

Yield Outlook

Time to pause but what next?

Fixed income markets have had plenty to mull over in recent weeks, including important monetary policy meetings at the ECB and the Federal Reserve. Long yields in Europe are largely unchanged over the past month, but day-to-day fluctuations have remained significant. Upside economic surprises in the US and higher oil prices have combined with monetary policy announcements to pull yields higher across the curve. This has played out in tandem with higher market-based inflation expectations in the US and to some extent Europe. In this *Yield Outlook*, we focus on recent yield movements in Europe and look ahead to the most likely risk scenarios in the coming year. Our take on the other currencies we cover (USD/GBP/NOK/SEK) can be seen in the overview on page 5.

ECB hikes but signals a pause

As expected, the ECB raised its key policy rates by 25bp in September, though this was not done until prior to the meeting. Pre-meeting uncertainties had been fuelled by the recent weakening of activity data in Europe, which now paints a clearly more anaemic picture of growth. Conversely, underlying inflationary pressures are still too high, and ECB staff project inflation to remain above 2% through their 2025 forecast horizon. The inflation outlook was ultimately at the crux of the interest rate decision, though we should add that the ECB has now explicitly raised the bar for further rate hikes. Going forward, attention will likely focus much more on how long current rates will have to be maintained for the ECB to meet its inflation target. In other words, focus has shifted from 'level' towards 'horizon'. We see the horizon as being just short of a year and therefore expect rate cuts in the eurozone to materialise around next summer, when we expect quarterly cuts of 0.25 percentage points to start, providing for a relatively slow return to a more neutral deposit rate of around 2% (vs. 4% currently).

Could still go either way

However, the expected gradual normalisation of monetary policy over the coming years is not set in stone, and the likely ending of the hiking cycle has not cleared the fog when looking ahead. Inflation in Europe and to some extent in the US is still elevated, and considerable uncertainties remain on just how much policy tightening to date will affect these economies. When central banks might again dare move towards less restrictive monetary policies will be determined by developments in GDP growth and inflation data.

Looking at the US, which has the best historical database, we can see that since 1984 about 9 months passed from the final rate hike until the first rate cut. However, these historical instances unfolded very differently in terms of both timing and speed, as a recession (of varying severity) has often followed in the wake of a tightening cycle. Soft landings are clearly a rarer breed and, after a year of the most aggressive monetary policy tightening in decades, we cannot yet write off the risk of a deep recession this time around. Getting the dosage correct when tightening has always been notoriously difficult.

At the other end of the outcome range, the main risk is that interest rates remain at current levels for longer than markets are pricing. This would most likely go hand-in-hand with an economy that demonstrates greater resilience to the already delivered rate hikes.

Shortcuts

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Central bank policy rates

Country	Spot	+3m	+6m	+12m
USD	5.50	5.50	5.25	4.75
EUR	4.00	4.00	4.00	3.50
GBP	5.25	5.25	5.25	4.75
DKK	3.60	3.60	3.60	3.10
SEK	4.00	4.00	4.00	3.75
NOK	4.25	4.25	4.25	3.75

10Y government bond yields

Country	Spot	+3m	+6m	+12m
USD	4.48	4.20	3.90	3.70
EUR	2.73	2.55	2.40	2.25
GBP	4.31	4.10	4.00	3.80
DKK	2.99	2.80	2.65	2.50
SEK	2.91	2.85	2.75	2.70
NOK	3.92	3.60	3.40	3.20

Note: EUR = Germany

10Y swap rates

Country	Spot	+3m	+6m	+12m
USD	4.13	3.95	3.65	3.45
EUR	3.28	3.10	2.95	2.80
GBP	4.15	4.05	3.95	3.75
DKK	3.44	3.25	3.10	2.95
SEK	3.37	3.25	3.00	2.85
NOK	4.12	3.85	3.65	3.45

Source: Danske Bank (all three tables)

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In Europe, consumers are key to this scenario. So far, European households have remained remarkably buoyant despite high interest rates and inflation, as well as a significant decline in real wages over the winter. In fact, the savings-to-income ratio has been higher than normal in the past year, and this comes on top of substantial savings accumulated during the COVID-19 pandemic that have not yet been eaten into. Rising real wage growth could potentially provide a foundation for considerably stronger GDP growth than expected, pushing rate cuts further into the future. Looking at the probabilities priced into the options market, we note that the higher-rates-for-longer scenario clearly appears to be the main concern for the coming year.

Long yields set to decline in coming year

In our baseline scenario, both the ECB and the Federal Reserve see inflation and GDP growth weaken sufficiently over the next year for them to start easing off the brakes. We therefore expect long yields to gradually decline across currencies as the impact of the rate hikes on the economy/inflation becomes more pronounced and central bank rhetoric less hawkish. Our view remains that market pricing of ‘stable’ policy rates in both the US and Europe is too high for the longer term, and we reckon market pricing will gradually converge towards our position over the next year.

In the shorter term, we expect the rate hikes in the US and Europe to dampen interest rate volatility a tad, which is fully in line with the historical picture after previous tightening cycles. That being said, the relatively significant rate cuts the market is pricing for next year (70bp in the US, 60bp in the eurozone) mean the data stream (especially related to inflation) could prompt sizeable fluctuations. For companies with floating rate exposure, we continue to recommend moving out to the long end of the swap curve in order to hedge the risk of higher-rates-for-longer. For shorter-term horizons, we prefer using cap/floor structures to potentially profit from a greater decline in rates and yields than the market is currently pricing.

