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Event Update - Benchmark Interest Rate Hikes

December-2015

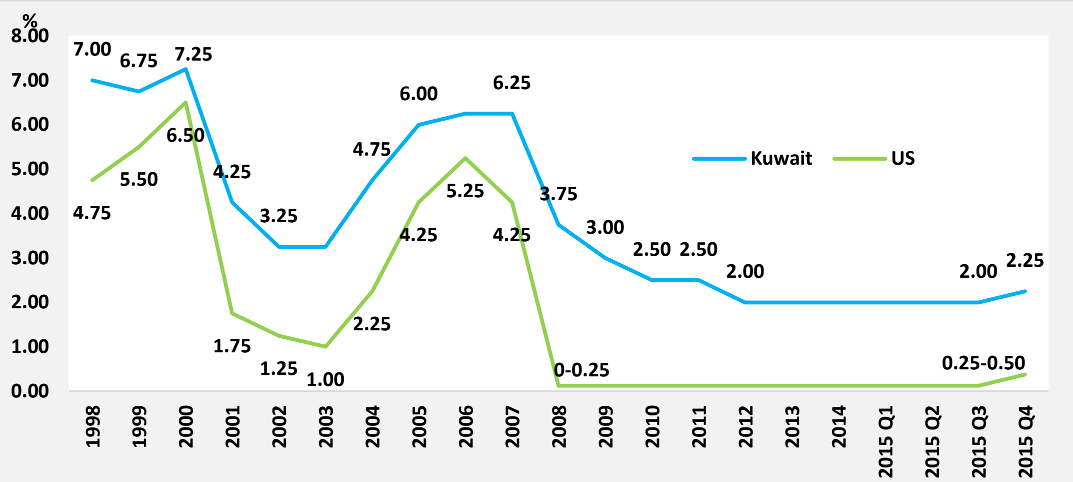
In a much anticipated move, the Federal Reserve raised interest rates for the first time in almost eight years to a new target range of 0.25% to 0.5%, up from zero to 0.25% since 2008. According to the official statement, the rate hike would be followed by a gradual tightening based on higher inflation levels in the forecast period. *According to the official forecast, a rate of 1.375% is expected at the end of 2016, implying four 25 bps increase in the target range next year. The move by the Fed was seen as one of the loosest fiscal tightening measures sending a dovish signal to the market. The marginal increase also sent a positive signal, especially for the equity markets, as it gave depositors a marginally higher interest earnings, stemmed investor confidence in the economy and expectations of a little bit higher prices in the near term.*

Following the US. Fed rate hike announcement, Saudi Arabia, Kuwait and Bahrain raised their benchmark rates. *Saudi Arabia raised its overnight reverse repo rate by 25 bps to 50 bps but left its benchmark repo rate unchanged at 2.0%. Meanwhile, the Central Bank of Kuwait (CBK) raised its benchmark discount rate by 25 bps to 2.25%, whereas Bahrain, while keeping the repo rate unchanged at 2.25%, raised its overnight interest rate by 25 bps to 0.5% and its rate for one week also by 25 bps to 0.75%.*

The move by the three gulf countries was expected since the GCC countries have pegged their respective currencies against the USD *(with the exception of Kuwaiti Dinar which is pegged against a basket of currency dominated by the USD). The rate hike, as also highlighted by Fitch Ratings, is primarily to maintain the currency peg and does not represent any urgency or fiscal/monetary pressure. On the other hand, absence of a rate increase would have put pressure on the local currencies and in the longer run lured investors to sell their local assets in the gulf region and invest in higher-yielding dollar-based investments.*

The rate hikes comes at a time when gulf economies are suffering from a severe economic slowdown due to the excessive dependence on oil revenues. Also, banks in the gulf region have been hit with tightening liquidity conditions in the recent months owing to the decline in oil prices. *The decline in oil revenues has affected the flow of oil money flowing in the form of bank deposits. Moreover, higher interest rates on bank loans would act as a deterrent for borrowers in the region. Clearly, changes in the benchmark rate affect the behavior of consumers and businesses, as well as the stock market, although the impact on the latter is not immediate.*

Fed Fund Rate vs. Kuwait Central Bank Discount Rate



Data indicates end-of-period target rates/ranges. Source: US Federal Reserve, Central Bank of Kuwait

