Highlights of Recent Trends in Financial Markets

I. Overview

Financial markets have shown resilience …

Financial markets have shown resilience in an environment of marked increases in oil and commodity prices and somewhat diminished expectations about the strength of the economic recovery. Major stock markets, which had risen over most of the first quarter, showed some weakening at the end of March, and again in late May and in mid-August, losing part of the gains they had made since the end of the downturn in the first half of 2003. Since then, however, equity markets have risen moderately or at least held steady and bond markets have absorbed, better than had been feared by some analysts, the turn in the interest rate cycle.

… in the face of a changing interest rate environment…

Aided by clear signals by central banks, markets have adjusted well to the end of an era of low official interest rates, effectively pricing in changes in policy rates, in particular, the consecutive moves by the US Federal Reserve System which began in June. However, the recent increases in yields at the short end of the spectrum have been accompanied by declines in long-term rates, resulting in a flatter yield curve. The declines in long rates partly result from lower inflationary expectations, but they also reflect the unwinding of carry-trades, which many institutions had used to exploit the steeper yield curves when interest rates at the short end were lower. Corporate bond yields have declined as well of late, generally maintaining their spreads to government bonds at fairly low levels, amid signs of stable-to-improving credit quality and still favourable liquidity conditions. Emerging market spreads have contracted further in line with a positive outlook for those economies.

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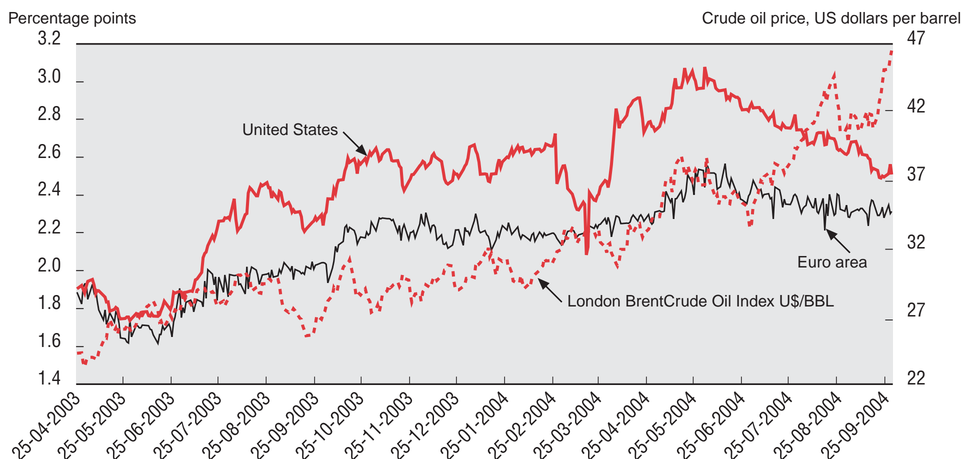
Figure 1. **Implied inflation expectations and crude oil price**



Note: Daily data until 29 September 2004. Implied inflation expectations ("breakeven inflation") are differences in yields between 10-year government benchmark bonds and inflation indexed bonds (Merrill Lynch government inflation-linked bond indices).
Source: Thomson Financial Datastream.

… and downside risks to the recovery, like higher oil prices…

In the second quarter, various economic data reports showing weaker-than-expected economic performance generated uncertainty and divergent views regarding the economic outlook. However, third quarter data have underpinned expectations of a sustained upturn in the global economy. Oil prices, which had been steeply rising since the end of June, reached historical highs recently.[1] In general, expectations regarding price developments remain highly sensitive to factors affecting supply. Nonetheless, higher oil prices have less effect on the industrialised economies than they had some decades ago, and the recent hikes have only marginally slowed growth in the major OECD economies.[2] Furthermore, higher oil prices do not seem to have fed into broader inflationary expectations, which have continued their downward trend when judged by the performance of inflation-indexed bonds (Figure 1). So far, this development has also allowed central banks to adopt a measured approach in withdrawing monetary accommodation.

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... and economic imbalances, which weigh on investors' expectations.

Among other factors, some concerns have been expressed about the large imbalances in major economies, as the manner and the speed in which fiscal and current account deficits are unwound can have a major impact on the financial sector and the real economy. So far, however, the transition to monetary policy tightening has been orderly, and investors seem to have maintained their optimism about the economic outlook despite some recent downward revisions of GDP forecasts.[3]

II. Equity markets

The upswing in equity markets has slowed in pace ...

On the major equity markets, prices softened in March and in May (for Japan only in May) this year, and while modest in their extent, these reversals were the largest since the end of the post-2000 downturn in the second quarter 2003 (Figure 2 and Table 1). Behind this softening were companies' profit warnings and macroeconomic data that came in weaker than expected. Furthermore, strong US employment data in May raised fears about an earlier tightening by the Fed. Along with rising oil prices (and uncertainty over oil supply), these developments dented some of the optimism about the economic recovery. However, as recent actual earning reports have been quite positive and major economies seemed to have been able to shrug off some downside risks, especially the higher oil prices, investors seem to have regained confidence in equities. Since their lows in mid-August, market performance has been more upbeat and major indices have mostly regained their mid-year levels or levels they had reached earlier in the year. In line with a more positive outlook and waning uncertainties, volatility (as implied by option prices) has declined, most notably in the euro area (Figure 3).

...but fundamentals provide a positive outlook.

While recently released earnings data remain mixed, investors seem to be basing their longer-term strategies on the overall positive outlook for the corporate sector. In the United States, for example, where profits have been growing in the two-digit range since 2002, this performance is expected to continue throughout 2004 according to Consensus Forecasts. The turnaround in profitability has been the fastest in more than a decade, and US companies have outperformed

