KAMCO INVEST

Investment Strategy & Research

GCC Fixed Income Market Update

June-2023

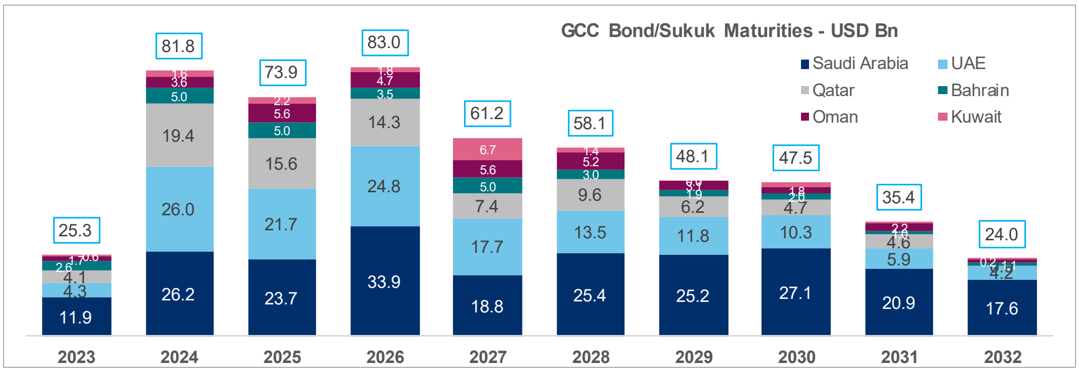
Rate hike pause and Fed comments further muddles the FI market...

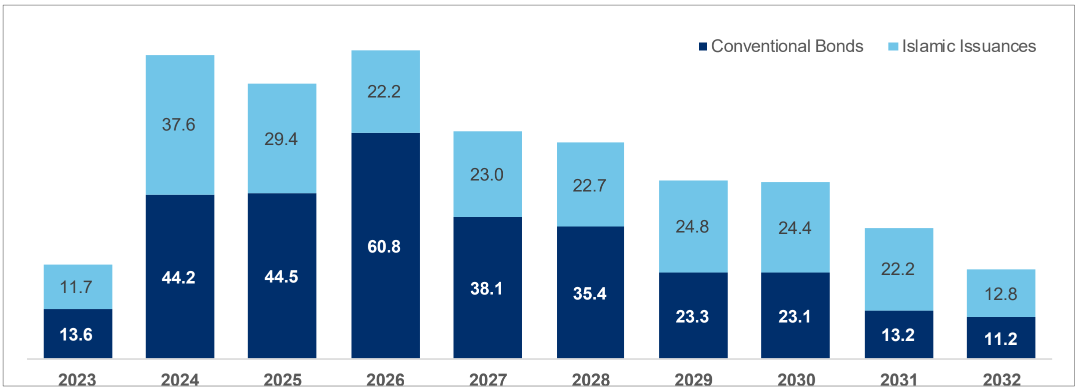
The latest comments from the US Fed was unexpected and came as a surprise to the market mainly in terms of the two rate hikes it said would be implemented this year as well as indications that there would be no cuts this year. *The pause in rate hikes this month after 10 consecutive hikes was expected by traders, however, with core inflation remaining consistently high, the US Fed decided on a wait-and-watch stance before going in for further hikes or announcing cuts in the near term. As a result, concerns mounted over refinancing of pandemic-related issuances that are expected to mature in the near term as well as risk of rising corporate defaults as refinancing at decades-high rates would be costly for businesses.*

On the regional front, the GCC economies are expected to feel the heat of slowing global economic demand led by rate increases both in the region and globally and slowing economies while taming inflation, although strong domestic demand, especially from the infrastructure sector, is expected to help offset some of the negative impact. *In addition, the strong credit profile of most countries in the GCC with upgrades to two sovereigns this year also provides stability to currency and the fixed income funding market.*

