جدوى للإستثمار
Jadwa Investment

September 2015

Macroeconomic update:

Oil sector growth revised up

- We have revised some of our 2015 and 2016 forecasts to take account of a recent flow of data that has generally been slightly weaker than we had anticipated.

- With higher than expected year-to-date oil production, we have revised up our forecast for oil sector GDP growth.

- Elevated levels of public spending and credit growth should support non-oil growth with construction, transport, and retail sectors in the lead.

- The high level of spending on the economy, together with low oil prices, will mean a larger than anticipated fiscal deficit, while the current account deficit will be small in 2015.

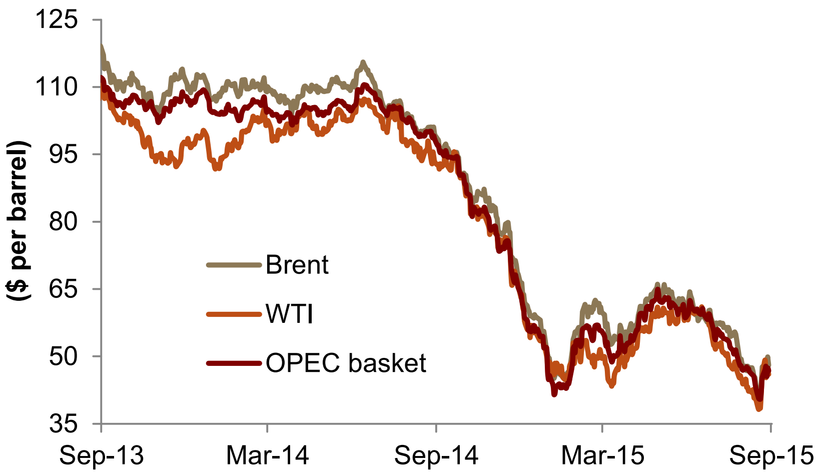
- However, the new government deficit financing strategy of reserve withdrawals and debt issuance will ensure a stable and gradual consolidation in public expenditure as the fiscal balance starts to improve from 2016.

Over-supplied oil market and moderate demand growth

Brent oil prices year-to-date average is currently 55 per barrel (pb), down 51 percent, year-on-year. The combination of relative resilience in shale oil supply, higher OPEC output and moderate growth in global oil demand will mean limited upside to prices for the remainder of the year.

On the supply side, shale oil has managed to maintain growth despite low oil prices, with a number of cost-cutting measures and

Figure 1: Oil prices



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OPEC output in July was the highest in 2 years.

hedging allowing year-on-year production rises, so far. However, on a monthly basis US shale oil production is starting to show signs of slower growth. Month-on-month growth in shale has been negative since May 2015 (Figure 2). The expected lower price environment going forward will increase financial pressure on shale oil companies, especially some smaller and midsized one, resulting in US crude oil production growth decelerating at a more rapid pace in the last quarter of 2015, with sustained drops throughout 2016. OPEC output in July was the highest in 2 years, with large gains from Iraq (700 tbpd), Iran (130 tbpd), and Saudi Arabia (350 tbpd), year-on-year.

Year-to-July data shows that Saudi Arabian crude production rose sharply to 10.2 mbpd.

Year-to-July data shows that Saudi Arabian crude production rose sharply to 10.2 million barrels per day (mbpd), up 4 percent year-on-year. The Kingdom's oil policy has suggested cuts in its own output will not be implemented. Higher refinery input will keep Saudi domestic consumption at around 2.7 mbpd whilst exports will be targeted above 7 mbpd in order to maintain market share. As a result, we have revised our 2015 forecast for Saudi oil production to 10.1 mbpd, up from 9.8 mbpd previously. Even as shale oil growth slows in 2016, competition amongst OPEC members will see yearly Saudi production remaining at 10.1 mbpd in 2016 as well (Figure 3).

Looking ahead, the outlook for oil demand remains moderate in 2015 and 2016.

