

2 FINANCIAL MARKET DEVELOPMENTS IN 2007

1	Money Markets	21
2	Foreign Exchange Markets	23
3	Bond Markets	27
4	Credit Markets	30
5	Equity Markets	31
6	Commodity Markets	32



1 MONEY MARKETS

Tensions in the US sub-prime mortgage market, which had already begun in 2006, intensified much more in 2007. As a result, the risk appetite of investors declined sharply and market volatility increased across all asset classes. The functioning of money markets in most parts of the world was severely disrupted, and the Euro area money market was among the most affected. The US, at the origin of the problem, was of course impacted in a very similar way.

In Europe and in the US, banks but also insurance companies and hedge funds had to disclose huge exposures to the sub-prime markets, mainly acquired indirectly through asset backed securities on which they incurred severe losses. The impact of this was seen in the deterioration of the functioning in the longer-dated interbank deposit market and in non-government repos. Trading in these two segments virtually came to a stand-still. This squeeze in the interbank money market reflected the fear by the investors about counterparty credit risks. Major financial institutions started to hoard cash adding to the shortage of liquidity. The crisis was exacerbated first by the fact that credit risk, as measured by credit default indices (CDS), had reached historically low levels just before the sub-prime appeared in its full dimension. The second reason was the understanding by market participants that risky credits had been spread around through vehicles like CDOs. Eventually, those packaged mortgages had been sold to major financial institutions, which due to generous rating agencies, giving easily away AAA-ratings and a long period of low rates forcing them to hunt for higher returns, had piled up on what was year-long perceived as a low risk-high return investment. The products were grouped into so-called structured investment vehicles (SIV) and were booked off balance sheet. A large part of the debt issued by the SIVs and conduits took the form of asset backed commercial paper or ABCP; short term debt typically bought by money market funds and other conservative investors. So when finally investors got to know what products they had subscribed to, the ABCP market collapsed and with it, major money markets went into disruption.

The frictions spilled over to the very short-term money markets, namely the maturities shorter than one-week. Major European and American banks were unable to raise liquidity to fund operations. Their effort to convert Euros into US-\$ to support their US conduits brought the foreign exchange swap market nearly to a halt. Unable to refinance their ABCPs, banks started to look for alternative funding methods and credit lines were drawn. Other financial institutions were reluctant to lend money in the unsecured interbank deposit market, as doubts rose about funding needs in the industry. Add to this, mistrust about the real credit quality of the counterparts, and you end up with a standstill in the interbank market. Short term money rates- as measured by the LIBOR fixings- were skyrocketing at the same moment when future rate expectations were starting to fall. Tensions were also felt in the euro-commercial paper (ECP) market. Newly issued papers had to bear much higher yields to draw any interest from potential buyers. Average maturities of new issues fell significantly as investors were reluctant to take any longer exposures.

In response to these tensions, the FED and especially the ECB, reacted promptly by carrying out several special refunding operations, helping to address tensions in the short maturities and later in the longer ones. The spread between deposit rates and EONIA swap rates, often used as indicator of credit/liquidity risk in the money market, had gone from 5-6 bps in early July to a high of 93 bps in December. The liquidity injections by major Central Banks showed only limited results. Liquidity conditions continued to be rather difficult. At year-end banks were still reluctant to lend cash to one another for periods beyond one month and preferred to keep cash on their balance sheet. Market conditions still favor a continuation and maybe a worsening of the stretched situation, especially if banks would have to announce further losses or if the crisis would spread to other sectors of the economy that until recently have fared relatively well.

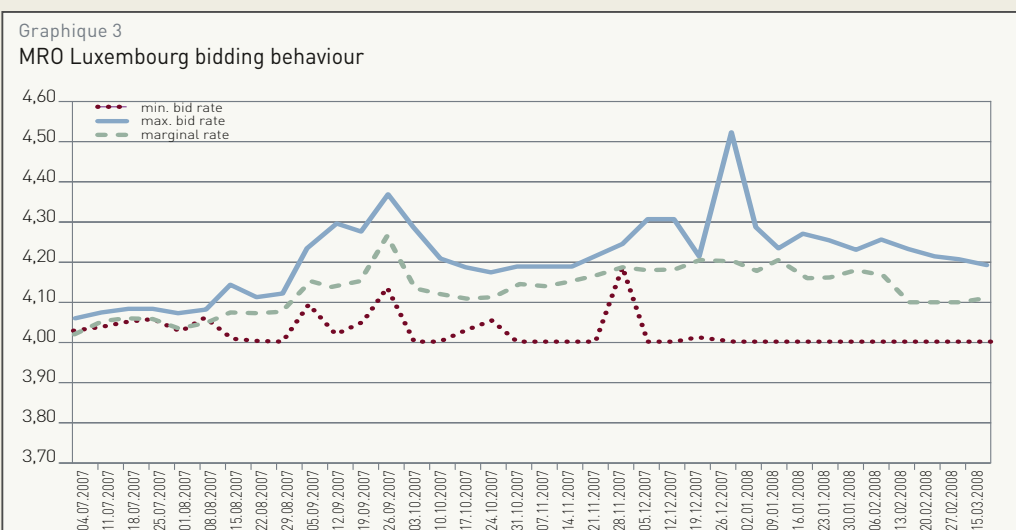
ASPECTS OF CENTRAL BANK LIQUIDITY IN LUXEMBOURG

The term 'liquidity' is used frequently to help explain market liquidity conditions. 'Ample global liquidity' is the explanation most commonly furnished to describe the environment that prevailed until August. When in August, short term money markets and interbank markets started to show signs of malfunctioning, central banks and most notably the ECB started to intervene providing additional funding and meet elevated liquidity needs. Market conditions had started already to deteriorate in the course of the year when credit conditions worsened in capital markets, starting with the problems in the US subprime mortgage market. The ongoing episode of turbulence is marked by an extended period of illiquidity in a large number of markets. As the world economy has globalised and financial markets have become progressively deregulated, the rapidity at which market illiquidity was transmitted into funding illiquidity was unprecedented. This was particularly visible in the securitization market. There are multi-purpose explanations and a lot of dimensions for a whole collection of 'liquidity' related phenomena, but this contribution is limited to the analysis of the provision of central bank liquidity from the Eurosystem with a focus on the implication on Luxembourg market liquidity.

