

Investing in Sukuk: Challenges and Opportunities

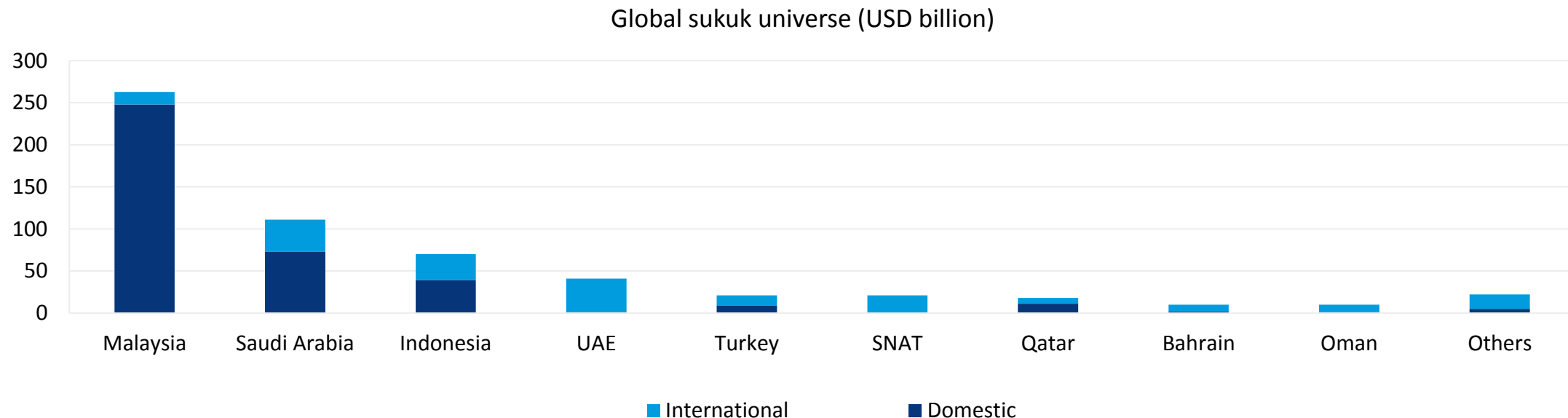
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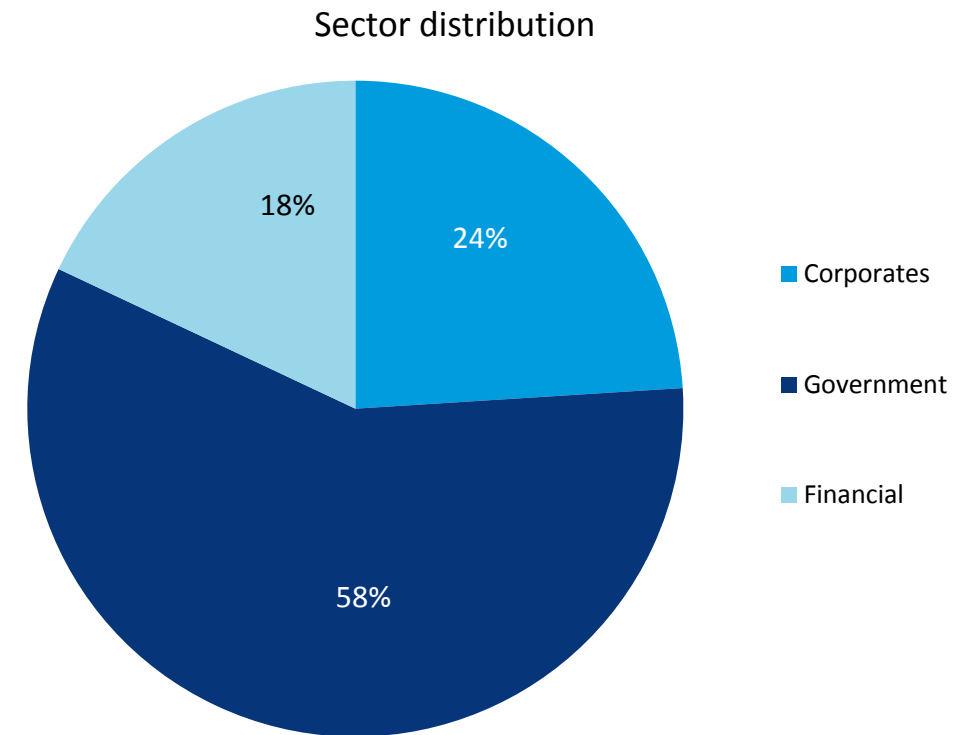
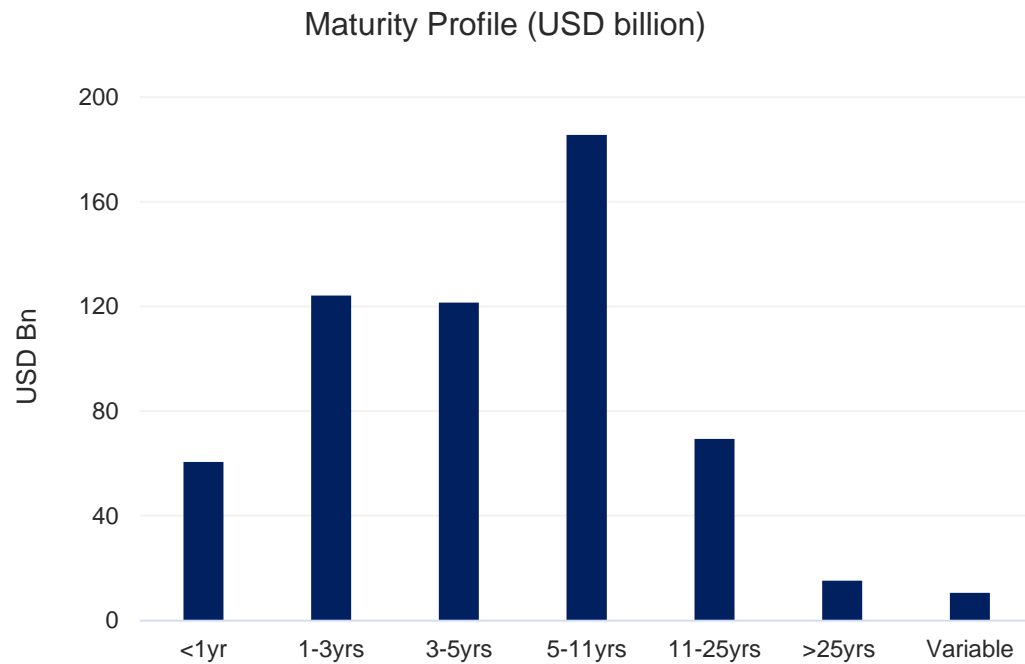
Global (domestic + international) sukuk universe

- Islamic Finance is estimated to be around the USD 2.5 trillion mark.
- Globally, total sukuk outstanding is around USD 587 billion.
- Two thirds of outstanding sukuk are in domestic markets, denominated in domestic currencies of the main Islamic economies.
- One third is in international tradeable format and largely denominated in USD.
- Malaysia is the largest sukuk market followed by Saudi Arabia and Indonesia.
- As a region, GCC dominates the sukuk universe accounting for circa 33% of the total.



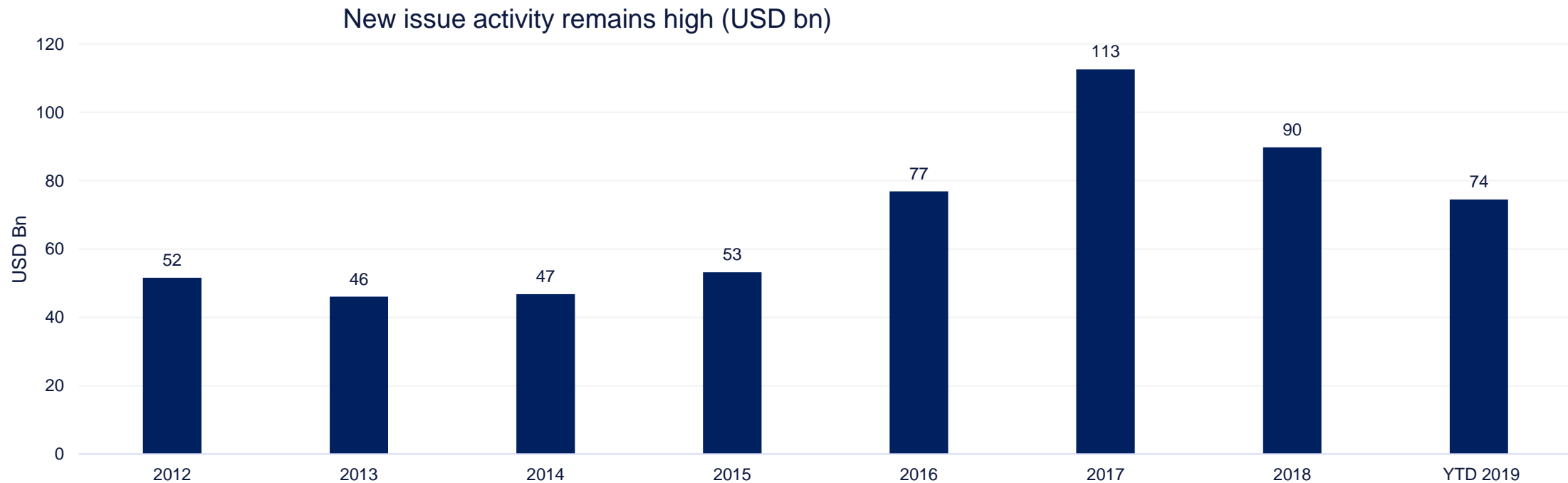
Global (domestic + international) sukuk universe

- Governments are the dominant issuers followed by financial institutions.
- Corporates account for 24% of the universe, much like the wider conventional bond universe.
- Circa 84% mature in less than 11 years.



Global (domestic + international) sukuk universe

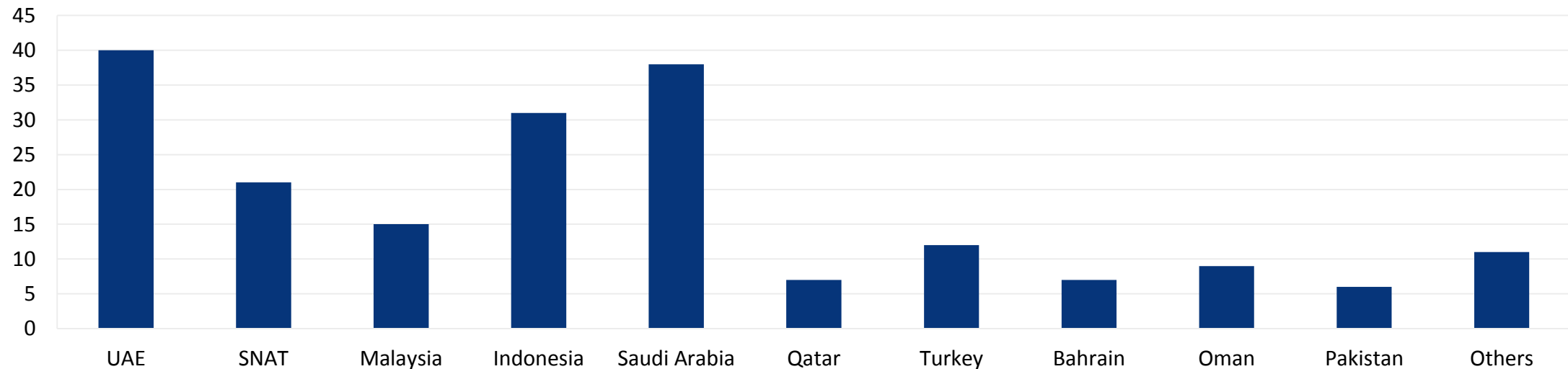
- Sukuk is the fastest growing segment in the Islamic finance space.
- New issues in the recent past have been high, particularly from GCC and oil exporting countries.



International sukuk universe

- Total outstanding in the internationally tradeable sukuk universe is USD 197 billion . This is more than double of where the market was five years ago.
- About 97% of this is denominated in USD followed by EURO at about 1%.
- Governments are the largest issuers accounting for circa 65% of total issues.
- 60% of the universe by amount is investment grade rated.
- **Nearly 55% of hard currency sukuk issues are from the GCC region.**

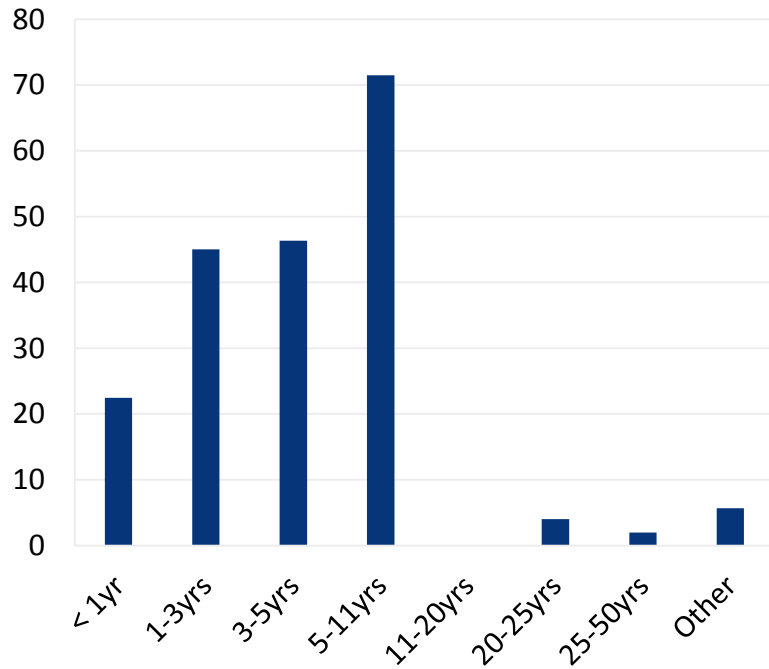
International sukuk by country of risk (USD billion)



