12 August 2022

FX Strategy

DKK-EUR liquidity divergence commences

- **An opulence of liquidity reached the Danish money market in June; the discount in EUR/DKK FX forwards now largely reflects the spread between policy rates.**
- **A larger discount hinges on a potential unilateral interest rate cut by Danmarks Nationalbank (not our base case) and tighter excess liquidity in the euro area.**
- **We keep our recommendation to receive 2Y EUR/DKK FX swap from June.**

Tight liquidity conditions reigned the Danish money market after the COVID-19 crisis, but the regime ended in June when excess cash parked at corporations' tax accounts returned to the market. Overall, our predictions in *FX Strategy - Winds of change for DKK-EUR liquidity conditions in June*, 2 June 2022, are starting to materialise. The discount in EUR/DKK FX forwards has increased – a further increase hinges on different factors.

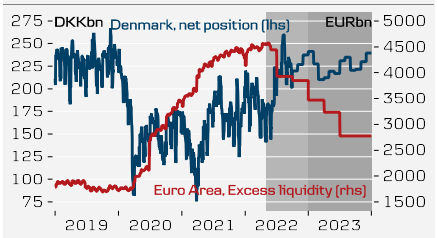
The 12M EUR/DKK FX swap now trades around -0.11%, thus in line with the -0.10% spread between key policy rates of Danmarks Nationalbank and ECB – a drop from -0.03% in May before liquidity conditions eased. It is reminiscent of the situation in 2019, when liquidity conditions last were easy. In the medium term, the most important determinant of the discount in FX forwards is the spread between policy rates.

EUR/DKK sits tight in the low end of the historical trading range – it seems stuck in the 7.4360-7.4450 range despite tumultuous market conditions. The Danish current account surplus tells part of the story. It likely rose above 10% of GDP in Q2 as the savings glut in the Danish economy continued to build. The higher surplus, all other things equal, favours a low EUR/DKK spot and a larger discount in FX forwards. While not our base case, we think it is fair to discount some probability over the coming year that EUR/DKK drops to 7.4360 – the recent FX intervention level of Danmarks Nationalbank – and triggers a unilateral interest rate cut of around 10bp in Denmark. A unilateral cut would increase the discount in FX forwards correspondingly. Neither the swap market nor the FX forward market discount a probability of a unilateral cut on 12M.

While liquidity conditions in the Danish money market have eased, ECB has started tightening EUR excess liquidity. The change in relative liquidity conditions will likely move the market in the spring of next year. Normally, liquidity tightens temporarily in Denmark during Q1, when pension funds pay taxes and push the 3M EUR/DKK FX forward higher. Losses on bonds and equities this year will likely reduce the tax payment and the negative effect on liquidity. Large TLTRO redemptions and a drop in excess liquidity await in the euro area next spring. Hence, liquidity conditions look to be relatively easy in Denmark next year – at odds with the normal seasonal pattern. The 6M3M EUR/DKK FX swap trades around -0.12%; hence, the market looks positioned for this.

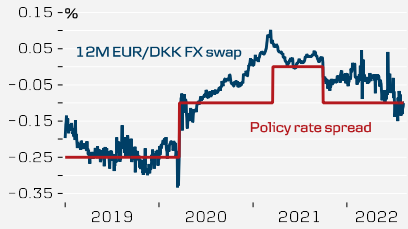
The 2Y-1Y part of the curve steepened after liquidity conditions eased – this part of the curve has not been this steep since 2015. In June, we recommended receiving 2Y EUR/DKK FX swap. We keep the recommendation, which has performed 51pips so far, but note further performance hinges on the market discounting a unilateral rate cut in Denmark and on a decline in the 1Y1Y part of the FX swap.

Easier liquidity conditions in Denmark



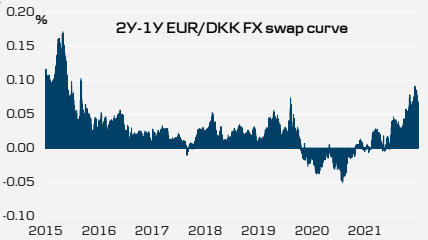
Source: Macrobond Financial, Danske Bank

Re-anchored at policy rate spread



Note: Past performance is not a reliable indicator of current or future results.
Source: Macrobond Financial

Steep 2Y-1Y FX swap curve



Note: Past performance is not a reliable indicator of current or future results.
Source: Danske Bank

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