Oil fall and China's slowdown steered the stock market rout

KFH CAPITAL INVESTMENT RESEARCH

Year 2015 witnessed a market downturn due to a sharp and prolonged decline in oil prices along with rising geopolitical tensions in the region. The mounting fear of a prolonged China slowdown further added fuel to the fire. Also; the world developed nations saw a marginal growth in their respective economies fueled partly by the quantitative easing program (Eurozone) and lastly, the Fed rate hike, just before the year end, forced investors to balance their strategy from markets to markets or other safe investment avenues. In general, the stated factors had a negative impact on the KSE market performance as well as on its GCC peers.

On the KSE market, all the indices ended the year in red as the KSE Price Index lost 14.1percent from its previous year closing and stood at 5,615.12; well below the psychological 6,000 mark, while the KSE Weighted Index fell by 13.0percent to close at 381.70. Meanwhile, the Islamic Universe of Kuwait Index; relatively performed better as it restricted its loss up to 7.64percent during the year. In terms of market capitalization, the overall market lost around KD 3.77 billion from the previous year closing; as total market cap fell by 12.59percent and stood at KD 26.15 billion in the end of 2015. On the trading activity, the market floor remained muted due to weak investment sentiments as total volumes were down by 22.02percent reaching to 41.56 billion shares during the year.

GCC Region

Based upon market capitalization, on an average the GCC market category reported a drop of 9.2percent compared to a small surge of around 3.0percent a year ago. None of the GCC indices closed in green. Doha, the best performer of 2014; turned out to be the worst performing market for 2015; down by 16.9percent; or to say; losing our $26.03 billion in the year. Bahrain remained the close competitor by losing 16.2percent of the last year market cap (-$ 3.61 billion). The heavyweight, Saudi Arabia, lost its sheen by 6.8percent despite the fall of 17.1percent in its index, which is the highest in the GCC Matrix. Courtesy to 3 new listings, which restricted a severe fall in its market cap.

The GCC markets performed in complete doldrums; and with a bitter fate if compared to other markets. Globally, the risks of greater market volatility, Fed's move towards the monetary tightening, slowing down trend of China's economy, persisting weakness in Japan and other emerging markets steered the global markets in a difficult volatile phase. In addition, the plunge in oil prices due to "oversupply-constraint" and slowdown in major oil importing economies acted as a dual-edge sword for the GCC countries. The markets did not show any respite to the US Fed hike by the year end, as poor "number-show" by China, and the post action of devaluing Yuan, cost markets too dearly. Also; the repetition of OPEC's determined decision of not to cut the production for the price-sake took a toll on regional markets as well.

