Emerging Markets Debt

MENA's Growth Presents Opportunities, but Challenges Remain

November 2018

Prepared by:

Jaymeson Kumm, GEM Debt Portfolio Manager

Amanda La Marca, Senior GEM Debt Product Specialist

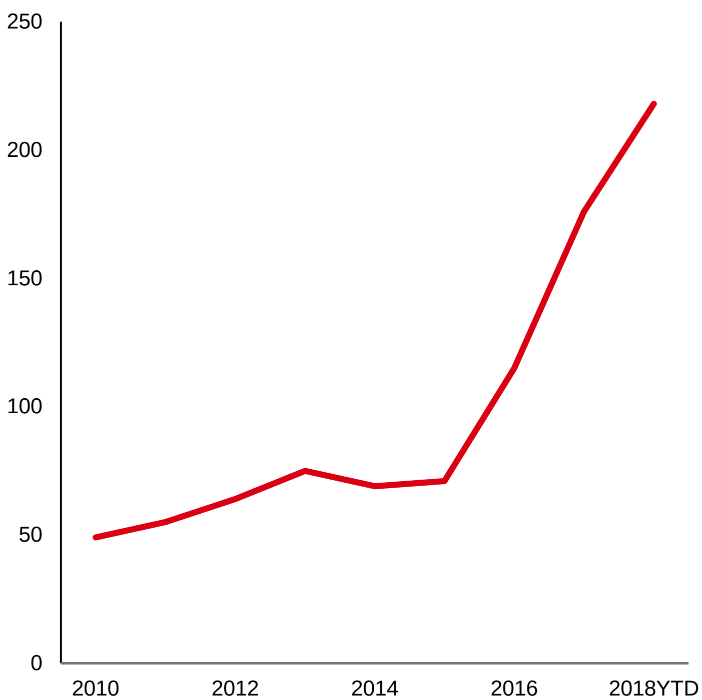
HSBC Global Asset Management

MENA issuance grows along with structural challenges

Against a backdrop of fiscal and structural adjustments, a large increase in bond issuance in MENA countries will continue

The Middle East North Africa (MENA) region has entered the radar for many investors given the increase in external debt issuance by corporates and sovereigns in the region over recent years. Stock of outstanding MENA sovereign bonds has increased from $70 billion in 2014, to over $210 billion today.

Historical EM hard currency sovereign debt stock (US$bn)*



This means MENA bonds now form a larger composition of emerging market hard currency indices, which has led to a heightened focus from emerging market and global investors alike.

Across the countries comprising the MENA region, there are broad similarities as well as important distinctions. The similarities consist of demographics, domestic challenges, geopolitical tensions, and the pressing need for structural reforms. The notable differences include availability of natural resources, currency regime (fixed or floating), and the pace and depth of required structural reforms.

Challenging demographics with high levels of youth unemployment - which average around 30% - is one similarity within the region. It highlights the need for structural reforms that tackle labor laws, education, and encourage investment by the private sector. For decades the public sector has been the main source of economic activity and employment - particularly in the Gulf Cooperation Council (GCC) countries where public employment can account for over 70% of total employment. This means transformation will not be easy. Private sector investments have historically been constrained due to preferential treatment of public sector companies which benefit from government contracts and access to financing.

The importance of oil and gas to the region is well known. Oil and gas have served as the centerpiece of the region's model for stability.

For most of the 21st century, higher energy prices supported the external balances of energy exporting countries while also allowing these countries to provide donor aid to energy importing countries in the region. In 2014, the price of commodities began to fall which exerted pressure on this operating model, resulting in weaker external balances and less income to finance budgets for energy exporting countries. For oil importing countries, this translated to less aid provided by the energy exporting countries.

In a lower oil price environment, the historic operating model is no longer viable, forcing long delayed efforts of economic transformation. The result is that MENA countries have had to undergo both fiscal and structural adjustments.

$210bn
stock of outstanding MENA sovereign bonds today versus **$70bn** in 2014

*Source: HSBC Global Asset Management, October 22, 2018.

Differentiating across MENA countries

On the fiscal front, lower oil prices turned current account surpluses into deficits which will need to be addressed by tax revenue measures and a reduction in spending on public wages and subsidies. In terms of structural adjustments, these countries will need to diversify their economies as well as broaden employment by increasing labor participation in the private sector.

