A review of the Iraqi Equity Market for May 2017

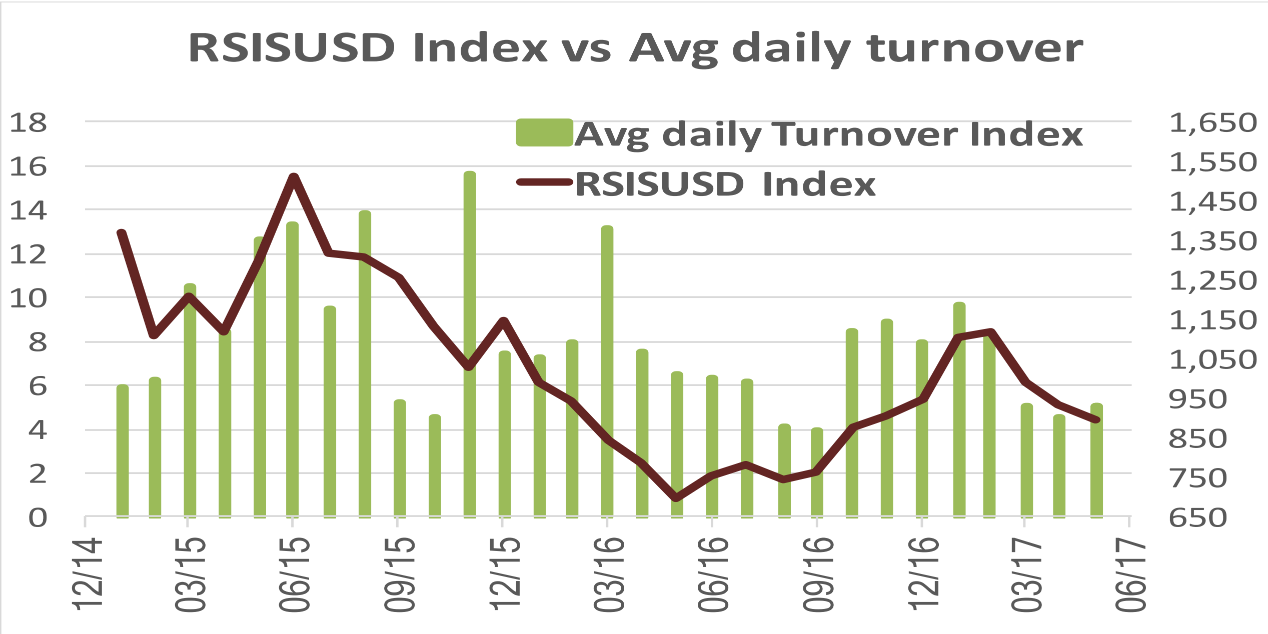
Ahmed Tabaqchali 25 May 2017

The equity market, as measured by Rabee Securities' RSISUSD index, followed the theme of the prior month with declines deepening on continuing low turnover, down by about -4% for the month but higher than the worst point a few days earlier when it was down -7.7%.

The average daily turnover (regular turnover excluding block/arranged transactions by insiders/strategic holders whether local or foreign) has been slightly higher than last month.

The data is as of May 25th, with one week to go for the month, but the last trading day before Ramadan during which turnover is expected to decline further and most likely follow a continuation of the recent theme.

Avg. daily turnover Index on the Iraq Stock Exchange (ISX) (green) vs RSISUSD Index (red)

