15 April 2009

New yield forecasts

Yields set to increase over time

Recent market developments

Long yields in both the US and Germany are more or less unchanged from a month ago, but they have certainly not been stable during the past month. The US central bank, the Fed, prompted a sharp downturn in yields when it announced, at its policy meeting on 18 March, that it would be buying Treasuries. However, US long yields have almost recouped the lost ground since then on a combination of good economic news, positive statements from the financial industry, increased risk appetite, rising stock markets and continued focus on the large government bond supply.

US yield movements have been reflected in German yields. Economic news out of the eurozone has not been good, although the positive news about support for central and eastern Europe (CEE) has shored up optimism. The ECB disappointed market participants when it cut its benchmark rate by only 25 basis points and clearly the ECB is not even considering buying government bonds. All in all, German yields are currently slightly higher than a month ago.

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. However, signs are emerging that the economy is beginning to stabilise, and we expect it to start growing again in H2 2009 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 is expected to 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 probably maintain the fed funds rate at 0-0.25% for a long time. The big question is if the Fed will expand its quantitative easing measures, for example, by buying even more Treasuries. We do not believe it will, so the latest measures could mark the end of the dramatic quantitative easing in the US. Short-term, movements in risk appetite and any new Fed statements would impact substantially on yield movements. In the long term, we expect the massive supply of Treasuries and a slowly improving economic outlook to drive **US long yields** substantially upward.

Key news

- Leading indicators begin to suggest there is light at the end of the tunnel.
- Fed is done easing.
- The ECB set to ease further and to launch new alternative monetary measures.
- Long yields expected to increase on both sides of the Atlantic.
- *Next yield forecast due out on 15 May 2009*

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The **ECB** will probably cut rates by another 25bp to 1% in May before finishing off its easing cycle. The question of alternative monetary policy in the form of purchases of credit instruments also looms in the eurozone, and the ECB has promised that it will make an announcement about this issue at its May policy meeting. While we consider purchases of Commercial Paper the most likely outcome, we do not believe that the ECB is even considering the possibility of buying European government bonds.

Short-term, the outlook for further monetary easing by the ECB could put a damper on any yield increases, and any fluctuations in risk appetite – not least, in relation to CEE – would continue to substantially affect German long yields. Higher US yields and an improved economic outlook should send eurozone yields up 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 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.

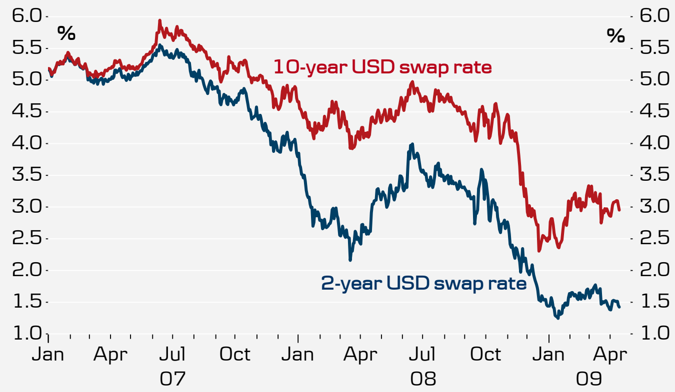
New forecasts

EUR	Refi rate	3m euribor	2-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	1.25	1.42	1.90	3.52	1.34	2.33	3.16
+3m	1.00	1.25	1.90	3.65	1.40	2.45	3.35
+6m	1.00	1.20	1.95	3.75	1.50	2.60	3.50
+12m	1.00	1.10	2.40	4.10	2.00	3.00	3.90

USD	Fed funds	3m libor	2-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	0.13	1.12	1.41	2.94	0.85	1.71	2.77
+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

