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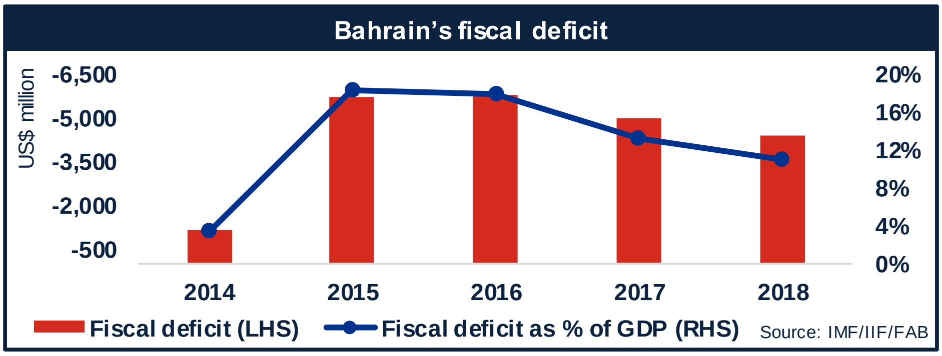
Global Markets

Bahrain:
Battered but not broken

Bahrain has appeared in regional financial market headlines regularly over the past few months as concerns rose about its specific fiscal and economic pressures. Such fears were highlighted by the jump in the 5-year CDS which hit an all-time high of 431bps at the end of last week. However although there is no doubt that the Kingdom is facing some extremely challenging times we feel that the current situation is not quite as bad as it may seem at first glance and one should first look past the media headlines to get a clearer perspective of the actual potential risks involved.

Reliance on oil & the need to diversify

The first oil well discovered in the Arabian Gulf began pumping crude in Bahrain in June 1932, and the resulting domestic energy sector remains the primary source of government revenues there. Thus the sharp drop in oil prices in 2014 severely impacted Bahrain's finances resulting in a wider current & fiscal account deficit and a rise in the country's public debt levels. It also triggered a ratings downgrade by the three main agencies in 2016/17. Outside of price volatility Bahrain has been experiencing a decline in its overall crude and gas output since the hiatus of the 1970s and oil reserves are reported to have since fallen to just under 125 mio barrels. The country currently pumps close to 45,000 bpd and receives income from an equally shared offshore deposit with Saudi Arabia called Abu Safah, which produces 300,000 bpd and is operated by Saudi Aramco. Meanwhile Bahrain relies heavily on natural gas to meet its domestic energy demand and reserves of this have slipped to an estimated 3.3 trillion cubic feet last year from 5.1 trillion in 1998.



So considering the above, the need for Bahrain to shift away from its historical reliance on oil is clear, and in fact the country has achieved some level of success in its diversification efforts over the past decade, especially in the areas of finance, manufacturing and hospitality. Aluminum production in particular has grown and now accounts for over 30% of Bahrain's total non-oil exports. Such steps have also helped to reduce the government's reliance on the hydrocarbon sector, with its income from this particular source declining from 87% in 2013 to its current level of around 75%. Other diversification projects are ongoing including the construction of a new LNG terminal and a US$10 bio upgrade of the country's refining capabilities. Meanwhile on the investment front Bahrain is soon to introduce a 10-year renewable residency visa for foreign investors, the rules covering bankruptcy have been updated and streamlined, a regulatory sandbox has been set-up to boost the FinTech sector and a new law is being prepared that would allow for 100% foreign ownership of companies based in the Kingdom.

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Chavan Bhogaita
Managing Director & Head of Market Insights & Strategy

Glenn Wepener
Exec. Director & Geopolitical Analyst

Simon Ballard
Exec. Director & Macro Strategist

Rakesh Sahu
Analyst

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For the time being of course oil will retain its strategic importance and ironically could even provide some dramatic relief to the government's coffers in the medium term if the recently announced discovery of up to 80 bio barrels of tight oil and 10-20 trillion cubic feet of gas lying off the coast is proven to be physically and financially extractable. Further investigations into the quality of this find are ongoing and will probably only produce clearer results in 2019, but even if only 10% is accessible it would still provide a significant fillip to an economy the size of Bahrain's.

