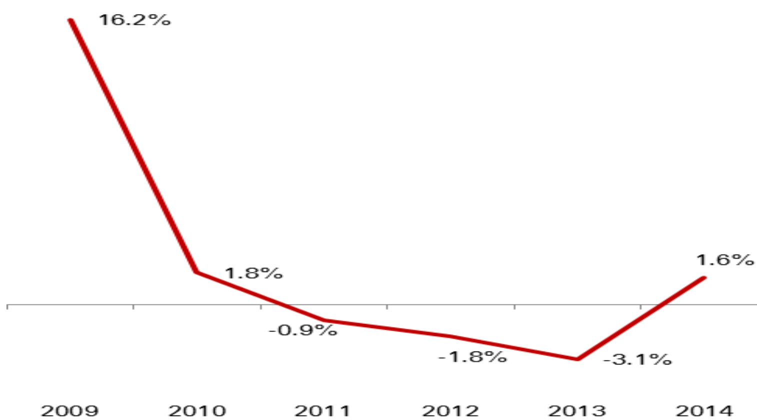
Lebanon's Eurobonds Market in 2014: Timid Performance amid a double-faceted Year

BBI Yearly Performance (End of Period)



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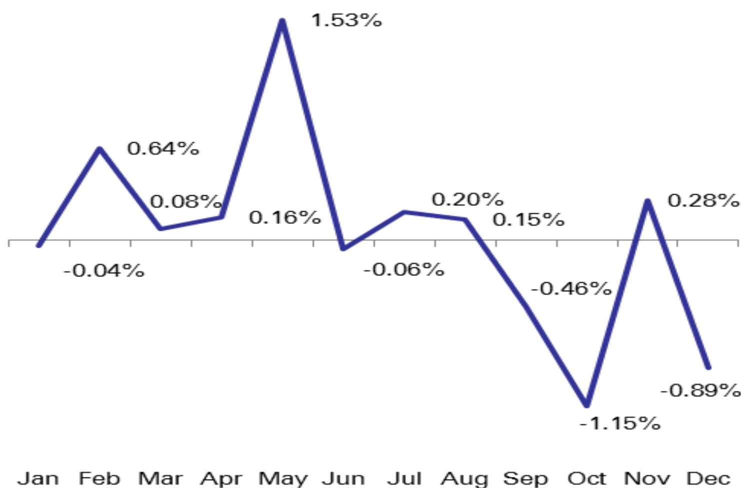
BBI Month-ago Performance in 2014 (End of Period)



Source: Bloomberg, BLOMINVEST Department

Despite the overall flat outcome, Lebanon's Eurobonds market finally took off and recovered in 2014 following 3 years of negative performance. The Lebanese safe assets have proven over the year to be highly correlated with the country's political and security environment. The relationship binding Lebanon's Eurobonds market to the local scene was way much stronger than the impact of the international trend driven by the United States (U.S.) Treasuries. Thus, the BLOM Bond Index (BBI) mirrored the local market's performance and added a mere 0.41% year-on-year (y-o-y) compared to the respective 0.90%, 1.79% and 3.13% yearly losses recorded in 2011, 2012 and 2013.

However, demand for the Lebanese safe assets was partially influenced by the positive performance of the US Treasuries and its implications on the international bond markets in the developing and emerging countries. With political and economic turbulences spreading around the globe, overseas investors preferred investing in U.S. Treasuries on the expense of equity

markets and emerging junk bonds. Accordingly, the increasing demand for U.S. Treasuries over the year sent their yields lower with those of the 5Y notes and 10Y bonds decreasing by 10 basis points (bps) and 87 bps to 1.65% and 2.17%, respectively.

In Lebanon, Eurobonds witnessed in 2014 a relatively prosperous first half, while the worsening political and security developments that painted the second half of the year triggered down investors' appeal for the Lebanese bonds market. This explains the BBI's yearly increase of 1.56% after hovering between a lower band of 105 points and a higher band of 109 points to end the year near the middle band at 107.29 points. Summing up 2014, rising demand characterized the Lebanese market during January-June 2014, leading the weighted average yield on holding the Eurobonds to tumble by 40 bps from December 2013 to 5.22%. However, the latter managed to add 7 bps in the next six months of 2014 to reach 5.29%. As for the 5Y and 10Y Lebanese Eurobonds' yields, they tumbled by 30 bps and 39 bps to 5.34% and 6.26%, respectively.

