FIXED INCOME

Why GCC Fixed Income Is an Overlooked Asset Class

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Many investors could be underinvested in Gulf Cooperation Council (GCC) bonds, according to Dino Kronfol, chief investment officer, Global Sukuk and MENA Fixed Income. He explains why he believes the fixed income landscape is approaching a turning point—and why more investors may want to consider adding this dynamic asset class to their portfolios.

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The landscape for fixed income investing has evolved significantly in recent years. The steady decline of bond yields has been well documented in recent decades, and a lack of divergence in returns has made it harder for managers to benefit from market movements, making alpha[1] more difficult to achieve.

This has likely been a consequence, at least in part, of the dearth of global liquidity developed-market central banks had created through quantitative easing. It has led investors to seek areas outside of traditional asset classes and geographies in the search for yield, alpha and diversification.[2] We think that, despite this trend, many investors continue to miss out on opportunities and overlook bonds in the Gulf Cooperation Council (GCC).[3]

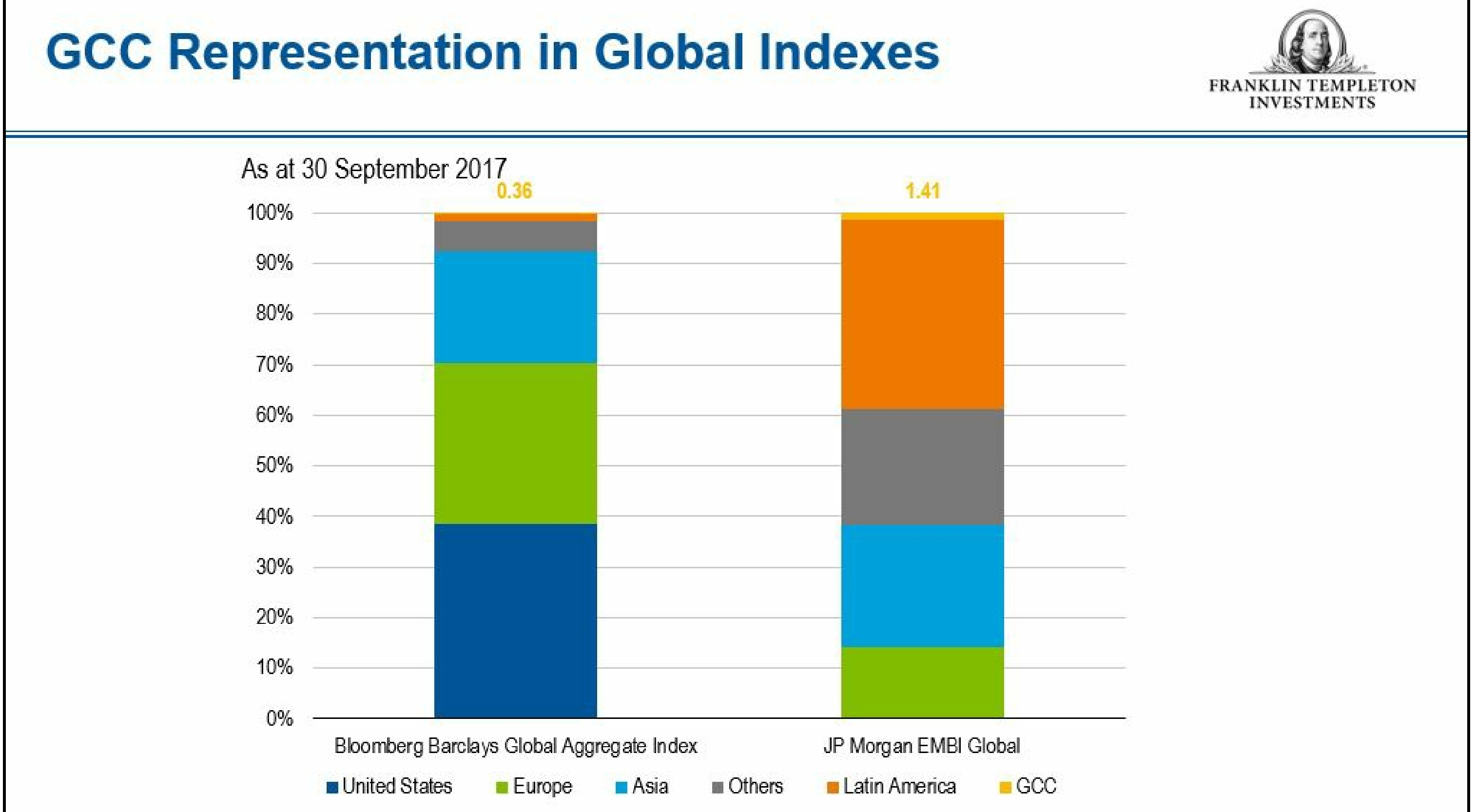
We believe GCC fixed income is an attractive asset class that generally has lower volatility and potentially offers higher yields than developed-market bonds. And, we'd argue these assets often have better underlying fundamentals and higher credit ratings than emerging-market bonds in other regions.

However, while some investors may believe active managers with a global or broad emerging-market mandate may already be providing sufficient exposure to GCC bonds, our research suggests this is most likely not true. According to our analysis, very few active bond managers appear to invest in GCC countries.

