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Economic Update

NBK Economic Research Department I 20 April 2023

Debt markets

Bond yields fell in 1Q23 amid higher recession risks and softening inflation

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Highlights

- **Global benchmark bond yields fell sharply in 1Q23 as banking sector stress heightened US recession risks.**
- **GCC medium-term sovereign yields followed global peers lower, with Saudi Arabia seeing a relatively modest fall.**
- **Saudi sovereign issuance gained momentum in Q1, while other GCC markets (except the UAE) were muted.**
- **A significant fall in yields from here may be unlikely until economic readings and inflation deteriorate abruptly. Inversely, signs of resilient economic conditions and more persistent inflation could stall Fed rate cuts and keep yields higher.**

Global bond yields retreat amid US banking tremors

Global benchmark bond yields fell sharply during 1Q23 as the risks of a US recession increased. The US bank failures have fueled fears about tightened credit and liquidity conditions, along with persisting risks about the health of the commercial real estate market, causing a domino effect. The market expects interest rates to soften later this year, boosting bond prices. In addition, the incoming economic data continue to be weaker, raising hopes of a sustained disinflationary trend. GCC sovereign yields fell too, taking global cues. Going into 2Q, bond yields remain relatively soft despite ticking up recently, with worries of a recession lingering. Swelling concerns about the deteriorating economic backdrop could further boost bonds' usual "safe-heaven" appeal, pressuring yields. Inversely, volatile commodity prices, including oil, present uncertainty for the inflation rate trajectory, keeping bond markets on tenterhooks.

Meanwhile, GCC debt issuance increased further during 1Q23, as regional governments and companies raised $21.3bn* in debt, following $17.2bn in 4Q22. As usual, the new issuance was dominated by sovereign/quasi-sovereign sales in Saudi Arabia.

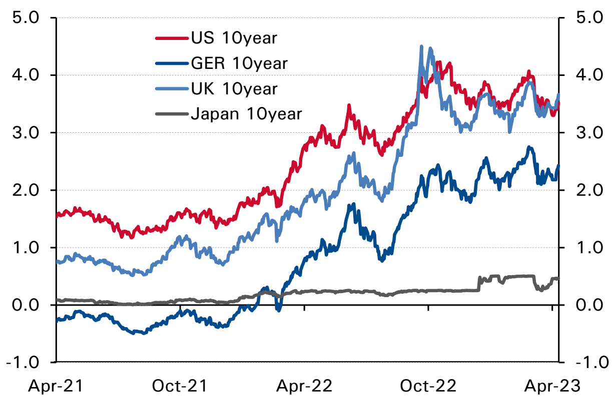
Recession worries put interest rates on a falling trajectory

Headline inflation in developed economies has started to ebb as the impact of tightened monetary policies takes place and energy costs decline versus a year ago. However, core inflation remains elevated and has yet to soften as much. Most central banks continued to push policy interest rates up, albeit downshifting the pace versus 2022. The Fed raised rates by 25 bps each in its last two meetings, while the ECB delivered two equal increments of 50 bps during Q1. The latest hikes came despite still-developing turmoil in the US and European (Credit Suisse fiasco) banking industry. However, expectations are building that the current rate-hike cycle is nearing its end as the disinflation process continues.

Bond yields initially rose in early March on a hawkish Fed stance. But they subsequently gave up those gains, as the failure of the US-based Silicon Valley Bank worsened jitters about a recession and a potential credit crunch, driving yields lower in the second half of the month. (Chart 1.) For now, a full-blown banking crisis seems unlikely, with deposit outflows reversing the trend in recent weeks, implying relative stability in the banking sector. Bonds may become volatile if contagion fears resurface, leading to materially squeezed liquidity and credit conditions. But any strong responses from policymakers – as seen in late March – will help ease liquidity, restore confidence, and stabilize yields.

