Financial markets

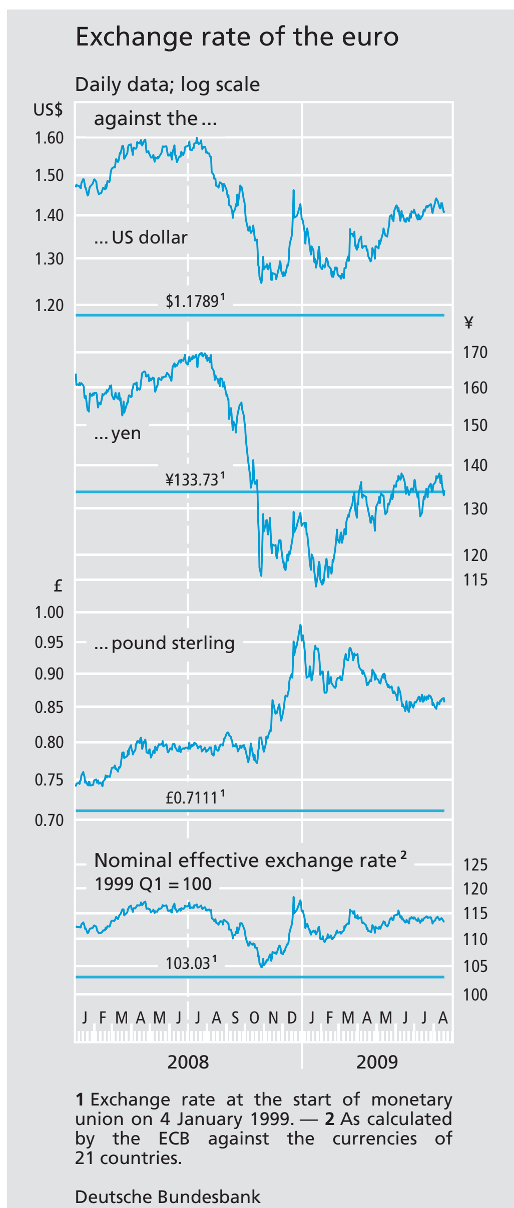
Financial market trends

Financial market setting

In the second quarter of 2009, the international financial markets were characterised by growing confidence regarding an end to the cyclical downward movement. On either side of the Atlantic, positive economic indicators, government aid for the financial sector and support measures of central banks led to a recovery on the financial markets. Against the backdrop of a somewhat higher risk appetite, market participants apparently reversed earlier portfolio shifts to safe-haven assets and increased their exposure to the international stock markets, thus significantly boosting share prices worldwide. At the same time, corporate bond spreads, which had reached record highs towards the end of the previous quarter, narrowed significantly. Following temporary doubts concerning an improvement in economic activity towards the end of the quarter, it was mainly positive earnings reports by enterprises, among other things, which ensured that the recovery in the equity and credit markets continued in July. On the foreign exchange markets, the effective euro depreciated somewhat on balance since the end of the first quarter. Exchange rate gains against the US dollar, the Chinese renminbi and the Japanese yen were more than offset by losses against the pound sterling, some commodity currencies as well as central and eastern European currencies.

Exchange rates

After reaching up to US$1.35 at the beginning of the second quarter, the euro-dollar



1 Exchange rate at the start of monetary union on 4 January 1999. — 2 As calculated by the ECB against the currencies of 21 countries.

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Euro exchange rate development against the US dollar, ...

exchange rate subsequently depreciated and dropped below the US$1.30 mark. The announcement of the greater than expected rise in US consumer confidence and remarks by the Federal Reserve had given the impression that the US economy would cope comparatively well with the fallout from the financial crisis and had thus bolstered the US dollar on a broad front. At the same time, meanwhile, the euro was weakened by mostly negative news from the euro area – such as the steep slide in turnover in manufacturing in Germany or the renewed downgrading of Ireland's credit rating. Speculation regarding an upcoming key interest rate cut in the Eurosystem also likely contributed to the depreciation of the euro.

