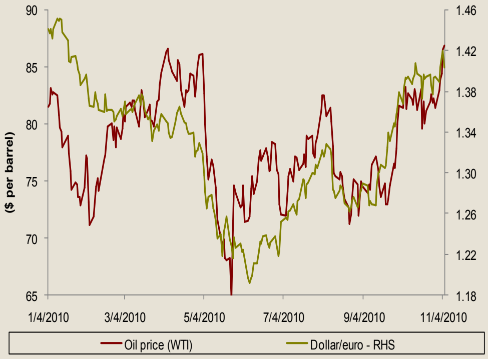
November 2010

Monthly Bulletin

Falling dollar lifts oil price comfort zone

Oil prices have jumped to two-year highs primarily because of the weakness of the US dollar. Seemingly in response to this dollar depreciation, the Kingdom appears to have lifted the ceiling on its preferred level for oil prices. For some time the Kingdom and other Opec producers had identified a price range of $70-80 per barrel as being comfortable for producers and consumers. In early November, the ceiling of this range was raised to $90 per barrel. We have therefore nudged up our forecast for oil prices (WTI) this year to $79 per barrel. We continue to expect WTI to average $80 per barrel in 2011.

Oil price and the dollar



WTI reached $87.1 per barrel on November 8, the highest level since October 2008. This rise is largely in response to the weakening of the dollar. The correlation between moves in oil and the dollar has fallen this year. Nonetheless, there is a clear relationship. Oil prices have been pushed up by investors wanting to hedge their exposure to a decline in the dollar by buying dollar-denominated assets such as oil and other commodities. The jump above $80 per barrel at the end of September was caused by the US Fed indicating that it would resume the process of quantitative easing, which by effectively printing money puts downward pressure on the dollar. The current rise in oil prices began in early-November, just before details of the new round of quantitative easing were announced.

We think that the move in the Kingdom's preferred price level was taken to adjust for the reduced purchasing power of the dollar. In trade weighted terms, the dollar has fallen by 11 percent since the end of June. The bulk of the Kingdom's imports are from outside of the US or countries with dollar-pegged currencies, with the EU the largest source, accounting for 30 percent in 2009. The weakening of the dollar, and therefore the riyal, is raising the effective cost of imports and means that consumers elsewhere in the world are not necessarily facing higher oil prices. For example, since the end of June WTI has risen by 14.9 percent in dollar terms, but fallen by 0.3 percent in euro terms.

Higher oil prices are beneficial to the Kingdom's economy. Oil accounts for around 85 percent of both budget and export revenue and the oil price that the government needs to balance its budget has rise from around $25 per barrel in 2003 to $72 per barrel this year. Nonetheless, the Kingdom is under no financial pressure in the near term (both the budget and current accounts are expected to be in surplus this year) and we do not think the increase in the preferred oil price ceiling is primarily driven by domestic economic concerns. Maintaining the current pace of spending growth over the longer-term will, however, strain the budget.

The run-up in oil prices in early November follows remarkable

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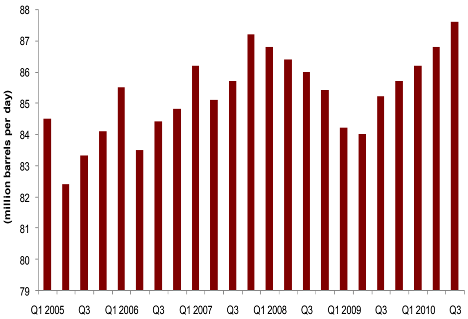
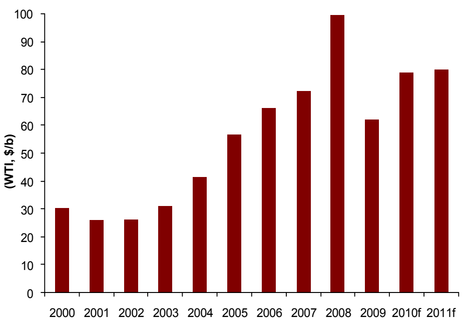
Oil price in euros

Global oil demand



Annual average oil prices



stability during October, with WTI trading in a very tight range between $83 per barrel and $79 per barrel. Monthly oil price volatility, as measured by the difference between the high and the low in percentage terms, since 1995 has only twice been lower than it was in October. Indeed, despite the recent jump, demand and supply trends have been little changed for some time.

