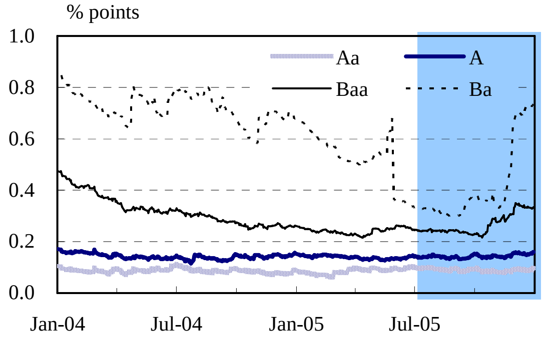
4. Credit market

Credit spreads have been stable at tight levels on the whole, and the favorable environment for financing remained unchanged as the amount issued and originated increased for products such as CPs, corporate bonds, and syndicated loans. The stable environment in the credit markets in recent years remained underpinned by: (1) solid corporate earnings and improvement in balance sheet quality, (2) investors' search for yield behavior, and (3) positive lending attitude of banks.

Credit spreads remain at tight levels on the whole

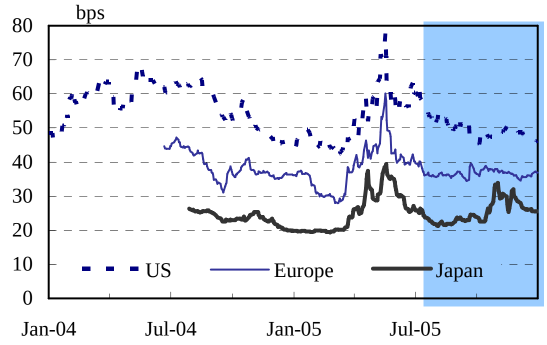
Looking at the credit spreads in detail, spreads with a rating of single A and higher remained stable at extremely tight levels while corporate bond spreads and CDS premiums for firms with a rating of triple B or double B widened (Charts 37 and 38). The widening of spreads was due largely to idiosyncratic concern over some firms with disappointing performance and did not suggest deterioration in the credit market as a whole. Furthermore, the shape of the credit curve has remained almost the same because the change in spreads observed in this period for ratings of triple B and others was limited from a relatively long-term perspective (Chart 39).

Chart 37: Corporate bond spreads



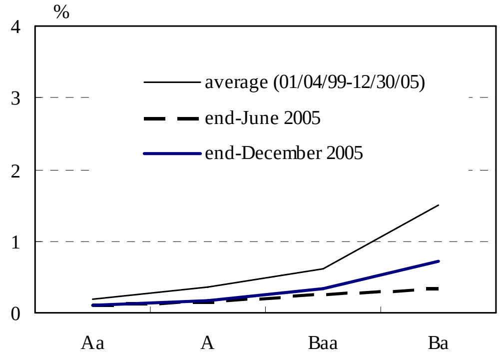
Notes: 1. Spreads on bonds with 5-year maturity.
2. The indicated ratings are those of Moody's.
Source: Japan Securities Dealers Association

Chart 38: CDS indices (Japan, US, Europe)



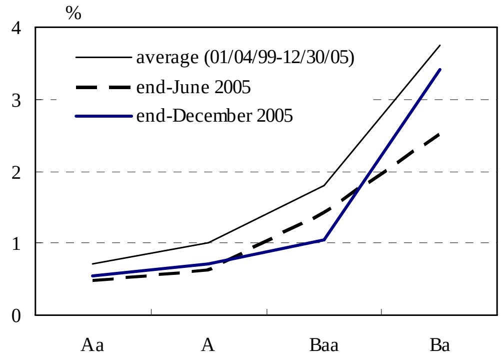
Notes: Japan: iTraxx CJ, US: DJ CDX NA.IG, Europe: iTraxx Europe
Source: Markit Group

Chart 39: Corporate bond credit curves (Japan)



Notes: 1. Spreads on bonds with 4- to 6-year maturity.
2. The indicated ratings are those of Moody's.
Source: Japan Securities Dealers Association

(Reference) Corporate bond credit curves (US)



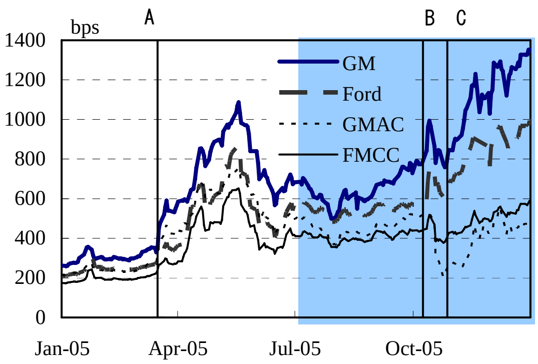
Note: Spreads on bonds with 3- to 5-year maturity.
Source: Merrill Lynch

