Danske Bank

Investment Research

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Corporate Hedging

Still downside for 10Y USD rates over next three months

We have seen significant moves in US yields and rates over the past couple of weeks and the uncertainty is where we are heading over the next couple of months and quarters. In principle, we see three main drivers for longer dated yields and rates: supply, QE from the Fed and the business cycle outlook.

We argue that 10Y US treasury yields and 10Y USD swap rates will edge lower towards 0.50% over the next couple of month as the economy stays under pressure and Fed QE supports the bond market. However, on a 6M to 12M horizon, we expect yields to move higher again as the economy improves. A better economy would allow the Fed to let yields drift slightly higher. We have 6M and 12M forecasts of 0.8% and 1.0%, respectively, for 10Y US treasury yields.

1. Supply is booming

The US has put in place a wide range of both fiscal and monetary measures. This week the White House and Congress agreed a USD2.0trn stimuli package. The stimuli package comes in a situation where the US economy is heading for a very deep recession, so we expect a significant decline in taxes on top of the extra fiscal spending.

Hence, we expect the US supply to rise significantly in 2020 and coming years. The exact funding need is very difficult to estimate before we have more details of the package. Furthermore, we expect a significant part of funding to be in T-bills. However, even if T-bill issuance secures a significant part of the funding, there is little doubt in our minds that under normal circumstances such a large jump in US treasury supply would push yields and rates higher across the curve.

2. QE is open-ended and could outpace supply

The Federal Reserve has been very forceful in its response to the crisis. Not only has it cut rates to zero, it has also opted for open-ended QE. Hence, the Fed can buy as many US treasuries and mortgage bonds as it wants. Given that the Fed needs to have as low, longer dated yields as possible to get the full impact of the monetary stimuli, we believe the Fed will be very determined to keep yields low. Low treasury yields and purchases of mortgage bonds work to keep mortgage yields in check, which is an important part of the general easing conducted by the Fed.

We assume that the Fed will continue to be a dominant buyer in the bond market for several years and that this will be the most important factor in keeping yields and rates from rising.

3. 3M USD Libor rates to fall back

For USD swap rates, there is an issue with USD Libor fixings, which have stayed high despite Fed funds being cut to zero. If this becomes the new standard, US swap rates could over time rise relative to government bond yields (wider asset swap spreads). So far, the market is pricing this as a temporary issue. The reason is the Fed initiatives, where liquidity is increased rapidly in the US money market through QE, repo operations and various target facilities.

Key points

- We argue that 10Y US treasury yields will fall to 0.50% over the next couple of month, as the economy stays under pressure and Fed QE supports the bond market strongly.
- The combination of QE and a weak business cycle outlook should mitigate the upward pressure from higher bond supply.
- However, on a 6M to 12M horizon, we expect yields to move slowly higher as the economy improves and supply stays higher. In our view, the expected growth recovery should allow the Fed to let yields drift slightly higher.

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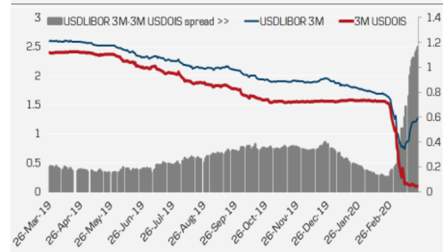
We believe total liquidity is likely to surpass the post-financial crisis high from 2014 this week. The effect is starting to show in overnight rates, where upward pressure has started to ease. Money-market rates, e.g. 3M USD LIBOR, are still elevated though – more than 115bp above 3M USD OIS. In line with the market, we expect the Fed's liquidity operations eventually to send 3M USD LIBOR lower and normalise the 3M USD LIBOR-OIS spread towards 20-30bp and push USD Libor rates towards 30-35bp. If not, the Fed will, in our view, come up with new initiatives until it works.

