FINANCIAL MARKET UPDATE

May 2003

International Capital Markets Department
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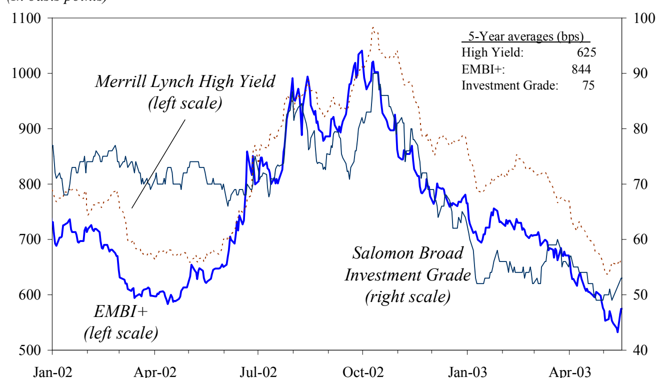
Data as of May 16, 2003 or as noted

- Ample liquidity in main financial centers and improved market confidence spur rally in corporate and emerging market bonds through mid-May.
- Concerns about U.S. dollar overshooting and uncertain prospects for global growth pose risks.
- Emerging bond market has benefited from a global quest for yield that has compressed spreads to quite low levels. Primary issuance, however, has lagged earlier years.
- Rebound in global growth needed to sustain recent improvements in credit quality and financial strength.

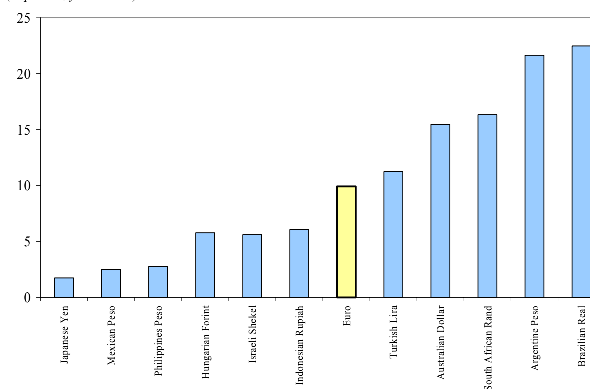
Ample liquidity in the main financial centers searching for yield is contributing to the compression of credit spreads in both mature and emerging bond markets. The compression has been evident since the peaks of October 2002 (Figure 1). Higher-yielding currencies have also appreciated so far this year, reflecting a flow of funds to local markets (Figure 2). Policy interest rates and government bond yields in Europe, Japan, and the United States are expected to remain unusually low, effectively reducing financing costs and encouraging a reduction in investors' cash positions.

Figure 1. Credit Spreads
(In basis points)



Sources: J.P. Morgan Chase, Merrill Lynch, and Salomon Smith Barney.

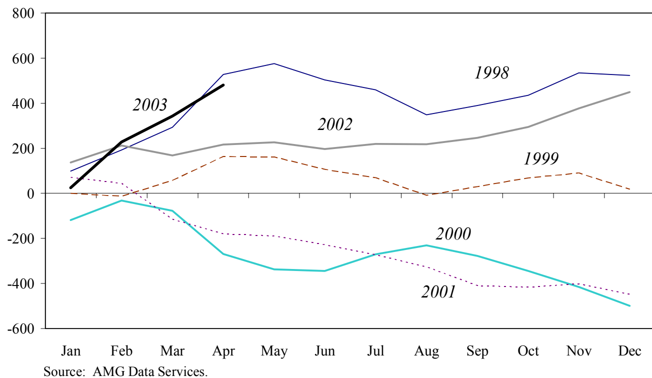
Figure 2. Selected Currency Performance
(In percent, year-to-date)



Source: Bloomberg L.P.

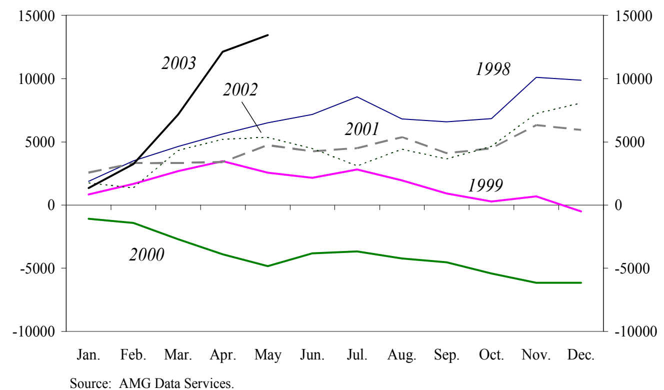
The search for yield has also been reflected so far in 2003 in substantial inflows into high-yield and emerging market mutual funds (Figures 3 and 4) and in increased allocations by institutional investors to emerging market bonds as an asset class.

Figure 3. Cumulative Flows into U.S. Mutual Funds Investing in Emerging Market Debt
(In millions of U.S. dollars)



Source: AMG Data Services.

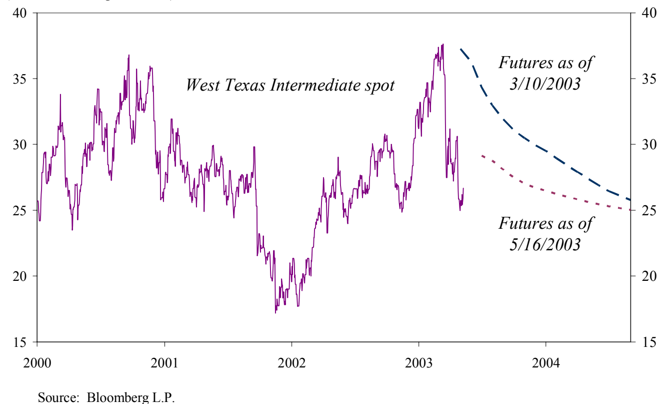
Figure 4. Cumulative Flows into U.S. Mutual Funds Investing in U.S. High Yield Corporate Debt
(In millions of U.S. dollars)



Source: AMG Data Services.

Liquidity is not the sole driver of flows, however. More fundamental factors—including progress in corporate balance sheet repair in the United States and a marked change in investor attitude toward the prospects for reform in Brazil—have helped underpin the strong rally in corporate and emerging market bonds. Credit default spreads have narrowed substantially across virtually all mature and emerging market sectors, pointing to a widespread improvement in market assessments of credit quality. Since March 11, equity markets in the United States and Europe have rebounded strongly. The rally in the United States stems in part from positive earnings reports in the first quarter, a tentative indication of improving fundamentals. In addition, the end of the war in Iraq helped ease investor concerns and resulted in a moderation of spot and future oil prices (Figure 5).

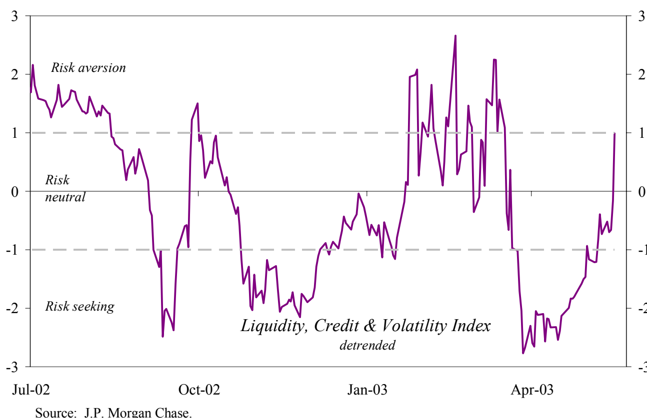
Figure 5. Crude Oil Spot and Futures
(In U.S. dollars per barrel)



Source: Bloomberg L.P.

