



July 26th 2019

Contact Information

Economist: Rouba Chbeir

rouba.chbeir@blominvestbank.com

Head of Research: Marwan Mikhael

marwan.mikhael@blominvestbank.com

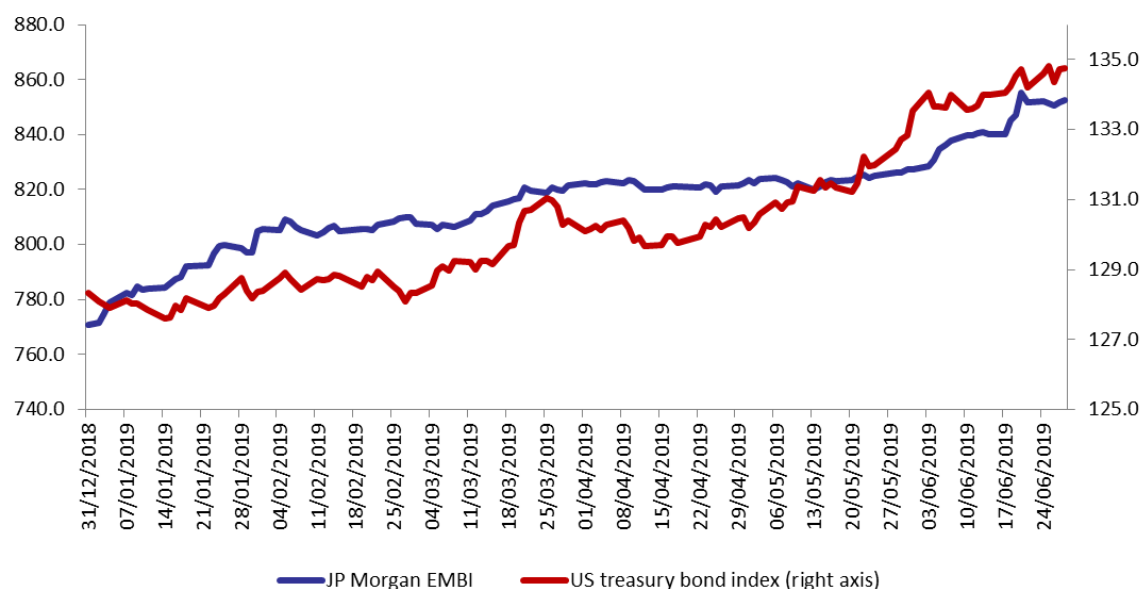
Research Department

Tel: +961 1 991 784

Abstract

Within the context of the most comparable bond markets to Lebanon's fixed income, namely the US and Emerging markets, the study aims to analyze the most distinctive indications driving the performance of Lebanese Eurobonds. The period's key events were Lebanon's government formation by end January 2019, and an 'austerity', reform-packed draft budget igniting some controversy before it was endorsed by May.

Snapshot



Source: Bloomberg; BLOMINVEST Bank

The US bonds market in H1 2019 was "where the action is". Demand on US treasuries grew as seen in the upward trend of bonds prices depicted in the graph. The Bloomberg compiled US Treasury bond Index registered a 5.16% YTD upturn by June 2019. The fixed income market emitted powerful signals on where the US economy may be headed. Uncertainty regarding the USA's economic outlook in H1 2019 heightened

on the back of 3 core developments: the partial government shutdown witnessed over building a wall on the US-Mexico border; ongoing heated negotiations and tensions over a permanent trade deal between Washington and Beijing which has been like an ebb and flow to investors up until the June G20 summit meeting when tensions were partially eased spurring some optimism; lastly, indications of an inverted yield curve alongside the FED's pledges to "*act as appropriate*" signaling an interest rate cut is almost a done deal in July 2019.

