

MENA debt: an evolving world for fixed income investors

January 2019



In this co-authored white paper, Emirates NBD Asset Management, KAMCO Investment Company and Fisch Asset Management have partnered to take an in-depth look at the MENA debt market in 2018 and provide an outlook for the year ahead.

Executive summary

The year was one of turmoil in the global fixed income space, as the great bull-run in bond markets came to a halt. However, MENA fixed income provided a relative oasis of calm against volatile market moves. The GCC benchmark index returned 0.30% in 2018 compared to -1.72% for the emerging market benchmark JP Morgan CEMBI Index and -1.20% for the Bloomberg Barclays Global Aggregate Index.

Looking ahead to 2019, we expect the fixed income space to continue to be impacted by the uncertain global economic and policy framework. Despite likely challenges, it is our belief that international bond investors can still benefit from a higher allocation to MENA markets. This thesis is derived from the following factors:

1. GCC governments continue to take bold steps, admittedly with mixed results, with their programme of fiscal reforms to diversify their economies, which should lead to long-term sustainable business models
2. Fiscal deficits should continue to drive further issuance, increasing the region's share within emerging market debt and leading to improved transparency
3. Regional bonds continue to be attractively priced as international investors attach a higher risk premium compared to the broader emerging markets space
4. Inclusion of local bonds in global indices should attract a more diversified bid for regional issues

At the same time, both regional and global markets face challenges that cannot be ignored. The key factors to keep in mind are:

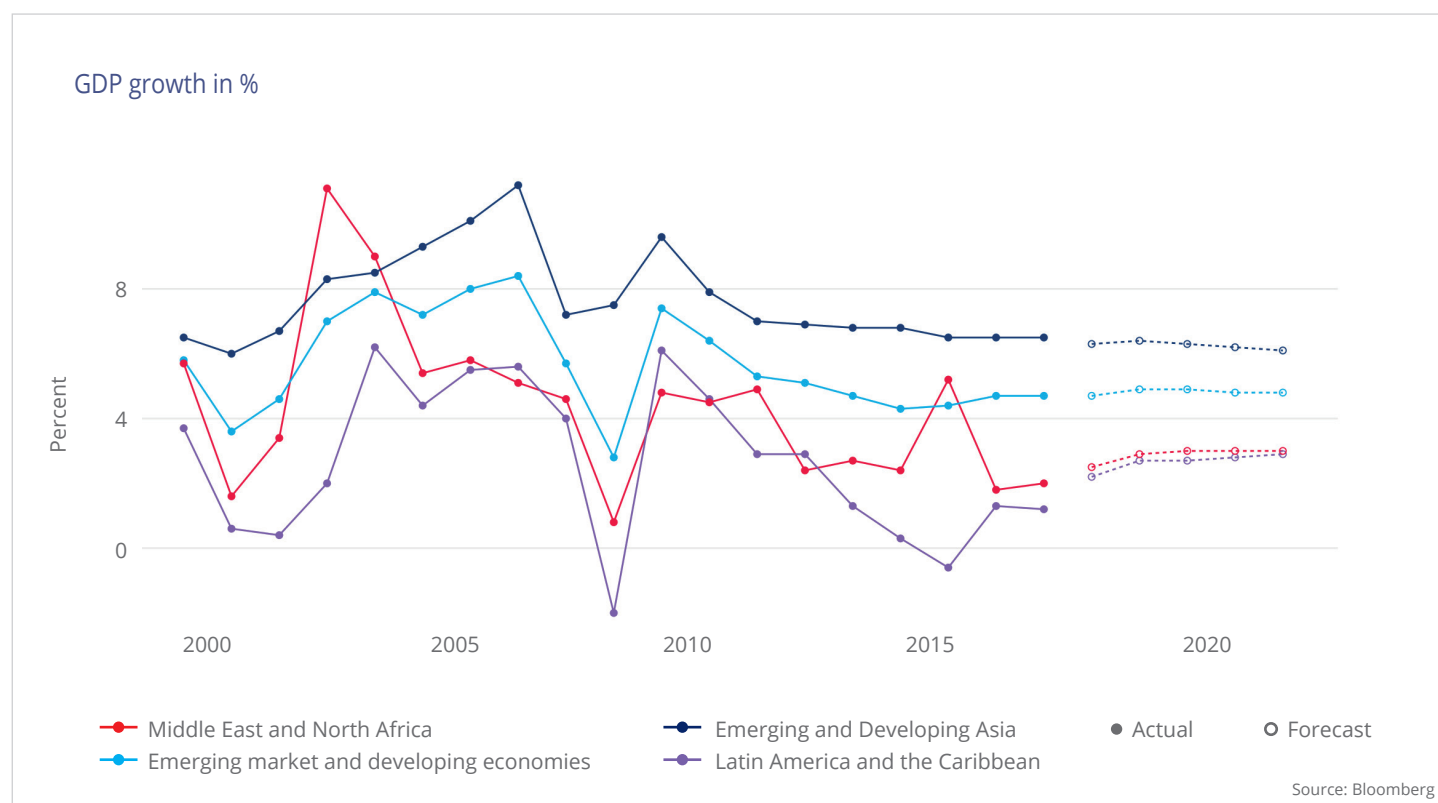
- The collapse of global oil prices in Q4 2018 will put pressure on the fiscal balances of GCC countries
- Geopolitical tensions are likely to continue and could impact investor sentiment and behaviour
- Ambitious restructuring plans place a high emphasis on further issuance, increasing the level of indebtedness

A shifting macroeconomic environment

Global macro trends

Global growth is likely to be a mixed bag as changes in tariff and trade policies take hold, leading to challenges and uncertainty. While the US is likely to remain in a strong economic position, at least in the short term, other developed market economies across Europe are likely to disappoint. On the emerging markets front, the outlook remains positive with overall growth above 4%.

However, this is likely to be driven primarily by Asian economies with China, Latin America and MENA markets likely to see muted growth. The slump in global commodity prices since 2014 has been the main driver for volatility and pressure on growth in MENA and Latin America, as compared with a greater level of stability in Asia.



