

## Market Review: Changed Oil Dynamics & Liquidity

Ahmed Tabaqchali, 25 October 2017

October was mostly a replay of the [dog days of the summer](#) as far as the market was concerned. However, two developments are worth noting: the changed dynamics of oil prices with significant implications for local liquidity, and emerging details of the Saudi led refinancing of the reconstruction of liberated territories.

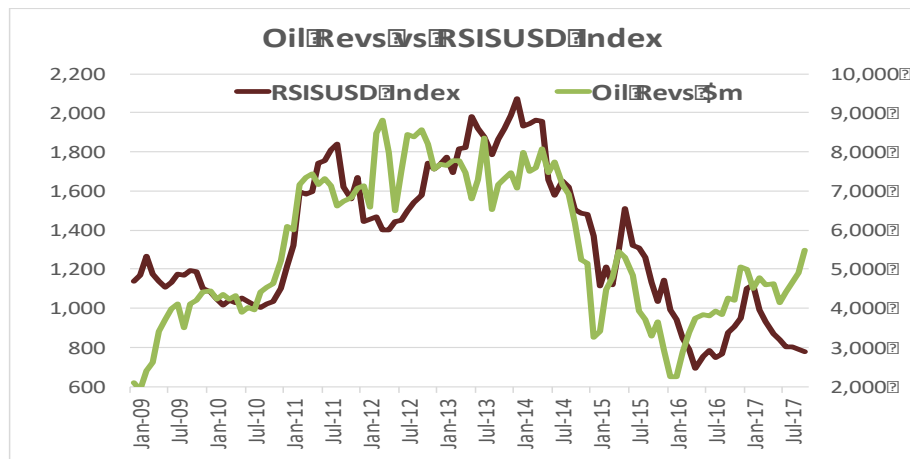
The market weakened in the last 10 days, however, this weakness is a function of continued low volumes due to the progress of the Arba'een pilgrimage, as reported [last month](#), and not the events in Kirkuk. Average daily turnover was 10% above the multi-year lows of a holiday shortened September but at only 69% of the YTD average daily turnover, which itself is very low to start with. Amid the absence of buying interest most stocks drifted lower, with the market, as measured by the Rabee Securities RSISUSD Index, down -2.2% MTD.

The most interesting development in the oil market is the changed supply-demand dynamics from the over-supply of the last three years to balance as the Backwardation chart (below) demonstrates. It charts the price difference between the WTI<sup>1st</sup> & 7<sup>th</sup> future months, indicating tightening in the spot market as a function of increased demand relative to supply. It shows how increased supply following the fight for market share in late 2014 resulted in a huge price gap, followed by weak demand as a Chinese led global slow-down in the summer of 2015 and culminating in fears of a world awash in oil in early 2016. OPEC's supply cut in late 2016 was clearly in the direction of least resistance as the market was already moving towards a rebalance. Stronger demand expectations vs constrained OPEC supply with more realistic views of Shale supply growth will probably be the fundamental reasoning for firmer prices. The changed dynamics, suggest the near prices are likely to be in range of USD 55-60 for Brent as opposed to the USD 50-55 or lower.



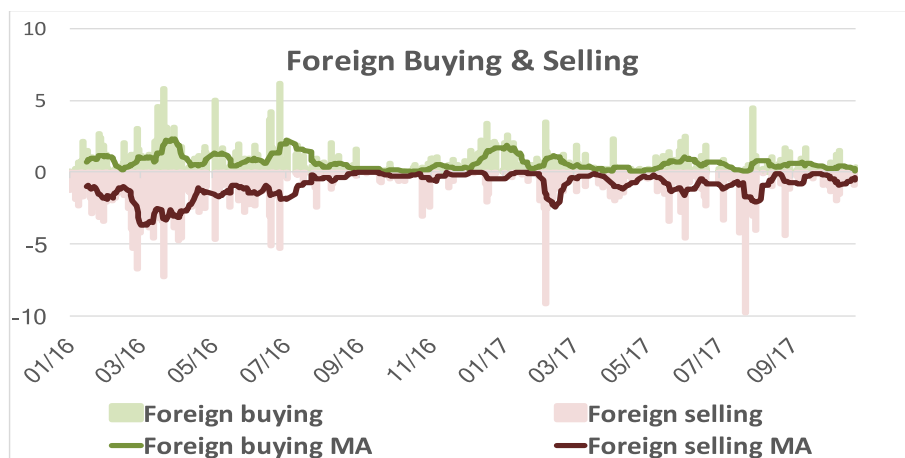
(Source: Bloomberg, data as of 24/10/2017)

All of this is extremely positive for Iraq's economy due to the high oil dependence and the country's strong export growth coupled with the expansionary effects due to the upcoming end of conflict. Oil revenues are correlated with and tend to lead the equity market (chart below), and so it's logical to conclude that this should have positive implications for the equity market's future direction.



