

# Yield Outlook

## 10Y Bund yields set to remain close to zero far into 2020

In the March issue of *Yield Outlook*, 11 April, we argued that the ECB would help keep short and long yields low – at close to current levels – for the remainder of 2019. First, the ECB extended its forward guidance at its March meeting. Second, the central bank opted to launch a series of new long-term loans for European banks (TLTROs) when the existing loan programme expires later this year. Third, the ECB clearly signalled an easing bias. The ECB is thus prepared to take further measures if the economy fails to recover. In this issue, we argue that short and long yields are set to remain low into 2020 and we do not expect the ECB to remove its negative deposit rates until 2022.

### Markets unlikely to price ECB rate hikes for the next 12 months

We have cut our yield forecasts a little further. We are now even more certain that both short-term and long-term yields are set to stay low for the rest of 2019 and far into 2020.

We have pushed back our call for the next ECB rate hike (policy rate currently at -0.40%) from H2 20 to early 2022. As such, we no longer expect the fixed income market to price rate hikes during H1 20.

As a result, we expect German Bund yields to trade at close to zero for the next 12 months. Risk appetite will be the main determinant of yield levels. Due to the trade conflict, risk aversion is currently high, but we expect it to subside slightly on a 12-month horizon. We expect 10Y Bund yields at 0.15% (0.30%) 12 months from now.

### ECB possibly staying on hold for the next two or three years

According to most market participants over the past few years, it has been only a matter of time before the ECB would begin to normalise interest rate levels. The view was that at the end of the day negative yields are an ‘extraordinary’ situation, and that the ECB would take steps to normalise rate levels once the eurozone output gap contracted and wage pressures mounted, initially by eliminating negative rates. That has helped keep 10Y Bund yields in positive territory other than in periods of uncertainty such as the current one, and it has held the 2Y-10Y yield curve at a ‘normal slope’.

We would argue now that the situation has reversed. Economic growth and inflation quite simply do not look likely to go high enough in coming years to offer the ECB an opportunity to hike its policy rates. That means we would not see the expected upward pressure on interest rates resulting from markets pricing rate hikes once risk aversion subsides or the underlying economy recovers.

Moving the next ECB rate hike further out into the horizon also reflects that we have lowered our assumptions for the neutral rate of interest, which plays a key role in market pricing of long-term forward rates. In December 2018, the ECB released a comprehensive paper reviewing various estimates for the neutral rate of interest (e\*). The estimates show a protracted fall in the neutral rate of interest over the past 10 years to the current level of between minus 1.5% and about 0%. We have assumed a neutral rate of interest at the mid-point of this range. We have also assumed that the neutral rate of interest will continue to fall over the coming years.

#### Quick links

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#### Policy rates

Country	Spot	+3m	+6m	+12m
USD	2.50	2.50	2.50	2.50
EUR	-0.40	-0.40	-0.40	-0.40
GBP	0.75	0.75	0.75	0.75
DKK	-0.65	-0.65	-0.65	-0.65
SEK	-0.25	-0.25	-0.25	-0.25
NOK	1.00	1.25	1.25	1.50

#### 10Y government bond yields

Country	Spot	+3m	+6m	+12m
USD	2.41	2.35	2.40	2.50
EUR	-0.05	0.00	0.05	0.15
GBP	1.11	1.15	1.25	1.30
DKK	0.04	0.10	0.15	0.20
SEK	0.21	0.30	0.30	0.40
NOK	1.71	1.80	1.85	2.00

Note: EUR = Germany

#### 10Y swap rates

Country	Spot	+3m	+6m	+12m
USD	2.38	2.35	2.40	2.50
EUR	0.45	0.55	0.60	0.70
GBP	1.30	1.35	1.45	1.50
DKK	0.56	0.65	0.70	0.80
SEK	0.79	0.90	0.90	0.95
NOK	2.05	2.15	2.20	2.35

Source: Danske Bank

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## Economy performed better than expected in Q1 19, but recovery threatened by trade war

We would emphasise that our postponement of the first ECB rate hike does not reflect an expectation of the eurozone economy moving into recession in 2019. In *Macro-monitor Eurozone*, 13 May, our macro-economists argue that the risk of a recession in the eurozone has eased – with data painting a more optimistic picture in recent months which has been confirmed by the GDP data for Q1 19, which delivered an upside surprise, as growth came out at 0.4% q/q. It would also appear that manufacturing is no longer a drag on growth, while Italy has emerged from recession with q/q growth of 0.2% in Q1 19. The German economy, too, appears to have more wind in its sails despite the low Q1 PMI figures.

We have to underline, however, that the latest twists and turns in the trade conflict between the US and China have not yet been reflected in the numbers, so there is a risk the economy could again disappoint – and indeed recent PMI figures have been mixed.

The low level of inflation has long been a major headache for the ECB, with core inflation in particular being too low. In this *inflation research* from 13 May, our eurozone economist argues that core inflation is likely to rise from an average 1% since the start of 2018 to 1.3-1.4% by the end of 2019. However, in our view, this is unlikely to prompt the ECB into reopening the discussion on normalising monetary policy, or the market to buy into imminent rate hikes for that matter – the inflation level is still too far from the 2% target.

## Markets likely to continue pricing US rate cuts

Earlier this year, we argued that rising US 10Y yields would push eurozone 10Y yields higher. However, there is now much to suggest that causality in 2019 would be the other way round. Uncertainty about the trade war between the US and China has caused the market to start pricing US rate cuts, although – given the strength of the US labour market – we do not envisage the Fed cutting rates. The market will likely disagree with us, though, and keep pushing rate cuts back in coming quarters without cuts ever actually materialising. In combination with 10Y yields of close to zero in both Japan and Germany, we expect this to keep US yields low, with investors being pushed towards the US.

