

Bahrain Economic Quarterly

March 2015



SUMMARY

NON-OIL GROWTH TAKES THE LEAD

The opening months of the year 2015 have been characterized by considerable volatility in asset prices and currencies. While the oil price correction is necessitating steps toward fiscal restructuring in the Gulf, the regional economies continue to be characterized by strong non-oil growth drivers which serve as an important source of continuity.

- ▶ **Bahrain's GDP expanded by a real 4.5% in 2014.** Even though this marks a slight deceleration from the 5.3% rate recorded in 2013, it is underpinned by a clearly stronger momentum in the non-oil economy, something that suggests strong underpinnings for economic activity in the years ahead.
- ▶ **Growth in the non-oil economy accelerated sharply while oil production surprised on the upside.** The rate of expansion in the non-oil sectors rose markedly from the 3.0% rate recorded in 2013 to 4.9% in 2014. At the same time, the hydrocarbons sector posted stronger growth than originally expected, expanding by 3.0% (15.3% in 2013 due to normalization from technical maintenance in 2012).
- ▶ **Economic confidence in the GCC remains robust.** In spite of increased market volatility and steps toward fiscal consolidation, the non-oil growth drivers in the region appear firmly anchored in long-term project spending and relative fiscal policy continuity. Business confidence indicators have remained favorable with the regional businesses typically maintaining an expansionary stance.
- ▶ **Renewed global volatility has created new challenges.** The beginning of the year has been marked by a resumption of volatility which has tested the sentiment in asset and commodity markets. The anxiety has been mainly driven by the prospect of US monetary tightening and concern over emerging market growth prospects. However, significant changes in the global policy stance seem unlikely.

Bahrain economic outlook

	2013	2014f	2015f	2016f
Real GDP growth, %	5.3%	4.5%	3.6%	3.3%
Non-hydrocarbons sector	3.0%	4.9%	4.5%	3.9%
Hydrocarbons sector	15.3%	3.0%	0.0%	0.5%
Nominal GDP growth, %	8.3%	3.0%	0.1%	8.4%
Inflation (CPI %)	3.3%	2.8%	3.5%	3.0%
Current account (% of GDP)	7.8%	7.7%f	2.6%	4.4%
Fiscal balance (% of GDP)	-3.3%	-4.5%f	-5.3%	-2.5%
Crude Oil Arabian Medium (USD)	106.4	96.0	70.0	80.0

Source: Bahrain Economic Development Board

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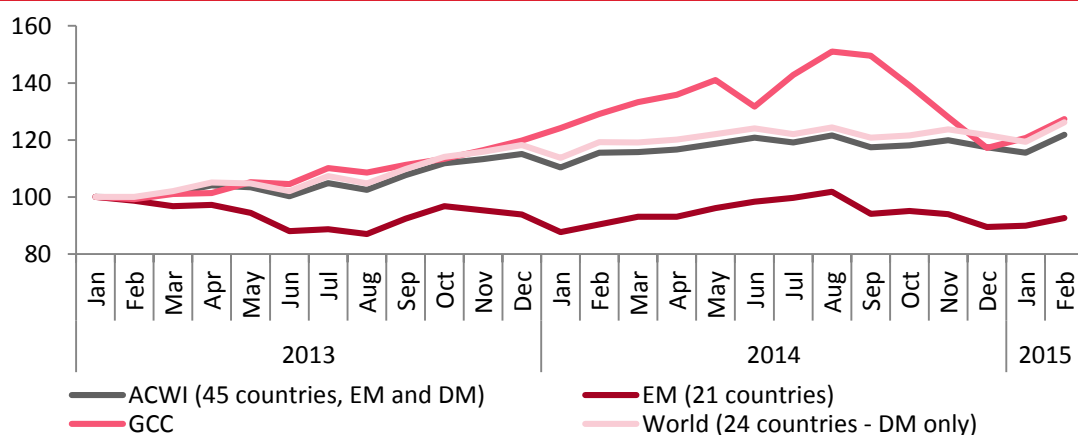
GLOBAL ECONOMY

LOOKING FOR DIRECTION

A period of elevated market volatility is showing signs of passing, although major risks persist

The opening months of the year have been characterized by exceptional volatility and uncertainty for the global economy. Continuing a recurrent pattern of cyclicalities that has emerged during the crisis, market pessimists have once again tended to outnumber optimists as the US has been virtually alone among major economies to deliver a predominantly positive narrative. Nonetheless, tentative signs are emerging of renewed stabilization in the financial markets. A number of major economies have benefited from monetary stimulus measures while concerns about an abrupt hike in US interest rates are giving way to a much less alarming scenario. This has engendered a temporary spell of optimism among traders. Structural risks still abound with concerns about asset bubbles, especially in the bond market, as well as anxiety about the ability of Greece to honor its financial obligations. Nonetheless, there seem to be signs of even the hardest-hit economies – including the Euro-zone – regaining their footing. As a result, for instance the Organization for Economic Development and Cooperation (OECD) recently upgraded its global growth forecast to 4% this year and 4.3% in 2016.

MSCI regional indices (Base Jan 2013=100)



Source: MSCI

Out of sync

The monetary policy stances of the US and other major economies have been trending in opposite directions

As much as the possible withdrawal of the US Federal Reserve's ultra-loose monetary policy stance has been a source of market anxiety, it also reflects the highly uneven nature of global growth patterns. While opinions continue to differ about the timing and pace of rate increases in the US, it is clear that the policy stances of the major central banks globally have been moving in opposite directions.

The US has in recent months firmly established itself at the forefront of the global recovery. The economic data have remained generally favorable with the rate of open unemployment declining to the fairly low level of 5.5% as of February, down markedly on 6.7% a year earlier. Real GDP in 2014 rose by 2.4%. More problematically, while the strengthening data has allowed the Fed to wind down its quantitative easing program, it has also come at the cost of a sharp appreciation in

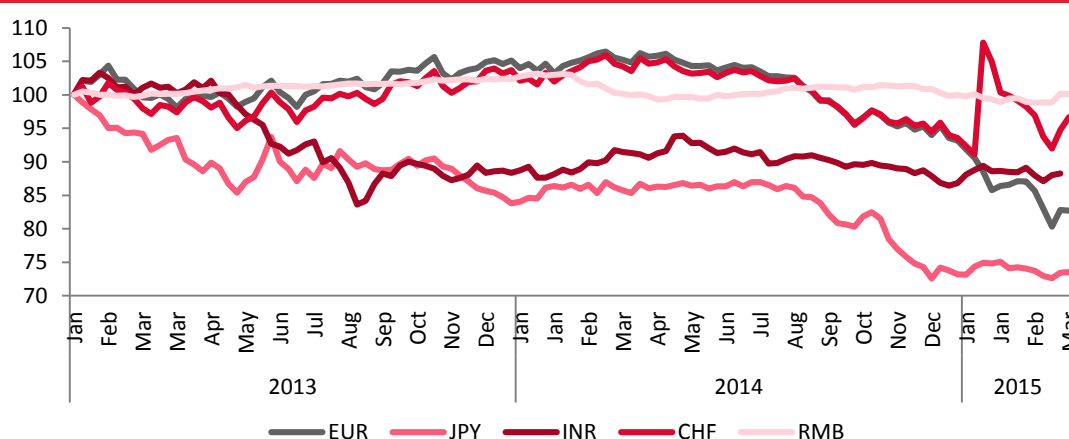
A significantly stronger Dollar has tightened monetary conditions in the US and prompted the Federal Reserve to tone down its rhetoric on tightening

the US Dollar exchange vis-à-vis virtually all other major currencies. This has also reflected the fact that the monetary stances of most other central banks are moving in the opposite direction. More than 25 central banks have cut rates this year with Sweden's Riksbank introducing negative rates.

The stronger Dollar, which itself represents a significant tightening of monetary conditions, appears to be driving a rethink at the Fed. The Open Market Committee in March signaled that, while it stood ready to raise interest rates, it would not be in a rush to tighten policy. Any monetary tightening was clearly linked to inflation dynamics and labor market conditions. However, inflationary pressures have been fairly subdued of late, with headline consumer price inflation trending down thanks to declining commodity prices. The Fed also lowered its natural rate of unemployment estimate from a range of 5.2-5.5% to 5.0-5.2%, suggesting that there is still unused spare capacity in the economy.

The recent Dollar strength has coincided with deliberate monetary loosening in many other countries. The European Central Bank (ECB) on 9 March launched a program of EUR60bn worth of monthly government bond and other asset purchases. The discord around Greece's austerity program, against the backdrop of rapidly deteriorating financial conditions in the country, has further contributed to a weaker Euro. The Euro has been trending toward parity against the Dollar with a cumulative decline of some 12% since the beginning of the year. For the Euro-zone, this marks a long-awaited opportunity to achieve export growth through increased competitiveness. It is also helpful in terms of staving off the prospect of deflation. The launch of quantitative easing, along with lower bond yields, is driving a carry trade toward higher-yield assets. It has driven Euro-zone stocks to their highest levels since 2000. The OECD in March projected a pick-up in European growth because of the stimulus effect of lower oil prices and looser monetary policy. The OECD projects Euro-zone growth of 1.6% this year and 2.0% in 2016.

Major currencies vis-à-vis the US Dollar, 2013=100 (foreign currency per USD)



Source: Reuters Eikon

The ultra-loose monetary stance being pursued by virtually all major central banks around the globe is fuelling concern about asset market bubbles and the risk of potential disruptions once the permissive policies finally begin to be withdrawn. While any policy reversals are currently seen as highly gradual at best, the possibility of a more abrupt change in policy stance constitutes a major uncertainty for the global financial markets.

Asian uncertainties

The performance of the major emerging markets remains uneven and overshadowed by significant uncertainties in a major departure from the role in driving global growth earlier during the crisis

The performance of the emerging markets continues to be a source of market anxiety with limited evidence of a clear pick-up in growth in recent months. The changing realities facing these countries are particularly pronounced in the case of China, where the authorities have again reduced their growth target for the economy – from 7.5% to around 7% – while resorting to additional monetary stimulus measures. The Chinese economy grew by 7.4% YoY last year, which marked the slowest pace since 1990. The International Monetary Fund (IMF) recently lowered its 2015 Chinese forecast from 7.1% to 6.8%, whereas the latest assessment by the Asian Development Bank (ADB), by contrast, sees the economy expanding by more than 7% a year over the coming two years. Among other things, China's near-term growth prospects should benefit from lower commodity prices and more permissive monetary policy, as well as the government's renewed reform agenda. But the economy faces risks created by a rapid build-up in domestic credit to USD34trn as well as the heavy dependence of Chinese growth on construction and leverage. While looser monetary conditions may help revive activity to an extent, they also risk delaying the rebalancing of the growth that the authorities have identified as a priority.