Across the region, the transformation of the operating model has not been uniform and these adjustments are occurring at a diverging pace. Some countries have implemented reforms and taken harsh measures which are beginning to yield some benefits; however other countries have yet to adapt.

As a result, it is important to differentiate across the approximately 20 MENA countries that issue external debt. We have broken down the countries into the following three categories based on severity of required structural reforms and willingness/ability to act:

1. **Countries without a pressing need for macroeconomic adjustment**

   These countries have historically benefitted from higher energy prices which allowed them to build large external reserves, and as a result the adjustment is more gradual, particularly with oil prices higher in 2018. Examples include select GCC countries: Kuwait, Saudi Arabia, Qatar, and United Arab Emirates.

2. **Countries undergoing macroeconomic adjustments**

   This group of countries are in the process of undergoing an adjustment through both fiscal consolidation and structural reforms. They are adopting flexible currency regimes and in some cases have are turning to the aid of the International Monetary Fund. Examples include Egypt, Morocco, and Tunisia.

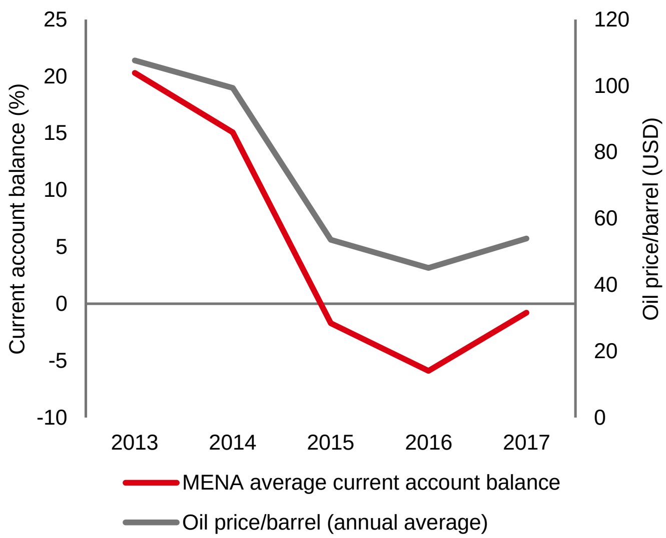
3. **Countries not undergoing necessary macroeconomic adjustments**

   These countries have a pressing need for a macroeconomic adjustment but have so far delayed the necessary measures. They have weaker fundamentals and require the support of foreign aid to prevent a balance of payments crisis. Examples include Lebanon, Bahrain, and Jordan.

Increased representation in EM indices

Many of the GCC countries fall in the first category and have garnered particular attention given the rapid growth in issuance, which came after a drop in oil prices resulted in large budget and current account deficits. During the period of very low oil prices, the current account balances began to deteriorate for many of these countries which led to a drawdown on the sizeable foreign currency reserves accumulated in prior years. To slow the depletion of foreign currency reserves, they turned to borrowing US dollars in international markets. Some of the countries - such as Saudi Arabia and Kuwait - issued hard currency bonds for the first time. The stock of outstanding GCC sovereign bonds increased from $25 billion in 2014 to nearly $150 billion today.

GCC current account balances (%) vs. oil

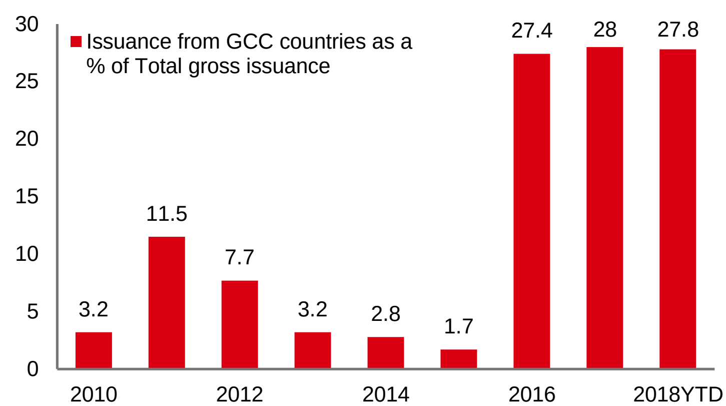


Source: HSBC Global Asset Management, October 31, 2018.
"MENA average" is an average of the current account balances for Saudi Arabia, Qatar, Oman, Kuwait and Bahrain over the respective calendar year. The price/barrel annual average is an average of daily prices for each respective calendar year beginning March 01, 2013 and ending November 30, 2017.

