From the CIO Office

GCC Bond Markets
Introduction

Gulf Cooperation Council (GCC), political and economic alliance of six Middle Eastern countries – Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman.

The Gulf Cooperation Council (GCC) is the political and economic alliance of six Middle Eastern countries – Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman.

The GCC was established in Riyadh, Saudi Arabia, in May 1981. The purpose of the GCC is to achieve unity among its members based on their common objectives and their similar political and cultural identities, which are rooted in Islamic beliefs. Presidency of the council rotates annually.

Arguably the most important article of the GCC charter is Article 4, which states that the alliance was formed to strengthen relations among its member countries and to promote cooperation among the countries’ citizens. The GCC also has a defence planning council that coordinates military cooperation between member countries. The highest decision-making entity of the GCC is the Supreme Council, which meets on an annual basis and consists of GCC heads of state. Decisions of the Supreme Council are adopted by unanimous approval. The Ministerial Council, made up of foreign ministers or other government officials, meets every three months to implement the decisions of the Supreme Council and to propose new policy. The administrative arm of the alliance is the office of the Secretariat-General, which monitors policy implementation and arranges meetings. Some of the most important achievements of the GCC include the creation of the Peninsula Shield Force, a joint military venture based in Saudi Arabia, and the signing of an intelligence-sharing pact in 2004. Presently it encompasses a total area of 2,672,700 sq.km. The official language is Arabic.
Introduction

Exhibit 1: GCC sovereign wealth funds accounts for over 40 percent of assets among top global SWF’s

- Mubadala Investment Company
- Investment Corporation of Dubai
- Public Investment Fund (Saudi Arabia)
- National Social Security Fund (China)
- Qatar Investment Authority
- Temasek Holdings
- Government of Singapore Investment Corporation
- SAFE Investment Company (China)
- SAMA foreign holdings (Saudi Arabia)
- Hong Kong Monetary Authority Investment Portfolio
- Kuwait Investment Authority
- Abu Dhabi Investment Authority
- China Investment Corporation
- Norway - Government Pension Fund

Source: Bloomberg as of 20 Sep 2018

Exhibit 2: Gulf sovereign wealth funds’ assets haven’t been historically oversensitive to lower oil prices

- 2014
- 2015
- 2016
- 2017
- 2018F
- 2019F
- 2020F

Source: Bloomberg as of 20 Sep 2018

Exhibit 3: GCC Population is growing

Source: Bloomberg as of 20 Sep 2018
GCC bond markets – a unique and promising proposition

- GCC bond markets have evolved both in terms of depth and breadth
- Regional reforms are driving sustainable recovery
- GCC bonds are undervalued relative to their fundamentals and their volatility
- Higher oil prices and current valuations should attract international investors
- GCC issuers are increasingly included into global EM indices
- We prefer regional Sovereigns bonds across both IG and HY
- In Financials – We maintain our conviction on Tier-1 hybrid securities
- In Corporates, our preferred sectors are Oil & Gas, Utilities, Telecoms and Logistics

Over the last decade, the GCC bond markets have evolved and demonstrated some resilience during times of global market stress. In this publication, we highlight the various drivers of this evolution, at a time when the regional economies are gradually diversifying from the sole hydrocarbon revenues. Indeed, the GCC region has embarked on various socio-economic reforms and while high oil prices are still a predominant driver, it is now coupled with rising government spending leading to a revival of the non-oil sectors.

The GCC nations are adapting to changing global economic conditions. However, challenges remain, such as relatively high local unemployment in certain Sovereign nations leading to a heavy reliance on expatriate workers, and an ongoing dependency government sector to drive growth. Deeper private sector involvement is and must keep on being stimulated, as the public sector continues to further improve efficiency.

Overall, the GCC’s GDP is expected to grow to 2.4 per cent this year, up from 0.1 per cent last year. The trend is only expected to accelerate in 2019, as the Organisation of the Petroleum Exporting Countries (OPEC) phases out its output cut, providing a boost to oil exporting countries and the region.

