Overview of Global and Lebanese Bond Markets in 2023

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February 6, 2024

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Introduction:

This time last year, Chairman Jerome Powell assured that the Federal Reserve would persist with rate hikes until achieving economic stability. In the face of elevated inflation and a lopsided labor market, a record number of CEOs predicted a looming U.S. recession, compounded by bank stress, debt ceiling debates, government shutdown threats, and global geopolitical tensions. Fast forward to today, inflation has more than halved while maintaining resilience in economic growth. As a result, economists are predicting a soft landing scenario, while the Federal Reserve envisions three rate cuts in the upcoming year.

In Europe, the Central Bank also opted to tighten its monetary policy. Notably, inflation, which stood at a staggering 8.6% in January 2023, has been reined in to 2.9% by December 2023. This shift signifies the concerted efforts to balance economic stability while addressing inflationary pressures. In contrast, Japan opted to maintain an ultra-loose policy throughout 2023. BOJ Governor Kazuo Ueda's cautious approach reflects a deliberate stance, balancing the need for economic stimulus against the potential challenges of negative interest rates.

On another note, looking at the local economy, Lebanese hardship continued in 2023. Since the onset of the crisis, GDP has fallen by about 40%[1], the parallel exchange rate has seen a 98% devaluation, unemployment and poverty have increased to historic levels and the central bank's foreign exchange reserves have diminished by two-thirds. Additionally, inflation has soared to 192.26% in December 2023 as the country has become dollarized and cash cased. Unfortunately, a significant number of Lebanese citizens have migrated in search of a better future overseas. Finally, public sector institutions are failing, leading to substantial reductions in basic services like electricity and water for the population. It is unfortunate that since the departure of Michel Aoun from the

[1] IMF: 2023 Article IV Consultation Press Release Staff Report and Statement by the Executive Director for Lebanon , June 2023

presidential palace on October 31, 2022, Lebanon has been facing a prolonged presidential vacuum with no solution in sight.

In the dynamic landscape of the global economy in 2023, the bond market has undergone notable shifts across various regions, reflecting the intricacies of each jurisdiction's economic policies and challenges. This review aims to dissect the repercussions of these monetary policy shifts and regional economic developments on the global Eurobond market in 2023. By unraveling the interplay between central bank decisions, economic performances, and investor responses across the United States, Europe, United Kingdom, Japan, and emerging markets, we seek to provide a comprehensive understanding of the forces that shaped the Eurobond market on the international stage throughout the past year.

The US Bonds Market

The Federal Reserve raised its benchmark rate 11 times since March 2022, including four increases in 2023 to cool the economy and combat inflation. As a result, inflation eased and by end of 2023, consumer price index was up by 3.4%, however it is still above the Fed's 2% target. The Fed has left rates unchanged at 5.5%. at its last three meetings from July 26 till December 14, 2023 and is now forecasting that it will reverse policy and cut rates three times in the upcoming year.

Looking at the previous year, In January 2023, the United States surpassed its debt limit of 31.4 trillion U.S. dollars, exceeding 120% of the annual GDP. The Treasury Department employed extraordinary measures to avoid a default on its debt ceiling, which was set on June 5th. The resolution, passed in June 2023, suspended the debt limit until 2025 and imposed constraints on government spending. This agreement, signed into law by President Joe Biden on June 3rd, aims to prevent an economically disastrous default on the federal government's debt. Additionally, it establishes budget targets for the next two years to ensure fiscal stability amid the escalating political season.

Later on, in the spring of 2023, Silicon Valley Bank (SVB), Signature Bank, and First Republic Bank experienced sudden and high-profile collapses, causing significant disruption in the financial markets. While factors such as rising interest rates, declining commercial property values, and a looming recession contributed to the banking sector's troubles, each bank faced unique challenges.

As a matter of fact, SVB, a California regional bank catering to tech startups, declared insolvency on March 10, 2023, due to a bank run triggered by a $1.8

billion loss and credit downgrade. Signature Bank, based in New York City and focused on private real estate, private equity, and cryptocurrency, faced federal receivership on March 12, 2023, amid investigations into its failure to recognize unlawful activities related to a cryptocurrency exchange. First Republic Bank, based in San Francisco, collapsed on April 28, 2023, despite a $50 billion liquidity infusion from major banks, as it struggled with a high loan-to-deposit ratio and customer withdrawals.

