Overview of Global and Lebanese Bond Market in 2022

BLOMINVEST BANK

February 10, 2023

Contact Information

Stephanie Aoun

stephanie.aoun@blominvestbank.com

In this report, we will provide an overview on Lebanon's Eurobond market, in addition to a brief review of the US, Japan, Emerging and EU markets in 2022. Indeed, last year had been a year full of uncertainties and challenges, as global economic activity experienced a sharper than expected slowdown and record high inflation. The cost of living crisis, tightening financial conditions in most regions, Russia's invasion of Ukraine, and the lingering COVID-19 pandemic have caused shockwaves across the world. Three big shocks essentially happened in 2022.

First, on February 24, 2022, the Russian military invaded Ukraine, creating global upheaval, conflict and unrest blighting all parts of the world. In fact, global fuel and food prices soared and the war was the main contributing factor to projections of a global economic downturn, in a world still reeling from the consequences of the Covid-19 pandemic.

Second, China employed a "Zero Covid-19 policy" in an effort to fight COVID-19 and keep cases as close to zero as possible. To that effect, the country implemented mass testing, quarantined the sick in government facilities and imposed strict lockdowns that can span entire cities. As China chose health over wealth, its own economy continuously suffered due to the prolonged shutdowns, adding to the fact that the policy had a significant negative effect on the global economy as it damaged global supply chains and contributed to rising inflation across the world. Nevertheless, by the end of the year 2022, China announced a series of measures rolling back some of its most draconian anti-COVID-19 restrictions, including limiting harsh lockdowns.

Third, in an effort to fight inflation, the Federal Reserve increased interest rates during seven consecutive meetings this year between March and December, bringing its benchmark rate from 0.25% to 4.5%, the most rapid tightening campaign executed by the central bank since the 1980s. Chair Jerome Powell constantly highlighted the importance of the Fed’s interest hike to temper demand and fight inflation. Nevertheless, in its final meeting of the year, the FOMC expected fewer steep hikes in the year ahead, although that is subject to change depending on economic conditions.

On another note, looking at the local economy, Lebanese hardship continued in 2022, as no agreement was reached with the IMF. In fact, Lebanon is still in the midst of a humanitarian, economic and political crisis with more than 50%[1] of its population living below the poverty line and increasing unemployment rate from 11.4% in 2018-19 to 29.6% in 2022[2]. Moreover, since the departure of Michel Aoun from the presidential palace on October 31, 2022, Lebanon has been facing a presidential vacuum with no solution in sight. In fact, political divisions have prevented the creation of a new cabinet, thus ruling out any agreement on a consensual presidential candidate. Consequently, the country entered the New Year 2023 without a president, while prime minister-designate Najib Mikati acts as the head of a caretaker government.

Tough year for the US bonds Market

U.S. gross domestic product (GDP) expanded at an annual rate of 2.9% in the fourth quarter of 2022, prior to 3.2% in the third quarter, but nonetheless a solid end to an upside down year in which the economy contracted in the first six months. The continued growth in the fourth quarter showed the resilience of consumers and businesses in the face of inflation and rising interest rates.

The year 2022 was the worst year on record for US bonds; largely due to the Federal Reserve raising interest rates aggressively to fight inflation,

[1] World Bank: “Lebanon Overview: Development news, Research, Data”, November 2, 2022
[2] World Bank: “Lebanon Overview: Development news, Research, Data”, November 2, 2022

which clobbered bond prices, especially those for long terms. As a result, over the year 2022, the yields have surged remarkably and are significantly higher today than have been in recent years. In more details, the benchmark 10-year Treasury bond yield topped 4% for the first time since 2009. Moreover, by the end of the year, the yield curve was pointing towards a notable recessionary scenario as the yields on short term maturities reached the highest figures. As such, 6-month Treasury bills were paying a higher interest rate than 10-year Treasury notes. By the end of 2022, bond yields shifted lower, mainly due to expectations of falling inflation, thus a less aggressive tightening monetary policy. In fact, U.S. inflation eased in December to stand at 6.5%, down from 7.1% in November and well below a 9.1% peak in June. These figures show signs that inflation is recovering and the economy is cooling following last year's surge.

