From the Editor

More than ever in recent months, investors now have reason to wonder where next for financial markets, very much on shifting sands, given the increasing dislocation between asset prices based on relentless outpourings of dollar liquidity and the trend of what are usually called economic fundamentals.

Despite the potential calamity of the US’s dysfunctional debt ceiling negotiations, the dominance of its policy leadership has been revealed for all to see. Developed-economy blocs may only just be escaping chronic stagnation, in terms of generating jobs anyway, but emerging markets have shown their acute vulnerability to international funds flows.

So much rests on the realities and interpretations of (the persistence of) the extraordinarily easy monetary policy on which the US itself appears to depend -- with bond markets showing themselves to be scared of the potential tapering of QE, now abandoned for the moment owing to the Fed’s own frightened reaction. Is there conceivably a way out?

Meanwhile, Europe in aggregate remains subdued, hidebound by the supposed requirements of the euro, Japan is stuck on the structural reform bit (surprise, surprise) of its grandiose experiment, and China is moving sideways and undergoing some kind of quiet transformation, if reports are to be believed. Pretty much everywhere else has to respond to the combined global indicators. Islamic instruments inevitably have been caught by the crossfire of doubts.

This edition of the bulletin tracks the immediate issues and pace of economic recovery, whether via the regular market commentaries, or in the specialist insight of a practitioner in the Gulf region, commenting on central bank strategy.

It also carries featured content on current themes in Islamic finance and economy, namely as to the efforts of Dubai to establish an advantage as a centre both for market practice and standards, and of the takaful sector to make strides in the Gulf region.

Our initial digest of developments provides the continuum of the newsflow on sectoral prospects around the world, covering for instance the recent pick-up in plans for various sukuk issuances, including among frontier names. We will continue to monitor how much the decidedly conventional domain of US Treasuries influences that and other evolutions.
Policy shifts: There is no escaping the fact that the policymaking disturbances playing out in the US are governing the mood of international financial markets, and therefore informing all related commentaries. The turnaround by the Federal Reserve on tapering of QE, followed by temporary government shutdown and tough debt ceiling negotiations, have threatened to underline both credibility and even ratings of creditworthiness. Global bonds have become volatile, more affected than stocks; the dollar has shown a certain falling out of favour.

Dubai: Not content with vying for the honours in the race to play a leading part in Islamic finance, Dubai has broadened the scope of its engagement with Shariah-compliant business by addressing the far-reaching ‘Islamic economy’, including non-financial sectors. Reflecting the emirate’s renowned ambition, boosted recently by economic revival, the idea is to develop a centre not only for servicing Islamic financial instruments, but to set common standards across a range of products and industries.

Commodities: Copper in particular, and base metal price movements generally, epitomise the prevailing uncertainty as to the pace and sustainability of economic growth per se, let alone their extrapolation by financial markets. The speculative dimension of commodity charts is much less evident than it has been, including for gold and oil, with their own, mixed structural drivers. Copper’s example shows sentiment on the edge, looking for direction, with inventories having eased but supply likely still to outpace demand.
Recent Developments in the Islamic Finance Industry

UAE’s Islamic centre ambitions

In the past two months the UAE has unveiled plans and initiatives seeking a position of leadership in the Islamic economy. Many countries are competing to attract investments in this domain, with the associated demand for goods and services increasing.

Having successfully used its international ties to become the Gulf’s main centre for finance, trade and travel, Dubai’s focus now is on business related to the religious beliefs of the world’s 1.6 billion Muslims.

The UAE has massively expanded sukuk issuance and the opening of Islamic windows and fully-fledged Islamic banks. It has also launched awareness campaigns across the country on Islamic banking and consumer wealth management, such as that organized by Emirates Islamic Bank this month.

The country is also considering Islamic re-insurance, which has only 19 firms globally, and engaging in certifying halal food and other products complying with Islamic principles. It plans to set up an international laboratory and accreditation centre by first quarter 2014, aiming to gain 10% of the global market in the next three years (see article, p.10).

Source: AMEinfo.com, Reuters, Khaleej Times

With the total foreign trade of the Muslim world reported at $4trn, GOLCER thinks a clear target is visible to Dubai, aiming to rival the main hubs for Islamic bonds (Malaysia and Bahrain). Islamic endowments (Waqf) are another area which Dubai is targeting, estimated to be worth hundreds of billions of dollars globally. GOLCER is optimistic about the success of the Islamic economy sector in UAE, but still thinks that standards for the management and quality of this sector in the country still need to be upgraded to international standards. Structural problems might restrict the country’s potential, with the industry more sensitive to world economic fluctuations since the global credit crunch.

Takaful faces slower growth

According to a report by Ernst & Young, the expansion of the takaful (Islamic insurance) sector appears to be slowing, as firms struggle for scale and face growing competition. Even so, the sector is still poised to sustain double-digit growth (see article, p.7).

Driven largely by Saudi Arabia and Malaysia, takaful is intended to produce a range of social benefits, including reduced civil/cross-border conflicts. The industry attracted $10.9 billion in gross contributions worldwide last year, with core markets in the Gulf and Southeast Asia. Takaful globally is expected to grow by 16% annually in coming years, compared to an average 22% in 2007-11, says the report.

So far firms have expanded in narrow product segments, such as auto insurance, which are saturated by competitors. Portfolio allocation is a major problem, typically overweighted to equities relative to fixed-income. Although Saudi takaful firms allocate relatively more to sukuk than others, over 40% is still held in low-yielding cash deposits because of regulatory requirements.

