BLME ASSET MANAGEMENT

Q1 2015 Market Commentary

By Jason Kabel, Head of Fixed Income

Published on 13th April 2015

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 (%)	2.17	1.92	-25bps	Manufacturing PMI	50.3	49.9	China	01/03
GOLD	1184.9	1183.7	-0.1%	ISM Manufacturing	57.6	52.9	US	02/03
Bbg EM $ Bond Index	140.83	143.85	+2.1%	Inflation (CPI) YoY	1.4%	1.4%	China	10/03
Brent crude	57.33	55.11	-3.9%	Change in non-farm payrolls	353k	295k	US	06/03
S&P 500	2058.9	2067.9	+0.4%	Retail sales MoM	0.4%	-0.6%	US	12/03
DXY $ Index	90.27	98.36	+9.0%	Retail sales YTD YoY	12.0%	10.7%	China	11/03

It was a rocky start to the year as volatility rose sharply caused by geopolitics, a continuation in the selloff in oil and what has turned into a currency war of sorts with a number of surprise moves by central banks aimed at tackling global disinflation – as such there have been a number of rate cuts around the world. The nervousness experienced by the market was evident from the US Treasury performance at the beginning of the month when the 10yr yield fell 53bps in the month of January. The risk-off sentiment was not only felt by markets but on the economic front both the World Bank and the IMF cut its forecast for global growth this year by 40bps and 30bps respectively.

Loosening monetary policy around the world and the policy divergence between the US versus the rest of the world has led to US Dollar strength, with the US Dollar Index up 9% year to date. However, the appreciation in the US Dollar has dampened expectations of a rate rise in the US in a weakening inflation environment and as the currency hurts corporate earnings forecasts. Despite all this, US Federal Reserve members have reminded us on a number of occasions that the timing of a rate rise is very much data dependent and the data remains a mixed bag for the moment, so a rate rise could still be on the cards for the end of the year.

On the subject of loose monetary policy the European Central Bank (ECB) has embarked on a large quantitative easing program, purchasing €60bn a month of bonds issued by Euro-area governments and European institutions including ABS and covered bonds. This will continue until September 2016 or until a sustained adjustment in the path of inflation. The ECB also mentioned that it would purchase bonds with a yield as low as the deposit facility rate which is currently at -0.20%.

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

SUKUK MARKET

So what does all this mean for fixed income and, in particular, the Sukuk market? Global inflation has been softening, while the US Federal Reserve has been marginally more dovish than hawkish year to date. This has kept the fixed income market with a firm tone, as represented by the decline in US Treasury yields. As such Sukuk has fared well; not only on the rates front but credit spreads have also tightened. For example the DP World 5yr CDS spread has tightened 20bps to 191bps.

The overall positive performance in credit has been despite the falling price in oil which, as expected, has not had a significant impact in the Sukuk market as most of the GCC countries have substantial fiscal surpluses to provide a buffer from softening hydrocarbon prices. However, the oil price was met by some support as geopolitical risk ensued in the region from Saudi and allied forces carrying out airstrikes against rebels in Yemen. This caused some widening in credit spreads but investors saw it as an opportunity to add to positions at favourable levels. There has also been a more pronounced differentiation between high yield and investment grade Sukuk this year, reflected by a divergence in performance as risk sentiment is expressed.

Credit spreads in Dubai corporates and government-related entities were helped by positive news flow regarding Dubai World's debt restructuring. A deal was reached with a majority of its creditors in January to restructure c. $14.6bn of debt. This provides Dubai with a boost and helps the region further overcome the stigma attached to it (through risk premia) after the 2009 debt crisis. Dubai will also benefit from the framework agreement reached between Iran and the P5+1 countries (the five permanent members of the UN Security Council plus Germany). The agreement outlines a framework for the termination of Iran's nuclear weapons' development and subsequent dropping of US and EU economic sanctions, which would be a positive for Dubai due to its status as a trading hub in the region.

US Dollar denominated new issuances (excluding money market instruments) made a slow start to the year, with the Dubai Islamic Bank tier 1 perpetual being the only one during the first couple of months. March brought a flurry of issuances with $4.663bn[3] raised in the US Dollar Sukuk market by the likes of the Islamic Development Bank, Sharjah Islamic Bank, Petronas, Ras al Khaimah and Emirates Airlines.

The Emirates Airlines Sukuk is worth highlighting as it is an innovative structure and the first of its kind. The airline is funding the purchase of 4 aircraft using the proceeds of the Sukuk which is being guaranteed by the UK's Export Credit Agency; a credit enhancement allowing the issuer to borrow at lower rates. This is a convenient way for sub investment grade issuers to finance at lower rates with the help of government agencies' backing.

Corporate earnings have been supportive of Sukuk for the most part with banks being the outperformers as they have exhibited strong bottom line growth due to expanded financing books funded by positive deposit flows. Meanwhile, in the corporates space, Dubai real estate had a good year with strong sales numbers and bottom line growth. However, after 16,000 new homes were completed in 2014, we may see the market soften this year as has already been evidenced by data released by CBRE which show that house prices in Dubai fell 2% QoQ[4].

[3] Source: Islamic Finance Information Service
[4] Source: The National Newspaper, 8th April 2015

CONCLUSION

A number of factors have caused volatility in the global financial markets in the last few months – US Dollar strength, geopolitical tension and a lower oil price – which warrant risk aversion. It seems market participants are wary of risk assets which should, in theory, help buoy fixed income. And as technical indicators still favour the Sukuk market, with a relative lack of supply versus demand, this should help our market outperform. The caveat to this thesis is the falling price of oil. However, those economies which are net oil-importers should continue to benefit as the fiscal balance improves on falling fuel costs and lower prices feed into the real economy.

The strength of the US Dollar (and its effect on US exports and therefore corporate earnings), soft global inflation and mixed data out of the US may cause the members of the US Federal Reserve to hesitate before they raise rates, which has been seen in the fall in FOMC members' median rate forecast at last month's FOMC meeting. This means a June hike is less likely but a rate increase is still anticipated by the end of the year.

The oil price may continue to hover around depressed levels, especially now that a framework for a deal has been reached with Iran, although sectarian violence in the region could escalate and is, therefore, an upside risk to the price.

As the Sukuk market becomes more diversified and less skewed towards the GCC, regional as well as sectoral hedging strategies can be implemented, allowing investors to execute credit themes more effectively. Judging by the new issuance pipeline for the next 18 months we should see a continuation of debut issuances from the likes of Egypt, Morocco, Kenya, Garuda Indonesia and Tunisia. Volatility should persist in the Sukuk market, in line with global markets, however this is likely to be in spread terms as rates are likely to hold steady till Q4 2015 given the economic fundamentals prevalent in the US as discussed above.