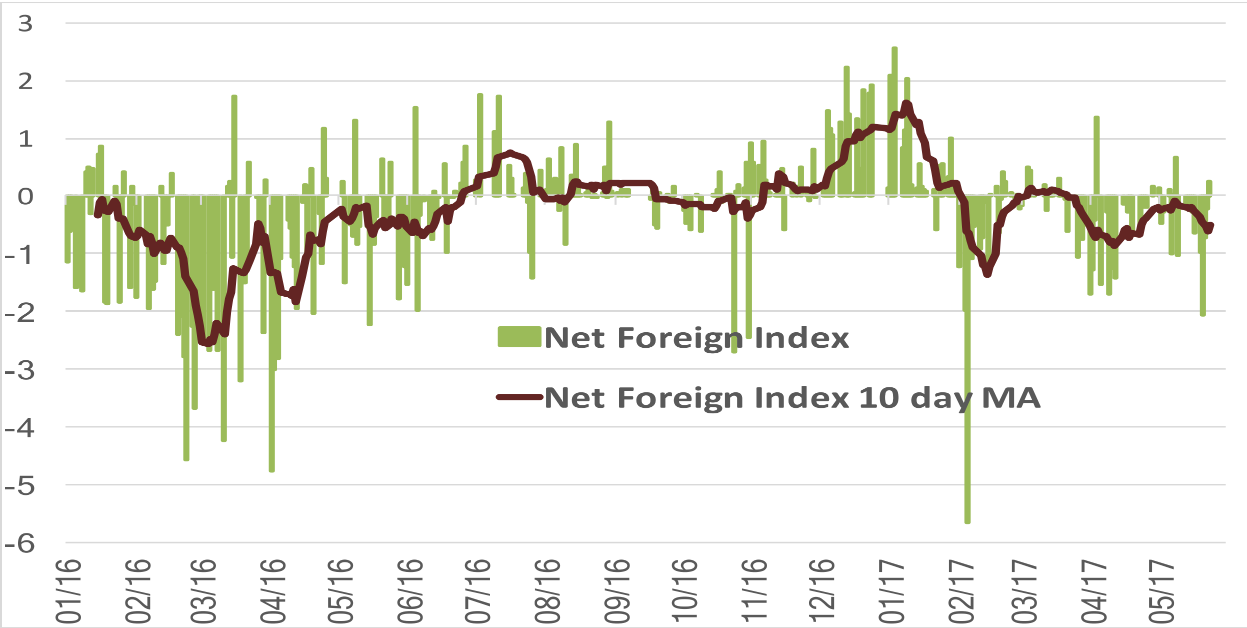


(Source: Iraq Stock Exchange (ISX), Rabee Securities, Asia Frontier Capital (AFC). Data as of 25/05/17)
(Note: Regular turnover excluding block/arranged transactions by insiders/strategic holders whether local or foreign)

Net foreigner turnover which was negative in April has become somewhat less negative as the chart below shows. However, what it doesn't show is the net figure is made up of expanded selling with the avg. daily sells for the last 3 weeks at 1.4 x the average daily sells of the previous 10 weeks but the average daily buys of the last 3 weeks at 7.5x the very low average daily buys of the previous 10 weeks.

However, the chart clearly shows that there is no sustainable trend, as of yet, suggesting the selling is limited and nowhere near the persistent and widespread selling of the prior year but also that there is no new cycle of foreign interest in Iraq.

Foreign Turnover index on the ISX (green) vs 10-day average (red)



(Source: Iraq Stock Exchange (ISX), Rabee Securities, Asia Frontier Capital (AFC). Data as of 25/05/17)
(Note: Regular trading and excludes block/arranged transactions by insiders/strategic holders whether local or foreign)

The market after reasserting its historic correlation with Brent prices and Iraq's Euro Dollar Bond (USD 2.7 billion, issued 2006, due 2028 with a 5.8% coupon) from mid-2016 into February 2017, has once again diverged much as it for during the first half of 2016.

This divergence is most pronounced with the equity market moving in opposite direction to that of the Bond from March onwards.

The Bond, which trades institutionally & internationally, continues to move higher as Iraq's rehabilitation in the eyes of foreign institutional investors continues with the narrowing of the yield differential with the 10-year US Bond.

