is sufficient slack in the economy to prevent domestically driven inflation for some time. Rental inflation is the exception. An ongoing shortage of accommodation will keep rental inflation well into double digits for the reminder of the year.

External sector

The external position has worsened this year in line with much lower oil export receipts. Non-oil exports and imports are both down so far this year because of lower commodity prices and reduced demand. It is likely that the services deficit has narrowed as a result of decreased payments for imported professional services. While all are likely to pick up as the economic recovery gains traction in the final quarter, we nonetheless expect the current account to fall to a deficit of 6.1 percent of GDP from an all-time high surplus in 2008.

Export revenue



With oil accounting for around 90 percent of export revenues, the decline in oil prices and production in comparison with last year has caused a substantial fall in oil export receipts. Over the first eight months of the year we estimate that oil revenues were 57 percent below their total for the same period of last year. Non-oil exports totaled $10.4 billion in the first five months of 2009, compared with $13.4 billion in the same period of last year (a decline of 22.2 percent).

Large declines were recorded across all categories of exports. Petrochemical, plastics and minerals account for around two-thirds of non-oil exports and in each case revenues have fallen notably owing to lower prices (in volume terms petrochemical exports were up). By far the largest decline (in both percentage and absolute terms) was recorded by re-exports. Re-exports are goods that enter through the Kingdom's ports and are then transported to other countries in the region. The decline reflects the problems the global slowdown has caused to some neighboring countries.

Outlook for oil prices

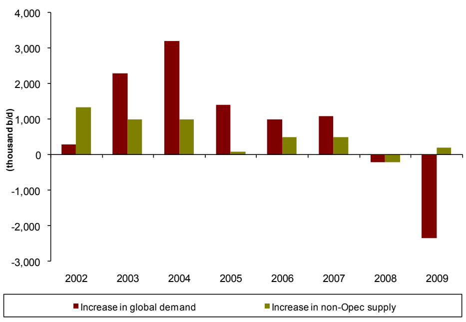
Oil prices have been strong this year given the exceptionally weak state of the global economy. With global economic conditions set to improve, but oil output also likely to tick up as Opec member compliance with agreed production cuts slips further, we expect oil prices to fluctuate between $60 per barrel and $80 per barrel over the remainder of the year. We therefore forecast an annual average price for WTI of $58 per barrel (equivalent to $55.7 per barrel for Saudi oil).

Oil price

WTI averaged $55 per barrel over the first eight months of the year. This is higher than the average for 2004 to 2006 when the global economy was growing at over 5 percent per year. Oil prices have broadly moved in line with gyrations in sentiment on the health of the global economy over the past months and WTI hit a peak for the year of $73.7 per barrel on August 24, more than double its January low.

Lower supply from Opec has contributed to the relative strength of prices. Opec production is set to be down by around 3.5 million b/d compared with last year (the International Energy Agency expects non-Opec to rise by 200,000 b/d this year). In contrast, the IEA forecasts that global demand will fall by 2.35 million barrels per day this year. This is the largest decline since 1981 and means that oil demand this year will be at its lowest level since 2004. Oil stocks in the OECD were at a 16-year high at the end of July, though those in the US have declined sharply in recent weeks.

