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1. Overview: the recovery keeps investors waiting

The onset of summer 2001 was marked by fading hopes for an early global economic recovery. As discussed in the June 2001 issue of the *BIS Quarterly Review*, spring had been a time of cautious optimism in financial markets, with participants generally convinced that monetary easing by the principal central banks in the developed countries would quickly turn the global economy around. In June and early July, however, disappointing macroeconomic data from Japan, Europe and the United States, accompanied by profit warnings from European and North American companies, indicated that the slowdown was not only continuing but also spreading. Stock markets fell sharply, giving back their earlier gains and extending the correction that had begun a year before.

The general deterioration in stock markets was compounded in July by turmoil in emerging markets. News about problems in Argentina, Turkey and Poland affected equity values and currencies of a number of emerging economies, although there were also many countries that escaped these spillover effects. The contagion started to abate within two weeks as market participants again began to differentiate between countries.

In contrast to the gloom in global equity markets, there was little sign of a credit crunch in global fixed income markets. Yield curves in the major economies retained their steep slopes, indicating a degree of confidence in a near-term economic recovery. Despite rising losses from defaults, credit spreads narrowed steadily over the first half of the year, as investors sought to add corporate bonds to their portfolios. Even spreads in the troubled telecoms sector narrowed. In the international market, firms continued to take advantage of favourable conditions by floating long-term debt securities in the second quarter, albeit at a slower pace than before. At the same time, with banks providing ready financing, announcements of new international syndicated credit facilities surged, reversing a two-quarter decline. Many corporate borrowers, however, used the funds to pay off other obligations, especially maturing long-term debt and commercial paper, rather than investing in new equipment and acquisitions.

Equity markets focus on earnings as technology firms report large write-offs

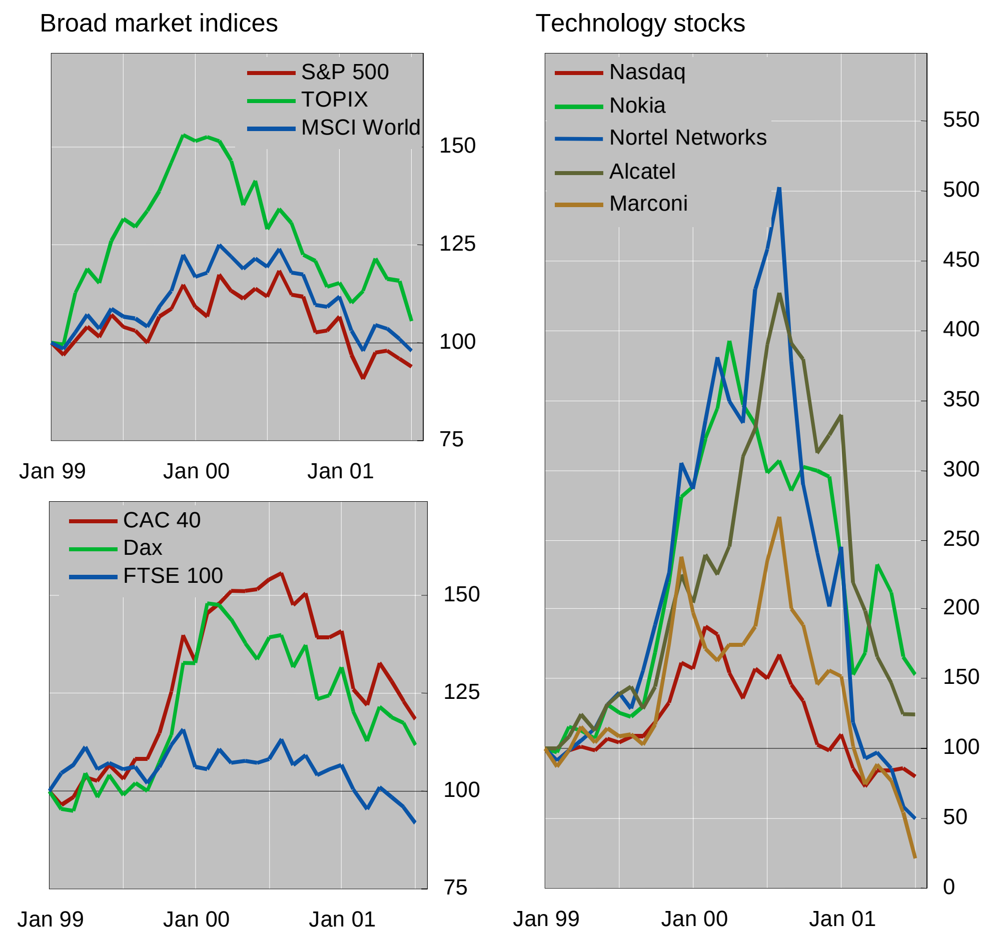
Participants in equity markets found reason to cheer in April. After sharp drops in technology stock prices in February and March, investors welcomed a series of relatively encouraging earnings announcements in April, particularly the news that Dell Computer would be able to meet its latest earnings forecast. The effect of positive earnings news was reinforced two weeks later by an inter-meeting policy rate cut by the US Federal Reserve, the second surprise reduction after the one in January. As a result, the Nasdaq Composite Index rose 15% during April (Graph 1.1). In Japan, the election of a new prime minister on 24 April injected confidence into the Tokyo market and lifted the TOPIX by 6% in the days that followed (Table 1.1).

