



## TASI reaches multi-year highs

- In the last few months we have seen a number of positive developments that have lifted investor sentiment in the Kingdom and led to an improvement in the performance of the Saudi stock market.
- In fact, the Tadawul All Share Index (TASI) has risen by around 8 percent since the beginning of 2018 and is currently trading at levels last seen back in August 2015.
- Whilst multi-year high oil prices have no doubt firmed up sentiment, this is only part of the story. Investor confidence has also been buoyed by recent clarity and direction of the Kingdom's economic policy, as well as Saudi Arabia's expected inclusion, which later materialized, into the FTSE Emerging Market (EM) index.
- The promotion to EM status marks a key milestone for Saudi Arabia and rewards the depth and pace of reform that has taken place with the Kingdom's capital markets in the last few years. Furthermore, the inclusion of Tadawul into FTSE EM, once completed in December 2019, is expected to attract around \$5 billion in passive inflows.
- The inclusion into FTSE EM has also encouraged record buying by foreigners. Specifically, net purchases of SWAPs and buying by QFIs totaled SR7.9 billion during Q1 2018.
- Looking ahead, we expect inflows from QFIs and SWAPs seen so far in 2018 to continue, especially as the likelihood of Saudi Arabia's inclusion into MSCI EM index has been greatly increased following the FTSE EM inclusion, with a decision on the former index expected in June 2018.

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**Figure 1: TASI hit multi year highs recently**





## Overview

*In the last few months we have seen a number of positive developments that have lifted investor sentiment in the Kingdom...*

*...and led to an improvement in the performance of the Saudi stock market.*

*In fact, the Tadawul All Share Index (TASI) has risen by around 8 percent since the beginning of 2018 and is currently trading at levels last seen back in August 2015.*

*An expansionary Saudi fiscal budget together with the loosening of QFI criteria...*

*...as well as higher oil prices...*

In the last few months we have seen a number of positive developments that have lifted investor sentiment in the Kingdom and led to an improvement in the performance of the Saudi stock market. In fact, the Tadawul All Share Index (TASI) has risen by around 8 percent since the beginning of 2018 and is currently trading at levels last seen back in August 2015. What is even more encouraging is that this renewed optimism has come about at a time when global equity markets are exhibiting increased levels of volatility. Whilst multi-year high oil prices have no doubt firmed up sentiment, this is only part of the story. Investor confidence has also been buoyed by recent clarity and direction of the Kingdom's economic policy, including the announcement of the largest ever budgeted expenditure in this year's fiscal budget. In addition, further liberalization of the qualified foreign investor (QFI) criteria, at the start of the year, has been enacted by the Capital Market Authority (CMA). This, in turn, induced an overwhelmingly positive message being conveyed by Morgan Stanley Capital International (MSCI), and raised the possibility of Tadawul being included into MSCI's emerging market (EM) index. In many respects, the recent decision to include Tadawul in the FTSE EM index can be seen as a precursor to MSCI EM inclusion, with a decision on the latter index expected in June 2018.

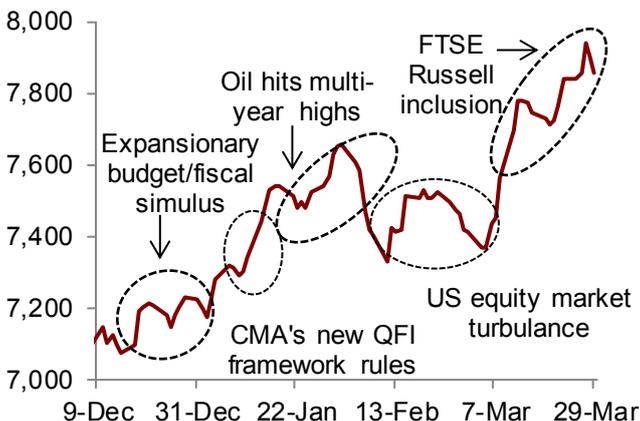
## TASI Performance

An expansionary Saudi fiscal budget together with the loosening of QFI criteria as well as higher oil prices were some of the contributing factors to TASI's positive performance during initial weeks of 2018. Later in Q1 2018, despite some fallback during February, as result of turbulence in the US equity market, TASI rallied to reach two and half year highs on the back of expectations of inclusion, which later materialized, into the FTSE EM index (Figure 2).

