GCC Fixed Income Market : *2017 - The Year That Was…*

Fixed income issuances in the GCC in 2017 saw one of the biggest jumps since the financial crisis with growth recorded in both bonds and sukuk markets. It was a record year for the GCC countries as sustained low oil prices coupled with rising budget pressure at home as well as infrastructure spending requirements triggered some of the biggest issuances in the region. Ongoing trends also indicate a healthy pipeline of issuances in the near term. In addition, central banks in the region are also under pressure to raise interest rates due to rising interest rates in the US and the pressure to keep currency pegs within a manageable limit. This has also forced some issuers in the region to lock in favorable rates before the interest rates are raised.

In terms of individual country share, Saudi Arabia continued to account for the lion's share of total fixed income market issuances that reached a record level of USD 40.6 Bn as against around USD 20 Bn during 2016. The increase was primarily in terms of Sukuk issuances that reached USD 28.1 Bn during the year as against merely USD 1.7 Bn during 2016.

On the economic front, the GCC continues to boast one of the biggest project markets in the region with almost USD 3.1 trillion worth of projects in pipeline, according to MEED. This is more than USD 300 Bn or 11.6% more as compared to the projects pipeline at the end of 2016, requiring additional funding requirements and thereby increasing the possibility of higher issuances in the fixed income market in the near term. Furthermore, with banks becoming more stringent in their lending process amid liquidity constraints, corporates are increasingly looking at the fixed income market and are actively tapping in record deals.

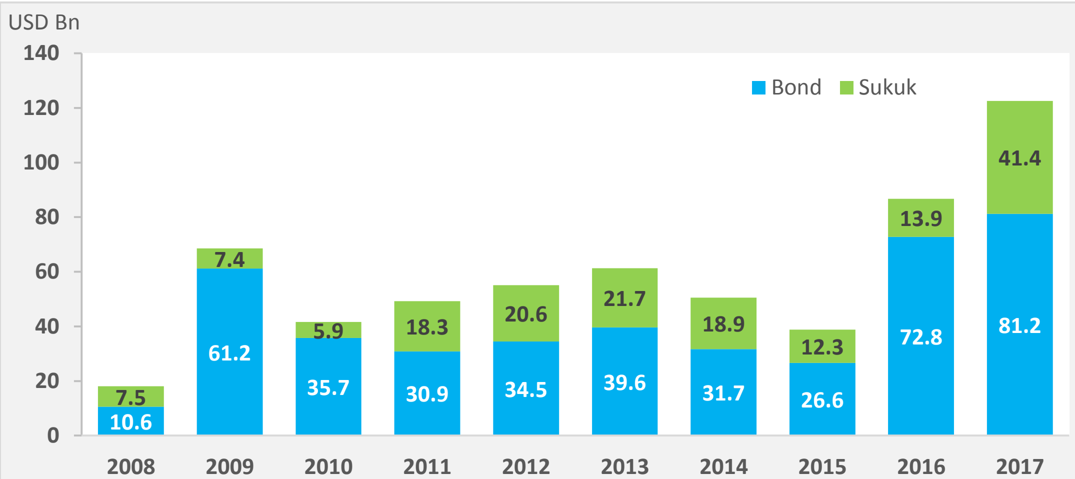
In terms of quality of issuers, most of the MENA oil exporters have adequate credit quality enabling them to comfortably raise debt in the international market. This is particularly the case with the GCC countries with most of the larger economies continuing to boast investment grade ratings despite several downgrades by rating agencies since the start of the oil price decline.

For 2018, KAMCO Research expects fixed income market issuances to be led by Saudi Arabia followed by Qatar, Oman and Bahrain as these countries look at ways to finance their respective investment plans and plug budget deficits. GREs are increasingly tapping the international bond markets and this new trend is expected to see noticeable growth in 2018.

