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Government bond yields will be rising – but ever so moderately (Translated by Calyon)

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Demand for paper is limiting pressure on ten-year interest rates, despite substantial new issue volume and central banks' exit strategies

Although equity markets have rebounded since early summer, appetite for risk-free assets – government bonds – has not faltered. The trend even seems to be up. Since September 22, yields on ten-year German government bonds eased from 3.39% to 3.15%. In the United States, the picture looks the same. Ten-year U.S. Treasury yields have moderated by 28 basis points, to 3.2%, since September 21.

The outlook for recovery to be modest is supporting the bond market, as are expectations for low inflation or even deflation in 2010. "I believe the current balance of risks around the inflation outlook lie to the downside [...] We would not need much of a decline in inflation to run the risk of an outright deflation," stated William Dudley of the Federal Reserve Bank of New York. Société Générale's strategists find that "Dudley's latest missive is very bullish for bonds."

Besides, strong demand for government bonds is keeping yields down. "In the eurozone, banks bought 55% of new sovereign debt issued in the first six months of the year," notes David Keeble, Calyon's head of interest rate strategy. In the United States, "Treasuries benefit from the Fed's vast buying program, as well as demand from foreign and domestic investors," explains Nicolas Forest, head of interest rate strategy at Dexia AM. The experts believe that this appetite for securities is likely to continue.

All this is enough to moderate the pressures that should be coming into play on bond yields. The U.S. government will have to bring a substantial volume of debt to market in 2010. Eurozone government debt issues will amount to €934 billion next year, compared with €893 billion in 2009, according to Calyon. Central banks' exit strategies and a gradual increase in key interest rates will also penalize the government bond market, limiting the attractiveness of carry strategies.

In this environment, traders expect yields to rise modestly. For late 2010, Calyon expects a ten-year yield of 4.30% for the Bund and 4.50% for U.S. Treasuries. Barclays Capital is forecasting 4.35% for the Bund and 4.60% for Treasuries in the same time frame.