Financial markets

Financial market setting

Financial markets affected by intermittent heightened uncertainty and further monetary policy easing

The year 2016 began in the international financial markets against the backdrop of lacklustre growth in the global economy and further accommodative monetary policy measures in major economies. Not least of all, oil prices, which fell sharply until mid-January before stabilising, however, weighed on stock markets for a time. The attendant shifts into safe haven investments sent bond yields tumbling. At the same time, the lower yield level also reflected market participants' expectations of additional expansionary monetary policy measures in the euro area and Japan. On 10 March, the ECB Governing Council announced an extensive package of measures comprising, amongst other things, an increased and expanded asset purchase programme as well as a further reduction in the deposit rate. The Bank of Japan had already taken further monetary policy measures in January. In addition, the period under review saw a consensus emerge among market participants that the Federal Reserve would raise its policy rate more slowly than the market had assumed at the start of the year. Whereas yield levels remained close to their historical lows as this report went to press, equities on both sides of the Atlantic recouped some of the losses they had sustained into February. However, bank shares, which faced particular challenges, were only able to claw back previous losses to a comparatively minor extent. In foreign exchange markets, too, attention was focussed on the alternating views on the pace of further interest rate hikes in the USA and the uncertainty surrounding global economic growth. Overall – despite fluctuating distinctly and to different degrees against individual currencies – the euro appreciated by around 3% in real terms.

Exchange rates

Euro exchange rate movements against the US dollar, …

The euro reached its highest level against the US dollar since October 2015 (US$1.13) in mid-February; it subsequently fell back again markedly to stand at US$1.08 by early March 2016. Surprisingly strong US retail sales figures had again somewhat fuelled expectations of further interest rate hikes in the USA, boosting the US dollar. At the same time, speculation about additional monetary policy loosening in the euro area was driven by the publication of negative euro-area inflation figures, which depressed the euro.

Although the ECB Governing Council adopted an extensive package of expansionary measures in early March, the euro subsequently gained markedly against the US dollar. The single currency was buoyed by receding expectations of interest rate cuts in the euro area, and surprisingly favourable figures for euro-area industrial output and an unexpectedly strong rise in the Ifo business climate index were in keeping with that assessment. Moreover, the expectation had increasingly gained ground in the markets that the US Federal Reserve would raise its key interest rates only very slowly due both to the risk that persisted for the global economy and to moderate inflation figures for the US economy. Following the announcement of surprisingly strong economic growth in the euro area for the first quarter and the publication of a series of poorer-than-expected data on the US economy, the euro advanced to as high as US$1.16 at the beginning of May. As this report went to press, the euro stood at US$1.14; this was 4.6% up on the level at the start of the year.

… the yen and …

The euro appreciated noticeably against the yen after the Bank of Japan introduced negative interest rates in January, rising to as high as ¥132, before it depreciated markedly in February. By the end of the month the euro fell to

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 19 countries.
Deutsche Bundesbank

¥123. Weak foreign trade data from China and high price losses affecting bank shares in various countries had helped unsettle the financial markets and boosted the yen as a traditional safe haven currency. And although the euro-yen exchange rate subsequently stabilised somewhat to begin with, in early April the euro gave up the gains it had made as the risk awareness of the financial market participants grew, giving the yen broad-based support. As this report went to press, the euro was trading at ¥125, which is 5.0% below its level at the beginning of the year.

... the pound sterling

By contrast, the euro appreciated markedly against the pound sterling in the opening months of this year, as uncertainty about whether the United Kingdom (UK) will stay in the European Union (EU) and the risks for the British economy related to a "Brexit" scenario put the UK currency under broad-based pressure. However, in mid-April, various opinion polls supported expectations that the UK would opt to remain a member of the EU; from then onwards, the pound sterling stabilised somewhat. At the end of the period under review, the euro was trading at £0.79. Nevertheless, the value of the euro against the pound sterling was 7.5% higher than at the beginning of the year.

