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STRATEGY NOTE

THE RESURGENCE OF GCC FIXED INCOME

NBK CAPITAL
INVESTMENT STRATEGY & ADVISORY

HIGHLIGHTS

- The GCC fixed income market has seen increased activity on the back of governments' efforts to plug budget deficits as oil prices do not seem to be recovering to the previous highs in the short to medium term.

- MENA's debt capital market is small and relatively under-developed at a mere 0.25% of its global counterpart with plenty of room to grow given the low government debt to GDP and high reserves.

- The majority of GCC government and corporate issues (those with at least USD 200m outstanding) are investment grade rated and provide investors with the opportunity to earn a premium on a risk-adjusted basis.

- The current impending need for governments to plug deficits will promote the development of yield curves, paving the way for GCC corporates to issue debt instruments.

- The GCC, as a whole, has experienced a drop of approximately 2.3% in their reserves over the past two years. Saudi Arabia's reserves have dropped 21% while Oman's reserves have dropped 24%.

- There are several key challenges to the development of a regional debt market such as depth and liquidity of the secondary market, corporate transparency and governance for private companies, and education of investors in trading this asset class.

BACKGROUND

Activity in the GCC fixed income market has been picking up significantly over the past two years, driven by sovereign issues as GCC governments are again tapping the debt markets for financing in an effort to plug budget deficits resulting from declines in oil revenues.

Even though the GCC has previously gone through many cycles of increasing and declining oil prices, the current down cycle seems to be holding. Oil prices have declined steeply from the highs of 2014, and although there has been a significant recovery from the lows of early 2016, prices seem to be stabilizing around the current range of USD 50-55 per barrel, with little chances of a meaningful recovery beyond these levels.

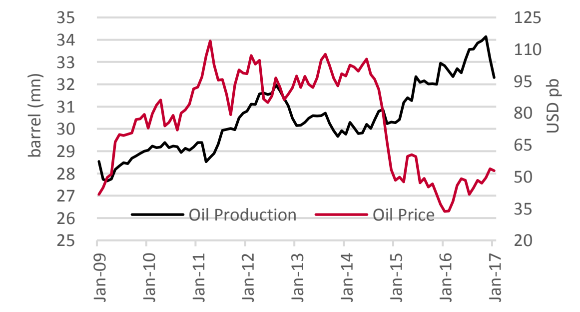
With oil revenues down, GCC governments initially resorted to their financial reserves and sovereign wealth funds in addition to deposits in the local banking system to finance deficits. While withdrawing deposits from local banks managed to solve part of the problem for a short time, it proved to be costly on the domestic economies as it limited the ability of local banks to extend credit to the private sector and created a liquidity crunch in the system. Resorting to international debt markets seemed to be a more sustainable solution especially in the current environment of low interest rates.

Tapping the international debt markets is an important step towards developing a regional fixed income market. Frequently issuing sovereign paper along the maturity spectrum is essential to establishing active sovereign yield curves for the region. Such yield curves would act as benchmarks for private sector issuers to price their papers.

THE OIL DILEMMA

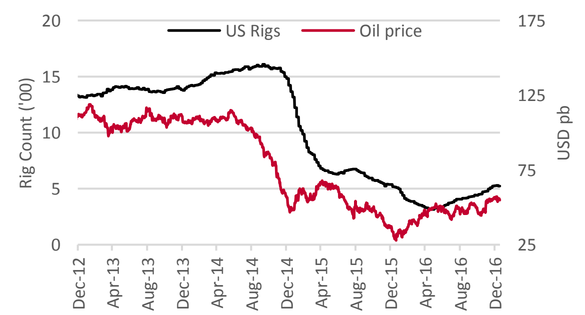
When oil prices started their decline in mid-2014 OPEC producers maintained their pump-at-will policy in an effort to maintain market share and to drive out the competition, mainly non-conventional high-cost producers, namely US shale, and hoped that the markets would eventually balance. This policy worked as far as driving out the competition is concerned, with US rigs declining steeply from a high of approximately 1,600 towards the end of 2014 to a low of slightly over 300 by November 2016.

