Financial market developments

- *Government bond prices in most major markets continued to fall during the third quarter, as stronger growth rates led to concerns about inflation and uncertainty over interest rate movements. There were also fears in many markets about a potentially heavy supply of debt.*

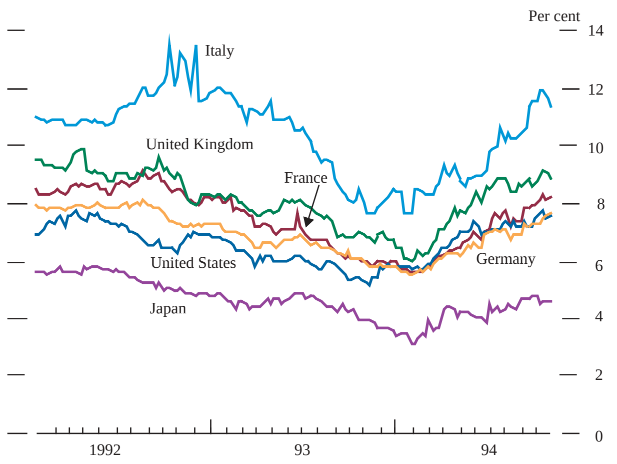
- *As in the second quarter, issuing activity in the international capital markets was at a subdued level because of market turbulence.*

- *Prices in most major equity markets remained weak; and the level of new issues continued to be low.*

Overview

The major bond markets were slightly calmer throughout the third quarter than earlier in the year, but uncertainty persisted. The US bond market weakened, as inflation expectations increased and the timing of future interest rate changes remained uncertain to market participants. This may have contributed to price falls in most European bond markets, which were also influenced by uncertainty about interest rates and persistently high public sector deficits. Despite the major economies being at markedly different points in the cycle, movements in their government bond prices remained highly correlated during the quarter, with prices continuing their downward trend (see Chart 1).

Chart 1
Ten-year government bond yields



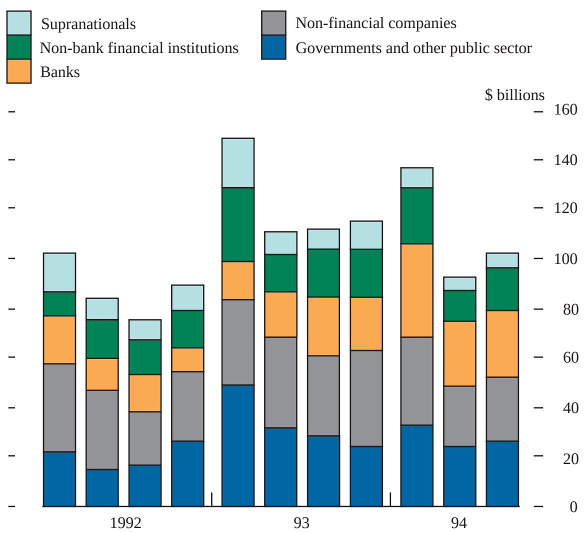
Source: Bloomberg.

Most major equity markets rose during the first two months of the quarter because of the favourable economic background, but fell back in September. Of them, only North American and UK markets managed price rises over the quarter as a whole.

Real government bond yields in the major industrial countries have risen to historically high levels during 1994. Partly in response to this, the Group of Ten industrial countries recently adopted a proposal by the Chancellor of the Exchequer to study global savings and investment trends, and their implications for real interest rates.

The level of new issues in the international capital markets remained subdued. The uncertain market environment led to a shift of funds into shorter-term assets. Among currency sectors, there was a shift in composition towards yen bond issues and away from European currencies. And there was some switching towards floating-rate borrowing, reflecting falling fixed-rate bond prices and investor demand for floating-rate instruments in an environment where interest rates were expected to rise. Sovereign borrowers were again prominent in the international bond markets, while corporate borrowing remained subdued (see Chart 2). Emerging market borrowers continued to find issue conditions difficult, although total borrowing by such issuers increased slightly.

