KAMCO Research

GCC Fixed Income Market : *2016 - The Year That Was...*

The decline in oil prices over the past two years pushed MENA oil exporters to pursue policies that would have otherwise been thought unachievable. There was an urgent need to raise capital to fund the expected budget deficits in the near term as the surpluses accumulated over the past decade or more could support future deficits for only a limited period of time. On the positive side, 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 almost all of the economies continuing to boast investment grade ratings despite several downgrades by rating agencies over the past 18 months.

As a result, the GCC fixed income market is expected to continue to grow during 2017, although the pace of growth is not expected to be as strong as the sudden jump seen during 2016. The key drivers to the increase in fixed income issuances in the GCC during 2016, which more than doubled to USD 66.5 Bn, was primarily the sovereign bond issuances by Saudi Arabia, UAE and Qatar. On the other hand, issuances during 2015 witnessed a marginal decline from the previous year as the investment cycle was more on a wait-and-watch mode in relation to the recovery in oil prices.

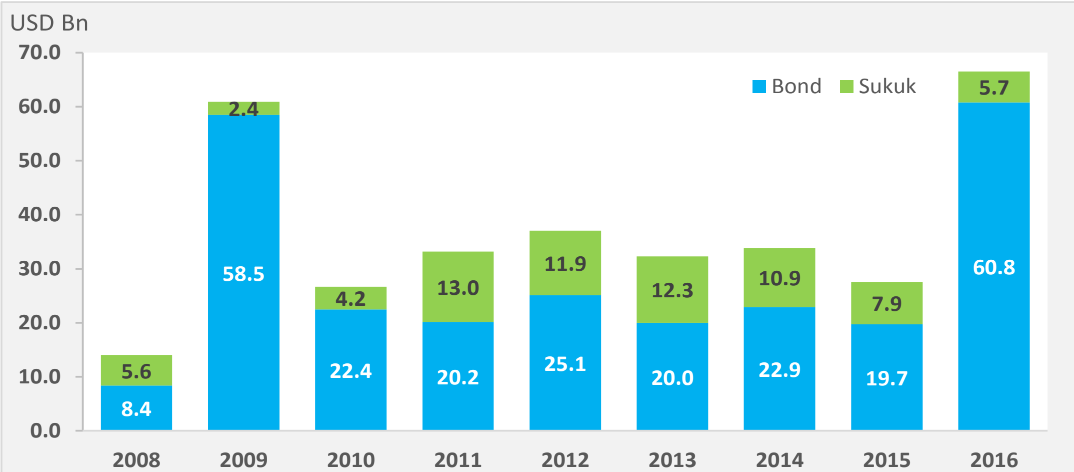
Moreover, in terms of instrument type, bonds dominated the market during 2016 while sukuk issuance took a backseat, although globally sukuk issuance was slightly higher than last year. Sukuk issuance for the MENA region declined for the third consecutive year by 25% in 2016, slightly lower than the 27% decline during 2015. On the other hand, bond issuance jumped from USD 42 Bn in 2015 to USD 75.8 Bn during 2016, a surge of more than 80%. The decline in sukuk issuance in 2016 came primarily as banking liquidity came under under pressure due to the decline in oil deposits and this could have affected the demand for shariah-compliant instruments from Islamic banks and funds. As a result, sovereigns had to rely on international investors to raise funds. Moreover, the demand from international investors were especially higher, as they seek better yields and safer investments, as expected from GCC sovereigns.

On the international front, high yield bond issuance declined for the fourth consecutive year primarily due to the decline in M&A transactions which is one of the key drivers for bond issuance. Nevertheless, we believe that the prospects for the fixed income market are brighter in 2017 owing to expectations of higher economic growth rate across key markets of US and Europe, in addition to a revival expected in the investment cycle that has was crippled for a few years now.

