GEMs Paper

Saudi Arabia – look past geopolitics and supply

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GEM Fixed Income Strategy & Economics
EEMEA

Macro: a potentially pivotal year for transformation

In the absence of geopolitical tensions, we think Saudi economic activity and diversification are likely to pick-up as a) some mega-projects open their doors in 2024; b) emerging sectors could drive further reform; and c) fiscal policy is supportive. Escalation could impact fiscal and diversification (Foreign Direct Investment) trends. Still, Aramco's East-West pipeline provides it with export route flexibility, and potential targeted US security guarantees could reduce geopolitical uncertainty.

Saudi energy policy: it's not (only) the economy

The revision to the targeted Saudi Aramco Saudi Maximum Sustainable Capacity (MSC) likely reflects medium-term oil market fundamentals, large existing spare capacity and fiscal funding needs. We estimate the MSC target revision will lead to modest fiscal savings of 1.5% of GDP over four years that could be directed to priority megaprojects.

Equity: stress-testing Red Sea impact

Chemicals are negatively impacted by regional tensions due to higher freight costs and weak demand. However, the impact on bank profits via slower lending is moderate; implications for asset quality can be lumpy. Saudi consumer, healthcare and telecom sectors are least directly impacted as minimal supplies come through the Red Sea.

Fixed income: how much is too much issuance?

Large and persistent issuance of Saudi Arabia external debt could weaken investor appetite and impact borrowing costs. Further increases in Saudi's index weight are likely limited, but benchmarked investors have not been the main purchaser of Saudi bonds for some time already. Although medium-term structurally dependent on oil prices, robust domestic and regional bid is likely to offset benchmarked demand erosion.

Local debt: more work needed for GBI-EM index inclusion

Investment plans support authorities' target to grow the local debt capital markets and diversify away from external issuance. Liquidity is a constraint for inclusion in the Government Bond Index - Emerging Markets (GBI EM) and will likely take time to tackle.

Corporate credit: Saudi corps & banks issuance set to rise

2024 Saudi corporate issuance is likely to grow materially, driven by Public Investment Fund (PIF)-related debut issuers and banks. PIF megaprojects are focused on achieving "proof of concept"; banks tapped alternative onshore and offshore funding sources.

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Macro: A potentially pivotal year for transformation

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Middle East geopolitical risk premium back on the rise

Middle East geopolitical tensions represent tail risks to the global economy. Geopolitically induced spikes in commodities or freight costs can be among the most challenging exogenous shocks for markets due to their potential stagflationary impact. Sustained Red Sea Houthi attacks could disrupt shipping costs and supply chains in Europe, Asia and the United States (US). In turn, this may lead to renewed inflation pressures, especially in destination countries, and give rise to downside risks for trade volumes. A regional military conflict, especially if prolonged, could have more seriously damaging consequences.

Red Sea disruptions: A global chokepoint

The Red Sea (extending from the Suez Canal to the Bab-al-Mandab Strait) is an important global chokepoint. Nearly 15% of global seaborne trade passes through the Red Sea, including 8% of global grain trade, 12% of seaborne-traded oil and 8% of the world's Liquefied Natural Gas (LNG) trade. Re-routing cargos around the Cape of Good Hope in South Africa would add significant cost and weeks of delay to the delivery of goods (equivalent to 18 days to a voyage from the Middle East to Northern Europe).

Exhibit 1: Map of the Middle East's transit chokepoints
The Red Sea is a strategic route for global shipping

Source: US Energy Information Administration. SUMED = Arab Petroleum Pipelines Company.
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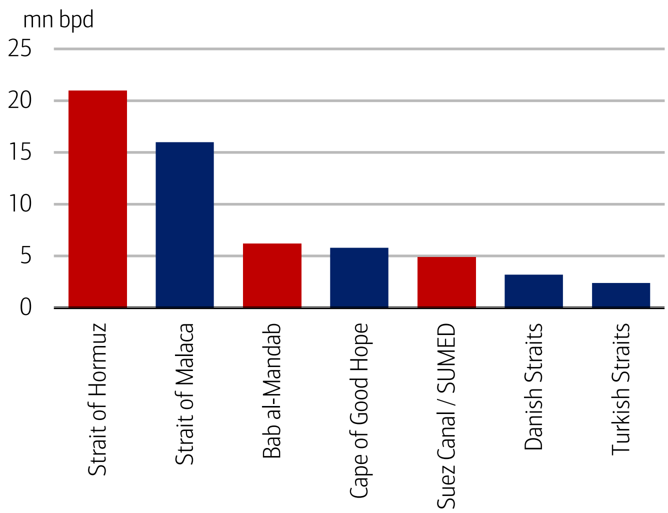
Exhibit 2: Global energy transit chokepoints
The Middle East is home to 3 of the global transit chokepoints (in red)



Source: US Energy Information Administration (EIA), BofA Global Research. As of 2019. SUMED = Arab Petroleum Pipelines Company.
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Red Sea – no regional war but no traffic either

Red Sea Developments have been playing out in line with our view of ongoing disruptions to shipping costs and supply chains that could persist for some time (see Global rate cuts lost at (Red) Sea? and A Sea of Red). Houthi disruption of maritime traffic has not stopped yet, despite United States (US) and United Kingdom (UK) strikes. US pronouncements have highlighted that the strikes have not yet materially eroded Houthi offensive capabilities. US and UK warnings have led to more announcements of traffic being rerouted away from the Suez Canal.

Conference call: conflict likely confined to Red Sea area

The key takeaway from our recent conference call on the Red Sea is that our speaker sees a risk of continued tit-for-tat between US/UK forces and Houthis in the near-term. His base case is for tensions to remain confined around the Red Sea area. He suggests that lower Iranian logistical support to Houthis (through the withdrawal of a spy ship) may mean less sophisticated Houthi attacks, but that any redeployment of the spy ship could then be interpreted as an escalatory gesture. The Houthi announcement that they would not target Saudi Arabia or United Arab Emirates (UAE) reduces the risk of a regional escalation, in our view. Recall that the United Nations (UN) brokered a ceasefire that took effect in Yemen in April 2022.

Saudi Arabia most at risk from disruptions in the Gulf

Saudi Arabia could be economically affected by an escalation in the Red Sea through two main channels: a) resumption of Yemen hostilities could pressure fiscal accounts; and, b) increased geopolitical uncertainty could impact economic diversification. The bulk of Saudi Aramco's oil exports is shipped through the Hormuz Strait rather than the Red Sea; its East-West pipeline provides it with export route flexibility.

Escalation could weigh on Saudi fiscal and business environment

Saudi Arabia could be economically affected by an escalation in the Red Sea through two main channels: a) a resumption of hostilities in Yemen could pressure Saudi fiscal accounts; and, b) increased geopolitical uncertainty could impact economic diversification efforts under Saudi Vision 2030. Persistent and escalated regional geopolitical tensions could shave c1ppt off Saudi non-hydrocarbon real GDP growth (bringing it to c3%), assuming no offsetting fiscal spending, in our view.

Renewed military spending could weigh on budget

Any increased military spending should the Yemen war resume could add to spending pressures on the Saudi budget, similar to the 2015-16 period. On-budget defense spending is a risk item in this regard. The US$5.3bn (0.8% of GDP) disclosed increased military and security projects over 2015 amounted to a US$15mn per day cost. The 2016 actual budget spending recognized SAR25.9bn (1.0% of GDP) in military overspending (US$6.9bn or US$19mn per day cost), compared to SAR20bn (US$5.3bn) in 2015. There may have been additional off-budget spending pressures.

Geopolitical volatility could affect Foreign Direct Investment

Saudi policy-making pronouncements suggest a key focus on economic diversification and attracting Foreign Direct Investment (FDI) in the coming period. A stable geopolitical outlook is likely to be necessary for that, in our view. A number of mega-projects (including in the tourism sector in the Red Sea) are due to open their doors this year. The Regional HeadQuarters (RHQ) program with preferential treatment in Saudi government procurement has taken hold from 1 January 2024. The revision to FDI statistics following methodological changes endorsed by the International Monetary Fund (IMF) paints an improved picture, but greater access to foreign capital is needed to fund the ambitious domestic investment plans, in our view.

Only minority of Saudi oil exports cross the Red Sea

We note that, for now, there has been no disruption to Saudi oil tankers. The Strait of Hormuz and the Suez Canal are key shipping routes for Saudi Aramco products. Saudi Aramco's East-West pipeline provides it flexibility to export from the East and West coast of the country, and has capacity of 5-6.5mn bpd. Following a rehabilitation and upgrade program, the Yanbu oil terminal on the Red Sea (West Coast) has seen its average handling and export capacity increase in 2018 by 3mn bpd to over 4mn bpd.

We understand that Saudi Arabia exports only c10% of its total crude exports through its Red Sea terminals to Europe. The bulk of Aramco's oil exports is instead shipped through the Ras Tanura and Juaymah terminals (across the Hormuz Strait). We note however that the Hormuz Strait has itself been the target of Iranian disruption to shipping in past episodes of regional tensions. Saudi crude oil tankers have not been targeted in the Red Sea for now.

Joint Organisations Data Initiative (JODI) data suggests Saudi maintains 149.6mn bbl of crude oil stocks as of October 2023. Saudi Aramco indicates it operates four crude export terminals with a total storage capacity of 66.4mn bbl as at 31 December 2020. In addition, Saudi Aramco has strategic international delivery points located in Rotterdam (Netherlands), Ain Sukhna (Egypt), Fujairah (United Arab Emirates) and Okinawa (Japan).

Assuming the storage capacity in Saudi Aramco's crude export terminals consists of purely crude oil stocks (and not oil products) and are full, this implies that Saudi Aramco maintains 83.2mn bbl of crude oil stocks outside Saudi Arabia. This suggests that Saudi Aramco could supply international clients for around 9 days prior to depleting its international stocks, if both East and West export routes are obstructed due to geopolitical developments.

US-Saudi security guarantees could reduce geopolitical uncertainty

A US-Saudi deal englobing security guarantees could create greater investor confidence about a more stable geopolitical backdrop and support attraction of Foreign Direct Investment (FDI) within the context of Saudi Vision 2030 projects, in our view. Press reports suggest Saudi normalization talks with the US administration have resumed. One of the aims of the talks would be US security guarantees, with a goal to finalize a deal prior to US presidential elections, according to press reports. However, regional geopolitical volatility likely creates challenges to complete such a deal, in our view. See Tectonic shifts in the Middle East for an in-depth discussion of the economic implications of normalization deals.

Transformation moves forward

In the absence of geopolitical tensions, we think Saudi economic activity and diversification are likely to pick-up as a) mega-projects are on track, with some opening their doors in 2024; b) new emerging sectors are likely to drive economic diversification and the next leg of reforms, with non-hydrocarbon real Gross Domestic Product (GDP) growth to hover around 4-5%; and, c) fiscal policy is supportive.

Non-hydrocarbon real GDP growth to remain robust

We expect Saudi Arabia to register robust non-hydrocarbon real GDP growth of c4-5%year-on-year (yoy) going forward. Economic activity could accelerate over the medium-term on public (mega-projects) and the private (Shareek program) investment drive. Saudi Arabia registered a technical headline recession of -0.9%yoy in 2023, driven by a contraction of the hydrocarbon sector. Still, the non-hydrocarbon sector grew by 3.2% 2023, with robust growth across the manufacturing, transport and domestic trade sectors.

Mega-projects to lead diversification

The start of the handoff of the first phases of the mega-projects is likely to enable the emergence of new, untapped, growth sectors uncorrelated with the oil sector, in our view. This could come at the expense of a modest downshift in the growth of the construction sector.

The United Nations Educational, Scientific and Cultural Organization (UNESCO)-listed Diriyah Gate Development opened its doors in late November 2022. Some of the Red Sea resorts will open by end-2023 and have started to accept reservations. Authorities announced the set-up of Riyadh Air to improve global connectivity.

Authorities are planning to place Saudi Arabia on the proverbial tourist map through a number of high-profile global events: a) Saudi Arabia won the bid in November 2023 to host the World Expo 2030; b) Saudi Arabia is the sole football association bidder to host the 2034 Federation Internationale de Football Association (FIFA) World Cup; and, c) the 2029 Asian Winter Games will be held in Trojena, a newly planned outdoor skiing destination in Saudi's Neom mega-project.

Tourism sector – early, but potentially promising

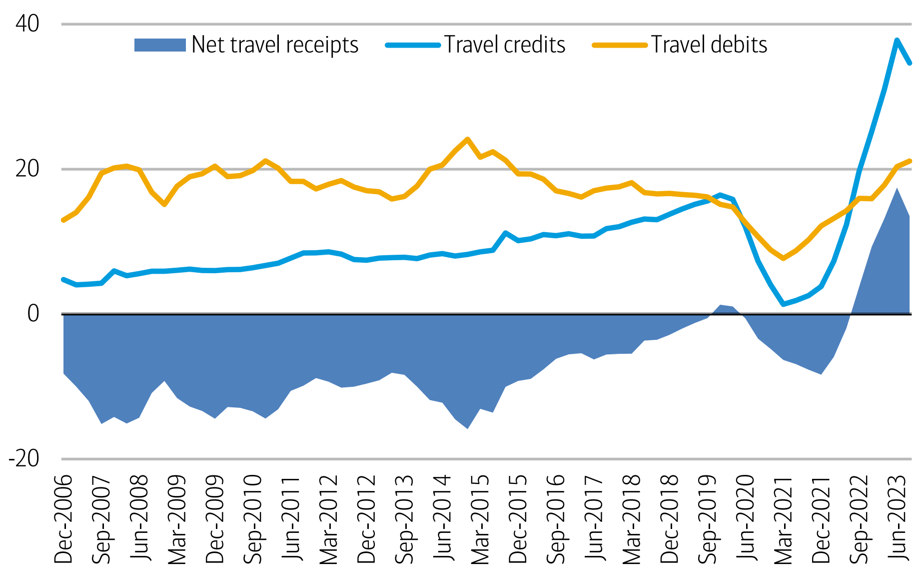
We expect the emergence of a tourism industry to capture a portion of the outbound tourism spend of Saudi nationals. Authorities highlight that outbound tourism for 2022 saw spending of SAR22.5bn with 9.5mn Saudi national travelers. In comparison, domestic tourism stood at spending of SAR107.3bn among Saudi national visitors of 77.8mn while inbound tourism is growing strongly from a low base, with SAR98.3bn spending for 16.6mn tourists. Religious visitors are estimated at 16.5mn in 2022.

Authorities revised in October 2023 its 2030 target to 150mn visitors, from the previous 100mn target, given the strong growth witnessed already from a low base. The new target is aimed to equally divided across international and domestic travelers. The old target included a target of 37mn for religious visitors and 63mn for leisure visitors. The tourism sector contribution to GDP is targeted to double from 5% to 10% by 2030.

Given the competition among high-end luxury tourism destinations and global airline carriers, we expect a potential further relaxation of social etiquette. Press reports suggest a licensed liquor store could open in the coming period in Riyadh to serve solely non-Muslim diplomats.

Exhibit 3: 4-quarter trailing net travel receipts (US$bn, 4Q06-3Q23)

Increase in inbound tourism pushes net travel balance in balance of payment to cUS$15bn annual surplus



Source: Haver, BofA Global Research.

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Regional HeadQuarters (RHQ) program picking-up

Authorities highlighted that Regional HeadQuarters (RHQ) licenses have been awarded to more than 180 companies so far, beating the 2023 target of 160. This should modestly support population growth, in our view. Saudi Arabia's latest iteration of the RHQ program appears to permit co-existence with the UAE's business model. Preferential treatment in Saudi government procurement from 1 January 2024 would apply to new contracts and not to existing projects, for instance. This is also reflected in the RHQ target for employment and incentives provided as well as potential infrastructure bottlenecks (schooling), in our view.

Authorities announced in early December 2023 they will offer a 30-year tax break (0% rate for corporate income tax and withholding tax) as an incentive for global companies that move their regional headquarters to the country.

Foreign Direct Investment (FDI) revision - positive but more is needed

The revision to Foreign Direct Investment (FDI) statistics following methodological changes endorsed by the International Monetary Fund (IMF) paints an improved picture, but greater access to foreign capital is needed to fund the ambitious domestic investment plans. According to authorities, FDI averaged 2.3% of GDP over the 2015-22 period, from less than 1% of GDP previously. FDI increased by 22% to stand SAR122bn (US$33bn) in 2022.

The FDI picture partly reflects the authorities' purchases of stakes in global firms in return for domestic localisation of some production facilities. We think this is a scalable model, with the main constraints being business opportunities, de-risking of greenfield sectors, infrastructure and regulatory framework, and, to a lesser extent, capital. The launch of four Special Economic Zones (King Abdullah Economic City, Jazan, Ras Al Khair, Cloud Computing) could attract further investment to take advantage of financial and non-financial incentives.

Unemployment trend on the mend

Implementation of the Labor Market Strategy (LMS) has helped reduce Saudi unemployment and increase labor force participation. Localization, female friendly policies (childcare, transportation, labor substitution in specific sectors) and Saudization efforts (under the Nitaqat program and the Wage Protection System) have been instrumental to achieve progress. Saudi Vision 2030 labor force participation rate targets have been already met while unemployment targets appear within reach if non-hydrocarbon real GDP growth remains robust. While the low-hanging fruits of reform have been met, gaps remain versus peers with similar income per capita.

