

Frank Packer

+41 61 280 8449

frank.packer@bis.org

Philip D Wooldridge

+41 61 280 8819

philip.wooldridge@bis.org

1. Overview: reassessing the recovery

July and August 2004 saw a divergence in market views about the strength of the global economic recovery. Bond yields and equity prices fell but credit spreads remained little changed. Increases in US policy rates in June and August – the first since 2000 – were well anticipated by market participants but surprisingly weak growth in US employment weighed on bond and equity markets. Higher oil prices added to the negative sentiment. By contrast, investors in corporate debt markets seemed unfazed by economic developments.

In emerging debt markets, investors even turned bullish despite signs of global economic weakness. Most of the widening in emerging market spreads seen in April and May had reversed by August, with the renewal of carry trades reportedly contributing to the rally. Owing to such favourable financing conditions, the pace of borrowing by emerging market debtors showed no signs of moderating in the second quarter and early part of the third, with Asian firms in particular stepping up their international issuance.

Yields fall on growing uncertainty

A muted response
to higher policy
rates ...

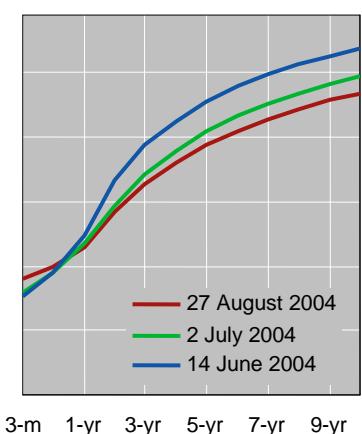
The much anticipated turn in the US policy rate cycle finally occurred on 30 June, when the US Federal Reserve raised its target rate by 25 basis points. At its next meeting six weeks later, the Fed hiked rates by another 25 basis points. Significantly, the response of long-term yields was to fall rather than rise. From their peak in mid-June, yields on 10-year US dollar interest rate swaps moved 65 basis points lower by 27 August. Over the same period, yields on 10-year euro and yen interest rate swaps fell by around 35 and 20 basis points, respectively (Graph 1.1).

The movement of long-term yields contrasted sharply with their response to the first rate hike by the Fed in February 1994, also following a long period of low interest rates (Graph 1.2). In 1994 yields had risen sharply subsequent to the first move in the policy rate. The behaviour of volatilities also differed between 1994 and 2004. In 1994 implied volatilities had risen, while in July and August 2004 volatilities declined.

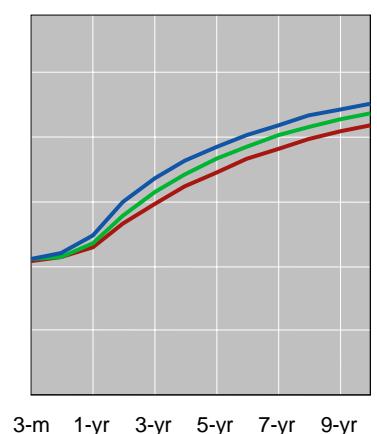
Swap yield curves

In per cent

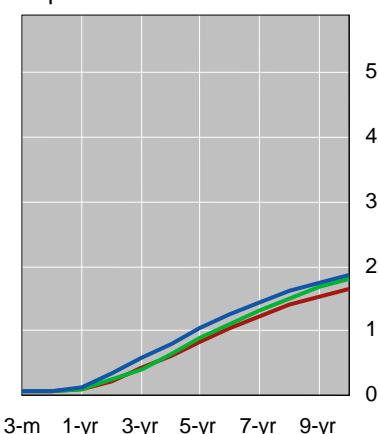
United States



Euro area



Japan



Note: For three-, six- and 12-month US dollar and yen maturities, Libor; for three- and six-month euro maturities, euro deposit rates.

Source: Bloomberg.

Graph 1.1

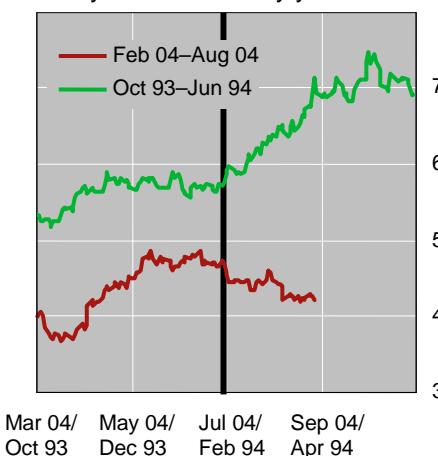
There are at least two reasons for the markedly different behaviour of bond markets in 2004 compared to 1994. One is that the Federal Reserve now communicates more fully and widely about its intentions.¹ As a result, whereas the move in February 1994 had surprised market participants, the most recent moves were already priced into bond markets. Indeed, in June and August

... due to prior Fed communication ...

