Debt markets

GCC: Yields lower in 2016 on improving outlooks; bond issuance hit record

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Global and GCC yields trended down for most of 2016 before picking up in 4Q16. The election of Mr. Trump, a Fed rate hike, and an OPEC agreement to cut output all helped yields higher towards the end of the year. Even with the pick-up, GCC yields ended the year lower, on the back of improving fiscal outlooks. Meanwhile, the large financing needs of GCC governments saw sovereign activity dominate issuance in 2016. International borrowing was strong, helping to ease domestic liquidity pressures. GCC debt activity is expected to remain robust in 2017; however, a stronger USD and a more hawkish Fed may weigh on sentiment.

During most of 2016, concerns of slower global growth and deflation risks, combined with heightened political uncertainty saw global bond yields pressured to unprecedented lows. Indeed, both the 10-year US Treasuries and 10-year Bunds hit record lows of 1.37% and -0.18%, respectively, in July 2016. This followed Britain's surprise vote to leave the European Union in June, which saw averseness amplified by the unexpected decision.

Global growth momentum turned during the second half of 2016. The stream of relatively stronger economic data releases in 2H16, from advanced economies, had set yields on a steady upwards path. The positive change in economic outlook also drove commodity prices higher. This in turn set in motion a marginal upward shift in growth and inflation expectations (Charts 1 & 2).

Upward pressures on yields were further catalyzed in 4Q16 by the election of Mr. Trump, with investors interpreting his presidency as inflationary. The President's economic policies were expected to focus on fiscal stimulus potentially funded through debt. This prompted a sell-off in government bonds across the globe and saw yields on US 10-year bonds shoot up by 20 basis points (bps) on the day following the election and 53 bps during November 2016.

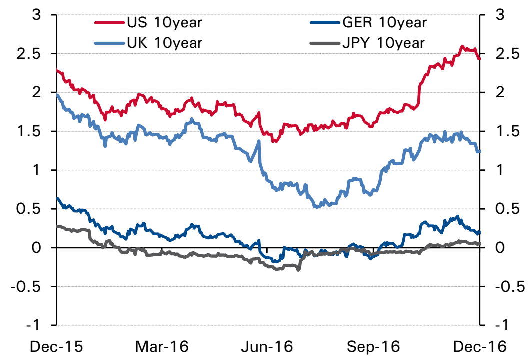
The improvement in global economic sentiment culminated with the Fed's only rate hike in 2016. After much speculation, the Fed finally raised the federal funds target by 25 bps in December 2016. The move had little impact on bond markets as it was largely priced-in. Still, a surprisingly more hawkish outlook for 2017, with expectations of three rate hikes rather than two, did help lift yields further supported by a string of strong data releases in December. This encouraged the protraction of the bond sell-off, pushing 10-year US Treasury yields higher, to finish the year at 2.43%, up 16 bps (Chart 1).

In the Eurozone and Japan, central banks remained in quantitative easing (QE) mode, helping to keep yields down. The ECB, determined to steer inflation higher, extended its QE program by nine months in December 2016. The extension is expected to run through April 2017 to December 2017, although at a slower pace of EUR 60 billion. The BOJ offset unwanted movement in yields through its "yield curve control" mechanism. As such, yields on 10-year Bunds ended the year down 35 bps, while 10-year JGBS were down 22 bps (Chart 1).

Political and financial uncertainty also contributed to pressuring core

Chart 1: Global benchmark yields

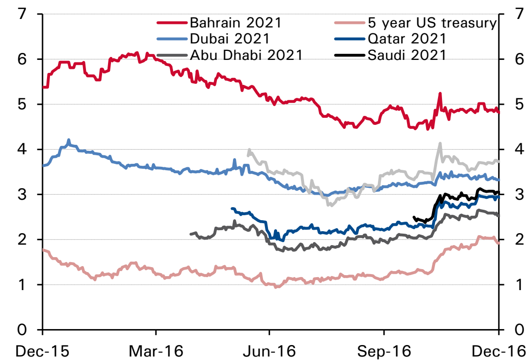
(%)