The US Fed is likely to continue its interest rate hike programme, but this will probably be less substantial than previously expected. For the European Central Bank, monetary policy predictions for 2019 are less clear. The question remains whether US and global growth will be a sufficient driver to encourage growth in Europe and Asia, or whether we will enter a lower growth scenario, where central banks become more accommodative to financial markets.

Volatility has returned to oil markets and looks like it is here to stay in the short to medium-term. In the last months of 2018, global crude oil prices moved from 4-year highs to a 14-month low, triggered by geopolitical actions that clouded near-term supply visibility and by a softening global economic outlook.

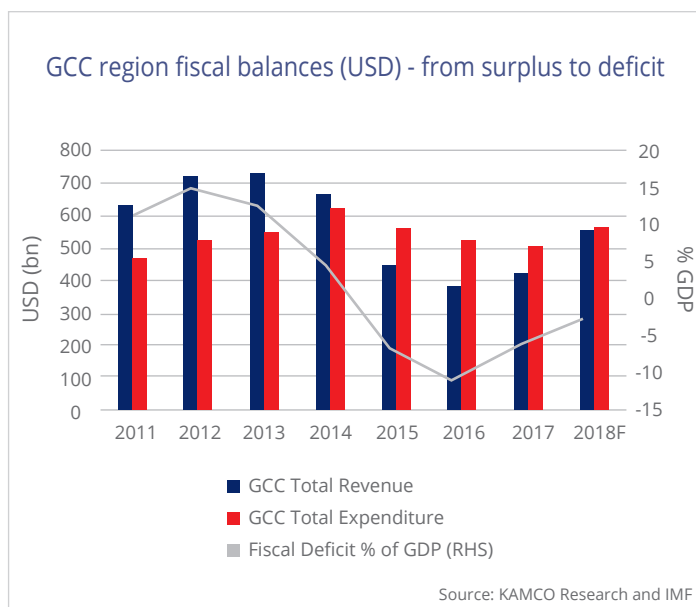
MENA macro trends

Any analysis of the MENA fixed income landscape must define the markets on which it is focused, since these can vary widely. In this report, we define the Middle East and the North Africa regions to include the following countries:

- GCC (Gulf Cooperation Council): Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates
- Non-GCC MENA: Egypt, Morocco, Jordan, Lebanon and Tunisia

The two groups have distinct characteristics that reflect their very different economies. The GCC countries are oil-rich states that were, until recently, self-financed.

On the other hand, while non-GCC MENA countries typically have more diverse economies, they are characterized by lower savings rates, negative correlation to higher oil prices and a high social burden. Furthermore, the macroeconomic environment since the 2011 Arab Spring hasn't offered these economies room to improve their twin balances, putting further reliance on



external debt markets. Relatively speaking, these countries have been ahead in the region in terms of regulation relating to fixed income instruments.

Responding to the challenge: policy change and fiscal adjustment

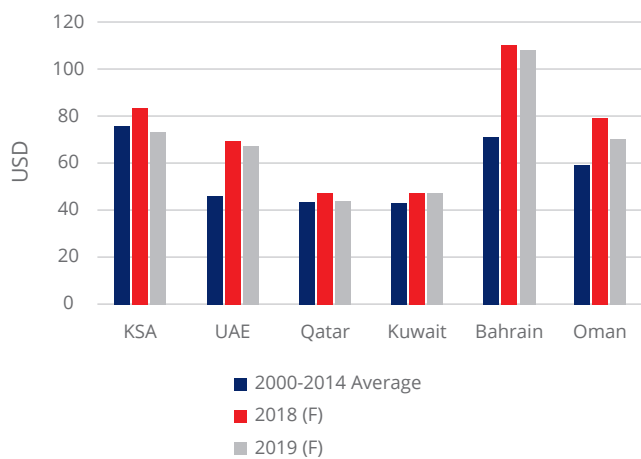
GDP growth forecast for the MENA region for 2018 was recently reduced by the IMF by 120 basis points (bps) and for 2019 by 110 bps. Current GDP growth forecasts for the MENA region stand at 2.0% and 2.5% for 2018 and 2019 respectively. Within the GCC, the largest economy – Saudi Arabia – is expected to grow at a relatively faster pace compared to the last three years, driven by a pick-up in non-oil economic activity as a result of government diversification efforts and a recently announced expansionary budget.

Owing to higher oil price forecasts, conditions for the GCC are expected to improve over 2018 and 2019 as major oil exporters in the region are expected to record positive current account

balances. This expectation may need to be tempered as global oil prices came under considerable downward pressure in the final months of 2018. The recent OPEC+ production cut extension should, however, go some way to shoring up prices that are supportive of a budget surplus for the GCC.

Non-GCC MENA economies are expected to grow at 3.8% and 4.1% in 2018 and 2019 respectively. Egypt is expected to achieve real GDP growth of 5.3% in 2018 and 5.5% in 2019, up from 4.2% in 2017, driven by a recovery in tourism, pick-up in natural gas production and improved confidence indicators in line with its IMF programme.