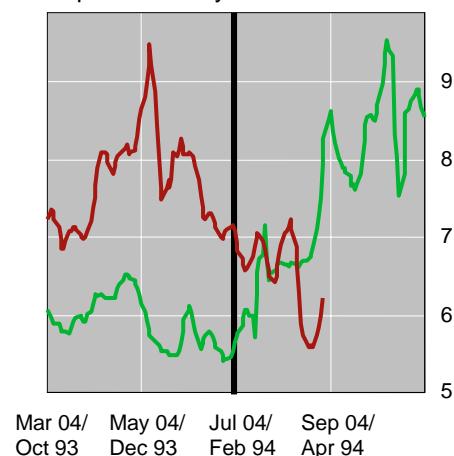
US bond markets in 1994 and 2004¹

In per cent

Ten-year US Treasury yield



Implied volatility²



¹ Vertical lines = 29 June 2004/3 February 1994. ² Five-day moving average; volatility implied by the price of at-the-money call options on 10-year US government bond futures contracts.

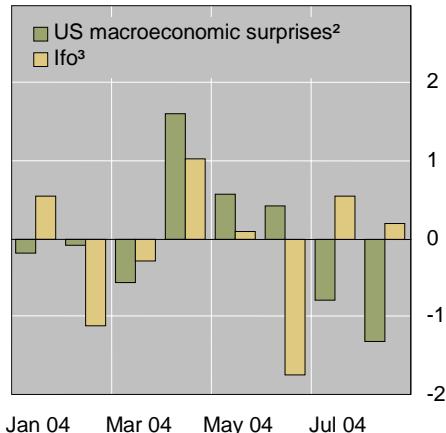
Source: Bloomberg.

Graph 1.2

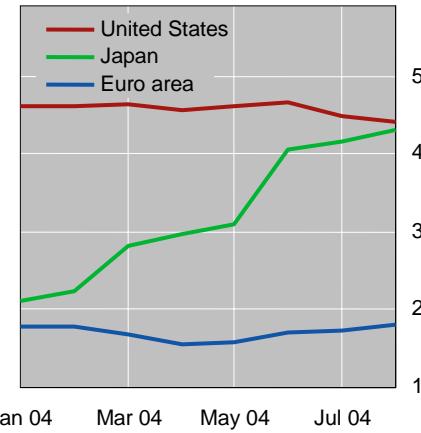
¹ See Bank for International Settlements, *74th Annual Report*, 28 June 2004, pp 73–80.

Macroeconomic data and growth forecasts

Macroeconomic surprises¹



Growth forecasts for 2004⁴



¹ Normalised announcement surprises, based on the difference between actual numbers and consensus forecasts. The observations are positioned in the month in which the actual numbers were released. ² Weighted average of normalised surprises of the ISM survey, non-farm payrolls, retail sales and producer price and consumer price announcements. ³ The German Ifo survey is a business climate index derived by the Institut für Wirtschaftsforschung from survey responses.

⁴ Percentage changes over previous year. Forecasts as published monthly by Consensus Economics. The observations are positioned at the end of the month in which the forecast was made.

Sources: Bloomberg; © Consensus Economics; BIS calculations.

Graph 1.3

movements in long-term rates showed investors responding more to nuances in the statements accompanying the rate decisions than to the policy rate increases themselves. Market participants were reassured by the likely “measured pace” of future rate rises indicated by the Fed starting with its statement of 30 June.

... and a weaker than expected recovery

A second reason is that the economic news released in the weeks following the June rate increase indicated a less robust economy than seemed the case following the 1994 increases. The US employment reports released in early July and August were both far weaker than expected, triggering a sharp fall in bond yields around the world. Yields on 10-year US Treasuries fell by close to 20 basis points following each release. Combined with other weak reports, these caused economists to revise down their growth forecasts for the United States (Graph 1.3).

Bund yields respond more to US than to German data releases

In Europe, data releases came in stronger than many had expected. Nevertheless, long-term yields in the euro market, which had decoupled from dollar yields during the sell-off in April, tracked dollar yields closely in July and August. The fact that the European recovery depended on strong demand from abroad probably contributed to the renewed correlation in euro and dollar yields. For example, many observers interpreted the better than expected Ifo number on 27 July as reflecting improvements in exports rather than domestic demand, and the response of German bund yields to the announcement was muted.