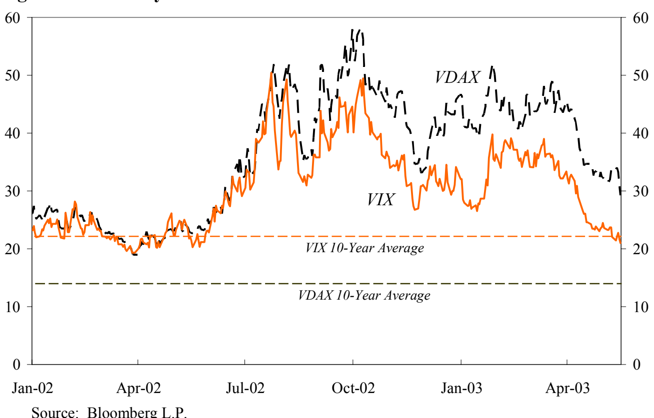
In April 2003, the combination of falling credit spreads, the strengthening of high-yielding currencies, and the decline in implied volatilities in major equity and currency markets pushed indicators of risk appetite to record high levels (Figures 6 and 7). Since end-April, however, risk indicators suggest waning risk appetite, owing mainly to an increase in the implied volatility of currency markets. The risk of overshooting in the fall of the dollar against the euro and the yen has become an increasing concern for investors.

Figure 6. Index of Risk Appetite



Source: J.P. Morgan Chase.

Figure 7. Volatility Indices



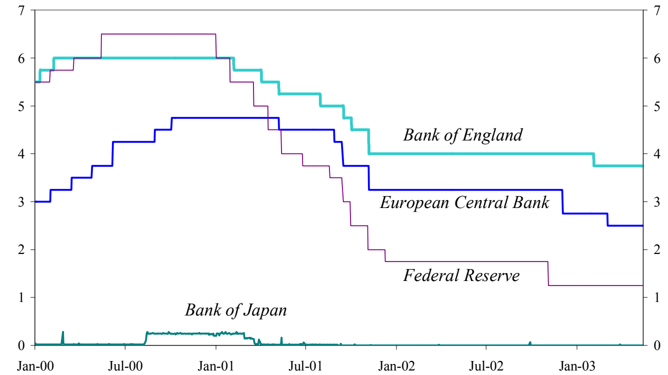
Source: Bloomberg L.P.

Indeed, the dollar has now fallen to four-year lows against the euro, raising concerns about the financing of the U.S. current account deficit and European growth prospects. The outlook for global growth, corporate earnings, and mature equity markets thus remains uncertain.

Slow Growth and Low Inflation Priced into Major Bond and Money Markets

In the face of sub-par growth and limited inflationary pressure, monetary policy in the euro area, the United Kingdom, and the United States has remained accommodative. Japan has expanded its open market operations to include purchases of long-term government bonds (Figure 8).

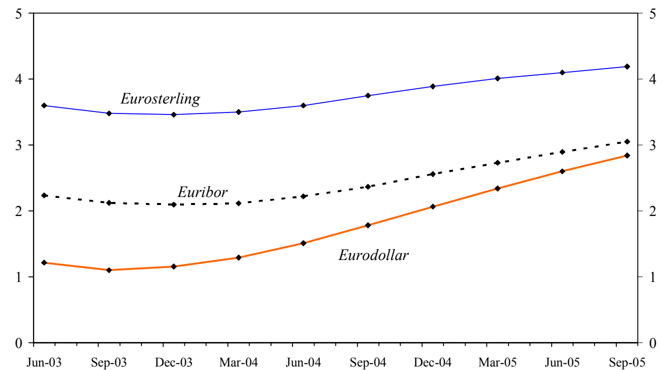
Figure 8. Benchmark Interest Rates
(In percent)



Source: Bloomberg L.P.

Government bond markets are pricing in continued sluggish growth and limited inflationary pressure in the euro area, the United Kingdom, and the United States. So far this year, yield curves have fallen across the maturity spectrum. Reflecting concerns over falling inflation rates, futures contracts suggest market expectations for further central bank easing this year. Nevertheless, short-term rates are priced to rise thereafter (Figure 9).

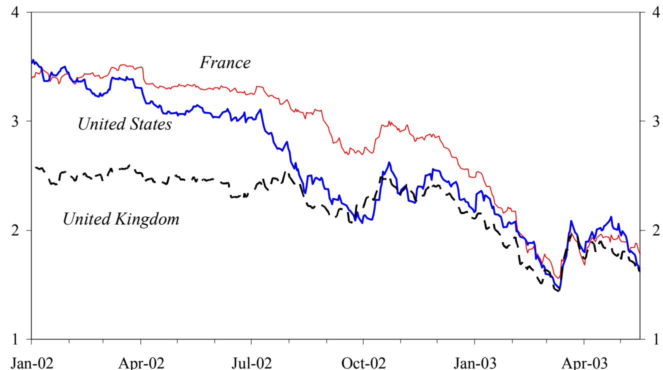
Figure 9. Three-Month Interest Rate Futures Strips
(In percent)



Source: Bloomberg L.P.

Real yields on inflation-indexed bonds in the euro zone, the United Kingdom, and the United States remain low (Figure 10), notwithstanding an increase in mid-March following the end of the war in Iraq. Market expectations for sub-par economic growth, and the perception that protection against inflation risk is of little value in the current environment, have helped keep real yields on inflation-linked bonds low.

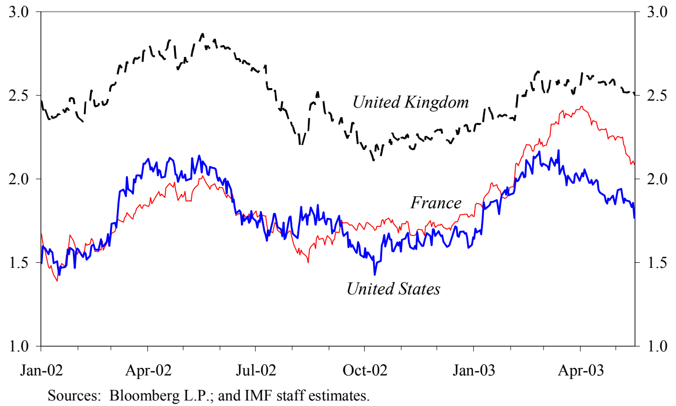
Figure 10. Inflation-Linked 10-year Bond Yields
(In percent)



Source: Bloomberg L.P.

Market expectations for inflation in the euro area, the United Kingdom, and the United States—as proxied by the spread between the real yield on inflation-indexed government bonds and the nominal yield on their conventional counterparts—continue to suggest limited inflationary pressure (Figure 11). In most cases, expectations for future inflation are below currently prevailing inflation rates.

