

Yield Outlook

Downside to yields remains despite better risk appetite

Ten-year Bund yields have been trading in a range of minus 0.60% to minus 0.45% for the past month, trending slightly up over the past week.

A much-discussed theme this year has been whether long European yields are low because of Brexit and the US-China trade war pushing investors towards safe havens, or whether other factors dominate.

Indeed, yield increases over the past week have been modest despite news from the US that president Donald Trump has struck a 'phase 1' deal with China and news that the British seem likely to secure another extension to the Brexit deadline, or even a Brexit agreement with the EU.

In our view, markets not sending yields up much despite the positive news about the trade war and Brexit looks like the right thing to do. The reasons are that (1) the underlying eurozone macro economy has remained quite weak, (2) ECB monetary stimulus should not be underestimated and (3) the market has lost faith in higher inflation.

1. Underlying economy still weak

The eurozone economy has been humming along at two speeds since the beginning of the year – a swift service sector and a sluggish manufacturing sector. Yet, September marked this year's first month with a significant slacking of the previously fast-paced service sector activity, as services PMI fell to a year-low of 52.0 from 53.5 in August. The slackening comes on the back of deteriorating new business, which furthermore means that the services sector has now scaled back new hiring too. Hence, signs are growing that the transmission of the manufacturing malaise to the services sector has started.

Patient zero in the eurozone is still Germany and many economists (including Mario Draghi) encourage surplus countries such as Germany and the Netherlands to ease fiscal policies. Hope rested on the climate package totalling EUR54bn through to end-2023, announced by the German government last month.

However, the package will not do much to cure the current cyclical weakness, as most of the measures will become effective only from 2021 onwards and are not designed to conflict with the German government's balanced-budget strategy. The package is set to be funded by higher taxes, including carbon taxes, rather than borrowing/fiscal easing. Furthermore, due to Germany's self-imposed 'debt brake' and balanced-budget strategy ('black zero'), fiscal space for a sizable stimulus programme is limited (see *Research Germany - Loosening the brake*), 5 September.

The market focus has also been on the Netherlands, which is discussing a EUR50bn investment package. The idea is to take advantage of negative yields to boost investment in, for example, infrastructure. However, the package is still in the making and final approval seems a long way off. In addition, even if the package were to be adopted in 2020, it would probably not vitally affect either fixed income markets or the economy next year – not least as the intention seems to be to build the package over the next 10-20 years.

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Policy rates

Country	Spot	+3m	+6m	+12m
USD	2.00	1.50	1.00	1.00
EUR	-0.50	-0.50	-0.50	-0.50
GBP	0.75	0.75	0.75	0.75
DKK	-0.75	-0.75	-0.75	-0.75
SEK	-0.25	-0.25	-0.50	-0.50
NOK	1.50	1.50	1.75	1.75

Source: Danske Bank

10Y government bond yields

Country	Spot	+3m	+6m	+12m
USD	1.73	1.40	1.10	1.20
EUR	-0.45	-0.60	-0.60	-0.50
GBP	0.64	0.55	0.55	0.60
DKK	-0.44	-0.60	-0.60	-0.50
SEK	-0.18	-0.20	-0.20	-0.10
NOK	1.23	1.25	1.30	1.30

Note: EUR = Germany

Source: Danske Bank

10Y swap rates

Country	Spot	+3m	+6m	+12m
USD	1.62	1.30	1.00	1.10
EUR	-0.04	-0.20	-0.20	-0.10
GBP	0.82	0.70	0.70	0.75
DKK	0.04	-0.15	-0.15	-0.05
SEK	0.34	0.35	0.35	0.45
NOK	1.74	1.65	1.70	1.70

Source: Danske Bank

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2. Don't underestimate ECB's QE

In other words, there is no prospect of any sizeable increase in the supply of government bonds in 2020 driven by more expansionary eurozone fiscal policies.

Add to this that the ECB has relaunched its QE programme and is set to make monthly government bond purchases of EUR17bn starting in November. On top of this comes the ECB's reinvestment programme.

Given the current government budgets in the eurozone, we estimate that the volume of German government bonds available to investors in 2020 could fall by EUR50bn. For the eurozone as a whole, we estimate the supply of bonds could decline by EUR33bn once the ECB has taken its share. By comparison, European government bonds issued so far in 2019 amount to EUR166bn.

In addition, remember that the new ECB QE programme will continue until it raises short-term interest rates. This will not happen until inflation approaches 2% and we believe this could take several years. Hence, the market now knows with great certainty that there will be a major buyer in the bond market for the next many years.

