Financial market developments

- *Developments affecting the Japanese markets, including the depreciation of the yen against the dollar, were the focus of attention for many market participants during the third quarter.*
- *Total gross debt issues continued to increase compared with their low levels last year and the recovery in emerging-market debt continued.*
- *Prices in most major equity markets rose strongly as expectations of further interest rate rises waned, but turnover was mixed; and on most major derivatives exchanges volumes were down.*

Overview

During the third quarter, the attention of many market participants was focused primarily on developments in Japan, with sentiment strongly influenced by the depreciation of the yen against the dollar.(1) But the other major bond markets were fairly settled in the period and total gross debt issues continued to increase after the generally low levels in 1994. In particular, international bond issues rose during the quarter and their average maturity increased. The recovery in emerging-market debt also continued: the Salomon Brothers Brady Bond index rose 6.6%, with Brazilian Brady bonds particularly strong.

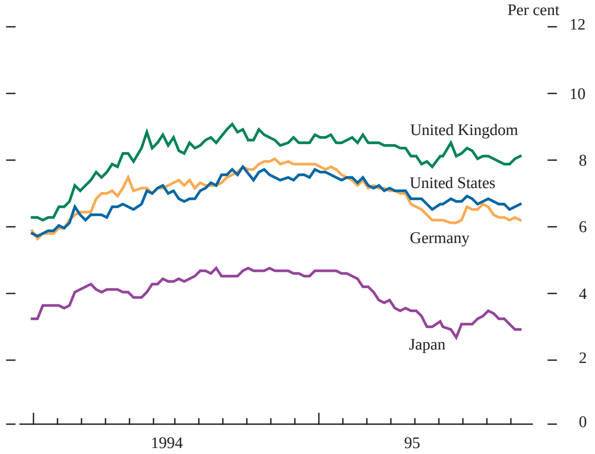
Prices rose strongly in nearly all the world's major equity markets during the quarter, as expectations of interest rate rises waned. Turnover on the US exchanges increased strongly, whereas—with the exceptions of Paris and Switzerland—turnover on most of the European exchanges fell slightly; and the fall in turnover on the Tokyo Stock Exchange was particularly striking. Equity issues with an international tranche increased in the quarter and are expected to remain buoyant.

Turnover on the world's major derivatives exchanges fell slightly during the quarter, with the exception of the main German derivatives exchange (the DTB). In particular, turnover on the Chicago Mercantile Exchange (CME) was down 16% compared with the second quarter.

Bond and other debt markets

The Japanese authorities' announcement on 2 August of measures to promote purchases of overseas assets led to expectations of higher Japanese investment in other major bond markets. The measures were interpreted in many quarters as a response to the strength of the yen against the dollar, and may have been one factor that contributed to the subsequent fall of the yen. Survey data suggested that many

Chart 1
Ten-year government bond yields



Source: Bloomberg.

investors began to lengthen their dollar, and shorten their yen, positions.(2) Ten-year Japanese government bond yields fell as low as 2.6% at the beginning of the quarter, 200 basis points lower than at the beginning of the year. They then rose to 3.4% by the middle of the quarter, but fell back to end the quarter at 2.9%. On 8 September, the Japanese government announced a large fiscal stimulus package in order to forestall disinflationary forces.(3)

The Federal Reserve's cut of 25 basis points in the federal funds target rate on 6 July led many market participants to conclude that the chances of any further reduction were evenly balanced, and there was no strong trend in yields over the rest of the quarter. Ten-year yields rose from 6.21% to just over 6.5% in mid-August, but fell again to 6.32% by the end of the quarter. In Germany, market sentiment continued to be dominated by signs of weaker economic growth. The Bundesbank cut its discount and Lombard rates by 50 basis points on 24 August. Yields on ten-year government bonds (Bunds) fell as low as 6.43%, but then recovered slightly to end the quarter down 25 basis points.

(1) For more detail on exchange rate developments during the quarter, see the review of the operation of monetary policy on pages 317–24.
(2) Source: Merrill Lynch Global Investor Survey.
(3) For more detail on this, see the review of the international environment on pages 331–38.

