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Money Market

Central banks adopted less accommodative policies in 2006 in response to address inflation risks issues. Even the Bank of Japan abandoned its zero-rate policy to raise its target rate to 0,25% in July 2006.

The ECB went on with the process of normalisation of interest rates, initiated in December 2005. On five occasions, the ECB raised the minimum bid refinancing rate by 25 basis points, bringing the reference rate from 2,25% to 3,50%.

The gradual improvement of the economic situation in the Euro-zone combined with inflation pressures in a context of record energy prices provided the framework for these rate hikes. From September on, the headline inflation rate went under the 2% level and seemed to anchor under this ceiling. Nevertheless, the analysis of the economic indicators is still pointing to inflation risks, therefore paving the way to further tightening in 2007.

The predictability of actions of the ECB, properly announced by consistent statements, have allowed the markets to react smoothly to monetary decisions.

The appointment of Mr. Bernanke as the Chairman of the Federal Reserve Board was welcome smoothly by market participants. The successor of Mr. Greenspan raised the interest rates on its first meeting as a Chairman, consistent with the action of his predecessor, only his comments appearing more hawkish than expected by the market participants. After continuing with interest rate hikes during the first half-year, adding altogether 100 bps to the target rate to reach 5,25% as of 29 June, the Federal Reserve ended the tightening process and kept a monetary status quo throughout the second part of the year, however always pointing towards inflation risks.

Even with these rate increases, monetary policies remained accommodative and liquidities fairly abundant, allowing market participants to access cheap funding easily.

The euro area money market turnover expanded in 2006, recovering from 2004 and 2005. This global trend can be put in the perspective of 2006's monetary policy changes and related market participants changing anticipations. The strongest increase was in interest rate products. Globally the degree of concentration remained high. Cross-border trading is increasing gradually, but remains conducted mainly within the euro-area. Electronic trading is increasing but at a moderate pace and its share remains at or below 20% with an exception for the secured market where it reached some 49% of the transactions.

Unsecured transactions have continued to increase, but at a moderate pace and less than other money market segments. The secured market continued to expand. The volume of triparty repos grew significantly, but the number of banks active in triparty repos remained limited. Compared to the US where it is a mature market representing some 50% of the total repo market, triparty repos in the euro area account only for 10-15% of the total repo market. Both unsecured and secured markets remain concentrated in the very short-term maturity segment, namely below one-month. The share of transactions made via electronic trading platforms increased significantly over the last years, a factor that allowed liquidity to improve. Furthermore the integrated platform combining trading, clearing, settlement and collateral processes for repos launched in 2005 was increasingly used. This facility is also being prepared for triparty repos.

The OTC derivative business recovered from the lower levels of 2004 and 2005. In particular, Eonia swaps (OIS) turnover increased again in 2006, in a context of monetary policy rate changes. OIS, with their tight bid-offer spread and very large transaction size, remain the main tool for speculating and hedging against interest rate movements in the euro area with Euribor futures. FX swaps have been used increasingly as a daily liquidity management tool. Divergence of market participants' expectations about policy rate changes in the euro area and the US was a determining factor of the growth of this segment in 2006. Increased use of interbank trading platforms is only true for FX swaps. Other OTC derivatives remain essentially traded directly or via voice broker as they are less standardised. Activity in euro OTC derivatives remains highly concentrated.

Turnover of short-term interest rate futures contracts went to new highs, in a context of anticipations of monetary policy decisions. Euribor futures contracts

continued to dominate futures trading in Europe. Trading on EONIA futures remained weak and is on a downward trend. Indeed, opposite to the US situation, where fed fund futures take the lead over OIS, EONIA swaps, as an OTC instrument with very tight bid-offer spreads fulfil the need of managing short-term funding risk.

The short-term securities secondary market turnover increased significantly. With the return of risk appetite, carry trades were favoured and non-bank issues turnover rose strongly. However the short-term securities' market remains very fragmented as domestic markets still have different standards or practices. In an attempt to overcome this difficulty, the ACI and the FBE have signed the STEP market convention in June 2006. A STEP label will be granted to issues complying with a set of requirements aiming at facilitating comparisons and cross-border trading. The US commercial paper market was taken as a benchmark. Besides, statistics are now provided regularly by the ECB on the yields and volumes of the STEP market in order to ensure improved transparency.