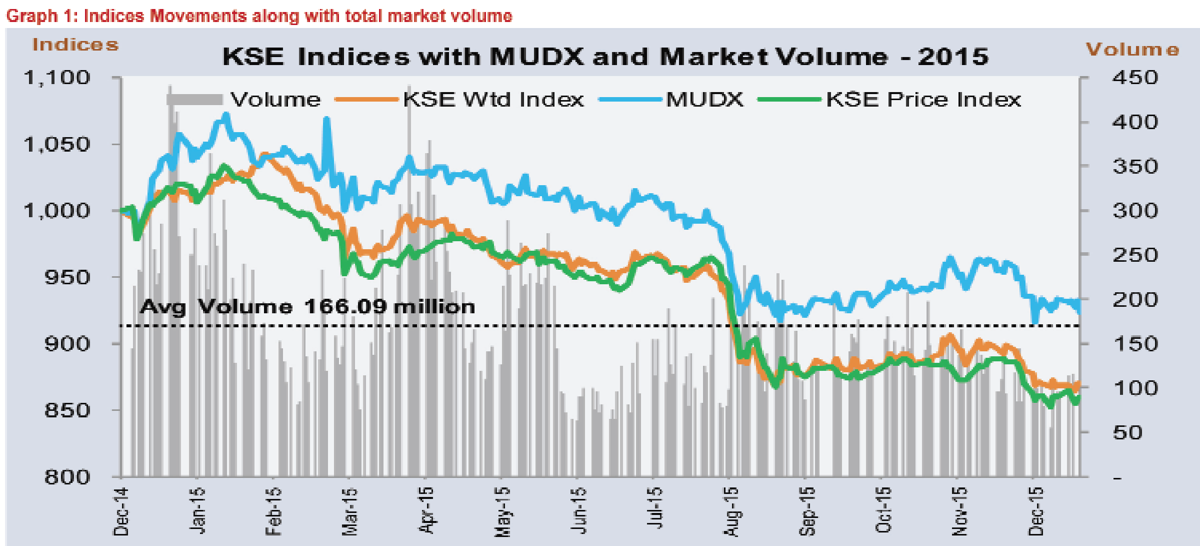
KSE performance

Q1-2015: Better than expected earnings; shareholder windfalls in terms of cash Dividends and/or Bonus Shares resulted in buoyant sentiments for the KSE at the inception of 2015. Riding high on these announcements, the KSE Price Index witnessed two months cumulative gain of 65.71 points to close at 6,601.43 on February 24, 2015. However; arising geo-political developments in the region resulted in a sharp correction as the KSE Price Index shed 318.67 points in the month of March itself. Nonetheless, the KSE Price Index closed at 6,282.46; down by 3.88 percent which we believe has been the case for majority of the regional markets with a few exceptions like Saudi - TASI which was up by 5.35 percent riding high on its previous stupendous gains. On the trading parameters, total volumes were up by 3.11 percent with 12.66 billion shares exchanging hands in the market which is an YTD daily average volume of 211 million shares.

Q2-2015: Throughout the second quarter of 2015, the market remained buoyant; in particularly starting from April till the end of the first week of May where the KSE Price Index touched its peak at the level of 6,416.18. Thereafter, the market lost its momentum and the Index declined by 213.23 points from its peak. By the end of second quarter, the market lost 79.51 points on q-o-q basis. Market's failure to sustain the upward trend might be a result of the uncertainty in global financial markets including the Greek debt crisis and volatility of the Chinese market. Also, the market was apparently affected by the oil price direction as the Brent oil price jumped by 20.25 percent during April to $ 64.42 pbl at the month end but couldn't extend its rebound till the quarter end and closed the quarter at $ 63.59 per barrel; thus registering an increase of 18.70 percent during the quarter. On the trading parameters, total volumes were almost stable; merely down by 0.04 percent with 12.66 billion shares exchanging hands in the market which is a daily average volume of 194.74 million shares.

Q3-2015: During the quarter, all KSE indices closed in the red zone as the Price Index lost 7.69 percent from its previous level to close below the 6,000 mark shedding 476.99 points and the Islamic barometer "MUDX" declined by 6.8 percent to close at 559.50 down 40.82 points. Market heavyweights were no exclusion from these extended bearish sentiments, as the Weighted Index went down by 7.51 percent whereas KSX15 declined by 8.06 percent. Total market cap stood at KWD 26.55 billion, marking a deflation of 7.45 percent during 3Q15. Trading activity remained muted, as the quarter's volumes stood at 8.09 billion shares, down sharply by 36.12 percent compared to previous quarter. Investors maintained a "Wait & Watch" mode for the listed companies' due to their awaited 3Q results.

Graph 1: Indices Movements along with total market volume



Source: KFH Capital Research

Q4-2015: The last quarter of the year was no exception and could not recover from losing streak. All of the KSE indices closed lower with the KSX15 being the worst performer as it reached to a level of 900.43 (down by 3.7 percent) followed by the Price index which lost 110.84 (-1.9 percent) to close at 5,615.12. Also, the KSE Weighted index lost 6.7 points (-1.7 percent) and closed the quarter and year at 381.70. On the market activity parameter, total volume were almost at the same level of the previous quarter; merely up by 0.62 percent with 8.12 billion shares and the daily average volume stood at 128.93 million shares.

Indices Peak & Lows: Towards the end of Year 2015, all market indices witnessed a major downtrend due to the weak market sentiments resulted from the persistency of low oil prices and the unstable geopolitical situation in the region. Market gauges couldn't get over their losses as all the indices reached their lowest level of the year in the month of December. Market volatility is still evident and observed through the wide range between the indices' year peaks and lows.

