



TASI continues climbing

- The inclusion of Saudi Stock Exchange (Tadawul) into the MSCI EM as well as improved investor sentiment related to higher oil prices were some of the macro-level factors behind Tadawul All Share Index's (TASI) 7 percent rise in Q2 2018.
- TASI's year-to-date gains currently stand at around 17 percent, making it the best performing equity market when compared to major international and regional indices. What is more impressive is that this performance has come at a time when emerging market equities have seen some pullback, with global fund investors decreasing their emerging market bond and equity allocations in recent months.
- Net purchases of SWAPs and buying by qualified foreign investors (QFIs) totaled SR4.4 billion in Q2 2018, taking total net QFI inflows to SR12.3 billion since the start of the year. Looking ahead, we expect the combination of both FTSE EM and MSCI EM inclusion to bring in a minimum of \$15 billion in passive inflows by the end of 2019.
- In addition, we expect active investors benchmarked to MSCI EM to start entering the market prior to actual inclusion, which is expected to drive TASI performance even higher, similar to patterns observed with other regional equity markets prior to MSCI EM inclusion.
- More specifically, we view a rise of at least 20 percent between now and early 2019 as totally plausible, thereby pushing TASI to around 10,000 points, compared to circa 8,400 points currently.

For comments and queries please contact:

Fahad M. Alturki
Chief Economist and Head of Research
faltaruki@jadwa.com

Asad Khan
Director
rkhan@jadwa.com

Head office:

Phone +966 11 279-1111
Fax +966 11 279-1571
P.O. Box 60677, Riyadh 11555
Kingdom of Saudi Arabia
www.jadwa.com

Jadwa Investment is licensed by the Capital Market Authority to conduct Securities Businesses, license number 6034-37.

View Jadwa Investment's research archive and sign up to receive future publications:
<http://www.jadwa.com>

Figure 1: TASI has risen significantly since the start of the year





Overview

The Tadawul All Share Index (TASI) has continued to rise over the last three months, pushing year-to-date gains to around 17 percent.

One major factor behind rises in Q2 2018 is related to investor anticipation, and eventual inclusion, of Tadawul into the MSCI EM index...

...another factor was higher oil prices.

The rises came despite seasonally observed subdued activity during Ramadan and Eid-al-Fitr...

...and as global fund investors scaled

The Tadawul All Share Index (TASI) has continued to rise over the last three months, pushing year-to-date gains to around 17 percent. As mentioned in our previous report ([Update on The Saudi Stock Exchange, published April 2018](#)), part of the rises in Q1 2018 were due to an expansionary fiscal budget, improving sentiment linked to higher oil prices, the Capital Market Authority's (CMA) amendments and FTSE EM index inclusion. Whilst some of the above factors will also have been behind the rises in Q2 2018, another major reason was investor anticipation, and eventual inclusion, of the Saudi Stock Exchange (Tadawul) into the MSCI emerging market (EM) index. In late June, the MSCI upgraded Tadawul from 'Standalone' to 'Emerging Market' status, thus capping three years of preparation and reform which started with opening up to qualified foreign investors (QFIs) back in mid-2015. Whilst the inclusion into MSCI EM, and FTSE EM, has precipitated a sizable inflow from QFIs since the beginning of the year, it is important to highlight that this is not the only reason for higher inflows. Indeed, we believe growing confidence in the nature and direction of structural economic reform, instituted as part of the Kingdom's Vision 2030, has provided the backdrop to facilitate such sizable investments into the Saudi Stock Exchange.

TASI Performance

The inclusion of Tadawul into the MSCI EM as well as improved investor sentiment related to higher oil prices were some of the macro-level contributing factors for TASI's 7 percent rise in Q2 2018 (Figure 2). Furthermore, this rise came despite seasonally observed subdued activity during Ramadan and Eid-al-Fitr (for more on this please see our [Seasonality in the Saudi Stock Market](#) report published June 2015), and as global fund investors scaled back portfolio allocations in emerging markets.