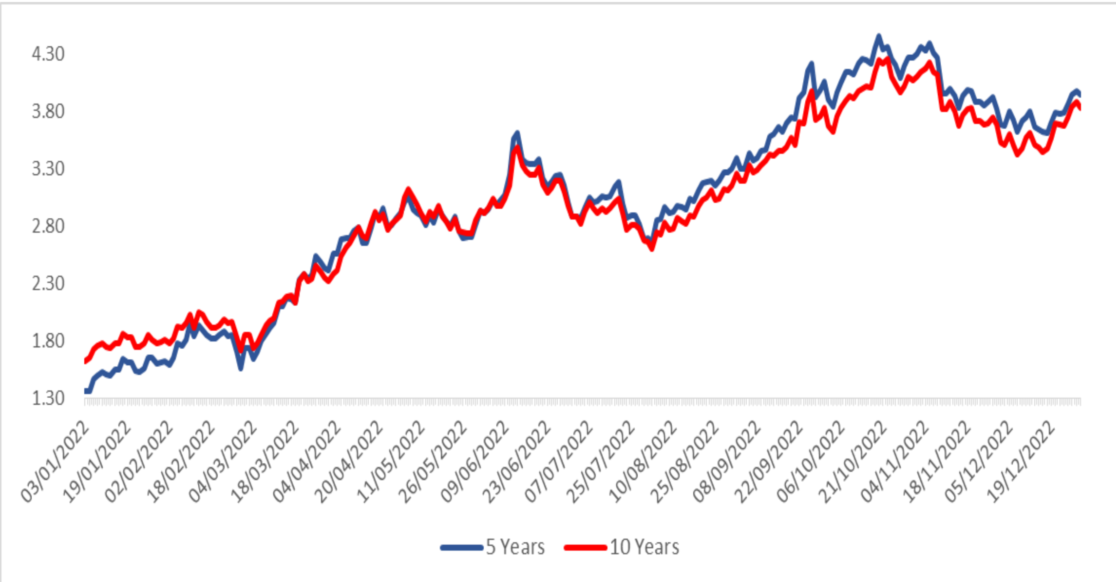
US Jobless claims reached 206,000 by the end of year 2022, down from a level of 224,000 at the beginning of the year. In parallel, the unemployment rate reached a five-decade low of 3.5% by the end of the year, down from 3.9% by end 2021. The latest US employment report highlighted the resilience of the nation's labor market through 2022, despite the most aggressive pace of monetary tightening in decades. While high-profile firms in the finance, technology and real estate sectors have announced tens of thousands of job cuts in recent months, the broader labor market remains strong. In fact, firms continued to hire at a solid pace amid resilient consumer demand. That said, many economists expect further layoffs in the months ahead as the Federal Reserve's interest rate hikes hit the economy, and as there are usually lags in the effect of monetary policy.

On another note, the Federal Reserve's most aggressive tightening campaign resulted in rising mortgage rates in 2022. As a matter of fact, US mortgage rates reached the highest levels in two decades, standing at 6.7% by year end and peak of 7.3% in October and November 2022. As a result, sales of previously owned US homes fell in December 2022 to the slowest pace in over a decade, signaling one of the housing market's worst years on record and marking the biggest annual slide since 2008.

However, US home sales are expected to pick up again soon since mortgage rates have declined to 6.37% in January 2023.

For the year 2023, we expect that the yields will be lower for all maturities as the Fed will stop its aggressive monetary policy. In fact, in their last meeting on February 1, 2023, Chair Jerome Powell and fellow policymakers lifted the Fed's target for its benchmark rate by only a quarter percentage point to a range of 4.75%. Finally, although a recession is likely in 2023, investors must look beyond it and position for recovery in a new investment environment shaped by relatively higher rates, lingering inflation, and hawkish central banks.

US Five and Ten years Treasury yields



Source: BlomInvest

Europe Bonds Market

European countries had high hopes for the year 2022, amid the decrease of Covid cases and reopening of local businesses. However, the war between Ukraine and Russia in February 2022 has led to a global energy crisis, particularly evident in the Eurozone. As a matter of fact, Russia was the main EU supplier of crude oil, natural gas and solid fossil fuels, but as the Eurozone sided with Ukraine, Russian President Vladimir Putin decided to limit natural gas supplies to European countries.

