LEBANON FIXED INCOME MARKET REPORT

IMPROVING FUNDAMENTAL OUTLOOK FOR A DEFENSIVE CREDIT

- Long-term financial sector resilience providing a continuous support to sovereign credit
With the Lebanese banks accounting for the bulk of Lebanese Eurobonds outstanding (more than 60%), the bond market is significantly correlated with the conditions of the Lebanese financial sector at large and with the growth of its funding base. Perhaps the most fascinating aspect about the Lebanese financial model is the noticeable sustainability over time despite the volatile operating environment on the one hand and the acute imbalances on the other hand. While public finance imbalances grew larger, the country was able to maintain a long term sustainability trend in its low inflation rates, its stable exchange rate, its recurrent capital inflows, and its resilient banking activity.

- Recent macro trends reinforcing further Eurobond market conditions
The most important credit-sensitive recent developments are the large swap operations of the Central Bank of Lebanon with important financial sector consequences over the second half of last year and the political trend reversal with the credit-positive domestic political settlement since the last quarter of 2016 that lead to improved economic growth prospects, better bank deposit growth perspectives and corollary positive bond markets implications. Within this environment, the Lebanese Eurobond market witnessed a spread tightening of 135 basis points since the presidential elections last October, underlining improving market perception of sovereign risks.

- Low Eurobond market volatility reflecting market's defensiveness
Over the past few years, and within the context of global market volatility, regional unrest, low oil prices piling pressure on regional liquidity, and tense local political climate, Lebanese bonds proved rather immune to external and internal shocks. They demonstrated their defensiveness, with sovereign papers being less volatile than regional and global peers. They posted a volatility of 11.7% over the past 5 years, compared to 29.6% in the MENA region and 17.5% in emerging markets.

- Potential for further spread compression despite recent rally
Despite the recent price appreciation, Lebanese Eurobonds still trade today on average 18% wider than emerging market peers, underlining a further opportunity for spread compression ahead despite the rally already observed on local papers. One must not forget that the actual foreign investors holdings of Lebanese Eurobonds is still well underweight when looking at the JP Morgan Emerging Markets Bond Index Global (EMBIG) or even the EMBIG Diversified, which is a technical variant of the former. JP Morgan is actually recommending investors to allocate a weight of 2.78% to Lebanese debt papers in their emerging market bond portfolio, while they are currently allocating a weight of less than 2%.

- Improving deposit growth and liquidity to provide some support for Eurobond market
The current year started with a sound reflection of an improving domestic financial environment. Bank deposits grew by US$ 1.4 billion over the first two months of 2017 (against a net decline over the same period of 2016). Such deposit growth is in line with our annual projection for 2017 (US$ 10 billion), mainly accounted for by FX deposits. It is enough to ensure a healthy demand for Lebanese Eurobonds, especially that the Lebanese banks FX sovereign exposure has declined recently in both absolute and relative terms. As to banks FX primary liquidity in foreign banks, although the latter reached a low of US$ 8.5 billion in August 2016, it rose again to its pre-swap level of US$ 11.7 billion in February 2017, apt to provide potential support to the Lebanese Eurobond market.

- Risks ahead tilted to the upside despite looming challenges at the horizon
The potential passing of a 2017 budget, the foreseen agreement on a parliamentary law and the plausibility of holding country wide parliamentary elections (despite a technical delay), the resumption of GCC nationals touristic visits to Lebanon, the launch of the oil and gas exploration process prior to year-end are all credit positive developments and are likely to favorably impact the Eurobond market prospects. While such opportunities are genuine, there are risks as well lying ahead. Of these, we mention the continuing spillover effects of the war in Syria, the escalating faceoff between Israel and Hezbollah and the controversial conundrum of the public sector wage scale, all apt to create some noise on Lebanese markets. Still, we believe strengths and opportunities outpace threats and challenges, with risks tilted to the upside.

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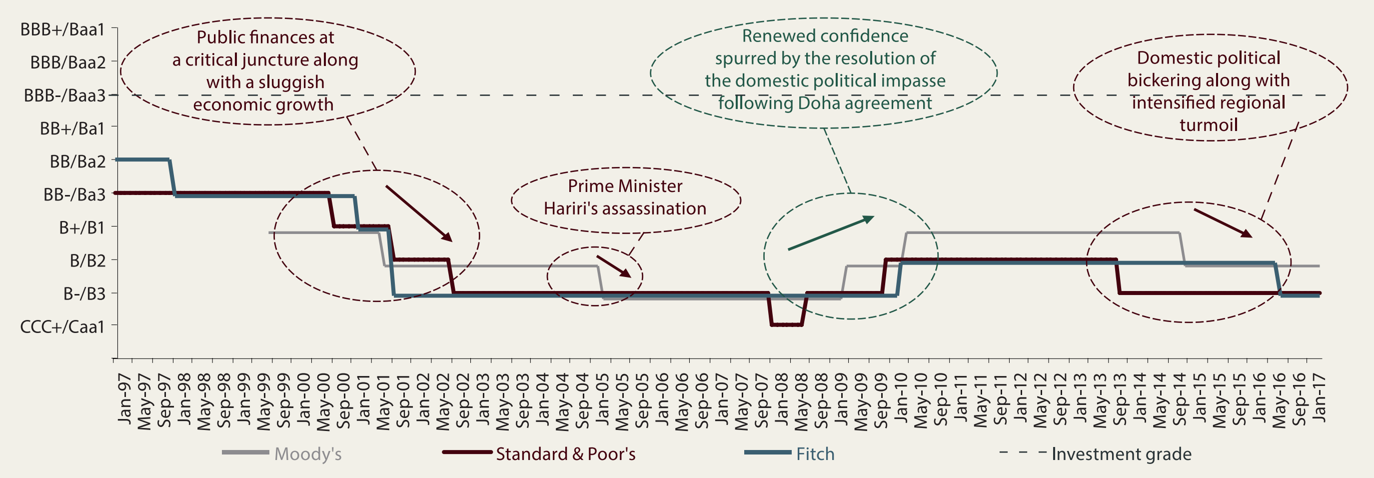
1. CREDIT FUNDAMENTALS

Lebanon, rated B2 by Moody's, B- by Standard and Poor's and B- by Fitch, is a country of investment paradox with a long track record of financial and market resilience in an overall environment with significant imbalances and uncertainties.

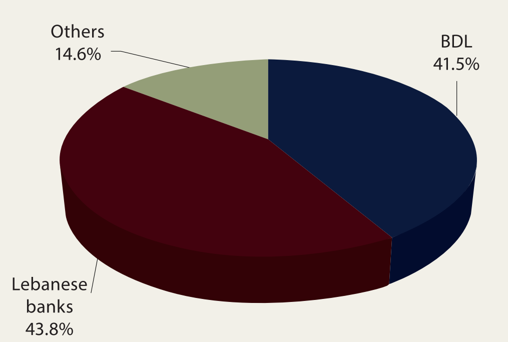
Within this environment, the Lebanese fixed income market is mainly driven by Lebanese sovereign Eurobonds that account for 93% of Lebanon's foreign currency debt which in turn represents circa 40% of overall public debt. Lebanese banks hold circa 60% of total Lebanese Eurobonds, leaving the remaining 40% for retail resident and non-resident investors and foreign institutional investors. With the Lebanese banks accounting for the bulk of Eurobonds outstanding, the bond market is significantly correlated with the conditions of the Lebanese financial sector at large and with the growth of its funding base.