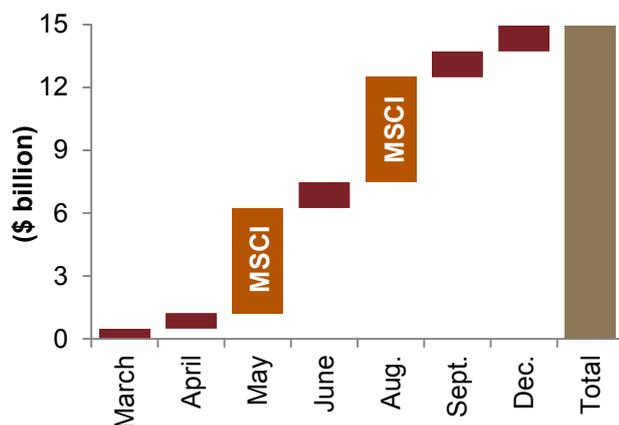
MSCI EM Inclusion:

Back on 21 June 2018, the MSCI announced, in its Annual Market Classification Review, that Saudi Arabia would be upgraded to the EM index. According to the review, the inclusion itself would take

Figure 2: Macro-level contributory factors to TASI's recent performance



Figure 3: \$15 billion in passive inflows expected from MSCI EM and FTSE EM during 2019





back portfolio allocations in emerging markets.

Back in June 2018, the MSCI announced that Saudi Arabia would be upgraded to the EM index....

...with the inclusion taking place in two tranches, in May 2019 and August 2019.

The combination of both FTSE and MSCI EM inclusion is therefore expected to bring in a minimum of \$15 billion in passive inflows by the end of 2019.

During Q2 2018, as oil prices trended up to three year highs, this contributed to pushing TASI up as well.

So far this year, TASI has been the best performing equity market when compared to major international and regional indices.

place in two tranches, one in May 2019 and another in August 2019. According to MSCI estimates, Saudi Arabia would constitute 2.6 percent of total MSCI EM index.

According to MSCI's Modern Index Strategy, published in May 2018, there were over \$1.9 trillion in assets benchmarked globally to its EM index, of which, according to the CEO of Saudi Stock Exchange, roughly 25 to 30 percent are passive investors. As such, based on these figures, Saudi Arabia should expect to see a guaranteed inflow of passive funds totaling at least \$10 billion through MSCI EM by August 2019. Added to this is expected passive inflows associated with Saudi Arabia's inclusion into the FTSE EM index. Based on FTSE EM index's current market capitalization of around \$4.7 trillion, and with the FTSE Saudi Arabia All Cap index market capitalization of circa \$133 billion, Saudi Arabia's weighting is calculated to be around 2.7 percent of the EM index. According to FTSE Russell, an estimated \$200 billion of passive assets is currently tracking the FTSE EM index, which would mean Saudi Arabia's inclusion, upon completion in December 2019, would attract around \$5 billion in passive inflows. The FTSE EM upgrade is scheduled to be implemented over five tranches, with the first tranche commencing in March 2019, and the final in December 2019. The combination of both FTSE and MSCI EM inclusion is therefore expected to bring in a minimum of \$15 billion in passive inflows by the end of 2019 (Figure 3).

Improvement in oil prices:

During April 2018, oil prices started rising as speculation grew that the US Administration would reapply sanctions on Iran. In May, the US officially announced that sanctions would be applied, and oil prices rallied further. In fact, between 3rd April and 22nd May, Brent oil prices rose by 23 percent. Accordingly, as oil prices trended up to three year highs, this contributed to pushing TASI up as well (Figure 2). Despite the correlation between TASI and oil prices being dislocated somewhat recently, there are still sentimental effects of oil prices on the stock market, especially following sharp changes in the price of oil.

Comparative performance:

So far this year, TASI has been the best performing equity market

Figure 4: Global stock market performance (year-to-July, percentage change)

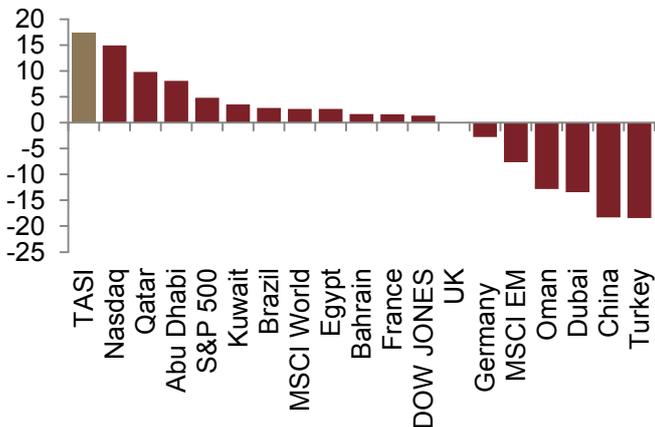
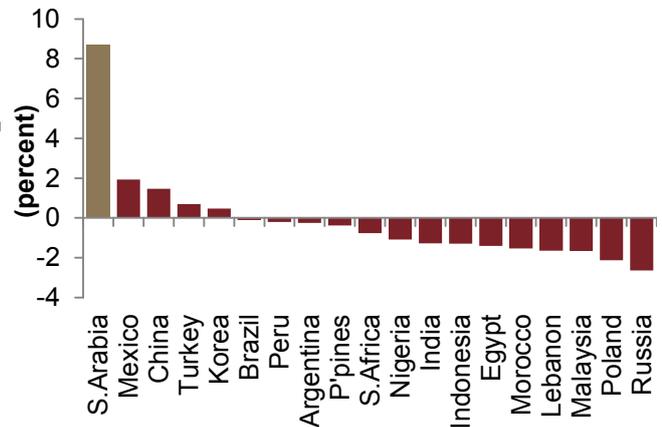