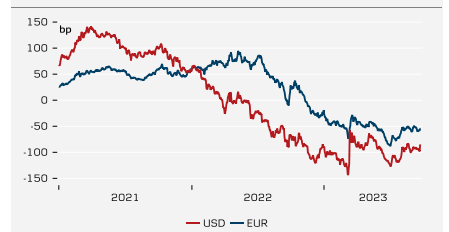
Long yields have risen over the past month (EUR swaps)



Note: Past performance is not a reliable guide to future returns

Source: Macrobond Financial, Danske Bank

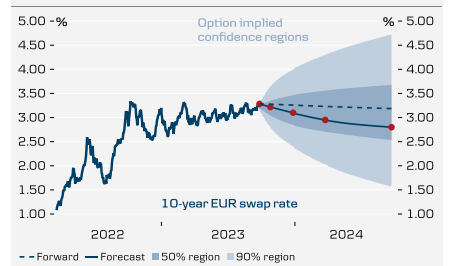
2Y-10Y (swap) yield curves



Note: Past performance is not a reliable guide to future returns

Source: Macrobond Financial, Danske Bank

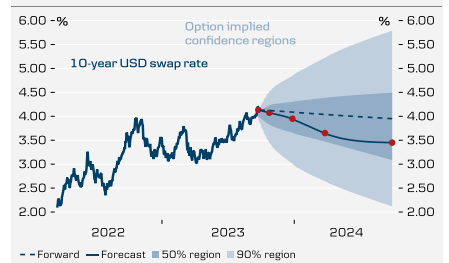
Forecast: 10Y EUR swap rates



Note: Past performance is not a reliable guide to future returns

Source: Macrobond Financial, Danske Bank

Forecast: 10Y USD swap rates



Note: Past performance is not a reliable guide to future returns

Source: Macrobond Financial, Danske Bank

Forecast*

	Horizon	Policy rate	3m xlbbr	6m xlbbr	2y gov	5y gov	10y gov	2y swap	5y swap	10y swap
USD**	Spot	5.50			5.13	4.61	4.48	5.07	4.37	4.13
	+3M	5.50			4.90	4.35	4.20	4.75	4.10	3.95
	+6M	5.25			4.50	4.00	3.90	4.35	3.75	3.65
	+12M	4.75			4.10	3.80	3.70	3.95	3.55	3.45
EUR*	Spot	4.00	3.96	4.07	3.25	2.74	2.73	3.86	3.39	3.28
	+3M	4.00	3.95	3.85	2.95	2.55	2.55	3.55	3.20	3.10
	+6M	4.00	3.83	3.66	2.75	2.40	2.40	3.35	3.05	2.95
	+12M	3.50	3.34	3.18	2.40	2.15	2.25	3.00	2.80	2.80
GBP**	Spot	5.25			4.87	4.43	4.3	5.19	4.50	4.15
	+3M	5.25			4.70	4.30	4.1	5.00	4.40	4.05
	+6M	5.25			4.40	4.05	4.0	4.70	4.15	3.95
	+12M	4.75			4.00	3.75	3.8	4.30	3.85	3.75
DKK	Spot	3.60	3.99	4.14	3.25	2.95	2.99	4.00	3.55	3.44
	+3M	3.60	4.00	4.03	3.00	2.70	2.80	3.70	3.35	3.25
	+6M	3.60	3.88	3.82	2.85	2.55	2.65	3.50	3.20	3.10
	+12M	3.10	3.39	3.31	2.50	2.30	2.50	3.15	2.95	2.95
SEK	Spot	4.00	4.12	4.20	3.59	3.08	2.91	4.09	3.57	3.37
	+3M	4.00	4.12	4.17	3.45	2.80	2.85	3.90	3.40	3.25
	+6M	4.00	4.10	4.04	3.10	2.65	2.75	3.50	3.10	3.00
	+12M	3.75	3.60	3.57	2.70	2.60	2.70	3.10	2.90	2.85
NOK	Spot	4.25	4.73	5.04	4.3	4.09	3.92	4.91	4.37	4.12
	+3M	4.25	4.75	4.89	3.8	3.65	3.60	4.40	4.05	3.85
	+6M	4.25	4.64	4.63	3.5	3.40	3.40	4.10	3.80	3.65
	+12M	3.75	3.99	4.03	3.2	3.15	3.20	3.80	3.55	3.45

* German government bond yields and euro swap rates ** Based on OIS/SOFR swap rates

