19 September 2019

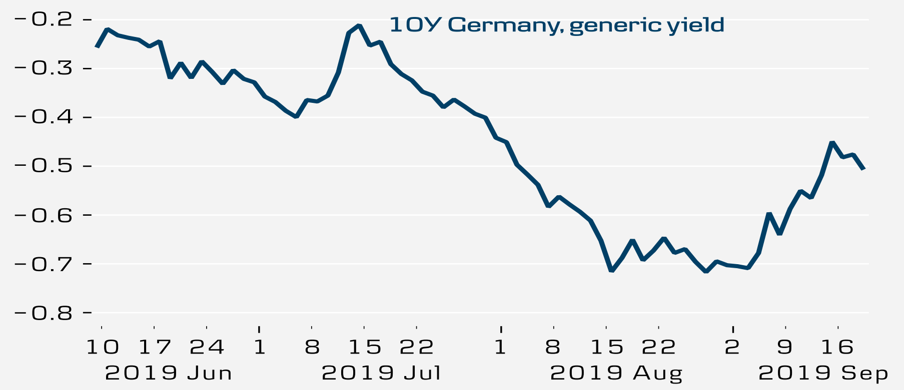
Yield Outlook

Long yields set to fall back again

The past month has been hectic on the financial markets. During the second half of August, the 10Y Bund yield traded below -0.70% at times, while 30Y Bund yields sometimes dipped below -0.25%.

In September the picture changed somewhat, with long yields rising a little. 30Y Bund yields are back in the black, while the 10Y yield has risen by around 20bp to -0.5%.

Higher long yields in September likely to be short lived



Source: Bloomberg, Danske Bank

However, in this edition of *Yield Outlook* our clear message is that we are not heading for a period of rising yields, as we saw, for example, in 2015, when 10Y Bund yields rose close to 1 percentage point in a short space of time. On the contrary, we expect long yields to fall back again to August levels.

Several reasons why yields have ticked higher in September

Improved risk appetite

There are several reasons why long yields have ticked around 20bp higher in September. Geopolitical risks moved centre stage over the summer. Fears of a hard Brexit reached new heights when Boris Johnson suspended the UK parliament. However, Brexit fears calmed somewhat after Johnson lost his majority in the Commons and a parliamentary majority - prior to prorogation - bound him to work towards an agreement with the EU or seek yet another extension of the Brexit deadline. Fears that the US-China trade war cannot be resolved have also subsided. The improved risk appetite has been reflected in global equity markets, which so far have had quite a decent September.

Quick links

Forecasts table

Forecasts for the Eurozone

Forecasts for the US

Forecasts for the UK

Forecast for Denmark

Forecasts for Sweden

Forecasts for Norway

Policy rates

Country	Spot	+3m	+6m	+12m
USD	2.00	1.50	1.00	1.00
EUR	-0.50	-0.50	-0.50	-0.50
GBP	0.75	0.75	0.75	0.75
DKK	-0.75	-0.75	-0.75	-0.75
SEK	-0.25	-0.25	-0.50	-0.50
NOK	1.50	1.50	1.50	1.75

10Y government bond yields

Country	Spot	+3m	+6m	+12m
USD	1.77	1.40	1.10	1.20
GER	-0.49	-0.60	-0.60	-0.50
GBP	0.65	0.55	0.55	0.60
DKK	-0.46	-0.55	-0.55	-0.45
SEK	-0.19	-0.20	-0.20	-0.20
NOK	1.36	1.25	1.30	1.30

Note: EUR = Germany

10Y swap rates

Country	Spot	+3m	+6m	+12m
USD	1.66	1.30	1.00	1.10
EUR	-0.09	-0.20	-0.20	-0.10
GBP	0.78	0.70	0.70	0.75
DKK	0.00	-0.10	-0.15	-0.05
SEK	0.34	0.35	0.35	0.35
NOK	1.75	1.65	1.70	1.70

Source: Danske Bank

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ECB opts for open-ended QE

However, the key factor for the fixed income market has once again been the global central banks, and not least the ECB. The ECB opened its long-awaited policy package at last week's meeting. Overall, the package was probably a bit of a disappointment, not least because a number of ECB policy hawks subsequently distanced themselves somewhat from the package, arguing that the ECB had gone too far.

First, the ECB restarted its QE programme, pledging to buy EUR20bn worth of bonds a month. That is a lower amount than many had anticipated, but on the other hand no closing date has been set for the programme. Purchases will continue until the ECB decides to raise interest rates, so the programme could continue undiminished for many years, we believe. Hence, the market now knows with great certainty that there will be a major buyer in the bond market for the next many years. On top of this, there will be reinvestments in the government market alone of around EUR15bn a month.

Rate cuts and a two-tier interest system

Second, the ECB announced a 10bp rate cut, which disappointed the market and drove up yields.

Third, the ECB introduced a tiered interest system allowing banks to place about 45%, or some EUR800bn, of their surplus liquid funds at 0% interest instead of at minus 0.50%. That had the effect of lifting the average deposit rate last week. It also spurred a sell-off of short-term government bonds, some of which were picked up by European banks wanting to avoid placing surplus funds at minus 0.40% with the ECB. The new system encourages banks to sell negative-yielding short bonds and place the proceeds at 0% where possible. As a result, short-term bond yields have risen in the past few days.

Stronger forward guidance

Lastly, the ECB revised its forward guidance. Instead of as previously keeping rates on hold for a defined period, the ECB will now stay on hold until inflation is close to 2%, stressing that this means underlying inflation and not inflation driven by, say, higher oil prices.

