Emerging Market Spotlight: **Stuck (Happily) In The Middle (East) With...Money!**

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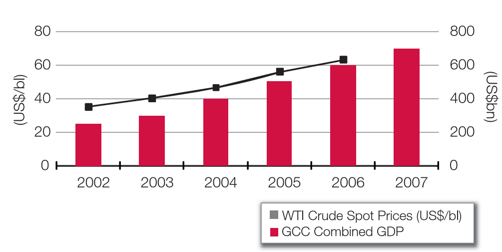
Literally being in the Middle between East and West has placed the region the U.S. terms "the Middle East" in quite an attractive spot.

Even if we discount the obvious commodity associated with the predominantly Arabic states that occupy parts of North Africa and Europe, location alone gives the Middle East a pristine position for global trade, and has done so for the past millennium. It serves as a connection point between Europe and Africa, and parts of Asia and Europe, as well as between Africa and Asia.

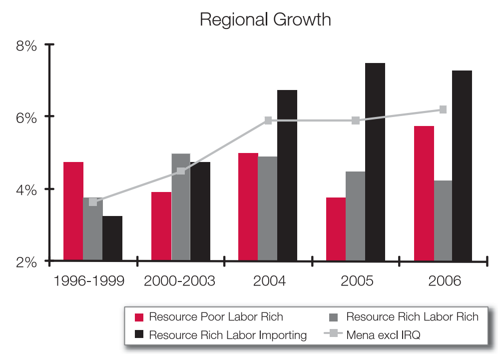
The Middle East nations are surprisingly less dependent on oil than the average person would believe. Continually increasing global trade alone sets up an attractive revenue source, as the trade also brings with it workers and foreign infrastructure investment. The region is in the early stages of diversification, with the financial sector, real estate and infrastructure projects being the driving forces.

There is also the seemingly insatiable appetite the world has for energy. Unless a landmass the size of Russia east of the Ural Mountains suddenly sprouts corn (which then miraculously converts to ethanol without using more energy than ethanol will deliver in return), the green revolution is not going to turn on all the light bulbs and cars in China and India. That massive powering will result from oil. All of these factors leave the Middle East in an enviable position, as evidenced by the development of several of the major countries' economies in the region.

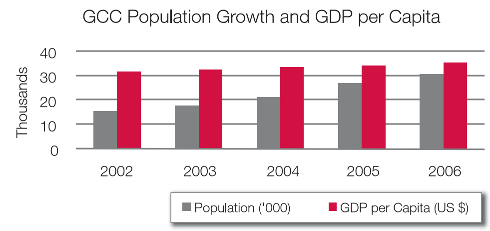
Holding aside some of the disparities that exist amongst the countries, the overall growth rate of the Middle East/North Africa region has been strong (especially when compared to some of its not-far-off European neighbors). Average real GDP growth has increased in the region from under 4% in the late 1990s (when crude oil averaged less than $10/barrel), to over 6% in 2007 (when the same crude averaged $65/barrel and touched $87/barrel towards the end of the year). There is clearly a tie between oil and GDP growth.



Whereas the majority of people polled would assume the growth is solely tied to the price of oil, looking at the breakdown of growth between resource rich/poor and labor rich/poor paints a potentially unexpected subplot. The resource rich countries have done well, but in some years the resource poor countries have fared better than those with resources. The difference, however, may be due in part to labor. Not the quantity of available labor, but the quality. Those countries importing human resources have done better with their natural resources than those that have only local human resources.



Again, there is a clear tie between oil and GDP growth. As commodity prices rise and regional development occurs from foreign sources and increased government coffers, there is increased investment which means increased construction and in turn translates into greater demand for labor and so forth. But without having exact statistics on productivity splits between the labor pools that are imported and those that are homegrown, we look at the real GDP growth results between resource rich countries that have plenty of labor and those that import. Clearly those that import have significantly outperformed over the same period. One conclusion is that the imported labor resources are more productive. Of the few parallels one can draw between the U.S. and the Middle East, we draw a parallel between what we have long claimed is a bedrock of strength for the U.S. – hungry immigrants who come to strive in one of the greatest free market economies of the world – and what seems to be part of the driving force of the Middle East economic development. This is not to stray from the obvious fact that the oil revenues have helped, but it does point out that government policies on labor, fiscal discipline and other factors can combine to accentuate (or detract from) the effects that natural placement may have on countries in the world. Dubai, for example, has imported labor at breakneck speeds for development projects it is undertaking, but it is also prudently diversifying itself away from oil, and gets its strength from shipping/ports, trading, investment and services in general. Most people would be shocked to know that less than 10% of GDP is actually driven directly by oil. These diversified revenues from oil and other sectors ultimately makes it easier for governments (those that choose to act prudently) to raise the standards of living for their populations.



