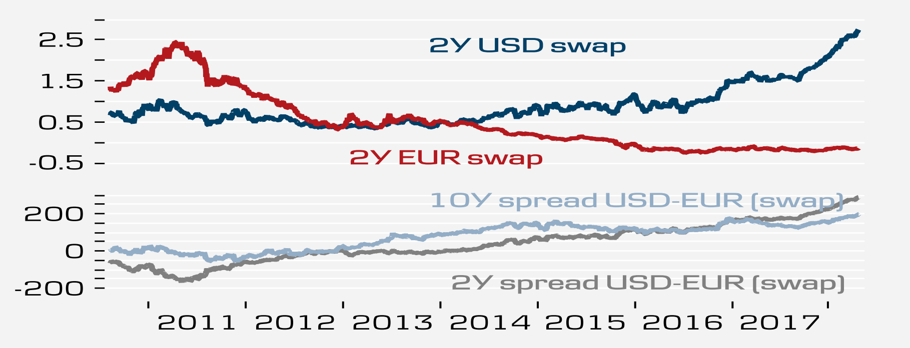
23 April 2018

Yield Outlook

The risk of a severe spike in yields in 2018 is small

The global bond sell-off that characterised the first six weeks of Q1 18 reversed in March and April and 10Y German yields are more or less back to the level at the beginning of the year, even after German yields rose again last week. The picture is somewhat different in the US. The combination of continued rate hikes from the Fed and higher inflation expectations has recently pushed 10Y US treasury yields back towards the 3.0% level. Hence, the 10Y spread between US and Germany/EUR has continued to widen. In addition, the spread in the short-end has widened further as the Fed continues to hike and as 3M USD Libor specifically has been pushed higher due to tighter USD liquidity.

Swap-spread between US and EUR continues to widen (bp)



Source: Macrobond Financial, Bloomberg

We have become more certain that yields will not rise significantly in the euro zone in 2018

In the latest issue of *Yield Outlook – Higher 10Y yields very much a 2019 story*, 15 March, we argued that, in particular, Nordic/European 10Y rates and yields would not rise significantly in 2018 and that higher 10Y yields would be very much a 2019 story. Over the past month, we have become more confident in this view for two reasons.

1. Business cycle has peaked

It seems that the global business cycle is losing momentum. Last week, we published *Research – Global business cycle moving lower*, 19 April, which looks at the global business cycle.

We argue that there are clear signs that the global business cycle peaked in early 2018. Furthermore, our business cycle *MacroScope models* point to a further deceleration over coming quarters. Declining PMI levels across regions tend to cause some anxiety about the strength of the recovery and would normally put a cap on bond yields. We rarely see yields moving higher at the same time as business cycle indicators such as the PMIs move lower.

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Policy rate outlook

Country	Spot	+3m	+6m	+12m
USD	1.75	2.00	2.00	2.50
EUR	-0.40	-0.40	-0.40	-0.40
GBP	0.50	0.75	0.75	1.00
DKK	-0.65	-0.65	-0.65	-0.65
SEK	-0.50	-0.50	-0.50	-0.50
NOK	0.50	0.50	0.75	1.00

Source: Danske Bank

10-year government bond yield outlook

Country	Spot	+3m	+6m	+12m
USD	2.99	3.00	3.10	3.30
GER	0.63	0.75	0.80	1.10
GBP	1.52	1.65	1.80	2.00
DKK	0.64	0.75	0.80	1.10
SEK	0.80	0.95	1.00	1.20
NOK	1.90	2.05	2.15	2.50

Note: EUR = Germany
Source: Danske Bank

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2. ECB will not hike before late 2019

Second, we doubt that we will see a change in rhetoric from the ECB in 2018. Last week, we changed our forecast for the ECB (see *ECB Preview – Not on Draghi's watch*, 20 April) and we now forecast that the ECB will not hike before December 2019, when Mario Draghi and other 'dovish' members have left the ECB. Previously, we had pencilled in a first rate hike in Q2 19. If we are correct that the European business cycle is weakening, it should further diminish the risk of a change in rhetoric from the ECB. Indeed, over the weekend, Draghi said that 'economic indicators…suggest that the growth cycle has peaked'.

Regarding central bank rhetoric, note also that Bank of England Governor Mark Carney struck a dovish tone in an interview last week, stating that a few rate hikes may be warranted over the next few years, thus essentially questioning whether a May hike is a done deal after all.