Sovereign Credit Ratings

Country	Moody's	S&P	Fitch
Abu Dhabi	Aa2	AA	AA
UAE	Aa2	NR	NR
Bahrain	Ba2	BB-	BB+
Kuwait	Aa2	AA	AA
Oman	Baa1	BBB-	NR
Qatar	Aa2	AA	AA
Saudi Arabia	A1	A-	AA-

Fixed Income Issuances in GCC



Source: Reuters, KAMCO Research
Note: Outstanding amount of bonds in the report excludes treasury issuances by respective governments

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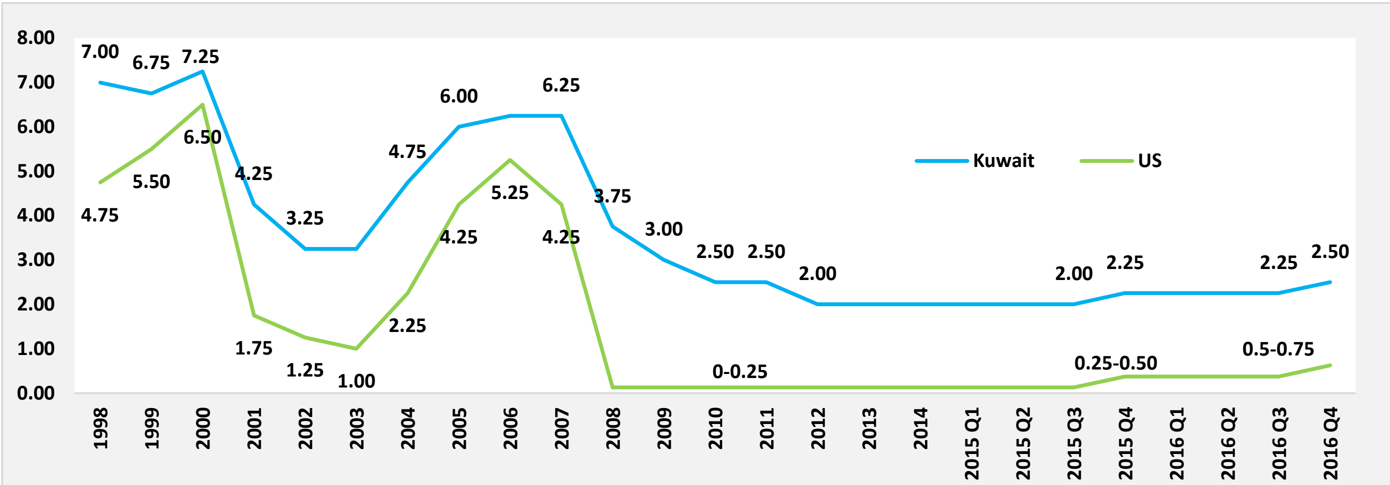
US & MENA Rate Hikes

The rate hikes announced by GCC countries as a response to the 25 bps rate hike in US Fed funds rate in December-16 could push up cost of bank debt in the GCC. However, the response from GCC central banks was more targeted at maintaining the currency peg with the greenback. Saudi Arabia's move to keep the repo rate unchanged was likely to ensure that liquidity in the banking sector was still comfortable, and to mitigate interbank lending rates from steeply rising, in our view. The Central Bank of Kuwait also guided that the move to hike rates in response to the Fed's rate hike was to ensure the continued competitiveness and attractiveness of the national currency as a store of domestic savings. Borrowing costs for Kuwait are likely to rise by about 11%, according to our calculations. However,

