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Maintaining Sukuk’s Momentum

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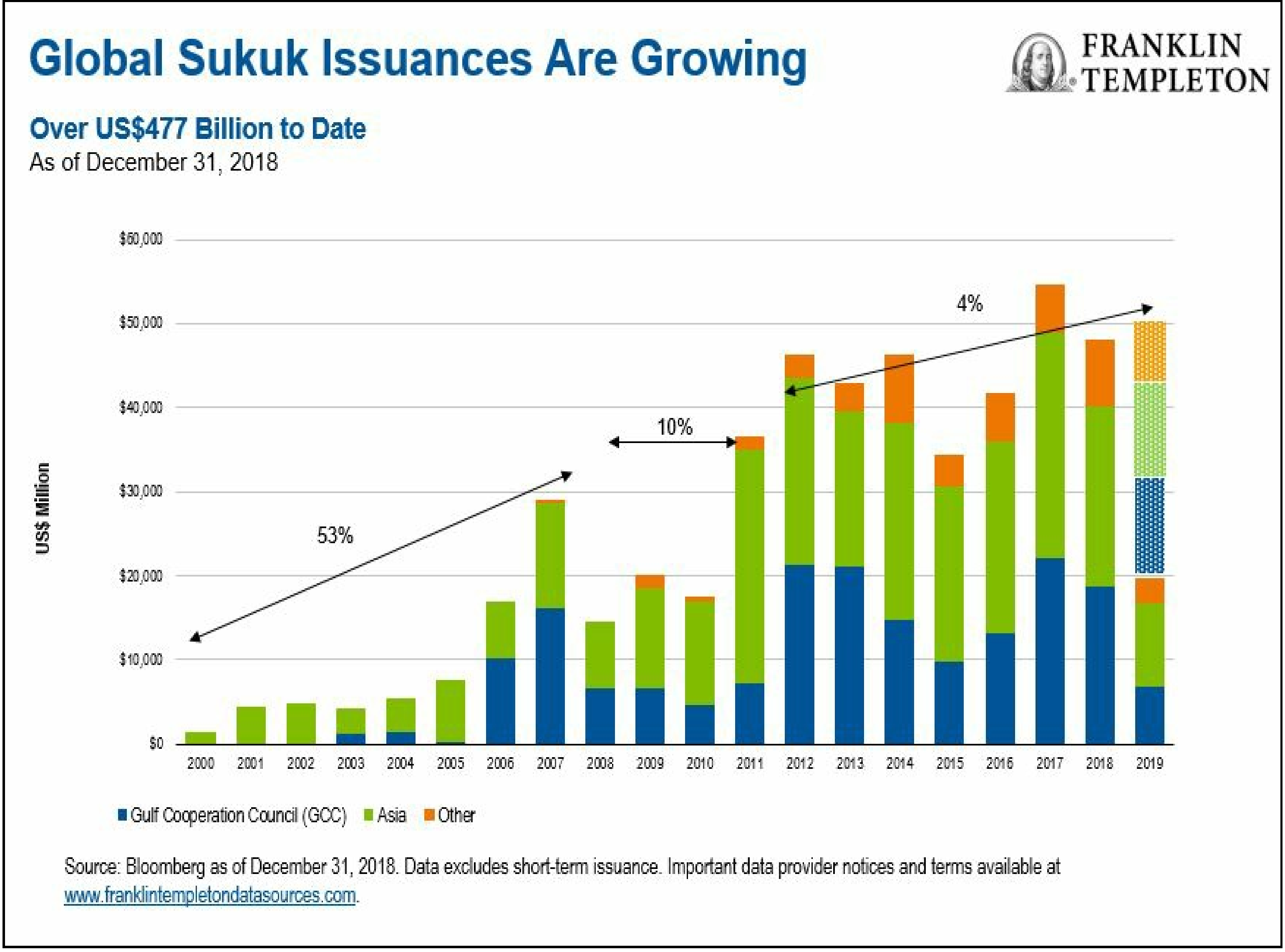
Islamic finance has grown at a healthy pace, and within this market, sukuk—Shariah-compliant bonds—have increasingly attracted attention from investors across the globe. Franklin Templeton Global Sukuk and MENA Fixed Income’s Dino Kronfol is optimistic about the next decade for sukuk’s role in the global fixed income space. He shares what developments he’d like to see to make that happen.

Sukuk—bonds that comply with Islamic law—are becoming increasingly mainstream. Over the last 15 years, we’ve watched sukuk run on a positive growth trajectory in terms of size and issuances, creating ample potential opportunities for active investors.

We think the future is bright for investing in sukuk. We are confident that sukuk can capture more market share in the global fixed income space.

Our more than 10 years of investing in the asset class suggests sukuk could provide the type of resilience and stability that mitigates an uncertain global economy, particularly as more risk management tools, environmental, social and governance (ESG) analysis and fintech capabilities become increasingly integrated into sukuk products.