Foreign exchange markets

After a firm first quarter, the dollar suffered from the slowdown of the US economy in the second and third quarter as well as from inflation concerns. Then it moved sideways until October and depreciated further until the end of the year. Over 2006, the dollar lost some 10% against the euro. The major driver for the EUR/USD was the perspective of a narrowing gap between US and EUR interest rates and yields as the Federal Reserve was keeping a status quo policy and the ECB was still pointing towards rate hikes. The current account deficit of the US went on deteriorating in 2006, but at a slower pace, notably thanks to a weaker dollar that favoured US exports. Markets continue not to perceive the current account gap widening as a threat to the stability of the currency as long as net foreign purchases of US securities are healthy. Until now, the high savings level of the big Asia emerging countries provided for the financing of the US gap, without a major interest rate increase or depreciation of the dollar. The main risk still remains however an important reallocation of the foreign reserves by the major central banks. Besides, as reflected in BIS data, in 2006 oil producing countries have reduced their exposure to the dollar to the lowest level in two years and exchanged their USD-denominated income in EUR, JPY and GBP, confirming market speculations about a move out of the dollar that could put additional pressure on the greenback.

In China, since the exchange rate reform in July 2005, the renminbi has appreciated by some 6% against the dollar.

The Yen fluctuated between 110 and 120 JPY per USD, and lost some 11% against the EUR. This declining trend can notably be explained by the fact that the Japanese currency continued to be used in the context of carry trades, as a funding currency. Financing of carry trades in Yen should remain easy, notably as Japanese banks try to revive the credit business. Globally, carry trades are positive for the global liquidity as they distribute the additional liquidity created in weak currency countries in the other stronger currencies countries. However, as a tool to be exposed voluntarily to exchange risk, carry trades are a potential source of financial instability. First, the tightening of monetary policies has pushed up the cost of carry. Consequently, participants are paying more attention to the economic fundamentals of countries with high interests (i.e. emerging countries). Moreover, participants to carry trades are essentially international investors such as investment funds or hedge funds that would quickly and massively sell assets in case of unfavourable developments. Speculative crowded trades could be undone massively and rapidly if a high yielding currency was on the verge of depreciation, and trigger an even higher depreciation of the currency. Although the situation is considered reassuring from the point of view of market participants, there are still factors of concern. On the one side, there is a wide range of carry trade operations and the volumes concerned are not so well known. On the other side, the interest rate differential between the Yen and the dollar or the euro is not huge and would not compensate for an important appreciation of the funding currency.

Bond markets

The inversion process of the yield curve went on in the US while in the Euro-zone, the yield curve flattened. Structurally, long-term yields went back to historically low levels as they were still supported by the high demand for very long bonds, notably pension funds.

Bond yields went upwards until June as the monetary tightening process was going on and inflation pressures were intensifying. The US Treasuries yield curve had a 75 basis points upward parallel shift on the 2-10 years segment, while the short-term part inverted and the 30-year slightly over-performed the rest of the curve. The move was globally similar in the Euro-zone, the whole curve gaining between 70 and 78 basis points over the first six months. The reassessment of the perception of economic growth especially in the US, and of the probability of further rate hikes in the US stopped the decline of bond markets. The sentiment was confirmed in August, when the reappraisal of the inflation picture in the US and two consecutive status quo decisions by the Federal Reserve pushed the bond yields down in the US as in Europe. In the second half-year, the US yield curve went down anew, fully inverted on the 2-5 years segment, flat on the 5-10 years part and showing a slope of only 10 basis points in the 10-30 years part. The Euro-zone yield curve flattened completely, the 2-year gaining 33 basis points while the 10-year lost 12 basis points, as the monetary tightening process of the ECB went on and inflation figures were reassuring, a similar move to the one that occurred in the US in 2005.

In terms of global performance however, 2006 has been a poor year for bond investors. Altogether the Euro-zone government bonds had a negative return even including reinvested coupons (JP Morgan government bond total return index: -0,25%).

The performance of Treasuries was positive measured in dollars (+3,09% for the JP Morgan total return index) but for the EUR-based investor the return is negative at -7,78%, considering the -10,23% decline of the dollar against the EUR in 2006.