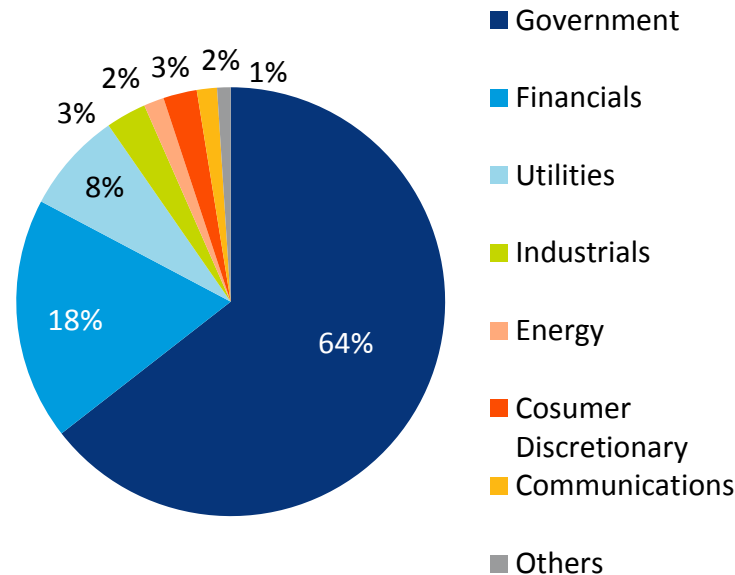
International sukuk universe

- Sukuk maturity profile is concentrated in the short end with 94% of the total outstanding maturing in less than 11 years

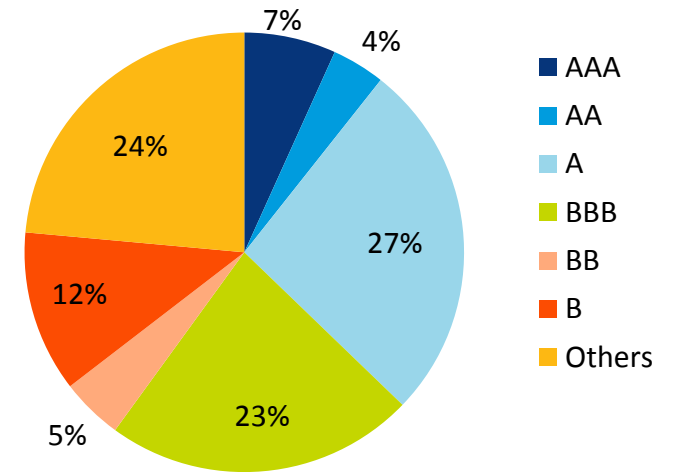
Maturity profile (USD billion)



Sector distribution

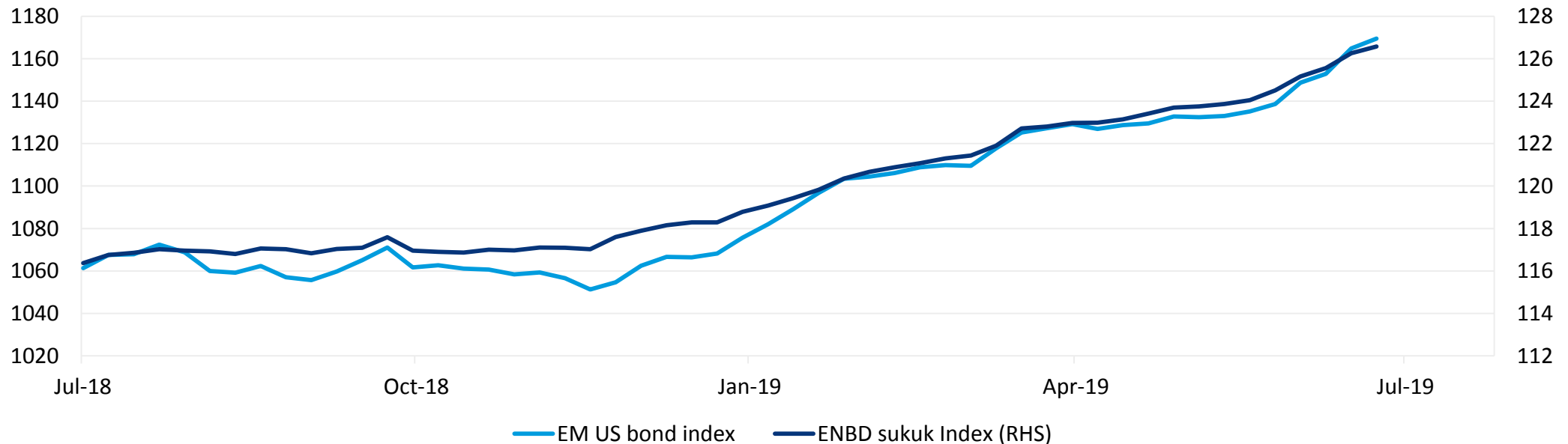


Rating distribution



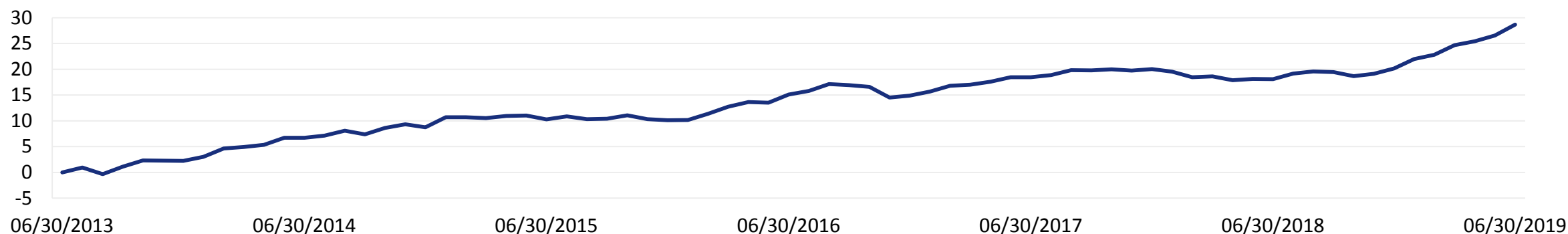
International sukuk – secondary market performance

- Even though international sukuk did not remain unscathed amid general sell off in EM assets, they did noticeably outperform their conventional bond counterparts last year. Total return on Emirates NBD Markit iBoxx Sukuk Index was a small gain of +0.26% last year compared with a loss of -2.5% on EM bond index.
- In the current year, sukuk performance has lagged conventional bonds owing to a higher starting base and better credit quality of this universe. In the year to date, total return on Emirates NBD Markit iBoxx Sukuk Index is 8.09% compared with 10.26% on EM USD bond index



Sukuk market returns compare well with global peers

DJ Sukuk Total Return Index – Cumulative Return (%)



Risk Metrics

Period: June 2013 - June 2019

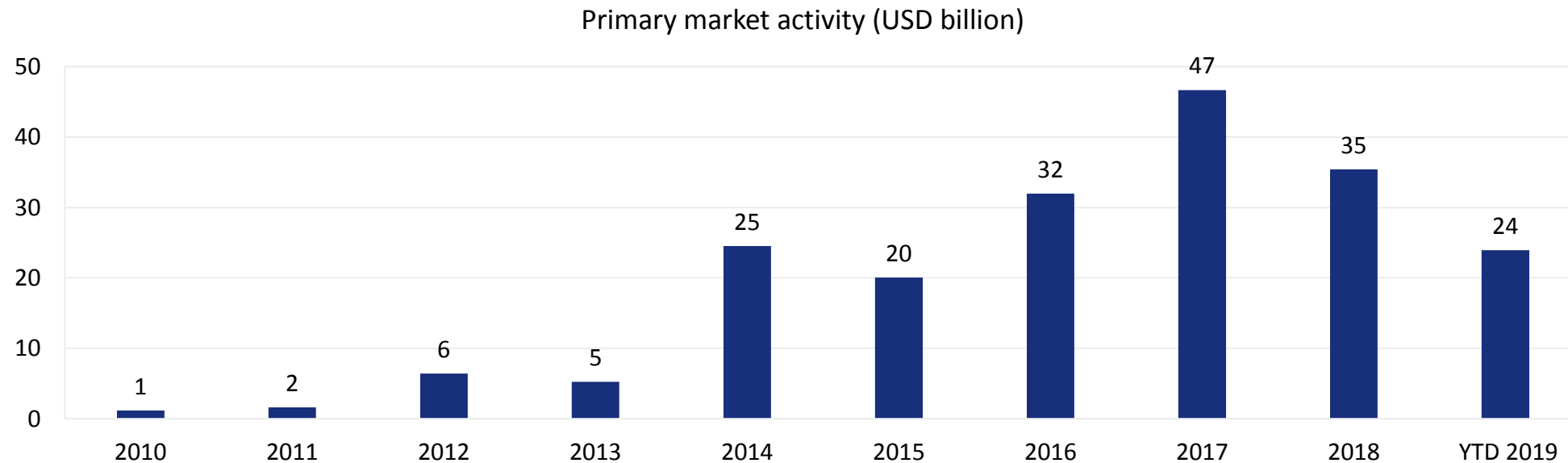
Description	Annualized Return	Annualized Standard Deviation	Sharpe Ratio	Maximum Drawdown	Maximum Gain	% Positive Returns	% Negative Returns	Modified Duration June 2013	Modified Duration June 2019
Bloomberg Barclays Global Aggregate	4.05	2.46	1.39	-2.76	26.87	68.06	31.94	-	7.07
JP Morgan MECI GCC Bond Index	5.19	3.14	1.45	-2.60	35.48	68.06	31.94	5.52	6.96
JP Morgan EMBI Global Index	5.54	5.95	0.82	-5.98	40.66	62.50	37.50	7.69	6.85
Dow Jones sukuk Total Return Index	4.29	2.48	1.47	-2.25	29.13	68.06	31.94	6.42	4.95
Emirates Global Sukuk Fund	4.80	2.51	1.66	-2.17	32.51	70.83	29.17	4.03	4.64

Benchmarking options

	Dow Jones Sukuk Total Return Index	Markit iBoxx Emirates NBD Sukuk Index	JP Morgan MECI Sukuk Index
Investable universe	USD 82.7 billion	USD 100.3 billion	USD 66.8 billion
Number of securities	76	105	70
Average rating	A	A-	A-
Yield to Maturity	3.03%	3.74%	3.75%
Average Coupon	3.73%	4.07%	4.39%
Average spread	115 bps	184 bps	182 bps
Rebalancing frequency	Monthly	Monthly	Monthly
1- year tracking error vs. Emirates Global Sukuk Fund	1.40%	1.18%	0.91%
Inclusion Criteria	<ul style="list-style-type: none"> • Includes fixed/floating rate sukuk • Minimum time to maturity is one year • Includes perpetual sukuk • Sukuk must be rated investment grade by at least one of the three rating agencies (Moody's/Fitch/S&P) • Amount outstanding must be greater than USD 200 million 	<ul style="list-style-type: none"> • Includes fixed/floating rate or amortizing sukuk • Includes rates and unrated sukuk • Minimum time to maturity is one year • Amount outstanding must be greater than USD 250 million 	<ul style="list-style-type: none"> • Includes fixed/floating rate or amortizing sukuk • Includes perpetual sukuk • Includes rates and unrated sukuk • Minimum time to maturity is one year • Amount outstanding must be greater than USD 300 million
Advantages	Most widely tracked sukuk index with a long track record	Broadest universe with no geographic or rating restrictions	Includes perpetual and sub-investment grade sukuk issued in MENA
Disadvantages	Excludes sub-investment grade sukuk leading to high tracking error	Excludes perpetual sukuk - a expanding universe	Excludes non-MENA sukuk leading to high tracking error

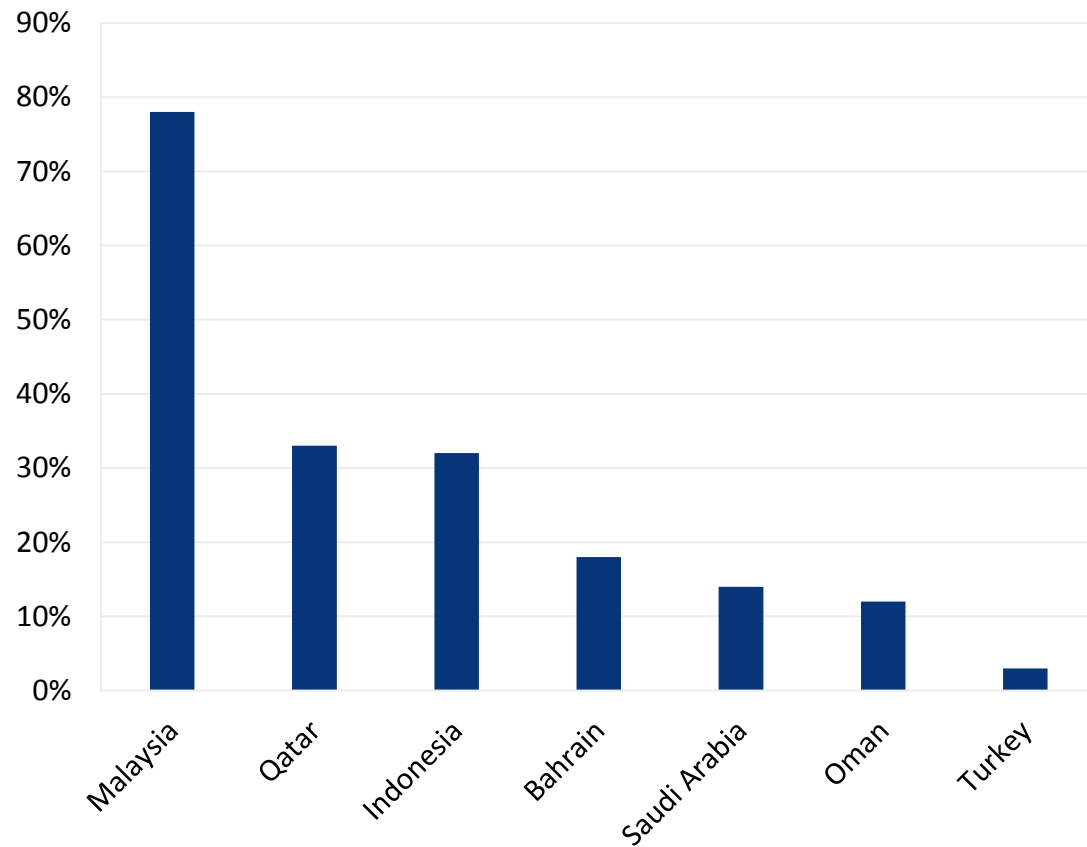
International sukuk – primary market activity