Effective euro exchange rate

Measured against the currencies of 19 major trading partners, the euro appreciated by 3.1% overall compared with the beginning of 2016. These marked gains against the pound sterling, the US dollar and the renminbi contrasted with losses against the yen and the currencies of several commodity-exporting countries which profited from the rebound in oil prices. The price competitiveness of euro-area suppliers deteriorated somewhat as a result of the euro's appreciation, but in terms of the long-term average their competitive position can be regarded as broadly neutral.

Securities markets and portfolio transactions

Yields in international bond markets still shaped by expansionary monetary policy

Yields in the international bond markets receded at a faster pace from the end of December. On the one hand, this was attributable to the more expansionary monetary policy stance adopted by the central banks of the major currency areas. In the USA, market expectations that yields would rise more slowly than anticipated at the beginning of the year took a firmer hold given the global risks for the US economy. On the other hand, the analysts polled by Consensus Economics in the April survey round revised their growth expectations for the coming years downwards for the euro area, the USA and Japan compared with January. Against this backdrop, ten-year US Treasury yields were, at 1.8%, 52 basis points down on the turn of the year of late. Japanese yields likewise contracted considerably after the Bank of Japan introduced at the end of January, for the first time, negative interest rates on some of the deposits it holds for commercial banks. Having fallen 39 basis points, yields on ten-year Japanese sovereign bonds were in negative territory (-0.1%) as this report went to press. The Eurosystem, too, again loosened its monetary policy stance, pushing yields in the euro area down.

Bund yields close to all-time lows

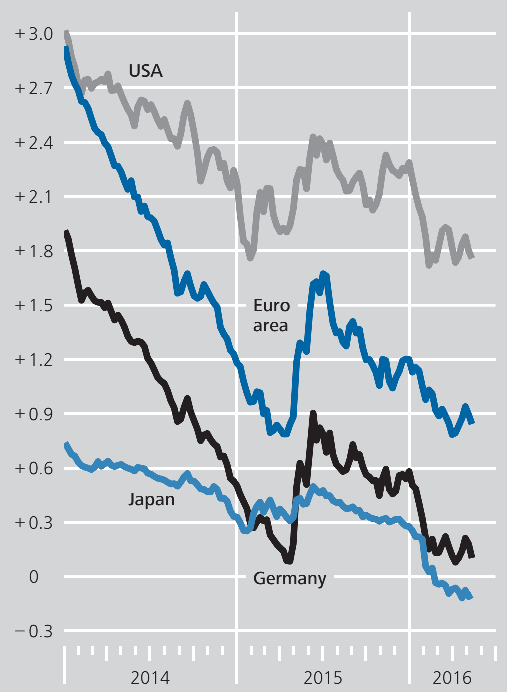
In the reporting period, yields on ten-year Bunds fell 50 basis points to 0.1%. This decline was accompanied by a drop in commodity prices, uncertainty over global economic developments and the share price losses at the beginning of the year. In this environment, market participants primarily sought safe investments and demand for Bunds increased. As the equity and commodity markets stabilised, yields recovered slightly for a time. Despite the difference in monetary policy stance between both sides of the Atlantic and the difference in yield levels as a result, yields on Bunds and US Treasuries moved largely in lockstep up to the end of the reporting period.

Yield curve for Bunds flatter

The German yield curve derived from yields on Federal securities shifted downwards from the end of December 2015. The decline in yields was more pronounced in the long-term maturity segment than for shorter-term maturities, causing the yield curve to flatten on balance. Nevertheless, yields on short-dated Federal instruments slipped to a level below the (lowered) deposit facility rate. As this report went to press, two-year Federal securities were yielding -52 basis points. This could be a reflection of market expectations regarding a further deposit rate cut. Long-term yields also came close to their all-time lows. During the reporting period, negative yields for paper with a nine-year residual maturity were recorded for the first time, albeit briefly. This was due to the fact that market participants expect the spell of low interest rates to continue for some time to come. On the other hand, however, lower term premiums, which reward buyers of long-dated bonds for assuming interest rate risk, also contributed to the decrease in long-term yields as of the turn of the year.