Ongoing strength in emerging economies, which are the main source of new demand growth, continues to push up total demand. The International Energy Agency (IEA) projects global oil demand for 2010 at 86.9 million barrels per day, up by 700,000 barrels per day from its estimate in December 2009 and 2.1 million barrels per day higher than the total for last year. According to the IEA global oil demand hit an all-time high in the third quarter of this year at 87.6 million barrels per day, 3.6 million barrels per day higher than in the second quarter of last year, the recent low point.

Supply from non-Opec producers has also risen gradually, up to 29.8 million barrels per day in the third quarter from 29.4 million barrels per day in the final quarter of last year according to IEA data, as has supply from Opec. These changes have been insufficient to dent significantly the unusually high level of stocks in the US, but stocks elsewhere in the world have fallen and those offshore have been almost entirely drawn down.

Given these conditions, it was not surprising that Opec maintained its production quotas at its meeting in Vienna on October 14. Opec noted that there remained high risks to the global economic recovery and it would therefore be imprudent to raise formal production quotas even though prices were slightly above its then preferred range of $70-80 per barrel. Emphasis on compliance to existing quotas was reduced. Opec overproduction has been scaled back in recent months, with total Opec production (excluding Iraq) estimated at 26.66 million barrels per day in October against a recent high of 26.99 million barrels per day in May. It appears that Opec is currently content to influence prices by marginal monthly changes in production rather than formal quota adjustments.

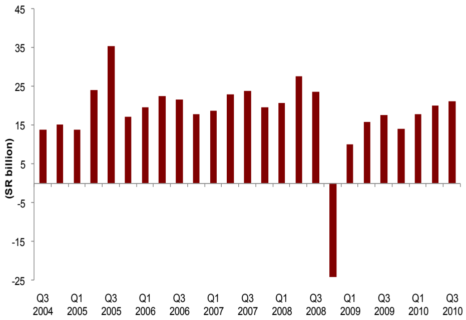
We see little change in the demand and supply fundamentals over the near term. Movements in investment flows are less easy to predict. Sentiment about the dollar has swung rapidly this year and further sharp moves are possible. Although the dollar has been on a strong downward trend recently, consensus forecasts are that it will strengthen against most major currencies over the next few years (though it will fall against many emerging market currencies). Investment in commodities is also being boosted by the very loose monetary policies in many of the world's largest economies. Investors are placing large amounts of very cheap money in commodities and emerging markets, raising concerns about potential bubbles.

Given our uncertainty over investment flows, we base our forecast on the fundamentals. With WTI averaging $78.1 per barrel so far this year and unlikely to move too much from current levels, we have slightly raised our forecast for the average WTI price this year to $79 per barrel (equivalent to $75 per barrel for Saudi export crude) from $75 per barrel (which has been our forecast since November 2009). This has resulted in a modest improvement in our projections for the budget and current account surpluses in Saudi Arabia this year. For 2011, we have kept our forecast unchanged at $80 per barrel.

