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Maastricht has encouraged investors to look at European government bonds

High interest after summit

By Sara Webb

Europe's government bond markets are ending the year on a bullish note.

The agreement on monetary and political union at the European Community summit in Maastricht last week has heightened investor interest in many of the high-yielding European bond markets. Investors have been encouraged by the agreement on a set date for the single currency and by the insistence of France and Germany that economic convergence criteria must be met.

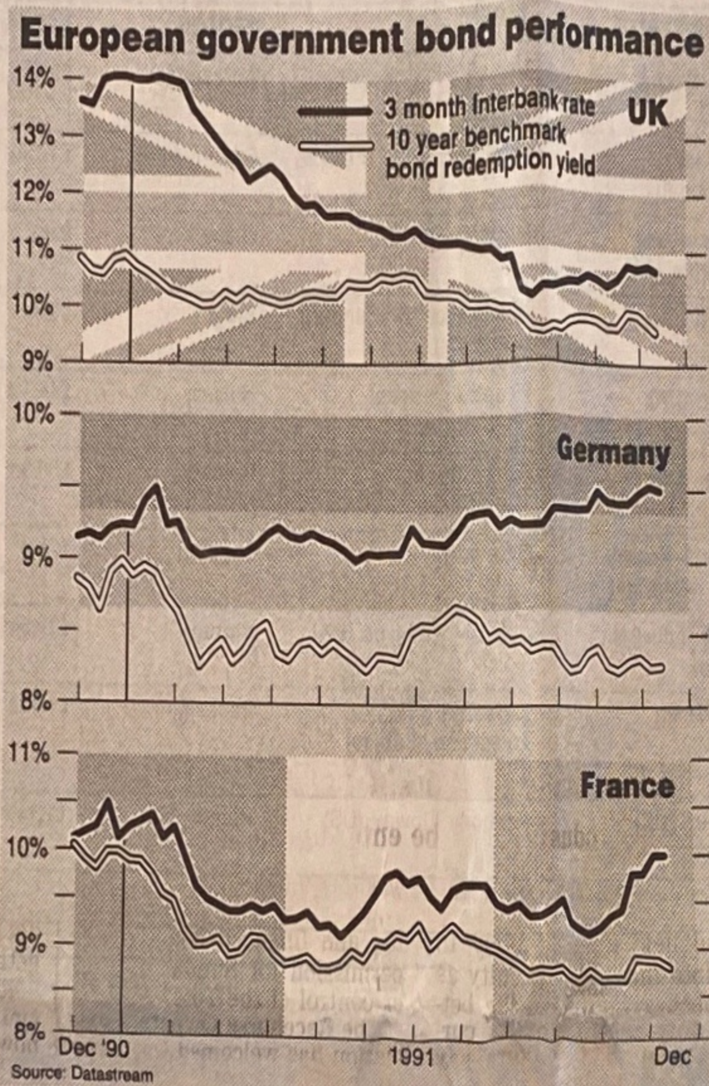
Investors are keen to buy into those markets where the prospects for economic convergence look favourable – namely those EC member countries which either already meet or which are considered ready to meet the criteria for the convergence of economic performance in inflation, long-term interest rates, fiscal policy and exchange rates.

Many of the European government bond markets – including France, the UK, Spain, Italy, and the Ecu bond market – made considerable gains last week following the successful outcome of the Maastricht summit. "The reaction to Maastricht is a predictable one, as the meeting went well, in that a firm date has been outlined for a single currency and the convergence of bond yields," said Mr Gerard Lyons, chief economist at DKB International, the Japanese-owned bank.

Traders reported some switching out of German government bonds and into these high-yielding markets, but added that US, Japanese and European investors also placed new funds in the European markets.

As a result, the yield on the benchmark 11¾ per cent gilt due 2003/07 closed at 9.523 per cent on Friday, compared with 9.723 per cent at the beginning of the week. In the French government bond market, the yield on the 9½ per cent Treasury bond (OAT) due 2001 ended the week at 8.78 per cent, compared with its opening last Monday of 8.91 per cent.

In the Ecu market, the price of the Ecu OAT bond due 2002 climbed from 97.30 before the Maastricht agreement to trade at 98.50 on Friday.



"The clearest winner to emerge from Maastricht is the Ecu," said Mr Kit Juckes, international economist at S.G. Warburg Securities. Economists and investors now feel the Ecu bond market has a clearer future: the eventual need for the Ecu has been established and the Ecu bond market is expected to develop further in coming years.

With a set timetable for the adoption of the Ecu as the single currency, investors have been concentrating on the long end of the Ecu market, namely those bonds which mature after 1999.

Further investment in high-yielding markets which are members of the exchange rate mechanism of the European Monetary System, is also expected to be encouraged, pushing up prices over the next few weeks.

"The whole Maastricht agreement is good for the long end of these bond markets," said Mr Juckes. However, investor interest over the longer-term is likely to be restricted to those markets where the chances of meeting the convergence criteria are good. The convergence criteria are:

- Inflation of not more than 1.5 per cent above the average of the three lowest inflation countries;
- Long-term interest rates of not more than 2 per cent above the average of the three lowest countries;
- Budget deficits of less than 3 per cent of GDP;
- The public debt ratio must not exceed 60 per cent of GDP; and
- The exchange rate must be maintained in the 2.25 per cent narrow bands of the ERM for at least 2 years before the Emu review date.

Only France and Luxembourg already meet the convergence criteria but economists say the UK, Denmark and Holland are in a good position to meet the criteria soon. However, high-yielding markets such as Italy and Spain – which have been popular with European investors because of the prospects for falling interest rates – are now being viewed more cautiously for the long-term as economists point to large budget deficits and high inflation.

Mr David Gibson, head of fixed income at Schroder Investment Management, said: "It is time to be more selective about which markets can continue to converge." He favours the French and UK bond markets, while large budget deficits in countries such as Belgium and Italy are likely to deter investment.

Germany also fails the convergence test on two counts – inflation and the budget deficit. Although the German bond market has suffered in recent months from worries about German inflation, the possibility of higher German interest rates, and the spillover from events in eastern Europe and the Soviet Union, economists believe that the turning point may have been reached.

German inflation is believed to have reached its peak and traders report renewed buying interest in short-dated German paper where investors hope to lock into high interest rates.

All in all, the combination of the Maastricht agreement and the general forecast for weak economic growth in the world economies is seen as favourable for the European bond markets.

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