In Japan too, market participants tended to attach greater significance to US news than to domestic developments. Macroeconomic data generally consistent with strong momentum in exports and business investment had

triggered a sharp run-up in long-term yen yields in June. However, yields moved back down in July and August despite further signs of a recovering economy. For example, on 9 August bond markets took little notice of a surprisingly strong machinery orders report and instead focused on the US employment report that had come out earlier.

Equity markets soften on profit warnings

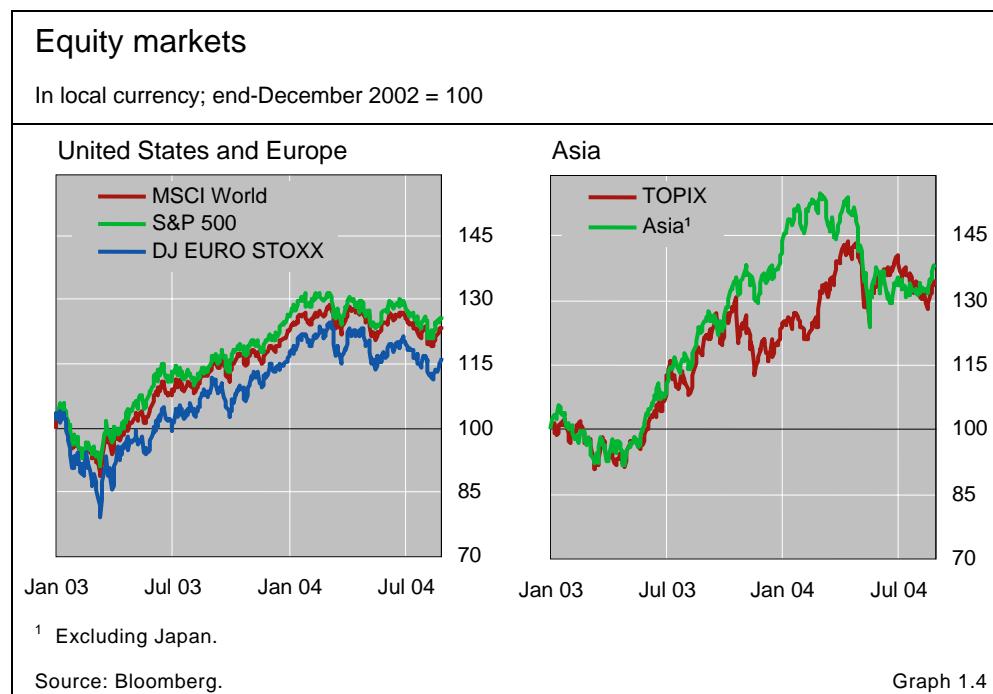
Concerns about the strength of the economic recovery also loomed large in equity markets. Global equity markets had rebounded briefly in May but then in July resumed their downward trend. By 27 August, the S&P 500 was down by 3% compared to end-June 2004 (Graph 1.4). Similarly, the DJ EURO STOXX and TOPIX were 3% and 4% lower, respectively, than at the end of June 2004.

Equity markets tended to shrug off positive reports on second quarter earnings and instead focus on warnings about future profits. Nearly 70% of firms in the S&P 500 Index beat analysts' profit forecasts for the second quarter of 2004, up from approximately 65% for the same period a year earlier. However, firms' announcements about future earnings and revenue growth took a turn for the worse starting in June (Graph 1.5).

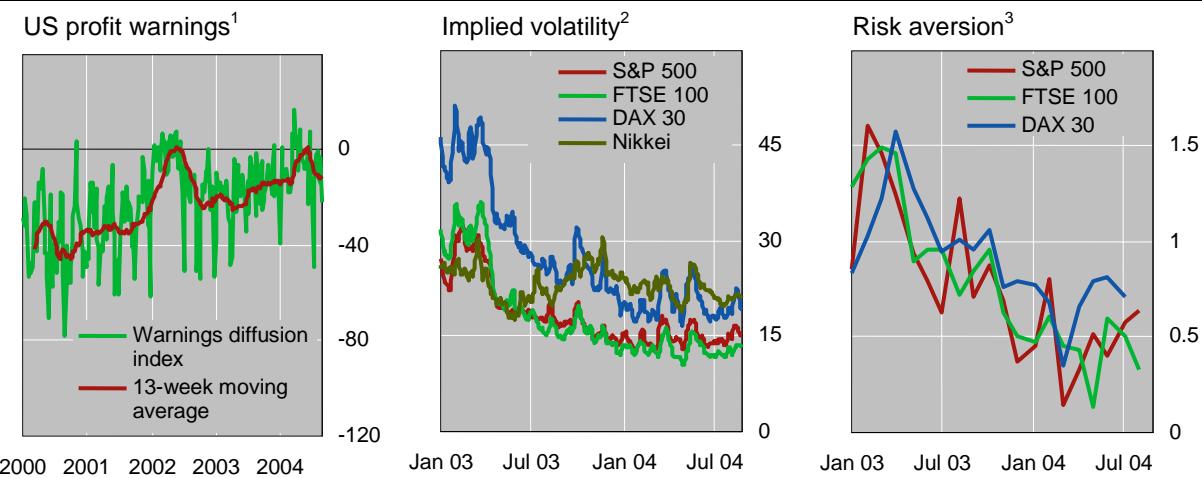
Profit warnings by IT firms had an especially large impact, and the IT sector underperformed broader indices. Intel's warning on 13 July that profit margins in the second half of 2004 would be less than expected led to a widespread sell-off in equity markets, including in Asian markets. Other bellwether technology companies whose guidance disappointed investors included Cisco Systems, Hewlett Packard and Nokia. Microsoft's announcement on 20 July of increased dividends and share buybacks totalling \$75 billion over four years, which would normally have been viewed as positive for equity markets, was interpreted negatively by many investors as signalling a lack of investment opportunities in the technology sector.