Source: Thomson Reuters Datastream

Chart 2: GCC sovereign yields

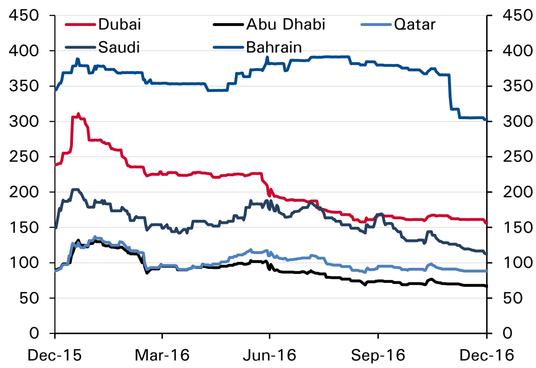
(%)



Source: Thomson Reuters Datastream

Chart 3: GCC 5-year credit default swaps

(basis points)



Source: Thomson Reuters Datastream

rates down in Europe. Uncertainty over Italy's leadership following the resignation of its PM and substantial capital shortfalls at its banks weighed on sentiment.

In the GCC, yields were in line with international markets, yet ended 2016 lower, on the back of an improving fiscal outlook. Indeed, even with a pick-up late in the year, rates were dominated by a downward trend for most of 2016. This is best illustrated by Dubai's 2021 paper, which dropped 31 bps over 2016, despite increasing 15 bps in 4Q16.

The buy-in into GCC paper was driven by their relatively attractive returns, supported by recovering oil prices and steadily more robust and transparent fiscal and economic mandates. The latter was crucial for competitive access into international debt markets, which in turn saw outstanding offers from GCC sovereigns, spearheaded by Saudi Arabia and Qatar.

Saudi Arabia took advantage of the region's growing popularity, introducing the largest ever sovereign emerging market bond offering. It tapped international debt markets for $17.5 billion, with an order book that totaled $67 billion. The successful bond sale reflected the turn-around in investors' outlook vis-à-vis the region, with the positive sentiment spilling over across the GCC.

The overall improvement in confidence helped temper fears of sovereign default, with CDS rates falling for all tracked GCC countries. Many saw substantial improvement in the second half of the year. This coincided with many investment friendly and fiscally responsibly announcements, as well as the OPEC agreement to cut oil production. Dubai saw the largest drop, down 82 bps in 2016, followed by Bahrain and Saudi, down 42 bps and 37 bps respectively (Chart 3).

Issuance in the region saw a large increase in 2016 on the back of growing government financing needs. Gross issuance totaled $105 billion in 2016, up $32 billion from the previous year, and double what was issued in 2014. This saw the stock of outstanding bonds jump $69 billion, to settle at $376 billion at the end of 2016. Sovereigns led the issuance, with GCC governments having tapped domestic and international bond markets for $85 billion (Table 1 & Chart 4).

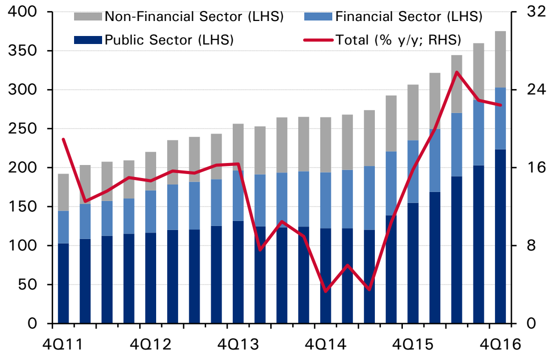
Sovereign issuances dominated 4Q16, with gross issuance topping $23 billion. Saudi Arabia accounted for most of the activity, thanks to its sizeable issuance, while Bahrain and Kuwait borrowing accounted for the rest (Table 2).

With the exception of Kuwait, all GCC sovereigns tapped international debt markets in 2016, in a bid to cope with tightening domestic liquidity, issuing $39 billion worth of dollar denominated bonds. The year saw first time issuer Saudi Arabia come to market with its international debt offer of $17.5 billion, as well as Qatar's sizeable $9 billion offering, while Abu Dhabi returned after a seven year hiatus, issuing $5 billion. Meanwhile, Oman borrowed $4.5 billion throughout the year, and Bahrain $2.5 billion. This is not to mention their large forays into the international syndicated loan market, where Saudi Arabia, Qatar, and Oman borrowed a combined $26.5 billion.