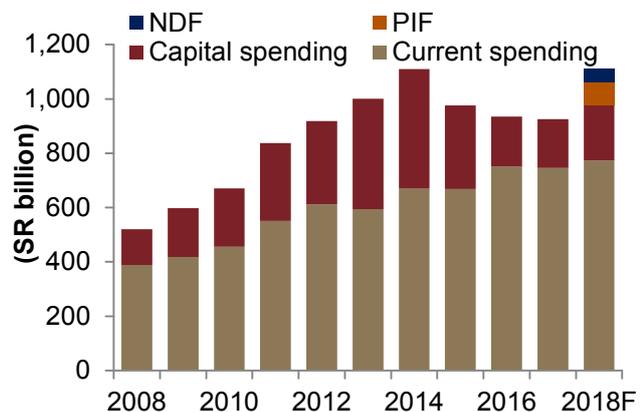
### Saudi fiscal budget:

The 2018 budget disclosed the largest ever budgeted expenditure at SR978 billion, up by SR88 billion or 10 percent year-on-year (Figure 3). Significantly, the more growth enhancing aspect of government

**Figure 2: Contributory factors to TASI's recent performance**



**Figure 3: Largest ever budgeted spending in 2018, including higher yearly capital expenditure**





...were some of the contributing factors to TASI's positive performance during the initial weeks of 2018.

A royal decree in early January 2018, which, amongst other things, included a monthly payment of SR1,000 for civil servants over the year, helped raise sentiment.

Brent oil prices rose 8 percent quarter-on-quarter in Q1 2018, to \$67 pb...

...as oil prices have trended up towards three year highs, this has contributed to pushing TASI up as well.

spending, capital expenditure, is budgeted to rise by 14 percent year-on-year in 2018, to SR205 billion, compared to SR180 billion in 2017. Concurrent to the budget, the government disclosed that a total of SR133 billion would be expended by the Public Investment Fund (PIF) and the National Development Fund (NDF) during the year. Separately, SR72 billion worth of measures to stimulate growth in the private sector, as per a royal decree, were also announced before the budget (for more on this please refer to our [2018 Saudi Fiscal Budget](#) report published in December 2017).

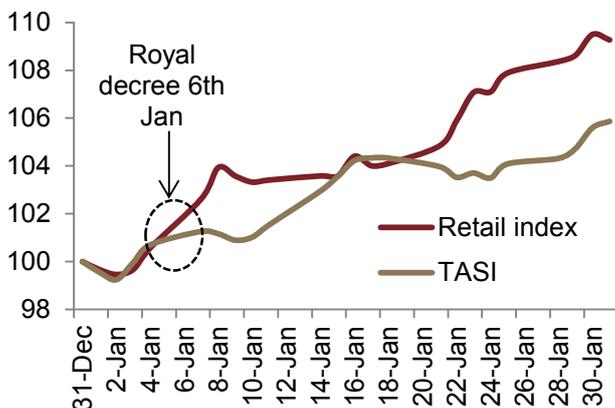
As Figure 2 shows, positive sentiment related to an expansionary budget had already helped raise the TASI index during the latter part of December 2017, but a royal decree in early January 2018, which, amongst other things, included a monthly payment of SR1,000 for civil servants over the year, to compensate for higher living costs, also helped raise sentiment. More specifically, these allowances were seen as improving the level of disposable income of some Saudi households, with a part of this additional income likely being directed towards consumption of retail goods and services. As a result, the retail index within TASI saw one of the biggest gains following the royal decree (Figure 4 & Sectorial analysis below).

**Oil prices:**

A brighter outlook for the global economy and tighter oil markets resulted in Brent oil prices rising 8 percent quarter-on-quarter in Q1 2018, to \$67 per barrel (pb), with prices currently trending close to three year highs of around \$70 pb.