Fed Fund Rate vs. Kuwait Central Bank Discount Rate

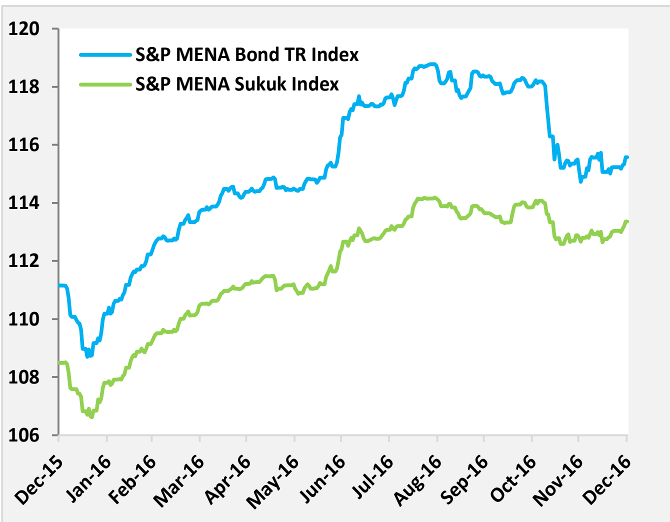


Data indicates end-of-period target rates/ranges. Source: US Federal Reserve, Central Bank of Kuwait

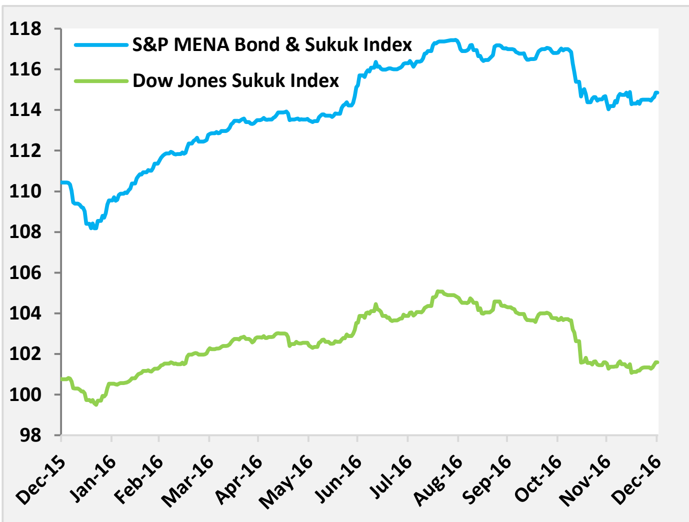
even as overnight interbank rates rose, the 3-month interbank rates exhibited mixed trends as Saudi Arabia, Kuwait and Qatar rates rose, while the rate in the UAE declined from 1.4029% to 1.3336%, as banks would have likely released funds on softer terms. Though some central banks have kept the lending rates unchanged in response to the rate hike in the US in order to keep the liquidity in their economies comfortable, future rate hikes would eventually reflect on in interbank rates and eventually lead to higher borrowing costs in the region.

