Financial markets

Financial market setting

Financial markets shaped by high inflation and anticipated monetary policy response

The international financial markets were influenced by surprisingly high inflation rates and increasing inflation expectations during the second half of 2021 to date. Market participants gradually revised their inflation expectations upwards, primarily for the next two years. Recently, therefore, market-based expectations of average annual inflation rates for 2022 were very significantly over 2% in many currency areas and at 3% in the euro area. Rising inflation expectations also led to the view that the central banks' monetary policy response would potentially be swifter than previously indicated. Against this backdrop, nominal interest rates worldwide rose until the end of October, chiefly for short-term maturities. The decision by the US Federal Reserve (Fed) to taper net purchases in several stages had been widely expected. Of late, however, the major central banks have moved to counter expectations of faster monetary policy tightening. This has contributed to yields across the maturity range declining again in many places. On balance, ten-year government bond yields increased markedly on their end-June levels in the United States and the United Kingdom, while remaining virtually unchanged in the euro area. Overall, yields on BBB-rated European corporate bonds rose slightly. On the whole, though, financing terms in the European bond market remain very favourable. Stock markets recorded price gains worldwide, boosted by a good reporting season and higher corporate earnings forecasts. Market participants' concerns regarding the further course of the pandemic initially took somewhat of a back seat, but have recently returned to the fore. The previously mentioned expectations about inflation developments and future monetary policy in the individual currency areas also shaped developments in the foreign exchange markets. On balance, the US dollar appreciated on a broad basis, while the euro depreciated in effective terms.

Exchange rates

Euro down against the US dollar on balance

On balance, the euro weakened against the US dollar compared with the start of the third quarter of 2021. This decline set in back at the beginning of August and was triggered by the publication of surprisingly high inflation rates in the United States and better than expected figures for the US labour market, the Federal Reserve having previously established the recovery of the labour market as a prerequisite for monetary policy tightening. In the second half of August, however, there was a temporary shift in sentiment in favour of the euro after the publication of the minutes of the July meeting of the Federal Open Market Committee (FOMC) made clear that there was disagreement among its members about the monetary policy stance. The closely watched speech by Fed Chair Jerome Powell in Jackson Hole also boosted the euro, as he explicitly dampened expectations of rising interest rates. By contrast, the annual consumer inflation rate in the euro area published at the end of the month was significantly higher than expected at 3%. This led to market expectations that the ECB Governing Council could discuss paring back its pandemic emergency purchase programme (PEPP) in the foreseeable future and that the differences in the monetary policy stances of the Eurosystem and the Fed would narrow. This provided the euro with additional buoyancy against the US dollar.

However, in the ensuing period, the euro was weakened once again by a series of worse than expected economic data for the euro area. Furthermore, in mid-September, the warning that Chinese real estate group Evergrande could default on payments temporarily unsettled the financial markets. The flight to safety this