After seeing a steep decline in 2022, fixed income issuances in the GCC witnessed partial recovery during the first six months of 2023 as compared to the corresponding period in 2022. *The y-o-y growth was mainly driven by higher corporate bond issuances this year that was partially offset by a steep decline in government issuances. In terms of type of instrument, bonds outweighed sukuks registering a strong y-o-y growth while Islamic issuances declined. Corporate issuances mainly reflected refinancing of maturing instruments at higher rates as compared to new instruments. On the other hand, a decline in government issuances indicated elevated oil prices that traded in a tight range of USD 70 - USD 80/b levels.*

Meanwhile, economic indicators in the GCC remain robust and point to higher issuances this year as compared to 2022. *The PMI reading for key economies in the region remains well above the growth mark of 50, including in Saudi Arabia, Qatar, UAE and Dubai. Corporate profitability based on the latest Q1-2023 earnings showed q-o-q growth in most markets. The non-oil economy also remains vibrant with related GDP growth of 4.2%, a slight decline from 4.9% seen in 2022, according to the IMF. This was also reflected in the regional project market with new contract awards of more than USD 100 Bn expected this year, according to MEED Projects.*





Sources : Bloomberg, Kamco Invest Research. Note: All data as of 19-Jun-2023, including YTD-2023 issuances.

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Sovereign rating actions

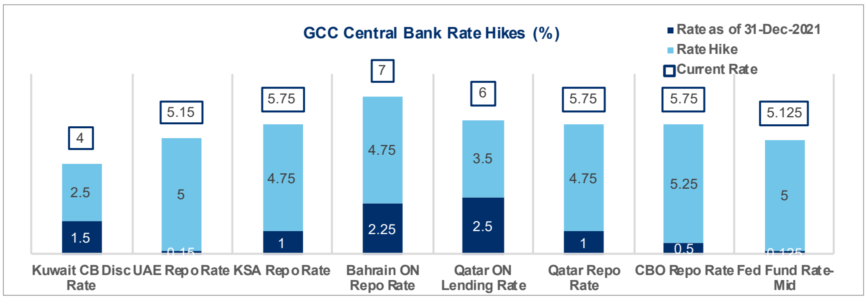
Sovereign rating actions since the start of 2023 were almost equally split between downgrades and upgrades. According to data from Bloomberg, this year almost 27 sovereign rating downgrade and upgrade rating actions were taken by global rating agencies. There were around 14 sovereign downgrades since the start of the year as compared to 13 upgrades. Most of the downgrades were made to emerging and developing economies. On the other hand, sovereign upgrades were scattered across the globe.

GCC - Sovereign Credit Ratings Profile

	S&P		Moody's		Fitch	
	Rating	Outlook	Rating	Outlook	Rating	Outlook
Bahrain	B+	POS	B2	STABLE	B+	STABLE
Kuwait	A+	STABLE	A1	STABLE	AA-	STABLE
Oman	BB	POS	Ba2	POS	BB	POS
Qatar	AA	STABLE	Aa3	POS	AA-	POS
Saudi Arabia	A	STABLE	A1	POS	A+	STABLE
UAE	NR	NR	Aa2	STABLE	AA-	STABLE
Abu Dhabi	AA	STABLE	Aa2	STABLE	AA	STABLE

Sources : Bloomberg, Kamco Invest Research

Sovereign rating actions in the GCC favored positive actions with two upgrades since the start of the year. Oman's sovereign rating once again witnessed an upgrade this year by Moody's from Ba3 to Ba2 in May-2023. The rating agency changed its rating on Oman after almost three years and maintained its Positive outlook on the rating. The upgrade reflected improvements in Oman's debt burden and debt affordability metrics during 2022 led by higher oil and gas revenue. The government's spending restraint and the move to use surplus and previous buffers to pay down debt also supported the ratings. The sovereign rating of Saudi Arabia was also upgraded by S&P and Fitch this year. S&P upgraded its rating on the Kingdom to A from A- with a Stable outlook. The upgrade reflected the governments reform plans that support the development of the non-oil sector and lower the dependence on oil sector. The upgrade by Fitch from A to A+ with a Stable outlook reflected the Kingdom's strong fiscal and external balance sheets and significant fiscal buffers in the form of deposits and other public sector assets.