Bond yield curves have turned flat (Euro-zone) to inversed (US) in the run of 2006, which in the past could be synonymous of an upcoming period of recession. At the same time stock markets have performed well for the fourth year in a row and markets anticipate an average profit growth of some 10% for 2007. Although seemingly paradoxical, this situation between bonds and stocks could last as long as the current ideal non-inflationary growth scenario remains valid. This is notably based on the equilibrium between the evolution of profits on the one side and of wages on the other side. Currently wages have been maintained but they could rise if wage claims would be satisfied. The impact on markets would depend on price evolution. At constant prices, the margin rates would shrink which would have a negative impact on equities. On the opposite, if wages increases were passed on in prices to keep the margin rate constant, this would be negative for bonds. However, wages pressures could continue to be curbed in the context of globalisation. Despite tamed wages, the ECB continues to see inflation risks skewed to the upside due notably to high money supply, oil price, and accessorily German VAT increase.

Another apparent paradox prevailing in bond markets is the persistence of the low level of long-term yields. However, the low level of long-term interest rates can be validated by three major factors. First, a decrease in anticipated inflation[7] has been observed since the second half of 2006. Second, real long-term yields were driven low thanks to the world saving surplus, mostly in the big Asia emerging countries. The third explanatory factor is the most impressive: risk premiums incorporated in long-term yields or term premiums have decreased to nil since 2004-2005[8], reflecting a lower risk perception by investors. Danger could clearly arise from the underestimation of risks by investors.

Credit markets

2006 was characterised by the continued expansion of credit and the tight credit spreads prevailing on all levels of credit quality, reflecting the weakness of risk premiums.

Indeed, as far as the continuous tightening trend is concerned, not only investment grade corporate bonds are concerned, but also high yield bonds (corporate with weak credit quality or emerging countries) and spreads have decreased to levels close to historical lows. Indeed, as the average default rate has fallen to an all-time low, risk aversion of investors in search of higher yield in a context of abundant liquidities has decreased dramatically. Strong growth of profits and a high proportion of cash in corporate balance sheets plead in favour of a low default risk level for 2007.

7 *As measured by the break-even point of inflation bonds and by inflation swaps.*

8 *According to figures calculated by the US Federal Reserve.*

Moreover, of all Euro asset classes, not only Euro High yield bonds realised an excellent performance in 2006 just behind equities, but also showed the best risk/return performance, thanks to their extremely low volatility.

The boom of credit derivatives, the fastest growing segment of OTC derivatives in 2006, has significantly contributed to the yield spread compression of corporate bonds. Credit default swaps growth accelerated in 2006, especially multi-name CDS. Growth would have been even higher, if it had not been for increasing early terminations. Early terminations seem to have processed smoothly thanks to private firms that are offering multilateral termination services.

Decreasing costs for buying a CDS – if the price of a CDS goes below the bond yield spread – allowed investors to make arbitrages: buying a risky bond together with a CDS protection and gain more than a comparable risk free bond. The expansion of these trades has brought the credit spreads of high yield corporate bonds to historical lows.

Moreover, the tremendous success of CDOs, has enlarged the investor base for corporate credit risk and therefore added to the compression of credit spreads. CDOs built from derivatives on investment grade bonds are returning more than an individual bond bearing the same rating. But as there is no free lunch, this is due to the fact that the loss risk in case of default is higher on CDOs than on bonds. In case of default, a bond investor will get back 40% of the amount invested (historical average). On the opposite, a CDO investor can loose the entire amount invested in a subordinated tranche if the percentage of loss has reached a certain level in this particular tranche.

Besides, apart from the credit risk measured by the rating and the market risk, there are other risks related to CDOs that are not present when investing in a regular bond, namely liquidity risk (which has become lower for CDS but not for CDOs that are structured products), operational risk and risks linked to valuation models used that may prove not robust enough. Moreover, one has to consider the risk of correlation between the different names included in the CDO.

All in all, credit derivatives are a mean to redistribute the risks between financial institutions and final investors, thereby contributing positively to the efficiency and resiliency of the financial system. However credit derivatives and their assorted risks have not yet been tested in a real crisis situation.

The decline of stock markets in 2006 was brutal but temporary. As was its impact on credit spreads. The spread widening that occurred in May-June was rapidly absorbed and not only spreads of high yield bonds tightened over the whole year, but already over the first half year 2006!

As it can also be said about equity markets, macroeconomic factors were of no significant influence on the development of spreads in 2006. Likewise, if the monetary tightening of the ECB affected swap spreads, it did not affect credit spreads.

