

Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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Executive Summary

- Facing the potential of another sharp drop in oil prices, OPEC for the first time in nearly eight years has finally put forward a diplomatic measure on hope to keep a floor on oil prices.
- The aforementioned dynamic of expected lower interest differentials will clearly help the greenback gain ground by the end of this year, despite the fact that the trade-weighted dollar has marginally declined by around 4% year-to-date.
- It is becoming increasingly likely that the yellow metal [gold] will be range-bound around USD1300-1350/Oz by the end of the year, with most analysts predicting the persistence of such levels or even lower during the next couple of years.
- The transition of deposits is expected to continue over the coming months as consumer and business confidence remains low coupled with the anticipation of the second interest rate hike in 2016 by the US Federal Reserve.
- During 2016, only three companies participated in initial public offerings, undermining the CMA's vision of achieving 250 listed companies within seven years.
- As for the private sector, credit lines extended to businesses and individuals have reached SAR61.3 billion over the first seven months of 2016, a drop of 23.3% in comparison to the same period of 2015
- Lackluster global inflation stemming from low energy prices permeated most trade goods, leading to less non-oil exports and imports, in value terms, than last year.

View of the Month

The banking system's immediate challenge is liquidity indicated by the interbank lending rate jumping to over 2.3%. According to SAMA's monthly bulletin, the loans-to-deposits (L/D) ratio reached 90.5% by the end of July, breaching the recently relaxed, 90% limit. SAMA injected SAR12 billion and SAR20 billion into small and medium sized banks to alleviate their pressures.

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Macroeconomic Indicators

	2011	2012	2013	2014	2015	2016F
Real Sector						
Average KSA Crude Spot Price, Arab Light, USD/BBL	108.1	110.2	106.4	97.2	50.2	45.0
Average Daily Crude Oil Production, MMBD	9.3	9.8	9.6	9.7	10.2	10.5
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,791.3	2,826.9	2,422.5	2,253.0
GDP at Current Market Prices, USD billion	670.4	734.9	745.3	754.8	646.9	601.6
Real GDP Growth Rate*	10.0%	5.4%	2.7%	3.6%	3.5%	0.8%
CPI Inflation, Y/Y % Change, Average	3.7%	2.9%	3.5%	2.7%	2.2%	4.5%
External Sector						
Current Account Balance, USD billion	158.5	164.8	135.4	73.8	-53.5	-56.8
Current Account Balance/GDP	23.6%	22.4%	18.2%	9.8%	-8.3%	-9.4%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	609.7	544.8
Fiscal Sector (Central Government)						
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1,044.4	596.9	603.9
Actual Expenditure, SAR billion	826.7	873.3	976.0	1109.9	969.6	892.1
Expenditure Overrun, %	42.5%	26.6%	19.0%	29.8%	12.7%	6.2%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-65.5	-372.8	-288.1
Budget Balance/GDP	11.6%	13.6%	6.5%	-2.3%	-15.4%	-12.8%
Break-Even Oil Price	75.3	73.9	82.6	100.1	82.1	68.0
Financial Sector						
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75
Growth in Broad Money (M3)	13.3%	13.9%	10.9%	11.9%	2.6%	-0.4%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	9.8%	7.3%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	0.9%	2.5%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.2%	0.3%	0.9%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	70.4	56.4	160.0

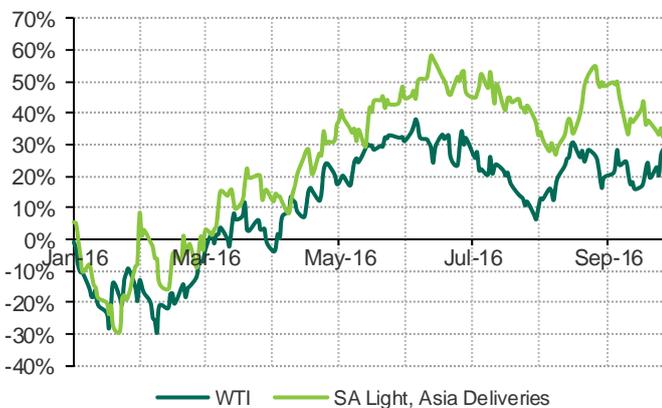
Sources: Thompson Reuters, SAMA, General Authority for Statistics, and NCB
 Note: Saudi Economic Review Data, August 2016 Update (Historical and Projections)

Oil Market

A Step towards Easing the Supply Glut

Brent crude was up 4% and West Texas Intermediate (WTI) rose by 8% in September, helped by the latest OPEC's tentative plan to cut production by 0.75mb/d. Crude oil Brent future is trading near USD50.0 a barrel, while WTI future is trading around USD48.0 a barrel for November delivery. Despite the tentative agreement among OPEC's members, oil prices did not rally significantly as market participants remain skeptical over whether the deal will be enforced. Facing the potential of another sharp drop in oil prices, OPEC for the first time in nearly eight years has finally put forward a diplomatic measure on hope to keep a floor on oil prices. The OPEC members decided to take action as the fall in oil prices has led to sharp declines in their government budgets and has weighed ultimately on economic growth. This decision was taken on the sidelines of an energy conference held on 26-28 September in Algeria.

