Financial markets

Financial market trends

Financial market setting

The international financial markets were, in the fourth quarter of 2007, dominated by the ongoing credit market disruption and growing concern about the global economy. Although global stock markets were supported by US rate cuts and proved relatively robust until year-end, global equities suffered heavy losses in January 2008 given fresh concerns about the impact of the credit market turmoil on financial institutions and mounting fear of a US recession. Significantly greater risk aversion on the part of investors resulted in a "flight to security" and put considerable pressure on government bond yields; in addition, spreads on risky bonds widened significantly. At the end of the reporting period, two more US rate cuts totalling 125 basis points and relatively positive economic signals for the euro area helped calm things down. Against this backdrop, the euro appreciated further, reaching a new historic high at the beginning of January 2008, but subsequently slipped back again slightly.

Exchange rates

Euro exchange rate against the US dollar ...

In the fourth quarter of 2007, the euro put in a strong performance overall. This was particularly true against the US dollar. Following the change in direction in US monetary policy in mid-September, the euro's upward trend was, for the most part, unbroken, as a number of negative US economic data releases led market players to expect further Fed rate cuts. In addition, US banks' problems as a result of the crisis on the US credit markets detrimentally affected the US dollar in this period. The euro slipped slightly, but only temporarily – in response to unexpectedly strong US consumer price inflation. However, the risks to the US economy rapidly moved centre stage again in response to falling prices on the US real estate market as well as disappointing labour market data; consequently, the euro-dollar exchange rate strengthened to US$1.47 at year-end. It was thus almost 12% up on the year and roughly 25% higher than at the start of monetary union.

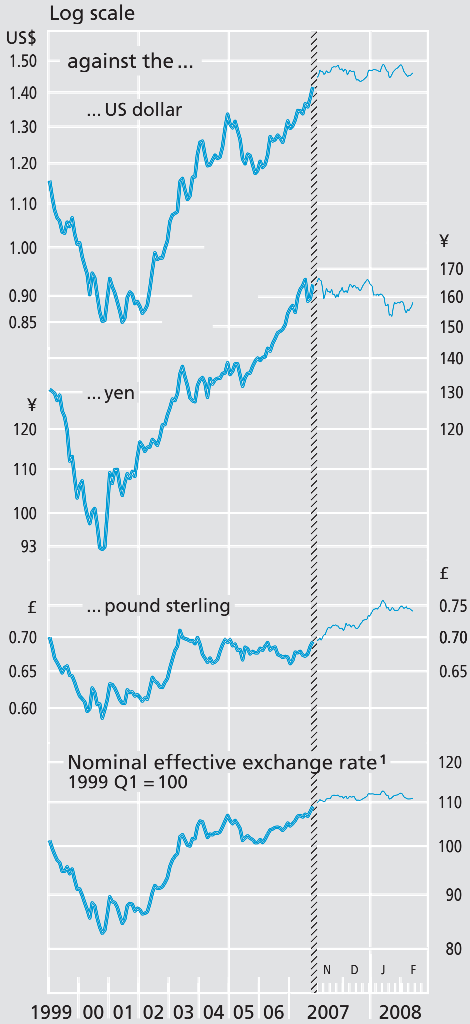
At the beginning of the new year, sentiment towards the euro on the foreign exchange markets initially remained positive, and the single currency reached a new historic high of US$1.49. In mid-January, however, concerns that the real estate crisis in the United States was spilling over to the euro-area economy appear to have hurt the euro. The euro-dollar exchange rate slipped slightly as a result, and, when this report went to press, the euro was trading at US$1.46 and thus below its all-time high again.

... against the yen ...