## 10Y Bund yields to remain close to zero for the next 2-3 years

Given multiple uncertainties and recent announcements from the ECB, we continue to expect no noticeable increases in 10Y Bund yields over the coming 12 months.

As such, we expect the benchmark Bund yield to trade in a narrow range between -0.1% and 0.25% for the next 12 months. Where precisely it would trade within that range will depend mainly on risk appetite.

**We expect to publish the next issue of Yield Outlook by mid-June 2019.**

### German 10Y yields to remain close to zero in coming 12 months



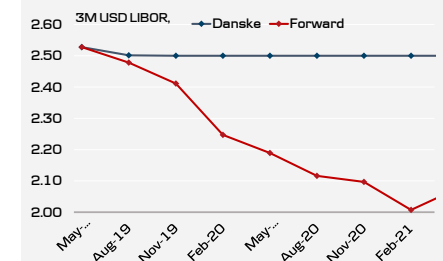
Source: Macrobond Financial

### Core inflation likely to edge up slightly in 2019...but not enough for the ECB to change its strategy



Source: Macrobond Financial, Danske Bank

### Markets will probably continue to price rate cuts in 2019...but we do not envisage cuts materialising



Source: Macrobond Financial, Danske Bank

# Forecasts

Forecasts*		Horizon	Policy rate	3m xlbbr	2-yr swap	5-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
USD	Spot		2.50	2.53	2.27	2.21	2.38	2.19	2.19	2.41
	+3m		2.50	2.50	2.30	2.25	2.35	2.20	2.20	2.35
	+6m		2.50	2.50	2.30	2.30	2.40	2.20	2.25	2.40
	+12m		2.50	2.50	2.30	2.35	2.50	2.20	2.30	2.50
EUR	Spot		-0.40	-0.31	-0.23	-0.03	0.42	-0.66	-0.52	-0.10
	+3m		-0.40	-0.31	-0.20	-0.05	0.55	-0.60	-0.50	0.00
	+6m		-0.40	-0.31	-0.15	-0.05	0.60	-0.55	-0.50	0.05
	+12m		-0.40	-0.31	-0.10	0.10	0.70	-0.50	-0.35	0.15
GBP	Spot		0.75	0.81	0.98	1.13	1.30	0.71	0.84	1.11
	+3m		0.75	0.84	1.05	1.30	1.35	0.75	1.00	1.15
	+6m		0.75	0.84	1.10	1.40	1.45	0.80	1.10	1.25
	+12m		0.75	0.84	1.20	1.50	1.50	0.90	1.20	1.30
DKK	Spot		-0.65	-0.34	-0.16	0.07	0.54	-0.66	-0.51	0.01
	+3m		-0.65	-0.33	-0.10	0.05	0.65	-0.65	-0.50	0.10
	+6m		-0.65	-0.33	-0.05	0.05	0.70	-0.60	-0.50	0.15
	+12m		-0.65	-0.33	0.00	0.20	0.80	-0.55	-0.35	0.20
SEK	Spot		-0.25	-0.05	0.03	0.29	0.79	-0.61	-0.42	0.21
	+3m		-0.25	0.05	0.05	0.35	0.90	-0.65	-0.40	0.30
	+6m		-0.25	0.00	0.10	0.35	0.90	-0.60	-0.40	0.30
	+12m		-0.25	0.00	0.10	0.35	0.95	-0.60	-0.35	0.40
NOK	Spot		1.00	1.62	1.79	1.89	2.05	1.34	1.44	1.71
	+3m		1.25	1.80	1.85	1.95	2.15	1.40	1.50	1.80
	+6m		1.25	1.96	2.05	2.15	2.20	1.60	1.70	1.85
	+12m		1.50	2.14	2.15	2.25	2.35	1.70	1.80	2.00

\* German government bond yields and EUR swap rates used.

Source: Danske Bank

# Denmark forecasts

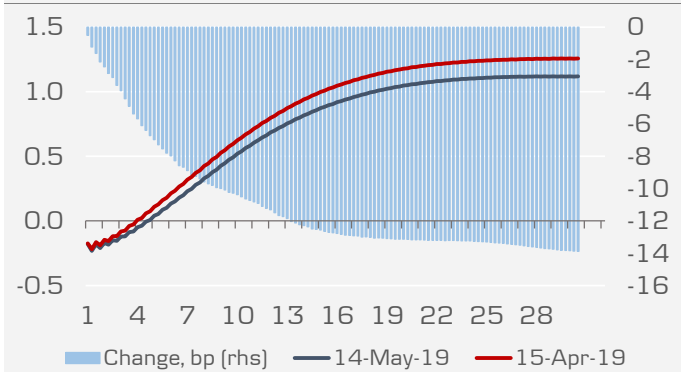
- No rate hikes for the next 12 months, as we expect Denmark’s Nationalbank to shadow the ECB 100%.
- Banks’ net balances set to be significantly higher in 2019, putting downward pressure on short rates, including CIBOR.
- 10Y DKK yields set to follow Bunds, potential for modest spread narrowing.

