BLME ASSET MANAGEMENT

Q2 2015 Market Commentary

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MACROCONOMIC BACKDROP

KEY ASSET MOVEMENTS[1]				KEY DATA RELEASES[2]				
Security	Price		1mth change	Data point	Reading		Country	Date
	Start	End			Previous	Latest		
UST 10yr yield (%)	1.92	2.35	+43bps	Manufacturing PMI	49.9	50.2	China	01/06
GOLD	1183.7	1172.4	-0.95%	ISM Manufacturing	52.9	52.8	US	01/06
Bbg EM $ Bond Index	143.85	144.30	+0.31%	Inflation (CPI) YoY	1.4%	1.2%	China	09/06
Brent crude	55.11	63.59	+15.39%	Change in non-farm payrolls	295k	280k	US	05/06
S&P 500	2067.9	2063.1	-0.23%	Retail sales MoM	-0.6%	1.2%	US	11/06
DXY $ Index	98.36	95.49	-2.92%	Retail sales YTD YoY	10.7%	10.4%	China	11/06

There is a lot for markets to digest at the moment – weak global growth, the Greek debt negotiations, Chinese equity market volatility, the timing of a rate hike in the US, another round of selling pressure in commodities and an undercurrent of geopolitics – resulting in a recipe for volatile fixed income yields. Markets have, however, been helped by quantitative easing in Europe and accommodative monetary policy around the world, without which the move in global yields could have been more pronounced.

The Federal Reserve has not made any notable changes to their stance on raising the US benchmark rate and still remains data dependent in their decision. Consideration may have to be given to the effect a rate hike would have on emerging market economies, some of which have borrowed significant amounts in recent years in the low USD rate environment. The 'dot plots' – which chart the interest rate expectation of individual FOMC members – show that two rate hikes are still expected by year end, with median analyst forecasts showing one hike in each of Q3 and Q4[3]. However, the implied probability of a rate rise according to Fed fund futures has ticked lower since the beginning of June as the weakness in commodity prices dampens the argument for a rise.

After all the negotiating, rhetoric, and a referendum, the Greeks agreed to proposals which on the face of it seemed tougher than those set out at the beginning of the talks. An agreement has been reached on an €86bn bailout package; however the IMF said that European creditors would need to agree on more debt relief if the Fund is to participate in the bailout; so the saga continues. Greek headlines have caused much volatility in the market as sentiment was reflected in German bunds and to a lesser extent US Treasuries.

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[1] Source: Bloomberg
[2] Source: Bloomberg
[3] Source: Bloomberg

The Chinese equity market bubble finally burst in June, with the tech market (ChiNext Index) posting a peak to trough fall between June and July of over 41%[4]. The Chinese government has taken a number of steps to support up the market, including suspending IPOs, cutting trading fees and relaxing requirements on margin loans. China has also loosened monetary policy, cutting both the benchmark rate and reserve ratio requirement. Despite all these efforts, the equity market continued to sell off. The magnitude of the selloff is such that it will likely affect the country's growth figures, which may prove to have implications in broader markets.

This brings us on to the continued weakness in the price of oil, exacerbated by the recent Iran deal, which should help oil importing countries boost GDP as input costs are reduced. However, this has put a dampener on inflation and is forcing many central banks around the world to cut rates, a theme that has been prevalent since the beginning of the year. In fact, commodity prices have fallen more than 7%[5] since the end of March as demand wanes from developing countries.

Meanwhile Europe seems to be growing at a faster pace than the US, in signs that the quantitative easing in Europe is working, albeit at a gradual pace. June's GDP figures showed that the Eurozone grew at 0.4% quarter-on-quarter[6], while the US contracted 0.2%[7] in the same period. However, the contraction in the US may be explained by bad weather at the beginning of the year, with some also saying that seasonal adjustments are not being accurately reflected.