The euro displayed no clear trend against the yen in the fourth quarter of last year. Although changing assessments of what economic impact the credit market crisis would have on Japan resulted in temporary losses, the European currency was quick to recover. The fact that the euro-yen exchange rate frequently correlates with US and European equity indices could be an indication that international investors have financed stock market investments in the United States and Europe using yen liabilities. In this environment, the euro ended 2007 at ¥165, and thus 5% up on the year. However, the turmoil on the international stock markets at the beginning of 2008 and the further increase in exchange rate volatility resulted in broad-based and significant yen gains. This also depressed the euro-yen exchange rate. As this report went to press, the single currency was therefore trading slightly lower, at ¥158, than at the beginning of the year.

Exchange rate of the euro*

Log scale



* Monthly averages; from November 2007, daily data. — 1 As calculated by the ECB against the currencies of 22 countries.

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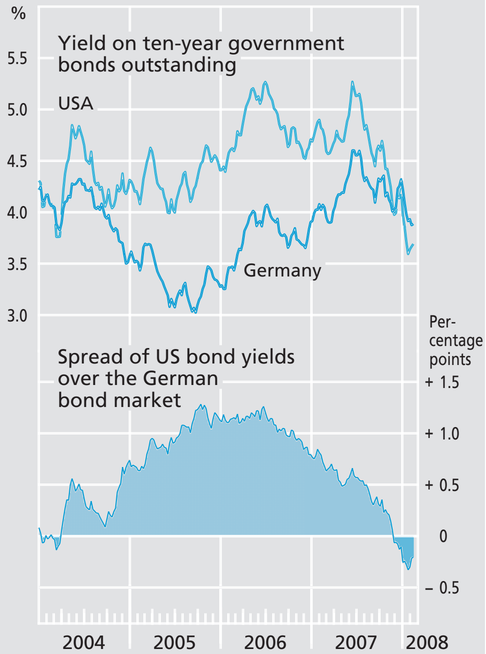
Bond yields in Germany and the USA

Weekly averages



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... and against the pound sterling

The economic risks associated with developments on the financial and real estate markets meant that market participants came to a new assessment of UK interest rate trends in November 2007, particularly as the Bank of England had trimmed its growth forecast for 2008 in its inflation report. The emerging turnaround in UK monetary policy was then confirmed at the beginning of December when the central bank carried out a base rate cut to 5.5%. Even after that, the deteriorating economic outlook for the UK continued to weigh on the pound sterling. The euro-pound exchange rate therefore remained on a continual upward trend during the fourth quarter and reached a peak of £0.76 in mid-January 2008. At the end of the reporting period, however, the euro slipped back again somewhat to trade at £0.74 against the euro.

Effective euro exchange rate

The accession of Malta and Cyprus to the euro area means that the effective euro index is calculated vis-à-vis 22 rather than 24 important trading partners since the beginning of the year. In the light of movements in bilateral exchange rates, the euro has, on balance, appreciated against the currencies contained in the exchange rate index since the end of October 2007, marking a new high at the beginning of January 2008. When this report went to press, however, it was trading just below its level of the beginning of the year and some 8% above the level it stood at when monetary union was launched. Taking into account the different levels of inflation in the euro area and the economies of the euro area's major trading partners, the effective euro exchange rate was therefore still well above its longer-term average.

Securities markets and portfolio transactions

Capital market rates fall in euro area ...

On the securities markets, investors realigned their portfolios at the turn of the year. Having remained virtually unchanged overall in the fourth quarter of 2007 – despite slight fluctuations – yields on ten-year European government bonds have dropped by more than ¼ percentage point to slightly more than 4% since the beginning of January as stock market prices have fallen. In a very nervous environment, the decline in yields is not least the result of portfolio shifts in favour of liquid and safe government bonds. Bond market investors' uncertainty is reflected in the corresponding volatility indices, which picked up significantly on both sides of the Atlantic at the beginning of 2008 and currently stand at a four-year high.[1] In addition, one cannot rule out the possibility that the financial markets are expecting large write-downs by banks and the danger of a significant slowdown in the United States to result in the pace of economic growth slowing in Europe, too. This is borne out by the fact that real interest rates in the euro area have fallen significantly since the beginning of the year.