## DKK forecast summary

15/05/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
DKK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<b>Money Market</b>							
CD	-0.65	-0.65	-0.65	-0.65	-	-	-
Repo	0.05	0.05	0.05	0.05	-	-	-
3M	-0.34	-0.33	-0.33	-0.33	0	0	-1
6M	-0.18	-0.18	-0.18	-0.21	0	1	-5
<b>Government bonds</b>							
2-year	-0.66	-0.65	-0.60	-0.55	-	-	-
5-year	-0.51	-0.50	-0.50	-0.35	-	-	-
10-year	0.01	0.10	0.15	0.20	-	-	-
<b>Swap rates</b>							
2-year	-0.16	-0.10	-0.05	0.00	4	7	6
5-year	0.07	0.05	0.05	0.20	-5	-9	-3
10-year	0.54	0.65	0.70	0.80	8	9	10

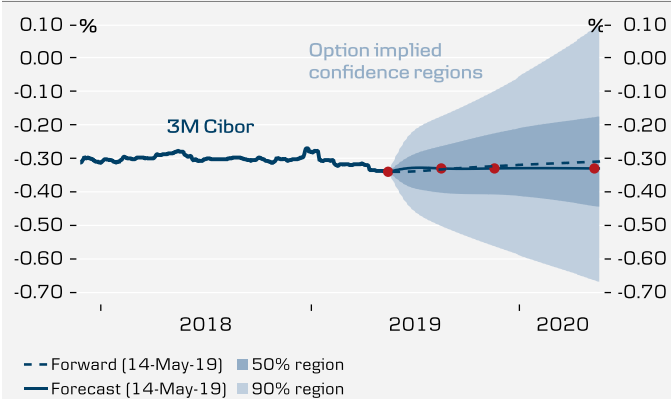
Source: Danske Bank

## 1M change in 6M Cibar



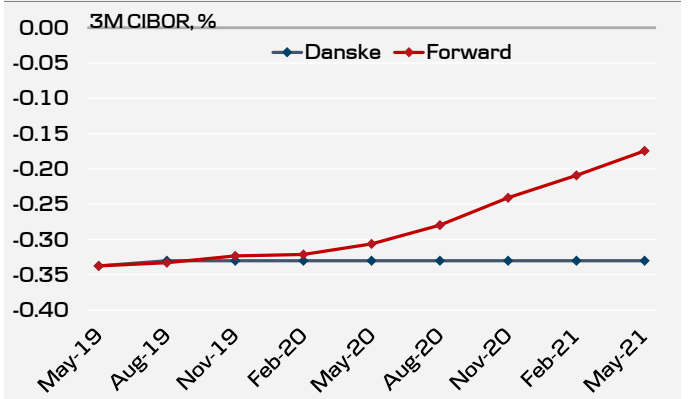
Source: Danske Bank

## 3M Cibar



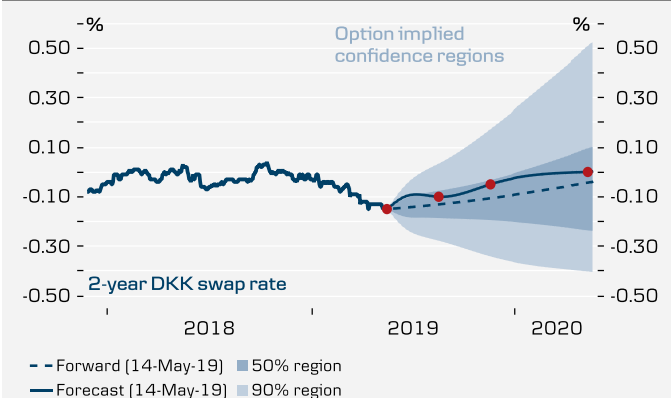
Source: Macrobond Financial, Danske Bank

## Danske Bank forecast and forwards



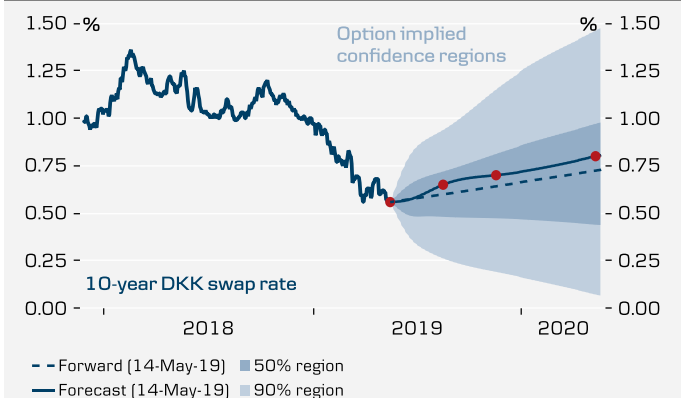
Source: Macrobond Financial, Danske Bank

## 2Y DKK swap rates



Source: Danske Bank

## 10Y DKK swap rates



Source: Danske Bank

# Eurozone forecasts

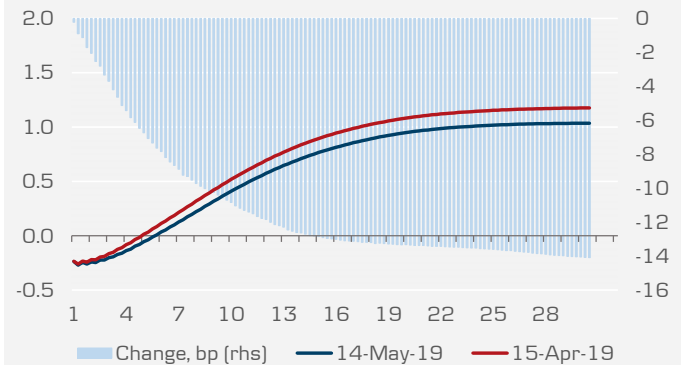
- The eurozone economy currently looks weak, although we are seeing nascent signs of improvement, primarily in the service sector. We therefore still expect the economy to pick up further over the course of 2019, though the US-China trade war has taken uncertainty to exceptional highs.
- We expect no ECB rate hikes in 2019 or 2020. 10Y Bund yields are set to trade in a narrow range of -0.10% to +0.25% over the next 12 months.