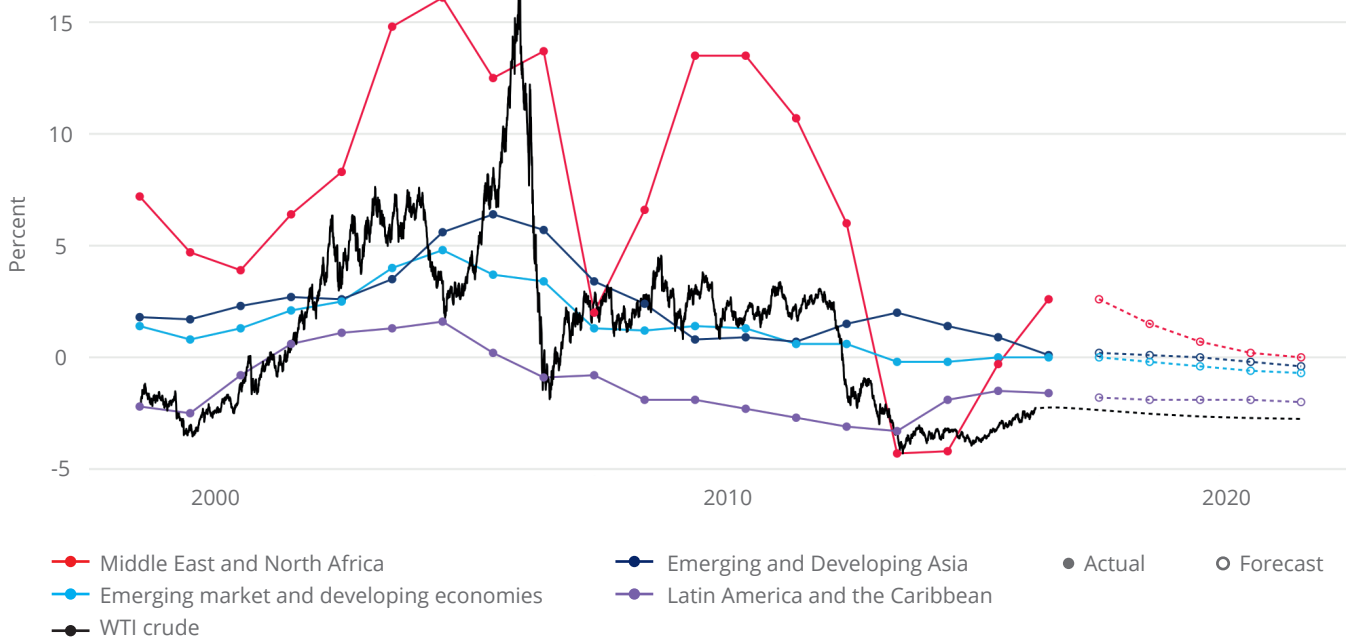
Breakeven oil price: GCC states (USD per barrel)



Source: IMF

The volatility of current account balances, caused by oil price movements, make the region vulnerable. However, large foreign reserves in the form of sovereign wealth funds provide a cushion to ride out any short-term volatility. That being said, the recent lower oil price environment has actually had positive implications for the region. In the case of MENA oil importers, lower prices have reduced the energy bill. Meanwhile, as lower oil prices put pressure on GCC government revenues, policymakers have been forced to undertake wide-reaching economic diversification and reform measures.

Current account balance in % of GDP & WTI crude oil



Source: Bloomberg

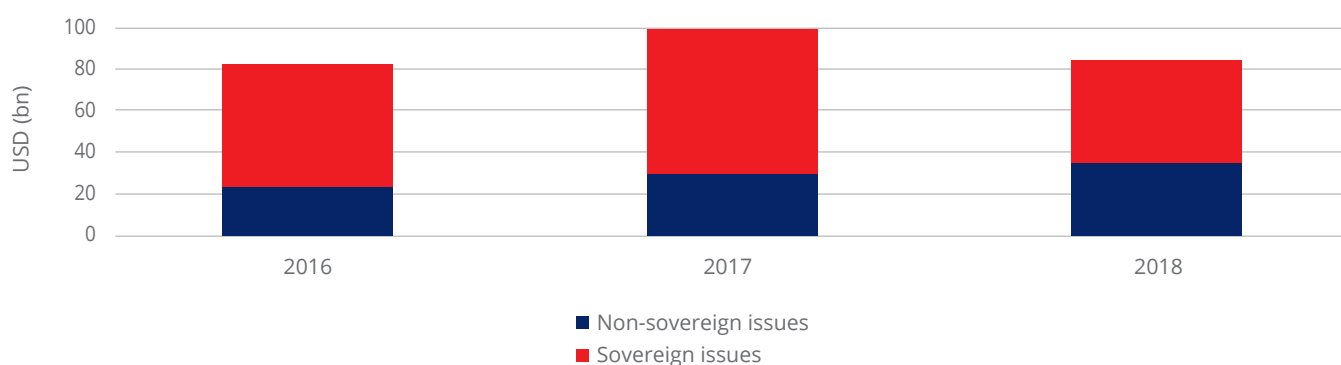
MENA debt: drivers and outlook

Regional issuance in 2018

Total hard currency (USD, EUR, GBP and CHF) issuance in the MENA region stood at USD 84 billion in 2018 compared to USD 100 billion in 2017. While the bulk of this issuance was by sovereigns, several corporates from the region issued public debt for the first time, diversifying their funding base – these included the likes of General Holding (Senaat), Oman Telecommunication, and repeat issuers such as SECO, SABIC, NMC Health and Tabreed. Jumbo issuances of note were – Qatar

and Saudi Arabia sovereign which printed USD 12 billion and USD 11 billion across multiple tranches in April 2018 in their respective single deals. Demand for new issues remained high as regional debt was oversubscribed 2x-2.5x on average in primary markets. Allocation to regional investors was around 50-60%, while the rest was placed outside the region. In terms of investor type, the bulk of allocation was to fund managers at approximately 60%.

