

April, 2015

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

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%

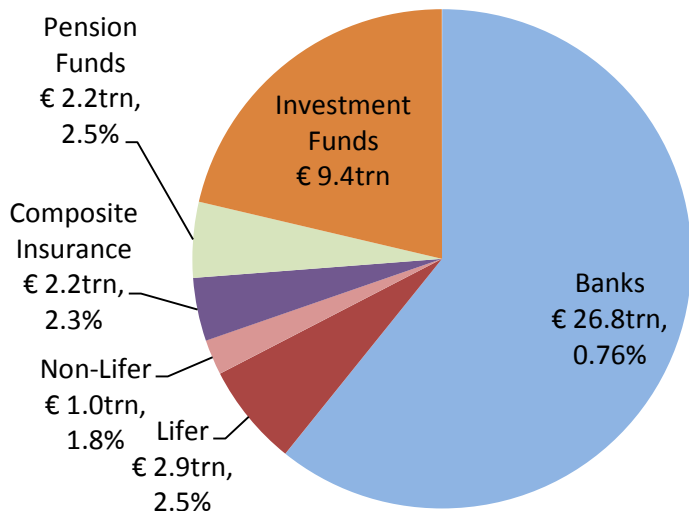
European “natural habitat” in fixed income assets unlikely to change