Figure 11. Inflation Expectations
(In percent)



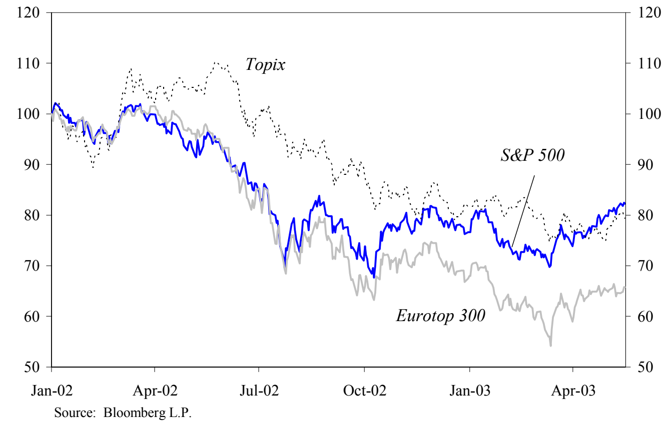
Sources: Bloomberg L.P.; and IMF staff estimates.

In Japan, tenacious deflationary pressures, continued low expectations for economic growth, and the Bank of Japan's monetary policies have kept government bond yields at virtually zero for maturities of three years or less. These have also reduced 10-year bond yields to less than 60 basis points and have resulted in 30-year yields falling to about 1 percent.

Fundamentals Contributed to March Equity Rebound; Accelerating Revenue Growth Needed To Sustain Rally

Notwithstanding a strong rally in mid-March following the end of the war in Iraq, European and Japanese equity markets have declined so far this year, while U.S. equities have shown only modest gains (Figure 12).

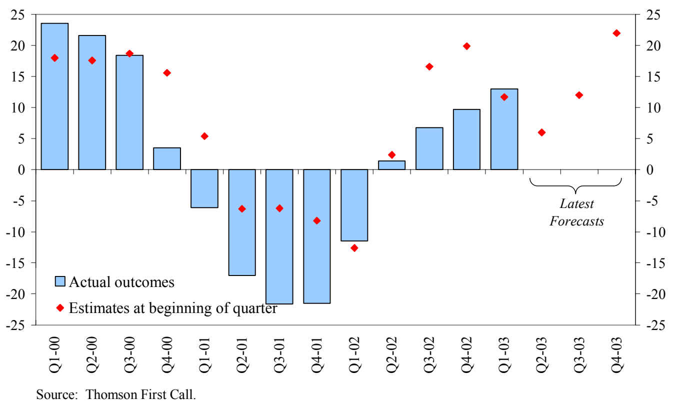
Figure 12. Equity Market Performance



Source: Bloomberg L.P.

The relatively strong performance of U.S. equities since March reflects better-than-expected profit growth of 12.9 percent (year-on-year) in the first quarter, fueled largely by revenue growth of 9.8 percent (Figure 13). Having actual first-quarter corporate earnings outstrip analyst projections buoyed sentiment. In addition, a recent survey of more than three hundred fund managers shows that earnings volatility is widely expected to decline in future, which would help boost equity valuations and performance.

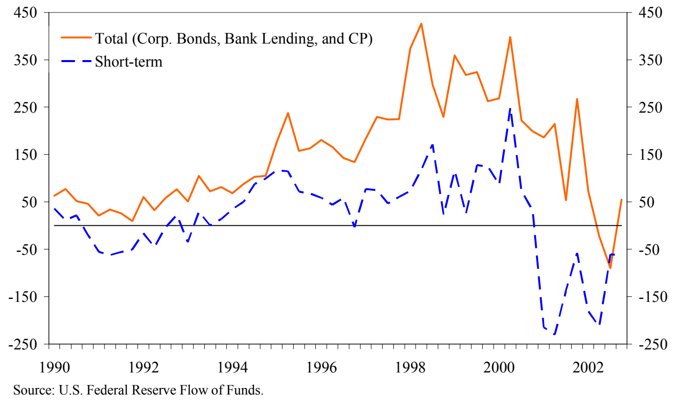
Figure 13. S&P 500 Quarterly Earnings Growth
(In percent, year-on-year)



Source: Thomson First Call.

Another favorable fundamental stems from the ongoing balance sheet repair by the U.S. corporate sector. This has resulted in a substantial reduction in short-term debt, while corporate cashflow has risen substantially (Figure 14). The resultant perception of a decline in corporate default risk has supported the sustained rally in corporate bonds, especially the high-yield segment. Moreover, rising corporate credit quality has tended to precede improvement in corporate earnings. This raises the prospect of continued earnings growth, if the economy is supportive.

Figure 14. Net Changes in U.S. Nonfinancial Corporate Debt
(In billions of U.S. dollars)

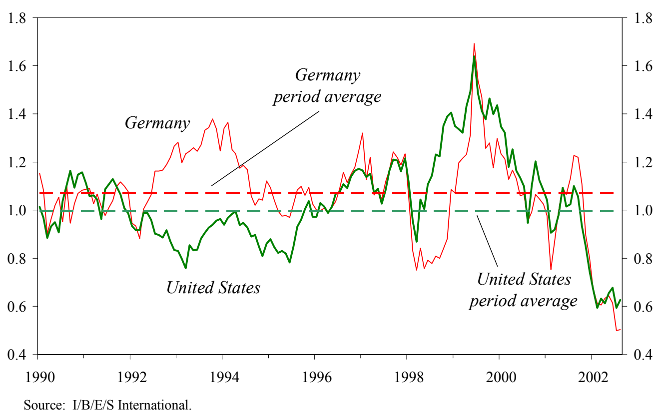


Source: U.S. Federal Reserve Flow of Funds.

In addition, banks and insurance companies, especially in Europe, have benefited from the rally in stock and corporate bond markets. Coupled with the recent effort by several institutions to raise fresh capital, banks and insurance companies in the United States and Europe are financially stronger today than nine months ago.

U.S. equities appear reasonably valued relative to bonds, notwithstanding the rally since mid-March, owing largely to historic low yields on U.S. treasuries. The earnings yield ratio reflects past earnings rather than expected earnings, suggesting that slow but steady earnings growth would prove supportive for equities (Figure 15). However, a number of short-lived equity rallies have occurred since the bursting of the equity bubble. The sustained earnings growth needed to underpin equity market valuations requires stronger economic growth, whose prospects remain uncertain.

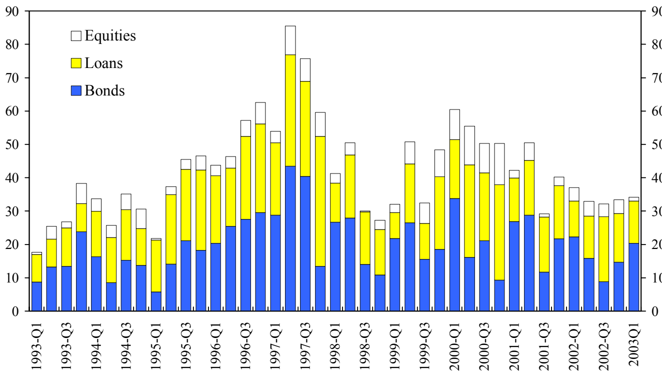
Figure 15. Bond-to-Earnings Yield Ratio



Source: I/B/E/S International.

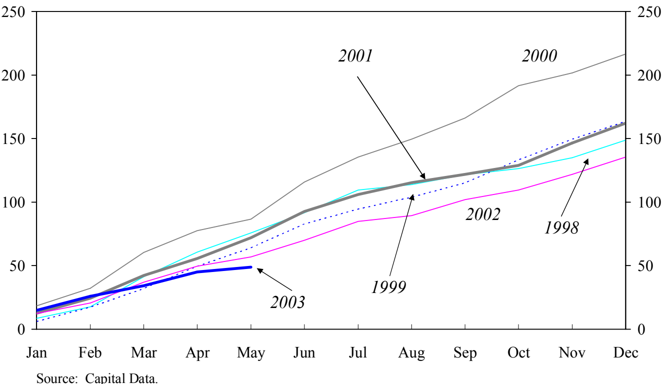
Despite Flows to Secondary Markets, Emerging Market Financing Remains Subdued

Figure 16. Emerging Markets Financing
(In billions of U.S. dollars)



Source: Capital Data.

