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1. Overview: are markets looking beyond the slowdown?

Swings in market sentiment were particularly pronounced in the early months of 2001. While it was clear that the US economy had begun to slow substantially, market participants vacillated in their views about the likely length and depth of the slowdown, the extent to which it would spread to Europe and elsewhere, and its ramifications for corporate earnings and credit quality. Inter-meeting policy rate cuts by the US Federal Reserve buoyed the markets in general, while company profit warnings tended to depress the equity markets. By April, investors seemed to be confident of a brief slowdown and to be looking beyond it to a strong recovery in corporate earnings.

Compared to equity investors, participants in fixed income markets seemed less prone to change their views. As short-term interest rates fell against a background of confidence in an imminent recovery, yield curves in both US dollars and euros tended to become progressively steeper and credit spreads narrower. The resulting favourable conditions in the long-term debt market brought low- and medium-rated corporate issuers back in force. A few emerging market borrowers also returned to the market. A large part of the funds raised in the market went to repay bank and commercial paper debt assumed in the fourth quarter of 2000.

International banks tended not to recycle these repayments into new lending. Having reluctantly accommodated the short-term financing needs of low-rated borrowers at the end of 2000, the banks pulled back from credit extension in the first quarter of 2001. Syndicated lending, in particular, fell sharply. Net issuance of commercial paper, which usually requires a backup credit facility from a bank, was weak on the international market and negative in the US market.

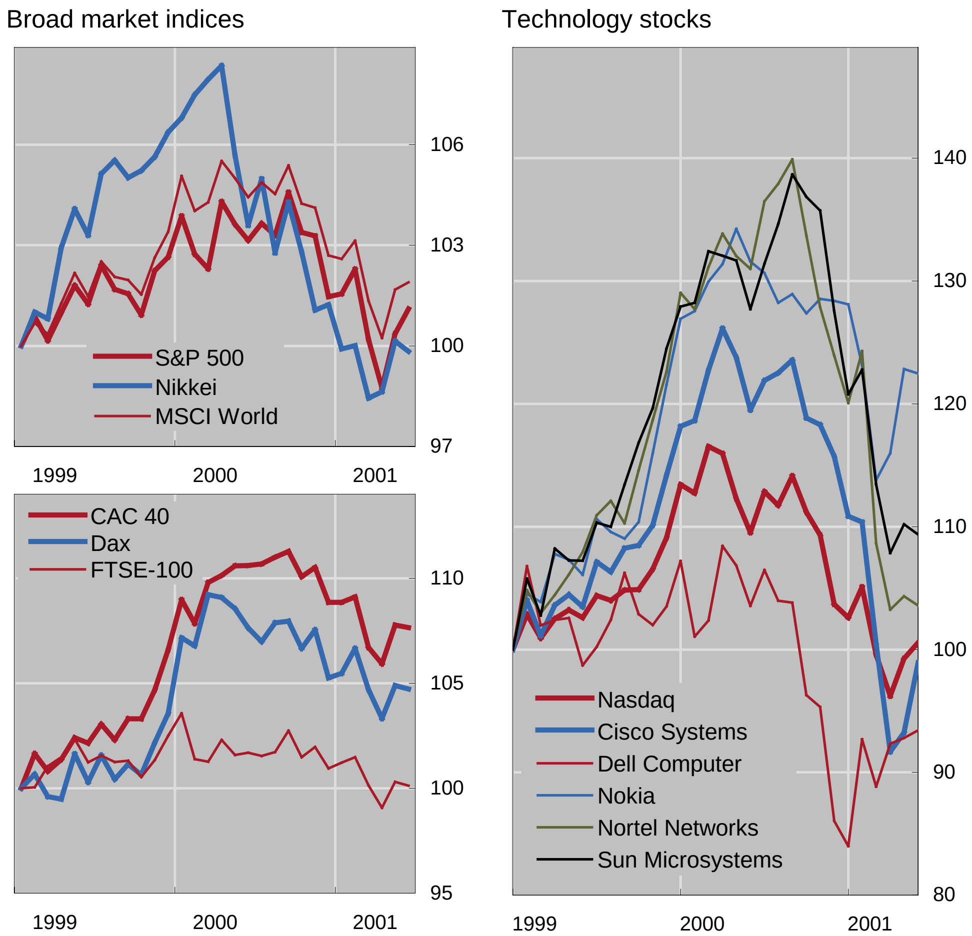
Swings in sentiment buffet equity markets

Stock price correction continues ...

