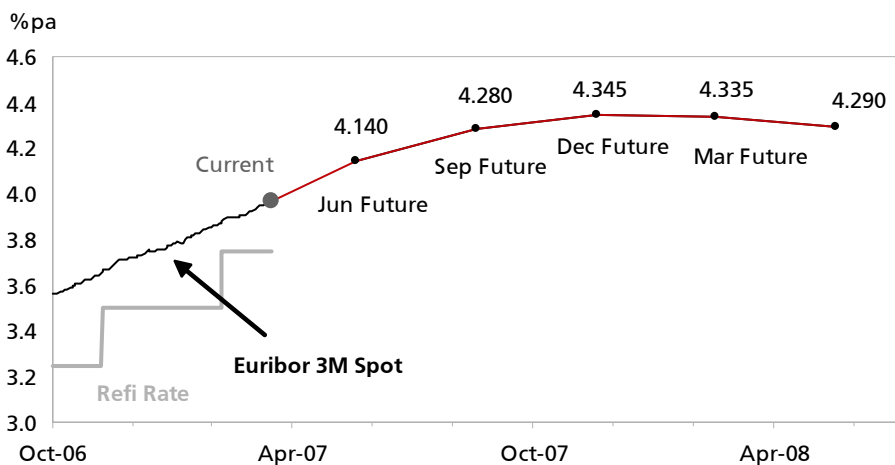


- As widely expected, the ECB last week kept rates unchanged at 3.75% and Trichet's post meeting comments confirmed that a rate hike is on the cards for June.
- The bond market sold off, pushing Bund yields to 5-year highs but remains reluctant to fully price two rate hikes for the remainder of this year. With Dec Euribor futures only implying a rise in 3M rates to 4.35%, there still remains significant upside risk to Bund yields.
- While we don't think that the ECB will take the Refi rate beyond 4% this year, we expect bearish momentum in the bond market to continue in the near-term.
- The 2Y and 10Y Bund yields are hence likely to rise further and the 2Y/10Y Bund curve should continue to bear-steepen.
- However, if we are correct, and the ECB indeed does not take the refi rate above 4% this year, the bearish curve steepening is likely to be short-lived.

Not the top in Bund yields yet

As widely expected, the ECB last week kept rates unchanged at 3.75% and Trichet's post meeting comments confirmed that a rate hike is on the cards for June. The bond market sold off, pushing Bund yields to 5-year highs but remains reluctant to fully price two rate hikes for the remainder of this year. With Dec Euribor futures only implying a rise in 3M rates to 4.35% (Chart 1), there still remains significant upside risk to Bund yields.

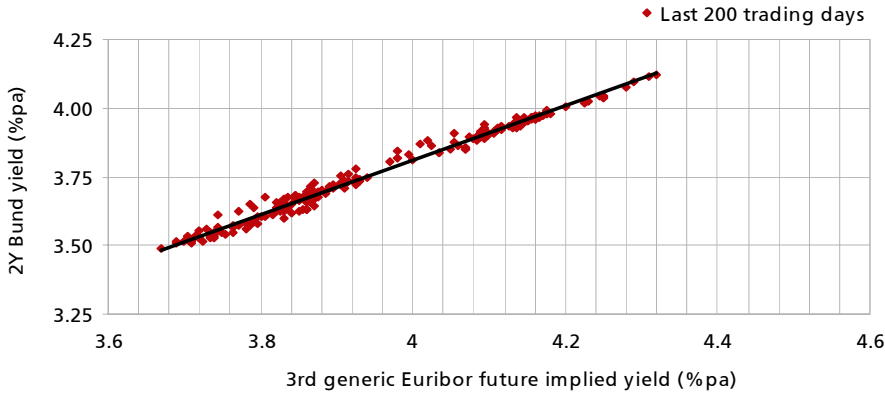
Chart 1: Euribor Futures Implied Expectations for 3M Euribor Spot



We believe the ECB will not take the Refi rate beyond 4% this year but, if fresh economic data does not come in consistently below expectations, the market is likely to price two

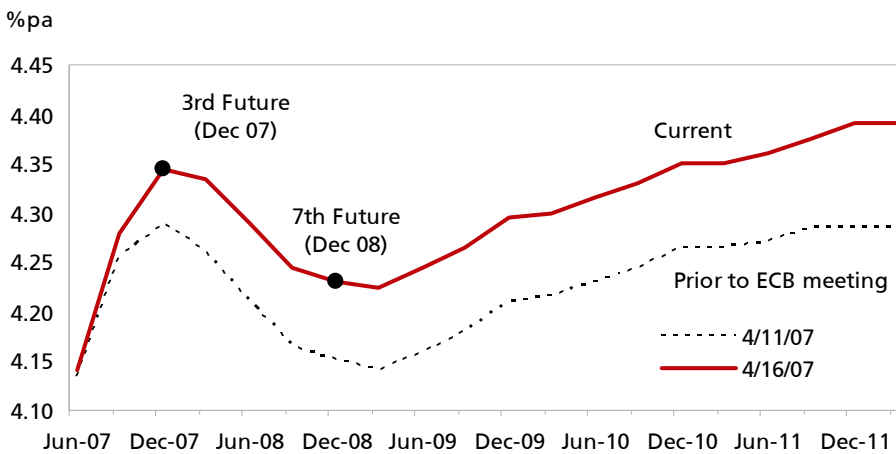
rate hikes fully over the next couple of weeks, which would put the Dec Euribor future implied yield above 4.4% and the 2Y Bund yield above 4.2% (Chart 2)¹.