Most optimism regarding the near-term growth prospects of Asia has been linked to India where the government in late February unveiled a budget that committed the country to a number of overdue structural reforms. This now creates a realistic prospect of India's growth outpacing China's in the near term. Following a relative slowdown in recent years, the ADB expects India's real GDP to expand by 7.8% in this fiscal year, followed by 8.2% in FY2016/17. Among other things, India has been among the principal beneficiaries of the recent oil price correction. The economy has also benefited from cautious steps by the Reserve Bank toward a looser monetary policy with two rate cuts amounting to 50 basis points this year, which have taken the main policy rate to 7.5%. At least one more cut is seen as likely this year. Infrastructure limitations remain among the main constraints on India's growth potential. Among its priorities, the 2015/16 budget has decelerated fiscal consolidation in order to channel more resources into physical capital investments.

In Japan, the fresh mandate of Prime Minister Shinzo Abe has lent renewed impetus to economic reforms. The loose monetary policy of the Bank of Japan and changing regulations for institutional investors are continuing to put downward pressure on the Yen, which in trade-weighted terms has fallen to its lowest level since the early 1970s. This has boosted the export-oriented manufacturing sector, as well as the stock market. Partly as a result, growth appears to be picking up with a 2.2% YoY expansion in Q4 following a technical recession during the two preceding quarters. Inflation still seems a remote concern in Japan with the most recent reading of core inflation at 0.9%.

Oil prices looking for a floor

Following a rapid decline in the closing months of 2014, oil prices are showing signs of stabilizing

An exceptionally rapid decline in the oil price during the closing months of 2014 has given way to a much more mixed picture characterized by continued volatility around a gradual upward trend. Production growth has generally continued to outpace consumption, although tentative signs suggest that the gap may be beginning to close. According to the International Energy Agency (IEA), global production increased by 1.3 mbd YoY to 94 mbd in February. Non-OPEC production rose

270,000 b/d to 57.3 mbd, while OPEC production declined by 90,000 b/d to 30.22 mbd. At the same time, consumption growth accelerated from an annual 900,000 b/d in Q4 to 1 mbd in Q1. The IEA has increased its demand growth forecast for the year as a whole to 1 mbd, which would take the annual total to 93.5 mbd. This would translate into a 30.3 mbd 'call on OPEC' by the second half of the year, which is just in excess of the organization's 30 mbd target. OPEC sees global demand growing by 1.17 mbd to 92.37 m this year. This compared to a gain of 960,000 b/d in 2014.

The new market environment for oil prices reflects a number of factors, chief among them significant cutbacks in investment by producers virtually across the spectrum. The average capital expenditure cuts of energy companies around the world stand at some 27% since the price reversal. This is beginning to curb production growth in many countries, although it has typically not yet led to an actual reduction in output. Especially many unconventional producers in North America have achieved significant productivity gains, while also benefiting from lower input and operating costs. The US rig count is continuing to slide with active rigs falling by 41% since December to 866 (as of mid-March), the lowest figure since April 2011. Nonetheless, US oil output in March exceeded 9.4 mbd in the highest level since the 1970s. Shale production growth is expected to slow to its lowest pace in four years in April at just 1,000 b/d. Canadian active rigs in early March were down 61% YoY, but January's Syncrude output was at a three-month high.

There is a risk of the supply side contracting faster and further than what is needed to meet global demand growth. While the US shale story contributed more than 1 mbd a year to the global output for three years in a row, total demand growth averaged 1.7 mbd a year from 2010 to 2013. Due to declining fields, the world is projected to need additional 15% gross production growth from 2015-2018 to be adequately supplied, even with fairly cautious assumptions about demand growth. Some private sector estimates suggest that the current rate of depletion of oil fields – at the rate of 5% per annum – necessitates new supplies of 5 mbd by 2030. OPEC Secretary General Abdalla el Badri expects oil investments of USD10trn are needed by 2040 to meet a projected 60% increase in demand.

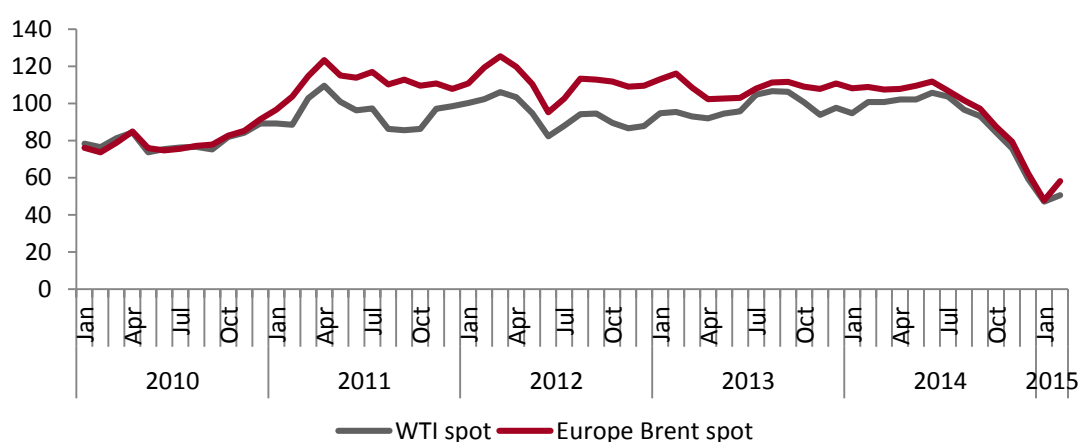
In the near term, oil prices appear subject to a range of contradictory influences:

- ▶ The aggressive monetary loosening in different parts of the world is likely to stimulate demand, which may further benefit from strategic reserve purchases by key producer nations. Recent indications by the US Federal Reserve, that steps toward rate increases are likely to be more gradual than expected, should support commodity prices and contain Dollar appreciation
- ▶ Production disruptions in Iraq and Libya have driven market volatility and signs of stabilization would contain upward pressures on prices. Similarly, the prospect of a nuclear deal with Iran would boost optimism about the country's ability to boost production and increase exports, although the actual impact on global markets after years of underinvestment in the sector is likely to be gradual at best. More recently, the GCC military operations in Yemen have pushed up the risk premium on prices
- ▶ A contentious political debate in the US about lifting the long-standing ban on crude exports may result in some relaxation of export restrictions. This would reduce the divergence

between WTI and Brent, which has recently hovered at close to USD10. This has taken many North American shale fields close to or below their break-even price and a modification in the regulations might stimulate investment and production. US crude exports rose 11.2% MoM to 491,000 b/d in January, most of them to Canada

Any near-term change in policy by OPEC, which has focused on defending its market share, is generally seen as unlikely, although some members have called for modifications. Indeed, some estimates suggest that OPEC will try to cap price increases before prices hit USD60, as that might stall rig declines in the US.

Crude oil prices (USD/barrel)



Source: US Energy Information Administration

Global oil demand and supply dynamics (mbd)

	IEA	OPEC	EIA
2013 Global oil demand (mbd)	91.8	90.2	90.5
Advanced economies	46.1	46.0	46.1
Emerging economies		29.0	
China	10.1	10.1	10.6
2014 Global oil demand (mbd)	92.4	91.1	91.4
Advanced economies	45.6	45.7	45.8
Emerging economies		29.8	
China	10.3	10.4	11.0
2015 Global oil demand (mbd)	93.3	92.3	92.3
Advanced economies	45.6	45.6	45.8
Emerging economies		30.6	
China	10.6	10.7	11.3
2013 Global oil supply (mbd)	91.4	90.2	90.2
OPEC	30.5	30.3	30.0
Non-OPEC	60.9	54.2	54.1
2014 Global oil supply (mbd)		91.1	92.0
OPEC	30.2	29.4	29.8
Non-OPEC		56.0	56.0
2015 Global oil supply (mbd)		92.3	92.8
OPEC		28.9	29.7
Non-OPEC		57.3	56.8

Source: International Energy Agency, Organization of the Petroleum Exporting Countries, US Energy Information Administration

Implications for Bahrain

The global economic backdrop, while still challenging, is showing some signs of moving in a more benign direction.

- ▶ Recent expectations of US tightening may have been overplayed, while other economies are continuing to relax monetary conditions. This should contain increases in the cost of capital
- ▶ Anxiety about the prospects for the Asian economic markets seems to have abated somewhat, which should be good for trade as well as for incremental oil demand
- ▶ While oil prices remain subject to a range of contradictory forces, there are signs of stabilization with investments slowing and demand growth accelerating

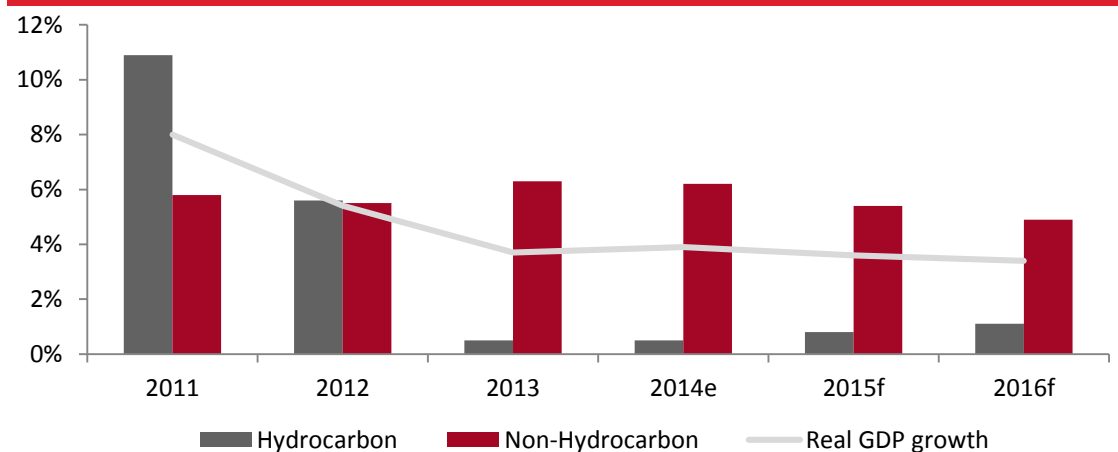
THE GCC REGION

CONFIDENCE AND CONTINUITY

The non-hydrocarbon sector has established itself as the main driver of growth across the GCC

In spite of recurrent financial market volatility in response to the oil price dynamics, the growth momentum of the regional non-oil economy has held up well. This reflects the strength of the structural growth drivers, along with the scale and importance of long-term capital investment projects. Even as steps toward fiscal re-engineering either already have been taken or are being considered across the region, economic activity continues to be characterized by remarkable continuity underpinned by historically high business confidence levels. Headline growth in the GCC region is expected to remain robust in the near- to medium- term. The Institute of International Finance (IIF) projects regional aggregate real GDP growth of 3.6% in 2015, followed by 3.4% in 2016. Non-hydrocarbon growth is expected to moderate somewhat from an estimated 6.2% in 2014 to 5.4% in 2015 and 4.9% in 2016. Hydrocarbons sector dynamics are expected to remain subdued over the coming two years following a 0.5% expansion in 2014.