The early months of 2001 extended the global stock price correction that began about a year ago. Having declined by 13% from April to December 2000, the MSCI World Index slid a further 5% from January to May 2001 (Graph 1.1). Technology stocks were the hardest hit, with the Nasdaq

Stock prices and market indices

Month-end data, December 1998 = 100 (logarithmic scale)[1]



[1] Index calculated as the natural log of total return index divided by the log of 100, and then rebased to 100.

Sources: Bloomberg; Datastream. Graph 1.1

tumbling 15% in the first five months of 2001 for a cumulative decline of 45% since April last year.

While most major equity markets around the world moved together during the first few months of 2001, the Tokyo market stood out by going its own way. A de facto return to zero policy rates in March and a new government in April brought renewed strength to the market. The Nikkei average surged by 15% in March and April, outperforming the other national indices.

... interrupted by bouts of optimism

The global slide in stock prices did not proceed uninterrupted. Price movements were characterised by sharp and sudden reversals as investor sentiment swung from optimism in January, to pessimism in February and March, back to optimism in April and again to a gloomier outlook in mid-May. The bouts of optimism were associated with surprise policy rate cuts, while those of pessimism were marked by news about corporate earnings and macroeconomic developments.

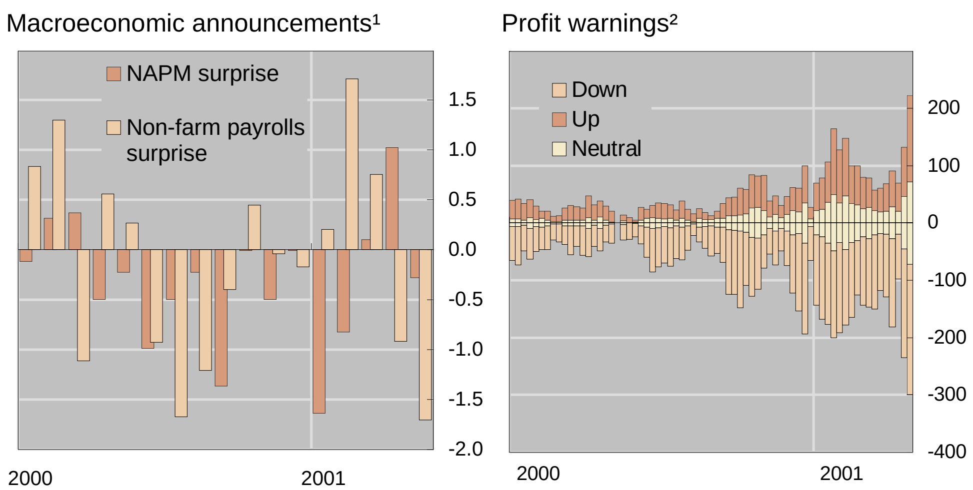
High operating leverage hits earnings

The periods of depressed equity markets were characterised by investor unease at the apparent sensitivity of corporate earnings to the performance of the global economy. A spate of profit warnings in February and March suggested a decline in corporate earnings that was deeper than investors had anticipated, particularly in the case of technology firms (Graph 1.2). In May, a profit warning by Sun Microsystems set off a round of price declines. The economic slowdown exposed two weaknesses of these firms. First, they had overestimated the demand for their products and had overinvested in development, equipment and inventory. Second, a salient feature of their production processes has been high fixed costs and low variable costs. This high operating leverage meant that production cutbacks in response to large declines in sales did not result in comparable declines in costs. For both these reasons, technology firms tended to report a more pronounced collapse in earnings than other firms.

Equity markets welcome surprise monetary policy moves …

The periods of buoyant markets pointed to the power of surprise policy rate cuts. In the United States, the Federal Reserve twice announced a 50 basis point reduction in its federal funds target rate outside a scheduled Federal Open Market Committee (FOMC) meeting. Both actions, the first on 3 January and the second on 18 April, caught market participants by surprise and generated global market rallies (Table 1.1). The announcements of three other policy rate cuts were different in that they came at the time of FOMC meetings, and the news failed to boost the markets. On 19 March, the Bank of Japan said that it would shift to a "quantitative easing" strategy, effectively pushing its policy rate back to zero. Following this unanticipated shift, the Nikkei gained 7% on the first trading day. Investors apparently took these surprise actions as signals that the central banks were determined to revive their respective economies. Other policy rate cuts not anticipated by market

Public information in the US stock market



[1] Normalised announcement surprises (for zero mean and unit variances), based on the difference between realised numbers and consensus forecasts. [2] Number of US companies issuing profit warnings during the week.

