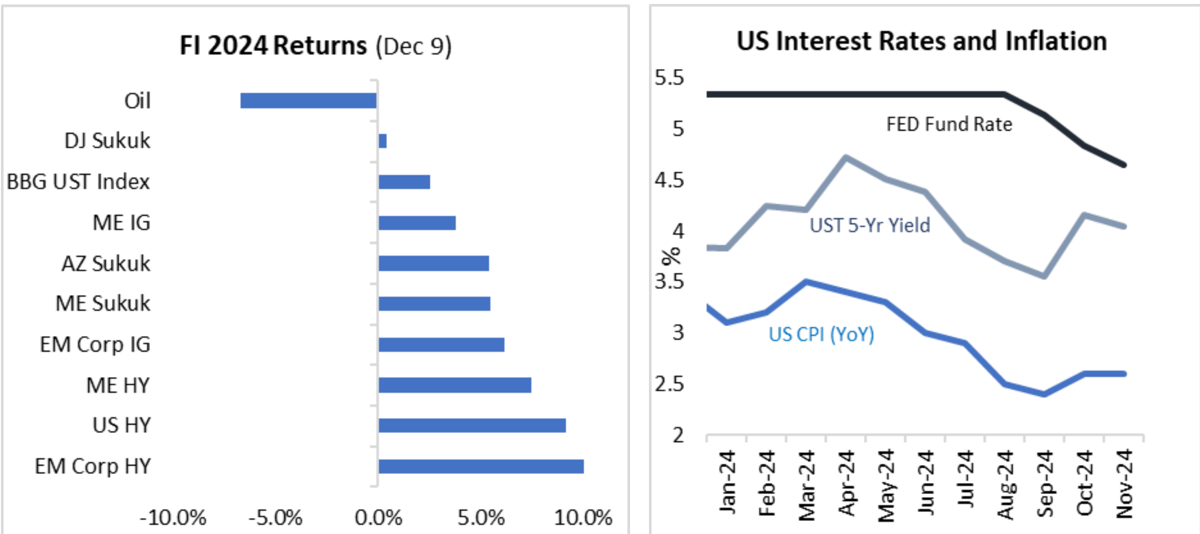
GLOBAL SUKUK OUTLOOK 2025

Market Backdrop

Notwithstanding the elevated volatility episode in early August, 2024 turned out to be a relatively predictable year for global fixed income investors. Going into the year, investor expectations, as highlighted by interest rate futures market, indicated that the Federal Reserve (Fed) would start cutting rates sooner rather than later and that the US economy would come under pressure after the Fed raised rates at a record pace in 2022-2023 to get a handle on elevated inflation. During the early part of 2024, markets did not move as forecasted as inflation continued to surprise on the upside while economic data continued to come in better than expected. This in turn stopped the Fed from cutting rates in 1H2024.

In comparison to 1H2024, markets' trajectory unfolded in a much more predictable manner during most of 2H24. Inflation took a decisive leg downwards while US jobs data began a negative turn in the job market. Consequently, the Fed surprised the market by delivering a 50bps interest rate cut in the September meeting with an additional 25bps cut in November. To an extent, the Fed rates cut had already been priced and longer dated US treasury yields trended higher in November driven in part by Donald Trump's decisive victory in the 2024 elections in early November.



