CHAPTER

INTERNATIONAL ECONOMIC DEVELOPMENTS

This chapter describes major developments across the main global economic blocks in 2019, as well as the economies of Timor-Leste's principal Trading Partners, together with the most relevant international trends in global financial markets for our economy.

Based on this assessment, the chapter further looks into the main transmission channels of external developments to our domestic economy, detailing the influences observed in 2019 and the prospects expected from 2020 to 2022. Given the current importance and the serious impacts of the new coronavirus economic crisis, this chapter already includes a first assessment of the international economic impacts, based on the IMF's latest world economic outlook, published in April of 2020.

1.1 Major World Economies

1.1.1. Economic Growth in Major World Economies

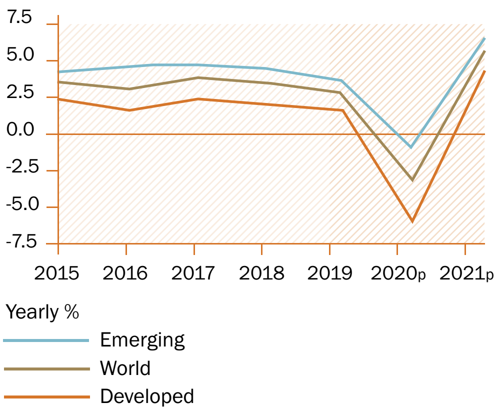
In 2019, global economic growth (3%) registered a slight slowdown compared to the previous year (3.6%), continuing the cycle of growth and recovery from the global financial crisis of 2008-2009. This slowdown was due to the slowing growth in developed economies, which should only grow 1.7% in 2019 compared to 2.3% last year, as well as in developing economies, which are expected to grow 3.9% compared to 4.5% 2018.

In view of the impact of the Covid-19 crisis, the IMF - in its April 2020 World Economic Outlook - has substantially revised its growth forecasts for 2020, now expecting the world economy to decline by - 3% this year. It should also be noted that the growth projections for 2020 are worse for Developed Countries (-6.1%) than for Developing Economies (-1.1%). The IMF further expects a marked recovery in growth in 2021 in global terms and in the 2 main blocs, forecasting a complete and relatively short recovery from the recessive levels of 2020.

The world economy continued to expand in 2019, despite a slight slowdown in growth rates.

Chart 1.1

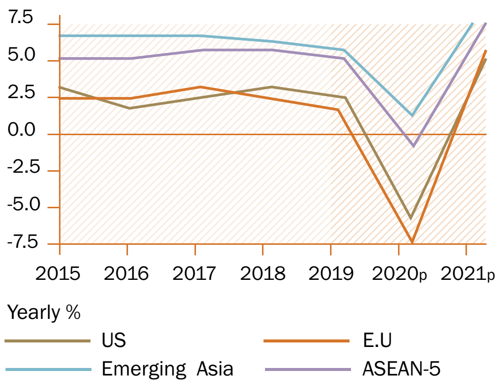
GDP Growth - 3 Major Blocks



Source: IMF WEO, April 2020

Chart 1.2

GDP Growth - Selected Regions



Source: IMF WEO, April 2020

Global growth perspectives for 2020 are now substantially negative, due to the Covid-19 crisis impact.

ASEAN economies have also maintained a robust growth level in 2019, but they will also be severally affected by the new coronavirus crisis in terms of 2020 economic growth.

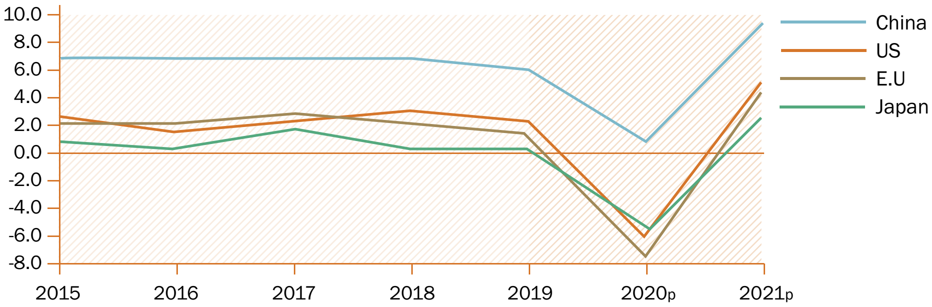
Regionally, Asia has continued to lead in terms of GDP growth (5.9%) in 2019, despite the slight slowdown compared to 2018 (+6.4%). Growth in ASEAN's five largest economies amounted to 4.8% in 2019, representing a slight reduction in the rate over the previous year (5.2%). Growth in the US (2.4%) in 2019 was again higher than in the European Union (1.5%), but both economies expanded less when compared to +2.9% and 2.2% recorded in 2018.

Despite their greater resiliency, Asian economies will also be negatively affected by the Covid-19 crisis in 2020. However and for 2021, the Fund anticipates a substantial economic recovery across the Asian economies, in line with its global optimism for that year.

Chart 1.3

GDP Growth - Top 4 World Economies

Yearly %



Source: IMF WEO, April 2020

In terms of the 4 major world economies' performance - the US, EU, Japan, China – it should be highlighted that China recorded a further slight slowdown in growth in 2019 (6.1%), and should continue to exhibit a gradual and slight deceleration in the medium term. Japan continued to record GDP growth levels well below those of the US and EU, growing only 0.9% in 2019, compared to 0.8% 2018.

In terms of the impacts of the new coronavirus, the Fund expects the US, EU and Japan economies to be significantly more affected than China in 2020, but anticipates a substantial and synchronized growth pickup in the top 4 world economies in 2021.

