1. FINANCIAL MARKET DEVELOPMENTS IN 2005

1 FINANCIAL MARKET DEVELOPMENTS IN 2005 10

1 Financial market developments in 2005

1.1 Money Markets

In December 2005 the ECB raised the minimum bid rate by 0.25% to 2.25%, ending a period of no change in the level of monetary policy rates interest rates since June 2003. An improving economic outlook and upward revisions in forecasted inflation rates supported this move. From the standpoint of financial stability the general conditions in money markets remained favourable. Market participants had no difficulties to access short term funding, spreads between EONIA swap rates and cash markets remained tight, a sign that liquidity conditions remain favourable. Repo markets by now are the largest money market segment, implying a reduction in counterparty risks. Spreads between repo rates and unsecured interbank money market rates have also remained very low across all short-term maturities.

The Fed has continued its mission to return money market interest rates to neutral against a background of continued economic growth. The Federal Open Market Committee (FOMC) increased interest rates gradually by 25 basis points at each of its meetings and by the end of 2005 the target rate has been raised 13 times in total to a level of 4.25%. Some degree of concern on counterparty credit risk as expressed by the Ted spread was evidenced at the time of the downgrades of GM and Ford, but these fears quickly evaporated suggesting a robust financial position of the main counterparties in the US money markets. But heightened sensitivity to interest expense in a highly levered finance-based economy like the USA seems to be a logical consequence of the Fed action.

The Bank of Japan left monetary policy unchanged in 2005. Despite a clear turnaround in macroeconomic data, Japan remained most vulnerable to the adverse impact of higher interest rates or slower growth. Government debt/GDP is running in excess of 150%, and the deficit remains above 6 % of GDP. This is not a backdrop for an aggressive tightening by the BOJ and therefore the removal of the zero interest rate policy and quantitative easing is expected to take longer. Policy makers are expected to move cautiously, which should be good news for global market stability. The ‘carry trade’ has funded a lot of speculative positions over the Japanese market and therefore any change is bound to have some liquidity impact.

1.2 Foreign Exchange Markets

As policymakers have globally embarked on a gradual removal of monetary policy stimulus, markets try to decipher which implications lower global liquidity could have on the economy and on investor attitudes towards asset classes. Higher interest rates are bound to lead to a reduction in excess liquidity and could equally lead towards an increasingly discerning attitude towards the relative merits of currencies in both major and emerging markets, with a positive interest rate differential no longer being a guarantee of out-performance. High levels of global liquidity have fuelled risk appetite and chase for yield keeping the ‘carry trade’ in favour. Several currencies continued to benefit in 2005 from the ‘carry trades’, the investor base for emerging markets continued to broaden. Among emerging market currencies, the Brazilian Real outperformed, supported by strong inflows and improving economic fundamentals. Carry trades are now at risk of being squeezed from both sides, the rates of return in high yielding currencies declining and the increasing funding costs. A general decline in yield appetite could make foreign exchange investors more selective towards market fundamentals and lead to an exit from some high yielders.

In 2005 the US current account deficit reached a record high of over $ 700 bn, or 6.5% of US GDP, but opposite to 2004 and the expectations of market participants the value of the dollar did not slump in 2005, nor has the USA slipped into recession. The further widening of the current account deficit, which in the previous years got centre stage was dropped from the analysis. The interest rate and growth differential were cited as the most important factors to explain the strength in the USD against major international currencies and the role of hedge funds in this equation was not ignored. Since the Fed began to raise rates, the dollar strengthened. As seen partially in the composition of US Treasury TICS data, lower capital inflows from Asian central banks have easily been compensated by inflows from other private investors. Oil exporting countries recycled more petrodollars due to the windfalls from substantially higher oil prices, providing support and stability to the USD. OPEC oil revenues totalled $ 430 bn, up 27 % from 2004 and the BIS reported a sharp rise of dollar deposits as a result of the rise in US interest rates. The repatriation of corporate profits from US companies, which has accelerated as a result of the Homeland Investment Act, was given as an additional explanation.