The Eurozone found itself in crisis mode and its inflation rate reached its peak at 10.7% in October 2022, up from 5% figure at the beginning of

2022. Currently, December inflation came in at 9.2%; this was the second consecutive monthly drop in prices across the region. In response, the European Central Bank raised interest rates four times throughout 2022, bringing its benchmark rate to 2.5% by year-end.

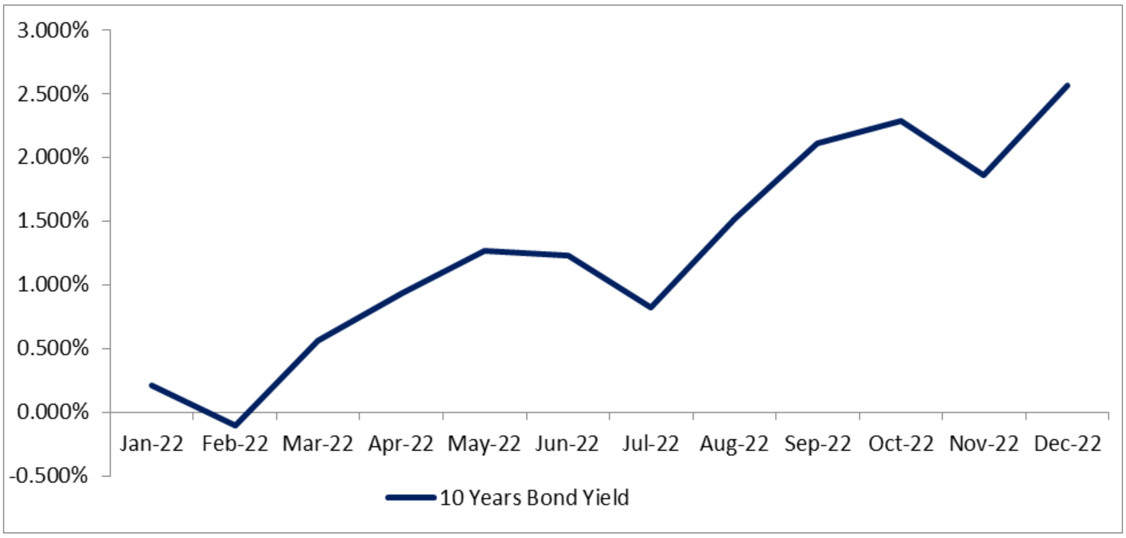
The ECB's hawkishness seems especially related to rising concerns over a wage-price spiral taking hold in the euro area. In the Eurozone, wage growth is strengthening, supported by robust labor markets and some catch-up in wages to compensate workers for high inflation. As these factors are set to remain in place, the December 2022 projections see wages growing at rates well above historical averages and pushing up inflation throughout the projection period. The ECB may be worried about wage increases in 2023, bolstering the need to keep rates in restrictive territory. In response, Klaas Knot, president of Nederlandsche Bank, has made it clear that there will be other rate hikes in 2023. Fortunately, the Bundesbank reported that in view of the currently stable situation of the banking system in the euro area, it’s unlikely that the tightening of monetary policy envisaged by the Governing Council of the ECB will lead to major negative feedback loops between the financial system and the real economy.

Below, we will focus specifically on Germany and the UK.

Germany

Germany’s economy contracted in the fourth quarter of 2022 by 0.2% following an expansion of 0.4% in the previous quarter. High inflation and uncertainty in view of the war in Ukraine weighed heavily on the German economy. In fact, the historically high annual inflation rate stood at 10% and above for three consecutive months of September, October and November while the month of October was the year's peak at 10.4%. However in December, the rate of inflation dipped remarkably to reach 8.6%. Adding to that, supply chain issues and commodity shortages also contributed to the price pressures, many of which can be traced to aftereffects of the COVID pandemic. As a result, yields on 10-year German bond followed an increasing trend and closed at 2.57% by the year-end.