Chart 1: Global benchmark yields

(%)

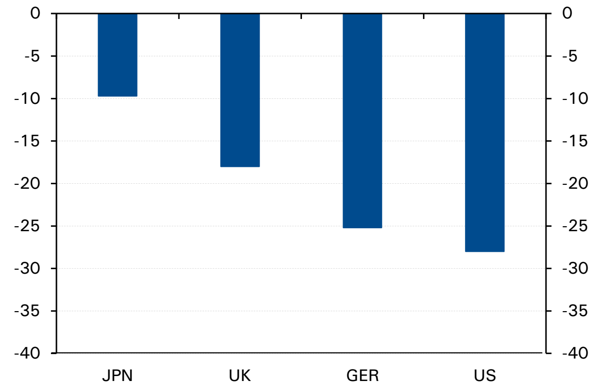


Source: Refinitiv, as of 14 April 2023

The drop in developed market yields in 1Q23 was led by US treasuries (10Y yield down 28 bps), followed by German Bunds (-25 bps) and UK gilts (-18 bps). (Chart 2.) Japanese government bond yields also declined from the Bank of Japan's (BoJ) ceiling of 0.5%. The change in leadership at the BoJ initially fueled a rally in yields but faltered on ambiguity about a potential change in the BoJ's ultra-loose monetary policy.

Chart 2: Change in global 10-year yields in 1Q23

(basis points, q/q)



Source: Refinitiv, as of 31 March 2023

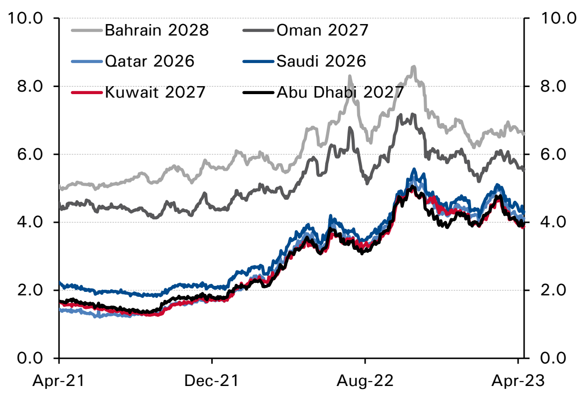
The Fed remains steadfast in achieving its 2% inflation goal and does not expect to reduce rates this year. The markets, however, hold an alternate view and believe the Fed will relent amid deteriorating economy, with expectations of at least a 50 bps rate cut factored in current yields. No change in the Fed's stance (in case of renewed/sustained inflationary pressures) may drive volatility in bond markets. In contrast, continued weakness in economic releases and a further loosening in the labor market would help move more funds into relatively safer assets, including benchmark bonds, sending yields lower.

GCC sovereign yields tracked global peers lower

Medium-term sovereign bond yields in 1Q23 retreated for the second consecutive quarter, with Qatar and Kuwait leading the drop, declining by 29 bps and 27 bps, respectively. (Charts 3 and 4.) Saudi Arabia, usually the largest issuer in the region, recorded a smaller fall in yields (-7 bps) during Q1, despite an upgrade in its credit rating by S&P to 'A/A-1' with a stable outlook citing significant progress on reforms and a structural improvement in non-oil segments. Given an overall solid improvement in the sovereign profile of Saudi Arabia, the country's bond prices had rallied strongly in 4Q22, resulting in lower yields and a narrower spread over US benchmark bonds. However, in 1Q23, the spread widened again, as the yield on Saudi Arabian bonds fell by less than the decline in the US and other GCC countries.

Chart 3: Medium-term GCC sovereign yields

(%)

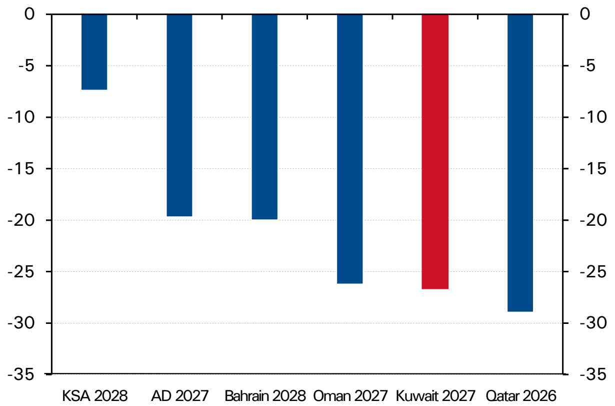


Source: Refinitiv, as of 31 March 2023

Looking ahead, the appeal of the regional bond market remains intact, as stronger balance sheets amid elevated oil prices and sustained progress on reform-oriented policies provide a better view of the long-term economic outlook. As such, GCC bonds are likely to be relatively well supported in case of any heightened uncertainty in the global bond markets.

