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Opinion Editorial: On the Day After, Lebanon Needs a Great Reset *by RG*

The late American economist Herbert Stein once propounded what later became known as Stein's Law, a tongue-in-cheek tautology that states, "if something cannot go on forever, it will stop." What he meant was that processes that are inherently unsustainable will eventually be stopped one way or another, if not by a political decision, then by collapsing under their own weight. One cannot know when or how they will stop but they eventually will.

Lebanon may soon become the latest manifestation of Stein's Law as the country has been on an unsustainable path for way too long. Nearly all economic activity in the country happen in spite of, rather than because of, the government's economic policies. In Lebanon's highly politicized economy, the state uses ever more ingenious ways to continuously extract more and more wealth (currently about \$11 billion a year) from the real economy (i.e., real production, the creation of goods and services, and the ability to consume real things) in order to fund the livelihoods of about 350,000 mostly unproductive state employees and provide various services to political supporters who are unaware that they could have obtained better and cheaper services had the state not been suffocating the market through taxes, regulations, corruption, and waste in the first place.

As the state suffocates the real economy, more and more people seek the help of the state, which is then forced to extract more wealth from the real economy, in an unstoppable downward spiral to the bottom. At the same time, the county's youths are forced to emigrate in order to earn a living and help their families in Lebanon through remittances. But instead of allowing these remittances to go to their

intended recipients, the government colludes with the country's banking cartel to divert the remitted funds to the state's coffers. The partnership between the state and the banks is able to do this by combining government debt instruments with the practice of fractional reserve banking, which allows the same dollar to be present in two places at the same time. But for the trick to work the dollars have to stay inside the system. So the banks are forced to offer high interest rates on dollar deposits. This comes at the cost of starving local businesses of loans. And the state has to impose high tariffs to make it harder for the people to send their dollars abroad to import the stuff they need to improve their lives. The net result is the destruction of the economy and the impoverishment of the people.

This game can go on for quite a while, but the claims on the dollars will eventually come due, and like a game of musical chairs, when the music stops someone is going to be left without a seat. But even after this, life will go on. And if the Lebanese people act smartly and responsibly after the music stops, they can turn the crisis into opportunity by performing a Great Reset to their country's economy.





This Great Reset involves transforming the Lebanese economy from a politicized economy into a market economy where the people’s scarce resources are allocated based on market calculations instead of political calculations. The Great Reset consists of two things: liberalizing the economy and reforming the banking system. Liberalizing the economy is accomplished by replacing government regulations with market regulations. Drastically curtailing government regulations—such as licenses, permits, special privileges, state-protected monopolies, labor laws, zoning laws, consumer protection laws, minimum standards laws, regulations for opening and closing businesses, capital controls, bailouts, subsidies, tax credits, loan guarantees, import quotas, etc.—would automatically strengthen market regulations, which will come in the form of increased competition and more consumer choices as Lebanon would become a highly attractive environment for entrepreneurs and investors. Removing those regulations would also strip the politicians of the tools they use to keep the people under their control.

With regard to the banking system, it should be reformed by replacing the practice of fractional reserve banking with that of full reserve banking, which will keep everyone honest by clearly identifying the owner of each dollar and giving him full control over it. In a full reserve system, a central bank is not needed, bank runs and liquidity crises are impossible, and bankruptcies, including government defaults, will be paid only by those who voluntarily chose to take the risk of loaning their own money. In a full reserve system the size of the state will be kept in check because the state cannot borrow money without the approval of the real lenders (meaning the people, not the banks). And bankers will have to go back to performing their original economic functions of securing the people’s money and matching savers with borrowers, not bypassing the people’s wishes and lending their money behind their backs to the most inefficient, corrupt, and unproductive entity in the country and that can repay its debts only by taxing the wealth of the very people it borrowed its money from. It is true that Lebanon is heading toward a crisis, but if the Lebanese people act wisely by embracing the free market and rejecting the welfare state their country will quickly rise from the ashes like the legendary phoenix, with its best days still ahead of it.