Sovereign Credit Ratings

Country	Moody's	S&P	Fitch
Abu Dhabi	Aa2	AA	AA
UAE	Aa2	NR	NR
Bahrain	B1	B+	BB+
Kuwait	Aa2	AA	AA
Oman	Baa2	BB	BBB-
Qatar	Aa3	AA-	AA-
Saudi Arabia	A1	A-u	A+

Fixed Income Issuances in GCC



Source: Bloomberg, KAMCO Research
Note: Outstanding amount of bonds in the report excludes short term (<1 year) treasury issuances by respective governments

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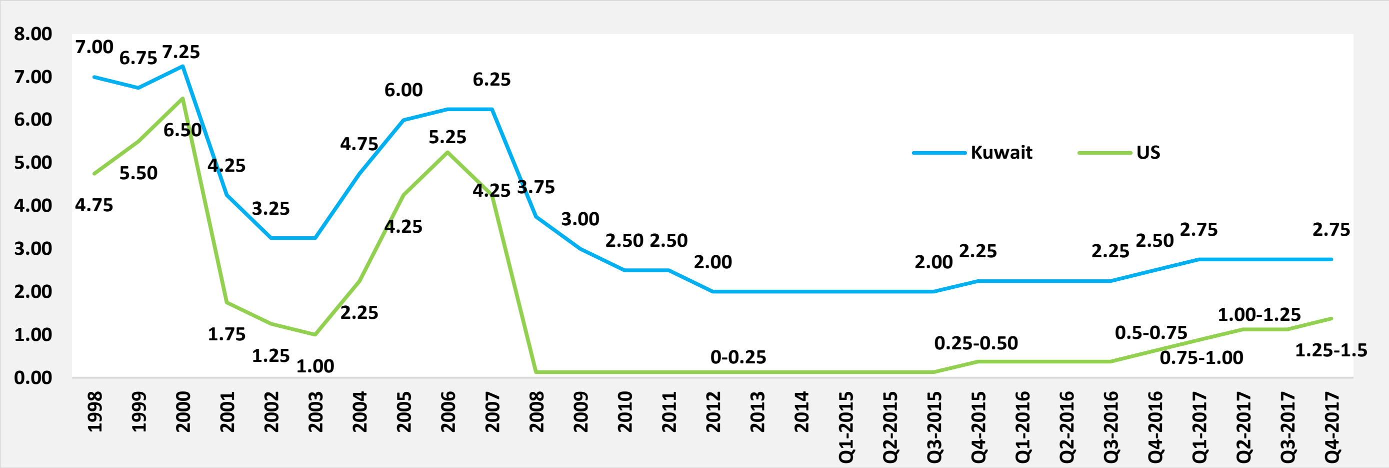
US & MENA Rate Hikes

After a single rate hike in 2016, the US Fed raised benchmark interest rates three times in 2017 and raised the rate by 75 basis points in three 25 bps steps to a higher range of 1.25% - 1.5%. The rate hikes came on the back of a synchronized expansion with improving global economic growth rates, solid US growth rates as well as declining unemployment that was recorded at a low of 4.1%. In its announcement, the Fed highlighted that its inflation target of 2% is yet to be achieved, although December consumer inflation saw a big spike signaling expectations that the Fed would raise rates as early as in March-18. The Fed's forecast for the next two years shows three rate hikes in 2018 and another two in 2019. The tax reforms announced recently in the US is aimed at boosting the economy which would have the potential to further tighten labor market and boost inflation rates, further supporting the forecasted rate hike decisions.

Fed Fund Rate vs. Kuwait Central Bank Discount Rate

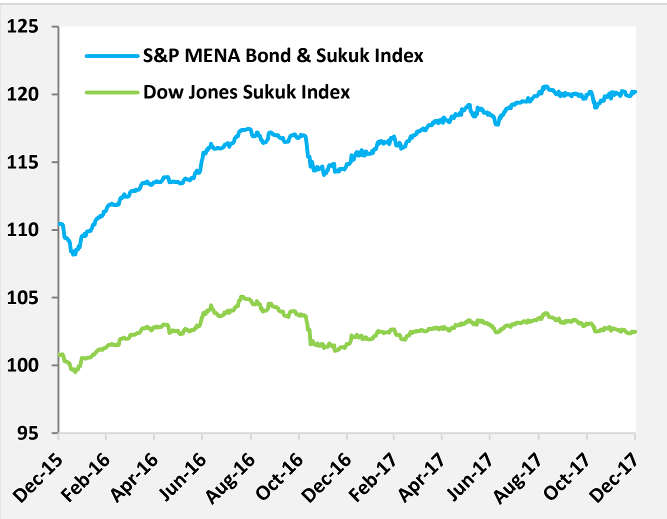


Data indicates end-of-period target rates/ranges. Source: US Federal Reserve, Central Bank of Kuwait, Bloomberg