Figure 5: Q2 2018 cumulative global equity fund flows (as a percentage of total assets under management)





What is more impressive is that this performance has come at a time when emerging market equities have seen some pullback.

Saudi Arabia has seen the largest cumulative equity fund flows across emerging markets in recent months.

Net purchases by foreigners continued to be positive in Q2 2018...

...with total net QFI inflows at SR12.3 billion since the start of the year...

...with the combined market ownership of QFIs and SWAPs at 1.78 percent in June 2018. A rise in net purchases of SWAPs and buying by QFIs has helped raise

when compared to major international and regional indices. Whilst other regional indices have seen rises, mostly due to improving sentiment linked to higher oil prices, they have not been able to match the Saudi bourse's performance so far (Figure 4).

What is more impressive is that the Saudi performance has come at a time when emerging market equities have seen some pullback. A combination of recent developments have resulted in the retreat from emerging market assets. With the US Federal Reserve embarking on interest rate tightening, this has helped push up yields on US Treasury to multi-year highs. Currently, the yield on 10 year US treasury bills is around 2.87 percent, which has led to some global asset managers shifting a part of their portfolio allocation away from emerging markets to these 'safer' US assets. Additionally, the volatility caused by recent escalation in trade tensions between the US and China seems to have added to the 'risk-off' attitude by global investors. Regardless of these developments, data from international fund investors show Saudi Arabia seeing the largest cumulative equity fund flows across emerging markets in recent months. In fact, the Kingdom saw a massive 8.7 percent rise in cumulative equity fund inflows during Q2 2018, whilst many other emerging markets saw outflows (Figure 5).

Key Trends

Net inflows remain strong:

Net purchases by foreigners continued to be positive in Q2 2018, carrying on the momentum seen in the previous quarter. Specifically, in the second quarter of 2018, net purchases of SWAPs and buying by qualified foreign investors (QFIs) totaled SR4.4 billion in Q2, taking total net QFI inflows to SR12.3 billion since the start of the year (Figure 6). Although profit-taking in June saw a lower level of net QFI inflow, we expect inflows to regain momentum in the next six-to-twelve months, especially as certain QFIs, such as hedge funds, position themselves to take advantage of the anticipated flows ahead of Tadawul's actual inclusion into the EM index in 2019 (see Outlook section below).

According to the latest Tadawul market report, the combined market ownership of QFIs and SWAPs stood at 1.78 percent in June 2018, up from 1.05 percent in January 2018 and 0.93 percent a year ago.

Figure 6: Net purchases of SWAPs and QFIs has totaled SR12.3 billion so far this year

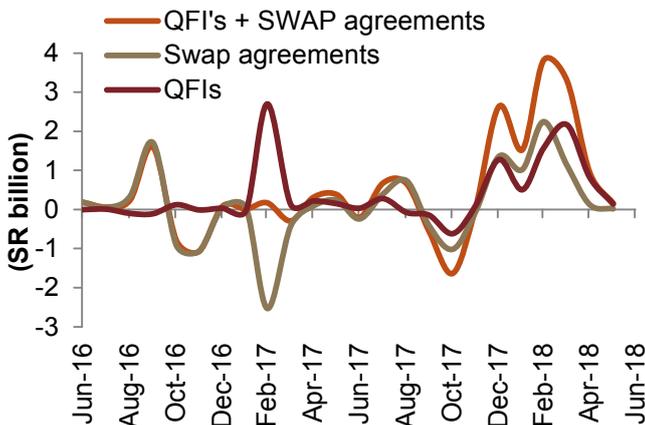
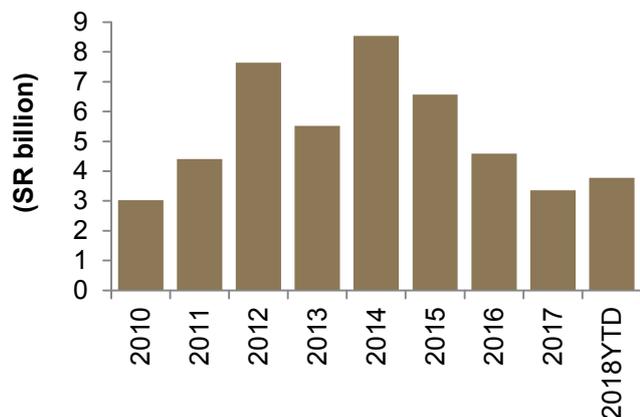


