Danske Bank

23 November 2023

Yield Outlook

Too much too soon?

Have yield dynamics turned a corner? The significant decline in yields over the past month, which contrasts sharply with the dramatic increases earlier in the autumn, could suggest this is the case. Long yields are now back at mid-September levels, with 10Y US yields down no less than 0.6 percentage points over the past month to 4.4%. Germany has seen a fall of around 0.4 percentage points, but the rise in German yields back in September was also less pronounced. US factors have been the principal drivers of the decrease in yields in the past month. Both inflation and non-farm payroll numbers for October were softer than expected, while the Federal Reserve policy meeting in early November underlined that the US central bank is now less keen to raise interest rates. However, what could probably be the most important driving forces of yield movements in the past month have played out beyond the macroeconomic and monetary policy spheres.

Pronounced fluctuations in bond market term premium have driven yields

A key factor behind September's dramatic increase in yields was rooted in the outlook for the US government deficit and the consequences for bond issuance. Due to the debt ceiling debacle, the US Treasury could not issue new bonds in early 2023 but issuance has since picked up considerably – and we expect next year, in particular, to see a significant upswing in the volume of long bonds coming to the market. The challenge with this is that investor appetite for long bond duration has so far proved lacklustre among 'traditional' buyers of US Treasuries (including foreign investors and the L&P industry). In part this is because the correlation between the return on equities and that on bonds has remained positive, making bonds less useful for hedging risk. Meanwhile, alongside the absence of traditional buyers, the Federal Reserve continues to reduce its bond holdings at pace.

This cocktail of rising long bond issuance and declining demand pushed the bond market term premium substantially higher in September/October. However, this has corrected somewhat of late. Earlier this month, the US Treasury's issuance plan partially dampened fears of a 'duration bomb' in 2024, given that much of the issuance is still expected to be placed at the short end of the yield curve. Nevertheless, the term premium on long bonds will most likely remain higher than previously, as the US budget outlook – regardless of the short-term composition of issuance – remains a distinct structural challenge.

There is nothing to indicate that Biden and the Democrats will address the grim outlook for the US budget deficit ahead of the elections next year. More generally, we could ask whether the fragmented political landscape in the US is even capable of delivering the necessary trimming at some point. We have our doubts, and Moody's decision to put the US's (last) AAA rating on negative outlook in November due to the budget dispute underscores Washington's current political dysfunctionality, in our view. In Europe, the supply of new bonds also looks set to be relatively significant next year – just as in 2023. Moreover, we expect the ECB to opt in favour of accelerating the shrinking of its bond portfolio by phasing out reinvestments of bonds bought under the Pandemic Emergency Purchase Programme (PEPP) earlier that it is currently signalling (reinvestments continuing until the end of 2024). This could justify a higher term premium on European bonds than we have grown accustomed to in recent years.

Shortcuts

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	3.50
NOK	4.25	4.25	4.00	3.50

10Y government bond yields

Country	Spot	+3m	+6m	+12m
USD	4.40	4.40	4.30	4.20
EUR	2.58	2.65	2.50	2.35
GBP	4.24	4.15	4.00	3.90
DKK	2.83	2.90	2.75	2.60
SEK	2.68	2.80	2.90	2.85
NOK	3.61	3.40	3.25	3.10

Note: EUR = Germany

10Y swap rates

Country	Spot	+3m	+6m	+12m
USD	4.07	4.05	3.95	3.85
EUR	3.07	3.15	3.00	2.85
GBP	4.08	3.95	3.80	3.70
DKK	3.25	3.30	3.15	3.00
SEK	3.05	3.00	3.00	2.95
NOK	3.73	3.65	3.50	3.35

Source: Danske Bank (all three tables)

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We expect yields to decline, though much has already materialised

We expect long yields to continue declining over the coming year, though, in our view, much of the fall is already behind us following recent yield movements. Market pricing is currently well aligned with our expectation of rate cuts totalling 100bp in the US next year, while market pricing of 90bp worth of rate cuts in the eurozone is a tad more aggressive than our forecast (75bp) for the first time in a long time. Our key divergence from the market remains our view on where policy rates are likely to ultimately stabilise once the rate cutting cycle ends. We expect the bottom at considerably lower levels than markets are currently pricing – but how long will the market take to reach the same conclusion?

In our view, the impact of tighter monetary policies on GDP growth in both the US and Europe needs to be more visible for market expectations to adjust. However, going by the economic data, there is much to indicate that policy tightening may be slower in feeding through to GDP growth than previously thought. Hence, the 'higher for longer' narrative can probably live on for quite some time yet. While we have maintained our 12M forecasts for 10Y US Treasuries (4.20%) and equivalent Bunds (2.35%), we have lowered our short-term yield forecasts.

We see upside risks to eurozone long yields in the short term. ECB members are clearly keen on not letting the significant decline in yields run much further, as the rhetoric has turned increasingly hawkish of late. In our view, the market will likely need to adjust down its expectations for the number of ECB rate cuts next year. If long yields decline much further in the short term, the ECB may ultimately feel forced to again step on the brakes and hike policy rates once more. This risk is not negligible, even though we have no further ECB rate hikes in our forecast.