- After peaking in 2017, new issuance slowed in 2018 as USD interest rates increased every quarter, making it expensive for issuers to raise funding. However, with increasing expectations of rate cuts in the US and continued budget deficits in most oil exporting countries, new issues have picked up pace again this year
- New supply was abundant in H1 2019 and augurs well to meet or exceed our target of between USD 40 billion to USD 50 billion in new sukuk issues this year. Beside sovereigns, corporate issuers are expected to be active with several new issuers such as Aramco and Saudi Telecom having already tapped the market and were heavily over subscribed

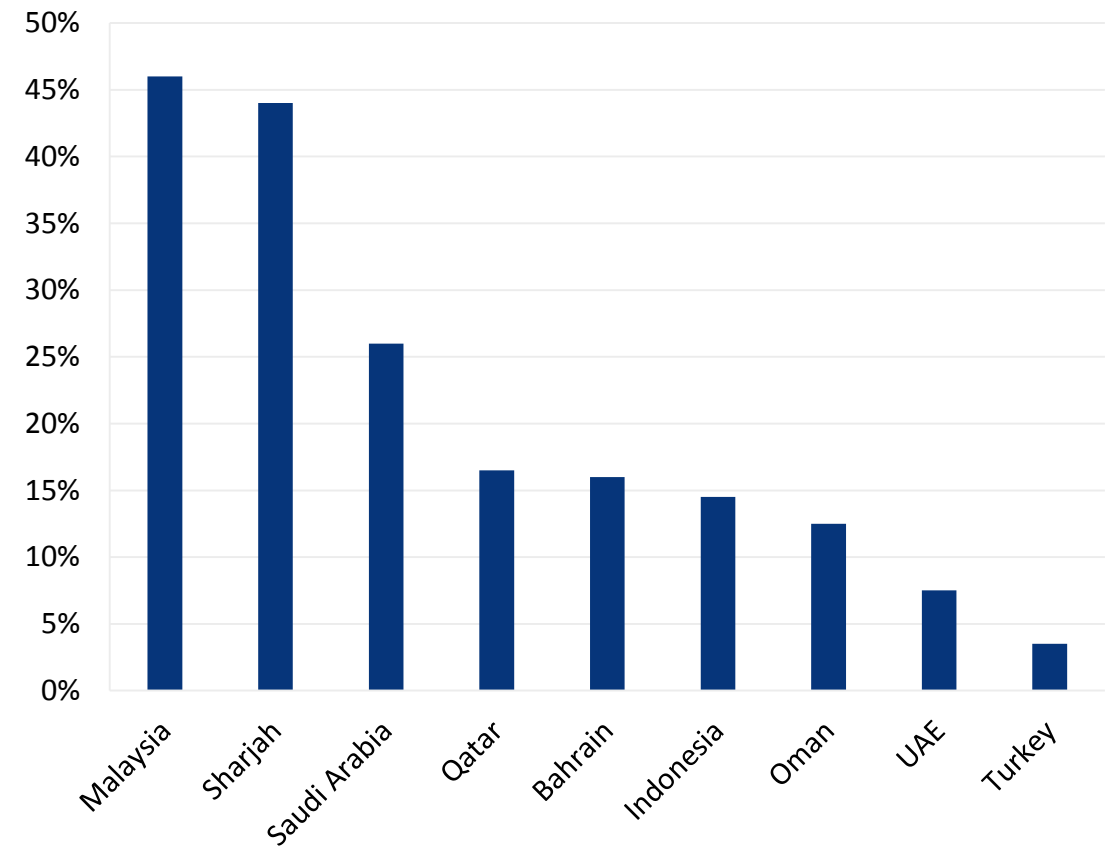


Sukuk for deficit financing

Share of sukuk in fiscal deficit financing (2015-2018)

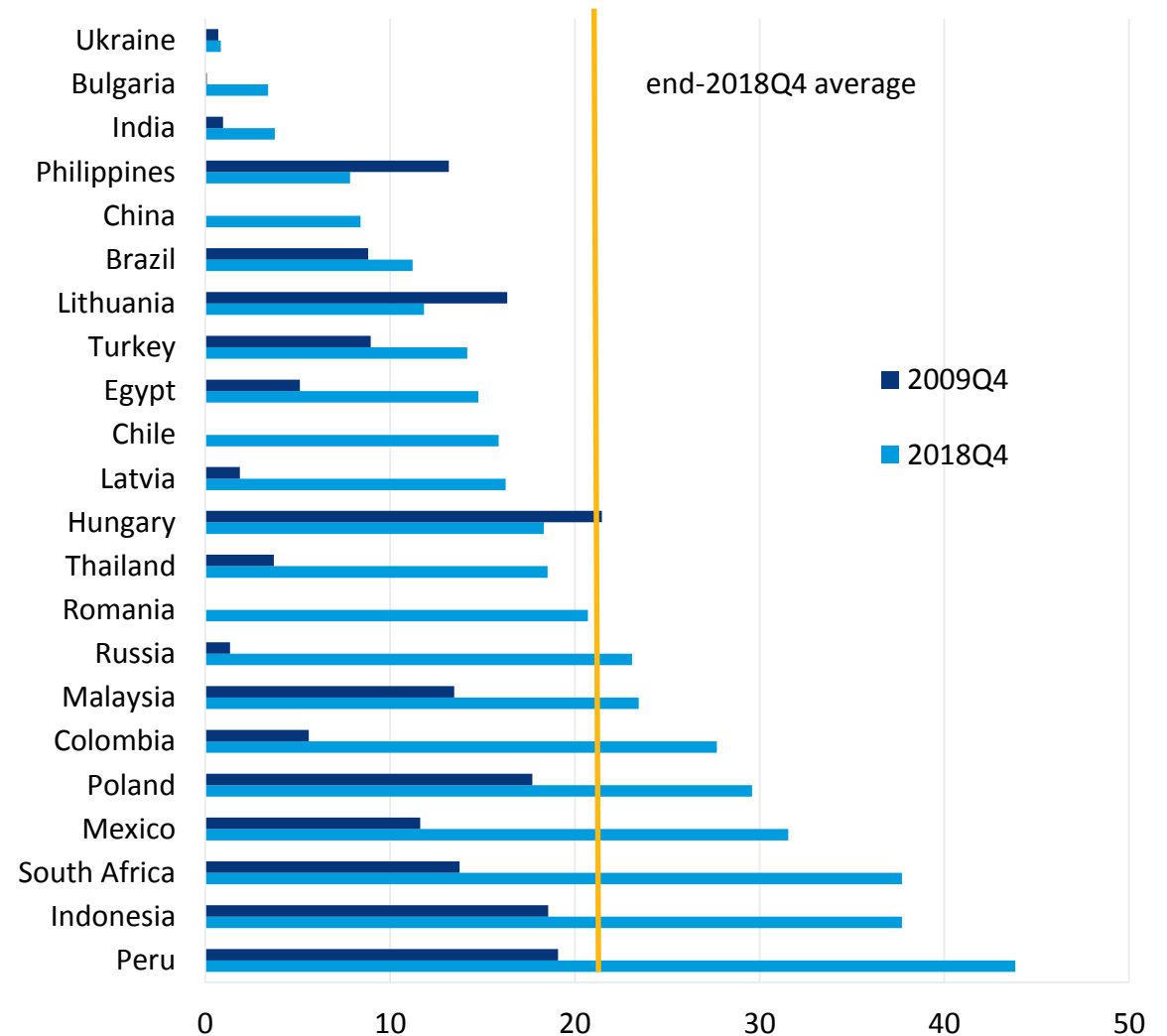


Share of sukuk in total government debt - 2018



Potential for new entrants & higher crossover participation

- **The Emirate of Ajman** is considering tapping international debt capital markets, either through a US dollar bond or a sukuk, which would make it the fifth emirate to do so
- **Egypt** announced that during the fiscal year July 2019 it might tap a number of unconventional sources of financing, including panda bonds and international sukuk
- In **Ghana**, the ministry of finance indicated that the country could issue a sukuk as part of its plan to raise \$3 billion from the international debt capital markets in 2019
- **Government of Sri Lanka** said to explore the possibility of tapping non-conventional capital markets, including sukuk, during 2019 to diversify its foreign funding sources
- SEC of **Philippines** has issued Memorandum Circular No 12 (Series 2018) containing guidelines for issuance of green Sukuk under the ASEAN Green Bond Standards
- Refinancing from the United Kingdom (Matured 07/19), **Hong Kong** (September 2019), South Africa (June 2020)



Investing in international sukuk – opportunities and challenges

Opportunities

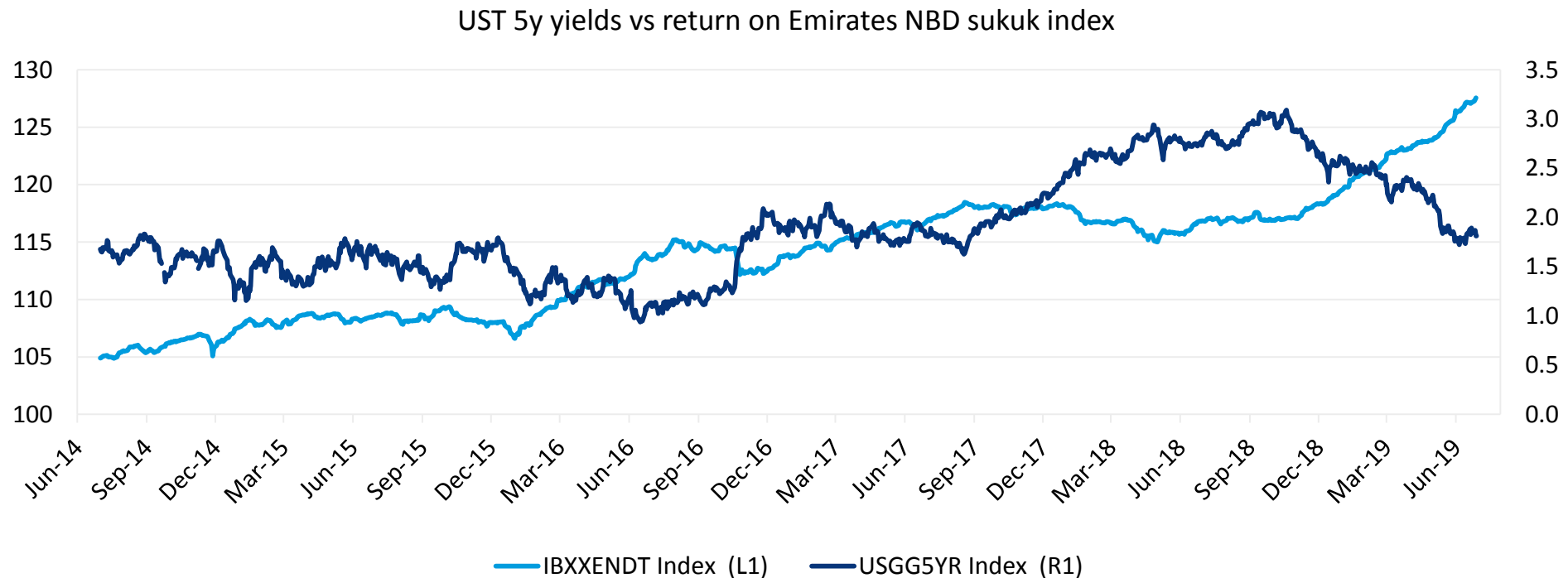
- Falling USD interest rates.
- Bid for EM assets: Hunt for Yield.
- Cheap global liquidity.
- Improving standardization, innovation and fintech adoption.
- Good fit with green finance.
- Healthy new issue pipeline.
- Inclusion of GCC sukuk in the EMBIG index.
- Opportunity to benefit from M&A activity in the GCC.

Challenges

- GDP growth in key Islamic economies is slowing.
- Risk of fallen angels.
- Geopolitical concerns in the Middle East.
- Subdued outlook for oil prices.
- Complexity and higher cost of doing sukuk vs conventional bond.
- Sharia's prohibition on speculation hinders hedging long term risk. Lack of hedging products.
- Duration constraints.