1.1.2. Inflation in Major World Economies

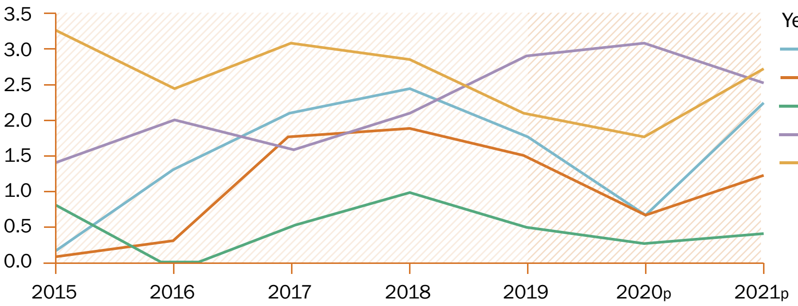
In 2019 there was an easing of inflationary pressures in the major economies, reversing the upward trend observed since 2016.

Inflationary pressures were down in 2019....

The US closed the year 2019 with an inflation rate of 1.8%, below the official FED's reference and 2018's inflation of 2.4%, which allowed the FED to cut its reference interest rates in 2019 to mitigate growth risks amidst the worsening of trade tensions between the US and China. On the other hand, the EU and Japan recorded inflation rates of 1.5% and 1% in 2019, which also represented a decline in the case of the EU, which had registered inflation of 1.9% in 2018.

Chart 1.4

Inflation Rates - 5 Selected Economies



Source: IMF WEO, April 2020

The inflation slowdown resulted mainly from the lagged impact of interest rates increases in most world economies until the end of 2018 and the economic slowdown in 2019, driven mainly by rising trade disruptions worldwide. The decline in inflation was also influenced by the slight decrease in the general price of 'commodity' throughout the year, particularly food prices.

.... due to the slowdown in global economic growth and price restraint in international commodity markets.

The IMF now expects inflation rates to slowdown in the main world economies in 2020 in line with the negative growth performance, which should then be followed by a pickup in inflation in 2021, due to the strong resumption of growth across the main economies in that year.

It is also interesting to note that the IMF continues to expect that the Japanese and EU economies will continue to record lower inflation rates than the US, given the existence of “space” in terms of resources not employed in these economies, which continue to operate below their potential levels. However, despite the economic recovery in the EU and Japan in recent years, both economies will need to continue to grow robustly for several consecutive years so that they effectively close the gap in terms of economic resources’ employment and substantial inflationary pressures are again materialized in these economies.

1.1.3. Global Commodities Markets

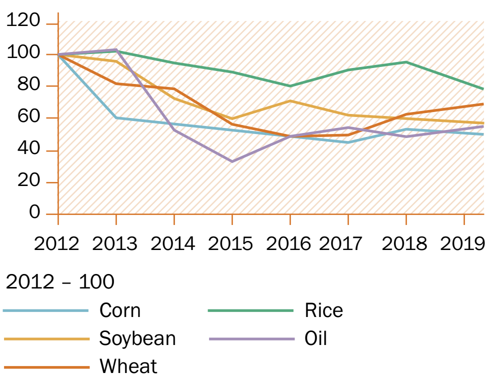
Commodity prices recorded mixed changes in 2019.

Commodities recorded mixed price changes in 2019, but crude oil (Brent reference) rose 17%. This increase lent further support to the ongoing recovery trend, recorded since the prices of these items touched multi-year minimum levels in 2015/2016.

For the exporting economies of these assets, typically developing countries, the evolution of international prices translates into a significant fluctuation of their external income and consequently their economies.

Chart 1.5.1

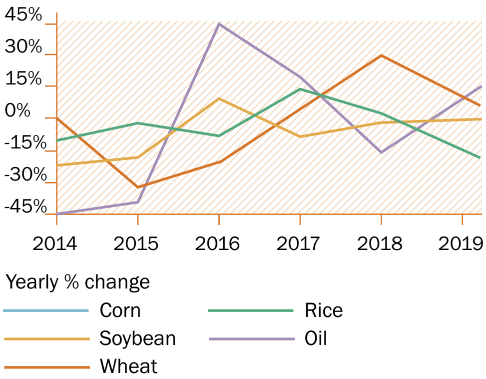
Major Commodities Prices



Source: World Bank

Chart 1.5.2

Major Commodities Prices



Source: World Bank

1.1.4. Major Global Financial Markets

In terms of financial markets, we begin by analyzing trends across major bond markets, particularly those of Treasury bonds, which allow us to assess trends and changes, as well as expectations, of monetary policies, economic growth and inflationary pressures of the various world economies.

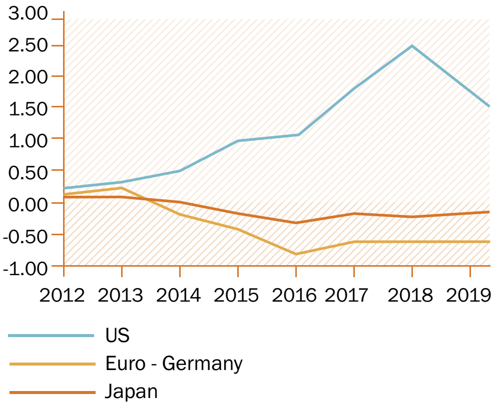
The 2-year interest rates, more sensitive to monetary policy changes, recorded a significant decrease in 2019, especially in the US market. This development resulted in the reversal of the interest rate hike cycle observed since 2013 in the US market, brought by the FED's multiple interest rate cuts decided in 2019, following the central bank's growing concerns over the unfavorable economic impacts of higher trade tensions with China. The dollar's 2-year interest rate declined from 2.49% to 1.57% at the end of 2019.

2 Years interest rates declined significantly in the US market, in line with the fall in FED's interest rates ....

However, in both 2 and 10-year terms, US interest rates remained at levels well above those recorded in Eurozone and Japan, as a result of the superior economic performance of the US economy in recent years and the FED's past interest rate hikes, implemented between 2013 and 2018.