The open market operations of the Eurosystem had several aims during the times of turmoil. As in normal times the ECB aims to keep the overnight rate as close as possible to the minimum bid rate, i.e. the policy rate decided by the Governing Council to signal the monetary stance. In addition, the open market operations aimed at ensuring continued access of solvent banks to liquidity and to ensure a smooth functioning of the money market, also at a term maturity. As a consequence of the US sub-prime mortgage market crisis and before year-end, a breakdown of the money market, particularly at term maturity was witnessed since August 2007 with liquidity risk premiums moving substantially higher. From a financial stability perspective several instruments of the operational framework were activated to contribute to the resilience of the financial system. The ECB changed the liquidity provision during the maintenance period, provided front loading and provided excess allotments above benchmark. On two occasions the liquidity policy was complemented with a variant of full allotment. The frequency of operations was increased namely via fine-tuning operations. The maturity of operations was lengthened by the conduct of supplementary LTRs and one exceptional 2 week MRO operation before year-end. Finally also international cooperation was evident with the conduct of the USD Term Auction Facility.

The increased volatility of market rates did also affect our domestic counterparties and a wider dispersion of bids was evident. On an aggregate level the average bid cover ratio in MROs declined from 88% in the pre-turmoil phase, to 67% in the period under review. The average bid cover ratio in LTRs even declined from 78% to 56%.

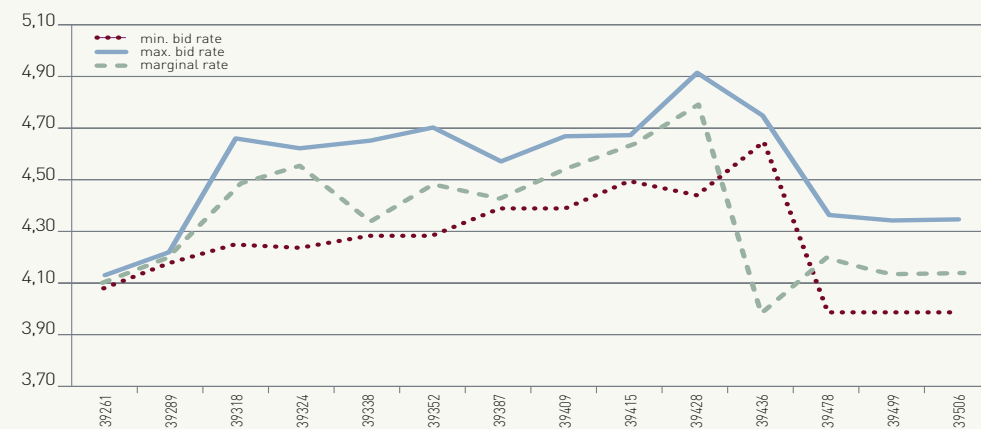
The comments regarding the widening of bid array may be symmetrically translated to our domestic case as evidenced by the 2 graphs below.



Whereas on average the number of bidders in MRO operations remained unchanged, we have nevertheless observed some tender days where 4 to 5 more counterparties than usual participated in the refinancing operations with BCL. In order to increase their chances to secure at least some liquidity in the volatile market conditions, counterparties have spread their bids over a wider

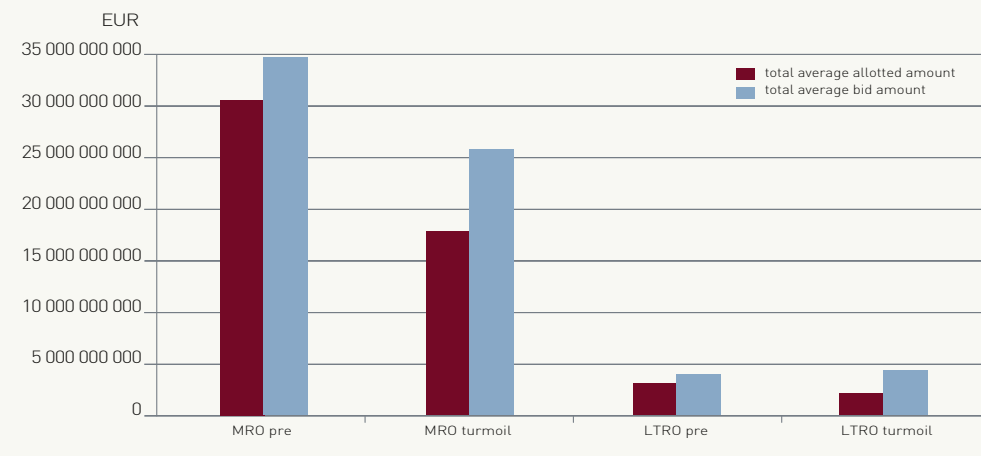
range and also significantly increased the number of bids submitted. The average number of bids rose from 28 to 40, with a maximum of 64 bids observed on 12 September. Since the beginning of the market turmoil, the average number of LTRO counterparties rose from 8 to 10, and the average number of bids from 16 to 31.