Source: The Islamic Global, Reuters

GOLCER finds clear threats to the takaful industry due to lack of expertise, poor structuring and weak cost-controlling strategies relative to conventional competitors. These factors imply large risks for efficiency and profitability. It seems in fact that...
gaining market share will be at the expense of profitability. GOLCER also thinks that expanding the industry globally is difficult due to the complex mixture of regulatory requirements, even within one region. Consolidation may be a way out, such as is currently under active consideration in the GCC.

Oman may issue sukuk

Oman’s government may issue an international sovereign Islamic bond by 2014; no details yet provided on size. State finances are under pressure because of rising expenditure, prompting the possible return to the international debt market for the first time since 1997. S&P believes 2013 global sukuk issuance is on course to cross the $100 billion mark despite challenges this year. The Islamic Development Bank (IDB) is emerging as a key player in enabling GCC and also African sovereigns (e.g. Morocco) to enter the sukuk market.

Source: Reuters, Khaleej Times

Libya seeks first Islamic borrowing

As holder of Africa’s largest crude reserves, Libya is considering a sukuk offering. It comes as the OPEC member wants to secure finance to more than double its refining capacity and expand chemical production, with projects forecast to cost $60 billion. By comparison, conventional loans for a petrochemical venture between Saudi Arabian Oil Co. and Dow Chemical Co. are expected to cost as much as 185 basis points over Libor. Hence, Libya may have to pay at more than a 6% rate. The average yield on sukuk from borrowers in the six nations of the oil-producing Gulf Cooperation Council (GCC) was 3.87% this month.

Source: Bloomberg, September 25th

With another option available to Libya (i.e. loans from local or foreign banks), GOLCER finds the consideration of undertaking Islamic debt an important government initiative in a country where Shariah-compliant products have been restricted over the past 60 years. Libya, like neighbouring Egypt and Tunisia, began developing its Islamic finance industry in the wake of the regional uprisings of the so-called Arab Spring, and as Shariah borrowing costs tumbled globally. Libya in fact passed a law this year to ban non-Shariah-compliant banking by 2015. GOLCER also expects Libya to offer good risk in sukuk, appealing to investors in the MENA region, as an oil- and gas-rich country currently without debt.

Senegal launching $200m sukuk

Senegal is reviving plans to issue its first Islamic bond, through a 100 billion CFA franc ($200 million) sukuk programme to be initiated next year. The Senegalese government is planning to sell the issue in co-operation with the Jeddah-based Islamic Corporation for the Development of the Private Sector (ICD), an affiliate of the Islamic Development Bank. The country has been studying the possibility of an issue for some years. Its purpose is to fund innovative infrastructure and energy projects. The ICD has been trying to expand the consumer base of Islamic finance across Africa by helping to establish institutions, for instance in Mali and Benin.

Source: Reuters, October 13th
GOLCER believes that the planned issuance of the first sovereign sukuk from Senegal represents an important step in developing Islamic finance in sub-Saharan Africa, currently characterized by only a small percentage of sukuk issuance. The governments in the region are nowadays viewing Islamic finance as an important channel to attract cash-rich Islamic funds from the Gulf and Southeast Asia.

Philippines’ central bank promoting Islamic finance

Among the most ambitious efforts to facilitate Islamic finance in a non-Muslim country, the Philippines’ central bank is pushing further several initiatives to develop the sector and attract Muslim-minority investments. It has asked Congress to have its charter amended, a move that would allow it to provide Shariah-compliant instruments through Islamic banks, particularly interbank lending products. The effort comes after a deal signed in October 2012 which sought to end a 40-year conflict with Muslim separatists that has killed 120,000 people.

Source: Reuters, September 27th

GOLCER views the central bank’s attempts as signifying renewed interest in the country to build key drivers for peace, as well as create a more inclusive financial system, given the high Muslim population becoming economically active. A newly-proposed Islamic banking law in the country is expected to attract more market participants, with only one Islamic bank to date, which has been struggling financially.

BLME lists on Nasdaq Dubai

Bank of London and The Middle East (BLME) listed its shares on Nasdaq Dubai this month. The London-based Islamic bank listed 195,733,691 shares on the Middle East’s international financial exchange. However, neither was new capital raised nor were fresh shares issued. BLME provides a link between the financial markets of Europe and the Middle East, and its new listing can serve issuers and investors from the region and beyond.

Source: Khaleej Times, October 9th

GOLCER suggests that this equity listing is a further step towards Dubai’s targeted progress, which will help in meeting the country’s hopes to become the world’s centred Islamic economy. However, the fact that there was reportedly no trading in the shares on IPO day suggests there is work yet to be done to develop the desired profile.
The Takaful market in the countries of the GCC has grown rapidly in recent years, although in absolute terms it still represents a small proportion of overall insurance premiums.

According to most reported statistics, Sharia-compliant insurance contributions usually include Saudi Arabia, given the Islamic rules it is governed under, and as such, it is deemed to be the major contributor to Sharia-compliant insurance growth within the GCC.

However, there is a conceptual distinction between the Sharia model adopted in Saudi Arabia to that of Takaful models in other GCC markets, with all insurance companies established in a “co-operative” manner, with strict rules governing the co-operative set-up and standardised approach to surplus distribution.

While the concept of Sharia-compliant cover has existed for decades, it has gained momentum significantly in the past ten years, with an influx of new Takaful companies into most GCC markets to take advantage of this growing sector.

However, although Takaful operators are deemed to operate in a niche sector, generally they are in competition with conventional companies for the same target market.

Despite the decrease of new entrants in more recent years, most Takaful and Re-Takaful market participants are young operators that find it difficult to establish themselves and create a balance between market franchise and profitability. Rather than distinguish themselves through targeting new untapped segments of the market, they tend to compete directly with their conventional counterparts.