In the market of yen-denominated bonds issued by non-residents (Samurai bonds), spreads of the financing-arms of some U.S. automakers widened (Chart 40). In the markets of public sector bonds (government guaranteed bonds, municipal bonds, and Fiscal Investment and Loan Program Agency bonds), reflecting the political discussions on privatization and consolidation of governmental financial institutions, spreads on some institutions widened (Charts 41 and 42). However, most of the other issues performed solidly in both markets.

During the second half of 2005, spreads on some firms have widened. But these were for idiosyncratic reasons with little effect on the credit market as a whole, leaving overall spreads tight.

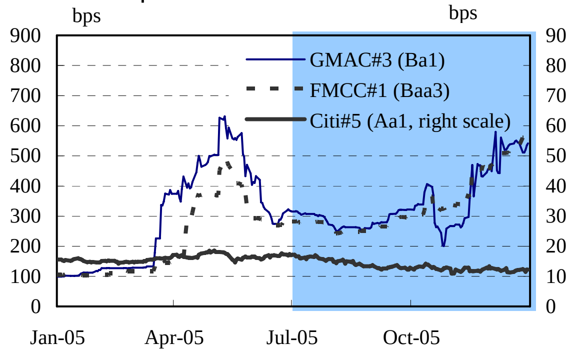
Meanwhile, in the U.S. market, spreads for GM and Ford which had been fairly stable during the summer, started to widen again due to the Chapter 11 bankruptcy of an auto-parts company that had strong business relations with GM. Nonetheless, as was the case in Japan, while the spreads of auto-related firms widened, spreads of the overall market remained tight against the background of solid corporate performance.

(Reference) CDS spreads on GM/Ford



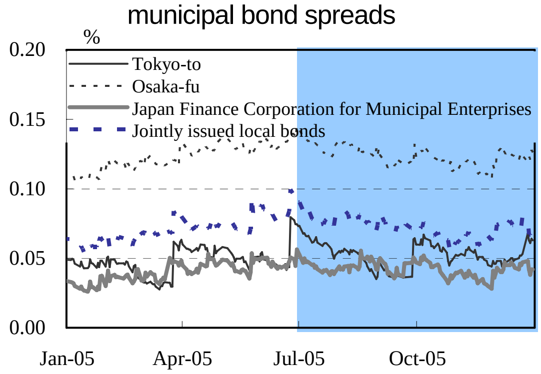
Notes: 1. (A) Mar. 16: GM lowered its first-quarter and full-year 2005 earnings guidance.
(B) Oct. 8: Delphi filed for Chapter 11 bankruptcy.
(C) Oct. 27: GM and GMAC received subpoenas from SEC.
2. Spreads on bonds with 5-year maturity.
Source: Bloomberg

Chart 40: Yen-denominated foreign bond spreads



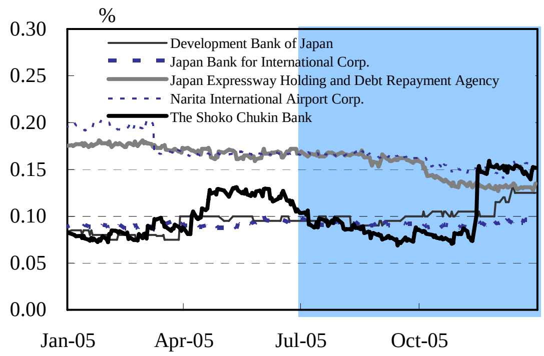
Notes: 1. Spreads on bonds with 3-year maturity.
2. The indicated ratings are those of Moody's at end-December 2005.
Source: Bloomberg

Chart 41: Government guaranteed bond and municipal bond spreads



Note: Spreads on bonds with 10-year maturity.
Source: Japan Securities Dealers Association

