Financial markets

Trends in the financial markets

Financial market trends

Against a backdrop of falling oil prices, rising corporate earning forecasts and vigorous acquisition activity, the stock markets have been decidedly benign in recent months, in some cases even reaching record highs. By contrast, developments in the bond and foreign exchange markets have been influenced mainly by the changing growth and inflation expectations for the US economy. In this setting, the long-term interest rates in the major economies fell, while exchange rates mostly moved "sideways" with only moderate fluctuations. Central bank interest rate decisions on both sides of the Atlantic had been largely expected and therefore had only a limited short-term effect on the financial markets.

Exchange rates

Euro exchange rate movements ...

In the light of the described changes in the international money and capital market interest rates, movements in the foreign exchange markets were comparatively calm in late summer and autumn. The euro did initially make some gains against the currencies of major trading partners as the market players were expecting further interest rate increases by the ECB following surprisingly positive quarterly data on euro-area GDP. However, the euro depreciated somewhat again on balance later in the reporting period.

against the US dollar ...

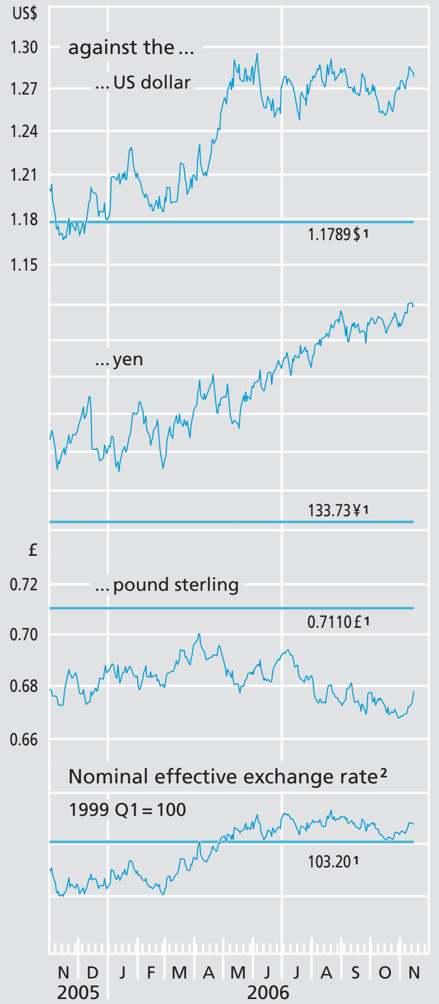
In mid-August, the euro initially again reached levels against the dollar that were close to its peak this year of US$1.30; however, it then fell below this mark. The emerging correction in the US real estate market and the resulting expectation by the markets that there would be a cooling of the US economy ultimately benefited the euro given the more favourable outlook for economic growth in the euro area. However, in September the fall in oil prices formed a certain counterweight with market players anticipating that this would have a positive impact on the US economy and the US current account deficit. The euro made up some ground again in November and, at US$1.28 at the end of the period under review, was 8½% up on its level at the beginning of the year.

... against the yen ...

The pick-up in economic activity in Europe and the accompanying expectations of higher interest rates on the part of market players led to gains for the euro against the yen. While the Bank of Japan discontinued its zero interest rate policy against a backdrop of a brightening economic outlook in July, further interest rate moves were, at first, mostly considered to be very unlikely. This pushed the euro-yen exchange rate to over ¥150 per euro at the end of August. The announcement that central bank presidents and finance ministers would be discussing the yen's exchange rate and considering monetary policy measures at the G7 meeting in Singapore subsequently led to notable gains by the Japanese currency. However, a sustained recovery failed to emerge when the publication of the official G7 communiqué made it clear that no specific conclusions had been reached. The yen's exchange rate then fluctuated within a narrow band around ¥149 against the euro before reaching a new record high of over ¥151 in early November.

Exchange rate of the euro

Daily data, log scale



1 Rate at the beginning of monetary union on 4 January 1999. — **2** As calculated by the ECB against the currencies of 23 countries.