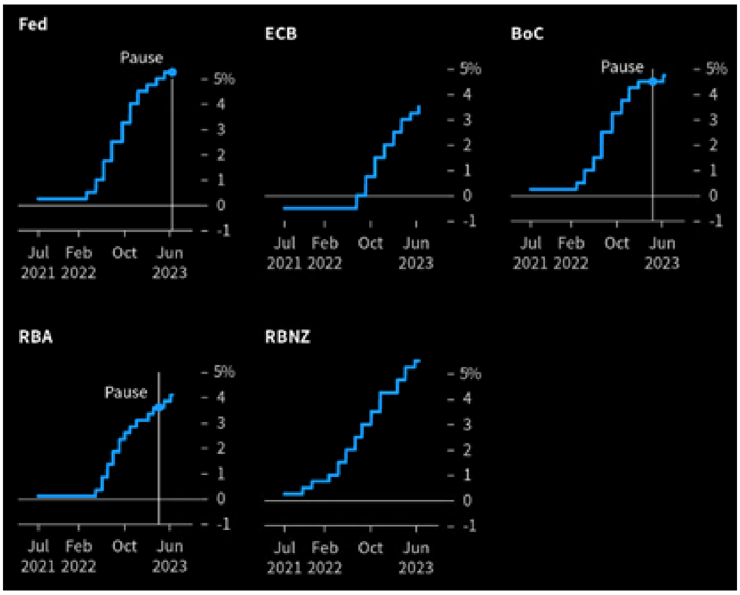


Sources : Bloomberg, Kamco Invest Research

Inflation and interest rate hikes - A rate pause and a caution for future hikes

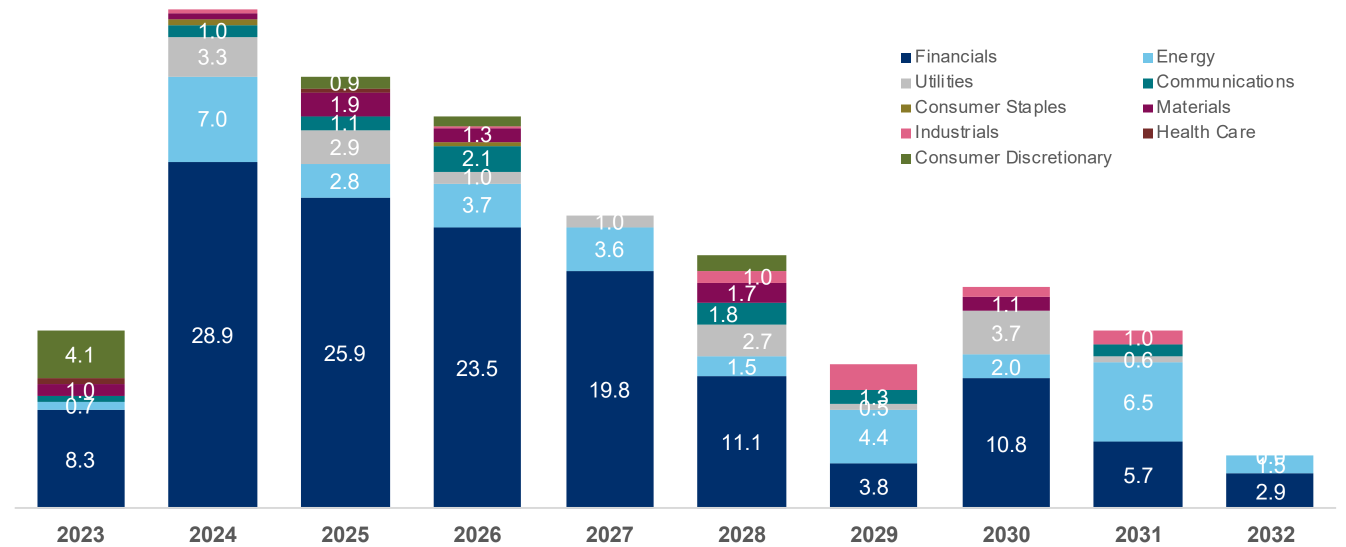
In its most recent meeting, the US Fed kept the rate unchanged in the range of 5.00% - 5.25% after 10 straight hikes over the last 15 months. This was expected by the market as inflation is seen cooling in the rest of the year, although economic data continues to remain stronger-than-expected while the impact of higher rates on inflation was less than planned. The most recent reading of inflation came in at 4.0% during May-2023 after declining consistently over the last 11 months. However, the market enthusiasm faded as the Fed maintained a hawkish tone and said it expects further rate hikes in the rest of 2023 led by elevated inflation and labor market strength. The Fed chair indicated at least two rate hikes of 25 bps each as early as in July-2023. As a result, the dot plot now shows median estimate of rates to rise to 5.6% by the end of 2023.

