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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

Contents

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Executive Summary

- If oil prices start to rise beyond the current levels, non-OPEC suppliers with a compressed cost curve will eventually find incentives to raise production further, and accordingly, the weak economic data could weigh on oil demand growth.

- The EUR continued to fluctuate between USD1.05 and USD1.15 in the month of April, with an average closing price of USD1.07. A plausible yet unlikely near-term scenario, however, is a Greek exit; whereby the single currency could drop below parity to around USD0.90.

- By the end of the quarter, gold prices had erased all gains made in 2015, standing at USD1,183.9/oz. We expect gold prices to remain between USD1,100/oz and USD1,300/oz, benefiting from risk aversion, albeit to a lesser degree than what was witnessed in 2011 and 2012.

- Housing and utility prices rose higher, making 2.8% on an annual basis. Rentals for housing rose by 4%, the highest rate since June 2014. .

- Last month, the P/E ratio increased to 18.11 with the usual majority of transactions being made by Saudi individuals. The speculative nature of the market will be addressed with the commencement of trading by QFIs mid-June.

- The Saudi government appears to be adopting a wait-and-see approach in regards to moving rates in tandem with the US Federal Reserve. Currently low inflationary pressures and expectations make it unlikely that we will see a preemptive decision regarding policy this year.

- Settled letters of credit (LCs) in the month of February rose 12.1% Y/Y, the first double-digit acceleration in four months. Total settled LCs reached SAR19 billion in February, contrasting with around 16 billion in the same period last year.

View of the Month

The market's price-to-earnings ratio had dropped to 14.63 for 2014 from 15.2 in 2013, coupled with the Kingdom's sturdy economy, such cheap valuations will attract QFIs to diversify their investments and penetrate a newly opened market. Actual trading will commence on June 15 which we expect to reflect positively on the index's second half performance. Furthermore, the gradualist approach targets the inclusion of the Saudi exchange in the MSCI index which is expected in 2017.

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Macroeconomic Indicators

	2009	2010	2011	2012	2013	2014P	2015F
Real Sector							
Average KSA Crude Spot Price, Arab Light, USD/BBL	59.2	77.6	108.1	110.2	106.4	102.0	80.0
Average Daily Crude Oil Production, MMBD	8.2	8.2	9.3	9.8	9.6	9.7	9.5
GDP at Current Market Prices, SAR billion	1,609.1	1,975.5	2,510.7	2,752.3	2,806.7	2821.7	2662.6
GDP at Current Market Prices, USD billion	429.7	526.8	670.4	734.9	749.4	753.5	711.0
Real GDP Growth Rate*	1.8%	7.4%	8.6%	5.8%	4.0%	3.6%	3.4%
CPI Inflation, Y/Y % Change, Average	4.1%	3.8%	3.7%	2.9%	3.5%	2.7%	2.5%
External Sector							
Current Account Balance, USD billion	21.0	66.8	158.5	164.8	132.8	106.5	36.3
Current Account Balance/GDP	4.9%	12.7%	23.6%	22.4%	17.7%	14.1%	5.1%
Net Foreign Assets with SAMA, USD billion	405.9	441.0	535.9	648.5	717.7	710.1	678.0
Fiscal Sector (Central Government)							
Actual Revenues, SAR billion	509.8	741.6	1,117.8	1,247.4	1,156.4	1046.0	848.1
Actual Expenditure, SAR billion	596.4	653.9	826.7	873.3	976.0	1100.0	995.5
Expenditure Overrun, %	25.6%	21.1%	42.5%	26.6%	19.0%	28.7%	15.8%
Overall Budget Balance, SAR billion	-86.6	87.7	291.1	374.1	180.3	-54.0	-147.4
Budget Balance/GDP	-5.4%	4.4%	11.6%	13.6%	6.4%	-1.9%	-5.5%
Break-Even Oil Price	60.8	64.1	75.3	73.9	82.6	96.2	89.7
Financial Sector							
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Growth in Broad Money (M3)	10.7%	5.0%	13.3%	13.9%	10.9%	12.1%	10.4%
Growth in Credit to the Private Sector	-0.6%	4.8%	11.0%	16.4%	12.1%	12.1%	8.4%
Average 3M SAR Deposit Rate	0.9%	0.7%	0.7%	0.9%	1.0%	1.0%	1.0%
Average 3M USD Deposit Rate	0.6%	0.3%	0.3%	0.4%	0.3%	0.3%	0.4%
Spread, in Basis Points, SAIBOR-LIBOR	26.4	39.8	40.9	55.2	68.7	70.0	60.0

Sources: Thomson Reuters, SAMA, and NCB

* All historical growth rates prior to 2013 are based on 1999 prices. However, 2013, 2014P, and 2015F are based on 2010 prices.