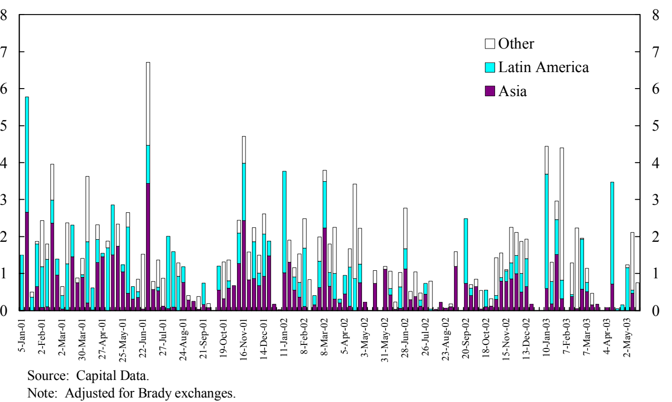
Figure 17. Cumulative Gross Annual Issuance of Bonds, Loans, and Equity
(In billions of U.S. dollars)



Source: Capital Data.

Until mid-May, emerging markets had raised $48.8 billion in gross funding in the international capital markets (Figure 16). Bond issuance was strong in January, suffered a lull as a result of uncertainty surrounding the Iraq war, and has accelerated since the conclusion of the war. Syndicated loan commitments were low as international banks continued to withdraw from the emerging markets. Equity placements virtually dried up amid ongoing concerns about global economic activity. Taken together, through mid-May, the cumulative gross issuance of bonds, loans, and equities by emerging markets is lagging previous years (Figure 17).

Figure 18. Weekly Bond Issuance
(In billions of U.S. dollars)

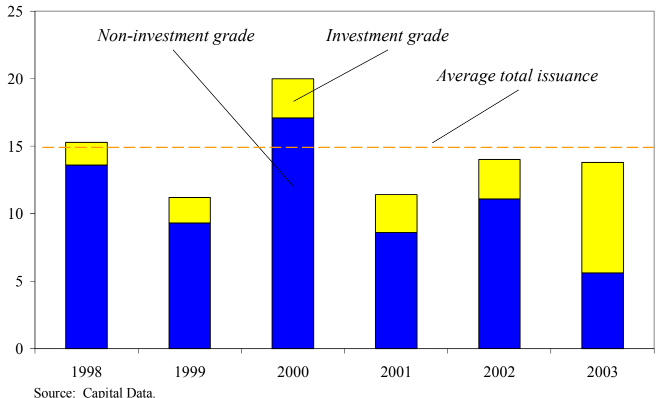


Source: Capital Data.
Note: Adjusted for Brady exchanges.

War uncertainties moderated bond issuance in the first quarter (Figure 18), notwithstanding apparent investor appetite in a yield-seeking environment and rising emerging market bond prices in the secondary market. In contrast to previous reopenings, credit tiering persisted, with roughly two thirds of financing extended to investment-grade credits in the quarter.

Sovereign bond placements accounted for $13.8 billion, or roughly two thirds of total bond issuance, in the first quarter. Sovereign issuance in the first quarter was broadly in line with average levels for the same period over the past five years (Figure 19). Many governments have already achieved their 2003 financing targets, although some have not, notably Brazil, Turkey and the Philippines.

Figure 19: First Quarter Emerging Market Sovereign Bond Issuance
(In billions of U.S. dollars)

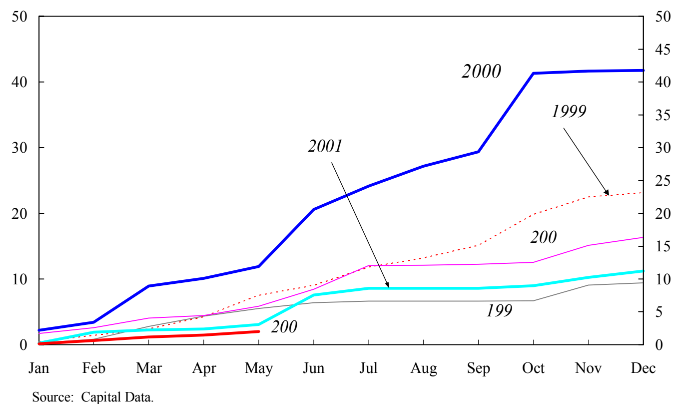


Source: Capital Data.

The inclusion of collective action clauses (CACs) in sovereign emerging bond issues gained momentum this year. Mexico and Brazil each issued global bonds with CACs. And South Africa has issued a global bond under New York law with CACs. These issues were well received and heavily oversubscribed. In addition, the bonds issued under Uruguay's debt swap also included CACs.

A handful of placements brought total equity issuance to a mere $1.2 billion in the first quarter of 2003, significantly below the already subdued levels of recent years (Figure 20).

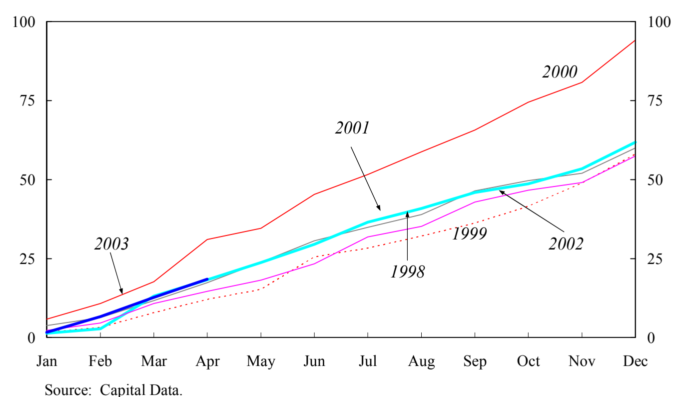
Figure 20. Cumulative Gross Annual Issuance of Equity
(In billions of U.S. dollars)



Source: Capital Data.

Syndicated lending by international banks remained weak in the first quarter (Figure 21). As in bond markets, discrimination according to credit quality persisted.

Figure 21. Cumulative Gross Annual Issuance of Loans
(In billions of U.S. dollars)



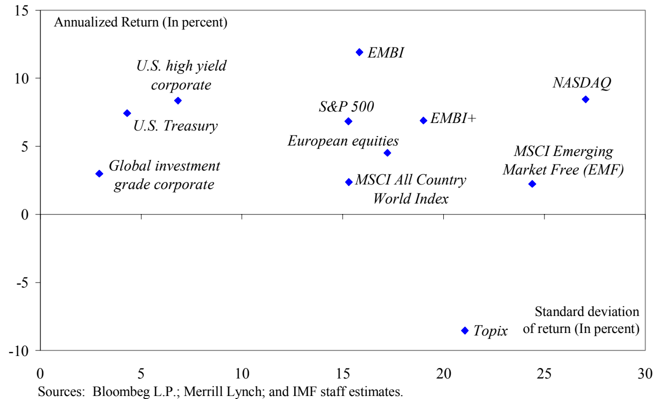
Source: Capital Data.

