GCC FX OUTLOOK

By Lyndon Loos and Alison Higgins

The GCC FX markets rolled with the punches in 2020, with the local currencies rebounding for most of the second half, despite still historically-weak oil prices, the economic impact of the pandemic, and ratings downgrades for Oman, Bahrain, and Kuwait. Indeed, the levels at which spot rates and swaps were trading towards the end of last year may have been indicative of a fairly robust regional economic expansion to come, and a degree of recovery in crude prices.

However, the actual economic environment is still quite difficult. The depression of the FX forward curves to their current extent is probably due to the generation of USD funding by the region's banks (deposits are taken in local currency and swapped into USD utilizing the relatively deeper FX swap markets). At the beginning of the Covid-19 crisis regional currencies took a beating as oil prices collapsed below US$30/barrel, driving both spot and swaps aggressively higher for GCC/US dollar currency pairs. The table below, showing USD/GCC FX offshore rates, illustrates this.

The year closed with Brent trading close to US$51/barrel, on the back of the OPEC+ signatories agreeing to increase their output only slightly, by 500,000 barrels/day from January, retaining the bulk of the earlier agreed curbs to cope with soft demand. The trend in crude prices will clearly be a key factor in regional economic recovery, but particularly for the GCC where, despite the impressive progress made by most states towards economic diversification, there is still a heavy reliance on hydrocarbons to balance the books.

Having said that, the outlook now appears to be more positive. FAB expects a moderate recovery in crude prices over the next two years, with Brent forecast to average around US$58/barrel in 2021, and US$65 in 2022. This is more optimistic than the IMF's official forecasts published in October last year, which suggested a US$40-US$50/barrel trading range for 2021.

However, oil prices are expected to be subdued during the current half-year, despite the vaccine breakthroughs. The time taken to distribute vaccines to meaningful numbers of the global population is forecast to be 8-10 months, which although allowing a gradual easing of restrictions does not provide rapid relief for the oil industry. Indeed, the application of fresh harsh lockdowns in the UK and much of Europe at the end of last year and into 2021 to contain a more virulent strain of Covid-19 highlights the obstacles governments face in effectively combating the pandemic.

In conclusion for GCC FX markets, many of the swaps curves are trading at relatively cheap levels and should provide good opportunities this year. Although not always highly liquid, the two- to five-year tenors in US dollar swaps against GCC currencies will likely continue to see buying interest from international banks and funds. However, the carry is steep, so investors may choose to offset this with some short-end plays for the spread.

CURRENCY	TENOR	Mar/Apr 2020	Dec-2020
AED	Spot	3.6732	3.6730
	12m swap points	120	23
SAR	Spot	3.7690	3.7516
	12m swap points	300	10
KWD	Spot	0.31500	0.30365
	12m swap points	480	225
OMR	Spot	0.38525	0.38500
	12m swap points	2400	360
BHD	Spot	0.38050	0.37705
	12m swap points	250	140

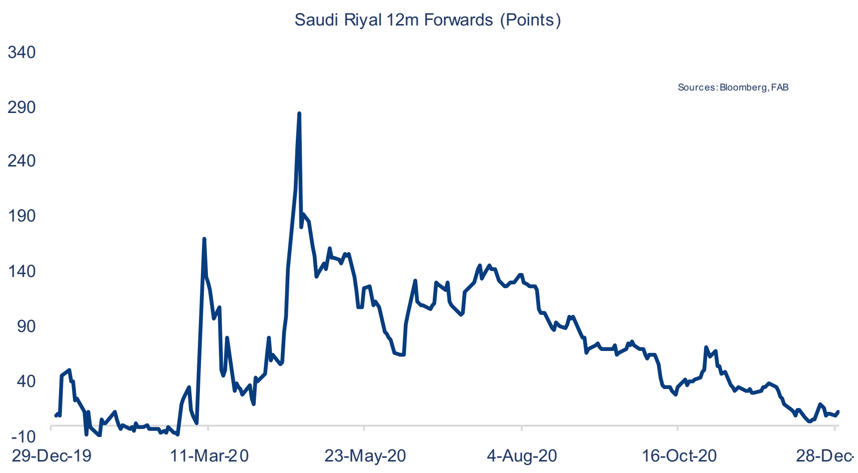
Saudi Arabia: Although the immediate economic outlook for 2021 remains cautious, there is a solid story of reform settling into KSA, with deepening foundations over the last few years. The sizeable fiscal and monetary stimulus aimed at combating the impact of Covid-19 has also helped to strengthen the Kingdom's diversification story. For this regional behemoth, the reliance on a global recovery to shore-up oil demand may still be high, but reforms have opened up new markets, and a degree of economic recovery appears assured.

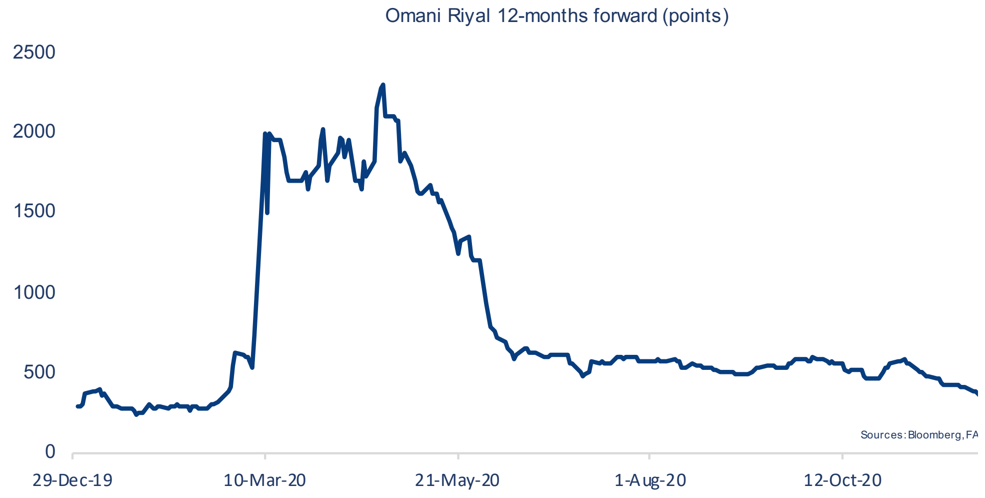
United Arab Emirates: While the UAE has not been immune to the impact of the pandemic, its response was swift, clear and effective. The economy has essentially remained open, with relatively short lockdowns last year. Although stringent regulations for travel have impacted domestic airlines, UAE residents' staycations have provided some relief to the leisure and hospitality sectors. Dubai differentiated itself by keeping its borders open to international travelers. The widespread availability of Covid-19 vaccines and EXPO 2021 should be supportive of the UAE's economic recovery this year.

Kuwait: The World Bank suggests that real GDP in Kuwait is likely to have contracted by 7.9% of GDP in 2020, a further decrease of 2.5% from its original projection made last June.

Bahrain: Bahrain has been hit hard by structurally low oil prices and the spread of Covid-19. Another tough year is expected in 2021. Some value is seen in local treasury bills, with no imminent changes expected in the implicit support received from its regional neighbours.

Oman: Tourism and oil are key contributors to the economy, and both came under severe pressure from the pandemic last year. The World Bank has projected a GDP





contraction of over 9% in 2020, putting the country's already tight finances under even further pressure.

However, vaccine availability should facilitate economic recovery during the second half of 2021. The USD/OMR forward curve was not reflecting any particular stress coming into 2021, with the one-year currency swap trading close to 375. This was only a premium of 23% above pre-pandemic levels, and considerably below those of March last year.