Chart 1: OPEC Crude Oil Production vs Brent Price



Source: Bloomberg

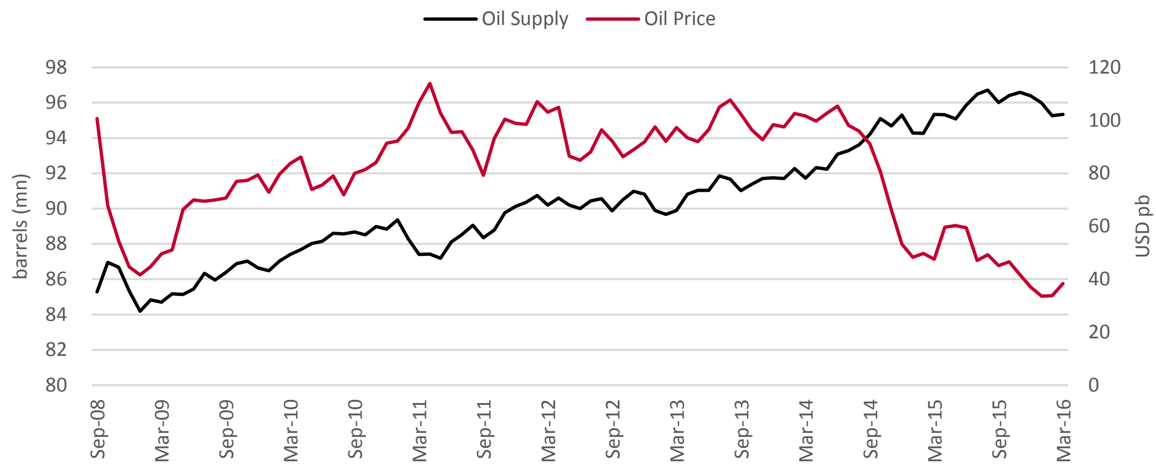
Chart 2: US Rig Count vs Oil Price



Source: Bloomberg

Oil prices, however, continued their decline and the supply glut persisted under a sluggish global growth environment. This scenario proved too painful for conventional oil producers, which led to a historic agreement in November 2016 among OPEC and non-OPEC producers to cut production by as much as 1.8 million barrels a day starting January 2017 for a renewable six months period. Oil prices, since then, have rallied significantly and are currently trading in a tight range between USD 50 and 55 per barrel.

Chart 3: Global Oil Supply



Source: Bloomberg

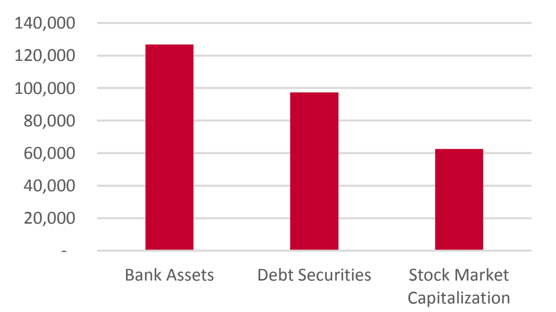
The production cut of conventional producers led by OPEC and Russia managed to set a floor for oil prices at least over the short term, but at the same time, it caused more and more of the shale production to become feasible. Today oil prices may rise but any such rise is capped by the threat of US shale production coming online. Total US production increased from around 8.4 million bpd before the production cut to slightly below 9.0 million bpd currently.

The bottom line for oil is that all indicators point to the fact that a meaningful recovery in oil prices to the previous record highs seems to be far-fetched, at least in the short to medium term. This will reinforce the drive of oil producers, and GCC governments in particular, to adapt to current levels of oil prices and budget accordingly. On the positive side, this will lead to an increase in the regional debt issuing activity, initially on the part of sovereigns for budget management purposes and subsequently this will spread to the private sector and ultimately lead to a deeper and more liquid fixed income market in the region.

