Macroeconomic outlook

UAE: Non-oil sector in good shape amid lower oil prices

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Overview and outlook

- **Real GDP growth is expected to moderate in 2015 alongside anemic oil GDP growth. Non-oil sector is poised to remain resilient at about 5% on buoyant hospitality, transport and construction sectors.**
- **CPI inflation expected to steady in 2H15 and average around 3.5% for the year. Inflation accelerated in 1H15 on higher rental and utility costs.**
- **Fiscal balance forecast to churn out a small deficit.**
- **Credit growth is gradually recovering but remains constrained by tighter lending restrictions.**
- **The main stock market indexes have recently been hit by disappointing economic data from China, but remain at relatively high levels.**

Real GDP growth in non-oil sector poised to remain resilient

Real economic growth in the UAE is forecast to slow down modestly in 2015 to around 3.5% year-on-year (y/y) in 2015, as real oil GDP growth continues to get stung by conditions in the international energy markets. (Chart 1.)

Growth in oil GDP is expected to be anemic in the near-to-medium term amid weak global demand and ample supply in the oil market. Real oil GDP is projected to come in at around 0.3% y/y in 2015, versus the 4.0% y/y growth rate seen in 2014. Non-oil sector growth is poised to be resilient at rates of near 5% y/y in 2015 and 2016. This sector will continue to be led higher by buoyant levels of activity in the tourism and construction (particularly in transport and hospitality) sectors. Activity in the construction sector is set to accelerate as the Dubai Expo 2020 draws closer.

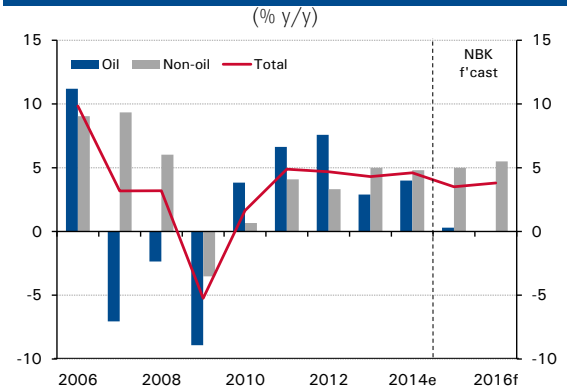
The Markit Purchasing Managers' Index (PMI) witnessed a healthy pick up in August. (Chart 2). After softening over recent months, UAE's headline PMI (a forward looking economic indicator) rose again in August from 55.8 in July to 57.1, thanks to strong gains in output, new orders and

Table 1: Latest macroeconomic forecasts

		Year			
		2013	2014e	2015f	2016f
Nominal GDP	USD bn	387.1	399.4	359.1	384.7
Real GDP	% y/y	4.3	4.6	3.5	3.8
- Oil	% y/y	2.9	4.0	0.3	0.0
- Non-oil	% y/y	5.0	4.8	5.0	5.5
Inflation	% y/y	1.1	2.3	3.5	3.5
Budget balance	% of GDP	7.2	3.0	-1.3	-1.6

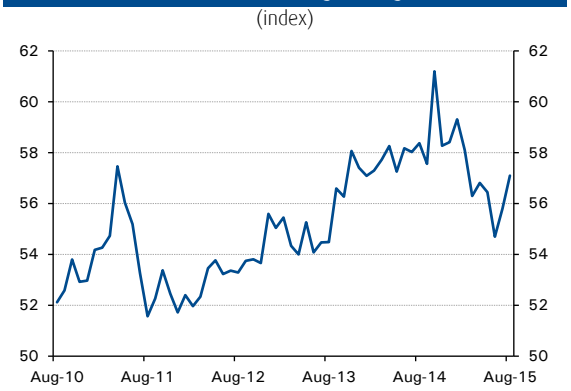
Source: Official sources, NBK estimates

Chart 1: Real GDP



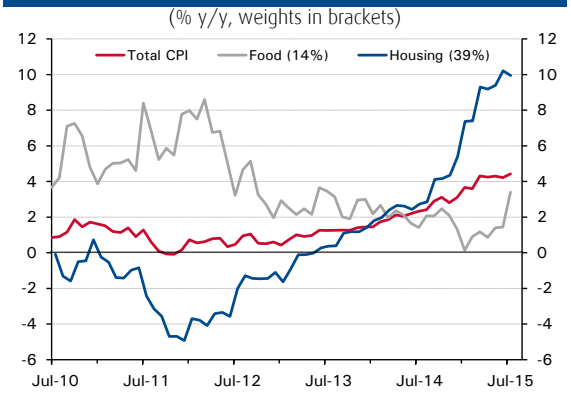
Source: UAE National Bureau of Statistics, NBK estimates