Looking ahead, the outlook for oil demand remains moderate in 2015. Only Canada and the US are contributors to growth in OECD demand but weak economic growth from the EU and Japan will continue as a drag on oil consumption in 2015. Non-OECD demand is expected to hold up, regardless of the devaluation in China. Year-to-July Chinese oil demand was up 7 percent year-on-year, whilst imports were up 3 percent over the same period. OPEC data also points to yearly gains from India (2.9 percent) and the Middle East (2.7 percent). In 2016, the continued moderate pace of global economic growth will result in flat year-on-year global oil demand growth.

All this means there is little upside to oil prices which has led us to downgrade our full year 2015 Brent forecast to $56 per barrel and $61 per barrel for 2016.

The glut in global oil markets has resulted in OECD commercial crude stocks rising, especially in the US, where rises in shale output and ban on crude oil exports has seen record stockpiling. Stockpiling is expected to continue for the remainder of 2015, with some easing in 2016. As a result of all the above factors, global oil surpluses will remain above 1.5 mbpd in Q3 & Q4 2015, but will trend downwards throughout 2016. All this means that there is little upside to oil prices, which has led us to downgrade our full year 2015 Brent forecast to

Figure 2: US Shale oil production

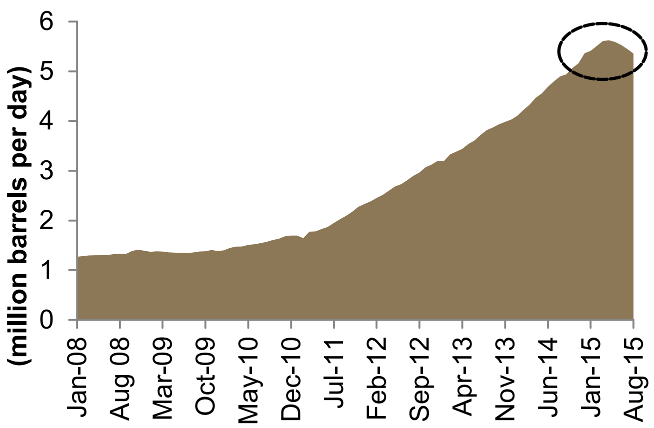
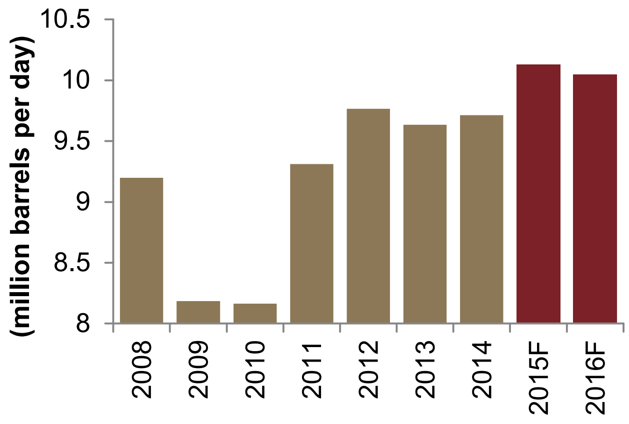


Figure 3: Saudi Arabia oil production forecast



$56 per barrel, from $61 per barrel previously, and 2016 prices to $61 pb, from 68 pb previously.

2015 overall GDP growth revised down slightly

We forecast real GDP growth to reach 3.2 percent, and 2.3 percent in 2015 and 2016 respectively.

We forecast real GDP growth to reach 3.2 percent, and 2.3 percent in 2015 and 2016 respectively, down from 3.5 percent in 2014. We see a slight moderation in economic growth during 2015, with annual oil sector GDP growth increasing to 3.4 percent, up from 1.5 percent in 2014. This is mainly due to higher oil production which has increased to record levels so far in 2015. Our forecast for non-oil private sector GDP is 3.8 percent for 2015. Data on the first half of 2015 shows that year-on-year growth for non-oil private sector GDP has slowed to 3 percent, down from 5.8 percent during the same period in 2014, which we believe is partially reflective of the negative sentiment associated with the uncertainty regarding the direction of fiscal policy.

We expect the government to maintain elevated spending...

...thereby reducing the current uncertainty regarding fiscal policy in this low oil price environment.