LEBANON'S CREDIT RATING EVOLUTION



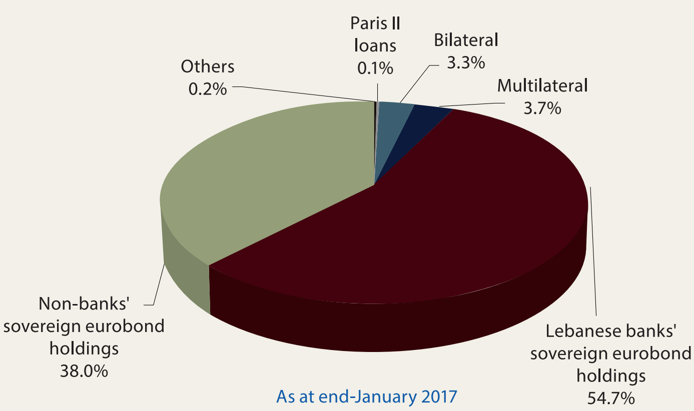
Sources: Rating agencies, Bank Audi's Group Research Department

LOCAL CURRENCY DEBT BY TYPE OF DEBT HOLDER



Source: Central Bank of Lebanon

FOREIGN CURRENCY DEBT BY TYPE OF DEBT HOLDER



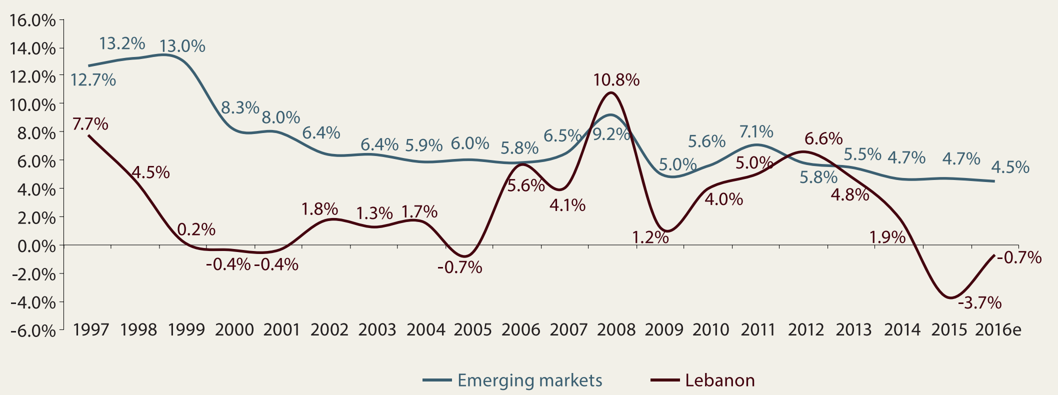
Source: Central Bank of Lebanon

1.1 Long term financial sector resilience

At the level of the financial sector, the financial and monetary conditions continue to witness an atypical resilience, with a new resilience phase extending the long-term financial/monetary sustainability. Perhaps, the most fascinating aspect about the Lebanese economic model is the noticeable sustainability over time despite the volatile operating environment on the one hand and the acute imbalances on the other hand. The country was actually able to maintain a long term sustainability trend in its inflation rates, its exchange rate, its capital inflows, and its banking activity.

First, the sustainability of low inflation: It was quite noticeable how Lebanon could sustain low one-digit inflation rates over a long period of time which extends for more than two decades, avoiding erratic price pressures. The Lebanese economy is actually operating on the flat Keynesian side of its aggregate supply curve allowing growth in aggregate demand to take place without significant price pressures. In particular, over the past 5 years, inflation has averaged 1.8% per annum, against an average of 5.6% for emerging markets. Bear in mind that a net deflation was reported in 2015 and a close to nil inflation was reported last year amid the drastic decline in oil prices. Also bear in mind in this regard that the low inflation rates offset the recent appreciation of the Lebanese Pound (that paralleled the US dollar appreciation relative to the world currencies), thus leaving Lebanon's real effective exchange rate broadly unchanged.

INFLATION RATE

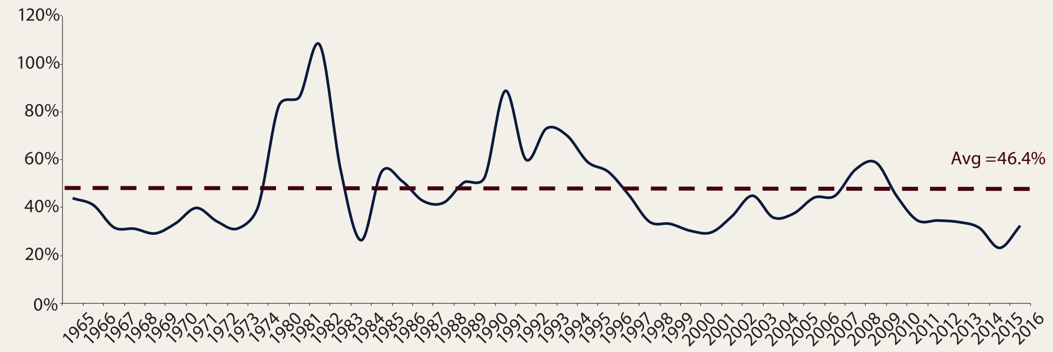


Source: International Monetary Fund

Second, the sustainability of the currency peg: Lebanon has remarkably sustained the stability of its pegged exchange regime, with no drift in the currency's exchange rate since 1993 despite some temporary monetary pressures at times of uncertainties. The sustainability of the peg was supported by macro and monetary dynamics, with the Lebanese Pound in line with the country's macroeconomic fundamentals. Maybe a tangible support for that is the average annual growth in M3 since 1993 (US$ 5.3 billion) and that exceeds the average annual domestic money creation (US$ 4.3 billion) in its two components of growth in bank claims on the private and public sectors. Having said that, with BDL foreign assets including gold almost fully covering the stock of Lebanese pounds outstanding, the exchange sustainability is likely to continue prevailing at least in the near term. Even when excluding gold, foreign reserves currently account for 76% of Lebanese Pound Money Supply, more than double the average for similarly rated markets, suggesting a strong Central Bank capacity to maintain the currency peg.

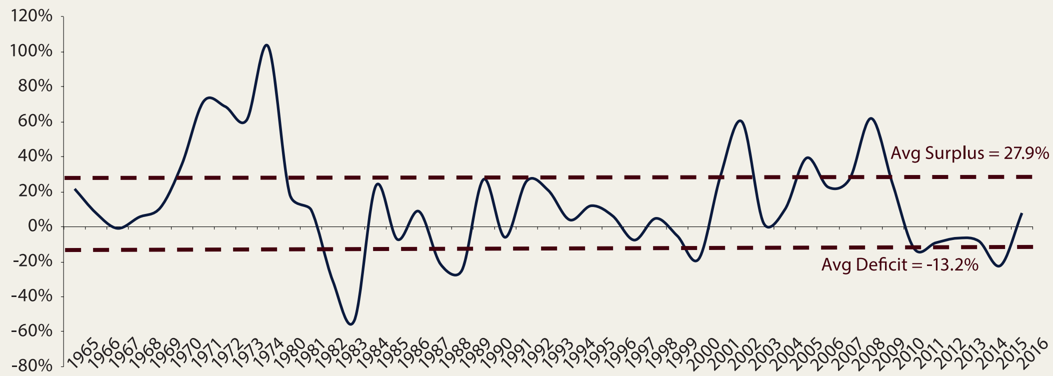
Third, the sustainability of financial inflows: Lebanon rises among the very few countries with sustained large capital inflows over a long period emanating mainly from a very large Diaspora of Lebanese non-residents equivalent to three times the Lebanese residents and keeping strong ties with the home economy. Lebanon's financial inflows to GDP averaged above 30% over the past half a decade of regional turmoil, supporting the country's financial equilibrium. Despite the relative correction in inflows since the collapse in oil prices, financial inflows still report more than US$ 1.4 billion per month, the bulk accounted for by remittances. As a matter of fact, over the past 25 years, Lebanon did not witness erratic fluctuations in the balance of payments, on the background of an average deficit of 5% of GDP and an average surplus of 9% of GDP.