We anticipate these markets will continue to rely on international dollar bond markets, even as oil recovers, in an effort to rebuild reserve buffers that had been partially drawn down, as well as to raise funds to help diversify their economies. This significant growth in hard currency issuance has contributed to JP Morgan's decision to include sovereign and quasi-sovereign bonds from the GCC region (Saudi Arabia, Qatar, United Arabs Emirates, Bahrain, and Kuwait) in its EMBI hard currency indices beginning in early 2019 (Oman was previously added in 2016).

This family of emerging market debt indices is one of the most widely tracked by benchmarked investors. With $360 billion of assets tracking the JPM EMBI indices, the inclusion of GCC countries will result in heightened investor demand. These countries should also benefit from continued access to markets given the large investor base. Further benefits resulting from the index inclusion include fostering liquidity, compressing borrowing costs, diversifying the investor base, and finally supporting the rollover of 40% of outstanding short-term sovereign bonds.

Recent EM sovereign issuance trends indicate GCC issuers accounted for close to 30% of new supply in each of the last 3 years



Source: JP Morgan, October 31, 2018.

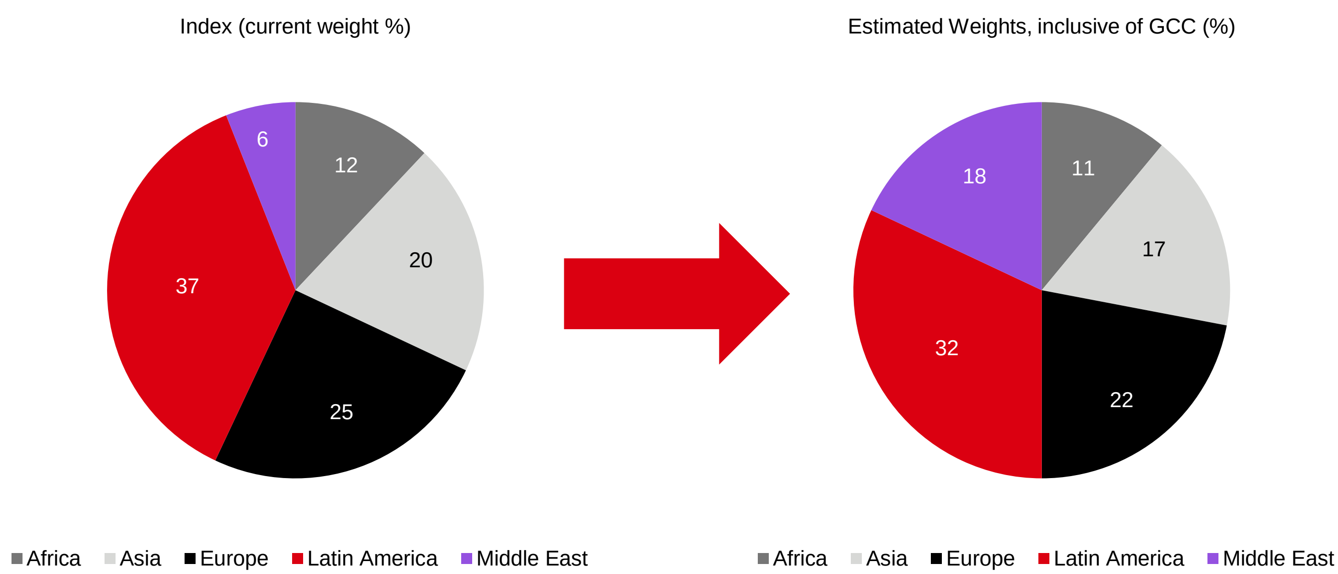
Potential opportunities for active management

We expect continued reliance on international debt markets by those countries featured in the second and third grouping of the country categories. However, we believe that investors will begin to differentiate among the countries in these two categories and in fact we are already beginning to see evidence of this by diverging performance in credit spreads and the ability to access to international markets.

Egypt, for example, has shown a commitment to undertaking economic reforms and despite challenging fundamentals we have started to see gradual improvements which have afforded the country access to international markets (Egypt has issued over $12 billion in external debt over the past two years) and compression of credit spreads. On the other hand, Lebanon has delayed implementing the needed reforms, which has resulted in a meaningful widening of credit spreads and limited access to international debt markets.

