2013 Eurobonds Market in Perspective

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Contact Information

Research Analyst: Mirna Chami

mirna.chami@blominvestbank.com

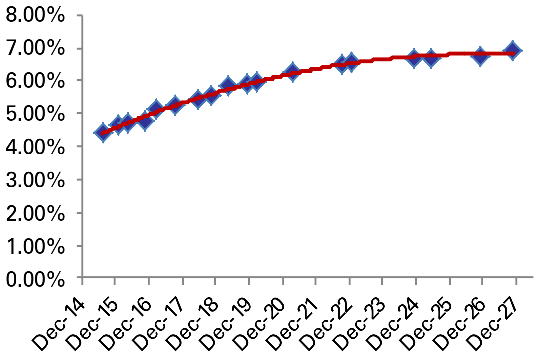
Head of Research:Marwan Mikhael

marwan.mikhael@blominvestbank.com

Research Department

Tel: +961 1 743 300 ext:1285

2013 Lebanon's Yield Curve



Source: Bloomberg, Blominvest Research Department

Lebanon's political stalemate, security uprisings and external headwinds from the Syrian war kept on clouding the bonds market performance in 2013. Besides local and regional developments, an international bearish trend driven by the United States (US) Treasuries also impacted safe assets trading in Lebanon over the year. Hence the BLOM Bond Index (BBI) [1] mirrored the market's negative performance and shed 3.13% year-on-year (y-o-y) compared to the 1.79% yearly loss recorded in 2012.

The BBI moved in seesaws over the year, hovering between a lower band of 102 points and a higher band of 111 points to end the year near the middle band at 105.64 points. Summing up the year, slowing demand characterized the Lebanese market especially during Feb-August, leading the weighted average yield on holding the Eurobonds to surge by 143 basis points (bps) to 6.45%. However, the latter declined in the following 4 months 83 bps to end the year at 5.62%.

The performance of the medium and long term Lebanese Eurobonds reflected investors' demand that faded during Feb-August before regaining some lost ground in the following months. The 5Y bond and the 10Y bond reached by the end of June their highest respective yields of 5.78% and 7.23% after the security clashes that took place in the southern part of the country. Demand started picking up in September but couldn't end the year near last year's level as instability incidents kept on recurring during the last quarter of 2013. The two benchmark notes ended the year on a considerable change, with the 5Y Lebanese Eurobonds' yield reaching 5.41%, up by 39 bps since year start and the 10Y bond maturing in 2023 yielding 6.54%, up by 56 bps from the end of 2012.

[1] *The BBI tracks the performance of the Lebanese government Eurobond market, excluding coupon payment*

Selected Countries by S&P's "B-"Rating of Foreign Currency Long Term Debt

	S&P		Moody's		Fitch	
Country	**Rating**	**Outlook**	**Rating**	**Outlook**	**Rating**	**Outlook**
Cyprus	B-	Stable	Caa2	Negative	B-	Stable
Egypt	B-	Stable	B3	Negative	B-	Stable
Greece	B-	Stable	B3	Stable	B-	Stable
Lebanon	B-	Negative	B1	Negative	B	Negative
Venezuela	B-	Negative	Caa1	Negative	B+	Negative

Source: Bloomberg

Eurobonds market was barely affected by the downgrade of Lebanon's sovereign debt rating outlook by credit agencies like Fitch, Moody's and Standard & Poor's (S&P) in 2013. The stated credit agencies lowered the country's outlook from stable to negative on concerns over the Syrian's war spillovers on Lebanon's political and economic situation. In November's report, S&P insisted on the impact of the Syrian's conflict on Lebanon's economic growth as it dampens its key drivers like tourism, trade and investment.

Demand from foreign investors was more influenced by the negative performance of the US Treasuries and its implications on the international bond markets in the developing and emerging countries. Overseas investors preferred investing in profitable equity markets on the expense of bonds. As US economic activity improves, equity market will follow and interest rates hikes will start showing up in the horizon leading investors to shift their funds from bonds to equities. In details, the first four months of the year were relatively stable for US bonds with a steady demand, slow economic growth and low inflation. In May, the US economy was seen firmer with strong positive signs of improving labor market, recovering housing sector and enhanced consumer confidence data. In this context, the US Federal Reserve (Fed) chairman, Ben Bernanke announced that the Fed may start tapering its "quantitative easing" program in the coming period. The direct outcome was plainly visible in investors' behavior on the bonds market as they hurried to pocket profits before the Fed cuts its financial stimulus.