The successful and smooth implementation of the value-added tax (VAT) by most of the GCC nations is emblematic of the current transformations. After having stomached the difficulties of low oil prices, the region is taking precautions. Policymakers have focused on fiscal consolidation with some visible success on their financial situation and budgetary framework.

From the start of this year, the economic outlook had been revised upwards with significant growth witnessed in the GCC construction industry. The agreement between OPEC and non-OPEC oil-producing countries to place a cap on oil production until the end of 2018 and the consecutive rise in oil price, have boosted both sentiment and demand. The announcement of new megaprojects by Saudi Arabia (Vision 2030 transformation agenda), and by the UAE have boosted the broader regional outlook. In the UAE over twenty-three Expo 2020-related construction contracts worth more than USD 2.5bn are expected to be awarded by the end of this year. The country is set to be a top performing economy again in 2018.

The financial sector has demonstrated strong growth and profitability. With the commitment on the currency pegs to the US dollar, the sector has benefitted from the rate hikes implemented by the US Federal Reserve, as interest rates have rising in parallel.

The volume of GCC sovereign bond issuance has grown exponentially in the last three years, primarily due to increasing funding needs by governments with lower oil prices as a backdrop. As the market grew and gained depth, international investors have been attracted, bringing a great amount of liquidity, mainly from Asia. Having said that, the risk premium has remained significant, as it is logical in a context of dependency on external capital funding. It is worth noting that on a relative value basis, GCC sovereigns have outperformed EM peers, such as Indonesia, Malaysia, Korea, Poland, Brazil, or Mexico.

The GCC nations are adapting to changing global economic conditions
The potential inclusion of many regional bond issuers (both Sovereign and Corporate) into global indices is also a key driver for the credit-spread-driven outperformance. We estimate that international benchmark-aware investors have been particularly active in the five to ten-year maturity bucket as well as in the long-dated maturities, where most of the spread compression is visible. The shorter-maturities are typically sought-after by regional investors both on a levered and non-levered basis, whereas banks (ALM desks) have always been a massive bidder for short-dated securities.

GCC corporate issuers have also be supported by their rarity, i.e. some scarcity of new issuance. We believe that this is linked to liquidity-rich banks being very active lenders to corporate, reducing the participation in the primary bond markets. What we have witnessed is a growing need for project related bonds where various structures have been tested with regional investors. Despite being primarily designed to target institutional asset owners, they have also been welcomed by individual investors and promoted by wealth managers, sometimes with a levered component. In addition, the credit quality of such project bonds has remained strong, as there are generally links between the issuing corporate entity and the governments. This feature has driven comfort and sponsorship from the investors community.

Exhibit 4: Record borrowing from GCC debt issuers

The shorter-maturities are typically sought-after by regional investors.
GCC bonds markets – a unique and promising proposition

Exhibit 5: GCC key macro indicators

<table>
<thead>
<tr>
<th></th>
<th>Current Account (% of GDP)</th>
<th>Budget Balance (% of GDP)</th>
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<td>United Arab Emirates</td>
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Source: Emirates NBD and IMF data

Exhibit 6: CDS, S&P rating

Source: Bloomberg as of 20 Sep 2018
GCC Sovereign states are active presence in the international markets

Exhibit 7: USD Bahrain Sovereign Fitted Curve (Total Issuance size: USD 14.2bn)

Source: Bloomberg

Exhibit 8: USD Saudi International Fitted Yield Curve (Total issuance size: USD 52bn)

Source: Bloomberg

Exhibit 9: USD Abu Dhabi Sovereign Fitted Yield Curve (Total issuance size: USD 16.5bn)

Source: Bloomberg

Exhibit 10: USD Oman Sovereign Yield Curve (Total issuance size: USD 17.5bn)

Source: Bloomberg
# Best Ideas in the GCC debt markets

## Exhibit 11:

<table>
<thead>
<tr>
<th>ISIN</th>
<th>Issuer</th>
<th>Currency</th>
<th>Maturity</th>
<th>Coupon</th>
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Source: Bloomberg prices as of 14 October 2018
## Best Ideas in the GCC debt markets

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Source: Bloomberg prices as of 14 October 2018
Saudi Arabia

Since the start of the millennia, the Kingdom experienced a significant fiscal surplus representing 8.7 percent of its GDP. That lasted until the 2014 drop in oil prices, which led to a deficit of .8 percent of GDP in 2015, as seen in Exhibit 12. Prior to the drop, fiscal spending was steadily increasing and macroeconomic stability was strengthening, allowing the Kingdom to wisely build large financial reserves.