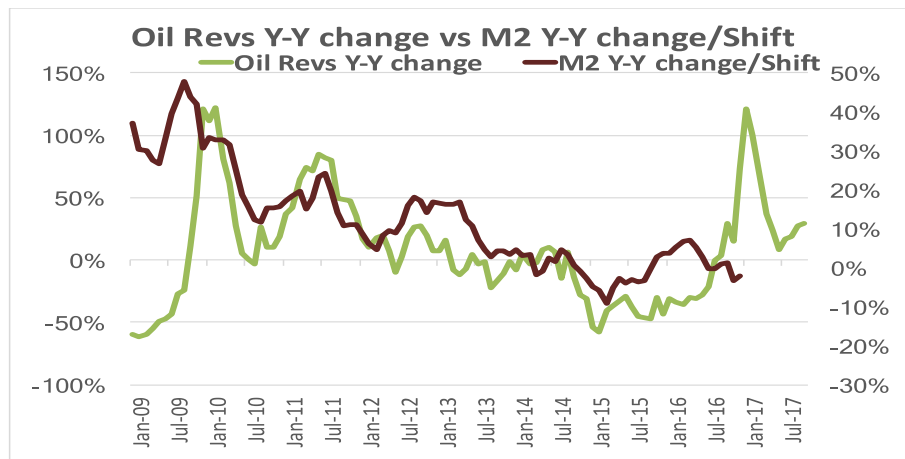
(Source: Iraq Stock Exchange (ISX), Rabee Securities, Iraq's Ministry of Oil, Central Bank of Iraq, Asia Frontier Capital (AFC))  
(Data is as of Oct)

However, the market continues to lag and the obvious question is what gives? The answer is simply a function of low liquidity suffering from the continued absence of foreign investors and still constrained local liquidity. The chart (below) shows an index of foreign activity on the ISX, highlighting anaemic foreign activity, indicating lack of major inflows, and continued selling as reported in the last few months, but with both sides meaningfully lower than last year and certainly below earlier years.



(Source: (Source: Iraq Stock Exchange (ISX), AFC)

While foreigners are an important source of liquidity, yet local liquidity is far more important but it too has been almost non-existent which is a function of the significant time lag between recovery in oil revenues and the liquidity filtering down into the real economy and ultimately into the equity market. The observed time lag is about 7-9 months, which the chart below shows: it shifts the Y-Y percentage change in M2 back by 9 months vs the Y-Y percentage change in oil revenues. While, no correlation is perfect nor always true, yet the chart suggests that the money supply has yet to reflect the significant recovery in oil prices of late 2016 coupled with higher export levels. Arguably, the changed dynamics of the oil market suggest that the recovery in oil prices should have a sustainable positive effect on local liquidity.



(Source: Iraq's Ministry of Oil, Central Bank of Iraq, AFC)  
(M2 data are as of Jul with estimates by AFC for Aug & Sep, while Oil revenues are as Oct)

Following the events of Kirkuk, Iraq's PM visited Saudi Arabia, Kuwait, Jordan, Turkey and Iran, with the most important being Saudi Arabia in which the two countries proceeded to the planning stages for implementing the Saudi led financing for the reconstruction of liberated areas as discussed in [last month](#). The immediate steps announced are easily implementable such as developing the recently opened border crossing and increasing investments by Saudi companies in Iraq<sup>ii</sup>, with other steps to come down the road.

Unlike the negatives of the liquidity crunch in 2014 which were felt in relatively short order with the equity market down about -68% from peak to bottom, the positives of the of the revival in liquidity are taking much longer to filter through to the economy and ultimately to the equity market. All of which underscores the opportunity to acquire attractive assets that have yet to discount a sustainable economic recovery. A sense of the attractive valuations was highlighted in [June](#) showing leading banks' market capitalizations at under 20% of their assets, which themselves are over 70% in cash and cash-equivalents.

#### Disclaimer

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<sup>i</sup> WTI spread used as opposed to Bent, given the extremely detailed data available on US storage and resultant supply demand balance. Which given the intense US market centric focus, serves as an extremely well discounted market picture.

<sup>ii</sup> Although, this is viewed as Saudi projection of influence to counter Iran, yet it offers an avenue for growth for local Saudi companies given the slowed domestic market and Saudi fiscal consolidation.