Graphique 4
LTRO Luxembourg bidding behaviour



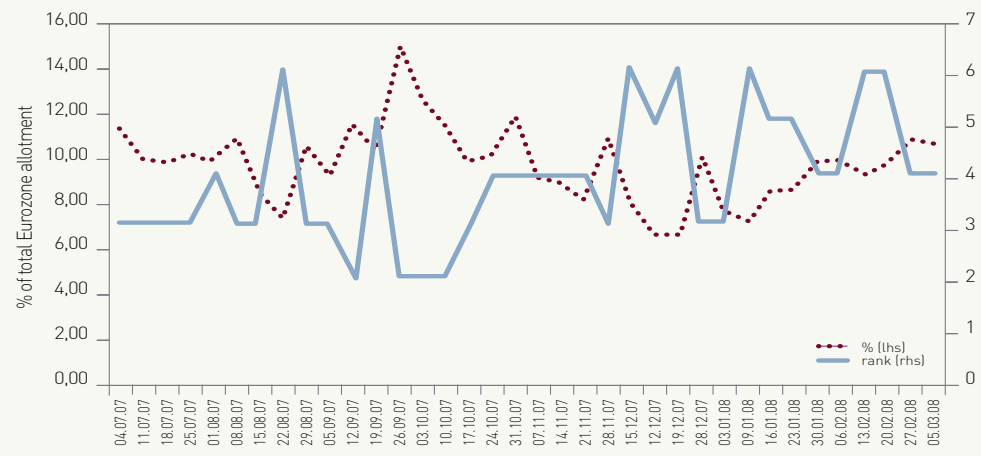
The average bid amount fell slightly from 35 to 28 billion in MRO operations, but rose from 3.9 to 4.3 billion³ in LTRO operations.

Graphique 5
MRO/LTRO bidding behaviour/allotment nominal amounts



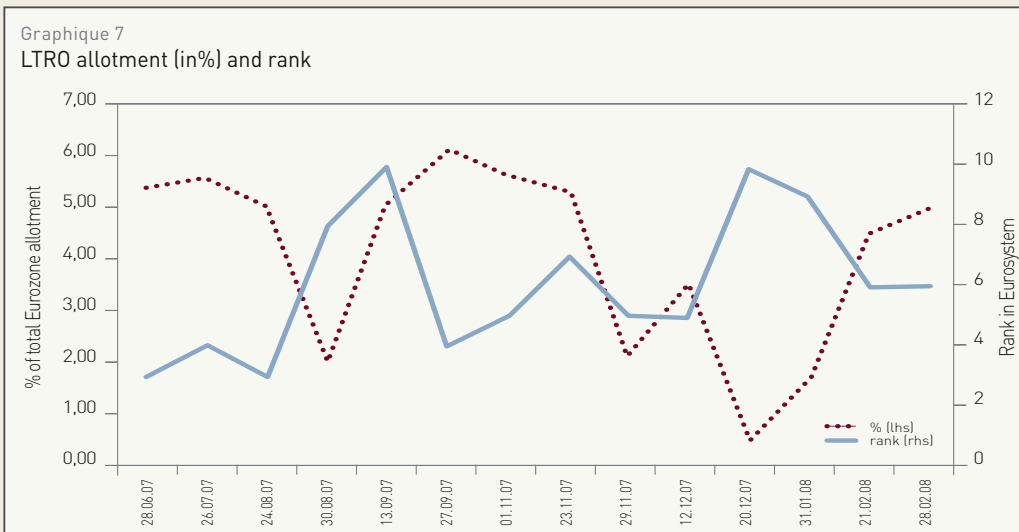
In terms of allotment, the increased volatility in the markets has also been reflected in the allotment results of our counterparties, as these reached from 7 to 15% of the liquidity awarded euro-area wide in the different MROs. The picture looks however more stable if the above mentioned figures are averaged, because here our counterparties were able to secure on average 10.56% of the Eurosystem liquidity prior to August and still 9.68% during the turmoil months.

Graphique 6
MRO allotment (in %) and rank



3 For the last LTRO of 2007 bids were quite low at 245 million, because of ample liquidity conditions. Without taking into account this last LTRO, the average bid amount in LTRO increased even to 4.8 billion (instead of 4.3 billion).

Graphique 7
LTRO allotment (in%) and rank



When comparing the pre-August phase with the market turmoil, for LTRO operations the average allotted volume declined from 3 to 2,1 billions even though the average bid volume had risen as explained above. This also entailed a decline in the average allotment rate from 5,97% to 3,94%.

RECOURSE TO THE STANDING FACILITIES

In order to accompany its monetary policy operations, to support its minimum reserves system, and to contribute to the orderly conditions in the money markets, the Eurosystem provides its counterparties with an access to the so-called standing facilities, i.e. the marginal lending facility and the deposit facility.

Especially the use of the marginal lending facility, through which counterparties can obtain collateralized loans at a 1% margin above the official rate, receives increased attention in times of stress. Indeed one could conclude that institutions that make a large recourse to this facility are in a difficult financial situation as they cannot secure the required funds via the money markets. In most cases however such recourse has purely technical reasons, like for example the failure of a settlement or the non-receipt of a large payment. One can therefore not automatically deduct any financial stability issues from the recourse to this facility.

At the same time discussions with our counterparties have also shown that the market still attaches a stigma to the use of the marginal lending facility. A counterparty which is known to have recourse to this facility is automatically penalized by the market and sees its refinancing costs rising. The ECB, which is only explicitly notified by NCBs for recourses above a certain threshold, therefore has to treat such information in the most confidential manner.

At BCL, none of these amounts raised any concerns, as most were pre-announced and also well explained by the respective counterparties.