Forecast*

	Horizon	Policy rate	3m xlbor	6m xlbor	2y gov	5y gov	10y gov	2y swap	5y swap	10y swap
USD**	Spot	5.50			4.90	4.43	4.40	4.71	4.14	4.07
	+3M	5.50			4.80	4.40	4.40	4.55	4.10	4.05
	+6M	5.25			4.45	4.25	4.30	4.20	3.95	3.95
	+12M	4.75			4.20	4.10	4.20	3.95	3.80	3.85
EUR*	Spot	4.00	3.96	4.06	3.02	2.55	2.58	3.52	3.09	3.07
	+3M	4.00	3.98	4.01	2.95	2.55	2.65	3.45	3.10	3.15
	+6M	4.00	3.77	3.76	2.65	2.35	2.50	3.15	2.90	3.00
	+12M	3.50	3.28	3.23	2.20	2.10	2.35	2.70	2.65	2.85
GBP**	Spot	5.25			4.70	4.29	4.24	4.89	4.31	4.08
	+3M	5.25			4.40	4.10	4.15	4.60	4.20	3.95
	+6M	5.25			4.20	3.90	4.00	4.40	4.00	3.80
	+12M	4.75			4.00	3.75	3.90	4.20	3.85	3.70
DKK	Spot	3.60	3.94	4.14	3.01	2.79	2.83	3.67	3.29	3.25
	+3M	3.60	3.94	3.99	2.95	2.85	2.90	3.60	3.25	3.30
	+6M	3.60	3.72	3.75	2.65	2.65	2.75	3.30	3.05	3.15
	+12M	3.10	3.23	3.20	2.20	2.40	2.60	2.85	2.80	3.00
SEK	Spot	4.00	4.15	4.34	3.38	2.72	2.68	3.69	3.15	3.05
	+3M	4.00	4.12	4.12	3.20	2.85	2.80	3.40	3.10	3.00
	+6M	4.00	3.97	3.93	2.90	2.90	2.90	3.00	3.00	3.00
	+12M	3.50	3.47	3.44	2.70	2.80	2.85	2.80	2.90	2.95
NOK	Spot	4.25	4.76	4.98	3.93	3.64	3.61	4.46	3.89	3.73
	+3M	4.25	4.52	4.58	3.70	3.45	3.40	4.25	3.75	3.65
	+6M	4.00	4.25	4.31	3.40	3.25	3.25	3.95	3.55	3.50
	+12M	3.50	3.78	3.84	3.10	3.05	3.10	3.65	3.35	3.35

** 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

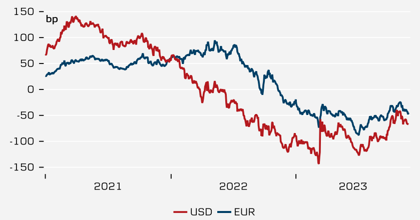
Source: Danske Bank

Term premium on 10Y Bunds markedly higher

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

Source: Macrobond Financial, Danske Bank

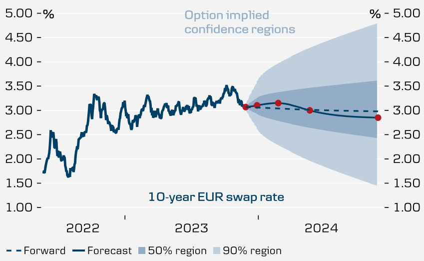
2Y-10Y (swap) yield curves



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

Source: Macrobond Financial, Danske Bank

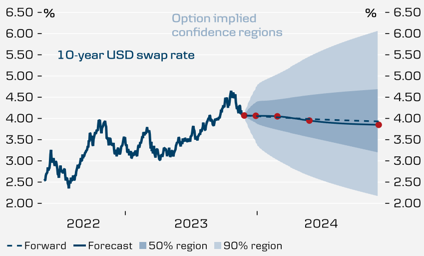
Forecast: 10Y EUR swap rates



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

Source: Macrobond Financial, Danske Bank

Forecast: 10Y USD swap rates



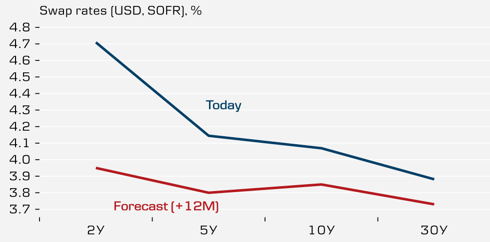
Note: Past performance is not a reliable guide to future returns

Source: Macrobond Financial, Danske Bank

Overview

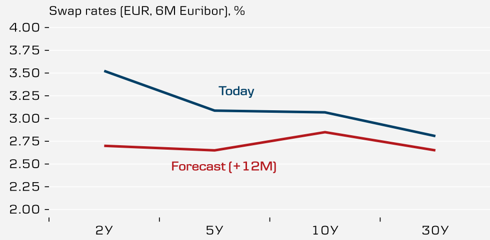
USD

- The US central bank (the Fed) has maintained the Fed funds rate at 5.25-5.50% since July. We envisage no more rate hikes and recent indicators (inflation/jobs report, etc.) support our outlook.
- Easing inflation pressures will likely open the door to rate cuts from early 2024 but risks to this outlook are high.
- We expect the swap curve to gradually steepen over the coming year as the focus shifts to rate cuts.



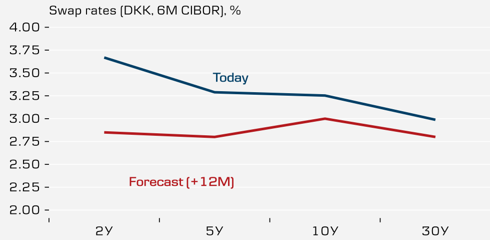
EUR

- The ECB raised its deposit rate to 4% in September. While we expect no more rate hikes, risks to our forecast remain. We expect the first rate cut to come 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 remain 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 over the next year.



