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**

| Source: ECB, Morgan Stanley Sales & Trading | Source: ECB, Bloomberg, Morgan Stanley Sales & Trading |

<table>
<thead>
<tr>
<th></th>
<th>1.5</th>
<th>2.0</th>
<th>2.5</th>
<th>2.5</th>
<th>3.0</th>
<th>3.5</th>
<th>4.0</th>
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<tbody>
<tr>
<td>Lending Rate</td>
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<tr>
<td>Funding cost</td>
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<td>0.9</td>
<td>(0.9</td>
<td>0.05</td>
<td>0.9</td>
<td>0.9</td>
<td>0.9</td>
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<tr>
<td>Operating cost</td>
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<td>1.1</td>
<td>1.4</td>
<td>1.4</td>
<td>1.7</td>
<td>1.9</td>
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<tr>
<td>Pre tax</td>
<td>-0.2</td>
<td>0.0</td>
<td>0.2</td>
<td>1.1</td>
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<td>0.9</td>
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<td>0.0</td>
<td>0.1</td>
<td>0.3</td>
<td>0.1</td>
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<td>Allocated capital</td>
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<td>Net income</td>
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<td>0.2</td>
<td>0.8</td>
<td>0.3</td>
<td>0.5</td>
<td>0.6</td>
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<td>ROE</td>
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<td>3.2</td>
<td>15.1</td>
<td>6.3</td>
<td>9.5</td>
<td>12.6</td>
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</table>
The Low Yield Environment – Insurance Companies

Impact of Low Interest Rate Environment on Key Indicators

Capital Charges for Each Asset Class

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

Source: EIOPA
Investment Implications

Investment Fund Size YoY Growth

Investment Universe

<table>
<thead>
<tr>
<th>Yield</th>
<th>Rating</th>
<th>Current</th>
<th>2013</th>
<th>2010</th>
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<tr>
<td>Govt Bond</td>
<td>A or above</td>
<td>0.4%</td>
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<td>3.4%</td>
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<tr>
<td></td>
<td>BBB- or above</td>
<td>0.8%</td>
<td>2.3%</td>
<td>3.6%</td>
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<tr>
<td>Corp Bond</td>
<td>A or above</td>
<td>0.9%</td>
<td>2.0%</td>
<td>3.6%</td>
</tr>
<tr>
<td></td>
<td>BBB or above</td>
<td>1.1%</td>
<td>2.3%</td>
<td>4.0%</td>
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<tr>
<td>Equity *</td>
<td></td>
<td>3.0%</td>
<td>3.6%</td>
<td>3.3%</td>
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</tbody>
</table>

* Dividend yield

<table>
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<th>Size (EUR Bn)</th>
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<th>2013</th>
<th>2010</th>
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<td>3,063</td>
<td>3,964</td>
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<td>BBB- or above</td>
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<td>917</td>
<td>857</td>
<td>997</td>
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<tr>
<td></td>
<td>BBB or above</td>
<td>1,573</td>
<td>1,374</td>
<td>1,344</td>
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<tr>
<td>Equity *</td>
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<td>8,744</td>
<td>7,396</td>
<td>6,712</td>
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* MSCI Europe Market Cap

Eurozone Investors’ Purchase of Foreign Assets

Banks’ External Asset Growth

Source: ECB, DataStream

Source: Iboxx, DataStream, Morgan Stanley Sales & Trading
Investment Implications

Forward Yields

Source: Morgan Stanley Sales & Trading
Investor Net Buying/Selling Flow

Overall Net Flow Jan 22 to Mar8

Overall Net Flow Since QE

Overall Net Flow Jan22 to Mar8

Overall Net Flow Since QE

Source: Morgan Stanley Sales & Trading
Appendix
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