Overview of eurozone bond supply in 2019 and 2020

Expected issuance	Deficit (% of GDP)*	Bond supply EUR bn**		Redemptions (EUR bn)		Net supply		ECB QE		Net supply incl. ECB QE and redemptions	
	2020	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019
Germany	0.5%	164	164	164	148	0	16	49	0	-50	16
France	-2.2%	190	200	127	129	63	71	38	0	25	71
Italy	-2.1%	255	250	202	195	53	55	32	0	20	55
Spain	-1.8%	105	114	84	92	21	22	23	0	-2	22
Belgium	-1.7%	28	28	21	22	7	6	7	0	0	6
Austria	0.3%	15	20	15	26	0	-6	6	0	-6	-6
Netherlands	0.4%	25	21	30	29	-5	-8	11	0	-16	-8
Finland	-0.8%	10	9	13	5	-3	4	4	0	-6	4
Ireland	0.2%	17	16	17	13	0	3	4	0	-4	3
Portugal	-0.3%	13.2	14.6	8	8	5	7	5	0	0	7
Greece	0.1%	5	5	1	9	4	-4	0	0	4	-4
Total		827	842	682	675	145	166	536	0	-33	166

* Domestic central banks/Ministry of Finance/EU Commission/Danske Bank

** Nominal and index-linked bonds

Sources: Domestic central banks, Ministry of Finance, EU Commission, Danske Bank

3. Market has lost confidence in higher inflation

We doubt very much whether the ECB's new package will succeed in jumpstarting the euro area economy and sending inflation higher. This would be the case only if we expected long-term interest rates to continue increasing. Investors would then place a higher risk premium on bonds and inflation expectations would rise.

We expect the opposite to happen over the next couple of quarters. The economic cycle is still pointing downward, the German economy being a particular case in point. The economy contracted by 0.1% in Q2 19 and we believe Germany is likely to see negative growth and go into technical recession in Q3. In our view, it is very likely the next step could be unemployment beginning to climb, as already seen in Sweden.

Indeed, the ECB has not succeeded in restoring market confidence in higher inflation. Many investors monitor 5Y5Y EUR inflation (average 5Y inflation rate in five years' time). It edged up a tiny bit after the ECB announced its package but has since fallen back again and, at 1.19%, has remained far below the ECB's target. In other words, the financial markets have very little confidence that what the ECB is doing will be enough to drive up inflation in the long term. The same picture seems to be developing if we look at analysts' long-term inflation expectations (Survey of Professional Forecasters).

Recent disagreements within the ECB Governing Council do not help either. Since the September meeting, a number of ECB hawks have dissociated themselves from using QE to boost economic activity. This weakens confidence in new ECB chief Christine Lagarde being able to ease policy further if need be. This, in turn, is likely to affect inflation expectations negatively – lower inflation expectations mean lower nominal interest rates.

Yields set to fall back again

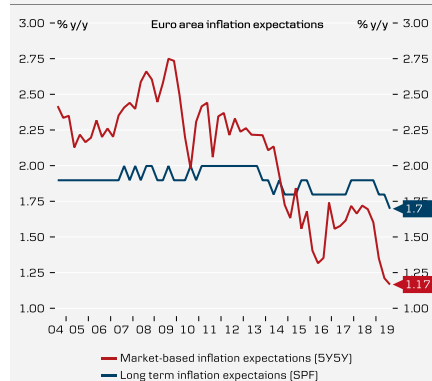
Overall, we expect German yields broadly to fall back to August levels and we maintain our call that the benchmark German bond yield is likely to fall to minus 0.60% within the next three months. The combination of a weakening economic cycle, ECB QE, the failure by Europe to apply fiscal policies and low inflation expectations among investors points in that direction.

The US Federal Reserve has already cut rates and while Governor Jerome Powell was very cautious about promising a string of rate cuts, we now believe we will see a series of US rate cuts and that the Fed funds rate will fall to 1% by March 2020. To read more, see *FOMC Research – New Fed Call: five more from Fed*, published on 15 August. Given our Fed call, we expect 10Y US Treasury yields to decline to 1.1% on a six-month horizon. This would help put downward pressure on long-term European yields.

European yields in particular have been under heavy pressure due to the weak economic cycle and while we expect it to improve slightly over the next 12 months, yields are not likely to increase significantly and we definitely do not expect a change to an upward sloping trend in yields.

We expect to publish the next issue of *Yield Outlook* by mid-November.

