Financial markets

Financial market trends

Financial market setting

Developments in the international financial markets in the fourth quarter of 2010 and in early-2011 were influenced above all by the more favourable global economic outlook as well as by the debt crisis in several euro-area peripheral countries. In the United States and Japan, market participants' confidence in the economic recovery grew. In the euro area, upbeat German growth prospects made a substantial contribution to the more benign outlook. In this setting, capital market rates rose worldwide. This was also reflected in higher yields on the international corporate bond markets. On the international equity markets, the reversal of previous safe-haven flows as well as positive corporate results and improved expectations of earnings growth on both sides of the Atlantic led to sharply higher stock prices. At the same time, investor uncertainty declined perceptibly. The exchange rate developments of the euro show no clear-cut tendency in light of the conflicting determinants. Of the euro-area peripheral countries, market participants focused on Ireland. At the end of November, given the enormous burdens for the state budget as a result of the financial sector restructuring process, Ireland formally requested the rescue package offered by the EU.

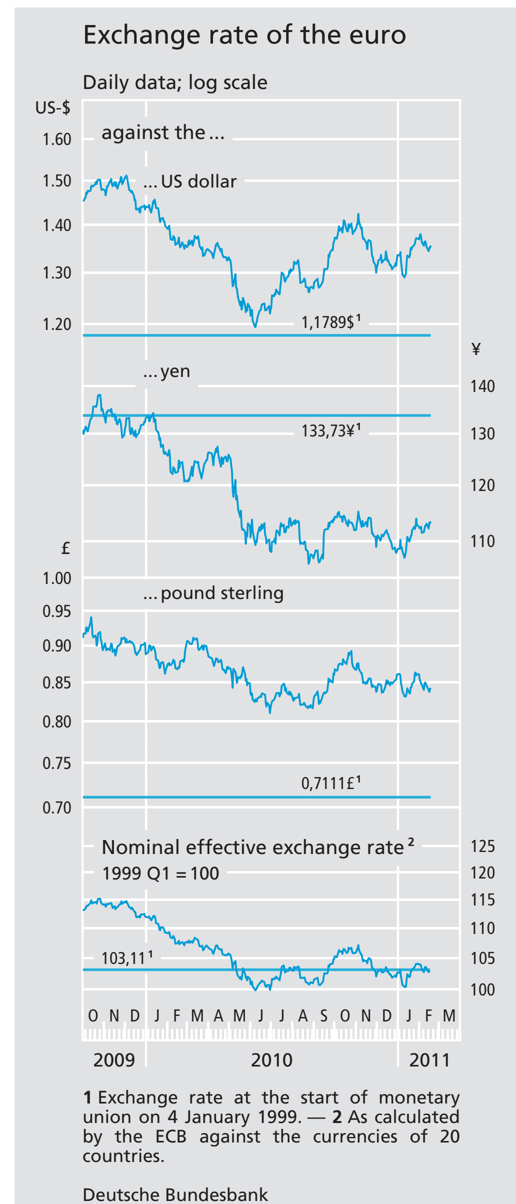
Exchange rates

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

In the fourth quarter of 2010 and the early part of 2011, changes in market participants' assessment of the economic situation as well as the sovereign debt crisis in several coun-

tries of the euro area drove foreign exchange market developments, too. At the beginning of November, following the Federal Reserve's decision to purchase further government bonds worth a total of US$600 billion (in an environment of still subdued economic expectations for the United States), the euro-dollar exchange rate climbed to US$1.42. This was the highest level since January 2010. However, as the financial and government crisis in Ireland intensified and the threat of a credit rating downgrade for Portugal evolved, the friendly sentiment turned against the euro, and it came under downward pressure. In addition, the US dollar received a boost from unexpectedly favourable US labour market data. By the end of November, the euro had slipped to US$1.30. The single currency initially stabilised somewhat in the time that followed, before further positive economic data from the United States again burdened the euro-dollar exchange rate at the beginning of the new year.

