Economic Update

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Debt markets

Sovereign bond yields fluctuate in 4Q22 on shifting inflation and interest rate outlook

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Highlights

- Global bond yields fluctuated during Q4 but are still off their October highs on moderating inflation and smaller rate hikes.
- GCC medium-term sovereign yields dropped as limited supply boosted the attractiveness of local sovereign bonds.
- Inflation expectations, Fed rate policy moves, and the economic outlook will continue to influence bond market dynamics.
- GCC issuance reversed the declining trend in Q4, driven by the sovereign papers sold by Saudi and the UAE.
- Increasing interest rates and reduced sovereign financing needs may limit the flow of new issuances in the region.

Global bond yields fluctuate wildly in 4Q22; GCC sovereign bonds outperformed

Sovereign bond yields rose sharply in October before retreating later as the outlook for inflation appeared to moderate. However, a continued hawkish commentary by central banks pushed yields higher in the second half of December. GCC medium-term sovereign bonds outperformed their global peers, closing the final quarter of 2022 on a better note and posting quarter-on-quarter (q/q) declines in yields. The latest inflation print for most economies indicated that the worst phase of rising consumer prices has likely passed, although prices are still significantly elevated compared to pre-2022 years. In addition, the price momentum seems to be shifting from goods (such as energy) to services, which could keep the core inflation rate relatively elevated over the coming months. Major global central banks in December downshifted to interest rate hikes of 50 bps, following outsized increases earlier in the year. Further rate hikes are likely in 1H23, given still-elevated consumer prices and a tighter job market, which could keep bond yields high from a historical perspective. Inversely, any policy pivot towards rate cuts during the latter part of 2023 should drive a rally in bond prices and hence lower yields for benchmark papers.

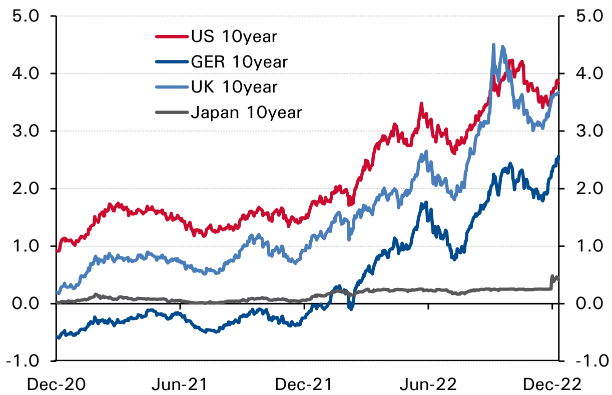
Meanwhile, GCC debt issuance reversed its declining trend and rose to $15.9 billion* in 4Q22 from $11.8 billion in 3Q22. The new issuance was mostly dominated by sovereign/quasi-sovereign sales in Saudi Arabia ($11.3 billion). Improving fiscal positions supported by higher oil prices this year helped the GCC governments lock in tighter spreads over US treasuries, despite lower financing needs.

Moderating inflation outlook pushed yields lower from historic highs despite continued rate hikes

Headline inflation in many developed economies has started to recede from decade-highs earlier last year as energy prices weakened. The core inflation print has also shown early signs of softening, albeit at still-high levels relative to previous years. This prompted central banks, including the Fed, to opt for a smaller rate hike of 50 bps in December, bringing the cumulative increase in the Fed funds target rate in 2022 to 4.25%. The widely watched dot-plot projections indicate a further 75 bps increase in the rate in 2023. The ECB and the BoE also delivered similar, smaller hikes of 50 bps each in December, after 75 bps increases in respective meetings earlier.

Bond yields faltered during 4Q22, softening from multi-year highs in October. (Charts 1 and 2.) However, benchmark bonds gave up the gains (except for UK gilts) in late December, following hawkish remarks by central banks, and ended the quarter with net q/q increases in yields.

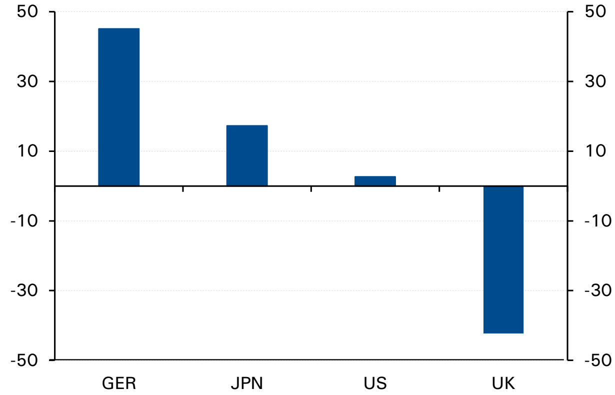
Chart 1: Global benchmark yields
(%)



Source: Refinitiv, as of 31 December 2022

In the final quarter, the yield on 10Y German bunds increased by a steep 45 bps q/q as the ECB president maintained a hawkish stance and anticipated two similar rounds of 50 bps increases in the benchmark rate in 1H23. In Japan, the BoJ unexpectedly allowed the trading band for yields on the 10Y Japanese government bond (JGB) to widen by 50 bps in either direction from its 0% target. This led to a quick jump of 17 bps in the yield during 4Q22. Yields on 10Y USTs were little changed q/q, although they had fallen by almost 40 bps from their peak in October after a sustained moderation in the headline inflation rate. As for UK gilts, these recovered significantly after the fiscal loosening measures announced by former PM Liz Truss were rolled back by the Sunak premiership. Moreover, as the outlook for the UK economy further deteriorated, the market anticipated the BoE pursuing a slower pace of policy rate rises.