Emerging Bond Market Benefits from Global Quest for Yield

The global quest for yield in a context of accommodative monetary policies in the major financial centers has created a positive external environment for emerging market bonds. Flows from institutional and retail investors into the secondary emerging bond market have been strong, with apparent appetite for new issues of emerging market bonds. The favorable external environment coupled with a marked change in investor attitudes toward the new Brazilian administration have buoyed emerging market bond prices. Higher-yielding emerging market credits—particularly Brazil—performed especially strongly. The secondary market for emerging market bonds has also been supported by high interest and amortization payments. Spreads have narrowed considerably and in many cases are well below historical averages, suggesting that valuations have become stretched.

Some analysts see a structural shift toward fixed-income investments by institutional investors, notably U.S. and European pension funds. Successive years of falling equity prices have highlighted the risks inherent in the longstanding mismatch between pension fund assets that are predominantly allocated to equities and their bond-like liabilities. Emerging market bonds are also benefiting from a track record of strong risk-adjusted returns and low correlations with other asset classes (Figure 22). Such characteristics look quite attractive for portfolio optimization. Given the cumbersome, committee-driven decision-making approach of institutional investors, these flows are expected to continue over the next several months, unless a major emerging market borrower suffers a serious setback.

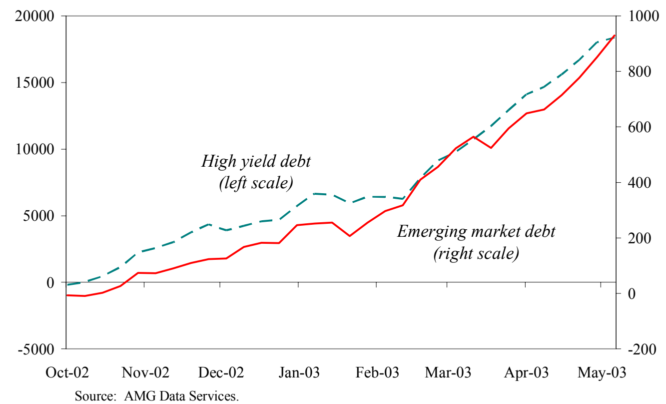
Figure 22. Long-Term Risk and Return of Selected Asset Classes
(From 1990 or index inception)



Sources: Bloombeg L.P.; Merrill Lynch; and IMF staff estimates.

This structural shift is being amplified by investors, mainly in the retail sector, chasing high returns in corporate and emerging bond markets. The flows into high-grade and high-yield corporate bond funds have also helped support emerging market bonds as many fund managers have taken temporary positions in the higher-yielding and more liquid market for emerging market debt pending opportunities in the high-yield corporate sector (Figure 23). These flows, and those from other cross-over investors, however, are likely to be reversed more quickly than the new dedicated mandates from institutional investors. Such a reversal would likely affect high-grade emerging market bond prices most, as cross-over investors typically invest most heavily in high-grade emerging market paper.

Figure 23. Cumulative Net Inflows to US Mutual Funds
(In millions of U.S. dollars)

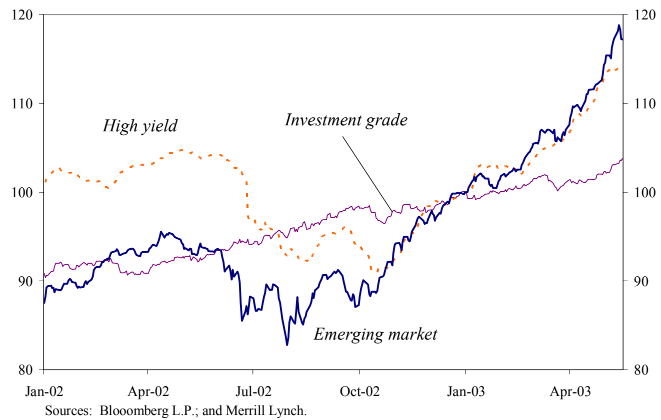


Source: AMG Data Services.

Market participants also report increased participation of hedge funds in the emerging bond market, especially in the sub-investment-grade sector. Nevertheless, the degree of leverage and the size of hedge fund positions appears to have remained well below pre-1998 levels.

These inflows have fueled a rally in all high-yielding assets, including emerging bonds that have performed especially strongly (Figure 24). Led by higher-yielding bonds, the EMBI+ has gained 17 percent through May 15, handily surpassing the return expectations of most market participants for the year.

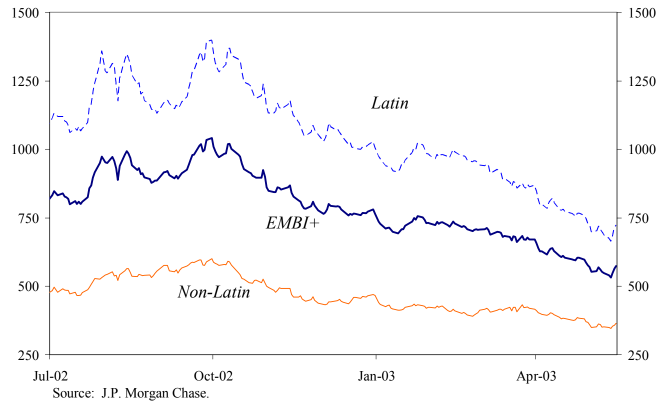
Figure 24. Debt Class Performance



Sources: Blooomberg L.P.; and Merrill Lynch.

Spreads on emerging market bonds have narrowed substantially as a result, and in many cases are near record lows (Figure 25). The spread of the EMBI+ narrowed to 574 basis points from a high of 1,040 basis points last year. This impressive compression of spreads was led by the high-yielding credits in Latin America. In particular, Brazilian spreads more than halved since the height of the difficulties last year.

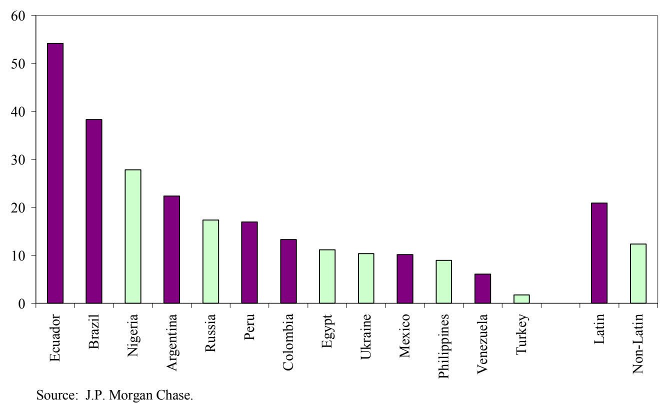
Figure 25. Sovereign Spreads
(In basis points)



Source: J.P. Morgan Chase.

With the chase for yield motivating the emerging debt market rally, high-yielding credits have been the greatest beneficiaries. Brazil, Ecuador, and Nigeria have been the top performing credits year-to-date, and Argentina has also performed strongly (Figure 26). There have been notable exceptions to the pattern of strong relative performance by high-yielding credits, however. Turkish and Venezuelan bonds have lagged the broader market by a significant margin, notwithstanding their high yields.

