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MIDDLE EAST EQUITIES POISED FOR STRONG RECOVERY

Executive Summary

Strong Fundamentals and Growing Oil revenue – Strong economic fundamentals backed by sizeable currency reserves. The oil revenue will be crucial to the Middle East economies moving forward.

Projected GCC Local Government Spending to boost downstream activities – Domestic downstream activities will receive a boost from the massive local government spending over the next 3 years.

Fair Equities Valuation and Low Correlation with Global Equities – Middle East equities had been a laggard so far in the recovery; Valuations are reasonably cheap on a relative basis.

Introduction – Relooking at the Middle East Equities

Our focus of the month will be on Middle East equities. The ongoing credit market turmoil in Europe and tightening within Asian continent had put many investors on the edge. Nevertheless, Middle East equities have been performing relatively well on a Year-To-Date basis. Back in end-Nov'09, investors were shocked following the announcement by the Dubai Department of Finance that one of the key government-owned holding companies in Dubai, Dubai World, would be restructuring its debt. Since then till date, confidence in the GCC (Gulf Cooperation Council) had recovered and high-quality sovereigns from the region have largely shrugged off the contagion.

The basis of our recommendation will be built upon the following 3 factors. Firstly, fundamentally, majority of the Middle East economies are sitting on healthy fiscal balances and current account surpluses thanks to the massive oil revenues. The massive amount of foreign reserves is a certain plus point to help avert possible economic calamities. Secondly, with local governments looking to increase investment spending on domestic economy over the next 3 years, downstream activities will be given a boost. Lastly, the corresponding indices such as MSCI GCC and MSCI Arabian Markets had been a laggard so far in the recovery since last year, giving greater room for upside potential.

Latest development on Dubai World

In the latest development on the Dubai World debt's woes, Dubai World offered to pay 30% of its US\$14.2 billion debt to creditor banks in 5 years and the remainder amount in 8 years on 19 May. Dubai World and its property unit Nakheel PJSC look to continue to renegotiate terms on the combined US\$24.8 billion of liabilities after the global credit crunch battered Dubai's real-estate market and left the emirate's companies facing huge refinancing difficulties.

We feel that the recent announcement is another strong indication that the worst may be over for the debt-ridden Dubai and the Middle East economies will be back on track for potential strong growth.



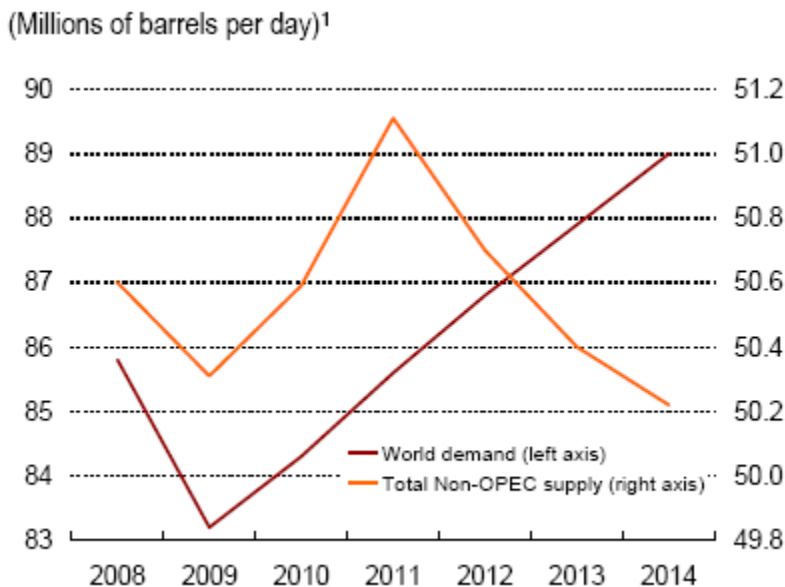
Strong Fundamentals and Growing Oil revenue

Backed with strong economic fundamentals and sizeable currency reserves, the Middle East region is likely to fare better than countries in other parts of the world in the current economic climate. As we saw in the Dubai World turmoil back in end-Nov'09, these oil exporting countries are able to draw upon their large reserves to cushion any impact of the global slowdown on their own economies as well as the economies of their neighboring countries.