Sources: Bloomberg; BIS calculations. Graph 1.2

participants did not seem to send such a message and thus had smaller effects on stock markets. On 10 May, for example, the European Central Bank and the Bank of England both reduced their policy rates with little warning, but equity market participants seemed to shrug off these actions. It should be noted, however, that there was no suggestion that the central banks intended to influence asset prices.

… but are sceptical about others

The periods of market rallies also revealed an abiding optimism about corporate prospects beyond the current slowdown, as investors proved eager to "see through" the current slowdown towards an expected pickup in profits in the future. A sign of this optimism was a tendency of equity investors to welcome the mere absence of bad news. On 4 April, for example, the news that Dell Computer would meet its much reduced earnings estimate sent the Nasdaq Composite soaring by 9% and the MSCI World Index by 3% in a single day. In previous periods, such news would have depressed stock prices, as investors would have expected the company to exceed the estimate. In April 2001, investors increasingly held the belief that the global slowdown would be short and that recovery would restore strong growth in corporate earnings. Indeed, the market rally that month brought the prices for stocks in the S&P 500 index to 27 times trailing earnings, a price/earnings multiple that was nearly double the historical average. Optimism ran even higher for technology stocks, with the Nasdaq Composite giving a price/earnings multiple that was six times that of the S&P 500.

Anticipation of a prompt recovery lifts price/earnings multiples

One interesting development during the period under review was the unusually swift response of US mutual fund investors to market performance. For the first time since the Russian debt moratorium in August 1998, these investors pulled funds out of US equity mutual funds. As stock prices fell in February and March 2001, net outflows from these funds amounted to $24 billion during those two months (Graph 1.3) Investors transferred some of the money to bond mutual funds and some to money market mutual funds.

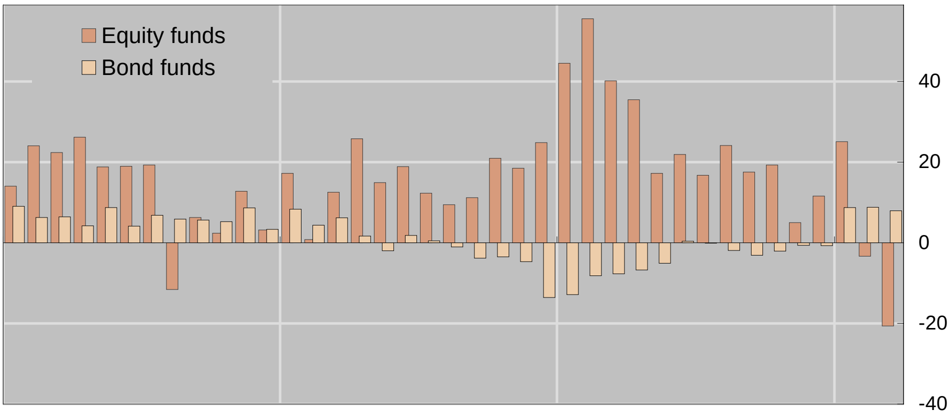
Monetary policy rate cuts and stock prices in 2001

Date	Monetary authority	Policy rate cut (in basis points)	Market index	One-day price move (percentage change)
3 January	Federal Reserve	50	Nasdaq	14.2
31 January	Federal Reserve	50	Nasdaq	– 2.3
8 February	Bank of England	25	FTSE 100	– 0.3
1 March	Bank of Japan	10	Nikkei	– 3.3
19 March	Bank of Japan	15	Nikkei	7.5
20 March	Federal Reserve	50	Nasdaq	– 4.8
5 April	Bank of England	25	FTSE 100	1.6
18 April	Federal Reserve	50	Nasdaq	8.1
10 May	Bank of England	25	FTSE 100	1.2
10 May	European Central Bank	25	DJ Euro Stoxx	1.9
15 May	Federal Reserve	50	Nasdaq	0.2

Table 1.1

US mutual fund flows

Monthly net cash flows in billions of US dollars



Source: Investment Company Institute. Graph 1.3

Yield curves suggest growing optimism

The dollar and euro yield curves became progressively steeper in the early part half of 2001, with most of the steepening reflecting declines in short-term rates rather than increases at the long end (Graph 1.4). While there was a dip in long rates in both dollars and euros in March, as some of the gloom affecting equity markets began to weigh on bond markets, this was reversed in April, with bond markets returning to the view that any slowdown in the United States or Europe would be relatively short-lived. The steepness of the US dollar curve beyond the one-year maturity suggested market confidence in the effectiveness of policy rate cuts in spurring a recovery in growth. However, the rise in rates at the long end have may also indicated some concern about inflation risk.

