

The yin and yang of yields

The rapid rise in bond yields of the last few months signals a welcome normalization of inflation expectations, and not mounting fears of rampant inflation. As economic activity stabilizes and financial market stress drops back to pre-Lehman levels, inflation expectations of about 2% should come as a relief to both investors and central bankers. Markets however have over-reacted, and are pricing an unrealistically prompt tightening of monetary policy in both the US and Europe. I believe both the Fed and the ECB will remain on hold for another twelve months, but it will be an anxious wait, and bond markets are in for a rough and bumpy ride. The short end of the curve looks most vulnerable to both an early correction and higher volatility; the long-end will correct further as markets take a more sober view of the recovery, but supply concerns will keep a solid floor under long-term yields. Indeed, I remain convinced that the definition of an exit strategy is most urgently needed on fiscal policy. This weekend's G8 might set the stage, but we need to see concrete decisions at the national levels. As we enter 2010, the key challenge will be to position at the right time for what promises to be a marked bear flattening, as central banks will have a lot whole of hiking to do once they break the impasse, while long term growth and inflation prospects will remain subdued.

The rapid rise in bond yields of the last few months has generated an intense and at times confusing debate on its causes and possible consequences: some see it as confirmation that loose monetary policy is laying the ground for a burst of inflation, some worry instead that it might nip the fragile recovery in the bud. Views on how the Fed and the ECB are likely to react are equally polarized. In this note I briefly summarize our view, which is discussed in greater detail in some of the publications we issued this week.

First: while the surge in long-term bond yields has been driven largely by a rise in inflation expectations, both signal a reassuring normalization rather than fears of runaway inflation. US inflation expectations as measured by break-even (BE) rates have climbed to 200bp, but starting from expectations of zero inflation or deflation at the start of the year. An inflation rate of 2% means price stability, not rampant inflation. In fact, inflation expectations are now back to the average of the last five years (based on 5Y 5Y forwards BE) or still a bit below (based on 10Y BE, see the note by my colleague Harm Bandholz in today's Friday Notes). This to me is fully consistent with the signs of stabilization in the real economy, with the alleviation of stress in financial markets which has brought most indicators down to pre-Lehman levels, and with the attendant pick up in risk appetite.

Second, in line with this, I do not see the rise in bond yields as a significant threat to the recovery at this stage. At current levels of below 4.0% (about 3.80% at the time of writing), 10Y UST yields are low by historical standards and broadly in line with levels prevailing last year, when the worst of the recession still lay ahead. While a sustained further rise would put undesired upward pressure on mortgage costs, current levels do not see to pose a serious threat to the much-needed stabilization of the housing market.

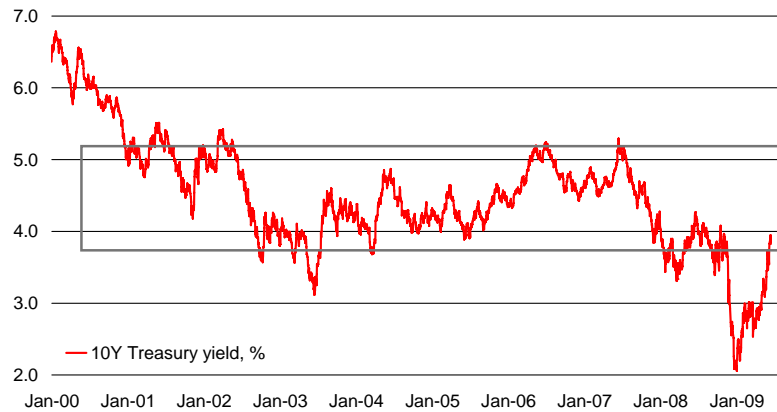
Marco Annunziata

Chief Economist - UniCredit Group
Head of Global Economics & FI/FX Research
+44 20 7826-1770
marco.annunziata@unicreditgroup.co.uk

