



According to the *Morningstar*, "bond markets remained steady for 2017."

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This report chooses to highlight the performance of bonds in the Lebanese, US, and EU markets. It aims to analyze 2017's distinctive indications that drove the performance of bonds whose markets witnessed unique overriding themes this year, namely highlighting: Lebanon's Prime Minister (PM) resignation crisis, the flattening of the US yield curve, as well as the noticeable improvement in the Eurozone's (EZ) growth and inflation.

US Bonds and a Flattening Yield Curve

In the US, investors' confidence in the economy improved in 2017. In fact, the Federal Reserve Bank (FED) hiked interest rates (IRs) in March, June, and December to the price range of 1.25% to 1.5% despite a stubborn inflation rate still below the FED's 2% benchmark. Increased IRs signaled investors' confidence in the market despite geopolitical tensions arising with North Korea throughout the year. Meanwhile, the economy's steady growth was underpinned by the FED's plans to shift its monetary policy and gradually begin to reduce its balance sheet.

Moreover, the US tax reform proposal fueled economic optimism. The Republican's tax cuts legislation slashed the corporate tax rate from 35% to 21%, fueling the economic optimism which culminated in US stocks indices gaining up to 20% over the year. By November, US payrolls expanded by 228,000 while the unemployment rate fell to a 17-year low of 4.1%, as inflation improved by 0.1%.

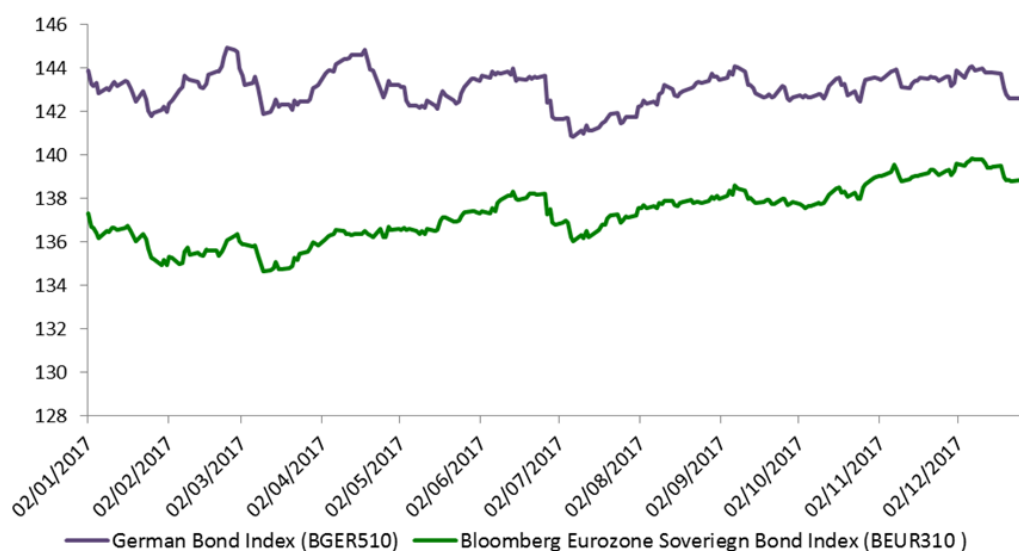
Against this backdrop, the spread between the 10Y and 2Y Treasury yields narrowed. Interestingly, the difference between the 10Y and 2Y yields narrowed from 125 basis points (bps) in Dec. 2016 to just 51 bps by Dec. 2017, driving the new phenomenon of a flattening yield curve. In details, the yield on the 2Y Treasury note, which is more sensitive to the path of rate increases, rose by as much as 69 bps from Dec. 2016 to December this year, while those on 10Y bonds stood at 2.4%, almost not budging from where they had started the year.

