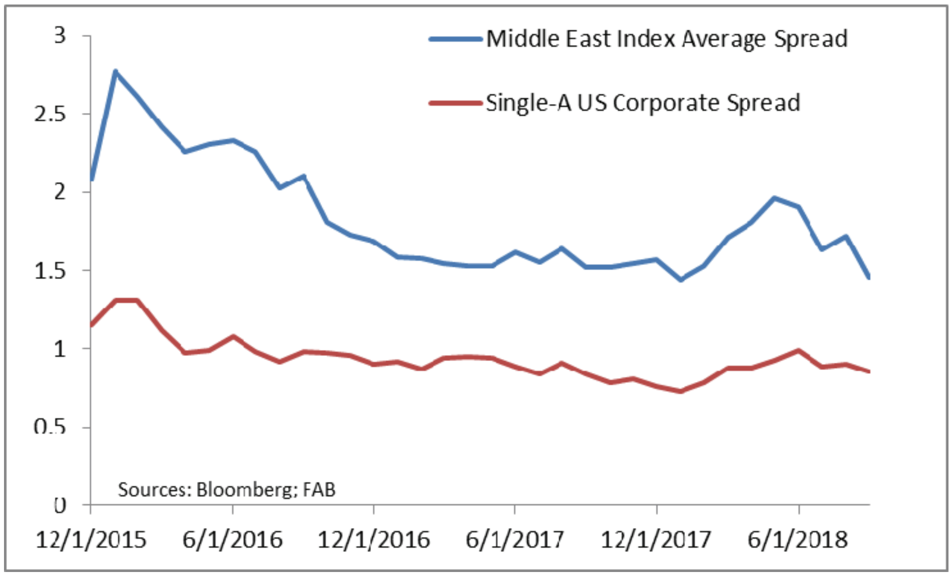
Global investors are nudged to turn to GCC bonds

While the world watched the outcome of the Federal Reserve rate-setting meeting on Wednesday, investors in the Gulf Cooperation Council received news that could mean their bonds gain even as the asset class worldwide suffers the effects of rising rates. On 26th September, JP Morgan announced it had added debt from five nations in the GCC to its EM Global Diversified and Global Bond Indices. Fixed income securities from Bahrain, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates will represent about 11.2% of the two gauges once the inclusion is implemented in January.



The inclusion has the potential of reducing the yield premium bonds from these countries pay over similar securities from elsewhere. In total, these two indices have a market cap of more than US$1.4 trillion. A 2015 study by IMF economists found that up to one third of foreign holdings of local bonds in emerging markets sit in benchmark-tracking funds. However, even funds that do not track indexes tend to measure their performance against them and therefore often have holdings that are similar to the benchmarks.

A back-of-the-envelope calculation suggests that between US$30 billion and US$50 billion of assets could now gravitate towards bonds from these five GCC countries. At the high end of that estimate, the amount of additional demand will represent more than 10% of the total US$465 billion of dollar bonds outstanding from these Gulf nations.

Now, global investors already had plenty of reason to buy these bonds. On average, bonds from the energy-producing nations in the GCC offer a premium of 75-100 basis points over similarly-rated bonds with the same maturity (see chart). The best example is a comparison between the bonds of the Republic of the Philippines, rated BBB, due in February 2028, which yield 3.85%, and those of the Kingdom of Saudi Arabia, rated A+, due in March 2028, and which yield 4.2%. Normally, it should be the opposite, the lower-rated sovereign dollar bond should yield much more than the higher-rated one. Indeed, the average yield on single-A-rated corporate debt in the US is 3.98%, while for triple-B securities it is 4.53%.

Much of the additional yield may have been justified by the lower liquidity of bonds in the region, as it was only recently that these nations started to consistently access debt markets. For most of recent history, the maximum amount of dollar bonds issuers in the five nations included in the JPM EMBI Global sold in a single year was US$38 billion. That changed in 2016, when these companies and sovereigns issued US$96.5 billion of dollar bonds, followed by US$120.3 billion last year. So far, in 2018, US$83 billion has been sold.

Bonds are inherently less liquid than stocks, and two factors can make a big difference when it comes to selling or buying these securities: index tracking and amount outstanding. The more bonds there are from a nation, region or corporation, the more investors will be tracking them and the more liquid they are. When included in an index, the number of investors following these bonds jumps, making them more liquid. Fixed income securities are also often evaluated in relative terms. This means a drop in the premium paid by the most important issuers in a region or industry tends to percolate to all the other securities in that region or industry. In other words, even though only five nations in the GCC had their bonds included in the JPM EM Global and Global Diversified Bond Indices, the move is likely to have a lasting effect on many Middle-Eastern bond issuers.

