Lebanese Eurobonds amid International Bond Markets in H1 2017

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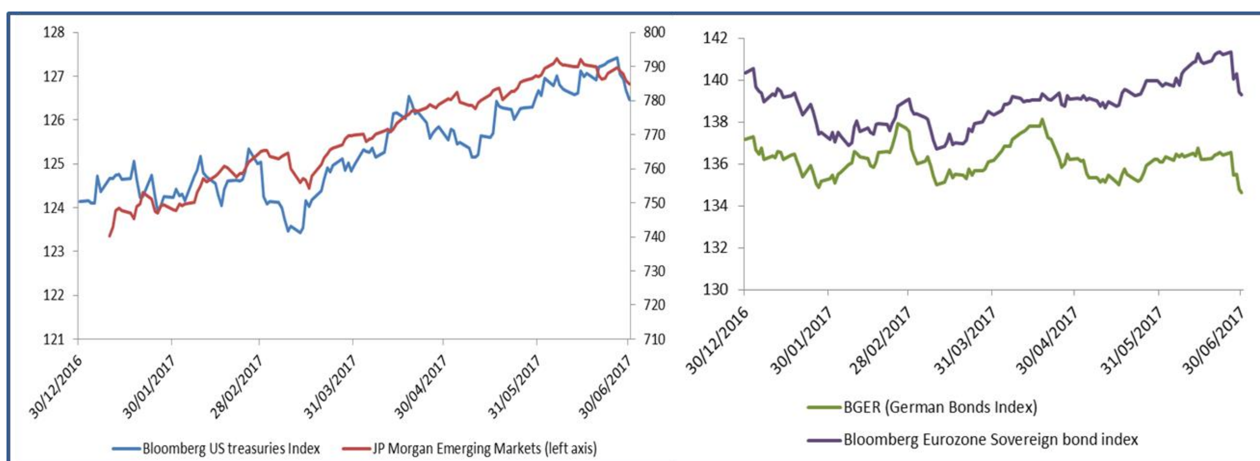
Global Overview of Bond Markets in H1 2017



Graph: BLOMINVEST; Source: Bloomberg

In the US, the Bloomberg Index of US Treasuries grew by an incremental 1.88% y-t-d to 126.47 points at end-June, reflecting a cautious demand for US treasuries during H1 2017.

In Q1 2017, strong economic data favoured equity investments. Trump’s pledge to infrastructure spending kept markets optimistic, thus boosting equity investments. Therefore, the Bloomberg Index of treasuries only grew by a marginal 0.68% by March 2017 to 124.99 points.

Shifts in the FED’s policies during Q2 2017 ended H1 with a higher US treasuries index. In Q2, with Trump’s unfulfilled (postponed) promises on multiple fronts: reforming Obamacare,

infrastructure projects.., and as inflation kept on softening, the demand on government bonds improved and the index rose by 1.18% quarter-on-quarter (q-o-q). As such, the yields on US treasuries maturing in 5 and 10 years slipped from 1.93% and 2.45% at end-2016 to 1.89% and 2.31%, respectively. It is worthy to mention that the FED hiked interest rates twice in H1 2017 by a quarter percentage points in each of March and June 2017.

In Europe, the economic growth kick-off mainly sent managers to rebalancing portfolios into equity investments. Therefore, the demand on bonds declined in H1 2017 as the Bloomberg Eurozone Sovereign Bond Index lost 0.73% y-t-d. In details, the Eurozone (EZ) sovereign bond index registered a 1.43% downtick during Q1 as the race for the French presidential election spurred uncertainty and economic growth being on a solid footing. In Q2, the index recorded a 0.71% q-o-q improvement largely attributed to the continuous softening of inflation and the clearing of the political hurdles with the election of Emmanuel Macron as French president.

The new monetary stances of the ECB and FED in H1 were partly behind the increasing demand for emerging markets' (EM) sovereign bonds. Over the period, the JP Morgan Emerging Markets Bond Index posted an annual 6.2% gain to settle at 784.9 points by June 2017. In details, Q1 2017 carried expectations of increased US interest rates and protectionist trade policies by Trump, which reduced yields on EM bonds. Accordingly, the JP Morgan EMBI index rose by 4.18% y-t-d to 769.98 points by March. In Q2, the JPMorgan index jumped by 1.94% q-o-q. The key drivers of demand for EM bonds in the period were tied to successful structural reforms in some of the EMs including China, which boosted global demand for commodities, opening up growth paths for Brazil and Russia.