The US treasuries yield curve continued to flatten and yields on long-term bonds slumped. Short-term yields climbed over longer-dated yields, reflecting borrowing costs in the shorter-term are higher than the longer term which renders the yield curve more likely to 'invert'. In fact, yields on 10Y treasuries slipped from 2.69% on Dec. 30th 2018 to lows of 2% on June 28th 2019 and they were in fact surpassed by the yields on 3M treasuries standing at 2.12% by end June. Moreover, the differential between 10Y and 3M treasuries in its turn fell from 24bps by end-December 2018 to -12 bps by end June 2019, which is generally viewed as a precursor to a recessionary period. Meanwhile, the 10Y-2Y treasury yield spread grew closer to the "zero" mark as depicted below.

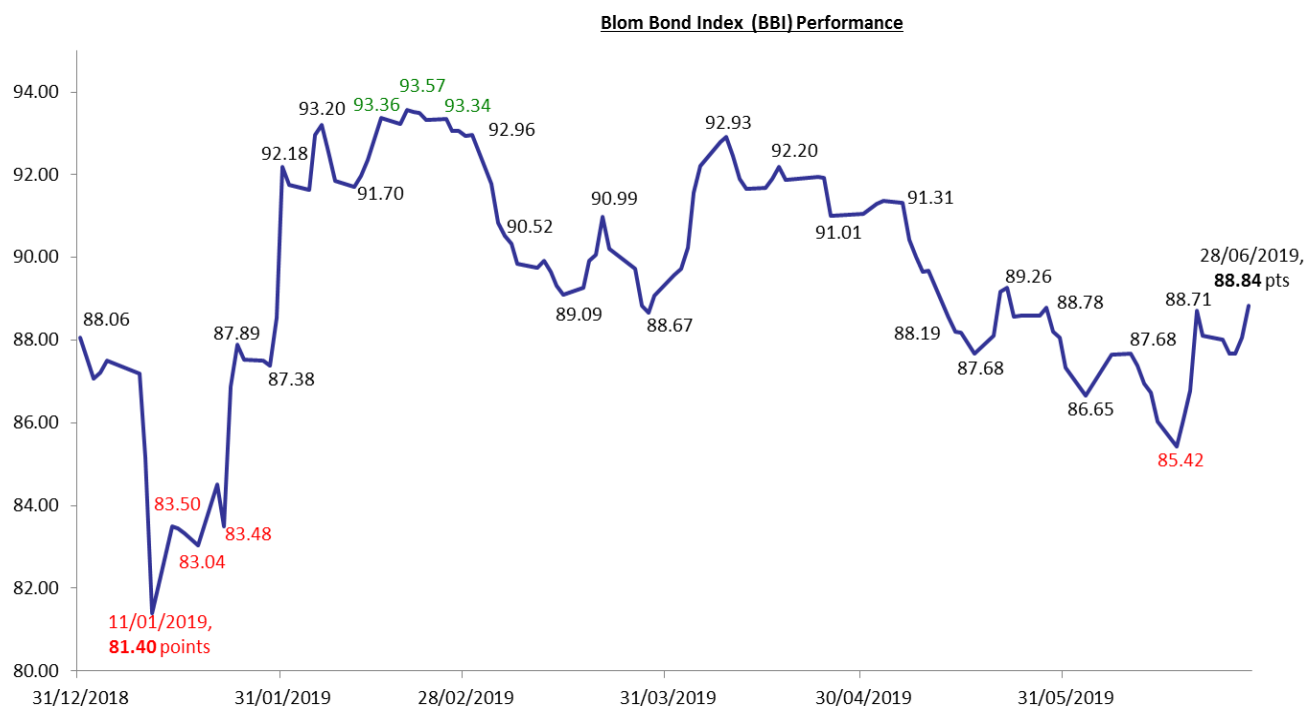


Source: FRED, US Treasury Dept.; BLOMInvest Bank

Consequently, yields on bonds in the emerging markets (EMs) also slumped. In H1 2019, the international bonds markets reflected a much slower growth environment which was also reflected in the EM's. With yields on US treasuries flattening, EM bond yields followed suit. The ongoing uncertainty in the euro zone (EZ) economy fueled by a slowdown in Germany and a deadlock among politicians on Brexit also resulted in the EU cutting its forecast growth to 1.3% from 1.9%. Concerns about the widespread impact from a prolonged trade war between US & China became a global risk factor, such that the IMF cut global growth from 3.7% to 3.5% for 2019 while some emerging economies also held off their bond issuances amid the rising tensions. Accordingly, the JP Morgan emerging Markets index recorded a 10.6% YTD growth to stand at 852.4 points end of H1 2019.

