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GCC/MENA Bond market update

Perspective from Franklin Templeton Fixed Income

December 2022

Summary

- Fixed income markets rebounded during the fourth quarter of 2022, including the FTSE MENA Bond – GCC Index, which increased by 4.38%.
- The pace of issuances was moderate during the period.
- Persistent inflation remains a key risk for 2023.
- In our opinion, higher-quality fixed income assets are well poised for this point in the cycle and should benefit from a more moderate US monetary policy stance.

Market review

US inflation eased over the fourth quarter of 2022, as energy prices moderated, while the US economy grew at an annualised rate of 3.1% during the third quarter. Although relatively robust employment data fuelled hopes that the US economy could avoid a deep recession, November saw a marked contraction in business activity as manufacturers and service providers both recorded steep declines in new orders. The US Federal Reserve (Fed) raised interest rates by 75 basis points (bps) in early November, then by only 50 bps in December. Despite this softer stance, Fed Chair Jerome Powell stated that the central bank remains “strongly committed” to returning inflation to its 2% target and pushed back on investor expectations of a rate cut towards the middle of 2023. Though they dipped in December, global equity prices rose over the fourth quarter, helped by robust performance in October and November. However, 2022 was a difficult year overall for global stock markets. Sticky inflation and aggressive rate hikes from the Fed weighed heavily on investor sentiment throughout the year, with growth and technology stocks hit particularly hard. Geopolitical concerns and volatile economic data also kept investors on edge.

Bond yields followed an erratic path over the fourth quarter. Despite the hikes in US interest rates, benchmark 10-year US Treasury (UST) yields were broadly flat, finishing December at 3.83%. Yields in the eurozone rose, however, with the European Central Bank raising rates by 75 bps in October and 50 bps in December. Although the outlook for the eurozone remained bleak, there were encouraging signs that the region’s economic downturn may be less harsh than expected. The JPM Emerging Market Bond Index Global Diversified, which tracks hard-currency emerging market (EM) government bonds, rose 8.11% during the quarter, outperforming the FTSE MENA Bond – GCC Index, which increased 4.38% over the period. The US dollar depreciated against most major currencies during the fourth quarter of 2022; this pullback helped to improve investor sentiment towards EM asset classes.

After rising for the first time in five months in October, oil prices then fell almost 7% in November, notwithstanding tight global supplies and the decision of OPEC+ to lower production, hurt by concerns about a global economic slowdown. They then steadied in December, falling only marginally. The price of Brent Crude oil ended the quarter at US$85.9 per barrel, up from US$83.5 at the end of September.

Despite increasing in October, the **United Arab Emirates’ (UAE)** Purchasing Managers’ Index (PMI) was down over the quarter as a whole, dropping to 54.4 in November, impacted by a weaker global backdrop, with new work at a 14-month low. Respondents "continued to show only a moderate degree of optimism" for output over the next 12 months. Indeed, output prices fell steadily over the period, as cost inflation moderated and businesses looked to bolster sales growth through competitive pricing.

Saudi Arabia’s PMI fell to 56.6 in September but then rose in October and November, reaching 58.5, with new exports rising at their fastest pace since 2015. However, employment among private sector firms was only fractionally higher in December, despite new orders accelerating to 65.7, a 14-month high, and non-oil business activity expanding at the fastest pace in more than seven years.

Egypt’s PMI improved marginally in October, a month in which the country’s central bank lifted its key overnight deposit rate by 200 bps to 13.25%. The PMI then fell to 45.4 in November, the second-lowest reading since June 2020, remaining in contractionary territory, as it has been for two years. A weaker currency - the Egyptian pound depreciated significantly against the US dollar - weighed on the cost and the availability of foreign goods. In December, Egypt’s central bank raised rates to 16.25%, well above expectations of 14.75%. The rise followed the International Monetary Fund’s (IMF’s) approval of its loan package and was aimed at anchoring inflation expectations and demand-side pressures.

With employment at its lowest reading since the series began, Qatar's PMI was down in September and October, when it dropped to 48.4, moving the headline figure into contractionary territory for the first time since the outbreak of COVID. However, it recovered slightly in November to reach 48.8.