FINANCIAL INFLOWS TO GDP RATIO



Sources: Central Bank of Lebanon, Lebanon's Higher Customs Council

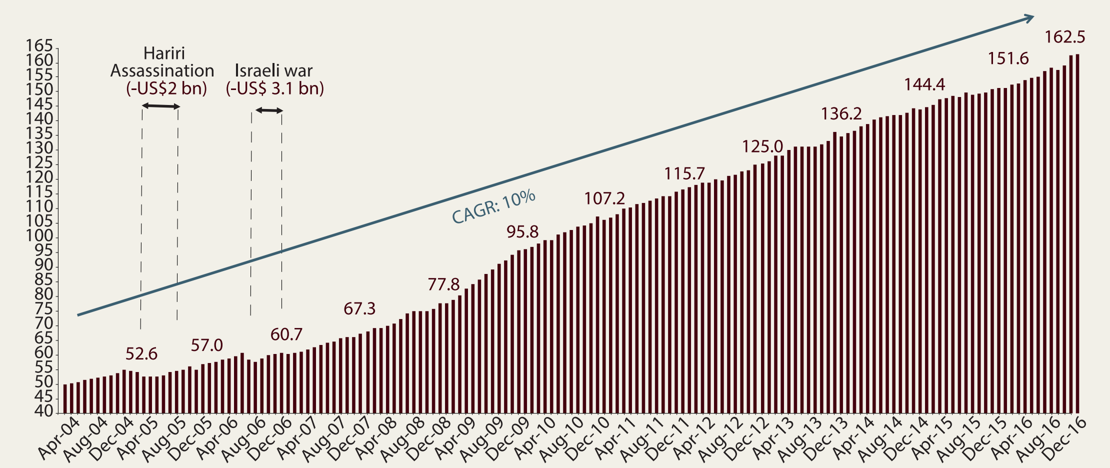
BOP TO TRADE DEFICIT RATIO



Sources: Central Bank of Lebanon, Lebanon's Higher Customs Council

Fourth, the sustainability of banking activity: Last but not least, not far from the sustainability of financial inflows, the resilience of the banking industry in Lebanon over the past years has been intensively reported by almost all international reference institutions. What was particularly noticeable is the unique resilience of Lebanese banks that sustained activity during periods of domestic and external turmoil. Over the past two and a half decades, deposit growth reported an average CAGR of 15% per annum, with no single year-on-year decline in the deposit base. Despite the relative slowdown in deposit growth over the last few years, it is still enough to finance the economy's borrowing needs in its private and public sector components. Supported by strict regulatory regime and well diversified conservative structures, such successful episodes of historical resilience are likely to further protect the banking industry in front of potential future shocks in a short to medium term horizon. In few words, Lebanon's banking sector represents the country's key inflow attractiveness and the cornerstone of its paradoxical resilience to turmoil amid volatile domestic and external conditions at large.

EVOLUTION OF BANKS' DEPOSITS (US$ BILLION)



Sources: Central Bank of Lebanon, Bank Audi's Group Research Department

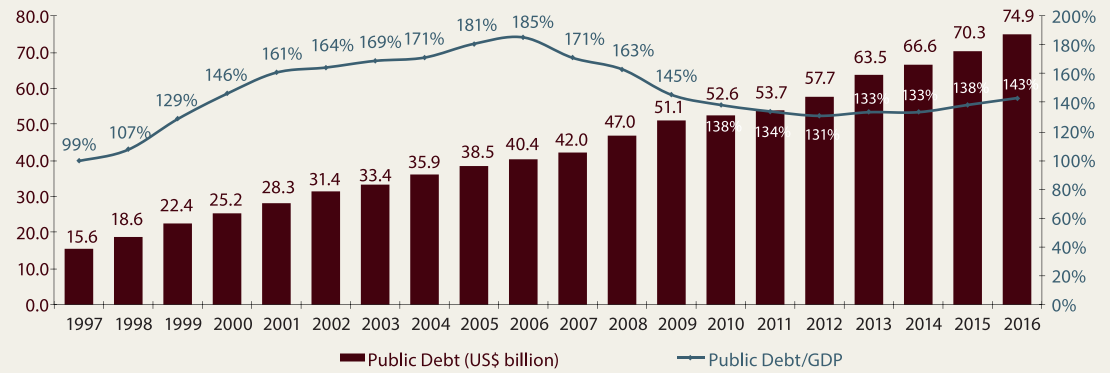
The country's noticeable financial and monetary sustainability amid uncertainties henceforth lies at the heart of the Lebanese atypical conditions that have increasingly intrigued a large deal of keen observers in business and financial circles worldwide. It is this ongoing Lebanese paradox, and which could be fundamentally assimilated to an "equilibrium" within an overall "disequilibrium", that actually characterizes the intrinsic features of Lebanon's atypical model across time and space.

1.2 Persisting public finance imbalances

When talking of disequilibrium, the most significant imbalances that Lebanon has are public finances and external deficits, though bearing in mind that Lebanon's trade deficits are largely offset by recurrent inflows of capital, which leaves us with the main issue of fiscal imbalances. At the level of the public sector, what we have witnessed is a net deterioration over the past few years with budget deficit now hovering around 9.5% of GDP and public debt hovering around 143% of GDP, after relative improvement over the second half of the previous decade.

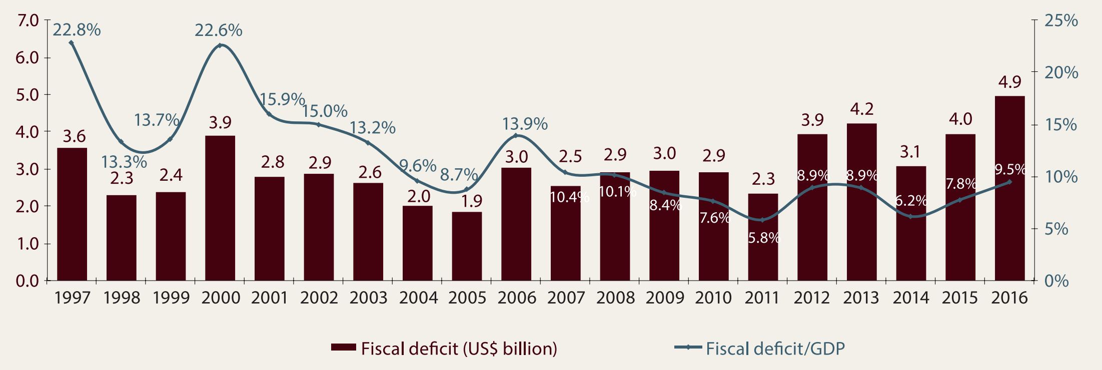
Actually, although Lebanon's public finance debt and deficit are undeniably elevated and need to be curbed, there are a number of factors that need to be taken into consideration when addressing Lebanon's public finances and its fiscal drifts and that make us believe that Lebanon is not in a fiscal trap scenario. These considerations are mainly the 87% resident component of public debt, the large foreign assets at the Central Bank covering 180% of foreign currency debt, the persisting positive net asset value of the State, the potential exits in a low resource mobilization environment and room for spending rationalization and the significant oil and gas reserves estimated to cover three times Lebanon's current public indebtedness at large.

PUBLIC INDEBTEDNESS



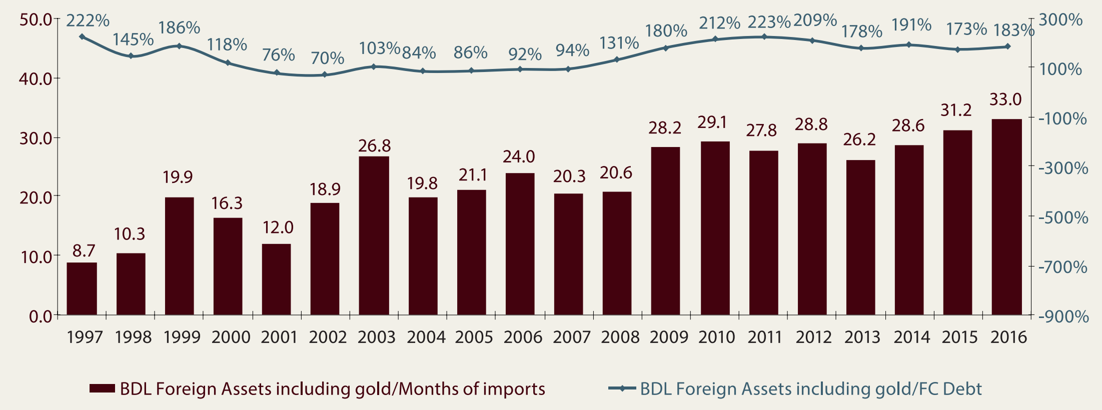
Sources: Ministry of Finance, International Monetary Fund

FISCAL DEFICIT



Sources: Ministry of Finance, International Monetary Fund

EXTERNAL CREDITWORTHINESS



Sources: Central Bank of Lebanon, Ministry of Finance

Finally, although all these intrinsic considerations are real and genuine, the fundamental economic sanity and Lebanon's long term macro and markets stability requires a long awaited fiscal consolidation to ensure the much needed soft-landing scenario of the Lebanese economy at large. It is only then that Lebanon's economic resilience can turn into fundamental immunity in an environment of domestic and external shocks and lingering uncertainties.

