Economic Update

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Debt markets

GCC debt issuance weak in 1Q18; central banks hike rates

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Highlights

- **After a buoyant 2017, GCC sovereign issuance was quieter in 1Q18 at $12 billion.**
- **A combination of still-favorable borrowing costs, high oil prices, and continued foreign investor interest is expected to keep market access relatively easy this year.**
- **Global and GCC monetary policy has been tightened, while international and regional bond yields moved higher, triggered by reflationary concerns.**

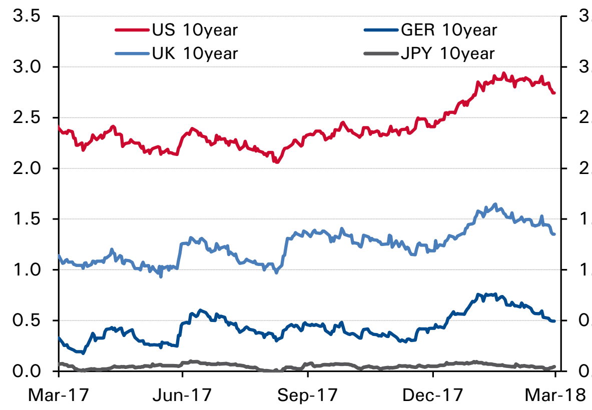
After a buoyant 2017, GCC sovereign issuance was quieter in 1Q18 at $12 billion. But a combination of still-favorable borrowing costs, high oil prices, and continued foreign investor interest are expected to keep market access relatively easy this year. Meanwhile, global and GCC monetary policy has been tightened, while international and regional bond yields moved higher triggered by reflationary concerns.

International: strong growth and rising inflation push yields higher

Fears that strong global growth is pushing up inflation caused global benchmark yields to finish 1Q18 higher, offsetting concerns over global geopolitics and trade wars. US 10-year treasury yields rose 33 bps q/q to 2.74%, while 10-year Bunds increased 7 bps to 0.50%. (Charts 1 and 2.)

Chart 1: Global benchmark yields

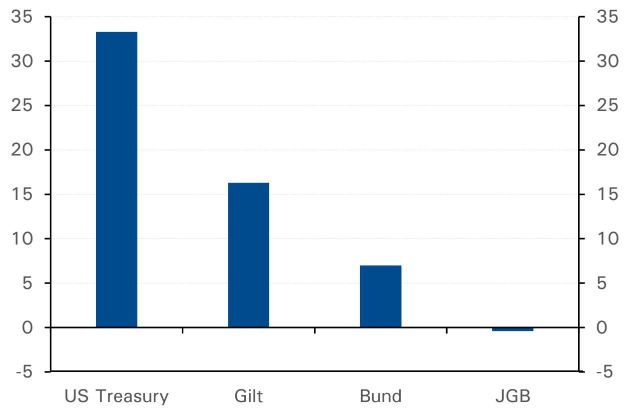
(%)



Source: Thomson Reuters Datastream

Chart 2: Global benchmark yields q/q in 1Q18

(basis points)



Source: Thomson Reuters Datastream

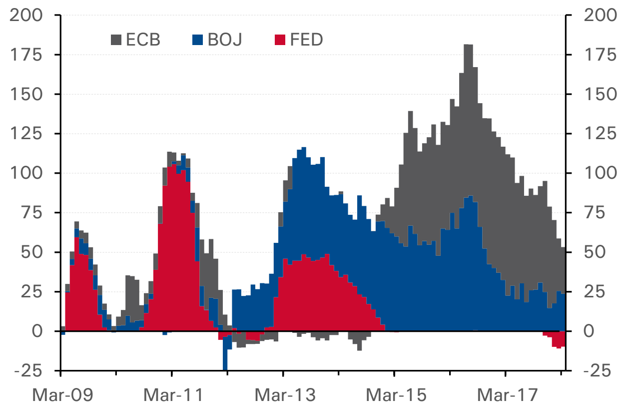
In the US in particular, yields were driven by signs of gradually rising inflation and wage pressures together with strong economic activity data. Indeed, inflationary expectations appear to have shifted: US 10-year breakeven rates – which project average inflation over the next decade – averaged 2.1% in 1Q18, their highest since 2015 and up 32 bps from 2017.

