KAMCO
كامكو

KAMCO Research

Event Update : IMF Releases Global Financial Stability Report

April-2016

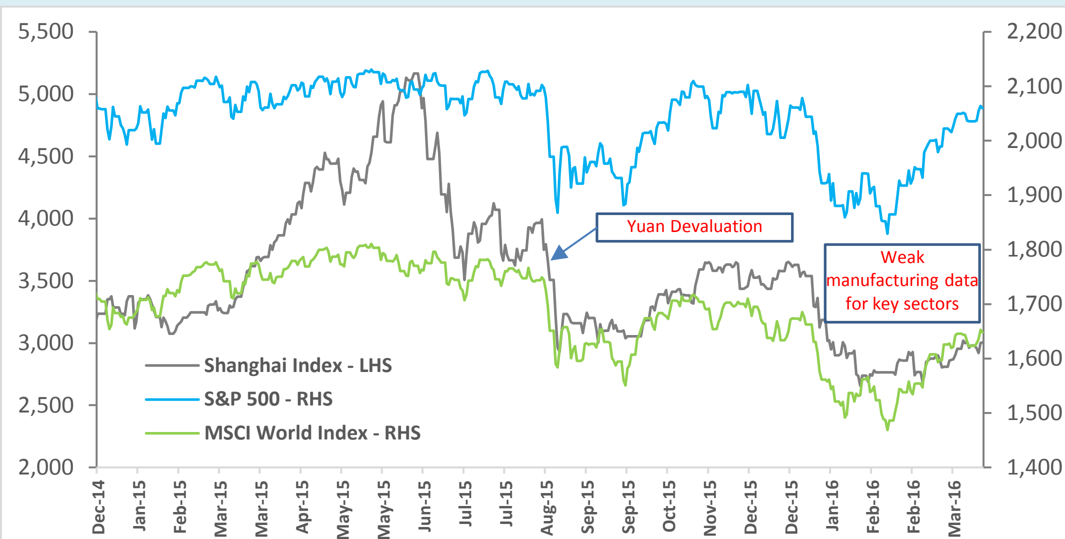
IMF released the April-16 update for the Global Financial Stability Report that primarily highlights the interdependencies between the emerging market economies and the rest of the world and how the interconnected nature of the global financial markets results in spillovers and volatility. *In the current report, the IMF analyzed the emerging market equity and foreign exchange markets and their impact on asset returns in other countries followed by a deep dive into insurance sector. We have focused our analysis on the former in this report.*

According to the report, there has been a substantial increase in spillovers of emerging market shocks to equity prices and exchange rates in advanced and emerging market economies that now explain over a third of the variation in asset returns in these countries. *On the other hand, bond market continues to display resilience to regional shifts and are largely moved by global factors. One of the reason for the spillover is the structural changes in the financial markets, e.g. the expansion of the mutual fund industry that now involves retail investors on a larger scale than before. Moreover, the impact of developments related to economic fundamentals on the equity market in both emerging market and advanced economies has been rising.*

For instance, in the case of China's economic slowdown, the impact on the local and global equity markets has been significant. As seen in the below chart, China's equity markets were swayed by a currency devaluation (August-15) and later on by negative manufacturing data for key sectors. *This affected the local stock markets and had a significant impact on the global equity markets as well. Moreover, the correlation between Chinese equity markets was significantly stronger in 2015 as compared to the correlation in 2014. The primary reason for this was an expected slowdown in Chinese economy and fears of a hard landing over the past couple of years that became more certain during 2015.*

As far as policy implications are concerned, policymakers need to take into account economic and policy developments in emerging market economies. In addition, a reverse impact from changes in policies and economic conditions in advanced economies on emerging market economies is also likely to become more significant owing to higher policy cooperation between the two groups. *Moreover, widening the depth of local capital markets in the emerging markets should reduce the dependence and/or spillover from external shocks. Considering the rising importance of mutual funds and the direct relationship between corporate debt and vulnerability to external spillovers, countries must implement a strong risk surveillance mechanism to guard against financial stability risks and risks related to excessive increases in corporate leverage.*

Trend in Chinese Equity market vs. US and Global Indices



Source: Bloomberg, KAMCO Research

Faisal Hasan, CFA
Head - Investment Research
+(965) 2233 6907
faisal.hasan@kamconline.com

Junaid Ansari
Assistant Vice President
+(965) 2233 6912
junaid.ansari@kamconline.com

The Financial Crisis of 2009 set the tone...