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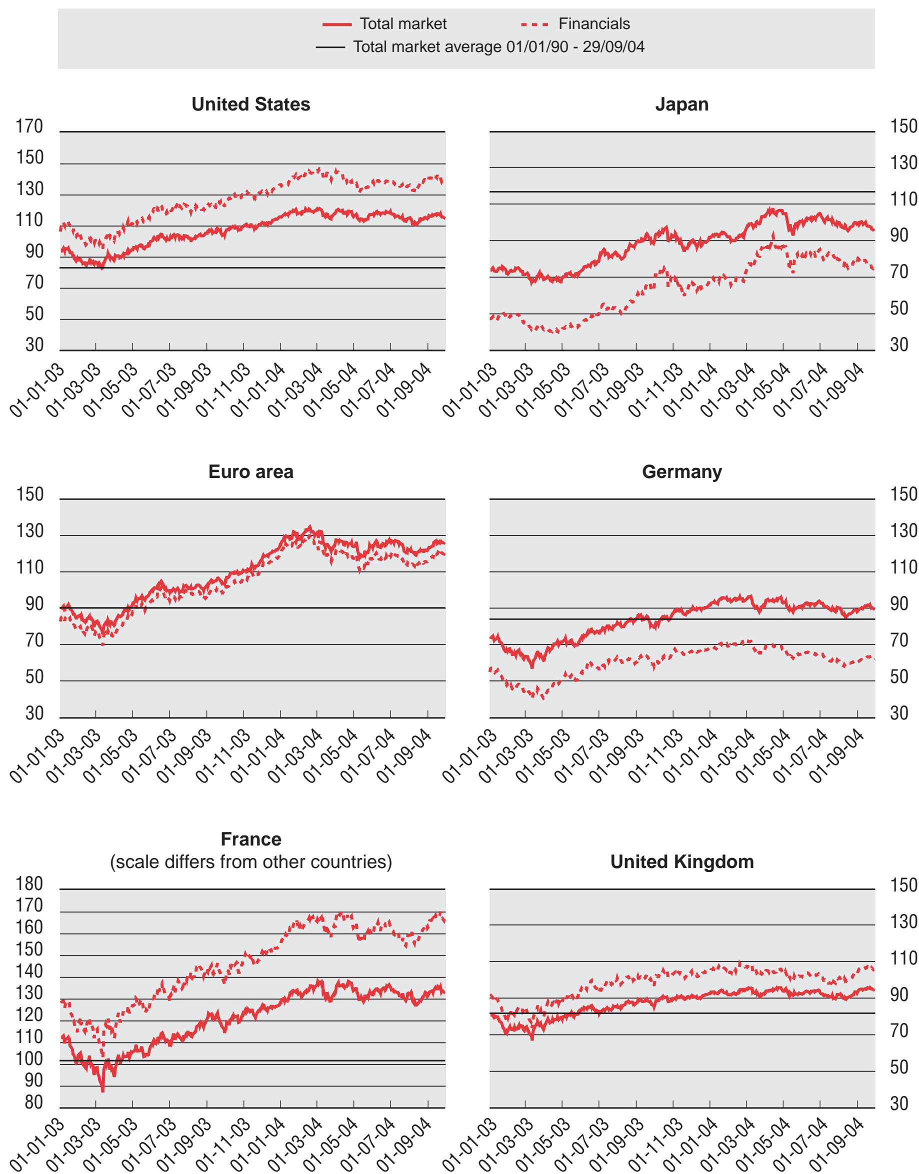
Figure 2. **Major stock markets**

Total market and financial sector equity price indices, 1 Jan 1998 = 100



Note: Datastream indices. Daily data until 29 September 2004.
Source: Thomson Financial Datastream.

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Table 1. **Overall and sectoral stock market performance in major economies**

	United States	Japan	Euro area	Germany	France	Italy	United Kingdom	Canada
	Broad stock market indices							
	WILSHIRE 5000	NIKKEI 225	DJ EURO STOXX	DAX 30	CAC 40	MILAN MIBTEL	FTSE 100	S&P/TSX COMP.
Pct.chg. Dec-03 - Sep-04	3.4%	7.5%	3.5%	0.9%	5.4%	3.8%	3.7%	5.4%
Pct.chg. Mar-04 - Sep-04	–0.9%	–3.1%	–1.0%	–0.3%	0.7%	2.4%	2.6%	–1.5%
P/E Aug.04[b]	19.3	31.2	14.0	11.9	13.9	15.3	14.0	16.9
P/E avg.Jan.90-Sep.04[b]	21.5	51.1	16.5	17.7	15.2	19.4	17.5	19.2
P/E avg.90-94[b]	17.6	48.7	14.2	17.4	12.5	17.8	15.4	19.2
	Telecom, Media, IT[a]							
Pct.chg. Dec-03 - Sep-04	–6.5%	0.5%	–4.3%	–1.8%	–8.9%	–1.0%	–4.7%	3.0%
Pct.chg. Mar-04 - Sep-04	–6.8%	–6.4%	–10.0%	–5.1%	–11.5%	–2.9%	–6.9%	–7.7%
P/E Aug.04	28.0	31.9	17.8	14.3	18.3	16.7	15.9	22.8
P/E avg.Jan.90-Sep.04	29.5	66.6	22.2	33.8	19.8	21.2	25.2	29.0
P/E avg.90-94	21.2	49.7	14.3	28.6	13.0	13.6	14.8	27.1
	Financials[a]							
Pct.chg. Dec-03 - Sep-04	5.5%	19.1%	3.1%	–7.0%	9.5%	–0.4%	2.7%	10.2%
Pct.chg. Mar-04 - Sep-04	–1.9%	–2.8%	–0.7%	–9.3%	2.4%	2.1%	1.0%	1.5%
P/E Aug.04	13.5	31.7	12.2	9.3	12.1	14.5	12.7	13.4
P/E avg.Jan.90-Sep.04	15.5	67.2	16.2	20.6	12.3	21.0	17.1	13.4
P/E avg.90-94	12.5	61.1	14.8	22.1	11.2	18.6	18.4	12.7
	of which: *Banks*[a]							
Pct.chg. Dec-03 - Sep-04	4.4%	18.6%	4.0%	–5.6%	9.0%	–2.6%	1.2%	5.0%
Pct.chg. Mar-04 - Sep-04	–0.3%	–0.3%	0.6%	–8.7%	3.5%	3.4%	2.3%	–0.6%
P/E Aug.04	14.6	43.0	12.2	11.6	10.4	13.1	11.4	12.7
P/E avg.Jan.90-Sep.04	14.3	104.5	13.3	13.8	10.7	16.3	14.5	12.7
P/E avg.90-94	11.3	64.4	10.6	13.4	9.5	11.0	14.5	12.5
	Insurance companies[a]							
Pct.chg. Dec-03 - Sep-04	7.2%	14.1%	–0.3%	–11.9%	4.0%	6.8%	–5.5%	7.0%
Pct.chg. Mar-04 - Sep-04	–3.0%	–5.8%	–3.3%	–10.5%	–4.2%	2.1%	–15.0%	–0.1%
P/E Aug.04	11.9	14.7	9.4	6.4	13.7	16.4	11.4	15.0
P/E avg.Jan.90-Sep.04	18.8	47.7	22.1	35.3	13.7	31.0	25.1	13.5
P/E avg.90-94	13.9	49.3	24.7	47.7	11.4	33.6	29.2	12.2
	of which: *Life insurance companies*[a]							
Pct.chg. Dec-03 - Sep-04	12.7%	42.2%	–5.6%	19.0%	29.2%	–7.4%	8.1%	21.1%
Pct.chg. Mar-04 - Sep-04	2.3%	13.3%	–7.7%	–0.9%	12.0%	–6.4%	0.8%	6.5%
	Non-life insurance companies[a]							
Pct.chg. Dec-03 - Sep-04	4.4%	14.1%	1.4%	–7.8%	n.a.	14.6%	–2.0%	12.1%
Pct.chg. Mar-04 - Sep-04	–2.9%	–5.8%	–8.4%	–6.0%	n.a.	–5.9%	–14.5%	8.3%

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Table 1. **Overall and sectoral stock market performance in major economies** (*cont.*)

	United States	Japan	Euro area	Germany	France	Italy	United Kingdom	Canada
	Reinsurance companies[a]							
Pct.chg. Dec-03 - Sep-04	–6.6%	n.a.	–13.4%	–12.7%	–12.1%	n.a.	–18.0%	n.a.
Pct.chg. Mar-04 - Sep-04	–12.6%	n.a.	–12.0%	–11.1%	–19.8%	n.a.	–18.4%	n.a.

Note: Calculations based on monthly averages (September averages until 29 Sep.). Earnings per share, the denominators of the price-earnings ratios, are based on the latest annualised rate reflecting the last financial year or derived from an aggregation of interim period earnings. For France, the current earnings per share are a forecast provided by local sources. For the United Kingdom, the earnings are calculated by a rolling 12 months method of analysis based on interim, final and annual accounts.

a) Datastream indices.

b) From Datastream Total Market indices.

