## Lebanon's Eurobonds Market: Negative Performance despite Political Breakthrough

Global bond markets fluctuated significantly during the year as a result of major international developments on both the political and economic front. As such, the Brexit vote, the U.S. presidential election and record low/negative yields in sovereign and corporate bonds have all influenced the world with considerable implications on bond market.

**US Treasuries Witnessed a Volatile Year:**

The first half of 2016 marked a higher demand for safe haven assets as the US Treasuries Index grew 5.43% year-to-date (y-t-d) to 129.55 points. Moreover, the negative yields in Europe and Japan facilitated the uprise in demand for US Treasuries, where the Bank of Japan and the European Central Bank cut interest rates to -0.1% and -0.4%, respectively. The 5Y and 10Y yields dropped from 1.80% and 2.31% in the beginning of the year to reach 1.01% and 1.49%, end of June 2016.

Similarly, in the second half of the year, ahead of the uncertain presidential elections and after the Brexit decision, investors preferred safe haven investments rather than riskier assets. As such, short and long-term US treasuries' yields registered record-low levels, with 5Y and 10Y maturities bottoming at 0.94% and 1.37%, respectively, on July 5th 2016.

In the last two months of the year, the U.S. election as well as the Fed's interest rate hike brought their share of volatility to the marketplace. The partial recovery of oil prices which incited expectations of a higher inflation, in addition to President Trump's promises of fiscal stimulus dragged down the demand for safe haven assets. As such, the yield on US treasuries maturing in 5 years increased from 1.8% end of 2015 to 1.93% end of December 2016. Similarly, the yield on US Treasuries maturing in 10 years rose from 2.31% to 2.45%, during the same period.

**Brexit's Decision had a Disparate Impact on Sovereign and Global Bonds**

As for the United Kingdom, the Brexit decision did not engender major macroeconomic changes on Britain over the short term, but the weakening currency had a sizeable effect on UK government bonds. As the pound slid by 18% post-Brexit till year end, yields on gilts escalated by 20 to 35 basis points at the 5-year maturity and 10-year gilt yields increased by 22 basis points by early December 2016.

As a reaction to the result of the UK referendum, the Bank of England unveiled a quantitative easing (QE) program to buy government and corporate debt alongside the first interest rate cut in seven years. Hence, demand for UK gilt shot up, sending yields to fresh lows.

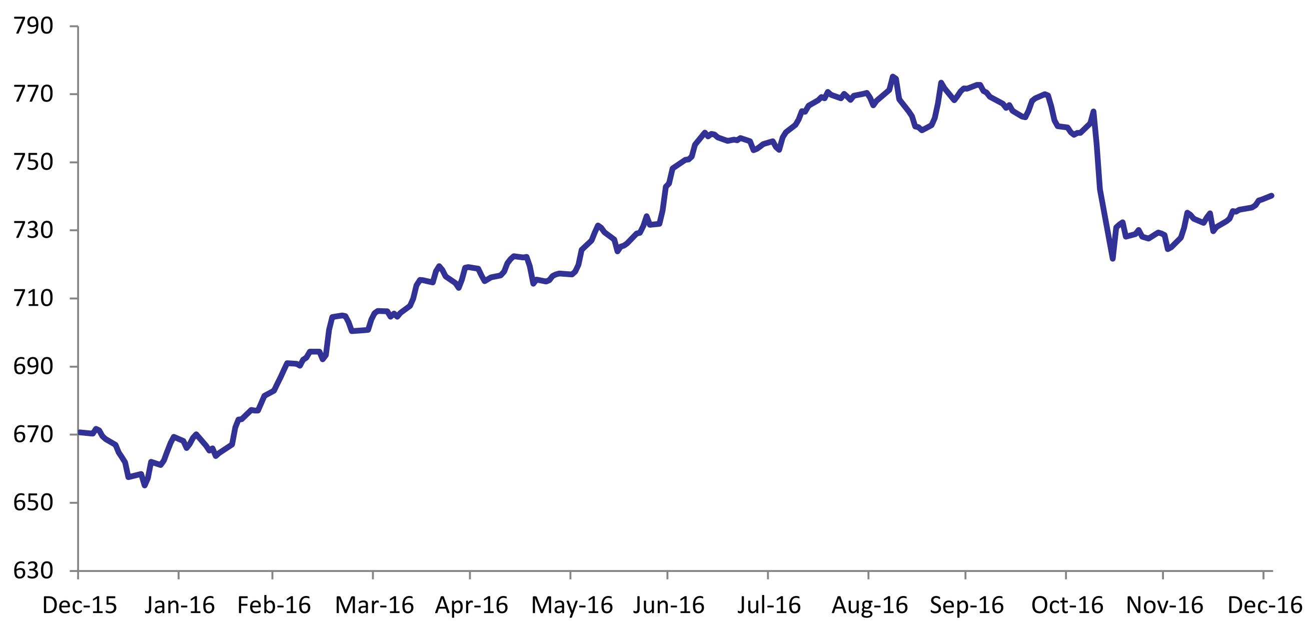
However, the surge in demand for the UK government bonds was short-lived following the President Trump's election and the Fed's interest rate hike. As such, yields on 10, 20 and 30-year gilts rose as high as 1.52%, 2.06% and 2.17% respectively on the day of the US rate rise, the highest levels for 20 and 30-year gilts since the UK referendum vote.