## EUR forecast summary

15/05/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
EUR	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<b>Money Market</b>							
Refi	0.00	0.00	0.00	0.00	-	-	-
Deposit	-0.40	-0.40	-0.40	-0.40	-	-	-
3M	-0.31	-0.31	-0.31	-0.31	2	3	3
6M	-0.24	-0.24	-0.24	-0.24	1	2	0
<b>Government Bonds</b>							
2-year	-0.66	-0.60	-0.55	-0.50	-	-	-
5-year	-0.52	-0.50	-0.50	-0.35	-	-	-
10-year	-0.10	0.00	0.05	0.15	-	-	-
<b>Swap rates</b>							
2-year	-0.23	-0.20	-0.15	-0.10	2	6	6
5-year	-0.03	-0.05	-0.05	0.10	-5	-9	-2
10-year	0.42	0.55	0.60	0.70	9	10	12

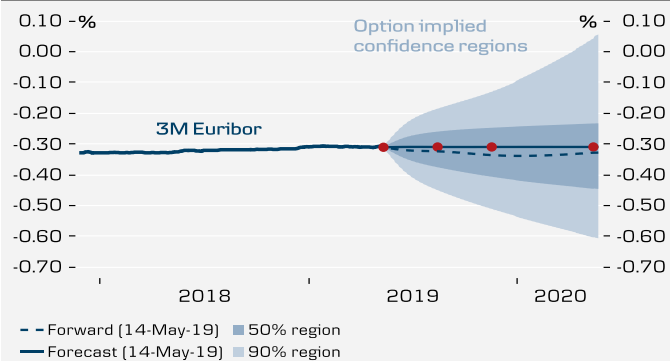
Source: Danske Bank

## 1M change in 6M Euribor



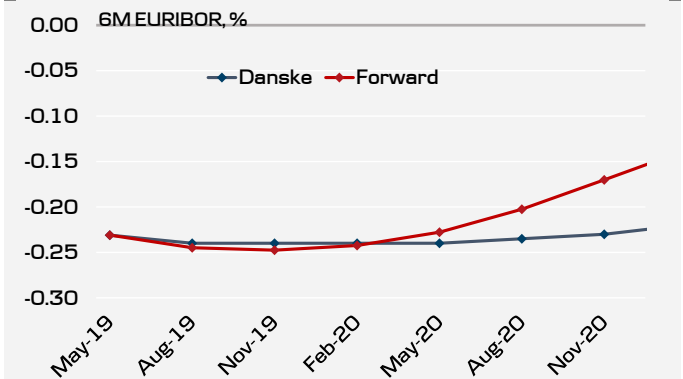
Source: Danske Bank

## 3M Euribor



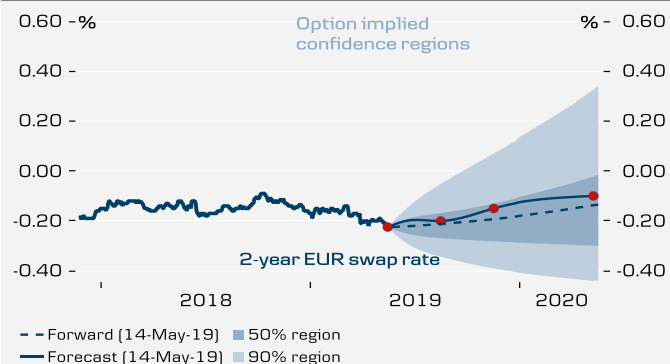
Source: Macrobond Financial, Danske Bank

## Danske Bank forecast and forwards



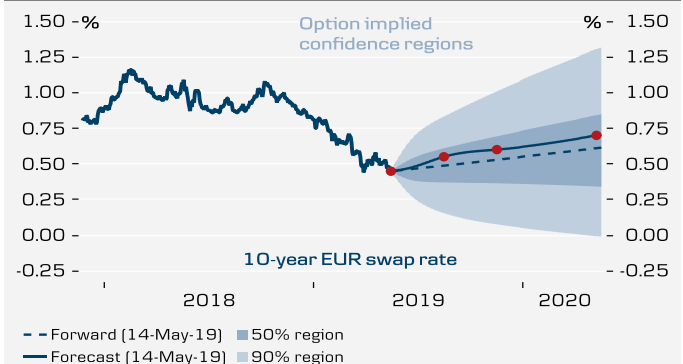
Source: Macrobond Financial, Danske Bank

## 2Y EUR swap rates



Source: Danske Bank

## 10Y EUR swap rates



Source: Danske Bank

# US forecasts

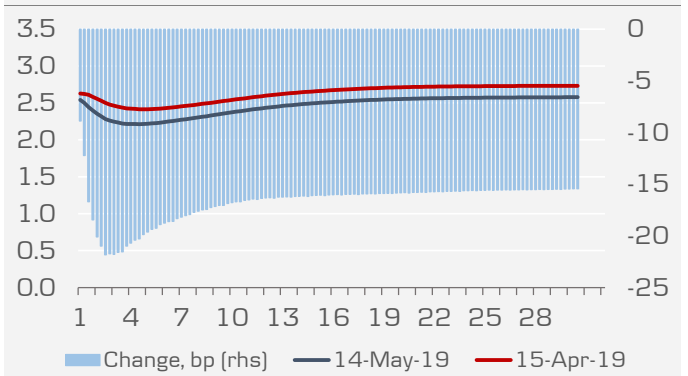
- The Fed is firmly on hold due to concern about lower global economic growth and still modest inflationary pressures in the US economy – notwithstanding continued GDP and job growth in the US.
- As such, we expect the Fed to keep rates unchanged over the next 12 months. Markets, on the other hand, are pricing almost three 25bp rate cuts by the end of 2020. We expect only modest upward pressure on 10Y US yields this year, as low eurozone and Japanese yields, low inflation, rate cut expectations and concern about the trade war are putting a lid on long-term US yields.