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

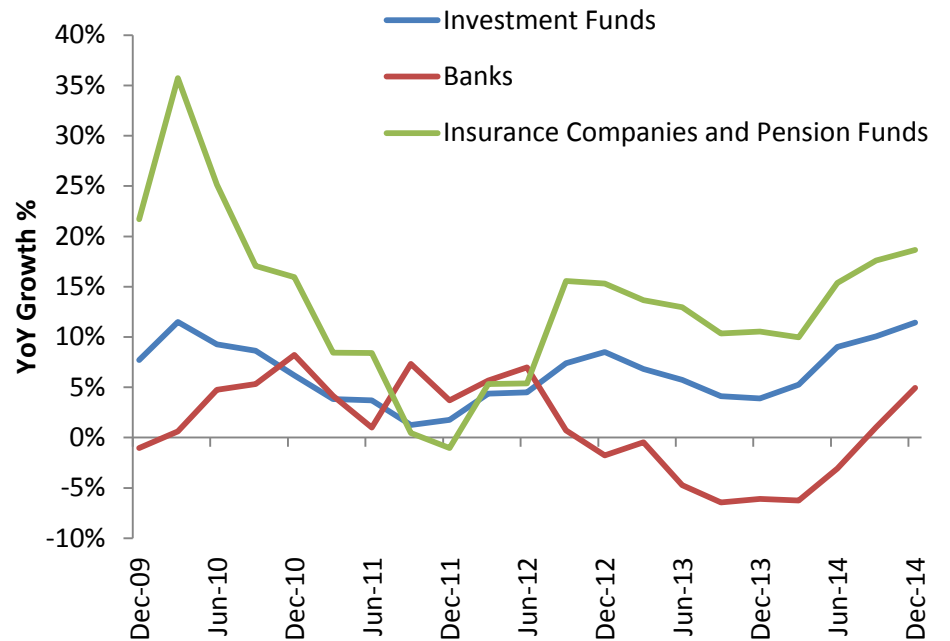
Structure of Eurozone Financial System

- 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

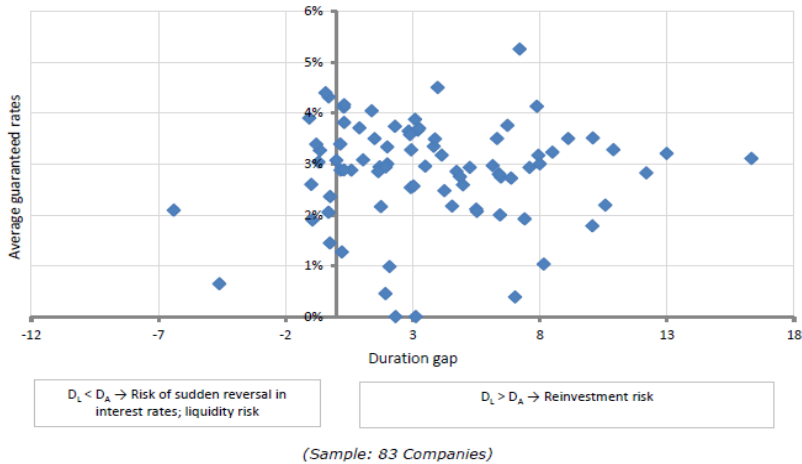


Banks: Lending Profitability Scenarios

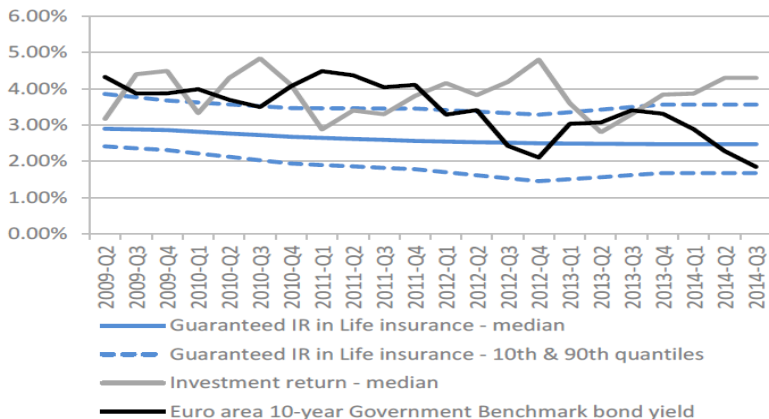
	1.5	2.0	2.5	2.5	3.0	3.5	4.0
Lending Rate	1.5	2.0	2.5	2.5	3.0	3.5	4.0
Funding cost	0.9	0.9	0.9	0.05	0.9	0.9	0.9
Operating cost	0.8	1.1	1.4	1.4	1.7	1.9	2.2
Pre tax	-0.2	0.0	0.2	1.1	0.5	0.7	0.9
Tax	-0.1	0.0	0.1	0.3	0.1	0.2	0.3
Allocated capital	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Net income	-0.2	0.0	0.2	0.8	0.3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

