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DUBAI DELIVERS PHANTOM PUNCH

While investors were coasting towards an overwhelming victory for stocks this year, out of the blue comes a "phantom punch" from Dubai when it announced that it is suspending debt payments of Dubai World.

The government of Dubai has asked creditors for a six-month standstill on Dubai World's debt obligations until at least May 30, 2010. Dubai World's property arm, Nakheel is due to redeem $3.5 billion next month.

Obviously, the announcement of delay of debt payments of is being seen as a prelude to a forced restructuring of Dubai World's estimated $59 billion in liabilities. This has caused a re-pricing of risk both in and beyond the Gulf.

Flight to safety

Globally, financial markets took a hit across the board last Thursday after Dubai World's announcement. Stock markets, especially those in Europe, had their biggest one-day declines since April. Emerging market bonds dropped and even commodities faltered as global investors moved money out of risky assets and into safe havens such as the yen, US treasuries and German bonds.

The yen rose to a fifteen year high 84.82 against the US dollar on Thursday. The yield on two-year US Treasuries fell 9 basis points to 0.65 percent, its lowest level this year. Meanwhile, the yield on the 2-year German bond fell 9 basis points to 1.26 percent, its lowest since April.

Excess and froth

Dubai World is by its own description Dubai's "flag bearer in global investments." It is a sprawling holding company, wholly owned by the city state's government, with interests in real estate, transportation, logistics and natural resources.

Dubai World's Nakheel develops residential, commercial and leisure real estate. It is the master developer of The Palm Trilogy, The World, and other projects that have made Dubai synonymous with grandiose, excess and froth.

"The World," for example is a development of 300 islands in the shape of the world's continents, being created off the coast of Dubai. The Palm Trilogy refers to three man-made islands (Palm Jebel Ali, Palm Jumeirah, and Palm Deira) shaped like palms.

European banks most exposed

European banks are said to have the biggest exposures in Dubai as well as the rest of the UAE. According to the Bank for International Settlements, foreign banks have USD 123 billion of claims against UAE as of June 2009. European banks account for 72 percent of

the total or USD 88 billion. UK banks account for 41 percent, while US and Japanese banks account for 9 percent and 7 percent of the total, respectively.

While most banks do not disclose exposure by country in the Middle East, a document published by the Emirates Banks Association mentions the top foreign banks by lending loan exposure to the UAE (see table).

Foreign Banks Loan Exposure in the UAE

	USD bn	% of total loans
Standard Chartered Bank	7.8	4.20%
HSBC Bank Middle East Ltd.	17.0	1.80%
Barclays Bank Plc	3.6	0.50%
Citibank N.A.	1.9	0.30%
ABN-Amro Bank N.V.	2.2	0.20%
BNP Paribas	1.7	0.20%
Lloyds TSB Bank Plc	1.6	0.10%

Source: BNP Paribas, Emirates Banks Association

But their exposures, while large in some cases, appear to be manageable when considered as a percentage of total loans, according to a study by BNP Paribas. Given these numbers, Standard Chartered appears to be the most affected by the situation in Dubai. HSBC is too large a group for the exposure to be worrisome.

Philippines' exposure

Fortunately for us, there is very minimal exposure, even none at all, as far as local banks are concerned. However, those likely to be affected are the overseas workers, especially those in the Gulf region. This is very significant because in 2008, 51 percent of OFWs deployed went to the Gulf region. UAE accounted for 19.9 percent of total OFWs deployed in 2008. UAE also experienced the biggest increase in deployment, up 60.6 percent in 2008.

Dubai's financial problems will likely result in lower risk aversion and less capital flows into the Gulf region. As a result of the reduction in financing, the demand for Filipino workers will likely be cut, especially those in the infrastructure and construction sectors. Thus, remittances coming from the Gulf region may slow down.

A black swan?

People have short memories. In just one year, it seemed that the worst bear market in history is so far behind us. Dubai's financial woes, however, reminds us that things may happen unexpectedly. In the worst case, one cannot rule out a "black swan" scenario where this would escalate into a major sovereign default, which would resonate across global emerging markets in the same way Russia did in the 1990s or Argentina in the early 2000s.

The greatest danger is contagion to other countries whose fundamentals are weak, such as Greece, Latvia, Hungary and Vietnam. It is similar to the way Kazakhstan allowed its

banks to default. Vietnam, last week, devalued its currency because of unsustainable budget and trade deficits.

This is a warning to the Philippine government in 2010. While the Philippines does not have a current account deficit because of OFW remittances, it has to address its ballooning budget deficit.

Deep correction, a buying opportunity

The market has not had a deep or substantial correction since the March lows. We've had several shallow pullbacks so far, but none that is substantial enough. If a substantial correction happens, this will be seen as an opportunity to invest the market.

A problem in Dubai is not the same as a problem in the US or China. The suspension of Dubai World's debt payments is a major event, but it is not in the same magnitude as the US subprime and credit crisis. It will be totally different if it will be the US or China that will have a liquidity crisis. That is why a correction, caused by this Dubai debacle, must be seen as a buying opportunity.

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