A more pronounced slowdown during 2016 will be driven mainly by changes in oil production and oil sector growth, as we see oil sector GDP falling to 0.2 percent in 2016. We forecast non-oil private sector GDP growth to accelerate to 4.7 percent in 2016, mainly due to an expected improvement in private sector activity as it adjusts to the new environment of lower oil prices. We also expect the government to maintain elevated spending (see the fiscal section below) thereby reducing the current uncertainty regarding fiscal policy in this low oil price environment. Firms and investors will overcome the short-term sentimental impact and uncertainty regarding the continuity of an elevated level of government spending on the economy (Figure 4).

While the sentimental impact of a drop in oil prices has been running its course...

...some sectors within the non-oil private economy continued to post healthy growth

We believe that the non-oil private sector will continue to be supported by the government's sustained commitment of keeping spending elevated, which has been highlighted by the recent shift in financing strategy through series of debt issuance. While the sentimental impact of a drop in oil prices has been running its course, some sectors within the non-oil private economy continued to post healthy growth. Construction and transport were the fastest growing sectors, with both growing by 4.5 percent year-on-year during the first half of 2015. Other sectors, including wholesale and retail and utilities, also posted healthy year-on-year growth above 3 percent (Figure 5). We therefore see construction, transport, and wholesale and retail as the fastest growing sectors within the non-oil

Figure 4: Real GDP growth
(year-on-year change)

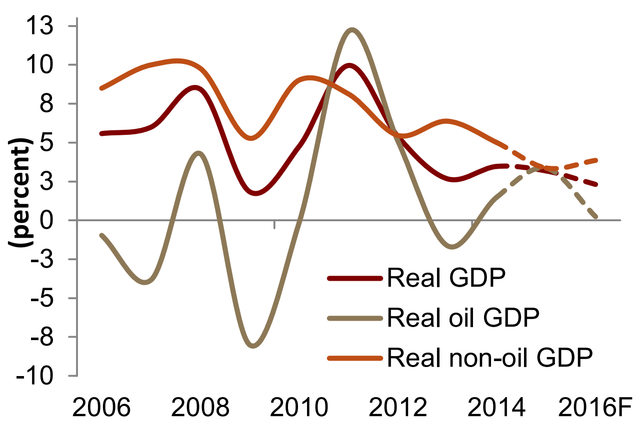
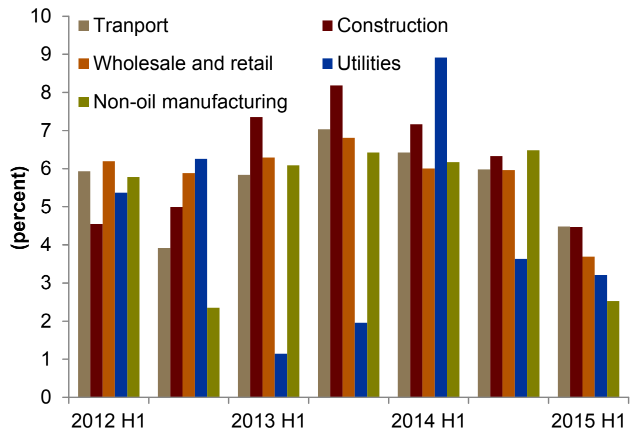


Figure 5: Non-oil private sector GDP growth
(year-on-year change)



Bank credit to the private sector has slowed down slightly but maintained solid growth during the first seven months of 2015.

the outstanding value and number of planned and ongoing projects remains very high…

...which points to the government's commitment in completing key infrastructure projects.

We revised up our 2015 forecast for the budget deficit to SR403 (16.4 percent of GDP).

private economy. Consumer spending, bank credit to private sector, the projects market, and other business survey data all continue to point to slowing, but healthy levels of performance in non-oil real GDP.

Recent monthly data have continued to show positive growth in the non-oil private economy during the first seven months of 2015. Data on consumer spending points to an expansion in consumer oriented sectors, albeit at slowing levels compared to previous years (Figure 6). Bank credit to the private sector has slowed down slightly but maintained solid growth during the first seven months of 2015. We view this as reflective of negative short-term sentiment and change in regulations, not a deterioration of credit conditions. The banking system still enjoys ample liquidity, as indicated by the notable improvement in commercial banks' acquisitions of foreign assets since the start of the year (Figure 7).