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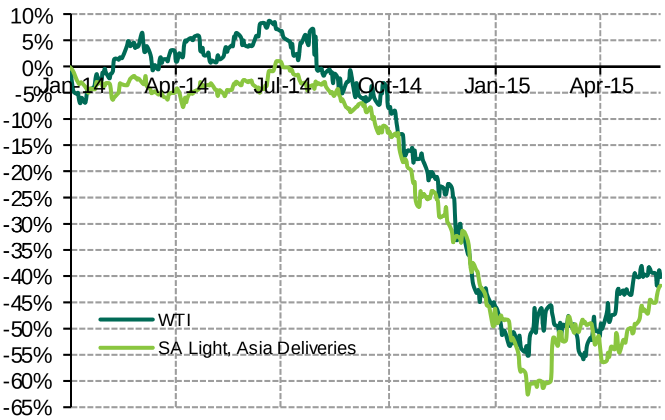
Oil Market

Brent Reversing Trend

Brent futures prices have risen in line with the increases in spot prices, seemingly heading toward USD70.0 a barrel, but this recovery started to lose momentum recently. Meanwhile, oil prices continue to consolidate in the mid USD60.0s a barrel for Brent, as the prospect of declining US output in the coming months was balanced by expectations of a partial recovery in shale production later in the year. In addition, oil prices were also supported by the return of geopolitical risk on the conflict in Yemen, which represents a proxy war between the region's two largest producers. As oil prices have rebounded, the market is much less focused on the positive effects of lower oil prices, though they are still 42% below the average levels prevailing before the June's peak. However, oil supply is still expected to far exceed demand and speculative positioning is again elevated, while the dollar is expected to resume its uptrend later this year with the Fed likely hikes. These factors suggest that the positive effects of lower oil prices can still support consumption. If oil prices start to rise beyond the current levels, non-OPEC suppliers with a compressed cost curve will eventually find incentives to raise production further, and accordingly, the weak economic data could weigh on oil demand growth.

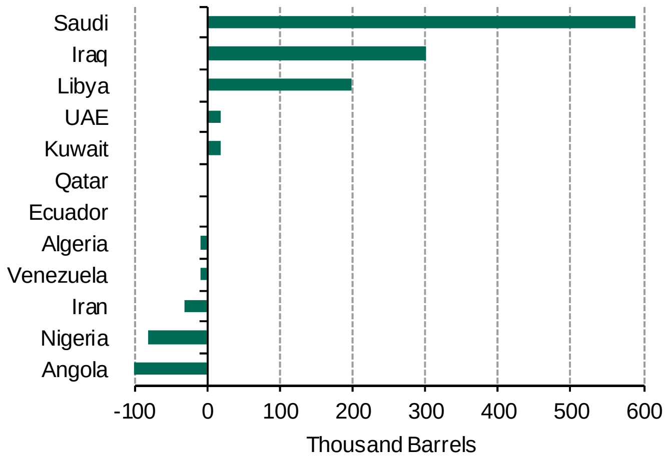
Chart 1: Oil Price Developments, YTD



Source: Thomson Reuters

On the demand side, consumer consumption, not industrial demand, is what induced oil prices recovery in the US and several Asian countries. The recovery in oil prices over Q1,15 was largely due to the strength in demand for gasoline in Asia. The divergence in consumption patterns is reflected in the strength of gasoline demand growth compared to the demand growth for diesel. In India, for example, gasoline demand grew by 19% y/y in Q1,15, while diesel demand grew by 5% y/y only. In China, there was strong growth in oil imports in April, up by 13% from March's levels and nearly 9% from a high base a year ago. However, given that there was little sign of a strong pickup in fuel demand in April, this indicates that the oil buying is largely opportunistic and intended for storage purposes. Overall, Q1,15 saw the first stage of the market's balancing act led by global demand growth and to a lesser extent by slowing non-OPEC supply.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

On the supply side, US EIA expects US shale oil output to start declining from May and the fall to accelerate next month. It also expects the US total production to restart its upward trend by the end of 2015, as the recent rise in oil prices will justify some shale production to return. The number of active oil rigs in the US fell again in May, and based on the relationship with prices, the decline seems to be a little overdone. A rebound in the number of drilling rigs, once taking place, should help to keep prices around current levels in 2016. In Saudi Arabia, according to JODI, the combined crude and oil product exports touched 8.7mb/d in March, up y/y by 0.732mb/d. This is reflected in the Kingdom's elevated production that reached 10.2mb/d this month. The rise in OPEC's production in Q1,15 has largely been led by both Saudi Arabia (up 130 kb/d y/y) and Iraq (up 200 kb/d y/y). Therefore, Saudi's market share within OPEC remains intact and close to previous highs.

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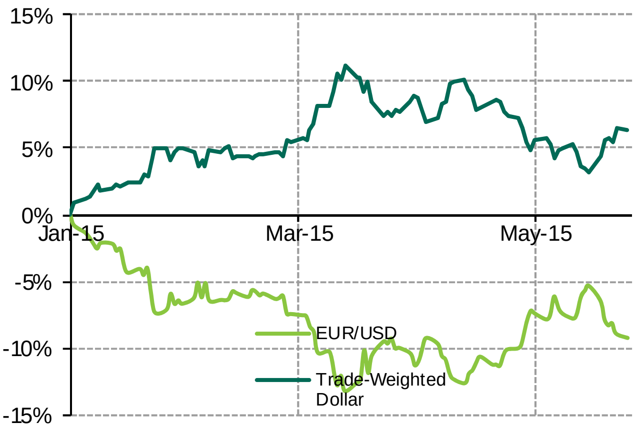
Foreign Exchange

USD Rally Moderates, EUR Finds Floor

In the month of April, the US dollar underwent a brief period of consolidation despite maintaining a broad-based strengthening bias against other major currencies. The Federal Reserve's rhetoric continues to voice concerns that a stronger dollar will erode exports revenue and that the path towards policy normalization may be longer than the market anticipated. The EUR/USD, the world's most tradable currency pair is expected to trend lower, albeit at a more modest pace than the first quarter. The ECB's efforts to prop up the economy via various liquidity-inducing measures provides a cushion against falling below parity, while the Fed's deferral from hiking interest rates in June decelerated the dollar's upside movement. The EUR continued to fluctuate between USD1.05 and USD1.15 in the month of April, with an average closing price of USD1.07. A plausible yet unlikely near-term scenario, however, is a Greek exit; whereby the single currency could drop below parity to around USD0.90.