Source: Thomson Financial Datastream.

their peers in other G7 economies. Upward revisions of second quarter real GDP growth in the United States in September have corroborated investors' sentiment of a generally positive performance of the economy. In Japan, buoyant exports and business investment have led many forecasters to expect growth to be above potential this year. In the euro area, despite stark differences between its member economies, recent growth figures have surprised on the upside.

Sectoral differences in performance are substantial, with technology stocks losing ground after a more upbeat first quarter…

The performance of overall indices masks considerable differences across sectors, as reflected in the performance differentials in sector share price indices (Table 1). Particularly bad performers were technology stocks, which in the United States, the euro area and the United Kingdom lost more than about five per cent since the end of last year until September this year, while they almost stagnated in Japan and rose three per cent in Canada. In the period from March until September, those indices fell in all major markets. The drop was fuelled in part by profit warnings of some major technology companies (like Intel, Cisco Systems, Hewlett Packard and Nokia), and even though Microsoft had announced an increase in its quarterly dividend, investors interpreted its planned buy back of shares over the next few years as reflecting a lack of investment opportunities in the technology sector rather than as a positive sign for the market.[4]

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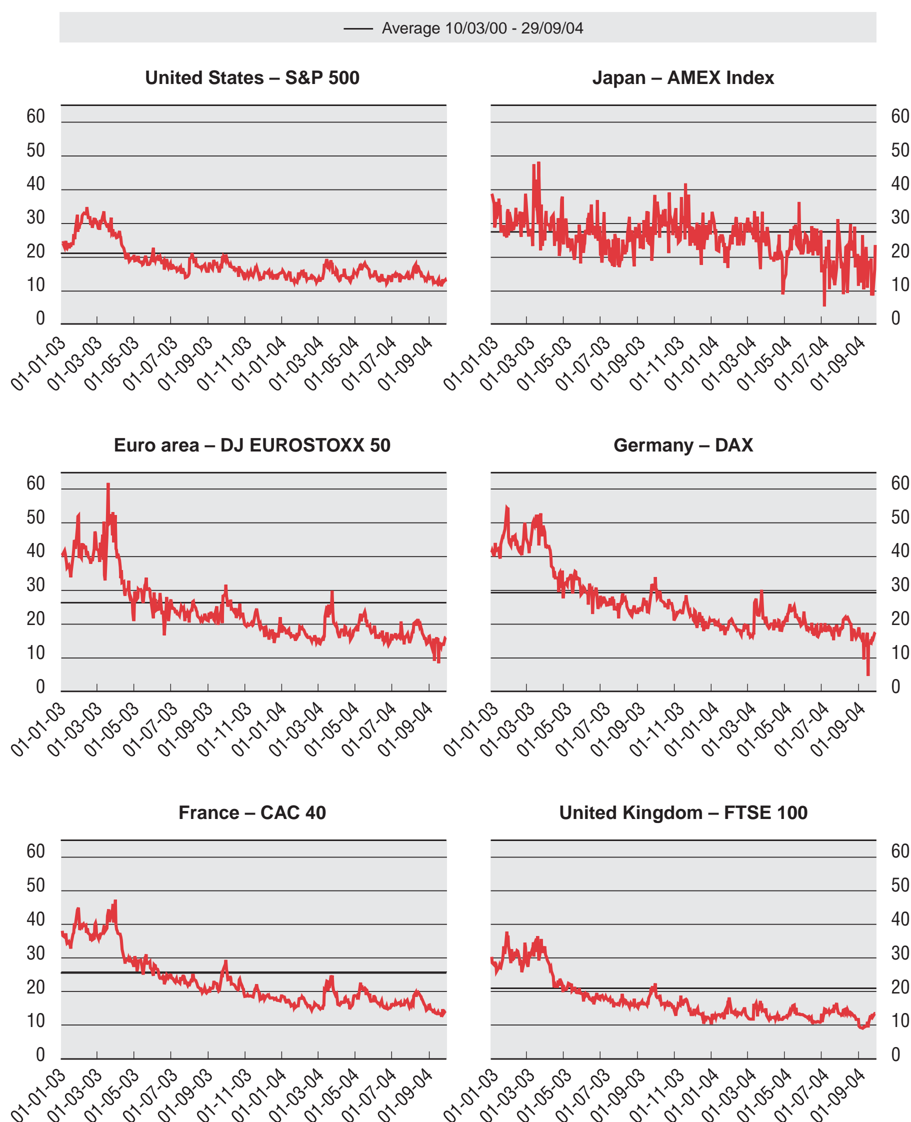
Figure 3. **Stock markets: implied volatilities**



Note: Daily data until 29 September 2004. Implied volatility can be interpreted as market expectation of risk (future volatility) and is derived from at-the-money call option prices (interpolated) using the Black-Scholes formula. The Cox-Rubinstein binomial method is used for American style options.
Sources: Thomson Financial Datastream.

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... but IPOs are making a comeback.

The recent weakness in the technology sector is in marked contrast to the relatively brisk performance well into the second quarter. During that period, venture capital financing had also recorded a comeback, driven by reduced concerns of a capital overhang, improved technology in IPO markets and the presence of established groups seeking to raise funds.[5] In the United States, venture capital funds raised USD 7.9 billion over the first quarter of 2004, compared with only one billion USD in the same quarter of 2003. In comparison, in Europe, led by the United Kingdom, only EUR 70 million were raised for venture capital in the first three months of this year, a major drop from the EUR 392 million in the first quarter of the previous year. As European venture capital typically lags the United States sector by six to twelve months, a better performance in the region may be seen in the second half.

Financial equities performed better earlier in the year but declined recently.

Stocks of financial institutions in major economies generally performed better than technology stocks, with the exception of those in Germany, where the financials index fell almost ten per cent in the period from March until September. In Japan, the financials index maintained a good overall performance owing to a strong first quarter. Despite its downward trend over the third quarter, over the year to date (December 2003 until September 2004) the index has grown almost 20 per cent, suggesting that financial sector reforms have begun to bear fruit. Over the past few months (from March until September), the overall index for the financial sector declined also in the United States and the euro area as a whole, despite the generally better performance at the beginning of the year.

The financial sector's performance may be strengthened by the Basel II Accord.

Stock price performance also has varied considerably across subsectors in each country. In Japan, boosted by the publication of strong results, banks have fared very well earlier this year, but the banking index has lost its earlier gains by September. Even though there were some equally upbeat profit reports by major German banks earlier this year, the overall banking index in Germany has declined over the year through September, and the same is true for Italy. With the endorsement of the "Basle II" proposal in June,[6] banks and the financial sector in general may come out stronger in

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the longer run. The accord will establish a more risk-sensitive capital regime than the current capital adequacy framework for credit risk. Some have feared that pro-cyclicality may be introduced by the new rules, as they may exacerbate a credit squeeze in times of distress. However, as there is growing anecdotal evidence that the increased use of more formal lending processes has led to a damping of credit availability, such fears seem unwarranted, although supervisors will need to keep this issue under review.[7]

Life-insurance fared particularly well …

The life-insurance sector index largely outpaced the other indices over the year through September, with the exception of Italy, where its decline was to a large extent responsible for the decline in both the overall Italian financials index and the euro area life-insurance index (the latter declined despite the relatively positive performance of the sector in Germany and France). Over the past several months (from March until September), when stock market conditions deteriorated and overall financial indices, as well as most of its sub-indices, fell in many major economies, the life-insurance indices showed a remarkably positive performance in Japan, France and Canada. For non-life insurance, the results were in many cases different. Over the nine months ended in September, the non-life insurances fared poorly in Germany, and also declined in the United Kingdom – in particular in the third quarter – , but it grew in the other G7 economies.