Figure 7: TASI average daily traded values showing improvement so far in 2018





liquidity in the market...

...and, in turn, contributed to pushing up average daily traded values.

TASI valuations have risen recently...

...currently, TASI's price-to-earnings (PE) ratio is 18.62, the highest level in three years...

...although not all sector PEs are trending higher than the two year average.

We expect active investors to start entering the market prior to actual MSCI EM inclusion next year...

...with around \$35 billion in active inflows...
driving TASI performance even higher in the remainder of 2018 and

Traded values slowly improving:

A rise in net purchases of SWAPs and buying by QFIs has helped raise liquidity in the market and, in turn, contributed to pushing up average daily traded values. So far in 2018, average daily traded values have improved, rising by 13 percent over full year 2017 averages, at SR3.7 billion, but are still 56 percent below record highs of SR8.5 billion registered in 2014 (Figure 7).

Valuations beginning to rise:

With the Saudi stock market rallying and earnings per share (EPS) remaining unchanged, quarter-on-quarter, TASI valuations have risen. Currently, TASI's price-to-earnings (PE) ratio of 18.62 is the highest in three years, and above its two year average of 16.78 (Figure 8). Looking ahead, we see the inclusion of the Tadawul into MSCI EM raising the risk of over-pricing of stocks in the short to medium term, similar to trend seen in both Dubai (DFM) and Abu Dhabi (ADX). In the year between announcement and implementation of the upgrade into MSCI EM, DFM's PE rose from 16.2 to 20.6, whilst ADX's PE rose from 11.4 to 19. With the greater dominance of retail investors and their higher risk appetite, there is a strong possibility that the TASI could move beyond fair values as well.

That said, seen from a sectorial viewpoint, currently, not all PEs are trending higher than the two year average, with Banks, Insurance, and Telecoms all below the average (Figure 9).

Outlook

As highlighted above, we expect to see passive inflows of around \$15 billion by the end of 2019, directly as a result of both MSCI EM and FTSE EM inclusions. That said, considering around 70-75 percent of investors benchmarked to the MSCI EM index are active investors, we would expect up to \$35 billion in active inflows as well. Based on the experiences of other regional equity markets, active investors entering the market prior to actual inclusion is expected to drive TASI performance even higher. For example, DFM, ADX and Pakistan's (KSE) equity markets all exhibited strong performances in the year between announcement and implementation of the upgrade into MSCI EM. In fact, the DFM rose 108 percent, whilst ADX rose

Figure 8: Price-to-earnings has risen recently...

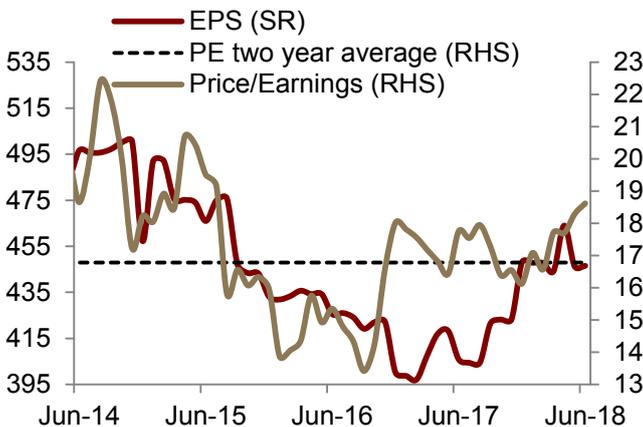
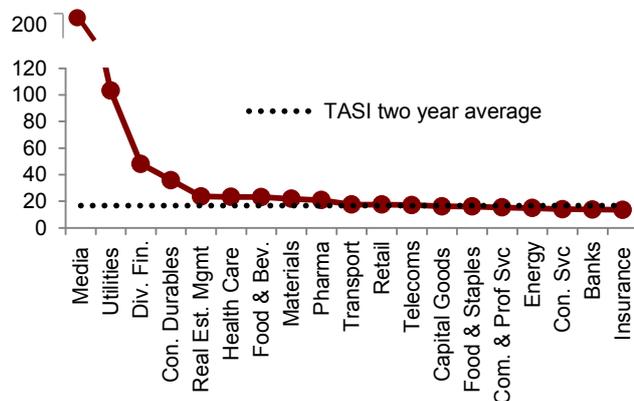