Given that some existing conventional companies benefit from a strong reputation and economies of scale, Takaful operators find it difficult to establish profitable operations. Moreover, pressure from shareholders to service capital can lead to the pursuit of premium income through pricing practices. As a result, in a low interest rate environment -- whereby operators are more dependent on underwriting performance rather than investment income to generate profits -- these competitive pressures can be particularly challenging.

Furthermore, some conventional companies have established Takaful windows as vehicles to extend their market coverage. This strategy is evident in some GCC markets, used particularly by the leading players, and assists them to retain key relationships with customers that desire a Sharia-compliant offering, in addition to capturing an increasing share of the expanding Takaful segment. While this strategy is permitted within the GCC markets, companies may be forced to choose between a pure conventional or Takaful offering.
This restriction may be beneficial to the Takaful operators over the medium term.

When compared to South East Asia, the Family Takaful segment is underdeveloped in the GCC, which is in line with the low demand for life insurance in the region.

Takaful operators in the GCC therefore compete primarily for non-life risks. As with the conventional insurance market, Takaful companies will front commercial insurance, with a good portion of the risk ultimately being placed with the international reinsurance market – unless the Takaful company is a subsidiary of a larger entity or has a sister company, in which case the risk will be transferred to the international reinsurers via the non-Takaful affiliate. Retrocession should ideally be placed with ReTakaful companies but, in reality, a lot of the risk is ceded to conventional reinsurers as ReTakaful operators have insufficient capacity to support large and volatile commercial risks or lack the rating required by the ultimate insured.

A.M. Best believes Takaful companies should focus on value-added services that can be provided to clients in compliance with Sharia provisions.

The Takaful structure plays an important role in the effectiveness of the relationship between the shareholders and policyholders, such that both parties can benefit from the structure. Whilst the main consideration is being Sharia-compliant, the shareholders will require a return on their investment, and policyholders should benefit from any surplus generated by the policyholders’ fund. This balance of earnings and distribution can be difficult to achieve, particularly for new operators, and it presents a major challenge in competitive markets.

There are a variety of structures in common use, with the Al Wakalah model being the most preferred. This allows operators to charge a management fee to cover expenses plus the cost of capital, in addition to a share of investment returns. The operator will support the policyholders’ fund through the Qard’ Hasan – a benevolent loan – which would need to be repaid through future profit generation of the policyholders’ fund.

The main concern with Takaful structures is the operators’ ability to generate surpluses within the policyholders’ fund so that it becomes self-sustained in terms of capital requirements. There are many operators currently running a policyholder deficit, with a high dependence on the Qard’ Hasan to support the policyholders’ fund. This can become critical for policyholder protection in regimes where there is no specific provision for the seniority of policyholder protection and the need, at all times, to provide a Qard’ Hasan.

“For Takaful operators need to ensure they can maintain a suitable balance between risk and reward, in addition to having sufficient liquidity to meet insurance obligations.”

From policyholders’ point of view, the distribution of surpluses seems to become an increasingly important factor in their decisions to purchase Sharia-complaint products. This, therefore, exerts pressure on operators to run policyholders’ funds profitably, in order to have surpluses to contribute.
A.M. Best notes most funds are in deficit. The Al Wakalah model – whereby a Takaful insurer does not participate or share in any underwriting results – can result in fees, plus the cost of capital, being relatively high and draining resources from the fund. We believe that funds should move to a surplus as early as possible in order to ensure the long-term viability of the specific companies in question.

Furthermore, given that many Takaful operators are young, there is an expectation that there will be a dependence on the Qard’ Hasan, due to start-up costs. However, given the competitive strain on profitability, some funds are finding it difficult to repay the loan back to their operators within their anticipated time horizons.

Investment markets in emerging economies, such as those of the GCC, tend to be developing, and while Islamic investment options available to Takaful companies have been increasing over recent years, choices are still limited. As with conventional insurers and reinsurers, Takaful operators need to ensure they can maintain a suitable balance between risk and reward, in addition to having sufficient liquidity to meet insurance obligations.

Takaful companies are more limited than their conventional counterparts with respect to their investment policies, and are quite restricted with assets in the Islamic banking sector. That can result in lower returns, and risk concentration within asset classes or Islamic investment providers.

However, the development and availability of Islamic investment providers has improved in recent years, with an increased number of public and private sukuks being offered. Furthermore, the secondary market for sukuks continues to improve, creating greater liquidity for these instruments.

Despite the challenges facing the Takaful sector, A.M. Best expects the market to continue to present opportunities and grow at a faster rate than the conventional insurance market over the short-to-medium term.

As the Takaful market has evolved in recent years, the level of regulation governing this niche market has developed, which is encouraging. A few years ago, it was rare for insurance supervisors to have specific Takaful regulations. Now, however, some regulators have introduced or are considering the introduction of specific rules that cater for the Takaful market and its unique characteristics.
Dubai has emerged from its part of the global financial crisis with its ambitions undimmed. Despite a 50% fall in property values during the intervening trough, resulting in a banking sector weighed down by non-performing loans, the emirate has quickly bounced back. Economic growth is reviving, tapping into both an historical, commercial rationale and a clear commitment of the leadership to a growth strategy creating a state-of-the-art megacity. Real estate is booming again. Onwards and upwards.

Its latest challenge is to become the self-styled ‘Capital of the Islamic economy’, with a three-year time-frame. The “comprehensive platform” envisaged by the ruler Sheikh Mohammed bin Rashid Al Maktoum would make Dubai the leading hub for: i) sukuk and Islamic financial services; ii) standards for halal goods and services; and iii) regulation of the world’s Islamic markets.