The spreads between most 'non-core' European (including Italian, Spanish and Swedish) government bonds and Bunds fell for most of the quarter. Greater currency stability led investors to treat some non-core markets as in effect high-yield Bunds—which increased demand for these bonds. So the spreads on ten-year Italian government bonds fell to 366 basis points, having been as high as 493 basis points in the second quarter, and Spanish government bond spreads were some 60 basis points lower than their average during the second quarter. But public discussion of the prospects for economic and monetary union (EMU) led to some turbulence—and widening of spreads—at the end of the quarter.

International issues

At \$121 billion, total international gross bond issues in the third quarter reached their highest level since the first quarter of 1994. The growth of floating-rate bond issues was particularly strong, with the ratio of floating to fixed-rate issues rising from 0.17 to 0.24 in six months. Announcements of syndicated loans totalled \$72 billion in the quarter (of which \$21 billion was accounted for by a single loan to an American corporate borrower), 29% below the peak of the first quarter of this year, but 21% higher than in the third quarter of 1994. The fall over the course of this year has been partly because borrowers have seen bond markets as an increasingly attractive alternative to loans. Total euromedium-term note (EMTN) announcements were up 29% on the same quarter last year, as the market continued to offer low fees to many of the more frequent borrowers.

The increase in issues was coupled with an increase in the average maturity of international issues, which rose to 6.2 years—its highest level since the second quarter of 1994. The average maturity of yen-denominated issues rose 76% compared with second quarter to 6.6 years; the average maturity of new dollar issues was 7.7 years.

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

\$ billions; by announcement date

	1994 Q1	Q2	Q3	Q4	1995 Q1	Q2	Q3
International bond issues							
Straights	77.1	68.6	75.0	75.6	81.7	82.7	92.3
Equity-related	20.7	5.7	4.0	2.8	2.3	4.6	6.7
of which:							
Warrants	*8.2*	*0.8*	*0.7*	*1.1*	*0.9*	*0.5*	*1.2*
Convertibles	*12.45*	*4.9*	*3.3*	*1.7*	*1.4*	*4.1*	*5.5*
Floating-rate notes	38.7	17.8	17.9	18.3	14.2	16.6	22.2
Bonds with non-equity warrants	0.5	—	—	—	—	—	—
Total	**136.5**	**92.1**	**96.9**	**96.7**	**98.2**	**103.9**	**121.2**
Credit facilities (announcements)							
Euronote facilities	35.7	46.0	40.2	71.4	54.9	62.8	75.9
of which:							
CP	*3.9*	*15.4*	*10.9*	*6.2*	*6.8*	*8.9*	*6.4*
MTNs	*31.9*	*30.6*	*29.3*	*65.2*	*48.1*	*53.9*	*69.5*
Syndicated credits	53.8	64.5	59.3	72.8	101.6	74.9	72.1
Total	**89.5**	**110.5**	**99.9**	**145.8**	**156.5**	**137.7**	**148.0**
Memo: amounts outstanding							
All international							
Bonds (b)	1,888.4	1,947.7	2,020.8	2,041.8	2,188.5	2,225.3	2,204.4
Euronotes (c)	289.8	330.3	378.7	406.1	461.6	517.1	555.8
of which, EMTNs	*177.9*	*216.5*	*259.4*	*292.0*	*347.1*	*397.5*	*426.4*

(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.

Since the start of 1994, banks have increased their share of international bond borrowing: by the third quarter, it was 31%, up from 28% in the same quarter a year earlier. Non-financial companies' share has also risen slowly, from a trough of 18% in the fourth quarter of last year to 24% in the third quarter of this—which was comparable with the figure for the first half of 1994.

