Economic Update

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Debt markets

Sovereign bond yields rise sharply amid persistent inflation and outsized rate hikes

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Highlights

- **Global bond yields surged during Q3 on persistently high inflation and larger rate hikes by most central banks.**
- **GCC medium-term sovereign yields followed global counterparts higher, also reflecting a fall in oil prices.**
- **Inflation expectations, Fed rate policy and the economic outlook will continue to influence bond market dynamics.**
- **GCC issuance eased further in Q3, with new issuance mostly driven by sovereign entities from Qatar, Saudi and the UAE.**
- **Increasing interest rates and reduced sovereign financing needs may further slow issuance in the region.**

Global yields surged in September to multi-year highs

Bond yields across most markets went past their June highs in September to touch multi-year highs. Persistently elevated inflation, outsized interest rate hikes, and hawkish commentary by major central banks led to sell-offs in most financial assets, including benchmark sovereign bonds. Moreover, weakening global currencies against the US dollar provided no respite from high imported inflation (mainly energy and other-commodity-related), keeping the outlook for further rate hikes intact in many markets. As a result, yields may remain high until consumer price inflation moderates convincingly and/or central banks alter the course of policy tightening amid the deteriorating economic landscape. Yields in GCC bond markets largely mirrored their global counterparts, as regional central banks followed the US Fed in increasing the local policy rates, with Kuwait pursuing a more measured approach than other regional banks.

Meanwhile, GCC debt issuance further eased to $11.1 billion* in 3Q22 from $14.7 billion in 2Q22 and $18.3 billion in 1Q22. The new issuance was mostly dominated by sovereign schemes in Qatar, Saudi Arabia, and the UAE. The underlying trend of easing new issuance in the region could continue in the coming quarters, given improved fiscal positions (due to elevated oil prices) and the rising interest cost.

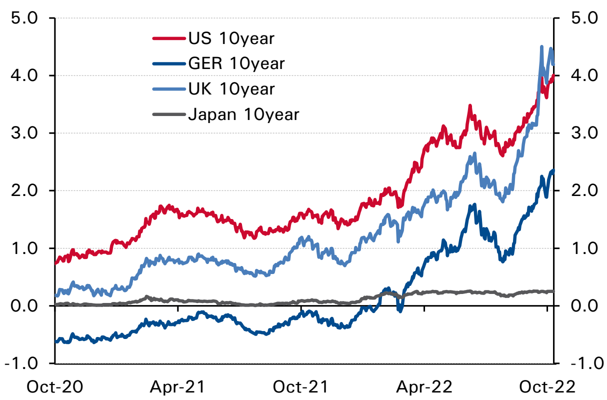
Stickier inflation kept yields high amid Fed hawkishness

Despite headline inflation showing some easing in the US, the core rate has remained sticky. Core CPI inflation accelerated to 6.6% y/y in September from 6.3% the month before. While in Europe, inflation has been hovering around 10% mark and is refusing to budge so far. The Fed in September increased rates by 0.75%, bringing cumulative hikes to 3% since March this year. The widely watched dot plot projections indicated a further 1.25% increase in the Fed fund target rate by the year-end, followed by a 0.25% rise in 2023. The ECB and the BoE also delivered hikes of 75 bps and 50 bps, respectively.

Acute selling followed in the bond markets, pushing yields higher in late September, with the US 10-year treasury crossing the 4.0% mark for the first time in 12 years. Although it then fell back, this drop was subsequently reversed as investor expectations regarding a Fed's pivot shifted following the latest high US inflation print. Adding to market nervousness, the BoE was forced to buy long-dated UK gilts as an interim measure in order to address spiking yields linked to liquidity issues facing pension funds. UK yields have continued to waver, and remain high amid worries over the government's unfunded fiscal expansion programme (which it was forced to cut back in mid-October) and the BoE's planned suspension of its emergency bond-buying programme.

Chart 1: Global benchmark yields

(%)

