

■ Financial markets

■ Financial market setting

Financial markets affected by expansionary monetary policy

Events on the international financial markets in the third quarter of 2013 were heavily influenced by factors related to monetary policy and macroeconomic developments. The financial markets came entirely under the spell of altered expectations about the future course of Federal Reserve monetary policy. Whilst most market participants had previously been expecting an imminent gradual tapering of bond purchases by the US central bank along with rising yields, and had reduced their provision of capital to the emerging market economies, the yield trend then turned around on both sides of the Atlantic in September. This came about largely because the US central bank had reaffirmed that it would maintain its accommodative monetary policy stance and its asset purchases in their full extent against a backdrop of weak labour market figures and, at that time, the unresolved budget dispute. The continuation of monetary easing was also echoed in price gains on the equity markets, which received additional support from predominantly positive economic data in a host of countries. On the foreign exchange markets, changing expectations about US monetary policy exerted significant pressure for a time on the currencies of a number of emerging market economies with weak fundamentals. By contrast, the euro gained slightly on balance as a weighted average against the currencies of 21 major trading partners.

■ Exchange rates

Euro firmer against the US dollar on balance

The euro appreciated against the US dollar by around 2½% on balance compared to the end of June. Standing at around US\$1.38 at one point, the currency even reached its highest level for roughly two years. Changes in economic sentiment and the resulting revisions to market participants' expectations regarding the

future monetary policy stance both in the United States and in the euro area played a key role in determining the exchange rate pattern. Moreover, events surrounding the US budget dispute impacted on exchange rate movements.

At the beginning of the reporting period, the single currency initially came under downward pressure when the Governing Council of the ECB reaffirmed its intention to keep the euro-area policy rate low for an extended period of time. Remarks by the US central bank that the US economy would be in need of a highly accommodative monetary policy for the foreseeable future then triggered a clear countermovement. On top of this, a successful auction of Spanish money market paper served to support the single currency. In mid-August, stronger-than-expected US economic data fuelled speculation that the Federal Reserve would pare back its bond-buying programme sooner than expected, causing the euro to falter temporarily. However, when the Fed indicated in mid-September that it would not cut back its bond purchases – much to the surprise of market participants – the euro rebounded perceptibly.

In October, movements in the USD/EUR exchange rate mirrored the course of events in the United States budget dispute. Speculation that an agreement might be imminent led to periodic downward pressure on the euro, while growing scepticism on the part of market participants as to whether a deal could be reached at all had the opposite effect. That the eventual agreement reached nonetheless drove the euro noticeably higher is due to the fact that it was merely possible to agree on a postponement. Latterly, the euro relinquished some of its gains on account of the lower-than-expected inflation rate reported for the euro area at the end of October. This stoked speculation among market participants that a cut in interest rates

Exchange rate pattern largely attributable to changing expectations concerning the monetary policy pursued in the United States and in the euro area

Postponement of a solution to the US budget dispute bolsters the euro, ...

... but lower inflation rate and a reduction in the ECB's key interest rates weigh on single currency



might be around the corner, a move which then was indeed implemented by the ECB Governing Council at the beginning of November. As this report went to press, the euro was trading at US\$1.34.

Euro also appreciates against the yen, ...

The euro also made gains against the yen. It benefited, in particular, from the debate about the Japanese government's contemplated postponement of its planned VAT increase, which gave market participants reason to doubt Japan's commitment to fiscal consolidation. By contrast, Prime Minister Shinzo Abe's subsequent announcement at the beginning of October confirming that the VAT rate

would indeed be raised in April 2014 hardly impacted on the EUR/JPY exchange rate, as it coincided with the presentation of a new economic stimulus package. Of late, Japan's weaker third-quarter growth figures have worked to the euro's advantage. At the end of the reporting period, the single currency stood at ¥134, which was almost 4% up on its level at the end of June.

