KAMCO Research

Event Update - GCC Benchmark Interest Rate Hikes

March-2017

US Fed hikes rate for second time in three months; future normalization path unchanged :

The Federal Reserve (Fed) raised the fed funds rate for the second time in three months and for the first time in 2017, by 25bps on 15-March to a range of 0.75%-1.00%, from a range of 0.50% - 0.75%. The Fed acknowledged that economic activity has expanded at a moderate pace and labor market conditions have strengthened. The current dot plot retains the pace of rate hikes in 2017, from their Dec-2016 expectations. The stance was broadly less hawkish than what was expected, given the strength of economic data to the lead up of the FOMC meeting.

GCC states hike rates to keep currency peg, interbank rates rise:

GCC states barring Oman also raised rates through the same policy tools used in Dec-2016, given their currency pegs to the USD. Saudi Arabia raised the reverse repo rate to 1.00%, while keeping the repo rate unchanged yet again at 2.0%, after raising the reverse repo rate in Dec-2016 to 0.75%. The Central Bank of Kuwait (CBK) lifted the discount rate by 25bps from 2.50%-2.75%, while the UAE raised rates on its certificates of deposits by 25 bps to 1.25%. Borrowing costs for Kuwait are likely to rise by about 10%, according to our calculations. Bahrain and Qatar also raised key interest rates by 25bps. As a result, the 3-month interbank rates also rose for Saudi Arabia, UAE, Kuwait and Qatar.

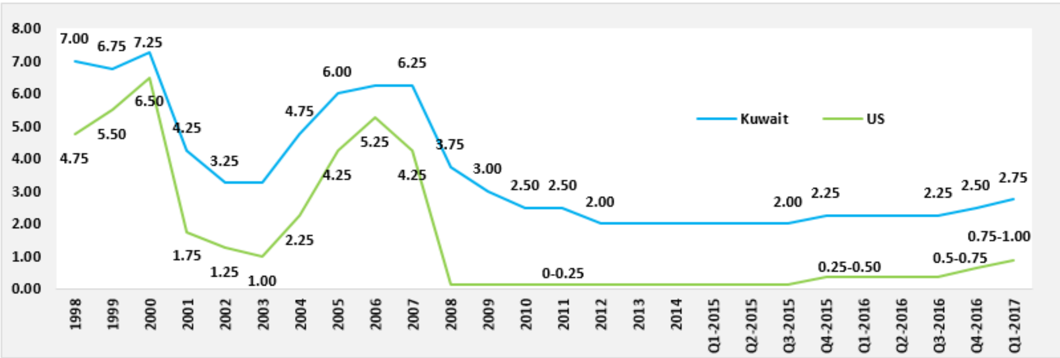
USD cool-off temporary, GCC focus shifts back to oil price :

The USD cooled off post the FOMC Meet on 15 March -2017 following the dovish stance from the Fed. Nevertheless, KAMCO Research expects fresh long positions in the USD to build up again, in anticipation of more policy action and a more hawkish stance at the FOMC meet in June-2017, and taking into account the Fed's rate differential path as compared to other major central banks. The Fed alluded to liquidity conditions being comfortable, which drove emerging market (EM) equities (+2.1%) and GCC equities (+1.1%) as fund flows to EMs are expected to remain positive. However, the focus now shifts back on oil prices and its impact on sentiment towards GCC equities, given slowing credit conditions and a mixed earnings season.

More international sovereign funding likely; Kuwait 5-Yr CDS drops 47% post bond sale:

Oman (USD 5 Bn) and Kuwait (USD 8 Bn) issued their bonds in 2017 on better terms prior to the rate hike. GCC sovereigns are likely to further tap into the international market sooner than later in order to take advantage of lower borrowing costs. Apart from shoring up budgetary finances, we believe that international bond sales also make GCC credit default spreads (CDS) now more relevant as a measure of credit risk. Kuwait's 5-Yr CDS dropped by 47.6% on 14-Mar-2017 from 108.95 bps, following its international bond sale, and could move lower from its current spread of 54.70 bps, given its strong state finances and since it currently has the lowest fiscal breakeven price of oil in the GCC.

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

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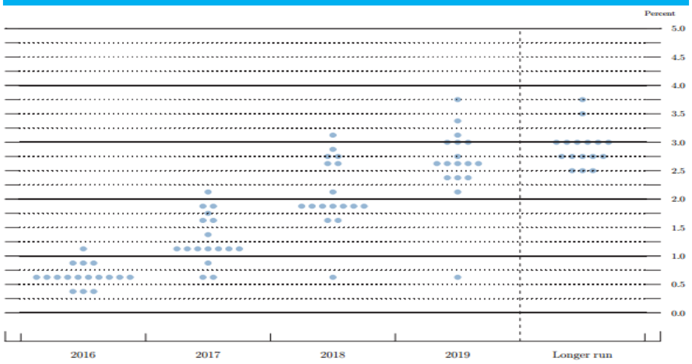
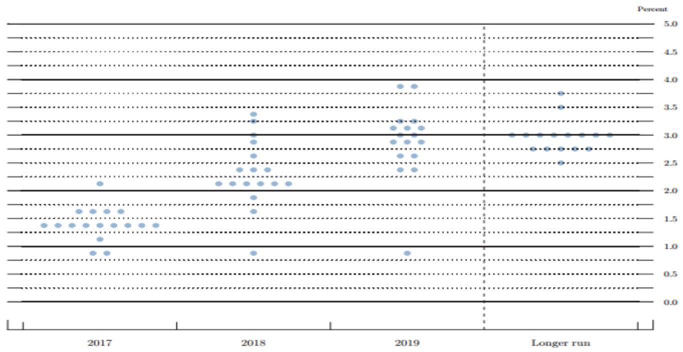
Fed Dot Plot - December 2016