… while reinsurance indices incurred heavy losses over the year.

The global equity market recovery, improved credit quality as well as more sophisticated risk management techniques have allowed insurance companies to strengthen their balance sheets. More complex risks, however, have remained more difficult to hedge, affecting the reinsurance sector in particular. The sector's indices showed negative results throughout the past several months, with particularly heavy declines in the United Kingdom and, more recently, in France. However, Standard and Poor's upgrade of the global reinsurance sector in September is already showing up in the indices, which mostly recovered from their August lows, especially in France. The upgrade was based on improved earnings prospects, despite the recent hurricanes which will cost reinsurers a significant amount, and despite the difficulties of the Swiss reinsurer Converium.

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Risks related to the change in the interest landscape may not materialise...

Future developments in the financial sector in general will depend on the ability of financial institutions to deal with rising interest rates and flattening yield curves. Prior to the round of tightening moves by central banks, many institutions took advantage of the wide differential between the long and the short end of the yield curve by engaging in carry trades. Although there were fears about the simultaneous unwinding of such trading positions, thus far, investors have been able to price in the changes in interest rates pretty well, and the unwinding of trading positions has taken place in a gradual fashion, owing perhaps to the increased transparency and better communications by central banks. With some exceptions, the results of financial institutions announced since the beginning of the tightening cycle suggest that the sector has been well prepared for the change in interest rate policy.

… but the expansion of hedge funds…

The era of low interest rates has been a bounty for hedge funds, as the availability of cheap credit has made it easier for them to increase their leverage.[8] According to Van Hedge Funds Advisors International, the number of funds has increased globally to 8100 in 2003, from 7500 in 2002, and is expected to reach 8800 at the end of 2004. Assets under management of hedge funds are expected to reach USD 970 billion, up from USD 820 billion in 2003. Judged by the Van Global Hedge Fund Index, which showed returns of 1.3 per cent net over the first semester, those funds surpassed the recent performance of major equity benchmarks. However, in April and July, against the backdrop of adverse stock market conditions, those index returns were negative at 1.2 and 0.9 per cent, respectively.

… may bear watching and more transparency may be required from the industry.

The absolute return characteristics of hedge funds have also led to an increased inflow of funds from institutional investors, particularly from pension funds. By year-end 2003, about 400 US institutions had USD 66 billion invested in hedge funds. As hedge funds may employ more leveraged strategies in order to maintain or enhance historical performance to cope with diminishing returns owing in part to increased competition, the industry is becoming a concern for some regulators.[9] Some argue that with enhanced transparency and adequate oversight of hedge funds, regulators

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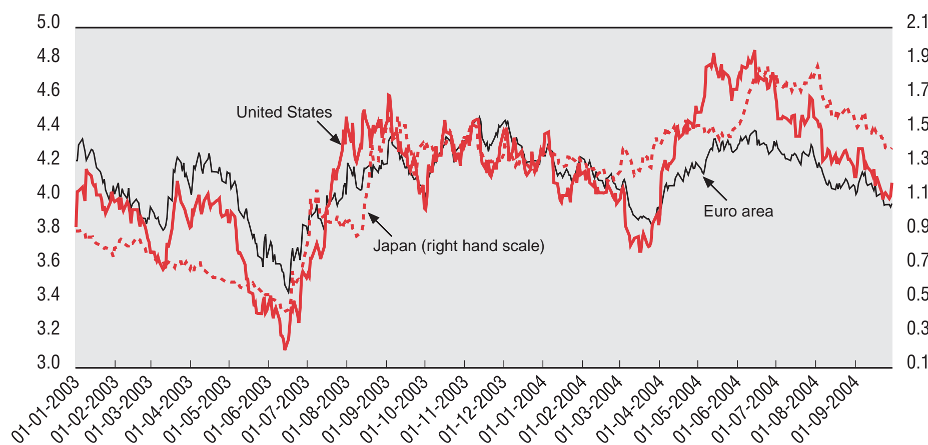
could better monitor them and counteract risks to financial stability they may pose, but supporters of the sector suggest that stricter oversight of the sector is not needed. In either case, so far, the risks do not seem outsized, as leverage in the hedge fund industry today seems to be at manageable and relatively moderate levels.[10]

III. Bond markets and interest rates

Long-term benchmark yields declined…

The rebound of stock markets in September has led to a slight disconnect with bond markets, where yields of 10-year government benchmark bonds have been on a declining trend since the end of the second quarter (Figure 4). In the United States, yields have slipped the most, from above 4.8 to close to four per cent, and are now aligned with euro area benchmark yields. Yields also dropped in Japan, although from much lower levels, and are now just slightly above one per cent. However, yields in all cases remain above their lows of June last year, when some investors feared that a bond market bubble was developing.

Figure 4. **10-year government benchmark bond yields**



Note: Daily data until 29 September 2004.
Source: Thomson Financial Datastream.

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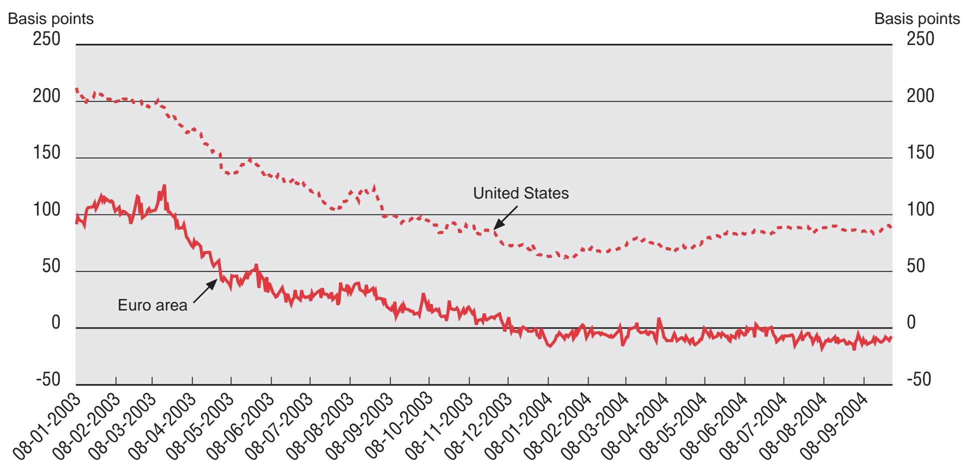
... partly due to a reversal of trading positions...

The rise earlier this year and the subsequent decline at the long end of the yield spectrum have also been attributed to trading strategies as reflected in the relatively high activity on the respective derivatives markets. Earlier in the year active investors had taken short positions in anticipation of higher interest rates, putting downward pressure on bond prices and bidding up yields. When bond prices started rising again, these investors reversed their positions, pushing yields downwards.

... but corporate bond spreads remain low with increased credit quality ...