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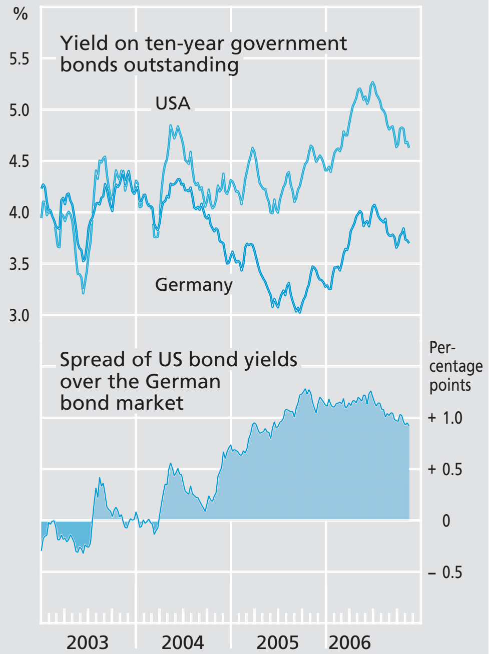
At the time this report went to press, the exchange rate was at just over ¥151 to the euro, which was approximately 9% higher than at the beginning of the year.

... and against the pound sterling

Largely, the euro has been slightly weaker against the pound sterling since the height of summer. It is possible that the British currency has at times been supported by some central banks stepping up their sterling reserves. At

Bond yields in Germany and the USA

Weekly average



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least, this is suggested by the latest IMF figures published on the denomination of foreign exchange reserves.[1] The robust economic situation has undoubtedly played a part in this development of the euro-pound sterling exchange rate as it was seen as an indicator of a further tightening of UK monetary policy. The Bank of England left its key interest rate unchanged in September and October in the wake of its surprising interest rate move in August, but it raised its key interest rate to 5.0% at the beginning of November against a backdrop of heightened inflation risks. At the end of the reporting period, the pound sterling's exchange rate against the euro stood at GBP 0.68. which was around 1% below its value at the beginning of the year.

Effective euro exchange rate

In the period under review, the euro weakened on average slightly vis-à-vis the currencies of the 23 major trading partners included in the exchange rate index. As this article went to press, the effective exchange rate stood at just over 3½% above the level at the start of this year and 1% below its level at the start of monetary union. In real terms, ie taking into account the prevailing inflation differentials between the euro area and its major trading partners, the euro's effective exchange rate has gone up by approximately 3% since the final quarter of 2005.

Securities markets and portfolio transactions

Overall decline in capital market rates in euro area

Following their record highs for this year in early July, capital market rates in the major economies fell noticeably again in the summer and autumn. At 3.8% most recently, ten-year government bond yields in the euro area were almost 40 basis points lower.

Decline in interest rates due to expectations of weaker US growth and less inflation compensation

The fall in yields in the major capital markets was initially driven by the correction in the interest-rate and growth prospects for the United States. Added to this was the fact that oil prices have declined sharply since mid-August. This has dampened inflation expectations, particularly in the United States, thus making a significant contribution to the decline in US interest rates. By contrast, ten-year inflation-protected bond yields, which are interpreted as long-term real interest rates, hav-

1 In the first half of 2006, foreign exchange reserves denominated in pound sterling grew from US$102.6 billion to US$129.4 billion. This refers to reported reserves only.

ing likewise declined in August and September, were, overall, virtually unchanged from their early-July level. The corresponding nominal yields in Europe and Japan also fell owing to the international links between interest rates. However, against a backdrop of robust business cycle data for the euro area, interest rate developments in the euro area moved away from the pattern set in the United States for a time. On balance, however, the yield advantage of ten-year US government bonds over European government bonds remained at around 90 basis points.

