GULF: THE GLOBAL POWER CHESS GAME'S CRITICAL PIECE

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CHINA'S WESTWARD AMBITIONS

After a decade of U.S. equity market outperformance, a value opportunity may be on offer in the WisdomTree Middle East Dividend Fund (GULF), our frontier markets ETF[1]. Unlike U.S. equities, the WisdomTree Middle East Dividend Index has actually returned -0.36% per year since it was incepted in June 2008. In contrast, the MSCI Emerging Markets Index and the S&P 500 are up 4.22% and 10.95% per year, respectively.[2]

Yet despite the performance trouble confronted by Middle Eastern equities over those years, GULF witnessed some periods when it would have materially diversified emerging markets risk. For example, emerging markets were down 2.4% in 2013, but GULF returned 37.1% that year. Emerging markets declined marginally the very next year too, and yet GULF posted gains of 11.4% in 2014.[3]

But by and large, GULF has refused to participate in the global equity rally, opening up a potentially compelling relative valuation case. The WisdomTree Index that GULF tracks is now changing hands for 11.6 and 11.1 times trailing and forward earnings[4], respectively, with a dividend yield[5] of 5.0%.[6]

Promisingly, the region offers exposure to a series of bullish secular theses, from a Chinese "going out" strategy that relies on warm relations with the Mideast to a potential moderation of intraregional conflicts. Also, the region's equities stand to benefit from developing capital markets, specifically as foreigners take equity stakes in Saudi Aramco, the state oil company some value at $1.5 trillion.[7]

THE SILK ROAD

Importantly, GULF may offer backdoor exposure to China's massive "Belt and Road Initiative," the multicontinental infrastructure build-out that President Xi Jinping hopes will give rise to superpower status. For years, rumors swirled of a new Chinese "Silk Road," a series of railroads, pipelines, roadways and other such projects that would snake through central Asia and the Mideast and into Europe. It was made official less than three years ago.

[1] Frontier markets: Typically characterized by a higher degree of potential risk, including issues that may inhibit the flow of assets across national borders and awareness of potential difficulties for foreigners to establish accounts.
[2] Source: Bloomberg, 6/30/08–1/31/18.
[3] Source: Bloomberg, using MSCI Emerging Markets Index. Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at wisdomtree.com.
[4] Trailing earnings: The amount of profit that a company produces during prior fiscal year. Forward earnings: A company's forecasted, or estimated, earnings made by analysts or by the company itself.
[5] Dividend yield: a financial ratio that shows how much a company pays out in dividends each year relative to its share price.
[6] Source: Bloomberg, as of 2/11/18.
[7] Source: Matthew Winkler, Filipe Pacheco and Shin Pei, "How a $1.5 Trillion Aramco IPO Could Transform Global Stocks," Bloomberg Markets, 1/24/18.

The UK Telegraph's Dan Steinbock holds that the new Silk Road's total expenditure could be $4-8 trillion, far exceeding the $130 billion present value of the Marshall Plan.[8] No surprise then that many hypothesize that infusing so much Chinese capital across Central Asia, Russia and the Mideast will be transformative for beneficiary regions.

Look at the signaling. When President Xi officially announced Belt and Road in 2015, he was not at the White House or in Berlin or Paris or even East Asia. He was in Kazakhstan.

Building through the "stans"—Uzbekistan, Kyrgyzstan and so forth—China will gobble fossil fuels and base metals in grand fashion. For scale, consider that China's cement behemoth intends to construct 100 new factories in 50 countries in the next three years.[9] Infrastructure builds will push west to Turkey, north to Russia and finally into Europe, tapping that mother lode of demand.

GULF, which gets just a fraction of the attention of WisdomTree's bigger funds like DLN or EPS,[10] may prove interesting for a Belt and Road build-out thesis. It is certainly not a leap to propose that the fuel-rich region could keep the U.S. at bay by sidling up to China as the latter nation showers friendly players with billions in capital.

That assertion rose to a new level on January 25, when President Xi moved another chess piece.

XI'S NEXT MOVE

Intriguingly, as if the original scale of the Belt and Road wasn't large enough to begin with, Xi has now tossed a westward northern maritime passage above Siberia into the fray: the "Polar Silk Road." In so doing, China is wagering on melting ice caps making northerly shipping progressively less treacherous.