Authorities plan to transition to a tiered skills-based visa system to manage expatriate population growth. Expatriate employment in the private sector declined over 2018-21, due to substitution and covid-19. It is now back to the pre-covid peak levels, although it has been accompanied by an increase in Saudi national employment. Expatriate employment remains high in the construction sector but is lower in wholesale sector due to localization and labor substitution initiatives (in cinemas/malls/jewellery outlets).

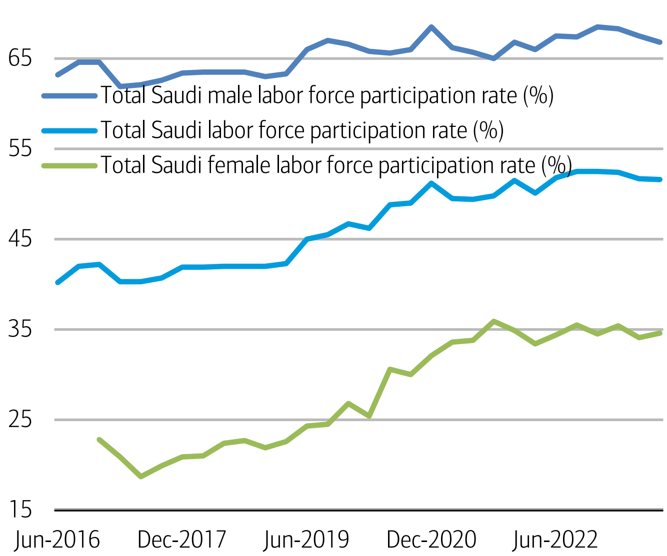
The reform to the Kafala system announced in March 2021 appears to have facilitated an increase in job mobility and flexibility for expatriates in the private sector, and a reduction in the wage gap between Saudis and expatriates. Still, while input and capital costs are competitive or subsidized, resolving the productivity mismatch is likely to be needed to ensure the private sector can be internationally competitive, in our view.

The Saudi Vision 2030 targets for Saudi unemployment rate, labor force participation rate and female labor force participation rate are 7%, 60% and 30% respectively. The total Saudi unemployment rate dropped to 8.6% in 3Q23, from 12.0% in 4Q19. The Saudi male and female unemployment rate dropped to 4.6% and 16.3% in 3Q23, from 4.9% and 30.8% in 4Q19, respectively. The total Saudi labor force participation rate increased to 51.7% in 2Q23, from 46.7% in 4Q19. The Saudi male and female labor force participation rate increased to 66.8% and 35.9% in 3Q23, from 66.6% and 26.0% in 4Q19, respectively.

Downward revision to population improves per capita macro indicators

The downward revision to population estimates improves per capita macro indicators and may reduce infrastructure spending pressures. Data from the 2022 Census published in May 2023 suggests that the total population (nationals and non-nationals) stood at 32.2mn in 2022. Population estimates were revised downwards by c8% on average over 2010-21, largely due to a lower national population rather than expatriate population.

Exhibit 4: Saudi labor force participation rate (2Q16-3Q23)
Rapid increase in Saudi female labor force participation rate



Source: Haver, BofA Global Research.

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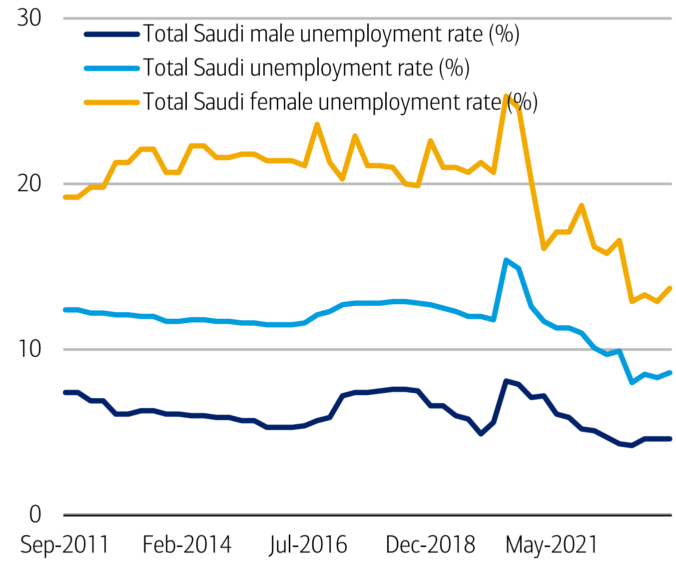
Exhibit 5: Saudi labor force unemployment rate (2Q16-3Q23)
Increase in Saudi female employment drives down total unemployment rate



Source: Haver, BofA Global Research.

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Shareek program – positive step forward

The announcement of the Shareek program in Saudi Arabia in early March is a positive step forward to increase Gross Fixed Capital Formation (GFCF). The program is focused on large corporates and has so far supported energy-focused (traditional and green) corporates. Recall that Shareek aims to unlock private investments of SAR5trn over 2021-30, of which Saudi Aramco and Sabic would account for SAR3trn.

SAR192bn in domestic incremental investment plans for 12 deals across 8 corporates have been announced (c4% of total planned for the coming decade). This is a positive step but a slow start, especially as the Shareek program was floated in 2021. We suspect financing is likely to be determined on a corporate case-by-case basis. Indeed, we understand that the Shareek program does not deal with the capital structure of companies (i.e. funding).

Government incentives offered include government off-take agreements and access to subsidized loans or financing support. We understand that the cost of the interest rebate on bank loans would be borne by the Saudi Ministry of Finance. (Shareek is a government body, with a budget allocation by the Saudi government).

National Development Fund (NDF) on the rise

The National Development Fund (NDF) establishment will likely support improved funding for the domestic economy in support of development priorities within Saudi Vision 2030.

The NDF was established by Royal Order in October 2017. It is the new umbrella for the government Specialized Credit Institutions (SCIs). Alongside six historical SCIs (Agriculture Development Fund, Social Development Fund, Saudi Industrial Development Fund, Real Estate Development Fund, Saudi Fund for Development, Human Resources Development Fund), a further six SCIs have been established recently (Cultural Development Fund, Events Investment Fund, Saudi Exim Bank, Tourism Development Fund, Small & Medium Enterprise Bank, National Infrastructure Fund).

SCIs have historically competed with domestic banks. However, the new NDF strategy is less focused on total disbursements and more on volume of deals to minimize this going forward.

Authorities have indicated that potential fiscal surplus will accrue into central government deposit accounts at the Saudi Central Bank (SAMA) initially. Subsequently, an undisclosed portion will be allocated to the Public Investment Fund (PIF) and the National Development Fund (NDF). We understand that the latter has however not yet benefited from government capital injections.

The NDF maintains a unlevered capital of cSAR500bn. It currently is in the process of a) resolving legacy Non-Performing Loans (NPLs); b) centralizing Treasury functions; c) introduce International Financial Reporting Standards (IFRS) accounting practices across SCIs; d) engage with rating agencies over the next 12-18 months; and, f) finally, prepare for an international sukuk issuance (without government guarantee).

Fiscal impulse supports economic activity

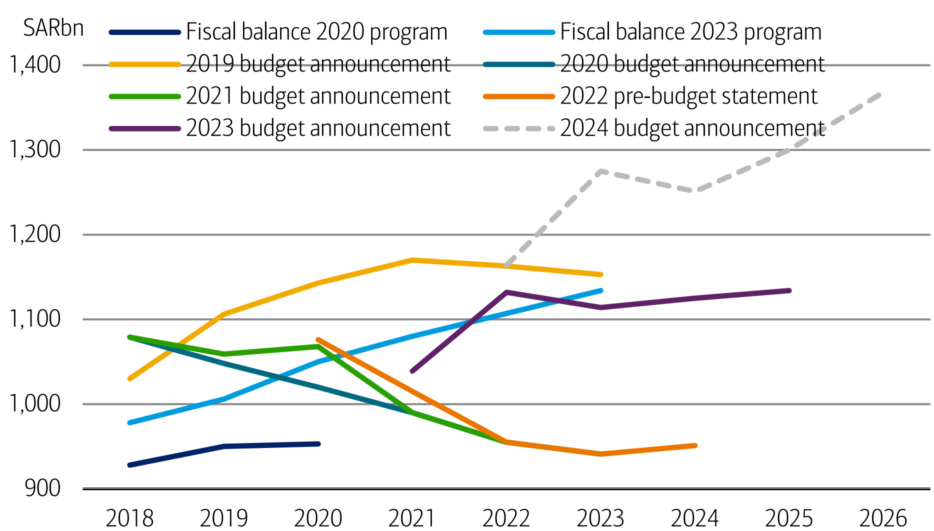
Medium-term budget framework suggests higher fiscal spending

The 2024 pre-budget statement is bullish for economic growth as authorities are raising fiscal expenditures in response to the oil windfall. Coupled with Public Investment Fund (PIF) investments off-budget, this fiscal impulse should ensure a robust growth outlook for the non-hydrocarbon economy. However, this is likely to increase the Saudi fiscal position vulnerability to oil prices.

No medium-term breakdown of spending (current versus capex) is given. Spending is set to rise by an average of 13% over 2023-25 versus guidance in the 2023 budget announcement released in December 2022. We suspect that the higher spending may reflect a revised costing of Saudi Vision 2030 projects. According to authorities, the fiscal accounts will be in a small deficit position over 2024-26 rather than a surplus position, as previously guided.

Exhibit 6: Medium-term expenditure path 2019-2024 budgets and 2020/23 fiscal balance programs

The medium-term expenditure path has been revised higher, highlighting Vision 2030 spending pressures



Source: Ministry of Finance, BofA Global Research.

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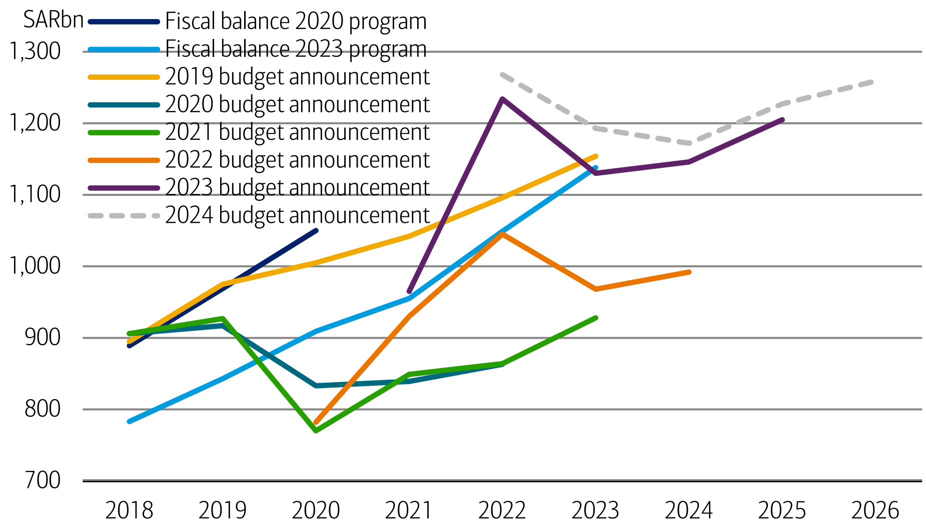
Exhibit 7: Medium-term revenue path in 2019-2024 budgets and 2020/23 fiscal balance programs
Saudi Aramco dividends push the medium-term revenue path higher



Source: Ministry of Finance, BofA Global Research.

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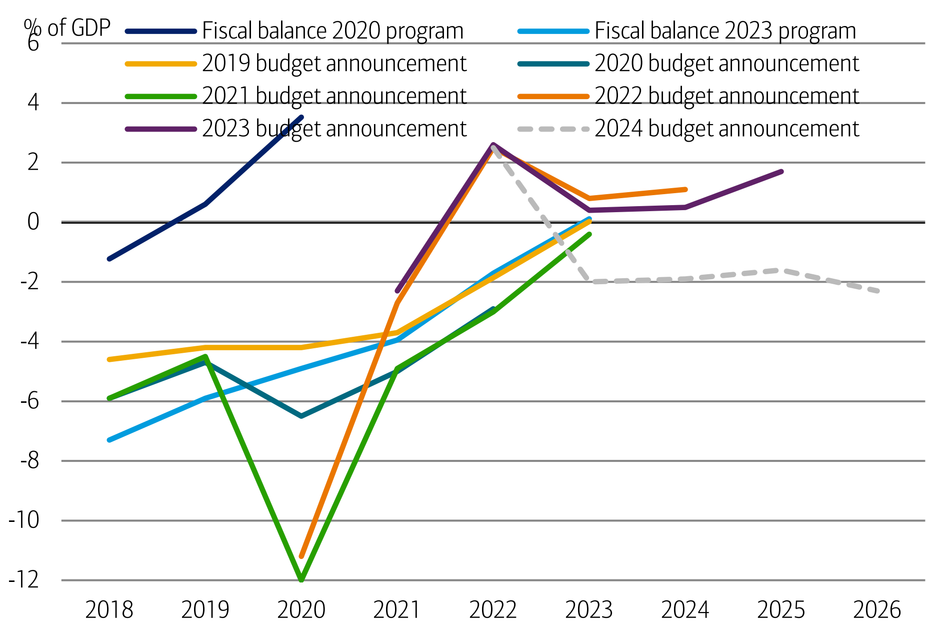
Exhibit 8: Medium-term fiscal balance path in 2019-24 budgets and 2020/23 fiscal balance programs
Fiscal balance shifts into modest deficits over the medium-term



Source: Ministry of Finance, BofA Global Research.

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PIF linkages could mean higher government funding needs

The Public Investment Fund (PIF) ambitious domestic investment and Assets Under Management (AUMs) targets likely suggest a funding gap and, in turn, potentially higher central government funding needs. (We think however that part of the targeted AUM rise could also reflect revaluation of the PIF's land bank, domestic assets and further government asset transfers). Another linkage to the central government balance sheet could arise if mega-projects medium-term profitability is put into question. See Saudi Arabia – rise of the PIF for a further discussion.

Authorities have suggested that that the fiscal surpluses at the Ministry of Finance (MoF) are likely to be transferred to the Public Investment Fund (PIF) and the National Development Fund (NDF). As such, we think authorities could likely target meaningful fiscal surpluses to generate the liquidity necessary for PIF and NDF to carry their off-budget investment plans.

The PIF's domestic investment mandate has effectively reduced on-budget capital spending. Its funding needs are mainly at the holding level given that PIF subsidiaries are meant to be self-financed entities eventually. in the meantime, their cash call on the PIF would necessarily be reflected in higher funding needs for the PIF. (The reported central government fiscal accounts are also cash-based).

Estimating a Free Cash Flow (FCF) proxy for PIF

We estimate a proxy FCF measure for PIF at the holding level, as the PIF only publishes consolidated financials in its disclosures (see table below). This is an imperfect measure, but its 5-year (2019-23) average level of cUS$3.5bn suggests we may have been able to account for the bulk of the PIF cash-based financing needs and sources over this period.

The PIF's main sources of funding over 2019-23 were capital injections by the government, borrowings, earnings from investments, and the proceeds of the US$69bn sale of Sabic to Saudi Aramco. The latter sale was fully pre-paid in 1H23, well ahead of schedule, boosting the PIF's liquidity profile in 2022-23 in a one-off basis. The main funding needs of the PIF consist of the targeted US$40bn annual domestic investments and capital injections. We expect the PIF to be a frequent eurobond issuer.

Our preferred metric for the additional cash call on the central government is proxied by the PIF FCF outflows minus dividends, interest and eurobond issuance (totalling US$20bn). In the absence of government capital injections or PIF loans/divestments, this effectively increases the simple measure of the central government fiscal breakeven oil price by cUS$10/bbl, if the PIF funding gap is met by the central government.

Exhibit 9: Estimate of Free Cash Flow (FCF) for the Public Investment Fund (PIF) at the holding level
Capital injections, borrowings, earnings from investments have contributed to meet PIF funding needs

US$bn	2019	2020	2021	2022	2023
Inflows	45.6	52.1	25.8	57.4	52.4
Equity holdings dividends	4.0	2.6	3.7	4.7	4.9
Private equity dividends	2.0	2.0	2.0	2.0	2.0
Aramco promissory notes	0.0	7.0	5.0	26.8	31.2
Syndicated loan issuance	10.0	0.0	15.0	17.0	0.0
Eurobond issuance	0.0	0.0	0.0	3.0	5.5
Capital injections	29.4	40.0	0.0	0.0	0.0
Saudi Aramco dividends	0.0	0.0	0.0	3.0	7.8
Treasury interest	0.1	0.4	0.0	0.9	0.9
Outflows	41.1	42.0	40.9	51.2	41.1
Committed private equity flows	25.2	0.0	0.0	0.0	0.0
Syndicated loan repayment	0.0	10.0	0.0	11.0	0.0
Syndicated loan interest	0.3	0.0	0.0	0.2	0.8
Eurobonds interest	0.0	0.0	0.0	0.0	0.3
Sovereign dividends	0.0	6.4	0.9	0.0	0.0
Investments	15.5	25.6	40.0	40.0	40.0
Free Cash Flow (FCF) proxy	4.5	10.1	-15.0	6.2	11.3

Source: Public Investment Fund (PIF), Softbank, Blackstone, Saudi Aramco, press reports, Bloomberg, BofA Global Research. Dividends from equity holdings are calculated based on reported public holdings. Dividends from equity holdings for 2023 represent the trailing 12-month dividends paid to the PIF based on end-September 2023 reported positioning. Private equity dividends are dividends from Softbank Vision Fund. The schedule of Aramco promissory notes reflect pre-payments made over 2022-1H23, which extinguished any further Aramco liabilities to the PIF in regards to the acquisition of Sabic. Capital injections represent the transfer of proceeds of the Saudi Aramco Initial Public Offering (IPO) in 2019 and of a portion of the Saudi Central Bank (SAMA) Fx reserves in 2020. Saudi Aramco dividends reflect the ownership share of the PIF in Aramco (4% in 2022 and 8% in 2023, accounting in the latter for the share of PIF subsidiary Sanabil). Interest on Treasury holdings is estimated to accrue based on the Secured Overnight Financing Rate (SOFR). The Committed private equity flows represent the capital injections of the PIF into the Softbank Vision Fund and the Blackstone Infrastructure Fund. Sovereign dividends are distributions of the PIF to the government. Investments are realized investments/capital injections of the PIF into Saudi entities (2019-20) and targeted ones thereafter (2021-23).