Composition GCC real growth (%)



Source: International Institute of Finance, March 2015

Strong structural drivers underpin non-oil growth

The key growth drivers across the GCC appear resilient in the face of oil price volatility

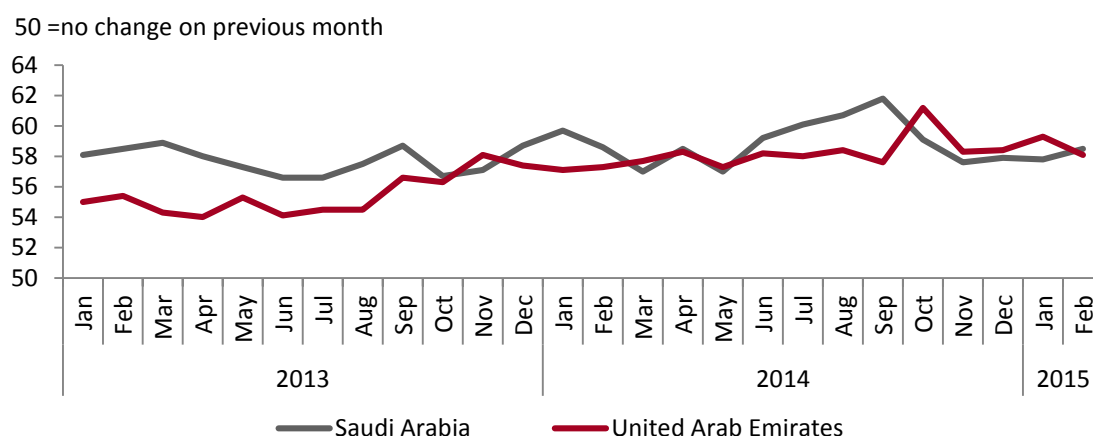
In general, recent growth dynamics across the GCC region point to a continued strong momentum in the non-oil economy. While the increase in global commodity and financial market volatility has tested sentiment, the growth momentum of the regional economies has become firmly linked to long-term structural growth drivers. These are unlikely to be vulnerable to short-term market gyrations. All the regional economies are undertaking large-scale investments in the context of structured development programs and in response to their demographic expansion.

Key indicators of business activity across the region have remained strongly positive in recent months. For instance, Saudi Arabia in January recorded all-time highs in steel and cement production. In the UAE, the Dubai International Airport has established itself as the busiest hub in the world with passenger traffic expected to exceed 78.4mn this year. Passenger growth in January reached 7.7% YoY. By contrast, the price dynamics of the UAE real estate market have stabilized with some market segments seeing falls. This is likely to be linked to higher fees and tighter

mortgage regulations which have allayed overheating concerns. Similarly, growth in the hospitality sector has been curbed somewhat by the strong Dollar. Kuwait has announced plans to spend some KWD45.5bn under its 2015-20 development plan. Some regional economies are continuing to see significant population increases linked to an infrastructure build-up. For instance, Qatar's population rose by 10.1% in 2014.

The most widely used indicators of business sentiment in the region point to a high degree of continuity. The SABB/Markit Purchasing Managers' Index (PMI) for Saudi Arabia rose to 58.5 in February from 57.8 in January, a figure that represented the highest reading since October 2014. By contrast, the corresponding HSBC/Markit index for the UAE fell to a five-month low, but the reading of 58.1 is both in line with recent trends and indicative of continued strong expansion in the non-oil private economy.

HSBC/Markit Purchasing Manager's Index



Source: HSBC, SABB

Steps toward fiscal re-engineering

Most regional governments have unveiled measures to rationalize spending and develop new revenue sources

The overall asset position of the GCC economies remains favourable with the IIF estimating their combined gross public external assets at some USD2.2trn – or roughly 120% of the region's GDP. The gross government debt, excluding government-related entities, stands at 13% of GDP, a very low level by global standards. While this position offers a comfortable cushion and serves as a source of continuity in many areas, it is evident that the renewed oil price volatility has prompted policy makers across the region to embark on a review of their fiscal models.

GCC governments have almost invariably unveiled deficit budgets for this year and much more attention is being paid to efforts to rationalize government expenditure and boost revenues. Steps are underway in several areas:

- **Expenditure cuts.** Oman's budget announced in early January proposed a 5% real spending cut with some suggestions that more might follow as the budget is estimated to have relied on a fairly high oil price assumption of approximately USD80 per barrel. The budget foresees an OMR2.5bn deficit. Kuwait, which has the highest dependency on oil revenues in the region, announced a 17.8% spending cut in its 2015/2016 budget

- ▶ **Subsidy rationalization.** Oman's 2015 budget includes cuts in energy subsidies. The budget expects to spend roughly 4% of GDP on oil product subsidies, which is less than half the 2013 figure. Kuwait this year stopped subsidies on diesel, kerosene, and aviation fuel. Similar measures are being considered for petrol, electricity, and water
- ▶ **New revenues sources.** Oman has announced plans to study new taxes and customs duties, while Kuwait is developing a plan for a national corporate tax with the International Monetary Fund. The country currently levies a 15% profit tax on foreign companies only. Dubai has sought to align its recurrent expenditures with recurrent revenues. The emirate now raises 74% of its income from government services and 21% from financial sector taxes and customs duties
- ▶ **Public-private partnerships.** Kuwait plans to finance half of the capital expenditure under its new development plan through public-private partnerships
- ▶ **Divestment.** Oman has announced plans to sell-off stakes in state-owned enterprises, including the petrochemicals firm Orpic and subsidiaries of the Oman Oil Company

As one source of fiscal discipline, many countries have significantly lowered their oil price assumptions for budgeting purposes. For instance, Kuwait reduced the figure from USD75 to USD45 per barrel. Qatar is reportedly using a price of USD65.

Regional producers maintain discipline but eye future gains

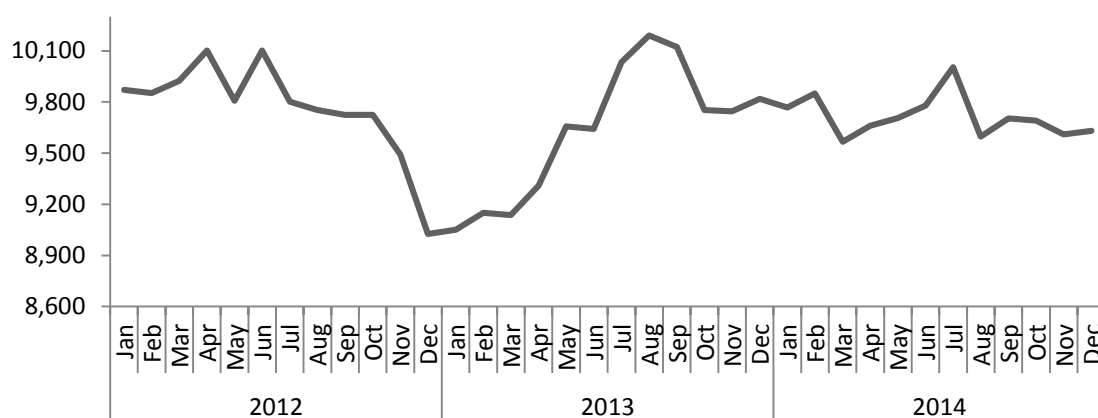
In spite of generally flat output levels, the regional countries are seeking ways to boost production in the coming years

Oil production in the GCC has remained fairly static in recent months, largely in reflection of the commitment by the largest producers to OPEC's current quota. Especially Saudi Arabia has seen some variation in its exports in response to market conditions. Whereas overall Saudi production averaged 9.71 mbd in 2014, the figure for the last quarter was 9.64 mbd. Saudi oil exports averaged 7.11 mbd last year, down from an 11-year high of 7.54 mbd in 2013. Last year's figure, as reported by the Joint Organisations Data Initiative, was the lowest since 7.05 mbd in 2011.

Even as the near-term outlook is one of minimal production gains, the regional economies are looking to develop their upstream assets further:

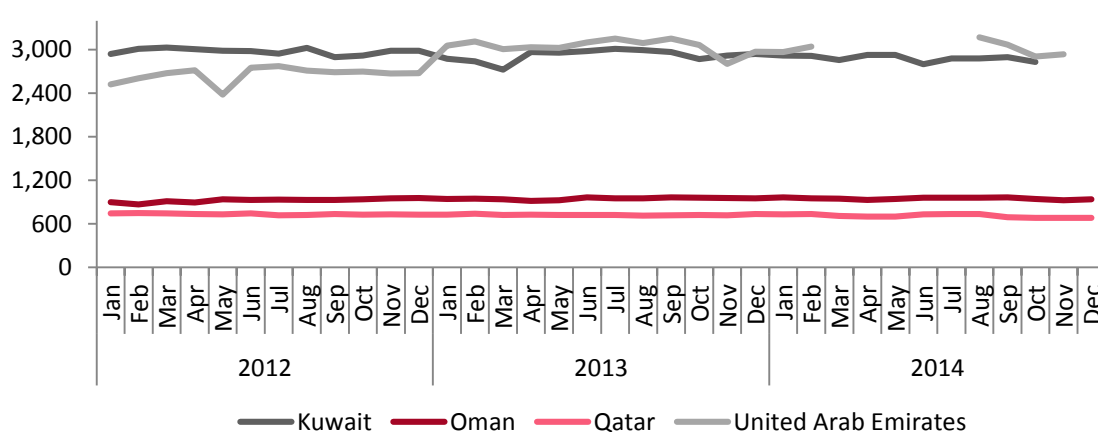
- ▶ In a departure from its earlier plans to maintain production at 950,000-960,000 b/d until 2018, Oman is hoping to boost its output to a minimum of 965,000 b/d this year. The 2014 output was 943,000 b/d, the highest level in 13 years
- ▶ Kuwait is planning to boost its capacity to 4 mbd by the end of the decade. It is hoping to collaborate with international oil companies to develop its heavy oil fields, as well as to enhance recovery from more mature fields. Kuwait's current production of 2.85 mbd compares to estimated capacity of 3.2 mbd

Monthly oil production by Saudi Arabia ('000 b/d)



Source: Joint Organisations Data Initiative

Monthly oil production by other GCC producers ('000 b/d)



Source: Joint Organisations Data Initiative

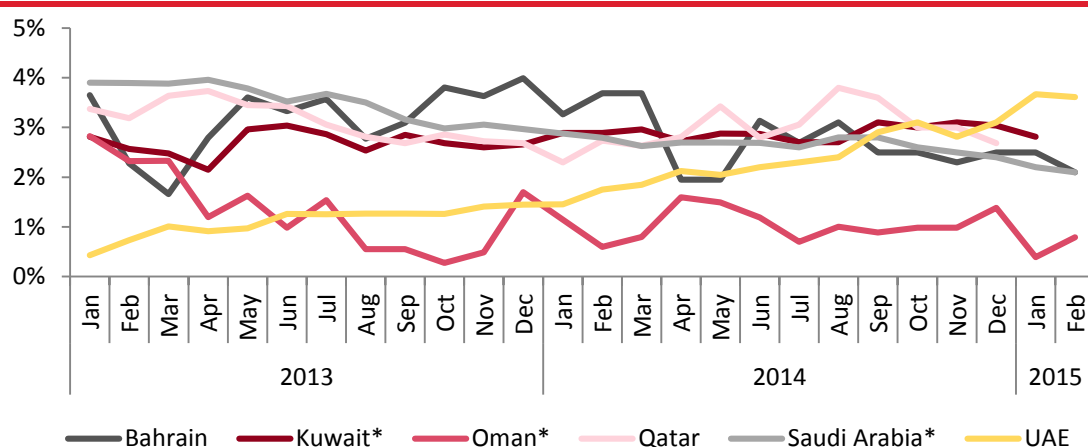
Regional price outlook showing signs of renewed divergence

Easing food price pressures and a stronger US Dollar have kept consumer price inflation stable

Consumer price inflation across the GCC region has generally continued its recent pattern of stability. However, money supply growth has tended to lose momentum fairly markedly with the exception of Oman and the UAE. Nonetheless, YoY growth remains comfortable at more than 5% outside of Kuwait and typically in the low double digits.