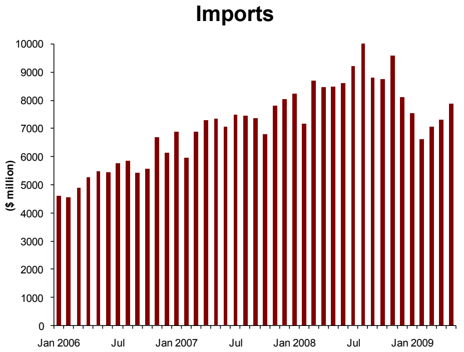
Oil demand and non-Opec supply

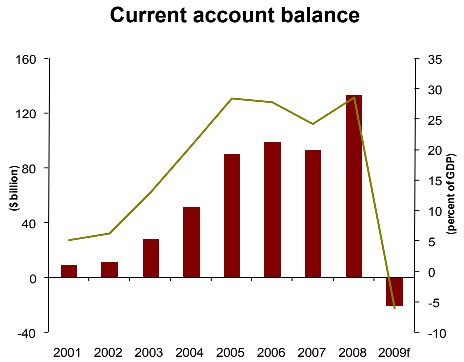


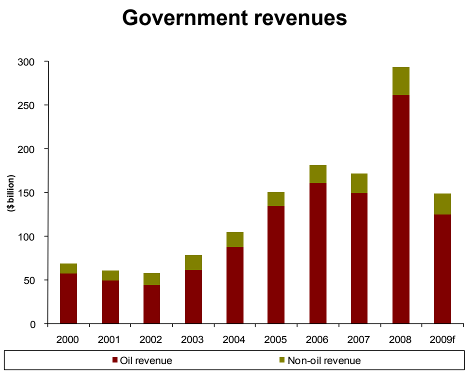
It also appears that investment flows have again been an important factor driving prices up. Improved investor sentiment about the health of the global economy, reflected in gains in global stock markets, has supported the rise in prices. In addition, the renewed fall in the dollar appears to be attracting financial flows into oil (as it did during 2007 and much of 2008) and a closer relationship has been reestablished since May.

All indications are that Opec will not change its production quotas this year. Saudi Arabia has said that it considers $75 per barrel a fair price for oil, but this is a goal rather than a short-term target. With oil prices approaching this level in very difficult economic circumstances, we do not see any scope for lower output, particularly as it could hit the global economy and damage Opec's reputation. While the strengthening global economy makes it likely that Opec's next move will be to raise production, uncertainty over the vitality of the recovery means that we do not anticipate any formal hikes this year, though adherence to quotas is likely to slip further.

Imports have fallen across all categories, though the decline in total imports over the first five months of the year was less pronounced than that for exports; to $36.4 billion from $41 billion (11.2 percent).







The drops are largest for minerals and food products, as prices are sharply lower. Imports of machinery and equipment and transportation equipment are only slightly down from last year, consistent with our view that government project spending has increased.

Data on other components of the balance of payment is not available, but we think the following assumptions are reasonable:

- **Lower service payments:** Reduced costs, less use by the private sector and a growing domestic skill base will cut spending on imported professional services. In addition, fewer imports and lower fuel prices will cut transportation costs.

- **Lower investment income:** With the bulk of government foreign assets believed to be invested in US government debt, lower interest rates on these instruments will result in reduced investment income.

- **Higher remittances:** Saudi Arabia has not seen the major exodus of expatriate workers experienced elsewhere in region. While the number of new entrants has declined, we think there has been a large net inflow of expatriates this year and expect economic difficulties in home countries to mean a larger outflow per expatriate worker.

These trends are expected to continue, reducing the deficit on the services, incomes and transfers component of the current account. Imports are likely to pick up over the remainder of the year as the economy revives and work commences on more government projects. Non-oil exports should benefit from the recovery in commodity prices. Similarly oil export revenues will be higher in the second half of the year based on our assumption of higher prices and production creeping up. Nonetheless, with oil revenues expected to be down by almost 60 percent for the year as a whole, we forecast a current account deficit of $21 billion (6.1 percent of GDP). This will be the first deficit since 1998.

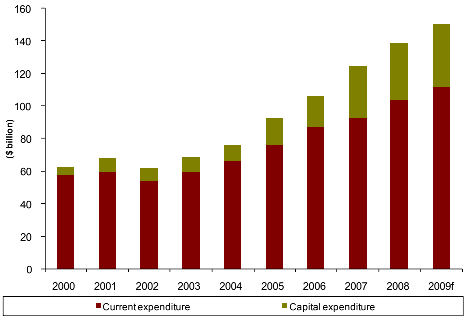
Government finances

We forecast that the government will run a budget deficit this year, though it will be smaller than that projected in the 2009 budget. Both revenues and expenditures are set to be comfortably above the level projected in the budget.

