Highlights of Recent Trends in Financial Markets

I. Overview

Financial market prices have remained strong.

Over the past few months, prices in major financial markets have remained strong despite further oil price increases. After major equity markets had shown a soft spot around March and April, they regained their upward trend in the second quarter. Terrorist attacks in London in July and the hurricane Katrina in the United States which hit the New Orleans region at the end of August did not disrupt markets, despite the large size of human, economic and insured losses associated with the latter event.

Bond yields remained low in the United States and have fallen further in the euro area.

Bond yields have stayed at low levels. Long-term benchmark yields in the United States have fluctuated but generally have maintained their average levels over the year to date, while yields in the Euro area have declined further, reaching historical lows in September.

Credits spreads stayed below historical averages.

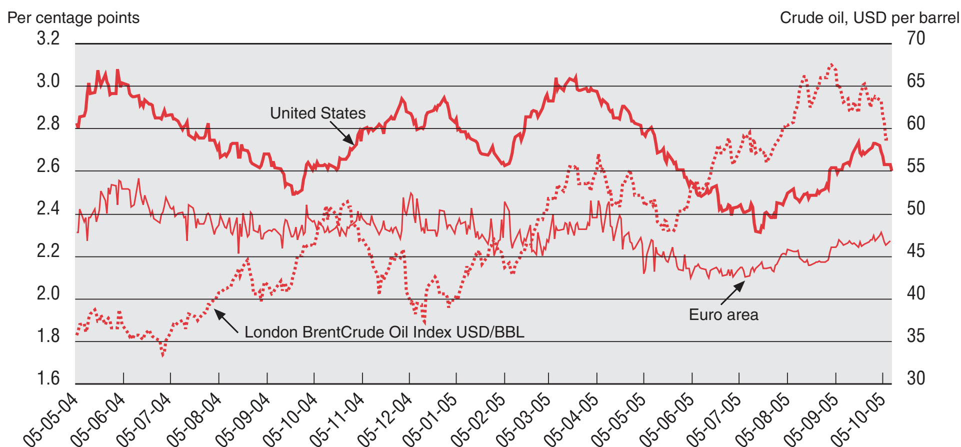
Meanwhile, credit spreads recently have eased somewhat from their compressed levels, but they remain nonetheless well below their historical averages. While uncertainties about the outlook related to increases in commodity prices and possible adjustments to global imbalances probably have not dissipated, volatility has remained low in most market segments.

Despite continued tightening in the United States, global liquidity has remained relatively ample.

The US Federal Reserve's Open Market Committee has continued its tightening cycle by raising interest rates, which along with hawkish statements by some Fed officials served to vindicate expectations for further tightening that had been implied in forward rates. A rising dollar had somewhat eased monetary conditions in the euro area, were the ECB left policy rates unchanged. Global liquidity, though slightly drying up, has remained accommodative, supporting a continuation of the "search for yield" in financial markets.

© OECD 2005

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



Note: Daily data until 10 October 2005. 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.

Emerging markets continued buoyant, and EMBI spreads remained compressed.

Emerging markets equities have again outperformed those of most of the major OECD economies over the past few months. Relatively ample global liquidity conditions and the associated continuing search for yield, together with healthy growth expectations for most emerging markets have further pushed spreads on emerging market bonds downwards, some to all-time lows. China introduced more flexibility to its exchange rate regime in July by replacing the fixed peg to the US dollar with a managed float based on a basket of currencies.

II. Equity markets

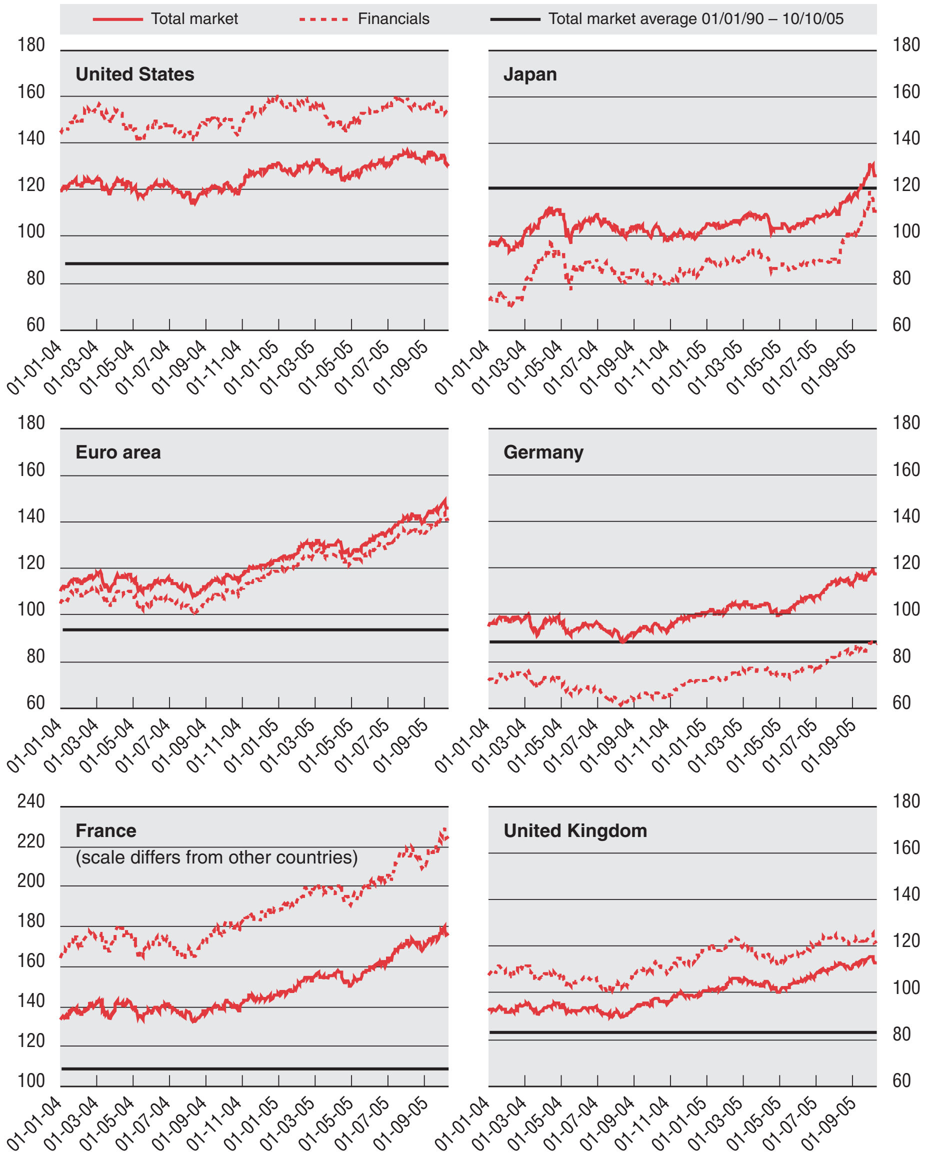
Equity markets in major economies have shown a robust performance…

Equity markets in major economies have shown robust performance over the past few months, reflecting a generally positive outlook and on-going confidence of investors in the economies' ability to absorb the increases in commodity prices (Figure 1) and adjustments to global imbalances (Figure 2). Earlier in the year, however, such downside risks paired with weak economic data weighed on markets in March and April and in Europe until early May. Back then, such data raised fears

© OECD 2005

Figure 2. **Major stock markets**

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



Note: Datastream indices. Daily data until 10 October 2005.
Source: Thomson Financial Datastream.

© OECD 2005

of slower US growth, while continued inflation fostered expectations that a progressive interest rate tightening by the Federal Reserve would further constrain growth. At the same time, various indications of weaker corporate profits of some multinationals added further to a negative picture, although earnings reports themselves continued to be positive.

... backed by corporate profits and positive economic news ...

Eventually, such earnings reports formed the basis for a rebound which set in by mid-April for the US market and in May for European shares. In both economies, corporate earnings increased more than ten per cent year-on-year in the second quarter, and even though this was less than the previous year's growth, it was higher than investors had expected. These developments were also backed by other positive economic news like rising retail sales and higher job creation data which further lifted business and consumer confidence.

... in particular in Japan, where growth prospects made equity increasingly attractive for foreign investors.

