GCC markets outperform global peers, while trade tensions invite caution

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Highlights

- **World markets improved in 2Q18, but trade war concerns are weighing on sentiment.**
- **GCC equities are outperforming international peers, supported by higher oil prices and index reclassifications.**
- **US markets are benefitting from robust economic growth and a strong earnings season.**
- **Emerging markets are faltering due to a stronger dollar and uncertainty over President Trump's trade policies.**
- **Saudi will be added to MSCI's emerging market index in 2019, while Kuwait may join in 2020.**
- **Foreign inflows into the region are expected to increase substantially over the next two years, but risk being moderated if investors become more cautious of emerging markets.**

World markets rebounded in 2Q18 following a turbulent first quarter that saw the return of volatility, with performance almost flat in the first half of the year. Meanwhile, regional markets continued to outperform, benefitting from firmer oil prices and index reclassifications, with both Kuwait and Saudi now elevated to emerging market status. Currently, diverging global growth and looming trade war concerns have shaken investor confidence, triggering flows to safe havens, with China suffering the most.

International markets

In addition to comments lambasting the strength of the US dollar and the Fed's monetary policy, President Trump's escalating trade rhetoric further dampened international sentiment, with emerging markets bearing the brunt of the impact. Chinese stocks declined markedly (-12% YTD) in tandem with a depreciation in the renminbi, followed by a drop in equity markets of close Chinese trading partners. Developed markets, on the other hand, fared slightly better, supported by improving data and a strong earnings season, but sentiment there remains highly sensitive to Mr. Trump's views.

Overall, international markets performed better in 2Q18, as softening growth in some parts of the world implied a more gradual tightening in global financial conditions; driving the MSCI All Country World index up 2% q/q and offsetting the previous quarter's decline. (Charts 1 & 2.)

US equities led the increase supported by growing strength in the US economy. However, trade sensitive companies, which make up most of the Dow Jones Index, witnessed a relatively muted performance. That index was up a mild 0.7% in 2Q18, compared to the S&P 500's 2.9% increase. (Chart 2.)

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

Source: Thomson Reuters Datastream

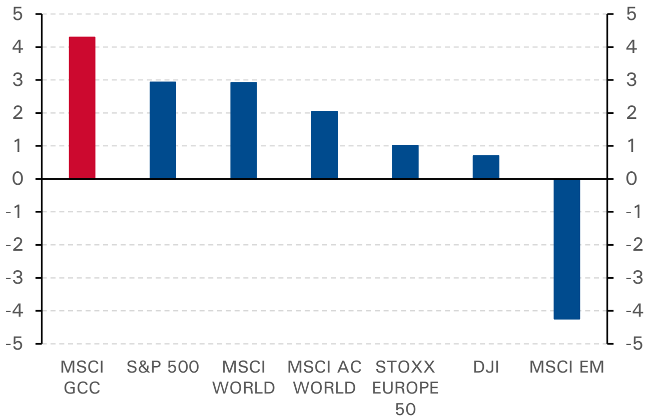
In Europe, equity markets were up slightly in 2Q18, as the return of political uncertainty and increasing trade tensions erased most of the gains European equities enjoyed early in the quarter. Investor sentiment was also weighed down by softer economic data that hinted at another quarter of mild growth. The Euro Stoxx 50 was up 1% in 2Q18, but down 3.1% in the first half of the year. (Chart 2.)

Intensifying trade tensions, in addition to a stronger US dollar, prompted vast capital outflows from emerging markets.

Investors exited positions in countries with high levels of foreign debt, as well as from those exposed to Mr. Trump's trade policies. As such, the MSCI EM index was down 4.2% in 2Q18 and 3.9% in 1H18 (Charts 1 & 2.)

