

Yield Outlook

Central banks gradually turning more hawkish

In the past few editions of *Yield Outlook*, we have argued that bond yields (represented by 10Y US Treasuries and German Bunds) are likely to range trade through 2017. This is still our view. However, over the past months, yields have moved to the low end of their ranges in both Europe and, not least, the US. The decline in yields should be viewed against the background of still low inflation and a certain repricing of the Federal Reserve, as well as the market focus on North Korea and the US debt ceiling, which has triggered safe-haven purchases.

We believe that the downward pressure on 10Y yields is gradually easing. Also, yields could begin to increase towards the top of the range in coming months and the risk of a more significant and abrupt rise in yields seems to have increased, in our view.

Improving global economy and lower geopolitical risks

The global economy seems to be in good condition, in our view. Global confidence indicators such as PMI indices are running at high levels and cyclical metal prices have increased after the summer holidays. True, inflationary pressures are low; but the fear of deflation has gone.

Also, global uncertainty has declined. While the conflict with North Korea has not at all been solved, it does not make the headlines the same way it did just a couple of months ago. The agreement to suspend the US debt ceiling until December has postponed a looming political crisis in the US. Furthermore, the costs in connection with Hurricane Irma look likely to be smaller than feared. The reduced global uncertainty could put a damper on safe-haven assets and, viewed in isolation, could push rates and yields up.

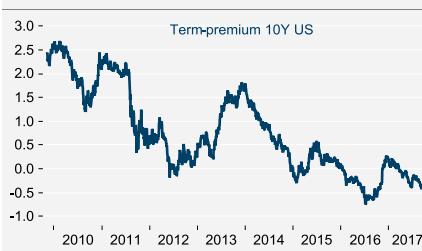
This movement could be further reinforced by the term premium currently being rather low. The term premium refers to the extra premium (now negative) that investors demand for buying a 10Y bond rather than 10 1Y bonds over the next 10 years. In other words, investors receive no additional payment for buying, for example, a 10Y compared to 10 1Y bonds. In the US, the 10Y term premium is in fact as low as minus 0.42%. If this premium normalises, we should expect nominal yields to increase – all else being equal.

Yields have fallen again recently



Source: Bloomberg, Macrobond Financials

Term premium low once again



Source: Bloomberg, Macrobond Financials

Quick links

[Eurozone forecasts](#)

[US forecasts](#)

[UK forecasts](#)

[Denmark forecasts](#)

[Sweden forecasts](#)

[Norway forecasts](#)

[Forecasts table](#)

Policy rate outlook

Country	Spot	+3m	+6m	+12m
USD	1.25	1.50	1.50	1.75
EUR	-0.40	-0.40	-0.40	-0.40
GBP	0.25	0.25	0.50	0.50
DKK	-0.65	-0.65	-0.65	-0.65
SEK	-0.50	-0.50	-0.50	-0.50
NOK	0.50	0.50	0.50	0.50

Source: Danske Bank

10-year swap rate outlook

Country	Spot	+3m	+6m	+12m
USD	2.16	2.35	2.45	2.70
EUR	0.85	0.95	1.05	1.20
GBP	1.31	1.45	1.55	1.75
DKK	1.06	1.20	1.30	1.45
SEK	1.17	1.30	1.50	1.65
NOK	1.84	1.95	2.05	2.30

Source: Danske Bank

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Central banks back off on the accelerator

The ECB has announced it will decide at its October monetary policy meeting on extending QE when the current programme expires at the end of 2017. We expect the ECB to taper its monthly bond purchases from EUR60bn currently to EUR40bn. Investors may interpret this as the start of monetary policy normalisation in the eurozone, potentially prompting the market to bring forward the expected date of the first ECB rate hike. The market currently expects a modest rate hike of 10bp in spring 2019.

However, the ECB backing off on the accelerator is not the same as pressing on the brake. And while the risk of deflation has gone, inflation remains rather modest, plus the ECB is, not least, concerned about the impact of recent EUR strengthening. The USD has cheapened by more than 13% since early March, which should eventually push import prices lower and thus make achieving the inflation target even more difficult for the ECB.

Still, the risk is once again asymmetric. The ECB might put more weight on the better economic data and argue that an extension of the QE programme is unnecessary. The 'lack' of eligible bonds might also force the ECB to end its QE programme earlier than we expect. If the QE programme is not extended or scaled back quickly in 2018, it would tend to steepen the yield curve further. Also, it is still worth keeping an eye on Sweden. Higher Swedish inflation and an already high ownership share by the Riksbank make it unlikely that the Swedish QE programme will be extended into 2018, in our view.