Among the major markets, the Japanese market showed the strongest performance, as positive prospects for economic growth led to a large inflow of foreign capital which boosted the Japanese equity markets. Consensus forecasts for Japan's 2005 GDP growth had continuously been revised upwards, from one per cent in May to almost two per cent in September surveys. Foreigners generally have been net buyers of Japanese shares since 2003 and their appetite for the Japanese stock market significantly increased with growing optimism about Japanese economic recovery. According to some equity strategists, foreign "long-short" hedge funds had given key support to the market by deciding to "go long" on Japanese stocks. Also, while the rise in oil prices to new nominal records created nervousness about the global economy elsewhere, overseas investors were relatively relaxed about the effect of oil prices on Japan, which has been very energy efficient compared with other OECD economies.

Regions differed in their performance, with growth of US markets weaker than those of Europe and Japan.

Measured over monthly averages, the Nikkei 225 rose over 14 per cent from March until October, slightly higher than growth of the Euro Stoxx index over the same period, which increased more than 12 per cent (Table 1). Over the year, measured from December 2004 until early October this year, the Japanese index also outpaced the European index, growing over 20 per cent compared to growth over 18 per cent in Europe. Among the big euro area economies' indices,

© OECD 2005

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. 04-Oct. 05	1.7%	21.4%	18.5%	19.8%	20.6%	14.0%	14.1%	17.8%
Pct. chg. Mar. 05-Oct. 05	2.2%	14.0%	12.2%	16.1%	12.7%	8.0%	9.4%	11.1%
P/E Oct. 05[b]	18.3	32.6	15.4	13.5	14.7	19.1	14.5	19.2
P/E avg. Jan. 90-Oct. 05[b]	21.4	48.6	16.2	17.0	15.2	19.1	17.2	19.0
P/E avg. 90-94[b]	17.7	48.8	14.2	17.5	12.5	17.8	15.5	19.3
	Telecom, Media, IT[a]							
Pct.chg. Dec. 04-Oct. 05	–3.7%	16.4%	5.4%	0.8%	7.5%	–3.2%	6.8%	3.2%
Pct. chg. Mar. 05-Oct. 05	1.6%	12.7%	5.4%	6.6%	8.9%	–2.9%	4.4%	3.8%
P/E Oct. 05	25.7	31.5	20.4	19.3	15.7	26.2	16.5	26.3
P/E avg. Jan. 90-Oct. 05	29.5	62.6	21.9	31.7	19.7	21.1	24.3	28.6
P/E avg. 90-94	21.2	49.8	14.3	28.7	13.0	13.5	14.8	27.1
	Financials[a]							
Pct. chg. Dec. 04-Oct. 05	–2.7%	31.9%	20.8%	22.3%	21.0%	18.8%	6.3%	13.2%
Pct. chg. Mar. 05-Oct. 05	0.4%	22.1%	12.6%	15.0%	14.1%	10.1%	4.5%	8.3%
P/E Oct. 05	13.5	33.7	13.9	12.0	13.1	19.2	13.0	16.4
P/E avg. Jan. 90-Oct. 05	15.4	63.2	15.8	19.2	12.4	20.4	16.7	13.6
P/E avg. 90-94	12.5	61.8	14.8	22.1	11.2	18.5	18.4	12.7
	Of which: *Banks*[a]							
Pct. chg. Dec. 04-Oct. 05	–8.3%	37.1%	19.4%	25.0%	16.6%	20.9%	2.5%	14.2%
Pct. chg. Mar. 05-Oct. 05	–4.7%	28.2%	11.5%	16.9%	12.5%	11.0%	2.9%	9.7%
P/E Oct. 05	12.6	35.9	14.2	14.5	11.1	17.7	11.8	17.0
P/E avg. Jan. 90-Oct. 05	14.3	97.7	13.3	13.7	10.7	16.2	14.2	12.9
P/E avg. 90-94	11.3	65.3	10.6	13.4	9.5	11.1	14.6	12.4
	Insurance companies[a]							
Pct. chg. Dec. 04-Oct. 05	1.0%	31.4%	18.7%	15.0%	33.0%	10.4%	21.1%	20.2%
Pct.c hg. Mar. 05-Oct. 05	1.3%	19.7%	10.2%	9.9%	17.3%	5.1%	14.2%	13.1%
P/E Oct. 05	13.2	29.4	11.3	8.5	16.0	20.6	12.5	11.3
P/E avg. Jan. 90-Oct. 05	18.3	44.5	20.5	31.6	14.2	29.3	23.7	13.5
P/E avg. 90-94	14.0	48.9	24.5	47.4	11.4	33.5	29.2	12.2
	Life insurance companies[a]							
Pct. chg. Dec. 04-Oct. 05	17.0%	32.0%	14.8%	31.3%	4.1%	3.5%	6.6%	9.6%
Pct. chg. Mar. 05-Oct. 05	16.4%	14.4%	9.4%	18.7%	3.6%	0.3%	–1.6%	5.4%

Note: Calculations based on monthly averages (October 2005 data are until 10 October only). 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 he United Kingdom, the earnings are calculated by a rolling 12 months method of analysis based on interim, final and annual accounts.

a) Datastream indices. The Insurance index includes non-life insurance companies, insurance brokers and other insurance companies; it does not include life insurance companies.

b) From Datastream Total Market indices.

Source: Thomson Financial Datastream.

© OECD 2005

the German DAX 30 showed the strongest performance, growing more than 16 per cent from March until early October. In comparison to Europe and Japan, equity markets in the United States showed weaker performance, even though the US economy has still been growing and is forecast to grow at a considerably faster pace than those in the former two countries.

Uncertainties around the economic outlook made investors sensitive to economic news,…

Investors in the US have reacted to news which could change the picture of the health of the economy. In March and April, for example, negative economic news caused markets to drop. By contrast, the negative news on the US employment report released early in July caused major indices to spike upwards. The report undershot expectations and tamed fears of overheating which might have forced the Fed to adopt a more restrictive stance in the pace of its monetary tightening. By the same reasoning, higher-than-expected US non-farm payrolls released early in August, along with further oil price increases, heightened fears of a more advanced monetary tightening which could have put strains on the economy, and thus caused temporary drops in equity markets.

… but broad markets remained resilient in the face of terrorist attacks and natural catastrophes.

Despite these uncertainties, markets in general remained resilient in the face of man-made or natural disasters. The terrorist attacks in London on 7 July caused a drop of the UK total market index of 1.4 per cent and a drop of the euro area total market index of 1.1 per cent, but this decline was ephemeral, as by 8 July these markets had regained their previous levels. The London attacks did not appear to have any effect on the US market, and, if at all, only a minor one on the Japanese market. Note in comparison that after the attacks in the United States on 11 September 2001, as well as after the bombings in Madrid in March 2004, markets in the affected countries took more than a month to recuperate their pre-disaster levels. Broad markets were also barely affected by hurricanes Katrina and Rita, which hit the United States Gulf Coast region at the end of August and in September, and where the former caused major human losses and a vast destruction of infrastructure. However, the increase in oil prices in the wake of these windstorms which destroyed oil fields and refineries in the Gulf of Mexico has weighed on markets more generally of late, and US markets have lost some of their earlier gains, even though early in October they are still above their mid-year levels.

© OECD 2005

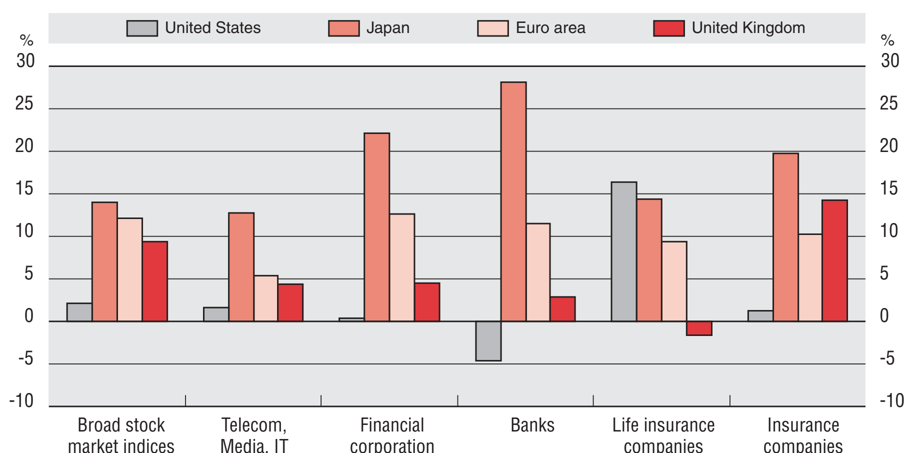
It is yet not clear how strongly these hurricanes will affect insurance companies' results. Reports by a big reinsurer in mid-September, doubling its estimates for the total insured loss from Hurricane Katrina and raising its provisional figures for the claims it would face, put further downward pressure on the sector's equity price index. But, as previous experience had shown, for some insurers the catastrophe brought the prospect of higher premiums which counterbalanced the downward trend of the sector's indices.