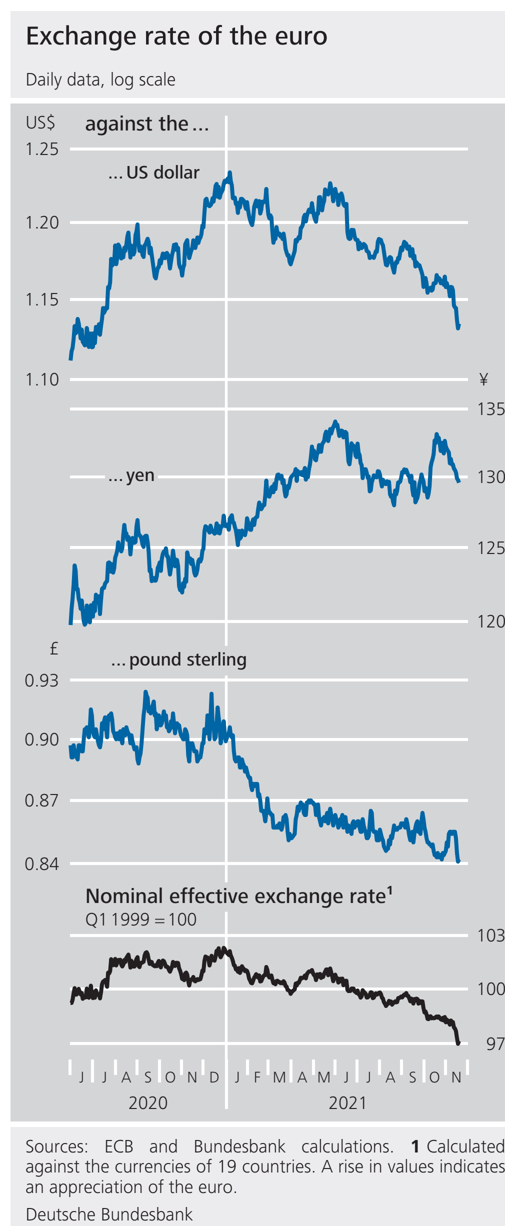
sparked on the part of investors caused the US dollar to appreciate against the euro and a large number of other currencies. The FOMC also contributed to the strength of the US dollar against the euro, signalling after its September meeting that a tapering of bond purchases could soon be justified, given the recent high inflation rates and the recovery of the labour market. Furthermore, the projections by FOMC members indicated that key policy rates could potentially be increased earlier than previously thought. An additional detrimental factor for the euro was that yields on US Treasuries rose markedly in this monetary policy environment, and the yield spread vis-à-vis the euro area widened. After the announcement of surprisingly high consumer price inflation in the United States, the euro once again depreciated markedly against the US dollar in November, falling to its lowest level since July 2020. As this report went to press, the euro was trading at US$1.13, which is 4.5% lower than at the beginning of July 2021.

Euro also weaker against pound sterling …

Compared with the beginning of the third quarter, the euro depreciated on balance against the pound sterling. At the end of September, the sudden petrol shortages at British petrol stations, which were triggered by supply chain frictions and resulted in economic woes, induced a short-lived and marked depreciation of the pound sterling. However, as of the beginning of October, these concerns faded into the background following the publication of surprisingly good economic figures. This firmed expectations of an imminent tightening of monetary policy in the United Kingdom, bolstering the pound. In November, a temporary countermovement set in after the Bank of England decided to leave the base rate unchanged at its historical low, which took markets by surprise. Despite this, at the end of the reporting period, the euro was trading at £0.84, down 1.9% from its level at the end of June.

… and against the yen

Looking at the period since the beginning of the third quarter, the euro suffered initial losses against the yen and then lacked any clearly discernible trend for a long time. It then appreciated markedly in the first half of October. This was attributable to market expectations that the Japanese central bank would maintain its accommodative monetary stance for several more years to come, given persistently low rates of inflation. By contrast, fledgling discussions about unwinding monetary support in the euro area boosted the euro. That said, as this report went to press, it was trading lower again at ¥130, down 1.4% in value compared to the beginning of July 2021.

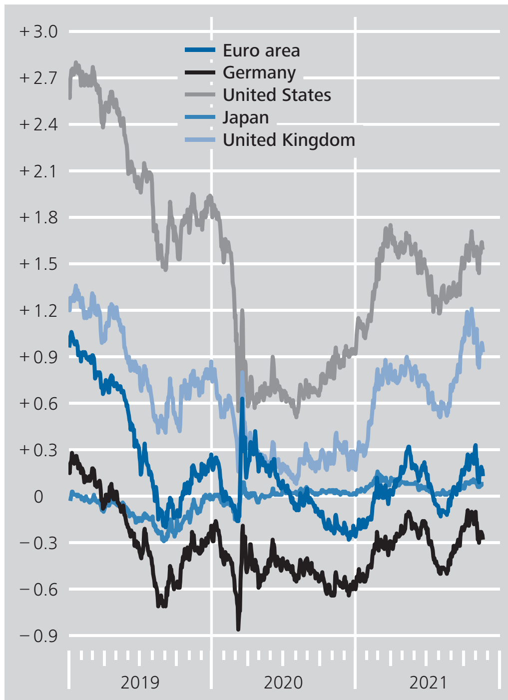


Sources: ECB and Bundesbank calculations. **1** Calculated against the currencies of 19 countries. A rise in values indicates an appreciation of the euro.
Deutsche Bundesbank

On a weighted average against the currencies of 19 major trading partners, the euro depreci-

