European Capital Markets Institute

ECMI Commentary No. 3
17 January 2006

Will yield spreads remain tight in Europe's capital markets?

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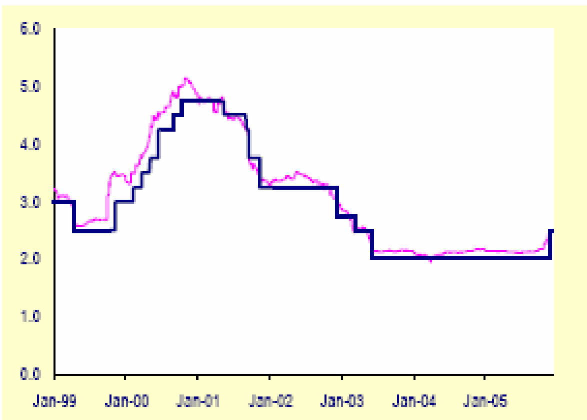
Despite credit downgrades and recent fiscal excesses by EU governments, yield spreads remained tight on European capital markets throughout 2005. The tightness of the spreads is rather remarkable, given that fiscal positions differ rather significantly across the Eurozone. For sure, this attests to the high degree of integration of the European capital market, but it also may suggest that the market believes the ECB would act as a lender of last resort. The recent increased spread tightness is probably the result of the low level of interest rates prevailing in the euro area, prompting investors to go on a yield hunt. An interesting question to ask is how the recent policy stance of ECB (it raised interest rates in December 2005 and accompanied this action with an announcement that interest rates would probably rise at a measures pace) has modified investors' behaviour and what effects it can be expected to have in the future.

The liquidity overhang and lax monetary policies that reigned in capital markets in recent years have led investors to adopt a distinct pattern of investment behaviour. Low interest rates and excess liquidity gave investors a taste for higher-risk assets such as investment-grade corporate debt, junk bonds and emerging market debt in an environment of depressed returns. Such a strategy can be described as a great leap towards risk. Spreads on such risky investment opportunities, especially emerging market debt, (now at pre-1997 levels) have now fallen so low as to render their risk/return profiles unattractive for further investments. The low-yield environment in developed markets also prompted investors to execute part of their investments through carry trades.[2] By opting for such a strategy, investors exposed themselves to credit spread movements and to exchange rate risks, but these have generally been hedged with various derivative instruments such as interest rate and exchange rate products. Given the interest rate hike of December 2005 and the further likely raise announced for the first quarter of 2006, interest rate differentials ought to widen, increasing hedging costs and reducing the attractiveness of carry trade strategies.

Figure 1 ECB minimum bid rate and 3-month inter-bank rate, 1999-2005



Source: ECB.

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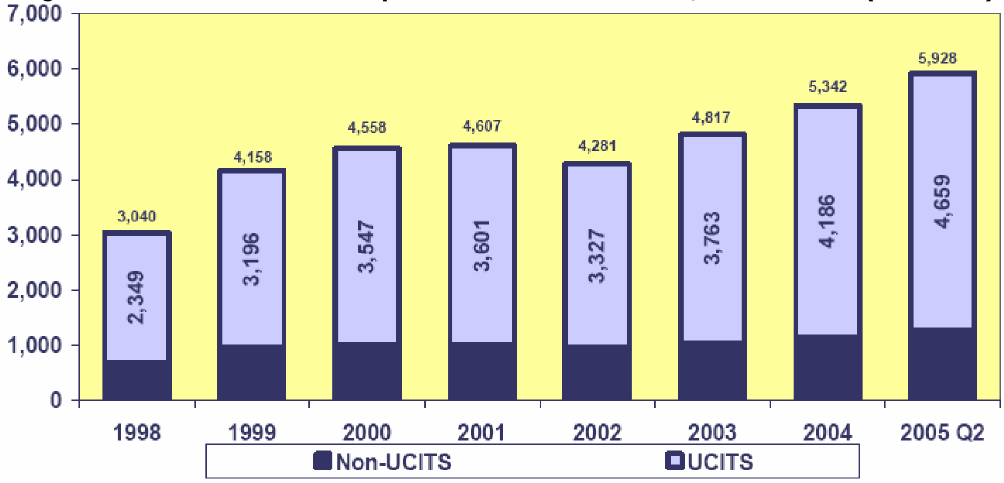
[2] i.e. borrowing on the short end of the yield curve of countries with low interest rates, to lend on the long end of the yield curve of countries with higher interest rates.

Another outcome of the search for yield was the increased allocation of investments to hedge funds. As can be seen in figure 2, the quantity of net assets allocated to European investment funds has doubled between 1998 and 2005 (naturally, part of this development was also structural). Yet the large sums flowing into those funds have had the effect of lowering the risk/return ratio, meaning that hedge funds are now struggling to maintain their rate of return as the value of assets under management grows ever larger.

Figure 2 Net assets of European investment funds, 1998-2005 (€ billion)



Source: EFAMA.org

Faced with the current shortage of attractive investment opportunities and lulled by a favourable credit environment, it seems that European investors have not been assessing the risk components of their investments properly. In fact, they either took on even riskier positions (i.e. investing increasingly in corporate and junk bonds) or they invested in government bonds regardless of the underlying fundamentals. In our view, this is one of the reasons why demand for corporate bonds remained high and yield spreads on government bonds were unaffected by fiscal excesses.

This tendency seems continue: an issue of a €1billion bond on the high-yield market in Germany on January 12th reinforced the signal that investors' appetite for riskier investment has not dwindled. According to the FT, "yield on the bonds came down from initial guidance, which is a sign of strong demand", says FT.[3] Another test for the euro investor's appetite is to come next week, as multi-billion euro deals will be offered on the corporate bond market.[4]

The mopping up of excess liquidity induced by monetary tightening should push investors to more carefully discriminate their investment choices as they adapt to a macroeconomic environment of higher interest rates. Consequently, yields will probably widen over 2006 and become more responsive to credit risk in the corporate sector and to fiscal profligacy on the part of EU governments.[5] So long as the ECB does not cause stress to financial markets by doing so in an unpredictable and variable manner, the raising of interest rates should lead investors to unwind their risk positions in an orderly manner.

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[3] "Bond investors retain risk for appetite", Ivar Simensen, *Financial Times*, 13th January 2006

[4] Telefonica is about to issue €4 billion of bonds with maturities of 5 and 10 years, as well as £1billion split into maturities of 12 and 20 years, FT 13th January 2006.

[5] Excessive deficit procedures are being taken by the commission as Germany, France, Cyprus, Malta, Italy and Portugal are expected to have deficits above 3% GDP ceiling stipulated by the SGP in 2005 and 2006 on the basis of their current policies.