Market and forecasters losing faith that inflation will ever return to 2%



Source: Macrobond Financial, Danske Bank

Forecasts

Forecasts*									
	Horizon	Policy rate	3m x1bor	2-yr swap	5-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
USD	Spot	2.00	2.00	1.61	1.51	1.62	1.59	1.55	1.73
	+3m	1.50	1.14	1.30	1.25	1.30	1.30	1.30	1.40
	+6m	1.00	1.00	0.90	0.95	1.00	0.90	1.00	1.10
	+12m	1.00	1.00	1.00	1.10	1.10	1.00	1.15	1.20
EUR	Spot	-0.50	-0.42	-0.41	-0.33	-0.04	-0.69	-0.67	-0.45
	+3m	-0.50	-0.41	-0.50	-0.45	-0.20	-0.80	-0.80	-0.60
	+6m	-0.50	-0.41	-0.50	-0.45	-0.20	-0.80	-0.80	-0.60
	+12m	-0.50	-0.41	-0.40	-0.30	-0.10	-0.70	-0.65	-0.50
GBP	Spot	0.75	0.78	0.77	0.77	0.82	0.50	0.44	0.64
	+3m	0.75	0.79	0.70	0.65	0.70	0.40	0.35	0.55
	+6m	0.75	0.79	0.70	0.50	0.70	0.40	0.20	0.55
	+12m	0.75	0.79	0.80	0.60	0.75	0.50	0.30	0.60
DKK	Spot	-0.75	-0.44	-0.33	-0.24	0.04	-0.74	-0.64	-0.44
	+3m	-0.75	-0.45	-0.45	-0.40	-0.15	-0.85	-0.80	-0.60
	+6m	-0.75	-0.45	-0.45	-0.40	-0.15	-0.85	-0.80	-0.60
	+12m	-0.75	-0.45	-0.35	-0.25	-0.05	-0.75	-0.65	-0.50
SEK	Spot	-0.25	-0.08	-0.02	0.05	0.34	-0.54	-0.54	-0.18
	+3m	-0.25	-0.10	-0.10	0.00	0.35	-0.70	-0.60	-0.20
	+6m	-0.50	-0.30	-0.20	-0.05	0.35	-0.80	-0.65	-0.20
	+12m	-0.50	-0.30	-0.20	-0.05	0.45	-0.80	-0.65	-0.10
NOK	Spot	1.50	1.93	1.85	1.73	1.74	1.17	1.18	1.23
	+3m	1.50	2.10	1.90	1.60	1.65	1.30	1.20	1.25
	+6m	1.75	2.15	2.00	1.70	1.70	1.40	1.30	1.30
	+12m	1.75	2.13	2.05	2.00	1.70	1.45	1.60	1.30

* German government bond yields and EUR swap rates used
Source: Danske Bank

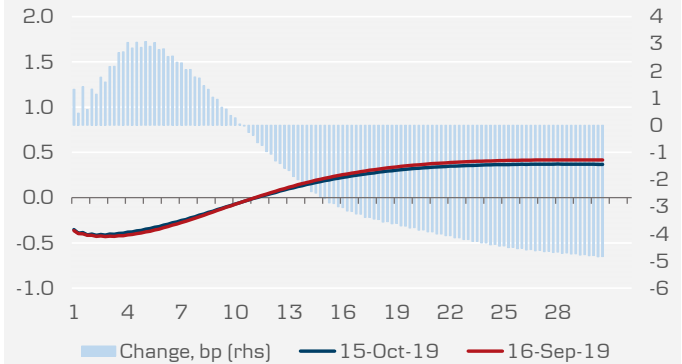
Eurozone forecasts

EUR forecast summary

EUR	15/10/2019				--- Forecast ---		--- Fcst vs Fwd in bp ---	
	Spot	+3m	+6m	+12m	+3m	+6m	+12m	
Money Market								
Refi	0.00	0.00	0.00	0.00	-	-	-	
Deposit	-0.50	-0.50	-0.50	-0.50	-	-	-	
3M	-0.42	-0.41	-0.41	-0.41	3	7	11	
6M	-0.35	-0.36	-0.36	-0.36	2	6	8	
Government Bonds								
2-year	-0.69	-0.80	-0.80	-0.70	-	-	-	
5-year	-0.67	-0.80	-0.80	-0.65	-	-	-	
10-year	-0.45	-0.60	-0.60	-0.50	-	-	-	
Swap rates								
2-year	-0.41	-0.50	-0.50	-0.40	-9	-8	0	
5-year	-0.33	-0.45	-0.45	-0.30	-14	-15	-4	
10-year	-0.04	-0.20	-0.20	-0.10	-18	-20	-16	