REGIONAL NEWS

Geopolitics

Iran, together with the US and Europe finally reached a deal on the nuclear issue. The deal does not need congressional approval in the US but Republicans are expected to bring in legislation to try and block the lifting of sanctions. If the deal is implemented successfully, the Gulf region, particularly Dubai, will benefit from an increase in trade as Iran is already one of the UAE's main trading partners. There has been a marked decline in Iranian use of UAE goods and services which should see a trend reversal as the deal is implemented. In fact, a positive reaction has already been seen in the Sukuk market as the banks and real estate companies perform well. This is despite a fall in property prices in Dubai as the weakness should partly be mitigated by the potential demand from Iran.

Turkish elections took place in the beginning of June and resulted in a hung parliament for the first time in 6 years. Prime Minister Erdogan's AKP Party lost its parliamentary majority but remained the largest political party in parliament. The main surprise was the strong result of the pro-Kurdish party HDP. This caused volatility in the fixed income market as Turkish credit default swap spreads widened and bonds sold off. Turkish assets did however pair losses when there was talk of a coalition, this has not amounted to an effective agreement as of yet as deep-rooted differences remain between the Islamic-inclined AKP and the opposition secularist CHP and MHP parties.

Ratings changes

Jebel Ali Free Zone (JAFZ) was upgraded to BBB- by Fitch based on DP World's recent acquisition of JAFZ. Fitch cited an increase in the group's operating efficiency at the Port of Jebel Ali that would allow it to expand its logistic

[4] Source: Bloomberg
[5] Source: Bloomberg Commodity Index
[6] Source: Bloomberg
[7] Source: Bloomberg

capacity[8]. The rating change resulted in the Company's first investment grade rating which provided an uplift in the Sukuk price as investors with ratings restrictions were able to purchase the Sukuk.

Pakistan was upgraded one notch to B3 by Moody's as the Country benefited from a lower oil price. Moody's cited a strengthening external liquidity position helped by privatizations, and growing net foreign reserves[9]. Pakistan has also made progress in implementing structural reforms under the IMF program which should see the Government meeting deficit-reduction targets and extending the maturity of sovereign debt.

Bahrain has fallen victim to the fall in the price of oil due to the relatively small size of its economy and as such both Moody's and Fitch downgraded the Country one notch, to Baa3 and BBB- respectively. Bahrain had been suffering from fiscal deficits for the last five years, thereby increasing government debt and weakening its ability to tackle a prolonged period of weak oil prices.

Earnings

So far there has been a positive set of first half/second quarter earnings releases from the majority of Sukuk issuers. The UAE real estate companies continue to perform well, with Aldar continuing to pay off its debt and increasing its recurring revenue, while Emaar also posted an increase in its recurring revenue. Nakheel seems a far cry from its 2009 woes, posting more than a doubling in first half profits from a year ago. In Saudi Arabia Dar al Arkan surprised to the downside as it has not been able to monetize its land bank and posted lower than expected sales. In the telecoms sector, Ooredoo posted disappointing results despite an increase in revenue due to the FX weakness in some of its frontier geographies and a challenging environment in Iraq. The FI issuers out of the region beat estimates for the most part, continuing a trend of strong growth. Profitability increased on the back of a growth in financing and non-performing assets exhibit improvement, notably Dubai Islamic Bank, posting a 1.8 percentage point decline to 6.2% for 1H2015.

