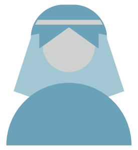

UAE - A DIAMOND IN THE SAND

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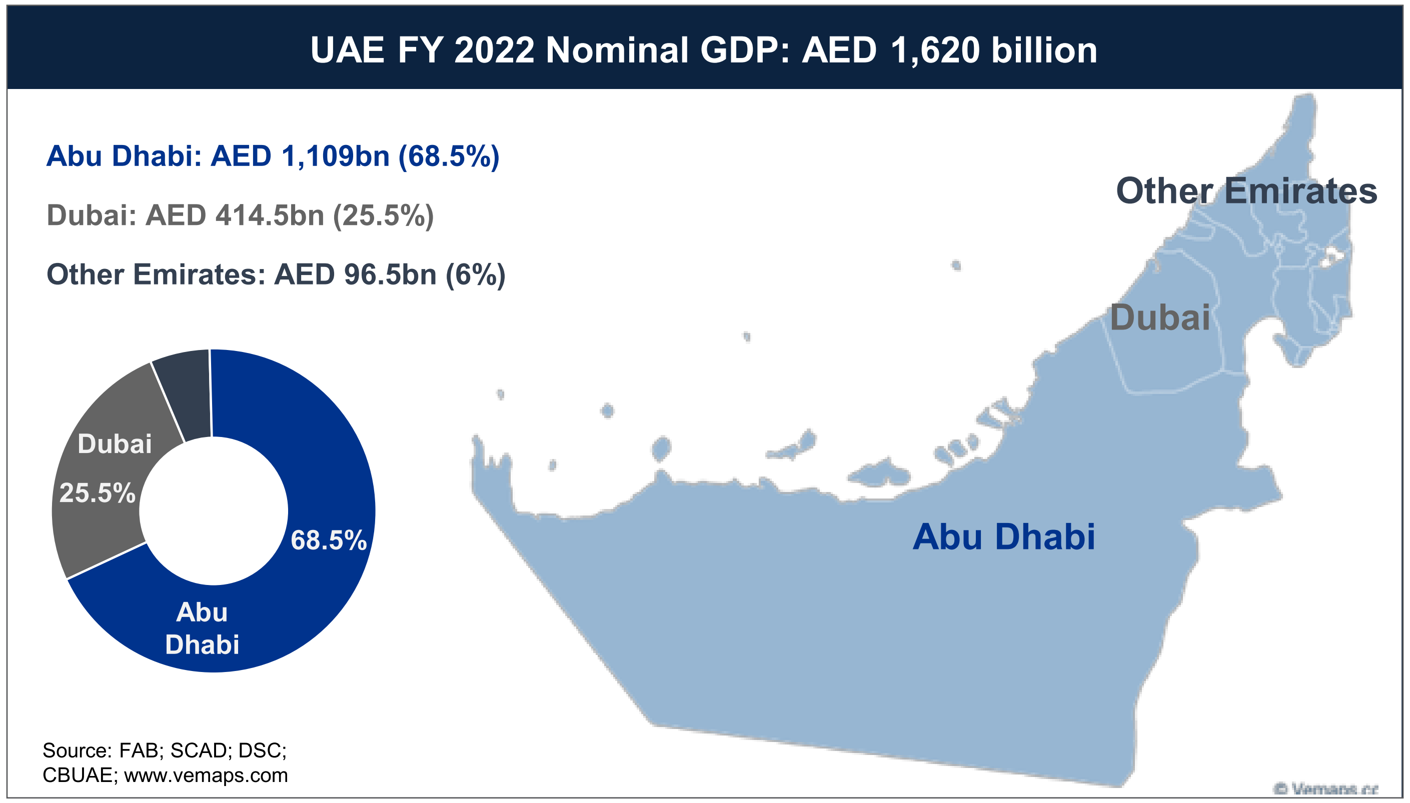
The United Arab Emirates (UAE) is an economic beacon against the backdrop of Middle East geopolitical complexities. With a GDP per capita exceeding that of Britain and France, the UAE is regarded as a hub for international business. Whether it be flagship industry leaders such as Emirates Airlines connecting more destinations than any other competitor globally, or DP World who now cover 11% of all shipping container traffic, the United Arab Emirates stands out as a "diamond in the rough". Just as a diamond's allure lies in its brilliance, rarity, and resilience, so do UAE bonds present investors with a unique blend of stability, growth potential, and a commitment to economic diversification within a global investment outlook.

This note delves into the facets that make UAE bonds a coveted gem in today's uncertain economic landscape.

Objectives

This study has three primary objectives. Firstly, it aims to analyze the various factors that make UAE bonds an attractive investment option in the current economic climate. Secondly, it assesses the historical performance of UAE bonds to provide investors with valuable insights. Lastly, this thesis offers practical recommendations and strategies to guide investors in their decision-making process.