At the end of April, the euro started to recover sharply as confidence in the economic power in the euro area was supported following the announcement of unexpectedly large rises in sentiment indicators. The key interest rate cut by the European Central Bank in May had been generally anticipated by the markets and therefore had no discernible impact on further exchange rate developments. In the first half of July, the euro-dollar exchange rate was somewhat weaker again as negative news – such as the worse than expected report on the US labour market and the decline in US consumer confidence – temporarily dampened hopes for a stabilisation of the global economy. Positive news then caused investors' economic optimism to rise again, and the euro-dollar exchange rate to temporarily climb to a new annual high of US$1.44. However, this was still 10% below its historical high in the summer of last year (US$1.60). At the end of the period under review, however, the euro traded somewhat weaker again and stood at US$1.41, which is just over 1% above its level at the beginning of the year, while short-term exchange rate volatility was on a continued downward trend but still raised by historical standards.

... against the yen ...

The euro initially also depreciated markedly against the Japanese yen in the reporting

period. However, as the expectation of a cyclical bottoming-out in the euro area increasingly spread across the markets, the euro picked up again and reached a new annual high of ¥138 in the second week of June. But already in the first half of July, the single currency weakened significantly again and temporarily dropped back to ¥128. The yen also rose markedly against other currencies in this period, after a stabilisation of the economy also appeared likely in Japan. However, this recovery phase of the yen proved short-lived. At the end of the period under review, the euro stood at ¥134, which was just under 6½% above its level at the start of the year.

... and against the pound sterling

Having traded at £0.93 at the end of March of this year, the euro-sterling exchange rate subsequently dropped sharply in value, hitting £0.84 in the second half of June. The publication of a series of favourable economic indicators for the United Kingdom – such as rising house prices and the increase in the Purchasing Managers' Index for the manufacturing sector – had bolstered the British pound on a broad front during this time. Subsequently, however, the pound was hit by the unexpected decline in British industrial output and the announcement of the UK government's budget deficit, which reached a record high in June. During the entire reporting period, however, the euro depreciated noticeably against the pound sterling. As this report went to press, the euro stood at just under £0.86. It was thus 10% down from the beginning of the year.

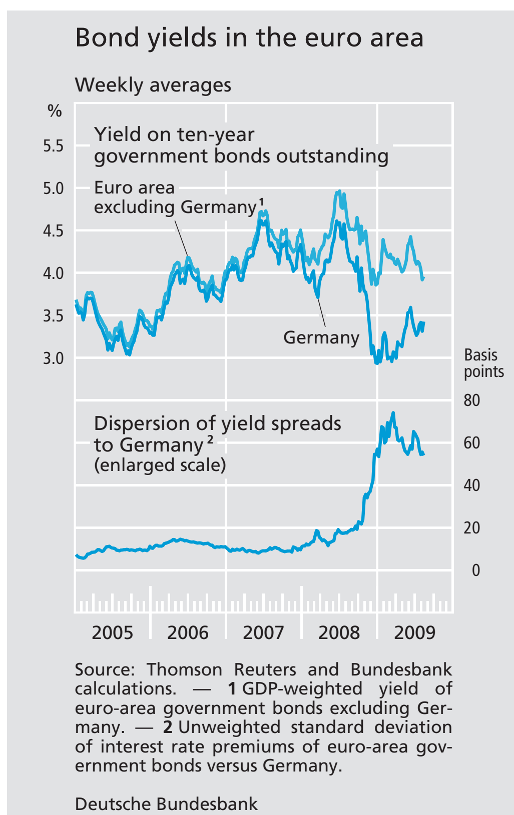
Effective euro exchange rate

The euro's average value vis-à-vis the 21 major currencies in the exchange rate index fell somewhat since the end of March. The single currency appreciated against the US dollar, the Chinese renminbi and the Japanese yen. Renewed foreign exchange interventions by the Swiss National Bank meant the euro also appreciated against the Swiss franc in the reporting period, but the rise in the exchange rate was comparatively low. All in all, however, the exchange rate gains mentioned above were more than offset by losses against the British pound as well as against some commodity currencies and central and eastern European currencies. As this article went to press, the effective exchange rate was about 2% below its level at the beginning of the year and around 10% higher than at the start of monetary union. In real terms, too, ie taking account of the simultaneous inflation differentials between the euro area and its major trading partners, the effective exchange rate of the euro did not move much in the reporting period. It was thus still significantly higher than at the launch of monetary union.