The recovery in the market for emerging-market debt continued, with Latin American international bond issues again high, at \$6.3 billion, and improved secondary market conditions. Investor demand was strong as volatilities fell: the 90-day volatility of the Salomon Brothers Brady Bond index fell from a peak of 39% in April to around 17% at the end of September. The much smaller East European debt market benefited both from the general positive sentiment towards emerging-market debt and from Moody's rating of Polish sovereign debt at investment grade: East European bond issues totalled \$0.9 billion, down on the second quarter's peak, but 3.6 times higher than in the first quarter. Eastern European borrowers, such as Slovakia, also increasingly tapped the syndicated loans market. The first South African Rand-denominated international bond was issued.

Dollar issues

The proportion of dollar-denominated international bond issues rose to 38% over the third quarter, whereas yen-denominated issues fell to 19%; since the start of 1994, the yen's share of quarterly issues has varied from 8% to 25%. Market commentators suggested that a widening of dollar swap rates, after a period when they were narrow compared with recent years, encouraged borrowers to issue in dollars.

Table B
Currency composition of international bond issues

\$ billions

Currency denomination	1993 Year	1994 Year	Q2	Q3	Q4	1995 Q1	Q2	Q3
US dollar	175.6	147.3	26.2	30.6	37.3	30.6	32.8	46.4
Yen	58.7	77.8	20.7	23.9	22.1	13.6	25.4	23.5
Deutsche Mark	56.4	39.8	8.4	8.5	9.2	14.3	20.1	15.8
Sterling	42.6	29.5	6.6	5.3	4.1	6.5	4.5	4.9
French franc	42.3	28.7	8.5	3.1	3.5	4.8	3.2	2.5
Swiss franc	27.5	20.8	3.2	6.2	4.3	5.7	6.8	9.3
Italian lira	12.3	17.1	5.0	4.6	2.7	5.9	1.7	2.0
Ecu	11.4	7.6	1.8	1.5	0.9	2.9	0.2	2.7
Other	58.2	53.3	11.6	13.2	12.3	14.0	9.2	14.0
Total	**485.0**	**421.9**	**92.0**	**96.9**	**96.4**	**98.2**	**103.9**	**121.1**

Source: Bank of England ICMS database.

In the US domestic market, falling volatilities and generally improving conditions encouraged issuers. The asset-backed securities (ABS) and mortgage-backed securities (MBS) sectors benefited most, with the ABS market continuing its rapid expansion and the MBS market showing signs of recovery. ABS issues totalled \$27 billion in the quarter, 29% up on the same quarter in 1994, assisted by the growth in consumer credit. MBS issues totalled $15 billion, but were still down on the third quarter of 1994. Proposed legislation in the United States—already home to the biggest of these markets—would make it even easier to issue ABSs.

Yen issues

As Japanese domestic interest rates fell, Japanese investors continued to search for ways of maintaining returns on their portfolios. One option is to hold foreign currency assets; but in recent years such holdings have often resulted in losses, as the yen has appreciated. An alternative is to invest in the domestic equity market, but over the second quarter the Nikkei 225 index fell and Japanese investors turned to the yen-denominated eurobond market. During the third quarter, although the index recovered and the appreciation of the yen slowed, market reports indicated that Japanese demand for yen-denominated eurobonds remained high.

Sterling issues

Announcements of sterling bond issues totalled £3.0 billion in the third quarter, a fall of £354 million on the previous quarter. £2.05 billion of this quarter's total was in fixed-rate eurosterling form (£650 million of which was made up of issues by the regional electricity companies), £155 million was fixed-rate domestic bonds and £765 million floating-rate. Outstanding sterling commercial paper rose by £0.6 billion to £6.7 billion over the quarter and outstanding sterling issues of MTN programmes rose to £15.4 billion from £14.0 billion.

British Land launched an innovative 40-year first-mortgage debenture in eurosterling, which is a bearer, rather than a registered, security and therefore will allow overseas investors to participate. It also pays interest gross, so non tax paying investors will not have to wait to receive reclaimed tax. Two banking institutions launched £100 million perpetual subordinated debt issues over the quarter; each had an issuer call option, with a step-up coupon if the call was not made.

The most notable feature of the third quarter was the further tightening of spreads between corporate bonds and gilts in maturities over five years: the effect of the recent change in the Inland Revenue's regulations allowing a widening of the range of instruments eligible in PEPs continued to be felt,[1] as PEP managers began to purchase bonds for their issues. A large number of such PEPs have now been launched by a range of investment management houses.

