



2021: Navigating Icarian Markets *Outlook and Trends*

Introduction

“Vertigo, is something other than the fear of falling. It is the voice of the emptiness below us which tempts and lures us, it is the desire to fall, against which, terrified, we defend ourselves”

– Milan Kundera, *The Unbearable Lightness of Being*

2020 will go down in history as a year of reference; a year of pre and post. While the world witnessed the epidemic insidiously morph into a pandemic, global economies hit a roadblock at a time when supply chains were stretched and optimized to perfection. In consequence, asset prices fell across the board; but then in the midst of the first global lockdown, markets took a turn and never looked back. The rise in global equity prices surged hand in hand with the number of confirmed deaths from Covid-19; no doubt rendering the job of stock pickers with value inclinations arduous both at the moral and the technical levels.

Judging by the reaction of commodities – especially those that comprise raw industrial indices that found their bottom towards mid-April – the reflation trade has already been upon us and continues on; echoing the move from the end of 2008 to mid-2011.

Post the Global Financial Crisis (GFC), fiscal stimulus was cut short - arguably rather too soon - and the burden fell on central banks to do the heavy lifting via massive QE programs; to the surprise of many including ourselves, global inflation remained subdued for the longest part of a dozen years. This time around however, fiscal stimulus and deficit spending seem here to stay, all under the umbrella of Yield Curve Control with lightning fast vaccine innovation and rollout promising a relatively quick return to whatever new normal our world will converge to.

So if all systems are ‘go’, 2021 and probably 2022 will further support the reflation/momentum trade; unless and until...!

At the risk of uttering the most dreaded words in investment, this time could indeed be different, in that we should make allowance for a scenario were the reflation trade turns into an inflationary one, prior to employment levels hitting their theoretical respective targets:

- Given expected fiscal spending programs, including ‘green projects’ which would require miners to extract more from their decade-long capital-starved mines, potentially pushing metal prices even higher.
- Due to the realization that more should be done closer to their end consumer markets, along with the shift from ‘just-in-time’ to ‘just-in-case’ supply chains, thus reversing at the margin the deflationary trends that were achieved through globalization.

With central banks never being more dovish and actual-data driven than they are now, we risk encountering Milton Friedman's 'fool in the shower' trap- wildly altering the temperature of the water in search for a suitable balance, without allowing sufficient time for the true temperature to make itself apparent, with massive repercussions. After all, the rise in equity prices is understandably due to subdued interest rates that lowered discount rates across the risk curve, which in turn led the tides to rise and lift nearly everything; some more than others though, and this is key.

Remaining sanguine about future equity market returns proves particularly difficult when they are trading at such stretched multiples but here is our attempt anyway.

When comparing the performance of companies listed in the MENA region over the lockdown quarters (Q2 & Q3) relative to the same quarters of 2019, we notice that 46% of all companies by free-float adjusted market cap witnessed some form of improvement along the Revenue and/or the Operating Income metrics (this is in line with other global markets). Now we must realize and study the difference between those that did well (operationally) because of the lockdown and those that did well in-spite of the lockdown. The "in-spite" bucket remains of particular interest to us; as they happen to exhibit the highest resilience on their path of reversion to operational historic mean. The market has on average rewarded many of them adequately, bestowing upon them headline multiples that are hard to digest. Yet despite that, several of those companies that would likely continue to revert to their operational mean still offer decent future FCF returns to current market prices.

At the other extreme are the companies with (i) decent balance sheets, but (ii) abysmal operational performance, because of the lockdowns, AND (iii) that are yet to rerate sufficiently on the back of vaccine development. These are also in our portfolio and/or on our radar for entry (or addition).

From a cash-flow duration perspective, we would maintain a relative barbell approach with a slight and gradually growing tilt towards lower duration and higher Book to Market or Adjusted Assets to EV priced businesses. As we write this outlook, we are actively abstaining from buying lofty projections and rather opt to focus on companies that are compounding their cash flow generation in a boring (for lack of a better word) fashion.

We endeavor to 'invest behind a veil of ignorance', borrowing from the political philosopher John Rawls. In this parallel, though, we remain observers and students of the macro environment; our original position is one where we do not know nor bet on which one of the many permutations of the macro picture will prevail, and thus seek to design portfolios that actively attempt to reduce bias towards one macro outcome or another.

This comes with a big disclaimer: WE MAY UNDERPERFORM A RUNAWAY MARKET.

The rein on markets' volatility by Central banks is highly concerning to us; the longer it goes, the deeper the ensuing cuts when – not if – volatility hits again. Value managers embrace volatility as it increases the possibility of acquiring decent companies at good prices, thus ultimately – but counterintuitively - reducing the long term portfolio's risk.

During the year 2020, several of our investments delivered outstanding outperformance, allowing us to mitigate and effectively overcome the drag of keeping a substantial cash buffer for further acquisitions on shocks. We ended the year comfortably outperforming our mandates' targets.

Adding further to our good fortunes was the decision to include a few quality businesses to our portfolio when the pre-election market turmoil hit our region. We brace for more of these spikes in volatility but -hopefully- for completely benign reasons.

Executive Summary

- Stimulus in response to the jolt of the pandemic has the potential to exacerbate inflation shocks down the line. The Fed's attention to employment indicators can and will prolong a low rate environment. How inflation is being measured, as discussed in the letter, can produce policy miscalculation. Fiscal and monetary stimuli, coupled with yield curve control, lead to low discount rates, and are probably the reason behind the aggressive rebound in asset prices and valuations.
- Historically, globalization has helped reduce prices to end consumers as supply chains have been extended as far out as possible, in pursuit of efficiency. The pandemic puts this model to risk, urging governments to consider smaller trade zones and shorter supply chains. These are likely to reverse the multi-decade negative trend in global inflation.
- Climate action now appears more concerted and coordinated. The projections of carbon capture projects adopted by the likes of ADNOC and Aramco, taken at face value, would dramatically reduce the already low CO2 emissions-per-barrel produced, and allow for the region's oil to remain competitive over the coming decades, even as the world moves towards renewables and relies less on fossil fuels.
- Addressing climate challenges requires the electrification of nearly everything, but would be of only marginal environmental benefit should the grid not be decarbonized, or if the sourcing and transportation of the materials needed is carbon intensive. This secular move is happening, but until humanity is able to mine asteroids or colonize Mars, we will need to mine for these metals and innovate further across the periodic table of the elements.
- The region's geological profile is promising. In fact, according to Saudi Arabian authorities, the kingdom is home to large untapped resources, which when coupled with relatively low country risk renders it a likely candidate for new FDIs in mining projects (both upstream and downstream), thus helping to reverse the downward trend in FDIs witnessed in the past. KSA's recent new mining law passed in June is a step in this direction, while new resource discoveries in Abu Dhabi amid privatization initiatives add to the palette of FDI destinations in the region.
- Over the medium term, Saudi Arabia is likely to succeed in enacting economic transformation plans, while simultaneously correcting its twin deficits and reducing reliance on oil revenue. Expanded fiscal collections (VAT) was buffered by the various financial stimulus packages that were administered in parallel during the pandemic. The UAE and Qatar continue to enjoy large wealth buffers, comfortable fiscal positions and diversified economies, while Kuwait's accumulated wealth should allow it to sustain a small fiscal deficit, though much needed spending remains impeded. Egypt may well achieve its target deficit reduction this year. A modest primary surplus remains achievable as revenues recover, consistent with the country's targets under the standby funding agreement with the IMF.
- The development of downstream manufacturing industries can fuel the next phase of economic diversification in Saudi Arabia, the benefits of which include significant job creation, a reduction in the trade deficit, real GDP growth, and a chance to recoup FDIs that have fallen in recent years. The UAE's economic diversification far surpasses its GCC peers, thanks to Dubai's success in the airline, tourism and real estate sectors. As Abu Dhabi pioneers regional nuclear power production and makes big strides in harnessing solar energy, oil that was previously consumed will be freed up for export or to be supplied downstream towards petrochemical manufacturing.