## USD forecast summary

14/05/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<b>Money Market</b>							
Fed Funds	2.50	2.50	2.50	2.50	-	-	-
3M	2.53	2.50	2.50	2.50	3	9	32
<b>Government Bonds</b>							
2-year	2.19	2.20	2.20	2.20	-	-	-
5-year	2.19	2.20	2.25	2.30	-	-	-
10-year	2.41	2.35	2.40	2.50	-	-	-
<b>Swap rates</b>							
2-year	2.27	2.30	2.30	2.30	10	15	21
5-year	2.21	2.25	2.30	2.35	5	11	15
10-year	2.38	2.35	2.40	2.50	-3	1	9

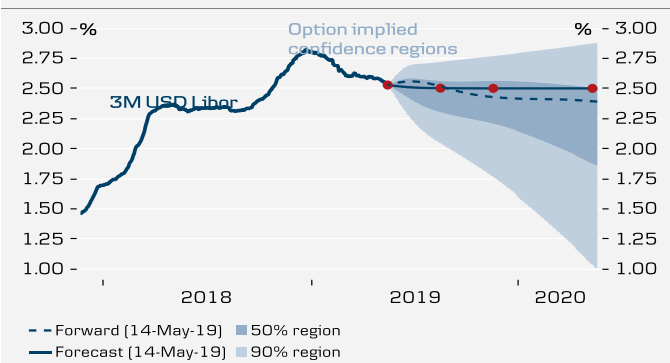
Source: Danske Bank

## 1M change in 3M USD Libor



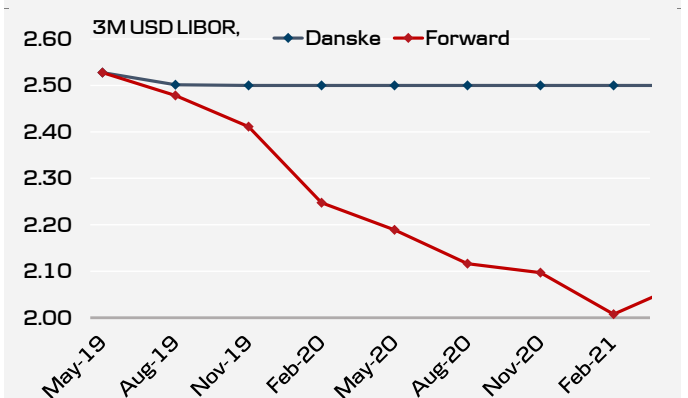
Source: Danske Bank

## 3M USD Libor rates



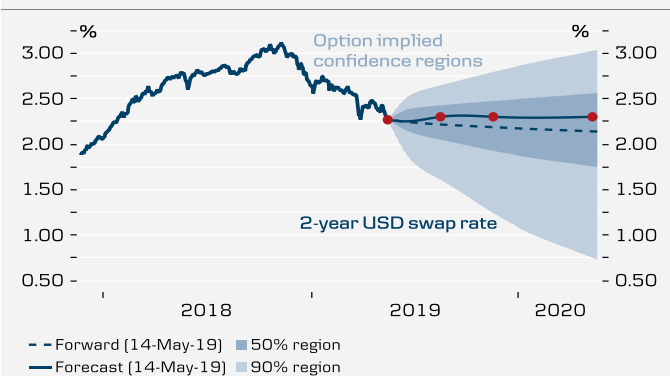
Source: Macrobond Financial, Danske Bank

## Danske Bank forecast and forwards



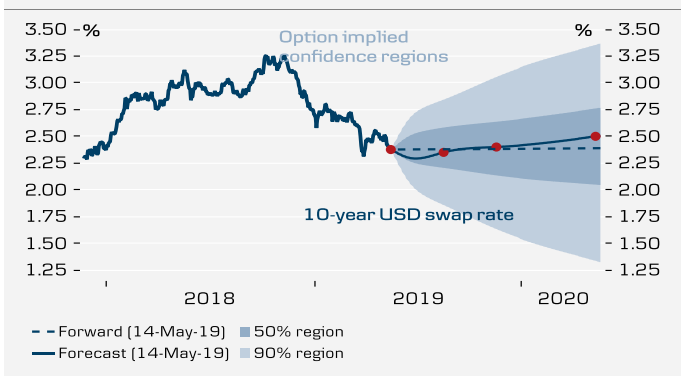
Source: Macrobond Financial, Danske Bank

## 2Y USD swap rates



Source: Danske Bank

## 10Y USD swap rates



Source: Danske Bank

# UK forecasts

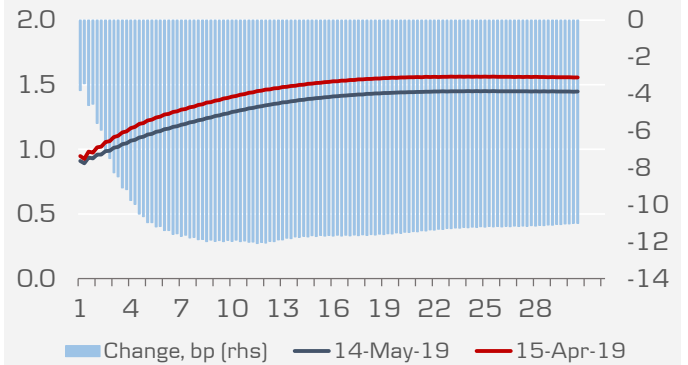
- While we do not expect a ‘hard’ Brexit, the Bank of England does not seem likely to hike rates within the next 12 months, in our view.
- Long yields likely to tick upwards slightly in 2019 as the market begins to price rate hikes in 2020.