Chart 2: 2Y Bund Yield & 3rd Generic Euribor Future Implied Yield



This front-end led rise in yields, if it materializes, should put steepening pressure on the 2Y/10Y Bund curve as it should be accompanied by a less aggressive pricing of falling short rates in 2008. Put differently, the spread between the Dec07 and Dec08 Euribor future implied yields should narrow if strong data leads the market to up bets on further tightening (Chart 3).

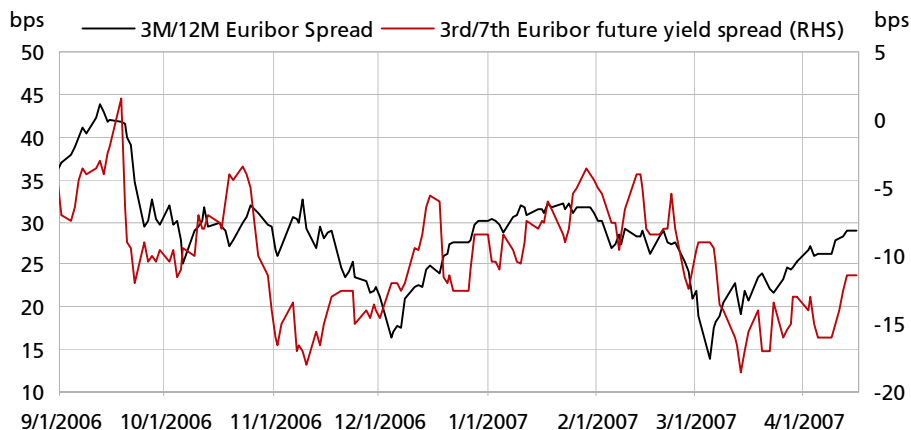
Chart 3: 90-day Euribor Futures Implied Yields



¹ Economic data that has been coming out of the euro area have confirmed the possibility of robust growth so far. We believe this trend is likely to continue in the coming quarters given the optimistic outlook for the economy, as seen from the Ifo and ZEW surveys as well as the improving retail sales, falling unemployment levels and steady industrial production numbers. Inflation figures have surprised on the lower side (averaging 1.8% in Jan-Mar07) given the minimal impact of Germany’s three-percentage point hike in VAT this year. Looking ahead, the annual HICP inflation is likely to ease (barring oil price shocks) in the coming months, before rising towards end-2007. According to our estimates, this will take the eurozone inflation to 1.8% YoY for full year 2007, well within the ECB’s comfort zone. While the ECB has remained concerned about wage-induced inflation and an expansion in credit and monetary growth, we have recently seen signs of moderation in monetary expansion. Also, if we consider the loans structure, it is to be noted that the loans to the non-financial sector, which had been rising in spite of the past few rate hikes (against an easing in the housing loans during the same period) is now slowing. Given this scenario, we believe that the robust growth picture alongside easing inflation will give room for the ECB to raise rates just once by 25bps to 4.0%.

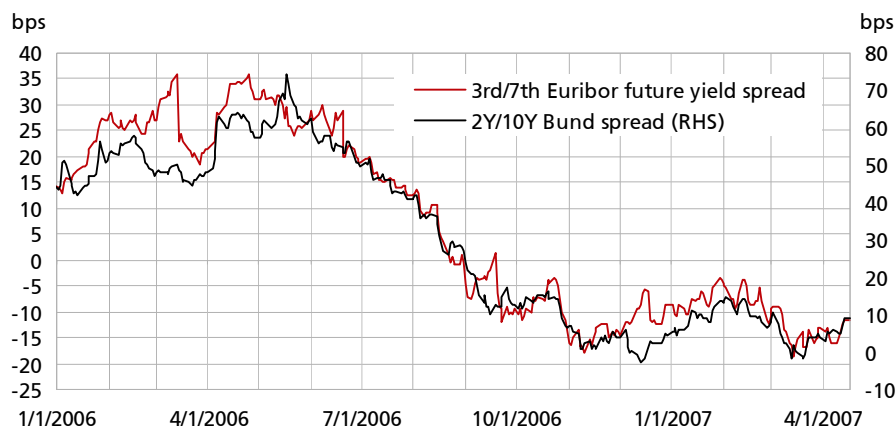
In fact, because data in the Eurozone has been surprising on the upside since early March, the spread has been narrowing alongside a steepening money market curve (Chart 4).