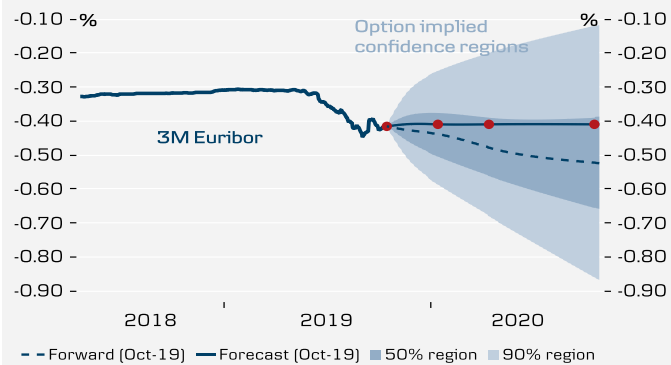
Source: Danske Bank

1M change in 6M Euribor



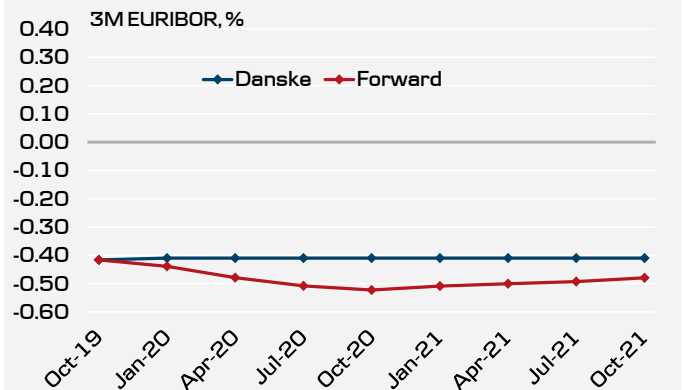
Source: Danske Bank

3M Euribor



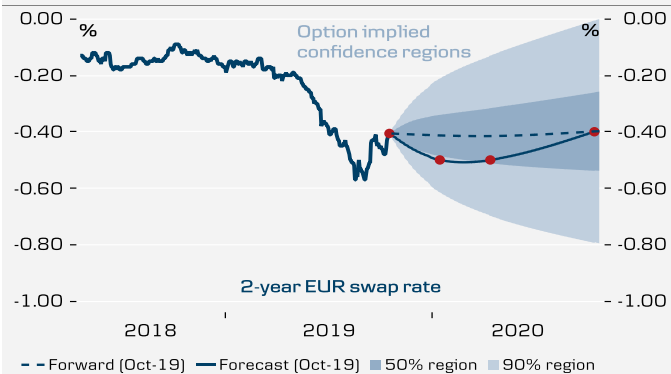
Source: Macrobond Financial, Danske Bank

Danske Bank forecasts and forwards



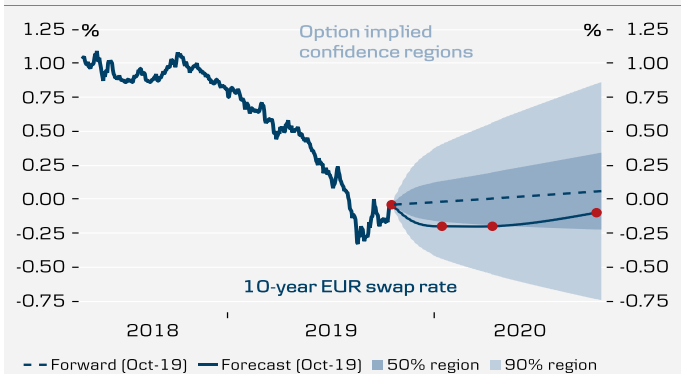
Source: Macrobond Financial, Danske Bank

2Y EUR swap rates



Source: Danske Bank

10Y EUR swap rates



Source: Danske Bank

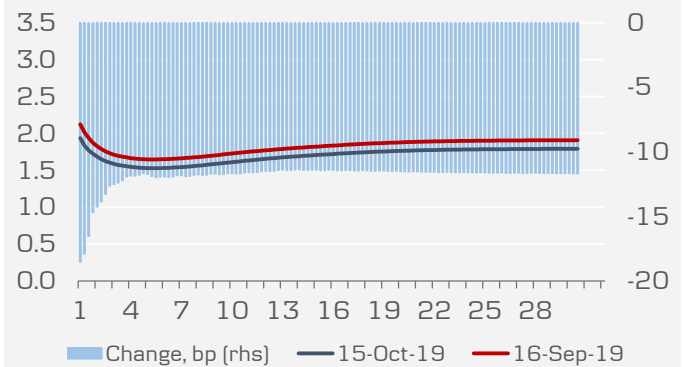
US forecasts

USD forecast summary

15/10/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Fed Funds	2.00	1.50	1.00	1.00	-	-	-
3M	2.00	1.14	1.00	1.00	-69	-63	-52
Government Bonds							
2-year	1.59	1.30	0.90	1.00	-	-	-
5-year	1.55	1.30	1.00	1.15	-	-	-
10-year	1.73	1.40	1.10	1.20	-	-	-
Swap rates							
2-year	1.61	1.30	0.90	1.00	-24	-58	-44
5-year	1.51	1.25	0.95	1.10	-23	-52	-37
10-year	1.62	1.30	1.00	1.10	-31	-61	-53