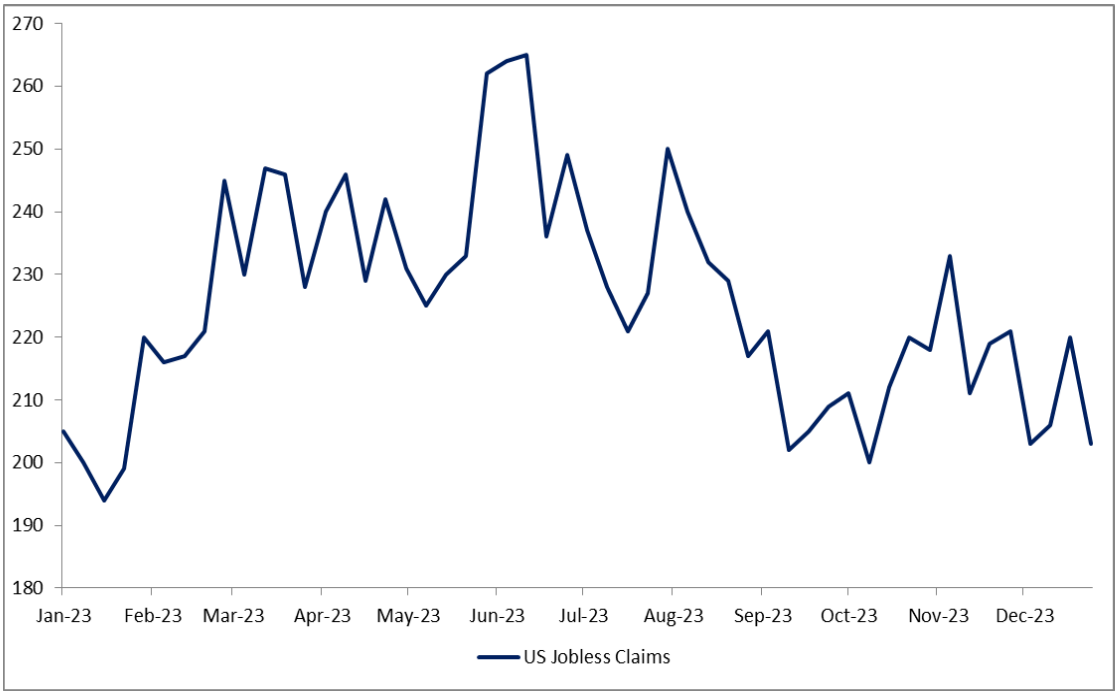
The government responded to the banking crisis with a multi-pronged approach. The Federal Reserve provided emergency loans to distressed banks while signaling a potential end to rate hikes to alleviate sector-wide turmoil. Ultimately, these measures aimed to stabilize the fragile banking system in the aftermath of the high-profile collapses.

Following recent setbacks, on August 1st, 2023, Fitch Ratings downgraded the United States' long-term credit ratings from AAA to AA+, a decision that reverberated across financial markets. Following this downgrade, in November 2023, Moody's shifted the outlook on the United States' ratings from "stable" to "negative." Although, the US government managed to avert default on June 5, the surge in US debt became central to the rating agencies' decision. Indeed, the debt-to-GDP ratio surged from 93% in 2011 to 118% in 2023, exacerbating the challenge. With interest rates reaching historic highs, the government's interest payments ballooned to almost $1 trillion in 2023[2], crowding out spending on vital areas such as infrastructure and national defense.

Looking at year 2023, the American economy expanded an annualized 3.3% in the fourth quarter of 2023, beating expectations and boosting optimism that the Fed can deliver a soft landing. Previously, the economy had expanded by 4.9% in the third quarter and by 2.1% in the second quarter of 2023. Moreover, US Jobless claims reached 214,000 by the end of year 2023, up from a level of 205,000 at the beginning of the year. In parallel, the unemployment rate reached 3.7% by the end of the year, up from 3.5% by end 2022. As such, the labor market remained resilient through 2023, despite the most aggressive pace of monetary tightening in decades. Nonetheless, in more recent months, prospective job seekers have seen news of high-profile layoffs, smaller pay bumps and sharp slowdowns in hiring in certain industries.

[2] Atlantic Council, Two credit downgrades in the US are a much-needed warning, August 15, 2023