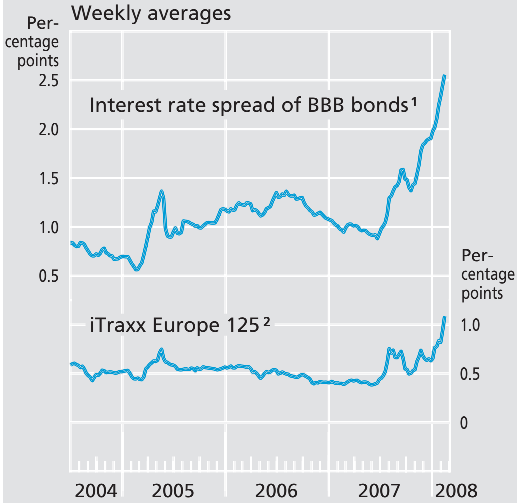
... and even more so in dollar area

The drop in yields on US government bonds, which started in the third quarter of 2007, has – with just brief interruptions – continued over the past few months. Against the backdrop of emerging recession fears for the United States and large Fed rate cuts, the average yield on ten-year government bonds has dropped by almost 1 percentage point since the end of September to currently 3¾%. As a result, US capital market yields have declined more sharply than their euro-area counterparts, which means that European government bond yields are higher than those on US bonds for the first time since 2004 and most recently offered an interest-rate advantage of around ⅓ percentage point.

Inverse yield curve

The impact of portfolio shifts in favour of bonds with no credit risk and revised growth expectations can also be seen in the downward shift in the yield curve for Bunds. This curve has recently inverted in the short to medium-term maturity segments – a development temporarily witnessed back in the period from November to the beginning of December. Market participants obviously expect interest rates to fall over the aforementioned horizon.

Financing conditions on the European capital market



Sources: Bloomberg, Merrill Lynch and Thomson Financial Datastream. — 1 Yield advantage of euro-denominated seven to ten-year BBB rated corporate bonds versus matched-maturity euro-area government bonds. — 2 Credit default risk premiums for 125 European companies with an investment grade rating.

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Significant widening of corporate bond spreads

Financing conditions for companies on the bond market became more difficult over the reporting period. Against the backdrop of declining government bond yields and rising corporate bond rates, euro-area bonds in the lowest investment grade rating category, BBB, have seen their spreads widen by two-thirds to 260 basis points since the end of September. Spreads are thus at a five-year high. At the same time, the iTraxx Europe Index, which reflects 125 companies' credit risk, has risen significantly. The difference in the spreads on five and ten-year contracts has largely disappeared, which points to heightened credit risk in the next five years

1 As measured by the implied volatility of options on the Bund future and T-note future over a three-month horizon.

Investment activity in the German securities markets

€ billion

Item	2006 Q4	2007 Q3	2007 Q4
Debt securities			
Residents	4.6	– 85.5	– 45.2
Credit institutions	21.6	– 0.2	25.4
of which			
Foreign debt securities	38.4	13.8	29.5
Non-banks	– 16.9	– 85.3	– 70.6
of which			
Domestic debt securities	– 20.8	– 74.4	– 47.4
Non-residents	40.0	50.6	83.4
Shares			
Residents	– 23.2	– 18.3	4.7
Credit institutions	9.7	– 4.0	5.3
of which			
Domestic shares	5.1	– 2.8	2.7
Non-banks	– 32.9	– 14.3	– 0.6
of which			
Domestic shares	– 28.7	1.2	– 2.2
Non-residents	25.8	2.6	2.7
Mutual fund shares			
Investment in specialised funds	7.0	– 1.2	9.2
Investment in funds open to the general public	– 1.9	– 6.9	– 0.3
of which: Share-based funds	– 1.9	– 2.5	– 0.1

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compared with the subsequent five-year period.

German bond market experiences fourth-quarter revival ...