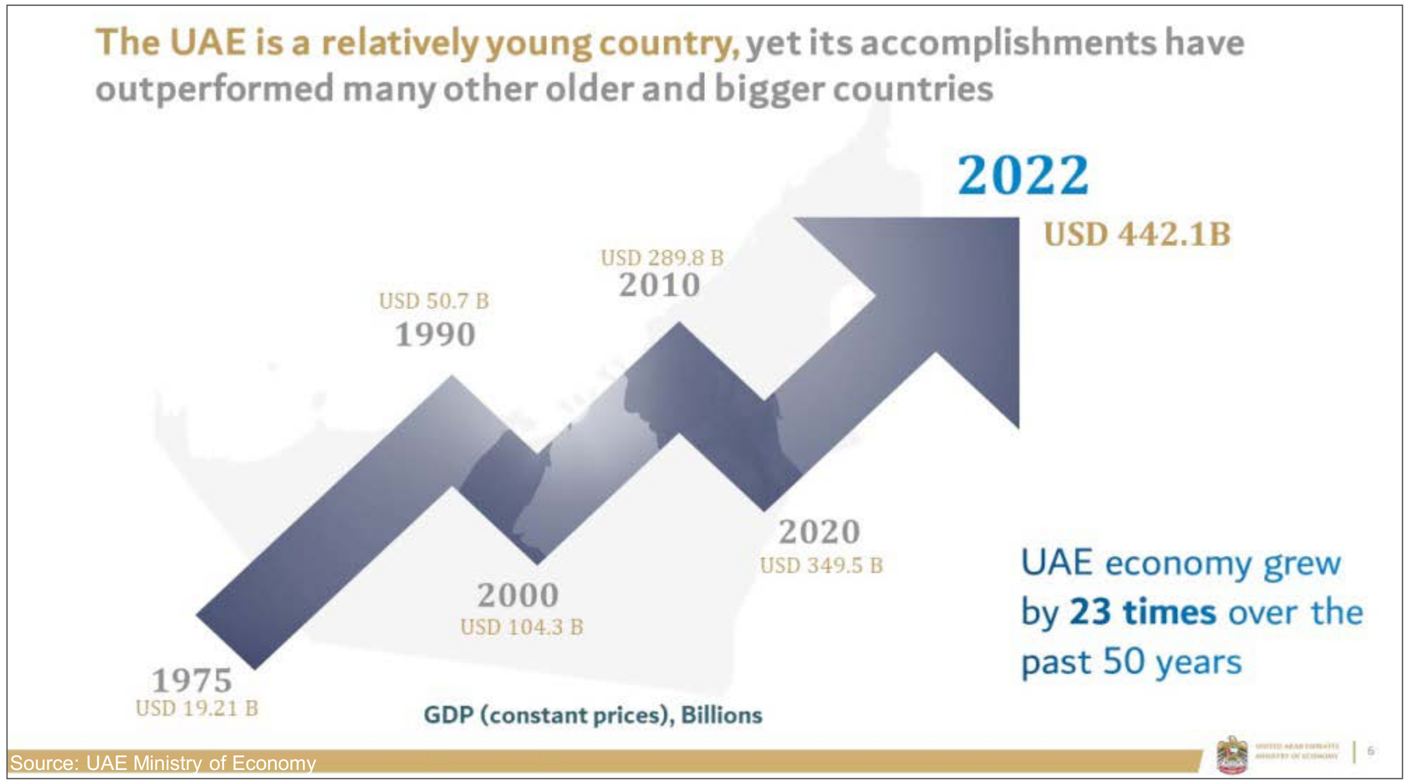


Source: FAB; SCAD; DSC; CBUAE; www.vemaps.com

Background and context

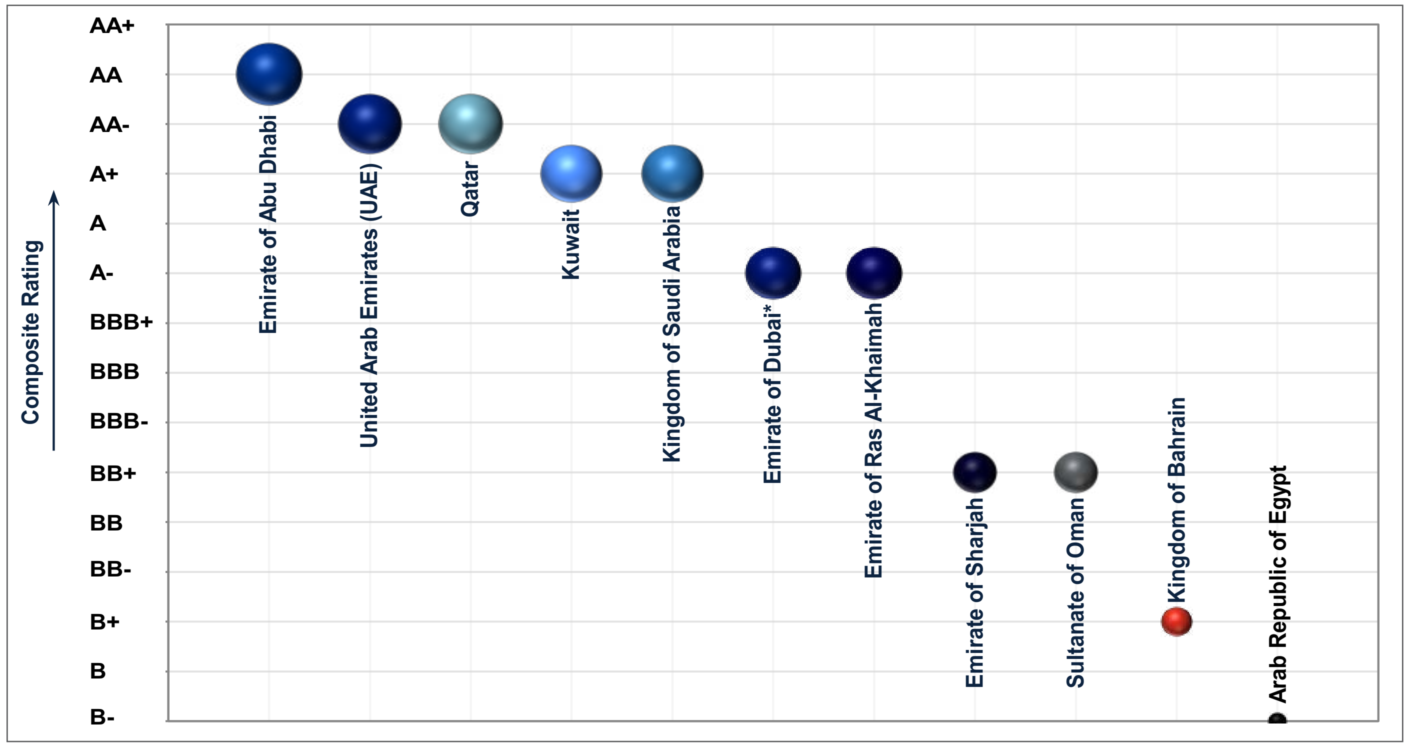
The UAE stands at the crossroads of the Middle East, where geopolitical complexities have recently been inflamed. Over the past few decades, the country has rapidly emerged as a center of economic growth and financial stability. Its strategic location, diversified economy, and robust financial infrastructure have made it an attractive destination for global investors.