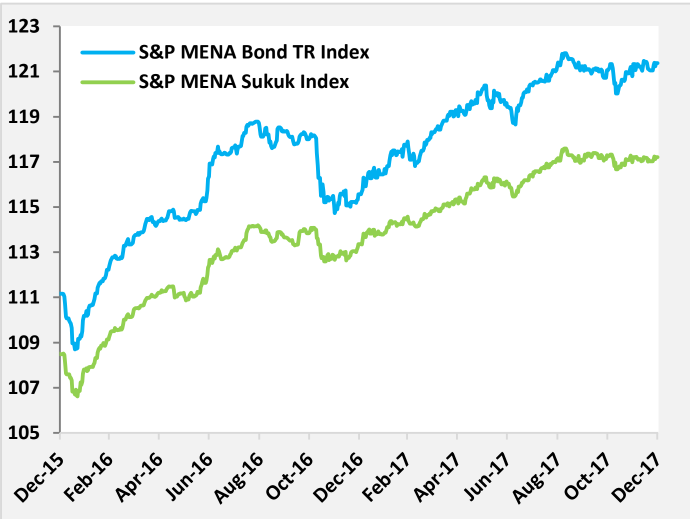
GCC central banks' response to the US rate hikes during 2017 were mixed. Initially most of the central banks raised rates in response to the first rate hike in March-17 and the second hike in June-17. However, the latest rate hike in the US was followed by similar hikes in Saudi Arabia, UAE and Bahrain, while Kuwait kept its rates unchanged. The Central Bank of Oman and Qatar Central Bank did not announce a decision. The GCC regulators will have to manage a tight rope walk in terms of balancing the much needed economic growth while keeping currency pegs intact.