Bond yields* in the euro area and selected countries

% p. a., daily data



Source: Bloomberg. * Government bonds with a residual maturity of ten years.
Deutsche Bundesbank

Euro depreciates in effective terms

ated by 2.6% on balance. In addition to its fall in value against the currencies mentioned above, the euro depreciated markedly against the renminbi and the Swiss franc. The Swiss currency, which is often regarded as relatively safe, benefited from elevated demand in the wake of higher uncertainty in the global markets in September. Furthermore, the euro also recorded notable losses against the Norwegian krone and Canadian dollar, which – being currencies of oil-exporting countries – were given a broad-based boost by the rise in oil prices. By contrast, the euro appreciated against the currencies of some central and eastern European countries such as the zloty and the forint, which have faced downward pressure as a result of relatively high inflation rates and rising coronavirus infection rates.

Securities markets and portfolio investment

Bond market

Mixed developments in ten-year sovereign bond yields

The nominal yields on government bonds in the major currency areas presented a mixed picture on balance in the period under review, with some considerable shifts occurring in the components of the nominal yield. In analytical terms, the nominal yield can be broken down into the components of real interest, inflation expectations, the real term premium and the inflation risk premium. In the period under review, market-based inflation expectations and inflation risk premia rose worldwide. Real interest rates, by contrast, fell to close to their historical lows.

Real yields on ten-year US Treasuries down

In the United States, yields on ten-year US Treasuries rose on balance by 12 basis points to 1.6%. The aforementioned shifts in the components of the ten-year US yield were very clearly in evidence here. For example, in the reporting period, expectations of average inflation over the next ten years as derived from inflation swaps rose (+44 basis points), as did expectations based on Consensus Economics surveys, though somewhat less sharply. The inflation risk premium, which roughly speaking is calculated as the difference between market-based and survey-based expectations, thus also increased. By contrast, the real yield on ten-year inflation-linked bonds fell to close to historical lows in the reporting period, standing at -1.1% as this report went to press. The declining real ten-year yield also potentially reflected the recent resurgence in uncertainty about the possible economic impact of the pandemic in the final quarter of 2021 and the first quarter of 2022. In addition, the fiscal package adopted in the United States at the beginning of November was smaller than originally announced, and therefore so too was the amount of expected borrowing, which, when viewed in isolation, also lowered the real yield and compensated for movements in the opposite direction

seen in the first quarter of 2021 (on the fiscal package see the box on pp. 17 f.).[1]

Forward inflation rate up in United States

The forward inflation rate derived from US inflation swaps for a period of five years starting in five years' time also rose in comparison to the end of June, latterly standing at 2.6%. At the end of October it had been higher still, at 2.7%. One reason for the recent dip in the forward inflation rate could be the FOMC's decision at its early November meeting to gradually taper bond purchases as of mid-November. Given the current inflation developments, this tightening measure had largely been expected and increasingly priced in by market participants prior to the meeting.

Yield on ten-year Bunds down

Amid major fluctuations, the yield on ten-year Bunds dropped by 7 basis points from the end of June to -0.3%. The decline is attributable above all to lower real term premia, which potentially reflected uncertainty about the business cycle going forward. Alongside persistent supply bottlenecks for intermediate goods, which have been hampering industrial production for some time now (see pp. 51 ff.), concerns about the economic impact of the pandemic grew again recently, also in Germany. By contrast, the inflation risk premium rose significantly in recent months and was up roughly 25 basis points in the ten-year maturity segment on its level at the end of June. Despite the higher inflation expectations and inflation risk premia, the implied risk-neutral expectations for short-term interest rates exhibited volatility but rose only slightly on balance.

