Review of the Lebanese Eurobonds' Market in the First Half of 2014

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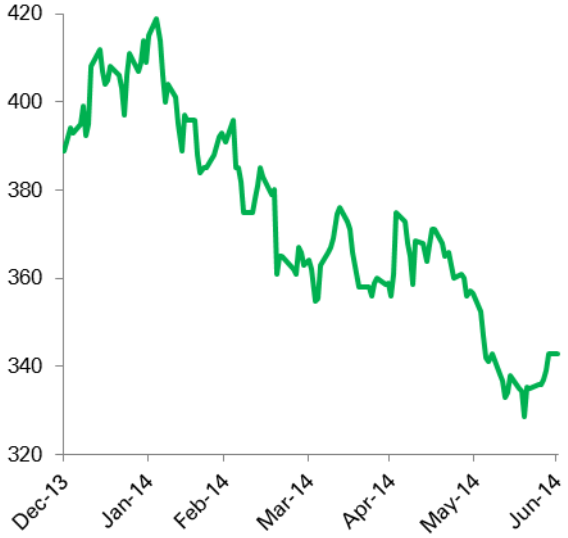
The 5Y Spread between the Lebanese Eurobonds and their U.S. Benchmark



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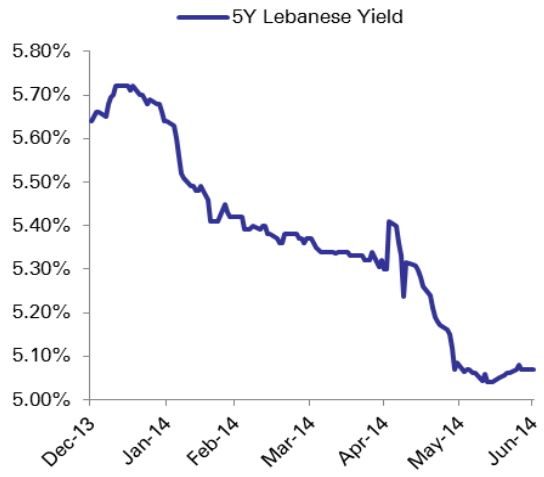
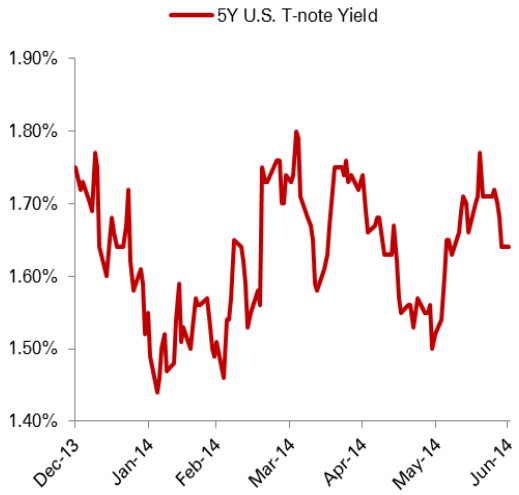
5Y Yields of Lebanese and U.S. notes





Source: Bloomberg, Blominvest Research Department

The first six months of 2014 saw a rebound in the Lebanese safe assets market. Lebanon kept on suffering the local and regional instabilities in the first half of the year that heavily burdened its whole economy. Despite the challenges, Lebanese Eurobonds found their positive path again in 2014 amid the chaotic situation of the country. The BLOM Bond Index (BBI) revealed a 2.33% year-to-date (y-t-d) uptick to settle at 108.10 points, up by 5.22% from 2013's level of 102.74 points.

Some positive political and security improvements were behind the progress of the Lebanese safe assets market. After 10 months of political stalemate, the Lebanese new Cabinet was finally formed in February spurring a positive market sentiment on the Eurobonds' market. The security plan implemented by the new Cabinet also boosted Eurobonds' activity in April and May despite the failure to elect a president and the state of presidential vacuum that did not deter investors' interest .