MAP OF THE MENA DEBT CAPITAL MARKETS

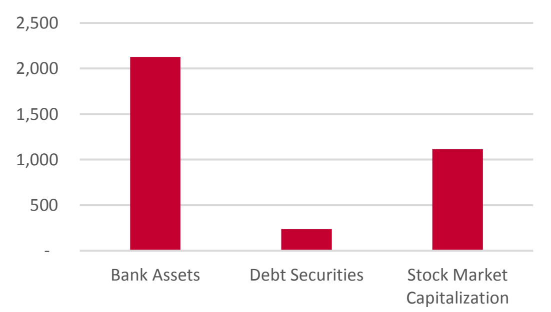
The MENA debt capital market is small, representing a mere 0.25% of its global counterpart, especially when taking into consideration that the MENA region contributes around 3.9% (as per the IMF) of global gross domestic product. Moreover, in terms of capital structure, the MENA debt capital market is still underdeveloped. Debt securities represent around 21% of the region’s stock market capitalization and 11% of total bank assets, while on a global level debt securities represent 150% of stock market capitalization and 77% of global bank assets according to the Global Financial Stability Report published by the IMF.

Chart 4: World Capital Structure ($bn)



Source: IMF Global Financial Stability Report 2015

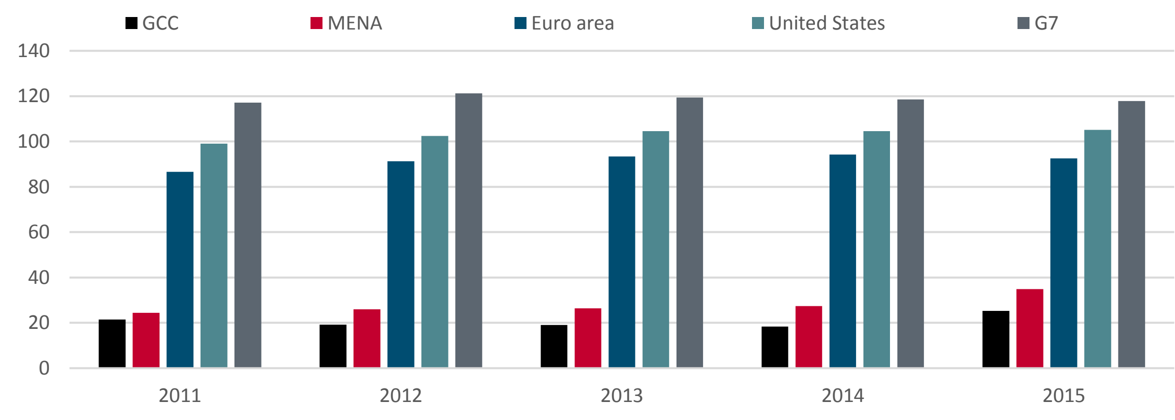
Chart 5: MENA Capital Structure ($bn)



Source: IMF Global Financial Stability Report 2015

Further supporting this notion is the fact that government debt as a percentage of GDP is significantly low when compared to other regions and countries. The numbers are relatively low for the MENA region and particularly low for the GCC. Government debt to GDP hovered at around 19% through 2014 then increased to slightly over 25% by the end of 2015. This compares to 35% for the MENA region, 92% for the Euro area, and 118% for the G7, which leaves plenty of room for GCC governments to optimize their capital structure by issuing additional sovereign debt to finance their budgets.

Chart 6: Government Debt as a % of GDP (%)



Source: IMF, NBK Economic Research

The MENA debt capital market is valued at approximately USD 261.9bn, considering Eurodollar issues with outstanding amounts of USD 200mn or more. Sovereign issues represent 46% of this value at USD 120.1bn, while corporates constitute the remaining 54% or USD 141.8bn.

Of the total sovereign debt issues of USD120.1bn, 44 issues are GCC sovereign issues, amounting to USD74.2bn or 62%. The remaining 38% is comprised of issues out of Egypt, Iraq, Jordan, Lebanon, and Morocco. The yield to maturity (YTM) on the GCC sovereign issues range from less than 1% to 7.2% depending on the issuing government and maturity. The majority of GCC governments are investment grade rated by one or more rating agencies with the exceptions of Bahrain, which is below investment grade, and Dubai, which has no rating.