While the reinsurance sectors were hit by the recent catastrophes,…

The performance of insurance sector stock market indices has been positive over the past few months, lagging the broader market by only a little in the United States and Europe. Banking indices in the United States significantly underperformed the broader market and other sectors. Under strain by rising interest rates and a flattening yield curve, US banks lost more than 8 per cent of their index value over the period from the end of last year until October, and almost 5 per cent since March (Table 1 and Figure 3). Japan again fared better than other major markets, with the financials sector outpacing the already strongly growing broad market index. In that segment, the banking

… the insurance and financial sectors in general fared well, in Japan in particular, while banking indices underperformed in the United States.

Figure 3. **Recent sectoral stock market performance in major economies**
Percentage changes from March 2005 until October 2005



Note: Calculations based on monthly averages (October data are until 10 October only). Indices as specified in Table 1.
Source: Thomson Financial Datastream.

© OECD 2005

sector's good performance was driven by the successes of previous reforms which had strengthened banks' balance sheets. And in August, figures by the Bank of Japan showed that bank lending was up – the first rise dating back to 1998 when such data had been recorded for the first time –, fostering confidence in a positive turnaround of the Japanese economy.[1] Furthermore, the sector was boosted by prospects of the merger between the second largest Japanese Bank, Mitsubishi Tokyo Financial Group, and UFJ, the fourth largest Japanese bank, to create Mitsubishi UFJ as the biggest bank globally.

The life insurance sector showed strong growth as well, but the TMT's performance remained lacklustre.

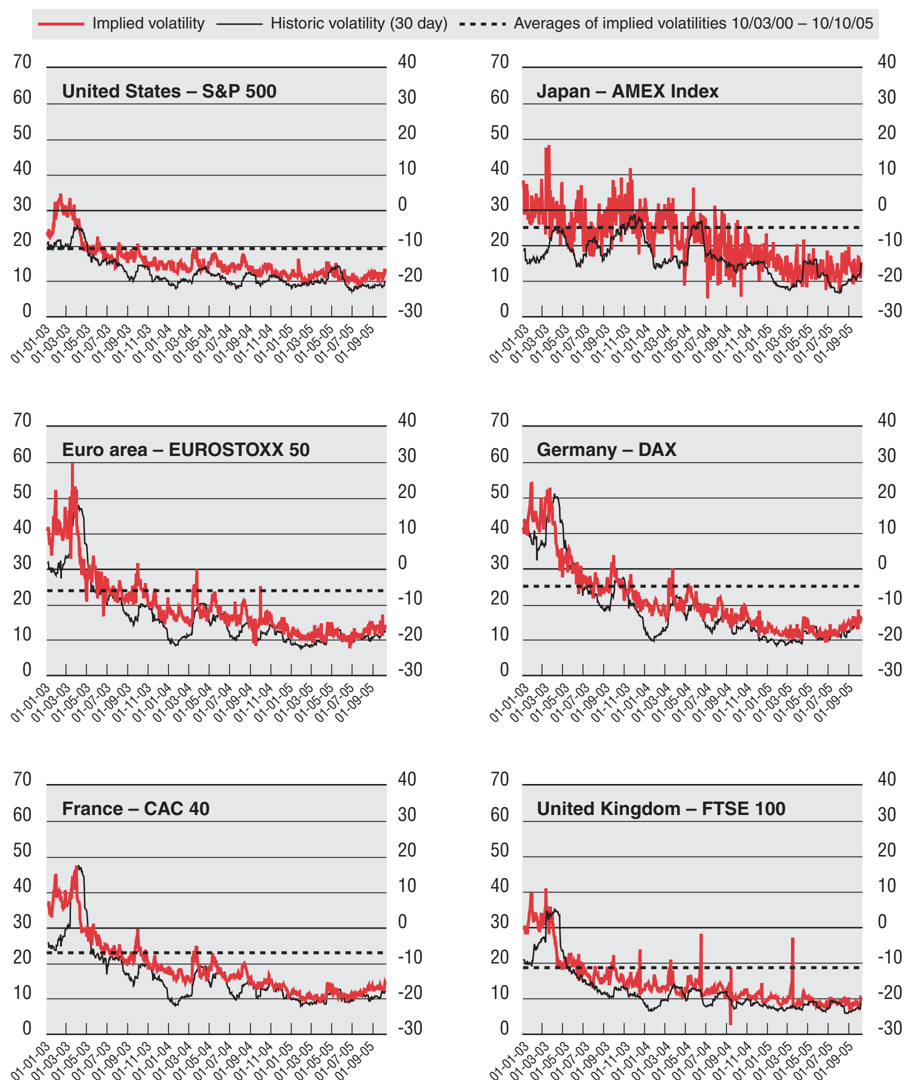
The strongest gains among the Japanese financial sector sub-indices were recorded in the life insurance sector. Its index rose 32 per cent for the first three calendar quarters and over 14 per cent since March. The life insurance sector outperformed other indices as well in the US, rising almost 17 per cent from March until October, against an almost stagnant overall financials index over the same period. Life insurance also performed well in European Markets, growing almost 10 per cent from March until October. The telecom, media and IT (TMT) sector, which underperformed the broader markets across major economies, fared relatively better in Japan. In Europe, this sector performed well in France, but declined substantially in Italy, almost 3 per cent from March until October.

Overall, volatility remained low, and valuation far from speculative levels.

Over the past few months, volatility remained low or slightly declined further, staying below five-year averages in all major equity markets (Figure 4). This is true for both volatility measured as implied by options prices (implied volatility) and in terms of share price variations (historical volatility). The former, implicitly forward-looking measure was higher than the latter, historical measure from June or July onwards across all major markets. As well, price-earnings ratios (based on past earnings) have on average over the past few months been broadly in line with, and even below, their long-term averages, indicating that market valuation is far from speculative levels. In Japan, price-earnings ratios are still well below their long-run averages.

© OECD 2005

Figure 4. **Stock markets: implied and historic volatilities**



Note: Daily data until 10 October 2005. Historic volatilities are monthly volatilities calculated from daily data. 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.

Source: Thomson Financial Datastream.

© OECD 2005

III. Bond markets and interest rates

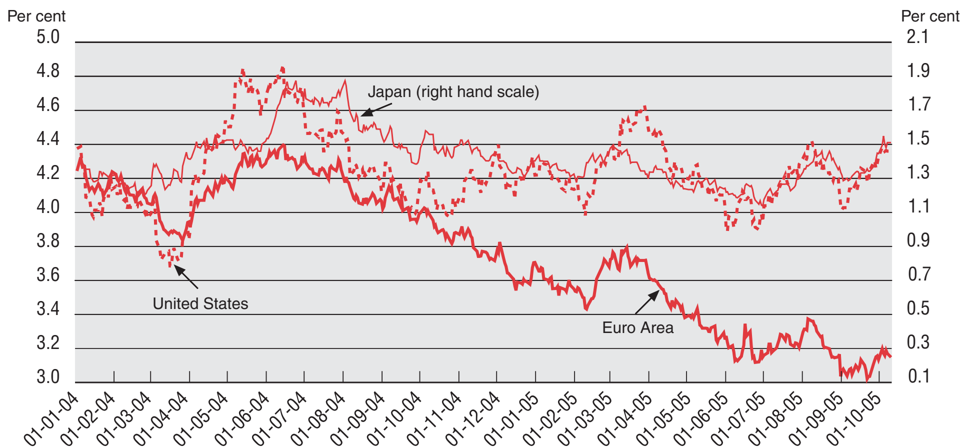
Long-term benchmark yields declined substantially in the euro area…

As compared to a year ago, long-term government benchmark bond yields have declined slightly, on balance, in the United States and Japan, and more substantially, about one percentage point, in Europe, where they reached historical lows in September (Figure 5).

… and yield curves have become flatter in the United States and the euro area, but steepened in Japan.