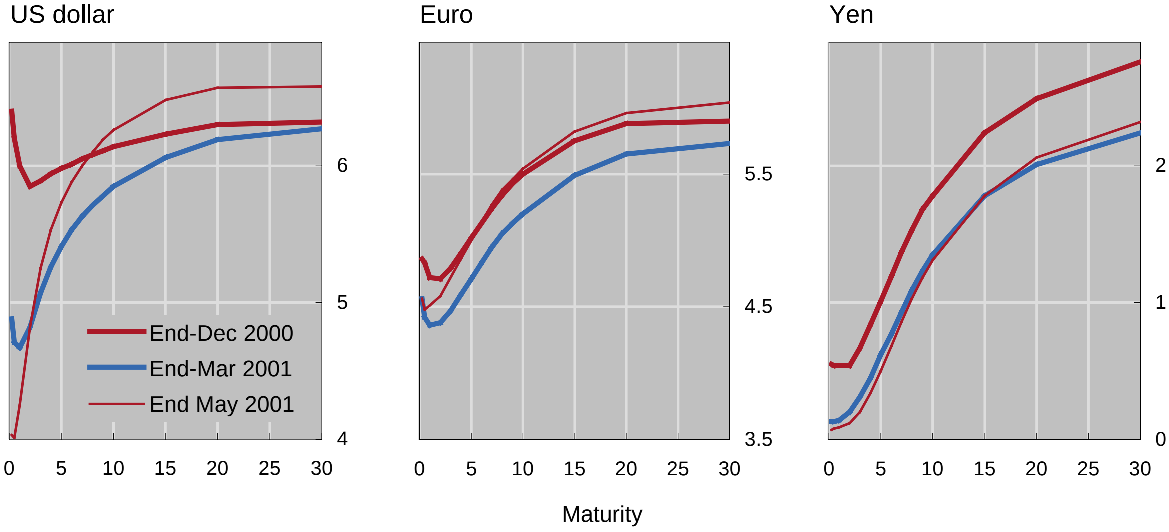
Low risk premia in yield curves suggest high confidence

The changing shape of the yield curve at the short end tracked closely the evolution of market views about the responses of monetary authorities to the slowdown. A pronounced dip in the curve around the intermediate maturities was unusual in that, during previous periods of monetary easing, risk premia had tended to keep the curve relatively flat. The dip suggested the absence of such premia, indicating that market participants held their expectations with a high degree of confidence. In January and February, the curves incorporated the anticipation of monetary easing in both the United States and the euro zone, with policy rates bottoming out in late 2001. By mid-May the downward slope in the curve near the short end had all but disappeared. In the case of the dollar curve, this was because the Fed had cut rates aggressively, to the point where the market was willing to wait and see how macroeconomic indicators developed before pricing further rate cuts into the yield curve.

In the case of the euro zone, where the steepening movement had in any case been less pronounced, two phases can be discerned. From February to

Yield curves for interest rate swaps

In percentages



Source: Bloomberg. Graph 1.4

early May, expectations that the Eurosystem would follow a similar strategy to the Fed were gradually abandoned, resulting in a progressive rise and flattening of the short-term forward curve. After the surprise rate cut on 10 May, the market revised its outlook for euro short-term rates downwards, but long rates remained little changed.

Currency markets support the dollar regardless of growth scenarios

In currency markets, traders found reasons to support the US dollar under both optimistic and pessimistic scenarios. A rapid, "V-shaped" recovery was expected to result in a resumption of strong US GDP and productivity growth and a revival in US equity prices, thus reinstating the factors that have supported the dollar against other currencies over the past two years. A more lengthy US slowdown, ironically, may also have been considered positive for the dollar, because of safe haven effects and the perception that this would mean substantially slower growth and lower investment returns elsewhere. Thus, the dollar strengthened from 0.94 to less than 0.88 to the euro in March, at the same time that US (and other) stock markets fell to recent lows. Yet when global equity markets recovered in April and May, the dollar remained in a trading range of 0.88-0.90 to the euro, before subsequently strengthening further.

