Schroder ISF* Middle East
Fund Update

Market Review

Global equity markets retreated over the period as continuing concerns over a potential sovereign debt default in Greece and broader fears about the outlook for global economic growth weighed on sentiment. In the US, economic data releases in the manufacturing sector were weaker than expected, in part reflecting the knock-on effects of the Japanese earthquake, while core CPI rose 0.3% in May, adding to inflation fears. Equities sold off against this backdrop but some developed markets, such as Germany and Japan, bucked the trend. MENA markets performed broadly in line with developed markets in June but marginally underperformed broader emerging markets, reflecting renewed political tensions in some markets and a sell-off in crude oil prices.

Tunisia was the strongest MENA market in June, outperforming its MENA peers and wider emerging markets. The World Bank approved loans to Tunisia during the month and in late June it was confirmed that Tunisia is seeking to become a member of the EBRD as it pursues social and economic reform. Meanwhile, Bahrain outperformed MENA and the wider emerging bloc, with political risks easing after the government said it would lift a ban on the National Democratic Action Society. At the end of the month, Saudi Arabia announced a withdrawal of most of its troops from Bahrain and the market responded positively to easing political risks. Oman outperformed MENA and emerging markets, supported by resilient performance from certain index heavyweights. Qatar outperformed although the market faced headwinds after MSCI announced that it would delay its decision on whether to raise Qatar to emerging markets status. The Turkish market declined, reflecting local currency weakness, but outperformed MENA. Concerns over inflation and the current deficit continued to weigh on the lira but political risks eased as the AKP triumphed in the general election. Elsewhere, Lebanese markets outperformed the MENA regional index. Prime Minister Najib Mikati announced his cabinet in mid June, ending a period of protracted negotiations over ministerial positions.

The remaining MENA markets underperformed in June. Kuwait underperformed MENA and emerging markets, reflecting weaker oil prices and news that Moody's had lowered its ratings on National Bank of Kuwait. Saudi Arabia underperformed, with crude oil prices weakening on news that the IEA would release 60 million barrels of crude and oil products from its stockpiles. As was the case in Qatar, equities in UAE suffered after MSCI said it would delay its decision on whether to raise the market to emerging market status. Morocco underperformed as the King's proposed constitutional changes failed to settle investors' nerves and trading volumes remained low. The Jordanian market declined, with the acceleration in annual inflation to 5.2% in May weighing on sentiment. However, Egypt was the main laggard, as fears over the currently slow pace of reform resulted in fears of further political unrest.

Performance Comment

On an underlying basis, the fund outperformed the benchmark in June. Asset allocation was neutral while stock selection was positive. In terms of asset allocation, the main positives were the void in Morocco, which underperformed, and the overweight in Qatar, which outperformed. However, the overweight in UAE, which underperformed in June, detracted from returns. The impact of our other asset allocation decisions was neutral. Stock selection was strongly positive in Saudi Arabia and Turkey, and was favourable in Kuwait, UAE and Oman. These positive contributions more than offset the negative impact of stock selection in Qatar.

Outlook/strategy

We maintain our overweight in the UAE as valuations remain attractive relative to the wider MENA average. In Qatar, we modestly increased our overweight in early July, making it our largest overweight, as the economy is benefiting from strong rates of growth and we continue to find strong bottom-up ideas. Meanwhile, in Lebanon, we stay overweight as valuations are reasonable. Elsewhere, we maintain overweight positions in Oman and Saudi Arabia. Valuations in Oman continue to improve, and although Saudi valuations are rich, the market should benefit from a favourable macroeconomic backdrop given the current level of crude oil prices.

The fund is neutrally positioned in Turkey. Turkey's economy is likely to remain subject to currency and current account deficit concerns in the short term and Turkish stocks are now fairly valued in our view.

We moved to a small underweight in Egypt in early July. Political instability remains a concern and it is not clear how Egypt will finance its budget deficit now that it has rejected World Bank/IMF support. However, equity valuations in Egypt are improving. We have no exposure to Bahrain as the market is illiquid and offers only limited stock picking opportunities. Kuwait remains our largest underweight position, 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 poor. Morocco is expensively valued and there are no attractive opportunities at the stock level.

Political uncertainty in North Africa and the Middle East remains, but in our view the risk of further escalation to more significant markets has subsided, and the fund is fully invested.

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