With relatively stable oil prices and the anticipated re-emergence of global demand, oil revenues (also known as Petrodollar) are likely to increase for these oil exporting economies. Oil exporters will be able to build on their current level of international reserve positions – by more than US\$100 billion in 2010, a figure projected by IMF. Global demand and supply are projected to reach 89 million barrels per day and 93.4 million barrels per day by 2014 respectively, according to International Energy Agency (See Chart 1 below). With the non-OPEC countries facing tight liquidity conditions on both upstream and downstream investments and aging fields, the OPEC cartel (with Middle East countries making up the majority) are well-positioned to capitalise.

Lastly on the domestic front, the inflation outlook on majority of GCC countries depends to a large extent on the domestic housing market, with the cost of housing making up 39.33% of the UAE's CPI basket. Given that the UAE's housing market is still under pressure from the onset of Dubai World's credit woes, inflation (especially in UAE) will be kept subdued in the near term. (All GCC countries except Kuwait peg their currencies to the dollar. As a result, the scope for independent monetary policy will be limited in attempts to cool inflation.)

Chart 1: Global Oil Medium-Term Prospects



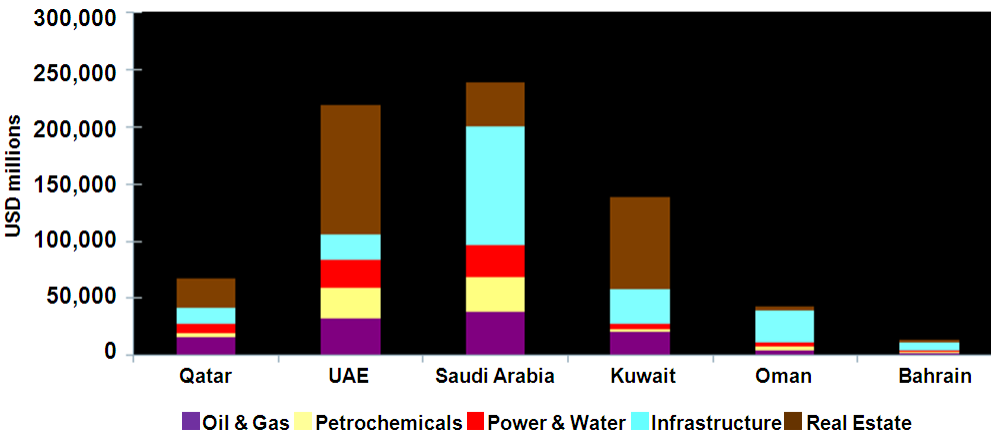
International Energy Agency forecasted a strong linear growth in global oil demand over the next 4 years. Total non-OPEC supply will be constrained with limited oil investments.

Source: International Energy Agency, as of 2Q2009



The Future – Projected GCC Local Government Spending for 2010-13

Chart 2: Projected GCC spending, 2010-13



Source: MEED Projects, as of 23 March 2010

- Over the next 3 years, a massive US\$250 billion of planned projects in the GCC will be allocated to the real estate sector, with the UAE taking up US\$110 billion. However, the recent downturn in the real estate sector should see projects put on hold or delayed, pending a pickup in market demand. This may result in the re-channeling of funds to other sectors such as financial services and tourism – which will provide beneficiary diversification to the oil-dependent regional economy.

- Also, the oil & gas and petrochemicals sectors will have US\$117 billion and US\$67 billion, respectively, in planned projects on a whole until 2013. Saudi Arabia will have close to US\$ 22.8 billion in refinery-related spending in the oil & gas sector, investment which is badly needed in light of the global scarcity of refining capacity and aging fields.

- At the same time, local governments are likely to continue their spending on infrastructure projects (e.g. transportation and hospitals etc.) as part of their socioeconomic programmes. With the backing of the local governments, there should not be any funding problems on the line. Thus, infrastructure projects in the region are likely to underpin regional domestic demand such as the service sector.