Chart 2: Markit Purchasing Managers' Index



Source: Markit

Chart 3: Consumer price inflation by sector



Source: Thomson Reuters Datastream

purchases. A reading above 50 demarks expansion, whilst one below demarks a contraction in activity. The strong gains in output and new orders more than offset the drop in the new export orders index. Export orders fell to a two-year low of 54.4 in August against a backdrop of a stronger US dollar (and thereby UAE dirham) and weak global demand. Inflationary pressures appeared to be rather subdued as input costs and staff costs remained steady. It is also worthwhile to note that employment conditions have remained stable, even amid lower oil prices, with the sub-index consistently above 52 over the past five months. This should help allay fears of major disruptions to domestic consumption and thus the overall economy.

We may be seeing the nascent affects of the long-awaited changes in the UAE's companies' law. One of the changes includes lowering the minimum percentage of equity that a company needs to float, from 55% to 30%. This should lead to an increase in initial public offering (IPO) activity, as the 55% requirement was deemed too high by entrepreneurs, reluctant to divest too much from their own businesses.

Residential property price growth in Dubai softened sharply in 2014 and early 2015

Growth in sales prices in Dubai's residential property sector continued to trend lower in early 2015. Growth in both apartment and villa sales prices slipped back into negative territory at the beginning of 2015, for the first time in three years. According to Asteco, a major real estate services company, prices of apartments in Dubai fell by 5% y/y in 2Q15 whilst villa prices fell by 10.2% y/y during the same period. (Chart 4.)

The imposition of higher transaction fees in 4Q13 and federal mortgage caps in early 2014 undoubtedly delivered the desired results of cooling off the property sector and curbing speculative buying. These measures have also been recently compounded by an on-going rise in housing levels, and a change in preferences and risk appetite within the residential property market.

Against a backdrop of greater supply, sellers have become increasingly willing to lower prices to meet buyers' expectations. Also, more and more buyers are opting for more affordable (mid-range) and/or end-use housing. While transaction values continue to fall, growth in the number of transactions, has to some extent, been recovering of late thanks to rising activity in the more affordable housing segment, (Charts 5 and 6.). Looking ahead, we expect to see more of this shift towards mid-range housing. As a result, the pickup in activity in the mid-range sector may eventually help offset the slowdown in activity in the luxury segment.

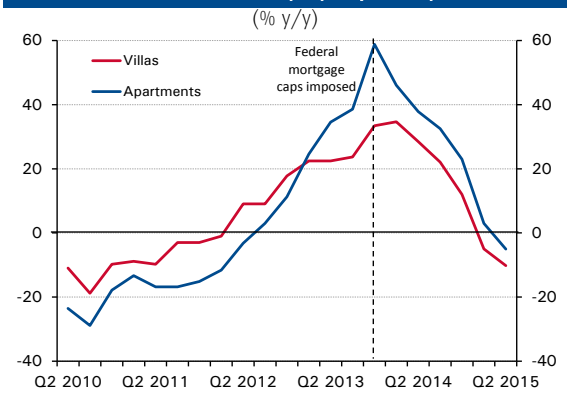
The property market has also been hampered by a stronger dirham relative to key emerging market currencies, denting sales from Russian as well as from Asian nationals. But with the majority of buyers being from the UAE or GCC region (dollar-based), the impact is expected to be limited going forward.

It is safe to conclude that Dubai's property market is going through a significant correction and that the measures that were put in place have so far shepherded the market in the right direction: steadier price growth and an increase in end-users rather than speculative buyers. But it may be still too early to say if the correction ran its course.

