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CIO Viewpoint Special Report

Gulf Steam: economies in the region gather pace

Investment Solutions

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Amid high oil prices, the Middle East will be a bright spot among emerging markets this year. Oil diversification and labour market reforms will be key in coming years, while we see economic competition between Saudi Arabia and the UAE as a largely positive growth and reform driver.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- High oil prices should drive high single-digit growth in the main GCC economies this year, as well as improving fiscal and large external balances. Qatar has further reasons for cheer
- Booming growth and rising inflation should make following the Fed's tightening cycle manageable, maintaining currency pegs
- Progress on non-oil diversification is patchy but improving; labour market reforms have seen less success
- We foresee growing economic competition between Saudi Arabia and the UAE proving well managed and driving further market-positive reforms in the years ahead.

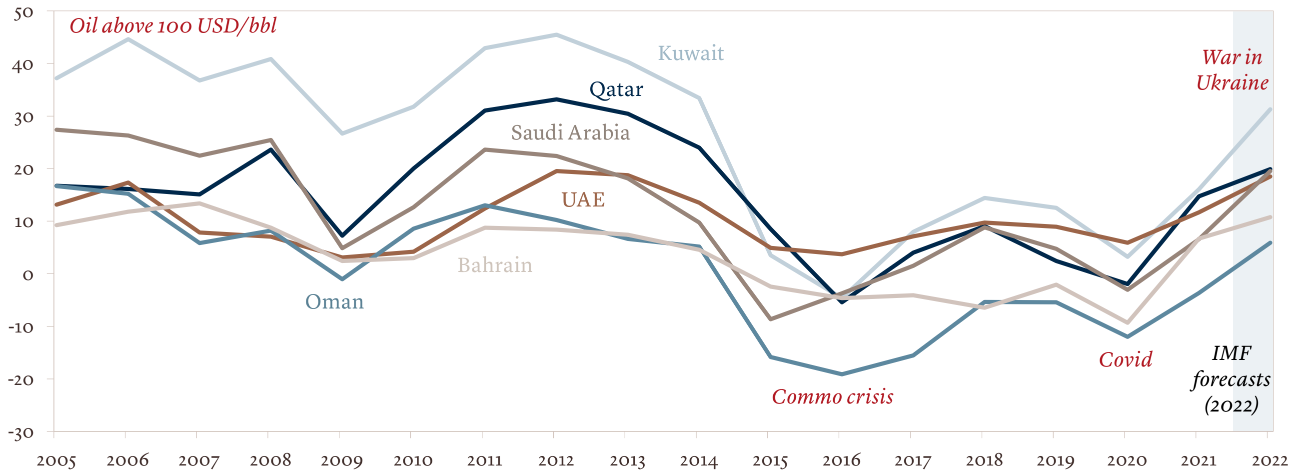
Emerging markets are having a tough 2022. Soaring food and energy prices, higher US interest rates, slowing global growth and trade have come hot on the heels of Covid-19. Yet one region is bucking the trend. While the MSCI emerging market index is down around 16% this year, indexes in the United Arab Emirates (UAE) and Saudi Arabia are up around 15%. Amid record stock inflows, the Middle East was the only region in the world to see public listings rise in the first quarter, notes Dealogic, including a multi-billion dollar chunk of Dubai's electricity and water authority, and a pharmacy chain in Saudi Arabia.

Oil windfall – and Qatar's rise

High oil prices have proved an unexpected windfall for the Gulf Cooperation Council (GCC) region this year, prompting a mini economic boom. Saudi Arabia's economy grew 9.6% in the first quarter, its highest rate in a decade. Unplanned oil revenues are rapidly improving economic fundamentals. Fiscal deficits from Covid are being erased. Saudi Arabia, the UAE, Oman, Qatar and Bahrain are all now expected to post budget surpluses this year, the latter two years ahead of national targets. Kuwait could register its first budget surplus in nine years. Most GCC countries are also set to enjoy large current account surpluses in 2022 (see chart 1, page 2). We believe oil prices could spike again, to around USD120/barrel in the fourth quarter, as markets return to deficit and the impact of strategic reserve releases fades away. Meanwhile, Qatar is also emerging as a key beneficiary of Europe's attempts to diversify from Russian gas, which has coincided well with its plans to raise production capacity 40% by 2026. Germany, France, Italy and Belgium are all now in talks to secure long-term liquefied natural gas (LNG) contracts with the world's second largest natural gas exporter – not bad for a country of fewer than three million people. Qatar has also benefited from a construction boom, as it prepares to host football's World Cup this November.

