Financial markets

Financial market trends

Financial market setting

Developments in the financial markets in the third quarter of 2009 were characterised by growing confidence. Growing risk appetite due, not least, to a more positive economic outlook helped lift stock market prices and drove down corporate bond yields. As a result, many stock indices recorded year highs in mid-October, while the spreads of good-quality corporate bonds over government bonds dropped to levels last seen at the beginning of 2008. At the same time, the interest rate spreads of other euro-area government bonds over German Federal bonds (Bunds) narrowed perceptibly. At the end of October, however, consumer confidence slipped and the deterioration of public finances in most euro-area countries became increasingly apparent, dampening sentiment in the capital markets. Moreover, it is not clear to what extent the momentum in the equity and bond markets is being driven by the generous economic stimulus programmes and an abundant supply of liquidity around the world. Thus, some doubt remains as to the sustainability of the upturn on the financial markets once the support programmes have been wound down and the foreseeable gradual normalisation of the provision of liquidity in the euro area begins. On the foreign exchange markets, the single European currency appreciated on a trade-weighted average. Exchange rate gains were recorded against the US dollar and the pound sterling, while the euro depreciated against the currencies of several smaller economies.

Exchange rates

Euro exchange rate developments against the US dollar …

The euro-dollar exchange rate, which is often the focus of market observers' interest, rose above all from mid-August onwards, when a series of upbeat economic reports from the euro area took the markets by surprise; at the same time, expectations were not fulfilled that the US Fed would specify its monetary-policy exit strategy. After the euro had stabilised temporarily at US$1.43, exchange rates rose again in September. According to market participants, during this time the US dollar was increasingly being used as a financing currency for carry trades, which put pressure on its exchange rate. This development was favoured on the one hand by growing risk appetite, reflected, for instance, in rising equity prices on both sides of the Atlantic. On the other hand, the already low interest rates on US money market paper slipped further. Thus, not only did the positive yield spread offered by corresponding euro-area paper increase – there was even an interest rate discount compared with short-term debt securities from countries like Japan and Switzerland, which had previously often been used to finance such currency transactions.

At the end of September, the euro temporarily surrendered some of its gains vis-à-vis the US dollar when the Fed announced that it would phase out the purchase programmes for government paper and a number of leading indicators in Europe proved disappointing. However, the euro resumed its upward trend in October after the publication of a very high US budget deficit, reports of strong inflows into inflation-protected bonds and the continued expansionary monetary policy in the United States sparked renewed debate regarding medium-term inflationary risks. The euro temporarily stood at US$1.50 – a new high for the year. Most recently, however, it depreciated again somewhat, and at the end of the reporting period the single European currency was just short of US$1.49, or 7% above its level at the beginning of the year.

… against the yen …

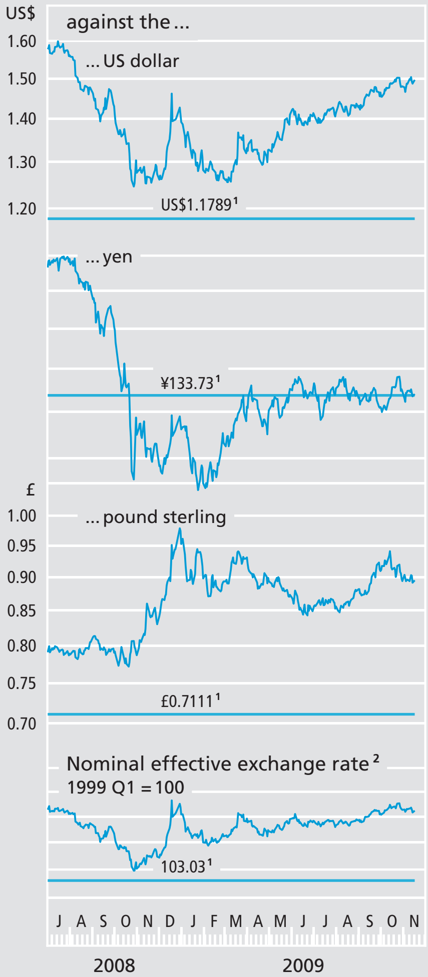
Although the euro-yen exchange rate hardly changed on balance since the beginning of the third quarter, it did have to contend with considerable volatility during the summer months. The beginning of July saw the euro initially depreciate markedly against the yen amidst growing signs in Japan of an unexpectedly swift economic stabilisation. The euro recovered quickly, however, and for several weeks range-traded between ¥132 and ¥138. Following the change of government in Japan, the new finance minister repeatedly spoke out against intervening in the foreign exchange market, which again exposed the yen to appreciation pressure at times. As this report went to press, the euro again stood at just under ¥133, which is 5% stronger than at the beginning of 2009.