Yields* in euro area and selected countries

% pa, weekly averages



Source: Thomson Reuters. * Government bonds with a residual maturity of ten years.
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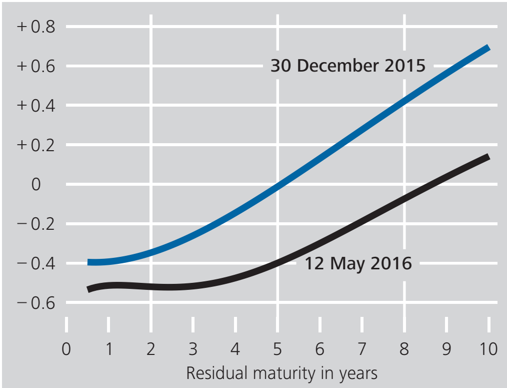
Yield curve on the German bond market*

%



* Interest rates for (hypothetical) zero-coupon bonds (Svensson method), based on listed Federal securities.
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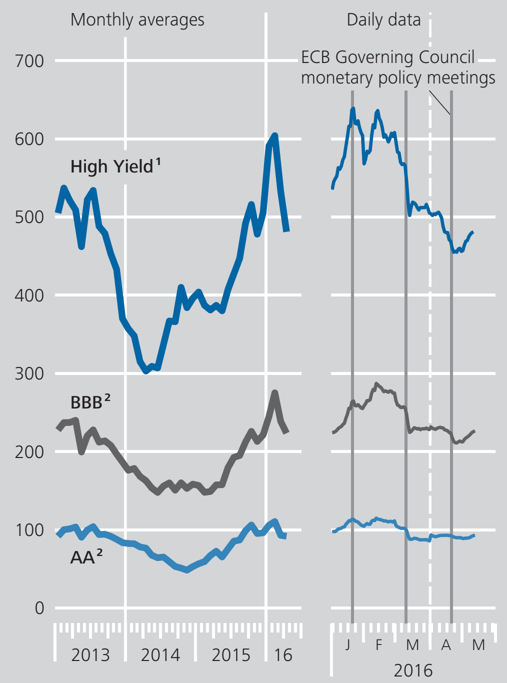
Yield spreads of corporate bonds*

Basis points



* Compared with Federal securities with residual maturity of seven to ten years. **1** Merrill-Lynch index across all maturities. **2** In each case, iBoxx indices with residual maturity of seven to ten years.

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Euro-area yields move mostly in same direction

Yields on bonds issued by other euro-area countries largely followed a path similar to that of Bunds. As this report went to press, the GDP-weighted yield on ten-year bonds issued by euro-area countries (excluding Germany) stood at 1.1%. This was 31 basis points below its level at the end of December 2015. The decline affected bond yields of almost all countries. Yields on Portuguese bonds were an exception. From the turn of the year, Portuguese bond yields advanced by a considerable 71 basis points to 3.2%. On the financial markets, the loosening of the austerity drive by the new government fuelled fears that, amongst other things, Portugal's rating might be downgraded further. However, these fears proved to be unfounded. In Greece, too, yields rose significantly at the beginning of the year amid political debate on reforms which are a precondition for funds to be paid out under the third support package. However, yields again fell significantly after a conclusion to negotiations was deemed more likely and, more recently, the Greek parliament passed a pension and tax reform. This means that, overall, Greek yields likewise fell during the course of the first quarter (by 89 basis points to 7.4%).

Financing conditions for enterprises remain favourable

Yields on European corporate bonds went up somewhat at the beginning of January 2016 in line with an initial rise in credit risk, which is also reflected in European credit default swap premiums (iTraxx index), before yields dipped in this market, too. This decline was not just the outcome of the lower general level of interest rates. Liquidity and credit risk-specific mark-ups on corporate bonds versus Federal bonds narrowed, too, in no small part due to the announcement of a corporate bond purchase programme. The interest rate spread of BBB-rated corporate bonds over same-maturity Bunds dropped by almost 20 basis points immediately after the decision was taken. As a result, European corporate bonds with a BBB rating and a residual maturity of seven to ten years were yielding 2.2% (just under ½ percentage point below its end-2015 level) as this report went to press. Yields developed less favourably in the case of financial corporations than of enterprises with a real economic orientation. Moreover, it is worth noting that the impact of the programme's announcement was not restricted to "buyable" corporate bonds, but had a comparatively strong effect on the yields of high yield bonds whose rating does not satisfy the announced programme criteria.