## UK forecast summary

14/05/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
GBP	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<u>Money Market</u>							
Repo	0.75	0.75	0.75	0.75	-	-	-
3M	0.81	0.84	0.84	0.84	1	-3	-7
<u>Government Bonds</u>							
2-year	0.71	0.75	0.80	0.90	2	8	16
5-year	0.837	1	1.1	1.2	14	24	31
10-year	1.11	1.15	1.25	1.30	-4	4	3
<u>Swap rates</u>							
2-year	0.98	1.05	1.10	1.20	4	7	11
5-year	1.13	1.30	1.40	1.50	15	23	13
10-year	1.30	1.35	1.45	1.50	3	12	13

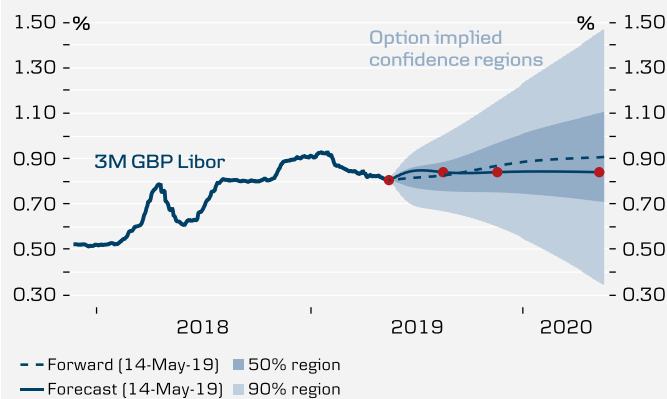
Source: Danske Bank

## 1M change in 6M GBP Libor



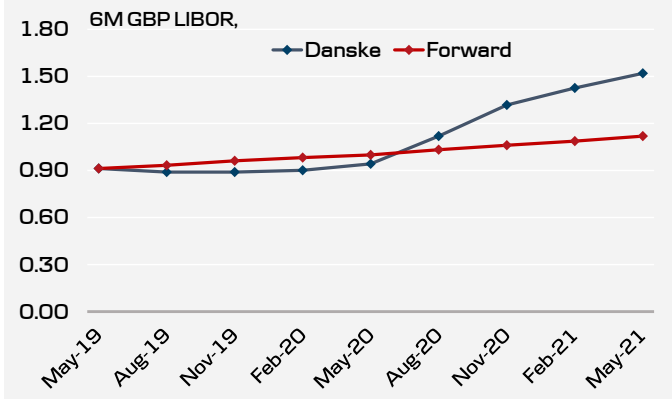
Source: Danske Bank

## 3M GBP Libor rates



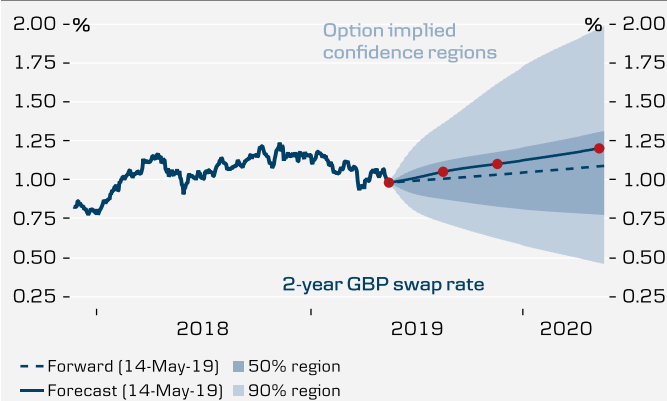
Source: Macrobond Financial, Danske Bank

## Danske Bank forecast and forwards



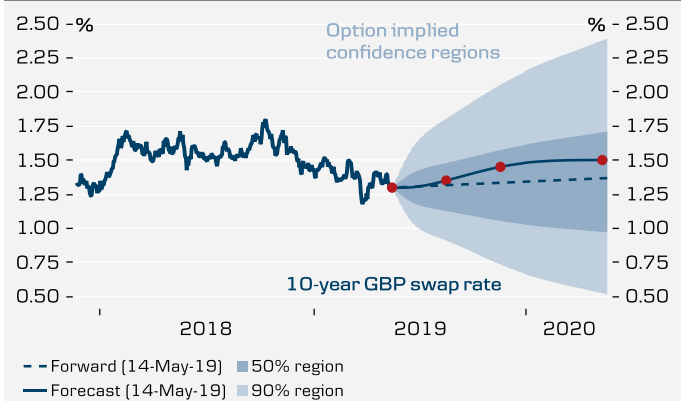
Source: Macrobond Financial, Danske Bank

