

## Financial markets

### Financial market trends

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Despite the higher energy prices, the autumn and winter months saw the re-emergence of more optimistic economic expectations in the international financial markets. This was especially the case for Europe, where economic growth has progressed more slowly than in other regions. Against this backdrop, long-term rates rose significantly worldwide. Given that its interest rate spread was slightly smaller at the end of the period under review, the US dollar tended to depreciate against the euro, and also against other currencies, up until the end of January. In the stock markets the positive economic indicators, which were also reflected in the largely favourable quarterly results and improved profit expectations of enterprises, resulted in strong share price gains, particularly in the euro area.

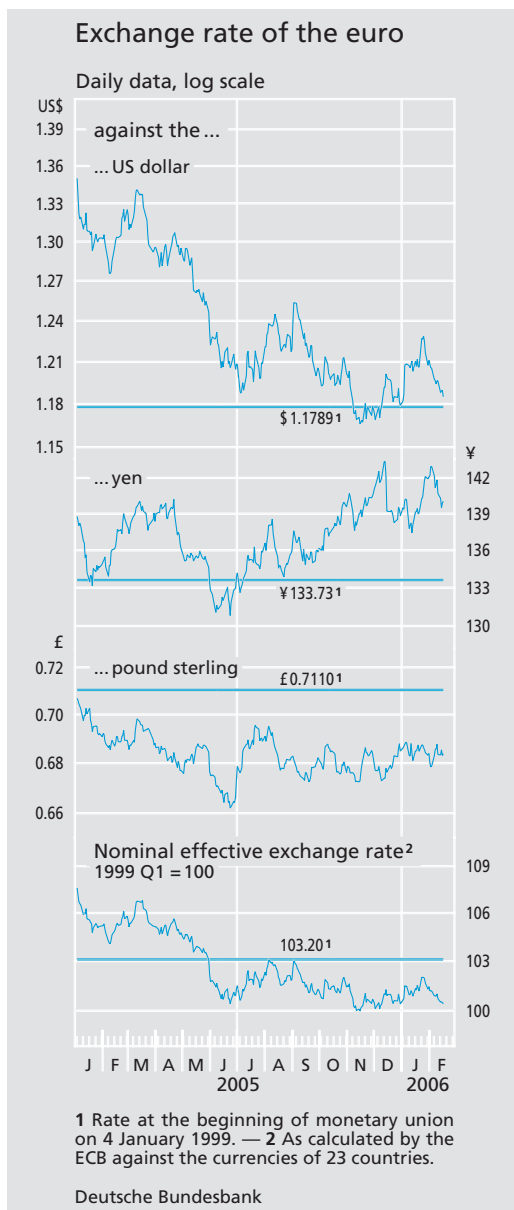
*Financial  
market  
environment*

### Exchange rates

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At the turn of 2005-06, the sentiment in the international foreign exchange markets turned in favour of the euro for a while. The euro had tended to depreciate slightly against the US dollar in the fourth quarter of 2005 and by mid-November was trading at a two-year low of less than US\$1.17, but expansionary forces subsequently gained momentum. First, the market players seemed to be ever more convinced that an end to the cycle of interest rate rises by the US Federal Reserve was in sight. Second, following the change in key ECB interest rates at the beginning of December 2005, they considered that further key interest rate increases are to be expected

*Euro exchange  
rate  
movements  
against the  
US dollar, ...*



during the course of 2006. The resulting expectation of a narrowing interest rate differential between US and European investments led to the euro briefly rising above US\$1.20 again as early as mid-December.

The market players' expectations of a convergence of the central bank rates of both currency areas were strengthened by some surprisingly positive economic indicators for the

euro area at the beginning of this year. Furthermore, the concerns regarding the long-term sustainability of the US trade balance again seemed to be more present, although the deficit had fallen more sharply than predicted in November (to US\$64.2 billion). At the beginning of the year, the euro-US dollar exchange rate remained largely at around US\$1.21 before falling again at the beginning of February. Favourable labour market data for the USA gave rise to renewed speculation of further interest rate increases by the US Federal Reserve. The euro was trading at US\$1.19 at the end of the period under review, slightly above its level at the start of monetary union.