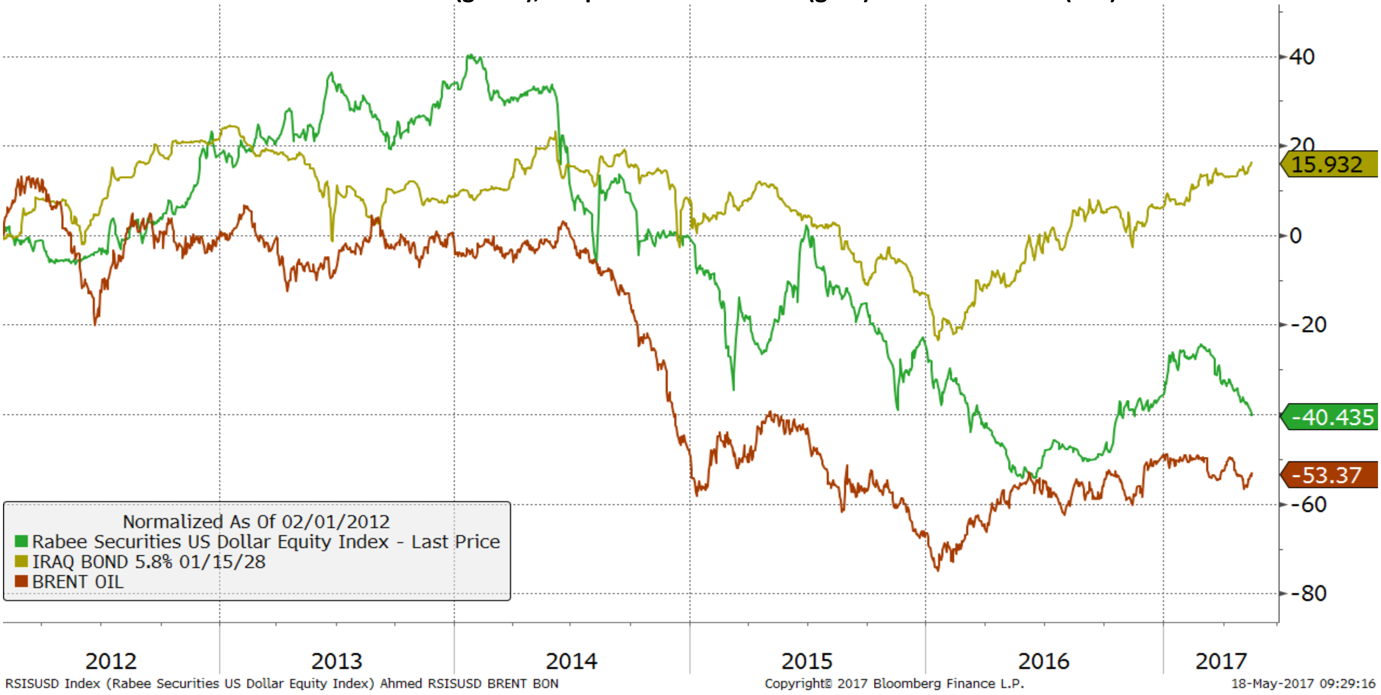
The yield differential or a measure of Iraq's risk premium declined for much of last year but accelerated with the start of the battle to liberate Mosul in October into the present.

This is noteworthy as the move since October was, for the most part, in a rising yield environment indicating a specific narrowing of Iraq's risk premium.

It seems logical to conclude that this implies favourable foreign interest in Iraq and that it would likely be followed by Foreign Direct Investments (FDI's) and eventually by equity inflows.