Historically reliant on oil revenues, it has successfully diversified its economy through the "UAE Vision 2021" initiative, focusing on technology, tourism, and financial services. The government's proactive approach in promoting innovation and entrepreneurship have fostered economic stability and growth. Adopting prudent fiscal policies ensures sustainable growth and fiscal discipline, bolstering investor confidence.



Source: UAE Ministry of Economy

The UAE has the highest credit rating amongst the GCC countries, at AA-/Aa2 from Fitch and Moody's, underpinned by its strong net external asset position, and robust economic outlook. The rating is also a reflection of the Emirate of Abu Dhabi's solid credit rating – AA/Aa2/AA by S&P/Moody's/ Fitch. Fitch Ratings sees Abu Dhabi's Sovereign Net Foreign Assets (SNFA) to GDP ratio growing to 200% of GDP (USD 605 billion) by 2025 end, from its estimated 187% (USD 582 billion) at the end 2022. Official government figures showed Abu Dhabi's Nominal GDP was AED 1.1 trillion (USD 302 billion) at the end of FY 2022, contributing around 69% of UAE's Nominal GDP, which was AED 1.620 trillion (USD 442 billion) in 2022 with a real GDP growth of 7.9%.

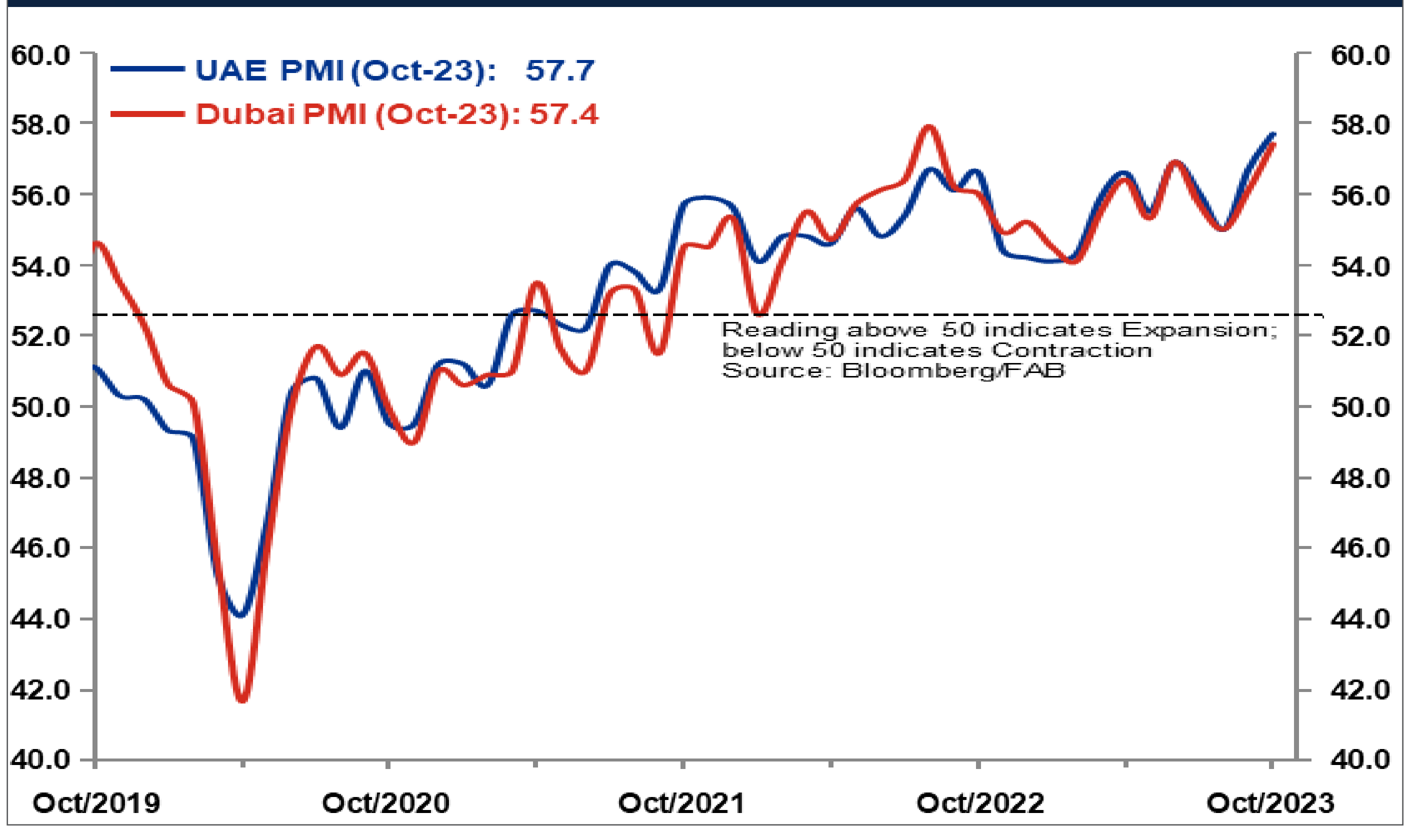


Notes: The ratings mentioned here are composite credit rating for each issuer; *Dubai is not rated by any rating agency and we have assigned a proxy rating of 'A-' based on its fundamentals and a relative comparison with Dubai GREs like DP World (BBB+/Baa2), DEWA (Baa2), JAFZ (Baa2) and Emaar Properties (BBB/Baa2) and other emirate like Ras-Al-Khaimah (A-/A); Source: Bloomberg/FAB

We expect the UAE's GDP to expand by 3.7% this year and 4.0% in 2024, with the non-oil economy being the main driver of growth, while the oil sector is foreseen to contract year-on-year, due to oil production cuts and lower realized oil prices as compared to 2022.

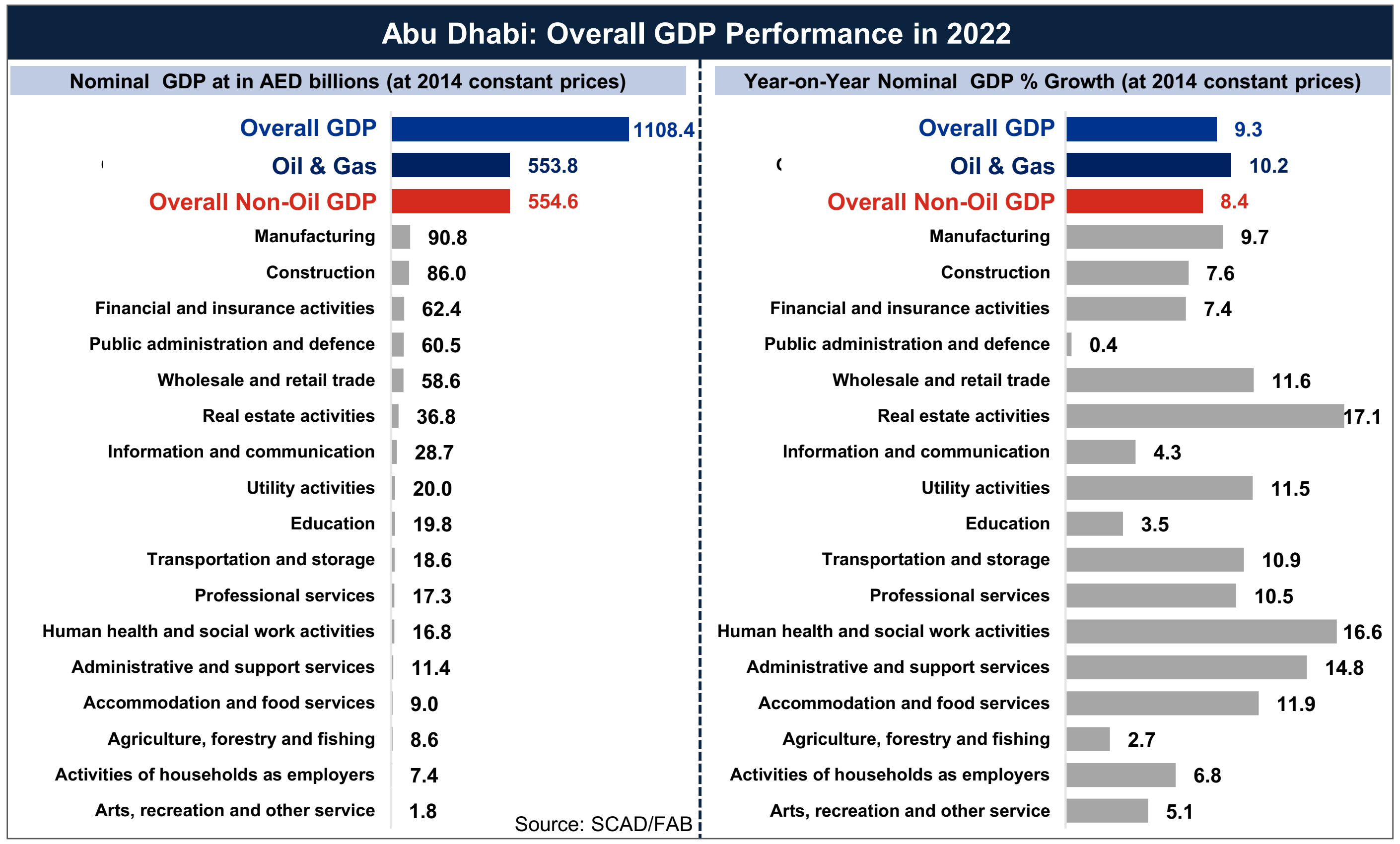
UAE's non-oil PMI indicators suggest solid underlying momentum, as the headline PMI is running above 50 (indicating expansion in activity) since December 2020. The PMI reading in October surged to 57.7, the highest in more than four years, supported by strong demand seen by business through new client acquisitions and more project work. Indeed the new orders sub-index rose to 65.2 in October, also the highest since June 2019, while the output sub-index of the PMI advanced to a four-month high at 63.1.

