HIGHLIGHTS OF RECENT TRENDS IN FINANCIAL MARKETS

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Financial markets under the influence of high oil prices.

1. One of the main outside influences on international financial markets in the second and third quarters of 2000 was the rise in energy prices. The price of crude oil reached 35 US dollars (USD) per barrel in September 2000, its highest since the levels that were briefly recorded during the Gulf war. This arguably contributed to financial market uncertainties about the outlook for inflation -- although it must be recognised that little evidence of this is so far been seen in the pricing of index-linked bonds. Also, by causing uncertainties about the macroeconomic outlook in the major economies, the rise in energy costs has contributed to a more uncertain financial market environment. This is particularly the case in some West European countries where the energy price hike was accompanied by domestic political setbacks. An additional factor contributing to unsettle European financial markets was uncertainties about the outcome of the Danish referendum on 28 September on euro-participation.

a) Foreign exchange markets

2. Movements in the major currencies were also among the factors that influenced the mood in financial markets during the summer. While the Japanese yen (notwithstanding the differences in cyclical positions) remained firm vis-à-vis the US dollar, the pound sterling which had previously been rather stable vis-à-vis the dollar gradually followed the euro downward (Figure 1). The euro, in particular, declined to its lowest-ever international value in mid-September at a bilateral rate of 0.85 vis-à-vis the dollar. The euro’s weakness became a source of attention from media and policy-makers. Euro-zone central banks first undertook changes in the foreign reserve management that were interpreted by market participants as an attempt at supporting the currency and next engaged in concerted exchange market intervention. The efforts had considerable short-term effect on the euro, not least, according to analysts, because markets were unprepared for the significant participation by monetary authorities outside the euro-zone.

3. The weakness of the new currency should, however, not give rise to undue market concern. The precursor for the euro, the ECU basket, was constructed with a view to long-term parity with the US dollar. This implies that at the current juncture -- years of comparatively high economic growth and interest rates in the United States and a limited difference between US and euro-zone inflation -- there could be macroeconomic reasons for the euro to be trading below par. Indeed, portfolio and direct investment flows from Europe to the United States have long been recognised as an important factor behind the changes in bilateral exchange rates over the past 1½ years. On the other hand, it may well be that, as suggested by some analysts, the continued weakening of the currency reflects a degree of overshooting due to herding behaviour in foreign exchange markets.

4. Some more structural factors could also be at play. In this context, arguments have been put forward to the effect that the weakness of the euro could indicate that the new currency has been a victim of its own success. Articles in earlier issues of the Financial Market Trends have focused on the euro-zone’s considerable success in rapidly developing deep and liquid debt markets (and, to a lesser extent, boosting the existing stock markets), which have been an important vehicle for.
financing corporate investment as well as mergers and acquisitions (M&As). On the other hand, the corporate sectors across the euro-zone remain diverse and few if any financial institutions can claim area-wide presence. In fact, as pointed out recently by senior financial executives, “most banking and financial services do not, at present, offer the same facilities at a European level that they provide in their domestic markets”. According to this logic, the introduction of the euro led to a rapid development of euro-zone vehicles for obtaining corporate finance, whereas the large nation-wide US corporate sector remained a more attractive target for portfolio investment, direct investment and M&A. In the same vein, the strength of the euro is related to the longer-term attractiveness of the euro-zone to foreign investors. Further efforts aimed at removing barriers to creating truly area-wide financial structures may be needed to bolster confidence in the euro by facilitating establishment inside the zone and lowering the cost of operating on a truly cross-border basis.

b) Euro-zone debt securities

5. The rapid development of euro-zone securities markets continued into the second quarter of 2000. In May, the gross issuance of debt securities by euro-zone borrowers (including the public sector) totalled euro (EUR) 390.3 billion, compared with EUR 301.0 billion one year earlier and an average monthly gross issuance of EUR 323.5 billion over the previous 12 months (table 1). Net issuance was also above the average of previous months, but less markedly so. As a result, the amount outstanding of debt securities was 8% higher than a year earlier.

6. The growth of euro-zone debt securities would have been even faster but for the fact that government debt has been stagnating or even shrinking across the area. A sectoral breakdown shows that the annual rate of increase in the amount outstanding of euro-denominated debt securities issued by the banking financial institutions had risen to 10.8% in May. At the same time, the issuance of debt securities by non-financial corporations was particularly high in mid-2000. The amounts outstanding of such debt securities were up by 14.1% year-on-year in May. Much of this issuance activity was at the shorter maturities that are commonly used for raising corporate working capital. Finally, the amount of debt securities issued by non-monetary financial corporations continued to grow at a very fast -- albeit slightly reduced when compared with the previous months -- rate of 35.1% over the same period last year.

c) Bond pricing

7. Bond prices in the major financial markets changed very little during the summer (Figure 2). Since spring, interest rates on long-term US treasury bonds have fallen slightly, while rates in other countries have remained constant or edged up marginally. According to analysts, one of the chief factors behind the relative calm is the fact that market participants in Europe and North America expect only limited further tightening of monetary policy as the upturn matures (Europe) or comes to an end (United States). Interestingly, the UK benchmark bond rates have been closely shadowing similar maturities within the euro-zone for most of the year, even as short term rates in the United Kingdom were considerably higher than elsewhere in Europe. Market participants have related this to a recent tendency -- which is arguably also reflected in the co-movements of exchange rates in recent months (Figure 1, above) --
for markets to respond to the UK economic slowdown by treating sterling-denominated financial assets as a closer substitute to euro-denominated ones.

