SAUDI ARABIA ECONOMIC REPORT

A RECESSIONARY YEAR FOR THE KINGDOM AMID OIL SECTOR WEAKNESSES AND PANDEMIC SPILLOVERS

TABLE OF CONTENTS

CONTACTS

Research

Marwan S. Barakat
(961-1) 977409
marwan.barakat@bankaudi.com.lb

Jamil H. Naayem
(961-1) 977406
jamil.naayem@bankaudi.com.lb

Salma Saad Baba
(961-1) 977346
salma.baba@bankaudi.com.lb

Fadi A. Kanso
(961-1) 977470
fadi.kanso@bankaudi.com.lb

Gerard H. Arabian
(961-1) 964047
gerard.arabian@bankaudi.com.lb

Farah N. Nahlawi
(961-1) 959747
farah.nahlawi@bankaudi.com.lb

- Saudi economy falling into recession
  The oil sector weaknesses along with the COVID-19 crisis are pushing the Kingdom's economy into recession. Saudi's real GDP growth is forecasted at -2.3% in 2020, down from 0.2% in 2019. This slowdown comes within the context of OPEC+ members agreement to cut oil production, which looks set to cause a substantial decline in Saudi exports, adding to the adverse effects of the global spread of COVID-19 and the collapse in oil prices. The 2020 contraction actually represents the sharpest contraction in the Kingdom's growth over the past couple of decades.

- Current account surplus shifting back into deficit on the back of a sharp decline in oil prices
  In light of the coronavirus pandemic spread, depressing global oil demand leading to a sharp decline in oil prices since the end of January, Saudi Arabia witnessed, so far, a net deterioration in its external position at large. In fact, the current account balance is expected to shift from a surplus of 6.4% of GDP in 2019 to a deficit of 3.1% of GDP in 2020 as per the IMF, as oil and non-oil merchandise exports are expected to fall drastically this year, accompanied with a drop in tourism receipts with the suspension of religious tourism.

- Dwindling oil prices to significantly widen the fiscal deficit this year
  The oil price shock and the measures to contain the spread of the coronavirus have weighed negatively on Saudi's fiscal position at large. The fiscal performance over the first quarter of 2020 indicates a tough start, as the global shock due to the coronavirus pandemic significantly impacted the non-oil sector, while sharply lower oil prices constrained drastically oil revenues. As such, the fiscal balance registered a shift from a surplus of SR 27.8 billion (or US$ 7.4 billion) in the first quarter of 2019 to a deficit of SR 34.1 billion (or US$ 9.1 billion) in the first quarter of 2020. In fact, fiscal revenues are expected to decline by about one third this year, almost tripling the fiscal deficit to 12.6% of GDP in 2020, from 4.5% of GDP in 2019, as per the IMF.

- Banking sector adequately buffered against double-blow of COVID-19 and low oil prices
  The Saudi banking sector is facing difficult times on the back of the double blow induced by the ongoing global Coronavirus pandemic that has pretty much halted economic activity and the spillovers of low oil prices on the domestic economy and financial sector. Nonetheless, banks' solid financial standing buffers them sufficiently against arising risks, even if the latter eventually lead to some weakening of liquidity, asset quality and profitability metrics. Measured by the total assets of banks operating in the Kingdom, banking sector activity grew by 4.3% in this year's first four months to reach the equivalent of US$ 731.7 billion at end-April 2020, thus adding to the 9.7% yearly growth witnessed in full year 2019.

- Saudi equities down while bond prices up amid flight to safety
  Saudi equities plunged in the red during the first five months of 2020, mainly weighed down by the oil price crash and growing global recession fears after the Coronavirus outbreak, while the Saudi debt papers traced an upward trajectory, mainly tracking US Treasuries move, as Coronavirus jitters stoked demand for safety.

- Growing macro challenges at the horizon
  Looking forward, fiscal retrenchment will have a negative impact on consumer and business confidence and activity in the coming years, weighing on private consumption. Reduced government funding for development projects, and revenue-raising measures such as tax hikes will weaken domestic demand, given the large role still played by the State in stimulating the Saudi economy at large.

The Saudi Arabia Economic Report can be accessed via internet at the following web address: http://www.bankaudigroup.com

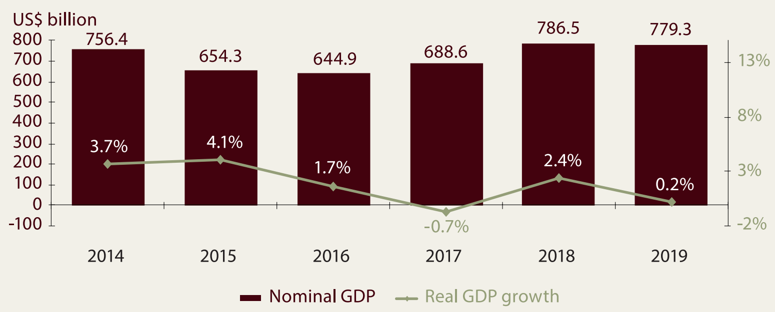
The oil sector weaknesses along with the COVID-19 crisis are pushing the Kingdom's economy into recession. Saudi's real GDP growth is forecasted at -2.3% in 2020, down from 0.2% in 2019. This slowdown comes within the context of OPEC+ members agreement to cut oil production, which looks set to cause a substantial decline in Saudi exports, adding to the adverse effects of the global spread of COVID-19 and the collapse in oil prices. The 2020 contraction actually represents the sharpest contraction in the Kingdom's growth over the past couple of decades.

As a matter of fact, renewed OPEC+ oil production cuts would cause Saudi exports to contract. OPEC+ has agreed to re-implement oil production cuts to the tune of 9.7 mn barrels per day (b/d) from May 1 in a bid to support oil prices. The cuts are to remain in place until June 30, when they will be reduced to 7.7mn b/d, and falling further to 5.8 mn b/d between January 2021 and April 30 2022. Saudi Arabia is expected to shoulder a large share of the cuts as it has done previously, lowering its crude, NGPL and liquids production by around 3.2% y-o-y in 2020, and raising it only slightly by 1.9% in 2021. In turn, Saudi oil exports look set decline markedly in 2020 before recovering only gradually in 2021. Non-oil exports are likely to follow a similar trajectory as near-term external demand is negatively impacted by COVID-19-related activity disruptions. The Kingdom's current account is expected to fall into deficit of 3.1% of GDP in 2020, against a surplus of 6.4% in 2019.

At the fiscal level, it is expected that Saudi government's oil revenues will halve in 2020, on the back of low oil prices and OPEC+ restrictions. Non-oil revenues also look set to decline this year, as the COVID-19 outbreak takes its toll on the economy. The government will cut back on "non-essential" spending, but this will not be enough to fully offset revenue losses. As such, fiscal deficit is forecasted by the IMF to widen from 4.5% of GDP in 2019 to 12.6% in 2020. The deficit will be covered via a mix of reserves depletion and debt issuance, leading overall public debt to rise from 23.2% of GDP in 2019 to 33.1% in 2020. Finally, if the impact of the Coronavirus outbreak on the non-oil economy turns out to be more severe than currently assumed, the government may provide additional fiscal stimulus to the economy, reflecting subsequent on its fiscal deficit and debt growth.