Table 3: Indices and its Sectors Performance - 2015

Sectors	KSE Price Index			MUDX Index		
	Dec-15	Dec-14	Chg %	Dec-15	Dec-14	Chg %
Oil and Gas	818.74	1,062.97	-22.98%	435.24	799.01	-45.53%
Basic Materials	986.38	1,131.32	-12.81%	NA	NA	NA
Industrial	1,043.03	1,070.37	-2.55%	1,133.16	940.38	20.50%
Consumer Goods	1,094.91	1,225.89	-10.68%	905.26	873.68	3.61%
Health Care	925.34	940.27	-1.59%	1,234.29	1,205.71	2.37%
Consumer Services	1,008.68	1,081.55	-6.74%	678.92	582.65	16.52%
Telecomunication	598.63	570.43	4.94%	259.90	234.40	10.88%
Banks	907.08	1,005.09	-9.75%	975.50	1,067.24	-8.60%
Insurance	1,126.99	1,177.41	-4.28%	475.53	941.02	-49.47%
Real Estate	940.76	1,129.97	-16.74%	997.59	1,223.85	-18.49%
Financial Services	595.38	832.14	-28.45%	608.25	714.86	-14.91%
Technology	820.16	916.29	-10.49%	723.57	776.32	-6.79%
Total Market	5,615.12	6,535.72	-14.09%	554.91	600.79	-7.64%

Demand Outlook: 2016

As for 2016; global oil demand is estimated to be at 94.13mb/d with an addition of 1.25mb/d or 1.34 percent increase over 2015. OPEC believes an unwarranted macroeconomic environment is to restrain 2016 demand compared to 2015 additions of 1.53mb/d. As shown in the table below undoubtedly it is the emerging economies which include China & India; the Middle East and North America as the key demand drivers for crude. North America with 24.84mb/d is expected to report a growth of 1.22 percent (0.3mb/d) for 2016. Other Asia region which includes India is forecasted to record a 2.47 percent (12.05mb/d) growth of which India's demand forecast is 4.12mb/d an increase of 3.65 percent. For China the growth is forecasted to be 2.77 percent (11.14mb/d). The Middle East is estimated to record 2.52 percent jump in demand to 8.55mb/d; which we believe is due to the demand from the power sector Middle East region exploits crude to generate power.

Oil Supply
Current Scenario: 2015

The total Non-OPEC supply for 2015 is expected to be 57.51mb/d an increase of 1.75 percent over 2014. As anticipated the supply surge among Non-OPEC is to be led by the OECD region of which specifically the US. The estimated supply from the OECD for 2015 is to be 24.9mb/d which is an additional 0.71mb/d of supply in the market which translates to a supply increase of 2.89 percent over 2014. Of which the US supply stood at 13.77mb/d a whopping 6.25 percent increase over previous year.

As of 2014 the supply from the US stood at 12.96mb/d meaning that 2015 saw an additional 0.81mb/d of supply from the US which was primarily due to shale oil producers. However with the price decline and high operating costs for shale oil producers has elevated concerns of sustainability resulting in a production decline which is evident from the decline in oil rig counts across the US. Thus we are looking at a rapid deceleration in supply beginning Q4 of 2015 which is likely to be seen in coming quarter of 2016 as well. The supportive fact include the Q32015 supply numbers for US which stood at 13.87mb/d while the preliminary forecast for Q42015 is 13.57mb/d.

The other Non-OPEC regions are likely to provide an incremental increase in supply like the "Developing Countries (DC)" to add an additional 0.14mb/d to the overall supply which is to reach 12.33mb/d an increase of 1.1 percent while the "Other Regions" which includes Russia is to add 0.12mb/d to touch 18.09mb/d figure a marginal increase of 0.66 percent over 2014.

Supply Outlook: 2016

We are likely to witness a balance in the supply side which we believe is triggered by the prolonged low crude oil prices. The supply slowdown will be apparent foremost in the OECD region predominantly the US; the OECD supply for 2016 is estimated to be 24.56mb/d a 1 percent decline compared to 2015. Of which the US supply is likely to be at 13.6mb/d a drop of 1.23 percent over 2015 wherein it is to average at 13.77mb/d.

The total Non-OPEC supply is projected at 57.14mb/d decrease of 0.37mb/d compared to 2015 as shown in the table above. On regional basis the "Developing Countries (DC)" is likely to be the only region with supply addition for 2016; the total DC supply is estimated to be at 12.38mb/d a minimal increase of 0.47 percent over 2015. While the "Other Regions" which includes Russia is to be muted with supply decrease by 0.93 percent to 17.91mb/d with Russian supply to be at 10.7mb/d a marginal 0.65 percent decline.

On the Supply & Demand balancing scale, as shown in the table below; our opinion of a price prompted demand supply balance holds strong. As shown in the table below world demand is going to increase by around 1.25mb/d while the Non-OPEC supply is to come down by 0.37mb/d to 57.14mb/d while the NGLs and Non-conventional are to supply 0.17mb/d, meaning a supply decline of 0.2mb/d from these two categories. Thus the OPEC will witness an increase of 1.44mb/d which is a whopping 4.91 percent increase in supply from the OPEC members in order to balance the Supply/Demand equation.

