# Financial markets

## Financial market setting

*Financial markets influenced by geopolitical risk and monetary policy easing*

In the spring months of 2014, events in the international financial markets were dictated largely by the very expansionary monetary policy in the major currency areas. For instance, the Governing Council of the ECB adopted further monetary policy stimulus measures in June. This led to a considerable reduction in bond market yields, especially in the euro area. At the same time, market participants still had a strong appetite for risk, which meant that risky assets were trading at extremely narrow yield spreads up to and into June. The high prices of equities and corporate bonds were supported by market participants' positive assessment of economic activity. However, the market valuations of European enterprises in particular were subsequently dragged down by heightened geopolitical tensions as well as – in a probably related development – some weaker-than-expected business indicators recently, notably for the euro area. As a case in point, European equity markets have sustained net equity price losses of around 5% since the end of March, while the US equity market has fared more favourably. Foreign exchange market price developments were largely driven by current monetary policy decisions and expectations regarding the future monetary policy path on both sides of the Atlantic. On balance, the euro has lost about 2½% of its trade-weighted value since the end of March.

## Exchange rates

*Euro falls against the US dollar on balance, …*

In the foreign exchange markets, the easing of monetary policy in the euro area had a markedly negative effect on the euro exchange rate. Compared with the end of March 2014, the euro has depreciated against the US dollar by around 3% on balance.

*… having initially risen to its highest rate in more than two years*

Up to the beginning of May, however, the euro initially gained in value, even temporarily peaking at just under US$1.40, its highest recorded level since autumn 2011. On the one hand, this occurrence was attributable to favourable economic data in a number of euro-area countries and the positive market response to Greece's first issuance of sovereign bonds. On the other hand, the euro-dollar rate benefited from the publication of the minutes to the Federal Reserve's meeting, which prompted most market participants to assume that the prospect of a swift hike in the US policy rate had become more remote.

*Euro weakened by further monetary policy easing in the euro area …*

The upward trend in the euro's fortunes was not interrupted until ECB President Mario Draghi hinted at a further loosening of monetary policy in June. During this spell, the euro was additionally weakened by deteriorating economic expectations. Then, at the beginning of June, the pressure on the currency was upped when the reduction in the main refinancing rate in the euro area, to a record low of 0.15%, was indeed implemented and further measures to ease monetary policy were announced.

*… and the growing expectations of an interest-rate reversal in the United States*

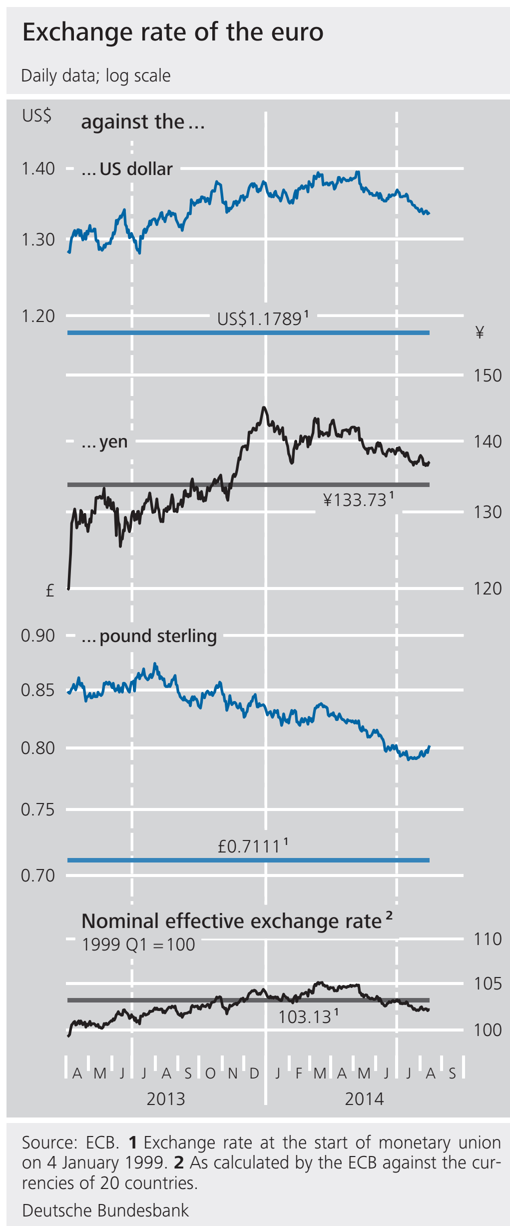
After stabilising temporarily, the euro came under renewed downward pressure when better-than-expected US labour market figures were published at the beginning of July. The upbeat economic data led market participants to believe that the Fed was more likely to hike rates sooner. On top of this, the euro was burdened by the political tensions brewing over the Ukraine conflict. As this report went to press, the euro stood at just under US$1.34, close to its hitherto lowest point this year.

