Debt markets

GCC: Yields tighten in 3Q16 on waning risk; sovereigns dominate issuance

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GCC yields continued to decline in 3Q16, driven largely by an improving credit outlook and higher oil prices. GCC yields also appeared to benefit from the search for yield, with spreads to international benchmarks tightening. US benchmark yields were little changed during the quarter. GCC debt issuance was strong in 3Q16, dominated by sovereign paper, as governments sought to plug their growing deficits. Domestic offerings dominated sovereign issuance, as liquidity conditions improved for most following large international bond offerings in 2Q16. Saudi Arabia saw liquidity conditions deteriorate in 3Q16 on the back of its regular domestic government debt offerings.

GCC and global yields began the quarter under pressure following the UK's vote to leave the EU, as investors feared spillovers from the referendum. However, swift action by the Bank of England, which included a 25 basis points (bps) interest rate cut and an expansion of its asset purchase program, and a smooth transition of the UK leadership provided some reassurance to investors and helped stabilize markets (Charts 1 & 2).

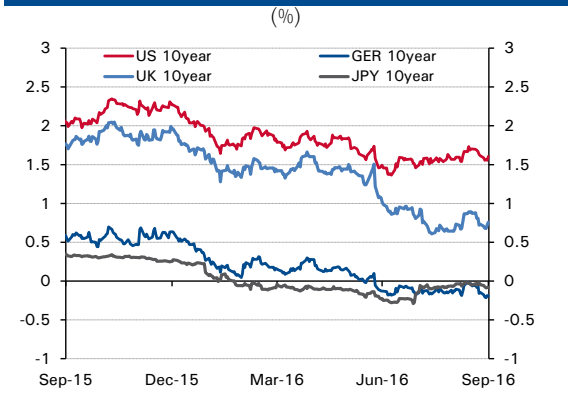
The second half of 3Q16 saw global yields driven by slow growth and asynchronous monetary policies (Charts 1&2). Indeed, suspicions over the growing ineffectiveness of monetary easing saw the ECB refrain from taking any action during the quarter, keeping German long term bunds relatively stable. The BOJ, on the other hand, desperate to "do whatever it takes", adopted new innovative tools, such as "yield curve control", to help lift Japanese 10 years. In the US, recurring monetary policy inaction over the quarter pointed to the Fed's December meeting as to when the benchmark rate would be raised for the first and maybe only time in 2016. This helped edge 10 year treasuries up over the quarter.

In the GCC, yields tightened in 3Q16 as fiscal outlooks appeared to improve and oil prices benefited from signs OPEC might cut oil supply. The quarter saw a number of reform initiatives materialized across the region. Facing deficits of over $120 billion in 2016 and growing domestic liquidity pressures, authorities across the GCC pursued fiscal reforms more aggressively. This helped increase the region's appeal to international creditors. It was boosted by OPEC's decision later in the quarter to cap the cartel's oil production in an effort to support oil prices.

Improved risk profiles coupled with international search for yield saw spreads of higher yielding sovereigns to US treasuries tighten. The spreads of Dubai, Oman, and Bahrain, bonds to 5-year US treasuries declined by 20-42 bps. This was at the expense of safer bets, such as Abu Dhabi and Qatar, whose spreads were relatively unchanged in 3Q16 (Chart 2).

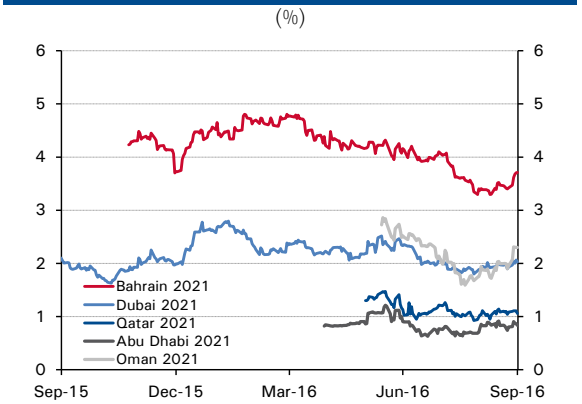
Regional credit default swap rates also reflected the improved risk profile. CDS rates were down across the board, with Dubai seeing the largest decline at 39 bps on the quarter and down 146 bps from its peak in January 2016. The rest finished the quarter down between 20 bps and 24 bps (Chart 3).

Chart 1: Global benchmark yields



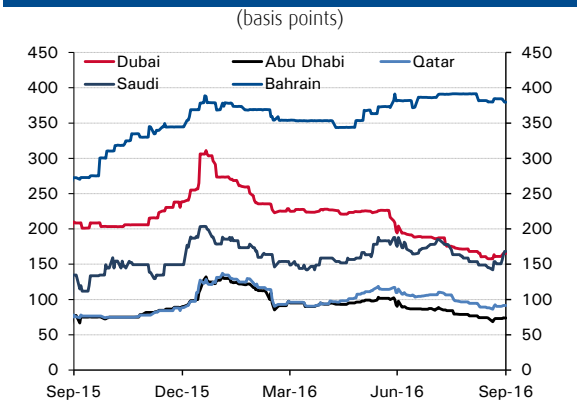
Source: Thomson Reuters Datastream

Chart 2: GCC spreads to 5-year US treasuries



Source: Thomson Reuters Datastream

Chart 3: GCC 5 year credit default swaps



Source: Thomson Reuters Datastream

GCC debt issuance was strong in 3Q16, led once again by sovereigns. Gross issuance totaled $23 billion during the quarter, with the stock of outstanding bonds increasing by 23% in 3Q16 to $360 billion (Chart 4). GCC sovereigns dominated issuance, adding $19.5 billion worth of new paper in 3Q16 (Table 1).