Summing up the first half of 2014, rising demand characterized the Lebanese market especially during January- June 2014, leading the weighted average yield on holding the Eurobonds to tumble by 40 basis points (bps) from December 2013 to 5.22%. However, the latter declined 117 bps from June 2013's level of 6.39%.
Investors' appetite for the medium and long term Lebanese Eurobonds reached new heights as optimism about the future period reigned H1 2014 once the Cabinet was formed. Over the past six months, the increasing demand for the 5Y and 10Y Lebanese Eurobonds have sent their yields down by 57 bps and 44 bps to 5.07% and 6.21%, respectively .

Worth noting, that foreign investors and funds were attracted to the relatively high Lebanese returns. The Lebanese sovereign debt saw a rising foreign demand for the high-yielding Eurobonds boosting performance in H1 2014 .

On another note, a debt exchange offer took place by the end of March helping the Lebanese debt market maintain its positive performance. The exchange offer was completed on notes maturing in April 2014 against new longer-dated ones. In details, the Lebanese government's offer and additional notes gathered a participation rate of 79.84%, and resulted in aggregate new issues of $1.4 billion maturity of 2020 and 2026. The new 2020 issues amounting to $600 million yielded 5.8% with an issue price of 100. As for the $800 million tap on 2026 maturities, bonds' prices were quoted at 99.147 yielding 6.7%. The new cash from the 2020 maturities stood at $341.43 million while that from 2026 maturities stood at $354.71 million. The reported allocations were 88.5% on 2020 & 66% on 2026 for local investors, while international orders were around 25% on both tranches.

Several external factors also enhanced the Lebanese Eurobonds performance in H1 2014. The economic contraction of the U.S and the extremely low interest rates from European central banks stimulated investors' flight to safety. Despite the irregular global economic growth and the geopolitical tensions in Ukraine and Iraq, many emerging borrowers also drew the attention of high-risk investors due to their considerably greater yields. Lebanese Eurobonds could also have been part of the shift of international investors towards bond markets .

Even though the Federal Reserve's (Fed) maintained its decision to taper its $85M monthly bond buying, U.S. Treasuries picked up after the publication of a 2.9% economic contraction in Q1 2014. It was the worst quarterly performance in 5 years and was triggered by the harsh winter that hit the U.S this year. However, the positive economic indicators reduced the negative repercussions of the economic contraction with the 5Y and 10Y U.S. notes and bonds shedding by 13 bps and 51 bps from the beginning of the year to settle at 1.62% and 2.53%, respectively .

Another reason was the high U.S. yields reached after a considerable period of ongoing increases that followed the Fed's announcement of its tapering policy. U.S. Treasuries offered greater yields compared to their counterparts in some other major government debt markets such as Germany and Japan where the 5Y yields stood by the of June 2014 at 0.34% and 0.17%, respectively. Accordingly, investors preferred the trade-off of risk hence returning to the safe assets market in the U.S.

