First published in *Al Bayan* 4th July 1998

The UAE stocks, what is moving it? Where will it go next?

One cannot help notice the rapid rise in the UAE public shareholding companies shares. Share prices for companies with no history have doubled in a short period. Without any significant change in the fundamentals, share prices of certain companies have made dramatic movements overnight. The entire stock index is moving basically in one direction – up! What is making these shares move in this fashion? What is the story behind such frenzy that is occupying the minds of even high school dropouts?

This is what we will try to explore in this article. We will try to answer the above questions. We will look at some of the economic forces and the speculation that is pushing up the share prices in the UAE.

First, let us establish the economic parameters of the UAE share market. Here we see that in comparison to the available wealth, the total number of shareholding companies operating in the country is relatively small. In fact, the total capitalized amount in these shareholding companies is relatively insignificant as compared to the total wealth held by individuals and institutions. Furthermore, income from crude oil sales and from returns on foreign investments outpaces the investment opportunities that are created in the country each year.

On the supply side, other than the small number of shares that are traded in the market place, investors do not have much of an option to trade in other financial instruments. What is happening in the equity market is that a relatively large amount of investment funds are chasing a relatively small number of shares. That is, demand for shares are exceeding supply by a large margin.

Although the increases in the share prices seem to be across the board, nevertheless, some shares are not as much in demand as other shares. This means that prices of some shares tend to increase faster than other shares.

Why is it that demand for shares of certain companies are greater than that of other companies? There are several reasons for this. A list of factors that influence the demand and thus the relative prices of shares are given below:

1. Being a Dubai or Abu Dhabi based company makes a difference to an investor.
2. Companies in which either the Local or the Federal Government is involved, as one of the founding members, tends to do better than a company in which no such involvement is present.
3. When influential personalities participate in the equity of a company the relative demand for that company's shares to increases.
4. Having a select group of well-connected technocrats on the Board of a company helps push up the price of that company's shares.
5. Expectations that the government or the rulers would bestow favors on a public shareholding company in the form of land grants, job contracts, etc., or the actual granting of such favors lead to an increasing number of people demanding shares of that company.
6. Companies that are authorized to exercise monopoly power, and whose monopoly position is protected, whether in writing or not, attracts investors.
7. Shares of well-managed companies with strong fundamentals are always preferred.
8. The higher the expected dividends over a share's face value the greater the demand for that company's shares.
9. The more an investor wants to acquire control of a company the higher will rise the prices of that company's stocks.
10. Share prices of companies whose stocks are held only by a few conservative people who have a reputation for holding on to their stocks do not fluctuate as much as shares of companies that held by many investors and are traded all the time.
11. Rumors that an insider is buying shares of a particular company pushes up the prices of that company's stocks.

The above points are by no means exhaustive, but they do give investors and speculators a framework for operating in this market. Nevertheless, the above points are unable to explain why sometimes the whole market moves suddenly.

In countries where the capital market is sufficiently developed, a sudden jump in the market normally occurs when people's exceptions of economic performance are not in line with the actual performance. For example, if the market was expecting an inflation rate of say 6% for the past quarter, but inflation as measured and officially published was 4% then across the board the bond and stock prices would move up. This would happen because investors would expect an easing of the monetary policies. In other words they would expect the money supply to increase, which may involve pushing down the prevailing interest rates, and that would unleash a relatively more funds to chase the existing pool of stocks.

In the UAE, however, the reasons for sudden moves in the stock market are not based on this kind of misalignment between market expectations and actual economic performance. Here, the market tends to be less informed about economic performance. The reason is that economic statistics are not released in a timely fashion for investors to take appropriate investment decisions. Nevertheless, in the UAE, as in any other country, sudden jumps in the stock market have to do with increases in the total liquidity.

Liquidity increases may occur in any of these several ways. If individuals or institutions in the UAE liquidate their foreign investments and transfer the proceedings into this country then domestic liquidity will increase. Any money laundering activity that passes through a UAE washing machine will also have the effect of increasing domestic liquidity. Furthermore, a reduction in the amount of remittances by guest workers, flight of funds from other countries into the UAE, or foreign direct investment into the UAE would all help to increase domestic liquidity.