… and against the pound sterling

During the first half of the third quarter, the euro continually traded at around £0.86 before appreciating steadily to £0.94 in mid-October. This was due, not only, to unfavourable economic reports from the United Kingdom. It also became increasingly clear that the pressure to consolidate the UK's public-sector budgets is considerably greater than had hitherto been assumed. In the light of the continuing problems facing the British fi-

Exchange rate of the euro

Daily data; log scale



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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nancial sector, moreover, debate ensued on whether the Bank of England would lower still further the interest rates paid on deposits from financial institutions. This development was amplified by the British central bank's statements to the effect that the financial crisis had impaired investors' willingness or ability to finance the country's trade deficit, thereby weakening the pound on a long-term basis. However, the Bank of England let it be known that the weak pound would help make the necessary structural adjustments to the British economy in order to achieve a more competitive export sector, and as such was beneficial to economic recovery. Following the announcement of favourable UK labour market figures, the euro relinquished part of its gains and, as this report went to press, stood at £0.89, or 7% below its level at the turn of the year.

Effective euro exchange rate

Since the beginning of the third quarter, the euro's average value vis-à-vis the currencies of 21 major trading partners rose 1%, bringing it to roughly the level at the beginning of 2009. During the last week of October, the effective exchange rate reached a high for the year. Indeed, only the figure in December of last year was – briefly – higher. During the reporting period, significant exchange-rate losses were sustained vis-à-vis, for example, the currencies of Poland and of individual economies such as Norway and Australia, where the economic recovery has already led to increases in key interest rates. The euro has appreciated in real terms, ie taking account of the inflation differentials between the euro area and its trading partners. This is having a negative impact on the international price competitiveness of euro-area exports.

Securities markets and portfolio transactions

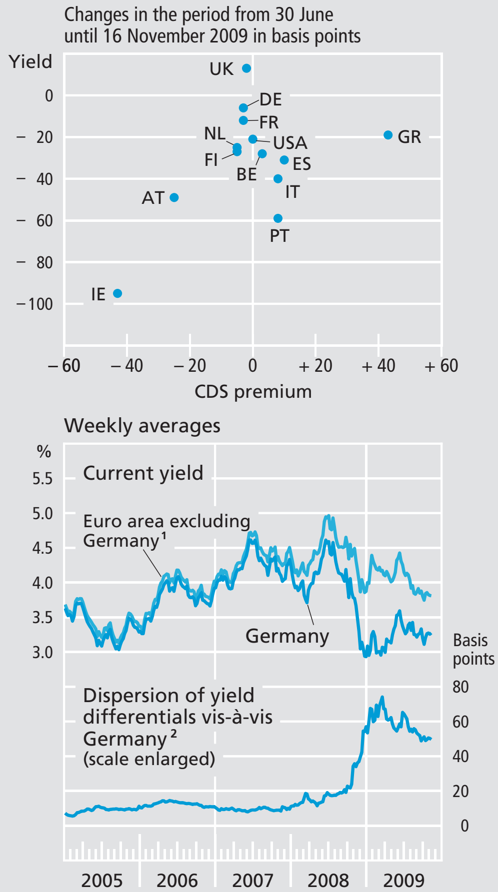
International bond markets

Long-term government bond yields receded on both sides of the Atlantic during the summer months. The GDP-weighted average yield on ten-year euro-area government bonds dipped by slightly more than ¼ percentage point since the end of June to 3¾%, roughly its level at the beginning of the year. Over the same period, yields on the considerably more volatile ten-year US Treasuries declined at a markedly slower pace, causing the interest rate differential between the two economic areas to shrink to ¼ percentage point. Japanese government bond yields were largely unchanged on balance during the reporting period.