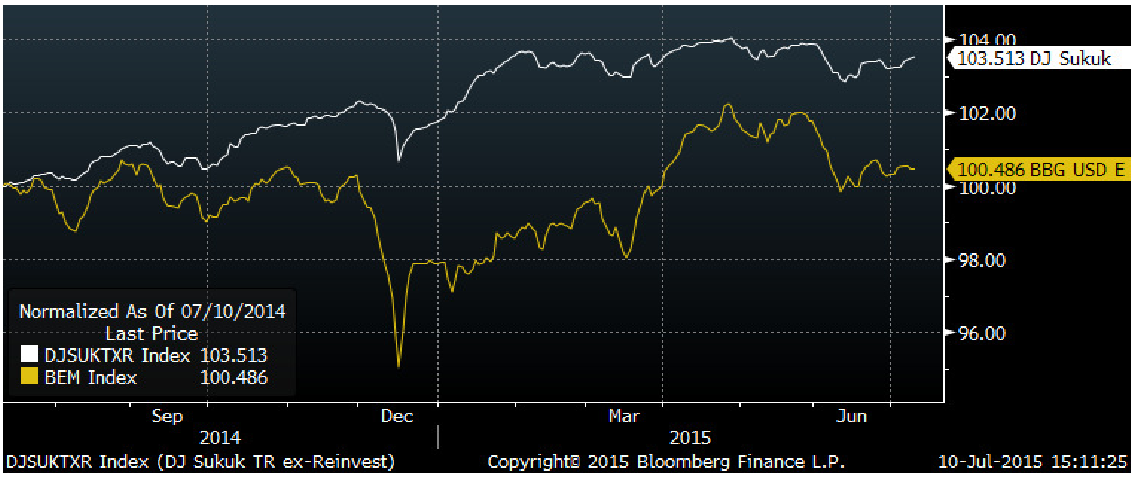
MARKET IMPACT

With the selloff in oil, the key theme in the Gulf has been to diversify and reduce dependence on oil revenues. As such, Saudi Arabia has opened its stock markets to foreign investors managing at least $5bn. The Government has decided to open the market in an effort to help expand the private sector and reduce the dependence on oil revenues. Saudi Arabia has also borrowed in the local market for the first time in 8 years; the country raised $4bn to maintain the high level of expenditure following King Salman's ascension to the throne as bonus salaries to government and military employees are paid. This spending is in addition to infrastructure developments to diversify away from oil revenues which have become a necessary requirement given the weakness in the price of oil. This is likely to result in a larger than expected budget deficit this year estimated at $130bn[10] which, due to low domestic debt/GDP of 1.6%[11], is easily financed by raising debt.

Sukuk prices have performed well on a relative basis, as technically demand outstrips supply, while fundamentally the GCC remains on strong ground for now despite the price of oil remaining at depressed levels. This has been due mainly to the current account surpluses accumulated over the years while oil traded at a high price as well as an

[8] Source: Fitch
[9] Source: Moody's
[10] Source: Financial Times
[11] Source: Trading Economics

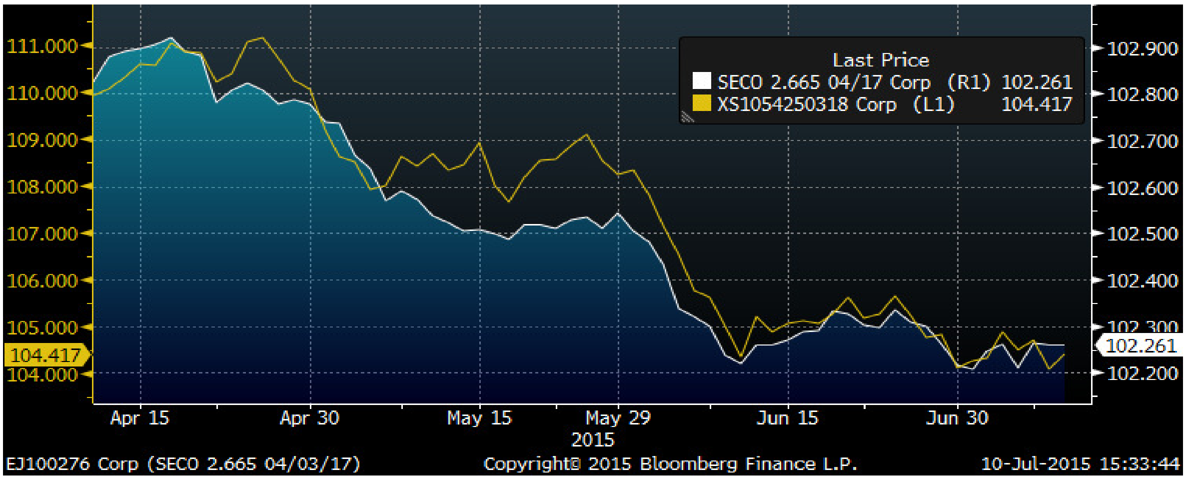
effort to diversify away from oil revenues. The below chart shows the Dow Jones Sukuk Index versus the Bloomberg Emerging Market Composite Index, this exhibits the Sukuk market's resilience to global macro moves.