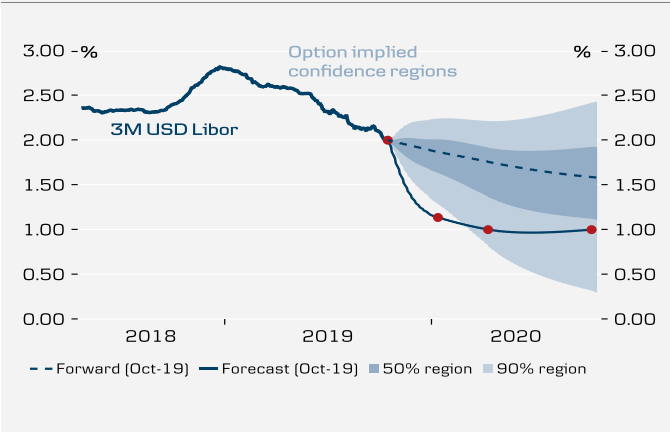
Source: Danske Bank

1M change in 3M USD Libor



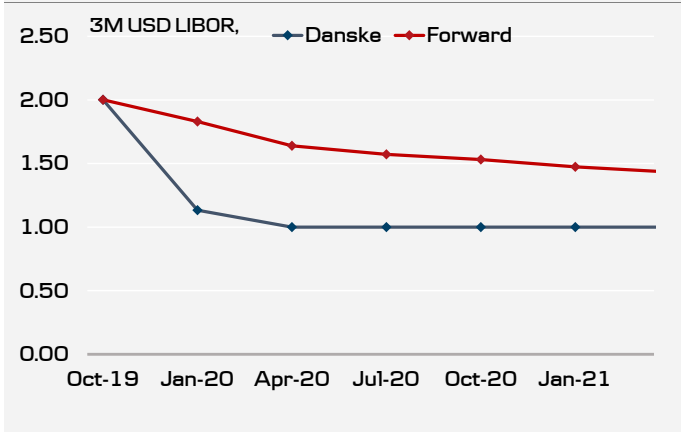
Source: Danske Bank

3M USD Libor rates



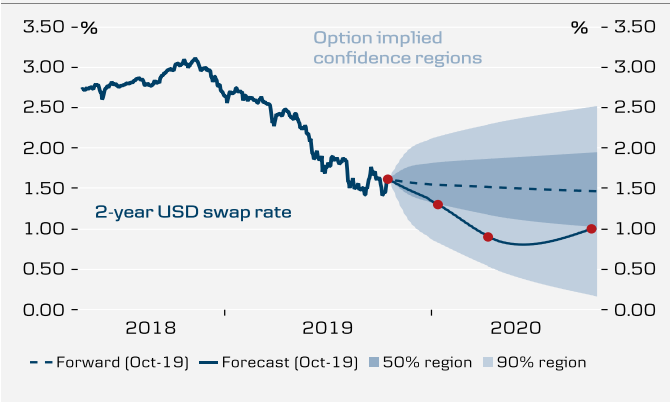
Source: Macrobond Financial, Danske Bank

Danske Bank forecasts and forwards



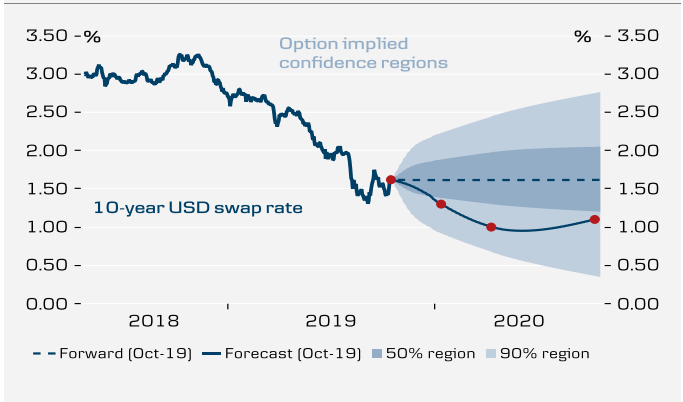
Source: Macrobond Financial, Danske Bank