As a result of the yield differential between European and Japanese debt securities, the euro – which had been appreciating against the yen since the third quarter – continued its upward trend. Following the speculation of market players that the Bank of Japan would continue its expansionary monetary policy for some time to come in order to avoid jeopardising its economic recovery, the euro rose to over ¥143 in mid-December, its highest level ever. The Bank of Japan's quarterly Tankan survey did, in actual fact, confirm the favourable economic outlook for Japan. The euro consequently lost some of its gains against the yen again. However, the signs of more favourable economic developments in the euro area and the increase in key ECB interest rates had a stabilising impact. As this report went to press, the euro was quoted at ¥140.

The changes in the exchange rate of the euro against the pound sterling remained within

... against  
the yen ...

*... and against  
the pound  
sterling*

narrow bounds in the autumn and winter months. Neither the current economic data nor the results published in the Bank of England's inflation report in mid-November last year point to a lasting effect in the foreign exchange market. Since the turn of the year, the euro-pound sterling exchange rate has remained at £0.68, with only modest fluctuations. The exchange rate is thus more than 3½% below its value at the beginning of monetary union.

*Effective euro  
exchange rate*

During the period under review, the euro appreciated on average against 23 currencies. As this article went to press, the effective exchange rate stood at around the same level recorded at the beginning of this year and thus just over 2½% below the level at the start of monetary union. In real terms – ie taking account of the simultaneously prevailing inflation differentials between the euro area and its major trading partners – the effective euro exchange rate, which is also a measure of the price competitiveness of companies in the euro area, was again clearly above its longer-term average. By this measure, the competitiveness of euro-area enterprises as a whole against non-euro-area countries is therefore less favourable than that of German enterprises.

### Securities markets and portfolio transactions

*Bond yields  
increased on  
balance...*

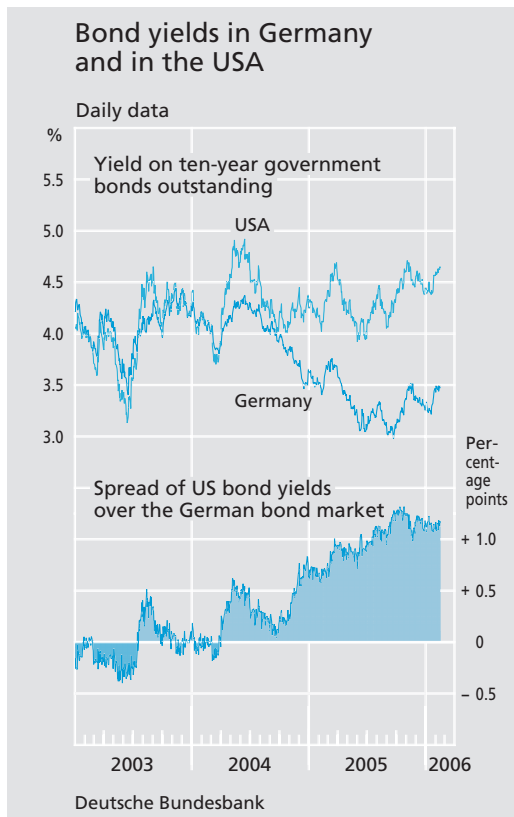
On balance, there was an increase in yields in the international bond markets in the fourth quarter. Given the largely improved leading economic indicators, this development, in

particular, reflects a greater level of confidence in future economic developments on the part of market participants. This was also visible from surveys which showed an improvement in growth prospects for 2006, particularly in the euro area. The high oil price had only a limited effect on the buoyant economic expectations. The tension in the international energy markets contributed to the fact that the short-term inflation expectations of market players were revised upwards in part. However, the long-term inflation expectations for the euro area remained largely stable at the same time. This can be interpreted as an indication of confidence in the policy and competence of the European Central Bank in terms of maintaining price stability.