Economic Snapshot

Overall, Bahrain's economy expanded by 3.8% (GDP) last year up from +3.2% in 2016 and +2.90% in 2015. We do expect the economy to moderate slightly to 3.20% growth for full year 2018 though.

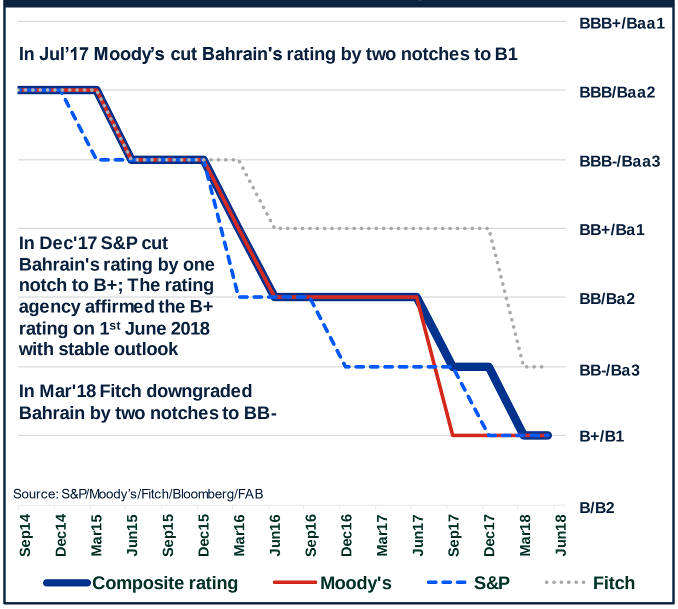
Meanwhile the country's overall fiscal deficit is estimated to have declined to 13.20% of GDP, from around 18% in 2016, as a result of higher oil prices and government fiscal consolidation measures, however the recent rise in public debt levels is a concern. Debt to GDP rose to 89% in 2017 and could move above 100% over the course of the next financial year, which in turn would be a clear constraint on the Kingdom's fiscal flexibility. The current account deficit appears relatively stable around the 4.5% mark, but the central bank's gross international reserves remain low (US$2.07 bio in April 2018), and cover just over 1.5 months of prospective non-oil imports. It's worth noting however that this does not include the assets held by Bahrain's sovereign wealth fund.

Bahrain's local currency, the Dinar, has been pegged to the U.S. dollar at the same level since 1980 and this has helped to keep inflationary pressures at bay. Despite the recent recovery in the oil price, inflation in Bahrain remains modest, currently trending around 2.80% yoy. We also do not foresee any change in the peg in the near term; this view is in line with other institutions such as S&P, who also feel that Bahrain would most likely receive the necessary financial support from its GCC neighbours should it be required. A recent example of such was this week's pledge by the KSA, Kuwait and the UAE to provide Jordan with a US$2.5 bio aid package.