**Geopolitical and Economic Events Mandated Emerging Bonds**

Emerging markets were seeing an increasing demand up until November, when a drop of 6% accompanied the US presidential elections and the resulting severe outflows from the emerging markets in favor of US equities. Nonetheless, the bond markets stabilized and remained resilient after the fall. Consequently, JP Morgan's emerging markets bond index posted an 11.91% y-o-y gain during 2016 to settle at 738.79 points, up from December's 2015 level of 660.17 points.

As for Credit Default Swap (CDS) in emerging markets, they saw narrowing spreads due to the recovering oil prices and the improvement of geopolitical situations. For example, Egypt 5Y CDS went from an average of 479 bps in 2015 to end 2016 at 452 bps. This can be directly attributed to the $12B IMF loan as well as the Central Bank's decision to free float the Egyptian pound. On a different note, Turkey's coup d'etat on July 15 exacerbated the security status of the country with 5Y CDS reaching 289 bps on July 20, compared to 222 bps on July 14. However, the state recovered and the 5Y CDS stood at 273 bps in the end of the year. In Brazil, after major economic reforms that pushed up demand for Brazilian Eurobonds, Brazil's 5Y CDS dropped from 501 bps to 281 bps.

**JP Morgan Emerging Markets Bond Index**

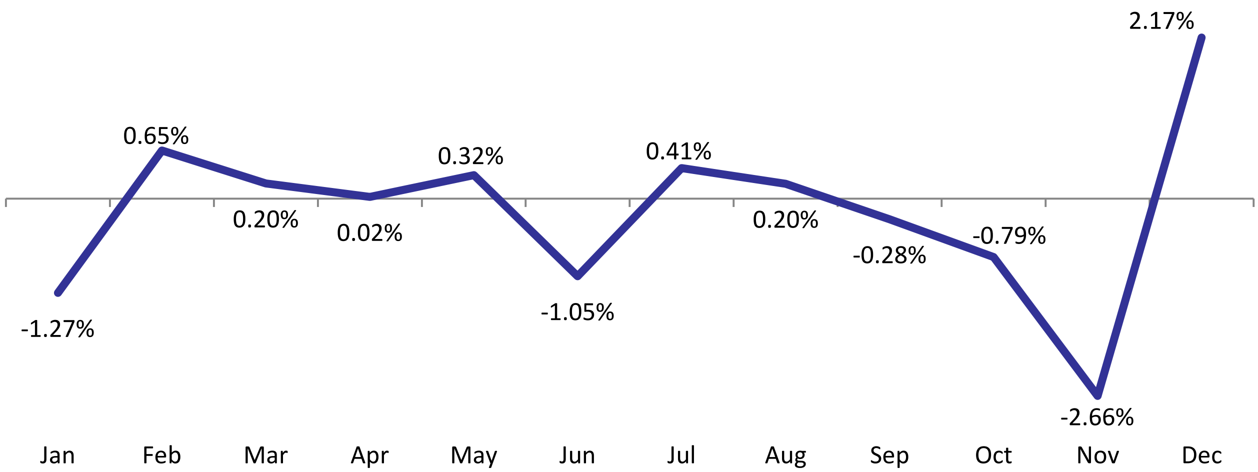



Source: Bloomberg

**Lebanese Eurobonds Ended 2016 in the Red**

During the year 2016, the Lebanese Eurobonds market maintained its downward trend despite the end of year political breakthroughs in the country, as it was mostly affected by the US and Emerging markets' geopolitical events. Consequently, the BLOM Bond Index (BBI), mirroring the Lebanese Eurobonds' prices, dropped 2.12% from the beginning of the year to stand at 101.90 points, its lowest level in more than 5 year.

