Middle East Strategy

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Navigating Tensions in the Red Sea

- Red Sea Tensions: Heightened geopolitical pressures in the Red Sea, escalated by Houthi assaults and subsequent Western military actions, have rerouted maritime traffic to avoid these risky waters, leading to the most substantial disruptions in global trade since the Covid-19 pandemic, raising shipping costs, potentially fuelling global inflation, and threatening the fragile recovery of supply chains; all while underscoring the Red Sea's critical role as a trade conduit, especially pivotal for energy supplies amidst Russian sanctions.
- Saudi Arabia's pause of oil production capacity expansion by over a million barrels daily by 2027 reflects OPEC+'s strategic response to global oil market fundamentals and the challenge of competing with emergent producers like US shale. This suggests OPEC+'s short-term commitment to a baseline price of $70/barrel on a Brent basis.
- With a current production capacity of 12m bpd, Saudi Arabia's self-imposed reduction to approximately 9m bpd reflects a cautious outlook on future oil demand growth and an adaptation to the impending energy transition, eschewing the maintenance of expensive surplus capacity.
- The Wealth Outlook 2024 anticipates a transitional year as economic stabilise post-COVID-19 with slower growth expected in early 2024 before a potential expansion from the second half of 2024 and into 2025.
- The Gulf Cooperation Council (GCC) is projected to experience a deceleration, with a mere 0.1% year-on-year GDP growth in 2024 due to voluntary OPEC+ production cuts put in place last year, and softer oil prices, after an impressive 7.7% growth in 2022.
- GCC market performance in 2023 was diverse; the regional equity index modestly increased by 3.7%. Within the GCC, four markets gained, with Dubai and Saudi Arabia's indices notably increasing by 21.7% and 14.2%, respectively, due to strong investor sentiment and solid earnings in major companies.
- Equity Market Strategy: We continue to see opportunity in global equities markets through broadening earnings and equity performance beyond large cap US tech. The GCC's strategic positioning favours cyclical markets. Our Global Investment Committee maintains a neutral allocation to Emerging Market equities and would expect to increase this exposure in the coming months as many non-US equities in cyclical industries reach trough levels and eventually discount a stronger world growth recovery in 2025. (See Quadrant | Welcome to 2024. No Collapse in Sight.)

Red Sea Tensions: In it for the long-haul?

The crisis in the Red Sea has had a profound effect on shipping and logistics costs. The escalation of tensions, primarily due to Houthi attacks and subsequent retaliation by US and UK forces, has forced many vessels to alter their usual routes, avoiding the Red Sea altogether. Consequently, many shipping companies have opted to reroute traffic around the southern tip of Africa – the Cape of Good Hope. This longer and more costly journey has heightened concerns about inflation and the resurgence of supply chain disruptions that the world economy had only just begun to recover from

Understanding the Red Sea's strategic significance is crucial in grasping the full impact of the crisis. The Red Sea serves as the gateway to the Suez Canal, a pivotal corridor linking Europe's vast consumer markets with major suppliers in Asia. Nearly 12% of global trade, including around 30% of container traffic, passes through this route annually, amounting to over $1 trillion in goods. Additionally, the Red Sea is a vital conduit for massive volumes of oil, natural gas and petroleum products. With western sanctions imposed on Russia, the Red Sea's role in the global trade of crude has become even more significant, especially for Asian markets increasingly reliant on Russian petroleum.