Looking at the Gulf Coast Cooperation states (GCC) overall, even with its population doubling in just five years, the per capita GDP has risen over 12%. Not all of that money is going directly back into the hands of the worker and citizen, but certainly some is helping to improve infrastructure, medical services, education and social services.

And while the dominant export of the region is oil, there are also countries such as UAE and Bahrain, where oil exports are not a large portion of total exports, even if the revenue from oil is a large portion of the total revenue of the country.

Overall fiscal discipline has also been exercised to raise the level of economic strength of the region. Government debt has come down as a percent of GDP. As a result, credit ratings on the government debt of the leaders in the region have improved to AA- or higher, which only further helps drive up the investment the region sees, on top of what used to be more oil-tied investment. The Sovereign Ratings chart illustrates the credit ratings of several GCC countries.

But there are also cracks in the foundation that need to be addressed. Inflation is on the rise in many countries, with the average up to 8-9%. This is being driven by strong growth in demand, large inflows of investment and monetary policies that are accommodating these inflows. Oil exporters have seen an even larger jump from 7% in 2006 to over 10% in 2007. With currencies either pegged to the dollar or heavily managed, higher inflation is the result. Unfortunately no major changes are expected in policy; therefore, we do not see inflation decreasing significantly in 2008.

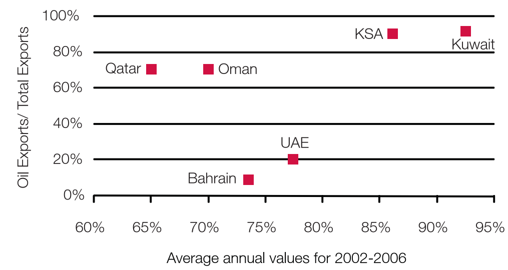
Savings have also declined, as oil-rich producers have increased spending, dropping their current account surpluses from 21% to 17% percent in 2006 and 2007, respectively. A combination of national and private sector funds totaling over $800 billion have been spent over the last five years across several sectors, including oil and gas, real estate and infrastructure. The picture of savings of oil exporting countries is better in this regard than non-oil exporting. The oil exporters have savings rates that have dropped, but from 45% in 2005-2006, to just over 40% in 2007-2008.

Capital markets across the region has so far weathered well against the global crisis, with foreign sovereign funds providing a welcome cushion in the Great Capital Strike in the U.S. While IPOs have slowed, Islamic bond (sukuk) issuances continue to grow. There is, however, tightened liquidity and widening bond spreads for some banks that are exposed to distressed global borrowers.

For long-term economic sustainability without reliance on the oil sector, Middle East nations are making fiscal and financial sector reforms a priority. The goal is to strengthen the banking sector to increase transparency in the global capital markets and to increase overall economic diversification.

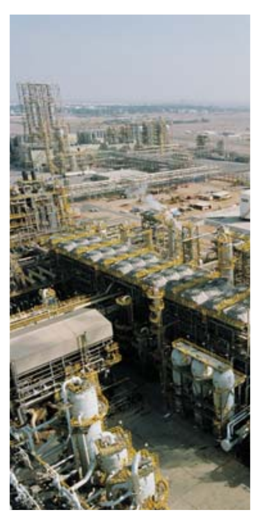
Saudi Arabia. The goliath of the region remains the Kingdom of Saudi Arabia (KSA), with a clear dominance over most of the next largest countries combined. There are other significant contributors to the growth as well, including United Arab Emirates and Kuwait, but with the world's highest oil reserves and fourth highest gas reserves, the KSA is getting quite a boost from rising global energy prices. This has driven GDP growth rates

Oil Revenue/ Total Revenue



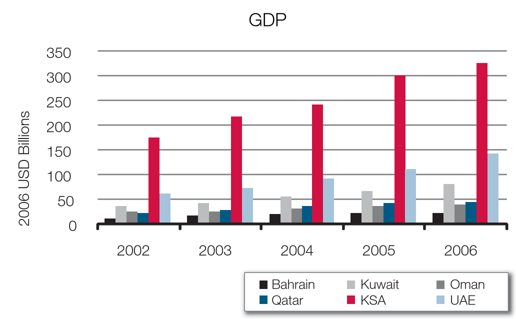
Soverign Ratings

	A&P	Moody's
Bahrain	A	A3
Kuwait	AA-	Aa3
Oman	A	A3
Qatar	AA-	Aa3
KSA	AA-	A3
UAE	A+	Aa3



in the Kingdom to as high as 26% in 2005, after having grown 3% in 2002. Estimates for 2007 are for 3.5% real GDP growth. The government has pushed for diversification into non-oil private sector GDP growth, with real estate and construction already comprising around 12.5% of GDP in 2006.

