

The Next Phase for Global Sukuk



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The main characteristics of global Sukuk are solid returns with low volatility and low correlation to other assets. They offer unique return profiles with important diversification benefits and significant risk-adjusted returns. For Shariah-compliant investors, we think it is very straightforward to invest in global Sukuk.

At 2%-plus volatility, the stability of returns from global Sukuk has been quite remarkable and it has been the case for a number of years. Part of the reason is the function of the Sukuk index (the Dow Jones Global Sukuk Index) itself. It has a lower duration as compared with many other bond indices. Constituent Sukuk are also denominated in US dollars. As such, they do not have foreign exchange (FX) risks. In addition, the global Sukuk market is anchored by long-term, buy-and-hold Islamic institutions and Islamic banks and that have repressed the volatility of the asset class.

On the whole, the size of the global Sukuk market has grown from US\$39.5 billion¹ in 2005 to US\$442.2 billion¹ as of Dec 31, 2017.

Today, we have more sector representation across the board in global Sukuk, and they are increasingly included in benchmark bond indices.

Investors today are increasingly worried about rising rates and risk assets. Investors can take comfort that Sukuk, as measured by the Dow Jones Sukuk Index, have provided downside protection as compared with major global fixed income benchmarks over the past 10 years [from March 2008 to February 2018]. The market conditions that have been supporting the global Sukuk market remain intact. We expect the asset class to continue to grow and deliver strong risk-adjusted returns due to their low volatility.

DEBUNKING MYTHS OF GLOBAL SUKUK

There is a general misconception that the Sukuk market is not that liquid and that Sukuk investors may not be able to buy and sell or trade in and out easily, and that active management may be compromised. I would generally disagree with that.

The liquidity of the global Sukuk market has in fact been improving over the years.

There are more issuances, bigger issues and a wider acceptance of Sukuk. I think liquidity in the Sukuk market is in line with that of other fixed-income markets.

For our part, we have been actively managing relationships with brokers. We have our own liquidity scores and we have always been very conscious of liquidity risk.

The bulk of our funds can be liquidated in a relatively short period of time. If you look at the turnover of our funds, the numbers are very healthy and totally consistent with an active strategy.

Many investors tend to associate Sukuk with oil-exporting countries such as those in the GCC region and Malaysia. So it is very difficult for people to believe that the correlation of Sukuk to oil prices is very low. But the evidence is in front of us. Sukuk's correlation to oil prices has been low over both short and long timeframes. Part of the reason is sovereign issuers in the global Sukuk space have significant financial buffers, which give them sufficient time to properly implement policies. That keeps the correlation [of Sukuk and oil prices] quite low. This is good news for Sukuk investors, who do not have to worry about oil prices.

AN IDIOSYNCRATIC RISK EVENT

Dana Gas, an oil and gas company operating in Egypt and Kurdistan, which had undergone restructuring in late 2012, defaulted on its Sukuk payment obligation in October 2017, claiming that its US\$700 million Sukuk were unlawful and not Shariah compliant

While that unfortunate event has left a sour taste in many people's mouths, it would be ridiculous to say that investors are losing faith and confidence in the

1. Source: Bloomberg LP as of 31 December 2017

global Sukuk market due to the default of Dana Gas. There is no way you can project one story onto a US\$450 billion global Sukuk industry. This is an idiosyncratic risk.

Since the default of Dana Gas, the market has moved on with US\$10 billion of Sukuk issued since October 2017 across the spectrum, including high yield corporate issuances. The reality is that the Sukuk market is more widely accepted, more mainstream and you see more people invested in it today. The [default of Dana Gas] is not something one can use to discredit the Sukuk market.

INTEREST RATE RISK AND OUTLOOK

More investors are now concerned about higher interest rates and inflation. But in our view, inflation isn't likely to pick up significantly. So we are not that worried about long-term rates rising very rapidly. As such, we are positioning our portfolios for higher short-term rates and an additional flattening of the yield curve. For credits, we would like to increase our corporate exposure. Many of the companies that we are looking at are starting to see improved fundamentals. This will continue.

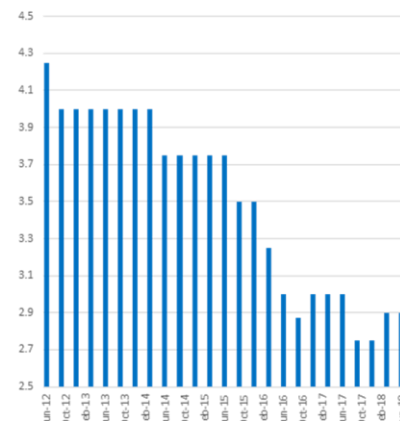
For many of the Sukuk-issuing countries, they are at a different stage of the credit cycle as compared with developed markets. We have been defensive over the past 12 to 18 months. But now, we are looking to increase portfolio risk. GCC governments have reduced spending in response to lower oil prices and many GCC economies are now on a more sustainable footing. For the first time after three years, we are starting to see many of these GCC government focusing on growth again.

Interest Rates Waiting for Inflation

Fed Funds Rate vs 10 Year US Rates



Estimates of Potential Growth Declining



Source: Bloomberg, Federal Reserve: Longer-Run Fed Funds Rate Median Projection From Summary of Economic Projections, as of June 2018. There is no assurance that any projection, estimate, or forecast will be realized.

Outside of the GCC, there have been very positive developments in countries such as Indonesia and Malaysia, both of which have taken the right monetary and fiscal policies. And that has been reflected in their growth numbers and currencies. Nigeria and West Africa have also benefitted greatly from commodity uplifts, which constitute a window to rebalance economies to sustainable, more diversified growth paths. For currencies, we are seeing value in those of Malaysia, Indonesia and Nigeria, among others.

Looking ahead, we expect to see more growth and more issuers. Clients are going to be demanding more customised portfolios and we are going to see more Shariah-compliant risk management tools. We are going to see more standardisation, transparency and governance around the structures of Sukuk.

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