Chart 2: Change in global 10-year yields in 3Q22
(basis points, q/q)



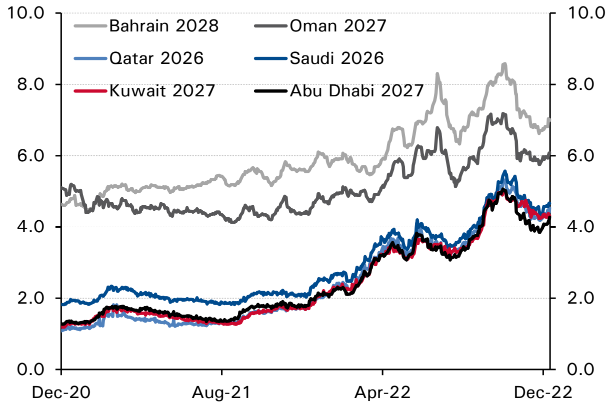
Source: Refinitiv, as of 31 December 2022

Economic growth prospects, Fed policy, and inflation expectations will continue to influence bond market dynamics. A continued tight job market has bolstered the hopes of a softer landing for the US economy than previously envisaged. If the trend in the job market is sustained, a higher allocation to riskier asset classes, including equities, could put some downward pressure on the prices of sovereign bonds. Moreover, the continued gap in the near-to-medium-term inflation trajectory and the central banks' 2% inflation target could keep policy rates elevated, supporting higher yields. On the other hand, a sharp deceleration in inflation due to perhaps sudden economic weakness, and consequently the adoption of a less hawkish approach by global central banks, could drive a surge in bond prices. Furthermore, any additional material pullback in the US dollar will also be supportive for bond prices in other markets, including Europe. Meanwhile, the Fed is currently pursuing 'passive QT' by allowing maturing US treasuries and agency mortgage-backed securities, at a rate of $60 billion and $35 billion per month, respectively, to roll off its balance sheet, which, all else equal, will add to upward pressure on yields. Any changes to these limits or announcements of other quantitative tightening schemes will impact the bond market.

GCC sovereign yields fell during 4Q22 amid strong fiscal balances and low bond issuance

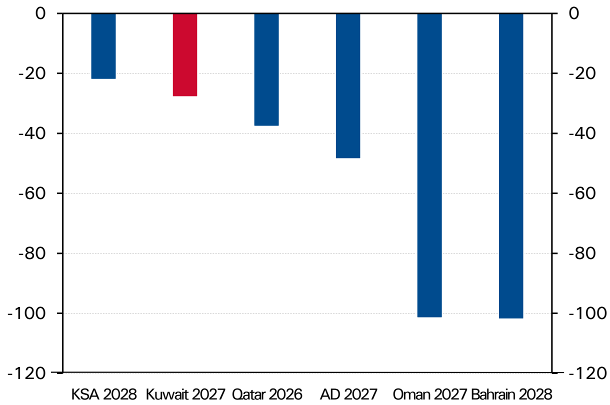
GCC medium-term sovereign bond yields fell in 4Q22, unlike their global peers, as strong fiscal balances and robust non-oil growth outlooks boosted the attractiveness of regional bonds amid a falling supply of new benchmark papers. Bahrain and Oman led the drop, with both seeing over 100 bps falls in yields, while larger oil producers, including Kuwait, recorded relatively moderate declines, ranging from 22-48 bps during the quarter. (Charts 3 and 4.) Rating agency S&P upgraded Oman's sovereign credit rating twice in 2022, most recently in November to 'BB' (stable) from 'BB-,' citing significant improvements in the Sultanate's public finances. As for Bahrain, its revenue consolidation approach, including increasing the VAT to 10% earlier last year, along with a positive spill-over effect of rising non-oil GDP in Saudi Arabia, has helped improve the fiscal position. S&P in November raised the outlook for Bahrain to positive from stable.