This is especially critical given potentially fractious political relations with South Asia, namely India, with President Narendra Modi not keen to just stand by while China claims the mantle of regional hegemon without contention. Relations between the two population behemoths are contentious, and border disputes dating to the 1962 Sino-Indian War remain to this day.

Additionally, the rise of Hindu nationalism in India's halls of power adds another layer of complexity to the South Asian puzzle. The Belt and Road will pour billions into nuclear-armed Pakistan, which is also locked in an ugly border dispute with India over Kashmir. To say the least, Modi may not take too kindly to warm Sino-Pakistani relations.

Suddenly an image of a northern route to Europe that goes above Russia, in contrast to one that relies on the Indian Ocean, seems like a wise backup plan. But it's not as though Chinese control of the Arctic is some foregone conclusion.

For one thing, President Vladimir Putin has had a Russian flag planted on the bottom of the ocean in the polar north for nearly 11 years. Russia is just one of many nations claiming sovereignty over pieces of the pole, with others including Canada, Norway and Denmark.

The U.N.'s 1982 Law of the Sea Treaty allows a country to claim "an exclusive economic zone over the continental shelf abutting its shores,"[11] so no "southern" nations like China are even included in the discussion when it comes to ownership. To move cargo through those waters, China will need friendly relations with Putin, and that is hardly a given.

Further, this is to say nothing of U.S. interests in the region, with President Trump never hesitant to pull power cards with China. If it isn't the ice that checks China above Siberia, it will be the U.N., Russia or the U.S. naval fleet.

[8] Source: Dan Steinbock, "How the Belt and Road Could Change the 21st Century," The Telegraph, 5/24/17.
[9] Source: Angus McNeice, "China to Build 100 Cement Plants in Belt and Road Region," China Daily, 12/13/17.
[10] The WisdomTree U.S. Large Cap Dividend Fund and WisdomTree U.S. Earnings 500 Fund, respectively.
[11] Andrew E. Kramer, "Russia Presents Revised Claim of Arctic Territory to the United Nations," The New York Times, 2/9/16.

CHINA'S DISTANT FRIENDS: THE SUNNI MONARCHIES?

Aside from the indoor ski slopes in Dubai, nothing could be further from arctic passageways than the Middle East, replete with the world's most abundant oil and gas reserves. Often overlooked in the equation is the "Maritime Silk Road," the waterway through the Persian Gulf and the Suez, into southern European ports.

Meanwhile, unlike India, Russia and Japan, all of which had military conflicts with China in the last century, GULF component nations have no such acrimony with the Chinese. They were always too physically distant to be at war with the Far East.

And from the Chinese view, if Saudi Arabia specifically is to be friendly, it would seem imperative to take a strategic stake in Saudi Aramco when the state oil behemoth floats its initial public offering (IPO), maybe this year. If China does not play the Aramco angle, the rest of the Tadawul All Share Index of Saudi stocks has a digestible total market capitalization that is measured in the billions, not trillions.[12]

SAUDI'S MULTIDECADE VISION

Furthermore, if Riyadh's own futuristic build-out, Saudi Vision 2030, goes as planned, then the regional Sunni power broker can flex muscle over its neighbors to make sure there is little protest over a rising Chinese presence in the Persian Gulf.

If that's the case, and, say, Sino-Russian relations revert to historic mutual suspicion and hostility, as was the case during the Soviet era, then suddenly the Persian Gulf passage to Europe becomes Beijing's imperative. In turn, we theorize that the Sunni monarchies will "ask" China for capital to kick-start SV2030. A Chinese-funded university here, some high-speed trains there, and so on.

Much of this is contingent on a new guard taking the reins of power in the Sunni states. With 32-year-old Crown Prince Mohammad bin Salman (MbS) posing as a possible reformer—although the jury is still out about how much he wants to socially modernize—owners of GULF will need him to tack progressively with respect to women's rights and religious tolerance. If not, SV2030's futuristic cities are just a fleeting apparition.