For a long time, we have argued that the Federal Reserve will raise interest rates once more this year at its December meeting. We maintain this view despite the latest US inflation figures showing less inflationary pressures than expected. In our opinion, the Fed will continue to focus on unemployment being at a 17-year low and expect the effect on wage growth to be only a matter of time. The market has far from priced in a further rate hike this year, and certainly not two more in 2018, which is our expectation.

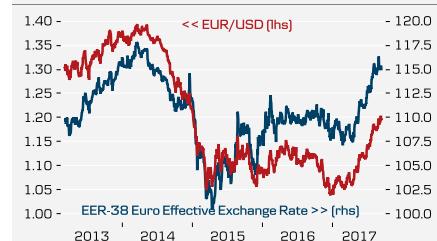
As well as the issue of potential US rate hikes, focus is also on the planned 'quantitative tightening' in the US, i.e. the reduction of the Fed 'balance sheet'. We can expect an official announcement on this at the FOMC meeting on 20 September.

Risks are still asymmetric

Despite the continued recovery in the eurozone and the risk of both the ECB and the Fed coming out more hawkish later in the year, we stick to our view that 10Y bond yields in Germany, Scandinavia and the US are likely to remain in a relatively close range for the rest of 2017. However, following their recent fall the risk is more of yields increasing than decreasing. We would also again stress that the risk of a more pronounced move higher should not be underestimated. When the Fed announced a tapering of bond purchases in 2013 the 10Y yield subsequently rose by more than 1.0 percentage points within a few months.

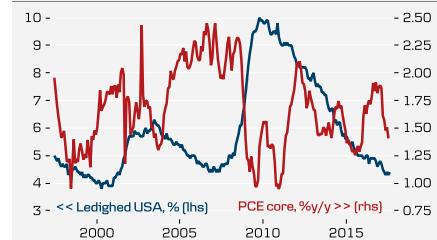
However, in 2018 central banks are set to turn even more hawkish. The ECB will – almost unavoidably – have started tapering and the Fed will probably be on course to deliver further rate hikes in a situation when very little is priced into the US curve. The risk is that this scenario could materialise this year and not in 2018, underlining the asymmetric risks to yields. All in all, we expect the US 10Y yield to be 2.7% and the corresponding German yield to be 0.75% 12 months from now.

Strong euro keeping inflation low



Source: Macrobond Financials

Low unemployment – not low inflation – is causing concern at the Fed



Source: Macrobond Financials

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Eurozone					4
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Forecasts table					10

Eurozone forecasts

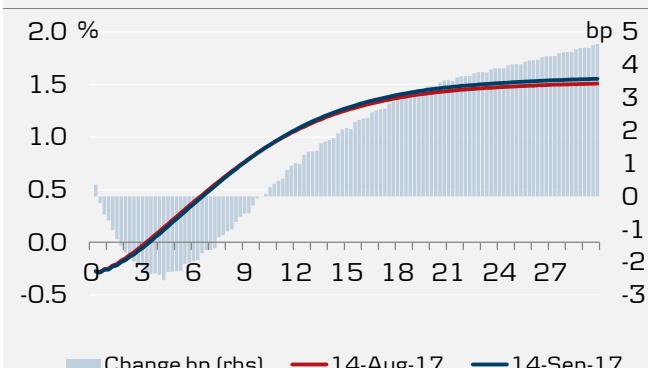
- In recent months, economic data releases have revealed strong growth in the euro area, a falling unemployment rate and a slightly higher core inflation rate. This should be exactly what the ECB was hoping for ahead of its QE decision next month, but the stronger euro is the ‘party pooper’ and because of this we do not expect the ECB to sound cautious when talking about ‘policy normalisation’.
- We still expect the ECB to continue its QE purchases – albeit at a reduced rate of EUR40bn per month in H1 18. The bank has announced that many details regarding the QE programme beyond 2017 will be revealed at the October meeting.
- We continue to expect a steeper EUR yield curve for the 2Y10Y in 2018. The ECB maintains a 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 elevated by higher US yields and a market slowly pricing in an end to the QE programme/tapering in 2018.

EUR forecasts summary

EUR	--- Forecast ---			--- Fcst vs Fwd in bp ---			
	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<u>Money market</u>							
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	-6
<u>Government bonds</u>							
2-year	-0.72	-0.65	-0.60	-0.50	-	-	-
5-year	-0.32	-0.25	-0.20	-0.10	-	-	-
10-year	0.41	0.50	0.60	0.75	-	-	-
<u>Swap rates</u>							
2-year	-0.19	-0.10	-0.05	0.00	+5	+5	-1
5-year	0.19	0.25	0.30	0.40	+0	-1	-5
10-year	0.85	0.95	1.05	1.20	+4	+8	+12