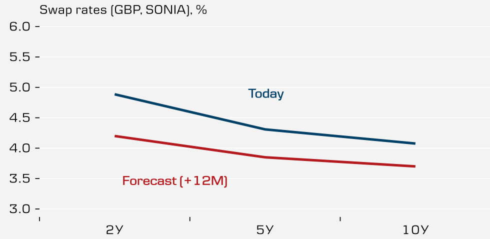
DKK

- 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 the Danish central bank to cut the policy rate from summer 2024 in tandem with the ECB.
- The DKK swap curve has steepened recently, reflecting the development in the US and the rest of Europe. In line with our eurozone outlook, we expect the DKK yield curve to steepen further from here as rate cuts draw closer.



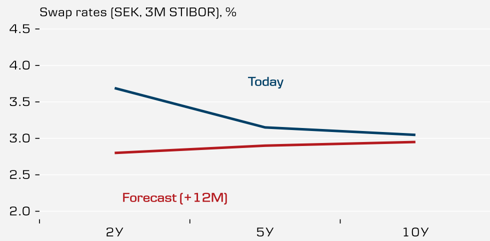
GBP

- The Bank of England (BOE) raised key policy rates markedly over the past year to 5.25%. GDP growth has slowed recently and we expect inflation to decline quite significantly going forward.
- Our monetary policy outlook implies a decline in rates across the UK swap curve in the time ahead – although a more modest decline than previously expected, as market pricing of the BOE is now close to our own outlook.



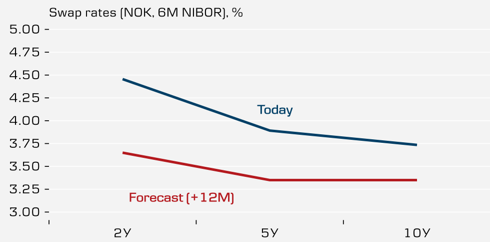
SEK

- 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, although risks are skewed to the upside.
- 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 in 2024.



NOK

- 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 further rate hikes.
- We expect Norges Bank to commence cutting rates in H1 24, while markets are pricing rate cuts to be slower
- Our forecast, which is some distance from consensus, entails a significant decline in short swap rates over the coming year, with the yield curve set to steepen markedly.



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

Source: Danske Bank

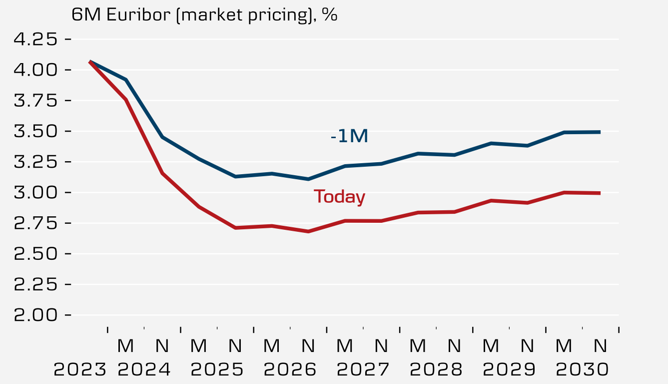
Eurozone forecast

EUR forecast summary

		--Forecast--			-- Fcst vs Fwd in bp--		
EUR	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Deposit	4.00	4.00	4.00	3.50			
Euribor (3M)	3.96	3.98	3.77	3.28	6	-1	4
Euribor (6M)	4.06	4.01	3.76	3.23	5	0	5
Government Bonds							
2-year	3.02	2.95	2.65	2.20			
5-year	2.55	2.55	2.35	2.10			
10-year	2.58	2.65	2.50	2.35			
Swap Rates							
2-year	3.52	3.45	3.15	2.70	11	-2	-20
5-year	3.09	3.10	2.90	2.65	9	-5	-21
10-year	3.07	3.15	3.00	2.85	11	-1	-13

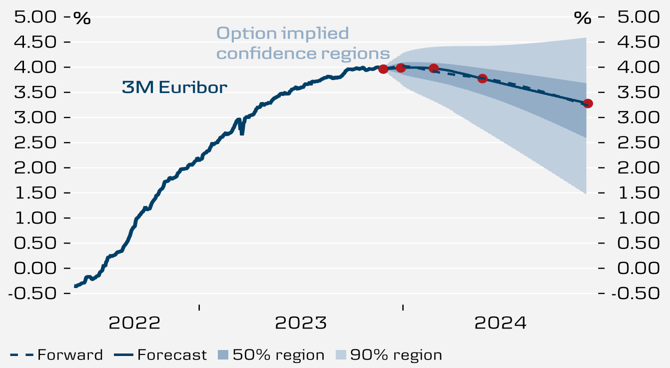
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in EUR swap rates