Declining forward inflation rates in major currency areas

In the euro area, the five-year forward inflation rate in five years derived from inflation swaps shed 20 basis points on balance from the end of December 2015 and last stood at 1.5%. It fell, in particular, on the back of the rapid oil price slump in the first weeks of this year, whereas the subsequent rebound of commodity prices had no marked impact. By contrast, market-based inflation expectations in other major currency areas rebounded somewhat of late. Here, too, however, the market-based indicators fell on balance from the turn of the year. Their low levels were attributable in part to the inflation risk premium, which has been negative in the euro area for some time now.

Net sales in the bond market up

Gross issuance in the German bond market stood at €367 billion in the first quarter of 2016, well up on the figure for the previous quarter (€314 billion). After deducting redemptions and taking account of changes in issuers' holdings of their own bonds, net sales of domestic debt securities came to €30½ billion. Moreover, foreign borrowers placed debt securities worth €37 billion in the German market. Thus, funds totalling €67½ billion net were raised in the German bond market in the reporting period.

Rise in credit institutions' capital market debt

Domestic credit institutions issued new bonds worth €23½ billion net in the first quarter of 2016. Debt securities of specialised credit institutions (€13 billion) constituted the lion's share of issues, followed by other bank securities that can be structured flexibly (€7½ billion) and mortgage Pfandbriefe (€4 billion). This contrasted with net redemptions of public Pfandbriefe (€1 billion).

Net issuance of corporate bonds

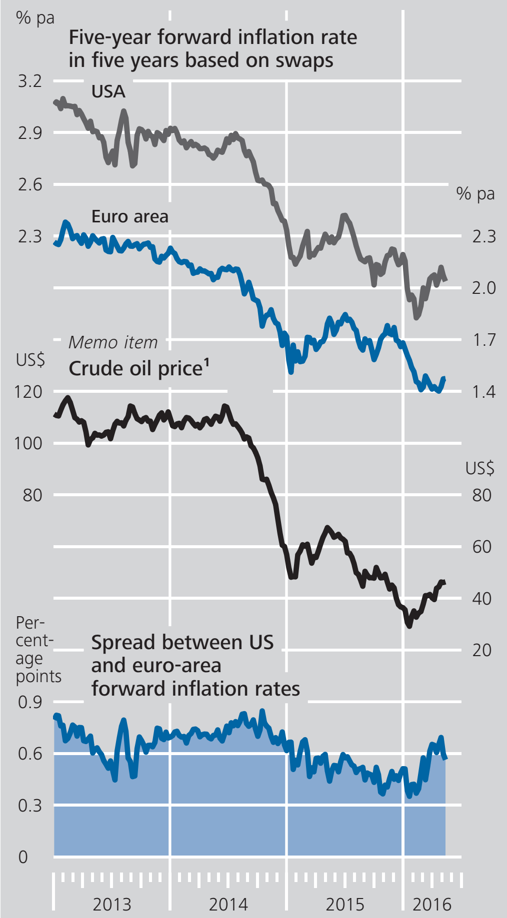
In the quarter under review, domestic enterprises issued debt securities worth €8½ billion net. On balance, the vast majority of these were bonds with maturities of more than one year. Net issuance was mainly attributable to non-financial corporations, while other financial intermediaries redeemed bonds on balance.

Fall in public sector capital market debt

The public sector took advantage of the favourable fiscal situation and pared back its capital market debt by €2 billion net in the first quarter of 2016, after net issues totalling €9½ billion the previous quarter. These figures include issues by resolution agencies set up for German banks, which are ascribed to the public sector for statistical purposes. Central government itself principally redeemed ten-year bonds (€5½ billion) and five-year Federal notes (Bobls) (€4½ billion). This contrasted with net issuance of 30-year bonds, two-year Federal Treasury notes (Schätze) (worth €2½ billion each) and Federal Treasury discount paper (Bubills) (€2 billion). In the quarter under review, state governments redeemed their own bonds to the tune of €2 billion net.