## 2Y UK swap rates



Source: Danske Bank

## 10Y UK swap rates



Source: Danske Bank

# Sweden forecasts

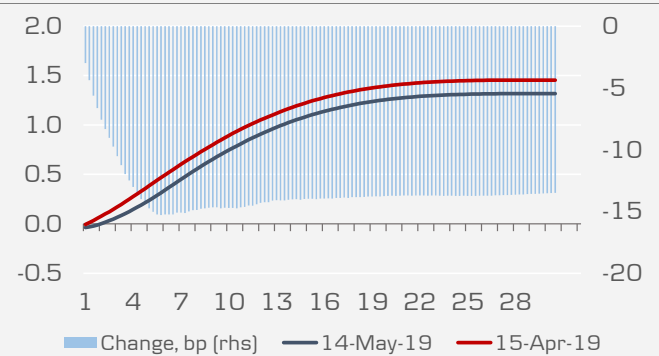
- At the April meeting, the Riksbank postponed the next projected hike to late 2019 or early 2020, flattened the repo rate path and decided to reinvest parts of its bond holdings (SEK45bn until December 2020). Despite the dovish message, we still expect inflation and growth to undershoot the Riksbank's forecast and we expect the repo rate to remain unchanged for the next 12 months.
- The market is currently pricing around 10bp of hikes over the next 12 months and given our view on the Riksbank, we do not expect any significant moves higher at the short end. The longer end is set to follow international yields, with limited upside potential.

## SEK forecast summary

14/05/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
SEK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<b>Money market</b>							
Repo	-0.25	-0.25	-0.25	-0.25	-	-	-
3M	-0.05	0.05	0.00	0.00	8	2	-3
<b>Government bonds</b>							
2-year	-0.61	-0.65	-0.60	-0.60	-	-	-
5-year	-0.42	-0.40	-0.40	-0.35	-	-	-
10-year	0.21	0.30	0.30	0.40	-	-	-
<b>Swap rates</b>							
2-year	0.03	0.05	0.10	0.10	-1	1	-7
5-year	0.29	0.35	0.35	0.35	2	-3	-13
10-year	0.79	0.90	0.90	0.95	7	2	-1

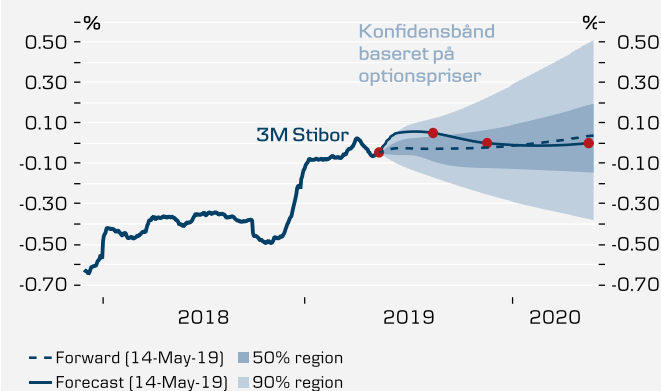
Source: Danske Bank

## 1M change in 3M Stibor



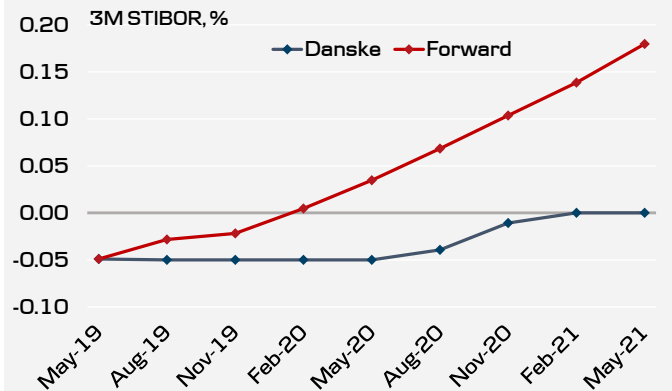
Source: Danske Bank

## 3M Stibor rate



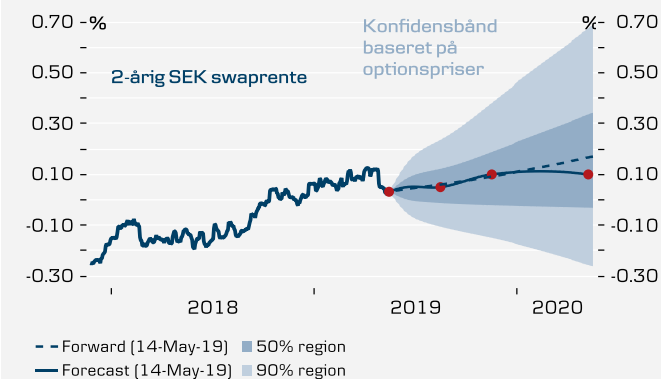
Source: Macrobond Financial, Danske Bank

## Danske Bank forecast and forwards



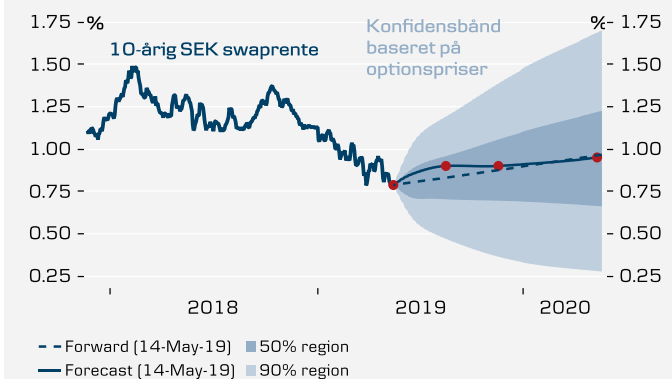
Source: Macrobond Financial, Danske Bank