US Treasury Yields			
	2Y	5Y	10Y
Dec-16	1.20%	1.93%	2.45%
Jun-17	1.38%	1.89%	2.31%
Dec-17	1.89%	2.20%	2.40%

Source: US Dept. of the Treasury

Nonetheless, the flattening of the yield curve is not alarming yet. Historically, the flat (and subsequently inverted) shapes of the Treasury yield curve, which plots the yields of the various debt securities issued by the U.S. government, spark investor warnings of an impending economic slowdown. However, FED chair Janet Yellen, reassured the global community that the yield curve since the 2008 global financial crisis has been driven by the “sentiment in the credit market” rather than by the credit default risk. Other market experts also explained that a flattened yield curve is not as alarming, given that the global economy witnessed a multi-dimensional growth fueled by US pro-growth policies, central bank’s forward-guidance on their policies, and the ample liquidity which especially came on the back of the ECB’s and Bank of Japan’s accommodative bond-buying extended through 2017.

The European Bonds Market



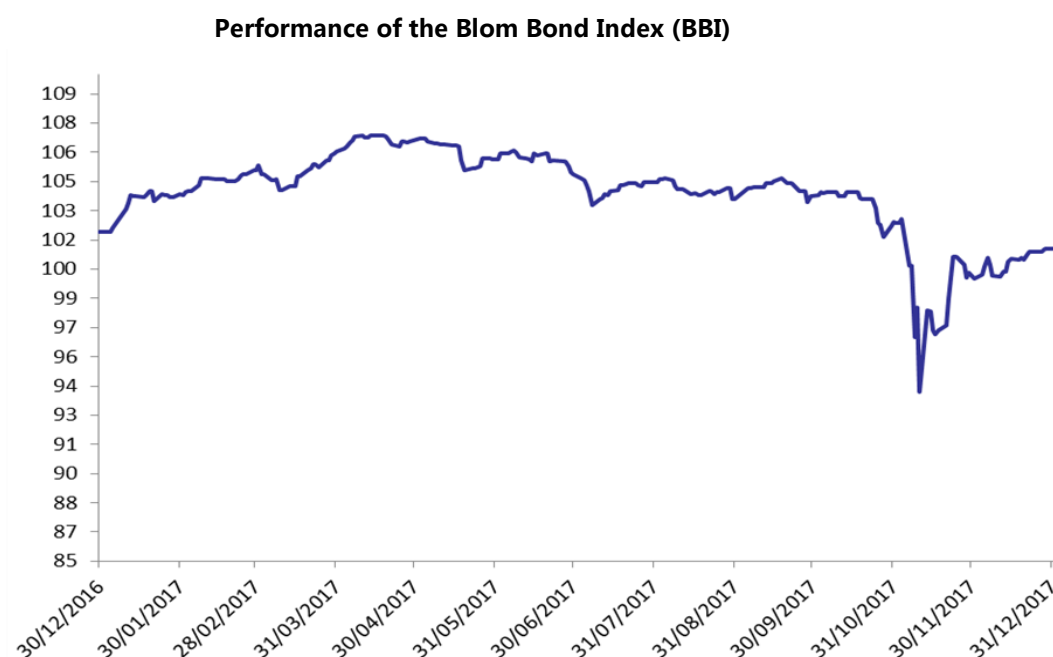
Source: BLOOMBERG

In Europe, the EZ expanded for 17 consecutive quarters as inflation rose. Investor’s confidence in the economy heightened, as unemployment hit an 8-year low of 8.8% in October and inflation stood at 1.5% in Nov. 2017, up from 0.6% in the same period last year. Meanwhile, the ECB extended its bond-buying program until Sept. 2018, but cut its purchases to €30B per month. The optimistic outlook to the economy may be attributed to the victory of Macron over French populist Le Pen early on in the year, coupled with the ECB’s flexible and accommodative monetary policy. Such a positive momentum dampened investors’ concerns regarding the ECB’s plan to taper quantitative easing. As such, Bloomberg’s compiled *Eurozone Sovereign Bond Index* rose by 0.96% y-o-y to end 2017 at 138.38 points, with most yields retreating by 1 to 2 bps by end December 2017 and yield curves flattening as they are driven by the US’s curves.