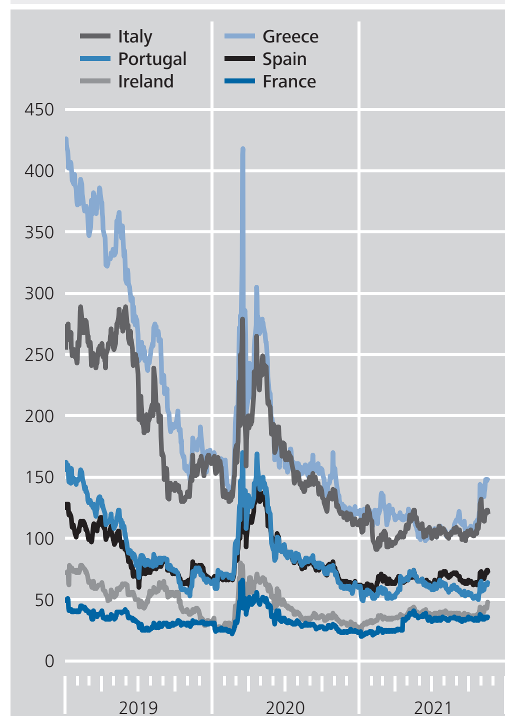
Market participants revised their inflation expectations upwards for the euro area in 2022

In the euro area, the rise in inflation expectations and the inflation risk premium was particularly pronounced for shorter-term horizons. In the period under review, market participants revised their expectations upwards multiple times. The expected average inflation rate in the euro area for 2022 derived from inflation swaps rose to 3.0%, after having stood at 1.6% at the end of June and at 1.0% at the end of

1 See Deutsche Bundesbank (2021).

Spreads of ten-year government bonds over Federal bonds

Basis points, daily data



Sources: Bloomberg and Bundesbank calculations.
Deutsche Bundesbank

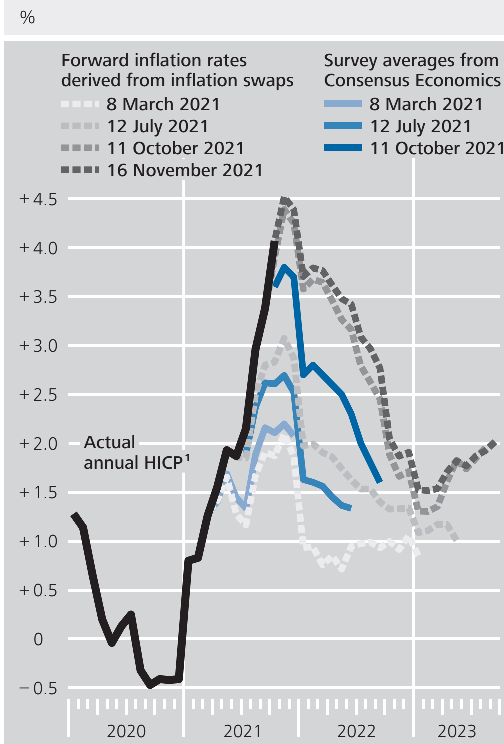
Forward inflation rates* and expectations in the euro area and the United States

Weekly averages

Sources: Bloomberg, Thomson Reuters, Consensus Economics 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 United States) realised over the next five or ten years.
Deutsche Bundesbank

Short-term HICP paths for the euro area

%



Sources: Fenics Market Data, Consensus Economics, Eurostat and Bundesbank calculations. **1** Excluding tobacco. Year-on-year change.
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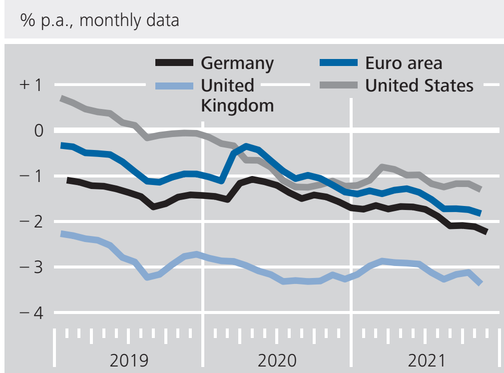
Ten-year real interest rates in various currency areas*

% p.a., monthly data



Sources: Bloomberg and Bundesbank calculations. * Real interest rates based on ten-year nominal interest rates less concurrent inflation expectations based on inflation swaps. For Germany, the inflation swaps of the euro area are used.
Deutsche Bundesbank

March of this year. Inflation expectations based on Consensus Economics surveys were also revised upwards several times. It is noteworthy here that market expectations for inflation developments up to the end of 2022 were again higher than survey-based expectations.