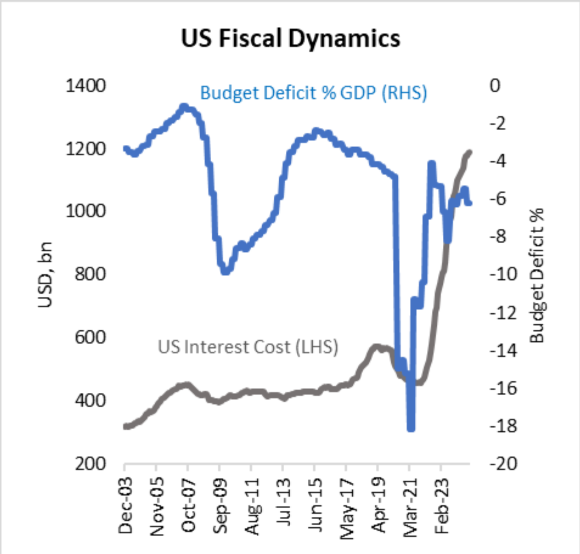
Source: Bloomberg

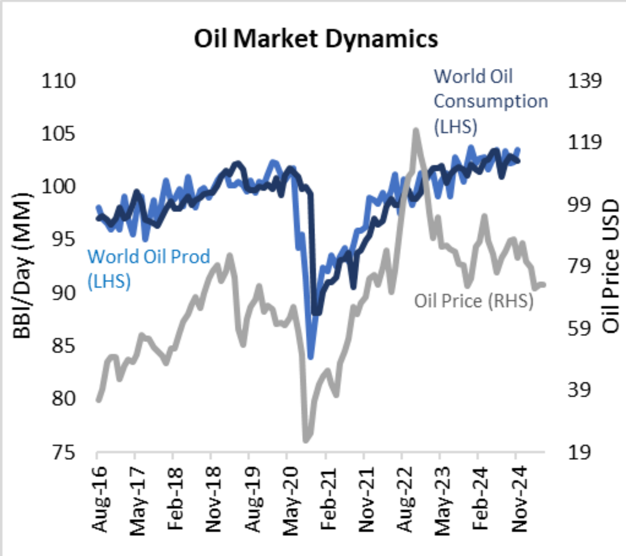
Compared to 2024, in 2025 we expect market volatility to pick up due to (i) to uncertainty surrounding policy implementation by the Trump administration on sectors such as trade, immigration and regulations, and (ii) elevated geopolitical risks highlighted by the continued US/China tension and the ongoing conflict in the Middle East. We expect the incoming Trump administration to take a hardline stance vis-a-vis

Iran which could have unforeseen ramifications on the oil market. However, despite rising uncertainty, we are comfortable in maintaining a constructive view on global fixed income, with high yield (HY) credit an area which can still exhibit positive returns and where we prefer subordinated debt. Current US bond yields provide fixed income investors with a degree of protection against volatility. Supported by the easing policies adapted by major central banks, we expect the global economy to maintain a steady state of growth in 2025 which should translate into low default rates and thereby translating into a positive environment for HY credit. We expect most of the returns to be generated from carry, as spreads already reflect the positive market backdrop. While we anticipate US government bond yields to remain stable in 2025, this stability could be accompanied by bouts of volatility, driven by shifting market dynamics and macroeconomic factors. We also expect the Chinese government to take more aggressive steps to bolster lacklustre domestic growth. This in turn should provide support to the global economy.

Rates and oil

We stay neutral on longer dated rates despite positive real rates and an easing monetary policy backdrop globally. We expect a higher floor on US government bond yields due to increased debt issuance driven by (i) tax cuts implemented by the incoming Trump administration, and (ii) higher defence spending as a result of elevated geopolitical risks. We also expect higher oil price volatility driven by elevated geopolitical turbulence in the ME. This would be as a result of aggressive policy posture adapted by the US on Iran and by the unpredictable consequences of events unfolding in Syria. In our view, markets are under-pricing the possibility of sustained hostilities in the region. The overthrow of the longstanding Baathist regime in Syria will have unpredictable consequences. Going by how events unfolded in Iraq, Egypt and in Libya post removal of long ruling leaders, we expect to see political turbulence in Syria for the foreseeable future. Given Syria's central location, we expect an adverse fallout on neighbouring countries with possible repercussion on regional oil supplies. As in 2024, we expect OPEC+ alliance to proactively manage oil demand/supply balance. We expect OPEC+ countries to rollover the recently extended production cuts to the second quarter of 2025. Over the medium term, we expect oil to trade in the range between US$70/barrel to US$90/bbl. We expect OPEC to increase oil supply in the event of event of a sudden spike in oil prices as OPEC does not want to see a global recession caused by higher oil prices. The alliance has spare production capacity which should come online should prices jump unexpectedly.