It appears that progress on awarding contracts and project implementation has slowed down as the government pushes for more efficiency in capital spending on infrastructure projects. Nevertheless, the outstanding value and number of planned and ongoing projects remains very high, which points to the government's commitment in completing key infrastructure projects. The high, but slowing level of government spending will remain the main stimulus to the economy. The new series of sovereign development bond issuance will further support this type of spending in 2015 and beyond, as it will reduce the pressure associated with solely relying on foreign exchange reserves withdrawals to finance capital projects (see next section). We see capital spending on key sectors, including healthcare, transport, and education, to be sustained; as investment in these areas mostly serves the broader economic development goals.

Fiscal balance and public debt

We revised up our 2015 and 2016 forecast for the budget deficit to SR403 (16.4 percent of GDP), and SR302 billion (11.6 percent of GDP) respectively. Lower oil revenues will lead to slightly larger deficits than our earlier forecast, while gradual consolidation in the Kingdom's finances should help with a steady improvement in the deficit over the next few years.

Oil revenues are the source of around 90 percent of budget

Figure 6: Consumer spending
(year-on-year change)

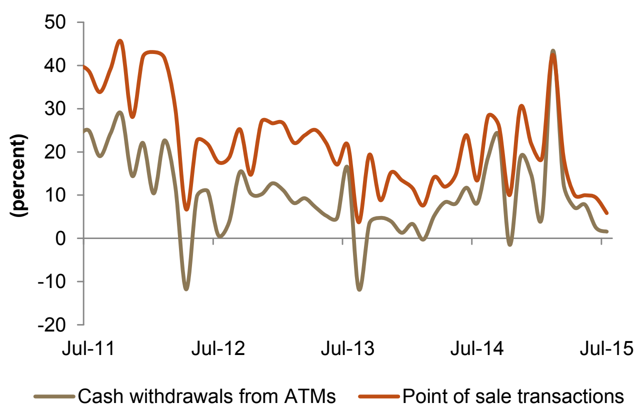
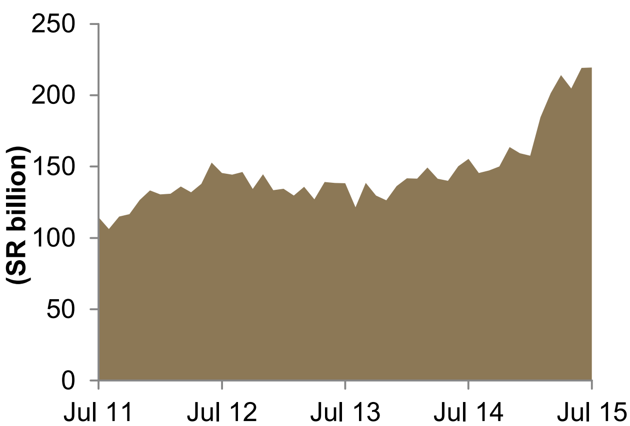


Figure 7: Bank holdings of net foreign assets



revenues, which we now expect to reach SR545 billion in 2015, down from SR913 billion in 2014. Non-oil revenues are forecast to grow from SR131 billion in 2014 to SR134 in 2015. As for 2016, we forecast a recovery in oil revenues, up to SR549 billion. We also see non-oil revenues growing at a faster rate in 2016, reaching SR140 billion, as the government becomes more prudent in its efforts to maximize revenues from existing sources.

We see government spending reaching SR1,082 billion in 2015…

...with a lower spending of SR991 billion in 2016.

We see government spending, particularly on wages and salaries likely remaining high this year. However, the government will be able to manage the growth of this type of spending in the future through Saudization initiatives in the private sector. While capital spending should start slowing gradually, government spending on operations and maintenance will likely see the fastest growth in the future, as many infrastructure projects enter the operational phase. Our forecasted slowdown in capital spending will mean that total government expenditure will reach SR1,082 billion in 2015, slightly lower than SR1,110 billion in 2014, but actually higher as a percent of GDP (from 39.7 percent in 2014 to 43.9 percent in 2015), mostly due to the contraction in nominal GDP. In 2016, we forecast total government expenditure to slow further to SR991 billion (38 percent of GDP), as a further gradual reduction in capital spending and a diminishing impact of the one-time fiscal stimulus included in the January 2015 Royal decrees takes shape. We also see the possibility for the government to reduce non-consumer subsidies in 2016, particularly within utilities. We believe, however, that the initial high level of spending will keep the fiscal position in a deficit during 2016 (Figure 8).

