

**We view the zone as awash in investment opportunity, regardless of the emotional perceptions it may invoke. We believe the region merits consideration by anyone looking at emerging markets.**

Our **Strategic Research** series aims to provide timely commentary on investment topics to our clients and friends. As a specialized investment firm bridging Islamic and conventional markets, Codexa Capital's analytical work explores niche and evolving aspects of asset management.

*Portfolio Strategies for the Global Investor:*

## **The Islamic Triangle: Tilting Toward Opportunity**

The investment industry likes to contend with geographic complexity by inventing unifying principles. This is why jargon like G7 and BRIC earns slots in our lexicon, along with over-arching concepts such as “developed world” and “emerging markets.”

In this spirit, we think global investors should consider adding to their market framework the concept of “Islamic Triangle.” We define this space as stretching from Casablanca, to Istanbul, to Muscat. Investment specialists refer to this area as MENA (Middle East North Africa). Historic local terminology applies the labels Mashreq and Maghreb. Nineteenth-century imperialists called it the Near East; politically correct internationalists now call it West Asia. Less informed Americans these days may call it “over there.”

We view the zone as awash in investment opportunity, regardless of the emotional perceptions it may invoke. Our rationale combines the region's unique relationship to US monetary policy, with strategic attributes and at-hand features, in an equation that yields a compelling allocation story. Any investor who looks at the major emerging markets, such as China or India, should further consider the Islamic Triangle in the mix of opportunities.

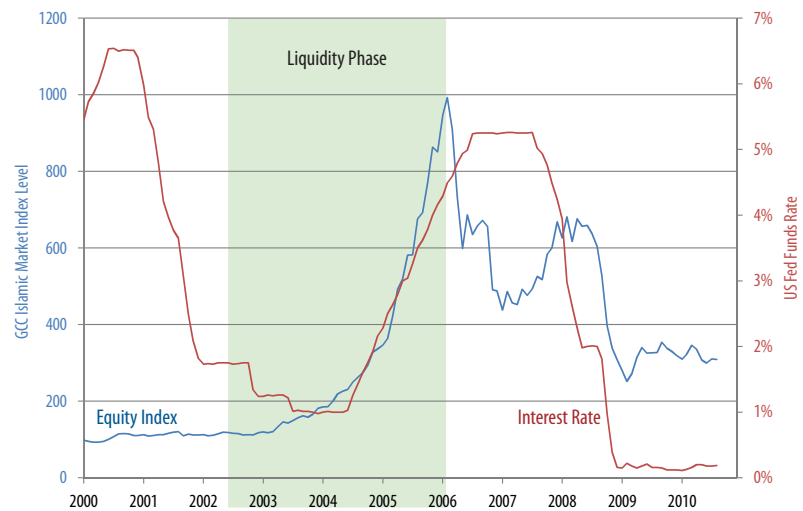
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### **Impact of US Rate Policy**

Our case for more aggressive exposure to the Islamic Triangle rests fundamentally on the likely impact of a prolonged period of low US interest rates. Nearly all of the region's nations have effectively outsourced monetary policy to the Federal Reserve, by linking their currencies to the US dollar. Low interest rates in the US will reflate these economies faster than the developed world because they lack the structural problems that plague the major economies. While the timing is hard to predict, the opportunity cost may be well worth the wait.

The connection between US monetary policy and Islamic Triangle markets shows four different patterns over the past decade. The plunge in the Fed Funds Rate early in the decade helped stimulate a “Liquidity Phase” that saw stock prices rise dramatically. The current phase may represent a foundation for coming growth.

### US Monetary Policy: Reflating Asset Prices in the Islamic Triangle



Source: Federal Reserve Board, Global Investment House, Codexa Capital.

Of the 20 countries in our Islamic Triangle universe, about half peg their currency to the US dollar. None link to the euro, although the Maghreb countries use a composite that is heavily influenced by EU exchange-rate movements. The only country in our universe with an independently floating currency is Turkey. (See table, page 7, for further details.)