The first six months of 2014 saw a rebound in the Lebanese safe assets market on improving security and political conditions. In fact, and after 10 months of political stalemate, the Lebanese new Cabinet was finally formed in February 2014 and a consensus over the controversial policy statement was also reached by the end of March, which spurred a positive market sentiment on the Eurobonds' market. The security plan implemented by the new Cabinet similarly 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 on the short term. Accordingly, the BLOM Bond Index (BBI) revealed a 5.22% y-o-y uptick to settle at 108.10 points by end of June 2014, up from 2013's level of 102.74 points.

Unfortunately, Lebanon went back to its chaotic state on both the security and political fronts as of the second half of 2014, triggering down the Lebanese Eurobonds' market. In this context, H2 2014 started with a political stalemate since parliamentary sessions failed to elect a consensual president placing the country in a presidential vacuum state that continued till the year end. In addition, Lebanon had its share of the regional turmoil, where the first week of August started with clashes between the Lebanese Army and militants in Arsal that ended with jihadists capturing around 29 Lebanese soldiers and policemen. Even though a ceasefire went into effect after almost a week, threats of hostages' execution amounted over the last six months of 2014 worsening security situation and confidence among Lebanese and foreigners. The poor political and security situation were coupled to continuing arguments over the public salary scale sending the BBI down by 0.75% to end the year standing at 107.29 points.

The performance of the medium and long term Lebanese Eurobonds reflected investors' demand that altered between H1 2014 and H2 2014. Each of the 5Y bond and the 10Y bond saw their yields respectively declining by 57 bps and 44 bps to 5.07% and 6.21% by the end of the first half on improving investors' sentiment. In contrast, H2 that was overshadowed by political and security instabilities pushed the 5Y and 10Y yields up. In details, the former jumped 27 bps to 5.34% by the end of December 2014, while the latter added 6 bps to 6.26%.

Besides the impact of foreign demand on the Lebanese bonds market, several external factors influenced, to a certain extent, the Lebanese Eurobonds performance in 2014. The international bullish trend in global markets led by the U.S definitely had its partial effect over the Lebanese market.

In the first half of 2014, and despite the irregular global economic growth and the geopolitical tensions in Ukraine and Iraq, many emerging borrowers drew the attention of high-risk investors due to their considerably greater yields. In particular, the JP Morgan emerging countries' bond index edged up by 9.10% on a year-to-date basis by June 2014 to reach 684.97 points. Lebanese Eurobonds could also have been part of the shift of international investors towards bond markets especially the relatively high Lebanese returns offered to foreign investors and funds.

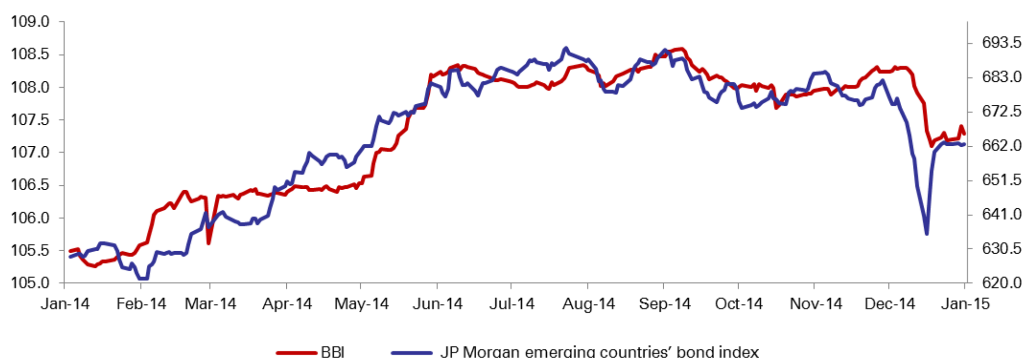
On a different note, U.S. Treasuries showed positive performance in H1 2014 despite the economic contraction of the U.S that was coupled with extremely low interest rates from European central banks which should have stimulated investors' flight to safety. In fact, and while the Federal Reserve (Fed) 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 over the 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 end of June 2014 at 0.34% and 0.17%, respectively. Accordingly, some conservative investors preferred to get away from towards the safe assets market in the U.S.