Note: Past performance is not a reliable guide to future returns

Source: Danske Bank

Overview

<p>USD</p>	<ul style="list-style-type: none"> The US central bank (the Fed) has maintained the fed funds rate at 5.25-5.50% since July. We envisage no more hikes, but it is a close call, as the Fed again signalled one further rate hike this year at its September meeting. Easing inflation pressures open the door to rate cuts from early 2024 but uncertainty has clearly increased here, too. We expect the swap curve to gradually steepen over the coming year as focus shifts to rate cuts. 	
<p>EUR</p>	<ul style="list-style-type: none"> The ECB raised its deposit rate to 4% in September. While we expect no more rate hikes, risks to our forecast remain. We see the first rate cut coming in mid-2024. The economy emerged from the energy crisis in solid shape but has lost some momentum recently. Labour markets are hot and inflation pressures have remained high. Swap rates look set to gradually reflect the outlook for rate cuts from 2024 onwards. We expect yields to fall and the curve to steepen considerably in the next year. 	
<p>DKK</p>	<ul style="list-style-type: none"> The Danish central bank has maintained a policy rate spread to the ECB of 40bp since early 2023, and we expect this to continue for now. The CD rate was raised to 3.6% in September. We expect rate cuts from summer 2024. The DKK swap curve has inverted markedly since the start of the year, reflecting the aggressive monetary tightening and thus the potential risk of a hard landing for the economy. As with the eurozone, we expect the yield curve to steepen from here as rate cuts draw closer. 	
<p>GBP</p>	<ul style="list-style-type: none"> The Bank of England (BOE) has raised key policy rates markedly over the past year to 5.25%. GDP growth remains solid, the labour market is tight and inflation is still too high. We expect unchanged rates going forward, while the market is pricing a 60% chance of yet another hike. Our monetary policy expectations imply a decline in rates across the UK swap curve in the time ahead - though a more modest decline than previously expected, as market pricing of the BOE is now closer to our own outlook. 	
<p>SEK</p>	<ul style="list-style-type: none"> Since kicking off its tightening cycle in early 2022, the Riksbank has raised its repo rate to 4%. We expect no further rate hikes from here and look for rate cuts in H2 24. The Swedish economy performed better than expected in H1 23. Business activity has remained high, the labour market is tight and inflation is still elevated. We expect rates and yields - not least, short and medium-term swap rates - to decline over the coming year as policy rate cuts approach. 	
<p>NOK</p>	<ul style="list-style-type: none"> Norges Bank surprised with a 50bp pre-summer rate hike and subsequently raised rates by a further 50bp to 4.25% in September. We expect no more rate hikes. We expect Norges Bank to commence cutting rates next summer, while the market is pricing the first rate cut of 25bp for early 2025. Our forecast, which is some distance from consensus, entails a significant decline in short swap rates over the coming year. The yield curve is set to steepen markedly. 	

Note: Past performance is not a reliable guide to future returns

Source: Danske Bank

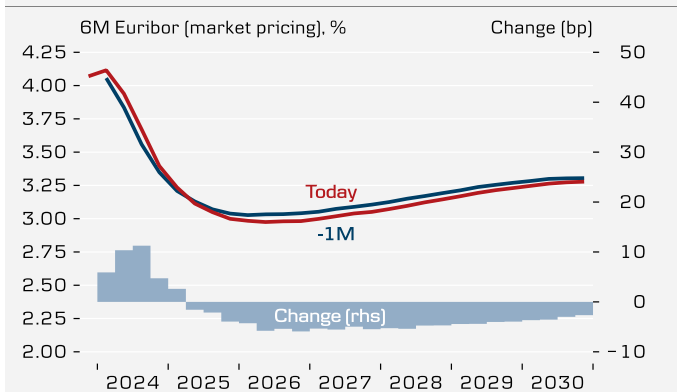
Eurozone forecast

EUR forecast summary

EUR	--Forecast--				--Fost vs Fwd in bp--		
	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Deposit	4.00	4.00	4.00	3.50			
Euribor (3M)	3.96	3.95	3.83	3.34	-12	-12	-35
Euribor (6M)	4.07	3.85	3.66	3.18	-33	-26	-49
Government Bonds							
2-year	3.25	2.95	2.75	2.40			
5-year	2.74	2.55	2.40	2.15			
10-year	2.73	2.55	2.40	2.25			
Swap Rates							
2-year	3.86	3.55	3.35	3.00	-20	-7	-35
5-year	3.39	3.20	3.05	2.80	-13	-7	-35
10-year	3.28	3.10	2.95	2.80	-16	-13	-39

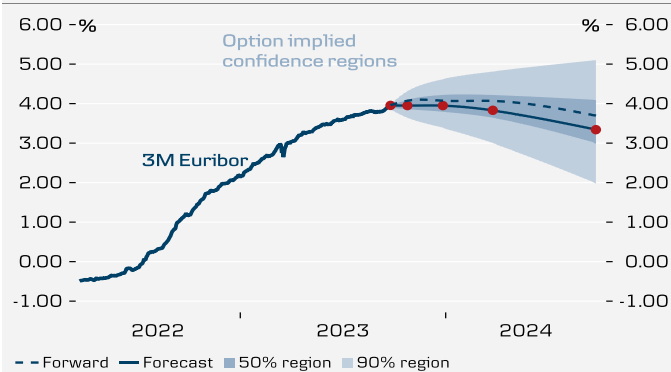
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in EUR swap rates



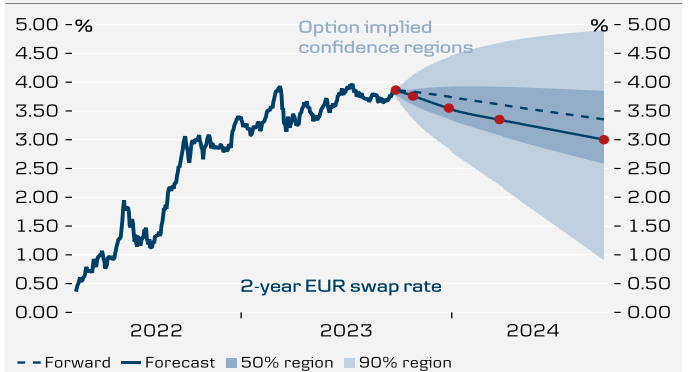
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Euribor rates



