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# Global Portfolio Flows and Impact on European Markets

## Investment Implications of a Low Yield Environment

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## Global Portfolio Flows and Their Impact on European Markets

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### An asset yield shock

**The asset /liability spread has reversed:** investment margins are at decade lows, driving search for yield strategies and increasing diversification

**Little expectation of yield recovery:** inflation markets, forward rates and policy guidance all point to a substantial period of low yields

**PSPP outlook is critical:** forward markets are pricing either PSPP extension or a material further contraction of investor liability costs. Both seem unlikely.

### With an incomplete response

**Asset allocation is constrained:** Pension and life insurers are constrained by regulatory charges (Solvency II) and historically strict investment mandates. While the debate has picked up, substantial change is unlikely in the medium term

**A limit to bank diversification strategies:** given inevitable information asymmetries in non-listed/private markets

**Global factors also at work:** the hunt for yield is a global phenomenon, though an accelerating one under PSPP.

### Flows are likely to be large and volatile

**Diversification could be temporary:** Incentives to diversify probably reverse materially once yields reach around 2.5%

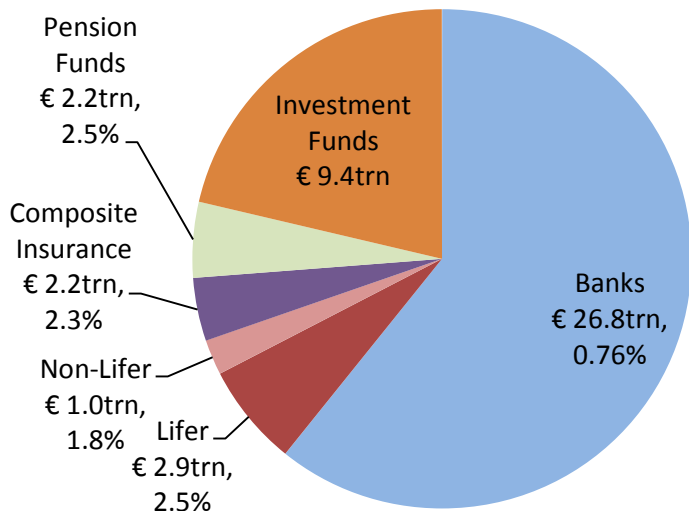
**European “natural habitat” in fixed income assets unlikely to change**

**Scale of potential “temporary” flows is in any case very large**

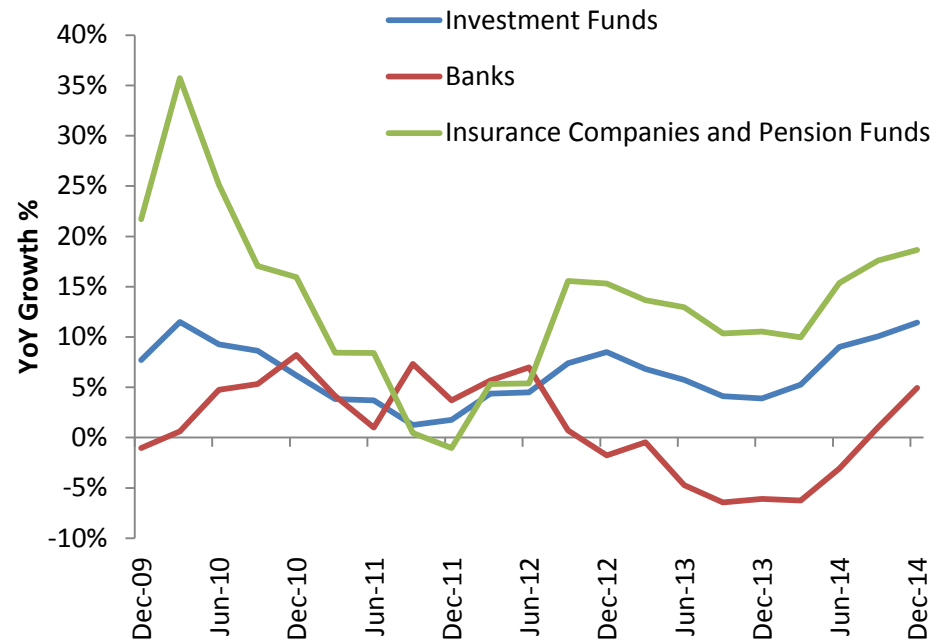
## Structure of Eurozone Financial System