In Europe, despite the European Central Bank's (ECB) early confidence in the Eurozone's economic recovery, the rise in yields was relatively restrained. Efforts by the ECB to dispel any signs of hawkishness, coupled with political uncertainty, peaking economic growth and stubbornly low inflation helped cap the rise in German Bund yields.

Monetary policy continued to tighten globally, emboldened by the flow of relatively strong economic data. While the Fed was the only central bank to raise its policy rate in 1Q18 – by 25 bps to 150-175 bps – the rhetoric from other central banks turned marginally more hawkish. Official projections from the Fed are close to shifting from three hikes this year to four; the ECB dropped its commitment to expand the size of its bond buying program; the Bank of England became more hawkish on inflation; and the Bank of Japan bought fewer government securities during the quarter. The pace of government security purchases by the main central banks fell to its lowest since 2013. (Chart 3.)

Chart 3: Central Bank purchases of securities

($ billion, 3-month moving average)



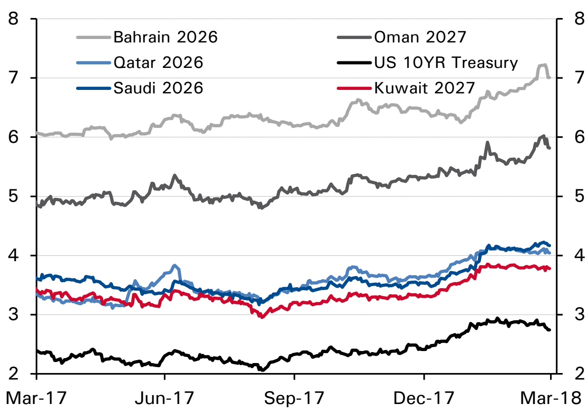
Source: Thomson Reuters Datastream

GCC: regional yields track US, while issuance was weak in 1Q18

GCC yields moved higher alongside US Treasuries and escalating regional tensions. This was despite firmer oil prices – Brent rose 9% q/q in Q1 to $67/bbl – which would typically contribute to lower yields. Yields on 8-9 year sovereign debt for GCC sovereigns rose 40-64 bps in 1Q18, with Saudi and Bahrain up the most. (Charts 4 and 5.) The yield on the latter breached 7% for the first time, while Kuwaiti debt was the lowest yielding, steady at around 3.8%.

Chart 4: GCC sovereign yields

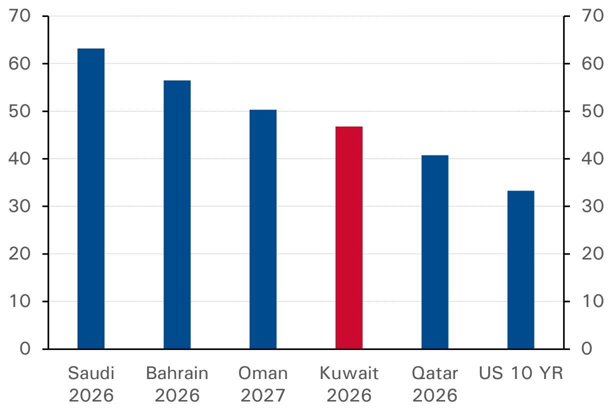
(as of 29 December, 2017; bps)



Source: Thomson Reuters Datastream

Chart 5: GCC sovereign yields quarterly change

(bps)

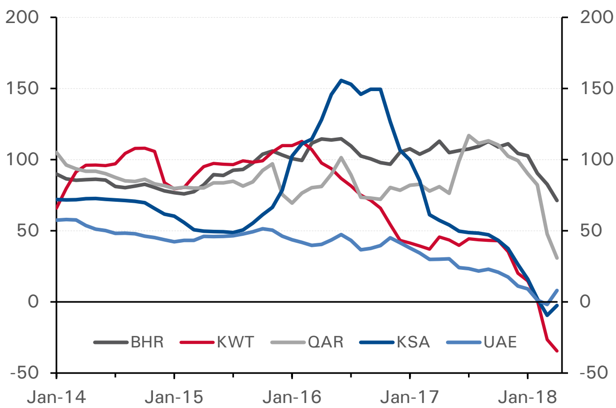


Source: Thomson Reuters Datastream

A combination of dollar-linked currency pegs and tightening interbank spreads saw GCC central banks follow the Fed's 25 bps March hike. Interbank spreads had narrowed to decade lows, with higher policy rates looking to address this trend and support the attractiveness of local currencies. (Chart 6.) In an unusual step, the Saudi central bank hiked its policy rate pre-emptively, one week ahead of the Fed's move.