Figure 1: US jobless claims in 2023

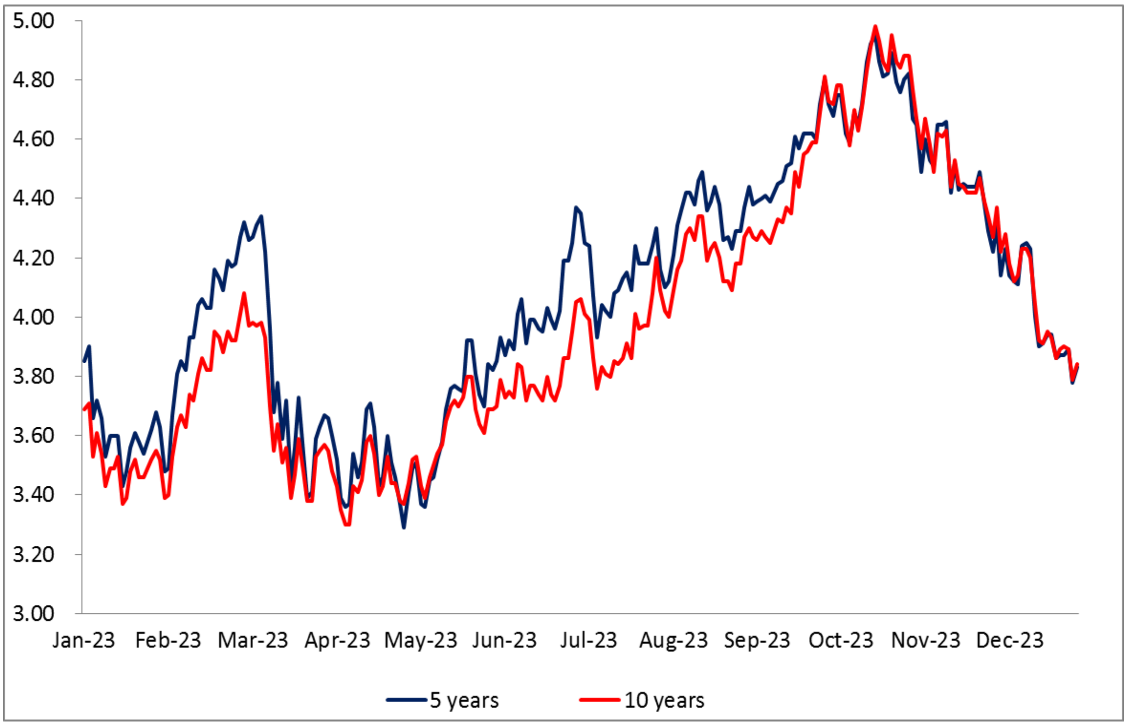


Source: Bloomberg

Mortgage rates in the US ended the year at 6.99%, the lowest level since June 2023. Many industry-watchers are optimistic that the steady slide in borrowing costs — from a peak of 8.09% in late October — will fuel fresh demand for home purchases in the coming months. Yet listings remain in short supply, prices are still out of reach for vast numbers of Americans, and 30-year mortgage rates are more than double where they started in 2022, thus suggesting an uneven rebound. Finally, the Federal Reserve has indicated a potential benchmark rate cut in the New Year, which could subsequently alleviate burdens for prospective homebuyers.

The US Treasury yield curve, which displays the yields of US government bonds of increasing maturities, has been inverted. Indeed, short-term yields have exceeded long-term ones since July 2022, which typically signals a potential recession. Nonetheless, as inflation stabilizes, investors expect less contractionary monetary policy and lower short-term rates in the future, leading many economists to predict a soft landing scenario and a flatter yield curve.

Figure 2: US Five and Ten years Treasury yields



Source: BlomInvest

Europe Bonds Market

The Eurozone experienced a twist in its inflation narrative in December 2023, with a year-on-year increase of 2.9%, slightly below the anticipated 3%, breaking a seven-month decline streak. The European Central Bank (ECB), in its last meeting of 2023 on December 14, opted to keep interest rates unchanged, maintaining the deposit rate at 4.00%. This decision followed a series of rate hikes from July 2022 to September 2023 in response to the Eurozone's annual inflation rate exceeding the 2% target.

As of now, the ECB signals a commitment to sustaining high interest rates, potentially postponing discussions about an early exit from its tightening program. Analysts highlight potential inflation risks arising from the Israel-Gaza conflict and its impact on the oil market, adding complexity to the ECB's decision-making amid increased downside risks to growth.

Indeed, caution is advised against a premature shift toward a rate cut, with expectations pointing towards a potential risk shift in June 2024, contrary to the anticipated cut in September. The Governing Council emphasizes the importance of avoiding a hasty pivot and anticipates careful consideration of policy adjustments in upcoming meetings.

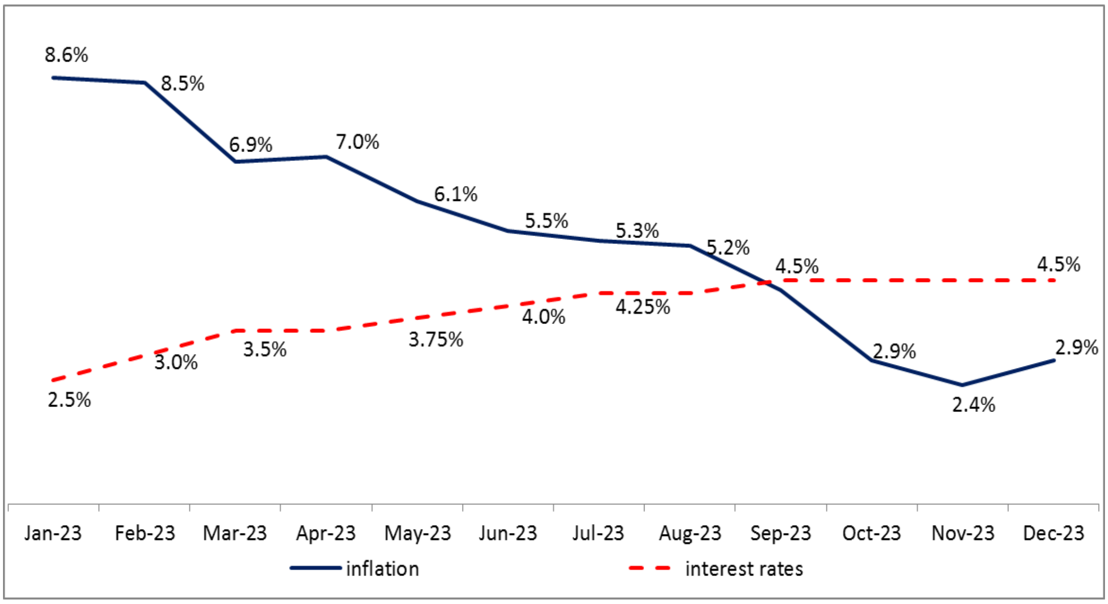
Inflation's entrenchment in Europe poses a challenge for the ECB, making it less likely to implement rate cuts similar to the Federal Reserve this year. Wage growth, growing positively in real terms, and the reluctance of firms to reverse pandemic-driven mark-up increases are identified as potential sources of persistent inflation.

