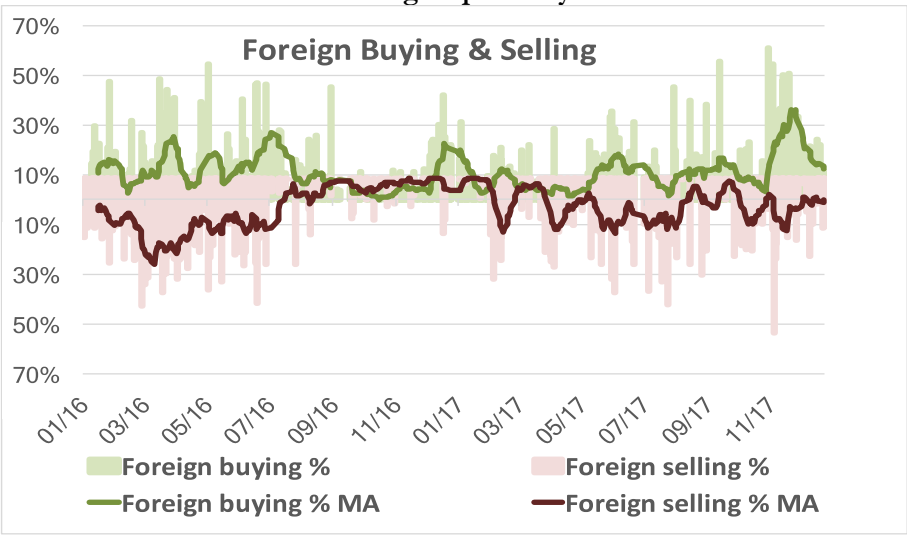
# December 2017 market review & 2018 Outlook

**Ahmed Tabaqchali, 04 January 2018**

The market continued to build on the November recovery, up +3.0% for the month, with locals picking up the buying interest from foreigners, whose recovery in buying activity in November was mostly a re-investment of dividends and partly fresh inflow as the spike in the chart below shows.

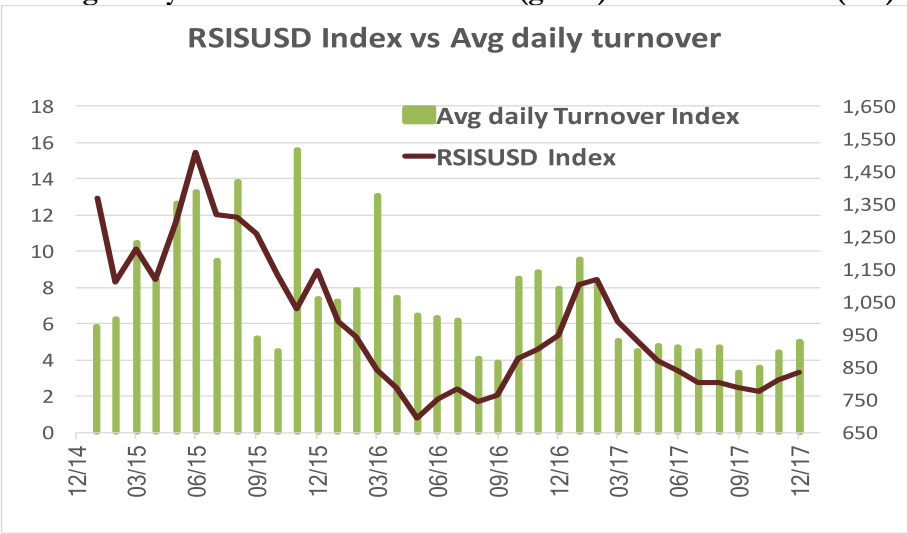
**Foreign Buying (green), Foreign Selling (red) & their moving averages, as percentage of total buying & selling respectively**




*(Source: Iraq Stock Exchange (ISX), Asia Frontier Capital (AFC))*

Foreign selling continued along the same lines of November as the spike in foreign buying ran its course. But, the increased local liquidity led to a +14% increase in average daily turnover versus the average of the March-September decline as can be seen from the chart below. Nevertheless, it is only in-line with the YTD average daily turnover, and significantly below that seen during the powerful October-February rally.