8. The yield curves in both the United States and the United Kingdom have been inverted for some time. The reason may not be entirely the same: the UK long-term interest rates are now thought to reflect widespread expectations of an eventual easing of monetary policy. In US markets the high and increasing pricing of long-term bonds has rather reflected concerns about a shrinking pool of Treasury debt — especially among categories of investors who either have a long horizon or who look for safe-haven assets. Even so, there were signs in September of investors re-assessing their position. For example, the yield on 30-year treasuries, after remaining below the 10-year benchmarks for most of the year, nudged up whereby the long end of the yield curve was normalised (Figure 3). According to US analysts, the reassessment of the pricing of very long-term bonds reflected rekindled concerns about inflation in the wake of the oil price increases as well as uncertainty about future fiscal policies in the run-up to the presidential elections.

9. The declining yield on treasuries highlighted a focus on “quality” in US bond markets: The decline in government bond rates that was not mirrored by similar declines in other categories of longer-term bonds, so spreads between both high-graded and lower-graded corporate bonds and treasuries have widened almost to the level prevailing at the time of the LTCM crisis (Figure 4). As for the pricing of corporate bonds per se, investors seem to be displaying an increasing focus on quality. Among other things this relates to the fact that the US upturn is perceived to be in its final stages at which point, judged by historical evidence, some companies start facing difficulties with servicing their debt.

10. In Japan the zero-interest rate policy was abandoned in August, and short-term interest rates are set to increase as the cyclical position improves. On the other hand, judged by long-term interest rates that continue to hover below two per cent, market participants do not expect rises in short-term rates to be particularly quick or abrupt. All the same, the bond markets have been under a degree of additional strain since the government confirmed that it will implement a supplementary fiscal budget before March 2001, which could further boost the issuance of government bonds in the near term. In the longer term, markets are said to be uncertain whether a drop in government bond supply in the course of an eventual cyclical upturn will be sufficient to offset an expected substitution by investors toward purchasing equity.

d) Stock market fluctuations

11. The North American and West European stock markets remained comparatively calm during the summer. Since the late spring of 2000, the main indices of these areas appear to have fluctuated within a narrow band of no more than five per cent maximum deviation (Figure 5). This contrasts with Japan, where the Nikkei 225 declined by 7% in July to reach a level some 15% below the stock prices recorded at the beginning of the year. The relative stability of stock prices in large markets other than Japan appears to have been the product of contrasting influences: for example, a
number of US companies, particularly in the technology sector, posted earnings for the second quarter of 2000 that were better than anticipated by analysts. On the other hand, stronger-than-expected US economic growth (and slightly higher inflation) seemed to rekindle uncertainties about the future path of monetary policy. European stock prices were on repeat occasions supported by a buoyant market assessment of earnings growth, whereas uncertainties surrounding the telecom sectors weighed down on the overall indices. As to the latter, telecommunications stock prices declined by 10% in the course of July, reaching a level that was 17% below the pricing that prevailed at the end of 1999.

12. A cautious mood pervades the Japanese stock markets after the fluctuations of the first half of the year. Stock prices reached a peak in spring, with the Nikkei 225 approaching the 21,000 mark in mid-April, whereafter they tumbled under the influence of a correction in US high-tech equity. The index is currently hovering around 16,000. One factor bearing down on equity pricing in Japan during the summer relates to financial market uncertainties following the filing for reconstruction proceedings by a major retailer.

13. Reflecting this relative calm in stock markets, the implied price volatility gradually declined. Following a volatility peak in April 2000, when a correction in internet stocks unsettled the pricing of more traditional companies, indicators such as the CBOE stock market volatility index receded (Figure 6) -- even as technology shares actually continued to display higher-than-average volatility in mid-2000. As for the European markets, the implied volatility on the Dow Jones EURO STOXX 50 index temporarily dropped to levels below 20% per annum, which were close to the lowest levels seen since the introduction of options on this index in mid-1998.

e) Indebtedness and debt quality in the United States

14. The balance sheets of US households have, for some time, given rise to some concern in financial markets and among policy-makers. The household savings ratio is zero or even negative, indicating that increases in household net wealth in recent years has been a product solely of the rises in asset prices. If few further revaluation gains are to expected at this juncture, some market participants have asked themselves how households’ saving and investment strategies may change and what impact this may have on financial markets. One illustration of the stagnant household investments is the fact that net flows into mutual funds were stagnant over the summer. In consequence, the net assets of mutual funds taken as a whole remained virtually unchanged, with stock funds actually declining (Table 2).