Focusing on the KSA, aside from the oil prices supporting the government, credit is allowing for much of the private sector growth in development of the country. While credit facility activity for building and construction did not change much from the late 1990s to the start of the 2000s, it started to increase between 2002 and 2003. Saudi banks have picked up the pace in the past several years. The latest data suggests construction credit grew 36% during 2005, 20% during 2006 and 17% through the first three quarters of 2007. Oil is allowing much of the banks' lending exposure for construction, with over SR45 billion in new loans during the third quarter of 2007. Smaller scale commercial lending is also driving ahead, with an average annual growth rate of over 30% since 2000.



As a whole, real estate is not heavily regulated in the GCC region, with Saudi Arabia being no exception. Land primarily belongs to state and locals through grant, freehold or long-term leases. Land ownership is permitted, though foreign ownership is still restricted. That said, most of the GCC countries are now moving forward with regulations to allow for foreign owned land, although progress towards a clear statement of such allowance is still slow across the region.

Building permits leveled off in 2007 – a good sign to rein in recent aggressive construction trends. The waters ahead are not clear, and opening land ownership to foreigners will likely drive further development. At least 2007 showed a retreat from the pace of growth over the past several years. Residential permits are still the predominant driving force. Our concern is that the exuberance of the market is potentially setting a supply-demand imbalance, whereby residential properties will be left unfilled. Again, the slowing in residential permits is a good sign for now, but market balance should be watched carefully.

Consumer and Credit Card Loans

In SR mn	Real Estate Financing	Cars & Equipment	Others	Total	Total Credit Card Loans*
2001	3,295	13,893	21,259	38,447	2,222
2002	4,506	25,568	22,800	52,873	2,857
2003	5,191	28,859	39,255	73,305	2,579
2004	8,790	27,926	78,590	115,306	3,295
2005	13,656	29,025	138,174	180,856	4,259
2006	13,690	34,262	132,759	180,710	7,349
2Q07	14,984	37,108	131,805	183,897	8,308
CAGR% 01-06	33.00%	19.80%	44.20%	36.30%	27.00%

**Include Visa, Mastercard, and others*

Price increases have averaged 13-17% per year for housing and commercial office, with notable variances amongst some cities. Demand by pilgrims is driving much of the pace of development in holy cities like Makkah and Madinah. Vacancies in office space in prime areas of Riyadh and Jeddah are hovering in the low single digits, helping to drive rents up. Prime office space ranged between US$225-$290 per square meter, ranging down to under US$100 per square meter for tertiary locations.

Retail malls have been experiencing growth across the region, and have driven annual rents up to US$250 to over US$800 per square meter. (For quick math, divide by 10 for rates per square foot).

The KSA government has pressed hard (and succeeded) in marketing itself as an industrial hub for the region. By the end of 2006, there had been over 1.5 billion square meters of industrial area developed across Riyadh, Jeddah, Dammam and Al Madinah (with Riyadh accounting for over 95% of the total).

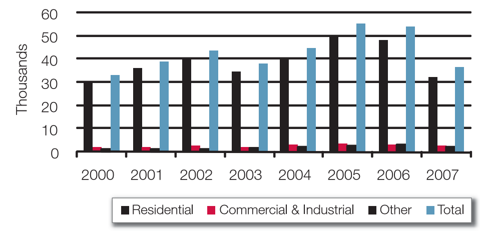
The Saudi Industrial Estates Authority is now developing several new major industrial estates in the Kingdom, including 10 million square meters in Sudair Industrial Estate Phase I, 3.5 million square meters in Jeddah and 2 million square meters in Jazan. Additionally, the Royal Authority, rather than the SIEA, has developed Jubayl and Yanbu', with 1 million square meters and 185,000 square meters, respectively. All of this activity is in anticipation of rising industrial and business activity, which is expected to be driven by the New Investment Law of 2000 and the land ownership laws for foreigners.

In additional to industrial space, KSA is developing "economic cities", which will comprise both residential and commercial space, and with the intention of accommodating a population of over 1.5 million people in the near- to medium-term, and over 5 million people by 2020. These cities (King Abdullah Economic City, Knowledge Economic City, Prince Abdulaziz Bin Mousaed Economic City and Jazan Economic City) are expected to drive further investment into the region as a whole, and specifically around each of the cities. Estimates vary for the development, but are anywhere between US$60-$80 billion. There are also plans under way for two more cities, Tabuk and one in the Eastern Region.