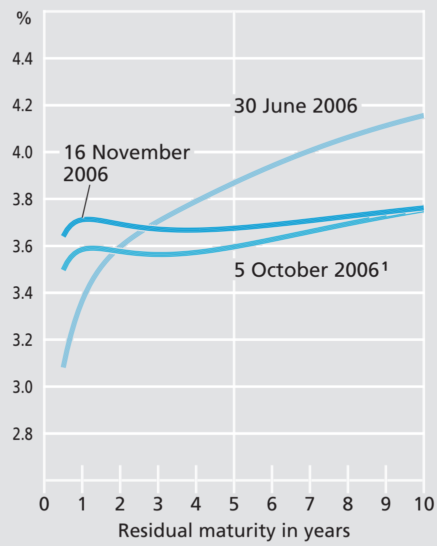
Term structure of interest rates clearly flatter

The German term structure of interest rates reflects the shifting influences on short and clearly long-term interest rates in the reporting period. While interest rates with maturities of up to two years rose as a consequence of the ECB Governing Council's decision of 5 October to increase the minimum bid rate of the main refinancing operations and owing to sustained expectations of higher interest rates in the money market, the long-term yields of German government bonds (Bunds) fell in line with developments in the United States. As a result, the German yield curve in the maturity range of up to four years inverted. It has since also flattened significantly across the entire maturity spectrum, with a spread of 3 basis points between one and ten-year interest rates.

Favourable financial conditions

In the autumn, the yields of BBB-rated corporate bonds in the euro area fell even more sharply than the yields of government bonds with comparable maturity. The interest rate premiums for these corporate bonds with the lowest investment grade rating declined by around 20 basis points to just under 1¼ percentage points. This means that they are currently back at the same level as at the beginning of the year. The more favourable financing conditions for the corporate sector are probably mainly a result of the positive economic situation as well as improved earnings prospects, fuelled in large part by falling oil prices. Furthermore, abating uncertainty about future developments in the bond and stock markets[2] may also have had a positive effect on the price development of corporate bonds.

Yield curve in the German bond market*



* Interest rates for (hypothetical) zero-coupon bonds (Svensson method), based on listed Federal securities. — **1** Before the interest rate increase of 25 basis points by the Governing Council of the ECB.

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Markedly lower bond sales

Despite the low interest rate level, issuing activity remained weak in the German bond market. At €248 billion, third-quarter gross

2 Measured in terms of the implied volatility of options on stock price indices and Bund futures.

Investment activity in the German securities markets

€ billion

Item	2005 Q3	2006 Q2	2006 Q3
Debt securities			
Residents	4.7	60.9	2.6
Credit institutions	– 10.2	23.6	– 0.8
of which Foreign debt securities	– 0.9	25.5	10.0
Non-banks	14.9	37.3	3.5
of which Domestic debt securities	0.3	18.4	– 2.5
Non-residents	25.3	10.8	19.3
Shares			
Residents	– 3.4	– 13.3	16.1
Credit institutions	6.0	– 8.2	3.7
of which Domestic shares	4.5	– 5.1	– 2.5
Non-banks	– 9.5	– 5.1	12.5
of which Domestic shares	– 8.5	– 2.0	4.6
Non-residents	7.7	9.1	2.0
Mutual fund shares			
Investment in specialised funds	6.3	9.7	5.7
Investment in funds open to the general public	6.2	– 2.1	– 3.9
of which: Share-based funds	1.2	– 3.0	– 1.1

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sales of domestic debt securities were down on the previous quarter (€ 267½ billion). At just €6 billion, net sales after deducting redemptions and changes in issuers' holdings of their own bonds and notes were also clearly below the level of the second quarter (€27½ billion). At €16 billion, there was also significantly less investment in foreign bonds in Germany between July and September than in the previous three months (€44½ billion). As a result, total funds raised through the sale of domestic and foreign bonds amounted to €22 billion compared with €71½ billion in the preceding quarter.