The Federal and regional governments in Germany, in their capacity as bond issuers, were the main beneficiaries of investors' pronounced risk aversion. Overall, domestic debt securities worth €338½ billion were sold in the fourth quarter of 2007. Taking into account lower redemptions, German issuers raised €32 billion on their domestic market in the final quarter of the year, while the volume of outstanding domestic bond securities had dropped by €37½ billion in the previous quarter. In addition, foreign debt securities with a net value of €6 billion were sold on the German bond market, compared with €3 billion in the third quarter of 2007. On balance, all these bonds were denominated in foreign currency in the fourth quarter, as in the third quarter. Overall, German bond market issuance thus totalled €38 billion in the fourth quarter, whereas net redemptions of €35 billion had been recorded in the previous period.

... as public-sector issuance picks up

Of domestic bond issuers, the public sector recorded the strongest inflows of funds. In the period from October to December 2007, it raised €28½ billion on the capital market, while the Federal Government's favourable financial situation had allowed it to reduce bond market debt by €31 billion in the third quarter. Overall, the German Federal Government issued €23 billion worth of debt securities, including five-year Federal notes or Bobls (€18 billion), ten-year bonds (€4½ billion) and two-year Federal Treasury notes or Schätze (€1½ billion). By contrast, net redemptions of 30-year bonds, Federal Treasury financing paper and Federal savings notes were down on the quarter. State governments tapped the capital market for €5½ billion in the fourth quarter of 2007, compared with €2½ billion in the third quarter.

Credit institutions' market debt continues to decline

By contrast, domestic credit institutions further reduced their domestic capital market debt by €4½ billion from October to December, compared with €8½ billion in the third quarter. Again, this was largely the result of large net redemptions of public Pfandbriefe (€8 billion, compared with €14 billion in the period from July to September). By contrast, banks recorded net sales of €2 billion worth of other bank debt securities, which allow particularly flexible structuring, and this amounts to a slight drop from the third quarter (€4 billion). Specialised credit institutions raised €1½ billion in the capital market. In addition, the reporting period saw small-scale net issuance of mortgage Pfandbriefe (€½ billion) by banks for the first time since the first quarter of 2006.

Enterprises borrow on the money market

Domestic enterprises stepped up borrowing on the domestic market in the period from October to December and issued debt securities with a net value of €8 billion. This involved selling €9½ billion worth of commercial paper and redeeming longer-term bonds.

Purchases of debt securities

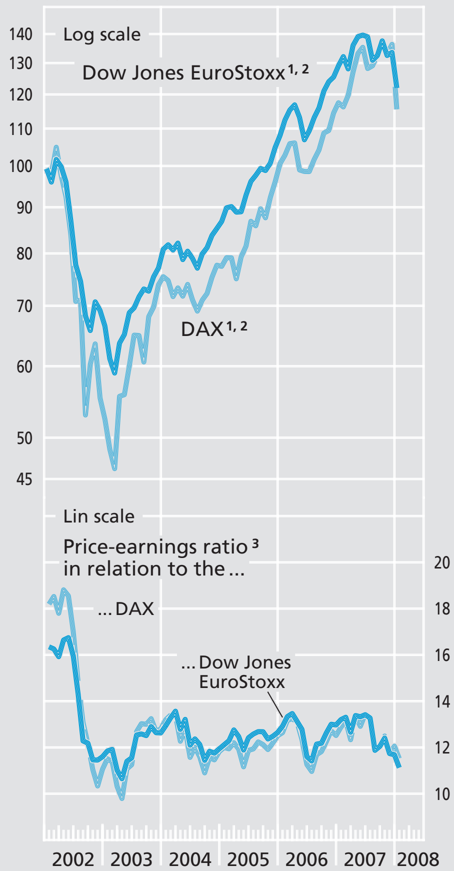
As in the third quarter, non-resident investors, who have in the past frequently shown a preference for German bonds as safe and liquid instruments in times of heightened uncertainty, were the only net buyers of debt securities on the German market between October and December. They invested a net total of €83½ billion in German paper, almost two-thirds of which were used to buy bonds issued by the private sector. By contrast, German investors sold €45 billion worth of debt securities. This can be attributed solely to selling by domestic non-banks, which offloaded debt securities worth €70½ billion net. Domestic credit institutions purchased €25½ billion worth of bond market paper, ultimately buying only domestic bonds (€29½ billion). Some of this buying represented the takeover of asset-backed securities issued by the institutions' own securitisation vehicles.