Conversely, the single currency made slight losses against the pound sterling. These were mainly due to better-than-expected sentiment indicators and growth figures for the United Kingdom which raised expectations among market participants that the Bank of England would step back from its expansionary path sooner than originally imagined. Most recently, the euro was trading at £0.84, down by around 2½% on its value at the end of June.

... but loses a little ground against the pound sterling

The euro saw a slight gain in value compared with the end of the second quarter vis-à-vis the currencies of the 21 most important trading partners of the euro area. At last count, the single currency was about 3½% up on the beginning of the year and around ½% below its level at the launch of monetary union. In real terms, too, ie taking account of the inflation differentials between the euro area and its major trading partners, the effective euro exchange rate rose somewhat on balance in the period under review. This diminished – albeit only marginally – the price competitiveness of euro-area exporters, which should be considered significantly worse than the long-term average.

Effective exchange rate of the euro likewise somewhat firmer

Securities markets and portfolio transactions

The international bond markets saw mixed developments in the third quarter. While yields on long-term bonds in the euro area dipped, ignoring the slightly brighter economic outlook, ten-year US Treasury yields at the end of the period under review were slightly up on balance compared with the end of the second

International bond markets exhibit mixed behaviour

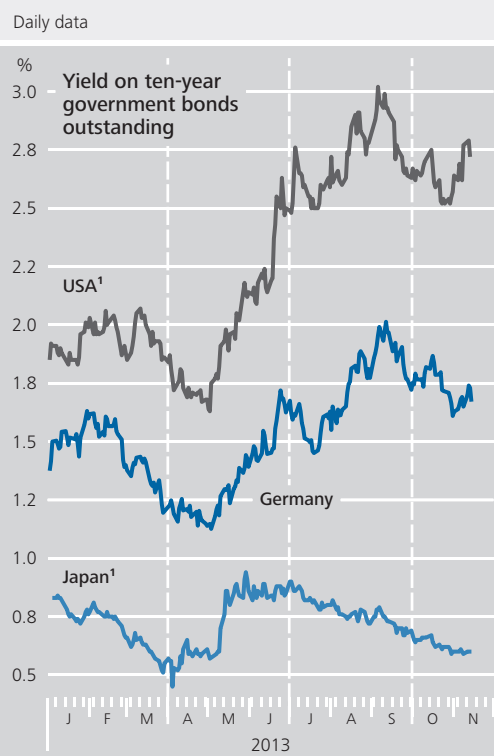
quarter at around 2.7%. However, US yields did not follow an even path. Instead, they were influenced by shifting monetary and fiscal policy factors. By September, the upward tendency shown by yields since May initially continued its course to 3.0% amid market expectations of an imminent tapering-off of bond purchases by the Federal Reserve. However, in September the Fed announced that it would continue to buy US\$85 billion in bonds each month until further notice as the labour market data still provided no clear-cut signs of a definite recovery. This unexpected decision not to begin gradually tapering asset purchases initially curtailed the upturn in US yields, broadly driving down yields. The US budget debate that unfolded at the end of September, coupled with the temporary shutdown of some of the country's public administration services, caused US yields to spike only for a time at the beginning of October. Nevertheless, the imponderables for the bond markets that were triggered by the government shutdown were reflected in a temporary widening of CDS spreads. Latterly, long-term US Treasury yields nonetheless picked up again slightly in view of the better-than-expected US labour market data.

Monetary and fiscal policy discussions in the United States also had a significant indirect impact on the development of yields on long-term government bonds issued in the euro area and in Germany. In this context, yields on ten-year Bunds continued to rise into the month of September, briefly peaking at a level of 2% for the first time since March 2012. However, the decline in yields observed in the United States since mid-September also caused German yields to fall once more; these stood at 1.7% at last count. Compared with the end of the second quarter, this nevertheless constitutes a modest increase of 11 basis points.

German yield curve remains steep

The yield curve for Federal securities with a maturity of between two and ten years therefore remains fairly steep, which would suggest that market participants anticipate higher short-term interest rates over the next few years.

