Lebanon 2011: bearish stock market vs resilient Eurobonds

by Marwan Mikhael, Blominvest Bank

2011 will be remembered as a bearish year for stock markets, not only in Lebanon but also in the region and on the international markets. The year was characterised by the local tensions between political factions, the protest movements sweeping the region, global fears of a double dip recession in the US, and the ongoing financial and debt crises in Europe. Stock markets all over the world registered large declines with investors flying to safety instruments such as bonds, including Europe where they divested away from peripheral countries and invested in Bunds (German government bonds).

BLOM Stock Index (BSI), the leading index in Lebanon, kicked off the year on a strong footing. It had gained 3.81% in the week of January 3, 2011, and reached a high of 1538 points on January 11 – when the Lebanese government collapsed. During the day that followed the cabinet resignation, the BSI reversed the gains of that one week to close at 1,488 points on January 12. As Lebanon stayed without a government for more than five months, worried investors sent the index down to below 1,350 points in June.

This downward trend was accompanied by heightened political tensions and signs of a decelerating economic growth. Some economic indicators were on the downside with 8.25% decline in new vehicles sales and the balance of payments recording a deficit of US$1bn in the first five months of the year. The number of tourists tumbled more than 25% year-on-year up until May 2011, leading to a decline in the hotels occupancy rate. However, the economy rebounded in the second half of the year, growing to record a 3% real GDP growth for the whole year.

But confidence among equity investors remained dented by the mixed developments on the political stage.

On the one side, a new cabinet headed by Najib Mikati was formed in June, five months after the toppling of Saad Hariri's government, and the central bank governor Riad

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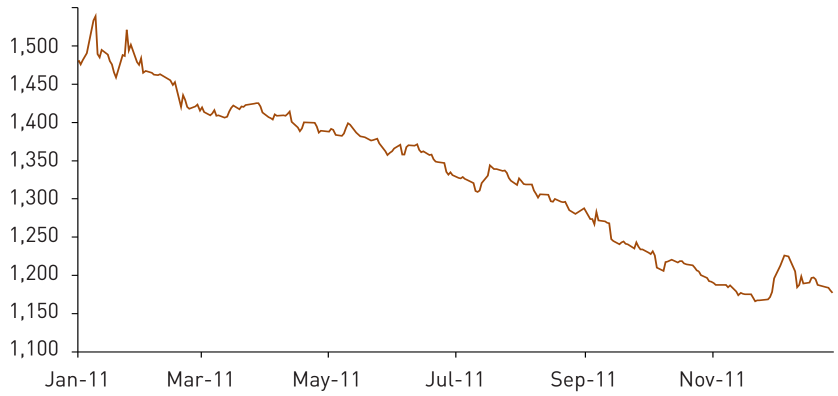
BLOM stock index (BSI) **Exhibit 1**



Source: Economic Research Department of Blominvest Bank

Salameh's term was renewed for another six years. On the other side, we witnessed the issuance of the long-awaited indictment for the 2005 assassination of former prime minister Rafic Hariri.

Furthermore, bickering among politicians over the funding of the International Special Tribunal for Lebanon (STL) as well as tension between employers, labour unions and the government over wage rises dragged the BSI to a low of 1,166 points on November 28. This was a 21% decline from the year end of 2010 and 24.2% lower than its peak in January.

Lebanon's payment of its US$32.6m share of the annual funding for the STL boosted slightly sentiments in December but its impact on the Lebanese stock market was short-lived.

The second half of the year saw a decoupling between the real economy and the stock market. While the real economy was rebounding after the positive political developments mentioned above (a new government and the renewal of Salameh's term), the stock market continued its downward trend. The same phenomenon took place during the outburst of the global financial crisis of September 2008. At that time, international investors liquidated their Lebanese portfolios to cover losses on the international markets, which led the BSI tumbling by 36% during the fourth quarter of the year. This took place at the same time when the real economy was realising a record growth rate of 8.6%, and the balance of payments was registering a huge surplus of more than US$3.4bn.

In Lebanon, this dichotomy between the stock market and the real economy is explained by the small size of the stock exchange that contains only a handful number of companies with low volume of trades. Hence the stock market is not a good representation of the whole economy. What is odd is that the same decoupling took place in the US during 2010 but in the opposite direction – a surging stock market and a lagging jobs market. Briefly, this was the result of increasing profits for companies, which came not from better revenues but from reduced costs and improved productivity.

Impact of political tension

Political squabbling dragged the already slim trading activity on the Beirut Stock Exchange (BSE) to multi-year low. The daily average traded volume slumped to 318,497 shares as opposed to 858,209 shares recorded a year earlier, while the daily average traded value reached US$2.12m, its lowest level in seven years. As for the total volume, it attained 76.76 million shares worth US$511.6m compared with 103.84 million valued at US$1.46bn in 2010. The turnover ratio stood at 5.65% in 2011 as opposed to 13.25% a year earlier.

