GCC Fixed Income Market : *2015 - The Year That Was...*

The MENA fixed income market is expected to continue to grow during 2016 after a marginal growth of 4% in 2015. Sukuk issuance in MENA is expected to outpace bond issuance in 2016 (as against a 38% decline in sukuks in 2015) primarily due to still abundant liquidity in that market as against tight liquidity with conventional banks. Also supporting the expected issuance are the oil price led fiscal deficit gap and the need to invest in infrastructure by the sovereigns.

The year 2015 saw higher issuances by sovereigns led by Saudi Arabia which tapped the market after an eight year hiatus. However, corporate issuers in the GCC pulled back from the bond market resulting in a decline of almost 22% in this segment during 2015. For 2016, Saudi Arabia has already announced that it would tap the international bond market to plug the expected budget deficit during the year. In addition, the excellent credit ratings of the GCC sovereigns should make their fixed income issuance attractive to investors globally.

On the international front, a process of normalization was finally initiated during December-15 when the US Fed raised benchmark rates after almost 8 years of a zero rate policy. However, the initial response to the rate hike by the year-end was a flattening yield curve. Short term interest rates saw an upward trend by year-end reflecting the increase in Fed benchmark rates. On the other hand, long term interest rates are yet to see the same pace of increase in response to the benchmark rate hike, which points towards a lack on confidence in the long term growth of the US economy. This has raised concerns of an "inverted curve" or recessionary pressure in the long run.

In fact, in 2015 the yield on 2-year US treasury note posted the biggest yearly rise since 2006. A number of factors were responsible for this, including a steep decline in oil prices, recurring concerns of slowing global growth with continued slowdown in Europe, a bumpy landing expected in Chinese economy as well as the Yuan devaluation in August-15.

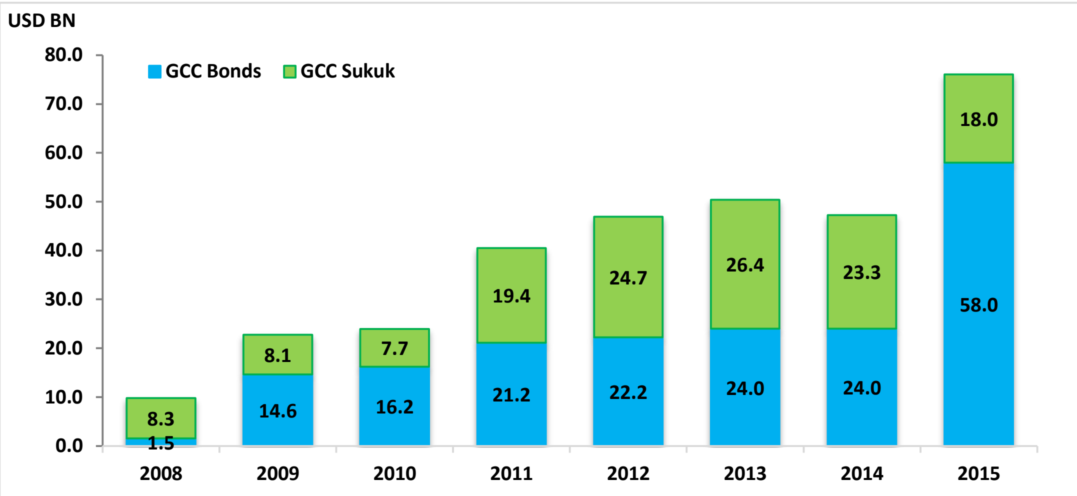
In terms of international focus, demand for US bonds have increased globally resulting in a capital flight from emerging markets and some Asian economies as they seek safer bets. The higher investment was also due to a strengthening USD against the EUR, Yen and a number of currencies. Meanwhile, in terms of bond preference, municipal bonds in the US were preferred that generated higher total return as compared to junk category bonds and corporate bonds.