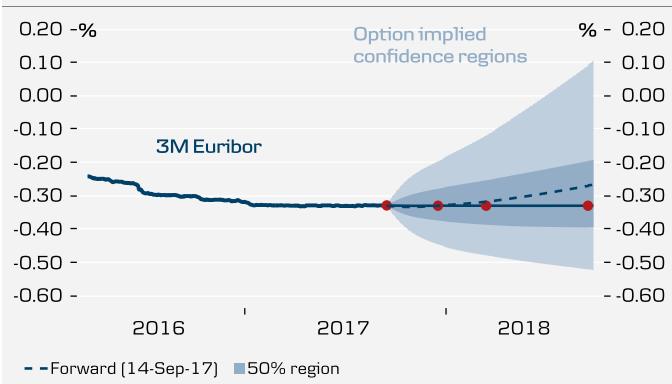
Source: Danske Bank

EUR swap curve - One month change



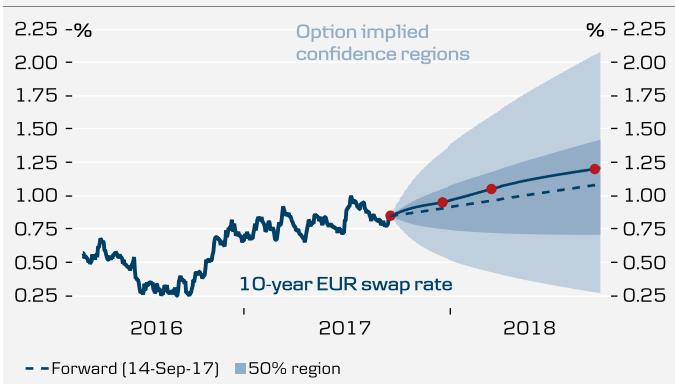
Source: Danske Bank

3M Euribor



Source: Macrobond Financial, Danske Bank

10Y EUR swap rates



Source: Macrobond Financial, Danske Bank

US forecasts

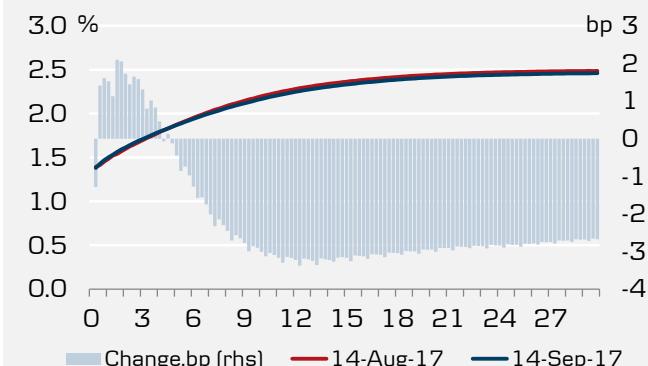
- At the meeting next week, we expect the Fed to announce it will begin 'quantitative tightening' in October. We still call for a third Fed hike in December with a probability of around 55%, as the Fed puts more weight on labour market data than inflation rates. We expect two hikes next year although it is more difficult to say what will happen given there are four vacant seats on the Board of Governors and possible five if President Trump does not reappoint Yellen as Fed chair.
- We still think risks are skewed towards the Fed pausing its hiking cycle due to low inflation, which may not be just 'transitory' given the low inflation expectations. We have already seen increasing discussions between the doves and the hawks.
- Markets have only priced in a December hike with a probability of approximately 30%, which is too low in our view. Hence, if our baseline scenario is correct, it should tend to push US yields slightly higher. However, we do not see a major sell-off this year. In 2018, we expect growth in the US economy to continue, which would trigger another rate hike in the summer of 2018. We continue to expect a flattening of the curve for the 2Y10Y on a 12M horizon. The short-end would be pushed higher by Fed rate hikes, while the long-end would be kept low by investors buying 'high yielding' US fixed income assets.

USD forecasts summary

	... Forecast Fcst vs Fwd in bp ...			
	USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<u>Money market</u>								
Fed Funds	1.25	1.50	1.50	1.75	-	-	-	-
3M	1.32	1.55	1.68	1.92	+13	+15	+29	
<u>Government bonds</u>								
2-year	1.35	1.50	1.60	2.00	-	-	-	-
5-year	1.77	1.95	2.10	2.30	-	-	-	-
10-year	2.20	2.40	2.50	2.70	-	-	-	-
<u>Swap rates</u>								
2-year	1.59	1.75	1.85	2.25	+10	+14	+45	
5-year	1.85	2.05	2.20	2.40	+15	+26	+38	
10-year	2.16	2.35	2.45	2.70	+16	+23	+42	