The yield on ten-year Federal bonds outstanding (Bunds) rose in line with the worldwide increase in bond yields by around ½ percentage point to 3½% by mid-November compared with its low in September 2005. This level was last reached in the spring of 2005. However, during the following two months, long-term interest rates fell by a further ¼ percentage point before reaching 3½% again in January 2006 against the backdrop of improved economic indicators. Given the largely unchanged long-term inflation outlook – as mentioned above – the nominal yield on ten-year Federal bonds moved closely in parallel with the real yield of comparable inflation-linked bonds,<sup>1</sup> which was at somewhat more than 1¼% at the end of the period under review. The long-term real rate of interest for

*... in line with  
real interest  
rates*

<sup>1</sup> These are based on ten-year French government bonds, which are linked to the consumer price index of the euro area.



the euro area calculated in this way has thus increased almost as strongly as in the United States since September. Given the virtually unchanged long-term inflation expectations, the interest rate spread of ten-year US Treasuries over the respective euro-area government bonds remained at well over 1 percentage point. Thus, the interest rate spread is currently a relatively good reflection of the existing differences in the analysts' nominal growth expectations for the euro area and the USA.

*Higher interest rate premiums on corporate bonds, ...*

The interest rate premiums on BBB-rated corporate bonds in the euro area gradually increased to almost 130 basis points in the fourth quarter of 2005. At the end of the period under review, they were up by approximately 70 basis points on their low

reached in the spring of 2005. Nevertheless, the financing conditions for the corporate sector remained favourable on a longer-term comparison. The increase in corporate bond spreads, which was especially large in the case of borrowers with a poor credit rating – particularly in the segment of high-yield bonds – indicates that market players are becoming less inclined to take risks and that they appear to attach greater significance to default and liquidity risks overall. In addition, the widening of interest rate spreads could reflect a certain credit rating deterioration of those enterprises included in the indices as west European enterprises were increasingly downgraded by rating agencies in the fourth quarter.<sup>2</sup>

*... but financing conditions in the bond market remain favourable*

In the fourth quarter of 2005, gross sales of domestic debt securities were clearly below the issue volume of the previous quarters at €247½ billion (Q3: €282 billion). Gross issues were also down on the year by just over €32 billion. Since, owing to seasonal factors, the redemptions clearly exceeded the gross issues in December, issuers repaid German bonds and notes to the net value of €23 billion in the fourth quarter, after taking account of redemptions and changes in issuers' holdings of their own bonds. In the previous quarter, German borrowers had sold securities in the bond market to the net value of €16½ billion. Foreign bonds were sold for €33½ billion in Germany in the period under review, three

*Seasonal net redemptions of domestic bond issuers*

<sup>2</sup> After an almost balanced upgrade-downgrade relationship in the previous quarters, the number of downgraded west European non-financial enterprises between October and December 2005 was just over 20% above the number of upgrades. During 2005, the deterioration of the respective relationship of US enterprises' ratings was even greater than in Europe.

quarters of which were euro-denominated securities. As a result, the total funds raised through the issuance of domestic and foreign debt securities amounted to €9½ billion compared with €29 billion in the preceding quarter.

*... with low level of funds raised by the public sector, ...*

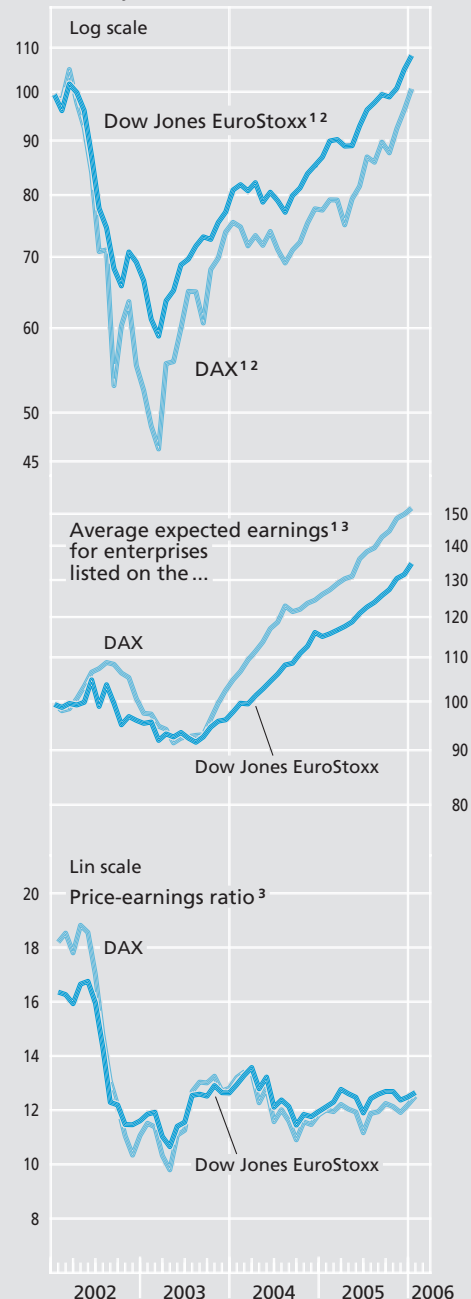
In terms of the domestic market, only the public sector tapped the bond market in the fourth quarter. However, the amount raised by government issuers at just €6½ billion was significantly below the level recorded in the third quarter (€27½ billion). Within the public sector, only the state governments sold their own bonds in the German capital market on balance (€7½ billion), whereas the Federal Government – not least in view of the favourable cash balance in the final quarter of 2005 – and other public issuers reduced their bond market debt by almost €1 billion and €½ billion respectively on balance. The Federal Government generated a net total of €7½ billion from issuing five-year Federal notes (Bobls) and issued two-year Federal Treasury notes (Schätze) worth a net value of €1½ billion. At the same time, the Federal Government reduced its liabilities arising from ten-year bonds outstanding by €9 billion and from 30-year bonds outstanding by €1 billion on balance.