Figure 9: ...but some sectors are trending below the two year PE average





early 2019.

More specifically, we view a rise of at least 20 percent between now and early 2019 as totally plausible, but not guaranteed.

That said, it is important to highlight that this is not the only reason for interest in Tadawul....

...with growing confidence in the nature and direction of economic reform also providing the backdrop to facilitate such sizable investments.

40 percent in the year to June 2014, whilst KSE rose by 33 percent in the year to June 2017 (Figure 10).

Based on the above experiences, we expect a similar pattern of performance for the Saudi stock exchange as it draws closer to the first tranche of implementation into MSCI EM in May 2019. More specifically, we view a rise of at least 20 percent between now and early 2019 as totally plausible, putting TASI at around 10,000 points, compared to circa 8,400 points currently (Figure 11).

Whilst the inclusion into MSCI EM, and FTSE EM, is likely to precipitate a sizable inflow of funds going forward, it is important to highlight that this is not the only reason for interest in Tadawul. Indeed, we believe growing confidence in the nature and direction of economic reform has provided the backdrop to facilitate such sizable investments. Moreover, the recent unveiling of the [Financial Sector Development Program \(FSDP\)](#) and the [Privatization Program](#) have no doubt clarified the future direction of not only the Saudi equity market, but the wider financial sector as well.

Finally, as recently released Q1 2018 GDP data has shown, the Saudi economy is performing relatively well despite the implementation of major structural economic reform since the turn of the year. As oil prices trend higher on a yearly basis, this will help improve the government's fiscal position, with higher than budgeted oil revenue contributing to lowering the fiscal deficit (for more on this please refer to our recently published [Macroeconomic update](#)).

Figure 10: Regional markets rose between announcement and implementation of MSCI EM*

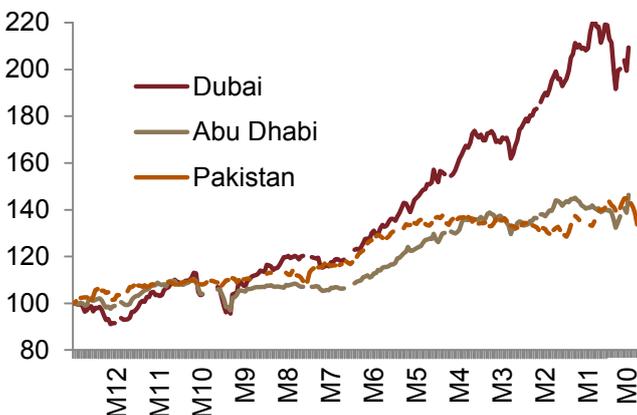


Figure 11: TASI could reach 10,000 points by early 2019*



*Rebased to 100 at 2nd June 2013 for Dubai & Abu Dhabi and 1st June 2016 for Pakistan
 *M12 to M0 = June 2013 to June 2014 for Dubai & Abu Dhabi, and June 2016 to June 2017 for Pakistan

* Past performance is not indicative of future results



Disclaimer of Liability

Unless otherwise stated, all information contained in this document (the "Publication") shall not be reproduced, in whole or in part, without the specific written permission of Jadwa Investment.

The data contained in this research is sourced from Reuters, Bloomberg, Institute of International Finance, FTSE Russell, MSCI, SAMA and Tadawul.

Jadwa Investment makes its best effort to ensure that the content in the Publication is accurate and up to date at all times. Jadwa Investment makes no warranty, representation or undertaking whether expressed or implied, nor does it assume any legal liability, whether direct or indirect, or responsibility for the accuracy, completeness, or usefulness of any information that contain in the Publication. It is not the intention of the publication to be used or deemed as recommendation, option or advice for any action(s) that may take place in future.