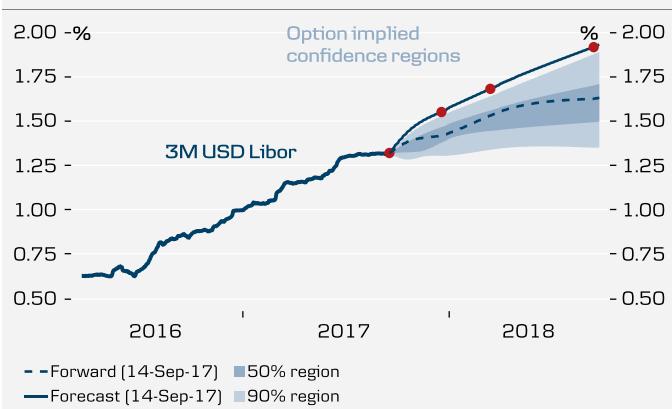
Source: Danske Bank

USD swap curve – One month change



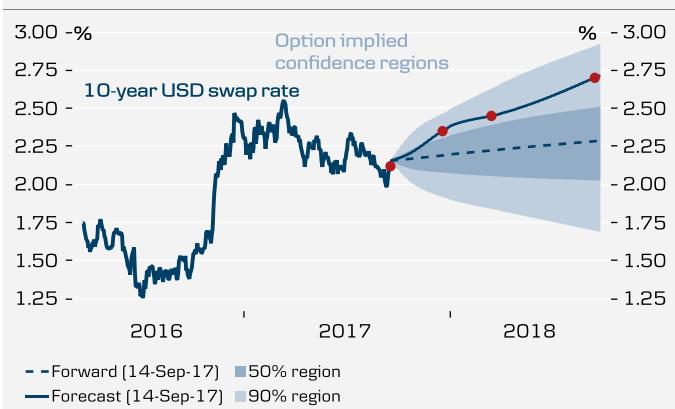
Source: Danske Bank

3M USD Libor rates



Source: Macrobond Financial, Danske Bank

10Y USD swap rates



Source: Macrobond Financial, Danske Bank

UK forecasts

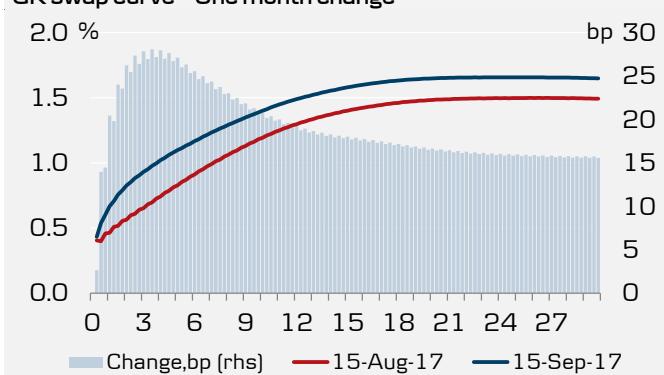
- The Bank of England (BoE) caught us and the market by surprise at its September MPC meeting by warning of a possible forthcoming rate hike 'over coming months' if underlying inflation moves higher and the unemployment rate moves lower. While this caused us to move our call for the first BoE hike to Q1 18 and saying November was a close call, we have been caught by another surprise, as BoE's Vlieghe, once über dove, evolved into a hawk at his speech the day after the BoE meeting. As Vlieghe now seems to support a hike despite slower growth and Brexit uncertainties, we now think it is more likely than not that BoE hikes in November, although it still depends on the incoming labour market and inflation data. That said, we think this is merely BoE taking back its 'emergency cut' it delivered in August last year (after the Brexit vote) and not necessarily the beginning of a new hiking cycle. At least it seems as the dovish-leaned BoE members want firmer evidence that wage growth is picking up, as this is one of the main assumption behind BoE's forecast of increasing growth next year.
- UK gilt yields increased substantially following BoE meeting and again after Vlieghe's hawkish speech. The markets are now pricing in around a 80% probability of a November hike while a full hike is priced in by January. We see moderate upside to UK yields across the curve ahead of the November meeting. Further out, the second hike is priced in by November 2018 and the third around year-end 2019, so markets expect a once hiking cycle at the moment. We expect the 2Y10Y and 5Y10Y yield curves to steepen further on a 6-12M horizon, with the long end of the curve being driven by higher yields in the US and Europe.