2. RECENT MACRO TRENDS

The most important recent developments are the large swap operations of the Central Bank with important financial sector implications over the second half of last year on the one hand and the political trend reversal with the domestic political settlement since the last quarter of 2016 on the other hand.

2.1 Innovative BDL financial engineering operations

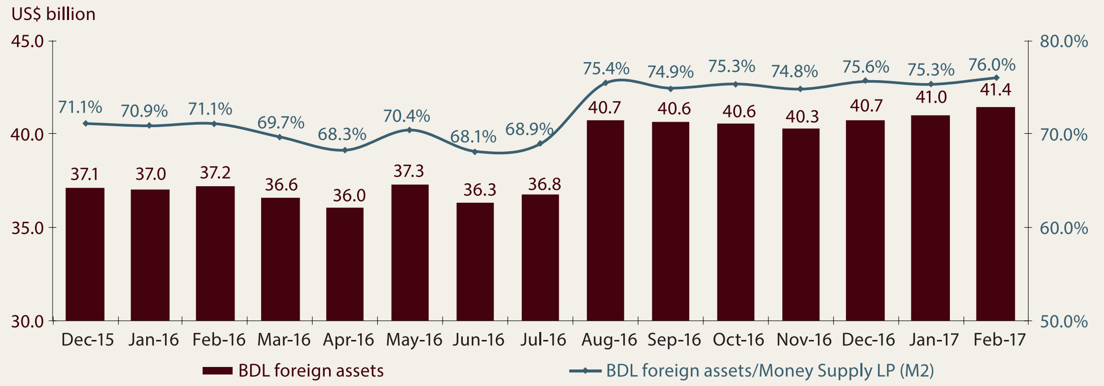
The Central Bank of Lebanon, in tight coordination with Lebanese banks, has undertaken over the past few months successfully innovative financial engineering operations that targeted reinforcing Lebanon's foreign assets, supporting the balance sheets of operating banks and improving the lending activity of banks to the private and public sectors.

The financial engineering operations started with a swap of LP Treasury bills held by the Central Bank with new Eurobonds issued by the Lebanese Treasury by the end of May. The Ministry of Finance has accordingly increased the amount of public debt held in dollars by swapping with the Central Bank local currency debt into US$ 2 billion worth of Eurobonds. More importantly, the new Eurobonds acquired by the Central Bank have been all subsequently sold to banks, in addition to the sale of additional Eurobonds and CDs by the

Central Bank. In parallel, BDL actually offered to discount LP Tbs and LP CDs held by banks at an attractive premium (well above current market) at the condition of banks investing in turn at the Central Bank in US dollars by the same amounts.

While the swap operations, which revolved around a total of US$ 15 billion, had some adverse effects at the level of banks primary liquidity and banks exposure at the Central Bank, they held significant benefits reported at various levels and in different realms. The overall BDL swaps reinforced Central Bank reserves to a new record high. BDL's foreign assets have reported a total of US$ 41 billion at the end of February 2017, the equivalent of 76% of the Lebanese Money Supply and 26 months of imports, which suggests monetary resilience is continuing on a bolstered overall Central Bank standing.

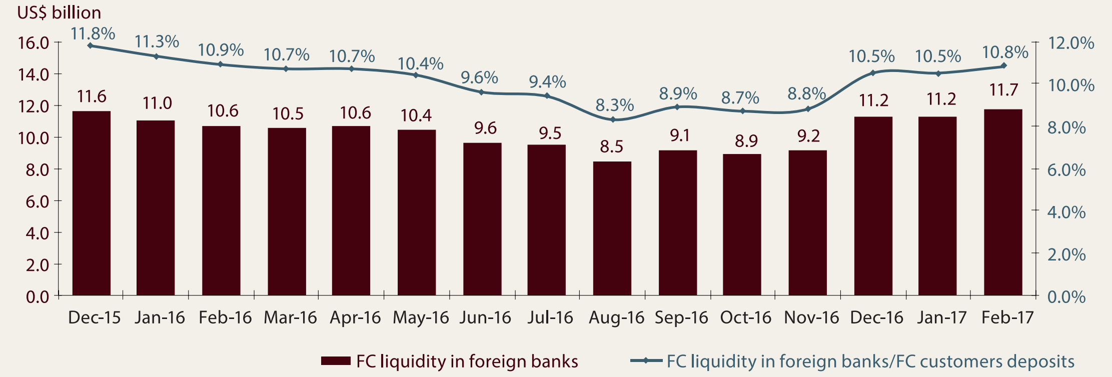
EXCHANGE MARKET INDICATORS



Source: Central Bank of Lebanon

Furthermore, the BDL swaps had positive effects on banks balance sheets. The Central Bank has imposed on banks to allocate the extra revenues that they realize from the swap operations to collective provisions in preparation for IFRS 9 requirements which banks have to abide by starting 2018, strengthening Lebanese banks balance sheets at large. Notwithstanding the incremental positive effect on banks profitability, after return ratios had reported consecutive declines over the past few years. Meanwhile, while swaps carried an adverse effect on liquidity in foreign banks (from 11.8% of FX deposits in December 2015 to 10.5% in December 2016), banks have embarked on subsequent measures to replenish their liquidity. Bear in mind that their overall FX primary liquidity position (including placements at foreign banks and at the Central Bank) remains at 55% of FX deposits at end-December, still one of the highest levels in emerging markets. To reinforce their FX liquidity positions post-swaps, some banks have been offering attractive conditions to fresh deposits, mainly coming from outside Lebanon, thus somehow sharing with customers some of the profits realized by the Central Bank operations. This has reflected positively on banks deposits growth, which had been relatively lagging over the early months of 2016 but which now show an excess by the end of December over the previous year's same twelve-month period by circa 50%. As a result of the significant growth in net foreign assets since July, the large first-half deficit in the balance of payments turned into a twelve-month surplus of US$ 1.2 billion in 2016.

LEBANESE BANKS' LIQUIDITY IN FOREIGN BANKS



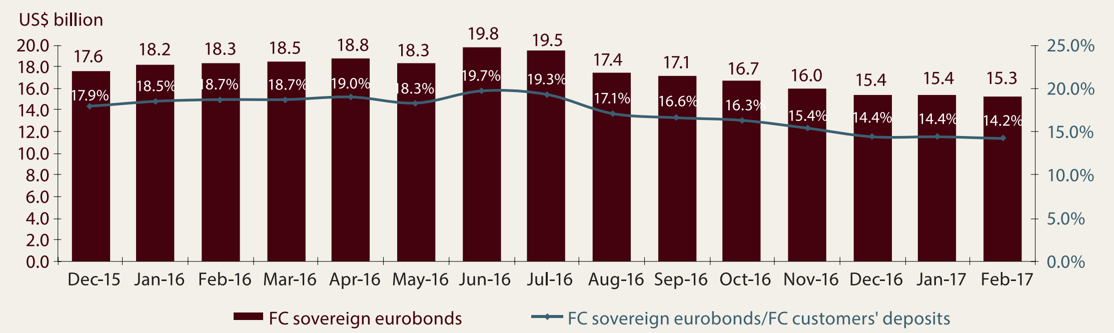
Source: Central Bank of Lebanon

BALANCE OF PAYMENTS BY COMPONENT

US$ million	Dec-15	Jun-16	Change 6M	Dec-16	Change 12M	Change Jun-Dec
BDL						
Foreign Assets	46,940	48,425	1,485	51,411	4,471	2,986
o.w gold	9,848	12,148	2,300	10,705	857	-1,443
o.w foreign currencies*	37,092	36,277	-815	40,706	3,614	4,429
Foreign Liabilities	213	213	0	212	-1	-1
Net foreign assets (excluding gold)	**36,879**	**36,064**	**-815**	**40,494**	**3,615**	**4,430**
Banks						
Foreign Assets	23,795	22,253	-1,542	23,100	-695	847
o.w Claims on non-resident private sector	6,180	6,429	249	6,140	-40	-289
o.w Claims on non-resident financial sector	11,557	9,594	-1,963	11,240	-317	1,646
o.w Other foreign assets	6,058	6,230	172	5,720	-338	-510
Foreign Liabilities	38,401	38,378	-23	40,241	1,840	1,863
o.w Non-resident private sector deposits	31,858	32,171	313	33,961	2,103	1,790
o.w Non-resident financial sector deposits	6,543	6,207	-336	6,280	-263	73
Net foreign assets	**-14,606**	**-16,125**	**-1,519**	**-17,141**	**-2,535**	**-1,016**
Total						
Foreign Assets (excluding gold)	60,887	58,530	-2,357	63,806	2,919	5,276
Foreign Liabilities	38,614	38,591	-23	40,453	1,839	1,862
Net foreign assets	**22,273**	**19,939**	**-2,334**	**23,353**	**1,080**	**3,414**
Change in Net Foreign Assets adjusted for currency fluctuations			**-1,774**		**1,238**	**3,012**
* As per BDL bi-monthly balance sheet			**BOP 6M 2016**		**BOP 12M 2016**	**BOP Jun-Dec**