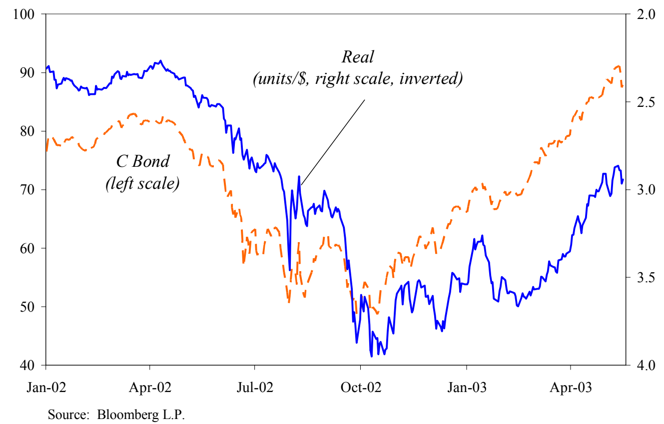
Figure 26. EMBI+ Returns
(In percent, year-to-date)



Source: J.P. Morgan Chase.

In Brazil, a marked change in investor sentiment in response to improved prospects for the structural reform agenda have buoyed the market, quite apart from the strong performance of the external and fiscal accounts. The appreciation of the *real* has been attributed to the raising of short-term financing by corporates and banks, while longer-term capital flows have remained subdued (Figure 27). Foreign direct investment (FDI) flows, in particular, have fallen this year, in part owing to slow economic growth and investor uncertainty over the direction of regulatory and pricing policies.

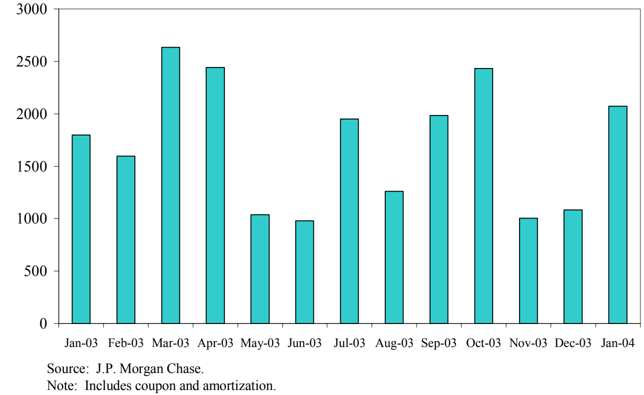
Figure 27. Brazil



Source: Bloomberg L.P.

The secondary emerging bond market is also likely to be supported by the high level of amortization and interest payments falling due throughout the year (Figure 28).

Figiure 28. Total Bond Payments for EMBIG & EMBIG Euro
(In millions of U.S. dollars, as of January 2003)

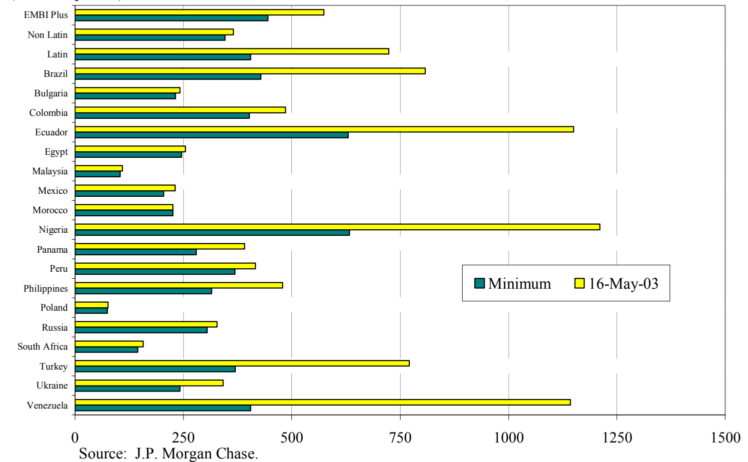


Source: J.P. Morgan Chase.
Note: Includes coupon and amortization.

Has Emerging Market Bond Spread Compression Gone too Far too Fast?

Risks to the current favorable outlook could arise from a deterioration in the external environment, or from a reversal in a major emerging market economy. While few market participants see much near-term risk of major disruption, the pace of spread compression has been quite rapid compared with previous experiences. In the current seven-month rally, the EMBI+ spread declined by about 600 basis points, compared with an average decline of 220 basis points over a similar time frame in three previous rallies. The emerging bond market is

Figure 29. Sovereign Spreads Versus Historical Lows
(in basis points)

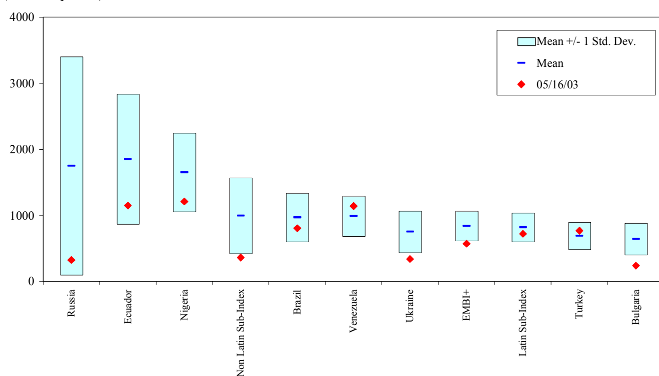


Source: J.P. Morgan Chase.

vulnerable to bouts of profit taking, as occurred in mid-May. More fundamentally, the compression of spreads on emerging market bonds to well below their historical averages increases the risk that investors may shift out of emerging market bonds if the external environment deteriorates (Figure 29). Flows in the past have temporarily masked vulnerabilities and led to complacency in implementing needed reforms. This highlights the need for emerging market countries to avoid complacency in pursuing policies aimed at securing medium-term sustainability, including in particular measures to improve the structure of public sector debt.

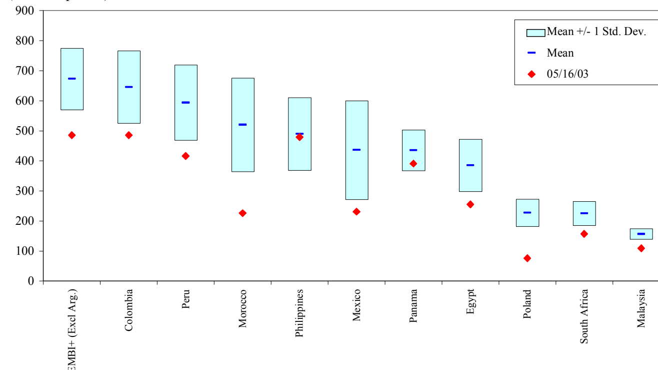
The spread of the non-Latin American component of the EMBI+ index is approaching its all-time low. Spreads are more than one standard deviation below their long-term means for 11 of the 18 constituents of the EMBI+ (excluding Argentina). Spreads exceed their long-term means only in the cases of the Philippines, Turkey, and Venezuela (Figures 30 and 31).

Figure 30. Deviation of Spreads from Long-Term Means
(In basis points)



Source: J.P. Morgan Chase.

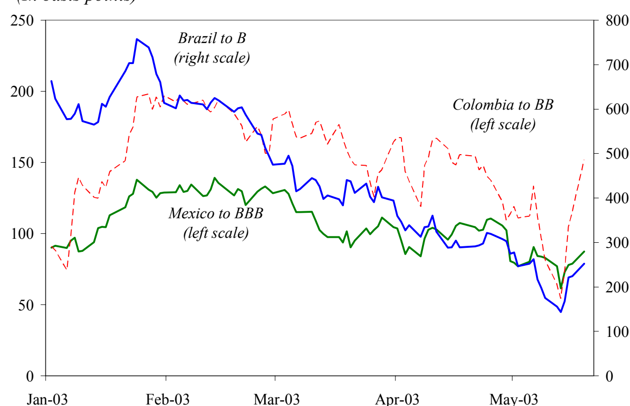
Figure 31. Deviation of Spreads from Long-Term Means
(In basis points)



Source: J.P. Morgan Chase.