Corporate bond investors look past the slowdown but bank lenders are wary

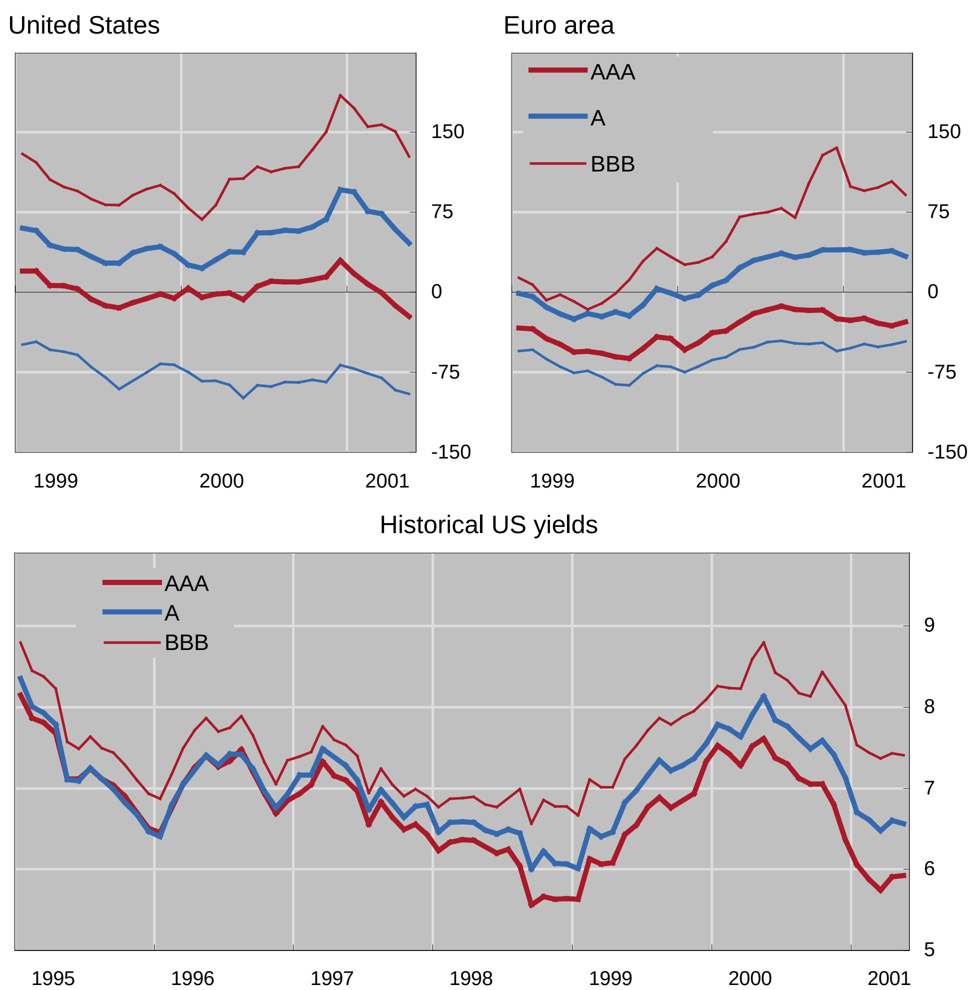
While equity investors struggled to assess the outlook for profitability, corporate bond investors seemed to be less prone to swings in sentiment and instead appeared to adopt a relatively optimistic view of growth and credit conditions. In part this reflected the fact that bond markets had gone further in incorporating a negative growth outlook in the final months of 2000. From a longer-term perspective, bond markets had begun to incorporate expectations of increased corporate credit risk since the financial crisis of autumn 1998. The gloomier earnings outlook of late 2000 and early 2001, even when reinforced by profit warnings, thus had less of an impact on bond markets than on stock markets.

Credit spreads narrow, contributing to a decline in overall credit costs ...

Corporate credit spreads on most debt categories narrowed sharply in January, and more slowly in subsequent months (Graph 1.5). While high-yield spreads did not narrow as consistently, and while the narrowing of spreads on other debt categories merely brought them back to their levels of mid-2000, the fact that underlying risk-free rates also fell meant that the overall price of corporate credit declined sharply in the first quarter of 2001. The Merrill Lynch A and BBB yield indices fell to roughly 6.5% and 7.5% respectively, levels not seen since the first half of 1999. However, some borrowers, notably telecoms

Corporate and government bond spreads[1]

