THE NEW UAE DIRHAM BOND MARKET
AND ITS OUTLOOK

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Introduction:

As a result of the UAE Federal system, we have for many years seen bond issuances by the individual emirates. Abu Dhabi, Dubai, Sharjah, and Ras Al Khaimah have each had their own bonds and yield curves. While the market has for a very long time expected a bond to be issued at the federal level denominated in US dollars, this only finally occurred last year. Despite the extremely challenging market conditions we have witnessed in the fixed income space, the country issued its first AED-denominated Federal bond program, commonly known as T-bonds. Fully 'Euroclearable', it was structured in a slightly different way to its regional peers, and clearly aiming not just to be sizeable, but also widely available to international investors. Across the emerging market local currency spectrum, the usual suspects remain Saudi Arabia, Mexico, Singapore, Hong Kong, Indonesia, and Korea. The UAE has joined this list, with the initial successful issuance of 2-year and a 3-year bond issues in May, followed by a 5-year issuance in September. While the primary objective of this exercise has been to develop the AED yield curve, the future implication is to have a local reference index for different products, including - but not limited to - mortgages, financing projects, or local issuers of bonds.

Discussion: Whilst this might appear at first glance to be a simple means of diversification to balance the dependency on international capital markets, we believe this program augments the country's vision in terms of growth, and shows a determination for it to develop as a key regional financial hub. A new market has been born, and as with any new-born, we expect it to grow, develop, and mature with time. As it grows, it will re-shape the way business is done, both locally and regionally.

The second significant change that the UAE fixed income space has seen over the last few years is the adoption of the AAIOFI (Accounting and Auditing Organization for Islamic Financial Institutions) standards, which set compliance standards for institutions wishing to gain access to the Islamic banking market. Market participants, including issuers and banks, have needed some time to become fully compliant and to become used to the changes, with a clear aim to have a stricter – hence safer – Islamic finance framework across products, including Sukuks.

During 2022, increased interest rate volatility caused a number of refinancing issuances to be delayed, globally and regionally, with issuers either waiting for a window to launch their primary offering, or turning to other financing methods such as bank loans. At the time of writing, less than 25 Sukuks of benchmark size had been issued globally during 2022. As a result, the regional liquidity for Sukuks was negatively impacted. Whoever held the paper typically held onto it tightly, given the difficulty in replacing it should the bond be sold, or if it matures. Unless there is a significant shift in rates in the very short term, we believe more of the same is to be expected in the coming quarters.

With the UAE hosting the next COP meeting during 2023, we are looking forward to seeing an acceleration of the ESG transformation, both locally and regionally. At a global level, the race is definitely on. Indonesia issued its largest green Sukuk tranche to date in May last year (USD 1.5bn); the country increased the transaction size, demonstrating strong demand and a successful issuance. Moreover, this was the first issuance across Asia to be fully AAOIFI-compliant, and also aligned to the guidance of the UAE's Higher Shariah Authority. It looks as though the broad Islamic bond class is moving towards a more uniform landscape. While it is still early days, the course looks set.

Conclusions: Looking forward, we continue to believe that the outlook for regional MENA fixed income is constructive. Market participants have plenty of dry powder to deploy, while inflation rates are such that cash placed on deposit is subject to capital erosion. Longer-dated, lower-rated instruments are seeing increased demand, within and outside MENA's borders. Meanwhile, the lack of efficient regional fixed income hedging tools will in our view continue to underscore the increased use and development of non-cash derivatives instruments, such as credit default swaps (CDS). Recently the sovereign CDS curves have seen plenty of activity during 2022; these contracts effectively provide insurance against the underlying credit risk that bonds are exposed to. As debt finance becomes more expensive, and as regional risk management becomes more advanced, hedging will be increasingly sought via CDS instruments.

We also anticipate a rising regional trend in what are commonly called 'basis trades', which are designed to exploit potential arbitrage opportunities between CDS and cash or bond prices. To reiterate, during 2022 we saw increased buying of protection via CDS, and expect this trend to accelerate into 2023.

In addition to such activity we anticipate more use of so-called 'decompression' trades in our region, such as Saudi and/or Abu Dhabi exposure being used to moderate the higher perceived risk of Oman/Bahrain exposure, although investors may also use such a spread to increase risk if desired. Otherwise, we expect to see the birth of new markets and sub-asset classes within regional fixed income. Watch this space!