Diversification is at the heart of this initiative, with the halal industries ranging from food to pharmaceuticals to logistical services.

The outlooks for what can be termed ‘Islamic economies’ certainly provide validation for such a vision. The world’s Muslim population, at around 1.6 billion, is growing at over twice the worldwide pace. What by association is being identified as ‘the global Islamic economy’ is estimated to be increasing at a double-digit rate, albeit including countries whose economies and businesses have grown on the back of a substantially secular dynamic.

The financial sector looms large on this horizon, valued at USD 1.5 trillion globally and growing by 15-20 per cent per annum, according to research consultancy Oxford Business Group.

Considering the GCC region alone, rating agency Standard & Poor’s reports the Islamic banks outgrowing their conventional peers, by 17.4% to 8.1% between 2009 and 2012 in asset total. This trend is assisted by “significant direct and indirect support from government, ruling families and authorities.”

The outstanding prospect naturally brings increased competition for business.

Saudi Arabia, Kuwait and Qatar have all been promoting their Shariah-compliant financial sectors, while, only down the road from Dubai, Abu Dhabi recently outlined plans for a full-service financial zone, including Islamic finance. Bahrain, long viewed as the industry’s regional leader, has stalled with the disturbances of recent years taking their toll on the country’s reputation.

Beyond the Gulf, Malaysia is clearly a leading player, and then there are the aspirational European centres, most prominently London, which aims to be the leading Islamic centre in the Western world.

Dubai has ratcheted up again the perennial issue of creating a set of clear, commonly accepted standards. Could it establish a dominance over the broader Islamic sector that it intends?

The emirate’s financial credentials are already well-established, having set up Dubai International Financial Centre (DIFC) in 2004, enticing international banks, asset managers and insurers with promises of a zero-tax environment for fifty years.

DIFC has attracted financial companies literally from around the world. With 97% current occupancy, plans are advanced to expand the facility.

Complementary developments have now been launched with the Dubai Global Sukuk Centre.
and Dubai Centre for Islamic Banking and Finance (DCIBF). These institutions are designed to address outstanding issues of corporate governance and product standardization that, amid regulatory rivalries, are considered barriers to the further advancement of global Islamic finance, and an underpinning of academic authenticity.

Earlier in the year, Dubai Financial Market invited contributions towards setting comprehensive standards for the sukuk market. Building on that theme, Dubai’s new initiative will provide a centre for issuing, listing and trading the Islamic bond-like instruments that have gained such traction as a funding and investment vehicle, indeed to encourage countries and companies to issue sukuk instead of conventional bonds.

DCIBF, backed by the government and the Hamdan Bin Mohammed e-University, will conduct research to “advance the professional and theoretical foundation for Islamic banking and finance”. Venturing into implicated topics such as principles of Shariah, economics, accounting, and risk management, it is meant to stimulate access to Islamic banking and finance education for the wider Arab world.

There is a perception of Dubai punching above its weight in such matters, and these latest moves are in tune with the expansive ethos manifested by its vast construction plans, and growth of its international businesses, such as DP World and Emirates airline. Its new airport, after all, is called World Central.

Indeed, notwithstanding the cultural emphasis implicit in the Islamic Economy strategy, the leadership continues to make a virtue of Dubai’s spiritual and geographic location at the crossroads of East and West. The city-state’s cosmopolitan feel is a critical part of its economic model, in terms of attracting tourists and conference facilities. The Expo 2020 bid aims to capitalize on that internationalist identity.

Sheikh Mohammad has emphasised that the government will not compromise its openness and commitment to the free market. “By strengthening Islamic economic principles as an integral part of our overall approach to growth and development, we are further supporting the entrepreneurial community, especially from the Arab world,” he said.

Clearly, Dubai wants to become a centre for business beyond banking and insurance, encompassing the likes of food processing, tourism and education.

According to Sayd Farook, global head of Islamic Capital Markets at Thomson Reuters, quoted in Gulf News, it’s about “more than Islamic finance and halal chicken; it is a multi-billion dollar industry that will have a monumental impact on global trade”.

Islamic consumer products form a $4.8 trillion global sector, “yet it is not an easily accessible, homogeneous market, due to a multiplicity of standards [and] local cultural preferences”, he said. For instance, 300 different certification bodies exist for halal foods.

Still, it will be difficult for one player to achieve everything by itself in this regard. “Dubai can lead it, seed it and sponsor its existence, but needs to work with key stakeholder bodies around the globe to ensure acceptance,” Farook suggested.

Someone has to identify the opportunity and be first mover, though, which is what Dubai appears to have done and may be rewarded for.
GCC

Gulf stocks rebounded in September, while ultimately restrained in their performance relative to global and emerging-market indices, whose recovery followed the US Federal Reserve’s backtracking on the tapering of its monetary stimulus programme (QE). The threat of foreign military intervention in the Syrian crisis evaporated, and investors turned to the pending earnings season in October, with mixed expectations reported in the region for brokers’ consensus. Those local bourses that had led the year’s charge so far -- particularly the UAE’s Dubai and Abu Dhabi markets, boosted in the financial services component -- resumed their momentum. Saudi Arabia made moderate progress almost across the board, Kuwait and Bahrain as well, while Qatar and Oman slipped slightly.

MENA

Egyptian stocks continued their upward tack since a semblance of political stability was restored, reaching their highest mark for a year even as the US decided to trim its yearly financial aid. Perceptions are that Gulf assistance worth $12bn since the deposal of President Morsi in July -- liable to prompt another stimulus package in the new year, and giving ballast to the currency -- far outweighs the loss of some $260m in cash disbursement. Notably, foreign institutional began to return, with local equities among the cheapest globally, and dividend yields projected to surge by a third next year. Balance of payments figures improved, and there are signs of FDI being revived. Having suffered similarly earlier in the year, Turkish stocks also turned a corner, surging conspicuously with the Fed’s about-turn on QE.