Elsewhere, in Europe, the ECB and the BOE also raised rates in view of higher inflation. The ECB raised its deposit rate for the eighth consecutive time to a 22-year high level of 3.50% from 3.25%. The ECB expects inflation to remain higher for a longer term after a sharp increase in core inflation and said more rates are coming in the near term. For the forecast, the ECB expects inflation to remain above the 2% target until the end of 2025. The latest reading on inflation for the EU showed an increase of 6.1% as of May-2023. Nevertheless, with 22 different economies in the group with employment and inflation at differing levels, future policies may vary depending on where the key economies are on the graph. The UK has also the problem of inflation with traders pricing in four more hikes and rates peaking in at 5.75% and even reaching 6% early next year, the highest level since 2000.



Sources : Bloomberg

GCC Corporate Bonds/Sukuk Maturities by Sector - USD Bn



Sources : Bloomberg, Kamco Invest Research

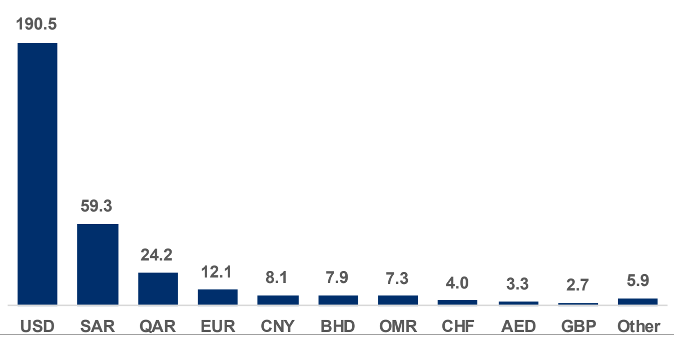
Bond/Sukuk Maturities

GCC governments are expected to see USD 175.8 Bn in fixed income maturities over the next five years (2023-2027), whereas corporate maturities stand slightly lower at USD 149.4 Bn. Both bond and sukuk maturities are expected to remain elevated starting from 2023 until 2027 and then gradually taper for the rest of the tenor. The higher maturities during the next five years reflects a number of short-term (less than 5-year maturity) issuances in 2020 and 2021 as governments raised funds to plug-in deficits during the pandemic. A majority of these maturities are denominated in USD at 58.6% followed by local currency issuances in SAR and QAR at 18.2% and 7.4%, respectively. In addition, due to the credit rating profile of the GCC governments, a majority of these maturities are in the high investment grade or A rated instruments. In terms of type of instruments, conventional bonds dominate with USD 201.2 Bn in maturities over the next five years, whereas sukuk maturities are expected to be at USD 124.0 Bn. In terms of country split, Saudi Arabia has overtaken UAE in terms of biggest maturities over the next five years. The Kingdom is expected to see maturities of USD 114.5 Bn until 2027 followed by UAE and Qatari issuers at USD 94.6 Bn and USD 60.9 Bn, respectively.