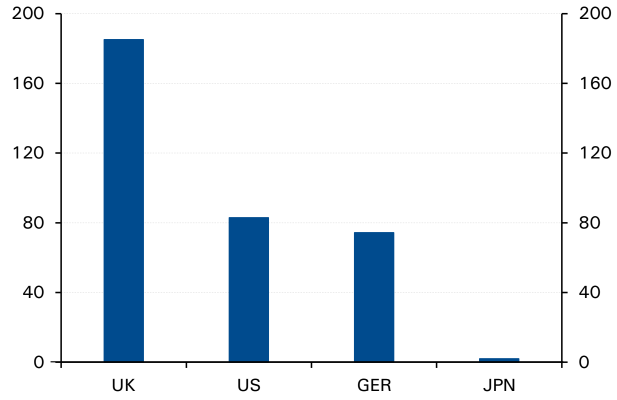


Source: Refinitiv, as of 14 October 2022

In Q3, yields in developed markets increased steeply, with UK 10-year gilts posting the sharpest rise of 185 bps to 4.09%, propelled by PM Truss's contentious deficit budget and other economic reforms in the latter half of September as noted above. The US 10-year bonds also saw yields rising 83 bps to 3.8%, with the 2-10 year spread widening to the most inverted reading in several years of almost 50 bps, foretelling an impending recession. German bunds were no different, with yields soaring by 74 bps to 2.11% during 3Q22. Japanese bond (JGBs) yields wavered during the quarter and ended with a small increase of 2 bps q/q to 0.25%, on 10-year paper, after rising by 8 bps from early August lows. The BoJ is actively seeking to contain JGB yields at around the 0.25% level by rigorously buying the bonds.

Chart 2: Change in global 10-year yields in 3Q

(basis points, q/q)



Source: Refinitiv, as of 30 September 2022

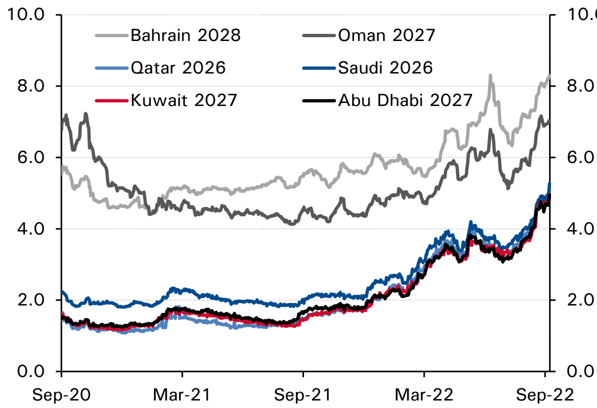
Economic growth prospects, Fed policy, and inflation expectations will continue to influence bond market dynamics. The US 10-year treasury yield could rise further in the event of steep rate hikes amid persistent inflation and robust economic data (mainly on the employment front). On the other hand, a possible deceleration in inflation and/or sudden economic weakness, and consequently a less hawkish approach by the Fed, would be among the counter-weighing factors. Meanwhile, the Fed is current pursuing 'passive QT' by allowing maturing US treasuries and agency mortgage-backed securities 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 followed global peers higher

GCC medium-term sovereign bond yields rose in tandem with global markets, up by 78-130 bps during Q3. A 23% fall in crude oil prices in Q3 also weighed on GCC bonds, as the region's large oil producers saw among the higher increases in yields. (Charts 3 and 4.) The yield on Qatar's 2026 bonds jumped by 130 bps followed by a 109 bps rise in Abu Dhabi's 2027 bond. Kuwait's 2027 bond also recorded a 103 bps increase in yield during Q3. Sovereign bonds of Oman and Bahrain did better as the premium over other GCC countries appeared to narrow during the quarter. Fitch recently upgraded Oman's sovereign credit rating 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 this year, along with a positive spill-over impact of rising non-oil GDP in Saudi Arabia, has helped improve the fiscal position.

Chart 3: Medium-term GCC sovereign yields

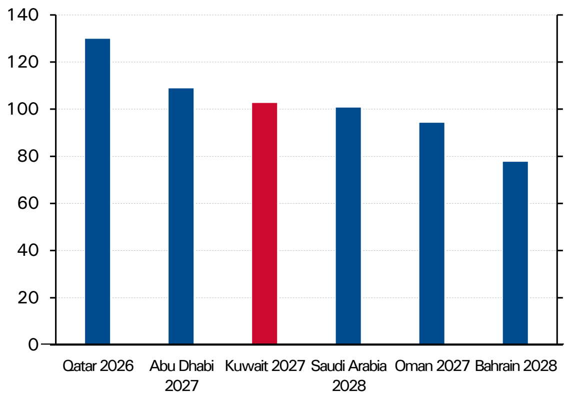
(%)



Source: Refinitiv, as of 14 October 2022

Chart 4: Change in GCC medium-term yields in 3Q

(basis points, q/q)



Source: Refinitiv, as of 30 September 2022

GCC central banks also ratcheted up benchmark rates in response to the rise in the US Fed rates. While Saudi Arabia and the UAE delivered two hikes of 75 bps each during Q3, mirroring the Fed, the Central Bank of Kuwait took a more gradual approach and raised the discount rate by 25 bps in three separate moves. (Chart 5.) The graded rise in the Kuwait discount rate has pushed the historical positive spreads over Saudi Arabia, the UAE, and the US policy rates into a negative territory.