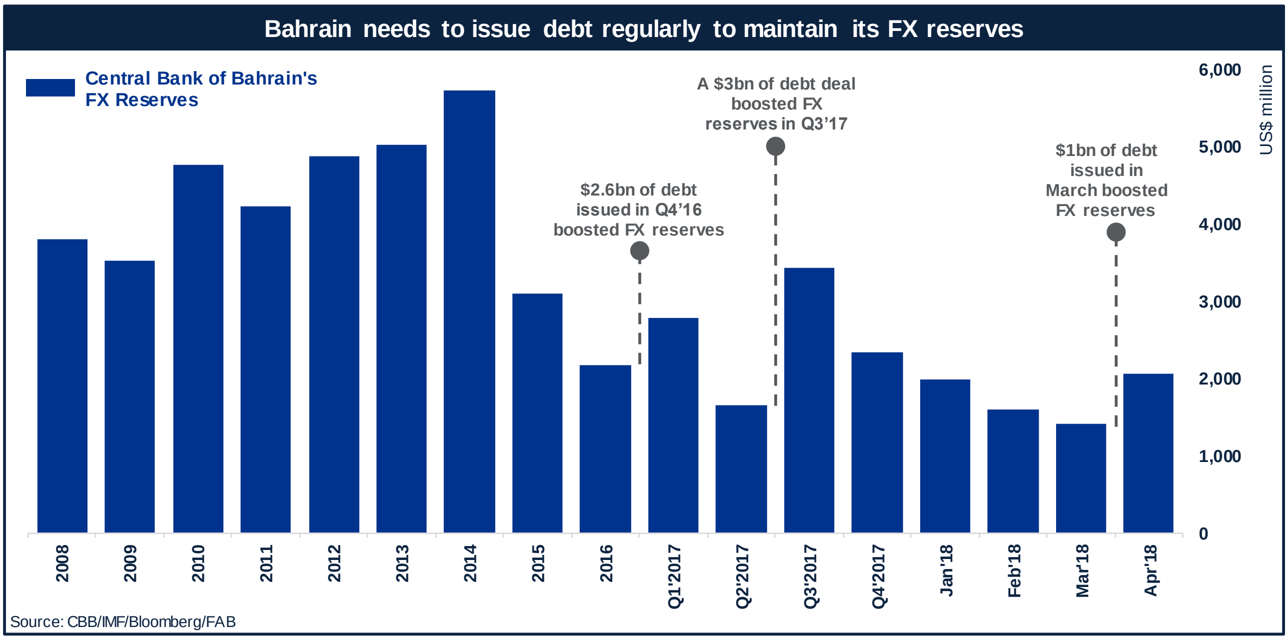
As outlined in our introduction the decline in oil prices since 2014 – notwithstanding the recent rebound as a result of OPEC and non-OPEC production cuts – has weakened Bahrain's fiscal and external positions. As such, we believe that the sovereign must continue to implement meaningful fiscal reforms, comprising revenue and expenditure initiatives. Significant fiscal deficits exacerbate external imbalances, in turn increasing government debt levels with which to finance these deficits. Thus any lengthy delay in pursuing further reform measures - and if fiscal and external pressures were to intensify – such a combination could re-ignite negative pressure on Bahrain's credit profile.

From a macro perspective, we suggest that the above risks are already clearly reflected in Bahrain's sovereign ratings of B+/BB- (S&P/Fitch). Last December S&P cut the Kingdom's rating to B+ citing concerns about the low level and heightened volatility of the central banks' international reserves, but importantly the agency affirmed this B+ rating earlier this month. This recent affirmation and stable outlook are founded on the well capitalized and liquid characteristics of Bahrain's banking system whilst also reflecting the assumption that financial constraints could by balanced by implicit financial support from neighboring sovereigns in times of significant financial duress. As far as the fiscal position of Bahrain is concerned, S&P's stable credit outlook is also supported by the ratings agency's assumption that the sovereign's fiscal imbalances will moderate to around 7% of GDP by 2021.