Chart 1.6

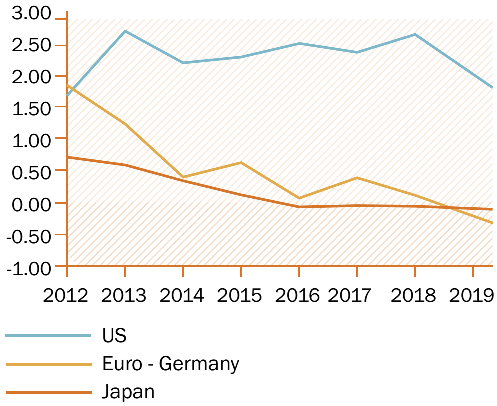
2-Year Interest Rates %



Source: Bloomberg

Chart 1.7

10--Year Interest Rates %

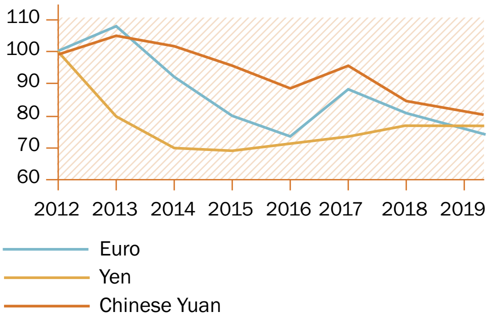


Source: Bloomberg

Naturally, bond market developments, together with the referred above economic developments, have also determined much of the developments in major and global currency and equity markets.

Chart 1.8

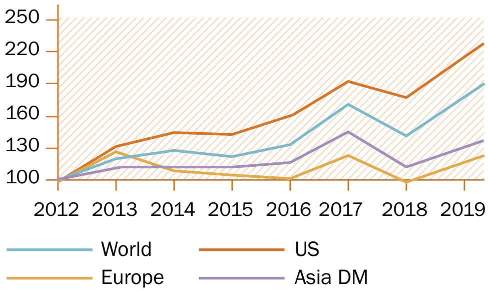
Major Currencies vs USD. 2012=100;
Decline corresponds to depreciation



Source: Google Finance

Chart 1.9

Stock Markets, USD prices
2012=100



Source: Google Finance

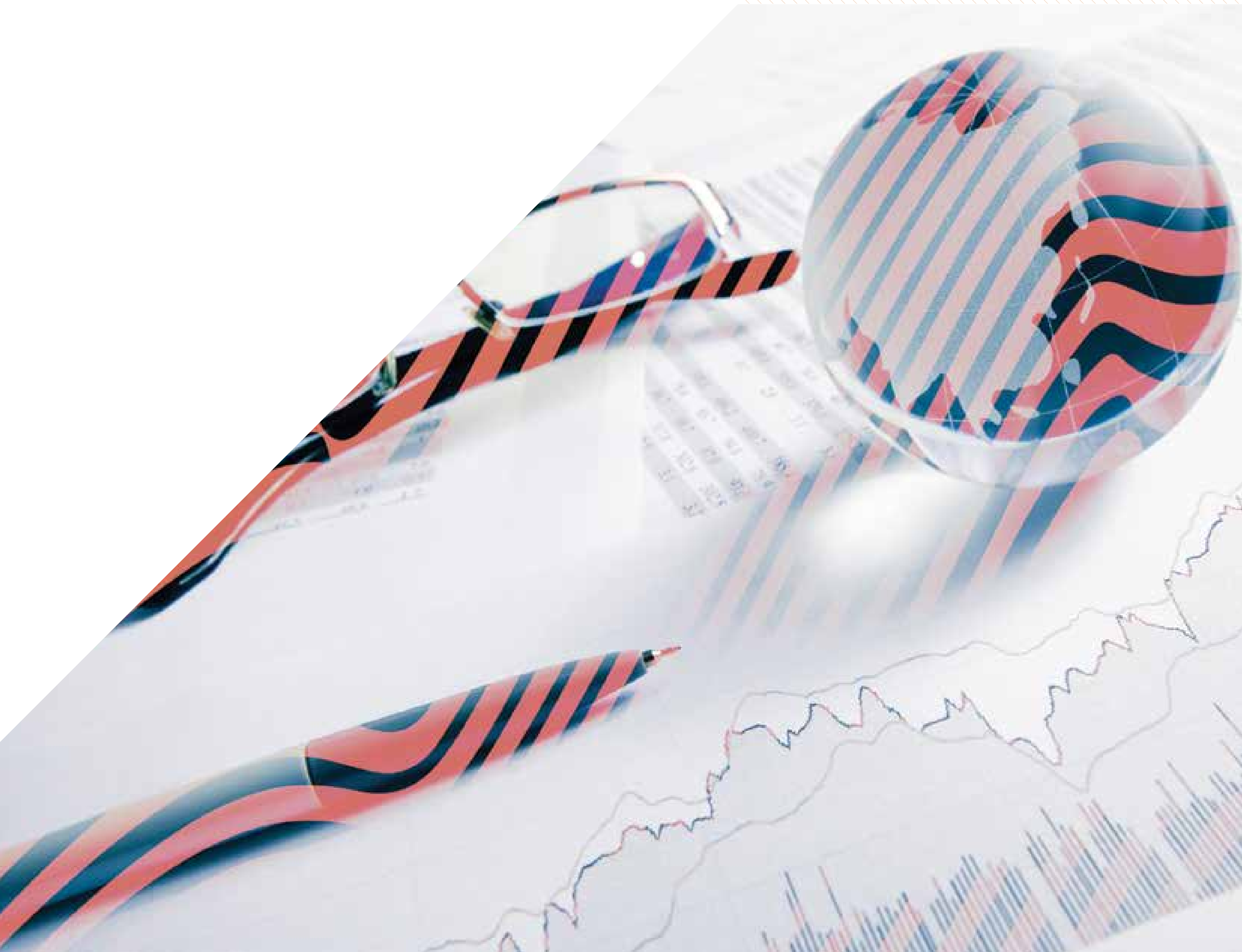
.... but the dollar appreciated slightly against major world currencies.