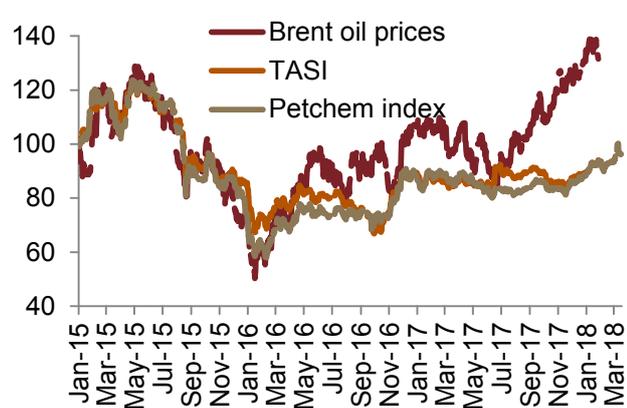
In the past, when a major movement in international oil prices occurred, this was usually accompanied by an immediate/short-term impact on the stock market, as a result of change in sentiment. This is primarily because retail investors make up around 85 percent of daily traded volumes, so sentiment often plays a bigger part in investment decisions compared to more developed stock markets (for more on this please see our report [Oil prices and the Saudi Stock Exchange](#) published June 2015). Although in recent years the correlation between TASI and oil prices has dislocated somewhat (Figure 5), there are still sentimental effects of oil prices on the stock market, especially following a sharp change in price. Accordingly, as oil prices have trended up towards three year highs, this has contributed to pushing TASI up as well.

**Figure 4: Retail sector improved after the royal decree on allowances\***



\*index rebased to 100 at 31 December 2017

**Figure 5: TASI and oil prices have de-coupled recently**



\*index and oil prices rebased to 100 at January 2015



*Earlier this year, the Capital Market Authority (CMA) announced measures to further ease restrictions for foreign investors.*

*A statement released by the MSCI, shortly after the above announcements, conveyed an overwhelmingly positive message...*

*...which raises the possibility of the Saudi stock exchange being included into the MSCI EM index, when the announcement is made in June 2018.*

*Towards the end of March 2018, FTSE Russell, a global index provider, confirmed the decision to include Saudi Arabia into its EM index.*

**CMA amendments:**

Earlier this year, the Capital Market Authority (CMA) announced measures to further ease restrictions for foreign investors. Specifically, in the amendments announced in January 2018, the CMA reduced the minimum requirement for assets under management of qualified foreign investors (QFIs) for buying publicly-traded companies, to US\$500 million from \$1 billion previously. Further, the CMA streamlined the registration process for QFIs with itself, and updated the Independent Custody Model (ICM) to enhance QFIs access to the market.

A statement released by the MSCI, shortly after the above announcements, conveyed an overwhelmingly positive message and highlighted that there were no issues with respect to the new operating model in Tadawul, which has been in place since April 2017. Although the MSCI did highlight that some more time may be needed to fully assess the new model, the above developments do raise the possibility of the Saudi stock exchange being included into the MSCI EM index, when the announcement is made in June 2018.

**FTSE EM inclusion:**

Towards the end of March 2018, FTSE Russell, a global index provider, confirmed the decision to include Saudi Arabia into its EM index. The decision completes a journey which began back in September 2015, when the Saudi index was first put on the list for inclusion. The upgrade came as the Saudi stock market passed FTSE Russell's key market quality and regulatory criteria, having previously failed to achieve it back in 2016 (Table 1).

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

**Table 1: FTSE Quality of Markets Criteria Matrix: Saudi Arabia**

Criteria	Secondary Emerging	Sept 2017	Sept 2016
World Bank GNI per Capita Rating		High	High
Credit Worthiness		Investment	Investment
<b>Market and Regulatory Environment</b>			
Formal stock market regulatory authorities actively monitor market (e.g., SEC, FSA, SFC)	✓	Pass	Pass
No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income	✓	Pass	Not Met
<b>Custody and Settlement</b>			
Settlement-Rare incidence of failed trades	✓	Restricted	N/A
Custody -Sufficient competition to ensure high quality custodian services	✓	Pass	Not Met
Clearing & Settlement—T + 2 / T + 3	✓	T+2	T+0
<b>Dealing Landscape</b>			
Brokerage—Sufficient competition to ensure high quality broker services	✓	Pass	Not Met
Liquidity—Sufficient broad-market liquidity to support sizable global investment	✓	Pass	Pass
Transaction costs—Implicit and explicit costs to be reasonable and competitive	✓	Pass	Pass
Transparency—Market depth information / visibility and timely trade reporting process	✓	Pass	Pass



Saudi Arabia's weighting is calculated to be around 2.7 percent of the EM index...