Stock markets relatively robust until year-end ...

Developments on the international stock markets were also dominated by the marked shift in sentiment among financial market players over the year-end. Nevertheless, up until the end of last year, stock markets on both sides of the Atlantic proved relatively resistant to the distortions on the credit markets, the gloomy economic outlook in the United States and the higher oil price. The fact that the US central bank cut the key interest rate by 25 basis points in October and again in December and that market players expected further rate cuts is likely to have been a factor. In this environment, share

Share 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	2006 Q4	2007 Q3	2007 Q4
I Current account 1,2	+ 43.1	+ 38.2	+ 49.8
Foreign trade 1,3	o + 45.9	+ 50.6	+ 49.4
Services 1	– 1.4	– 10.2	– 2.3
Income 1	+ 7.0	+ 9.1	+ 10.3
Current transfers 1	– 3.5	– 8.6	– 6.0
II Capital transfers 1,4	– 0.1	+ 0.4	– 0.3
III Financial account 1 (Net capital exports: –)	– 35.1	– 17.7	– 65.6
1 Direct investment	+ 9.6	– 14.8	– 27.2
German investment abroad	– 9.5	– 32.8	– 33.7
Foreign investment in Germany	+ 19.1	+ 18.0	+ 6.4
2 Portfolio investment	+ 5.8	+ 48.6	+ 79.7
German investment abroad	– 52.8	+ 0.5	– 9.7
Shares	– 3.3	+ 5.3	+ 5.8
Mutual fund shares	– 7.3	– 2.0	– 9.3
Debt securities	– 42.3	– 2.9	– 6.2
Bonds and notes 5	– 44.2	+ 3.4	+ 0.3
of which Euro-denominated bonds and notes	– 38.7	+ 10.3	+ 5.0
Money market instruments	+ 1.9	– 6.2	– 6.5
Foreign investment in Germany	+ 58.7	+ 48.1	+ 89.4
Shares	+ 17.3	– 3.3	+ 5.4
Mutual fund shares	+ 1.4	+ 0.8	+ 0.6
Debt securities	+ 40.0	+ 50.6	+ 83.4
Bonds and notes 5	+ 48.3	+ 31.6	+ 67.8
of which Public bonds and notes	+ 21.3	+ 3.5	+ 35.1
Money market instruments	– 8.3	+ 19.0	+ 15.7
3 Financial derivatives 6	– 3.0	– 33.1	– 29.5
4 Other investment 7	– 48.1	– 18.1	– 89.2
Monetary financial institutions 8	– 56.1	– 24.7	– 55.5
of which: short-term	– 23.0	+ 10.3	– 19.5
Enterprises and households	– 5.4	+ 6.0	– 11.0
of which: short-term	+ 1.0	+ 10.1	– 1.8
General government	+ 3.6	+ 28.6	– 7.2
of which: short-term	+ 2.9	+ 29.1	– 7.9
Bundesbank	+ 9.8	– 27.9	– 15.5
5 Change in reserve assets at transaction values (increase: –) 9	+ 0.6	– 0.3	+ 0.7
IV Errors and omissions	– 8.0	– 20.8	+ 16.1

1 Balance. — 2 Including supplementary trade items. — 3 Special trade according to the official foreign trade statistics (source: Federal Statistical Office). From January 2007, excluding supplies of goods for/after repair/maintenance, which, up to December 2006, were deducted via the supplementary foreign trade items. — 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. — o Positively influenced by late reports.