At the monetary level, CPI inflation stood at a yearly 1.2% over the first four months of 2020 relative to the 2019 similar period. Money Supply M3, which grew by 7.1% in 2019, rose by 2.6% in the first four months of 2020. In parallel, SAMA's reserves assets reported US$ 448.6 billion at end-April 2020 (the equivalent of 90.9% of Money supply in local currency), against US$ 499.6 billion at end-2019 (the equivalent of 104.7% of Money supply in local currency). It is worth mentioning that SAMA has cut its policy rate by 75 basis points and announced a private sector financing program of US$ 13.3 billion (1.9% of GDP).

NOMINAL AND REAL GDP



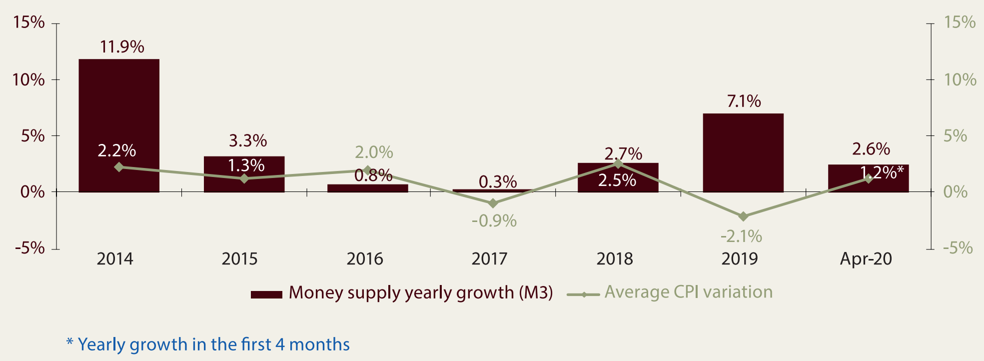
Sources: Saudi Arabian Monetary Agency, IMF, Bank Audi's Group Research Department

At the banking sector level, banking activity, measured by assets of operating banks, grew by 4.3% over the first four months of 2020, following a growth of 9.7% in full-year 2019. The most significant growth driver was loans to the private sector which grew by 6% year-to-April, almost equivalent to their last year's annual growth. Banking sector profits however declined by 11.0% over the first four months of this year relative to the same period of last year.

With respect to capital markets, equity markets were on the downside this year, mirroring the adverse overall macroeconomic conditions. In fact, the share price index fell by 14.0% over the first five months of this year, contracting market capitalization from US$ 2.4 trillion at end-2019 to US$ 2.2 trillion at end-May 2019. In parallel, the 5-year CDS spreads, a measure of the market perception of sovereign risks, rose by 83 basis points over the period, moving from 57 basis points at end-2019 to 140 basis points at end-May 2020. In contrast, Saudi debt papers traced an upward trajectory during the first five months of 2020 as a result of demand for safe-haven assets.

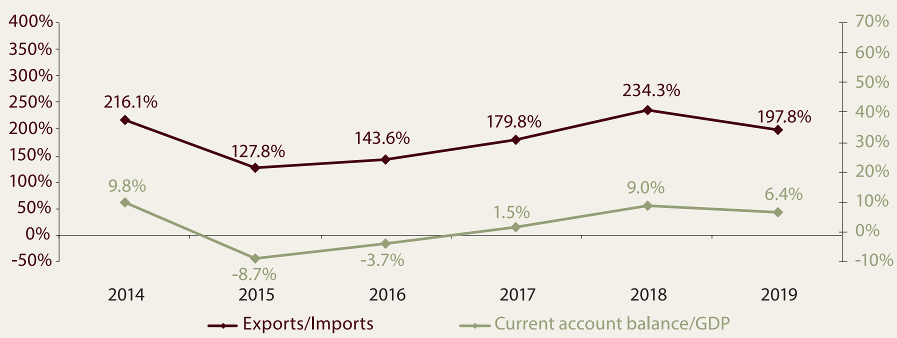
The detailed developments in the real sector, external sector, public sector and financial sector are outlined in the sections that follow while the concluding remarks address Saudi Arabia's middle to long term economic outlook looking forward.

MONEY SUPPLY AND INFLATION



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

FOREIGN SECTOR INDICATORS



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Hydrocarbon Sector

KSA hydrocarbons sector comes under pressure amidst twin shocks

Saudi Arabia's hydrocarbon sector came under pressure in 2020 amidst the twin shocks of the decline in oil prices and the COVID-19 pandemic. The sector is anticipated to weaken by 6.0% in 2020 after contracting by 3.6% in 2019, as per the Institute of International Finance (IIF).

The country's daily average crude oil output is estimated to register a fall of 6.0% this year from 9.8 million barrels per day in 2019. It is worth noting that the Kingdom forms one fifth of the world's proven oil reserves, with the figure standing at 267 billion barrels at the end of 2018. Saudi Arabia's production also constituted 27.6% of the total OPEC countries daily crude oil production.

The Saudi Arabian hydrocarbon sector's share out of total GDP significantly declined from 28.3% of GDP in 2019 to an estimated 20.1% of GDP in 2020, as per the same source. The latter took place primarily because of a drop in oil prices in 2020 alongside the diversification efforts of the Kingdom.

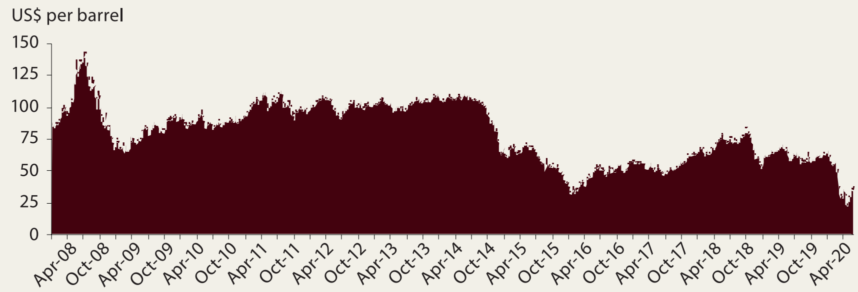
Within this context, the value of Saudi Arabia's hydrocarbon exports are expected to decline by 39.9% in 2020 to reach US$ 116.0 billion this year against US$ 193.0 billion in 2019, according to the IIF. It is worth adding that the bulk of the Kingdom's crude oil exports was accounted for by countries of Asia in the Far East region, followed by North America. Western Europe came in third position. In order to support crude exports, Saudi Arabia has increased the role of gas in the domestic power and industrial sectors.

Moving on to the Kingdom's oil revenues, they would fall by an anticipated 43.7%, amidst the drop in oil prices, to attain only US$ 89.3 billion in 2020 against US$ 158.5 billion in 2019 because of the twin shocks of the COVID-19 pandemic and drop in oil prices. The actual oil revenue's share out of total revenues declines from 64% in 2019 to 51% of total revenues in 2020.

Furthermore, Saudi Arabia's oil consumption saw an estimated drop of 8.0% this year on an annual basis. As a matter of fact, consumption of refined products in the Kingdom are estimated to reach 3,375 thousand barrels per day in 2020, down from 3,668 thousand barrels per day on average in 2019, according to the Institute of International Finance.

