

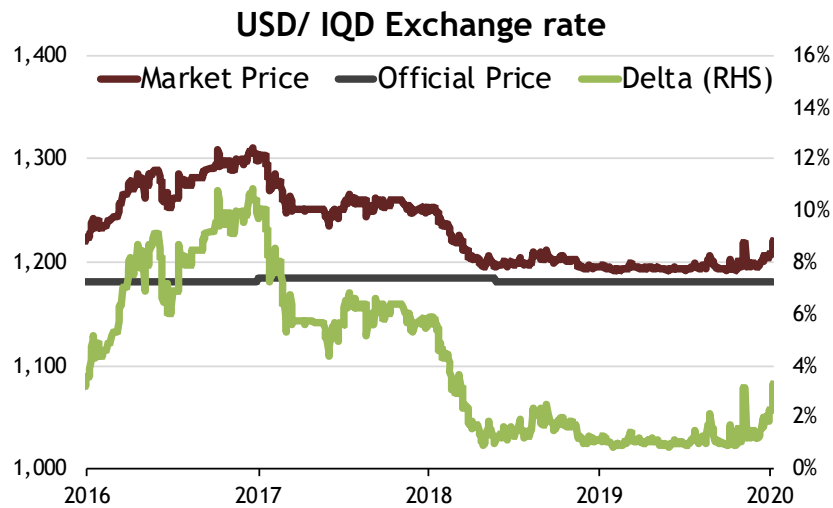
Market Review: “2019 Review and 2020 Outlook”

Ahmed Tabaqchali, January 7th, 2020

Stop the Press: Just as this article was being readied for publication, the news came of a US strike in Baghdad that targeted a car carrying Iran’s top general and a senior commander of Iraq’s Paramilitary Units (PMU). The attack raised the often-discussed spectre of a US-Iran proxy war fought in Iraq. While this is a real possibility, and events are extremely fluid, there are a few points that should be taken into account amidst the breathless media coverage:

- *Angry rhetoric from Iran promising fire and brimstone is a given, however, irrespective of all the bluster, Iran cannot afford a direct or indirect full confrontation with the US given the severe weakness of its economy.*
- *Iran’s false reading of the US’s hesitation to order a full strike a few months ago led it to push the envelope assuming the US would not retaliate. This attack, demonstrating the extreme extent to which the US will go to defend its interests, will force Iran to re-calculate especially given that the US will be in the midst of an election campaign that will likely see the re-election of the current administration.*
- *The dilemma for Iran is the need to retaliate to save face, but without crossing the now abundantly clear US red line, or for that matter starting a wider conflict in the region that it can ill-afford to wage.*
- *Iraqi politicians, especially some with sympathies to Iran will, after expressing their perquisite outrage over the violations of sovereignty and threats of revenge, realize that being placed in the same position as that of sanctioned Iran is not advantageous to them, to Iraq, or to Iran.*
- *The recent decision by the Iraqi parliament regarding foreign military presence supports the argument made here, in that it’s high on theatrics, but low on substance. It was not a decision to end US military presence, but a typical Iraqi fudge. In essence, it’s a resolution asking the government to do five things, of which two are worth noting: (1) Cancel the request for global coalition support made in 2014; and (2) for the government to work towards ending the presence of all foreign troops. Crucially, the request for global coalition support in 2014 was made by the then government, without parliamentary oversight, and as such could have been cancelled directly by the government, yet it chose to pass the buck to parliament using the excuse of being a caretaker government, but parliament then passed it back. The next steps would involve a lot of noise and bluster, but most likely the resolution would be watered down to an aspiration once the uproar subsides.*
- *Finally, within Iran, the government finds itself for the first time in a position to conduct a rational foreign policy, unlike the shadowy operations that were Iran’s effective de-facto foreign policy in the region. This will likely manifest through back channel diplomacy once the dust settles over the next few months.*
- *However, the next few weeks are to be marked by a lot of noise and come with spurious threats and counter threats that are reminiscent of the fire and fury that marked the exchanges between the US and North Korea a few years ago, but this time taking place in the most volatile region in the world.*

While these events are being played out, it’s worthwhile to look at the Iraq investment story purely on its own merit, especially as the stock market was up +1.5% for the year as of Tuesday 7th January and was building on the trends discussed below. Crucially the market price of the US versus the Iraqi Dinar has only moved up by about +2.0% above the levels for most of the last 20 months. After stabilising in early 2018, It has traded briefly at current elevated levels before the elections in May 2018, during the tanker hits during the summer, and finally, the recent attacks on Saudi oil installations.