Fed Dot Plot - March 2017



Source: US Federal Reserve

Medium term forecasts for the US broadly unchanged

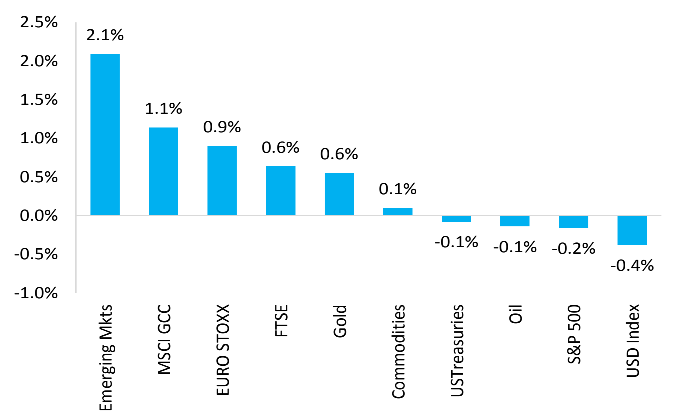
The Fed broadly retained its economic projections over 2016-19 and for the longer run, reaffirming their optimism of forecasts for real GDP, employment and personal consumption expenditures (PCE) inflation. Post 2017, the Fed kept expectations of benchmark rates in the US reaching above 3%, unchanged to an upper end of the range of 3.4% by as early as 2018, as was the case for expectations of longer term rates post 2019, which remained at 3.8% on the higher end. Real GDP growth range on the other hand was revised downwards on the upper end of the range by close to 10bps for 2017, while this drop was compensated in 2018, as the upper end of the range now is forecasted at 2.4% as compared to 2.3% in December-2016. Real GDP growth is expected to average close to 2% per annum over 2017-19.

Median Fed macroeconomic projections (2016– 2019)

	2017	2018	2019
GDP (Y-o-Y%)			
Dec-16	2.1%	2.0%	1.9%
Mar-17	2.1%	2.1%	1.9%
Unemployment rate (%)			
Dec-16	4.5%	4.5%	4.5%
Mar-17	4.5%	4.5%	4.5%
PCE Inflation (Y-o-Y%)			
Dec-16	1.9%	2.0%	2.0%
Mar-17	1.9%	2.0%	2.0%
Fed funds rate (%)			
Dec-16	1.4%	2.1%	2.9%
Mar-17	1.4%	2.1%	3.0%

Source: US Federal Reserve

Asset class returns post Fed rate hike—1 day returns (%)

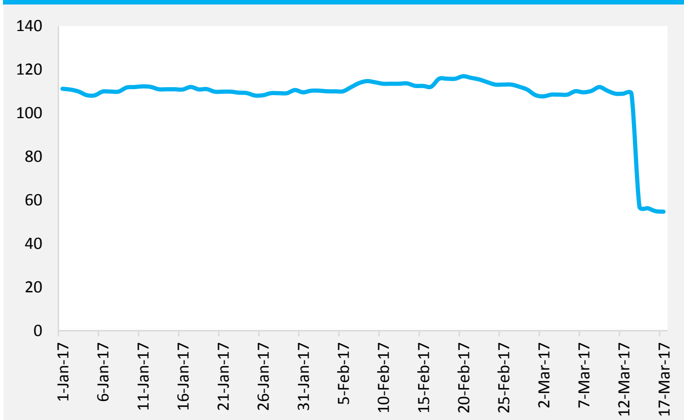


Source: Bloomberg

Oil price environment becomes more relevant for GCC

GCC interbank rates rose broadly following the rate hike by the Fed and respective central banks. Nevertheless, a host of measures adopted by SAMA have reined in interbank rates in Saudi Arabia from Q4-2016, as SAIBOR tightened until March-2017. Oman's government took the international funding route and raised USD 5 Bn through their single bond issuance in 5yr, 10yr and 30yr tranches, covering 90% of its borrowing plan for 2017, as order books for the issue were closed to USD 20 Bn reportedly. Kuwait raised USD 8 Bn with USD 3.5 Bn 5-year and USD 4.5 Bn 10-year sold at a yield of 2.8% and 3.6% respectively, even as the issue witnessed an equally strong USD 29 Bn of bids reportedly. Given the backdrop of slowing credit growth prevalent in the GCC, with likely more tightening on the cards, we expect the development of oil price and oil revenue receipts in the near term to become more relevant for GCC countries until diversification measures take effect.

Kuwait CDS -since January 2017 (bps)



Source: Bloomberg

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