As for the Kingdom's gas sector and as per the latest figures, reserves expanded by 4.1% to 320 trillion cubic feet by end-2018, against 308 trillion standard cubic feet by end-2017. Gas production in the Kingdom would reach an estimated 1,812 thousand barrels per day in 2020, against 1,888 barrels per day in the past year. Within this context, the development of the Kingdom's unconventional gas resources

CRUDE OIL PRICES



Sources: Bloomberg, Bank Audi's Group Research Department is accelerating, with the Kingdom announcing major investments into the Jafurah unconventional gas field. The development is slated to begin production in 2024, ramping up to peak production by 2036. At peak, the field will produce 22.7 bcm of natural gas, 4.5 bcm of ethane and 550,000 b/d of condensates and NGLs.

Last but not least, the Kingdom's hydrocarbons sector is anticipated to come under further pressure amidst the twin shocks of lower oil prices and the COVID-19 pandemic. Supply-chain disruptions and lockdowns across the world have severely impact demand for oil and gas, and this is anticipated to dampen the Kingdom's hydrocarbon revenues. Nonetheless, the economic shock is event-driven (COVID-19) in the Kingdom, and recovery is expected to be sharp once lockdowns ease and businesses reopen.

1.1.2. Non-hydrocarbon Sector

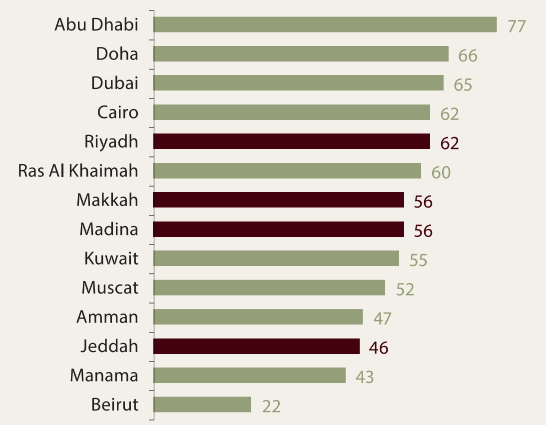
Spread of the COVID-19 pandemic weighs on the performance of Saudi Arabia's non-hydrocarbon sector

Due to the COVID-19 pandemic and the partial lockdown enforced by the Kingdom, the performance of the non-hydrocarbon sector in Saudi Arabia slowed down this year and its growth is forecasted to stand at a negative 1.9%, compared to a positive 3.2% in 2019, as per the IIF. The non-hydrocarbon sector continues to be a major contributor to the country's economy, especially with the decline in oil prices. In this context, the Saudi government is investing in the non-oil sectors, as it aims to diversify the economy and boost job creation and investment.

Looking at the real estate sector, construction is estimated to maintain its contribution of 4.9% in 2020, however, growth in the sector is expected to drop from 2.0% in 2019 to -1.5% in 2020, as per the IIF. The picture is unfavorable for the office and retail segments as oversupply puts downward pressure on rental rates. The bright spot is the industrial segment, where rental rates are expected to increase steadily mainly due to more balanced supply and demand, as per Fitch Solutions. Nearly 5,200 real estate projects are currently under construction in Saudi Arabia, whereby the most prominent of these are the three mega projects as laid out in Vision 2030, namely the transnational Neom City, Qiddiya City and Amaala City. These large-scale projects offer good opportunities across all three real estate sub-sectors, and will stimulate further investment in upgrading infrastructure which plays an important role in enhancing the ease of doing business and trading in the Kingdom.

Looking at the consumer and retail market, real household spending slowed down during this year and will cause pressure on the yearly growth which is expected to stand at 1%, the slowest growth rate since 2016. Consumer behavior and government measures to control the spread of the COVID-19 infection are causing major variations in consumer purchasing patterns. It is worth noting that consumers are placing a greater focus on essential spending categories and priority purchases.

COMPARATIVE HOTEL OCCUPANCY RATES (%)*



* First quarter of 2020, four and five star hotels

Sources: Ernst & Young, Bank Audi's Group Research Department

In a look at tourism, Saudi Arabia's tourism market was hit significantly due to the COVID-19 spread. This shock is set to cripple the industry throughout 2020. Widespread border closures, social lockdowns, flight suspensions and economic uncertainty all put pressure on market sentiment over the coming quarters. Jeddah's hospitality sector witnessed an occupancy decline of 3.2 percentage points from 49.1% in the first quarter of 2019 to 45.9% in the same quarter of this year. This was coupled with an avergae daily rate (ADR) decrease of 1.1% in Q1 2020 when compared to the same period last year. This led to a RevPAR drop of 7.5% down from US$ 80 to US$ 74 over the aforementioned period, as per Ernst & Young. Jeddah's subdued occupancy is the result of movement restrictions such as entry and exit bans, the closure of entertainment facilities, halted flights, and a suspension of Umrah pilgrimage in an effort to contain the spread of COVID-19.

Riyadh's hospitality market saw an ADR increase of 2.5%, from US$ 165 in the first quarter of last year to US$ 169 in the same quarter of 2020. However, occupancy dropped year-on-year by 4.8% which led to a RevPAR drop of 4.9% from US$ 110 in Q1 2019 to US$ 105 in Q1 2020. The hospitality sector's recovery will be heavily dependent on the country's ability to curb the virus spread, issuance of support packages by the government and the eventual lifting of restrictive measures imposed nationwide, as per EY.

As for the power sector, the disruptive effects of COVID-19 will reduce electricity demand through 2020, while supply chain disruptions and challenges in funding and financing delay the implementation of projects currently in the pipeline. Yet, a number of large-scale thermal power projects are in the final construction and testing phases, hence, near-term growth will maintain its strength despite these pressures. Total electricity generation was estimated at 335.1 Terawatt-hour (TWh) in the Kingdom in 2019, however is forecasted to stand at 322.2 TWh this year, as per Fitch Solutions.

Finally, Saudi Arabia made sure to maintain its efforts in implementing it diversification strategy, as the decline in oil prices did put pressure on the oil-exporting country's economy. However, the spread of the COVID-19 pandemic came along to put negative pressure on various sub-sectors of the non-oil economy, whereby the various government measures including the lockdown left these sub-sectors with noticeably unfavorable conditions.

1.2. EXTERNAL SECTOR

Current account surplus shifting back into deficit on the back of a sharp decline in oil prices

In light of the coronavirus pandemic spread, depressing global oil demand leading to a sharp decline in oil prices since the end of January, and in addition to the cut in oil production implied by the recent OPEC agreement, Saudi Arabia witnessed, so far, a net deterioration in its external position at large. In fact, the current account balance surplus, after showing a strong improving trend in 2018, registered a tangible yearly drop of 29.4% in 2019, and it is expected to shift from a surplus of 6.4% of GDP in 2019 to a deficit of 3.1% of GDP in 2020 as per the IMF, as oil and non-oil merchandise exports are expected to fall drastically this year, accompanied with a drop in tourism receipts with the suspension of religious tourism.

In fact, Saudi Arabia's foreign trade figures showed a strong decline in exports by 20.7% alongside a 6.1% drop in imports in the first quarter of 2020, when compared to the first quarter of 2019, contributing to a considerable decline in the foreign trade surplus by 36.6%, according to SAMA. Saudi's merchandise trade surplus went down from US$ 31.9 billion in the first quarter of 2019 to US$ 20.2 billion in the first quarter of 2020. It is worth mentioning that the full-year 2019 witnessed a tangible yearly drop in trade surplus by 23.4% due to an 11.2% decline in exports alongside a 5.3% increase in imports in 2019 compared to 2018.