## 2Y SEK swap rates



Source: Danske Bank

## 10Y SEK swap rates



Source: Danske Bank



# Norway forecasts

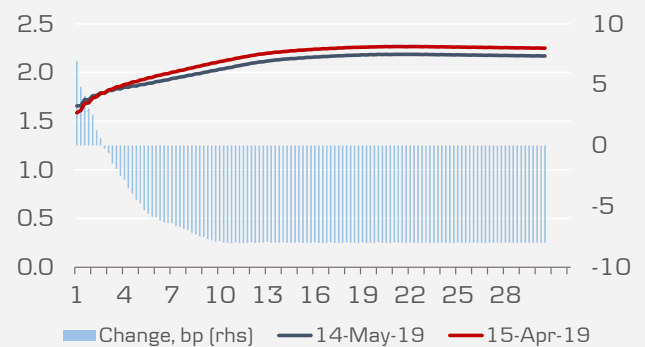
- The Norwegian economy continues to grow above potential driven by higher oil, construction and public investment. Core inflation was down slightly in April but, at 2.6%, is still running above the 2% target. A weak NOK and higher wage growth are now feeding through.
- We expect another two rate hikes from Norges Bank in 2019 (June and December). At its May meeting, Norges Bank again signalled a June rate cut. We expect long NOK yields to edge slightly further up vs. Bunds but the 2Y-10Y curve looks likely to flatten.

## NOK forecast summary

14/05/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
NOK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<b>Money market</b>							
Deposit	1.00	1.25	1.25	1.50	-	-	-
3M	1.45	1.60	1.80	2.02	1	9	26
6M	1.62	1.80	1.96	2.14	7	19	29
<b>Government bonds</b>							
2-year	1.34	1.40	1.60	1.70	-	-	-
5-year	1.44	1.50	1.70	1.80	-	-	-
10-year	1.71	1.80	1.85	2.00	-	-	-
<b>Swap rates</b>							
2-year	1.79	1.85	2.05	2.15	2	19	26
5-year	1.89	1.95	2.15	2.25	3	21	28
10-year	2.05	2.15	2.20	2.35	8	11	22

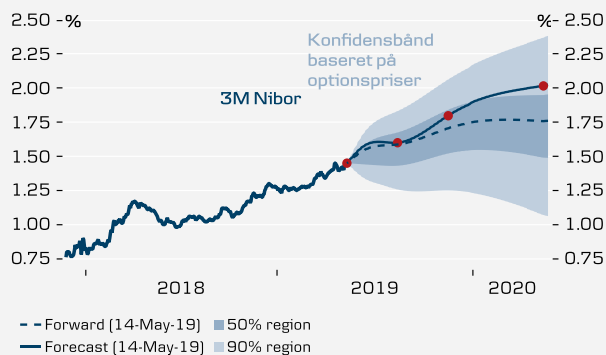
Source: Danske Bank

## 1M change in 6M Nibor



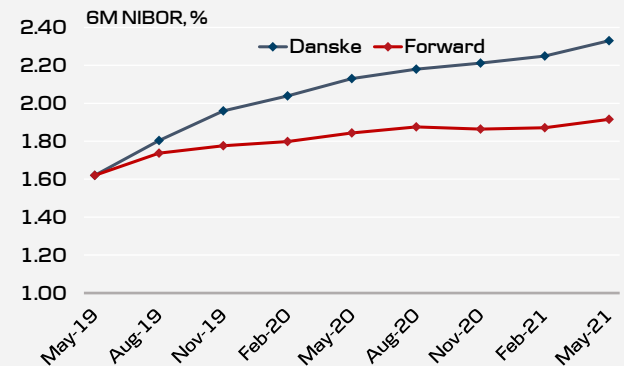
Source: Danske Bank

## 3M Nibor



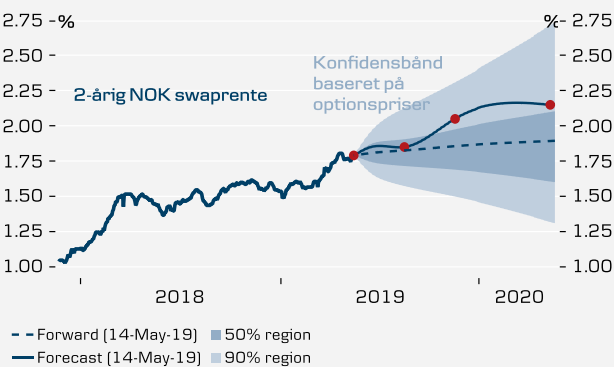
Source: Danske Bank

## Danske Bank forecast and forwards



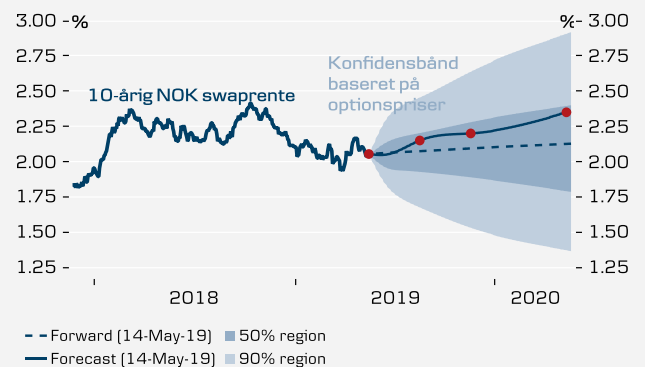
Source: Danske Bank

## 2Y NOK swap rate



Source: Danske Bank

## 10Y NOK swap rate



Source: Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Arne Lohmann Rasmussen, Chief Analyst.

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