In addition, the valuation of emerging market bonds appears high relative to comparably rated U.S. corporate bonds. For example, triple-B Mexican bonds are trading barely above their equivalently rated U.S. corporate counterparts (as of May). The spread between Brazil and a single-B U.S. corporate (of 224 basis points), however, remains relatively attractive (Figure 32).

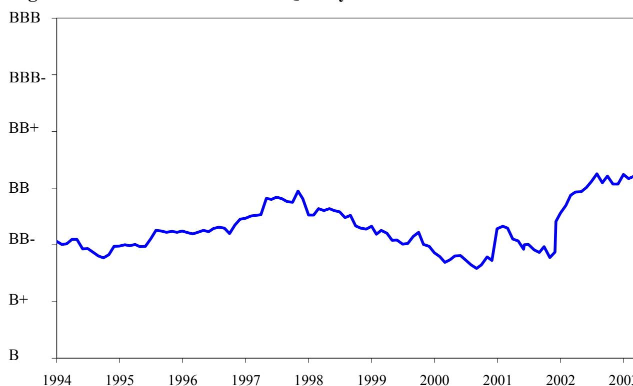
Figure 32. Latin American Spreads to U.S. Corporates
(In basis points)



Sources: Bloomberg L.P.; and Merrill Lynch.

When seen from the perspective of improvements in emerging market fundamentals, however, the compression in spreads appears less extreme. The credit quality of emerging markets—calculated as the average across the constituent countries in the EMBI Global based on their weightings in the index—has improved by one notch since 1997 (Figure 33). At that time, the emerging market yield spread reached an all-time low of 330 bps (EMBI), well below current spread levels. This improvement reflects measures taken to reduce vulnerability to external shocks, including the increased adoption of flexible exchange rate regimes and the buildup of foreign exchange reserves. Credit quality has moreover improved as external indebtedness has declined over the past years, driven largely by a reduction in bank financing.

Figure 33. EMBI Global Credit Quality Index



Sources: Bloomberg L.P.; Moody's; Standard & Poor's; and IMF staff estimates.

Since part of the market justification for yield compression is improving credit quality, a prolonged slowdown in global growth represents another potential source of risk for emerging markets. An extended period of sluggish global growth would erode the fundamental prospects of emerging market economies and could lead to a reassessment of the appropriate risk premiums for emerging market bonds.

In this context, a slowdown in global growth could potentially trigger a decline in foreign direct investment, which has been mainstay of emerging market finance. Latin America would be particularly vulnerable, given the continued weakness in the capital accounts of several countries.

Alternatively, rising interest rates on government bonds in the mature markets and improved sentiment toward equity markets in the United States and Europe could attract flows away from emerging market bonds and lead to less investor receptivity to new issuance. An increase in U.S. treasury yields in the context of improved growth prospects would likely affect high-grade emerging market bonds more than their high-yielding counterparts, given the limited yield cushion on high-grade emerging market bonds. In contrast, higher U.S. interest rates could be accompanied by further spread compression in the case of high-yield emerging market bonds, if global growth was expected to accelerate and boost the outlook for these economies.

Also, emerging market issuance could become too ambitious and trigger a sell off. Emerging markets are prone to wide swings in spreads, often arising from overzealous issuance when investor appetite is strong. While issuance has so far been readily accommodated, there are signs of froth, notably the issuance by some second-tier Russian corporates.

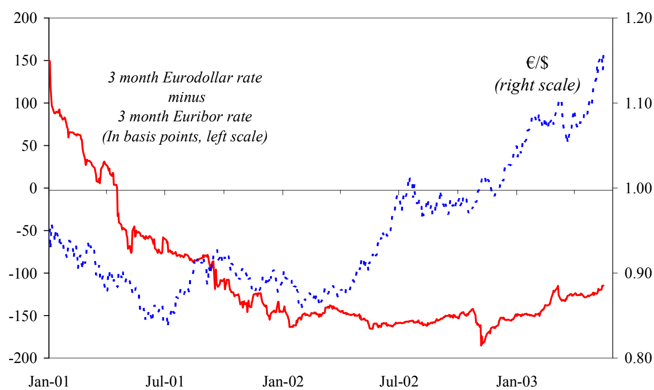
Finally, there is a risk of further credit ratings downgrades across dollarized economies following the change in Moody's ratings methodology. The Dominican Republic, Peru, and Turkey are among the countries that could be affected.

Global Markets Need a Rebound in Economic Growth

Overall financial market vulnerabilities appear to be receding. Accommodative monetary policies have reduced funding costs. The improving fundamentals of emerging markets and the strengthening of corporate balance sheets and recent rebound in corporate earnings provide evidence of improving credit quality and financial strength. These improvements, however, can only be sustained by stronger global economic growth. One factor that could dampen global economic growth prospects is the vulnerability of the dollar to overshooting.

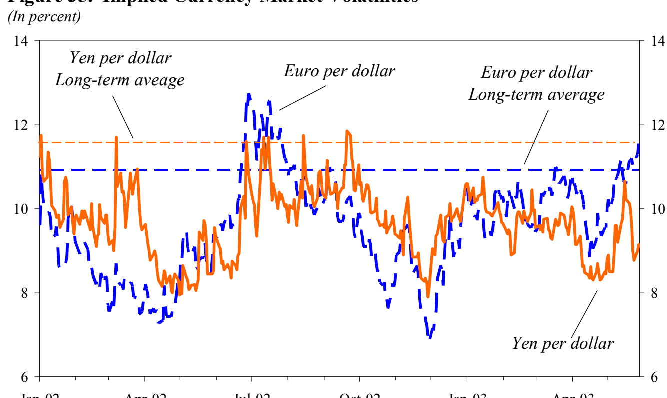
The U.S. dollar has fallen to a four-year low against the euro (Figure 34). Investor concerns over the dollar have been reflected in rising implied volatilities on currency options (Figure 35). The need to continue to attract large capital inflows to finance the U.S. current account deficit and the already large share of foreign ownership of U.S. treasuries (32 percent), corporate bonds (21 percent), agency securities (12 percent), and equities (12 percent) heightens the risk of overshooting in the event of a deterioration in sentiment toward U.S. assets. In that event, the dollar would decline, undermining economic activity in the euro area and in Japan, and real yields would rise in the United States, dampening growth prospects there.

Figure 34. Euro/Dollar and Interest Rate Differentials



Source: Bloomberg L.P.

Figure 35. Implied Currency Market Volatilities
(In percent)



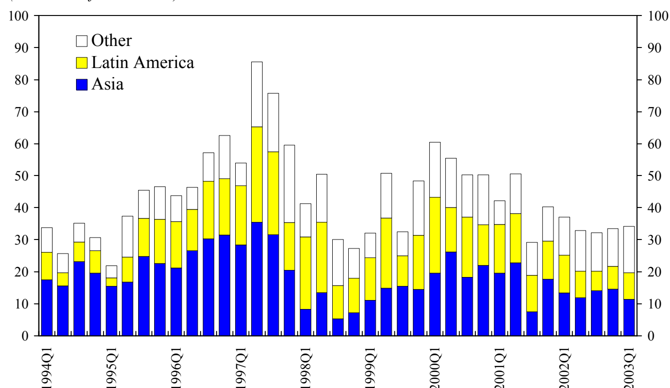
Source: Bloomberg L.P.