In Germany, September elections locked the country in a political stalemate with no government formed. Accordingly, German bond prices retreated by a yearly 0.88% to end 2017 at 142.48 points. The

yields on 10Y German bonds, used as a benchmark for the EU, dropped by 2 bps to 0.4% in Dec. 2017. Only by December did the parties agree to convene and break the impasse.

Lebanese Eurobonds: New Budget, Electoral Law, and a Shock Resignation

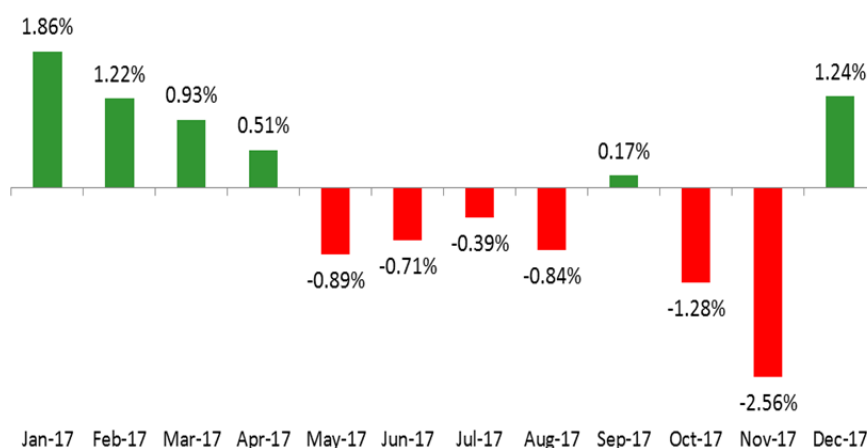


Source: BLOMINVEST Bank, Economic Research Dept.

In Lebanon, major disruptions on the political scene coupled with some security developments in the North of the country spurred speculation in the market, which translated into a weak performance of bonds throughout 2017. In fact, the Blom Bond Index (BBI), which tracks the prices of Lebanese Eurobonds, slipped by an annual 0.81%, to end the year at 101.06 points, which was its lowest in 8 years. Specifically, the performance of bonds in H1 2017 surpassed that of H2, knowing that foreign investors' perception of Lebanon's default risk in Q4 reached record highs of 616 basis points (bps), on the back of the shock resignation announced by the Lebanese Prime Minister (PM) Saad Hariri in the quarter.

During H1 2017, the performance of Lebanese Eurobonds was mixed. Knowing that the bonds market is highly correlated to the nation's political developments, the election of Michel Aoun as President in October 2016 after two years of presidential void and the formation of a cabinet thereafter spurred a positive performance in the beginning of the year. With the approval of the electoral law on June 16th, the BBI managed to gain 1.89% year-on-year (y-o-y) to stand at 104.88 points by June 2017. The BBI also rose by 2.92% year-to-date (y-t-d); however, the uptick was short-lived given investors were in a 'wait-and-see' mode vis-à-vis the endorsement of a draft budget.

Monthly Performance of the BBI



Source: BLOMINVEST Bank, Economic Research Dept.

As a result of investors' confidence growing in Q1 and in April, yields went down. The weighted average yield of Lebanese Eurobonds, inversely related to price, fell from 6.67% on Dec. 30, 2016 to 6.15% on June 30, 2017. As such, the yields on the 5Y and 10Y Lebanese Eurobonds contracted, slipping from 6.67% and 7.11% on Dec. 30, 2016, to 5.98% and 6.75% on June 30, 2017, respectively. The spreads between the 5Y and 10Y yields on Lebanese Eurobonds and their US counterparts narrowed from 474 bps and 466 bps in Dec. 2016, to 409 bps and 444 bps, respectively, in H1 2017. These reflected local investors' greater confidence in the Lebanese papers. Moreover, the 5Y Credit Default Swaps (CDS) quote which reflects foreign investors' perceived default risk by the government, narrowed substantially from a mid-quote of 520 bps on Dec. 30, 2016 to a mid-quote of 437 bps on June 30, 2017.