*... reduced capital market debt of enterprises...*

Despite low financing costs, non-financial enterprises again reduced their bond market debt and lengthened maturities. For the second quarter in a row, there was a net redemption of money market paper worth €5 billion, whereas the liabilities arising from longer-term securities increased by almost €3½ billion.

### Price movements and earnings estimates for European and German public limited companies

Monthly data



1 January 2002 = 100. — 2 Source: Deutsche Börse AG. — 3 Based on year-on-year I/B/E/S analyst estimates ("earnings before goodwill"). Source: Thomson Financial Datastream.

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### Investment activity in the German securities markets

€ billion			
Item	2004	2005	
	Q4	Q3	Q4
<b>Debt securities</b>			
Residents	- 18.5	2.9	- 4.6
Credit institutions	2.5	- 10.2	- 1.3
<i>of which</i>			
Foreign debt securities	17.3	- 0.9	24.3
Non-banks	- 21.0	13.1	- 3.3
<i>of which</i>			
Domestic debt securities	- 21.9	- 0.7	- 11.4
Non-residents	22.6	26.4	13.8
<b>Shares <sup>1</sup></b>			
Residents	4.6	- 4.0	7.6
Credit institutions	11.0	6.0	7.2
<i>of which</i>			
Domestic shares	8.8	4.5	1.6
Non-banks	- 6.4	- 10.0	0.4
<i>of which</i>			
Domestic shares	- 6.3	- 9.1	- 12.2
Non-residents	0.5	8.3	17.4
<b>Mutual fund shares</b>			
Investment in specialised funds	7.4	6.3	13.9
Investment in funds open to the general public	- 6.5	6.2	- 3.4
<i>of which: Share-based funds</i>	1.1	1.2	1.7

<sup>1</sup> Including shares acquired in the course of direct investment.

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... and high redemptions of bank debt securities

Net redemptions by credit institutions in the amount of €27½ billion were the main reason for the (negative) overall result from the issuance of German debt securities in the fourth quarter. In December 2005, in particular, more securities of these credit institutions matured owing to seasonal reasons than were newly issued. Thus, the trend among credit institutions since the middle of the year to reduce their domestic capital market debt continued after they had borrowed a total of €77½ billion from the bond market during the first half of 2005.<sup>3</sup> On balance, the credit institutions redeemed other bank debt securities and public Pfandbriefe for €16½ billion and €11½ respectively in the fourth quarter. By contrast, they sold a small amount of debt securities issued by specialised credit institutions and mortgage Pfandbriefe.

As in the preceding period, foreign investors were the sole buyers of domestic debt securities in the fourth quarter with net purchases of €14 billion. On balance, they only purchased public sector securities (€14½ billion). By contrast, domestic credit institutions and non-banks resold domestic bond holdings to the net value of €25½ billion and €11½ billion respectively. The bulk of the net resales by German credit institutions were bank debt securities (€24 billion). Domestic non-banks reduced their holdings of securities from German private and public sector borrowers by €5 billion and €6½ billion respectively. By contrast, both credit institutions and non-banks invested in foreign debt securities (€24½ billion and €8 billion respectively).