Graph 2: Market Cap and its Growth

Source: KFH Capital Research

Oil Outlook - 2016

As we compile the annual report; the crude prices have already breached the $ 30 per barrel mark as the NYMEX recorded trading at $ 29.4 per barrel while the Brent Crude at $ 28.84 per barrel. Given the recent sharp correction in oil prices we believe prices for crude will continue to remain subdued and volatile during the 1H2016. However; our analysis supports the argument of a gradually uptick in prices during the second half of 2016 and in line with the BMI forecast of Brent Crude range of $ 48-51 per barrel for 2016.

Continued supply glut; weak demand; currency fluctuations are the basis of potential downside risk on crude oil prices during the 1H. Thus the High supply and Low Demand situation will prevail during 1H2016 resulting in the prices to remain subdued as shown in the Demand-Supply matrix.

However; continued recovery of developed economies supported by expansive monetary policies in Eurozone; Japan and key structural reforms on the back of lower commodity prices in key emerging economies will drive demand growth. Thus renewed demand coupled with supply rebalancing will result in a relatively High Demand and Low supply situation during 2H2016 resulting in price recovery.

* Strong Demand: As per BMI the world GDP for 2016 is estimated to be at 3 percent compared to 2015 wherein the preliminary numbers suggest world GDP to be at 2.7 percent. While IMF estimates are far aggressive as it estimates GDP growth of 3.1 percent for 2015 and a strong 3.6 percent recovery in 2016. As per our understanding the considerable uptick in economic activity is on the back of lower commodity prices and accommodative monetary policies. While the latter will be the key driver for advance economies the former will provide the stimulus required in emerging economies for structural economic reforms.

* Supply Rebalancing: The recent decline US shale oil supply will be more prominent as the year progresses; the excess supply created by US shale oil producers will accelerate more aggressively in 2H on the back of prolonged low oil prices due to unsuitability of production margins at current levels.

Kuwait Economy - All set to record first deficit; since 1999

Kuwait has made substantial fiscal surplus in past more than 15 years, but remains somewhat vulnerable to fluctuations in global energy markets. Under the falling trend of oil prices, there is an eminent threat for the end of the massive budget surpluses seen over the past few years, even if oil prices recover to a level of around $55-60/bbl over the coming five years. The worst case, if dependency on the energy sector is not reduced and substituted by non-oil industries, threats could emerge to long-term economic sustainability. Despite efforts by the government to diversify, oil exports remain the backbone of Kuwait's economy, and it is not expected to change any time soon. Earlier the Business Monitor Index (the economic source of this report) forecast a real GDP growth of 2.7 percent and 2.5 percent for 2015 and 2016 respectively; but the same is revised further to a lower level of 2.5 percent and 1.9 percent respectively in the coming two years.

Main concerns and key challenges on the road ahead:

* The sustained decline in oil prices over the coming years will weigh only modestly on private consumption and government spending.
* Non-oil economic activity will remain relatively strong and provide a fillip to headline GDP.
* Kuwait will remain a laggard in the GCC.
* Fixed investment will be buoyed by the approval of the five-year development plan, and become an increasingly important growth driver in the coming years.
* Export growth will pick up slowly as low-cost producers such as Kuwait are able to increase output with oil around $50-60 a barrel.

Outlook

On a regional level, Kuwait will continue to lag the rest of the Gulf Cooperation Council (GCC) over the coming years: the dominant hydrocarbons sector will weigh on headline growth while efforts to diversify the economy away from oil remain on a small scale.

e/f = BMI estimate/forecast. Source: BMI, Ministry of Finance

While a general study warns for "cautious outlook" about the country's medium-term investment, it also suggests that an acceleration in bank lending in the first half of 2015 and signs of progress on some of Kuwait's development projects have improved the growth prospects for gross fixed capital formation.

Lagging behind in terms of diversification, Kuwait has not seen the same the kind of consumer boom seen in the UAE, Qatar and Saudi Arabia over recent years, with a stagnation in the retail sector since 2010. Not only this, the country has fallen well behind other Gulf States in terms of vehicle sales growth in recent years, due to the structure of the economy. There was growth of 3.2 percent in automotive sales in 2014 (with sales peaking at 112,728 units), following a 0.2 percent decline the year before.