With the country's political negative developments taking the upper hand, the Lebanese stock market had one of the worst annual performances among Arab markets in 2011. The BSI underperformed the S&P Pan Arab Composite LargeMidCap that retreated 13.25% to 106.52 points as all Arab markets closed in the red, except for Qatar's bourse that managed to end the year 1.12% higher. Regional equities were hit hardest by the political turmoil that ousted longstanding leaders in Tunisia, Egypt, Libya and Yemen, and led to political unrest in Syria, Bahrain, Jordan and Kuwait. The BSI recorded the same performance as the MSCI emerging index that tumbled 20.41% to settle at 916.39 points as the downgrade of the United States' rating and the cut of some European countries ratings intensified global slowdown fears.

In detail, banking stocks dominated trades on the Beirut Stock Exchange, partly due to cross trades conducted by BLOM, Audi and Byblos banks. The banking sector captured 55.11% of the total value traded, followed by the real estate sector that grabbed 43.98%.

Lebanese financial stocks failed to outperform their regional peers as the Lebanese banking sector was highly affected by countries undergoing political changes, especially the turmoil in neighboring Syria. The BLOM Lebanese Banking Index (BMBI Lebanon) plummeted by 29.66% to end the year at a two-and-a-half year low of 2,643 points, while the BMBI for the MENA region dropped 15.64% to 2,429 points. Demand for banking stocks decreased further after Moody's Investors Service changed the outlook for local banks from stable to negative. BLOM Global Depositary Receipt (GDR) retreated 28.02% to US$7.45 and GDRs of Audi bank tumbled 37.33% to US$5.64, while Byblos common stock dropped 10.93% to end the year at US$1.63.

Lebanese banking stocks became much more attractive compared to their peers in the Middle East and North Africa (MENA) region as their stock prices dropped while they maintained their profitability. The net combined profits of the three largest banks reached US$876.46m in 2011, increasing by 1.76% from 2010. The average price-to-earning (P/E) ratio of banking stocks stood at 7.56 compared with 14.44 for MENA banks that had a market cap of between US$1bn and US$6bn. Byblos had the lowest P/E ratio of 4.7 as opposed to 4.95 and 5.66 for BLOM and Audi respectively. Moreover, their share prices became lower than their book value per share that reached 8.56, 6.31, and 2.02 for BLOM, Audi, and Byblos banks respectively.

The real estate giant Solidere recorded sharp losses in 2011, proving once again its high sensitivity to political circumstances. Solidere stock fluctuated in the 13 to 20 range with its class A hitting a high of US$20.4 at the start of the year and a low of US$13.4 at the end of November to close 22.4% lower at $14.38. Solidere B declined 22.17% to settle at US$14.50. In June, 2011 Blominvest Bank downgraded the fair value of Solidere's stock to US$19.40 to account for the additional risk premium resulting from the political turmoil associated with the UN's Special Tribunal for Lebanon, the regional political shocks that had affected investor sentiment in the region, and the high likelihood that the Lebanese real estate market might have peaked.

Resilient Eurobonds

This negative performance of the stock market was counterbalanced by a resilient Eurobonds market. The BLOM Bond Index (BBI) ended 2011 at 110.94 points with a mere 1% annual loss, while the average weighted yield on holding Lebanese Eurobonds slid back to its year-start value of 4.78%. The relatively stable performance of the Eurobonds market was attributed to the support of local investors, mainly banks, and to the conservative monetary policy adopted by the central bank.

Just like the stock market, Eurobonds had dipped following the jolt of the financial crisis in 2008. The BBI tumbled 12%

between September and end of October 2008. This was due to foreign investors exiting the market, fearing that Lebanon would suffer a similar crisis affecting the advanced and some emerging markets. In fact, Lebanon had some vulnerability in its macroeconomic indicators, especially when it comes to the level of its public debt that reached US$47bn by end of 2008, with its ratio to GDP hitting 158.4%.

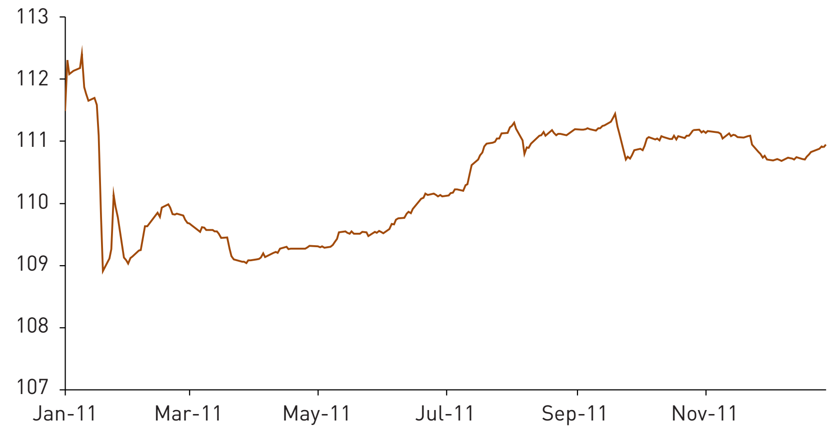
While the crisis unfolded as a financial one at the beginning, Lebanon was shielded by its strong banking sector and conservative regulations by the central bank that has forbidden banks, from 2002 onwards, to invest into structured complex foreign instruments especially the mortgage-backed securities in the US. Hence the Eurobonds market was quick to rebound after from the global crisis of 2008.