Reserves withdrawals and sovereign bond issuances will finance the deficit.

We expected that the government would start issuing bonds earlier in the year…

The deficit will be financed through a combination of reserves withdrawals and new government development bond issuances. According to news sources, new sovereign bond issuance will reach SR120 billion in 2015 as the government finances part of the deficit. We think the total public debt this year will reach SR148 billion, of which SR28 billion is left from previous years. This is lower than what we had expected earlier in the year *(see our Q1 2015 oil market update)*, as we had expected the government to start issuing at the beginning of the second quarter.

This series of sovereign bond issuance is the first since 2007, and is likely to continue on a monthly basis throughout the remainder of 2015 and 2016. We also see this new dual financing strategy of debt

Figure 8: Fiscal balance

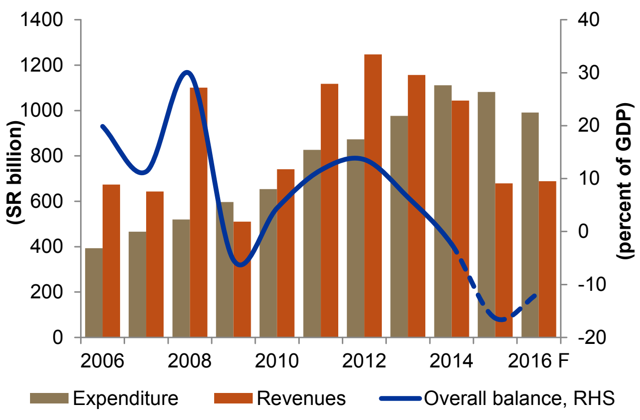
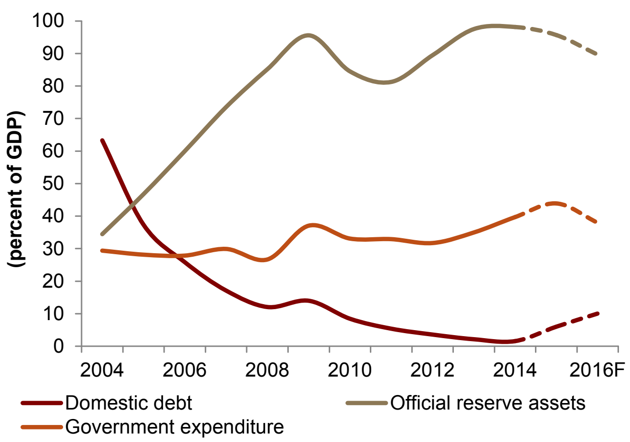


Figure 9: Public spending, debt, and reserves



...we therefore have revised our forecast for total public debt to SR148 billion in 2015.

We see plenty of room for the banking sector to absorb this issuance without crowding out credit to the private sector.

issuance and foreign exchange reserve withdrawals to provide the government more flexibility with regards to the timeframe needed for fiscal consolidation. The government will be able to afford fiscal expenditures for a longer time as it taps its large borrowing capacity. The solid credit profile and ample reserves enjoyed by the Kingdom meant the cost of financing is low, with yield spreads on the ten year tranche only 48 basis points (bp) above US treasury bonds. Furthermore, we see plenty of room for the banking sector to absorb this issuance without crowding out credit to the private sector. We estimate that domestic banks have more than SR460 billion in excess liquidity that may be utilized to finance the new bond issuance. This liquidity includes bank holdings of SAMA bills, deposits at SAMA, and net foreign assets. Looking ahead, we forecast total domestic debt to rise from SR148 billion (6 percent of GDP) in 2015, to SR263 billion (10.1 percent of GDP) in 2016. This means that the public debt will remain significantly lower than foreign exchange reserves in 2016, providing enough space and time for a gradual fiscal consolidation even if oil prices remain low for the longer-term (Figure 9).