The euro began to rally strongly around mid-January after worries about the sustainability of public finances in the euro-area peripheral countries were eased somewhat by the successful auction of Portuguese sovereign bonds, reports of the Japanese government's plans to buy European debt securities and the successful placement of the EFSF's inaugural bond. Moreover, the publication of the Ifo business climate index for Germany, which was again better than expected and reached a new record high, gave the euro an additional boost. As this report went to press, the euro stood at US$1.36, somewhat below the level recorded at the end of September and



1 Exchange rate at the start of monetary union on 4 January 1999. — 2 As calculated by the ECB against the currencies of 20 countries.

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about 1½% above its level at the start of 2011.

... against the yen ...

After the euro at first fluctuated around the 114 yen mark in October last year, it subsequently depreciated somewhat when Japan presented unexpectedly favourable economic growth figures, falling in the first half of January 2011 to as low as 107 yen. When the Ifo business climate index was announced and

the euro-area sovereign bond markets gradually calmed down, the euro subsequently appreciated on a broad front. By contrast, the downgrading of Japan's creditworthiness and less favourable economic data put a strain on the yen around the turn of the year. As this report went to press, the euro stood at 113 yen, or 4½% above its value at the beginning of the year.

... and against the pound sterling

Against the pound sterling, too, the euro initially lost value in November as a result of the debt crisis affecting several euro-area countries. However, the losses were comparatively slight, and were almost totally reversed by the end of the year. Market participants' speculations that the Bank of England might raise interest rates to counter growing inflationary pressures in the United Kingdom strengthened the pound sterling in the first half of January, causing the euro-pound sterling exchange rate to fall from 0.86 pound sterling to 0.83 pound sterling. The announcement of a negative growth rate for the UK economy in the fourth quarter subsequently burdened the pound sterling, however. As this report went to press, the euro was trading at 0.84 pound sterling.

Effective euro exchange rate

Following the accession of Estonia to the euro area, the euro effective exchange rate index has been calculated vis-à-vis 20 instead of 21 major trading partners since the beginning of the year. Since the end of September, the euro has depreciated somewhat on average (-2%) against the currencies of these countries. In December, the single currency fell to a new low against the Swiss franc, which is apparently considered a comparatively safe investment haven in times of heightened nervousness in the financial markets. However, the euro began a comparatively strong recovery, also against the Swiss franc, at the beginning of the new year.

As this report went to press, the effective exchange rate of the euro was ½% above its level at the turn of the year and on par with its value at the launch of monetary union. In real terms, ie taking account of the simultaneous inflation differentials between the euro area and its major trading partners, it was therefore still well above its longer-term average. This indicates an unfavourable price competitiveness of euro-area suppliers.