Sovereign Credit Ratings

Country	Moody's	S&P	Fitch
Abu Dhabi	Aa2	AA	AA
Bahrain	Baa3	BBB-	BBB-
Kuwait	Aa2	AA	AA
Oman	A1	BBB+	NR
Qatar	Aa2	AA	AA
Saudi Arabia	Aa3	A+	AA

Source: Bloomberg

Fixed Income Issuances in GCC



Source: Zawya, KAMCO Research

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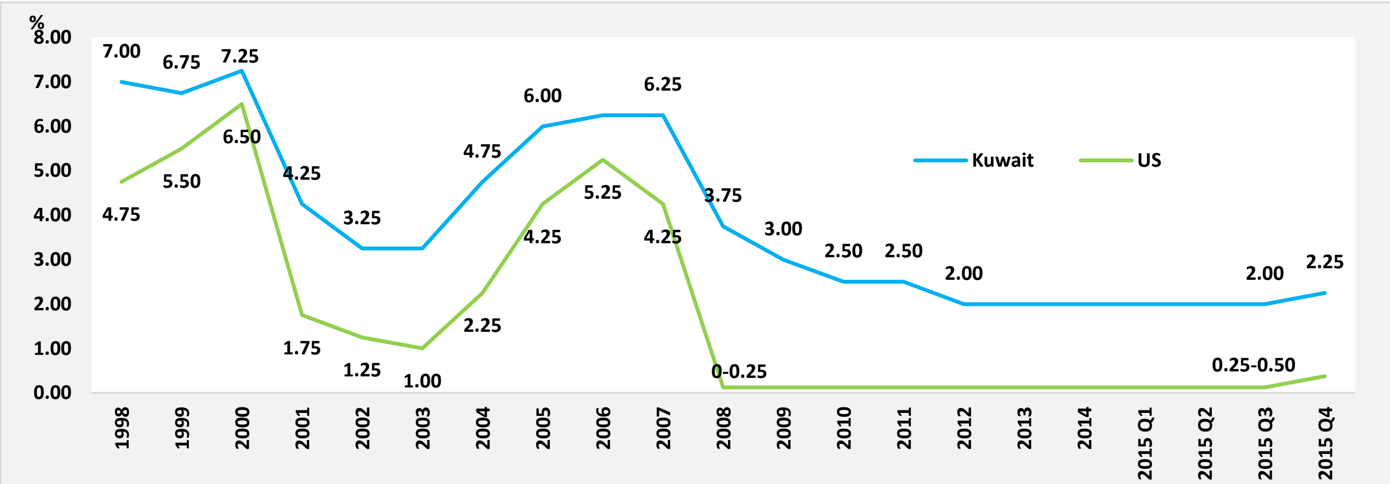
US & MENA Rate Hikes

Following the US. Fed rate hike announcement, Saudi Arabia, Kuwait and Bahrain raised their benchmark rates. Saudi Arabia raised its overnight reverse repo rate by 25 bps to 50 bps but left its benchmark repo rate unchanged at 2.0%. Meanwhile, the Central Bank of Kuwait (CBK) raised its benchmark discount rate by 25 bps to 2.25%, whereas Bahrain, while keeping the repo rate unchanged at 2.25%, raised its overnight interest rate by 25 bps to 0.5% and its rate for one week also by 25 bps to 0.75%. The move by the three gulf countries was expected since the GCC countries have pegged their respective currencies against the USD (with the exception of Kuwaiti Dinar which is pegged against a basket of currency dominated by the USD).