In its turn, the KSA marked H1 2017 with its second large tapping of international bond markets via Sukuks. Following a crash in oil prices that afflicted the country's budget surplus, Saudi Arabia was forced to reshape its oil-dependent economy, slashing spending and tapping international bond markets for a second time in April 2017 (October 2016 was the first external financing).

Saudi Arabia raised US$9B in its first dollar-denominated Islamic bond (sukuk) sale. The issuance was jointly coordinated by Citigroup Inc., HSBC Holdings Plc and JPMorgan Chase & Co., with BNP Paribas SA, Deutsche Bank, AG and NCB Capital helping to manage the sale. According to Bloomberg, the government sold a US$4.5B 5Y sukuk tranche at 100bps over the mid-swap rate and an equally-sized 10Y tranche at a spread of 140 bps to the benchmark. Moody's Investors Service had assigned a provisional rating of A1 to the sukuk, while Fitch Ratings an A+.

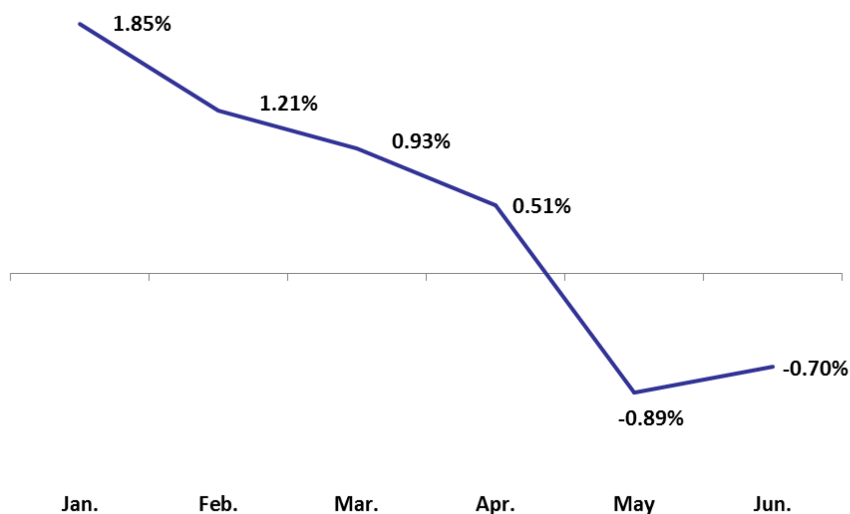
The recent diplomatic crisis highlighted Qatar's economy in H1 2017 but did not change the country's bonds status. Even though Qatar's diplomatic crisis severed relationships between the country and the KSA, UAE, Bahrain, and Egypt in beginning June 2017, the oil and gas-driven economy benefited from the partial recovery in global oil prices during H1 2017 to boost public revenues, leaving it with no need to raise funds externally. Nonetheless, the exposure to Qatari sovereign debt rose.

Wrap Up of Lebanese Eurobonds in H1 2017

Source: BLOMINVEST Research Dept.

H1 2017 marked a fluctuating performance of Lebanese Eurobonds. In Lebanon, Eurobonds market proved highly sensitive to political developments. The election of a president and the ensuing formation of cabinet, both of which occurred in October and November 2016, respectively, propagated a positive jolt into the market which partly reflected on the Lebanese bonds market in Q1 2017. On the counterpart, the uncertainty surrounding the electoral law and draft budget both weighed down on the portfolio' s performance especially in Q2 2017.
As such, the Blom Bond Index (BBI) by June 2017 gained 1.89% year-on-year (y-o-y) and 2.92% year-to-date (y-t-d), to stand at 104.88 points owing it to the approved electoral law by June 16th. However, the gain was only marginal as investors were in a wait-and-see mode vis-à-vis the endorsement of a draft budget.