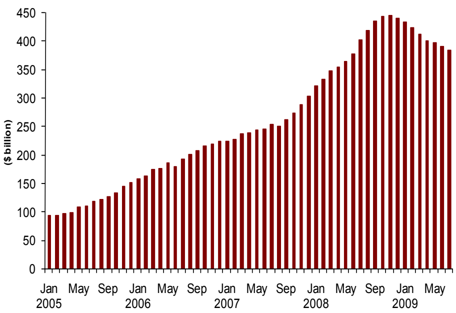
The 2009 budget was based on revenue of SR410 billion and expenditure of SR475 billion, resulting in a deficit of SR65 billion. We estimate that oil production of 8.1 million barrels per day at a price for Saudi oil of $44 per barrel is consistent with the oil revenue projection in the budget. With Saudi oil averaging around $54 per barrel to date and production broadly in line with our projection, revenues are likely to have been in excess of the budgeted level (oil accounts for 80-90 percent of total revenue).

We are confident that expenditure has also exceeded its target, though we are not certain about the extent of the overspending. Spending has been greater than the projection in the budget in each of the last 10 years, by an average of 19 percent. Current spending (mainly wages and salaries), the largest component of total

Government expenditure



SAMA net foreign assets



expenditure, is likely to be on target to rise by around 8 percent this year. A 5 percent government pay rise was awarded and the number employed by the public sector employment should continue to rise (though by less than the 8 percent it rose by last year).

Capital spending is less easy to track and the data are contradictory. As we outlined in the Economic Growth section of this report, a large number of new government contracts have been awarded, but it is unlikely that there has been much spending related to these projects. Similarly, many contracts announced last year were retendered to take account of much lower raw material prices, so again there will have been little actual government spending on these. In addition, the Public Investment Fund and other government agencies are taking a greater role in financing projects and their expenditure is not captured in the central government budget.

Nonetheless, we do think that government project spending has gone up so far this year. The size of the reduction of net foreign assets appears to suggest spending in excess of the budgeted level and higher capital spending seems the most likely source of additional spending. Cessation of work on many projects elsewhere in the region has freed the necessary technology and expertise and the government is clearly committed to pressing ahead with its capital spending program. A draw down of local stocks built up since the fourth quarter of last year accounts for the fall in imports of construction materials.

Where have the government foreign assets gone?

A huge stock of foreign assets was amassed during the years of high oil prices. Between the end of 2003 and the end of 2008 net foreign assets at SAMA rose by $378 billion to $438 billion as oil receipts greatly exceeded government spending. Drawing down these assets during the current period of lower oil prices allows the government to continue with spending programs that are vital to supporting the economy given the weakness of the private sector. It is therefore not a surprise that net foreign assets have fallen over the first seven months of the year. What has surprised us is the size of the fall.

Over the seven months of the year, we estimate that government receipts amounted to $88 billion (based on oil revenues of $74 billion and non-oil revenues of $14 billion). Assuming that government spending is split equally between each month of the year and that it has exceeded its target by 19 percent (the historical average) then spending over the seven months was also $88 billion. Over the same period, net foreign assets dropped by $56 billion. In July alone, they fell by $7.1 billion, even though Saudi oil averaged $64.3 per barrel a level well in excess of the $50 per barrel we estimate is required to balance the budget.

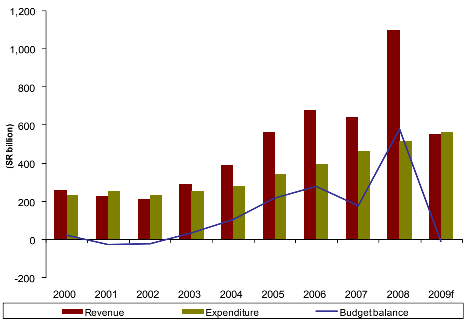
While the relationship between the budget balance and the change in foreign assets is not tight, the sharp divergence is puzzling. Part of this discrepancy can be accounted for by government activity. Between January and July government deposits in the local banking sector rose by $14 billion and the government paid off $9 billion of bills and bonds that were held by commercial banks. In both cases these actions make funds available for the banks to lend.

Nonetheless, this still leaves a large gap. We do not think that losses on investments contributed as there is not a relationship between asset price moves and SAMA net foreign assets (largely because of what are thought to be large holdings of foreign government bonds). Similarly, exchange rate effects appear insignificant (the dollar index was little changed between the end of December and end-July).