Moreover, concerns about cyclical inflation are on the rise, with leading indicators pointing towards an increase in oil-price growth in the next three-to-six months. This development could reverse the cyclical trend and reinforce structural Consumer Price Index (CPI) growth, contributing to upward pressure on headline inflation.

Adding to the complexity, China's continued easing measures and a potential full-blooded recovery could further boost growth in Europe, exacerbating cyclical price pressures. As Europe navigates these economic intricacies, the Eurobond market remains a dynamic arena, responding to the nuanced interplay of global and regional factors.

Finally, in the face of a challenging economic landscape marked by persistent inflation and heightened interest rates, Europe grapples with the intricacies of its financial trajectory. Projections for the European Union in 2024 paint a picture of modest GDP expansion at 1.2%, a considerable improvement from the meager 0.5% growth observed in 2023. This anticipated recovery hinges on factors such as increased consumer spending, driven by the easing of price pressures, rising real wages, foreign expansion and the resilience of labor markets.

Figure 3: Eurozone Inflation in 2023 and interest rate hikes



Source: Bloomberg

United Kingdom (UK)

In 2023, the United Kingdom confronted significant economic challenges, characterized by high inflation and subpar performance, leading to a persistent cost of living crisis. Despite a reduction in inflation, economic growth remained sluggish, raising concerns about the country's vulnerability to recession.

In more details, Inflation in the UK has surged, with the consumer price index (CPI) peaking at 10.4% in February 2023, but subsequently easing to 3.9% in November, the lowest rate since September 2021. As such, it marked a significant improvement from the 41-year high of 11.1% recorded in October 2022. This decline was in majority due to the 14 consecutive rate hikes, by the Bank of England, starting in December 2021 and resulting in the current basic interest rate reaching a 15-year high of 5.25%. However, although inflation eased to 4% by the end of the year, the rate remains nearly double the Bank of England's 2 percent target, with the bank expecting a return to the target by the end of 2025.

Furthermore, the UK's gross domestic product (GDP) faced contraction, declining by 0.1% in the third quarter of 2023 and further shrinking by 0.3% in October. Projections from the central bank indicate a broadly flat GDP in the fourth quarter of 2023 and 2024, with a meager 0.25% growth anticipated in 2025. Anna Leach, Deputy Chief Economist of the Confederation of British Industry (CBI), anticipates 2024 to be another year of weak growth, citing the continued impact of higher interest rates on household spending power and business cost pressures.

Concerns are further exacerbated by business surveys, such as the S&P Global/CIPS UK Construction Purchasing Managers' Index, registering a decline to 45.5 in November. Additionally, a September survey by the British Chambers of Commerce (BCC) revealed that nearly half of firms expressed negative impacts from the rising cost of borrowing. BCC Director General Shevaun Haviland highlighted the struggles of businesses in paying off debts and obtaining loans.

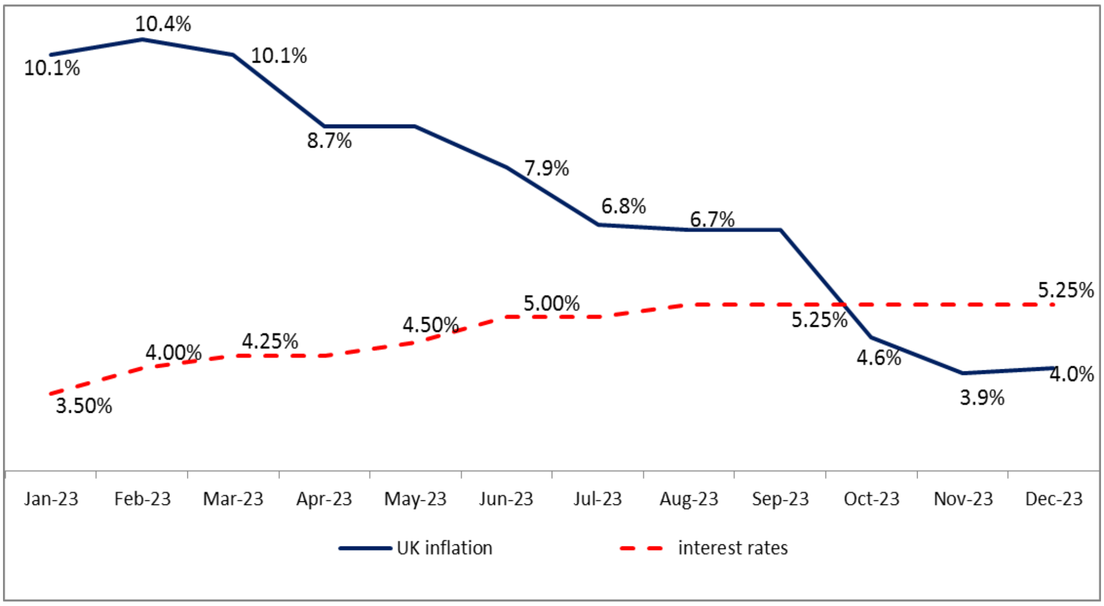
UK businesses grapple with trade barriers with the EU and ongoing worker shortages, calling for a clear, long-term growth plan that addresses infrastructure, skills, and green innovation, according to the BCC. Professor Patrick Minford from Cardiff Business School emphasized the detrimental impact of government decisions, particularly the significant increase in corporation tax and the failure to index income tax thresholds, resulting in high marginal tax rates that hinder business incentives. He criticized the government's short-term focus on reducing public debt through tax hikes instead of fostering long-term growth with low taxes.