MENA hard currency issuance >USD200 million



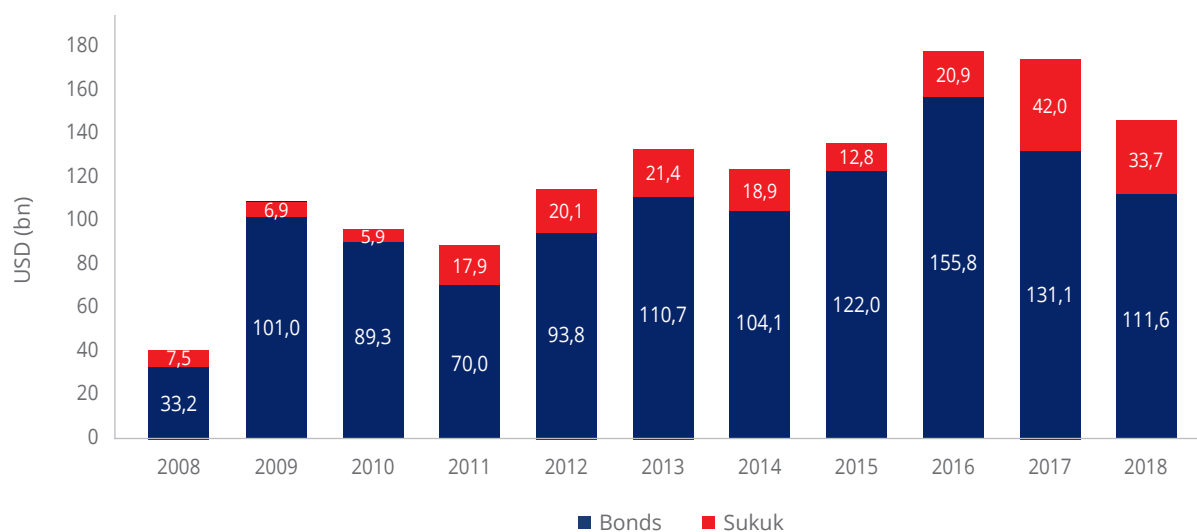
Source: KAMCO research

If we include local currency issuance from the MENA region, the total issuance increases to USD 145 billion in 2018, compared to a 5-year average of USD 150 billion. Although total deal value was less, issuance volume increased, weighted heavily towards conventional over Islamic instruments. Top three contributors to total issuance (local plus hard currency) in 2018 were Saudi Arabia, Qatar and UAE. Total issuance was led by Saudi Arabia with USD 32.4 billion worth of issuance followed by Qatar at USD

29.1 billion and UAE at USD 28.2 billion. For the non-GCC MENA countries, Lebanon maintained its leading position, although issuance dropped by more than a third to USD 15.1 billion compared to USD 23.4 billion in 2017.

GCC issuance fell to USD 72.6 billion as compared to USD 81.4 billion in 2017, while non-GCC MENA issuances stood at USD 39.1 billion as compared to USD 49.8 billion in the previous year.

Fixed income issuance (local and hard currency) in MENA (USD billion)

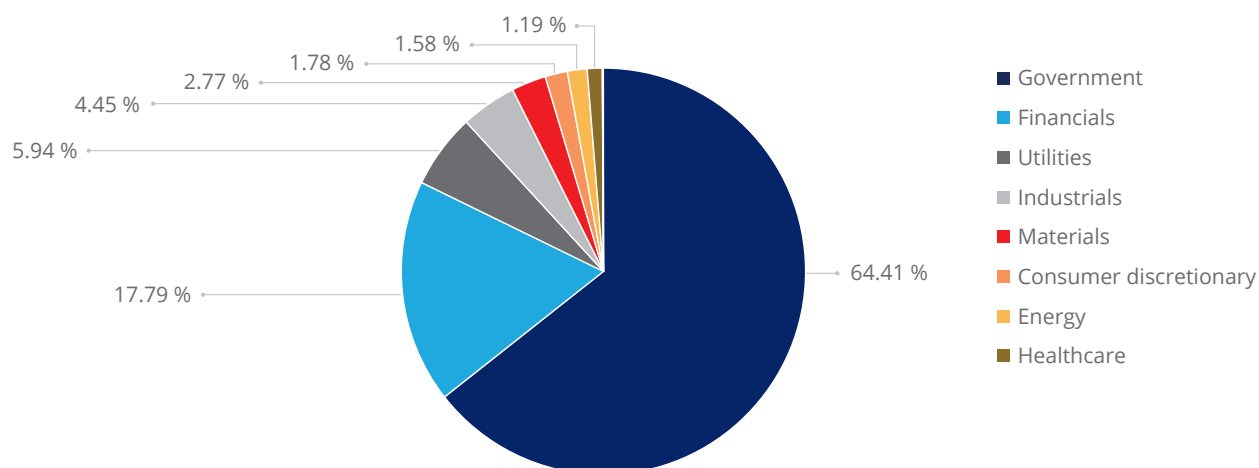


Source: Bloomberg, KAMCO Research

Total Sukuk issuance from MENA in 2018 was USD 34 billion (local and hard currency) compared to its 5-year average of USD 26 billion. Islamic issuance was again concentrated in the GCC, as non-GCC MENA issuers continued to prefer conventional

debt. The Moroccan sovereign tapped the local currency Sukuk market for the first time in 2018, with a debut offering of USD 106 million in June, while Jordan issued its maiden local Sukuk in August.

MENA Sukuk issuance in 2018 - sector distribution



Source: Bloomberg, KAMCO Research



In terms of issuer breakdown, sovereign issuers dominated the Sukuk market during 2018, although their share decreased from 76% in 2017 to 64% in 2018. Total Sukuk issuance by sovereigns dropped by 32%, or almost USD 10.4 billion during 2018 to reach USD 21.7 billion, with corporate issuers partially offsetting this decline by increasing Islamic issuance by 21% year-on-year.

