Lebanese Eurobonds' Performance H1 2018

BLOMINVEST BANK

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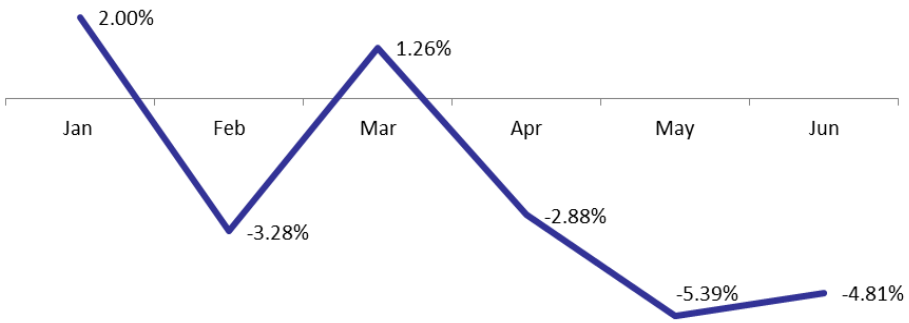
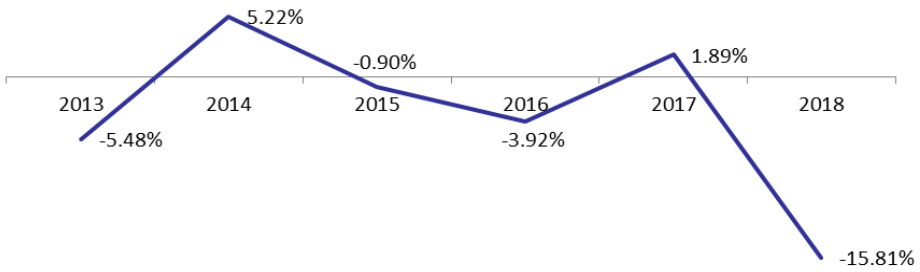
Monthly Change in the BLOM Bond Index



Source: BLOMINVEST Research Department

Yearly Change in the BLOM Bond Index



Source: BLOMINVEST Research Department

Global demand for fixed income securities fluctuated during the first half of the year. In the US, a hawkish Fed and stronger than expected economic data across the US accompanied by the China trade war has led to the shy demand for US safe haven instruments. As such, demand for short and long term US treasuries was frail during H1 2018, which led to the U.S. 10Y yield breaching 3%. Furthermore, the US Treasury Bond Index compiled by Bloomberg ended the first half of 2018 at 125.67 points, revealing a

1.05% drop compared to 127 points, end of 2017. Consequently, the yield on the US Treasury notes maturing in 5 years and 10 years rose from 2.20% and 2.40%, at the end of 2017, to 2.73% and 2.85%, at the end of June 2018.

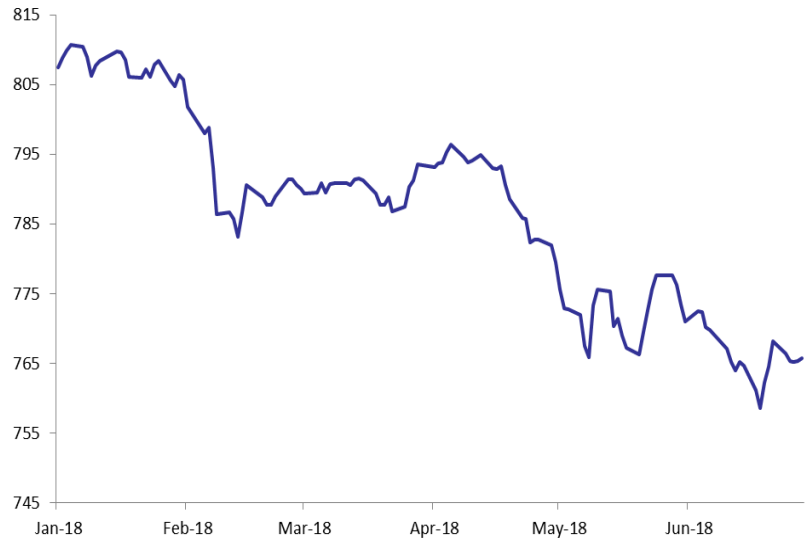
Worth noting, the treasury yield curve continued to flatten. The narrowing difference between yields on 2Y US treasuries compared to the 10Y notes persisted. At the end of June, the yield differential was 33 bps, down from 52 basis points at year end and 93 bps at the end of H1 2017.