Corporate bond markets seemed to be little affected by concomitant developments in equity and government bond markets. Credits spreads between corporate BAA-rated bonds and 10-year benchmark yields have not risen much from the historical lows reached around the end of last year (Figure 5). In the euro area, these spreads had declined below zero at that time, and they have remained in or close to the negative region since. High-yield spreads also have not widened much (Figure 6). Even though high-yield spreads in the euro area have risen somewhat since May, they remain close to their historically low levels there and in

Figure 5. **Corporate bond spreads**



Note: Daily data until 29 September 2004. Aggregate corporate BAA bond yields (Lehman indices) minus 10-year government benchmark bond yields.
Source: Thomson Financial Datastream.

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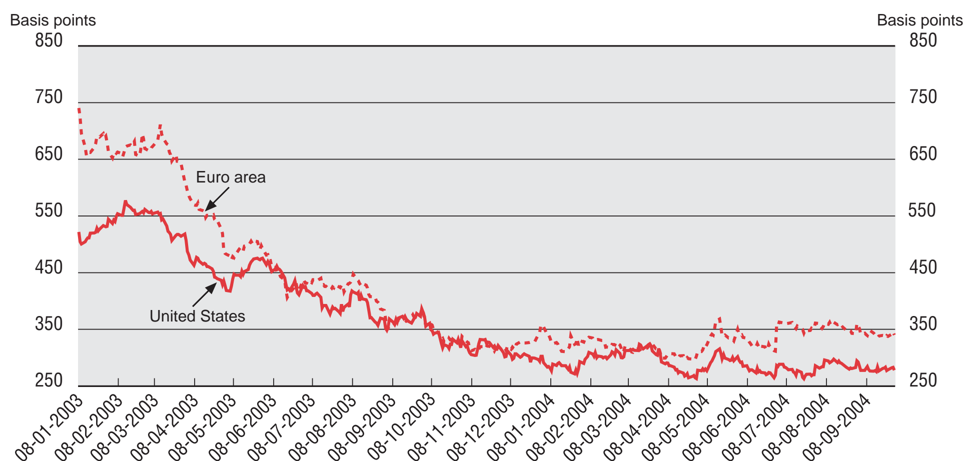
Figure 6. **High-yield bond spreads**



Note: Daily data until 29 September 2004. Aggregate corporate high-yield bond yields minus aggregate corporate BAA bond yields (Lehman indices).
Source: Thomson Financial Datastream.

the United States. One factor at play for spreads having remained low may be improved credit quality. In the United States, the number of defaults and rating downgrades continued to decline during the first two quarters, and in August the default rate had its largest month-to-month drop in 2004, to 2.3 per cent. Furthermore, for the first time since 2002, upgrades started to exceed downgrades.

…while credit derivatives helped to manage risks.

Another positive development has been portfolio managers' increased use of credit derivatives to manage credit risks. Credit derivatives markets have become more liquid and products more standardised, which has facilitated these efforts. While banks, securities houses, insurance companies and hedge funds are the major buyers, the latter in particular have now also become active on the sell side.

Bond issuance has dropped significantly in the United States…

The low corporate spreads may also owe to supply side effects, as firms have tried to strengthen their balance sheets by reducing debt levels. In the United States bond issuance fell in the first two quarters of this year as compared to last year (Figure 7). This is partly due to the large

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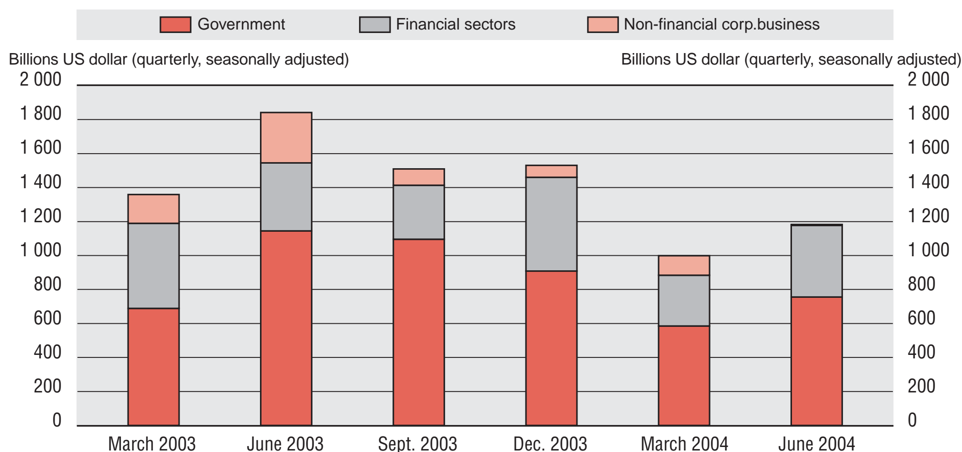
Figure 7. **Net issuance of US bonds**
In billions of US dollars



Note: Government includes Treasury, Municipal and Agency Securities.
Source: US Federal Reserve Board, Flow of Funds Accounts of the United States.

drop in bond issuance of non-financial corporations, which in the second quarter declined almost 100 per cent (as compared to the second quarter of 2003) to a relatively modest amount of USD 5.7 billion.

... and more slightly in Europe.

In the euro area, in contrast to the pattern in the United States, only second quarter issuance was weaker than in the same period the year before, as government bond issuance had increased in the first quarter, compared to the same period the year before (Figure 8). The non-financial corporate sector lowered its issuance, although by relatively less than in the United States. On a quarterly basis, the sector issued almost 40 per cent less in the first quarter, compared to the same quarter in the year before, and around 20 per cent less in the second quarter.

Major central banks have started a tightening round ...

On the 30th of June, the US Federal Reserve ended an era of low policy rates by increasing the historically low Federal Funds rate, which had been at one per cent since 25 June last year, to 1.25 per cent. Two further quarter-

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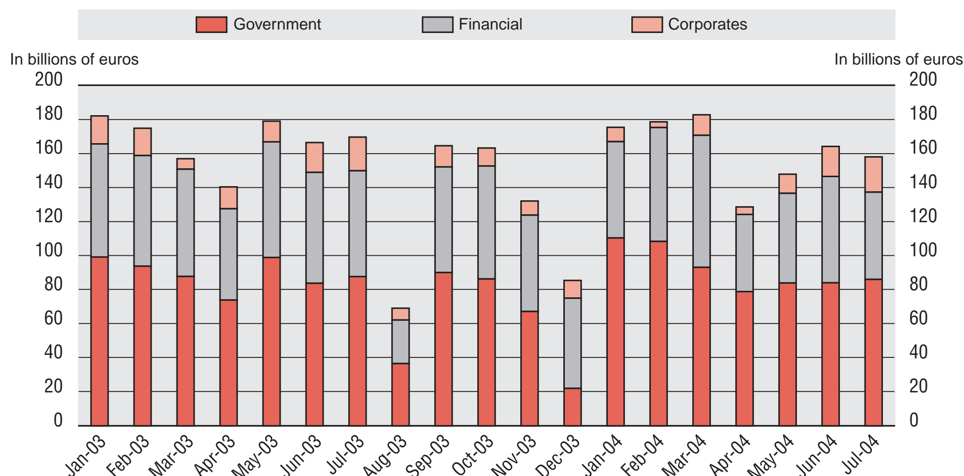
Figure 8. **Euro-denominated bond markets: volumes issued by type of issuer**
In billions of euros