...and is expected to attract around \$5 billion in passive inflows.

Some regional oil-producing countries' equity markets saw improved performances, but none have matched TASI's performance since the beginning of the year.

Daily traded values averaged SR8.5 billion in 2014, but dropped by an average of 27 percent per annum in the next three years.

around \$5 billion in passive inflows. The upgrade itself is scheduled to be implemented over five tranches, with the first tranche commencing in March 2019, and the final in December 2019. The reason behind this stalled process is, amongst other things, to ensure minimal price pressure on TASI and to spread outflows from other FTSE EM markets, which will be sold down (Figure 6).

Overall, the promotion into EM status marks a key milestone for Saudi Arabia and rewards the depth and pace of reform that has taken place with the Kingdom's capital markets in the last few years. Further, this upgrade also significantly increases the probability of Saudi Arabia's upgrade to MSCI EM status come June 2018. Moreover, we believe the inclusion of Tadawul into FTSE EM index will not only help confer benefits to capital markets, but also to the wider economy as well.

**Comparative performance:**

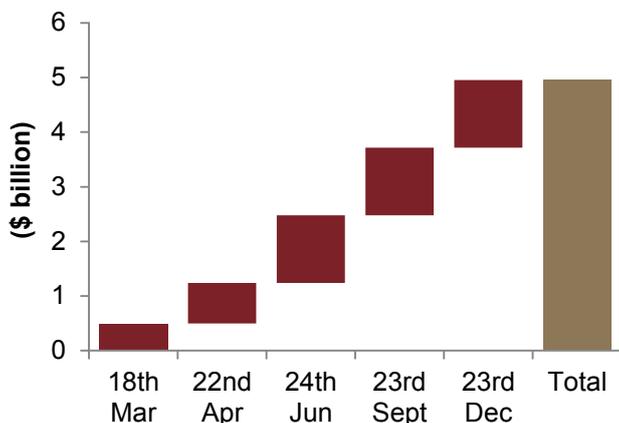
The improved performance of TASI, due to the above factors, has led to sizable rises since the end of 2017, from around 7,200 points to current levels of around 7,800, making it one of the best performing equity markets amongst major global and regional indices (Figure 7). Increased fears of higher inflation in the US and, as a consequence, expectations of tighter monetary policy by the US Federal Reserve resulted in a sell-off in US and other, mainly developed market, equity markets. At the same time, some regional oil-producing countries' equity markets saw improved performances, but none have matched TASI's performance since the beginning of the year.

**Key Developments**

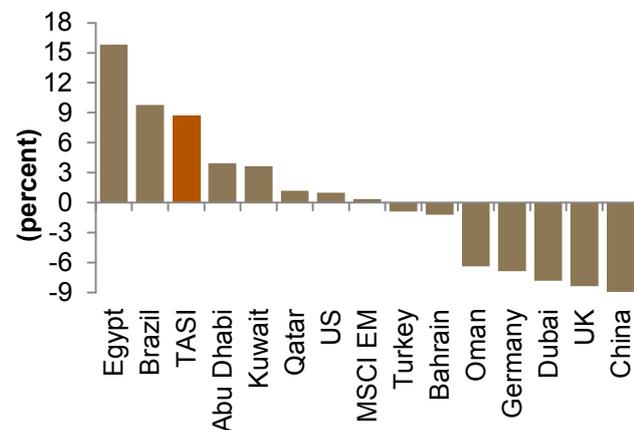
**Traded values remain low:**

Average daily traded values have been declining since record highs back in 2014. As we highlighted in our [The Saudi Stock Exchange \(Tadawul\) in 2016](#), (published April 2016), a lack of policy clarity combined with the backdrop of lower oil prices, emerging market portfolio outflows, and heightened regional geopolitical tension had contributed to driving down monthly traded values. Daily traded values averaged SR8.5 billion in 2014, but dropped by an average of

**Figure 6: Inclusion into FTSE EM will result in circa \$5 billion inflow over five tranches in 2019**



**Figure 7: TASI is one of the top performing indices globally so far in 2018**



\*end of Dec 2017 till end of March 2018



*So far in 2018, daily traded values have been edging up slightly which is in line with the historically observed pattern.*

*March saw the largest ever net inflow of combined SWAPs and QFI purchases, at SR3.8 billion.*

*We see the inclusion of Tadawul into FTSE EM and the prospective inclusion into MSCI EM as the short term driver of the record inflows.*

*Unsurprisingly, in line with TASI's performance, most sectors have seen positive performances since the start of year.*

27 percent per annum in the next three years. So far in 2018, daily traded values have been edging up slightly, which is in line with the historically observed pattern; that is, traded values usually rise in line with the TASI index (Figure 8).