US 2Y yields and 10Y yields differential

Source: US Treasury Department

The Emerging Markets' (EM) fate was no different than that of Lebanon, yet to a lower extent. A stronger dollar and rising short-term US interest rates have shaken faith across emerging markets with investors dumping stock and bond funds. Slowing growth in China has further weakened EM sentiment, as investors become increasingly concerned over the trade war initiated.
Moreover, higher U.S. bond yields have fueled volatility in emerging markets bonds. In fact, the selloff seemed to be set off by some U.S developments. 10 Y U.S. Treasury yields breaching to 3% and constant dollar strength weakened the appeal of certain emerging markets currencies and bonds. As such, the JP Morgan Emerging Markets Bond Index recorded a 5.23% y-t-d decline to stand at 765.69 points, end of H1 2018.

JP Morgan Emerging Market Bond Index



Source: Reuters

Given the relationship binding Lebanon's Eurobonds market to the local political and economic scenes, the Lebanese safe haven assets failed to attract investors. The BLOM Bond Index (BBI) mirrored the local market's performance and plunged by a yearly 15.81% year-on-year (y-o-y) compared to a 1.89% gain in 2017. Moreover, the BBI ended the first half of 2018 at 88.30 points, down by 12.62% year-to-date. The weighted average yield of Lebanese Eurobonds, which is in an inverse relationship with the price, rose in H1 2018. After ending the year 2017 at 6.90%, the weighted yield surged to 9.97% at the end of June 2018.

The first half of the year reflected several issues for Lebanon on the political and economic fronts. In details, the smooth parliamentary elections failed to attract foreign investments as the cabinet formation remains obstructed. On the economic front, the drop in oil prices has adversely affected foreign investments in the country and the negative balance of payment revealed a large amount of capital outflows. As such, external and fiscal deficits have persisted, pushing the public debt further up, increasing the risk of default and thus dragging Eurobonds' prices downwards.

Hence, the performance of the Lebanese Eurobonds' market in the first six months of 2018 was feeble, and was unable to prove its resilience in the face of the bitter economic and political scenes. As such, the yields on the Lebanese Eurobonds maturing in 5 Years and 10 Years rose from 6.90% and 7.40% at the end of 2017 to 10.02% and 10.55% at the end of June, respectively.

Moreover, the weak performance of the BBI mainly came about due to an oversupply of Eurobonds in the market, which resulted from BDL's financial engineering scheme. In fact, local commercial banks, holding more than half of the Eurobonds portfolio, freed up dollars through the sale of Eurobonds in an effort to place dollars at the Central Bank in exchange for attractive returns. This act has triggered a sell off from foreign funds, which currently hold up to $9B of the Lebanese Eurobonds portfolio.

BDL's current financial engineering scheme entailed a debt exchange between the Lebanese Ministry of Finance (MoF) and BDL, with the central bank's T-bills exchanged for $5.5B worth of new Eurobonds issued by the government. Moreover, BDL would subscribe to the equivalent of LBP 8,250B in T-bills, for maturities ranging between 3 and 10 years, with a coupon rate of 1%.

The new Eurobonds are issued in four tranches; two of them were reopening of maturities already held by BDL following October 2017's issuance (2028 and 2031) and the other two are new ones maturing in 2033 and 2034. In details, the four tranches will be distributed as follows:

- An additional $1B on March 2028 maturity with a coupon rate of 8%
- An additional $1.5B on November 2031 maturity with a coupon rate of 8.1%
- $1.5B maturing in May 2033 with a coupon rate of 8.2%
- $1.5B maturing in May 2034 with a coupon rate of 8.25%.

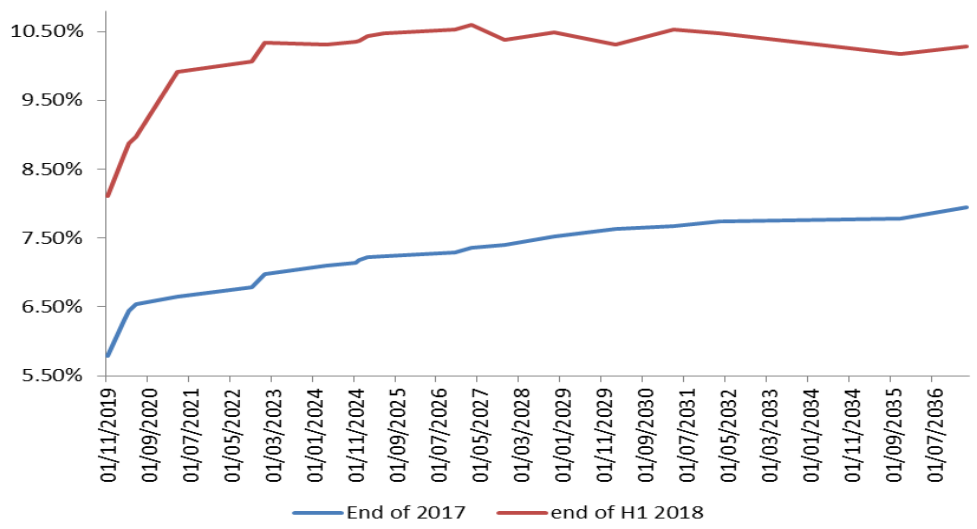
BDL sold $3.02B worth of Eurobonds from its portfolio, which exceeded the original $1B planned due to high demand by local commercial banks.

In the Eurobond sale process, BDL provided commercial banks loans with low interest rates at 2% in Lebanese pound to the banks, yet BDL also agreed with banks to deposit 125% of the amounts the former granted them at a 10.5% interest to be blocked over the next 10 years. As such, this will help the banks achieve gains valuing 10.25% on their blocked LBP deposits at BDL.

Investors' lack of confidence in the Lebanese fixed income market materialized as revealed by the widening spreads between the yield on the Lebanese Eurobonds and their US comparable. The spread between 5Y and 10Y yields between Lebanese Eurobonds and their US comparable surged from 470 bps and 500 bps, end of 2017, to 729 bps and 770 bps, respectively.

Worth noting, foreign investors are usually holders of medium term securities. Given that Lebanon was also negatively affected by the emerging markets' selloff, the Lebanese yield curve steepened in the first 6 months of the year.

Yield Curve for Lebanese Eurobonds



Source: BLOMINVEST Bank Research Department

Moreover, the economic slowdown and high public debt coupled with political uncertainty domestically and regionally, was reflected by the increasing 5Y Credit Default Swap (CDS), which reached its highest levels in more than a decade. In fact, 5Y CDS stood at 724 bps, end of June 2018, compared to 520 bps at year end. However, this increase can be partially justified by the excess supply in Eurobonds as well as higher public debt and continuous political uncertainty. In details, during the month of May, the US embassy opened in Jerusalem which led to dozens of Palestinians being killed and wounded in protests at the border fence between the Gaza Strip and Israel. As such, Lebanon was adversely affected as revealed by the CDS which rose by a daily 38 bps and the BBI which dropped by 1.7%. Moreover, the United States and Gulf countries imposing additional sanctions on Lebanon's Hezbollah leadership, on the 17th of May, led to a 36 bps increase in CDS overnight.

Lebanon 5Y Credit Default Swap

Source: Reuters

The Lebanese fixed income market is highly correlated with local political improvements and developments. As such, a breakthrough in the cabinet formation complemented with the new reforms set during the CEDRE conference could attract new foreign investments and bolster demand for Eurobonds, hence restoring prices and yields to their normal levels.

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