Chart 42: FILP agency bond and bank debenture spreads



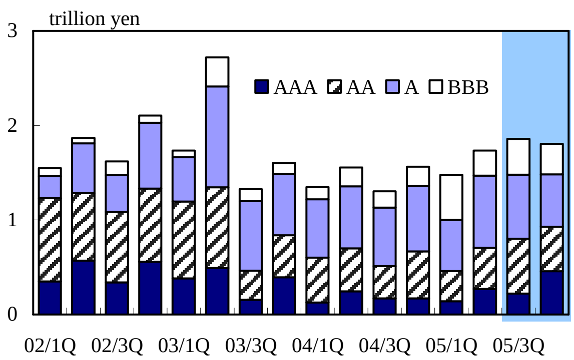
Notes: 1. Spreads on bonds with 5-year maturity for Development Bank of Japan and the Shoko Chukin Bank, while those with 10-year maturity for the others.
2. Japan Expressway Holding and Debt Repayment Agency took over Japan Highway Public Corporation on 1st October 2005.
Source: Japan Securities Dealers Association

Favorable financing environment

Looking at the primary market, outstanding of CPs increased, reflecting the financing needs of corporations for larger winter bonus payments and so forth. Issues of corporate bonds (SBs) increased as well (Charts 43 and 44). The amount issued by electric power companies, which had been declining for the last several years, started to increase due to expanded plans for business fixed investment. The amount of subordinated debt issued by major and regional banks rose as well. Looking at the amount issued by rating grades, there was a notable increase in issuance by triple B-rated firms (Chart 45).

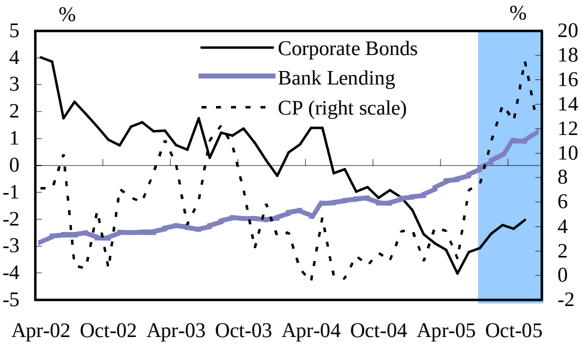
During the second half of 2005, there was a notable increase in the number of firms that issued SBs for the first time. In 2005, the number of companies that issued their first bonds reached to 37, the highest since 1998, when firms increased their bond issuance as a substitute for bank loans against the background of constraints on banks' lending capacity amidst the financial system problems (Chart 46 and 47). Among these 37 firms, about half were regional banks and bank holding companies issuing subordinated debts. At the same time, issuance by real estate investment trusts (REIT) and IT related companies increased.

Chart 45: Domestic straight corporate bond issuance by ratings



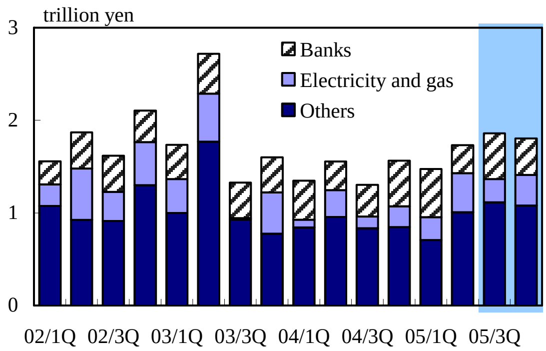
Notes: Issuers are classified by the highest rating among S&P, Moody's, R&I and JCR.
Source: I-N Information Systems

Chart 43: Year-on-year change in Bank lending, corporate bonds and CP issuance



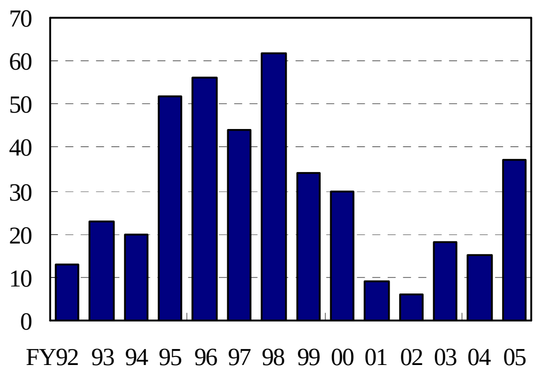
Notes: 1. The bank lending amount is adjusted to exclude factors such as the liquidation of loans.
2. The corporate bonds and CP are figures as of end of month.
3. The latest figure of corporate bonds is as of Nov., 2005.
Sources: Bank of Japan, Japan Securities Dealers Association, I-N Information Systems