Earnings news and lower interest rates boost stocks in April ...

In June, however, cheer turned to gloom as less favourable earnings news dashed hopes of a quick economic recovery. This time, many of the significant earnings reports came from companies outside the United States. The initial

Stock prices and market indices

Month-end data; January 1999 = 100



Sources: Bloomberg; Datastream. Graph 1.1

News events in stock markets

March–August 2001

Date	Event	Most affected stock market (index name)	Cumulative price change (in %)	Number of days of price change
9 March	Non-farm payrolls more than expected	Nasdaq	– 11.6	2
21 March	Ifo survey lower than expected	Dax	– 7.0	2
5 April	Dell meets earnings estimate	Nasdaq	8.9	1
18 April	US rate cut	Nasdaq	13.0	2
24 April	Koizumi elected in Japan	TOPIX	6.2	5
8 June	Nortel profit warning	TSE 300	– 1.2	2
2 July	*Tankan* survey worse than expected	TOPIX	– 1.1	1
2 July	IMF delays loan to Turkey	National 100	– 23.8	4
5 July	Marconi profit warning	FTSE	– 3.8	5
6 July	Non-farm payrolls less than expected	Nasdaq	– 3.7	1
10 July	Argentine bond auction	Merval	– 13.6	3
12 July	Yahoo! and Microsoft issue favourable profit warning	Nasdaq	5.7	2
14 August	Bank of Japan announces boost in money supply	TOPIX	2.7	1

Sources: Bloomberg; national data. Table 1.1

shock came from Canada early in the month in the form of Nortel Networks' announcement of a $17 billion loss. The Toronto stock market fell 1.2% (Table 1.1). A series of adverse information events followed, including disappointing profit news late in June from several bellwether European technology firms. Indeed, news about a few bellwether companies has tended to exert a disproportionate influence on markets. During 2001 so far, the last weeks of January, April and July have seen the largest number of US profit warnings (Graph 1.2). Nonetheless, the S&P 500 on average rose during those weeks and fell during other weeks. The bellwether companies tend to release profit warnings early in the month and these have been the times that account for the overall trend of market decline.

… but large write-offs drive markets down in June

A notable feature of the news about corporate earnings was the prominent role of write-offs by technology firms. The largest write-offs tended to relate to goodwill charges against acquisitions, although there were also significant write-offs related to vendor financing and inventory charges. The loss announced by Nortel Networks, for example, stemmed largely from the impairment of goodwill values in the Canadian firm's acquisitions of other companies. The loss reported in July by JDS Uniphase, a North American manufacturer of fibre-optic components, involved the writing-down of nearly $45 billion in the value of its acquisitions.

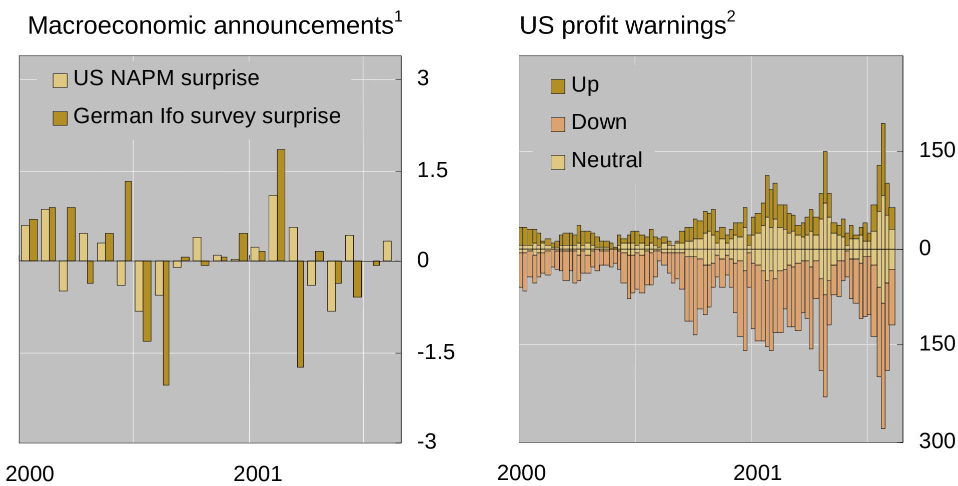
Markets focus on the implications of macroeconomic news for earnings …