10-Year German bonds



Source: Trading Economics – Germany Government Bond 10Y

UK

The British economy contracted by 0.3% in the third quarter of 2022 and is forecast to fall into recession in the final three months of the year. Currently, Prime Minister Rishi Sunak struggles to contain inflation that reached a four-decade high. In fact, since September, the inflation in UK reached two-digit figures standing at 10.5% in December 2022 and reaching its peak of 11.1% in October. Consequently, the Bank of England raised its benchmark rate progressively to 3.5% by year-end, the highest level for 14 years, thus pushing up repayment costs for people with mortgages and loans. In addition, the interest hike is expected to increase unemployment rate in the months ahead, which has reached a figure of 3.7% as of November 2022.

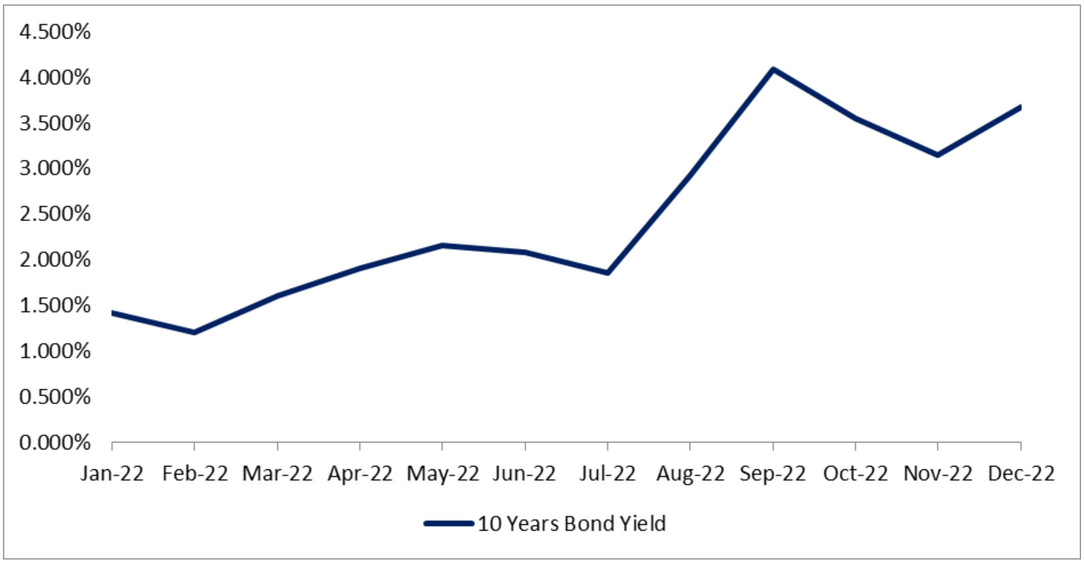
In September 2022, UK Prime Minister Liz Truss was forced to resign due to fallout from the mini budget that included massive tax cuts with little explanation of how the budget would be balanced. Therefore, Liz Truss became the shortest-serving prime minister in British history, after only 49 days in office. This immediately triggered a major drop in the bond markets, leading to the significant fall of the value of the British pound.

On another note, the UK government sank deeper into debt in December as rising debt-interest payments and the cost of insulating consumers and businesses from the energy-price shock strained the public finances.

According to the Office for National Statistics, the budget deficit stood at £27.4 billion ($34 billion), a record for the month and almost triples the £10.7 billion shortfall a year earlier. A recession is likely expected to further dry up tax revenue and expand the deficit. Interestingly, the cost of subsidizing gas and electricity is also taking its toll, amounting to £7 billion in December alone.

The yield on the UK' s 10-year followed an increasing trend, reaching 3.669% at year-end as investors believed that Bank of England will continue its interest rate hike in 2023.