According to the report, financial market spillovers from emerging market economies have been significantly stronger since global financial crisis. The trend remained elevated after the crisis for almost 4 years only to pickup from late 2014. In terms of specific regions, the BRICS economies have seen a rise of 40% in spillovers. In addition, emerging market that have more integrated financial markets (Brazil, Chile, Mexico, Poland and South Africa) have seen a greater degree of equity market spillovers as compared to spillovers from larger emerging market economies that have a more segmented financial markets, like the ones seen in China and India. In addition, differences in country risk have become less significant in determining spillovers to advanced economies.

Financial factors vs. trade relations

The role of financial factors in increasing spillovers measured in terms of FDI and FII flows have risen as compared to trade relations between economies measured in terms of trade openness and bilateral trade volumes. On an average, trade linkages account for 10%-20% of equity return spillovers in emerging market economies and is higher in the case of commodity-exporting countries. On the other hand, 30%-40% of equity market spillovers from emerging market to advanced economies are contributed for by higher market integration.

In terms of sectors, spillovers between same sectors are more as compared spillovers between different sectors. Moreover, larger and economically important sectors like finance, basic materials and oil & gas have seen consistently higher spillovers whereas sectors such as retail, consumer goods and services have seen lower spillovers.

Mutual funds fueling growth in spillovers

The presence of common investors or asset managers investing in similar asset classes across borders are more likely to reduce their exposure to the asset class in case of declining returns and vice versa as compared to benchmark returns. For instance, an investor in frontier markets benchmarked to the MSCI Frontier Markets index is more like to reduce his exposure to the entire group of countries in case he is overexposed to these markets especially when the risks are expected to escalate. This comes primarily on the back of the largescale globalization of the financial sector with strong integrated financial markets and limited flow of money in and out of a particular country. Moreover, financial interdependence through common investors is a major factor in equity return spillovers that has seen a significant increase post the global financial crisis.

Gulf markets to play a larger role going forward

With the ongoing turbulence in the oil market affecting state coffers of Gulf economies, a number of new capital raising efforts are ongoing and an even stronger trend is expected in the near-to-mid term. KAMCO Research believes that this new phase in capital markets in the GCC would make them mainstream in the global context owing to the relatively strong credit standing of a majority of the gulf states (miniscule debt -to-GDP ratio) as well as abundant resources in the form of oil.

The aforementioned trend was evident when UAE and Qatar markets were included in the MSCI Emerging Markets index in 2014 and the serious efforts being put in by Saudi Arabian capital markets regulator to open the markets to foreign investors. This inclusion in MSCI led to additional flow of passive funds in these markets. We expect a number of new corporate and government bond issuances in the region as the fixed income asset class is still at a very nascent stage and could be tapped in a bigger way. Moreover, in the equity market, we believe that the IPO market would gain stream once the markets stabilize after recovering from oil woes. Another positive trend is the increasing acceptance of Islamic financial products in the global fund markets that should drive a number of issuances going forward. The above factors should result in greater spillovers from the Gulf regional markets to the global capital markets.

Disclaimer & Important Disclosures

KAMCO *is authorized and fully regulated by the Capital Markets Authority ("****CMA, Kuwait****") and partially regulated by the Central Bank of Kuwait* ***("CBK")***

This document is provided for informational purposes only. Nothing contained in this document constitutes investment, an offer to invest , legal, tax or other advice or guidance and should be disregarded when considering or making investment decisions. In preparing this document, KAMCO did not take into account the investment objectives, financial situation and particular needs of any particular person. Accordingly, before acting on this document, investors should independently evaluate the investments and strategies referred to herein and make their own determination of whether it is appropriate in light of their own financial circumstances and objectives. The entire content of this document is subject to copyright with all rights reserved. This research and the information contained herein may not be reproduced, distributed or transmitted in Kuwait or in any other jurisdiction to any other person or incorporated in any way into another document or other material without our prior written consent.

Analyst Certification
Each of the analysts identified in this report certifies, with respect to the sector, companies or securities that the individual analyses, that (1) the views expressed in this report reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly dependent on the specific recommendations or views expressed in this report.

KAMCO Ratings
KAMCO investment research is based on the analysis of regional and country economics, industries and company fundamentals. KAMCO company research reflects a long-term (12-month) target price for a company or stock. The ratings bands are:

* ***Outperform:*** *Target Price represents expected returns >= 10% in the next 12 months*
* ***Neutral:*** *Target Price represents expected returns between -10% and +10% in the next 12 months*
* ***Underperform:*** *Target Price represents an expected return of <-10% in the next 12 months*

In certain circumstances, ratings may differ from those implied by a fair value target using the criteria above. KAMCO policy is to maintain up-to-date fair value targets on the companies under its coverage, reflecting any material changes to the analyst's outlook on a company. Share price volatility may cause a stock to move outside the rating range implied by KAMCO's fair value target. Analysts may not necessarily change their ratings if this happens, but are expected to disclose the rationale behind their view to KAMCO clients.