- ESG: The vast wealth of GCC hydrocarbon businesses renders them particularly well positioned to invest in clean energy and to offset their carbon footprint. On the governance front, we see increased scrutiny being applied to the ownership structures, related party dealings, reporting standards and capital usage of listed businesses, in the aftermath of several high-profile cases that emerged in 2019-2020.
- The long-term theme of increased home ownership by citizens in Saudi Arabia is a powerful one. Mortgage lending growth has been tested and visible, and the development of a Fannie Mae/Freddie Mac equivalent will be conducive to the securitization of loans, and potentially relieve future pressure on the banks' balance sheets, if non-mortgage lending activity were to pick up pace, mainly in relation to megaproject financing.
- We selectively construct a portfolio of industrial stocks that have suffered in the outgoing cycle and have demonstrated sufficient balance sheet resilience to remain viable, and are positioned for operating leverage-driven recovery in operating cash flow yields. We see a 5-10 year opportunity via the construction sector and its suppliers.
- Several emerging e-commerce platforms in MENA will likely mature into a concentrated ecosystem of market places and order fulfillment service providers, as online retail captures permanent market share away from traditional retail.
- We see a strong, rehabilitative surge in regional tourism over the next 2 years. If held as currently scheduled, the Expo 2021 event may not fulfill its attendance potential, given that global vaccination estimates foresee another 12-24 months before critical immunization thresholds are reached. However, the 2022 World Cup event in Qatar may face fewer challenges. The re-opening of routes between the GCC and Qatar is likely to help reduce the reliance of the event on long-haul travelers attending the matches, and induce a spillover of tourists towards the UAE's 100,000 hotel keys, as well as Saudi Arabia's new adventure, nature and cultural tourism offering.
- The healthcare and education sectors remain the most interesting secular growth stories in the MENA region. Healthcare plays in MENA enjoy strong volume catalysts while downside risks (via potential expatriate exodus from GCC) for now remain counterbalanced by relaxed residency measures (excluding Kuwait). Education plays in MENA are of great interest to us, underpinned by strong demographic and fundamental drivers.
- The Coronavirus pandemic exacerbated the oversupply situation in most petrochemicals products. Long term demand growth can offer ARAMCO an alternative channel to monetize crude oil, perhaps even at greater profit per barrel of oil equivalent. This is especially relevant in a world that is more environmentally minded and increasingly reliant on electricity for transportation.
- The market's exuberance was not completely baseless nor solely driven by low discount rates; in fact, between 40 and 60% of listed companies have reported improved financial performance, either growing their operating income or revenue headline figures (or both) during the lockdown quarters of 2020, versus the same period of 2019. As far as our region is concerned, 48% of non-financial companies by free float market cap have improved along these lines.
- Some of those companies did well *because* of the lockdown (food retail, logistics), while others did well *in spite* of them (select industrials, financials). It is this bucket that is of most interest to us as investors. These potentially resilient businesses are what we would like to maintain and increase exposure to, as they prove less susceptible to exogenous shocks and/or happen to be at the epicenter of longer secular change.
- Risks: Mutations in the virus that pose new obstacles and setbacks to inoculation efforts, geopolitical tensions, and inflation spikes that lead to uncontrolled jumps in interest rates.

Tracing our steps through the fog

Our inaugural annual letter, sent at this time last year, began with this now-seemingly understated phrase:

A historic, long awaited year for the region is upon us: Riyadh hosts the G20 Summit and Dubai the Expo2020 event. The year is however unfolding in the midst of a macroeconomic climate impacted by trade tensions (and their potential resolution), a slowdown in growth in China (and global headwind created by the Coronavirus epidemic), falling oil prices despite flares in geopolitical tensions, and mixed signals for global growth and interest rates.

A ‘historic year’ was indeed most certainly upon us. With the advantage of hindsight, the above accurately encapsulates the inherent limitations of a forecaster’s trade: one may often identify key risks over a foreseeable timeline, but seldom will one be able to correctly anticipate the severity of such factors and their derivatives, ex-ante.

Indeed, there is little doubt that 2020 will occupy a position of much significance in history. A year of reference perhaps, defining eras of ‘pre’ and ‘post’, due to the substantiality of the events that occurred within it. A typical year is remembered for one or two salient, defining events. 2020, by contrast, was a series of shocks to global risk: it dawned with the assassination of a top Iranian commander and dusked with that of a top Iranian nuclear scientist. It witnessed a standoff between soldiers of the two most populous nuclear armed nations in a literal fight to the death with sticks and clubs, followed by a deadly explosion of corruption at the Port of Beirut, amid widespread protests in the US as race relations and issues of social justice came to the fore by mid-year. And lest we forget, an epidemic morphing into a pandemic caused by a virus that is feared to do what viruses usually do, mutate. These events share a common denominator: they are seismic and irreversible in their implications, and on aggregate, have steered the course of global events in directions not many would have brazenly predicted.

Though we did, in our last letter, acknowledge the pandemic’s potential to create unforeseen risk, we did not anticipate the resolute and concerted fiscal and monetary stimulus efforts pursued across markets, believing that ammunition of the requisite variety was in short supply. As it turns out – in contrast - the magnitude and scope of global stimulus measures taken, contributed to a dark market behavior: global markets rose from their March lows in tandem with the number of recorded deaths from Covid-19.

The current liquidity glut across markets, coupled with a growing get-rich-quick retail participation has exacerbated the stimulus trade. The ‘momentum du jour’ mentality appears to have dominated over quality or other common sense investing metrics. However, we believe there was more to it than pure rampant speculation; in fact, though valuations in equity markets have skyrocketed, we note that this is against a backdrop of exceptionally low discount rates.

In the context of opportunity cost, 2020 earnings yields are in fact far better than their underlying capital’s next best use, relative to previous peaks.

Whether the incoming year is doomed for an equity-market correction or a continuation of the monetary easing-driven liquidity parade, or both, remains in the realm of conjecture. What we do know however, is that this juncture is not simply a choice between betting on a global recovery, backed by vaccination success, versus a series of aftershocks that would derail the progress made so far. In other words over short period of times, what is good for the world is not necessarily good for the markets and the opposite is also true - as 2020 managed to remind us.

Should we be bracing for volatility?

There is a case for a more orderly world in 2021:

- Joe Biden's electoral win brings with it, at the very least, the expectation that the US adopt reconciliatory foreign policy, rejoin climate accords, defuse tariff and trade tensions with China, and tackle the pandemic with better effect. The resolution of differences among GCC member states and the normalization of political and economic relations with Israel by the UAE, Bahrain, Sudan and Morocco all point in the direction of a reduced tension closer to home.
- The miracle of science and capitalism delivering multiple vaccines in a record time, through building on technologies that may eventually prove game changers in the field of medicine, biotechnology and eventually demographics. Mass vaccination rollout over phases would dramatically reduce the death toll of the pandemic and alleviate the pressures on healthcare systems. At the time of writing this letter, the UAE had reached an 18% vaccination rate, and official statements guide for a 50% rate by the end of the first quarter of the year. Countries that achieve high vaccination rates (*or costlier herd immunity*) may be well on their way to speedy economic recovery.

But all this 'hoped for' stability comes with the implication that fiscal stimulus extended to banks and financial institutions will likely be withdrawn, along with other elements of economic and social support such as reduced administrative fees for government services and loan repayment holidays. In fact, we had recently argued that the markets seem to have developed a Pavlovian preconditioning to economic pain whereby, the deeper the expected economic shortfall, the larger the expected stimulus and subsequently the higher risky assets would go. Taking this thought to its opposite extreme, we wonder if the end-game for this cycle in equities markets would come hand in hand with actually improving economic outlook.

In sum, we see fewer volatility-inducing events occurring in 2021, yet we remain cognizant that due to the residual impact of stimulus measures taken last year with more expected this year, volatility is still very much with us in 2021.

A key variable, with both long and short term implications remains global interest rates and in particular the impact of subdued rates for prolonged periods and its historical correlation with lower future growth. While governments may stand to benefit from extending the duration of their borrowings to lock in low borrowing rates, we note that the weighted average duration of issued US treasury bonds has however shrunk to 6 years. As such, we are skeptical that the Fed- and other central banks for that matter- will initiate tapering (the gradual reversal of a quantitative easing policy) before this happens.

The risk of short lived spikes in interest rates in the meantime however is material. These may come in the form of small battles that central banks may momentarily lose before restoring order, in a way that would be reminiscent of the US repo market in Q3 2019.

Those battles could erupt under the banner of expected long term inflation. We say long term because it is almost a certainty that readings of the second and third quarter of 2021 would appear high given the extreme low year on year base against which the period is compared. Furthermore, the accuracy of inflation measurements, which inform rate decisions, is a function of how well official metrics truly represent the comprehensive state of the economy. The basket composite representing inflation is not as dynamically updated as to account for the behavioral shocks over short periods of time as the ones that were inflicted upon the consumer in the midst of the lockdown.