Solid momentum in non-oil activity

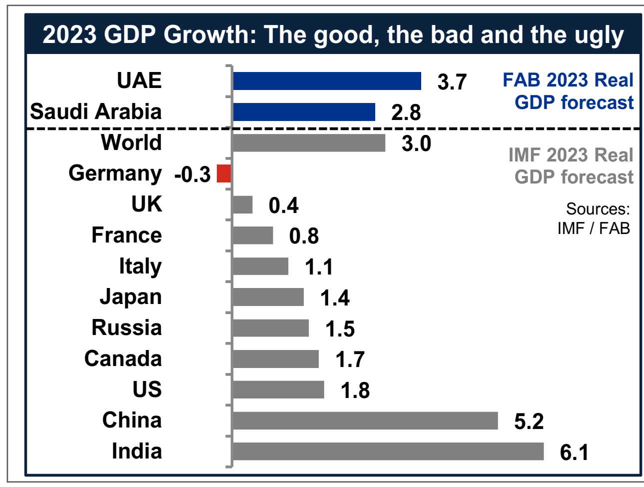


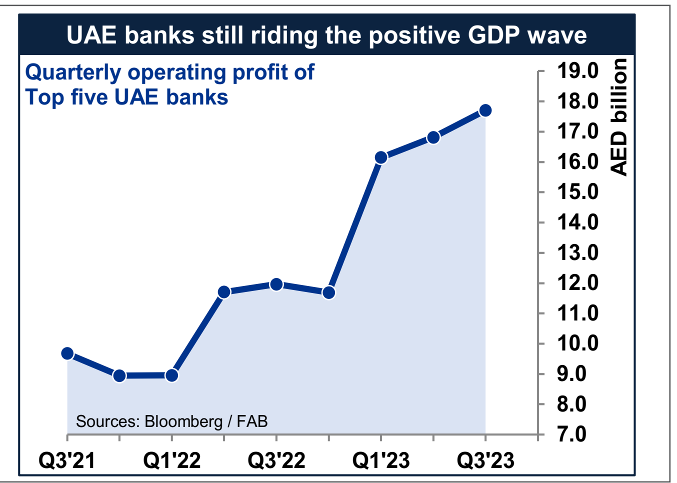
Dubai, which contributes around 25% to UAE's GDP, is predominantly a non-oil economy and is experiencing strong business momentum, particularly in services, retail, tourism, real estate and construction. This has also helped the emirate to deleverage substantially in the past two years.

Contrary to the wider perception (outside GCC) that Abu Dhabi is mainly an oil economy, non-oil activity contributes 50% of Abu Dhabi's GDP. Abu Dhabi's non-oil economy is also witnessing strong underlying momentum. Abu Dhabi's overall economy grew by 3.5% annualized rate in Q2 2023 and 3.8% in Q1 2023. Abu Dhabi's non-oil sector accelerated 12.3% YoY in Q2 2023, while QoQ growth was 5.5%. Non-oil GDP contribution was 53.7% in Q2 2023.



When we compare the UAE's 2023 expected GDP growth to the GDP growth elsewhere, the UAE is clearly well positioned which is also reflected in several corporates results.