So while stocks overreacted in 2011 to the resignation of the cabinet, Eurobonds remain resilient to maintain a stable market. The BLOM Bond Index lost only 2.8% to reach 108.91 points by January 21 due to the sell-off following the government resignation and from sudden foreign capital outflows. The result was an increase in the portfolio's average weighted yield to 5.65% from 4.78% and the widening of the spread against the US benchmark yield from around 300bps to 400bps. As the initial fear driven reaction subsided, institutional investors that customarily hold papers until maturity seized the opportunity to buy into the undervalued and high yielding Eurobonds. The market was thus quick to recover, regaining most of its losses by the end of the year.

Domestically, the spread between average yields on Lebanese Eurobonds and US treasuries remained around 400bps for the most part of 2011, even when demand for Lebanese papers was faring relatively well. While this spread attracted additional investment into the market, Lebanon failed to reap the full benefits of the growing appeal for emerging market debt on account of the political risk associated with the entire region. In contrast, the JPMorgan Emerging Markets Bond Index ended 2011 with an 8.6% annual gain.

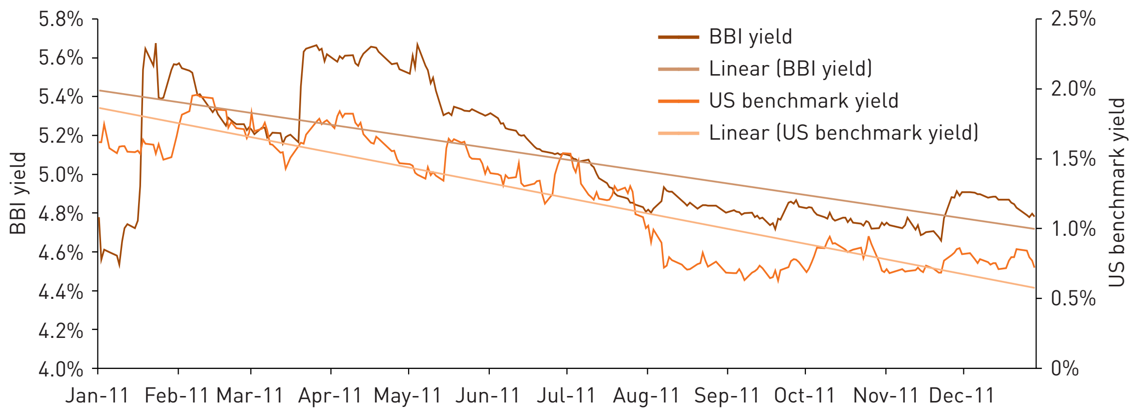
The risk aversion of international investors was reflected by the value of Lebanon's five-year credit default swaps (CDS) that remained well above the spread between Lebanese and US corresponding yields. Following the country's domestic political setback in January, Lebanon's CDS quotes surged to an average 395bps from around 310bps, and continued to climb throughout the year in response to deteriorating regional politics and concerns

BLOM BOND index fluctuations in 2011 **Exhibit 2**



Source: Economic Research Department of Blominvest Bank

Weighted average yields of Lebanese eurobonds and US treasuries **Exhibit 3**



Source: Economic Research Department of Blominvest Bank

over a full-fledged financial crisis in the European Union. Five-year CDS quotes thus hovered around an average 470bps by the end of the year, while the spread of Eurobond yields against their US counterparts remained within the margin of 400bps.

Looking forward

Looking into 2012, internal political frictions as well as reverberations from instability in Syria led both the stock and Eurobonds markets to register losses in the first six months of the year. Lebanon's main equity gauge, the BSI, declined 3.2% between January and June 2012 to settle at 1,139 points. The BBI also lost almost 2% in H1 2012 with the average weighted yield on Lebanese Eurobonds increasing by 70bps to 5.46% and the spread with the US treasuries jumping 80bps to register 483bps. However, the activity on the Eurobond market remained weak, especially in the second quarter of the year with the decline in the BBI coming from the widening of the bid-ask spread rather than from the decline of both. In fact, the bid side decreased as investors were keen to buy the Eurobonds at a lower price while the ask side remained constant as investors were not ready to sell Eurobonds below a certain price level.

Finally, as the stock market remains very fragile towards domestic and regional political and security developments, the Eurobonds market appears much more resilient. The latter is providing high yields with minimum fluctuations in price while the former seems to be much more volatile during the previous year, although with a downward trend. However, many Lebanese stocks are starting to become to a great extent undervalued, and some of them have their market cap lower than their book value while realising high and growing net incomes, thus presenting an opportunity for investors.

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