Bond yields in Germany, Japan and the USA



1 Source: Thomson Reuters.
 Deutsche Bundesbank

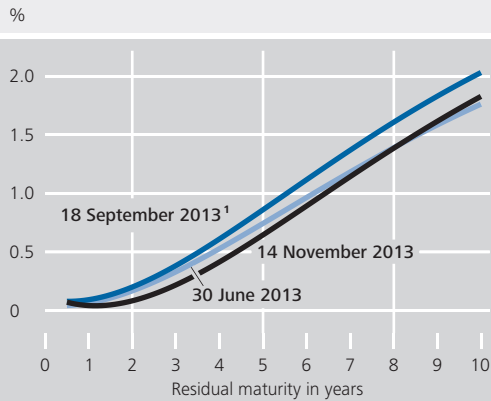
Some of the yield differential between long and short maturities also remunerates long-term investors for assuming interest rate and inflation risk. Since the end of June, implied inflation expectations (ie the break-even inflation rates) for paper with a ten-year maturity, which are derived from the spread between nominal and real yields on Federal bonds, have fallen by 27 basis points to a level of 1.2%.

During the period under review, the GDP-weighted long-term yields on bonds issued by other euro-area countries fell from 3.6% to 3.3% at last count. This was principally due to clearly declining yields in peripheral countries. Third-quarter macroeconomic data confirm signs of a degree of economic stability in the programme countries. As a result, peripheral countries benefited from reduced risk premiums and narrowing CDS spreads.

Yields in other euro-area countries down

Changing expectations in relation to US monetary policy had a particularly major impact on

Yield curve on the German bond market*



* Interest rates for (hypothetical) zero-coupon bonds (Svensson method), based on listed Federal securities. ¹ Before the meeting of the Federal Open Market Committee. Deutsche Bundesbank

Financing conditions for euro-area enterprises

Weekly averages



¹ Euro-denominated BBB-rated bonds with a residual maturity of seven to ten years, included in the bond market indices (iBoxx) of the International Index Company. Source: Thomson Reuters. ² Spreads on five-year credit default swap (CDS) contracts included in the indices (iTraxx) of the International Index Company. Source: Bloomberg. Deutsche Bundesbank

the financial markets of emerging market economies. The Fed's announcement in May of its intention to taper off its bond purchases put particular pressure on the currencies and stock markets of EMEs with current account deficits. While the quantitative easing measures of the world's key central banks generated capital flows to EMEs in recent years, disinvestment from EME investment funds indicated that capital was being drained from these countries. Some countries reacted by tightening monetary policy or intervening in the foreign exchange markets. The Fed's surprising decision in September not to proceed with its tapering plans initially put these trends into reverse: the bond, equity and exchange markets all rallied to a degree, and investment funds geared specifically to EMEs started to attract more capital again. It will be crucial for these countries to use the time available to reduce their external vulnerability.

Tapering measures leave their mark on EME financial markets

For the most part, the path followed by yields on long-term Japanese government bonds diverged from developments in other countries, with the effect that it remains primarily influenced by the fiscal and monetary policy steps announced back in January and April of this year. These measures which are designed to overcome deflation while bolstering economic growth and which encompass large-scale bond purchases by the Japanese central bank contributed to a decline in long-term bond yields in Japan from the end of the second quarter onwards, down by 25 basis points to 0.6%. During the same time period, Japan's five-year inflation expectations, measured on the basis of break-even inflation rates, rose significantly by 44 basis points to stand at 1.5% as this report went to press. This is consistent with the results of the survey on long-term inflation expectations (consensus forecasts) published in October which, in the case of Japan, have climbed to 1.3% in the period since April. According to both these measures, however, inflation expectations remain well below the inflation target, which was raised to 2% in January.