The recent CPI data in the GCC has been broadly in line with the patterns observed in 2014, supported by the relative absence of imported inflation, partly thanks to the stronger Dollar. Most regional economies have experienced a slight downtrend in inflation in recent months. Oman has seen the most pronounced drop in headline inflation which, having averaged just over 1% in 2014, dropped to 0.39% in January and 0.79% in February. By contrast, UAE inflation has accelerated somewhat from a 2014 average of 2.3% to more than 3.6% in January-February. In general, cross-country differences have tended to echo real estate market dynamics.

Consumer price inflation in GCC countries (% YoY)



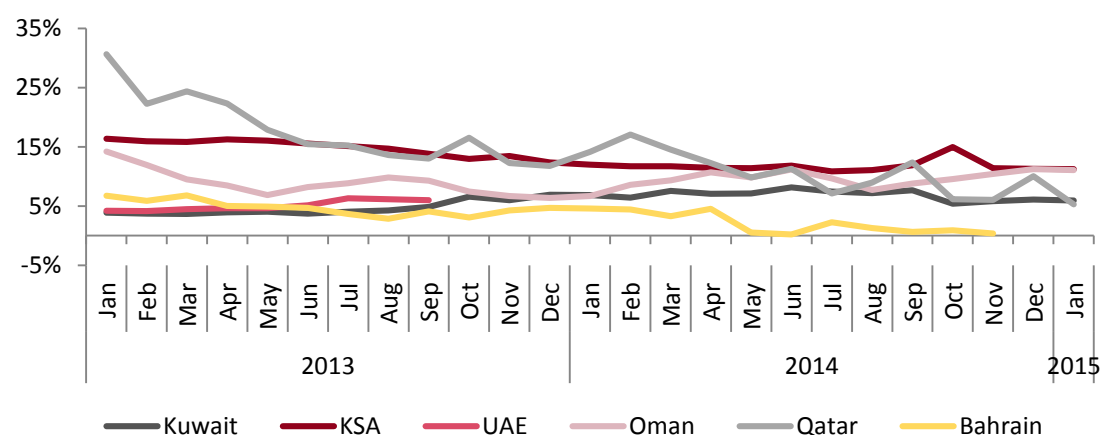
Source: National statistical offices

Regional bank lending growth moderates somewhat

Bank lending has been growing somewhat more slowly in the region although rates of expansion are still comfortable by historical standards

In general, credit growth in the region has remained robust with Qatar, Saudi Arabia, and Oman seeing a double digit expansion in bank loans during 2014 – by 13.0%, 11.6%, and 11.3%, respectively. Credit growth in the UAE was 8.9% and in Kuwait 6.2%. Deposit growth was fastest in Saudi Arabia at 12.4%. It outpaced lending growth also in the UAE, where deposits rose by 11.1%. Kuwait saw the slowest deposit build-up at 3.6%. Qatar is now the only regional economy with a triple-digit loan-to-deposit ratio (105%). The ratios for Saudi Arabia and Kuwait stood at 80% as of the end of the year.

YoY growth of domestic bank credit (%)



Source: National central banks

GCC equity markets echo oil prices

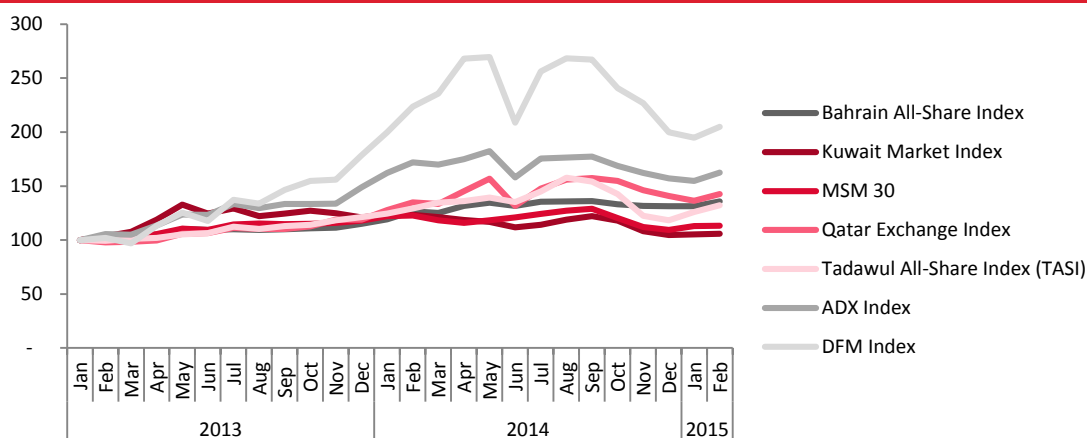
Most regional equity markets have displayed volatility around a fairly flat trend since the beginning of the year. Many markets have tended to take their cues from the oil price dynamics even as the performance of the regional corporate sector remains generally robust. More recently, events in Yemen have tested the mood.

Regional bourses have exhibited considerable volatility in the opening months of the year in reflection of oil price volatility

The best-performing regional exchange during the year-to-date has been Saudi Arabia's Tadawul, which posted a 5.3% gain. All other markets, bar Bahrain, have recorded losses during the year to date. Dubai led the way with a 6.9%, while Qatar shed 4.7%. Kuwait fell by 3.9%, Abu Dhabi by 1.3%, and the Muscat Securities Market by 1.7%.

In contrast to a healthy Q4 last year and unusually by historical standards, the region saw no IPO activity in Q1. This suggests that issuers are waiting for the market volatility to abate with a number of offerings waiting in the pipeline.

GCC equity market indices (Jan 2013=100)



Source: Bahrain Bourse, Kuwait Stock Exchange, Muscat Securities Market, Qatar Exchange, Tadawul, Abu Dhabi Securities Exchange, Dubai Financial Market

Fixed income markets reflect caution

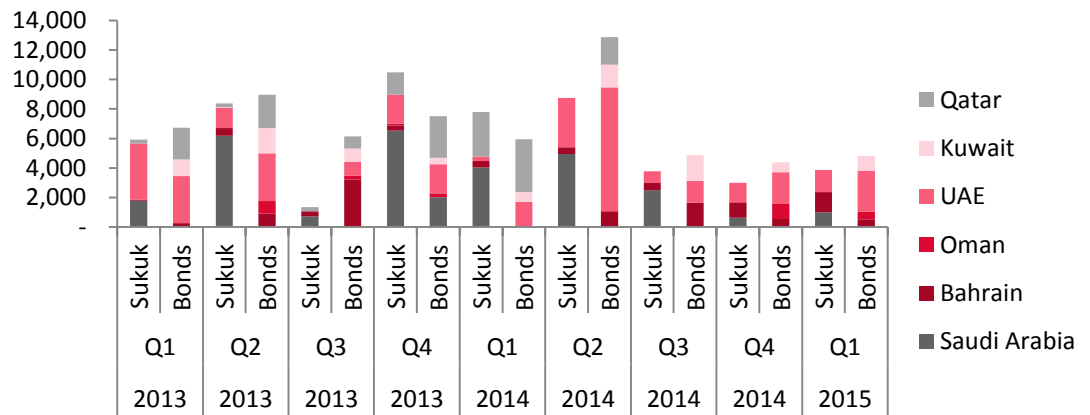
Q4 was characterized by a clear slowdown in issuance activity in both conventional and Shariah-compliant fixed income markets

The regional bond and sukuk markets saw a pronounced slowdown in issuance in the second half of last year in response to seasonal factors and the oil price volatility. This pattern has carried over to this year as well, suggesting that a clear paradigm shift in the market conditions is yet to take place in spite of a substantial pipeline.

In the conventional bond space, the region saw a total of 16 primary issues worth USD4.8bn during the first three months of the year. This compared to eight issues with an aggregate value of USD5.6bn a year earlier. The UAE was the most active market with a total of USD2.8bn issued through eight offerings made by two banks. Kuwait saw six issues, all of them sovereign, worth just over USD1bn. Bahrain placed one Treasury issue worth USD530.5mn and Oman a Government Development Bond worth USD519mn.

Primary sukuk issuance contracted even more sharply than conventional issuance in YoY terms. The first quarter witnessed a total of 11 GCC sukuk offerings worth just under USD3.9bn. This compared to 12 sukuk raising a total of USD7.8bn a year earlier. The UAE was marginally the most active market with two bank sukuk worth a total of USD1.5bn. Eight Bahraini sovereign offerings raised a total of USD1.4bn. The Islamic Development Bank placed a USD1bn five-year sukuk.

GCC bond and sukuk issuance (USD mn)



Source: Zawya

Implications for Bahrain

Economic confidence in the GCC has held up well and key indicators of activity point to a high degree of continuity. This should offer a benign backdrop for Bahrain as the most regionally integrated GCC economy.

- ▶ Most GCC businesses remain in an expansionary mode, which will create new opportunities for tapping into regional value chains. This will also support the offshore banking sector.
- ▶ Strong non-oil growth augurs well for regional tourism flows, with Bahrain particularly well-positioned to benefit from the continued increase in Saudi visitors.
- ▶ There are indications that regional investors are turning to the Bahraini real estate markets for value investments.