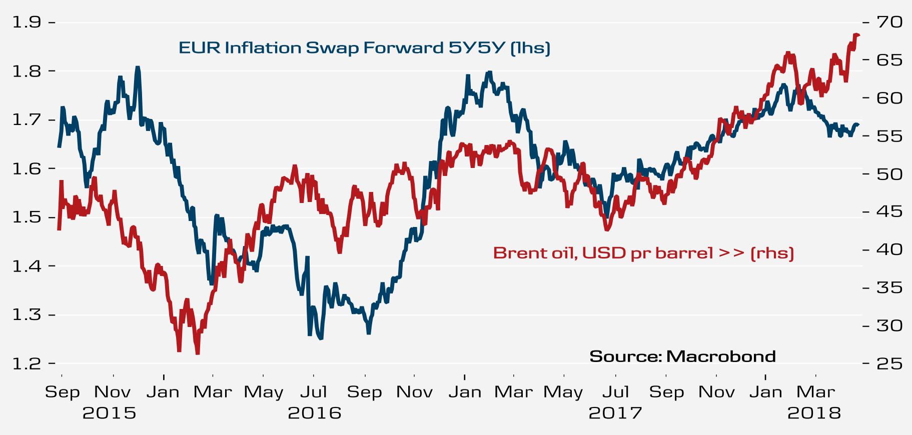
We also expect a soft stance from the Riksbank this week, as we expect it to postpone the first rate hike to 2019 (see *Reading the Markets Sweden*, 20 April.

Commodity prices are the risk factor for global fixed income markets

In our view, the main risk factor for global fixed income markets over the next two quarters is the global commodity market. The sanctions against Russia could still push some metal prices higher even after aluminium and nickel prices jumped recently.

In the oil market, it is noteworthy that the supply and demand balance has improved in 2018 (lower stocks). However, oil prices, in particular, could be pushed higher if Donald Trump's administration decides to take a tougher stance on Iran. However, it would be a supply-driven oil price, which the ECB should be less eager to react on but there is still a close correlation between inflation expectations and oil prices. Hence, higher oil prices, all else being equal, tend to push nominal rates and yields higher.

Higher oil prices tend to push inflation expectations higher



Source: Macrobond Financial, Bloomberg

Fed set to raise above the 2.75% long-run dot

We continue to see a further widening of the two-year spread between USD and EUR rates. We expect the Fed to hike three times this year and next. Importantly, we still expect the Fed to raise the Fed funds rate above the longer run dot of 2.75% (the Fed's estimate of the natural rate of interest when the economy is normalised) in coming years.

Hence, we continue to disagree with markets, as they believe the Fed will hike less than twice in 2019. We believe the Fed will continue to hit the brakes, as fiscal policy has become more expansionary and the output gap has nearly closed.

ECB trying to convince the market we will see no taper tantrum

It is notable that the ECB is eager to communicate to the market that we should not see a 'taper tantrum' in the eurozone bond market this year (surge in US yields in 2013 after the Fed announced lower monthly bond purchases). The ECB argues that the 'free float' of German bonds, in particular, is very limited and close to 10%, as a large part is own by the ECB itself and other central banks. This is very different from the US treasury market in 2013. That the ECB has a large stock means that the impact of the ECB ending the QE programme should be small, as, in particular, the reinvestment flow of coupons and matured bonds will be sizeable over the near future. For more on this subject, see this *speech* from ECB member Benoît Coeuré from 23 February.

Our fixed income view – higher yields mainly a 2019 story

We have lowered our 12M forecast for German 10Y yields slightly from 1.20% to 1.1% due to the change in the ECB deposit rate forecast. We also continue to see a subdued inflation picture in the eurozone and a weaker European business cycle in 2018. We also expect the ECB ending the QE programme this year to have only a small effect on the bond markets. Hence, we continue to see most of the expected rise in yields being in 2019.

We continue to expect a steeper 2Y10Y German yield curve. The ECB still maintains a relatively tight grip on the short end of the curve, especially with the first ECB rate hikes expected late in 2019. However, this is not the case for the 10Y segment of the curve, which we still expect to be pushed by higher US yields in 2019. We have 1.1% (previously 1.2%) and 3.3% (unchanged) 12M forecasts for the 10Y German Bund yield and the 10Y US Treasury yield, respectively.

The boost to fiscal policy in the US and the possible pricing of more rate hikes in the US are the main reasons we still see upside for US 10Y yields. In our view, the latter will have a tendency also to push long yields in the eurozone higher.

We plan to publish the next issue of Yield Outlook at the beginning of June.

Contents and contributors

Eurozone forecasts

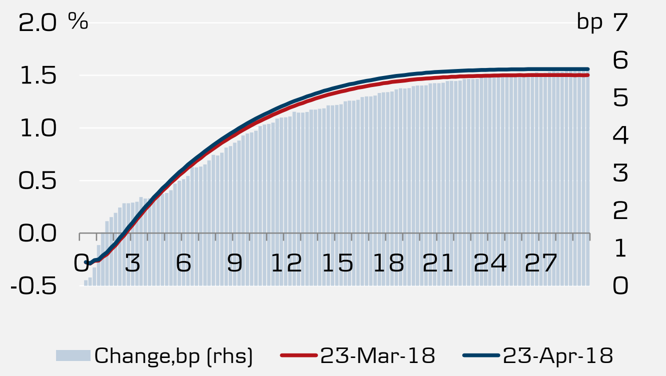
- Sentiment indicators, including PMI, Ifo and ZEW have pointed towards abating growth momentum in the eurozone. Although we expect the euro area business cycle to move one gear lower, we still look for robust growth of 2.1% in 2018 and 1.9% in 2019 (see *Research: Global business cycle is moving lower*). We now expect the first ECB hike of 20bp only in December 2019, due to increased downside risks to the growth and inflation outlook (see *ECB Preview - Not on Draghi's watch*). With core inflation disappointing again on the downside at 1.0% in March and economic momentum moderating, we do not expect the ECB to shift towards more optimistic language with regard to the inflation outlook anytime soon. This also means we do not expect the next change in the ECB's forward guidance to come before the July meeting.
- We continue to expect a steeper EUR yield curve on a 12M horizon. The ECB still maintains a relatively tight grip on the short end of the curve. However, this is not the case for the 10Y segment of the curve, which we expect to be pushed by higher US yields, the end of ECB QE from the ECB and pricing of rate hikes in 2020. An expected higher-term premium works in the same direction. We have a 12-month 1.1% (previously 1.2%) forecast for 10Y Germany. Higher 10Y yields is mainly a 2019 story.