As a function of a strengthening USD, the Japanese Yen and the EUR weakened despite improving economic fundamentals. The JPY continued to weaken and was down by 15.7% on a real effective basis over the past year and down 13.9% against the dollar, a startling decline for the currency of a country that has a persistent current account surplus (estimated at USD 146 bn). This deprecation occurred in the face of generally good economic data, a strong equity market (+36% in YEN terms) and earlier positive developments on the political front. High oil prices, a declining trade surplus, capital outflows from Japan provided some justification for the decline. However the currency's low yield remains the largest culprit as this encouraged non-resident fixed-income investments carry trades. With interest rates at zero the JPY continued to be used to finance many speculative investments. As a result of the strengthening economic outlook and also due to growing inflation risks, the ECB matched the hawkish rhetoric of the Fed in the second half of the year, helping to limit the damage on the EUR from more aggressive US interest rate expectations. Going forward the dollar will not necessarily decline, especially if US economic growth remains robust. However as the interest rate story becomes less attractive, the current account deficit of the US could return to the forefront of investors' minds.

The long-awaited Chinese FX regime change occurred in July 2005. China revalued by 2.1% and shifted its FX policy management from a dollar-peg to a more flexible managed floating system on a basket of currencies. Ultimately this move did not have a large market impact neither on the USD nor on the US Treasury market. Towards year-end China's foreign reserves continued to rise sharply by a further $ 50 bn to $ 819 bn and China is on course to overtake Japan as the largest holder of reserves. This will maintain pressure on the Chinese authorities to allow faster appreciation of the renminbi in an economy that continued to grow by 9.8% in 2005. But this small step should help some rebalancing between the Chinese and the global economy. For China it adds a market-oriented tool to the inefficient administrative controls now in use to manage the economy. It should also mark a step in reducing the huge accumulation of savings in Asia that have distorted international trade and investment and has its counterpart in the huge US current account deficit, a helpful step in curing some of the global financial imbalances, which can trigger crises if left unchecked.

With the international mobility of capital, positive and negative current account balances are a natural consequence, reflecting the different time preferences of savers and consumers and different international investment opportunities. The dollar has been able to withstand structural pressures from a rise in the current account deficit, allowing interest rates to dominate as the key driver. Many new academic theories have been developed of late to put the issue of the deficit into context. Some have questioned if the statistics used to measure savings, consumption and investment are correct. Others have highlighted the appeal of US investments to explain the flow of capital (Cooper 2005), differing demographic structures and the higher market share and economic importance of the USA. Nevertheless, the simplest statistic to measure – the balance of trade- shows a deterioration in the deficit over the past 10 years and cannot be rationalised away completely. These imbalances remain large and persistent and still represent a risk factor for disruptions in global foreign exchange markets, the global economy and financial stability.

1.3 Bond Markets

The global liquidity and low official rates still served as an anchor for longer term yields. Excess capital and globally high savings continued to sponsor the search for yield. Global yield curves have flattened or even have started to invert like in the US towards the end of the year. Trades to benefit from flattening of the yield curves (two-ten year spread) were most popular and had a dynamic of their own. At the same time the slope of the swap curve further compressed. Carry trades have remained popular. Despite the removal of monetary policy accommodation and strong macroeconomic fundamentals the historical low level of long-term interest rates in bonds continued to prevail, a situation that was not completely expected in a low interest rate environment. Several structural factors to cite a few, continued to keep demand intact for long-term investments in bond markets: The excess supply of savings as a result of the low level of investment; a reduction in the inflation risk premium as a result of central bank predictability and credibility; Asian central banks continuous reserve accumulation; institutional investors (pension funds, insurances) portfolio switches from equities to bonds partially as a result of regulatory and demographic developments.

In the euro area fixed income markets, the long term yields reached a historical low close to 3.0% in September in the aftermath of Hurricane Katrina and concerns that a rise in oil prices could have a negative impact on economic growth. Euro area long-term rates subsequently went back to a level of 3.5%, which has been the level prevailing most of the year. The euro area yield curve also flattened but remained relatively steeper than the US curve, which almost inverted. The focus on growth rather than inflation remained globally a dominant theme and explains a substantial decline in real long-term interest rates in 2005.

The volume of trade in emerging market debt instruments hit it highest level since 1997 before the Russian and Asian crisis, reaching $5.485 tn. But opposite to 1997, where most of the trading was in local market instruments, this time 48% of the trading was in Eurobonds. The low level of long-term rates in itself has increased demand for higher returns in higher risk bonds and other types of investments. The investor base has broadened and strategic long-term investments e.g. from pension funds were observed. Emerging market bond spreads have tightened to record levels on search for yield but also on improving fundamentals like active debt management and debt reduction. All in all, emerging markets have proven remarkably resilient to a variety of shocks. Nevertheless some emerging market countries with weaker fundamentals are vulnerable to an increase in international risk aversion.