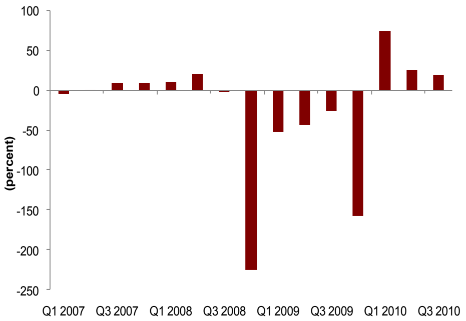
Stock market watch

Third quarter results in line with expectations

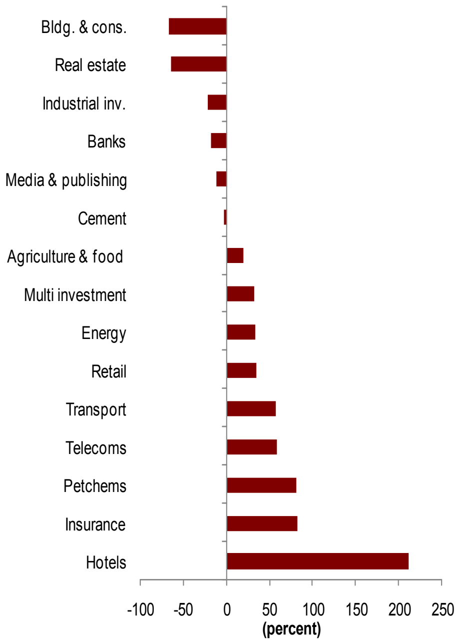
Net income of listed companies



Annual change in net income



Change in net income by sector



Third quarter results of listed companies were broadly in line with expectations and provided little support to the stock market. Profits were up in both quarterly and annual terms and several companies, notably Sabic, Mobily and Saudi Electricity Company, posted strong performance. Particularly hot weather affected companies requiring outdoor labor and a hike in electricity tariff had a notable impact on some energy intensive businesses. Banks' results were again undermined by high provisions for non-performing loans.

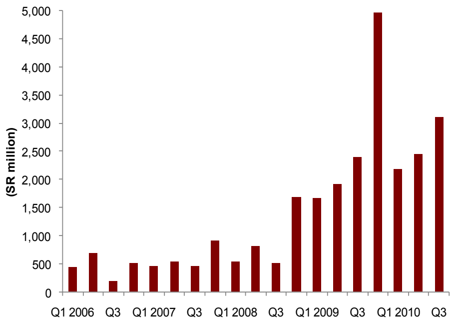
Net income of listed companies was SR21.2 billion in the third quarter, the largest since the third quarter of 2008. It was 19.4 percent higher in year-on-year terms and up by 6.1 percent on the second quarter. In both cases, growth was slower than in the second quarter. Two of the smaller sectors, hotels and insurance, led the gains. The hotels sector was boosted by the seasonal improvement in revenues and internal restructuring at the companies in the sector. For insurance the growth reflects the continued strengthening of many of the new players in the sector. Petrochemicals was the third best performing sector (with Sabic beating expectations) owing to higher prices and production, including the ramping up of production at new facilities.

Construction and real estate were the worst performing sectors, with the former hit particularly by the very high temperatures this summer. For the first time, the Ministry of Labor ordered that work be suspended for three hours from noon for those working outdoors or in direct sunlight. Cement companies were also affected by slowing construction activity. Real estate and industrial investment companies were the most adversely affected by an increase in electricity tariffs. Electricity tariffs to commercial and industrial users were raised by 9 percent at the start of July.

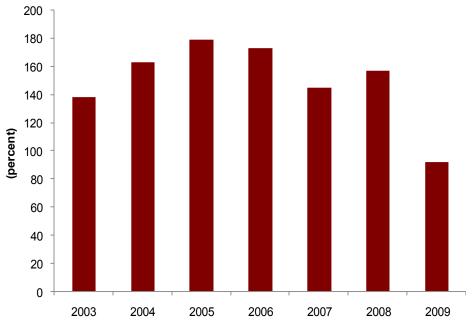
The quarterly comparison was affected by the coincidence of summer, Ramadan and Eid al-Fitr in the third quarter and the resultant increase in spending and reduction in outdoor activity. In line with the seasonal trend, telecoms, hotels, retail and food processing performed strongly and building and construction was weak. Insurance recorded the largest gain in quarterly net income, reflecting improved performance at the many young companies in the sector, followed by utilities, which benefitted from the increase in electricity tariffs.

The results were not enough to lift the TASI, which has been trading between 6,200 and 6,500 since early September in very low volumes. Although generally in line with expectations, even when larger companies outperformed, it was not sufficient to cause the market as a whole to rise. As with much of last year, we think that the TASI has been weaker than justified by economic fundamentals and company performance owing to negative sentiment. Ongoing low volumes (September and October saw the two lowest numbers of monthly stock market transactions since January 2005) suggest that investors prefer to place their money in real estate or, in the case of larger investors, directly in their businesses. Conditions are ripe for a revival of the TASI, though with global economic and market conditions uncertain, it may take until first quarter results before there is a significant move upwards.

