FRANKLIN TEMPLETON

Investment Team Update
31 December 2020

Perspective from Franklin Templeton Emerging Markets Equity

Middle East North Africa Insight

Fourth Quarter 2020 Review

Now that the US elections are over, all attention will revert to the economic effects of the global pandemic's progression. Equity investors will likely pay special attention to the efficacy of vaccines and the speed by which governments can introduce them into their populations and build herd immunity. While outbreaks continue to flare up in most parts of the world, the outlook for the world economy will remain volatile until the spread of the virus is reduced. However, we are cautiously optimistic that the worst is behind us and that equity investors should look beyond the noise and refocus their attention on longer-term earnings growth.

That being said, we expect monetary and fiscal stimulus measures to continue being accommodative well into 2021. The commitment from central banks remains unwavering, and we continue to believe that interest rates will remain lower for longer throughout the year. We expect global inflation to remain relatively muted as the path to recovery remains steady yet uneven. However, with Democrats now controlling both the House and the Senate, record fiscal spending in the United States is more likely. Consequently, we run the risk of upward pressure on interest rates if investors believe that fiscal policy has become too loose.

We believe the stage is set for a sustainable bull market in emerging markets (EM) equities, supported by accommodative liquidity and the overall recovery. We expect strong currency performance relative to the US dollar across EM equity markets. We highlight that EM growth stocks have had an unprecedented run versus value over the past decade. The pandemic has amplified the run of growth stocks and accelerated the prospects of tech-dominated companies. Going forward, we expect the secular trends in the tech sector to continue; however, we expect market laggards to perform well in 2021 as oil prices recover and commodity prices strengthen.

MENA economy

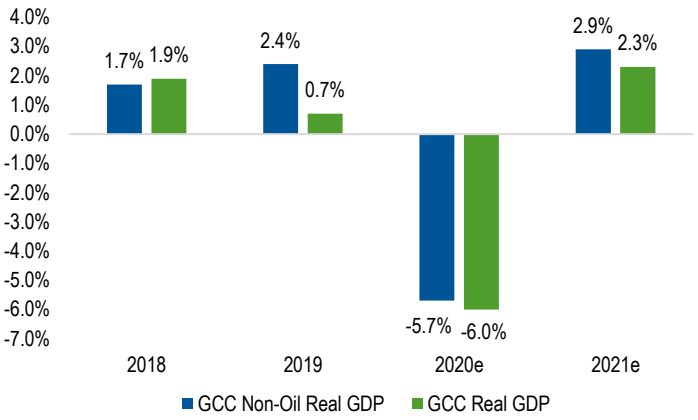
MENA's economic recovery is expected to be positive yet nuanced in 2021. We are optimistic on the overall operating environment as business activity continues to improve, supported by oil price recovery, better fiscal discipline and stronger reform. The speed of the vaccine rollout is expected to be a key catalyst which should allow MENA economies to reopen and resume normalised economic activity. Furthermore, the long-awaited lifting of the Qatari embargo is expected to further support intra Gulf Cooperation Council (GCC) business activity.

It is worth noting that as COVID-19 vaccines are rolled out and economies recover, we expect to see less emphasis on thematic trends and a more diverse range of performance drivers return in 2021. We expect MENA economies to recover at different speeds. As such, investors will need to monitor the state of the pandemic and policy responses in each country to properly assess opportunities. This environment should favour investors willing to go off the beaten track and undertake bottom-up due diligence on companies in previously overlooked markets.

We see meaningful investment opportunities in industries most directly hit by the pandemic, including real estate, hospitality/travel, discretionary retail and selective banks as industry consolidation coincides with economic recovery. As of now, we continue to see abundant opportunities and compelling valuations. Similarly, we continue to favour geographies dominated by informal economies like Egypt, which in our view will likely see a V-shaped recovery post-pandemic.

GCC GROSS DOMESTIC PRODUCT (GDP) TO BOUNCE BACK IN 2021

Exhibit 1: Regional Economic Outlook
2018–2021E



Source: International Monetary Fund (IMF), Regional Economic Outlook for Middle East-and-Central-Asia, October 2020. There is no assurance that any estimate, forecast or projection will be realised.