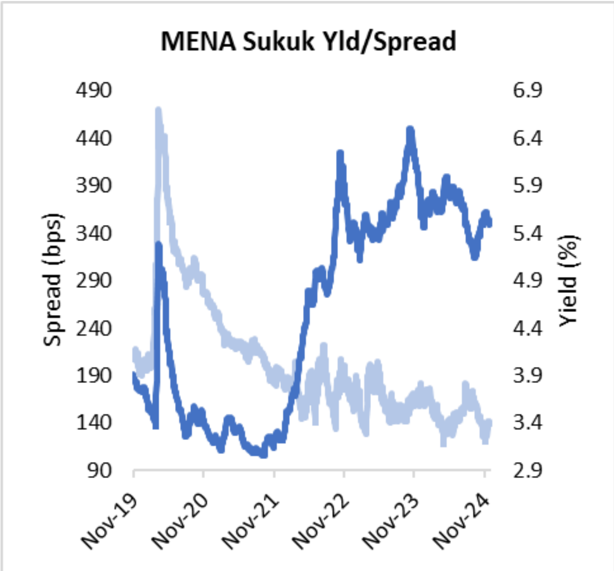


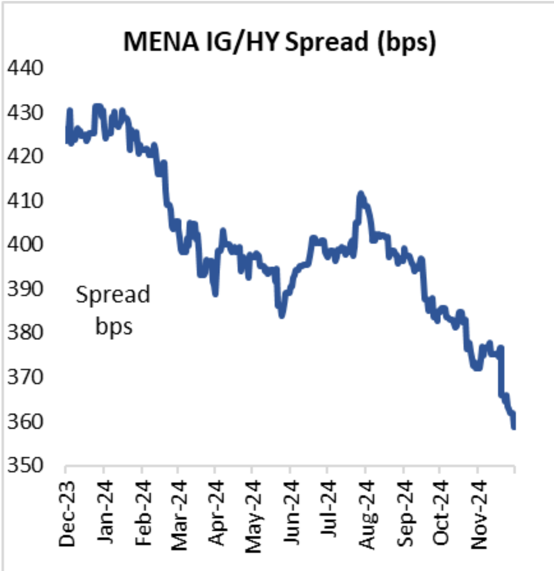
Source: Bloomberg

GCC credit

Defying the heightened geopolitical risk backdrop, GCC credit spreads have continued to tighten throughout 2024. We expect the GCC region to be largely immune to any negative fallout from developments in Syria or from an escalation in US hostility towards Iran. The region has good relations with all the global power centres as indicated by Abrahamic accords, Saudi reproachment with Iran, trade ties with China and OPEC+ alliance with Russia. Given the region's strategic location as well as its importance to global energy supplies, we expect global powers to do all that they can to ensure GCC stability. Moreover, even under an adverse geopolitical scenario, GCC countries are well positioned to support domestic economies given their strong fiscal and external buffers. Oil prices could rally as a result of unexpected escalation which can benefit the GCC.

GCC fixed income valuations, as indicated by credit spreads, reflect the upside and we see limited room for further tightening from current levels. The direction of US interest rates will likely determine the performance of investment grade (IG) credit. Within the GCC investment spectrum, we prefer HY over IG due to (i) yield pick on HY, (ii) supportive economic environment, and (iii) multiple refinancing sources available to HY issuers. We expect the credit profile of GCC issuers to be underpinned by the continued expansion of the non-oil sectors driven by the sizeable momentum achieved by regional economic diversification drives. Taking advantage of the oil windfall, GCC governments continue to expand public spending as part of strategic initiatives to lessen their reliance on the hydro-carbon sector. Reform programs have translated into an increasing expat population, improved consumer sentiment, higher consumer spending and rising private investment.





