Debt markets

GCC: Yields mixed in 2Q17; bond issuance led by sovereigns

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Global and GCC yields were mixed in 2Q17 as markets reacted to a more optimistic economic outlook, low inflation, and geopolitical risks. Issuance in the GCC was strong but slightly slower than in 1Q17, led again by sovereigns. Oman and Saudi were the only sovereigns to issue internationally. The ongoing rift with Qatar has increased the region's riskiness and has applied some pressure on Qatar's liquidity. GCC primary debt market activity is expected to be healthy in the second half of 2017.

International benchmark yields were range-bound, trading within a 28-35 bps window in 2Q17. Investors balanced geopolitical uncertainty and stubbornly tepid inflation expectations against a gradually more positive global economic backdrop. Overall, yields trended downwards for most of the quarter, jumping up twice throughout: once in mid-May on the back of strong economic data, and again towards quarter's end on hawkish remarks from global central banks (ECB, BOE, BOC). (Chart 1.) A fully priced Fed rate hike had little impact on markets, with most GCC central banks following suit in support of their USD pegs. Other major central banks stood pat.

US government 10-year Treasury yields were down in 2Q17, finishing 9 bps lower at 2.35%, in spite of the Fed's rate hike in June. Downward pressures emerged from weak to moderate economic data, from little progress on healthcare and tax reform, and from political/media shenanigans surrounding the White House. This has underpinned skepticism over future inflation momentum and the government's short-term pro-growth policies. US 10-year yields experienced their largest daily drop in almost a year (11 bps) on 17 May when President Trump was rumored of having interfered with an FBI investigation**.**

Yields on 10-year German Bunds were up 14 bps in 2Q17, registering at 0.47% following the French presidential election and hawkish ECB statements. The emergence of pro-EU reform minded Emmanuel Macron as France's president saw investors unwind risk-off positions throughout the quarter, helping 10-year Bund yields rise. But weaker than expected inflation data, which favored policy inaction during two ECB meetings held during 2Q17, tempered the rise in yields and pressured them downward. 10-year Bund yields would later experience their largest increase since the US presidential election, jumping by 10 bps on 27 June, following remarks made by ECB president Draghi. Markets interpreted his comments as surprisingly hawkish and further affirmed what is now seen as a change in tone in the ECB's outlook.

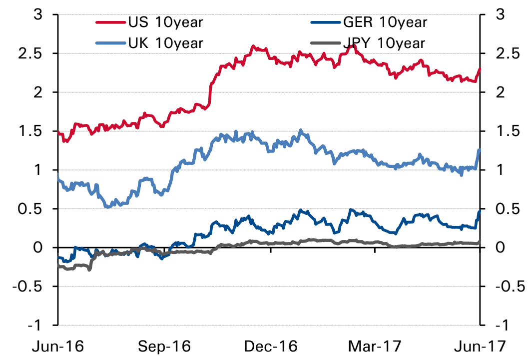
Qatari and Omani yields jumped following increased geopolitical risks for the former and financial risks for the latter. The rest of the GCC sovereign yields were down or little changed as they tracked US Treasuries. (Chart 2.)

Qatar's rift with neighboring countries saw yields on Qatari sovereign bonds maturing in 2021 breach 3% and finish the quarter at a record high of 3.12%, up 45bps. The regional ostracism of Qatar also resulted in Moody's revising its outlook to "negative".

Oman's downgrade to lower than investment-grade by S&P, on the

Chart 1: Global benchmark yields

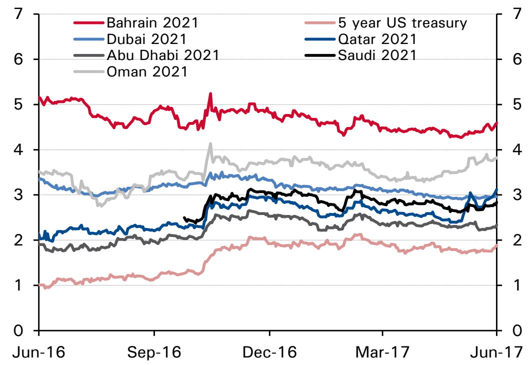
(%)



Source: Thomson Reuters Datastream

Chart 2: GCC sovereign yields

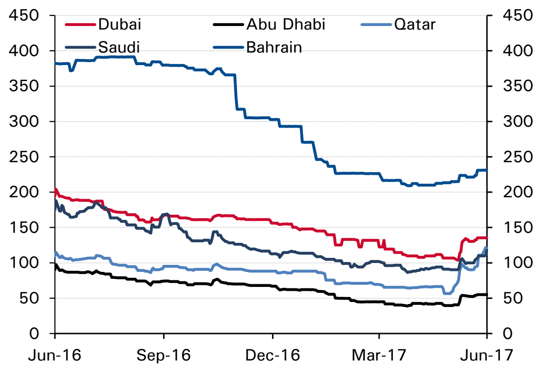
(%)



Source: Thomson Reuters Datastream

Chart 3: GCC 5-year credit default swaps

(basis points)



Source: Thomson Reuters Datastream

grounds of weaker financial buffers, saw the yield on Omani paper due in 2021 jump up 40 bps in 2Q17.** The latter was exasperated by weakening oil prices during the quarter and a still large financing deficit.

The Federal Reserve remained the only major central bank tightening its monetary policy, as it hiked its policy rate again in 2Q17. The Fed increased its target federal funds rate by 25 bps to 1.00-1.25% in June. This was its second rate hike this year and occurred despite somewhat weaker national data. The Fed's rate outlook, for now, still sees only three hikes in 2017. Markets expect the next move to happen in December with close to 50% certainty.