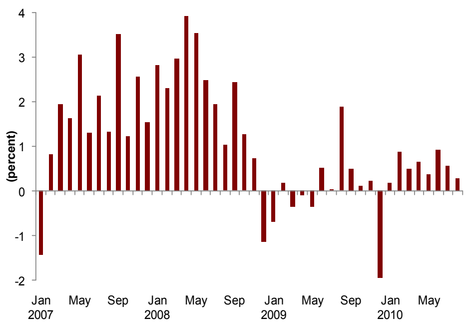
Provisions for non-performing loans



Non-performing loan coverage



Bank lending to the private sector
(month-on-month)



Stock market watch

Increased provisioning hits bank earnings

Bank earnings generally came in below analysts' forecasts again in the third quarter. In many cases, large new provisions for non-performing loans remained the main drag on profitability. SAMA has urged all banks to raise their provisions for non-performing loans to a sufficient amount to cover all non-performing loans on their books by the end of the year, probably in the hope that this would make banks more comfortable with accelerating lending. Less need for provisions should improve the financial performance of banks in 2011.

Total net income of the listed banks fell by 18 percent in year-on-year terms in the third quarter, the fourth consecutive year-on-year decline. Profits fell at all apart from Bank al-Bilad (where the gain and total in riyal terms was very small). On a quarterly basis, net income was down by 15 percent, with only Saudi Investment Bank recording quarter-on-quarter growth.

The main reason for the decline in profits was an increase in the amount of money banks have set aside to cover bad loans. Total provisioning for bad loans in the third quarter was SR3.1 billion, up 27 percent on the previous quarter and 30 percent on one-year earlier. Provisioning for bad loans has jumped in recent years as a result of high profile defaults at some private sector groups and the general slowdown in the economy. Total provisions since the end of the third quarter of 2008 amount to SR20.4 billion.

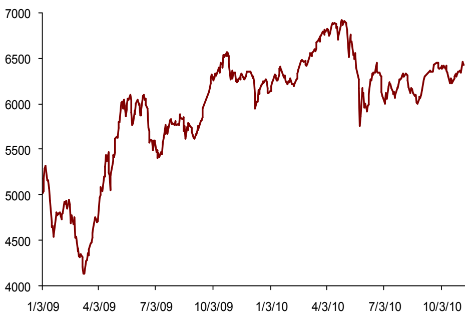
Shortly before the end of the third quarter SAMA announced that it wanted all banks to increase provisions to cover 100 percent of non-performing loans by the end of the year. SAMA has traditionally taken a fairly tough line on bank provisioning. Total provisions averaged over 150 percent of non-performing loans between 2004 and 2008. (Banks can often to recover some loans they categorize as non-performing, so coverage in many countries is well below 100 percent.) High provisions at the onset of the financial crisis have helped banks' financial performance in the past two years.

It seems that SAMA's actions are motivated by the assumption that once banks have covered all existing bad loans they will be prepared to resume lending (note that non-performing loans lag economic conditions, so there will still be a need for new provisions next year). The absence of reasonably priced bank credit has been a key factor holding back the performance of the private sector over the last two years. Total bank credit to the private sector was flat last year and has climbed by only 4 percent in the first eight months of this year, following average annual growth of 27 percent between 2004 and 2008. Although setting aside funds as provisions reduces the amount of money banks have available to lend, banks are liquid and their lack of lending stems from unwillingness rather than inability.

Total outstanding loans were higher for five banks in the third quarter, compared to the third quarter of 2009, with the four Islamic banks leading the way. This broadly reflected the pattern of asset growth, with the four Islamic banks among the seven that reported asset growth in year-on-year terms. The lack of lending has also contributed to the decline in banks' profits, as have very low interest rates and tough competition in the investment banking business.