COLLATERAL ISSUES

The Eurosystem requires collateral to cover all its lending operations. The Eurosystem accepts a very broad range of assets in contrast to the policy of many other central banks. Credit claims, asset-backed securities and uncovered bank bonds are asset types which are hardly even accepted as collateral in interbank repo markets, especially not during the financial market turmoil. Some international commercial banks indicated furthermore that it would be helpful if the larger central banks agreed to a broader use of cross border collateral arrangements. In a period of stress, counterparties quite naturally tend to hold more collateral (over-collateralization) with their central bank in order to be sure to have access to the liquidity they need, be this through refinancing operations, intraday credit, or the marginal lending facility. It is interesting to see that through the summer months, the average aggregate amount of liquidity provided by BCL to its counterparties has not risen compared to the end of July, and thus the collateral needed to collateralize monetary policy operations would not have had to be increased for this purpose. The graph below demonstrates clearly the change of behaviour on the money markets: The amounts allotted on a 3-months term increased whereas the total amounts of liquidities allotted declined.

Still, the amount of collateral deposited by our counterparties has risen substantially since July, i.e. from 60 to 73 billion (+20%).

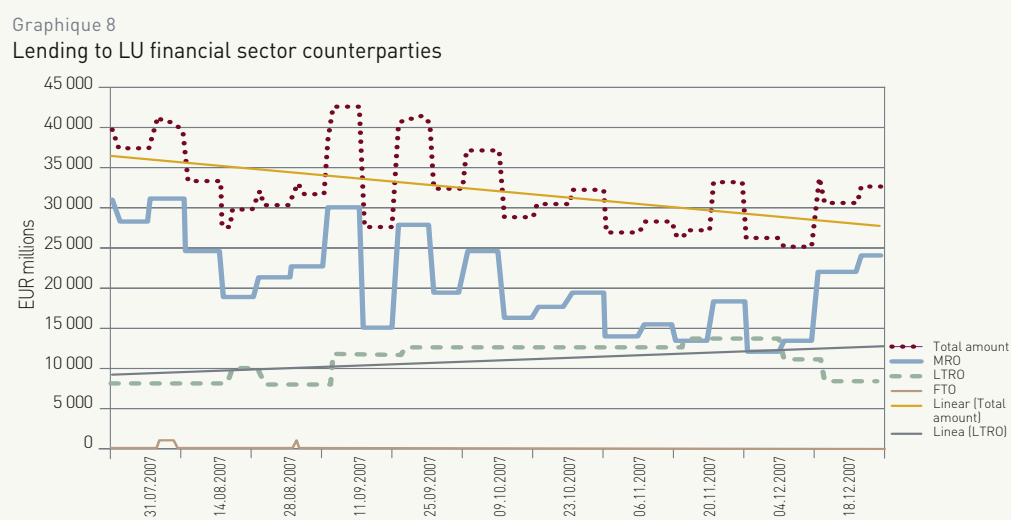


Tableau 5

Collateral deposited by LU counterparties in EUR millions

Issuers	JUL.	AUG.	SEP.	OCT.	NOV.	DEC.	CHG	CHG in %
Agency - credit institution	162,80	232,86	231,88	164,17	164,14	248,16	85,36	52%
Supranational	268,21	272,05	273,97	274,90	240,06	160,71	-107,50	-40%
Jumbo mortgage bonds	2 242,54	1 655,17	1 855,66	1 663,25	1 750,58	1 361,92	-880,62	-39%
Mortgage Bonds	3 360,54	3 692,94	3 322,36	3 306,02	3 390,68	3 549,23	188,69	6%
Local Government	2 467,53	3 241,63	3 656,88	3 770,33	3 663,02	3 538,33	1 070,80	43%
Central Government	3 725,32	5 387,16	3 903,96	3 379,48	3 228,45	3 340,99	-384,33	-10%
ABS	6 931,70	9 281,12	9 453,16	9 490,84	8 981,96	10 504,01	3 572,31	52%
Corporate	7 881,13	9 582,96	9 566,41	9 881,06	10 017,88	10 368,04	2 486,91	32%
Credit institutions	33 190,84	38 470,16	38 997,48	38 294,21	38 304,18	39 215,98	6 025,14	18%
Total	60 230,61	71 816,05	71 261,76	70 224,27	69 740,95	72 287,36	12 056,75	20%

Several issues can be highlighted when analyzing these figures in more detail:

Assets issued by credit institutions have registered the strongest increase in nominal terms. This was to be expected as this asset class is already by far the largest.

Asset-backed securities have seen the biggest increase in nominal terms as these assets could no longer be refinanced in the market.

Central government bonds increased significantly in August as banks needed to shift their collateral quickly towards the central bank. However the high opportunity cost of these assets led banks to withdraw them quickly.

Jumbo mortgage bonds have seen a steady decrease through the summer as this very liquid asset class, just like government bonds, also bears high opportunity costs.

FURTHER CONSIDERATIONS

Although risks taken by/or individual/financial institution should be assumed by the institution itself, it is not excluded that for reasons of financial stability, central banks may act as lender-of-last resort towards an illiquid, but solvent entity. In order to be in a position to take timely and adequate decisions in this context, it is of utmost importance for a central bank to have at its disposal quantitative and qualitative supervisory information regarding individual financial institutions, this in normal time, i.e. on an ongoing basis, and in times of problems. Hence the need for a central bank to be involved in banking

supervision, be it directly or through formalized cooperation arrangements with the supervisory authority. Luxembourg represents an exception in this context on the Eurosystem level.

CONCLUSION

On an aggregated level, and compared to 2006 levels, the participation in the Eurosystem refinancing operations by Luxembourg banks has been slightly regressing since the beginning of the market turmoil. This trend continued throughout Q3. On a more individual level BCL has observed that several traditionally large counterparties which are known as liquidity providers in the money markets, have significantly reduced or abandoned their bidding in the Eurosystem operations. Other counterparties have increased or started their bidding activity after the beginning of the turmoil, albeit on a smaller scale. Throughout the turmoil counterparties in Luxembourg as well as the Eurosystem as whole were interested in secure refinancing for longer periods, which was reflected in a relative shift towards LTRO activity. At the end of 2007, there was still no certainty that this episode of turbulent markets was finished and bidding strategies from counterparties adapt to changing market conditions during the turmoil.