Yield movements in the euro area

The heavy recourse by public-sector issuers to the bond markets is still not reflected in yields. It has been absorbed by, among other things, brisk demand from euro-area credit institutions and foreign monetary authorities. Whereas the sharp rise in yields in the United States at the beginning of the quarter was checked from mid-August onwards by falling confidence indicators, euro-area yields slipped continuously. This decline in yields is largely due to lower risk premiums for euro-area bonds versus German government bonds. Whilst record spreads over Bunds of more than 2½ percentage points were still recorded in countries such as Ireland and Greece in the first half of 2009, they fell steadily from June onwards. Most recently they widened again somewhat given the poorer credit assessment of Greek government bonds. This was due to the renewed damage to investor confidence caused by sharp corrections of the budget deficit and the closer monitoring of Greece and Portugal by rating agencies given the lack of strategies for lowering the higher government debt. All in all, however, the yield spread of paper of other member states over Bunds narrowed by

Yields and credit risk of government bonds*



Sources: Bloomberg, Thomson Reuters and Bundesbank calculations. — * Yields and CDS premiums of ten-year government bonds. — **1** GDP-weighted yield of bonds of euro-area member states excluding Germany. — **2** Unweighted standard deviation of interest rate spreads of euro-area bonds vis-à-vis Germany.

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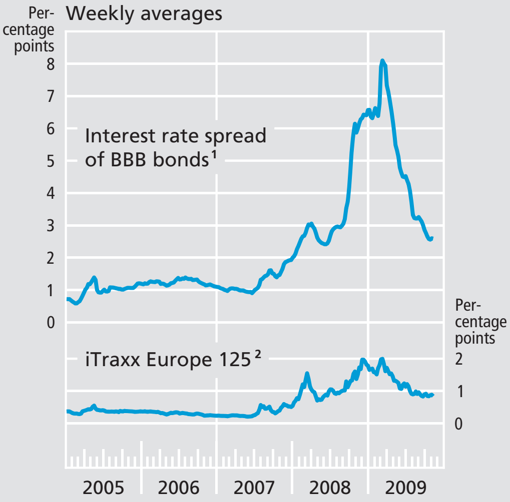
¼ percentage point. Lower credit default risk premiums are consistent with this. Evidently, investors' aversion to risk is waning, and they are willing to buy European government bonds with less than a first-class rating and with yields lower than March levels.

Considerable uncertainty about future yield trends

Nevertheless, there is still great uncertainty about further developments on the bond markets. In addition to the persistently high

Financing conditions on the European capital market



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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government borrowing needs, speculation about central banks' exit strategies could put pressure on yields in future. Implied volatility calculated from options on futures contracts on long-running government bonds serves as an indicator of this uncertainty. Although it receded in the case of Germany and, in particular, of the United States in the reporting period, this measure remains above its five-year average.

German yield curve flatter

The yield curve of German Federal securities is somewhat flatter than it was at the end of the second quarter. The spread between ten and two-year yields is 2¼ percentage points, which is nevertheless relatively high by historical standards. Whereas money market rates for maturities up to 12 months have decreased perceptibly again since the end of June, yields on short-term German debt securities have remained virtually unchanged on the whole. This may have to do with the high gross issuance of Treasury discount paper (Bubills) with a maturity of up to 12 months totalling €48 billion in the third quarter. At the same time, yields for longer-term paper were just less than ¼ percentage point lower, causing a modest flattening of the yield curve.

Improved financing conditions for enterprises

The financing conditions for enterprises on the capital markets continued to improve strongly in the euro area since the end of June. The yields investors demanded on corporate bonds of all rating categories fell. In consequence, the spreads of corporate bonds of the lowest investment-grade category, BBB, versus government paper with the same maturity also declined significantly by 204 basis points, sending premiums on better-quality corporate bonds down to their five-year average; those for BBB-rated paper are now only slightly above it. Here, too, market players' declining risk aversion seems to have been a driving force behind the narrowing of spreads. Enterprises took advantage of the favourable market setting to tap the international capital markets. In Europe they issued three times more debt securities than in the year-earlier quarter. However, issuance was down in comparison with the previous two quarters, which indicates that enterprises were anticipating their borrowing requirements for the year.

Net redemptions in the bond market

In the third quarter of 2009, domestic debt securities worth €383½ billion gross were issued in the German bond market. Issuance was thus down on both the previous quarter and the third quarter of 2008. All sectors contributed to this decrease. With a slight decline in redemptions, and taking changes in issuers' holdings of their own bonds into account, domestic borrowers paid back a total of €22½ billion to investors. By contrast, foreign borrowers sold debt securities for €16 billion net in Germany, which was accounted for solely by euro-denominated paper on balance. In total, therefore, €6½ billion was redeemed on the German bond market in the months July to September, which is unusual for a third quarter. However, this must be seen in the context of very high issuance in the previous period and the German Federal government's still comparatively good cash balance situation.