Chart 3: Trade-Weighted Dollar and the Euro

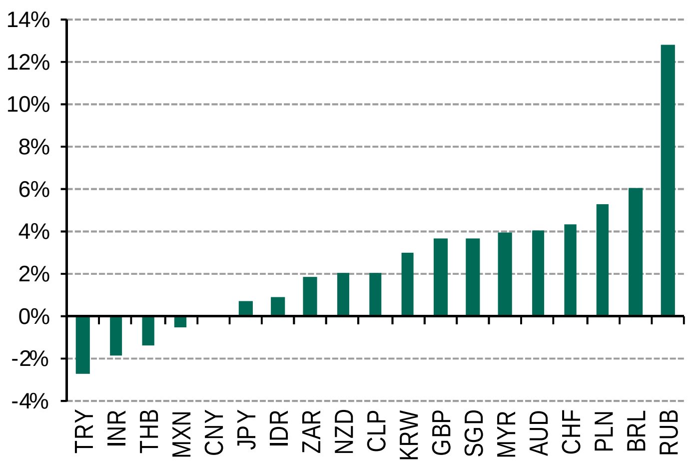


Source: Thomson Reuters

US fundamentals remain largely positive although March's payroll figures have been below expectations, registering the creation of 126,000 jobs, while the unemployment rate was unchanged at 5.5%. The Fed now uses a more encompassing metric in order to gauge the overall strength of the economy contrary to the labor market-centric approach it used while piloting QE3. Negative first quarter annualized inflation figures added worries of a stagnant wage-growth amid cheaper factors of production, allowing the USD to enter a range-bound movement since mid-March. The dollar index fell below the 100-point -mark in the second half of March and most of April, averaging around 98.

The British pound has been steadily underperforming against the USD since July 2014 as the prospect of monetary tightening faded by disinflationary dynamics and a global preference for the USD, in addition to uncertainties associated with approaching elections early May. Inflation in the UK remained flat at 0% in the two consecutive months of February and March, pushing expectations for interest rate hikes to the first quarter of 2016, lagging behind the Fed. On a YTD basis, the GBP weakened by an average of 4% by the end of March, and continued to further weaken in April, touching USD1.46 on the 10th before rebounding slightly. We expect the GBP to maintain a weakening bias in the near term and that the Bank of England will closely monitor inflation as it decides the timing and magnitude of its next policy move. The Japanese yen remains on the defensive after Japan's fundamental backdrop deteriorated.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

The Bank of Japan's (BoJ) struggle towards the 2% inflation target continues; however, it may need to further boost its monetary stimulus in order to reach the desired effect. Although Japan's regional banks are finally diversifying away from Japanese government bonds into riskier assets, the impact on the Japanese deflationary mindset is yet unclear. On one side, Japanese equities have seen the Nikkei surge by over 15% in April, breaking the 20,000 points level; reflecting optimism regarding the ongoing asset purchasing program. While on the other side, as the Liberal Democratic Party remains in power, the VAT tax increase re-scheduled for April 2017 may act as a future drag for reflation. Amidst the divide between the BoJ's accommodation and the fiscal consolidation, the Japanese yen ended the first quarter flat at 120.15 for the dollar, and is expected to maintain a weakening bias, interrupted by periods of risk-induced strength.

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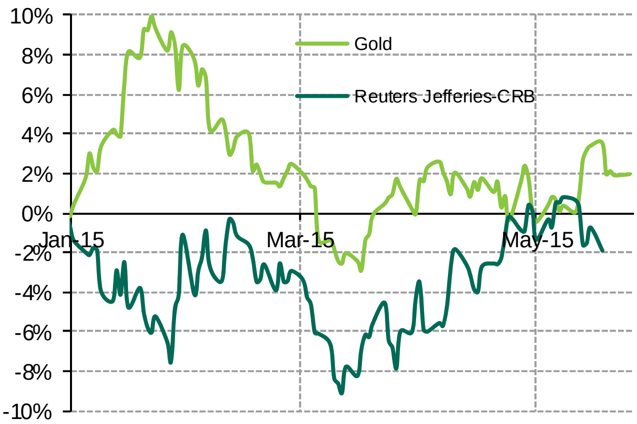
Commodities

A Rebound on Improving Fundamentals

Since the end of the commodity super cycle four years ago, we have been witnessing a broad-based weakening in all commodity based asset classes. Gold lost its allure in 2012, industrial metals dwindled on weak demand, food grains tanked on ample supply, and last but not least, the oil market crashed mid-2014 on the back of a stronger dollar and over supply. Nevertheless, although oversupply continues to threaten price recovery in 2015, some rebound has been witnessed. The Reuters/ Jeffries bottomed out on the 17th of March, falling by 9.1% from the beginning of the year to 209 points before rebounding towards the end of the month, registering a loss of 5.5% M/M. A stronger rebound ensued in April, influenced by climbing oil prices, subsequently pushing the index to end the month flat on a YTD basis at 229.5.