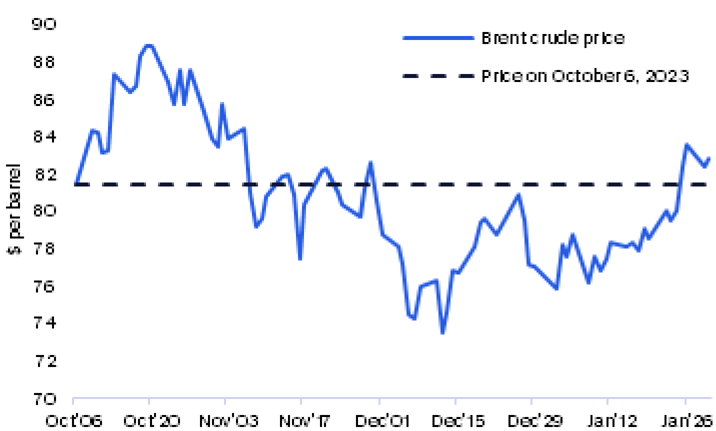
In recent days, the killing of US troops in Jordan marked the first American casualties since Israel and Hamas went to war on October 7. The US administration has vowed retaliation, heightening the possibility of a direct clash between US and Iran, an outcome that both sides have endeavoured to avoid. As a result, Brent prices rose to $84/barrel, but have since pared back gains to around $82/barrel. Markets have hardly reacted to the events in the Middle East, see **FIGURE 1**, where prices fell in the first few weeks of war.

The intensifying exchange of hostilities could shift the epicentre of the conflict from Gaza and Bab el-Mandeb closer to Iran and the Strait of Hormuz. The impact of disruptions to the Red Sea shipping lanes have so far resulted in a muted response in energy markets. However, any potential shift to the Strait of Hormuz would have a profound impact on the global economy where a fifth of global crude supply would be at risk. It is important to reiterate, both the US and Iran lack the appetite for direct confrontation, and markets are taking the view that regional risks won't turn into a global crisis.

As we've previously noted, most geopolitical crises do not result in lasting effects on the markets, which, up until this point, includes the October 7th attack in Israel and the subsequent conflict that ensued. Despite the importance of the Red Sea to global trade, we expect the final impact on consumers and markets around the world to be modest, in the aggregate. We've written before that most regional geopolitical crises do not have durable market impacts including, for now, the war in the Middle East.

Read CIO Bulletin | Worries, Realities and the Red Sea for more on the topic.

FIGURE 1: Brent prices have had a muted response to rising geopolitical tensions



Source: Bloomberg as of 31 January 2024. **Past performance is no guarantee of future results. Real results may vary**.

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Saudi Arabia – Oil Capacity Expansion Pause

The decision by Saudi Arabia to halt the expansion of its state-oil company's production capacity by over one million barrel per day by 2027 signals a growing awareness within OPEC+ of a significant challenge ahead. This challenge involves the increasing surplus capacity in the global oil markets and Saudi Arabia's need to yield a portion of its market share to rising competitors, such as US shale. It is reasonable to infer that, at least in the short term, Saudi Arabia and its allies in the OPEC+ group of producers are committed to maintaining a baseline oil price of $70 per barrel, regardless of the costs involved.

Currently, the kingdom has capacity to produce 12 million barrels of oil per day but has voluntarily limited its output to around 9 million barrels per day as part of OPEC+ efforts to support prices. This strategic move indicates a possible moderation in Saudi Arabia's expectations for global oil demand growth in the coming years. By not maintaining additional spare capacity, which is costly in itself, the kingdom is adjusting to the anticipated slowdown in oil demand due to the energy transition. The OPEC+ group, consisting of 16 members formed in 2016, finds itself in the increasingly difficult position of ceding market share to support prices.

Oil Market Outlook

In 2024, the global oil market is expected to maintain a delicate equilibrium, primarily due to OPEC+ potentially extending its first-quarter production cuts throughout 2024, possibly tapering in 2H'25. This move aims to stabilise oil prices, with the anticipation of holding them above $70 per barrel on a Brent basis. While this approach may necessitate the loss of market share, it is considered economically sensible for OPEC+ members, considering both immediate earnings and long-term market share prospects. (See Wealth Outlook 2024 - OPEC's unlikely role in the energy transition.)

For 2025, however, the oil market may confront more significant challenges. Despite potentially prolonged production cuts by OPEC+, a surplus in balances is expected, potentially leading to difficulties sustaining the $70/barrel price level. Should OPEC+ begin tapering cuts in the second half of 2025, a surplus of 1.2 million barrels per day is projected, leading to a possible price decline to the $60 level by the latter half of the year.