Chart 2
Borrowers in the international bond market



Source: Bank of England ICMS database.

Ordinary share issues by UK companies fell from the high levels seen earlier in the year, perhaps because those earlier issues had sated issuers' immediate demand for funding and because company profits had been boosted by economic recovery. Likewise, few equity-related bonds were issued in the international markets. The improvement in most major economies, and in banks' balance sheets and profitability, meant that announcements of international syndicated credits continued to be strong, even though bank credit in the United Kingdom remained subdued.

Bond market developments: prices and yields

Prices in the major government bond markets continued their recent downward trend in the third quarter, led by falls in the United States that reflected market concerns about inflation and interest rate movements. European markets were affected by a view that the low point of the present interest rate cycle might already have been reached. In addition, there were growing concerns about the supply of debt in some markets, notably in continental Europe and Japan. The prices of Japanese government bonds fell in parallel with other markets—in contrast to the second quarter—suggesting that market comment earlier in the year about the decoupling of bond markets might have been premature.

The prices of US Treasuries continued to fall over the quarter; in September, the yield on the 30-year long bond peaked at 7.85%—its highest since 1992. After the Federal Reserve's decision to raise both the federal funds rate and the discount rate by 50 basis points (to 4.75% and 4% respectively) on 16 August, the (positively-sloping) yield curve flattened: the yield differential between ten-year and three-month rates fell by 26 basis points over the quarter, to just over 280 basis points. But Treasury bond prices continued to fall, reflecting doubts about whether the authorities' action was sufficiently timely. And the market continued to be sensitive to data on the pace of growth and to any signs that further rate rises might be necessary. By the end of the quarter, eurodollar futures suggested that market participants expected further rises in short-term interest rates—of around 50 basis points—before the end of the year.

Japanese government bond prices fell steadily throughout the first part of the quarter. Concerns about potentially high bond supply—particularly of government debt—unsettled the market and counteracted the positive effects of low inflation and the strength of the yen. But the continued weakness of share prices—which were also affected by fears of oversupply—led some institutional investors to switch out of equities into bonds, prompting a tentative rally in government bonds towards the end of the quarter. Over the period as a whole, the yield on the ten-year bond rose by 30 basis points.

In Germany, Bund prices fell sharply in the last two months of the quarter, as it became apparent that further interest rate cuts were unlikely in the immediate future; the view that much of continental Europe had begun to move into the upward phase of the interest rate cycle strengthened as a result. Uncertainty over the direction and timing of the next interest rate move adversely affected the market; the yield on the ten-year Bund reached a high point for the year of 7.71% towards the end of the quarter.

Prices in most other continental European bond markets continued to fall during the quarter, depressed by expectations of increases in official interest rates. Futures prices appeared to suggest a market view that short-term interest rates had reached their low point not only in those countries that had already raised rates, but also in Germany and France. This view reflected a growing belief in the onset of economic recovery in continental Europe. Interest rate rises in Italy and Sweden on 11 August were unfavourably received by bond markets: yields on both countries' debt rose more sharply than elsewhere. Concerns about public indebtedness, and about the effects of higher short-term interest rates on the governments' debt-servicing costs, were pronounced in both countries.

International bond issues

$102 billion was raised in the international bond markets during the third quarter, an increase of $10 billion over the second quarter, which indicated some steadying of the markets after the conditions earlier in the year (see Table A). Fixed-rate borrowing totalled $80 billion despite the continuing interest rate uncertainty. The volume of yen-denominated fixed-rate issues was unusually strong, probably reflecting the low yields on yen issues and perhaps expectations about the exchange rate (see Table B). The bulk of the straight bonds issued were—as in the second quarter—of short maturity, in response to investor demand