Chart 5: Reuters Jefferies vs. Gold

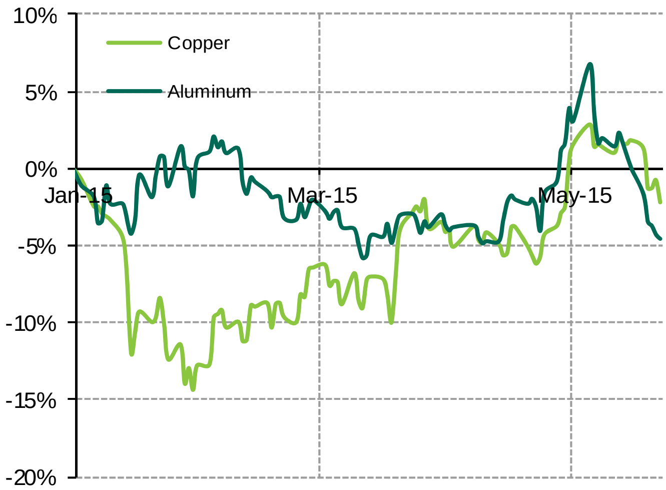


Source: Thomson Reuters

Copper bounced back to positive territory after worries on waning demand in China have eased. The red metal plunged by 14.4% earlier this year, reaching its lowest price point of USD5,395/ton on January 29th . Recovery took place after the People's Bank of China adopted an easy monetary policy, effectively cutting its benchmark one-year lending rate by 40 bps in November, followed by a decision to cut by another 25 bps on March 1st. Current interest rate in China stands at 5.35%, a notch above the record low of 5.31%. Copper prices climbed up to USD6,041/ton by the end of Q1 and continued to recover gradually in April back to pre-2015 levels. Benchmark LME aluminum prices reached their lowest levels mid-March, falling by 5.8% from the beginning of the year at USD1,745/ton after China removed its 15% export tax on aluminum alloy. In the second half of the month, however, as speculations of smelter closures by two of the world's largest aluminum producers, Rusal and Alcoa exacerbated supply concerns. By the end of the first quarter, aluminum closed at USD1,785/ton, and continued to surge in April, closing 3.9% above January at USD1,925/ton.

After gold's 10% rally in January whereby the precious metal reached USD1,302.2/oz, gold prices fell as central banks, such as the ECB and the BoJ accelerated monetary loosening, while the Fed and the BoE maintained their accommodative stance. By the end of the quarter, gold prices had erased all gains made in 2015, standing at USD1,183.9/oz. We expect gold prices to remain between USD1,100/oz and USD1,300/oz, benefiting from risk aversion, albeit to a lesser degree than what was witnessed in 2011 and 2012.

Chart 6: Base Metals



Source: Thomson Reuters

Meanwhile, the S&P/ Goldman Sachs Agricultural Index continues to tumble on the back of ample supply of soft commodities. The index recorded a 9% decline in the first quarter, falling to 293.5. Wheat futures have fallen the most among food grains to cents 511/bushel, a 13.9% decline from January 1st. Favorable weather conditions relative to global demand resulted in downward price pressures. In addition, the falling currencies of both Russia and Ukraine allowed the prices of Black Sea wheat to spiral downward. Corn futures slid 7.3% in the first quarter to cents 376.25/bushel on high supply and slackening demand. With drought threatening areas like California and parts of the US Midwest, corn production in 2015 is projected down 4% from the record 2014 crop, although at 13.6 billion bushels production, this year's crop is still the third highest.

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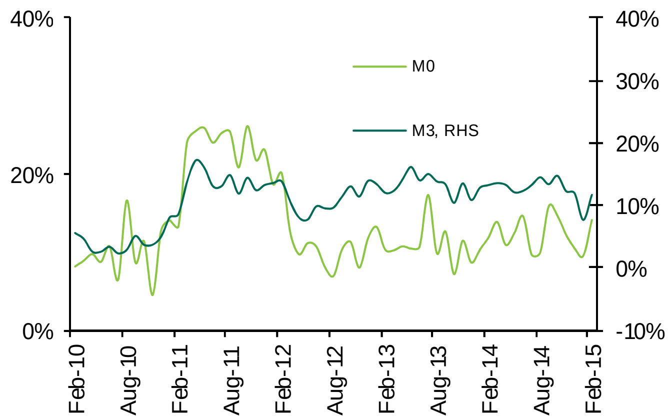
Money & Inflation

A Plateauing , Yet Strong Money Supply

The money supply continues to have room for annualized growth despite last year's high levels. Broad money grew at 11.7% Y/Y in the Saudi monetary system, approaching SAR1.8 trillion by the end of February. Although approaching lower double-digit growth, most of the moderation stems from declining quasi monetary deposits and a plateau in time and savings deposits. The monetary base was up 14.1% in February at SAR299 billion, on the back of a 16% surge in currency outside banks, reaching SAR169.2 billion. Deposits with SAMA also shows an annualized upturn of 11.3% to SAR 103.2 billion.