Macroeconomic announcements also battered the markets in Europe and the United States. Even here, however, markets seemed to respond to economic news primarily in terms of the implications for corporate earnings, rather than for monetary policy as had been the case earlier in the year. This focus on earnings suggests that equity market investors viewed the monetary policy easing cycle as being largely completed in the United States, with continental Europe lagging behind in its economic cycle. Market participants attached special significance to a comparison of the US NAPM index of manufacturing activity with the German Ifo survey of the business climate, suggesting that the euro area was six to seven months behind the US economy in the cycle (Graph 1.2). The US employment report on 6 July showed an unusually large loss in non-farm payrolls. Six or nine months previously such a report might have led to a market rally in the expectation that monetary policy would ease. On this occasion the Nasdaq Composite fell 3.7%, with the Fed having just indicated that the 25 basis point policy rate cut on 27 June would probably be the last for some time.

… and, in Japan, on policy decisions

To a greater extent than European and US markets, the Japanese market continued to respond to macroeconomic news in terms of the implications for the effectiveness of fiscal and monetary policy. The *Tankan* survey released on 2 July showed a further weakening of the economy and led to a 1.1% decline in the TOPIX that day. On 14 August, the index soared 2.7% after the Bank of Japan said it would boost money supply by allowing bank reserves to increase

Macroeconomic and earnings indicators



[1] Normalised announcement surprises (for zero means and unit variances), based on the difference between released numbers and consensus forecasts. The US NAPM is an index from a survey by the National Association of Purchasing Management, and the German Ifo survey is a business climate index derived by the Institut für Wirtschaftsforschung from survey responses. [2] Number of US companies issuing profit warnings during the week. Positive surprises are shown as positive figures, negative surprises are shown as negative figures and neutral announcements are centred on the x-axis.

Sources: Bloomberg; BIS calculations. Graph 1.2

and purchasing greater amounts of government bonds. Coming after the new government had announced that it would rein in fiscal deficits, the central bank's action signalled its intent to further strengthen monetary support for stimulating the economy. Japanese stocks soon resumed a broad decline, however, as the market digested the extent to which the worsening global outlook would curtail the earnings even of relatively healthy export-oriented firms.

Contagion returns briefly to emerging markets

Crises in Turkey and Argentina in early 2001 …

Unfavourable developments in both Argentina and Turkey had been attracting market participants' attention since late 2000. In February, the Turkish authorities had been forced to devalue the lira after funding difficulties at a local bank and signs of political disarray raised concerns about the stability of the banking system, which in turn precipitated capital flight. A few weeks later, sovereign spreads on Argentina's debt had widened to double their February levels when falling tax revenue and the resignation of two finance ministers in as many weeks raised doubts about the government's ability to carry out fiscal reforms. In both cases, investors had not reacted by automatically reducing their exposure to emerging economies across the board, but instead appeared to discriminate carefully among countries in terms of sovereign risk. The crisis in Turkey had seemed to pass after an IMF support package promised breathing space for longer-term restructuring. By June, the prospects for Argentina had also appeared encouraging after the authorities succeeded in swapping nearly $30 billion of debt coming due for longer-term securities.

… do not spread to other emerging economies

Pressures reappear in July …

In July, however, pressures in Turkey and Argentina resumed and were compounded by the emergence of problems in Poland. On 2 July, a disagreement over the composition of a new executive board for government-owned Turk Telekom led the IMF to delay the release of funds. Four days later, market participants were caught off guard by a near collapse of the government in Poland over an unexpectedly large budget deficit. On 10 July, it was news about Argentina's bond auction that stoked the fire. The auction was so poorly received that the government was forced to shorten the maturity of the new debt and to pay rates as high as those during the Russian crisis in 1998.

