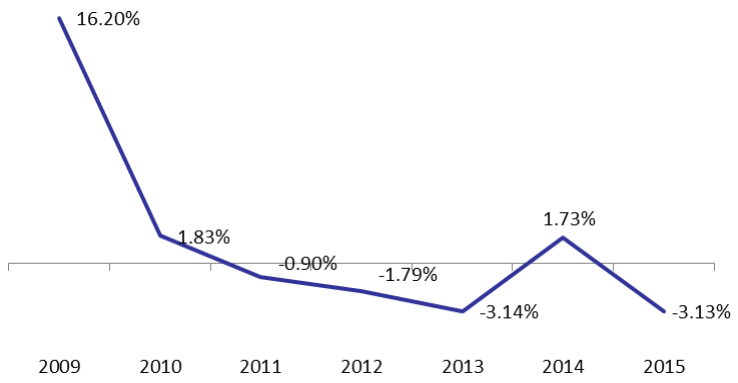
Lebanon's Eurobonds Market in 2015

BLOMINVEST BANK

BBI Yearly Performance (End of Period)



Source: BLOMINVEST Department

January 10, 2015

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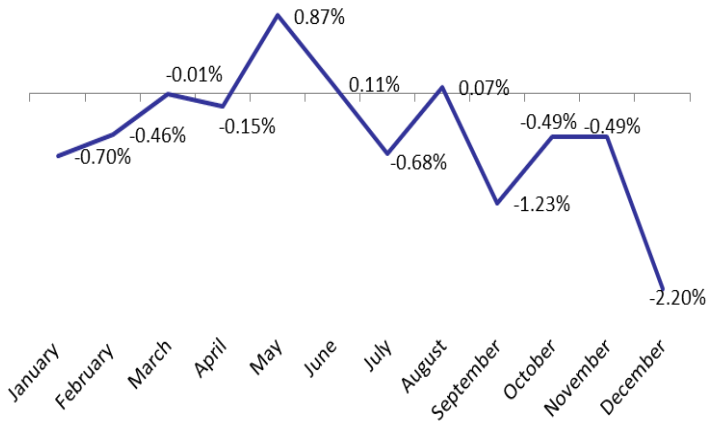
BBI Month-ago Performance in 2015



Source: BLOMINVEST Department

The local Eurobonds market witnessed a lackluster year, not only because of the worsening security developments in Lebanon that affected the capital markets in general but also due to the global dynamics and monetary decisions influencing developed and emerging markets. This kept the BLOM Bond index (BBI) on its downward trend in 2015 with the BBI declining by 3.13% during the year to 104.11 points. Excluding the mere 0.41% yearly gain in 2014, the BBI had been witnessing losses since 2011, declining by 0.90%, 1.79% and 3.14% in 2011, 2012 and 2013, respectively.

Overview of Global Bond Market Performance

Internationally, investors rushed to safer assets in developed economies to hedge against several challenges on the global scene, and emerging markets participants, including Lebanon, preferred to follow the same lead to escape the "black swans".

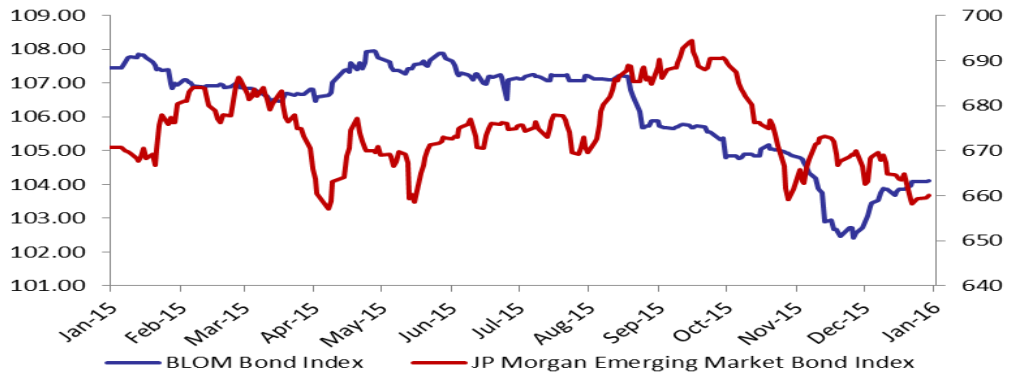
The challenges that marked 2015 were namely the bearish trend of oil prices, the launching of the European quantitative easing program, the political tensions between Russia and Ukraine, the Greek economic crisis, the Chinese equity market's plunge, and the much-awaited US interest rates' hike. In fact, the JP Morgan Emerging Markets Bond Index lost 1.26% throughout the year to end up at 662.27 points by December 2015, while the fixed income markets in developed countries, such as US and Europe, ended in the green in 2015. This was illustrated by the US Treasury Bond Index compiled by Bloomberg and the S&P Eurozone Sovereign Bond Index up ticking by a yearly 0.64% and 1.04% to 122.07 points and 213.85 points, respectively, by December.