Going further into details, total exports reached a total of US$ 52.7 billion in the first quarter of 2020, a decline from US$ 66.5 billion in the first quarter of 2019. The breakdown of exports by category, according to SAMA, suggests that exports of mineral products, grabbing the lion's share of total exports with 76% of the total, posted a drop of 23.1% between the two periods, while exports of chemicals, with a share of 7.4% of total exports, went down by 18.9%, followed by plastic products (7.2% of total exports) with a decline of 25.7% over the same period.

At the level of imports, a total of US$ 32.5 billion was registered in the first quarter of 2020, compared to US$ 34.6 billion in the first quarter of 2019, marking a depressing local demand within the weaker economic outlook for 2020 in the face of COVID-19. The breakdown of imports by category suggests that imports of machinery and transport equipments posted the highest share of 38.8% of total imports, followed by chemicals and related products with 11.2%, base metals with 9.9%, vegetables and live animals with a share of 9.7% and prepared foodstuffs with 5.4% of total imports.

On the other side of the external sector, the latest available figures show that the financial account surplus recorded a considerable contraction from US$ 67.4 billion in 2018 to US$ 46.3 billion in 2019. This was mainly due to direct investment that reported a drop from a surplus of US$ 18.7 billion in 2018 to US$ 8.6 billion in 2019, in addition to a shift in portfolio investment from a surplus of US$ 3.8 billion to a deficit of US$ 12.7 billion, as portfolio investment inflows increased significantly as the Saudi Stock Exchange (Tadawul) became listed in the Emerging Markets Stock Indices.

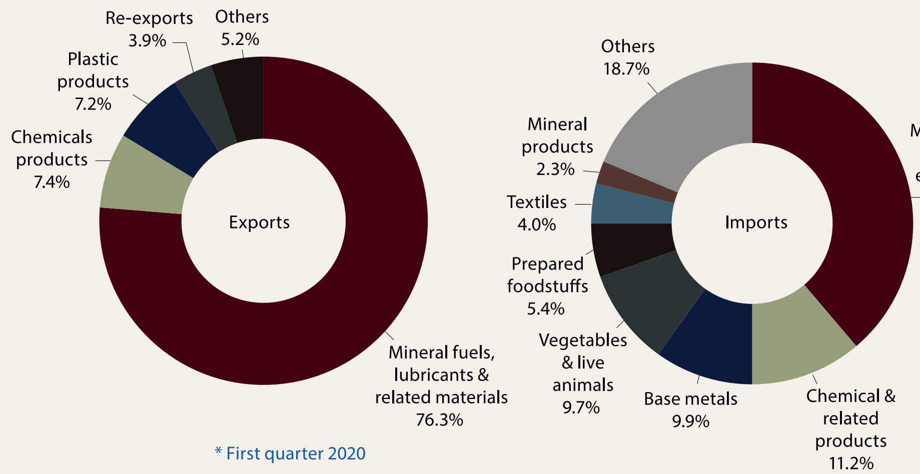
1.3. PUBLIC SECTOR

Dwindling oil prices to significantly widen the fiscal deficit this year

The oil price shock and the measures to contain the spread of the coronavirus have weighed negatively on Saudi's fiscal position at large. The fiscal performance over the first quarter of 2020 indicates a tough start, as the global shock due to the coronavirus pandemic significantly impacted the non-oil sector, while sharply lower oil prices constrained drastically oil revenues. As such, the fiscal balance registered a shift from a surplus of SR 27.8 billion (or US$ 7.4 billion) in the first quarter of 2019 to a deficit of SR 34.1 billion (or US$ 9.1 billion) in the first quarter of 2020. It is worth mentioning that public sector finances have posted a narrower deficit in 2019, estimated at 4.5% of GDP when compared to a deficit of 5.9% of GDP in 2018, as the fall in oil revenues in 2019 was compensated by a strong growth in non-oil revenues, which increased from reducing VAT registration threshold and expanding excise taxes and fees, while total spending slightly decreased with capital spending bearing the bulk of these cuts.

Going further into details, the first quarter actual figures, as released by the Ministry of Finance, showed that public revenues went down significantly by 21.7%, from SR 245.4 billion (or US$ 65.4 billion) in the first quarter of 2019 to SR 192.1 billion (or US$ 51.2 billion) in the first quarter of 2020, on the back of a significant drop in oil revenues by 23.8% year-on-year (constituting 67.0% of total public revenues)

EXPORTS AND IMPORTS*



* First quarter 2020

Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

on the one hand, and driven by a decline in non-oil revenues by 17.1% on the other hand. Within this context, Saudi policy makers announced a range of measures on 11 May to contain the country's fiscal deficit, which included a tripling of the VAT rate to 15%, to be effective in July, yet the increase in revenue collection this year will likely be muted by lower discretionary spending given virus disruptions, and the full impact of the VAT hike is likely to kick in only next year.

On the spending front, total public expenditures went up by 4.0% over the same period, from SR 217.6 billion (or US$ 58.0 billion) in the first quarter of 2019 to SR 226.2 billion (or US$ 58.0 billion) in the first quarter of 2020. A breakdown of public expenditures shows an 81% increase in infrastructure and transportation expenses, military expenses went up by 7%, while health and social development expenses went down by 13% over the same period. It is worth mentioning that Saudi policy makers announced lately the elimination of certain social benefits introduced in 2018, and scaling back capital-spending plans. In fact, cuts to bonuses and cost-of-living allowances mark a start to addressing the wage bill that absorbs more than 50% of total spending. As such, the announced measures (including VAT tripling) could represent around SR 100 billion (or US$ 27 billion) in fiscal savings, which is roughly 4% of nominal GDP forecasts for 2020.

In light of these tough operating conditions, the fiscal position is set to deteriorate sharply in 2020, as prices and OPEC production cuts drive oil revenues lower and non-oil earnings struggle for traction against a backdrop of contracting domestic demand and falling yields on overseas assets. As such, fiscal revenues are expected to decline by about one third this year, almost tripling the fiscal deficit to 12.6% of GDP in 2020, from 4.5% of GDP in 2019, as per the IMF.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Sharp falls in SAMA's reserves on one-off non-redundant transaction

Saudi monetary conditions saw resurgent inflationary pressures over the first four months of 2020 after grappling with deflation in 2019, while Saudi rates continued to follow the lead taken by the US Federal Reserve in loosening its monetary policy given the Saudi riyal peg to the US dollar. This came along sharp falls in SAMA's FX reserves, mainly due to a one-off non-redundant transaction that aimed to maximize returns on the Kingdom's assets amid the financial fallout of the Coronavirus pandemic.

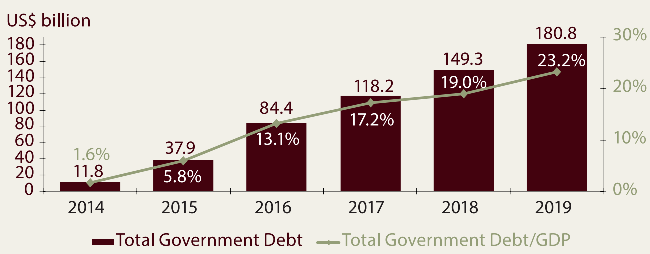
In details, consumer prices in Saudi Arabia grew by 1.2% on average during the first four months of 2020 when compared to the same period of the previous year, amid rising food prices due to global value chain distortions because of the COVID-19 precautionary measures applied globally. This followed a 2.1% contraction in consumer prices in 2019 that was mainly driven by the fading impact of a 5% VAT imposed on most goods and services in January 2018.