GCC Fixed Income Is an Overlooked Asset Class

We consider GCC fixed income to be a growing asset class with characteristics of both emerging and developed markets, and an area which many—if not most—global investors underappreciate.

Firstly, GCC bonds are not included in most major benchmark indexes, or have negligible representation in them. In the chart below, the region has only a 0.4% allocation in the Bloomberg Barclays Global Aggregate Index,[4] and a 1.4% allocation within the JP Morgan EMBI Global.[5]



Source: FactSet. The Bloomberg Barclays Global Aggregate Index measures global investment grade debt from 24 local currency markets and includes treasury, government-related, corporate and securitised fixed-rate bonds from both developed and emerging market issuers. The JP Morgan Emerging Market Bond Index (EMBI) Global is an index of US dollar-denominated sovereign bonds issued by emerging market countries. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.** See www.franklintempletondatasources.com for additional data provider information.

The GCC's negligible representation in these benchmarks is due in part to the backward-looking nature of index construction, which is based on historical debt-issuance trends. Over the past several decades, developed-market countries such as the United States, Japan and some European countries have increased leverage and issued vast stocks of debt amid a steadily decreasing global interest-rate environment.

In contrast, GCC countries have self-financed government expenditures in recent decades while simultaneously building sizeable financial reserves—thanks to large oil-export revenues.

Looking ahead, we believe we are at an inflection point which has accelerated since 2014, when oil prices faced a steep decline. GCC governments have wisely recognised the unsustainable nature of their economies in the long term due to their young and fast-growing populations, as well as the inefficiencies built up over years of bloated bureaucracies and dominating public sectors. This recognition is causing an increase in investment spending to transition GCC economies away from oil and toward service sectors that are faster-growing and better-positioned for long-term growth. These include technology, health care and tourism.

Investment spending to boost the growth of non-oil economies and the partial retention of historical fiscal largess in the form of subsidies and other benefits has come at a cost, however. GCC countries are now operating with growing deficits. These deficits, which we believe are likely to remain for the medium term, can be financed either via liquidation of large asset reserves built up over recent decades, or via debt issuance. While it is likely that a mix of these two approaches will likely finance government deficit spending going forward, it is our view that GCC debt issuance could rise, making it an increasingly important part of the global fixed income universe for many bond investors. This is one of the reasons why we believe demand will remain strong in a low-return world, and that there is a capacity for many investors to absorb significantly more GCC debt.

GCC Fixed Income Is Becoming an Increasingly Important Component of the Investible Universe

There may be a few reasons for investors' under-allocation toward the GCC region.

Firstly, GCC bonds appear to suffer from a lack of active managers who have "boots on the ground." And without that on-the-ground research, it could be a difficult market for a non-local investor base to understand. Secondly, many investors assume the GCC is susceptible to headline risk and oil price volatility, despite the counterintuitive reality that GCC bonds have very low correlations to the price of oil, as an example.

Therefore, the assumption that active investment managers (even in the emerging-market space) provide significant exposure to the GCC is not a correct one. And this under-allocation limits investors' potential to achieve alpha.

The GCC Is an Attractive Bond Market Benefiting from Solid Fundamentals

In summary, we believe the GCC bond market is an attractive asset class for a number of reasons. The market's size alone is one representing some US$300 billion.[6] In addition, there's been a healthy level of issuance growth that has picked up over the last few years amid the lower oil price environment. The GCC region also benefits from credit fundamentals such as sizeable pools of reserve assets, relatively low debt to gross domestic product (GDP) and a well-capitalised and committed investor base.

Moreover, GCC bonds generally benefit from strong credit ratings. Even amid the new lower oil-price environment (which prompted rating actions on the weaker sovereign credits, namely Bahrain and Oman), the region continues to retain an attractive and high investment-grade average rating and further downgrades appear limited, in our view. In a fixed income environment where potential downgrades are at historic highs, we believe the GCC, with almost US $3 trillion in foreign exchange reserves (representing approximately 200% of the region's GDP),[7] is more insulated than the rest of the global credit universe.

And lastly, GCC bonds have proven relatively stable amid geopolitical uncertainties. Dedicated domestic demand for GCC bonds remained resilient even during downside scenarios. Therefore, amid the geopolitical tension we could face in the coming year, we think GCC fixed income could be an increasingly attractive asset class for many investors moving forward.

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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.

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1. Alpha is a risk-adjusted measure of the value that an active portfolio manager adds to or subtracts from a portfolio's return.

2. Diversification does not guarantee profit or protect against risk of loss.

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

4. The Bloomberg Barclays Global Aggregate Index measures global investment grade debt from 24 local currency markets and includes treasury, government-related, corporate and securitised fixed-rate bonds from both developed and emerging market issuers. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

5. The JP Morgan Emerging Market Bond Index (EMBI) Global is an index of US dollar-denominated sovereign bonds issued by emerging market countries. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

6. Bloomberg, as of 30 September 2017. See www.franklintempletondatasources.com for additional data provider information.

7. International Monetary Fund World Economic Outlook, April 2017, Sovereign Wealth Fund Institute.