… and spillover effects are more evident …

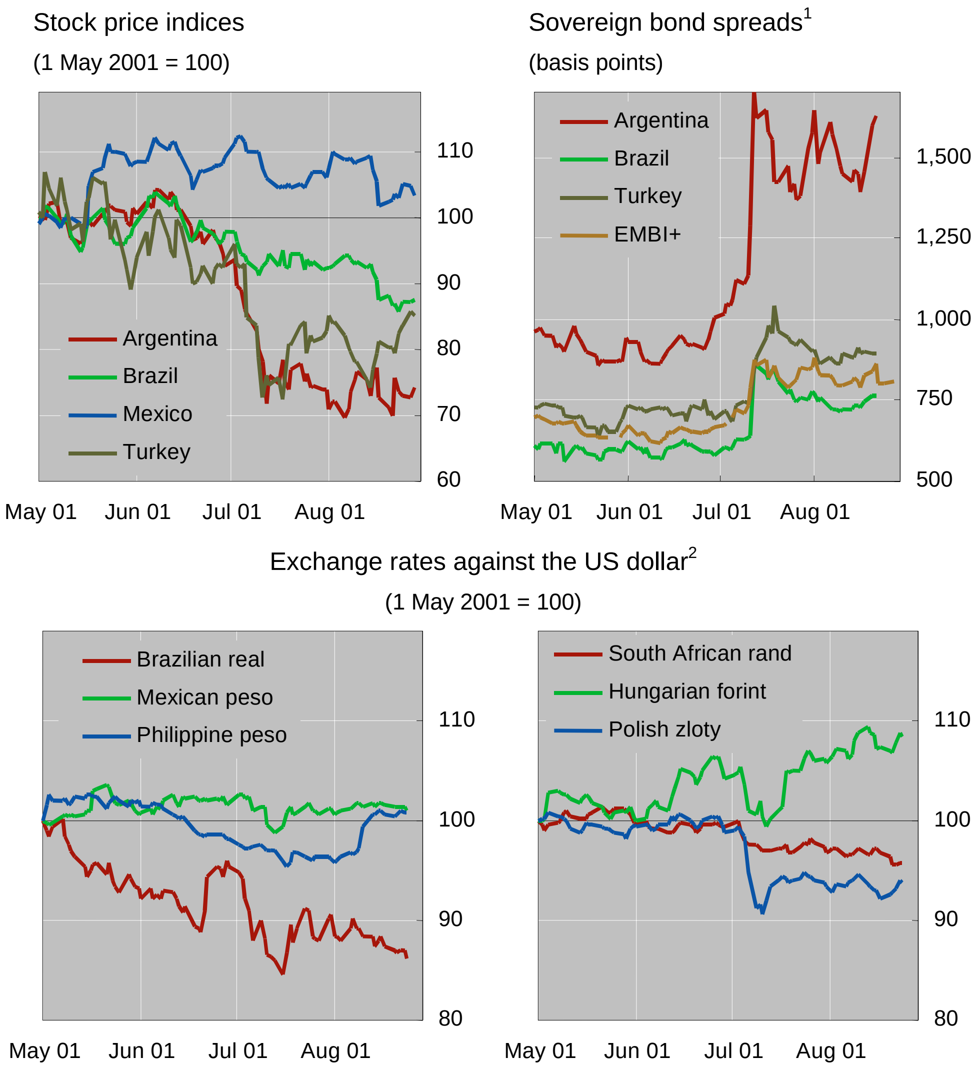
Selling pressure hit a surprising number of emerging markets, with spillover effects somewhat more in evidence in July than earlier in the year. Those currencies already under pressure, such as the Turkish lira and Brazilian real, depreciated sharply. The Polish zloty, which had been one of the year's best performing currencies, fell by 4% against the dollar, apparently as speculators began to reverse carry trades funded with euro and Swiss franc loans. However, previously unaffected currencies, such as the Mexican peso, Hungarian forint and South African rand, began to weaken as well (Graph 1.3). One reason for the spread of the turmoil seems to have been heightened risk aversion vis-à-vis emerging markets, especially countries with problems related to domestic debt. In the case of the South African rand, the impact of these concerns was compounded by the use of the rand as a proxy for other African currencies. Nonetheless, most prominent emerging economies in Asia were largely spared these contagion effects.

... although still limited

The contagion, however, remained limited in scope and was also short-lived. Within days, international investors seemed to be again differentiating carefully between sovereign risks. A resolution of the dispute between Turkey and the IMF and the approval of a reduced government budget in Poland led to some recovery in emerging market asset prices.