Investors' confidence was also reflected in the Eurobonds' decreasing yields. The weighted average yield of Lebanese Eurobonds, inversely related to price, fell from 6.67% on Dec.30, 2016 to 6.15% on June 30, 2017. As such, the yields on the 5Y and 10Y Lebanese Eurobonds contracted, slipping from 6.67% and 7.11% on Dec. 30, 2016, to 5.98% and 6.75% on June 30, 2017, respectively. Investors' greater confidence in the Lebanese papers was reflected in the narrowing spreads between the 5Y and 10Y yields on Lebanese Eurobonds and their US counterparts. These fell from 474 basis points (bps) and 466 bps, end of 2016, to 409 bps and 444 bps, respectively, end of H1 2017.
Moreover, the 5Y Credit Default Swaps (CDS) quote which reflects the perceived default risk by the government narrowed substantially from 495-545 bps with a mid-quote of 520 bps on Dec.30, 2016 to 425-450 bps with a mid-quote of 437 bps on June30, 2017.



Source: BLOMINVEST Research Dept.

The US$3B Eurobonds issuance on March 23rd kept the BBI in the green in Q1. A positive sentiment propagated across the market as the Lebanese Ministry of Finance (MoF) issued US$3B in Eurobonds to finance the public debt, of which $1.5B replaced Eurobonds maturing on March 20th, while the rest was injected as "fresh money" into the market.

March's issuance was the biggest single sovereign bond issuance denominated in foreign currency. The MoF mandated four domestic and international banks (Barclays plc., Byblos Bank s.a.l, Societe Generale de Banque au Liban, J.P. Morgan Chase and Co.) to be the lead underwriters (to co-manage) the issuance of US$1.5B to replace Eurobonds maturing on March 20, 2017. The issuance was made under the Lebanese Republic's existing global program entitled, the Medium-term Notes (MTN– program).

Eurobonds Issuance Details: March 23, 2017				
Tranche	**Interest Rate (Coupon)**	**Issuer**	**Maturity Date**	**Value (in US$)**
10Y	6.85%	Republic of Lebanon	2027	1.25B
15Y	7%	Republic of Lebanon	2032	1B
20Y	7.25%	Republic of Lebanon	2037	750M

Source: BLOMINVEST Bank Research Department

Participation of foreign investors in the new issue drove the demand for Lebanese Eurobonds up in H1. According to the MoF, the Issuance was 6 times oversubscribed, reaching $17.8B, of which $1.25B came from "foreign" investors including banks and financial

institutions. These snapped a total of 20% of the issuance, equivalent of $600M, one of the highest recorded for Lebanon.
Foreign investors were underweighting Lebanon in their portfolio before the last quarter of 2016 and decided to raise Lebanon to market weight after the resolution of the political crisis with the election of a president in October 2016. Moreover, fund managers needed to improve the performance of their fixed income funds in an environment of very low interest rates. The buying spree of foreign investors started in the last quarter of 2016 after the election of a new president, and whereby Lebanese banks were eager to sell their Eurobonds, even at a discount, in order to participate in the financial engineering operation undertaken by the central bank of Lebanon (BDL).

However, demand on Eurobonds lost momentum in Q2 2017. The BBI’s deceleration in Q2 followed President Michel Aoun’s suspension of parliamentary sessions to give MPs a month to reach a compromise. The wait-and-see negotiations period prompted the BBI to slip by 0.89% and 0.7% in May and June 2017, respectively. In fact, May 15th was the due date for an agreement on the electoral law, but as political bickering persisted, the session was postponed and so was a voting law decision.
By June 13th, market sentiment turned pessimistic as protests were raised by different parties on suggested elements of the electoral law before cabinet finally referred the bill to the parliament by June 16th.

Looking forward: Lebanese Eurobonds and debt

The MoF’s large issuance was performed to finance a magnified public debt rated “B2 (negative)” by Moody's who emphasized, *“the country's resilient liquidity position, very high debt burden, and deteriorating fiscal deficit”* in its May 2017 report. Similarly, Standard & Poor’s and Fitch rate the sovereign debt as “B-minus”.
Moodys is highly critical of the overexposure of Lebanese banks to public debt, and in Jan. 2017, like the IMF too, it warned the country of rising expenditures on the back of higher interest rates, bundled with a mild recovery in oil prices which benefited oil-importing Lebanon, and the adjustment of the salary-scale for public-sector employees.

Overall, the performance of Eurobonds by June 2017 improved owing it to the overcoming of 1 of the 2 major hurdles facing Lebanon. Looking forward, a new electoral law was approved and it could set the country on a track for reform and economic growth as elections are now set for May 2018. In the meantime, the public sector salary scale and thus the related draft budget become a national priority for H2 2017. In fact, debt-servicing constituted 9.54% of GDP in 2016 to stand at US$4.77B), compared to 9.02% of GDP in 2015.

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