Credit institutions' net redemptions

The smaller inflow of funds to the domestic bond market primarily reflects the net redemptions of credit institutions, which reduced their bonded debt by €10½ billion after positive net sales of €12½ billion in the previous quarter. Public Pfandbriefs were redeemed on balance for €4½ billion, continuing the trend of the preceeding quarters. The maturing of the large-volume Jumbo Pfandbriefs, which were first issued about ten years ago, had a major influence on this. However, mortgage Pfandbriefs, debt securities issued by specialised credit institutions and other bank bonds were also redeemed for a total of €6 billion.

Higher public sector borrowing

By contrast, the general government sector borrowed more on the bond market (€20 billion) than in the previous quarter (€6½ billion). Central government issued €21½ billion (net) worth of debt securities. In the longer-term maturity segment it issued ten-year Bunds for €21 billion net and 30-year Bunds for €5½ billion net. At the shorter end of the market, it placed Federal Treasury financing paper totalling €½ billion. By contrast, five-year Federal notes and two-year Federal Treasury notes were redeemed for €4½ billion and €1 billion net respectively. State government also redeemed issues in the amount of €1½ billion.

Enterprises reduce bond market liabilities

While companies made use of the low costs of financing in the long-term segment and issued €8 billions' worth of corporate bonds, they redeemed shorter-term commercial paper totalling €12 billion net. Overall, domestic enterprises' bonded debt fell by €4 billion. This suggests that companies active in the capital market continue to be in a good financial position.

Purchases of debt securities

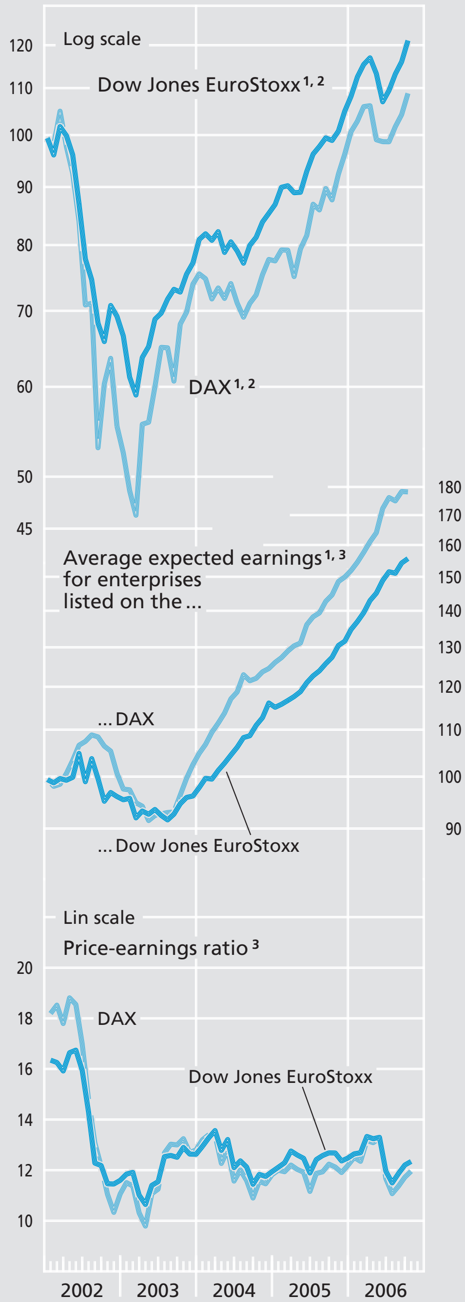
In the third quarter, foreign investors were the main purchasers in the German bond market. They acquired German paper from private and public sector issuers in nearly equal amounts (in total €19½ billion). Domestic non-banks invested €3½ billion in the bond market, which was used exclusively for foreign debt securities (€6 billion). Credit institutions reduced their bond investments by €1 billion. Although they invested €10 billion in foreign paper, which usually offers slight yield advantages, they removed €11 billion in domestic debt securities from their portfolios.