2Y USD swap rates



Source: Danske Bank

10Y USD swap rates



Source: Danske Bank

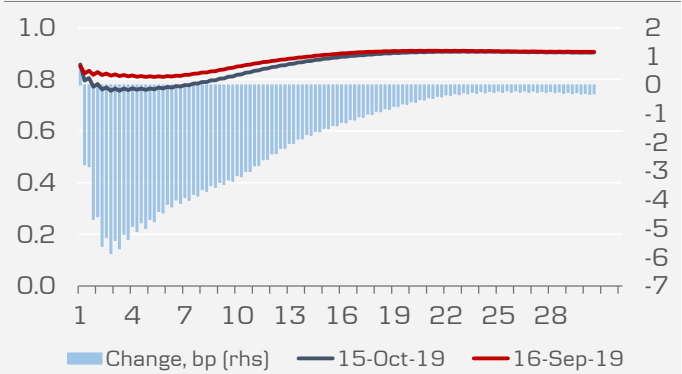
UK forecasts

UK forecast summary

15/10/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
GBP	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money Market							
Repo	0.75	0.75	0.75	0.75	-	-	-
3M	0.78	0.79	0.79	0.79	3	9	12
Government Bonds							
2-year	0.50	0.40	0.40	0.50	-3	2	16
5-year	0.443	0.35	0.2	0.3	-4	-17	-4
10-year	0.64	0.55	0.55	0.60	-10	-12	-11
Swap rates							
2-year	0.77	0.70	0.70	0.80	-6	-5	5
5-year	0.77	0.65	0.50	0.60	-11	-26	-23
10-year	0.82	0.70	0.70	0.75	-12	-12	-8

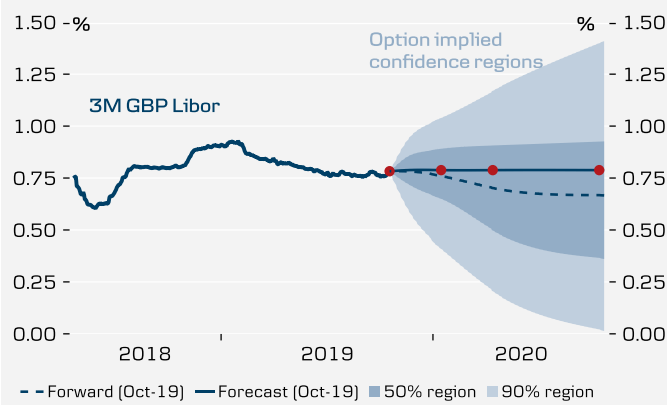
Source: Danske Bank

1M change in 6M GBP Libor



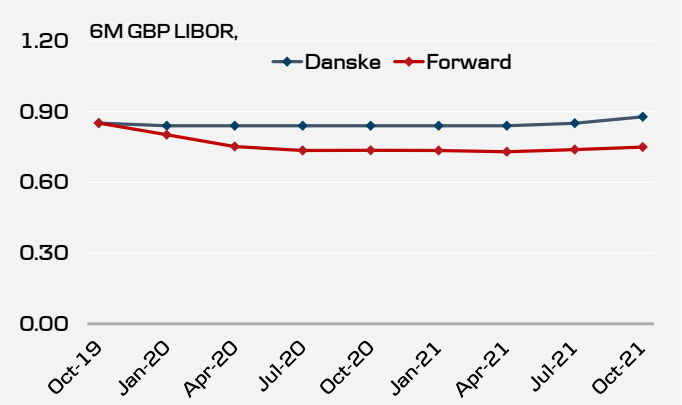
Source: Danske Bank

3M GBP Libor rates



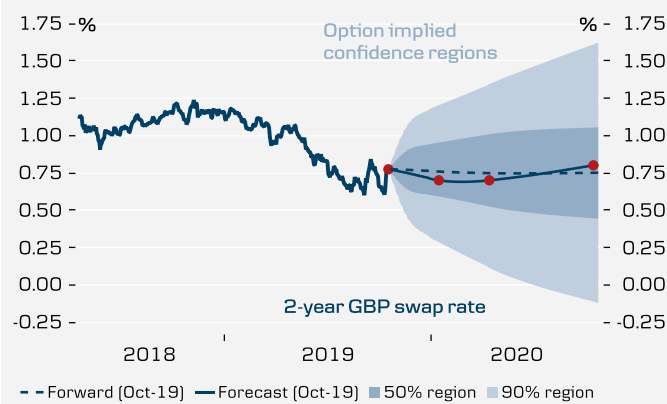
Source: Macrobond Financial, Danske Bank