The chart above presents our view by comparing the Fed Funds Rate and the GCC Islamic Market Index over the past decade. We use the Islamic index to demonstrate the resilience of our case, because this index excludes the conventional bank stocks one would expect to have a tight correlation with interest-rate policy.

Equity-market activity essentially falls into four periods, each reflecting a set of external circumstances:

- **Engagement:** before 2002. In the context of lingering fallout from the Asian currency crisis, global investors may have paid scant attention to any emerging-market allocations. Financial-market reform in many Middle East countries was limited in scope.
- **Liquidity:** 2002-2006. Regional markets saw impressive gains from buoyant oil prices and unfolding “cultural demonstration,” as residents shifted investment focus internally post-9/11. Loose US monetary policy formed the foundation for these gains, especially as liberalization took hold in some markets.

- **Volatility:** 2006-2009. Interest-rate increases took their toll on valuation readings, leading to a sharp decline in asset prices. The heavy presence of retail investors in some markets may have exacerbated volatility. Still, the region may have been on the verge of a stock-price recovery, were it not for the spread of the credit crisis.
- **Stagnation:** since 2009. The global backdrop has kept investors out of Islamic Triangle markets in general, reinforced by turbulence in local rebalancing processes. More constructively, the sideways market may have established a stock-price floor that is ready to support an upward trajectory once sentiment improves.

This link between US monetary policy and investment gains in the Middle East has been seen before and will likely be seen again, although the upside may be less dramatic. The Islamic Triangle extends beyond the GCC, of course, but Saudi Arabia is still the largest market in the region. More buoyant activity in the Kingdom will have attendant cross-border investment implications for markets as dispersed as Morocco and Turkey.

**We see a strong likelihood of regional markets sustaining outperformance, not unlike what we saw in the 2002-2006 period. We see two catalysts triggering a change in investor sentiment.**

### **On-Ramps for Upturn**

Granted, the potential for US low-interest-rate policy exporting inflation to the developing world may raise longer term issues, as well as reviving debate within the Islamic Triangle about the merits of the US dollar currency peg. But nearer term, we see a strong likelihood of regional markets sustaining outperformance, not unlike what we saw in the 2002-2006 period.

In this context, the most important question may be what will trigger a change in sentiment to bring investors meaningfully back into Islamic Triangle markets. We see two catalysts:

- **Rebalancing of Local Economies.** The excesses of the past cycle are in the final stages of being wrenched from the system. Timely examples include the downgrading of Bahrain's credit rating, and Dubai World's concession to creditor demands by announcing asset sales. To eventual investor effect, such acts of capitulation are filling the news flow.
- **Strengthening Activity in Europe.** As Germany's economic recovery gains momentum, it will have a positive impact on North African and Eastern Mediterranean economies, helping to compensate for lingering weakness in the US. Europe is the major trading partner for Turkey, Morocco, and Egypt.

One specific indicator generating positive signals is private-sector loan growth. Having bottomed-out in 2009 and early 2010, lending by commercial banks is beginning to see signs of recovery. Egypt, in particular, seems to be leading the region because of strong asset quality, supported by the rationalization within the banking sector over recent years.

Oil is a special case. Further strength in hard commodity prices will also support sentiment, given pockets of exposure in parts of the Islamic Triangle. Jordan and Morocco aggressively export phosphates. Saudi Arabia and Sudan are both established gold producers, albeit limited in scope. Egypt has been reforming its extractive industries' policies and procedures.

**If young people are the drivers of economic development, then the Islamic Triangle has an impressive future. Youth as a share of working-age population is about twice the proportion in the developed world.**

### Long-Term Confidence in the Story

As most of the world's major economies continue slogging through recession, the tactical case for the Islamic Triangle is convincing. The strategic case for exposure to the region also deserves consideration. Exposure to oil makes the obvious case. Two others are less clear:

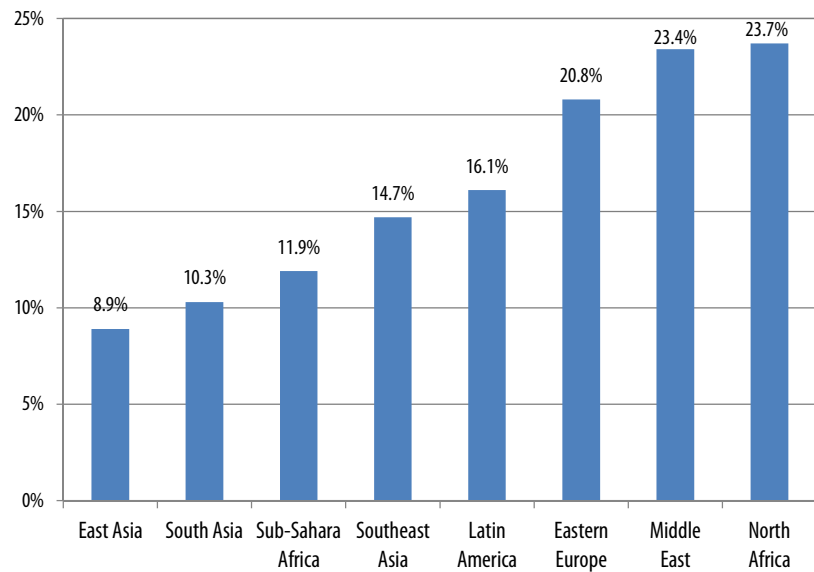
■ **Demographics.** If young people are the drivers of economic development, then the Islamic Triangle has an impressive future. Youth (age 15-24), as a share of working-age population in the Islamic Triangle, is about 30%, twice the proportion in the developed world (based on data from the International Labor Organization).

The benefits of social inclusion and productive potential begin to drift away, however, when one considers the unemployment problem in this age group. The Middle East and North Africa have some of the highest youth unemployment rates in the world, at 23%-to-24%.

Exacerbated by the global recession, this problem demands intra- and extra-regional attention. Fiscal taps will open wide as governments aim to attract new industries, develop educational initiatives, and expand public works programs. It is the positive rate-of-change in unemployment trends that will lend strong support to the story.

■ **Islamic Finance.** We believe that when global financial-market history is written about the past decade, the growth of Islamic finance will be a dominant theme. Based on principles of sharing risk and avoiding speculation—in addition to a core tenet prohibiting interest (“making money from money”)—the industry's growth has helped the Middle East's service economy grow and prosper.

**Emerging Markets: Youth Unemployment Rate**



Source: International Labor Organization, Global Employment Trends for Youth, August 2010. Estimates for 2009.

AAOIFI, the Bahrain-based Accounting & Auditing Organization for Islamic Finance Institutions, claims more than 200 member firms worldwide, but few have cross-border footprints. This may explain why the industry is poorly understood within conventional circles. Outside Muslim-dominated geographies, Britain has likely made the largest strides in advancing the Islamic banking industry.

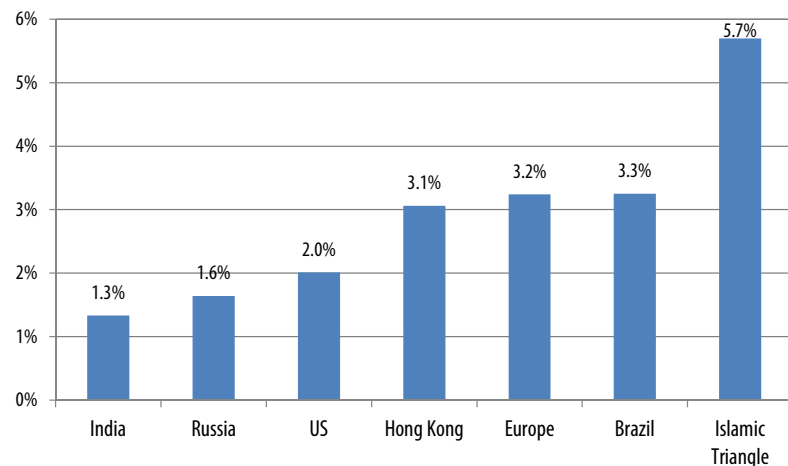
Obviously there are nuances to these points in each of the region’s economies. For instance, King Abdullah’s economic development strategy in Saudi Arabia is heavily premised on accelerating advanced education. Witness the overnight development of Riyadh Women’s University, now being built along the Airport Road and set to be the largest such institution in the world. On a more sober note, the political backdrop in some countries has inhibited local development of the Shariah-compliant financial services sector.