Securities markets and portfolio transactions

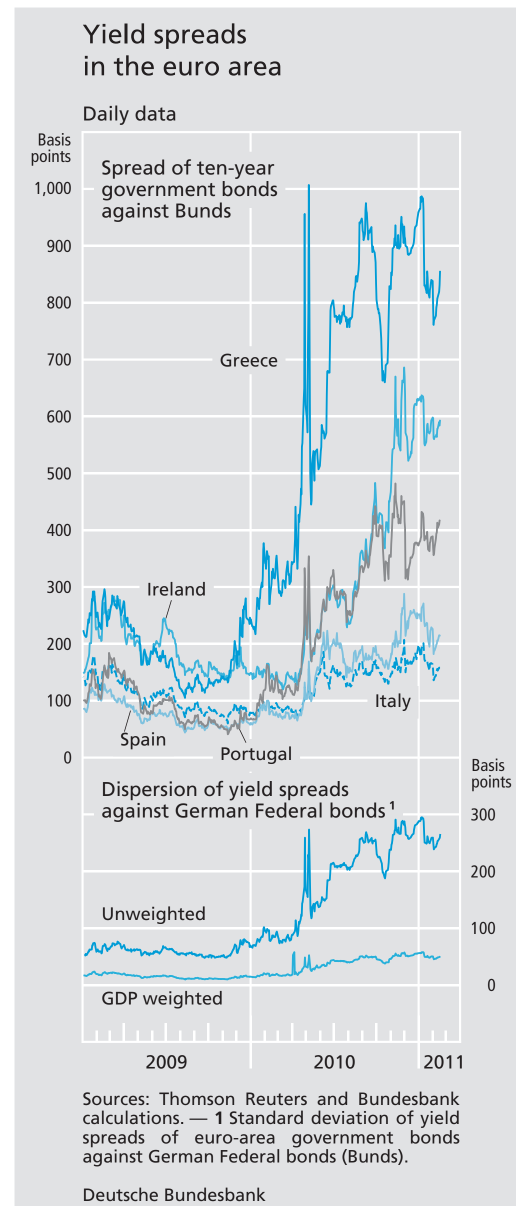
International bond markets

Government bond yields in large industrial countries rose significantly during the fourth quarter of 2010 and into 2011. Since end-September 2010, the yield on ten-year Bunds has increased by 1 percentage point to 3¼%, while the yield on US Treasuries of the same maturity moved up by just over 1 percentage point to 3½%, and that for bonds of the Japanese central government climbed by 40 basis points to just over 1¼%. In an environment of sometimes high uncertainty, yield movements – as gauged by the implied volatility of options, which was above the five-year average – reflect above all the growing signs of a stronger economic upturn. This upturn has been visible not only in higher real interest rates but also – with food and commodity prices on the increase – in rising inflation ex-

pectations. Credit risk premiums also went up in the market segment for public sector bonds, probably driven *inter alia* by investors' worries about the extent to which the burdens caused by the rescue packages might jeopardise the general sustainability of government debt in individual European countries. In the United States the announcement at the beginning of November that there would be renewed purchases of sovereign bonds briefly caused yields to fall before the economic recovery and higher inflation expectations there, too, drove them up again.

Yield spreads in the euro area

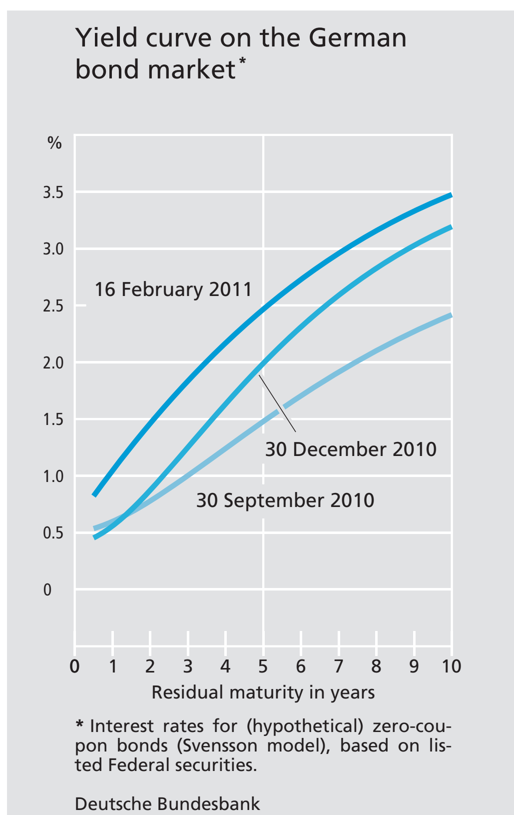
The worsening of Ireland's problems in the final quarter of 2010 had a decisive impact on yield spreads in the euro area. Support measures for the financial sector going well into the double-digit billions of euro once again put the Irish government budget under substantial pressure. Irish risk premiums on the capital markets rose to all-time highs, pulling premiums of other peripheral countries up with them. Ireland requested international assistance at the end of November. However, the situation on the capital markets did not ease dramatically at first. Instead, the gulf between the financing conditions of individual countries widened further on the whole, not least as a result of market participants' growing sensitivity with regard to the sustainability of public debt. The GDP-weighted yield spread of long-term euro-area government bonds over Bunds rose to an all-time high of almost 190 basis points before shedding 30 basis points by the end of January 2011; on balance, it was 2 basis points above the level recorded at the end of September 2010.