*Purchases of debt securities*

The improved economic outlook was also reflected in the stock markets. After a temporary dip in October, the stock markets in Europe and particularly in Germany resumed the favourable development observed in the previous quarter and experienced extremely buoyant growth. Price developments in the US stock markets, on the other hand – as in the preceding months – were somewhat more subdued. Measured against the broad Dow Jones Euro Stoxx and CDAX indices, share prices rose by 10% and 14% respectively compared with the beginning of October, thereby reaching the high levels last recorded just over 4½ years ago. As well as the aforementioned favourable economic outlook with relatively low long-term interest rates, other contributors to the rise in stock

*Favourable and buoyant stock markets*

<sup>3</sup> This is partly due to smaller issues by the Landesbanken following the abolition of public guarantees for new liabilities in mid-July.

prices were the predominantly positive quarterly corporate earnings results, speculation on acquisitions and the ongoing improvements of the estimates of analysts regarding corporate profits. Despite the marked rise in share prices, European equities, which had a price-earnings ratio of almost 13 at the end of the period under review, still had a relatively low valuation in a multi-year comparison. Thus, the risk premium on equity investment calculated from dividend discount models was at a high level. Against this backdrop, the key interest rate increase of 25 basis points at the beginning of December did not have a noticeable dampening effect on share prices, but seemed to be assessed as reasonable and moderate by investors. Nor did the high oil price and the temporary abrupt slump in prices in the Japanese stock market have a lasting effect on share prices. The robust condition of the stock market was consistent with a virtually unchanged and, in a multi-year comparison, relatively low level of uncertainty about further share price developments.<sup>4</sup>

*Further increase  
in funds raised  
in equity  
market*

Issuing activity in the German share market continued to pick up in the fourth quarter against the backdrop of the favourable stock market developments. Listed German enterprises issued new shares worth €5 billion, after issuing €3 billion in the previous quarter. This increase was due to both capital increases of some already listed public limited companies and to several initial public offerings. There is also a certain degree of confi-

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<sup>4</sup> In terms of the VDAXnew or if calculated as the implied volatility of options on the Dow Jones EuroStoxx 50 index.

### Intensification of direct investment flows through acquisitions and restructuring of multinationals

In the final quarter of last year, there was a marked revival in cross-border financial transactions arising from direct investment. This was shaped by fairly large acquisitions and restructuring of multinationals. In some cases, however, the associated quite considerable gross flows in the individual months cancelled each other out over the quarter. There were net capital imports of €20½ billion through direct investment in the period under review, compared with net capital exports of €3 billion in the preceding period.

The inflows of funds can be put down primarily to foreign direct investment in Germany, which amounted to €14 billion. An acquisition in the banking industry accounted for a considerable proportion of this. Moreover, the acquisition, which was financed by an exchange of shares, triggered an equal amount of capital flows in opposite directions through cross-border portfolio investment. While some of the buyer's shares were acquired by German residents, which led to a large net acquisition of foreign shares by residents, free-float holdings of the acquired enterprise's shares were transferred abroad.<sup>1</sup> Foreign parent companies provided their German affiliates with additional funds worth €10½ billion through internal group credit transactions, predominantly in the form of long-term financial loans.

German firms also engaged in buoyant direct investment at the end of the year. Various acquisitions in the insurance and transport sectors as well as in tourism and the metal-working industry played a crucial role in this regard. By contrast, several foreign participating interests were sold in connection with the restructuring of a German enterprise, which, in turn, is itself foreign-owned. This reorganisation led to the proceeds of the sale being transferred from the United States to the French parent company. Furthermore, German proprietors took out loans – predominantly short-term – from their foreign subsidiaries. In total, German enterprises withdrew €6½ billion from their affiliates abroad.

<sup>1</sup> Total net capital exports through portfolio investment amounted to €47½ billion between October to December. Share transactions accounted for just under half of this.