Profit warnings hurt equity markets ...

... especially in the IT sector



Profits, volatility and risk aversion



¹ Companies in the S&P 500 Index. ² Based on equity index put options; five-day moving average. ³ Derived from the differences between two distributions of returns, one implied by option prices with varying strike prices and one based on actual returns estimated from historical data. For more details, see the March 2004 issue of the *BIS Quarterly Review*.

Sources: Bloomberg; Chicago Mercantile Exchange; Eurex; London International Financial Futures and Options Exchange; BIS calculations.

Higher oil prices hit equities as well

Rising oil prices also contributed to the weakness in global equity markets. Growing demand in the face of short-term constraints on supply helped to push up oil prices in 2004. By the end of June, the price of crude was nearly 14% higher than at the end of 2003; and the price rose another 17% by 27 August. Concerns about possible supply disruptions in some important oil-exporting countries, including Saudi Arabia, Russia and Venezuela, added to upward pressure on oil prices. Increased speculative activity was often cited as a factor contributing to the rise in oil prices, yet its significance is far from clear (see the box on page 6).

While higher oil prices have several times in the past preceded an increase in inflation, this time market participants seemed less concerned about this possibility and more worried about the dampening effect higher oil prices might have on aggregate demand and corporate profits. Long-term inflationary expectations – whether based on surveys or the prices of inflation-indexed bonds – remained restrained.

Low volatilities despite diminished risk appetite

Even as bond and equity investors reassessed near-term growth prospects, equity volatilities remained at low levels. The implied volatility of options on the S&P 500 Index stayed well below its 1995–2003 average of 20% and any upward jumps, such as following the release of the US employment report on 6 August, were quickly reversed. Measures of risk aversion derived from these options indicate that equity investors turned more risk-averse in the second and third quarters of 2004. This would normally be associated with an increase in implied volatilities. However, the impact was seemingly offset by investors' expectations that volatility would remain unusually low in the future.

In search of black gold: speculation in oil markets

The rapid increase in oil prices in recent months has focused attention on the role of speculators in the oil market. With prices in most major equity, bond and credit markets moving sideways or even declining, investors in search of higher returns have reportedly turned to commodity markets, oil in particular. Available data indicate that those market participants typically labelled as speculators have indeed increased their positions in oil markets. However, their motivation for increasing their positions and their influence on oil prices are unclear.