SELECTED PUBLIC FINANCE INDICATORS

US$ billion	2015	2016	2017	2018	2019	Var 19/18
Public revenues	163.4	138.5	184.4	241.5	247.2	2.3%
Public revenues/GDP	25.0%	21.5%	26.8%	30.7%	31.7%	1.0%
Public expenditures	267.0	221.5	248.0	287.9	282.5	-1.9%
Public expenditures/GDP	40.8%	34.3%	36.0%	36.6%	36.3%	-0.3%
Fiscal balance	-103.6	-82.9	-63.6	-46.4	-35.4	-23.7%
Fiscal balance/GDP	-15.8%	-12.9%	-9.2%	-5.9%	-4.5%	1.4%

Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

PUBLIC INDEBTEDNESS AND DEBT RATIO



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

The breakdown of the cost of living index by category during the first four months of 2020 shows that the food and non-alcoholic beverages segment registered the largest year-on-year expansion of 3.8%, followed by the transport segment with +2.4%, the miscellaneous goods and services segment with +1.7%, the restaurants and hotels segment with +1.6%, the education segment with +1.5%, the furnishings, household equipment & routine household maintenance segment with +1.1%, the recreation and culture segment with +1.0%, the tobacco segment with +0.9% and the clothing and footwear segment with +0.4%. In contrast, the housing, water, electricity, gas, and other fuels segment reported a year-on-year contraction of 1.0% during the first four months of 2020, followed by the communication segment with -0.8% and the health segment with -0.3%.

The Saudi riyal remained pegged against the US dollar at SR/US$ 3.75, with SAMA reiterating recently its commitment to the peg as an anchor of monetary and financial stability despite the twin shock of low oil prices and the Coronavirus pandemic. Given the Saudi riyal peg to the US dollar and following two rate cuts by the US Federal Reserve to near zero to ease the economic impact of the fast-spreading COVID-19, Saudi Arabian Monetary Authority slashed its repo and reverse repo rates twice in March 2020 by a total of 125 bps each to reach 1.0% and 0.50% respectively at the time of writing this report. This followed three rate cuts in 2019 for a total of 75 bps that have broadly tracked US rates.

In parallel, the narrow measure of money supply (M1) grew by 9.0% during the first four months of 2020 to reach US$ 375 billion at end-April, given a 9.2% rise in money in circulation and a 9.0% increase in demand deposits. This followed a 5.5% expansion in (M1) in 2019. The broader money supply (M2), which grew by 7.6% in 2019, widened by 3.4% during the first four months of 2020 (the equivalent of US$ 16.4 billion) to reach US$ 494 billion amid a 10.9% drop in time and saving deposits. The money supply in its broadest sense (M3) expanded by 2.6% during the first four months of 2020 (the equivalent of US$ 13.5 billion), within the context of a 5.6% decline in quasi-money deposits. This followed a 7.1% expansion in 2019. Given a higher growth in demand deposits than money supply (M3) during the first four months of 2020, the demand deposits to broader money supply (M3) ratio reached 58.8% at end-April 2020, up from 55.4% at end-December 2019. In parallel, the M1/M3 ratio was quoted at 69.0% at end-April 2020, moving up from 64.9% at end-December 2019.

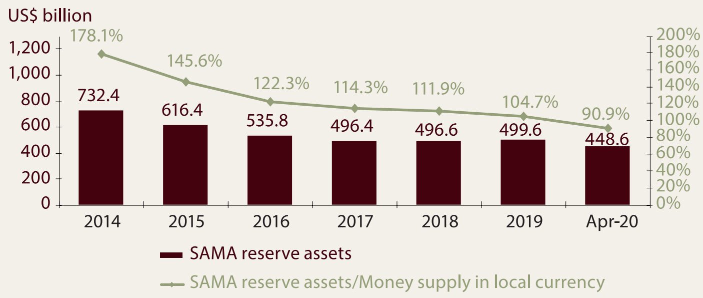
SAMA's reverse assets, which grew by US$ 3 billion in 2019, registered a significant contraction of US$ 50.9 billion during the first four months of 2020 to reach US$ 448.6 billion at end-April. The reserve burn is largely due to a US$ 45.4 billion fall in "Investment in Foreign Securities", which resulted from a US$ 40 billion exceptional transfer made to the Public Investment Fund over the March/April 2020 period for the purpose of providing it with liquidity to carry out opportunistic international asset purchases amid the financial fallout of the Coronavirus pandemic.

EVOLUTION OF MONETARY SITUATION

Variation (US$ million)	2015	2016	2017	2018	2019	4M-20
Net foreign assets	**-98,484**	**-102,915**	**-38,343**	**-5,207**	**-8,977**	**-50,541**
SAMA	-115,362	-80,276	-39,731	670	4,469	-49,869
Commercial Banks	16,878	-22,639	1,389	-5,877	-13,446	-672
Domestic Assets	**41,291**	**37,779**	**16,508**	**24,158**	**50,044**	**34,475**
Claims on Private sector	34,306	8,817	-3,389	10,678	27,005	26,958
Claims on Public sector	8,806	24,602	20,301	13,496	20,938	7,851
Claims on Non-financial Public Sector Enterprises	-1,821	4,360	-403	-15	2,102	-333
Broad Money (M3)	**14,994**	**3,767**	**1,457**	**12,926**	**35,065**	**13,513**
Money Supply (M1)	1,518	-595	7,495	12,342	18,004	31,013
Quasi-Money	13,476	4,362	-6,038	584	17,061	-17,499
Government Deposits	**-106,183**	**-76,559**	**-36,722**	**-14,993**	**-15,613**	**-12,316**
Other Items (Net)	**33,996**	**7,656**	**13,430**	**21,018**	**21,614**	**-17,262**

Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

FOREIGN EXCHANGE MARKET INDICATORS



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

In the coming period, a Value Added Tax hike from 5% to 15% staring July 1, 2020, which makes part of a slew of austerity measures adopted by the Saudi government to contain the impact of the double blow of an oil price crash and the Coronavirus crisis, is forecast to push inflation higher, while SAMA's FX reserves are not expected to see significant drops after the recent one-off transaction.

1.4.2. Banking Activity

Challenged by but adequately buffered against double-blow of COVID-19 and low oil prices

The Saudi banking sector is facing difficult times on the back of the double blow induced by the ongoing global Coronavirus pandemic that has pretty much halted economic activity and the spillovers of low oil prices on the domestic economy and financial sector. Nonetheless, banks' solid financial standing buffers them sufficiently against arising risks, even if the latter eventually lead to some weakening of liquidity, asset quality and profitability metrics. Measured by the total assets of banks operating in the Kingdom, banking sector activity grew by 4.3% in this year's first four months to reach the equivalent of US$ 731.7 billion at end-April 2020, thus adding to the 9.7% yearly growth witnessed in full year 2019.

