

A GUIDE TO THE MIDDLE EAST JIGSAW



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“The change in leadership with the enhanced inclusion of young Crown Prince Muhammad bin Salman is also moving Saudi Arabia into a more aggressive stance in all relevant political issues”.

What is your analysis of recent events in the Middle East?

MD We think that recent events in the Middle East – in particular, the night of the long knives in Saudi Arabia and the resignation (then retracted) of Lebanese Prime Minister Saad Hariri – are pieces in the same jigsaw puzzle: the attempt to redraw political boundaries and delineate new geopolitical equilibria in the region.

Other pieces reflecting the current state of the Middle East jigsaw include:

- The ballistic missile intercepted near the King Khalid international Airport in Riyadh, probably fired by the Iranian-supported militia;
- The mysterious helicopter crash near the border with Yemen in which Saudi Prince Mansur bin Muqrin was killed;
- The Kurdish defeat in Iraq by the Iraqi government forces (supported by Iranian-backed Shia militias) after the recent referendum for an independent Kurdish state;
- The Assad/Hezbollah's victory in Syria.

As such, disconcerting events that are escalating tensions in the region should not be considered as isolated episodes, but rather as part of a greater whole aimed at rebalancing power away from Iran and towards the new Saudi leadership.

What implications could the change in Saudi Arabia's leadership have for the Middle East?

MD The change in leadership, with the rise of young Crown Prince Muhammad bin Salman, appears to imply that Saudi Arabia is shifting to a more aggressive stance in all relevant political areas: from Qatar to Yemen, from Iraq to Iran, and from Syria to Lebanon – all areas where Saudi Arabia has progressively lost its influence.

The Qatar diplomatic crisis has been at an impasse since June and currently appears no closer to being resolved, despite Kuwait and US mediation efforts. The Arab Quartet (Saudi Arabia, the United Arab Emirates, Egypt and Bahrain) which accused Qatar of supporting terrorism is discussing a new round of sanctions.

Amid escalating tensions in the region, the Saudis ordered all citizens to leave Lebanon, sparking fears of a potential conflict. On the one side, the Saudis believe the missile targeting Riyadh airport was fired on behalf of the Lebanese group Hezbollah, and Iran was behind this action. On the other hand, Hezbollah accused the Saudis of forcing Hariri's resignation in order to rebrand Lebanon as an Iranian outpost dominated by Hezbollah.

Given the significant uncertainty, estimates for Saudi Arabia's GDP growth have been revised downwards continuously to reflect a stretched fiscal position and tightening financial conditions. In order to increase domestic spending regarding military procurement, Saudi Arabia announced the creation of a new national military industries company (similar to that of the United Arab Emirates), wholly owned by the government, which aims to contribute to GDP growth, create new jobs, and bolster a sense of national identity.

Crown Prince Muhammad bin Salman also ordered a few rounds of arrests targeting his top internal opponents as a pre-emptive strike against any threat to his power base (apparently authorities do not seem to know how many people were to be arrested when the purge started). More arrests can be expected in the following weeks, in our view. The purge was justified as a way to change the dynamic between politics and business in Saudi Arabia and to convince foreign investors. Further, the purges are meant to strengthen the kingdom as a destination for investment, rather than representing an arbitrary power grab.

However, the “anti-corruption” campaign has also been an opportunity to support the Kingdom's balance sheet through asset seizures, with literally billions in fiscal inflows,

although we don't believe these measures will be sufficient to improve the (bad) domestic economic conditions.

What could be Lebanon's role in such a context?

MD PM Hariri's announcement about putting his resignation on hold makes the Lebanese situation more stable and should contribute to lower geopolitical risk in the Middle East. In his resignation speech, Hariri accused Iran and Hezbollah of sowing strife in the region. We also hypothesise other important reasons beyond his decision. Iran denounced Hariri's resignation as potentially having been forced by Saudi Arabia as a political line in the sand regarding Iran, which could be interpreted as a signal from Saudi Arabia regarding its intentions to expand its influence in Lebanon and the region more generally.

The unexpected resignation could also be read in the context of a "gentlemen's agreement" between Hariri and Prince bin Salman to not interfere in reciprocal businesses. Hariri has strong economic and financial interests in Saudi Arabia, and as a relevant investor, he can influence (both positively and negatively) the power base of Prince bin Salman. On the other hand, Hariri had already subjected to Saudi pressure in the past (in particular, over the Syrian issue).