There were no indications of developments towards a shortage of eligible collateral. One might argue that from a financial stability perspective the acceptance of a broad range of assets including some less liquid collateral to a large range of counterparties has avoided some further instability in capital and money markets.

Stability in financial institutions and financial markets are closely interrelated. Banks and other financial institutions need funding to perform their intermediation functions and liquid markets through which they can conduct their risk management operations. BCL has continued to provide the central bank liquidity requested by the financial institutions in Luxembourg during this emergence of liquidity tensions, thereby reducing also not resolving tensions in the money markets.

The role of central banks and their crises' management tools in case of liquidity squeeze are currently widely discussed in numerous European and international fora. BCL actively participates in the work of various task forces and working groups within the European Central Bank and the Banking Supervision Committee, investigating liquidity issues.

2 FOREIGN EXCHANGE MARKETS

The major phenomenon last year was certainly the renewed weakness of the USD on the one hand and the unwinding of carry trades on the other. After having lost 10% in 2006, the USD had another difficult year in 2007, losing more than 10% in value against the Euro. This should not necessarily be read as Euro strength, but more as continued USD weakness. Indeed, the USD lost between 10-15% against all major currencies, namely as said the Euro but also the Swiss Franc or the commodity related currencies as the CAD, the NZD or the AUD. The only other major currency that did not appreciate on a 12-month basis against the USD has been the GBP, which had given back all its intra-year gains. The rate of appreciation of the Euro was particularly fast in the second half of the year, with the Euro reaching a new historical high by early November.

The Yen lost approximately 4 % against the Euro, but much more symptomatic than the simple price depreciation was the speed of declines and rebounds and the erratic movements that one could observe. These were mainly driven by the liquidation of outstanding carry trade positions funded in Yen. Significantly higher volatility in a number of asset classes decreased the return per unit of risk of such investments and at the same time increased the likelihood of sudden and adverse exchange rate movements. Risk reversals provide indications of perceptions of the balance of risks in future short-term movements in exchange rates. According to this metrics, further upside for the Euro against the USD appeared rather limited, even if large swings in the risk measure suggested that significant uncertainty remained. More fundamentally, the appreciable short term interest rate spread narrowing made Euro denominated investments, as deposits

or ECP's more interesting to foreign currency rich investors from Asia or the Middle-East. In fact, over the course of the year, the Fed cut its rates from 5,25% in January to 4,25% while at the same time the ECB went with their main refinancing rate from 3,50% to 4,00%. This has probably been one of the reasons that pushed Central Banks from China to other major emerging countries to announce that larger parts of their huge foreign reserves might be converted into Euros. Even, if this kind of sword rattling might more be seen from a geopolitical point of view, as a message to the US administration, to stand more to their publicly expressed opinion of support to a "strong \$ policy", it certainly gave no incitement to investors to invest in the USD.

As to other peripheral currencies, there were only minor tensions in pegged exchange rates unlike the floating emerging and high-yielding currencies. In particular carry trades in the Brazilian real or the Turkish lira were unwounded to some degree. But weakness hit also currencies that had been favorites of private investors. Indeed, the ZAR lost 10% against the Euro and while the Iceland Krona was flat YoY, it had been up 15% by mid-year only to give up its gains as tensions rose and the crisis broke out. Derivative measures of uncertainty suggest that the risk of sharp movements in exchange rates has risen, thus increasing the risk of greater fragility of players in the market, even if in the short-term gradual reduction of global imbalances may be supportive.

LES STRATÉGIES DE PORTAGE AU LUXEMBOURG

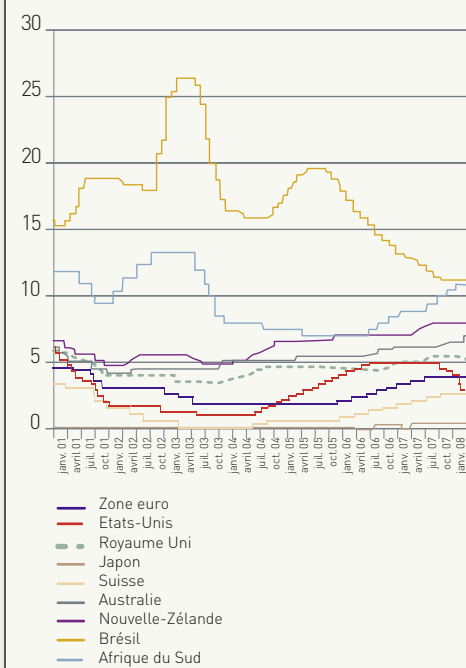
Dans le contexte des marchés des changes, les stratégies de portage (« carry trades ») consistent à tirer parti de l'écart de rendement entre actifs libellés en devises de financement et devises de placement. Les emprunts se font dans une devise à faible rendement pour être investis ensuite, souvent à effet de levier, dans des actifs libellés en devises dont le rendement est plus élevé. Cette stratégie n'est donc profitable que si les gains résultant de l'écart de rendement sont plus importants que les pertes (le cas échéant) liées à l'évolution des taux de change.