Far East

US policymaking remained the dominant force governing trends in Asian stocks, initially as regards QE in September, then as concern mounted, then eased, over debt ceiling and budget negotiations. The danger of default hung heavily over the region’s bourses,
demonstrating their high sensitivity to American leadership, although Malaysia showed some resilience. International funds flows were still broadly in retreat, although Thailand was amongst those drawing currency favour as the US dollar came under pressure owing to the political impasse. The Philippines benefited from an upgrading of growth forecasts, and re-rating of sovereign debt by Moody’s. Some positive signals on China’s services sector also provided general regional underpinning.

Rest of the World

For most global markets September marked a turnaround from August’s decline, aided by firmer manufacturing data in the US, yet also the Fed’s retention of its rate of QE, in response to a shock in bond yields upon its previous tapering announcement. The rally stalled, however, when budget negotiation and debt ceiling fears kicked in. For international markets investor confidence was lifted also by better economic indicators out of China, also prominent countries such as Brazil and Russia. Meanwhile, European stocks were buoyed by the eurozone’s recorded emergence from recession, the return of Angela Merkel as German Chancellor, alongside the European Central Bank’s commitment to persistently easy monetary policy. Japanese equities showed a strong trend, aided still by the government’s expansionary Abenomics experiment.

Sources: GIC, Global Investment House, Emirates NBD, Bloomberg, Reuters, broker reports
Islamic or Shariah compliant indices exclude industries whose lines of business incorporate forbidden goods or where debts/assets ratios exceed 33%. The increasing popularity of Islamic finance has led to the establishment of Shariah compliant stock indices in many stock markets across the world, even where local Muslim populations are relatively small, such as in China and Japan.

Volatility is a measure of uncertainty of market returns. It is calculated as the standard deviation of the returns in the reported month. The formula for the standard deviation is:

\[ \sigma = \sqrt{\text{E}[(X-\mu)^2]} \]
Commodities

Oil

Crude prices were propped in September by supply outages and lingering geopolitical tensions, but then subsided as it became apparent that the market was well supplied. As the political risk premium relating to Syria dwindled, rising production from both Libya and Iraq compounded the bearish shift. Also, the US shutdown and budget morasse implied directly slower demand, and a potentially very damaging knock-on for the world economy. US inventories rose, and the scope for American rapprochement with Iran, with implications for easing of sanctions, added a further downward twist in October. OPEC warned of sluggish prospects, and its own output easing, with Asian countries removing subsidies on usage and Europe’s weakness continuing.

Natural Gas

US weather predictions dominated the profile of natural gas prices through September and into October, although a switch by money managers from previously net short to net long positions added a speculative overlay to the underlying prompts. They had been provoked partly by increased demand due to seasonal maintenance at some nuclear plants. Across the period reviewed, temperature predictions gave few signs of stockpiles being boosted, while prices then picked up with an Energy Information Administration (EIA) report forecasting higher use of natural gas by households this winter, and climbed further with colder conditions emerging in most recent weeks. Analysts suggest the fourth quarter has become even more influenced by weather dynamics. Partial resolution of the US debt ceiling issue gave another lift to the market.

Gold

A medium-term downtrend has remained in place for gold, interrupted only by the suggestion that the Fed will maintain its rate of QE injections, then that the US was jeopardizing its creditworthiness and credibility by infighting over the Treasury’s debt ceiling. Whereas hedge funds in September reacted to geopolitical tensions and the metal’s safe-haven appeal, the disadvantageous comparison with steadily advancing equities, and continuing lack
of inflationary threat amid modest signs of economic growth, denuded gold of its key comforts. Its store of value cachet was disproved by its sustained price decline, with physical demand from China and India limited. Consensus forecasts for the next 12 months foresaw prices dropping to $1175 by 2014Q3.

Copper/Base Metals
As perhaps the most obvious bellwether of global economic trends, copper (like other base metal) prices tracked broadly sideways in September and into mid-October, given very mixed news and perceptions about the world recovery. Europe seemed to offer the suggestion of overcoming the worst of its trauma, while China also appeared to have found an even keel, even to be picking up again. The US’s fiscal fiasco imparted both negative and (subsequently offsetting) positive impetus. Investors tended to be sidelined, with current inventory data falling, but with analysts clearly expecting a surplus of supply to prevail in 2014. A tripling of prices over a decade have induced additional mining from several countries, due to bring production on-stream.

Sugar/Agriculturals
While soft commodities were range-bound through the period under review, pincered by the restraints of anaemic economic recovery, sugar made a notable advance, responding partly to the unwinding of a medium-term cycle. Global output dropped for the first time in five years, promising an easing of the glut previously established. Yields declined in top producer and exporter Brazil, with low prices leading classically to higher prices as operating margins have been squeezed. China and Indonesia were notably buying large quantities. Poor weather and then a warehouse blaze in Brazil, also festive demand in India and technical price support, combined to add propulsion to the market.

Edible Oils
A rebounding Malaysian ringgit initially put pressure on palm oil sales early in this period -- as the Fed renounced its previous declaration to taper its monthly buying of bonds -- before going into reverse. Equally, improved weather in the US MidWest boosted the likely outturn
for the soybean crop and its oil derivative. Palm continued down upon speculation that reserves were gaining upon increasing production, inadequately absorbed by exports, but then recovered smartly on the reverse interpretation, that in fact output was slower than forecast, with short covering seen. Record soybean oil output in India took away that bolster, but higher Malaysian shipments ultimately confirmed suspicions that stocks of palm would peak considerably lower than earlier expected, giving a solid progression to the later trend.