Declining yields in Japan

Further improvement in financing conditions for enterprises

Funding terms for corporations on capital markets tended to improve further. European financials saw their yields on corporate bonds with a residual maturity of seven to ten years and a BBB rating fall from a mid-year level of 5.1% to 4.5% latterly, while European enterprises forming part of the real economy recorded a yield dip of 0.3%, down to 3.0%.¹ As a result, corporate bonds were yielding considerably less than the five-year average. Moreover, yields remained below the levels at which they had stood before the Lehman bankruptcy in September 2008. The yield spreads of European BBB-rated corporate bonds over Bunds with comparable maturities likewise narrowed during the summer months by 70 basis points for bonds issued by financial corporations and by 33 basis points for non-financial corporate debt to 2.8 and 1.4 percentage points respectively at last count. This contraction in spreads reflects a further reduction in market participants' risk aversion and mirrors the parallel narrowing of credit default risk premiums (iTraxx) as well as reduced stock market uncertainty. In light of the continuing worldwide low-interest-rate environment, the low spreads are also likely to be indicative of an ongoing search for yield by investors.

Declining risk aversion and credit risk premiums

Reduced debt outstanding in the German bond market

In the third quarter of 2013, gross issue volume in the German bond market amounted to €380½ billion, which was below the level for the previous quarter. After deducting the higher redemptions and taking account of changes in issuers' holdings of their own bonds, net redemptions of debt securities came to €39½ billion. In addition, foreign borrowers placed debt securities worth €20½ billion on the German market. The outstanding amount of debt securities in the German market therefore decreased by €19 billion in the period under review.

Net public sector redemptions, ...

The public sector redeemed debt securities in the amount of €9 billion during the third quarter of 2013, compared with net issuance of €8 billion one quarter earlier. Central government principally redeemed ten-year bonds

Investment activity in the German securities markets

€ billion

Item	2012	2013	
	Q3	Q2	Q3
Debt securities			
Residents	10.4	24.9	- 7.1
Credit institutions	- 4.9	- 2.5	- 7.7
of which			
Foreign debt securities	- 5.7	8.9	- 0.1
Deutsche Bundesbank	- 0.6	- 3.7	- 2.7
Other sectors	15.9	31.2	3.3
of which			
Domestic debt securities	- 9.4	7.5	- 20.2
Non-residents	1.9	- 14.8	- 12.1
Shares			
Residents	5.0	11.3	6.1
Credit institutions	7.9	- 1.1	6.9
of which			
Domestic shares	4.7	- 1.3	3.2
Non-banks	- 2.9	12.4	- 0.8
of which			
Domestic shares	- 4.0	6.7	- 6.6
Non-residents	0.9	1.8	3.9
Mutual fund shares			
Investment in specialised funds	21.1	13.0	15.6
Investment in retail funds	0.0	1.5	3.2
of which			
Equity funds	- 0.5	- 1.0	0.6

Deutsche Bundesbank

(€16½ billion), and, to a smaller extent, two-year Federal Treasury notes (Schätze) totalling €3½ billion as well as Treasury discount paper (Bubills) worth €2 billion. This contrasted with net issuance of Federal notes (Bobls) in the amount of €11½ billion and 30-year bonds worth €2 billion. On balance, the Federal states only tapped the capital market to a marginal extent in the reporting period.

Domestic credit institutions took advantage of their positive financial situation and attractive alternative forms of financing by further paring back their capital market debt in the third quarter of 2013, paying down €26½ billion. They mainly focused on "other bank bonds" (€17 billion), but also redeemed public Pfandbriefe and mortgage Pfandbriefe (€4½ billion in each case).

... net redemptions by credit institutions ...

¹ Based on corporate bond yields included in the various iBoxx bond indices for different rating grades.

Prices and earnings expectations for German, European and US public limited companies

End 2012 = 100, log scale



Sources: Deutsche Börse AG and Thomson Reuters. ¹ Using 1-year forward I/B/E/S estimates. In each case, status is the last week of the month.
 Deutsche Bundesbank

... and enterprises active in the bond market

While gross issuance of non-financial corporate bonds in Germany in the third quarter was almost as high as in the second quarter, redemptions were significantly up as this report went to press. Between July and September, non-financial corporations thus reduced their capital market debt despite the improved financing conditions by just under €½ billion in net terms. Insurers and other German financial institutions redeemed as much as just under €4 billion worth of corporate bonds in net terms during the period under review. On balance, these were chiefly bonds running for terms of more than one year.