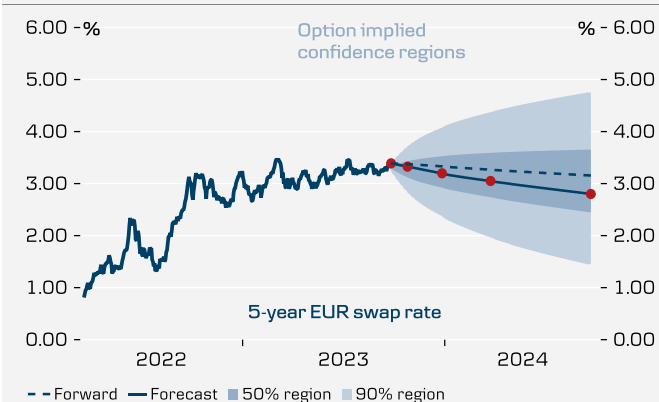
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y EUR swap rates



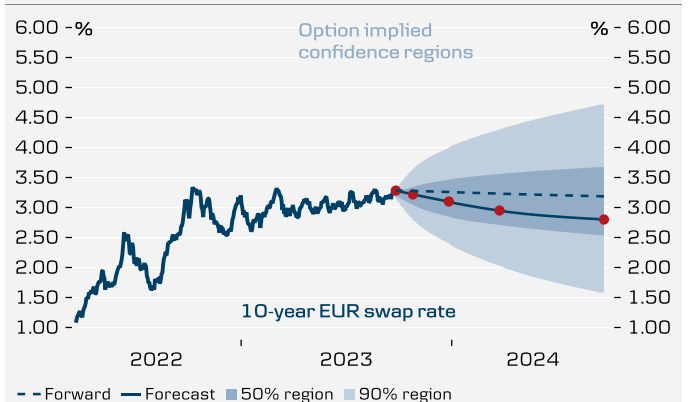
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

5Y EUR swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y EUR swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

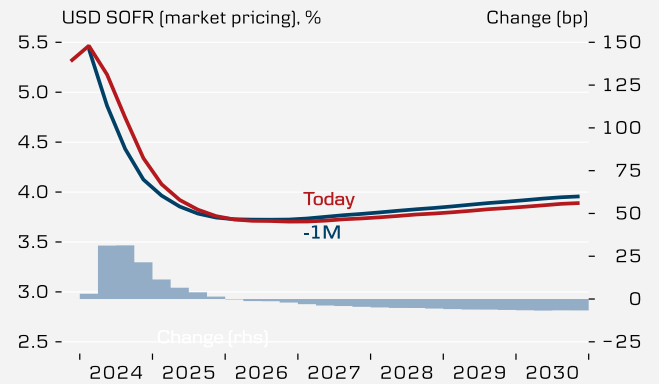
US forecast

USD forecast summary

USD	Spot	--Forecast--			--Fcst vs Fwd in bp--		
		+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Fed Funds	5.50	5.50	5.25	4.75			
SOFR	5.30	5.30	5.05	4.55	-14	-15	-53
Government Bonds							
2-year	5.13	4.90	4.50	4.10			
5-year	4.61	4.35	4.00	3.80			
10-year	4.48	4.20	3.90	3.70			
Swap Rates							
2-year	5.07	4.75	4.35	3.95	-14	-34	-36
5-year	4.37	4.10	3.75	3.55	-18	-44	-47
10-year	4.13	3.95	3.65	3.45	-14	-39	-50

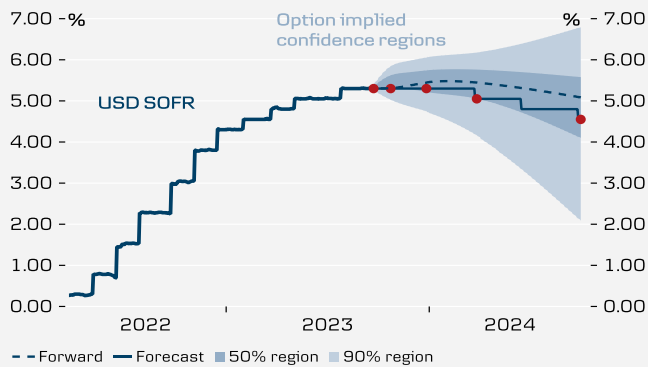
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in USD swap (SOFR) rates



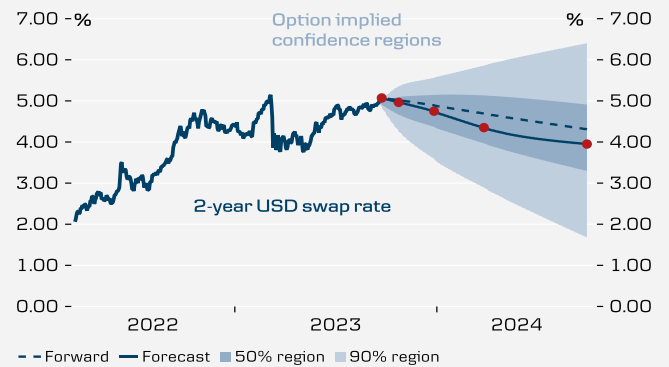
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