Consumer price inflation expected to steady in 2H 2015

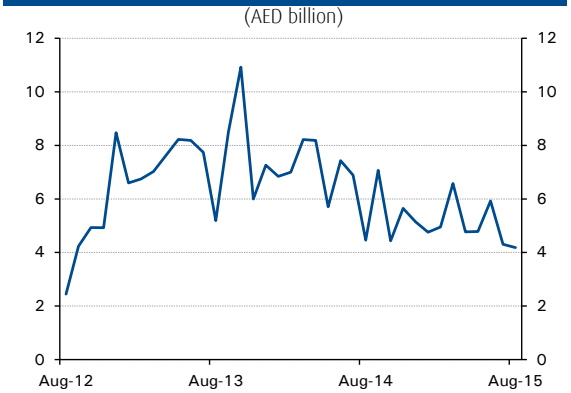
After accelerating throughout 1H15, headline inflation is expected to steady over the coming months as housing inflation (which weighs heavily on overall inflation) sees some stabilization. A stronger US dollar

Chart 4: Residential property sales prices



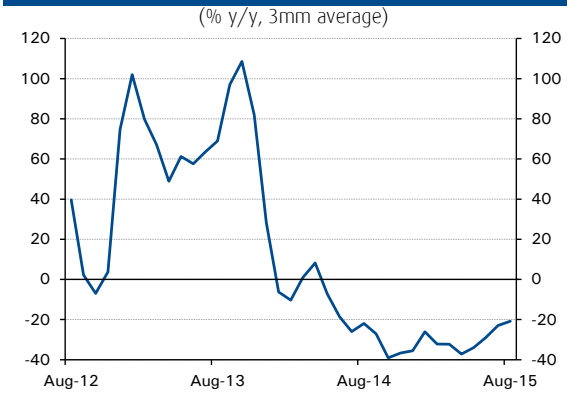
Source: Asteco, JLL

Chart 5: Value of transactions



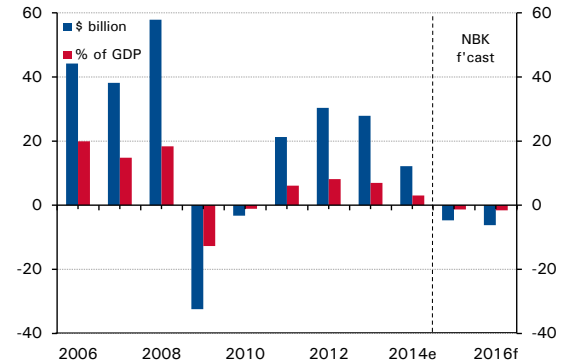
Source: Dubai Land Department

Chart 6: Number of transactions



Source: Dubai Land Department

Chart 7: Budget balance



Source: UAE National Bureau of Statistics, NBK estimates
Note: Budget balance includes ADNOC profits & investment income.

and lower commodity prices will also help limit any further significant gains in the headline inflation rate. Subsequently we forecast inflation in the consumer price index (CPI) to average close to 3.5% in 2015.

Latest data (July) showed inflation in the CPI reaching a new high of 4.4% y/y. This came on the back of another month of double digit growth in housing costs and a somewhat steep rise in food inflation (from 1.4% y/y in June to 3.4% y/y in July). The sharp rise in food inflation is projected to be short-lived however, as it was likely due to the timing of the Holy Month of Ramadan and the Eid Holiday, during which the demand for food typically sees a relatively stronger pick up.

Furthermore, whilst housing inflation did log in another consecutive month of double digit growth, it eased slightly from 10.2% y/y to 10.0% y/y. Inflation in the housing segment has been on an upward trend since the end of 2013 on the back of a recovery in the residential property sector. (Chart 3.) The steep rise in housing costs in 1H15 mainly came on the back of the one-off hike in electricity and water tariffs (for both nationals and expatriates) and the removal of the rental cap in Abu Dhabi. But with more housing set to enter the market and the effect of the one-off hike in utility tariffs set to wane, we should see inflation in the housing segment steady over the medium-term.

Small fiscal deficit in 2015 on high spending levels and lower oil revenues

The UAE's 2015 fiscal balance (breakeven oil price is $70/b) is expected to churn out a small deficit amid steady spending and lower revenues. The UAE government has no current plans to cut back on spending.

The fiscal balance is projected to fall from an estimated surplus of 3% of GDP in 2014, to a deficit of approximately 1.3% in 2015. (Chart 7.) With abundant financial reserves, which make up a staggering 200% of GDP, it is unlikely that the UAE economy will carry out any significant fiscal consolidation at least in the medium-term. Both Dubai and Abu Dhabi are scheduled to maintain their high levels of public spending. Public spending in Dubai is expected to accelerate in the run-up to the Expo 2020 event and as a large portion of its maturing debt becomes due around the same period.

