Schroder ISF* Middle East
Fund Update

Market Review

Global equity markets delivered strong returns in February, as US economic data continued to point to a steady recovery while European markets benefited from news that business confidence in Germany had reached an all-time high. In contrast to the strength in developed markets, emerging markets declined over the month as political unrest in the Middle East and further policy tightening weighed on sentiment. MENA markets sold off in February and underperformed broader emerging markets as political unrest in Egypt spread to Libya, sparking fears that contagion could affect other states in the region.

All markets in the MENA benchmark except Morocco and Bahrain produced negative total returns in February. Morocco was by far the strongest market, strongly outperforming both the regional MENA index and broader emerging markets. In contrast to a number of other countries in the region, attempts to establish a protest movement in Morocco met with only limited success. The market was also buoyed by further signs of recovery in the eurozone, which remains the key export market for Morocco. Bahrain produced a flat return despite widespread political unrest and violent clashes between protestors and troops in Pearl Square. In response to the protests, the King ordered an increase in food subsidies and reshuffled the cabinet, resulting in an easing of tension. Meanwhile, widespread unrest in Egypt eventually forced President Mubarak to step down despite his initial intention to stay in office until the presidential elections in September. Egypt's stock market remained closed throughout February. Turkish equities retreated in February but they outperformed MENA markets while underperforming wider emerging markets. Concerns over the government's unorthodox monetary policy stance continued to weigh on the market although the main headwind came from the surge in the oil price, as this will lead to a further deterioration in Turkey's already large current account deficit. However, the domestic economy remained in good health with the purchasing managers' index for the manufacturing sector moving further into expansionary territory in February.

The other markets in the benchmark all underperformed the MENA index and wider emerging markets. The Lebanese market retreated, reflecting poor performance from banking stocks and fears over political stability following the collapse of the unity government in January. Kuwaiti equities also lost ground as fears of political contagion weighed while political protests in Jordan provided a headwind for its equity market. In response, the King appointed a new prime minister and cabinet to implement political reform. The Saudi markets retreated as fears grew that unrest in Libya could provoke widespread protests but these concerns began to ease after the King announced a $37 billion benefits package for lower and middle income Saudis. Qatar's market was dragged lower by weakness in the other Middle Eastern bourses, but very low levels of unemployment in the state meant that there were few signs of political unrest. The UAE underperformed, with poor performance from property stocks weighing on the market as risk appetite diminished. Tunisian equities suffered heavy losses as earnings outlooks continued to be subject to uncertainty following the collapse of the previous regime. However, Oman was the weakest market as political unrest prompted a series of cabinet reshuffles as the King responded to demands for reform.

Performance Comment

The fund underperformed the benchmark in February, with asset allocation and stock selection both detracting from returns. In terms of our country selection, our zero weight in Morocco provided the main negative contribution as Morocco strongly outperformed. The impact of our other asset allocation decisions was broadly neutral. Stock selection in Kuwait and the UAE added to returns during the month but was more than offset by negative contributions from our choice of stocks in Qatar, Turkey and Oman.

Outlook/strategy

We maintain our overweight in the UAE as valuations remain attractive relative to the wider MENA average. In Qatar, we remain overweight as the economy is benefiting from strong rates of growth and we continue to find strong bottom-up ideas. We retain an overweight to Turkey although we trimmed the extent of the overweight in early March. Turkish valuations are attractive but the market is likely to remain subject to currency and current account deficit concerns. Meanwhile, in Lebanon, we stay overweight as valuations are attractive and GDP growth should be at least 6% this year. Elsewhere, we moved from overweight to neutral in Oman and Saudi Arabia in early March. Valuations in Oman continue to improve but there are relatively few stock picking opportunities. Saudi valuations remain rich, but the market should benefit from a favourable macroeconomic backdrop given the current level of crude oil prices.

We moved to a small underweight position in Egypt in early March as Egyptian ADR/GDR stocks were sold. We await increased clarity on the impact of political uncertainty on GDP and earnings growth. We have no exposure to Bahrain as the market is illiquid and offers only limited stock picking opportunities. Kuwait is still our largest underweight position relative to the benchmark, reflecting a relatively expensive rating for the broader market and few opportunities at the stock level. We have no exposure to Jordan, Tunisia and Morocco. Jordan's market suffers from weak momentum and there are limited value opportunities. Tunisia's market is illiquid and the growth outlook is relatively weak and subject to political uncertainty. Morocco is expensively valued and there are no attractive opportunities at the stock level.

Although political unrest has surfaced to varying degrees in the Middle East, the more severe disruptions within our universe have been largely limited to Tunisia, Bahrain and Egypt. However, should unrest in the MENA region escalate to larger, more strategically important countries, the impact on global equities, including those in the MENA bloc, is likely to be significant. Keeping this in mind, and taking into account the relatively modest market reaction seen year to date, we believe risks have increased and we decided to increase our cash allocation in early March.

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