(Source: Central Bank of Iraq, Iraqi Foreign Exchange Houses, Asia Frontier Capital)

The Iraqi equity market, as measured by the Rabee Securities RSISX USD Index (RSISUSD), ended December up +2.6% and down -1.3% for the year. The outlook for the Iraqi equity market for 2020 will be shaped by the three events that marked 2019:

- The equity market's bottoming following a multi-year bear market
- The increasing signs, at both a macro and company level, of an economic recovery
- The repercussions of a youth led protest movement that is bringing with it profound changes (mostly positive) to the Iraq story culturally, politically and economically

Protest movement art in Baghdad's Tahrir Square



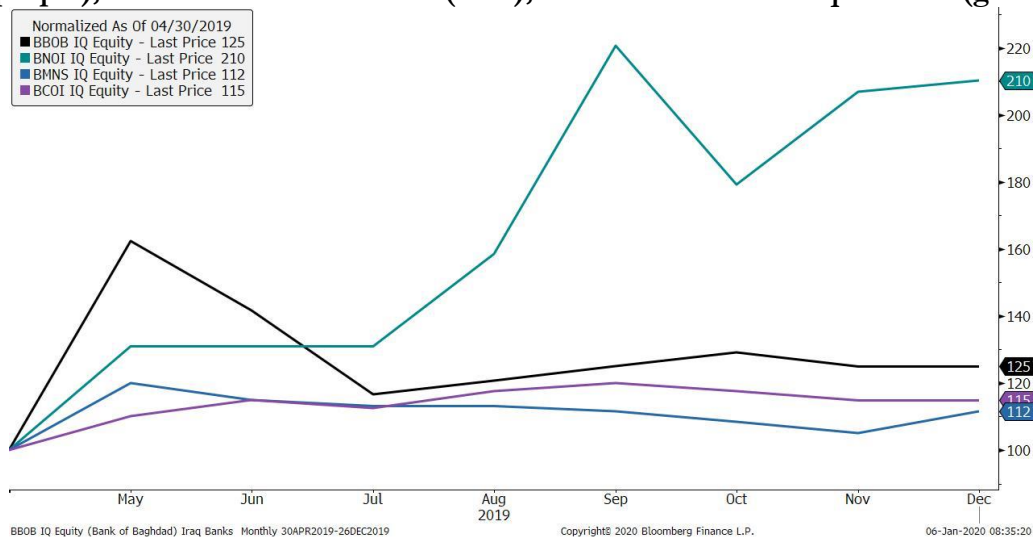
(Source: Art by Yota Namir, Ra'ed Modab & Noor Namir, photo by Mohammed Ghani posted [on Baghdad Projects' Facebook page](#))

2019's decline of -1.3% by the Rabee Securities RSISX USD Index (RSISUSD) comes on the back of declines of -15.0% in 2018, -11.8% in 2017, -17.3% in 2016, -22.7% in 2015, and -25.4% in 2014.

The small scale of the 2019 decline, the improved market dynamics and the bottoming in trading turnover all point to a bottoming market formation after a brutal bear market that saw the index decline by –66.1% from the peak in early 2014 to the end of 2019.

The first of the market’s improved dynamics is its discriminating nature in evidence throughout the bank rally that started in May 2019, which at the time was led by a stunning rise in Iraq’s leading bank, the Bank of Baghdad (BBOB), which was up +62.5% in May on hopes it would resume dividend payments for the year. These expectations led to other leading banks such as the National Bank of Iraq (BNOI), Mansour Bank (BMNS) and Commercial Bank of Iraq (BCOI) to join the rally. Subsequently, BBOB’s quarterly earnings results confirmed expectations that it is following through with the recovery in its fortunes that began in 2018 as part of the overall conditions in place for the sector’s future revival. Nevertheless, BBOB did not resume dividend payments for 2018’s earnings. However, unlike in prior years, BBOB declined from the May 2019 peak, yet did not lose all the gains– and more importantly while it pulled the other leading banks up with it in May, it did not drag them lower in the following months. By year end all of the leading banks were meaningfully higher than their pre-May rally lows.