Only domestic non-banks were active as buyers in the third quarter of 2013, adding debt instruments totalling €3½ billion to their portfolios. These were exclusively foreign debt securities on balance. By contrast, foreign investors and domestic credit institutions disposed of debt securities amounting to €12 billion and €8 billion respectively.

Purchases of debt securities

On the whole, share prices in the world's leading financial centres continued to rise as of the mid-year point. The sounder economic outlook, especially for the euro area, along with enterprises' improved quarterly earnings figures and the Fed's unexpected decision to continue its bond purchase programme all played a role in this development. By contrast, the US budget dispute which dominated the first half of October unsettled the markets. However, despite the absence of any real solution to the US budget dispute, uncertainty over future share price developments continued to wane in mid-October on both sides of the Atlantic once a provisional agreement had been reached to raise the debt limit.

Share prices buoyed by more stable economic conditions and continuation of bond purchases by Federal Reserve

Given the persistent low-interest-rate environment and the search for yield, analysts' corporate profit projections lagged behind the performance of the broad-based market indices (see chart on this page), reflecting the higher price-earnings ratios prevailing in both the euro area and the United States. From the middle of the year onward, price rises of 11.5% for the S&P 500, 17.2% for the Euro Stoxx and 15.8% for the German Prime All Share Index, contrasted with only marginal increases in expected corporate earnings. On balance, the price-earnings ratios of the US and the euro area alike, both measured on the basis of expected profits, were thus noticeably above their respective five-year averages. This is also reflected in declining risk premiums demanded by investors for holding equities. With regard to the aforementioned indices, at the end of October these risk premiums stood more than half a percentage point below their mid-year level, thus likewise falling short of their five-

Higher price-earnings ratios, flanked by low price uncertainty

The return expected from stocks tilted downwards

year averages. While both the Euro Stoxx and the German Prime All Share Index, as measured by the price index,² have failed to approach their all-time highs of late, this development nonetheless points to a reduced degree of risk aversion on the part of investors. European bank stock prices, not least in the peripheral countries of the euro area, clearly outperformed the market as a whole. European banks listed in the Euro Stoxx gained 34.1% in value as of the middle of the year, while the prices of US bank shares were just 5.1% up on their end-of-June level, which meant that they underperformed the US market as a whole.

European banks see particularly sharp price increases

Notwithstanding the positive trend shown by German equity prices, issuing activity remained comparatively subdued in the third quarter. Domestic enterprises issued €½ billion worth of new shares, the majority of which were listed equities. The volume of foreign shares on the German market rose by €9½ billion in the same period. Equities were mainly bought by domestic credit institutions (€7 billion) who made net purchases of both foreign and domestic stocks. Foreign investors, meanwhile, acquired German equities for €4 billion. By contrast, domestic non-banks parted with shares in the amount of €1 billion.

Low level of stock market funding

During the reporting period, domestic investment companies recorded inflows of €19 billion, after raising funds totalling €14½ billion in the previous three months. On balance, the vast majority of new funds went to specialised funds reserved for institutional investors (€15½ billion). Among the asset classes, chiefly mixed funds (€7 billion) and mixed securities-based funds (€6½ billion), and to a lesser extent share-based funds and bond-based funds (€2 billion each), were able to attract new subscriptions. Mutual funds distributed by foreign companies on the German market recorded net inflows totalling €7½ billion.

Sales and purchases of mutual fund shares

² Unlike performance indices, price indices take no account of reinvested profit distributions by enterprises listed in the indices.