UK forecasts summary

	... Forecast Fcst vs Fwd in bp ...			
	15/09/2017 GBP	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<u>Money market</u>								
Repo	0.25	0.50	0.50	0.50	-	-	-	-
3M	0.30	0.52	0.53	0.53	-1	-12	-28	-
<u>Government bonds</u>								
2-year	0.48	0.50	0.55	0.70	-4	-2	+8	-
5-year	0.76	0.80	0.95	1.20	-6	+3	+17	-
10-year	1.33	1.40	1.50	1.70	-1	+3	+13	-
<u>Swap rates</u>								
2-year	0.79	0.80	0.90	1.05	-9	-6	-1	-
5-year	1.08	1.10	1.25	1.50	-4	+7	+24	-
10-year	1.39	1.45	1.55	1.75	+2	+9	+22	-

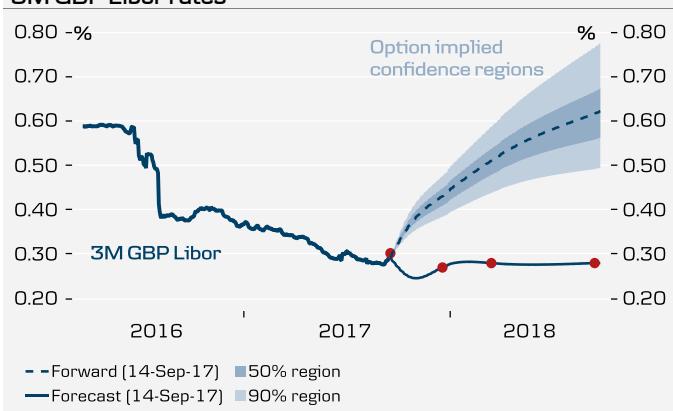
Source: Danske Bank

UK swap curve - One month change



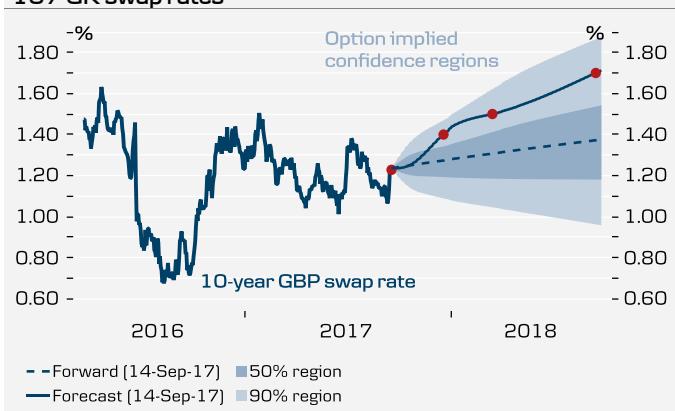
Source: Danske Bank

3M GBP Libor rates



Source: Macrobond Financial, Danske Bank

10Y UK swap rates



Source: Macrobond Financial, Danske Bank

Denmark forecasts

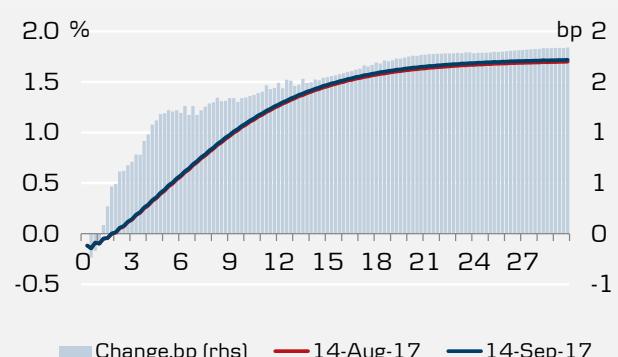
- We do not expect rate changes from the Danish central bank over the next 12 months. If anything, we could see the central bank intervening in the market to weaken the krone, as fundamentals such as the significant current account surplus are still tending to strengthen the DKK. The 3M Cibor-Euribor has continued to tighten after the widening seen in Q2. It seems that the move lower in Euribor fixings over the summer is being reflected in lower Cibor fixings as well. We expect DKK fixings to remain at the current level or fall to a slightly lower level for the time being.
- Despite the slightly wider fixing spread in Q2, we saw that DKK swap rates continued to tighten versus EUR swap rates – 10Y and 5Y5Y spreads, in particular, have tightened. We could see a continuation of this overall trend for the rest of the year, particularly as the fixing-spread has started to tighten.
- Danish government bonds have also tightened versus those of Germany this year. The Debt Management Office intends to continue to conduct switches to support liquidity, particularly in the new 2Y and 10Y bonds. The Debt Office also does outright buybacks funded by the booming government account at the central bank. Supply in 2018 is expected to be unchanged at DKK65bn, according to the new budget. Our base scenario expects the bond yield spread to Germany to remain at the current level or move slightly tighter.