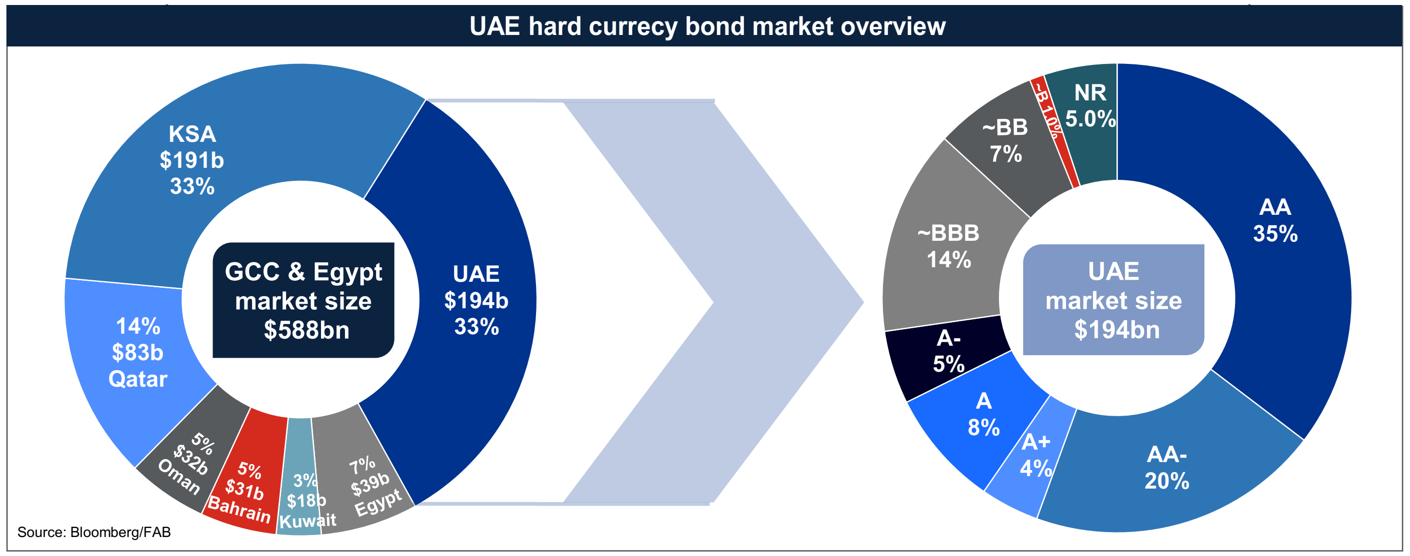


Bond market dynamics

Traditionally, money managers prioritize capital protection and liquidity over risk-adjusted returns. Post the Global Financial Crisis, low interest rates prompted a shift towards higher-yielding investments, such as equities, benefiting from low volatility and negative correlation with government bonds. However, the financial landscape is evolving, marked by prolonged higher interest rates, unpredictable economic cycles, and a positive correlation between stocks and bonds.

The changing investment landscape calls for a reassessment of asset allocation and diversification strategies. In this shift, fixed income takes on a crucial role, not just for capital preservation but also income generation. UAE investment-grade sovereign debt in hard currency is highlighted as a reliable asset class, historically demonstrating stability and resilience during market volatility. This suggests its potential as a strategic component in diversified investment portfolios.

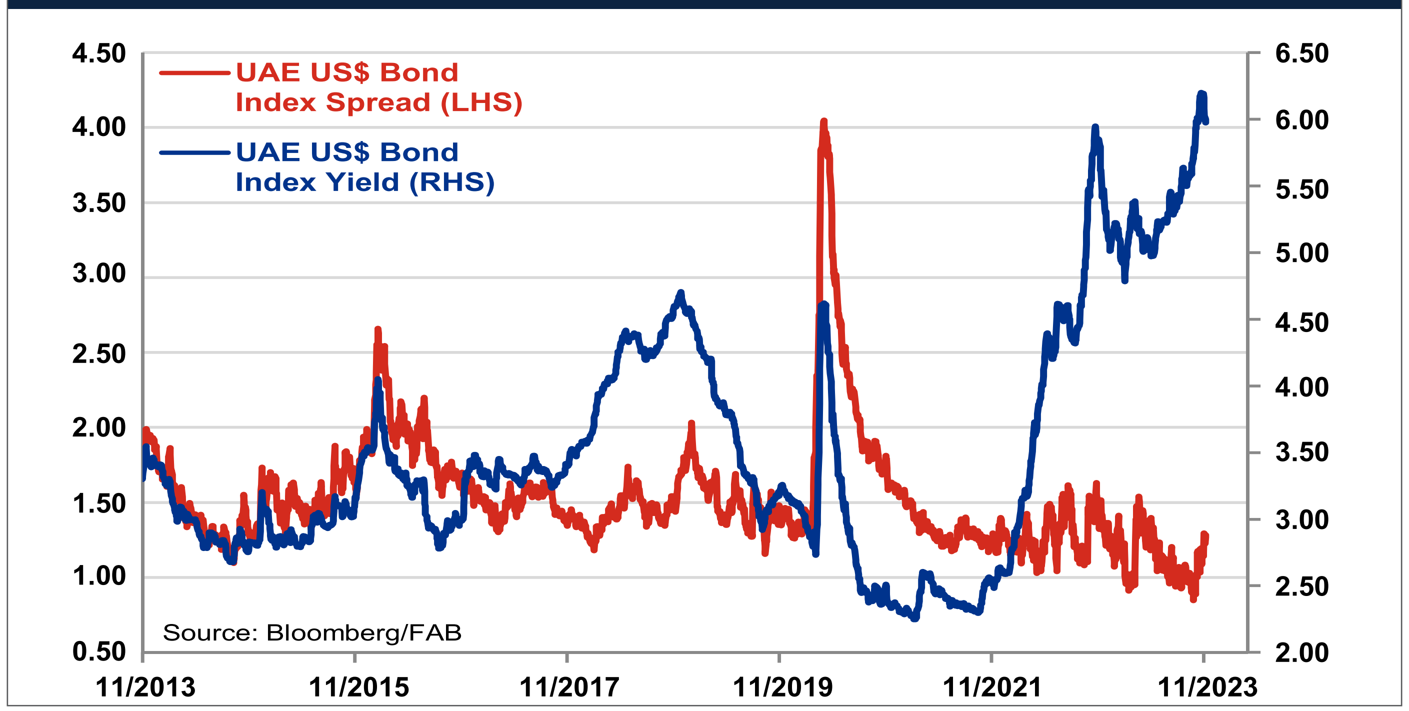
As of Sept 2023, the UAE's hard currency bond market reached USD 194 billion, predominantly denominated in USD (94%). The UAE holds a 33% market share in the USD 588 billion GCC & Egypt hard currency bond market. With over 50 issuing entities, the UAE boasts the most diversified market in the region. The composition includes sovereign papers (33%), government-related entities (35%), financials (27%), and private corporates (5%). Notably, 55% of UAE bonds carry 'AA/AA-' ratings, affirming a strong credit standing in the international market.