Note: "Government" comprises bonds of agencies, central governments, municipals, regions, cities, and supra-nationals. "Financial" comprises asset-backed securities, financials' bonds, and Pfandbriefe. The latter includes Pfandbrief-style paper issued in EU-countries, like for instance French Obligations foncières, Spanish Cedulas hipotecarias, etc.
Source: European Commission (DG ECFIN).

point increases followed on 10 August and 21 September, bringing the rate up to 1.75 per cent. While these moves had been expected, as discussed above they were accompanied by drops in long-term rates, rendering the yield curve flatter (Figure 9). Given that the economic recovery in the euro area is on a weaker footing, the European Central Bank has so far not followed the Fed's tightening and left its repo rate at 2 per cent, unchanged since 6 June 2003. By contrast, market interest rates at the short end have risen over the past few months in the euro area. The Bank of Japan announced in September that it would end its policy of purchasing bank shares. This policy measure had been put into place in September 2002 in order to help restore banks' balance sheets and as a measure, among others, to end deflation. The decision to halt this unorthodox policy reflects the improved outlook for the

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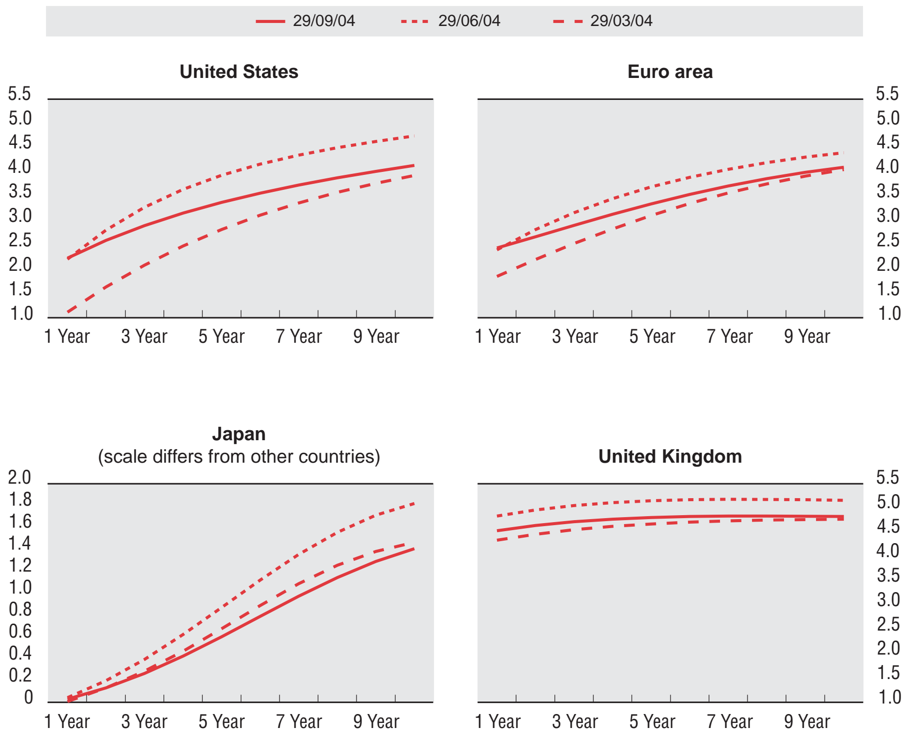
Figure 9. **Yield curves**



Note: Monthly averages of daily data.
Source: Thomson Financial Datastream.

financial sector and the Japanese economy as a whole. In the United Kingdom, given the robust expansion, the build-up of inflationary pressures and rising house prices, the Bank of England, which had begun tightening already in November last year, increased its repo rate further in several steps. Its latest actions were taken on May 6, June 10 and August 5, each of them raising the repo rate by a quarter point. The repo rate now stands at 4.75 per cent. The Bank of Canada started tightening on September 8, lifting its target for the overnight rate a quarter point to 2.25 per cent.

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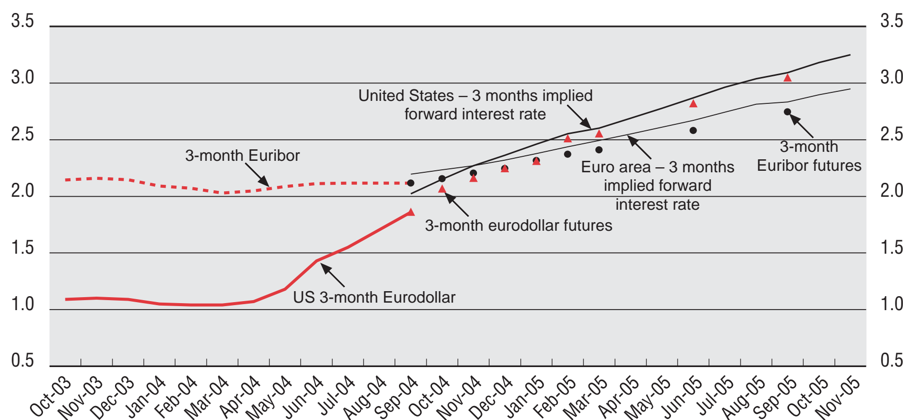
Figure 10. **Implied forward and futures short-term interest rates**
United States, euro area and Japan



Note: Data as of 29 September 2004. Actual rates: United States: 3-months eurodollar middle rate; euro area: Euribor 3 month offered rate; Japan: uncollater. 3-month middle rate. Implied forward rates are derived from zero-bond yield curves. Eurodollar futures: 3-month (CME); Euribor futures: 3-months (LIFFE).
Sources: Thomson Financial Datastream, OECD.

… which is expected to continue throughout the recovery.

Further increases in short term interest rates are expected by market participants, as judged by futures and implied forward rates (Figure 10). In the United States as well as in the euro area, investors expect further tightening by the central banks in the fourth quarter. In Japan some more substantial increases are expected in the second half of next year, but forward rates in Japan should be interpreted cautiously given their very low levels and the fact that the current zero interest rate policy of the Bank of Japan has rendered that signal less relevant. In the United Kingdom, after the last increase of interest rates, market participants attach a very low probability to further increases in the near future. In Canada, further rate increases are expected by the end of the year or earlier.

IV. Foreign exchange markets

The decline of the dollar has flattened out…

The decline of the dollar against the euro largely came to a halt by the end of February (Figure 11). After it had lost 20 per cent of its value against the European currency (and about 15 per cent on a trade-weighted basis) in 2003, the dol-

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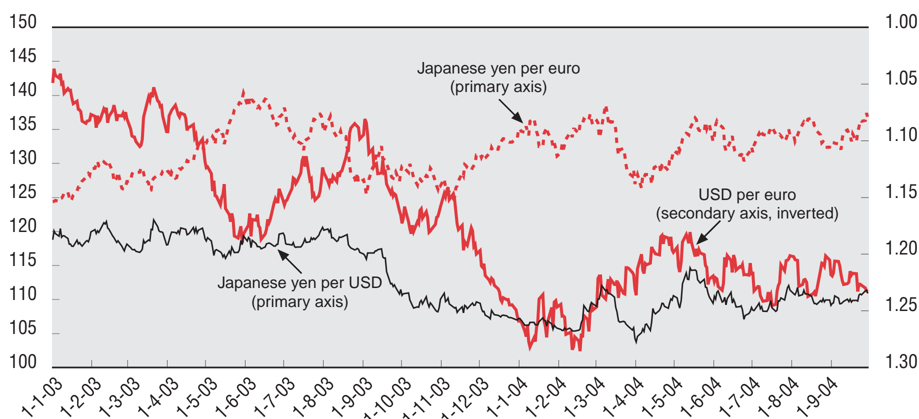
Figure 11. **Major exchange rates**



Note: Daily data until 29 September 2004.
Source: Thomson Financial Datastream.

lar went on an upward trend following the G-7 meeting in February 2004. Then, in May, weaker-than-expected macro-economic data as well as concerns about the impact of higher oil prices on the recovery led to renewed depreciation in the dollar against the euro later. After temporary rebounds, the dollar troughed again at the end of June and in mid-August, the latter date coinciding with the equity market lows.