DKK forecasts summary

14/09/2017 DKK	... Forecast Fcst vs Fwd in bp ...		
	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<u>Money market</u>							
CD	-0.65	-0.65	-0.65	-0.65	-	-	-
Repo	0.05	0.05	0.05	0.05	-	-	-
3M	-0.30	-0.30	-0.30	-0.30	-4	-6	-10
6M	-0.15	-0.15	-0.15	-0.11	-6	-9	-15
<u>Government bonds</u>							
2-year	-0.63	-0.55	-0.50	-0.40	-	-	-
5-year	-0.36	-0.30	-0.25	-0.15	-	-	-
10-year	0.52	0.65	0.75	0.90	-	-	-
<u>Swap rates</u>							
2-year	-0.04	0.10	0.15	0.20	+9	+9	+2
5-year	0.37	0.45	0.50	0.60	+2	-	-5
10-year	1.06	1.20	1.30	1.45	+8	+12	+15

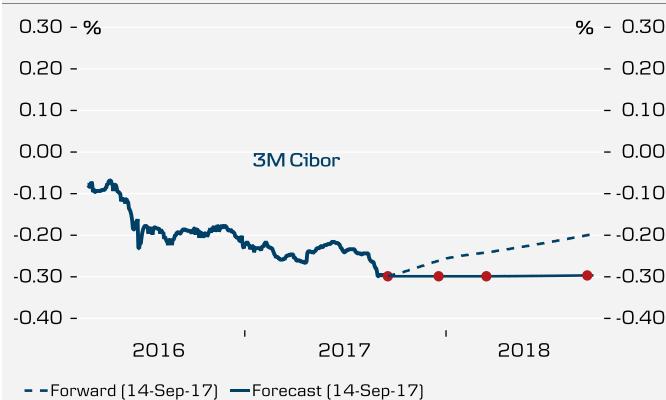
Source: Danske Bank

DKK swap curve – One month change



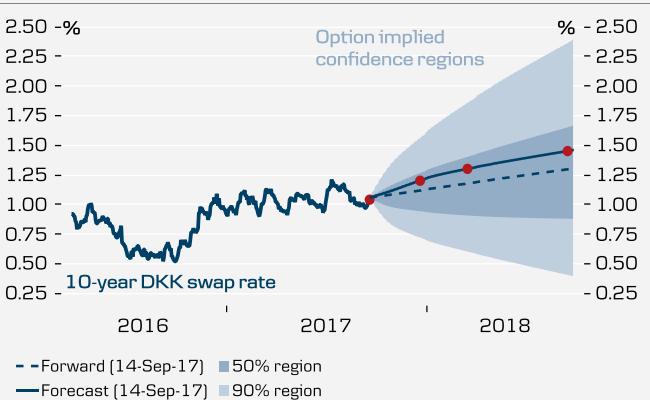
Source: Danske Bank

3M Cibor rate



Source: Macrobond Financial, Danske Bank

10Y DKK swap rates



Source: Macrobond Financial, Danske Bank

Sweden forecasts

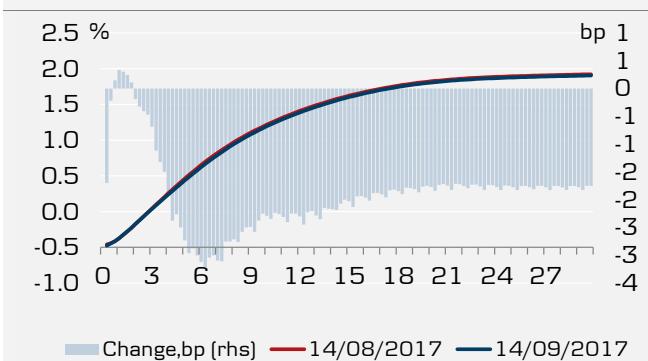
- The inflation rate moderated in August as we expected (due to primarily package tours moving closer to normal levels), but we expect CPIF to remain reasonably close to the 2% target in the coming months.
- While the Riksbank is likely to reiterate its message, which should help anchor the short end of the yield curves, the relatively high level of inflation and signs that central banks are nearing the exit could put some pressure on yields from the mid-segment of the curve and beyond.
- Later this year, possibly at the time of the 26 October policy announcement, the Riksbank needs to make a decision about further bond purchases. Our guess is that purchases will be ended by year-end but that re-investments of coupons will continue. This is likely to trigger a steeper curve over time.

SEK forecasts summary

SEK	... Forecast Fcst vs Fwd in bp ...		
	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<u>Money market</u>							
Repo	-0.50	-0.50	-0.50	-0.50	-	-	-
3M	-0.42	-0.45	-0.45	-0.45	+8	-7	-25
<u>Government bonds</u>							
2-year	-0.70	-0.70	-0.65	-0.50	-	-	-
5-year	0.07	0.05	0.10	0.20	-	-	-
10-year	0.82	0.90	1.10	1.30	-	-	-
<u>Swap rates</u>							
2-year	-0.23	-0.25	-0.20	-0.05	-11	-17	-23
5-year	0.39	0.50	0.55	0.60	+2	-3	-18
10-year	1.17	1.30	1.50	1.65	+6	+19	+20