Opportunities – falling US interest rates

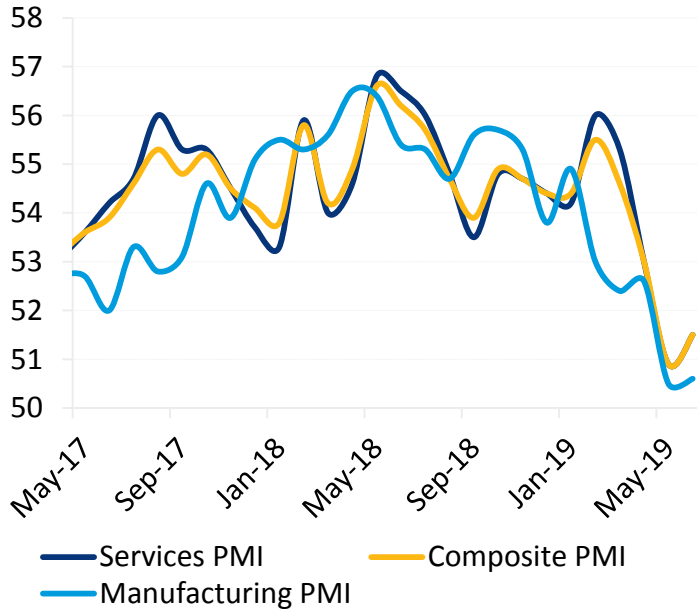
- Circa 97% of internationally tradeable sukuk are denominated in USD which places them well for capital gains in the face of impending rate cuts in the US.
- Performance of EM bonds and sukuk is strongest in the rate easing cycle that happens in non-recessionary times vs the cycle that follow recessions



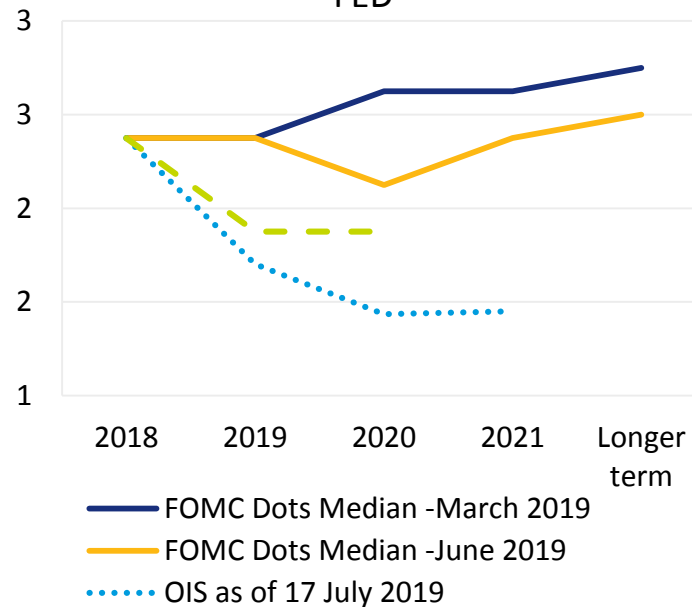
Opportunities – falling US interest rates

- US economic data is mixed with some loss of momentum in activity surveys, but with the labour market still firm. Fed Chair Powell’s testimony to Congress and the June FOMC minutes showed a dovish bias highlighting an uncertain outcome of the US-China trade talks and slowing global growth weighing on business sentiment and investments.
- Consequently, market expectations of a 25bp rate cut on 31 July appears to have been cemented, possibly to be followed by another 25bp cut before the end of the year, as uncertainty is likely to remain elevated. The market is currently pricing in a 100% chance of a 25bps rate cut and 26% chance of a 50bps cut at FOMC’s July meeting. We assume two rate cuts over the 1-year forecast period, but political pressure to cut rates further in 2020 is likely to mount.

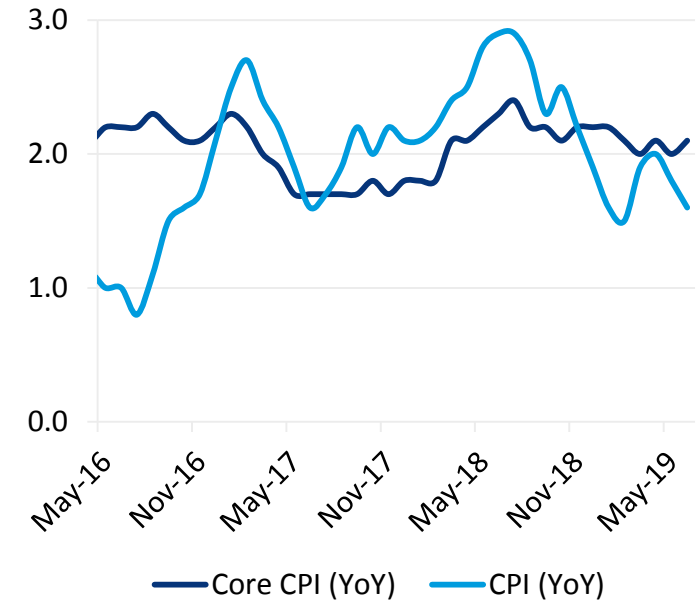
U.S. PMI data showed slight rebound



Markets still more dovish than the FED



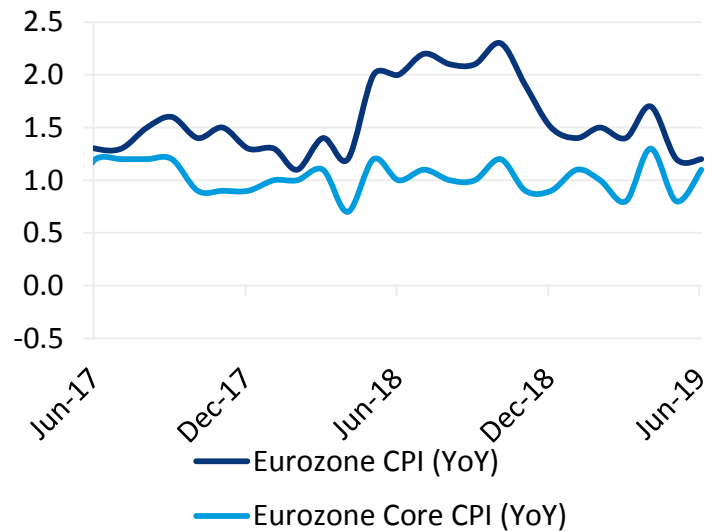
Core inflation is steady



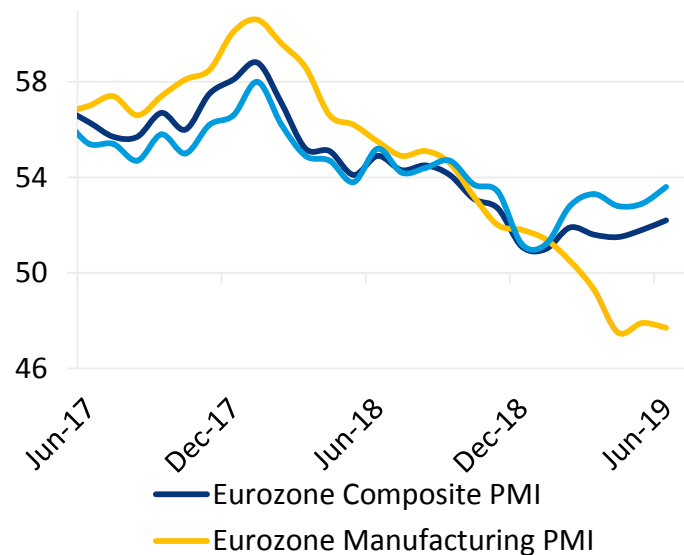
Opportunities – rising liquidity: ECB likely to ease

- Eurozone Q1 growth was 1.2% y/y, but PMI readings continue to point towards weakening economic growth momentum in Q2. With inflation still well below its 2.0% target the ECB has clearly become dovish, bringing forward the possibility of further rate cuts and re-introduction of QE by the end of 2019
- In the UK, the increasing possibility of a no-deal Brexit in October is clearly denting activity with PMI releases reflecting a sharp deterioration in June. In such an environment the BoE is likely to remain on hold even though headline wage growth of 3.6% is likely to put upward pressure on inflation

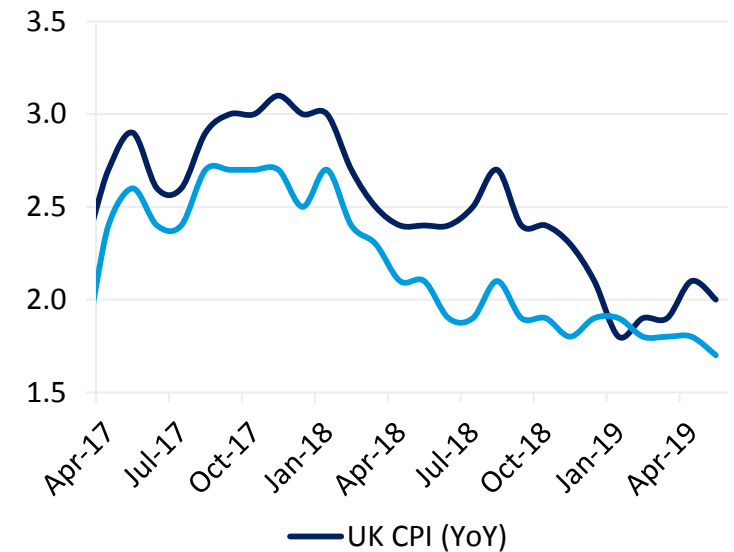
Eurozone inflation is far from the ECB's 2% target



Trade concerns continue to weigh on Eurozone sentiment



UK inflation is within the target range



Opportunities : improving regulation - recent developments in the GCC

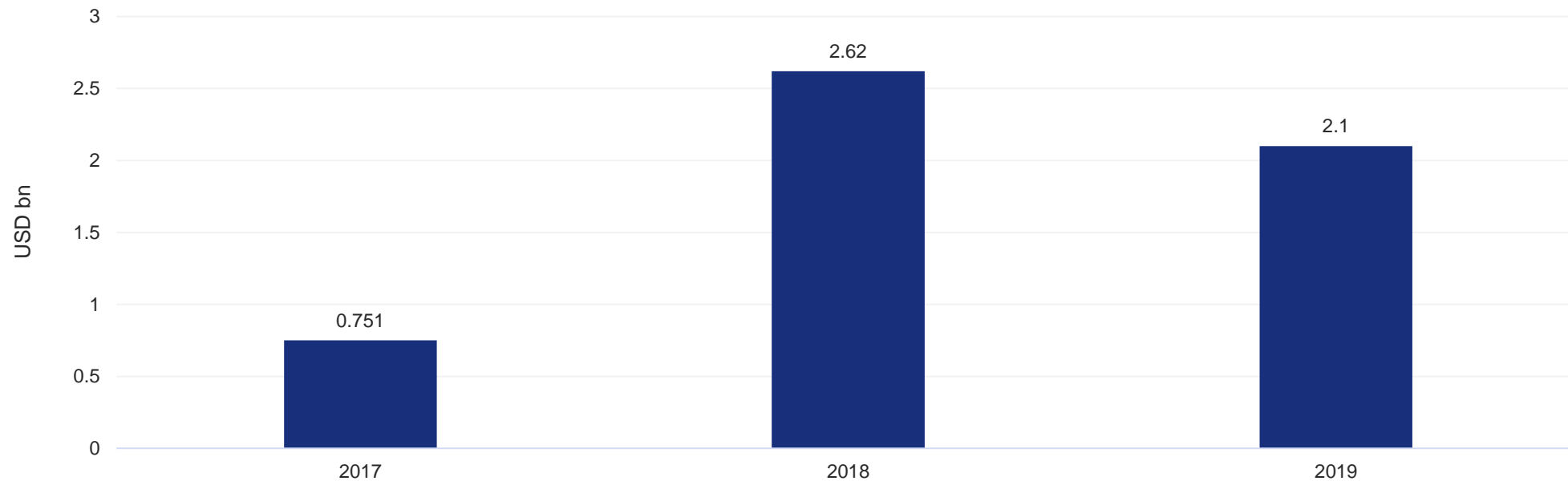
- In the GCC, five of the six sovereigns now have local currency sukuk, thereby creating the risk free benchmark curves.
- Sukuk regulations in the region have strengthened substantially with Capital Market Authorities (CMAs) having rolled out formal rules.
- New sukuk regulations were launched in Kuwait in November 2015.
- In Oman, the Capital Market Authority strengthened sukuk listing rules last year, stipulating higher standards for transparency and governance while providing protection to investors.
- In the UAE, Securities and Commodities Authority (SCA) issued rules and resolutions emphasizing need to disclose mechanism of resolving dispute in the event that a sukuk is no longer sharia compliant. Also the Fatwa must detail the process of how the sharia scholars reached the sharia opinion.
- Higher Sharia Authority at the CBUAE has made it mandatory to adopt sharia standards recommended by AAOIFI.
- Nasdaq Dubai has introduced sukuk indices and plans to allow individuals to invest in sukuk market.

Opportunities : improving standardisation and adoption of fintech

- Progress on standardization is being made with the different standard setters of the industry--the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Service Board (IFSB) and the International Islamic Financial Market (IIFM)- - working together to advance this agenda. AAOIFI published an exposure draft on sukuk governance in December 2018 that included provisions to protect investors in case a sukuk is terminated.
- Types of sukuk structures used are being narrowed down to a select few. New innovations to sukuk structure such as the combination of mudaraba-murabaha structure used by the Saudi Telecom will boost investor confidence.
- Blockchain and smart contracts could improve the traceability of cash flows and assets.
- Smart contracts could facilitate out-of-court resolution in a pre-agreed way from the onset of the transaction.

Opportunities – sukuk aligns well with ESG and green finance

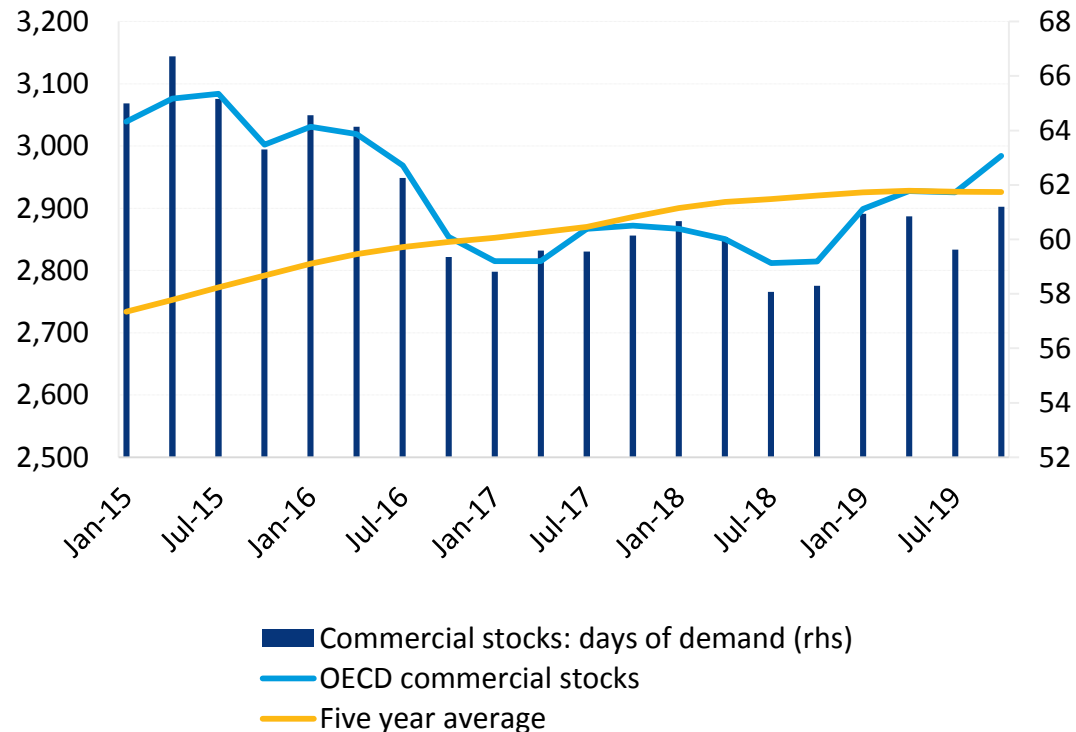
- Islamic finance's goal to protect life aligns with sustainable finance principles, which emphasize environmental and social protection. Green sukuk's mandate fits well with UN's Sustainable Development Goals.
- Green sukuk are gaining traction. While Malaysia and Indonesia lead the way, recently Majid Al Futtaim (MAF) issued world's first largest corporate green sukuk .