Table A
Total financing activity:(a) international markets by sector

$ billions; by announcement date

	1992	1993		1994		
	Year	Year	Q4	Q1	Q2	Q3
International bond issues						
Straights	281.5	375.7	82.6	77.1	68.6	79.9
Equity-related	24.0	39.6	12.0	20.7	5.7	4.1
of which:						
Warrants	*18.3*	*20.8*	*5.3*	*8.2*	*0.8*	*0.7*
Convertibles	*5.7*	*18.8*	*6.8*	*12.5*	*4.8*	*3.4*
Floating-rate notes	43.2	68.5	20.3	38.7	17.8	17.9
Bonds with non-equity warrants (currency, gold, debt)	1.2	1.5	0.1	0.1	—	—
Total	**349.9**	**485.4**	**115.1**	**136.6**	**92.1**	**101.7**
Credit facilities (announcements)						
Euronote facilities	113.2	117.4	55.9	35.7	46.0	40.2
of which:						
CP	*21.5*	*24.2*	*12.2*	*3.9*	*15.4*	*10.9*
MTNs	*90.8*	*92.7*	*43.6*	*31.9*	*30.6*	*29.3*
NIFs/RUFs	*0.9*	*0.5*	*0.1*	—	—	—
Syndicated credits	221.4	221.2	55.0	52.0	64.5	59.3
Total	**334.6**	**338.6**	**110.9**	**87.7**	**110.5**	**99.5**
Memo: amounts outstanding						
All international						
Bonds (b)	1,686.4	1,847.9	1,849.6	1,977.4	2,060.1	. .
Euronotes (c)	173.1	255.8	255.8	289.8	330.3	378.7
of which, EMTNs	*61.4*	*146.6*	*146.6*	*177.9*	*216.5*	*259.4*

. . not available.

(a) Maturities of one year and over. The table includes euro and foreign issues and publicised placements. Issues which repackage existing bond issues are not included. Figures may not add to totals because of rounding. Bond total includes issues from MTN programmes.
(b) BIS-adjusted figures, including currency adjustment. Includes issues of fixed-rate bonds and floating-rate notes.
(c) Euroclear figures.

for bonds which hold their value better in an environment of falling prices.

Table B
Currency composition of fixed-rate bond issues(a)

Percentage of total issues announced

Currency denomination	1992 Year	1993 Year	Q4	1994 Q1	Q2	Q3
US dollar	32	30	28	24	24	27
Deutsche Mark	11	13	16	13	4	6
French franc	8	11	12	13	12	4
Sterling	6	8	6	12	4	4
Yen	14	13	16	8	28	32
Italian lira	2	3	2	6	5	6
Canadian dollar	6	8	5	5	6	4
Ecu	7	3	2	4	3	2
Swiss franc	5	5	5	2	4	5
Other	9	6	8	13	10	11
Total	**100**	**100**	**100**	**100**	**100**	**100**

(a) Excluding equity-related issues.

The volume of international floating-rate note (FRN) issues in the third quarter was almost the same as in the second—at just under $18 billion, with nearly half dollar-denominated. Such issues were popular with investors as a means of protecting themselves against future rate rises; issuers could still obtain fixed-rate costs using the swaps market.

Fixed-rate issues

US dollars

After a weak second quarter, the volume of dollar-denominated international issues recovered to $21 billion. Sovereign borrowers continued to be prominent in the dollar sector. 36% of borrowing was by public sector entities, reflecting their continuing borrowing needs despite pre-funding earlier in the year.

A notable development in the international primary market was the return of a group of highly-rated borrowers whose issuance is potentially very sizable. US federal agencies, including the Federal National Mortgage Association (‘Fannie Mae’) and the Federal Home Loan Mortgage Corporation (‘Freddie Mac’), have recently sought to diversify their sources of funding by launching large international issues. This development may have consequences for the terms and conditions that other borrowers face in the future, as the agencies are among the largest issuers of debt in the world. Their issues form a large proportion of borrowing in the US domestic bond markets—considerably more than the entire investment-grade corporate sector—but until this year no agency had launched an international issue since 1989. Since the spring, they have made a number of global bond issues of $1–1.5 billion. The rationale for these large issues is that they are likely to be more liquid over the term of the bond and to appeal to a wider variety of investors; they therefore offer the prospect of lower funding costs.