As 2014 neared around the corner, the price of oil began to drop, reaching a trough of USD 27.88 per barrel in 2015, as shown in Exhibit 13. The impact on public accounts prompted the Kingdom to take broad measures, which included a substantial spending cut in late 2015, followed by a reformed and tighter budget for 2016. In mid-2016, Vision 2030 and the National Transformation Program (NTP) were announced, outlining the medium-to-long term strategy the kingdom would follow to reduce its reliance on oil and engage in an ambitious journey for sustainable and diversified prosperity. Later that year, the Fiscal Balance Program (FBP) was also announced, set to target a balanced budget by 2019. The fiscal deficit has averaged around 10 percent of GDP over the last 3 years.

In late 2016, the impact of the drop in oil coupled by the reduction in subsidies (energy and water) led to a temporary rise in CPI inflation. Bank liquidity became tighter due to less government spending and more payment arrears.

Although markets, specifically the non-oil sector, slowed down in 2016, it is expected to gradually pick up as business confidence continues to grow, civil service wage allowances are restored and the Public Investment Fund makes larger investments. It is unlikely however that the non-oil sector exceeds the levels of the past decade in the near-term, i.e. before the benefits of Vision 2030 come to fruition.

The government remains the first employer in the Kingdom, and has taken clear initiatives to stimulate the private sector and reduce the unemployment rate, which is still significant especially within the youth and female.

The Kingdom has taken clear initiatives to stimulate the private sector
Saudi Arabia

There is however no question: The Kingdom’s balance sheet is very strong, maintaining low public debt and very sizable financial assets. Government deposits made up 28% of GDP in 2016, which decreased to 23% in 2017 and estimated to arrive to 17%, 15% and 12% in the following respective years 2018, 2019 and 2020. Government debt, on the other hand, has increased from 1.6 percent in 2014 to 17 percent in 2017, and is expected to grow to 21, 24 and 26 percent in the following respective years 2018, 2019, 2020, as shown in Exhibit 14 & 15. Note that 70% of GDP is the threshold for high government debt within emerging markets. The Kingdom is still very far from this level.

Banks are well capitalised and are in a strong position to manage non-performing loans. In addition, risks of contingent liabilities from banks to the government are low. In fact, the Kingdom was able to access international markets twice in 2016, getting a syndicated loan worth USD 10bn and then a USD 17.5bn three-tranche sovereign bond valued at USD 5.5bn, USD 5.5bn and USD 6.5bn with maturity dates of 5, 10 and 30 years. That issuance of bonds was the largest ever made by an emerging market country and was very well received by international investors. In 2017, the government issued a USD 9bn sukuk split into two tranches of USD 4.5bn each (5 and 10 years); later that year, it issued bonds worth USD 18bn split into three tranches, USD 3bn, USD 5bn and USD 10bn of 5, 10 and 30 year bonds respectively.

The IMF made a “worst case” analysis: According to the Fund, if oil prices had remained low from 2017 onwards and fiscal deficit remained at 12 percent, the Kingdom would not have reached the 70 percent GDP debt level before 2024. Incidentally, the price of oil has picked up and is following a positive trend, which pushes the kingdom even further from the likelihood of meeting that debt threshold. Although the kingdom has decided to carry out a faster pace of fiscal adjustment, which would ultimately impact growth and employment in the near-term, it still has significant fiscal buffers at its disposal aside from the pickup in oil prices.
Irrespective of the “lower-for-longer” oil price environment, the UAE has adapted well. Its large financial buffers, safe-haven status, diversified economy and robust policies are facilitating the fiscal adjustment as well as protecting the economy. The current positive developments of oil are thus only an additional cyclical support for the economy and sentiment.