Current account deficit revised down

We have revised our 2015 forecast for the current account deficit to $14.3 billion (2.2 percent of GDP).

We have revised our forecast for 2015 current account deficit from $24.7 billion (3.7 percent of GDP) down to $14.3 billion (2.2 percent of GDP), before recovering to a balanced position in 2016 (Figure 10). Our downward revision is mainly due to a smaller than expected deficit in the services account. Q1 2015 data has shown a reduction to the deficit in the services account to $17 billion, down from record highs of $25 billion and $21 billion in the previous two quarters.

Our downward revision is mainly due to a smaller than anticipated deficit in the services account.

Our 2015 forecast for total exports is $221 billion. We forecast oil exports (which makes up over 80 percent of total exports) to fall to $166 billion in 2015. Non-oil exports are also likely to fall slightly in 2015 and reach $55 billion, mainly due to the subdued global demand in 2015 for petrochemicals and plastics, the Kingdom's two largest non-oil exports. Our 2015 forecast for imports is $158 billion, almost unchanged from a year earlier. Year-to-July imports recorded a small 3.2 percent fall compared to the same period in 2014. In 2016, we see total exports recovering to reach $233 billion, supported by an increase to both oil and non-oil exports, with imports also growing but a slower rate to reach $159 billion. Our forecast for a higher increase in total exports will mean a balanced current account in 2016.

Figure 10: Current account balance
(year-on-year change)

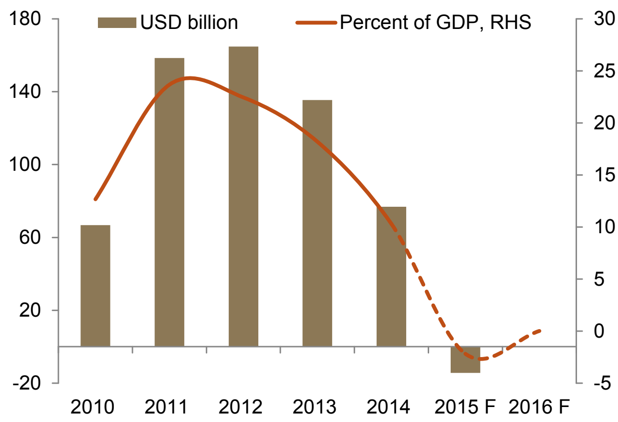
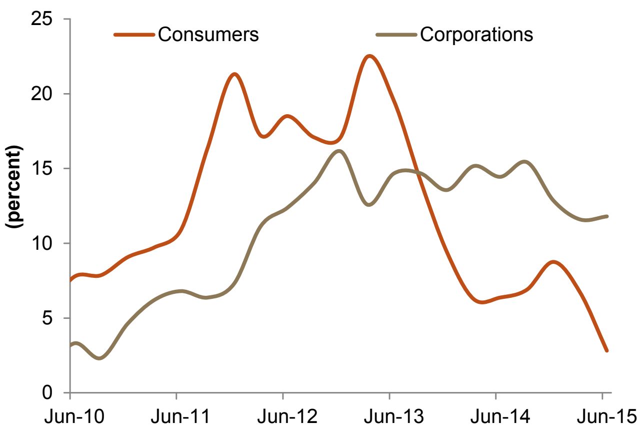


Figure 11: Credit to consumers and corporations



Strong fundamentals to support growth in Monetary aggregates

Year-on-year growth in bank credit reached 9.8 percent in July…

...slowing down from 11.7 percent during the same period last year...

...confirming our view that the oil price drop and the prospect of government deficits will lead to a slowdown in credit growth.

Year-on-year growth in bank credit reached 9.8 percent in July, slowing down from 11.7 percent during the same period last year, and confirming our view that the oil price drop and the prospect of government deficits will lead to a slowdown in credit growth (*see our Saudi economy in 2015 publication*). The majority of this new growth in credit came from the corporate sector, while consumer credit growth slowed down (Figure 11). We view this slowdown in consumer credit as mainly due to the commencement of new regulations on consumer lending by SAMA earlier in the year in an effort to curb consumer debt servicing burdens and introduce international best practice. These include new limits on credit card issuance as well as caps on fees which banks may charge customers . Looking ahead, we expect the year-end growth in credit to the private sector to slow further to 9.5 percent year-on-year, followed by a slightly slower growth of 9.3 percent at the end of 2016. This is due to the prospect of interest rate hikes in coming months as credit slowly becomes more expensive. However, the loan-to-deposit ratio standing at 81.2 as of July, and bank excess reserves at SAMA standing at SR38 billion, suggests limited funding risks, and plenty of room for banks to continue extending credit at a healthy pace.