The evolution of the debt market for the MENA region, including the GCC index inclusion, will have a notable impact on the JP Morgan indices with the weight of the broader MENA region increasing from approximately 10% to over 20% (JPM EMBIG Diversified) by the end of 2019. As a result of these changes, the benchmark will experience a one-notch rating upgrade. We believe these changes present opportunities for active management with differentiation and selectivity being critical given the diverging fundamentals and pace of transformation among the countries within the MENA region.

New rule implementation results in a significantly more representative Middle-East region



Source: JP Morgan, October 31, 2018.

Key Risks

Risk Considerations. There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- **Exchange Rate Risk** Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly.
- **Counterparty Risk** The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations.
- **Liquidity Risk** is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors.
- **Operational Risk** may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things.
- **Derivatives Risk** Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset.
- **Emerging Markets Risk** Emerging markets are less established, and often more volatile, than developed markets and involve higher risks, particularly market, liquidity and currency risks.
- **Interest Rate Risk** When interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.
- **Default Risk** The issuers of certain bonds could become unwilling or unable to make payments on their bonds.
- **Credit Risk** A bond or money market security could lose value if the issuer’s financial health deteriorates.
- **CoCo Bond Risk** Contingent convertible securities (CoCo bonds) are comparatively untested, their income payments may be cancelled or suspended, and they are more vulnerable to losses than equities and can be highly volatile.

Important information

Past performance is no guarantee of future results.

This document is for information only and does not constitute investment advice, a solicitation or a recommendation to buy, sell or subscribe to any investment. It is not intended to provide and should not be relied upon for accounting, legal or tax advice.

The views expressed were held at the time of preparation and are subject to change without notice.

Forecasts, projections or targets are indicative only and are not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets.

Index returns assume reinvestment of all distributions and do not reflect fees or expenses. You cannot invest directly in an index.

HSBC Global Asset Management is the marketing name for the asset management businesses of HSBC Holdings Plc. HSBC Global Asset Management (USA) Inc. is an investment adviser registered with the US Securities and Exchange Commission.

HSBC Global Asset Management has based this material on information obtained from sources it believes to be reliable but which it has not independently verified. HSBC Global Asset Management and HSBC Group accept no responsibility as to its accuracy or completeness.

Portfolio characteristics, including position sizes and sector allocations, among others, are generally averages, are only for illustrative purposes, and do not reflect the investments of an actual portfolio unless otherwise noted. The investment guidelines of an actual portfolio may permit or restrict investments that are materially different in size, nature and risk from those shown.

US persons (both entities and individuals) are subject to US taxation on their worldwide income and may be subject to tax and other filing obligations with respect to their US and non-US accounts. The Foreign Account Tax Compliance Act (FATCA) is a US law designed to prevent the use of non-US accounts or non-US entities to avoid US taxation of income and assets. To meet this objective, FATCA imposes on US and non-US entities certain documentation, due diligence, withholding and reporting requirements with respect to accounts and certain payments. Investors should consult their independent tax advisors about investment tax implications.

The contents of this document are confidential and may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose without prior written permission.

In Chile: Operations by HSBC's headquarters or other offices of this bank located abroad are not subject to Chilean inspections or regulations nor are covered by warranty of the Chilean state. Further information may be obtained about the state guarantee to deposits at your bank or on www.sbif.cl

In Colombia: HSBC Bank USA NA has an authorized representative by the Superintendencia Financiera de Colombia (SFC) whereby its activities conform to the General Legal Financial System. SFC has not reviewed the information provided to the investor. This presentation is only for the exclusive use of institutional investors in Colombia and is not for public distribution.

In Peru: HSBC Bank USA NA has an authorized representative by the Superintendencia de Banca y Seguros in Perú whereby its activities conform to the General Legal Financial System - Law No. 26702. The Fund has not been registered before the Superintendencia del Mercado de Valores (SMV) and are being placed by means of a private offer. SMV has not reviewed the information provided to the investor. This presentation is only for the exclusive use of institutional investors in Perú and is not for public distribution.

Investment products:

ARE NOT A BANK DEPOSIT OR OBLIGATION OF THE BANK OR ANY OF ITS AFFILIATES	**ARE NOT FDIC INSURED**	**ARE NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY**	**ARE NOT GUARANTEED BY THE BANK OR ANY OF ITS AFFILIATES**	**MAY LOSE VALUE**

All decisions regarding the tax implications of your investment(s) should be made in connection with your independent tax advisor.