Danske Bank forecasts and forwards



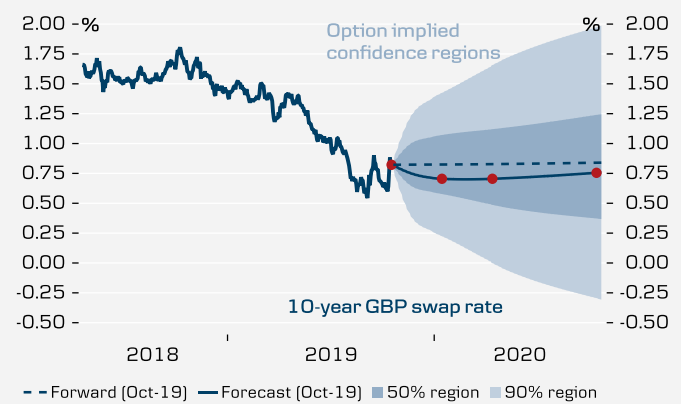
Source: Macrobond Financial, Danske Bank

2Y UK swap rates



Source: Danske Bank

10Y UK swap rates



Source: Danske Bank

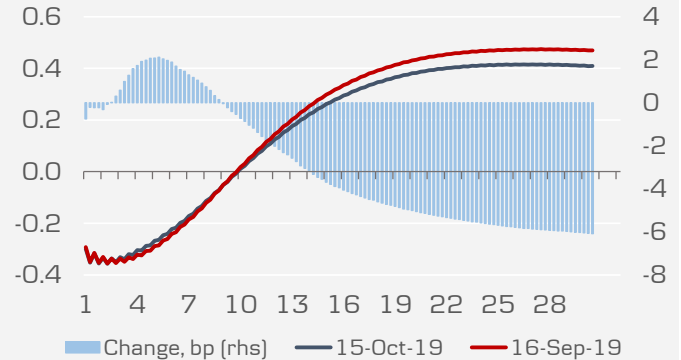
Denmark forecasts

DKK forecast summary

DKK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
15/10/2019							
--- Forecast ---							
--- Fcst vs Fwd in bp ---							
Money Market							
CD	-0.75	-0.75	-0.75	-0.75	-	-	-
Repo	0.05	0.05	0.05	0.05	-	-	-
3M	-0.44	-0.45	-0.45	-0.45	1	3	6
6M	-0.30	-0.30	-0.30	-0.30	1	2	6
Government bonds							
2-year	-0.74	-0.85	-0.85	-0.75	-	-	-
5-year	-0.64	-0.80	-0.80	-0.65	-	-	-
10-year	-0.44	-0.60	-0.60	-0.50	-	-	-
Swap rates							
2-year	-0.33	-0.45	-0.45	-0.35	-11	-12	-3
5-year	-0.24	-0.40	-0.40	-0.25	-17	-19	-8
10-year	0.04	-0.15	-0.15	-0.05	-21	-24	-19