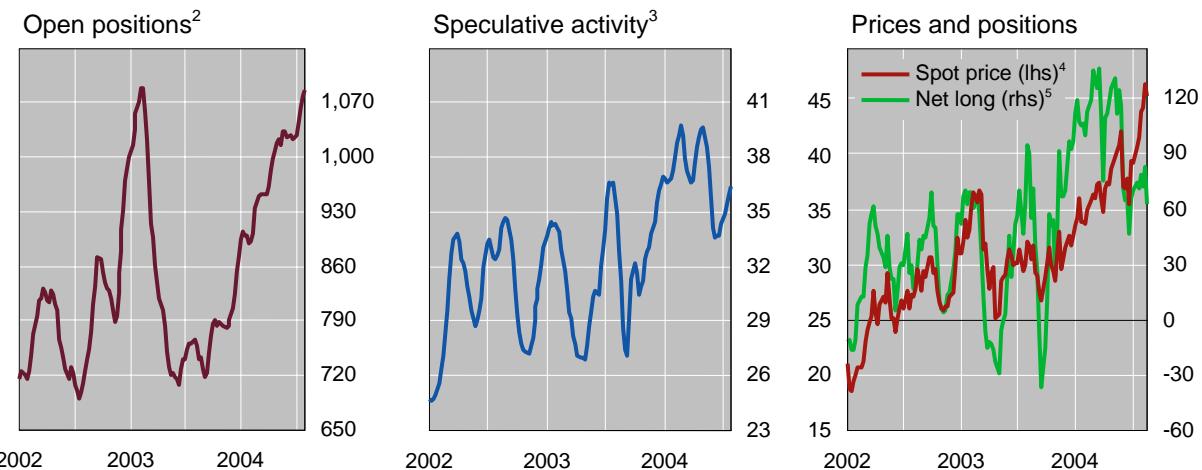
Speculation in oil markets occurs mainly in the futures market, where standardised contracts promote liquidity. A long position in futures markets is equivalent to borrowing funds to purchase the underlying good in the spot market and paying the carrying charges associated with storing the good until delivery. Consequently, arbitrage ensures a close link between futures and spot prices. Futures trading is highly concentrated: the New York Mercantile Exchange accounts for approximately 65% of global turnover in crude oil futures, the International Petroleum Exchange in London slightly more than 30%, and all other exchanges combined less than 5%.

Data compiled by the US futures regulator, the Commodity Futures Trading Commission (CFTC), indicate that non-commercial traders stepped up their activity in oil futures markets starting in late 2003. In particular, they sharply increased their long positions in expectation of a rise in oil prices. Non-commercial traders include investment banks, hedge funds and other market participants who trade in futures markets primarily for speculative purposes. Commercial traders are defined by the CFTC as those traders seeking to hedge their production or consumption.

Open positions in crude oil futures – contracts entered into but not yet offset by a reversing trade or delivery – increased by more than 25% over the first eight months of 2004 (see left-hand panel of graph below). Positions held by non-commercial traders increased to 37% of all open long positions on average over this period, up from 32% in 2003 (centre panel of graph below). By contrast, non-commercial traders' share of open short positions was on average down slightly from 2003. Changes in non-commercial traders' net long position – open long positions less open short positions – have tended to coincide with changes in the oil price. In fact, the correlation between weekly changes in oil prices and weekly changes in non-commercial traders' net long positions was close to 0.8 over the first eight months of 2004.

It is possible that the larger presence of non-commercial traders in the oil market contributed to herd-like behaviour. Their presence, coupled with the upward trend in oil prices, might have made traders wary of positioning against further increases in oil prices, thereby effectively reinforcing the upward trend. However, it is also possible that shifts in activity in the futures market were driven by changing perceptions of fundamental imbalances in the supply of and demand for oil, including the changing perceptions of commercial traders. The available data shed little light on the motivations behind changes in positions.

Oil futures markets¹



¹ Crude oil futures contracts traded on the New York Mercantile Exchange. ² Four-week moving average; in thousands of contracts. ³ Long positions of non-commercial traders as a percentage of total reportable long positions; four-week moving average. ⁴ Price of West Texas Intermediate oil; in US dollars. ⁵ Net positions (long minus short) of non-commercial traders; in thousands of contracts.

Sources: Bloomberg; New York Mercantile Exchange; national data; BIS calculations.

Improving credit quality supports credit spreads

Credit spreads tighten ...