Buoyant equity markets

After suffering a temporary setback in May and June in the wake of major uncertainty, the stock markets performed very well from summer into November, thus matching the upward movement at the beginning of the year. All the major stock exchanges experienced a broadly based price recovery in a setting of favourable growth expectations for the world economy. Measured against the broad Dow Jones Euro Stoxx and CDAX indices, equities of European and German public limited companies reached a five-year high in mid-November and the S&P 500 recorded its highest levels since 2000. US and European indices gained 11% and 17% respectively on the beginning of the year. It was only on Japan's Nikkei index that the gains were more modest at +1% since January, although the Nikkei had already made very large gains in the previous year. In terms of the fundamentals, the upward trend in the euro-area equity market was supported by enterprises' positive 12-month-ahead earnings growth expectations, particularly as analysts have revised their forecasts further

Price movements and earnings estimates for European and German public limited companies

Monthly data



1 January 2002 = 100. — **2** Source: Deutsche Börse AG. — **3** Based on year-on-year I/B/E/S analyst estimates ("earnings before goodwill"). Source: Thomson Financial Datastream.

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Major items of the balance of payments

€ billion

Item	2005 Q3	2006 Q2	2006 Q3
I Current account 1,2	+ 19.5	+ 21.6	+ 19.1
Foreign trade 1,3	+ 41.1	+ 37.6	+ 40.1
Services 1	– 12.0	– 4.1	– 11.4
Income 1	+ 3.3	– 2.1	+ 3.2
Current transfers 1	– 7.6	– 4.8	– 7.5
II Capital transfers 1,4	+ 0.1	+ 0.0	– 0.2
III Financial account 1 (Net capital exports: –)	– 15.6	– 52.3	– 5.8
1 Direct investment	– 6.5	– 4.5	– 6.3
German investment abroad	– 7.4	– 10.3	– 10.2
Foreign investment in Germany	+ 0.9	+ 5.8	+ 3.9
2 Portfolio investment	+ 6.4	– 9.6	+ 8.0
German investment abroad	– 29.1	– 30.4	– 19.0
Shares	– 3.4	+ 11.3	– 1.9
Mutual fund shares	– 12.0	+ 2.7	– 1.1
Debt securities	– 13.7	– 44.4	– 16.0
Bonds and notes 5	– 9.5	– 36.4	– 15.4
of which: Euro-denominated bonds and notes	– 4.0	– 30.9	– 13.5
Money market instruments	– 4.2	– 8.0	– 0.5
Foreign investment in Germany	+ 35.6	+ 20.8	+ 27.0
Shares	+ 8.4	+ 8.6	+ 6.4
Mutual fund shares	+ 1.9	+ 1.5	+ 1.3
Debt securities	+ 25.3	+ 10.8	+ 19.3
Bonds and notes 5	+ 26.8	+ 8.2	+ 23.1
of which: Public bonds and notes	+ 17.0	+ 1.1	+ 10.4
Money market instruments	– 1.6	+ 2.6	– 3.9
3 Financial derivatives 6	+ 4.4	+ 2.0	– 0.2
4 Other investment 7	– 19.0	– 40.6	– 8.2
Monetary financial institutions 8	– 16.0	– 56.0	+ 13.0
of which: short-term	+ 6.1	– 38.9	+ 28.3
Enterprises and individuals	+ 4.5	+ 16.5	+ 0.9
of which: short-term	+ 1.7	+ 10.0	+ 4.1
General government	+ 0.3	– 15.1	+ 5.9
of which: short-term	– 5.0	– 15.1	– 1.0
Bundesbank	– 7.9	+ 14.0	– 28.0
5 Change in reserve assets at transaction values (increase: –) 9	– 0.8	+ 0.4	+ 0.8
IV Errors and omissions	– 4.0	+ 30.7	– 13.1

1 Balance. — **2** Including supplementary trade items. — **3** Special trade according to the official foreign trade statistics (source: Federal Statistical Office). — **4** Including the acquisition/disposal of non-produced non-financial assets. — **5** Original maturity of more than one year. — **6** Securitised and non-securitised options as well as financial futures contracts. — **7** Includes financial and trade credits, bank deposits and other assets. — **8** Excluding the Bundesbank. — **9** Excluding allocation of SDRs and excluding changes due to value adjustments. Discrepancies due to rounding of figures.