Yields on 10-year UK bonds



Source: Trading Economics – UK Government Bond 10Y

Emerging Markets

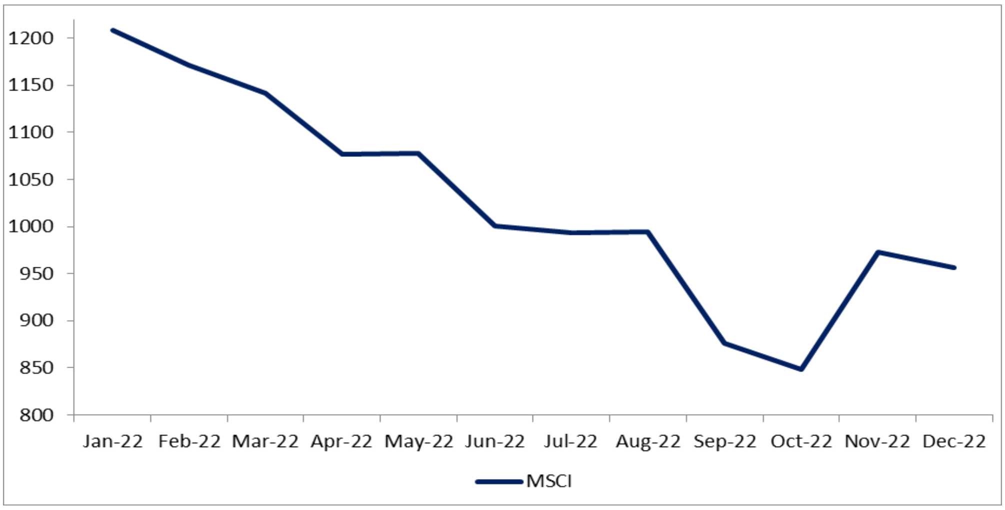
It has been a challenging year for emerging markets (EM) as they were especially affected by US tightening, an energy shock from the war in Ukraine and China' s Zero Covid-19 policy. As a result, inflation is peaking in the emerging markets and their debts have risen sharply in response to both the pandemic and global inflation.

Recently, elevated debt in emerging market economies has raised concerns about countries' capacity to sustain these levels of debt. Covid-19 is adding to spending needs as countries seek to mitigate the health and economic effects of the crisis. In fact, certain lower-rated emerging market economies have already lost access to external bond markets, challenging their ability to meet near-term external and fiscal needs, and to repay upcoming debt maturities. Looking ahead, from the perspective of currency reserves relative to external financing needs, Pakistan, Sri Lanka, Bolivia, Argentina, Angola and Egypt are among the most vulnerable. From the perspective of high debt loads and high-debt servicing costs, Egypt, Ghana, Sri Lanka, Ukraine and Zambia are among the most challenged.

The good news is that EM economies have two key alternative funding sources to global capital markets: bilateral lenders and the International Monetary Fund (IMF). The bad news is that securing financing from both sources is proving challenging. China is the leading bilateral lender to EM countries, particularly to lower-income countries, but funding from China has slowed in recent years. Importantly, in December 2022, the IMF Executive Board approved a 46-month arrangement under the Extended Fund Facility (EFF) for Egypt in an amount of about US$3 billion, which will help meet the balance of payments need and provide support to the budget.

To that effect, bond markets in EM have been hit hard amid rising interest rates in the US. The MSCI Emerging Markets (EM) Index fell by 22.47% in 2022 to reach 956.38 by year-end compared to an index of 1233.5 at the beginning of the year.