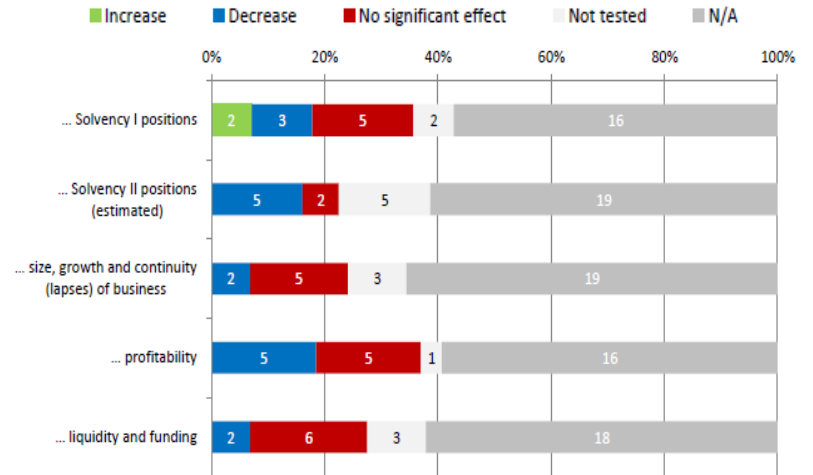


Life Insurance Guaranteed Rate vs Investment Return, Euro area Govt bond Yield



Source: EIOPA

Impact of Low Interest Rate Environment on Key Indicators



Capital Charges for Each Asset Class

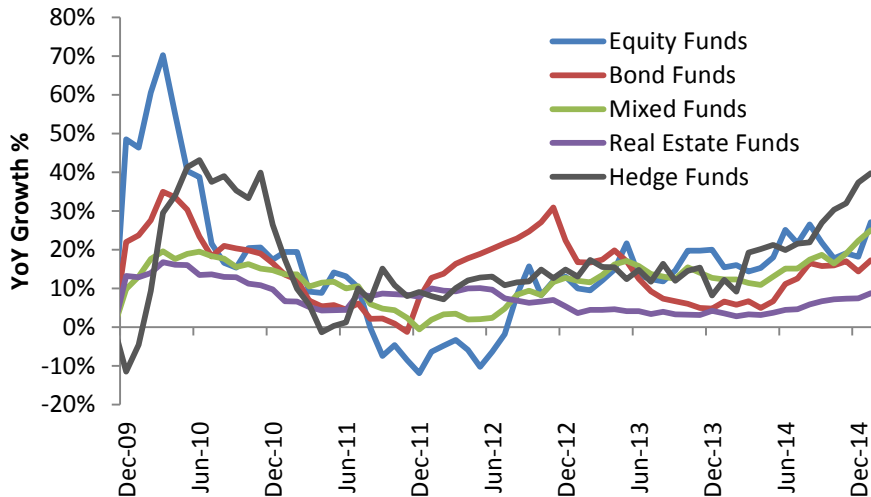
Capital Charges	Rating	Eurozone	US*	EM - Local Currency*	EM - Foreign Currency*
Govt Bond	A - AAA	0.0%	0-5.5%	0-5.5%	4.5-7.0%
	BBB	0.0%	7.0%	7.0%	12.5%
Corp Bond	A - AAA	4.5-7.0%	4.5-7.0%	4.5-7.0%	4.5-7.0%
	BBB	12.5%	12.5%	12.5%	12.5%
Equity		39.0%	39.0%	39.0%	39.0%

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

Source: EIOPA

Investment Implications

Investment Fund Size YoY Growth



Investment Universe

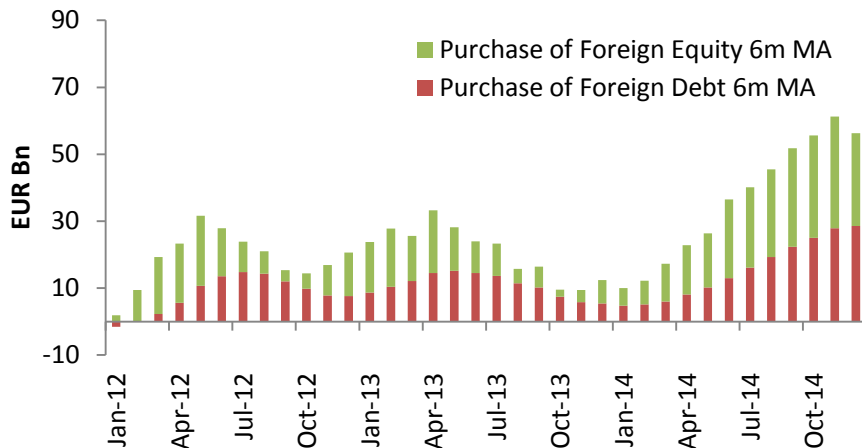
Yield	Rating	Current	2013	2010
Govt Bond	A or above	0.4%	1.5%	3.4%
	BBB- or above	0.8%	2.3%	3.6%
Corp Bond	A or above	0.9%	2.0%	3.6%
	BBB or above	1.1%	2.3%	4.0%
Equity *		3.0%	3.6%	3.3%

* Dividend yield

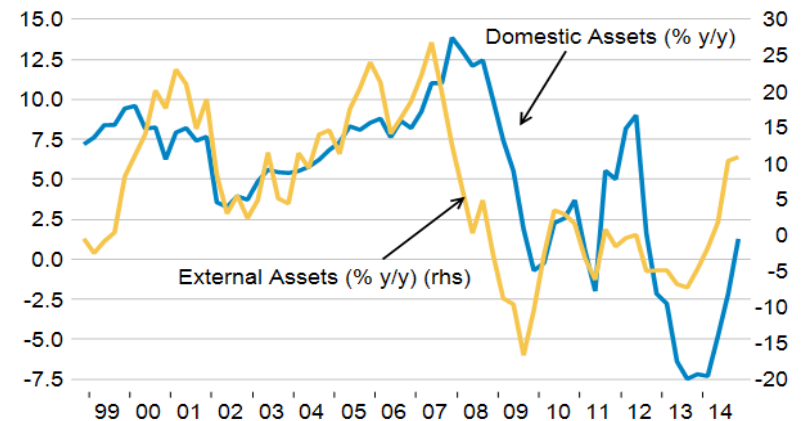
Size (EUR Bn)	Rating	Current	2013	2010
Govt Bond	A or above	3,653	3,063	3,964
	BBB- or above	5,783	4,830	3,990
Corp Bond	A or above	917	857	997
	BBB or above	1,573	1,374	1,344
Equity *		8,744	7,396	6,712