SOFR rates



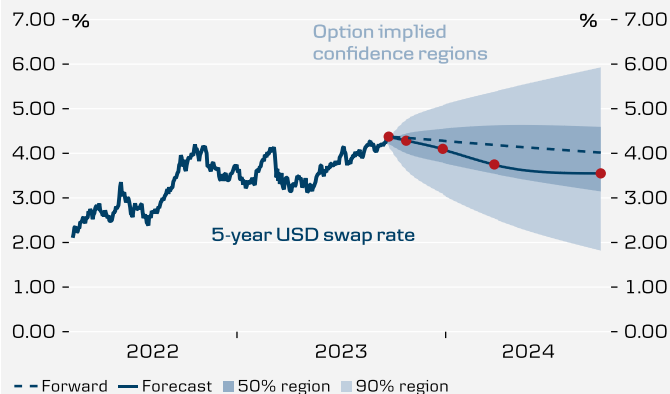
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y USD swap rates



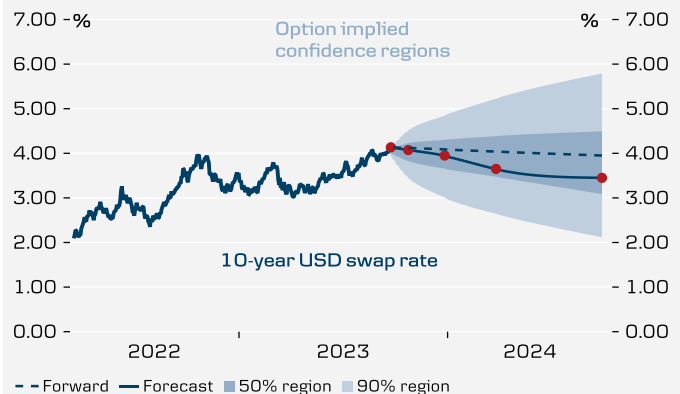
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

5Y USD swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y USD swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

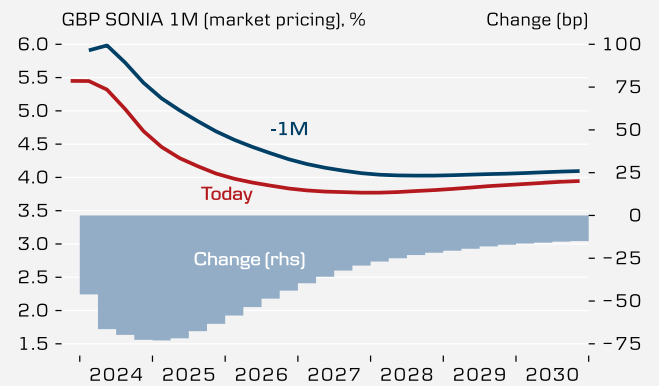
UK forecast

GBP forecast summary

GBP	Spot	--Forecast--			-- Fcst vs Fwd in bp--		
		+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Bank rate	5.25	5.25	5.25	4.75			
SONIA (1M)	5.31	5.20	5.20	4.70	-23	-24	-44
Government Bonds							
2-year	4.87	4.70	4.40	4.00			
5-year	4.43	4.30	4.05	3.75			
10-year	4.31	4.10	4.00	3.80			
Swap Rates							
2-year	5.19	5.00	4.70	4.30	-6	-20	-26
5-year	4.50	4.40	4.15	3.85	-1	-16	-27
10-year	4.15	4.05	3.95	3.75	-6	-11	-22

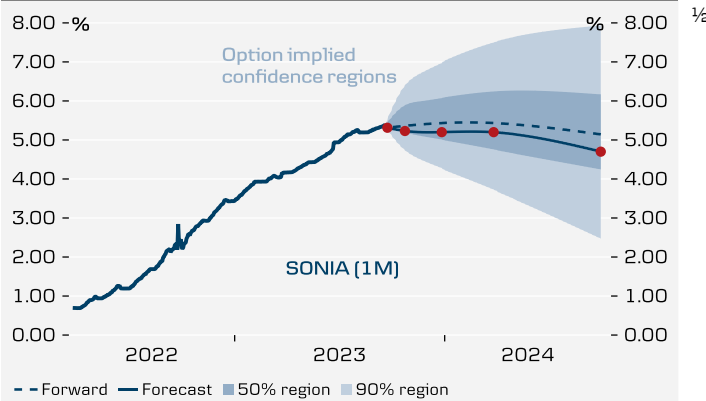
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in GBP swap (OIS)



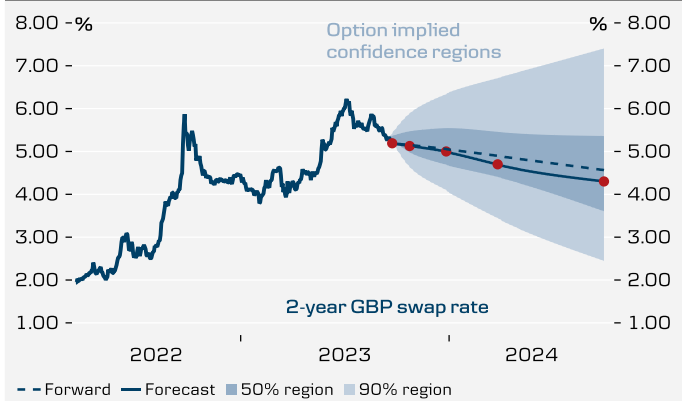
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

SONIA (1M)