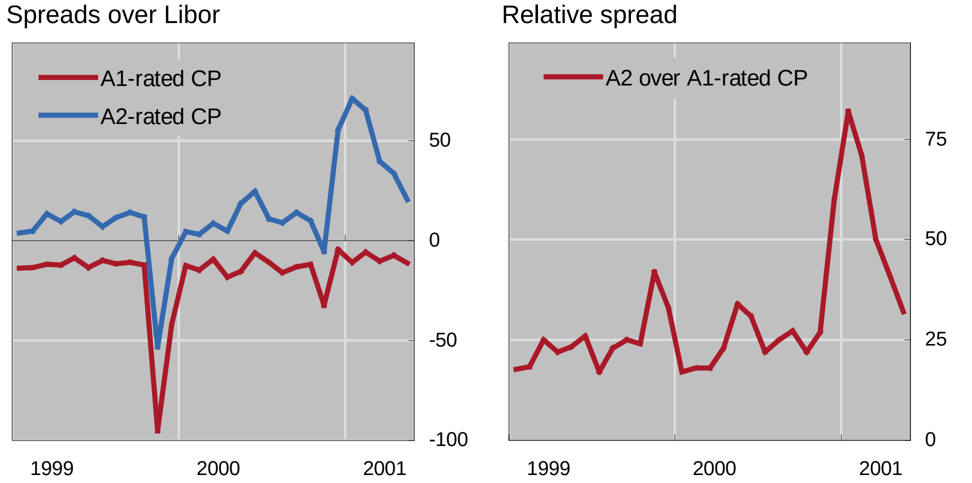
Month-end data



[1] Bond index yields against 10-year swap rates, in basis points, except for historical US yields (in %).

Sources: Bloomberg; Merrill Lynch; national data. Graph 1.5

US commercial paper spreads[1]



[1] On 30-day yields, in basis points, at month-end.

Sources: Bloomberg; Datastream; BIS calculations. Graph 1.6

companies, experienced significantly higher secondary market yields than others in the same credit rating category. Moreover, spreads stood at very high levels by historical standards. The spreads of single-A and triple-B yields over US dollar swaps remained at levels last seen only twice in the past decade: at the beginning of 1991 and, briefly, in the autumn of 1998.

... despite declining stock prices and rising default rates ...

Unusually, narrower spreads were juxtaposed with continued declines in stock prices for much of the first quarter. This does not necessarily mean, however, that the bond market was projecting lower default probabilities at the same time as the equity market was reducing corporate earnings forecasts. Indeed, according to Moody's, some 7.5% of speculative grade issuers defaulted between May 2000 and April 2001, while the number of issuers downgraded exceeded upgrades by around 2%. Moody's now forecasts the speculative grade default rate to reach 10% for 2001 as a whole. If this forecast proves accurate, it would represent the highest level for this rate since 1991, when slightly more than 10% of speculative grade issuers defaulted.

... as investors show increased tolerance of corporate credit risk

Instead, narrower corporate spreads reflected in part a renewed willingness among investors to increase their exposure to corporate credit risk. In the United States, another factor contributing to narrower spreads may have been a fall in the scarcity premium attached to government securities, as a result of the progress of the new administration in implementing a fiscal policy that was expected to lead to a slower reduction of outstanding debt than the market had previously assumed. The equity market's retreat in February and March was thus not associated with a "flight to quality" of the kind seen in autumn 1998 or, to a milder degree, in the run-up to the millennium changeover. Rather than switching from risky securities of all types to government bonds as in the past, on this occasion many investors, including holders of US mutual funds, seem to have switched from equities to corporate bonds (Graph 1.3).