Chart 1: Oil Price Developments, YTD

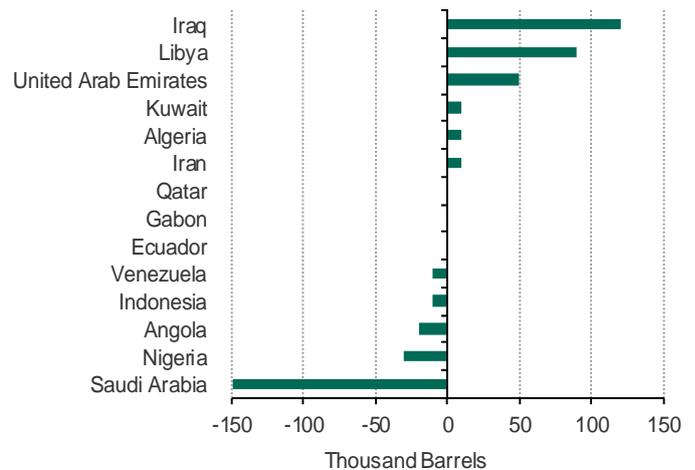


Source: Thomson Reuters

OPEC added that it would arrange a follow up meeting to discuss individual country allocations, which have yet to be decided, and their implementation. Talks will also be extended to non-OPEC members such as Russia. The final details of the agreement will be presented at the upcoming OPEC's meeting on 30th November. Meanwhile, markets are still cautious about whether the preliminary deal will eventually become definitive at the next OPEC's meeting. There is no agreement about the reintroduction of country quotas or enforcement mechanisms. Moreover, there are still unclear points regarding when the agreement would come into effect, which sources are used to validate compliance, and whether the agreement goes into effect only if Russia sign on or whether it is effective irrespective of its position.

According to IEA, OPEC's production was 33.4mb/d in August, thus following the November's meeting, it is expected to fall to 32.7mb/d. Though this agreement is significant, especially to the changing position of Saudi Arabia, the plan to cut production come only following the peak demand during the Summer season, as Kingdom's crude exports are expected to remain at 7.2-7.5mb/d. The Kingdom was producing at record levels of 10.6mb/d in July -August, and perhaps has limited production on the upside. Moreover, Iran expressed its firmness to increase its production to pre-sanction level of around 4.0mb/d from August's production level of 3.65mb/d. Accordingly, Saudi Arabia, Russia and even Iran are producing near capacity levels and thus have less to lose by participating in a freeze or even cut now versus in April. In addition, there are certain countries that would receive an exemption from the freeze agreement, including Nigeria, Libya and maybe Iran until its output reaches 4.0mb/d. On balance, OPEC finally agreed to a deal that may restore confidence to the market participants and reaffirm its relevance as the market start to adjust to a new price level.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

On the demand side, global oil demand growth is expected to rise by 1.23mb/d, averaging 94.2mb/d in 2016, after a marginal upward revision, mainly due to better-than-expected OECD data for the first half of the year. Contributing to the higher demand is the crude stock building up of strategic reserves in China. The implied crude stock building rate accelerated to 1.1mb/d for the month of August, higher than the year-to-July stocking rate of 0.78mb/d. In 2017, world oil demand is anticipated to rise by 1.15mb/d, to average 95.42mb/d. The main growth for next year continues to be attributed to strong demand in India, China and the US.

Foreign Exchange

Greenback will Gain Ground by Year End

Uncertain global outlook and uneven growth, in addition to mounting disinflationary pressures will remain a hanging cloud over advanced and emerging market currencies and it is widely anticipated that a decision by the Federal Reserve to raise its short-term interest benchmark, for the second time since 2006, will also intensify volatility. The Fed fund futures do reflect a 59% probability of a hike at the two-day meeting ending December 14th. Evidently, we do expect a market response similar to last year's reaction to the 25bps hike by the Fed that saw a rout across emerging market assets. A United States policy reversal will reignite another cycle of capital outflows that will surely weigh negatively on emerging market currencies especially those that suffer from structural deficiencies in their current and fiscal accounts. Hence, more monetary accommodation is expected from other central banks that will try to counter the negative spillover effects from this event risk on their respective economies.