Several eurodollar issues by Japanese government guaranteed entities were, however, less well received by investors when they were launched in September, largely because of concerns about future supply of similar-maturity paper from comparable Japanese entities.

Yen

At $26 billion, borrowing in Japanese yen was strong in the third quarter. This reflected high issue levels during the first two months of the quarter; there was a relative dearth of issues in September, as the end of the half-yearly accounting period approached at the end of the month. The strength of the currency was the main stimulus to overseas demand for yen-denominated issues; investment was also boosted by Japanese investors repatriating funds before the end of the accounting period. The low yields and continuing deregulation of the yen markets may also have made such issues more attractive to borrowers.

There was at the same time a clear trend away from Samurai bonds (yen-denominated bonds issued in the Japanese domestic market by a foreign borrower), which in recent years had accounted for up to a third of international yen offerings. Foreign borrowers have increasingly preferred to issue in the euroyen sector: Samurai issuance fell 56% between the first half of 1993 and the first half of 1994, and new issuance has not recovered to its former level. In July, it was $2.8 billion out of total international yen issues of $15 billion. The shift has been largely the result of regulatory changes earlier in the year which removed the ‘lock-up’ period(1) for foreign public sector borrowers; euroyen issuance by Japanese borrowers has similarly been made easier by the easing of rating restrictions. The euroyen sector was also buoyed by banks shifting their portfolios from listed government debt into unlisted euroyen issues, in the light of a Tokyo Stock Exchange disclosure rule which would have meant revealing trading losses made in the first six months of the year.

European currencies

The share of fixed-rate issuance in European currencies fell to 34% during the quarter, compared with 42% in the second quarter. There were no fixed-rate offerings in the French franc sector until late in the period; swap opportunities were unattractive, and many major franc borrowers had already completed their funding programmes. There were likewise few Deutsche Mark issues—a total of only $4.9 billion over the three months—as the outlook for German interest rates remained uncertain. Eurolira issues picked up to $4.4 billion in the period, in spite of growing market concerns over Italian political stability; the issues were targeted at retail investors attracted by the high coupons relative to other sectors. The Swiss franc sector was also active with $4.2 billion of issues. Borrowers were attracted by favourable swap opportunities, investors by a number of high-quality issuers and attractive coupons.

Sterling debt issuance in July was quite substantial at £1.9 billion, of which the vast bulk was eurosterling; some

(1) Prior to the change, euroyen bonds could not be sold to Japanese domestic investors for a period of 90 days after issue, though issuers regularly sought to circumvent this rule by ‘warehousing’ bonds—registering investor interest on the day of issue but only delivering the bonds after 90 days. Issues by public sector entities became exempt from these 90-day ‘seasoning’ restrictions with effect from 1 January.

two thirds of this was issued by UK borrowers. British Telecom announced a £300 million long-dated fixed-rate issue to refinance its liability position, having purchased a tranche of its outstanding debt back from HM Treasury in its auction of privatised utilities' debt. August was a far quieter month, with only £0.5 billion of new issues announced; but in September borrowing rose to £1.5 billion.

The attraction of asset-backed floating-rate debt issued through special-purpose vehicles continued to be evident, with mortgage-backed issues by Residential Property Services (in three tranches totalling £500 million) and Household Mortgage Corporation (£210 million, again in three tranches) and £66 million of consumer loan backed bonds by First 4 plc. Outstanding issues in the sterling CP market declined slightly to £5.6 billion at the end of the quarter. Total outstandings of sterling MTNs rose again to £11.1 billion.

In the Ecu sector, activity was very subdued and concentrated in high-quality short-term instruments. The Bank's monthly Ecu Treasury bill auctions continued to be oversubscribed at all three maturities on offer, with overall cover of at least two times at each auction, at levels of around Ecu Libid to 10 basis points below Ecu Libid. ECU 200 million of one-month, ECU 500 million of three-month and ECU 300 million of six-month bills were on offer at each tender. There are currently ECU 3.5 billion of Ecu Treasury bills outstanding across the maturities. Monthly turnover averaged over ECU 2 billion in the quarter. Liquidity in all three of the outstanding Ecu Treasury notes—maturing in 1995, 1996 and 1997—has been fairly steady, with turnover of around ECU $1\frac{1}{2}$ billion a month.