**Average daily turnover Index on the ISX (green) vs RSISUS Index (red)**

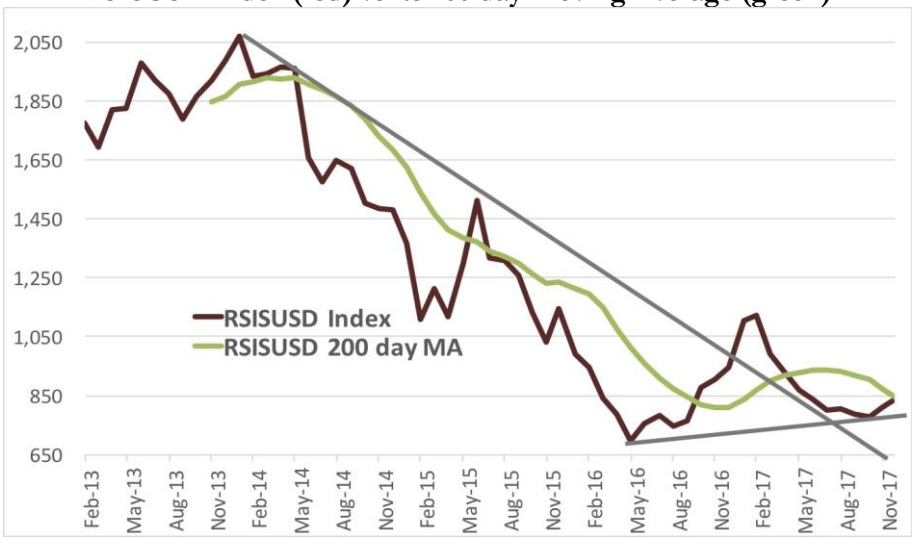



*(Source: Iraq Stock Exchange (ISX), Rabee Securities, Asia Frontier Capital (AFC))*

It's looking increasingly likely that the market's correction that began in March has run its course (see chart below). By October, the correction took the index down -31% from the February high, yet it was a positive sign that even at that low, it was still about 12% above the important May 2016 low. The higher lows, May 2016 and October 2017, should signal the end of the bear market that took the market down -68% from the February 2014 high.

From a technical perspective, the downtrend line marking the major bear market from February 2014 until May 2016, acted as support for the index during the current decline as can be seen from the grey lines in chart below, which would support the above line of reasoning.

**RSISUSD Index (red) vs its 200 day Moving Average (green)**




*(Source: Iraq Stock Exchange (ISX), Rabee Securities, Asia Frontier Capital (AFC))*

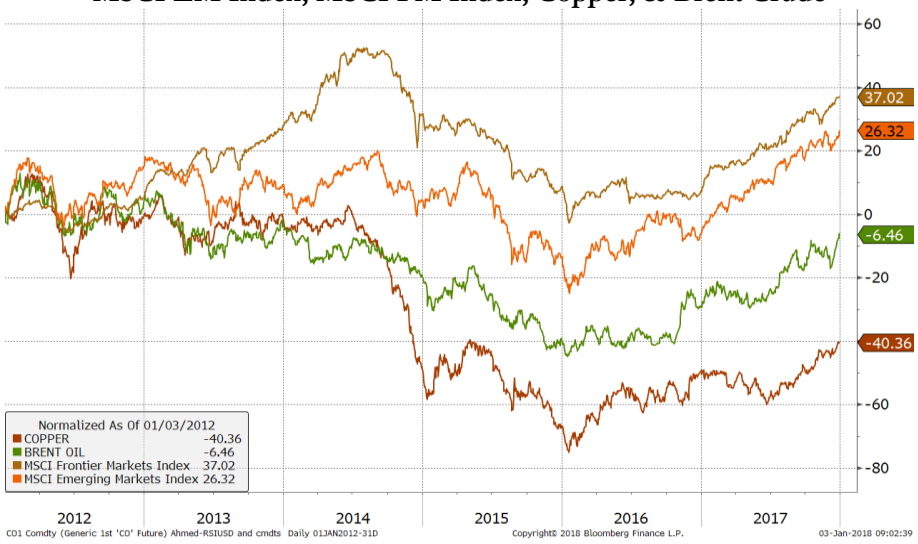
## Outlook for 2018 & Review of 2017

*"You can only predict things after they have happened"*
*Eugene Ionesco*

For the first time in a number of years, the new year outlook for Iraq is brighter with improving fundamentals after a number of extremely difficult years. The ISIS invasion that nearly tore the country apart in 2014, and consumed all of its resources over the last 3 years has wound down as the year came to an end. The military campaign, with its escalating costs has ended with the liberation of all ISIS held territories within Iraq.