Table 1: Government Issues by Amounts Outstanding & Credit Rating

Government of	Value USD (bn)	S&P	Fitch	Moody's
Qatar	21.90	AA	AA	Aa2
Bahrain	10.95	BB-	BB+	-
Dubai	5.07	-	-	-
Kingdom of Saudi Arabia	17.50	-	AA-	A1
Abu Dhabi	6.50	AA	AA	Aa2
Oman	9.50	BBB-	BBB	Baa1
Ras Al Khaimah	1.50	A	A	-
Sharjah	1.25	BBB+	-	A3
Kuwait	-	-	AA	-
Total	**74.17**			

Source: Bloomberg (as of March 5, 2017)

Of the total MENA corporate issues of USD 141.8bn, 201 issues are GCC corporate issues accounting for USD 134.8bn or 95% of the total. The remaining 12 issues amounting to USD 7bn are from corporates out of Morocco, Lebanon, Jordan, and Tunisia. In terms of credit ratings, 158 corporate issues are investment grade rated by at least one of the three major rating agencies while the remaining bonds are non-investment grade (18 issues) and unrated (37 issues). The UAE corporates are the largest issuers in terms of amounts outstanding at USD 83.6bn, followed by Qatar corporates at USD 27.2bn. With respect to sectors, Financials are the largest with an outstanding amount of USD 75.5bn, followed by Utilities, Energy, and Telecom with amounts of USD 20.3bn, USD 13.9bn, and USD 10.4bn outstanding, respectively.

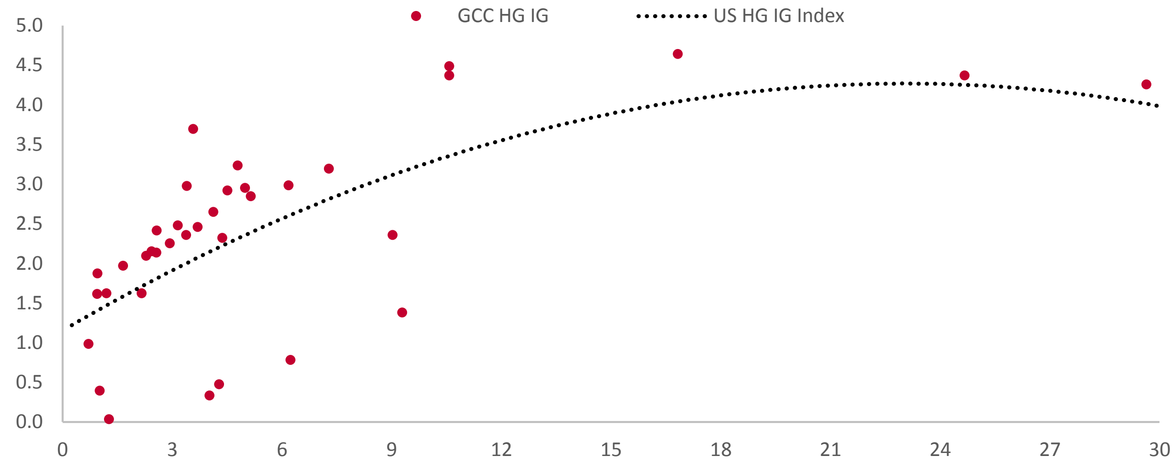
Table 2: Corporate Issues by Country & Sector

Country	Basic Material	Telecom	Consumer Cyclical	Consumer Non-Cyclical	Diversified	Energy	Financial	Industrials	Utilities	National Wealth Fund
UAE	-	4	6	5	-	13	74	2	15	4
QTR	-	8	-	-	-	4	25	-	2	-
KWT	3	-	-	-	3	1	7	-	-	-
KSA	2	-	-	-	-	-	3	-	6	-
BHR	-	1	-	-	-	-	7	-	-	-
OMN	-	-	-	-	-	-	5	-	1	-
LBN	-	-	-	-	-	-	4	-	-	-
MRC	3	-	-	-	-	-	1	-	-	-
JDN	-	-	-	1	-	-	-	-	-	-
TNS	-	-	-	-	-	-	3	-	-	-

