



GCC debt market tested

Pricing in the GCC debt market will be tested in the future after the Dubai debt worries that hit the global market in late November. **Matein Khalid** wonders how investors will price issues that have implicit government guarantors after Dubai.

The events of November 27 have, naturally, unsettled the attitude of emerging debt fund markets toward investing in the GCC sukuk, sovereign and corporate debt markets. Despite Abu Dhabi's decision to lend US\$10 billion to Dubai to avoid a ruinous Nakheel default, implicit guarantees on quasi-sovereign debt no longer

have any intrinsic value in investor calculus of repayment risk. Implicit guarantees, like offplan flipping and bank name lending, will not survive the endgame of the 2008-2009 financial debacle in the Gulf capital markets. On a more immediate basis, I believe risk premiums will remain exceptionally high in the Gulf for a protracted period of

time as Dubai Inc. restructures its colossal external debt. This means that Gulf borrowers, governments quasi sovereign and corporates will pay a higher spread above the risk-free US Treasury note rate for all maturities. It is, after all, significant that Abu Dhabi and Qatar sovereign debt sold off after the shock of the Nakheel standstill



announcement on November 27, meaning contagion from Dubai debt is a reality in the GCC debt markets. In any case, it is also significant that credit default swaps for Dubai and Abu Dhabi, which plummeted after the bailout, have nowhere near returned to the levels that existed before the Nakheel standstill announcement.

The Abu Dhabi bailout stabilised the UAE financial markets, but it also highlighted the fact that communications among Gulf governments cannot be accurately predicted by investors. The Nakheel sukuk was, after all, investment grade, yet it twice traded more than

50 per cent below its par value, an unsettling scenario for offshore fund managers forced to mark to market their holdings of GCC debt. This has naturally led to lower allocations to GCC debt and even equities, where an illiquid, smallish stock market can close limit down or up for successive trading sessions.

While Abu Dhabi's decision permits the repayment of the sukuk maturing December 2009, it is conditional upon Dubai World concluding a successful standstill with its myriad creditors. This means that a complex, protracted international restructuring of Dubai World is inevitable. This Abu Dhabi support means that trade, contractor and bank creditors to Dubai World will not be forced to take a painful haircut.

Negative impact

Fitch, Moody's and Standard & Poor's have all cut ratings of UAE banks and state-owned companies, as implicit government guarantees that once commanded two to five notch credit ratings are no longer viewed as credible by both analysts and investors. The three rating agencies will not upgrade or reverse their credit downgrade on UAE borrowers as long as the Dubai World restructuring does not come to a successful endgame, a prospect I can easily envisage as another six months away. Dubai World is quite possibly the most complex business conglomerate in the Middle East, with the highest debt held by dozens of banks all over the world. These include vastly different businesses like Nakheel, DP World, Istithmar, Limitless, Dubai Drydocks, Jebel Ali Free Zone, P and O Ferries and real estate holdings everywhere from the City Center complex in Las Vegas to hotels in New York.

When all is said and done, the Dubai debt shock reminds the world that the post-Lehman-Brothers global financial crisis is

still not over and despite the trillion-dollar central bank easings and government fiscal stimuli, the world economy is still fragile. Dubai, after all, was not the only example in the world that amassed cheap debt to finance a construction boom that overheated the emirate's domestic economy, triggering off a spectacular asset bubble whose collapse precipitated the Nakheel debt shock. As the fall in the Gazprom bond suggests, investors are no longer willing to trust implicit state guaranteed by a credit as strong as the Russian Federation, with its US\$500 billion in hard company assets. Downside risk in quasi-sovereign borrowers simply cannot be calculated, as investors do not know how to price implicit government guarantors after Dubai.

This will have a negative impact on the valuation of markets dominated by banks, insurers and property developers owned by the state, an existential reality across the Gulf. Government policy will become mission critical in investing, as debt shocks in countries as diverse as Dubai, Latvia, Greece, Ireland and Spain suggest that dimensions of systemic risk are mispriced by the capital markets. The linkages between Dubai and the broader emerging markets are not linear, the reason the markets stabilised after a savage sell-off on November 28. Yet, I do not consider it a coincidence that gold has lost US\$100 an ounce in the last month, crude oil is down from US\$80 to US\$69, that the euro has fallen from 1.5150 to 1.4500 and that the US Dollar Index surged from 74 to 77 in a fortnight. Risk is, after all, a four-letter word in emerging market investing, and so is ruin. Caveat emptor!

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