Chart 2: Global equity markets

(% q/q, 2Q18)



Source: Thomson Reuters Datastream

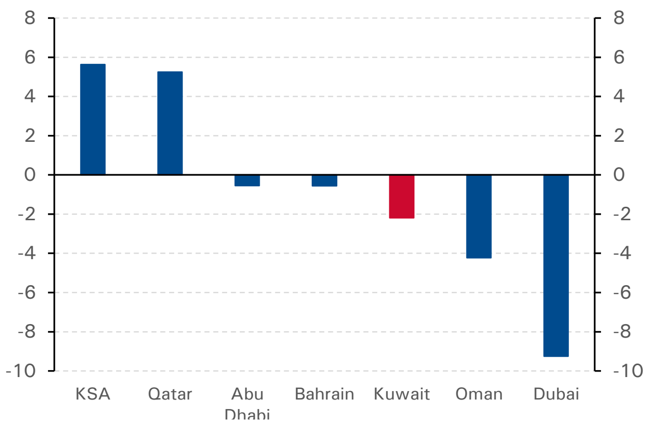
Regional markets

Recent momentum is being supported by surprising bank earnings that have benefitted from an improving operating environment. Indeed, this has seen most regional bourses increase by 2-6% in the first three weeks of 3Q18, with Kuwait leading the way.

As for 2Q18, firmer oil prices, stable currency pegs, and emerging market index reclassifications helped shield regional stocks from the capital outflows affecting other emerging markets. The MSCI GCC index outperformed once again, climbing 4.7% to finish 1H18 11.7% higher. (Charts 1 & 2.)

Chart 3: GCC equity markets

(% q/q, 2Q18)



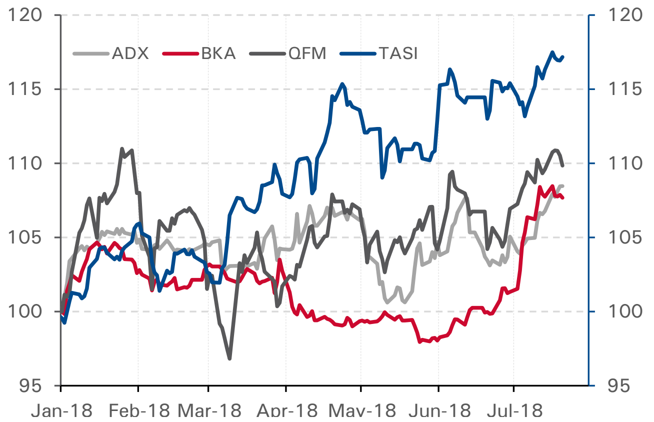
Source: Thomson Reuters Datastream

The expected inclusion of the Saudi stock exchange in MSCI's emerging market index and the re-weighting of some Qatari stocks within that same index saw these two markets outperform the rest of the region in 2Q18. Saudi's Tadawul was up 5.6% q/q, while QFM increased by 5.2%. (Chart 3.) Year-to-date, Saudi is up a whopping 17%. (Chart 4.)

In Kuwait, 2Q18 witnessed a major structural overhaul that initially unsettled domestic investor sentiment, with the Boursa All Share index declining 5% in the first two months of the quarter. However, growing interest from international investors, boosted by the addition of Kuwait to MSCI's emerging market watchlist and the approach of its official inclusion into FTSE's emerging market index, helped reverse that decline late in the quarter, and continues to do so. In fact, Kuwait outperformed most regional markets in the first three weeks of 3Q18, up 6.4%. (Chart 4.)

Chart 4: GCC top performing markets

(rebased, 28 December 2017=100)



Source: Thomson Reuters Datastream

Foreign inflows to the region are expected to increase substantially over the next two years. Saudi will be included in the MSCI EM and FTSE EM indices in 2019 with around a combined $15 billion in expected passive inflows and possibly $35 billion in active money. The expected partial sale of Aramco will also attract overseas investors. Meanwhile, Kuwait is expecting $0.9 billion in passive flows late this year, and potentially another $1.5 billion in 2020, not to mention the associated inflows of active money. However, these large inflows may be moderated if the emerging market contagion spills over to the region.

Regional equities are expected to continue their strong performance, supported by a strengthening backdrop in light of easing fiscal consolidation and private sector stimulus programs. However, the increasing likelihood of a full-scale trade war could derail regional and global momentum.

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