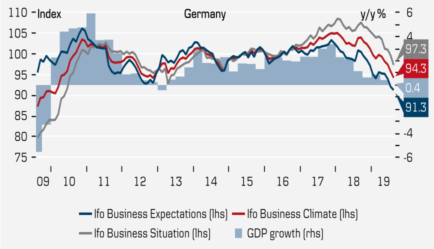
Note also that the ECB very explicitly urged euro area countries with fiscal room for manoeuvring, like Germany and the Netherlands, to pursue more active fiscal policies.

Will the new ECB package work? No, it will not

We doubt very much that the ECB's new package will succeed in jumpstarting the euro area economy and send inflation higher. That would only be the case if we expected long-term interest rates to continue to go up. Investors would then demand a higher premium for holding bonds and inflation expectations would rise.

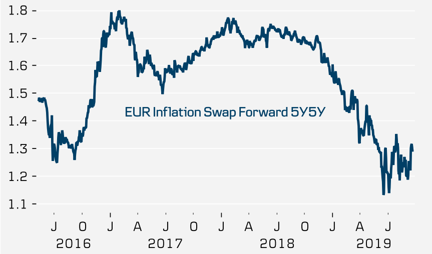
We expect the opposite to happen over the next couple of quarters. The economic cycle is still pointing downward, the German economy being a particular case in point. The economy contracted by 0.1% in the second quarter and Germany will likely see negative growth and go into technical recession in the third quarter. Very likely, the next step could be unemployment beginning to climb as already seen in Sweden.

German economy trending downward



Source: Macrobond Financial, Danske Bank

Markets have low inflation expectations



Source: Macrobond Financial, Danske Bank

Indeed, the ECB has not succeeded in restoring market confidence in higher inflation. Many investors monitor the 5Y5Y EUR inflation (average 5Y inflation rate in five years' time). It edged up by only a tiny notch after the ECB had announced its package and remains well below the ECB target, at 1.30%. In other words, the financial markets have very little confidence that what the ECB is doing will be enough to drive up inflation in the long term. We fully agree.

On the other hand, we do believe that one of the ECB's tools will have an effect and that is the open-ended QE programme. In combination with reinvesting, as already mentioned, it will probably pull a large volume of bonds out of the market, putting downward pressure on European government bond yields throughout 2020.

Yields set to fall back again

Overall, we expect German yields to fall back to August levels and we maintain our call that the benchmark German bond yield is likely to drop to minus 0.70% within the next three months. The combination of a weakening economic cycle, monetary easing by the ECB – not least QE – and the ongoing struggle by investors to avoid negative yields points in that direction.

The US Federal Reserve has already cut rates and while Governor Powell was very cautious about promising a series of rate cuts, we now believe that we will see a series of US rate cuts and that the Fed funds rate will drop to 1% by March of next year. To read more, see *FOMC research: New Fed Call: Five more from Fed*, published on 15 August. Given our Fed call, we expect 10Y US Treasury yields to drop to 1.1% on a six-month horizon. That would help push down long-term European yields.

European yields in particular have been under heavy pressure due to the weak economic cycle and while we expect it to improve slightly over the next 12 months, yields are not likely to increase significantly and we definitely do not expect a change to an upward sloping trend in yields.

Low yields for a very long time

On 13 June, we published the research note *Global Research: Euro area rates to stay very low for very long*. In this report, we looked at the factors that have driven the neutral real rate of interest lower in Europe and discussed the consequences for long nominal yields. We concluded that current yields are not particularly low and as we have previously argued elsewhere, the market is unlikely to speculate in rate hikes from the ECB for the next three or four years.

With low inflation expectations and a negative neutral real interest rate, current short and long yields are, in reality, not particularly low. In other words, there is no longer a gravitational or normalising force that would tend to pull yields higher over time.

This does not mean that yields cannot rise again. An improving economy or greater risk appetite would tend to push interest rates up and so would the US and China putting an end to the trade war or a hard Brexit being avoided.

However, there is no longer a trend inevitably pulling yields higher over time, and right now the economic cycle, in fact, points to lower yields rather than higher yields.

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

Forecasts

Forecasts*

	Horizon	Policy rate	3m xlbor	2-yr swap	5-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
USD	Spot	2.00	2.16	1.73	1.60	1.66	1.75	1.66	1.77
	+3m	1.50	1.22	1.30	1.25	1.30	1.30	1.30	1.40
	+6m	1.00	1.00	0.90	0.95	1.00	0.90	1.00	1.10
	+12m	1.00	1.00	1.00	1.10	1.10	1.00	1.15	1.20
EUR*	Spot	-0.50	-0.40	-0.42	-0.36	-0.09	-0.72	-0.71	-0.49
	+3m	-0.50	-0.41	-0.50	-0.45	-0.20	-0.80	-0.80	-0.60
	+6m	-0.50	-0.41	-0.50	-0.45	-0.20	-0.80	-0.80	-0.60
	+12m	-0.50	-0.41	-0.40	-0.30	-0.10	-0.70	-0.65	-0.50
GBP	Spot	0.75	0.78	0.78	0.75	0.78	0.52	0.47	0.65
	+3m	0.75	0.79	0.70	0.65	0.70	0.40	0.35	0.55
	+6m	0.75	0.79	0.70	0.50	0.70	0.40	0.20	0.55
	+12m	0.75	0.79	0.80	0.60	0.75	0.50	0.30	0.60
DKK	Spot	-0.75	-0.43	-0.33	-0.27	0.00	-0.76	-0.67	-0.46
	+3m	-0.75	-0.45	-0.40	-0.35	-0.10	-0.80	-0.80	-0.55
	+6m	-0.75	-0.45	-0.45	-0.40	-0.15	-0.80	-0.80	-0.55
	+12m	-0.75	-0.45	-0.35	-0.25	-0.05	-0.70	-0.65	-0.45
SEK	Spot	-0.25	-0.05	-0.06	0.02	0.34	-0.60	-0.55	-0.19
	+3m	-0.25	-0.10	-0.15	-0.05	0.35	-0.70	-0.65	-0.20
	+6m	-0.50	-0.30	-0.25	-0.05	0.35	-0.80	-0.65	-0.20
	+12m	-0.50	-0.30	-0.25	-0.05	0.35	-0.80	-0.65	-0.20
NOK	Spot	1.50	1.77	1.86	1.74	1.75	1.28	1.34	1.36
	+3m	1.50	2.07	1.90	1.60	1.65	1.30	1.20	1.25
	+6m	1.50	2.19	2.00	1.70	1.70	1.40	1.30	1.30
	+12m	1.75	2.32	2.05	2.00	1.70	1.45	1.60	1.30