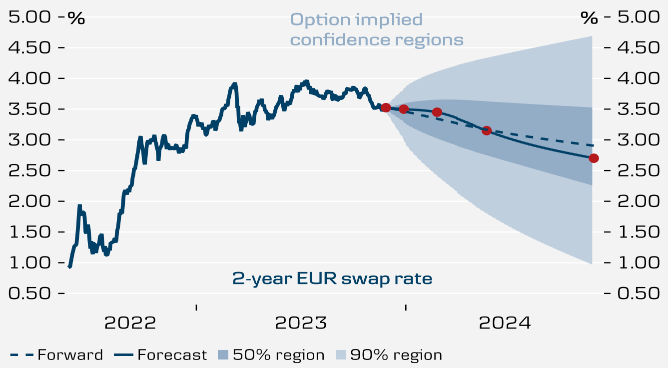
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Euribor rates



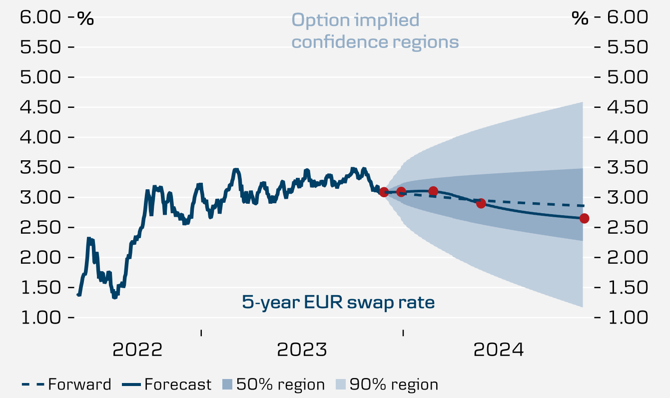
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y EUR swap rates



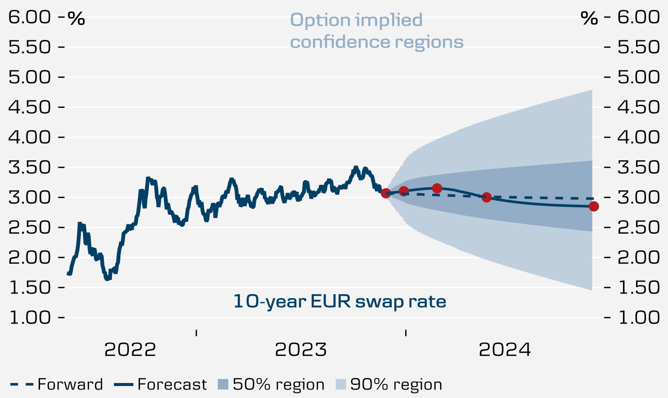
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

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

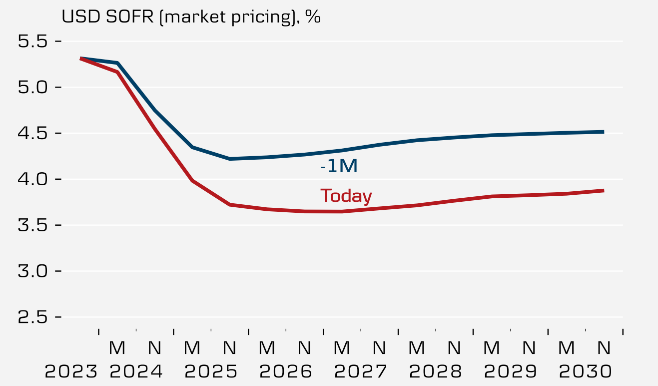
US forecast

USD forecast summary

USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
		--Forecast--			-- Fcst vs Fwd in bp--		
Money Market							
Fed Funds	5.50	5.50	5.25	4.75			
SOFR	5.31	5.30	5.05	4.55	-6	-14	-6
Goverment Bonds							
2-year	4.90	4.80	4.45	4.20			
5-year	4.43	4.40	4.25	4.10			
10-year	4.40	4.40	4.30	4.20			
Swap Rates							
2-year	4.71	4.55	4.20	3.95	6	-7	2
5-year	4.14	4.10	3.95	3.80	5	-2	-4
10-year	4.07	4.05	3.95	3.85	2	-4	-8

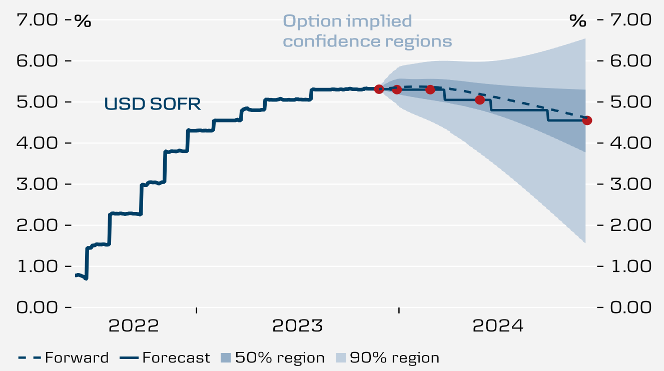
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in USD swap (SOFR) rates



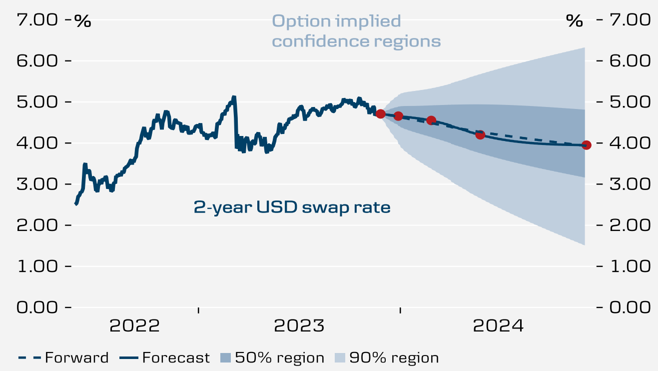
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