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General Overview: Lebanon in Limbo as Government Formation Drags On

Lebanon may well find itself at risk of losing a chunk of the \$11bn pledged at this year's CEDRE conference due to the prolonged delay in forming a government and undertake necessary reforms. Further economic slowdown might also follow if the current caretaker government fails to take a range of measures that would at least lessen the effect of the slowdown and offer some breathing space. Recent talks of an imminent collapse in Lebanon, however, seem to be relatively exaggerated, despite the prevailing confusion and the lack of confidence from consumers and investors alike.

The World Bank Vice President for the Middle East and North Africa Ferid Belhaj recently called on stakeholders to put an end to the confusion over the financial and economic situation in Lebanon and to produce a climate of confidence.

Most importantly, he said that reforms in Lebanon are losing momentum, which means that without the government enacting reforms at the right time, it can do little to reverse the economic downturn. It also means that if reforms are delayed furthermore, the chances for Lebanon's economic revival could be distant and the possibility to put its debt back on a sustainable footing could be lost.

Still more worrying is that Lebanon could unfortunately witness an economic collapse if reforms aren't enacted at all. In a recent Associated Press article, Mr. Belhaj said: "in the absence of reform, the crisis can be very nasty.... If we don't go about these reforms fast, the Lebanon that we know will fizzle away."

To be sure, Lebanon has not reached yet the point of bankruptcy because the government is still able to finance its needs, paying public sector employees' salaries and issuing new bonds, albeit at a higher interest rate.

However, the chances are narrowing, the conditions are becoming less favorable, and the government may well find itself facing a major credit risk, among other challenges. For starters, if banks and international investors see the government unable to deliver on its promised bond payments, the probability of its future default will increase. The riskier the government becomes – potentially because of an indefinite delay in forming a new cabinet or still due to more adverse economic and political conditions – the less certain its apparent ability to repay the loan, resulting in a higher level of the interest demanded by banks and international investors, and consequently an increase of the cost of capital. In a worst-case scenario, the government may find itself unable to raise funds to cover its budget deficit. At this point in time, the government would have squandered its chances and the average Lebanese would then have to bear the consequences of a likely economic recession.

It is no wonder then why Fitch Ratings, one of the big three credit rating agencies alongside Moody's and Standard & Poor's, revised its standing for Lebanon from stable to negative, attributing it to increased deficit and debt dynamics that were mainly caused by the salary scale hike in late 2017. This led to Lebanon's finance minister recently admitting that "Highly-indebted Lebanon has exceeded its budget for 2018 to meet the rising costs of health, electricity, garbage disposal and increased public sector wages", while also underlining that Lebanon is "passing through a slightly delicate stage which requires a higher level of coordination between political decision-making, the ministry of finance and the central bank".

On the political front, the prolonged and unexpected delay in forming a government seems to be part of a broader political conflict, rather than just the result of partisan squabbling over seats or portfolios.



In fact, political bickering over shares in the new cabinet has taken a dramatically different turn, arguably because of the broader regional struggle engulfing Lebanon.

During a recent interview, Lebanese President Michel Aoun said Lebanon no longer had the luxury of wasting time as a six-month government formation crisis drags on and economic pressures mount. Therefore, if the delay drags on furthermore, it could stir up political turmoil and perhaps result in long-term and profound political crises that neither party is able or willing to tolerate given the dire economic and social conditions.

Emerging Markets Debt Capital: 2018, a Year of Reality Check *By Jamil Hallak*

Lebanon sovereign became more and more an idiosyncratic situation, while macro backdrops are still not supportive either. What affects performances for higher or lower yields are a combination of external and internal factors.

Macroeconomic & Political events are among the main factors that can affect debt valuations. If Emerging Markets (EM) as an asset class is witnessing market pressure, it will undoubtedly have consequences across all pool of countries with various magnitudes.

In the case for Lebanon, 2018 has been characterized as the worst year for Emerging Markets where all countries have posted negative returns, and most importantly pull out from investors globally. Countries that got more affected are the ones with the largest stock of hard currency debt on an absolute basis, weakest local currencies, and the highest ratios of Debt to GDP.