Bloomberg
UCGR, UCFR

Internet
www.globalresearch.unicreditmib.eu

10Y UST YIELD HAS RISEN, BUT REMAINS LOW BY HISTORICAL STANDARDS

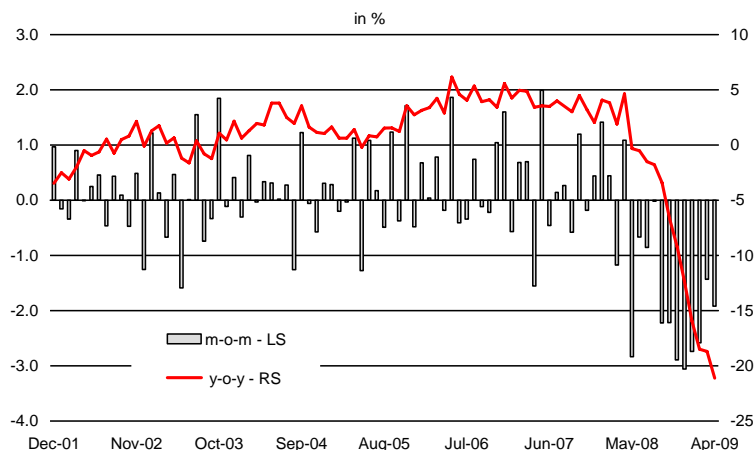


Source: Bloomberg, UniCredit Research

I therefore do not believe that the Fed will try to counteract the rise in yields by stepping up its UST purchases: barring a sudden renewed downturn in economic activity, normalization in bond yields can actually facilitate the transition towards an eventual “exit strategy”, whereas stepping up liquidity injections at this stage would risk fueling a counterproductive debate on inflation risks. Similarly, I think some further upward drift in eurozone bond yields would dovetail nicely with the ECB’s current wait-and-see attitude: policy rates on hold, and the covered bonds asset purchase program unfolding as announced without any extensions in amount or range of eligible assets.

Markets are now pricing an implausibly early tightening of monetary policy in both the US and Europe. Fed futures signal a 60% probability of a first Fed rate hike by the end of this year, and the eurozone OIS curve is pricing a first ECB hike in April next year. Green shoots, inflation fears, and the debate on exit strategies are all focusing investors’ attention on the next turn in the monetary policy cycle—and central bankers are certainly conscious of the risks of keeping rates too low for too long. On the other hand, however, both policymakers and investors need to be mindful of the fragility of the recovery. Disappointing eurozone industrial production data released today came as a cold shower; US housing data remain worryingly weak; unemployment continues to climb on both sides of the Atlantic; there is serious skepticism on the consumption stamina of US households; and some concern remains on the health of the financial system. This is more than enough to remind central bankers of the risks of premature tightening.

EUROZONE: IP DISAPPOINTS ONCE AGAIN

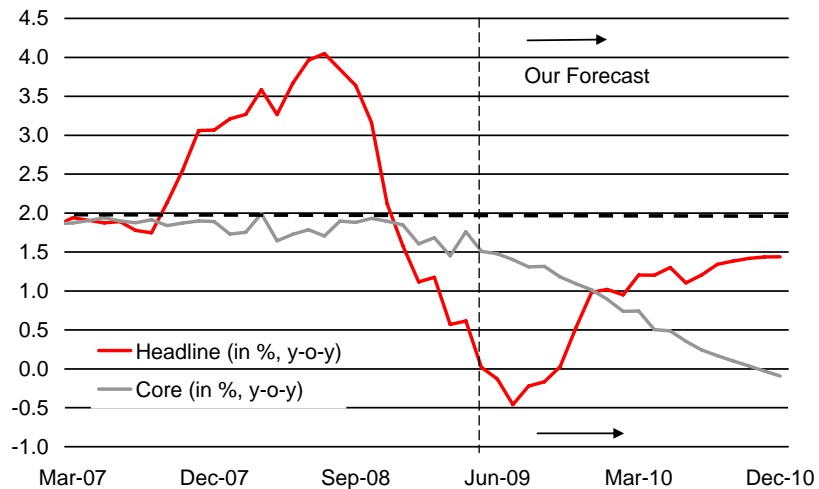


Source: Eurostat, UniCredit Research

I do not expect the Fed will hike before summer next year. My colleague Harm Bandholz points out that the shortest lag between the peak of the US unemployment rate and the start of a Fed tightening cycle has been twelve months. The Fed might well move sooner this time, but a hike in 2009 still seems highly unlikely. The first key tell-tale sign will be the deletion from the FOMC statement of the commitment to keep rates low “for an extended period”; once that happens, we should be within six months of the first rate hike, based in the 2004 experience (again, see Harm’s above-mentioned piece).