Chart 3: Trade-Weighted Dollar and the Euro

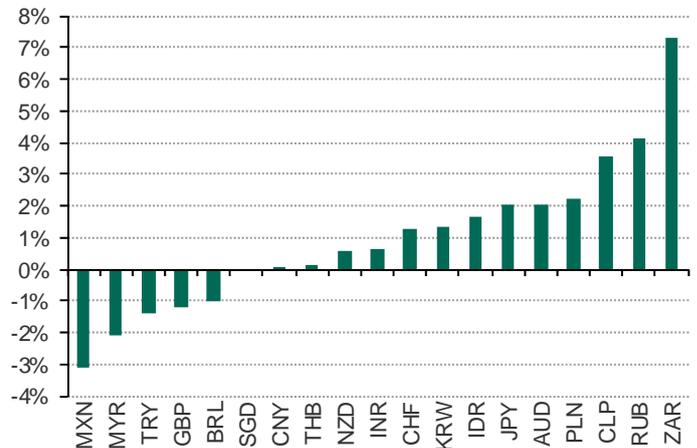


Source: Thomson Reuters

The aforementioned dynamic of expected lower interest differentials will clearly help the greenback gain ground by the end of this year, despite the fact that the trade-weighted dollar has marginally declined by around 4% year-to-date. In contrast, the economic outlook of the 19-nation currency block will be impacted by post Brexit uncertainties, with the IMF revising downwards growth projections by 0.1% and 0.2% for this year and next. Accordingly, the Euro is expected to be driven lower in the next quarter, retesting the 1.0497 per dollar posted in March 2015 and possibly parity by early next year if the Fed adopted a series of hikes, especially that Stanley Fisher the Federal Reserve Vice Chairman had un-

derscored that the interest rate decision will not be "One and Done" and that the pace will be data driven.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

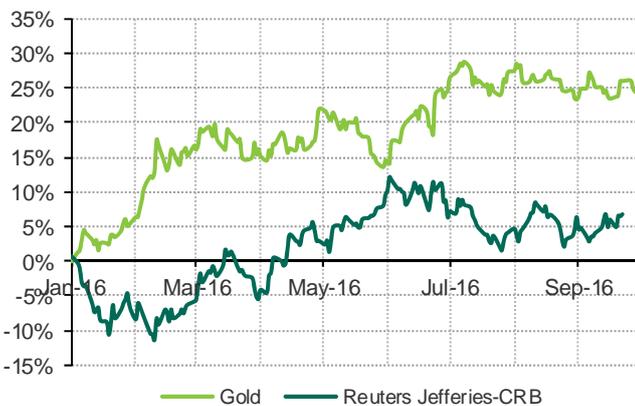
The recent figures reported by 145 central banks via the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) sheds a light on the continued dominance of the dollar. By the end of the first quarter of this year, the dollar's share of allocated reserves that amounted to USD7.1 trillion was 64%, around USD4.6 trillion, a 17% Y/Y increase compared to 1Q2015. More importantly, during the last two years, the dollar's share had increased from 53%, which came at the expense of the Euro that was mired in the Greek crisis. Meanwhile, the Euro came as a distant second with a 20% share, representing around USD1.5 trillion. The third and fourth spots were reserved for the Pounds sterling and the Japanese yen, with both respectively representing a meager 5% and 4% of overall allocated reserves. The Bank of International Settlements (BIS) had also released its triennial survey on the FX market, with the greenback maintaining the most-traded currency status being on one-side of 88% of the deals, 1% higher from the previous survey. Meanwhile, the Euro was second, albeit the falling share that stood at 31%. We do believe that the USD will remain the reserve currency of choice supported by higher interest rates and resilient economic growth going forward.

Commodities

Commodities Might Lose Momentum

Commodities unexpectedly had a stellar first half this year, a reversal from a five year bear market, outperforming the USD, US Treasuries, and global equities. Investors factored in a slow path of normalizing interest rates by the Federal Reserve, which contained the dollar appreciation witnessed over the last two years and made commodities an attractive asset class on the fundamental and speculative sides. The remainder of the year, in our opinion, and as witnessed after the summer will see commodities pressured, thus, limiting increases for some and dragging others into the negative territory. Expectations of supply gluts across the asset class and the anticipated rate increase by the Fed will support this overall weakness as investors unwind positions, evident from them withdrawing around USD791 million out of exchange-traded funds (ETFs) tracking commodities during August. More specifically, investors pulled USD991 million from energy ETFs and USD39 million from industrial metals.

Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

On the precious metals front, gold and silver maintained their double-digit gains despite the normalization talk, registering around 26% and 42% year-to-date, respectively. It is becoming increasingly likely that the yellow metal will be range-bound around USD1300-1350/Oz by the end of the year, with most analysts predicting the persistence of such levels or even lower during the next couple of years. The lack of inflationary pressures will contain any rebounds towards the historical high recorded in 2011. China and India that account for more than half of global jewelry demand might be a hanging cloud as well, with their demand faltering. SPDR Gold Trust, the largest gold ETF, showed an outflow in August for

only the second month this year, with its holdings dropping by 15 million tonnes. The physical supply deficit for silver, however, might allow it to enjoy another year of a double-digit gain. According to the World Silver Survey 2016, there is a supply deficit of around 130 million ounces, with demand going strong especially in solar panels that could account for 13% of total industrial demand by the end of this year.

