Economic Update

NBK Economic Research Department I 15 July 2021

Debt markets

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Global sovereign yields trend downwards as Fed signals policy shift, transitory inflation

Highlights

- **Global medium-term sovereign bond yields fell in Q2 as investors mulled a Fed policy shift, easing long-term inflation concerns.**
- **GCC sovereign yields tracked their global counterparts lower on higher oil prices, an improved outlook, and vaccine progress.**
- **Future yield movements will depend on Fed policy, the economic outlook, inflation, oil prices and Covid developments.**
- **GCC debt issuance fell to $16.5 billion in 2Q21 (-57% y/y) despite sizable debt maturities, likely due to softer borrowing needs.**
- **GCC issuance to remain strong in 2021 given ongoing deficit financing needs and low borrowing costs, but may moderate due to higher oil prices and easing fiscal pressures.**

Sovereign yields fall on Fed policy shift and outlook

Global medium-term sovereign bond yields fell in 2Q21 (led by US treasuries down 30 bps q/q) as investors mulled a shift in the Fed's stance, which curbed long-term inflation concerns. The Fed asserted that policy would remain accommodative and that rising inflation is transitory, but signaled the possibility of two rate hikes in 2023 – an earlier tightening than before – in line with the pickup in growth and a recovering labor market. Reduced inflation fears usually lead to higher fixed income demand, driving yields lower (although inflation fears returned following strong June inflation data, pushing yields up again). The asset purchases by the Fed are an ongoing factor that help in keeping yields subdued, although there was no acceleration in this regard. GCC sovereign bond yields, which often have different dynamics, tracked global yields lower, as much higher oil prices and thus easing fiscal concerns meant a lower risk profile for these sovereigns and continued robust international demand for GCC debt. To a lesser extent, renewed Covid fears amid the spread of the new delta variant, posing increased uncertainty, may have been a contributing factor to lower yields.

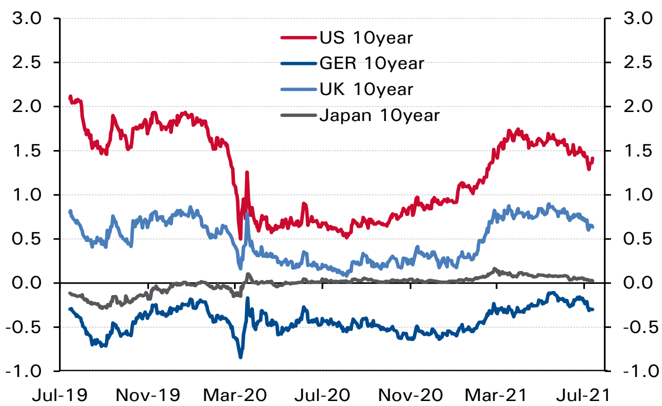
Meanwhile, GCC debt issuance slowed to $16.5 billion in 2Q21 from about $33 billion in the previous quarter, possibly on lower borrowing needs in line with the surge in oil prices. Nevertheless, GCC issuance year to end-June remained relatively strong at $49 billion, though 18% less than the $60 billion seen in the same period last year, as issuers continue to take advantage of still relatively low yields. Issuance in 2Q21 was dominated by UAE sovereign bonds, with over half of total issuance coming from that country.

US treasuries led yield declines as inflation fears eased

Most major benchmark yields (with the exception of German Bunds) fell in 2Q21 as inflation fears eased, supported by signals of tighter Fed policy ahead and as the bank's ongoing view that the current inflation surge is likely transitory gained some wider support. The higher inflation could be explained by pandemic-induced supply constraints, base effects, higher savings, pent-up demand given the reopenings, and unprecedented stimulus leading to a supply-demand imbalance, which could normalize in the coming months.

Chart 1: Global benchmark yields

(%)



Source: Refinitiv, as of July 13

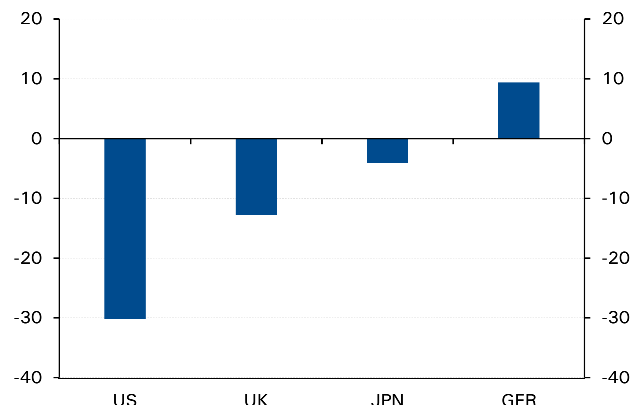
The US 10-year treasury yield fell to a 4-month low, down 30 bps q/q to 1.44% as of June 30, and further down to 1.36% as of July 6, likely pushed down as well (in addition to the above mentioned factors) by strong foreign demand due to the yield differential with the other developed-market alternatives. A weaker dollar (to multi-month lows) may also have helped boost demand, as this makes it cheaper for foreign investors to acquire US debt, with greater room for dollar appreciation.