Due to robust credit fundamentals and a diverse investor base, we maintain a positive outlook on UAE credits for 2024. We expect the UAE's economy to stay resilient and outperform emerging market economies.

Current all-in yields are at a decade-high, making UAE credits attractive on a relative value basis in the emerging markets credit universe. Anticipating a tapering of long-term US Treasury yields in 2024, we expect UAE credits to deliver positive total returns in 2024.

UAE carry yields stay attactive



In 2024, the UAE faces nearly USD 20 billion in bond maturities, ensuring a steady supply in the primary market and sustaining activity in the secondary market, thereby bolstering liquidity. The region is also witnessing a surge in sustainable bond issuance, as issuers are aligning their framework with the UAE's net-zero commitments. Around USD 19 billion of ESG bonds issued year-to-date, compared to USD 8.5 billion in FY 2022. The current ESG bond market in GCC&E is estimated at USD 39 billion, with the UAE contributing USD 18 billion, holding a significant 45% market share.

UAE dirham bond market

In 2018, the UAE enacted a public debt law enabling the Federal Government to issue bonds through the Ministry of Finance (MoF). The goal was to build a strong domestic debt market, introducing a local currency bond market, that would complement the thriving Eurobond market. The UAE issued its first Federal bond in USD in 2021 and followed by a debut Dirham Treasury Bond (T-bond) in 2022.

The first T-bond auction was a huge success with 6.3x oversubscription for a two-tranche (2Y & 3Y) issue, each worth AED 750 million. Since then, with the help of its authorized primary dealer banks – FAB is proud to be one of the main dealers – the MOF has come a long way in establishing a dirham yield curve with regular auctions, with orders significantly outweighing allocations due to huge demand. Following on from the success of its debut auction, the MoF issued its first 5-year T-Bond in September 2022 and is now regularly doing auctions for the 2, 3 and 5-year tranches and expected to launch longer tenors soon.

The MoF expanded the dirham bond issuance program to the Islamic finance segment this year to support the growing demand from investors who have a Sharia mandate. The MoF auctioned its debut Dirham Treasury Sukuk (T-Sukuk) in May 2023 by issuing 2-year and 3-year dirham sukuks worth AED 550 million each and the auction was 7.3x oversubscribed with combined bids of AED 8.3 billion. The 5-year T-sukuk tranche was introduced in August 2023.

The MoF has indeed successfully executed its strategy in establishing a dirham yield curve, enabling other UAE entities to use it as a pricing benchmark for dirham bonds Some major dirham bonds issued in 2023 were: Emirates NBD's 3-year AED 500 million bond; Emirates Islamic Bank's AED 2.5 billion 5-year sukuk; FAB issued the first green dirham sukuk through an AED 1.3 billion 3-year note; and Abu Dhabi's Mamoura Diversified Global Holding issued an AED 750 million Regulation-S dirham bond. We expect more local issuers to tap the dirham bond market in 2024, exemplifying the overall stability within the UAE.

Yield and risk analysis

Over the past decade, the UAE's sovereign debt has roughly doubled in size and the economy has expanded exponentially more than other similarly rated developed market economies. This growth has not been solely the result of increased government spending. The gross government debt remains below 35% of the GDP (gross domestic product), whereas advanced economies have consistently exceeded 100% in this regard.

The robust economic growth in emerging markets also leads to a higher number of net creditor countries. Taking into account, and the latest projection of the UAE's international investment position, the total net foreign assets minus foreign liabilities for investment-grade sovereigns included in the JP Morgan Globally Diversified Emerging Market Bond Index (EMBI) amounts to USD 2.5 trillion.

Yields on investment-grade UAE bonds still remain at attractive levels in our assessment. Negative net issuance of UAE external debt is anticipated, which should exert upward pressure on the prices of existing bonds. Consequently, this asset class appears to be one of the few fixed income opportunities where one can invest in growth at a reasonable price.

UAE Federal Govt Outstanding Eurobonds (Source: Bloomberg)

Security	Currency	Matrurity	Amount Outstanding ($ million)	Coupon	Mid Yield	Mid Price	ISIN
UAE 10/31 7.9Y	USD	19-Oct-31	1,000	2.00	4.859	81.443	XS2397053757
UAE 7/32 8.6Y	USD	07-Jul-32	1,750	4.05	4.844	94.46	XS2492384818
UAE 9/33 9.8Y	USD	25-Sep-33	1,500	4.92	4.869	100.364	XS2684502623
UAE 10/41 17.9Y	USD	19-Oct-41	1,000	2.88	5.56	69.811	XS2397083820
UAE 7/52 28.6Y	USD	07-Jul-52	1,250	4.95	5.625	90.459	XS2492385203
UAE 10/61 37.9Y	USD	19-Oct-61	2,000	3.25	5.457	64.806	XS2397055703

Abu Dhabi 5-year CDS spread (in basis points)