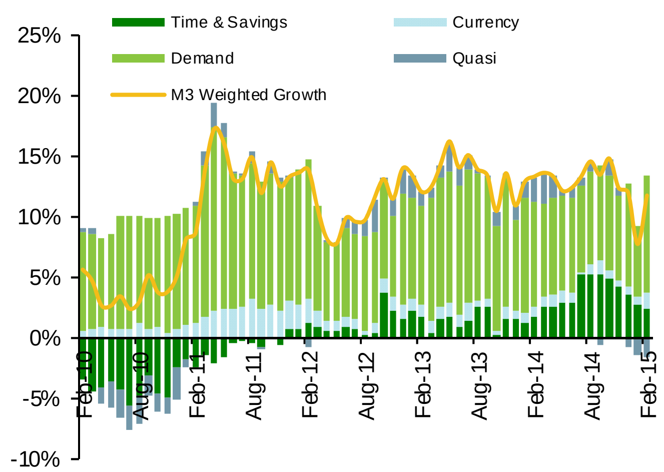
Chart 7: Growth in Monetary Aggregates



Sources: SAMA and NCB Estimates

Demand deposits which account for around 58.9% of the money supply recorded a solid growth of 17% in February, in line with the Kingdom's expansionary policies. Adding currency outside banks and demand deposits, we find that narrow money (M1) rose by 16.8% Y/Y in February, the largest since November 2013. This, in addition to the deceleration in savings deposits, indicates a rise in short-term liquidity needed to fuel economic activity. Point of sale (POS) transactions, which are used as a proxy for consumer demand, surged by 42.5%, its highest rate since January 2012, and reached a historical record of SAR16.7 billion. Time and savings deposits rose by 10.3% Y/Y, the lowest growth rate since February 2014. Total deposits in this account stood at SAR384.5 billion in February, falling from the 401.6 billion peak of August 2014. Quasi monetary deposits which consist of foreign currency deposits, marginal deposits for letters of credit, outstanding remittances, and bank repo transactions with private sector declined by 12.8%, the largest on record, to SAR173.1 billion. Saudi bank reserves reached a record high of SAR217.7 billion on the back of an annualized 447.4% surge in current deposits, rendering excess reserve ratio to rise to 51.5%. Statutory deposits at SAMA were SAR92.6 billion in February, in line with the overall increase in money supply.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

Meanwhile, annualized inflation levels averaged 2.1% in February, the fifth consecutive monthly deceleration. Food and beverages, the largest category in the consumer basket, edged up by the lowest pace on record, at 1.7%. Ample global supply of food grains, in addition to low imported inflation backed by a stronger dollar are the main contributing factors to lower price change in this category. Housing and utility prices rose higher, making 2.8% on an annual basis. Rentals for housing rose by 4%, the highest rate since June 2014. Water supply prices continue to act as a drag for this category as it tumbled by 23.8% Y/Y. The transport category had an almost constant price level since the beginning of the year, mainly due to motor vehicles' prices edging downwards. Since mid-2012, car prices fell by an average of 4.4% prices, exerting a downward price pressure on the whole category. Overall, we expect to see inflation levels edging up as the lower base effect takes place; however, it will remain below 3% in the short term.

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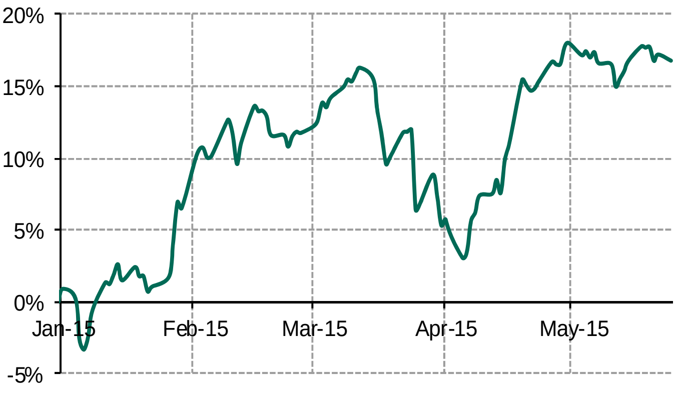
Capital Markets

Regaining Traction

Saudi Arabia had led its first ever military intervention into Yemen, dubbed "Decisive Storm". A collaborative airborne military action against the Houthi revolt in Yemen to restore power to Hadi's regime. The sudden decision to take action was announced on March 25 which caught market investors off-guard. Additionally, the first quarter corporate earnings for Saudi listed companies revealed significant declines for numerous companies. The decline of oil prices was an indication for lower revenues and investors priced-in the declines prior to company announcements. As a result, Tadawul's main index bottomed at 8'589.7 in beginning of last month which only translates to a 3.1% YTD gain. However, following the aforementioned, the market rebounded as operation decisive storm ended on the 21st of April and Saudi officials declaring it successful by achieving key objectives in weakening Houthi threats. The subsequent operation, Restoring Hope, had been announced which aimed to guide the country towards a stable future. Furthermore, the timeframe for announcing the final regulations for Qualified Financial Institutions (QFI) to enter the market was announced mid-month (See Special Focus). Accordingly, Tadawul had gained 12.0% by the end of April to reach 9'834.49. On a sectoral basis, the real estate

Chart 9: Tadawul All-Share Index

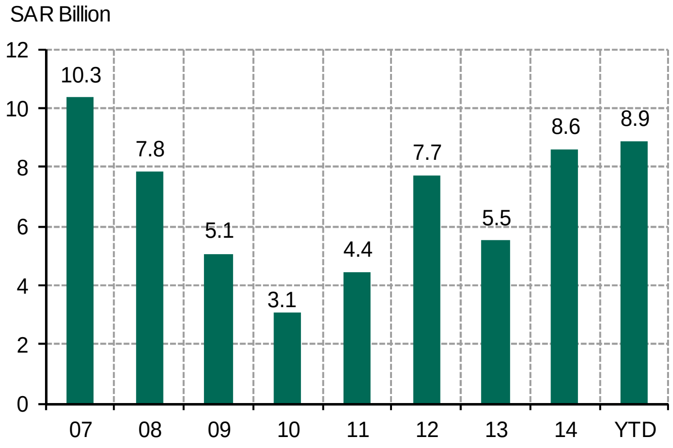


Source: Tadawul

sector recorded the largest growth YTD with a 40.7% gain by the end of last month, followed by the industrial investment and transport sectors which posted 39.2% and 35.0%, respectively, for the same period. The only sector remaining in the negative is the telecommunications which is pressured by Mobily's unfolding of their accounting discrepancies.