Note: * German government bonds are used, EUR swap rates are used

** German government bond yields and EUR swap rates used*
Source: Danske Bank

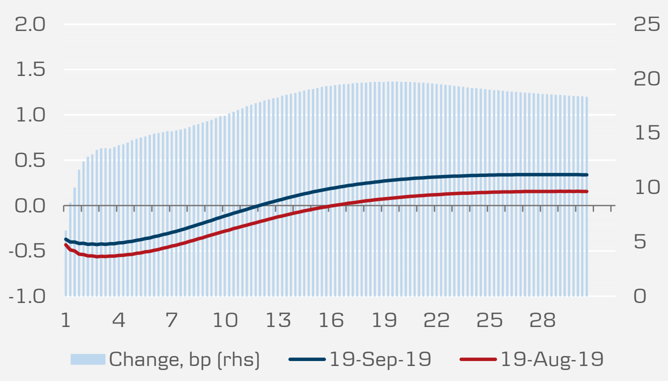
Eurozone forecasts

EUR forecast summary

19/09/2019		--- Prognose ---			Afvigelse fra forward i bp		
EUR	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Pengemarked				
Refi	0.00	0.00	0.00	0.00	-	-	-
Deposit	-0.50	-0.50	-0.50	-0.50	-	-	-
3M	-0.40	-0.41	-0.41	-0.41	3	8	11
6M	-0.37	-0.36	-0.36	-0.36	4	7	9
			Statsobligationer				
2-årig	-0.72	-0.80	-0.80	-0.70	-	-	-
5-årig	-0.71	-0.80	-0.80	-0.65	-	-	-
10-årig	-0.49	-0.60	-0.60	-0.50	-	-	-
			Swaprenter				
2-årig	-0.42	-0.50	-0.50	-0.40	-7	-6	3
5-årig	-0.36	-0.45	-0.45	-0.30	-10	-11	0
10-årig	-0.09	-0.20	-0.20	-0.10	-14	-16	-11

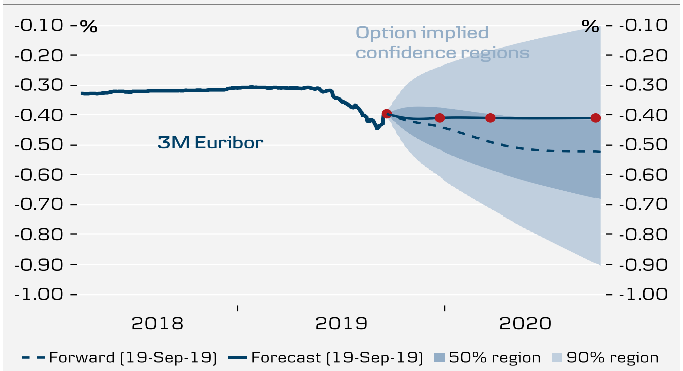
Source: Danske Bank

1M change in 6M Euribor



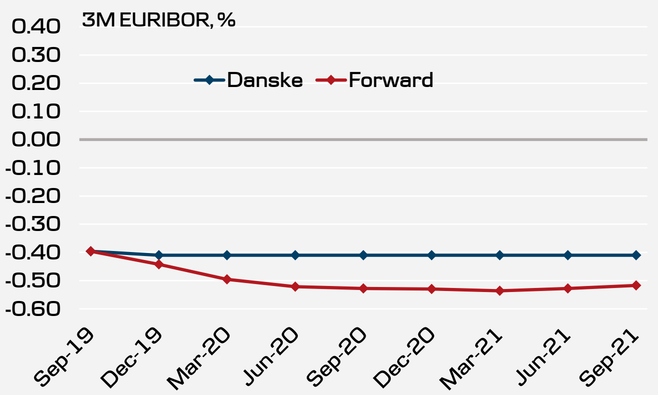
Source: Danske Bank

3M Euribor



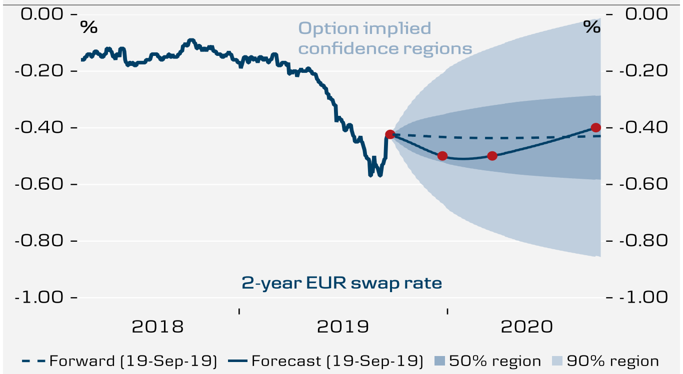
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