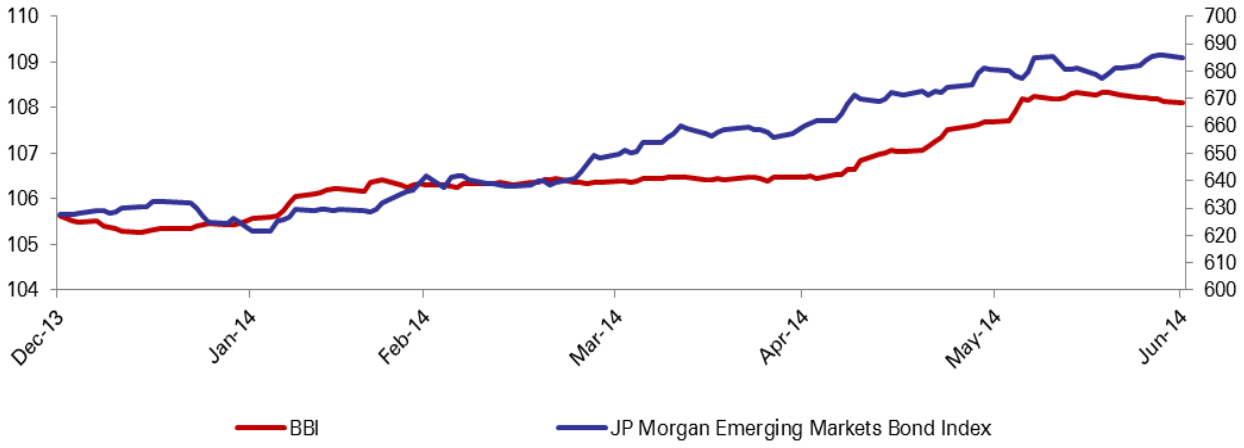
The combination of the internal and external factors led to the better performance of the Lebanese Eurobonds compared to their U.S. benchmarks. Consequently, the spread between the Lebanese 5Y yield and its US comparable narrowed from 389 bps in December 2013 to reach 345 bps by the end of June 2014. As for the 10Y yield, it widened by 7 bps to 368 bps .

On the other hand, the 5Y Lebanese Credit Default Swaps (CDS) which reflect the perceived default risk of the government, stood at 345 bps by the end of June 2014, tightening by 48 bps from December's level and by 182 bps from June 2013's peak that followed Sidon clashes.

Given Lebanon's country risk, its CDS remained higher than other regional economies such as Saudi Arabia, Dubai, and Egypt at 51 bps, 155 bps and 321 bps, respectively. The Lebanese credit default risk was also greater than that of numerous emerging markets such as Brazil and Turkey at respective levels of 144 bps and 177 bps. However, the 5Y Lebanese CDS remained respectively lower than the average 5Y Ukrainian and Iraqi CDS of 450 bps and 380 bps, and in line with the Cypriot and Greek respective 5Y CDS of 380 bps and 334 bps.

Still, the 5Y Lebanese CDS was mainly trading at close levels to the 5Y spread between the Lebanese Eurobonds and their U.S comparable for the past 6 months. This reveals that risk factors perceived by domestic investors, as they are the main holders of Eurobonds, are also taken into consideration by international traders of CDS .

BBI and JP Morgan Emerging Markets Bond Index Year-to-Date Performance



Source: Bloomberg, Blominvest Research Department

The shaky economic standing of several Asian countries, the geopolitical turmoil and the relatively high U.S. yields did not attenuate emerging bonds' luster in the first half of 2014. Bond sales surpassed $260B despite the Russian-Ukrainian conflict and the rising tensions in Iraq. In spite of the substantial risk of investing in emerging markets, the widening spreads between emerging bonds' yields and US Treasuries bolstered investors' appetite for high yielding bonds.

Risk-taking investors were also interested in the European debt markets as substantially high yields were offered by some frail European countries such as Portugal (4.11%) and Greece (4.23%(

In this context, the JP Morgan's emerging markets bond index managed to reverse 2013's bearish trend posting a 9.1% y-t-d uptick during the first half of 2014 to settle at 684.97 points. The gauge revealed an 11.4% year-on-year surge from June 2013's level of 614.82 points when emerging bonds were suffering the Fed's tapering decision of its financial stimulus .

Lastly, the Lebanese Eurobonds' market inaugurated 2014 with optimistic expectations that are gradually fading away. The country' stability remains however the main barometer of the market to measure its stance. In the second half of the year, the picture may remain bright if the political and security events in the country stabilized. Lebanese Eurobonds proved their ability to return into positive territories even in times when the

global trend went against safe assets. The reason behind the steadiness of the market resided in the dedicated investors' base, with a large part of outstanding Eurobonds held by the Lebanese banks that kept disclosing robust performance despite local and regional disturbances.

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