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Saudi Aramco dividends reduce fiscal breakeven oil price

Gyrations to Saudi central government fiscal breakeven oil price in 2023

Significant policy changes have imparted material volatility to the Saudi central government fiscal breakeven oil price in 2023. The latter is a critical metric to energy and macro markets, in our view. In effect, in 2023, authorities:

a) **Have implemented a voluntary 1mn bpd oil output cut for a full six-month period (2H23).** Every 250mn bpd annual cut to crude oil production would increase the fiscal breakeven oil price by US$2.5/bbl on our estimates;

b) **transferred 4% of the government shares in Saudi Aramco in April 2023 to Sanabil Investments, a wholly-owned subsidiary of the Public Investment Fund (PIF).** (4% was already transferred to the PIF in February 2022). This reduces the share of Saudi Aramco dividends upstreamed to the sovereign by the same proportion, increasing the fiscal breakeven oil price;

c) **implemented their pledge of a sustainable and progressive base dividend policy for Saudi Aramco.** This means that the base dividend increased to US$78bn/year in 2023, a 4% increase from US$75bn/year previously, with payments starting in 1Q23. This serves to modestly reduce the fiscal breakeven oil price;

d) **and, introduced performance-linked dividends for Saudi Aramco, with quarterly payment schedule brought forward from 1Q24 to 3Q23.** These additional dividends are targeted in the amount of 50-70% of Aramco's annual Free Cash Flow (FCF), net of the base dividend and other amounts including external investments. (Saudi Aramco guidance for annual capex spend, up until the recent change to the Maximum Sustainable Capacity (MSC) policy, has been US$45-55bn). These dividends will be determined going forward with the annual results (ie in March annually) and to be paid quarterly.

   Saudi Aramco announced an additional performance-linked dividend of US$9.9bn in 3Q23 and said it would distribute such performance-linked dividends over six quarters from 3Q23. Saudi Aramco guidance is that 3Q23 performance-linked dividend was determined on the basis of 2022 and 1H23 results, 4Q23 performance-linked dividend was determined on the basis of 2022 and 9m23 results, 2024 quarterly performance-linked dividends will be determined on the basis of 2022 and 2023 results, and 2025 quarterly performance-linked dividend will be determined on the basis of 2024 results.

Additional Aramco dividends shield the budget but make it pro-cyclical

The start in 2H23 (rather than 1Q24) of Saudi Aramco payments under its performance-based dividend policy is positive for Saudi fiscal accounts, and will also upstream more cash to the Public Investment Fund (PIF) for domestic investments. This could nevertheless make fiscal performance more pro-cyclical and accentuate volatility in the fiscal breakeven oil price. In effect, higher oil prices will likely lead to higher distributions, reducing the fiscal breakeven oil price all else being equal. This will likely reverse in periods of low oil prices.

The performance-based dividend policy also adds a layer of complexity to the analysis of the central government fiscal breakeven oil price. This is because the dividend distributions are a function of Aramco's FCF, itself depend on oil production and prices.

A mix of factors to affect the Saudi fiscal breakeven oil price in 2024

The 2024 fiscal breakeven oil price is likely to be affected by a) the pace of withdrawal or deepening, if any, of the 1mn bpd oil output cut; b) any changes to the amount of performance-linked dividends to be paid (unchanged plans would reduce the breakeven oil price by a US$9/bbl in 2024 as it increases fiscal oil revenues all else being equal); c) any further divestments of Saudi Aramco (we estimate that every additional 1% stock listed could increase the fiscal breakeven oil price by cUS$0.5/bbl, all else being equal); and, d) fiscal policy (with the budget announced each December for the following year).

2024 budget calls for elevated oil prices

Overspending continues in 2023

The preliminary 2023 fiscal balance registered a preliminary deficit of SAR82bn (US$2.19bn; -2.1% of GDP). Fiscal discipline continues to be loosened pro-cyclically. Spending increased by 9.5%yoy and came 14.5% ahead of the budgeted amount. Capital spending surged by more than 40%yoy, while current spending increased by just 5%yoy.

Oil revenues were supported by Saudi Aramco dividends, with the surge in oil revenues in 4Q23 suggesting that the performance-linked dividends for 2H23 were fully paid to the government in 4Q23. (Recall that there was a discrepancy of SAR49.2bn (US$13.1bn) between what Saudi Aramco reported it paid to the government in 3Q23 (SAR196.2bn) and the reported 3Q23 fiscal oil revenues (SAR147.0bn). The full-year fiscal outturns suggest this was likely a timing discrepancy).

We estimate the Saudi government fiscal breakeven oil price was US$91.6/bbl in 2023.

2024 spending envelop appears tight

Saudi authorities plan to keep 2024 spending flattish versus realized 2023 levels (a 1.9% drop). We see overspending of at least 5%yoy. We suspect capital expenditures and goods and services spending could remain robust as Saudi Vision 2030 projects make progress, if the oil price environment is comfortable. Historical precedents suggest capital expenditures are likely to be pared back first if there is a sustained drop in oil prices.

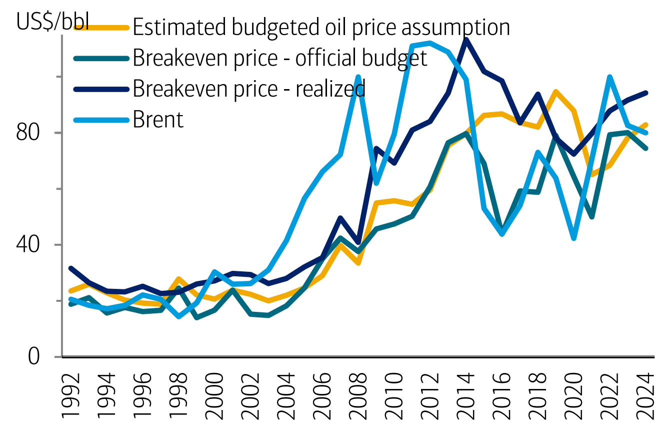
Our commodities team forecasts oil prices of US$80/bbl for 2024. We see resistance to cut crude oil production below 9mn bpd on the Saudi front, and the remainder of OPEC+ countries appear to also resist further cuts unless there is a major shock on the demand side. On the flip side, the supply-demand balances suggest very little room for Saudi Arabia to reverse much of their cuts this year. As such, we keep crude oil production flat at c9mn bpd for 2024.

We estimate our crude oil production and oil price forecasts would lead the Saudi fiscal balance to register a deficit of 3.2% of GDP (US$34.9bn; SAR130.9bn). However, current dynamics suggest the risk is to the downside on oil production, oil prices and to the upside on fiscal spending.

Reduced transparency complicates the estimation of the budgeted Saudi fiscal breakeven oil price for 2024. Our estimate is that the budgeted fiscal revenues for 2024 are consistent with an oil price of US$70-75/bbl (corresponding to a range of crude oil production of 9.2-10mn bpd, i.e. assuming the partial or full reversal of the crude oil production cuts that would have been implied by the OPEC+ 2023 meetings and oil market conditions prevalent at the time of the drafting of the 2024 budget).

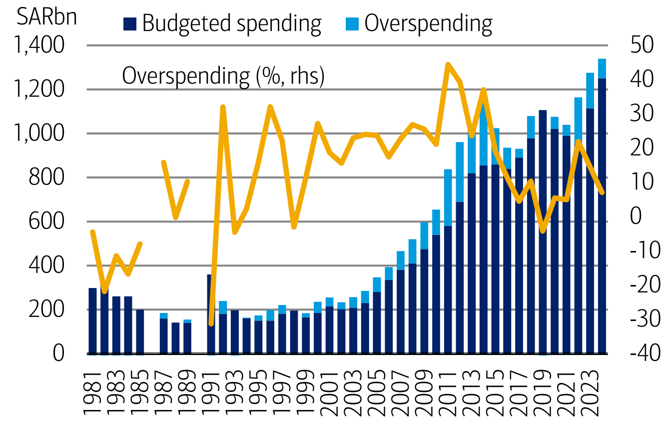
We see the fiscal breakeven oil price at nearly US$94.2/bbl for 2024 as lower average crude oil production versus 2023 is partially offset by the disbursement of 2 additional performance-linked dividends from Saudi Aramco versus 2023.

Exhibit 10: Budgeted, assumed and realized fiscal breakeven oil price
Fiscal breakeven oil price on the rise



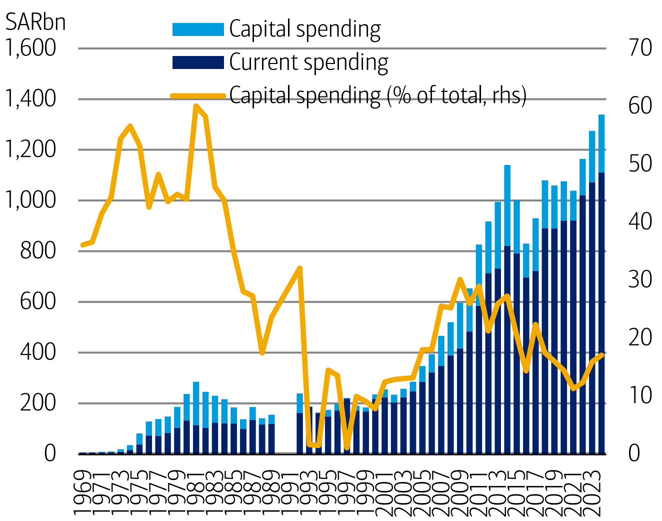
Source: Haver, SAMA, Ministry of Finance, BofA Global Research.
BofA GLOBAL RESEARCH

Exhibit 11: Budgeted and overspending (1981-2024F)
Overspending resumed, although at more moderate levels than pre-2014



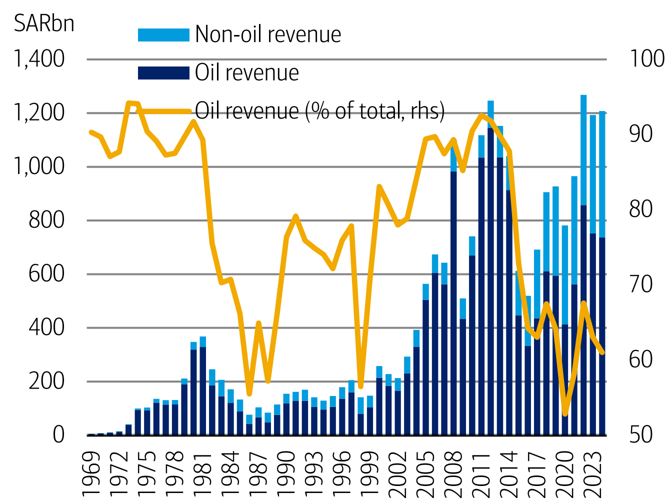
Source: Haver, SAMA, Ministry of Finance, BofA Global Research.
BofA GLOBAL RESEARCH

Exhibit 12: Current and capital expenditures (1969-2024F)
On-budget capex picking up, but remain below historical trends



Source: Haver, SAMA, Ministry of Finance, BofA Global Research.
BofA GLOBAL RESEARCH

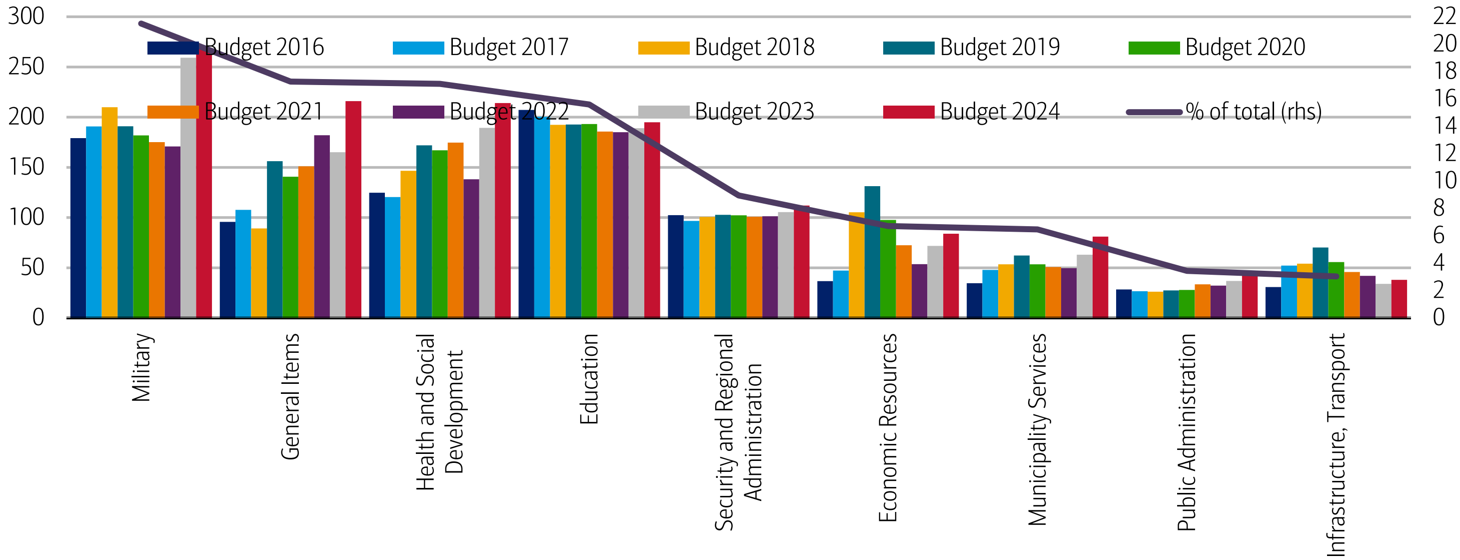
Exhibit 13: Oil and non-oil revenues (1969-2024F)
Non-oil revenues have increased since 2014 fiscal reforms



Source: Haver, SAMA, Ministry of Finance, BofA Global Research.
BofA GLOBAL RESEARCH

Exhibit 14: Breakdown of budgeted spending (2016-2024)

Military appropriations are the largest item in the 2024 budget



Source: Ministry of Finance, BofA Global Research. % of total refers to 2024 budget appropriations.

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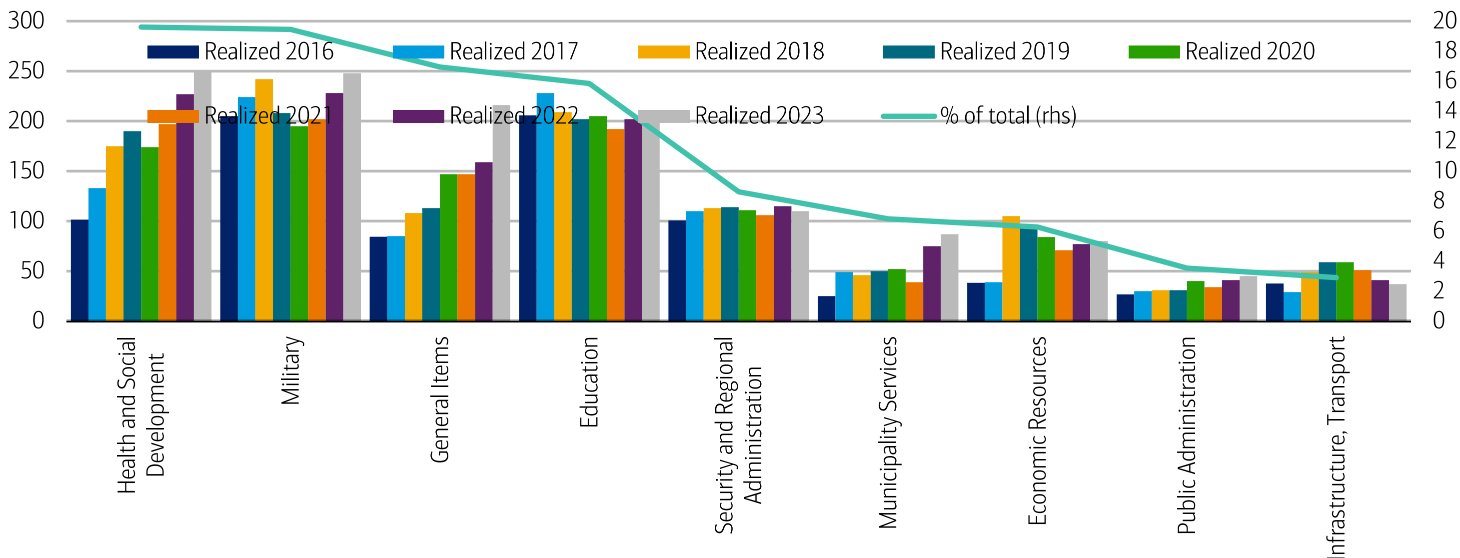
Exhibit 15: Breakdown of realized spending (2016-2023)

The health and social development sector saw the largest spending in the 2023 realized fiscal outturns



Source: Ministry of Finance, BofA Global Research. % of total refers to realized 2023 fiscal outturns.