British companies are grappling with increased prices triggered by attacks on shipping in the Red Sea, disrupting supply chains and potentially fueling inflation, which may deter immediate interest rate reductions. Despite an optimistic S&P survey suggesting the UK's likelihood of avoiding a recession, heightened activity and upward price pressures raise uncertainties about the Bank of England's swift shift from inflation-fighting to economic protection through lower rates.

As a result, the Bank is expected to continue resisting the prospect of near-term interest rate cuts in the upcoming week. The looming risk lies in the potential delay of policy easing by the Bank of England due to the threat of renewed activity and increased cost pressures arising from the Red Sea tensions.

Recent attacks on ships in the Red Sea by Houthi militants in Yemen have compelled companies to redirect deliveries around the Cape of Good Hope, introducing delays and higher costs to each delivery. These surveys mark early indicators that the Red Sea conflict is impacting the UK economy. This supply chain disruption could impede the Bank of England's efforts to bring inflation back to its 2% target, with expectations of inflation reaching the goal in the spring now challenged by potential price hikes resulting from shipping disruptions.

Figure 4: United Kingdom Inflation in 2023 and interest rate hikes



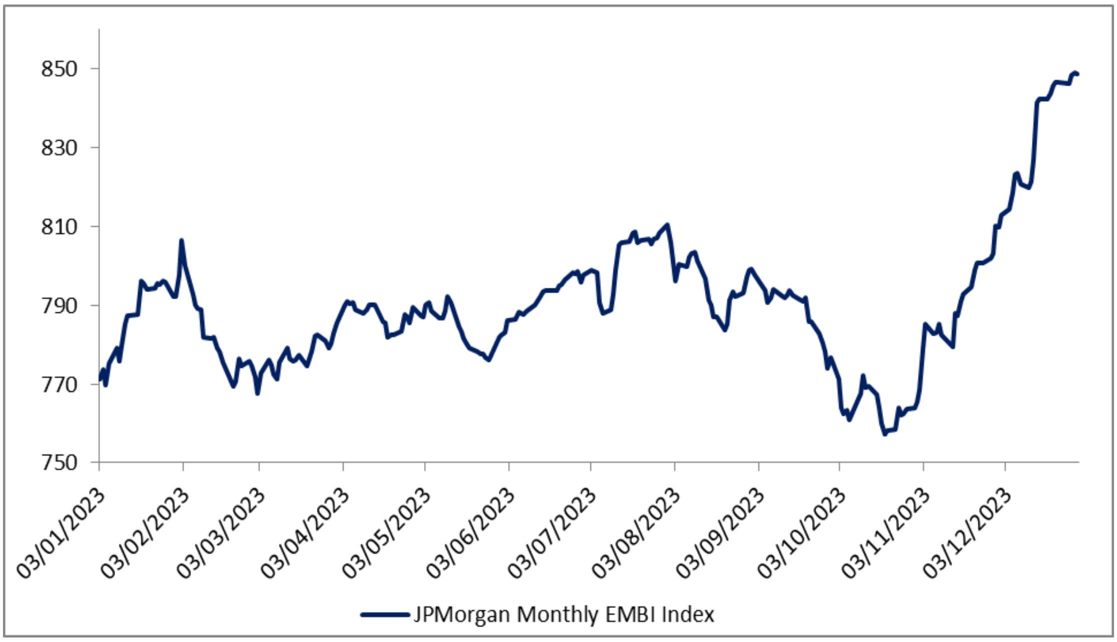
Source: Bloomberg

Emerging Markets

After a challenging period for developing nations, marked by rising interest rates, investors believe the upcoming wave of debt maturities is manageable. Sovereign Eurobond principal payments for emerging markets will rise to $78.4 billion in 2024, up from $43.6 billion this year, according to JPMorgan. Countries must secure funds to pay or find new lending sources for refinancing. Emerging economies face risks such as a potential global recession and escalating conflicts in the Middle East, necessitating careful financial management to navigate these challenges.