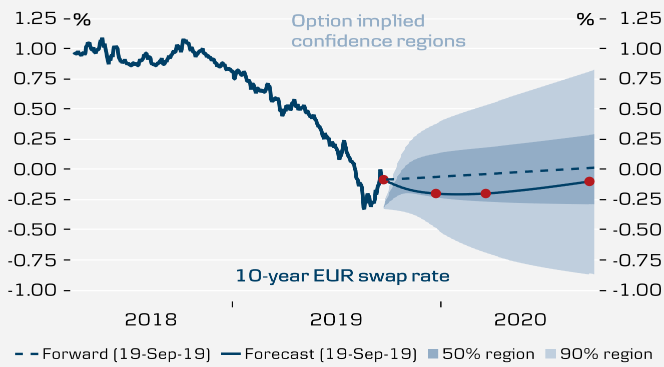
Source: Macrobond Financial, Danske Bank

2Y EUR swap rates



Source: Danske Bank

10Y EUR swap rates



Source: Danske Bank

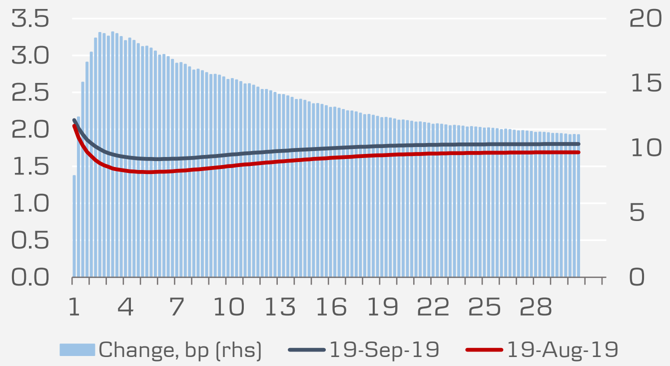
US forecasts

USD forecast summary

19/09/2019		--- Forecast ---			--- Fcst vs Fwd in bp ---		
USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money Market				
Fed Funds	2.00	1.50	1.00	1.00	-	-	-
3M	2.16	1.22	1.00	1.00	-84	-79	-57
			Government Bonds				
2-year	1.75	1.30	0.90	1.00	-	-	-
5-year	1.66	1.30	1.00	1.15	-	-	-
10-year	1.77	1.40	1.10	1.20	-	-	-
			Swap rates				
2-year	1.73	1.30	0.90	1.00	-34	-67	-50
5-year	1.60	1.25	0.95	1.10	-32	-59	-43
10-year	1.66	1.30	1.00	1.10	-36	-65	-56

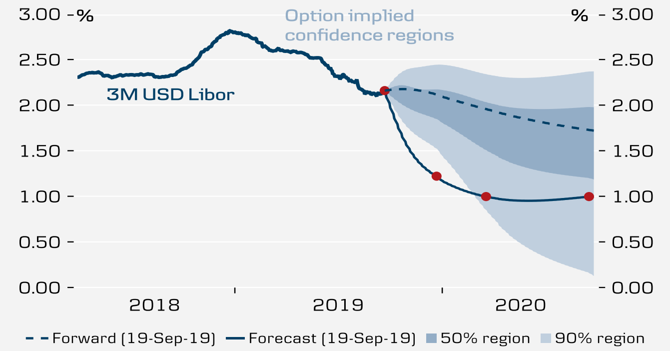
Source: Danske Bank

1M change in 3M USD Libor



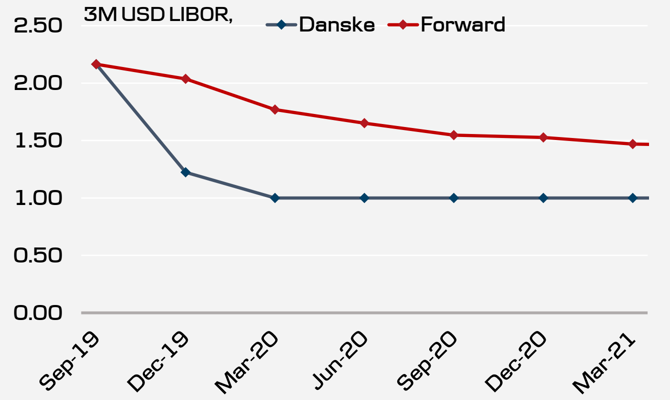
Source: Danske Bank

3M USD Libor rates



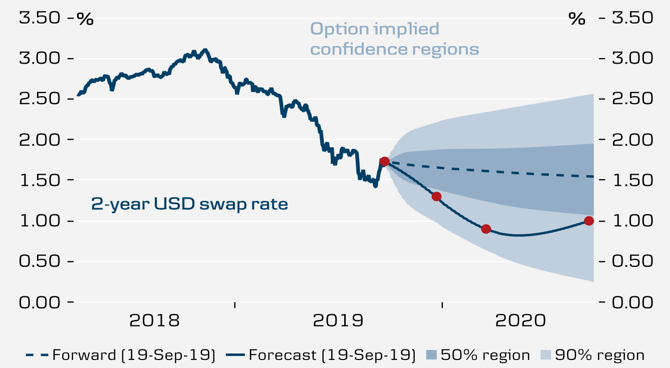
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