However, more recently, yields reversed course to edge higher as June inflation rose to a 13 year high of 5.4%, causing renewed inflation fears. Meanwhile, UK gilt yields only partially tracked US treasury yields lower (down 12.8 bps q/q to 0.72%) driven by continued BoE dovishness in light of a still ongoing economic recovery, and given that UK yields are already low relative to US ones, implying less room to fall. German yields, still in negative territory and the lowest among the comparison group, rose modestly, (+9 bps q/q) to -0.2%, helped by an improved economic outlook. Japanese yields, as is typical, were little changed, held stable by BoJ's zero yield target policy.

Looking ahead, yield movements will depend on a sustained economic recovery, Fed policy, inflation prospects and Covid developments. Yields may rise should the higher inflation persist, and should the Fed decide to hike rates sooner than expected. A further upside risk to yields is the possibility of Fed asset purchase tapering (unwinding of stimulus). On the other hand, yields may remain low should inflation prove temporary, and if tapering happens later than expected. In fact, the Fed's statements about tapering and the market's interpretation of these statements will likely be the most important drivers of US treasury yields going forward. Further, given that US treasuries continue to trade at a significant positive spread versus developed-market counterparts, it is likely that demand will remain strong, capping potential yield increases.

Chart 2: Change in global 10-year yields (q/q)

(basis points)



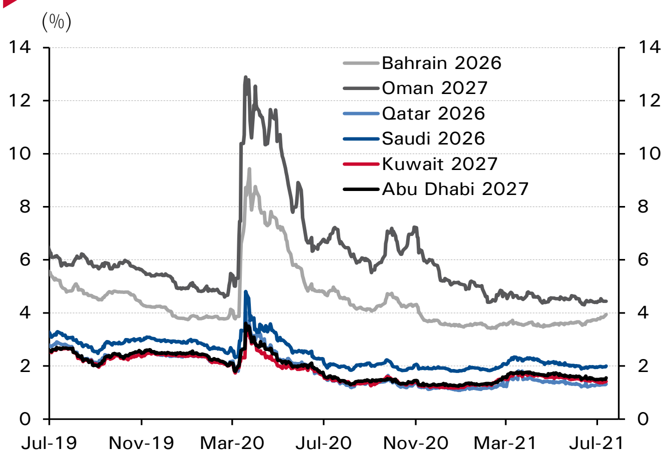
Source: Refinitiv

GCC yields track global peers lower in 2Q21

GCC medium-term sovereign bond yields broadly tracked their global counterparts lower on an improving economic backdrop and vaccine progress. A surge in oil prices to multi-year highs alleviated fiscal pressures and bolstered investor sentiment/demand for GCC debt. Yield declines were led by Oman (-40 bps q/q), the highest yielding and lowest rated GCC sovereign (credit rating B+ "non-investment" grade by S&P), helped also by fiscal consolidation plans, despite a surge in offerings this year (higher supply) due to refinancing needs. A strong investor appetite for higher yields (in a still low global yield environment), likely kept demand for Omani (and other GCC) debt high, pressuring yields lower. However, challenges pertaining to reform implementation in Oman remain, as well as relatively high debt levels reaching 80% of GDP in 2020. Other GCC bond yields saw smaller declines, ranging from -33 bps for Saudi Arabia and -16 bps for Bahrain. As for Kuwait, yields fell 28 bps, despite the backdrop of a lack of much-needed reforms, including but not limited to the renewal of the debt law, and a persistent fiscal deficit.

Finally, GCC yield prospects will continue to depend on the regional/global economic recovery, direction of global yields, virus containment backdrop, in addition to oil price movements.

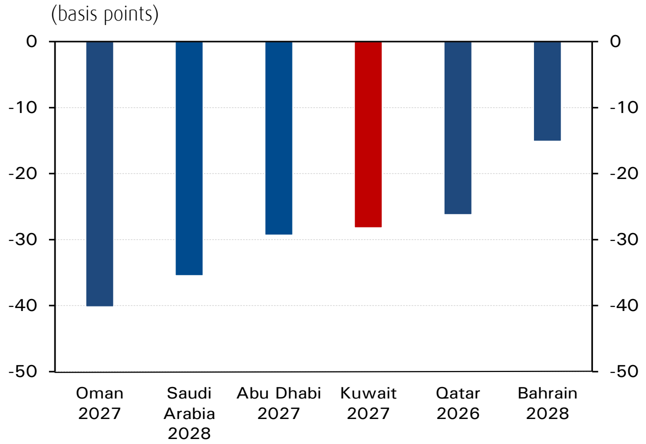
Chart 3: Medium-term GCC sovereign yields



Source: Refinitiv, as of July 13

Chart 4: Change in GCC medium-term sovereign yields (q/q)

(basis points)