A look at the balance sheet of banks operating in Saudi Arabia reveals that while bank deposits with SAMA declined so far this year, they continued extending credit to the economy as well as to the public sector. Banks partly benefited from higher deposits to fund the rise in credit, noting that deposits rose by 1.9% in the first four months of 2020 to reach the equivalent of US$ 487.8 billion at end-April (after a 7.3% yearly growth in 2019). Banks' funding profile could yet be pressured in the months ahead by weaker public sector deposit inflows due to low oil prices and falling household savings capacity and corporate earnings. It is important to mention that the banking sector is able to support higher demand for credit domestically as the loan-to-deposit ratio, even though slightly edging up when compared to end-2019 to reach 78.5% at end-April 2020, remains well under the SAMA limit of 90%.

As a matter of fact, Saudi banks enjoy a good liquidity position, as evidenced by various liquidity metrics, even though the latter has been pressured in the first few months of this year. On the one hand, the SAMA announced in its latest financial stability report that the Liquidity Coverage Ratio (LCR) declined slightly last year to reach a sector average at 198% at end-2019. SAMA requires banks to hold a minimum of 100% of High Quality Liquid Assets (HQLA) to expected 30-day net outflow. Given the current developments related to the COVID-19 pandemic, SAMA expects it to weigh-in on the LCR especially if cash flows are impacted. However, given the buffer levels of this ratio for the banking system, reaching levels lower than SAMA requirement is highly unlikely, added the SAMA report.

On the other hand, the Net Stable Funding Ratio (NSFR) is indicative of long-term liquidity position of the system, which enjoys an adequate liquidity supported by the pick-up in deposits towards end-2019. The NSFR improved to reach 130% by the end of the year, accompanied with lower standard deviation, according to the sector regulator. Anyhow, the core liquidity ratio, which we measure as the sum of cash, deposits with SAMA and deposits with banks and branches abroad to total deposits, reached 15.9% at end-April 2020, against a higher 19.5% at end-2019. This is due to lower other deposits with SAMA and dues from banks abroad along with higher deposits at Saudi banks affecting the denominator portion of the ratio, thus hinting at the impact of the ongoing health pandemic on banks' liquidity, although the latter remains acceptable on the overall.

As such, and in line with the sector regulator's directives, banks continued to extend loans to the Saudi economy. Claims on the private sector rose by 6% in the first four months of 2020 to reach the equivalent of US$ 439.4 billion at end-April, almost matching the 7% growth in the full-year 2019, and claims on the public sector grew by 6.3% in the covered period of 2020. This adds to a noticeable expansion of 24.1% in claims on the public sector last year on the back of subscriptions in the government and quasi-government bonds as the Kingdom of Saudi Arabia tapped bond markets anew. In this respect, we note that for the first time, sovereign exposure (to government and quasi-government bonds) exceeds the capital accounts of banks, but the firepower and wealth of the Kingdom's public sector mitigates sovereign exposure risks to a large extent.

The rise in bank loans this year comes as the regulator just announced it would inject SR 50 billion into the banking system to support the liquidity of banks to help them provide credit to the private sector. The regulator also aims to help banks restructure loans at no additional charge to the borrower and to cover for a number of fee exemptions. On a similar note, residential mortgages are likely to continue being extended in the near term, supported by the government's initiative to raise home ownership among Saudis.

Having said that, banks have extended new waves of credit while being quite cautious about their asset quality ratios. According to the latest SAMA statistics covering 2019, the non-performing loans to gross loans ratio stood at 1.9% at end-December 2019, against 2.0% at end-December 2018. This ratio remains more than favorable both in absolute terms and relative to international benchmarks in the 7% range. It is true that the double blow of low oil prices and COVID-19 pandemic is likely to challenge asset quality metrics of Saudi banks, as the halting of economic activity would affect the cash flow generation capacity of borrowers and as banks experience concentration of large loans to single borrowers/sectors. Yet, Saudi banks have had those loans well provisioned, given that the non-performing loans net of provisions to capital ratio remains negative at -3.6% at end-December 2019, suggesting non-performing loans are more than fully provisioned for.

Along the same lines, even if banks come to encounter pressures on their capital base, they do benefit from comfortable capital buffers. In fact, the regulatory capital to risk-weighted assets ratio stood at high 19.4% at end-December 2019, the bulk of which consisting of Tier 1 capital (Tier 1 ratio of 18.1% at end-December 2019), with both ratios above regulatory requirements and international averages and providing adequate loss absorbency as borrowers come under stress.

Finally, and after moderating in 2019 with a 4.5% yearly rise (lower than the previous couple of years), banking sector profitability declined in the first four months of this year with an 11.0% year-on-year contraction. This is likely attributed to the impact of COVID-19 and lower oil prices, with the former forcing the US Federal Reserve to cut key policy rates. Since the local currency in pegged to the greenback, SAMA followed suit which hit asset yields of Saudi banks, not to mention possibly higher provisioning incurred by banks this year and lower fee income generation capacity in light of recent developments. All of the latter more than offset a structurally favorable cost structure evidenced by low cost deposits leading to a low cost-to-income ratio in the mid-30% range, and contributed to lower bottom line figures for Saudi banks so far this year.

BANKING SECTOR RATIOS

	2015	2016	2017	2018	2019	Apr-20
Banking sector dimension in economy						
Assets/GDP	91.0%	94.6%	91.0%	81.3%	90.0%	94.3%
Deposits/GDP	65.9%	67.4%	63.2%	56.7%	61.5%	62.9%
Loans to private sector/GDP	54.4%	56.4%	52.3%	47.1%	51.0%	54.4%
Loans to public sector/GDP	1.6%	2.3%	2.1%	1.8%	2.1%	2.1%
Growth rates (YTD)						
Assets	4.7%	2.5%	2.7%	2.0%	9.7%	4.3%
Loans to the private sector	10.9%	2.1%	-0.9%	2.8%	7.3%	6.1%
Investments	-9.0%	-11.1%	11.7%	8.4%	18.7%	7.5%
Deposits	2.6%	0.8%	0.2%	2.5%	7.3%	1.9%
Capital and reserves	9.0%	10.3%	6.3%	-4.3%	13.0%	8.8%
Profit growth (year-on-year)	5.6%	-4.8%	8.6%	9.8%	4.5%	-11.0%
Financial ratios						
Primary liquidity/Deposits	17.4%	20.3%	22.5%	19.7%	19.5%	15.9%
Loans to the private sector/Deposits	82.6%	83.7%	82.7%	83.0%	83.0%	86.5%
Capital accounts/Assets	14.0%	14.8%	15.4%	14.7%	14.9%	14.2%
ROAA	1.94%	1.79%	1.89%	2.03%	2.00%	1.85%
ROAE	14.1%	12.4%	12.5%	13.5%	13.5%	12.7%

Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

To sum things up, banks are being challenged by difficult operating conditions tied to the COVID-19 pandemic and a contraction in oil prices to new lows, with decelerating deposit growth and contracting bottom lines. However, they are comforted by the fact that they withhold sufficient liquidity, asset quality and capital adequacy buffers, in addition to the support of the wealthy sovereign, to steer through these shocks in the foreseeable future.