- The annual GCC electricity demand is expected to grow by 10% and desalination demand by 8% until 2015 (according to the World Nuclear Association). The GCC region has one of the youngest populations around the world, with rising needs for power and water generation. Of Saudi Arabia's population of more than 27 million people, 32% are under the age of 15, with rapid urban and industrial expansion expected in the future.

The projected GCC government spending over the next 3 years is likely to provide a boost to domestic downstream activities.



Fair Equities Valuation and Low Correlation with Global Equities

In terms of valuations, we feel that the Middle East equities are trading at a discount compared to global equities at the moment. Notably, the MSCI Qatar is trading at an attractive 12-mth dividend yield of 4.41%. Its Price-to-Earnings ratios are slightly above 10, seemingly a discount compared to global equities in other parts of the world. At the same time, the MSCI UAE is trading at a Price-to-Book ratio of under 1.0, an indication that the index equities are priced below the book value of their equities at the moment. Compared with the MSCI World Index, which is trading at a 12-mth dividend yield of 2.45%, a Price-to-Book ratio of 1.79 and Price-to-Earnings ratios close to 15, the market seems to be undervaluing the Middle East equities at the moment (See Table 1 on the next page for details).

Secondly, the MSCI Arabian Markets and MSCI GCC equities are both lagging behind in their recovery back to respective pre-crisis levels since their sharp declines back in mid-2008 (See Chart 3 below for details). In particular, the MSCI GCC had a sharp decline of over 480 points before its modest recovery of less than 200 points since March 2009, a recovery of less than 40% of the losses. An investment adage says “You need a 100% gain to erase a 50% loss”. A look at Chart 4 and Chart 5 will show that, with the exception of MSCI Turkey, recovery in Middle East equities across the board are indeed lagging. However, the consensus would argue that the Middle East equities were not too far worse off from their pre-crisis level, as market players would have observed with reference to the improved credit ratings and tightening of spreads in the Middle East credit market. As such, equities prices should reflect the improved fundamentals in time to come.

Lastly, the correlation table on the next page (Table 2) showed that the Middle East equities had a low correlation with global equities over the most recent 2 years period. This decoupled nature of Middle East equities with global major equities will help to bring diversification to individual investor’s portfolio.

Chart 3: Price Performance of MSCI GCC (2007 till date)



Source: Bloomberg, as of 13 May 2010

Price performance of MSCI GCC had been a laggard so far, despite improving fundamentals of Middle East companies over the last few quarters.



Table 1: Valuation table on Middle East Equities

Index	Dividend Yield	Price to Book	Forward PE	Current PE
MSCI Qatar	4.41	1.87	11.44	10.91
MSCI Oman	3.89	1.99	10.87	13.17
MSCI Bahrain	3.87	0.96	4.35	---
MSCI Jordan	3.19	1.77	6.75	20.37
MSCI Egypt	3.18	2.14	10.86	13.79
MSCI Turkey	2.79	1.78	9.47	9.47
MSCI United Arab Emirate	1.58	0.82	8.10	18.79
MSCI Kuwait	1.13	1.79	10.78	22.52
MSCI World	2.45	1.79	13.76	17.88

Source: Bloomberg, as of 21 May 2010

The equities in Middle East are trading at a relatively cheap valuation compared to global equities as measured by MSCI World Index.

Table 2: Low correlation with major global equities

	MSCI GCC	MSCI Arabian Markets
U.S. S&P 500	0.071	0.087
STI	0.318	0.352
Hang Seng Index	0.401	0.439
Commodities	0.134	0.156
MSCI Emerging Markets	0.245	0.272
MSCI World	0.237	0.273
MSCI Asia Pacific ex Japan	0.39	0.434