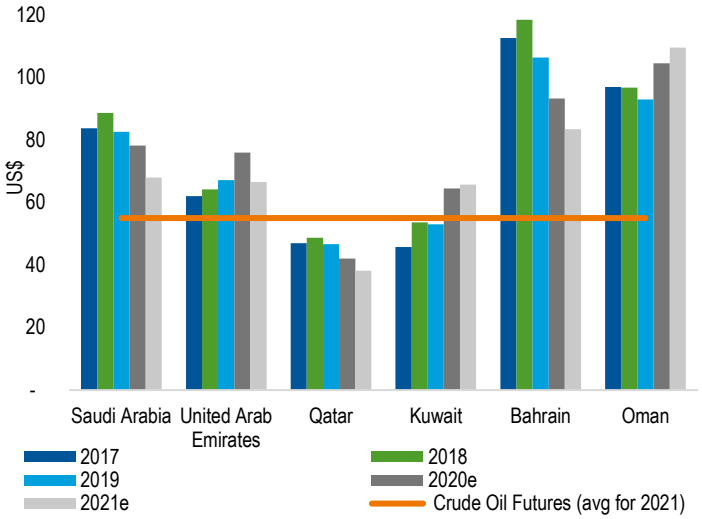
Oil – Uncertainty remains, OPEC+ support still needed

The recent Saudi Arabia unilateral one million barrels output cut surprised the market and pushed prices higher. The bold move signals a breakaway from the kingdom's previous strategy to maintain market share and could signal its growing concern regarding the resurgence of the virus in Europe and the United States. It is still unclear whether the steep cut will continue to

stabilise prices as virus cases climb sharply in many parts of the world, triggering new economic restrictions. For now, though, the move sent a stronger-than-expected message from the world's most flexible producer that it was committed to keeping prices buoyant.

ADJUSTING BUDGETS TO REFLECT LOWER OIL PRICES

Exhibit 2: Budget Breakeven Oil Price
2018-2021E



Source: Bloomberg, IMF, Regional Economic Outlook for Middle East-and-Central-Asia, October 2020. There is no assurance that any estimate, forecast or projection will be realised.

Looking ahead, our outlook for oil remains supported by the OPEC+[1] commitment to balance market dynamics as well as the weaker US dollar environment. Oil demand in 2021 is expected to recover strongly but remain lower than it was at pre-COVID-19 levels. The pace of the recovery will be highly contingent on the success of the vaccines and the containment of the pandemic. Uncertainty remains high as the current surge in COVID cases in Europe and the United States may trigger another round of shutdowns and restrictions. However, we are confident that OPEC would delay or limit production increases if need be. The US Energy Information Administration (EIA) in its recent release (January 2021) expects Brent prices to average US$53 per barrel in 2021 and 2022 versus US$43 per barrel in 2020.[2] The forecast for higher crude oil prices next year reflects EIA's expectation that while inventories will remain high, they will decline with rising global oil demand and restrained OPEC+ oil production.

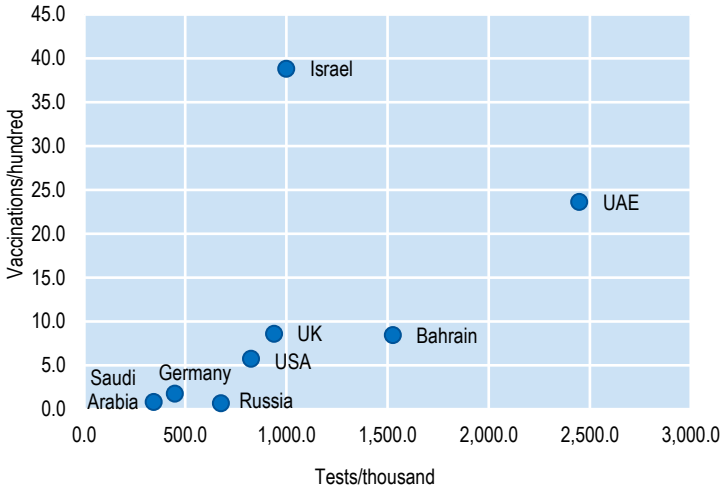
COVID-19 – A tale of two halves

With several COVID-19 vaccines on the horizon, many investors are looking ahead to the manufacturing and distribution of them. We are in uncharted territory—never have we encountered an instance where we were trying to vaccinate the whole world at once. There is an unprecedented requirement for cooperation, coordination, synchronisation and integration to deliver vaccines to every country and city and to overcome the inherent logistical challenges.