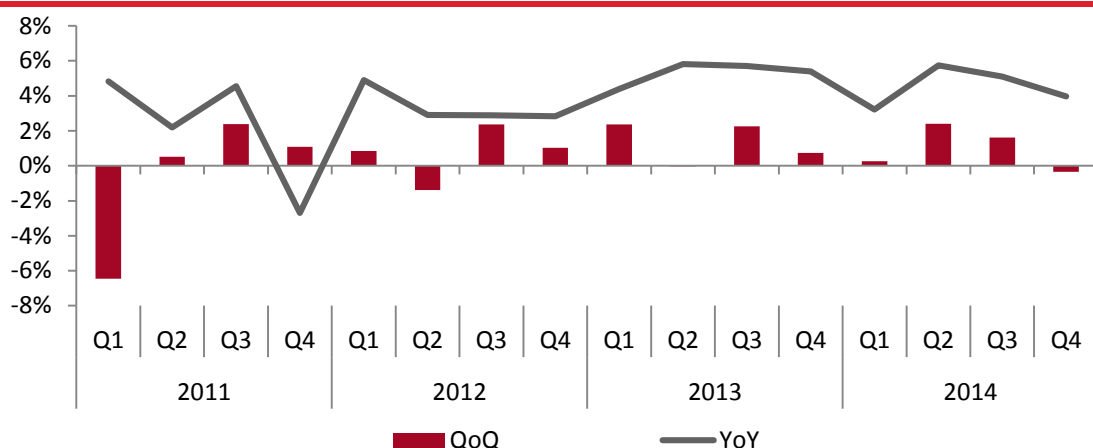
BAHRAIN

NON-OIL DRIVERS ARE STRENGTHENING

Bahrain saw a clear and sustained acceleration in non-oil growth in 2014 and the positive trend is expected to continue

Reflecting broader regional trends, the last quarter of 2014 saw a slight deceleration in overall economic activity in Bahrain. However, headline growth in Q4 nonetheless reached 4.0%, leaving the total real GDP expansion for the year as a whole at 4.5%. Moreover, the loss of momentum in Q4 was entirely attributable to a seasonal drop in oil output with the oil sector contracting by 5.9% YoY after three very strong initial quarters. By contrast, the pace of YoY growth in the non-oil economy accelerated following a steady build-up throughout the year. The non-oil economy grew by an annual 6.7% during Q4 and by 4.9% during the year as a whole. It hence clearly outpaced the 3% expansion seen in the hydrocarbons sector.

Real GDP quarterly growth



Source: Central Informatics Organisation

Non-oil drivers set the tone

The construction sector saw a dramatic pick-up in growth in Q3 and Q4 thanks to the initiation of several infrastructure projects

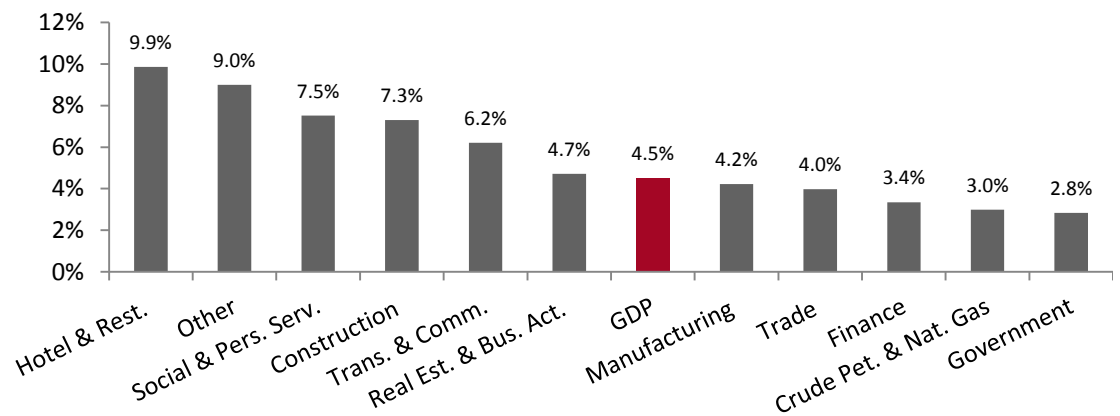
The expansion of the Bahraini economy in 2014 was firmly led by the non-oil economy. Whereas the oil sector generally performed above expectations during the first three quarters of the year, the closing months of 2014 saw a reversal, which nonetheless left the sector with a higher than expected 3% real growth rate for the year as a whole. By contrast, the non-oil sector experienced a sustained pick-up in activity from a 3.0% YoY growth rate in Q1 to 6.7% in Q4. This marked the fastest pace of expansion in over two years.

The acceleration in non-oil growth toward the end of 2014 was broad-based. However, by far the strongest pick-up in activity was observed in the construction sector which, having grown by 1.4% in Q1, accelerated to 3.6%, 12.3% and eventually 12.5% YoY in the three successive quarters. This reflects the initiation of a number of major infrastructure projects in areas such as road transportation.

The hotels and restaurants sector continued its strong performance with an 11.9% YoY increase in Q4. The sector has been a strong performer throughout the year with an overall expansion rate of 9.9% YoY during 2014 as a whole. The sector has benefited both from a significant capacity build-

up, with several new establishments opening in 2014, but also a continued positive momentum in visitor numbers. Continuing an established pattern, social and personal services again featured among the top sectors of the non-oil economy. This is attributable to ongoing robust expansion in private healthcare and education, an area where Bahrain can, among other things, capitalize on its advantageous location in the broader region. The sector expanded by 7.5% in 2014, having consistently been one of the most dynamic sectors over the past decade.

Real GDP growth by sector, 2014

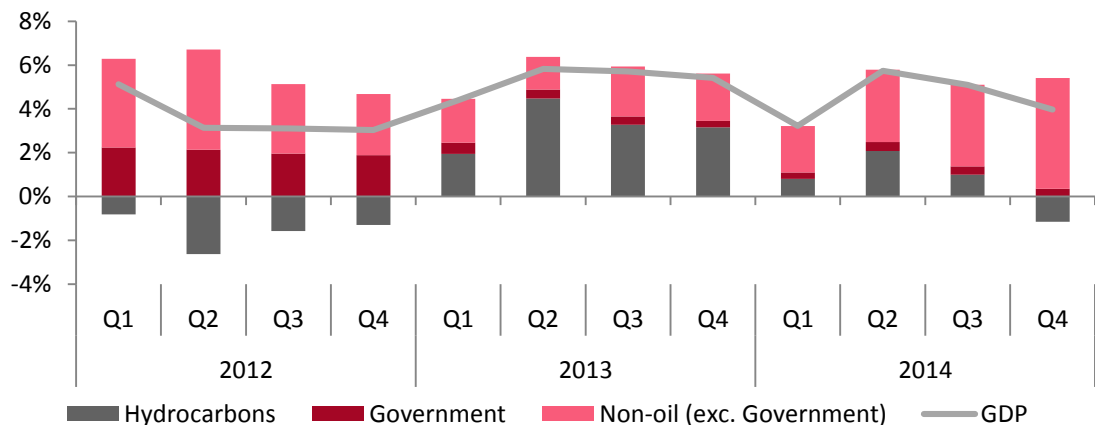


Source: Central Informatics Organisation

Growth has become significantly less reliant on government services in recent years

Encouragingly, the growth momentum of the economy has become increasingly reliant on private sector activity. In a marked contrast to as recently as 2012, the government services sector now accounts for a modest proportion of overall growth in the Kingdom. Government services expanded by 2.8% in Q4 as well as during the year as a whole. This compared to 12.1% growth in 2012 and was largely comparable to the 2.1% rate of expansion seen in 2013.

Breakdown of quarterly growth (in real terms, YoY)



Source: Central Informatics Organisation

YoY real growth of key sectors, 2012-2014

YoY growth	2012	2013	2014				
	Annual	Annual	Annual	Q1	Q2	Q3	Q4
Crude pet. & Gas	-8.5%	15.3%	3.0%	4.1%	9.3%	4.7%	-5.9%
Manufacturing	4.7%	3.2%	4.2%	0.8%	4.4%	4.1%	7.6%
Construction	4.1%	2.7%	7.3%	1.4%	3.6%	12.3%	12.5%
Retail	6.2%	2.0%	4.0%	3.9%	3.1%	4.4%	4.4%
Hotel & rest.	11.2%	9.5%	9.9%	9.9%	10.3%	7.4%	11.9%
Trans. & Comm.	4.5%	2.5%	6.2%	4.9%	6.4%	4.0%	9.4%
Social & pers. Serv.	12.7%	6.5%	7.5%	6.6%	8.2%	6.6%	8.7%
Real est. and Bus. Act.	3.6%	2.4%	4.7%	4.4%	4.5%	4.6%	5.3%
Finance	4.0%	2.3%	3.4%	1.9%	3.9%	3.5%	4.1%
Government	12.1%	2.1%	2.8%	2.3%	3.3%	3.0%	2.8%
Other	11.2%	2.8%	9.0%	5.9%	6.3%	12.2%	11.6%
GDP	3.4%	5.3%	4.5%	3.1%	5.6%	5.1%	4.0%

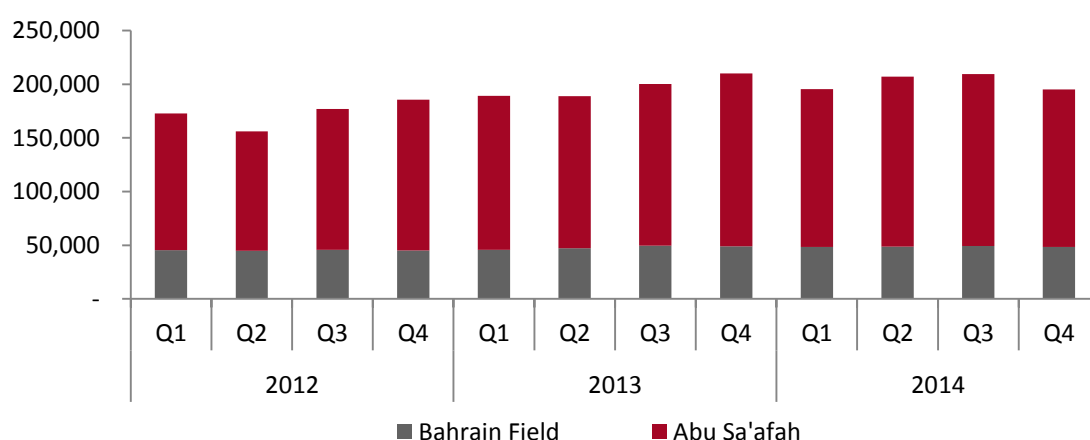
Source: Central Informatics Organisation

The oil sector reverting to the norm

Oil production exceeded expectations in 2014 but is likely to remain at capacity this year

The hydrocarbons sector post unexpectedly robust growth until the closing quarter of 2014, driven by sustained levels of output from both the onshore Bahrain and the offshore Abu Sa'afah fields. Following three consecutive quarters of annual growth rates of 4.1%, 9.3%, and 4.7%, respectively, the last quarter recorded a 5.9% YoY in production in a reversal toward the norm. During 2014 as a whole, the average production from the Bahraini share of the Abu Sa'afah offshore field amounted to 153,637 b/d – in other words, at 102.4% of the field's full capacity. The onshore Bahrain field averaged a production rate of 48,780 b/d. We currently expect oil production during 2015 to be more or less comparable to last year's total.

Monthly oil output (barrels per day)



Source: National Oil and Gas Authority

Near-term outlook linked to non-oil drivers

The near-term outlook for the Bahraini economy is likely to be very strongly linked to the non-hydrocarbon economy. The current bout of oil price volatility, along with the expected tightening by the US Federal Reserve later this year, are risk factors with the potential to test confidence. However, the main near-term growth drivers are very resilient in our view, and the low loan-to-deposit ratios of retail banks suggest that the cost of capital is unlikely to be the main constraint on lending activity for now.

