

# New yield forecast

## Yield increases ahead

### Recent market developments

Although economic data has been more mixed of lately the picture have on balance continued to improve. In the financial markets equity markets have reached new year-highs and a credit and money markets have improved further. Even so, bond yields have continued to drift lower on a mix of unusual conditions.

Firstly, central banks remain very dovish and does not signal any imminent rate hikes. Secondly, although there are signs, that the recovery has got more traction, it is still perceived as fragile. Thirdly, the very steep yield curves make it hard to speculate against higher yields, because such positions have very negative carry. Finally, it seems as there is currently an unusual high demand for bond yields due to deleveraging (more saving, less borrow), Asian central bank buying and the potential need for bigger liquidity buffers in commercial banks.

While rate hike expectations have changed little over the past month, the remaining factors have exerted downward pressure on long bond yields, leaving the curves flatter in both US and Euroland.

### Macro outlook

**The US economy** is out of recession and most of key indicators are now consistent with an ongoing recovery. Over the next couple of quarters we expect to see relatively strong growth on back of stimulus driven spending, a re-alignment of production to demand and relief of pent-up demand.

The big issue is whether the initial boost to the economy from these factors, will be sufficient to initiate a self-sustaining recovery. Although there is a minor risk that the recovery could fizzle out, we believe that demand from household and business will be sufficiently strong by early next year to avoid this. To key issues in this respect is that the labour market begins to deliver jobs from by year-end and that the US personal savings rate does resume its ascend from earlier this year.

**Euroland** has also pulled out of recession. A combination of a major production backlog and the turnaround in the global industrial cycle is helping exports and at the same time boosting investment. Solid growth in the USA and Asia will benefit Euroland in the coming quarters.

Inflation is not a problem in either Euroland or the USA. Low capacity utilisation and slowing wage growth mean the outlook is for falling core inflation in the coming quarters. Headline inflation will increase as a result of higher commodity prices, but it will remain modest in both the USA and Euroland.

### Key news

- The economic picture has improved further, equities have reached new year-highs and credit markets have continued to improve – yet yields have fallen.
- The US Fed is done with easing monetary policy, but will be on hold for a long time.
- The ECB is also finished cutting rates, and we expect to see the first hike next summer.
- We expect higher long yields on both sides of the Atlantic
- *Next yield forecast due out on 13 November 2009*

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## Central banks and bond yields

**The Federal Reserve** is done with easing monetary policy, and the focus now is on exit strategies from the alternative monetary policy measures. It has ended its Treasury purchase program, but will continue to buy mortgage debt until March 31 2010. Most liquidity measures will expire by March 31 2010, but some not before mid next year. The Fed is expected to keep its key interest rate at 0-0.25% for a long time. Inflation is low, and there is abundant spare capacity in the economy, meaning the need for tighter monetary policy is not imminent.

Even so economic growth, the massive supply of Treasuries, the Fed ending its purchase of Treasuries/mortgages and increased risk appetite are expected to lead to significantly higher yields in the coming quarters.

**The ECB** is expected to hike interest rates next summer, when the upswing has taken a firm hold and the labour market has clearly turned. The ECB is focused on money supply and credit growth, and by next summer the money supply will be growing briskly for quite some time. Besides, the key rate in Euroland is at a historic low. The ECB fears new bubbles, and it has learnt its lesson.

We expect European yields to rise in the coming year as the economic outlook brightens and interest rate hikes move closer. There is also considerable issuance pressure from government bonds in Euroland.

## Yield curves

On the very short horizon the outlook is for steeper yield curves in Euroland. However, as the economy continues to improve, yields rise and fixed income markets increasingly begin to speculate in upcoming rate hikes from the ECB the curve will start to flatten.

The US curve could become slightly steeper in the near term before flattening a little in the longer term. A significant flattening will not be in the card before Fed hikes are more up front.

## Country spreads

In the short term, US yields will probably increase most, and the fixed income markets will expect more rate hikes in the USA than in Euroland. When it becomes obvious to all that the ECB will be the first to hike, the picture will reverse and yields can be expected to increase most in Euroland.

## Danish rates and yields

The Danish central bank (Nationalbanken) is not expected to cut rates further. The inflow to the currency reserve seems to have eased off partly to due the rate cut already delivered and partly due to higher money market rates in Euroland.

CIBOR rates are close to bottom. The bulk of the spread narrowing between money market rates is expected to come from higher EURIBOR rates when the ECB begins to roll back its temporary, alternative monetary policy. Eventually, 3M EURIBOR will again move higher than the refi rate.

When the ECB begins to raise interest rates next summer, Nationalbanken will follow suit, and money market rates will rise in both areas. Long Danish rates are expected to increase in the coming quarters in line with the developments in Euroland.