Chart 44: Domestic corporate bond (SB) issuance by sectors



Note: Banks include bank holding companies.
Source: I-N Information Systems

Chart 46: Numbers of new issuers



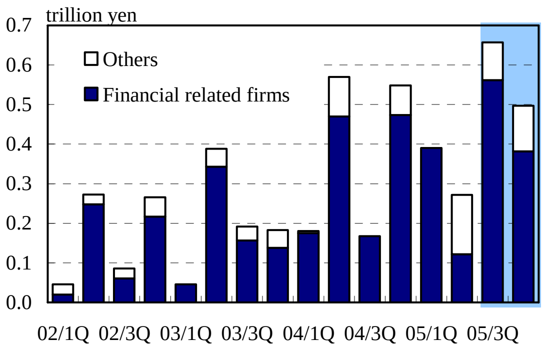
Source: I-N Information Systems

The number of Japanese REIT has increased and its market capitalization has reached around 3 trillion yen (Chart 48 and Box 3). In 2005, these funds started issuing REIT bonds as a means of diversifying their financing sources. For the corporate sector, triple B-rated firms, many of which are IT related firms having a strong need for financing to expand their business, increased the amount issued.

In the Samurai bond market, issuance amounts increased mainly for the financial related sector (Chart 49). The low issuance costs in Japan seemed to have attracted the issuers.

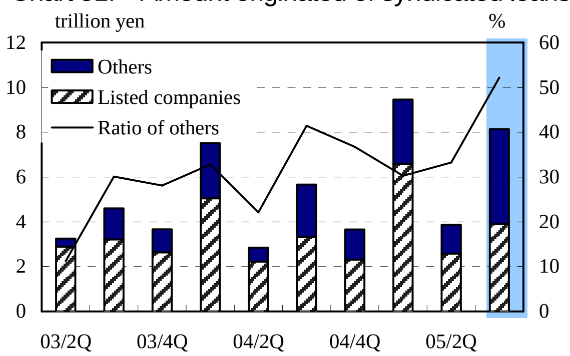
Meanwhile, the issuance of public sector bonds excluding the residential mortgage backed securities (RMBS) issued by the Government Housing Loan Corporation (GHLC), decreased compared with a year ago (Chart 50). This was mainly due to the decrease in government guaranteed bonds issued by the Depositary Insurance Corporation of Japan.

Chart 49: Amount issued of yen-denominated foreign bonds



Source: I-N Information Systems

Chart 51: Amount originated of syndicated loans



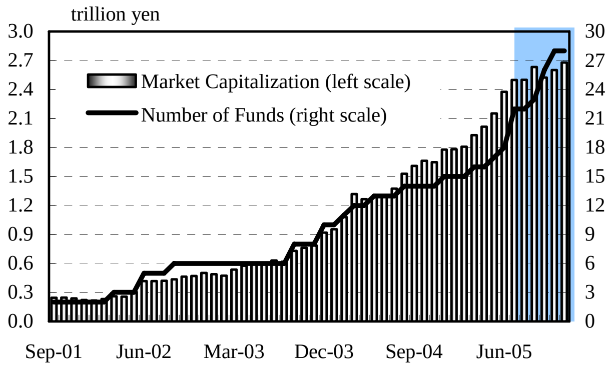
Source: Bank of Japan

Chart 47: New issuers by sector

	CY 2004		CY 2005	
	Issuers	Amount	Issuers	Amount
New issuers	15	6,335	37	10,800
Banks	6	3,550	19	5,450
Local Banks	2	350	15	2,250
REIT	0	0	7	1,750
Others	9	2,785	11	3,600
BBB rated	6	1,085	7	2,120

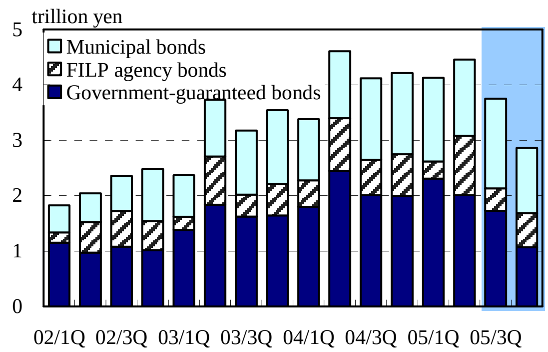
Notes: 1. Issuers are classified by the highest rating among S&P, Moody's, R&I and JCR.
2. Volume unit: 100 million yen
Source: I-N Information Systems

Chart 48: J-REIT Markets



Note: Figures are as of month-end.
Source: QUICK

Chart 50: Amount issued of government guaranteed bonds, FILP agency bonds and municipal bonds