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Large external issuance likely to persist

The medium-term budgeted fiscal path for Saudi Arabia implies vulnerability to a drop in oil prices, and continued large external issuance. Saudi Arabia issued US$12bn in eurobonds in early January and suggested opportunistic further issuance this year. The budgeted financing needs and the government's targeted financing mix suggest external bond issuance of up to US$9bn in 2024. However, our projected fiscal deficit suggests total external bond issuance could reach US$15bn in 2024, assuming the same financing mix. An external syndicated loan may be possible instead or in addition.

Authorities suggested they partly pre-financed 2024 funding needs and reduced 2024 domestic debt maturities through a domestic sukuk and bond liability management transaction. The latter redeemed domestic securities maturing in 2024, 2025, and 2026 with a total value of SAR36bn and simultaneously issued domestic sukuk for the redeemed amount.

international funding sources contributed accounted for 53% of total funding raised in 2023, through US$16bn in eurobonds and US$11bn in a syndicated loan. The latter capitalized the Government Alternative Funding (GAF) channel, and led to drawdowns of SAR6bn from the GAF to finance capital expenditures and infrastructure projects for financing agreements that were signed in 2022.

Authorities indicate the projected distribution of financing channels of the total funding plan for 2024 includes a) up to 35% in domestic SAR-denominated debt; b) up to 40% in international debt markets; and, c) up to 50% in the Government Alternative Funding (GAF) channel.

Saudi Arabia's overall cost of funding on its outstanding debt stock stood at 3.62% at end-2023, with an average time-to-maturity of 9.5 years.

Exhibit 16: Breakdown of budgeted and projected financing plan for 2024

The higher projected (BofAe) fiscal deficit may mean authorities could tap again the international bond market later in the year

	Budget		BofAe	
	SARbn	US$bn	SARbn	US$bn
Fiscal deficit	**79.0**	**21.1**	**130.9**	**34.9**
Total debt maturities	40.0	10.7	40.0	10.7
External debt maturities	4.1	1.1	4.1	1.1
Domestic debt maturities	35.9	9.6	35.9	9.6
Domestic liability management exercise	19.0	5.1	19.0	5.1
Remaining domestic debt maturities	16.9	4.5	16.9	4.5
Total remaining debt maturities	**21.0**	**5.6**	**21.0**	**5.6**
Pre-funding	**14.0**	**3.7**	**14.0**	**3.7**
Total funding needs	**86.0**	**22.9**	**137.9**	**36.8**
Total financing channels	**107.5**	**28.7**	**172.4**	**46.0**
Domestic SAR-denominated debt	30.1	8.0	48.3	12.9
International debt markets	34.4	9.2	55.2	14.7
Government Alternative Funding (GAF)	43.0	11.5	68.9	18.4

Source: Ministry of Finance National Debt Management Centre (NDMC), BofA Global Research. Assumes the distribution of financing channels of the total funding plan for 2024 is set at 35% in domestic SAR-denominated debt, at 40% in international debt markets, and at 50% in the Government Alternative Funding (GAF) channel.

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Macro table

Exhibit 17: Saudi Arabia selected economic and financial indicators

Saudi Arabia remains a hydrocarbon-dominated economy, although diversification makes gradual progress

Saudi Arabia	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023E	2024F	2025F
Summary Data																			
Nominal GDP (US$ bn)	415.7	519.8	429.1	528.2	676.6	741.8	753.9	766.6	669.5	666.0	715.0	846.6	838.6	734.3	874.2	1,108.6	1,059.4	1,080.0	1,152.7
GDP per capita (US$)	-	-	-	22,028	26,966	28,349	27,290	27,080	22,454	21,516	23,081	28,036	27,893	23,271	28,396	35,305	33,078	33,060	34,591
Non-oil GDP per capita (US$)	-	-	-	12,128	13,275	14,162	14,687	15,644	16,388	16,229	16,618	17,766	18,653	17,174	18,713	20,022	20,781	21,607	22,602
Unemployment rate (%)	5.6	5.0	5.4	5.5	5.8	5.5	5.6	5.7	5.6	5.6	6.0	6.0	5.7	7.4	6.9	4.8	-	-	-
Saudi unemployment rate (%)	11.0	9.8	10.5	11.2	12.4	12.1	11.7	11.7	11.5	11.6	12.8	12.7	12.0	12.6	11.0	8.0	-	-	-
Population (millions)	-	-	-	24.0	25.1	26.2	27.6	28.3	29.8	31.0	31.0	30.2	30.1	31.6	30.8	31.4	32.0	32.7	33.3
Saudi population (millions)	-	-	-	14.0	14.3	14.7	15.1	15.5	16.0	16.4	16.7	17.1	17.5	18.0	18.4	18.8	19.2	19.6	20.1
Oil production (mn bpd)	8.8	9.2	8.2	8.2	9.3	9.8	9.6	9.7	10.2	10.5	10.0	10.3	9.8	9.2	9.1	10.6	9.6	9.0	9.2
Brent oil price (US$/bbl)	72.2	99.9	62.0	79.5	111.0	112.0	108.8	99.0	53.0	43.9	54.0	73.0	63.8	42.3	70.5	99.9	82.6	80.0	80.0
Economic Activity																			
Real GDP growth (% yoy)	1.8	6.2	-2.1	5.0	11.0	5.4	2.9	3.6	4.7	2.4	-0.1	2.8	0.8	-4.3	4.3	8.7	-0.9	0.1	4.5
Oil Sector (% yoy)	-4.0	4.4	-9.6	-0.2	12.4	5.1	-1.7	2.1	5.3	3.6	-3.1	2.3	-3.3	-6.7	0.2	15.4	-9.2	-6.6	4.4
Non-Oil Sector (% yoy)	8.9	8.0	5.9	9.6	9.9	5.5	6.6	5.5	4.2	1.5	2.4	-0.9	3.5	-3.0	6.4	5.3	3.2	3.8	4.5
Private Non-Oil Sector (% yoy)	11.9	10.2	6.2	10.5	10.6	5.6	7.2	6.2	4.9	1.9	3.0	-2.4	4.1	-3.7	8.1	5.5	3.5	4.0	4.5
Government Non-Oil Sector (% yoy)	1.9	2.4	5.0	6.8	7.9	5.4	4.9	3.3	2.3	0.2	0.3	3.9	1.7	-0.6	1.1	4.6	2.1	3.0	4.5
Real private consumption growth (% yoy)	13.1	12.2	8.9	3.9	1.8	11.9	3.9	7.4	8.3	2.6	4.6	2.5	6.5	-8.1	9.5	4.9	-	-	-
Real government consumption growth (% yoy)	1.8	3.7	0.6	1.2	16.6	8.1	11.1	12.0	-1.7	-17.5	3.3	9.3	-3.0	3.3	0.8	9.3	-	-	-
Real investment growth (% yoy)	20.4	24.8	-3.7	12.1	12.4	2.9	0.9	6.2	5.6	-11.1	-3.0	-9.4	16.7	-10.5	8.9	0.6	-	-	-
Real export growth (% yoy)	0.2	-1.2	-10.7	4.4	10.2	3.4	0.2	-1.9	0.7	8.0	-3.1	7.2	-5.0	-10.6	1.0	19.7	-	-	-
Real import growth (% yoy)	23.1	10.5	-6.3	6.6	5.5	7.7	3.7	6.6	-1.2	-18.2	0.3	2.6	9.6	-19.7	8.3	12.4	-	-	-
Monetary Sector and Prices																			
CPI inflation (% avg)	4.2	9.9	5.1	5.3	5.8	2.9	3.5	2.2	1.2	2.1	-0.8	2.5	-2.1	3.4	3.1	2.5	2.6	2.2	2.1
Nominal exchange rate (vs. USD, eop)	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Nominal exchange rate (vs. USD, avg)	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Central Bank policy rate (%)	4.00	1.50	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	1.50	3.00	2.25	1.00	1.00	5.00	6.00	5.25	4.25
Monetary base (% yoy)	8.4	15.4	5.9	12.9	23.1	11.7	8.7	10.5	6.3	0.6	-0.2	3.2	4.2	8.6	1.0	2.2	3.5	-	-
Money supply M3 (% yoy)	19.6	17.6	10.7	5.0	13.3	13.9	10.9	11.9	2.5	0.8	0.2	2.7	7.1	8.3	7.4	8.1	7.6	-	-
External Sector																			
Current Account balance (% of GDP)	23.9	26.9	6.6	14.1	24.4	23.4	19.0	10.5	-7.9	-3.7	1.7	8.6	4.6	-3.5	4.8	13.7	7.5	4.3	4.1
Current Account balance (US$ bn)	99.4	139.7	28.3	74.4	165.0	173.7	143.1	80.3	-52.6	-24.5	12.1	73.0	38.5	-25.5	41.7	151.5	79.5	46.2	46.8
Current account breakeven oil price (US$/bbl)	35.5	50.4	49.6	48.8	48.3	49.5	56.9	68.2	72.4	52.3	49.0	45.7	48.5	52.0	51.7	35.9	49.2	59.3	59.7
Trade Balance (US$ bn)	150.6	212.0	105.2	153.7	244.7	246.6	222.6	184.0	44.3	55.8	98.5	168.7	121.3	47.9	136.5	235.3	165.1	134.4	137.6
Exports, f.o.b. (US$ bn)	233.2	313.5	192.3	251.1	364.7	388.4	375.9	342.5	203.5	183.6	221.9	294.4	261.6	173.9	276.2	411.2	312.4	290.1	302.2
Imports, c.i.f. (US$ bn)	82.5	101.5	87.1	97.4	120.0	141.8	153.3	158.5	159.3	127.8	123.4	125.6	140.3	125.9	139.7	140.9	147.3	155.7	164.5
International Reserves (US$ bn)	305.4	442.2	409.7	444.7	543.6	656.1	725.3	731.9	616.0	535.4	496.0	496.2	499.1	453.2	454.9	459.4	436.5	412.7	412.9
International Reserves (% of GDP)	73.5	85.1	95.5	84.2	80.3	88.4	96.2	95.5	92.0	80.4	69.4	58.6	59.5	61.7	52.0	41.4	41.2	38.29	35.8
Central Government deposits at SAMA (US$bn)	113.9	259.8	224.5	239.5	284.4	369.1	395.8	367.7	272.9	194.8	171.0	150.0	141.1	116.4	102.7	123.5	114.7	100.8	85.9
Central Government deposits at SAMA (% of GDP)	27.4	50.0	52.3	45.3	42.0	49.8	52.5	48.0	40.8	29.3	23.9	17.7	16.8	15.9	11.8	11.1	10.8	9.3	7.5
Public Sector																			
Central Gov. Primary Budget Balance (% of GDP)	-	-	-4.5	4.9	11.3	10.5	5.1	-4.4	-16.3	-16.5	-8.6	-5.0	-3.5	-9.8	-1.4	3.2	-1.1	-2.1	-2.1
Central Gov. Nominal Budget Balance (% of GDP)	11.3	29.8	-5.4	4.4	11.0	10.3	4.9	-4.6	-16.4	-16.7	-8.9	-5.5	-4.2	-10.7	-2.2	2.5	-2.1	-3.2	-3.2
Non-oil fiscal balance (% of non-oil GDP)	-50.0	-46.4	-54.9	-53.5	-60.4	-61.8	-58.9	-62.9	-46.8	-39.8	-34.9	-39.0	-34.6	-34.8	-29.4	-32.0	-33.4	-32.8	-31.8
Non-oil primary fiscal balance (% of non-oil GDP)	-	-	-53.4	-52.5	-59.8	-61.4	-58.6	-62.7	-46.7	-39.5	-34.5	-38.3	-33.6	-33.6	-28.2	-30.7	-31.9	-31.0	-30.1
Fiscal balance (US$bn)	47.1	154.9	-23.1	23.2	74.7	76.1	37.1	-35.1	-109.8	-110.9	-63.6	-46.4	-35.4	-78.4	-19.6	27.7	-21.9	-34.9	-37.2
Revenues (US$bn)	171.5	293.6	135.9	197.6	298.0	332.4	307.4	277.4	163.4	138.5	184.4	241.5	247.2	208.5	257.5	338.2	318.1	322.2	336.3
Oil revenues (US$bn)	150.0	262.2	115.8	178.7	275.8	305.3	276.0	243.6	119.0	89.0	116.2	163.0	158.5	110.1	149.9	228.6	200.5	196.6	202.4
Non-oil revenues (US$bn)	21.5	31.4	20.1	18.8	22.2	27.1	31.4	33.8	44.3	49.5	68.2	78.5	88.6	98.3	107.5	109.6	117.6	125.6	133.9
Expenditures (US$bn)	124.4	138.7	159.0	174.4	223.3	256.3	270.2	312.4	273.1	249.5	248.0	287.9	282.5	286.9	277.0	310.5	340.0	357.0	373.5
Current expenditures (US$bn)	92.6	103.7	111.1	129.1	155.7	190.2	195.2	219.0	210.9	207.0	192.6	237.6	237.3	245.5	245.8	272.2	285.9	296.1	306.5
Capital expenditures (US$bn)	31.8	35.0	48.0	45.3	67.6	66.0	75.1	93.5	62.2	42.4	55.4	50.2	45.2	41.4	31.3	38.3	54.1	60.9	67.0
Fiscal breakeven oil price (US$/bbl)	49.5	40.9	74.4	69.2	80.9	84.1	94.2	113.2	101.9	98.5	83.5	93.8	78.0	72.4	79.7	87.8	91.6	94.2	94.7
Debt Indicators																			
Gross External Debt (% of GDP)	24.3	20.3	28.1	23.9	18.3	17.8	18.2	18.9	20.3	22.0	15.4	16.6	20.8	30.7	30.7	23.8	26.4	26.6	25.7
Public (% of GDP)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Private (% of GDP)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Gross Government Debt (% of GDP)	17.1	12.1	14.0	8.4	5.3	3.0	2.1	1.5	5.7	12.7	16.5	17.6	21.6	31.0	28.6	23.8	26.4	27.1	26.5
Domestic (% of GDP)	17.1	12.1	14.0	8.4	5.3	3.0	2.1	1.5	5.7	8.5	9.7	9.6	11.9	18.3	17.0	14.8	16.2	17.0	17.1
External (% of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	4.1	6.9	8.0	9.7	12.7	11.6	9.0	10.2	10.0	9.4

Source: BofA Global Research estimates

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Saudi energy policy: it's not (only) the economy

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The revision to the targeted Aramco Saudi Maximum Sustainable Capacity (MSC) likely reflects a mix of medium-term oil market fundamentals, large existing spare capacity and ongoing fiscal funding needs. We estimate modest fiscal savings from the MSC target revision at 1.5% of GDP (cUS$17.5bn) over four years or 0.4% of GDP per annum, assuming unchanged payout ratio. The additional funds could be put into use into priority domestic diversification projects instead, in our view.

Saudi energy policy makes a U-turn

Main pillars of Saudi energy policy

We believe that are three aspects that are central to energy policy in Saudi Arabia: a) competition for global market share in upstream operations or swing oil producer role (affecting spot prices); b) future investment decisions and maintaining of spare capacity buffer (affecting long-term oil prices); and c) focus on integration and expansion of downstream ventures to create domestic jobs, secure captive demand for crude and make operations less volatile.

Saudi energy policy decisions are likely to finely balance OPEC (Organization of the Petroleum Exporting Countries) members' funding needs, the impact on oil demand, internal group cohesion considerations, reliability as a major oil supplier, and public perceptions (both domestically and internationally).

Strong near-term incentives to support high spot oil prices

The more assertive nationalistic 'Saudi First' policy and the ongoing mega-projects spearheaded by the Public Investment Fund (PIF) suggest large medium-term financing requirements and the need for elevated oil prices.

We think Saudi Arabia's interests remain centered around market stability, rather than spiking or too elevated oil prices that could lead to global oil demand destruction and more rapid decarbonization efforts. Indeed, the Saudi Minister of Energy self-describes energy policy as 'proactive, pre-emptive and precautionary'.

Press reports suggest authorities are considering a further secondary market listing for Saudi Aramco shares this year (current free-float is 1.8%). A potential sale may be aided by a supportive oil price backdrop, in our view.

The sliding fiscal regime allows authorities to capture the upside in oil prices. The royalty rate on crude oil and condensate production, amended effective 1 January 2020, is 15% for Brent prices up to US$70/bbl; rising to 45% for Brent prices between US$70/bbl and US$100/bbl, and to 80% for Brent prices above US$100/bbl).