**Foreign investors rising**

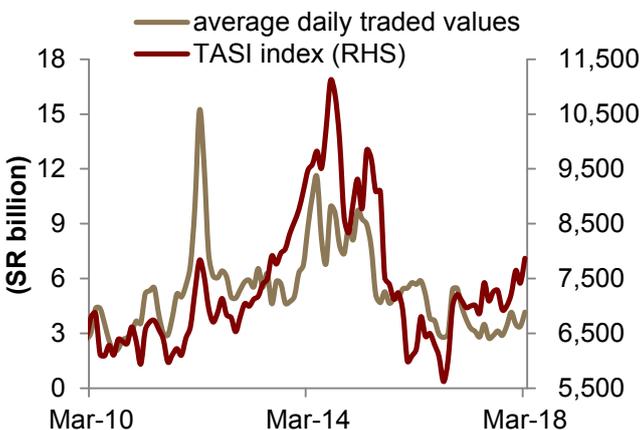
The start of 2018 has seen a large rise in net purchases by foreigners. Specifically, in the first quarter of 2018, net purchases of SWAPs and buying by QFIs totaled SR7.9 billion. In fact, March saw the largest ever net inflow of combined SWAPs and QFI purchases, at SR3.8 billion (Figure 9). According to the latest Tadawul market report, the combined market ownership of QFIs and SWAPs stood at 1.53 percent in March 2018, up from 1.05 percent at the end of January 2018 and 0.93 percent a year ago.

We see the inclusion of Tadawul into FTSE EM and the prospective inclusion into MSCI EM as the short term drivers of the record inflows. More broadly, the rise in net purchase is likely driven by factors outlined previously, in particular, the recent CMA amendments to further ease QFI investment rules. In addition, despite a number of potentially disruptive economic reforms coming into effect in 2018, such as energy price rises, Value Added Tax (VAT), and expat levies, we see the increased inflow as a vote of confidence in the direction of macroeconomic policy. More to the point, it seems that international investors have been convinced of the initiatives that support the overarching goals of the Vision 2030, both under the 2018 fiscal budget and as laid out by the revised Fiscal Balance Program (FBP, for more on this please see our report on [The Saudi Economy in 2018](#) published February 2018).

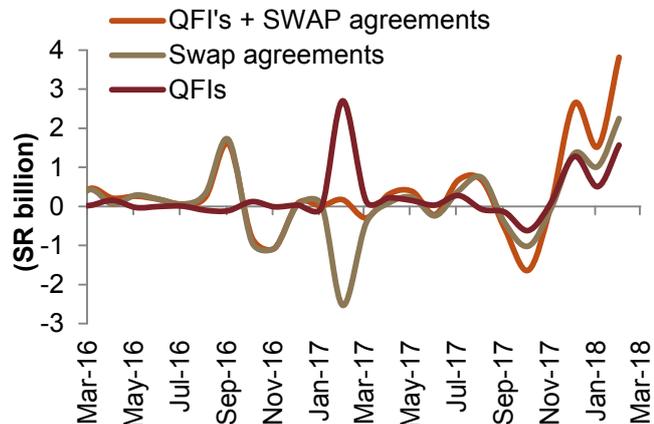
**Sectorial Analysis**

Unsurprisingly, in line with TASI's performance, most sectors have seen positive performances since the start of year (Figure 10). Whilst the above stated macroeconomic factors have helped overall performance of the Saudi stock market, differing factors have impacted each sector's performance. The top performing sectors since the beginning of 2018 include Media, Food & Retail, and Retail, whilst the worst performing sectors include Insurance, Consumer Durables and Real Estate Management.