- The Euro-zone financial system is dominated by banks and the insurance and pension sector
- Both sectors have sticky liability costs that drive investment choice plus regulatory constraints
- AuM growth has been solid in recent years, further pressuring yields

**Size and Breakdown of Eurozone Financial System and Respective Cost of Liability, Blended Average Cost of Liability: 1.1%**



**Annual Growth Rates of Each Financial Sector**



Source: ECB, EIOPA, European Pension, Morgan Stanley Sales & Trading

Source: ECB

## The Low Yield Environment - Banks

- Bank funding costs have fallen meaningfully in recent years and now stand at 15 year lows
- Asset yields, and therefore spreads, are also low by historical standards
- This will lead to increasing competition for higher yielding assets as banks try to reach their cost of equity targets

Average Marginal Funding Cost for Banks

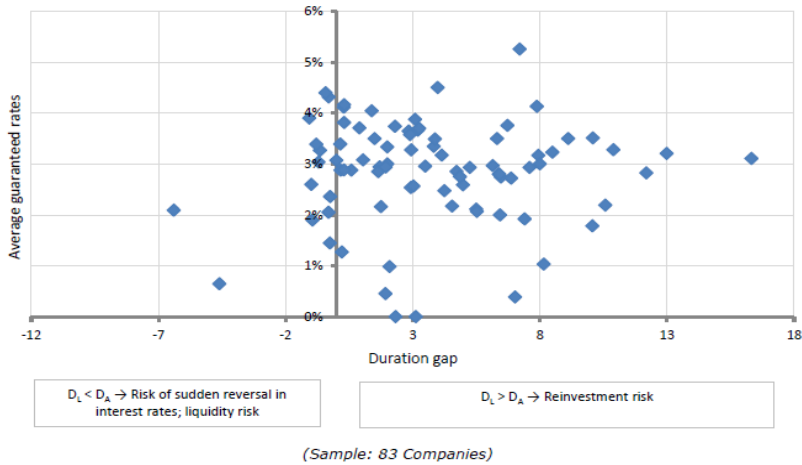


Banks: Lending Profitability Scenarios

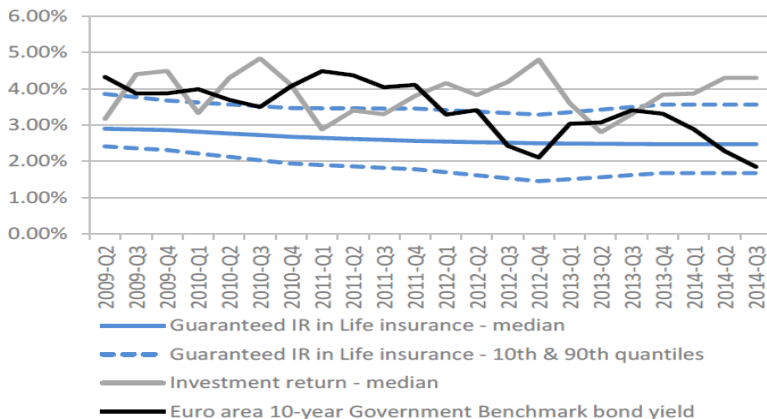
	1.5	2.0	2.5	2.5	3.0	3.5	4.0
Lending Rate	1.5	2.0	2.5	2.5	3.0	3.5	4.0
Funding cost	0.9	0.9	0.9	0.05	0.9	0.9	0.9
Operating cost	0.8	1.1	1.4	1.4	1.7	1.9	2.2
Pre tax	-0.2	0.0	0.2	1.1	0.5	0.7	0.9
Tax	-0.1	0.0	0.1	0.3	0.1	0.2	0.3
Allocated capital	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Net income	-0.2	0.0	0.2	0.8	0.3	0.5	0.6
ROE	-3.2%	0.0%	3.2%	15.1%	6.3%	9.5%	12.6%