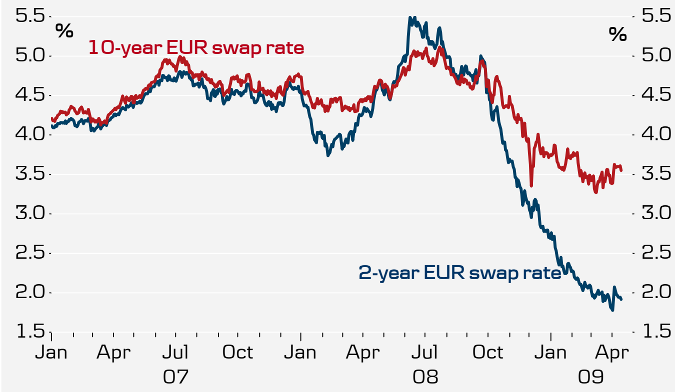
Source: Danske Bank

USD swap rates



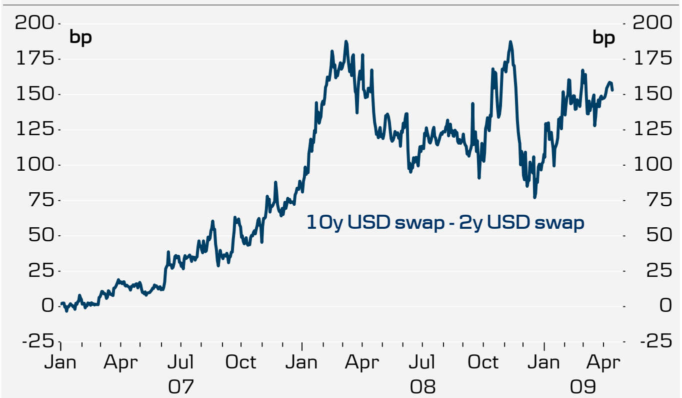
Source: Ecowin

EUR swap rates



Source: Ecowin

Slope of swap-rate curve, USD



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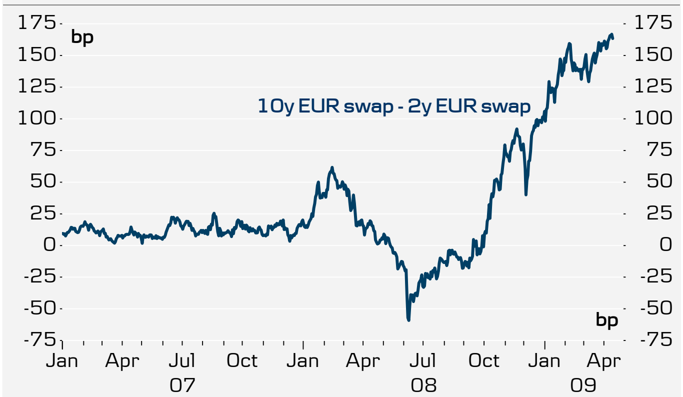
Slope of swap-rate curve, EUR



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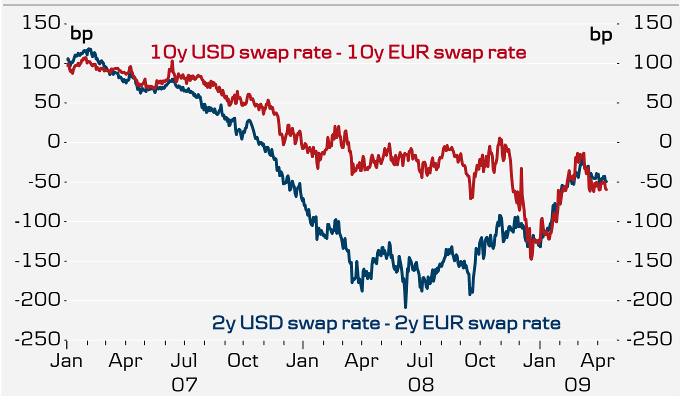
Country spreads



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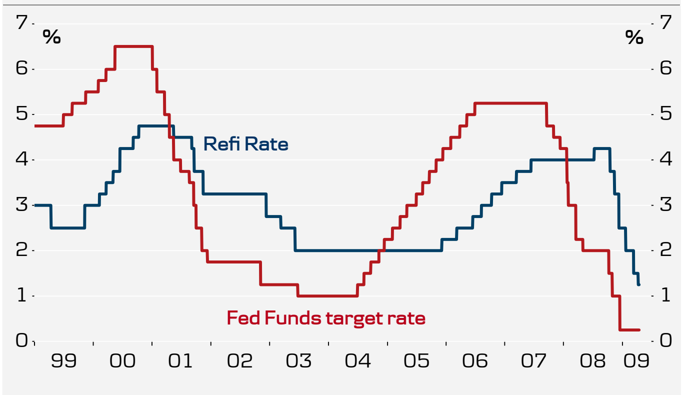
Policy rates



Source: Ecowin

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