With the exception of the yen, the dollar appreciated slightly against major world currencies in 2019, which resulted from the continued divergence in terms of interest rates, despite the FED rate cuts, and from the outstanding US economic performance.

The main global stock markets recorded considerable gains in 2020, continuing the upward trend observed since 2009.

In equity markets, 2019 was marked by the general recovery of the major world markets, supported by the implementation of monetary policy support measures in virtually all geographies and the reduction of global trade tensions, especially at the end of 2019, with the increasing expectation of completion of the first phase of the trade agreement between China and the US. In terms of performance, the US market continued to lead, recording a gain of 28% in 2019, despite the remarkable performance of the European market (+ 21%) and developed markets in Asia (+ 15%). The overall market rose 24% in 2019. These increases have enabled equities to completely recover from the losses experienced in 2018.

As can also be observed in chart 1.9, the US equity market far outpaced the performance of other global markets in the last seven years and benefited from the higher strength of the US economy and the recent approval of substantial fiscal stimulus. In view of the remarkable performance of US equities over the last ten years, which resulted in the substantial appreciation of stock prices' ratios to corporate earnings, it should be noted that a possible economic slowdown in the US economy or an eventual corporate earnings underperformance could trigger a correction in this equity market.



1.2 Asian Economic Developments

After summarizing the broad global macroeconomic developments, it is important to deepen the assessment of economic developments across the Asian space, in particular ASEAN, as the main economic partners of Timor-Leste are located in this region. Our analysis focuses on the five major economies of ASEAN and China, whose economy has increasingly more global and regional relevance. In turn, from these six economies, Indonesia continues to be Timor-Leste's main commercial partner, which justifies some further specific comments on its economic developments.

ASEAN's economic growth remained robust in 2019 ....

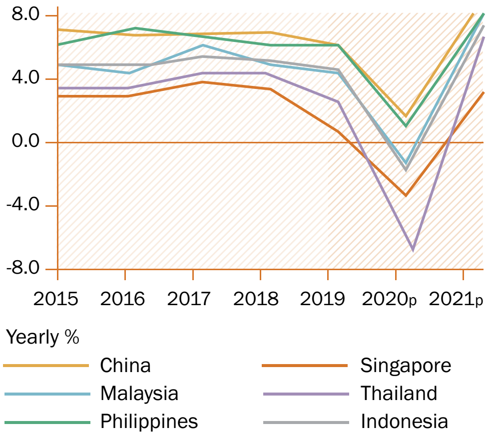
In terms of the two main macroeconomic indicators, GDP and inflation rates, growth levels remained robust in the region in 2019, with the average rate of growth standing at 4.1%. Nonetheless, this translates to a renewed slowdown when compared to the average growth rates of 5% and 5.3%, recorded in 2018 and 2017 respectively.

In terms of prospects, in light of the impact of the new coronavirus crisis, the IMF now expects a substantial drop in economic activity levels across the region in 2020, especially in Thailand, Singapore and Malaysia, which are expected to face recessions in this year. In line with its global optimism for 2021, the Fund then expects a marked resumption of growth across all Asian economies, predicting a complete recovery of the ground lost in 2020.

With regard to inflation, prices in the region rose by 1.8% on average in local currency terms, which translates into a slowdown from the 2.2% of 2018, while the Philippines' economy recorded the stronger disinflation in 2019. Despite the strong decline in inflation seen in Indonesia since 2015, this economy continues to register the highest inflation levels in the region, or 3.2% in 2019.

Chart 1.10

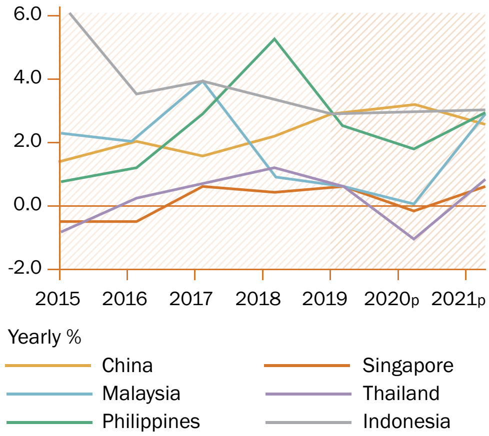
GDP Annual Growth



Source: IMF WEO

Chart 1.11

Inflation Rate



Source: IMF WEO

The slight slowdown in economic growth in the region in 2019, more moderate inflation rates in the various economies and the slight average depreciation of regional currencies against the dollar, explained in turn, the fall of regional inflationary pressures, as measured in US dollar terms.

.... while regional inflationary pressures trended lower.

These macroeconomic drivers explain, and are also explained, by the developments in two main financial markets, the foreign exchange and bond markets. In currency markets, 2019 was marked by a slight depreciation of the Asian currencies against the dollar, with the Chinese, Malaysian and Singaporean currencies recording stronger falls in the region. Note, however, that the Thai baht appreciated versus the US dollar and that the Indonesian and Philippines' currencies remained broadly unchanged.

Regional currencies recorded a slight depreciation against the USD in 2019 ....

The IMF also expects that most regional currencies will remain relatively stable against the dollar between 2020 and 2022, which will contribute, if materialized, to stabilize inflationary pressures in the region and, above all, to stabilize prices of Timor-Leste's imported articles. It should be noted, however, that this exchange rate stability scenario can be materially affected in the context of the of the new coronavirus crisis, especially if the impacts are to be more profound and lasting than those predicted by the IMF.

