Rethinking Global Investment Themes for the Middle East

By Dr. Philippa Malmgren and Samer Solh

Conflicting forces in the world economy are causing grave uncertainty for some investors and historic opportunities for others. Investors worldwide have experienced impressive rallies in risk asset prices for the last year. However, significant economic and liquidity policy challenges are looming that may affect sources of returns in the future.

There are generally two types of assets: (1) assets that rally when liquidity is strong and government bailouts support market prices; and (2) assets that have genuine unimpaired cash flows that will do well even if governments begin to reduce liquidity or simply cannot continue to engage in bailouts.

Therefore, investors need to "triage", or separate, their investments and fully understand which assets belong in which category above.

The precarious nature of the markets was made apparent in May 2010 when the Europeans announced a €750 billion package that was designed to protect the major European banks from default if a Greece or a Portugal defaulted themselves. The market has blown the spreads beyond where they were when the package was announced.

The bottom line is that Greece is due to make its last repayment in 2050. In the meantime, it must endure some three years of depression followed by roughly 15 years of recession. That means that a whole generation is lost.

Our guess is that default is the likely end game once people realize that human beings cannot bear that much pain for that long. A default would permit the restoration of inflation and growth. Devaluation would strongly encourage inflation and growth.

Inflationary pressures are already apparent in the world economy even though debt deflation is also bearing down on markets. The combination of the two will create different investment outcomes in different locations: inflation will continue to accelerate in emerging markets while the debt burden in the West will absorb the same inflationary pressures or it will crush margins, thus further damaging capacity. Greater capacity destruction always leads to more inflation.

Therefore, we must draw attention to the nature of investors' assets and liabilities with a close examination of quality of returns, industrial capacity, debt and expectations of inflation and deflation.

CHALLENGES AHEAD

The U.S. Federal Reserve and other central banks seem to have greater conviction that the global economic recovery is now genuine and sustainable in that the restocking of inventory no longer drives it. Businesses in most global economies feel they have found a new base of demand and, as long as unemployment does not rise, are confident they are profitable.

One the other hand, investors still need to consider that:

- The enormous sovereign and consumer debt burden will continue to pressure financial markets. We expect outright defaults, including sovereign defaults.

- The losses in the financial system are still playing themselves out, including in the Middle East.

- The "recrimination phase of the economic cycle" is not over and investors must expect more legal prosecutions of the financial services sector and of failed businesses (one can include BP, for example, here) as well as tougher regulation both internationally and in the Gulf.

As a result of these pressures and contradictory signals, it is not surprising that investors are finding it hard to figure out where they are in the economic cycle.

THE INFLATION VS DEFLATION DEBATE

There is debate and disagreement between the inflation vs. deflation camps that can be best explained by this: it all depends on the location and the "bogey" or measurable target. Our view is that it will pay to follow real or actual inflation rather than the government's measurement of it.

In the West, deflation remains the prominent theme and consensus view. This is in part because the market watches only the consumer price index or CPI. However, if one disaggregates the real cost components, then inflation pressures are more apparent. For example, the U.S. just a few months ago had the biggest jump in food prices in 26 years. The U.K. inflation rate is moving beyond the Bank of England's expectations. In Australia and Canada, inflation pressures are on the rise.

In emerging markets, inflation is already rising quite rapidly. Therefore, it is critical for investors to understand the intertwined framework of global policy, liquidity and industrial activity with which to judge relative risks and likelihood of each.

The financial markets are rich with opportunities for those who have conviction in their views.

INFLATION PRESSURES FROM EXCESS LIQUIDITY

The world economy has never seen such a large injection of liquidity from both fiscal and monetary policy within and among so many large economies at any one moment in time. Government policy has, in effect, moved the losses of the financial crisis from personal and private balance sheets onto public, government balance sheets. The location may have changed but the debt still needs to be dealt with.

Unfortunately, policy options to manage or reverse the effects of this liquidity expansion are limited. For example, in the U.S., the Federal Reserve may commit to mopping up the excess liquidity but it will be ineffective if there is no brake applied to fiscal spending. So far and despite political rhetoric, there is little evidence that the fiscal side can be constrained at all in the U.S., let alone in a hurry if growth is restored quickly (which seems to be occurring even now).

Exit strategies assume that the economic recovery will happen very slowly, when in fact, recoveries usually occur pretty quickly. People assume that banks will not lend and therefore growth will be restrained. In fact, the lack of bank capital available to borrowers – which continues to be the case – puts huge pressure on firms to cut unnecessary costs, reduce capacity further, innovate and to become more productive, all of which tend to increase growth over time.

INFLATION PRESSURES FROM INDUSTRIAL CAPACITY CONSTRAINTS

Contrary to widespread views, there may not be as much, if not any, excess industrial capacity left to absorb demand pick-up. The Bank of England mentioned this problem in the last inflation report. They said that maybe a good deal of capacity is not merely dormant. Maybe it is dead – technology has rendered many formerly productive assets genuinely useless. Destroyed capacity is worthless and is a source of inflation.

The credit crunch damaged and destroyed many of the marginal additional producers globally. Virtually free money conditions in the 1990s through the 2000s fuelled the establishment of many new firms around the world from dry cleaners to miners. But when the cash dried up and consumers stopped spending, many of these firms went bust as is apparent from the rising small business and corporate default rates from America to China.

This seems to have been especially true for assets that we extract from the ground – agriculture (farmers are extremely credit dependent), mined assets (from iron ore to diamonds) and energy (especially oil).

Interestingly, the prices of these commodities have risen dramatically since the crisis, dwarfing returns on equities. No doubt these prices are very volatile and have large setbacks. But, overall, there is less capacity to deliver these resources to the world than before the crisis began. Supply constraints were already a problem at the peak of the boom years. As excess capacity is destroyed, the firms that remain in business naturally raise their prices to reflect the diminished competition.