**BLOM BOND INDEX (BBI) Monthly Performance**




Source: BLOMINVEST Bank Research Department

In details, the first half of the year commenced by unstable geopolitical dynamics and a presidential void carrying on since more than 26 months. The beginning of 2016 was marked by the GCC countries (Bahrain, Kuwait, Qatar, and Saudi Arabia) warning their citizens from travelling to Lebanon, as Saudi Arabia ceased $4B in aid to the Lebanese Armed Forces in response to political differences with the Lebanese government. As such, these events deterred investment fund and weakened the BBI's performance, which registered a 1.14% year-to-date drop and a 3.93% yearly fall by June 2016. In fact, the BBI ended H1 2016 at 102.93 points.

Moreover, as a result of feeble demand for medium- and long-term Lebanese Eurobonds, the weighted average yield of Lebanese Eurobonds, increased from 6.14% end of December of 2015 to 6.38% by H1 2016. In details, the yields on the 5Y and 10Y Lebanese Eurobonds increased by 21 bps and 27 bps to stand at 6.31% and 6.94%, respectively, in June 30th 2016.

The Lebanese government successfully completed a new Eurobonds issuance in April, for 2 tranches: 8Y (April 2024) and 15Y (April 2031). The size of the 8Y issue was $700M, while that of the 15Y issue was $300M. Both tranches were oversubscribed, and the coupon rates for the 8Y and 15Y maturities stood at 6.65% and 7%, respectively, paid semi-annually. Foreign participation was around 7.5%. The lead managers of this issuance were BLOM Bank S.A.L, Byblos Bank S.A.L, and Deutsche Bank. When compared to other countries in the region, Lebanon's success in Eurobond issuance comes as it offers long-term bonds as well as high coupon rates. For example, Jordan issued $1 billion worth of Eurobonds, where the coupon rate on the 10-year issue was 5.75 per cent.

The second half of the year was a further, yet slower, continuation of Lebanese Eurobonds' market contraction. The BBI saw a 1% decline from the first half. During the second half, BDL subscribed to Eurobonds denominated in dollars, worth $2 billion issued by the Ministry of Finance against treasury bills denominated in lira. However, the drop in demand can be mainly attributed to the U.S presidential elections, in November, and the Fed's decision to raise interest rates for the first time in 2016. Nonetheless, the Lebanese presidential elections as well as the Cabinet formation paved the way for some improvement for the BBI during the last month of the year. As a result, the BBI ended the year standing at 101.90points, with a monthly uprise of 2.17% in December.

In turn, the weighted yield escalated from 6.38% end of H1 2016 to 6.67% on December 30th 2016. Moreover, the yields on the 5Y and 10Y Lebanese Eurobonds increased by 36 bps and 17 bps from the first half of the year to stand at to 6.67% and 7.11%, respectively. This lower demand can be justified by the loss of the investment appetite to Lebanon and its weakening economy as well as the tight liquidity in Arab countries, specifically Saudi Arabia and the UAE.

Despite sluggish performance during the year, Standard and Poor's (S&P) outlook on Lebanon was upgraded, in September, from negative to stable, and Lebanon maintained its B-/B rating for its banking sector. The outlook revision reflected the perception of a substantial growth in Lebanese banks' deposits to support the government's borrowing requirement and the country's external financing needs, regardless of the political turmoil across the region.

Nonetheless, Lebanon's default risk as perceived by both international and local investors widened during the year. In fact, the spread between the yield of the Lebanese 5Y and 10Y notes and their US counterpart, which mirrors the local views of the Eurobonds markets' outlook, broadened from 430 bps in 2015 to 517 bps in 2016. Similarly, the 5Y Credit Default Swap (CDS) that depicts foreigners' insights of the Lebanese government default risk increased from 426 bps to 520 bps.

With the local and global geopolitical changes dominating the year 2016, the Lebanese Eurobonds market failed to recuperate despite of the central bank's efforts, political breakthroughs in the country, and an improved credit rating.