Ratings

- In November, credit rating agency S&P upgraded Qatar to AA due to a stronger fiscal position.
- Also in November, S&P upgraded Oman to BB, citing the improvement in fiscal and external metrics from its fiscal reform and high commodity prices.
- S&P upgraded Boubyan Bank's rating to A in November, with the agency believing that the combination of balanced growth, solid earnings and a manageable dividend pay-out ratio would likely help the bank maintain strong capitalisation.
- S&P also upgraded Commercial Bank of Qatar's rating to A- in November due to strengthened stand-alone creditworthiness, given the improved asset quality and lower exposure to high-risk sectors and geographies.
- In November, S&P upgraded Qatar National Bank to A+.
- In December, S&P upgraded Gulf Finance House to B to reflect good performance and resilience over the 2020-2022 period.
- Also in December, credit rating agency Fitch upgraded Sohar International Bank and Ahli Bank to BB- from B+. Fitch has also upgraded the banks' Government Support Ratings (GSRs) to BB- from B+.
- Fitch upgraded Tunisia to CCC+ in December, as the Staff Level Agreement with the IMF is expected to unlock funding and support fiscal consolidation.

Issuance

- In October, the Public Investment Fund, the sovereign wealth fund of Saudi Arabia, issued its debut green bond with a US$3 billion three-tranche deal. The five-year tranche was priced at a spread of 125 bps over USTs, the 10-year tranche was priced at a 165-bps spread over USTs, and the 100-year tranche was priced at a yield of 6.7%. Initial guidance for the issuance were spreads of 150 bps, 190 bps and a 7.25% yield, respectively. The deal attracted over US$21 billion in orders.
- Also in October, First Abu Dhabi Bank, the largest bank in the United Arab Emirates, issued a US$700 million green bond with a five-year maturity. It was priced at a spread of 125 bps over USTs versus an initial guidance of 145 bps over USTs, as the deal attracted over US$1.6 billion in orders.
- Saudi Arabia issued a US$2.5 billion Sukuk in October with a six-year maturity, as well as a 10-year US$ 2.5 billion bond. The Sukuk was issued at a spread of 105 bps over USTs while the bond was issued at a spread of 150 bps over USTs. Initial guidance for the instruments was 135 bps and 180 bps, respectively, as the deal attracted over US$26 billion in orders.
- In October, Emirates NBD, a UAE-based bank, issued a US$ 500 million five-year bond at a spread of 155 bps over USTs, compared with an initial guidance of 175 bps, as the deal attracted over US$1 billion in orders.
- Mamoura Diversified Global Holding PJSC, an investment holding company based in the UAE, issued a US$1 billion 10-year bond in October at a spread of 165 bps over USTs. The initial guidance was 200 bps over USTs, as the deal attracted over US$4 billion in orders.
- Also in October, Arada Developments LLC, a property developer in the UAE, raised a US$100 million Sukuk with a 2027 maturity, in a reopening of a transaction that raised US$350 million in May.
- In November, Dubai Islamic Bank issued a US$750 million sustainable Sukuk at a spread of 155 bps over USTs versus initial guidance of 175 bps, as the deal attracted over US$1.5 billion in orders.
- Also in November, Banque Saudi Fransi issued a US$700 million five-year senior bond at a spread of 170 bps over USTs versus initial guidance of 195 bps, with the deal attracting over US$3 billion in orders.
- Mashreqbank issued a US$500 million Tier 2 bond in November at a yield of 7.95% versus initial guidance of 8.25%, as the deal attracted over US$1 billion in orders.
- There was no issuance of note in December.

Outlook

When we came into 2022, we expected the Fed to raise real rates and tighten financial conditions. By the middle of the year, we thought its job may have been done, with 10-year Treasury real rates above 0.75%, having risen from -1%.[1] However, real rates kept rising to above 1.5%, presenting attractive opportunities to take advantage of yields that had reached levels not seen in two decades. In a relatively short period of time, the Fed raised rates by 425 bps, transforming the potential income and protection fixed income can provide to portfolios.

Looking into 2023, we believe investors will want to take advantage of these yields. The turnaround in fixed income may have already started in November, but the outlook for bonds and Sukuk remain more attractive to us than other risk assets—certainly on a risk-adjusted basis, but potentially also on an absolute basis.

The challenge, of course, is that the Fed seems intent on continuing to tighten financial conditions, against what we see as an ongoing economic slowdown. Policymakers are guiding to a higher terminal rate well above 5%,[2] and intend to stay there at least through 2023, and only cut rates gradually thereafter.

The market may change its view as economic data comes through—particularly inflation data—but for now has lowered its estimate for the terminal rate slightly to 4.9% by March 2023 and expects rate cuts to begin by July 2023.

Implicit in both projections is that inflation has peaked, and the majority of rate hikes are behind us. From our perspective, it seems sensible to at least project stable benchmark rates, that may also decline faster if the recession in the US is more significant, or inflation declines more rapidly. We recognize these as critical inputs and enter the year with long duration exposure.