However, the pickup was not enough to leave infrastructure projects in the UAE immune. It experienced a slowdown similar to global trade, which dropped from 3.8 percent in 2015 to 2.0 percent in 2016. Even though the UAE has adapted well to its surroundings, its financial conditions have tightened, with higher interest rates, as well as some pressure on stock and property prices. Current account surplus shrank in 2016 to 2.4% versus 4.7% in the prior year – still, a surplus.

Debt declined by 5 percentage points of GDP, down to 24.7 percent, due to repayments of bonds and syndicated loans by government entities. This includes both Abu Dhabi’s Eurobond issuance of USD 5bn as well as Sharjah’s sukuk issuance of USD 0.5bn in 2016.

Shrinking interest margins and a pick-up in impairment charges reduced profitability in the banking sector during the slowdown. Credit continued to grow at slower rate of 5.3 percent year-on-year in the first quarter of 2017. Although deposit growth strengthened and liquid asset ratio remained at a comfortable 22 percent, banks continued to access wholesale funding to diversify their funding base.

Altogether, economic activity is expected to strengthen, as the non-oil sector picked up 3.3 percent in 2017 and is expected to remain above 3 percent over the medium term, which reflects the increase in domestic public investment, such as Expo 2020, as well as growth in global trade. To that extent, the situation of the UAE between Asia and Europe limits its direct exposure to the current US/China trade war. Oil sector, on the other hand, contracted in 2017; due to the UAE’s commitment to OPEC’s agreement to reduce production of crude oil from 3.03 million barrels per day in 2016, to 2.88 million barrels per day in 2017. UAE’s real (real oil? Typo?) GDP growth is expected to bounce back from -2.9 percent to 3.2 percent. VAT is not expected to have a significant impact on growth since its implementation in January of 2018. Current account surplus is expected to improve by 2.6 percent in 2017, mainly due to rising in non-oil exports, and reach 3.8 percent by 2022, due to oil revenues rising with increase oil production complimented by growth of non-oil exports and tourism.

Despite the positive outlook of the economy, many risks can come into play such as a possible decline in oil prices or production; lower global growth due to reduced crossover investments and trade; or even tighter financial conditions could increase risks for government entities, banks or sovereigns. See Exhibit 16 for UAE current account balance.

For the UAE to flourish in the new environment of persistently lower oil revenues, it needs to pursue its remarkable transition towards more diversification.

Altogether, economic activity is expected to strengthen, as the non-oil sector picked up...
**Kuwait**

Like the UAE, Kuwait was able to adapt to the “lower-for-longer” oil price environment. Due to Kuwait’s high dependency on hydrocarbons, the 2014 drop in prices had a strong direct impact on fiscal balances, but not to the extent of a fiscal deficit. Nevertheless, large financial buffers, estimated to be around 470 percent of the country’s GDP, and low debt allowed the country to experience smooth financial consolidation. See Exhibit 17 showing fiscal balance over the years.

Although confidence plummeted temporarily in the non-oil sector, there have been signs of recovery comforting the soundness of the banking system, as seen in Exhibit 18.

Since the 2014 oil dilemma, Kuwait has launched a comprehensive reform strategy aimed to reduce dependence on oil and gas, and rather focus on job creation and boosting growth in the economy. Non-oil sectors grew by a modest 2 percent from 2015 to 2017. Although prices of oil have bounced back, a commitment to OPEC to reduce oil and gas output will keep oil revenues lower than full potential – bringing Real GDP down to 2.9 percent in 2017 and an expected growth of 1.8 percent in 2018. Current Account recorded its first deficit from the past 6 years, which was again largely due to the decline in oil prices. Regardless, it is expected to recover in 2018 and signs are already visible.

To aid in fiscal consolidation, Kuwait sought to cut spending over the past 2 years by KD 3.25bn to balance out the reduction in oil revenues.

Banks in Kuwait feature high capitalisation, steady profitability, low non-performing loans and high loan-loss provisioning. Due to the decline in deposits at the Central Bank of Kuwait since 2015, financing needs remained significant which led the government to issue sovereign bonds worth of USD 8bn in 2017.