EUR forecasts summary

23/04/2018	--- Forecast ---				--- Fcst vs Fwd in bp ---		
EUR	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Refi	0.00	0.00	0.00	0.00	-	-	-
Deposit	-0.40	-0.40	-0.40	-0.40	-	-	-
3M	-0.33	-0.33	-0.33	-0.33	-	-1	-10
				Government bonds			
2-year	-0.55	-0.55	-0.50	-0.30	-	-	-
5-year	0.01	0.10	0.20	0.40	-	-	-
10-year	0.64	0.75	0.80	1.10	-	-	-
				Swap rates			
2-year	-0.13	-0.15	-0.10	0.10	-8	-12	-12
5-year	0.43	0.55	0.65	0.85	+4	+6	+10
10-year	1.05	1.15	1.20	1.50	+4	+4	+22

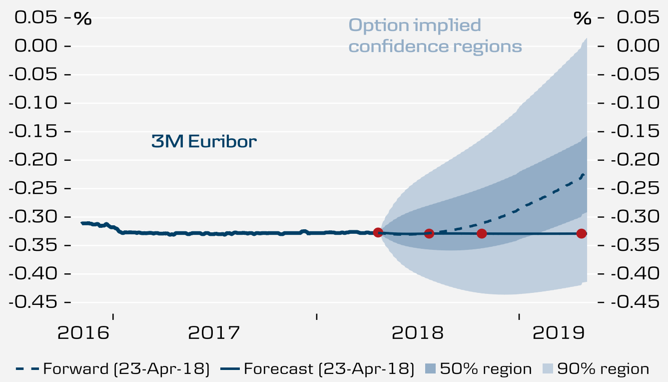
Source: Danske Bank

EUR swap curve – one-month change



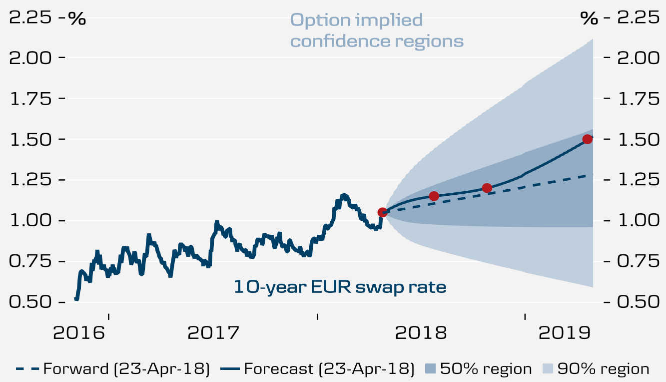
Source: Danske Bank

3M Euribor



Source: Macrobond Financial, Danske Bank

10Y EUR swap rates



Source: Macrobond Financial, Danske Bank

US forecasts

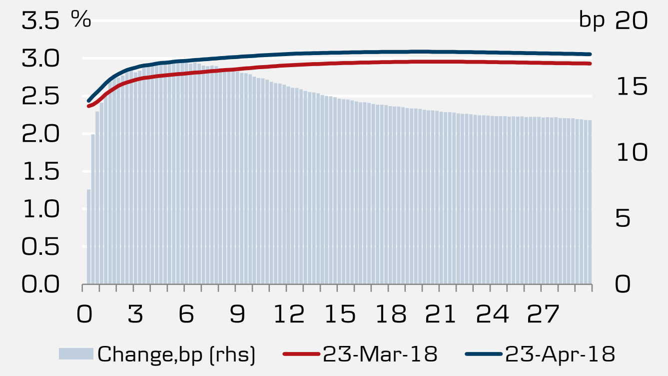
- We expect the Fed to hike twice more this year with risks skewed toward a third hike. This was also the message the Fed sent at its March meeting, where the median dot was unchanged at three this year but underlying details showed the committee was divided between a total of three and four hikes this year. As the economic expansion continues, it is still the subdued inflation and wage growth that will be the key determinants for the hiking pace.
- In line with our expectation, the Fed also signalled it is ready to start hitting the brakes soon, as the committee now signals it is ready to raise the Fed funds rate above the longer-run dot of 2.875% (which is the Fed's estimate of the natural rate of interest where monetary policy is neither expansionary nor contractionary). We expect three additional hikes next year and it is possible that the hiking cycle will continue into 2020. We still think the markets are pricing the Fed too dovishly over the coming years.
- We still see a case for a Fed repricing in 2019/20, pushing 2Y yields higher. We continue to expect a flattening of the curve for the 2Y10Y on a 12M horizon. However, we still see the 10Y US treasury yield at 3.30% in 12M, as we see a further repricing of the US term premium given the risk of higher interest rate volatility and as we see an effect from the more expansive US fiscal policy going forward, which will boost US bond supply.