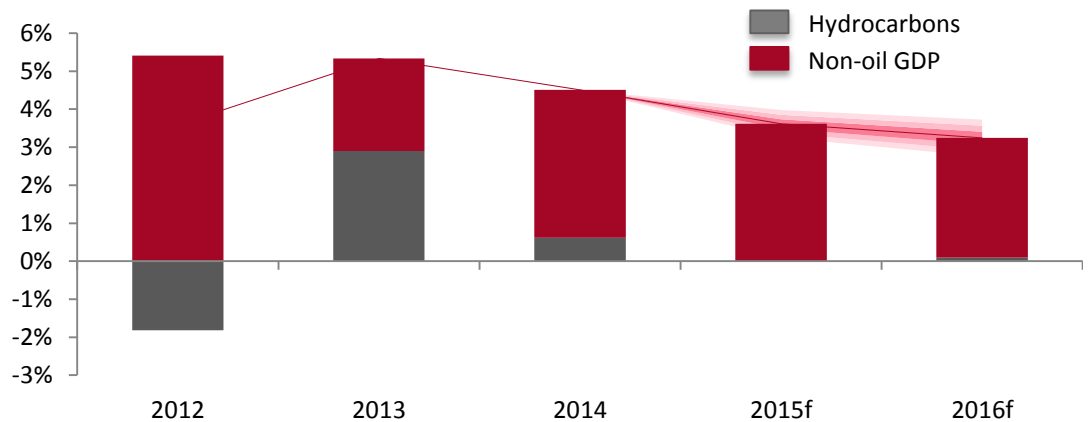
The non-oil sector should account for virtually all incremental economic activity this year

A significant build-up of activity is underway in a range of physical and social infrastructure projects funded by the Gulf Development Fund and other sources, including private investors and government-related entities. Even though the infrastructure projects will result in an influx of foreign labor as well as increase in remittances, it is also likely to have strong forward and backward linkages, including a pronounced multiplier effect across the rest of the economy. Similarly, the build-up in activity will boost both investor and consumer confidence and create more credit opportunities for the financial services sector.

New initiatives are also underway in terms of support for small and medium-sized companies. The national labor fund Tamkeen has signed agreements with Khaleeji Commercial Bank and Bahrain Development Bank to expand low financing options available to the SME sector and to expand the number of incubator centers as part of its Business Incubator Support Programme. The expanding SME support infrastructure, along with a strategic refocusing around result-oriented and company-specific support solutions by key national support institutions, should help put more local companies on a growth trajectory.

We expect headline real GDP growth to decelerate somewhat below the 4% mark over the coming two years. Our current estimates foresee 3.6% and 3.2% growth in 2015 and 2016, respectively. However, this apparent slowdown is the result of the flat output level we expect to see in the hydrocarbons sector. By contrast, the non-oil sector is projected to remain in a strongly expansionary mode. We expect project spending on infrastructure, tourism, and increased private sector activity to drive non-hydrocarbon growth and offset to a large extent the impact of any decline in government revenues.

Projected GDP growth



Source: Central Informatics Organisation, EDB estimates

Real estate and hospitality an important investment focus

Hotels and restaurants, construction and real estate & business services have been among the most dynamic sectors of the economy in recent years. A number of important developments in these areas are likely to drive this positive progress further in the near to medium term.

The Government has recently taken important steps to boost regulatory standards in the real estate sector. A formal tenancy registration process is designed to better protect the rights of tenants and landlords, and new legislation has been approved for new development projects. The Government announced in February that it would oversee the completion of several stalled real estate projects, through the engagement of local and regional financial institutions, among others. Priority projects include Villamar at the Bahrain Financial Harbour, Amwaj Gateway Towers, Marina West, and Riffa Views.

New projects include a 1.5mn sq m Ras Al Barr Resort reclamation project by PK Development Company. Located to the south of Durrat Al Bahrain, the mixed-use waterfront development will offer housing, hotels, retail spaces, and public beachfront facilities, along with community facilities. The Diyar Al Muharraq development in the north of Bahrain signed a major agreement with the Ministry of Housing in March to provide 3,100 residential units at a cost of BHD276mn under the auspices of the Ministry's Social Housing Programme. Such public-private partnership models are establishing themselves as an increasingly important way of meeting the country's growing housing needs with private sector involvement.

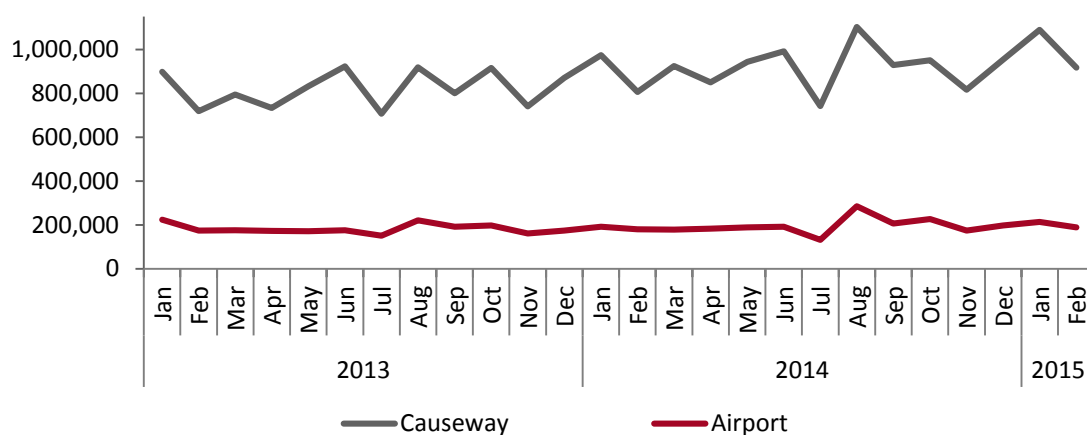
The number of visitors to Bahrain has remained on a fairly consistent upward trend, some seasonal volatility notwithstanding. The total number of arrivals to Bahrain through the King Fahad Causeway in February 2015 was 918,204, which represented a 13.8% YoY increase. The number of arrivals through the Bahrain International Airport rose by an annual 5.1% in February to a total of 173,495. Sea port arrivals reached 12,999 in February, an impressive growth of 35.3% compared to the same month last year. Overall, the total number of visitors to the Kingdom was 997,089 in February this year, representing a YoY increase of 12.5%. These data continue a positive pattern established in 2014 when more than 10mn people visited Bahrain in an 11.1% gain over 2013. GCC

The hospitality sector has established itself as an increasingly important contributor to growth on the back of increasing visitor numbers

visitors numbered 6.6mn, up 16.8%. This is particularly important at present as they are not affected by the gyrations of the US Dollar. The number of visitors from Saudi Arabia rose 19.3% to 6mn. Bahrain received 26 cruise ships and 41,000 tourists, up 8.5% on 2013. Among other things, tourism has become an increasingly important source of employment for nationals and the hospitality sector now employs 2,100 Bahrainis.

A number of new facilities have begun operations in the hotels and restaurants sector. The inauguration of the Four Seasons Hotel on 1 March marked an important addition to the five-star segments. The hotel will operate at a Bahrainization rate of 10%, with the potential to reach 15% at peak capacity. Other facilities to have launched in the opening months of the year include ART Rotana, an ocean-front development in Amwaj Islands, and Ibis Hotel in the commercial district of the capital.

Monthly tourist arrivals in Bahrain by port of entry, 2013-2015



Source: Ministry of Interior

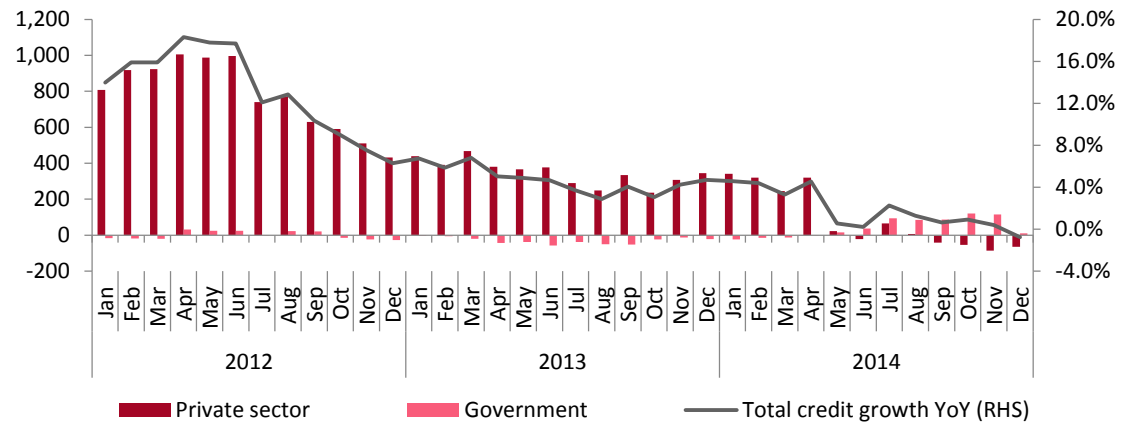
Strong bank performance with moderate credit growth

Most of the leading financial institutions in Bahrain posted strong results in 2014, with the YoY percentage increase in net profits ranging from 4% to over 50%. This reflects the strength of the country's regulatory regime and the health of the financial sector which can serve as an important source of economic continuity in the face of volatile oil prices. With loan-to-deposit ratios of less than 50%, the retail banking sector remains highly liquid and therefore in a position to accelerate lending further.

Liquidity remains strong and credit growth fairly stable

In spite of the robust health of the banking sector, credit growth has been relatively measured, something that we expect will change as the build-up in infrastructure projects develops momentum. The recent data on bank lending does not permit direct comparisons as some institutions have changed their licenses from retail to other types. However, the data suggests that lending growth in recent months has been relatively flat, much in line with the pattern observed in 2014. Bank deposits, similarly, appear to have continued to reflect the continuity seen in recent years, although license reclassifications complicate direct comparisons.