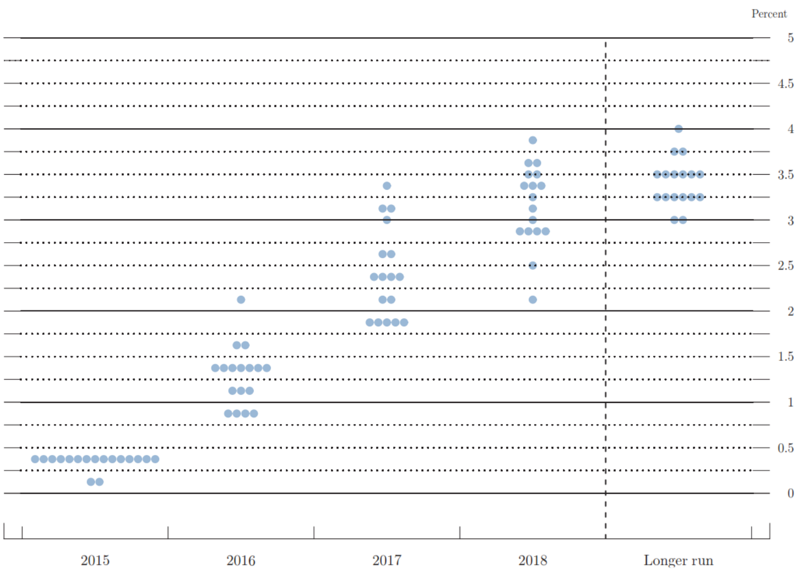
Faisal Hasan, CFA
Head - Investment Research
+(965) 2233 6907
faisal.hasan@kamconline.com

Ziad Chehab, MBA, CVA
Vice President
+(965) 2233 6909
ziad.shehab@kamconline.com

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

Brace for further impact…

Fed Dot Plot



Source: US Federal Reserve

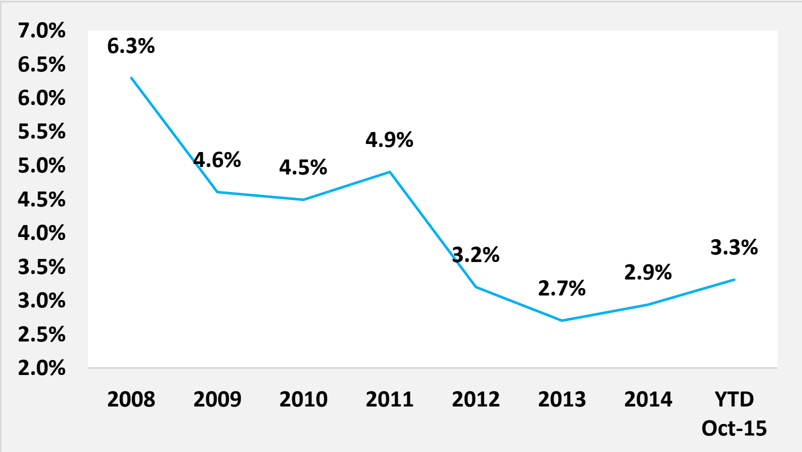
Although gradually, interest rates in the US are expected to rise significantly in the near term. According to the official expectations, the medium term rates are expected to reach above 3% by as early as 2018, whereas the longer term rates are expected to remain slightly higher but within the 3-4% range. According to the Fed's December Summary of Economic Projections, the median monetary policymaker believes that it would be appropriate for the federal funds rate to end 2016 at close to 1.4%. Markets would be in for a surprise if, as per the indications of the dot plot, the Fed increases the rate four times during 2016. Nevertheless, the average expectations of policymakers have declined as compared to the September-15 meeting. The average expectation by the end of 2017 is at 2.4% as compared to previous expectation of 2.6%. Similarly, the average rate projection for 2018 is 3.2%, down from 3.3% previously. Moreover, according to Bloomberg, markets are expecting a much slower pace of increase to reach just about 1% by the end of 2016.

Immediate impact would be minimal…

The marginal increase in rates would is expected to have minimal impact on gulf economies in the near term. Its effect on the Kuwaiti economy would be insignificant in the short term as it is already priced across asset classes such as equities, bonds and real estate. However, subsequent rate hikes, as indicated by the Fed Reserve, would result in higher financing costs for corporates and therefore would in turn affect corporate profitability and performance in the long-run. It would also keep oil and commodity prices under pressure. Moreover, the apparent flow of higher interest earnings (higher NIM) to banks would fade as demand for financing declines amid higher borrowing costs (it will affect their loan portfolio growth). Consequently, the spread between the yield on investment and the benchmark rate will narrow. Higher rates would affect capital expenditure and will slow down the pace of growth which in turn will spill over to the economy and stock market causing less attractive prices. Lack of growth in the business along with higher financing cost will affect corporates' topline and bottom-line results which will lead to sell-offs and therefore drive stock prices down.