The quarter saw domestic bonds dominate sovereign issuance, following a strong showing for international debt earlier in the year. Oman was the only sovereign to tap international markets for $2 billion. The previous quarter's large international offerings helped ease domestic liquidity for some. Indeed, Qatar returned to its domestic market in 3Q16 for the first time in 2016 to borrow $2.5 billion, in a sign that liquidity conditions had improved following a $9 billion international bond in 2Q16. Qatar's interbank rate was steady at around 1.59% all quarter (Chart 6).

Domestic liquidity in Saudi Arabia did not fare as well, as domestic issuance continued to strain the market. Monthly domestic government debt offerings absorbed the equivalent of $11 billion from local banks in 3Q16 and $57 billion since their introduction last year. As a result, the 3-month interbank rate rose to 2.35%, a level not seen since the 2008 financial crisis. In an effort to address the tight liquidity, the Saudi Arabian Monetary Agency (SAMA) increased the maximum lending ratio to 90% and has offered banks cheap long term loans. Late September, SAMA injected the equivalent of $5 billion into domestic banks, effectively sterilizing the most recent government debt issue. Delays to their international offering, which was expected sometime in 3Q16, did not help matters. (Table 2 & Chart 6).

GCC debt is expected to remain robust in the final quarter of 2016, with issuers seeking to take advantage of the favorable global rates environment supported by their improving fiscal sustainability. We have already seen Bahrain re-tap international markets following a failed foray earlier in the year, while Saudi Arabia just completed the largest emerging market issuance ever, collecting $17.5 billion. Meanwhile, Kuwait is expected to issue an international bond in 4Q16 or 1Q17 that could raise up to $10 billion. Weak fiscal pictures are also expected to push government-related entities to debt markets, with Omani and UAE state owned firms expected to lead the way. The ongoing crunch in domestic liquidity, if left unattended, may futher see local banks turn to international markets for funding.

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

	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16
Public	3.3	5.0	3.0	21.7	21.3	16.3	26.6	19.5
Financial	2.8	5.0	7.3	0.6	4.3	2.1	5.6	3.3
Non-Financial	0.9	0.9	0.9	2.0	1.0	1.0	3.5	0.3
Total	7.0	10.9	11.2	24.3	26.6	19.4	35.7	23.1

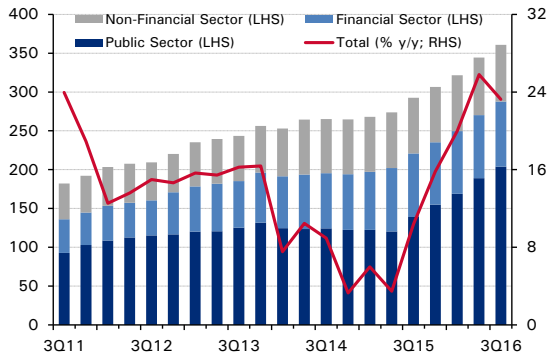
Table 2: Gross GCC issuance by country ($ billion)

	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16
Bahrain	1.1	1.5	0.9	2.0	2.0	0.5	0.8	0.8
Kuwait	0.7	1.0	2.2	1.2	0.9	2.1	4.6	2.5
Oman	1.0	0.5	1.3	0.9	0.9	0.4	3.3	3.0
Qatar	0.0	0.0	0.5	2.9	3.0	1.7	12.6	4.3
KSA	0.6	1.0	2.1	17.2	18.1	12.8	6.4	11.5
UAE	3.5	6.9	4.1	0.2	1.6	2.0	8.1	1.1
GCC	7.0	10.9	11.2	24.3	26.6	19.4	35.7	23.1

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

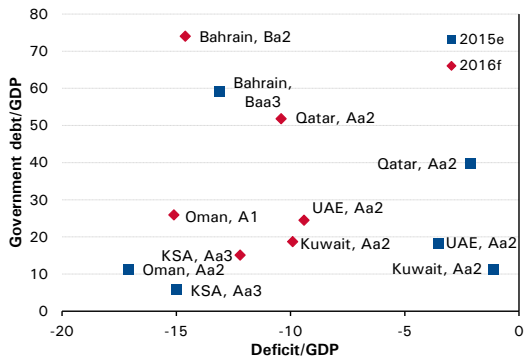
Chart 4: Outstanding GCC debt securities

($ billion)



Sources: Zawya, Thomson Reuters Eikon, NBK

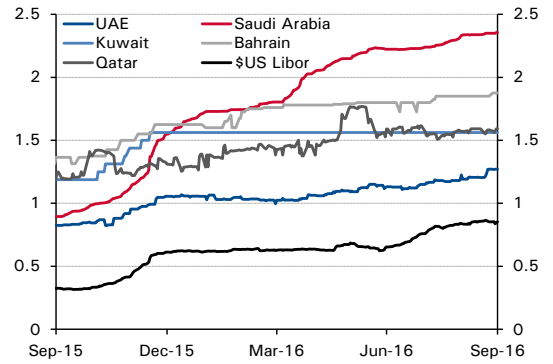
Chart 5: GCC debts, budget balances, and ratings



Source: Moody's Investors Service

Chart 6: GCC interbank rates

(%)



Source: Thomson Reuters Datastream

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