While some concerns persist, the mix of countries with debt due provides some reassurance. Gulf nations like Bahrain, despite facing maturities, benefit from ample resources due to elevated oil and gas prices. Turkey, with improved borrowing prospects from its shift to orthodox monetary policies, plans to issue $10 billion internationally and source the remainder domestically to cover its $8 billion maturing in 2024. Limited sovereign bond issuance in 2023 leaves room for more lending next year, supported by investors' capacity, cash, and liquidity. However, elevated interest rates and low credit ratings will exclude some African sovereigns, with Ghana, Zambia, and possibly Ethiopia remaining in default. Kenya, Tunisia, and Egypt face significant maturities in 2024, with Kenya planning to buy back a quarter of its $2 billion bond and Tunisia having $850 million due in February. Egypt's President Abdel Fattah al-Sisi is expected to implement currency devaluations, sell state assets, and possibly increase borrowing from the International Monetary Fund, as part of the reform program.

Figure 5: JPMorgan EMBI Index in 2023



Source: Bloomberg

Japan

In December 2023, the Bank of Japan adhered to anticipated measures by maintaining its ultra-loose policy settings. The decision reflected the bank's cautious stance, awaiting additional evidence regarding the potential rise in wages and prices before considering a shift away from substantial monetary stimulus. Contrary to some traders' expectations, the central bank made no alterations to its dovish policy guidance in December 2023, dashing hopes for a near-term end to negative interest rates.

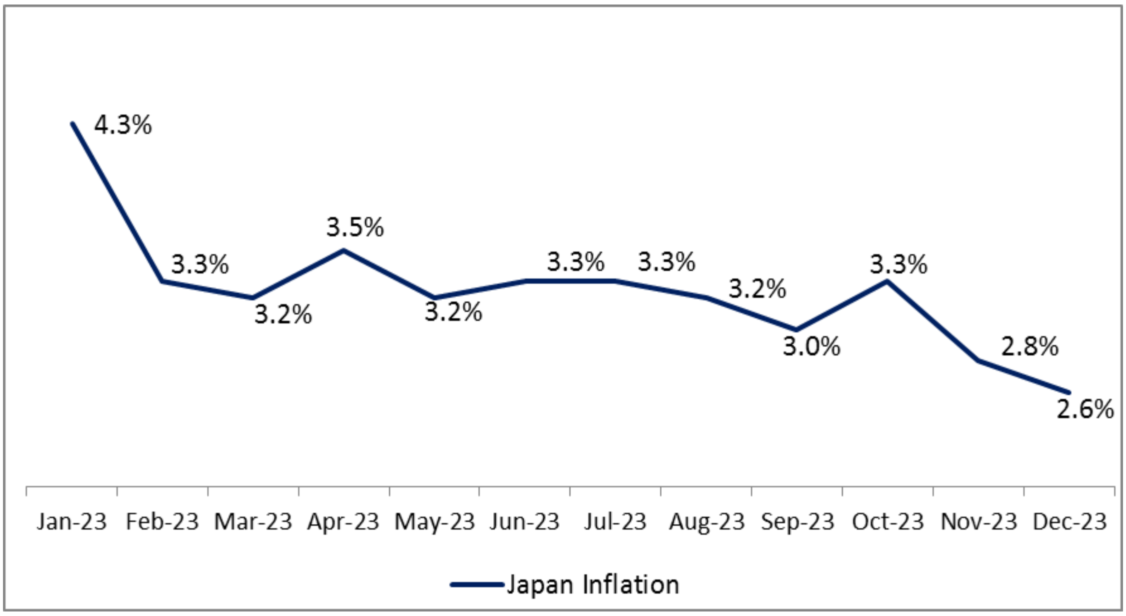
BOJ Governor Kazuo Ueda acknowledged positive movements in prices and wages, signaling the prospect of sustained wage gains in the coming year, yet emphasized persisting uncertainties. During the two-day meeting in December 2023, the BOJ maintained its short-term rate target at -0.1% and the 10-year government bond yield around 0%, along with a commitment to escalate stimulus "without hesitation" if deemed necessary. While inflation in Japan has exceeded 2% for over a year and some firms express readiness to continue raising wages, expectations rise for the BOJ to depart from its dovish stance. Over 80% of economists anticipated the end of the negative rate policy next year, with April being considered the most likely timing.

Ueda offered no explicit signal on the timing of exiting negative rates, asserting that limited data would be available before the next policy meeting on Jan. 22-23, 2024. He also clarified that the BOJ wouldn't hastily raise rates in response to potential cuts by the U.S. Federal Reserve. Since assuming office in April 2023, Ueda has gradually dismantled the radical stimulus of his predecessor, easing the bank's control on long-term rates.

Market expectations suggest a potential hike in short-term rates to around zero from the current -0.1%. Concerns arise that if wages don't rise sufficiently to offset inflation, consumption, already softening, could worsen in the coming year. Despite this, the BOJ maintains its conviction that consumption is gradually increasing, supporting its belief in the economy's recovery.

