Reading and Understanding the FINANCIAL TIMES

Updated for 2010–2011

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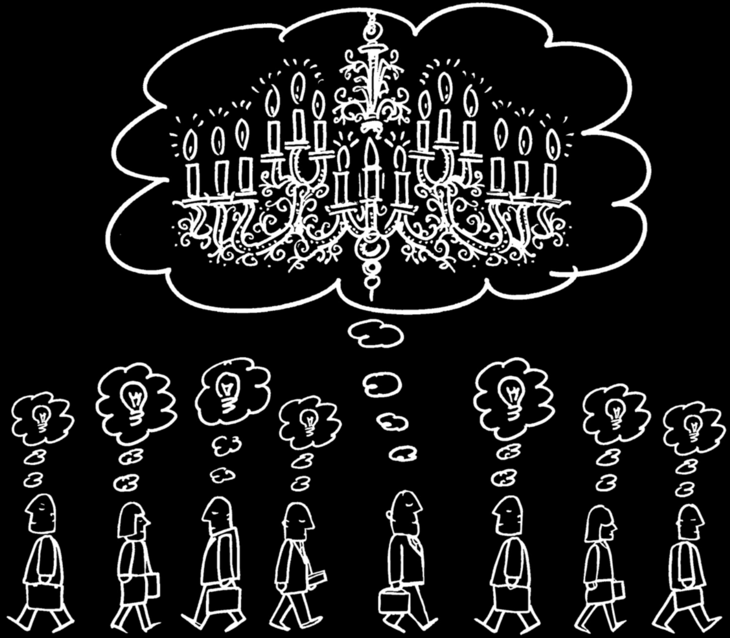

shorter-term Treasuries. This upward move in bond yields was matched in the Eurozone and UK bond markets as investors reacted to increased interest rates from the European Central Bank and the fear of another increase from the Bank of England soon. In addition there was a clear realisation that there was no prospect of the Fed cutting interest rates in the near future.

The role of the Lex column is to pick out the key financial stories each day and provide a clear commentary putting some perspective on the short-term market reaction. It starts here by suggesting the bond market has been acting as a 'stabiliser for the US economy'. So, when the economy takes a downturn we see a fall in bond yields that acts as a stimulant to economic activity; and when the economy picks up we see a rise in bond yields which acts to suppress economic activity.

However, there is now a worry that this latest rise in bond yields could act to destabilise the US economy. There are three main factors that have caused the surge in 10-year bond yields. First, the economic outlook in the United States has shown a marked improvement. The labour market is strong, the housing market looks less vulnerable and manufacturing activity is recovering. This all means that investors can no longer look to the Fed to cut interest rates. A second factor that might explain the rise in bond yields could be the foreign selling of US Treasuries as the Asian central banks start to diversify their massive foreign exchange reserves into non-dollar currencies. As they sell US Treasury bonds their yields must increase. Finally, there is the strength of the global economy and the consequent rise in international yields which could pull US yields higher as well.

At this stage the Lex writers appeared to be fairly relaxed. They see the small rise in bonds yields so far as being 'unlikely to cause too much pain'. However, there remains the threat that any further spike in bond yields could signal a much more serious correction in stock prices.

Key terms

Benign credit conditions This simply refers to the cost of borrowing money. It might be a government borrowing (in the government bond market), a company borrowing (in the corporate bond market), a house owner (with a mortgage) or a consumer (with a credit card). We have 'benign credit conditions' when the cost of borrowing is considered to be low by historic standards. So low bond yields are seen as supporting the stock market. How does this work?

Well, in the first place, if bond yields are low then investors will look to buy shares instead in the search for a better return. Second, a low cost of borrowing will encourage a stronger level of economic activity which will fuel demand for goods and services which leads to higher corporate profits. This ultimately feeds through into higher dividend payments which are the key to higher share prices. Finally, a low cost of borrowing will make it cheaper for companies to borrow money, which will make investments more profitable.

German DAX index The DAX index is the most important German stock market index. It is considered to be the standard benchmark for shares quoted on the Frankfurt Stock Exchange. It started in 1984 with an initial value of 1000.

10-year bunds Bunds are simply German government bonds. These are used to fund the difference between Federal government spending and revenue. As normal the benchmark long-term government bond is the 10-year maturity.