This is naturally valid as long as we live in the new perfect world of solid growth and controlled inflation that has prevailed recently and that favours the current global risk loving behaviour of investors. Therefore, a significant change in this major hypothesis could trigger a spread widening again. Risks to the current macroeconomic scenario are not absent. A decline of the US housing market more serious than expected could affect ultimately investment grade credit spreads due to a revival of risk aversion. A higher than expected growth slowdown in the emerging markets and more specifically in China or India would affect high-yield spreads and transmit to investment grade spreads. Moreover default rates could rapidly increase. Besides, inflation could accelerate as some central bankers statements point out and consequently, interest rate would rise.

Other factors that are bound to have a negative impact on credit spreads are the tremendous development of merger and acquisitions and LBOs. The impact of booming merger and acquisitions on credit quality has increased in 2006 as some 80% of the transactions were cash or debt financed (65-70% in 2005, Standard and Poors). Payment of dividends, share buy-backs and net acquisitions are now accounting for some 68% of the free cash flow of corporates. Besides, dividends and acquisitions growth has outpaced free cash flow growth, therefore triggering an important increase of debt and the deterioration of debt ratios. Interest coverage ratios were high in 2006, but could deterior-

ate in 2007 due to the delayed effect of interest rate increases.

In the wake of M&As, LBOs have increased dramatically, i.e. by some 60% worldwide in 2006, taking advantage of the low funding cost environment. LBO's were accounting for some 17% of M&As transactions, from some 12% in 2005 (source: Decalogic). Besides, private equity funds are believed to have raised more than USD 170 trillions of debt in 2006 and 9 of the 11 biggest LBOs were realised last year. As far as stability is concerned, it seems that recently credit spreads react more smoothly to LBOs announcements that only impact the credit spread of the name concerned, leaving the sector unaffected. However, LBOs boom has several negative consequences. First the withdrawal of quotation, if LBOs exceed IPOs, can impact the liquidity of stock markets. Moreover transparency is affected as unquoted companies have less information requirements. Second the balance sheet is deteriorating due to the increase of indebtedness and the deterioration of interest coverage ratios and the consequent decrease in own funds. Interestingly, Moody's has recently observed that acquisitions realised by private equity funds, can increase the default probability of the acquired company, under certain circumstances. Downgradings by notation agencies could then rise, therefore triggering spreads enlargements and price falls.

Equity markets

Globally, 2006 was another good year for stock markets. Besides, European markets took the lead. In local currency, the Eurostoxx50 returned 15,12%, the S&P 500 13,62% and the Nikkei 6,92%, all in local currencies. Taking into account the change effect for the EUR-based investor, the S&P returned 2%, while the Nikkei lost 5,08%.

Equities outperformed every other asset class, including hedge funds, high yield bonds and emerging bonds. Only the volatility was important in 2006 hampering the risk/return profile.

Ex post, the good performance of equity markets in 2006, the fourth year in a row, can be explained by other factors than a favourable macroeconomic environment or expectations of higher corporate earnings, even if these factors were reasonably in favour of the equities markets in 2006. It can also be considered as a valuation adjustment. Indeed, even after three years of a gradual recovery of stock markets, equities remained attractive. The average P/E of the S&P 500 in 2006 was 17,5 and the one of the Eurostoxx50 was 12,4. Besides, risk premiums are not abnormally weak for this asset class, considering the low interest environment and the earnings perspectives. The resumption of merger and acquisitions activity found an ideal ground in the combination of the three following factors: historically low funding costs, low-leveraged companies, and attractive stock valuations. Besides, the risk adverse behaviour of the investors – that prevailed after the crash of 2000 – has gradually disappeared. Investors eager to invest excess liquidities in markets where there is a lack of alternative juicy investment opportunities turned towards equities anew. Moreover, when institutional investors have to meet duration criteria, and therefore do not invest massively in stocks, the private equity sector that expanded tremendously over the last years took over from classic investors and became an important actor on the quoted sector. Consequently the usual opposition between defensive and cyclical sectors or value and growth was not a valid explanatory factor of sector performance in 2006. Performance was realised by stocks that were attractive in terms of potential acquisition. For example, utilities that are traditionally neglected in a positive growth outlook context, was one of the best performing sector in 2006 in response to the merger and acquisitions activity.