Among the United Kingdom's other foreign currency debt, the DM 5.5 billion five-year and US $3 billion ten-year bonds, launched in 1992 to complete HMG's ECU 10 billion borrowing programme, have continued to trade well since launch. Over the third quarter, they remained liquid and continued among the more actively traded Eurobond issues settled through the international settlement systems.

Floating-rate notes

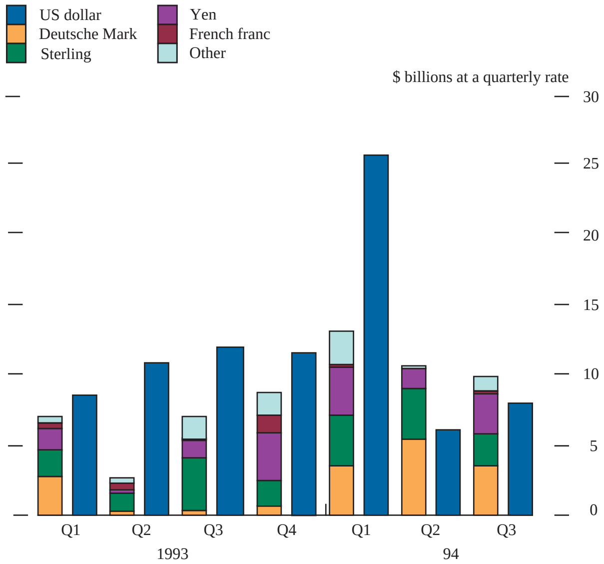
Floating-rate note (FRN) issues rose marginally to $17.9 billion in the third quarter; almost half of the issues were dollar-denominated (see Chart 3). In an environment of rising short-term interest rates, FRNs are attractive instruments for investors. Borrowing in FRNs had faltered during the second quarter, but in recent months activity has picked up again as interest rate uncertainty continues to lead investors to seek defensive strategies. Few structured FRNs have been issued in recent months; they accounted for less than 5% of floating-rate issues during the quarter.

Other debt

Equity-linked debt

The convertible market continued to be subdued, with $3.3 billion issued in the period, as European borrowers

Chart 3
Currency composition of floating-rates issues



Source: Bank of England ICMS database.

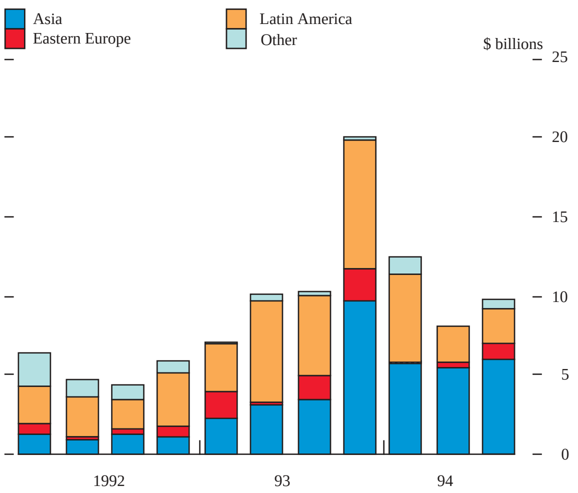
continued to be almost entirely absent. The Swiss franc/yen dual currency convertible sector opened in the first week of July: issues are denominated and pay coupons in Swiss francs, but repay principal in yen at a predetermined exchange rate. The sector was viewed as potentially attractive because of changes in Japanese accounting rules that made issuing bonds with attached equity warrants more expensive. The sector had become almost inactive by the middle of July, however, as early issuance sated demand; Swiss investors were viewed as having a preference for Swiss franc issues, and the very low coupons also deterred demand. Issue volumes of bonds with attached equity warrants continued to be depressed, partly reflecting the changes to Japanese accounting rules; issues totalling just $0.7 billion were made.

