Economic Update

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Equity Markets

US markets outperform in Q3, EM concerns worsen while FTSE upgrades Kuwait

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Highlights

- **World markets strengthened overall in 3Q18, but sentiment shifted due to higher interest rates and global tensions.**
- **US markets recorded their best quarter in five years thanks to robust economic growth and corporate earnings.**
- **Emerging markets faltered due to concerns over growth and debt sustainability.**
- **GCC equities weathered the emerging market sell-off thanks to higher oil prices and hard currency pegs.**
- **Kuwait received $200 million in net foreign inflows in September, and more than $500 million year-to-date.**
- **Higher oil prices, firm regional economies, and healthy corporate earnings are expected to continue to support regional equities in the coming months.**

The prospect of a tighter-than-expected US monetary policy and slower global growth is once again reshaping investors' outlook, with equity markets the world over re-pricing accordingly. Those worries culminated in October's strong correction, but the shift in sentiment built up throughout 3Q18 as investors weighed diverging global growth and the Fed's more hawkish outlook on interest rates.

The global recovery, which has been underway since 2016, has recently become less balanced. Robust US growth – driven by fiscal stimulus – now contrasts sharply with the softer outlook for the EU, China, and other major economies. Meanwhile, tighter global financial conditions, led by the Fed's bullish rate normalization and a stronger US dollar, have seen a reversal of capital flows to emerging markets – particularly those with significant stocks of foreign debt and vulnerable external positions. Atop all of this is the US's aggressive trade policy, which still shrouds with uncertainty the outlook for the global economy.

International markets

Overall, international equities performed well in 3Q18, buoyed by the strong performance of US equities, which more than offset weakness in emerging markets. The MSCI All Country World index rose by 4.2% q/q. (Charts 1 & 2.)

US equities recoded their best quarter in five years, riding high on a wave of strong economic growth and expected corporate earnings. The S&P 500 was up 7% q/q in 3Q18, while the DJI registered an impressive 9% gain. Domestic momentum, driven by solid US manufacturing, a tightening labor market, and resilient consumption had more than offset concerns over global geopolitics and the ongoing US-led trade wars. Mr. Trump's tax overhaul has also seen US corporates register higher capital expenditures, in addition to record earnings over the first half of 2018, with investor's expecting a similarly strong performance in 3Q18. (Chart 2.)

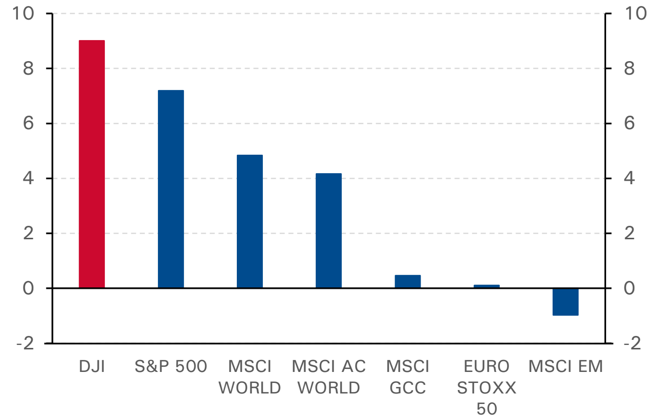
Chart 1: Global equity markets
(rebased, 28 December 2017=100)

Source: Thomson Reuters Datastream

European equities, however, lagged behind their US counterparts, as business confidence declined in light of trade uncertainty, emerging market unease, and concerns over Italy, leaving the Euro Stoxx 50 relatively flat over 3Q18. (Chart 2.) IHS Markit's September manufacturing PMI revealed that new export orders, shaken by trade uncertainty, were at their lowest in five years, while Eurostat's economic sentiment index declined throughout the quarter. Concerns were also worsened by the exposure of EU banks to crisis-hit Turkey. Meanwhile, with a projected fiscal deficit of 2.4% of GDP in 2019 – three times' previous official estimates – Italy's government is at odds with EU regulators, adding further uncertainty to the region's economic and political outlook.

Chart 2: Global equity markets

(% q/q, 3Q18)



Source: Thomson Reuters Datastream

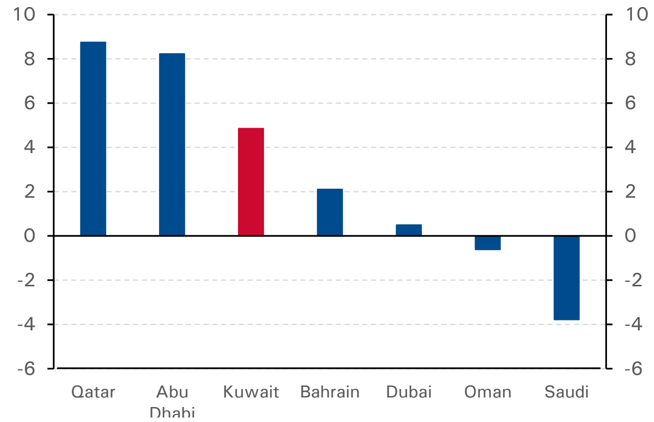
As for emerging markets, they experienced a perfect storm of challenges, causing the MSCI EM index to retreat by 1.0% q/q in 3Q18, and eroding all of its gains for the year. An uncertain trade outlook, tighter Fed policy, a stronger US dollar, and a softer Chinese economy saw investors reassess their EM exposures, with greater concern now placed over growth and foreign debt sustainability. Worst hit were China, Turkey, and Argentina, but there has been contagion to most emerging markets. Although most affected economies have implemented some stopgap measures, sentiment towards them remains cautious. The IIF expects emerging markets to attract only $24 billion of portfolio inflows in 2018, $11 billion less than in 2017.

Regional markets

GCC markets were mixed, but most were able to withstand the emerging market sell-off thanks to credible US dollar pegs and the rise in oil prices. (Chart 3 & 4.) The MSCI GCC index was up a small 0.5% q/q. The increase was led by Qatar, Abu Dhabi, and Kuwait, but was mostly offset by a decline in Saudi equities, as investors sought to lock-in profits in the wake of emerging market uncertainty, and weakness in Dubai due to further declines in real-estate stocks. This was despite several government stimulus measures, which included spending packages in Saudi and Dubai and the introduction of long-term visas for expats in the UAE.

Chart 3: GCC equity markets

(% q/q, 3Q18)



Source: Thomson Reuters Datastream

Kuwait's stock market finished the quarter up 4.9%, buoyed early in 3Q18 by its approaching ascension to FTSE's emerging market index, which concluded its first phase on 24 September. The move attracted a record amount of net foreign buying, totaling close to $200 million dollars in September alone. So far this year, the prospect of inclusion has helped attract in excess of $500 million in net foreign inflows. Kuwait is expected to complete its inclusion late in December. The bourse may also be potentially admitted by MSCI in 2019 and effectively included in the index by 2020, attracting more foreign funds.

Chart 4: Select GCC markets

(rebased, 28 December 2017=100)

Source: Thomson Reuters Datastream

Solid oil prices, firm regional economies, and strong corporate earnings are expected to continue to support GCC stocks in coming months. The prospect of Saudi's inclusion into the MSCI EMI index next year, and possibly Kuwait thereafter should also elicit greater foreign interest in the region. However, lingering concerns over emerging markets, tighter US monetary policy, as well as geopolitical pressures, may pose downside risks.

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