Year-on-year credit growth to the private sector and government (BHD mn)



Source: Central Bank of Bahrain

Deposit liabilities to non-banks (BHD mn)

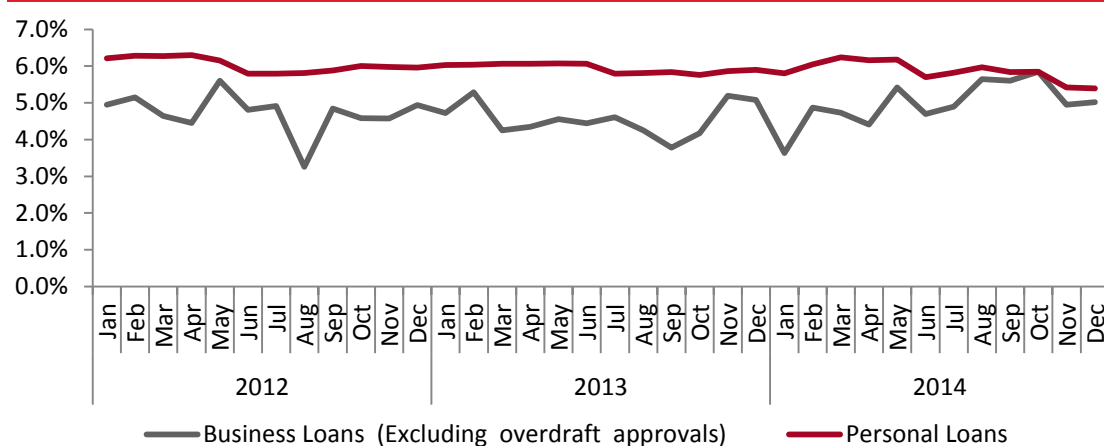


Source: Central Bank of Bahrain

Interest rates for personal and business loans start to converge around 5.7%

Interest rates for business and personal loans have continued their recent pattern of convergence and experienced a slight decline in the closing months of 2014. In December, the average rate of interest for personal loans was 5.4% and for business loans 5.0%. Personal loan rates have remained virtually flat around 6% since early 2012, while the cost of business loans has fluctuated much more around the 5% mark.

Average rate of interest on credit facilities (conventional retail banks)



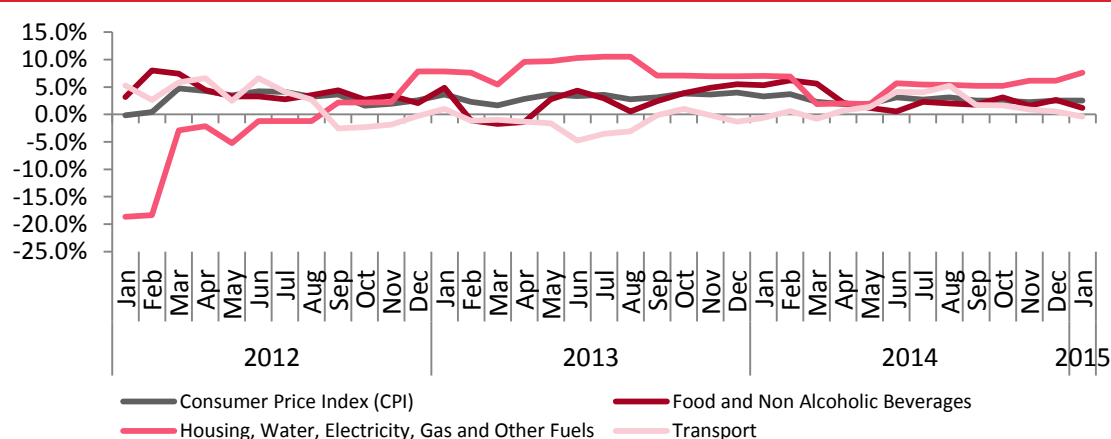
Source: Central Bank of Bahrain

Consumer price stability continues

Headline CPI figures suggest an absence of significant price pressures with an annual rate of 2.1% as of January

Inflation dynamics in Bahrain have manifested a high degree of continuity, much in line with broader regional trends, during this year. Headline consumer price inflation stood at 2.1% in February 2015, a moderation from the January reading of 2.5% and the 2014 average of 2.7%. However, the component parts of the index has seen some divergence in recent months. Housing, water, electricity, gas and other fuels continues to experience the fastest growth in prices at 7.8%, a level last seen 16 months ago. On the other hand, prices in the food and non-alcoholic beverages sector, which constitutes 16% of the total basket, fell by 0.9% YoY. Similarly, the transport sector witnessed a decline in prices of 0.4%.

Sector-specific consumer price inflation indicators (YoY, %)



Source: Central Informatics Organisation

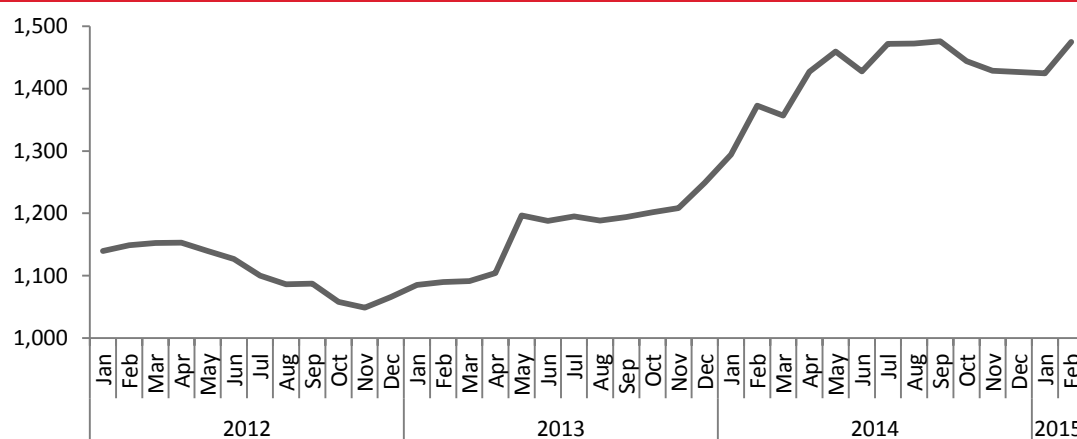
Capital market resilience

Bahrain Bourse has emerged as one of the region's resilient stock markets, especially during recent months when other regional bourses have experienced far greater volatility. Following a robust 21% gain in 2014, the Bahrain All-Share Index advanced by 1.6% in the first quarter of this year

following a 1.7% during the month of March. This nonetheless left it as one of only two GCC exchanges (along with Saudi Arabia's Tadawul) to have posted positive growth in Q1.

Bahrain All-Share Index

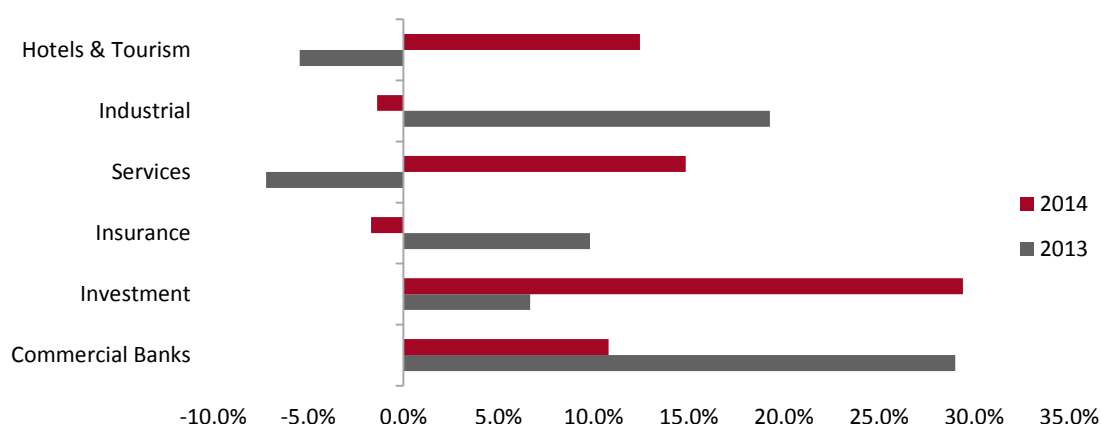
The Bahrain All-Share Index has remained in positive territory with a 1.6% gain in Q1



Source: Bahrain Bourse

The relative resilience of Bahrain Bourse reflects its limited exposure to the oil markets and related activities, itself a consequence of the advanced diversification of the national economy. The Investment sector led the Bahrain All-Share Index in 2014, growing by 29.4% and eclipsing the commercial banks sector, which had led the way in 2013. It was followed by the Services and Hotels & Tourism sectors, which posted 14.9% and 12.4% gains, respectively.

Sectoral stock market indices, 2013-2014



Source: Bahrain Bourse

As part of its most recent efforts to diversify its product and service offerings to both investors and issuers and enhance trading activity in the Kingdom, Bahrain Bourse plans on launching the "Bahrain Investment Market" (BIM) this year as indicated by the consultation paper issued in December 2014. A pioneering venture in the Middle East, the BIM will target the listing and trading of Bahraini and regional small and medium-sized enterprises (SMEs), providing a suitable financing mechanism for the growing population of SMEs in the GCC.

The International Organization of Securities Commission (IOSCO) approved Bahrain Bourse as an affiliate member of the Commission, marking a milestone for the capital markets of the Kingdom.

Bringing together the world's securities developers and including 124 ordinary members, the IOSCO is recognized as the global standard setter for the securities market. In collaboration with the BIBF, Bahrain Bourse launched a series of awareness sessions to educate the public in efforts to encourage and promote an investment culture that would potentially increase market activity in the Kingdom.

The fixed income market of the Kingdom has seen significant activity in the new year. Apart from ongoing short-term issuance by the Central Bank, the opening months of the year saw three longer sovereign offerings. A BHD100mn three-year *sukuk al ijarah* was placed in January with a 3% profit rate. It was followed by a BHD250mn, 10-year facility with a 5.5% profit rate. Both deals were significantly oversubscribed at 321% and 147%, respectively. A 12-month Treasury bill worth BHD200mn was placed in early March with a 1.06% coupon.

In the commercial bonds space, BBK launched a USD400mn, five-year conventional issue in March. The security will be priced at 200 bps over midswaps, according to lead arrangers BNP Paribas, HSBC, and National Bank of Abu Dhabi. A number of corporate issues are expected to be launched in 2015, with players including Gulf Finance House and Al Baraka Banking Group having already announced plans for *sukuk* issuances later in the year.