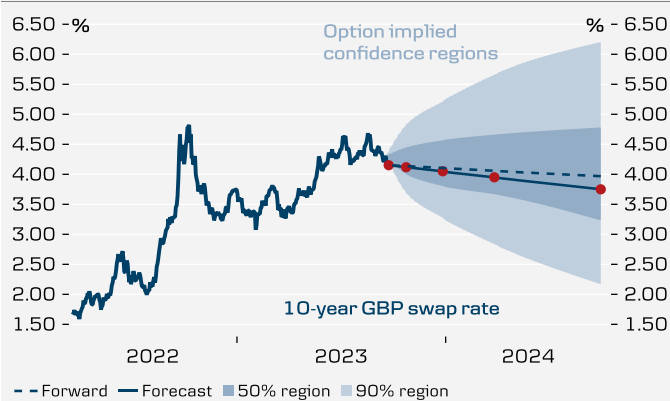
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y UK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y UK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

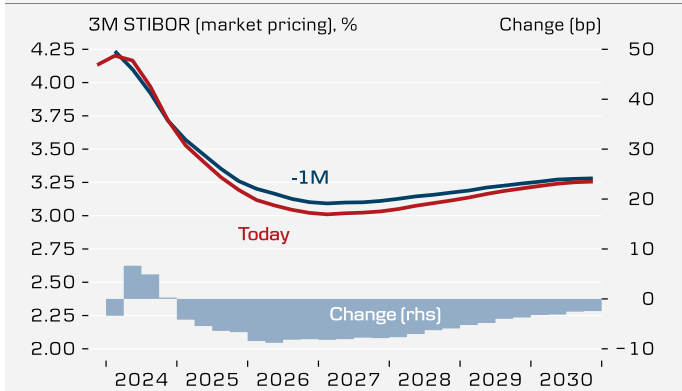
Sweden forecast

SEK forecast summary

SEK	--Forecast--				-- Fcst vs Fwd in bp--		
	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Repo	4.00	4.00	4.00	3.75			
STIBOR (3M)	4.12	4.12	4.10	3.60	-14	-18	-36
Government Bonds							
2-year	3.59	3.45	3.10	2.70			
5-year	3.08	2.80	2.65	2.60			
10-year	2.91	2.85	2.75	2.70			
Swap Rates							
2-year	4.09	3.90	3.50	3.10	-9	-36	-49
5-year	3.57	3.40	3.10	2.90	-10	-33	-40
10-year	3.37	3.25	3.00	2.85	-9	-31	-40

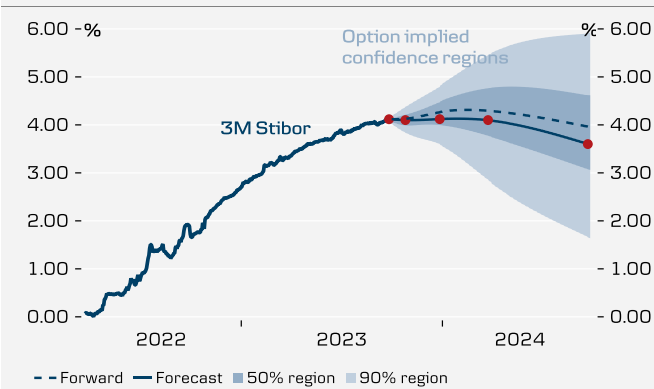
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in SEK swap (3M)



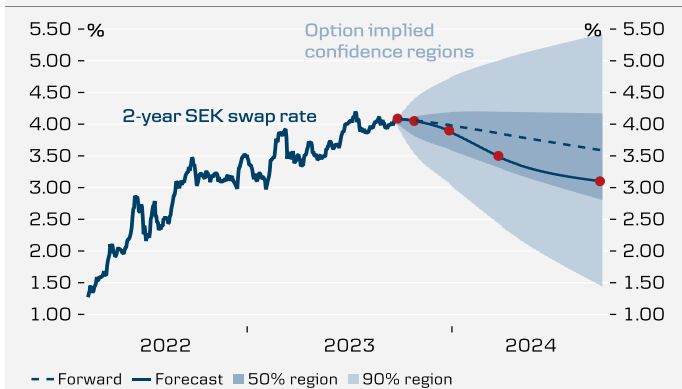
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Stibor rates



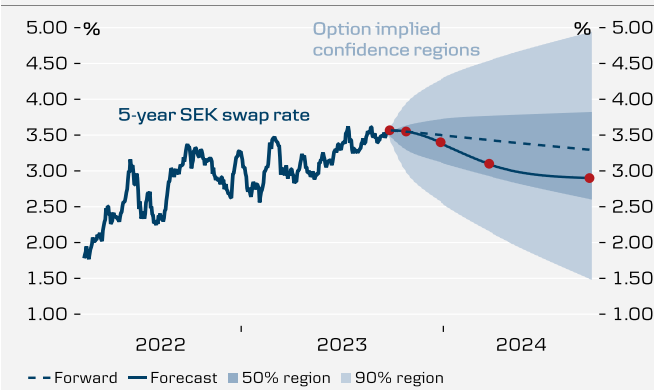
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y SEK swap rates



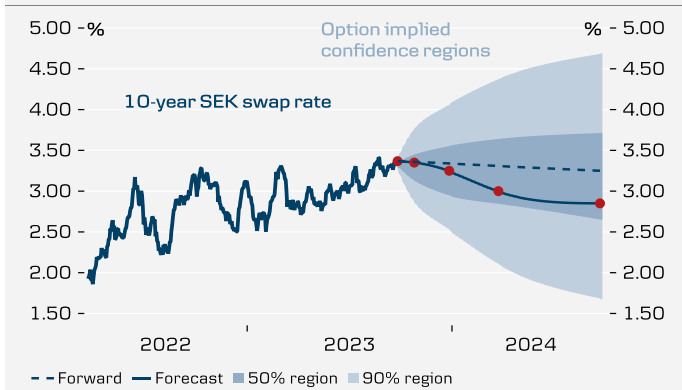
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

