

# New yield forecast

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## ECB pulling short bond yields down

**Recent market developments:** Sentiment has changed in the direction of higher rates and yields in recent weeks. The main reasons are (1) the weakening of leading economic indicators has ended; (2) fiscal policies are very expansionary – not least, in the US; (3) a massive supply of government bonds is on the cards; and (4) the Federal Reserve did not step up its quantitative easing measures at the January policy meeting. The last point was broadly viewed as the Fed's implicit acceptance of higher long-term US yields. The increase in US yields has fed through into long eurozone yields, while a still dovish tone and continued rate cuts from the ECB have pulled short yields down in the eurozone.

**Macro outlook:** The US economy is still in freefall. 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 take off until H2 09 on the back of fiscal easing, low inflation (supporting real incomes) and improved monetary transmission as the financial system rights itself.

**Euroland** 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 be running close to 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. Add to this the significant rise in yields recently, the massive supply of government bonds and the continued gloomy outlook – and uncertainty about long US yields is high. We generally expect yields to range trade, though with large fluctuations, in the coming three months. US long yields will again begin to move upwards as the economy puts the recession behind it.

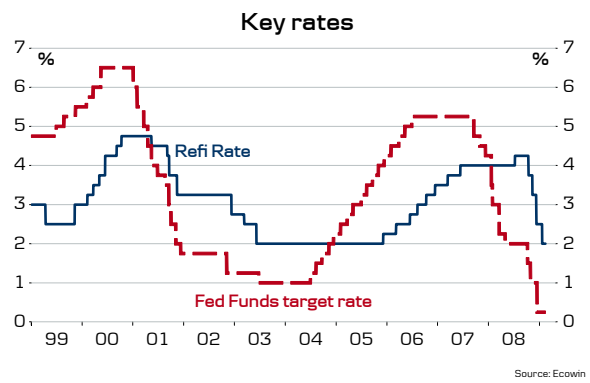
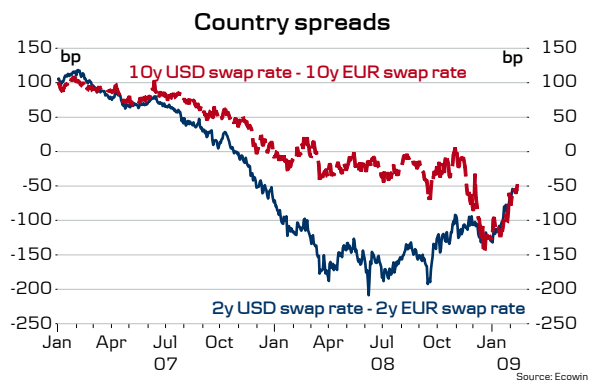
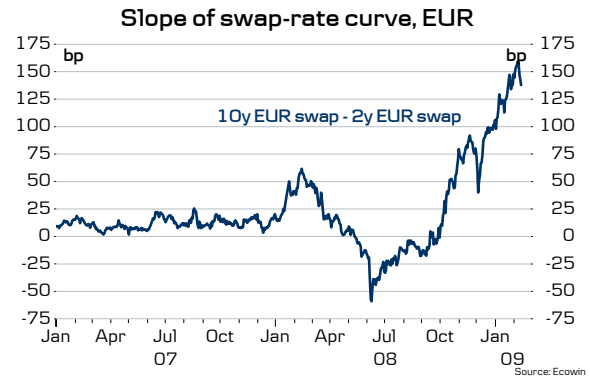
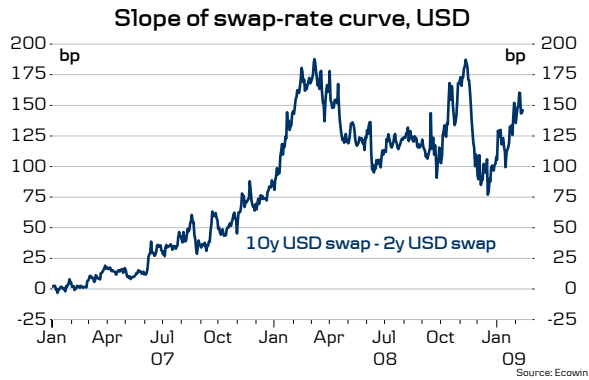
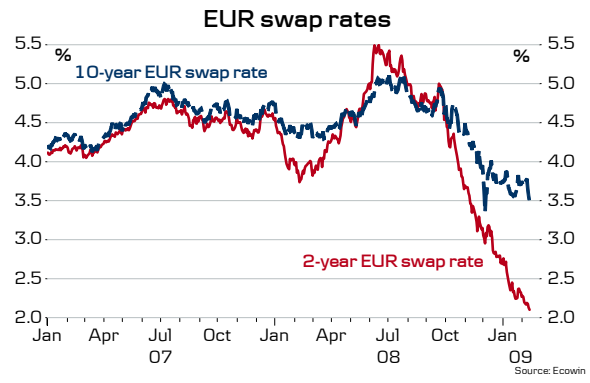
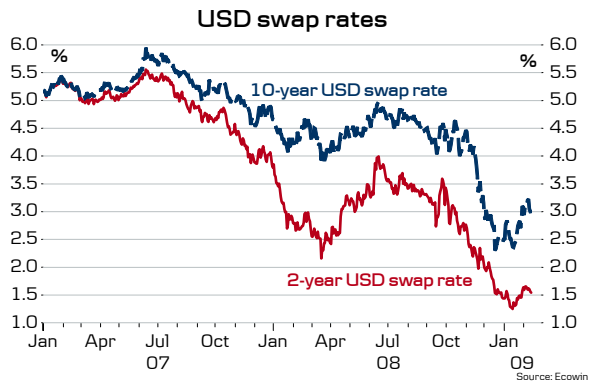
We expect the ECB to ease monetary policy further. The recession continuing and very low inflation will probably cause the ECB to cut rates by 50bp in March and by a further 25bp twice in spring 2009. For a more detailed discussion of our new ECB forecast, please see [ECB expected to reach 1% by summer](#). This will prepare the ground for further falls in short rates (such as 2Y rates) in Euroland over the coming three to six months. In the slightly longer term, European long yields will broadly track the upward movement in US yields, although at a more moderate pace.

**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 will steepen. The curve will not flatten again until the Fed is about to abandon its zero interest rate policy, and that is a long way off. In Euroland there is room for further falls in 2Y rates and hence a modest further steepening of the yield curve as the ECB cuts rates. In the long term, 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 13 March 2009.*



**New forecasts**

EUR	Refi rate	3m euribor	2-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
Spot	2.00	1.96	2.09	3.50	1.31	2.23	3.11
+3m	1.25	1.50	1.75	3.45	1.10	2.20	3.10
+6m	1.00	1.40	1.75	3.60	1.20	2.35	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	1.23	1.55	3.04	0.93	1.80	2.82
+3m	0.13	0.85	1.30	2.95	0.80	1.75	2.80
+6m	0.13	0.85	1.35	3.35	0.90	2.00	3.25
+12m	0.13	0.85	1.90	4.05	1.50	2.80	3.75

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