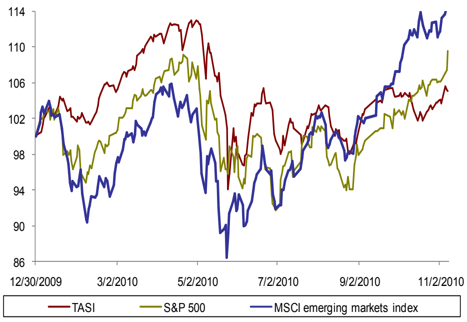
In brief: Stock market

TASI



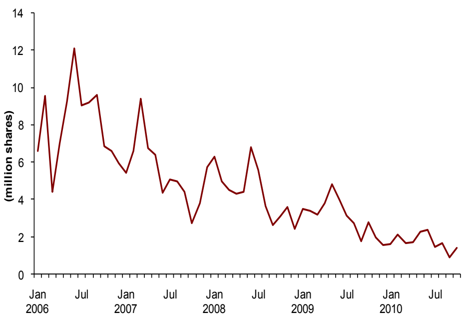
The TASI has continued to trade in a fairly tight range, between 6,200 and 6,500, over the past month or so. Third quarter results generated little response in the index as a whole, though sectoral performance has varied; the petrochemicals sector is up by 12 percent since October 16 (the day before the Sabic results were announced). The main recent gain stemmed from the jump in oil prices and international markets following the announcement of the next phase of quantitative easing in the US. This pushed the TASI to a five-and-a-half month high on November 6. Since then the market has fallen slightly.

Comparative stock market performance
(December 30, 2009 = 100)



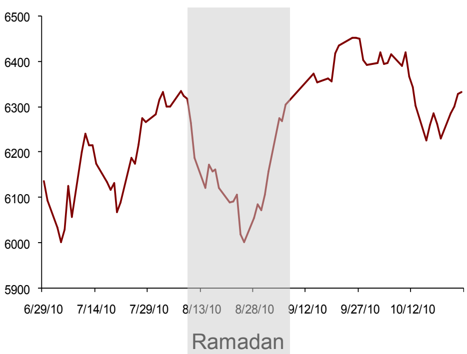
The stability of the TASI is in contrast to the rise in many other developed and emerging stock markets. The TASI is up by 0.6 percent since the end of September, while over the same period the US S&P 500 has climbed by 6.8 percent and the MSCI emerging markets index is 8 percent higher. As a result of recent moves the TASI has now underperformed both indices since the start of the year, as it did last year. Recently, the TASI has also underperformed the main regional markets, with the exception of Dubai. There is no obviously justification for the divergence in performance. It appears to reflect the lack of confidence in the market by local investors, who are instead investing in land, real estate or directly into their own businesses.

Number of stock market transactions



Stock market volumes remain very low. Total transactions in October were the second lowest since January 2005 (with September 2010, when the number of trading days was cut by Eid al-Fitr, the lowest). The number of shares traded was at a four-month high in October, though this was 48 percent below the number in October 2009. Ongoing lackluster volumes have raised speculation of a broader opening of the market to foreign investors, which would be likely to revitalize local investor sentiment. Low volumes are not putting off foreign investors. Foreign investor net purchases through the swap agreement were at their highest level since April 2009 in October, at SR731 million. Nonetheless, some foreign investors are not comfortable with using the swap agreement.

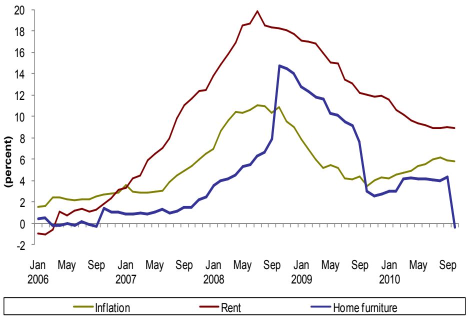
TASI around Ramadan 2010



Share price moves in and around Ramadan were broadly in line with the historical precedent we identified in our report, *Stock market performance in Ramadan*, issued on July 31. Unlike the trend over the previous 10 years, the TASI did not fall in the week before Ramadan, but it did decline in each of the first three weeks of Ramadan before rising in the final week, as was suggested by the historical data. The TASI rose in the first week after Eid al-Fitr, in line with the norm over the previous decade, but then declined in each of the next four weeks. In absolute terms the movements virtually cancelled each other out. The fall during the first three weeks of Ramadan was 3.9 percent; the recovery over the subsequent two weeks was 5.7 percent; and the decline in the following four weeks was 2.4 percent.

