

Edging towards Emu

 The most obvious place to look for the market implications of Emu entry is in the gilt market. Although gilt spreads have closed considerably against other European bonds over the last few years, there is still more to go for. UK gilts currently yield 60bp over bunds. While these levels do not offer the potential for the spectacular profits that have been generated in the Italian or Spanish bond markets since 1994, further gilt convergence does still offer scope for healthy gains. Falling gilt yields on the back of the UK moving closer to Emu will continue to provide very powerful valuation support for the UK market.

With much of the gilt convergence story already played out, the scope for rate convergence remains much greater at the short end of the yield curve. Despite the recent spate of aggressive cuts, UK base rates remain considerably higher, at 5.5%, than the 3% rate prevalent in Europe. At present, markets

project that UK three-month rates in March 2002 will be about 1.5% above euro rates (a gap that will, of course, automatically fall to zero if the UK has joined Emu by then).

Such falls in UK short rates would continue to be an important driver for UK financial asset markets. The falls would mean the big cash positions of the major UK investment institutions would still look uncomfortable. The low interest rates will continue to drive the UK retail saver out of deposit accounts and into financial savings products (pensions, life policies, ISAs) in search of better returns. These flows will then be invested in financial markets.

At the corporate level, low cash returns will drive further share buy-backs as companies look to shift an underperforming asset off their balance sheets. Cheap financing will also drive more take-overs. The corporate sector is likely to continue to be a big net buyer of UK equities.

A boost to the UK economy

Sharply lower UK interest rates at Emu convergence should provide a boost to the UK economy and those cyclical sectors (most obviously house builders or the more geared retailers) that have significant domestic exposure. However, we would emphasize that excess capacity, particularly in the consumer sectors, will continue to be a problem and that the ongoing lack of pricing power (ie, low inflation) means that the impact of a stronger economy on profitability will be muted.

Probably more important are the implications of further strong market cash flows. Falling base rates will drive more retail cash into UK markets. That money will more naturally find its way into the biggest, most liquid, stocks in the UK equity market.

Consequently, any move closer to Emu is likely to drive the domination of the UK's biggest stocks to even more extreme levels. Lower interest rates would provide further support to the momentum investor.

The prospect of the UK joining Emu could continue to make life very difficult for the more naturally contrary investor. ■

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INTERNATIONAL EQUITIES

These are a selection of issues announced recently. The details, updated to the middle of last month, were supplied by IFR Securities Data, London and other sources.

Issuer	Amount raised (m)	Type of issue	No shares (m)	Offer price	Pricing date	Exchange listing	Fees (%)	Bookrunner (s)
Air France	EUR598.2	S	42.44 (a)	EUR14.2	9 Feb/99	Paris	2.5	Société Générale (b) Morgan Stanley Dean Witter (c)
<i>Comment: Privatisation sale by French government. (a) 14.54m international, 27.9m shares domestic. (b) For two domestic and one international tranches. (c) for one international tranche.</i>								
COLT Telecom	GBP300	P	26.55 (a)	GBP11.30	2 Mar/99	London	3.5	Morgan Stanley Dean Witter
<i>Comment: UK company funding development of fibre optic connections in Europe. (a) 20.44m international, 6.11m domestic.</i>								
Equant	EUR3191.66	S	48.3 (a)	EUR66.08	11 Feb/99	NASDAQ Paris	3.5	Morgan Stanley Dean Witter
<i>Comment: French telcomms and postal company. (a) 46.74m international, 1.56m domestic.</i>								
Guardian iT	GBP75	S	12.5 (a)	GBP6	25 Feb/99	London		Warburg Dillon Read
<i>Comment: UK-based computers and office machinery company. (a) 1.875m international, 10.625m domestic.</i>								
Medion	EUR221	PS	2.6(a)	EUR85	25 Feb/99	Frankfurt Neuer Markt		Deutsche Bank AG
<i>Comment: German computer and peripherals company, proceeds for general corporate purposes, founder selling some stock. (a) 1.56 international, 1.04 domestic.</i>								
South African Breweries	GBP350.37	PS	81.85 (a)	GBP4.28	1 Mar/99	J' burg London	3.5	Cazenove Goldman Sachs Robert Fleming
<i>Comment: Proceeds to finance acquisitions in beverages market, including holdings in three Polish breweries. (a) 25.2m international, 56.65m domestic.</i>								
P = primary; S = secondary.								