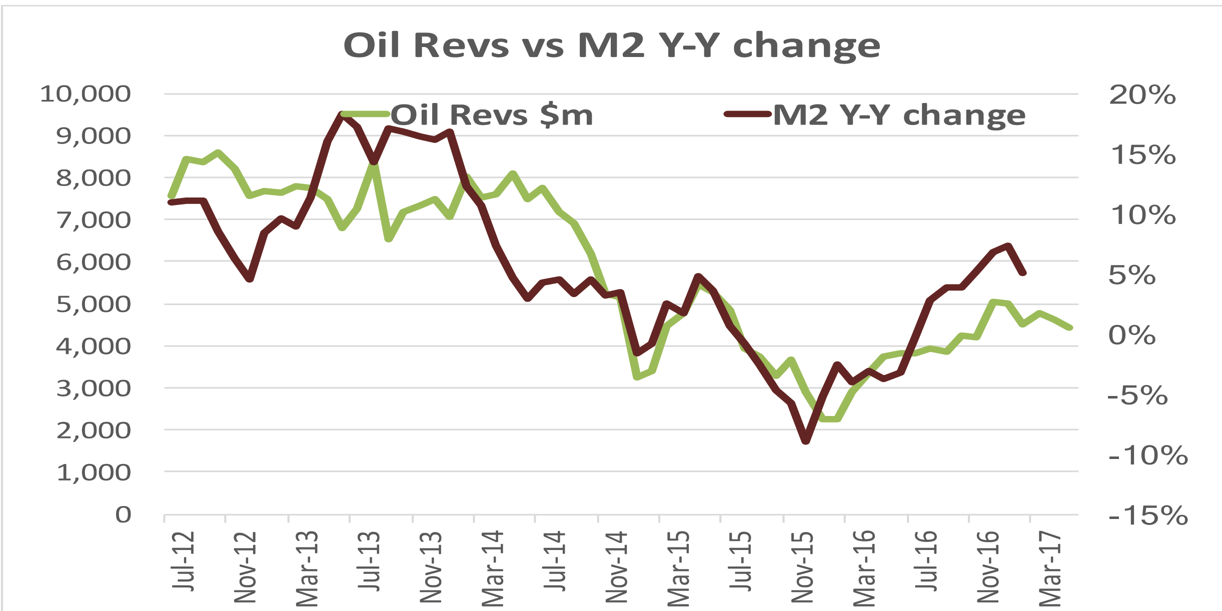
The re-rating of Iraq's credit worthiness such as that by Fitch's outlook upgrade from "Negative" to "Stable" in March is a positive for this line of reasoning.

Rabee Securities' RSISUSD Index (green), Iraq's USD 2.7 bn Bond (gold) and Brent Crude (red)



(Source: Bloomberg as of 18/05/17)

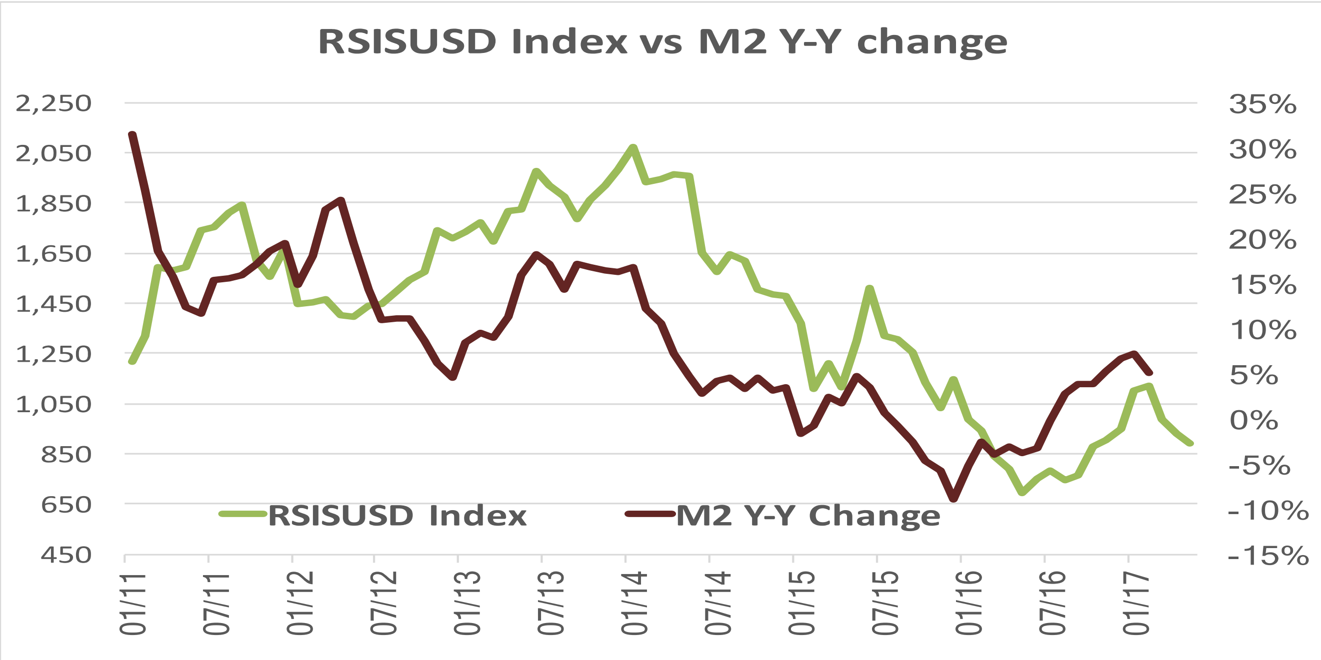
The divergence since March, for the most part, could be explained by the fragility of the early stages of local liquidity revival in the economy. The liquidity crunch, since mid-2014, driven by the combination of low oil prices and increased military spending had a huge negative effect on economic activity and ultimately on the equity market. The government's response by underspending on wages, pensions, goods, services, and investments was devastating for the economy as it is the largest employer in the country and the largest player in the non-oil economy with its orders/contracts driving multiple industries. This dynamic is best illustrated below with the close correlation between oil revenues and M2 or liquidity.