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prices in Germany and Europe range traded, while US equities suffered moderate losses.

... but sharply lower in January

However, fresh concerns about the extent of the write-downs which many financial institutions would have to make and spreading fears of a more pronounced economic slowdown in the USA resulted in sharply lower and volatile global stock market prices in January. A case of fraud at a large European credit institution as well as fears that monoline insurance companies in the USA could experience difficulties similar to those of banks further hit share prices. The stock market slump was accompanied by increasing risk aversion and considerably heightened uncertainty about further price trends.[2] By contrast, the US rate cuts by 75 and 50 basis points in January had a stabilising effect on the markets. Another such effect was positive growth signals for Germany, for instance the good results of the Ifo business climate index and an anticipated further increase in corporate profits overall, which are likely to have supported prices at the lower level. Since the end of September, German and European equities have generally suffered losses of 12% and 14% respectively as measured by the broad market indices CDAX and Dow Jones Euro Stoxx, while the US S&P 500 also slipped by 12%. With the exception of the CDAX, all the above indices have recently been trading lower than at the end of December 2006 and have thus reversed last year's gains.

2 Measured by implied volatility indices (VDAX, VIX).

Issuing activity in the stock market increases

Despite pronounced price volatility, issuance in the German share market picked up slightly in the fourth quarter. Domestic enterprises placed new shares worth €3 billion, compared with €1 billion in the third quarter. The vast majority of these shares were listed equities. In addition, net sales of foreign shares on the German market totalled €4 billion.

Share purchases

In the fourth quarter of 2007, domestic credit institutions represented the main group of buyers in the equity market. Banks added domestic and foreign equities worth a total of €5½ billion to their portfolios. Foreign investors acquired shares to the value of €2½ billion, on balance exclusively in the form of portfolio investments (€5½ billion).[3] Domestic non-banks reduced their stock market exposure overall (€½ billion), but were net buyers of foreign equities (€1½ billion).

Sales of mutual fund shares

Domestic investment companies recorded inflows of funds amounting to just under €9 billion in the fourth quarter, compared with fund outflows of €8 billion in the preceding three months. On balance, only the specialised funds reserved for institutional investors were able to attract new monies (€9 billion). By contrast, there were small-scale redemptions of mutual fund shares in German funds open to the general public (€½ billion). Bond funds (€2 billion) and money market funds (€1½ billion) suffered the highest net outflows, although open-ended real-estate funds were also affected (€½ billion). By contrast, mixed securities funds sold €2 billion worth of shares. In addition, net sales of mutual fund shares in foreign funds on the German market totalled €9½ billion.

Purchases of mutual fund shares

Domestic non-banks were the biggest buyers of mutual fund shares in the fourth quarter (€24 billion), adding mutual fund shares issued by domestic and foreign investment companies to their portfolios in roughly equal proportions. Foreign investors purchased €½ billion of mutual fund shares in the German market. By contrast, credit institutions were net sellers of domestic and foreign mutual fund shares (€6½ billion in total).

Direct investment

Further net capital exports in the field of direct investment

As in the preceding three quarters of 2007, direct investments again resulted in net capital exports between October and December (€27 billion). Outflows thus increased somewhat on the quarter (third quarter: €15 billion).

This can mainly be attributed to lively investment activity by German enterprises abroad (€33½ billion). They primarily increased their equity capital investment in their non-German affiliates (€18 billion). The main recipient countries were the United States and – largely as a result of a single transaction – Russia. In addition, €9 billion flowed abroad, particularly to the Netherlands, via intragroup loans. The pace of foreign companies' investment in German subsidiaries was slower in the final quarter of 2007 than in the period from July to September (€6½ billion compared with €18 billion).

3 For more details on direct investments, see below.