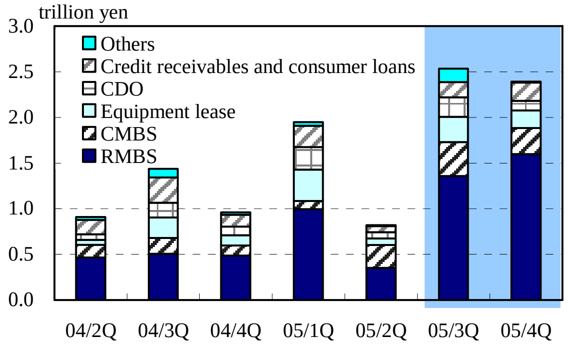


Notes: 1. RMBS issued by the Government Housing Loan Corporation are excluded from FILP agency bonds.
2. The amount issued in 05/4Q is the figure of Oct. and Nov. only.
Source: I-N Information Systems

Steady development of a broad range of financing channels

Syndicated loans can be characterized as an intermediate financing means between traditional over-the-counter bank loans and capital market financing instrument such as corporate bonds. The loan market has grown steadily by about 30 percent year-on-year (Chart 51). Loans to non-listed entities accounted for more than 50 percent of the total outstanding and, as was the case with the corporate bond market, the borrower base was expanding.

Chart 52: Amount issued of securitized products



Source: Bank of Japan

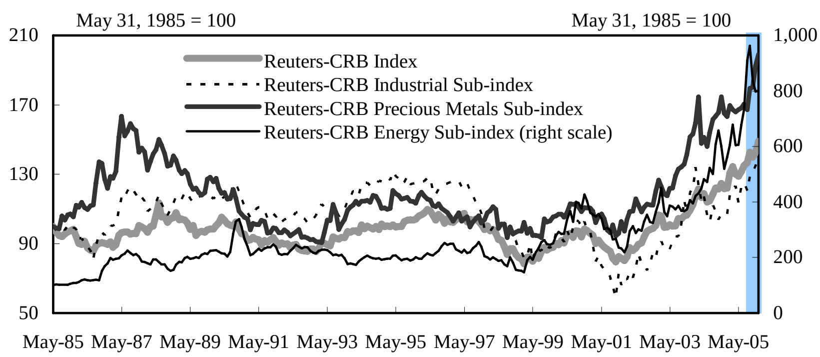
The issuance of securitized products has also increased (Chart 52). Looking at the type of underlying assets, issuance of products backed by real-estate related property such as RMBS and commercial mortgage backed securities were notable. This increase was mainly due to the fact that the GHLC started to issue large block of RMBS backed by mortgage loans originated in the past, following the partial amendment of the law governing GHLC in June.

Investors' demand for yield

Investors' search for yield behavior has helped maintain a favorable financing environment such as expansion of the borrower base and stable tight spreads. The overall low long-term interest rates seemed to be a background to such behavior (Box 4). Investors' search for yield behavior could be observed not only in the credit markets but also in other markets. Individual investors have increased their trading in the stock markets. Furthermore, the amount outstanding of mutual funds investing in foreign assets and equity mutual funds that pool corporate and individuals' investments into risk assets has been on the rise (Box 5).

While the U.S. and European long-term interest rates remain low, investors searched for yield in global financial markets as well. Investments in emerging markets were increasing once again, as well as in the equity and corporate bond markets in major countries. Especially, bank loans to emerging countries, mainly to Eastern Europe and Asia by Euro-area banks, were at an historical high. Japanese bank loans to Asia were recovering albeit at low levels (Box 6). Investments in hedge funds continued as well (Box 7). Although the performance of hedge funds has declined in recent years, institutional investors' demand for hedge funds has been still strong in order to gain absolute returns and to diversify their portfolio. At the same time, investments in commodity markets were expanding (Chart 53). Search for yield behavior has increased the interaction between domestic and foreign markets through expansion of arbitrage trading and diversification of investments.

Chart 53: Commodity Index Prices



Note: Energy Sub-index is consisted of crude oil, heating oil and natural gas. Industrial Sub-index is consisted of copper and cotton, Precious Metals Sub-index is consisted of gold, platinum and silver.
Source: CRB

5. Foreign exchange market

The yen fell against major currencies such as the U.S. dollar (USD) and the Euro (EUR), and against Asian currencies (Chart 54). On the contrary, the USD continued to strengthen against major currencies following the trend in the first half of 2005.