(Source: Central Bank of Iraq (CBI), Iraq Ministry of Oil, Asia Frontier Capital)

(Note: M2 Figures available until February 2017, Oil revenues until April 2017 with May as estimates by Asia Frontier Capital, $ is USD)

The effects of the liquidity crunch were transmitted to the stock market through lower prices from mid-2014 until mid-2016, and the reverse for its recovery afterword's as seen below.

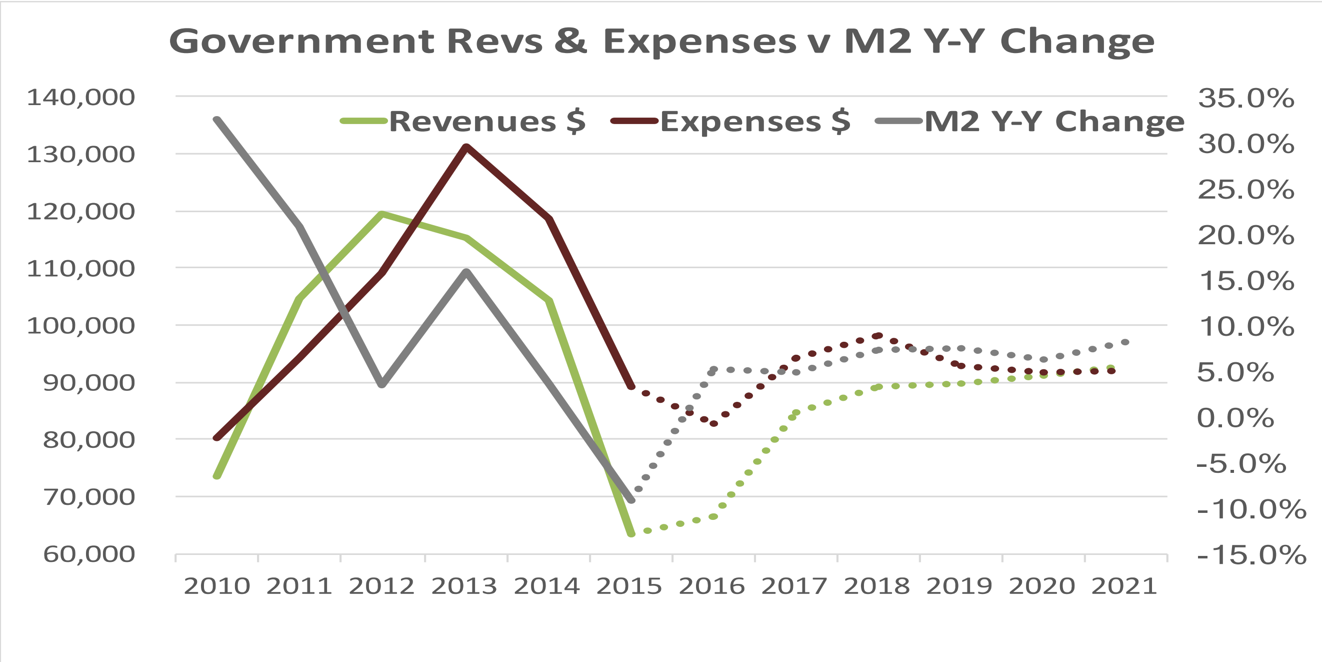


(Source: Central Bank of Iraq (CBI), Iraq Stock Exchange(ISX), Rabee Securities, AFC)
(Note: Data as of 25 May, M2 Figures available until February 2017)

Unlike the negatives of liquidity crunch which were felt in relatively short order, the positives of the of the revival in liquidity will take much longer to filter through to the economy. The reason is that the government is continuing to pursue a restrictive fiscal policy through major cost cuts, and thus the upturn will be driven solely by a recovery in non-oil capital investment spending.

Non-oil capital investment spending is estimated to be up +192% yoy in 2017 after contractions of -68% in 2016 and -50% in 2015, which in turn will drive a growth of non-oil GDP of +3% in 2017 vs. contractions of -5% & -14% in 2016 & 2015 respectively (IMF Iraq Country Report No. 16/379 December 2016). Such capital spending will take time to move from the planning stage to the implementation stage given the chronic structural and institutional challenges that Iraq suffers from while at the same time all resources are focused on the battle to liberate Mosul and Western Anbar, while maintaining basic services in the country at large.

The point to note is that Iraq is no longer at the mercy of falling oil prices and escalating cost of war as it was for much of the time since mid-2014, with the change of direction driven by the reversal of these circumstances, i.e. deescalating & eventually declining costs of war, Brent crude averaging above USD 50 a barrel for much of 2017, foreign aid, and loans. The IMF (Iraq country report December 2016 & WEO April 2017) estimates that government expenses will exceed revenues until 2021 with the gap bridged by a combination of external (60% in 2017) and Internal financing (40% in 2017) until the economy can sustain itself. The effect on economic activity is felt thorough the resumption of M2 growth as the chart below shows, and ultimately into the equity market.