5Y SEK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y SEK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

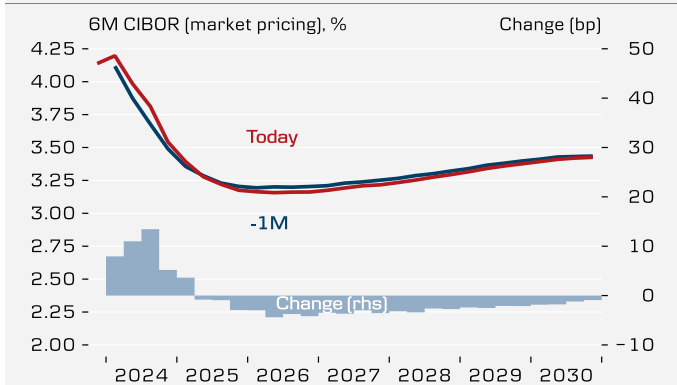
Denmark forecast

DKK forecast summary

DKK	Spot	--Forecast--			-- Fcst vs Fwd in bp--		
		+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Repo	3.75	3.75	3.75	3.25			
Deposit	3.60	3.60	3.60	3.10			
CIBOR (3M)	3.99	4.00	3.88	3.39	-9	-18	-38
CIBOR (6M)	4.14	4.03	3.82	3.31	-19	-32	-48
Government Bonds							
2-year	3.25	3.00	2.85	2.50			
5-year	2.95	2.70	2.55	2.30			
10-year	2.99	2.80	2.65	2.50			
Swap Rates							
2-year	4.00	3.70	3.50	3.15	-19	-26	-36
5-year	3.55	3.35	3.20	2.95	-15	-23	-38
10-year	3.44	3.25	3.10	2.95	-16	-29	-39

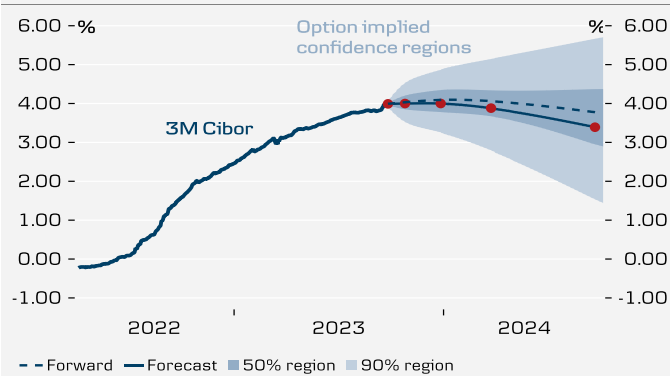
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in DKK swap (6M)



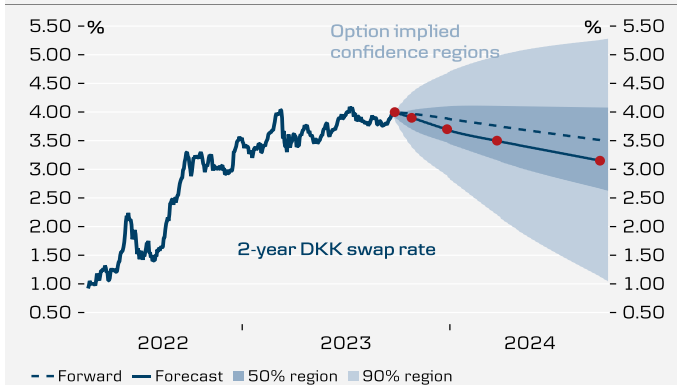
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Cibur



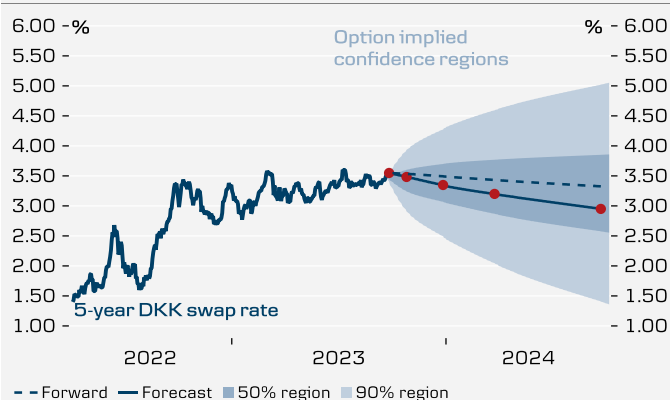
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y DKK swap rates



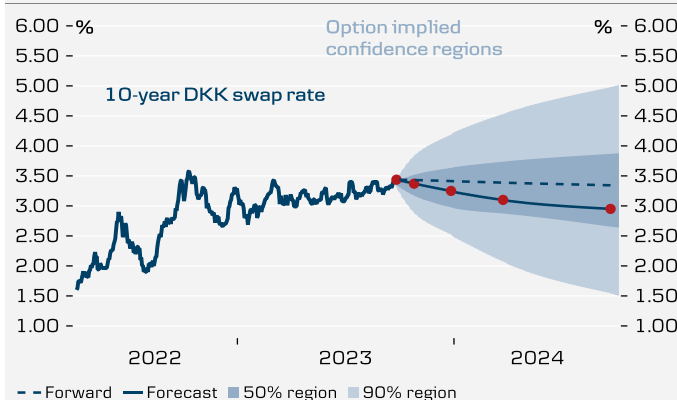
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