Chart 4: 3M/12M Euribor Spread vs 3rd/7th Euribor Future Implied Yield Spread



That these changes in the shape of the Euribor futures curve should put a steepening spin on the 2Y/10Y curve is shown in Chart 5.

Chart 5: 3rd/7th Generic Euribor Future Implied Yield Spread vs 2Y/10Y Bund Spread

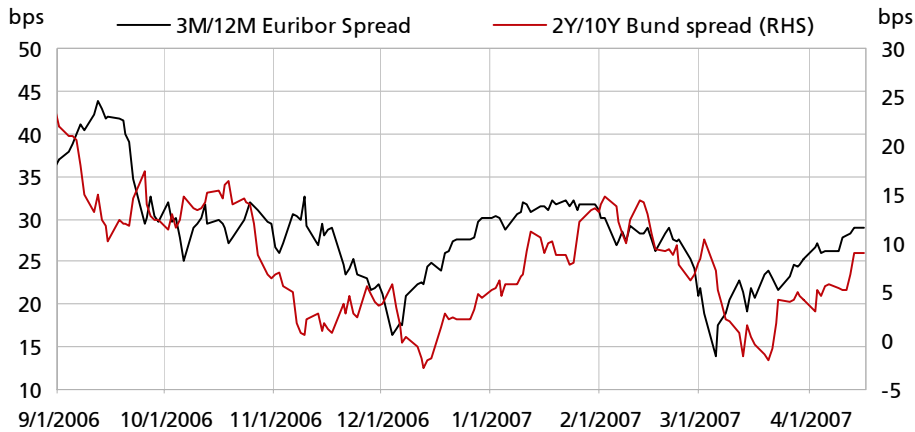


The strong relationship between the Dec07/Dec08 sector of the Euribor curve and the 2Y/10Y spread in Bunds stems from the fact that Euribor future implied yields further out the curve (beyond Dec 08) tend to rise too if the Dec 08 future's yield rises. A narrowing of the Dec07/Dec08 Euribor future implied yields hence tend to have a greater impact on the 10Y Bund yield than the 2Y Bund yield.

Given the above outlined dynamics it is not surprising that movements in the 2Y/10Y Bund curve, in the recent months, have corresponded closely to changes in the money market curve (Chart 6, next page). That is, the Bund curve has steepened into selloffs (bear-steepening) and flattened into rallies (bull-flattening).

In summary, we expect the bearish momentum in the Euro bond market to continue in the near-term and yields to rise further. We expect the 10Y Bund to underperform and the 2Y/10Y Bund curve to bear-steepen. The 10Y Bund yield should rise above 4.3% if the 2Y Bund yield rises above 4.2%. However, if we are correct, and the ECB does not

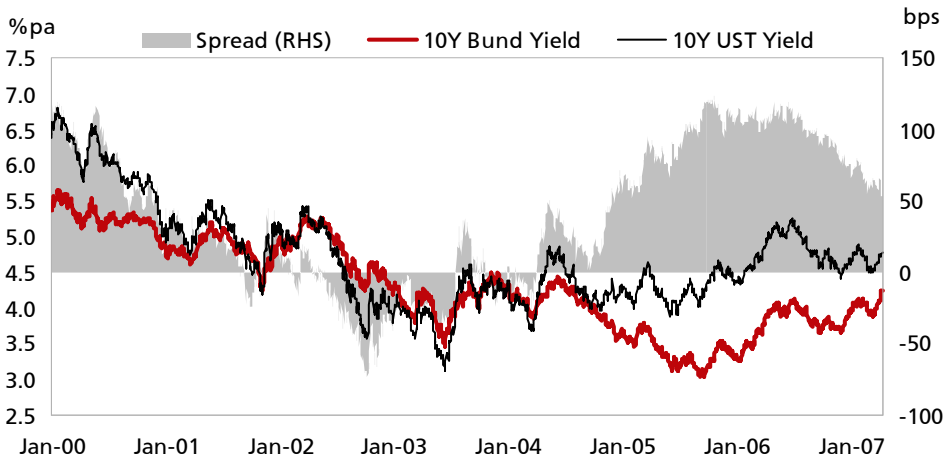
Chart 6: 3M/12M Euribor Spread vs 2Y/10Y Bund Curve



take the refi rate above 4% this year, the bearish curve steepening is likely to be short-lived.

Lastly, it is noteworthy that our bearish near-term outlook for Bunds stands in contrast to our bullish call on US Treasuries. In other words, we expect the 10YBund/UST spread to narrow further in the near-term.

Chart 7: 10Y Bund Yield vs 10Y UST Yield



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