Fixed Income Market Performance

MENA Fixed Income Indices



MENA Vs. Global Sukuk Index

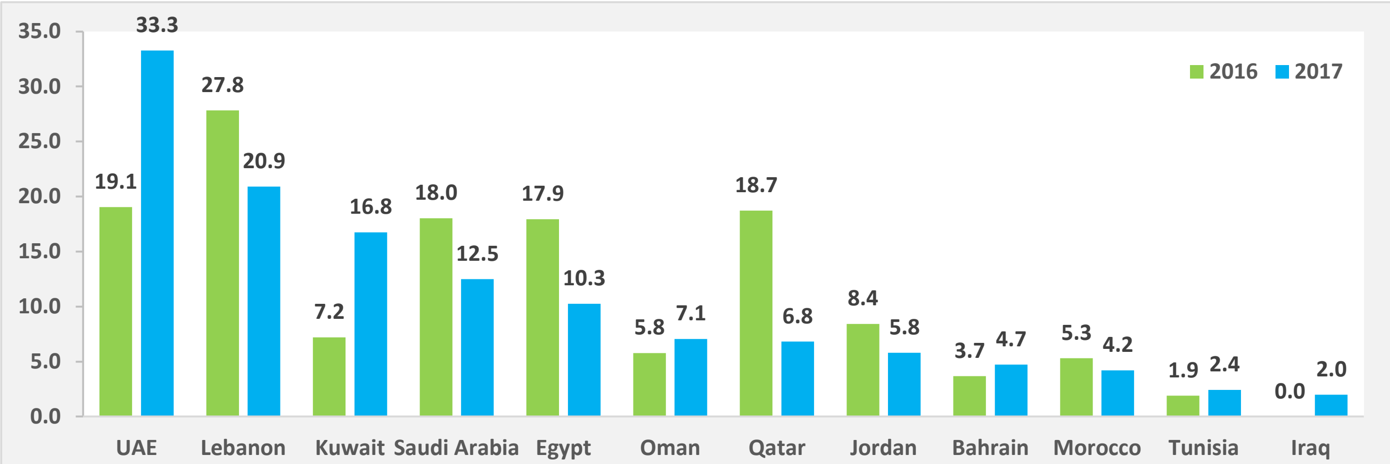


Source: Bloomberg, KAMCO Research

The trend in the global sukuk index and the MENA fixed income indices continued to remain divergent although sukuk issuance saw a big boost in 2017. This spike was reflected in the MENA bond and sukuk indices that have shown a steady uptrend since the decline seen at the end of 2016.

MENA Bond Issuances

Bond Issuances - 2017 vs. 2016



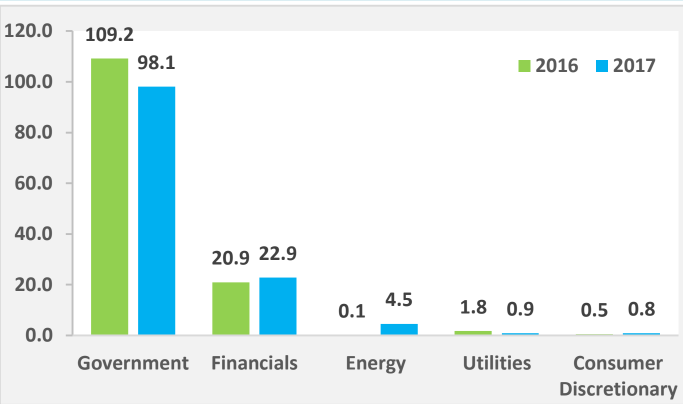
Source: Bloomberg, KAMCO Research

Bond issuances in the MENA region declined during 2017 as record issuance by GCC countries failed to offset the decline recorded in other MENA economies. Total bond issuance by GCC countries stood at USD 81.2 Bn, up 11.6% or USD 8.4 Bn as compared to USD 72.8 Bn in 2016. UAE saw the biggest increase in 2017 with bond issuances totaling USD 33.3 Bn as compared to USD 19.1 Bn during 2016. Issuances by Kuwait also more than doubled to USD 16.8 Bn as compared to USD 7.2 Bn during 2016. Saudi Arabia, however, witnessed a decline from 2016 with issuances totaling USD 12.5 Bn in 2017 as compared to USD 18.0 Bn in 2016 as the Kingdom issued more sukuks as compared to bonds in 2017. Qatar, which was the second largest bond issuer in 2016 witnessed a steep decline in 2017 with issuances totaling USD 6.8 Bn as compared to USD 18.7 Bn in 2016. A similar decline was witnessed in Egypt which recorded bond issuances of USD 10.3 Bn in 2017 as compared to USD 17.9 Bn in 2016.

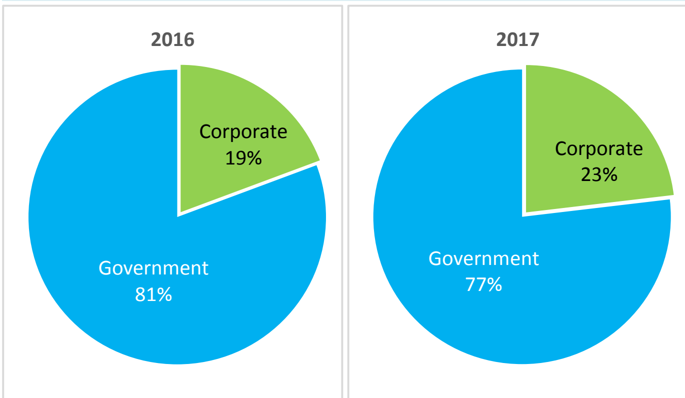
In terms of issuers, apart from the government and its agencies, financials sector topped the chart with issuances totaling USD 22.9 Bn as compared to USD 20.9 Bn during 2016. The energy sector followed with issuances worth USD 4.5 Bn, a significant jump as compared to the previous year. On the other hand, the sovereign/corporate split of issuances continued to remain skewed towards the sovereigns, although their share declined from 81% in 2016 to 77% in 2017. Moreover, the decline in issuances by government were only partly offset by higher bond issuances by corporates. MENA sovereigns issued bonds worth USD 98 Bn in 2017 as compared to USD 109 Bn while corporates issuances stood at USD 29.5 Bn as compared to USD 26.1 Bn during 2016.