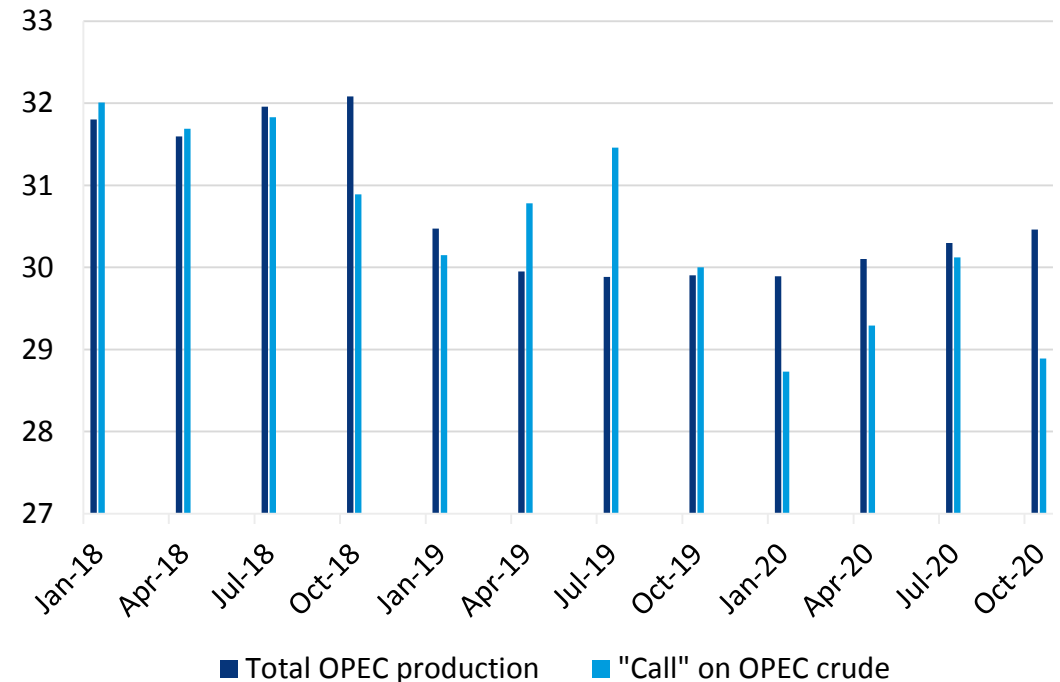
Challenges : weaker oil prices looming despite OPEC+ cuts

- OPEC+ will maintain supply cuts until Q1 2020 in effort to draw down global inventories and support prices. Compliance with production cut targets has been good so far but is likely to decrease as compliance has been excessive in some cases (Saudi Arabia at 260% compliant in June)
- The OPEC+ cuts won't be enough to offset persistent growth outside the bloc in a demand constrained world. Non-OPEC supply to expand by +2m b/d in 2020, led by US. Market will need less OPEC oil in 2020
- Market surplus is expected by Q4 2019 and into next year, even on OPEC's own market assessment

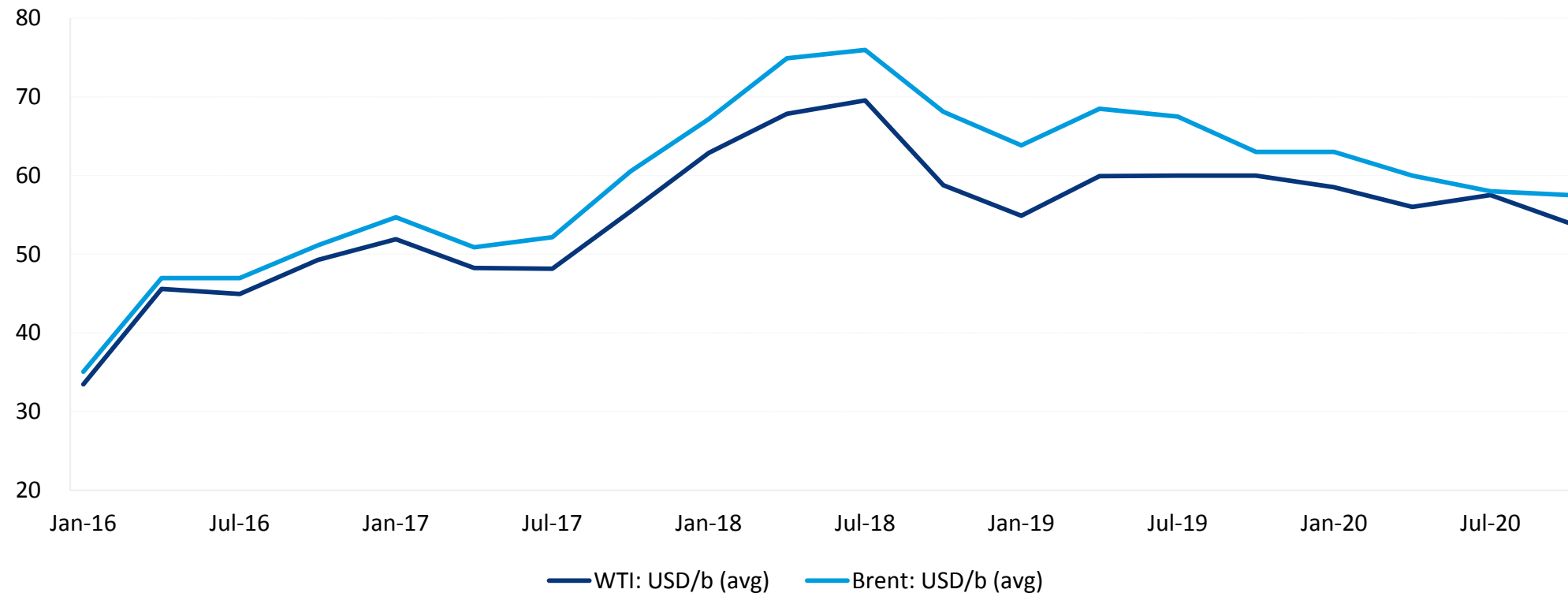
Inventories will start to build again (USD billion)



OPEC production levels not low enough (million barrels per day)

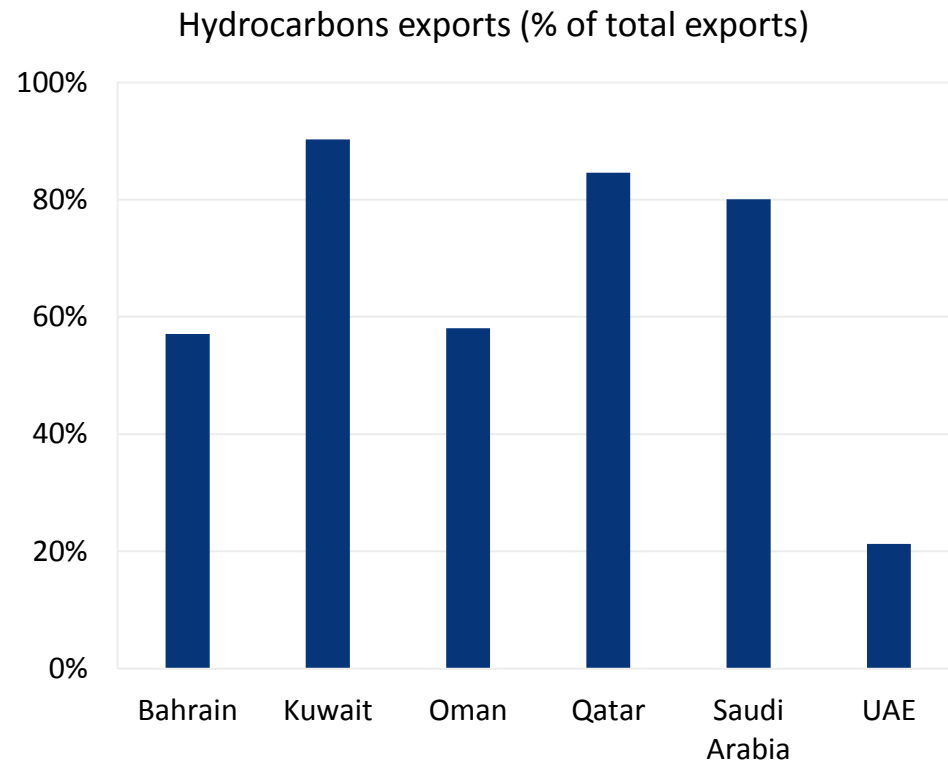


Emirates NBD Research oil price forecasts



GCC's reliance on oil

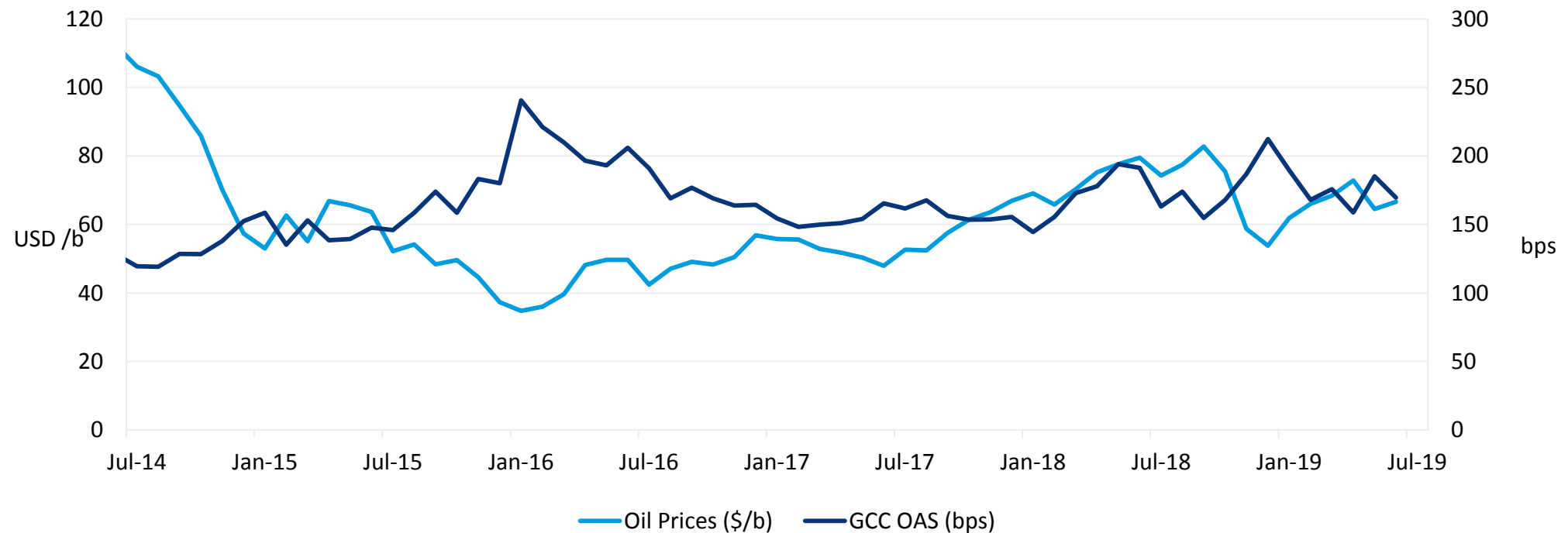
- Though diversification efforts have begun to show some benefits, GCC government revenues remain highly reliant on oil prices.
- With oil price assumptions of between \$55 - \$60 per barrel, planned budget deficits in the GCC are expected to be circa \$60 billion in 2019. However, actual may be lower given that oil prices have averaged higher than \$60 per barrel so far.



2019 Budget (assuming oil prices \$55-60/b) USD bn	GDP	Revenue	Expenditure	Deficit	Budget Deficit (% of GDP)
Bahrain	39	6.9	9.4	-2.4	-6%
Kuwait	141	59	67	-7.7	-6%
Oman	79	28	34	-6.4	-8%
Qatar	191	55	53	2.1	1%
Saudi Arabia	791	244	289	-44.3	-6%
UAE	423			0.0	4%

GCC spreads versus oil prices

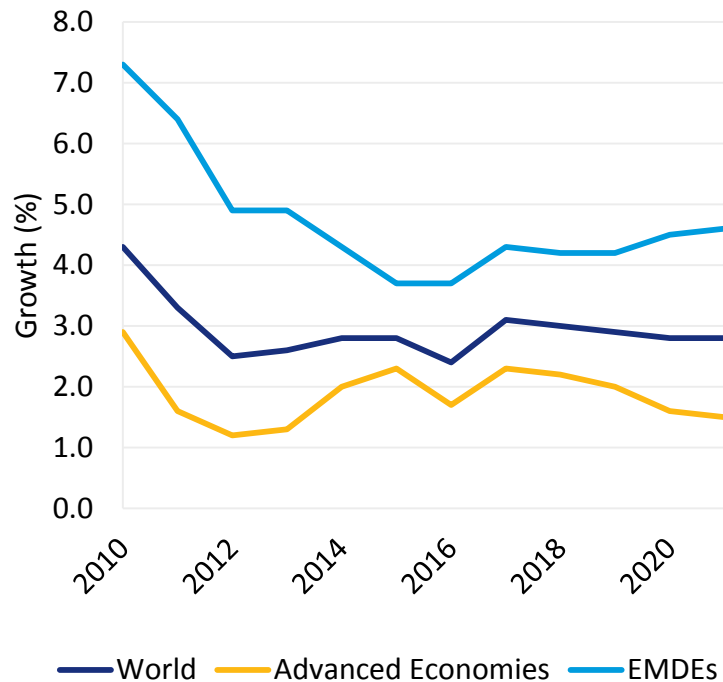
- Nearly 55% of hard currency sukuk is from the GCC region.
- The relationship between GCC bond and sukuk spreads with oil prices is strong. However, it very frequently gets overshadowed by other issues such as political concerns, EM capital flows and movements in the UST benchmark yield curve.



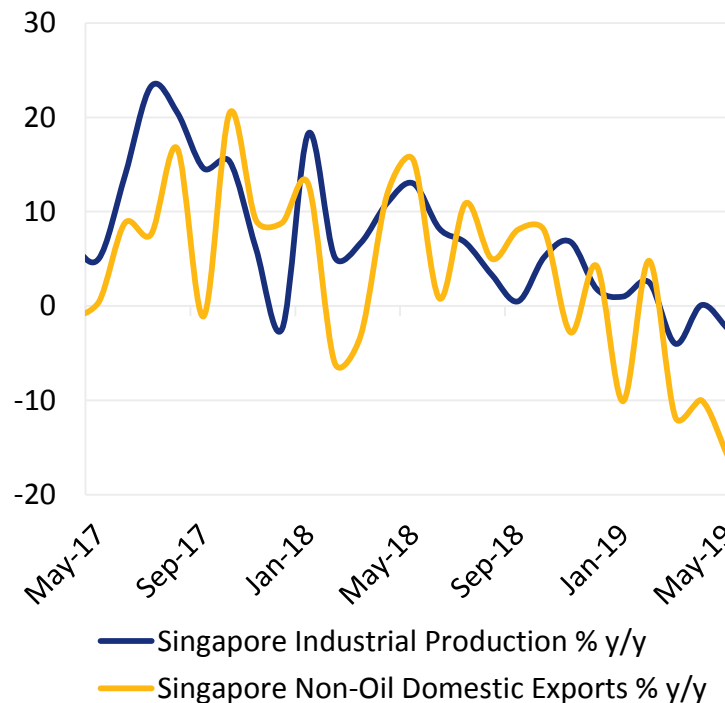
Challenges – global tensions and risks

- Despite the resumption of US-China trade talks, existing tariffs remain in place weighing on activity and on supply chains. Also the apparent ‘truce’ may still prove to be short lived as fundamental differences have not gone away
- World trade volumes are contracting and the global composite PMI output index shows the global expansion clearly slowing
- Against this backdrop, ongoing trade tensions will increase recession risks for some major economies. Central banks are hence positioning for rate cuts, with the RBA and EM central banks already easing, with more likely to come

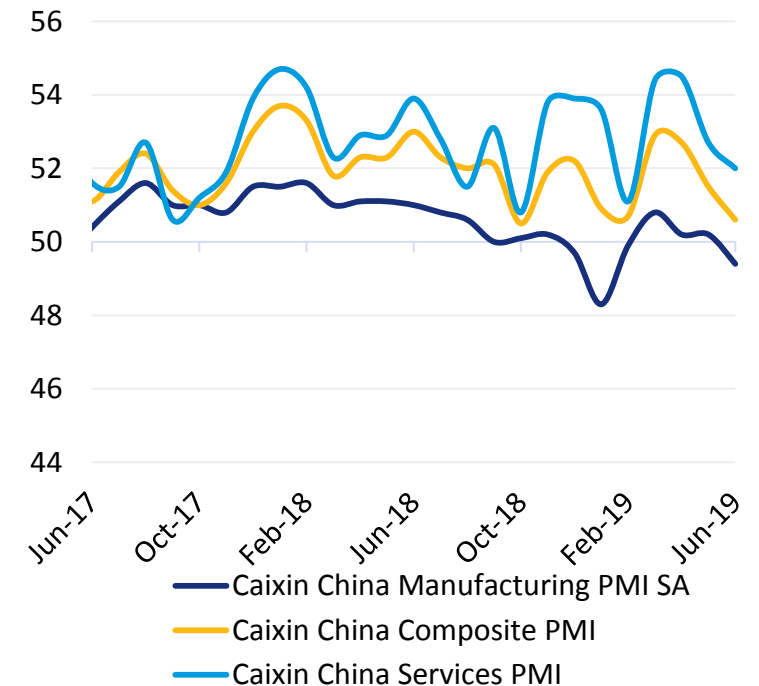
Global Growth Flattens



Singapore exports and production



China PMI



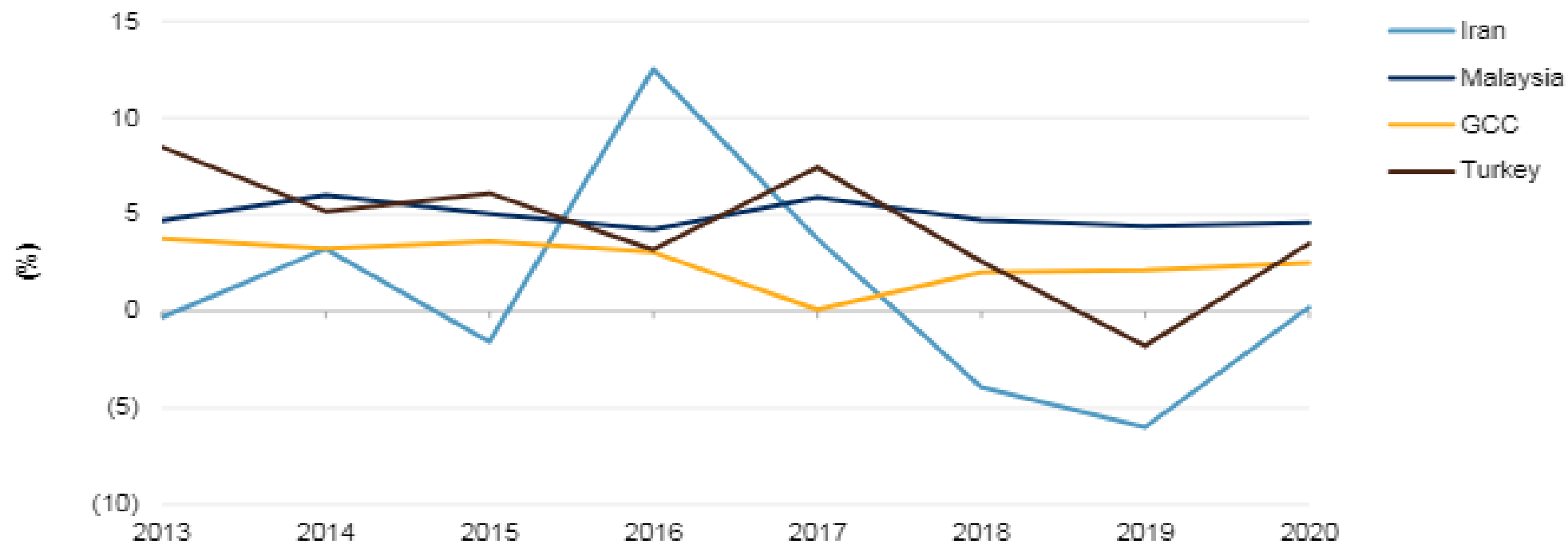
Challenges – geopolitical concerns in the Middle East

Ongoing geopolitical concerns in key Islamic finance jurisdictions

1. Turkey : Currency depreciation.
2. Iran: Sanctions and political tension.
3. Qatar: GCC embargo.
4. Pakistan: Balance of Payment crisis.

Challenges – economic slowdown in key Islamic markets

Real GDP Growth In The Main Islamic Finance Markets

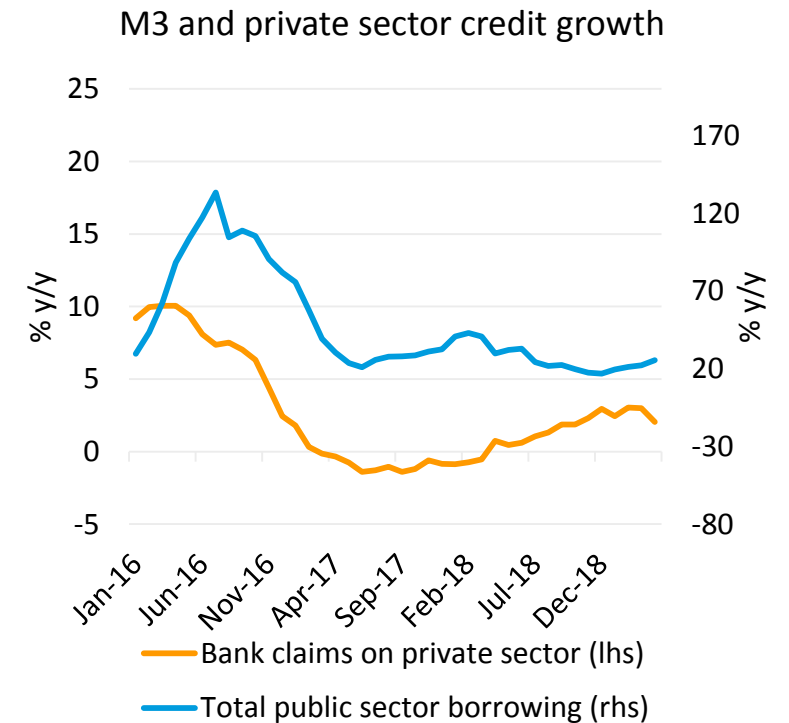
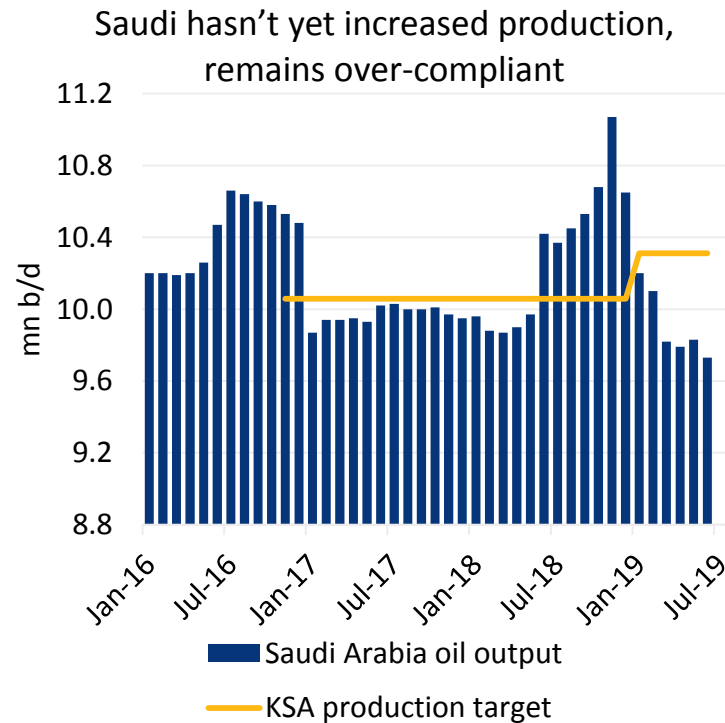
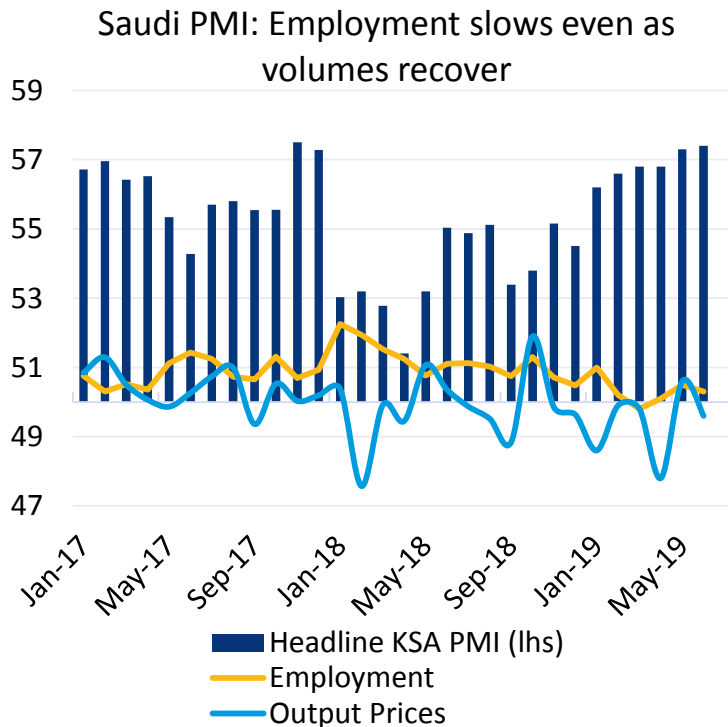


GCC--Gulf Cooperation Council. Source: S&P Global Ratings, International Monetary Fund.