*Euro also loses ground against the yen …*

In late spring and the summer months of this year, the euro also depreciated against the yen, after chalking up gains of more than 25% last year. For one thing, this fall in value was due to higher-than-expected growth in the Japanese

Exchange rate of the euro

Daily data; log scale




Source: ECB. **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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economy during the first quarter. For another, the yen is also likely to have benefited from the heightened uncertainty prevailing in international financial markets which, in the past, has frequently helped the Japanese currency to gain ground. Latterly, the euro was trading at ¥137, which was down by around 4% on its level at the end of March.

*… and against the pound sterling*

The single currency also made losses against the pound sterling. These were triggered largely by repeated signals on the part of the Bank of England that it might raise its policy rates earlier than the market expected. The UK labour market's surprisingly rapid recovery, which brought the national unemployment rate down to its lowest level since November 2008, likewise contributed to a revision of market expectations, thus eroding the euro-pound rate. Most recently, the euro was trading at £0.80, around 3% down on its level at the end of March.

*Effective exchange rate of the euro likewise weaker*

Vis-à-vis the currencies of the 20 most important trading partners of the euro area, the euro recorded a loss in value of around 2½% compared with the end of the first quarter. As a result, the single currency was latterly trading around 1% 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 fell in the period under review. The price competitiveness of euro-area exporters improved as a result but is still somewhat worse than the long-term average.

## Securities markets and portfolio transactions

*European bond markets characterised by low interest rates*

During the period under review, bond markets in the euro area were anticipating measures to ease monetary policy and feeling the pressure of intensified geopolitical tensions; this environment fostered an additional boost in demand for low-risk bonds. These safe haven inflows, combined with lower policy rates and the announcement of non-standard measures by the Eurosystem helped to feed the ongoing decline in capital market yields across Europe. Latterly, yields on European government bonds in many euro-area countries, including Germany, hit new lows (see the chart on page 51). Overall, since the end of March, the GDP-weighted yield on ten-year bonds issued by euro-area countries (excluding Germany) has shrunk from 2.7% to 2.1%, compared with a yield decline of 54 basis points to slightly above 0.9% for Bunds with the same maturity.

*Sovereign bonds of euro-area periphery countries see sharp interest rate decline*

The fall in yields on sovereign bonds issued by euro-area periphery countries was stronger than average. Even so, heterogeneous developments were evident within this group of countries. For instance, the interest rate level fell more sharply in Spain than in Italy, not least because Spain's GDP growth expectations (according to the Consensus Forecast) developed more favourably in comparative terms. In both countries, credit default swaps (CDSs) simultaneously declined. Overall, with the exception of Portugal and Greece, the sovereign spreads of long-term bonds issued by euro-area periphery countries narrowed against Bunds with comparable maturity.[1] Market participants' upfront confidence in future reform progress has therefore tended to grow stronger.

*United States also marked by falling interest rates*

Given the geopolitical risks at hand, interest rates in the US bond market were likewise affected by safe haven flows. On balance, yields on ten-year US Treasuries receded from 2.75% to 2.4% in the course of the reporting period. At the same time, the US Federal Reserve maintained its stance of gradually scaling back its monthly purchases of Treasuries and mortgage-backed securities in steps totalling US$10 billion. Since yields on US sovereign bonds fell less substantially than those on German Bunds, the interest rate spread between ten-year US Treasuries and German Bunds with the same maturity stood at 147 basis points at the end of the period under review, compared with 125 basis points in March. The spread has therefore been hovering close to its highest recorded level since the launch of monetary union.