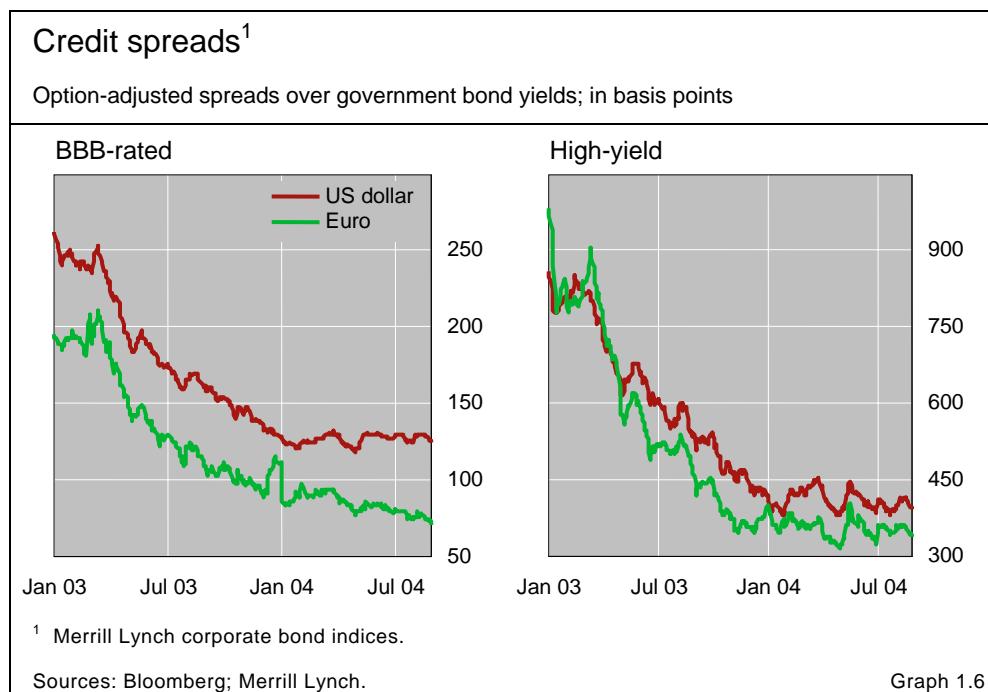
Investors in credit markets seemed unfazed by developments in bond and equity markets. Spreads on US dollar-denominated bonds issued by BBB-rated corporations were largely unchanged over the first eight months of 2004, fluctuating between approximately 120 and 130 basis points. Spreads on BBB-rated euro-denominated bonds actually inched downwards, falling to about 80 basis points by late August from 90 basis points at the end of 2003 (Graph 1.6). Corporations rated below BBB are typically more sensitive to higher interest rates than investment grade corporations because they tend to have larger debt burdens and shorter-term liabilities. Yet, even high-yield corporate spreads remained relatively stable following the increases in US policy rates. Indeed, in early August high-yield corporate spreads in the dollar market approached the lows reached earlier in 2004.

... as defaults decelerate ...

Credit investors appeared to take comfort from continued improvements in corporate credit quality. The number of defaults and rating downgrades fell further in the first half of 2004. Indeed, according to Moody's, global upgrades exceeded downgrades for the first time since 2000, albeit by a slim margin. In both Europe and the United States, the turnaround in credit quality was led by financial institutions, especially banks. Among non-financial corporations, downgrades still exceeded upgrades, but the gap continued to narrow.

... and corporations deleverage

New borrowing by US, European and Japanese corporations remained restrained as firms continued their efforts to deleverage. Corporate bond issuance in the US dollar market was down by 15% in the first half of 2004 compared to the same period a year earlier, and in the euro market issuance was almost 40% weaker (Graph 1.7). While syndicated lending surged to record levels in the second quarter, much of this reflected refinancing activity (see "International syndicated credits in the second quarter of 2004" on page 23). Banks enticed borrowers to refinance loans before maturity by



offering ever more attractive financing terms; spreads on syndicated loans appeared to continue to narrow in the first half of the year even though spreads on corporate bonds were little changed.

Corporate borrowing could pick up in the near future. In the United States especially, much of the improvement in corporate balance sheets in 2002–03 was driven by a rebound in corporate profitability.² With profit growth now beginning to slow, corporations' borrowing requirements are likely to increase if the rebound in capital investment, which began in mid-2003, persists. Already there are signs of a rise in short-term borrowing. For example, issuance of commercial paper by non-financial corporations in the United States and the euro area recovered in the first half of 2004 (Graph 1.7).

While US and European firms have in recent years accumulated substantial amounts of cash, it is not clear that they will choose to run down these assets either to reduce new borrowing or to retire outstanding debt. By end-March 2004, liquid assets equalled 23% of debt owed by US non-financial corporations, compared to 18% on average during the 1990s (Graph 1.8). Cash and deposits held by euro area corporations equalled nearly 25% of outstanding debt. These assets could be used to meet financing requirements, for example to retire maturing debt, and thereby benefit bondholders. Alternatively, they could be used to finance mergers and acquisitions, share buybacks or dividend payouts – actions which benefit shareholders more than bondholders.