Ecu issues

In the United Kingdom, there were regular monthly auctions of ECU 1 billion of Ecu Treasury bills during the third quarter, comprising ECU 200 million of one-month, ECU 500 million of three-month and ECU 300 million of six-month bills. The auctions were strongly oversubscribed, with issues being covered by an average of 2.5 times the amount on offer. Bids were accepted at yields up to 15 basis points below the Ecu Libid rate of the appropriate maturity—a somewhat wider spread than in the previous quarter. There are currently ECU 3.5 billion of Treasury bills outstanding. Secondary market turnover averaged ECU 2.0 billion a month, similar to volumes in the previous quarter.

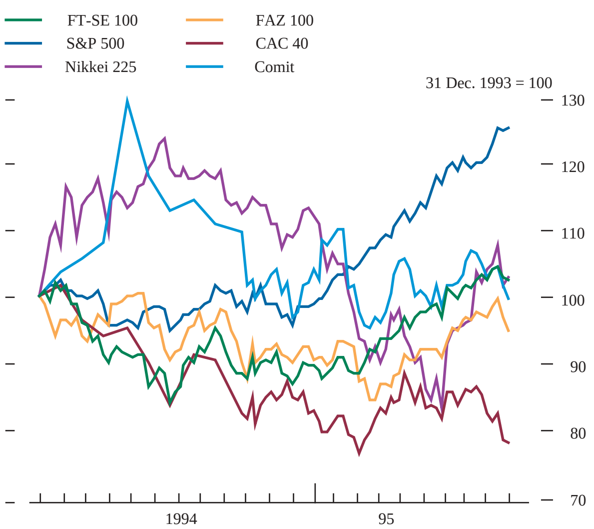
On 18 July, the Bank reopened the Ecu Treasury note maturing in 1998 with a further tender for ECU 250 million, raising the amount outstanding to ECU 1.75 billion. Cover at the tender was 10.2 times the amount on offer and bids were accepted in a range of 6.75%–6.77%. The total of notes outstanding under the UK note programme rose from ECU 6 billion to ECU 6.25 billion. Turnover in the notes continued to be higher than in 1994. The UK government's total outstanding Ecu debt rose from ECU 12.0 billion to ECU 12.25 billion over the quarter.

The French government issued ECU 1.8 billion in bonds and notes during the third quarter, taking its outstanding Ecu debt to ECU 20.8 billion (excluding stock bought back or held for repo purchases). The Italian government issued ECU 1 billion of notes, but because of redemptions the total outstanding fell from ECU 24.9 billion to ECU 23.4 billion over the quarter. In addition, the total of Italian government Ecu eurobonds outstanding remained at ECU 5.9 billion. Other Ecu issues included borrowings by the Kingdom of Sweden, and by French and German financial institutions.

Equity markets

In the United States, the Standard and Poor's 500 index rose by 7.3% during the third quarter. A strengthening of the dollar against the yen combined with better-than-expected company results led the index to reach a series of all-time highs, peaking on 20 September at 586.77; towards the end of the quarter, however, the rise was stemmed following the

Chart 2
Equity indices(a)



(a) End-week prices.

(1) For more details on this, see the review of financial market developments in the August 1995 *Quarterly Bulletin*, pages 242–43.

sharp weakening of the dollar. Technology shares were particularly strong: the NASDAQ index, which is heavily weighted in this sector, rose by 11.8% over the quarter.

The FT-SE 100 index rose by 5.8% over the period, reaching a record high of 3,570.8 on 13 September. Take-over speculation—especially in the utilities sector—was a major driving force behind this, underpinned by expectations that UK interest rates were unlikely to rise further in the short term and by the optimistic US sentiment. Again, at the end of the quarter prices declined from their peaks in response to international currency pressures.

