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# Economic News

## INTEREST RATE FORECASTS

### ECB 1.5%, 10Y Bund close to 3%, steeper curve

While inflationary pressure has eased, prospects for economic growth have deteriorated rapidly over the past few weeks and months. Given this, there is much to suggest the ECB will continue to slash interest rates. We expect the rate cutting cycle to go further than the market is currently pricing in and look for it to bottom out at 1.5% by the middle of next year. This should therefore lead to a further steepening of the Bund curve while the 10Y yield could ultimately hit 3%.

The ECB is about to slash interest rates further. During the downturn at the start of this decade, the ECB lowered its refinancing rate from 4.75% to 2% over a period of about two years. The profound problems in the banking sector and the rapid downturn experienced by the economy suggest that the ongoing rate cutting cycle will be both steeper and lower. In our Outlook 2009 study, which is due out at the end of November, we will lower our forecasts for growth and inflation for the Eurozone (and elsewhere) once again. Given the contracting economy and mounting threat of deflation, we now expect the ECB to cut its key rate to 1.5% by next summer, which is lower than the market currently expects. By the start of December, the refi rate may well already have been cut to 2.75%.

#### More bull curve steepening in the near-term ...

Our revised call for the trough in the ECB easing cycle has significant implications for our view on the shape of the Eurozone curve over the next few months. With the market already pricing in a drop in ECB rates to 2% by next Spring, the rapid steepening trend in the 2/10Y Bund spread which commenced in mid-September has slowed somewhat over the past fortnight. The 2/10Y spread has soared by around 140bp over the past 9-10 weeks but has only managed to grind higher by around 10-15bp in the last two. Given our forecast of a more aggressive ECB rate cut cycle, however, we fully expect the curve steepening trend to remain safely intact going forward. While the Schatz-Bund steepener first recommended in our Oct 17 *Bondletter* has hit both its initial target at 135bp and its revised goal at 145bp, we now see clear scope for the 2/10Y Bund spread to challenge the highs reached during the 2001-03 ECB rate cut cycle of around 185bp.

During that cycle which ended with the ECB at 2%, the Schatz yield set a low at 1.87%. Consequently, this time around, as the ECB continues to cut and the market moves towards pricing in the 1.50% refi rate that we anticipate, the 2Y Schatz yield could well fall as far as the 1.35-1.40% area before a bottom is found. The short end of the curve, therefore, still has plenty of room to rally in our view and we would by no means rule out the possibility of the 2/10Y Bund spread hitting 200bp.

#### FORECASTS

Interest rates / yields as %	Current	in 3 in 6 in 12		
		Months		
Main refi rate	3.25	2.25	1.75	1.50
3M money	4.19	3.00	2.20	2.00
2Y Bunds	2.18	1.80	1.50	2.00
5Y Bunds	2.82	2.50	2.25	2.80
10Y Bunds	3.68	3.40	3.20	3.80

2/10Y Bund spread can target 185-200bp

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On the EUR swap curve, the recent steepening trend has been slightly more gentle due to the elevated levels of short-dated swap spreads vs. Bunds which are directly related to the ongoing pressures within the money market. Given that we expect a gradual normalisation in the functioning of the money market, particularly once the year-end funding 'hump' has passed, we also see plenty of room for further swap curve steepening. In fact, given the scope we see for a narrower 2Y swap spread, a 2/10Y swap curve steepener should ultimately produce a stronger profit, although the ride up may well be somewhat bumpier!

### **... and eventually even a record-equalling 10Y Bund yield**

Recession not supply is the key factor

Obviously, the curve steepening that we expect will be driven primarily by the development at the short-end of the curve but where does that leave long-end yields – higher due to the likely jump in government issuance or lower due to ECB cuts, negative growth and rapid disinflation? We strongly believe that it is the fundamental outlook which is the key factor in determining market direction rather than supply. For example, the German government clearly broke the Maastricht budget deficit/GDP criteria for four consecutive years during 2002-05 but the 10Y Bund yield saw a peak-trough drop of around 225bp within the same period due to the prolonged phase of sluggish growth.

10Y Bund yield can ultimately hit 3%

Recently, the 10Y Bund yield has been bumping against the 3.60% level which, from a chart perspective, appears to have been a crucial hurdle in the past. Given our views on the ECB and the Eurozone economic outlook, however, we fully expect this level to be breached going forward with the door then opening to a move over the next 3-6 months down to the 3.25% area, and even the 3% record low set in September 2005. Given that we expect the ECB refi rate, growth and inflation to all fall to lower levels than those seen during the 2002-05 period, it is only the increase in government issuance next year that prevents us from projecting a 2-handle for the 10Y Bund yield.

The key risk to our call for substantially lower Bund yields over the next 3-6 months is basically a rapid reduction in risk aversion and a rebound in equity and credit markets despite the poor fundamental backdrop. However, we think that even the danger of that occurring will only arise once the market is able to start considering when this recession will come to an end. Over the next few months at least, we expect the market to continue fretting about just how bad this recession is actually going to be.

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