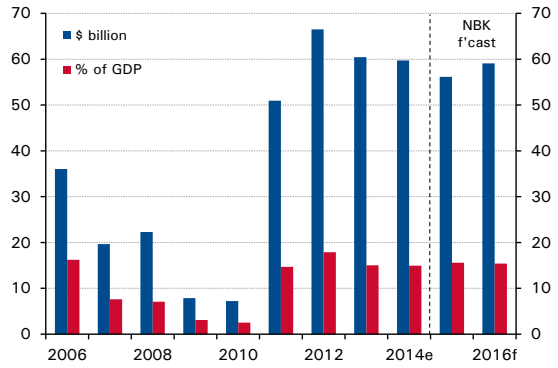
Should the UAE be pressured to do some fiscal consolidation or budget cuts, then we may see further reductions in the subsidy levels (5% of GDP in 2014) and Abu Dhabi federal services (7% of GDP in 2014). In July the UAE authorities announced that fuel prices would be deregulated starting in August. This should help lower subsidy costs over the medium-term, when global oil prices are expected to recover.

Current account surplus to remain resilient on strong non-oil earnings

The current account surplus is poised to remain resilient and steady at around 15% of GDP in 2015, on the back of strong non-oil export revenues. Downward pressures on the surplus from lower oil export earnings and higher imports, are being partly offset by robust non-oil export revenues, especially from the tourism and real estate sectors. (Chart 8.) Also, the stronger US dollar and therefore dirham, has helped lower the cost of imports.

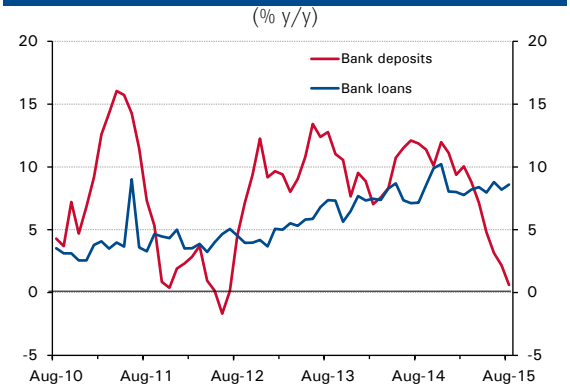
A potential removal of sanctions on Iran by the West, could be a huge boost for UAE trade, particularly in the non-oil sector. The UAE is Iran's biggest non-oil trading partner and Iran's biggest source of imported goods.

Chart 8: Current account balance



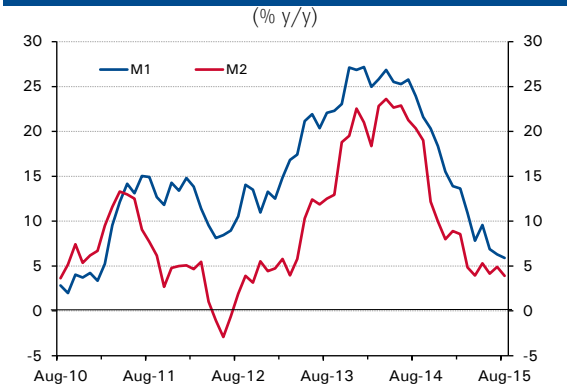
Source: UAE National Bureau of Statistics, NBK estimates

Chart 9: Bank lending



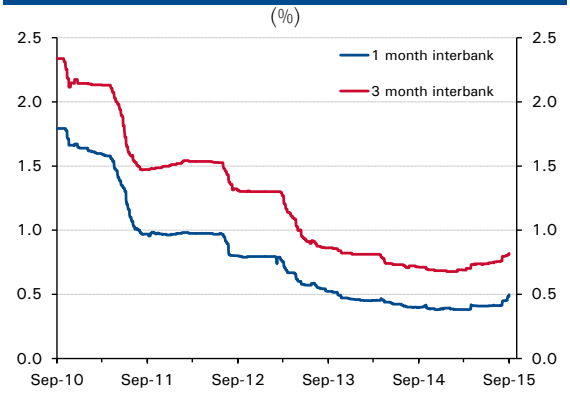
Source: Central Bank of the UAE

Chart 10: Money supply



Source: Thomson Reuters Datastream

Chart 11: Interbank rates



Source: Thomson Reuters Datastream

Bank credit growth continues to recover, but deposits growth fails to keep up

Growth in bank loans continues to trend upwards even amid softer oil prices and a slowing real estate market, as the rest of the non-oil sector continues to hold strong, the construction sector in particular. Loan growth (as of August) is currently hovering at around 8.6% y/y. With capital spending expected to increase further in the run-up to the Expo 2020 in Dubai, we should continue to see healthy gains in loan growth. (Chart 9.)