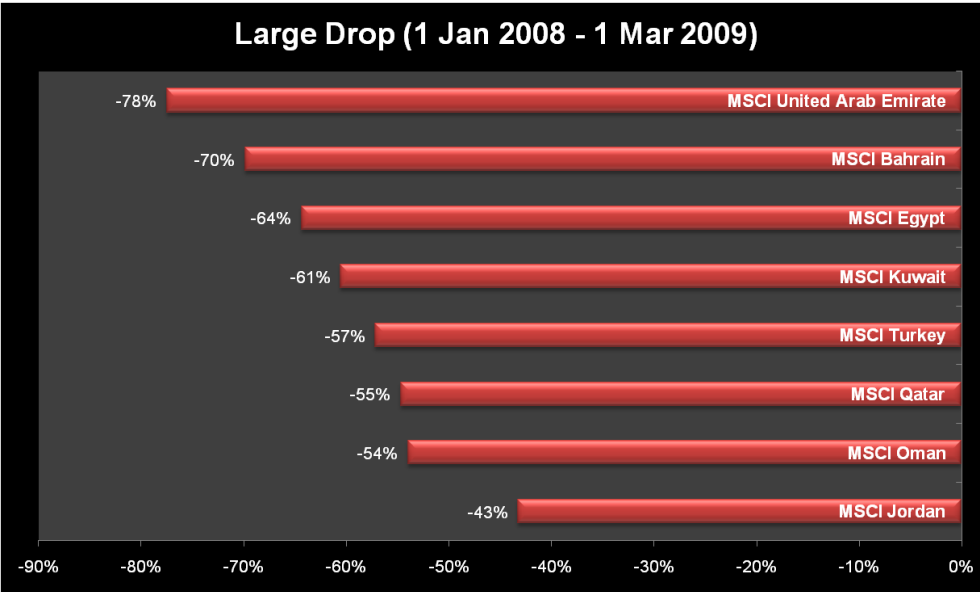
Source: Bloomberg, as of 21 May 2010

The returns correlation of MSCI GCC & MSCI Arabian Markets against the global equities and commodities is relatively low (below 0.5).



Chart 4: Losses accumulated during the credit crisis

Large Drop (1 Jan 2008 - 1 Mar 2009)

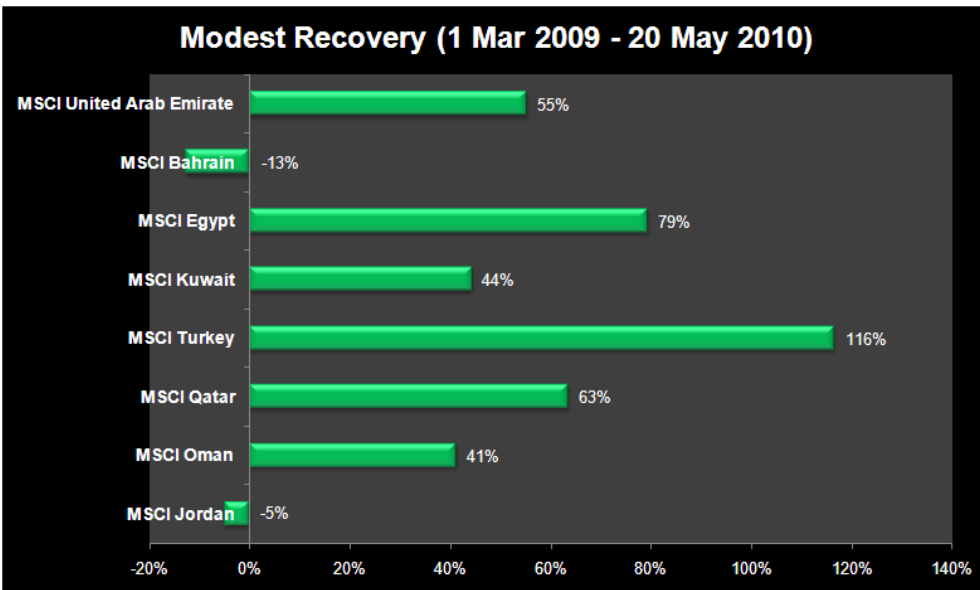


Source: Bloomberg, as of 21 May 2010

Middle East equities are not spared from the credit crisis, down an average of 60%.

Chart 5: Modest recovery (since March 2009 till date)

Modest Recovery (1 Mar 2009 - 20 May 2010)



Source: Bloomberg, as of 21 May 2010

Recovery in Middle East equities had not been impressive so far, with only MSCI Turkey the outstanding performer.



