RBC Global Asset Management

Geopolitical Tensions
Notes from the Emerging Market Debt Desk

Market review

Events in the Middle East have been an important focus over the course of the last month and the situation remains very fluid. Whilst the tragic human element of the conflict remains central, we also wanted provide a brief overview of our outlook for the region and the extent to which recent developments could impact individual credits. As we have mentioned before, our base case remains that the conflict will not spread to include other countries and that regional players will not want to be drawn in. Given this view, we continue to hold positions across a number of Middle Eastern credits in both the sovereign and corporate sectors.

We have summarised below some of the key factors that are driving our view and positioning:

Escalation is unlikely

Whilst the on-going conflict between Israel and Hamas is proving to be bitter and bloody, with civilians bearing the brunt of the casualties, we still think the risk of escalation into a wider regional conflict is limited. The US, for one, has its hands full already supporting Ukraine against Russia, backing Israel against Hamas while also keenly monitoring other potential risks globally that could draw on its military resources, including heightened tensions between China and Taiwan. An extension of the current Israel-Hamas war to include other regional players would risk stretching US military resources to breaking point. The US hence seems eager to limit risks of being drawn into any such direct conflict with Iran - dispatching two carrier groups to the region to send a warning shot across the bows of Tehran and its proxies, such as Hezbollah, to stay out of the current conflict.

Regional players including Iran, have also appeared reluctant to become involved directly and, if anything seem eager to tone down tensions with rivals (Saudi Arabia, for instance in the case of Iran) or are working behind the scenes to contain the conflict – this includes Oman and Qatar, particularly, but also the leaders of Turkey, Egypt and Jordan. The calculation behind their actions is motivated by the need to balance their individual domestic economic and political challenges against the rising anger, particularly in the Arab street, at the plight of the Palestinians. Indeed, the risk of social unrest, triggered by the conflict and exacerbated by economic hardship, will likely be a stronger driver of policy decisions amongst some domestic players whilst the desire to contain the conflict could drive the Western governments and international organisations to potentially show leniency where they may have previously taken a harder line.

Outlook for individual credits

In the **EM hard currency sovereign strategy**, broadly speaking we have maintained strategic overweight to Oman and selective names in UAE, while implementing either underweight allocations to other countries or having CDS in names such as Saudi Arabia and Egypt. [as of 13th November 2023].

Active management is key

As we continue monitoring the region, we are reminded of the volatility that political and geopolitical events can create in markets and the economic fallout that can reverberate across the global economies. Investors cannot avoid political volatility entirely in their portfolios, but these events highlight once again the importance of employing active management in order to be able to minimise the impact and protect against some of the downside risks. Our decision to exit the Russian positions during the Nov 2021-Feburary 2022 period is one example of the benefits of active management. Likewise, our Israel CDS positions in the portfolio prior to the attack by Hamas helped mitigate against the ensuing market volatility. Currently we remain cautious on Egypt and Saudi Arabia among others, and have implemented various hedging strategies against the possibility of further political volatility in the Middle East as well as potential movement in oil prices.

If you or your clients have questions or would like further information, please don't hesitate to reach out to us.

Country	Bond	CDS	Total portfolio exposure	Comments
Saudi Arabia	-3.64%	-2.42%	-6.06%	We have expressed our concerns around the region through CDS on Saudi Arabia which is quite tight; it is also a hedge against oil beta.
Bahrain	-2.68%		-2.68%	We maintain underweight due to tight valuations now and concerns around high leverage still, and mixed reform progress.
Qatar	-1.61%		-1.61%	We maintain underweight due to tight valuations
United Arab Emirates	1.48%		1.48%	We have maintained overweights since UAE is characterised by low leverage, large sovereign wealth buffers and now strong reform momentum.
Kuwait	-0.70%		-0.70%	We maintain underweight due to tight valuations and slow reform momentum.
Jordan	-0.53%		-0.53%	An illiquid position and exposed to regional volatility leads to an underweight
Lebanon	0.16%		0.16%	Small legacy position
Egypt	0.17%	-0.49%	-0.32%	We have maintained a hedge through CDS due to possibility of social unrest in Egypt. But actively monitoring the story as we think conditionality could be relaxed to enable big ticket Gulf/Western financial support.
Iraq	0.34%		0.34%	We have cautiously positive conviction on Iraq, given the oil hedge, moderate debt levels and large FX reserve buffers.
Oman	4.33%		4.33%	Oman remains one of our key strategic overweights due to improving fundamentals and lowering leverage. Oman also has export routes outside the Gulf, strong relations with all players in the region, and benefits from a strong oil hedge.

Protecting portfolios in the face of rising geopolitical volatility

Hedging strategies and portfolio positioning examples

- **Russia – Ukraine**
  - Complete UW to Russia into the conflict
  - Russia CDS
  - Short RUB
- **Israel – Hamas**
  - Israel CDS
  - Egypt CDS
  - RV in the Middle East UW volatile names vs OW Oman / UAE
- **China**
  - UW across all portfolios
  - UW real estate

Investors need to choose an active manager who can appropriately hedge portfolios and manage through the volatility.

Source: RBC Global Asset Management, CFR Global Conflict Tracker as of September 2023

RBC BlueBay Asset Management

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