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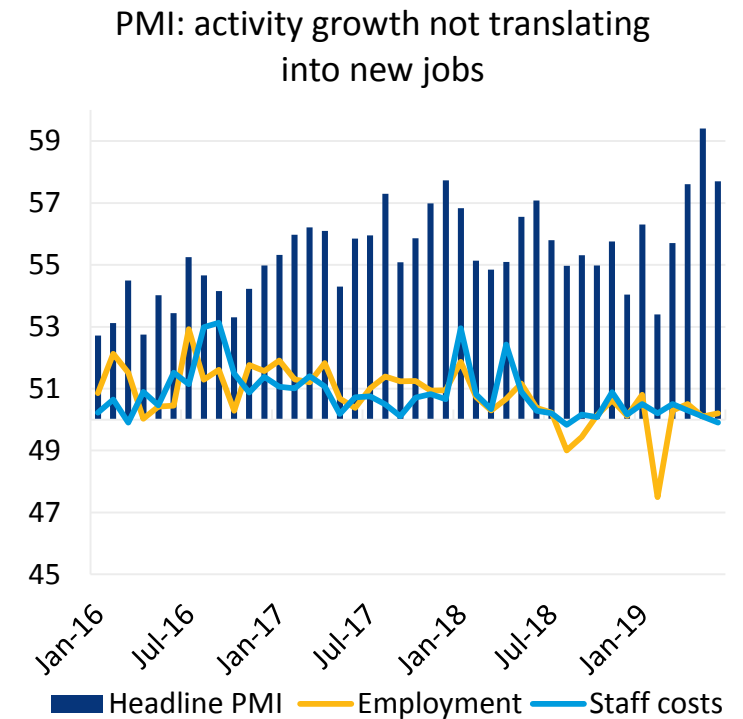
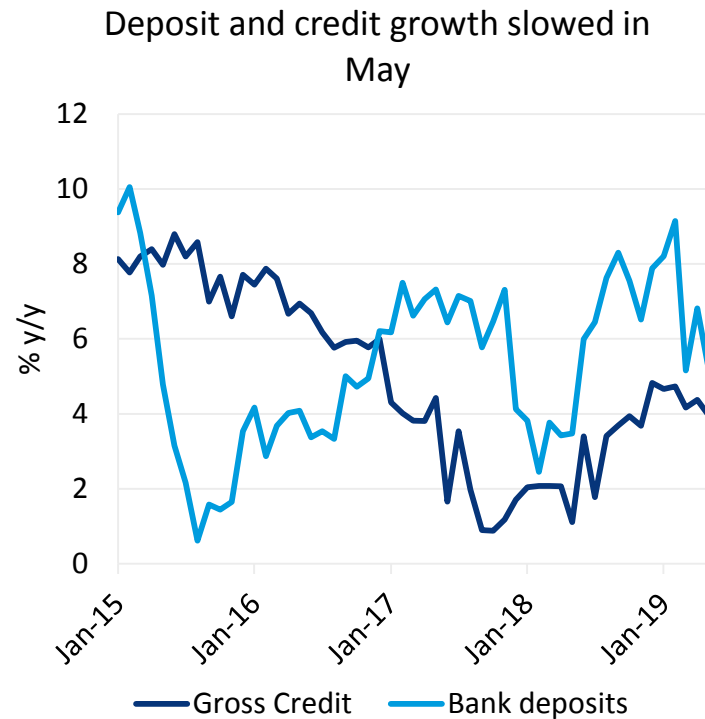
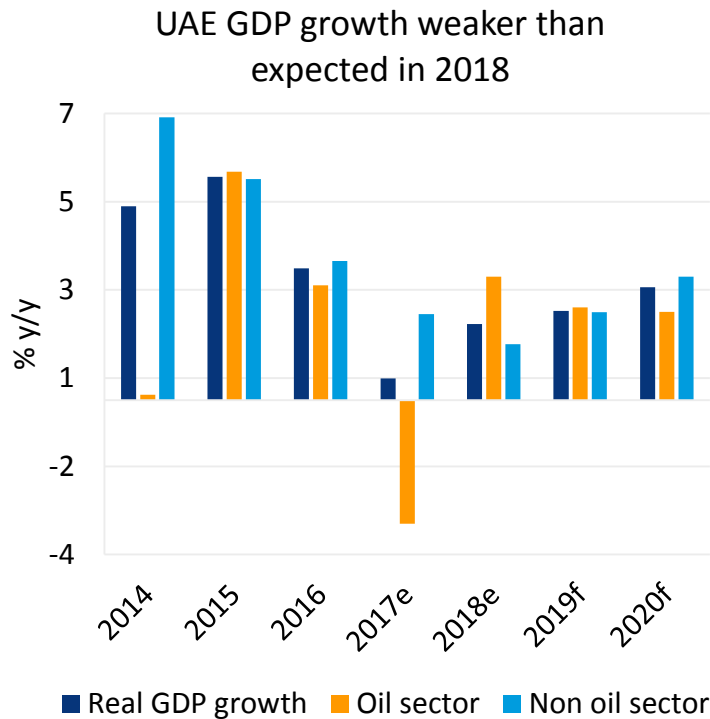
Challenges: weakness in key economies – Saudi Arabia

- Oil production cuts YTD have been deeper than agreed with OPEC, and this is likely to remain the case through H2 2019
- The headline PMI rose to 57.4 in June on new orders and output growth; the highest reading since Dec. 2018. However, there has been almost no job growth in the private sector this year
- Private sector credit growth accelerated to 3.2% y/y in May, the fastest since Nov 2016. Point of sale transactions growth remains robust
- Net foreign assets rose to USD 511bn in May, the highest since 2017. The proceeds of Aramco’s bond issuance likely contributed to the rise in reserves in Q2, as did inflows to the equity market on the back of EM index inclusion



Challenges: weakness in key economies – UAE 2019 growth forecast at 2%

- Preliminary estimates put 2018 growth at 1.7%. 2017 GDP was revised down to 0.5% from 0.8% previously. The weakness in the non-oil sector was in Abu Dhabi, Dubai's economy grew 1.9% in 2018 and 3.1% in 2017
- Headline PMI has rebounded strongly year to date, suggesting non-oil sector growth has accelerated. Growth in activity is underpinned by price discounting and improving external demand. There has been no job growth in the UAE's private sector this year, suggesting consumption is likely to remain sluggish
- Gross credit growth stood at 4.0% in May, but private sector credit growth slowed to 2.3% y/y. Individuals' borrowing continues to contract



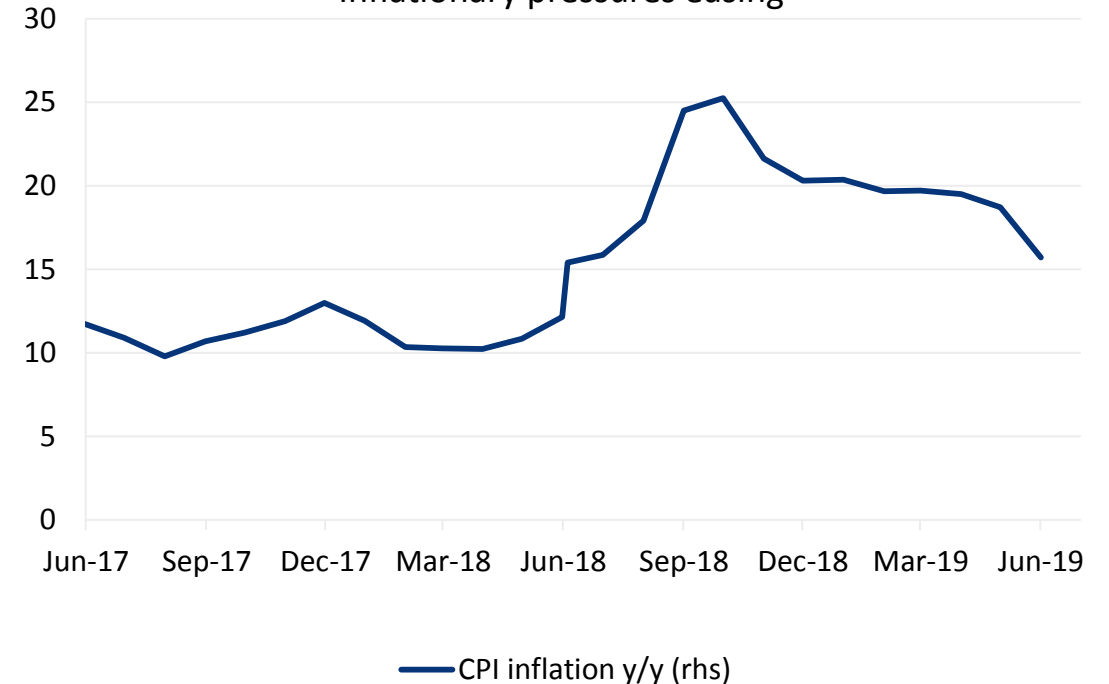
Challenges: weakness in key economies – Turkey

- Turkish CPI inflation fell to 15.7% y/y in June, the slowest pace since July last year, when the country’s financial meltdown and lira sell-off began in earnest
- The slowdown in inflation paved the way for a the 425bps rate cut earlier this month at the TCMB’s July 25 meeting. The benchmark one-week repo rate had been static at 24.00% since September, but the marked slowdown in inflation and a strengthening lira gave the central bank considerable leeway to act.
- Political risk remains to the fore as relations with the US are frayed by the Turkish acquisition of Russian S-400 air defense systems, posing a threat of sanctions

USD/TRY susceptible to sanctions threat



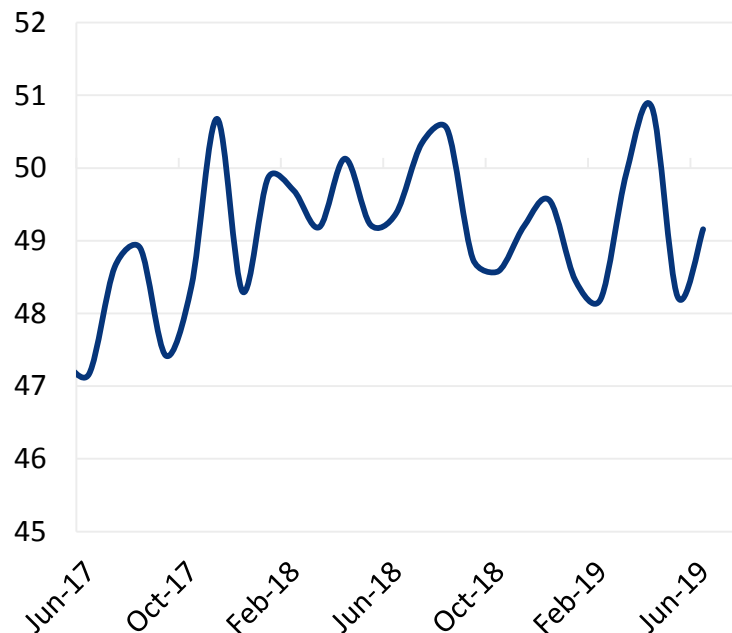
Inflationary pressures easing



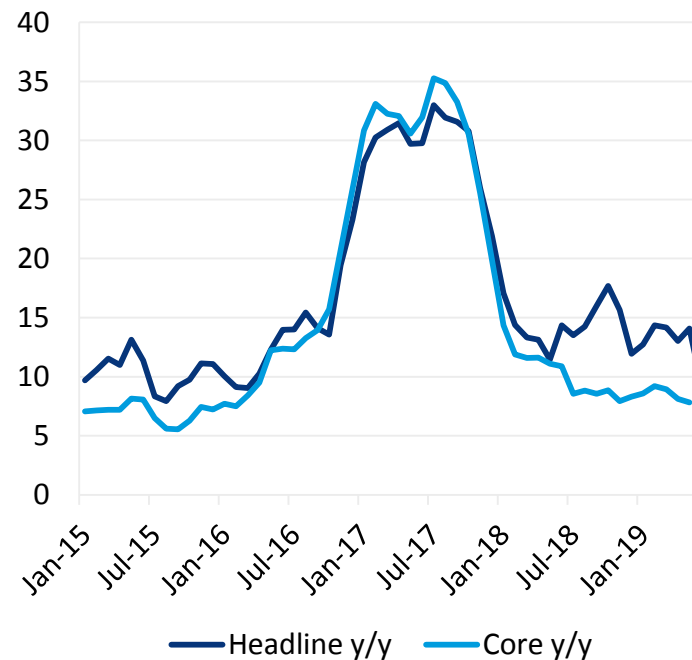
Challenges: weakness in key economies – Egypt

- The CBE kept its benchmark interest rate unchanged at its July meeting, and we forecast that policy will remain static at the August 22 meeting also. However, the likelihood that the bank resumes its rate-cutting cycle in September is now higher given the lower-than-expected inflation print in June
- Egypt’s non-oil private sector remained under pressure in June, although the pace of decline slowed from May. The Emirates NBD Purchasing Managers’ Index (PMI) stood at 49.2, up from 48.2 the previous month
- We expect a narrowing in Egypt’s budget deficit, forecasting a shortfall equivalent to 6.9% of GDP in 2019/20

