MENA FIXED INCOME: 2023 – A PROMISING YEAR OF LOSS REVERSAL?

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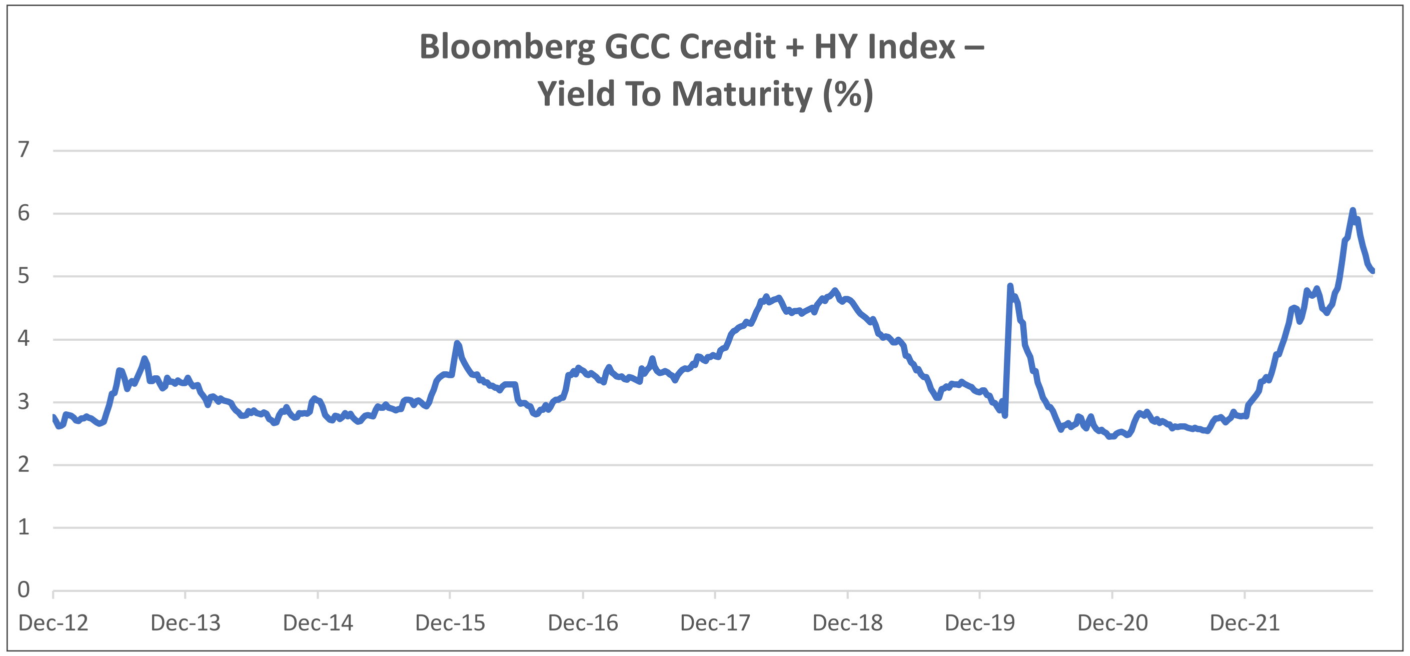
Introduction

The sell-off in fixed income markets in 2022 was painful for many, and especially to market participants with a career span of 30 years or less. The silver lining is that yields and valuations now look more attractive than they have for many months. Fixed income as a broad asset class now finally offers the income factor, after yields rose globally. This is also true for the still relatively young regional MENA fixed income market, which is shaping up to be a genuine contender for global fixed income asset allocators, helped by a growing importance within global and regional tracking indices. The inception of the Bloomberg GCC Credit + High Yield Index Total Return Index (Value Unhedged) (Ticker: BGCCTRUU) was only in 2010.



Source: Bloomberg/FAB

Discussion

For investors focused on this subset of the EM debt universe, the catastrophe that the year 2022 was for fixed income markets has indeed boosted the allure of regional bonds, after being starved of yield for years. The peak yield of the BGCCTRUU reached in October 2022 at the market low was 6.09%, a significant move from 2.84% ten years ago. Even after the recent rally, the yield-to-worst on the index is as high as 5.05%.

In our view the structural case for regional credits has improved, especially for the investment grade (IG) segment. Since about last November, investors locally and abroad have raised their average positioning to overweight, both tactically and strategically. As the macro conversation has shifted from inflation, more towards concerns about slowing growth and looming recession, the relatively defensive quality of regional credits has come to the fore. Regional sovereigns have seen their balance sheets strengthen on the back of surplus revenues, as well as their ability to engage in opportunistic debt refinancing at still quite low yields, to support their growth plans.