The March 23rd \$3B Eurobonds issuance which secured 20% participation by foreign investors also kept Q1's BBI in the green. The Lebanese Ministry of Finance (MoF) successfully issued US\$3B in Eurobonds to finance the public debt, of which \$1.5B replaced Eurobonds maturing on March 20th whilst the rest was injected as "fresh money" into the market. March's issuance made up of 3 tranches was the biggest single sovereign bond issuance denominated in foreign currency. According to the MoF, the issuance was 6 times oversubscribed, reaching \$17.8B of which \$1.25B came from "foreign" investors, namely banks and financial institutions, who subscribed to approximately \$600M of the total, one of the highest recorded for Lebanon. Lebanon's paper became "market-weighted", as investors believed the end of a 2-year presidential void will begin to support the economy.

However, demand on Eurobonds lost momentum by June 2017. The BBI decelerated in Q2 after President Michel Aoun suspended April's parliamentary sessions to give MPs the time to agree on an electoral law but the decision was delayed until June 16th. During this 'wait-and-see' period, the monthly BBI slid by 0.89% and 0.71% in May and June 2017, respectively.

Lebanese Eurobonds' performance in H2 2017 was inflicted by heightened security threats and the PM's shock resignation in November. Q3's BBI witnessed a 1.05% downtick from the first half of the year. Investors perceived Lebanon as a high-risk country, as the Lebanese Army stepped up its attacks against ISIS in Al Qaa and the outskirts of Ras Baalbeck and the outcomes were uncertain. Nevertheless, the contraction in the Eurobonds' performance was further amplified in Q4 which was packed with political disruptions. In fact, by September, the army announced its victory, yet the national priority became the draft budget and the proposed controversial tax hike law. Moreover, the resignation announcement of the Lebanese Prime Minister Saad Hariri from the KSA on Nov. 04, 2017 constituted the highlight of the year.

Against this backdrop, the BBI plummeted by 3.65% from H1, to stand at 101.06 points by December 2017, striking an 8-year low. The weighted average yield of Lebanese Eurobonds escalated from 6.15% by end June 2017 to end the year at 6.90%. Moreover, yields on the 5Y and 10Y Lebanese Eurobonds surged by 92 bps and 65 bps from H1 2017, to stand at 6.9% and 7.4%, respectively. Such a contracted demand on Lebanese bonds can be justified by the loss of investment appetite, as the economy was expected to weaken especially as it copes with the "Prime Minister crisis". Local investors' confidence in Lebanese bonds temporarily diminished, as shown by the swelling of spreads between the 5Y and 10Y yields on Eurobonds and their US counterparts. These jumped from 409 bps and 444 bps by June 2017, to end the year at 470 bps and 500 bps, respectively. Moreover, foreign investors' concerns rose in light of November's political crisis. This was apparent in the 5Y CDS quote which advanced from a mid-quote of 437 bps on June 30th, to a mid-quote of 520 bps on Dec. 29, 2017.

In Focus: November's Shock Resignation Crisis

It is worthy to explore the detailed impact of the Eurobonds' performance following the Nov.4th PM resignation that shook the country and raised speculation in the Lebanese bonds market by the end of 2017. The key repercussions and the country's improved yield curve can be summarized as follows:

Key Indicators of the Lebanese Bonds Market

	Nov. 3, 2017	Nov. 04, 2017	Nov. 10, 2017	Nov. 17, 2017	Nov. 22, 2017	Nov. 24, 2017	Dec. 01, 2017	Dec. 08, 2017	Dec. 15, 2017	Dec. 29, 2017
Blom Bond Index* (BBI) (in points)	102.59	PM Hariri Resignation Announcement	93.69	96.85	PM Hariri Resignation Suspended	100.64	99.53	99.64	100.51	101.06
5Y Lebanese yield	6.45%		8.55%	8.01%		7.00%	7.40%	7.30%	7.00%	6.90%
10Y Lebanese yield	7.23%		8.90%	8.18%		7.40%	7.62%	7.60%	7.50%	7.40%
5Y Lebanese Credit Default Swaps (in basis points)	498		553	592		528	545	541	530	520
5Y US yields	1.99%		2.06%	2.06%		2.07%	2.13%	2.14%	2.16%	2.20%
10Y US yields	2.34%		2.40%	2.35%		2.34%	2.37%	2.38%	2.35%	2.40%
Blom Stock Index (BSI) (in points)	1,167.50		1,130.09	1,094.84		1,108.86	1,115.82	1,118.95	1,136.40	1,148.57

Source: BLOMINVEST Bank, Economic Research Dept.

The resignation of the Prime Minister on Nov. 04th declared from Saudi Arabia shook Lebanon and raised geopolitical tensions. The BBI declined from 102.59 points pre-crisis (Nov.3rd), to 93.69 points post-resignation announcement, as foreign investors pulled away. The speculation around the return of the PM and the “official” resignation translated into Lebanon’s 5Y CDS escalating from 498 bps pre-crisis, to a record high of 616 bps on November 9th and down to 553 points on Nov.10th. Foreign investors pulled away from Lebanese safe haven investments, namely from medium-term Lebanese Eurobonds whose yields surged from 6.45% pre-crisis to 8.55% by Nov.10th. Similarly, yields on the 10Y Eurobonds rose from 7.23% pre-resignation announcement, to 8.90% by Nov.10th, reaching their highest levels in more than 5 years. Hence, the 5Y and 10Y spreads between the Lebanese Eurobonds and their US comparables climbed from 446 bps and 489 bps to 649 bps and 650 bps, respectively, over the same period.

By November 24th, markets began to absorb the impacts of the shock resignation. PM Hariri returned to Lebanon, only to also announce the withdrawal of his resignation upon the request of the president. Eurobonds started to move back to their pre-resignation shock levels; yet the recovery remained partial as revealed in the preceding table. In parallel, the 5Y and 10Y yields on Lebanese Eurobonds also began to readjust, respectively declining from 8.01% and 8.18% on Nov. 17th, to 7% and 7.4% on Nov. 24th.

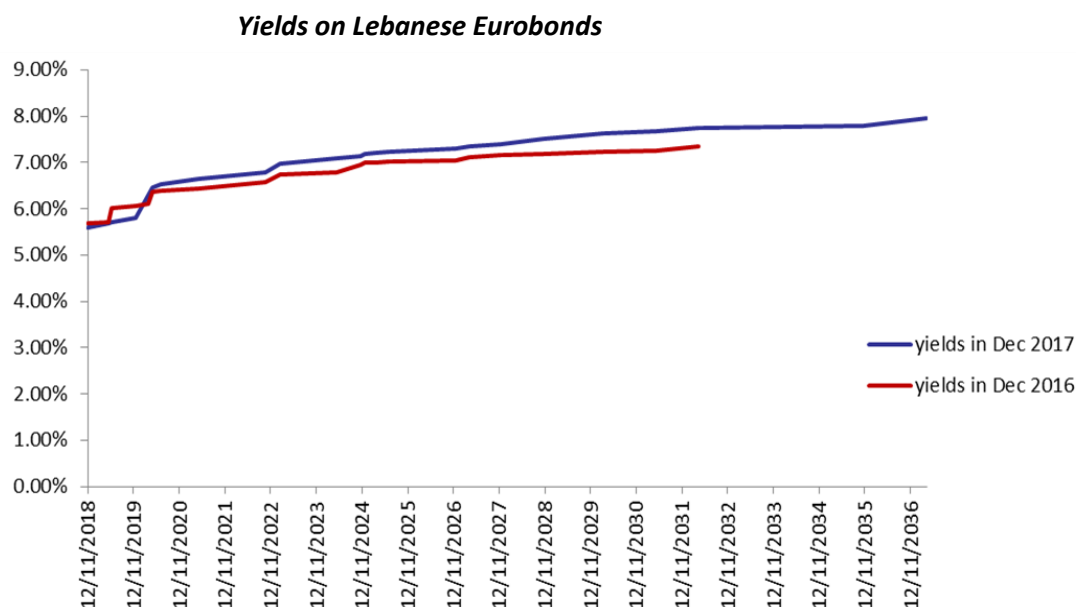
Following the resolution of the PM resignation crisis, the recovery of the Lebanese bonds market was partial. As the Lebanese bonds market began to recover end-November, the correction of yields on medium term maturities happened at a slower pace than that of the longer term issuances. In fact, the level of the 5Y yield stood at 55bps higher than its level pre-crisis, while that on the 10Y yield is at a 17 bps premium. This was complemented by the 5Y exceeding the spread on the 10Y bonds during the week ending Nov.30th. Together, both parameters may signal a lack of liquidity in the market, or alternately reflect investors’ preference for medium-term maturities over the longer term bonds. Nonetheless, commercial banks’ portfolio of Eurobonds in November recorded a monthly 2.51% decline to \$14.3B. This was a direct result of banks selling some of their Eurobonds post-crisis, to replenish their liquidity for USD which had contracted on the back of some depositors exchanging their LBP savings into USD amid the political crisis’ uncertainty.