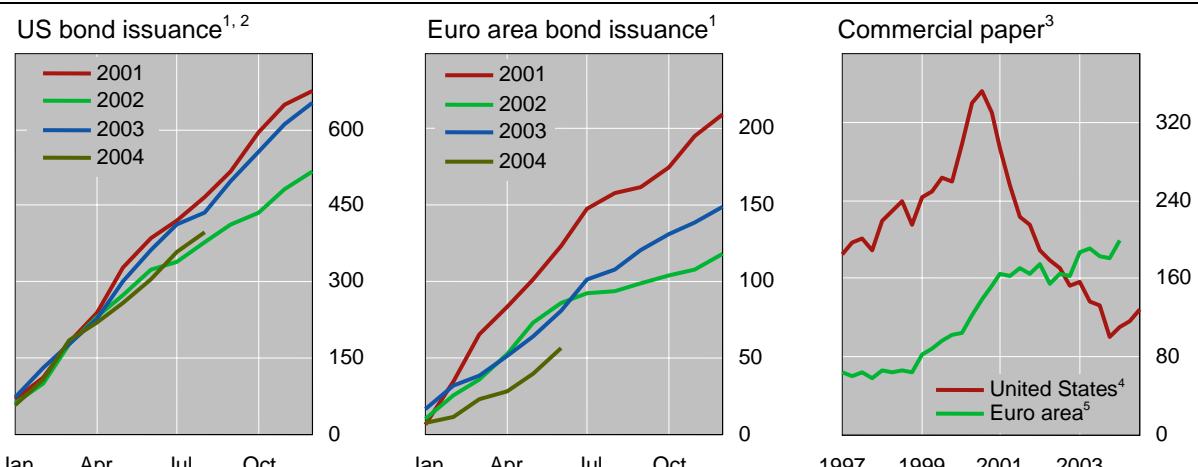
Firms appear to be opting for the latter uses. Acquisitions, including leveraged buyouts, and share repurchases are increasing. Available data indicate that share buybacks by US companies have risen by more than initial

Increased corporate liquidity ...

... has triggered share buybacks

Corporate debt markets

Non-financial corporations; in billions of local currency

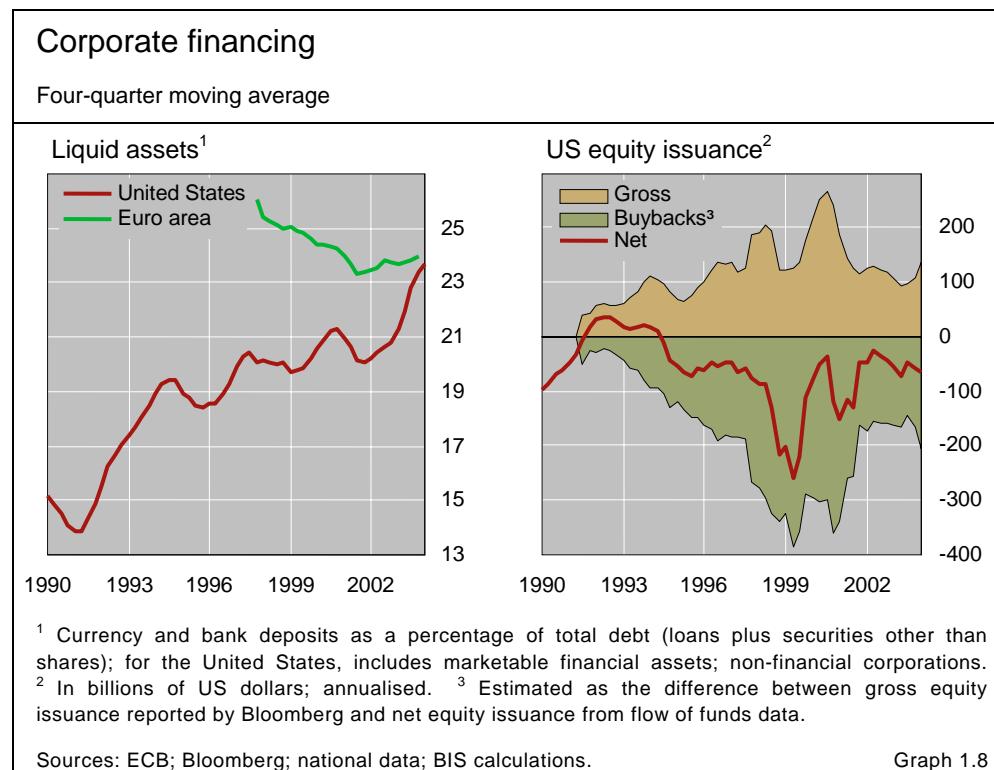


¹ Cumulative gross monthly issuance. ² Including financial corporations. ³ Amounts outstanding. ⁴ Seasonally adjusted. ⁵ Issued in domestic and international markets.

Sources: European Commission; Bloomberg; Euroclear; national data; BIS calculations.

Graph 1.7

² See Bank for International Settlements, *74th Annual Report*, 28 June 2004, pp 111–12.



and follow-on share offerings since mid-2003, resulting in a decline in the net issuance of equities. In contrast to the early 1990s, net issuance of equities by US firms never turned positive during the most recent period of corporate deleveraging.

Emerging markets rebound despite rate hikes

Emerging market spreads also tighten ...