It seems likely that a combination of the following factors account for a further proportion of the reduction in net foreign assets:

- Government spending is well above the budgeted level.
- Spending at state oil company Saudi Aramco is higher than we had anticipated, so less oil revenue is being transferred to the budget (all oil revenue is earned by Aramco and only the that remaining after Aramco spending is accounted for is transferred to the government budget).
- Large transfers have been made that are not captured in the budget. For example, there is a commitment to inject $7 billion into the Real Estate Development Fund over the five years from 2008. Net lending by the specialized credit agencies (the Saudi Agricultural Bank, Saudi Credit and Saving Bank, Public Investment Fund, Saudi Industrial Development Fund and the Real Estate Development Fund) soared last year and is likely to have risen further this year.

Budget balance

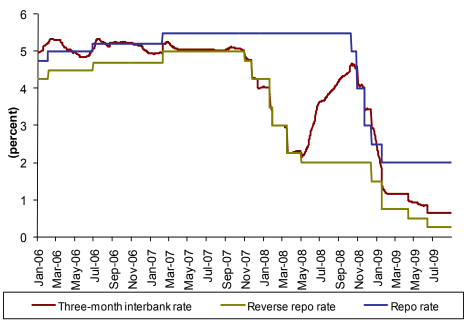


Government spending growth is expected to pick up over the remainder of the year, as implementation of those projects recently signed or retendered begins. We also anticipate a rise in revenues due to higher oil prices. For the whole of 2009 we expect a budget deficit of SR7 billion. This can comfortably be financed by the drawing down of foreign assets or deposits at domestic banks.

Monetary policy

SAMA has continued to implement an appropriately loose monetary policy. Interest rates have been cut further this year and are expected to remain at their current exceptionally low levels for the remainder of the year. While lower interest rates and other policy measures have brought down interbank rates, they have yet to stimulate a sustained revival in commercial bank lending.

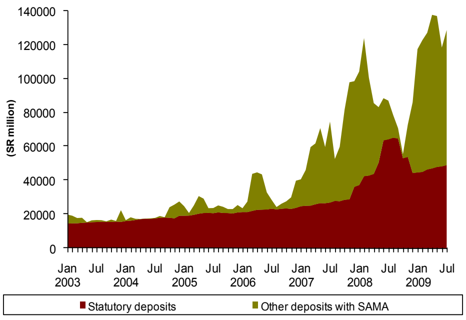
Interest rates



There have been three interest rate cuts so far this year. In mid-January, SAMA lowered the repo rate (the rate it charges for lending to commercial banks) to 2 percent from 2.5 percent and the reverse repo rate (the rate it pays for deposits) from 1.5 percent to 0.75 percent. The reverse repo rate was then cut to 0.5 percent in mid-April and to 0.25 percent in mid-June, while the repo rate has been left unchanged.

Given the exchange rate peg and the absence of capital controls, it is usual for interest rates in Saudi Arabia to broadly shadow those in the US, but all of the reductions so far this year were done independently of US rates. This is partly because there is effectively no scope for US rates to go any lower; the Fed funds rate has been at 0-0.25 percent since mid-December. In addition, SAMA has judged that the succession of interest rate cuts in the final quarter of last year have has not been sufficient to effectively stimulate the economy.

Commercial bank deposits with SAMA



Euro/dollar exchange rate

The reductions to the reverse repo rate appear designed to encourage a resumption of commercial bank lending, which would be a key sign that economic conditions were improving. Bank caution caused deposits at SAMA in excess of the statutory requirement to surge from SR0.9 billion in October to a peak of SR88.9 billion in April (they had fallen back to SR79 billion in July but this was not reflected in higher lending). Reducing the reserve repo lowers the return on these deposits and potentially encourages banks to lend, rather than hoard, these funds. Other policy steps taken during the year, such as reducing the issuance of treasury bills and holding the price at which the bills were issued below the interbank deposit rate, have also been designed to free funds for banks to lend.