In its turn, the MoF conducted a \$1.7B Eurobonds swap issuance on Nov. 27th. In parallel to banks increasing their deposits with BDL and selling some Eurobonds to replenish their USD liquidity, the MoF finalized a \$1.7B debt exchange with the Central Bank on Nov. 20th, to help boost BDL’s foreign currency reserves post-crisis. In details, LBP2.56 trillion worth of Treasury bills were redeemed in return for the equivalent of \$1.7B in Eurobonds. The new Eurobonds were issued in two tranches at par; a \$1B tranche maturing in 2031 with a coupon rate of 7.15%, and a \$700M tranche maturing in 2028, with a coupon rate of 7%. Only the composition of the debt stock was changed as a result of this transaction.

Lebanon’s Healthier Yield Curve

By December 29th, the recovery of the bonds market remained partial, owing it to increased interest rates on deposits. In details, the yields on the 5Y and 10Y bonds stood at 6.9% and 7.4%, compared to pre-crisis levels of 6.45% and 7.23%, respectively. This is largely attributed to interest rates on dollar deposits increasing from 3.72% in October to around 4% in December 2017. BDL’s hiking of interest

rates throughout the year paralleled the FED's 3 interest rate hikes conducted in the US in March, June and December 2017.



Source: BLOMINVEST Bank; Economic Research Dept.

Lebanon's higher interest rates post-crisis shifted demand away from Eurobonds, keeping bond prices subdued (capped) at low levels. As such, the respective 5Y and 10Y spreads between Lebanese bonds and their US comparables fell to 470 bps and 500 bps, compared to pre-crisis (Nov.3rd) levels of 446 bps and 489 bps. As for foreign investors, they partly feared the political uncertainty in the market regarding the concessions Hezbollah is willing to offer to resolve the resignation crisis. Hence, Lebanon's 5Y CDS locked at 520 bps on Dec. 29th, up from the 498 bps recorded on Nov.3rd.

Nevertheless, the yield curve in December 2017 is normalizing compared to 2016's, meaning yields on medium to long-term Eurobonds increased. The PM resignation crisis indeed pushed investors to demand a greater risk premium to lock in the rates on longer-term Treasuries in Lebanese Eurobonds. However, historically, the yield curve is not supposed to be as flat as December's 2016. In fact, 2017's lifted interest rates on USD and LBP deposits solidly sent yields on Eurobonds higher, especially on medium to long term bonds.

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