Source: Central Bank of Lebanon

BANKS' SOVEREIGN EXPOSURE



Source: Central Bank of Lebanon

At the level of the Lebanese Eurobond market, in order to reinforce their FX liquidity following the swaps with the Central Bank, Lebanese banks enhanced their sales efforts with foreign investors holding Lebanese Eurobonds and that are mainly underweight relative to the bond indices. Accordingly, Lebanese banks bond sales to foreign investors are estimated to have exceeded US$ 4.4 billion since the beginning of the swaps, to almost double the foreign institutionals holdings. Some foreign investors have recommended to their customers as well to invest in Lebanese Eurobonds on the back of attractive relative bond prices raising the risks of underweight.

Last but not least, the reinforced financial sector resilience, in both its banking and Central Bank components, carries positive spillover effects on the sovereign risk and the ability of the government to meet its borrowing needs. It is within this context that lies the S&P decision to improve Lebanon's rating outlook from "negative" to "stable" on the back of resilient financial system and deposit inflows.

2.2 Improving macro outlook on the basis of the recent domestic political settlement

The other material development with market implications is the recent domestic political settlement. Following a net slowdown over the past few years due to the regional turmoil and the domestic political bickering, the Lebanese economy is now set to rebound on the basis of Lebanon's domestic political settlement in the last quarter of 2016 that lead to successful presidential elections with regional and international support and that lead to the formation of a Government of National Unity. Beyond any obstacles that might emerge, there is no doubt that the domestic political settlement fundamentally improved the risk profile of Lebanon and lifted the economic opportunities at the horizon.

Our macro forecasts for 2017 post-presidential elections and cabinet formation but with the persisting absence of a regional settlement, rest on a rising real GDP growth to almost double the average it reported over the past 6 years.

The improving growth would be driven primarily by private investment which had seen a wait-and-see attitude over the past few years and that lead to a gradual fall of the capital formation rate to 23% last year. Our forecasts for 2017 suppose a 15% growth in private investment driven by the improvement in the country's political risk profile, which would raise Lebanon's capital formation rate to 25% as the Lebanese would be taking more investment initiatives that they had delayed over the past few years.

The amelioration of the investment climate would be accompanied by an outgrowth of private consumption driven by a better consumption behavior of Lebanese residents, a growing incoming of Lebanese non-residents and a gradually improving touristic season at large, especially after the political normalization between Lebanon and GCC countries post-presidential elections. As such, private consumption would grow by circa 7% per annum in nominal terms and account for the bulk of GDP formation.

The improvement in Lebanon's politico-economic conditions could generate no less than a 20% rise in financial inflows in 2017, following the noticeable double-digit growth that was reported in 2016 and that was driven by the financial engineering operations of the Central Bank. A net surplus in the balance of payments would be realized for the second year in a row after the 5-year cumulative deficits that were realized between 2010 and 2015.

In parallel, we project a 7% growth in Money Supply for the year, driven both by domestic money creation and the positive change in net foreign assets. This moderate money supply growth is likely to yield a deposit growth of close to US$ 10 billion in 2017 (15% more than the average of the past three years), with total banking sector deposits exceeding the threshold of US$ 170 billion. At the uses level, bank loans to the private sector are likely to benefit from rising financing needs in a faster growth economy. We forecast a circa US$ 4 billion growth in bank lending to the private sector (25% more than the average of the past 3 years), driven by growing lending opportunities to finance new projects, corporate expansion and working capital.

While the realization of such a scenario could be somehow subject to few risk factors, we believe that such risks have narrowed noticeably recently and that macro opportunities do outpace potential threats at a foreseeable horizon paving the way for a plausible materialization of our pre-mentioned forecasts. It is worth mentioning that in the event of a regional political breakthrough via a regional settlement, such figures are apt to expand accordingly, though we believe the probability of this happening over the near term is still unlikely.

3. RECENT EUROBOND MARKET PERFORMANCE

Price gains across the board in Lebanese bond market along with contractions in CDS spreads

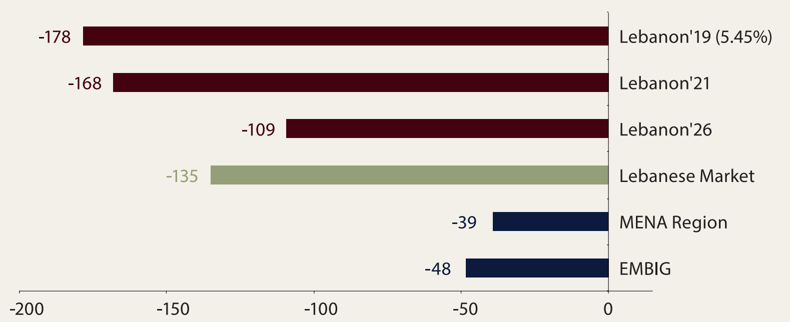
Lebanon's fixed income market benefited from improved investor sentiment following the successful Presidential elections at end-October 2016 and the formation of a national unity cabinet in December 2016. The improvement in Lebanon's political risk profile since end-October 2016 was accompanied by replenished foreign currency liquidity in the banking system towards the end of the year, given the banks' attractive packages for foreign currency deposits and as banks enhanced their sales efforts with international institutional investors that are mainly underweight relative to the bond indices and that have seen a carry opportunity in Lebanese Eurobonds given the wider Lebanon z-spreads relative to JP Morgan EMBIG z-spreads.

This ensured a healthy local and international demand for Lebanese Eurobonds over the past few months. This was reflected by a 26.8% contraction in the z-spread based Audi Compiled Lebanon Bond Index since end-October 2016. Also, the weighted average yield fell from 5.99% on October 31, 2016 to a current 5.65%, moving down by 34 basis points given the strong investor appetite.

On the back of these favourable market conditions, the Lebanese Republic raised in March 2017 circa US$ 3 billion from the sale of a triple-tranche bond in order to finance the public debt and meet the needs of the State. The issue was almost six times oversubscribed, attracting order books of circa US$ 17.8 billion, which resulted into a final yield tightening relative to initial price thoughts. In details, the 10-year US$ 1.25 billion bond was issued at a final yield of 6.85% as compared to initial price thoughts in the 6.95% area; the 15-year US$ 1.0 billion bond at a final yield of 7.00% as compared to initial price thoughts in the 7.125% area; and the 20-year US$ 750 million bond at a final yield of 7.25% as compared to initial price thoughts in the 7.35% area.

That being said, the Lebanese fixed income market witnessed upward price movements across the board since end-October 2016, along with z-spreads contractions. Shorter-term papers maturing between 2017 and 2020 registered price gains hovering between 0.75 pt and 3.50 pts, noting that Lebanon'19 (offering a coupon of 5.45%), which is among the most liquid bonds, recorded price rises of 3.25 pts along with a 178 bps contraction in z-spreads. Also, the belly of the curve registered healthy price increases, with papers maturing between 2021 and 2027 closing up by 2.13 pts to 4.13 pts. It is worth highlighting that Lebanon'21 and '26, which are among the most liquid papers, posted price gains of 3.50 pts and 2.88 pts respectively, along with z-spreads contractions of 168 bps and 109 bps respectively. As to longer-term papers, sovereigns maturing between 2028 and 2035 posted price rises ranging between 0.13 pt and 2.13 pts.

