VOLKSBANK AG RESEARCH

Interest Rate and FX Perspectives

2nd Quarter 2010

Since mid 2009, the major economies all have witnessed moderately positive growth rates, but the recovery has been stronger in the USA than in the EMU. While the recovery of private demand has been sluggish so far, public spending had to be reduced already in some European countries and is set to be cut down in all European countries observed in the years to come. The medium-term outlook for GDP growth in the EMU is accordingly faint. In the US, public spending seems to stay elevated for a longer period of time. Spending cuts are not likely to be announced before the mid-term elections in November. Here, private consumption seems to stabilise on a somewhat lowered level due to the ongoing deleveraging process and weak labour market conditions. A certain gap between consumer confidence and business climate can be observed everywhere. In combination with low rates of capacity utilization, this is leading to a lack of price pressure for consumer goods. Low credit demand and weak monetary growth are operating in the same direction. Once again, the (only) possible source of future consumer price inflation is to be found in commodity prices. Monthly price increases have been in the two digits for some commodities during this spring, boosted by low money market rates as well as strong economic growth in many emerging countries outside Europe.

Our **baseline scenario** for the future economic environment has barely changed since the last edition of this report. Especially in the first half of 2010, GDP growth will continue to be supported by the inventory cycle and the ongoing economic stimulus packages. Similarly, monetary policy will remain expansive, although a certain tightening stance is expected. We thus expect moderate GDP growth in both the USA and the eurozone, but growth figures for the entire year should be higher in the US. In 2011, exports and investments should be the main drivers of GDP growth; no impulses should be expected from consumption and government spending. This is due to the high unemployment rates (consumption) and the necessity to reduce the high fiscal deficits (government spending). The latter have different effects for **long-term yields** in the Eurozone: On the one hand, the acute fiscal problem of Greece has increased the demand for “safe haven” securities, namely the German government bonds, driving their yields substantially lower during the last weeks. The high total financing needs of governments, however, is working in the opposite direction. This effect will be more and more visible when private demand for capital starts to increase again. Business surveys published during the last months indicate that this process could have already started – albeit at a very modest pace. The fragile economic outlook and low capacity utilization are setting quite narrow limits to such development. Inflationary and deflationary tendencies still seem to be balanced. We thus expect only a cautious **monetary tightening**. As suggested in our last issues the tightening stance will first relate to the “extraordinary measures” introduced during the crisis. With the maturities of ECB long-term refinancing operations in June, September and December, refinancing will face an increasingly tighter market environment and we expect the 3-months euribor to increase by approx. 60 basis points until year end. Discussions and uncertainties around the Greek fiscal disaster have strengthened the US dollar further against the euro and contributed to lower than expected German benchmark yields, while those of T-bonds behaved totally in line with our latest forecasts. As to some extent public (re-) financing problems at the eurozone’s periphery should stay on the agenda even after the delivery of IMF and EMU countries aid to Greece in the course of May, we have lowered our expectations for Bund yields, while those for US T-Bonds and for money market rates have been barely changed.

Forecast Results

Interest rates and yields					
USA	**29.04.10**	**Jun.10**	**Sep.10**	**Dez.10**	**Mar.11**
Base rate	0 - 0,25	0 - 0,25	0 - 0,25	0,75	1,25
3m interbank	0,34	0,50	0,60	1,20	1,50
10y government	3,77	3,90	4,10	4,25	4,40
Eurozone	**29.04.10**	**Jun.10**	**Sep.10**	**Dez.10**	**Mar.11**
Base rate	1,00	1,00	1,00	1,00	1,25
3m interbank	0,66	0,85	1,10	1,25	1,50
10y government	3,01	3,20	3,40	3,50	3,70
Switzerland	**29.04.10**	**Jun.10**	**Sep.10**	**Dez.10**	**Mar.11**
Base rate	0 - 0,75	0,00 - 0,75	0,00 - 0,75	0,0 - 1,00	0,0 - 1,00
3m interbank	0,25	0,25	0,30	0,50	0,60
10y government	1,85	2,00	2,20	2,30	2,50
Japan	**29.04.10**	**Jun.10**	**Sep.10**	**Dez.10**	**Mar.11**
Base rate	0,10	0,10	0,10	0,10	0,10
3m interbank	0,24	0,30	0,35	0,40	0,50
10y government	1,29	1,50	1,70	1,85	2,00
Currencies:					
	29.04.10	**Jun.10**	**Sep.10**	**Dez.10**	**Mar.11**
USD/EUR	1,33	1,35	1,35	1,33	1,33
CHF/EUR	1,43	1,44	1,44	1,44	1,45
YEN/EUR	124,71	124,20	125,55	127,68	129,68
YEN/USD	93,98	92,00	93,00	96,00	97,50

Time for an interim rallye of the euro due to a positive interest rate spread is getting shorter – we expect the first hike by the Fed in late 2010, while the ECB seems to wait until next year. In the medium-term, the USD will be boosted vis-à-vis EUR, CHF and JPY by more attractive growth rates and interest rates. On the other hand, once the eurozone’s fiscal situation has started to stabilize, the US fiscal deficit and a possibly deteriorating US trade balance will come back into focus. Therefore we do not expect a further appreciation of the dollar and a slight decrease of CHF and JPY against the EUR. Due to the current turmoil on European bond markets, risks to this outlook are of course exceptionally high.

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