SOFR rates



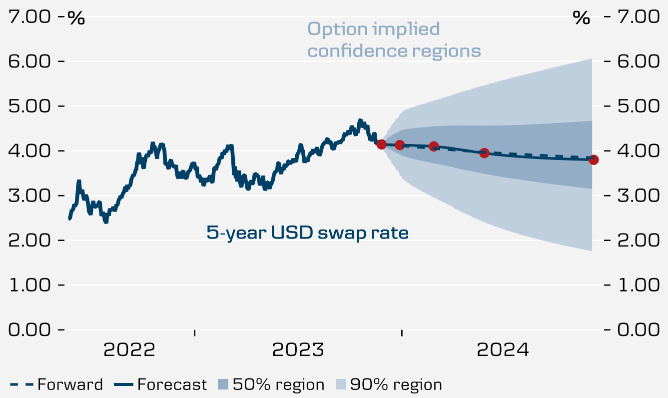
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y USD swap rates



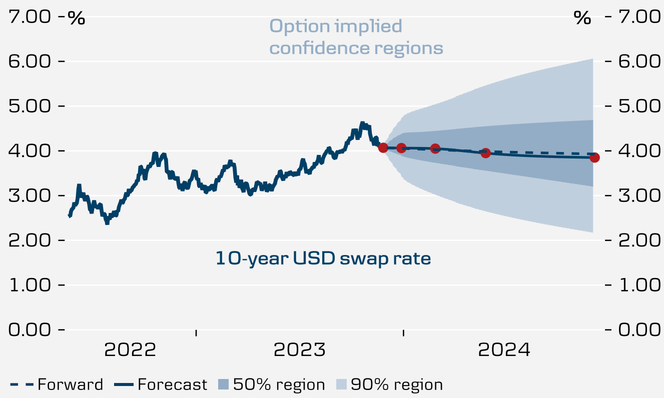
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

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

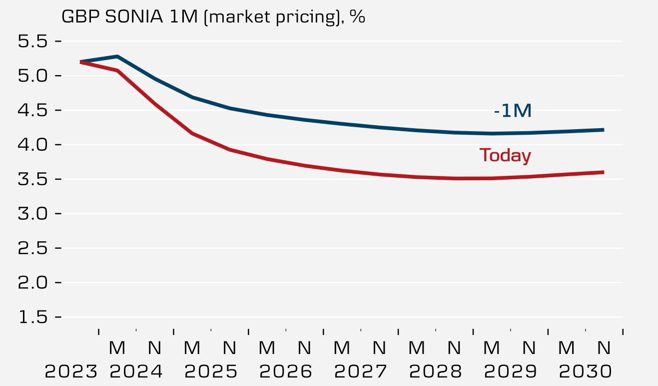
UK forecast

GBP forecast summary

		--Forecast--			-- Fcst vs Fwd in bp--		
GBP	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Bank rate	5.25	5.25	5.25	4.75			
SONIA (1M)	5.20	5.20	5.12	4.59	-6	-7	-18
Government Bonds							
2-year	4.70	4.40	4.20	4.00			
5-year	4.29	4.10	3.90	3.75			
10-year	4.24	4.15	4.00	3.90			
Swap Rates							
2-year	4.89	4.60	4.40	4.20	-14	-18	-8
5-year	4.31	4.20	4.00	3.85	-2	-13	-13
10-year	4.08	3.95	3.80	3.70	-9	-20	-23

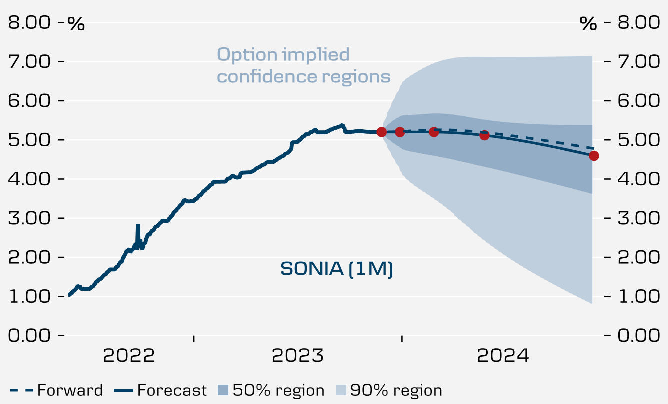
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in GBP swap (OIS)



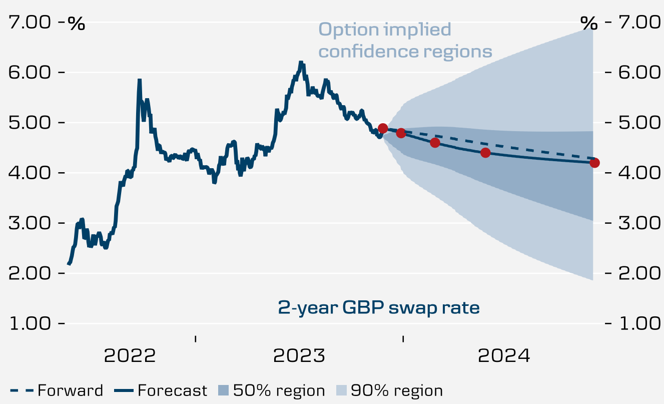
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