While the supportive monetary policy has not yet contributed to a recovery in bank lending, it has helped push interbank rates (the rates at which banks lend to one another) to all-time lows. The three-month Saudi interbank offer rate (SAIBOR) current stands at 0.65 percent down from 2.51 percent at the end of last year. Lending and particularly deposit rates have also fallen notably (an additional reason for the last cut in the reverse repo was that it was above short -term deposit rates, meaning that SAMA was paying out more to the banks than it needed to).

We do not expect a change in interest rates over the remainder of the year. The US Fed funds rate is likely to remain at its current level over this period (the market is pricing in a rate hike next March) and we do not anticipate SAMA taking further independent moves. We think that SAMA has done what it can to make the environment conducive to lending and that it is risk aversion rather than lack of liquidity that is discouraging banks from lending. Provided there are no major new shocks from family businesses and the improvement in external conditions continues, lending is likely to pick up in the final quarter of the year.

Exchange rate

The riyal has depreciated modestly against the currencies of Saudi Arabia's main trading partners so far this year, though it generally remains much stronger than its mid-2008 levels. Owing to its peg to the US dollar, it has fluctuated in line with market views on the health of the global economy, weakening with signs of improvement and vice versa. There has been no pressure on the exchange rate this year, though longer-term questions about the position of the dollar in the global financial system have been raised.

For the bulk of the year movements in the dollar (and therefore the riyal) have been driven by investor perceptions about the health of the global economy. The dollar surged in the final quarter of last year as investors rushed into safe haven US assets. After a sharp fall and then rise around the turn of the year, the dollar has gradually slipped as signs of improvement in the global economy have allayed investor caution.

In recent weeks there are signs that US economic fundamentals are playing a greater role in determining the direction of the dollar. Indications that the US economy is set to grow faster than other leading global economies over the near term have caused the dollar to strengthen whereas for most of the year the dollar would have weakened as investors became less cautious and moved assets out of the US. The consensus view is that the dollar will stay broadly flat over the remainder of the year as these two forces offset each other.

Despite the recent decline, the riyal generally remains well above where it was in the middle of last year. The table below looks at the riyal's movements against the currencies of its main trading partners. It shows that the riyal is currently nearly 10 percent stronger than it was against the euro, the currency of the Kingdom's main trading partner, at the end of June 2008. At the moment exchange rate is playing an important role in moderating inflation, though this will cease to be a factor in the final quarter given the surge the previous year.

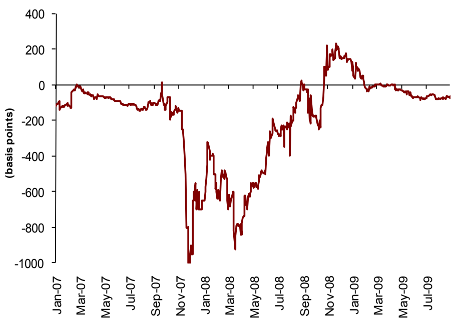
Country	Share of imports (percent)	change since end-2008 (percent)	change since end-June 2008 (percent)
Eurozone	24	-2.3	9.2
US	14	0.0	0.0
China	11	0.1	-0.5
Japan	8	3.4	-12.2
South Korea	4	-1.4	18.7
India	4	-0.1	13.1
UK	4	-12.3	18.4

Questions raised about the dollar's global role

Concerns have been raised in recent months about the role of the dollar in the global economy. The dollar is the global reserve currency. It accounted for 65 percent of global foreign exchange reserves at the end of the first quarter and is the currency used to settle the bulk of global trade. Questions over the dollar's status have arisen because the vast economic stimulus in the US involves the creation of a huge number of new dollars, which has the potential to seriously undermine its value. Some major emerging economies that have large dollar-denominated reserves have been particularly vocal in calling for an alternative.

However, new reserve currencies cannot be established overnight. Previous changes in reserve currencies (such as from the pound to the dollar) have taken decades. At present there is not another currency that provides assets with the safety, liquidity and returns available in US financial markets. Small shifts in reserve holdings in some countries may be taking place, but over the near term we do not see any change to the dollar's predominance.