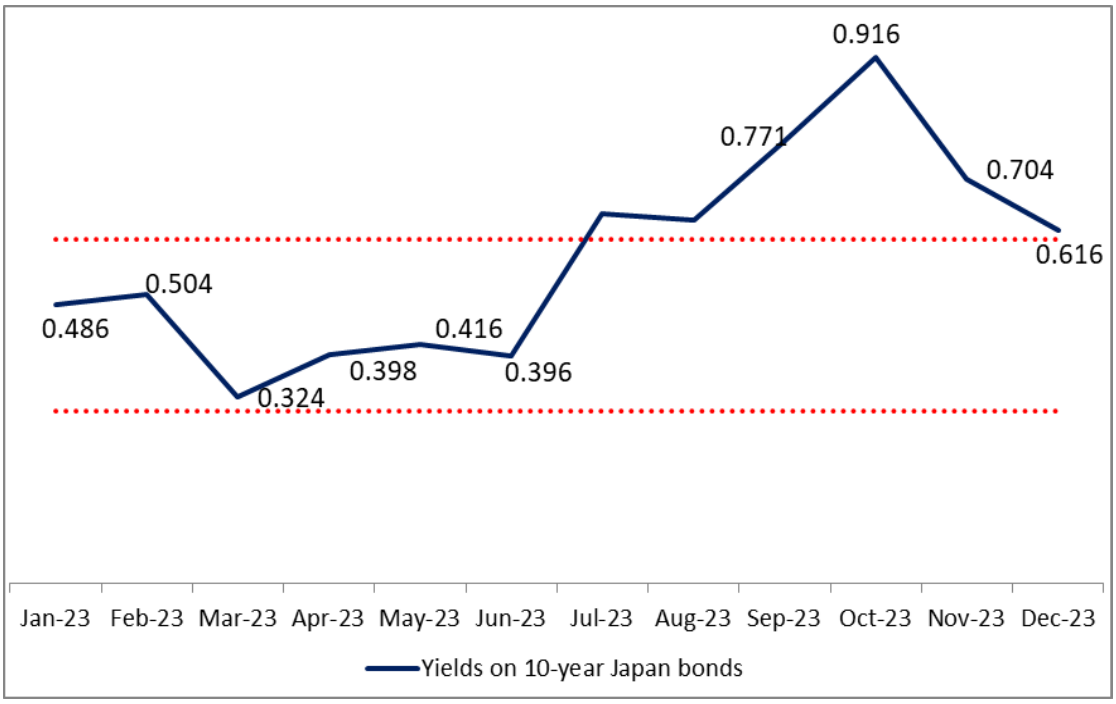
While inflation-adjusted real wages continue to decline, Ueda emphasized that this alone wouldn't hinder the normalization of ultra-easy policy if the BOJ foresees real wages turning positive. Analysts suggest the BOJ may find it opportune to make policy moves in months like January and April when it releases a quarterly outlook report. However, the evolving landscape of global monetary policy, with U.S. and European central banks signaling a cessation of rate hikes, adds complexity to the BOJ's decision-making process. The potential for a spike in the yen, negatively impacting big manufacturers' profits and deterring wage hikes, further underscores the delicate balance the BOJ seeks to maintain.

Figure 6: Inflation in Japan in 2023



Source: Bloomberg

Figure 7: Yields on 10-year Japan bonds



Source: Trading Economics – Japan Government Bond 10Y

Lebanon

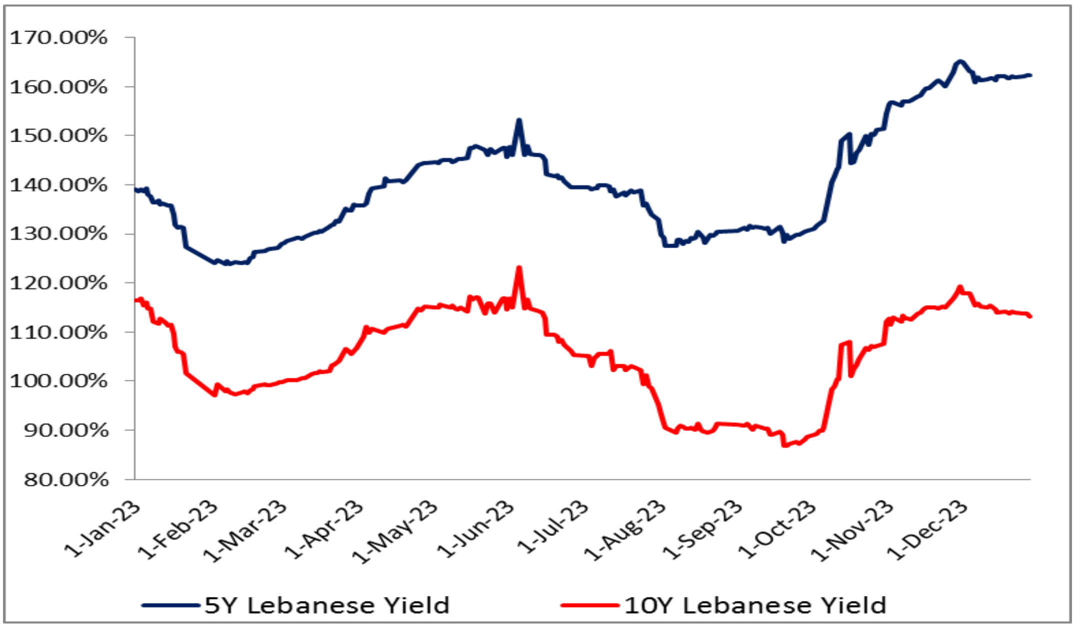
The International Monetary Fund warned in the past year that Lebanon was in a very dangerous situation as the country failed to implement the agreed-upon reforms stated in the staff level agreement signed in 2022. Indeed, Lebanon's prolonged crisis has persisted for over three years. The situation continues to worsen as the country has been without a president since the end of term of former head of state Michel Aoun in October 2022. The current parliament, one of the country's most deeply divided, has failed many times to elect a successor. Unfortunately, the failure to enact necessary policy measures has allowed the crisis to endure and deepen. The economic and social consequences are severe: a 40%[3] contraction in output from 2019-2022, a 98% devaluation of the lira in the parallel market, triple-digit inflation impacting real incomes, and a notable rise in unemployment and poverty.