Non-AAA borrowers respond quickly with increased long-term issuance

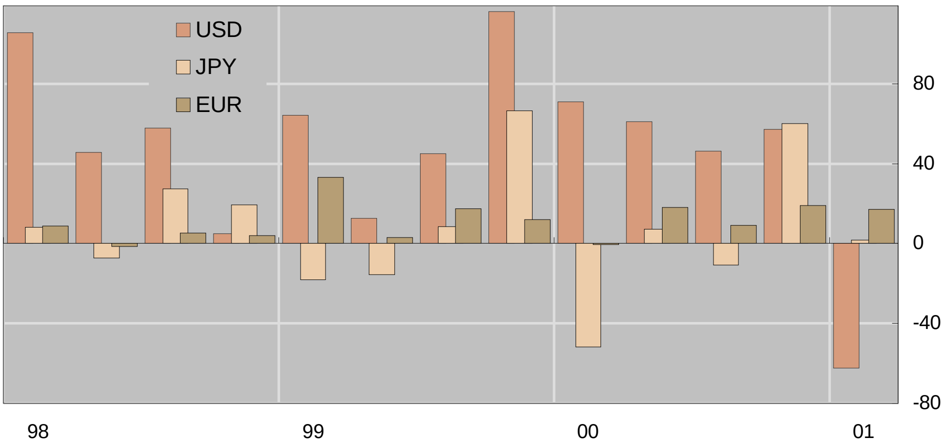
The revival of investor interest contributed to a sharp increase in long-term debt issuance by non-AAA-rated coporates in the first quarter (see Section 3). Corporations were especially eager to issue bonds given the cooling of investor interest in new equity offerings. Faced with persistently high and volatile commercial paper spreads (Graph 1.6) and a sceptical attitude on the part of bank lenders, many companies took advantage of their revived access to debt markets to reduce their CP and bank debt. Telecoms companies, facing large debts related to licence fees as well as the need to construct or upgrade their networks, were especially quick to take advantage of the improved financing conditions.

Bank lenders are cautious ...

In contrast to bond investors, bank lenders appear to have adopted a cautious approach towards taking on new credit exposures in the early months of 2001. Banks had incurred unintended exposures towards the end of 2000, when many borrowers found themselves unable to refinance bridge loans in the bond market and others drew on bank backup lines. While the revival of the corporate bond markets allowed some of these debts to be repaid in 2001, banks were reluctant to extend new loans out of concern about declining corporate credit quality. New international syndicated credit facilities fell by 20% in the first quarter on a seasonally adjusted basis, with the amount of CP backup facilities falling particularly sharply (see "Syndicated credits: large amounts of telecoms facilities mature in 2001" on page 21). Surveys of senior bank loan officers by the Federal Reserve in January, March and May found that roughly half had tightened standards on commercial and industrial loans to large firms in the first half of 2001, a fraction that has risen considerably since last year. In parallel with the corporate credit spreads cited earlier,

Domestic and international net issuance of commercial paper[1]

In billions of US dollars



[1] Data on domestic issuance for the first quarter of 2001 are preliminary.

Sources: Euroclear; national authorities. Graph 1.8

this indicator of credit market tightness had last stood at comparable levels in late 1990 and early 1991.

... contributing to weak commercial paper issuance

Perhaps as a consequence of banks' increased wariness about credit risk, issuance of commercial paper, which usually requires a bank backup line, slowed in the first quarter. Net issuance of CP on the international market ("euro-CP") fell from $27 billion in the fourth quarter of 2000 to $16 billion in the first quarter of 2001 (Graph 1.7), while aggregate net issuance on the largest domestic markets was negative. Spreads between higher and lower-quality commercial paper issues, which had soared at the end of 2000, remained turbulent during the first quarter, after two California electricity utilities defaulted on their obligations and other large borrowers faced repayment difficulties. By the end of the quarter, however, these spreads had returned to their usual levels.

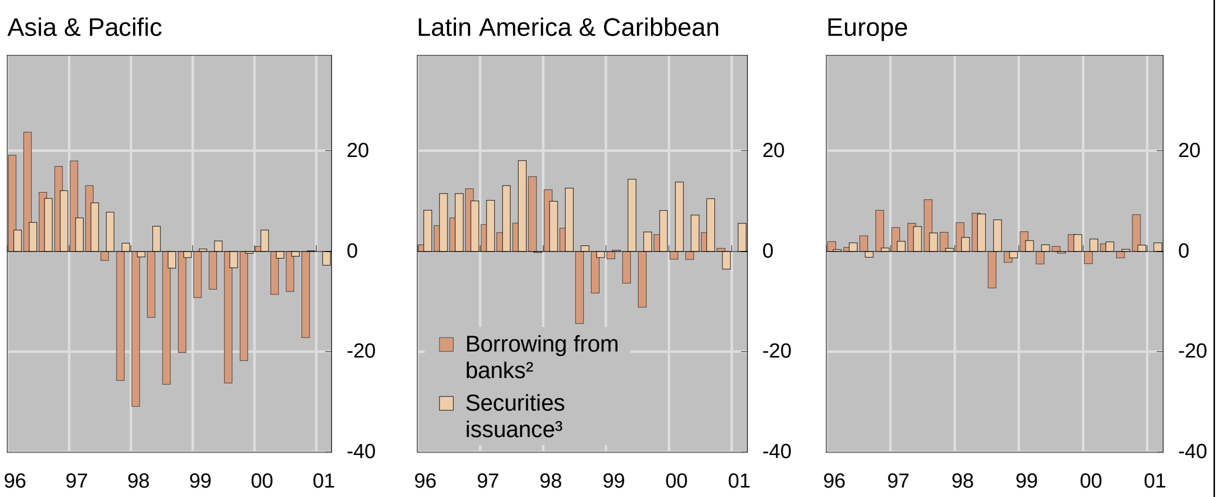
Borrowing by emerging economies revives in a multi-tier market

Flows to emerging markets rise ...