1.4.3. Equity and Bond Markets

Saudi equities down on oil price crash, bond prices up amid flight to safety

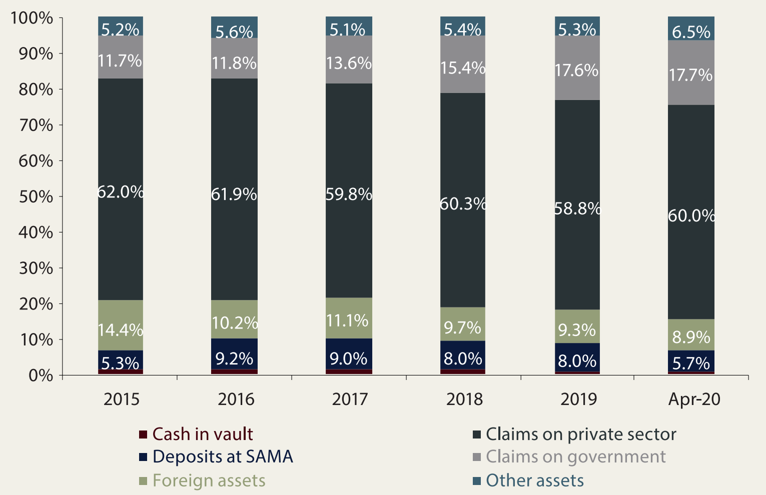
Saudi equities plunged in the red during the first five months of 2020, mainly weighed down by an oil price crash and growing global recession fears after the Coronavirus outbreak, while the Saudi debt papers traced an upward trajectory, mainly tracking US Treasuries move, as Coronavirus jitters stoked demand for safety.

An oil price crash after the spread of the Coronavirus pandemic and the collapse of KSA's oil-cutting alliance with Russia, compounded with the fears over the worst global economic downturn since 1930s due to the "Great Lockdown" imposed by COVID-19, to put downward price pressures on Saudi equities, with the latter ending the first five months of the year 2020 on a negative note.

Price contractions over the first five months of 2020 took place despite an equity price recovery observed over the April/May 2020 period, which was mainly driven by: (1) April OPEC+ deal on a historical global oil production cut of 10 mbpd, which has put an end to a month-long Saudi-Russian crude price war; (2) signs of a global oil demand recovery as several countries around the world started relaxing lockdowns imposed by the COVID-19 outbreak; (3) an oil price recovery from historical lows; (4) Saudi pledge for additional oil production cuts in June 2020 to help drain a global oil glut; (5) a SR 120 billion stimulus package unleashed by the Kingdom to support the private sector after COVID-19 outbreak; and (6) some favorable corporate earnings.

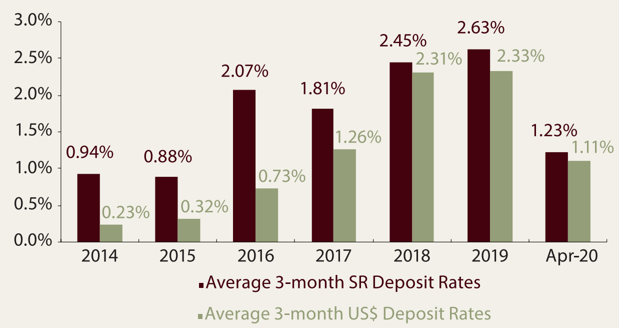
That being said, the Saudi Tadawul recouped some losses over the April/May 2020 period. This brought down contractions in the Tadawul All-Share Index from 22.5% during the first quarter of 2020 to 14.0% over the first five months of 2020. This followed a 7.2% expansion in the Tadawul All-Share Index in 2019 following Saudi Arabia's inclusion in three major international indices and the Kingdom's announcement of a sweeping infrastructure plan worth of US$ 425 billion under Vision 2030.

BANKING SECTOR ASSET COMPOSITION



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

BANKING SECTOR DEPOSIT RATES



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

The breakdown of the TASI by the industry groups during the first five months of 2020 shows that the commercial and professional services sector registered the highest index contraction with -24.0%, followed by the media & entertainment sector with -23.09%, the real estate management and development sector with -20.28%, the capital goods sector with -19.98%, the banks sector with -19.95%, the consumer services sector with -19.51%, the transportation sector with -18.58%, the retailing sector with -16.89%, the utilities sector with -15.07%, the materials sector with -14.35%, the REITs sector with -13.28%, the diversified financial sector with -11.39%, the consumer durables and apparel sector with -10.05%, the energy sector with -8.20%, the healthcare equipment and services sector with -4.42%, the insurance sector with -2.33% and the telecommunication services sector with -0.43%. In contrast, the food & staples retailing sector reported the highest index surge with +41.56%, followed by the software & services sector with +25.45%, the food & beverage sector with +10.18% and the Pharma, Biotech and & life science sector with +2.39%.

In line with equity price falls during the first five months of 2020, the number of listed companies rose from 199 companies at end-2019 to 201 companies at end-May 2020. Within this context, the Saudi market capitalization contracted by 7.7% over the first five months of the year, moving from US$ 2,406.8 billion at end-2019 to US$ 2,220.7 billion at end-May 2020. This followed a five-fold rise in the Saudi market capitalization in 2019, mainly due to the listing of 1.5% of Saudi Aramco's shares on December 11, 2019, with a market valuation of circa US$ 2 trillion.

The total trading value in the Saudi Tadawul amounted to US$ 118.5 billion during the first five months of 2020, rising by 54.9% relative to the same period of the year 2019. The division of the total turnover by industry groups during the first five months of 2020 showed that three out of 21 sectors captured 55.4% of activity, namely the banks sector with 25.0%, the materials sector with 19.5% and the energy sector with 10.9%. Given the large growth in the market capitalization after the listing of Saudi Aramco's shares at end-December 2019, the annualized turnover ratio reached 12.8% during the first five months of 2020 and compared to 34.4% during the same period of 2019.

As to fixed income markets, Saudi debt papers traced an upward trajectory during the first five months of the year 2020, mainly tracking rises in US Treasuries, as growing concerns over a global economic slump caused by the fast-spreading Coronavirus pandemic, mounting US-China tensions and the US Federal Reserve's dire warning of a prolonged recession in the US resulting from the COVID-19 outbreak, flocked demand for safe-haven assets. Also, the Saudi bond market benefited from improved investor sentiment in May 2020 given an oil price rebound from historical lows after OPEC+ members agreed to slash global oil supplies by 10%, and on signs of a global oil demand recovery after several countries around the world started easing lockdowns imposed by the Coronavirus pandemic.

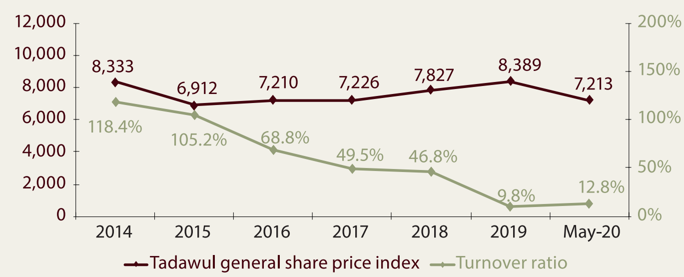
In details, Saudi sovereigns maturing in 2021, 2023, 2025, 2028 and 2030 registered price gains ranging between 0.81 pt and 2.38 pts during the first five months of 2020. Saudi Aramco'24 closed up by 1.95 pt. Prices of STC'29 improved by 2.13 pts. SECO'24 was up by 0.74 pt. This followed decent price gains in 2019 when intensifying trade war between the US and China spurred demand for safety.