Bahrain's credit rating trend



Source: S&P/Moody's/Fitch/Bloomberg/FAB

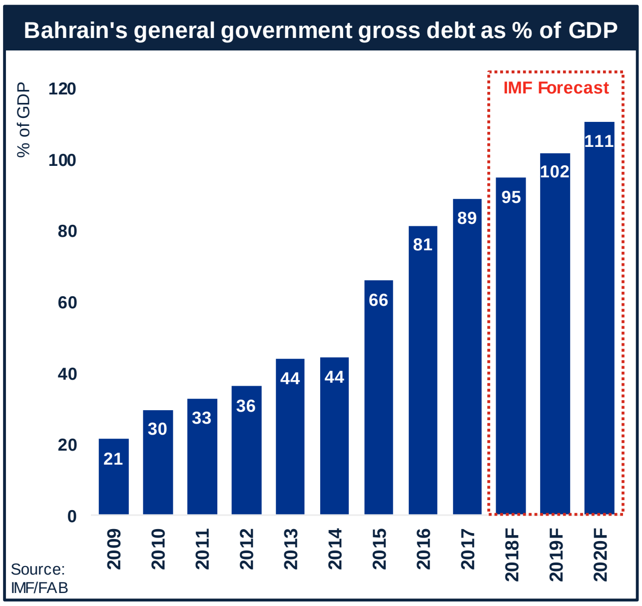


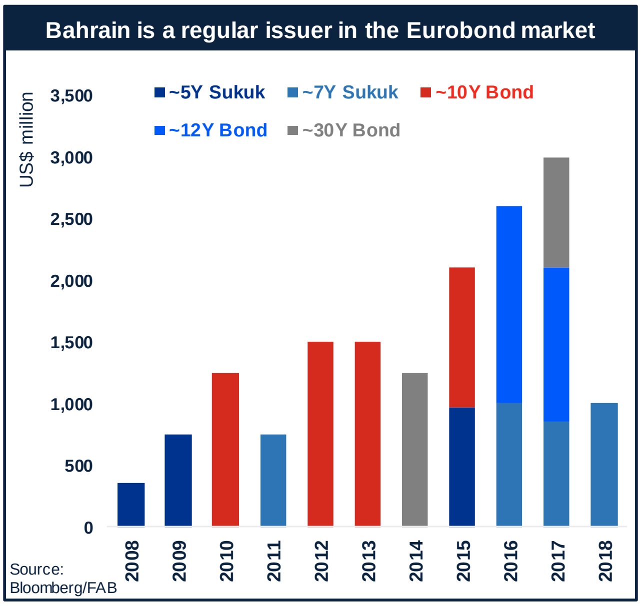
Credit Outlook

Notwithstanding the fact that the Kingdom of Bahrain is rated in the sub investment grade category by the three main credit rating agencies (Moody's, S&P and Fitch), the negative pressure on its ratings appear to have subsided for the time being. However it is also clear that the country's continued access to debt capital markets is a key factor in the sovereign's credit metrics and any material change in this regard would be viewed negatively by the rating agencies.

Government Debt

Bahrain's fiscal situation has resulted in the sovereign being a fairly regular debt issuer, and while this in itself isn't necessarily a concern the sustainability of such a high level of Government debt stock is indeed something that needs to be watched.

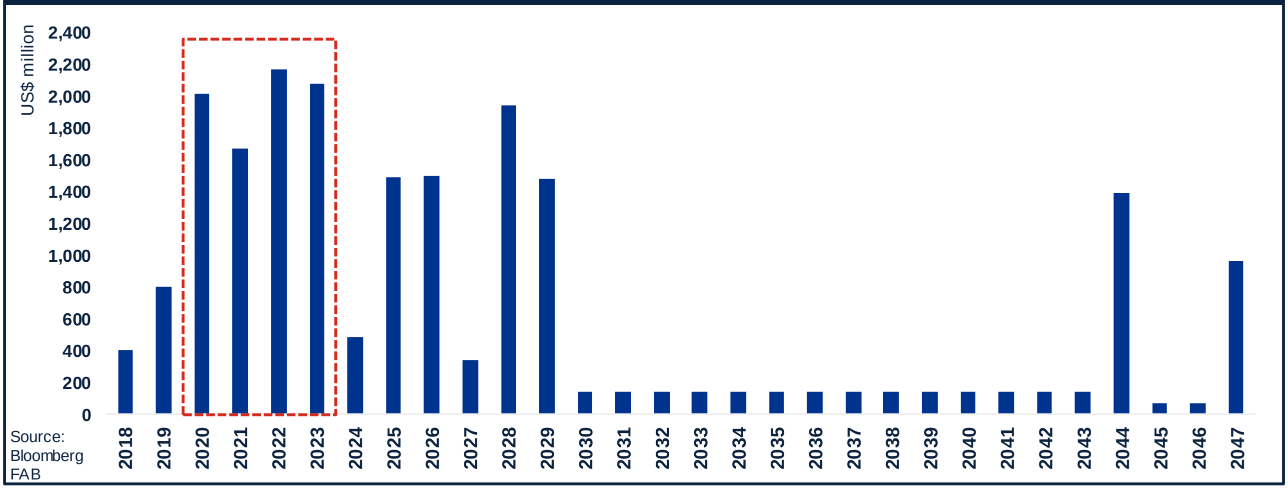




The Sovereign printed its latest transaction in March 2018 through a US$1 billion 7.5 year sukuk deal, however it was expected to be a three-tranche deal but the conventional legs – 12 and 30 years in tenor respectively – weren't printed and this probably came down to price and of course investor demand. The sovereign had the flexibility to pull back from issuing these two tranches however the question lingers over when the sovereign will need to tap the debt markets again.

Looking at the below debt maturity profile it is clear that while the maturities in 2018 and 2019 may not seem that challenging, there is close to $8 billion of debt maturing in the 2020 – 2023 period and this is something that will need to be refinanced, hence another factor that investors will be watching carefully going forward.

