

FX Strategy

Immense DKK strength – DN to hike 10bp less than ECB

- **DKK is still going strong vis-à-vis EUR despite facing headwinds from all angles in the past month.**
- **We now expect Danmarks Nationalbank (DN) to widen the spread to ECB another 10bp in 3M, i.e. to hike its key policy rate to 2.40% in March.**
- **The market is already discounting this scenario to some extent and we therefore only expect limited impact on EUR/DKK spot, i.e. a rise to around 7.4400.**

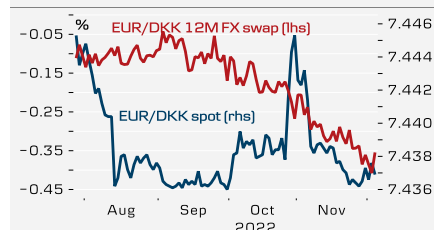
Developments since late October underscore the immense strength of DKK. Global container freight rates dropped another 20%, USD/DKK is down about 5%, Danish equities have outperformed US equities, Danish mortgage bonds have recovered a bit and the discount in EUR/DKK FX forward widened to around -35bp in 12M. All these factors should send EUR/DKK higher, yet, the pair still trades close to the 7.4365 floor set by Danmarks Nationalbank (DN). In fact, DN sold DKK4bn in FX intervention in November to maintain the floor. Is it time for DN to widen the spread to the ECB's policy rate further?

We now expect DN to widen the policy rate spread another 10bp on 3M, i.e. hike its key policy rate to 2.40% in March next year. We think it is a close call whether DN moves as early as next week. On the one hand, DKK4bn in FX intervention in November is modest and not something that on its own warrants a move in interest rates. On the other hand, the 15bp widening of the spread in October was clearly not enough to weaken DKK vis-à-vis EUR and end the need for FX intervention selling of DKK. The benefit of moving again next week, e.g. widening the spread another 10bp by 'only' hiking its key policy rate 40bp in response to a 50bp hike from ECB, would be that DN avoids the confusion of having to potentially cut interest rates in between ECB rate hikes. It would further help put an end to EUR/DKK downwards pressure now rather than potentially after another bout of large-scale FX intervention selling.

The current pricing of the EUR/DKK market nears the extremes of the '2015 rally into DKK'. 12M EUR/DKK FX forward trades around 7.4100 (mid) and thus far below where DN historically floored the spot. Obviously, it reflects the combination of a low spot rate, the recent widening of the policy rate spread to the ECB and expectations of more to come. But it also underscores the lack of interest in the market to buy EUR/DKK spot or forward at extreme low levels. In 2015, the lower bound on interest rates posed a constraint on DN – it did not dare to cut its key policy rate below -0.75%. Now that interest rates are positive again, we think the scope for a wider policy rate spread to the ECB is much larger.

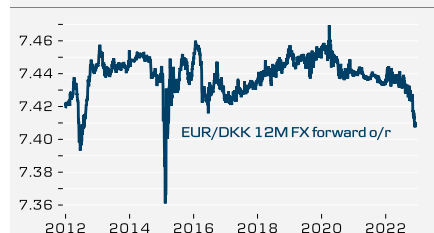
We think it matters less to DN whether the spread to ECB is -35bp, -50bp or even -100bp – in particular now when it can hike interest rates and widen the spread at the same time. The RFR swap market discounts about a 4bp widening of the spread next week. If DN follows ECB 1:1 next week, DKK rates and FX forwards might move slightly higher, but the market will look towards February for a widening of the spread. If DN hikes 10bp, DKK rates and FX forwards should drop slightly and send EUR/DKK to around 7.4400 and end the immediate need for more unilateral monetary policy action from DN.

Downwards pressure in EUR/DKK spot and forwards



Source: Macrobond Financial, Bloomberg

EUR/DKK market nears '2015' and 'debt crisis' extremes



Source: Macrobond Financial, Bloomberg

Director and Chief Analyst
Jens Nærvig Pedersen
+45 4512 8061
jenpe@danskebank.dk

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None

Date of first publication

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