One-year riyal forwards



There has been no pressure on the riyal's peg to the dollar this year. Since the onset of the global recession, some of the key arguments for dropping the peg (desynchronization of economic cycles between Saudi Arabia and the US, inappropriateness of interest rate policy and the contribution of currency weakness to inflation) have lost their relevance, at least in the short term. The global recession has realigned the economic cycle of Saudi Arabia with that of the US, interest rates are at an appropriate level and a strengthened dollar is supporting the decline in inflation. One-year exchange rate forwards, which measure what the market expects the exchange rate to be in one-year's time, point to no change for the riyal against the dollar.

Stock market

The TASI has climbed by 17 percent so far this year. For much of the first half of the year it fluctuated in line with movements on global markets, touching a near five-year low in the process. In recent months it has been held back by concerns surrounding family businesses. Financial performance of listed companies has been disappointing so far this year. We think it will improve in the second half, but maintain our projection for end-year fair value for the TASI of 6,200.

Market movements so far this year fall into the following three phases:

- To mid-March the TASI was on a downward trend, falling by 14 percent to a near five-year low of 4,130 on March 9.
- Between mid-March and mid-May the TASI recovered strongly, rising by 48 percent to its high for the year to date of 6,101 on May 23.
- Subsequently, the TASI has drifted sideways and currently stands at 8 percent below its peak.

The first two of these phases were closely aligned with moves in global stock markets. Owing to restrictions on foreign investment, the Saudi market historically had little correlation with global markets, but after the dramatic intensification of the global financial crisis last September the TASI and the US S&P 500 moved virtually in lockstep until the middle of May. The close correlation was common to many markets across the world. The downward move reflected concern about the economic outlook, which was followed by a strong rally owing to an improvement in confidence amid indications that economic conditions were improving and growth would resume later in the year.

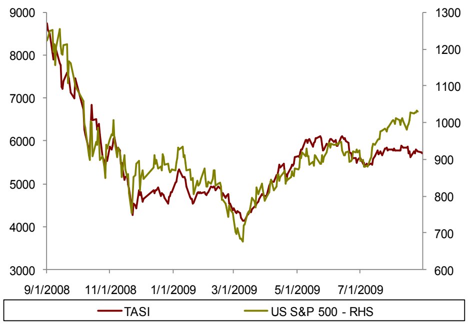
Since the middle of May, the relationship with global markets has broken down. Many markets have continued upwards in recent months, but the TASI has slipped. This is because investors are concerned about the lack of transparency surrounding the problems at the Saad and Gosaibi groups and their potential impact on listed companies (notably the banks) as well as the financial health of other family businesses within the Kingdom. Were it not for these concerns, we think the market would currently be around 500 points higher.

Unlike elsewhere in the region, the primary market has remained active during 2009. There have been eight new listings so far this year (raising a total of SR3.7 billion), compared to just three elsewhere in the GCC. Each recorded sizeable gains on their first day of trading (an average of 253 percent; 35 percent if the four insurance companies are excluded) and all are currently trading well in excess of their offer price.

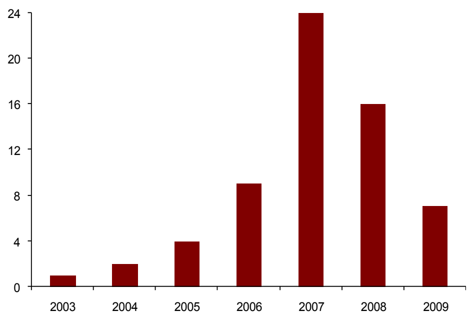
Trading volumes have moved in line with market sentiment. They fell over the first three months of year, picked up strongly in April and May and have then slipped back from June. While individual Saudi investors still dominate stock market trading (accounting for 92 percent of all trades by value in August), it is notable that institutional