Our 6–12-month Citi Research Commodities outlook for crude oil is neutral-to-bearish and price forecasts have been adjusted to an average of $74 per barrel in 2024 and $60 in 2025, marking a decrease from the $82 average in 2023. While short-term price targets remain unchanged, ongoing tensions in the Middle East, particularly in the Red Sea, could introduce a higher risk premium and near-term price volatility.

For now, geopolitical tensions will continue to simmer, providing support to oil prices in the near term, there's a risk that market projections might overstate demand. Should any geopolitical events threaten global inventories, production, or halt transit, it could drive oil prices above $90 / barrel. Nevertheless, potential supply deficits could theoretically be offset by spare capacity of OPEC+, predominantly held by Saudi Arabia.

GCC - Setting the Scene for 2024

As we've noted in our Wealth Outlook 2024, we expect this year to be one of transition, as economies continue to normalise in the aftermath of the COVID-19 pandemic. For global markets, 2023 ended on a high, with both equity and bond markets rallying in December. However, while we expect 2024 to post positive returns, we do believe that a period of near-term slower growth is likely to unfold in the first few months of year as prospects for a sustained expansion into 2025 gathers pace (**FIGURE 2.**)

Following an impressive growth rate of 7.7% year-on-year (YY) in 2022, the Gulf Cooperation Council (GCC) group of countries likely decelerated in 2023 with a projected growth of around 0.7% YY. 2024 is likely to see a further slowdown on the back of voluntary OPEC+ production cuts and softer oil prices, leading to a marginal 0.1% YY expansion in GDP.

FIGURE 2: Citi Global Wealth (CGW) real gross domestic product (GDP) forecasts

CGW Real GDP Forecasts (%)				
	2022	2023	2024E	2025E
US	1.9	2.4	1.6	2.6
China	3.0	5.5	4.0	4.0
EU	3.4	0.5	0.4	1.3
UK	4.3	0.6	0.6	1.5
Global	3.3	2.6	2.2	2.8
CGW EPS Forecasts (%)				
	2022	2023	2024E	2025E
S&P 500	6.0	0.9	5.1	6.8

Source: Citi Global Wealth Investments and Bloomberg as of November 12, 2023. All forecasts are expressions of opinion are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

The slowdown in aggregate GCC activity in 2023 was precipitated by voluntary OPEC+ oil production cuts, led by Saudi Arabia, after the group agreed to deepen supply cuts following weaker crude prices and expectations of a balance surplus in 2024. We anticipate these production cuts to be extended through year-end 2024, before we see a tapering off in 2H'25.

The voluntary OPEC+ production cuts have directly influenced the region's economic trajectory. This deliberate deceleration has led to further downward revisions to GCC GDP growth estimates, with oil's share of GDP expected to contract 3.5% in 2024 while non-oil sectors are forecasted to experience a 3.4% increase vs a previously estimated 4% YY. The anticipated trajectory of lower oil production and declining prices is expected to lead to an increase in the aggregate budget deficit of the region (excluding the UAE), to 1.8% of GDP in 2024, from 0.3% in 2023.

Economic momentum within the GCC is sustained, in part, by ongoing structural reforms. However, this progress does not render the region immune to the overarching high-interest-rate environment, which has notably curtailed growth in specific sectors. The non-oil sector in the GCC region is anticipated to continue its strong performance, albeit at a more moderate pace, supported by ambitious national diversification plans. Although the increase in spending this year is expected to be more restrained compared to previous years, it is not anticipated that governments will implement cuts or enforce stricter fiscal policies through increased taxes, with the exception of those already declared measures such as the corporate income tax in the UAE that was implemented in mid-2023.

Across the GCC, inflation has been significantly lower than in many advanced and emerging market economies. This is partly due to repeated interest rate increases aligned with the US Federal Reserve (Fed), which have helped keep inflationary pressures contained. The International Monetary Fund (IMF) expected inflation in the region to average 2.3% in 2023, which was attributed to several factors including higher interest rates, government subsidies and the strength of US dollar-pegged currencies which helped to dampen import costs. Intra-regional variations were apparent, with some countries experiencing higher rates than others due to local factors, including the introduction of taxes of changes in VAT rates.