The episode of contagion came after a period in which emerging market borrowers had started to return to capital markets in a significant way. Many major emerging economies had refrained from significant borrowing since the Russian moratorium in 1998 (Graph 1.4). In the second quarter of 2001,

Stock prices, foreign debt and currencies of emerging economies

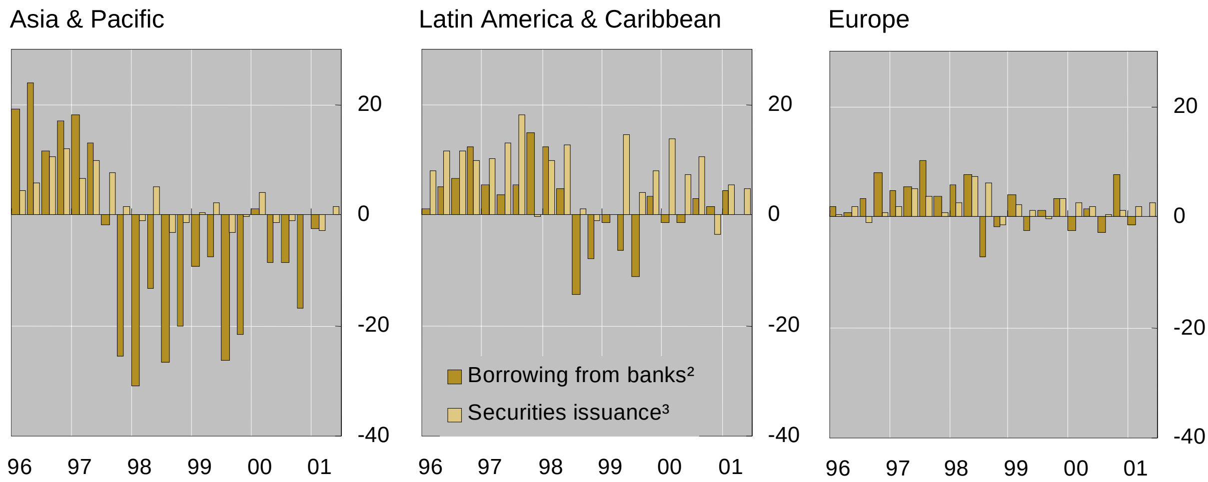


[1] Ten-year US dollar bond spreads over swap rates. [2] An increase indicates an appreciation against the US dollar.

Sources: Bloomberg; Datastream. Graph 1.3

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 second quarter of 2001. [3] Net issues of international money market instruments, bonds and notes.

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

Graph 1.4

Mexico and Brazil return to the market

developing countries issued $10 billion in debt securities. The turmoil in July at first made it seem less likely that this return to the capital markets would continue. By August, however, both Mexico and Brazil had successfully launched large issues. The reception international investors gave Mexico's $1 billion 30-year bond and Brazil's ¥200 billion two-year samurai issue, so soon after the troubles in Argentina and Turkey, showed a rather resilient market.

US dollar begins to waver

Unwinding of carry trades a possible factor …

The US dollar first seemed to waver during the Argentine and Turkish crises. It fell by 2.7% against the euro during the height of the crises from 6 to 11 July. Some market participants attributed this movement to the unwinding of carry trades involving exposures to Poland. In these carry trades, although short-term interest rates in euros had been higher than those in dollars, speculators may have chosen to borrow in euros because of the high correlation between this currency and the Polish zloty. Unwinding these trades meant selling Polish assets and buying euros, leading to the euro's strength and the appearance of dollar weakness.

… but subsequent dollar depreciation seems primarily driven by the growth outlook

Soon afterwards, the dollar began to weaken more broadly against the other major currencies. From its early July highs to 20 August, it declined by a total of 9.1% against the euro and 4.6% against the yen. This represented only a partial reversal of its previous appreciation, as the dollar remained 22.7% stronger against the euro and 7.1% stronger against the yen than it had been at the start of 1999. Nevertheless, there were signs that many of the factors that had contributed to the dollar's strength over the previous two years had begun to exert less influence on market views. Thus, continued weak macroeconomic indicators led market participants to revise expectations of a quick return to growth in the United States. A downward revision to past productivity growth estimates also led them to question the formerly prevailing opinion that, once the current slowdown was over, GDP growth would again be significantly faster in the United States than in other developed economies. As stock markets continued to decline, retail investors and acquisition-minded executives began to lose their enthusiasm for US corporate equity. Attention became focused on the sustainability of cross-border flows into US corporate bonds, which were thought to have been a factor in the dollar's strength in the first half of 2001. Market uncertainty regarding the official stance towards exchange rates may also have contributed to the dollar's decline in July.

Fixed income markets harbour more confidence

Monetary policy boosts confidence in fixed income markets ...