The German equity market, as measured by the FAZ index, continued the strength seen in the second quarter: the index rose by a further 4.3%, helped by expectations of improved company profits and the interest rate cut on 24 August. The French market, however, continued its recent lacklustre performance—falling by 3.6% during the quarter—as political tensions and concerns about the fiscal deficit undermined the optimism which had accompanied the result of the presidential elections earlier in the year.

Italian and Spanish equity prices rose by 1.3% and 4.1% respectively, with the positive factors of lowered expectations of European interest rate increases and stabilising domestic political environments outweighing currency concerns. Scandinavian equity markets recorded a series of all-time highs, as rises in telecommunications shares were reported to be attracting foreign buyers; the market indices of all four main markets rose by over 5% during the quarter.

Japanese equity prices recovered markedly during the third quarter, with the Nikkei 225 index rising by 23.4% to levels last reached in February. As the yen weakened against the dollar, overseas investors returned to the Tokyo market, buying high-technology and other export-orientated company shares. Domestic investors, however, appeared more cautious about the stability of the financial sector, and this uncertainty—combined with a downturn in the dollar against the yen in the second half of September—restrained further price rises.

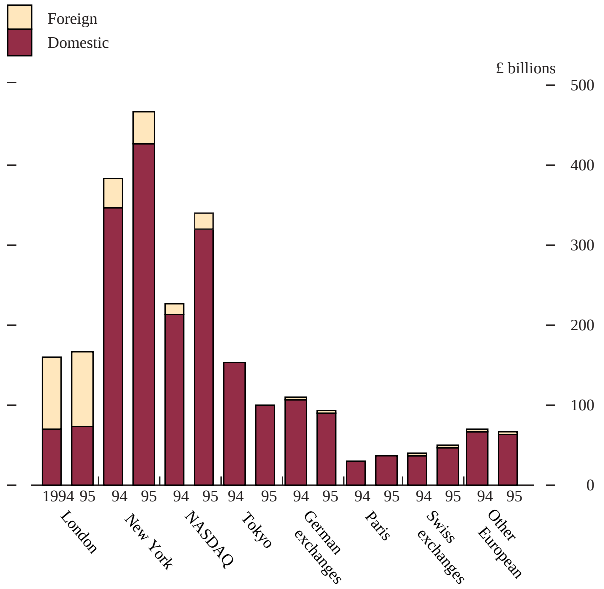
Turnover

Chart 3 compares equity turnover on the major exchanges for the second quarter of this year with the same quarter of 1994. Both the New York Stock Exchange and NASDAQ recorded large increases in turnover over the period, up 21% and 50% respectively. Turnover on most European exchanges fell slightly, with the exceptions of Paris and Switzerland, where volumes rose by 16% and 30% respectively. Turnover on the Tokyo stock exchange remained subdued—it was some 35% lower than in the same quarter of 1994.

Equity issues

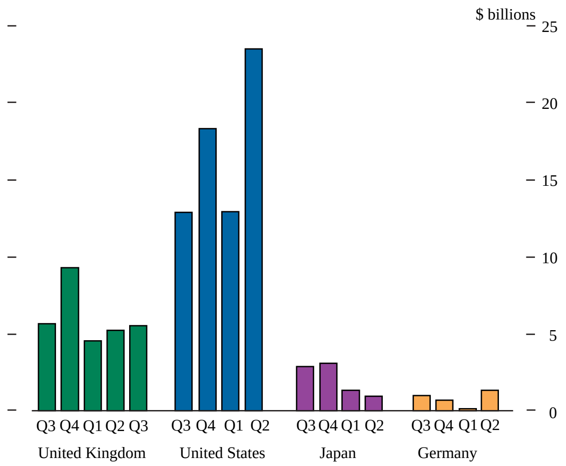
In the UK equity market, £2 billion was raised in rights issues by UK and Irish companies during the third quarter, compared with £1.2 billion in the previous quarter. 43 companies joined the Official List, of which 16 raised capital of £443 million—compared with £1.1 billion in the previous quarter—and 22 transferred from the Unlisted Securities Market. The balance were non capital raising introductions. In the United States, $23.4 billion of equities were issued in the second quarter, up from $13.5 billion in the first. Equity issues in Germany also increased sharply in the second quarter, rising from $179 million to $1.33 billion.