## The Low Yield Environment – Insurance Companies

### Insurance Companies: Average Guarantee Rate for Lifers vs Duration Gap

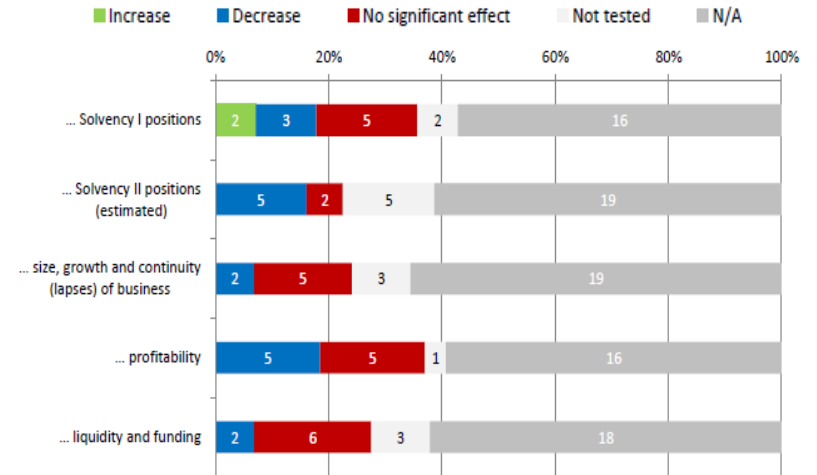


### Life Insurance Guaranteed Rate vs Investment Return, Euro area Govt bond Yield



Source: EIOPA

### Impact of Low Interest Rate Environment on Key Indicators



### Capital Charges for Each Asset Class

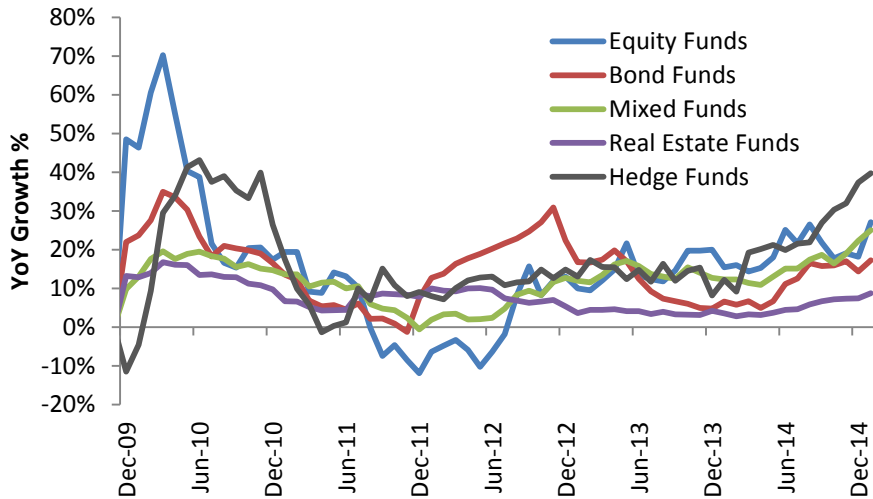
Capital Charges	Rating	Eurozone	US*	EM - Local Currency*	EM - Foreign Currency*
Govt Bond	A - AAA	0.0%	0-5.5%	0-5.5%	4.5-7.0%
	BBB	0.0%	7.0%	7.0%	12.5%
Corp Bond	A - AAA	4.5-7.0%	4.5-7.0%	4.5-7.0%	4.5-7.0%
	BBB	12.5%	12.5%	12.5%	12.5%
Equity		39.0%	39.0%	39.0%	39.0%