Similar to Saudi Arabia and the UAE, Kuwait’s overall GDP is expected to pick up over the medium term; driven by an increment in non-oil sector growth, rise in oil revenues and an expected peak in inflation. Fiscal balance overall is expected to remain solid or fairly improve over the next few years depending on the outlook for energy prices. Aside from oil risk, the region exposes heightened security risks and a volatile geopolitical environment, which may affect investor sentiment. A fiscal deficit expectation of USD 100bn over 5 years will push Kuwait to seek domestic borrowing, external borrowing, and drawdown of GRF assets.

Large financial buffers, estimated to be around 470 percent of the country’s GDP, and low debt allowed the country to experience smooth financial consolidation.
The lower oil price environment has taken its toll on Oman’s fiscal and current account balances; the Sultanate has experienced double-digit deficits over the past few years, leading to substantial increments in debt and a decline in external buffers, as seen in Exhibit 19. Nonetheless, the government has launched reforms to strengthen the fiscal position, support growth and encourage diversification.

This strategy has been fruitful so far, as non-oil economic growth has picked up by 1.5% in 2016 and 2% in 2017, following a slow but positive trend. Additionally, the rebound in oil prices have helped mildly facilitate fiscal consolidation. In contrast, real GDP growth turned negative in 2017 due to significant contraction in oil output, committing to previous agreements set with OPEC related to oil production, as seen in Exhibit 20. The government’s diversification strategy includes the completion of major infrastructure projects, expected to bring non-oil economic growth to an approximate 4 percent over the medium term. In addition, it plans to introduce VAT, eliminate taxes and continue to control expenditures.

High capitalisation, low non-performing loans, shown in Exhibit 21, and strong liquidity buffers have left the banking sector standing strong. Credit growth is likely to remain healthy, although private sector credit growth has somewhat moderated and interest rates are expected to increase.
Bahrain

With the decline of oil prices in 2014 and absence of buffers, Bahrain’s debt to GDP rose to 90% raising concerns of their high debt burden. Today its government debt to GDP is above the 70% average threshold to be considered as highly indebted for emerging markets, as seen in Exhibit 22.

Although output grew by 3.8 percent in 2017, growth is projected to decelerate over the medium term allowing deficits to continue as well. Nonetheless, the banking sector remains robust with large capital buffers. Altogether, delays in fiscal consolidation and changes in market sentiment could present downside risks to the baseline.

In June, Bahrain announced that its gulf neighbours, Saudi Arabia, UAE and Kuwait, will offer aid to strengthen its financial position and its economy.

Exhibit 22: Bahrain – Government Debt (% of GDP)

Source: Bloomberg as of Oct 2018

the banking sector remains robust with large capital buffers
Market Activity – Relative value

Exhibit 23: GCC Sovereign bonds offer value when compared to their EM counterparts.

Source: Bloomberg as of Sep 2018

Exhibit 24: Relative value on the regional hybrid securities

Source: Bloomberg as of Sep 2018

Exhibit 25: GCC Financials are priced to perfection amongst their peers

Source: Bloomberg as of Sep 2018
Primary bond activity – a focus on GCC

Exhibit 26: Record borrowing from GCC debt issuers

Source: Bloomberg as of Sep 2018

Exhibit 27: GCC bond issuers 2018

Source: Bloomberg as of Sep 2018

Exhibit 28: GCC rating by S&P in 2018

Source: Bloomberg as of Sep 2018

Exhibit 29: Top 5 issuers for 2018

Source: Bloomberg as of Sep 2018

Exhibit 30: GCC debt issuers have increased volumes over the years

Source: Bloomberg as of Sep 2018
Interesting facts about the GCC

United Arab Emirates

- The Dubai Mall is the largest mall in the world by total area at 1,124,000 square meters. In other words, it is equivalent to 50 football pitches! It is part of the 20-billion-dollar Downtown complex, and includes 1,200 shops. There is a waterfall inside the mall and that’s not the only special part. It’s an illusion waterfall. There are statues that are diving from the waterfall and if you stare at one, the others disappear!