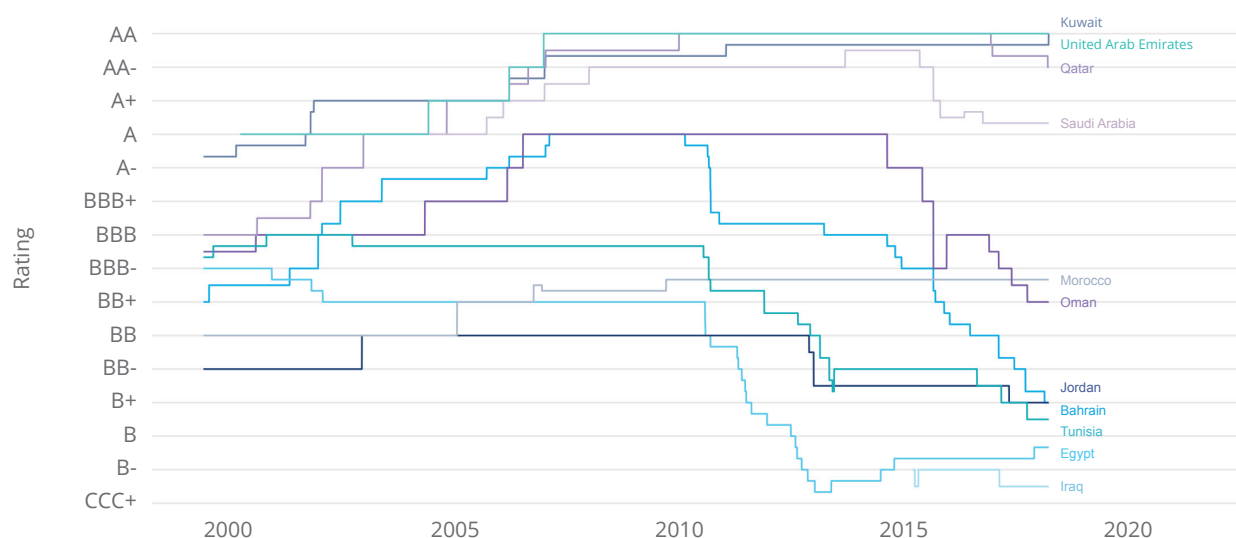
MENA credit ratings

On the ratings side, Saudi Arabia, Abu Dhabi and Kuwait maintained stable outlooks for 2018 and we expect this to continue in 2019. Qatar was on a negative watch-list at the start of 2018, however, given its apparent economic resilience to the ongoing diplomatic crisis, its outlook was revised to stable by Moody's in July. Similar to 2017, we continued to see diverging trends in terms of ratings for Oman and Bahrain compared to the rest of the GCC. With both countries having suffered downgrades, governments will have to step-up on their reform agendas.

For Oman, after Fitch Ratings' downgrade to BB+ it lost membership on some of the largely followed global Investment Grade (IG) indices, which resulted in outflows and spread widening. For Bahrain, ratings stabilized after the GCC USD 10 billion aid package – which took care of near-term refinancing risk and put the sovereign on a definitive reform path. Egypt was upgraded by S&P Ratings during the year from B- to B, and we expect similar action from both the other rating agencies in 2019, as the country takes decisive steps in reshaping its economy and adhering to IMF recommendations. In addition, we expect ratings for Jordan and Morocco to remain stable in 2019 while Lebanon and Tunisia could see downgrades (as manifested by the negative outlooks of rating agencies).

Historical ratings

Equally weighted composite rating of (available) S&P, Moodys, Fitch



Source: Bloomberg

Emerging market index inclusion to attract inflows and improve transparency

GCC sovereign and quasi-sovereign debt will become eligible to be included in the JP Morgan Emerging Market Bond Index (EMBI) series from 31 January 2019. Both conventional bonds and Sukuk will be eligible for index inclusion, however Sukuk will need to have a credit rating from at least one of the three major rating agencies. Approximately USD 300 billion worth of assets are benchmarked against the JP Morgan EMBI series, so this inclusion could translate into around USD 30 billion of additional inflows to GCC debt instruments. Furthermore, the benchmark index inclusion provided a strong technical bid for regional debt in 2018, as active investors positioned ahead of the actual implementation date. We expect to see a further boost as passive asset allocators follow suit in February 2019.

Saudi Arabia, Qatar, United Arab Emirates, Bahrain and Kuwait are expected to have an approximate weight of 3.1%, 2.7%, 2.6%, 2.1% and 0.8%, respectively. As a result, after the addition

of these high-quality names, the average rating of the index is expected to improve. Oman is already in the index with a weight of 2%. On an aggregate basis the GCC is expected to represent about 13% of the Index.

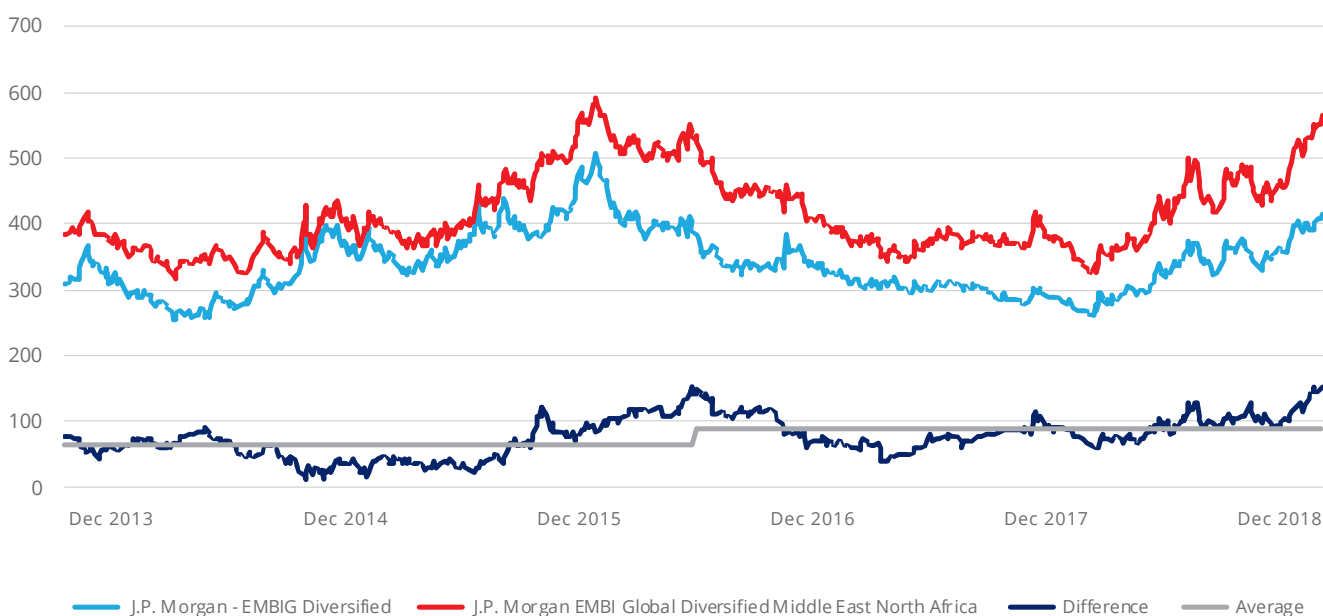
With the inclusion of GCC countries we can expect a few things to happen - the average credit quality for the Middle East basket will move above the global emerging market sovereign bond universe average. The risk premium will thereby turn in favor of the Middle East basket, and regional bonds will trade at lower credit spreads compared to average emerging market levels.

The average credit quality for the Middle East sovereign universe at the end of 2018 (prior to GCC inclusion) was two notches lower than for global emerging market sovereign bonds, so these sovereigns had to pay an above-average risk premium. The premium has increased by 50% from 60 bps to 90 bps in the last five years.