Higher forward inflation rates in euro area

Market-based inflation expectations and the inflation risk premium also rose for longer-term horizons. The five-year forward inflation rates starting in five years' time, as derived from inflation swaps, rose significantly in the euro area to 2.0%, some 36 basis points higher than at the end of June. At the end of October they briefly surpassed the 2% mark, thus reaching their highest level since 2014. In October, inflation expectations for the euro area six to ten years ahead, as calculated by Consensus Economics on the basis of surveys, remained virtually unchanged on the previous survey in July. The inflation risk premium was thus positive again in this long-term maturity segment for the first time in a long while.

Market participants see upside risks to inflation

At present, market participants appear to attach greater importance to the upside risks to inflation, especially for short-term maturities, than to the downside risks. This can be attributed to market participants' fear that inflation could prove less transitory than currently assumed.

Slight widening of yield spreads in euro area

The GDP-weighted euro area yield (excluding Germany) remained virtually unchanged overall – up 1 basis point to -0.3%. As with Bunds, a steeper rise in yields given the perceived inflation risk was partly offset by lower real term premia. The yield spread over ten-year Federal bonds therefore widened by 8 basis points to 0.6%. There was slightly greater widening in the yield spreads of Italian and, in particular, Greek government bonds (+17 basis points and +43 basis points respectively). One reason why spreads widened could be that market participants revised down their expectations regarding the volume of net asset purchases under the PEPP following the ECB Governing Council's monetary policy meeting in October. If expected Eurosystem purchase volumes are lower, the yields on government bonds issued by countries with high levels of public debt will probably react more strongly to fundamentals again. Under the influence of the PEPP, news proved to have only a very weak impact on yields. Since the end of June, market stress indi-

cators, which include liquidity indicators, have consistently pointed to a relaxed market situation for government bonds in the euro area.

Yields in Japan unchanged

In Japan, meanwhile, yields on ten-year government bonds stood at 0.1% at the end of the reporting period and thus remained virtually unchanged compared with mid-2021. Yields continued to move within the range in which market participants assume that the Bank of Japan wishes to keep interest rates.

Yields up in the United Kingdom

In the United Kingdom, the yield on ten-year gilts recorded a strong increase on balance, rising by 21 basis points to 0.9%. This was mainly due to market-based inflation expectations and inflation risk premia rising even more significantly in the United Kingdom than in the United States and the euro area. The expectations concerning average inflation over the next ten years derived from inflation swaps increased by more than 100 basis points. Nevertheless, the Bank of England refrained from raising the policy rate at its latest monetary policy meeting. Market participants had priced in such an interest rate move prior to the meeting. The Bank also maintained the pace of its asset purchases. As a result, there was a considerable drop in nominal interest rates immediately following the decision.

Yields on corporate bonds in line with government bond yields

The yields on European corporate bonds developed broadly in line with the yields on European government bonds. As this report went to press, both the yields on bonds issued by BBB-rated financial corporations with residual maturities of between seven and ten years and those on non-financial corporate bonds of equivalent maturity were slightly up compared with the end of June (1.2% and 0.8% respectively). Since the yields on maturity-matched Federal securities declined on balance, yield spreads widened – by 16 basis points for financial corporations and 13 basis points for non-financial corporations. In line with these slightly higher risk premia, the credit default premia for European corporations also increased somewhat from the end of June (ten-year iTraxx 125 up 2 basis points). Nonetheless, the financing conditions for European corporations in the bond market remained highly favourable.

Investment activity in the German securities markets

€ billion

Item	2020 Q3	2021 Q2	2021 Q3
Debt securities			
Residents	60.8	90.1	73.8
Credit institutions	– 21.5	– 20.4	– 4.5
of which:			
Foreign debt securities	– 18.9	– 5.8	– 1.5
Deutsche Bundesbank	65.8	72.2	60.1
Other sectors	16.4	38.3	18.2
of which:			
Domestic debt securities	– 0.4	8.4	6.6
Non-residents	135.0	– 6.1	– 11.1
Shares			
Residents	45.9	34.8	30.9
Credit institutions	1.9	1.5	3.5
of which:			
Domestic shares	0.2	1.5	0.7
Non-banks	44.0	33.3	27.4
of which:			
Domestic shares	25.3	6.4	9.1
Non-residents	– 16.0	– 0.6	0.4
Mutual fund shares			
Investment in specialised funds	18.9	21.4	14.9
Investment in retail funds	4.9	9.9	10.2
of which:			
Equity funds	3.4	4.3	2.4