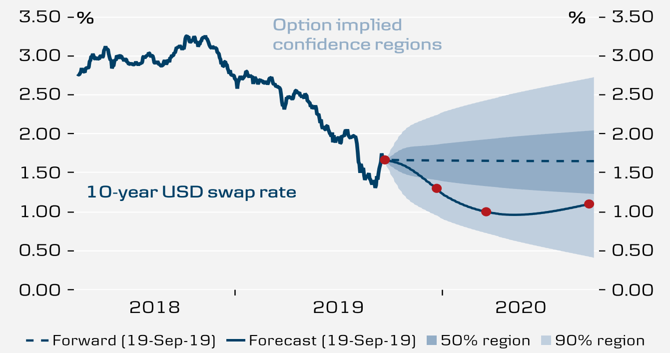
Source: Macrobond Financial, Danske Bank

2Y USD swap rates



Source: Danske Bank

10Y USD swap rates



Source: Danske Bank

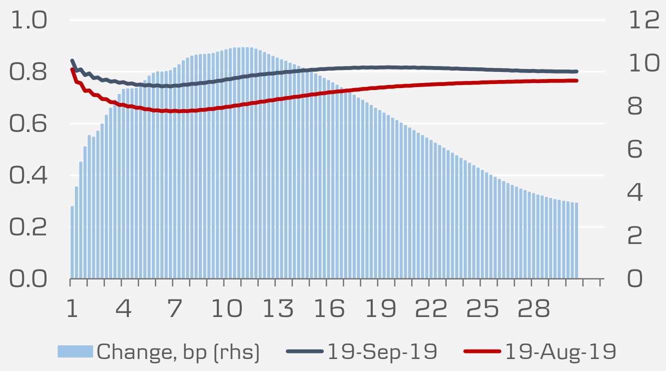
UK forecasts

UK forecast summary

19/09/2019		--- Forecast ---				--- Fcst vs Fwd in bp ---		
GBP	Spot	+3m	+6m	+12m		+3m	+6m	+12m
				Money Market				
Repo	0.75	0.75	0.75	0.75		-	-	-
3M	0.78	0.79	0.79	0.79		0	6	9
				Government Bonds				
2-year	0.52	0.40	0.40	0.50		-6	-1	12
5-year	0.466	0.35	0.2	0.3		-7	-19	-6
10-year	0.65	0.55	0.55	0.60		-11	-12	-11
				Swap rates				
2-year	0.78	0.70	0.70	0.80		-6	-5	6
5-year	0.75	0.65	0.50	0.60		-9	-24	-18
10-year	0.78	0.70	0.70	0.75		-8	-8	-3

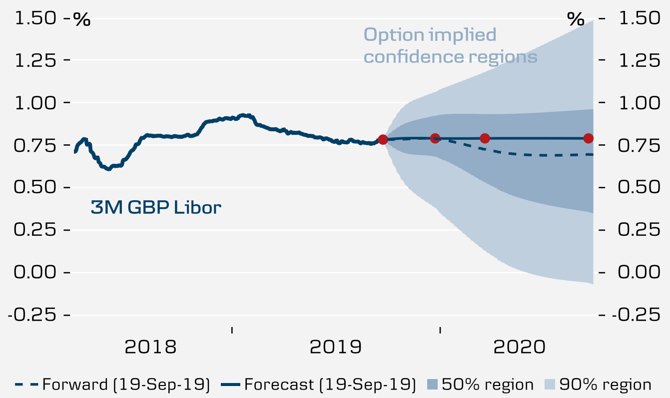
Source: Danske Bank

1M change in 6M GBP Libor



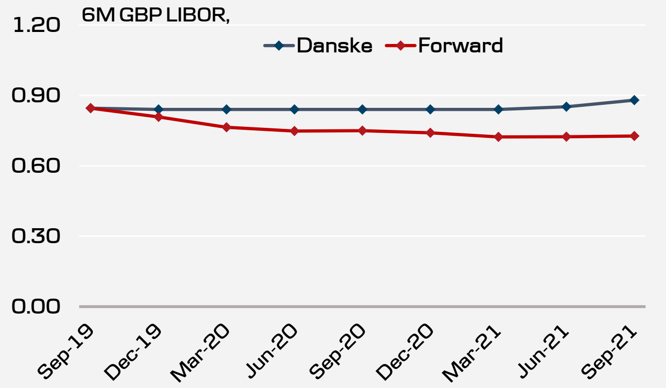
Source: Danske Bank

3M GBP Libor rates



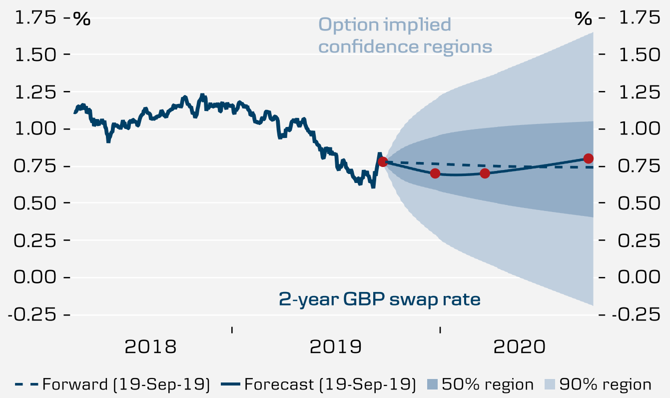
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