Similarly, the outlook for oil prices, the main source of its income, is improving as the excess supply that crushed prices over the last 3 years has been reduced by a combination of OPEC production cuts and improving world growth prospects. The MSCI Emerging Market Index, MSCI Frontier Market's Index, Copper, and Brent crude, can be thought of as proxies for world growth: Emerging and frontier markets are driven by export growth, while copper and oil are direct beneficiaries of demand recovery, both highly dependent on resumption of world growth. The chart below shows a significant recovery in 2017 for Emerging Markets, Frontier Markets, Copper, and Brent crude after a 5-year bear market that ended in early 2016.

**MSCI EM Index, MSCI FM Index, Copper, & Brent Crude**




*(Source: Bloomberg)*

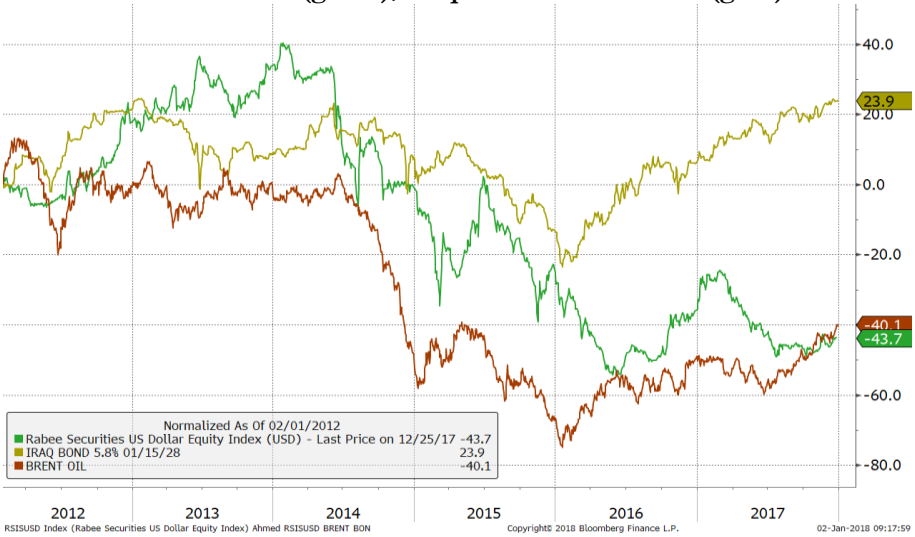
While Iraq is not a component of the MSCI Frontier Market Index, yet it has started to correlate with it from 2012 when it first witnessed meaningful foreign fund inflows. Correlations are never perfect nor constant, yet the RSISUSD Index diverged in 2016, and looks like it is lagging the MSCI Frontier Markets & Emerging Markets indices by about 6 months as seen from the chart below. In particular, it shows that the MSCI Emerging Market and MSCI Frontier Market Indices bottomed in early 2016, but within 12 months corrected to 20% & 7% above these lows, having peaked few months earlier.

**MSCI EM Index, MSCI FM Index & RSISUSD Index**

*(Source: Bloomberg)*

The RSISUSD index, has also diverged from its historic correlation with Iraq's Euro Bond (USD 2.7 billion bond issued in 2006, due in 2028 with a 5.8% coupon) and Brent crude (see chart bow). Both of Iraq's Euro Bond and Brent were up about +16.7% and +17.1% in 2017 vs. the RSISUSD's decline of -11.8%. This happened in the first half of 2016, but then the RSISUSD resumed its correlation after a lag, yet it still ended 2016 down -17.3% vs. Iraq's Euro Bond up +23.3% and Brent up +63.1%.