Chart 6: GCC 3m interbank spreads to $Libor

(basis points, monthly average)

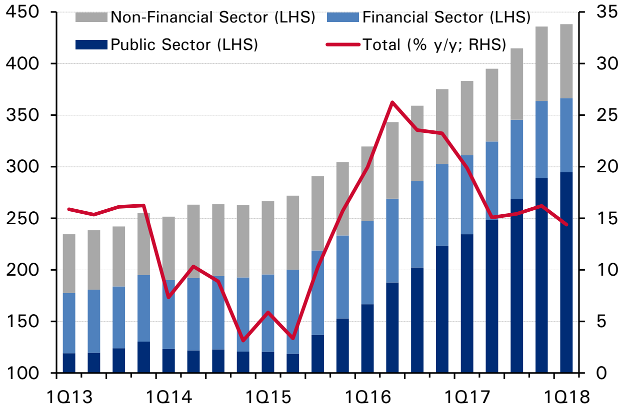


Source: Thomson Reuters Datastream

GCC gross issuance was at its weakest in almost three years, totaling $12 billion in 1Q18. Activity was boosted by Oman's $6.5 billion sovereign issue, with most of the rest coming from the financial sector. Total outstanding regional debt increased by a small $2 billion to $438 billion, with growth easing to 14% y/y. (Chart 7.)

Chart 7: Outstanding GCC debt securities

($ billion)



Source: Thomson Reuters Datastream

Higher oil prices helped credit default swap rates – one measure of risk – decline for most GCC sovereigns in the quarter, while credit ratings and outlooks were largely confirmed. However, renewed concerns over fiscal and external positions led to credit rating downgrades for Bahrain (Fitch: to BB- from BB+) and Oman (Moody's: to Baa3 from Baa2). Oman currently stands at the edge of the investment grade spectrum, while Bahrain moved deeper into sub-investment grade status.

GCC borrowing still seen strong in 2018

The prospect of higher rates, still-large fiscal needs, and relatively easy market access has favored the frontloading of GCC borrowing in 2018. So far, 2Q18 saw both Saudi Arabia and Qatar issue sizeable bonds – $11 billion and $12 billion, respectively – with the latter engaging in its first international debt market foray since 2016. Saudi's order book topped at $50 billion, while Qatar's reached $52 billion; still reflecting deep appetite for GCC sovereign debt. Pricing was also competitive for both.

Bahrain's attempt, however, was not as successful, with investors turning down its conventional bond due to unfavorable pricing, while its subsequent sukuk was priced at a steep increase from the previous issue. In Kuwait, delays in passing a new debt law may see the state turn to its reserves to fund its estimated $10 billion deficit for 2018. The previous debt law expired in September 2017.

Although still accommodative, the climate for global fixed income is becoming slightly less positive. Still-strong global economic growth and a tightening labor market are expected to push global inflation moderately higher, implying tighter policy. However, recent data have hinted at softening growth in both the US and Europe, which could yet see monetary tightening/stimulus reduction proceed less rapidly than expected. Central banks are also expected to keep a close eye on financial conditions and levels of leverage, wanting to avoid instability by raising rates too fast.

Table 1: Gross GCC Issuance by sector (USD billion)

	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
Public	27.0	18.5	23.5	20.0	18.2	22.7	23.4
Financial	5.6	3.3	1.4	4.7	1.7	0.9	1.0
Non-financial	3.5	0.3	2.3	1.5	1.1	0.4	4.5
Total	36.2	22.1	27.2	26.1	21.0	24.0	28.9

Table 2: Gross GCC issuance by country (USD billion)

	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
Bahrain	1.2	0.8	2.8	1.1	0.0	4.2	1.5
Kuwait	4.6	2.5	4.4	11.6	3.2	4.6	0.3
Oman	3.3	2.0	0.3	5.0	2.9	0.8	0.9
Qatar	12.6	4.3	1.0	5.1	3.5	0.6	0.0
KSA	6.4	11.5	17.5	0.0	9.5	11.1	12.6
UAE	8.1	1.1	1.3	3.4	1.9	2.7	13.6
GCC	**36.2**	**22.1**	**27.2**	**26.1**	**21.0**	**24.0**	**28.9**

Source: Zawya, Thomson Reuters Eikon, Central Bank of Kuwait, press

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