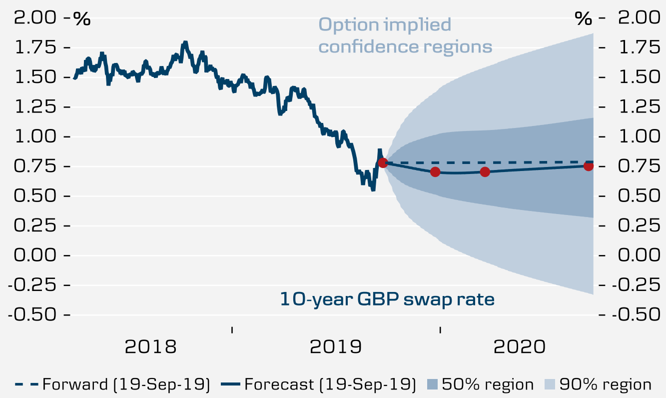
Source: Macrobond Financial, Danske Bank

2Y UK swap rates



Source: Danske Bank

10Y UK swap rates



Source: Danske Bank

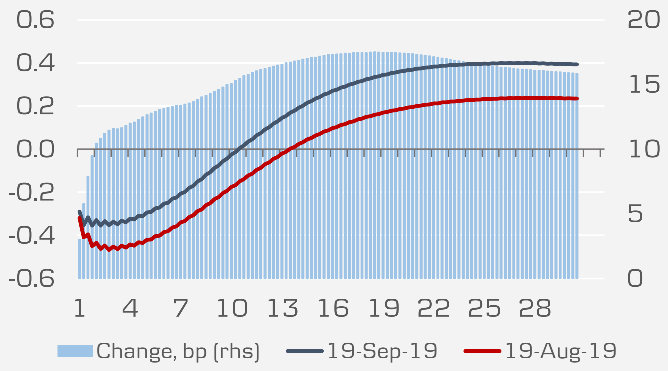
Denmark forecasts

DKK forecast summary

19/09/2019		--- Forecast ---			--- Fcst vs Fwd in bp ---		
DKK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money Market				
CD	-0.75	-0.75	-0.75	-0.75	-	-	-
Repo	0.05	0.05	0.05	0.05	-	-	-
3M	-0.43	-0.45	-0.45	-0.45	0	2	6
6M	-0.29	-0.30	-0.30	-0.30	1	3	5
			Government bonds				
2-year	-0.76	-0.80	-0.80	-0.70	-	-	-
5-year	-0.67	-0.80	-0.80	-0.65	-	-	-
10-year	-0.46	-0.55	-0.55	-0.45	-	-	-
			Swap rates				
2-year	-0.33	-0.40	-0.45	-0.35	-6	-10	-1
5-year	-0.27	-0.35	-0.40	-0.25	-9	-15	-4
10-year	0.00	-0.10	-0.15	-0.05	-13	-20	-15

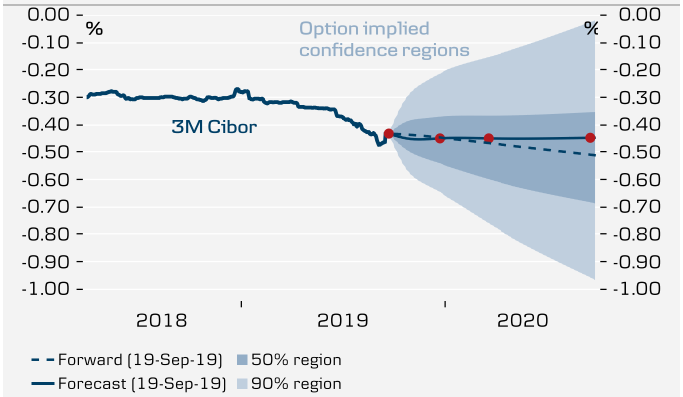
Source: Danske Bank

1M change in 6M Cibor



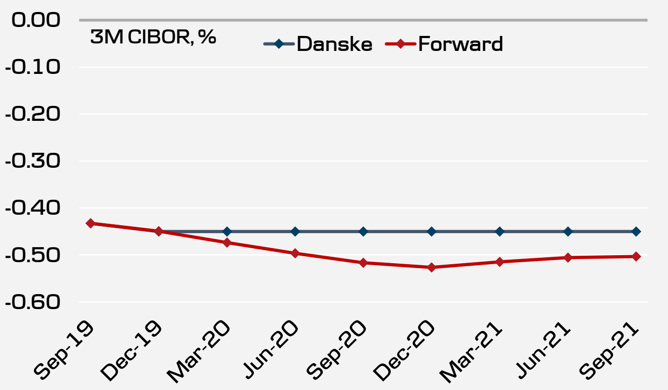
Source: Danske Bank

3M Cibor



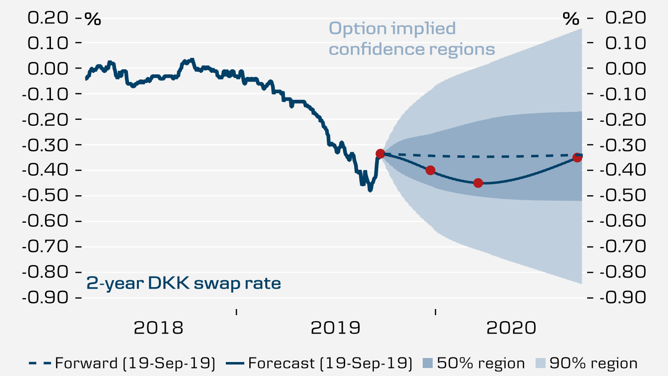
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