… and its volatility against the euro has stayed within relatively narrow limits...

The troughs, however, were not at particularly low levels, but at values attained at the beginning of the second quarter, and while volatility has increased, the exchange rate has remained in a relatively narrow band between 1.20 and 1.25 US dollars per euro. Changes in the effective exchange rate were a bit more pronounced. On a trade-weighed basis, the dollar first appreciated until May, recovering from its lows at the beginning of the year, but has since depreciated until August, leading to an overall loss of more than ten per cent against its trading partners' currencies since January.

… as it did against the Japanese yen.

The Japanese yen, like the euro, weakened against the dollar after the G-7 meeting in February, mainly due to currency interventions. Subsequent data showed that the Bank of

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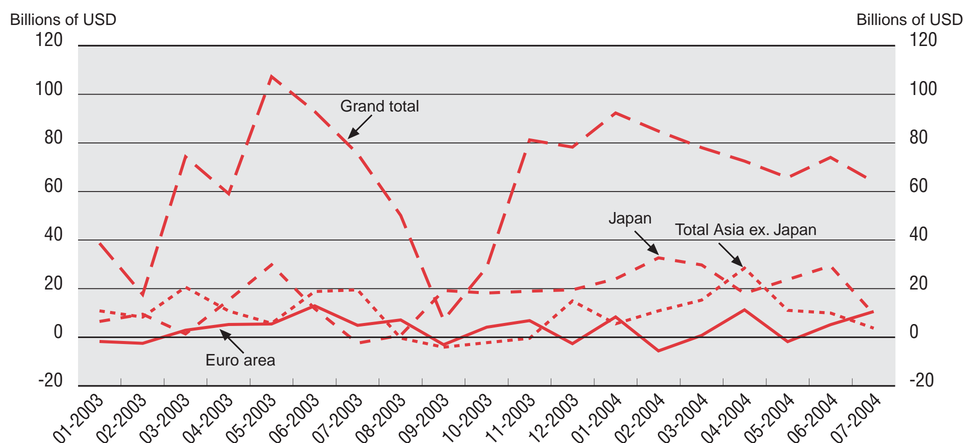
Japan's intervention in the currency market to weaken the yen was suspended in mid-March, and the currency started to rise. It slipped back in April and May, and after appreciating through late June it fell again slightly and has since been fluctuating within a relatively narrow band around 110 yen per US dollar. The reports of relatively disappointing second quarter growth in Japanese GDP did not have much of an effect on the yen exchange rate. In effective terms, the yen has largely maintained its value against its trading partners' currencies. It has also stayed relatively stable against the euro over the past few months.

Asian economies are reducing their purchases of US assets, but US capital inflows are still comfortably high.

While Japan remains the largest single holder of US assets, it has lately reduced its purchases, as have other Asian economies (Figure 12). Concerns about US dollar weakness may be a factor in the decision by China, the second-largest buyer of US Treasury bonds after Japan, to start diversifying its foreign currency portfolio by increasing its holdings of European and Asian bonds. In this context, it should be noted that the investments of Asian economies have pro-

Figure 12. **Net portfolio flows into US by region**
Billions of US dollars



Source: US Treasury, Treasury International Capital (TIC) Reporting System.

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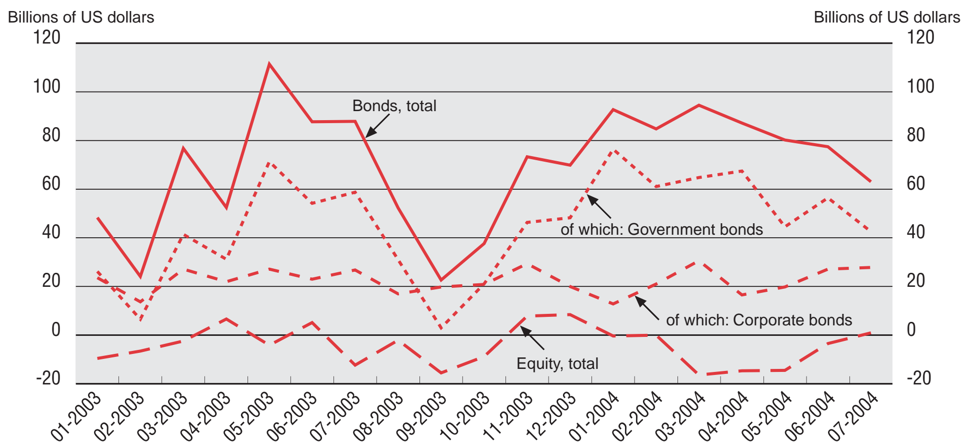
Figure 13. **Net portfolio flows into US by category**
Billions of US dollars



Source: US Treasury, Treasury International Capital (TIC) Reporting System.

vided the backbone of the financing of the US budget deficit and that a sustained drop in these investments, other things equal, could weaken the dollar and put upward pressure on interest rates. Nevertheless, recent data suggest that the decline of purchases of US treasuries has been compensated by increased foreign purchases of US corporate bonds and equities (Figure 13).

V. Emerging economies

Emerging markets, after a short downturn, continue their strong performance.

The overall performance of emerging markets has been strong of late. However, from the end of the first quarter through late May major emerging stock market indices fell sharply (Figure 14). In this sense, emerging markets followed a pattern exhibited by major stock markets of G-7 economies, indicating the substantial correlation between the markets. The downturn had been driven in part by uncertainty about the effects of higher oil prices on the economies as well as about the effects on emerging markets of a possibly weaker-than-expected recovery in the major

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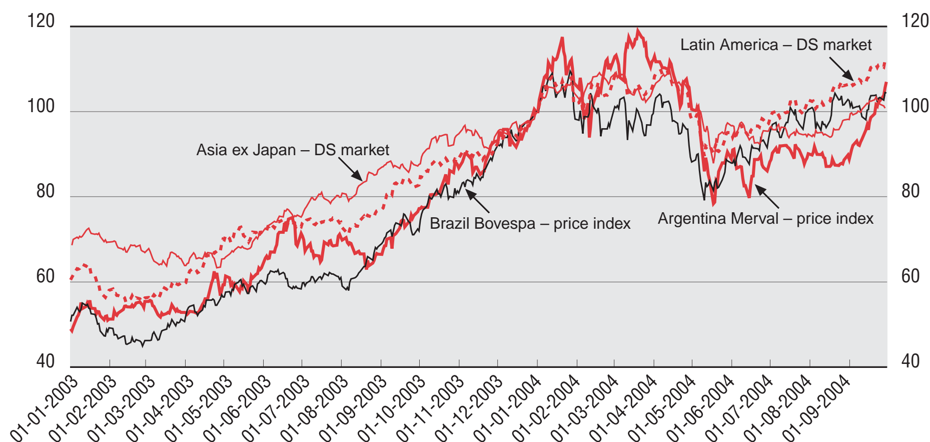
Figure 14. **Stock market performance in selected emerging economies**
Equity price indices, 1-Jan-04 = 100



Note: Daily data until 29 September 2004.
Source: Thomson Financial Datastream.

economies. During that downturn, some markets lost up to ten per cent of their value, but most of them have more than recuperated their losses since then, as shown, for example, by the Latin American total market index.