Ces investissements peuvent toutefois être inversés rapidement et les stratégies de portage peuvent donc être porteuses de risque pour la stabilité financière. La question se pose alors si le secteur financier au Luxembourg est exposé à ce genre de risque ou non, étant donné que les stratégies de portage sont devenues de plus en plus attrayantes ces dernières années. En l'absence de données sur les stratégies de portage en tant que telles, il n'est cependant pas possible d'analyser à quel degré le secteur financier est exposé aux risques liées à ces opérations de change. Cet encadré exploite néanmoins une des sources disponibles qui fournissent une indication sur l'utilisation des stratégies de portage au Luxembourg.

Quelles sont tout d'abord les devises utilisées dans le cadre des stratégies de portage ? Comme mentionné ci-dessus, il convient de distinguer entre devises de financement (c'est-à-dire les devises à faible rendement) et devises de placement (c'est-à-dire les devises à rendement élevé). Les rendements des actifs varient en fonction des taux directeurs sous-jacents, qui à leur tour sont fixés par les banques centrales respectives à des fins de politique monétaire. Ainsi, pour identifier les devises de financement d'un côté et les devises de placement de l'autre, il est opportun de comparer les taux directeurs pratiqués par les banques centrales à travers le monde.

On constate tout d'abord que depuis 2001, les taux directeurs n'ont pas évolué de façon uniforme ; par conséquent, une devise peut devenir plus ou moins attrayante en tant que devise financement ou de placement selon l'évolution

Graphique 9
Taux directeurs pratiqués par diverses banques centrales



Sources: Bloomberg

des taux de base et des rendements qui y sont liés. Ceci fut le cas, notamment, pour le dollar américain : entre mi-2003 et mi-2004, le taux objectif des fonds fédéraux s'établissait à 1,0% et la devise américaine fut donc très attrayante en tant que devise de financement. Néanmoins, vers la mi-2006 le taux objectif des fonds fédéraux s'inscrivait à 5,25% suite à une succession de hausses des taux par le Comité fédéral d'open market.

Deuxièmement, on constate que le différentiel des taux directeurs est très avantageux pour certaines paires de devises. Par exemple, fin 2007 le taux de base de l'Afrique du Sud s'établissait à 11,0%, alors que le taux de référence du yen japonais continue à s'inscrire à des niveaux très bas. Pourtant, certains investisseurs préfèrent utiliser des devises ou paires de devises moins volatiles en dépit d'un différentiel de taux moins avantageux. En effet, une évolution peu propice des cours de change peut rapidement réduire, voire même inverser, les gains qui découlent d'un différentiel de rendement positif.

A titre d'exemple, les devises généralement associées aux financements des stratégies de portage sont le yen japonais et le franc suisse ; il s'agit de devises qui depuis des années peuvent être empruntées à des taux très favorables en raison de leurs taux directeurs sous-jacents peu élevés. Les devises de placement qui sont fréquemment associées aux stratégies de portages sont le dollar australien, le dollar néo-zélandais, la livre sterling (dans une moindre mesure), la couronne islandaise, le rand sud-africain, le peso philippin, la livre turque, le réal brésilien, la roupie indienne et la roupie indonésienne, pour n'en citer qu'une partie.

En l'absence de données sur les stratégies de portage en tant que telles, quelles sont alors les sources de données qui se prêtent à une analyse cohérente, bien qu'interprétative ? Une

des sources utilisées à ces fins est l'enquête triennale sur les marchés des changes et dérivés, coordonnée au niveau international par la Banque des règlements internationaux (BRI). Sur base des volumes de change, cette enquête permet de calculer l'utilisation moyenne journalière de certaines devises, ainsi que leur part dans le volume de change total ; cependant, la période d'évaluation se limite à la période de recensement, dont la plus récente est le mois d'avril 2007. Les résultats obtenus peuvent alors être comparés à ceux des enquêtes précédentes. Dans la mesure où les données de l'enquête ne sont disponibles que pour un seul mois tous les trois ans, les résultats sont toutefois à interpréter avec précaution. Une augmentation de la part des devises de placement (investis à effet de levier) permettrait de confirmer l'utilisation des stratégies de portage au Luxembourg. Un des avantages de l'enquête est qu'elle couvre les opérations de change liées à des instruments qui ne figurent pas dans les bilans des banques, tels les swaps cambistes qui sont souvent utilisés dans le cadre des stratégies de portage.


En effet, comme le démontre le tableau ci-dessous, la part relative de certaines devises de placement a augmenté au fil des dernières années.

Tableau 6
Volume des opérations de change, ventilation par devise (pourcentages)⁴

	2001	2004	2007
Dollar américain	87,0	83,2	84,2
Euro	60,7	54,8	70,3
Yen japonais	14,1	15,0	9,5
Livre sterling	10,9	13,6	12,5
Franc suisse	11,1	9,6	8,0
Dollar canadien	2,4	2,7	1,2
Dollar australien	0,4	0,9	3,7
Réal brésilien	0,0	0,0	0,1
Yuan chinois	0,0	0,0	0,0
Couronne tchèque	0,1	0,1	0,3
Couronne danoise	0,8	4,2	1,8
Dollar de Hong Kong	0,5	0,2	1,0
Forint hongrois	0,0	1,2	0,3
Roupie indonésienne	0,0	0,0	0,0
Roupie indienne	0,0	0,0	0,0
Won de la Corée du Sud	0,0	0,1	0,0
Peso mexicain	0,0	0,0	0,1
Couronne norvégienne	1,8	2,4	1,6
Dollar néo-zélandais	0,1	0,4	0,6
Peso philippin	0,0	0,0	0,0
Zloty polonais	0,1	1,0	0,6
Rouble russe	0,0	0,0	0,0
Couronne suédoise	1,1	2,1	2,0
Dollar de Singapour	0,1	0,1	0,2
Baht thaïlandais	0,0	0,0	0,0
Livre turque	0,4	0,0	0,6
Dollar taïwanais	0,0	0,0	0,5
Rand sud-africain	0,2	0,2	0,3

Source: BCL

4 Total des instruments « change au comptant », « terme à sec » et « swaps cambistes ». Dans la mesure où chaque transaction implique deux devises, la somme des parts de chaque devise dans les échanges vaut 200%. Cependant, pour les années 2004 et 2001, la décomposition des devises est incomplète ; par conséquent, les parts des devises autres qu'EUR et USD sont sous-représentées et la somme des parts est donc inférieure à 200%.



