Opalesque Exclusive: **Middle-East faring better than E.M. peers, the 6 MENA-focused HFs are long-only with adds-on, regulators to look into synthetic short-selling that is taking place**

Benedicte Gravrand, Opalesque London, reports on Tuesday's JetFin conference "Middle East hedge funds" and on emerging markets – October 15th, 2008

Middle-East faring better than its emerging market peers
The Middle-East is faring better than its emerging market peers, although the ride is still a bit bumpy. Gulf stock markets tumbled several days in a row last week and the week before that, Kuwait injected cash into the financial system, a move aimed at shoring up confidence in its banks as a deepening global financial crisis caused liquidity to tighten in Gulf states (coverage).

The MSCI Frontier Market (which include 6 Middle East countries among 19) index was down 4.27% yesterday, -8.44% MTD and -30.77% YTD.

The MSCI Arabian Market index was up 5.25% yesterday, -4.39% MTD, -32.14% YTD, the GCC Countries index was up 5.44% yesterday, -3.73% MTD, -32.98% YTD.

And the MSCI Emerging Market index is experiencing a bigger decline; it was up 5.99% yesterday, -14.38% MTD and -45.91% YTD.

The Credit Suisse/Tremont Emerging Europe, Middle East and Africa index dropped -19.07% in September and -10.71% in August (Source).

Middle-East and North Africa (MENA)'s population amounts to 460m and covers:
- Turkey
- Levant (Syria, Lebanon and Jordan – as well as Palestine and Israel)
- Iraq
- Saudi Arabia, United Arab Emirates
- Other Gulf States (Kuwait, Bahrain, Dubai, Oman, Qatar)
- Yemen
- Egypt
- Other North Africa countries (Morocco, Algeria, Tunisia, Libya)

Where the ball is going to
Some of the overriding ideas at the conference were that the region was not insulated from the financial crisis as investors were fleeing emerging market funds, but it could fall back on its significant liquidity levels. The region's stocks were down around 30% but other E.M. markets were down around 50%. Real estate continues to grow due to high demand – this sector is deemed to have no systemic risk. And Shariah investing can - and should - be seen as ethical investing.

This region is where the ball is going to, said Eric Swats, of Rasmala Investments (UAE). Economic activity will remain robust with oil prices and government investments. The average GDP growth for 2008-09 is forecasted at 5.9%. While in 2003-05, there was a huge bull run in which markets were overvalued, 2006 saw a spectacular correction. The next stage will be a multi-year secular bull market.

The investment opportunity in MENA, as its market capitalisation is around $1.36tln, is making it comparable to Brazil and India; price earnings rations are 15X; the return on equity is high due to a limited competition in many key industries and foreign participation will grow quickly as interest expands, markets liberalize and barriers to entry to investments are expected fall. The risk profile is much lower than in other E.M. countries. Furthermore, the MENA equity markets have exhibited a low correlation (between -0.01 and +0.2) to all key asset classes, which will remain quite modest into the future.

Eric Swats told Opalesque that the key macro-economic factors in the region were oil and monetary policies. He also said that the region was heading towards monetary union as plans are underway. The region is also home to a lot of resource-intensive manufacturing process, it exports fertilisers (an output of petro-chemical process) and it is a logistical hub for imports and exports transportation.

Unofficial short-selling
The GCC (Bahrain, Qatar, Kuwait, Oman, Saudi Arabia, United Arab Emirates) fund industry's AUM is $57.150bln and there are 542 funds, said Pamela Cahikhani of ABQ Zawya (UAE). Hedge funds are still new to the Middle-East; there are now 6 MENA-focused hedge funds with $2.19bln in total AUM and 5 MENA fund managers operating global hedge funds. The first hedge fund (Argent or Amina) was registered in 2006 in Dubai.

There are obvious challenges for hedge funds as financial transactions have to comply with the Islamic Shariah law. So short selling is not permitted (you cannot sell what you do not own). However some synthetic short selling is being done offshore by companies outside the Gulf.

Pamela Cahikhani explained to Opalesque that this was not illegal, although it was non-official: it is done through foreign prime brokers who short-sell Gulf stocks – from abroad. "It's a form of mimicking and you can never get to the bottom of it," she said. "Regulators are looking into it. They won't necessarily restrain it but there will be reforms."

Strategies in ME
Big institutions offer prime brokerage internationally, but prime brokers don't always have access to MENA stocks, said Amin El Kholy of Shuaa Asset Management (UAE). So it also all depends on who wants to lend.

Strategies for Middle East hedge funds are long-only, long hedges and long/short (since 2006). The ME investible universe comprises approximately 500 companies. Most of the 6 MENA-focused hedge funds use long-only investments with adds-on. There is a long-only secular story in the region, he pointed out. You can short GDRs and TRS but the reality is that shorting is a real constraint. Other methods such as pair trading, trading via commodity prices, convertible arbitrage - are all very risky, as there is insufficient data, and markets are unpredictable.

Manic depressive
The region is either in a manic state or in a depressive state, said Raghu Mandagolathur, of Kuwait Financial Centre "Markaz". This year, it is depressive.

Although the fundamentals are very strong, the financial crisis (a black swan event) has affected it. But oil would have to be priced at below $30 p.b. for the GCC governments to really slow their spending. They are sitting on a huge surplus at the moment.

So what can change the picture? Stability in oil price; earnings surprises; dollar strength (the region is dollar-pegged); support from sovereign wealth funds (they did not come to the rescue in 2006); and monetary relief. "Today there are very cheap valuations: one can go bargain hunting," he added. A lot of international fund managers missed the GCC story in 2000 and now is their second chance.

Compared to… emerging markets
With stocks tumbling and investments out-flowing at record pace, emerging markets seem to be unlikely – but logical - victims of a credit crisis that had started elsewhere. Foreign investors who

saw the strong fundamentals of those rising economies, have been investing heavily in E.M. over the last few years, also embracing the risks attached to them. Now they are redeeming, either to meet liquidity needs or to park their capital in safer havens. Add to that a fall in commodity prices – commodities are some of the E.M.'s main assets – and the situation is now dire.

The MSCI Emerging Markets Index fell 6.5% to 630.14 yesterday. It rallied 14 percent in the previous two days, the most since it was set up two decades ago. Emerging market stocks and bonds had rebounded after a record 20 percent slump in the MSCI Emerging Markets Index last week (Bloomberg.com).

IOSCO's Emerging Markets Committee met in Marrakech this week to launch an task force to assess the implications of the current financial crisis within emerging markets jurisdictions, and the IMF has decided to use a emergency-loan program to lend hundreds of billions of dollars to emerging markets as the credit squeeze threatens to hobble nations (coverage).

A Merrill Lynch report last week said that that emerging markets remained in "maximum danger" and had suffered $30bln in outflows in recent weeks. But "there is a much better case for a soft landing in emerging markets than in the G7" (coverage).