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upwards in recent months in the light of falling oil prices. Declining long-term interest rates (and thus also falling discount factors) as well as corporate acquisitions also contributed to the upsurge on the market. At the same time, uncertainty regarding future developments in stock market prices also eased again after increasing suddenly along with sharp price mark-downs in late spring. At the end of the period under review, the measures of volatility were back to near pre-turbulence values and were therefore at an exceptionally low level measured by the long-term average.

Raising funds in the stock markets ...

Given the favourable financial market environment, issuing activity in the German share market showed a further slight upturn. Domestic enterprises sold shares in the amount of €4 billion in the third quarter, thereby doubling the placement volume of the previous quarter. At €1 billion, the injection of equity by an already listed chemicals enterprice had a sizeable impact. Nearly €1 billion was also raised by the IPO listing of an energy corporation. Just under €2 billions' worth of unquoted equities were sold in the period from July to September. In Germany, purchases of foreign shares amounted to €14 billion, compared with sales in the amount of €6 billion in the second quarter. However, the main reason for the turnaround was a large cross-border corporate acquisition without which the volume of foreign shares held in Germany would have declined yet again.[3] The majority of German equities were purchased by domestic non-banks (€4½ billion),

3 See opposite page for direct investment.

which also added foreign shares worth €8 billion to their portfolios as a part of the direct investment mentioned above. In addition, non-residents invested €2 billion in German equities. Domestic credit institutions purchased shares in non-resident enterprises for €6 billion, while selling domestic paper worth €2½ billion net.

Sales of mutual fund shares

Despite the benign stock market climate, the inflow of resources to domestic investment funds, at €2 billion net in the third quarter, was down perceptibly on the period from April to June (€7½ billion). The resources were channelled solely into specialised funds which are open only to institutional investors (€5½ billion), whereas mutual funds open to the general public, as in the preceding two quarters, had to redeem shares to the value of €4 billion net. Almost all asset classes were affected by this decline in investment. While €1 billion was withdrawn from share-based funds, money-market and bond-based funds (€1½ billion each) sustained the greatest outflows of funds. Investors also liquidated shares in open-end real estate funds on a small scale (€½ billion). However, there was a further slowdown in the outflow of funds that followed three open-end real estate funds temporarily suspending the redemption of shares in the first quarter. In the case of specialised funds, share-based funds, bond-based funds and money market funds lost investable funds (€6, €2½ and €½ billion respectively). At the same time, mixed funds (€14 billion) enjoyed widespread popularity, which enabled specialised funds to achieve an overall inflow of resources amounting to €5½ billion. By contrast, the sale of foreign mutual fund shares, at €1 billion, was quite subdued.

Purchases of mutual fund shares

Mutual fund shares were purchased on balance by domestic banks (€2 billion), which invested exclusively in foreign mutual funds. By contrast, German non-banks reduced their investment in mutual fund shares, in some cases switching between foreign (-€1 billion) and German investment products (€½ billion), although they evidently preferred direct investment in the relevant markets in the reporting quarter. Foreign investors purchased just over €1½ billion in mutual fund shares in the German market.

Direct investment

Net capital exports in direct investment

In the third quarter, net capital exports amounting to €6½ billion were recorded in the field of direct investment following net outflows of funds in the two preceding quarters. German investors continued to expand their foreign investment (€10 billion), although, as mentioned above, one large corporate takeover in the gas sector was of particular importance. German acquisitions of participating interests abroad focused on the United Kingdom.

In the period from July to September, non-residents' direct investment in Germany, at €4 billion, was lower than German investment abroad. Direct investment was divided in roughly equal parts between an expansion of domestic equity capital and reinvestment of earnings.