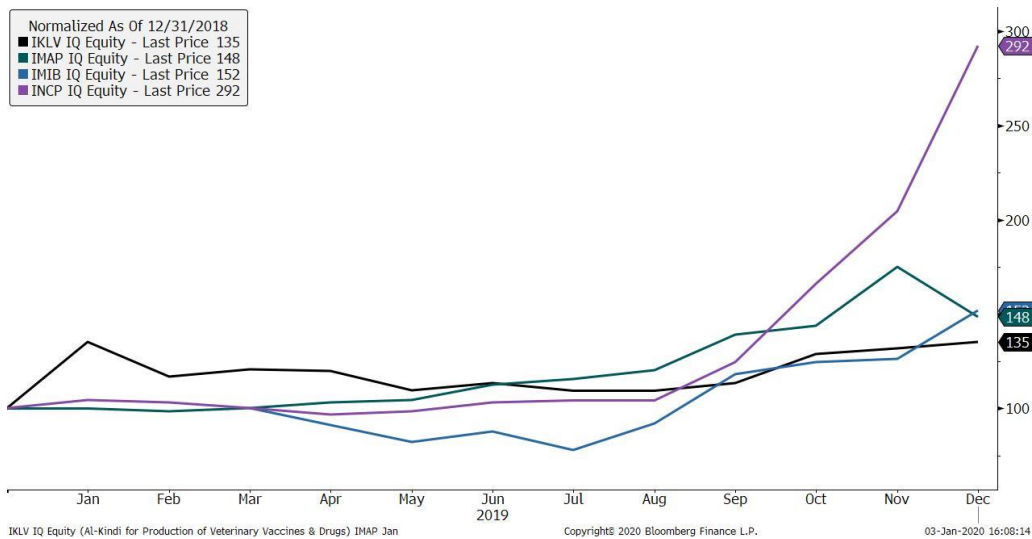
Indexed performance: Bank of Baghdad - BBOB (black), Commercial Bank of Iraq – BCOI (purple), Mansour Bank – BMNS (blue), National Bank of Iraq - BNOI (green)



(Source: Bloomberg, data from 30/04/2019 – 31/12/2019)

The second aspect of the improved market dynamics is the broadening of breadth and the market’s focus on the hopes of an earnings recovery for some of the industrial stocks even before any signs of such recovery can be detected in their earnings report during 2019. This dynamic was evident in small industrial companies and in healthcare providers classified under the industrial sector on the Iraq Stock Exchange (ISX), as discussed here in the last few months. The chart below shows the price action of Al-Mansour Pharmaceuticals Industries (IMAP), Al-Kindi of Veterinary Vaccines Drugs (IKLV), National Chemical & Plastic (INCP), and Metallic & Bicycles Industries (IMIB).

Indexed performance: Al-Mansour Pharmaceuticals Industries- IMAP (green), Al-Kindi of Veterinary Vaccines Drugs- IKLV (black), National Chemical & Plastic – INCP (purple), Metallic & Bicycles Industries -IMIB (blue)

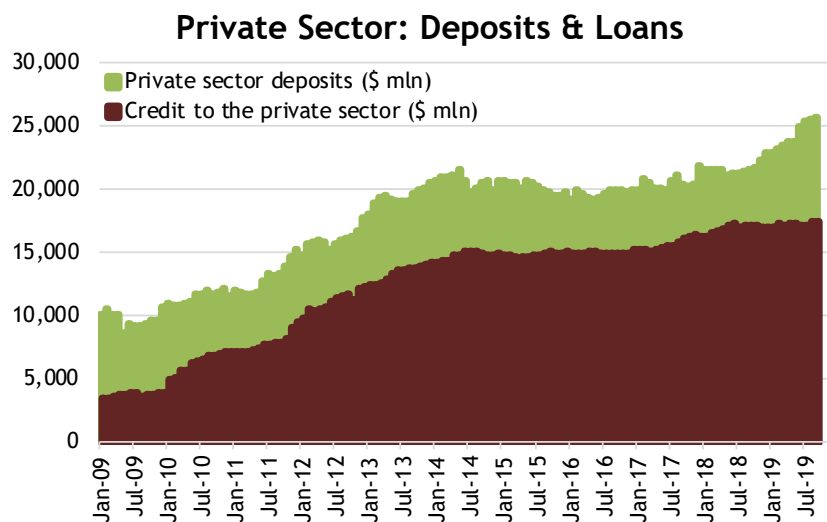


(Source: Bloomberg, data from 31/12/2018 – 31/12/2019)

Normally, cyclical stocks outperform defensive or growth stocks at the start of economic recoveries even though their earnings do not support this outperformance – at least initially. It can be argued that similar dynamics are taking place through the action of cyclicals on the ISX in 2019 such as the banks, mentioned earlier, versus those of market stalwart growth stocks – Pepsi bottler Baghdad Soft Drinks (IBSD) which was down –8% for the year, or for mobile telecom operator Asiacell (TASC) which straddles the cyclical and defensive sectors due to the specifics of its earnings drivers since 2014, which was up +12% in 2019. In contrast, in 2018 both were up +34% and +47% respectively, but the banks were down, such as BBOB –52%, BMNS –20%, BNOI –28%, BCOI –4%. Even though the analysis of cyclicals versus growth stocks can only go so far on the ISX, given its illiquidity and limited diversification, the logic of an economic recovery driving cyclical earnings is applicable.

This economic recovery was initially driven by the revival in government spending on goods and services and on wages, the evidence of which was seen in: (1) the upturn of the country’s exports and in new vehicle sales as reported here in [October](#), and (2) the continued growth of broad money, or M2, as a proxy for economic activity as reported here in [December](#).

