

New Yield Forecasts

More yield increases in the offing

Recent market developments

Long yields in both the US and Germany have moved upward over the past month. Economic news has been encouraging, with clear bright spots – especially in Asia, but also in the US and the eurozone. We may have put the worst of the economic downturn behind us. Meanwhile, stock markets have increased, so the failure of the Federal Reserve to announce any new measures at its latest policy meeting prepared the ground for higher yields. US long yields are now running well above their levels before the Fed announced its intention to buy Treasuries.

The ECB delivered the expected rate cut on 7 May, while also announcing plans to buy covered bonds. However, clearly the ECB is not even considering buying government bonds, and German yields are currently higher than a month ago.

Macro outlook

The **US economy** suffered its worst downturn in many years in Q4 08 and Q1 09. However, the economy has now stopped deteriorating, and signs of improvement are emerging. For instance, the important ISM indicator is rising sharply at the moment. We believe that the economy has begun to stabilise, and we expect a soft recovery to take off in 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 working its way out of a severe recession that was prompted by 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 rather 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. It looks increasingly as if the Fed has completed its quantitative easing measures, and we do not expect the bank to step up its purchases of Treasuries. Short term, movements in risk appetite could impact considerably on yield movements. In the long term, we expect the massive supply of Treasuries and a continued improvement of the economic outlook to drive **US long yields** substantially upward.

The **ECB** lowered its benchmark policy rate by another 25bp to 1% on 7 May and is probably done cutting rates. The bank has announced plans to buy covered bonds, but the details of this move are yet to be published. Meanwhile, we do not believe that the ECB is even considering the possibility of buying European government bonds, and we expect it to be done easing monetary policy with the announced initiatives. The ECB will likely keep its benchmark rates unchanged for a relatively long time to come.

Short term, any fluctuations in risk appetite – not least, in relation to central and eastern Europe (CEE) – could 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.

Key news

- Economic news has been encouraging, and we may have put the worst of the economic downturn behind us.
- The Fed is done easing.
- While the ECB is also done cutting rates, it has not yet implemented the announced purchases of covered bonds.
- Look for higher long yields on both sides of the Atlantic.
- *Next yield forecast due out on 15 June 2009*

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Yield curves

The slope of the US yield curve will be shaped by movements in 10Y yields. As the economy improves 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 is 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.

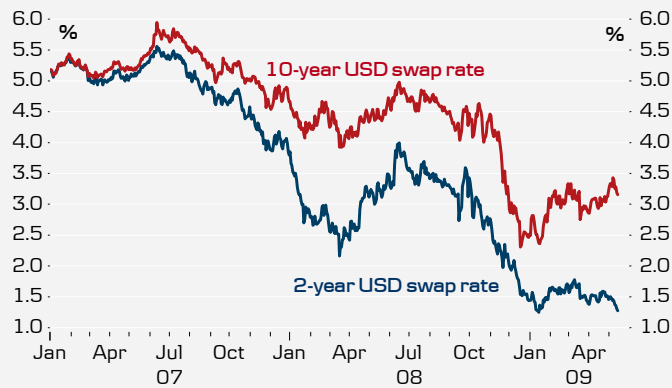
Country spreads

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.

New forecasts							
EUR	Refi rate	3m euribor	2-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	1.00	1.27	1.66	3.45	1.24	2.36	3.27
+3m	1.00	1.20	1.70	3.60	1.40	2.60	3.50
+6m	1.00	1.20	1.85	3.75	1.60	2.75	3.65
+12m	1.00	1.25	2.40	4.10	2.20	3.10	4.00
USD	Fed funds	3m libor	2-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	0.13	0.85	1.26	3.16	0.86	1.96	3.08
+3m	0.13	0.75	1.45	3.57	1.10	2.35	3.50
+6m	0.13	0.65	1.55	3.85	1.25	2.55	3.75
+12m	0.13	0.70	1.90	4.10	1.60	2.80	4.00