In Lebanon, the performance of the bonds market is highly correlated with the domestic and regional developments. Compared to its two counterparts, Lebanon's bond market witnessed increased demand on Eurobonds post-government formation, but it also mirrored an inverted yield curve best interpreted in-line with the country's political and economic scenes.

Lebanese Eurobonds



Source: BLOMINVEST Bank, Economic Research Dept.

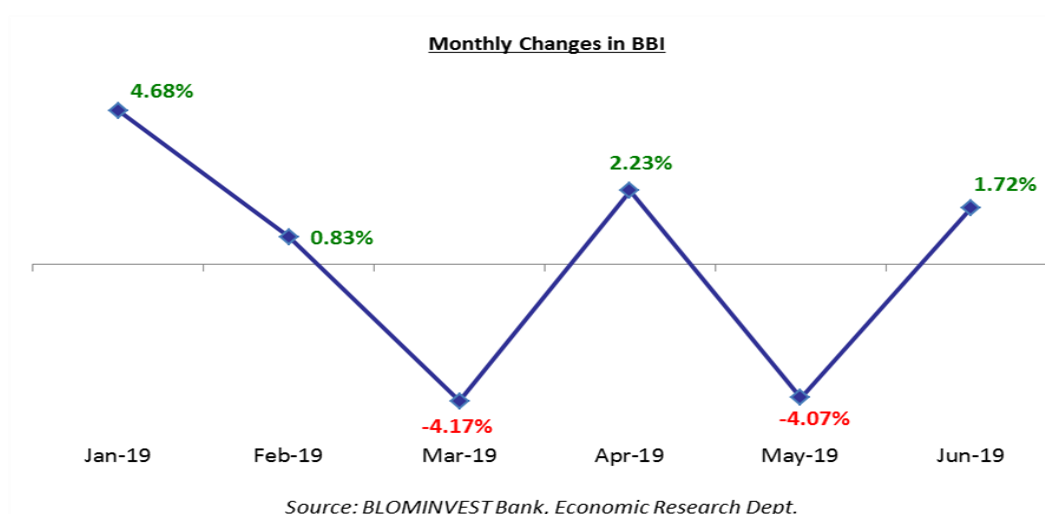
It is interesting to observe the index's price trend before government formation (Jan 31st) and post-formation during H1. Lebanon's economic growth stood at an estimated 0% by June 2019 while foreign and local investors were monitoring the political and economic developments. After 9 months of delay, Lebanon's government was formed on 31/01/2019 with the BBI marking a 4.55% YTD growth and the 5Y credit default swap falling from 793 bps to 709bps within 1 week. Prior to this date, Lebanon's Eurobonds prices witnessed declines, as depicted in the performance of the Blom Bond Index (BBI) above. The BBI witnessed short-lived adjustments after the 31st as pressures on the bonds market eased and the Lebanese 5Y credit default swaps (CDS) temporarily slumped, but investor's confidence was not fully restored in H1.

The appetite for Lebanese fixed income instruments was mixed in H1 2019, yet remained shy overall. The BLOM Bond Index (BBI), compiled by BLOMInvest Bank to track the prices of Lebanese Eurobonds, recorded a marginal 0.61% year-on-year (y-o-y) growth compared to a 1.89% gain in H1 2017 and a 15.81% plunge in H1 2018. The BBI also ended the first half of 2019 with feeble performance at 88.84 points, up by 0.89% year-to-date (YTD). The yields on 5Y and 10Y Eurobonds rose respectively from 10.80% and 10.70% by end 2018, to highs of 11.68% and 10.75% by end June 2019.