Wide spread between 3M USD Libor and 3M OIS rate (%)

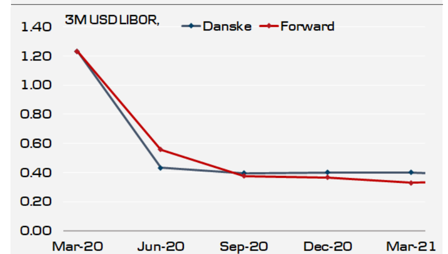


Source: Danske Bank

4. The economic outlook is week over the next couple of months

This is the last uncertainty and there is little doubt in our minds that the US is currently in a recession. However, markets are forward looking and the uncertainty is whether we are getting closer to the point where financial markets will look beyond the crisis. Our economists expect US GDP to contract by 3.9% q/q in AR in Q1 and by -18% q/q AR in Q2. Their underlying assumption is that the virus will shut down the economy throughout April (despite Donald Trump's recent statement that he wants it to reopen soon) but with a gradual reopening in May. They further base this on the assumption that the spread of the coronavirus will peak in late April. However, they believe things should improve in H2 and expect GDP growth to be 13.0% q/q AR in Q3 and 7.9% q/q AR in Q4. In total, they expect GDP growth in 2020 to be -1.9% rebounding to 3.1% in 2021. For more, see *Macro US – Sharp GDP contraction but we still expect a rebound in H2*, 24 March.

In line with market we expect 3M USD Libor fixings to come down

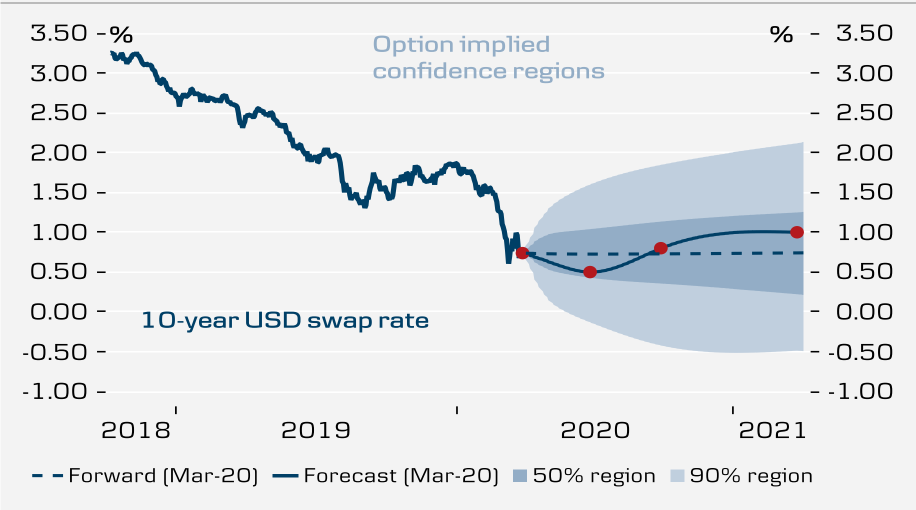


Source: Danske Bank

Conclusion – 10Y yields and rate to fall further over the next three months

Overall, we argue that *10Y US treasury yields and swap rates will edge lower towards 0.50% over the next couple of months, as the economy remains under pressure and Fed QE supports the bond market. However, on a 6M to 12M horizon, we expect yields to move higher once again as the economy improves, allowing the Fed to slow down the QE programme somewhat. We have a 0.8% and 1.0% target on 6M and 12M horizons, respectively.*

Danske Bank forecast 10Y USD swap-forecast



Source: Danske Bank

Our forecast is that the combination of hefty QE and the deepening recession will keep downward pressure on 10Y US yields over the next three months and that the elevated 3M USD Libor will start to drift lower. Hence, we have a 3M forecast for 10Y Treasury yields and 10Y USD swap to 0.60%. We assume a flat swap spread. However, on 6M and 12M horizons, we see renewed upward pressure. Supply kicks in, the economy is improving and the Fed might accept yields edging higher. We pencil in 0.8% and 0.9%, respectively.

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Arne Lohmann Rasmussen, Head of Fixed Income Research.

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None.

Date of first publication

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