Official Consumer Price Indices for example still capture elements of the economy that are suffering at current (tourism spending, leisure, travel). The Billion Prices Project, co-founded by Dr. Cavallo Alberto - a collaborative effort between MIT and State Street to develop a better alternative to CPI, presents a stark finding; the deflation in CPI reported in the first 3 months of 2020 can be viewed as being largely exaggerated, as their alternative, lockdown focused basket shows a far more modest deflationary effect. The trend continued on into the September reading¹. We note however, that historically, the CPI measure did not divorce much – if at all – from measures such as the Billion Dollar Project. The concern now is that the recent consumer behavioral changes become structural and survive beyond the lockdown economy. Should the preferred measure not follow suit in its representativeness, we risk Milton Friedman’s ‘fool in a shower’ drama, especially given the FOMC’s focus change from expected to observed inflation. It simply might become too late by the time actual inflation shows a sustainable breach above 2%. What is concerning is the assumption that given the persistently low muted inflation in the aftermath of the Global financial crises, there is a case to be made that inflation will never pick up this time around as well.

Under the August updated five-year strategy, the Fed may well allow inflation to spike on occasion but will likely focus on managing sustainable breaches above 2%. In fact, the Fed’s Guide to changes in the 2020 Statement on Longer-Run Goals and Monetary Policy Strategy recently stated that “The Committee’s employment and inflation objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it takes into account the employment shortfalls and inflation deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate”. In essence, employment shortfalls can and do become near term priorities over general price stability – provided the latter does not sustainably push higher.

Globalization setbacks and the post-pandemic economy

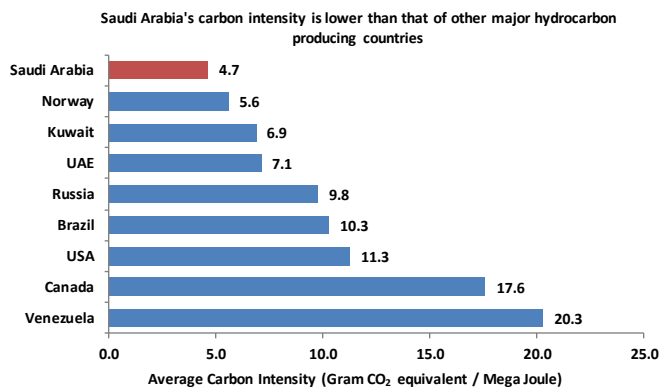
The pandemic has precipitated a growing conviction (whether rational or not) that more needs to be done closer to home (dubbed a just-in-case inventory system), primarily in terms of supply chains for manufacturing and agricultural commodities. Future policymaking, especially with the pandemic’s devastation still raw in the minds of policymakers, will likely be designed to prevent the same debilitating shocks from recurring. In essence, supply chains will probably become more expensive, more localized, and certainly less efficient. Globalization’s sure-footed decades-long march will in all likelihood suffer a durable setback.

Furthermore, mining and related industries that were once starved for capital are now increasingly in vogue. The US will soon rejoin the Paris accords, and global awareness (coupled with tangible action on all fronts) is at an all-time high. We see a stronger drive towards the E in ESG, and rising investments at the margin in clean tech and clean commodities. The cost of production of most commodities will likely price in one form or another of an environmental tax component.

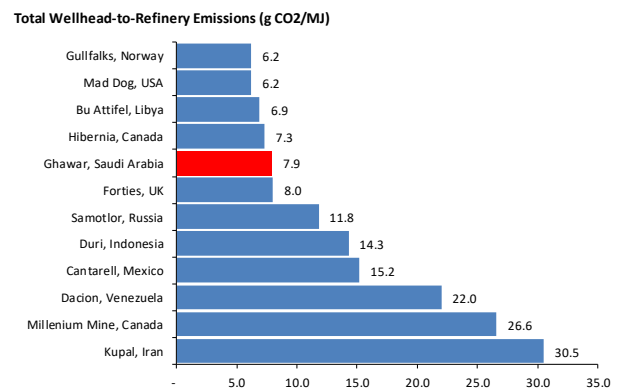
¹ Cavallo, Alberto, 2020, "Replication Data and Code for: "Inflation with Covid Consumption Baskets" NBER Working Paper Series, No. 27352, October 2020." Abstract: The Covid-19 Pandemic has led to changes in expenditure patterns that can introduce significant bias in the measurement of Consumer Price Index (CPI) inflation. I use publicly-available data on credit and debit card transactions to update the official CPI weights and re-calculate inflation with Covid consumption baskets. I find that the US CPI underestimated the Covid inflation rate, particularly during the first three months of the Pandemic, as consumers spent relatively more on food and categories with inflation, and less on transportation and other categories experiencing deflation. By September, US Covid inflation was 1.90% compared to 1.41% in the official CPI, and was impacting low-income households the most. I also find evidence of higher Covid inflation in 12 out of 19 additional countries. (2020-10)

We are likely to find ourselves in an environment in which suppliers to the green economy need to step up production to meet demand. The sources of demand can be summarized in 3 key drivers:

- The electrification of everything: Smarter and more efficient conductors and alloys would spur an investment boom in mining
- De-carbonization of electricity grids: Reducing the emissions per unit of electricity generated of a distribution grid
- Cleaner sourcing of materials: Does your Tesla consume electricity that is cleanly generated? Is its production footprint clean, regardless of the footprint generated through its useful life?



Source: Science magazine, August 2018



Source: International Council on Clean Transport

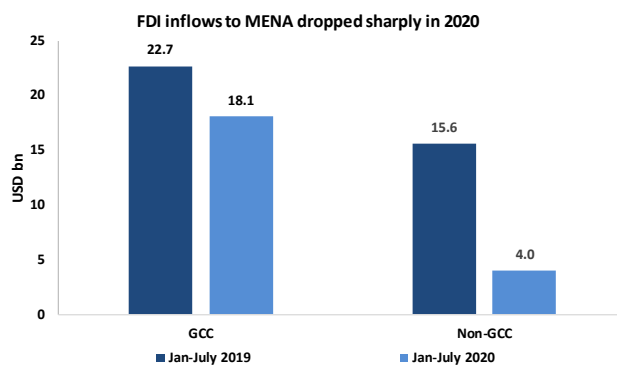
The MENA region is naturally at the heart of the debate on climate policy. Indeed fossil fuels and both their producers and users are under much scrutiny and criticism. There is however a silver lining that oil producers in the region can explore: their upstream CO₂ footprint per barrel is already among the lowest globally. This has room, technology as well as the capital to improve further.

Back in February 2020, at the ICCUS conference on carbon capture hosted by Saudi Arabia, ADNOC's CEO Dr. Sultan Al Jaber stated that the company is on track to execute a plan to expand on its successful implementation of existing carbon capture projects and reach carbon neutrality by 2030. Saudi Arabia has already shipped its first batch of hydrogen fuel in the form of ammonia, with more investments earmarked in that space, prompting the kingdom's energy minister to claim an eventual uncontested position as the "biggest exporter of hydrogen on earth".

The future of oil is potentially a tighter market, as transportation eventually turns electric. Therefore, marginal demand of fossil fuels and crude oil in particular will probably be on the decline, but the environmental costs could force marginal supply to fall faster. Should regional National Oil Companies execute their carbon capture programs and eventually expand them across their value chain, they should be able to remain the uncontested producers of a key commodity well into an extended future.

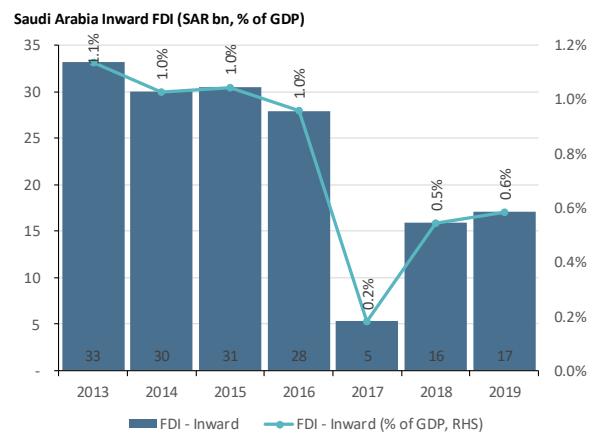
Tailwinds: Saudi Arabia and the broader GCC's latent commodities potential

As stated earlier, regional FDI flows suffered greatly in the first half of 2020. The critical path of Saudi Arabia's diversification drive passes through a key requirement: the successful attraction of FDIs into new economic sectors. In early January of this year at the World Economic Forum, the Kingdom's Crown Prince indicated that USD 6tn worth of investment opportunities will be made available in Saudi Arabia over the next decade, half of which in new projects. The Public Investment Fund (PIF) is due to finance 85% of the projects, along with the private sector. The residual, an implied and not-insignificant USD 900bn, would be open to regional and global participation. The Royal Commission in the Jubail province of the country aims to attract 3 automakers to set up operations in the region, and to supply 90% of their raw material needs domestically. The Commission expects to manufacture the first Saudi Arabian-made vehicle by 2022. Ambition of this sort is likely accelerated by the urgency to produce meaningful economic diversification, after a year in which oil prices widened budget deficits and potentially set transformation plans like the Kingdom's 'Vision 2030' blueprint back by several years.