More investors focused on employing leverage and alternative investments to enhance performance. As a result, the yield spreads between government bonds and spread products in the credit markets continued to narrow further.

1.4 Credit Markets

The tight credit spread environment, which started in 2002 continued to prevail for the major part of the year. Over the last years the corporate bond markets have benefited from the hunger for yield in an environment of global ample liquidity and low real interest rates. Solid macroeconomic environment and financial innovation have contributed to a low risk premium. Whilst corporate bond spreads reached historical lows in early 2005, spreads widened only shortly in the aftermath of some volatility in Q2 2005 on concerns about GM and Ford. But after a short episode of stress the broad credit indices remained confined to relatively narrow trading ranges, both in cash and CDS markets. Actual volatility and measures of forward-looking volatility, implied from options have remained low for most of the period. However, spread dispersion has been steadily on the rise, idiosyncratic risk has been a predominant market feature. Against a backdrop of heightened event risk, following the GM and Ford downgrades and difficulties in the airline sector, some outperformance of financials, perceived as a 'safe-haven' versus corporates could be observed. But even within corporate bond markets, half of the issues still tightened, highlighting an asymmetry of risks and a need for selective approach. Despite a relatively strong earnings cycle, spreads have widened for issuers whose leverage has increased significantly due to either debt financed M&A or LBOs. The 'valuation stretch' within the market rather than a broad-based re-pricing of credit spreads has been observed.

The corporate balance-sheet repair has been a supporting element over the last years, but there are some indications that this pace has slowed down and that the corporate earnings cycle is turning. A further removal of liquidity and a rise in the real short-term risk-free interest rate could lead to some more pronounced differentiation of spreads, especially in lower quality issuers. Corporate earnings have been well in line with expectations, companies have strong balance sheets and this kept credit spreads in a tight range. It is a crucial question if the quality of corporate debt, which so far has remained high, could deteriorate in 2006 if liquidity is further withdrawn.

Implied default rates remain extremely low. S&P reports one single default only in European corporate debt, the lowest figure since 1998. But looking ahead, global default rates in the corporate sector for non-investment grade issuers should rise from a low 1.9% in 2005, according to Moody's outlook due to a substantial rise of issuance in speculative grade debt which started three years ago. But, those defaults are still expected to remain below the historical average of 5%.

New products and different players have changed the conditions in the corporate bond market. In the past five years, there has been a massive growth in credit derivatives, CDOs and CLOs. The global market of credit default swaps (CDS) has grown nearly five fold in 5 years to an estimate of $6.200 bn (source: Morgan Stanley), which allowed investors to gain significant exposure to credit markets. The smooth behaviour of the corporate bond markets can also be partially explained by the impressive developments of credit derivatives. The credit derivatives markets have certainly helped cash bond markets to become more resilient to adverse market events like those observed in 2005. So despite global debt outstandings of $ 453.1 bn , the downgrades of Ford and GM did not cause major, long lasting ripple effects. But at the same time it became apparent that the changes in credit risk transfers have impacted linkages between CDOs, corporate bonds and credit derivatives markets. In the credit derivatives market some operational challenges were witnessed with the confirmation backlog issue. Furthermore some difficulties to gauge the real extent of counterparty exposure (the assignment issue) caused some concern for financial stability. In the credit derivatives market the pricing dynamics have undergone changes and the potential of liquidity squeezes and price dislocations have not disappeared. The potential for new channels of contagion in the financial system in a crisis situation should not be forgotten.

An increased participation of hedge funds in all segments of credit markets has added liquidity. Net investor inflows into hedge funds have remained strong in the context of search for yield whilst performances have been relatively weaker in the recent past. Several financial market players are increasingly active in innovative instruments that embed leverage and which may prove illiquid in stressed market conditions. Despite an apparently smooth reaction to recent idiosyncratic events, unanticipated large defaults could still cause a general repricing of risk, irrespective of innovative markets and instruments. A general reduction in risk appetite could limit the ability of economic agents to continue stabilising credit conditions.