USD forecasts summary

23/04/2018	--- Forecast ---				--- Fcst vs Fwd in bp ---		
USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money market				
Fed Funds	1.75	2.00	2.00	2.50	-	-	-
3M	2.36	2.37	2.51	2.94	-11	-12	+10
			Government bonds				
2-year	2.47	2.50	2.70	3.00	-	-	-
5-year	2.82	2.80	2.90	3.10	-	-	-
10-year	2.99	3.00	3.10	3.30	-	-	-
			Swap rates				
2-year	2.76	2.80	3.00	3.30	-4	+8	+28
5-year	2.94	2.95	3.05	3.25	-3	+4	+20
10-year	3.03	3.05	3.15	3.35	-	+8	+25

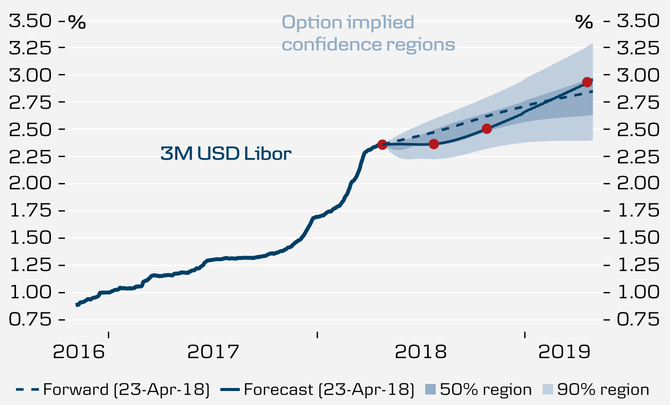
Source: Danske Bank

USD swap curve – one-month change



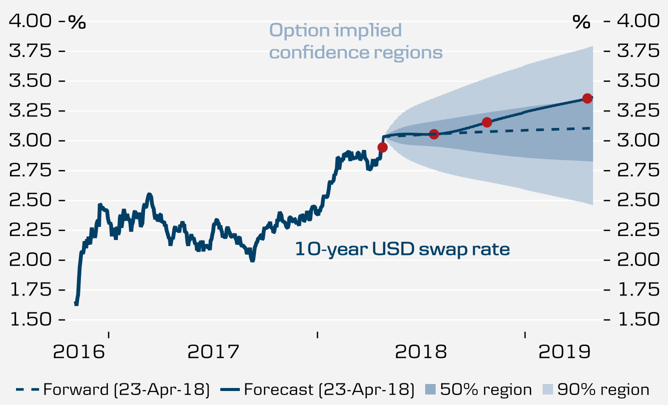
Source: Danske Bank

3M USD Libor rates



Source: Macrobond Financial, Danske Bank

10Y USD swap rates



Source: Macrobond Financial, Danske Bank

UK forecasts

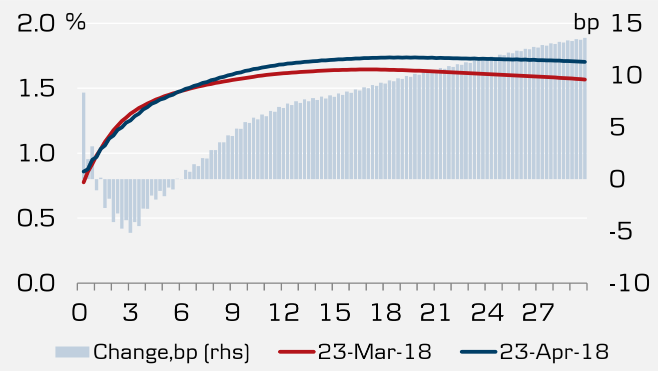
- Despite UK data having weakened in Q1, we still believe the Bank of England will raise the Bank Rate to 0.75% at its meeting in May. We still expect another hike in November, taking the Bank Rate to 1.00% by the end of the year, but the timing and pace of future rate hikes is merely a function of GBP appreciation/depreciation, energy prices and wage growth. If the trade conflict escalates into a full-blown trade war (not our base case), the Bank of England would be likely to be forced to postpone further hikes.
- Our expectations of a ‘two hikes per year hiking cycle’ is more hawkish than consensus and more hawkish than market pricing. The market is now pricing in approximately a 70% probability of a rate hike in May (18bp priced) while two full 25bp rate hikes are priced in around summer 2019. However, given the high economic and political uncertainty in relation to Brexit, we expect the market pricing to remain somewhat behind the curve, which was also the case in the US when the Fed started its hiking cycle.
- We generally forecast higher yields across the curve and with the BoE expected to lift the front end much faster than market pricing, we look for a gradual flattening of the 2-10 and 5-10 yield curves. We forecast yields on 2Y gilt at 1.40% in 12M and target yields on 10Y gilts at 2.00%.