SELECTED STOCK MARKET INDICATORS

	2015	2016	2017	2018	2019	May-20
Market capitalization (US$ billion)	421.1	448.5	450.6	495.7	2,406.8	2,220.7
Trading value (in US$ billion)	442.8	308.5	223.0	232.2	234.7	118.5
Number of transactions (in millions)	30.4	27.3	21.9	25.0	28.4	19.9
General share price index (base 1999=100)	6,912	7,210	7,226	7,827	8,389	7,213
Number of listed companies	171	176	179	190	199	201
Change in share price index	-17.1%	4.3%	0.2%	8.3%	7.2%	-14.0%
Price/Earnings ratio	13.8x	15.7x	15.2x	15.8x	19.5x	19.7x
Price/Book value ratio	1.7x	1.7x	1.7x	1.8x	4.3x	8.2x
5-year CDS spreads (bps)	156	113	92	105	57	140

Sources: Tadawul, Bank Audi's Group Research Department

CAPITAL MARKETS PERFORMANCE



Sources: Tadawul, Bank Audi's Group Research Department

In the aim of shoring up its finances in the face of the Coronavirus pandemic and plunging oil prices, Saudi Arabia followed Qatar and Abu Dhabi in 2020 in tapping international debt markets. The Kingdom raised US$ 7 billion in April 2020 through the sale of a triple-tranche bond that has attracted orders of circa US$ 54 billion. KSA sold US$ 2.5 billion notes maturing in 2025 at 260 bps over US Treasuries, US$ 1.5 billion notes maturing in 2030 at 270 bps over the same benchmark and US$ 3 billion notes maturing in 2060 at a coupon of 4.50%, which is the longest-dated bond issued in US dollar by a GCC borrower.

It is worth noting Saudi Arabia continued to account for the largest share of bond issuances in the MENA region during the first five months of 2020, as total bond issues in KSA reached US$ 14.4 billion at the time of writing this report, which represents 30.7% of total MENA bond issues. This followed bond issuances of circa US$ 29 billion in 2019, of which US$ 10 billion and € 3 billion are sovereigns.

As to the cost of insuring debt, Saudi Arabia's five-year CDS spreads, which measure the market's perception of sovereign risks, expanded significantly by 84 bps during the first five months of 2020 to reach 140 bps at end-May, staying well below the average regional sovereign five-year CDS spreads of 293 bps. This followed a 48 bps contraction in 2019.

As to credit ratings, Moody's changed in April 2020 the outlook to "negative" from "stable" on the Government of Saudi Arabia's issuer rating and affirmed the issuer and senior unsecured "A1" rating and the "(P) A1" senior unsecured MTN rating. The "negative" outlook reflects increased downside risks to Saudi Arabia's fiscal strength stemming from the severe shock to global oil demand and prices triggered by the Coronavirus pandemic, and from the uncertainty regarding the degree to which the government would be able to offset its oil revenue losses and stabilize its debt burden and assets in the medium term.

Also, Fitch affirmed in April 2020 Saudi Arabia's Long-Term Foreign-Currency Issuer Default Rating at "A" with a "stable" outlook. Saudi Arabia's rating reflects, as per Fitch, its strong fiscal and external balance sheets, including exceptionally high international reserves and low government debt. These are tempered by oil dependence, weak World Bank governance indicators and vulnerability to geopolitical shocks. The Kingdom's fiscal and external balance sheets have been weakening, and the recent sharp downturn in oil prices has accelerated this trend.

Standard and Poor's affirmed in March 2020 its "A-/A-2" unsolicited long-term and short-term foreign and local currency sovereign credit ratings on Saudi Arabia, with a "stable" outlook. The "stable" outlook reflects S&P's expectation that the current low oil price environment, although affecting fiscal flows, would be counterbalanced by Saudi Arabia's strong government and external balance sheets, with net asset-stock positions on both.

Looking forward, an easing of the Coronavirus pandemic, extended oil price recovery, and the implementation of fiscal consolidation measures which offset the oil revenue shortfall, would provide positive signals to Saudi capital markets and help lifting risk sentiment.

2. CONCLUDING REMARKS

Looking forward, fiscal retrenchment will have a negative impact on consumer and business confidence and activity in the coming years, weighing on private consumption. Reduced government funding for development projects, and revenue-raising measures such as tax hikes will weaken domestic demand, given the large role still played by the State in stimulating the Saudi economy.

At the external level, export growth would moderate compared with historical standards, as oil output weakens. Over the longer term, however, this trend could accelerate should Saudi authorities add on sector capacity. Meanwhile, non-oil exports are likely to see relatively steady growth in the next decade as a result of the government's economic diversification drive, albeit from a low base. Import growth would be slower than in the past decade, as a less expansionary fiscal policy stance reduces the demand for imported goods. That said, demand for capital goods, raw materials, and machinery from abroad would remain fuelled by Saudi Arabia's infrastructure investments and economic diversification drive.

At the monetary level, the Saudi Arabian Monetary Authority (SAMA), the Kingdom's central bank, has limited ability to respond to changes in inflation levels, due to the riyal peg to the US dollar. As the Kingdom is not expected to abandon the peg over the coming decade, SAMA will hike its reverse repo rate – its main monetary policy instrument to control money supply in the country – in line with moves from the US Federal Reserve. With respect to the currency, it is expected that Saudi Arabia can still comfortably defend its peg even in the current context of ultra-low oil prices.

At the fiscal level, the Saudi government is expected to revert back to fiscal consolidation over the coming years, in line with its Vision 2030 and fiscal rebalancing programs. Debt accumulation is likely to continue in the medium to long term, although at a slowing pace than the one expected in 2020, as improving macroeconomic conditions and resultant revenue gains, coupled with moderate spending restraint, help narrow the fiscal deficit and subsequently the Kingdom's borrowing requirements. Still, relatively wide fiscal deficits are expected over the next few years, due to low oil price assumptions and sizable fiscal expenditure, despite an increase in oil production and improved non-oil revenue collection.

The analysis of the Kingdom's short to medium term outlook actually requires a careful examination of strengths and opportunities relative to the threats and challenges. At the level of the former, we mention the country's ample oil reserves, the largest in the World, with low extraction costs, the relatively low, but steadily rising government debt burden, and the strong fiscal and external balance sheets amid robust fiscal and foreign currency reserve buffers and prudent financial regulation.

At the level of risks constraining the outlook, we mention the high dependence of nominal incomes and growth on oil prices, the rigid government spending structure and revenue vulnerable to oil price volatility and the political risks stemming from geopolitical tensions and social challenges presented by rapid population growth and high unemployment. While those risk factors are real challenges, we believe strengths outpace weaknesses and opportunities outweigh threats at the horizon.

That said, lower oil prices provide the urgency to tackle difficult fiscal issues, such as the large and rigid spending spending on public sector compensation and benefits – which will need to be assessed against the obvious need for fiscal mitigation of the effects of COVID-19. Despite efforts to foster greater diversification, the hydrocarbon sector remains the economic driver with further large investments indicated for oil and gas expansion during the current oil price turmoil. Other large capital investments and mega projects are envisaged under Vision 2030, generating significant financing needs and fiscal risks, with potential crowding out of private-sector-led growth as per the World Bank. Finally, Saudi Arabia nationals are being incentivized to fill the gap left by expatriate exodus, but a key challenge will be to make private sector opportunities appealing enough for nationals, coupled with better management of foreign labor admission and mobility.

DISCLAIMER

Bank Audi sal - Group Research Department - Bank Audi Plaza - Bab Idriss - PO Box 11-2560 - Lebanon - Tel: 961 1 994 000 - email: research@bankaudi.com.lb