Chart 6: Base Metals



Source: Thomson Reuters

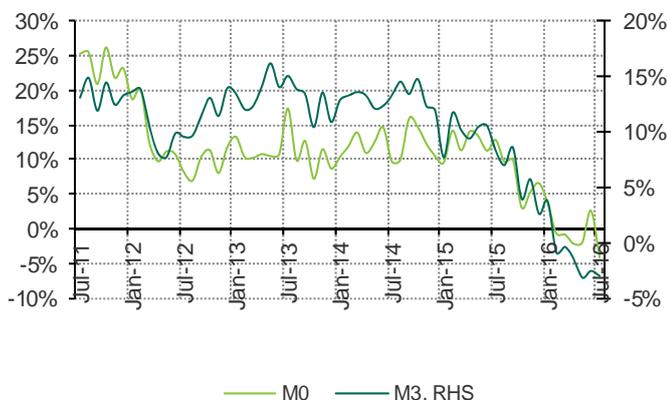
As for agriculture commodities, the S&P Goldman Sachs Agriculture Index returned to the positive territory in September, increasing by around 4% in 2016 YTD. Nevertheless, record US harvests for corn and soybeans that had beaten the expectations of most analysts on the back of ample rainfall in the Midwest will likely weigh on prices. The outlook for base metals are weakening amid signs of a slowdown in Chinese demand that is evident from the lower headline GDP growth rates of recent quarters, with the IMF expecting decelerating growth during this year and next respectively at 6.6% and 6.2%. Additionally, an expected increase in copper production from mines in Zambia and the Democratic Republic of Congo in addition to restarting mothballed production with margins for aluminum smelters improving will also act as drags. Accordingly, copper and aluminum single-digit gains are expected to stagnate by year-end. Looking ahead, there is no denial that fundamentals are pivotal, yet speculative outflows might cause a rout in commodities in the next couple of months leading to and following the rate decision by the Fed.

Money & Inflation

Inflation Eases in July

Saudi Arabia has been coping with lower oil revenues to manage its finances through a dual mandate of reducing spending and increasing debt issuances. These measures will soften the impact of lower oil revenues as the Kingdom gradually builds up non-oil revenues over the coming years to lessen the reliance on an inherently volatile commodity. The rationalization of government spending, the only channel to convert the country's oil wealth into economic development, has adversely affected domestic liquidity. The prudent management of the Saudi Arabian Monetary Agency over the past years has supported the banking during the current difficulties, yet, the economy's slowdown has certainly weighed on the monetary system domestically. The narrowest measure of money supply (M0) has contracted in five of the past six months ending in July, declining by 4.1% on an annual basis to settle at SAR306.6 billion. Bank deposits, representing almost a third of the monetary base, posted its fifth consecutive monthly decline at 4.9% Y/Y by the end of July. The bulk of M0 is comprised by currency outside banks which represents 57%, totaling SAR174.9 billion. The annual decline of money in circulation by 2.3% is the largest since 2001, furthermore, the fact that the drop coincided with Eid, the biggest festive season of the year for Saudis, signifies a possible shift in consumer behavior which is underpinned by the drop in the headline inflation rate to 3.8% from 4.1% during the previous month.

Chart 7: Growth in Monetary Aggregates

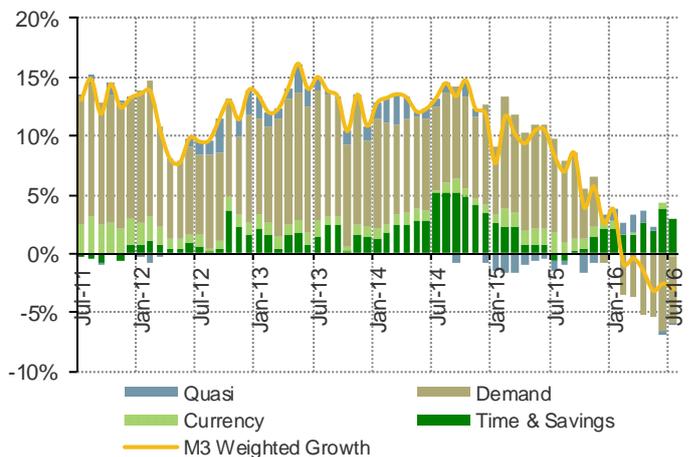


Sources: SAMA and NCB Estimates

The broadest measure of money supply (M3) has maintained a downward trend for the past six months ending July with a contraction of 3.0% annually. The largest component of M3, demand deposits, continued to wit-

ness substantial withdrawals, dropping 9.7% Y/Y to settle at SAR964.6 billion. The waning level of non-yielding deposit base has increased the cost of funds for banks as they have introduced time and savings products with competing rates to compensate the decline in demand deposits. In July, time and savings deposits gained 14.2% on an annual basis to reach SAR430.6 billion, marginally below June's historical record level of SAR443.5 billion. The transition of deposits is expected to continue over the coming months as consumer and business confidence remains low coupled with the anticipation of the second interest rate hike in 2016 by the US Federal Reserve. As for other quasi-monetary deposits, the 28.1% drop in remittances was undermined by a pickup in letters of credit, foreign currency deposits, and repo transactions.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

