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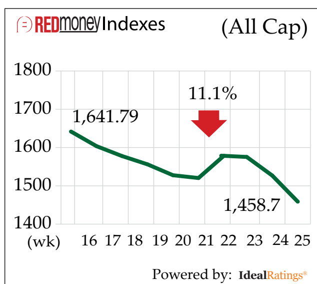

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Sukuk issuance could stall amid rate hike rampage

The past week has seen a slew of rate hikes from central banks desperate to control spiralling inflation — sending global stocks tumbling, and bond markets into turmoil. As yields soar and corporate bond funds see a mass exodus of investors, what impact will the latest macro pressures have on Sukuk issuance? LAUREN MCAUGHTRY explores.

It was a rough week last week. The Federal Reserve (Fed) hiked their rate by an expected 75bps, while the UK monetary policy committee followed with a further increase to hit its highest interest rate in 13 years, and in a surprise move, the Swiss central bank followed suit: with an unexpected 50bps hike (for the first time in 15 years) to bring its long-term negative base rate ever closer to zero — a sure-fire sign that the central banks are seriously concerned. With inflation running at record levels, their concern is unsurprising — but the jumps have sent global markets jittery, with both stocks and bonds sliding.

Global equities slid their fastest in two years last week, while bonds saw investors flee. The S&P 500 is down over 11% month-to-date, while the S&P 500 Shariah Index has fared little better, losing -10.77% over the same period, -5.6% of which was over last week alone. And we should expect worse to come.

"Fed Chair Jerome Powell this week took the podium in a very weak position," said Franklin Templeton Fixed Income CIO Sonal Desai in a recent briefing. "The Fed had badly mismanaged communication ahead of this week's Federal Open Market Committee (FOMC) meeting: it had telegraphed a 50bps hike but at the last minute signaled the larger 75bps hike it then delivered — and which had therefore been largely priced in by markets. Upside surprises on headline Consumer Price Index and inflation expectations had badly shaken the credibility of FOMC forecasts and of the moderate policy tightening that had been foreshadowed in last month's meeting.

"The FOMC outcome was a timely reminder that economic data eventually rule the day. In my view, the post-meeting press conference delivered a clear warning that investors should be prepared for further hawkish surprises."

But what is this market turmoil going to do for future Sukuk issuance? We have already seen a number of issuers jump in over recent weeks, despite the poor market conditions, trying to take advantage of the strong appetite and high demand before the Fed raised its rates — something it is likely to do again in July and throughout the rest of the year, while the European Central Bank has also strongly indicated that it intends to pursue an aggressive quantitative tightening policy including a substantial rate hike in July and again in September. Could we be going from bad to worse?

A handful of issuers appear to believe so. Despite the dearth of issuance out of the GCC, Sharjah's Arada Developments raised US$350 million in its debut issuance at the beginning of the month, while in Malaysia, national mortgage corporation Cagamas slid in just before the bell on the 20th June to close a RM100 million (US$22.71 million) three-year private placement priced just ahead of the FOMC meeting — thus

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locking in a significantly better rate (40bps above corresponding government papers) than it could have expected to achieve post-hike.

"The transaction was successfully priced ahead of the widely expected further interest rate hike by the Federal Reserve in its efforts to contain inflation," confirmed Cagamas CEO Chung Chee Leong. "The Fed later announced an increase of 75bps in interest rate, the largest increase since 1994."

> ***"The transaction was successfully priced ahead of the widely expected further interest rate hike by the Federal Reserve in its efforts to contain inflation"***

But what does this mean for future issuers? Despite relatively low inflation rates compared to the developed world, Malaysia unexpectedly raised its own interest rate 25bps to 20% in May this year to head off rising inflation, while Indonesia is expected to follow suit. "We expect Bank Indonesia to lift the benchmark policy rate by 25bps to 3.75% at its June meeting. Much like the situation in the rest of Asia, expectations around future inflation will be key in shaping this month's decision," said Steve Cochrane, the chief APAC economist at Moody's Analytics.

"Although consumer inflation has trended north of 2% since the start of this year and core price pressures have gained some pace, headline inflation at 3.6% y/y [year-on-year] in May remained below Bank Indonesia [BI]'s target ceiling of 4%. There is some room to extend the current policy rate of 3.5% for a month or two. But it is increasingly likely that BI will take a stronger view on the expected inflation trajectory following the Federal Reserve's decision to increase interest rates more aggressively in June. This will likely budge BI from its pandemic-induced low interest rate regime and see it adopt earlier-than-planned rate normalization."

Cochrane

Most GCC countries (apart from Oman) also followed the Fed this month with increases of their own — unsurprisingly, as most of their currencies (apart from Kuwait, which is a basket) are pegged to the dollar.

These movements, despite positive economic growth, are likely to have an inevitable impact on Sukuk issuance, as issuers hold back from an expensive cost of funding and wary investors withdraw their appetite in uncertain circumstances. S&P Global Ratings forecasts total Sukuk issuance will decline in 2022, compared with a stabilization at US$147.4 billion in 2021, versus US$148.4 billion in 2020.

"We note the total volume of issuance was down 23.2% and foreign currency denominated issuance increased 12.3% in first-quarter 2022, after some issuers frontloaded their plans to benefit from market conditions prior to interest rate rises. Many of these issuances were either from low-rated counterparties or in the form of capital-boosting instruments. Despite the decline in volumes, we expect Sukuk issuance to still exceed Sukuk maturing in 2022, which we estimate at about US$96 billion," predicted Dr Mohamed Damak, the global head of Islamic finance, speaking to IFN.

Dr Mohamed

However, Sukuk could still see an easier ride than other segments of the market, particularly conventional corporate bonds.

"Tighter financial conditions are starting to impact global Sukuk issuance in a meaningful way," agreed Mohieddine Kronfol, the chief investment officer of global Sukuk and MENA fixed income at Franklin Templeton Investments. "Issuance YTD[year-to-date] is running about 15% below last year, similar to global emerging markets, but significantly better than other sectors, like the GCC for example, where we see declines greater than 50%.

"Our fund, and the global Sukuk market generally, has weathered this drawdown well. Global Sukuk's defensive characteristics have stood out once again, declining about a third of the decline of emerging markets, benefiting from higher quality issuers and higher oil prices, no direct exposure to Russia and Ukraine, and modest duration.

Mohieddine

"We have made a conscious effort to increase sovereign exposure at the expense of corporates, high quality at the expense of high yield, while reducing our elevated cash levels by investing into longer-duration Sukuk," Mohieddine revealed to IFN.

And not everyone is pessimistic. Salman Ahmed, a partner at Trowers & Hamlins, is hopeful for the rest of the year. "In my view, there would not be a decline in issuance because the Sukuk market and its participants have matured and gone through various ebbs and flows of the market over the last two decades. That has created resilience and commercial nous within the key players. New avenues such as ESG-compliant Sukuk are being explored so the market will adapt," he told IFN.

"The increased oil prices have improved the outlook and credit ratings of most of the GCC countries, which were downgraded during the COVID-19 times, so any upward change in the pricing is likely to be offset by improved credit ratings."

Salman