MENA FIXED INCOME OUTLOOK

By John Fairs and Louis Najem

With global bond yields having fallen to levels not seen in almost a decade, and the amount of negative yielding debt reaching new records, bonds in the MENA region offer attractive risk-adjusted returns for 2021.

The region has lagged other emerging markets as low oil prices weighed on investor sentiment surrounding it. As of the first week of December, the average spread of the Bloomberg Barclays GCC Credit & High Yield Index (unhedged in USD) stood at 174 basis points. That is much tighter than the 429 basis points peak in March last year, but still much wider than the all-time low of 109 basis points seen in September 2014.

Perhaps more importantly, the relative recovery of the GCC bond index to date has been weaker than that of its peers. The spread of the broader Bloomberg Barclays Emerging Markets US Dollar bond index was already below pre-Covid levels in the first week of December, even if still wider than its all-time low.

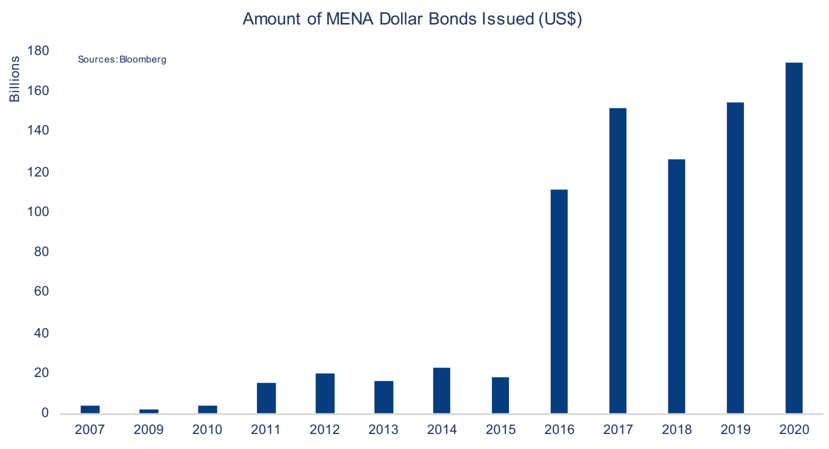
The relative underperformance of GCC credits in 2020 can be partly explained by two things: record issuance in the region, and low oil prices. In summary, investors have been attaching a higher discount to GCC bonds because they have seen fiscal deficits in the region widen as oil prices fell.

Both these factors contribute to an outlook of more bond issuance in the region, particularly in sovereign bonds. In some ways, the premium MENA issuers are paying is partly due to expectations of a continued increase in bond supply, after a year when a record US$174 billion of dollar bonds were issued in the region.

The Sultanate of Oman is perhaps a good example of the higher relative yield premiums available in the GCC. The country's bonds have been trading with a higher yield premium to US Treasuries relative to many sovereigns with lower credit ratings and worse economic metrics.

In early December, medium-dated sovereign bonds from Oman offered a premium almost twice those offered by similar maturity bonds of Jamaica, rated B2 by Moody's, B+ by S&P and B+ by Fitch. Oman is rated Ba3, B+ and BB– respectively by the same credit agencies.

Oman was also paying more than Senegal, which has the same ratings but is participating in the Debt Service Suspension Initiative of the G-20. Unlike Oman, Jamaica has a recent history of restructurings, having forced a haircut on many creditors a little over a decade ago.



The outlook, however, continues to change. Oil prices had stabilized by December and rating agencies are forecasting slightly higher average prices in 2021. Many of the oil-producing countries in the region have also implemented a number of new revenue-generating measures, from new taxes in Oman, to a tripling in VAT in Saudi Arabia.

Riyadh, for instance, has shown its commitment to maintaining its high credit rating and improving its fiscal balances. In November, after Fitch Ratings put the country's A credit rating under a negative outlook, the Kingdom of Saudi Arabia indicated they would pare back their bond issuance plans, despite expectations of a continuing fiscal gap.

The pandemic also served as a good reminder to global investors that many of the corporate issuers in the MENA region are government-linked and should receive support in times of need. This has made the evaluation of investing in corporate bonds in the region more attractive, as many of the credits here may be viewed as government-related debt with a yield premium.

Meanwhile, many of the GCC countries were able to reopen their economies faster than other emerging markets, having succeeded early in controlling the spread of the Covid-19 virus.

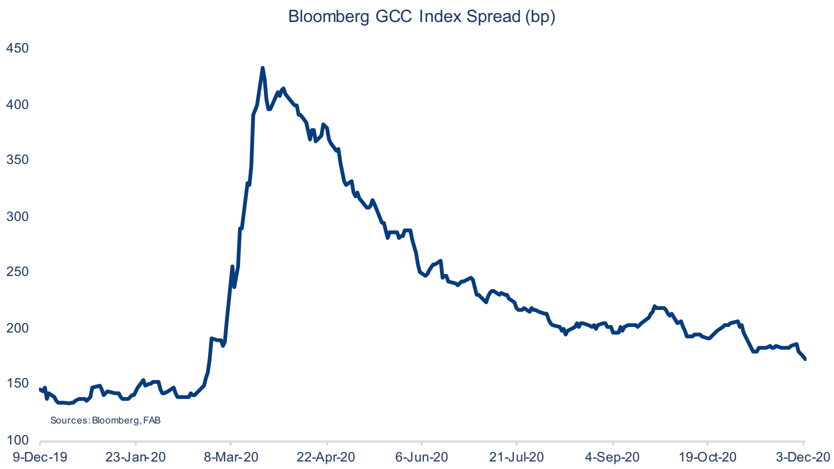
Most economies in the region have not contracted meaningfully during 2020. Saudi Arabia, the biggest economy in the region, is a good benchmark against which to measure the economic effects of the coronavirus pandemic in other countries in the region.

The Saudi economy grew 1.2% in the third quarter, compared to the previous quarter, although it still shrank by 4.9% between the first and third quarters, according to the Kingdom's statistics authority. While the rebound comes off a low base, it was the fastest growth for the country since early 2018.

While the authorities did not link that rebound to oil, the average price of a barrel of Brent crude in the third quarter was US$43.31, 30.3% higher than in the second quarter. The dual effect of higher oil prices and a lower base could mean accelerated headline GDP growth in the MENA region next year.

The crisis also prompted some major policy changes in the region, which are likely to accelerate growth in the non-oil sectors of the GCC next year. The UAE, for instance, introduced the ability of foreigners to fully-own onshore companies, and changed its laws to make retirement in the country more attractive for expatriates. These, along with a host of other initiatives to open up and modernize the local economy, are likely to pay dividends in the form of higher growth this year, and could make the UAE one of the favourite destinations for global EM bond investors.

Furthermore, countries in the region have made significant progress in terms of ensuring peace and stability, with the UAE and Bahrain establishing diplomatic relations with Israel.



The kinds of economic reforms mentioned above, in particular, should serve to reduce the historic geopolitical yield premium associated with credits in the region. Accordingly, bond spreads in the region over Treasuries could tighten during 2021, and in the coming years the previous all-time low in spreads could be revisited.

Such factors, along with the sustained global hunt for yield, should favour bonds in the region. The recent growth and development of the debt curves in MENA are also expected to continue, which increases the liquidity of regional bonds, also making them more attractive to international investors. In addition, an improving macroeconomic outlook could also help tighten bond spreads.