**Atypically high for emerging markets, dividend yields across the Islamic Triangle average 5.7%. While unsustainable as stock prices rise, it helps support the at-hand buying decision.**

**Regional Feature: High Dividend Yield**

The Islamic Triangle is chock-full of compelling features for the global investor. We think one of the most important at this time is the region’s high dividend yield, atypical of emerging markets. Such impressive relative value is unsustainable as stock prices rise, but it helps support the at-hand buying decision.

### Emerging Markets: Comparative Dividend Yield



Note: Measure is calculated on generally accepted broad-market indices. Source: Bloomberg, MENA Capital (London).

The average dividend yield across these markets is 5.7%, according to our colleagues at London-based MENA Capital. This contrasts impressively to figures seen elsewhere around the world. As the long-term US bond yield moves toward 2%, a high dividend yield is compelling.

Investors should be duly cautious, of course, in buying stocks as a substitute for income-based assets such as bonds or real estate. In the extreme, dividend streams can dry up unexpectedly (e.g., BP in the wake of the Gulf of Mexico disaster). But having made the point, we note that dividend payouts tend to be relatively stable, in part to help corporate management mitigate stock-price volatility.

Our short list of features can easily be extended. Market technicians may be drawn to the low correlations with the major market indices, supporting a case for diversification, while economists will appreciate the impact of relatively high per capita income, especially in the GCC markets. Fundamental analysts will value the under-researched nature of most of the equities in the region.

**This is not a single, highly liquid market with deep trading volumes in well-researched stocks. The cacophony of technical, fundamental, and strategic themes may be best understood by a specialist investment team.**

### Opportunity Lies in Imperfection

For a New York or Hong Kong investor monitoring multiple portfolio positions across a range of asset classes, the Islamic Triangle may not be a top priority, but perhaps should be. At just over \$1 trillion, the Islamic Triangle's total market capitalization is just a bit less than Brazil's or India's. Among major markets, it compares with Australia or Switzerland. Relative to GDP—a sign of an equity market's importance to a local economy—the

number is nearly 60%, relatively low, but indicative of the structural potential over time. (The relationship in Malaysia and Taiwan is roughly 90%.)

**Classification of Exchange Rate Regimes and Monetary Policy Framework**

Exchange Rate Arrangement	Monetary Policy Framework					
	Exchange Rate Anchor			Monetary Aggregate Target	Inflation Targeting Framework	Other*
	Dollar	Euro	Composite			
Currency Board	Djibouti					
Other Conventional Fixed Peg Arrangement	Bahrain Jordan Lebanon Oman Qatar Saudi Arabia UAE Yemen		Kuwait Libya Morocco Tunisia			
Pegged Exchange Rate Within Bands			Syria			
Crawling Peg	Iraq		Iran			
Managed Float (No Pre-Determined Path)			Algeria	Sudan		Egypt
Independent Float					Turkey	

\*Includes countries that have no explicitly stated nominal anchor, but rather monitor various indicators in conducting monetary policy. Source: International Monetary Fund, 2008.

These capitalization-based comparisons are tabulated from an aggregate figure for what is a highly fractionalized region. This is not a single, highly liquid market with deep trading volumes in well-researched stocks. Instead, one faces a cacophony of technical, fundamental, and strategic themes that may be best understood by a specialist investment team. The poor representation of Islamic Triangle markets in the major benchmark indices reinforces this requirement for dedicated oversight, managing the situation for its absolute-return potential.

We acknowledge some bias in our view, given that our own business focuses on this part of the world. Yet, as Brazil, Russia, India, and China inspire notions of a “power shift” to the developing world, we think the Islamic Triangle deserves consideration for a “portfolio shift” to a more prominent position among investment holdings.