Chart 3
Turnover of domestic and foreign equities on major stock exchanges(a)



(a) Turnover in the second quarter of the year indicated.

Chart 4
Equity capital raised on major stock exchanges



After low levels in the first half of the year, total issues of equity with an international tranche increased in the third quarter; and they are expected to remain buoyant. Issuing activity is thought to have increased for two reasons: low levels of investor interest in the first half of the year led to a delay in many offerings; and European governments are keen to complete as much of their privatisation programmes as possible before the Deutsche Telekom privatisation, which is expected to dominate the European equity market next year.

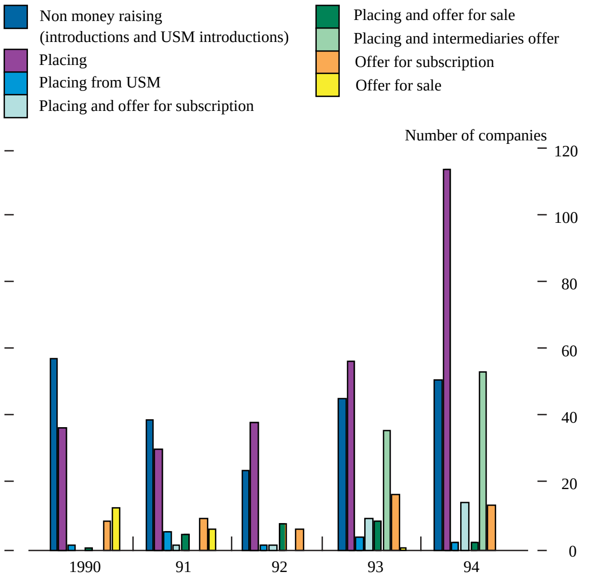
Listing on the London Stock Exchange

On 16 August, the London Stock Exchange announced the results of its consultation on its Listing Rules. It has decided to abolish the rule governing initial public offerings—which requires offers of equity of over £50 million to include a public offer—on the grounds that it serves no investor protection purpose and makes raising equity capital more expensive. From 1 January 1996, companies will be able to issue shares by any method, and it is likely that more companies will issue through placings—already the favourite method, because it is cheaper and easier—so denying the retail investor direct access to new issues.

In recent years, there have been a number of changes to the Listing Rules. The recommendations of the Ross-Russel review (implemented from the start of 1991) led to companies capitalised at between £15 million and £30 million being allowed to use intermediaries offers,(1) or placings in conjunction with an intermediaries offer or an offer for sale. In 1993, the maximum size of placings was increased to £25 million and that for intermediaries offers to £50 million.

The number of new issues has increased dramatically over the past five years: this may be partly because of the increasing flexibility afforded to new companies raising equity capital. As the chart shows, placings have become increasingly significant, whereas offers for sale have become less common (they are now used mainly for privatisations).

Methods of joining the Official List



Source: London Stock Exchange Quarterly Review.

(1) *Intermediaries offers* allow intermediaries other than the lead manager to subscribe for new shares on behalf of their clients, so enabling retail investor involvement without the need for a public offer.

Structural developments

During the quarter, two significant moves in the UK equity market opened up alternative, automated trading to investors. For larger investors, on 21 September Tradepoint Investment Exchange began to offer subscribing institutions an order-driven, screen-based trading system for 400 stocks listed on the London Stock Exchange. The system competes directly with the Stock Exchange's market-maker system. In a separate move, a joint venture between Sharelink, the broker, and Electronic Share Information (ESI) enabled retail investors to place orders to buy and sell shares with Sharelink via the Internet, using share price information distributed through the Internet.