However, the progression of equities was not smooth throughout the year. Equity markets tumbled in May, notably due to worrying inflation data in the US and a global sell-off occurred. A profit-taking wave reached the best performers until then and the riskier values. There was a flight to quality as investors shifted away from equities to bonds. The decline of stock markets went on in June, as investors seemed unsure of macroeconomic developments. A second sell-off wave took place in July, triggered by geopolitical concerns in Israel and Lebanon.

Emerging equity markets were severely hit by the market turmoil in May-June. The unwinding of trades by leveraged investors generated a major fall of emerging markets indices. Latin America was the most severely

hit on a regional basis, while India suffered the most on a country basis.

But markets managed to absorb temporary disturbances. Equities began to rise again in late July after the publication of the second-quarter earnings in the US showed that more than two-thirds of companies beat expectations. The status quo of the Federal Reserve in early August and the fact that the rhetoric of the Federal Reserve highlighted more concerns about growth than inflation allowed market participants to expect the end of the tightening process.

The emerging equity markets also recovered substantially thanks notably to unchanged positive fundamentals. Globally, economic and financial stability in emerging markets has increased investors' confidence, offsetting risk considerations that however materialised in 2006 such as for example in Indonesia hit by a tsunami or in Thaïland that suffered a military coup in September.

Even the collapse of the Amaranth Advisors hedge fund, that lost 6,6 billion USD in September on wrong bets about natural gas was properly absorbed. Even if this fund had twice the size of the LTCM hedge fund that collapsed in 1998, the relative importance of a single failure is of a lesser impact on the markets in 2006, as the hedge funds market is currently more than five times larger than in 1998 in terms of capital under management. Albeit, the importance in size of macro hedge funds and the fact that they often adopt similar strategies implies that simultaneous portfolio shifts could have disruptive effects on prices. Moreover, the tremendous increase in size of the hedge fund market raises increasingly the problem of the lack of transparency of this market. Indeed, a code of conduct of the hedge fund industry is still missing, that would encompass transparency, risk management and corporate governance issues, as are ratings for these instruments.

Commodity markets

Compared to the oil crises of the 70's and the 80's, the oil price rises of last years have been well absorbed by oil-importing countries.

Rising steadily since 2004, the oil price reached a new high in early August notably on the back of concerns about the situation in the Middle East, Iran's nuclear activities, physical outages in Iraq and Nigeria, the shutting of a major oil field in Alaska. After the peak of August, the oil price declined however substantially. From a high of 78,64 USD (higher price of the Brent crude future quoted on 7 August), the Brent fell by some 23% in two months to hover around 60 USD till the end of the year. Interestingly, for the first time since 1985, the oil demand emanating from OECD countries dropped substantially in 2006, most probably in reaction to high prices. However the upwards longer-term trend is not impacted.

A renewed rise of oil prices would have a dampening effect on the global economy, notably through losses in purchasing power. Risks surrounding the oil market are still present: spare production capacities are very limited, refinery capacities are almost fully used, geopolitical tensions are prevailing. The global demand for crude oil continues to rise – although at a slower pace due to the moderation of global economic growth –. Besides, oil-producing countries have reintroduced production restrictions.

Apart from the traditional fundamental risks threatening oil prices, the change in the structure of market participants in the energy markets may also play a role. Indeed, next to the traditional actors present on energy markets (energy producers and consumers, financial institutions, commodity trading advisors) institutional investors and macro hedge funds are now playing an increasing role. The collapse of the Amaranth hedge fund due to wrong bets about natural gas prices has highlighted this source of risk. Even if in this particular case this single failure was well absorbed by the markets, the booming of the hedge funds business and the fact that macro hedge funds often take similar bets could threaten the stability of these markets.

Base metals have followed a similar trend to energy in 2006, with notably copper and nickel prices rising exponentially on concerns of spare capacity running out.

As for precious metals, Gold continued to benefit from the increased interest of investors in commodities for speculative purposes and as an alternative instrument in diversified portfolios. The gold price has risen steadily since 2001 and boomed in 2005 and early 2006. The

spot price went as high as 730,40 USD in May, i.e. a 41% price rise from the start of the year, to drop significantly below the USD 600 and close the year at 636,70 USD. This progression occurred in a context of tensions in the Middle East, high oil prices and a weaker dollar. Gold is expected to continue benefiting from this environment. Indeed, with an expected slower global growth, inflationary pressures and geopolitical tensions, gold is expected to continue playing its role of a safe-haven investment and hedge against inflation. However, the fact that speculators now own more gold than the central banks constitutes a risk factor to the price evolution.