In the US, the treasury market was mainly based around when the Federal Reserve would increase interest rates, creating a cautious sentiment among investors regarding placing their money in risky assets. In fact, the Federal Reserve had initially announced that the interest rate hike would take place in June 2015 only to postpone that event to September 2015, and with eventually implementing it in December through a 25 bps increase. The decision of increasing US rates came on the back of a recovery following a 0.8% inflation rate (still below the targeted 2%) and a 5% unemployment rate (the rate targeted by the Fed). Furthermore, the plunge of Chinese equities that started in the beginning of June 2015 was another factor that drove investors into the US treasuries. Short-term US treasuries were the place to go at the expense of medium and longer term notes. This was illustrated by the yields on the 5Y notes increasing by 12 bps to 1.80% in 2015, and that of the 10Y went up by 11 bps to 2.31%.

Moving to the Eurozone, an improved outlook for European bonds came on the back of tensions in the area in addition to the introduction of the Quantitative Easing (QE) program. The Greek debt crisis in addition to the Russia/Ukraine conflict was prominent throughout the year especially during the first. Peace between Ukraine and Russia remained elusive throughout 2015, which also caused a wary outlook for investors across the region. After numerous deliberations between Athens and its Eurozone creditors, and despite the situation being partially resolved with a third bailout program in July, the bond market in the Eurozone market still improved. A deal of $7.16bn in emergency funding from the European Central Bank, enabled the government to pay its debts with the International Monetary Fund (IMF).

In emerging countries, some investors exited their respective markets, especially in the second half of the year, in hopes of higher returns in safer assets in the US and Europe. Thus, the bonds market's performance in emerging markets ended the year in the red, and yet still achieved better than the Eurobonds market in Lebanon. Speculation about an economic recovery in developed nations following better than expected job data in the US, partially caused the largest monthly sell off in emerging market in May since the summer of 2013 (also known as the taper tantrum when US treasury yields surged during that period). In details, there was about $4.4B worth of notes that were sold. The continued disruptions in Ukraine, the heightening geopolitical risks in the Middle East coupled with the depreciation of several emerging countries' currencies also contributed to the fall of the JP Morgan Emerging Market Bond Index throughout the year. In fact, the Turkish Lira, the Indian Rupee, The Korean Won and the Chinese Yuan all experiences devaluations throughout 2015.

Performance of the BBI and JP Morgan Emerging Market Bond Index in 2015



Source: BLOMINVEST Department

Developments in the Lebanese Eurobonds Market varied between H1 and H2, 2015

Locally and throughout 2015, the Lebanese capital markets were subject to a bleak political and security framework that impacted the country's economic performance. In hindsight, the Syrian spillovers, the local presidential deadlock, numerous security incidents in addition to a number of demonstrations regarding the garbage crisis, clouded the year. This is illustrated by the mere 0.5% forecasted GDP growth in 2015 as well as the BLOM Purchasing Managers' Index (PMI) remaining below the 50 point mark at an average of 48.4 points all year.

The weak performance in the Lebanese bond market's performance followed that of emerging markets but fared worse because of the local security downfall and the negative outlook of credit agencies on Lebanon. Actually, Lebanese Eurobonds in H1, 2015 showed a loss, albeit a mere one, but recorded a larger decline in H2.

The BLOM Bond Index (BBI) ended H1 at 107.13 points, down by 0.89% year-to-date. Demand for medium and long term notes improved, but what actually held back the performance of the BBI was the fall in demand for short term bills (which constitute 32% of outstanding total bonds).

Each of the 5Y and 10Y bonds saw their yields respectively decline by 10 bps each to 5.20% and 6.06%.