Sources: OPEC, Reuters, Bloomberg

Evolution of highly traded commodities in September 2013. MTM Change and Percentage Volatilities. US $ and US c indicate United States Dollar and United States cent respectively. bbl = billion barrels, MMBTU = Million British Thermal Unists, MT = Metric Tonne, LB = Pound and Bsh=Bushel. Prices represent the price of the respective commodity at 30/9/2013. Source: Datastream
The policy stance of the US Federal Reserve has evidently become a critical factor for fixed-income markets globally, with US Treasuries leading the way. We asked Ricky Husaini, chief investment officer of investment advisory firm Trading Portfolio, for his insights.

What do you feel will be the main factors driving US Treasuries for the rest of the year?

Besides the usual demand & supply issues, economic indicators and inflation expectations, I think the ‘fear premium’ and ‘growth expectations’ will be important drivers. With ten-year US Treasuries yielding 2.50% [at time of writing], I would be looking to borrow long-term sooner rather than later, having seen a greater than 50bp drop in the long end of the curve. That [reaction] has mainly been the result of shorter-term political uncertainty rather than any serious reversal of both the US and the global macro economic & growth environment. Interestingly enough, stocks have not shown this reversal, and have steadily chugged higher, with Dow Jones 18% up YTD, and the more cyclically-oriented small-cap Russell 600 index posting a whopping 32% increase. Budget negotiation and government funding deadlines both approach in the coming two to three months, which will also make an impact on rates in the short term.

How far can overseas bonds (and sukuk) differentiate their own outcomes?

The probability of divergence seems to be getting lower with every passing day, with a lot more of globally co-ordinated intervention happening increasingly. However, the increasingly ‘buy-and-hold’ sukuk market does have liquidity as a major driver behind prices remaining well-bid, and I definitely see a lower correlation between developed market bonds and Islamic market sukuk than between different G7 bond markets. In my opinion [that] is actually an opportunity to include sukuk as an active diversifier into a developed bond market portfolio.

What do you say about the credibility of ‘forward guidance’ to guide the bond market?

The real position-takers in the bond market always follow the forward (rather than spot) markets, with expectation of where rates will be in the future probably the major driver of not only the level of yields but also the slope of the yield curve. Basically, forward guidance is a strategy by regulators to prepare large position-holders about impending changes (or not for some time, as the recent case is) in their key monetary tools, such as the level of short-term interest rates. In fact, the US Fed has actively adopted the ‘forward guidance’ route for five years at least, the UK and even the ECB now following suit.

So, will keeping short rates down necessarily keep long rates down?

Forward guidance ‘feelers’ -- such as indicating for example that no change will happen to short-term rates for a sustainable period of time -- automatically make the market re-think its view on lending on a longer-tenor basis. [In this case] it then directly drives down the far end of the yield curve, and makes the curve flatter as well. Sensitivity to expected rate changes on the short end is first and foremost felt and factored into movements in the longer-tenor rates, which is the core concept behind duration risk.
The mood and direction of Gulf fixed-income markets pivoted on the unexpected volte-face by the Fed on its previous tapering decision. Whereas a certain gloom had descended, with the idea that the long bull market was well and truly over, investors in the GCC arena took the news as the cue to dive into regional credits. CDS spreads tightened – particularly for Dubai, whose story is strengthening -- in every case except for Bahrain, and the primary market suddenly re-emerged. Owing to the scale of pent-up demand, the subsequent news of US government shutdown and debt ceiling fright had minimal impact. Secondary trading was relatively light, though, with the focus on new issuance in its window of opportunity. Analysts saw steady improvement in sentiment, but cautioned about the potential for sudden loss of liquidity, given the uncertainty associated with the US benchmark.

By contrast with the Gulf, Egyptian bonds ploughed their own furrow, considering the unique circumstances of the country and the prior dislocation of its markets. Optimism returned sufficiently in September for yields to drop markedly (by 200-300 bps since July’s military intervention), as foreign investors looked afresh at the medium-term possibilities for the country. The improvement to FX reserves, bolstered by $12bn of aid pledged from leading GCC states, and recovering Egyptian pound allowed the central bank to trim interest rates in mid-month, while growth, unemployment and budget pressures evidently remained substantial challenges. The violence associated with the political transition reasserted itself during October, however, reaffirming the element of doubt about stability, and trimming market gains.

The Fed’s taper delay was similarly the dominant factor behind renewed momentum among Asian credits, which exhibited sharp associated volatility, especially in the high-yield space. Emerging market funds flows returned, creating technical support as well; so too primary issuance, although local currency bonds had in any case been less affected than foreign equivalents. Once the froth had settled, fundamentals re-entered the picture, so that Indonesia suffered for its balance of payments fragility. Overall, nervousness over the US’s interest-rate cycle still applied, considering the precedent of the recent, dramatic reversal in Asian markets,
that had led to currency fallout. The uncertainty of China’s economic condition also kept investors in wait-and-see mode. Malaysia’s market adopted a positive tone ahead of the pending budget announcement for 2014.

Global Benchmarks

The Fed’s U-turn on its quantitative easing plans – sparked by precipitant financial tightening in the bond markets themselves -- clearly broke the rising trend of bond yields that had prevailed through the middle of the year (although year-to-date returns remained negative). The appointment of Janet Yellen as the next chair also gave a dovish signal. Given the doubtful backdrop to prospects for Treasuries, traders tended to look for tactical positions, not to over-commit to the overall trend, despite the fillip the central bank aimed to offer by continuing with unchanged monthly liquidity injections. Only a reprieve to the price downtrend was assumed, while the debt ceiling debate proved only an interruption. With Europe arguably showing some modest sign of recovery, and Japan still in the early stages of its economic policy experiment, key overseas sovereign debt markets were also lacking direction.