Major items of the balance of payments

€ billion

Item	2012	2013	
	Q3	Q2	Q3
I Current account ^{1, 2}	+ 45.4	+ 45.9	+ 44.0
Foreign trade ^{1, 3}	+ 50.8	+ 48.6	+ 49.9
Services ¹	- 7.2	+ 0.4	- 6.9
Income ¹	+ 19.0	+ 8.3	+ 18.3
Current transfers ¹	- 9.4	- 7.6	- 10.3
II Capital transfers ^{1, 4}	+ 0.1	+ 0.3	+ 0.1
III Financial account ¹ (Net capital exports: -)	- 62.1	- 65.2	- 70.1
1 Direct investment	- 15.8	- 12.0	- 3.5
German investment abroad	- 9.7	- 5.0	- 8.1
Foreign investment in Germany	- 6.1	- 7.1	+ 4.7
2 Portfolio investment	- 26.7	- 49.6	- 43.8
German investment abroad	- 28.0	- 36.8	- 36.8
Shares	- 2.4	- 3.3	- 8.8
Mutual fund shares	- 6.5	- 4.1	- 7.7
Debt securities	- 19.2	- 29.5	- 20.4
Bonds and notes ⁵	- 17.7	- 30.1	- 19.9
of which Euro-denominated bonds and notes	- 15.7	- 23.1	- 10.9
Money market instruments	- 1.5	+ 0.6	- 0.4
Foreign investment in Germany	+ 1.3	- 12.8	- 7.0
Shares	+ 0.5	+ 2.8	+ 3.9
Mutual fund shares	- 1.1	- 0.8	+ 1.2
Debt securities	+ 1.9	- 14.8	- 12.1
Bonds and notes ⁵	+ 16.3	- 20.7	- 5.5
of which Public bonds and notes	+ 12.4	+ 2.7	+ 4.2
Money market instruments	- 14.4	+ 5.9	- 6.6
3 Financial derivatives ⁶	- 3.8	- 6.1	- 2.3
4 Other investment ⁷	- 15.7	+ 2.6	- 21.3
Monetary financial institutions ⁸	- 36.4	- 13.7	- 15.5
of which short-term	- 43.2	- 24.5	- 25.9
Enterprises and households	- 11.1	+ 4.4	+ 4.3
of which short-term	- 4.9	+ 7.5	+ 10.5
General government	- 12.2	+ 9.8	- 12.2
of which short-term	- 14.1	+ 8.3	- 10.4
Bundesbank	+ 44.0	+ 2.1	+ 2.0
5 Change in reserve assets at transaction values (increase: -) ⁹	- 0.1	- 0.1	+ 0.8
IV Errors and omissions	+ 16.6	+ 19.0	+ 26.1

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

Domestic non-banks were the main net buyers overall, adding €26½ billion worth of mutual fund shares to their portfolios. Foreign investors acquired fund units worth €1 billion net. On the other hand, domestic credit institutions offloaded fund shares in the amount of €1½ billion.

■ Direct investment

*Capital exports
in direct invest-
ment*

As with cross-border portfolio investment, which experienced net outflows amounting to €44 billion in the third quarter of 2013, there were also net capital exports in the direct investment account. On balance – at a value of €3½ billion – these were, however, well below the prior-quarter figure (€12 billion).

The allocation of €8 billion worth of funds by German proprietors to their foreign subsidiaries

proved a key factor during the reporting period. Here, capital accumulation was largely achieved by means of reinvested earnings (€10 billion). Parallel to this, direct capital interests were expanded (€1½ billion). However, these amounts were offset by incoming cash flows arising from intra-group credit transactions (€3 billion). In the summer months, Malta and the United States were by far the most popular destinations for German direct investment (€3½ billion each).

*German direct
investment
abroad*

Foreign investors supplied their subsidiaries in Germany with funds to the tune of €4½ billion in the third quarter. This was likewise achieved through the reinvestment of earnings generated by the branches as well as through intra-group loans. Most of the impulse to invest came from euro-area countries, notably Belgium (€2 billion) and France (€1 billion).

*Foreign direct
investment in
Germany*