Fund in Focus - Schroder ISF Middle East Fund

The Schroder Middle East Fund had been a consistent performer, based on its 3-Month, 6-Month and 1-Year returns. The Year-to-Date performance is about 5%, putting it as one of the top performing regional equity fund. In terms of geographical allocation, it had over 20% exposure to Turkey equities, which are still at seemingly cheap valuations (See Table 1 for details). The fund is also overweight in the financial sector, which are mostly well-capitalised and had minimal exposure to the U.S. toxic assets, defined previously during the global credit crisis.

Figure 1: Fund performance (as of 19th May 2010)

Fund Name	AUM	Y-T-D (%)	3-Mth (%)	6-Mth (%)	1 Year (%)	Sharpe (1Yr)	Currency
Schroder ISF - Middle East Fund	262.7mln	5.53	2.45	8.79	15.37	1.2	SGD
Schroder ISF - Middle East Fund	262.7mln	4.78	2.40	6.96	19.26	1.51	USD

Source: Bloomberg, as of 21 May 2010

Schroder ISF – Middle East Fund had been one of the better performing fund on a year-to-Date basis.

Figure 2: Fund top holdings and Geographical allocation

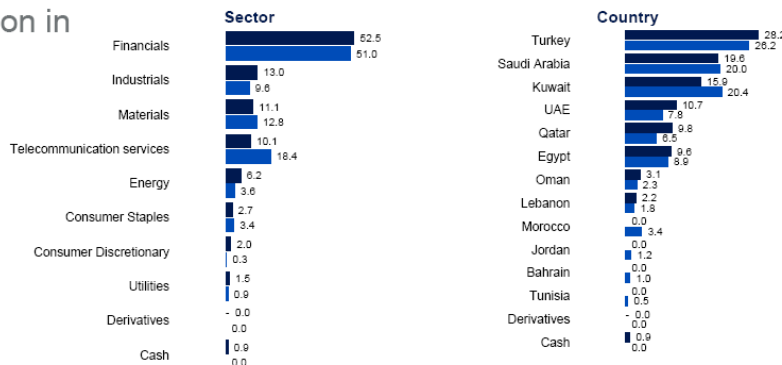
Holdings Analysis

Top 10 Holdings in %		Sector		% NAV	
Rank	Holding	Sector	% NAV	Rank	Holding
1.	Turkiye Garanti Bankasi	Financials	8.3	1.	Turkiye Garanti Bankasi
2.	Saudi Basic Industries	Materials	6.2	2.	Turkiye Halk Bankasi
3.	Mobile Telecommunications	Telecommunication services	6.1	3.	Turkcell Iletisim Hizmet
4.	Tupras Turkiye Petrol Rafine	Energy	4.0	4.	Qatar National Bank
5.	The National Bank Of Kuwait	Financials	3.9	5.	Yapi Ve Kredi Bankasi
6.	Turkiye Halk Bankasi	Financials	3.8	6.	Turkiye Vakiflar Bankasi Tao
7.	Emaar Properties	Financials	3.8	7.	Dp World
8.	Qatar National Bank	Financials	3.6	8.	
9.	Al Rajhi Bank	Financials	3.2	9.	
10.	Dp World	Industrials	3.1	10.	
			Total	46.0	
Overweights	in %	Underweights	in %	Market Cap Split	in %
Turkiye Garanti Bankasi	3.2	Akbank	-2.5	<500 Million	0.0
Turkiye Halk Bankasi	2.7	Turkcell Iletisim Hizmet	-2.4	>=500<1000 Million	4.1
Qatar National Bank	2.6	Maroc Telecom	-1.8	>=1000<2000 Million	3.3
Tupras Turkiye Petrol Rafine	2.5	Yapi Ve Kredi Bankasi	-1.2	>=2000<5000 Million	13.4
Dp World	2.3	Turkiye Vakiflar Bankasi Tao	-1.0	>=5000 Million	32.2
				Unclassified	47.1

Overweights and underweights data are based on fund's exposure to holdings grouped by name.

Fund holdings and geographical allocation are reflective of fund manager's bullish stance on the various sector/geography in the Middle East region.

Asset Allocation in %



Source: Fund Factsheet, as of Apr 2010



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