GCC governments have been proactive in obtaining and distributing the vaccines. All GCC countries have approved vaccines and have launched free inoculation programmes to combat the pandemic and build population-level immunity to the virus in order to reduce illness and greatly slow the spread, enabling the lifting of all physical distancing measures and the reopening of economies.

UNITED ARAB EMIRATES (UAE) LEADING THE REGION IN TESTING AND VACCINATION

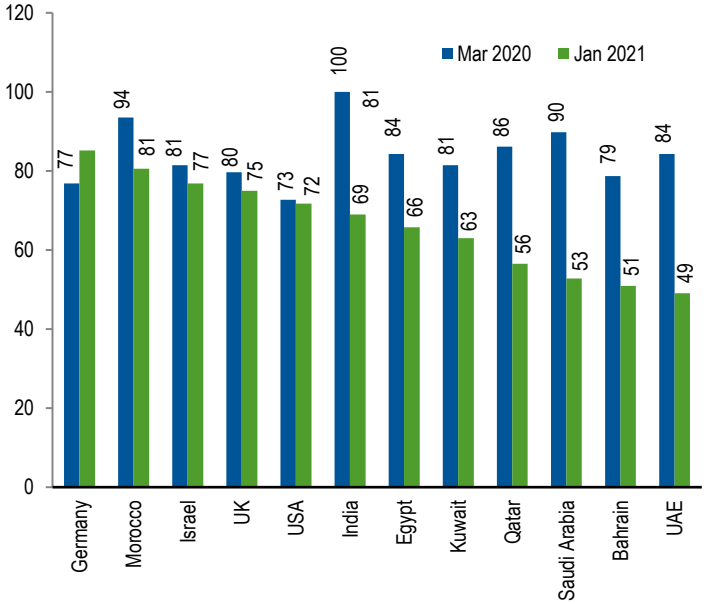
Exhibit 3: Vaccinations and Tests in Comparison with Other Regions
January 2020–January 2021



Source: Our World in Data, 22 January 2021.

ALLOWING MENA GOVERNMENTS TO BE LESS STRINGENT

Exhibit 4: Government Stringency Index
March 2020–January 2021



Source: Our World in Data, 10 January 2021. Government Stringency Index refers to Coronavirus Government Response Tracker (OxCGRT), published and managed by researchers at the Blavatnik School of Government at the University of Oxford. OxCGRT collects publicly available information on 17 indicators of government responses, spanning containment and closure policies (such as such as school closures and restrictions in movement); economic policies; and health system policies (such as testing regimes).

Qatar embargo ends

Saudi Arabia, the UAE and Bahrain are lifting airspace, land, and sea border restrictions imposed on Qatar in 2017 in response to Qatar's regional policies. The reopening of land, air and sea borders between the three countries and Qatar is expected to see a surge in cross-border trade and tourism between the GCC nations, which should benefit the GCC economies over the medium term. The agreement will once again allow visitors to Qatar from Saudi Arabia, Bahrain and the UAE, which accounted for almost 40% of total visitors prior to the dispute—an important development as the country gears up for the 2022 World Cup.

The UAE and Saudi Arabia will both benefit from the reopening of trade, tourism and investment channels with Qatar as well. Dubai, in particular, is well-positioned to gain from the thaw in relationships. Even though Qatari tourists accounted for about 1% of Dubai's visitors before the border closure, they accounted for a proportionately larger share of tourism receipts because of high income levels.