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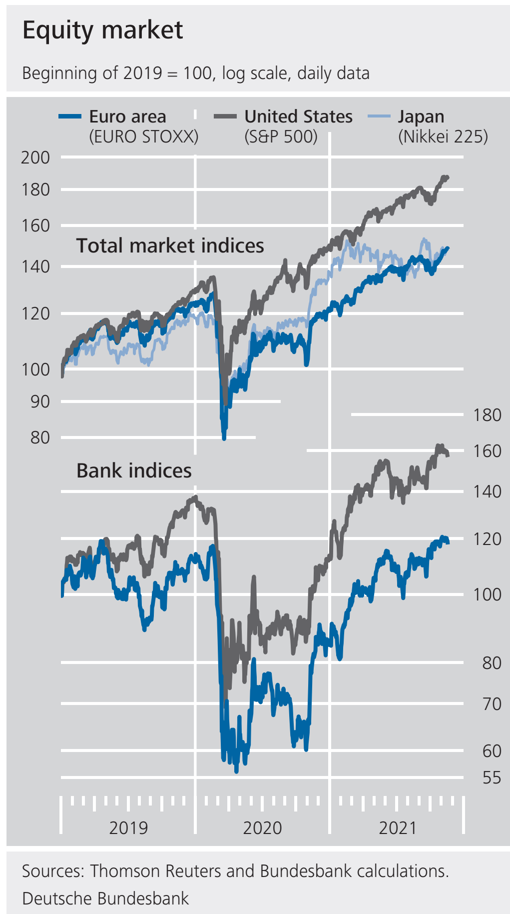
Continuing high net sales in bond market

At €442½ billion, gross issuance in the German bond market in the third quarter of 2021 was up slightly compared with the previous quarter's figure (€435½ billion). After deducting redemptions and taking account of changes in issuers' holdings of their own bonds, net sales remained relatively high at €55 billion. In addition, foreign borrowers placed debt securities worth €8 billion in the German market. Thus, funds totalling €62½ billion net were raised in the German bond market in the reporting period.

High net public sector issuance

The public sector issued own debt securities in the amount of €31½ billion net in the quarter under review. The Federal Government predominantly issued Federal bonds with a maturity of 30 years (€17 billion) as well as five-year Federal notes (Bobls: €11½ billion) and seven-



Sources: Thomson Reuters and Bundesbank calculations.
Deutsche Bundesbank

year Federal bonds (€10½ billion). Meanwhile, there were net redemptions of ten-year Federal bonds (€16 billion). State and local government issued debt securities worth €3½ billion net.

Higher capital market debt levels amongst enterprises

Domestic enterprises raised their capital market debt by €13 billion on balance in the third quarter, which was on par with the increase seen in the previous quarter. The bulk of these issues was attributable to non-financial corporations (€10½ billion).

Net issuance by credit institutions

Domestic credit institutions issued their own bonds to the tune of €10 billion net in the quarter under review. On balance, mainly debt securities of specialised credit institutions were issued (€14½ billion). Meanwhile, issuance of other bank debt securities and public Pfandbriefe declined (by €5½ billion and €1½ billion net respectively).

Purchase of debt securities

The Bundesbank was the biggest buyer in the domestic bond market in the third quarter of 2021, acquiring bonds amounting to €60 billion net, primarily under the Eurosystem's asset purchase programmes. Domestic non-banks expanded their bond portfolios by €18 billion in net terms, with their focus on foreign debt securities (€11½ billion). By contrast, foreign investors and domestic credit institutions sold bonds for €11 billion and €4½ billion net respectively.

Equity market

Equity markets with price gains despite inflation developments

The international equity markets appeared relatively unperturbed by developments in inflation and the debate on monetary policy tightening, recording significant gains, in some cases, at the end of the reporting period. Prices in the markets were driven by a positive corporate reporting season on both sides of the Atlantic and upward revisions to analysts' earnings forecasts. Higher earnings expectations potentially reflect, besides general economic optimism, the view that price increases will raise profit margins.