Sources: Thomson Reuters and Bundesbank calculations. — 1 Standard deviation of yield spreads of euro-area government bonds against German Federal bonds (Bunds).

Yield curve shifted upwards and steeper

During the course of the final quarter of 2010 the German yield curve shifted upwards at the long end, and interest rates have risen at the short end, too, since the beginning of this year. On the whole, higher real interest rates and increasing breakeven inflation rates led to a sharper increase for ten-year bonds than for short-dated Federal securities. In the latter case, the rise in yields was driven by the reduction of excess liquidity on the money



* Interest rates for (hypothetical) zero-coupon bonds (Svensson model), based on listed Federal securities.

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market and expectations of interest rate increases that had been moved forwards. The difference between ten-year and two-year yields widened accordingly by 35 basis points to 200 basis points, and is still well above its five-year average of just more than 110 basis points. Above all, this development may be attributed to the fact that market participants now expect a quicker normalisation of interest rate conditions on the money market and a lasting increase in interest rates.

Financing conditions for enterprises

In the period under review, the changed interest rate environment was also reflected in higher yields on European corporate bonds. Moreover, the yield dispersion between the countries increased – as with sovereign bonds –, with banks in several peripheral countries reporting an especially sharp rise in debt financing costs. All in all, at the end of the reporting period, yields on BBB-rated, euro-denominated corporate bonds – as measured by the iBoxx bond index, which comprises bonds issued by banks and non-banks – were, at 5½%, just more than ½ percentage point above the figure at the end of September.

By contrast, the corresponding interest rate spreads over German Bunds narrowed by about 40 basis points. On the one hand, this reflects the fact that market participants took a somewhat more optimistic view of enterprises' credit risk despite the higher yields, which is also expressed in the fall in price uncertainty observed on the equity markets and in lower credit derivative indices compared with September. On the other hand, a decline in the liquidity premium demanded by investors is likely to have played a part. The bottom line is that the financing conditions for enterprises on the capital market are not to be considered unfavourable given the improved economic outlook.

High issuance in the bond market

Sales and purchases in the German bond market in the fourth quarter of 2010 were influenced less by the international financial market environment described above than by securities transactions by the newly founded FMS Wertmanagement (FMS-WM), which as a public-law entity within the Financial Market Stabilisation Agency (FMSA) assumed Hypo Real Estate (HRE) Group risk exposure. Gross issuance figures in the German bond market rose sharply in the final quarter of 2010 as a result. Overall, German borrowers sold paper worth €425 billion, compared

with €324½ billion in the previous three-month period. However, taking into account the redemptions and changes in issuers' holdings, which were unusually high due to the FMS-WM transactions, domestic issuers increased their capital market borrowing by only €5 billion. In the fourth quarter, foreign debt instruments totalling €110 billion were sold in the German bond market. These high sales figures were attributable primarily to the transfer of assets from abroad following the foundation of FMS-WM in October 2010. Thus, the total outstanding volume of bonds in Germany rose by €115 billion in the quarter under review.

Sales of public sector debt securities

During the same period, the outstanding volume of public sector debt securities dropped by €85½ billion. This unprecedented decline is likewise due mainly to the transactions conducted by FMS-WM, which redeemed the SOFFIN-guaranteed bonds it had taken over from HRE in October and successively replaced them with its own issues. At the same time, FMS-WM strongly expanded holdings of its own bonds temporarily. Both the redemptions and the increased holdings of its own paper more than offset the large issuance volume, leading to negative net sales.[1] In addition, the Federal government itself issued, above all, 10-year bonds worth €15 billion as well as Treasury discount paper (Bubills) worth €3 billion and 2-year Federal Treasury notes (Schätze) worth €1 billion. On the other hand, it redeemed 5-year Federal notes (Bobls) and 30-year bonds (€8 billion and €3½ billion respectively). The Federal states tapped the bond market for €2 billion net in the fourth quarter of 2010.