Source: Bloomberg (as of March 5, 2017)

The GCC fixed income corporate space offers investors the opportunity to earn a premium over their global counter-parts on a risk-adjusted basis. The charts below plot investment grade GCC corporates by rating against the yield curve of US corporates with similar ratings. Corporates plotting above the curve can earn investors a premium of up to 100bps at various maturities.

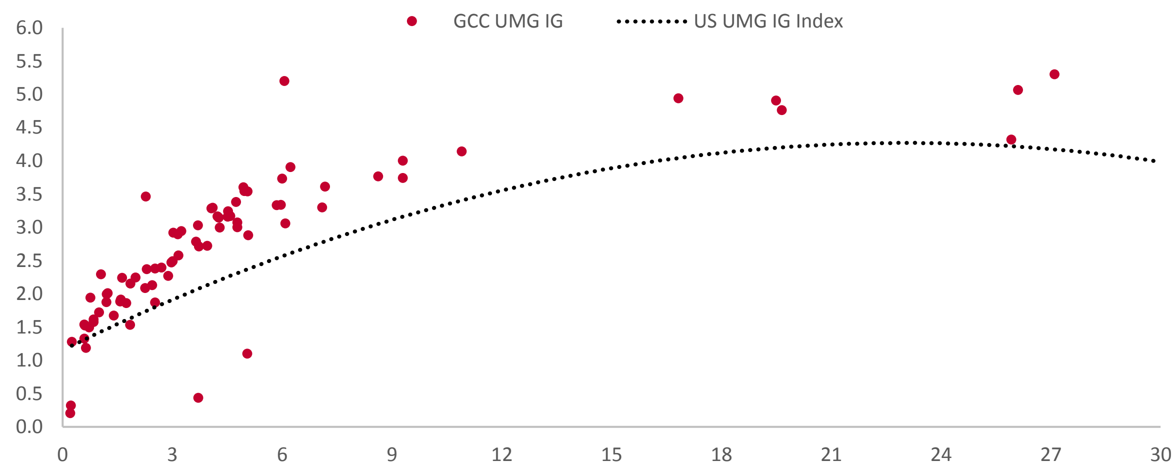
Chart 7: GCC High Grade Investment Grade Corporates vs US High Grade Investment Grade Index



Source: Bloomberg (as of March 5, 2017)

It is to be noted that the vast majority of the GCC issues are concentrated within the 0-5 years maturity bracket with few maturing within 10 years and even fewer beyond this range, while for developed markets the yield curve extends to much longer maturities of up to 30 years.

Chart 8: GCC Upper Mid-Grade Investment Grade Corporates vs US Upper Mid-Grade Investment Grade Index



Source: Bloomberg (as of March 5, 2017)

CATALYSTS FOR TOMORROW'S MARKET

A low oil price environment has governments, banks, and even corporates re-thinking their funding sources. This undoubtedly should lead to the development/growth of the regional debt capital market.

Immediately following the 2008 financial crisis, an increase in bond issuance activity occurred in Qatar, UAE, and Bahrain. This did not materialize across the rest of the GCC as oil prices began a recovery in December 2008, alleviating the need for alternate funding. However, by the end of 2014, oil prices plunged to USD 57.3pb after reaching a high of USD 115.1pb earlier in the year. As time progressed, a rebound in prices became less likely with oil reaching a low of USD 27.9pb in mid-January 2016.

Chart 9: Brent Prices (USD pb)

Source: Bloomberg

Servicing Government Deficits

As oil prices dropped, government revenues decreased and deficits began to take form. While Qatar and UAE reported budget surpluses in 2014, Qatar was the only GCC country reporting a surplus in 2015, although at a mere 10% of the prior year's surplus. It is expected that all GCC countries will report a budget deficit in 2016, which shall continue through 2018.

