MENA FIXED INCOME:
THE GLASS IS HALF FULL

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Introduction

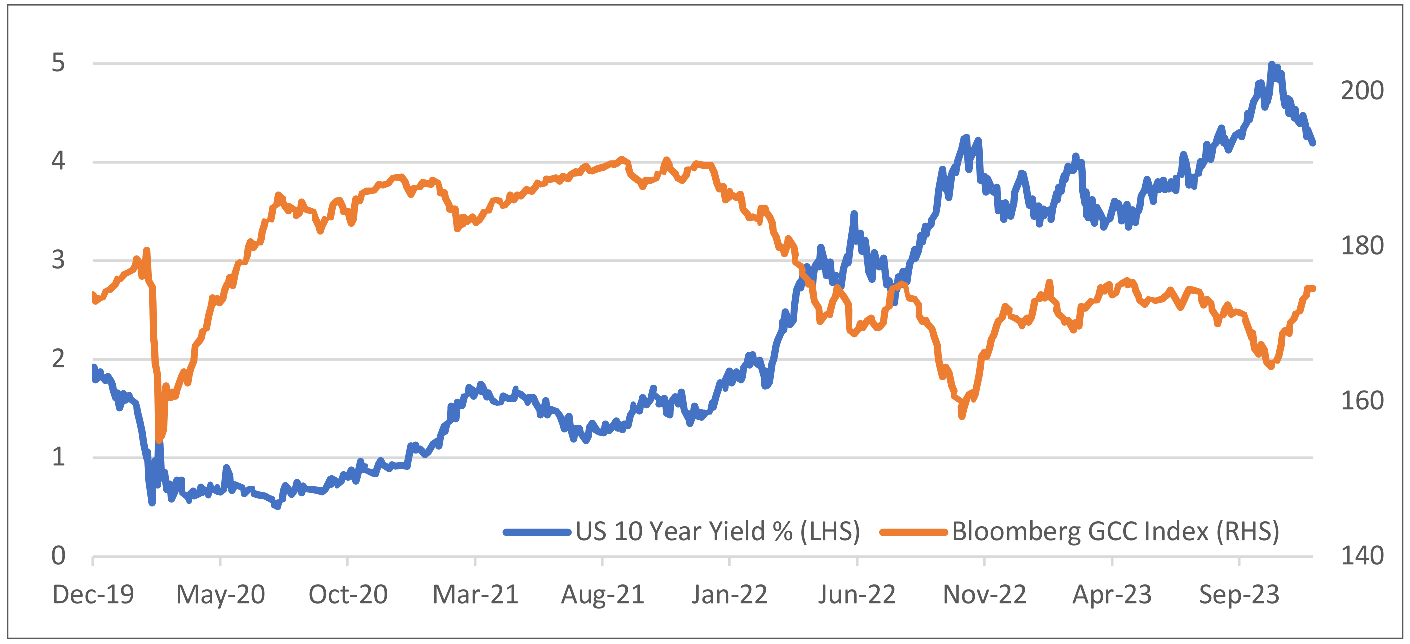
While investors were still reeling from the pain of double-digit losses in 2022, 2023 proved to be another roller coaster year. It was meant to be a more rewarding year for bond investors. The first ten months of 2023 continued to chart negative returns as interest rates reached the 5% mark on Fed Fund rates, and long end yields reached a new high, north of 5% in mid-October. At the point of writing, most bond indices are rebounding strongly from month-to-date rally in rates following a significant drop in expectation of a Fed rate hike for the rest of the year following soft economic data.

We repeat what we wrote last year, this time with conviction: fixed income is finally offering the income factor after yields rose globally. And especially true for the relatively young regional fixed income market which only took place and shaped into a significant percentage of global investor's portfolio in the last decade.

Discussion

After the largest sell-off in recent history the US Treasury 20+ year Index having lost over 45% of its value since July 2020, investors should now look ahead with quantified optimism. The aftermath of this great re-pricing has culminated in regional fixed income now offering the highest yields in 15 years. While uncertainty remains, the end of the hiking cycle is close, if not already upon us. For buy and hold investors, this is certainly the cue to enter. We have begun to embrace this, by moving into a medium-term duration to "lock in" yields and selectively extend duration and to capture value during periods of mispricing. Over the medium to long term, the probability of lower rates is higher and will drive returns, well into the double-digit figures.