Forward inflation rates* in the euro area and the USA

Weekly averages



Sources: Bloomberg, Thomson Reuters and Bundesbank calculations. * Derived from the fixed cash flow arising from inflation swaps which is swapped for the actual annual inflation rates (HICP excluding tobacco for the euro area and CPI Urban Consumers for the USA) realised across the next five or ten years. **1** Brent blend (for one-month forward delivery).

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Purchases of debt securities

The Bundesbank was the predominant buyer of debt securities in the German bond market in the first quarter of 2016, adding a net €38½ billion worth of paper to its portfolio under the Eurosystem's asset purchase programmes. Here, the vast majority consisted of domestic public sector instruments. Domestic non-banks and foreign investors acquired bonds worth €12 billion and €11 billion net respectively. Domestic credit institutions likewise expanded

Investment activity in the German securities markets

€ billion

Item	2015 Q1	2015 Q4	2016 Q1
Debt securities			
Residents	37.5	– 1.2	56.1
Credit institutions	9.0	– 48.4	5.5
of which			
Foreign debt securities	3.0	– 1.1	9.3
Deutsche Bundesbank	12.5	36.6	38.3
Other sectors	16.0	10.5	12.2
of which			
Domestic debt securities	– 15.9	3.6	– 15.4
Non-residents	12.4	– 54.5	11.2
Shares			
Residents	– 0.1	6.9	8.0
Credit institutions	10.5	1.4	– 9.4
of which			
Domestic shares	11.8	0.1	– 6.9
Non-banks	– 10.7	5.5	17.5
of which			
Domestic shares	– 17.7	– 2.5	8.8
Non-residents	6.2	5.0	– 1.6
Mutual fund shares			
Investment in specialised funds	45.9	30.6	27.1
Investment in retail funds	9.6	11.0	5.7
of which			
Equity funds	3.0	6.4	– 0.9

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their bond portfolios in net terms, by €5½ billion.

International equity markets experience major fluctuations

Major fluctuations beset the international equity markets from the beginning of 2016. As measured by the broad Euro Stoxx and S&P 500 indices, stock market investors experienced losses in value of up to 18% and 11% respectively into the first half of February. In the case of Euro Stoxx, these losses had not subsequently been fully recouped as this report went to press. The principal causes of the share price losses in the first months of this year included less favourable economic prospects for a number of countries and the considerable intermittent decline in the prices of oil and other commodities. Share prices of the oil and gas industries bore the brunt of the low oil price, which reached a multi-year low in mid-January. Enterprises in these sectors on both sides of the Atlantic saw the price of their shares plummet in the first months of 2016; however, they rebounded as the price of oil rose again from February onwards. In fact, as this report went to press, they were higher than at the end of 2015 and so outperformed the market as a whole.

Bank shares under particular strain

By contrast, bank share prices underperformed prices in the equity market as a whole throughout the quarter under observation, like the yields on financial enterprises' bonds. This was also reflected in banks' earnings prospects, which saw a below-average development from the beginning of the year. According to IBES surveys, between December and early May, analysts revised downwards the expected annual profits of European banks considerably more strongly (-11%) than the profits of all the companies included in the Euro Stoxx (-3%). Banks' trading results, which were down because of equity price losses on the stock market, played a part in both the deterioration of the fundamental prospects and the weak performance of bank shares. In addition, the valuations of European banks were also influenced by uncertainty about the possibility of further capital needs. This was compounded by concerns about the high level of non-performing loans on the balance sheets of some banks in euro-area periphery countries. Overall, European bank shares were most recently 23% down on their value at the end of 2015, while US bank share prices were 10% lower. By contrast, given the recent signs of recovery, the market as a whole performed better (-9% and +1% respectively).

Flight into safe haven investments

Falling prices in the European equity market, which were accompanied by a lower price-earnings ratio, also reflected shifts into safe haven investments. This is suggested by the pattern of rising equity risk premiums amid decreasing Bund yields, which prevailed into February. Overall, the risk premium for the broad Euro Stoxx index widened by only 0.3 basis point compared with the end of 2015, while yields on ten-year Bunds narrowed by 50 basis points.