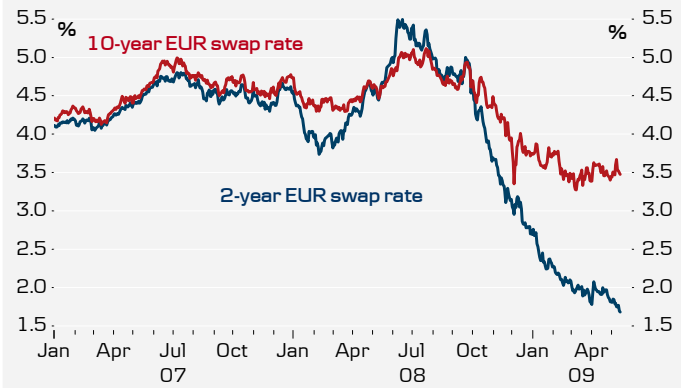
Source: Danske Bank

USD swap rates



Source: Ecowin

EUR swap rates



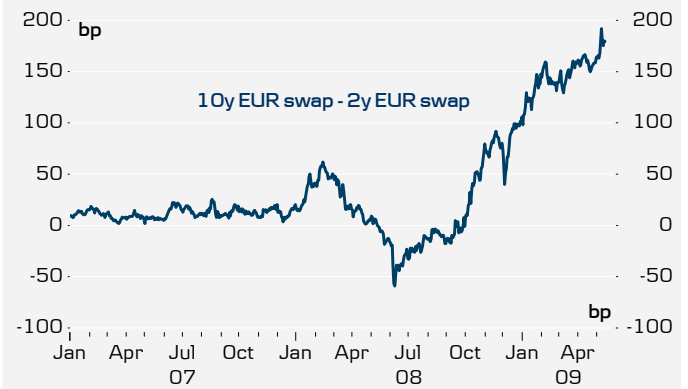
Source: Ecowin

Slope of swap-rate curve, USD



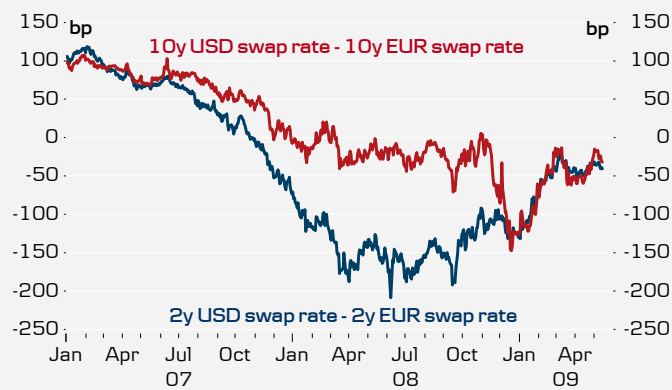
Source: Ecowin

Slope of swap-rate curve, EUR



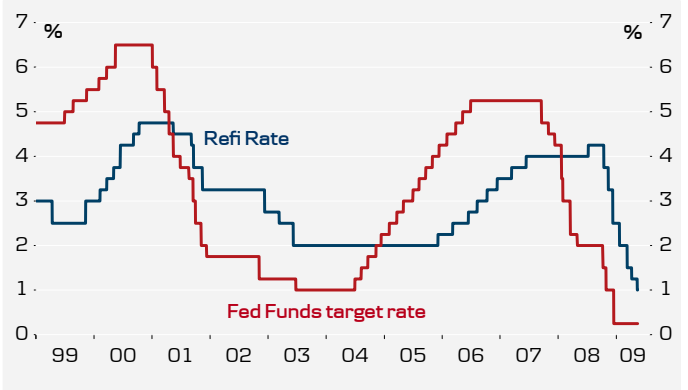
Source: Ecowin

Country spreads



Source: Ecowin

Policy rates



Source: Ecowin

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