SONIA (1M)



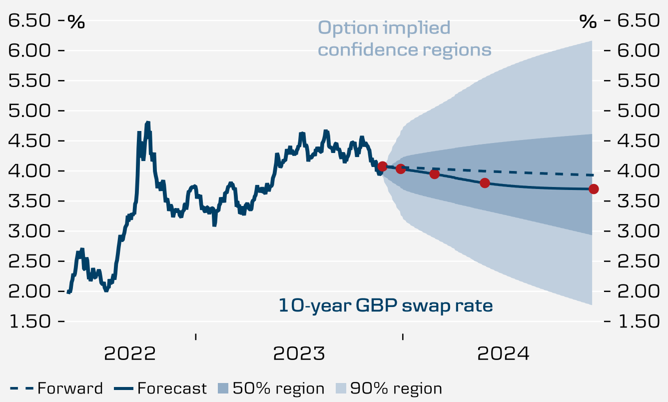
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

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

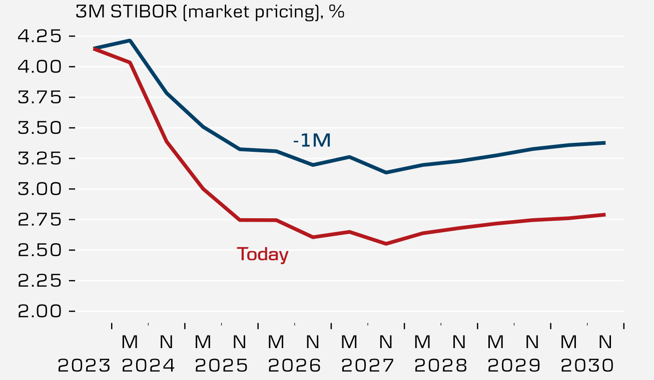
Sweden forecast

SEK forecast summary

		--Forecast--			-- Fcst vs Fwd in bp--		
SEK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Repo	4.00	4.00	4.00	3.50			
STIBOR (3M)	4.15	4.12	3.97	3.47	0	-4	5
Government Bonds							
2-year	3.38	3.20	2.90	2.70			
5-year	2.72	2.85	2.90	2.80			
10-year	2.68	2.80	2.90	2.85			
Swap Rates							
2-year	3.69	3.40	3.00	2.80	-12	-34	-25
5-year	3.15	3.10	3.00	2.90	3	0	2
10-year	3.05	3.00	3.00	2.95	-1	2	2

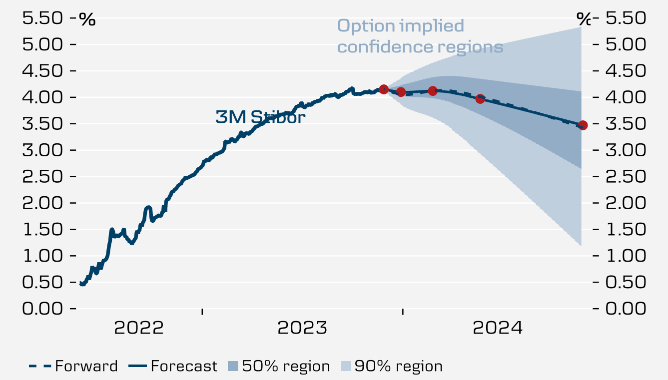
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in SEK swap (3M)



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

3M Stibor rates



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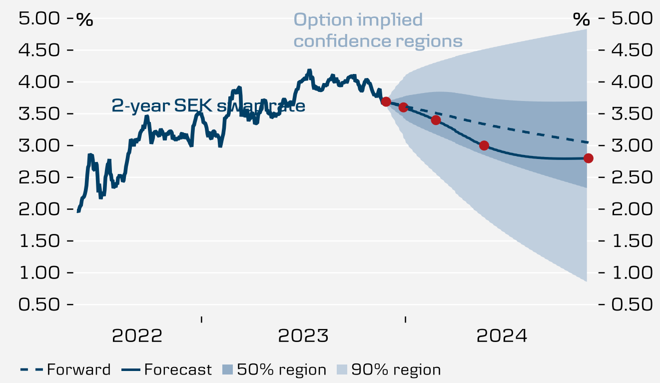
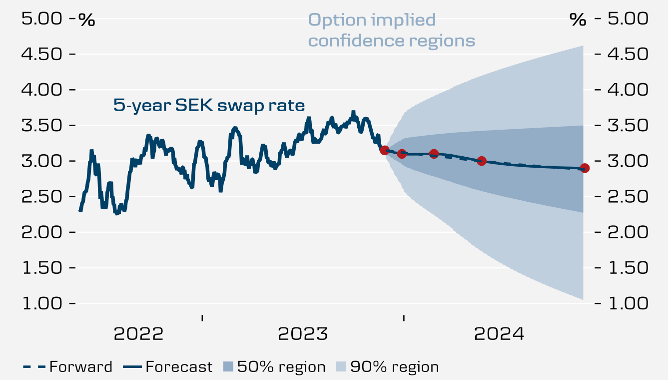
Source: Danske Bank