## New forecasts

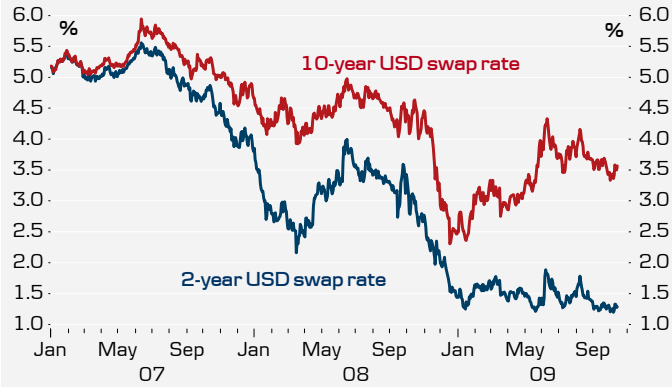
EUR	Refi rate	3m euribor	2-yr swap	5-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	1.00	0.74	1.80	2.77	3.51	1.37	2.45	3.29
+3m	1.00	0.90	1.90	2.90	3.55	1.50	2.55	3.35
+6m	1.00	1.20	2.10	3.05	3.70	1.75	2.75	3.50
+12m	1.50	1.80	2.80	3.45	4.05	2.50	3.20	3.90
USD	Fed funds	3m libor	2-yr swap	5-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	0.13	0.28	1.30	2.71	3.60	0.94	2.36	3.45
+3m	0.13	0.30	1.50	2.95	3.80	1.20	2.60	3.60
+6m	0.13	0.30	1.70	3.35	4.20	1.40	3.00	4.00
+12m	0.13	0.50	2.30	3.55	4.40	2.00	3.20	4.20
DKK	Repo rate	3m cibor	2-yr swap	5-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	1.25	1.58	2.40	3.20	3.77	1.72	3.16	3.53
+3m	1.25	1.60	2.60	3.30	3.80	2.10	3.25	3.65
+6m	1.25	1.80	2.70	3.40	3.95	2.25	3.35	3.80
+12m	1.75	2.30	3.25	3.75	4.35	2.90	3.70	4.15

Source: Danske Bank

See charts overleaf.