In the meantime, the S&P 500 is trading for 21.3 times trailing earnings, with a 1.93% dividend yield, pricier than broad emerging and frontier markets.[13] In contrast, frontier markets in general have been so out of favor relative to U.S. equities for so many years that the WisdomTree Middle East Dividend Index trades for just 11.6 times trailing earnings, yielding 4.95%.[14]

SUNNI AUTOCRACIES: SERIOUS ABOUT CRACKING TERRORISM?

It is tough to read MbS because Saudi Arabia's long game is a perpetual puzzle. For one thing, the stock market must contend with the Yemen proxy war between Saudi Arabia and Iran—where tens of thousands have died with little promise of resolution anytime soon. This war and other conflicts only hinder confidence in the region.

Furthermore, the United States had been attempting to be relatively neutral between Saudi-Iranian friction during the Obama years, but allegiances have shifted toward the Saudis. Recall that Trump's travel ban included nations such as Venezuela, which has not historically been associated with terror on U.S. soil, while Saudi Arabia was left off the list. Iran was included. This can only make Tehran feel backed into a corner, and cornered countries often make rash decisions.

[12] Source: Bloomberg, 2/12/18.
[13] Source: Bloomberg, WisdomTree, as of 2/12/18.
[14] Source: Bloomberg, WisdomTree, as of 2/12/18.

But given these obstacles, we take a contrarian positive view with respect to the Gulf Cooperation Council (GCC)[15] nations' recent hard line on Qatar, where they banded together and accused that country of funding terrorism. In this crisis, GCC nations including Saudi Arabia, the UAE and Bahrain formed an alliance with Egypt and others to cut off diplomatic relations with Qatar. Trade cuts caused Qatar's GDP growth to slink to 2.5% in 2017.[16] It also slowed the economies of the enforcing nations, with many slipping into recession themselves.

Wall Street, in its classic short-termism, looked at the near-term data and viewed the Qatar action as a negative, ignoring the reality that, whether Qatar was guilty or not, someone had to take a stand on epidemic terrorism. Not everything in life boils down to economic output in the immediate future, but the long view of peace and modernity relies on the region facing down terror.

Following up on the Qatar action, in November 2017, MbS successfully detained a few hundred oligarchs in the Riyadh Ritz-Carlton on charges of corruption. They were held captive there for several weeks, with most of them released from the peculiar prison only after they agreed to pay the government a collective total of about $100 billion.

This action secured MbS's grip on Saudi Arabia. The Street has rightly reacted with concern over allegations of torture inside the Ritz-Carlton and that innocents may have been caught up in the purge.[17] We suspect that some large percentage of the imprisoned were in fact corrupt, and they received the message loud and clear. But nevertheless, if MbS wants to show the world he is a reformer, the Ritz-Carlton fiasco did not help the cause.

In a change of tone, with regard to SV2030, here is a quote attributed to MbS on the initiative's website:

> Our Vision is a strong, thriving, and stable Saudi Arabia that provides opportunity for all. Our Vision is a tolerant country with Islam as its constitution and moderation as its method. We will welcome qualified individuals from all over the world and will respect those who have come to join our journey and our success.

We read that as slow-motion reform, and as always with the stock market, everything happens at the margin, when good news evolves into bad news or when bad news becomes good. Reform and an outreach to foreigners to visit, work and invest in Saudi Arabia is just that kind of marginal change needed to support a bullish Mideast equity thesis.

WORDS AND ACTIONS

Beyond the Qatar sanctions and the Ritz-Carlton surprise, there is more evidence of reform. Consider some baby steps, such as the lifting of the notorious Saudi restriction on female driving in late 2017. Also, Saudi theaters, closed for several decades because the clerics forced them shut, are reopening. Again, baby steps, but undoubted positives.

[15] Gulf Cooperation Council: A political and economic union of the Arab states bordering the Persian Gulf and located on or near the Arabian Peninsula.
[16] Source: Bloomberg. Year-over-year real GDP growth, as of 12/31/17.
[17] Source: Ben Hubbard, David D. Kirkpatrick, Kate Kelly and Mark Mazzetti, "Saudis Said ot Use Coercion and Abuse to Seize Billions," The New York Times, 3/11/18.