Along with the on-going monetary tightening, yield curves have become flatter in the United States (Figure 6). The Fed increased its target rate from 1 per cent to 3.75 per cent so far, in 11 steps since the end of June 2004 until 20 September 2005. In the euro area, with unchanged policy rates, the flattening of the yield curve came mainly through drops at the long end. In Japan, with short rates remaining at zero, rising long-term yields driven by the positive outlook on the economy led to a steepening of the yield curve. In the United Kingdom, the Bank of England counteracted an inversion of the yield curve and supported a weakening economy by lowering its policy rate to 4.5 per cent on 4 August, shifting a flat yield curve downwards. With a more vibrant economy, the Bank of Canada raised its policy rate on 7 September, from 2.5 to 2.75 per cent.

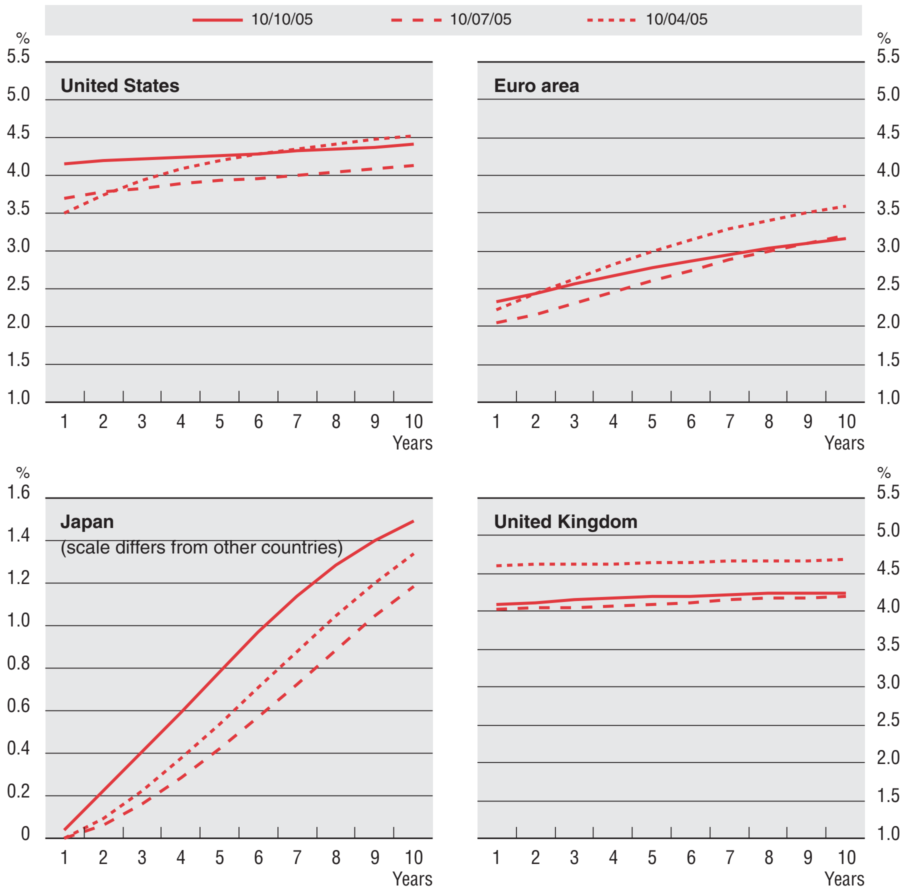
Figure 5. **10-year government benchmark bond yields**



Note: Daily data until 10 October 2005.
Source: Thomson Financial Datastream.

© OECD 2005

Figure 6. **Yield curves**



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

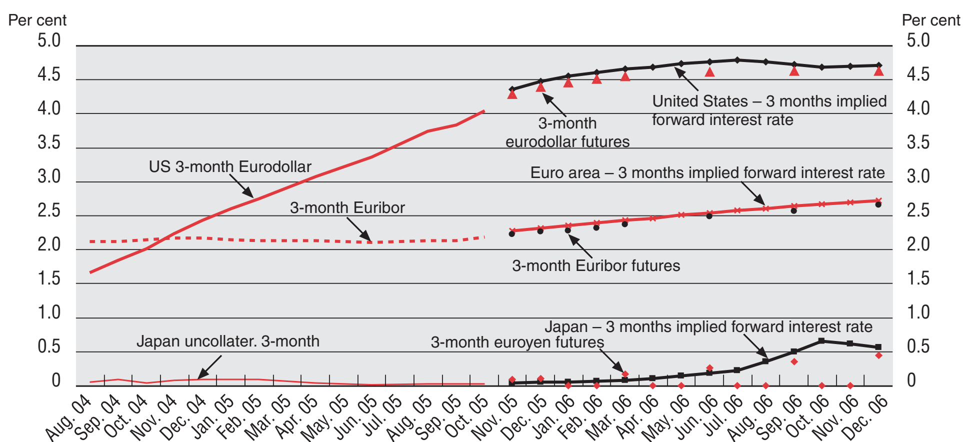
Based on futures and forward rates implied by the shape of the yield curve, further monetary tightening is expected in the United States (Figure 7). In the immediate aftermath of the devastating hurricane Katrina there was uncertainty about a suspension of further Fed funds target increases, and by early September futures had dropped significantly. But these expectations quickly dissipated, with futures again attaining pre-disaster levels. In the euro area, according to futures and implied forward rates, investors

Investors have been expecting further policy rate increases by the Fed, and the ECB on hold.

© OECD 2005

Figure 7. **Implied forward and futures short-term interest rates**

United States, euro area and Japan



Note: Data as of 10 October 2005. Actual rates: United States: 3-months eurodollar middle rate; euro area: Euribor 3 month offered rate; Japan: uncollater. 3-month middle rate; monthly averages. Implied forward rates are derived from zero-bond yield curves. Eurodollar futures: 3-month (CME); Euribor futures: 3-months (LIFFE), euroyen futures: 3-months (TIFFE).

Sources: Thomson Financial Datastream, OECD.

have been giving a very low probability to prospects for the ECB to raise its policy rates in the near future.

Uncertainties around the economic outlook made US benchmark yields fluctuate.

In the United States, while fluctuating substantially, long-tem benchmark bond yields maintained their year-to-date average levels, having reached about 4.4 per cent early in October. In between, yields had reached two lows, once at the beginning and again at the end of June. On the first of June, yields on ten-year US Treasury notes fell to their lowest level in more than a year, after a release of weak manufacturing data and suggestions that the Fed's rate rises would soon end. After some rebound, uncertainties about the Fed's policy led to a renewed decline in yields ahead of the FOMC meeting on 30 June. With the FOMC's decision to continue its monetary tightening, bond prices fell and yields climbed again. Later in August until early September, when oil prices rose to then record levels (which peaked at 67.5 USD for London Brent on 2 September), yields declined. When hurricane Katrina hit the New Orleans region and caused major devastation, fears of higher inflation were

© OECD 2005

probably strong driving forces behind rising yields. But with the concomitant increase in stock markets, this rise may also have reflected positive long-run growth expectations with the prospects of a positive impact from reconstruction work in the devastated region.

Euro area benchmark yields have been on a downward trend,...

European benchmark yields followed a similar pattern; however, along a declining path. While they were at par with US benchmark yields in September 2004, the spread to US yields has now widened to more than 1 percentage point (about 120 basis points early in October). With inflation expectations in check, sluggish growth expectations have been one of the major driving forces behind these developments. For example, euro area government bond prices rallied and yields fell when the German Ifo business climate index released in late May fell to 92.9 from 93.3 in April, its fourth consecutive monthly decline, and the German ZEW survey of investor confidence came in worse than expected. Some speculation of an ECB rate cut at the end of May added further to a decline in yields. With the ECB's stance unchanged, low growth expectations supported the decline in yields. Shortly thereafter, however, yields were soon under upward pressure brought on by rising oil prices, which fuelled fears of inflation and drove up yields through early August, before they fell again to new record lows in the second half of September. More recently, euro area yields have recovered somewhat to around 3.2 per cent early in October.

... and benchmark yields rose in Japan.