Fed Fund Rate vs. Kuwait Central Bank Discount Rate

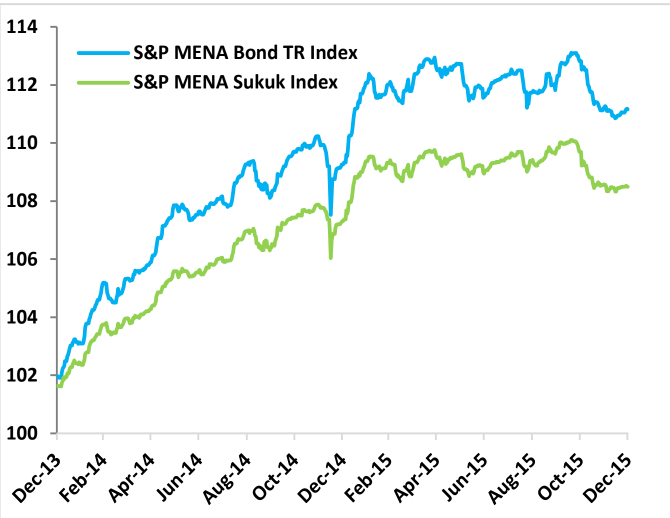


Data indicates end-of-period target rates/ranges. Source: US Federal Reserve, Central Bank of Kuwait

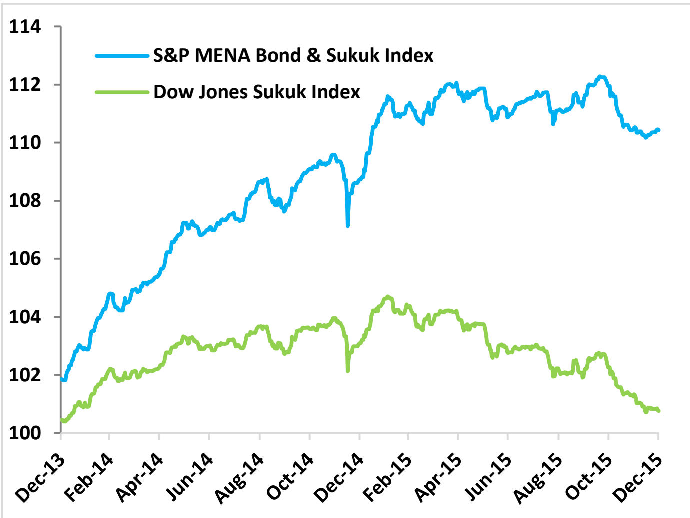
The rate hike, as also highlighted by Fitch Ratings, is primarily to maintain the currency peg and does not represent any urgency or fiscal/ monetary pressure. On the other hand, absence of a rate increase would have put pressure on the local currencies and in the longer run lured investors to sell their local assets in the gulf region and invest in higher-yielding dollar-based investments.