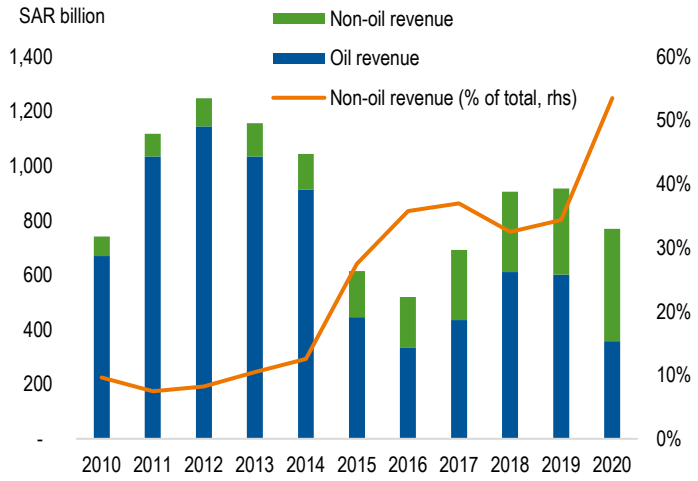
Similarly, we expect respective financial systems to benefit from the normalisation of relations, which could support renewed direct investment and cross-border lending within the GCC.

Saudi Arabia—A change in the rules of the game

Saudi Arabia announced its 2021 budget, which came in lower, as expected. The budget sets a fiscal deficit target of 4.9% of GDP[3] in 2021, down from 12% in 2020. Going forward, we expect policymakers to focus on bringing down the deficit and reducing spending further given the current oil backdrop. The 2021 budget reflects policymaking fiscal prudence and gradual normalisation after the COVID-19 impact on 2020 accounts.

SAUDI ARABIA LOOKS FORWARD TO INCREASED REVENUE WITHOUT OIL

Exhibit 5: Growing share of non-oil revenue
2010–2020



Source: Saudi Arabia Ministry of Finance.

The budget incorporates spending cuts in capital expenditure and a continuation of the non-oil revenue reform measures introduced in 2020. The budget appears to incorporate a realistic oil price assumption (US$50 per barrel) but sustained high dividends from Saudi Aramco. However, we highlight that capital expenditure investment in the kingdom will shift from the government to the Public Investment Fund (PIF), which is expected to pick up the mantle and roll out its ambitious development plan as a part of the country's Vision 2030. Saudi Arabia unveiled in January 2021 a new megaproject "The Line," a city within Neom[4] that will host one million residents and will stretch in a straight 170km line. The PIF is a cornerstone investor and has outlined plans to invest up to US$40 billion a year (>5 % of GDP) over the next 5 years.[5]

UAE—Open for business

The UAE economy was hard hit in 2020. Years of steering the economy towards other non-oil sectors have immensely benefitted the country, while simultaneously making it vulnerable to the specific risks of the pandemic. Its sizeable exposure to directly impacted sectors such as real estate, hospitality, transportation and retail made it vulnerable to lockdowns, retrenched spending, supply chain disruptions and tourism decline.

Policymakers have been quick to respond and have showed a willingness to take the necessary steps required to reinvigorate the UAE's leading position as a global hub. The UAE government rolled out a raft of reforms aimed at attracting foreign businesses and expatriate immigration. The country aims to leverage its world class infrastructure, strong connectivity and competitiveness at a time when the rest of the world is reeling from the negative ramifications of the pandemic.

UAE'S SWEEPING REFORMS TO REIGNITE EXPATRIATE GROWTH

Exhibit 6: Examples of reforms starting in mid-2019 and accelerating post-COVID-19

Sector	Reforms
Social Reforms	Legalization of alcohol consumption, divorce and inheritance laws based on citizenship, cohabitation of unmarried couples, stricter punishments for "honour crimes" and harassment of women.
Residency / Visas	Long-term (5-10 year) visas for high-net-worth retirees, entrepreneurs, investors, outstanding students and professionals. Launched visas for overseas remote work executives and 5-year multi-entry tourist visas.
Investments	100% foreign ownership in 122 economic activities across 13 sectors.
Capital Markets	Strengthening of corporate governance framework.
Real Estate	Established a Higher Real Estate Planning Committee to manage Dubai's real estate supply and demand.