Source: World Bank

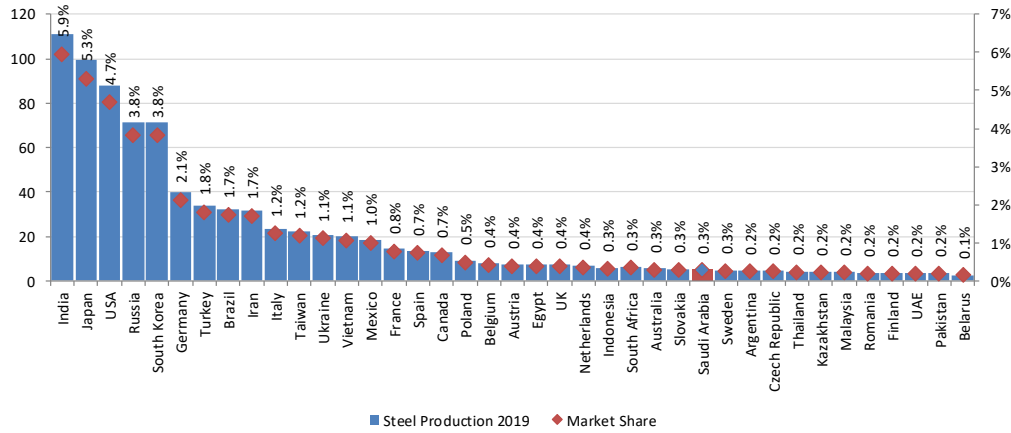
Note: GCC countries- Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates; Non-GCC countries- Algeria, Djibouti, Egypt, Iran, Iraq, Jordan, Lebanon, Libya, Morocco, Syria, Tunisia



Source: SAMA

Emerging themes and technologies should produce a long term rightwards shift in the demand curve for key commodities. From a regional standpoint, Saudi Arabia is the largest and most promising minerals play in MENA. Its vision to reduce reliance on oil and develop its minerals and mining industries now encounters an opportunity to attract FDIs (and reverse their outflows in recent years) and step up job creation for nationals. Coupled with the drive to preserve the returns of hydrocarbon wealth within the kingdom, these global and domestic factors suggest that MENA's next growth leg may result from the development of new resource industries, other than oil. Regulations that help hesitant FDI flows find their way into KSA (such as a stronger legal framework, which remains largely untested) would be well-timed to attract capital that is seeking exceptional returns as global demand is revived. Actively granting exploration and mining licenses to foreign companies would accelerate the process.

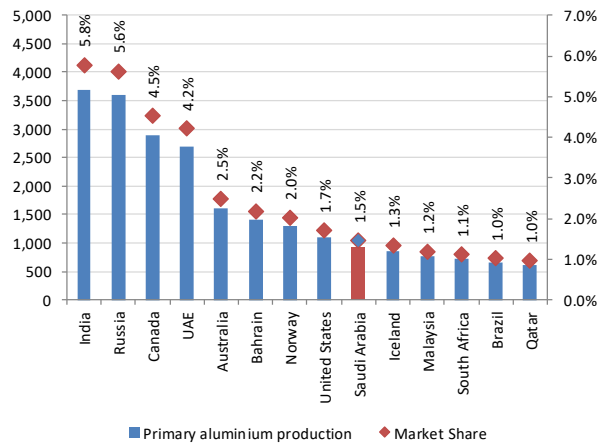
Steel Production & Market Share Ex-China (mIn MT) - KSA Ranked #29 globally



Source: British Geological Survey, USGS

Initially, most minerals will likely be exported in raw form. But over time, the development of existing metallurgical industries such as aluminium and copper smelting is a near-certainty. According to Fitch, a ‘mineral railway’ will be built in Saudi Arabia to link mineral mines to processing facilities. Additional smelters, finishing mills and manufacturing plants that use the finished materials would follow. This is reminiscent of the development path of the country’s oil and petrochemicals industries. However, unlike hydrocarbons, the mining sector is relatively labour-intensive, creating both production and management jobs for Saudi nationals.

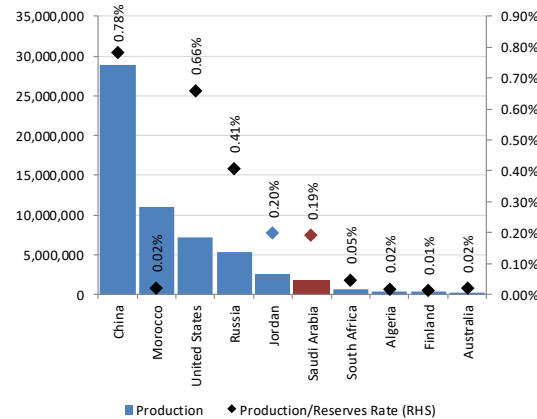
Aluminum Production & Market Share Ex-China ('000 MT) - KSA Ranked #10 globally



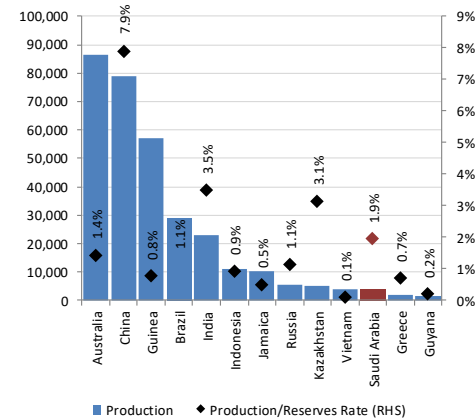
Source: British Geological Survey, USGS

At present, Saudi Arabia possesses a strong track record of developing natural resources, be it in the energy, mining or fertilizer industries. The Kingdom’s production rate (production versus reserves) of oil, gold, bauxite, and phosphate rock ranks high among global peers, demonstrating its commitment to developing and diversifying its economy at a baseline level. Additionally, government officials have recently been vocal about exploiting additional mineral resources through offering mining licenses to foreign investors.

Phosphate Rock Production & Production Rate in 2018 (tonnes)



Bauxite Production & Production Rate in 2018 ('000 tonnes)



Sources: International Organizing Committee for the World Mining Congress, Stockholm Environment Institute

The petrochemical sector's successful development was a first step towards developing downstream industries, and we envisage similar development of the aluminum and copper mining industries and a continued shift away from the export of basic manufactures towards higher value processed manufactures. Such a move would not only benefit the local economy's development (via job creation and ancillary industries), but would also serve to support the Kingdom's trade balance through import substitution. At present, imports of iron, copper and aluminum manufactures account for approximately 11% of imports and 2% of GDP.

However, not all GCC economies are focusing their spending on economic diversification yet. Qatar has recently renewed its commitment to further developing its vast energy resources (natural gas) after lifting a self-imposed moratorium on North Field production expansion. The mega project (>USD 50bn in cost) will increase Qatar's natural gas production from 77mtpa to 110mtpa in 2025 (+43%) and 126 mtpa in 2027 (+15%), comfortably cementing its position as the largest exporter of LNG globally. Qatar's geographical proximity to key markets coupled with its low production cost means that it is less concerned about short-term energy price fluctuations that might affect marginal producers, ultimately making a strong investment case for such a large project.

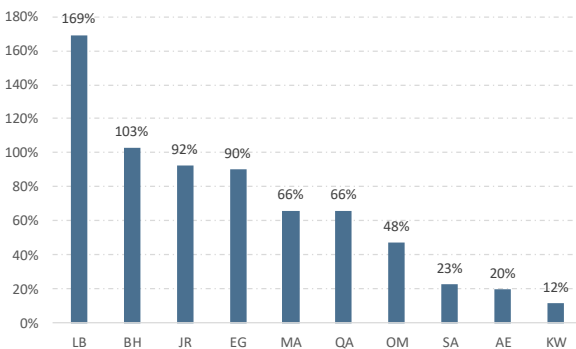
What this all means for MENA equities: a refresher on secular and cyclical trends

Our main expectations for increased regional relevance within the EM universe, due to favourable economic and demographic drivers coupled with catalytic events such as the G20 in Riyadh and the Dubai Expo 2020, suffered an upset due to the pandemic. In retrospect, it however appears that the GCC region within MENA has been spared the brunt of the fallout. Healthcare systems in the GCC appear to have functioned far more effectively in light of successful control of the virus's spread, when compared to broader MENA, Europe or the US. The G20 summit proceeded forward in November, albeit virtually. Political tensions within the region have been resolved as Qatar, Saudi Arabia and the UAE agreed to end a 3 year rift in relations. The political normalization process between the UAE, Bahrain, Morocco and Israel holds potential for meaningful trade, tourism and capital flows between the respective markets. Pandemic-related job losses however, with the usual departure of expatriate residents, may impede growth for multiple sectors in the GCC reliant on or sensitive to expatriate workers in the near term, until private sector activity resumes and job creation is restored. However, this was countered by the announcement of new long term residency schemes in the UAE, and changes to the foreign worker sponsorship system ('Kafala') in Saudi Arabia, designed to curb the potential departure of foreign residents, and to ensure the region retains its attractiveness among prospective long term residents.