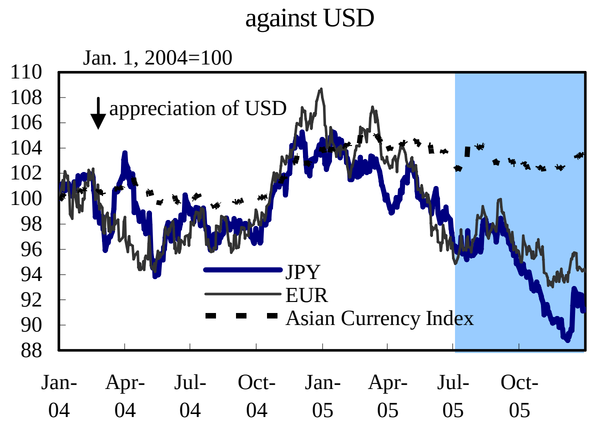
As for the developments in the foreign exchange markets, the yen had fallen against the USD to 121 yen by the beginning of December, from around 111 yen at the end of June 2005. The fall was due to the widening of the short-term interest rate differential between Japan and the U.S., and the increase in foreign asset investments from domestic investors. This was the first time that the yen had fallen to 121 yen since March 2003.

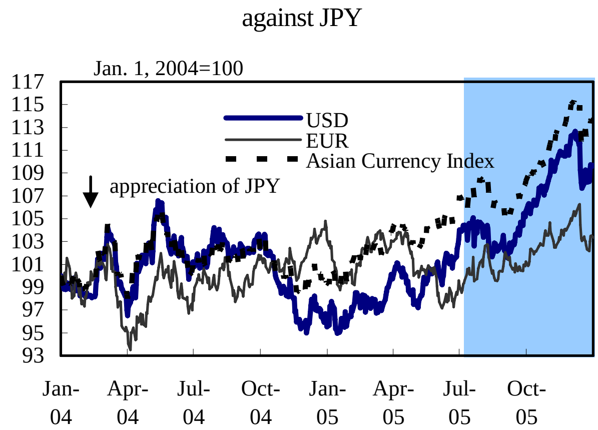
The EUR had fallen to around 1.17 USD/EUR by the beginning of December, from around 1.21 USD/EUR at the end of June 2005, due to the widening short-term interest rate differential and repatriation by U.S. corporations from overseas bases under the American Job Creation Act of 2004. Both the yen and EUR weakened against the USD, but since the yen fell basically against all major currencies, the euro-yen rate rose to 143 yen by mid-December from around 134 yen at the end of June. The yen hit its lowest level against the EUR since its introduction in 1999.

However, from mid-December 2005 to the beginning of 2006, USD fell somewhat against major currencies, as dollar selling related to position unwinding dominated the market.

Meanwhile, major Asian currencies held steady against the USD throughout the second half of 2005 (Chart 55). Asian currencies fell in October over concerns about economic disturbance caused by the rise in crude oil price, and the selling of Asian stocks by some investors to realize profits before their financial year end. However, by the year end, the solid performance of Asian economies, increase in policy rates, and the rise in stock prices contributed to the appreciation of their currencies. Meanwhile, since the revaluation of the Chinese Yuan (CNY) on July 21, the CNY remained flat on the whole, and the percentage rise against the USD

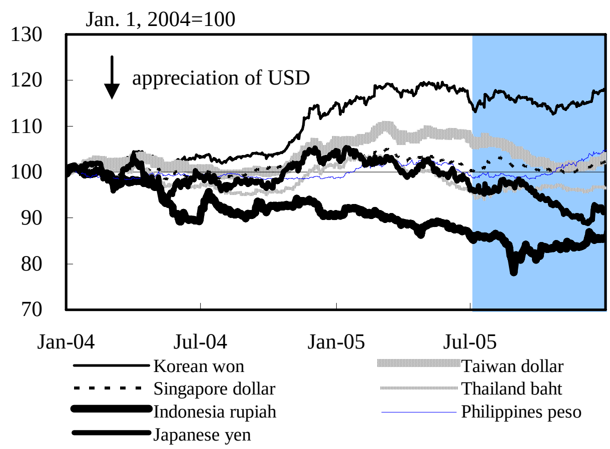
Chart 54: USD, JPY, EUR and Asian currencies exchange rates





Source: Bloomberg

Chart 55: Major Asian currencies/ USD exchange rates



Source: Bloomberg

was limited to 0.5 percent by the year end from 8.11 CNY/USD, the rate after the revaluation (Chart 56). During the second half of 2005, the yen fell against major Asian currencies. In 2006, reflecting Asian stock purchases by overseas investors, Asian currency rates remain solid against the USD.