If oil prices were to remain below USD 60/barrel for a 3-5 year period, oil-exporting countries may face widening deficits, which would make a reassessment of credit quality by the rating

agencies likely. Additionally, the lower risk premiums for MENA credits would adjust to align with wider emerging markets.

Sovereign bonds global EM vs Middle East



Source: Bloomberg

Deficits will continue to drive issuance in 2019

Gross government debt as a percentage of GDP increased from 29.7% in 2014 to 44.4% in 2018 after a spate of issuances in the region. Fiscal deficits for most MENA countries have been the reason for an increase in government debt. For example, Saudi Arabia's budget for 2019 projects a deficit of SAR 131 billion (approximately USD 35 billion) – the bulk of which is to

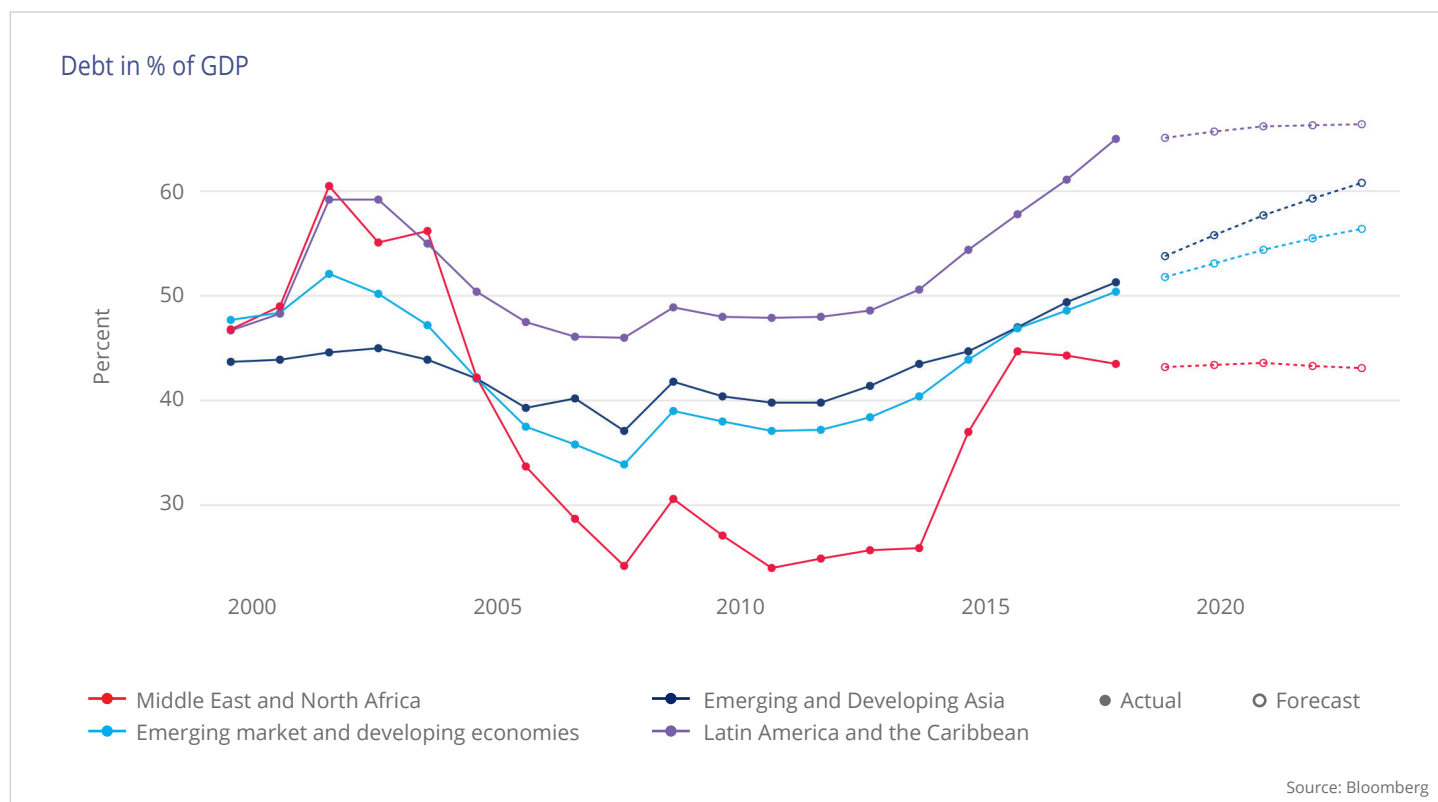
be funded from bond and Sukuk markets. Similarly, Oman is expected to issue about USD 4-5 billion to fund its 2019 budget deficit. The 2019/20 budget deficit for Egypt is expected to reach USD 24 billion, with a sizeable portion of it to be funded from the Eurobond market.

Spending on infrastructure and target sectors remains a priority for policymakers and expanding the non-oil sector to diversify economies away from oil dependence has received a supportive boost from almost all governments in the region. All GCC countries have embarked on long-term economic planning and announced vision statements with well-drafted policies and priority sectors. According to their programmes, individual breakeven levels vary substantially.

Deficit financing has also resulted in the downgrade of several sovereign ratings and marginally increased funding costs. With large hard currency issuances from the region recently, it has crowded out other historical heavy issuers in the Central Eastern

Europe, Middle East and Africa (CEEMEA) region, such as Turkey, South Africa and Russia. We expect this trend to continue in 2019 with the MENA region likely to issue about USD 80 billion (hard currency), in line with 2018.

Out of the gate, in January 2019, we have seen USD 9.1 billion issuance from three issuers (Saudi sovereign, First Abu Dhabi Bank Sukuk and Dubai Islamic Bank AT1), already setting the tone for the rest of the year. The much talked about Aramco issuance to fund its SABIC acquisition could take place in Q2 2019, according to reports, putting upside pressure on the issuance forecast.



Does MENA fixed income deserve higher portfolio allocation?