- Fiscal course-correction:** While Saudi Arabia pushes forward with its economic transformation and diversification plans, the Kingdom is also making good progress on the fiscal front, particularly in relation to correcting its twin deficits and reducing reliance on oil revenue. Although the timing of VAT increase (from 5% to 15%) in mid-2020 seemed counterintuitive as countries around the world sought to ease financial burdens on their citizens and residents, the impact was buffered by the various financial stimulus packages that were administered in parallel. The contribution of tax revenues to overall fiscal revenues has increased as a consequence, rising from 23.7% in 2019 to 25.5% in 2020 (despite the pandemic's pronounced impact on non-oil economic activity), and is expected to reach 30.3% of total fiscal revenue in 2021. Indeed, higher tax revenues will likely be the emerging fiscal correction's key short-term driver, helping shrink a fiscal deficit to -4.9% of GDP in 2021 and -0.4% of GDP in 2023 (Ministry of Finance).

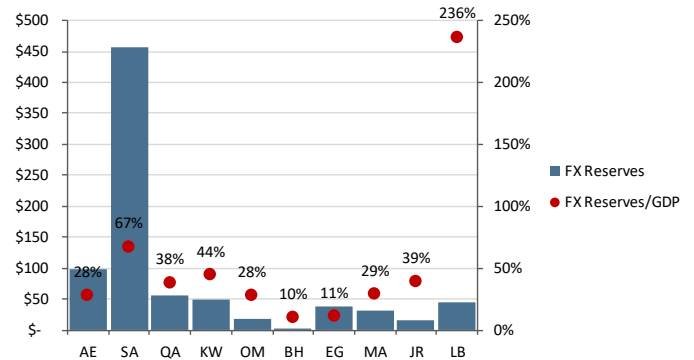
Among other GCC states that are highly oil-reliant, Oman & Bahrain remain economically disadvantaged due to low degrees of economic diversification, dwindling oil revenues and high leverage (debt/GDP 48% in Oman, 103% in Bahrain). In the case of Oman, we see some encouragingly positive corrective steps in the form of income taxes and hikes to VAT. We would hesitate to include Kuwait in the group of economically disadvantaged states since the country sits on vast amounts of accumulated wealth while sustaining a small fiscal deficit, but the persistent lack of progress on the administrative and legislative fronts is hindering the release of much needed infrastructure spending. Out of the group, only the UAE and Qatar enjoy large wealth buffers, comfortable fiscal positions and diversified economies (particularly the UAE). Qatar's investments in the airline and tourism sectors have yet to demonstrate the success that the UAE is enjoying, but showcasing the country during FIFA 2022 would help boost its global perception as a competing destination for human and financial capital.

MENA debt/GDP



Source: Central Banks, IMF

MENA FX Reserves (USD bn)



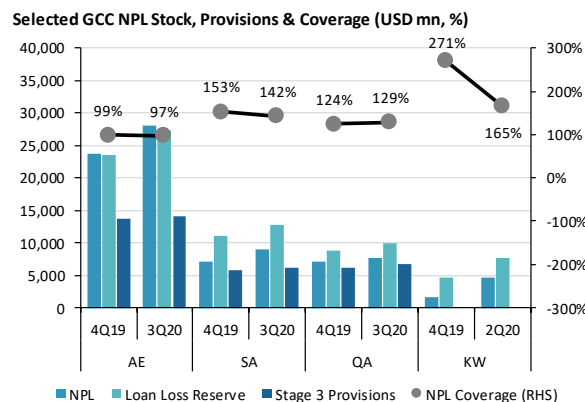
Source: Central Banks, IMF

Egypt on the other hand produced a fiscal deficit of 7.9% in 2019-20 (June), 0.7% higher than budgeted, but nevertheless improving modestly year-on-year. Due to much-reduced debt service costs (via aggregate rate cuts of 400bps in 2020), Egypt may achieve its target deficit reduction to 6.3% this year. A modest primary surplus remains achievable as revenues recover, consistent with the country's targets under the standby funding agreement with the IMF. The country's debt/GDP ratio of 87% would also gradually improve.

- Diversification:** We look towards material strides forward in the development of downstream manufacturing industries to fuel the next phase of economic diversification in Saudi Arabia, the benefits of which include significant job creation, a reduction in the trade deficit, and real GDP growth. The Kingdom’s decade-long investment in a new pillar of industrial diversification, Maaden, is likely bear fruit as the business begins to perform a vital role in the country’s economic diversification plan. Maaden will likely be the key enabler of downstream industrial manufacturing projects that rely on aluminum- as ARAMCO has been for the petrochemicals industry- and this will effectively create new avenues for international investors already enticed by FDI opportunities offered by the new megacity, NEOM.

The UAE’s economic diversification far surpasses its GCC peers, thanks to its success in the airline, tourism and real estate sectors. There are, however, notable developments related to power source diversification as the country pioneers regional nuclear power production and makes big strides in harnessing solar energy. The UAE already derives 7% of its power needs from clean sources, with the aim of reaching 25% by 2030. As for nuclear power, the plants under construction are capable of supplying 25% of the country’s needs once fully operational. Consequently, oil that was previously consumed will be freed up for export or to be supplied downstream towards petrochemical manufacturing.

- Financials:** The central banks of Saudi Arabia, UAE and Qatar demonstrated a high level of proactivity during 2020, deploying considerable targeted financial and regulatory support to banks designed to boost liquidity, bolster interest margins and protect against delinquencies resulting directly from lockdowns. Were it not for such intervention, banks across the region would have faced a double shock of lower interest income (via lower rates) and higher bad asset formation (from loss of business and employment), perhaps sufficient to compromise capital adequacy and solvency. The injection of interest-free liquidity into the banks, and the extension of these funds as loans to clients, buffered the decline in NIMs, while the imposition of loan repayment holidays shifted the (potential) bad asset formation cycle further out into the future. Consequently, operational profitability of banks in Saudi Arabia, UAE and Qatar was bolstered and pre-provisioning returns diminished only slightly. This, however, was not the case in Kuwait where the government in fact relied on private banks to cushion the economic blow, while offering minimal support.



Source: Company Filings, Central Bank of Kuwait

In Egypt, repayment holidays imposed in March-September of 2020 are possibly masking over asset quality issues building up over the period. Nevertheless, provisioning on the part of the banks has largely been prudent. Rate cuts of 400bps throughout the year and improving operating conditions for key industries (steel, fertilizers) suggest some degree of CapEx recovery in 2021. The surprise removal of CIB’s Chairman in late 2020 suggests increased regulatory scrutiny across the sector, whereas the directive to withhold dividend distributions for the year may be interpreted as a tacit instruction to the banks to retain further buffers in 2021.

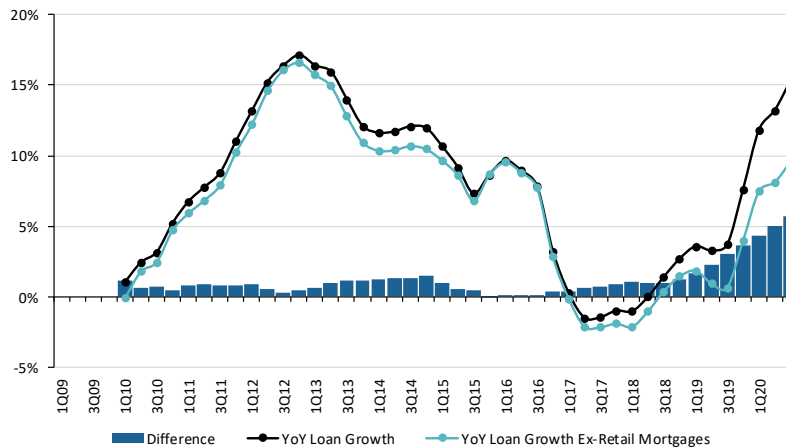
- **Egypt in focus:** Egypt's economy has been heavily impacted by the COVID-19 crisis, namely due to insufficient healthcare infrastructure, the interruptions to the tourism industry, impaired trade and logistics flows, and fiscal pressure resulting from support programs. Nevertheless, its successful adherence to a raft of IMF commitments has placed it well with regards to stand by funding agreements (USD 5.2bn) and tacit permission to intervene briefly on the currency front early on. External funding was also bolstered by USD 7bn from global markets. Contained inflation (arriving near the low end of the target range by year end and remaining consistently under control throughout the year, helped by a contraction in demand) has rendered real yields on treasury bills positive, in turn helping the carry trade remain viable. We see potential inflationary pressures in Egypt going into 2021, as vaccination roll out and continued stimulus support demand and in turn oil and commodity prices.