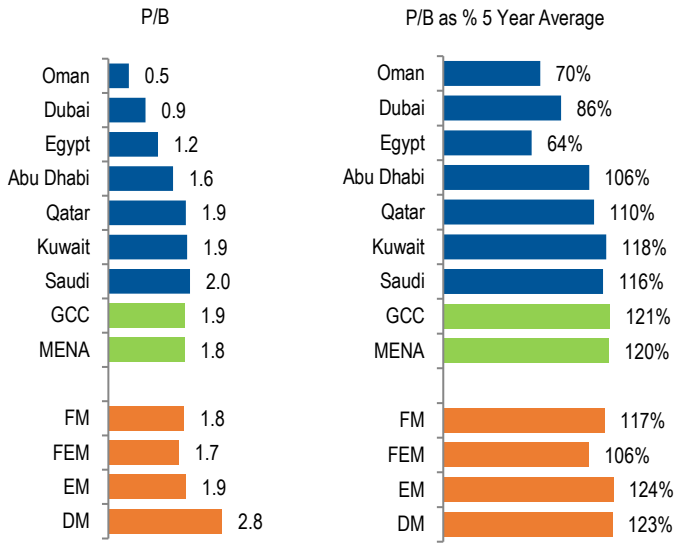
Dubai, in particular, has been quick to remove all restrictions on activity. The emirate was one of the few destinations in December that opened fully to receive tourists during the holiday season and has seen an influx of incoming tourists from Israel and the United Kingdom. There are concerns that such openness would lead to a spike in COVID-19 cases, which is currently materialising; however, it appears that the government is confident in its ability to address the health care risks given its hospitals' capacity and its inherently younger demographic.

It is worth noting that the UAE has launched a widescale free vaccination programme that aims at reaching herd immunity by the end of the year's first half. As of 22 January 2021, the UAE has achieved the second-highest inoculation level (23.65%) in the world, after Israel.

Dubai was one of the worst-performing markets in 2020; however, we believe that the global backdrop highlighted earlier will support the market in 2021. The reforms, vaccination rollout and economic recovery should bode well for the UAE market. Dubai scores high on valuation metrics and is trading at a significant discount to historical averages.

DISPERSION IN MENA VALUATIONS

Exhibit 7: Forward Price-to-Book (P/B) ratios vs 5-year average forward P/B ratios



Source: Bloomberg. MENA is represented by the S&P Pan Arab Composite Large Mid Cap Index as of 13 January 2021. GCC by S&P GCC Composite Large Mid Cap Index. Countries by respective country level S&P Large Mid Cap Indices.

Source: MSCI via Bloomberg. EM is represented by the MSCI Emerging Markets Index; DM is represented by the MSCI World Index; FM by the MSCI Frontier Markets Index, and FEM by the MSCI Frontier Emerging Markets Index as of 13 January 2021.

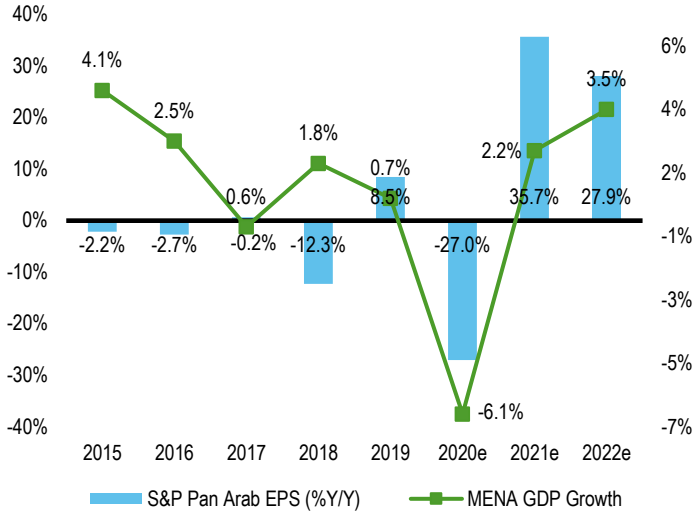
MENA markets

The variance in performance amongst MENA markets in 2020 could be attributed to the relative impact of the pandemic, with Oman and Dubai hit hardest by the collapse in oil prices, international trade and tourism. Saudi Arabia's equity index was above 2019-end levels, driven by a surge in retail participation in the market. Equity valuations in Saudi Arabia have risen sharply and currently stand at a 23% premium to 5-year historical averages.[6] We are cautious by the steep rise in valuations that appear, in some instances, detached from underlying fundamentals; however, we continue to find company-specific opportunities within the Saudi Arabia market.