\* Assume FX hedged, otherwise 25% charge for currency mismatch

Source: EIOPA

## Investment Implications

### Investment Fund Size YoY Growth



### Investment Universe

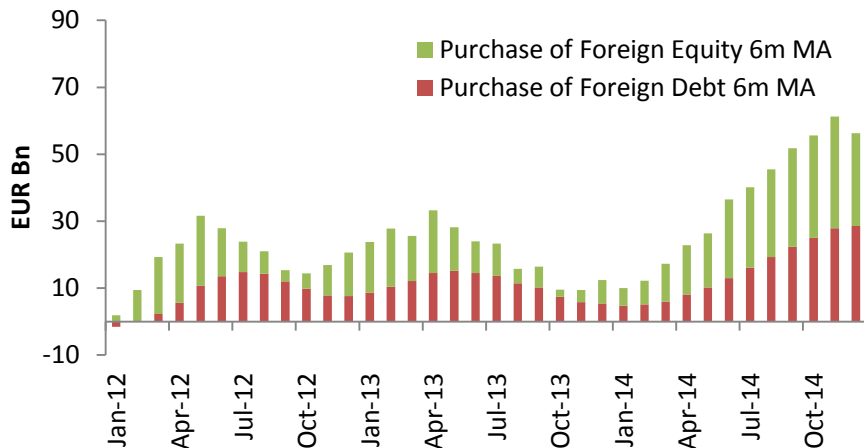
Yield	Rating	Current	2013	2010
Govt Bond	A or above	0.4%	1.5%	3.4%
	BBB- or above	0.8%	2.3%	3.6%
Corp Bond	A or above	0.9%	2.0%	3.6%
	BBB or above	1.1%	2.3%	4.0%
Equity *		3.0%	3.6%	3.3%

\* Dividend yield

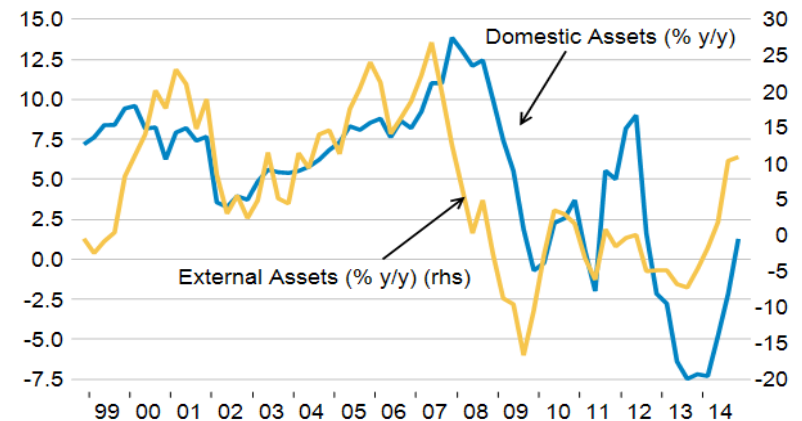
Size (EUR Bn)	Rating	Current	2013	2010
Govt Bond	A or above	3,653	3,063	3,964
	BBB- or above	5,783	4,830	3,990
Corp Bond	A or above	917	857	997
	BBB or above	1,573	1,374	1,344
Equity *		8,744	7,396	6,712