*Yield curve for German Federal securities flattens once again*

Since the end of March, the slope of the German yield curve derived from the yields on Federal securities has become flatter by 40 basis points, slipping to a level of 111 basis points, as measured by the yield differential between ten-year and two-year bonds. This represents a further narrowing of the interest rate differential, which started out at 187 basis points at the beginning of the year. The flatter yield curve is primarily a reflection of expectations that the

**Bond yields in Germany, the euro area ex Germany and the USA**

Monthly data

Source: Bloomberg and Bundesbank calculations.
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short-run interest rate will remain low for a prolonged period, a sentiment largely fuelled by the monetary policy measures of the ECB's Governing Council. By contrast, changes to term premiums were of lesser importance.

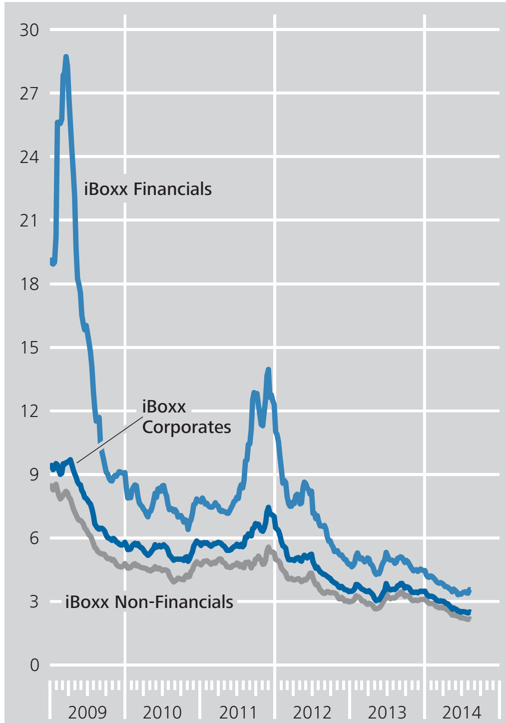
*Inflation expectations firmly anchored*

The five-year forward inflation rate in five years derived from inflation swaps remained virtually unchanged, at 2.1% per annum on balance. Against this background, longer-term inflation

1 In Portugal, the difficulties experienced by a private bank that had to be propped up by the state served to cushion this yield decline.

## Corporate bond yields in the euro area*

%, weekly averages




Source: Markit. * BBB-rated bonds with a residual maturity of seven to ten years.
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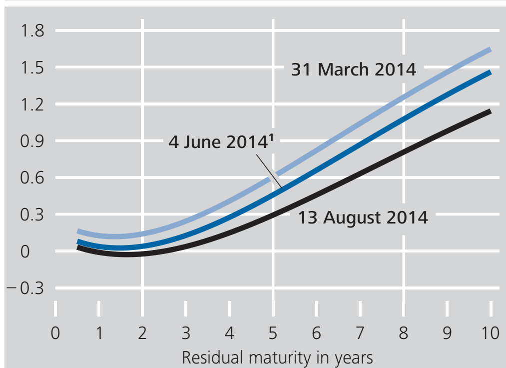
## Yield curve on the German bond market*

%




* Interest rates for (hypothetical) zero-coupon bonds (Svensson method), based on listed Federal securities. 1 Day before the most recent interest rate cut by the ECB Governing Council.
Deutsche Bundesbank

expectations are to be regarded as firmly anchored in the current interest rate environment.