The amount of available risk capital for proprietary trading desks and hedge funds seems to be a potential source of liquidity provision in stressed market conditions and has been perceived as a stabilising influence in several episodes over the past years. Even though the inflows into hedge funds have slowed as a result of lower performances, hedge funds have grown to more than a $1 tn under management and now account for a third of trading volume and are an important provider of liquidity in many markets. Hedge fund leverage is reported to be still lower than a few years ago, but a long period of low volatility may have led some to increase leverage in the search of return. An amplification of volatility or bigger disturbances cannot be excluded in the future. Caution is justified given the size of structured/leveraged credit risk and given that the underlying models used to construct/hedge these leveraged credit products have yet to be properly tested in a storm.

Regulators need to ensure that efficient risk management and credit standards are observed by financial institutions to avoid spillover effects of eventual large market corrections or disrupted market conditions. Chairman Greenspan, in a speech in May 2005 titled 'Risk transfer and Financial Stability' noted that *'the rapid proliferation of derivate products inevitably means that some will not have been adequately tested by market participants.'*

1.5 Equity Markets

The increase in prices that began in 2003 did continue in 2005 and major equity markets gave decent returns in a still strong economic context and despite some unfavourable fundamentals like rising commodity markets. The FTSE World index (in dollars) has climbed about 10% in 2005 and is within 8 % of its March 2000 high point. Japanese and emerging equity markets have been outperforming other mature markets and they were the asset classes with the highest returns next to oil and gold investments.

A 'Goldilocks scenario' whereby the world seems to be able to generate growth without inflation seems to be anchored in perceptions of market participants. In the late 90s, the driver of this trade-off of better growth/inflation was technology. Nowadays the emergence of China, India and Eastern countries as global players, lowered the costs for the corporate sector in the rest of the world. The valuation of equities (P/E ratios) in the largest markets was lower than in recent years and near their long-term average and provides a basis for further investor interest. As investors' appetite for short term return is back and needs to be satisfied, share buyback programs more than doubled in value and continued to be a supportive element for equity markets. Value sectors continued to outperform growth sectors. Volatilities in stock markets have remained exceptionally low. Sound economic fundamentals and international diversification of equity holdings continued to bolster financial stability.

The merits of globalisation have allowed US corporate profit margins to remain at a 35-year high, mostly via substitution of lower-cost overseas labour and production costs. Over the last ten quarters the profit growth has been in excess of 10%. If this trend will be continued in 2006 that will become the longest ever sustained acceleration in corporate profits. Nevertheless, record levels of share buybacks also have inflated the strength of earnings as companies return much of their excess cash to investors. Profit growth has also been robust in Europe and improved by 6.8% for the Eurozone and 9.5% for corporate Germany (source ABN). The weaker euro helped the region's export sector and contributed to higher output. European equity markets outperformed Wall Street by 15% in local currency terms and the European price/earnings ratios continued to look more attractive for investors.

But there are several other reasons why a correction in stock markets cannot be excluded. With globalisation came disinflation, which limits pricing power, and companies could face more pressure on return at some stage. We might be close to a peak in the profit cycle, which by definition would induce greater equity market volatility. Several long-term strategic investors like pension funds and insurance companies, encouraged by regulators, are switching from equities to bonds or other alternative investments because they consider equities unreliable to match growing long-term liabilities. An inversion of the US yield curve is perceived traditionnally as a precursor of economic weakness. Signs in a change of the economic trend, some exogenous shock, further corporate governance failures or excess complacency, make the equity markets vulnerable after the recovery that started in 2003. Global economic growth has aggregated 20% over the past 5 and half years according to IMF data and on that basis the rise of equity indices is not that spectacular. It also seems a paradox that, although corporate profits are high and share prices have been rising, this was not matched by a rise in business investments.

The rise in interest rates from a low level did not cause a problem for stock markets in 2005. Merger and acquisition activity went hand in hand with a rise in equity markets. European companies have equally become keener to exploit the arbitrage between low cost of capital and the high return on capital. The role of private equity groups has been on the rise as firms attracted huge amount of capital. Underfunded pension schemes were turning to alternative assets such as private equity. In 2005 private equity attracted a record $ 261 bn worldwide, beating its high in 2000. According to Thompson Venture Economics, returns for the year to September rose to 27 % compared to 12% annual returns over the last 10 years. In Europe, the buy-out market passed 100 bn for the first time. The UK industry accounted for 52% of all private equity activity in Europe and private equity has accounted for 30% of M&A from 1999-2005. Issues of good transparency, governance and valuation of portfolios need to be monitored closely to ensure financial stability.