Our expectation is that the Fed will shift towards less restrictive monetary policy in the second half of 2024, a move that is likely to significantly impact the economies of the GCC. Most of the GCC's central banks move in tandem with the Fed due to the currency pegs to the US dollar, with Kuwait the only exception with its dinar linked to a basket of currencies. Anticipated interest rate cuts can stimulate investment and consumption. Lower borrowing costs will encourage businesses to invest in expansion and new projects. Moreover, a Fed in easing mode often leads to increased liquidity in global financial markets, potentially resulting in greater foreign investment flows into the GCC region.

Risks to the growth outlook: recent escalations in geopolitical tensions in the Middle East and subsequent disruptions to shipping routes via the Red Sea, have pushed up freight costs to levels last seen in 2022 and is resulting in longer delivery times. Supply chain disruptions and potentially higher energy prices, if sustained, pose upside risks to inflation in developed markets and could delay monetary policy easing. An escalating conflict may also deter tourism to and within the region, which would pose a downside risk to growth.

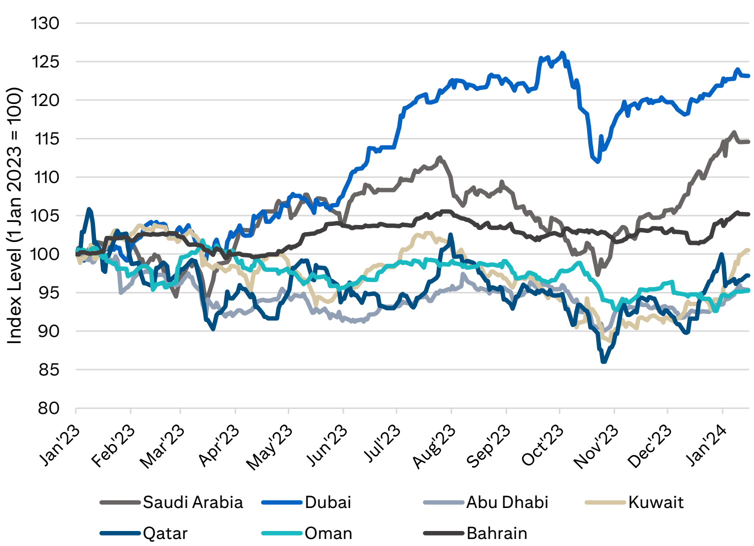
Equity Markets

In the last two months of 2023, stocks and bonds went in one direction: up. In 4Q'23, global equities rose some 11% while global fixed income was 6.8% higher. However, the GCC region underperformed the global rally as markets moved in different directions.

In 2023, the performance of GCC markets was mixed, with some markets rising significantly while others experienced pullbacks (**FIGURE 3**). The aggregate GCC equity market index closed the year with one of the smallest returns globally, registering a gain of 3.7%. Out of the seven exchanges in the GCC, four recorded gains while three declined. Notably, Dubai and Saudi Arabia's equity indices were the standout performers in the region, with Dubai's index surging 21.7% and Saudi Arabia's up 14.2%. This positive performance was attributed to strong investor sentiment and robust earnings growth for blue-chip stocks.

On the other hand, Kuwait's All Share Index fell by 6.5%, largely due to challenges in the banking sector and a decline in oil-GDP. The banking index in Kuwait, which accounts for a significant portion of the market, tumbled by 8.2%. Oman and the Abu Dhabi index also recorded declines, with Oman's index dropping 7.1% and the Abu Dhabi Index by 6.2%. Bahrain and Qatari indices showed modest gains of 4.0% and 1.4%, respectively. Comparatively, global markets, particularly in the US, performed very well in 2023. The MSCI World and S&P 500 indices rose substantially, by 21.8% and 24.2% respectively, driven largely by a handful of US-tech mega caps. This stark contrast highlights the underperformance of some GCC markets, despite some positive developments in the region.

FIGURE 3: Regional equity market performance since 2023, note 1 Jan 23 = 100.



Source: Bloomberg as of January 25, 2024. Note: Jan 1, 2024 = 100. **Past performance is no guarantee of future results. Real results may vary.**

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Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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