Inflation in the Kingdom has been subdued so far this year…

...which is mostly due to the weak inflationary pressure.

Overall, we see annual inflation averaging 2.1 percent in 2015.

Inflation in the Kingdom has been subdued so far this year despite strong domestic demand. Inflation has consistently been lower than the five year average since the start of the year (Figure 12). This is mostly due to the weak inflationary pressure which we think will keep inflation at a moderate level over the remainder of 2015. The inflation rate among the Kingdom's main trading partners remained subdued, international food prices are down 21.5 percent in year-on-year terms (according to the UN Food and Agriculture Organization) and most other commodity prices have been falling. There is little sign of dollar weakness or underlying inflationary pressures in the global economy. For the Kingdom, rents are the main risk to our inflation forecast. Rental inflation has recently showed a recent uptick, accelerating to its fastest rate in seventeen months to reach 4.9 percent in August. It appears that higher incomes and government current expenditures have lifted demand for rental property while delayed land-market reform has encouraged landlords to raise rents. Once a sufficient supply of new government housing becomes available, rental inflation will decline. Overall, we see annual inflation averaging 2.1 percent in 2015.

Figure 12: Inflation
(year-on-year change)

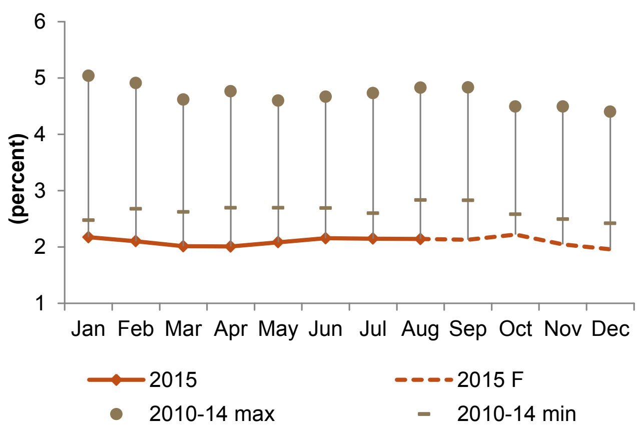
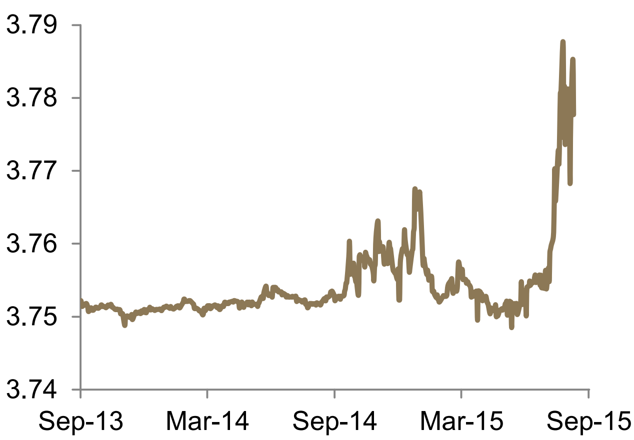


Figure 13: US Dollar/riyal one year forward rate



The main risks to our forecast are:

1) Concerns about global economic and regional political risks.

2) A prolonged period of lower oil prices .

The short-term uncertainty manifested itself in the forward exchange market…

...but we expect SAMA to maintain the fixed exchange rate for the foreseeable future.