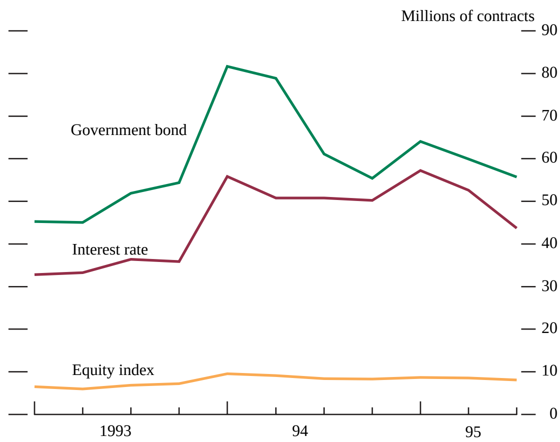
From 26 September, the Stock Exchange's Rule 4.2, the occasional trading facility for unlisted shares, ceased. Over the third quarter, the number of companies traded on the Alternative Investment Market (AIM) increased by 67 to 81, of which 54 had been traded under Rule 4.2. Market comments to date on AIM have been mixed, and have suggested that trading volumes are high but that trading is limited to private clients rather than institutions.

The *Nouveau Marché*—the new French market for small companies—will begin operations in mid-February 1996. The market will be managed by *Société du Nouveau Marché*, a subsidiary of the SBF-Paris Bourse. Bids and offers posted to a central order book will be matched twice daily; between matchings, market-makers will display bid and offer prices.

Derivatives markets

Turnover on the major derivatives exchanges was generally down on the previous quarter, but there were differences in performance between contract types. In the United States, turnover in longer-term government bond contracts fell less than that in short-term interest rate contracts, whereas in Europe the performance of different contract types was more mixed; discussion of the prospects for EMU led to increased activity in government bond futures towards the end of the quarter after a quiet start. The limited scope for introducing

Chart 5
Quarterly turnover of futures by type(a)



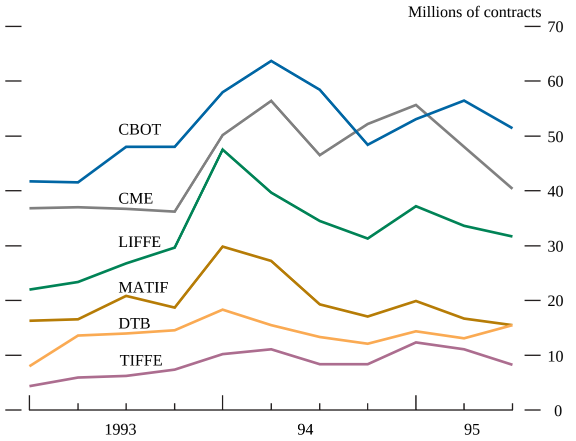
(a) Turnover in the major futures contract listed on the CME, CBOT, LIFFE, DTB, MATIF and TIFFE.

new interest rate contracts in what is now an increasingly mature market has encouraged exchanges to explore further other possible growth areas—such as currency, commodity and flex contracts.

Turnover on the London International Financial Futures Exchange (LIFFE) fell by 6% during the third quarter, but total open interest ended the quarter up 5%. Volumes in LIFFE's Bund futures contract overtook those in the notional bond futures contract on the main French derivatives exchange (MATIF) to become Europe's most actively traded contract. Turnover in LIFFE's new FT-SE 100 flex option was also strong and its new Bund basis-trading facility made a promising start.

LIFFE announced a feasibility study into transferring its individual equity options contracts from open outcry to automated trading, in an attempt to revitalise the United Kingdom's equity option market. Turnover in this market has remained sluggish, with volumes for the first three quarters of this year down 14% on the same period of 1994.

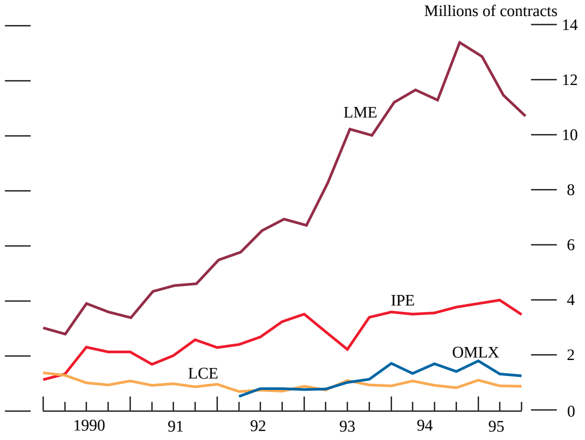
Chart 6
Quarterly turnover on major derivatives exchanges



Elsewhere, turnover on the DTB rose 15% during the quarter, whereas volumes on MATIF fell by 8% (see Chart 6). In the United States, volumes on the CME and the Chicago Board of Trade (CBOT) fell by 16% and 9% respectively. In the Far East, volumes on TIFFE, Japan's largest derivatives exchange, were down 22%.