US 10 Year Yield Vs. Bloomberg GCC Credit + HY Index



Source: Bloomberg/FAB

The global macroeconomic landscape continues to affect regional credit markets. Subdued global economic growth is likely to hit Emerging Market (EM) countries with lower credit quality and higher leverage commitments. This is not the case for the major economies in the Middle East and North Africa (MENA). Investment-grade issuers in particular, sovereigns and corporates from the UAE and Saudi Arabia we opine to perform well through 2024.

For global investors focused on this subset of the EM debt universe, the catastrophe in 2022 and most of 2023 has boosted the attractiveness of regional bonds. Having been deprived of yield for years, the peak yield of the Emerging Markets USD Aggregate: MENA Bond Index reached in October 2023 was a very attractive 7.28%, a significant move from the low of just over 3% less than 3 years ago.

MENA credit outlook

The case for regional credits looks compelling as we move into 2024, more specifically the investment grade space with the market moves in November 2023 as investors locally and abroad had raised their overweight, we believe it is set to continue in the coming months. As the macro conversation shifts from inflation to concerns about slowing growth and a looming recession, the defensive quality of regional credits is proving attractive, especially after the spread widening on the back of geopolitics – which at time of writing, seems to be limited. The key backstop to regional sovereigns is their strong balance sheets on surplus revenues as well as opportunistic refinancing debt at relatively lower yields to support growth plans vis-à-vis other similarly rated EM peers.

Oil revenue still provides the majority of income for most MENA economies. The elevated oil prices in 2022, which averaged USD91 on Brent, and USD82 for most of 2023 – a more subdued but sustainable level afforded most GCC sovereigns to record surpluses. These oil

price averages are above the fiscal breakeven levels of the major regional hydrocarbon-exporting economies. Even with the softening outlook as a result of demand side especially from China, the GCC with the exception of Saudi and Bahrain should continue with a surplus budget heading into 2024.

Indeed, Oman and Bahrain as high yield issuers have outperformed relative to their investment grade rated MENA peers, on the back of higher oil prices resulting in improved fiscal and current accounts forecasted for 2023 and 2024. On top of the fiscal positive measures, their debt levels have also moderated on combination of debt buyback and growing base of the nominal GDP.

Readers should be cognizant of the fact that GCC economies are different from many other parts of the EM debt universe. For one, the regional banking system is controlled and well-capitalized and prudently issuers have been relatively cautious in their debt-raising approach, witnessed by the significant drop in the new issue activity in 2023. Regional credits are most definitely a pocket of opportunity with an in-depth maturing credit cure. Corporate fundamentals are expected to remain robust, supported by the infrastructure development and spending to achieve ambitious plans such as Saudi Vision 2030. We think downgrade concerns are well-contained, allowing this subset of the EM universe to continue to be attractive.

Positioning

Investment grade corporate credits valuations have become cheaper since late September 2023 but still remain relatively tight to its similarly rated EM peers to trigger a material interest from global EM investors – however this is changing as ADGB and Dubai complex proved its resilience amidst recent geopolitical worries. Focusing on higher quality issuers is a prudent and could be a winning strategy. This is especially important when investment grade bonds are offering yields that could match the long-term average returns for equities. In addition, and unlike their high yield peers, investment grade issuers were able to term out funding needs to much longer maturities and can consequently better withstand the recent rise in cost of capital.

Having said that, there is still an argument for going down the credit curve. There are the BBB and BB rated quasi-sovereigns, a handful of long-dated project bonds, and the region's financial subordinated debt instruments and very selective strong conviction high yield real estate issuers. The complexity and inherent risks are often overlooked, but being selective could yield alpha. While regional high yield bonds offer an average yield of almost 10%, (9.3% in the US and 8.6% in Europe, spreads have remained relatively contained throughout 2023. What we need to be mindful is the maturity wall of 2025 and 2026, which may seem distant, but markets tend to look ahead and many of the most leveraged companies will have to absorb a much higher interest burden from then. Default rates in the region have been extremely subdued (we have seen more upgrade cases than downgrades), but we carry out thorough due diligence when adding a high beta name into the recovery year that is 2024.

Uncertainty is unlikely to disappear in 2024. We remain prepared to experience further volatility and ultimately, ready to embrace it with duration positioning and sector selection that can work as a hedge. Next year, income opportunities could morph into price (i.e., capital gain) opportunities. As always, diversification will be essential.