## Islamic Triangle Regional Profile

	(A) Market Cap (US\$ Billions)	(B) GDP (US\$ Billions)	(A) / (B)	Number of Stocks	Dividend Yield*
Saudi Arabia	323	370	87%	127	4.6%
Turkey	249	615	40%	315	7.6%
UAE	82	230	36%	103	6.2%
Kuwait	99	111	89%	189	5.6%
Qatar	86	84	102%	43	6.1%
Egypt	58	188	31%	94	6.1%
Morocco	69	91	76%	73	5.2%
Jordan	27	23	117%	191	5.7%
Bahrain	17	20	85%	44	8.0%
Oman	17	53	32%	134	4.8%
Lebanon	12	34	35%	10	6.1%
Tunisia	12	40	30%	50	2.7%
Total	1,051	1,859	57%	1,373	5.7%

\*Column total for Dividend Yield is the simple average of markets listed.

Data as of August 2010. Note: Market capitalization data represents the total equity market; GDP based on current exchange rates. Source: MENA Capital (London).

### Frequently Raised Issues

Global investors come in all shapes and sizes. Here are issues, reflecting the gamut of investor profiles, that we have commonly heard in our work. We offer indicative responses.

*I already have enough exposure to emerging markets through my holdings in Brazil, Russia, India, and China.*

Growth of course is not a zero-sum game. A well-designed portfolio can take selective advantage of several opportunities across the developing world. However, global investors may see the best opportunities where imperfect information feeds return potential and where the rate-of-change is most dramatic. The Middle East and North Africa fits these criteria impressively, in our view.

In August 2010, the IMF released a working paper, “Islamic Banking: How Has It Diffused?” The primary subject is somewhat off-point to our issue here, but it does articulate the positive impact that oil-price increases had on the region over the past decade, especially when paired with the catalyst of homeward-looking development and investment. These events provoked widespread, still-unfolding positive change in the region, although likely on hiatus during the recent recession.

The unleashing of these forces was similar to phenomena seen in the 1990s elsewhere in the developing world. Brazil’s successes can be traced to the *Plano Real* in 1994; Russian reforms were an outgrowth of the painful years in the run-up to the 1998 debt crisis. Indian liberalization and deregulation derives from a severe imbalance of payments in 1991. China meanwhile took its cue from the momentum of labor unrest, which peaked in 1998.

The rate-of-change in the Middle East and North Africa is more recent, and the investment possibilities therefore potentially more robust. A further argument supporting investment in the region is the clarity afforded by risk/return analysis between this region and others, given imperfect market-index correlations.

*Are these economies really competitive on a global scale?*

We look to “Doing Business” research by the IFC component of the World Bank. Underway since 2003, the project attempts to apply objective measurements to business regulation and its impact on commercial activity. The World Bank ranking assesses microeconomic factors that add up to a bigger picture of a given economy. See [www.doingbusiness.org](http://www.doingbusiness.org) for more information.

Many may be surprised that Saudi Arabia ranks so high, at 13 out 183 countries globally. This position puts the country ahead of Japan, Sweden, and Switzerland, in part a testimony to the micro-economic reforms implemented since King Abdullah came to power in 2005. The strength of the ranking comes from the nation’s top poll position worldwide in “registering property.”

Among the larger markets in the Islamic Triangle, the Moroccan economy ranks least favorably in Doing Business measures, but it is still incrementally better than both India and China. Looking at the details, Morocco’s most positive indicator is “getting credit,” a sign of the depth of the financial intermediation system, while its worst ranking is “employing workers,” a measure of effectiveness in engaging the workforce.

The Doing Business rankings of course are not designed to be portfolio recommendations. Good economies, after all, are not necessarily good markets, and vice-versa. Nor do the rankings include assessment of any national securities markets. Nevertheless, the information does provide a reasonable context for earnings analysis.

*My interest is in soft commodities, not hard commodities.*

If hard commodities are mined, then soft commodities are grown. While some, like phosphates and potash, have crossover characteristics, the expertise required to be successful may be quite different. Barriers to entry in soft commodities can be relatively low, while output can be dramatically affected by seasonality. Most specialists, for instance, suggest the recent price hike induced by the Russian ban on wheat exports to be temporary.

