RBC BlueBay
Asset Management

Polina's Perspective:
Middle East
A moment under the sun amidst muddy rain

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Have you ever been caught in muddy rain? It is not a pleasant experience. I recently came across this natural phenomenon as I landed at Abu Dhabi airport. Not only was everything covered in mud, but the city became paralysed for a few hours, as the rainstorm stopped cars on the highways and flooded many buildings and roads that were not designed with this weather in mind.

Some believe that the downpour was caused by global warming, as months of hotter-than-average sea surface temperatures added moisture to the atmosphere, making a heavy rainfall more likely. Thankfully the city was quick to issue a weather warning and revert to working from home, and the weather normalised over the next 24 hours.

In the ensuing days, however, what surprised me even more than the aftermath of the deluge was witnessing the pace of change across Abu Dhabi and other countries in the GCC over the last couple of years. Indeed, the scenes of chaos and disruption brought by flooding and mud storms should not be confused with the strong momentum behind entrenching financial and economic security amongst this group of countries. In particular, the UAE's richest emirate, Abu Dhabi, has transformed from a conservative, rich neighbour of Dubai to a global business hub.

We are overweight the Middle East region in our portfolios, with countries like the UAE and Oman being amongst our preferred picks. Despite the regional spread compression, we believe the fundamental improvements in select sovereign balance sheets warrants further positive rerating. We would expect new issuance to maintain its current pace and are mindful of weaker technicals, based on the size of the supply.

Moreover, we believe this region has a much bigger role to play, going forward, in shaping investors' global risk asset positioning. Whilst recognising that there remain a number of important ESG considerations within each country that need to be addressed – including political and social freedom, further transparency and governance of institutional decision making, as well as the reliance on fossil fuels, to name a few – we nevertheless also have to acknowledge the extent of transformation that is currently underway on the ground and the potential for positive outcomes this could eventually represent, both within and outside the realm of E, S and G.

What has changed? A few things. While the region has always been oil rich, the pace of wealth accumulation has picked up substantially. At over USD4 trillion, GCC Sovereign Wealth Funds (SWFs) account for over 40% of total SWF assets globally[1]. Last year, the GCC was named the "Region of the Year" in the Global SWF report, given that the "Oil Five" (the five most active Middle Eastern funds) were key drivers of SWF activity globally. The level of sophistication, international expertise and institutionalisation of the regional SWFs has increased substantially, with current asset allocation decisions focusing on rebuilding allocations to fixed income, extending duration and private credit exposure, as well as exposure to emerging markets. Hedge funds continue to be a core part of regional allocations.

Despite negative press coverage, SWFs in the region are also active in energy transition, accounting for almost half of USD26.1 billion investments in green assets deployed globally last year by these funds[2]. During my trip, we also engaged with UAE and Saudi institutions regarding providing solutions for funding transition assets, particularly in the energy sector. We believe regional sovereign players could meaningfully benefit from taking a more public stance with respect to their support of funding transition in this sector in emerging markets and more proactively addressing the negative public perception on this matter.

"Economic ties between the UAE and some European countries are now stronger than ever."

The pace of private capital accumulation is also staggering: BCG estimates show that the current pool of private wealth, based on 6000 ultra-high net worth individuals (or almost 50% of that in Canada), represents approximately USD1 trillion and is likely to triple, reaching USD3.5 trillion by 2027, thus transforming the region into a key global wealth management hub. Abu Dhabi has arguably the best standalone sovereign balance sheet in the world, with debt-to-GDP at 20%, regular, healthy annual fiscal surpluses and sovereign-owned assets that are more than 10x its GDP. Building on these strong fundamentals, the Emirate is focused on investing in the future.

Changes in transparency and engagement are also noticeable, from ease of doing business and tax advantages, with a focus on becoming a global financial hub, to re-engagement with developed market economies when it comes to global trade and co-operation. So far, anecdotal evidence is supportive of a successful execution, and country-level data already shows more than 50% of GDP of Abu Dhabi coming from non-oil sectors.

A senior government official stated that economic ties between the UAE and some European countries are now stronger than ever. For example, Italy has gone from not having a bilateral relationship with the UAE, two years ago, to now being its strongest counterpart in Europe.

Investors have been concerned about geopolitical risks in the region. Yet, the region seems determined to manage these risks through economic engagement rather than conflict escalation, including recent multi-billion assistance provided to countries like Egypt, as well as smaller disbursements to Kenya, Pakistan and other frontier economies, raising its global influence.

To transition from an oil exporter to an international financial and trading hub, with rivals like Singapore and Switzerland, the GCC also has to ensure that international compliance standards are high, including KYC due diligence on its clients. In February this year, the UAE was removed from the Financial Action Task Force (FATF) grey list in recognition of efforts over the last two years to address vulnerabilities in its approach to combating financial crime. A number of UK hedge funds have recently opened offices in Abu Dhabi and relocated large teams to the region, on the expectations of continued capital flows.

Not all countries in the region are making the same progress. Following our visit to Kuwait, we remain concerned about the current power-sharing model that has led to paralysis in decision making and the parliament being dissolved on four occasions over the last five years, given the disputes between the National Assembly and the cabinet.

[1,2] Global SWF Annual Report 2024.

Meanwhile, Bahrain feels like the most vulnerable country in the region from a fundamental standpoint. With debt-to-GDP over 130% (and growing) amidst substantial off balance sheet fiscal liabilities and large fiscal deficits, the country lacks transparency both in reporting and providing a breakdown of its liabilities and the path towards creating a sustainable debt management and growth strategy. Historically investors have, to some degree, closed their eyes to Bahrain's weak standalone fundamentals, given the support coming from its rich neighbour, Saudi Arabia.

However, as Saudi continues to introduce reforms that liberalise the economy and focus on the growth of the domestic leisure and entertainment industry, the need for its nationals to travel to Bahrain is likely to decrease. This could have further implications on funding support going forward.

"The UAE and other GCC countries are enjoying their moment under the sun, but longevity is key."

The GCC is transforming in many ways, simultaneously. There are also a number of examples illustrating the focus to move away from hard fundamentalism to a culture of tolerance and a more liberal mindset. The Abrahamic Family House is a case in point – the construction of this new interfaith complex completed in Abu Dhabi last year, housing a synagogue, a church and a mosque standing next to each other, speaks for itself and encourages dialogue and tolerance between faiths.

The Abrahamic Family House in Abu Dhabi: building a culture of tolerance

The UAE and other GCC countries are enjoying their moment under the sun, but longevity is key. We acknowledge that this time the region has dealt with external challenges very well, however consistency in delivery is vital to building investor trust. While countries like UAE and Saudi Arabia are determined to be perceived by international investors as developed economies, to us the focus should be more on policy consistency rather than a "developed markets" tag. Singapore is still part of EM fixed income indices and yet developed markets investors are comfortable with the sovereign and corporate risk in the country because of its track record.

As long as the region continues to successfully navigate the bouquet of challenges, from muddy rain to geopolitical risks, it has the potential to cement its transformation from an oil exporter to a global economic powerhouse to be reckoned with.

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