

Stock Market Review



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Will the ECB continue to raise interest rates?

Last week the European Central Bank announced an increase in interest rates of 0.25 percentage points (or 25 basis points) to 1.50 per cent. This is the second rise this year following a similar increase that was approved at the April 7 ECB meeting. Rates in the eurozone economies had been kept at the one per cent level since May 2009 after the ECB and other major central banks had responded to the bankruptcy of Lehman Brothers in September 2008 with a sharp lowering of interest rates within a short period of time.

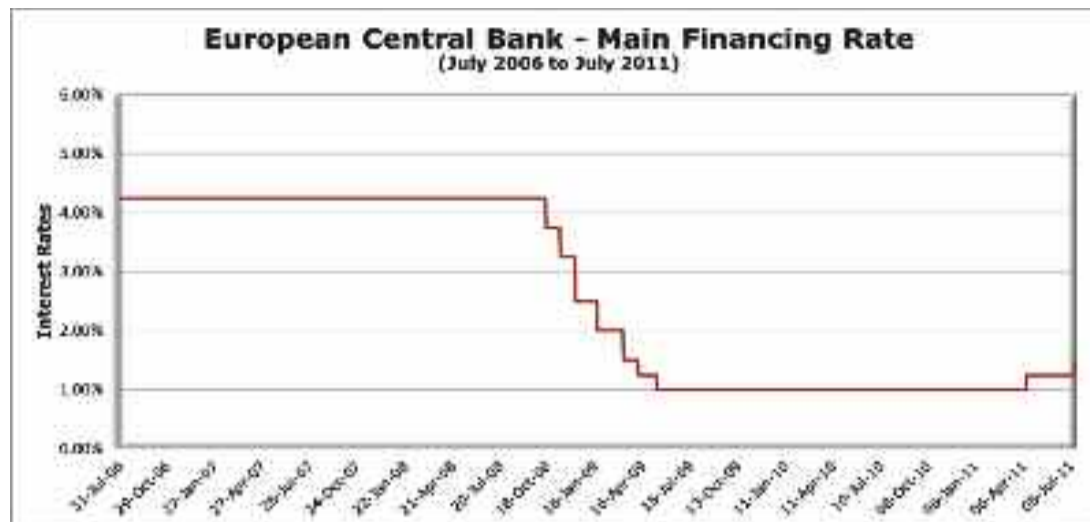
The recent July 7 hike in rates was widely expected as the ECB had warned in recent months that its ultimate objective remains that of combating inflation. Last month, the inflation rate in the eurozone was 2.7 per cent, remaining above the ECB's medium-term target of an annual rate "below but close" to two per cent for many months now.

Following this 50 basis point increase in the past three months, investors are now focusing on the outlook for rates in the coming months and beyond, as changes in rates affect different asset classes to varying degrees.

In view of the deterioration of the eurozone sovereign debt crisis and the slower rate of growth of German industrial production, the consensus among international economists is that although rates will continue to rise, the pace of growth will be slower. In fact, following the latest developments in the eurozone, the expectations point only to a further 25 basis point increase in rates in Q4 2011 to 1.75 per cent. Some commentators are taking the view that ECB president Jean Claude Trichet will not promote any more hikes before his term at the helm of the ECB comes to an end in late October. Mr Trichet will be replaced by Mario Draghi, the outgoing Governor of the Bank of Italy.

The latest fears of sovereign debt contagion that is spreading around the eurozone have trimmed expectations for interest rate increases in 2012 and 2013. However this monetary policy tightening must also be seen in the context of a gradual increase from the low emergency levels of one per cent in 2009 and 2010. Prior to the international financial crisis and global economic recession, the euro refinancing interest rate set by the ECB was stable at around the four per cent level in 2007 and 2008.