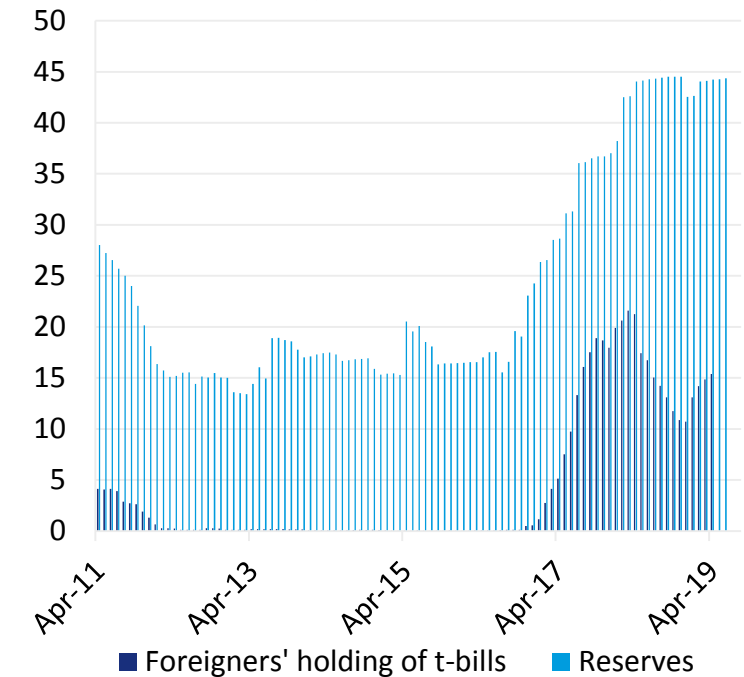
PMI struggles to remain positive



Inflation slows to multi-year low



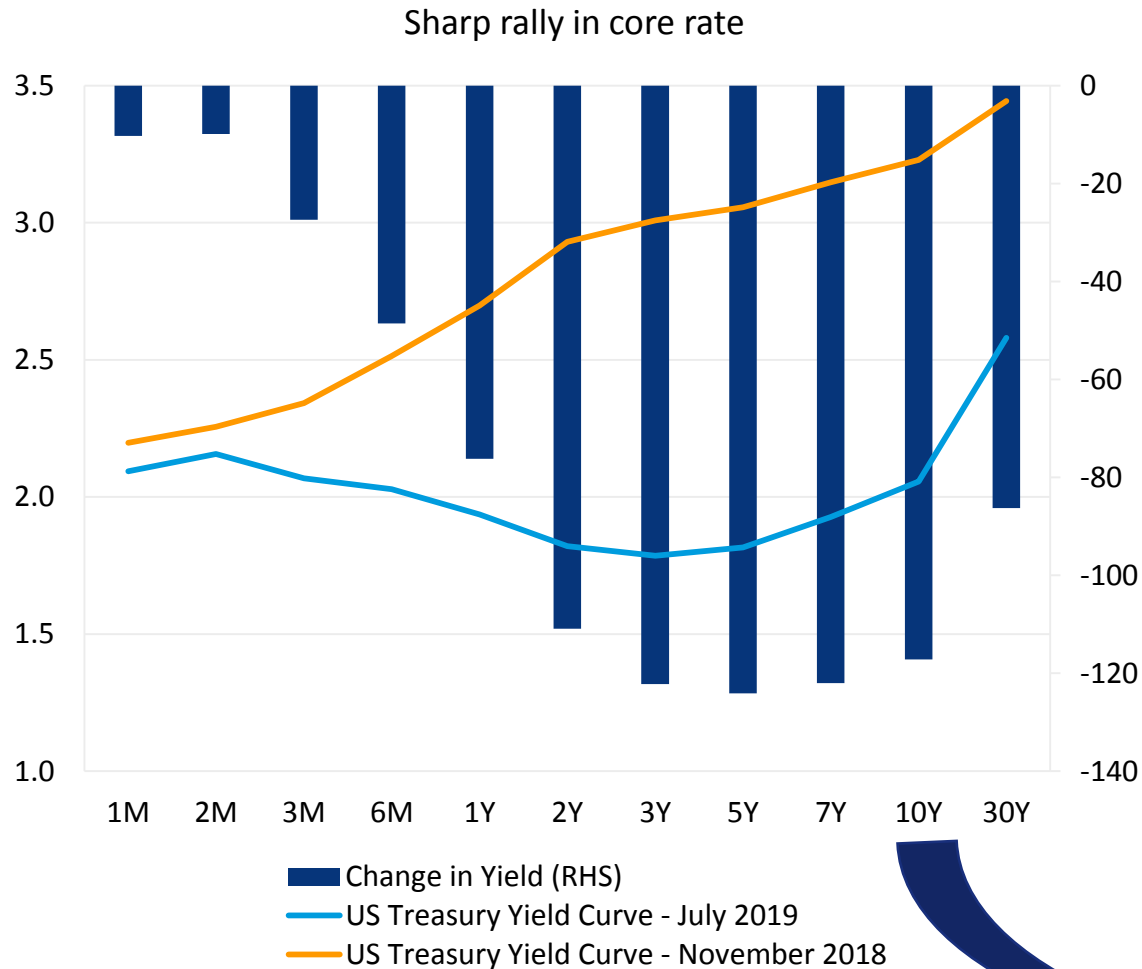
FX reserves position remains strong



Challenges – Lack of duration

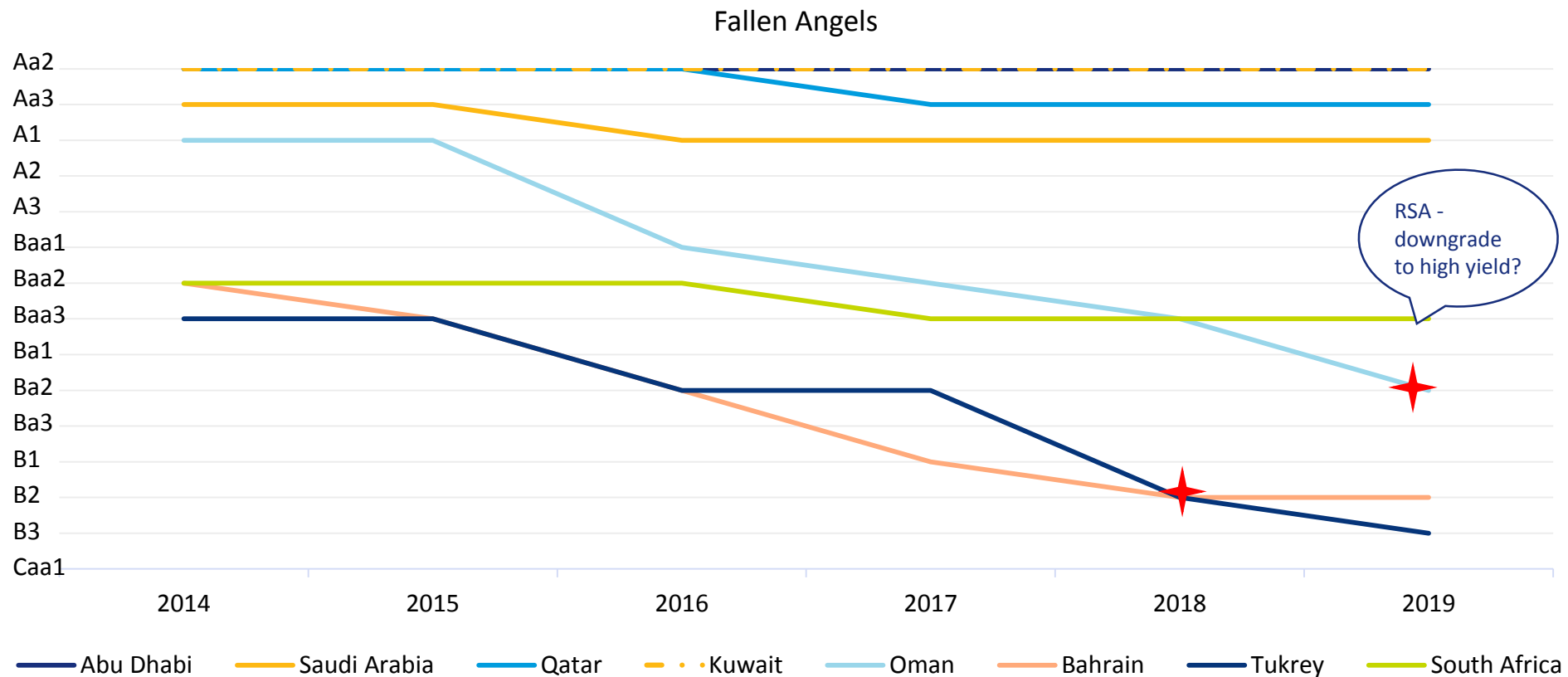
Duration profile	Dow Jones Sukuk Total Return Index	ENBD Markit iBoxx Sukuk Index	Bloomberg Barclays Global Aggregate	JP Morgan EMBI Diversified Index	JP Morgan MSCI GCC Total Return Index
Duration (years)	4.95	4.40	7.07	6.85	6.96
0-3 years	25.13%	32.67%	27.31%	20.63%	23.26%
3-5 years	32.02%	32.58%	25.20%	21.43%	20.56%
5-7 years	24.26%	22.44%	12.94%	22.02%	18.10%
7-10 years	14.48%	9.42%	12.31%	9.29%	15.63%
10+ years	4.12%	2.88%	22.25%	26.62%	22.46%

Challenges - duration management & yield curve positioning



JP Morgan EMBI Diversified Index	Total Return - YTD	Treasury Return
0-3 years	4.57%	2.52%
3-5 years	8.96%	3.67%
5-7 years	11.68%	4.69%
7-10 years	12.77%	5.61%
10+ years	17.08%	7.83%

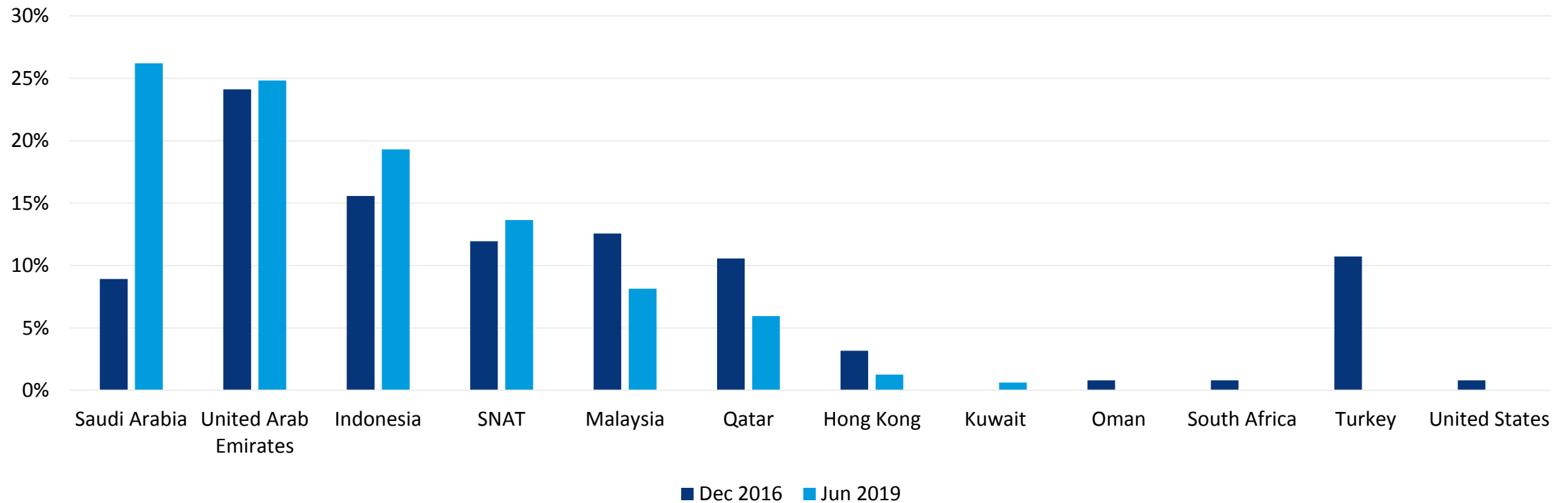
Challenges – rising risks of fallen angels



Exclusion from IG only indices

Challenges : concentration risk

Dow Jones Sukuk Index composition (% market cap)



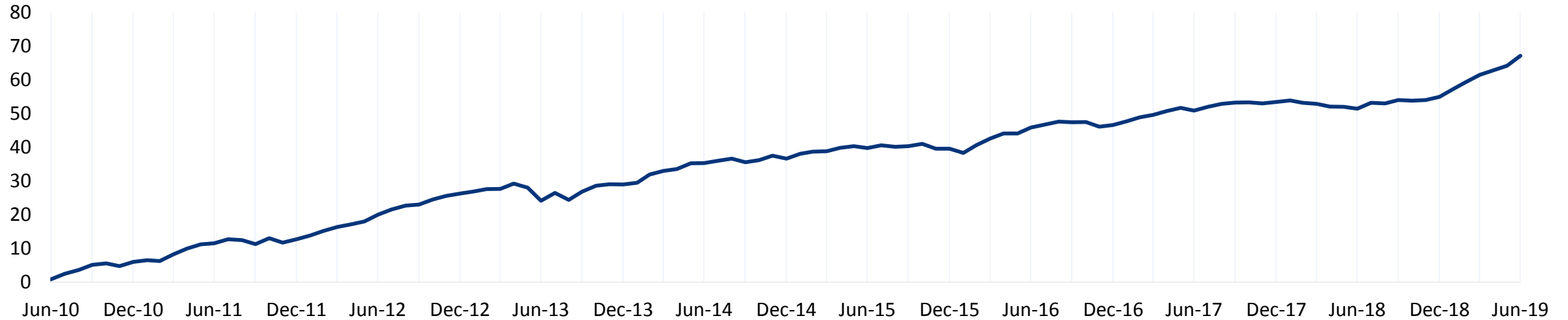
Challenges in investment positioning

Investment Positioning	Key Considerations
Sovereigns and Quasi (technical bid from being included in the EMBI index)	Inclusion ends in September. Selected GCC credits at risk of approaching country cap ceiling under ICA methodology
Sub debt / Tier 1 securities over senior	Attractive PONV premium for financials with strong government linkages and high pre-emptive support. Low precedence for extension risk
Long term exposure (curve flattening trades) over short term	Few long term issuances puts limitations on duration extension and curve flatteners
Investment grade bonds over High yield bonds (more sensitive to interest rate cuts)	IG-only accounts grappling with fallen angels and higher tracking error
Bullets over Structured amortising securities	Structured securities exhibit attractive valuations but poor liquidity. Spreads struggle to converge

Appendix

Emirates Global Sukuk Fund

Emirates Global Sukuk Fund – Historical Performance



Multi-Statistic Report

Period: June'10 to June'19

	Annualized Return	Annualized Standard Deviation	Sharpe Ratio	Max Drawdown	Max Gain
Emirates Global Sukuk Fund	5.82	2.88	1.85	-3.91	67.20

Calendar Year Report

Period: June'10 to June'19

	2011	2012	2013	2014	2015	2016	2017	2018	YTD 2019
Emirates Global Sukuk Fund	6.34	12.01	2.13	5.96	2.15	5.02	4.70	0.97	7.84

Markit iBoxx Emirates NBD USD Sukuk Index

Markit iBoxx Emirates NBD USD Sukuk Index – historical total return



Comparative Returns as at 29 July 2019

	1 Month	YTD	1 Year	3 Years	5 Years
IBXXENDT Index	1.11	8.04	9.36	12.36	21.72

Islamic capabilities

	YTD 2019	2018	2017
Emirates Global Sukuk Fund	7.26%	-0.12%	3.56%
Emirates Islamic Money Market Fund	1.20%	2.14%	1.32%
Emirates MENA Opportunities Fund	7.75%	3.68%	4.30%
Emirates Islamic Global Balanced Fund	9.24%	-9.70%	11.69%
Emirates Emerging Market Equity Fund	12.72%	-20.45%	26.19%
Emirates India Equity Fund	2.50%	-7.48%	33.03%

Emirates NBD

Investing in global sukuk

July 2019