On constate que la part du dollar australien a incontestablement augmenté entre 2001 et 2007, tout comme la part du dollar néo-zélandais. Il s'agit de deux devises qui sont très populaires en tant que devises de placement ; les résultats luxembourgeois pour ces deux devises sont d'ailleurs en ligne avec les calculs publiés au niveau international. Pour les autres devises de placement, les résultats sont moins évidents, souvent parce que pour la majorité de ces devises leur part dans le volume de change total est très faible. Par exemple, la part du rand sud-africain n'a augmenté que marginalement entre 2001 et 2007, passant de 0,2% à 0,3%, alors que celle du réal brésilien est passée de 0,0% à 0,1%.

Les calculs présentés dans le tableau illustrent aussi que cet indicateur est insuffisant pour conclure qu'une augmentation de la part d'une devise dans le volume de change total confirme avec certitude l'utilisation de stratégies de portage. La part de la couronne tchèque, par exemple, est passée de 0,1% en avril 2004 à 0,3% en avril 2007. Pourtant, entre avril 2004 et avril 2007, le taux de base en Tchéquie a varié entre 1,75% de 2,5% et la couronne tchèque a en fait été utilisée en tant que devise de financement par divers investisseurs.

L'analyse permet donc de conclure que certaines indications vont dans le sens de confirmer l'utilisation des stratégies de portage au Luxembourg, au moins pour ce qui est du dollar australien et du dollar néo-zélandais qui sont fréquemment utilisées en tant que devises de placement à travers le monde.

3 BOND MARKETS

Unlike what happened in money markets, liquidity remained relatively high in the government bond market, even if tensions arose. Peripheral and South European government bonds saw their spreads widen significantly. Liquidity completely disappeared in structured products and other segments of the credit market. Yields in the US were flat in the first half of the year only to rapidly fall in the second.

The theme of the year however, was the steepness of the curve. The 2-10 spread was negative, in other words the yield curve was negative in early 2007 and turned around a few months before the Fed changed the tone of their speech from "Inflation Risk" towards "Risk to Growth" on September 18th and simultaneously cut the rates for the first time to 4,75%. That same spread closed the year at 100bps. The positive slope of the yield curve, achieved by the continuous rate cuts by the Fed and the markets' expectations that there would be further cuts in 2008, certainly is a sine qua non condition to support the banks' basic business.

In Europe, the 2-10 spread had a very similar behavior than in the US, even if the speed and magnitude of steepening were less impressive. Other than this common point, government bond markets in Europe and in the US logged in totally different performances. During the US sub-prime related market turmoil, bond yields declined as investors sought a safe haven for their funds. This pushed yields generally much lower, in what is generally called a "bull steepener" in which the short maturities, stimulated by the Fed's action outperformed the longer ones. This meant in other words, that an investment in US Treasuries returned between 6 and 10% in 2007. This decrease in long-term yields occurred from levels that were already lower than could have been expected, given the macroeconomic growth and inflation outlook over the same horizon, possibly resulting from structurally strong demand for US Treasuries from non-residents, especially from Japan, China or the OPEC countries.

In Europe, on the other hand, we assisted to a "bear steepener" where short yields rose less than yields on longer maturities. An investor in European government bonds had rather dismal returns in the low single digits on short- and mid-term maturities, while the longer ones were flat at best. The hawkish perception of the ECB tone coupled to Frankfurt's decisive will to fight inflation which markets participants translated into higher rates expectations, might have postponed investments into European bonds in general, even if the government

sector in particular profited from its safe haven status. Looking ahead, the risk of an upturn in government bond yields remains as they have profited from a flight to quality from risk adverse investors. Foreign investors on the other hand, could become net sellers of US bonds in an environment of carry trades unwinding.

4 CREDIT MARKETS

Credit risk reappraisal has been the major theme in 2007. The widening of credit spreads came after an extended period of credit spreads tightening which meant that at its low, at the end of 2006, credit risk had been severely under-priced. The move did not really come as a surprise, as markets largely expected spreads to tend towards historical means, but the speed and magnitude of the correcting move took a lot of investors on the wrong foot. The sharp increase in risk aversion during the crisis had an impact across the rating class spectrum of credit. While the investment grade universe saw its spreads widen uniformly, the widening itself followed a much more erratic path. Indeed, financial issuer spreads widened extremely. Within this sector, a few issuers, based on the announced losses in an environment where liquidity was scarce, saw their spreads price in the probability of default. The corporate sector fared much better in the market turmoil, in line with fundamental data and actual economic situation, but a difficult year 2008 might ring the bell for corporate spread widening.

The crisis affected also the main US CDS indices as well as the CDX investment-grade and high-volatility indices. While default rates, through all investment classes hit all-time lows at the end of 2006, the crisis painfully reminded investors that risks were biased to the upside.

A direct consequence was the reductions of new issues, especially in the financial and low grade sector. Investors either showed no interest or asked for huge premiums, which most issuers did not want to pay. Finally, the fear of massive losses in the banking, brokerage and hedge fund industry, stemming from the original securitization of those poor-quality housing loans and from the collateralized debt obligations backed by these securitization spread to Europe, where most major financial institutions had to announce multi-billion write-downs or losses.