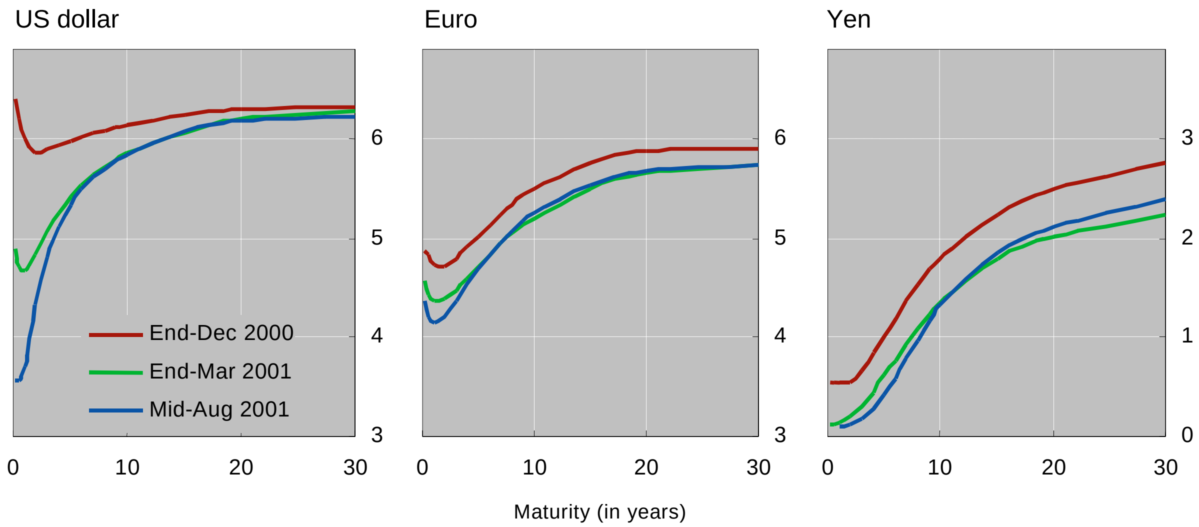
The gloom in equity markets and in the emerging economies contrasted with qualified optimism in fixed income markets. Over the first six months of the year, the US Federal Reserve had reduced its policy target rate by 275 basis points, culminating in a 25 basis point cut on 27 June. The ECB and the Bank of England also reduced their policy rates. The Bank of Japan, having announced in March a shift towards a more aggressive "quantitative easing" policy, went further in August by saying it would increase its purchases of government securities and allow a further rise in bank reserves. By late summer, participants in fixed income markets tended to conclude that these trends towards monetary easing would be sufficient to prevent the slowdown in the principal economies from deepening further. Nevertheless, views on the precise timing of the resumption of faster growth continued to be clouded with uncertainty.

... with steep yield curves suggesting cautious optimism

Reflecting this relative optimism, swap yield curves in US dollars, euros and yen tended to steepen (Graph 1.5). In the United States and the euro zone, the steeper yield curves incorporated hopes of a relatively rapid economic recovery, even if talk of a V-shaped turnaround was heard less often. During the first half of 2001, while the short-term ends of the dollar and euro yield curves shifted downwards significantly, longer-term yields declined only slightly or not at all. In part, the persistence of high long-term yields reflected specific, transient factors, notably a decline in the expected pace of debt reduction in the United States. Concerns about heightened inflation risks may also have played a role in keeping up long-term rates. Nevertheless, it was striking that both the surprise cut in policy rates announced by the Fed on 18 April and the rate cut by the ECB on 10 May only lowered the short ends of the dollar and euro yield curves without reducing long-term yields, thus causing a steepening of the curves. In Japan, by contrast, the steeper yield curve was a result of higher long-term yields, probably reflecting the anticipation of continued high levels of government borrowing.

Yield curves for interest rate swaps[1]

In percentages



[1] For three-month, six-month and one-year maturities, Libor rates.

Source: Bloomberg. Graph 1.5

These slope movements point to the important role played by monetary policy, and the expected medium-term reaction of the economy, in the recent evolution of benchmark yield curves in the major economies. The steeper yield curves were more or less unchanged during the summer, even as current macroeconomic conditions worsened, suggesting that market participants retained their confidence in the underlying scenario for the future.