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## Major items of the balance of payments

€ billion

Position	2005		
	Q4	Q3	Q4
I Current account 1,2	+ 20.0	+ 18.0	+ 20.6
Foreign trade 1,3	+ 35.0	+ 41.1	+ 34.7
Services 1	- 6.5	- 13.2	- 5.0
Income 1	+ 1.5	+ 2.0	+ 2.3
Current transfers 1	- 6.6	- 7.8	- 7.1
II Capital transfers 1,4	- 0.2	+ 0.0	+ 0.0
III Financial account 1 (Net capital exports: -)	- 29.2	- 22.4	- 41.2
1 Direct investment	+ 9.8	- 3.0	+ 20.4
German investment abroad	+ 8.7	- 2.8	+ 6.6
Foreign investment in Germany	+ 1.0	- 0.3	+ 13.8
2 Portfolio investment	+ 4.7	+ 8.3	- 47.6
German investment abroad	- 19.5	- 28.2	- 58.0
Shares	- 2.1	- 3.6	- 21.1
Mutual fund shares	+ 0.8	- 11.7	- 4.5
Debt securities	- 18.2	- 12.9	- 32.4
Bonds 5	- 20.2	- 8.6	- 31.2
of which:			
euro-denominated bonds	- 18.0	- 2.7	- 24.0
Money market paper	+ 2.0	- 4.3	- 1.3
Foreign investment in Germany	+ 24.2	+ 36.5	+ 10.4
Shares	+ 0.5	+ 8.3	- 1.5
Mutual fund shares	+ 1.2	+ 1.8	- 1.9
Debt securities	+ 22.6	+ 26.4	+ 13.8
Bonds 5	+ 22.6	+ 27.1	+ 24.8
of which: public bonds	+ 14.2	+ 16.5	+ 14.7
Money market paper	- 0.0	- 0.8	- 10.9
3 Financial derivatives 6	- 3.4	- 3.0	- 3.3
4 Credit transactions	- 39.3	- 23.7	- 10.2
Monetary financial institutions 7	- 38.0	- 15.9	+ 10.5
of which: short-term	- 31.0	+ 6.1	+ 38.5
Enterprises and individuals	- 2.6	- 0.3	+ 8.4
of which: short-term	- 1.5	- 2.7	+ 13.1
General government	- 1.9	+ 0.3	- 4.6
of which: short-term	- 1.3	- 5.0	- 6.2
Bundesbank	+ 3.2	- 7.9	- 24.5
5 Other investment	- 0.9	- 1.0	- 0.7
IV Change in the reserve assets at transaction values (increase: -) 8	+ 0.0	- 0.8	+ 1.9
V Balance of unclassifiable transactions	+ 9.4	+ 5.1	+ 18.6

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 Excluding the Bundesbank. — 8 Excluding allocation of SDRs and excluding changes due to value adjustments.

Deutsche Bundesbank

dence among market players that the upturn could continue, especially as further stimulus is anticipated for the primary market from investment companies such as private equity funds. On balance, German shares were purchased solely via direct investments by foreign investors (€19 billion). Domestic credit institutions increased their share portfolio by €1½ billion, whereas domestic non-banks sold German equities worth €12 billion (net). This was primarily due to an exchange of shares in connection with a major cross-border corporate acquisition (see box on page 33).

In the fourth quarter, domestic investment companies recorded inflows to the net amount of €10½ billion, which was somewhat lower than in the previous three-month period (€12½ billion). On balance, the resources were channelled solely to specialised funds which are only open to institutional investors (€14 billion), whereas mutual funds open to the general public had to redeem shares to the value of €3½ billion on balance. Among the latter funds, the outflows affected money market funds (€3½ billion) and open-end real estate funds (€3 billion), in particular, one of which was closed during the period under review. In net terms, bond-based mutual fund shares were returned for almost €½ billion. By contrast, share-based and mixed funds sold share units worth a net €1½ billion and €½ billion respectively. On balance, the sale of foreign mutual fund shares to the value of €4½ billion was below the level of the previous quarter (€11½ billion).

*Sales of mutual fund shares*



*Purchases of  
mutual fund  
shares*

On balance, most of the mutual fund shares (€12 billion) were purchased by domestic non-banks, which invested primarily in domestic mutual funds (€9 billion). Also domestic mutual credit institutions, which purchased fund certificates to the amount of €5

billion (net), favoured mutual fund shares of domestic investment companies (€3½ billion). Foreign investors, on the other hand, reduced their holdings of mutual fund shares in the German market by €2 billion overall.