Data from the Central Bank of Iraq (CBI) on private sector deposits and credit to the private sector support the above trends. These show private sector deposit growth of +12% for the year by end of September 2019 after a few years of no change, while credit to the private sector was up +3% for the period but should accelerate as the economy continues to recover.



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

The above chart is based on aggregate data for the private sector with the banking system as a whole – both for state banks, and commercial sector banks which accounted in 2018 for 36% of total credit to the private sector and 37% of private sector deposits – and thus do not show the performances of specific commercial banks listed on the ISX.

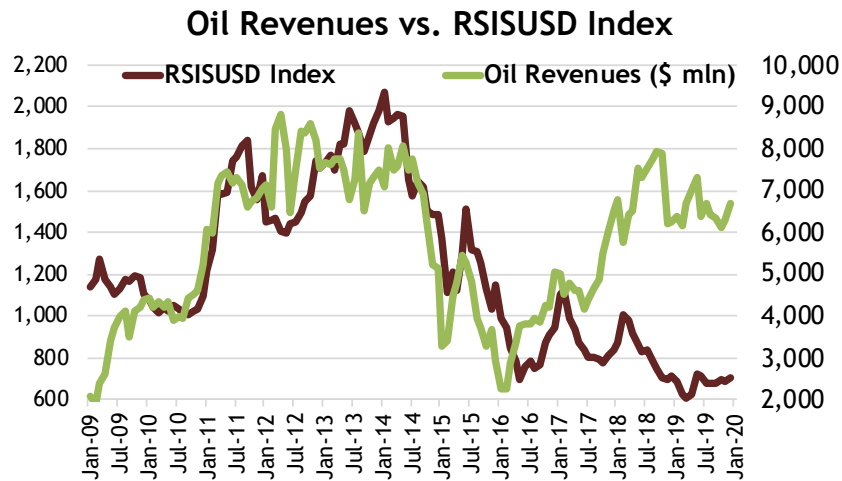
Drilling down to the company level within the commercial banking sector, the earnings profile of the National Bank of Iraq (BNOI) for the first nine months of 2019 (9M/2019) demonstrates the above macro trends. For BNOI private sector deposits were up +54% in 9M/2019, while credit to the private sector was up +116% for the same period. Its pre-tax earnings for 9M/2019 hold promise for strong full year earnings – a long way to go before recovering to pre-crisis levels– but supporting management’s bullish expectations for the year. While it’s not possible to extrapolate much from these results, or to generalize for the sector as a whole from them, they support in any case the argument that the conditions are in place for the sector’s recovery in 2020.

The macro and the micro trends discussed so far are affected by the youth protest movement that dominated all events in Iraq from the 25th of October 2019 after the initial wave of protests in early October. The protest movement forced the political elite to implement reforms that would threaten their interests – contrary to earlier expectations of the opposite. Parliament approved electoral reforms that if made into law would be a meaningful departure from the prior ones that largely allowed the political elite to maintain their oversized influence on successive government formations.

If the hoped-for early elections in 2020 are to be conducted under these electoral reforms they will most likely lead to the formation of the next government with a majority in parliament and parliamentary opposition, as opposed to the case since 2003 in which successive governments were composed of all parties in parliament. This was the root cause of the failures of the past to implement the reconstruction of the country, as each party pursued its own program within its own sphere of influence within an all-inclusive government.

These developments have yet to be played out and a lot of uncertainties remain, yet the near-term effect on the economy would be that the current caretaker government, while unable to act on capital spending plans, will follow up with implementing the current spending element of the 2019 expansionary budget. Moreover, it will continue to implement this budget in 2020 through the upcoming months of pre-election manoeuvring, elections, and post-election government formation. The government has plenty of firepower to fund this spending in the form of a 33-month cumulative surplus of about USD 28.9 bln that will increase in a firmer oil price environment. The most important

consequence of this is the sustainable continuation of the consumer led economic recovery discussed in earlier paragraphs.



*(Source: Iraq's Ministry of Oil, Rabee Securities, Asia Frontier Capital)
(Data for oil revenues as of December 2019)*

The stock market continues to look through the political developments to the upcoming economic recovery, and while it's in the early process of forming a base it is worthwhile to point out its continued divergence from its past close relationship with oil revenues (a proxy for the forces driving the economy). This divergence is still at the widest it has been for the last few years and it is showing tentative signs of narrowing this divergence as the above chart shows.

For further reading, here are some interesting, relevant news links related to Iraq:

- An interesting article on the emerging art and the future significance of the protest movement is "[Hip hop, poetry and Shia iconography: How Tahrir Square gave birth to a new Iraq](#)", Fanar Haddad, December 9th, 2019, Middle East Eye.
- For a full coverage of the protest movement's symbolic art form visit the [Facebook page of Baghdad Projects](#).

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