Chart **1.12**

Exchange Rates vs USD

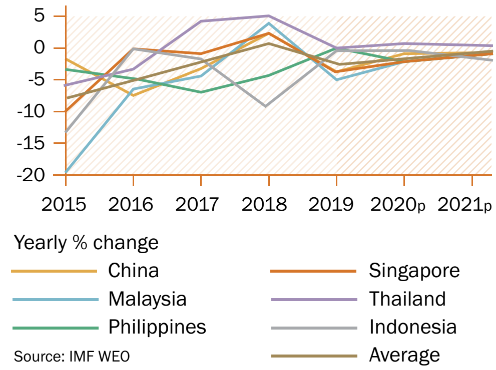
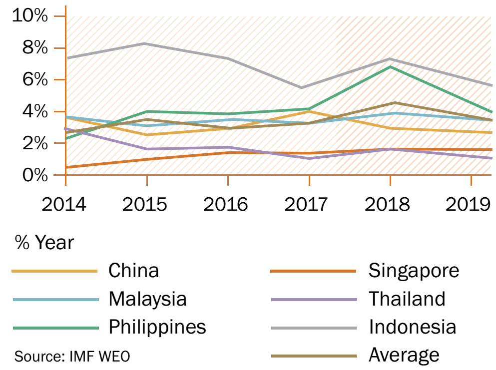


Chart **1.13**

2-Year Interest rates



.... with 2-year interest rates falling in line with the US market developments.

Bond markets' interest rates, here represented by 2-year interest rates, registered notable declines in 2019, as the average rate declined from 4% to 3% over 2019, tracking the aforementioned reduction in USD interest rates. It should also be noted that despite lower Indonesian and Philippines interest rates in 2019, these remain the highest in the region, standing at 5.8% and 4.1% in December of 2019.

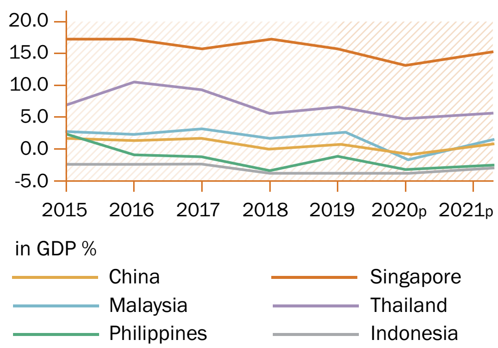
Regional external accounts remained in surplus, with the exception of Indonesia and the Philippines.

In terms of external accounts, most external partners continued to maintain substantial surpluses in 2019, except for the Philippines and Indonesia, which had external deficits of -2.9% and -2% of GDP in 2019. As Indonesia is a significant exporter of raw materials, especially of energy products and industrial metals, the decline in international prices of these "commodities" in the last five years has resulted in a substantial negative shock to its economy, requiring stronger restrictive macroeconomic policies to contain the dynamism of domestic demand, correct the external deficit and contain the depreciation of the rupiah against the dollar. The IMF still expects the economies of the region to record, on average, positive external balances in 2020 and 2021, anticipating however a deterioration of regional external balances in 2020, due to the Covid-19 crisis.

In terms of budgetary balances, 2019 was characterized by the maintenance of public deficits in this region, after the deterioration of fiscal positions recorded in both 2016 and 2017. In 2019, the two more extreme situations in the region were: Singapore, with a 4.3% fiscal surplus over GDP; and China, whose public deficit amounted to -6.1% of GDP in 2019. The IMF also expects that the virus crisis will substantially weaken the public deficits across the region in 2020, given the negative economic performance and economic support policies implemented to address this situation.

Chart 1.14

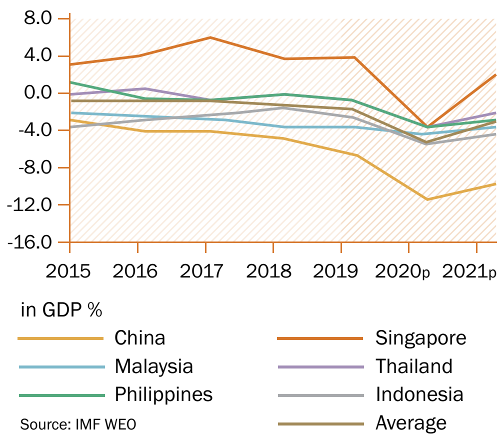
External Current Accounts



Source: IMF WEO

Chart 1.15

Public Sector Balances



Source: IMF WEO

Overall, the region's economies continue to be stable and robust in 2019.

In short, the regional macroeconomic background remained broadly stable in 2019, which underpinned the stability of most regional currencies against the dollar. Despite the recent and gradual deterioration of public balances in the region, the continued positive external surpluses still confer a substantial margin of adjustment for most countries in the region, in case they are faced with any unforeseen shock to their economies.

Note, however, that this general framework does not apply completely to the Indonesian economy, the largest trading partner of Timor-Leste. the Indonesian economy managed to grow substantially by 5% in 2019, compared to 5.2% in 2018 and 5.1% in 2017, despite experiencing past levels of notable exchange rate volatility and the mentioned above sizeable external deficit. Also on the positive side, the Indonesian rupiah remained broadly stable against the dollar in 2019, after recording substantial losses in 2018 and between 2013 and 2015.

The importance of this trading-partner to our economy implies of course the need to adequately monitor these developments, hoping that the continuity of the policy measures introduced by that Government and a tighter surveillance by its central bank will continue to gradually reduce the respective macroeconomic risks. This concern assumes now a greater priority, given the negative impacts of the corona virus crisis.

1.3 Timor-Leste's Economic Transmission Channels

1.3.1. Summary

The above review of major international economic and financial developments as well as of Asian economic developments, which are much more relevant for Timor-Leste, would not be complete without understanding the respective repercussions on our economy.