The ECB and the BOE turned hawkish late in the quarter in spite of dovish announcements early on. The ECB's official dovish policy stance in 2Q17, supported by weaker than expected inflation data, came at odds with record setting PMIs and healthy GDP growth. Remarks by the ECB at its 8 June policy meeting and by ECB president Draghi on 26 June at an ECB conference, however, revealed a gradual acceptance of a more optimistic outlook. Investors interpreted the newly positive tone as a primer for monetary tightening. Meanwhile, the BOE surprised by coming very close to hiking its policy rate, with 3 of its 8 members voting in favor, on the grounds of rising inflationary pressures. This was later substantiated by hawkish comments made by BOE governor Carney.

GCC central banks followed the Fed, raising their policy rates by 25 bps, with Oman and Kuwait being the exceptions. The moves were in line with the need to support USD pegs. As for Oman, this is the third time it passes on hiking its policy rate, despite its peg to the dollar, and the first for Kuwait. However, their central banks did hike repo rates, as they sought to protect their pegs without hurting domestic credit growth.

GCC debt issuance eased in 2Q17 as the quarter coincided with the holy month of Ramadan but remained strong nonetheless. Total new issuance amounted to $20 billion compared to $26 billion in 1Q17, driven almost entirely by sovereign activity. Private sector activity was relatively weak in 2Q17; with banks accounting for most of it. Total outstanding debt was up a healthy 11 billion, to rest at $394 billion. (Chart 3.)

Sovereign activity stayed strong during 2Q17 with $18 billion in new issuance, chiefly driven by Saudi Arabia and helped by Qatar, Oman, and Kuwait. Oman and Saudi were the only two to tap international markets for a $2 billion sukuk and a $9 billion sukuk, respectively. The offerings were well received, even with Oman's downgrade to below investment grade, reflecting the still strong attractiveness of GCC debt. Qatar and Kuwait issued domestic debt totaling $3.5 billion and $2 billion, respectively.

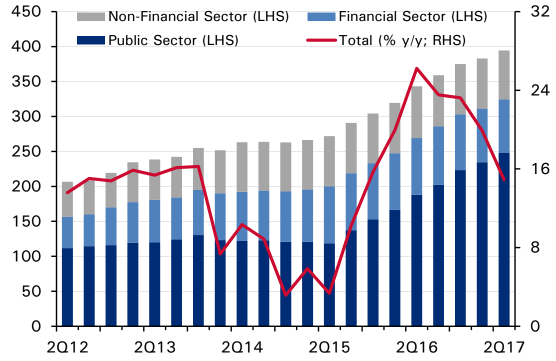
The riskiness of investing in the region has risen following the dispute between Qatar and four Arab allies. CDS rates rose across the board as investors digested the fallout. Qatar was the worst hit, with its CDS rate rising to 118 bps, up 48 bps on the quarter and the highest it has been in a year. As for the rest of the tracked GCC sovereigns, their CDS rates were up between 5 and 13 bps. (Chart 4.)

The rift has also stressed Qatar's liquidity, with its 3-month interbank rate jumping 50 bps in 2Q17, as regional institutions in the concerned countries, both private and financial, shied away from dealing with Qatari banks. As for the rest of the GCC, interbank rates rose to accommodate the June Fed hike, increasing between 5 and 18bps. (Chart 5.)

GCC debt issuance is expected to remain healthy for the rest of 2017,

Chart 4: Outstanding GCC debt securities

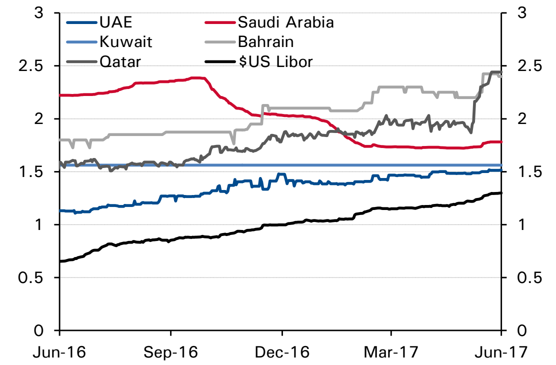
($ billion)



Source: Zawya, Thomson Reuters Eikon, press

Chart 5: GCC interbank rates

(%)



Source: Thomson Reuters Datastream

as sovereigns continue to seek cheap deficit financing, but will increasingly face growing risks. The geopolitical rift with Qatar has already weighed on investor confidence, and may hamper future regional issuance activity, especially if the dispute escalates or is drawn-out. The volatility in current oil prices stands as another risk, with oil prices failing to firm up following an extension to the OPEC agreement. The pick-up in global growth and the expected relative cheapness of the dollar may also divert investors' interests to other debt markets.

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

	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17
Public	21.2	20.8	15.8	27.0	18.5	23.5	20.0	18.2
Financial	0.6	4.3	2.1	5.6	3.3	1.4	4.7	1.7
Non-Financial	2.0	1.0	1.0	3.5	0.3	2.3	1.5	0.5
Total	23.7	26.1	18.9	36.2	22.1	27.2	26.1	20.4

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

	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17
Bahrain	1.5	1.5	0.0	1.2	0.8	2.8	1.1	0.0
Kuwait	1.2	0.9	2.1	4.6	2.5	4.4	11.6	3.2
Oman	0.9	0.9	0.4	3.3	2.0	0.3	5.0	2.9
Qatar	2.9	3.0	1.7	12.6	4.3	1.0	5.1	3.5
KSA	17.2	18.1	12.8	6.4	11.5	17.5	0.0	9.5
UAE	0.2	1.6	2.0	8.1	1.1	1.3	3.4	1.3
GCC	23.7	26.1	18.9	36.2	22.1	27.2	26.1	20.4

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

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