Lebanese versus U.S. interest rates: a decade in review

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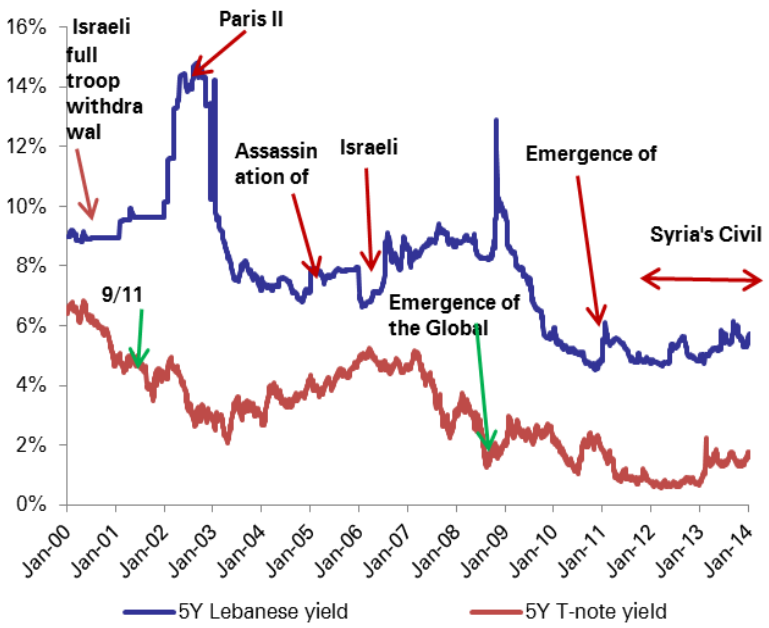
Historical Evolution of 5Y yield in Lebanon and the U.S.



Source: Bloomberg, U.S. Department of the Treasury and BLOMINVEST Data

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Since Lebanon's exchange rate is pegged against the United States (U.S.) dollar, its interest rates policy cannot be but highly determined by that of the U.S rates, especially over the long term but monetary authorities in Lebanon still have some freedom in the timing and the extent to which Lebanon's rates follow the U.S. ones. Therefore the relationship is not one to one, which means that an increase of 300 basis points in the U.S. rates will most probably lead to a lesser increase of the Lebanese interest rates and the reverse is also true. Moreover, there could be some short time periods where shocks may have different impacts on both the U.S. and Lebanon's interest rates such as at the start of the financial crisis in 2008. Also, interest rates' movements in Lebanon may be sometimes governed by numerous factors affecting only the Lebanese economy such as the country's political and economic stability, regional competition as well as the credit default risk.

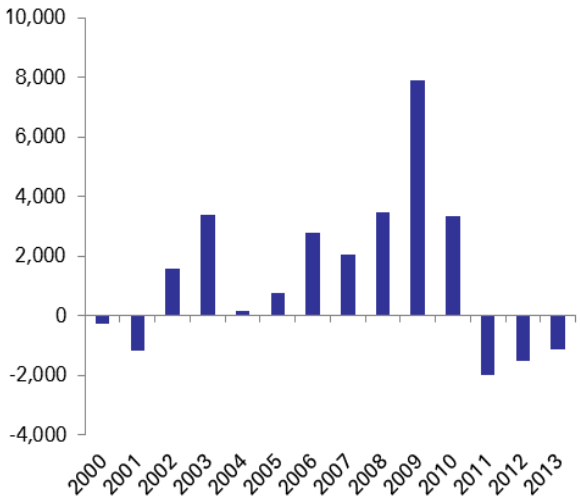
The relationship between Lebanese and U.S. rates will be analyzed throughout this paper by considering the 5-year Eurobonds rates in Lebanon as opposed to the 5-year treasury bonds in the U.S. In fact, Lebanon burdened over the fifteen past years high debt levels that reached $63.5B or 142.5%[1] of the Gross Domestic Product (GDP) by the end of 2013. Foreign currency debt holds around 41.2% of total gross debt of which 90% are Eurobonds.

Spread analysis provides insight about the relationship between Lebanese interest rates and their U.S. benchmarks as well as the level of risk being taken by investors. In fact, Eurobonds yield is always higher than its comparable U.S. Treasury yield with the spread reflecting the risk premium those Investors are asking for in order to take the risk of Lebanon.