This point tries to identify the main channels of transmission of the international developments to our economy. At present, it is reasonable to accept that these effects are still small and limited to certain sectorial aspects of our economy. This chapter seeks to illustrate the mechanism of operation of the main channels, specifically: the impact on domestic inflation levels, influence over oil revenues and effects on the Petroleum Fund's investments valuations. Foreign Direct Investment is certainly one of the variables most influenced by the external context, but the scarcity of effective investments and reliable data in Timor-Leste does not allow us to analyze this relationship properly.

Naturally, as our economy develops and effectively deepens interdependence relations with its regional economic partners, we expect that external developments will increasingly shape developments in our domestic economy, expanding the number and influence of the various transmission channels.

1.3.2. Imported inflation

One of the main transmission channels for our economy is in fact the impact of international prices on domestic inflation developments and respective expectations. Since Timor-Leste is a major importing economy - imports of goods and services accounted for 60% of non-oil GDP in 2018 - it is only natural to expect that international prices of imported goods and services will continue to substantially affect domestic inflation developments.

BCTL's empirical research and economic modeling has confirmed the importance of this channel. One of the main issues of our work in this context stems from the difficulty in defining an appropriate variable to measure the level of "external inflation" for Timor-Leste, given the absence of an import price index and the large variability of import basket and of the geographical structure of our imports. After experimenting with several functional forms for this variable, we concluded that the most appropriate empirical variable seems to be an average of the inflation rates of the 5 largest economies of ASEAN and China converted into dollars. In practice, this measure corresponds to an average of the regional inflation rate measured in dollar terms, which at the same time captures the impact of regional exchange rate variations against the dollar and local currency inflation rates.

BCTL's inflation model is based on two key drivers: domestic economic performance and average inflation rates across the Asian region.

As can be seen below on the chart on the left, domestic inflation tends to reasonably track the movements of foreign inflation rates, albeit with lower volatility. To the extent that the external inflation rate is the average of six economies already mentioned, the BCTL's inflation forecasting models use this variable and respective expectations to construct inflation forecasts.

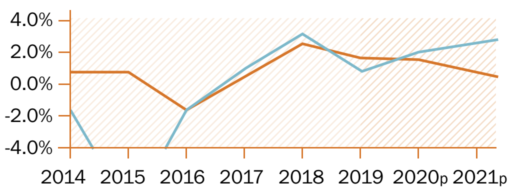
Foreign inflation rate has driven Timor-Leste inflationary developments ....

As can be concluded from the two charts, the recent inflation rises in Timor-Leste (2017 and 2018) was positively influenced by the pickup in foreign inflation rates. Of course, the relationship is not perfect, since the evolution of the non-oil economy of Timor-Leste, especially over the past few years, also strongly affects the domestic inflation's developments.

... as the 2017/2018 inflation pickup has been in line with the rise in external inflation.

Chart 1.16

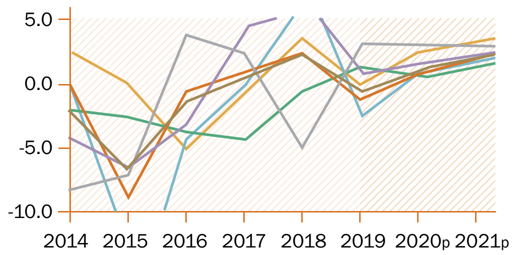
Domestic vs External Inflation



Source: DNE and BCTL calculations

Chart 1.17

Regional Inflation Rates in USD terms



Source: IMF WEO

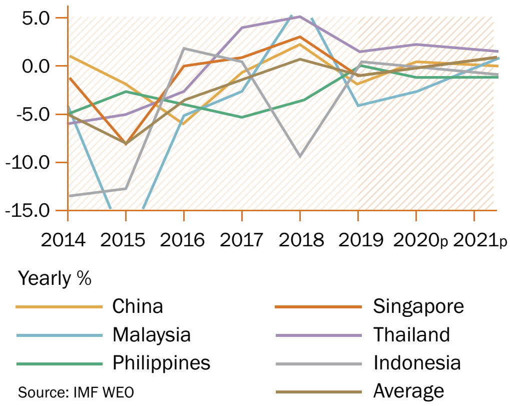
The decline in regional inflation rates in dollar terms in 2019, was mostly due to lower inflation rates in local currency terms of the various trading partners.

In 2019, the slight decrease in regional inflation rates in dollar terms, observed for most economies, were mostly due to lower inflation rates in local currency terms and the stability of Asian currencies against the dollar.

Since external inflation rates in local currency terms tend to be relatively stable over time, our Trading Partners' currencies developments against the dollar are fundamental in shaping developments in terms of our domestic inflation. In addition, the recent and substantial inflation fall in Timor-Leste is also due to the international price decreases of the many important commodities such as oil and food prices, as mentioned above.

Chart 1.18

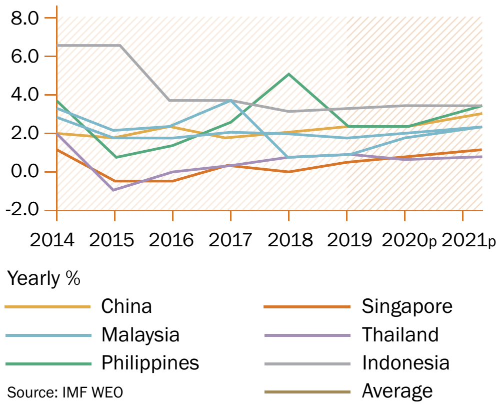
Asian Currencies vs USD



Source: IMF WEO

Chart 1.19

Regional Inflation in Local Currency Terms



Source: IMF WEO

Given the importance of this transmission channel, future developments in "external inflation" trends, strongly determined by the exchange rate changes, will continue to be one of the most influential factors in driving the evolution of domestic inflation.

In this regard, the BCTL expects, in line with the IMF, regional currencies to remain stable against the dollar in 2020 and 2021, which, together with moderate inflation rates in local currency, supports our view that imported inflation will remain stable over the next years, helping to steady inflation pressures in Timor-Leste in 2019 and 2020, under 2% on a yearly basis.