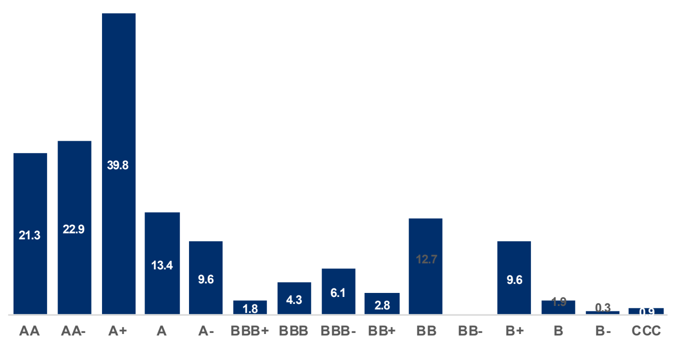
In terms of sector maturities, Banks and other Financial Services sector have USD 106.4 Bn in maturities in the next five years, accounting for around 71.2% of the total corporate maturities and 32.7% of the total maturities in the GCC until 2027. The Energy sector was next with maturities of USD 17.7 Bn or 11.8% of GCC corporate maturities until 2027 followed by Utilities and Consumer Discretionary at USD 8.2 Bn and USD 5.9 Bn, respectively. Banks in UAE have the biggest maturities over the next five years at USD 44.9 Bn followed by Qatari banks with maturities of USD 25.3 Bn. Banks in the two countries accounted for 21.5% of total bond/sukuk maturities over the next five years in the GCC. Real Estate maturities are concentrated mainly in the UAE and Saudi Arabia at USD 5.1 Bn and USD 3.0 Bn, respectively, until 2027.

The structure of maturities saw perpetual instruments seeing consistent growth until 2022. However, 2023 witnessed a steep decline in issuances of perpetual instruments. According to data from Bloomberg, aggregate issuances declined from USD 20.0 Bn in 2022 to merely USD 2.6 Bn during the first six months of 2023.

Bond/Sukuk Maturities 2023-2027 - By Currency of Issuance (USD Bn)

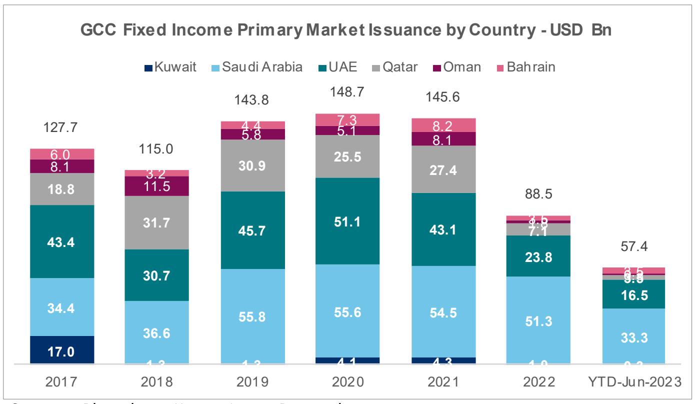


Bond/Sukuk Maturities 2023-2027 - By Rating (USD Bn)