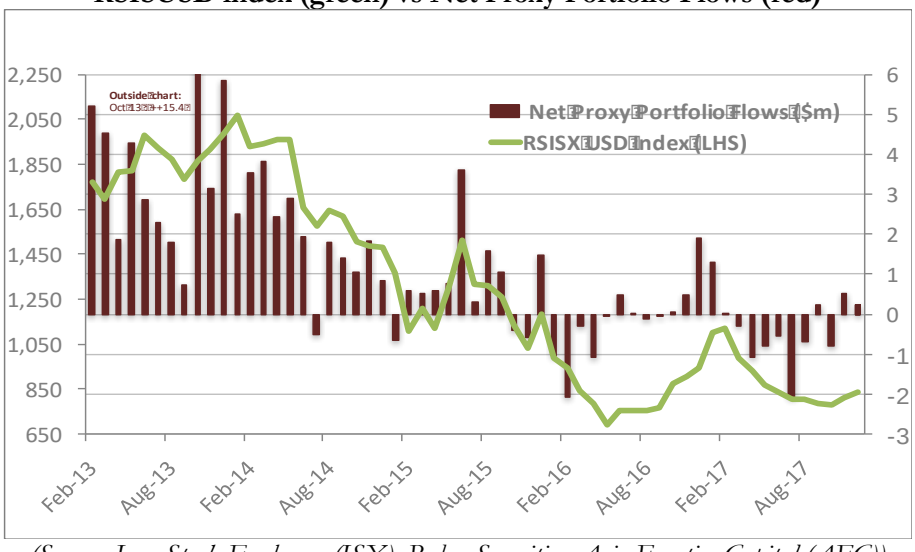
**Rabee Securities' RSISUSD Index (green), Iraq's USD 2.7 bn Bond (gold) & Brent Crude (red)**




*(Source: Bloomberg)*

Low liquidity in the equity market accounts for both divergences, as a result of the continued absence of foreign investors and still constrained local liquidity. Foreign inflows accounted for a part of the recovery in emerging and frontier markets, while Iraq's Euro bond trades institutionally & internationally and is not subject to the constraints of the local liquidity. The chart below is a proxy for net portfolio inflows into the equity market vs. the RSISUSD Index, which clearly points to a lack of inflows, and continued outflows.

**RSISUSD index (green) vs Net Proxy Portfolio Flows (red)**

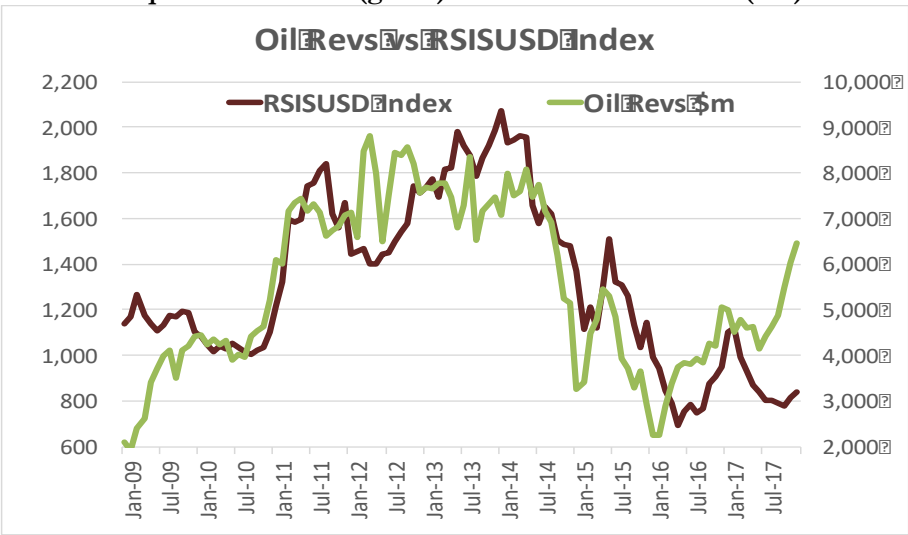



*(Source: Iraq Stock Exchange (ISX), Rabee Securities, Asia Frontier Capital (AFC))*

Local liquidity has been almost non-existent as a function of the significant time lag between recovery in oil revenues and liquidity filtering down into the real economy, and ultimately into the equity market. The time lag varies due to the state of the economy at the time, but has tended to be about 3-6 months. The chart below suggests that the equity market has yet to reflect the significant recovery in oil revenues. However, current oil market sentiment is extremely optimistic, which suggests that oil prices are due for a correction. Yet the changed supply-demand dynamics suggests the medium-term prices are likely to be in range of USD 55-60 /bbl for Brent, which should have a sustainable positive effect on the economy. The first visible beneficiary of the recovery in oil prices has been the country's foreign

reserves, which increased to USD 49.0bn by end of November vs USD 45.2bn at end of 2016, and IMF's estimates of USD 41.5bn by end of 2017.