Fixed Income Market Performance

MENA Fixed Income Indices



MENA Vs. Global Sukuk Index

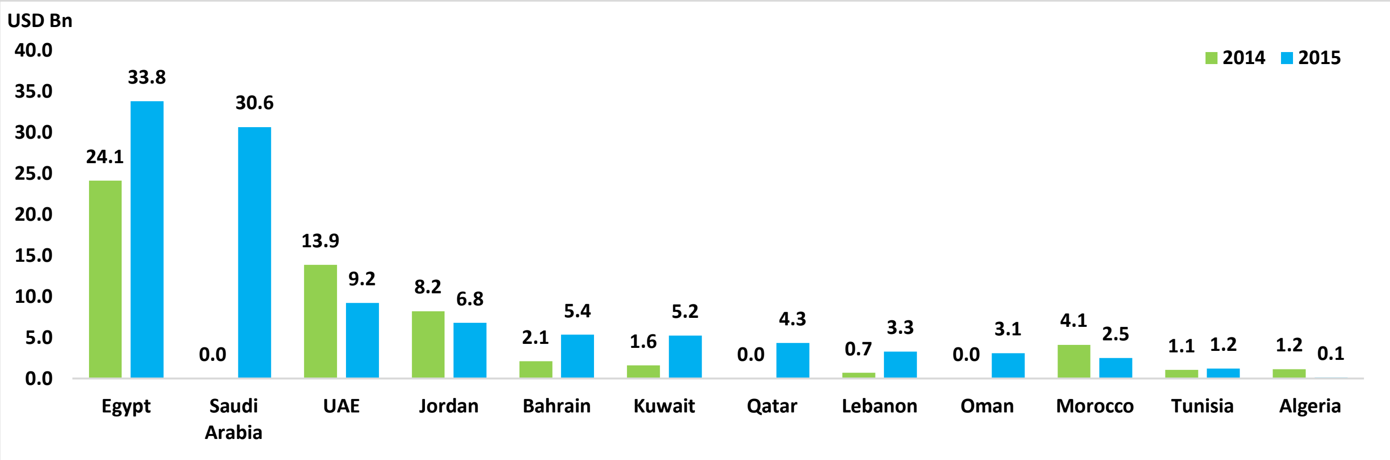


Source: Bloomberg, KAMCO Research

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 2015. The sukuk market got a boost as sovereigns continued to diversify their funding sources and the trend is expected to be stronger in 2016.

MENA Bond Issuances

Bond Issuances - 2015 vs. 2014



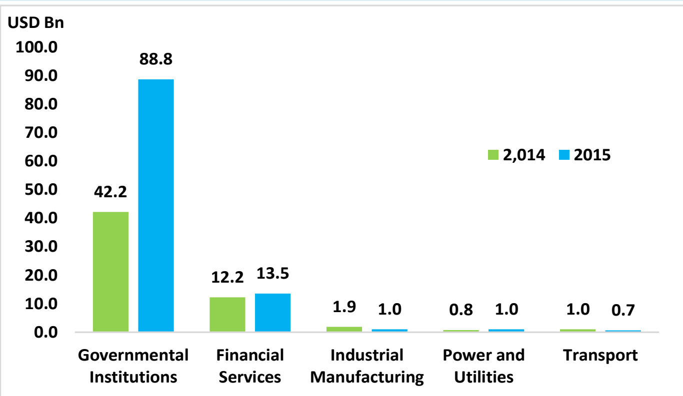
Source: Zawya, KAMCO Research

Total bond issuance in the MENA region touched USD 105.7 Bn during 2015, a strong leap of 67% or USD 42.3 Bn as compared to the previous year. Bond issuance activity got a boost from Saudi Arabia after the Kingdom issued bonds worth USD 30.6 Bn as compared to no issues in the previous year. Saudi Arabia resumed issuing local currency bonds to banks in July-15 for the first time since 2007 in order to cover budget deficits due to the fall in oil prices. The Kingdom issued an average of SAR 20 Bn (USD 5.3 Bn) every month since it started the program. Nevertheless, the market continues to be dominated by Egypt that issued USD 33.8 Bn in bonds during the year, an increase of 40% over the previous year level. The total number of issuances witnessed an increase of merely 4.5% during 2015 to reach 253. However, the average size of the bond offering in MENA was much larger as compared to the previous year.

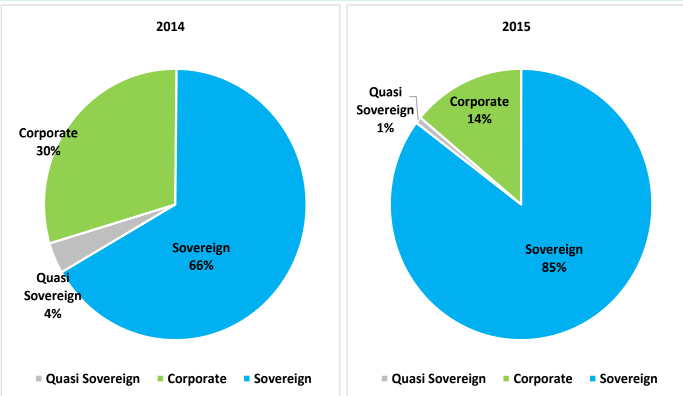
Government institutions continue to be the biggest issuers of bonds in the region with total issues having more than doubled to USD 88.8 Bn during 2015. Issues by banks totaled USD 13.5 Bn in 2015 as against USD 12.2 Bn during 2014. In terms of the share of total issuance, sovereign bonds accounted for 85% of total issues in 2015, a much higher share as compared to 66% in 2014, whereas the share of corporates slumped from 30% in 2014 to merely 14% in 2015. Bond issues in Kuwait saw a significant jump from USD 1.6 Bn in 2014 to USD 5.2 Bn in 2015 primarily on the back of higher issuance by the government further supported by capital boosting bonds launched by NBK in order to meet Basel III requirements and to boost Tier 2 capital.