The CME's eurodollar futures contract maintained its position as the world's most actively traded contract, though its turnover was down 22% during the third quarter, with open interest ending the quarter virtually unchanged. The CME's Mexican peso contract continued to be one of its fastest-growing contracts (albeit from a low base). Its proposed Growth and Emerging Markets Division announced plans to launch futures and options on the Brazilian *real*, a Mexico 30 Stock Index contract and Mexican Brady Bond contracts—in each case, pending regulatory approval.

Chart 7
Quarterly turnover on London's other derivatives exchanges



Turnover in the CBOT's US Treasury Bond future fell 12% during the quarter, but it maintained its position as the world's most actively traded bond futures contract. The fastest-growing contract on the exchange so far this year has been the 30-day Fed Funds futures contract (though, again, from a low base). The contract is based on the average overnight federal funds rate on a one-month basis. The CME is planning to introduce its own 30-day Fed Funds contract, which will have a smaller face value than the CBOT's and will expire simultaneously with the CME's other short-term interest rate contracts.

In the over-the-counter (OTC) markets, the International Swaps and Derivatives Association (ISDA)—which conducts a half-yearly survey of its members(1)—for the first time released a survey of replacement costs, as at the end of 1994. The gross replacement value of outstanding transactions totalled $172.6 billion, 2.0% of the notional principal. However, netting under ISDA master agreements reduced the figure to $77.9 billion (0.9%) and use of collateral reduced it further to $71.0 billion (0.8%). The Bank of England recently surveyed the UK market as part of the first internationally co-ordinated central bank survey of derivatives markets. The results are currently being collated with a view to their release before the end of the year; the Bank for International Settlements will publish data aggregated from 26 central banks.

Other exchange developments

There were further moves towards link-ups between commodity exchanges during the third quarter. In July, the New York based Coffee, Sugar and Cocoa Exchange (CSCE) approached the Board of the London Commodity Exchange (LCE) concerning a possible friendly bid. The LCE later announced that it was also entering into discussions with LIFFE and the International Petroleum Exchange (IPE) about separate collaboration proposals. The IPE has, as a result, delayed a decision on a site for its new trading floor. The

(1) See the financial market developments section, *Quarterly Bulletin* August 1995, page 249.

New York Mercantile Exchange (NYMEX) subsequently made a $38 million merger offer to the CSCE, along the lines of its recent merger with the New York based commodities exchange, COMEX, which resulted in COMEX's becoming a division of NYMEX. However, the CSCE and the New York Cotton Exchange have already signed a letter of intent to build a joint trading facility in New Jersey.

In a separate development, the LCE announced that it had signed a letter of intent with the CBOT to explore establishing a joint trading facility located in London. The facility is intended to trade existing CBOT agricultural contracts for which there is excess European demand, by open outcry, as well to develop new products. Work is progressing on the LIFFE/CBOT agreement to trade each other's most liquid government bond contracts.

Exchanges continued to extend the range of ancillary services they provide for exchange and OTC products: for example, the CME is developing a swaps collateral depository; the CBOT is developing its own 'HITS' system for trading, guaranteeing and clearing swaps. MEFF RF, one of Spain's two financial derivatives exchanges, is awaiting regulatory approval for the clearing of peseta-denominated interest rate swaps. And the Amsterdam-based European Options Exchange introduced a facility for clearing off-exchange trades for all its exchange-listed products; the deals will be cleared through the European Options Clearing Corporation, a wholly-owned subsidiary of the EOE.