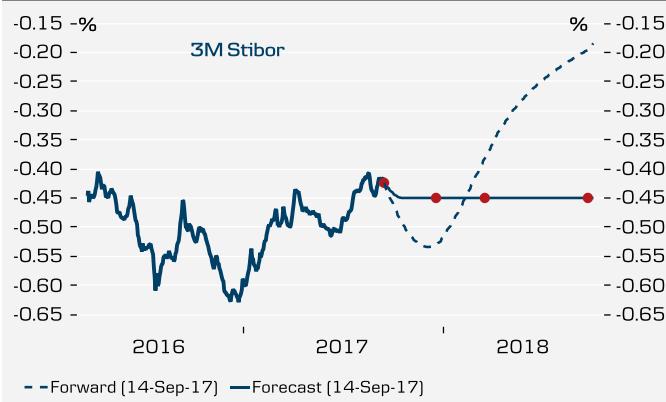
Source: Danske Bank

SEK swap curve - One month change



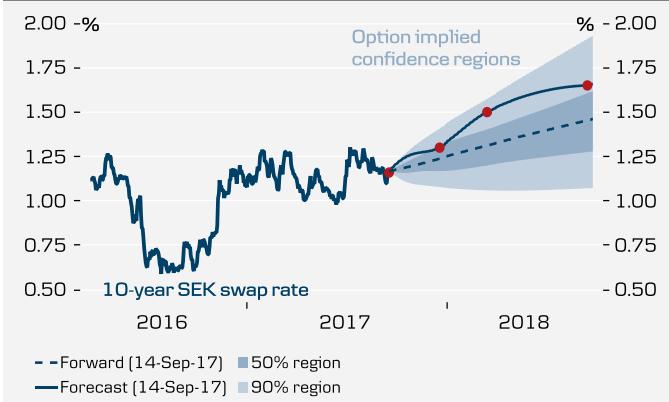
Source: Danske Bank

3M Stibor rate



Source: Macrobond Financial, Danske Bank

10Y SEK swap rates



Source: Macrobond Financial, Danske Bank

Norway forecasts

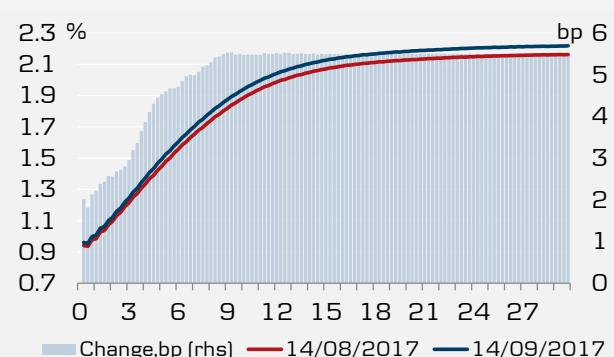
- At the 22 June monetary policy meeting, Norges Bank followed in the footsteps of the ECB and removed the downside to the interest rate projection but indicated lower rates for longer. The current targeted interest rate of 0.5% is likely to remain unchanged until end-2018. Norges Bank's rate projection by end-2020, i.e. the end of the projection period, is 1.28%. Recent data suggest only marginal revisions at the upcoming board meeting and new Monetary Policy Report on 21 September.
- The slowdown in the Norwegian housing market this summer, after strong growth in 2015 and 2016, has been more pronounced than expected by Norges Bank. Mortgage market regulations, introduced at the start of the year, seem to be cooling the housing market – particularly in the Oslo area. Despite the recent oil price recovery, the NOK is still rather weak from a historical perspective and remains supportive of growth in traditional industries.
- We do not expect the recent slowdown in the housing market to have any significant effect on monetary policy going forward. Capacity utilisation is about to tighten. We expect 5Y and 10Y yields to be stable versus peers in 2017, as the Norwegian economy is improving slowly, although it is still not out of the woods after the oil-led downturn.

NOK forecasts summary

NOK	--- Forecast ---				--- Fcst vs Fwd in bp ---		
	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<u>Money market</u>							
Deposit	0.50	0.50	0.50	0.50	-	-	-
3M	0.81	0.80	0.80	0.80	-8	-8	-15
<u>Government bonds</u>							
2-year	0.65	0.65	0.70	0.80	-	-	-
5-year	1.04	1.05	1.10	1.20	-	-	-
10-year	1.51	1.65	1.75	2.00	-	-	-
<u>Swap rates</u>							
2-year	1.04	1.10	1.15	1.25	-	+0	-2
5-year	1.39	1.45	1.50	1.60	+0	-	-1
10-year	1.84	1.95	2.05	2.30	+6	+12	+29