* MSCI Europe Market Cap

Eurozone Investors' Purchase of Foreign Assets



Banks' External Asset Growth



Investment Implications

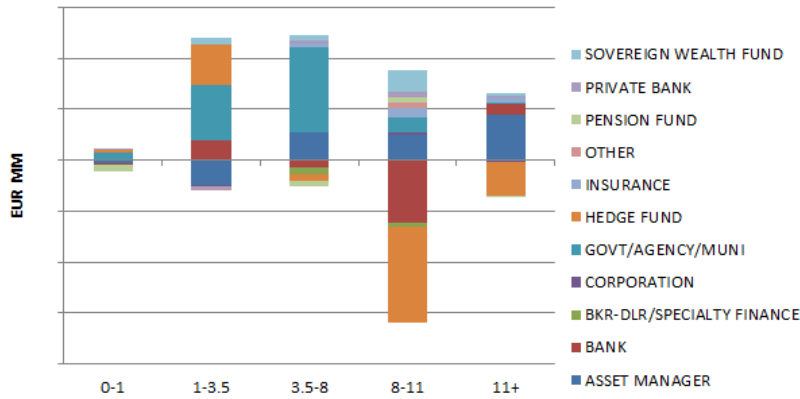
Forward Yields



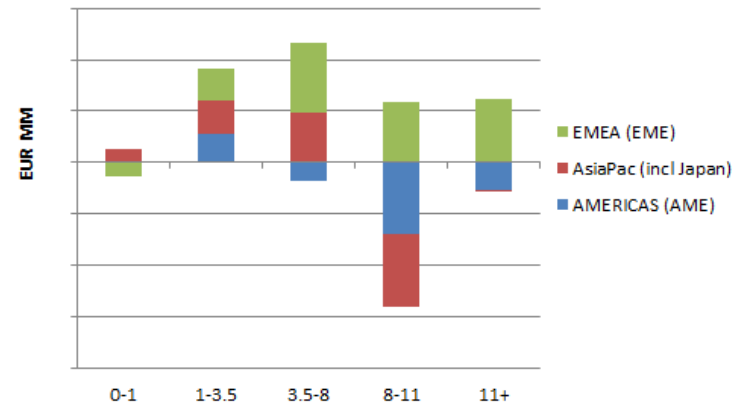
Source: Morgan Stanley Sales & Trading

Investor Net Buying/Selling Flow

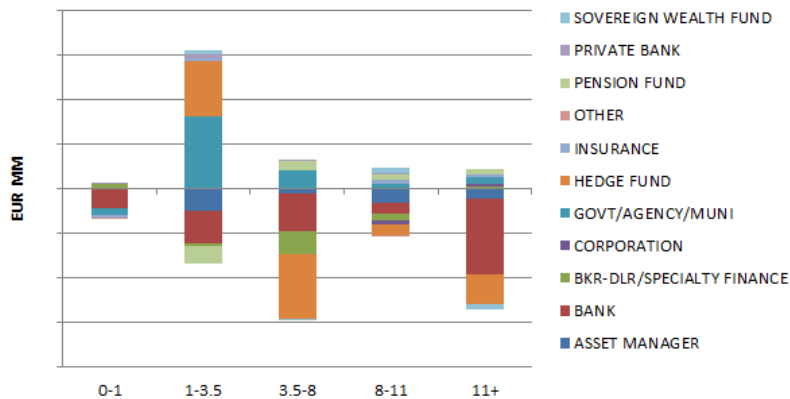
Overall Net Flow Jan 22 to Mar8



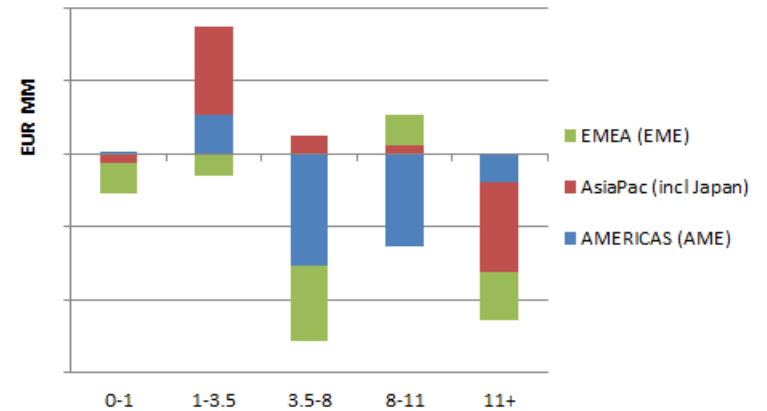
Overall Net Flow Jan22 to Mar8