Emerging markets

Conditions continued to be difficult for fixed-income issues by emerging-market borrowers; there were several predictions of market recovery, but this proved elusive. The market was affected by the continuing uncertainty affecting US Treasuries, and new issues were generally difficult to place. Many emerging-market borrowers interested in issuing resisted paying the spreads on offer.

Non-OECD international bond issues totalled $9.8 billion during the period, almost two thirds of which was by Asian borrowers (see Chart 4). Some countries—including Nigeria and Venezuela—continued to be seen as very risky; in July, the Venezuelan par bond was trading at a spread of almost 1,500 basis points over US Treasuries, compared with 530 basis points at the start of the year. There was positive news from Brazil, which decided not to go ahead with a planned $1 billion eurobond issue, because of strong capital inflows following the better-than-expected performance with its new economic programme. The Republic of Argentina successfully launched a eurolira issue. In secondary market trading, the Salomon Brady Bond Index, which gives an

Chart 4
International bond issues by non-OECD borrowers



Source: Bank of England ICMS database.

indication of the general movement of prices, rose 14.3% over the quarter, but was still 9.6% down on the year.

Syndicated credits

Announcements of international syndicated credits continued to be relatively strong in the third quarter; they totalled $59.3 billion. On the supply side, the market was encouraged by banks' improved profitability and balance sheets which led to an increased willingness to lend. On the demand side, improvement in most major economies led to increased demand from industrial and commercial companies, which normally account for over three quarters of the market. LDC borrowers accounted for 13% of borrowing.

Eurocommercial paper and euromedium-term notes

The attractiveness of short-term assets in a period of turbulence was reflected in both the announcements of, and issues from, eurocommercial paper (ECP) and euromedium-term note (EMTN) programmes. This continued the trend of the previous quarter. Net borrowing from ECP programmes totalled $3.0 billion, bringing outstandings to $88.8 billion. Announcements of new ECP programmes totalled $10.9 billion. Net borrowing from EMTN programmes continued to grow, to $42.9 billion, bringing outstandings to $259.4 billion. Announcements of new EMTN programmes totalled $29.3 billion, broadly similar to the previous two quarters.

Equity markets

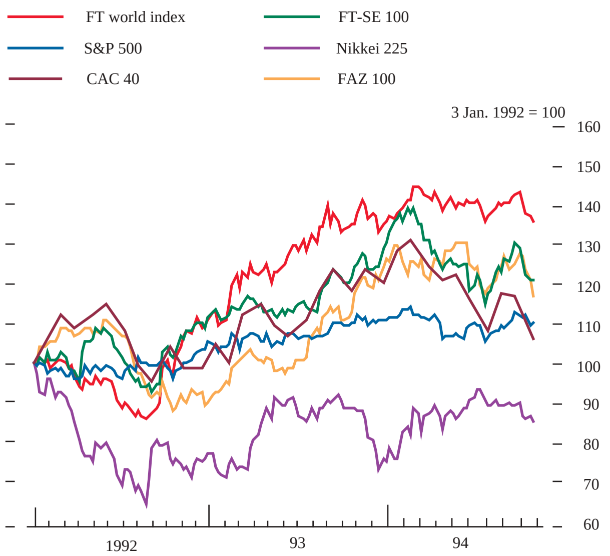
Equity prices in the G7 economies, affected by changing perceptions of interest rate movements and the pace of economic recovery, fluctuated throughout the quarter (see Chart 5). Prices in most major markets increased strongly in the first two months of the quarter, but all major indices declined in September. As a result, over the quarter as a whole North American and UK markets showed gains, but prices in the rest of the G7 fell. Overall, the FT-SE Actuaries world index rose 0.6% over the quarter.