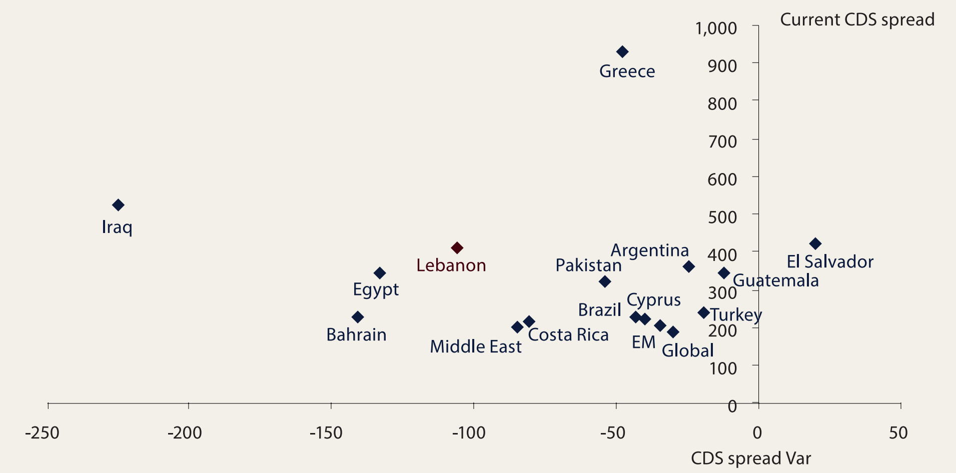
BONDS Z-SPREAD VARIATION SINCE END-OCTOBER 2016 (IN BPS)



Sources: Bloomberg, Bank Audi's Group Research Department

At the mirror image of the improved domestic political environment and increased investor confidence, Lebanon's five-year CDS spreads registered a significant contraction of 106 basis points since end-October 2016, moving from 517 basis points to a current 411 basis points, which is its lowest level since November 2015, in a sign of improved market perception of sovereign risks. This favourably compares to smaller contractions in the cost of insuring debt in the Middle East (-85 bps), emerging markets (-35 bps), and global markets (-30 bps) over the same period.

FIVE-YEAR CDS SPREADS VARIATION SINCE OCT-2016 (IN BPS)



Sources: Bloomberg, Bank Audi's Group Research Department

4. COMPARATIVE VOLATILITY ANALYSIS

Low volatility reflects Lebanese bond market's defensiveness

Over the past few years, and within the context of global market volatility, regional unrest, low oil prices piling pressure on regional liquidity, and tense local political climate, Lebanese bonds proved rather immune to external and internal shocks. Indeed, Lebanese Eurobonds demonstrated their defensiveness over the past five years, with sovereign papers being less volatile relative to regional and global peers due to a number of factors.

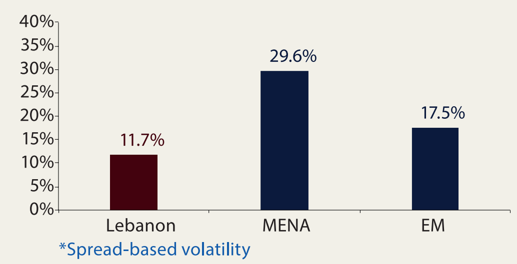
To begin with, Lebanese bonds were shielded from the effects of the Arab Spring, where the deteriorating politico-security conditions had contractionary effects on the region's real economy. Lebanon does not share the socio-economic characteristics that triggered the MENA turmoil, largely insulating the country and its markets from the spillovers of the adverse events.

Furthermore, the low volatility of Lebanese sovereign papers was supported by the country's low exposure to the global financial crisis and its long-lasting spillovers, or even to the Euro Area woes in the past few years. The country's tradition of stringent regulation at the Central Bank of Lebanon shielded banks from the crisis as they were not allowed to take on too much risk, in addition to the banks themselves having conservative practices and not having an appetite for toxic assets.

A third factor supporting the low volatility of Lebanese bonds is the fact that the majority of debt papers are owned by local investors. In fact, the majority of bonds are locally held by commercial banks. Thus, the financing of the government's needs proved resilient, as Lebanese commercial banks, the government's primary creditors, remain willing and able to purchase and roll over government debt given their significant deposit-funded resources, alleviating government liquidity and solvency risks.

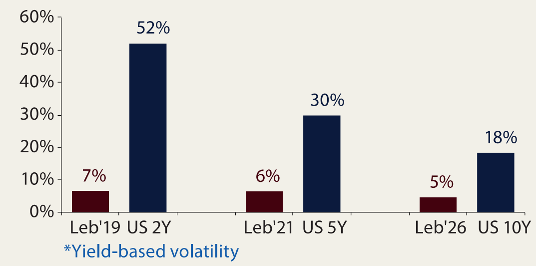
To illustrate the previously mentioned factors supporting the low volatility of papers, we resorted to the analysis of bond volatility based on spreads (except for comparisons with US Treasuries where yield-based volatility was computed instead, understandably enough). Lebanese sovereign bonds posted a volatility of 11.7% over the past five years (March 2012 to date), compared to 29.6% in the MENA region and 17.5% in emerging markets. Additionally, based on yield metrics, Lebanon'19 papers registered volatility levels of 6.5%, compared to 52.1% for the two-year US Treasuries. Lebanon'21 also attained a volatility score of 6.4%, against 29.8% for 5Y US Treasuries, while Lebanon'26 posted a volatility of 4.6%, relative to 18.3% for 10Y US Treasuries.

LEBANON VS MENA VS EM BOND VOLATILITY* (PAST 5 YEARS)



Sources: Bloomberg, Bank Audi's Group Research Department

SELECTED LEBANESE BONDS VS USTs VOLATILITY* (PAST 5 YEARS)



Sources: Bloomberg, Bank Audi's Group Research Department

It is worth noting that that volatilities are higher on the front-end of debt curves in general as maturities are nearer, and such debt papers are usually more demanded by non-buy-and-hold investors. Buy-and-hold investors usually tend to focus more on a curve's back-end, or at least go for longer maturities than others. As such, turnover on shorter term bonds sometimes tends to be higher, and hence these have higher volatilities.

Likewise, Lebanese papers' relative immunity to external risks can be seen through very low correlation levels with global and regional events. Based on a yield metric, the correlation of Lebanese 2Y, 5Y and 10Y papers with respective US Treasuries is almost inexistent during the past five years. Moving on to spread-based metrics, the correlation of Lebanese bonds with MENA bonds was very low at 0.027, and that of Lebanese papers with EM bonds was at 0.136, showing practically no correlation with peers abroad.

5. MARKET VALUATIONS

5.1 Potential for further spread compression despite recent rally

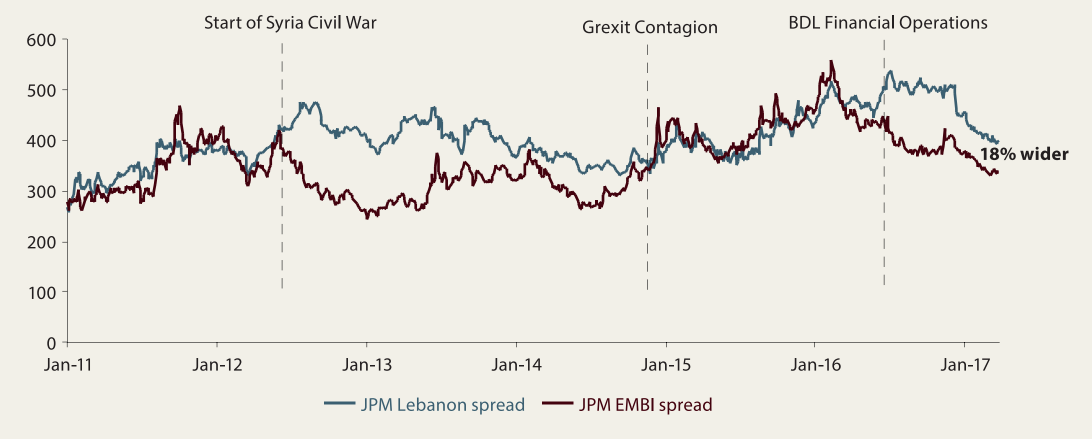
The recent rally in Lebanon Eurobonds across the board, coupled with the improvement in the overall investment climate in the country following the domestic political settlement scenario and with the ensuing improvement in markets' perceptions of sovereign risks, bodes well for Lebanese debt papers.

The cash market saw a surge in local and foreign investor interest after sell-offs triggered by the BDL swap operations, which saw local banks that are heavyweight investors in Lebanese Eurobonds, put their papers on the table for sale in order to raise US dollar liquidity as part of swaps with the BDL.