THE CREDITWORTHY GULF

Figure 1 reveals a development that is particularly quizzical: The credit default swaps (CDS)[18] market is distinctly more positive on GCC nations than the stock market. In the table, we see the cost of insuring five-year obligations of various governments, with the U.S. and several emerging market nations presented to place the Middle Eastern nations in context.

The cost of default insurance for the U.S. is 0.20%, which means that an annual payment of $20,145 per year insures $10 million of U.S. Treasuries.[19] In GULF's case, A1-rated Saudi Arabia, Aa2-rated United Arab Emirates and Aa3-rated Qatar[20] combine to 70% of the WisdomTree Middle East Dividend Index, and they each have tame sovereign risk in the eyes of the CDS market. At 0.84%, 1.05% and 0.94%, they require annual payments of $83,893, $104,580 and $93,668 to insure $10 million in notional value of government debt, respectively.

FIGURE 1: 5-Year Credit Default Swaps Pricing

	Weight in WisdomTree Index	CDS	Cost of Insuring Sovereign
Saudi Arabia	25.57%	0.84%	83,893
United Arab Emirates	22.25%	1.05%	104,580
Qatar	22.22%	0.94%	93,668
Kuwait	13.41%	0.54%	54,130
Morocco	4.25%	1.17%	116,815
Egypt	4.06%	2.79%	279,385
Oman	2.88%	N/A	N/A
Jordan	2.77%	N/A	N/A
Bahrain	2.60%	2.60%	259,505
United States	N/A	0.20%	20,145
South Korea	N/A	0.56%	56,166
China	N/A	0.66%	66,082
India	N/A	0.70%	70,195
Indonesia	N/A	0.95%	95,259
Mexico	N/A	1.11%	110,892
Russia	N/A	1.25%	125,223
Brazil	N/A	1.72%	171,605

Sources: Bloomberg, WisdomTree. Data as of 2/9/18. WisdomTree Index is the WisdomTree Middle East Dividend Index. CDS is the five-year credit default swap USD, except for the U.S., which is in EUR. Cost of insuring sovereign is the annual cost derived from the CDS for insuring against the default of $10 million in principal. Data for Oman and Jordan unavailable. Weights subject to change.

For context, those CDS prices are a bit higher than for China, the largest of the so-called BRIC[21] nations, so the derivatives market views the gulf nations as riskier borrowers than Beijing. Those three nations are also considered a bit riskier than India, but safer than Russia and Brazil.

[18] Credit default swap: A swap designed to transfer the credit exposure of fixed income products between parties. The purchaser of the swap makes payments until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third-party debt if this party defaults on the loan.
[19] Source: Bloomberg, WisdomTree, as of 2/9/18.
[20] Source: Moody's, as of 2/12/18.
[21] BRIC: Term denoting four of the largest emerging market economies, specifically Brazil, Russia, India and China. This quartet is commonly cited in investing circles as being among the sizeable emerging market economies that some hypothesize will hold growing geopolitical and economic sway in the 21st century.

Looking at a few more sizeable emerging markets to confirm the standing of the gulf states in the credit markets, the big trio is considered riskier than South Korea, roughly equivalent to Indonesia and a little safer than Mexico. Kuwait, also a sizeable allocation in GULF, has CDS pricing that implies the sovereign is a safer credit risk than all of the emerging markets in the table.

And if sovereign credit markets are an indicator of potential equity risk in these frontier markets, we could argue that this particular region may be safer, in aggregate, than emerging markets.

THE YEAR OF ZAYED

While most nations bring in the new year with fireworks and champagne, the United Arab Emirates (UAE) superimposed an image of its founder on Dubai's 163-story Burj Khalifa. Zayed bin Sultan Al Nahyan's face appeared on the tower, reminding the public that 2018 marks his 100th birthday, making it the "Year of Zayed."

The UAE wishes to promote four values in 2018: wisdom, respect, sustainability and human development.[22] According to the state, the Year of Zayed "will involve people of all ages, nationalities, faiths and backgrounds in the UAE and internationally" to celebrate his vision.

The emirates have long been known as a place where Western expats have lived, worked and played in luxury, a luxury afforded by years of compound returns from what is now an $828 billion sovereign wealth fund.[23]

Meanwhile, the MSCI United Arab Emirates Index trades for 11.1 times trailing earnings, a 48.5% discount to the MSCI USA Index (P/E of 21.5). Additionally, the UAE has a dividend yield of 5.2%, a level that some may find appealing for stocks domiciled in a wealthy, Aa2-rated nation. UAE companies make up 22.3% of the WisdomTree Middle East Dividend Index.