Credit spreads are more challenging to forecast; there is a risk they widen. That is why we have a pronounced preference for higher-quality credits that have financial buffers to manage slowing economic activity. This is not to say we are avoiding any risk, as there are opportunities in EMs reflecting dire outcomes that we think may not materialise, or at least compensate us for the risks involved. On average, however, our portfolios do have higher credit quality than the recent past.

Oil may be vulnerable to slowing demand, but we think both OPEC+, through production cuts, and the US administration, through commitments to replenish its strategic petroleum reserves (SPR), should manage to keep oil prices above US$70 a barrel, a supportive level for GCC sovereign credit profiles. It is worth considering that this oil-price cycle, because of reforms to national oil companies and fiscal budgets, has had a more benign impact on local liquidity, so financial conditions will likely remain tight across the GCC without further domestic monetary intervention.

The outlook for issuance appears set to improve, returning to annual levels of US$75-80 billion, on average. GCC governments are expected to see US$199.3 billion in fixed income maturities over the next five years (2023-2027), with corporate maturities at US$169.1 billion, for a total of US$368.4 billion).[3] Saudi Arabia is expected to see maturities of US$125 billion until 2027, followed by UAE and Qatari issuers at US$109.8 billion and US$73.1 billion, respectively. The GCC's share of EM issuance is set to increase, especially if lower-rated (single B and below) issuers continue to struggle accessing primary markets.

After every sharp drawdown in fixed income, there have been strong recoveries. Though one must be careful not to discount the adjustment that bond markets have just lived through, we believe high-quality bonds have the potential to deliver the best risk-adjusted returns.

Faced with continued uncertainty and an abundance of risk, one may be tempted to time the market or wait for attractive entry levels. We believe this may be a mistake. In our view, it would be more prudent to focus on asset allocation and consider an increase in higher-quality fixed income sectors, including GCC bonds or global Sukuk, that look poised to better defend portfolios and provide attractive levels of income.

Endnotes

1. Source: Bloomberg.
2. Source: Federal Open Market Committee "Dot Plots" as of December 14, 2022, which showed a median of 5.125%, and a high of 5.625%. There is no assurance that any estimate, forecast or projection will be realised.
3. Sources: Bloomberg; Kamco Invest Research, GCC Fixed Income Market Update, December 2022.

Quarterly Market Data Change

30 September 2022–30 December 2022

Currencies	30 Dec 22	30 Sep 22	% Change
EGP	24.76	19.54	-21.07%
PKR	226.66	228.15	0.66%
MAD	10.44	10.95	4.93%
LBP	1,519.75	1,512.75	-0.46%
TND	3.11	3.27	-4.74%
MYR	4.40	4.64	5.29%
IDR	15,573.00	15,227.00	-2.22%
DXY	103.52	112.12	-7.67%
EUR	1.07	0.98	9.21%
JPY	131.12	144.74	10.39%

Fixed Income GCC			
UST 10YR	3.87	3.83	0.05
DBR 10YR	2.57	2.11	0.46
MGII10Y Index	4.16	4.50	-0.34
DJ Sukuk	187.70	184.00	2.01%
FTSE MENA Bond - GCC Index	161.74	154.95	4.38%
FTSE World Gov Bond Index	835.32	804.56	3.82%
Bloomberg Global Agg	445.92	426.52	4.55%
EMBIGD	803.50	743.24	8.11%
Itraxx Crossover	472.70	642.94	-170.24
CDX Emerging Markets	238.61	331.66	-93.06

Equities	30 Dec 22	30 Sep 22	Total Return
All World	605.38	553.37	9.86%
EM	956.38	875.79	9.62%
ASIA x-JN	1,309.33	1,137.98	15.90%
Europe	142.50	130.44	9.61%
Dow	33,147.25	28,725.51	16.01%
S&P 500	3,839.50	3,585.62	7.55%
Nasdaq	10,939.76	10,971.22	-0.04%
Nikkei	26,094.50	25,937.21	0.75%
MICEX	2,154.12	1,957.31	18.83%
Sensex	60,840.74	57,426.92	6.13%
SHCOMP	3,089.26	3,024.39	2.32%
S&P Pan Arab	2,732.95	2,897.11	-5.67%

Commodities			
Oil-WTI	80.26	79.49	0.97%
Natural Gas	4.48	6.94	-35.49%
Gold	1,824.02	1,660.61	9.84%
Silver	23.95	19.03	25.89%
Copper	8,372.00	7,560.00	10.74%
Soy Beans	1,524.00	1,383.25	10.18%
Corn	678.50	684.00	-0.80%
Wheat	792.00	932.00	-15.02%

Source: Bloomberg.

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