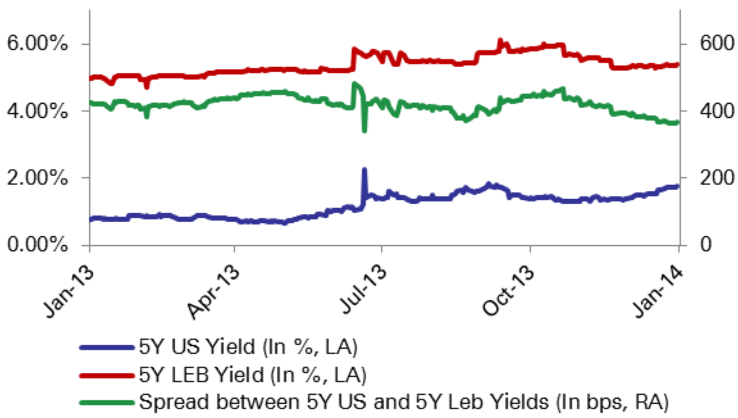
US treasuries had a bad year in 2013. Treasury yields were highly impacted by the Fed's announcement of tapering policy with the 5Y and 10Y yields soaring by 33 bps and 38 bps to 1.05% and 2.16% by the end of May compared to December's 2012 corresponding rates of 0.72% and 1.78%. US bonds kept on drifting over the second half of 2013 with the 5Y and 10Y yields ending the year at 1.75% and 3.04%, respectively.

However, Lebanese bonds fared relatively better than their US counterparts as witnessed by the shrinking spread between the two papers. A comparison shows that the spreads between the Lebanese 5Y and 10Y bonds yields and their US comparable narrowed from 430 bps and 420 bps in 2012 to reach 366 bps and 350 bps, respectively.

On the other hand, the 5Y Lebanese Credit Default Swaps (CDS) which reflect the perceived default risk of the government, stood at 393 bps by end December 2013, narrowing from 450 bps in December 2012, after peaking during June to 527 bps following Sidon clashes.

Hence, the 5Y Lebanese CDS kept on trading at lower levels than the 5Y spread between the Lebanese Eurobonds and their U.S comparable for a considerable period. This reveals that there are additional factors perceived by domestic investors, as they are the main holders of Eurobonds, not taken into consideration by international issuers of CDS. In fact, and in addition to the specific risk of the country, Lebanon may also be part of the shift of international investors away from emerging markets towards the safer U.S Treasuries.

Yearly Performance of the 5Y Lebanese and US Yields and the 5Y Spread



Source: Bloomberg, Blominvest Research Department

When compared to other emerging markets, the Lebanese Eurobonds market outpaced several countries that have its same credit rating. This was obvious in the yearly variation of their CDS posting respective increases in the risk profiles. For example, Egypt 5Y CDS went from an average of 510 bps in 2012 to end 2013 at 605 bps. This alludes to the political instability and the continuous security developments that severely hit Egypt's debt profile the government couldn't retain the credibility of weathering economic crises and not defaulting. Albeit Lebanon's country risk remained higher than other emerging markets such as Brazil and Turkey, both countries have seen their 5Y CDS at higher levels by the end of 2013. On one note, Turkey's anti-government demonstrations deteriorated the security status of the country with 5Y CDS reaching 244 bps, up by 113 bps from last year. On another note, Brazil also witnessed several protests again corruption, poor public services and increasing living costs sending its 5Y CDS 85 bps higher to 193 bps.

In Emerging countries, bond markets underwent in 2013 the 5Y repercussions of the Fed's tapering decision. The JP Morgan's emerging markets bond index posted a 6.58% y-o-y loss during 2013 to settle at 627.86 points, down from December's 2012 level of 672.10 points. Besides US Treasuries' influence, emerging markets suffered from several political, security and economic difficulties[2] that hampered their bonds performance more, sending their originally high yields to greater levels. Accordingly, risk burden became better perceived by investors in the emerging markets, widening spreads between their bonds and US Treasuries, directly sending some emerging markets bonds near junk rating grade.