Local investors' confidence post government formation failed to materialize in Lebanon's fixed income market, as shown by the inflated spreads between the 5Y and 10Y yields on Eurobonds and their US counterparts. These expanded from 834 bps and 811 basis points (bps) by end Dec. 2018, to 997 bps and 888 bps, respectively, in H1 2019, reflecting the frail confidence of investors in Lebanese papers.

Lebanon remained without a government into H1 2019, with the BBI recording its lowest levels in January. Eight months onwards from the May elections, the country was still in a political stalemate with no unanimous decision among policy makers. Even though the index recorded a 4.68% uptick in January 2019 compared to December 2018 (as per the graph above), the BBI hit its lowest historical levels since Jan. 2000. Knowing the Lebanese bonds market is highly correlated to the nation's political developments, the index slumped to lows of 81.4 points on the 11th of January, a day after the Ministry of Finance made a statement that implied a plan to "*restructure the Lebanese debt*".

In comparison, the BBI stood at 92.24 points on the same day in 2018. Moreover, the price index stayed at lows of 83.04 pts and 83.48 pts by Jan. 18th and 22nd, despite the correction and revoking of the minister's statement on restructuring. *Moody's* rating agency actually issued a statement on the 22nd, downgrading Lebanon's credit rating to Caa1. This further capped the bond index at inferior levels, from its initial 100 mark.



The bond index witnessed some short-lived recoveries from February onwards, but the economy grappled with sizeable headwinds. By Jan. 24th and 25th, the BBI partly recovered on the back of a statement by the Qatari foreign minister that revealed his country's willingness to buy \$500 million of Lebanese government bonds to support the Lebanese economy. Moreover, upbeat news on promising prospects of forming a new government by the end of the month temporarily lifted investors' confidence. And on January 31st 2019, the country formed a government, which partially jolted the market while investors began to anticipate the implementation of a series of reforms to tighten fiscal imbalances and place debt on a sustainable trajectory. The optimism spurred in the market was reflected in the monthly

upticks in the index plotted in the above graph. Nonetheless, the index gains remained short-lived as the bonds' prices slumped by a monthly 4.17% and 4.07% in March and May 2019, respectively.

In details, the country's external balance and lengthy budget discussions subdued foreign investments.

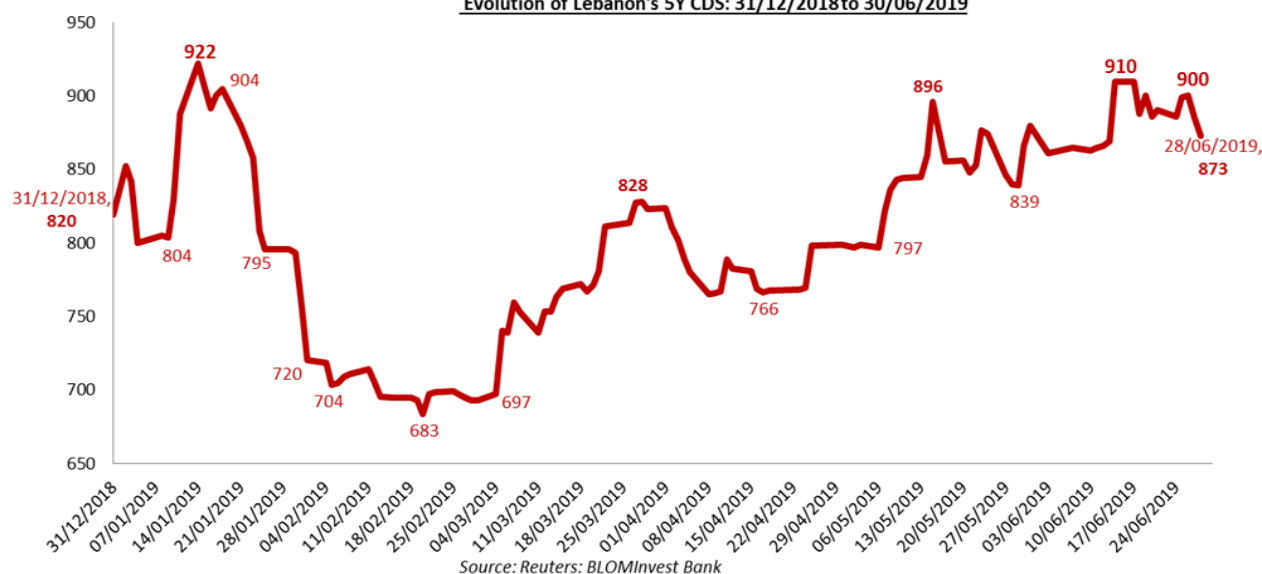
On the external front, the price of oil hit \$66.55/barrel on June 28th 2019, up from \$53.8/barrel by end Dec.2018. The growth in oil prices adversely impacted foreign investments coming into the country and further inflated capital outflows as recorded in Lebanon's balance of payments (BOP). In parallel, serious government talks regarding a new budget dominated the political scene, but the back-and-forth among members of parliament on the proposed reforms in the budget delayed its endorsement until May 2019. In fact, the BOP registered a deficit of \$5.19B by May 2019, reversing a \$430M in surplus by May 2018. The BOP deficit reached a sizeable \$1.88B in May alone, sending the BBI into a monthly 4.07% slump.