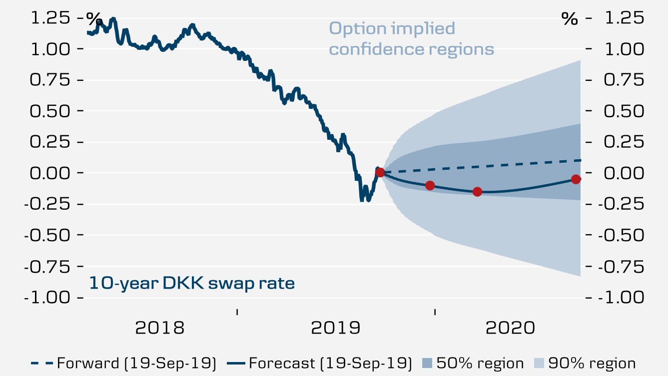
Source: Macrobond Financial, Danske Bank

2Y DKK swap rates



Source: Danske Bank

10Y DKK swap rates



Source: Danske Bank

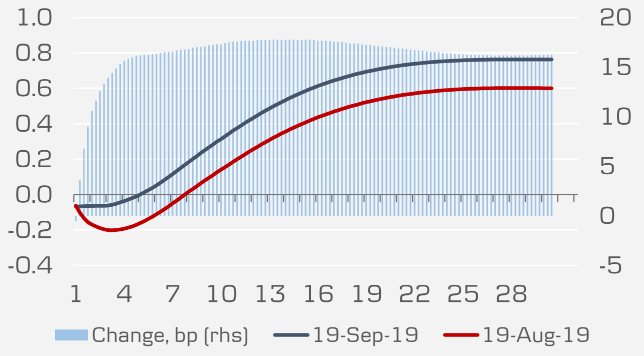
Sweden forecasts

SEK forecast summary

19/09/2019		--- Forecast ---			--- Fcst vs Fwd in bp ---		
SEK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Repo	-0.25	-0.25	-0.50	-0.50	-	-	-
3M	-0.05	-0.10	-0.30	-0.30	-2	-24	-24
				Government bonds			
2-year	-0.60	-0.70	-0.80	-0.80	-	-	-
5-year	-0.55	-0.65	-0.65	-0.65	-	-	-
10-year	-0.19	-0.20	-0.20	-0.20	-	-	-
				Swap rates			
2-year	-0.06	-0.15	-0.25	-0.25	-9	-19	-21
5-year	0.02	-0.05	-0.05	-0.05	-9	-11	-16
10-year	0.34	0.35	0.35	0.35	-2	-5	-10

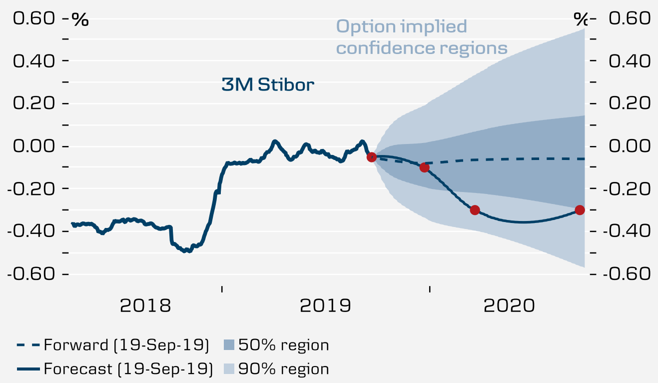
Source: Danske Bank

1M change in 3M Stibor



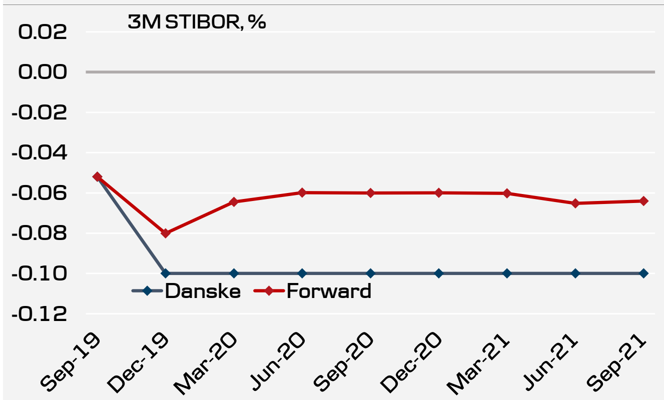
Source: Danske Bank

3M Stibor rate



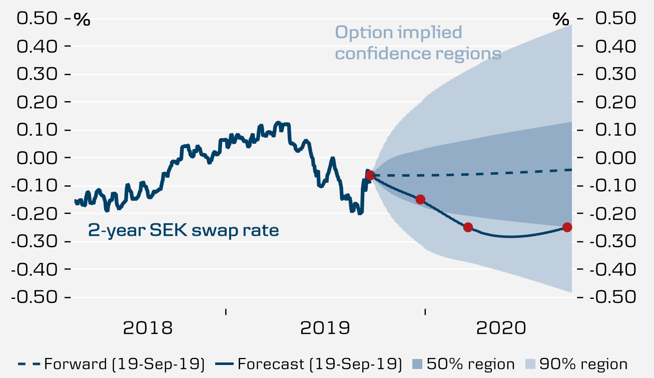
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



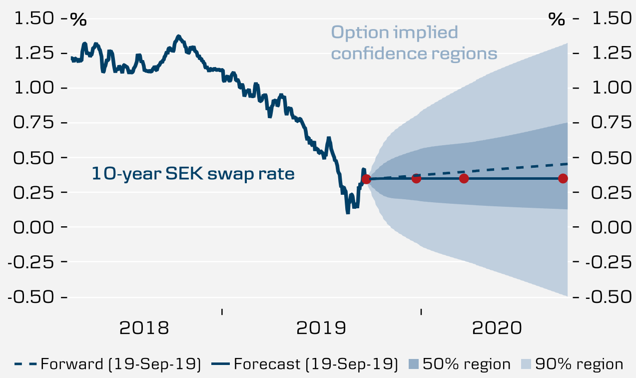
Source: Macrobond Financial, Danske Bank