1. Solid external surpluses

Current account balances, % of GDP



Source: IMF, Lombard Odier, national statistics agencies

Food prices, inflation and following the Fed

Of course, the GCC region is not immune to global problems, including much higher imported food prices (the UAE imports 90% of its food) and bottlenecks in global supply chains. These have helped drive inflation up to between 2-4% (see chart 2, page 3), marking a sharp reversal from deflationary dynamics in many of its six members between 2020-2021. Here again though, events have proved fortuitously timed. The region's currencies are pegged to the US dollar, meaning their central banks' actions typically mirror those of the Federal Reserve, even if their economic cycles do not always align. Today, amid booming growth and rising inflation, the US rate tightening cycle should not pose problems for the region. Even factoring in a sharp tightening in financial conditions to align with the Fed this year, we forecast above-consensus growth of 7.6% and 6.2% in Saudi Arabia and the UAE respectively. Sharp tightening cycles tend to prompt discussions around the logic of a currency peg. Yet while there may be a long-term political will for GCC countries to gradually follow a basket of currencies including the renminbi, any change would bring greater volatility, and we see no immediate move away from today's pegs.

The shift away from oil

While the oil price boom is driving optimism on this year's prospects, the region's medium-term outlook hinges on a shift away from the black stuff. Here, progress is patchy. Kuwait remains the most dependent on oil of the GCC countries, with oil and gas making up around 40% of GDP and over 90% of export revenues. With fewer oil reserves, the UAE was forced to diversify its economy earlier, and now relies on property and construction, tourism, financial services, logistics and trade – including in gold – to supplement hydrocarbon revenues. A gold price of around USD1,900-USD2,000/oz, which we see continuing in coming months, should prove a tailwind here. Even so, oil accounted for around 29% of UAE GDP in 2020, according to federal estimates. In 2016, when Saudi Arabia's Crown Prince Mohammed bin Salman unveiled his Vision 2030, he foresaw non-oil revenues rising almost fourfold by 2020. Today, however, oil remains the lion's share of the Kingdom's GDP, and has actually risen in recent years.

40%

planned increase in Qatar's gas production to 2026

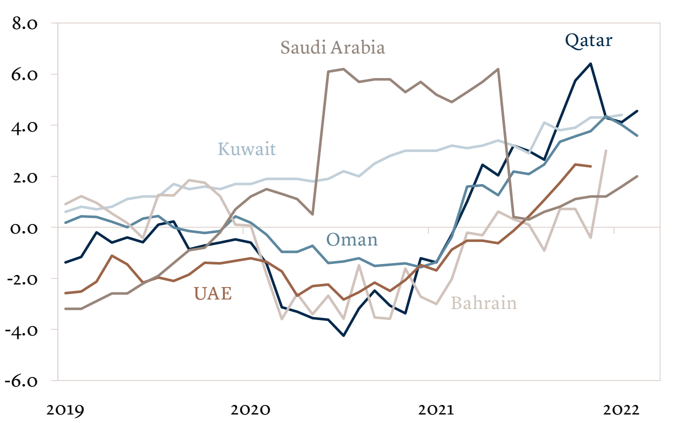
The big question now is whether the current oil price bonanza will fuel transition projects, or remove some of the urgency to diversify. We note that Russia has historically channelled oil revenues above USD42/barrel into its sovereign wealth fund, and the region's members would also benefit from formal mechanisms to sequester oil wealth. Yet we see reason for optimism that the windfall will not be squandered. GCC countries have demonstrated fiscal discipline in recent years. They have set out clear and quantifiable diversification targets in regional policy 'visions' (including Saudi Arabia's Vision 2030, Qatar's National Vision 2030 and Kuwait's Vision 2035). Their countries' leaders recognise that diversification is an

economic imperative. Global oil demand will have to start falling rapidly to meet net zero 2050 targets. In Bahrain, oil reserves are expected to run out within the next decade. To add to the urgency, the Middle East is badly affected by climate change: by some estimates, the region is warming at twice the global average, making some areas potentially uninhabitable this century.