The improvement in domestic conditions and return of local institutional investors to the market thus helped boost interest in Lebanese debt papers in the last few months. As a result, our in-house compiled Lebanon Bond Index, which is market-cap weighted, shows a contraction in spreads in the past few months after an expansion driven by swap-related sell-offs.

Despite the price appreciation, Lebanese Eurobonds still trade today on average trade 18% wider than emerging market peers when comparing Lebanese debt securities included by JP Morgan in their index to their wider JP Morgan EMBIG on a spread basis. This underlines a further opportunity for spread compression ahead despite the rally already observed on local papers in the aftermath of the domestic political improvement.

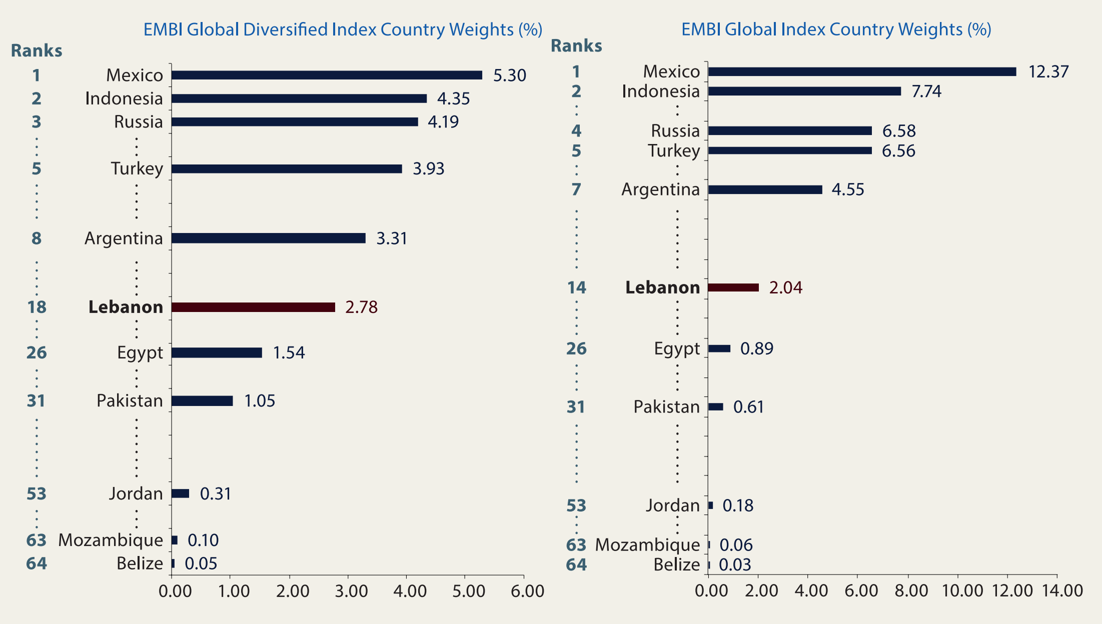
JPM LEBANON SPREAD VS JPM EMERGING MARKETS SPREAD (BPS)



Sources: Bloomberg, Bank Audi's Group Research Department

One must not forget that the actual foreign investors holdings of Lebanese Eurobonds is still well underweight when looking at the JP Morgan Emerging Markets Bond Index Global (EMBIG) or even the EMBIG Diversified, which is a technical variant of the former. JP Morgan is actually recommending investors to allocate a weight of 2.78% to Lebanese debt papers in their emerging market bond portfolio, while they are currently allocating a weight of less than 2%.

EMBI GLOBAL COUNTRY WEIGHTS



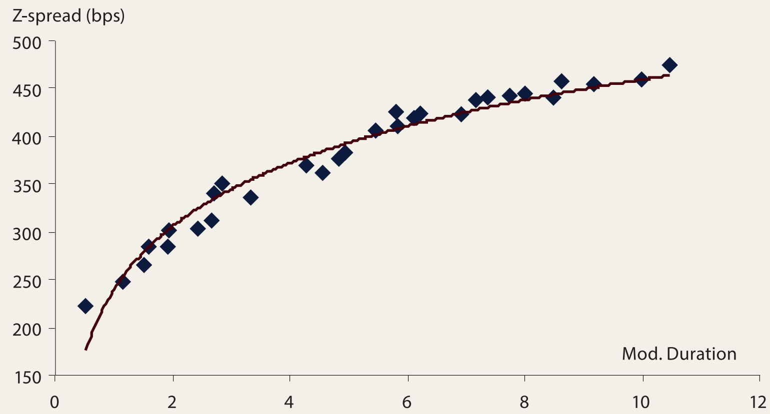
Sources: JP Morgan, Bank Audi's Group Research Department

It is true that following the BDL swap operations and ensuing massive bond sales to foreigners, the weight of Lebanon in EMBIG Diversified practically doubled, but there is still ample room for a further increase to be aligned with the market weight position and thus to see a further spread compression on Lebanese debt papers.

5.2 Liquid papers at front-end and belly of the curve benefit from upside potential

In this sense, Lebanese debt papers offer good value still, and when looking at the most liquid ones out there currently, there is a healthy upside potential. The flattish shape of the Lebanese debt curve means that back-ended papers trade rather in line with belly bonds for higher durations, and thus lead us to focus on shorter maturity liquid instruments.

LEBANON SOVEREIGN CREDIT CURVE



Sources: Bloomberg, Bank Audi's Group Research Department

For instance, on the front end of the Lebanese debt curve, the Lebanon'19 papers currently trade at a spread of 313 bps for a B- rating and trade 95 bps wider than the average of a selection of similarly rated emerging market peers with more or less similar maturities/duration.

Also, around the belly of the curve, the Lebanon'21 papers currently trade at a spread of 343 bps, 79 bps wider than the average of similarly rated peers with similar maturities/duration. When looking a bit further up the belly of the curve, the Lebanon'26 series currently trade at a z-spread of 422 bps, 33 bps wider than its peer group. It appears that the more investors are positioned on the front-end of the curve, the higher the pick-up those liquid Lebanese bonds offer relative to comparable peers.

Z SPREAD OF LEBANON VS COMPARABLE PEERS

Z-spread of Lebanon'19 vs Comparable Peers (Mar 28, 2017)

	Z-spread	S&P	Fitch	Moody's
Belarus'18	324	B-	-	Caa1
Lebanon'19 (Nov.)	**313**	**B-**	**B-**	**NR**
Pakistan'19	234	B	B	B3
Egypt'20	234	B-	B	B3
Kenya'19	225	B+	B+	NR
Argentina'19	161	B-	B	B3
Jamaica'19	129	B	B	B3
Peer average	**218**			

Z-spread of Lebanon'21 vs Comparable Peers (Mar 28, 2017)

	Z-spread	S&P	Fitch	Moody's
Rwanda'23	427	B	B+	NR
Nigeria'21	346	B	B+	NR
Lebanon'21	**343**	**B-**	**B-**	**NR**
Egypt'22	314	NR	B	B3
Argentina'21	304	B-	B	B3
Jamaica'21	127	NR	NR	NR
Jordan'21	63	NR	NR	NR
Peer average	**264**			

Z-spread of Lebanon'26 vs Comparable Peers (Mar 28, 2017)

	Z-spread	S&P	Fitch	Moody's
Argentina'26	434	B-	B	B3
Egypt'27	429	NR	B	B3
Lebanon'26	**422**	**B-**	**B-**	**NR**
Pakistan'25	415	NR	B	B3
Ivory Coast'24	392	NR	B+	Ba3
Jordan'26	356	BB-	NR	B1
Jamaica'25	305	B	B	B3
Peer average	**389**			

Sources: Bloomberg, Bank Audi's Group Research Department

The relatively low volatility and correlation of Lebanese bonds to US and emerging market peers we have seen over the past few years actually serves them well in defensive market times such as the ones we are seeing/about to see. With the US Federal Reserve raising rates and proceeding with monetary policy normalization, yields are set for successive increases across dollar-denominated bond markets such as emerging markets and our region. It is also in such an environment that Lebanese debt papers are apt to outperform markets.

Today, Lebanon's sovereign Eurobonds present both capital gain and more interestingly carry opportunities, especially for investors hunting for value in a global sell-off oriented bond market. They remain a relatively safe play given the expected expansion in US and EM yields in the period ahead, especially with the positive technicals Lebanese papers now benefit from, and which are tied to an improving country profile.