Financing flows to most emerging economies in the first quarter of 2001 benefited from the revived risk appetites of bond investors in the industrial countries. Net securities issuance was again positive in the first quarter, after having turned negative in the fourth quarter of 2000 (Graph 1.8). However, securities flows remained moderate in comparison with the levels that had prevailed in the first three quarters of 2000. The low level of flows represents a continuation of the pattern of recent months. The emerging market countries had been net repayers of bank debt in the fourth quarter of 2000, and for the

International bank and securities financing in emerging economies[1]

In billions of US dollars



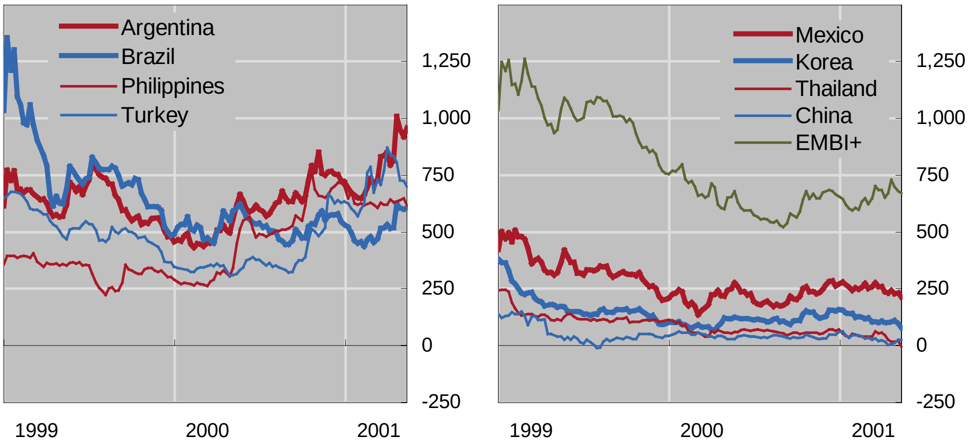
[1] See Annex Table `7A for a list of the countries included in each region. [2] Exchange rate adjusted changes in cross-border loans of BIS reporting banks. Data on bank lending are not yet available for the first quarter of 2001. [3] Net issues of international money market instruments, bonds and notes.

Sources: Bank of England; Capital DATA; Euroclear; ISMA; Thomson Financial Securities Data; national data; BIS locational banking statistics.

Graph 1.8

Spreads of US dollar sovereign bonds over 10-year swap rates

Weekly averages, in basis points



Sources: Bloomberg; Datastream.

Graph 1.9

year as a whole (see Section 2). In addition, oil exporters and East Asian economies placed large deposits with banks in the reporting area.

… but remain subdued

There are several reasons why the level of flows to emerging markets has remained relatively subdued. For one thing, many emerging market borrowers continued to benefit from current account surpluses and thus were not in need of external finance. Second, investors were wary of the impact of a slowdown in the US economy and continued weakness in Japan on growth in emerging economies, especially those that have been dependent on exports of electronic equipment. Markets appear to judge Asian countries as being vulnerable to the outlook for technology industries in the United States, while Latin American economies are exposed to broader shifts in equity market sentiment. A further weakening of the yen is also seen as a particularly salient risk for Asia. Third, banks in the industrial countries have increasingly sought credit exposures in emerging economies by purchasing local banks, rather than through cross-border lending.

A final factor that may have dampened lending to emerging economies was the continued economic turmoil in certain countries, most notably Argentina and Turkey. A comparison of secondary market spreads suggests that, while investors continue to attach relatively low risk premia to investment grade borrowers such as Mexico, Korea and Thailand, they have become somewhat more averse to the debt of lower-rated borrowers, including Brazil and the Philippines (Graph 1.9). As already noted, this has not yet had an appreciable effect on market access, if only because external financing needs have tended to be low. However, if investors and bank lenders remain averse to this risk category, this may cause problems for such borrowers when they next find themselves in need of ready access to international capital markets.