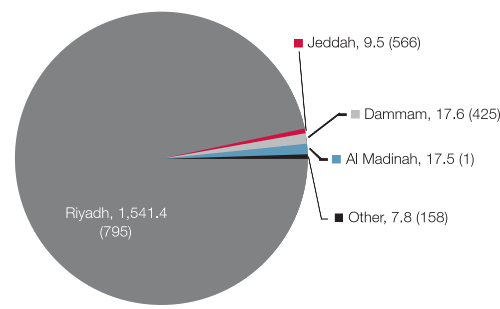
Dubai. Switching focus to Dubai, the activity of domestic firms importing labor, foreign firms setting up offices and placing staff, and general population demands are driving the growth of housing, office space and recreational facilities. The World Real Estate Development in Dubai is an example of the grandiose ideas that are becoming reality – 300 islands, shaped in the form of the world, and all with unique development plans. The World took over 320 million cubic meters of sand and 34 million tons of rock to be built up as foundation. But one only needs to look at the dozens of cranes on the Dubai skyline to know that there is serious development occurring.

Dubai residential markets are hot, but the government stepped in last year with a 7% residential rental cap. Deep pocketed developers and their financial backers are likely willing to temporarily withstand increasing vacancy (given expected continued economic

Building Permits by Type



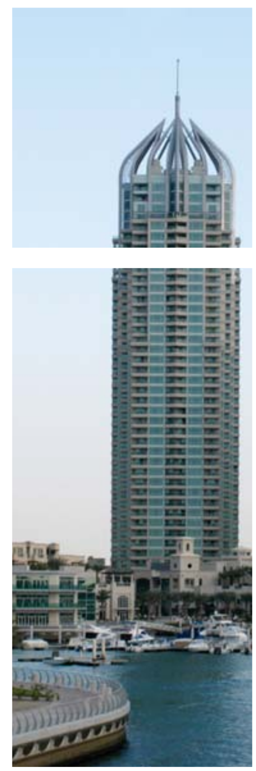
Industrial Estate in KSA 2006
Developed Area in Million Square Meters (# of Plants)



Economic City	Area (mn msq)	Investment Size (US$bn)	Jobs (mn)	Population (mn)
King Abdullah Economic City (KAEC)	168.0	27	1.00	2.00
Jazan Economic City (JEC)	100.0	27	0.50	0.25
Prince Abdul Aziz bin Mousaed Economic City (PABMEC)	156.0	8	0.06	0.30
Knowledge Economic City (KEC)	4.8	7	0.02	0.15

growth in the region) rather than face the prospect of lowering their rents. Pricing can vary significantly on residential product, from an annual rent of $15,000 for a studio in Al Barsha, to a high of around $50,000 for a three-bedroom at Sheikh Zayed Road or Dubai Marina (Phase I).

Office space in Dubai has been limited in supply, and thus rental rates have continued to rise as vacancies have remained at near full levels. Estimates are for a near tripling of office space by the end of 2009, which bodes well for corporate tenants, but could mean a serious glut of space. Current office inventory in Dubai is approximately 27 million square feet. Even with increasing demand, the pace of demand growth does not warrant the pace of development.



Dubai has become a retail destination for tourists from the region and the world. As such, mega shopping malls such as Mall of the Emirates (over 2 million square feet) and Mall of Arabia (when launched, expected to have nearly 4 million square feet of gross leasable area) are making Dubai the ‘it’ destination for retail in the region. With 1.5 billion people living within a two-hour flying radius to Dubai, being the ‘it’ destination is not insignificant. And with increasing coffers of cash, providing a destination even for just the region is a lucrative proposition. Add to that tourists from Asia and Europe who flock to buy the worldwide wares available in Dubai and you have a promising retail scenario, as well as an additional way the government is promoting diversification away from oil. Enclosed malls are expected to make up the prime retail product, given the regional climate. Smaller and older malls may feel rental pressure as more development occurs on larger scales. Given climate, malls become destinations for escape from the heat.

Hotels are experiencing the effects of increased business travel and retail draw for tourists, but have seen drops during summer months. Targeting 15 million annual tourists by 2012, strong sector growth is driving forward. Higher-end hotel development is setting up a potential oversupply. Occupancy has been solidly around 80% for several years, though increased supply and competition should adjust this figure downward.

If oil prices collapsed today, the Middle East would undoubtedly feel significant economic pain. However, the greater risk in these newly diversifying markets lies in overdeveloping too quickly beyond near-term demand.

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