6. MARKET OUTLOOK

When looking at the Eurobond market outlook, it is important to link it to the foreseen growth in Lebanon banks deposit base, the main holders of Lebanese Eurobonds, along with the appetite of foreign institutional investors for holding Lebanese risk. The recent improvement in the domestic political environment in Lebanon on the back of successful presidential elections, the formation of a cabinet of national unity and the launch of governmental works, of which the ratification of oil decrees and appointments of key positions in the public sector, reflect positively on Lebanon's overall financial framework and Eurobond market conditions. The potential passing of a 2017 budget low, the foreseen agreement on a parliamentary law and the plausibility of holding country wide parliamentary elections (despite a technical delay), the resumption of GCC nationals touristic visits to Lebanon, the launch of the oil and gas exploration process prior to year-end are all credit positive developments and are likely to favorably impact the Eurobond market prospects.

While such opportunities are genuine, there are risks as well lying ahead. Of these, we mention the continuing spillover effects of the war in Syria, the escalating faceoff between Israel and Hezbollah and the controversial conundrum of the public sector wage scale in Lebanon with corollary domestic riots related to its tax financing options, all apt to create some noise on the Lebanese financial markets. Still we believe strengths and opportunities outpace threats and challenges, with risks tilted to the upside. Within the same context, a political settlement in Syria, although unlikely in the near term, would be definitely credit positive for Lebanon and might have favorable effects on the Lebanese economy, its financial sector and the Lebanese Eurobond market in particular.

It is worth mentioning that the current year started with a sound reflection of an improving financial environment. Bank deposits grew by US$ 1.4 billion over the first two months of 2017 (against a net decline over the first two months of 2016). Such an observed deposit growth is in line with our annual projection for deposit growth in 2017 and that we forecasted at 6.2% (US$ 10 billion), mainly accounted for by foreign currency deposits. It is enough to ensure a healthy demand for Lebanese Eurobonds, especially that the Lebanese banks FX sovereign exposure has declined recently in both absolute and relative terms. As a percentage of their FX deposits, Lebanese sovereign Eurobond holdings declined from 19.7% in June 2016 (1.14 times equity) to 14.2% in February 2017 (0.83 times equity). As to banks FX primary liquidity in foreign banks, although the latter reached a low of US$ 8.5 billion in August 2016 (the equivalent of 8.3% of FX deposits), it rose again to its pre-swap level of US$ 11.7 billion (the equivalent of 10.8% of FX deposits) in February 2017, providing potential support to the Lebanese Eurobond market. It is worth mentioning that the recent US$ 3 billion issue on behalf of the Central Bank (as at March 20, 2017) did not have adverse impact on banks FX core liquidity, as the Central Bank allowed the discounting of FX CDs to subscribe in the new bond issue.

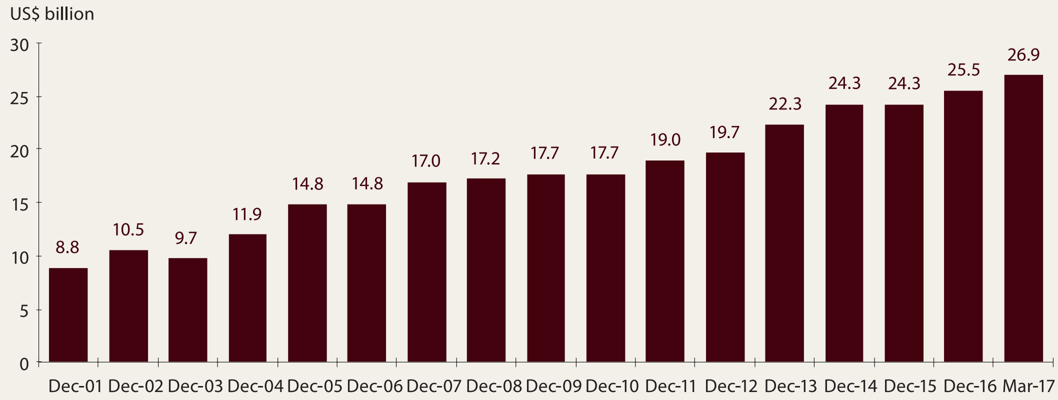
Looking ahead, the underweight status of Lebanese bonds relative to emerging market peers, despite the recent rally in the domestic arena, augurs well for the Lebanese sovereign credit markets. There is still room for further investments in domestic debt papers before they reach market weight status, would it be on behalf of foreign investors with an emerging market focus or local players with decreased sovereign exposure. This is especially true as there remains a non-negligible spread gap between Lebanese bonds and their emerging market peers.

International investors have in general increasingly positive outlook on Lebanon debt papers. Given the improved domestic conditions and assuming other things are held constant, the z-spread on the mid-curve (i.e. the 21/22/23 series) could still tighten by around 10%. Similarly, the longer end of the Lebanese sovereign curve could tighten albeit at a smaller pace of 7%-8%. As a matter of fact, there are a lot of bonds coming to maturity this year in the region and funds need to deploy cash again.

In this sense, Lebanese cash bond markets could benefit from such liquidity, and see foreign inflows of funds seeking good yield with upside potential in a global environment of lower cash prices and a regional environment of low oil prices and fragile security conditions. Again, we must caution that this all remains subject to political/security events and the positive tone might change depending on event risk or negative developments at large.

APPENDIX: LEBANESE EUROBOND MARKET IN FIGURES

EVOLUTION OF THE OUTSTANDING AMOUNT OF LEBANESE SOVEREIGN EUROBONDS



Source: Bank Audi's Group Research Department

CURRENT METRICS OF OUTSTANDING BONDS IN LEBANON (MARCH 28, 2017)

Lebanese Republic Bonds	Coupon Rate	Mid z-spread (bps)	Mid Yield	Avg. life (years)	Outs. Amount (million)
12 Oct 17	5.00%	222	3.47%	0.5	US$ 775
31 Dec 17	4.00%	220	3.49%	0.5	US$ 201
12 Jun 18	5.15%	253	3.96%	1.2	US$ 700
12 Nov 18	5.15%	265	4.18%	1.6	US$ 1,025
28 Nov 18	5.35%	279	2.70%	1.7	€ 445
23 Apr 19	5.50%	291	4.54%	2.1	US$ 500
20 May 19	6.00%	293	4.57%	2.1	US$ 650
28 Nov 19	5.45%	300	4.74%	2.7	US$ 1,500
9 Mar 20	6.38%	307	4.86%	2.9	US$ 1,200
14 Apr 20	5.80%	315	4.95%	3.0	US$ 700
19 Jun 20	6.15%	322	5.05%	3.2	US$ 600
12 Apr 21	8.25%	331	5.23%	4.0	US$ 2,093
27 May 22	6.25%	362	5.66%	5.2	US$ 500
4 Oct 22	6.10%	364	5.65%	5.5	US$ 1,540
27 Jan 23	6.00%	362	5.72%	5.8	US$ 1,100
26 May 23	6.40%	377	5.89%	6.2	US$ 500
22 Apr 24	6.65%	401	6.19%	7.1	US$ 700
4 Nov 24	6.25%	402	6.23%	7.6	US$ 539
3 Dec 24	7.00%	408	6.29%	7.7	US$ 250
26 Feb 25	6.20%	416	6.38%	7.9	US$ 800
12 Jun 25	6.25%	419	6.43%	8.2	US$ 800
27 Nov 26	6.60%	424	6.55%	9.7	US$ 1,600
23 Mar 27	6.85%	437	6.66%	10.0	US$ 1,250
29 Nov 27	6.75%	436	6.69%	10.7	US$ 1,000
3 Nov 28	6.65%	440	6.78%	11.6	US$ 893
25 May 29	6.85%	440	6.79%	12.2	US$ 1,000
26 Feb 30	6.65%	439	6.80%	12.9	US$ 1,400
22 Apr 31	7.00%	455	6.97%	14.1	US$ 300
23 Mar 32	7.00%	452	6.97%	15.0	US$ 1,000
2 Nov 35	7.05%	458	7.08%	18.6	US$ 600
23 Mar 37	7.25%	472	7.22%	20.0	US$ 750
Total Bond Market		**370**	**5.72%**	**7.3**	**US$ 26,948**

Source: Bank Audi's Group Research Department

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