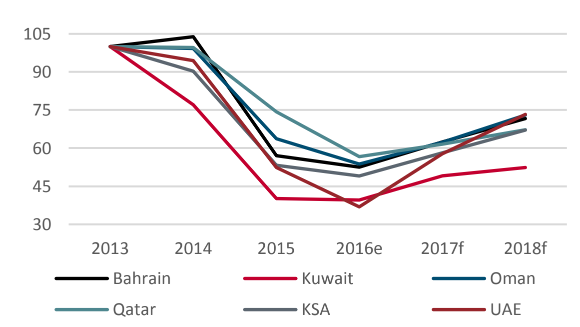
Table 3: GCC Budgets ($bn)

	2013	2014	2015	2016e	2017f	2018f
KSA	48.1	-17.5	-96.6	-76.8	-51.7	-49.4
UAE	40.4	19.9	-8.1	-11.8	-4.6	2.0
Qatar	29.3	25.6	2.1	-8.0	-4.7	-3.4
Kuwait	17.5	-9.4	-19.8	-18.9	-11.0	-10.5
Oman	0.7	-2.8	-12.0	-13.0	-9.7	-6.4
Bahrain	-1.0	-1.2	-5.2	-5.7	-5.2	-4.8
GCC	**134.9**	**14.7**	**-139.6**	**-134.2**	**-86.8**	**-72.5**

Source: National Sources, NBK Economic Research

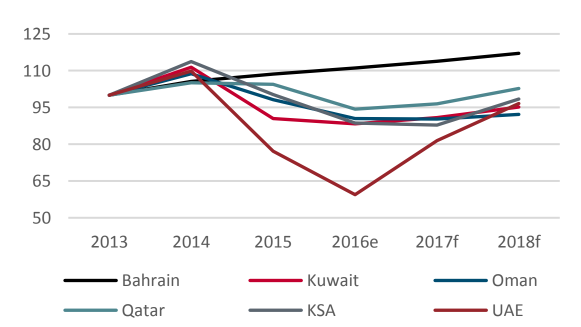
While governments tried to alleviate deficits during this period by implementing austerity measures and deferring mega projects, the year-on-year drop in expenditures was disproportionate to the drop in revenues. With oil prices not expected to regain their previous highs anytime soon despite the recent recovery, and socio-political factors at play, it is expected that expenditures will revert to 2013 levels by 2018, while revenues will not have fully recovered. Given these forecasted deficits, GCC governments will need to fund the shortfalls by either issuing sovereign debt, drawing from their reserves, or some combination of both.

Chart 10: GCC Government Revenue ($bn)



Source: National Sources, NBK Economic Research

Chart 11: GCC Government Expenditure ($bn)



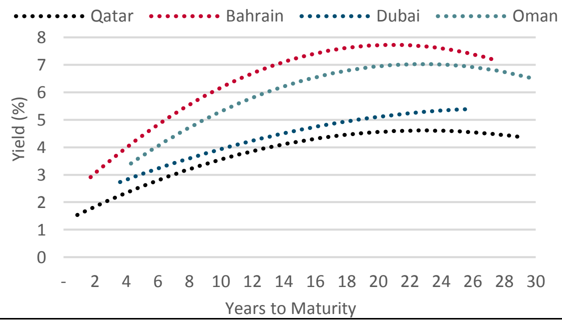
Source: National Sources, NBK Economic Research

Establishing a Yield Curve

Today, the majority of corporate funding comes directly from banks, as the absence of fully developed sovereign yield curves makes it difficult to price new issuances. In addition, until a government has issued a sufficient number of instruments with a wide range of maturities, their yield curve will remain incomplete. The current impending need for governments to plug deficits will promote the development of yield curves, paving the way for GCC corporates to issue debt instruments with relative ease, thus attracting regional and international investors.