*Capital market-based corporate funding costs at historical low*

Funding conditions for European enterprises in capital markets have continued to improve since the end of the first quarter. In July, corporate bond yields reached their lowest ever levels since the launch of monetary union, with the effect that for euro-area enterprises, bond financing had never been that cheap. On balance, European financials saw their spreads on corporate bonds with a residual maturity of seven to ten years and a BBB rating fall from 3.8% at the end of March to 3.5% latterly.[2] The corresponding bond yields for European non-financial corporations also dropped, from 2.7% to 2.1%. An initial downward movement in yield spreads over Bunds gave way to a countermovement in June when expectations that monetary policy would remain expansionary and the flight to safe haven bonds impacted on the Federal securities market in the form of a sharp dip in yields. Yield spreads on European corporate bonds have consequently widened a little in the intervening period, although they still fall somewhat short (by 5 basis points) of their levels at the end of March.

*CDS spreads narrower*

Premiums on credit default swaps for enterprises also experienced a decline. In the light of the continued low-interest-rate environment across the globe, this indicates that the level of investor compensation for implicitly expected credit default losses remains quite low.

*Net sales in the bond market down*

Gross issuance in the German bond market stood at €358½ billion in the second quarter of 2014 and was therefore well below its previous-quarter level (€395½ billion). After deducting redemptions and taking account of changes in issuers' holdings of their own bonds, net redemptions of domestic debt securities came to €1 billion. Foreign borrowers placed debt securities worth €28 billion on the German market. Thus, funds totalling a net €27 billion were raised in the German bond market in the reporting period.

*Higher public sector borrowing*

The public sector raised €14½ billion on the bond market in the spring quarter, compared with €4 billion in the preceding three-month

2 These calculations are based on corporate bond yields included in the various iBoxx bond indices for different rating grades.

period. The figures also include issues from resolution agencies of German banks, which are ascribed to the public sector for statistical purposes. For its part, the Federal government mainly issued ten-year and 30-year bonds (for €13 billion and €2½ billion respectively). In addition, it issued a long-term inflation-indexed bond worth €2 billion. By contrast, central government redeemed Federal notes (Bobls) and Federal Treasury discount paper (Bubills) each totalling €3½ billion net. In the quarter under review, state governments issued their own bonds to the value of €5½ billion in net terms.

*Net redemptions of corporate bonds*

Domestic enterprises, which cover much of their funding requirements using internal sources, redeemed debt securities in the amount of €5 billion net during the second quarter of 2014. On balance, these were solely debt instruments with maturities of up to one year. Financial enterprises increased their capital market debt while non-financial corporations initiated net redemptions to the tune of €6½ billion.

*Net redemptions by credit institutions*

As in the previous quarter, domestic credit institutions pared back their capital market debt – by €10 billion – compared with €17½ billion in the first quarter. In particular, they redeemed public Pfandbriefe (€8 billion) and, to a lesser extent, other bank debt securities that can be structured flexibly (€3½ billion) and mortgage Pfandbriefe (€2 billion). Specialised credit institutions, meanwhile, issued debt securities totalling €3½ billion net.

*Domestic non-banks main buyers of debt securities*

Between April and June, German non-banks were the main buyers in the domestic bond market, adding paper worth €20 billion to their portfolios. These investors focused primarily on foreign debt instruments (€30 billion) which typically generate higher yields than, say, Bunds. Non-resident investors bought German debt securities for €10½ billion. On balance, this was mainly paper issued by the private sector. German credit institutions likewise invested in interest-bearing paper, purchasing instruments of this kind worth €1 billion.

**Investment activity in the German securities markets**

€ billion

| | 2013 | 2014 | |
|---|---|---|---|
| Item | Q2 | Q1 | Q2 |
| **Debt securities** | | | |
| Residents | 27.3 | 1.2 | 16.6 |
| Credit institutions | – 2.5 | – 5.4 | 1.2 |
| *of which* | | | |
| Foreign debt securities | 8.9 | 5.0 | 2.3 |
| Deutsche Bundesbank | – 3.7 | – 2.3 | – 4.4 |
| Other sectors | 33.6 | 8.9 | 19.8 |
| *of which* | | | |
| Domestic debt securities | 7.7 | – 15.3 | – 9.8 |
| Non-residents | – 14.9 | 14.7 | 10.3 |
| **Shares** | | | |
| Residents | 11.5 | 10.7 | 15.7 |
| Credit institutions | – 1.1 | 7.2 | 2.8 |
| *of which* | | | |
| Domestic shares | – 1.3 | 5.7 | 0.5 |
| Non-banks | 12.6 | 3.5 | 12.9 |
| *of which* | | | |
| Domestic shares | 7.0 | 1.2 | 1.8 |
| Non-residents | 1.6 | – 6.0 | 7.7 |
| **Mutual fund shares** | | | |
| Investment in specialised funds | 13.0 | 20.9 | 11.7 |
| Investment in retail funds | 1.5 | 2.7 | 2.5 |
| *of which* | | | |
| Equity funds | – 1.0 | – 0.6 | 0.4 |