Sources: GIC, Invest AD, Bloomberg, Reuters, Financial Times, broker reports

Sovereign Bond Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>Price (%)</th>
<th>MTM Change (%)</th>
<th>Yield (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>132.47</td>
<td>2.93</td>
<td>5.64</td>
</tr>
<tr>
<td>Qatar</td>
<td>352.93</td>
<td>1.84</td>
<td>3.01</td>
</tr>
<tr>
<td>Egypt</td>
<td>216.28</td>
<td>8.83</td>
<td>7.72</td>
</tr>
<tr>
<td>Tunisia</td>
<td>226.11</td>
<td>2.42</td>
<td>5.95</td>
</tr>
<tr>
<td>Jordan</td>
<td>99.77</td>
<td>1.01</td>
<td>3.99</td>
</tr>
<tr>
<td>Lebanon</td>
<td>518.03</td>
<td>0.38</td>
<td>6.29</td>
</tr>
<tr>
<td>Thailand</td>
<td>187.11</td>
<td>4.76</td>
<td>3.66</td>
</tr>
<tr>
<td>Taiwan</td>
<td>191.15</td>
<td>2.06</td>
<td>1.50</td>
</tr>
<tr>
<td>Singapore</td>
<td>225.59</td>
<td>3.47</td>
<td>1.51</td>
</tr>
<tr>
<td>Indonesia</td>
<td>207.17</td>
<td>-5.53</td>
<td>8.54</td>
</tr>
<tr>
<td>Malaysia</td>
<td>275.09</td>
<td>1.18</td>
<td>2.05</td>
</tr>
<tr>
<td>India</td>
<td>257.79</td>
<td>6.36</td>
<td>9.07</td>
</tr>
<tr>
<td>China</td>
<td>190.85</td>
<td>-0.44</td>
<td>4.08</td>
</tr>
<tr>
<td>Turkey</td>
<td>203.81</td>
<td>4.97</td>
<td>8.80</td>
</tr>
<tr>
<td>Italy</td>
<td>414.74</td>
<td>2.53</td>
<td>3.53</td>
</tr>
<tr>
<td>Portugal</td>
<td>391.11</td>
<td>3.01</td>
<td>6.03</td>
</tr>
<tr>
<td>Spain</td>
<td>381.57</td>
<td>4.09</td>
<td>3.17</td>
</tr>
<tr>
<td>France</td>
<td>1153.67</td>
<td>3.44</td>
<td>1.00</td>
</tr>
<tr>
<td>Germany</td>
<td>871.03</td>
<td>3.30</td>
<td>1.09</td>
</tr>
<tr>
<td>UK</td>
<td>1062.67</td>
<td>5.39</td>
<td>2.31</td>
</tr>
</tbody>
</table>

Evolution of Bond Markets in September 2013 relative to the previous month. The table reports the price index on which the MTM Change is calculated (month-to-month) and the Yield of sovereign bond maturities typically between 6 months and 25 years. Data as at 30/9/2013.

Credit Default Swap Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>CDS Spread (bp)</th>
<th>MTM Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>248.36</td>
<td>0.06</td>
</tr>
<tr>
<td>Qatar</td>
<td>71.72</td>
<td>-18.27</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>64.77</td>
<td>-10.89</td>
</tr>
<tr>
<td>Dubai</td>
<td>213.55</td>
<td>-13.04</td>
</tr>
<tr>
<td>Abu Dhabi</td>
<td>105.26</td>
<td>-11.99</td>
</tr>
<tr>
<td>Egypt</td>
<td>642.34</td>
<td>-18.18</td>
</tr>
<tr>
<td>Thailand</td>
<td>133.56</td>
<td>-12.01</td>
</tr>
<tr>
<td>Indonesia</td>
<td>255.36</td>
<td>-5.17</td>
</tr>
<tr>
<td>Malaysia</td>
<td>129.66</td>
<td>-14.89</td>
</tr>
<tr>
<td>India</td>
<td>323.26</td>
<td>-13.16</td>
</tr>
<tr>
<td>China</td>
<td>118.11</td>
<td>-21.14</td>
</tr>
<tr>
<td>Italy</td>
<td>268.55</td>
<td>8.47</td>
</tr>
<tr>
<td>Portugal</td>
<td>494.29</td>
<td>-1.93</td>
</tr>
<tr>
<td>Spain</td>
<td>229.64</td>
<td>-2.18</td>
</tr>
<tr>
<td>France</td>
<td>68.87</td>
<td>-4.28</td>
</tr>
<tr>
<td>Germany</td>
<td>24.84</td>
<td>-15.35</td>
</tr>
<tr>
<td>UK</td>
<td>34.12</td>
<td>-10.93</td>
</tr>
</tbody>
</table>

Evolution of CDS Spreads in September 2013 relative to the previous month. The index reported here represents the average basis points (bp) of a 5-year CDS for protection against sovereign bonds. Data as at 30/9/2013. MTM Change refers to the change relative to the previous month.
Islamic Bonds (Sukuk)

Against the background of a defensive fixed-income environment for much of 2013, the Fed’s surprising decision to reconsider its QE tapering guidance sparked a rebound in sukuk secondary trading, in line with the return of international funds to higher-yield, emerging-market paper.