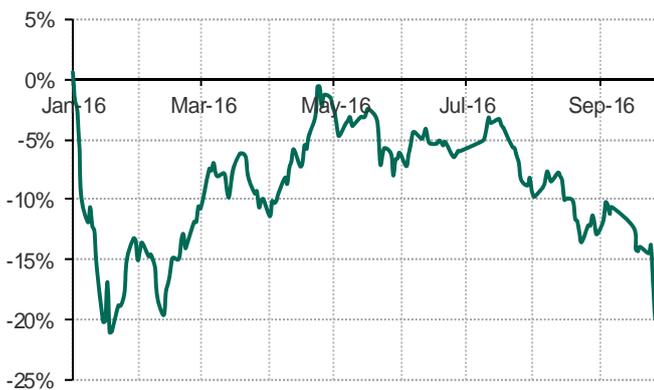
The annual inflation rate fell below 4% for the first time since the turn of the year. The reduction of subsidies on energy and water prices by the end of 2015 to raise non-oil revenues almost doubled consumer prices which posted a rise of 2.2% by the end of last year. However, annual food prices recorded the first decline since the inflation rate was rebased back in 2013 to the base year of 2007. The food and beverage category, which represents almost 20%, has contained domestic prices by contracting 0.1% on an annual basis in July. Meanwhile, the category for housing and utilities acted as the main driver by gaining 7.5% Y/Y. Low consumer confidence might weaken domestic consumption over the short-term and marginally reduce the headline inflation rate, yet our expectations for this year remains around 4% this year which will likely continue for 2017 as further subsidy cuts are expected to be announced throughout the National Transformation Plan.

Capital Markets

Stock Trading Activity Muted on Pessimism

Central banks are realizing that “more is less” regarding stimulus measures that have reached unprecedented levels over the past years. The European Central Bank’s (ECB) President Mario Draghi revealed that an extension to their bond-buying program has not been discussed during their last meeting. Recently, the Bank of Japan (BOJ) shifted its focus towards controlling the yield curve from aiming to expand money supply while keeping asset purchases at JPY80 trillion. Following the 2009 global financial crisis, equity prices have benefited from central bank capital injections and policy decisions as stock prices soared over the following years, evident by the MSCI’s World index gaining 141.2% by the end of August since the record low level reached in September 2009. In the US, the DOW and S&P500 reached record highs by mid-August, before retreating in anticipation of the Fed’s monetary policy meeting. The decision for the second rate hike since the financial crisis has been postponed by policy-makers due to fears of spillover effects from global markets. However, an interest rate hike is highly expected in December’s FOMC meeting by another 25bps. Equity markets have become accustomed to monetary easing and the path towards normalization will need adjustment by decision makers and equity investors alike. The ECB and the BOJ should take note of the Fed’s challenging path of unwinding stimulus without disrupting investors’ sentiment.

Chart 9: Tadawul All-Share Index

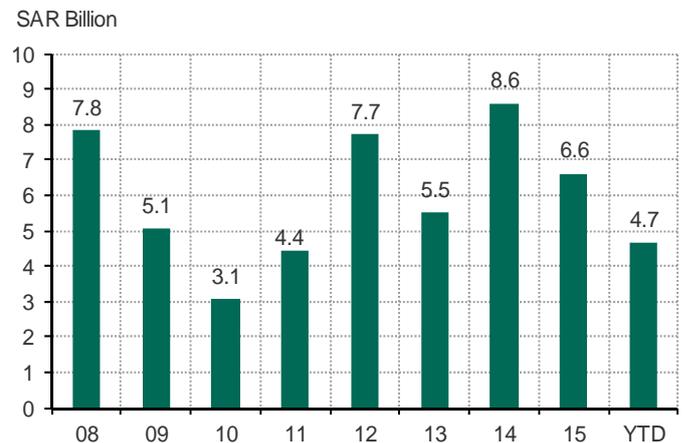


Source: Tadawul

The local equity market has been battered by domestic and international shocks as oil prices continue to pressure the transitioning economy. During the month of August, Tadawul dropped for the second consecutive month, losing 3.5% M/M. The worst performing sector, media and

publishing, registered a substantial 17.4% loss. Additionally, the speculative insurance sector, which was the third most traded sector, posted the second largest decline at 9.4% M/M. The only sectors gaining during August were energy, petrochemicals, and multi-investment recording 2.5%, 1.2%, and 1.0%, respectively. The average daily traded value was the lowest in five years, only managing SAR3.0 billion, a 20.5% decline over July’s average daily trading value. The banking and petrochemical sector received the bulk of the monthly transactions, representing 29.5% and 15.3% of total traded value, respectively. Due to the dominance of Saudi individual traders, the Capital Market Authority (CMA) recently relaxed the stringent entry requirements for Qualified Financial Investors in an attempt to increase liquidity. The domestic market lost 12.0% by the end of August since the beginning of 2016, settling at 6’079.51.