In this context, Lebanese medium-term bonds fared relatively better than their US counterparts. This was revealed by the shrinking spread between the two notes maturing in 5 years. A comparison shows that the spread between the Lebanese 5Y bond yield and its US comparable narrowed from 389 bps to 345 bps by June 2014. However, 10Y U.S. Treasuries slightly outperformed their Lebanese comparable as revealed by the spread between the 2 securities, which broadened by 7 bps to 368 bps.

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



Source: Bloomberg, BLOMINVEST Department

As for the second half of 2014, U.S Treasuries kept on rallying mainly on tumbling oil prices and fears of deflation. In reality, the specters of oil prices and deflation haunted global markets especially that oil prices had reached their lower levels in almost 4 years on dampening demand and excessive production. As for overall level of prices, the economic contraction assessed in the U.S. during H1 2014 also pointed to deflation.

Several reasons were also behind the persisting progress of U.S. Treasuries over the second half of 2014. The European Central Bank (ECB) quantitative easing resolution also explained why investors' demand was more oriented towards safe assets outside the Eurozone. Demand for treasuries intensified amid beliefs that the European Central Bank (ECB) would try to decrease borrowing costs, leaving returns on US treasuries higher than that of European debt. Moreover, the ongoing situation in Ukraine also bolstered further investors' appetite for the safest securities. Thus, investors' concerns concerning the future rose sending the 10Y yield on U.S. Treasury bonds 36 bps lower to 2.17%. Yet, the 5Y yield on Treasury notes, that saw a frailer demand, posted a 3 bps uptick to 1.65% by the end of December 2014.

On a comparative scale, the worsening situation of Lebanon and the robust progress of U.S. bonds market widened spreads between the mentioned markets. Correspondingly, the 5Y and 10Y spreads between the Lebanese bond yields and their US comparable widened by respective 24 bps and 41 bps to settle at 371 bps and 409 bps by the end of 2014.

In the emerging markets, a dissimilar scenario was recorded in H2 2014. Emerging bonds saw a downturn in the second half of the year resulting from investors favoring the U.S. safe bonds, geopolitical concerns and economic distresses in the developing countries. The economic contraction in Japan, the fragile Chinese recovery and news that the Brazilian presidential

candidate Eduardo Campos was killed in a plane crash, were some of the reasons for investors to escape the shaky environment in emerging markets. In addition, the continued disruptions in Ukraine and Gaza and the heightening geopolitical risks in the Middle East combined with the depreciation of several emerging currencies against the dollar, of which the Turkish lira, the Indian rupee, the Korean won, the Chinese yuan, the Philippine peso, and the Malaysian ringgit also lifted demand for safer government bonds. Hence, the JP Morgan emerging countries' bond index lost 3.27% to 662.57 points, sending its yearly performance to a positive 5.5%.

Back to Lebanon, the 5Y Lebanese Credit Default Swaps (CDS) which reflect the perceived default risk of the government, steadied at 394 bps by the end of December 2014 compared to the previous year. Specifically, the 5Y Lebanese CDS witnessed a 48 bps tightening in the first half of 2014 but reverted back by the end of 2014 to its original level.

Given Lebanon's country risk, its CDS remained higher than other regional economies such as Saudi Arabia, Dubai, and Egypt at 67 bps, 227 bps and 282 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 201 bps and 183 bps. However, the 5Y Lebanese CDS remained respectively lower than the average 5Y Ukrainian and Greek CDS of 2,199 bps and 1,272 bps.

Hence, the 5Y Lebanese CDS (394 bps) was mainly trading in 2014 at higher levels than the 5Y spread between the Lebanese Eurobonds and their U.S comparable (371 bps) for a considerable period. This reveals that there are additional risk factors perceived by international issuers of CDS, not taken into consideration by the domestic investors, the main holders of Eurobonds.

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.

With such a controversial year, the Lebanese Eurobonds' market succeeded in posting positive performance even after following the domestic and regional trends mainly in terms of politics and economy. However, the country' stability remains the main barometer in the bonds market as revealed over 2014 when Lebanese Eurobonds returned several times to positive territories in times when the global trend went against safer assets. This is mainly due to the faithful base of local investors, noting that the major share of government bonds is held by the Lebanese banking sector.

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