- Ski Dubai: the world’s largest indoor ski resort with 22,500 square meters of ski area. With a temperature maintained at a comfortable -1° to -2° up to 25 tonnes of snow fall each night in the 85-meter-high Ski Dubai hall, covering an area of 3000 square metres and making it the world’s largest indoor snow park. The luxurious Kempinski Hotel Mall of the Emirates offers Ski chalets with views of the slopes.

- In 1956, Frank Lloyd Wright wanted to build a mile-high building (528 stories) in Chicago. The World’s current tallest building, the Burj Khalifa is only 1/2 a mile high and was inspired by Wright’s design. With a total height of 829.8 m (2,722 ft) and a roof height (excluding antenna) of 828 m (2,717 ft), the Burj Khalifa has been the tallest structure and building in the world since its topping out in late 2008.

Kingdom of Saudi Arabia

- Saudi Arabia is the 13th-largest country in the world, and the second-largest in the Arab world — behind Algeria — at 830,000 square miles. Ninety-five percent of the country is considered a desert or semidesert, and it has some of the largest desert areas, including An Nafud and Rub al-Khali. Only 1.45% of the land is arable.

- The kingdom’s Ghawar oil field has enough reserves to fill 4,770,897 Olympic swimming pools. Saudi Arabia’s Ghawar field is the largest in the world. It has an estimated 75 billion barrels of oil left. (An Olympic-size swimming pool can hold 660,253.09 gallons of liquid)

- About 100 camels are sold in the capital of Saudi Arabia every day.
Interesting facts about the GCC

**Sultanate of Oman**
- Oman Flag: A horizontal tricolour flag of white, red and green with a vertical red stripe at the hoist, charged with the National emblem of Oman. Adopted on the 25th of April, 1995. White symbolize the Imam, the religious leader of the Omani Sultanate, and at times the political rival to the ruling Sultan. It also symbolizes peace. Green represents the Jabal al-Akdar, or “The Green Mountains,” which lie toward the north of the country. Red is a common colour in Gulf state flags. The national emblem dates back to the 18th century. A curved dagger and a pair of crossed swords.

- Oman is the oldest independent state in the Arab world. It has been ruled by the Al-Said family since 1744.

**Kingdom of Bahrain**
- Bahrain is the smallest among the Arabian countries. The name ‘Bahrain’ means two seas, which is attributed to the sweet water springs and salty water in the seas that surrounds the island country.

- The flag of Bahrain has a white and a red area that is separated by five red triangles merging in the red area. These five triangles represent the five pillars of Islam.

- Bahrain is the first Arab country to host the Gulf Air Grand Prix in 2004. Other major events include, Bahrain Grand Prix, Australian V8 Supercar event, etc.

**State of Kuwait**
- Kuwait is the first Gulf country to have established a constitution and parliament.

- Kuwait has the 15th-tallest sculpted tower in the world – The Al Hamra Tower. Located in Kuwait City, it is also the country’s tallest tower and it took almost six years to complete. It is 414 meters tall with 80 floors. The “Liberation Tower”, which is one of the world’s tallest towers, is the second-tallest structure in the country, measuring 1220 feet. The tower has a revolving restaurant and an observation platform.
Meet the Team

**Syed Yahya Sultan**  
Head of Fixed Income Strategy  
CIO Office | Wealth Management  
Email: yahyas@emiratesnbd.com  
Telephone: +971 4 609 3724  
Mobile: +971 55 886 3947

**Muna Alawadhi**  
Fixed Income Analyst  
CIO Office | Wealth Management  
Email: munaaaaa@emiratesnbd.com  
Telephone: +971 4 609 3511

**Additional Contributors**

**Sunny Naqi** – Associate Director  
Tel: +971 (0)4 609 3513  
Email: sunnyn@emiratesnbd.com

**Budour Al Fahim** – Equity Analyst  
Tel: +971 (0)4 609 3713  
Email: budourf@emiratesnbd.com
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