Chart 10: Average Daily Traded Value



Source: Tadawul

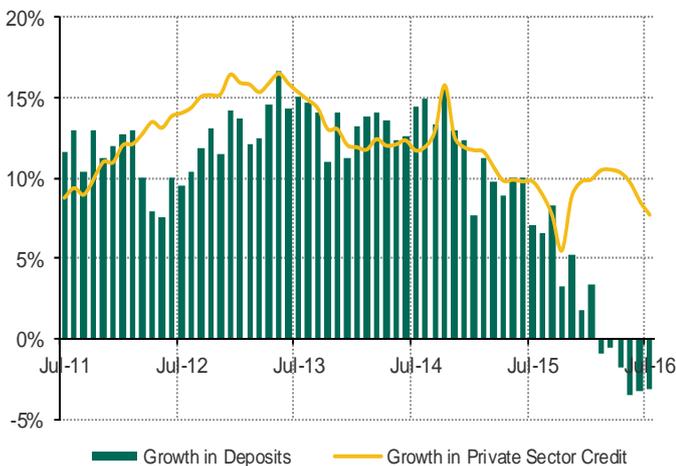
Business confidence is currently at its lowest as NCB’s Business Optimism Index for the non-hydrocarbon sector settled at its lowest levels since 2Q 2009. Along with a struggling economy, third quarter corporate profitability announcements over the coming weeks are expected to be on the negative side. The weak outlook has also fended off private companies from turning public. During 2016, only three companies participated in initial public offerings, undermining the CMA’s vision of achieving 250 listed companies within seven years. The market’s price-to-earnings ratio stood at 12.6 by the end of August, well below global peers. The expected inclusion into the regional MSCI index is likely in 2018 whereby Tadawul will benefit from passive inflows.

Loans Market

Unconventional Liquidity Solutions

The liquidity strains in the domestic economy stem from the declining trend of the depositary base. Forming the base of banks' balance sheets, total deposits in the Saudi financial system dropped by 3.1% to SAR1.58 trillion by the end of July, the sixth consecutive annual decline which brings the YTD drop to SAR26.3 billion. Banks utilize deposits to provide financing needs and SAMA regulates the banking system leverage to mitigate risks domestically. The drop in oil revenues has certainly acted as the main drag on bank deposits and coupled with the issuances of local debt, the banking system's balance sheets are feeling the pressure of the slowing economic cycle. The majority of withdrawals in bank deposits were attributed to demand deposits, posting a 9.7% Y/Y decline in July. Meanwhile, time and savings deposits registered a gain of 14.2% annually, during the same month. While the government entities has been reducing its interest-bearing deposits over the past year, businesses and individuals' time and savings deposits have recorded a double-digit increase for the past eleven months as banks compete to maintain their depositary base.

Chart 11: Private Sector Financing

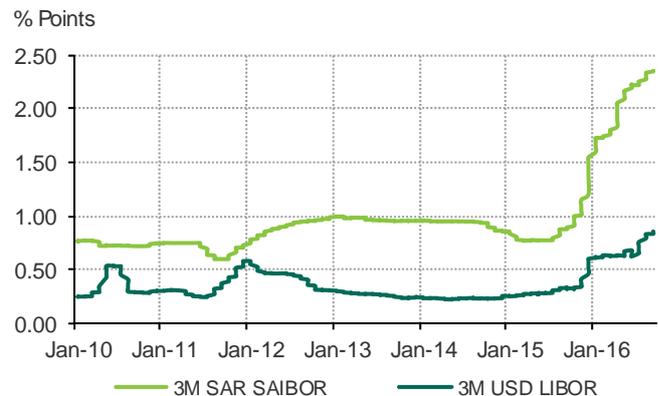


Sources: SAMA and NCB Estimates

Similarly albeit at a slower pace, total claims of the banking system, excluding T-bills and government bonds, decelerated for the fourth month by the end of July to an annual rise of 8.0%. Banks are exploiting momentum activity in the credit market but we believe growth will be difficult to maintain amid the current regulatory framework. Given the fact that the banking system has breached the 90% loans-to-deposits ratio limit, we believe sustaining growth would require easing the limit to 100% in line with regional counterparts. An injection of SAR12 billion by the central bank in

June to smaller banks indicates the willingness of decision makers to support local banks, yet the current challenges will need bolder moves in the coming months. By maturity, short term credit posted the slowest annual increase since October 2015 at 8.0%, albeit holding the largest share at 51.8%. Long term credit has also witnessed a deceleration relative to previous years at 8.0% Y/Y. Meanwhile, medium-term credit has increased substantially more than its counterparts, supporting our previous notion of banks attempting to raise deposits by offering lucrative rate on time and savings products.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

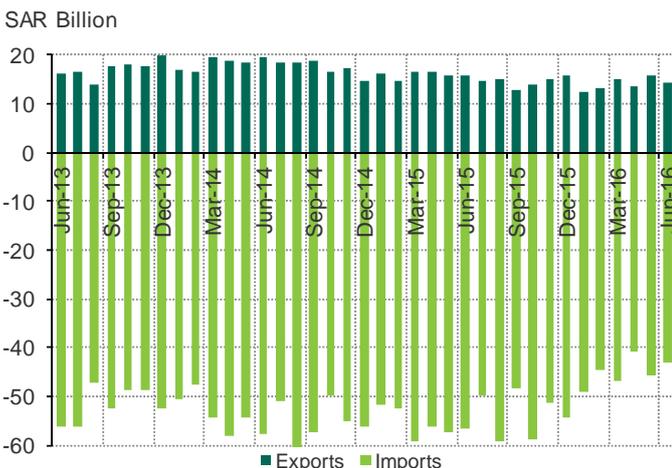
As for the private sector, credit lines extended to businesses and individuals have reached SAR61.3 billion over the first seven months of 2016, a drop of 23.3% in comparison to the same period of 2015. On an annual basis, credit to the private sector grew by 7.7%. Meanwhile, claims on the public sector declined by 14.2% as treasury bills reached the lowest level since 2007 at SAR44.0 billion to provide liquidity for government bond issuances, which registered a significant 217.8% annual rise to SAR167.3 billion. While there is little room for local banks to generate liquidity for further debt issuances, the government's decision to tap international markets will ease some of the pressures of the local market. As for the interbank rate, the abovementioned factors contributed to fierce competition on liquidity, driving the SAIBOR to above 2.3% in September. The differential between SAIBOR and LIBOR has widened to around 150bps, indicative of the domestic strains currently experienced by banks. Additionally, the interbank rate has surpassed SAMA's repo rate, currently set at 2%. The increase from the Federal Reserve in their main benchmark interest rate by 25bps, expected within the remainder of this year, will pressure the local market further given the SAR-USD peg. However, the kingdom remains committed to the peg that has served the economy well over the past three decades.