Looking back at the past decade, the spread between the 5Y yield on the Lebanese Eurobonds and its U.S benchmark has shrunk or widened depending on the events and factors that took place. The lowest spread was witnessed in the first half of 2006 where it bottomed at 165 basis points (bps), whereas the highest spread was seen both in 2002 and towards the end of 2008 hovering 1200 bps.

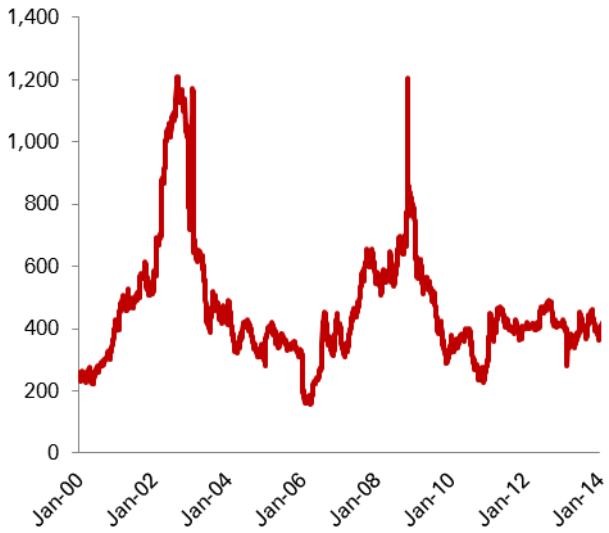
[1] According to the Ministry of Finance

Lebanon's Balance of Payments (In $M)



Source: BDL

5Y Spread between the 5Y Lebanese Eurobonds' Yield and the U.S. Benchmark (In bps)



Source: Bloomberg, U.S. Department of the Treasury and BLOMINVEST Data

During the period 2000-2002, the spread between Eurobonds and Treasuries was increasing due to some internal factors but also due to other external shocks. The collapse of the Dot-Com bubble in the U.S. took place during this period, causing the loss of $5 trillion in the market value of companies from March 2000 to October 2002. The 9/11 terrorist attacks accelerated the stock market drop with the Fed reducing interest rates at full speed following six times hike during the period 1997-2000. Investors were flowing towards safe haven assets, namely the U.S. Treasuries. At the same time, the Lebanese government was finding it difficult to finance its deficit as deposit inflows turned negative, and gross international reserves declined. Lebanon's balance of payments (Bop) posted a $1.17B deficit in 2001 as Central Bank's Net Foreign Assets slumped by $1.49B. In addition, Lebanon faced over the same period a fiscal deficit of $2.8B (16% of GDP) as well as a vicious cycle of rising national debt and dwindling economic activity.

U.S terrorist attacks had a direct and considerable impact on the performance of the Lebanese Eurobonds market. Following the 9/11 terrorist attacks, foreign investors in Lebanese papers were afraid of U.S. government reaction, especially that a Lebanese national was suspected among the 19 alleged hijackers, and therefore they deserted the Eurobonds market, which led to the large jump in yields.

Hence, while rates on five-year U.S. treasuries started falling, the comparable Lebanese Eurobond rate kept rising. The 5Y yield on U.S T-notes tumbled from 6.50% in January 2000 to reach 3.9% in September 2001, 2.8% in the second half of 2002, and 2.1% in April 2003. In Lebanon, the 5Y yield on the Lebanese Eurobonds kept on mounting over the cited period from 9.0% in January 2000 to 9.6% on the 11th of September 2001, and then it hit 14.7% in September 2002. Thus the spread reached 1200 bps.

In November 2002, the unsustainable situation in Lebanon was reversed by Paris II conference. The conference came to ease the Lebanese economy's burdens with donors pledging many billions of dollars in grants and soft loans hence dampening sovereign risk. Since then, Lebanese rates came down quickly to catch up with the decline in U.S. rates. Consequently, spreads came down as investors gained confidence in the credibility of the government and the Eurobonds market gained momentum instantly.

During 2003-2004, the effects of Paris II were continuing to feed into the Lebanese economy while the U.S. was starting an expansionary period that will last till 2007. Hence the impact was an ongoing decline in the Eurobonds yields, especially that capital inflow to Lebanon increased, with the Balance of payments coming

back into positive territories in 2002 and reaching a surplus of USD 3.3 billion in 2003. In the meantime, U.S. interest rates were starting their upward trend as the economy was booming with a particular emphasis on real estate.

