

FX Strategy

Slight upside potential to EUR/DKK FX forwards

- Several factors have reshaped the outlook for EUR/DKK FX forwards recently – overall there is potential for a slight increase in 3-6M FX forwards.
- The net position is still high and higher than we previously expected, which keeps FX forwards closely anchored to the -40bp policy rate spread.
- But the MRR effect falling on year-end and the potential for the market to scale back on pricing of many ECB cuts may send FX forwards slightly higher.

Several events during the summer have reshaped the outlook for EUR/DKK FX forwards. These include a surprise bump in net government spending, the stock market sell-off implications for tax revenue next year, the ECB minimum reserve requirement (MRR) related turn falling on year-end, and the increased expectations in the market that the ECB will deliver more rate cuts this year.

Government net spending was DKK17bn higher in July than projected in the May budget update. We are unsure why and it has so far not reversed in August. Consequently, we have revised our projection for the net position higher. We expect the net position to average DKK270bn for the rest of the year and end the year at DKK285bn.

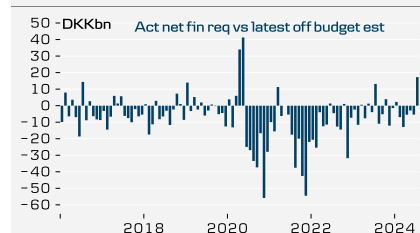
The stock market sell-off in the beginning of August dented the potential for tighter liquidity conditions in Q1 next year (see more in *Reading the Markets Denmark - DKK abundance overshadows political unrest*, 20 June). The mechanism is as follows – when stocks drop, the return on pension savings fall and along with it the tax on pension returns due in Q1. That reduces the seasonal increase in government deposits and drop in the net position. A corresponding drop in bond yields partly mitigate this effect. Whether liquidity conditions tighten in Q1 next year hinges on stock market returns for the rest of the year.

Euro area banks report their minimum reserves for the first maintenance period in 2025 at the end of December rather than the end of November, which may push EUR/DKK FX forwards higher over year-end (the MRR effect). The higher net position and still tranquil credit markets means there should be plenty of liquidity to meet banks' demand over year-end though, which in turn would reduce the effect.

We think the market is pricing too many cuts from the ECB over the coming meetings. We expect the ECB to cut in December and acknowledge the possibility of a risk management cut in September, but 85bp of cuts by January are too much. Because Danmarks Nationalbank (DN) is expected to follow the ECB 1:1 and because policy changes settle five days earlier in Denmark, the 3M EUR/DKK FX forward trade 1-2bp lower than what it would have if the market priced fewer cuts.

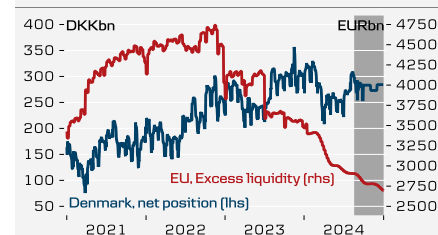
In conclusion, the high net position should keep EUR/DKK FX forwards anchored close to the -40bp policy rate spread (which we expect DN to maintain). The MRR effect in December and upside potential to short-term EUR rates could push 3-6M EUR/DKK FX forwards slightly up, while stock market jitters create uncertainty about the size of Q1 seasonal liquidity effect in the 9M FX forward, and thus the upside potential on this tenor.

Excess net spending in July



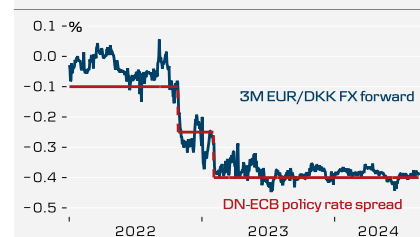
Source: Macrobond Financial, Danmarks Nationalbank, Danske Bank

We expect the net position to stay high



Source: Macrobond Financial, Danske Bank

3M EUR/DKK FX forward trade close to policy rate spread



Source: Macrobond Financial

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

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