Underwhelming November OPEC+ meeting does not help

The November 2023 OPEC+ meeting was underwhelming in terms of potential support to oil prices. We suspect it may lead to only result in a modest decline in production (possibly closer to a status quo outcome), and exhibited little cohesion (with Angola subsequently leaving the group). The agreed production cuts are valid only for 1Q24, with some signs that further cuts may be difficult to agree, all else being equal.

We see the following key points from the meeting:

a) OPEC+ production is likely slated to decline only modestly in 1Q24, given the low credibility of the pledged cuts. We estimate the cuts announced could result in a decline of only 300k bpd in production for 1Q24 versus October 2023 levels. OPEC+ announced additional voluntary cuts of 2.2mn bpd, but this includes the Saudi 1mn bpd cut rollover and 0.2mn bpd in Russia refined oil product cuts (i.e. 1mn bpd of cuts pledged excluding Saudi Arabia rollover and Russia oil product cuts). Our estimates are smaller because a) the cuts are voluntary adjustments, and valid only for 1Q24; b) a number of countries may not fulfil pledges (United Arab Emirates (UAE), Iraq, Russia); and, importantly, c) the voluntary adjustments are calculated from the 2024 required production level as per the 35th OPEC Ministerial Meeting held on June 4 2023, in addition to the voluntary cuts previously announced in April 2023 and later extended until the end of 2024, and not from current production reference levels;

b) note that Iran, Venezuela, Libya still have no quotas. Production may increase from these countries, depending on US sanctions or security conditions;

c) cohesion of the group may have weakened. Angola rejected its output quota which was based on three external assessments, although its planned production level is not significantly different from the OPEC+ target, and subsequently exited the group. The unilateral Saudi 1mn bpd supply cut may have weakened its hand in negotiations; we had suggested it may distort compliance and future negotiation incentives within OPEC+;

d) Brazil could join OPEC+ from 1 January 2024, but this may be symbolic as it has suggested output cuts would not be binding on it;

e) further revision of quotas in June 2024 or November 2024 meetings may be complicated. Recall that OPEC+ is planning to start the process of negotiating quotas for 2025 based on independently-assessed production capacity, likely helping fulfil a key demand by the UAE to increase its quota over the medium-term. This could minimize frictions between the UAE and Saudi Arabia. OPEC+ had suggested that, by end-June 2024, all OPEC+ countries will undergo an assessment by three independent secondary sources to identify production capacities to be used for 2025 reference production levels. (Nigeria, Angola and Congo external assessments have already been completed); and,

f) a steep decline in oil prices may be needed to force the hand of OPEC+. The next (37th) OPEC and non-OPEC Ministerial Meeting will be held on 1 June 2024, and no official meeting has been announced in the interim period until then for now. The next Joint Ministerial Monitoring Committee (JMMC) is to take place on 3 April 2024.

Spare capacity decisions can affect long-term oil prices

Saudi Aramco future investment decisions and maintaining of spare capacity buffer are a critical policy parameter of Saudi energy policy. In addition to its influence on spot prices through its ability to adjust production, Saudi Arabia can decide on pace of its reserves development which would potentially affect future supply to the market, and hence long-term oil prices. There are distinct trade-offs in this decision. If Saudi Arabia is producing at close to its maximum capacity, it will have little control over sharp upside movements in oil prices. On the other hand, if excess capacity is large, oil prices are likely to be under downward pressure.

MSC revision unlikely to be solely justified by government fiscal needs

The Saudi Aramco announcement holds an important signal for markets, both for the government fiscal accounts and long-term oil prices. Saudi Aramco announced in late January that it has received a directive from the Ministry of Energy to maintain its Maximum Sustainable Capacity (MSC) at 12mn bpd, and not to continue increasing its MSC to 13mn bpd.

Initial conditions have changed

Recall that the initial announcement of a 1mn bpd MSC boost was announced in mid-March 2020 in the midst of a price war with Russia. The initial conditions for such an announcement are likely to have dissipated.

Existing spare capacity is ample and could be costly to maintain

Furthermore, the current Saudi oil production profile suggests an ample capacity buffer of c3mn bpd, above the Saudi government stated policy of a capacity buffer of 2mn bpd. Maintaining a large spare capacity can be a costly endeavour for Saudi Aramco.

Long-term oil market fundamentals in the spotlight

Reducing MSC reduces headwinds to long-term oil prices, and could suggest less confidence from Saudi energy policy-makers about the peak level of medium-term oil demand. A declining medium-term oil demand profile could likely eventually spur Saudi and other OPEC members to shift from defending prices to maximizing market share. Saudi Aramco may have calculated it is currently maintaining a sufficient buffer, as of now. Less oil may be demanded in the future from OPEC (call on OPEC), but more of it could likely by produced by Saudi Arabia, UAE and Kuwait in this scenario, in our view.

Increasing gas production could provide offset to crude oil export capacity

The MSC halt is partially offset by the ongoing plans of Saudi Aramco to free up to 1mn bpd for crude oil exports by 2030 as a result of an eventual halt to using crude oil for power generation. Saudi Aramco plans to increase gas production by 50% by 2030 versus 2021 levels. Half of the planned gas production growth is aimed to go into domestic gas sources. This includes c1mn bpd liquids (oil-fired power plants) that are likely to be displaced for power generation. Associated liquids are targeted to be c1mn bpd by 2030 and to be used as feedstock for the petrochemical and industrials sectors. The other half is aimed for exports, including through hydrogen if there is interest in offtake contracts.

Fiscal savings are likely to be relatively modest

Fiscal funding needs are unlikely to be the main driver to the MSC revision, in our view. We estimate Saudi Aramco capex savings could boost Saudi government fiscal revenues by 1.5% of GDP (cUS$17.5bn) over four years or 0.4% of GDP per annum, assuming unchanged payout ratio. This is because a number of projects with Final Investment Decisions (FID) are likely to proceed, as per Saudi Aramco guidance, and offset natural declines. The main change in Saudi Aramco capex is likely to come from the deferral of the Safiniyah project, scheduled to come online by 2027-28. This suggests little savings for Saudi Aramco near-term, at about US$5-6bn in capex savings over four years (cUS$25bn or 2.2% of GDP in total and 0.5%of GDP per annum).

How will the UAE respond?

It is unclear how will UAE policy-makers respond to the Saudi MSC revision. Abu Dhabi does not face similar funding pressures, and, with unchanged policies, the optics suggest that Saudi Arabia could be ceding market share to the UAE. Abu Dhabi National Oil Company (ADNOC) announced in November 2022 it will bring forward its 5mn bpd crude oil production capacity target from 2030 to 2027, and guided its crude oil production capacity already reached 4.5mn bpd in July 2023.

In the meantime, the potential redistribution of OPEC output quotas for 2025 is likely to benefit Saudi Arabia and the UAE. Recall that the 35th OPEC and non-OPEC Ministerial Meeting that took place in June 2023 opened the door for a revision to output quotas going forward. UAE and Saudi Arabia could be winners of possible quota redistribution as they have the largest gaps between actual production versus production capacity. The UAE was granted in June 2023 a 0.2mn bpd upward revision to its OPEC quota.

Expert call highlights limits to current energy policy

Our recent conference call with an oil & gas expert highlighted OPEC+'s reluctance to cut production further unless there is a material demand shock, reducing potential support to oil prices. Our expert does not expect ADNOC to officially revise its oil production capacity target. Our expert suggested Saudi Aramco's focus on new field development helps it retain the optionality to return to an MSC target of 13mn bpd in the future.

Saudi Aramco to maintain MSC at 12mn bpd

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Saudi Aramco has announced receiving a directive from the Saudi Ministry of Energy (MoE) to maintain its Maximum Sustainable Capacity (MSC) at 12mn bpd and not increase it to 13mn bpd, which was expected to be complete in 2027. The decision to cancel the capacity increase could be driven, in our view, by: 1) Saudi Aramco's current spare capacity of c3mn bpd and uncertainty around when production will increase; 2) longer-term oil demand outlook; and, 3) the importance of Saudi Aramco to Saudi's fiscal position with potential capex reduction being directed towards an increase in dividends. Aramco is expected to provide updated capex guidance during its FY23 results in March.

Development of fields passed FID to continue

The development of the Dammam (2024 and 2027), Berri (2025), Marjan (2025), Zuluf (2026) fields, which have passed Final Investment Decision (FID), will continue. Through infill drilling, the company will control production capacity in each of these fields, which will help offset natural declines across other fields and eventually help the company maintain its MSC of 12mn bpd.

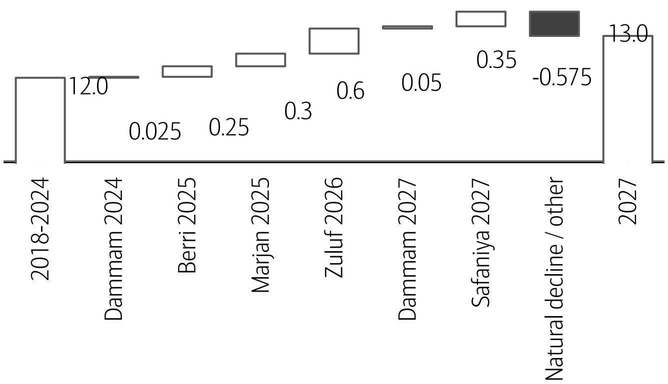
Since Saudi Aramco will continue to spend for development of these fields, it is difficult to forecast at this stage the impact of capex reduction due to cancellation of the MSC increase. Safaniya (700kbpd capacity, the world's largest offshore oil field) is the only large field of Aramco's MSC expansion plan awaiting FID, which is now likely to be deferred because of the announcement. The project was expected to generate US$10bn of Engineering, Procurement, Construction and Installation contract awards this year, according to Upstream. In total, Wood Mackenzie has estimated total project capex at over US$25bn. As a result of this, capex on average could drop by US$5-6bn per annum over the next four years.

Capital investment to still peak mid of decade

On the back of the announcement, while we expect lower capex over the medium-term versus our current estimates (average 2024E-27E capex: cUS$55bn), we still expect capex peaking next year given the continued development of the projects that have passed FID. Saudi Aramco has guided that, in the short-term, 60% of the capital investment is to be spent toward upstream, 30% downstream and 10% toward low-carbon initiatives, while over the medium- to long-term, 50% is likely to be spent toward upstream, 35% downstream and 15% toward low-carbon initiatives.

Aramco's proposed route to 13mb/d MSC

Exhibit 18: Aramco old MSC delivery plan decomposed (mn bpd)
Zuluf was expected to add 0.6 mn bpd with the remaining from other fields



Source: Company report. BofA Global Research. Note: Safaniya currently pending Final Investment Decision; c350mbpd planned delivery in 2027, with remainder after 2027

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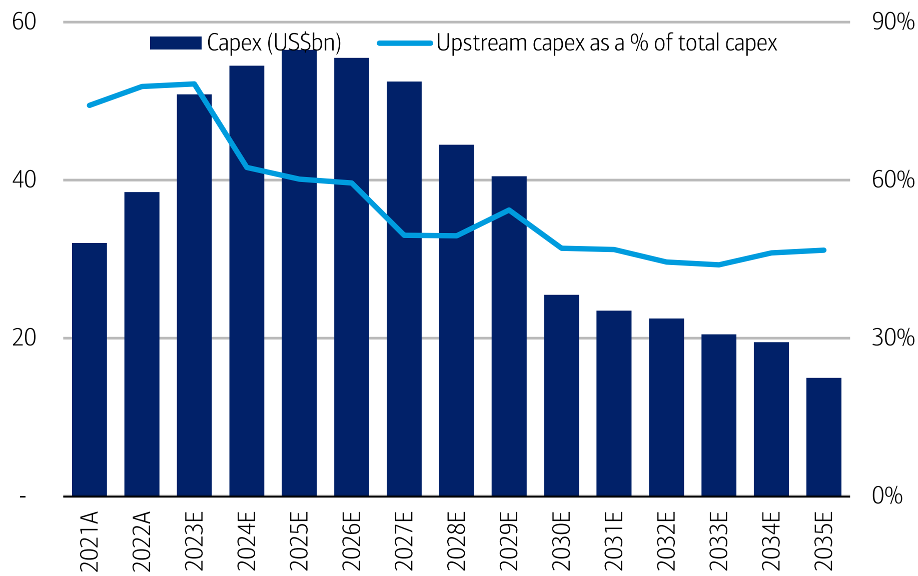
Exhibit 19: Saudi Aramco capital investment profile 2021-35E
We assume capital investment peaks mid of this decade around US$56bn



Source: Company data, BofA Global Research estimates

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Equity: stress-testing Red Sea impact

If tensions in the Red Sea were to escalate, we believe Saudi Aramco remains well positioned to increase production to help balance oil markets (given its spare capacity of c3mn bpd). Overall, however, we have a negative view on the impact on our chemicals coverage given increasing freight costs in a weak demand environment.

The potential implications of geopolitical tensions on Saudi banks are likely to occur via three main channels: 1) more sluggish corporate loan growth due to slower Saudi growth; 2) higher provisioning; and 3) delays in global policy rate cuts. The impact on profit via slower lending is moderate; implications for asset quality can be lumpy.

The Saudi consumer, healthcare and telecom are the least directly impacted sectors as minimal supplies come through the Red Sea.

Oils & chemicals: Saudi Aramco well positioned

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Oils and Chemicals trade flow disrupted

The Middle East is home to three of the global transit oil chokepoints, accounting for c40% of oil seaborne trade (the Red Sea c12% and the remainder from the Strait of Hormuz). If tensions in the Red Sea escalate, Saudi Aramco remains well positioned to increase production to help balance oil markets (given its spare capacity of c3mn bpd). A 1mn bpd increase in production at an oil price of US$80/bbl results in a FY24E EBITDA uplift of 9%.

Overall, however, we have a negative view on the impact on our chemicals coverage given increasing freight costs in a weak demand environment. Polymers are shipped in containers, with trade from the Middle East to Europe likely to be most impacted (c15% of revenues on average for our coverage). Rising import costs from the Middle East may also incentivize more domestic production in Europe, along with increasing United States (US) imports.

Saudi Aramco's volumes mainly through Strait of Hormuz

Asia remains Saudi Aramco's key market, accounting for c75-80% of total exports. Some c10% of its total crude is exported through its Red Sea terminals to Europe. In the first week of every month, the company is notified by the Saudi government of the maximum ceiling production for the next month. The 25 days' notice is used to manage customer expectations (see Aramco: BofA Global Energy Conference Insights). Production could be increased by 1mn bpd in a relatively short timeframe.

Saudi Chemicals on the West Coast of the Red Sea impacted

Saudi chemical producers on the West Coast of the Red Sea, such as Yansab, Natpet, Yanpet, PetroRabigh and Ibn Rushd, are likely to be most impacted by ongoing tensions. In case of prolonged period of disruptions, these producers will need to use trucks to deliver containers from the West to the East Coast, which will lead to elevated costs and longer delivery times. Chemicals consultant ICIS is reporting that Yanpet's (Saudi Yanbu Petrochemical Company, in which SABIC owns a 50% stake) MEG unit of 400kt capacity has been shut since mid-Jan 2024 due to the Red Sea situation. A prolonged period of turmoil could potentially lead to more such plant closures.

Saudi banks: implications complex, yet manageable

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Saudi banks: three main channels of possible impact

For Saudi banks, we see potential implications via three main channels: 1) more sluggish corporate loan growth due to slower Saudi GDP expansion; 2) higher provisioning; and 3) delays in global policy rate cuts. We estimate that a 1ppt slowdown in Saudi GDP would lead to a -1.7ppt average hit on profit before tax (PBT). Delayed benchmark rate cuts would postpone our expected Net Interest Margin (NIM) erosion. We think potential implications, if they were to materialize, would be manageable for Saudi banks.

Slower loan growth: -1ppt GDP = -1.7ppt PBT

A potential 1ppt slowdown of real GDP growth in Saudi Arabia translates into a 1.7ppt negative impact on Saudi banks' profit before tax via slower corporate lending, we estimate, all else being equal.

Extra cost of risk could be lumpy

Potential extra provisioning would depend on banks' loan book compositions and individual coverage levels. Saudi banks have a comfortable level of NPL coverage (155% average), but medium coverage of Stage 2 loans (13.2%). What helps though is that the Saudi banking sector loan composition is diversified: transportation and storage accounts for 2%, manufacturing for 7%, construction for 5%, and real estate for 10%.

Delay of rate cuts could postpone NIM erosion

Potentially later rate cuts due to the pickup in global inflation (see our note: Global rate cuts lost at (Red) Sea?) would delay our expected NIM erosion. Any prolonged delays could represent additional downside to loan growth and asset quality.

Saudi consumer: minimal supplies come through Red Sea

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The covered food/electronics retailers source from Asia through a closer Dammam port in the Gulf. Hence, they are not impacted by the Red Sea distruption. Higher freight rates may be a risk, though, if the conflict persists. Private label and direct import products are sourced from overseas suppliers (14% of the top line).

Saudi healthcare: smooth sailing for hospitals

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Air freight remains more important in Middle East – North Africa (MENA)

Pharmaceuticals (including vaccines) and medical technology are the key inventory that MENA hospitals import from abroad. They account for more than 95% of imported goods that are required for day-to-day operations. It is mainly shipped via air and hence we see limited direct impact on MENA hospital operators from the Red Sea disruptions.