The bond market outlook for 2016 largely shows a grim picture with a majority of the fund managers expressing a more bearish view for the overpriced bond market as compared to compelling valuations for the equity markets. The rate hike decision in Saudi Arabia, Kuwait and Bahrain following the U.S. rate hike in December-15 has pushed up short-term interest rates and reduced bond yields thereby resulting in shrunken buying for Gulf bonds. In addition, the severe decline in oil revenues has affected deposits with local banks resulting in significantly tight liquidity conditions. Nevertheless, expected issuance in 2016 include international bond issue by Saudi Arabia as indicated by the country's finance minister. Moreover, the yield on the expected bond issuance would largely depend on oil price. The yield spread over US treasuries would be much larger if oil price continues to be at low levels but if it increase to USD 50/b level, yields spreads could be in the range of 200-250 bps over US Treasuries.

Top Five Sectors by Bond Issuance



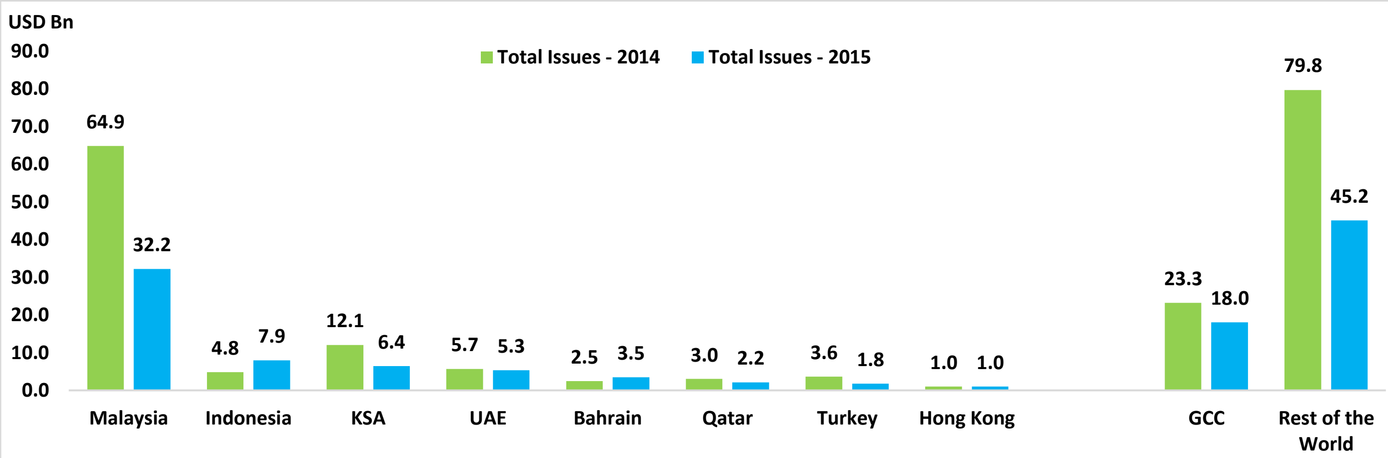
Breakdown by Issuer



Source: Kuwait Stock Exchange, KAMCO Research

Global Sukuk Issuances

Sukuk Issuances - 2015 vs. 2014



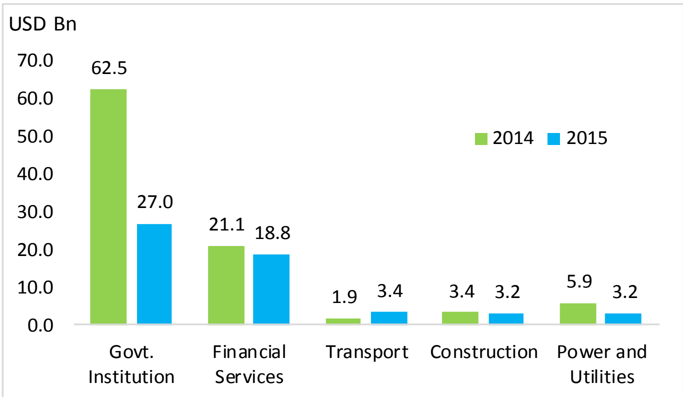
Source: Zawya, KAMCO Research

Total global sukuk issuances declined significantly during 2015 by almost 39% to USD 63.2 Bn vs. USD 103 Bn during 2014 as a result of volatility in rates and weakness in commodities. Nevertheless, as a percentage of global sukuk issuances, GCC's share increased from 23% in 2014 to 29% in 2015. Malaysia continued to dominate the world sukuk issuance center followed by Indonesia and Saudi Arabia. One of the primary reasons for the decline in the sukuk issuances during 2015 was the decision by the Central Bank of Malaysia to move away from Sukuk as a liquidity management tool for the Islamic banks in the country. Moreover, uncertainty over interest rates in the US also kept some of the issuers away from the market. A total of 709 sukuk issues happened during 2015 as compared to 809 during 2014.