The magnified trade and fiscal deficits were a drag on the prices of Eurobonds during H1 2019.

Lebanon's trade deficit stood at \$7.32B by May 2019, widening from \$6.64B by May 2018. Despite the cash basis-fiscal deficit narrowing from \$1.9B by Apr. 2018 to \$1.4B by Apr. 2019, it benefited from one off factors including the 3.8% annual slide in oil prices to \$65.78/barrel by Apr.2019 which reduced EDL transfers for the period, while the reduced costs of servicing local currency debt can be linked to BDL's May 2018 swap operation. Meanwhile, public debt continued its upward trajectory, growing by 3.5% year-on-year (YOY) to hit \$85.4B by May 2019.

In this context, the yields on Lebanese Eurobonds fluctuated during H1 but they remained high. The yields shot up pre-government formation & amid budget discussions but eased when strong political will for reform surfaced. In details, prior to government formation on January 31st, the yields on Lebanese Eurobonds maturing in 5Y & 10Y climbed to highs of 13.4% and 12.12%, respectively, on Jan 11th. Yields eased between Feb. and May as the government emitted signs of political and economic willpower to set an austerity budget. Nevertheless, the yields shot up again by June 17th to highs of 12.42% and 11.65%, respectively. Investors were still awaiting progress on a promised budget but the parliamentary sessions and agreement on reforms were prolonged.

Evolution of Lebanon's 5Y CDS: 31/12/2018 to 30/06/2019



Moreover, foreign investors' perception of Lebanon's default risk reached unprecedented highs in H1.

Foreign investors' concerns rose in the first six months of the year on the back of: a lengthy budget endorsement process, ambiguity regarding structural reforms needed to unlock the CEDRE funds and critical economic parameters. In fact, foreign investors' perception of Lebanon's default risk is best reflected in the 5Y Credit Default Swaps (CDS) which climbed to the 900s-level, never reached since 2009. The mid-quote of the 5Y Lebanon CDS in H1 widened from 820 bps on Dec. 31, 2018 to 922 bps on Jan. 14th 2019 pre-government formation. Even following the budget endorsement and the formation of a government early on in the year, the 5Y Lebanon CDS stood at 900 and 873 bps by June 26th and 28th 2019, respectively.