Chart 4: Change in GCC medium-term yields in 1Q23

(basis points, q/q)



Source: Refinitiv, as of 14 April 2023

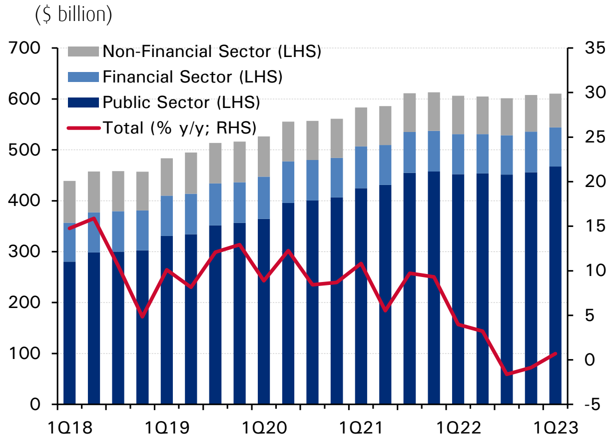
GCC bond issuance increases further amid lower needs

GCC domestic and (USD) Eurobond gross issuance gained momentum in Q1, rising to $21.3bn from $17.2bn in 4Q22 and $11.8bn billion in 3Q22. (Tables 1 & 2.) The region's outstanding debt stood at $611bn at the end of 1Q23, up slightly from the previous quarter. (Chart 5.) Overall, the near-term need to raise debt is lower, given elevated oil revenues and improved fiscal balances. Nonetheless, regional governments, particularly Saudi Arabia, have been taking advantage of a narrowing spread over benchmark US bonds (although spreads widened recently, they remain attractive on the back of improved fiscal positions), locking in better pricing, and issuing significant amounts of new bonds and sukuk, partly to refinance existing debt.

As usual, sovereign issues from Saudi Arabia and the UAE comprised the bulk of debt offerings in 1Q23. The Saudi government issued $10bn Eurobonds in 5, 10.5, and 30-year tranches. While Saudi-owned PIF raised its second green bond in four months, issuing $5.5bn in three tranches of maturity in 7, 12, and 30 years, receiving bids worth $32bn. In addition, the Saudi government continued with its domestic sukuk issuance programme, selling $2.8bn new sukuk, down from $3.3bn in the previous quarter.

The Emirate of Sharjah also raised $1bn in green bonds in 1Q. Among notable corporate issuance, UAE's First Abu Dhabi Bank issued $600mn bonds, maturing in 5.25 years.

Chart 5: GCC outstanding debt



Source: Refinitiv, Saudi National Debt Management Center

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

	1Q22	2Q22	3Q22	4Q22	1Q23
Public Sector	9.5	12.0	8.7	12.3	19.3
Financial Sector	6.5	2.4	1.7	4.4	1.8
Non-Financial Sector	2.3	0.4	1.4	0.6	0.2
Total	**18.3**	**14.7**	**11.8**	**17.2**	**21.3**

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

	1Q22	2Q22	3Q22	4Q22	1Q23
Bahrain	1.3	1.4	1.0	0.0	0.0
Kuwait	0.5	0.1	0.0	1.4	0.0
Oman	0.0	0.0	0.0	0.0	0.0
Qatar	0.6	0.2	2.1	1.8	0.7
KSA	11.0	10.2	3.5	11.3	18.3
UAE	4.9	2.7	5.2	2.7	2.3
GCC	**18.3**	**14.7**	**11.8**	**17.2**	**21.3**

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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