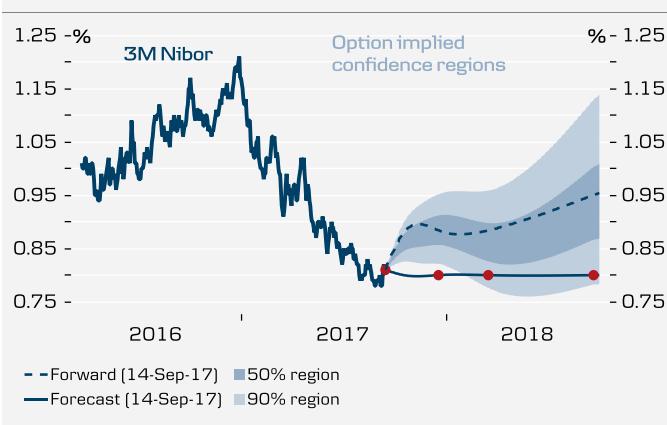
Source: Danske Bank

NOK swap curve - One month change



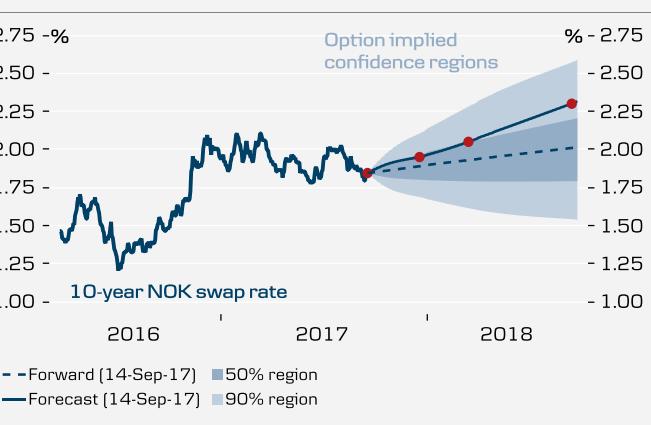
Source: Danske Bank

3M Nibor rate



Source: Danske Bank

10Y NOK swap rates



Source: Danske Bank

Forecasts table

Forecast table									
	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	1.25	1.32	1.59	1.85	2.16	1.35	1.77	2.20
	+3m	1.50	1.55	1.75	2.05	2.35	1.50	1.95	2.40
	+6m	1.50	1.68	1.85	2.20	2.45	1.60	2.10	2.50
	+12m	1.75	1.92	2.25	2.40	2.70	2.00	2.30	2.70
EUR*	Spot	-0.40	-0.33	-0.19	0.19	0.85	-0.72	-0.32	0.41
	+3m	-0.40	-0.33	-0.10	0.25	0.95	-0.65	-0.25	0.50
	+6m	-0.40	-0.33	-0.05	0.30	1.05	-0.60	-0.20	0.60
	+12m	-0.40	-0.33	0.00	0.40	1.20	-0.50	-0.10	0.75
GBP	Spot	0.25	0.30	0.72	0.99	1.31	0.39	0.66	1.24
	+3m	0.25	0.37	0.80	1.10	1.45	0.45	0.80	1.40
	+6m	0.50	0.53	0.85	1.20	1.55	0.50	0.90	1.50
	+12m	0.50	0.53	1.05	1.50	1.75	0.70	1.20	1.70
DKK	Spot	-0.65	-0.30	-0.04	0.37	1.06	-0.63	-0.36	0.52
	+3m	-0.65	-0.30	0.10	0.45	1.20	-0.55	-0.30	0.65
	+6m	-0.65	-0.30	0.15	0.50	1.30	-0.50	-0.25	0.75
	+12m	-0.65	-0.30	0.20	0.60	1.45	-0.40	-0.15	0.90
SEK	Spot	-0.50	-0.42	-0.23	0.39	1.17	-0.70	-0.07	0.82
	+3m	-0.50	-0.45	-0.25	0.50	1.30	-0.70	0.05	0.90
	+6m	-0.50	-0.45	-0.20	0.55	1.50	-0.65	0.10	1.10
	+12m	-0.50	-0.45	-0.05	0.60	1.65	-0.50	0.20	1.30
NOK	Spot	0.50	0.81	1.04	1.39	1.84	0.65	1.04	1.51
	+3m	0.50	0.80	1.10	1.45	1.95	0.65	1.05	1.65
	+6m	0.50	0.80	1.15	1.50	2.05	0.70	1.10	1.75
	+12m	0.50	0.80	1.25	1.60	2.30	0.80	1.20	2.00

* 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 the research report are Arne Lohmann Rasmussen, Chief Analyst, and Nina T. B. Andersen, Assistant Analyst.

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None

Date of first publication

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Report completed: 15 August 2017 at 12:22 GMT

Report disseminated: 15 August 2017 at 14:30 GMT