\* MSCI Europe Market Cap

### Eurozone Investors' Purchase of Foreign Assets

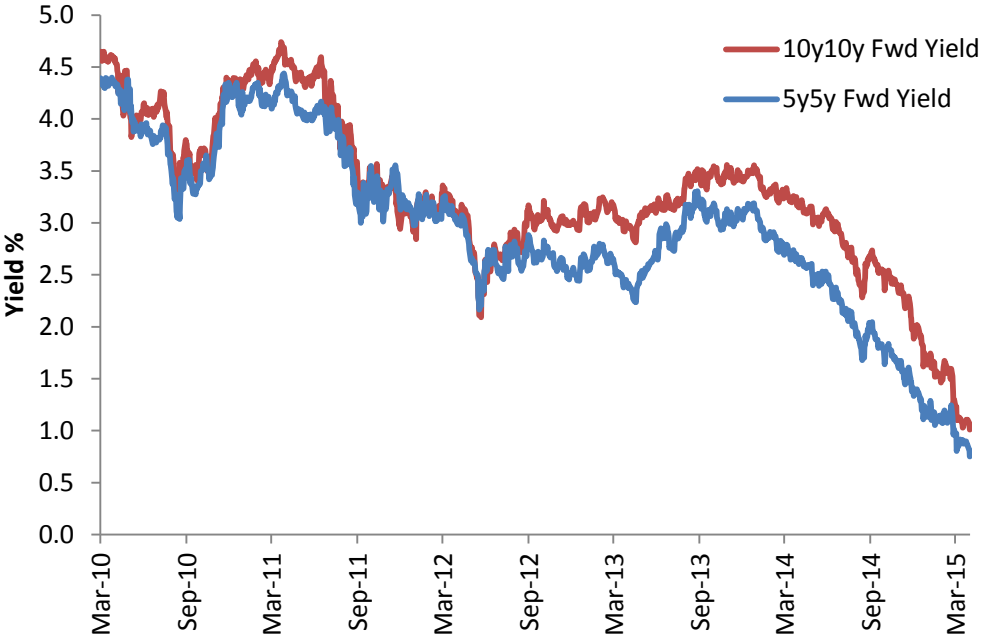


### Banks' External Asset Growth



# Investment Implications

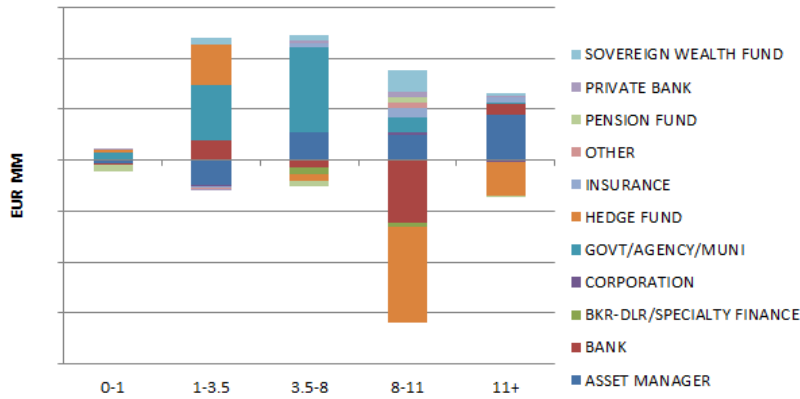
### Forward Yields



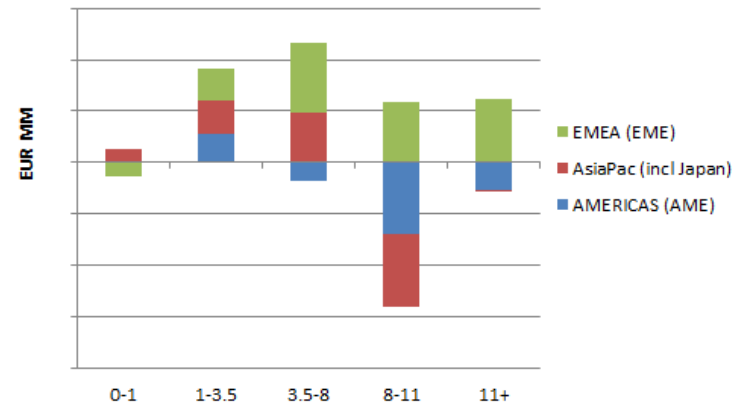
Source: Morgan Stanley Sales & Trading

## Investor Net Buying/Selling Flow

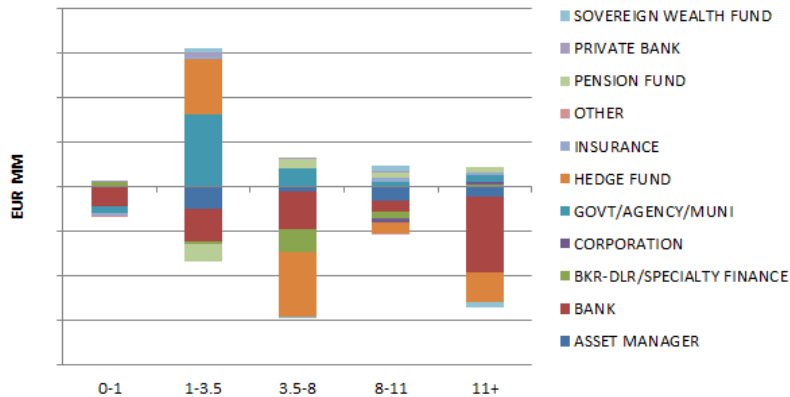
Overall Net Flow Jan 22 to Mar8



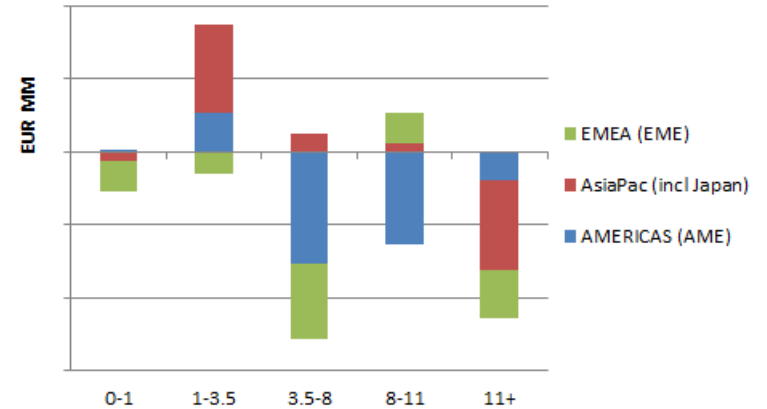
Overall Net Flow Jan22 to Mar8



Overall Net Flow Since QE



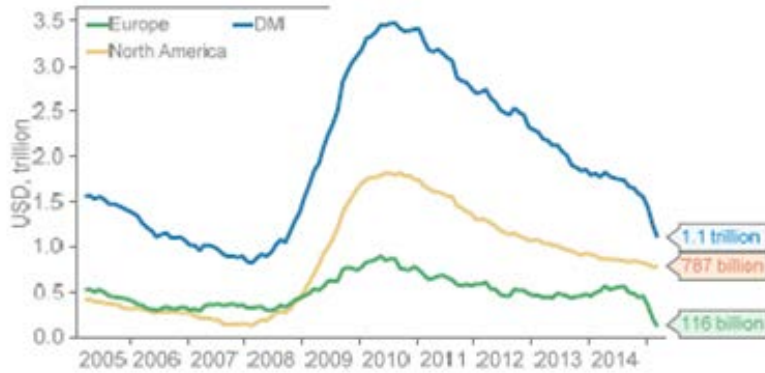