Negative factors had only a temporary impact on prices

Negative factors had only a temporary impact on prices. For instance, the tense financial situation at the Chinese real estate group Evergrande only led to short-lived losses. Market participants had been concerned about systemic financial contagion for a time, but such effects were not observed during the reporting period. The same is true of potentially elevated uncertainty as to how hard a fourth wave of the coronavirus pandemic – which is currently building – will hit the economy. On balance, euro area stocks, as measured by the EURO STOXX, went up by 7.6%, while German shares, as measured by the CDAX, recorded an increase of 3.8%. The US S&P 500 gained 9.5% and reached new historical highs during the reporting period, as did other indices. UK and Japanese equities also recorded gains – of 3.4% and 2.8% respectively. Bank shares likewise rose significantly during the reporting period. Shares in US banks climbed by 8.1%,

European banks gained 9.4% in value and UK banks ended the reporting period 6.8% higher.

Stock market volatility virtually unchanged

Price uncertainty in the equity market – as measured by the implied volatility of equity indices calculated from options – remained relatively stable at a low level during the reporting period. Only investors' concerns about contagion effects from the financially distressed Chinese real estate group Evergrande caused a temporary surge in price uncertainty during the second half of September. Equity market uncertainty for both US and European stocks was below its respective five-year averages at the end of the period under review.

Slight decline in the valuation level

A number of metrics indicate that European equity valuations are more favourable than they were at the end of June. For instance, the EURO STOXX earnings yield, calculated on the basis of earnings forecasts for the next 12 months (the inverse price/earnings ratio), rose in the period under review. According to a dividend discount model, the equity risk premium, which compensates investors for holding risky equities instead of safe Federal securities, also rose slightly. The implied cost of equity, i.e. the sum of the equity risk premium and the risk-free interest rate, also went up during the reporting period. By historical standards, European equity valuations therefore remained significantly below their long-term average. Different developments were observed in the United States. Looking at the US S&P 500, the expected earnings yield, the implied cost of equity and the equity risk premium remained roughly at their end-June level, meaning that US equity valuations remained virtually unchanged on balance in the period under review.

Stock market funding and stock purchases

Domestic enterprises placed new shares worth €10 billion net in the German equity market in the third quarter of 2021, following €7 billion in the previous quarter. The outstanding volume of foreign shares in the German market rose by €21 billion over the same period. On balance, equities were acquired almost exclu-

Major items of the balance of payments

€ billion

Item	2020[r]	2021	
	Q3	Q2	Q3[p]
I. Current account	+ 62.4	+ 56.4	+ 52.8
1. Goods	+ 56.0	+ 45.5	+ 45.7
2. Services	− 5.4	+ 4.9	− 8.7
3. Primary income	+ 22.1	+ 14.6	+ 29.0
4. Secondary income	− 10.4	− 8.6	− 13.2
II. Capital account	− 1.2	− 1.9	+ 1.9
III. Financial account (increase: +)	+ 68.3	+ 67.8	− 0.5
1. Direct investment	− 11.4	+ 3.7	+ 21.4
Domestic investment abroad	+ 15.1	+ 17.3	+ 36.6
Foreign investment in the reporting country	+ 26.5	+ 13.6	+ 15.2
2. Portfolio investment	− 89.4	+ 69.5	+ 61.2
Domestic investment in foreign securities	+ 44.7	+ 59.2	+ 49.4
Shares[1]	+ 18.8	+ 10.1	+ 19.4
Investment fund shares[2]	+ 27.4	+ 24.8	+ 22.1
of which: Money market fund shares	+ 12.0	− 1.3	− 2.3
Short-term debt securities[3]	− 0.9	− 5.8	+ 5.4
Long-term debt securities[4]	− 0.6	+ 30.1	+ 2.4
of which: Denominated in euro[5]	− 18.4	+ 19.5	− 3.1
Foreign investment in domestic securities	+ 134.1	− 10.3	− 11.8
Shares[1]	− 0.6	− 5.2	+ 0.4
Investment fund shares	− 0.4	+ 1.0	− 1.1
Short-term debt securities[3]	+ 49.0	+ 0.2	+ 8.3
Long-term debt securities[4]	+ 86.0	− 6.3	− 19.4
of which: Issued by the public sector[6]	+ 17.7	− 12.1	− 28.6
3. Financial derivatives[7]	+ 25.2	+ 13.5	− 11.4
4. Other investment[8]	+ 145.2	− 18.8	− 102.9
Monetary financial institutions[9]	− 13.8	− 11.2	− 30.6
Enterprises and households[10]	+ 59.6	+ 2.8	− 11.8
General government	+ 11.9	− 4.4	− 0.6
Bundesbank	+ 87.4	− 6.1	− 60.0
5. Reserve assets	− 1.3	+ 0.1	+ 31.2
IV. Errors and omissions[11]	+ 7.1	+ 13.3	− 55.2