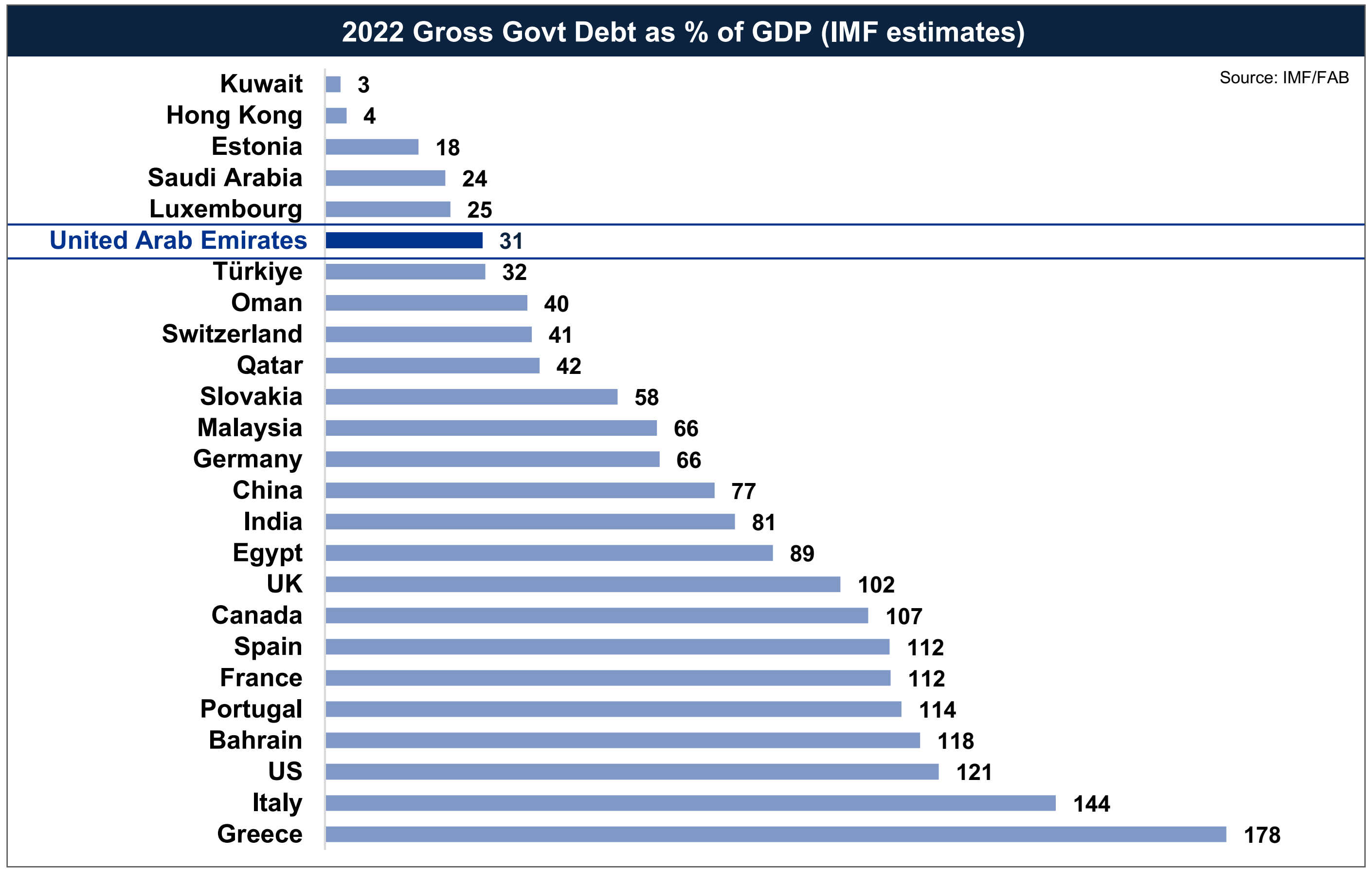
UAE's role in regional stability

The UAE's geopolitical stability is an important factor in its attractiveness as an investment destination. The UAE has positioned itself as a hub of stability. Its foreign policy is characterized by a commitment to peaceful coexistence and diplomacy, which has contributed to its reputation as a safe haven in the region. This geopolitical stability is a significant draw for investors looking to minimize geopolitical risks in their portfolios.

Future prospects and recommendations

In the context of managing inflationary environments, Emerging Market (EM) countries took the initiative to raise interest rates first and are currently implementing rate cuts ahead of Developed Market (DM) nations. This is expected to have a positive impact on EM debt yields. Additionally, the IMF is prepared to fulfill its role as a lender of last resort, with funds that are likely to be used for refinancing sovereign debt, providing an additional favorable factor for the region.

The UAE's debt market reflects a healthy outlook for its growing economy, characterized by low levels of indebtedness and a net creditor status. UAE hard currency sovereign debt presents an attractive risk-to-return proposition when compared to other asset classes under various economic scenarios. We believe it should hold a significant role in asset allocation considerations.



Conclusion

To conclude, in this era of financial globalization across the financial services industry, the UAE is now truly recognized as a major financial center on the world stage. Its success is evidenced by the growth and maturity of the local capital markets over recent years, as global investors have come to recognize the returns and stability that UAE bonds offer, indeed many have established or are planning to establish local offices giving testament to the allure of the UAE as a financial hub.