Overall Net Flow Since QE





## Appendix

**Sovereigns: G10 + EU 12M Net Issuance**



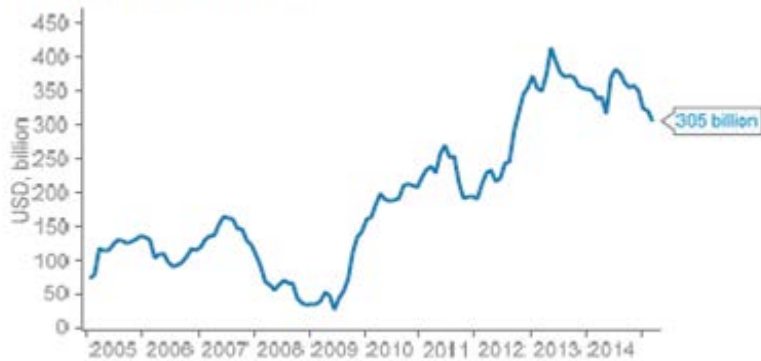
Source: Dealogic, Macrobond, Morgan Stanley Research

**DM IG Trailing 12M Net Issuance**



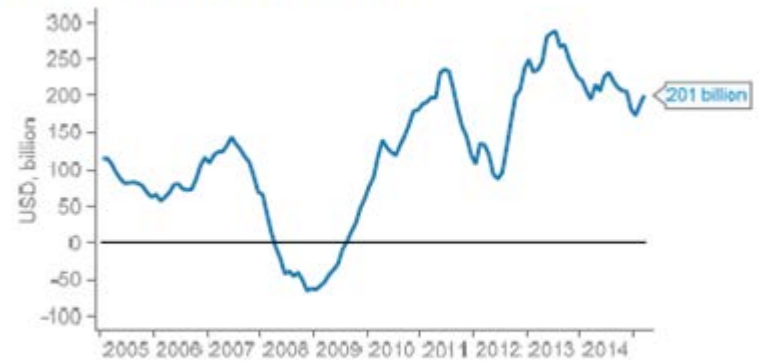
Source: Dealogic, Macrobond, Morgan Stanley Research

**EM Trailing 12M Net Issuance**



Source: Dealogic, Macrobond, Morgan Stanley Research

**DM HY Trailing 12M Net Issuance**



Source: Dealogic, Macrobond, Morgan Stanley Research

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