1.3.3. Energy Markets and Oil Revenue

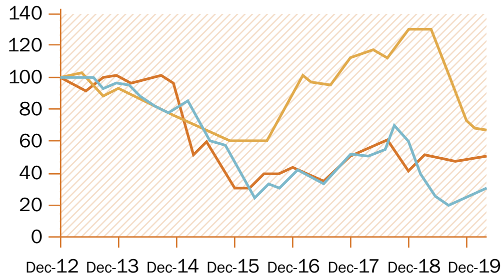
Oil, natural gas and other energy resources' prices are highly volatile, fluctuating substantially between periods of high and low-price levels. The charts below depict these fluctuations and allow us to place the recent developments in energy prices in a multiannual perspective. It should be noted that it is not uncommon for prices to fall by 50% and rise by more than 50% within 1 year. In terms of levels, the sharp decline in oil prices from the end of 2014 cancelled all nominal price gains recorded since 2009.

In 2019, crude oil price increased 17% (Brent benchmark) while, simultaneously, natural gas and coal prices fell. Despite the recent recovery in prices of energy inputs, note that these are still well below the figures recorded in 2012, after substantial declines observed in 2015.

In 2019, the oil price continued to recover, which diverged, but other Energy commodities recorded price falls.

Chart 1.20

Energy Prices - spot



2012 = 100

Oil, Brent

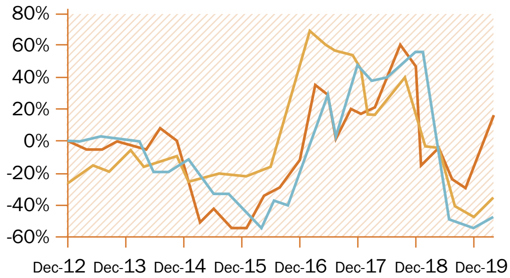
Coal, Australia

Europe Natural Gas

Source: World Bank

Chart 1.21

Energy Prices - % change



Yearly %

Oil, Brent

Coal, Australia

Europe Natural Gas

Source: World Bank

However, changes in energy prices are not easy to anticipate, as they result both from the interdependence between demand and aggregate supply on physical markets and, increasingly, from the less measurable and unpredictable effects resulting from the "financialization" of these markets, yielded by the expansion of the financial derivatives market and increased participation of financial intermediaries and speculators. An obvious proof of this inability to predict is clearly the most recent drop in oil prices, whose speed and breadth were not effectively predicted by the majority of market players and analysts.

This caveat is important because it prevents us from accepting simplistic scenarios and extrapolating further price declines, based only on the recent drops in oil prices. On the other hand, petroleum products prices are still important for Timor- Leste, since future oil revenues are still expected along the coming years.

Future oil revenues are now much smaller than in the past, thus reducing the impact of oil price fluctuations on Timor-Leste's Oil Wealth aggregate.

The impact of fluctuations in energy prices in the country's oil wealth is now much lower, compared to previous years. This follows from the fact that future oil revenues are now much lower when compared to what has already been extracted from the Timor Sea reserves, with the prospect of the exploitation of existing fields to cease completely by 2023. The expected future income from 2020 to 2023 amounts to $824 million in present value, which represents only 4.8% of the value of the Petroleum Fund at the end of 2019.

Taking into account the now diminished estimate of future oil revenues expected from the Timor Sea, we do not develop in this report, as we did in previous years, the sensitivity analysis of oil revenue to changes in future oil prices.

1.3.4. Financial Markets and the Petroleum Fund

Finally, we consider another transmission channel of international developments to our economy, which relates to the Petroleum Fund (PF), established to efficiently manage the country's oil wealth. The working mechanism of this channel is similar to the price of oil, to the extent that the price changes of international financial assets drive the value of the Petroleum Fund and, in turn, the value of 'Estimated Sustainable Income' of the Fund (ESI). At they drive changes in ESI and PF's value, financial asset prices end up influencing the amount of revenue available to finance the state budget and, consequently, the pace and scale of spending and public investment policies.

Financial asset prices influence the ESI and, in turn, overall funding of the State Budget.

The PF closed the year 2019 with the value of financial assets amounting to $17,692 million dollars, invested mainly (60%) in Treasury bonds issued by developed countries and stocks (40%) of thousands of global companies.

The PF currently invests 60% of its value in bonds and 40% in equities.

In 2019, the Fund recorded a remarkable gain net of fees and taxes of 2,100 million dollars, due to the combined and substantial returns of stocks and bonds holdings of the Fund, while the foreign exchange fluctuations only had a very marginal impact during the year.

Since its inception, the PF has expanded its investment universe, starting first by only investing in US Treasury bonds and bills, then moving gradually to invest in stocks and, finally, extending its investments to bonds issued by other developed countries' Treasuries. The gradual extension of the investment mandate was driven by the increasing demand for a higher expected return of the Fund and for a greater diversification of the investments and markets.

.... but only in fixed interest rate bonds.

Of course, this institutional development exposes the Fund to new risks and markets, but which, by benefiting from the diversification of the prices of the various assets, allows a more solid portfolio to be built and whose risk-return profile is more efficient. At present, the Fund invests only in fixed interest rate bonds and equities, so that interest

PF's performance is now crucially driven by price trends in global bond and equities markets....

on bonds and dividends on shares provide the Fund with a fixed and constant income, at least on 'a priori' basis. Naturally, by investing in bonds and stocks, the Fund benefits from increases in market values of these securities or, on the contrary, can be adversely affected by its decline. Therefore, the Fund's main financial risks correspond to possible losses arising from the fall in the prices of the bonds or socks in which the Fund is invested.

.... but foreign exchange fluctuations also affect the PF, which has invested in currencies beyond the USD.