Vast sovereign wealth reserves also give the GCC members an unprecedented tool to advance the diversification agenda (see chart 3). Saudi Arabia is using its fund to back electric vehicle manufacturer Lucid Group, with plans to buy between 50,000-100,000 vehicles over the next decade, and to create jobs in sustainable technologies and advanced manufacturing. With less than 2% of the land arable-farmed across much of the region, GCC countries are investing in vertical farms. Rapid urbanisation is fuelling investments in smart cities. Encouragingly, there are also signs that public and investor opinion is behind the sustainability transition: a recent Lombard Odier survey of wealthy Gulf individuals found that 85% are seeking to increase their exposure to sustainable investments.

2. Rising price pressures

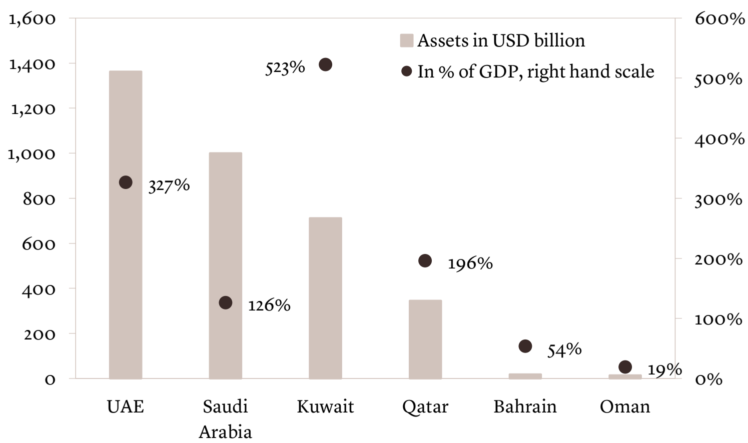
Annual growth in headline CPI, %



Sources: Datastream, Lombard Odier calculations

3. Oil riches

Sovereign wealth fund assets in USD bn and as % of GDP



Sources: Saudi Arabian Monetary Authority (SAMA), Public Investment Fund (PIF), Kuwait Investment Authority (KIA), SWF institute, Lombard Odier calculations

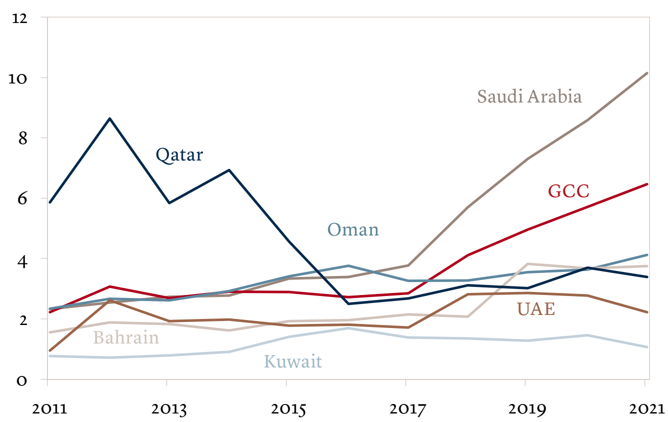
Tax revenues rising, amid further business reforms

The region is also actively seeking sources of financing outside the oil sector. Tax revenues are rising (see chart 4). Last year, Oman became the fourth GCC member to impose value-added tax (VAT), while also raising electricity and water tariffs. Meanwhile, a raft of more business–friendly reforms, including new bankruptcy laws and greater permitted foreign ownership of businesses, has been implemented, with Saudi Arabia, Bahrain and Kuwait among the top ten improvers in the World Bank's 2020 'Ease of Doing Business' report. In the UAE, some 2021 reforms were designed to bring the economy more in line with Western norms, including shifting the working week from Sunday-Thursday to Monday-Friday.

These reforms – combined with an easing of drinking laws and the UAE allowing unmarried couples to cohabit – go down well with foreign workers, who make up around half of the GCC's population. But in other areas, the business environment looks less attractive. In Saudi Arabia, multinationals including Uber have been hit by retroactive taxes worth millions of dollars. Unpredictable policy changes remain an issue. In 2021, Riyadh surprised the corporate world by declaring that after 2023 it would no longer sign contracts with foreign companies that did not have a regional headquarters there. Foreign investment in Saudi Arabia has correspondingly plummeted in recent years, and despite a recent uptick, remains well below levels seen a decade ago (see chart 5).