The level of activity, measured by the average daily traded volumes, fluctuated from as low as SAR5.3 billion to a peak of SAR14.9 billion to equate to a monthly average of SAR9.0 billion. Despite the decline of market activity by 3.8% M/M, market capitalization increased from SAR1.90 trillion in March to SAR2.2 trillion by the end of April, gaining 13.8% on a monthly basis. Additionally, the price-to-earnings (P/E) ratio had dropped to 15.2 by the end of the first quarter which prompted investors to grasp lucrative valuations. Last month, the P/E ratio increased to 18.11 with the usual majority of transactions being made by Saudi individuals. The speculative nature of the market will be addressed with the commencement

Chart 10: Average Daily Traded Value



Source: Tadawul

of trading by QFIs mid-June.

The primary market for 2015 was not expected to surpass 2014's activity, especially as Tadawul introduced the second largest initial public offering (IPO) globally, the National Commercial Bank. During April, the first IPO for 2015 offered 15 million shares at a price of SAR30, representing 30% of Middle East Paper Company. The second IPO was for Saudi Company for Hardware which offered 7.2 million shares at SAR70, also representing 30% of total company shares. The appetite for primary issuances remains strong in the local market as both IPOs were oversubscribed by 473% and 620%, respectively. We expect more issuances in the second half of 2015 as IPOs continue to attract capital, however, Adel Al Ghamdi, Tadawul's CEO, had announced that institutional allocations are likely to increase in the future to further add depth and stability to the market.

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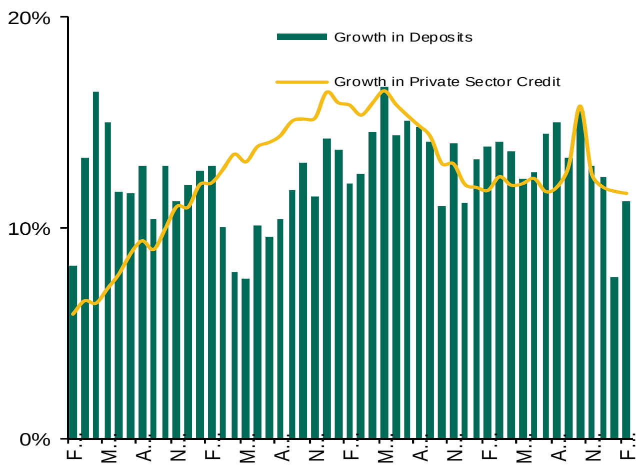
Loans Market
Private Sector Credit to Moderate

In the month of February, the annualized growth in the Saudi credit market reached 11.1% valued around SAR1.3 trillion. The overwhelming majority (around 96.6%) of bank credit are claims on the private sector which grew by 11.6% Y/Y , contrasting with an 11.2% Y/Y growth in deposits. Therefore, despite the slight moderation we witnessed after mid-2013, and the oil market turmoil after mid-2014, the Saudi credit market continues to grow due to sound internal fundamentals and the counter-cyclical policy that the Kingdom is pursuing. Total fresh credit to the private sector up until February reached SAR21.4 billion, and average annual growth is expected to remain in the lower double-digit category, with a possible single-digit rate. Bank deposits will continue to support lending as demand deposits surged by 17%, the highest rate since January 2014. Elevated levels of liquidity under the currently low inflation specter allows banks to take on more leveraged positions and expand their credit portfolios. In February, the loans to deposit ratio (L/D) was 79.4%, a notch below last year's average of 80.1%.

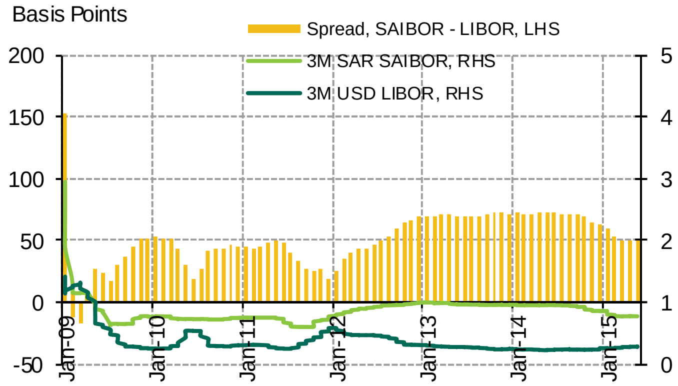
Chart 11: Private Sector Financing



Sources: SAMA and NCB Estimates

Saudi banks' credit portfolios reached their lowest yet in short-term loans allocations at 48.4% in favor for higher maturity loans. Medium-term loans currently stand at 17.9%, while long-term loans make up 33.6% of the consolidated Saudi banks' portfolio. The inclination towards longer maturity loans reflects banks' increased confidence as the market becomes more regulated and as more longer-term financing options, such as mortgages, are deployed. The conventional nature of the Saudi system and the prudent policies of SAMA has prevented overexposure to asset classes during the financial crisis of 2008, and kept banks well-cushioned against external shocks. As of February, statutory reserves held at SAMA stood at SAR92.6 billion, which is around 5.8% of total deposits, in line with last year's average. Due to the general increase in liquidity; however, statutory deposits upturned by 8.3% compared to last year while total deposits surged by 11.2%.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

Saudi banks' credit to the public sector stood at 43.3 billion in February, inching down by 2% from last year. On the other hand, banks' holdings of government securities reached SAR272 billion, surging by 10.3% Y/Y. Over 80% of government securities are treasury bills issued to mop up excess liquidity. The growth rate of T-bills' issuance has declined rapidly from a peak of 43.2% Y/Y on September 2013 to as low as 12.2% in February 2015. Lower inflationary pressure, coupled with the government's direction to easy monetary policy led to lower issuances of T-bills. The interest rate environment remains suppressed as the Saudi interbank offered rate (SAIBOR) moved in a declining trend reaching a new low of 0.81% in February. Thus, we notice a narrowing of interest rate differentials between the Saudi riyal and the US dollar to 55 bps compared to 70 bps on February 2014.