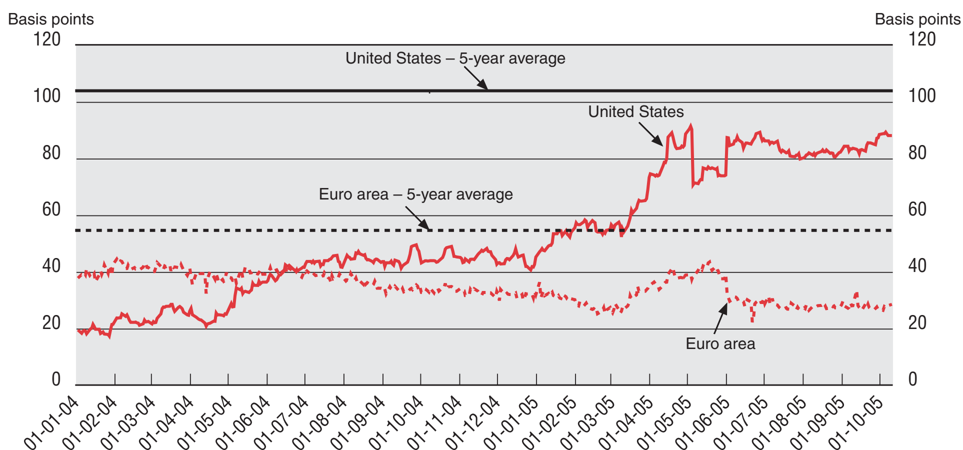
In Japan, positive expectations about the economic outlook, which were also reflected in equity markets, supported an upward trend in bond yields beginning at the end of June. A slight decline which set in around the second half of August also reflected investors' caution before the General Election which took place on 11 September. Since then, yields have risen again and have early in October regained their peaks of August and from earlier in the year.

Corporate spreads are still low...

Corporate spreads are still below long-run averages in the United States as well as in Europe (Figure 8), but have been rising significantly in the United States, partly due to supply factors (see below). Investment-grade spreads, *i.e.* spreads between BAA and benchmark yields, have risen

© OECD 2005

Figure 8. **Investment-grade corporate bond spreads**



Note: Daily data until 10 October 2005. Aggregate corporate BAA bond yields (Lehman indices) minus 10-year government benchmark bond yields for the United States; and JP Morgan Maggie government spread of investment grade credit, all sectors, all maturities, for the euro area.
Source: Thomson Financial Datastream, OECD.

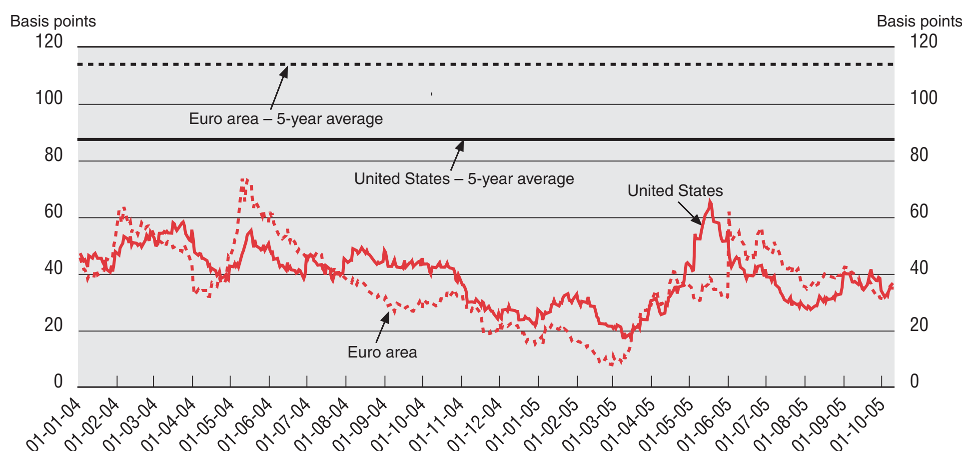
about 50 basis points since the beginning of the year in the United States, while in Europe they have moved mainly sideways, except for a slight increase in the second quarter, when further weaknesses of the euro area economy became apparent and depressed benchmark bond yields. This increase in spreads culminated in a drop of more than 10 basis points by early June. Spreads between high-yield and BAA bonds' yields also remained well below their long-run averages, despite rising somewhat in both economies (Figure 9). By mid-May and early-June, high yield spreads on both sides of the Atlantic had increased about 170 basis points from their lows earlier this year. Since then, they have again declined, by about 100 basis points as of early October.

… reflecting investors confidence,…

The low credit spreads (investment-grade as well as high-yield) reflected, in part, the overall positive sentiment. Strong economic growth in general and corporate earnings growth in particular helped to strengthen investors' confidence in the quality of credit. Moreover, corporate default rates were forecast to remain low for some time before picking up during 2006. Upgrades have been higher than

© OECD 2005

Figure 9. **High-yield bond spreads**



Note: Daily data until 10 October 2005. Aggregate corporate high-yield bond yields minus aggregate corporate BAA bond yields (Lehman indices) for the United States; JP Morgan Maggie government spread of high yield credit, all sectors, all maturities, for euro area.
Source: Thomson Financial Datastream.

downgrades in the United States, even though there are indications that this measure will further decline from its peak earlier this year. The downgrades in the US automobile sector early in May[2] which had led to a debt sell-off, seemed not to have had longer lasting effects, and by June the sector began to tap the unsecured market again.

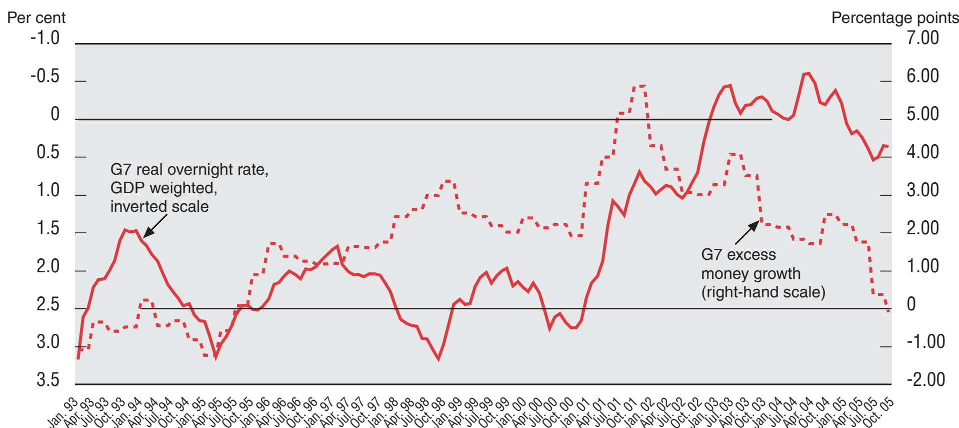
… but also ample liquidity.

Liquidity conditions, which continued to show some contraction along with the tightening stance of the Fed, have nonetheless remained accommodative (Figure 10) and have thus further contributed to keeping spreads tight and helping to averting corporate defaults. Relatively ample liquidity is also reflected by the easing of lending conditions, especially in the United States as reported in the *Federal Reserve Loan Officer Opinion Survey on Bank Lending Practices*. Similar results come from the *Euro Area Bank Lending Survey* conducted by the European Central Bank, which also showed a more pronounced increase in the net percentage of banks reporting easing credit standards in July.

© OECD 2005

Figure 10. **Proxies for global liquidity developments**

G7 real overnight rate, GDP weighted, inverted scale,
and actual money growth minus potential real GDP growth, in percentage points



Note: The global liquidity indicator based on real interest rate developments follows C. Borio and W. White (2004), "Whither monetary and financial stability? The implications of evolving policy regimes", BIS *Working Paper* No 147. The measure shows a weighted average of real overnight rates in G7 countries; for France and Germany, the Euro Overnight Index Average (EONIA) is used from 1999 onwards. The weights are based on USD GDP, and real rates are calculated by deducting three-month moving averages of year-on-year CPI changes from nominal overnight rates, including projected CPI changes in cases where most recent data have not yet been available. The other indicator focuses on G7 excess money growth (again as GDP-weighted average). Actual nominal money growth is the year-on-year growth of quarterly broad monetary aggregates; potential real GDP growth is corrected for trend velocity growth, *i.e.* it is a residual money growth measure derived from the quantity equation assuming zero inflation. Trend velocity growth is based on average velocity growth 1980-2002 in the respective economies, except for the euro area, where it is based on the mid-value of the range for velocity growth as assumed by the European Central Bank in deriving the quantitative reference value for monetary growth (0.75).

Source: Thomson Financial Datastream; OECD, *Main Economic Indicators* and *Economic Outlook* database; European Central Bank.

Yields have also been kept low by structural demand factors.

In addition to these factors, there is also a long-term structural increase in demand for bonds which is helping to keep rates low. Increased saving for retirement in ageing societies, in particular through pension funds, and demand from Asian economies, mostly through foreign exchange interventions by their central banks in order to keep the value of their currencies down, have added to the downward pressure on yields. And, according to a recent study, this global "saving glut"[3] is to a big extent driven by increased global corporate savings.[4] According to this research, companies have hoarded in excess of USD 1 trillion during the past four years, after they had gone on a spending spree in the late 1990s. This is a shift five times larger than the USD 200 billion plus change in emerging market savings between 2001 and 2005.

