INVESTMENT SOLUTIONS & PRODUCTS
Research

Research Alert

22/08/2017

Middle East

Egypt: Macro momentum continues to improve

- While Egypt continues to face significant challenges, we remain optimistic on the outlook for fiscal consolidation and see scope for the economic recovery to steadily accelerate.
- We keep our positive view on fixed income unchanged, primarily the shorter-dated t-bills market; we remain neutral on equities as the risk of a near-term consolidation has risen; and we see scope for further steady EGP appreciation on improved macro fundamentals.

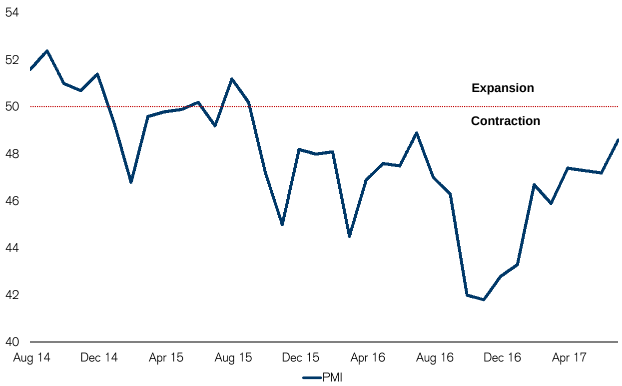
Fahd Iqbal
Head of Middle East Research

Economic environment gathering momentum

Economic indicators point toward steady and continued improvement in Egypt. The end of fiscal year 2016/17 in June saw GDP growth of 4.1%, down only modestly from 4.3% the previous year. Higher frequency PMI data paints a relatively more positive picture with July recording one of the sharpest MoM increases on record. At 48.7, the headline figure is still in contractionary territory, but it is the highest level seen in 12 months (see Fig. 1). Moreover, the new orders reading broke above the 50 level for the first time since September 2015, which suggests further gains over coming months.

We see several drivers for continued economic improvement over the medium term. Exports and foreign direct investment (FDI) have enjoyed a slow but steady recovery over the past two years; while both are still at an early stage of the cycle, the significantly reduced uncertainty over the EGP's path should drive an acceleration in this trend. Tourism has historically been a key driver of the economy (employing as much as 12% of the economy at its peak) but it is at an even earlier stage of recovery. While there has been a material pick-up in visitor arrivals over the past year, they are still only half of the pre-Arab Spring peak. However, the significantly cheaper EGP should help promote stronger growth over the coming seasonal peak in Q4.

Fig. 1: PMI recovering toward growth levels

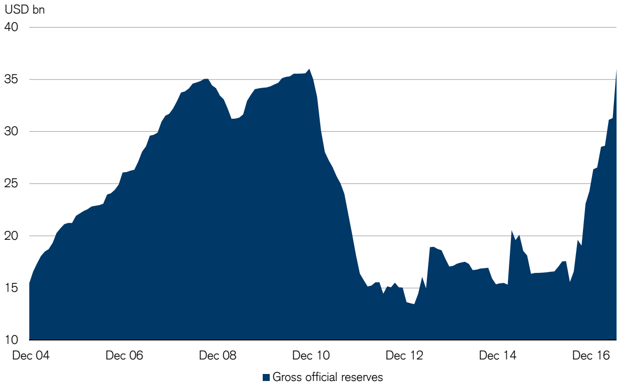


Last data point: 31/07/2017. Source: Bloomberg, Credit Suisse / IDC

Finally, the commencement of production at the Zohr gas field (the largest gas field discovery in the Mediterranean this decade) should drive a sizeable increase in domestic investment and improve Egypt's energy imbalances.

The fiscal deficit for FY 2016/17 came in at 10.9%, a material improvement from the previous year's 12.5%. Although IMF forecasts expect the deficit to reach a still elevated 7.5% by 2018/19, the primary balance is forecast to hit a surplus as early as next year. Foreign exchange reserves reached a record USD 36 bn, with July alone recording a remarkable USD 4.7 bn MoM increase (see Fig. 2). Reserves have more than doubled since the currency peg was dropped in November 2016.

