

New yield forecast

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Long yields set to increase in the long term

Recent market developments: US long-term yields are broadly unchanged from last month, while yields in the eurozone have declined. Renewed fears about the difficulties facing the financial industry and, not least, Central and Eastern Europe (CEE) have further dented risk appetite. In US fixed income markets, this has been offset by concern about the very large supply of Treasuries. Meanwhile, the ECB has continued easing monetary policy in the eurozone, which, together with the eurozone's close links with the CEE region, has pushed yields down.

Macro outlook: The **US economy** is still in free-fall. The breakdown of the credit market, tumbling equities and still falling house prices, combined with rapidly rising unemployment, have sent the economy spiralling down. GDP is contracting sharply at the moment, and we do not expect a gentle recovery to start until H2 09 on the back of fiscal easing, low inflation (supporting real incomes) and improved monetary transmission as the financial system rights itself.

The **eurozone** is also in the midst of a severe recession and is ailing under the effects of tighter credit, housing market woes and, not least, the sharp slowdown in exports following the collapse of international trade. The growth outlook will remain gloomy for most of this year, and the eurozone will need help from the outside world to fuel growth. We do not expect such help to arrive until H2 at the earliest. Given the sharp drop in commodity prices, eurozone inflation will move below zero this year and will remain below the ECB's target in the coming years.

Central banks and bond yields: The **Federal Reserve** will maintain the Fed Funds rate at 0-0.25% for an extended period. The big question is whether the Fed will step up its quantitative easing measures, for example, by buying government instruments. If so, long yields would drop sharply, which, in combination with movements in risk appetite, is making yield movements highly uncertain on a short-term horizon. In the long term, we expect the massive supply of Treasuries and a slow recovery of the economic outlook to drive US long yields substantially upwards.