Overall Net Flow Since QE

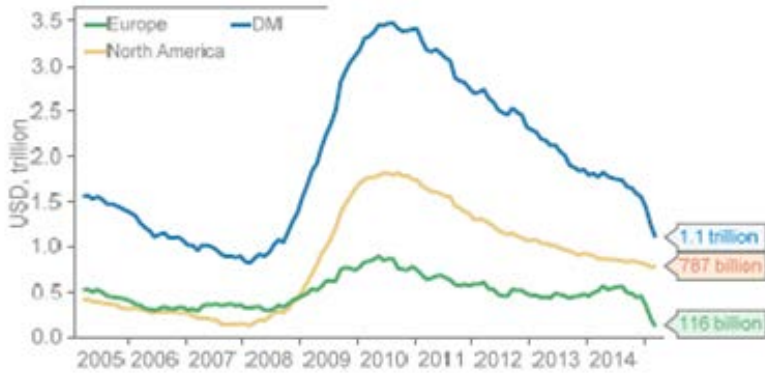


Overall Net Flow Since QE



Appendix

Sovereigns: G10 + EU 12M Net Issuance



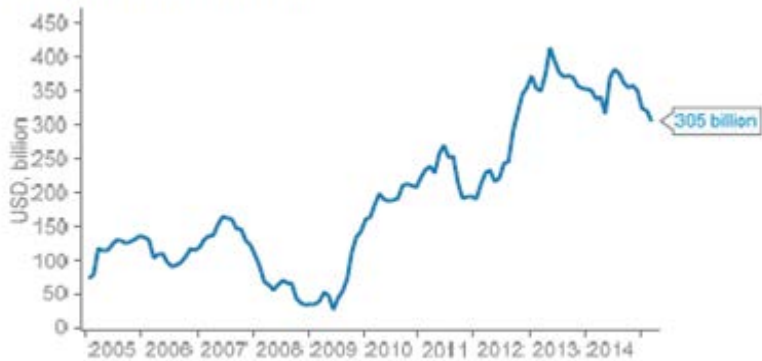
Source: Dealogic, Macrobond, Morgan Stanley Research

DM IG Trailing 12M Net Issuance



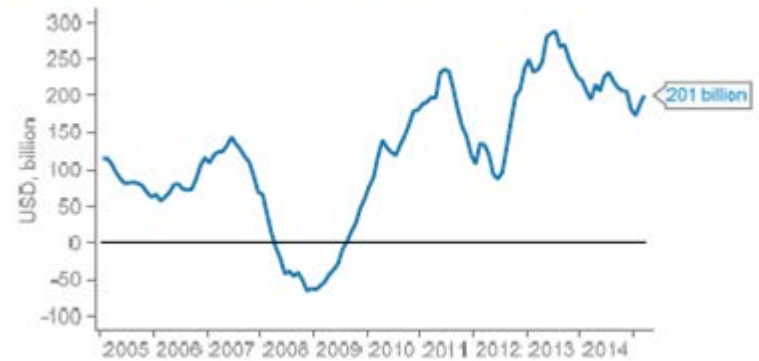
Source: Dealogic, Macrobond, Morgan Stanley Research

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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