Securities markets and portfolio transactions

International bond markets

The GDP-weighted average yield on ten-year euro-area government bonds has remained almost constant at about 3¾% on balance since the end of March despite declining key interest rates. While Japanese yields were also virtually unchanged, ten-year US Treasuries rose by ¾ percentage point, causing the interest rate differential between the two economic areas to dwindle to just under ¼ percentage point.



Bond yields in the euro area

Source: Thomson Reuters and Bundesbank calculations. — 1 GDP-weighted yield of euro-area government bonds excluding Germany. — 2 Unweighted standard deviation of interest rate premiums of euro-area government bonds versus Germany.

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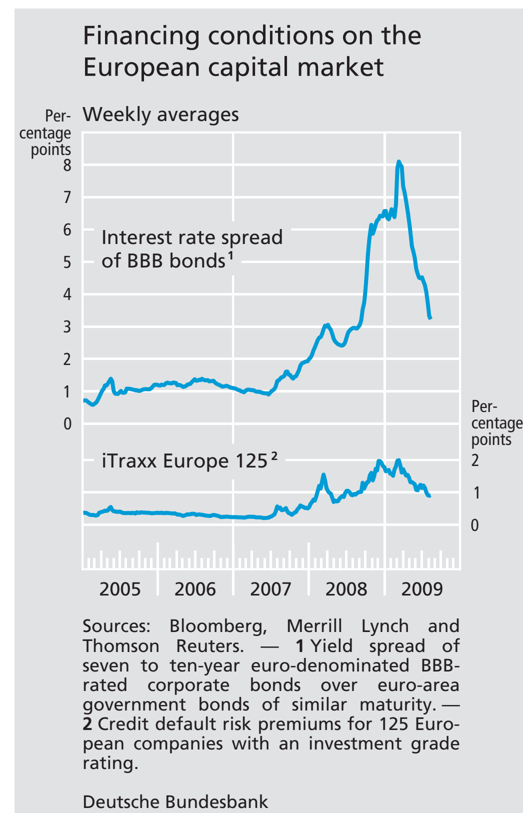
The heavy recourse of public issuers to the bond markets as well as the emerging hope of an end to the downward movement contributed to the stabilisation and to the rise in yields. Again this was the result of the initially better than expected economic sentiment indicators. In the course of June, uncertainty resurfaced among the market participants as to the degree to which these leading indicators can actually be interpreted as a sign that the economy is bottoming out. Most recently, however, first "hard" economic data supported the positive assessments, such as the rise in industrial output and in new orders in Germany as well as a decline in applications for jobless benefits in the United States. Investors' decreasing risk aversion in this environment led to a reversal of the safe-haven flows from the bond markets to the equity markets. At the same time, declining premiums on the credit default swaps of all major industrial countries indicated a reduction of the risk premium which investors demanded in view of the government's funding requirements for financial market stabilisation packages and real economic support measures. In this context, news that ten US banks have already fully paid back the government assistance of US$68 billion that had been allocated to them is also likely to have been a positive factor. This also fuelled hopes for Europe that the risks associated with the strain on government coffers could turn out to be lower than previously feared. Nevertheless, there is still great uncertainty about further developments on the bond markets, especially in the United States. The implied volatility calculated from options on futures contracts on long-term government bonds serves as an indicator of this. While it declined for Germany in the reporting period, it is higher than at the end of March in the USA. On both sides of the Atlantic, this measure of uncertainty remains above its five-year average.

Steep German yield curve

At the end of the period under review, the yield curve was just about as steep as at the end of the first quarter. In the case of Federal securities, the spread between ten and two-year yields is just under 2¼ percentage points. Just as shorter-term interest rates increased slightly although key interest rate cuts in the Eurosystem had already been partly priced in, the yields on longer-term paper were also somewhat higher. At the same time, yield differentials within the euro area narrowed.