Source: Bloomberg

The summer months have resulted in less liquid markets where trading has slowed and price movements have been to a large degree due to mark to market, reflecting the move in interest rates. The volatility in rates coupled with wider bid offer spreads have resulted in some softening in the Sukuk space, however the lack of supply and credit spread compression due to positive earnings has helped to mitigate some of this move.

The longer part of the curve has suffered the most from the volatility in rates, as the following chart shows. The chart below shows the 2017 (right axis) and 2044 (left axis) maturities of the Saudi Electricity Sukuk curve and is representative of a 55bps move in the long end of the US Treasury curve. As the chart shows, the 2044 maturity is down 6.5 points, while the 2017 is down 0.55 of a point.



Source: Bloomberg

There has been a slowdown in Sukuk issuance this year which has buoyed a market where demand was already outstripping supply. The initial read was that lower oil prices would lead to a cut in infrastructure spending and therefore lower borrowing requirements. However, as mentioned above, although infrastructure spending has stalled for new oil and gas related projects, due to the prolonged nature of the oil price weakness, governments are trying to grow their tertiary industries to lessen their reliance on the sector. This may result in a pick-up in GCC sovereign issuance in the second half of the year as most of the GCC countries are forecast[12] to be in deficit this year, with the exception of Qatar. This will be a welcome bout of supply but could cause some short-term weakness to the issuing Sukuk curves as the supply is absorbed.

A gradual uptick in borrowing costs in the bond market has also led to issuers being apprehensive to borrow in the Sukuk market, instead tapping the local loan market where the banks are familiar with their credit and banks still remain very liquid therefore able to provide competitive pricing.

COUNTRY	BUDGET BALANCE / GDP (2014 ACTUAL)[13]	BUDGET BALANCE / GDP (2015 FORECAST)[14]	DEBT / GDP (2014 ACTUAL)[15]
Qatar	13.2	0.10	31.5
United Arab Emirates	5.00	-3.1	16.7
Kuwait	28.93 (2013)	-0.4	5.30 (2013)
Bahrain	-5.5 (2013)	-13.5	42.0
Saudi Arabia	-2.3	-15.3	1.60
Oman	-3.4	-12.7	4.80

Corporate results out of the GCC have continued to be positive (as mentioned in the previous section) which has helped spreads to compress. Banks have done particularly well as financing books grow and impairments improve. A number of Middle Eastern banks have raised tier 1 capital, both through Sukuk and conventional bonds as several years of growth has led to falling capital positions and as Basel III standards are implemented. Dubai Islamic Bank, National Bank of Kuwait, Ahli United, Bank Dhofar and Qatar Islamic Bank have all raised tier 1 capital through perpetual issuances this year. Abu Dhabi Islamic Bank also sought shareholder approval to increase their tier 1 Sukuk program size by $1bn to $3bn.

CONCLUSION

A number of headwinds remain in the market which are threatening global growth and have required central banks to loosen policy to smooth financial markets and foster growth. The US is the exception, where pockets of positive data are swaying the Federal Reserve to start normalizing interest rates after a prolonged period in a zero interest rate policy environment. However, weakening global growth poses a risk to higher rates which the US may have to consider due to the enormous amount of emerging market USD debt outstanding following a preference to borrow in USD while rates were low. Also, the sustained weakness in the oil price without quantitative easing in the US will keep inflation anchored, so it may be the case that we only see one rate rise this year, rather than the two forecasted by the FOMC members' 'dot plot'. If this occurs it may mean a steeper rise in 2016 to compensate for a later lift-off.

Despite an initial rise in rates, we believe the Federal Reserve is not likely to raise rates considerably while the economy is still in recovery stage. To that end, although there is likely to be volatility in fixed income markets, there is not likely to be a pronounced sell-off. The Sukuk market should continue to perform well as supply has waned this

[12] Source: Bloomberg
[13] Source: Trading Economics
[14] Source: Bloomberg
[15] Source: Trading Economics

year, although there is expectation that some GCC countries may want to finance their budget deficits by borrowing in the debt capital markets which would lead to some welcome supply in the market.