The recovery play and pivot to value has been well underway early in 2021. We continue to believe MENA markets that underperformed in 2020, particularly Dubai and Egypt, are well poised to perform in 2021 on the back of attractive valuations, an improving earnings outlook and increasing liquidity, fuelled by renewed interest from international value seekers. We expect corporate earnings to rebound strongly in 2021 and are already seeing several upgrades to sell-side forward earnings estimates.

MENA MARKETS STARTING TO LOOK ATTRACTIVE IN 2021

Exhibit 8: MENA Region GDP Growth and Earnings Growth
2015-2022E

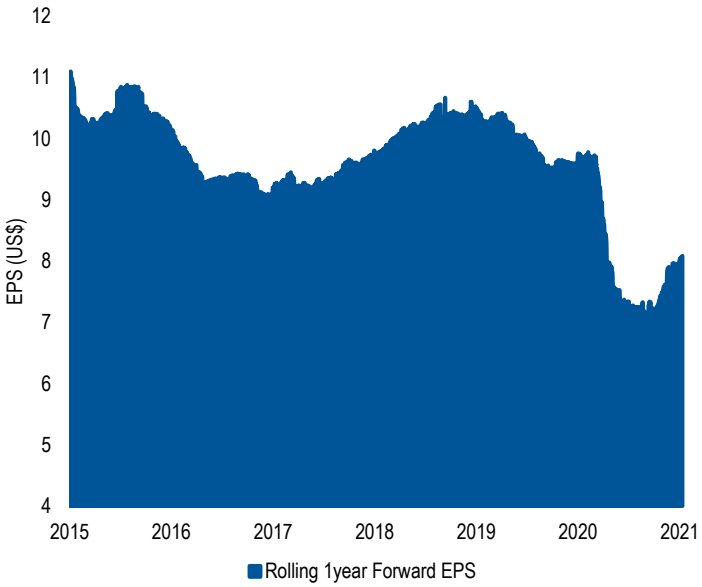


Source: Bloomberg, IMF - World Economic Outlook Database, October 2020. There is no assurance that any estimate, forecast or projection will be realised.

We expect performance dispersion in the remaining Gulf countries. Saudi Arabia and Qatar performed well in 2020, and valuations in these markets remain elevated. Overall performance will be highly contingent on the economic recovery and companies' ability to demonstrate meaningful earnings growth. In spite of the current uncertainty, we continue to identify company-specific, bottom-up opportunities within those markets.

CORPORATE EARNINGS FORECASTS IMPROVING

Exhibit 9: MENA Rolling 1yr Forward Earnings-per-share (EPS) estimate
2015-2022E



Bloomberg consensus data, Earnings estimates for S&P Pan Arab Large Mid Cap Index, as of 18 January 2021. There is no assurance that any estimate, forecast or projection will be realised.

We continue to favour resilient businesses that have the balance sheets and the flexibility to adapt to the new world post-COVID-19. We strongly believe companies that pursue big strategic moves, through every phase of the economic cycle, can increase their odds of outperforming their peers over the longer term. Our broad research footprint and well resourced, experienced team allow us to identify high-quality businesses with sustainable earnings power and structural competitive advantages, trading at a discount to intrinsic value. At the moment, our research and portfolio efforts are centred on identifying balance sheet strength and assessing business model resilience, impairment risk and the path to recovery.

Endnotes

1. OPEC+ is an alliance of oil producers, including members and non-members of the Organization of the Petroleum Exporting Countries.
2. Source: US Energy Information Administration, January 2021.
3. Source: Ministry of Finance – Saudi Arabia
4. Neom is a planned cross-border city in the Tabuk Province of northwestern Saudi Arabia. It is planned to incorporate smart city technologies and also function as a tourist destination.
5. Source: Reuters, 12 November 2020.
6. Source: Bloomberg, 19 January 2021.

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