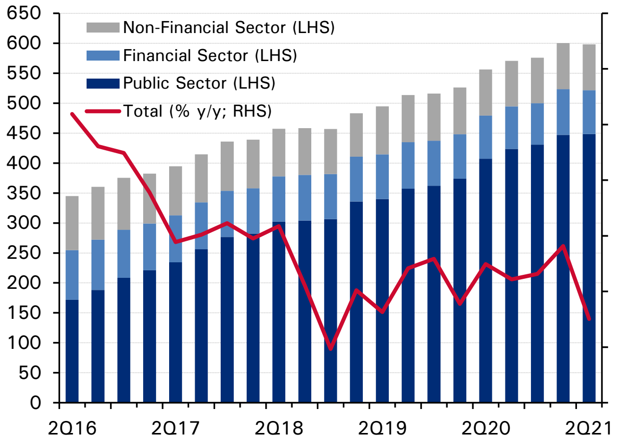
Source: Refinitiv

GCC issuance eases but remains strong year to date

Following strong GCC issuance in 1Q21 ($33 billion), gross issuance fell to $16.5 billion in 2Q21 (despite a relatively high $18 billion in maturing debt), possibly due to a lower need to refinance amid soaring oil prices. More than half of GCC issuance in 2Q 2021 came from UAE sovereigns and quasi-sovereigns, totaling $9.3 billion. Oman followed, with $3.3 billion in sovereign/quasi-sovereign debt issuance, of which $1.75 billion was from a nine-year Sukuk, the country's second venture this year into international debt markets, which was oversubscribed by five times. We expect issuance to remain relatively strong in 2021 given ongoing deficit financing needs and as sovereigns take advantage of still-low borrowing costs, but may moderate relative to the exceptional levels of 2019/20 given higher oil prices. With that said, oil markets are volatile and subject to considerable uncertainty, and it is not hard to envisage a near-term drop in oil prices elevating borrowing needs once again. Additional uncertainty stems from the lingering pandemic, which could lead to renewed economic and fiscal woes.

Chart 5: GCC gross debt outstanding

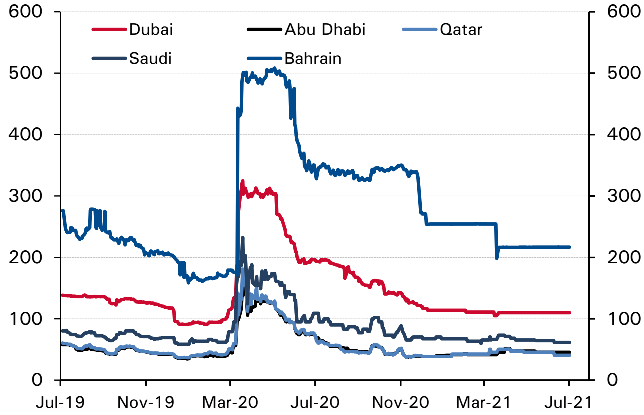
($ billion)



Source: Refinitiv

Chart 6: Five-year credit default swap rates

(Basis points)



Source: Refinitiv

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

	3Q-18	4Q-18	1Q-19	2Q-19	3Q-19	4Q-19	1Q-20	2Q-20	3Q-20	4Q-20	1Q-21	2Q-21
Public Sector	5.8	5.9	32.5	10.8	23.6	8.1	17.3	35.4	22.3	12.4	22.0	12.9
Financial Sector	1.0	1.9	2.1	3.6	5.3	1.8	4.1	1.6	4.4	2.1	8.1	1.1
Non-Financial Sector	0.8	0.5	0.0	12.6	0.8	0.8	0.0	1.0	0.0	0.8	2.6	2.5
Total	**7.5**	**8.3**	**34.6**	**27.0**	**29.6**	**10.8**	**21.4**	**38.0**	**26.7**	**15.2**	**32.7**	**16.5**

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

	3Q-18	4Q-18	1Q-19	2Q-19	3Q-19	4Q-19	1Q-20	2Q-20	3Q-20	4Q-20	1Q-21	2Q-21
Bahrain	0.4	1.0	0.0	0.0	3.3	0.5	0.1	2.8	3.2	0.0	3.0	0.9
Kuwait	0.1	0.7	0.0	0.0	0.0	0.5	0.0	0.0	0.0	0.5	0.0	0.0
Oman	0.9	1.8	0.0	0.4	3.3	0.5	0.4	0.5	1.0	3.8	6.1	3.3
Qatar	2.6	1.5	15.6	5.1	4.7	0.4	3.8	11.0	1.6	0.0	1.7	1.7
KSA	1.3	0.0	16.3	17.8	3.6	3.6	13.6	8.0	12.3	8.3	15.5	1.2
UAE	2.2	3.4	2.7	3.8	14.7	5.3	3.5	15.7	8.5	2.7	6.4	9.3
GCC	**7.5**	**8.3**	**34.6**	**27.0**	**29.6**	**10.8**	**21.4**	**38.0**	**26.7**	**15.2**	**32.7**	**16.5**

Source: Refinitiv, data as of June 30, 2021

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