Concerns about global economic and regional political risks, as well as a prolonged period of lower oil prices continue to be the main risks to our forecast. Global economic growth in the first half of the year has been slower than expected, risk appetite in financial markets has fallen and volatility has accelerated again. We remain concerned about the continued volatility and tightening of global financing conditions which could be triggered by an upward shift in market expectations of official interest rates. However, the implications for the Kingdom should not be exaggerated, as markets need to differentiate the Kingdom's stable outlook from other vulnerable economies on the back of the government's solid credit profile and ample reserves. The short-term uncertainty manifested itself in the forward exchange market, as speculative trading in response to the year-to-July fall in foreign exchange reserves pushed up the 1-year forward US Dollar/ riyal rate to 3.77 in September (Figure 13). However, we do not see a likely devaluation of the Saudi Riyal, given the large cushion of foreign currency at SAMA's disposal. We expect SAMA to maintain the fixed exchange rate for the foreseeable future, as total reserve assets remain at a very high level and can still cover up to 48 months of imports.

Key Data

	2008	2009	2010	2011	2012	2013	2014	2015F	2016F
Nominal GDP									
(SR billion)	1,949	1,609	1,976	2,511	2,752	2,791	2,798	2,465	2,610
($ billion)	519.8	429.1	526.8	669.5	734.0	744.3	746.2	657.3	696.1
(% change)	25.0	-17.4	22.8	27.1	9.6	1.4	0.3	-11.9	5.9
Real GDP (% change)									
Oil	4.3	-8.0	-0.1	12.2	5.1	-1.6	1.5	3.4	0.2
Non-oil private sector	11.1	4.9	9.7	8.0	5.5	7.0	5.6	3.8	4.7
Non-oil government	6.2	6.3	7.4	8.4	5.3	5.1	3.7	2.4	2.0
Total	8.4	1.8	4.8	10.0	5.4	2.7	3.5	3.2	2.3
Oil indicators (average)									
Brent ($/b)	97.2	61.7	79.8	112.2	112.4	109.6	99.4	56.0	61.0
Saudi ($/b)	94.0	60.4	77.5	103.9	106.1	104.2	95.7	52.0	57.0
Production (million b/d)	9.2	8.2	8.2	9.3	9.8	9.6	9.7	10.1	10.1
Budgetary indicators (SR billion)									
Government revenue	1,101	510	742	1,118	1,247	1,156	1,044	679	688
Government expenditure	520	596	654	827	873	976	1,111	1,082	991
Budget balance	581	-87	88	291	374	180	-67	-403	-302
(% GDP)	29.8	-5.4	4.4	11.6	13.6	6.5	-2.4	-16.4	-11.6
Domestic debt	235	225	167	135	99	60	44	148	263
(% GDP)	12.1	14.0	8.5	5.4	3.6	2.2	1.6	6.0	10.1
Monetary indicators (average)									
Inflation (% change)	6.1	4.1	3.8	3.7	2.9	3.5	2.7	2.1	1.9
SAMA base lending rate (%, end year)	2.5	2.0	2.0	2.0	2.0	2.0	2.0	2.4	3.4
External trade indicators ($ billion)									
Oil export revenues	284.1	166.9	215.2	317.6	337.5	322.0	285.2	165.7	172.2
Total export revenues	313.5	192.3	251.1	364.7	388.4	375.9	342.3	221.1	232.5
Imports	101.5	87.1	97.4	120.0	141.8	153.3	158.5	158.1	159.1
Trade balance	212.0	105.2	153.7	244.7	246.6	222.6	183.9	63.0	73.4
Current account balance	132.3	21.0	66.8	158.5	164.8	135.4	76.9	-14.3	0.1
(% GDP)	25.5	4.9	12.7	23.7	22.4	18.2	10.3	-2.2	0.0
Official reserve assets	442.7	410.1	445.1	544.0	656.6	725.7	732.4	628.7	623.9
Social and demographic indicators									
Population (million)	25.8	26.7	27.6	28.4	29.2	30.0	30.8	31.5	32.2
Saudi Unemployment (15+, %)	10.5	11.5	12.4	12.1	11.7	11.7	11.7	11.7	11.6
GDP per capita ($)	20,157	16,095	19,113	23,594	25,139	24,816	24,252	20,851	21,586

Sources: Jadwa forecasts for 2015 and 2016. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics & Information and Jadwa estimates for oil, social and demographic indicators.

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