Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Saudi Arabia Funds

Morgan Stanley Saudi Equity Fund

ACTIVE FUNDAMENTAL EQUITY | SAUDI ARABIAN EQUITY TEAM | QUARTERLY COMMENTARY | 30 JUNE 2019

Performance Review

In the twelve month period up until 30 June 2019, the Fund returned 10.78% (net of fees)[1], while the benchmark returned 6.10%. Since inception until 30 June 2019, the Fund returned 14.66% (annualised, net of fees)[1], while the benchmark returned 5.00%.

Market Review

In the region, the Kuwaiti stock market continued to perform strongly (approximately +20% year-to-date) on the back of the upgrade from frontier market to the MSCI Emerging Markets (EM) Index. MSCI announced its decision to upgrade Kuwait to the EM index for implementation in May 2020. However, this decision is subject to two conditions (omnibus account structures and same National Investor Number cross trades being made available for international institutional investors) that should be made available before the end of November. MSCI will communicate its final decision by December 31, 2019. If reclassified to EM, the MSCI Kuwait standard index would have nine stocks with a 3.0% weight in the MSCI EM EMEA Index and 0.5% in the MSCI EM Index (possibly bringing inflows from $2 billion passive to $4.7 billion including active).

The Emirates NBD United Arab Emirates PMI (non-oil private sector) declined to 57.7 from a four-and-a-half-year high of 59.4 in May. According to the report, output and new orders continued to grow on the back of further price discounting, while employment levels were broadly unchanged as businesses remain focused on keeping costs down. On the real estate front, the picture is mixed. Real estate price trends in the U.A.E. remained weak with rents and prices showing weakness. Most analysts are expecting this trend to persist in the near term. Large supply and a relatively weak level of economic activity are some of the main reasons behind it.

The International Monetary Fund (IMF) has cut Oman's 2019 economic growth forecast to 0.3% from 1.1% as OPEC-led production curbs slash oil-related growth among Gulf energy producers. In lowering Oman's expected real gross domestic product (GDP) growth rate to 0.3% from 1.1%, the IMF said it expected its oil GDP to decrease by 1.1% against April's estimate of a 0.6% contraction. Its gross government debt rose to 53.5% of GDP last year, according to the IMF. While Oman is not at immediate risk of a credit crunch, as it has sufficient reserves to cover debt repayments, it should work harder on fiscal adjustment reforms, said the IMF, which called for 'an expeditious introduction of VAT and measures to adjust government expenditure'.

A recent report by Fitch Solutions looked at the progress made by the Gulf Cooperation Council countries in diversifying their economies. According to this report, the U.A.E. topped the list of counties in their diversification efforts. While Saudi Arabia (second) and Bahrain increased their scores. Kuwait remains firmly at the bottom due to its weak business environment and limited impetus for reform.

Tensions with Iran are back on the front pages. The impact on regional economic conditions (excluding Iran) so far is limited, we believe.

In June, the Saudi PMI remained at an elevated level but was little changed over the previous month. The Emirates NBD Saudi Arabia PMI rose by 0.1 point to 57.4 in June, the highest level since November 2017. However, output prices and job creation decelerated.

Saudi Arabia real annual GDP fell to 1.7% in the first quarter of 2019 versus 3.6% in the fourth quarter of 2018. A decline in oil production pulled down the aggregate figure. In the non-oil economy, real GDP growth moved up slightly by 0.1% to 2.1%. The construction sector posted growth for the first time since the fourth quarter of 2015. Unemployment among all population in the Kingdom eased to 5.7% in the first quarter – compared to 6.0% in the fourth quarter of 2018, with 2.8% among males and 21.0% among females. The deflationary trend persisted in May (-1.5% year-over-year), though decelerating versus previous months. Point-of-sale/ATM transactions recorded a sharp rise at 15.3% month-over-month in May, partly due to the Ramadan effect, in our view.

In May, corporate loan growth remained muted but total loan growth was +3.1% year-to-date due to strong mortgage lending. We believe this trend is likely to continue in 2019. So far, there have been no major signs of corporate loan growth pick-up.

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1 Source: Morgan Stanley Investment Management Limited. Data as of 30 June 2019.

The OPEC+ countries, after several twists and turns, finally agreed to extend the oil cut agreement by nine months (up to the first quarter of 2020). Russia had earlier shown some reluctance but finally agreed. This was an important milestone and critical for short-term support for oil prices.

The second quarter 2019 earnings outlook is muted. The petrochemical sector will likely show a decline in sequential earnings as product prices are under pressure. Banking, retail and consumer sector companies are expected to register single-digit year-over-year growth in aggregate, we believe.

After an almost double-digit decline in May, the Saudi market recovered in June as investors repositioned their portfolios. We expect most of the index-related positioning to be over in August/September (MSCI inclusion on 28 August). We are expecting more volatility in the coming months.

Portfolio Activity

During the quarter, we participated in the initial public offerings of newly listed companies. In addition, we increased our exposure to selected names in the real estate investment trust sector, which offered attractive dividend yields. We also increased our allocation to the food sector in a stock which had lagged in terms of performance during the year.

On the other hand, we reduced the overweight to the banking sector on an increasing likelihood of a rate cut this year, which could have a negative impact on the sector's margins. We also reduced the allocation to the telecom sector on strong performance over the last 12 months.

Strategy and Outlook

We remain overweight to the banking sector, though at a lower level, as we believe loan growth will pick up driven by government projects over the next 12 months. However, the increasing likelihood of an interest rate decline is a negative for the sector. We are cautious on the petrochemical names due to decline in oil price and slowing economic growth in China. Industry consolidation has continued to help large retailers in gaining market share at the cost of smaller operators. Where possible, we will seek companies that we believe will benefit from industry consolidation.

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FUND FACTS

Launch date	Base currency	Benchmark
06 January 2009	Saudi Riyal (SAR)	Tadawul All Share Index

Annualized Performance in Saudi Riyal, net of fees, vs benchmark (%)

Calendar Year Returns (%)	2018	2017	2016	2015	2014
Fund	17.81	2.13	9.91	-3.51	27.55
Benchmark[2]	8.31	0.22	4.32	-17.06	-2.37

[2] The benchmark is a price return Index.

INDEX INFORMATION

The **Tadawul All Share Index (TASI)** is the major stock market index which tracks the performance of all companies listed on the Saudi Stock Exchange. The Index is disseminated by the Saudi Stock Market. Volume in the index excludes small trades (trades with value less than Saudi Arabian Riyal 15000).

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

The **MSCI Kuwait Index** measures the performance of the large- and mid-cap segments of the Kuwait market.

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The investment performance of the Morgan Stanley Saudi Equity Fund is calculated on a total return basis (i.e., with cash dividend reinvested), while the investment performance of the benchmark is provided on price return basis (i.e., it does not include dividends). The dividend yield as per Bloomberg for TASI was 3.48% as of 30 June 2019.

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Funds that specialize in a particular region or market sector are more risky than those which hold a very broad spread of investments. Where portfolio concentration is in one sector it is subject to greater risk and volatility than other portfolios that are more diversified and the value of its shares may be more substantially affected by economic events.

These investments are designed for investors who understand and are willing to accept these risks. Performance may be volatile, and an investor could lose all or a substantial portion of his or her investment.

Please click this hyperlink to the Information Memorandum for further information-regarding the principle risks, terms and conditions of investing in the Morgan Stanley Saudi Equity Fund.