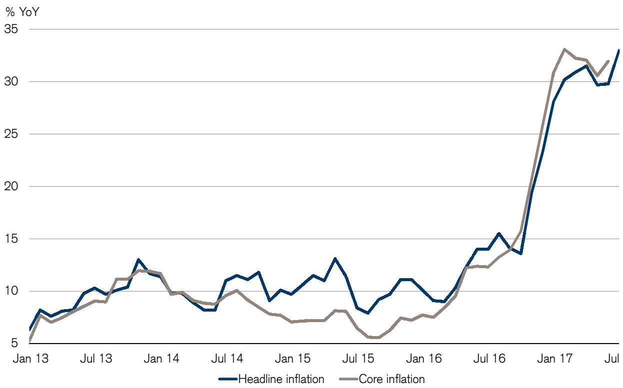
Fig. 2: Reserves have reached record high levels



Last data point: 31/07/2017. Source: Bloomberg, Credit Suisse / IDC

Inflation remains a significant drag with CPI hitting a record high of 33.0% in July (see Fig. 3) as recent subsidy cuts to electricity and fuel prices took effect. However, we expect inflation to peak in Q4 as the base effect from the currency de-pegging and subsidy withdrawals in November 2016 eases. Given that much of the increase in inflation has been driven by the effects of the FX pass-through and subsidy reform, inflation should see a significant reduction over the subsequent 12 months. The fact that the Central Bank of Egypt (CBE) has raised interest rates by 700 bp since November 2016 is also supportive of this.

Fig. 3: Inflation is likely peaking on one-off effects



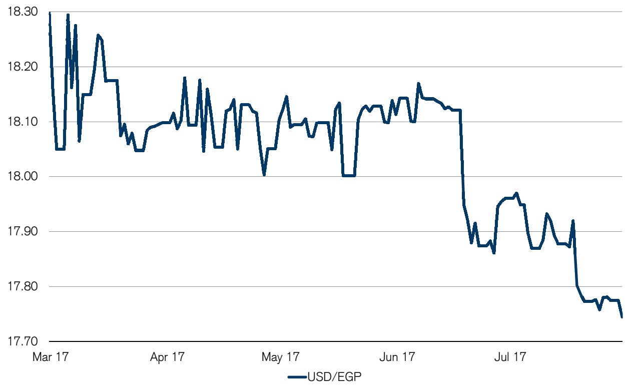
Last data point: 31/07/2017. Source: Bloomberg, Credit Suisse / IDC

The challenges facing Egypt remain significant and our recommendations therefore carry materially higher risk compared to our other Middle East recommendations. The government has considerable further fiscal consolidation to undertake and political instability in the face of this is a concern. However, we would argue that after two changes to the ruling government, which brought successively greater economic turmoil to the country, the public is much less likely to pursue further social unrest as a strategy. This factor, coupled with the government's clear commitment to the IMF program, suggests to us that the current administration is best positioned to drive the necessary change through.

EGP: Outlook improving, scope for further strength

On the back of improving macro data, and more importantly the sharp improvement in reserves, we have seen the EGP strengthen steadily over the past few months (see Fig. 4). As we highlighted earlier, the key sources of foreign exchange – namely tourism, exports, and FDI – are all seeing a broad-based recovery which should be supportive for the EGP over the medium term.

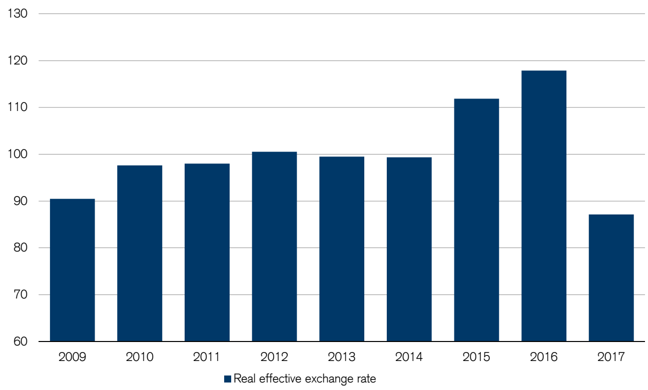
Fig. 4: EGP strengthening likely to continue



Last data point: 14/08/2017. Source: Bloomberg, Credit Suisse / IDC

We had highlighted previously that we expected USD/EGP to stabilize around 17, but with the macro improvements seen thus far, we see scope for the currency to overshoot this level and potentially strengthen to 16. Our more optimistic view is also supported by the real effective exchange rate which has become markedly cheaper in 2017 (see Fig. 5), suggesting that EGP remains undervalued.