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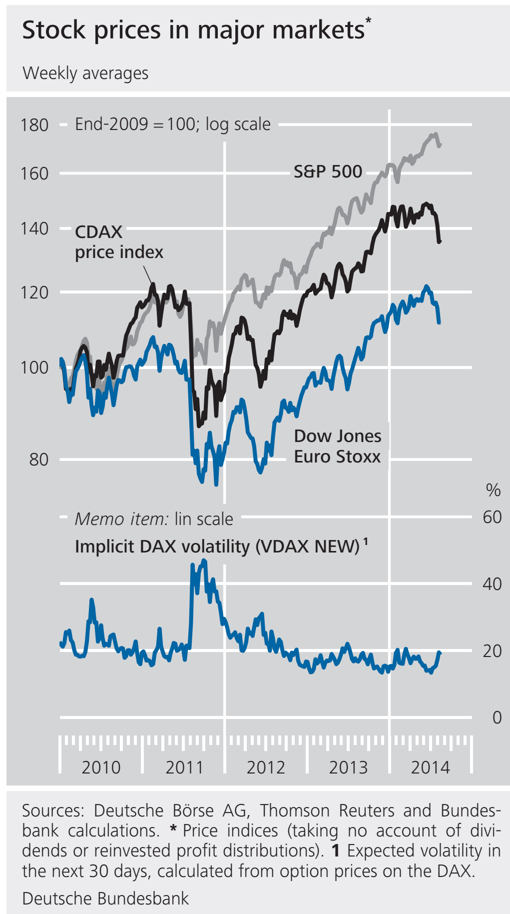
*Developments in equity markets mixed*

During the spring months, developments in the international equity markets were still predominantly positive (see the chart on page 54), with stock prices rising up to and into July and certain indices such as the US S&P 500 and the German DAX, the latter admittedly a performance index, reaching record levels. This upswing in European stock prices was driven not only by expectations that interest rates would stay low for a prolonged period on account of the cut in policy rates and the Eurosystem's non-standard measures, but also by the favourable economic environment and an improvement in long-term profit expectations. However, July then saw a deterioration in economic conditions and the earnings outlook. The quarterly results of US public limited companies were mostly better than analysts' expectations; however, the same cannot be said for those of German enterprises. Geopolitical risks also started to become a more pressing topic, with market participants in Europe and Germany being particularly concerned that the economic




Sources: Deutsche Börse AG, Thomson Reuters and Bundesbank calculations. * Price indices (taking no account of dividends or reinvested profit distributions). 1 Expected volatility in the next 30 days, calculated from option prices on the DAX.
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sanctions imposed on Russia as a result of the Ukraine conflict could weigh on enterprises. Overall, equity market developments have been somewhat heterogeneous since the end of the first quarter, with prices of US shares appreciating by 4% (as measured by the S&P 500), while European shares fell by 5% (as measured by the Euro Stoxx) and German stocks lost 6% (as measured by the CDAX price index).

*European bank stocks record considerable losses*

Events in the European equity market were impacted, in no small measure, by the negative developments in European bank stock prices, which, with a fall of 11%, suffered considerably greater losses than the market as a whole. Besides the acute crisis at a Portuguese bank in July, this might have owed something to the uncertainty surrounding the outcome of the asset quality review currently being carried out ahead of the introduction of the Single Supervisory Mechanism. Rating agencies also explained the deterioration in rating outlooks with the fact that once the Single Resolution Mechanism had been set up it was less likely that governments would bail out failing institutions. Capital increases implemented in the banking sector in order to meet the future capital adequacy standards intensified the pressure on bank stocks. Only Spanish banks recorded a slight appreciation in their share prices, reflecting the optimistic market assessment of the reforms that had been implemented.