In addition, since the PF invests in several markets, denominated in currencies other than the US dollar, the Fund is also exposed to the exchange rate risk of investments, understood as the possibility of depreciation of the various investment currencies against the dollar. In short, the PF's financial risk includes 3 types of market risks: equity risk, or risk of falling prices of the main world stock markets, interest rate risk, which translates to the risk of falling Treasury bond prices; and currency risk, which consists of the risk of depreciation of the investment currencies against the US dollar.

In 2019, the Fund recorded gains explained by the positive performance of investments in both equity and bond markets.

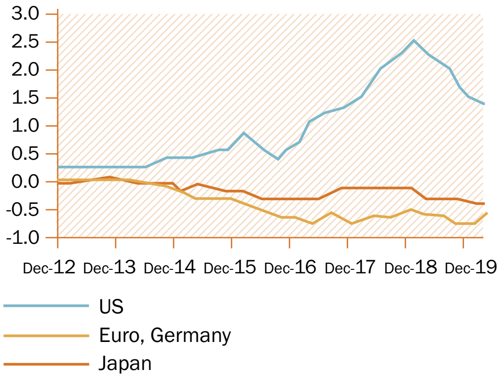
The price changes of PF's assets and the various investment currencies thus constitutes the true channel of transmission between international markets, the value of PF and its ESI and our country's economy. In terms of returns, 2019 was very positive for the FP, which returned +13.25%, as it benefited both from the exceptional and positive performance in the bond and equity markets.

The Bonds portfolio registered gains in 2019, also benefiting from the declines in interest rates in the US market.

In 2019, global bond markets recorded generalized declines in interest rates, especially the US market, more evident in the shorter 2-year segment, than in the longer 10-year term, closely tracking the FED's interest rate cuts. In the European and Japanese markets, long-term interest rates also registered slight decreases to negative territory. This general interest rates decline reversed the upward rate cycle of recent years, particularly in the US market, which constitutes the largest bond allocation of the Fund. This added to the FP's performance reinforcing the 'carry income' of such investments. The PF's bond portfolio thus recorded a global performance of 5.16% in 2019.

Chart 1.22

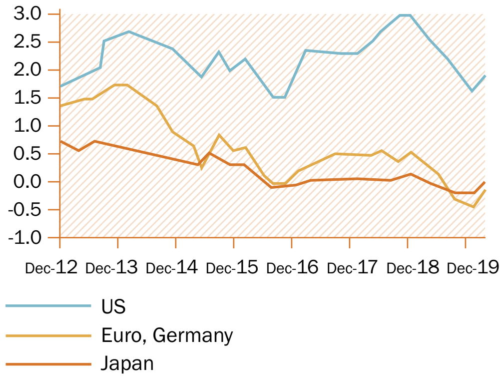
2-Year Interest Rates - % year



Source: Bloomberg

Chart 1.23

10-Year Interest rates - % year



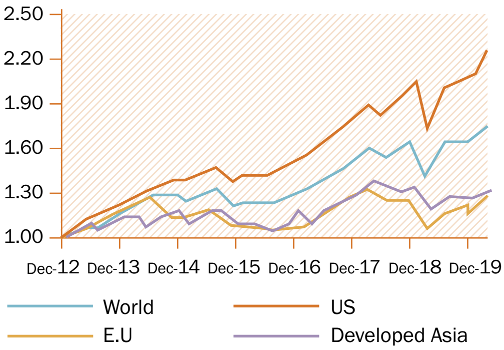
Source: Bloomberg

In terms of equity markets, the Fund's stocks benchmark – the black line in the chart below ("World") – posted wide gains in 2019, fully recovering from the losses incurred in 2018. The FP shares portfolio's gains resulted from the US market's strong rebound, but also from the strong performance of other important global markets. The Fund's stock investments returned a record27.26% in 2019. In terms of foreign exchange impacts, the FP's investment return was only marginally impacted by a slight depreciation of the USD versus the investment currencies.

The FP's stocks portfolio benefited from the strong performance across the large majority of global equity markets.

Chart 1.24

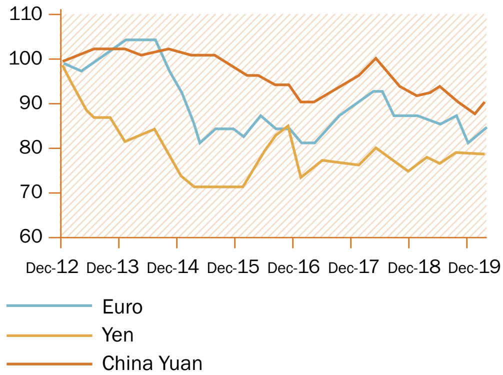
Stock Markets in USD terms – 2012 = 100



Source: Google Finance

Chart 1.25

Currencies vs USD – 2012 = 100



Source: Google Finance

In short, the Petroleum Fund currently holds a portfolio of a vast and diverse set of securities and is invested in major global stock and bond markets, which allows an optimized risk-return profile.

The PF's value and returns continue to largely depend on the price developments in dollar terms of various global financial assets.

However, given its substantial investments in global bonds and equities, the PF's financial value and its returns continue to depend on price developments of these financial assets, which are naturally and also affected by the evolution of the dollar against the currencies of its investments.

In a longer time-frame, we do think that the risk of a global stock or bond market correction is now significant, given the current and simultaneous high stock market valuations and the historically low levels of global bond interest rates. It should be noted in this regard that the US stock market, after its new rise in 2019, now trades at a level that corresponds to practically 2.5 times its value of December 2009 and close to an historical maximum level of price to corporate earnings ratio.

However, the long investment horizon of the Fund and its institutional framework should allow us to deal with the markets' short-term swings in a rational way and even to benefit from the occasional episodes of price declines across markets, by a rigorous implementation of the Fund's investment discipline and targeted asset allocation.