Fig. 5: REER is at post financial crisis low
Source: Institute for International Finance



While the improvement in Egypt's reserve position has been central to EGP strength, thus far, the central bank's repatriation mechanism has prevented flows from entering the broader economy – especially the interbank market. With the reserve positioning having strengthened, it is possible that the central bank eases or removes this restriction, which would be positive for the EGP.

Equities: Risk of near-term consolidation has risen

At a 12-month forward P/E of 10.6, we find Egyptian valuations relatively attractive. The market trades at a modest discount to its emerging and Middle East peers (both at 12.5). Valuations have been supported by a 7.8% increase in 12-month forward forecasts since March, which also underscores rising confidence in the macro outlook.

We had downgraded our equity view to neutral in March due to near-term consolidation risks. Equities remained supported for longer than we anticipated but in the past week we have seen a clear breach of the technical uptrend (see Fig. 6). The significantly higher returns on offer in t-bills (see the next section) also raises the risk of rotation out of equities into bonds, amplifying any profit-taking activities. We remain neutral and wait to see whether support levels at 12,600/12,500 hold before looking for entry opportunities.

Fig. 6: EGX30 index uptrend

Last data point: 21/08/2017. Source: Bloomberg, Credit Suisse / IDC

Fixed income: Carry trade still has further to go

Since our publication in March, t-bill yields had initially moved against our expectations, with a move higher toward 23%. Over the past month however, yields have contracted sharply, driven by a further strengthening in foreign investor inflows (see Fig. 7 and 8). The scale of move in yields in such a short time frame, not to mention the sharp increase in foreign inflows, raises the prospect of a pullback in yields. However, we would expect such a move to be temporary only, with the overall downward trend in yields to remain intact.

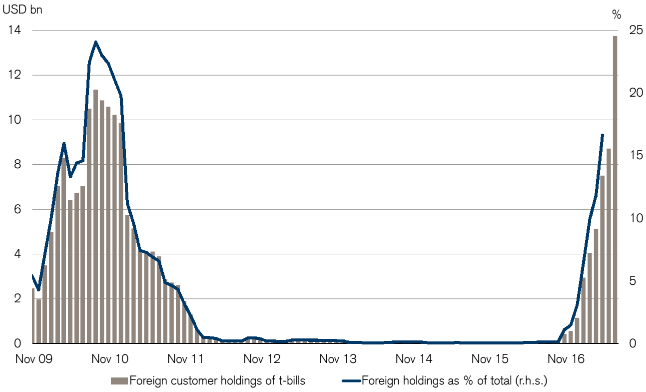
Despite this sharp move, the level of yield pick-up remains huge. The prevailing 19.5% for the front end of the curve and 17.25% for 4–10-year maturities offers a significant pick-up over the EMBI Global Credit B Blended index (duration of 7 years), which has a yield-to-maturity of 6.45%.

While the significant macro improvement has been reflected well in CDS spreads, the same cannot be said for Egypt's credit ratings (see Fig. 9), which have been largely unchanged since early 2014. Over the next 1–2 years, we see scope for credit rating upgrades as the macro environment improves, though it requires the government to keep making positive progress on the elevated fiscal deficit. In our view, this will support further yield contraction also.

Fig. 7: T-bill yields contracted sharply last month

Last data point: 21/08/2017. Source: Central Bank of Egypt, Bloomberg, Credit Suisse / IDC

Fig. 8: Foreign holdings of t-bills



Last data point: 21/08/2017. Source: Central Bank of Egypt, Reuters, Credit Suisse / IDC

Fig. 9: CDS spreads vs. sovereign credit ratings

Last data point: 21/08/2017. Source: Bloomberg, Credit Suisse / IDC

(22/08/2017)

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HOLD	42.25 %	63.78 %	818
SELL	13.65 %	55.47 %	265
RESTRICTED	1.75 %	85.29 %	26

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