Egypt's equity capital market should be directly impacted by the course of interest rates in 2021. Elevated rates on t-bills and certificates of deposit (CDs) at government banks such as the National Bank of Egypt rendered the opportunity cost of capital rather high, and compromised equity valuations. Though rate 'normalization' by way of further cuts to policy rates and allowing treasury bill yields to correct lower (now helped by a reduction to the rates on public bank CDs) is desirable to policymakers, this is understandably balanced against the imperative to maintain a stable currency, retain XF reserves, and provide import cover. In fact, the modest overall appreciation of the EGP through 2020 has helped portfolio flows into Egypt's carry trade (USD 12bn in July-Nov of 2020), a vital balancing component of the external position, helping rebuild FX buffers (foreign reserves are now at their highest since Q1 2020, and bank net foreign assets are back in the black). Equities on the other hand, suffered.

Our chief concern regarding Egypt is that it may have exhausted its ammunition of monetary and fiscal stimulus tools, at a time when growth requires a strong catalyst. Latest employment figures, despite suggesting that the labour market has overcome the initial shock of the pandemic, still show an overall 3% contraction from pre-pandemic levels. A resurgence in tourism flows and exports in 2021 would, in tandem with continued portfolio inflows, aid external sources of income and reduce financing needs.

- **ESG:** Increased environmental focus could benefit MENA oil producers, as their low energy intensity and cost competitiveness, coupled with efforts to reduce emissions further via carbon capture technology helps fulfill ESG obligations. The vast wealth of GCC hydrocarbon businesses renders them particularly well positioned to invest in clean energy and to offset their carbon footprint. On the governance front, we see increased scrutiny being applied to the ownership structures, related party dealings, reporting standards and capital usage of listed businesses, in the aftermath of several high-profile cases that emerged in 2019-2020.
- **Mortgage lending:** The key area of interest in the banking sector in 2020 is the same one that lends an opportunity for 2021: growth in Saudi Arabia's mortgage lending market, an event triggered by the long-term theme of increased home ownership by citizens. Over the past 5 years, mortgages were the main driver of loan growth in the Kingdom, and may continue to do so for several years to come. By November 2020, the number of mortgage loans issued grew by +83% YoY (T12M) and their corresponding value increased by +90% YoY (T12M). This amount represents 52% of total loans issued by Saudi Arabian banks in the period ending 3Q20. Our calculations suggest that Saudi Arabian banks on aggregate will be able to garner loan growth similar to that of 2020 on the mortgage front (SAR 130bn, USD 34.5bn) in addition to 5% non-mortgage loan growth, without requiring new/additional capital, or needing to raise significant amounts of deposits in order to meet capital and leverage requirements. This will help drive continued growth in assets and returns over the next 2 years at least. We further seek to play KSA's homeownership theme via suppliers and capacity builders in the residential real estate sector. Mortgage lending growth has been tested and visible, and the development of a Fannie Mae/Freddie Mac equivalent will be conducive to the securitization of loans, and potentially relieve pressure on the banks' balance sheets, if non-mortgage lending activity were to pick up pace, mainly in relation to megaproject financing.

Saudi Arabian Banks Loan Growth Including/Excluding Mortgages (% YoY)



- Industrials:** We selectively construct a portfolio of industrial stocks that have suffered in the outgoing cycle and have demonstrated sufficient balance sheet resilience to remain viable, and are positioned for operating leverage-driven recovery in operating cash flow yields. We see a 5-10 year opportunity via the construction sector and its suppliers, though we do not play contractors due to quality issues with cash flow subjectivity.
- Disruption:** Several emerging e-commerce platforms in MENA will likely mature into a concentrated ecosystem of market places and order fulfillment service providers, as online retail captures permanent market share away from traditional retail. The post-pandemic world has created new realities and questions: Will ‘work from home’ become a permanent and accepted practice, given its evident cost savings for all sizes of businesses? Does this in turn imply risks to the returns of commercial real estate and transportation plays?
- Catalytic events:** At the risk of suggesting a deficiency in skepticism, we see a strong, rehabilitative surge in regional tourism over the next 2 years.

Expo 2020 is now Expo 2021, and aside from a less marketable name, is still moving forward with more time to prepare. Despite the immediate tourism industry shock last year, UAE hotels continued to service local/domestic tourism, and reconfigured their service offerings to accommodate stringent safety standards. However, if held as currently scheduled, the Expo event may not fulfill its attendance potential, given that global vaccination estimates foresee another 12-24 months before critical immunization thresholds are reached. Dubai’s stock of 100,000 hotel keys may continue to operate a reduced occupancy rates.

However, it would appear as though a very fortunate combination of timing and global tourism recovery is setting the 2022 World Cup event in Qatar up for success. If the event were to be held in the winter as rumored, attendance numbers would likely benefit. The impact, relative to a country as much as Qatar in terms of population, is massive. Average attendance at the last 3 World Cup events stood at 3.2mn over 64 matches. Our quick math in the table below suggests that even when one assumes that the clip at which hotel keys needs to be added in Doha is somehow possible (+21,500 keys in the next 18 months), the hotel industry’s capacity would be insufficient. This holds even when assuming that the event draws 75% of what it would in a normal edition of the tournament. In fact, stadiums would need to be 50% vacant in order for there to be a spare room available to a visitor to Qatar during that time.

Edition		Average attendance per game	Games played	Total stadium attendance
2018	Russia	47,371	64	3,031,768
2014	Brazil	53,773	64	3,441,450
2010	South Africa	49,500	64	3,167,984
	Average	50,215		3,213,734
Assumptions- Demand			Assumptions- Supply	
Qatar 2022 Visitors		Mix	Qatar hotel keys	
Domestic	40%	964,120.20	Existing	27,261
Regional	35%	843,605.18	Additions- 2020	988
Long haul	25%	602,575.13	Additions- 2021	10,000
Factor	75%		Additions- 2022	11,500
Total		2,410,301	Total	49,749
Average stay*	Nights	Keys required	Total hotel nights available, Doha	
Domestic	-	-	Capacity completion assumed	75%
Regional	2	843,605	Total rooms expected	37,312
Long haul	3	903,863	Tournament length (days)	30
Total rooms nights required		1,747,468	Total room nights available	1,119,353
* Assuming an average occupancy of 2 visitors/room			Deficit (surplus), nights	628,115
				56%

The above is a benchmarking exercise that looks at historical attendance figures for previous World Cup events, and converts a reasonable attendance estimate for Qatar 2022 into an estimate for the required stock of hotel keys throughout the event's 30 day duration. This is then compared to the tally of hotel keys, both operational and under construction, in Qatar by 2022. It suggests that a conservative attendance estimate matched with a generous hotel key supply estimate still indicate a shortage of rooms.

And this brings us back to the stock of 100,000 keys in Dubai. The re-opening of routes between the GCC and Qatar in January 2021 is likely to help reduce the reliance of the event on long-haul travelers attending the matches, and induce a spillover of tourists towards the UAE's 100,000 hotel keys, as well as Saudi Arabia's new adventure, nature and cultural tourism offering.

At the onset of the pandemic, Egypt had emerged from a record tourism year in 2019, overcoming many unfortunate events that harmed its security reputation in the past. Egypt would likely return in force once travel restrictions are meaningfully eased. Saudi Arabia's carefully tailored tourism offering aims to capitalize on its untapped nature attractions as well as creating destination-based travel centered around sporting events, theme parks, leisure and culture.

