Global Sukuk outlook brightens for 2017

A rebound in global Islamic bond sales (Sukuk) last year has set the foundation for even more issuance in 2017, as investors look beyond traditional fixed income products for better yields and portfolio diversification. MOHIEDDINE KRONFOL explores.

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While Sukuk issuance trailed what was a blockbuster 12-month period for traditional debt sales in 2016, this trend, in our opinion, could reverse this year, as funding challenges push governments, especially hydrocarbon-dependent ones in the GCC region, to consider all options at their disposal to fund declining, but material, budget deficits.

As an emerging asset class, Sukuk continue to make great strides. In 2016, investment bank JPMorgan included Sukuk in their suite of global indexes for the first time, reinforcing the transition of Sukuk from the peripheries of the investment universe to more mainstream portfolios.

Sukuk's rising popularity goes some way to explaining its impressive performance in 2016. Global issuance amounted to US$44 billion, a 23.8% rise on 2015, according to data by Bloomberg. Backed by a robust pipeline of potential Sukuk issues, we expect 2017 issuance to show a further 20-25% improvement on last year's levels. Sukuk prices meanwhile will likely remain supported by the growing influence of Islamic banks and a supply/demand imbalance which continues to anchor the market for Islamic bonds.

For 2017, our constructive outlook is supported by a number of factors that are working in favor of Sukuk. Firstly, while a 25bps rate hike by the US Federal Reserve in December stoked some anxiety in debt markets, we remain of the view that US monetary policy will remain accommodative, perhaps more than the market currently projects. This bodes well for investor interest in the comparatively higher yielding and lower duration world of Sukuk.

Another fillip for sentiment, especially related to issuers in the oil-dependent GCC region, is the sharp rebound in crude oil prices. ICE Brent futures surged over 52% in 2016, the biggest annual gain since 2009. The most recent higher push came after the OPEC agreement in November 2016, along with other major suppliers, to cut global production by around 2%. Depending on compliance, this new pact increases the likelihood that a lingering oversupply in the oil market will be eliminated, providing a positive backdrop for oil prices and a much-needed boost to oil producers' finances.

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Oil aside, the investment case for the GCC has been further strengthened by the region's commitment to fiscal consolidation and capital market reform. The wide range of structural change currently being implemented by GCC governments is helping allay investor fears about some of the region's more oil-dependent economies.

For many debt investors, 2016 will be remembered as the year that Saudi Arabia sold its first-ever sovereign bond, a US$17.5 billion issue that ranked as the biggest in emerging market history. In our view, Saudi's bumper debt sale not only augurs well for more conventional local and regional issuance in the next few years but also lays the groundwork

for the Kingdom's first-ever international Sukuk issue, a potential transaction that would be transformational for the entire industry and one that could occur as early as the first quarter of this year. Looking beyond the GCC, after a tough 2016, Malaysia looks an interesting market again. The country has always been known as a leading issuer of Sukuk since the inception of Islamic finance in the 1980s, but a decision last year by Bank Negara Malaysia to cut short-dated Sukuk issuances and switch to other liquidity management instruments had a significant impact on overall issuance. Malaysia too was caught up in a broad emerging market sell-down in the wake of US president-elect Donald Trump's win. In our view, there is a lot of value in the local currency exchange and profit rates, while news that Malaysia's biggest pension fund will offer Shariah compliant plans should also underpin demand for local Sukuk.

Another region to keep an eye on is Africa, where governments are increasingly exploring alternative options to help finance the continent's significant infrastructure needs. Last year, Ivory Coast issued their second Sukuk, following Togo's debut Islamic bond sale, while countries such as Nigeria and Kenya have issued new Sukuk regulations amid expectations that both will issue Islamic bonds in the not-too-distant future. We remain hopeful that further issuance will help develop the entire Sukuk industry outside of the traditional centers of the Middle East, Turkey and Southeast Asia.