Deposit growth has been trending lower since the start of this year, mainly on the back of a slowdown in government deposit growth. As of August, total deposit growth stood at a mere 0.6% y/y. Growth in government deposits is slowing as public expenditures remain high and oil revenues continue to dwindle. Consequently, the loan-to-deposit ratio has been edging higher recently, but as of August it remains modest at 102.3%.

Government deposits are closely correlated with oil revenues. Unless oil prices pick up, growth in deposits is expected to slow further as oil revenues continue to weaken. As a result, we may see some lending restrictions imposed if credit growth begins to see significant gains and the loan-to-deposit ratio edges higher.

Annual growth in broad M2 money supply has been trending downwards since mid-2014, mainly due to a high base and more recently lower government deposits. (Chart 10.)

Monetary policy remains accommodative and there is room for monetary tightening if need be: the UAE's three-month and one-month interbank rates have remained low and below 1% in 2014 and in 2015 so far. (Chart 11.) Thus far in 2H15, we have seen a slight uptick in both rates. A rise in the US Fed rate is expected to further tighten liquidity conditions in the banking sector, albeit with some time lag.

Market performance remains solid

The main Abu Dhabi and Dubai indices, continue to hover at high levels, but were recently pressured by a ream of disappointing economic data from China and by jitters ahead of a potential US Fed hike. (Chart 12.)

Growing worries about China and a looming US Fed hike have also been reflected in the main credit default swaps (CDS), good indications of the level of risk within an economy, which ticked slightly upwards recently. (Chart 13.) The CDS on five-year Dubai and Abu Dhabi government debt stood at 209 and 65 basis points respectively, at the start of September.

US dollar-dirham peg is here to stay even amid on-going appreciation

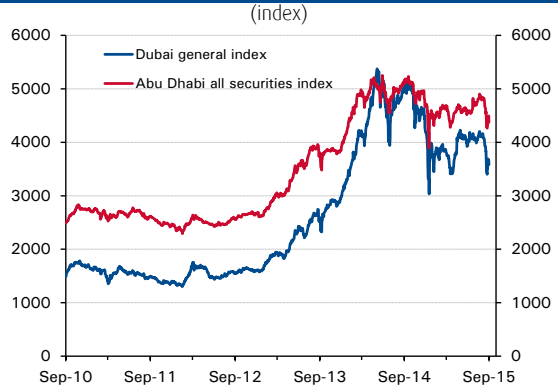
The dirham has been pegged to the US dollar at a rate of $1 = 3.673 Dhs since 1997. The current exchange rate policy has thus far helped the UAE economy instil macroeconomic stability, keep the rate of inflation in check and maintain investor confidence. However, the peg has come under pressure of late against a backdrop of falling oil prices and a stronger US dollar against most other currencies. However, thanks to the country's abundant foreign reserves, the UAE has enough ammunition to defend its peg to the US dollar.

The stronger dollar has led to an appreciation in the UAE's trade-weighted index (chart 14), increasing the costs of its exports and making it a more expensive place to visit and invest in for expatriates outside the GCC region and the US.

Exports, non-oil exports in particular, may be hammered slightly by the

Chart 12: Stock market indices

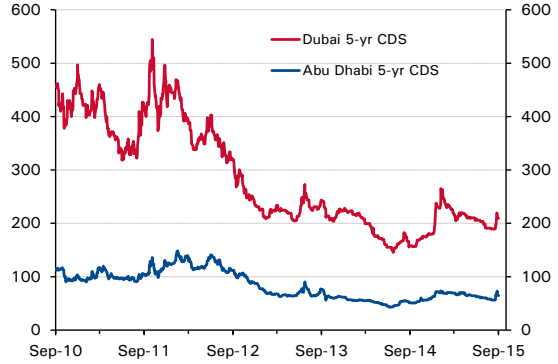
(index)



Source: Thomson Reuters Datastream

Chart 13: Credit default swaps

(basis points)



Source: Thomson Reuters Datastream

Chart 14: UAE trade-weighted index

(index, Jan 2000 = 100)

Source: Thomson Reuters Datastream, NBK

strength of the dirham; given that the UAE's major trading partners are in Asia, which continues to see further depreciations in their respective currencies. However, since a majority of tourists are from the GCC region and UAE nationals are the largest investors in real estate, concerns of a significant slowdown in the respective sectors and ultimately the non-oil economy should be limited.

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