**Figure 8: Traded values move in line with TASI index**



**Figure 9: Net purchases of SWAPs and QFIs rose to record highs recently**





*The top performing sectors since the beginning of 2018 include Media, Food & Retail, and Retail...*

*...in the case of the media sector, there seems to be no noticeable explanation for the sizable rise, of 25 percent, since the start of the year.*

*The worst performing sectors include insurance, consumer durables and real estate management.*

*The poorer performance of Insurance is likely related to the expected tightening of regulation within this segment...*

**Top performers:**

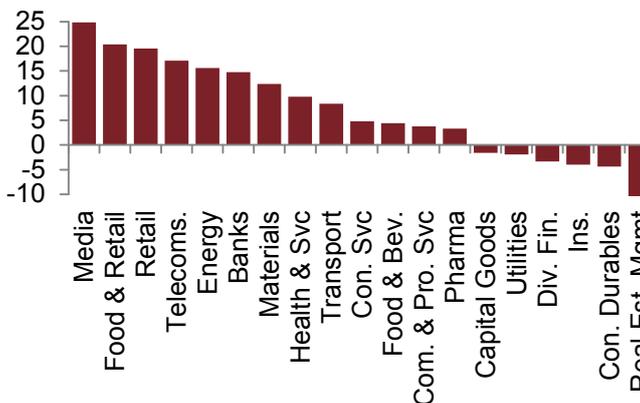
In the case of the Media sector, there seems to be no noticeable explanation for the sizable rise, of 25 percent, since the start of the year. No doubt, the re-launching of cinemas in the Kingdom during 2018 has helped raise sentiment, with the sector expected to benefit from spillovers effects, especially so in advertising. The more plausible explanation is that the Media sector is more open to speculative activity from retail investors. Retail investors in Saudi Arabia account for a high proportion of value traded, at around 85 percent of the total. Since retail investors, in general, tend to have larger risk appetites and shorter investment horizons compared to their institutional counterparts, they often focus on smaller sectors in the stock market, such as Media, which are more susceptible to price movements. For example, the Media sector was in either the top three worst or best performing sectors in nine out of the twelve months of 2017, quite often oscillating between sizable losses and gains. At one point in July 2017, the Media sector rose by 107 percent during the month for no discernible reason.

Meanwhile, payments under the Citizen's Account to protect the most vulnerable households from energy price reform, and a recent royal decree which included a monthly payment of SR1,000 for civil servants, in our view, are the drivers behind the improved performance of both Food & Retail and Retail sectors. Since the main recipients of such benefits are likely to be lower income households, which generally exhibit a higher marginal propensity to consume, the additional income is likely to be directed towards consumption of retail goods and services.

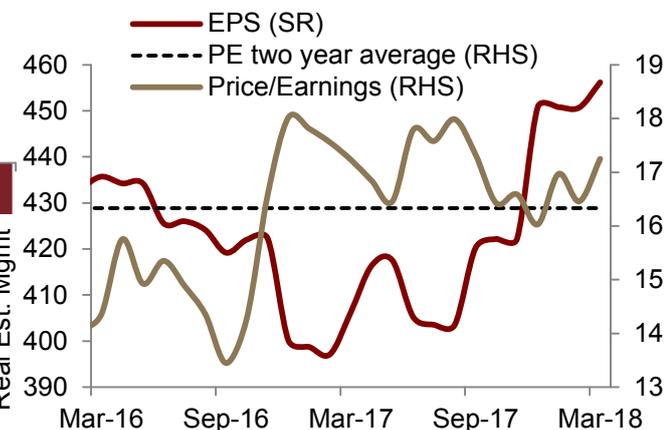
**Worst performers:**

Amongst the worst performing sectors since the start of 2018 are Insurance, Consumer Durables and Real Estate Management. The poorer performance of Insurance is likely related to the expected tightening of regulation within this segment. In recent months the Saudi Arabian Monetary Authority (SAMA) has banned a number of insurance companies from issuing, renewing or selling insurance either due to serious violations or due to issues related to capital adequacy.

**Figure 10: TASI sectorial performance (percentage change)\***



**Figure 11: TASI price-to-earnings and earnings per share**



\*end of Dec 2017 till end of March 2018



...Consumer Durables have suffered as a result of the implementation of VAT in the Kingdom....

...Real Estate Development continues to be affected by subdued activity in the construction sector.

Despite the Saudi stock market rallying, TASI valuations have cooled recently as a result of improved earnings.