Higher interest rates normally impact bond markets negatively as prices move inversely with changes in rates. As interest rates rise, sec-



ondary market yields generally also rise and this leads to lower bond prices (especially those of longer-term bonds). Shorter-term bonds are therefore generally in greater demand at this point of the interest rate cycle.

The eurozone benchmark yield (the 10-year German bund) touched an all-time low of 2.089 per cent on August 31 last year (compared to a high of over 4.5 per cent in 2007 and 2008). Since then, yields have increased sharply exceeding the three per cent level in recent weeks as had been widely anticipated for some time. The increase in yields and fall in bond prices was also reflected locally with a decline in most Malta Government Stock prices from last year's all-time highs.

Although rates have come off their lows and are expected to rise further by the end of 2011 and into 2012, yields and bond prices fluctuate widely almost on a daily basis also in response to other developments such as the ongoing euro area sovereign debt crisis. This was very evident at the start of the week as the market became increasingly concerned on the Italian debt situation. This resulted in euro benchmark yields dropping sharply and Malta Government Stock prices rallying.

With bond prices (especially longer-term) expected to fall as interest rates continue to edge upwards, international analysts are seeking higher exposures to equities that provide an attractive dividend especially to those companies which may also be expected to grow their dividend distributions to shareholders. On the local market, this view had gathered support towards the end of last year and in January/February 2011 with increased demand for some higher-yielding equities. However, this support lost momentum in recent months as sentiment towards the equity market was negatively

impacted by the sudden Libya crisis and the BoV/La Valette Multi Manager Property Fund saga.

Notwithstanding, companies that are not directly exposed to these developments should continue to register improved financial performances and as such dividends to shareholders should also rise. Although this seems to have been overlooked as evidenced by the significant decline in equity market volumes, investors should focus on company fundamentals on the understanding that as a company's business and value grows over time, its share price will eventually follow. The prevailing weak sentiment could therefore prove to be a good buying opportunity for long-term value investors.

Meanwhile, higher interest rates generally have an immediate positive impact on bank profitability levels. However, the banking sector is currently overshadowed by the potential default of Greece and the contagion effect among other eurozone members.

Probably the most negative impact of an increase in interest rates is on borrowers (both personal as well as corporate) which have borrowings at variable interest rates. Home loans or mortgages are generally at variable rates of interest linked to a base rate and this will undoubtedly hurt borrowers who may be overstretched especially at a time when they are also trying to cope with a higher cost of living mainly related to significant increases in utility rates.

The Economist recently commented that mortgages in southern Europe and Ireland are generally of a variable rate type whereas in the larger economies of Germany and France, fixed rate mortgages are more popular. This is the overriding concern by some economists opposing the timing of such interest rate

hikes especially in view of the sensitive state of some eurozone economies.

Many local companies with loans and overdrafts at variable interest rates will also start seeing their borrowing costs rise. In view of the low interest rate environment prevalent in 2009 and 2010, some local companies resorted to the bond market to fix their interest rate cost on some of their outstanding borrowings for a longish period so as not to be impacted by higher finance costs once interest rates begin to rise. Although rates have begun rising from historically low levels they are well below their long-term trend, and companies may still find it beneficial to use the bond market to lock-in rates over a defined period of time providing visibility into the future.

Admittedly, a rising interest rate scenario may prove challenging for corporates wanting to refinance existing bank borrowings or maturing issues, especially when the Government of Malta will need to refinance €510 million of maturing stocks in 2012 and a further €516.6 million in 2013 (apart from further amounts required to fund the annual budget deficit). Due to a rising interest rate environment, issuers including the Government of Malta would need to offer more attractive rates to raise funds. In fact, the recent Financial Stability Report issued by the Central Bank of Malta clearly indicates that the funding needed by the Malta Government in the next two years is substantial for the local market to absorb.

It is therefore becoming increasingly important for the market in all types of securities to become more liquid to attract more investors whether from Malta or overseas. The stock market must grow to meet the challenges facing both the Government and local corporates in 2012 and beyond.

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