Scarcely any borrowing by German government

During the reporting period, therefore, the public sector practically did not tap the capital market at all in net terms. In keeping with the German government's issuance planning, new issues and redemptions broadly balanced out after the targeted net issue volume for 2009 had already been reached in the first half-year. As it had done earlier in the year, the Federal government focused more on short-running debt instruments. For instance, it issued Federal Treasury discount paper (Bubills) with maturities of up to 12 months for €12 billion net, and redeemed two-year Federal Treasury notes (Schätze) totalling €6 billion. Moreover, the volume of ten-year Federal bonds (Bunds) outstanding decreased by €13½ billion; by contrast, the German Federal government sold five-year Federal notes (Bobls) worth €6½ billion net.[1] Like central government, the state governments were not active on the bond market on balance.

Issues by non-banks

As financing conditions on the capital market continued to ease, domestic non-banks issued debt securities (excluding money market paper) amounting to €8 billion net in the reporting quarter, compared with €14½ billion in the previous three-month period. This, too, was probably a reflection of an anticipatory effect in the first half of 2009. It should also be noted, moreover, that domestic enterprises' bonds are often issued through financing subsidiaries domiciled outside Germany. In the third quarter, too, enterprises continued to redeem commercial paper (€2 billion), albeit with volumes declining over the course of the year.

Net redemptions by credit institutions

Credit institutions continued to reduce their capital market debt in the quarter under review (€28½ billion). These net redemptions were mainly made by Pfandbrief banks, which repaid €29 billion net worth of public Pfandbriefe. Specialised credit institutions, meanwhile, redeemed their own instruments in the amount of €2½ billion. By contrast, smaller amounts of mortgage Pfandbriefe and other bank debt securities were sold (€2 billion and €1½ billion respectively). Pfandbrief sales were supported by the Eurosystem purchase programme launched in July. Bond purchases since then totalled €23½ billion as this report went to press.

1 This means that in the first three quarters of 2009, central government raised its debt in capital market instruments with an original maturity of at least two years by just over €9 billion, while increasing the outstanding volume of Bubills, which have a maturity of up to one year, by €66½ billion to €106½ billion.

Investment activity in the German securities markets

€ billion

Item	2008 Q3	2009 Q2	2009 Q3
Debt securities			
Residents	– 3.16	35.58	5.94
Credit institutions	4.36	27.38	– 5.44
of which Foreign debt securities	– 8.43	– 5.38	– 9.86
Non-banks	– 7.52	8.20	11.38
of which Domestic debt securities	– 4.08	– 22.89	– 14.42
Non-residents	28.01	35.52	– 12.49
Shares			
Residents	1.81	13.32	– 12.92
Credit institutions	2.59	– 2.35	– 8.00
of which Domestic shares	1.94	– 2.05	– 7.63
Non-banks	– 0.78	15.67	– 4.92
of which Domestic shares	– 1.22	11.21	– 5.84
Non-residents	4.79	– 0.65	18.11
Mutual fund shares			
Investment in specialised funds	7.31	– 4.75	12.32
Investment in funds open to the general public	– 2.90	5.07	0.88
of which: Share-based funds	– 1.16	2.34	1.29

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Purchase of debt securities

On balance, German credit institutions were the only net buyers of domestic debt securities (€4½ billion). Meanwhile, domestic non-banks and foreign investors were net sellers of German interest-bearing instruments (€14½ billion and €12½ billion respectively); the latter for the most part concerned paper issued by private-sector borrowers. Activity in foreign debt securities was characterised by contrary developments; domestic banks sold paper worth €10 billion net, whilst non-banks added paper totalling €26 billion to their portfolios.

Strong gains in the international stock markets ...

In the stock markets, the broad-based recovery that got underway in the second quarter continued until mid-October. From the end of the second quarter, the US S&P 500 index surged by up to some 20%, while the European Dow Jones Stoxx index and the German CDAX rose slightly more strongly still (23% and 24% respectively). One of the main drivers of the stock price increases were expectations with regard to an end of the recession, which were supported by positive economic data in large industrial countries and emerging market economies. Moreover, the risk premium investors demanded for holding equity – which can be determined using a dividend discount model – dropped further in the third quarter, returning to its level prior to the insolvency of investment bank Lehman Brothers (see chart page 45).[2] However, equity price developments were temporarily weakened after the quarterly results published by big corporations at the end of October failed in some cases to meet analysts' high expectations. On top of that, lower consumer confidence in Germany and the United States dampened stock market sentiment. As this report went to press, however, stocks were again trading at levels close to their highs for the year.