4. Increasingly taxing

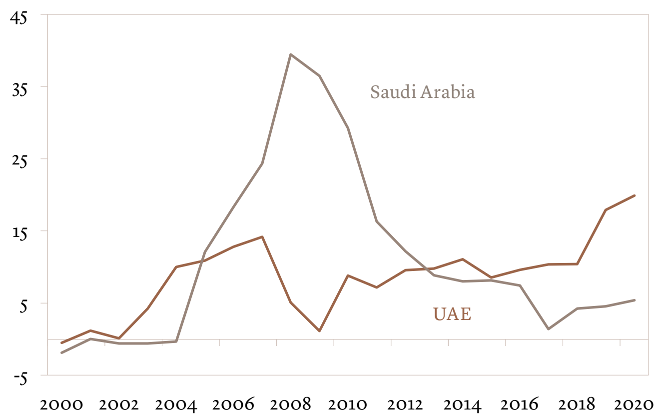
Tax revenues as a % of GDP



Sources: Bloomberg, IMF, Global Source Partners, Lombard Odier calculations

5. Chasing elusive foreign investment

Net foreign direct investment in USD bn



Source: World Bank

The 'resource curse' lingers over labour markets

Meanwhile, oil riches have long resulted in generous subsidies and benefits for nationals that can deter work. In the UAE, fewer than half of Emiratis participate in the labour market. GCC nationals that do work overwhelmingly take up jobs in the public sector, which tend to pay better, have longer holidays and shorter working hours. This stifles the private sector's development, an issue that Gulf states have spent decades trying to address. To date, these actions – principally via private sector wage subsidies – have seen little success. In Kuwait, which introduced them in 2001, the private sector still only employs around 8% of the total national workforce, and the economy has added more public than private sector jobs in recent years. Recent labour market reforms, including laws that prevent gender discrimination at work in Bahrain, Saudi Arabia and the UAE, and the introduction of a minimum wage in Qatar, are a step in the right direction, notes the IMF. Still, the GCC's youthful population underscores the need for structural changes, as more hit working age in coming years (see chart 6).

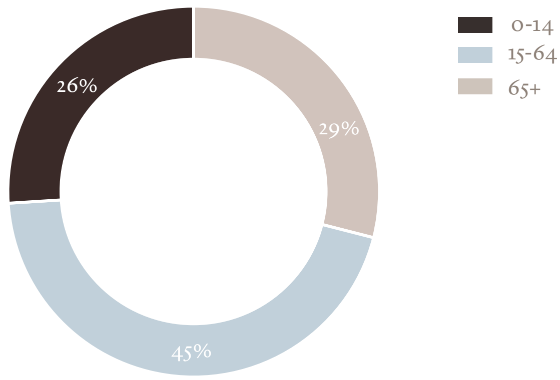
Healthy competition

One further reason for optimism is a trend that many see as a risk factor: growing competition between the region's largest economies, Saudi Arabia and the UAE. In July 2021, disagreement unexpectedly arose at an Organization of the Petroleum Exporting Countries (OPEC) meeting, reflecting different views on the speed of the energy transition: the UAE wanted to boost supply and monetise reserves earlier, while Saudi Arabia favoured restricting production. The desire to boost non-oil industries is resulting in greater rivalry in everything from foreign investment to golf courses. Yet we do not see this as a zero sum game. Mega projects like Saudi Arabia's new sustainable city NEOM could drive up foreign investment and tourism across the region. Concurrently, Abu Dhabi and Dubai are working more closely together, with discussions over consolidation in the banking sector, stock exchanges and airlines, as well as more regulatory and legal harmonisation that could all favour growth.

Indeed, as GCC countries move along the same path of relinquishing oil dependence, they will continue to share many of the same challenges and strengths. Now that previous issues with Qatar have been resolved, at 41 years old, the GCC has proved an enduring economic and political union. Its members share strong strategic and geopolitical interests that in our view should drive well-managed competition - and largely positive reform dynamics-in the years ahead.

6. Fountain of youth

Age breakdown of GCC population, 2020



Source: World Bank

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SWITZERLAND

GENEVA
Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA).

LONDON
Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
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Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com
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Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
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Lombard Odier (Europe) S.A. · Succursale in Italia[2]
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Lombard Odier (Europe) S.A. · Succursale en France[2]
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Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
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Israel Representative Office · Bank Lombard Odier & Co Ltd
Alrov Tower 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
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JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa · johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Lyford Cay House · Western Road · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
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Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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Lombard Odier (Singapore) Ltd.
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
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