Conventional bonds nevertheless outperformed sukuk through September. The HSBC Nasdaq-Dubai USD Sukuk TR Index (SKBI) closed at 145.62 from 143.51, while the HSBC Nasdaq-Dubai GCC Conventional USD Bond TR Index (GCBI) also gained three points at 159.42.

As bond market prospects universally appeared distinctly hazier, however, given the price escalation fuelled by prolonged monetary stimulus, and sense of pending global economic recovery, attention turned very much to primary activity. Borrowers sensed perhaps a last chance to tap into low-cost funding from very liquid sources.

Thus, following the extended break since Islamic Development Bank’s issuance in late May, a flurry of deals were announced in early October, feeding pent-up demand.

Abu Dhabi’s Al Hilal Bank issued a debut $500m sukuk, with a profit rate of 3.267%, 170 bps over mid-swaps, in what were described as conducive conditions. Orders from a well-spread and diverse set of investors eventually represented a 12 times oversubscription.

Turkey launched a US$1.25bn sukuk, rated Baa3 by Moody’s and BBB- by Fitch, priced at 300 basis points over mid-swaps, tightening from initial guidelines of 325bps. The country had previously entered the market in September 2012 with a $1.5bn deal.

Ras al Khaimah issued a US$500m, 5-year sukuk, as part of a $2bn programme, its first venture into the market since 2010. Order books were shut in excess of $5bn.

Nigeria became the first sub-Saharan African country with a sukuk, issued for Osun State, a cocoa-producing region, with a 7-year tenor and 14.75% coupon.

Sources: GIC, Reuters, Rasmala, Khaleej Times

Sukuk is the Arabic name for financial certificates, but commonly refers to the Islamic equivalent of bonds. Since fixed income, interest bearing bonds are not permissible in Islam, Sukuk securities are structured to comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.
The good thing about the recent resolution of the US budget impasse is that America avoided a damaging default whose effects would have transcended borders and upset world economic recovery. The bad thing is that the issue concerned is bound to return in a matter of months, as the agreement was only for the short term.

Since the long-term issue of accumulating deficits and debt can only entail intensifying pressure, the situation could yet get ugly.

As market commentaries in this bulletin have conveyed, sovereign debt and emerging markets have shown disturbing dependence on the US economy and its benchmark policy settings, as well as the portfolio funds flows that chase around the world in search of worthwhile capital and yield returns.

Moreover, since Congress is so divided (and the American executive and legislature so much at odds with each other as well), the prospect for curing the US’s own reliance on both fiscal and monetary laxity seems very limited. When a bipartisan approach to a structural shift in financial responsibility was found a few years ago, in the form of the Simpson-Bowles commission findings, it failed to proceed.

So the conditions in which financial markets have maintained their buoyancy this year look stretched, and the underlying economies uncertainly placed, as self-sustaining momentum has not materialized as yet.

Scanning the horizon and the other blocs, while the hard-pressed eurozone tries defiantly to keep its head above water, Japan’s government has decided that the third arrow of its Abenomics programme, the structural reform component, may be a river that’s too wide to cross. Meanwhile, China is subdued, preoccupied with re-inventing if not rebalancing its economy, and much of the rest of Asia’s confidence seems hooked on the sound of the US locomotive.

All in all, investors have to wonder whether to believe the politicians, who claim they can revive economic growth, or their own instincts, which tell them that those leaders are actually floundering in their efforts.

In fact, there’s every reason to believe that it is investors’ very lack of faith which is helping to keep interest rates low, and inflation relatively in check, with the combined growth outlook and government strategies unconvincing.

It means that a whole lot of downside presents itself to stock and bond markets, both conventional and Islamic, and a certain fatigue, if not fatalism, might set in.

How much further to the eldorado of economic performance catching up with equity indices? And how much risk is there to bond markets which are already twitchy? For not only have sovereign bonds as a class lost their risk-free identity, but now even US Treasuries have lost some safe-haven appeal.

This moving picture is becoming an edge-of-the-seat experience. The denouement that’s due, however, is like a distant train, whose time of arrival is as unknown as the answer to the question: how long is a piece of spaghetti?
Diary of Events

9th World Islamic Economic Forum (WIEF)
Date: 29-31/10/2013
Venue: London, UK
The 9th World Islamic Economic Forum will be convened this year in London, being one of the leading financial and cultural centres of the world and the business gateway between the Muslim and non-Muslim world. The forum will be held at Excel London on 29 – 31 October 2013, bearing the theme “Changing World, New Relationships” to encapsulate the emergence of new economic linkages between nations across borders, religions and cultures in a fast changing world.

Islamic Finance Conference (ifc) 2013
Date: 4/11/2013
Venue: Washington DC, USA
This conference would create an avenue for engagement with key financial market players and promotion innovative financial instruments in the United States.

IFN Hong Kong Roadshow 2013
Date: 7/11/2013
Venue: Hong Kong
With strong support from the Hong Kong Monetary Authority since inception, this event attracts solid interest from financial institutions and potential issuers from the Special Administrative Region and the mainland. A regular audience of 100+ come to hear from local and international experts in addition to the array of regulators. And following Khazanah’s groundbreaking issuance in 2012, there’s even greater attention on this relatively new comer to Islamic finance.

IFN Brunei Roadshow 2013
Date: 28/11/2013
Venue: Brunei
The Bruneian Islamic finance industry continues to make great strides in its development. With the establishment of the Brunei International Financial Centre, under the newly formed monetary authority, Authoriti Monetari Brunei Darussalam, it soon passed an international banking order covering international Islamic banking and Takaful. Brunei was one of the first destinations added when the IFN Roadshow series was launched, and is still the first to be added each year.
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