... although uncertainty remains high

Yet it would be premature to regard stock market developments, which have been friendly on the whole since March, as a signal that the financial and economic crisis has been overcome. First, positive indicators are a reflection, not least, of government fiscal stimulus programmes. Second, stock prices are likely to have benefited from the high global liquidity and the lower interest rate level. The robustness of the recent upturn will

2 Equity risk premiums for banks dropped remarkably sharply on both sides of the Atlantic. This shows that stock price increases have outpaced analysts' estimates of corporate earnings.

not be tested until governments and central banks start to unwind the support measures taken to combat the crisis. A further reason for caution is that uncertainty with regard to future stock price developments as gauged by the implied volatility of options on futures grew somewhat on both sides of the Atlantic during the reporting period, and is currently still above its long-term averages.

Stock market funding and stock purchases

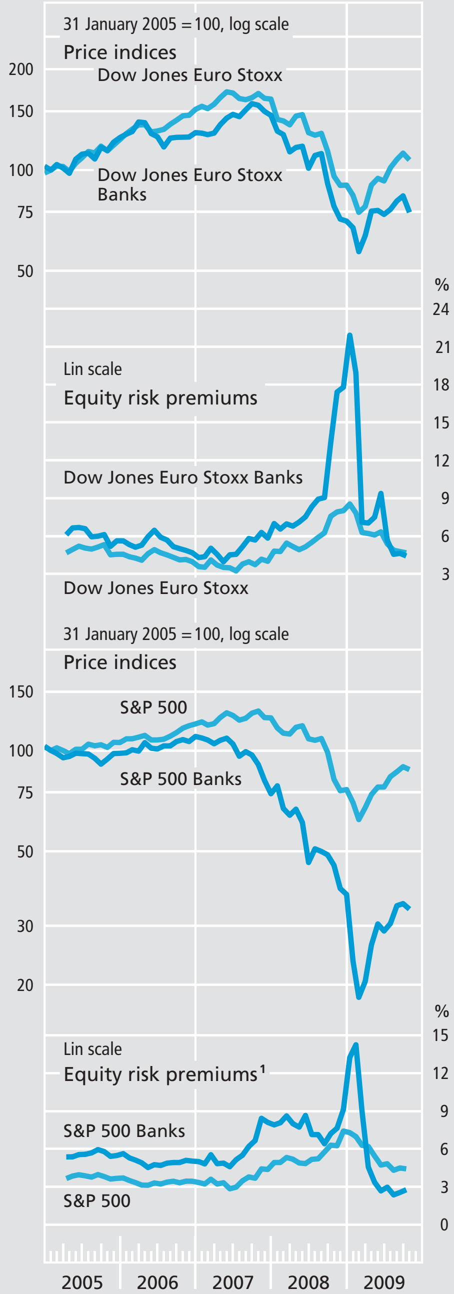
On the German equity market, new shares – mostly listed equities – totalling €4½ billion were issued in the third quarter. Despite the lower real cost of equity capital, share offerings were thus down on the previous quarter (€8½ billion), although in the second quarter a capital increase which came about with the government's help was a contributory factor. In addition, foreign shares were sold in Germany for €½ billion. Only non-resident investors purchased domestic shares (€18 billion), with most of the transactions constituting portfolio investment. By contrast, domestic credit institutions and non-banks were net sellers of German equities (€7½ billion and €6 billion respectively). Both domestic sectors made hardly any changes to their holdings of foreign stocks.

Sales and purchases of mutual fund shares

Domestic investment companies recorded inflows of €13 billion during the reporting quarter thanks to an unusually high inflow to specialised funds reserved for institutional investors (€12½ billion). Moreover, funds open to the general public received small inflows (€1 billion), equity-based funds in particular (€1½ billion). Bond-based funds, mixed funds and mixed security-based funds were also able to sell small volumes of certifi-

European and US equity markets

End-of-month levels



Sources: Thomson Reuters and Bundesbank calculations. — 1 Measure of the risk premium demanded by investors. Determined using a three-stage dividend discount model, on the basis of three to five-year IBES expectations of profit growth and long-term GDP growth expectations (consensus forecast).