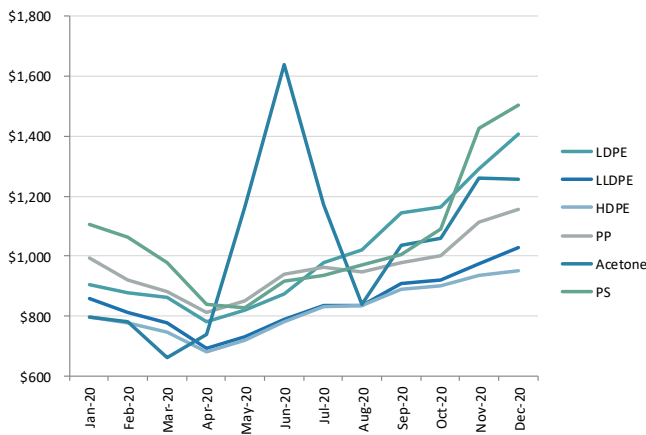
- Secular themes:** The healthcare and education sectors remain the most interesting secular growth stories in the MENA region. Healthcare plays in MENA enjoy strong volume catalysts (mandatory private sector health cover in KSA and the Universal Healthcare Act in Egypt), while downside risks (potential expatriate exodus from GCC) for now remain counterbalanced by relaxed residency measures. We watch for signals in Q1 2021, as Saudi Arabia's privately insured expatriate population base had shrunk in 2020, and the resumption of air travel in and out of the country now opens the gates for further departures. The overall state of the non-oil economy would dictate the net balance of expatriate residents in the country. Capacity growth across the system remains strong, as we see 50%+ growth in operating beds in KSA over the next 5 years.

Revisions to pharmaceuticals prices in Egypt hold upside risk to margins across the sector. Operating leverage will likely work well to support operating income growth across KSA hospitals, as available spare capacity (c.20% system-wide) can be utilized further post-pandemic. As has been the case in previous years, receivables across the sector remain a potential overhang, as government-linked business accounts for a considerable proportion of sales across hospital operators in MENA, as well as pharmaceuticals manufacturers and distributors in Egypt. Nevertheless, Saudi Arabia’s Ministry of Health recently allocated SAR 1.7bn towards the pro-rata settlement of receivable payments (a large component of which is linked to COVID-19 treatments), which partly mitigates the overhang.

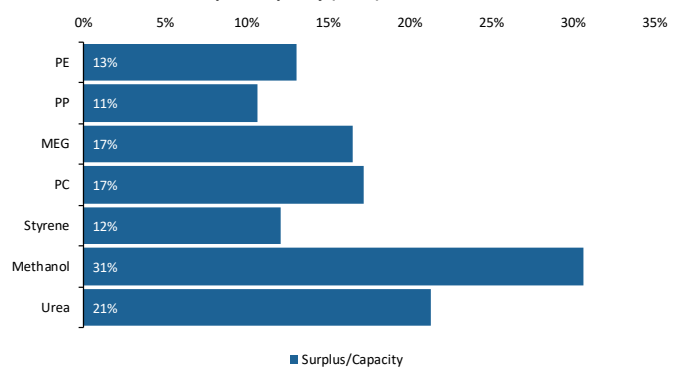
Education plays in MENA are of great interest to us, underpinned by strong fundamental drivers. 40% of Egypt’s population is within ‘education age’, while public sector capacity investments have generally been insufficient, creating an opportunity for private operators. In Kuwait, 2020 was to us a litmus test of the government’s commitment to upholding scholarship schemes, and it passed with flying colours, as fall 2020 scholarship numbers far outran expectations during a challenging year. This should continue to support private sector higher education providers.

- Cyclical themes:** We began 2020 with a bleak outlook for chemical prices, as global supply had exceeded present and near-term demand forecasts by a substantial margin, leading us to expect a weak cycle. The Coronavirus pandemic further exacerbated the oversupply situation in most products, and triggered decade-low prices and product spreads globally. For a brief period, the long standing cost advantage of GCC petrochemical producers vanished as higher cost competitors, utilizing unsubsidized energy sources, benefitted greatly from ultra-low market prices. Nevertheless, demand was greatly diminished as a result of global lockdowns.

Chemicals whose Prices Reacted Positively to Post-COVID Demand (USD/ton, Monthly)

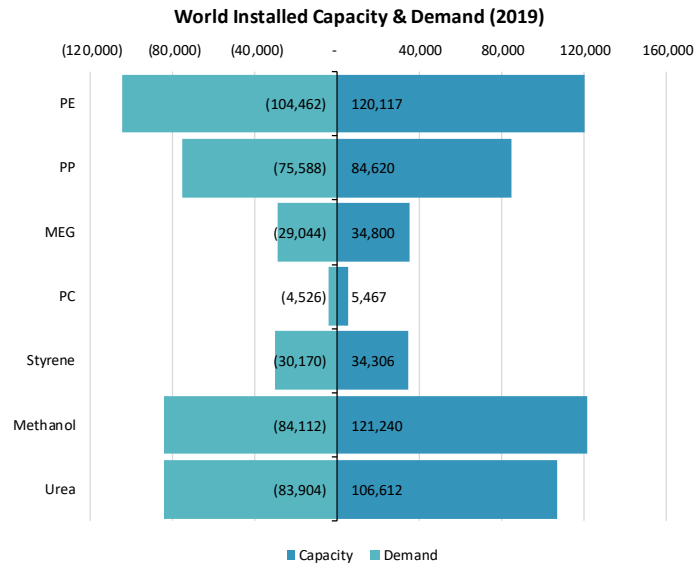


World Production Surplus/Capacity (2019)



Source: IHS estimates & HSBC estimates

Fortunately, the sector was soon to demonstrate its considerable self-correcting ability, which, coupled with growing demand for packaging materials and hygiene products, facilitated the bounce back. On the supply side, low demand and prices forced higher cost producers into shutdowns (maintenance or otherwise), gradually alleviating the supply glut. As for demand, we saw an early pick-up in demand for hand sanitizers in which acetone is a main ingredient, and facial masks made out of polypropylene. Increased appetite for online shopping during the lockdown period boosted demand for packaging materials such as polyethylene and polystyrene.



Source: IHS estimates & HSBC estimates

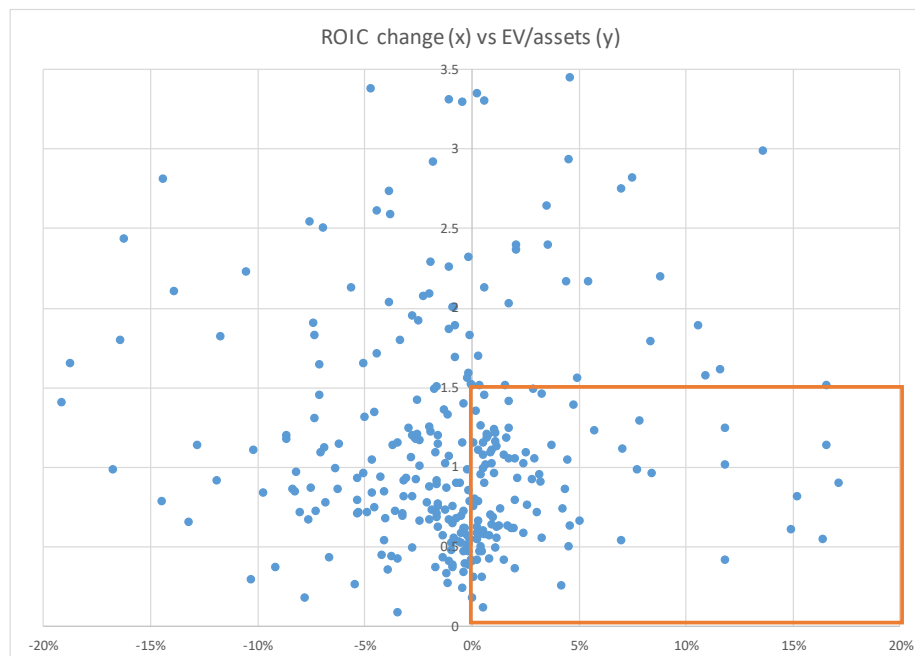
On a long time scale, we envisage global demand for petrochemicals to grow steadily, driven by advancements in sectors like technology, transportation and construction. Petrochemicals are recyclable and have such wide-ranging uses among various industries that it is hard to imagine an eco-friendly, innovation-driven future without them. This trend can be highly beneficial to an integrated oil/petrochemical companies like ARAMCO, and its subsidiary SABIC. Long term growth in demand for petrochemicals can offer ARAMCO an alternative channel to monetize crude oil, perhaps even at greater profit per barrel of oil equivalent. This is especially relevant in a world that is more environmentally minded and increasingly reliant on electricity for transportation.