BEING TRUE TO "GLOBAL"

A critical question for global asset allocators is "Just how global is 'global'?" As an industry, some portfolio objectives are to cover the total planet, with an index such as the MSCI All Country World commonly coming to mind as a benchmark in investment mandates.

The problem, of course, is that "All Country" does not mean "All Country." The way MSCI makes its Index, there is no exposure to Saudi Arabia, Kuwait, Morocco and many others. Then, of the Middle Eastern countries that are included, their percentages are just fractions of a percent, negligible even in sum. By leaving these economies out, "global" doesn't mean "global." Moreover, WisdomTree's Middle East Dividend Index has shown historic correlations to emerging, developed and U.S. stock markets of 0.64, 0.68 and 0.64, respectively, potentially aiding in diversification efforts.[24]

The total market capitalization of the WisdomTree Middle East Dividend Index is $752 billion, itself just a fraction of the $24 trillion value of the WisdomTree U.S. Earnings 500 Index of large-cap stocks. Trillions more sit in stock markets elsewhere. It would take just a fraction of the capital sitting in New York, Frankfurt or Beijing to move markets in the Mideast.

[22] Source: Official UAE government website for the Year of Zayed.
[23] The Abu Dhabi Investment Authority, as measured by the Sovereign Wealth Fund Institute, as of 2015.
[24] Monthly correlations with MSCI Emerging Markets, MSCI EAFE and the S&P 500, 6/30/08–1/31/18.

Maybe the Mideast benefits from implementation of the Chinese Belt and Road Initiative. Or maybe religious moderation takes hold and violence subsides. Or maybe none of that happens, and instead we just find the capital markets opening as the region diversifies from fossil fuels. However it unfolds, GULF could prove interesting for the independent and truly global investor who considers the global power chess game.

APPENDIX: Average Annual Total Returns as of 3/31/2018

			Market Price Return					NAV Return				
Fund/Index	Inception Date	Exp. Ratio	1-Yr.	3-Yr.	5-Yr.	10-Yr.	Since Fund Inception	1-Yr.	3-Yr.	5-Yr.	10-Yr.	Since Fund Inception
WisdomTree Middle East Dividend Fund (GULF)	7/16/2008	0.88%	9.49%	1.08%	6.87%	N/A	1.02%	9.78%	1.07%	6.46%	N/A	0.77%
WisdomTree Middle East Dividend Index			10.78%	2.82%	8.37%	N/A	2.43%	10.78%	2.82%	8.37%	N/A	2.43%
MSCI Arabian Markets ex Saudi Arabia Index			1.39%	-1.11%	3.54%	-3.44%	-3.38%	1.39%	-1.11%	3.54%	-3.44%	-3.38%

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com. WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

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There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. This Fund focuses its investments in the Middle East, thereby increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in emerging, offshore or frontier markets such as the Middle East are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. As this Fund has a high concentration in some sectors, the Fund can be adversely affected by changes in those sectors. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

The WisdomTree Middle East Dividend Index is a fundamentally weighted index that measures the performance of companies in the Middle East region that pay regular cash dividends on shares of common stock and meet specified requirements as of the index measurement date. The WisdomTree U.S. Earnings 500 Index is a fundamentally weighted index that measures the performance of earnings-generating companies in the large-capitalization segment of the U.S. stock market. The MSCI All Country World Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI Emerging Markets Index is a broad market cap-weighted index showing the performance of equities across 23 emerging market countries defined as "emerging markets" by MSCI. The MSCI United Arab Emirates (UAE) Index is designed to measure the performance of the large- and mid-cap segments of the UAE market. With 11 constituents, the Index covers approximately 85% of the UAE equity universe. The MSCI USA Index is designed to measure the performance of large- and mid-cap segments of the U.S. market. The S&P 500 Index is a market capitalization-weighted benchmark of 500 stocks selected by the Standard & Poor's Index Committee, designed to represent the performance of the leading industries in the United States economy.

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