Lastly, Hariri's decision to resign could be seen as an attempt to postpone elections in May 2018, since based on the current electoral law, it is unlikely that Hariri could win against Hezbollah (the Iran's ally).

Looking forward, the political scenario still appears unclear. It looks like the country is in a phase of discussion to find solutions to difficult issues. At the end of the day, Hariri represents the only possibility to ensure the political stability of Lebanon, in our view.

From an economic standpoint, the consequences may be critical. Our base-case scenario envisages a very difficult situation for Lebanon both economically and fiscally. If political stalemate continues, Lebanon's economic growth and reforms will be negatively affected, and investor confidence in the Lebanese economy will decline, with consequences regarding deposit growth, remittances, FX reserves, debt sustainability, and domestic debt market (recently, there has been an increase in international holdings of Lebanese Eurobonds).

If tensions flare in the region, the base-case scenario could quickly shift in a negative direction, with domestic political instability having global repercussions with regard to a renewal of military conflicts in the area, with Israel being concerned about the regional ascendancy of Iran and more US sanctions being introduced that could increase the isolation of Lebanon.

What could be the economic implications if Lebanon's political crisis were to escalate?

What are the risks for the currency if the peg is abandoned?

YS Given the lack of financial support from Saudi Arabia (especially now that Hariri is back as PM), the economic situation looks increasingly untenable. We are not sure if de-pegging will resolve all the macro distortions, given the degree of dollarisation of the banking sector and the overall economy. Rather, we see a necessity for debt restructuring to take place at some point to return debt to sustainable levels (the debt-to-GDP ratio is above 140%). Significant fiscal adjustments are also needed in order to stabilize public finances. In the absence of the IMF (for political reasons, we find it difficult to see Washington agreeing to multilateral support), it is difficult to see a framework for macro adjustments, and the government may try to muddle through for now based on the hope that political pressures subside. We prefer to stay disengaged until we see both adjustments take place.

Do you see opportunities or the possibility of contagion in other Middle Eastern countries?

YS Oman and Bahrain represent two other rather weak economies in the region. Both lack fiscal discipline and neither has made any significant fiscal adjustments after the oil price correction. The latter still enjoys support from Saudi Arabia (now explicit but conditional); the former is becoming more and more reliant on support from Qatar. We are cautious fundamentally on both countries, with tactically constructive view in Bahrain based on relative value considerations.

"The economic situation is increasingly untenable in Lebanon. Other economies in the region also need to address financial and economic issues".

"In Qatar, we believe that political and market volatility opened up opportunities to engage in otherwise very expensive markets – in particular, in the real estate sector".

On Saudi itself, we see the risks growing despite the country's overall strong financial position. Both the political situation and market conditions have deteriorated significantly, and we see increasing risks of oversupply on top of clumsy political moves by the young Saudi ruler. We prefer to wait for better levels to engage in either sovereign or corporate opportunities.

Regarding Qatar, we believe that the political and market volatility opened up opportunities to engage in otherwise very expensive markets – in particular, in the real estate sector. The Qatari government has demonstrated resilience, and on the funding side, it has a variety of options to address the financial and economic blockade by Saudi Arabia and UAE.

Will the recent unusual occurrences have an immediate impact on the oil market?

MD Middle East tensions raise concerns about oil supply shocks, but we believe that only extreme events (such as a Saudi or Israeli strike against Hezbollah targets) would have significant impacts on the oil price. At the time of writing, we assess the probability of extreme episodes as very low, at least in the near term: none of the players involved has an interest in starting a war that could derail the last 10 years of economic growth in the Gulf. Therefore, we could attribute the recent increase in the oil price to the globally synchronised recovery and China demand in particular.

In conclusion, despite a currently fragile situation, the Middle East crisis is not likely to be derailed on the oil price front and Saudis seem committed to not breaching last year's OPEC agreement. The mounting tensions between Saudi Arabia and Iran could lead to higher volatility in oil price, but fundamentals are in place to pave the way for a medium-term rebalancing of the oil price trend.

“Extreme episodes are likely to be averted in the near term, since no player involved has an interest in starting a military conflict”.

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