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Dow Jones Islamic Markets in February: Lessons from the turmoil

By Gérard Al-Fil

It is of no surprise that the Dow Jones Islamic Market Index (DJIM) covering Arab stock markets suffered the largest losses in February. Political crisis and civil unrest in Egypt, Jordan, Bahrain, Yemen, Morocco, escalating even to a civil war like in Libya, weighed on the markets. The turmoil led the DJIM Kuwait Index to drop 8.64% to close at 908.36 (as of February 22's close of trading). The DJIM Gulf Co-operation Council (GCC) Index finished down 5.03% at 1293.33 and the DJ Dubai Financial Market (DFM) Titans 10 Index lost 4.83%, closing at 1,977.82. These declines stand in stark contrast to the rise in energy prices, which usually lift Middle Eastern markets. The DJIM Oil and Gas Index (up 4.17 at 4096.17) posted the largest gain among the Shari'ah-compliant Dow Jones sector benchmarks. Meanwhile, analysts and bankers debate whether current trading levels mean buying opportunities. "Valuations at Gulf Arab markets are cheap, but international investors nowadays avoid the region," says Gary Dugan, Chief Investment Officer & Acting General Manager, Private Banking, at Dubai-based Emirates NBD, the Middle East's largest bank as measured by assets. "Based on this, we advise our clients to be cautious during the next three to five months."

In 1995, derivatives broker Nick Leeson toppled Barings Bank by covering losses when trading at Singapore's SIMEX. One of his mistakes was betting on a quick recovery of the Tokyo Stock Exchange after Japan was hit by an earthquake in Kobe on January 17, 2005. But Leeson was wrong. Markets, indeed, fell further. Barings went bankrupt under losses of US$1.4 billion and London's oldest merchant bank was eventually bought for the symbolic price of £1 by The Netherland's ING Group. Thus, the rule "Never catch a falling knife," -- meaning, do not buy stocks when prices haven't stabilized -- applies. Under Islamic, or Shari'ah, law, using derivatives is judged as gambling or *Qimar* and banned.

Another lesson of the ongoing turmoil in the Middle East and North Africa (MENA) for Western investors is that Islamic finance is not solely focused on the Middle East. In fact, 99% of all stocks in the DJIM universe are located in non-Muslim countries. The DJIM Thailand Index, for example, was the top gainer in February, closing 5.25% higher at 1811.50. It was followed by the DJIM Turkey Index (up 4.64% at 3792.64 and the gateway to Europe for Islamic finance),and the DJIM Indonesia (gaining 2.33% at 1438.88). As a direct comparison, the conventional U.S. Dow Jones Industrial Average advanced 2.70%, ending at 12212.79. Western trading had a strong start in 2011, raising fears that an overheating market will push up commodity prices, leading to rising interest rates in 2011. For the coming months, Emirates NBD's Dugan recommends a shift from equities to bonds of high quality.

In order to invest in interest-free Islamic bonds, or Sukuk, fund managers have been using the Dow Jones Citigroup Sukuk Fund as a benchmark since 2007. This index, which tracks only US-Dollar denominated Sukuk with investment grade, dipped 0.62% to close at 126.29 in February. Among the sector indexes, the DJIM Financials Index (down 2.46% at 811.86) was the main losing composite last month. Islamic insurers, known as Takaful operators, in particular suffered losses as the default risk increased in the MENA-region due to ongoing turmoil. On

February 22, the Dow Jones Islamic Market Indexes series launched the Dow Jones Islamic Market Global Finance & Takaful Index, which measures the performance of financial services stocks that pass rules-based screens for Shari'ah compliance. Eligible companies are banks, insurance and financial services companies. Included in the index are those stocks that pass financial ratio screens that are less than 33% in total debt, divided by trailing 24-month average market capitalization. Financial firms with excessive high-cash ratios are also banned from the index. Although staying liquid for any buying opportunities, Islamic finance denies hoarding money rather than investing it. Regarding equity investments for the coming months, Emirates NBD's Dugan recommends carefully building up positions in the health care and technology sectors, as both segments advanced in the past during rising inflationary periods. Both sectors are covered by DJIM industry indexes as well.

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