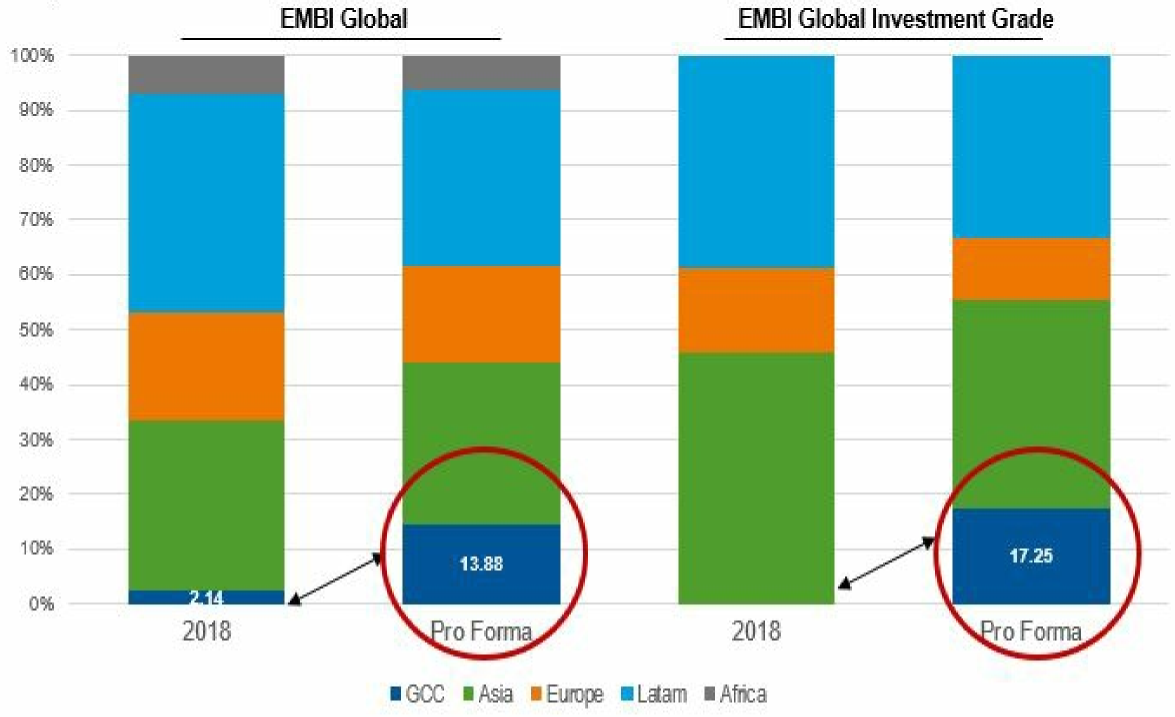
We are excited for what the next decade will bring.



Despite this, sukuk remains a misunderstood asset class, subject to misconceptions. Sukuk was recently included in J.P. Morgan's Asia Credit Index Core and Emerging Market Bond Indexes.[1] We believe that positive reception should spur further growth in sukuk and cement its place as a significant component of global markets.

GCC Debt Now Included in J.P. Morgan's Emerging-Market Indexes

As of January 2019



Source: Bloomberg, as of January 2019. Gulf Cooperation Council (GCC) bonds represented by Bloomberg Barclays GCC USD Credit Index. Important data provider notices and terms available at www.franklintempletondatasources.com. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges.

It's not a foregone conclusion that the sukuk market will hit our estimate of US$2.7 trillion in assets by 2030.[3] However, we've identified a number of developments we think should maintain momentum for the asset class. These primarily relate to growth in issuances from the market, and how we tackle obstacles around standardization, innovation and governance.

Maintaining Momentum—Three Developments We'd Like to See

- **Looking Further Afield for New Sukuk Issuance**

As market participants, we have an important role to play in promoting the industry. Governments and financial institutions are the biggest sukuk issuers globally, so their role in terms of pushing for market growth and development will remain vital. Asia, which has the biggest domestic sukuk market, has seen the volume of sukuk issuances decline 4% on average over the past five years. We think this trend should reverse as issuances come from new sources and attract more investors to the asset class.

Already, the number of sukuk issuers is expanding: Nigeria, Pakistan, Hong Kong, Turkey and Indonesia have become more significant sukuk issuers in recent years. One further possibility could be Chinese issuers looking to diversify their sources of funding.

We'd expect the Gulf Cooperation Council (GCC), particularly Saudi Arabia and the United Arab Emirates, to remain drivers of sukuk growth, since they make up a third of the market. Those countries also have ambitious economic diversification and capital market development plans.

Africa, from Egypt to Nigeria to South Africa, could also potentially emerge as a beneficiary or catalyst for the growth of Shariah-compliant finance, in our view.

Lastly, we believe encouraging providers of indexes to measure the non-dollar sukuk market could be another way to help foster growth. Most sukuk indexes are based in US dollars, that leaves a big portion of the market underrepresented. The emergence of more non-dollar indexes in vital emerging markets could open up the opportunity set further.

- **Improving Standardization and Innovation**

We recognize there is more work to be done on standardization and innovation in the sukuk field. Some cost and structural challenges exist in the market and the viability of imposing one common standard across all sukuk issuing markets. Our view, is that it would be difficult to achieve one set of standards. Instead, we think it is important to continue to innovate to help the market grow.

- **Compliance and Governance in the Spotlight**

We believe the market should address concerns about costs through more transparency around sukuk structures, rather than trying to oversimplify and “over-regulate.”

For example, introducing a universal rulebook that closely examines sukuk structures—and confirms if they are Shariah compliant—would help focus the attention of the market and make it more efficient. As a firm, we have recently developed our own sukuk rulebook to help portfolio management teams and investors navigate some of these challenges around Shariah compliance and governance.

In our view, sukuk is making its way from niche asset class into mainstream investing, as it shakes off the mystique typically associated with less conventional asset types. Participation from countries such as Nigeria, Pakistan, Hong Kong, Turkey and Indonesia has driven general interest.

If proponents of the asset class can reflect the growing interest from local governments in more issuance and better standardization and governance, we believe sukuk could prove attractive to open-minded investors.

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What Are the Risks?

All investments involve risks, including the possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

1. There is no assurance that any estimate, forecast or projection will be realized.

2. Source: Bloomberg, as of December 31, 2018.

3. The J.P. Morgan Emerging Markets Bond Index tracks bonds in emerging markets. The J.P. Morgan Asia Credit Index Core (JACI Core) consists of liquid US-dollar denominated debt instruments issued out of Asia ex-Japan. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges.