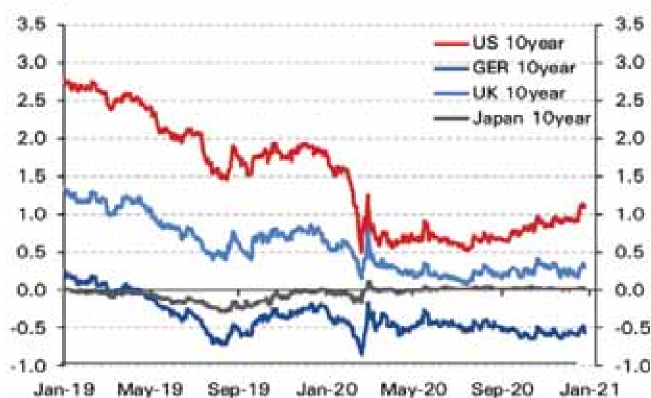
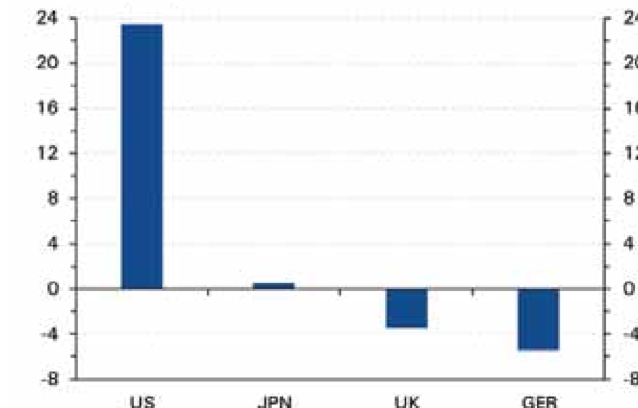
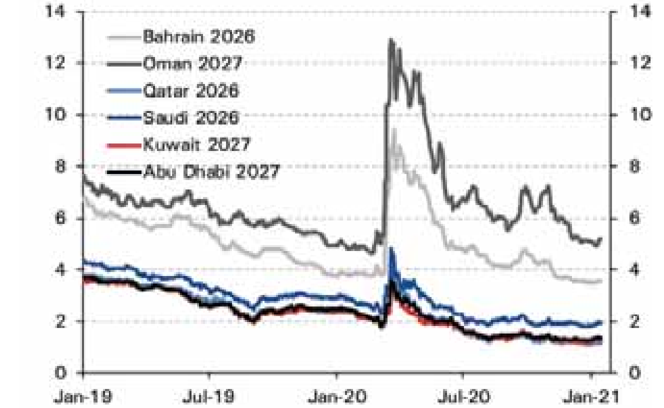
NBK ECONOMIC REPORT

GCC bond yields dropped in 4Q20 amid rising oil prices

US treasury yields surge in 4Q20 amid vaccine rollout, economic outlook







KUWAIT: The US 10-year treasury yield rose considerably in 4Q20, partially reversing the steep decline seen since the onset of the pandemic in 1Q20. The higher yield came on the back of an improved economic outlook, especially after the rollout of vaccines in December, a high volume of bond offerings amid the need for ongoing fiscal support, and perhaps also rising inflation expectations as stronger economic recovery prospects became more apparent. In contrast, EU and UK benchmark yields trended downwards, weighed down by renewed mobility and business restrictions, raising the odds of a double-dip recession and denting sentiment.

Meanwhile, GCC medium term sovereign bond yield spreads over US treasuries tightened, reflecting the continued improvement of regional economies (oil prices increased by 26 percent in 4Q) from the twin shocks of low oil prices and the pandemic-induced slowdowns. 2020 was an exceptional year for regional issuances, as governments sought to finance their budget deficits, which have been negatively impacted by the effects of the recession and lower oil prices. GCC sovereign dollar and local currency- denominated issuances reached over $100 billion in 2020, roughly in line with the elevated levels of 2019. We expect regional debt issuances to remain robust in 2021 on continuing budget deficits and relatively low yields.

Global yield movements diverge

The divergence of European and US yields in 4Q can be explained by a notable progress in the US economic scene, including ongoing fiscal support and the rollout of vaccines, although the latter has been slower than planned. Meanwhile, Europe faces the threat of a double-dip recession given more widespread and stricter lockdowns compared with the US. The US 10-year treasury yield rose by 23 bps q/q to reach 0.91 percent by the end of December, and climbed to 1.13 percent as of 11 January 2021, the highest level since March 2020, while German Bund and UK gilt yields fell by 5.5 and 3.5 bps q/q, respectively.

Looking ahead, EU and UK yield declines could reverse course if the virus situation materially improves, lockdowns are eased, or vaccination rates pick up, which would help the economic recovery to regain traction and the ECB's bond purchasing to taper. Also of note is the debut 17 billion Euro sale of bonds by the EU in October 2020 as part of The European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE), oversubscribed by nearly 14 times. With additional issuances planned in 2021 by the EU, some suggest that this could siphon demand for conventional European bonds and thus lessen the downwards pressure on yields. On the other hand, German debt could remain attractive as a hedge against future EU instability given its strong domestic economy.

In the US, a sustained rise in yields will also depend on the strength of the economic recovery especially under the Biden administration which is expected to adopt a more stringent policy on COVID-19, though it could be capped by the risk from the ongoing high virus infection rates. In contrast, further fiscal stimulus measures by the Biden administration will likely drive yields higher as well as a stronger expected vaccination campaign. However, it remains to be seen how much the Fed will allow an increase in long-term yields, and whether it will intervene to keep these rates in check by ramping up its asset purchasing.

GCC yields decrease

GCC medium term sovereign bond yields continued to trend downwards in 4Q20 thanks to a lower risk environment arising from higher oil prices. Further downward pressure on yields stems from the ongoing strong foreign investor demand, especially if the region's riskiness continues to be pereceived as improving by global investors, and given the yield differential backdrop with global markets. Signs of a possible end to the Qatar embargo (which materialized in January) may have also contributed to lower yields. Declines in GCC yields were led by Oman (-211 q/q) and Bahrain (-111 bps q/q), partly due to a much higher increase than peers earlier in the year as well as good progress on economic reforms in Oman, leading to a reduced risk profile for the sovereign. Meanwhile, sovereign yields in Qatar, Kuwait, Saudi Arabia and Abu Dhabi, which were significantly lower than in Oman/Bahrain going into Q4, saw much lower declines of 37, 32, 26 and 22 bps, respectively.

Looking ahead, the direction of future GCC yield movements is clouded with uncertainty surrounding several key factors, including oil prices, reform momentum, geopolitics, and virus/vaccine developments. Factors that may weigh down on yields include consistently higher oil prices, good progress on much needed reforms, the absence of adverse geopolitical developments, and lower new virus cases. On the other hand, yields could rise should the same factors move in the opposite direction, signaling a deterioration of conditions. Yield declines could also be curbed due to the narrowing spread between US yields and regional ones, especially in the case of Qatar, Kuwait and Abu Dhabi yields which have reached multi-year lows, limiting the potential for further declines, as demand for GCC debt could divert to other bond markets with more favorable risk-return profiles.

GCC issuance remains strong

Regional issuances were strong in 2020, exceeding $100 billion and roughly in line with 2019 levels. The 4th quarter of 2020 saw the issuance of about $15 billion, dominated by sovereign paper and led by Saudi Arabia with $8.3 billion, bringing the total GCC outstanding debt to around $575 billion as of the end of the year. The strong level of issuances were driven by a high need for financing amid mounting fiscal pressures due to lower oil prices and the pandemic induced economic slowdown, encouraged also by a relatively low cost of borrowing.

We expect GCC issuance to remain robust in 2021 to plug continuing holes in public finances due to slow economic activity, a continued need for public spending until the pandemic is contained, and oil prices likely remaining below fiscal breakeven prices. Given record low interest rates, GCC countries would rather rely on borrowing than drawing down their reserves, which are presumably fetching a higher rate of return. In Kuwait, where the debt market now is virtually non-existent, passing the debt law would reactivate the debt market and build a market driven yield curve. However, approval of the debt law does not seem near at this time given the parliament's opposition and the recent resignation of the cabinet.