> ***"The premium GCC nations pay could drop after part of the group was included in JP Morgan bond indices."***

That is good news for investors in the GCC, particularly those who have significant bond holdings. The asset class is under fire as the Fed increased funds rates eight consecutive times since 2016 to 2.25%, pushing the yield on the benchmark 10-year US-Treasury to 3.06% last week from 2.05% just a year earlier. Indeed, the FAB Asset Allocation Committee (AAC) has favored equities for some months, aware that the end of a 35-year bond bull market could translate into capital losses for fixed income portfolios. The JPM index inclusion, however, could provide gains for investors who bet on a reduction of GCC premiums. Accordingly, the FAB AAC had an extraordinary debate on whether to go overweight in GCC bonds last week. While a decision is yet to be made, several members were of the view that the potential gains from the index inclusion could warrant the move.

As for bonds in general, while they should remain part of any portfolio, the the FAB AAC maintains its position of low duration – or choosing bonds with higher coupons and shorter maturities. The Fed's decision last week may have reinforced the case for that stance.

The Chairman of the US central bank, Jerome Powell, made it clear that his style is very different from that of his three predecessors. Unlike Alan Greenspan, Ben Bernanke and Janet Yellen, Mr. Powell has signaled he intends to keep hiking interest rates until there are indications they have overshot. In contrast, the previous three chairs were more prone to wait for the effects of their interest rate moves on the economy before continuing their rate path.

To be sure, the US economic growth (and wages) are rising at one of the fastest clips in a decade, partly fueled by the lowest unemployment in almost half a century.

The trouble is that it takes between six months and a year for the economy to reflect the effects of interest rate hikes.

There are indications the US economy is already decelerating. Personal consumption expenditure (PCE), the Fed's favorite inflation measure, increased 0.3% month-on-month in August, while in July the print had been 0.4%. Core PCE, which excludes energy and food costs, remains parked at 2% year-on-year, spot on the Fed's target. That does not mean a recession is around the corner, a point the Fed Chairman made in statements after the meeting. Several indicators suggest the US is unlikely to contract for at least the next two years. It is hard to forecast anything beyond that. However, the Donald Trump administration plans to make further regulatory changes that could give the economy a second wind, after a reduction of corporate and personal tax brackets earlier this year pushed earnings gains of listed companies to multi-year highs.

That was reflected in the quarterly economic projections of the FOMC members released on Wednesday, together with the rate hike announcement. The median assumption of FOMC members shows the US growing 3.1% in 2018, while in June they had forecast a 2.8% expansion. The group's median forecast is for growth to be 2.5% next year, versus the 2.4% previously forecast. As a result, the FOMC members also now believe the neutral long-run benchmark rate to keep the US from overheating is 3%, compared to 2.9% in June.

This last figure is key, because it could be interpreted as what Fed economists consider the 'normal' rate and, therefore, where they want to take interest rates.

Before they get back to normal, however, economists are forecasting they may have to exceed that level. The median forecast for the Fed Funds Target Rate by the end of 2019 is 3.125% – implying at least three more rate hikes –, and 3.375% for 2020.

"The Fed does not seem to see reasons to stop hiking rates until 2020, implying more losses for fixed income and emerging markets."

The prospects for much higher US interest rates remain bad news for emerging markets. A 2015 study by Dallas Fed economists found that moves in US benchmark interest rates affect government bond yields, stocks and exchange rates of emerging economies, with peak effects happening five months after the rate move. This suggests the pain emerging markets have suffered since June have been a reaction to the rate hikes in December and, perhaps, March. **The effects are exacerbated for the so-called Fragile Five countries, Brazil, India, Indonesia, South Africa and Turkey**, which have had recurring current account deficit problems, the study found.

In fact, world growth is increasingly becoming bifurcated. While growth in the G7 countries is accelerating, the economies of the largest developing nations is slowing down.

Saudi Arabia was one of the only nations among the largest 10 emerging markets that saw its economy pick up significantly this year. That is partly due to increased awareness of global investors about the growth prospects of the region after the upgrade of Saudi Arabia to emerging market status in the MSCI stock indices and now the similar move on the bond side from JP Morgan. It is also the result of the reforms the GCC nations embarked on since 2014.

Now, those economies are not only reaping the rewards of their reforms, they are also getting a windfall from higher oil prices. **Brent crude passed the US$80/barrel mark last week and closed the week at US$82.73/barrel.** The price strength prompted forecasts of a return to US$100/barrel, as Iranian oil leaves the market and Venezuelan output dwindles.

In a meeting in Algeria, OPEC members, however, seemed unfazed, saying that demand has been fulfilled. Indeed, the growing issues in EM are likely to dampen demand enough to counter that supply pressure. Most of the oil demand growth has come from EM in the past decade.

Meanwhile, the AAC has continued to maintain its US$65-US$90/barrel target range for Brent crude prices for this year. As this report has highlighted in the past, that range appears appropriate, with price risks to the upside. However, any spike beyond the top of the range could be viewed as temporary as demand starts flagging.

INVESTMENT SUMMARY: The S&P 500 and the Stoxx 600 in Europe both ended the week lower, while the NASDAQ Composite gained 1.3%. The European market was rocked toward the end of the week by news that Italy was pushing for an aggressive budget, rekindling fears of populist moves by the new government led by Eurosceptics Luigi Di Maio and Matteo Salvini.

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From West to East

Weekly Investment View
30th September, 2018

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