External Trade

Faltering Demand of Emerging Economies

Non-oil trade in the Kingdom continued to contract annually during the month of June on the back of an unfavorable business cycle. Lackluster global inflation stemming from low energy prices permeated most trade goods, leading to less non-oil exports and imports, in value terms, than last year. Recurrent failure to curb the global oil supply glut is feeding into expectations of persistently low energy prices which is factored into prices of goods and services. The top two categories, plastics and chemical products, account for almost 60% of non-oil exports by value, enough weight to swing bottom-line figures. Ostensibly, due to these exports being essentially an extension of the oil production chain, there exists a strong correlation between the value of non-oil exports and oil prices. In June, exports posted a value of SAR14.3 billion, down by 10% Y/Y while the import bill for the same month amounted to SAR43 billion, tumbling by 23.9% Y/Y. Exports of plastics made up around 30.8% of the monthly total, valued at SAR4.4 billion, thus declining by 10.3%. Exports of chemical products recorded a 23.6% decline compared to last year after posting SAR4.1 billion. Furthermore, exports of base metals which account for 7.8% of the monthly total registered SAR1.1 billion, plummeting by 19.2% Y/Y.

Chart 13: Saudi Non-Oil Trade Balance



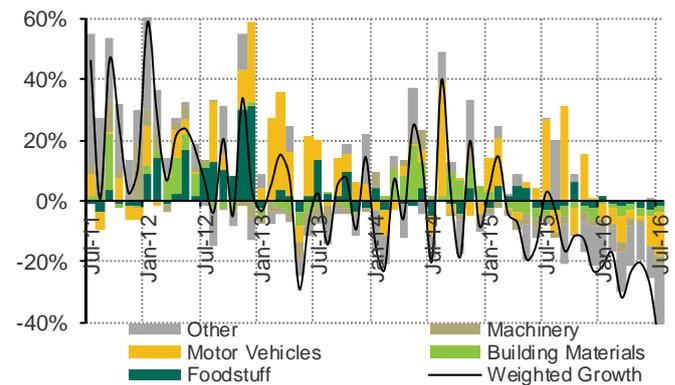
Sources: SAMA and NCB

By destination, the UAE accounted for 16.4% of the exports at SAR2.2 billion. Compared to the same period last year, exports to the UAE surged by 15.5% in contrast to China and India which declined by 18.9% and 17.8%, respectively. Exports to China were valued at SAR1.5 billion while exports to India recorded SAR908

million.

On the imports side, the monthly import bill reflected SAR43 billion, down by 23.9% Y/Y affected by the government's cost-reducing measures. The trickle-down effect yields lower construction activity, in turn, reducing demand for machinery and transport equipment. The bulk of imports consist of machinery and electrical equipment at 24.3%, transport equipment at 21.2%, and chemical products at 9.5%. The value of imported machinery and electrical equipment nose-dove by 35% after posting SAR10.5 billion, marking eight months of consecutive annual declines. Imports of transport equipment inched up 0.2%Y/Y, posting SAR9.1 billion, while imports of chemical products tumbled 18% Y/Y at SAR4.1 billion. Imports by country indicate that China came as the top trade partner in June despite declining by 21.1% at SAR8.5 billion, accounting for 15.6% of the monthly bill. Imports from the US amounted to SAR6.7 billion, down by 16.4% Y/Y, whereas imports from Germany tumbled by 34.8% Y/Y to SAR2.5 billion.