1 Including participation certificates. **2** Including reinvested earnings. **3** Short-term: original maturity of up to one year. **4** Long-term: original maturity of more than one year or unlimited. **5** Including outstanding foreign Deutsche Mark bonds. **6** Including bonds issued by the former Federal Railways, the former Federal Post Office and the former Treuhand agency. **7** Balance of transactions arising from options and financial futures contracts as well as employee stock options. **8** Includes in particular financial and trade credits as well as currency and deposits. **9** Excluding the Bundesbank. **10** Includes the following sectors: financial corporations (excluding monetary financial institutions) as well as non-financial corporations, households and non-profit institutions serving households. **11** 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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sively by German non-banks (€27½ billion), which also include mutual funds. Domestic credit institutions purchased equities worth €3½ billion net. Foreign investors increased their equity exposure in Germany by €½ billion net.[2]

Mutual funds

Sales and purchases of mutual fund shares

During the reporting period, domestic investment companies recorded inflows of €25 billion, after raising funds totalling €31½ billion in the second quarter. The majority of the fresh funds were channelled to specialised funds reserved for institutional investors (€15 billion). Among the various asset classes, mixed securities funds in particular were the chief sellers of new fund shares (€9½ billion), but new shares were also placed in the market, albeit to a lesser extent, by open-end real estate funds (€5½ billion), bond funds (€4 billion) and equity funds (€2½ billion). Foreign funds distributed in the German market attracted inflows of €22 billion net in the third quarter of 2021. Domestic non-banks were the main buyers, adding mutual fund shares worth €46 billion to their portfolios. Domestic credit institutions bolstered their fund portfolios by €2½ billion net, while non-resident investors reduced their fund portfolio in Germany by €1 billion.

Direct investment

Direct investment posts net capital exports

Transactions in cross-border portfolio investment resulted in net capital exports of €61 billion in the third quarter of 2021.[3] Direct investment, too, resulted in capital outflows (€21½ billion).

German direct investment abroad results in capital exports

Enterprises domiciled in Germany expanded their direct investment abroad by €36½ billion between July and September (previous quarter: €17½ billion). Domestic enterprises primarily boosted their equity capital in non-resident subsidiaries (€25½ billion); roughly one-half of this amount was in the form of reinvested earnings. Furthermore, they provided affiliated group entities with additional loans worth €11 billion. The third quarter saw considerable volumes of direct investment funds flowing from Germany to the Netherlands (€8½ billion), Sweden (€7 billion) and the United States (€5½ billion).

Capital inflows through foreign direct investment in Germany

Conversely, foreign enterprises increased their direct investment in Germany by €15 billion, following €13½ billion in the second quarter. Intra-group loans accounted for just over two-thirds of these additional direct investment funds. A further third (€4½ billion) was attributable to equity capital. Particularly high inflows of direct investment were recorded from the Netherlands (€12 billion) and the United Kingdom (€3½ billion) in the third quarter.

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2 For further details, see the section entitled "Direct investment" on this page.
3 In addition to portfolio investment, the allocation of new special drawing rights was reflected in the German balance of payments in the third quarter. Germany's reserve assets went up by €31 billion as a result of this measure alone. However, the corresponding counterpart item on the Bundesbank's balance sheet, which is recorded as a liability to the International Monetary Fund, also increased by the same amount. See also the table on p. 49.

List of references

Deutsche Bundesbank (2021), Financial Markets, Monthly Report, May 2021, pp. 41-50.