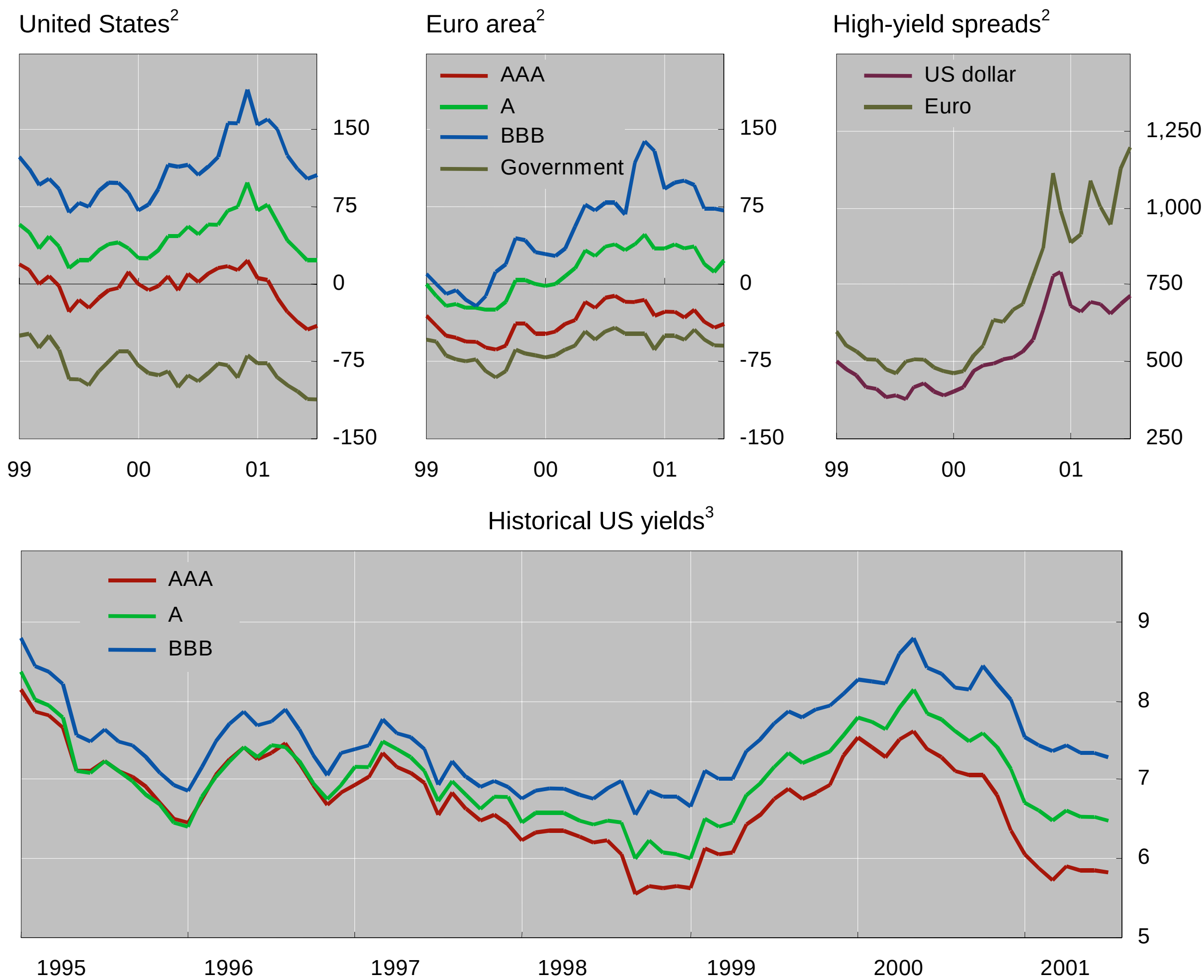
Corporate bond market remains resilient

Corporate spreads narrow steadily ...

The easing of monetary policy in the United States, the United Kingdom, the euro zone and Japan appears to have had strong effects on valuations in the corporate bond market. Over the first half of 2001, while equity market rallies proved short-lived, investment grade credit spreads in the bond market narrowed steadily (Graph 1.6). From the beginning of 2001 to end-July, the spreads of A-rated corporate bond yields over swaps declined from 71 to 24 basis points for dollar-denominated issues, and from 35 to 23 basis points for issues denominated in euros. In contrast to the experience during 2000, spreads on telecommunications company debt narrowed in line with those of other firms for most of the first half of 2001, though some telecoms issues, particularly those rated BBB and lower, continued to be shunned by investors. The low levels of yields available on short-term instruments and the persistence of low returns in equity markets appear to have been enough to prompt a favourable re-examination of corporate credit risk by investors, even as they remained sceptical with regard to corporate earnings prospects.

Corporate and government bond spreads[1]

Month-end data



[1] Bond index yields against 10-year swap rates. [2] In basis points. [3] In percentages.

Sources: Bloomberg; Merrill Lynch; national data. Graph 1.6

Spreads in the commercial paper (CP) market, which had widened sharply at the end of 2000 and in the first quarter of 2001, also narrowed gradually during the second quarter and had virtually disappeared by early June. The market shocks experienced around the turn of the year, which had reflected the downgrades and defaults of technology firms, electricity utilities and companies with exposure to asbestos lawsuits, eventually receded.