5Y DKK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y DKK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

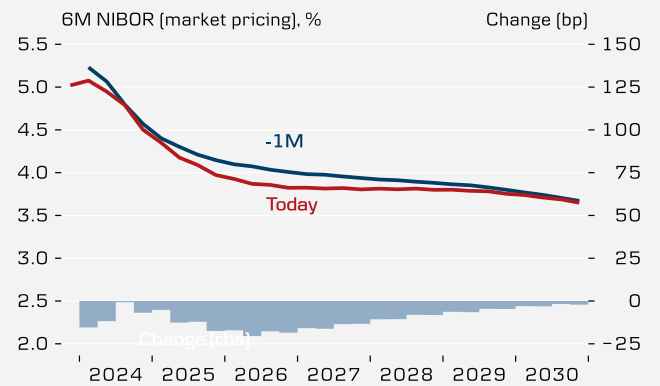
Norway forecast

NOK forecast summary

NOK	--Forecast--				-- Fcst vs Fwd in bp--		
	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Deposit	4.25	4.25	4.25	3.75			
NIBOR (3M)	4.73	4.75	4.64	3.99	-20	-16	-61
NIBOR (6M)	5.04	4.89	4.63	4.03	-27	-19	-71
Government Bonds							
2-year	4.30	3.80	3.50	3.20			
5-year	4.09	3.65	3.40	3.15			
10-year	3.92	3.60	3.40	3.20			
Swap Rates							
2-year	4.91	4.40	4.10	3.80	-41	-58	-62
5-year	4.37	4.05	3.80	3.55	-25	-42	-54
10-year	4.12	3.85	3.65	3.45	-23	-39	-51

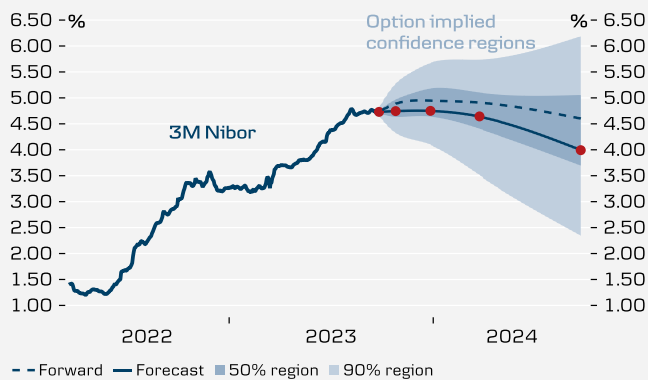
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in NOK swap (6M)



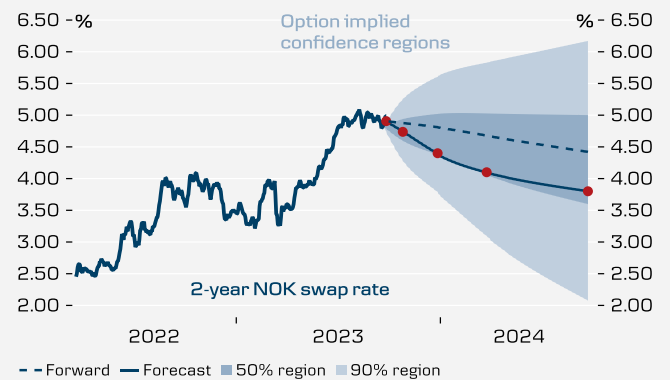
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Nibor



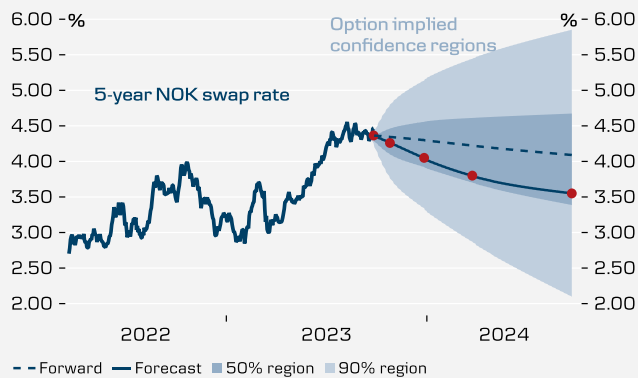
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y NOK swap rate



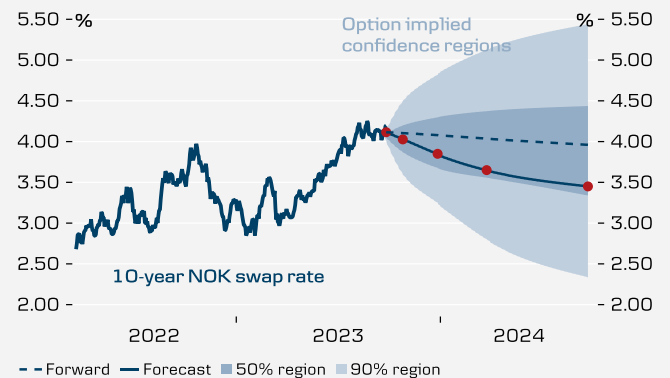
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

5Y NOK swap rate



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y NOK swap rate



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

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