*Price-earnings ratio remains high*

The implied equity risk premiums for the Euro Stoxx and the S&P 500, which were calculated using a dividend discount model, remained static at 8.5% and 5.8% respectively. This means that the level of compensation being sought by investors buying European shares is higher than the long-term average, while that in the case of US shares is slightly lower. Reflecting the fall in prices and the largely unchanged profit expectations, the price-earnings ratio, based on 12-month earnings growth expectations, fell to 13.8 at last count for the Euro Stoxx while the figure for the S&P 500 improved further on its end-March level. Both valuation indicators remain above their respective five-year averages, which continues to point to relatively high share valuations.

*Slight pick-up in stock market funding and stock purchases*

Issuing activity in the German equity market picked up somewhat in the second quarter. Domestic enterprises issued new shares totalling €10 billion, the majority of which were listed equities. A large proportion was associated with a capital increase by a DAX-listed enterprise. The volume of foreign equities outstanding in the German market climbed by €13½ billion. Equities were purchased primarily by domestic non-banks (€13 billion) and foreign investors (€7½ billion). Domestic credit institutions purchased equities in the sum of €3 billion. Both categories of domestic buyer invested predominantly in foreign shares.[3]

During the reporting period, domestic investment companies recorded inflows of €14 bil-

3 See below for further details on direct investment.

*Buoyant sales and purchases of mutual fund shares*

lion, after raising funds totalling €23½ billion in the previous three-month period. The fresh funds mainly accrued to specialised funds reserved for institutional investors (€11½ billion). With regard to the individual asset classes, equity funds were the main recipient of new flows (€5 billion), but mixed funds and mixed security-based funds also recorded inflows of €3½ billion each. Foreign funds traded in the German market attracted inflows totalling €8½ billion net in the second quarter of 2014. Resident non-banks were the main buyers, adding mutual fund shares worth €21½ billion to their portfolios. These were domestic shares for the most part. Foreign investors and domestic credit institutions each acquired mutual fund shares worth €½ billion.

## Direct investment

*Capital exports in direct investment*

As in cross-border portfolio transactions, which recorded a net outflow of funds totalling €22½ billion, net capital exports amounting to €16 billion were registered in the form of direct investment in the second quarter of 2014.

*German direct investment abroad*

The largest contributing factor was the comparatively high level of funding provided by German enterprises to their subsidiaries abroad, which amounted to €23 billion in the second quarter. German enterprises primarily increased their equity capital in the narrower sense (€10½ billion), reinvested profits (€8½ billion) and stepped up their direct investment loans (€4½ billion).[4] In the case of the latter, the increase in financial credits (€5 billion) – in par-

4 With the implementation of the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6) in Germany, the credit operations of affiliated companies are shown in accordance with the asset/liability principle. This means that direct investment loans abroad include loans made by domestic parent companies as well as loans made by branches domiciled in Germany to their owners located abroad. The same applies to incoming direct investment loans from abroad. See also Deutsche Bundesbank, Changes in the methodology and classifications of the balance of payments and the international investment position, Monthly Report, June 2014, pp 57-68.