Fixed Income Market Performance

MENA Fixed Income Indices



MENA Vs. Global Sukuk Index

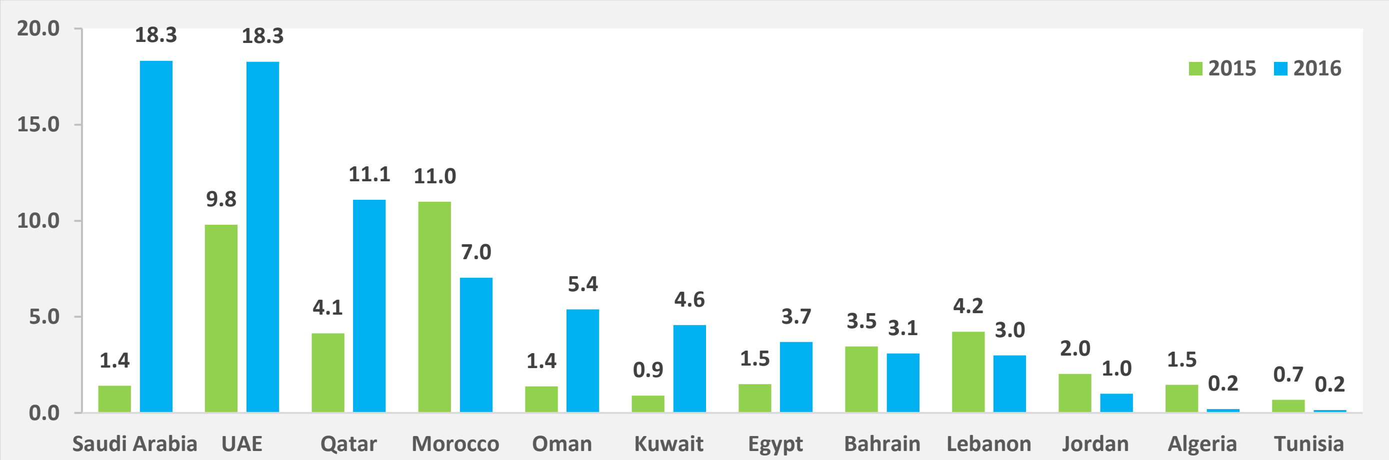


Source: Bloomberg, KAMCO Research

The trend in the global sukuk index and the MENA fixed income indices highlight the divergent trends in these markets and clearly reflects the weakness in sukuk issuances during 2016. As sovereigns preferred bonds over sukuk during 2016, the index growth aptly reflected the increase in demand for conventional bonds, both in the MENA region as well as internationally.

MENA Bond Issuances

Bond Issuances - 2016 vs. 2015



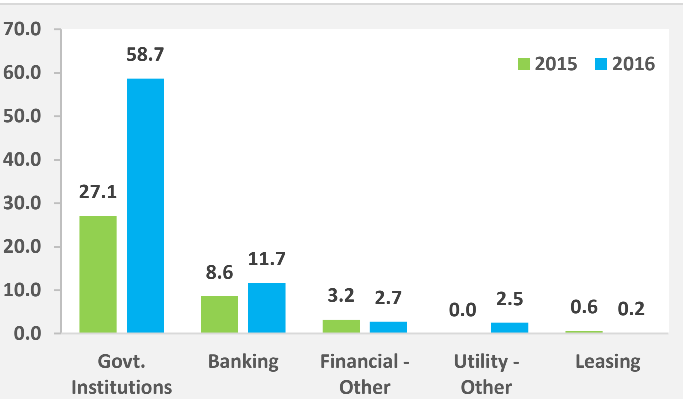
Source: Reuters, KAMCO Research

MENA bond issuances in 2016 almost doubled from the previous year primarily on the back of new sovereign issues by GCC countries that were aimed at plugging the budget deficit. Saudi Arabia's first international bond issuance valued at USD 17.5 Bn in October-16 was the biggest recorded emerging market bond, far outpacing the previous record of Qatar's USD 9 Bn sovereign bonds issued in May-16. Moreover, although the total bond issuance by Saudi Arabia during 2016 was almost equal to bonds issued by UAE, there was stark difference between the composition of the instruments. In the case of Saudi Arabia, the government was the sole borrower, however, for the UAE, it was corporate borrowers. There were also speculations that Kuwait would raise funds through a debt issuance in late 2016. However, the significant size of Saudi Arabia's bond made Kuwait and other regional economies take a pause to see the market reception of this jumbo offering. Moreover, after the successful issuance by the Kingdom that even saw an increase in total size (USD 15 Bn targeted vs. USD 17.5 Bn actually raised), Saudi Arabia has indicated further bond issuances in the near term and the Kingdom has a target debt-to-GDP ratio of 30% by 2020 as compared to 13.2% for 2016, based on preliminary data.

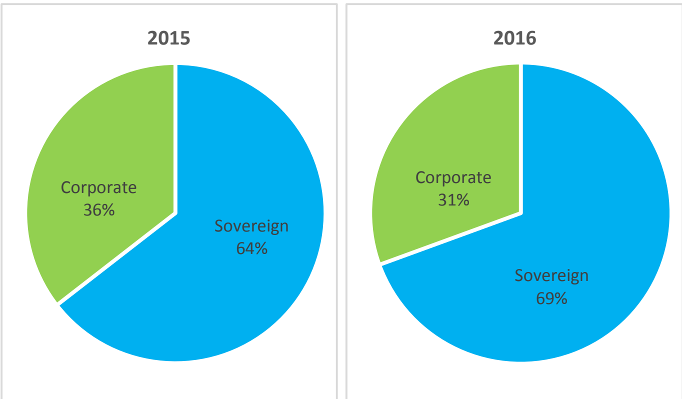
In terms of sector split, government still accounts for the bulk of total bond offering in the MENA region accounting for 69% of the total yearly issuances as against 64% for 2015. Banking sector contribution witnessed a steep decline from 22% in 2015 to 15% in 2016,although the size of the total offering increased by 36% to USD 11.7 Bn. Moreover, majority of the issuances by banks in the region were primarily to meet the capital requirement for the Basel III. For 2017, we expect another wave of bond issuance by regional banks that are still to meet the requirements of the new standard.