15. On the other hand, the upward trend in households’ short-term liabilities (excluding housing finance) was broken in 2000. In the first half of the year, consumer credits actually declined by 86 billion USD (Table 3). On a similar note, commercial banks reported improved consumer credit quality in the second quarter. The fact that pools of securitised assets make up a steadily increasing share of total consumer debt is taken to indicate that credit card debt has grown in importance in recent years. Commercial banks have undertaken considerable efforts to remove such debt from their balance sheets and finance it by means of asset-backed securities.
16. Corporate borrowers are, as indicated in the section about bonds, subject to current scrutiny by financial institutions concerned by the outlook for an eventual deterioration of debt quality. So far, however, there has been little sign of trouble. Data for the second quarter show banks’ credit quality deteriorated within commercial portfolios, but the amounts involved remained very limited. It should, however, be noted that those banks most active in the syndicated and leverage lending markets showed significant increases in commercial charge-offs.

f) Derivatives markets

17. Activities in exchange-traded derivatives markets expanded further in the second quarter of 2000, albeit at a slower pace than in the previous quarter. The total turnover rose by 4% to 104.6 trillion USD\(^9\), making 2000:Q2 one of the most active quarters of the last decade. Interest rate instruments expanded by 6%, while equity index and currency contracts declined by 11% and 12% respectively. Growth was more pronounced in Asia, in part owing to a significant rebound in the turnover of equity index contracts and the further rapid expansion of activity on some recently established futures exchanges.

...despite a cooling of the market for US treasuries.

18. One of the most interesting developments in the second quarter was in the contracts on US government bonds. Activity on all US Treasury instruments are arguably on a long-term declining trend, but the second quarter saw the turnover in the very long-term segment (30 years) decline markedly relative to the 10-year benchmarks. This, in turn, relates to the trends observed in spot markets for government bonds; the smaller gross issuance of government bonds together with an effort by the US Treasury to reduce the average duration of government debt has limited the supply of long-term paper. The resultant reduction in secondary market transactions had a negative impact on market liquidity in both the cash and exchange-traded derivatives markets. In consequence, traders have shifted part of their hedging activity to the swaps market. At the same time, the shrinking supply of government debt has encouraged large issuers to introduce alternative trading benchmarks. Since the introduction of contracts on the debt securities of US so-called “government-sponsored” agencies, activity on such instruments have expanded rapidly.

g) Financial markets in Russia

20. While the Russian economy performed strongly in the first half of 2000, not least because of the rise in oil prices, the rouble is under continuous pressure of real appreciation, having appreciated by over 5 per cent on a trade-weighted basis over the
first half of the year. In its efforts to maintain the desired stability of the exchange rate, the Central Bank had to inject substantial liquidity into the economy, resulting in a growth of secondary liquidity of over 36 per cent in the first seven months of the year. The structural weakness of domestic financial markets is still a dominant factor, and limits the opportunities for the Bank to sterilise its purchases of foreign currency.
...but banks remain troubled...

21. Financial markets are recovering from the 1998 crisis only at a very slow pace. Although trading volume in the stock market has increased lately, it has not returned to pre-crisis levels yet. Other options for raising medium and long-term funds are not very developed, even for larger firms, despite the fact that corporate bond issues often represent a preferred funding option for enterprises where dominant shareholders fear loss of control. Bank lending activity remains subdued as risk-averse banks prefer to hold additional liquidity on deposit in the Central Bank, albeit at low remuneration. Savings instruments other than time deposits and government securities are not generally available.

...and authorities attempt to restructure ailing institutions.

22. In the immediately aftermath of the August 1998 financial crisis, which dealt a severe blow to the whole Russian banking sector, the Central Bank lacked sufficient legal and coercive power to deal effectively with problem banks, especially those at the centre of powerful financial-industrial groups. Thus, following initial emergency injections of liquidity, little progress in rehabilitation of the stricken banks was made in 1998 or early 1999. However, the institutional foundations for fundamental restructuring of the sector were put in place during the Spring and early Summer of 1999. In particular, the Law on Restructuring of Credit Organisations empowered the restructuring agency, ARKO, to boost capital in healthy banks, restructure liabilities, replace the management of failing banks, assist in the initiation of bankruptcy proceedings against unsalvageable banks and attract new investors, including foreign, to those that can be saved. Yet, it seems that real progress in restructuring the banks is slow to manifest itself. The largest 30 banks experienced aggregate net losses equaling 25 per cent of their capital during the first half of 2000, posing a continued strong challenge for the Central Bank and ARKO.
Most recently, some of the evidence was surveyed in the “Highlights of Recent Trends and Developments”, *Financial Market Trends, Vol. 76.*


This is treated in more detail in the ECB Monthly Bulletin, August 2000.

The problem of pricing long-term bonds when government debt is declining was the topic of several articles in *Financial Market Trends, Vol. 72.*
