Danske Bank

15 June 2009

New yield forecasts

Look for more yield increases

Recent market developments

Long yields in both the US and Germany have moved up sharply over the past month. Economic news has surprised on the upside, and it is becoming increasingly evident that the worst of the economic downturn is probably behind us. Meanwhile, stock markets have risen and so has risk appetite on financial markets. Most recently, there has been speculation about potential rate hikes from the Federal Reserve (Fed) over the coming quarters. The market currently expects the Fed to hike rates by about 1% over the next 12 months.

The European Central Bank (ECB) stayed on hold in June, while presenting details about its planned covered bond purchases. Good economic news and higher US yields have pushed European yields upwards, and expectations of ECB rate hikes over the next year have been growing.

Key news

- Economic news has been encouraging, and the worst of the economic downturn is probably behind us.
- The Fed is likely done easing.
- While the ECB has also finished 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 August 2009*

Macro outlook

The **US economy** suffered its worst downturn in many years in Q4 08 and Q1 09. However, 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 start 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. This will likely happen in the second half of 2009, when we expect exports to pull eurozone growth into positive territory again. Given the sharp drop in commodity prices, eurozone inflation should move below zero this year, and although we expect inflation to rise again, it should remain below the ECB's target in the coming years.

Central banks and bond yields

The **Fed** will probably maintain the fed funds rate at 0-0.25% for a long time, and we believe that financial markets are pricing in far too aggressive rate hikes at the moment. Inflation is low and there is plenty of spare capacity in the economy, so there is no need for rate hikes in the very near future.

We would not rule out further quantitative easing by the Fed, following the recent sharp increase in yields, though we consider it more likely that the Fed will simply try to talk yields down, for instance, by emphasising once again that the fed funds rate will remain unchanged for a long period.

In the very short term, we see a risk of a downward correction in yields, but longer term, we expect the massive supply of government bonds and the continued improvement in the economic outlook to **drive US long yields upward**.

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The **ECB** lowered its benchmark policy rate by another 25bp to 1% in May and is probably done cutting rates. We expect the bank to start buying covered bonds next month. While this move will probably mark the end of the current easing cycle, ECB rate hikes are still a long way off. The market's expectations of further rate cuts in H1 09 seem mistaken. The turnaround has only just begun, inflation is likely to remain low, and there is plenty of slack in the economy. We expect benchmark rates to stay unchanged for a relatively long period.

Short term, we do not rule out the possibility of a correction in European yields, and any fluctuations in risk appetite – not least, in relation to central and eastern Europe (CEE) – could continue to substantially affect German long yields. However, 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

We expect the US yield curve to steepen further as long yields increase. The yield curve will probably not flatten much again until the Fed is about to start hiking rates – i.e., some time in H1 2010.

In the eurozone, higher long yields are also likely to trigger a modest steepening of the yield curve short term. In the long term, though, the yield curve should flatten again as the economy gathers momentum and the ECB adopts a more hawkish rhetoric.

Country spreads

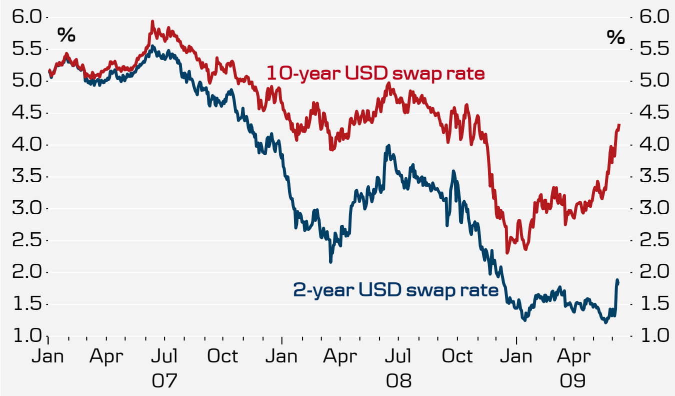
Euroland lags the US in terms of both the monetary and economic cycles. As such, we expect European bonds to outperform their US counterparts in the coming quarters.

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	1.26	1.99	3.76	1.64	2.76	3.57
+3m	1.00	1.20	2.00	3.95	1.70	2.95	3.85
+6m	1.00	1.20	2.15	4.10	1.90	3.10	4.00
+12m	1.00	1.25	2.75	4.30	2.50	3.40	4.20
USD	**Fed funds**	**3m libor**	**2-yr swap**	**10-yr swap**	**2-yr gov**	**5-yr gov**	**10-yr gov**
Spot	0.13	0.63	1.64	4.01	1.21	2.73	3.76
+3m	0.13	0.55	1.85	4.40	1.40	3.00	4.20
+6m	0.13	0.65	2.20	4.60	1.75	3.30	4.50
+12m	0.13	0.75	2.70	5.00	2.25	3.60	4.70