S&P estimates infrastructure spending of around USD 120-150 Bn in the GCC until 2019 that would require funding, and most preferably through bonds and sukuks due to liquidity pressure on regional banks. Additionally, GCC also faces refinancing needs of USD 23.6 Bn in corporate capital market debt due between 2017 and 2019 that could come under pressure of refinancing risk given the ongoing geopolitical uncertainties in the region and hence making bonds and sukuks as the preferred choice of funding infrastructure projects. Furthermore, with five more rate hikes expected over the next two years as indicated by the US Fed and the possibility that of most of these rate hikes would trickle down to the GCC, corporates as well as governments are keen on locking in lower rates for long term funding requirements.

Top Five Sectors by Bond Issuance - MENA



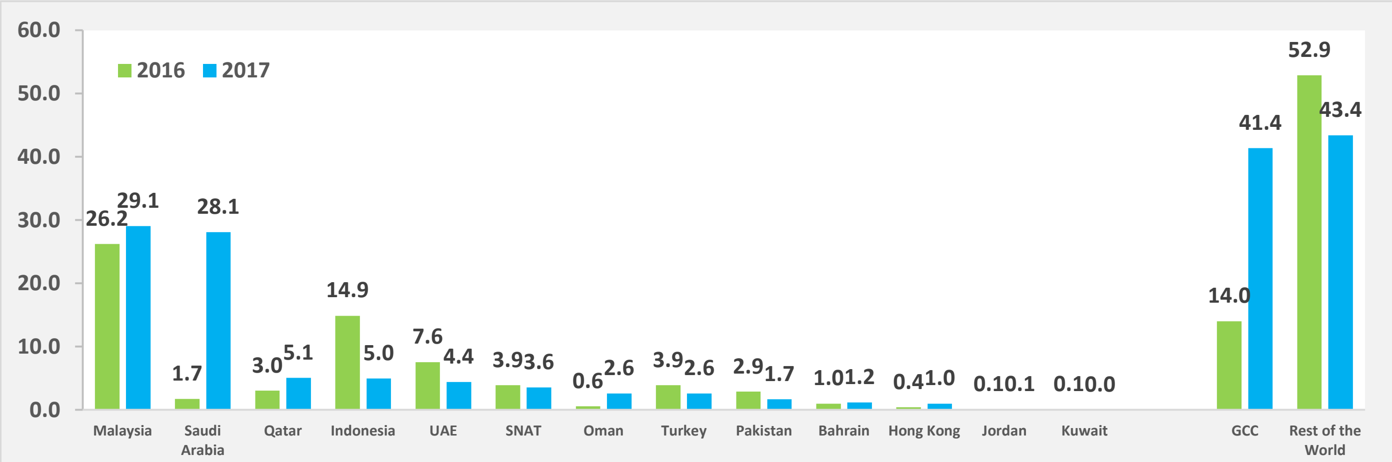
Breakdown by Issuer - MENA



Source: Bloomberg, KAMCO Research

Global Sukuk Issuances

Sukuk Issuances - 2017 vs. 2016



Source: Bloomberg, KAMCO Research

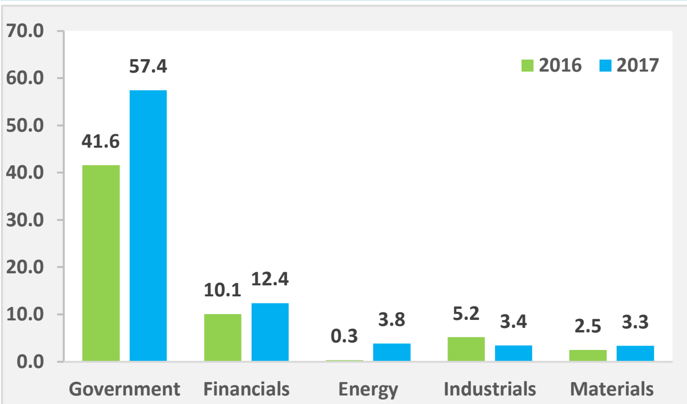
After increasing by 10% in 2016, global sukuk issuances increased by a strong 27% in 2017 to reach USD 84.8 Bn as compared to USD 66.9 Bn during 2016. The significant increase in sukuk issuances in 2017 came primarily on the back of higher issuances by Saudi Arabia followed by continued increase in issuance by Malaysia, which was still the biggest sukuk issuer in the world, although its share in the global sukuk issuance market fell from 39.2% in 2016 to 34.3% in 2017. Malaysia issued sukuks worth USD 29.1 Bn in 2017 as compared to USD 26.2 Bn during 2016. Saudi Arabia issued sukuks worth USD 28.1 Bn in 2017 as compared to USD 1.7 Bn in 2016 accounting for one third of the market as compared to merely 2.6% in 2016. Among the bigger issuers, the share of Indonesia declined from 22.2% in 2016 with issuance worth USD 14.9 Bn to merely 5.9% in 2017 with sukuks worth USD 5 Bn issued during the year.