Sources : Bloomberg, Kamco Invest Research

Issuances in 2023



Sources : Bloomberg, Kamco Invest Research

Aggregate issuances during the first six months of 2023 stood at USD 57.4 Bn as compared to USD 51.8 Bn during the corresponding period in 2022, resulting in an increase of USD 5.6 Bn or 10.7%. Full year issuances in 2022 stood at USD 88.5 Bn. The increase was mainly led by higher corporate issuances that went up from USD 20.0 Bn in 1H-2022 to USD 34.6 Bn in 1H-2023. On the other hand, government issuances dropped by more than a quarter to USD 22.8 Bn in 1H-2023 as compared to USD 31.8 Bn in 1H -2022. In terms of type of issuance, bond issuances more than doubled in 1H-2023 to USD 36.5 Bn vs. USD 15.1 Bn in 1H-2022 while sukuk issuances dropped by 43.0% to reach USD 20.9 Bn as compared to USD 36.7 Bn in 1H-2022. At the country level, Kuwait, Saudi Arabia and Oman reported declines in issuances in 1H-2023 vs. 1H-2022 while UAE, Qatar and Bahrain registered strong growth. UAE issuers reported the biggest absolute growth in fixed income issuances this year with an increase of USD 4.9 Bn or 42.7% to reach USD 16.5 Bn in issuances. Saudi Arabia reported a small decline of USD 1.5 Bn or 4.3% but remained the biggest issuer this year with aggregate bonds and sukuk issuances reaching USD 33.3 Bn in 1H-2023.

Outlook - Market optimism vs. Fed projections

The comments that the rates would be raised by around 50 bps may not be fully implemented as economists are expecting a continued decline in inflation towards the end of the year. However, the expectation of core inflation was raised by 30 bps to 3.9% and whether the Fed sticks to its 2% inflation target or is flexible in its approach in implementing rate hikes would determine the future course of action. In addition, the Fed committee now believes that in order to fight inflation, it needs a real rate of 2 percentage points above the inflation levels, which has increased from 1.1 percentage points above the projected inflation expected last year.

In the market, the real estate sector has started to show a decline with higher mortgage rates affecting the housing market. The yield inversion with longer dated treasury securities trading below shorter dated ones also indicated a recession. However, traders that were expecting a recession induced pause in rate hikes were also surprised with the spate of recent announcements by central banks.

Impact on the fixed income market

Fund managers across the board were expecting rates to pause at current levels and see cuts starting from the end of this year and had consequently booked long positions. However, the tone from the Fed's recent meeting clearly reversed these expectations. Rates across the advanced markets are being raised including in Australia, Canada, in the EU, UK and now the announcement from the US.

The fixed income market underwent a steep double-digit decline last year and with continued rising rates, the indices are showing minimal recovery this year. The enthusiasm seen before the Fed meeting faded after the Fed surprised by indicating further rate hikes in the near term. Investors are now bracing for higher for longer rates with traders now expecting no cuts this year from an earlier stance where they expected easing to start by the end of the year.

The impact on businesses would be higher borrowing costs for longer and with higher funding costs and shrinking money supply, the risk of defaults is escalating, especially for companies with challenged business models. Moreover, refinancing of cheap facilities taken during the pandemic days would further worsen the situation at current borrowing rates. Borrowers delayed a refinancing expecting a decline in rates. And this was reflected in the average maturity of junk bonds that fell to just over five years, the lowest on record, according to Bloomberg. Risk of bankruptcies would result in higher debt to equity swaps and buying back of debt at discounts.

On the global front, we expect that tighter monetary policies would limit fixed income issuances. However, economic growth in the GCC region is expected to beat global growth with project market activity expected to pick up from a slowdown over the last few quarters. As a result, fixed income issuances are expected to beat last year's level in 2023.

GCC bonds and sukuk maturities are expected at USD 25.3 Bn for the remainder of 2023 and the refinancing of these instruments are expected to account for the bulk of the issuances by corporates and governments in the region. That said, the higher cost of borrowing and strong profitability coupled with cash generation is expected to discourage some refinancing activity in the near term. We push our forecast of fresh issuances to next year as interest rates are expected to remain elevated this year with no rate cuts now forecasted by global central banks.

Corporate issuers would be discouraged to issue bonds/sukuks and would prefer to go in for equity market given elevated valuations currently in the market. On the other hand, most sovereigns in the GCC are expected to report fiscal surpluses due to elevated oil prices that would limit overall issuances. However, sovereigns in the region still require funding in the medium-to long-term to meet their long-term strategic visions. We expect overall fixed income issuance to remain flat in 2023 or show a small growth to range between USD 80-USD 85 Bn reflecting the aforementioned factors.

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