The bilateral trade negotiations continued to be an unsettling factor affecting the US and Japanese equity markets early in the quarter. Uncertainty over interest rate changes and concerns about inflation gained weight as influences as the quarter progressed. The US market was boosted by domestic factors, including good company results and a well-received interest rate rise on 16 August. Data published during September offered mixed signals about the pace of growth, but prices fell following indications on the trade deficit and housing starts. The S&P 500 index ended 4.2% up over the quarter as a whole. In contrast, the Nikkei 225 fell 5.3% over the period in very thin trading. There was a shortage of favourable domestic news, and interest from foreign investors and public funds was sporadic.

European equity markets were affected by uncertainty over future interest rate movements—particularly towards the end of the quarter, after rate increases in both Italy and Sweden and as market participants viewed further cuts in German interest rates as increasingly unlikely in the near term. In Germany, the FAZ 100 ended the quarter down 1.6%, while in France the CAC 40 fell 0.7%. Political concerns added a further dimension in Italy, where the Comit index ended the quarter down 1.4%.

In the United Kingdom, prices rose steadily through July and August, but fell sharply in September (see Chart 5); as a result, the FT-SE 100 index rose by only 3.7% over the quarter. The market was initially buoyed by the favourable

Chart 5
Equity indices(a)

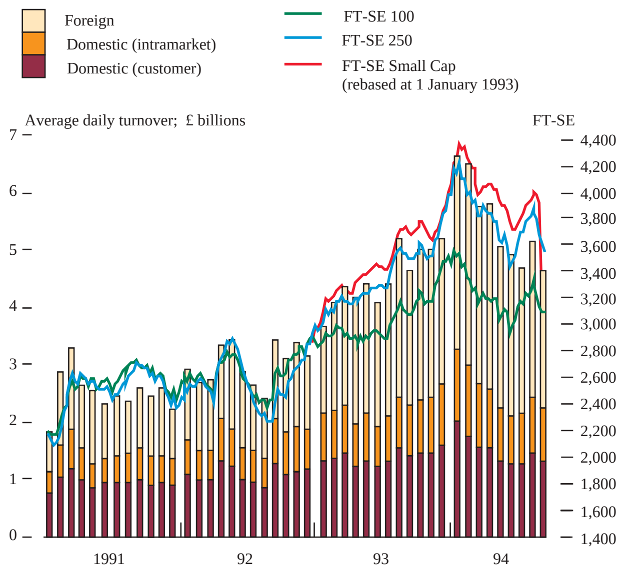


(a) End-week prices, except CAC 40 (end-month).

economic data releases and improved earnings prospects. These domestic factors reinforced the upward trend resulting from the generally favourable reception given to the US interest rate rise and stable German interest rates; the rate rises in Sweden and Italy gained a less favourable reaction. The increase in UK interest rates on 12 September also gained a favourable initial market reaction. But by the end of the quarter, prices had fallen again to the levels seen in mid-July.

Announcements of forthcoming equity issues by UK issuers totalled only £1.4 billion in the third quarter of 1994, compared with £4.2 billion in the second quarter and £5.3 billion in the first. UK companies announced

Chart 6
Equity turnover and prices on the London Stock Exchange



£0.8 billion of rights issues, including £0.3 billion raised by a UK insurance company to help fund its overseas expansion.

There were several notable structural developments. In August, the Stock Exchange announced the publication of new rules to promote the listing of Global Depositary Receipts (GDRs).[(1)] The rules are part of the Exchange's strategy to market itself to non-UK companies and strengthen London's position as an international trading centre. They are also a response to the increasing number of companies, particularly in developing economies, that use depository receipts to raise capital from international investors. To enable GDRs to be competitive with domestic securities, the listing requirements are less demanding than those for shares, and listing charges are also competitive with those on the home market. (Less-demanding listing requirements are possible because of the comparative sophistication of the investors involved.)