Financial markets in the MENA region are evolving at a fast pace and catching up to other emerging economies by developing more advanced regulation, a supportive legal environment and a sophisticated investor community. Policies are more outward-looking and aimed at integration with global markets. This economic liberalization comes by way of increasing the breadth of the financial instruments traded in the region and giving institutional and individual investors, both international and local, compelling reasons to invest. The GCC's share of global GDP is expected to increase from 1.8% in 2015 to 2.0% in 2019, while its share of emerging markets GDP is expected to increase from 4.7% to 5.0%. Debt-to-GDP ratios among most GCC issuers remain very healthy, especially when compared to similarly rated emerging market peers, despite some having risen sharply.

On the equity side, the recent inclusion of Kuwait and Saudi Arabia in emerging market equity indices owned by MSCI, FTSE Russell and S&P Dow Jones comes on the back of a number of positive changes made to trading systems and regulations. On the fixed income side, GCC bonds' inclusion in the JP Morgan EMBI will result in increased foreign participation. Reforms have also been aimed at increasing transparency to boost investor confidence and at the same time provide ample supervision and oversight to protect investors. These changes have helped,

to a great extent, in limiting the impact of political events and decorrelating them from financial markets.

An important driver for investors, whose demand encourages new supply, has been a widening of spreads as a consequence of rising interest rates in the US. Until a new equilibrium in the rate market is found, emerging markets remain attractive alternatives for allocation, with GCC countries among the most appealing of all. The GCC fixed income space is also unique for international investors as it has characteristics of both developed markets (e.g. credit ratings) and emerging markets. In addition, traditionally attractive emerging markets such as Turkey, with twin deficits, are experiencing growing pressure – encouraging investors to reallocate to markets such as those in the GCC, where a relative 'haven' can be found.

Other reforms in the pipeline include UAE federal law for development of dirham-denominated bonds, VAT implementation across the GCC, foreign ownership quotas relaxed in the UAE, introduction of bankruptcy law in Saudi Arabia and Bahrain, and reforms to strengthen minority shareholders' rights, among others. In short, there are a host of positive characteristics that make the region attractive, meriting portfolio allocation.

The region carries a risk premium

Although regional bonds look attractive on a ratings-adjusted basis, compared to their emerging market peers, there are several important considerations:

- **Geopolitical uncertainty**

Recent geopolitical events have attracted international displeasure, leading to investor concerns and dulled sentiment. Market participants will closely watch for improvements to the reform agendas.

- **Possible rating downgrades**

Credit downgrades carry risk, although in the case of most sovereigns this is mitigated by diversification initiatives. Banks and corporates are more exposed to downgrades, with the recent example of National Bank of Oman's re-rating to BB+ by Fitch putting it into the high yield category. Credit events of this kind usually lead to repricing, as certain investors are forced to sell bonds due to rating constraints. Overall, we are not foreseeing a great deal of rating pressure for the region in 2019, but any downgrades that do occur carry the possibility for adjustments to sentiment.

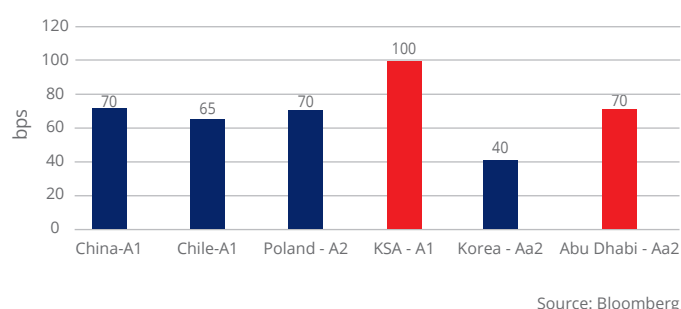
- **Increased supply**

Net new supply in the region is the highest of all emerging markets, which carries the risk of a supply glut outstripping appetite. We aren't there yet, but it is something that issuers will be mindful of in 2019.

- **Concentration of government revenue sources (oil)**

Diversification away from oil is a long-term process for countries in the GCC. The region still relies heavily on one asset – oil – making sovereign issuers with a high reliance on one revenue source vulnerable to market conditions. This will make the successful delivery of reform agendas during the coming years more important than ever.

Rating-adjusted risk premium looks attractive
(5-year CDS)



If oil prices stabilise and reforms continue, this relative risk premium could reduce. Given the recent index inclusion, more broad-based investors will look at the region, leading to efficient price discovery. In addition, with most GCC currencies pegged to the US dollar, this reiterates the attractive relative risk premium amid weakening emerging market FX rates and a stronger US dollar.

Default risk exists in emerging markets, but less in the GCC

Investors often do not pay enough attention to embedded credit risk in government bonds. Over the past few years, many sovereign issuers in emerging markets have defaulted on obligations (such as Argentina, Ukraine and Ecuador). Like corporate bonds, when sovereigns are close to defaulting on their obligations, market liquidity dries up and bid-ask spreads widen, leading to uneven price discovery. The growing risk of a decline in global growth has already resulted in a capital flight to safety from emerging markets to the US, and a rise in regional geopolitical discord may result in higher downside risk.