Economic Breakdown

Private Consumption: Private consumption growth will remain strong over the coming quarters supported by low interest rates, abundant liquidity conditions and increase in handouts earlier this year. In line to BMI, we also expect these trends to continue over the coming quarters and forecast private expenditure growth of 2.5 percent in both the years of 2014 and 2015, lower than earlier forecast of 3.0 percent.

In Q315, the IMF recommended the introduction of a value-added tax on a range of consumer items as well as a sharp reduction in subsidies on fuel. We believe, in line to the BMI, that these measures will not be enacted, given the huge fiscal buffers at the hands of the government and thus private consumption growth will be supported by fiscal spending.

Government Consumption Outlook: Kuwait's five-year development programme bodes very well for fixed investment in the country; an area which has traditionally been a weight on headline growth. The government has a plan to spend KWD 11.8 billion a year over the next five years, and there appears to be greater political will to ensure implementation rates are higher than the historical average of around 75 percent. If we put aside the issue of lower revenues, and think otherwise, then indeed, the collapse in oil prices has only served to increase the importance of the investment plans, especially given its focus on diversifying away from hydrocarbons. The BMI team forecast the government spending to increase by 3.0 percent and 2.5 percent in 2015 and 2016, respectively, a slight slowdown compared with the past two years.

Fixed Investment Outlook: Following the approval of the five year development plan, the traditionally lackluster performance of fixed capital investment will lessen slightly over the coming years and will bolster fixed investment. The plan envisages spending of over $100 billion on infrastructure projects, hospitals, power stations and more than 100,000 residential housing units. This includes the first phase of the Lower Fars heavy-oil project costing $ 4.2 billion. The average implementation rate of the CAPEX budget has been approximately 75 percent over the last five years, weighed down by several negative factors across political and legislative areas.

Net Exports Outlook: Recent developments within the OPEC group have led to a new equation, where a pressure to maintain market share could now be felt. Oil production growth in Iraq and the return of more Iranian crude to international markets from 2016 has added impetus to investment in Kuwait's oil sector. And it can, potentially lead to stricter regulation on production. However, as yet this has failed to translate into greater efficiency for in the approval of new projects

The oil and gas sector is all set to exhibit modest growth over the coming quarters and contribute only modestly to overall economic growth. Kuwait's crude output has flat lined, registering a growth of just 0.5 percent y-o-y over the first eight months of 2015. Output averaged 2.79mn barrels per day (b/d) in 2014, and the BMI's research team expects only modest gains over the medium term, with production including condensate and natural gas liquids expected to average around 3.05mn b/d in 2015. Due to increased domestic consumption of oil, it is expected that oil exports to grow by only 1.1 percent in 2015.

Fiscal Deficit: Kuwait will record its first fiscal deficit since 1999 in 2016 as oil prices remain weak and spending plans pick up, by the country's standards. As per the BMI team, the deficit of 2016 will amount to 0.5 percent of GDP, before small surpluses are recorded from 2017 onwards. On contrary, the government of Kuwait forecasts a deficit of 8.5 percent of GDP in 2016, with sustained deficits after. The forecast of government is based on the oil price averaging $45-50/bbl, far lower than BMI's forecasts. Indeed, the Kuwaiti government tend to underestimate revenues while also predicting far higher spending, despite historically low capital execution rates. This means that while Kuwait will see a drastic fall in the size of its fiscal surpluses over the coming years, it will not have to rein-in spending significantly, nor significantly touch its foreign reserves to plug deficits.

In a nutshell

Oil prices are not set for a rapid recovery. The US oil production constraint, supply dynamics in other major oil producers including Russia and Saudi Arabia, future demand weakness from China, and the likelihood of a breakthrough in Iranian sanctions negotiations are ky parameters which will keep the price in low-range for coming few years. Under the low-price factor, Kuwait's near total reliance on oil for budget revenues (92.1 percent in 2014) will cause a degree of restraint on the spending front with subsidies set to be one area targeted, but beyond this the broadly loose fiscal policy will remain unchanged. Non-oil revenues will rise slightly given earnings from overseas investments and growth in the transport sector; however, this will do little to counteract the impact of substantially lower oil prices. It is also likely that Kuwait will seek to cut subsidies for expats in a similar vein to actions by Bahrain and some emirates in the United Arab Emirates. Indeed, we remain cautious about the country's medium-term investment outlook given lower oil prices.