

Stock Market Review

Investing in a low-interest rate environment

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Last week the European Central Bank slashed its main interest rate by a another 75 basis points in the light of further downward revisions to growth and inflation forecasts. Eurozone GDP is expected to decline by up to 1 per cent next year, while in 2010 growth is expected to resume mildly. Moreover, inflation in 2009 is expected to be around 1.4 per cent, a significant decline from inflation levels in recent months. Last week's largest interest rate move brought ECB rates down by 175 basis points from a level of 4.25 per cent in the summer months to a current level of 2.5 per cent.

Although in the aftermath of the rate decision, ECB President Jean-Claude Trichet avoided making any commitment to reduce borrowing costs again at the next meeting on January 15, many international economists expect further interest rate cuts during the first quarter of next year. Some also anticipate rates to fall below 2 per cent during the course of the year on increased unemployment and lower inflation. However, the ECB President warned that central banks around the world had to avoid falling into the trap of cutting rates too far. Instead, Mr Trichet said that he preferred to see government measures including bank recapitalization plans and guarantees being put into operation while the ECB might also consider fresh moves to revive financial market confidence, including flooding the market with liquidity.

Most local investors have never experienced such low interest rates. With traditional bank deposits earning very low returns many would be searching for more rewarding opportunities and asking how best to deal with such a low interest rate environment.

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preferences and coupled with the expectation of aggressive rate cuts by all major central banks, government bond prices rallied in overseas market as well as in Malta. The yield on the benchmark 10-year German government bond slipped from 4.66 per cent in July to the current 3.15 per cent. Likewise, Malta Government Stock prices surged with the recently issued six-year paper at 101.50 per cent in October jumping to 107.38 per cent last week representing a yield of 3.60 per cent per annum.

Risk aversion among investors brought about a big pricing anomaly with many overseas institutional and private investors selling out of corporate bonds and seeking low-

risk government paper. As a result, some foreign investment grade corporate bonds offer very attractive yields compared to government stocks. Also, even among st government paper, the yield gap in 10-year yields between government bonds of countries like Italy and Greece compared to Germany are at their highest since the introduction of the euro.

In the local market, the yield differential between corporate paper and Malta Government Stocks has also widened significantly following the strong rally in Malta Government Stock prices. Despite the surge in prices of Government paper as the market maker revised his bid prices reflecting lower eurozone yields, many local corporate bonds remain trading at relatively unchanged levels to some months ago. However, although yields look very attractive compared to the lower returns on MGS, the lack of market makers in the corporate bond market has precluded investors from participating in these higher yields corporate bonds.

On the other hand, the lack of availability of good quality corporate bonds on the secondary market as well as the low interest rate environment should be welcome news for those companies who are seeking to tap the market through a new bond issue. Although interest rates on new issues should reflect the current interest rate environ-

ment, investors are likely to continue to focus on the fundamental strength of the issuer or guarantor prior to making an investment. Next year, should therefore see a number of companies coming to the market with new bond offerings since they are likely to attract participation from savers holding low-yielding bank deposits.

The declining interest rate environment should also be positive for the equity market. On the one hand, those companies who rely on bank facilities ought to incur lower interest expenses thus helping to offset potential higher expenses such as utility rates as well as lower levels of income due to slower economic growth.

On the other hand, investors may also be more attracted to some companies' high dividend yields. In fact, yields of some local companies had always been generally attractive and the recent sharp decline in share prices has pushed yields even higher. While some companies have decreased their dividend payments due to lower profitability, other companies are likely to sustain their current dividend payout levels.

The global recessionary environment has led to drastic interest rate cuts across the world and created various opportunities especially in the light of the dwindling returns offered by traditional forms of savings. Many analysts claim that this crisis presents a once in a lifetime

opportunity. While seasoned overseas investors seem to be taking advantage of such favourable price movements, the lack of activity on the local bourse indicates that investors with cash to invest have not yet started buying into the market at a time when sentiment is very likely to be at its lowest point.

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