Prospects for MENA bond issuances in 2017 appears bright based on further funding requirement in the region by both sovereigns and corporates as well as rising interest rates that would make bank lending costlier. Moreover, as the economic growth is estimated to pick up, spending by corporates on M&A and capital projects is expected to also grow that would have a direct impact on fixed income issuances. On the downside, banks continue to be well-funded with strong balance sheet, especially in the GCC region. More, customer deposits remain significant and a relatively cheap source of funds for banks. Issuances to meet regulatory capital requirements is expected to be the key driver for banks to tap the bond market.

Top Five Sectors by Bond Issuance - MENA



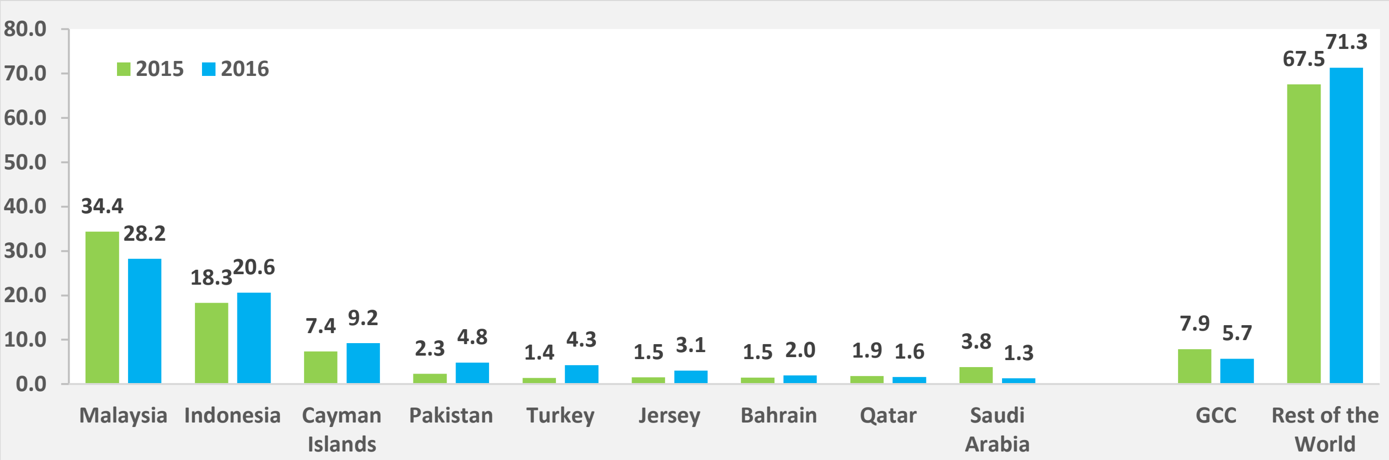
Breakdown by Issuer - MENA



Source: Reuters, KAMCO Research

Global Sukuk Issuances

Sukuk Issuances - 2016 vs. 2015



Source: Reuters, KAMCO Research

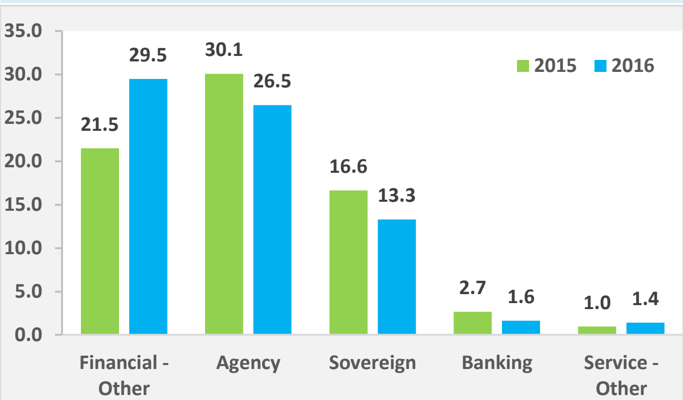
Global sukuk issuance increased marginally by 2.2% in 2016 to reach USD 77.1 Bn as compared to USD 75.4 Bn during 2015. This increase was much smaller than the 5.5% growth seen in 2015. The deceleration in growth was primarily due to the fall in sukuk issuance by Malaysia (USD 28.2 Bn in 2016 as compared to USD 34.4 Bn in 2015), in addition to the GCC countries that recorded a decline of USD 2.2 Bn in 2016. Nevertheless, Malaysia continued to dominate the market accounting for 38% of total global sukuk issuances in 2016 (47% during 2015) followed by Indonesia at 27% (25% in 2015) and Cayman Islands at 12% (10% in 2015). Moreover, despite the significant push by GCC countries to promote sukuk, the overall region accounted for a miniscule portion of the global sukuk market accounting for 7% in 2016, lower than a 10% share during 2015.