EMBI spreads are still low, with bond issuance remaining strong.

The positive performance is also reflected in the relatively low spreads of emerging market bond indices (EMBI) over US government paper (Figure 15). While these spreads had risen sharply from their historical lows in late April through mid-May, they have fallen since in most emerging economies. In April, investors started cutting back their exposure ahead of an expected rise in US interest rates, and this was further fuelled by positive news on US employment early in May, which at the time triggered fears of an advanced move by the Fed and a possible slowdown of the economy. After emerging market debt suffered its worst month since the Argentine debt crisis in April, investors subsequently returned on positive economic news regarding emerging market economies. Likewise, issuers of emerging market debt took advantage of the still favourable interest rate cli-

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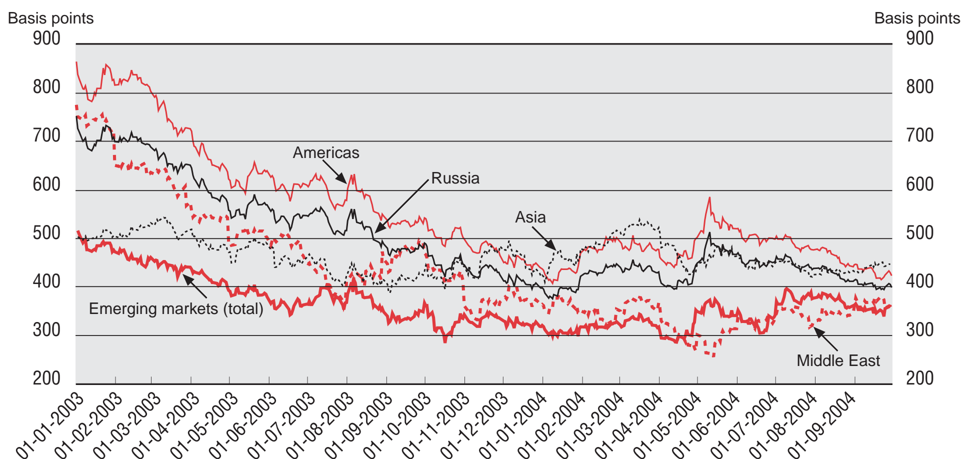
Figure 15. **Emerging market bond spreads**



Note: Daily data until 29 September 2004. Lehman indices, redemption yields minus 5-year US government bond index yield.
Source: Thomson Financial Datastream.

mate and continued their pace of borrowing, with Asian economies being the most active issuers.

While the outlook remains positive, vulnerabilities remain…

In Latin America, the financial market outlook improved in recent months after positive news regarding the economic outlook of the region, in particular from Brazil. There, GDP grew beyond expectations during the first quarter of 2004, putting the economy on a path of recovery after last year's severe recession. However, while many emerging market debtors were able to reduce their exposure, they remain vulnerable to higher interest rates. In Argentina, while investors are closely watching the debt restructuring process, stock markets reflect confidence in the economy, which continues to recover strongly. Overall, emerging economies' growth remains dependent on external demand and, thus, on the pace of the recovery in the major industrialised economies.

… in particular in major Asian economies.

In Asia, inflationary pressures remain in place, more so as the region is particularly vulnerable to oil price increases, given its high dependence on oil imports.[11] However, a

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favourable economic background and high foreign reserves, which would allow the authorities to provide policy support to ride out an oil price shock, mitigate this vulnerability. China, as the world's second largest oil importer, also has an important demand effect on oil prices. There, measures were taken to cool an overheating economy and growth rates slowed in response. So far, the Chinese authorities have refrained from raising interest rates, and investors remain confident that a "hard landing" of the Chinese economy can be avoided. A slump of the Chinese economy would hit many of its neighbours and in particular Japan which owed more than a third of its GDP growth last year to China. Further steps to improve the Chinese financial sector have been undertaken, including measures in preparation for greater capital account openness, but remaining weaknesses in the banking system may test the resilience of the sector should conditions deteriorate.

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Notes

1. The price of the London Brent Crude Oil Index reached a peak of 44.64 USD per barrel on 23 August 2004, driven by fears over Iraqi supply, and on 27 September, the New York Nymex crude futures spiked to record highs above USD 50 a barrel, after oil companies in Nigeria were warned by rebel groups to shut in anticipation of an "all-out war on the Nigerian state". These incidents also heightened fears over global supply in general. Other oil price indices peaked at around the same date, and have increased further since.
2. See *What is the economic outlook for OECD countries? An interim assessment*, Press briefing by Jean-Philippe Cotis, OECD Chief Economist, 21 September, 2004; and International Energy Agency (2004), *Oil Crises and Climate Challenges - 30 Years of Energy Use in IEA Countries*. Paris, IEA.
3. Such as recently by the OECD; see *What is the economic outlook for OECD countries? An interim assessment*, Press briefing by Jean-Philippe Cotis, OECD Chief Economist, 21 September, 2004; see also Consensus Economics, *Consensus Forecasts*, various issues.
4. See also BIS *Quarterly Review*, September 2004.
5. According to Almeida Capital, cited in "Transatlantic misalignment in fund-raising", *Financial Times*, April 21, 2004.
6. On 26 June 2004, central bank governors and the heads of bank supervisory authorities in the Group of Ten (G10) countries endorsed the publication of the *International Convergence of Capital Measurement and Capital Standards: a Revised Framework* (commonly known as *Basel* II). This new capital adequacy framework sets out the details for adopting more risk-sensitive minimum capital requirements for banking organisations.
7. See Hans J. Blommestein and Charles Ilako, *Basel II: Efficiency versus financial stability?*, mimeo, September 2004.
8. A study by Greenwich Associates, published in May, reveals that almost one-third of hedge funds have increased their use of leverage over the past 12 months; see Greenwich Associates, *For Hedge Fund Investors, New Notes of Caution*, 4 May 2004.
9. For example, the US Securities and Exchange Commission (SEC) has published for comment a proposed rule that would require the registration of hedge fund advisors under the Investment Advisers Act of 1940. While many of the largest hedge funds are already registered with the SEC, registration is still voluntary.
10. As assessed in the International Monetary Fund, *Global Financial Stability Report*, September 2004.
11. See Asian Development Bank (2004), *Asian Development Outlook 2004 Update*, September; and Cyn-Young Park (2004), *Higher Oil Prices: Asian Perspectives and Implications for 2004 –2005*, ERD Policy Brief No. 28, Economics and Research Department, Asian Development Bank, June.

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