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Major items of the balance of payments

€ billion

Item	2008 Q3	2009 Q2	2009 Q3
I Current account 1, 2	+ 35.1	+ 23.8	+ 25.4
Foreign trade 1, 3	r + 40.2	r + 31.7	+ 33.0
Services 1	– 7.8	– 3.8	– 9.7
Income 1	+ 14.3	+ 2.0	+ 13.5
Current transfers 1	– 9.0	– 3.3	– 8.6
II Capital transfers 1, 4	– 0.3	+ 0.3	– 0.1
III Financial account 1 (Net capital exports: –)	– 13.1	– 48.5	– 5.4
1 Direct investment	– 8.5	– 8.4	– 3.4
German investment abroad	– 9.0	– 17.5	– 12.8
Foreign investment in Germany	+ 0.5	+ 9.1	+ 9.4
2 Portfolio investment	+ 39.2	+ 6.6	– 16.1
German investment abroad	+ 10.0	– 28.3	– 17.1
Shares	+ 0.9	– 1.4	– 0.0
Mutual fund shares	– 2.7	– 1.1	– 1.1
Debt securities	+ 11.9	– 25.7	– 15.9
Bonds and notes 5	+ 9.9	– 28.2	– 18.6
of which Euro-denominated bonds and notes	+ 9.2	– 25.8	– 19.1
Money market instruments	+ 2.0	+ 2.4	+ 2.6
Foreign investment in Germany	+ 29.2	+ 34.9	+ 1.0
Shares	+ 3.3	– 0.6	+ 14.2
Mutual fund shares	– 2.1	– 0.0	– 0.6
Debt securities	+ 28.0	+ 35.5	– 12.5
Bonds and notes 5	+ 14.9	+ 3.7	– 26.0
of which Public bonds and notes	+ 14.9	+ 20.8	– 8.3
Money market instruments	+ 13.1	+ 31.8	+ 13.5
3 Financial derivatives 6	+ 0.2	+ 0.7	– 6.0
4 Other investment 7	– 45.7	– 47.5	+ 17.8
Monetary financial institutions 8	– 35.4	– 10.1	+ 25.3
of which: short-term	+ 7.0	+ 9.7	+ 11.7
Enterprises and households	– 22.0	– 1.2	– 13.0
of which: short-term	– 18.4	– 4.8	+ 1.3
General government	+ 13.2	– 19.5	+ 14.9
of which: short-term	+ 13.4	– 18.1	+ 15.1
Bundesbank	– 1.4	– 16.8	– 9.4
5 Change in reserve assets at transaction values (increase: –) 9	+ 1.6	+ 0.0	+ 2.3
IV Errors and omissions	– 21.7	+ 24.4	– 19.8

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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cates. By contrast, investors, faced with exceptionally low short-term interest rates, withdrew capital above all from money market funds (€1½ billion). Sales of foreign mutual fund units in Germany reached €1 billion net. Mutual fund shares were purchased predominantly by German non-banks (€13½ billion), with German banks also increasing their exposure to mutual funds slightly (€1½ billion). On the other hand, non-resident investors sold a small amount of German mutual fund shares (€½ billion).

Direct investment

Net exports of funds through portfolio investment and direct investment

An aggregation of the above cross-border portfolio transactions in the third quarter shows net capital exports of €16 billion. In addition, outflows of funds through direct investment totalled €3½ billion, as against €8½ billion in the previous three-month period. A longer-term comparison reveals that direct investment has decreased noticeably during the financial crisis as enterprises have adopted a generally more cautious approach in foreign investment, and as debt-financed company takeovers are now virtually impossible. In the last 12 months as a whole, direct investment resulted in net capital exports of €38 billion. This was only just over 40% of the figures for both 2008 and 2007.

German direct investment abroad

In the reporting period, domestic enterprises provided their foreign branches with additional capital of €13 billion. They primarily increased their capital stakes abroad (€11 billion) and provided non-resident subsidiaries with capital by reinvesting earnings (€5½ billion). Intra-group credit transactions with branches abroad, by contrast, resulted in inflows of €3½ billion. Two main regional targets for direct investment were Luxembourg (€6½ billion) and Ireland (€3½ billion). Overall, holding companies (€5 billion) and, once again, the financial sector (€3 billion) played a significant role in this respect.

Foreign direct investment in Germany

Foreign firms also increased the financial position of their branches in Germany in the third quarter (€9½ billion). On the one hand, funds were provided in the form of equity capital (€4 billion); in this context, the participation of an Arab sovereign wealth fund in a German automobile enterprise played an important role. On the other hand, foreign proprietors furnished – largely short-term – financial credits (€4½ billion).