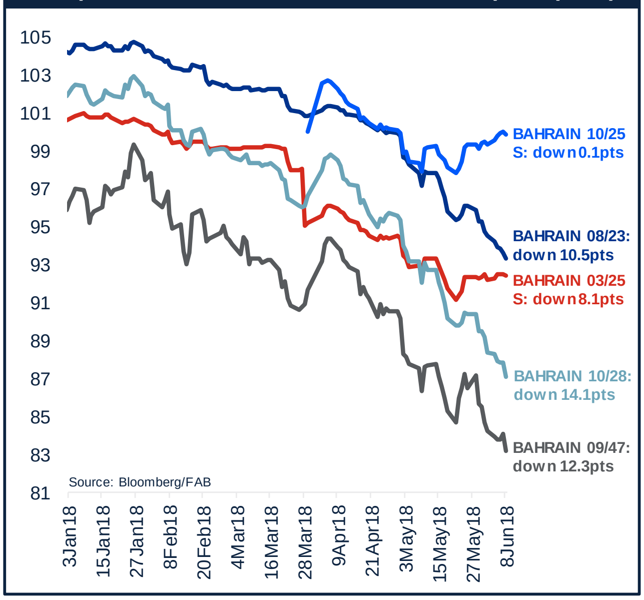
Bahrain's external debt maturity profile



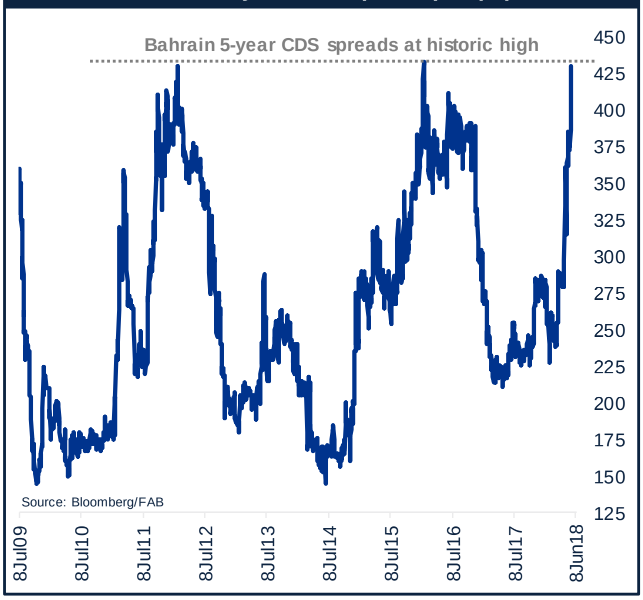
Secondary market performance

In the secondary market Bahrain Sovereign bonds have indeed taken a beating however given the underlying risk/reward profile of this paper there have been some opportunistic buyers stepping in on dips, especially with the yields on such paper looking attractive from an investor perspective. These buyers are likely factoring in the same implicit support from neighboring GCC countries as that referred to by S&P.

YTD performance of Bahrain bonds/sukuk (cash price)



Bahrain 5-year CDS spread (in bps)



Borrowing its way out of trouble?

Whilst the Kingdom of Bahrain has been a regular issuer in the debt capital markets, and indeed a name that is liked by many investors that look at the EM fixed income space, we believe the sovereign needs to closely monitor and manage its debt maturity profile and of course aggregate its level of borrowings per se, especially with its debt to GDP ratio rapidly approaching 100%. Debt has been a relatively successful measure as part of the Kingdom's efforts to address its overall financial situation but in the longer term it will need to find more sustainable solutions. On this note, the IMF recently published a report in which they recommend that not only should Bahrain implement VAT as planned, but the government should also consider introducing a corporate tax to provide another sustainable revenue stream.

Conclusion

The Kingdom of Bahrain clearly faces a difficult fiscal road ahead, at the same time however, and as discussed above, we feel that the recent market and media reaction to this may have become a little overstated and the country still has time and the ability to pull itself back onto a more sustainable economic path. The speedy implementation of further financial reforms is of course a necessary step but one which we think will be undertaken with the continued support of its regional allies.

Market Insights & Strategy

FAB Global Markets

Email: Marketinsights&strategy@bankfab.com

Tel: +971 2 6110 127

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