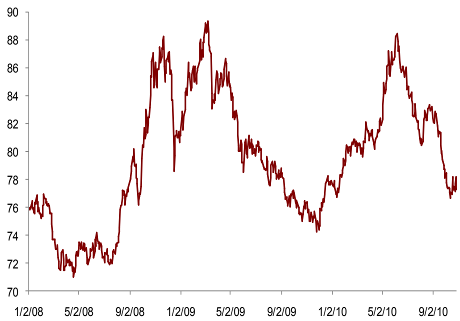
In brief: Economy

Inflation



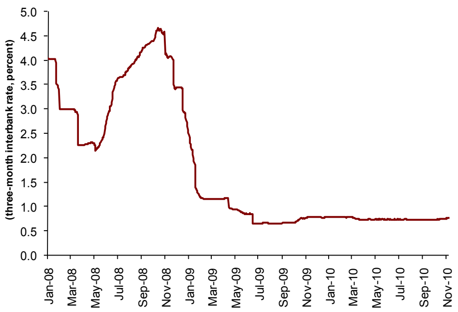
Inflation has slowed for two consecutive months to reach 5.8 percent in October. A slight slowdown in rental inflation and lower “home furniture” costs, stemming from what appears to be an annual revision to the price of domestic staff, are the main reasons for the dip. In contrast, food price inflation climbed to a 22-month high of 8.3 percent. Higher prices of fresh vegetables are the main cause of the increase; they are up by 32 percent in year-on-year terms and by 8 percent since September. Prices of “other expenses and services” also jumped, to 8.9 percent from 7.9 percent in September, primarily due to a 24 percent year-on-year increase in jewelry prices.

Trade weighted dollar



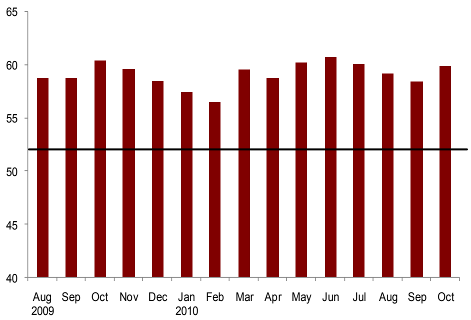
The dollar has fallen sharply against many other currencies in recent months; in trade weighted terms it is down by 12 percent since the end of May and 8 percent since the end of August. The riyal’s peg to the dollar means that the recent weakening will lower the cost of the Kingdom’s exports in local currency terms in most markets (aside from the US and countries that use dollar-pegged currencies), thereby boosting their competitiveness. Conversely, it will raise the price of imports and potentially add to inflation. The dollar has been subject to wild swings in recent years and we do not think it is on an irreversible decline. Short-term fluctuations in the currency do not alter the rationale for retaining the riyal’s peg to the dollar.

Three-month Saibor



By further easing monetary policy in early-November, through the adoption of a new phase of quantitative easing, the US Federal Reserve has indicated that it will be a long time before it tightens monetary policy by raising interest rates. According to consensus forecasts there is unlikely to be any change in US interest rates until 2012. This is important for the Kingdom, as the exchange rate peg to the dollar means that interest rates in Saudi Arabia shadow those in the US. We therefore think that interest rates will remain very low in the Kingdom. There is scope for a modest rise even if the Fed does not move rates, but this would require signs that money supply growth is feeding into inflation, which is far from the case currently. Interbank rates have been low and stable all year and again there is little reason for this to change.