Inflation levels remain in control…

Kuwait CPI (Y-o-Y Change)



Source: Central Statistical Bureau—Kuwait, KAMCO Research

Kuwait has maintained inflation levels in a very tight range of 1-3.5% over the past few years. This is an ideal range as also targeted by the US Fed and other central banks globally. A higher rate would result in lower inflationary pressure that would in turn result in lower realization for producers. The Kuwaiti government has announced an ambitious capital spending plan for the next five years. Governments' borrowing costs are also likely to increase that would affect infrastructure spending plans in the long run adding to the headwinds facing economic growth. But we feel Kuwait has enough financial cushion to overcome this issue. Kuwait inflation was recorded at 3.2% as of last quarter and KAMCO Research expects it to trend at the 4% mark especially when the government starts budget rationalization and gradually introduce taxes.

The benefits may pass on to capital markets…

Higher cost of financing by the end of 2016 would force corporates to look at other modes of funding. With the current rate hike, cost of bank borrowing will increase for businesses and consumers by at least 12.5%. This would provide a push to equity and fixed income financings. On the other hand, higher benchmark rate would increase the yield on bonds and therefore bonds will be selling at a discount, which will be more attractive to investors particularly since equity markets have been extremely volatile over the past one year and are expected to remain so in the next year. In terms of sector performance, the hike would decrease discretionary consumer spending putting pressure on businesses in these sectors. It's likely that businesses in defensive sectors such as education and healthcare to do better as they will be able to pass these increases to the consumer. Businesses with excess cash are likely seek acquisitions in order to continue growing which will spur M&A activities. As for consumers who might be facing decline in their disposable income, savings and capital protected investments shall be increasing gradually to create positive inflation-adjusted returns.

Positive indications for global economic growth...

If we look at the opposite view, raising of US rates shows strengthening of US economy which being the biggest economy will have positive bearing on the global economy and trade. On the energy markets too it will have a lag effect and the markets can react positively. Also taking in a positive view the borrowers who might be sitting without action thinking that rates will remain low will now start to raise debt so that they can raise at lower rates rather than later so we might see more debt issuances and the corporates might hasten their capital expenditure using the lower yielding debt. This can prove to be good for capital expenditure and corporate actions such as M&A which use debt.

Both fiscal and monetary prudence required…

Despite the fall in oil prices, Kuwait and most of the other GCC economies have adequate fiscal and monetary tools to deal with monetary policy changes in the US as well as within the region. Measures such as reducing subsidies and introducing taxes have already been implemented or are being seriously planned. Moreover, in addition to past fiscal surpluses that are now being drawn to finance capital projects, the valuation of sovereign wealth funds of most of the bigger economies in the GCC (Kuwait, UAE, Saudi Arabia, Qatar) have got a boost as the USD is strengthening. This should help in maintaining the creditworthiness of the economies in the region thereby enabling them to maintain/support their credit ratings and to raise additional funds. What is required from policymakers in the GCC and Kuwait is more efforts on fiscal prudence along with monetary policies so that we can create a more broad-based growth economies.

Themes to look out for…

The government has already initiated the implementation of infrastructure projects to energize the private sector to share the burden of creating sustainable jobs. This will be coupled with an increase in public debt (currently zero) and new tax regimes in order to fund these strategic projects. We shall see more stock market delistings, mergers to rationalize operating costs and over performance of defensive sectors. In light of possible further devaluation of Kuwaiti Dinar (expected KWD/USD of 310 fils), investments denominated in major foreign currencies shall witness an increase across the main asset classes such as equities, fixed income and real estate.

It is all about relative value or spreads above the discount rate. As discount rate increase, asset prices decrease assuming spreads remain the same. Nevertheless, these spreads represent the premium investors seek to compensate them for taking the risk. During times of expansion like the current environment, spreads usually contract as excess capital needs to be invested in profitable venues. We shall witness more rational decision making leading to finding bargains in equities and real estate.

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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