

# Saudi Arabia: Investors' appetite for Saudi equities spiked despite EM sell-off



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Boban Markovic, Senior Analyst, [bmarkovic@iif.com](mailto:bmarkovic@iif.com), +1 202 857 3632 [@BobMarkovic](https://twitter.com/BobMarkovic)

Garbis Iradian, Chief Economist, MENA, [giradian@iif.com](mailto:giradian@iif.com), +1 202 857 3304 [@Garbis\\_Iradian](https://twitter.com/Garbis_Iradian)

- Portfolio investments will be the main driver of foreign capital inflows increase to Saudi Arabia in 2019.
- Portfolio re-allocation benefits and natural currency hedge are driving investors' appetite for Saudi stocks.
- Supported by the MSCI upgrade, Saudi Arabia has attracted \$18 billion in foreign equity inflows so far this year.
- In contrast, renewed trade tensions sparked a sharp decline in portfolio equity flows to other emerging markets.

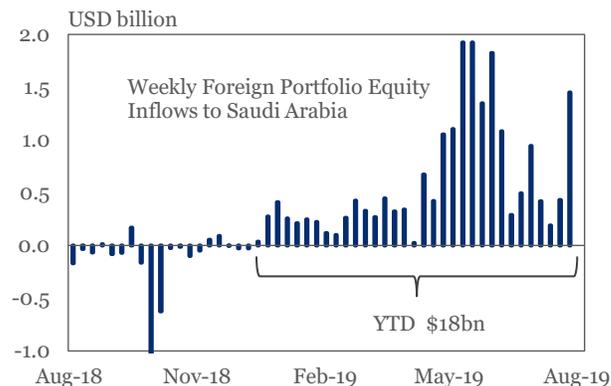
Investors' appetite for Saudi Arabia's equities spiked once again in August ahead of the second phase of MSCI emerging markets index (MSCI EM) inclusion. Saudi Arabia has attracted \$18 billion in foreign portfolio equity inflows so far this year, as foreign investors have significantly increased their exposure to Saudi equities ahead of the upgrade (Exhibit 1).

The inclusion of local stocks to broad equity benchmarks acknowledges the progress made by Saudi Arabia in reforming its capital market system. Following the upgrade in March of this year, FTSE Russell has already started adding Saudi equities to its index. After the first phase in June, when MSCI added Saudi Arabia's stock to its emerging markets index with an initial weight of 1.45%, the index compiler will complete the upgrade at the end of August by increasing the weight of Saudi equities to 2.8% of the total index. We expect the second phase of the upgrade to attract an additional \$5 billion in equity inflows to the oil-rich kingdom.

Early positioning by investors has been relatively slow since the MSCI inclusion announcement last year due to concerns about policy uncertainty, high valuations for Saudi-listed firms, and reputational issues related to the Khashoggi incident. Nonetheless, it seems that investors have shrugged off such concerns this year. Were it not for global trade conflict and concerns regarding the escalation of regional tensions, inflows to Saudi Arabia would have been even higher. In the first eight months of this year, foreign equity inflows to Saudi Arabia surpassed those of India and China, which is remarkable given that Saudi Arabia's economy is just a fraction of the size of India and China.

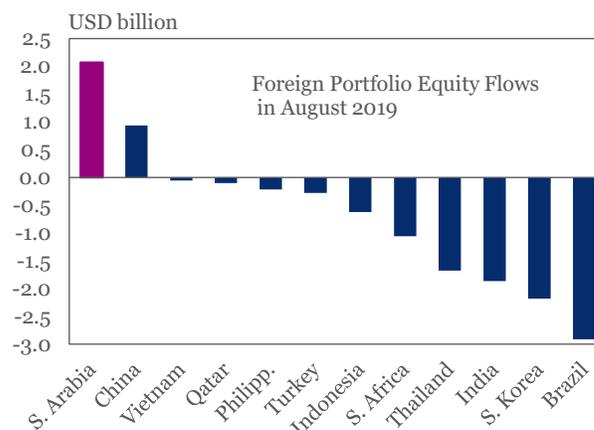
Strong inflows to Saudi Arabia stand in sharp contrast to other emerging markets (EMs). After a positive performance in the first quarter of this year, renewed trade tensions

Exhibit 1: Equity inflows to Saudi Arabia remain strong...



Source: Saudi Arabia Stock Exchange, Bloomberg, IIF

Exhibit 2: ...as compared to other emerging markets.