The ECB seems to have more of an itchy trigger finger, but a precautionary strike à la Weber would be both controversial and dangerous. I still expect the European recovery to be especially sluggish, and that the output gap will continue to cool down core inflation sufficiently to keep inflation risks off the table for the next 18-24 months. This is in line with the ECB’s own forecast and with Mr. Trichet’s cautious assessment of the signs of economic stabilization. Therefore, I do not expect an ECB rate hike before H2 2010.

EUROZONE - THE INFLATION OUTLOOK DOES NOT WORRY FOR NOW



Source: Eurostat, UniCredit Research

While central banks will remain anxiously on hold, bond markets are in for a very bumpy ride. Long term yields should correct from recent peaks as investors take a more prudent view of the recovery, but concerns about soaring fiscal deficits will prevent any major rally: we do not see 10Y USTs and 10Y Bunds moving below 3.50% and 3.30% respectively. The short end looks much more vulnerable to a correction and to continued volatility, as central banks continue to weigh the arguments pro and against tightening. As we think that rate hikes expectations are overdone, yield curves will remain steep in the coming months. As we enter into next year, however, we should gradually position for a strong bear flattening, as central banks will have a lot of rate hiking to do, while prospects for longer term growth and inflation should remain moderate. (see a more detailed discussions in the pieces by Luca Cazzulani and Giuseppe Maraffino in our latest Euro Compass, and by Kornelius Purps in today’s upcoming Curves & Crosses).

Disclaimer

Our recommendations are based on information obtained from, or are based upon public information sources that we consider to be reliable but for the completeness and accuracy of which we assume no liability. All estimates and opinions included in the report represent the independent judgment of the analysts as of the date of the issue. We reserve the right to modify the views expressed herein at any time without notice. Moreover, we reserve the right not to update this information or to discontinue it altogether without notice.

This analysis is for information purposes only and (i) does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any financial, money market or investment instrument or any security, (ii) is neither intended as such an offer for sale or subscription of or solicitation of an offer to buy or subscribe for any financial, money market or investment instrument or any security nor (iii) as an advertisement thereof. The investment possibilities discussed in this report may not be suitable for certain investors depending on their specific investment objectives and time horizon or in the context of their overall financial situation. The investments discussed may fluctuate in price or value. Investors may get back less than they invested. Changes in rates of exchange may have an adverse effect on the value of investments. Furthermore, past performance is not necessarily indicative of future results. In particular, the risks associated with an investment in the financial, money market or investment instrument or security under discussion are not explained in their entirety.

This information is given without any warranty on an "as is" basis and should not be regarded as a substitute for obtaining individual advice. Investors must make their own determination of the appropriateness of an investment in any instruments referred to herein based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial position. As this document does not qualify as an investment recommendation or as a direct investment recommendation, neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever. Investors are urged to contact their bank's investment advisor for individual explanations and advice.

Neither Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, Bayerische Hypo- und Vereinsbank AG Milan Branch, UniCredit CAIB Securities UK Ltd. and UniCredit Aton, nor any of their respective directors, officers or employees nor any other person accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

This analysis is being distributed by electronic and ordinary mail to professional investors, who are expected to make their own investment decisions without undue reliance on this publication, and may not be redistributed, reproduced or published in whole or in part for any purpose.

Responsibility for the content of this publication lies with:

a) Bayerische Hypo- und Vereinsbank AG, Am Tucherpark 16, 80538 Munich, Germany, (also responsible for the distribution pursuant to §34b WpHG). The company belongs to UCI Group.

Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany.

b) Bayerische Hypo- und Vereinsbank AG Milan Branch, Via Tommaso Grossi, 10, 20121 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.

Regulatory authority: "Bank of Italy", Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany.

The UniCredit CAIB Group, consisting of

c) UniCredit CAIB AG, Julius-Tandler-Platz 3, 1090 Vienna, Austria

Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Praterstrasse 23, 1020 Vienna, Austria

d) UniCredit CAIB Securities UK Ltd., Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom

Regulatory authority: Financial Services Authority (FSA), 25 The North Colonnade, Canary Wharf, London E14 5HS, United Kingdom

e) UniCredit Aton, Boulevard Ring Office Building, 17/1 Chistoprudni Boulevard, Moscow 101000, Russia

Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

POTENTIAL CONFLICTS OF INTEREST

Bayerische Hypo- und Vereinsbank AG acts as a Specialist or Primary Dealer in government bonds issued by the Italian, Portuguese and Greek Treasury. Main tasks of the Specialist are to participate with continuity and efficiency to the governments' securities auctions, to contribute to the efficiency of the secondary market through market making activity and quoting requirements and to contribute to the management of public debt and to the debt issuance policy choices, also through advisory and research activities.

ANALYST DECLARATION

The author's remuneration has not been, and will not be, geared to the recommendations or views expressed in this study, neither directly nor indirectly.

ORGANIZATIONAL AND ADMINISTRATIVE ARRANGEMENTS TO AVOID AND PREVENT CONFLICTS OF INTEREST

To prevent or remedy conflicts of interest, Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, UniCredit CAIB Securities UK Ltd., Bayerische Hypo- und Vereinsbank AG Milan Branch and UniCredit Aton have established the organizational arrangements required from a legal and supervisory aspect, adherence to which is monitored by its compliance department. Conflicts of interest arising are managed by legal and physical and non-physical barriers (collectively referred to as "Chinese Walls") designed to restrict the flow of information between one area/department of Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, UniCredit CAIB Securities UK Ltd., Bayerische Hypo- und Vereinsbank AG Milan Branch and UniCredit Aton and another. In particular, Investment Banking units, including corporate finance, capital market activities, financial advisory and other capital raising activities, are segregated by physical and non-physical boundaries from Markets Units, as well as the research department. In the case of equities execution by Bayerische Hypo- und Vereinsbank AG Milan Branch, other than as a matter of client facilitation or delta hedging of OTC and listed derivative positions, there is no proprietary trading. Disclosure of publicly available conflicts of interest and other material interests is made in the research. Analysts are supervised and managed on a day-to-day basis by line managers who do not have responsibility for Investment Banking activities, including corporate finance activities, or other activities other than the sale of securities to clients.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

Notice to Austrian investors

This document does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any securities and neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever.

This document is confidential and is being supplied to you solely for your information and may not be reproduced, redistributed or passed on to any other person or published, in whole or part, for any purpose.

Notice to Czech investors

This report is intended for clients of Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, UniCredit CAIB Securities UK Ltd. or Bayerische Hypo- und Vereinsbank AG Milan Branch in the Czech Republic and may not be used or relied upon by any other person for any purpose.

Notice to Italian investors

This document is not for distribution to retail clients as defined in article 26, paragraph 1(e) of Regulation n. 16190 approved by CONSOB on October 29, 2007.

In the case of a short note, we invite the investors to read the related company report that can be found on UniCredit Research website www.globalresearch.unicreditimib.eu.

Notice to Russian investors

As far as we are aware, not all of the financial instruments referred to in this analysis have been registered under the federal law of the Russian Federation "On the Securities Market" dated April 22, 1996, as amended, and are not being offered, sold, delivered or advertised in the Russian Federation.

Notice to Turkish investors

Investment information, comments and recommendations stated herein are not within the scope of investment advisory activities. Investment advisory services are provided in accordance with a contract of engagement on investment advisory services concluded with brokerage houses, portfolio management companies, non-deposit banks and the clients. Comments and recommendations stated herein rely on the individual opinions of the ones providing these comments and recommendations. These opinions may not suit your financial status, risk and return preferences. For this reason, to make an investment decision by relying solely on the information stated here may not result in consequences that meet your expectations.