Chart 3: Medium-term GCC sovereign yields
(%)



Source: Refinitiv, as of 31 December 2022

Chart 4: Change in GCC medium-term yields in 4Q22
(basis points, q/q)

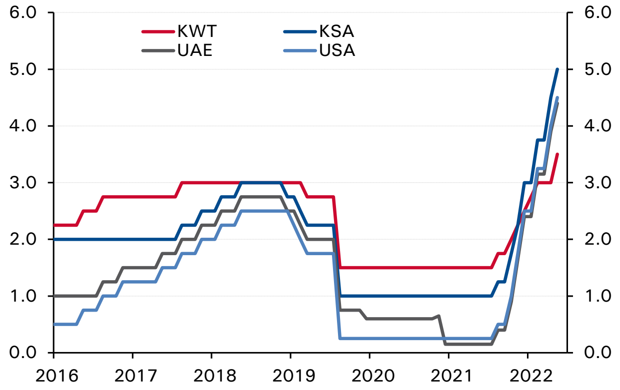


Source: Refinitiv, as of 31 December 2022

GCC central banks also ratcheted up benchmark rates in response to the rise in US Fed rates. Saudi Arabia and the UAE mirrored the Fed's moves, delivering a cumulative 125 bps hike during 4Q22. The Central Bank of Kuwait took a more gradual approach, only raising the discount rate by 50 bps in the fourth quarter in December (Chart 5.) The gradual rise in the Kuwait discount rate has pushed the historically positive spreads over Saudi Arabia, the UAE, and US policy rates into negative territory. GCC bond yields will continue to follow global markets broadly and could reverse some of the gains given still-high inflation and the possibility of further rate hikes by the Fed. That said, still-elevated oil revenues and much improved fiscal positions could lessen the potential for significant increases in regional bond yields, given lower financing needs.

Chart 5: Benchmark policy rates

(%)



Source: Refinitiv, as of 31 December 2022

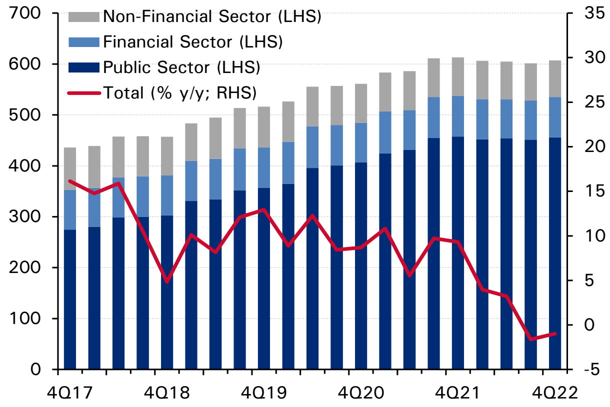
GCC bond issuance reversed the declining trend in Q4

GCC domestic and (USD) Eurobond gross issuance reversed its declining trend, increasing to $15.9 billion in 4Q22 from $11.8 billion in 3Q22 and $14.7 billion in 2Q22. (Tables 1 & 2.) The region's outstanding debt stood at $607 billion at the end of 4Q22, up slightly from 3Q22. (Chart 6.) During most of 2022, the amount of new issuance fell due to rising debt-servicing costs, reduced deficit financing needs amid elevated oil prices, and commitments to medium-term fiscal reforms. However, the rise in new issuance in 4Q22, particularly in Saudi Arabia, could be attributed to the government's willingness to lock in tighter spread over US treasuries as the region continues to benefit from high oil revenues and improving fiscal positions.

Sovereign issues from Saudi Arabia and the UAE comprised the bulk of debt offerings in 4Q22. The government of Saudi Arabia issued $5 billion through its first EMTN programme in almost a year, in two tranches of $2.5 billion each. In addition, Saudi government continued with its domestic sukuk issuance programme, selling $3.3 billion new sukuk, up from $2.1 billion in the previous quarter. Saudi's PIF also raised green bonds worth $3 billion in three tranches. In Abu Dhabi, Mubadala raised $1 billion in Formosa bonds. Among notable corporate issuances, Al-Ahli Bank of Kuwait, along with its Dubai-based subsidiary, signed a $825 million, 37-month term-loan facility. Kuwait sovereign issuances, however, will likely remain muted given the still-pending debt law, parliamentary approval of which will allow the government to tap international and local debt markets.

Chart 6: GCC outstanding debt

($ billion)



Source: Refinitiv, Saudi National Debt Management Center

Table 1: New GCC issuance by sector ($ billion)

	4Q-21	1Q-22	2Q-22	3Q-22	4Q-22
Public Sector	12.1	9.5	12.0	8.7	12.3
Financial Sector	1.3	6.5	2.4	1.7	3.6
Non-Financial Sector	0.8	2.3	0.4	1.4	0.0
Total	**14.2**	**18.3**	**14.7**	**11.8**	**15.9**

Table 2: New GCC issuance by country ($ billion)

	4Q-21	1Q-22	2Q-22	3Q-22	4Q-22
Bahrain	1.6	1.3	1.4	1.0	0.0
Kuwait	0.0	0.5	0.1	0.0	0.8
Oman	0.0	0.0	0.0	0.0	0.0
Qatar	0.8	0.6	0.2	2.1	1.0
KSA	6.5	11.0	10.2	3.5	11.3
UAE	5.3	4.9	2.7	5.2	2.7
GCC	**14.2**	**18.3**	**14.7**	**11.8**	**15.9**

Source: Refinitiv, Saudi National Debt Management Center
*Debt issuance figures comprise notes and bonds issued in domestic and Eurobond (USD denominated only) markets with tenors of one year or more (excludes short-term bills).

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