© OECD 2005

A drop in US treasury supply weighed on yields …

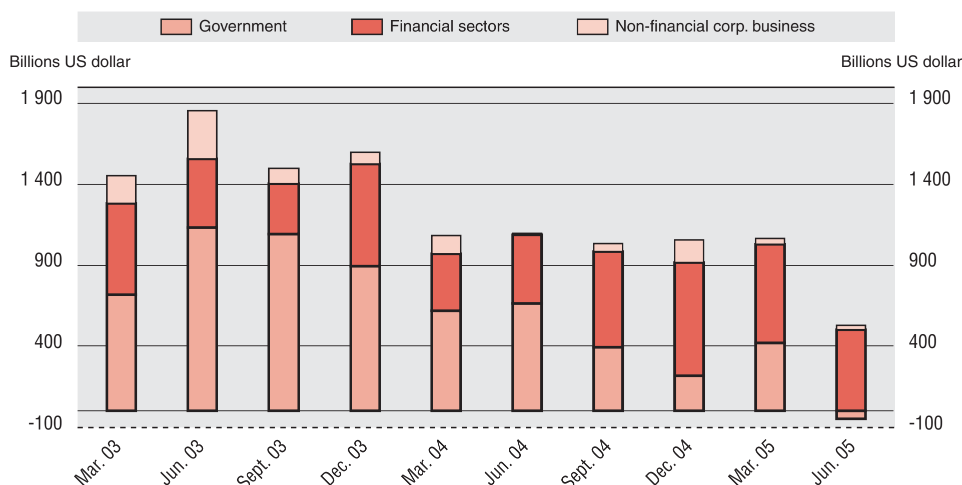
Looking at supply factors on bond markets, net issuance of government bonds in the United States, which had been on a downward trend since the beginning of 2004, turned negative in the second quarter (Figure 11). Apart from the demand factors discussed above, this drop in supply helped bid up treasury prices and showed up as downward pressure on yields. Over the second quarter, US 10-year benchmark yields fell around 60 basis points. As well, this supply contraction has partly been responsible for the increases in corporate spreads.

…but issuance held up elsewhere.

For corporate bonds, however, supply factors had somewhat less weight. While net issuance of non-financial corporations declined on average for the first half of 2005 as compared to averages of the years before, they held up relatively well. And so did the financial sector which has in the three previous quarters issued the lion's share of US bonds. In the euro-denominated bond markets, issuance remained strong (Figure 12), even disregarding a surge of financial sector issuance in June which has to be ascribed to special factors.[5] The advanced issuance in June likely accounts for the decline in issuance in the succeeding months.

Figure 11. **Net issuance of US bonds**

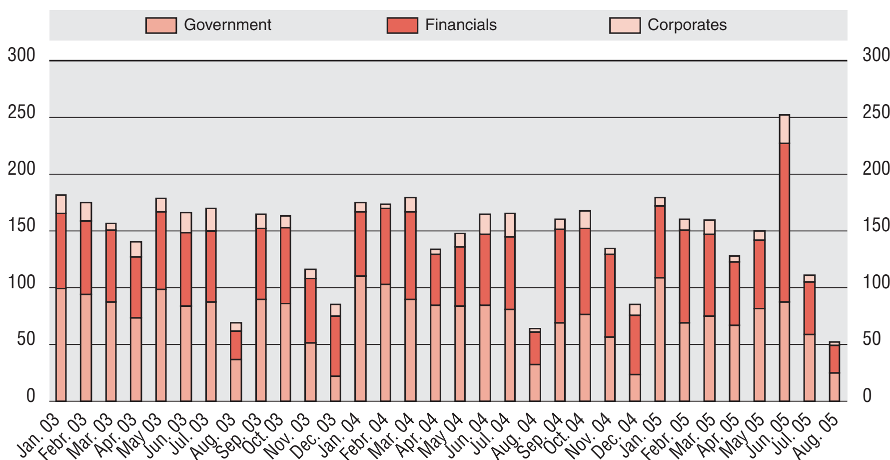
In billions of US dollars, quarterly, seasonally adjusted, at annual rates



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

© OECD 2005

Figure 12. **Euro-denominated bond markets: volumes issued by type of issuer**
In billions of euros



Note: Issues of a maturity of one year or more. “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.
Note that, according to information from the European Commission, the surge in issuance by financial institutions and by non-financial corporations in June 2005 seems to be mainly related to the implementation deadline of 1 July 2005 for the new EU Directive on prospectuses, which will require most companies to update their borrowing programmes before returning to the market.
Source: European Commission (DG ECFIN).

More long-term instruments entered the market, meeting institutional investors' demand.

In meeting increased demand from institutional investors, in particular from pension funds and insurers which need to match their ever lengthening liabilities, governments have further raised their issuance of ultra-long bonds. Already in 2004, the US Treasury had issued 20-year inflation-protected securities (Tips), and has recently announced plans to reintroduce a 30-year bond at the beginning of 2006. The issuance of the long bond had been discontinued in 2001 in the face of budget surpluses. Also in 2004, the Italian government successfully placed 30-year index-linked bonds, additional amounts of which were offered this year. In February, the French Treasury issued a 50-year bond. In May, the UK government re-introduced a 50-year gilt into the market after a break of more than four decades. This issue was followed by another auction in July. In September, the UK Treasury issued the world's first 50-year inflation-linked bond. The bond was sold through a syndicate of

© OECD 2005

banks. As the offer drew more than GBP 2 billion in demand, the offer size of GBP 1 billion was increased to GBP 1.25 billion. Moreover, the bond offered a real yield of only 1.112 per cent, the lowest ever on an inflation-linked bond, and 19 basis points below the 30-year inflation linker.

Credit derivatives soared as investors tried to shift risks, posing further challenges to policy makers.

Elsewhere, the credit derivatives market grew strongly this year as banks, hedge funds and others have substantially increased their use of complex financial instruments, according to a recent survey by the International Swaps and Derivatives Association.[6] In June, the total notional value of all outstanding credit derivatives contracts reached USD 12.43 trillion, a 48 per cent increase from January and a 128 per cent rise compared with a year earlier. The growth of this market segment highlights the changes under way in the global financial system as banks and investors use these instruments to manage risks. While these instruments offer benefits as risk management tools, they also pose challenges. Because trading occurs over-the-counter in private deals rather than on exchanges, the sector is very opaque and difficult to monitor. The rapid growth has also strained the trading infrastructure of banks and hedge funds which have a large backlog of back office processing.

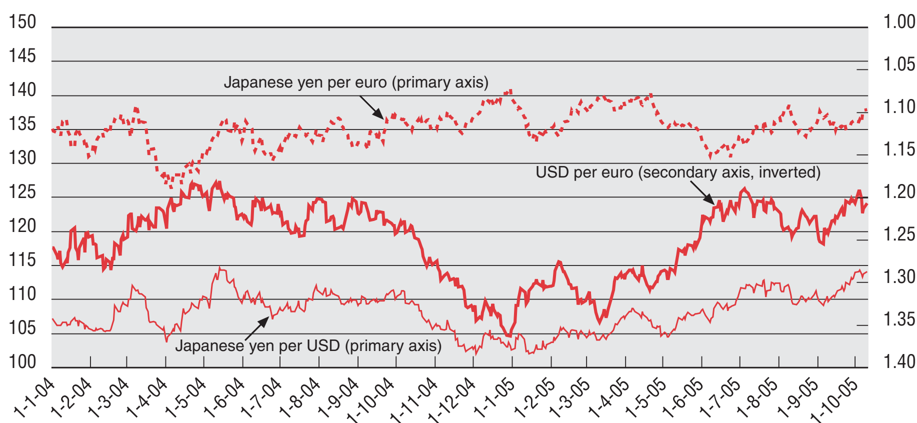
IV. Foreign exchange markets

The US dollar strengthened against the euro and the yen,...

Since mid-March until mid-July, the US dollar has been on an upward trend against the Euro and, somewhat more pronounced, against the yen, which in turn appreciated slightly against the euro until mid June (Figure 13). The subsequent weakening of the yen against the US dollar and the euro mirrored weak economic data (*e.g.* a fall in industrial production of 2.3 per cent between April and May) which investors interpreted as signs that a recovery of Japanese growth was still tentative. In mid August, uncertainties around the General Elections scheduled for mid September again put downward pressure on the yen. At the end of August and early September, the dollar sharply dropped in the aftermath of the Katrina disaster, beyond 125 cents to the Euro, but soon it continued its upward trend to around 120 cents per euro early in October.