**Soft Commodities: Selected Access**

Sector Breakdown of Economy in Top 10 Markets by Capitalization

	Agriculture	Industry	Services
Saudi Arabia	3%	59%	38%
Turkey	9	26	65
UAE	1	49	50
Kuwait	0	48	52
Qatar	0	68	32
Egypt	14	38	49
Morocco	19	31	49
Jordan	4	30	67
Bahrain	1	57	43
Oman	1	49	50

Data as of 2009. Note: Country totals may not equal 100 because of rounding. Source: CIA World Factbook.

Agriculture in general is not a particularly large component of the economies across the Islamic Triangle. Yet Turkey, Egypt, and Morocco—among the largest equity markets—all have vibrant agricultural export sectors. The most influential agricultural sector, in terms of the impact on the overall economic structure, may be in Morocco at 19% of GDP, versus a gratuitous 0.1% in Qatar.

*I already own the oil story through ExxonMobil.*

Many of the economies of the Islamic Triangle are dominated by the hydrocarbon industry, but not all. Nor does this consideration take into account the development and expansion of new industries within the region, ranging from biotechnology to logistics.

The idea of using a single stock to gain exposure to a region as diverse as the Islamic Triangle is fraught with problems. It might parallel a decision to buy Sony as a proxy for Japanese export potential. In practice, an investor may find that such a position could trade against developments in a completely different part of the world. The logic would only hold if a stock had a high correlation (perhaps greater than 0.90) with a regional market index over an extended period of time.

If the goal is to benefit from the transparency and liquidity of a major-market equity, then this same requirement potentially could be met by holding a basket of regional stocks that trade as global depository receipts (GDRs). Many specialist investment teams use such instruments in implementing their portfolio decisions.

*Am I supporting terrorism by investing in this region?*

While many terrorists are Muslim, not all Muslims are terrorists. Indeed, most governments within the region fight even more concerted battles against terrorism than Western governments fight. Virtually all financial authorities within the region follow generally accepted international standards to prevent money laundering, commonly associated with terrorist financing. We were recently required to add such language, for instance, to the filing of an offering document with the Central Bank of Bahrain.

The link between investing in public equities and concern about terrorist financing is rather artificial. In practice, most multilateral efforts to control terrorist financing have related to the use of *zakat* (a charitable donation tied to Muslim traditions) by certain private-sector social organizations, or

activities of *hawala* money-broking networks. These matters are far removed from stock-market investing.

For investors seeking further perspective on this issue, we encourage working through *Price of Fear* by Ibrahim Warde (University of California Press, 2007).

*My portfolio is only holding core positions at this time.*

A common defensive strategy is to retreat to core positions during difficult market environments. That may have different implications for a US or European investor than a Middle East investor. For example, as one of the largest stocks traded in Istanbul, Koç Holding may be a core position to a Turkish investor, but likely a fringe consideration elsewhere, except to a specialist investment team.

This strategy reflects an investor's home-market bias or comfort zone. But that may ultimately deprive an investor of the best diversification and asset allocation opportunities for a comprehensive global portfolio.

A common excuse for avoiding the region is the relatively small size of the markets within standard global benchmarks. Tunisia and Lebanon, for instance, are commonly lumped together with other frontier markets like Vietnam and Pakistan. The skills required for success in each of these markets and the macro-economic factors that affect them can be quite different.

We argue that an absolute return strategy, rather than relative return, may be the best way to position opportunities in the Islamic Triangle.

### Note on Codexa Capital

Codexa Capital bridges Islamic and conventional markets. Our expertise crosses project finance, product structuring, and capital introduction activity, in both the Islamic and conventional sectors. Our issuer audiences are global; our investor audiences spread primarily across the Muslim world. This note's principal author, Douglas Clark Johnson, is CEO and Chief Investment Strategist of Codexa Capital. He can be reached at [douglas.johnson@codexacapital.com](mailto:douglas.johnson@codexacapital.com).

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### Codexa Capital LLC

80 Broad Street, 5th Floor  
New York, NY 10004

[contact@codexacapital.com](mailto:contact@codexacapital.com)  
[www.codexacapital.com](http://www.codexacapital.com)