1.6 Commodity markets

In the low yield environment investors have increasingly turned to commodities in search of additional return. Like in the financial sector, the rapid money supply growth has pushed new money in the commodity sector and appears to chase price inflation as it moves from one asset class to another.

A broad range of commodities experienced significant price appreciation and speculative interest. The price in copper has more than doubled in the last two years. Demand for gold as a portfolio investment and alternative investment class has also increased. The price of gold continued to rise in 2005 from the nadir of July 1999 when gold traded at USD 253/oz. The pace of the ascent accelerated sharply towards year-end to a level above USD 550/oz reaching a 25-year high. Structural factors – primarily reduced mining and official sector supply and increased demand of jewellery, especially out of Asia – were often cited as the drivers of gold’s rally in recent years. But the acceleration in the bullion’s price seen in the second half of the year was based on additional factors. Speculative demand has produced a momentum-driven market and accounted for the dramatic price surge towards year-end. In the context of rising foreign exchange reserves and international reserve diversification there have been rumours that emerging market and petroleum exporting countries would be diversifying holdings away from the USD into the gold market. Even though inflationary expectations overall remained contained, the still prevailing accommodative monetary policy seems to have convinced several investors to consider gold in its traditional role of store-of-value as a hedge against inflation. In a scenario of financial stability and fiscal prudence, gold’s monetary role had retreated into the background. In a world of massive deficit spending, inflating currencies and financial imbalances it appears that gold’s monetary role is reasserting itself and the rise in the gold price is seen by some market participants as an early warning of a potential crisis. Gold and precious metals are perceived as one of the only asset classes that should perform well in either an inflationary or deflationary scenario.

The price of crude oil, driven by global demand continued to rise in 2005 even though OPEC continued to raise output considerably. The price of a barrel of West Texas Intermediate (WTI), the principal benchmark crude, rose in August close to a level of $70. Prices thereafter moderated but remain on high levels. One problem is a mismatch between the available grades of crude oil and refining technology. Geopolitical problems and the developments in the Middle East remain a major concern. But the biggest force moving the price may have been speculation, a large amount of net new investment entered the oil futures market this year. As a result, forward prices rose even more than spot prices for the largest part of the year.

1.7 Summary of financial market developments in 2005

The combination of excess global liquidity and extremely low risk aversion has caused historically high valuations in various asset classes. At the current lower growth rates of liquidity, the impact on asset markets has not been severe and has not led to a major repricing of asset classes. Risk aversion remains at extremely low levels. Confidence remains high that policymakers will aim at correcting imbalances in a controlled manner. Developments in the international economies and financial markets continue to give support to financial stability and recent disruptions did not result in serious problems. Solid economic developments have induced strong balance sheets in financial institutions. The structural changes of the international system via integration and diversification have increased the flexibility of the financial market participants. Thereby the ability of the financial system to react to disruptions has improved.

Since the beginning of this decade, central banks and policymakers contributed to an ample global liquidity environment via monetary and fiscal stimulus. With the strengthening of growth and a rise in inflation risks, monetary policy stimulus is moving gradually back to neutral. Despite not explicitly targeting liquidity, the normalisation of monetary accommodation at the Fed and other central banks seems to have induced a decline in the growth rate of global liquidity, with excess liquidity peaking at record levels in the first quarter of 2004. Over the last years investors have searched for alternative sources of return in credit, foreign exchange and commodity markets as the return on traditional asset classes like equities and fixed income have been under pressure. The need to generate alpha with alternative assets was growing. In the last four years uncorrelated markets have recovered together in most international markets helped by an environment of ample liquidity; notably in precious metals, oil, bonds and stocks. Historically, such correlations occur in the late stage of a credit cycle, making markets vulnerable for some kind of correction in a context of lower global liquidity.

Finally, the deterioration of some global imbalances has continued. The imbalances of current accounts, the increase in private household and public sector debt as well as the expensiveness of a large number of asset classes, particularly in the fixed income and real estate markets still make the international financial system vulnerable. Some correction of the global imbalances seems unavoidable, the jury is out if this readjustment will come through gradual or radical changes.