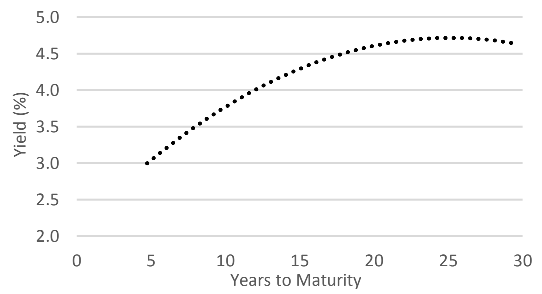
Historically, GCC governments issued Eurodollar bonds as one-offs, such as Oman back in 1997. Today, Qatar, Bahrain, Dubai, and Oman all have established yield curves at a wide range of maturities. Other governments such as KSA and Abu Dhabi have recently began issuing Eurodollar bonds, taking the first step in creating their own yield curve.

Chart 12: Established Yield Curves



Source: Bloomberg (as of March 5, 2017)

Chart 13: Saudi Arabia's Developing Yield Curve



Source: Bloomberg (as of March 5, 2017)

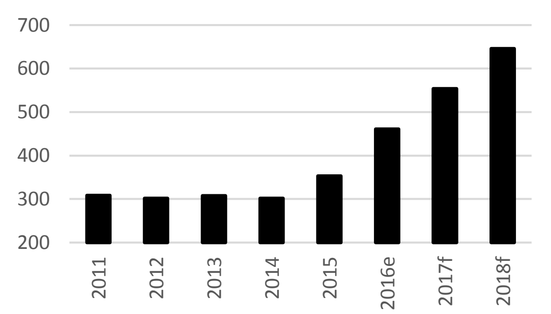
Table 4: GCC Active Bond Issues and Maturity Ranges

Government	Number of Active Issues	Range of Maturities (Years)
Qatar	11	1 - 29
Bahrain	9	1 - 28
Dubai	8	0.25 - 26
Oman	6	4 - 30
Kingdom of Saudi Arabia	3	5, 10, 30
Abu Dhabi	3	2, 4, 9
Ras Al Khaimah	2	2, 8
Sharjah	2	4, 8
Kuwait	-	-

Source: Bloomberg (as of March 5, 2017)

GCC governments' public issuances have increased, on average, by approximately 86% per year during the past two years and overall government debt is expected to almost double from USD 353bn to 646bn by 2018. In 2016 alone, issuances totaled around USD 39.1bn with Saudi Arabia making global headlines with its first ever issuance being the largest emerging market issuance ever at USD 17.5bn over multiple tranches with maturities extending up to 30 years. Kuwait expects to tap international debt markets with an inaugural issuance of up to USD 10bn in Q1 of 2017.

Chart 14: GCC Government Debt ($bn)



Source: National Sources, NBK Economic Research

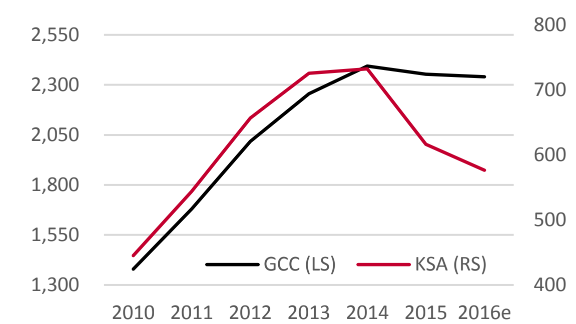
Chart 15: GCC Public Sector Gross Issuances ($bn)