Improved financing conditions for enterprises

The financing conditions for European enterprises have improved significantly in line with the recovery of the financial markets and the lower uncertainty. Spreads on corporate bonds of the lowest investment grade category, BBB, which had reached record highs towards the end of the first quarter, decreased by 400 basis points. The corresponding absolute yields also declined to a similar degree. The easing reflected declining credit risk premiums, such as those shown in the iTraxx Europe Index. Lower liquidity premiums also likely contributed to the decline in spreads. Compared with their long-term average, the interest rate premiums on BBB-rated corporate bonds – about 320 basis points as this article went to press – are nevertheless still at a relatively high level.[1]



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

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Net issues in the bond market

In the second quarter of 2009, domestic debt securities worth €442 billion (gross) were issued in the German bond market. Issuance was thus lower than in the previous quarter. However, owing to a decline in redemptions and taking changes in issuers' holdings of their own bonds into account, bonds worth €45½ billion net were issued in the market, while in the previous three months, debt securities had been redeemed on balance. Sales of foreign debt securities in Germany also rose significantly on the quarter to €26 billion, which was mainly accounted for by euro-denominated paper (€23 billion). In the first quarter of 2009, residents purchased foreign bonds to the tune of €7½ billion. All in all, the capital inflow from the sale of domestic and foreign debt securities in Germany was therefore €71 billion, which is the highest figure since the onset of the financial crisis in July 2007.

High borrowing by central government

In the second quarter of 2009, the public sector increased its bond market debt by the record sum of €53½ billion. Thus, it made use of the capital market to a much greater degree than in the first three months of the year (€32 billion). The majority of the borrowed funds – €49 billion – was accounted for by central government, almost doubling the net sales of the previous quarter (€26 billion). The record issuance of Treasury discount paper (Bubills) amounting to €30½ billion, whose maturity spectrum had already been extended in the last quarter from previously six months to include additional three, nine and

1 For the development of the financing conditions of credit institutions, see also explanatory notes on p 44.

Investment activity in the German securities markets

€ billion

Item	2008 Q2	2009 Q1	2009 Q2
Debt securities			
Residents	– 16.0	– 1.4	35.3
Credit institutions	33.3	10.1	27.4
of which			
Foreign debt securities	20.5	– 25.5	– 5.4
Non-banks	– 49.3	– 11.6	7.9
of which			
Domestic debt securities	– 58.6	– 44.6	– 23.3
Non-residents	46.7	4.6	36.0
Shares			
Residents	37.9	15.5	13.2
Credit institutions	– 14.3	– 5.1	– 2.4
of which			
Domestic shares	– 3.3	– 3.6	– 2.0
Non-banks	52.1	20.6	15.5
of which			
Domestic shares	49.3	16.5	11.1
Non-residents	– 44.7	– 4.6	– 0.6
Mutual fund shares			
Investment in specialised funds	2.8	5.9	– 4.7
Investment in funds open to the general public	1.2	1.8	5.1
of which: Share-based funds	1.1	0.7	2.3

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twelve-month paper, was particularly striking again. Moreover, on balance, central government sold two-year Federal Treasury notes (Schätze, €8 billion) and, at the long end of the maturity spectrum, ten and thirty-year Federal bonds (€3½ billion and €3 billion, respectively). By contrast, it redeemed five-year Federal notes (Bobls) amounting to €3½ billion net. As in the previous quarter, the disproportionately high borrowing in the short maturity spectrum could have served to finance the Special Fund Financial Market Stabilisation (SoFFin). The federal states also increased their capital market debt (€5 billion).

Issues by non-banks

Against the backdrop of easing financing conditions on the capital market, domestic enterprises without a banking licence issued debt securities amounting to €7½ billion in the reporting quarter, compared with €6½ billion in the previous three-month period. As in the previous quarter, enterprises issued only longer-term paper on balance (€14½ billion), while redeeming commercial paper.

Net redemptions by credit institutions

In the reporting period, credit institutions clearly reduced their capital market debt (€16 billion). However, the reduction was not as high as the record figures of the previous two quarters (€42½ billion in each case). The credit institutions mainly redeemed public Pfandbriefe and other bank debt securities (€12 billion and €6 billion, respectively) as well as small amounts of mortgage Pfandbriefe (€1½ billion). Specialised credit institutions, which include the public promotional banks, issued paper worth €4 billion (net).