European Central Bank (ECB) and key interest rate The ECB is the Eurozone's most important financial institution. It is in control of a single monetary policy for all the countries that have adopted the euro. The main policy objective of the ECB is to maintain price stability in the medium term. This is defined as a 0–2 per cent target range for consumer price inflation. The key part of the ECB is the Governing Council that meets every fortnight on a Thursday. However, interest rate changes can only be made in the first meeting each month.

The key interest rate is the ECB's repo rate. This is the main tool used by the ECB in providing refinancing operations in the money markets. Under a repo operation commercial banks bid for funds from the ECB at a fixed interest rate. The ECB will purchase various high-quality financial market securities from theses banks to act as security for the loans. Then after a set period (usually 14 days) the banks must repurchase their securities back from the ECB and pay interest on the borrowed funds at the agreed repo rate.

Yield curve The yield curve is a graph that shows the relationship between interest rates or yields and the level of maturity. You should see the key terms for Article 5 for a more detailed discussion of yield curve shapes.

The relationship between bond yields and economic activity A key aspect of economic activity is the borrowing and lending of money which causes a set of interest rates to be established. Economic activity is a key influence on short-term interest rates which ranges from overnight to one-year borrowing. In practice other economic factors tend to dominate in the setting of the longer-term bond market yields.

Short-term loans are set by the demand from companies for loans and the rates of return they think they can expect to earn on these funds.

In good times there are opportunities for high profits.
Companies borrow more money at high interest rates.

In bad times these opportunitites diminish.
Companies are less willing to borrow money at high interest rates.

The interest rates derived from economic activity tend to be very short term.

But most bonds are in practice much longer term. As a result a range of other factors come into the picture when setting long-term interest rates. The key factor for long-term interest rates is the rate of inflation. As inflation rises investors will demand a higher rate of return on bonds. This especially applies to long-term investors as the uncertainty of their purchasing power is greater. Inflation is very important in setting long-term bond prices.

The level of a country's fiscal deficit can also be of some relevance in setting longer-term bond yields. A larger deficit will require higher yields to attract new investors. At some stage increased borrowing can also impact on the level of credit risk. If a country is perceived as being a lower credit risk, the level of its bond yields must rise to compensate for this higher risk. Argentina is a good example of a country that has often had a bad credit rating because it has frequently defaulted on its bond issues in the past.

To conclude, there is a very complex set of factors that determines the level of interest rates. Most short-term interest rates and short-term bond yields are determined by the level of economic activity and the resulting activities of the central bank. In contrast, longer-term bond yields are primarily set by the inflation outlook.

What do you think?

1. Clearly define what is meant by the term 'benign credit conditions'.
2. Why is there a strong link between the level of bond yields and the world's stock markets?
3. What reasons does the Lex column article suggest can explain the 'surge' in US Treasury yields?

Investigate FT data

You will need a copy of the *Financial Times*. Go to the front page of the main section and look at the World Markets data on the bottom of the front page.

1. What is the current level of the S&P 500 index?
2. What is the current level of the Xetra Dax index?
3. What is the yield on 10-year US government bond yields?
4. What is the yield on 10-year German government bond yields?

Go to the web

Go the ECB's official website: www.ecb.int/home/html/index.en.html.

Find the current level of the ECB's main refinancing operation minimum bid. Now go to the section on monetary policy.

a. What are the main aims of monetary policy?
b. What are the benefits of price stability?

Research

For a good understanding of what moves the financial markets on a daily basis there is no short-cut. You need to read the *Financial Times* regularly, particularly after days when there have been significant movements in the main financial markets. Read the articles regularly (look at the Lex column as well) and you will soon get a feel for what drives the financial markets.

PODCAST

Go to **www.pearsoned.co.uk/boakes** to access Kevin's blog for additional analysis of recent topical news articles and to post your comments. Download podcasts containing short audio summaries of the main issues relating to each article and check your understanding of in-text questions with the handy hints provided.

Debt finance

We should begin this topic by explaining what is meant by the term ‘debt’. This is actually quite a straightforward concept as it simply represents something that must be repaid in the future. It could be a favour that a friend has granted you in the expectation that you will return the compliment in the years ahead. In financial markets we define debt in relation to financial commitments that often stretch far ahead in the future.