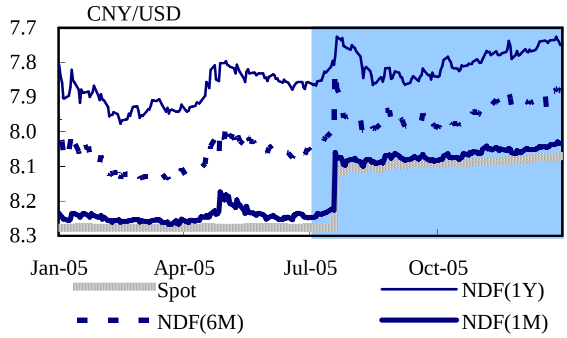
Factors behind the decline of the yen

As discussed above, in the second half of 2005, the yen continued to follow its downward trend from the first half of 2005 while Japan's economy recovered and stock prices outperformed overseas market. Three factors lie behind this trend.

Firstly, the short-term interest rate differential between Japan and the U.S. has widened as the U.S. has continued to increase its policy rate (Chart 57). This widening of short-term interest rate differential influenced investors' strategy toward investment and hedging activities through the change in funding and hedge costs. As discussed, the amount of domestic stocks purchased by overseas investors has exceeded one trillion yen every month since July. Overseas investors seem to have financed their Japanese stock purchases directly by yen, a low yield currency, or by hedging the foreign exchange risk. Furthermore, while the return on foreign bond (10-year) investments combined with transactions to hedge foreign exchange risks declined nearly to zero percent, domestic investors such as life insurance companies have unwound some of their hedge transactions or sold hedged foreign bonds to purchase JGBs due to the relatively higher return on JGBs. While the impact of these transactions on exchange rates is hard to quantify, the widening of the short-term interest rate differential seems to have put downward pressure on the yen through the above transactions.

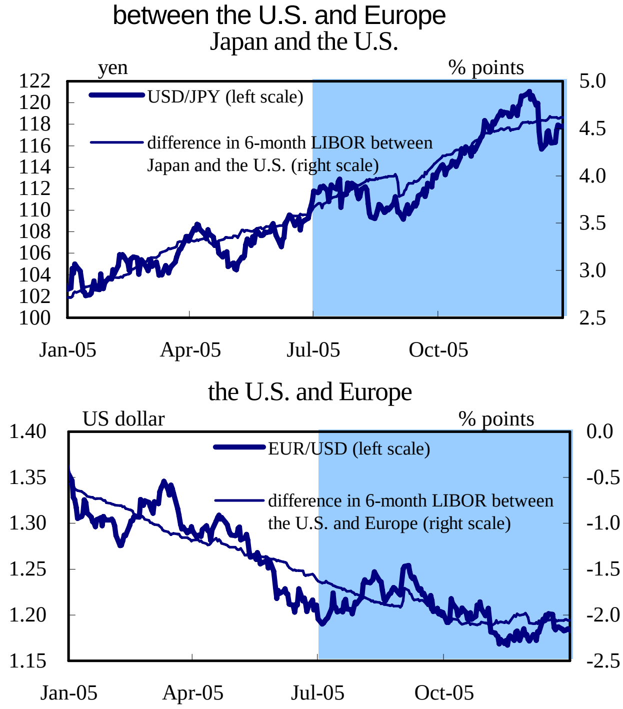
Secondly, Japan's trade surplus has declined sharply (Chart 58). With the rise in crude oil price and solid domestic demand, imports have risen and the trade surplus (balance of payment basis) from July to November 2005 was around 4.0 trillion yen, a decline of almost 30 percent, or 1.5 trillion yen, from a year ago. The reduction in the trade surplus has influenced the behavior of commercial operators such as export and import companies and reduced the yen purchasing pressure.

Chart 56: CNY spot and NDF exchange rates



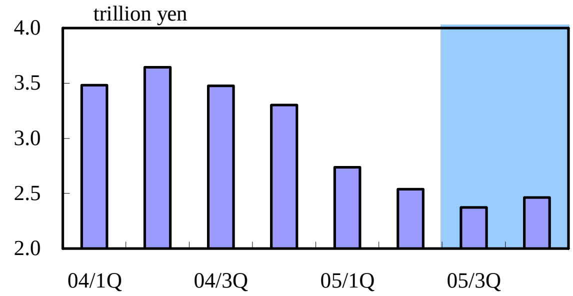
Note: NDF (Non-Deliverable Forward) is one of the forward transactions which trade the difference in amount between the contracted rate and the spot rate at a maturity date without a spot exchange transaction.
Source: Bloomberg