UK forecasts summary

23/04/2018	--- Forecast ---				--- Fcst vs Fwd in bp ---		
GBP	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Repo	0.50	0.75	0.75	1.00	-	-	-
3M	0.75	0.79	1.05	1.30	-5	+9	+18
				Government bonds			
2-year	0.85	1.00	1.20	1.40	+12	+26	+36
5-year	1.19	1.30	1.50	1.70	+8	+24	+36
10-year	1.52	1.65	1.80	2.00	+1	+12	+23
				Swap rates			
2-year	1.11	1.25	1.45	1.70	+7	+19	+32
5-year	1.42	1.55	1.75	2.00	+9	+24	+42
10-year	1.64	1.75	1.90	2.10	+8	+20	+36

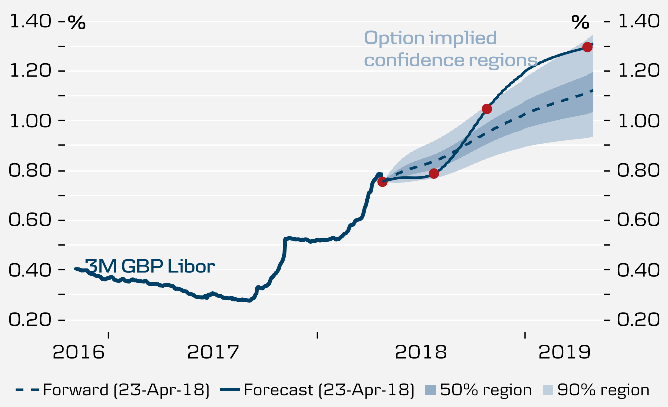
Source: Danske Bank

UK swap curve – one-month change



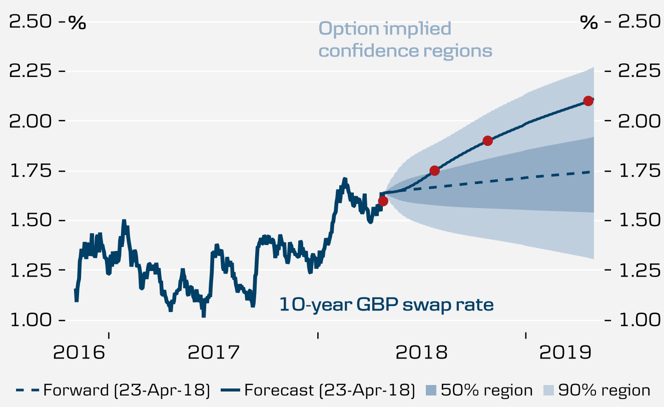
Source: Danske Bank

3M GBP Libor rates



Source: Macrobond Financial, Danske Bank

10Y UK swap rates



Source: Macrobond Financial, Danske Bank

Denmark forecasts

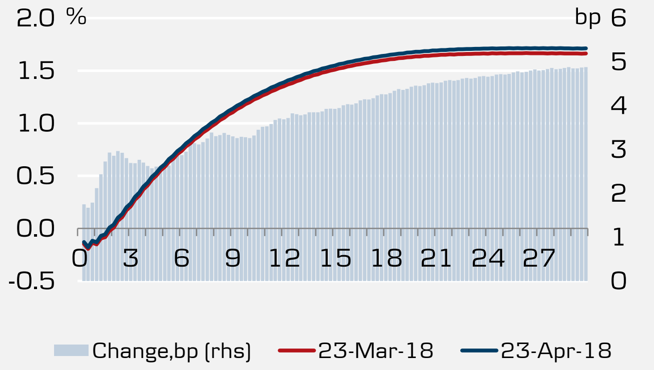
- We do not expect any rate changes from the Danish central bank over the next 12 months. If anything, we could see the central bank intervening in the market to weaken the DKK, as fundamentals such as the significant current account surplus still tend to strengthen the DKK. We expect DKK fixings to remain at the current low level for the time being.
- In January and February we saw underperformance for Danish mortgage bonds as global yields moved higher, which spilled over to both the Danish swap and government bond market and we saw a spread widening versus German government bonds and EUR swaps.
- This spread widening has now reversed and we continue to expect a further spread tightening in 2018. We expect the 10Y spread versus Germany to reach zero. Foreign demand for Danish fixed income is pushing spreads tighter. For government bonds, the buybacks by the debt office funded by the government's own cash buffer are also supporting the Danish fixed income market in 2018.