Specifically, quarterly earnings were up by 13 percent year-on-year which have helped push price-to-earnings (PE) ratio down.

Consumer Durables have suffered as a result of the implementation of VAT in the Kingdom. As we highlighted in our [Inflation Update \(published February 2018\)](#) households had an incentive to increase consumption and purchases of durable goods prior to VAT implementation in 2018, and reduce consumption thereafter. Point of sales transactions (POS), a key measure for consumer spending in the Kingdom, reached record levels of SR20 billion in December 2017, but then slumped 20 percent month-on-month in January 2018. Lastly, Real Estate Development continues to be affected by subdued activity in the construction sector. Cement sales, a leading indicator of construction activity, have not seen an improvement in 2018 so far, with sales currently at four year lows.

### Valuations

Despite the Saudi stock market rallying, TASI valuations have cooled recently as a result of improved earnings. Specifically, quarterly earnings were up by 13 percent year-on-year (Box 1) which have helped push the price-to-earnings (PE) ratio down. Currently, TASI's PE ratio of 17.25 is slightly above its two year average of 16.33 as a result of earnings growth (Figure 11). Seen from a sectorial viewpoint, only a handful of the sector PEs are trending significantly higher than the overall average. In particular, Real Estate Development, Media and Diversified Financials are the outliers (Figure 12).

### Box 1: Listed Company Results

Latest stock market filings show that Q4 2017 listed company results, reported under International Financial Reporting Standards (IFRS), were up on a yearly basis but down on a quarterly basis. Q4 2017 listed company net-income totaled SR15.2 billion, resulting in a 5 percent rise year-on-year. In 2017 as a whole, total listed company profitability rose by 13 percent year-on-year, marking a return to a growth in profitability following two consecutive years of decline. That said, the rise in profitability was heavily influenced by a rise in the most prominent sectors, banks and petrochemicals. Whilst both sectors combined have historically contributed to around two-thirds of total profitability, their contribution edged up to 70 percent of overall profits in 2017, up 3 percentage points compared to a year ago (Figure 13).

Figure 12: Price-to-earnings by sector

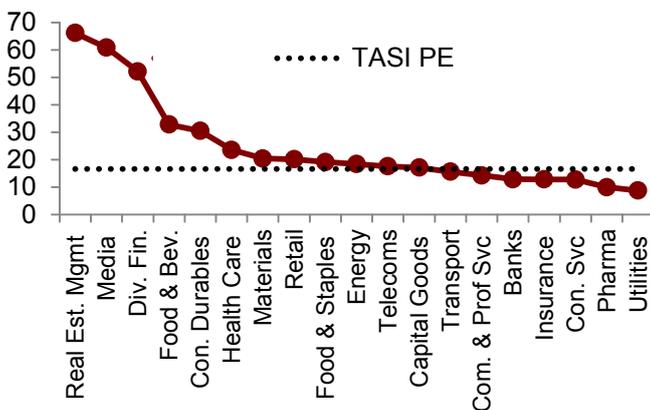
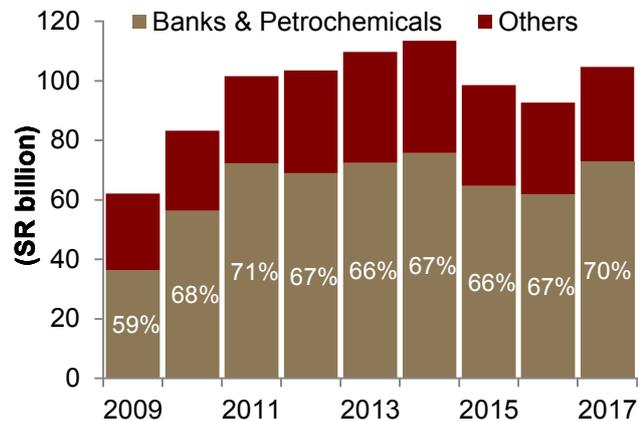


Figure 13: Banks and petrochemicals made up 70 percent of profits of listed companies in 2017





*Looking at a slightly longer time period of four years, PE for TASI relative to both MSCI World and MSCI EM have declined...*