Chart 57: Short-term interest rates differentials between Japan and the U.S., and between the U.S. and Europe



Source: Bloomberg

Chart 58: Japan's trade balance

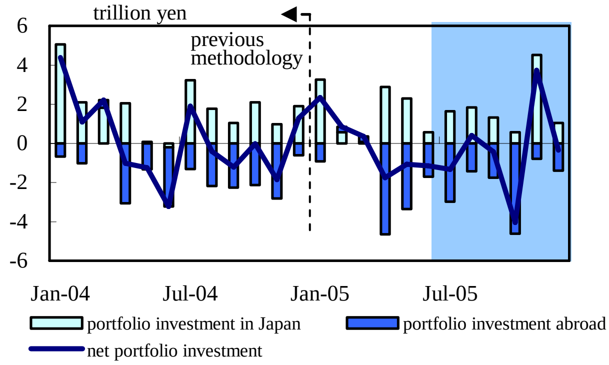


Notes: 1. The figure for 2005Q4 is 1 1/2 times the sum of the figures for Oct and Nov.
2. The figures for Oct and Nov are preliminary.
Sources: Ministry of Finance, Bank of Japan

Thirdly, outward investments in securities by domestic investors increased sharply (Chart 59). While inward investments in securities (sum of stock and bond investments) from July to December accounted for a net inflow of 10.9 trillion yen, net outward investments totaled 13 trillion yen, exceeding inward flows. This suggests that the supply and demand of funds for foreign exchange was net yen selling related to portfolio investment flows.

By investor, banks (banking account), securities houses and Japanese mutual funds were each a net seller of 5.6 trillion yen, 4.3 trillion yen and 4.6 trillion yen, respectively. The outflow through securities houses and mutual fund management companies included the foreign currency denominated bonds issued by non-residents to individual investors, and mutual funds that invest in foreign bonds. These funds include investments by individual investors for which the associated foreign exchange risk seem to be not hedged in most cases (Chart 60). Those individual investors who were willing to take foreign exchange risks for the sake of gaining returns from mainly the interest rate differential were increasingly using foreign exchange margin trading, which has lower transaction costs compared with other foreign currency denominated products such as foreign currency deposits. Backed by mainly domestic economic expansion and the rise in stock prices, individual investors seemed to have gained a greater appetite for risk and increased their investments in foreign assets. Also, the low volatility in the foreign exchange market has had effects on investors' decisions considering the risk reward on investments, thus fueling foreign asset investments (Chart 61).

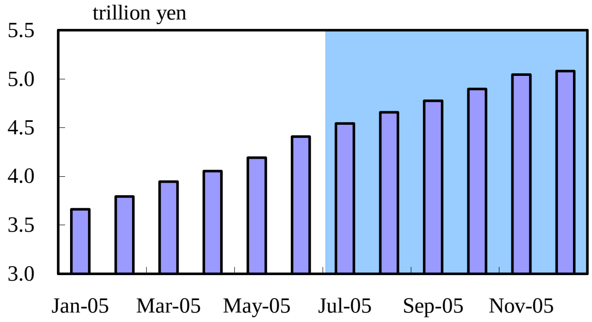
Chart 59: Portfolio investment



Note: There is a break in data due to a revision in methodology from Jan 2005. Data before 2005 are based on trades settled, data after 2005 are based on trades contracted. The figures for Oct and Nov 2005 are preliminary. The figure for Dec 2005 is based on reports from designated major investors.

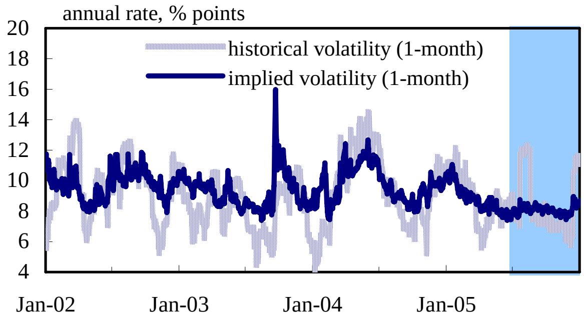
Sources: Ministry of Finance, Bank of Japan

Chart 60: Net assets amount of monthly-distribution-type mutual fund "Global Sovereign Open"



Source: Bloomberg

Chart 61: Historical and implied volatility of USD/JPY



Source: Bloomberg