... despite the high default risk implied by equity prices

The difference in investor sentiment between bond and equity markets could be seen in measures of default risk that rely on stock price information on individual companies. Such measures showed little or no appreciable decline in default risk in recent months (Graph 1.7) even as credit spreads narrowed. This difference may have reflected investors' unpleasant experience with equity markets over the past year, along with profound uncertainty about the earnings prospects of many large technology companies. Some telecoms operators were reported to be having difficulty carrying out their plans to reduce debt through asset disposals.

In accepting narrower long- and short-term credit spreads, investors also appear to have discounted rising measured default rates. Moody's reports that 7.7% of speculative grade issuers – 9.4% in dollar-weighted terms – defaulted in the 12 months to end-June 2001. In both issuer and dollar-weighted terms, default rates on speculative grade issues rose to twice their annual averages over 1995-2000. For 2001 as a whole, Moody's forecasts an increase in the default rate for speculative grade issuers to nearly 10%. At the same time, the number of firms downgraded into the speculative category has been increasing slowly but steadily; from July 2000 to June 2001 the number of issuer downgrades exceeded that of upgrades by more than 2%.

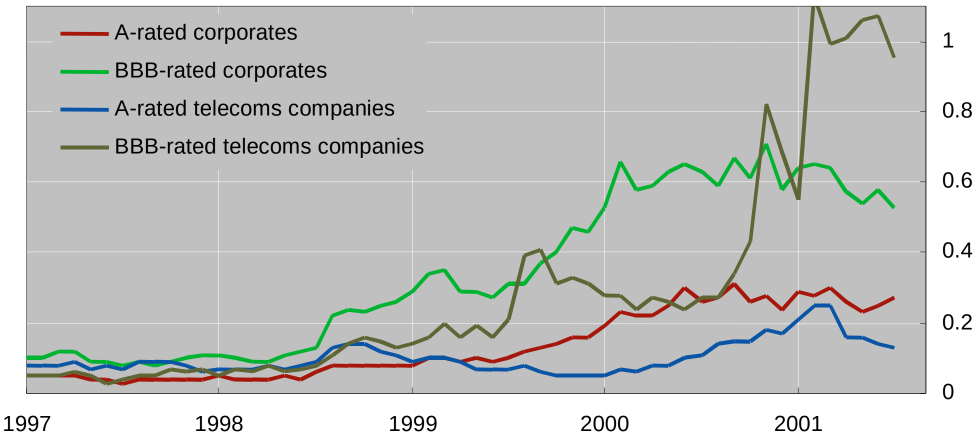
Banks remain willing to lend ...

Banks, like bond investors, remained willing to take on corporate credit exposure. After having declined in the first quarter, syndicated lending grew in the second (see "Syndicated credits: US borrowers return in the second quarter" on page 22). This followed a strong increase in cross-border lending to non-banks in the United States and, to a lesser extent, Europe in the first quarter, which was surprising given that announcements of new syndicated facilities had been weak. It appears that some corporations drew on already committed bank lines in the first quarter, then refinanced this debt with long-term bonds and new syndications in the second. There was also an increase in interbank lending, apparently related to the financing of dealers' corporate bond inventories as investors increased their purchases of long-term securities (see Section 2).

Private sector borrowers took advantage of the favourable conditions in the corporate bond and syndicated loan markets. With investors scrambling to add corporate bonds to their portfolios, corporations floated a record amount of

Implied default probability[1]

In percentages



[1] Median default probability for a one-year horizon based on KMV's expected default frequencies. The probabilities are estimated from Robert Merton's equations, which include market valuation of equity, equity volatility and leverage.

Source: KMV. Graph 1.7

long-term debt securities on international markets during the first half of the year. Gross issuance of bonds and notes by non-financial corporations on the international market totalled a record $156 billion in the second quarter of 2001, a small increase over the amount issued in the first. Yen-denominated issuance rose especially strongly in the second quarter and into July, in response to the persistence of low funding costs in yen. Some borrowers who had suffered reduced access to the unsecured CP markets at the turn of the year were able to find funding through asset-backed structures. Even in the junk bond market, where credit spreads have been high and volatile, corporate issuance was strong. Roughly $50 billion was issued on the US domestic high-yield market in the first half of the year, compared with $48 billion in the whole of 2000.

While the strength of *gross* issuance reflected a receptive market, a decline in *net* issuance also showed that the slowing global economy was beginning to dampen demand for financing. Net issuance by non-financial borrowers declined slightly as repayments increased, with corporate borrowers often using the proceeds to pay off their maturing long-term debt as well as their CP obligations (see Section 3). Despite the rise in syndicated lending in the second quarter, net issuance by financial institutions fell sharply, indicating that while banks did not withdraw from lending to the corporate sector, they also did not perceive a large enough volume of new lending opportunities to justify a significant expansion of their balance sheets.

… but lack lending opportunities