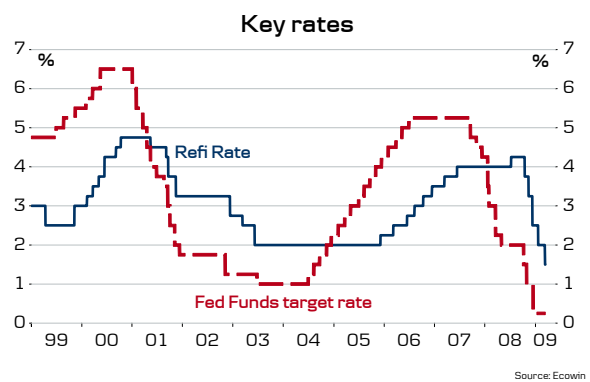
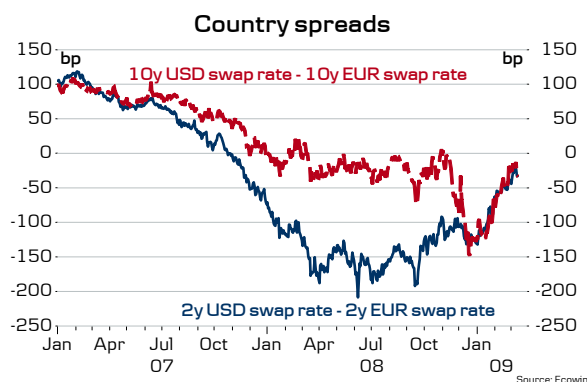
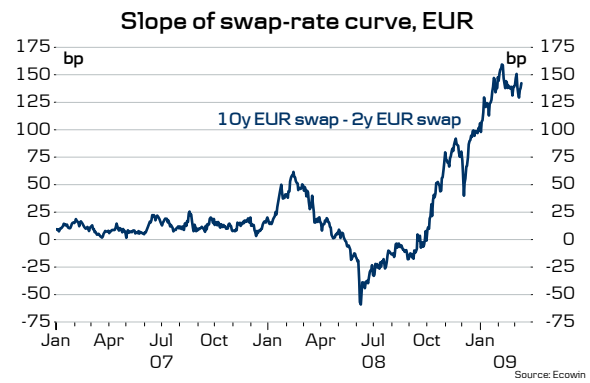
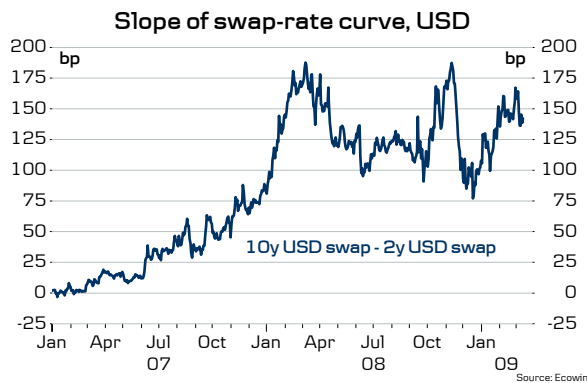
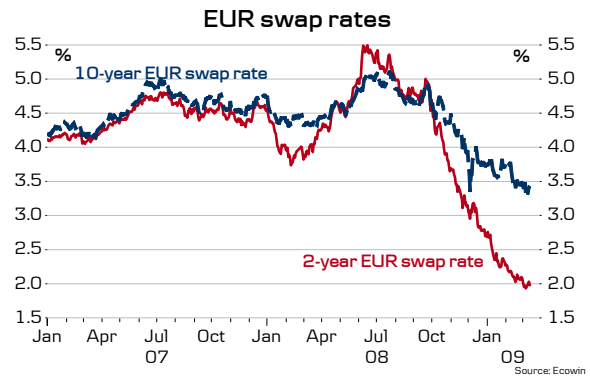
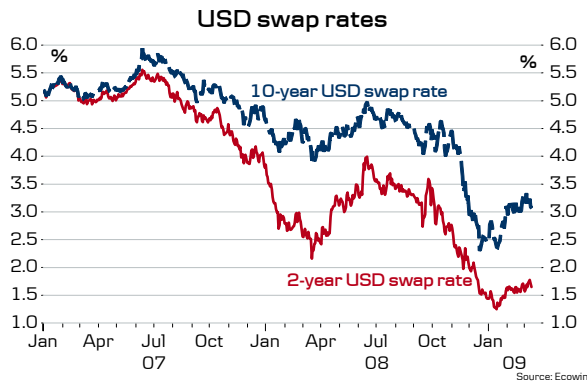
The **ECB** will likely cut its benchmark rate by another 50bp to 1% in April before it is done easing. The question of alternative monetary policy measures in the form of asset purchases also looms in the eurozone, though asset purchases are probably not just around the corner. We do not believe that the ECB is about to purchase, for example, European government bonds, but we do not rule out the possibility of the central bank buying commercial paper. Given the CEE crisis and a still gloomy economic outlook, we expect yields to stay close to their current levels in the short term, though there are large risks in both directions. Higher US yields and an improved economic outlook should send eurozone yields upwards over time, although the increase in yields will be more moderate in the eurozone than in the US.

Yield curves: The slope of the US yield curve will be shaped by movements in 10Y yields. As the economy stabilises and long yields increase, the yield curve should steepen. The curve will probably not flatten again until the Fed is about to abandon its zero interest rate policy, and that is a long way off. In the eurozone, the scope for a decline in 2Y yields is also limited, as the ECB will soon be done cutting rates. Therefore, we believe that higher yields will initially trigger a modest steepening of the yield curve also in the eurozone. In the long term, though, we expect the yield curve to flatten again as the economy gathers momentum and the

ECB adopts a more hawkish rhetoric.

Country spreads: Euroland lags the US in terms of both the monetary and economic cycles. As such, we expect European bonds to outperform their US counterparts in the coming quarters.

Next forecast due out on 15 April 2009.



New forecasts

EUR	Refi rate	3m euribor	2-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	1.50	1.65	1.97	3.44	1.35	2.24	3.08
+3m	1.00	1.50	2.00	3.45	1.40	2.25	3.10
+6m	1.00	1.40	2.05	3.60	1.50	2.40	3.30
+12m	1.00	1.30	2.50	3.85	2.00	2.90	3.60

USD	Fed funds	3m libor	2-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	0.13	1.32	1.69	3.09	1.05	1.96	2.92
+3m	0.13	1.20	1.60	3.45	1.10	2.15	3.25
+6m	0.13	1.05	1.65	3.75	1.20	2.30	3.50
+12m	0.13	1.00	2.15	4.30	1.75	2.80	4.00

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Expected updates

Next forecast due out on 15 April 2009

First date of publication

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