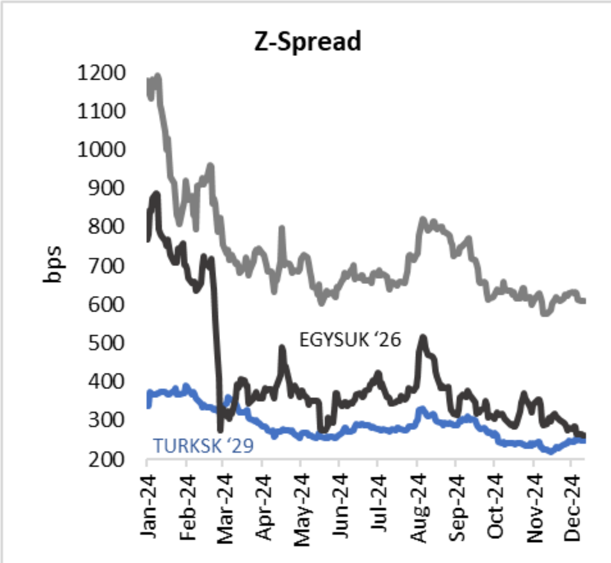
Source: Bloomberg

In terms of GCC sector allocation, we prefer to be overweight on bank bonds due to (i) their attractive spread pickup over sovereigns, (ii) sovereign ownership stake in banks and (iii) the stable credit outlook for the sector. We expect banks' asset quality indicators to worsen marginally because of slowing growth and loan seasoning. Profitability should stay strong thanks to loan growth and improvement in net interest margins, while continued automation and possible consolidation will drive operating efficiencies. We expect GCC banks to operate in a far more benign credit environment compared to global banks which are likely to face increased financial pressure as a result of the slowing economy. Healthy capitalization and high probability of government support, in case of need, continue to support banks' creditworthiness. Strong sovereign balance sheets increase the firepower of GCC governments to support banks and we expect to see continued ratings upgrades for the sector.

In the HY segment, we maintain overweight on bonds issued by real estate companies due to the yield pickup over IG bonds and stable issuer credit profile. From a fundamental perspective, we see continued momentum behind the UAE property market, but we expect the next 18 months to be less favourable than the last two years. In our view, the UAE real estate sector will continue to benefit from (i) economic reforms to attract further FDI for UAE's economic diversification, (ii) policy to attract HNWI to UAE bolstered by improving institutional framework and unmatched infrastructure, and (iii) low transactions cost and the ease of foreigners to buy UAE property in relative anonymity.

Non GCC HY sovereigns

HY sovereigns outside the GCC under our coverage, namely Egypt, Pakistan and Turkey, have generated strong gains in 2024. Some of the factors that have supported HY sovereigns in 2024 include improved risk appetite from the Fed pivot, expanding GCC cross border flows, greater willingness to impose macro policy tightening to reduce external funding gaps and IMF backstop. We expect these dynamics to persist in the near term although the upside offered on HY sovereign debt is much more balanced than that offered at the start of 2024.