**Iraq's Oil Revenues (green) vs the RSISUSD Index (red)**




*(Source: Iraq's Ministry of Oil, Rabee Securities, Iraq Stock Exchange, Asia Frontier Capital (AFC))*
*(Oil revenues are as of November with est.'s by AFC for December)*

Iraqi companies' own fundamentals have bottomed over the last 6 months, encouraged by tentative signs of recovery they have announced attractive dividends. In particular, high-quality banks declared dividend yields of up to 11% and mobile operator Asiacell a 14% dividend yield. In both cases, these attractive valuations come with improving fundamentals as the companies begin a recovery from the triple whammy that the ISIS conflict brought. In the case of the banks it was increasing NPL's (non-performing loans), declining deposits and negative loan growth. While for Asiacell it was a loss of the third of the country accompanied by subscriber losses and higher operating costs, decreasing ARPU's (average revenue per user) that accompanied the roll out of 3G in 2015, and finally weakened consumer spending made worse by the introduction of VAT on SIM cards in 2016.

The regional backdrop, is promising too for the first time in 3 years, and is showing signs of stability, after being marked by civil war in Syria which itself is winding down. While the recent Iranian demonstrations are a source of instability, yet it is worth noting that the demonstrators are in the thousands, unlike the millions who took part in the massive 2009 demonstrations. The common thread running through current demonstrations is economic dissatisfaction with demands for redirecting resources to the domestic economy away from foreign activities. While the demonstrations are likely to be contained, yet coming from the regime's support base, these demands would likely lead to a decreased Iranian involvement in the region. In time, this should have positive implications on the proxy conflicts that plagued the region over the last few years.

However, the most significant regional development to look for in 2018 is the furthering of the realignment of interests of regional players in dealing with the root causes of the conflict, i.e. the deep economic and political disenfranchisement, that were such fertile grounds for the rise of extremism. This furthering should lead to long-term solutions which will involve significant investments in infrastructure to bring much-needed development and create prosperity.

The first to emerge is the Iraq-Saudi Arabia alliance, in which Saudi Arabia, to be followed by the UAE, is to take the lead in funding the reconstruction of the liberated areas, i.e. the western part of the country from Mosul, spreading into Anbar and beyond. Its significance is the economic revitalization of the liberated areas first through trade and then reconstruction. The first steps were the resumption

of trade, through re-opening of the Iraq-Saudi Arabia border crossing and the Iraq-Joran border crossing. There are no data on the volume of trade with Saudi Arabia given the closure of the route in the 90's following the First Gulf War. But data for 2014 show that, prior to the emergence of ISIS and the border closures, imports from Jordan accounted for about 24% of all Iraq's imports. Their loss had a devastating economic impact on the area, i.e. Anbar, including the surrounding areas in Nineveh and Salah Ad-Din. This exasperated their disenfranchisement since 2003, but the resumption of these trade-links with their associated economic activities will provide a huge boost to the local economies. The reconstruction, even if the alliance is more modest than hoped for, will build upon and magnify the economic revival until it becomes self-sustaining. The economic rehabilitation of the liberated areas would be a crucial component in winning the peace and would go a long way towards the return of stability to the country. The rehabilitation of local economies would include these neighbouring Iraq, especially the ones associated with these trade routes, which ultimately leads to greater regional stability.

However, significant challenges remain for Iraq: the huge financial demands for reconstruction, winning the peace, defeating a likely emerging ISIS insurgency, controlling violence, and resolving the Kurdish issue. Finally, the upcoming parliamentary and provisional elections in May 2018 will likely be the focus of the government over the coming months. Which could lead to delays in addressing the other challenges, until the conclusion of the elections, in the process compounding the challenges ahead.

Yet, a change of direction is at hand, which underscores the opportunity to acquire attractive assets that have yet to discount a sustainable economic recovery. The prospects of the economic recovery following the ISIS conflict are discussed in the author's recent research piece as a non-resident fellow at the Institute of Regional and International Studies (IRIS) at the American University of Iraq in Sulaimani (AUIS): "Iraq's Economy after ISIS: An Investor's Perspective". However, the recovery will likely be in fits and starts with plenty of zig-zags along the way as liquidity is still scarce with a time lag before it can filter down into the economy and ultimately into the equity market.

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