(Source: The IMF Iraq country report Dec 2016 & WEO Apr 2017, dotted lines are estimates, $ is USD)

These estimates have room for expansion as they are based on estimates of flat oil production/exports from 2016 onwards and Iraqi Oil prices of USD 42 in 2017 increasing by an average of USD 2 a year (Iraqi oil sells at about USD 5 discount to Brent). While Iraq has joined OPEC's production cuts of 10% for 2017 until at least Q1/2018, yet this cut is from a higher baseline than that assumed in IMF's estimates or effectively Iraq's production target under the OPEC agreement is about 3.3% less than these estimates. YTD average realized prices have been higher than projected. Average Iraqi Oil realized prices January-April were about USD 48 while AFC estimates that average Iraqi oil price for May is USD 46 or effectively 13.3% higher YTD than estimates. The net effect of lower production and higher prices should be about 8.8% higher oil revenues than projected YTD (note: these are simplistic estimates as they assume that oil exports follow the same trajectory of production in estimates, baseline assumptions and cuts. They are likely to differ from real results given the variability of oil production and volatility of oil prices). With the budget being extremely sensitive to oil exports & prices, the higher than realized oil prices, should they be sustained by year end & beyond could have a meaningful positive effective on liquidity and M2 y-y growth and ultimately the market as they will either increase non-oil investment spending, lead to decreased demands on local financing or a combination of the two. On the other hand, the higher than projected revenues YTD should provide a cushion for revenues to meet initial projections for the year should oil prices decline from current levels.