The pick-up in international issuance helped ease liquidity constraints across the GCC. This helped moderate the climb in rates, with Saudi seeing the biggest improvement following its issuance. The Saudi 3-month interbank rate dropped 35 bps from its peak of 2.38%, to settle at 2.03% (Chart 6). However, it still remains high in comparison to its 5-year average

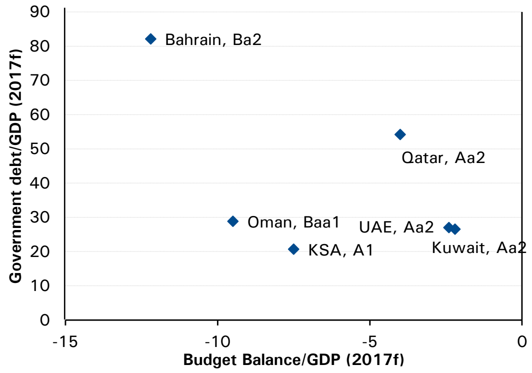
Chart 4: Outstanding GCC debt securities

($ billion)



Sources: Zawya, Thomson Reuters Eikon, NBK

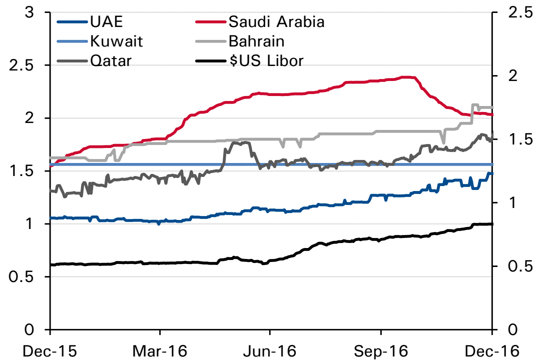
Chart 5: GCC debts, budget balances, and ratings



Source: Moody's Investors Service

Chart 6: GCC interbank rates

(%)



Source: Thomson Reuters Datastream

of 0.88%.

Private sector issuance was far more subdued, as bank appetite for debt diminished. Gross issuance of the private sector in the GCC eased for a third consecutive year, dropping to $20 billion in 2016, from $32 billion in 2013. The slowdown in activity was primarily due to the moderation of the non-oil sector, brought on by the decline in oil prices. This, and a diminished need to raise regulatory capital, saw issuance by banks decline. By contrast, issuance by non-financial companies picked up in 2016, after registering its worst performance in a decade in 2015.

GCC debt is expected to remain robust in 2017, with issuers seeking to take advantage of the still favorable global rates environment supported by their improving fiscal sustainability. The GCC's financing needs remain large, estimated at $87 billion for 2017. Oman has begun working on its next international issuance. Kuwait is close to issuing its international bond, which could raise up to $10 billion. Talk of a sizeable international Saudi sukuk also emerged following the announcement of their 2017 budget. Meanwhile, weak fiscal pictures will continue to push government-related entities to debt markets, with Omani and UAE state owned firms expected to lead the way.

Global risks in the form of continued strength in the dollar and a more hawkish Fed, both driven by uncertainties over US economic policy, will weigh on GCC yields. A stronger US dollar may deter non-USD investors, while a more hawkish Fed may see GCC rates move up in parallel. As a result, this may see GCC yields pushed up and issuance decline. Indeed, the region's peg to the dollar makes it very susceptible to US developments. This was observed following the most recent Fed rate hike. Kuwait, Saudi, Bahrain, Qatar, and the UAE all added 25 bps to their respective policy rates within days of the Fed move.

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

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16
Public	5.0	3.0	21.7	21.3	16.3	27.0	18.5	23.5
Financial	5.0	7.3	0.6	4.3	2.1	5.6	3.3	1.4
Non-Financial	0.9	0.9	2.0	1.0	1.0	3.5	0.3	2.3
Total	10.9	11.2	24.3	26.6	19.4	36.2	22.1	27.2

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

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16
Bahrain	1.5	0.9	2.0	2.0	0.5	1.2	0.8	2.8
Kuwait	1.0	2.2	1.2	0.9	2.1	4.6	2.5	4.4
Oman	0.5	1.3	0.9	0.9	0.4	3.3	2.0	0.3
Qatar	0.0	0.5	2.9	3.0	1.7	12.6	4.3	1.0
KSA	1.0	2.1	17.2	18.1	12.8	6.4	11.5	17.5
UAE	6.9	4.1	0.2	1.6	2.0	8.1	1.1	1.3
GCC	10.9	11.2	24.3	26.6	19.4	36.2	22.1	27.2

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

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