These arrangements are formalised in terms of a bond which is a contract where the holder lends money to another party in return for annual interest payments and the eventual repayment of the loan. On almost any day a quick review of the *Financial Times* will show that the international bond markets are a very important area in terms of their impact on financial markets. You will see many examples of new bond issues from companies, governments and a wide range of other large organisations. There are three main definitions for these new bond issues:

1. **Domestic bonds** where the issuer launches a bond in its local currency and home country. For example, a UK company might launch a new £500 m bond issue in London.
2. **Foreign bonds** where an issuer goes to another country to issue a bond in a foreign currency. For example, a German company might launch a new $500 m bond issue in the United States. This type of foreign bond issue is called a ‘Yankee bond’.
3. **Eurobonds** where the issue takes place outside the country of the currency in which the bond is denominated. For example, a German company might launch a new $500 m bond issue in France. This type of bond is called a Eurobond because the issue is in US dollars and it takes place outside of the United States. You should be aware the term ‘Eurobond’ does not mean that the issue has to take place within the European financial markets.

In the context of corporate finance, the term ‘debt finance’ refers to the money that a business has to borrow in order to fund its various activities. In practice, we normally divide this debt finance into short-term and long-term borrowing. We also differentiate between the different degrees of risk attached to various types of corporate debt issues. The main types are:

1. **Secured debt** (commonly known as a *debenture*). This is the highest grade of debt issued by a company. The issuing company gives the debt holders a secured claim on various assets that are owned by the business. So, if the company cannot meet interest or redemption commitments, the holders are entitled to receive these assets in exchange. The assets in question might be financial (various types of securities), property or other physical goods owned by the company.

When this form of debt is secured on property assets it is called a *mortgage debenture*.

2. **Senior unsecured debt**. This comes next in terms of the debt capital hierarchy. In the case of a company liquidation the holders have claim on the assets left after the secured debt providers have been fully paid.
3. **Subordinated or junior debt**. The holders of these debt securities accept a lower rank than the first two levels of debt in the case of a corporate default. In return, they will be normally compensated in the form of higher interest to offset this additional risk. In terms of risk they are often little better off than the preference shareholders. The only providers of capital below them are the ordinary shareholders, who always take the biggest financial loss if a company fails.

There are a number of other key terms associated with debt products that you should understand before we start to analyse the articles in this section:

1. **Fixed-income securities**. You might see the debt markets referred to as fixed-income securities. This is simply because most bonds carry a fixed interest rate (called the *coupon*) and a fixed maturity date (called the *redemption date*). You should be aware that, although this is the most common form of debt issue, there are many other types with variable interest rates and redemption dates.
2. **Convertible bonds**. These are bonds issued by companies that give the holder the right to exchange their debt market products for shares in the issuing company at some stage in the future. We will learn more about them in the articles that follow.
3. **Warrants**. These are financial instruments that give the holder the right to purchase financial market securities from the issuer at a set price within a certain time period. They are commonly attached to certain new bond issues giving the holder the right to buy some shares in the issuing company.
4. **Zero-coupon bonds**. These are bonds that do not have any interest payable but will instead be offered at a significant discount to the par value. This results in a large capital gain at redemption.
5. **Commercial paper**. This is a form of very short-term financing instrument used by companies. The normal maturity of commercial paper is 270 days. They are usually only made available to those companies with the best credit-rating.
6. **Bond yield**. When an individual or a company borrows money, there is a cost that they have to pay in order to obtain the funds. If it is a short-term loan (up to one year), this is normally referred to as an *interest rate*. So we might take out a one month bank loan with an annual interest rate of say 8.5 per cent. This is the interest rate, or the cost of obtaining the funds. If a company needs to borrow funds for a longer time period, this will normally be through the issue of a bond market security, which is usually repaid at a fixed rate of annual interest (this is called the *coupon*) until it is finally repaid on the date that it redeems or matures. The yield on the bond issue is the cost to the issuer or the return to the investor who buys the bond.

Every day there are many new bond issues from companies, governments and a wide range of large organisations. The first article in this topic looks at the process of