Notice to Investors in Japan

This document does not constitute or form part of any offer for sale or subscription for or solicitation of any offer to buy or subscribe for any securities and neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever.

Notice to UK investors

This communication is directed only at clients of Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, UniCredit CAIB Securities UK Ltd. or Bayerische Hypo- und Vereinsbank AG Milan Branch who (i) have professional experience in matters relating to investments or (ii) are persons falling within Article 49(2)(a) to (d) ("high net worth companies, unincorporated associations, etc.") of the United Kingdom Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 or (iii) to whom it may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This communication must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this communication relates is available only to relevant persons and will be engaged in only with relevant persons.

Notice to U.S. investors

This report is being furnished to U.S. recipients in reliance on Rule 15a-6 ("Rule 15a-6") under the U.S. Securities Exchange Act of 1934, as amended. Each U.S. recipient of this report represents and agrees, by virtue of its acceptance thereof, that it is such a "major U.S. institutional investor" (as such term is defined in Rule 15a-6) and that it understands the risks involved in executing transactions in such securities. Any U.S. recipient of this report that wishes to discuss or receive additional information regarding any security or issuer mentioned herein, or engage in any transaction to purchase or sell or solicit or offer the purchase or sale of such securities, should contact a registered representative of UniCredit Capital Markets, Inc. ("UCI Capital Markets").

Any transaction by U.S. persons (other than a registered U.S. broker-dealer or bank acting in a broker-dealer capacity) must be effected with or through UCI Capital Markets.

The securities referred to in this report may not be registered under the U.S. Securities Act of 1933, as amended, and the issuer of such securities may not be subject to U.S. reporting and/or other requirements. Available information regarding the issuers of such securities may be limited, and such issuers may not be subject to the same auditing and reporting standards as U.S. issuers.

The information contained in this report is intended solely for certain "major U.S. institutional investors" and may not be used or relied upon by any other person for any purpose. Such information is provided for informational purposes only and does not constitute a solicitation to buy or an offer to sell any securities under the Securities Act of 1933, as amended, or under any other U.S. federal or state securities laws, rules or regulations. The investment opportunities discussed in this report may be unsuitable for certain investors depending on their specific investment objectives, risk tolerance and financial position. In jurisdictions where UCI Capital Markets is not registered or licensed to trade in securities, commodities or other financial products, transactions may be executed only in accordance with applicable law and legislation, which may vary from jurisdiction to jurisdiction and which may require that a transaction be made in accordance with applicable exemptions from registration or licensing requirements.

The information in this publication is based on carefully selected sources believed to be reliable, but UCI Capital Markets does not make any representation with respect to its completeness or accuracy. All opinions expressed herein reflect the author's judgment at the original time of publication, without regard to the date on which you may receive such information, and are subject to change without notice.

UCI Capital Markets may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. These publications reflect the different assumptions, views and analytical methods of the analysts who prepared them. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is provided in relation to future performance.

UCI Capital Markets and any company affiliated with it may, with respect to any securities discussed herein: (a) take a long or short position and buy or sell such securities; (b) act as investment and/or commercial bankers for issuers of such securities; (c) act as market makers for such securities; (d) serve on the board of any issuer of such securities; and (e) act as paid consultant or advisor to any issuer.

The information contained herein may include forward-looking statements within the meaning of U.S. federal securities laws that are subject to risks and uncertainties. Factors that could cause a company's actual results and financial condition to differ from expectations include, without limitation: political uncertainty, changes in general economic conditions that adversely affect the level of demand for the company's products or services, changes in foreign exchange markets, changes in international and domestic financial markets and in the competitive environment, and other factors relating to the foregoing. All forward-looking statements contained in this report are qualified in their entirety by this cautionary statement

This document may not be distributed in Canada or Australia.