Very similar to what happened in the US; corporate credit significantly outperformed financial credit in Europe. Factors explaining this included continued low default rates, solid profit growth of non-financial corporations and virtually no exposure to the sub-prime market, neither directly nor through securitized products. Rating agencies were severely criticized for having given away top ratings to many structured products (ABS, MBS, RMBS, CDO etc.). These AAA ratings had to be adjusted sometimes several notches lower, further unnerving investors. Banks had to take off-balance conduits loaded with structured products back on their books, as they were unable to refinance the expiring maturities. Premiums in the European CDS market also reflected the weakness in credit markets. Prices rose sharply during the global risk re-pricing. The swings in these "option" premiums were more pronounced than in cash market, as liquidity remained at decent levels, creating distorted situations between the cash underlying and the CDS, thus favoring arbitrage trades.

Looking ahead, further credit widening has to be expected as the full impact on banks' results is made public and the slowing economic growth is finding its way to the consumer as the crisis is expanding to others sectors. Corporate results might stall and credit spreads in the sector widen. For the credit derivatives markets, uncertainty about the concentration and distribution of risks can be expected to remain, as well as about the length of the actual crisis.



5 EQUITY MARKETS

Amidst the most surprising facts of 2007 was the resilience of US and European equity markets to the continuous bad news flow coming out of the US-subprime market and to the abyssal losses announced by major financial institutions on both sides of the Atlantic. All major equity indices closed the year 2007 with positive returns. Mid-to high single digit returns for the S&P and the Dow Jones, a near 20% gain for the NASDAQ. The latter was a sign that the crisis had not yet fully spread to corporate America and that high capital expenditure coupled to innovative products kept the top weighted technology companies in the NASDAQ afloat. Not surprisingly financial stocks were among the losers, the Financial Select Sector SPDR having had a rather dismal performance, with a total negative return of nearly 20%.

Volatility indices, as measured by options, rose dramatically signaling great nervousness with investors. The resilience of stock prices to the market turmoil owes much to non-financial companies' reported earnings growth remaining high, to earnings being revised to the upside until well into the 3rd quarter, and to a high degree of positive earnings surprises in the first half of the year. Further support came from the news that companies and insiders were actively buying back their own shares, often a sign that people who should know best believe their company's share price is undervalued. An important counteracting factor was the abrupt halt of mergers and acquisitions and LBO activity.

For 2008 EPS growth for the S&P500 is estimated to be in the 3-5% area but this compares to a rather cheap stock market valuation. In fact, the Price-Earnings Ratio (P/E) based on projected earnings for 2008 stands around 15 times and is below the recent historical average.

Pushed by decent economic growth, the major beneficiaries of 2007 however have been selective emerging countries. Indeed, India, Brazil or Hong-Kong, as a benchmark for China, closed the year showing strong performances with returns at or above 40%.

In Europe, stock prices were subject to large price movements, before closing the year with an impressive 10% return, at least as far as the bellwether index EuroStoxx50 was concerned. Very surprisingly nonetheless were the marked differences within the single European indices, as the DAX was up more than 22% when at the same time the CAC40 only managed to be slightly positive. Similar to what investors experienced in the US, financial stocks have been a drag on the indices, being down as much as 20% for the year. Individual stocks in the banking sector, mainly those being particularly hard hit by the credit crisis, showed even worse returns. Looking at stock market valuation, a mixed picture emerged. The EuroStoxx50 price-earnings ratio based on twelve months forward earnings was at a reasonable level around 13. At the same time, however, the P/E on trailing earnings showed a rather large discrepancy in valuation between financial and non-financial stocks. While the first were trading on average at 9 times earnings, which historically was at the low end of the range, the latter were trading at lofty 19 times trailing earnings. The price/cash flow ratio also remained close to the highest levels since 1990, suggesting some downside risks to European stocks. This view was also shared by most financial analysts, who in their large majority remained negative as far as the 6-12 months outlook was concerned. It might however be wise to adopt a slightly less negative positioning in equity exposure and to apply to a certain degree a more contrarian view. Adding to this position, stock market sentiment indicators are all in negative territory.

Hence, near term uncertainties about the future path of economic growth or the final impact of the subprime crisis and the associated high borrowing costs on the consumer is certainly a harbinger for equity investors' sentiment stay negative. Periods of large price swings and important volatility probably lie ahead, but in a context of longer term growth potential, inexpensive valuations might attract fresh money in the second half of the year.

6 COMMODITY MARKETS

In Commodities, we had another year of significant moves. The price for oil, for instance, rose significantly throughout the year and closed 2007 up 60%. This was equally true for Crude and Brent. Tight underlying market fundamentals, geopolitical tensions and the scarcity of new oil fields helped to fuel the rally. Global oil markets remained tight with demand still exceeding output. Continued concerns over the supply availability in a context of declining oil inventories and lower OPEC output were other factors helping the oil hit nearly 100\$ a barrel at year-end. Looking ahead, the above mentioned factors should keep oil prices at high levels consistent with prevailing risks. Futures markets indicate that expectations tend to point to a slight fall in oil prices. These levels remain however high when compared to historical averages.

Natural Gas prices had a very similar path of increase, the only difference being the magnitude. Indeed, gas prices rose on average by more than 20% in 2007. Huge price increases were noticed in the European electricity markets. Depending on geographic samples, price releases showed a near 100% rise.

The prices of non-energy commodities continued their upward trend as well, despite some corrections in recent months. Precious metals reached new highs as demand continued to push prices higher. Gold reached an all time high just below 850\$ and trends point even higher. Looking ahead the psychological level of 1000\$ per ounce might well be tested. Other metals showed a more mixed picture. Platinum was the only other metal that rose steadily throughout the year. Copper, Aluminum or even Silver had a strong start into the year, but corrected most of the gains in the latter part of 2007.