*...and, despite a recent recovery, still stands at reasonable levels.*

*Looking ahead into the Q2 2018, a number of developments are likely to help keep the positive momentum going for TASI...*

*...and we expect inflows from QFIs and SWAPs, seen so far in 2018, to continue for the next few months...*

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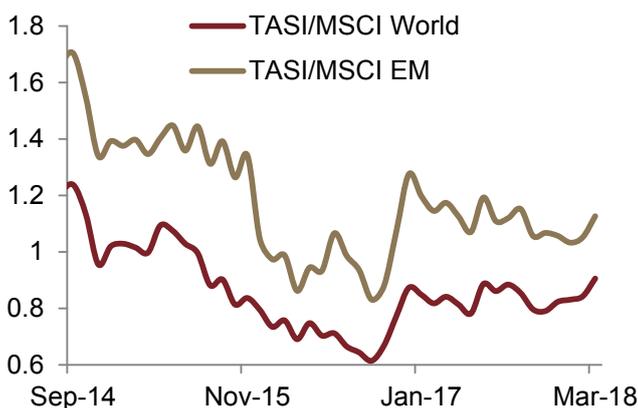
Looking at a slightly longer time period of four years, PE for TASI relative to both MSCI World and MSCI EM has declined and, despite a recent recovery, still stands at reasonable levels. The TASI vs. MSCI World and TASI vs. MSCI EM PE stood at 1.05 and 1.47 respectively, in mid-2014, but declined to 0.9 and 1.12 in March 2018 (Figure 14). Overall, the declines seen in TASI PE over the last few years have decreased the risk of over pricing. For example, at one point back in mid-2014, the Saudi bourse was moving towards being over heated. TASI rose by 14 percent in less than two months to seven year highs of 11,149 points in September 2014, and PE valuations were trending above the long term averages. Thereafter, TASI declined steeply until early 2016, and this ultimately contributed to cooling valuations, all of which have now made TASI better value for money.

### Outlook

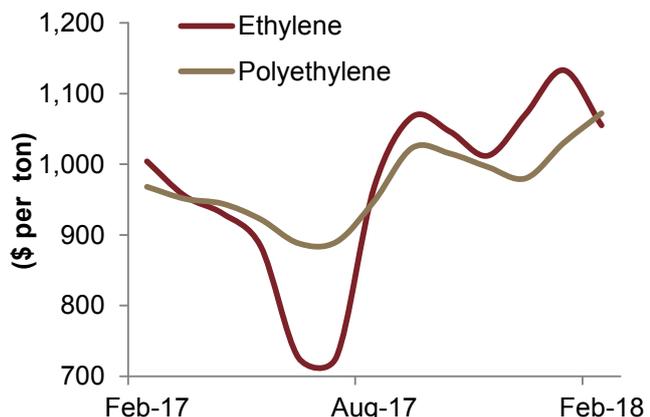
Looking ahead into the Q2 2018, a number of developments are likely to help keep the positive momentum going for TASI. We expect oil prices to continue trading around a range of \$65-70 pb over the course of Q2, which should support sentiment. On the other hand, Q1 2018 listed company earnings may show some effects of adjusting to the roll-out of macroeconomic policies since the beginning of year. That said, the two largest contributors to net-income, petrochemicals and banking, could well see some uplift. Firstly, a pick-up in global demand has seen an improvement in the price of petrochemical products such as ethylene and polyethylene, resulting in a rise in margins (Figure 15). Secondly, whilst a rise in both the Saudi repo and the reverse repo rate by 25 basis points in March will increase funding costs for most companies, it will be a boon for banks. Furthermore, latest survey data shows a 70 percent probability of an additional US interest rate hike, by 25 bps, in June 2018, which is likely to see another round of hikes in Saudi interest rates as well.

We expect the inflows from QFIs and SWAPs seen so far in 2018 to continue for the next few months, especially as the likelihood of Saudi Arabia's inclusion into MSCI EM has greatly increased following FTSE EM inclusion. Specifically, we see certain QFIs, such as hedge funds, taking up favorable positions to take advantage of the anticipated flows once MSCI EM inclusion is announced in June 2018, but implemented, along with FTSE EM, during 2019.

**Figure 14: TASI price-to-earnings have declined relative to MSCI EM and MSCI World**



**Figure 15: Saudi petrochemical product margins have improved recently**





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