Evaluation of the performance of the european bond market

Business, Management

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Abstract

This study addresses the contemporary issues that affect the performance of European bond over the recent period of 18 months. In order to identify the major events that have impact on the European bonds, analysis of the yield curve spread between 10 year and 2 year maturity was conducted. The results indicate that since the global crises of 2008 and the performance of Eurobonds have been widely violated and the weak performances of some European economies have created a problem of trust among the global investors.

In light of those evidences, it could be concluded that although with all the financial supports to stimulate the European bond market " EBM". The results of those supports would take a while before fully recover the current crises.

1. Introduction

The increasing importance of mutual funds in society by the individual investors and portfolio managers explains the massive number of studies conducted and broadcasted in the financial and academia press. The bond market is a topic which has been less studied comparing the stock market (Otten and Schweitzer 2002). With exception of the US bond market, others bond markets have been a reasonably negligible area which need more research to be conducted. Even though many researches were investigated the bond market in Europe, those studies were conducted about one country at the time[1]. According to Otten and Schweitzer (2002, P (1)) “ An important explanation for the lack of studies is the institutional setting of the industry in different European countries”. Hence, the aim of this study came from themotivationof further exploration of this topic and gives a comprehensive analysis of the performance of EBM over a relatively short period of 18 months. Many reasons were behind the selection of EBM; one of the most important reasons was the creation of the European currency “ the euro” has stimulated strong interest in EBM. Another reason is the fact of increasing demand for mutual fund services in Europe which has fuelled up the interest in the European mutual fund industry.

2. Definition of the European Bond Market

A simple definition of European bond was provided by Gros & Lannoo (2000) where they stated that Eurobonds are international bonds issued by the European governments and companies in any international currency often denominated in non-European currencies for instance dollar and yen

(Flowers & Lees 2002). The EBM consists of investors, banks, borrowers, and trading agents that buy, sell, and transfer Eurobonds. International bodies such as the World Bank have the right as well to issue Eurobond. Moreover, the original creation of the EBM was in 1963, but not until the early 1980s when the EBM has become a large and active in the international market.

The fact that Eurobonds offer certain tax shelters and anonymity to their buyer as well as providing the borrowers with advantageous interest rates and international exchange rates have made them very popular with issuers and investors. EBM has superiority over others bond markets due to numerous reasons; firstly, it is one of the most developed and sophisticated market in the world. The adoption of series of innovations have given a further extend to this market along with the special character which is offering certain types of government and corporatefinancethat are not provided somewhere else make the investors more convenient to trade in EBM (Choudhry, 2001). Secondly, Eurobonds have been designed with a range of instruments that are not available to certain investors in their domestic area. Finally, the tax advantages and the fact of issuing the bonds in different currencies, countries and trading in many financial centres have all attributed to make the EBM in top of all bond markets.

3. Evolution of the performance of the European bond market

In order to understand the performance of a bond market, the reasons that affect this performance have to be clarified. Generally, a bond appears to be an easy-to-understand security. It generates interest for a limited period at a specified interest rate and then sells it for a precise price. However, several external factors could affect the price of a bond, and change its yields through the changing in the price.

Even though the bond generates an unchangeable and fixed interest rate, the market interest rate plays very important role in determining the price of individual bond in the market. Generally, it is controversial relationship

All bonds are subject to inflation risk. Therefore, unpredictable level of inflation would move the price of bond in unsynchronised way and, consequently, its yield.

Any changing on credit ration of bonds reflects directly the level of risk that the investors bear by holding those bonds.

Finally, Bond prices are greatly influenced by the reputation and financial situation of the issuing institution. Any problems with the issuing institution would definitely reflect on their bonds prices.

Since the creation of the EBM, the yields on bonds issued by different European governments moved on synchronised way. Especially after the adoption of Euro and the benefits that every member state suddenly gain from “ free-riding” in the Euro-zone bond market, or borrowing at approximately the similar interest rates as Germany, regardless of whether the country’s economic fundamentals justified the lower rate. However, the impact of the global financial crises 2008 in the EBM was clearly noticed by the underperformance of 16 member Euro-zone bonds. The duration of this underperformance of the bond was long which explained the violated of the yield’s curve till the beginning of 2010, where the curve witnessed an appreciation. However, for many years, Greece, Spain, and Ireland took advantage of the easymoneythat came their way, borrowing beyond their treaty-set limits, while their trade deficits remained wide. Particularly Greek the big deficit of 14% in GDP in last year made the Greece government unable to honour their liabilities. An addition to Greece deficit, all of Spain, Portugal and Ireland have caused serious problems to the European economy in general, and the EBM in particular. Many affords have been made by the advanced countries in European to rescue the struggling economies. This support programme started with Greece by providing a support up to ˆ30 billion of three-year fixed- and variable-rate loans in the first 12 months. The recent agreements which has been made by last summit on 11 of march reached in principle to increase the effective lending capacity of the European Financial Stability Facility to ˆ440 billion, offer it greater flexibility and lower lending costs, and specifically, to lower the cost of loans to Greece by 100 basis points and to extend maturity to 7. 5 years.

4. Conclusion

The development of the mutual fund industry has made the subject of performance evaluation one of the most highly debated issues in the finance literature. The performance of EBM appeared to be effected by the global and domestic crises. In order to support the EBM, many financial affords has been made to save the Eurobonds from further deprecation.

With all that affords to stimulate the European economy, however many of the economists believed that the financial supports are worthwhile as long as it permits the struggling countries to organise and grow their economies. Yet there is a risk that the rescue is treated as an opportunity to relax which would influence the performance of EBM. In light of the uncertainty of recovery of the damaged economies, the global investors will be more selective and demanding higher interest rates, that put a massive pressure on the European leaders to solve the problem of high interest rates and to recuperate the reputation and financial situation of some European countries.

5. Reference

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