© OECD 2005

Figure 13. **Major exchange rates**



Note: Daily data until 10 October 2005.
Source: Thomson Financial Datastream.

… unexpectedly for some,…

According to some market analysts, this unexpected strength of the US dollar may have had negative effects for pension funds, trend-following hedge funds and private investors which had made bets on a declining dollar. The activity in exchange-traded derivatives, as investors were apparently increasingly trading dollar risks, rose 15 per cent to USD 3 trillion in the second quarter.[7] Elsewhere, overseas profits of US corporations have been flattening or falling as the dollar reversed the declining path it had been on throughout the second half of last year. The depreciation of the US dollar had made the earnings of US affiliates abroad an important source of profit for multinational companies.

… but it has been reflecting interest and growth differentials…

For many investors the still high US current account deficit along with increased fiscal spending had hinted at further downward adjustment of the dollar. But more immediate structural factors have been supporting the dollar's recent upswing, such as a widening interest rate differential between US and euro area long-term bonds, reflecting deteriorating growth expectations for the euro area, and continued strong demand for US assets.

© OECD 2005

… and continued appetite for US assets, in particular from Asian economies,…

Indeed, net capital inflows into the United States remained strong (Figure 14). While inflows from Japan have somewhat weakened over the past few months, demand from other Asian countries, in particular from China, increased. In June and July, China's net purchases of US securities amounted to USD 14.7 billion and USD 13.8 billion, respectively, close to their record of USD 16.9 billion in February. Again, most of the total inflows were invested in Treasuries, although corporate bonds surged in June, accounting for over 60 per cent of all net inflows in bonds (Figure 15). With strong US equity investments abroad meeting a likewise high foreign demand for US equities, net inflows in equities were roughly in balance. On a monthly average basis, foreigners invested USD 350 billion in US equity in the January to July 2005 period, up from USD 330 billion in 2004.[8]

… and, albeit on a smaller scale, OPEC countries.

Japan still holds the major share, about one third, of all US assets abroad, while over 20 per cent are held by other Asian countries, more than half of which is by China. And, while OPEC countries have a share of only about three per cent of US assets held by foreigners, it is interesting to note that over the last year, with the surge in oil prices, oil exporters have invested part of their windfalls in US assets (Figure 16). While they have diversified their exposure and moved somewhat out of dollar assets over the past few months, in July they still held USD 53 billion in US assets, more than in June 2004.

V. Emerging markets

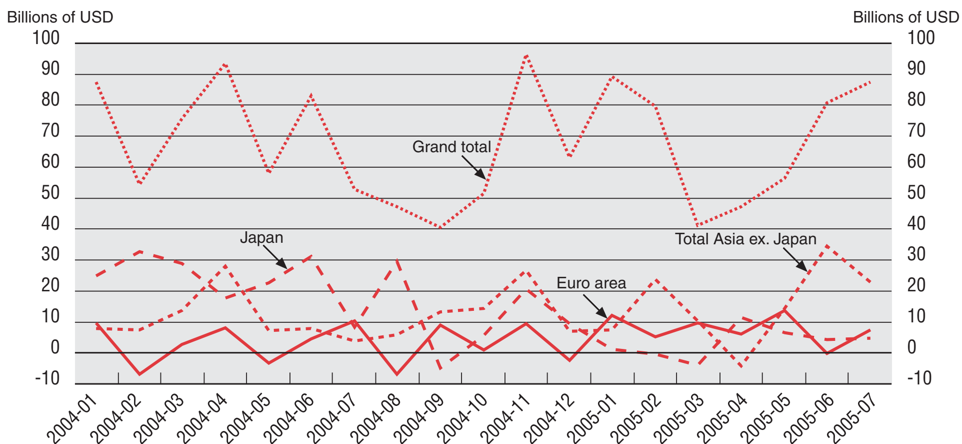
Record lows of EMBI spreads have reflected, in part, a positive outlook for emerging economies.

Growth in emerging markets has continued to attract foreign investors, and while the pace is expected to weaken somewhat as compared to the previous year, GDP growth in emerging economies remains well above OECD growth and higher than world growth.[9] The positive sentiment has been reflected in a further compression of yield spreads of emerging market bond indices (EMBI) over US government paper, which reached new historical lows in early October (Figure 17). This spread compression may be driven in part by positive growth differentials of emerging markets *vis-à-vis* industrial economies.

© OECD 2005

Figure 14. **Net portfolio flows into US by region**

Billions of US dollars

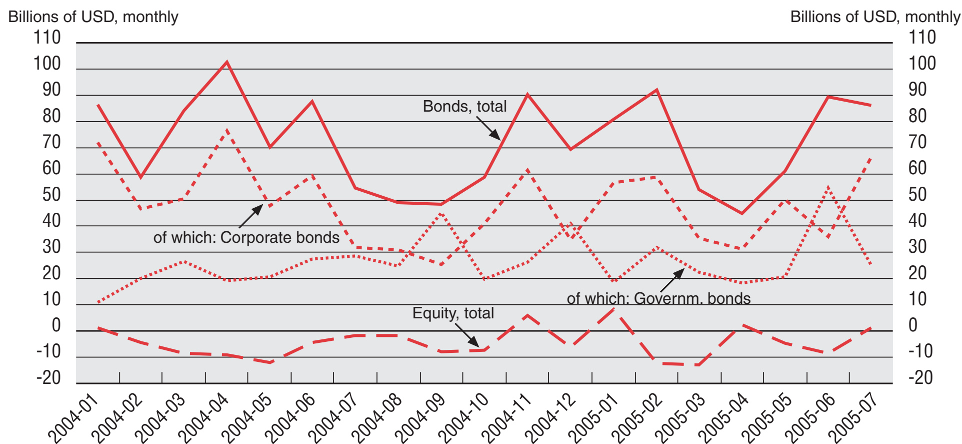


Note: Net portfolio flows are net purchases of assets by foreigners from US Residents (gross purchases – gross sales).

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

Figure 15. **Net portfolio flows into US by category**

Billions of US dollars



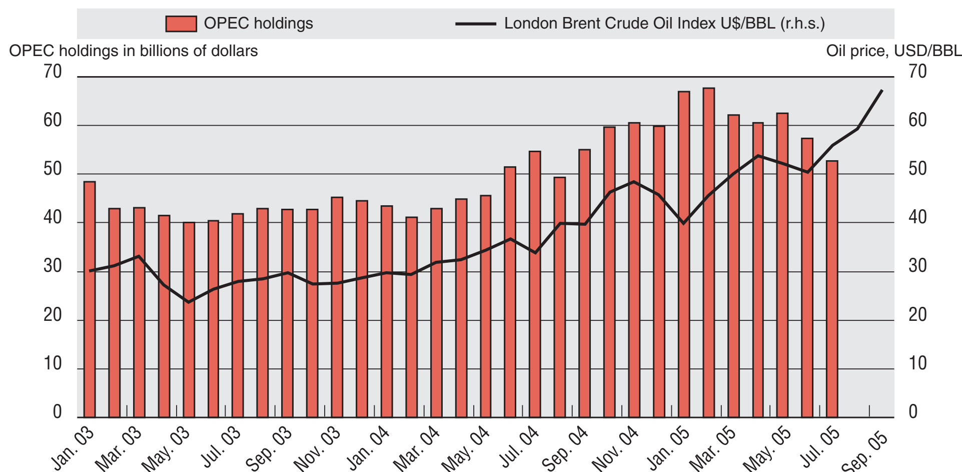
Note: Net portfolio flows are net purchases of assets by foreigners from US Residents (gross purchases – gross sales). Bonds comprise US and foreign bonds; government and corporate bonds as shown here are US bonds only; equity comprises US and foreign equity.