Bahrain sovereign short-term bond and *sukuk* issuance

Date	Issue	Value, BHD mn	Maturity, days	Average interest/ profit rate, %	Average price, %	Over-subscription, %
23 Mar 2015	Sukuk Al Salam No. 167	36	91	0.81		211
18 Mar 2015	Treasury bill No. 1539	70	91	0.81	99.795	180
17 Mar 2015	Sukuk al ijarah No. 115	20	182	0.80		110
8 Mar 2015	Treasury bill No. 1537	35	182	0.80	99.595	289
4 Mar 2015	Treasury bill No. 1536	70	91	0.75	99.811	118.5
3 Mar 2015	Treasury bill No. 24	200	12 months	1.06	98.944	196
23 Feb 2015	Sukuk al salam No. 166	36	91	0.72		235
18 Feb 2015	Treasury bill No. 1535	70	91	0.70	99.817	163
11 Feb 2015	Treasury bill No. 1534	45	91	0.70	99.823	157
10 Feb 2015	Sukuk al ijarah No. 114	20	182	0.75		250
8 Feb 2015	Treasury bill No. 1533	30	182	0.80	99.597	192
4 Feb 2015	Treasury bill No. 1532	45	91	0.69	99.825	183
28 Jan 2015	Treasury bill No. 1531	45	91	0.70	99.824	200
19 Jan 2015	Sukuk al salam No. 165	36	91	0.72		235
15 Jan 2015	Long-term Sukuk al ijarah No. 22	250	10 years	5.5		147
14 Jan 2015	Treasury bill No. 1530	45	91	0.70	99.823	192
13 Jan 2015	Sukuk al ijarah No. 113	20	182	0.82		270
7 Jan 2015	Treasury bill No. 1529	45	91	0.70	99.823	144
6 Jan 2015	Long-term Sukuk al ijarah No. 21	100	3 years	3.00		321
4 Jan 2015	Treasury bill No. 1528	30	182	0.80	99.597	174

Source: Central Bank of Bahrain

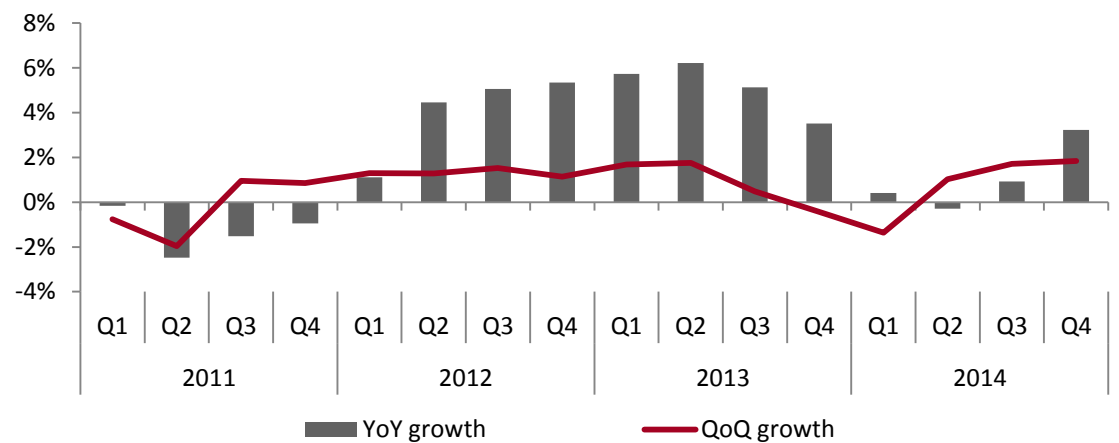
In one of the most significant debt finance transactions in Bahrain since 2014, Bahrain Steel launched a USD340mn term and revolving facility, which closed oversubscribed. With a syndicate comprising eight local and international banks, including HSBC Middle East, Mashreq Bank and Arab Banking Corporation as joint initial mandated lead arrangers, the facility proceeds will be utilized to refinance existing facilities and fund plans for operational expansion. Mumtalakat also signed a 5-year, USD500mn revolving credit facility with Bank of Tokyo-Mitsubishi, BNP Paribas,

Deutsche Bank, Standard Chartered, Arab Banking Corporation and NBB, primarily to refinance existing debt.

Labour market continuity

According to the Ministry of Labour and the Labour Market Regulatory Authority, job creation in Bahrain accelerated markedly towards the end of the year. Total employment in the Kingdom expanded 3.1% compared to the last quarter of 2013, its quickest pace since the beginning of the year. While Bahraini employment grew 2.5% YoY, the growth of expatriate labour saw an even faster increase of 3.2% YoY in reflection of the several labor-intensive infrastructure projects that were launched in the second half of the year.

Total private sector employment growth (excl. domestic workers)

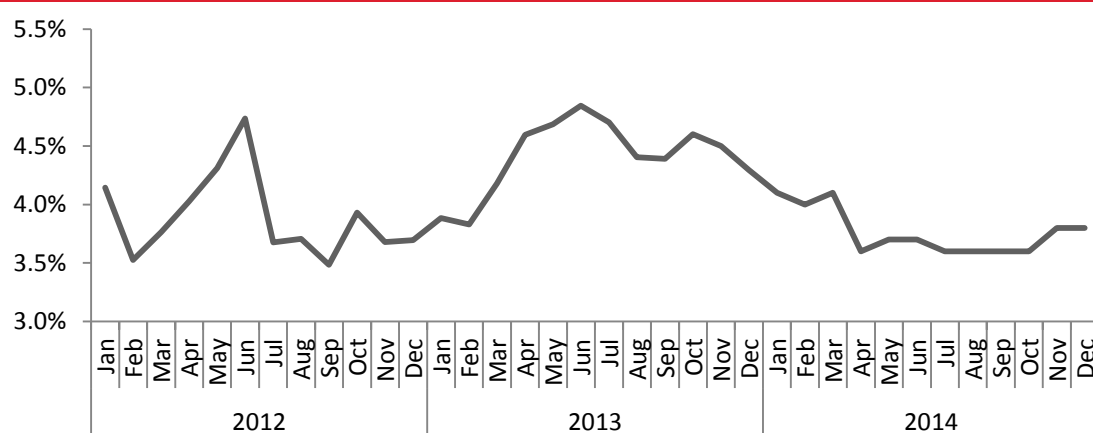


Source: Labour Market Regulatory Authority

Job creation for Bahrainis picked up in Q4 2014, in line with previous expectations

The private sector is driving the growth in the Kingdom's labor market, accounting for 90% of the increase in total employment. Private sector employment picked up significantly in 4Q14, growing by an annual rate of 3.2% and a QoQ rate of 1.8%. Continuing the trend in the previous quarters during the year, Bahraini employment outgrew non-Bahraini employment in the private sector (3.8% YoY vs. 3.1% YoY, respectively). The number of employees in the private sector reached 512,076 by year-end, a 15,986 increase from end-2013. This reflects the significant pick-up in activity in the non-oil economy since the beginning of the year.

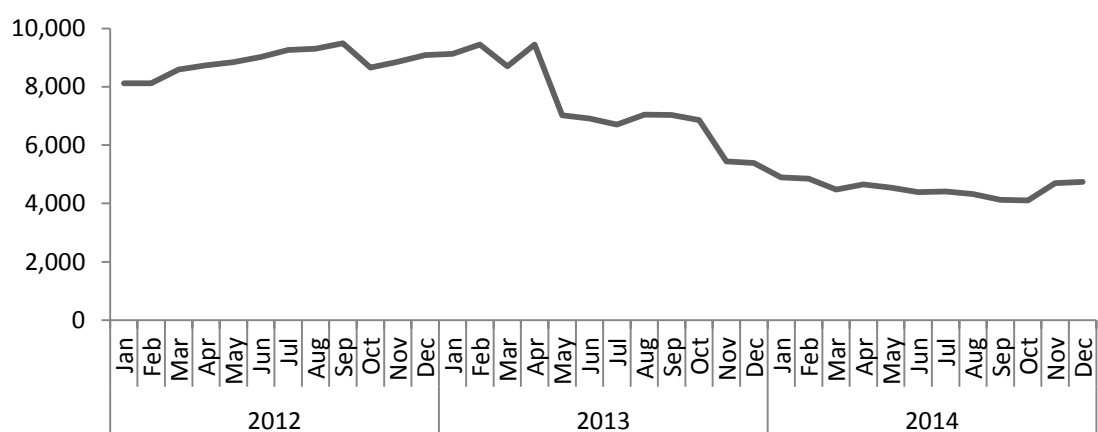
Unemployment rate (%)



Source: Ministry of Labour

The official unemployment rate has remained low in recent months with a reading of 3.8% in 4Q14. While this represented a slight increase on the preceding quarter, it also marked a significant improvement on 4.8% recorded a year earlier.

Number of vacancies reported by the Ministry of Labour



Source: Ministry of Labour

External assessments

Bahrain has generally continued to perform in international indices. The 2015 Index of Economic Freedom, published by the Wall Street Journal and the Heritage Foundation in January, ranked Bahrain as the region's top performer and 18th globally. Although Bahrain saw a marginal decrease of 1.7 points in its score and dropped five positions from last year's ranking, it was the only Middle Eastern economy to feature in the top 20. The Index evaluates countries across four broad policy areas that play a role in economic freedom: rule of law, limited government, regulatory efficiency and open markets.

In reflection of the effect of lower oil prices on public finance, Standard and Poor's Ratings Services and Fitch Ratings have recently revised downward their outlook on the region. The most challenging impact has been on the fiscal situation in Bahrain, which prompted a downward

revision in outlook to 'Negative' from 'Stable' by both rating agencies. S&P also cut its forecast for average Brent oil price to USD55 per bbl for 2015, which prompted the rating agency to downgrade its credit rating on the sovereign from BBB/A-2 to BBB-/A-3.

Bahrain news

- ▶ The upgrade of Bapco's Sitrah refinery is now due to be commissioned by 2019. The USD5.0bn project is set to increase capacity from 260,000 to 360,000 b/d
- ▶ Asteco, the region's largest independent full service real estate company, to establish first GCC franchise outside of the UAE in Bahrain. Operated by Rightway and Sana Real Estate, the franchise will focus on sales, leasing and property management
- ▶ "Investment Gateway - Bahrain", a development by Manara Developments is proceeding with its master plan. 89% of plots offered were sold at record time. Infrastructure construction started in Q3 2014, completion due in Q3 2016
- ▶ Dragon City, the new 115,000 sq m mall development in Diyar Al Muharraq City, has pre-let more than 60% of its retail space already. Still in its construction stage, the mall will house 750 retail store units and 4,500 sq m warehouse space
- ▶ Bahrain-based solar power project developer Terra Sola Ventures signed an MoU with the Egyptian Electricity Holding Company (EEHC) to develop 2GW of PV solar energy in Egypt, a project worth over USD3.5bn
- ▶ CBB granted a license to Türkiye Finans Katılım Bankası, a Turkish Shariah-compliant participation bank, to open a wholesale branch in Bahrain
- ▶ Bank of Khartoum plans to open a wholesale branch in Bahrain, the first branch in the GCC for Sudan's largest privately-owned Islamic bank
- ▶ Zain Bahrain launched Zain Pay, a direct mobile operating billing facility for Windows Phone Store (partnered with Microsoft and SLA Mobile). Customers will be able to safely and easily purchase apps, games, books and more by billing it to their post-paid or prepaid accounts
- ▶ Bahrain Bourse launched direct sales of local currency government debt through its exchange, opening up the market to Bahraini and non-Bahraini individual and institutional investors alike
- ▶ Investcorp made an investment of USD300mn into a portfolio of residential properties in the US in March. The portfolio includes 1,900 family and student housing units with a high occupancy rate of 96%
- ▶ Investcorp acquired a majority stake in Arvento Mobile Systems, marking the firm's 4th acquisition in Turkey
- ▶ Bahrain set to issue tenders for a new expo centre sometime later in 2015. The project is expected to boost exhibition industry's contribution to GDP to around USD278mn annually,

from around USD169mn. The facility will be located near the Bahrain International Circuit.

- ▶ Bahrain hosted the 4th Euromoney GCC Financial Forum in February 2015, bringing together more than 400 leading experts from the financial community to discuss the global economic outlook, its recovery and effect on regional financial markets.
- ▶ The Global Islamic Investment Gateway (GIIG), organized by Thomson Reuters and the Islamic Development Bank during the first week of March, brought together investors and cross-border Islamic investment opportunities.

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