Furthermore, elevated oil (and gas) prices for most of 2022 enabled most GCC sovereigns to record twin surpluses (i.e. on their current accounts as a percentage of GDP, and in terms of fiscal balances). The average oil price of above USD 90/barrel for Brent during 2022 was comfortably above the fiscal breakeven levels of the GCC economies. Even with a slightly softening outlook resulting from slacker crude oil demand, the GCC, with the exception of Bahrain, should continue with surpluses heading into 2023. The high-yield sovereigns, Oman and Bahrain, outperformed their investment grade-rated GCC peers, on the back of high oil prices disproportionately benefiting them, and also bearing in mind improved outlook forecasts from the agencies.

In addition to its improved fiscal metrics, Oman's debt levels have fallen, on the back of debt buybacks, ultimately funded by growing nominal GDP. The country benefited from two rating upgrades in 2022 by S&P, to the current BB, with a stable outlook. Doing well, although not as strong a recovery story as Oman, Bahrain (rated at B2/Stable, B+/Positive, and B+/Stable by the three main agencies) also outperformed its stronger credit peers. Its sovereign rating was upgraded by Moody's, with its outlook upgraded to Stable from Negative in April last year. Bahrain's VAT rate was doubled to 10% in January 2022, helping it to post a marginal 1% surplus (of GDP) in the first nine months of 2022, as well as the help from high oil prices.

Global credit spreads widened significantly last year. While higher yields for lower-quality credits signify higher overall risk, this has also thrown up some good higher-income opportunities. Yes, investors will almost certainly have to navigate a challenging macroeconomic environment, and likely during a recession this year. The case for regional MENA credits may be different

than other parts of the EM debt space, however – the region's banking system is increasingly well-controlled, and well-capitalised, while issuers in the sector have been relatively cautious in their debt-raising approach, as seen in the significant reduction in new issue activity in 2022. Regional credits are most definitely a pocket of opportunity, in our opinion, as their widened spreads are likely not very susceptible to the ongoing war in Ukraine, and could benefit from the ongoing energy crisis and heightened growth concerns in Europe. Overall regional corporate fundamentals are expected to remain robust, supported by infrastructure development (in Saudi Arabia) to achieve ambitious plans inherent in Saudi Arabia's Vision 2030. We believe downgrade concerns within the region are minimal, allowing this subset of the EM universe to continue to be attractive.

While there can always be intermittent volatility due to fluctuating crude prices or geopolitics, the potential for good total returns in regional debt over the medium-to-long definitely exists, in our opinion. Short-term fixed income (of under three years in tenor) probably possesses particular value. The recent rise in yields has reduced the need to take positions in high yield issues further along the duration curve, and with many securities trading at discounted prices, yet due to rise to par at maturity. This reduces the risk of capital loss, compared to holding on to a longer-duration security that is more susceptible to higher rates and spread uncertainties. The higher yields now on offer, together with the high average strength of balance sheets in the GCC, are for us solid reasons to overweight MENA IG credits, with better buying opportunities in HY likely to come later in 2023.

While the regional fixed income market has grown rapidly in recent years, it is still emerging, and susceptible to multiple external factors such as oil price fluctuations (arguably slightly less now, after economic diversification measures), regional geopolitics, fickle foreign institutional flows, and a range of other factors. Despite some of these characteristics, we believe regional credits have demonstrated sufficiently favourable risk and return attributes to warrant long-term investors' consideration. When comparing various regional and broad-based fixed income benchmarks, the Bloomberg GCC Credit + High Yield Index Total Return Index has demonstrated competitive performance for the five-year, three-year, and one-year periods ending 30 November 2022.

Furthermore, MENA regional debt issues provide global fixed income investors with very useful diversification, using this distinct sub-asset class. The key attributes of this region - its large capital buffers, vast hydrocarbon reserves, and strong credit ratings, provide considerable positives for investors, and which are unique among emerging and frontier markets. Accordingly, the region's bonds are being included in more global and EM fixed income benchmarks. The steady high-decile performance metrics, in conjunction with the sub-class's low-risk attributes, surely warrant investors' consideration as a part of their multi-class asset allocation.

The Development of Local Currency Issuances

There has also been a very interesting development in regional credits (covered in a dedicated article on AED bonds elsewhere in this GIO) – local and regional investors have become increasingly interested in local currency debt markets, which have only emerged in the last few years, and following governments' efforts to develop them. This has led to higher issuance of SAR-denominated debt from the Saudi government, corporates and financial institutions, including in the form of Tier-1 perpetuals. This has also been seen in the UAE, where the Federal government last year issued its inaugural AED-denominated multi-tranche debt – and which was heavily subscribed to at the primary level. Strong local investor appetite has in some cases driven these local currency issuances to tighter levels than comparable US dollar paper. So the local debt markets are continuing to evolve.