DKK forecasts summary

23/04/2018	--- Forecast ---				--- Fcst vs Fwd in bp ---		
DKK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money market				
CD	-0.65	-0.65	-0.65	-0.65	-	-	-
Repo	0.05	0.05	0.05	0.05	-	-	-
3M	-0.29	-0.30	-0.30	-0.30	-2	-5	-14
6M	-0.13	-0.15	-0.15	-0.12	-2	-5	-14
			Government bonds				
2-year	-0.43	-0.45	-0.40	-0.20	-	-	-
5-year	0.10	0.20	0.30	0.50	-	-	-
10-year	0.64	0.75	0.80	1.10	-	-	-
			Swap rates				
2-year	0.01	0.00	0.05	0.25	-8	-11	-11
5-year	0.58	0.70	0.80	1.00	+4	+6	+9
10-year	1.22	1.30	1.35	1.65	+3	+2	+20

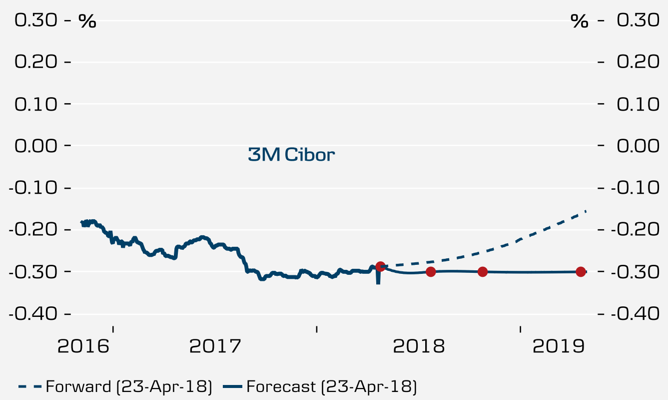
Source: Danske Bank

DKK swap curve – one-month change



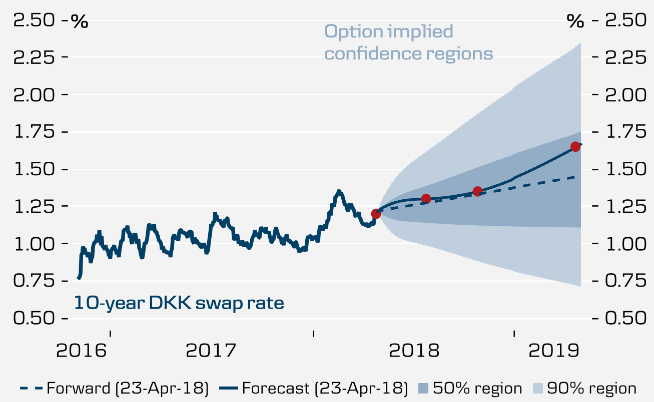
Source: Danske Bank

3M Cibor rate



Source: Macrobond Financial, Danske Bank

10Y DKK swap rates



Source: Macrobond Financial, Danske Bank

Sweden forecasts

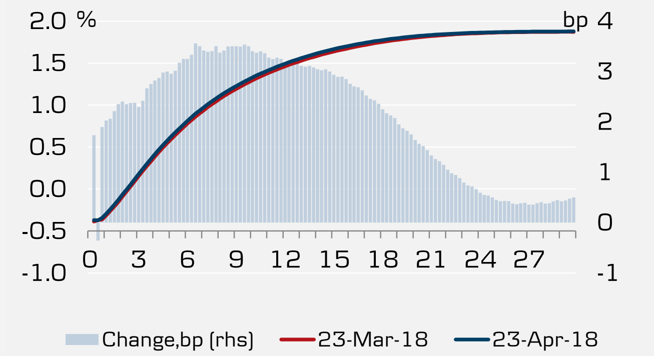
- On 26 April, the Riksbank is likely to provide some guidance on previously expected rate hikes around summer 2018. Importantly, minutes from the February meeting reveal that apart from Olsson, the Riksbank board was close to postponing rate hikes. Since then, inflation has continued to disappoint, especially when excluding energy prices. Also, the growth picture is looking more worrisome than previously. It is not just a matter of weaker growth in the eurozone. The previously booming housing construction sector is showing obvious signs of weakness and we expect construction to be a drag on GDP going forward. The SEK has weakened significantly versus the EUR, but we do not expect that to sway the Riksbank given that the underlying trend in inflation is pointing downwards. We expect rates hikes to be pushed into Q1 19 in the Riksbank's forecasts.
- Over the summer, SEK rates will benefit from positive cash flows to investor and significant index extensions. In a context where bond supply is very limited (significant government budget surpluses) and Riksbank QE continues unabated, we expect some downward pressure on SEK rates relative to EUR rates.