Any terms and conditions proposed by you which are in addition to or which conflict with this Disclaimer are expressly rejected by KAMCO and shall be of no force or effect. The information contained in this document is based on current trade, statistical and other public information we consider reliable. We do not represent or warrant that such information is fair, accurate or complete and it should not be relied upon as such. KAMCO has no obligation to update, modify or amend this document or to otherwise notify a recipient thereof in the event that any opinion, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. The publication is provided for informational uses only and is not intended for trading purposes. The information on publications does not give rise to any legally binding obligation and/or agreement, including without limitation any obligation to update such information. You shall be responsible for conducting your own investigation and analysis of the information contained or referred to in this document and of evaluating the merits and risks involved in the securities forming the subject matter of this or other such document. Moreover, the provision of certain data/information in the publication may be subject to the terms and conditions of other agreements to which KAMCO is a party.

Nothing in this document should be construed as a solicitation or offer, or recommendation, to acquire or dispose of any investment or to engage in any other transaction, or to provide any investment advice or service. This document is directed at Professional Clients and not Retail Clients within the meaning of CMA rules. Any other persons in receipt of this document must not rely upon or otherwise act upon it. Entities and individuals into whose possession this document comes are required to inform themselves about, and observe such restrictions and should not rely upon or otherwise act upon this document where it is unlawful to make to such person such an offer or invitation or recommendation without compliance with any authorization, registration or other legal requirements.

Risk Warnings
Any prices, valuations or forecasts are indicative and are not intended to predict actual results, which may differ substantially from those reflected. The value of an investment may go up as well as down. The value of and income from any investment may fluctuate from day to day as a result of changes in relevant economic markets (including, without limitation, foreseeable or unforeseeable changes in interest rates, foreign exchange rates, default rates, prepayment rates, political or financial conditions, etc.).

Past performance is not indicative of future results. Any opinions, estimates, valuations or projections (target prices and ratings in particular) are inherently imprecise and a matter of judgment. They are statements of opinion and not of fact, based on current expectations, estimates and projections, and rely on beliefs and assumptions. Actual outcomes and returns may differ materially from what is expressed or forecasted. There are no guarantees of future performance. Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors. This document does not propose to identify or to suggest all of the risks (direct or indirect) which may be associated with the investments and strategies referred to herein.

Conflict of Interest
KAMCO and its affiliates provide full investment banking services, and they and their directors, officers and employees, may take positions which conflict with the views expressed in this document. Salespeople, traders, and other professionals of KAMCO may provide oral or written market commentary or trading strategies to our clients and our proprietary trading desks that reflect opinions that are contrary to the opinions expressed in this document. Our asset management area, our proprietary trading desks and investing businesses may make investment decisions that are inconsistent with the recommendations or views expressed in this document. KAMCO may have or seek investment banking or other business relationships for which it will receive compensation from the companies that are the subject of this document. Facts and views presented in this document have not been reviewed by, and may not reflect information known to, professionals in other KAMCO business areas, including investment banking personnel. United Gulf Bank, Bahrain owns majority of KAMCO's shareholding and this ownership may create, or may create the appearance of, conflicts of interest.

No Liability & Warranty
KAMCO makes neither implied nor expressed representations or warranties and, to the fullest extent permitted by applicable law, we hereby expressly disclaim any and all express, implied and statutory representations and warranties of any kind, including, without limitation, any warranty as to accuracy, timeliness, completeness, and fitness for a particular purpose and/or non-infringement. KAMCO will accept no liability in any event including (without limitation) your reliance on the information contained in this document, any negligence for any damages or loss of any kind, including (without limitation) direct, indirect, incidental, special or consequential damages, expenses or losses arising out of, or in connection with your use or inability to use this document, or in connection with any error, omission, defect, computer virus or system failure, or loss of any profit, goodwill or reputation, even if expressly advised of the possibility of such loss or damages, arising out of or in connection with your use of this document. We do not exclude our duties or liabilities under binding applicable law.

KAMCO Investment Company - K.S.C. (Public)
Al-Shaheed Tower, Khalid Bin Al-Waleed Street- Sharq
P.O. BOX : 28873, Safat 13149, State of Kuwait
Tel: (+965) 1852626 Fax: (+965) 22492395
Email : Kamcoird@kamconline.com
Website : http://www.kamconline.com