2Y SEK swap rates



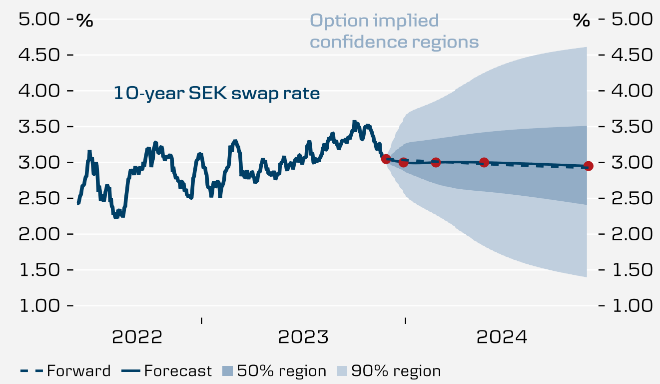
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

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

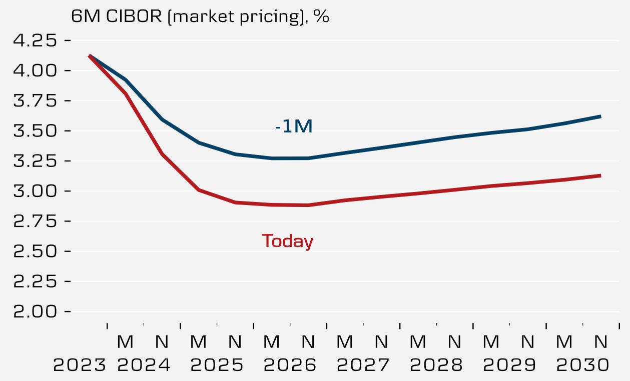
Denmark forecast

DKK forecast summary

DKK	Spot	--Forecast-- +3m	+6m	+12m	-- Fcst vs Fwd in bp-- +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)	3.94	3.94	3.72	3.23	0	-4	-9
CIBOR (6M)	4.14	3.99	3.75	3.20	-3	-6	-14
Government Bonds							
2-year	3.01	2.95	2.65	2.20			
5-year	2.79	2.85	2.65	2.40			
10-year	2.83	2.90	2.75	2.60			
Swap Rates							
2-year	3.67	3.60	3.30	2.85	9	-5	-27
5-year	3.29	3.25	3.05	2.80	2	-12	-28
10-year	3.25	3.30	3.15	3.00	7	-5	-17

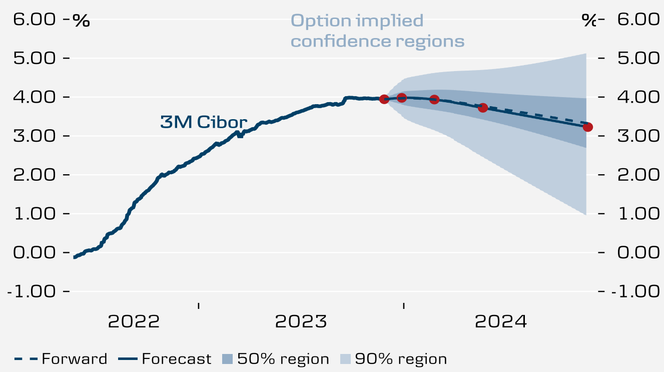
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in DKK swap (6M)



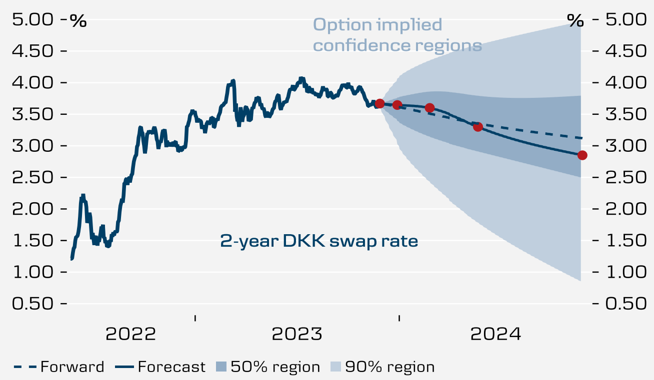
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Cibor



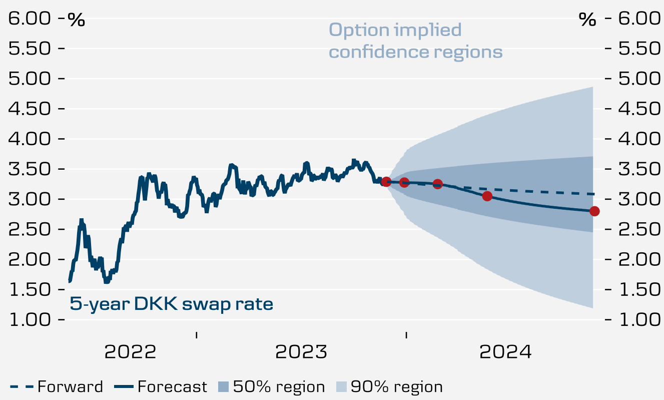
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y DKK swap rates



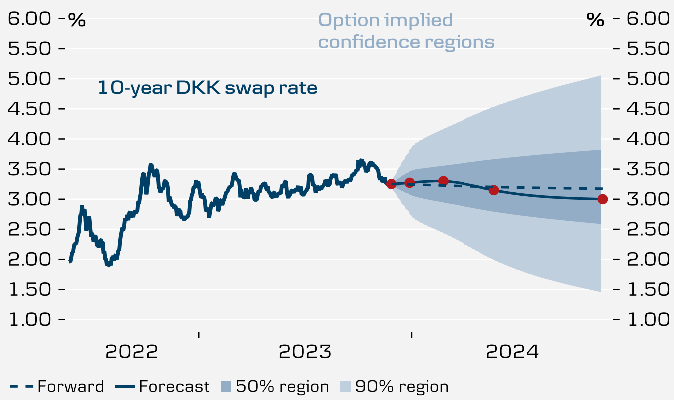
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