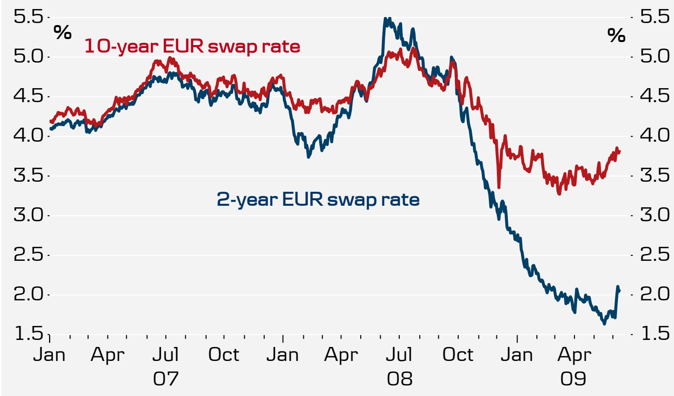
Source: Danske Bank

USD swap rates



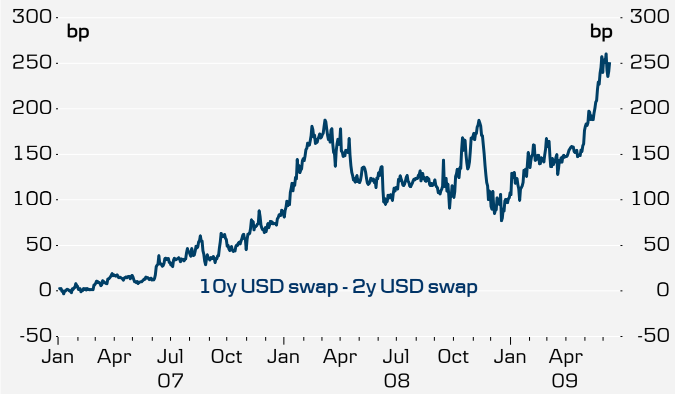
Source: Ecowin

EUR swap rates



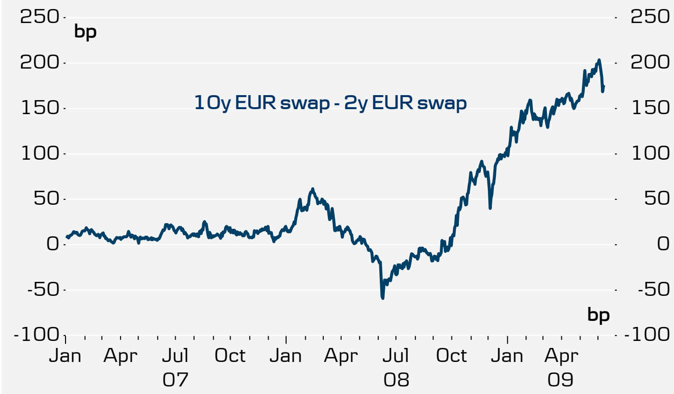
Source: Ecowin

Slope of swap-rate curve, USD



Source: Ecowin

Slope of swap-rate curve, EUR



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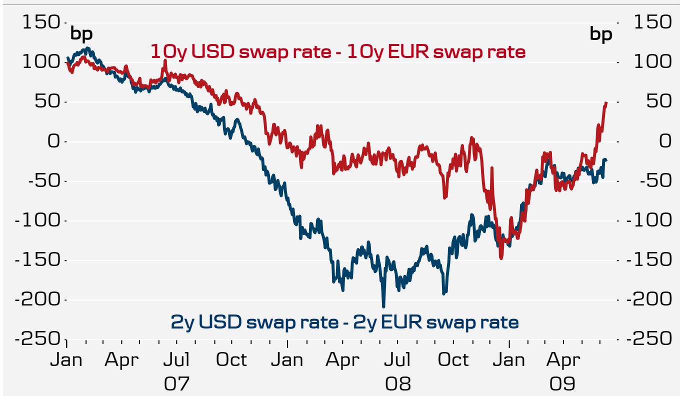
Country spreads



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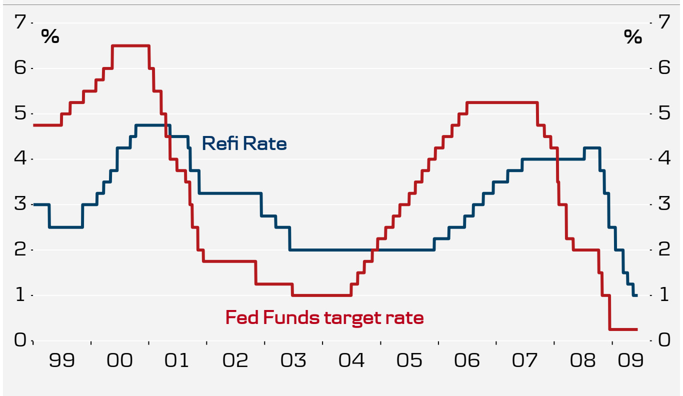
Policy rates



Source: Ecowin

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