In terms of issuer breakdown, corporates dominated the sukuk market during 2016 with an even higher share of the total pie during the year. Total sukuk issuance by corporates increased by USD 7.4 Bn during 2016 to reach 50.4 Bn or 65% of total amount issued in 2016 as against 57% in 2015. On the other hand, sovereign issuances declined by USD 5.8 Bn or 17.8% during 2016 to reach USD 26.6 Bn due to a shift in preference favoring conventional bonds as against sukuks. One of the reasons for the shift in aforementioned preference was that the governments, especially in the GCC, were in a hurry to raise additional funds to meet funding requirements, and going for a sukuk would have taken additional time due to its complexities as well as time to educate investors about its benefits.

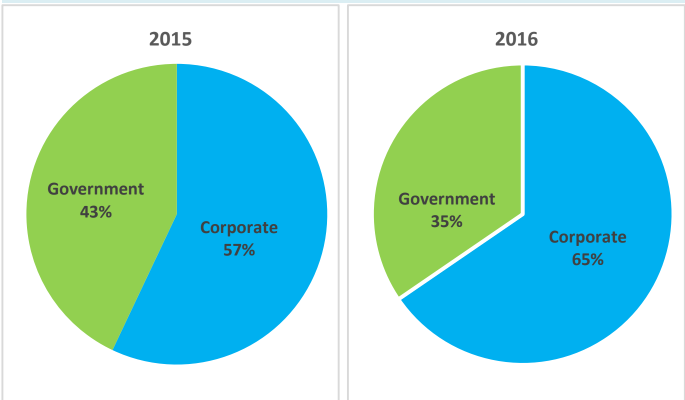
The total number of sukuk issuances declined for the third consecutive year after peaking in 2013 to reach 377 in 2016 as compared to 391 issuances in 2015. Malaysia continued to remain the biggest contributor in terms of number of sukuk issuances recording 276 in 2016 as compared to 308 in 2015 as both government and corporates issuances declined. On the other hand, the number of sukuks by Indonesia increased to 37 in 2016 as compared to 30 issuances during 2015. In terms of sector split, financial services sector accounted for the highest number of issuances, recording 208 sukuks in 2016 (including 12 issuances by banks) as compared to 218 sukuks in 2015.

The outlook for sukuk issuance in 2017 remains positive as GCC economies are expected to return to issuing sukuks to fund their deficits and tap the increasing demand Islamic investors in the region. Moreover, with stabilizing oil prices and austerity measures in place, GCC governments will have the time to standardize policies for Islamic instruments and tap the unfulfilled global demand.

Top Five Sectors by Sukuk Issuance



Breakdown by Issuer



Source: Reuters, KAMCO Research

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