2Y SEK swap rates



Source: Danske Bank

10Y SEK swap rates



Source: Danske Bank

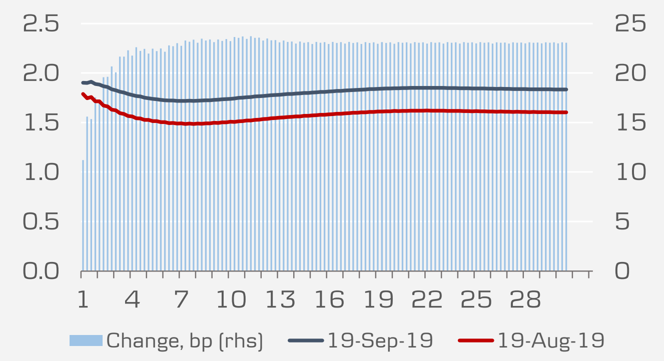
Norway forecasts

NOK forecast summary

19/09/2019		--- Forecast ---			--- Fcst vs Fwd in bp ---		
NOK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money market				
Deposit	1.50	1.50	1.50	1.75	-	-	-
3M	1.62	1.93	2.10	2.19	0	23	41
6M	1.77	2.07	2.19	2.32	11	28	49
			Government bonds				
2-year	1.28	1.30	1.40	1.45	-	-	-
5-year	1.34	1.20	1.30	1.60	-	-	-
10-year	1.36	1.25	1.30	1.30	-	-	-
			Swap rates				
2-year	1.86	1.90	2.00	2.05	6	19	30
5-year	1.74	1.60	1.70	2.00	-13	-1	32
10-year	1.75	1.65	1.70	1.70	-10	-5	-5

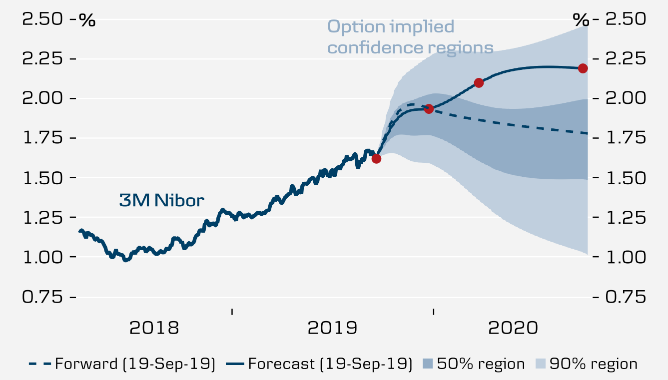
Source: Danske Bank

1M change in 6M Nibor



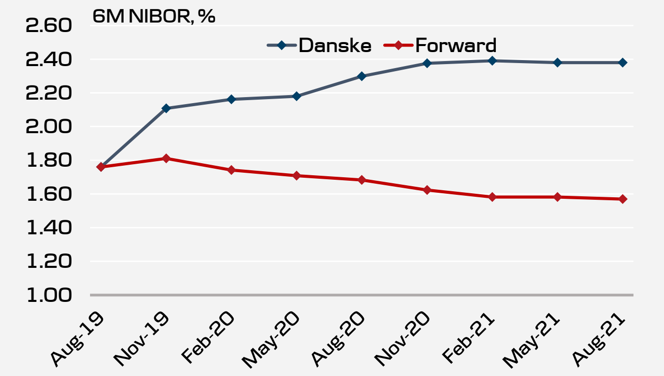
Source: Danske Bank

3M Nibor



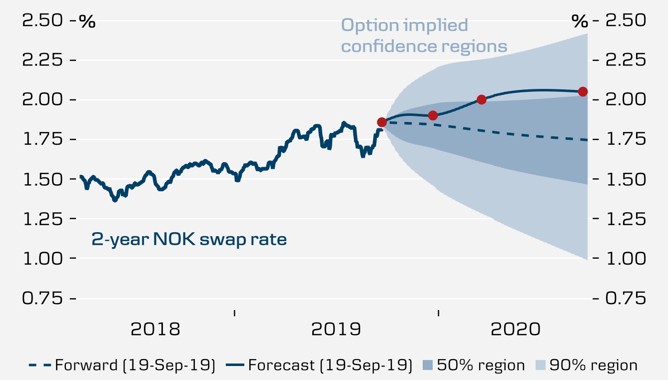
Source: Danske Bank

Danske Bank forecast and forwards



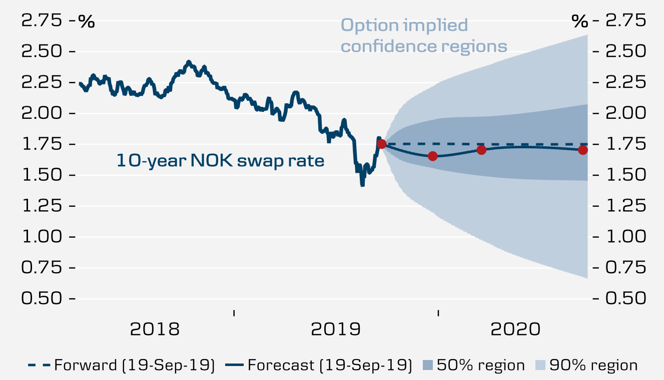
Source: Danske Bank

2Y NOK swap rate



Source: Danske Bank

10Y NOK swap rate



Source: Danske Bank

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