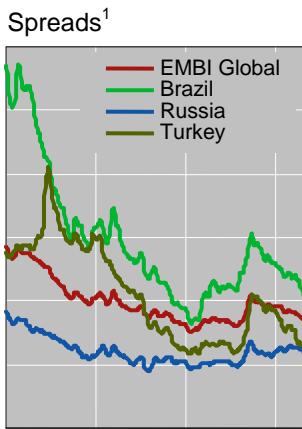
... spurred by the renewal of carry trades

Emerging market investors, like credit investors, seemed unperturbed by the negative news that dragged down bond yields and equity prices in the major markets. In fact, spreads on emerging market debt tightened as US yields fell (Graph 1.9). Most of the widening in emerging market spreads that had occurred during the sell-off in global bond markets in late April and early May was reversed over the next three months. On 27 August, emerging market spreads stood at 425 basis points, 125 basis points below their mid-May peak.

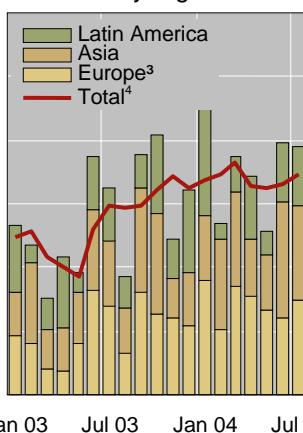
The renewal of carry trades that had been unwound during the sell-off reportedly contributed to the narrowing of emerging market spreads in July and August. Investors increased their positions in higher-yielding debt, helping to push sovereign spreads for Brazil, Turkey and other low-rated countries down sharply from their mid-May peak. Favourable domestic economic news, including a rising current account surplus in Brazil and strong productivity gains in Turkey, provided further support for the rally.

While changing expectations regarding US policy rates were the dominant drivers of market moves, other factors at times added to volatility. The German government's securitisation of bilateral loans to Russia raised the possibility of similar sales by other governments (see "The international debt securities market" on page 25). Consequently, immediately following the announcement of the transaction on 24 June, Russia's sovereign spread widened by more

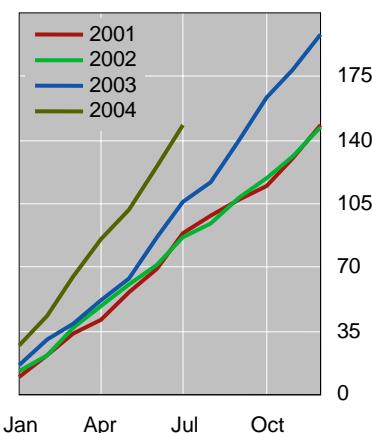
Emerging markets



Issuance by region²



Cumulative issuance²



¹ Sovereign stripped spreads over government bond yields, in basis points; JPMorgan Chase emerging market bond indices.

² Announced issuance of international bonds, notes and syndicated loans; in billions of US dollars. ³ Including the Middle East and Africa. ⁴ Three-month moving average.

Sources: Dealogic; JPMorgan Chase; BIS calculations.

Graph 1.9

than 20 basis points and the EMBI Global by 10 basis points. However, conditions quickly stabilised as market participants came to understand the one-off nature of the transaction.

Notably, a run on Russian banks around mid-year had little impact on even Russian markets. The banking crisis began in May, when the Russian authorities closed a bank allegedly involved in money laundering. Depositors subsequently withdrew their money from other banks suspected of similar activities, culminating in early July in a massive withdrawal of deposits from several of the largest privately owned banks. To ease banks' liquidity problems, the central bank relaxed reserve requirements in late June, encouraged state-owned banks to increase their interbank lending, and sponsored the introduction of deposit insurance in mid-July. Owners of banks faced with withdrawals injected additional capital or sold the bank to a stronger bank. Owing to the prompt response of the authorities and bank owners to the banking crisis, Russia's sovereign spreads were little changed (Graph 1.9). Even overnight interbank rates remained below the highs reached during the general sell-off of emerging market debt in April.

Minimal fallout from the Russian banking crisis

Emerging market issuers moved quickly to take advantage of the favourable financing conditions prevailing through mid-year. The pace of borrowing by emerging market debtors in international bond and syndicated loan markets showed no signs of slowing, with \$23 billion raised in July alone (Graph 1.9). Asian borrowers were especially active, mainly export-oriented firms from Korea and Taiwan, China. Prefunding in advance of anticipated increases in US policy rates contributed to the high level of issuance, with some of the surplus funds being deposited in turn with banks in the major financial centres (see "The international banking market" on page 11).

High growth of debt issuance