HSBC/Markit PMI
(50 = no change)



A helpful new guide to economic activity in the Kingdom has recently been introduced in the form of the HSBC/Markit Purchasing Managers Indexes (PMI). PMIs are viewed by investors as important indicators in many leading and emerging economies and by being published on a monthly basis are more frequent than the other surveys released in the Kingdom. They are also comparable across countries. Four hundred companies, selected to replicate the structure of the economy, are polled on whether a variety of business indicators for their company have improved, deteriorated or stayed the same. A level of 50 for the PMI indicates no change in conditions. In the Kingdom the PMI has been comfortably above 50 since it was first calculated, in August 2009, suggesting a continued expansion of the economy. It rose slightly in October.

Key data

	2003	2004	2005	2006	2007	2008	2009	2010F	2011F
Nominal GDP									
(SR billion)	804.6	938.8	1182.5	1335.6	1442.6	1786.1	1409.1	1640.3	1741.7
($ billion)	214.6	250.3	315.3	356.2	384.7	476.3	375.8	437.4	464.4
(% change)	13.8	16.7	26.0	12.9	8.0	23.8	-21.1	16.4	6.2
Real GDP (% change)									
Oil	17.2	6.7	6.2	-0.8	-3.6	4.2	-6.7	2.7	3.9
Non-oil private sector	3.9	5.3	5.8	6.1	5.5	4.6	3.5	4.7	5.2
Government	3.1	3.1	4.0	3.1	3.0	3.7	4.4	4.0	3.6
Total	7.7	5.3	5.6	3.2	2.0	4.2	0.6	3.9	4.5
Oil indicators (average)									
WTI ($/b)	31.1	41.5	56.6	66.1	72.3	99.7	62.0	79.0	80.0
Saudi ($/b)	26.9	34.7	49.5	60.5	68.1	93.4	60.5	75.1	74.8
Production (million b/d)	8.8	9.0	9.5	9.2	8.7	9.2	8.1	8.2	8.4
Budgetary indicators (SR billion)									
Government revenue	293	392	564	674	643	1101	510	653	670
Government expenditure	257	285	346	393	466	520	596	604	628
Budget balance	36	107	218	280	177	581	-87	49	41
(% GDP)	4.5	11.4	18.4	21.0	12.2	32.5	-6.1	3.0	2.4
Domestic debt	660	614	475	366	267	237	225	220	205
(% GDP)	82.0	65.4	40.2	27.4	18.5	13.3	16.0	13.4	11.8
Monetary indicators (average)									
Inflation (% change)	0.6	0.3	0.7	2.3	4.1	9.9	5.1	5.4	5.2
SAMA base lending rate (%, year end)	1.75	2.50	4.75	5.20	5.50	2.50	2.00	2.00	2.25
External trade indicators ($ billion)									
Oil export revenues	82.0	110.4	161.6	188.2	205.3	281.0	163.1	201.7	197.0
Total export revenues	93.0	125.7	180.4	210.9	233.1	313.4	192.2	236.6	234.8
Imports	33.9	41.1	53.8	63.0	81.5	100.6	86.4	95.0	104.6
Trade balance	59.1	84.6	126.6	147.8	151.6	212.7	105.8	141.6	130.2
Current account balance	28.0	51.9	90.0	98.9	93.3	132.3	22.8	52.1	35.7
(% GDP)	13.1	20.7	28.5	27.8	24.3	27.8	6.1	11.9	7.7
Official foreign assets	97.1	127.9	195.5	273.4	359.8	502.0	474.2	522.6	551.7
Social and demographic indicators									
Population (million)	22.0	22.7	23.4	24.1	24.8	25.5	26.3	27.1	27.9
Unemployment (male, 15+, %)	10.4	11.0	11.5	12.0	11.0	9.8	10.5	10.2	9.8
GDP per capita ($)	9745	11041	13503	14806	15523	18651	14276	16119	16627

Sources: Jadwa forecasts for 2010 to 2011. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics and Jadwa estimates for oil, social and demographic indicators.

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The data contained in this Research is sourced from Reuters, Bloomberg, Tadawul and national statistical sources unless otherwise stated.

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