An hour early to the boat

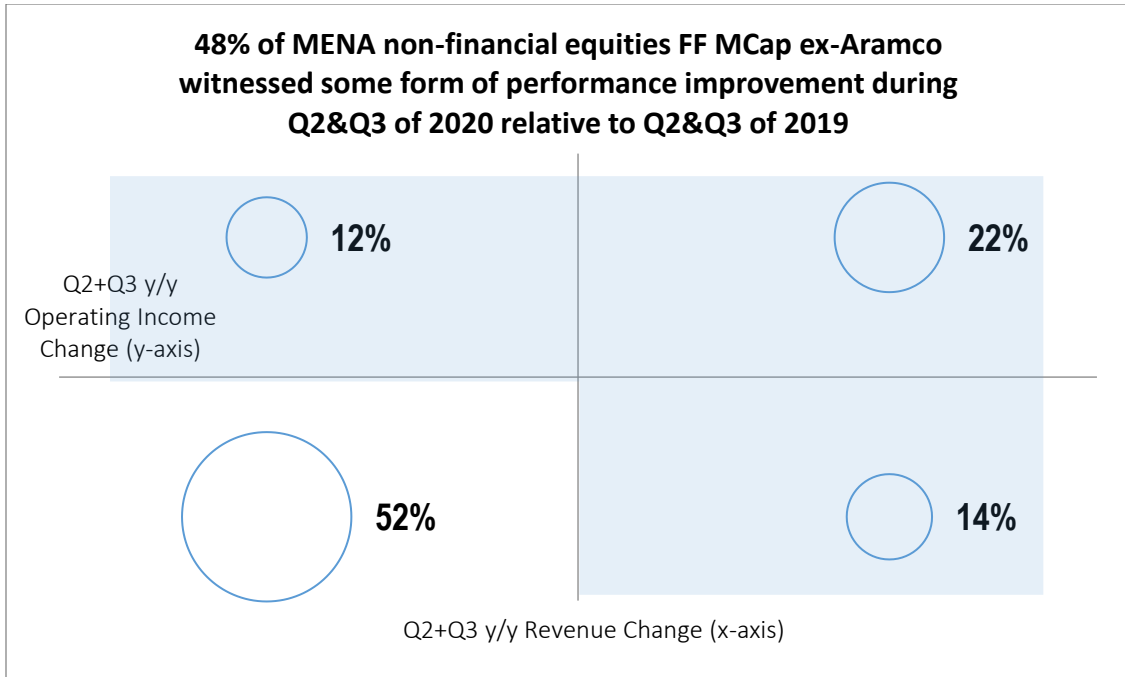
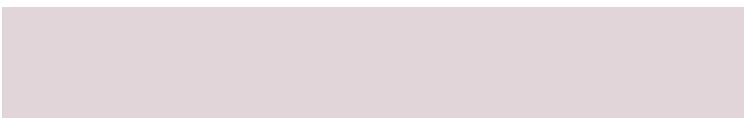
In our letter last year, we noted that we would ‘prefer to be an hour early to the boat, rather than miss its departure entirely’, referring to our conviction that timing our entry into cyclical value trades in the regional is secondary in importance to the imperative to select well. Our selection criteria sought to find businesses that had suffered substantial deterioration in earnings over several periods, but whose balance sheets had weathered the pressure. We then saw and continue to see a palette of candidate businesses in the industrials and materials sectors that fit the bill rather well.

Furthermore, and in the context of uncertainty over interest rates, we opt to diversify our exposure away from long duration businesses that derive the bulk of their value from further out into the future. A good barometer for this, in our opinion, is an EV/assets multiplier. A spike in interest rates would be detrimental to the valuations of companies with high multiples. We prefer to retain our ammunition for shorter duration, reasonably priced boring businesses that can realize a larger quotient of their intrinsic value over a visible timeline, during which discount rates can less dramatically alter affect business value, and leave enough room to add to such investments once the market decide to offer these businesses at a deeper discount.

Despite the hefty overall market valuations, companies that satisfy both criteria above may not necessarily be in short supply. A statistical scan of GCC and Egyptian equities that are liquid and above USD 100mn in market capitalization in size provides a reasonable deep selection pool.

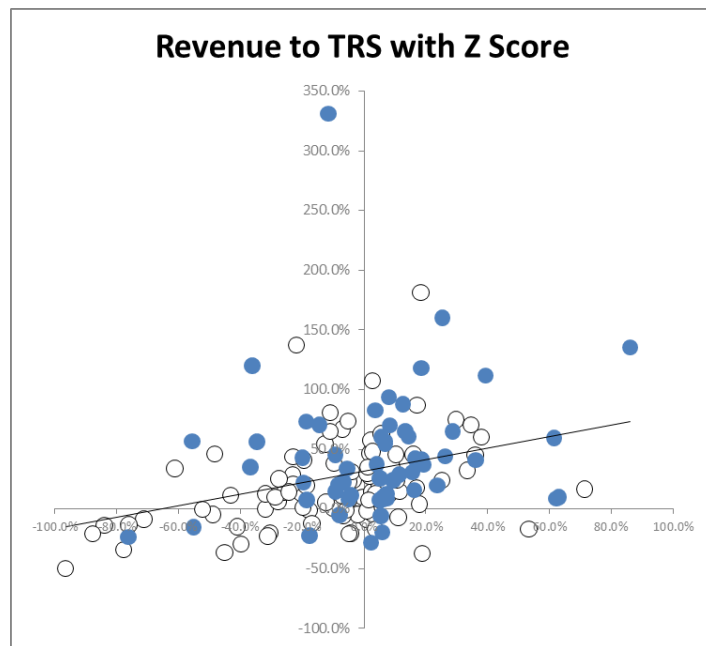


In the above chart, we plot the absolute change in the most recent trailing 12M Return on Invested Capital (ROIC) for candidate companies, against EV/assets. These businesses have endured the operational shock of the pandemic, and if fortunate to reside in the orange quadrant above, have either (i) directly benefitted from 2020, or (ii) produced enhanced returns *despite* it. Furthermore, they are among the cheapest businesses to invest in today.



Taking a look specifically at the two most affected quarters of 2020 (Q2 and Q3), and comparing revenues and operating income figures for regional non-financial businesses (and excluding Aramco, due to its size) with the corresponding period of 2019, it appears that 48% of MENA businesses (by free float market capitalization) experienced some form of performance improvement.

Another perspective on this would be to frame the pool slightly differently, as below:



The above exercise plots the change in revenues reported in the middle quarters of 2020 (Q2 and Q3, when the pandemic was arguably at its most severe), versus the respective period of 2019. It then compares that performance to the total return of each individual stock over that period. Businesses that operationally did well (right hand side of the chart), whether due to or in spite of the pandemic, may not necessarily have been fairly rewarded or punished by the market. The subset of companies below the trend line above suggests a candidate pool of businesses that have yet to be rewarded for resilience. The bubble colour also indicates the company's Altman z-score, which is a measure of business quality. The blue dots are the businesses that clear an Altman z-score threshold of >3 .

The key idea we wish to communicate is here is that:

-Despite the run up in valuations experienced in 2020, there is still ample selective value to be found, 2020 may not have been ideal to position for recovery in stocks beaten down by years of unfortunate cycle timing, 2021 presents that opportunity

-The risk of spikes in interest rates can materially disrupt the surge in equities, as discount rates are re-set higher and equity multipliers of all varieties de-rate.

-This requires that we select for low duration and deep value. This can be achieved by a robust process of screening for candidate businesses, which we believe yields a sufficiently deep pool of candidate companies that can produce a normalization in returns within a reasonably visible timeframe, and for which valuations are relatively attractive.

Concluding thoughts

Markets in aggregate seem to be currently priced to beyond perfection, in that much has to go right on the path to projected growth for them to justify the valuations bestowed upon them. And even then, they are not offering the kind of returns one would hope for over the next decade from where we are today.

In other words, equity markets are indeed expensive. The problem is, so is almost everything else. Except for some commodities related businesses and the value factor. We believe a good hedge against the inevitable reversal of the momentum trade could be in the form of growing exposure to selective concerns that correlate with these factors.

The timing of that reversal remains elusive, yet we know we are moving closer to it with every passing day.

Whenever we think that the markets are "approaching the sun" as Icarus did, we remind ourselves of former Federal Reserve Chairman Alan Greenspan who in December 1996 wondered whether the US equities markets had been exhibiting signs of irrational exuberance. Indeed by the eve of his speech, the market had quadrupled in as little as 7 years following the fall of the Berlin wall. The markets shrugged off those comments however, and instead went on a parabolic spin almost quadrupling again in as little as three years before they went crashing down. It follows that an expensive market is not a sufficient reason for it to crash.

But watching for euphoric and structural cracks along the way would probably better equip us to take advantage of the volatility to come.

Rereading Charles Kindleberger's *Manias, Panics and Crashes* may prove particularly insightful as it reveals a universal cycle of market participant behavior. In his description of Hyman Minsky's model, he writes: "At a late stage [*of a mania*], speculation tends to detach itself from really valuable objects and turn to delusive ones. A larger and larger group of people seeks to become rich without understanding the processes involved".

This- to us- sounds eerily contemporary.

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