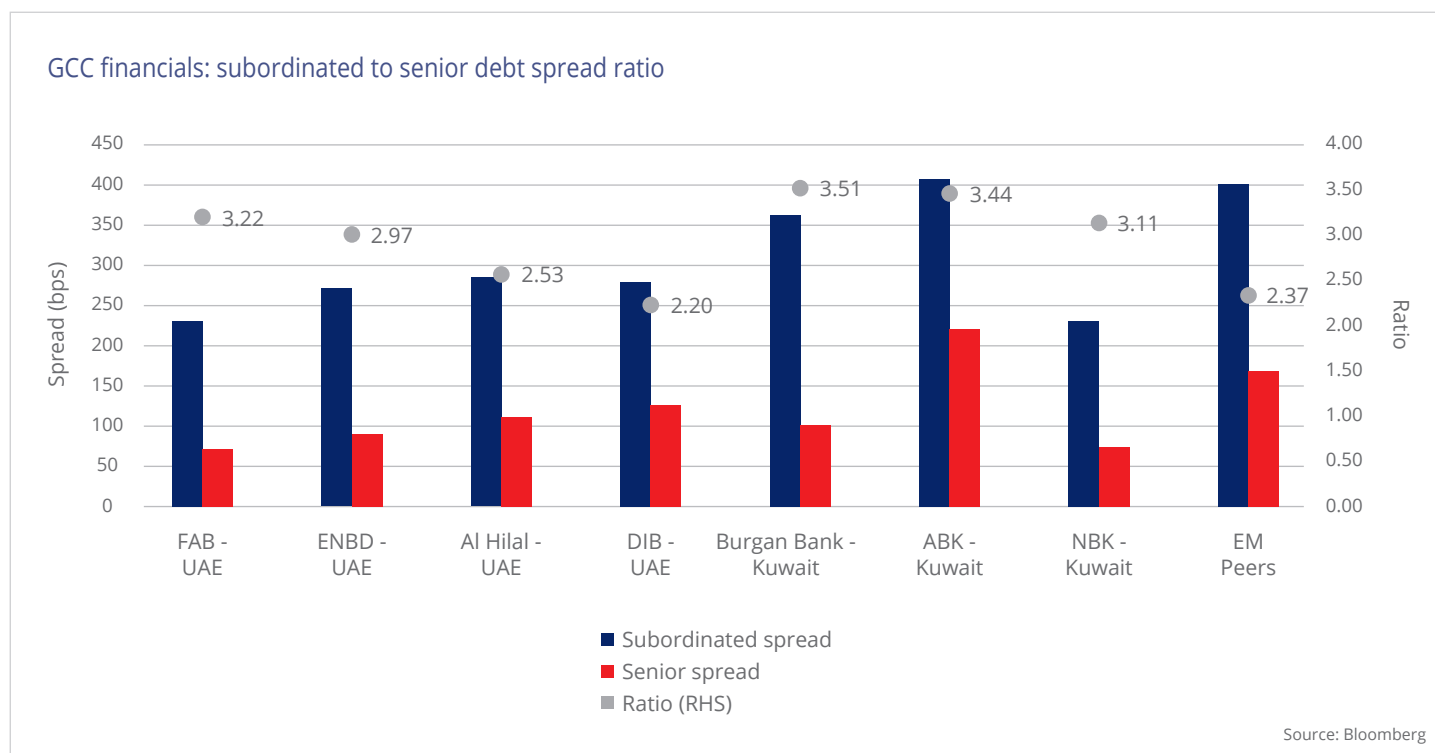
Despite volatility in oil prices in the last few years, the GCC region has seen very few defaults or restructurings compared to wider emerging markets. GCC governments have built large reserves – in the form of Sovereign Wealth Funds (SWFs) – offering support in times of distress and providing a liquidity cushion that can reduce default risk. As an example, during the diplomatic crisis in the GCC in 2017, Qatar's government stepped in to provide funding to local banks facing deposit outflows, with a significant portion of that support believed to have come from their SWF.

Financial sector: subordinated papers offer relative value

Subordinated callable debt issuances from the GCC broadly benefit from unique features including no hard capital ratio triggers, substantial ownership stakes from GCC sovereigns, the absence of a taxpayer base that reduces moral hazard in the event of any pre-emptive capital injections and typically high distributable profits that protect against coupon skips.

Given easy access to capital markets, issuers typically call issues on the first call date, and therefore extension risk is heavily

discounted in the region – something that is not common in other opportunities presented to emerging market debt investors. Despite low extensions risks, some of the regional banks' subordinated paper trade at higher AT1-to-senior spread ratios compared to their emerging market peers, offering relative value to investors, although premiums may vary across the region depending on the jurisdiction of the issuer.



Fund manager conclusions and outlook

Parth Kikani, CFA

Director Fixed Income, Emirates NBD
Asset Management

2018 was a landmark year for GCC fixed income, where it outperformed emerging market (EM) peers despite heightened oil price volatility, providing a safe haven during the EM sell-off.

For 2019, we think risks are more balanced, and investors will need to be more discerning in credit selection. While risks stem from further oil price volatility, increased issuance and geopolitical uncertainty, investors may benefit from attractive risk premiums, improving fundamentals and benefits of index inclusion.

For Saudi Arabia, the expansionary budget compensates for volatility in oil prices as non-hydrocarbon growth and private sector participation is likely to increase in line with the Vision 2030 diversification plan.

For the UAE, as federal stimulus gathers momentum and EXPO 2020-related activity picks up, we expect increased issuance across diverse sectors – both conventional and Sukuk.

As a bloc, the GCC will integrate further with global emerging markets deserving higher portfolio allocation. However, investors will need to be selective to generate alpha in their portfolios.

Faisal Hasan, CFA

CBDO and Head of Investment
Research, KAMCO

A number of reforms being implemented across MENA makes the region an attractive investment destination for foreign investors. This should drive economic growth and make it more sustainable as the countries, especially oil exporters, prioritize non-oil investments.

The PPP model is one such opportunity, along with other regulatory changes targeting international institutional investors. Although regional geopolitical issues have affected perceptions, significant buffers, strong government support and resilient corporate profitability have helped to offset most investor concerns.

In terms of issuance, the recent decline in oil price has once again highlighted the importance of sovereign issuances. We can expect to see more issuance next year, in both the conventional and Shari'a-compliant markets. This will also add depth to the regional yield curve.

Philipp Good

CEO and Head of Portfolio Management,
Fisch Asset Management

For 2019, we remain positive because of EMBI technicals and the recent index inclusion. We still like the support of the local investor base, but depending on oil prices, this support could vary through the course of the year. We expect companies from non-oil sectors to issue bonds, and these may originate from the telecom, F&B and consumer sectors.

Why is MENA still attractive to global investors? Overall indebtedness in the region is increasing, from a previously very comfortable level. The region will be able to source financing, but over the medium-term the discount to other global emerging markets will probably fade. We expect the spread curve to steepen, particularly in an environment of lower oil prices. The local investor base is certainly still a plus.

With regards to macro vs. political headwinds, we focus on the political headwinds, both for the GCC and MENA. Most countries are pushing their reform agendas, and the balancing of the pace of reform will be one of the key drivers for stability in the region. Meanwhile, oil price performance and stability remain crucial, and a key driver for credit.

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