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

© OECD 2005

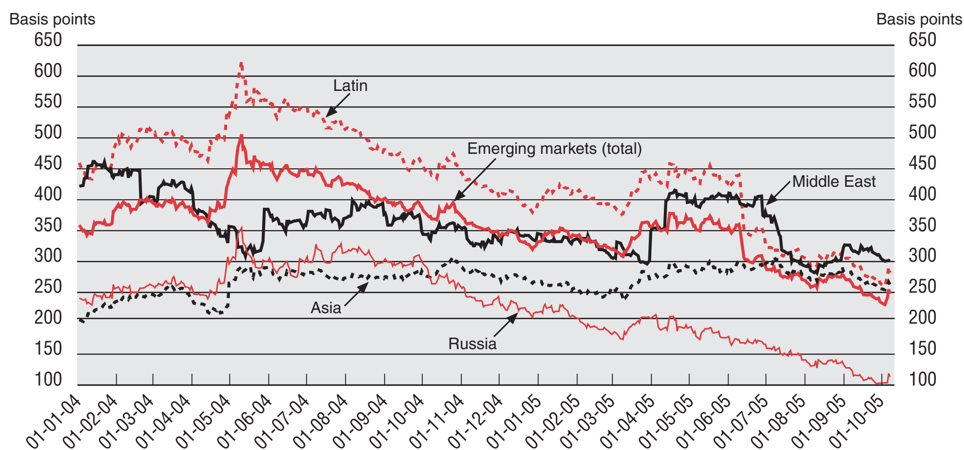
Figure 16. **OPEC holdings of US assets**

Total holdings of US assets by residents of OPEC countries,
in billions of US dollars, and oil price in USD/BBL, monthly averages



Source: US Treasury, Treasury International Capital (TIC) Reporting System; Thomson Financial Datastream.

Figure 17. **Emerging market bond spreads**



Note: Daily data until 10 October 2005. JP Morgan EMBI Global blended spreads over US benchmark bond yields. EMBI Global covers US dollar denominated Brady Bonds, Eurobonds, Traded Bonds and local market debt instruments issued by sovereign and quasi-sovereign entities.
Note also that, according to information from JP Morgan, the strong drop from 10 to 13 June 2005 in the Latin American and, consequently, in the emerging markets total index is due to an intra-month rebalancing triggered by the Argentina debt exchange. As a result of the rebalancing, Argentina defaulted debt (with spreads of 5000 b.p. and above) was partially replaced with performing debt with much lower spreads.
Source: Thomson Financial Datastream.

© OECD 2005

Increased emerging market debt issuance has been meeting demand.

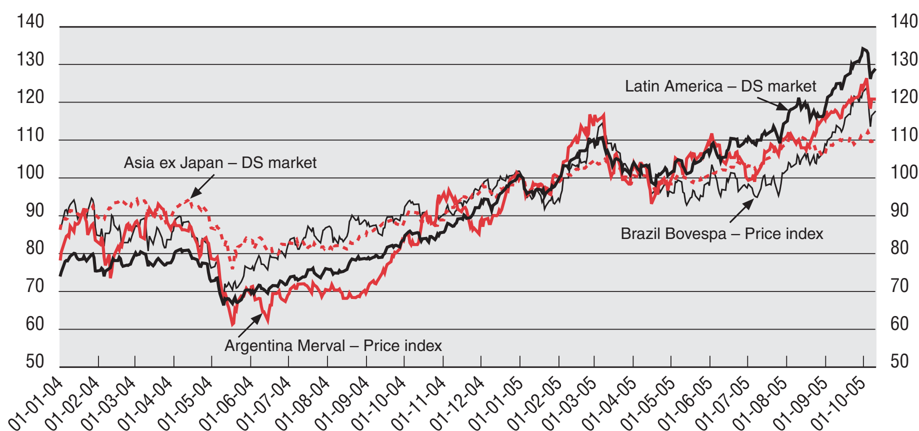
Emerging market debt has been continuously upgraded. More than half of the JP Morgan EMBI Global index is now investment grade, compared with about 10 per cent in 1998. In the search for yield, many institutional investors have increased their exposure to emerging markets.[10] In response to increased demand, emerging market debtors increased their issuance to a record amount during the first seven months of 2005, 22 per cent above the issuance volume over the same period of the previous year.[11] Recently, taking advantage of lower financing costs while being confident about a stable macroeconomic environment, many issuers – Latin American governments in particular – have placed their debt in major foreign currencies, mostly in US dollars.

Emerging stock markets have been buoyant, in particular in Brazil…

Driven by demand from foreign investors' as well as domestic demand, stock markets of major emerging regions have rebounded (Figure 18). The rebound was particularly pronounced in Latin America. However, it came only after a somewhat weaker performance in the second quarter. In Brazil, political uncertainty related to accusations of corruption in the government led to an increase in Brazilian bond spreads in late July and again in late August. Nonetheless,

Figure 18. **Stock market performance in selected emerging economies**

Equity price indices, 3 Jan. 05 = 100



Note: Daily data until 10 October 2005.
Source: Thomson Financial Datastream.

© OECD 2005

among the large countries of the region, Brazil's stock market has been one of the best performers recently, and in dollar terms, due to the strengthening real, has outperformed others by far.

... and, with successful debt restructuring, in Argentina.

In Argentina, investors gained renewed confidence after a successful debt restructuring and backed by a 7.5 per cent growth forecast for this year, which is more than double the growth of the Brazilian economy. The Argentine debt restructuring was initiated in February, and investors were offered about USD 35 billion of new securities for USD 100 billion of old debt and interest payments on the latter of more than USD 600 million. With 76 per cent participation, the result of the debt restructuring was a decline of the debt burden to 72 per cent of GDP (which was at 147 percent of GDP in 2002 after the country's record debt default in December 2001), along with a considerable improvement in the debt service profile. At the beginning of June, Standard and Poor's upgraded Argentina's long-term debt rating to a B- with a stable outlook, up from selective default (SD), sending a positive signal to investors who had remained cautious after the country's record debt default in December 2001.

Pressure from continued high growth in Asia's powerhouse China have led to more policy flexibility regarding the renminbi.

While Asian bond yield spreads have stayed above the total emerging market index yields since last August, they have declined in concert with other emerging market spreads. On 21 July, China revalued the renminbi by 2.1 per cent, at the same time introducing a managed float against the dollar of 0.3 per cent per day. Later it announced a non-dollar band of 1.5 per cent daily. In order to reduce its need of intervention on multiple currency markets, China's central bank announced on 23 September a further widening of the band of the renminbi, now permitting trading against non-dollar currencies within a band of 3 per cent per day.

© OECD 2005

Notes

1. After adjusting for special factors such as bad-loan write-offs, currency fluctuations and securitisations, the Bank of Bank of Japan figures showed August lending 0.2 per cent higher than a year before, at JPY 386,990 billion.
2. On 5 May 2005 Standard and Poor's downgraded the debt ratings of US automakers General Motors Corp. and Ford Motor Co. below investment grade, and Moody's Investors Service followed suit on August 25, by downgrading both auto producers to junk status.
3. The term was coined in Remarks by Governor Ben S. Bernanke, *The Global Saving Glut and the US. Current Account Deficit*, at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, on 10 March 2005.
4. See JPMorgan Research (2005), *Corporates are driving the global saving glut*, J.P. Morgan Securities Ltd, June 24.
5. According to information from the European Commission, the surge in issuance by financial institutions and by non-financial corporations in June 2005 seems to be mainly related to the implementation deadline of 1 July 2005 for the new EU Directive on prospectuses, which will require most companies to update their borrowing programmes before returning to the market.
6. ISDA – International Swaps and Derivatives Association, Inc. (2005), ISDA *Mid-Year* 2005 *Market Survey*, New York, ISDA (also available at *www.isda.org*). The ISDA survey covers both credit default swaps and synthetic collateralised debt obligations.
7. Bank for International Settlements, BIS *Quarterly Review*, September 2005.
8. Total inflows into the United States in equity, which consist of foreign purchases of US stocks as well as sales of foreign equity held by US residents, amounted to USD 512 billion for the January-July 2005 period, and to USD 469 billion in 2004 (monthly averages). In comparison, total inflows in bonds amounted to USD 1 183 billion for the January-July 2005 period, and to USD 1 065 billion in 2004 (monthly averages).
9. According to the recent IMF *World Economic Outlook* (September 2005), GDP growth for the group of emerging market countries was slightly revised upwards to 6.4 per cent in 2005 and 6.1 per cent in 2006, above world growth of 4.3 per cent in 2005 and 2006, and growth of industrialised countries of 2.5 per cent in 2005 and 2.7 in 2006. The current OECD *Economic Outlook* (June 2005) estimates GDP growth for the total of OECD countries at 2.6 per cent in 2005 and 2.8 per cent in 2006.
10. One example is the California Public Employees' Retirement System (CalPERS), the largest US public pension fund with assets totaling USD 182 billion; see *CalPERS Adopts Emerging Market Debt Investment Policy*, Press release, 15 June 2005, available at *www.calpers.ca.gov*.
11. Bank for International Settlements, BIS *Quarterly Review*, September 2005.

© OECD 2005