It is worth noting that local regulators control the pricing of pharma products at a country-wide level. Thus, potentially higher costs are likely to fall on local distributors, in our view. Furthermore, long shelf-life medicines are usually procured in advance for a minimum of six months.

MENA hospitals have renewed most of their medical technology post other supply-chain issues during COVID and we don't expect the next big cycle in at least next five years for most of the hospitals.

Lastly, MENA companies under our coverage confirmed no visible impact so far, and see minimal headwinds, given the protective nature of the regulator in the healthcare sector, which was proved well during the pandemic

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Fixed income strategy: Robust regional bid offsets benchmarked demand erosion

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Does Gulf demand depend on benchmark?

Large and persistent issuance of Saudi Arabia external debt could raise concerns of potentially waning investor appetite going forward. Saudi Arabia external debt already trades at a discount to peers on a ratings-adjusted basis. Any potential material weakening in investor appetite against a backdrop of robust supply could impact on sovereign borrowing costs, in our view.

Our analysis indicates however a more nuanced picture given a number of offsetting factors. Further increases in Saudi Arabia's index weight in external indices are indeed likely limited, but data highlights that benchmarked investors are not (or no longer) the main purchaser of Saudi bonds for some time already. Robust domestic and regional bid helps absorb large issuance or support secondary markets, in our view. A caveat is that such support may prove in part structurally dependent on oil prices over the medium-term. Also, anecdotal evidence suggests that there is likely interest and activity from cross-over accounts, which could add some volatility to demand.

We think that benchmarked investors are not the primary buyers of Saudi Arabia external debt or Gulf external debt in general, despite that there has been concern that the weight of Saudi Arabia in the EMBIG Diversified benchmark feels like it is bumping against a maximum. We have three reasons that support our view.

Demand from EMBIG Div benchmark assets is just 18% of the total debt stock

The benchmark index that many Emerging Markets (EM) investors use is the J.P. Morgan Emerging Markets Bond Index Global Diversified (JPM EMBIG Div), which we describe in a separate section below. To give a sense of the size, if there were US$400bn funds using the EMBIG Div benchmark, with a Saudi weight of around 5%, that would provide just US$20bn of demand, of the more than US$100bn Saudi Arabian sovereign bonds (<20%). This ratio is not too dissimilar to Türkiye (24%), Indonesia (22%), and Mexico (19%), on our estimates.

Buyers of primary issues show a regional bias

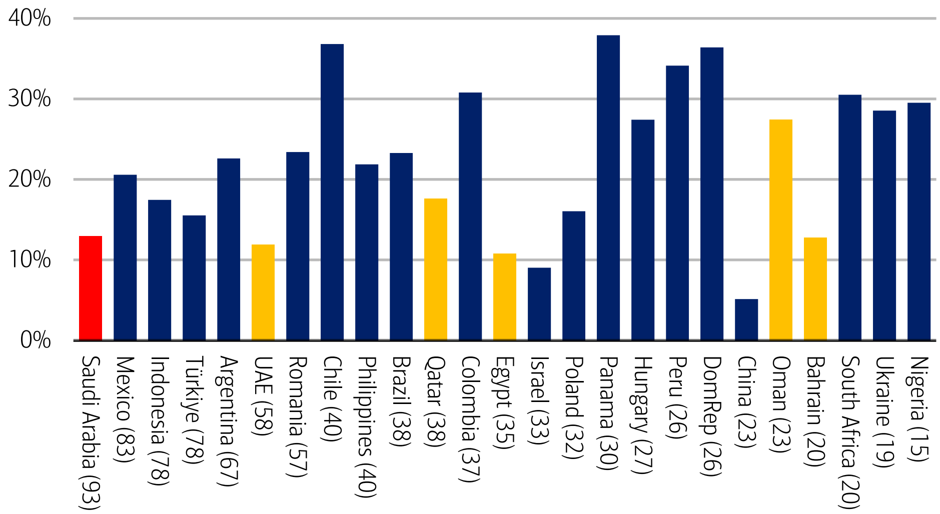
We obtained some data on who bought new issues. The data, though not comprehensive, indicates that there is a concentration of Gulf Cooperation Council (GCC) regional buyers more than on non-GCC bonds, and thus those buyers are not EMBIG benchmark driven.

We obtained data on the location of the buyers of several Middle East sovereign new issues. Unlike new issues in other countries, Saudi local banks and institutions hardly buy Saudi foreign currency government bonds in the primary market, in contrast to most other regions, where locals often have a stronger appetite for their own sovereign's debt. However, with the 4 regional bonds on which we have data, on average Middle East – North Africa (MENA) clients were 32% of the buyers, which could suggest a strong regional bias for placing bonds. Of note however is that half of those bonds were sukuks, where there was particularly strong demand from the Middle East, not related to index inclusion.

Fewer holders of GCC debt are funds with regulatory reporting requirements. While there is no source of data to identify who holds this external debt nor why, we see in our analysis of holders that a much smaller percentage of Saudi and other GCC bonds are held by funds that have regulatory reporting requirements (Exhibit 1). This chart shows the percent of bonds held by funds reported in Bloomberg and viewed via HDS, a measure of the holdings of investors who have regulatory filing requirements on their holdings, such as mutual funds, Exchange-Traded Fund (ETFs), insurance companies.

Note that HDS is not a clean measure of all benchmark investors. For example, it does not include segregated accounts who do not report but might follow a benchmark or an adapted benchmark. Also, in reverse, some of these reporting holders may not have an Emerging Markets benchmark at all. But we think that the HDS-indicated holdings on a country by country relative basis does relate to the relative amount of EM sovereign assets that follow a benchmark.

Exhibit 20: Reported fund holdings indicate a low 6% hold Saudi Arabia sovereign bonds
Percent of face of sovereign bonds held by funds that report via Bloomberg, in order of amount of face value of outstanding sovereign debt, ranging from Saudi Arabia (US$93bn) to Nigeria (US$15bn).



Source: BofA Global Research, Bloomberg, ICE Data indices, LLC.
Note 1: Saudi Arabia analysis was based on all Saudi government international bonds and not on Public Investment Fund (PIF) eurobonds.
Note 2: United Arab Emirates (UAE) (US$58bn) includes: Abu Dhabi (US$35bn), Dubai (US$5bn), Ras Al Khaimah (US$1bn), Sharjah (US$9bn) and UAE federal government (US$8bn).

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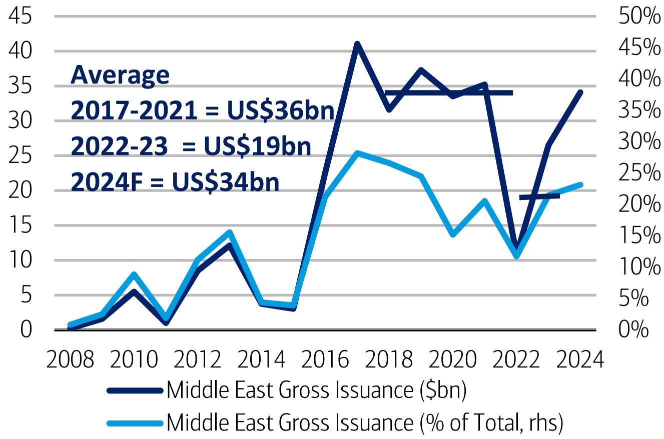
How much is too much issuance?

Some investors have expressed concern that Saudi Arabia has been issuing too much debt and that they may have saturated investor appetite. Saudi Arabia has indeed been the dominant sovereign GCC issuer since launching in 2016.

A look at the unprecedented external Middle East bond issuance since 2016
Middle East sovereign issuance was exceptionally high in 2017-2021, averaging nearly 36% of all new sovereign issuance. On a net basis it was an even larger percentage. The reason the net is higher is that the many GCC bonds are so new that most of those bonds have not come close to the maturity date. Thus, net issuance for the newer issuers is about the same as gross issuance. But for issuers that have been issuing for over 30 years, many have bonds that mature year after year and some issuance is rolling over that debt. Exhibits below show that our Middle East 2024 issuance forecast is back up to the level of the high issuance years, which may raise concerns. The table below shows that Saudi Arabia is still the largest ongoing issuer by far among the big GCC countries on the one hand, but on the other hand, Saudi Arabia already issued in excess of its full year projection in early January without a problem.

Exhibit 21: Large Middle East issuance since 2016 was well absorbed while demand was high
Middle East gross issuance in US$bn (left axis) and as % of total (right axis)



Source: BofA Global Research, Bloomberg, Bond Radar.
Note: Middle East countries include: Saudi Arabia, United Arab Emirates, Bahrain, Egypt, Jordan, Iraq, Qatar, Oman, Kuwait, Lebanon, Morocco, Tunisia, Abu Dhabi, Dubai, Sharjah, Ras Al Khaimah
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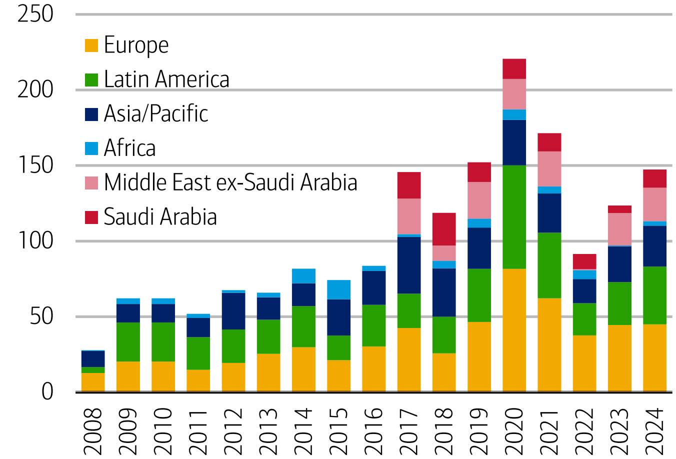
Exhibit 22: Middle East issuance picked up in 2017 sharply
Gross issuance by region/country in US$bn since 2008



Source: BofA Global Research, Bloomberg, Bond Radar
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Exhibit 23: GCC gross issuance peaked in 2017 at US$50bn and we forecast US$30bn for 2024
GCC countries gross issuance history since 2016 in US$bn

GCC Countries	2016	2017	2018	2019	2020	2021	2022	2023	2024F	Total
Saudi Arabia	18	22	13	13	12	10	5	16	12	120
Abu Dhabi	5	10	0	10	15	5	0	0	0	45
Bahrain	3	4	1	2	4	4	0	3	4	24
Dubai	0	0	0	0	4	0	0	0	2	6
Kuwait	0	8	0	0	0	0	0	0	0	8
Qatar	9	0	12	12	10	0	0	0	5	48
Oman	4	7	8	3	3	5	0	0	0	30
Sharjah	1	0	1	2	2	2	1	2	3	13
Ras Al-Khaimah	0	0	0	0	0	0	0	0	0	0
UAE	0	0	0	0	0	0	0	0	4	4
Total	**39**	**50**	**35**	**42**	**49**	**26**	**6**	**21**	**30**	**298**
Debt Outstanding	**750**	**868**	**949**	**1,050**	**1,200**	**1,287**	**1,221**	**1,263**	**1,261**	
GCC / Debt Outst.	**5%**	**6%**	**4%**	**4%**	**4%**	**2%**	**1%**	**2%**	**2%**	

Source: BofA Global Research, Bloomberg, Bond Radar, ICE Data indices, LLC.
Note: we define "Debt outstanding" based on the ICE sovereign indices which are fully market cap weighted and which exclude all sovereign bonds maturing in over 1 year
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Will Saudi Arabia hit an index cap?

Saudi Arabia's weight in the EMBIG Div is already among the largest

The EMBI Global Diversified construction process limits the weights of countries with larger debt stocks. A new issue in any one of the largest countries (including Saudi Arabia), does not create much index-driven incremental demand for the sovereign debt overall. This is the case in the other three big countries, as well (Mexico, Türkiye and Indonesia).

Though technically not formally capped, one can think of the high weight as limiting. The EMBI Global Diversified construction process limits the weights of countries with larger debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding. The larger the country, the smaller the proportion of debt is included. The large markets are weighted lower, and the small markets are weighted higher than in the regular EMBI Global Index that is based on unadjusted market capitalization. Mexico and Indonesia have been at the limit for years but are still issuing.

In early 2019, JP Morgan added high quality GCC countries to the EMBI Global that were not previously eligible (Saudi Arabia, United Arab Emirates, Kuwait, Qatar, and Bahrain), with a full phase-in by September 2019.

By then, Saudi Arabia was already the 4th largest country in the diversified index. Given that we forecast Mexico's 2024 net issuance to be US$16.7bn, we expect Saudi Arabia to remain at the current #2 spot. Any country in the top four range is still very high at 5-6%, because at that level, each new primary issuance hardly adds to the sovereign weight in the EMBI Global Diversified index. Instead, as the new bonds enter the index, the weights of the older outstanding bonds are scaled down even further.

Since 2019, both Middle East – Africa (MEAF) and Latin America (LatAm) debt have increased debt stock in the EMBIG Div by about 3% at the expense of both Central and Eastern Europe (CEE) and Asia. However, that could reverse in 2024, as we forecast significantly less net issuance for MEAF than for CEE and LatAm.

Note, we estimate the EMBIG Div weights based in instruments we have access to, which is the EMB ETF with a benchmark of JPEICORE. That also excludes a few small illiquid issuers versus EMBIG Div, and, thus, the largest weights are slightly more in our table than one would likely find in the EMBIG Div.

Saudi Arabia's index weight may likely not be larger than Mexico's for many years, given the high financing needs of Mexico. Pemex, which has been a large issuer in the past, is a 100% owned quasi, and thus is included in the EMBI Global, which adds to the Mexico market cap. At present, Saudi Arabia has US$110bn USD bonds (KSA & PIFKSA), but Mexico and PEMEX together have over US$140bn.

Exhibit 24: We estimate that Saudi Arabia represents about 5-6% of EM diversified debt

Country and regions weights of the top 10 issuers today and their historical weights since 2019 using the EMB ETF, which we use as a surrogate for the EMBIG Diversified, and net issuance 2024 forecast

		Estimate of EMBIG Div weights using EMB ETF as an indicator						Net issuance
Country / Region	Rating	2019	2020	2021	2022	2023	vs 2019	2024F
Mexico	BBB-/BB+	5.5	5.8	5.6	5.8	6.0	0.7	16.7
Saudi Arabia	A+	4.5	4.5	4.7	5.2	5.8	1.6	10.9
Türkiye	B-	3.9	4.0	3.9	5.1	5.3	1.3	1.1
Indonesia	BBB/BBB-	4.8	4.9	5.0	5.4	5.2	0.4	1.7
UAE	AA-/A+	3.2	4.2	4.5	4.9	4.7	1.5	0.3
Qatar	AA-	3.7	4.2	4.4	4.5	4.2	0.4	3.0
Philippines	BBB	3.5	3.7	3.6	3.7	3.7	0.1	2.4
Oman	BB+	2.8	2.8	3.1	3.7	3.6	0.9	-1.8
Brazil	BB	3.4	3.5	3.3	3.7	3.6	0.3	3.0
China	A+/A	3.3	3.5	3.7	4.0	3.4	0.2	4.0
Africa / Middle East	BBB/BBB-	32	32	33	36	35	3	14.0
Eastern Europe	BB/BB-	17	16	15	11	13	-3	22.1
Asia	BBB+/BBB	19	18	19	19	17	-2	4.9
LatAm	BBB-/BB+	32	33	33	35	35	3	33.9

Source: BofA Global Research, Bloomberg

Note, we estimate the weights based in instruments we have access to, which is the EMB ETF with a benchmark of JPEICORE, that also excludes a few small illiquid issuers versus EMBIG Div. Thus the largest weights are slightly more than one would find in the EMBIG Div.

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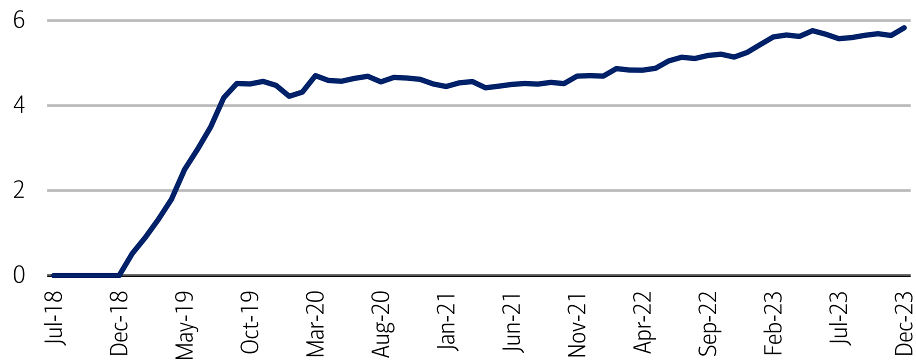
Exhibit 25: Saudi Arabia represented a 5.8% of the EMB ETF by December 2023 (%)
Saudi Arabia weight in the EMB ETF Jul'2018 – Dec'2023



Source: BofA Global Research, Emerging Portfolio Fund Research (EPFR) Global.

