Liquidity returns

NICK STADTMILLER EXPLAINS HOW RECENT MOVEMENTS IN BONDS AND EIBOR REVEAL A RESURGENCE IN INVESTOR CONFIDENCE IN EARNING HIGH RETURNS IN LOCAL FIXED INCOME IN THE UAE.

The UAE financial system has received substantial inflows of liquidity in the first part of 2011, which in turn have served to push local interest rates and credit spreads lower. One of the most visible signs of this transformation has been the easing in EIBOR (Emirates Interbank Offered Rate), which serves as an important benchmark for the pricing of many corporate loans, funding operations and other borrowings.

The closely watched three-month EIBOR figure began to head lower in early April. After remaining largely unchanged since late last October at around 2.13%, the rate finished April below 2%. Many observers follow the spread between EIBOR and dollar LIBOR as a gauge of local money market conditions, rather than outright levels of the rates.

Since the dirham is pegged to the dollar, economic theory says the interest rates for these two countries should be linked as well, with any differential representing idiosyncratic local conditions rather than diverging policy paths. Thus the difference between EIBOR and dollar LIBOR rates can be seen as a measure of the liquidity/credit premium in the local interbank market compared with the dollar funding market in the US. The spread between these two benchmark rates in the three-month tenor fell from 185bp earlier in the year to under 170bp in early May, and we see plenty of room for it to fall further.

SHIFTING DYNAMICS The dynamics of the spread between dirham and dollar interest rates are likely to shift going forward, as the US will eventually end its near-zero rates policy. While the spread has been driven so far by a falling EIBOR, rises in dollar rates will play an increasing role in future compression of the spread. We expect the Federal Open Market Committee (FOMC) to begin raising the Fed Funds rate in the first half of 2012 (which will be reflected in dollar LIBOR), and most likely the rise in dollar rates will contribute a good part of the tightening in the EIBOR/LIBOR spread in 2012.

It is useful to take a step back and examine the broader monetary backdrop to recent moves in EIBOR to gain insight into how conditions have affected the broader credit and interest rate markets, and how the situation may evolve through the rest of this year. Increased liquidity in the banking system has been the primary driver of changing conditions, driven by strong growth in deposits. UAE central bank figures show that Arab Emirates dirham (Dh) deposits were up 14.3% year on year in March, at Dh1,105bn. Momentum in deposit growth picked up in the first part of 2011; deposits were up 5.3% in the first three months of the year alone. Much of the inflow has originated from the private sector, especially individuals and non-financial business.

The increase in the deposit base has helped to push banks' loan-to-deposit (LTD) ratios lower. The ratio for the banking sector as a whole fell

below 100% last October for the first time since 2007, meeting the target threshold set by the central bank. Continued improvement in this measure over subsequent months has helped to restore confidence in the development of a sustainable trend, and the LTD ratio fell further in March to 94.8%. Some banks' LTD ratios are even lower, which has sparked a reassessment of their demand for further funds.

RECENT MOVES IN EIBOR AND BOND YIELDS ARE A REFLECTION OF INVESTORS' INCREASED CONFIDENCE AND OPPORTUNITIES TO EARN RELATIVELY HIGH RATES OF RETURN IN LOCAL FIXED INCOME

DOWNWARD PRESSURE As the supply of deposit funding demonstrated sustained gains, this inevitably put downward pressure on the market price for deposits (ie interest rates paid). Banks began lowering the rates they pay on deposits from the early part of this year, responding to an inflow of deposits that has spurred institutions to find ways to deploy this money on the asset side of the balance sheet.

By mid-March, lower rates on deposits gave investors an incentive to look elsewhere to generate higher yields. Fortuitously, around the same time consensus built that regional political unrest had stabilised and appeared increasingly contained. These conditions created demand for local bonds from two separate sources. International investors began to re-initiate positions they had removed through blanket region-wide sales earlier in the year, and regional accounts found attractive returns for their capital in local markets.

The rechannelling of cash into local credit markets has had a pronounced effect on higher-beta, shorter-duration issues, which has generated special interest in names within the Dubai space. The widely followed Dubai 2014 sukuks offer an indication of the magnitude of the repricing of credit risk over recent months. After offering as much as 6.57% at the end of January, yields on the benchmark sukuks fell to 5.46% at the end of in March and traded as low as 4.69% in early May – a lifetime-low yield for the bond.

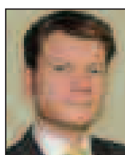
Ample liquidity from local investors, improving liquidity ratios in banks and a rally in local credit all set the stage for a drop in EIBOR rates in April. Continued pressure from these factors should sustain the downward momentum in interbank rates over coming months. At the same time, the supply of funds available and an improving economic backdrop should encourage businesses to raise funds in the local market to finance expansion.

BOND ISSUES So far this year there have been three large bond issues from UAE names. Emaar raised $500m in a sukuk sale in January. IPIC successfully sold E2.5bn and £550m in a multi-tranche issue during challenging market conditions in early March (in the midst of uncertainty within the broader Middle East/North Africa region), and Mubadala sold $1.5bn notes in five- and 10-year tranches in April. Current conditions appear optimal for further issuance, with credit spreads considerably tighter than a couple of months ago and dollar interest rates near their lows for the year. Several deals are likely to come to market soon, including sukuks from regional financial institutions, and there is talk that local sovereigns and government-linked entities may sell bonds later this year.

Growth in bank loans and advances has lagged other variables in the financial system and has remained subdued since the post-Lehman crisis in late 2008. After some signs of a gradual pickup in bank credit last year, loan growth stagnated in Q4 2010. There have been green shoots in the first couple of months of this year, although loans are still up only 2.5% year on year as of March. One constraint on loan growth has been expectations of continued rises in non-performing loans (NPLs). Although it is unclear if NPLs have reached their highs for this cycle, several observers have lowered their estimates for the peak to the low-teens, which is close to current levels.

Looking a bit deeper into sector-level loan data compiled by the central bank, a few areas have demonstrated growth in recent months. Increases in credit to heavy industry – such as mining and metal manufacturing – and personal loans for business purposes have shown signs of nascent growth. The latter augurs well for optimism among small businesses, an important engine of economic growth. Surprisingly, credit to wholesale and retail trade has been slow to take off, despite strength in foreign trade figures and anecdotal evidence of improvements in the retail sector. We would expect loans to the trade sector to pick up rather quickly once overall loan growth begins picking up, which we anticipate later this year.

In short, recent moves in EIBOR and bond yields are a reflection of investors' increased confidence and opportunities to earn relatively high rates of return in local fixed income. High interest rates and credit spreads cannot sustain themselves in equilibrium as the supply of funds increases and leads growth in demand for credit. Falling interest rates and bond yields are a reflection of this reality. The continued deployment of capital into local markets will inevitably make its way through the usual channels, moving from deposits to short-dated bonds and progressively through to longer-dated bonds and other risk assets.



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