The outlook is uncertain and lies on the authorities' commitment to implement overdue reforms. Without these reforms, the economy faces lasting depression with irreversible consequences. The primary focus should be on policies to enhance transparency and accountability, restructure the financial sector and unify the exchange rate. It is also crucial to restructure the Eurobond market while decreasing the debt-to-GDP ratio and addressing financing needs.

In analysing the Lebanese bond market we must bear in mind the central bank has a minimal power to influence the market. In contrast to many central banks around the world, who can change interest rates and adopt a monetary policy that can control spending and decrease inflation rate. As such, due to the crisis, BDL has lost its privileged ability to make any significant difference in the money market.

[3] IMF : Lebanon Technical Assistance Report- Tax and Customs Administration: an Urgent Need for Intervention – December 2023

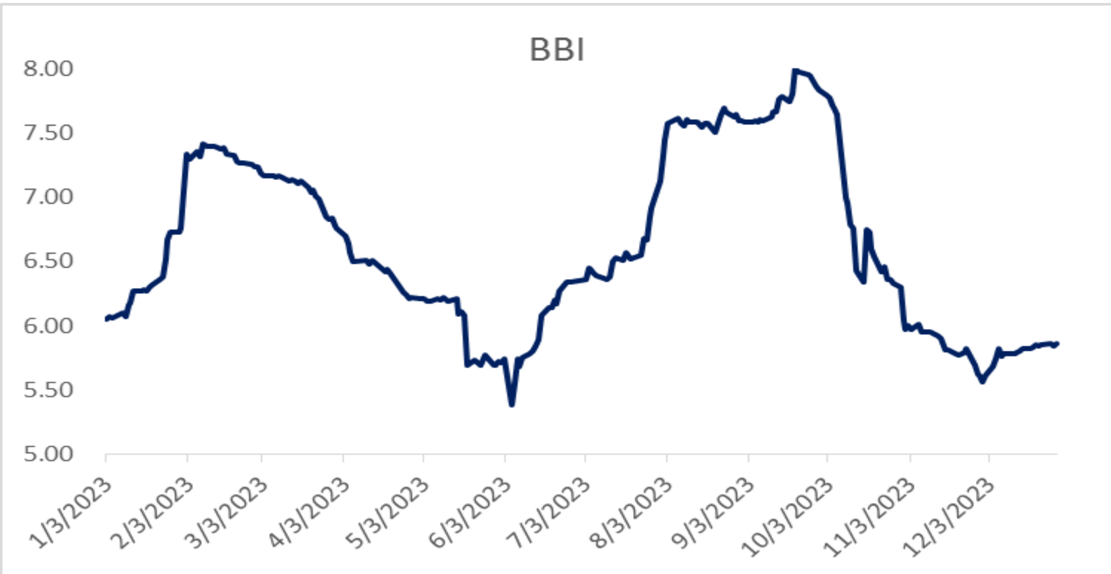
Figure 8: Lebanon yield curve in 2023



Source: BlomInvest

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 5.86 by the end of 2023, compared to 46.64 by the end of 2019. BBI specifically fell in 2023 by 2.82%.

Figure 9: Blom Bond Index 2023



Source: BlomInvest, BBI index

Conclusion:

In conclusion, in 2023, the global economy demonstrated unexpected resilience despite widespread monetary tightening and on-going policy uncertainties. While conflicts and climate-related shocks impacted millions, several developed economies exhibited strength, maintaining robust labour markets and consumer spending. Although inflation eased in many regions due to lower energy and food prices, many countries remain vulnerable while facing on-going risks. Looking at the year ahead, the conflicts in the Middle East will likely disrupt energy markets and pose on-going challenges.

Additionally, as major central banks prepare for the repercussions of interest rate hikes, the prospect of prolonged higher borrowing costs presents obstacles to an economy grappling with debt and the imperative for increased investment in growth, climate action, and progress towards Sustainable Development Goals (SDGs).

On the Lebanese front, Lebanon's economic and political landscape remains precarious, marked by the lack of reforms, the absence of a Head of State and the volatile economic environment. Furthermore, the on-going Israel-Hamas war introduces additional uncertainties that may impact Lebanon's economy throughout the upcoming year of 2024. Finally, urgent and comprehensive measures are essential to address these challenges and pave the way for stability and sustainable growth.

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