Source: IIF Capital Flows Tracker

sparked a sharp decline in equity flows to most EMs. According to our [Capital Flows Tracker](#), May 2019 was perhaps the worst-performing month for EM equity flows since the taper tantrum (June 2013). So far, August portrays an equally negative picture, as the EM sell-off in the first two weeks of this month was fairly even across the board. In contrast to other EMs, Saudi Arabia received more than \$4.5 billion in foreign equity inflows in May, and \$2 billion in the first three weeks of August, becoming the top equity investment destination among EMs (Exhibit 2).

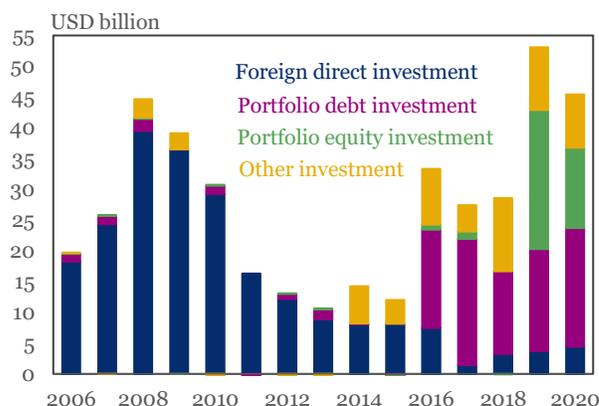
We expect Saudi Arabia to continue reaping the benefits of the capital markets reform and the inclusion in global indices. In the absence of major domestic and external shocks and further deterioration in EM investment sentiment, Saudi Arabia can count on additional equity inflows from active investors whose portfolios are benchmarked to the MSCI EM index. With continuous Eurobond issuance, portfolio investments will be the main driver of foreign inflows to Saudi Arabia this year (Exhibit 3).

Despite the recent weaker performance of Saudi Arabia's largest sectors – banking and energy – the rationale for investors' interest in Saudi Arabia's stocks can be explained by portfolio re-allocation benefits. Monthly returns on investment in Saudi Arabia's stock index show lower sensitivity to other emerging and developed markets (Exhibit 3). With the local currency pegged to the U.S. dollar and backed by large foreign reserves, exposure to Saudi Arabia's market represents a natural currency hedge for investors.

Experience shows that equity markets frequently rally after upgrade announcements but retract after the upgrade itself. This pattern was seen in the UAE, Qatar, and Pakistan. While Saudi Arabia has shown a similar increase after the announcement, there is a reason to think that a major correction will not necessarily occur, unless global oil prices fall to well below \$55 per barrel. First, foreign equity inflows remained high after the first phase of the upgrade. Second, the Saudi market is bigger, and more liquid compared to other markets in the region that joined the MSCI EM index recently. Third, many diversified portfolios are unlikely to ignore Saudi Arabia as the EM investment destination.

The kingdom's Public Investment Fund (PIF) remains the biggest investor in Saudi Arabia's stock market. With the surge in foreign inflows in May, Saudi state funds have liquidated around \$7.5 billion from their ownership in Saudi stocks (Exhibit 5). Considering the size of their market interventions in the past, this was the perfect opportunity to collect the profits and reduce their positions.

**Exhibit 3: Portfolio investments will be the main driver of foreign capital inflows to Saudi Arabia in 2019.**



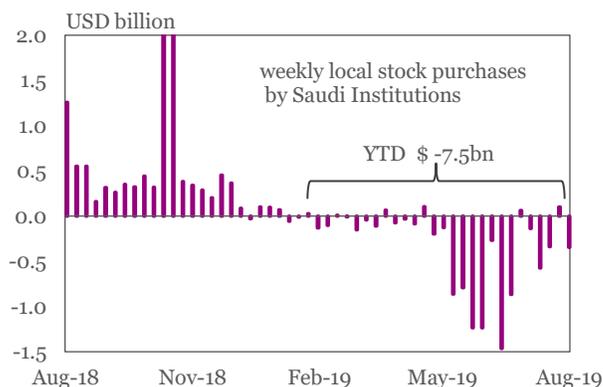
Source: IIF

**Exhibit 4: Saudi Arabia's stock returns have limited sensitivity to EM and developed markets' returns.**



Source: Bloomberg, IIF

**Exhibit 5: Government-related funds cleared some of their positions amid increased liquidity.**



Source: Saudi Arabia Stock Exchange, Bloomberg, IIF