Lebanese Eurobonds Performance in 2018

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Demand on fixed income securities was mixed during 2018. Trade and tariff barriers concerns remained in focus as the United States and China continued to engage in a back and forth over tariff policy. Adding to tensions, the U.S. government partially shut down on December 23 as Congress and President Trump did not agree on terms to pass the next budget. The House passed a budget in line with the President's request for funds to build a border wall; however, Senate Democrats have indicated they would not support this version of the budget. The increasing pressures have triggered a fall back in the demand for short and long term US treasuries. 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 2.51% and 2.69%, at the end of June 2019.

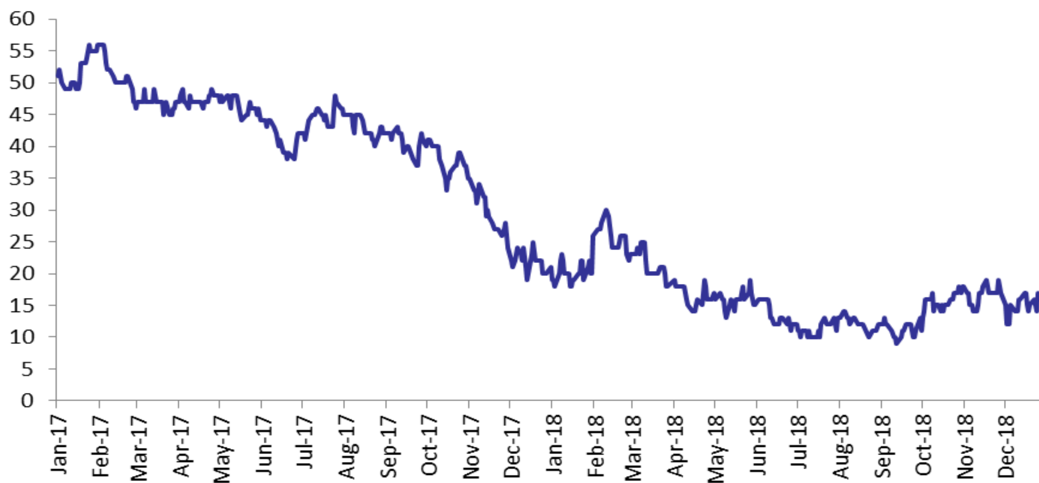
Moreover, the Federal Reserve's rate moves tend to influence the short-end of the yield curve, including the 2-year Treasury yield, more quickly. Expectations of a hawkish Fed that hikes too aggressively could tip the short end of the curve higher than the long end. As such, given that the Fed has increased interest rates four times this year, the difference between yields on 2Y US treasuries compared to the 10Y notes narrowed, signalling a flattening of the curve. At the end of the year, the yield differential stood at 18 bps, compared to 52 bps at the end of 2017.

As for the Emerging markets, the JP Morgan emerging markets bond index (EMBI) recorded a decrease of 4.61% from 807.95 to 770.7 in the year of 2018. Several factors have assisted this decrease with the movement of the US rates playing a major role along with other key movements in the economy.

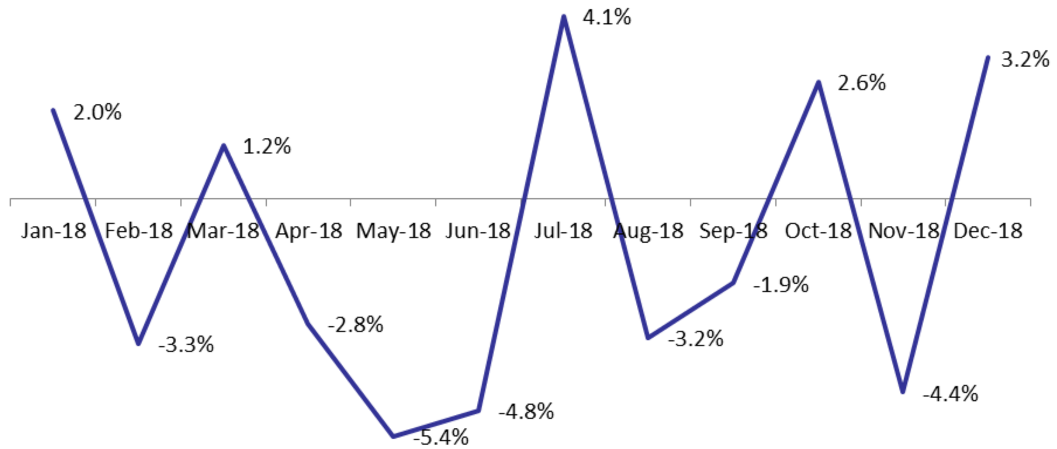
The strengthening US economy ,which expanded at a rate of 4.1% in the second quarter of 2018, has been a key player in sucking money up from emerging markets .To detail the background performance of the US economy , interest rates have been going up with the fed hiking rates four times in 2018 from 1.25% -1.5% to 2.5%-2.75% .Even after adjusting for inflation , real interest rates in emerging markets approached the near zero boundary which made the US interest rates higher with a stable inflation rate of 2% .Trump's trade rhetoric , with the ongoing trade war in place, has weighed much more heavily on emerging markets than on the dollar, and this triggered the concern of currency volatility in emerging markets relative to the strong dollar .

Therefore, investors found it risky to invest in local currency bonds in emerging markets and this triggered a major sell off with the great performance and risk minimizing economy in the United States which was considered a safer investment haven for fixed-income investments. On a final note, in the last two month of 2018 emerging market stocks were less volatile than US equities which may be a signal of why investors may have sold emerging market bonds and turned into investments in emerging markets equities therefore probably justifying the decrease of 4.61% in the JP Morgan EMBI.

10Y and 2Y Interest rate Differential



BBI Monthly Changes



In Lebanon, constant disappointment on the political front prevailed. Failure to form a government for more than 8 months coupled with a peaking balance of payments and fiscal deficit has taken its toll on the Lebanese safe haven assets. The BLOM Bond Index (BBI) reflected the loss of confidence in Lebanese Eurobonds. The index plunged by a yearly 12.47% to 88.46 points, compared to marginal fall of 0.2% in the previous year. Hence, the weighted average yield of Lebanese Eurobonds, which is in an inverse relation of bond prices, surged during 2018. In fact, the weighted yield escalated by 371 bps in 2018 to reach one of its highest levels, 10.61%.

The drop in Eurobonds prices, which was thought to be limited and temporary, worsened throughout the whole year. A timid 0.6% growth in 2017, a modest improvement in tourism, and a weakening real estate sector undermined by regional instabilities led foreign investors to gauge the risks of the Lebanese economy. In fact, the first half of the year was entitled by an oversupply of Eurobonds, driving prices lower, mainly due to BDL's financial engineering scheme.

BDL's current financial engineering scheme entailed a debt exchange between the Lebanese Ministry of Finance (MoF) and BDL, with the central bank's exchanging worth $5.5B holding of T-bills with 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%.
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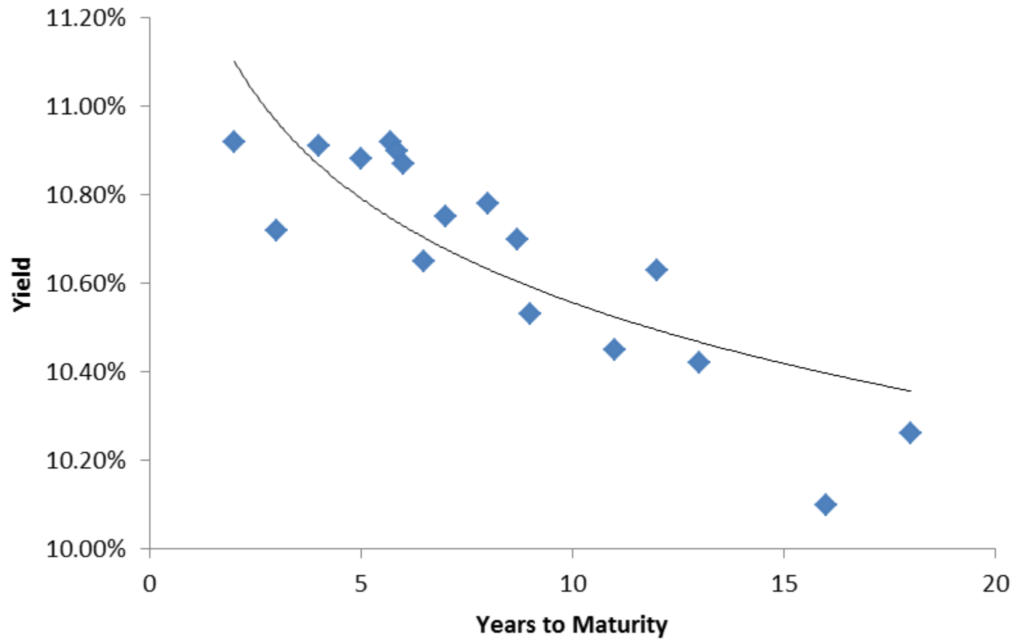
BDL sold $3.02B worth of Eurobonds from its portfolio, which exceeded the original $1B planned due to high demand by local commercial banks. In the Eurobonds sale process, BDL provided commercial banks loans with low interest rates at 2% in Lebanese pound to the banks, yet BDL also agreed with banks 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.

The second half of the year proved to be a shy recovery for the economic woes and chaos that occurred in the first half. However, this recovery was at a marginal 0.18% rise in the BBI. Lebanon's economy struggled in the second half as politicians struggled forming a new government. The year ended with rating agencies revising Lebanon's outlook from stable to negative. In details, both Moody's and Fitch rating agencies emphasized the risks to the medium-term sustainability of the government debt, which has risen to 154% of GDP. The rating agencies' "B-"reflect Lebanon's weak public finances, difficult political environment and anemic economic performance.

As such, the weakening economic situation and uncertain political circumstances resulted in the sluggish performance of the Lebanese fixed income securities. Hence, yields on Eurobonds maturing in 5Y and 10Y increased from 6.9% and 7.4% to 10.8% and 10.7%, respectively. As alarming as it may seem, the Lebanese Eurobonds yield curve "inverted" in the last quarter of the year.

An inverted yield curve is the bellwether for an economic recession. This can be explained by the fact that humans are more motivated by a fear of loss than anything else. When the possibility of loss comes up, people get scared. When people are scared, they tend to make incompetent decisions like selling off all their investments due to a dip in the markets. However, the inversion of the yield curve was not only affected by investors' loss of confidence in the Lebanese economy in the short term, but also by the emerging markets sell-off.

Lebanon's Yield Curve (end of 2018)



Source: BLOMINVEST Economic Research

Moreover, an increasing external and fiscal deficit accompanied by a drastic drop in FDIs, as a result of falling oil prices, amplified the hit on the Lebanese economy. Average 5Y credit default swap (CDS), rose from 441 bps in 2017 to 605 bps in 2018. After several empty promises on the formation of the government by the end of the holiday season, the 5Y CDS hiked to 820 bps, an all-time high.

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