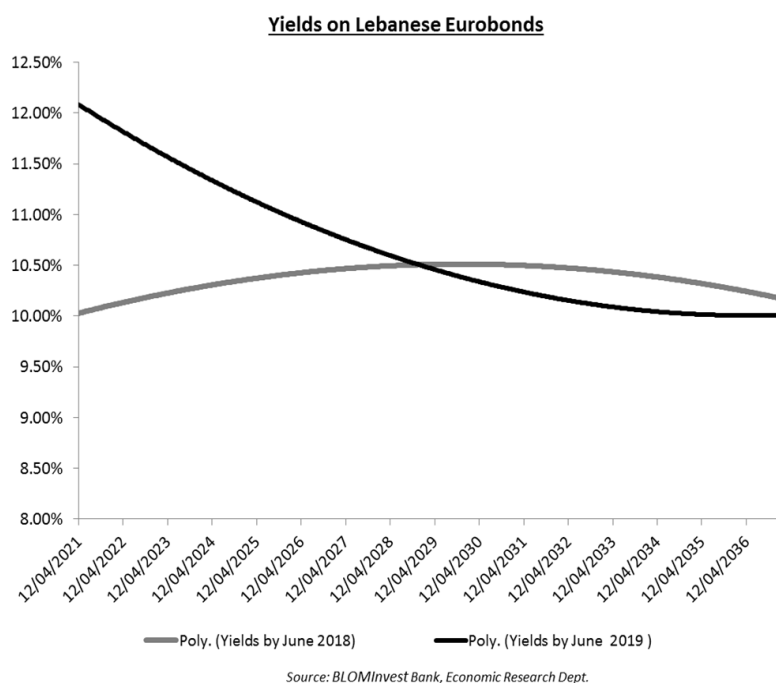
The yield curve remains inverted and reflects investors' fragile confidence in Lebanese papers. Bonds

are usually a safe haven. Hence, when investors lack confidence in the economy, like in Lebanon's today, they invest in long-term bonds to lock in the returns because they expect losses on the short term.

Against this backdrop, demand on long term 10Y Lebanese Eurobonds during H1 2019 was higher than 5Y bonds. As such, the yield curve below depicts higher yields for short-term bonds. In fact, Lebanon's inverted yield curve exhibited since Sept. 2018 to-date shows that Lebanon has still not

regained the confidence of investors with the slow and mixed developments on its political and economic fronts. However, with an increased demand on long term bonds, their yields begin to decline. Accordingly, the yields on the 2Y, 5Y, and 10Y Lebanese Eurobonds stood at 11.98%, an average of 11.44% for the different bonds maturing in 2024, and average of 10.25%, respectively compared to 9.92%, 10.34%, and 10.3%, respectively, on June 28th 2018.

Recent reports upgraded Lebanon's fixed income. The Lebanese bonds market is highly correlated with local political developments. At this stage, the country can attract once again new foreign investments and thus demand for Eurobonds can be bolstered albeit restoring prices & yields to normal levels if the budget implementation kicks off, political willpower remains robust, and implementation proves to be transparent. In fact, JP Morgan recently upgraded Lebanon from market weight to overweight. Moreover, Morgan Stanley Bank's July report stated that the latest parliament approval of the 2019 budget targeting a fiscal deficit of



7.45% of GDP would definitely help unlock some CEDRE funds, therefore restore investors' confidence and attract much needed capital inflows which in turn can spur growth in banking deposits which amplifies banks' ability to roll over sovereign debt.

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department Bab Idriss,
Weygand Str. POBOX 11-1540
Riad El Soloh Beirut 1107 2080
Lebanon

Rouba Chbeir, Economist

rouba.chbeir@blominvestbank.com

+961 1 991 784

Marwan Mikhael, Head of Research

marwan.mikhael@blominvestbank.com

+961 1 991 782

research@blominvestbank.com

Disclaimer

This report is published for information purposes only. The information herein has been compiled from, or based upon sources we believe to be reliable, but we do not guarantee or accept responsibility for its completeness or accuracy. This document should not be construed as a solicitation to take part in any investment, or as constituting any representation or warranty on our part. The consequences of any action taken on the basis of information contained herein are solely the responsibility of the recipient.