Source: Zawya, Thomson Reuters Eikon, Central Bank of Kuwait

Banks and Debt Capital Markets

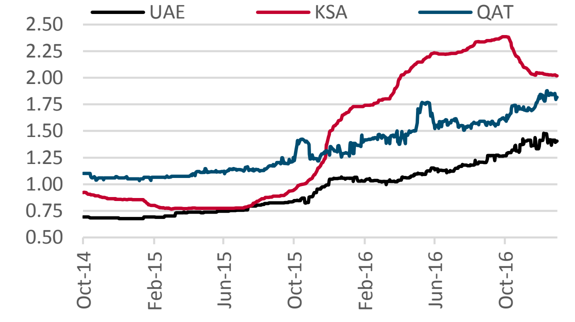
In the past, governments deposited a good part of surplus funds into the local banking system, providing sufficient liquidity to meet corporate lending requirements. This was traditionally viewed as a stable deposit base, which alleviated the need for local banks and corporates to issue debt instruments. As oil prices fell, governments began tapping reserves to fund expenditures. Most notably are KSA and Oman, whose reserves dropped approximately 21% and 24% respectively during the previous two years. The remaining GCC countries reported positive-growth rates with respect to their reserves, albeit significantly lower than previous years. The region as a whole has experienced a drop of approximately 2.3% in its reserves over the last two years creating a ripple effect with banks by crowding out lendable funds while increasing borrowing costs and ultimately lowering credit growth. Governments, such as KSA, have begun issuing debt as a means of slowing the rate at which they are depleting their foreign reserves.

Chart 16: GCC & KSA Reserves ($bn)



Source: SWF Institute, IIF, NBK Economic Research

Chart 17: 3 Month Inter-bank Rates (%)



Source: Thomson Reuters DataStream

Furthermore, Basel III requires banks to strengthen their capital base by either increasing equity or issuing Tier I bonds which most regional banks have complied with. Within the MENA corporate universe, GCC Tier I bonds account for USD 8.9bn. In 2012 and 2013, approximately 33.7% of the amounts outstanding were issued, whereas the remaining 66.3% were issued during the last three years. Going forward, if banks experience rapid balance sheet growth or asset quality deterioration, additional issuances will be required to maintain compliance.

CHALLENGES

There are several key challenges to the development of a regional debt market. To begin with, the lack of depth and weak liquidity within the secondary debt capital market is a major concern for investors. Historically, regional investors mainly institutions, such as banks or insurance companies, purchase these instruments with the intent to hold them to maturity and collect the income stream, which contributed to the low levels of secondary market liquidity. Diversification is another major challenge given the modest size of the region's market and current sector concentrations. This is to be expected in a region that is highly dependent on oil and where the energy sector in general is owned by the government. The private sector is dominated mainly by financial institutions and real estate companies and to a lesser extent by telecom companies, which creates a challenging environment to be able to create a diversified fixed income portfolio. Other sectors, such as consumer retail, include large corporates and family conglomerates that are privately owned with a minimal need for disclosures. These family businesses represent a major part of the private sector, non-oil related economy, and have been satisfying their financing needs either through internal means or traditional bank lending. This in itself is another challenge involving transparency and corporate governance. Furthermore, while average regional retail investors are relatively well experienced and familiar with investing in the equity market, they lack the knowledge and experience in dealing with fixed income instruments.

As the primary market develops over time and investor education increases with respect to this asset class, the secondary market should see major improvements in terms of both depth and liquidity. As issuances from sovereigns increase and banking liquidity decreases, corporates will need to begin issuing their own debt and inevitably implement more stringent corporate governance frameworks and increase transparency. As these corporate issues from family conglomerates and others come to market, diversification will become less and less of a concern for both regional and international investors.

FINAL THOUGHTS

Historically, fixed income in the region has received limited attention from regional and global investors. This is no longer the case as demand for regional issues is at record level highs. The Saudi sovereign issuance, back in November 2016, saw demand at four times the required issue size and more recently, a GCC corporate issue was eight times over-subscribed. International and regional investors are becoming familiar and comfortable in the region and can see the value of the extra yield pick-up, which regional issuers are still offering.

Low oil prices, government deficits, decreasing government reserves and tightening banking liquidity, in addition to banking regulation are all catalysts favoring the development of the regional debt capital market. Today, although small, the current market still provides investors with an opportunity to earn a risk-adjusted premium over other regions and countries. With time, as sovereigns and banks issue more debt, corporates will follow suit. As this development comes to term, liquidity and diversification should increase and transparency and corporate governance issues should fade away, further attracting both regional and international investors.

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