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Global Uncertainty Highlights GCC Debt Opportunity

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On January 31, 2019, the Gulf Cooperation Council officially joins one of the most influential emerging-market bond indices. Dino Kronfol, chief investment officer of Franklin Templeton Global Sukuk and MENA Fixed Income, believes that development could lead to billions of dollars in potential foreign investment. But it's just one of the reasons for his optimistic outlook for the region.

As investors around the world brace for an uncertain 2019 that will test the steeliest of nerves, the outlook for debt markets in the Gulf Cooperation Council (GCC) region[1] is a much brighter one, in our view, with the potential for strong risk-adjusted returns.

We expect GCC debt to outperform US and emerging-market peers again in 2019, as it has done for the much of the previous five years.[2] Since 2013, GCC bonds have delivered stronger risk-adjusted returns than many traditional bond sectors. This is evident through the Sharpe ratio—a measure of excess risk-adjusted return. (See table below.)

GCC Bonds vs. Global, Emerging Markets and European Bonds

	TRAILING FIVE YEARS		
Index Name	Sharpe Ratio	Annualised Return	Annualised Standard Deviation
FTSE MENA Broad Bond GCC Issuers Index (USD)	1.14	3.81	2.92
J.P. Morgan EMBI Global Diversified (Local)	0.91	5.38	5.34
Bloomberg Barclays U.S. Aggregate Index	0.62	2.16	2.68
Bloomberg Barclays Euro Aggregate Index	-0.05	0.15	7.54
Bloomberg Barclays Global Aggregate Index	0.06	0.75	4.35

Source: FactSet, as of September 30, 2018.
The FTSE MENA Broad Bond GCC Issuers Index measures the performance of both investment-grade and high-yield US dollar-denominated debt in the Middle East and North Africa region.
The J.P. Morgan EMBI Global Diversified Index is an emerging-market debt benchmark that limits the weights of countries with larger debt stocks.
The Bloomberg Barclays U.S. Aggregate Index tracks investment-grade, US dollar-denominated debt. The Bloomberg Barclays Euro Aggregate Index measures investment grade, euro-denominated debt. The Bloomberg Barclays Global Aggregate Index measures global investment grade debt from 24 local currency markets. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. There is no assurance that any estimate, forecast or projection will be realised.
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With many of the key ingredients for local market outperformance still in place, we think the GCC region can sidestep angst-filled global events like potential trade wars, new taper tantrums or emerging-market meltdowns.

What's Behind Our Optimism?

One major factor supporting a positive outlook for this year is our view that the US Federal Reserve won't aggressively raise interest rates in 2019. Inflation, after all, isn't a pressing issue, and the outlook for economic growth is uncertain. All of this makes a case for US interest rates rising marginally perhaps, but not aggressively.

We have come out of three to four tough years in the GCC region, and we are now entering a period where governments are moving their focus to growth, from a previous fixation on fiscal consolidation.

We started seeing signs of this change at the end of 2017 with several governments announcing expansionary budgets. On top of this, the likes of Abu Dhabi last year announced a raft of stimulus measures aimed at jump-starting growth. Overall, we expect on average a 2-3% expansion in economic activity across the GCC in 2019.[3] This means, that as we push through 2019, the region would be very much on an improving trajectory.

Emerging Market Bond Index Inclusion

While a stable economic backdrop remains supportive for GCC debt, we think that perhaps the most significant event for local bonds this year is the GCC's inclusion in JP Morgan's emerging market bond indices.[4] From late January, Saudi Arabia and four other Gulf states will enter JP Morgan's emerging market government bond indices, bringing with it potentially billions of dollars of foreign investment.

The move is significant as the indices are closely followed by international investors and inclusion should assist GCC countries in selling bonds, but also potentially help reduce borrowing costs. We expect more demand from international and local buyers to emerge this year, helping rectify what has traditionally been a chronic underweight investor stance on the region's debt.

Improved Relative Valuations

Another factor that underlines our constructive view on GCC debt this year is value. Relative valuations are better right now than they were 12 to 18 months ago.

This makes us want to maintain significant corporate exposure, as well as high-yield exposure, an area of interest we expect to resonate with investors in 2019. Regardless, the risk-versus-reward proposition remains attractive to us. Even when conditions have deteriorated during the past five years, annualised returns for GCC debt have been upwards of 5%, which we think underscores the region's resilience and stability.[5]

While the outlook for GCC debt in 2019 looks promising, there are potential speed bumps that could unsettle investors and markets. For instance, there is a risk that the pace of fiscal reform across the GCC will slow, a situation that could dampen investor sentiment.

In 2018, we saw the likes of Bahrain make a significant breakthrough in terms of securing financial support from its GCC neighbors. Investors, however, need reassurance that Bahrain and others can follow through with fiscal reform measures to maintain confidence that the change is real. Fiscal "slippage" will likely remain a big concern this year.

Lastly, any major break down in oil prices could have repercussions for the still hydrocarbon-dependent GCC region, especially when one considers the ambitious spending plans currently underway.

Our view remains that cooperation between the Organization of Petroleum Exporting Countries (OPEC) and Russia will persist. Late last year, OPEC, along with Russia and its allies, reached a deal to cut production by 1.2 million barrels per day. The move helped stabilise oil prices, giving GCC government coffers a welcome fillip as well.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in developing markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with their relatively small size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year. Investments in the energy sector involve special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector.

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1. World Bank, Gulf Economic Monitor, November 2018. There is no assurance that any estimate, forecast or projection will be realised.

2. The J.P. Morgan Emerging Markets Bond Index tracks bonds in emerging markets. Indices are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges.

3. FactSet, as of September 30, 2018. Based on five-year trailing figures for J.P. Morgan EMBI Global Diversified (Local). Past performance is no guarantee of future performance.

4. The Gulf Cooperation Council is an alliance between six Middle Eastern countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates (UAE).

5. Past performance is not an indicator or guarantee of future performance.

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