2018 has been a year where most EM adjusted to the new Macro reality (strong USD, higher USD rates) as well as to the new risk premium required by global investors (Real money, Indices, ETF...) to justify holding the risk.

This adjustment mechanism that translates as external pressures happened to be brutal to many countries like Argentina and Turkey where valuation levels reached extremes points.

The mechanism of re-valuation or re-pricing translates into 3 assets classes: FX, local T-Bills, hard currency debt (to highlight the magnitude of these adjustments we can take turkey as a benchmark, its currency depreciated more than 50%, their T-bills are at 20% discount, and their hard currency debt went from 6% up to 9,5%).

Needless to say that the process of revaluation affecting countries will rotate from one to another, and Lebanon didn't get immune. Additionally while external shocks were brutal for EM, Lebanon had its own obvious issues adding to the existing external pressure, resulting for Lebanon to be the highest yielding countries among EM Sovereigns.

In light of recent markets moves especially for Lebanon, it is important to provide a relative value perspective on how Lebanese Sovereign debt is performing in relative to other Emerging Markets performances, as this will provide a comprehensive analysis for the current situation, and make no mistake this is how the rational of a global investor.





Lebanese Sovereign Debt relative valuations: Lebanon still the highest Yield

The table below provides a holistic comparison for Emerging Markets Sovereign bonds in term of Yield and Year to Date (YTD) performances. As described in our background the EM Sovereign shock is clearly reflected among all Debt issuers posting negative performance for the year without exception.

Although Argentina had the largest drop in price Year to Date (YTD) -26%, among all sovereigns, we see Lebanese governments bonds reflecting the highest Yield 11% and the widest Credit spread of 816bp. Maybe we should mention the CDS here. Another interesting observation highlighted by the Argentinian case shows that IMF backed countries doesn't necessarily have positive impact on Credit Spreads valuations but rather stabilizes valuations. Make no mistake, even if Lebanon finds an IMF program that helps to relieve the stress, but won't ultimately solve the problem, other solutions needs to be added in order to support the credit profile.

Cash (10 years)	Price	Yield	Z-Spread	YTD (% change in price)	IMF Program
<i>Latin America 10 Years Sovereign Bonds Comparative Table</i>					
ARGENT 5 7/8 01/11/28	73.40	10.49	762.10	-26%	Yes
BRAZIL 4 5/8 01/13/28	95.68	5.23	236.00	-5.0%	No
<i>Central Europe, Middle East & Africa 10 Years Sovereign Comparative Table</i>					
LEBAN 6.65 11/03/28	73.93	11.05	816.70	-21.3%	No
EGYPT 7 11/10/28	95.39	7.67	475.50	-10.5%	Yes
TURKEY 6 1/8 10/24/28	89.74	7.62	474.90	-11%	No
JORDAN 5 3/4 01/31/27	92.52	6.97	411.90	-7.2%	Yes
BHRAIN 7 10/12/28	99.97	7.00	412.50	-1.8%	No
SOAF 4.3 10/12/28	87.67	5.98	310.30	-9.4%	No
OMAN 5 5/8 01/17/28	94.06	6.50	363.40	-6%	No
NGERIA 6 1/2 11/28/27	87.89	8.45	559.30	-15.8%	Yes

Source Bloomberg

Lebanon Debt curve shape: the only inverted Sovereign Curve

Credit curves shapes from 1 Year maturity up to 10 Year reflect the creditworthiness for the underlying credit, the steeper the curve the stronger is the credit and vice versa. Inversely inverted curves highlight the potential distress of the credit situation, and usually it is translated with 1-year Credit Spreads being yielding wider than longer maturities credit spreads in our case we take the 5-year point. We note that Lebanon sovereign Debt is the only inverted curve among all EM

Sovereign debt showing an inversion of 36bp while the average curves are +100bp or 1% steeper. While IMF programs don't have direct positive influence on the absolute valuation of credit spreads or yields, it is interesting to note using the below table that IMF programs positively affects the shape of the curves given that it lowers the default probabilities on the short term. In our example Lebanon 1 Year is at 8% (please bear in mind that cash bonds can be at higher yields,), Argentina 1 Year at 5.8% and lastly Turkey at 3.1%.