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Demand: primary and secondary activity

Non-GCC accounts are significantly larger than GCC accounts in the primary market. Interest is segmented by curve sector. In general, regional and local funds are active in 5-year tenor and under. In the primary market, Saudi banks usually get few to no allocations, but other GCC banks (non-Saudi) do buy Saudi bonds in the primary, mostly concentrated in the 5-year tenor. International (non-GCC) funds, especially from Asia, buy the 10-years and longer maturities. Consistent with this is that holdings of Saudi bonds by those who report (HDS) show 20-37% of the long bonds are held by funds that report, whereas shorter bonds are held by less than 10% of those who report. This is another indication that short bonds are likely bought by locals, regional institutions, or banks, in our view. Local funds and private banks are quite active in the secondary market, and mostly tend to buy-and-hold (and also buy on dips when internationals sell).

The rest of the non-benchmarked investors likely have different duration preferences. For example, banks typically buy shorter bonds, while pension funds and life insurance companies prefer longer bonds. We see that the Saudi government international bond curve is about 20bp steeper than similar sovereign curves, indicating there may be adequate demand for 10-years and under Issuance of long bonds could require larger concessions, were Saudi Arabia to come to market again this year.

One mitigant to the large sovereign issuance by Saudi Arabia and the index-capping it faces is the capacity of domestic investors (which are likely not benchmarked) to purchase the debt, particularly when oil prices are at comfortable levels and Saudi Arabia is running large current account surpluses (meaning it is a net lender to the rest of the world). Balance of Payments statistics show that Saudi Arabia as a whole owed US$136bn in face value of debt securities to the rest of the world (as of 3Q23), compared to about US$93bn pure Saudi sovereign and US$59bn corporate debt outstanding (including PIF) at the time (US$152bn in total).

By those measures, at least 10% of the debt is owned by domestic investors. However, we think this very likely understates the total amount of debt owned by locals (since domestic investors can purchase bonds via offshore entities, which may be recorded as a liability to a non-resident). Note that these statistics would incorporate primary market purchases and subsequent trading in the secondary markets.

In addition, according to our analysis using Bloomberg HDS and AGGD, funds' reported holdings on Saudi sovereign bonds are just between 4-7%, much lower than holdings of sovereigns outside the region.

Saudi sovereign curve

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Saudi Arabia has the highest spread among all of Abu Dhabi, Israel, Qatar, UAE and China. Saudi external long-dated bond yields closely track United States Treasuries (USTs), even when the oil price falls.

Exhibit 26: Saudi Arabia 30-year spreads versus peers
30-year risk premium 12-month range and yield

Country	Current 30Y bond spread	Actual rating	Implied rating	Implied change, notches	Current Risk Premium	Average 12M RP	1W Δ in RP	4W Δ in RP	Z score of RP (12M)	Cash prices
ASIA										
CHINA	95	A+	AA+	-3.3	-54	-42	-3	-13	-2.3	67
HONG KONG	109	AA	AA	-0.6	-10	-6	0	-5	-0.4	107
EEMEA										
ABU DHABI	155	AA	A+	2.3	42	42	-2	5	-0.2	67
ISRAEL	203	A+	A-	2.6	61	51	-1	-7	0.6	74
QATAR	158	AA-	A+	1.8	34	35	-2	8	-0.3	87
SAUDI ARABIA	214	A+	BBB+	2.3	58	51	0	11	0.7	71
UAE	162	AA-	A	2.1	41	41	-6	-6	0.0	95

Note: Risk Premium (RP) is market spread minus Implied spread from fitted global curve of 25 countries. Risk premium = actual – rating implied spread over time. **Source:** Bloomberg, BofA Global Research

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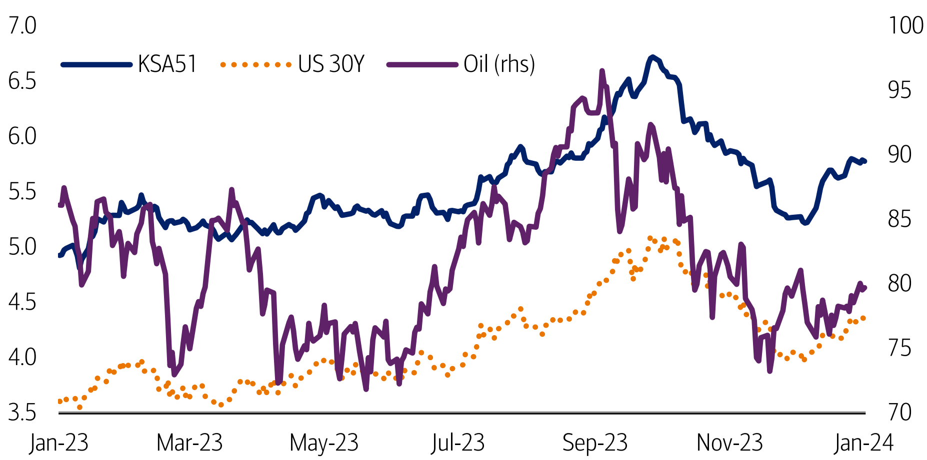
Exhibit 27: KSA 51 & US 30-year yields
The yields closely track each other, even when the oil price falls



Source: Bloomberg. Left axis in US$/bbl, left axis in %.

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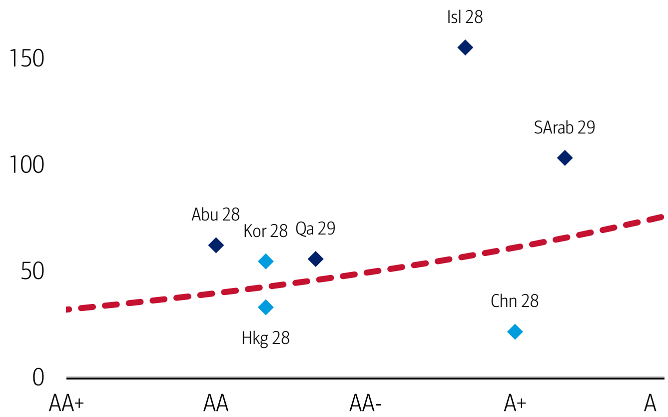
Exhibit 28: Spread versus rating 5Y credit curve
Saudi 5Yr versus peers



Source: Bloomberg, BofA Global Research. Axis in basis points (bps).
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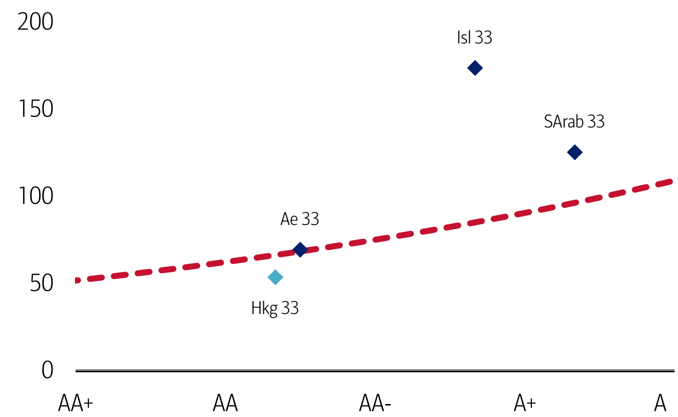
Exhibit 29: Spread versus rating 10Y credit curve
Saudi 10Yr versus peers



Source: Bloomberg, BofA Global Research. Axis in basis points (bps).
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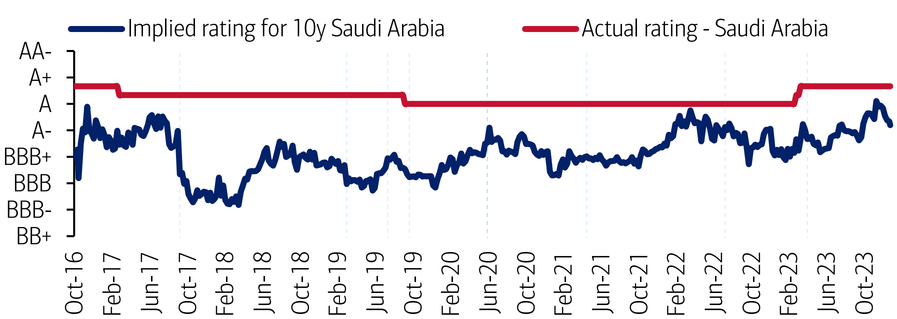
Implied rating has worsened slightly in recent months

The divergence between implied and actual ratings has increased slightly in recent months. Saudi is currently rated A+ and has an implied rating of BBB+. This divergence is probably driven by pressure on oil prices as the Saudi economy is oil-dependent. Looking at a longer time period, we see that the highest divergence between Saudi's rating and what the market was implying was at end-2017. This was mainly driven by a large issuance schedule that the market was trying to absorb, in our view. The Saudi government started coming to market in 2016.

Exhibit 30: Saudi Arabia implied rating based on 10Y Benchmark bond
Saudi Arabia implied rating based on 10Y benchmark bond versus actual rating



Source: Bloomberg, BofA Global Research
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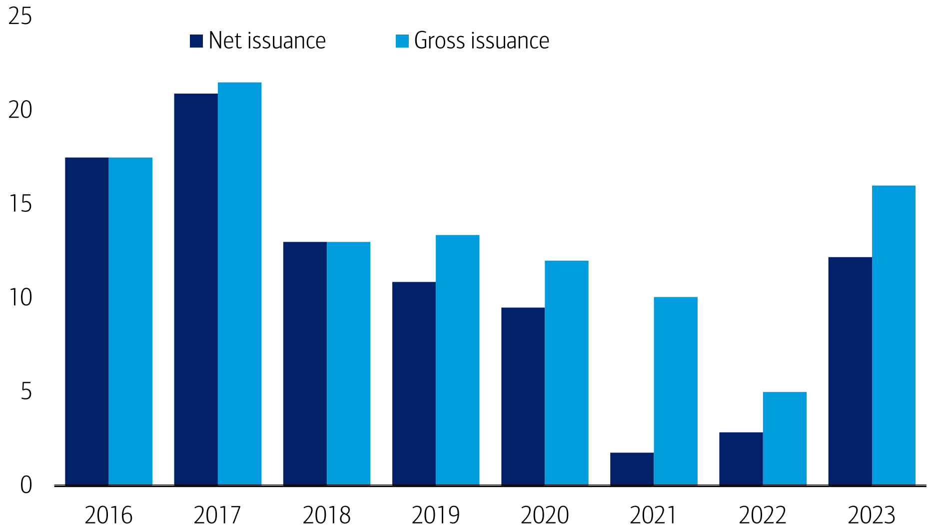
Exhibit 31: Saudi Arabia sovereign international bond issuance, 2016-2023 (US$bn)

Net issuance closely mirrors gross issuance, as Saudi Arabia is a recently established external issuer



Source: Bloomberg, BofA Global Research

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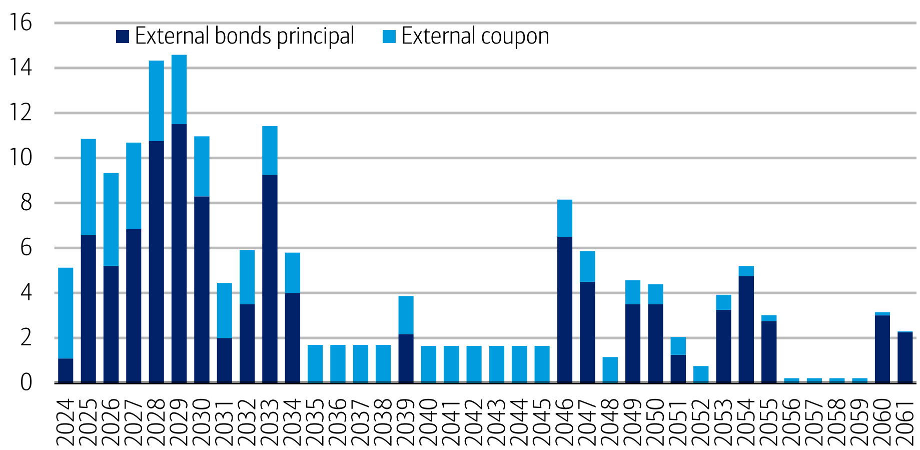
Exhibit 32: Principal and coupons due on Saudi sovereign international bonds (US$bn)

Amortization schedule appears crowded in 2025-30



Source: Bloomberg, BofA Global Research

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Local Debt Markets: GBI-EM index inclusion – more work is needed

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The large Saudi domestic investment plans support authorities' target to grow the local debt capital markets. This may support some diversification away from issuance in External Debt (EXD) markets. Index inclusion economic impact is however likely modest. Liquidity is the biggest constraint for Saudi local bond inclusion in the Government Bond Index - Emerging Markets (GBI EM), in our view. It will likely take several years to improve it.

Authorities target development of deep and liquid local bond market

The large domestic investment plans support Saudi authorities' medium-term target to grow its local debt capital markets. This is reflected in the Financial Sector Development Program, which is part of Saudi Vision 2030. The Saudi Securities Depository Center Company (Edaa) and Euroclear signed an agreement in October 2021 to give foreign investors access to the domestic sukuk and bond market within the Saudi Exchange (Tadawul), with the link operational from March 2022. Authorities also subsequently appointed a number of international banks as primary dealers in local government securities alongside local banks.

We expect the domestic bond market size to grow going forward. Greater development of the market could allow more reliance on local issuance to meet funding needs going forward. Authorities could thus count upon local pockets of liquidity as a source of funding for the large domestic investment plan.

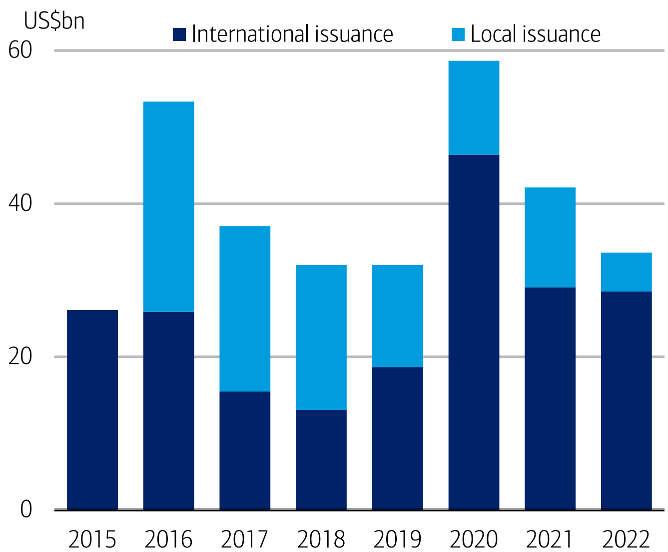
Authorities may consider external issuance is superior to domestic issuance in the sense that it brings in hard currency alongside the creation of a sovereign liability. However, the large and frequent external sovereign issuance from Saudi authorities could impact on borrowing costs. Also, authorities would likely be increasingly relying on volatile cross-over investors rather than dedicated Emerging Markets (EM) and regional investors as the Saudi weight in external indices is incrementally capped.

Impact of GBI-EM inclusion on the economy is likely to be modest

Our estimate of the projected foreign inflows into Saudi local bonds are small compared to the size of the economy. Inflows would represent 2.0% of M2 and 2.8% of Fx reserves. As such, we do not think index inflows would materially and sustainably ease domestic liquidity or reduce local funding costs for economic agents.

Development of the local bond market is likely to bring more volatility to capital flows into Saudi Arabia compared to international bond issuance. During risk-off periods, all EM bonds are likely to see outflows including Saudi Arabia, unless the risk-off is driven by a sharp increase in oil prices. However, on the international bond market, the government receives USD proceeds at the time of issuance and outflows from international bonds do not impact the exchange rate and reserves.

Exhibit 33: Saudi sovereign international and local issuance (2015-22)
We expect the domestic bond market size to grow going forward



Source: National Debt Management Center (NDMC)
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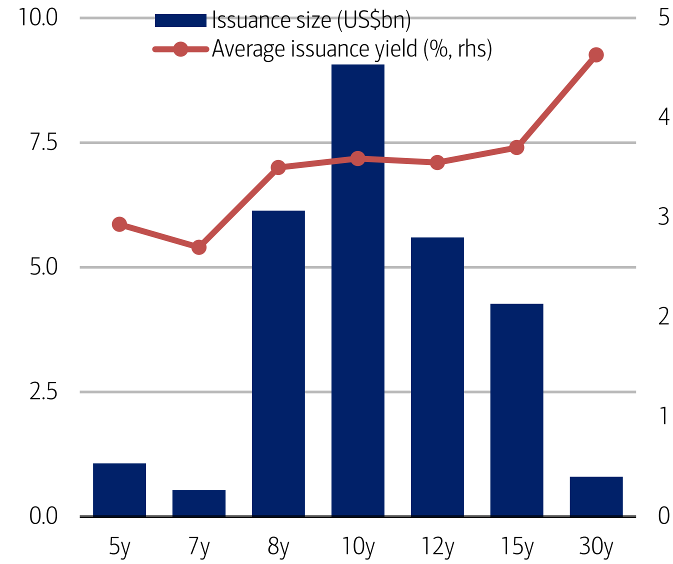
Exhibit 34: Saudi Arabia domestic sukuk issuance developments (2022)
Local issuance has concentrated around the 10-year tenor



Source: National Debt Management Center (NDMC)
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GBI-EM index inclusion - liquidity is the biggest constraint

Saudi authorities are aiming for inclusion of local bonds in the Government Bond Index - Emerging Markets (GBI EM). The large domestic investment plans support Saudi authorities' medium-term target to grow its local debt capital markets. Liquidity is currently the biggest constraint to index inclusion, and it will take several years to improve it, in our view. Better liquidity on the secondary market means wider ASW spreads for local bonds and higher yield for local relative to international bonds, in our view. The impact of GBI-EM inclusion on domestic liquidity is likely to be modest as projected foreign inflows are currently relatively modest versus the economy's size.