Morgan Stanley Emerging Market Bond Index



Source: Bloomberg

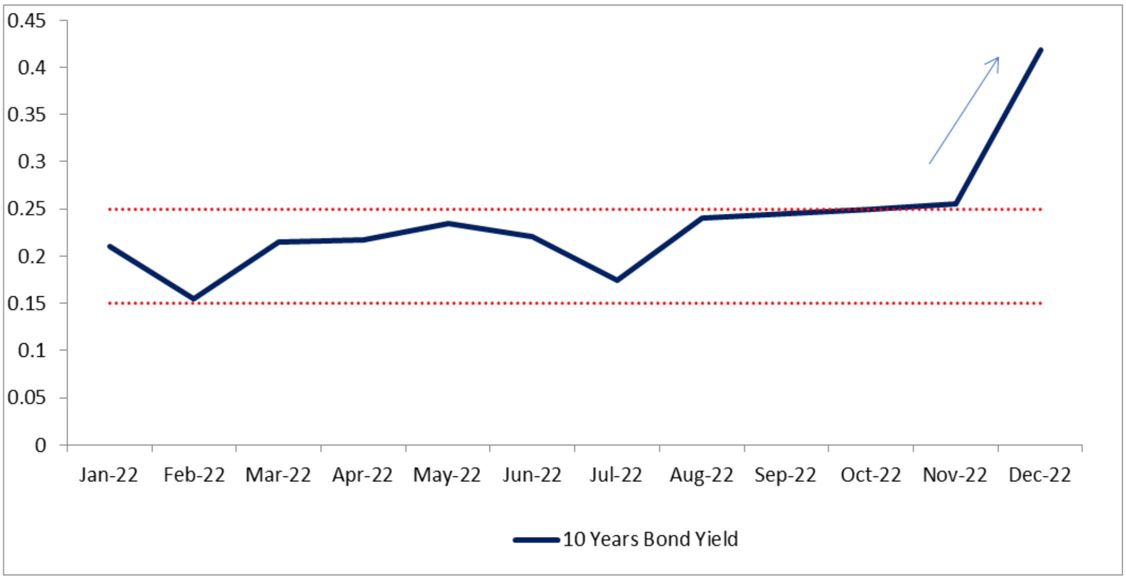
Japan

The Japanese economy contracted by 0.2% in the third quarter of 2022 following an expansion of 1.1% in the previous quarter. In 2022, The Bank of Japan (BoJ) crushed speculations by maintaining a dovish bias policy as interest rates remained unchanged throughout the year. In fact, the central Bank kept its yield curve control targets at -0.1% for short-term interest rates and around 0.25% for the 10-year yield, with the cap at 0.5%, as policymakers signalled that they are not seeking an immediate exit from massive stimulus despite mounting markets pressures. The BoJ reiterated it would take extra easing measures if needed while expecting short-and long-term policy interest rates to stay at their present or lower levels.

As a result of its Dovish policy, the country’ s unemployment rate remained unchanged at 2.5% in December 2022, in line with market forecasts and marking the lowest reading since February 2020. However, the annual inflation rate in Japan rose to 4% in December 2022 prior to 3.7% in the previous month, thus accelerating at the fastest pace since December 1981. Consequently, inflationary pressures continued to spread through the economy as core inflation exceeded the central bank’ s 2% target for the ninth straight month.

The BOJ policy of yield curve control, introduced in 2016, was aimed at keeping yields very low to encourage consumers to spend and businesses to invest, and to head off the risk of deflation that could destabilize the economy and make it harder for the government and large companies to pay off their towering debts. More recently, however, the appearance of negative interest rates had the effect of flattening the yield curve. Therefore, the policy has failed to boost Japan’ s economy in a sustainable way and led investors to doubt the credibility of the BOJ’ s ultra-loose rate policy. In response, on December 20, 2022, the bank adjusted the policy, known as yield curve control, allowing 10-year yields to rise to around 0.5%, up from a previous limit of 0.25%, while keeping both short- and long-term benchmark interest rates unchanged. BOJ Governor Haruhiko Kuroda said the decision was aimed at improving the functioning of the market. The bank also signaled it wanted to create the conditions for higher yields on long-term debt.