TASI

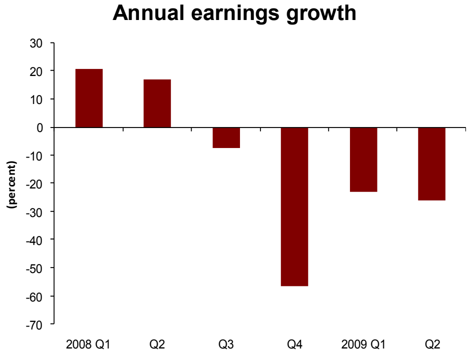
TASI and US S&P 500



Number of new listings

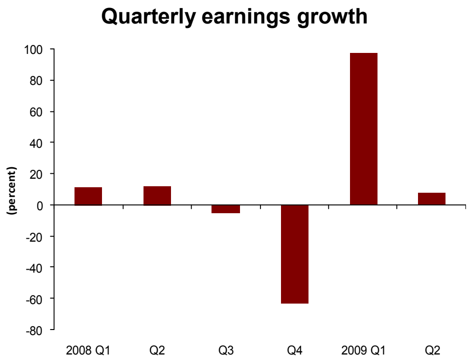


investors are increasing their holdings. Mutual funds and local corporations have been net buyers every month from March onwards and foreigners buying via swap agreements were only net sellers during June over that period.



Listed company earnings have been affected by the weak local and global economies. Earnings per share for the first half were 24.3 percent lower than the same period of 2008. The petrochemicals sector recorded the sharpest decline, down by just over 70 percent, owing to the collapse in product prices in the final quarter of last year. Real estate was the next worst performer owing to lower land prices and property sales caused by the economic difficulties. Earnings in the building and construction sector also fell by over 35 percent, with losses in the value of raw material inventory and lower property sales the main causes.

Insurance and hotels and tourism were the only sectors where earnings grew in the first half in comparison to the first six months of last year. In the case of the latter, it was because one company booked large revenues from a one-time land sale. For the former, it reflects the move into profitability of some of the recently licensed companies. The telecoms sector recorded the smallest decline in earnings per share as tougher competition reduced margins amid a continued rise in sales.



We think the second quarter results were in general fairly disappointing. Earnings per share were down by 26 percent in year-on-year terms, compared to an annual fall of 22.8 percent in the first quarter. Compared with the first quarter, earnings per share were up by 7.1 percent. This is despite strong recoveries in oil prices (and to a lesser extent petrochemical prices) and the stock market and a generally better economic environment than the first quarter.

With earnings falling and share prices rising, the TASI has got more expensive on a valuation basis. It is now trading on a 12-month trailing price-to-earnings ratio of 15.1, compared to 9.7 at the end of last year. The price-to-book ratio has moved up to 1.88 from 1.65 at end-December. Both ratios are below the historical average and also slightly below those for global emerging markets with similar growth prospects. As tends to be the case given the home bias of the large local investor base, valuations are higher in Saudi Arabia than elsewhere in the GCC.

Earnings growth is expected to return to positive territory for the second half of the year. In part this reflects the low base for the comparison; a very poor fourth quarter of 2008 will make the year-on-year performance look exceptionally strong in the final quarter of this year. It also reflects the improvement in the economy, both local and global, that we are anticipating. Nonetheless, for the year as a whole we expect earnings per share to decline by around 6 percent.

We see the earnings outlook for the major sectors as follows:

- **Banks:** We now expect banks to record negative earnings per share growth this year, largely because of greater provisioning for bad loans. No local bank has released details of its exposures to the troubled Saad and Gosaibi groups, but for the whole of the local banking sector it will run into several billions of dollars. Banks may also increase provisions if they are concerned about their exposures to other family groups. Total new funds set aside to provision for bad debts amounted to SR1.4 billion in the second quarter. Greater provisioning is inevitable over the remainder of the year. Bank lending will also be lower than we had anticipated, partly because of uncertainty around family businesses. Lower lending rates and brokerage revenues will add to pressure on profitability.

- **Petrochemicals:** Petrochemical prices have improved more than expected and demand will pick up in the second half of the year in line with the recovering global economy. Given the collapse in earnings in the final quarter of last year, we expect a strong rebound in the last two quarters of 2009.

- **Telecoms:** All telecoms operators will be affected by the tough competition within the sector, though domestic demand for new technologies and services will remain strong. We expect Mobily's financial performance to continue to outperform that of STC, whose foreign operations have been hit by the global recession. Both of the other two operators are still building up their operations and neither is expected to record profits this year.