On another note, the Lebanese government issued Eurobonds in 2013 for a total of $2.975B through four Eurobonds transactions, of which $1.275B were issued on the 23rd of April as part of the debt replacement agreements[3] between the BdL and the ministry of finance. $600M Eurobonds were issued in June 2013 and were subscribed by BdL, while a dual-tranche offering of $1.1B tapped on the primary market in April 17th, 2013 including two re-openings of respectively $600M and $500M.

The sole $1.1B market offering of April 17, 2013 was received with mixed attitudes especially that it came at a critical period. Investors' sentiments were shaken by the political divide about the electoral law and the extension to the term of a top security official amid political bickering on premiership candidates after the resignation of Mikati's government in March. Yet, the designation of Tamam Salam couldn't help in

[2] *The worst complication for emerging markets was the deterioration of numerous currencies like the Mexican Peso, the Indonesian Rupiah and the Malaysian Ringgit. In addition, Philippines saw a rising inflation and a falling peso, Turkey witnessed anti-government protests, while Moody's downgraded Brazil's outlook from positive to stable on rising debt and slowing economic growth data. Indonesia posted deficit of its current account, Thailand saw economic recession with rising household debt and the Indian Rupee plunged to its lowest levels due to budget and current account deficits.*

[3] *According to the agreement, the MoF is allowed to redeem Treasury Bills from BdL's portfolio against Eurobonds for the same amounts but at lower interest rates and longer maturities.*

enhancing the international participation to more than 20% in each of April's 17TH Eurobonds issuance that was brought to market for refinancing operations. In details, the first $600M series were reopening of 2023 bearing a 6% coupon, and the second $500M series reopening of 2027 bearing a 6.7% coupon.

Eurobonds constituted in October 90.5% of total foreign currency debt[4] that totaled $26.35B. Debt in Foreign currency accounted for 42.2% of total gross debt, and rose by 8.0% y-t-d and 15.5% y-o-y partly encumbering October's $62.44B Lebanese gross public debt. The debt-to-GDP ratio (projected 2013 GDP) stood at 139.7% at the end of October compared to 134.3% during the same period last year. The local currency share of total debt declined to 57.8% in October compared to the 59.7% stake recorded in the same period last year. Debt in LBP edged up 8.4% since year start and a 6.7% y-o-y to reach $36.09B.

Lebanon has accumulated a massive debt with no clear approach to deal with it, which was reflected in the country's fiscal position. High levels of spending[5] were coupled with slight decline in public revenues deepening the fiscal deficit and deteriorating the primary balance. In this context, Lebanon recorded in 2012 its first primary deficit since 2006 that reached $0.11B (or 0.003% of GDP) compared to a primary surplus of $1.66B or 4.18% of GDP registered during 2011. 2013 is looking worse than the previous year with the primary deficit up to October reaching $313.37M or 0.70% of 2013's projected GDP.

Considering 2013's abundant challenges on the local, regional and international schemes, it would be unfair to classify Lebanon's bond market under the year's worst performers. Lebanese Eurobonds returned several times over the year to positive territories in times when the global trend went against safe assets. This is explained by the dedicated investors' base, with a large part of outstanding Eurobonds held by the Lebanese banks that succeeded to maintain the banking sector's robust performance despite local and regional disturbances.

[4] *According to the latest economic letter published by the Association of Banks in Lebanon*

[5] *Public spending includes public sector wages, pension costs and interest payments.*

For your Queries:

BLOMINVEST BANK s.a.l.
Research Department
Verdun, Rashid Karameh Str.
POBOX 11-1540 Riad El Soloh
Beirut 1107 2080 Lebanon

Tel: +961 1 743 300 Ext: 1283
research@blominvestbank.com

Mirna Chami, Research Analyst
mirna.chami@blominvestbank.com
+961 1 743 300 Ext: 1285

Marwan Mikhael, Head of Research
marwan.mikhael@blominvestbank.com
+961 1 743 300 Ext: 1234