Credit Default Swap	1 Year	5 Year	Shape of Curve	5 Year - 1 Year
Latin America CDS Comparative Table				
Argentina	580.0	692.6	Normal	112.6
Brazil	103.3	208.5	Normal	105.2
Central Europe, Middle East & Africa CDS Comparative Table				
Lebanon	858.7	822.6	Inverted	-36.1
Egypt	212.6	342.8	Normal	130.2
Turkey	315.5	393.3	Normal	77.9
Bahrain	199.8	299.3	Normal	99.5
South Africa	129.1	235.2	Normal	106.1
Oman	91.8	248.9	Normal	157.2

Source Bloomberg

2018 Emerging Market issuance: first time Lebanon absent from the usual program

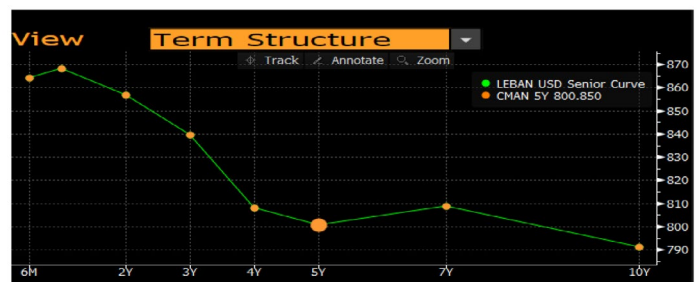
Following a record issuance in 2017 for USD 391bn, global Emerging Markets (EM) primary volumes has struggles to keep up pace. The notable absentees in the primary markets were large ME borrowers like Kuwait and Lebanon.

In regards to MENA sovereigns continue to dominate supply, with notable trades including the KSA \$11bn 7/12/31yr issuance, Qatar’s \$12bn 5/10/30yr issuance, and Oman’s \$6.5bn 5/10/30yr. Given that Lebanon is a market focus it is interesting to note the increase for issuance in weak Sovereign credit quality names within the High Yield space (Sub Investment Grade rating) with notable deals from Senegal (\$2bn 10/30yrs), Kenya (\$2bn 10/30yrs), Belarus (\$600m 12yr), Angola (\$4bn 10/30yr) and Egypt (\$4bn 5/10/30yr and €2bn 8/12yr).

Lebanese Sovereign bonds Outlook: Curve still inverted

It is obvious that market is in need of a material event risk response as long as

the curves 1Yr-5Yr as well as 5Yr-10Yr are inverted (as opposite to steeper credit spread curves) as we can witness in the CDS term structure.



Source Bloomberg: 6 month to 10Yr Lebanon Sovereign CDS Term str

2019 Outlook cloudy: but partially saved by the US Federal Reserve statements

As we highlighted the importance to watch and treat carefully external shocks, recent Macroeconomic dynamics have suddenly changed the landscape for financial markets especially risky assets, with a risk off sentiment.

Chairman Powell derailed the path for expectations, against the markets end of year wishes by tightening his monetary policy an additional 25bp while revising the Feds 2019 hike schedule to only two.



Resulting on one hand with a small relieve for emerging markets given lower UST Yield curve with 10 Year UST as low as 2.75% (compared to a month ago at 3.25%). While on the other hand risky assets like Equities, High Yields Debt have underperformed with S&P500 volatile index shoot up above 30 (VIX being an indicator for market stress, and appetite) 2019 looks challenging with continuing macroeconomic adjustments navigating between lower global growth and higher volatility, where liquidity is again key and the name of the game. As a summary Lebanon is in crucial need of an internal response while being sensitive in navigating macro adjustments.

Global major risks to monitor for 2019 are US Federal Reserve monetary policy with inverted US Yield curve and higher volatility. This could lead to USD funding crunch, further distractions could come from the EU governance crisis with increase of populism activisms derailing Europe providing inspiration to others, and the intensification of Trade wars affecting global growth. Finally yet importantly, a sustainable drop in oil price could hurt remittances and FDI, and send growth expectations to the downside as we experienced in 2015.