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

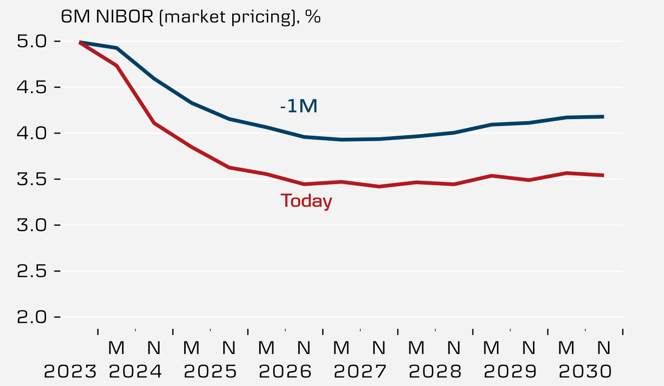
Norway forecast

NOK forecast summary

		--Forecast--			-- Fcst vs Fwd in bp--		
NOK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Deposit	4.25	4.25	4.00	3.50			
NIBOR (3M)	4.76	4.52	4.25	3.78	-19	-37	-29
NIBOR (6M)	4.98	4.58	4.31	3.84	-31	-38	-23
Government Bonds							
2-year	3.93	3.70	3.40	3.10			
5-year	3.64	3.45	3.25	3.05			
10-year	3.61	3.40	3.25	3.10			
Swap Rates							
2-year	4.46	4.25	3.95	3.65	-2	-14	-14
5-year	3.89	3.75	3.55	3.35	-5	-17	-24
10-year	3.73	3.65	3.50	3.35	-4	-15	-23

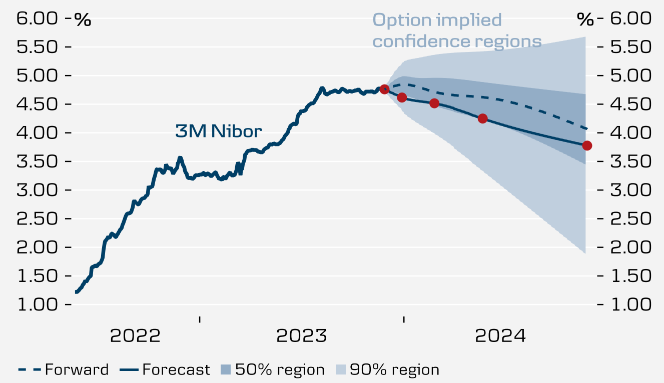
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

1M change in NOK swap (6M)



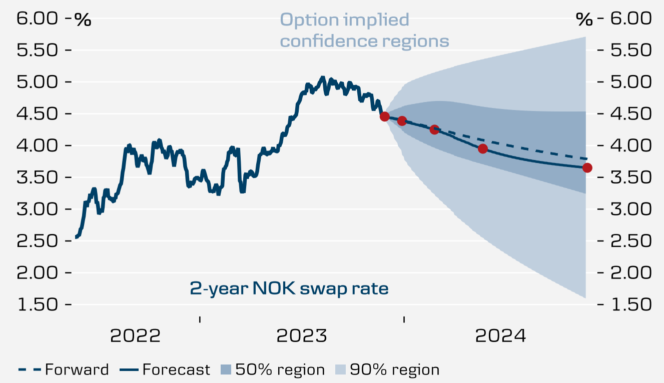
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Nibor



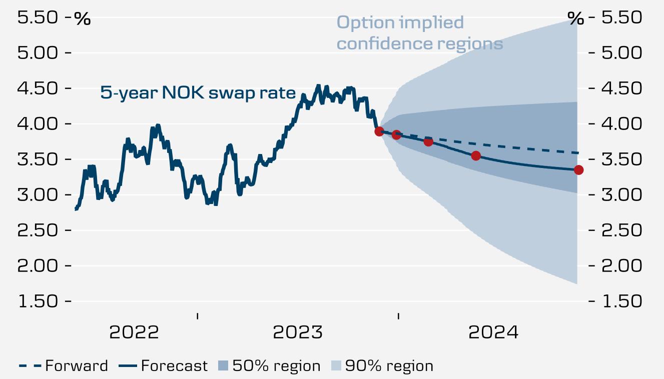
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y NOK swap rate



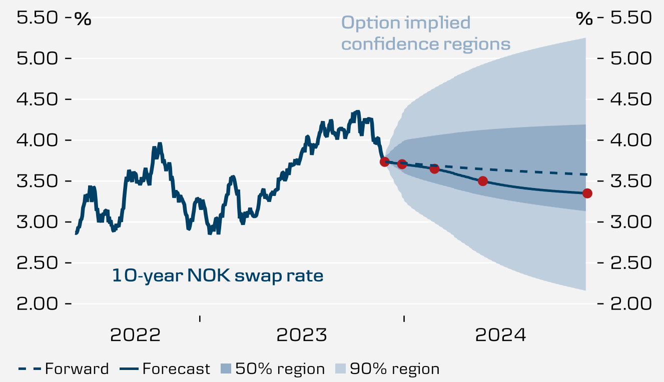
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

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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