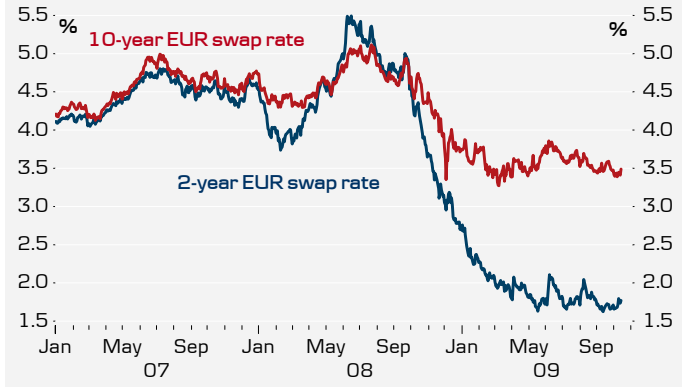
# International interest rates

## USD swap rates



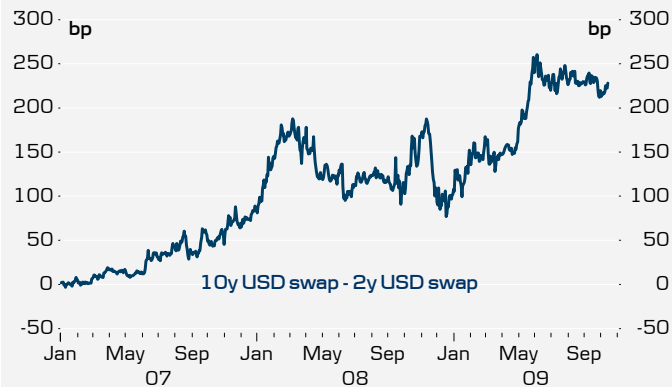
Source: Ecowin

## EUR swap rates



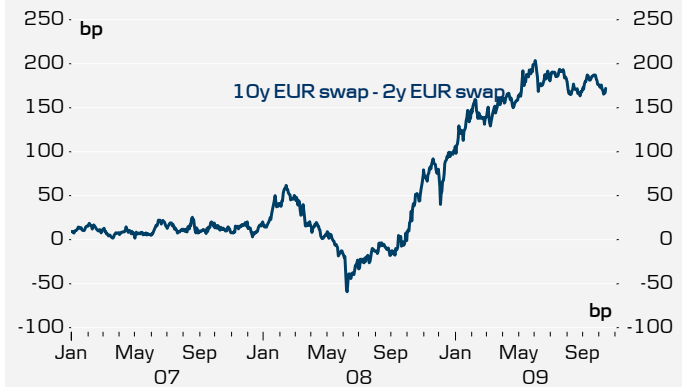
Source: Ecowin

## Slope of swap-rate curve, USD



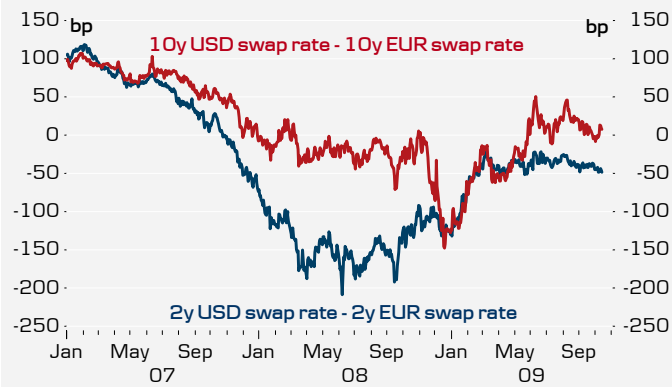
Source: Ecowin

## Slope of swap-rate curve, EUR



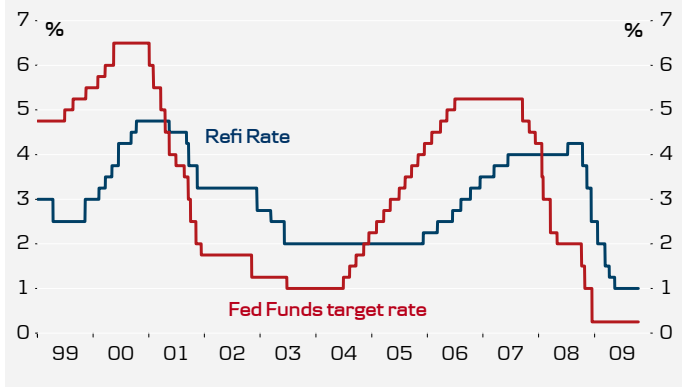
Source: Ecowin

## Country spreads



Source: Ecowin

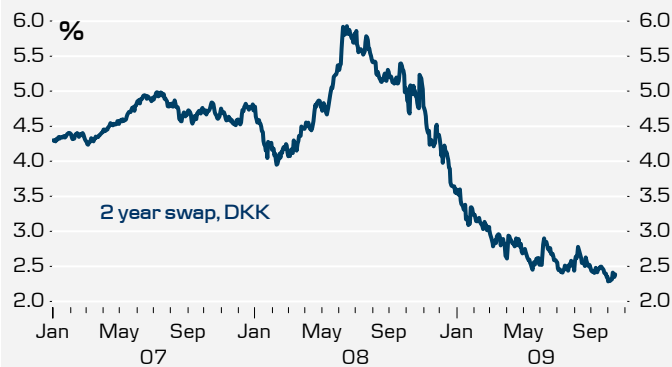
## Policy rates



Source: Ecowin

# Danish interest rates

## 2Y swap rate



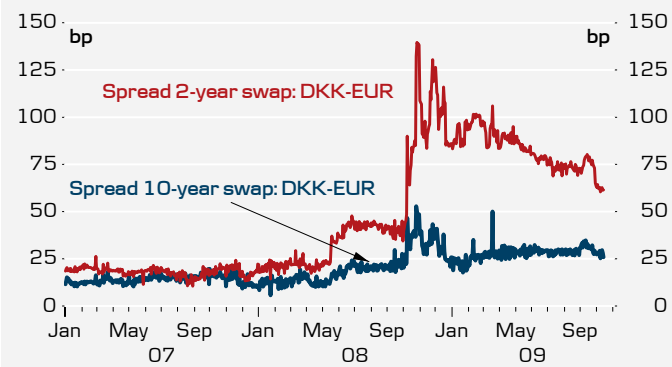
Source: Ecowin

## 10Y swap rate



Source: Ecowin

## Spreads to eurozone



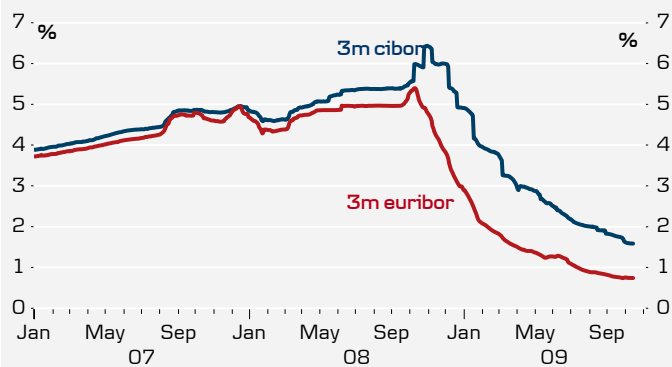
Source: Ecowin

## Slope of swap yield curve, DKK



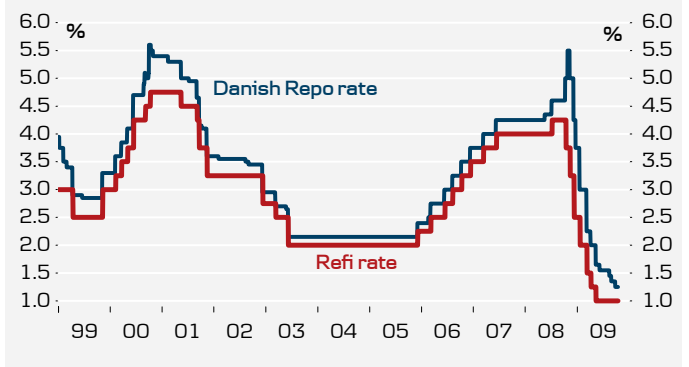
Source: Ecowin

## 3M money market rates



Source: Ecowin

## Policy rates



Source: Ecowin

## Disclosure

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