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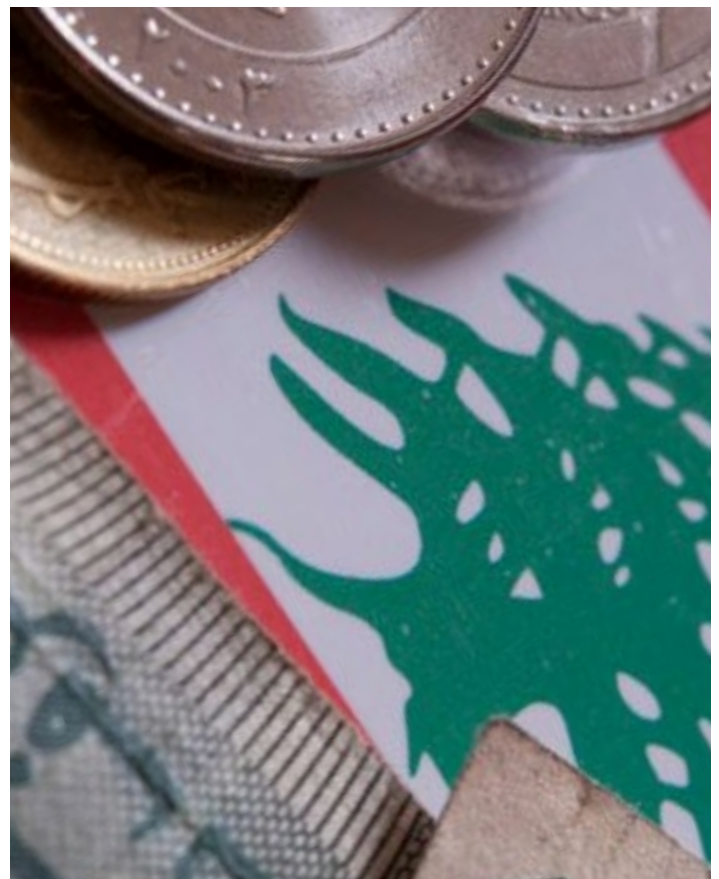
The Frailty of the System

The Lebanese financial sector, already under heavy public scrutiny, has been facing renewed pressure from the US to comply with recent sanctions against Hezbollah. An ABL delegation has already concluded visits to American decision-making centers such as the House of Representatives, Senate and the State and Treasury Departments. But a recent Annahar article sheds light on what it calls the frailty of the Lebanese financial system, revealing how Lebanon

can easily fall prey to punitive measures against Hezbollah or become subjected to measures beyond its ability to tolerate, arguably because stakeholders in Lebanon, usually priding themselves on sustaining good relationships with the US, are actually misinformed and misguided. Why? The article claims that financial-sector stakeholders in Lebanon believe the US would not allow a collapse in Lebanon because they retain constructive relationships with Office of Foreign Assets Control (OFAC).

However, what they do not know is that many other US agencies can still wreak havoc on anything in Lebanon, just as the DEA (Drug Enforcement Administration) did when it shut down the fifth largest bank (the Lebanese Canadian Bank) in Lebanon some years ago.

This lack of understanding of how the American administration works and how it can influence Lebanon is even made worse by the fact that Lebanese politicians think they can push the limits without risking any reaction from the US, such as paying the salary of a minister affiliated with a sanctioned organization.





Fitch Ratings: Lebanon's Outlook Revised from Stable to Negative

Lebanon's economic outlook took another hit after Fitch Ratings, one of the big three credit rating agencies, revised its standing from stable to negative. Fitch Ratings reaffirmed Lebanon's B- appraisal, which is a sign of government deficit and debt dynamics, citing a decline in deposit growth and an alarming budget deficit that it will likely reach 10.6% from 8.2% due to the effects of "hike in public sector wages, higher electricity subsidies and interest payments and a pick-up in capital spending." It also said the GDP ratio will continue its upward trend, reaching 169 percent of GDP by 2023.

LF Economic Policy & Research - Email LFEB@lebanese-forces.com, Prepared by RS; Reviewed by RB.

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