FRANKLIN TEMPLETON

Investing in Sukuk - The Future is Bright

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Islamic finance, once the domain of Islamic investors only, continues to grow at a healthy pace of more than 20% each year[1]. And within this market, Sukuk, or Shariah-compliant bonds, are becoming increasingly attractive to both Islamic and non-Islamic investors. With annual growth of about 24% over the past 15 years, the Sukuk space has been expanding much faster than the wider Islamic finance market itself[2]. We anticipate this rate of growth to remain robust moving forward.

The Sukuk market has come a long way in the past decade. In 2009, the asset class' market capitalization was just US$10 billion and comprised of two to three geographies[3]. Issues were generally small and the market was concentrated amongst a handful of issuers. Last year, however, the market approached an impressive US$500 billion[4]. This was due to an exponential growth in the number of large deals and the increasing diversification of issuers. Some estimates now suggest that conventional investors may account for between 40% to 60% of any individual Sukuk offering[5].

Yet despite this strong growth and emerging acceptance, it is still largely overlooked as an investment option. For example, since Sukuk have historically been a niche market for global investors, there is limited research on the space. This has made the market more opaque than traditional, developed fixed income asset classes where research, credit ratings and financial information are more readily available. But the Sukuk market is changing and developing quickly. Instead of keeping conventional investors out of it, we see an opportunity. We believe that with thorough and reliable credit research, global investors can uncover attractive opportunities in this rapidly expanding asset class.

In our view, there are three key reasons we think investors should consider investing in Sukuk.

FIRSTLY, SUKUK IS ON A POSITIVE GROWTH TRAJECTORY IN TERMS OF SIZE AND ISSUANCE.
Though it represents roughly 1% of the US$50 trillion indexed global debt market, it is on par with the size of other fixed income asset classes such as European High Yield[6]. If we continue with our projections for a lower rate of growth at roughly 15% per year, the global Sukuk space will likely be north of US$2.7 trillion by 2030[7]. Meanwhile, countries like Nigeria, Pakistan, Hong Kong, Turkey and Indonesia are fast becoming significant Sukuk issuers, highlighting the popularity of the asset class, with increasing diversification of portfolio risks.

SECONDLY, THE FUNDAMENTALS OF SUKUK ARE ATTRACTIVE.
Sukuk is a growing fixed income asset class with an attractive risk-return profile. These fixed income instruments exhibit less volatility (as measured by standard deviation) compared with conventional global bonds, offer appealing long-term returns, attractive yields, little correlation to the movement of oil prices and improving liquidity.

THIRDLY, SUKUK ARE MORE MAINSTREAM.
JP Morgan now includes the GCC in its emerging market benchmark, with the region accounting for approximately 18% of the gauge[8]. The GCC block now represents a significant proportion of emerging market debt, making it increasingly hard for investors to bypass. On top of this, in 2017, JP Morgan included Sukuk in their Asian emerging market indices, with the region now comprising more than 3-4% of the different indices[9].

Despite our positive outlook, there are several developments that need to take place for the Sukuk market to hit the US$2.7 trillion mark by 2030. These include tackling obstacles around standardization, innovation and governance.

As of today, there are some cost and structural issues that exist in the Sukuk market and an ongoing debate about whether there should be one common cost standard for all Sukuk issuing markets. Our view is that it is difficult to achieve one set of standards. Instead, it is important to continue to innovate to help the market grow. Costs can be addressed through more transparency around Sukuk structures, rather than trying to oversimplify and 'over regulate'.

In terms of overall development, market participants have an important role to play in stimulating activity. There needs to be a concerted effort to continue to monitor and develop the market so that issuance levels remain healthy. Governments and financial institutions for example are the biggest Sukuk issuers globally, so their role in terms of pushing for market growth and development will remain vital. And as the list of worries for investors grows amidst geopolitical uncertainties, Sukuk could provide the type of resilience and stability that mitigates an uncertain global economy, making the long-term outlook a truly exciting one.

1. Source Financial News, "Western Investors Warm to Sukuk," 17 July 2012.
2. FT estimate, based on Bloomberg data.
3. KFH Research.
4. Source: Bloomberg LP as of 31 December 2018. Data excludes short-term issuance.
5. Source FinanceAsia, "Malaysia's Islamic Bonds Lure 'Agnostic' Investors," 21 May 2014.
6. FT calculation, based on global indices.
7. Bank of America Merril Lynch, The Hitchhiker's Guide to the Investment Universe, 14 June 2018, FT Internal
8. Source: JP Morgan – February 2019.
9. Source: JP Morgan – February 2019

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