Inclusion of Saudi local bonds likely faces obstacles

Authorities are aiming to include Saudi local bonds in the Government Bond Index-Emerging Markets (GBI EM), the main emerging market (EM) local bond index. The issuer needs to meet several criteria to be included in the index. Of these, we think Saudi Arabia meets the following: 1) it does not have explicit capital controls, and 2) there are no tax or regulatory constraints.

The two possible constraints to inclusion for Saudi Arabia are:

1. Gross national income (GNI) per capita must be below the Index Income Ceiling (IIC) for three consecutive years or IPR (the ratio of gross domestic product (GDP) in USD at current prices to GDP in purchasing power parity (PPP) dollars) should be below the threshold for three consecutive years.

2. Two-way daily pricing should be available (i.e. the local bond market should be liquid).

We think the inclusion of Saudi local bonds into GBI EM is a medium-term prospect (3-5 years) as it is likely to take a few years to improve the liquidity and functioning of the secondary market for local bonds. Furthermore, India local bonds are currently in the process of gradual inclusion and engaging market participants, which could considerably delay the inclusion of Saudi local bonds into GBI EM.

Improved liquidity on the local bond market could initially lead to higher yields, in our view. This pick-up could improve the attractiveness of Saudi Arabia local bonds as a diversification play within EM in the context of high ratings, low volatility and a credibly pegged currency.

Saudi likely meets the GNI/IPR criterion currently …

Saudi Arabia's current GNI per capita is only 3.7% above Czechia's, the richest country in the GBI EM index. Therefore, this condition should not hinder Saudi Arabia's inclusion, in our view. In addition, we estimate the IPR in 2020-22 for Saudi Arabia was below the 62.9 threshold set for 2023.

…bond market liquidity is a much bigger constraint

Local bond market liquidity has been improving over the past few years, but is still a major constraint to inclusion, in our view. The National Debt Management Center (NDMC) controls yields in the primary market. This has a negative spillover on the secondary market, as primary dealers do not want to realise losses by selling bonds initially bought at 'artificially' low prices (versus fully market-determined prices). As a result, daily turnover on the local bond market is currently extremely low. This reinforces the buy-and-hold nature of local market participants.

In an unlikely scenario where the authorities improve liquidity quickly, Saudi local bonds would still probably only be considered for inclusion in the index after India's takes effect (June 2024), or more likely after its weight reaches 10% by end-March 2025.

Saudi's weight could be just below 6%, on our estimates

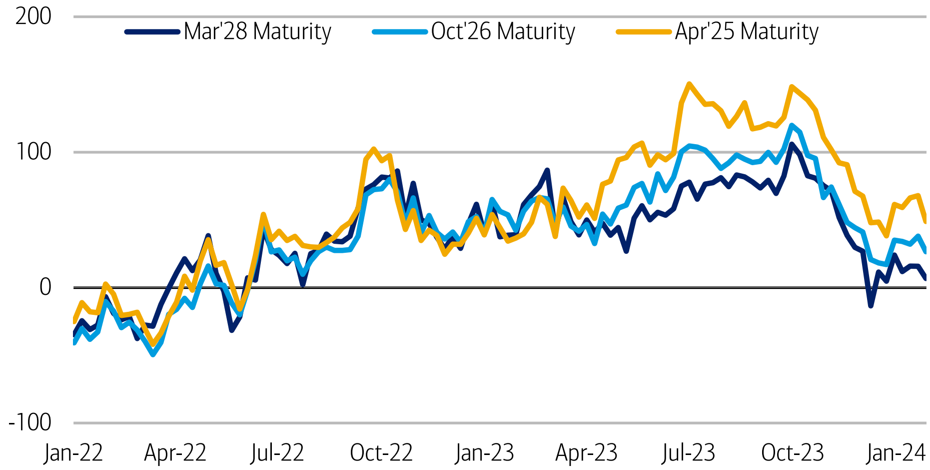
We estimate Saudi's weight in GBI EM at around 5.9% if all bonds that meet eligibility criteria were to be included in the index now. We calculate the weight by first finding the country in the GBI-EM index with a similar amount of bonds outstanding (Poland). This becomes the starting point for the weight calculation. We then adjust the weights of every country in line with the methodology adopted by the index provider.

The above means the total net inflows into Saudi could stand at US$12.4bn. This assumes mostly passive indexed inflows (with the index provider suggesting around US$210bn in assets under management (AUM) tracking the index).

The exact weight of Saudi Arabia if it were included in the index is uncertain. The authorities could increase the issuance of bonds ahead of inclusion to raise its weight. As a rule of thumb, countries with bonds outstanding of US$300bn or more usually receive the maximum 10% weight. On the other hand, if inclusion happens in a few years, some of the currently eligible bonds will no longer meet the criteria for inclusion.

To be included, a bond should have at least US$1bn outstanding and at least 2.5 years to maturity, and two-day daily pricing should be available. We estimate that 35 bonds (with face value of cUS$113bn) out of a total of 53 are currently eligible.

Exhibit 35: International Saudi bonds have slightly higher yields than local bonds
The chart shows the difference in yield between international and local bonds with the same maturity



Source: Bloomberg, BofA Global Research. Basis points (bps) on vertical axis.

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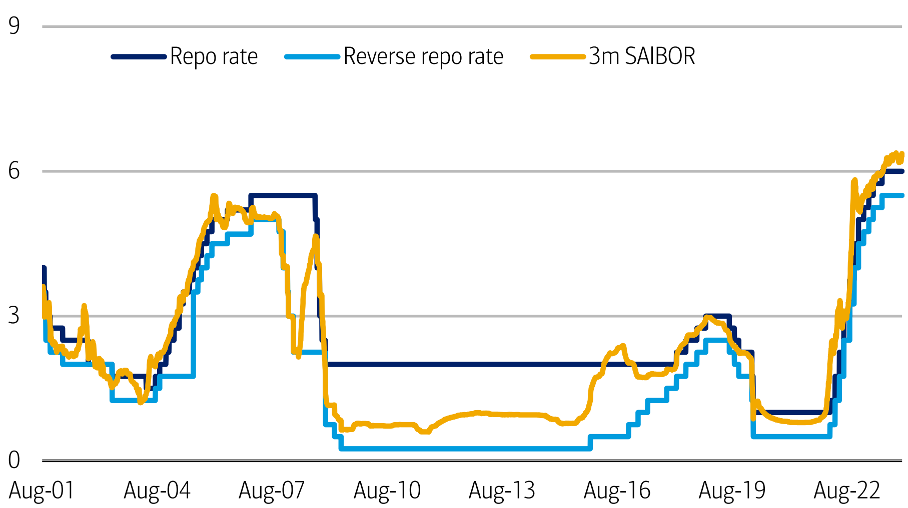
Liquidity oddities

The elevated Saudi interbank rates and the lack of an increase in Saudi Central Bank (SAMA) Fx reserves do not appear consistent with the level of oil prices. We think this reflects methodological factors (Saudi Arabian Interbank Offered Rate (SAIBOR) new computation), cyclical factors (fiscal surplus until recently and portfolio outflows from government entities), structural factors (increase in non-hydrocarbon revenues), regulatory factors (arbitrage difficulty) and liquidity factors (credit growth outpacing deposit growth, with excess deposits at SAMA being reduced). See our notes Saudi Arabia – oil oddities and SAIBOR spread to policy rates: it's all about banks' liquidity for an in-depth discussion, and the below for an update on liquidity trends.

3m SAIBOR is still misaligned relative to policy and other interbank rates

The chart below shows that the 3m SAIBOR has been significantly above the repo rate since late January 2022 – a rare occurrence over the past 22 years. Moreover, the 3m SAIBOR looks misaligned with 6m SAIBOR rates (less so relative to 1m SAIBOR), indicating that the interbank market is likely to be experiencing some funding pressures.

Exhibit 36: 3m SAIBOR is above the repo rate
This likely indicates funding pressures in the banking sector



Source: Bloomberg, BofA Global Research. Vertical axis in %.

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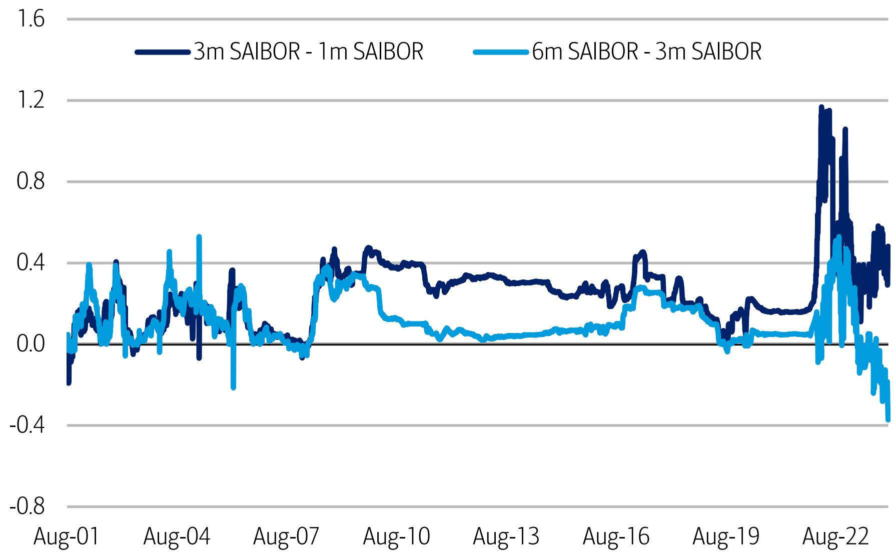
Exhibit 37: 3m SAIBOR also looks misaligned relative to 6m SAIBOR
This also likely indicates that the interbank market is under pressure



Source: Bloomberg, BofA Global Research. Vertical axis in %.

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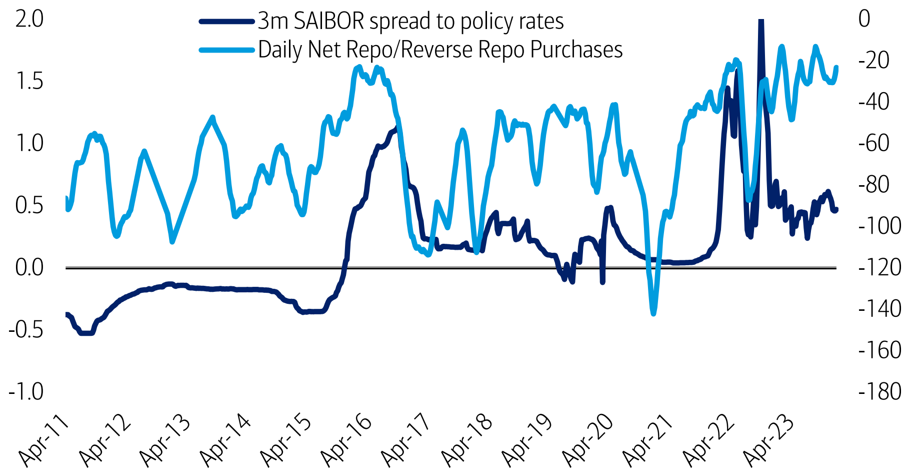
3m SAIBOR tracks closely interbank liabilities and volume of SAMA's repos…
The spread between the 3m SAIBOR and the middle of the policy rate corridor used to track closely the volume of repo/reverse repo transactions and interbank liabilities of commercial banks. Additional demand for interbank funding (to finance strong credit growth) puts upward pressure on SAIBOR. At the same time, SAMA injection of liquidity into the banking system acts as a substitute for interbank funding. This also means SAMA could exert a degree of control on the funding squeeze in the banking system by injecting more liquidity.

SAMA liquidity intervention is likely to alleviate the domestic funding squeeze only temporarily. The intervention amount is constrained by the economy's high propensity to imports and the likelihood that the SAR injection leads to increased FX demand, in turn weighing on FX reserves. This means SAMA may prefer to inject smaller amounts of liquidity gradually to retain monetary control, rather than intervene in a substantial way all at once.

Left unchecked, higher SAIBOR rates are likely to spread to lending rates and slow credit growth in the economy, tightening monetary conditions. However, this is unlikely to be welcomed by the authorities when mega-projects are being pursued and need medium-term funding. Also, given that mortgages are at fixed rates and partially subsidised to boost home ownership as part of Saudi Vision 2030, they may not respond fully to higher SAIBOR rates. As long as lending growth outpaces deposit growth, this is likely to lead to periodic bouts of volatility in domestic interbank rates, partially alleviated by SAMA interventions, in our view.

Exhibit 38: Net repo/reverse repo purchases used to drive 3m SAIBOR
Most recently the spread between the interbank and policy rates has been tight despite high net repo purchases, possibly because of elevated oil prices



Source: Bloomberg, BofA Global Research. Right vertical axis in %, left vertical axis in basis points (bps).

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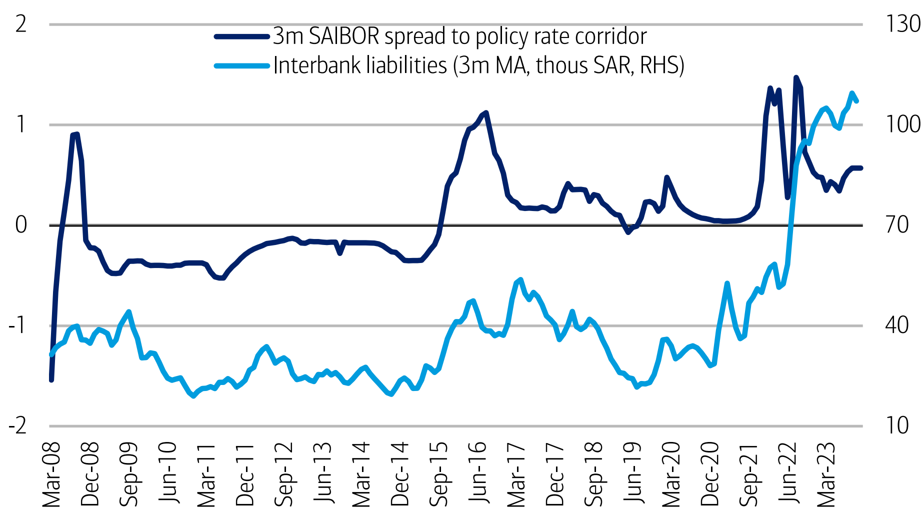
…and 3m SAIBOR is likely to go higher from here

Most recently, the correlation between net repos and interbank liabilities on one hand and SAIBOR spread to the middle of the policy rate corridor on the other has weakened. We still believe that the correlation is likely to strengthen, which means that risks are skewed towards a widening of the 3m SAIBOR to policy rate spread. This also means that the spread between 3m SAIBOR and Secured Overnight Financing Rate (SOFR) is likely to widen as well.

Exhibit 39: Rising interbank liabilities used to drive widening of 3m SAIBOR spread to the policy
This suggests that there is room for the spread to go higher from here



Source: Bloomberg, BofA Global Research. Right vertical axis in %, left vertical axis in basis points (bps). MA = moving average.

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Corporate credit: Saudi corporates and banks issuance set to rise

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PIF related entities likely to drive issuance higher in 2024

2024 Saudi corporate and bank eurobond / international sukuk issuance is likely to grow materially from the cUS$19bn issued in 2023, driven by several Public Investment Fund (PIF)-related debut issuers. This will likely come on top of PIF's own plan to tap the eurobond / sukuk market twice a year, as well as prospective issuance by banks. PIF real estate giga-projects are focused on achieving "proof of concept" status by delivering small sections of the projects in the near term; off-plan and land ownership laws will likely need to be amended to allow foreign participation.

Banks will likely continue to tap alternative source of funding such as the repo market (available to Islamic banks since 2020), debt capital market (including retail and wholesale local issuance and eurobonds opportunistically if pricing makes sense) and securitization (to PIF's owned Saudi Real Estate Refinance Co.). External deposits are another funding avenue under consideration by the Saudi Central Bank (SAMA).

Competition for Current And Savings Account (CASA) deposits is set to accelerate with the launch of 3 digital banks (STC Digital Bank already soft launched a pilot version). To provide additional liquidity buffers to banks, SAMA has amended the regulatory Loan-to-Deposit Ratio (LDR) calculation methodology in July 2023 to include capital instruments (Tier2s and Additional Tier 1s (AT1s)) and assign a better weight to long-dated term deposits. We are also starting to see some participation of United Arab Emirates (UAE) major banks in recent Saudi corporates syndications (STC, SEC) but not much yet in PIF project loans.

Corporate lending is likely to be an engine of growth going forward, driven by PIF's projects funding needs (drawdown expected to accelerate from 2H24) and contractors' activity, while mortgages (25% of total loans now) could see a normalised but healthier growth in high single digit (after the rationalisation of profit rate subsidies in February 2023 and the reduction in customer eligibility due to higher rates).

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Disclosures

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