Table 1. Emerging Market Financing Overview

	2000	2001	2002	2001 1st qtr.	2001 2nd qtr.	2001 3rd qtr.	2001 4th qtr.	2002 1st qtr.	2002 2nd qtr.	2002 3rd qtr.	2002 4th qtr.	2003 1st qtr.	2003 Jan	2003 Feb	2003 Mar	2003 YTD 1/
								(in billions of US dollars)								
ISSUANCE	**216.4**	**162.1**	**135.5**	**42.2**	**50.5**	**29.2**	**40.2**	**37.0**	**32.9**	**32.1**	**33.4**	**34.2**	**14.9**	**10.9**	**8.4**	**48.8**
Bonds	80.5	89.0	61.6	26.8	28.8	11.7	21.7	22.2	15.9	8.8	14.7	20.4	13.1	5.5	1.8	28.2
Equities	41.8	11.2	16.4	2.3	5.3	1.0	2.6	4.1	4.3	3.8	4.1	1.2	0.1	0.5	0.5	2.0
Loans	94.2	61.9	57.5	13.1	16.4	16.4	15.9	10.7	12.7	19.5	14.6	12.7	1.6	5.0	6.1	18.6
ISSUANCE BY REGION	**216.4**	**162.1**	**135.5**	**42.2**	**50.5**	**29.2**	**40.2**	**37.0**	**32.9**	**32.1**	**33.4**	**34.2**	**14.9**	**10.9**	**8.4**	**48.8**
Asia	85.9	67.5	53.8	19.6	22.8	7.5	17.6	13.3	11.9	14.1	14.6	11.4	2.9	4.6	3.9	14.8
Western Hemisphere	69.1	53.9	33.4	15.2	15.4	11.4	11.9	11.9	8.3	6.1	7.1	8.3	5.3	1.9	1.1	15.6
Europe, Middle East, Africa	61.4	40.8	48.2	7.4	12.4	10.4	10.7	11.9	12.7	11.9	11.7	14.5	6.7	4.5	3.4	18.5
SECONDARY MARKETS																
Bonds:																
EMBI+ (spread in bps) 2/	756	731	765	784	766	1,005	731	598	799	903	765	671	730	707	671	565
Merrill Lynch High Yield (spread in bps)	871	734	802	757	736	915	734	623	809	890	802	696	747	757	696	588
Salomon Broad Inv Grade (spread in bps)	89	78	62	89	80	77	78	69	73	75	62	55	56	52	55	52
US 10 yr. Treasury Yield (yield in %)	5.12	5.07	3.83	4.93	4.93	4.60	5.07	5.42	4.86	3.98	3.83	3.83	4.00	3.71	3.83	3.53
Equity:								*(in percent)*								
DOW	-6.2	-7.1	-16.8	-8.4	6.3	-17.5	15.7	3.8	-11.2	-17.9	9.9	-4.2	6.1	-2.0	1.3	4.5
NASDAQ	-39.3	-21.1	-31.5	-25.5	17.4	-30.5	29.9	-5.4	-20.7	-19.9	13.9	0.4	12.7	1.3	0.3	16.2
MSCI Emerging Market Free	-31.8	-4.9	-8.0	-6.2	3.1	-23.4	28.4	10.7	-9.0	-16.8	9.8	-6.8	9.1	-3.2	-3.2	4.5
Asia	-42.5	4.2	-6.2	-0.1	-1.6	-22.1	36.1	14.9	-6.3	-17.0	4.9	-9.3	6.6	-6.0	-5.2	-1.7
Latin America	-18.4	-4.3	-24.8	-3.5	7.1	-24.7	23.0	7.1	-22.0	-24.7	19.6	-0.9	14.8	-2.2	5.5	18.7
Europe/Middle East	-23.4	-17.7	-9.1	-22.0	4.5	-26.1	36.8	0.2	-11.0	-6.5	9.1	-1.4	6.6	4.2	-3.2	19.9

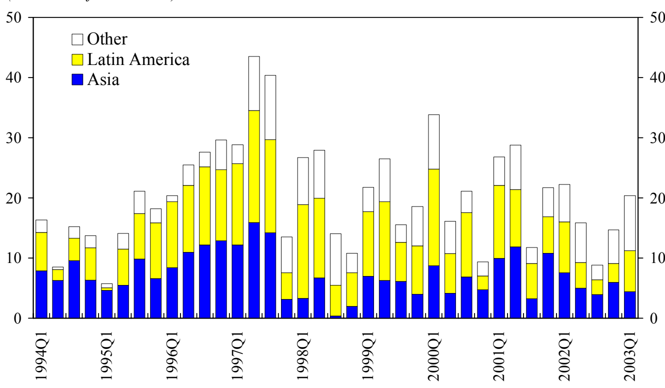
Sources: Bloomberg L.P.; Capital Data; Merrill Lynch; Salomon Smith Barney; and IMF staff estimates.
1/ Issuance data are as of May 12, 2003 close-of-business London and Secondary markets data are as of May 15, 2003 cob New York.
2/ On April 14, 2000 the EMBI+ was adjusted for the London Club agreement for Russia. This resulted in a one-off (131 basis points) decline in average measured spreads.

Figure 36. Total Bond, Equity and Loan Issuance
(In billions of U.S. dollars)



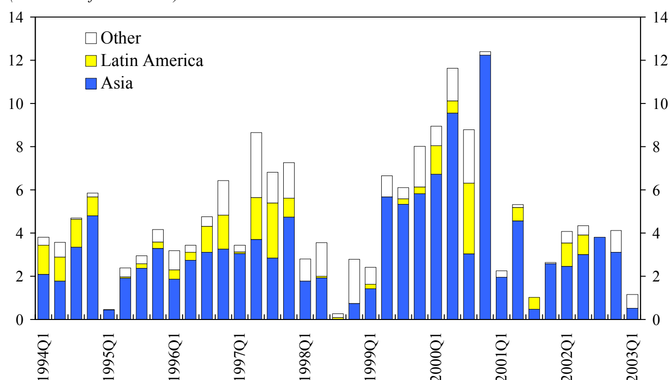
Source: Capital Data.

Figure 37. Bond Issues
(In billions of U.S. dollars)



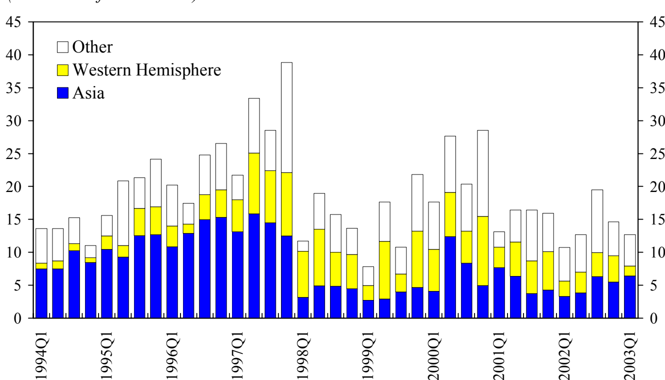
Source: Capital Data.

Figure 38. Equity Placements
(In billions of U.S. dollars)



Source: Capital Data.

Figure 39. Syndicated Loan Commitments
(In billions of U.S. dollars)



Source: Capital Data.