Chart 14: Attribution Analysis of Letters of Credit Opened



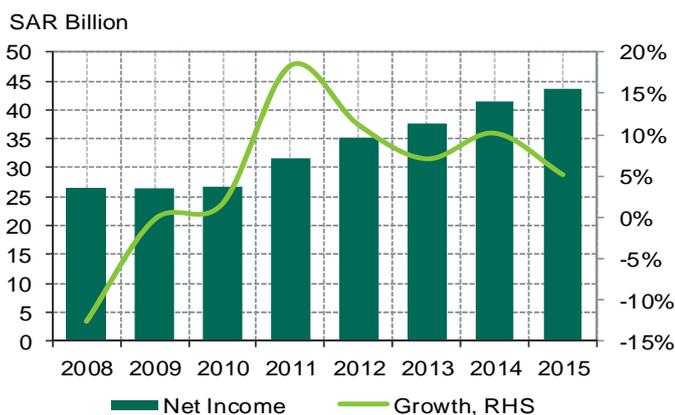
Sources: SAMA and NCB

The situation of private sector imports financed through banks as reflected by the value of letters of credit (LCs) is in line with the general trend of moderating economic activity. The month of July marked the ninth consecutive annualized decline, standing at a monthly total of SAR13.6 billion. Compared to July of 2015, settled LCs dropped 23.6% due to lesser LCs of motor vehicles, machinery, and building materials. Motor vehicle LCs dwindled by 42.8% Y/Y, standing at SAR2.3 billion, while machinery LCs declined by 42.6% to SAR718 million. Furthermore, declining government projects prompted private contractors to lessen their demand for building materials as their LCs fell by 17.3% Y/Y to SAR1.3 billion.

Special Focus: Decelerating Dynamics for Local Banks

The domestic economy is bearing the pressures from a suppressed oil market. The plan to diversify away from the volatile commodity takes patience and time especially in a subdued global economic environment. Early 2013, SAMA's adoption of Basel III, along with its prudent and countercyclical guidelines of raising banks' capital adequacy ratio positioned the banking system on a much sturdier foothold to withstand the current challenges. The latest consolidated financial statements show that the 12 locally incorporated banks managed to grow their balance sheets by the end of the second quarter. The banking system's total assets edged higher by 2.2% on an annual basis to reach SAR2.2 trillion. The structure remains relatively the same as the largest four banks, NCB, Al Rajhi, SAMBA, and Riyadh held 56.0% of total assets. Growth was mainly driven by banks' loans portfolio, expanding 8.1% to reach SAR1.4 trillion. Credit in the local market defied the economic slowdown and continues to register relatively strong figures. However, we expect these funds are utilized for cash flow management rather than business expansions which will eventually weigh on the pace of credit growth. Lower business activity, along with lower oil revenues, have impacted the depositary base in the banking system. Total deposits contracted by 2.5% Y/Y in 2Q16 to settle at SAR1.7 trillion. The majority of deposits are held by the largest four banks with a collective share of 45.6% by the end of June 2016.

Chart 15: Local Banks' Profits

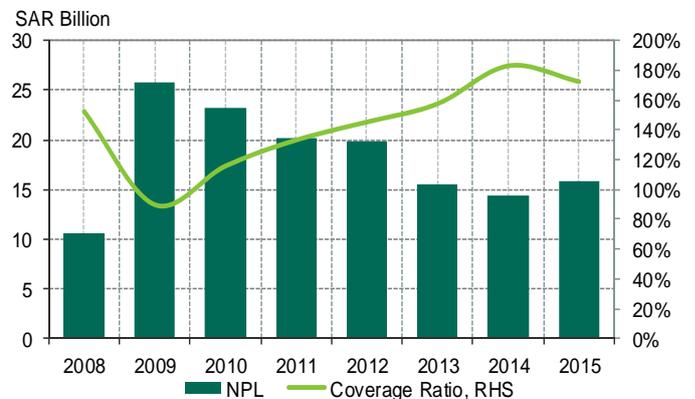


Source: Local Banks' Financial Statements

Bottom-line net income marginally grew by 0.9% Y/Y through the first half of 2016. Al Rajhi bank registered the highest income growth at 17.6% as its operating income increased by 9.2% while operating expenses were level at an annual gain of 0.8%. The market benefitted from higher margins as domestic rates began creeping higher. Net spe-

cial commission income rose by 7.0% to improve the banking system's profit margin to 54.6% by the end of 2Q16 from 53.8% in 2Q15. Income by business segment reveals the corporate side's dominance by 41.9%, totaling SAR9.7 billion. Furthermore, the treasury segment and consumer segment represented 29.7% and 21.4%, respectively. However, income generated from the consumer segment registered a significant growth of 49.2% annually. This is attributed to the increase in consumer loans by 9.3% Y/Y and the rise in credit card financing by 10.0% Y/Y as consumers opt to finance their expenditures given the current economic state. Despite the economic slowdown, banks' bottom-line will see some support from higher margins which will compensate declining volume growth.

Chart 16: Non-Performing Loans vs Coverage Ratio



Sources: Local Banks' Financial Statements

The banking system's immediate challenge is liquidity indicated by the interbank lending rate jumping to over 2.3%. According to SAMA's monthly bulletin, the loans-to-deposits (L/D) ratio reached 90.5% by the end of July, breaching the, recently relaxed 90% limit. SAMA injected SAR12 billion and SAR20 billion into small and medium sized banks to alleviate their pressures. However, we believe an upward revision to the L/D limit is needed to mirror regional counterparts. The government's current plan to tap international markets for the next bond issuance will lessen the burden on local banks which have participated in monthly domestic bond issuances since August 2015. Additionally, funds received from international participants will likely be injected into the local market. Over the short-term, pipeline risk gauged by the current non-performing loans (NPL) ratio, at 1.1% for the market, is the lowest on record. In addition, the NPL coverage ratio stands at a comfortable 178.3%, coupled with tier-1 capital adequacy ratio at 16.5%, underscores the ability of the banking system to weather the current headwinds.

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