The cause of this improved demand was the $2.2B Eurobonds issuance in February. It was the first time the Lebanese government issued a 15Y tenor bond which attracted a lot of hype because of its high yield. In fact, Investors' appetite for the issuance was substantial as bids almost reached 2.2 times the requested amount, hovering at $4.9B. The details of the issuance were as follows: it enclosed 2 new categories: $800M of 10Y Eurobonds maturing in 2025 and yielding 6.20%, and $1.4B of 15Y Eurobonds yielding at 6.65%. The lead managers for the issuance were: BLOM Bank, Citi, and Société Générale de Banque au Liban (SGBL). Besides the strong demand from Lebanon's local banks, Banque du Liban (BdL) also took a share of the new issuance. Finally, international orders were promising as they hovered around 15% which could be partly due to the overflowing cash in the global financial markets following the decreasing oil prices.

In the 2nd half of the year, the Lebanese Eurobonds market took a big hit. The BBI saw a 2.82% decline mainly due to the mentioned eventual rate hike in the US and repetitive local demonstrations regarding the garbage disposal crisis in Lebanon. The negative views of credit agencies on Lebanon didn't bode also. The Standards & Poor's downgraded their credit rating of Lebanon from B- stable outlook to B- negative outlook in September. Furthermore, there were speculations that Moody's would downgrade its credit rating on Lebanon as well, which they

eventually did in December, decreasing it from B1 to B2. Lebanon's sovereign rating occurred on the back of the country's high debt burden, dual deficits, and challenging political environment.

This had a large negative effect on the demand for medium term notes, as the yield on the 5Y bonds surged by 90 bps to 6.10% by December. The yield on the 10Y notes increased by 61 bps to 6.67%, also reflecting the weakened demand for long-Term Eurobonds in the latter part of the year.

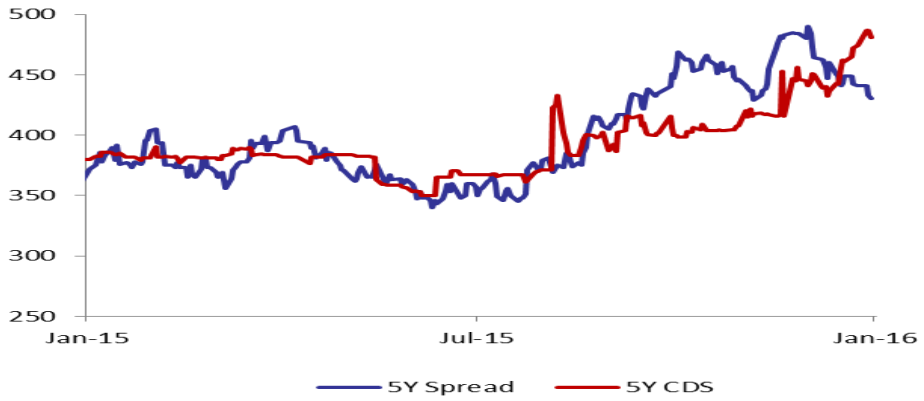
The $1.6B Eurobond issuance in November was received with mixed views. The specificities of the issuance were as follows: $500M of 10Y Eurobonds maturing in 2024 and yielding 6.25%, $500M of 13Y Eurobonds maturing in 2028 and yielding 6.65%, and $600M of 15Y Eurobonds maturing in 2030 yielding 7.05%. Leading managers were: Standard Chartered Bank, FransaBank and SGBL.

Perceived Risk in the Lebanese Eurobonds Market During 2015

The spread between the yield of the Lebanese 5Y and 10Y notes and their US counter-part broadened from 362 bps and 396 bps at the end of 2014 to 430 bps and 436 bps, respectively. This reflects the higher perceived risk from locals investors compared to 2014.

In the same context, the Lebanon's default risk as perceived by international investors fluctuated throughout the year. The 5Y Lebanese Credit Default Swaps (CDS) were trading at 426 bps in December 2015, compared to 379 bps in 2014. The 5Y Lebanese CDS actually dropped by 29 bps to 365 bps in H1 2015, and then widened by 61 bps in H2 2015 due to the worsening local security developments during that period.

Performance of the 5Y Spread and Lebanon's 5Y CDS in 2015



Source:BLOMINVEST Department

With the local political and security developments dominating in 2015 combined with macroeconomic changes in the global front, the Lebanese Eurobonds market witnessed a lackluster performance. Nevertheless, in 2015 the Lebanese government allotted 2 successful Eurobond issuances worth $3.8B. In turn, the government managed to extend the portfolio's duration from 4.07 years in 2014 to 5.19 in 2015 while the weighted yield increased from 5.24% to 6.14%, over the same period. Due to the recent increase of interest rates in the US, and the recent downgrade of Lebanon's sovereign credit rating of Lebanon, the bond market is likely to see higher yields in the coming future.

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