UniCredit Research*

Thorsten Weinelt, CFA
Global Head of Research & Chief Strategist
+49 89 378-15110
thorsten.weinelt@unicreditgroup.de

Dr. Ingo Heimig
Head of Research Operations
+49 89 378-13952
ingo.heimig@unicreditgroup.de

Economics & FI/FX Research

Marco Annunziata, Ph.D.,
Chief Economist
+44 20 7826-1770
marco.annunziata@unicreditgroup.co.uk

Economics & Commodity Research

Global Economics

Dr. Davide Stroppa, Global Economist
+39 02 8862-2890
davide.stroppa@unicreditgroup.de

European Economics

Aurelio Maccario, Chief Eurozone Economist
+39 02 8862-8222
aurelio.maccario@unicreditgroup.de

Andreas Rees, Chief German Economist
+49 89 378-12576
andreas.rees@unicreditgroup.de

Marco Valli, Chief Italian Economist
+39 02 8862-8688
marco.valli@unicreditgroup.de

Tullia Bucco
+39 02 8862-2079
tullia.bucco@unicreditgroup.de

Chiara Corsa
+39 02 8862-2209
chiara.corsa@unicreditgroup.de

Alexander Koch
+49 89 378-13013
alexander.koch1@unicreditgroup.de

Chiara Silvestre
chiara.silvestre@unicreditgroup.de

US Economics

Roger M. Kubarych, Chief US Economist
+1 212 672-5668
roger.kubarych@us.unicreditgroup.eu

Dr. Harm Bandholz
+1 212 672 5957
harm.bandholz@us.unicreditgroup.eu

Commodity Research

Jochen Hitzfeld
+49 89 378-18709
jochen.hitzfeld@unicreditgroup.de

Nikolaus Keis
+49 89 378-12560
nikolaus.keis@unicreditgroup.de

EEMEA Economics & FI/FX Strategy

Martin Blum, Head
+43 50505-82363
martin.blum@caib.unicreditgroup.eu

Dmitry Gourou
+43 50505-82364
dmitry.gourou@caib.unicreditgroup.eu

Vladimir Osakovsky, Ph.D.
+7 495 777 8877 3139
vladimir.osakovsky@unicreditaton.ru

Goran Šaravanja
+385 1 6006 678
goran.saravanja@unicreditgroup.zaba.hr

Pavel Sobisek
+420 2 211 12504
pavel.sobisek@unicreditgroup.cz

Thomas Steiner
+43 50505-82361
thomas.steiner1@unicreditgroup.at

Gyula Toth
+43 50505-82362
gyula.toth@caib.unicreditgroup.eu

Global FI/FX Strategy

Michael Rottmann, Head
+49 89 378-15121
michael.rottmann1@unicreditgroup.de

Dr. Luca Cazzulani, FI Strategy
+39 02 8862-0640
luca.cazzulani@unicreditgroup.de

Chiara Cremonesi, FI Strategy
+44 20 7826 1771
chiara.cremonesi@unicreditgroup.co.uk

Giuseppe Maraffino, FI Strategy
+39 02 8862-2027
giuseppe.maraffino@unicreditgroup.de

Armin Mekelburg, FX Strategy
+49 89 378-14307
armin.mekelburg@unicreditgroup.de

Roberto Mialich, FX Strategy
+39 02 8862-0658
roberto.mialich@unicreditgroup.de

Kornelius Purps, FI Strategy
+49 89 378-12753
kornelius.purps@unicreditgroup.de

Herbert Stocker, Technical Analysis
+49 89 378-14305
herbert.stocker@unicreditgroup.de

Publication Address

UniCredit Markets & Investment Banking
Bayerische Hypo- und Vereinsbank AG
Moor House
120 London Wall
London - EC2Y 5ET
Tel. +44 207 826-1770 - Fax +44 207 826-6830

Bloomberg
UCGR

Internet
www.globalresearch.unicreditmib.eu

* UniCredit Research is the joint research department of Bayerische Hypo- und Vereinsbank AG (HVB) and UniCredit CAIB Group (CAIB).