Investment activity in the German securities markets

€ billion

Item	2009 Q4	2010 Q3	2010 Q4
Debt securities			
Residents	19.7	– 37.1	105.9
Credit institutions	– 19.1	– 31.9	– 28.9
of which			
Foreign debt securities	– 9.0	– 10.9	– 21.4
Non-banks	38.8	– 5.2	134.8
of which			
Domestic debt securities	9.6	– 36.1	3.5
Non-residents	– 18.6	33.8	9.0
Shares			
Residents	7.6	– 2.9	25.5
Credit institutions	7.1	– 3.1	9.0
of which			
Domestic shares	4.8	– 1.4	7.7
Non-banks	0.5	0.3	16.5
of which			
Domestic shares	– 1.3	0.6	6.4
Non-residents	– 1.1	2.0	– 2.6
Mutual fund shares			
Investment in specialised funds	19.3	20.2	23.4
Investment in funds open to the general public	3.2	3.0	2.7
of which: Share-based funds	1.6	0.3	4.0

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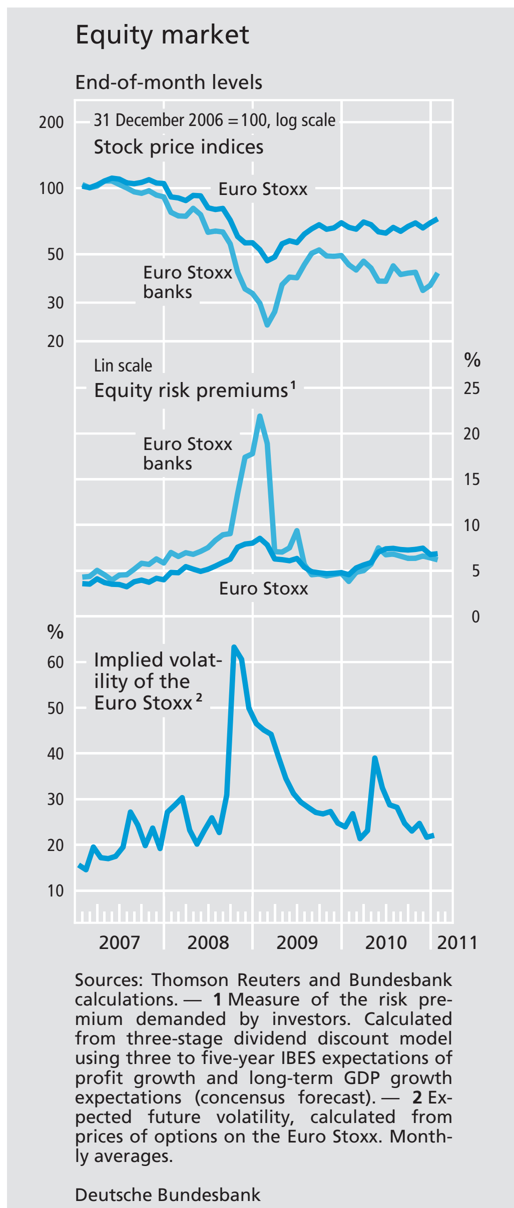
Sales of bank debt securities

While there was a decrease in public debt outstanding, a growth of almost equal dimensions was posted for debt instruments issued by credit institutions worth €83 billion. Thus, only the outstanding volume of other bank debt securities which can be structured flexibly rose (€96 billion). As mentioned above, HRE played an important role in this context by transferring extensive holdings of its own SOFFIN-guaranteed bonds to FMS-WM. By contrast, net redemptions of public and mortgage Pfandbriefe totalled €9 billion and €2½ billion respectively, while debt securities issued by specialised credit institutions to the tune of €2 billion were redeemed.

1 The calculation of sales in capital market statistics shows net sales at market prices less changes in issuers' holdings.



Sources: Thomson Reuters and Bundesbank calculations. — **1** Measure of the risk premium demanded by investors. Calculated from three-stage dividend discount model using three to five-year IBES expectations of profit growth and long-term GDP growth expectations (concensus forecast). — **2** Expected future volatility, calculated from prices of options on the Euro Stoxx. Monthly averages.