DEFLATION PRESSURES

In those economies that choose deflationary policies or where consumer spending will be held back, businesses will feel the squeeze between higher input costs and softer demand.

The opportunity for investors rests in firms best positioned to pass on higher costs or those that can better negotiate input cost hikes.

The higher input costs and supply constraints in food, mined assets and energy will hit margins in varying ways. Investors should want to own firms that have strong brands and monopolistic positions because they will be able to pass on higher input costs and negotiate down threatened price hikes by suppliers.

In addition, this should support new merger and acquisition activity as brands seek to strengthen their market share and market power. This explains in part the logic behind the Cadbury-Kraft deal. These are brand names that permit higher costs to be passed on to consumers.

In a world where western consumers face an extraordinary debt burden, most firms will not be able to raise their prices. Higher input costs in the West will prove to be a margin crusher for many competitors.

CONFLICTING SIGNALS

Taken together, the inflation pressures that are building in the system, combined with a high degree of uncertainty about inflation and deflation, should cause investors to lean toward hard and cash flowing assets.

After all, the rise in risk prices since the financial crisis has been a function of massive liquidity injections. These injections are now less dependable as governments begin to remove the quantitative easing measures and reveal that they have limited resources to keep up the liquidity.

In the future, the best protection against inflation, deflation, uncertainty and volatility is to own genuine unimpaired cash flows, bottlenecks and pricing power. This task presents itself to all investors.

The problem is that such cash flows are relatively rare. Investors are simply not going to find under-priced real cash flows that everyone else has overlooked. Instead, the trick is going to be taking a good cash flow and transforming it into better quality cash flow through active management.

This means owner-operator skills are now more valuable than financial engineering skills (which is a reversal of the skills that have driven private equity deals for many years).

IMPLICATIONS FOR THE MIDDLE EAST AND GULF REGION

Assessment

Equity and bond investors from and into the Middle East cannot afford to assume that the region functions in isolation from global financial pressures.

On the contrary, the region reflects most of these factors and will be subject to the impact of regional and international policies. For example, the region is vulnerable to food and energy price fluctuations given its dependency on food imports and energy sales (especially oil). Both constitute a much greater proportion of GDP than is true for any western country.

The various regional currency links and pegs to the U.S. Dollar potentially heighten the risk of inflation outcomes that are beyond the control of national authorities.

Consider the simple fact that the U.A.E. is reducing energy subsidies. Petrol prices will rise by 11% this year alone for local consumers through a subsidy reduction. This means a reduced standard of living, especially given the lack of public transportation alternatives. It is also an inflationary event.

The talk of a new value-added tax in the countries of the Gulf Cooperation Council ("G.C.C.") is important because it reflects the need to generate additional diversified revenue sources and the probability that consumers will pay higher taxes.

All this means the cost of doing business is bound to be higher. If that is the case, we cannot be surprised if some firms and balance sheets in the region have greater losses than are currently anticipated.

Seeking Themes

Investors from, or targeting opportunities in, the Middle East should be thinking along the same thematic lines as global investors.

Dependable themes here abound such as the growing middle class in emerging markets (think Saudi, Turkish or Egyptian consumers) or companies with unique advantages in the energy sector (think of the cost advantage and financial strength of Qatari or Saudi oil and gas producers and transporters).

In addition to the right themes, keys to success include finding opportunities with proven margins, margin management skills, strong and transparent balance sheets and, if applicable, those having strategic importance.

- Saudi Arabia and others in the region have started to move further up the value chain by moving into downstream petrochemicals, fertilizer and aluminium production and other energy-intensive industrial activities.

- Regional governments have been making credit available to select sectors and companies while banks, with balance sheet still under repair, continue to hamper a resumption of private sector lending.

- Consider the gas industry. Saudi Arabia, Oman, Qatar, Abu Dhabi and others have all started to build downstream, refined product facilities that are based on gas as the principal energy source. What will happen to these efforts as the price of natural gas rises or falls? While buyers today now increasingly purchase gas at lower spot prices instead of long term indexed contracts, investors must consider who wins and who loses. In addition to buyers, an advantage may still be viable to the lowest cost producers of energy, such as Saudi Arabia and Qatar, and those downstream operators who can compete with the most efficient plants.

- Retail businesses in Saudi Arabia have been transformed into higher value enterprises simply by improving the inventory management systems. Often, returns come from simple sources.

CONCLUSION

The issues we raise here should help investors think about investment opportunities and risks in the Middle East more accurately.

If, for example, inflation pressures in China and India are also going to be felt in this region, then investors should begin to consider those sectors and locations most vulnerable to inflation, for example: the food, construction or retail sectors; countries such as Egypt, Saudi Arabia or Jordan.

If global losses in the financial system are larger than expected, then it makes sense to try to discover where the debt holes are in Middle East balance sheets. The reduced availability of credit and the absence of deep, efficient regional capital markets may offer smart, skilled investors (such as family conglomerates or investment offices) an opportunity to fill in the funding gap for a large segment of the private sector.

If the debt burden, combined with higher input costs, is going to pressure margins elsewhere, then why would it not pressure margins in the Middle East too? If so, investors could profit from understanding the countries, industries and enterprises most and least likely to thrive in this environment.

There are many opportunities now for smart investors and owners of real businesses to stand behind the transformation of real assets. By this, we mean that investors can improve value through the application of a relatively small amount of capital combined with real human skills.

Thank you.

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Amwal Asset Management is the asset management arm of Doha, Qatar-based Amwal Q.S.C., an independent financial services firm founded in 1997. Regulated by the Qatar Central Bank, Amwal advises and manages portfolios for investors focused on the greater Middle East region.

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