The above sources of liquidity are, however, applicable to all countries. It is mostly uncontrollable. Normally central banks cushion the adverse effects of such liquidity bursts by resorting to appropriate monetary policy tools. With respect to the UAE, however, it is not clear whether the UAE Central Bank applies such monetary policy tools to control the adverse effects of excess liquidity in the system. But this does not mean that excess liquidity is not siphoned out of the system by commercial banks to a limited extent. The way the commercial banks do this is by converting their Dirham deposits to US Dollars or other currencies and transferring the funds out to another country. Nevertheless, most of these commercial bank conversions are linked to time deposits rather than demand deposits. That is why the commercial banks can cushion the adverse effects of sudden liquidity jumps only to a limited extent.

Having a relatively small equity market with limited opportunities for short-term investments, a little increase in the domestic liquidity could push up share prices relatively fast. Take for example the recent hike in the domestic share prices. What could have caused this hike? Oil prices are on the decline, the government did not publish any significant economic data, Abu Dhabi government announced a moratorium on new construction of buildings because of over supply, no major new projects were announced, but yet, stock prices went up, not a little, but significantly. Why?

It must have gone up because of an increase in liquidity, but where did the money come from. Could the UAE Central Bank be printing money? The answer is, most probably not. Could it have come from some external sources? Here, the answer is a strong, may be. But, if the liquidity originated from an external source then the next question is, from where?

In the period just before the hike in the UAE stock prices Pakistan froze all hard currency accounts. A fixed conversion rate was set to allow the account holders convert their foreign-exchange holdings into Rupees. This action lead to a loss of confidence in the Pakistani government. Depositors feared that the Rupee would further depreciate in the black market, and if so, the fixed conversion rate that the Pakistani government was offering would not be attractive in the long term. These depositors therefore converted their foreign currency holdings to Rupee at the fixed rate to immediately reconvert them into foreign currencies at the black market rate. The hard currencies thus acquired in the black market were then transferred to third countries using illegal channels (the havala). Even though the depositors incurred heavy losses in these conversions, in their view, having a foreign currency account in a more stable country was less risky than keeping their funds in Pakistan with the option of converting them into Rupees only at a fixed rate.

The UAE has strong links with Pakistan. A large number of Pakistani guest workers and businessmen live in the UAE with their families. Given the historical links, Pakistani familiarity with the UAE, and the UAE's short geographical distance from Pakistan, it will not be surprising to see that a large amount of these fleeting funds make their way into the UAE. If so, then it would not be surprising if a good proportion of these funds also make their way into the UAE's equity market.

But wait a minute, somebody might say. The UAE equity market is only for the UAE citizens, isn't it? To that, I would answer, may be, but aren't some banks operating the local equity funds that are not limited to UAE citizens only? Of course, the answer would be yes. Since both UAE citizens and non-citizens can buy into these funds, the fund is a funnel for investing foreign funds into the UAE equities. In addition to these funds, the UAE also seems to be full of unscrupulous citizens who would make quick buck for anything. These citizens normally invest on behalf of non-citizens in the equity market for a miniscule commission.

Therefore, could these fleeting funds from Pakistan explain the recent hike in the UAE stock prices? The answer is, to a certain extent because there are other explanations as well.

The testing of the nuclear bombs in the subcontinent raised an aura of economic instability in the affected countries. Western countries denounced the tests and announced a cut off of financial help to these countries. In some cases, unilateral trade sanctions were also applied to the two belligerents. All this implied that the two subcontinent economies were poised for a period decline and suffering.

A message this strong would definitely affect the economic behavior of non-resident subcontinent workers living in the Gulf countries. It would be plausible to assume that some of these non-resident workers would cut-down on the remittances that they normally make to their countries. The workers would have two reasons for cutting down on their remittances. The first reason is based on their expectations that the their home currency would continue to depreciate in the future, therefore, it is rational to maintain a larger saving in the country of residence rather than in the home country. The second reason is based on the expectations that a recession in the home country is enviable and this means fewer good investment opportunities in the home countries.

A reduction in remittances of non-resident workers in the UAE would mean an increase in domestic liquidity. Again, it is quite plausible that a portion of this increased liquidity finds its way into the UAE equities market.

Given that the UAE stock market is relatively small, liquidity increases from the above sources could significantly push up the market as a larger pool of funds seek a relatively small pool of stocks. An increase in the equity prices would in turn attract more speculators onto the bandwagon. This would further push up domestic share prices.

If we assume the validity of the above scenario then how stable is the UAE's stock market? The answer is, not very stable. The reason is that funds thus acquired are not destined to stay in the market. These are only temporary phenomena. An economic improvement in the home country, or a return of confidence in the home government, or a departure of the respective guest workers could trigger an outflow of funds as easily as it allowed its inflow. Therefore, investors should always be wiry about their exposure in the stock market whenever such a phenomenon occurs.

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