Some specific shocks had their toll on the Lebanese rates during the period 2005 -2007. The assassination of Prime Minister Rafic Hariri in February 2005 and its aftermath events steering the withdrawal of Syrian troops led to a spike in interest rates however limited in time and magnitude. Rates declined in the first half of 2006 as the economy was booming and foreign investments and capital inflows were pouring in the market. Hence the spread between the Eurobonds and U.S. Treasuries reached its lowest level ever of 300 bps in April. However interest rates between the U.S. and Lebanon diverged again leading to a higher spread following the Israeli aggression on Lebanon in July. Moving into 2007, although the economy was performing extremely well, several political and security events including assassination of important political and media figures deterred the spread from preserving its low level and hence it widened again at a time where U.S. interest rates were stabilizing.

2008 was rich in global as well as internal events that have followed each other and overlapped at times leading to a complex impact on domestic interest rates and their relationship with U.S. rates. The year started with escalating internal tensions between Lebanon's political parties undermining the country's stability. This was translated in a rating downgrade by one notch of the Lebanese long-term sovereign foreign currency by Standard & Poor's agency from B$^-$ grade in 2002 to CCC+ in 2008.

However things improved after the Doha accord and yields started to decline at the same time with the U.S. where investors were starting to favor Treasuries over equities as imminent decline in U.S. Fed rates was on their radar screen. As the Great Financial Crisis emerged during the last quarter of 2008, the Fed slashed its interest rates at a very high speed while investors feared the spillovers of the crisis and were accumulating huge losses on their equity investments in the U.S. and Europe. As a result, foreign investors were liquidating their positions in Lebanese equity and bonds markets to cover their losses elsewhere. Hence 5-year Eurobonds yields spiked to 13.9% with the spread against their U.S. counterpart reaching 1100 bps at end October. However this situation was reversed quickly when investors discovered that the Lebanese banking sector was spared from the financial crisis that hit banking sectors in Europe and the U.S. Eurobonds yields declined and capital inflows increased with the BOP realizing large surpluses reaching USD 7.9 billion in 2009.

From 2009 onward, rates in Lebanon moved in the same direction of U.S. rates however neither at the same pace nor at the same time. 5-year U.S. government bonds yields went down to 1.3% at end 2008, 1.25% in 2010, 0.8% in 2011, and 0.62% in 2012 when they reached their lowest levels ever as investors had pessimistic forecasts about the economy driving them towards safe assets' market at the expense of equities. Yields in Lebanon declined with the spread between Eurobonds and U.S. Treasuries shrinking to 326 bps in 2009 and 248 bps in 2010.

In 2012, U.S. economy started to recover with interest rates going up, pulling up, to some extent, Lebanon's yields. Following the application of the quantitative easing program in 2008, positive data is boosting investors' confidence in the U.S. economy pushing them towards risky assets. Yield on the 5Y T-notes stood at 1.7% in January 2014.

What about the relationship between the spread and the credit default swaps (CDS)?

The Lebanese Eurobonds yield spreads against their US benchmarks should be equal to the CDS, supposedly. Yet, facts showed that many developments dominate each of the 2 instruments sending the spread out of the range. Accordingly, when the spread is lower than the CDS it alludes to the fact that offered yields on the Lebanese Eurobonds are not fully reflective of the assessed risk premiums seen by international investors. This is mainly due to the stable and dedicated local investors with domestic banks constituting the core base of Eurobonds holders. Consequently, Eurobonds prices and their spread against the US treasuries reveal much less volatile than CDS spreads. However by the end of 2012, the difference

was narrowing, as on one hand the stabilization of the political situation in the country was accommodated by the markets, and on the other, the US yields dropped.

Historically, many political factors impacted the CDS's quotations. Lebanon's CDS edged up from 333 basis points (bps) in 2007 to reach 545 bps in 2008 on political deadlock and escalating internal clashes in the country's different regions. 2011 was another critical year especially after the emergence of Arab Spring and the increasing fears of its influence on the Lebanese scene. Accordingly, the 5Y CDS widened by a yearly average of 167 bps to hit 472 bps. However, the CDS price managed to tighten between 2011 and 2013, yet maintaining a high quote compared to its low levels reached during previous years.

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