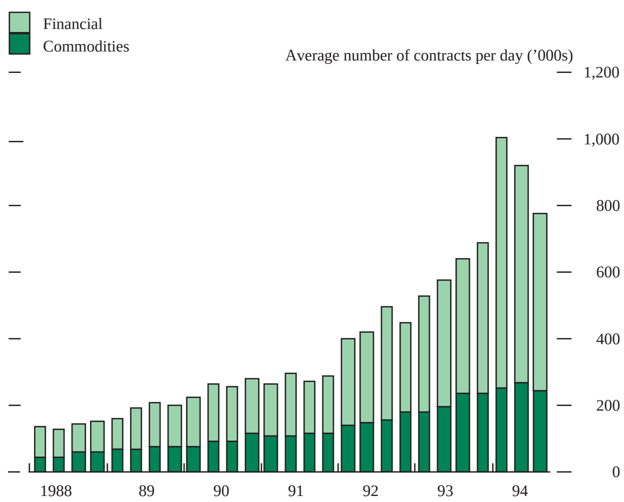
In September, the London Stock Exchange issued a consultative document describing the Alternative Investment Market (AIM), a proposed replacement for the Unlisted Securities Market (USM) which is due to close in 1996. The AIM is scheduled to begin operating in June 1995 and will provide small companies with a means of reaching a wide range of investors, both retail and wholesale, prepared to bear the greater risk associated with such companies.

To attract young companies with growth potential to the market, less stringent entry requirements than for the Official List are proposed. For example, no trading record prior to listing will be required, no minimum limit on company size will be imposed and the responsibility for the accuracy of company reports and news announcements will fall on company directors. Each application for listing must be accompanied by the sponsorship of a member of the Stock Exchange. The Stock Exchange sought comments on the consultative document by the middle of October.

Derivative exchanges

Interest rate uncertainty and concerns about inflation (highlighted by the fall in bond prices) provided the focus for the derivative markets during the quarter. Activity on London's derivative exchanges declined for the second successive quarter, but was still 17% higher than the same period in 1993 (see Chart 7). All LIFFE's major contracts posted declines in turnover in the third quarter, despite the volatility stemming from increases in interest rates in the

Chart 7
Turnover on the London derivative exchanges



United States, the United Kingdom and several continental European countries. It is possible that the decline in activity might indicate a return to more normal growth after an exceptionally strong first quarter, rather than a change in the medium-term growth trend.

LIFFE delisted its medium-term German government bond ('Bobl') future after the expiry of the September contract. Liquidity in the contract dried up in the third quarter, whereas the rival contract on the DTB (Frankfurt's derivative exchange) achieved daily turnover of just over 16,500 contracts. Two main factors seem to have contributed to the delisting of LIFFE's contract: the 15-month headstart of the DTB's contract (which allowed it to win liquidity) and the fact that the product's main appeal was to domestic German, rather than international, investors. LIFFE, however, retains its advantage in the

(1) A Global Depositary Receipt is a certificate which represents title to a specified number of shares in a foreign company. The underlying shares are held in custody by a financial institution, which receives any dividends and remits the proceeds to the holder.

trading of two other important Deutsche Mark contracts—the Bund ($8^1/_2$–10-year bond) and the Euromark (three-month interest rate) futures. LIFFE's market share of Bund and Euromark business was 71% and 98% respectively in the quarter.

OMLX (the London Securities and Derivatives Exchange) saw no trading in its contract on the FT-SE 250 index during the quarter. Both LIFFE and OMLX listed futures contracts on the index in the first quarter. After an initial flurry, OMLX's contract attracted low volumes; there was no turnover during the third quarter, and after the September rollover the open interest fell to zero. The turnover of LIFFE's contract has also been poor, with an average daily volume in the third quarter of only 145 lots.

The aggregate turnover on the London commodity exchanges (the LME, the IPE and the LCE) decreased by 9% in the quarter. Commodity price movements diverged: aluminium prices continued to rise, but copper and coffee sustained their July price levels. The oil price fell from $18 a barrel to just over $17 a barrel. There is some evidence that institutional investors have switched funds into commodities to enhance returns during the first three quarters of the year, encouraged by the fact that commodity prices tend to rise during periods of economic recovery.