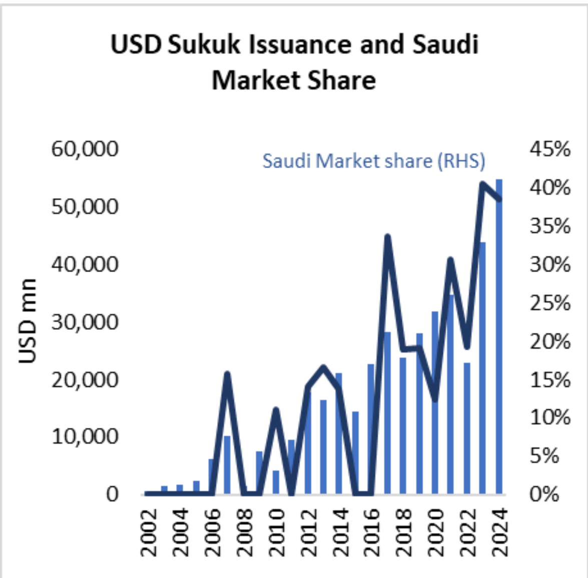
Source: Bloomberg

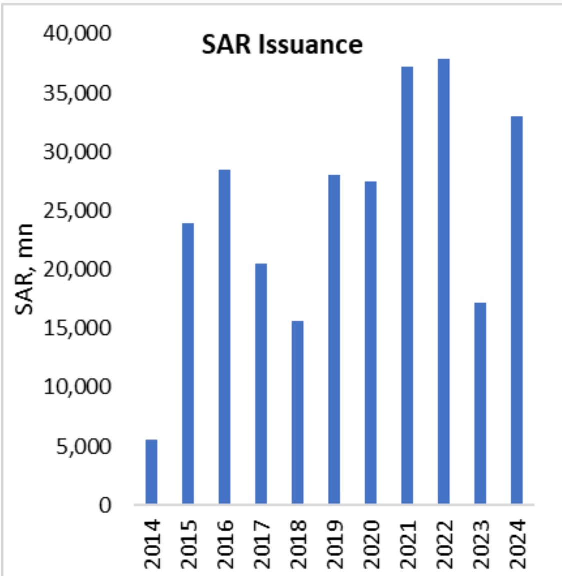
We expect GCC countries to maintain financial support for financial as well as strategic reasons. Geopolitical considerations have played a big part in driving financial flows by the GCC and by other entities to countries like Turkey, Egypt and Pakistan which are located close to geopolitical flashpoints. Swayed by the need to increase influence as well as to mitigate adverse fallout arising from Russia-Ukraine and Israel-Gaza conflicts, geopolitical rivals stepped in to provide support to either avoid a greater humanitarian crisis and/or to influence policy. The IMF support to Pakistan despite slow pace of reforms is an illustration of these developments. Most notable manifestation of a strategic foreign investment has been the US$35bn investment deal in Egypt's Ras El-Hikma by the UAE.

Although the outlook for HY sovereigns has improved, we take a neutral view on positioning and prefer to add on weakness. Egypt's financial prospects have greatly improved post announcement of the Ras al-Hikma investment and on continued support by the IMF. Despite external help, questions remain on the ability of the government to achieve sustainable macro-economic stability. The Egyptian government has a poor track record in boosting sustainable economic growth which among other things, requires raising domestic productivity, improving governance structures and ensuring a competitive domestic market. In our view, the pace of reform will be slow on this front.

Sukuk market trends

We expect to see continued mainstreaming of the fixed income sukuk asset class as a result of sustained expansion in sukuk issuances and market volumes and due to the attractive credit profile of sukuk issuers, as highlighted by the continued ratings improvement of sovereign sukuk issuers (Saudi Arabia, Oman, Egypt etc). We expect the record issuance volumes observed in 2024 to be sustained in 2025. We also note that issuance volumes have maintained record pace despite higher regional geopolitical risks. We expect growth in the sukuk market to be underpinned by Saudi Arabia's funding requirements. Saudi Arabia's unprecedented economic reforms coupled with transformational social change has proceeded at breakneck speed. The reforms announced in 2016 have gained traction over the last two to three years and, more importantly, proceeded far more smoothly than expected given the scale and pace of social change. In our view, Saudi economic transformation is in its earlier phase and the growth we have seen is structural rather than cyclical. A core pillar of the Saudi economic transformation is to reduce reliance on the hydrocarbon sector. The government aims to achieve economic diversification by ramping up infrastructure spending in non-oil sectors such as leisure, healthcare, tourism, and entertainment. Given that the Saudi economy comprises approximately 50% of GCC GDP, and that Saudi infrastructure quality significantly lags the infrastructure available in GCC peers, we expect a significant ramp-up in Saudi issuance to bring Saudi infrastructure to a level comparable to that of GCC peers. In our view, global investors, as recent trends highlight, will continue to support Saudi borrowing given that (i) Saudi bonds trade cheaply for the rating, and (ii) the credit fundamentals of Saudi issuers are likely to improve.





Source: Bloomberg

We also expect pickup in more Saudi local currency issuance based on the new set of regulations implemented by the Saudi Capital Market Authority in November 2024. The measures are designed to ease the requirements for debt and sukuk issuances. The rules should significantly lower transaction costs associated with bond and sukuk issuance. This in turn, should cause a jump in issuance volumes, particularly from the private sector whose participation is necessary in deepening the Saudi bond market. These measures should also boost foreign investment into Saudi bond markets. Foreign investors are increasingly drawn to Saudi Arabia's local currency bonds, thanks to the economy's size and growth potential. Greater diversity of issuers and larger issuance volumes will help to mitigate investment risks for foreign investors. Expansion of Saudi bond market should also make it easier for Saudi bonds to be included in global indices like JP Morgan's Fixed Income Index. As Saudi Arabia works to transform its economy and reduce dependency on oil revenues, the expansion of the debt market is essential. It provides companies with access to long-term financing, enhances corporate governance, and aligns with global best practices.

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