Based on our earnings projections for the remainder of this year, we think that the TASI is currently trading on an end-2009 P/E of 15.6. We have revised up our projection for an end-year fair value P/E for the market to 17.5. This in line with valuations in emerging markets with comparably strong growth prospects over the remainder of the year (principally countries in Asia). Valuations in these comparable markets have gone up much faster than we were anticipating as a result of rapid gains in share prices caused by improved sentiment about the economic outlook.

After examining quarterly performance and prospects, we maintain our view that fair market value for the TASI is 6,200 at end-2009. This is just over 10 percent above its current level. Markets often trade out of line with fair value and we think the TASI is more likely to overshoot than undershoot fair value over the remainder of the year. It has not rallied as much as other stock markets around the world owing to recent concerns about family businesses and if these are allayed then the market has the potential to catch up with some of the gains elsewhere. Global market movements will also play an important role in determining where the TASI ends the year; the consensus view is that there will be a further modest rise in US markets this year, though there is a large divergence in opinion.

Key data

	2002	2003	2004	2005	2006	2007	2008	2009F	2010F
Nominal GDP									
(SR billion)	707.1	804.6	938.8	1182.5	1335.6	1437.7	1753.5	1275.7	1445.3
($ billion)	188.6	214.6	250.3	315.3	356.2	383.4	467.6	340.2	385.4
(% change)	3.0	13.8	16.7	26.0	12.9	7.6	22.0	-27.2	13.3
Real GDP (% change)									
Oil	-7.5	17.2	6.7	6.2	-0.8	0.5	4.9	-9.5	5.2
Non-oil private sector	4.1	3.9	5.3	5.8	6.1	5.7	4.2	2.3	4.4
Government	2.9	3.1	3.1	4.0	3.1	2.7	3.0	2.8	2.3
Total	0.1	7.7	5.3	5.6	3.2	3.4	4.2	-1.0	4.1
Oil indicators (average)									
WTI ($/b)	26.2	31.1	41.5	56.6	66.1	72.3	99.7	58.0	70.0
Saudi ($/b)	23.7	26.9	34.7	49.5	60.5	68.1	93.4	54.5	64.8
Production (million b/d)	7.5	8.8	9.0	9.5	9.2	8.7	9.2	8.1	8.4
Budgetary indicators (SR billion)									
Government revenue	213	293	392	564	679	643	1101	558	662
Government expenditure	234	257	285	346	398	466	520	565	593
Budget balance	-21	36	107	218	280	177	581	-7	68
(% GDP)	-2.9	4.5	11.4	18.4	21.0	12.3	33.1	-0.6	4.7
Domestic debt	660	660	614	475	366	267	237	237	220
(% GDP)	93.3	82.0	65.4	40.2	27.4	18.6	13.5	18.6	15.2
Monetary indicators (average)									
Inflation (% change)	0.2	0.6	0.3	0.7	2.3	4.1	9.9	5.8	4.4
SAMA base lending rate (%, year	2.00	1.75	2.50	4.75	5.20	5.50	2.50	2.00	2.75
External trade indicators ($ billion)									
Oil export revenues	63.6	82.0	110.4	161.6	188.2	205.3	281.0	115.6	138.0
Total export revenues	72.3	93.0	125.7	180.4	210.9	233.1	313.3	143.0	167.7
Imports	29.6	33.9	41.1	53.8	63.0	81.5	100.6	95.6	98.5
Trade balance	42.6	59.1	84.6	126.6	147.8	151.6	212.7	47.4	69.2
Current account balance	11.9	28.0	51.9	90.0	98.9	93.3	147.0	-20.6	-3.2
(% GDP)	6.3	13.1	20.7	28.5	27.8	24.3	31.4	-6.1	-0.8
Official foreign assets	73.3	97.1	127.9	195.5	273.4	359.8	506.3	452.5	455.2
Social and demographic									
Population (million)	21.5	22.0	22.5	23.1	23.7	24.2	24.8	25.6	26.4
Unemployment (male, 15+, %)	7.6	8.2	8.5	8.8	9.1	9.0	8.8	8.5	8.2
GDP per capita ($)	8773	9745	11112	13640	15041	15814	18849	13291	14613

Sources: Jadwa forecasts for 2009 and 2010. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics and Jadwa estimates for oil, social and demographic indicators.

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