The increase in sukuk issuances by Saudi Arabia also pushed GCC's share to almost half of the global sukuk market as compared to a one fifth share in 2016. Total sukuk issuance by GCC countries stood at USD 41.4 Bn in 2017 as compared to USD 14 Bn in 2016. Issuances by UAE declined during the year by 41% to USD 4.4 Bn as compared to USD 7.6 Bn in 2016, while Qatar increased issuances by two thirds to USD 5.1 Bn as compared to USD 3.0 Bn in 2016.

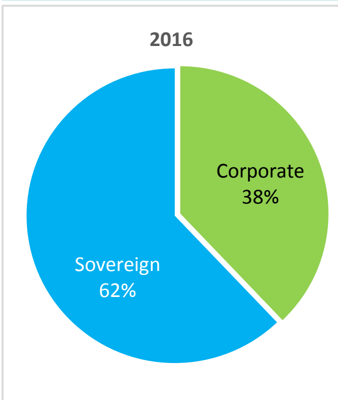
In terms of issuer breakdown, sovereign issuers dominated the sukuk market during 2017 with an even higher share of the total pie during the year. Total sukuk issuance by sovereigns increased by 38.1% or USD 15.8 Bn during 2017 to reach 57.4 Bn or more than two thirds of total sukuks issued during the year as against 62% or USD 41.6 Bn in 2016. On the other hand, corporate issuances increased at a much smaller pace of 7.9% and issued USD 27.4 Bn worth of sukuks during the year.

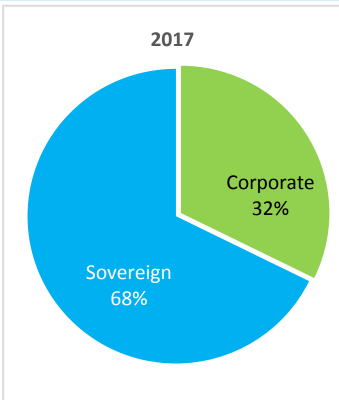
During 2018, we expect Islamic issuers to focus on sukuk market as the outlook for Islamic banks continues to remain weak given weaker economic growth rates especially in the GCC as well as pressure on liquidity due to declining oil deposits, although some trends point out to mild improvements. Some of these retail Islamic banks are also expected to tap the sukuk market in 2018. Moreover, product innovation and narrowing of spreads over conventional bonds are also factors pointed out by Moody's that would lead to higher sukuk issuances in 2018. A need to diversify financing mix by governments as well as increase the fiscal space by some of the GCC sovereigns would continue to make them active in the sukuk market in 2018.

Top Five Sectors by Sukuk Issuance



Breakdown by Issuer





Source: Bloomberg, KAMCO Research

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