**Major items of the balance of payments**

€ billion

| Item | 2013 Q2p | 2014 Q1p | 2014 Q2p |
|---|---|---|---|
| I Current account | + 46.8 | + 49.4 | + 44.1 |
| 1 Goods[1] | + 56.0 | + 53.1 | + 53.1 |
| 2 Services[2] | – 11.7 | – 7.1 | – 8.7 |
| 3 Primary income | + 9.9 | + 18.2 | + 6.6 |
| 4 Secondary income | – 7.4 | – 14.8 | – 6.9 |
| II Capital account | + 0.8 | + 1.7 | + 0.6 |
| III Financial account (increase: +) | + 67.2 | + 66.7 | + 64.2 |
| 1 Direct investment | + 15.0 | + 25.3 | + 15.8 |
| Domestic investment abroad | + 30.7 | + 27.1 | + 23.2 |
| Foreign investment in the reporting country | + 15.7 | + 1.7 | + 7.3 |
| 2 Portfolio investment | + 52.3 | + 31.2 | + 22.7 |
| Domestic investment in foreign securities | + 39.1 | + 40.5 | + 41.3 |
| Shares[3] | + 3.3 | + 3.4 | + 4.9 |
| Investment fund shares[4] | + 4.1 | + 9.7 | + 8.6 |
| *of which* Money market fund shares | – 1.1 | + 1.1 | – 2.0 |
| Long-term debt securities[5] | + 32.0 | + 22.5 | + 27.6 |
| *of which* Denominated in euro[6] | + 24.9 | + 22.3 | + 23.9 |
| Short-term debt securities[7] | – 0.2 | + 4.9 | + 0.2 |
| Foreign investment in domestic debt securities | – 13.2 | + 9.3 | + 18.6 |
| Shares[3] | + 2.5 | – 5.3 | + 7.7 |
| Investment fund shares | – 0.8 | – 0.1 | + 0.7 |
| Long-term debt securities[5] | – 18.5 | + 7.9 | + 11.0 |
| *of which* Public bonds and notes[8] | + 3.8 | + 19.7 | + 9.7 |
| Short-term debt securities[7] | + 3.6 | + 6.8 | – 0.6 |
| 3 Financial derivatives[9] | + 4.7 | + 5.0 | + 9.0 |
| 4 Other investment[10] | – 4.9 | + 5.8 | + 17.3 |
| Monetary financial institutions | + 13.3 | – 0.8 | + 41.8 |
| Enterprises and households[11] | – 10.2 | + 18.4 | – 4.0 |
| General government | – 6.0 | + 6.0 | – 3.5 |
| Bundesbank | – 2.1 | – 17.9 | – 17.1 |
| 5 Reserve assets[12] | + 0.1 | – 0.6 | – 0.6 |
| IV Errors and omissions[13] | + 19.5 | + 15.7 | + 19.5 |

1 Excluding freight and insurance costs of foreign trade. 2 Including freight and insurance costs of foreign trade. 3 Including participation certificates. 4 Including reinvestment of earnings. 5 Up to and including 2012, adjusted for accrued interest. Long-term: original maturity of more than one year or unlimited. 6 Including outstanding foreign D-Mark bonds. 7 Short-term: original maturity up to one year. 8 Including bonds issued by the former Federal Railways, the former Federal Post Office and the former Treuhand agency. 9 Balance of transactions arising from options and financial futures contracts as well as employee stock options. 10 Includes in particular loans and trade credits as well as currency and deposits. 11 Includes the following sectors: financial corporations (excluding monetary financial institutions) as well as non-financial corporations, households and non-profit institutions serving households. 12 Excluding allocation of special drawing rights and excluding changes due to value adjustments. 13 Statistical errors and omissions resulting from the difference between the balance on the financial account and the balances on the current account and the capital account.

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ticular to foreign subsidiaries – contrasted with a cutback in trade credits (€½ billion). During the period under review, Germany's relations with Sweden, Switzerland, Luxembourg and the United Kingdom were particularly noteworthy. While German direct investment mainly took the form of equity capital increases in Sweden (€7 billion) – particularly in vehicle manufacturing – and Luxembourg (€3 billion), it was increased by way of direct investment loans in Switzerland (€3 billion) and the United Kingdom (€2 billion).

*Foreign direct investment in Germany*

Foreign investors stepped up their activity slightly in Germany in the second quarter (€7½ billion), with capital mainly being accumulated by means of intra-group loans (€7 billion), predominantly from the Netherlands (€5 billion), which is a popular location for German financing institutions. The foreign subsidiaries of German enterprises domiciled there provided their parent companies in Germany primarily with funds they had previously raised through the issuance of securities in the international capital market.