Short-lived rise in stock price uncertainty

As prices slumped in the international stock markets, uncertainty among market participants about the future development of equity prices at first rose considerably. As gauged by the implied volatility of options, which is reflected in the German, European and US indices VDAX, VStoxx and VIX, it reached a level in mid-February 2016 that had last been seen in August 2015 when Chinese stock market turbulence unsettled markets worldwide. Tensions have gradually eased again in the meantime. The declining levels of uncertainty have, in turn, had a stabilising effect on equity prices, while signals that the Federal Reserve might raise its policy rate more slowly than the market anticipated have bolstered the US stock market.

Further monetary policy loosening reduces stock price uncertainty

Unlike the previous monetary policy decisions in December 2015, the Governing Council's decisions in March had no immediate noteworthy impact on price levels in European equity markets. This implies that market participants had already largely priced in this effect before the March decisions were taken. Nonetheless, these monetary policy decisions did trigger an appreciable decline in stock price uncertainty.

Subdued level of stock market funding

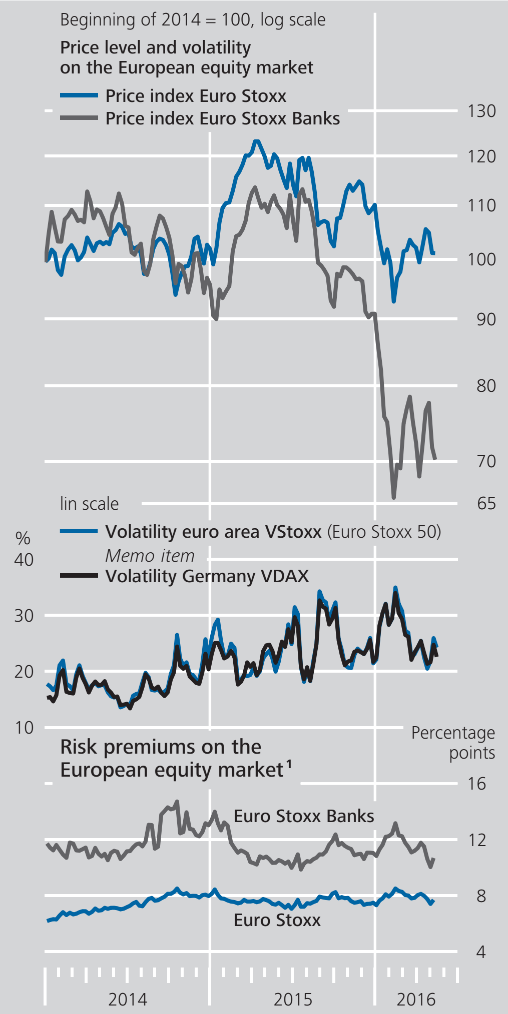
Issuing activity in the German equity market was relatively subdued in the first quarter of 2016. Domestic enterprises issued only small quantities of new shares. The outstanding volume of foreign shares in the German market rose by €6 billion over the same period. Equities were purchased primarily by German non-banks (€17½ billion). By contrast, domestic credit institutions and non-resident investors sold shares worth €9½ billion and €1½ billion net respectively.

Sales and purchases of mutual fund shares

During the reporting period, domestic investment companies recorded inflows of €33 billion, after raising funds totalling €41½ billion in the previous three months. The inflows were channelled mainly to specialised funds reserved for institutional investors (€27 billion). Among the asset classes, mixed securities-based funds attracted the most inflows (€14½ billion), though bond funds (€8½ billion), open-end real estate funds (€5½ billion) and funds of funds (€2½ billion) also sold fund shares. Foreign funds traded in the German market acquired new resources totalling €9½ billion net in the first quarter of 2016. Domestic non-banks were the main buyers, adding mutual fund shares worth €44 billion to their portfolios. On balance, their focus was very largely on German paper. Domestic credit institutions purchased investment fund shares for €1½ billion, while foreign investors sold German mutual fund shares worth €3 billion.