GCC bond yields will continue to follow global markets and could rise in the coming months, given high inflation and the possibility of further rate hikes. That said, still-elevated oil prices and much improved regional fiscal positions could lessen the potential for significant increases in yields, given lower financing needs.

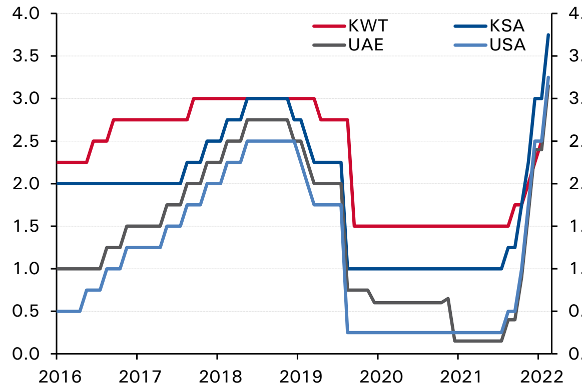
GCC issuance eases further in 3Q22

GCC domestic and (USD) Eurobond gross issuance eased further to $11.1 billion in 3Q22 from $14.7 billion in 2Q21. The region's outstanding debt stood at $601 billion at the end of 3Q22, down slightly from Q2. The falling value of new issuance could be attributed to rising debt-servicing costs, reduced deficit financing needs amid elevated oil prices and commitments to medium-term fiscal reforms. Most of the Saudi issuance this year appears to be refinancing-related, as stated in the Saudi Debt Management Center annual borrowing plan. Sovereign issues from Qatar, Saudi Arabia, and the UAE comprised the bulk of debt offerings in 3Q22. The UAE government issued federal Eurobonds worth $3 billion in two tranches of 10 years and 30 year maturities. Saudi Arabia continued with its domestic sukuk programme by issuing $2.1 billion new sukuk, down from $8.1 billion in 2Q. The Qatari government raised $2 billion in a 3-year local currency bond, while the Central Bank of Bahrain borrowed $530 million in Bahraini dinar. Among notable corporate issuances, Saudi's National Shipping Company (Bahri) raised $1 billion in a 7-year SAR-denominated sukuk, followed by Abu Dhabi Commercial Bank with a 5-year $500 million green bond.

As for Kuwait, issuance at the sovereign level will likely remain muted given the still-pending debt law, which will allow it to tap international and local debt markets. A new government has recently been formed, raising hopes of enacting much-awaited and wide-ranging reforms, including passing the debt law which could pave the way for the Kuwait government's return to debt markets for the first time since 2017.

Chart 5: Benchmark policy rates

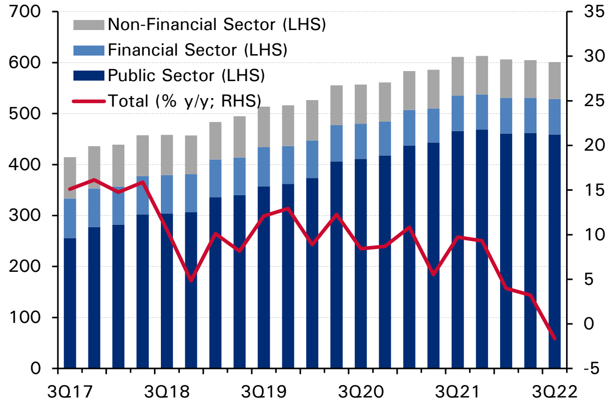
(%)



Source: Refinitiv, as of 14 October 2022

Chart 6: GCC outstanding debt

($ billion)



Source: Refinitiv, Saudi National Debt Management Center

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

	3Q-21	4Q-21	1Q-22	2Q-22	3Q-22
Public Sector	26.7	12.2	9.9	12.0	7.9
Financial Sector	4.3	1.2	6.1	2.3	1.9
Non-Financial Sector	0.5	0.8	2.3	0.4	1.4
Total	**31.5**	**14.2**	**18.3**	**14.7**	**11.1**

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

	3Q-21	4Q-21	1Q-22	2Q-22	3Q-22
Bahrain	0.9	1.6	1.3	1.4	0.5
Kuwait	1.0	0.0	0.5	0.1	0.0
Oman	0.0	0.0	0.0	0.0	0.0
Qatar	16.2	0.8	0.6	0.2	2.1
KSA	7.6	6.5	11.0	10.2	3.5
UAE	5.8	5.3	4.9	2.7	5.1
GCC	**31.5**	**14.2**	**18.3**	**14.7**	**11.1**

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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