Purchases of debt securities

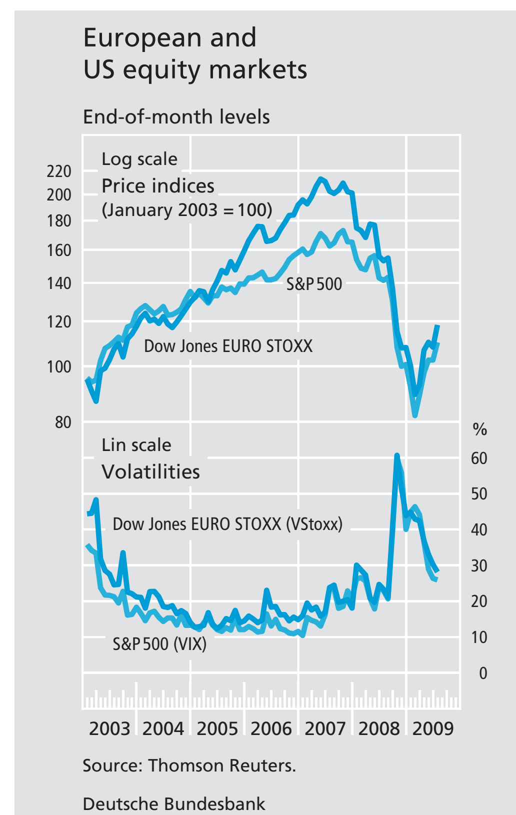
Domestic and foreign investors purchased about the same amount of German debt securities, buying paper worth €35½ billion net and €36 billion net, respectively. In the second quarter, domestic credit institutions added debt securities worth €27½ billion – exclusively domestic paper – to their portfolios, on balance. In particular, they purchased corporate bonds (€13½ billion), public bonds (€10½ billion) and own debt securities (€9 billion). Domestic non-banks switched out of domestic paper (-€23½ billion) and into foreign paper (€31 billion). Non-resident investors purchased public bonds exclusively and in record amounts (€46½ billion).

Strong gains in the international stock markets

In the reporting period, the international stock markets were marked by increasing hopes of an imminent end to the sharp cyclical downward movement of the previous two

quarters. The government aid for the banking system and the announcement and implementation of unconventional monetary policy measures have also likely supported share prices worldwide. In the United States, better than expected results of stress tests for US banks in early May boosted investor confidence regarding the overall state of the financial sector. Against the backdrop of brightening economic indicators and declining risk aversion, investors on both sides of the Atlantic apparently reversed earlier portfolio shifts from equity markets to bond markets (safe-haven flows). This significantly lifted share prices.

In this environment, which was initially marked mainly by improved sentiment indicators, unexpectedly weak reports from the US labour market in the second half of June, which fuelled doubts concerning a rapid end to the recession, and other factors, put temporary pressure on the international stock markets. However, supported by some favourable economic reports, which also included "hard" data, upwardly revised medium-term earnings expectations of European enterprises and surprisingly positive US quarterly results, in particular from the financial sector, the upward movement on the stock markets resumed, with European bank shares recording especially strong gains. At the same time, the uncertainty regarding further share price developments was significantly reduced and came close to its long-term average again. As measured by the broad-based stock price indices, European and Japanese shares recorded gains of 27% on balance since the end of March; US equities appreciated 23%.



Declining risk premiums on equity investments

The risk premium on equity investments, which can be determined using a dividend discount model, decreased further in the reporting period and is now at about the level of the summer of 2008. Together with declining share price uncertainty, this indicates greater confidence on the stock markets. The dividend discount model shows that, besides declining risk aversion, improved analyst estimates of medium and long-term expected corporate earnings also contributed to the higher share prices.

Stock market funding and stock purchases

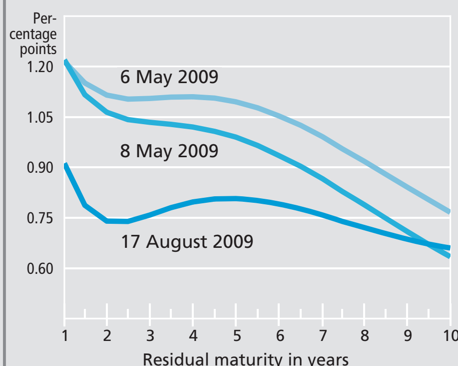
Against the backdrop of the decline in uncertainty on the stock markets, issuing activity on the domestic stock market remained quite buoyant. At €8½ billion, domestic enterprises issued a similar volume of new shares as in the previous quarter. The new issues reflect,

Eurosystem purchases of covered bonds – implications for the German Pfandbrief market