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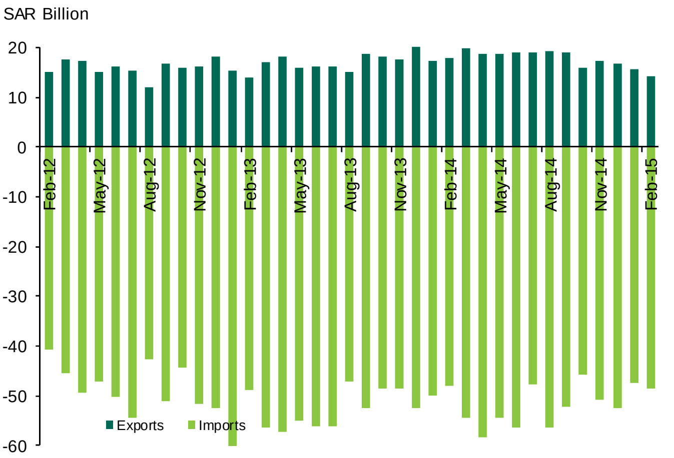
External Trade

Underwhelming Growth in Non-Oil Exports

The Kingdom's non-oil trade data for the month of February shows yet another contraction in non-oil exports met with an uptick in imports. Total non-oil exports tumbled by 19.9% Y/Y to SAR 14.2 billion on the back of lower returns from petrochemicals and plastics. On the other hand, total imports showed recovery on an annual basis after a few months of slack, recording SAR48.6 billion, a 1.7% upturn. By weight, we also note that exports shrank proportionally by around 20% from last year to 3.6 megatons, while the weight of imports declined by 12.4% to 5.2 megatons despite the higher bill. The balance of trade gap in February widened by 14.4% compared to the same period last year.

Chart 13: Saudi Non-Oil Trade Balance

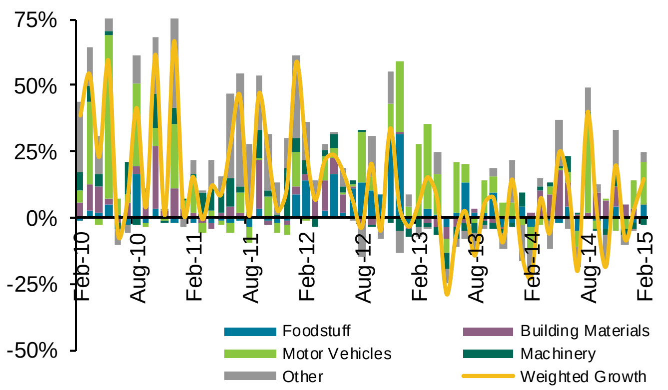


Sources: SAMA and NCB

Analysis of non-oil export components in value terms show an annualized 16.1% downturn in plastics to SAR4.8 billion, accompanied by a 46% plunge in chemical products to SAR3.4 billion. Plastics and petrochemicals account for 34% and 23.6% of total non-oil exports, respectively. The declines in these main categories is largely due to persistently low oil prices, in addition to the slowdown in China's trading activity during the two-week Lunar New Year holiday. Meanwhile, exports of base metals recorded a 19.1% Y/Y upturn, reaching SAR1.2 billion. The UAE accounted for around 13% of non-oil exports valued at SAR1.8 billion. Although unchanged from last year, the UAE remained the largest export market, advancing over China and India. The Chinese share of the exports was 11.1%, at around SAR1.6 billion. Chinese exports dwindled by 24.6% compared to last year due to the aforementioned holiday being a moving seasonality. India landed as the third largest market for Saudi non-oil exports in February, amounting to SAR0.7 billion which is 51.9% less than a year ago.

On the import side, machinery and electrical equipment dominated the import bill by around 27.7% valued at SAR13.5 billion, thus surging by 8.7% Y/Y. Transport equipment followed, making up 19.9% of imports in February at SAR 9.5 billion, an annualized upturn of 9.1%. Imports of base metals which account for around 11% of the monthly import bill inched downwards by 0.7% at SAR5.3 billion. Around 16.7% of the Kingdom's imports originated from China, valued at SAR8.1 billion, advancing over last year by 28.4%. Moreover, imports from the US constituted around 12.8% of the monthly bill at SAR6.2 billion, an upturn of 6.8% Y/Y . Japanese imports inched up 1.8% from last year after recording SAR2.8 billion in February, making around 5.8% of the import bill.

Chart 14: Attribution Analysis of Letters of Credit Opened



Sources: SAMA and NCB

Settled letters of credit (LCs) in the month of February rose 12.1% Y/Y, the first double-digit acceleration in four months. Total settled LCs reached SAR19 billion in February, contrasting with around 16 billion in the same period last year. LCs of motor vehicles account for almost a quarter of the monthly total at around SAR4.6 billion. In comparison to last year, motor vehicles LCs surged by 15.6%. In addition, LCs of building materials which account for roughly 11.4% of the monthly total at SAR2.2 billion shows an annualized surge of 6.9%. On the other hand, save livestock and meat which rose by about 5.1%, LCs of food stuff, which account for around 10% of LCs fell by 23.5%, mostly due to lower commodity prices.