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Paper issued by enterprises

In the quarter under review, domestic enterprises stepped up their capital market borrowing in Germany by just under €8 billion; this included short-term commercial paper worth €1 billion. On the whole, non-bank financial enterprises were especially active issuers (€5 billion). Non-financial corporations tapped the capital market in the amount of €1 billion, after redeeming paper worth €2 billion in the previous quarter.

Purchase of debt securities

In the fourth quarter of 2010, debt securities in Germany were purchased exclusively by domestic non-banks, which added €135 billion (net) worth of fixed-income securities to their portfolios; these were foreign debt instruments (€131½ billion) and domestic paper issued by private borrowers (€120 billion). These figures, too, very largely reflect the takeover of securities of the HRE Group by FMS-WM. Foreign investors increased their holdings of German debt securities by €9 billion. By contrast, domestic credit institutions sold fixed-income securities worth €29 billion; the focus here was on foreign bonds.

International equity markets influenced by improved economic activity

The international equity markets were marked by brighter economic prospects in the fourth quarter. In the United States, confidence grew following the publication of largely favourable economic data. Moreover, the expectation of many market participants that the expansive US monetary policy would continue for some time is likely to have bolstered the equity markets. In the euro area, equity prices received a boost from market participants' pronounced optimism with regard to German economic growth, which is also spilling over to other countries through increased imports. Another positive factor was that, after Ireland opted to make use of the rescue package, several peripheral countries were able to place new sovereign bonds. This seems to have encouraged investors to liquidate safe-haven positions and invest the freed-up funds on the equity markets. In this environment of growing confidence, uncertainty about future equity price developments declined worldwide and was appreciably

below the five-year average as this report went to press.

On both sides of the Atlantic, the brighter economic prospects had a positive impact on corporate results and on future growth expectations, which improved in both cases one-year-ahead and looking further into the future. In this setting, the capital market rate, which was also up, did not perceptibly dampen equity prices. Measured against the broad-based CDAX and S&P 500 indices, German and US equities have therefore made sharp price gains of 19% and 17% respectively since the end of September, with European equities (Euro Stoxx) appreciating 12%.

Equity risk premium

The excess return investors demand for an investment in European shares (Euro Stoxx) as compared to a safe investment, which can be calculated using a dividend discount model, slipped just less than ½ percentage point to around 6¾%. Despite the decline, it therefore remains clearly above the five-year average (about 5½%). This indicates that risk aversion among investors active in the overall market is still above average, despite the distinct price gains, and that the valuation of equities is not especially high. The implied risk premium for exposure to European banking stocks was almost unchanged at the end of the reporting period at just under 6¼%. This was because not only equity prices but also long-term earnings expectations for banks were down. Apparently, investors continue to demand less risk compensation for holding bank shares than for holding other equities.