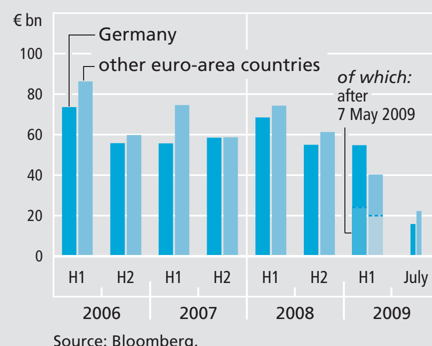
In view of the effects the financial crisis was having on the real economy, the Governing Council of the ECB decided at its meeting on 7 May 2009 to purchase euro-denominated covered bonds issued in the euro area. A total of €60 billion was earmarked for this purchase programme, which will focus primarily on covered bank bonds with, as a rule, a minimum rating of AA and a minimum issue size of €500 million. To be eligible, bonds are generally required to have a residual maturity of between three and ten years. This measure of the Eurosystem aims to boost primary and secondary market liquidity for private debt securities. Given that the consolidation of banks' balance sheets is likely to continue in the foreseeable future, the objective of the programme is to grant private-sector borrowers greater scope for obtaining finance, and to ease issuing credit institutions' funding conditions. In particular, it is hoped that improved market depth and liquidity will have the effect of narrowing the risk premiums (spreads) of covered bonds versus government bonds in the secondary markets. Ultimately, the purchase programme seeks to encourage lending by banks to non-financial enterprises. By 17 August 2009, the Eurosystem had purchased covered bonds worth a total of €7.1 billion.[1]

The Eurosystem measure is also beneficial to the German Pfandbrief market. Indeed, the programme's announcement alone, made in early May, led to a reduced interest rate spread across the entire maturity range. On 8 May 2009, 84% of all Pfandbriefe issued in Germany showed a lower spread versus matched-maturity Bunds than on 6 May 2009, one day before the measure was announced. On that day the spread narrowed on an average for all maturities by 8 basis points. More recently, too, the yield curve based on German mortgage and public Pfandbriefe has moved noticeably closer to that for Bunds compared with May, particularly in the short and medium-term maturity segments (see chart top right). Even after allowing for the effect of the announcement, Pfandbrief yields – for example, on Pfandbriefe with a maturity of three years – fell by a further 27 basis points vis-à-vis yields on Bunds. While the lower spreads point to reduced liquidity risk premiums, there was hardly any discernible impact on secondary market trading volumes until the purchase programme was actually launched. Trading activity did pick up once purchases got underway in July. Bid-ask spreads are still higher than they were prior to the financial crisis, however. By comparison, primary market activity grew as soon as the programme was announced on 7 May 2009. Almost half of the total volume of covered bank bonds issued in the euro area in the first half year was brought to market after the announcement (see chart below), with German Pfandbrief issuers accounting for over half of those issues. In contrast with the other euro-area countries, issuing activity in Germany's primary market in the first half of 2009 roughly matched the previous half year's level, despite the financial crisis. This indicates that sales opportunities continue to exist for the German Pfandbrief.

Pfandbrief/Bund spread (yield curve comparison)



Pfandbrief issues in Germany and covered bond issues in the other euro-area countries



Source: Bloomberg.

1 According to ECB figures, in the period from 6 to 31 July 2009, almost two-thirds of purchases were implemented on the secondary market.

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among other things, capital increases by financial enterprises, which have partly come about with the help of the government. Listed equities accounted for €5½ billion. As in the preceding two quarters, only resident non-banks, on balance, purchased German shares (€11 billion). By contrast, domestic credit institutions and non-resident investors reduced their holdings of German shares by €2 billion and €½ billion, respectively. The outstanding amount of foreign equities in the German market increased by €4 billion on balance. It was only domestic non-banks that purchased these securities in net terms (€4 billion), while credit institutions sold foreign shares to a small extent (€½ billion).