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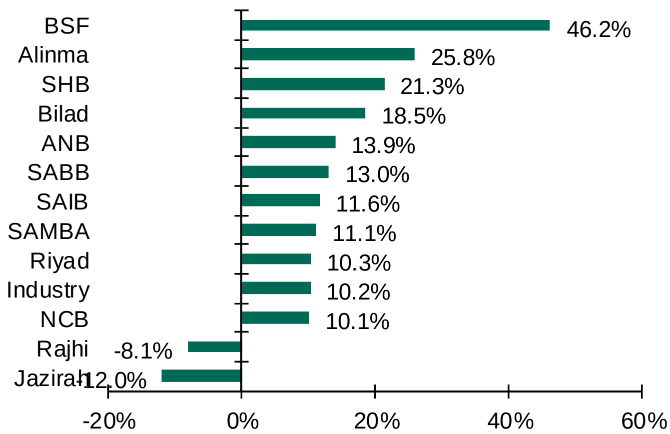
NCB الأهلي

Special Focus:
Stability rather than Liquidity

The Saudi stock exchange is larger than its Russian or Mexican counterparts, and it is certainly the largest in the Middles East. Given that perspective, Tadawul is heading towards global capital markets convergence as it seeks to attract foreign institutional investors. The Capital Market Authority (CMA) released the final rules and regulations for foreign Qualified Financial Institutions (QFI) to enter the Saudi stock market. The approval from the council of Ministers was announced in July 2014 which was swiftly followed with a regulatory draft by the CMA. A 90-day period to provide an opportunity for concerned and interested parties to offer feedback and suggest amendments. However, it took another eight months to announce the final rules and regulations as the CMA aimed for careful diligence given the importance of this critical development. Accordingly, interested foreign institutions must meet certain requirements in order to enter the local stock market. A QFI must either be a bank, brokerage or securities firm, fund manager, or an insurance company with an investment experience of 5 years or more. Furthermore, a QFI must have assets under management worth a minimum of USD5 billion with a possible waiver, the value can decrease to USD3 billion. The need for long-term investors is always welcomed in equity markets as they provide much needed stability. Government institutions and private sector institutions own almost 60% of stocks, however, market activity is predominantly comprised of retail investors, currently around 90% of daily trading which is causing rapid fluctuations as speculative trading is their main strategy. Prior to the announcement, non-GCC foreigners have been provided a limited window to trading in Tadawul through SWAP options since 2008.

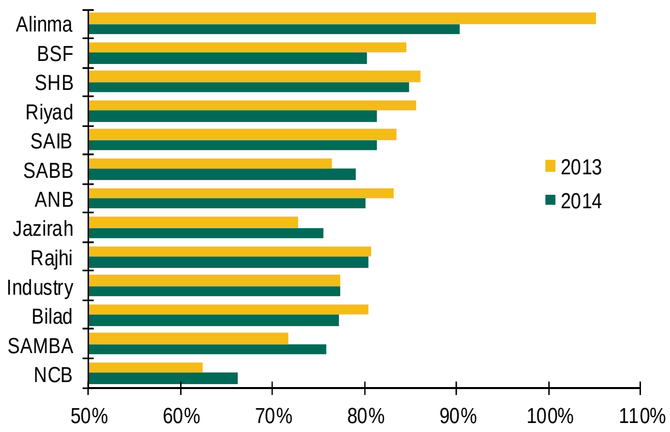
Table 15: Net Income Growth, 2014



Sources: Respective Annual Reports, and NCB

This phase would be considered the second stage of attracting foreigners towards Tadawul. The CMA emphasized that the purpose of opening up is to add depth and offer stability to the market and not primarily injecting liquidity at this moment of time. Following approval procedures which will take a maximum of 11 working days, QFIs will face some trading limitations as CMA seeks to safely maintain and control this huge milestone for Tadawul. A single QFI and its affiliates can only own up to 5% of a listed stock. Additionally, a client may not aggregately accumulate more than 5% of a stock through multiple QFIs. However, multiple QFIs may own as much as 20% of the issued shares of a certain listed stock. Furthermore, all types of foreign (QFI, GCC, residents, or SWAP) investors may not be allowed to own more than 49% of a listed company to maintain the majority of ownership for Saudis. Also, the total capital allowed for QFIs to enter the market will be limited to 10% of the market cap, equating to SAR189.9 billion by the end of 1Q2015. The current bylaws on foreign traders will also be imposed on QFIs such as the inability to own in Makkah or Madinah based companies.

Table 16: Loans to Deposits Ratio



Sources: Respective Annual Reports, and NCB

Despite the limitations, the inflow of capital is beneficial for the market especially as only around 45% of stocks are free float. Foreign capital will reduce fluctuations as their portfolio will likely target medium to long-term investment horizons. The market's price-to-earnings ratio had dropped to 14.63 for 2014 from 15.2 in 2013, coupled with the Kingdom's sturdy economy, such cheap valuations will attract QFIs to diversify their investments and penetrate a newly opened market. Actual trading will commence on June 15 which we expect to reflect positively on the index's second half performance. Furthermore, the gradualist approach targets the inclusion of the Saudi exchange in the MSCI index which is expected in 2017.

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