SEK forecasts summary

23/04/2018		--- Forecast ---			--- Fcst vs Fwd in bp ---		
SEK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money market				
Repo	-0.50	-0.50	-0.50	-0.50	-	-	-
3M	-0.37	-0.45	-0.45	-0.45	-7	-7	-35
			Government bonds				
2-year	-0.49	-0.50	-0.50	-0.40	-	-	-
5-year	0.16	0.10	0.20	0.30	-	-	-
10-year	0.78	0.75	0.80	1.10	-	-	-
			Swap rates				
2-year	-0.13	-0.15	-0.15	-0.05	-12	-23	-40
5-year	0.58	0.55	0.65	0.75	-13	-13	-24
10-year	1.30	1.25	1.30	1.50	-12	-14	-8

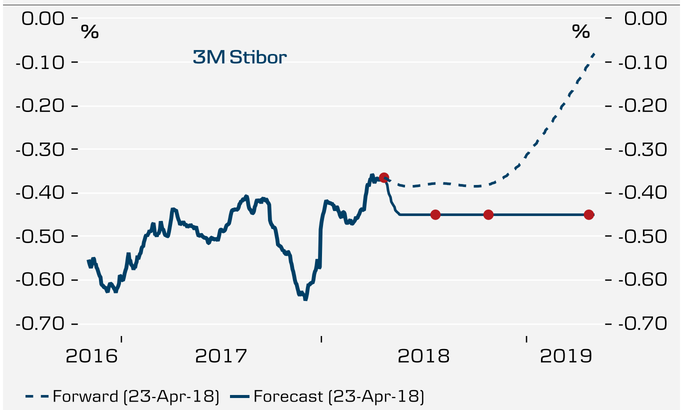
Source: Danske Bank

SEK swap curve – one-month change



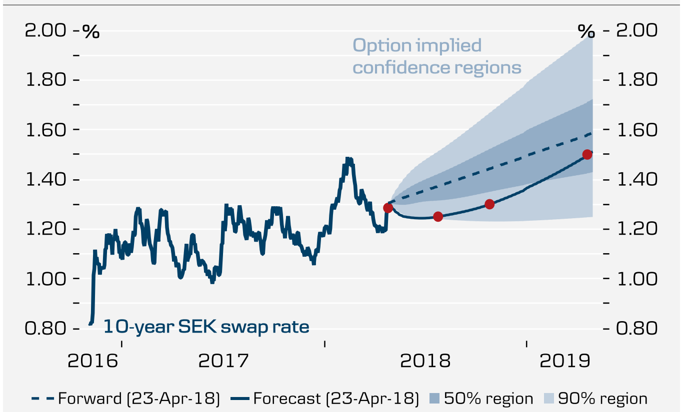
Source: Danske Bank

3M Stibor rate



Source: Macrobond Financial, Danske Bank

10Y SEK swap rates



Source: Macrobond Financial, Danske Bank

Norway forecasts

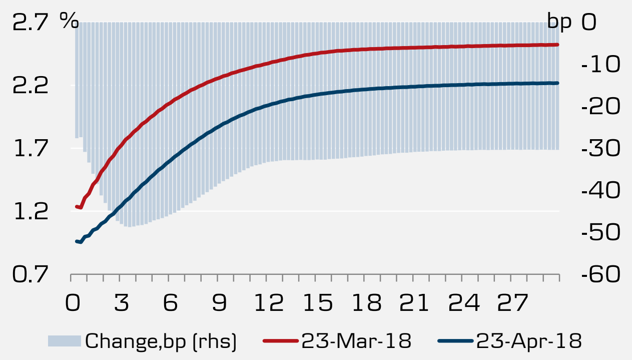
- In the Monetary Policy Report 1/18 15 March, Norges Bank moved the most likely time frame for the first hike in the sight deposit rate to September. The short end of the market curve is currently affected by the elevated Nibor fixings – reflecting a spill over from the USD FRA-OIS spread via FX-FWD. We expect a slight decline in Nibor towards the summer. Despite somewhat mixed economic data recently, we do not expect Norges Bank to back down on the plan to hike over the summer.
- Recent Norwegian data has been mixed. Core inflation was 1.2% y/y in March, below the expected 1.5%. However, two notoriously volatile components – airfares and food prices – surprised on the downside in the run-up to Easter. Adjusted for this, 'core-core' inflation rose y/y from 1.4% to 1.5%. Retail sales have been somewhat disappointing recently. However, the labour market is continuing to tighten. Recent wage talks point to wage growth of about 3.0% for 2018. It appears the Norwegian Philips curve is alive and kicking.
- The 2 March change to Norges Bank's inflation target from 2.5% to 2.0% may be viewed as a formalisation of an earlier practice. In line with this, Norges Bank pointed out that the change should not have any immediate effect on policy. If anything, the change makes it easier to normalise rates, but the nominal long-term rate level could be argued to be lower than before. However, we expect 5Y and 10Y yields to widen slightly versus peers in 2018, as the Norwegian economy is improving slowly and the higher wage growth versus international peers becomes apparent. Norges Bank will hike according to its own projections whereas the ECB will stay on hold.