Equity market

Weekly averages



Source: Thomson Reuters. **1** Implied equity risk premiums determined using dividend discount models on the basis of profit and dividend expectations (I/B/E/S).
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Major items of the balance of payments

€ billion

Item	2015 Q1	2015 Q4	2016 Q1p
I Current account	+ 58.2	+ 74.4	+ 65.7
1 Goods[1]	+ 60.4	+ 65.3	+ 65.7
2 Services[2]	− 4.7	− 5.7	− 6.1
3 Primary income	+ 18.3	+ 24.9	+ 19.6
4 Secondary income	− 15.8	− 10.0	− 13.5
II Capital account	+ 0.2	− 2.2	− 0.4
III Financial account (increase: +)	+ 30.4	+ 65.0	+ 24.3
1 Direct investment	+ 22.8	+ 25.5	+ 3.5
Domestic investment abroad	+ 35.8	+ 29.6	+ 30.6
Foreign investment in the reporting country	+ 13.0	+ 4.1	+ 27.1
2 Portfolio investment	+ 33.9	+ 66.8	+ 42.8
Domestic investment in foreign securities	+ 53.2	+ 17.7	+ 48.0
Shares[3]	+ 0.4	+ 7.6	+ 1.3
Investment fund shares[4]	+ 17.8	+ 4.6	+ 9.7
of which Money market fund shares	− 1.6	− 1.7	+ 6.2
Long-term debt securities[5]	+ 30.3	+ 6.0	+ 32.0
of which Denominated in euro[6]	+ 19.6	+ 2.5	+ 25.3
Short-term debt securities[7]	+ 4.7	− 0.5	+ 4.9
Foreign investment in domestic securities	+ 19.2	− 49.1	+ 5.2
Shares[3]	+ 1.9	+ 4.9	− 3.2
Investment fund shares	+ 5.0	+ 0.6	− 2.8
Long-term debt securities[5]	− 13.8	− 32.6	− 6.5
of which Issued by the public sector[8]	− 18.3	− 18.8	− 9.2
Short-term debt securities[7]	+ 26.2	− 21.9	+ 17.7
3 Financial derivatives[9]	+ 11.7	+ 5.5	+ 5.0
4 Other investment[10]	− 38.0	− 32.5	− 28.1
Monetary financial institutions[11]	− 66.6	− 10.9	− 29.5
Enterprises and households[12]	+ 1.7	− 24.6	− 9.2
General government	− 6.5	− 2.0	− 0.4
Bundesbank	+ 33.4	+ 4.9	+ 10.9
5 Reserve assets[13]	0.0	− 0.3	+ 1.2
IV Errors and omissions[14]	− 28.1	− 7.3	− 41.1

1 Excluding freight and insurance costs of foreign trade. **2** Including freight and insurance costs of foreign trade. **3** Including participation certificates. **4** Including reinvested earnings. **5** 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 financial and trade credits as well as currency and deposits. **11** Excluding the Bundesbank. **12** Includes the following sectors: financial corporations (excluding monetary financial institutions) as well as non-financial corporations, households and non-profit institutions serving households. **13** Excluding allocation of special drawing rights and excluding changes due to value adjustments. **14** 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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Direct investment

Direct investment sees low net capital exports

As in cross-border portfolio transactions, which recorded a net outflow of funds totalling €43 billion, net capital exports were also registered in the form of direct investment in the first three months of 2016, amounting to €3½ billion.

Cross-border direct investment by domestic enterprises abroad …

German enterprises invested €30½ billion abroad in the first quarter of 2016. This mainly stemmed from companies stepping up their equity capital (€22 billion). Of that amount, €14 billion was equity capital in the narrower sense and €7½ billion took the form of reinvested profits. Capital flows abroad were also recorded in intragroup lending (€8½ billion). This mainly took the form of loans by affiliated companies in Germany to branches abroad (€6 billion). Key destinations for investment were the Netherlands (€7 billion), the United Kingdom (€4½ billion) and the United States (€4 billion).

… and by foreign enterprises in Germany

Foreign enterprises invested €27 billion in Germany in the first quarter of 2016, mainly in the form of intra-group loans (€20 billion). In this context, mainly the branches of German enterprises abroad granted their German parent companies – predominantly short-term – loans (known as reverse flows) totalling €12½ billion. Moreover, foreign affiliates granted intra-group loans totalling €5 billion to branches in Germany. Foreign enterprises likewise provided affiliates with additional equity capital (€7 billion). Direct investment came primarily from Luxembourg (€11½ billion) and Switzerland (€5½ billion).