Sales and purchases of mutual fund shares

In the reporting period, domestic investment companies recorded small inflows of funds amounting to €½ billion, following €7½ billion in the previous quarter. Share certificates were sold only by funds open to the general public (€5 billion), while the specialised funds reserved for institutional investors suffered outflows of €4½ billion. Of the funds open to the general public, share-based funds, open-end real estate funds and bond funds, in particular, were able to sell own shares (€2½ billion, €2 billion and €1½ billion, respectively). Against the backdrop of the further decline in money market rates, money market funds, by contrast, again suffered outflows of funds (€1 billion). The holdings of shares in the other fund categories hardly changed overall in the second quarter. The funds operated by foreign companies and traded on the German market sold share certificates worth €1½ billion net. Domestic and foreign investment certificates were purchased in net terms only

Major items of the balance of payments

€ billion

Item	2008	2009	
	Q2	Q1	Q2
I Current account [1, 2]	+ 42.8	+ 20.1	+ 22.9
Foreign trade [1, 3]	+ 53.6	+ 26.8	+ 31.1
Services [1]	– 3.7	– 3.8	– 3.8
Income [1]	+ 0.8	+ 13.4	+ 1.9
Current transfers [1]	– 5.1	– 13.2	– 3.3
II Capital transfers [1, 4]	+ 0.3	+ 0.0	+ 0.3
III Financial account [1] (Net capital exports: –)	– 79.5	+ 3.0	– 49.8
1 Direct investment	– 28.3	– 8.0	– 8.9
German investment abroad	– 32.2	– 9.4	– 18.0
Foreign investment in Germany	+ 3.9	+ 1.4	+ 9.1
2 Portfolio investment	– 20.9	– 10.4	+ 6.9
German investment abroad	– 24.1	– 7.1	– 28.5
Shares	+ 12.4	+ 0.6	– 1.3
Mutual fund shares	– 6.8	– 0.1	– 1.4
Debt securities	– 29.7	– 7.5	– 25.8
Bonds and notes [5]	– 27.5	– 13.4	– 28.0
of which Euro-denominated bonds and notes	– 28.7	– 17.4	– 25.8
Money market instruments	– 2.2	+ 5.9	+ 2.2
Foreign investment in Germany	+ 3.2	– 3.3	+ 35.4
Shares	– 44.0	– 8.2	– 0.5
Mutual fund shares	+ 0.5	+ 0.3	– 0.0
Debt securities	+ 46.7	+ 4.6	+ 36.0
Bonds and notes [5]	+ 36.4	– 17.7	+ 4.4
of which Public bonds and notes	+ 23.7	+ 7.9	+ 20.5
Money market instruments	+ 10.3	+ 22.3	+ 31.5
3 Financial derivatives [6]	– 16.4	+ 2.9	– 0.5
4 Other investment [7]	– 13.0	+ 18.1	– 47.4
Monetary financial institutions [8]	– 27.8	+ 83.7	– 10.1
of which: short-term	+ 20.0	+ 87.3	+ 9.7
Enterprises and households	+ 26.3	– 23.9	– 1.0
of which: short-term	+ 29.4	– 19.8	– 4.8
General government	– 1.6	+ 16.7	– 19.5
of which: short-term	– 1.1	+ 17.5	– 18.1
Bundesbank	– 9.9	– 58.5	– 16.8
5 Change in reserve assets at transaction values (increase: –) [9]	– 0.9	+ 0.3	+ 0.0
IV Errors and omissions	+ 36.3	– 23.1	+ 26.6

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.

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by resident non-banks (€2½ billion). By contrast, domestic credit institutions sold fund shares (€1 billion).

Direct investment

In the second quarter of 2009, the net capital exports recorded among direct investment were somewhat higher than in the previous three months. They amounted to €9 billion compared with €8 billion from January to March.

German direct investment abroad

The main reason for this was that German proprietors provided their foreign branches with additional capital (€18 billion, compared with €9½ billion in the first quarter). Above all, they increased their equity capital abroad (€13½ billion). About half of this amount was accounted for by the increase in capital reserves to offset losses that were incurred in 2008. Further capital outflows – albeit much smaller – were recorded in the context of reinvested earnings and intra-group credit transactions with branches abroad (together €4½ billion). The main regional targets for direct investment – for which the financial sector again played an important role – were the United Kingdom (€6½ billion) and the United States (€4½ billion).

Foreign direct investment in Germany

Foreign firms also increased the financial position of their branches in Germany in the second quarter (€9 billion, compared with €1½ billion in the first quarter). This was done mainly by means of intra-group credit transactions. For example, foreign parent companies provided their affiliated enterprises domiciled in Germany with capital especially within the framework of financial credits. Investment in Germany mainly came from Luxembourg (€3½ billion) and the United States (€2½ billion).