NOK forecasts summary

23/04/2018	--- Forecast ---				--- Fcst vs Fwd in bp ---		
NOK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Deposit	0.50	0.50	0.75	1.00	-	-	-
3M	1.14	1.15	1.30	1.50	+0	+1	+8
				Government bonds			
2-year	0.80	0.80	0.90	1.30	-	-	-
5-year	1.51	1.70	1.80	2.20	-	-	-
10-year	1.90	2.05	2.15	2.50	-	-	-
				Swap rates			
2-year	1.50	1.55	1.65	2.05	-3	-2	+22
5-year	1.92	2.10	2.20	2.60	+12	+15	+43
10-year	2.29	2.45	2.55	2.90	+12	+18	+46

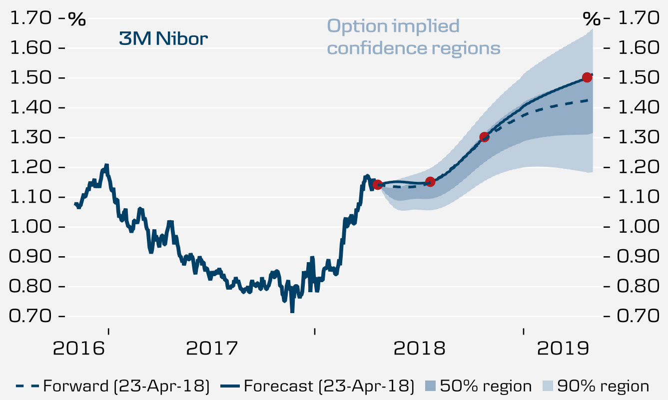
Source: Danske Bank

NOK swap curve – one-month change



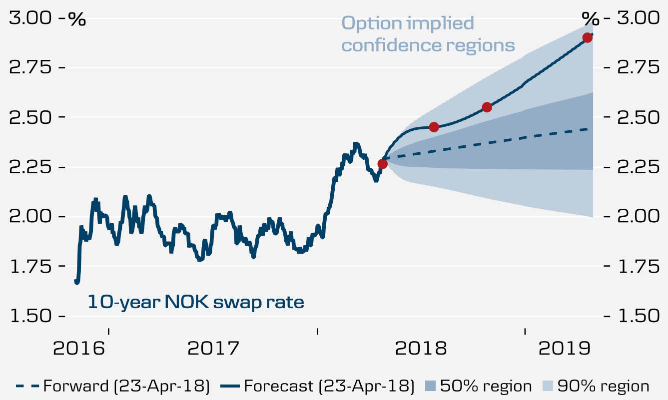
Source: Danske Bank

3M Nibor rate



Source: Macrobond Financial, Danske Bank

10Y NOK swap rates



Source: Macrobond Financial, Danske Bank

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	1.75	2.36	2.76	2.94	3.03	2.47	2.82	2.99
	+3m	2.00	2.37	2.80	2.95	3.05	2.50	2.80	3.00
	+6m	2.00	2.51	3.00	3.05	3.15	2.70	2.90	3.10
	+12m	2.50	2.94	3.30	3.25	3.35	3.00	3.10	3.30
EUR*	Spot	-0.40	-0.33	-0.13	0.43	1.05	-0.55	0.01	0.63
	+3m	-0.40	-0.33	-0.15	0.55	1.15	-0.55	0.10	0.75
	+6m	-0.40	-0.33	-0.10	0.65	1.20	-0.50	0.20	0.80
	+12m	-0.40	-0.33	0.10	0.85	1.50	-0.30	0.40	1.10
GBP	Spot	0.50	0.75	1.11	1.42	1.64	0.85	1.19	1.52
	+3m	0.75	0.79	1.25	1.55	1.75	1.00	1.30	1.65
	+6m	0.75	1.05	1.45	1.75	1.90	1.20	1.50	1.80
	+12m	1.00	1.30	1.70	2.00	2.10	1.40	1.70	2.00
DKK	Spot	-0.65	-0.29	0.01	0.58	1.22	-0.43	0.10	0.64
	+3m	-0.65	-0.30	0.00	0.70	1.30	-0.45	0.20	0.75
	+6m	-0.65	-0.30	0.05	0.80	1.35	-0.40	0.30	0.80
	+12m	-0.65	-0.30	0.25	1.00	1.65	-0.20	0.50	1.10
SEK	Spot	-0.50	-0.44	-0.15	0.57	1.32	-0.34	0.20	0.80
	+3m	-0.50	-0.45	-0.10	0.50	1.45	-0.40	0.15	0.95
	+6m	-0.50	-0.45	-0.05	0.45	1.50	-0.35	0.10	1.00
	+12m	-0.50	-0.45	0.05	0.75	1.60	-0.30	0.35	1.20
NOK	Spot	0.50	1.14	1.50	1.92	2.29	0.80	1.51	1.90
	+3m	0.50	1.15	1.55	2.10	2.45	0.80	1.70	2.05
	+6m	0.75	1.30	1.65	2.20	2.55	0.90	1.80	2.15
	+12m	1.00	1.50	2.05	2.60	2.90	1.30	2.20	2.50

** German government bonds are used, EUR swap rates are used*
Source: Danske Bank

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This research report has been prepared by Danske Bank A/S (‘Danske Bank’). The authors of this research report are Arne Lohmann Rasmussen, Chief Analyst, and Morten Ehlers, Assistant Analyst.

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