Yields on 10-year Japan bonds

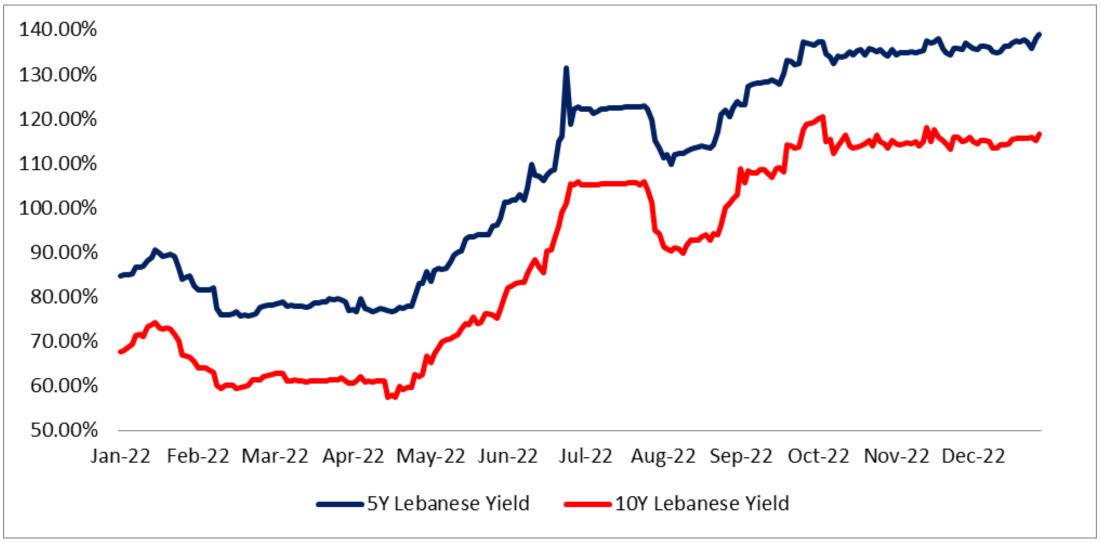


Source: Trading Economics – Japan Government Bond 10Y

Lebanon

In analyzing the Lebanese bond market we must bear in mind the central bank has a minimal power to influence the market. Unlike many central banks around the world, who can change interest rates and adopt a monetary policy that can control spending and decrease inflation rate. In fact, Lebanon' s inflation rate has soared to more than 120% in December 2022 due to the continuous devaluation of the national currency and the increase in energy prices around the world. Nevertheless, the inflation rate is expected to fall in 2023, due to lower base effects. Finally, due to the crisis, BDL has lost its privileged ability to make any significant difference in the money market.

Lebanon yield curve 2020-2022

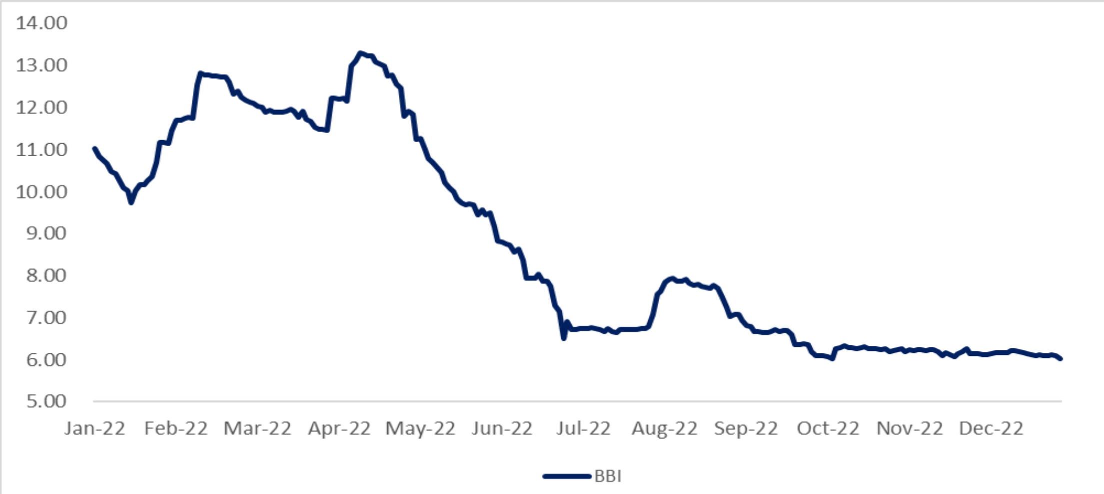


Source: BlomInvest

Michel Aoun left the presidential palace in Baabda on October 31, 2022, and till now there is no elected successor. In fact, despite eleven attempts, the Lebanese parliament constantly fails to elect a new Head of State with no consensus around the candidates. The presidential vacuum, although a common occurrence in Lebanon' s deeply divided political system, comes at a particularly serious time. The country is embroiled in a devastating economic crisis that led to steep devaluations of the local currency and to rising poverty rate. Prime Minister Najib Mikati' s government is in caretaker status and thus largely stripped of its powers.

We can clearly see the dramatic increase in yields of 5 and 10 year Lebanese bonds. Given the turbulence in the FX market, and the lack of corrective measures including a deal with the IMF and foreign creditors, the bonds market continues to suffer from lack of confidence. As a result, BBI fell to its lowest level of 6.03 by the end of 2022, compared to 88.06 by the end of 2019. BBI specifically fell in 2022 by 45.29%.

Blom Bond Index 2022



Source: BlomInvest, BBI index

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department

Zeituna Bey

POBOX 11-1540 Riad El Soloh

Beirut 1107 2080 Lebanon

Stephanie Aoun

stephanie.aoun@blominvestbank.com

Research Department

Tel: +961 1 991 784

research@blominvestbank.com

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