Major items of the balance of payments

€ billion

Item	2009	2010	
	Q4	Q3	Q4
I Current account [1, 2]	+ 44.2	+ 28.9	+ 42.8
Foreign trade [1, 3]	+ 40.9	r + 39.7	r + 39.3
Services [1]	+ 1.6	− 7.3	+ 2.5
Income [1]	+ 11.2	+ 10.2	+ 10.6
Current transfers [1]	− 7.4	− 10.6	− 6.8
II Capital transfers [1, 4]	− 0.5	+ 0.1	− 0.5
III Financial account [1] (Net capital exports: –)	− 75.4	− 24.0	− 42.7
1 Direct investment	+ 9.8	+ 11.1	− 0.2
German investment abroad	+ 1.9	+ 3.2	− 10.5
Foreign investment in Germany	+ 7.9	+ 7.8	+ 10.3
2 Portfolio investment	− 36.8	+ 12.2	− 107.5
German investment abroad	− 18.0	− 23.0	− 115.4
Shares	− 0.8	+ 2.6	− 2.3
Mutual fund shares	+ 3.0	− 5.5	− 3.2
Debt securities	− 20.2	− 20.0	− 110.0
Bonds and notes [5]	− 21.6	− 17.5	− 115.6
of which Euro-denominated bonds and notes	− 19.9	− 12.0	− 60.4
Money market instruments	+ 1.4	− 2.5	+ 5.6
Foreign investment in Germany	− 18.8	+ 35.1	+ 8.0
Shares	− 0.7	+ 1.9	− 2.1
Mutual fund shares	+ 0.5	− 0.5	+ 1.2
Debt securities	− 18.6	+ 33.8	+ 9.0
Bonds and notes [5]	− 14.2	+ 24.7	− 7.4
of which Public bonds and notes	+ 2.6	+ 25.0	+ 8.4
Money market instruments	− 4.4	+ 9.0	+ 16.3
3 Financial derivatives [6]	− 0.4	− 7.9	+ 0.3
4 Other investment [7]	− 48.6	− 39.6	+ 65.2
Monetary financial institutions [8]	− 37.7	+ 42.4	+ 47.0
of which: short-term	− 48.9	+ 15.5	+ 21.1
Enterprises and households	+ 2.9	− 14.1	− 3.6
of which: short-term	+ 10.3	− 1.4	+ 6.4
General government	− 15.4	− 7.2	+ 34.0
of which: short-term	− 15.1	+ 3.2	+ 75.2
Bundesbank	+ 1.6	− 60.7	− 12.3
5 Change in reserve assets at transaction values (increase: –) [9]	+ 0.6	+ 0.3	− 0.5
IV Errors and omissions	+ 31.7	− 5.0	+ 0.4

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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Stock market funding and stock purchases

Issuance on the domestic stock market picked up significantly in the fourth quarter of 2010. Domestic enterprises issued €11½ billion in new shares, compared with €1 billion in the months July to September. This was due mainly to a capital increase by a credit institution. The volume of outstanding foreign equities in Germany increased by €11½ billion. Shares were purchased by resident non-banks and by credit institutions (€16½ billion and €9 billion respectively). Whereas credit institutions primarily purchased German equities, German non-banks mostly bought foreign stocks. By contrast, foreign investors scaled back their holdings of German equities by €2½ billion, above all by unwinding portfolio investment.

Sales and purchases of mutual fund shares

In the reporting period, domestic mutual funds recorded a net inflow of €26 billion, compared with €23 billion in the previous quarter. The fresh money mainly benefited specialised funds reserved for institutional investors (€23½ billion). Among funds open to the general public, share-based funds in particular attracted positive inflows given the cheerful sentiment in the stock markets (€4 billion), followed by mixed securities-based funds, mixed funds and funds of funds (€½ billion each). By contrast, bond-based funds and open-end real estate funds recorded outflows (-€2 billion and -€½ billion respectively). Sales of foreign mutual fund units in Germany totalled €3 billion.

Mutual fund shares were bought overwhelmingly by domestic non-banks, which placed €26 billion worth of such shares in their portfolios, the vast majority being domestic fund shares (€25 billion). Credit institutions increased their exposure to mutual fund shares by €2 billion, buying only foreign fund shares on balance. Non-resident investors increased their holdings of domestic fund shares by €1 billion.

Direct investment

German direct investment abroad

Direct investment was almost balanced in the fourth quarter of 2010, compared with net capital inflows of €11 billion in the July to September period. This development was attributable mainly to an increase in cross-border investment by German enterprises, which supplied their foreign branches with €10½ billion; in net terms this consisted only of equity capital (€12 billion). The increase in foreign investment by German enterprises was primarily due to direct investment by the chemical industry (€6 billion), manufacturers of transport equipment (€4½ billion) and enterprises from the telecommunications sector (€4 billion). Most of the funds flowed to European countries.

Foreign direct investment in Germany

Direct investment by foreign enterprises in Germany likewise amounted to €10½ billion in the October to December 2010 period, exceeding the level recorded in the previous quarter (€8 billion). Primarily European and North American proprietors supplied their German-based subsidiaries with funds in the form of intra-group credit transactions.