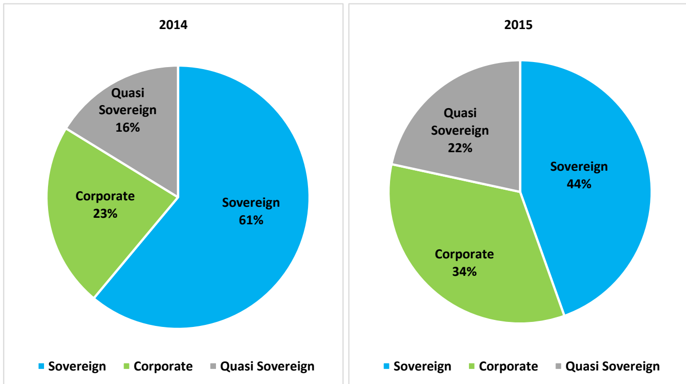
Sovereign issues continued to dominate the sukuk market during 2015; however the share in total issuance more than halved during the year. Total issuance by sovereigns stood at USD 28.1 Bn in 2015 as compared to USD 62.9 Bn during 2014, whereas quasi-sovereign issued USD 13.7 Bn of Sukuks as compared to USD 16.7 Bn in 2014. Sukuk issuance by corporates stood at USD 21.4 Bn in 2015 as compared to USD 23.4 Bn in 2014. Some of the notable sukuk issuances in the GCC included the USD 1.067 Bn issue by Riyad Bank and the USD 1 Bn soverign sukuk issued by the Ras Al Khaimah government. In terms of sector performance, banks dominated sukuk issuance in the private sector followed by transport sector and the construction sector. On the other hand, Sukuk issuance by power & utilities sector almost halved to USD 3.2 Bn as compared to USD 5.9 Bn in the previous year.

Going forward, we expect sukuk issuance to pick up owing to several factors and government issuance is expected to dominate the market. The infrastructure funding requirements by sovereigns should be positive for the sukuk market. Moreover, since there are limited expectations for any improvement in oil price in the near term, governments would increasingly be motivated to tap the sukuk market in order to fill the deficit gap. Moreover, conventional issues outpaced Islamic issues in 2015; consequently, there is still plenty of liquidity available in the Islamic fund market ready to be tapped by the governments and private sector. The market is expected to be dominated by Saudi Arabia and UAE that are expected to see a mix of both conventional and Islamic issues. Moreover, according to a Moodys, even Kuwait is looking at Sukuk issuance in 2016. Meanwhile, according to the Central Bank of Oman, the country could see more sukuk issuance following the 2015 issuance.

Top Five Sectors by Sukuk Issuance



Breakdown by Issuer



Source: Kuwait Stock Exchange, KAMCO Research

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