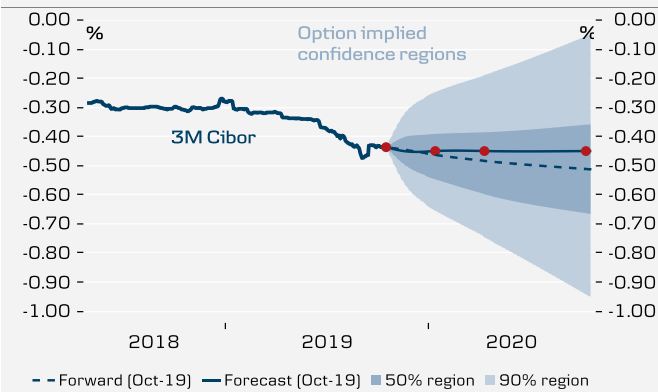
Source: Danske Bank

1M change in 6M Cibar



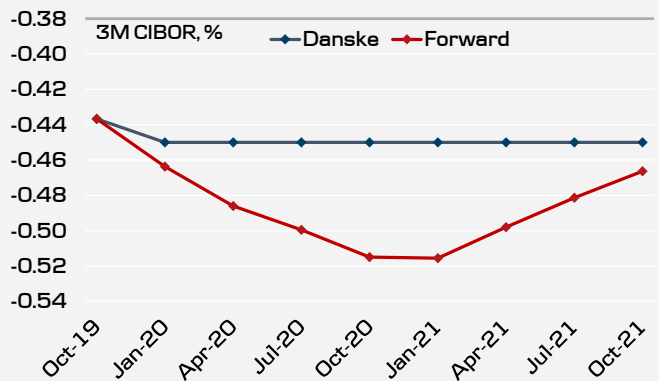
Source: Danske Bank

3M Cibar



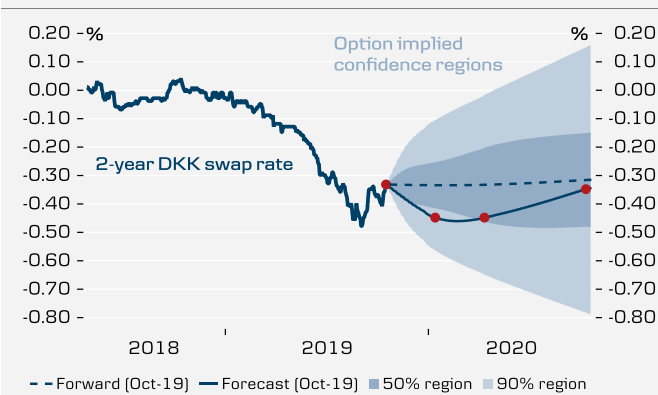
Source: Macrobond Financial, Danske Bank

Danske Bank forecasts and forwards



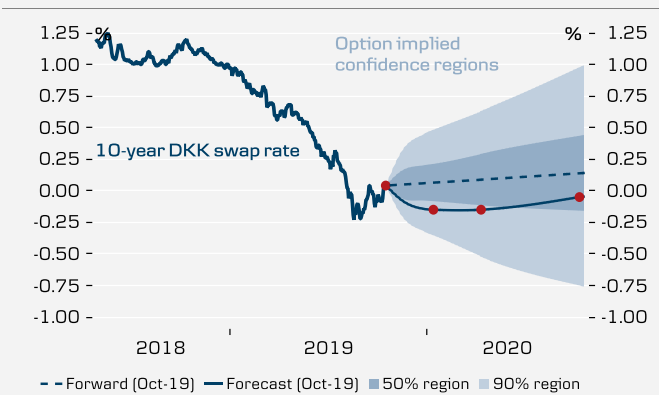
Source: Macrobond Financial, Danske Bank

2Y DKK swap rates



Source: Danske Bank

10Y DKK swap rates



Source: Danske Bank

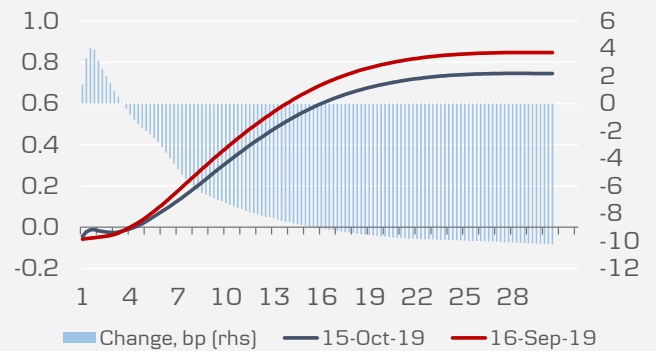
Sweden forecasts

SEK forecast summary

15/10/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
SEK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money market							
Repo	-0.25	-0.25	-0.50	-0.50	-	-	-
3M	-0.08	-0.10	-0.30	-0.30	-10	-33	-30
Government bonds							
2-year	-0.54	-0.70	-0.80	-0.80	-	-	-
5-year	-0.54	-0.60	-0.65	-0.65	-	-	-
10-year	-0.18	-0.20	-0.20	-0.10	-	-	-
Swap rates							
2-year	-0.02	-0.10	-0.20	-0.20	-9	-18	-18
5-year	0.05	0.00	-0.05	-0.05	-7	-14	-17
10-year	0.34	0.35	0.35	0.45	-2	-4	1

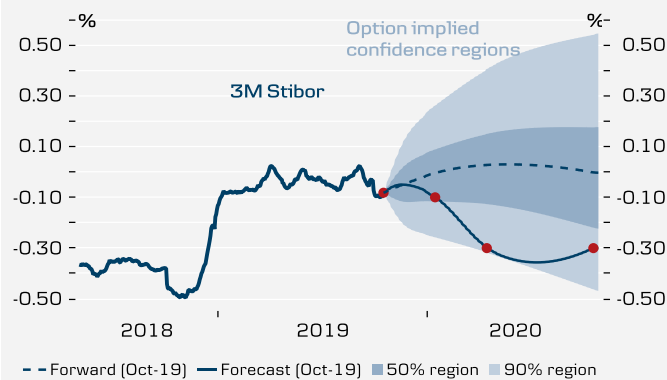
Source: Danske Bank

1M change in 3M Stibor



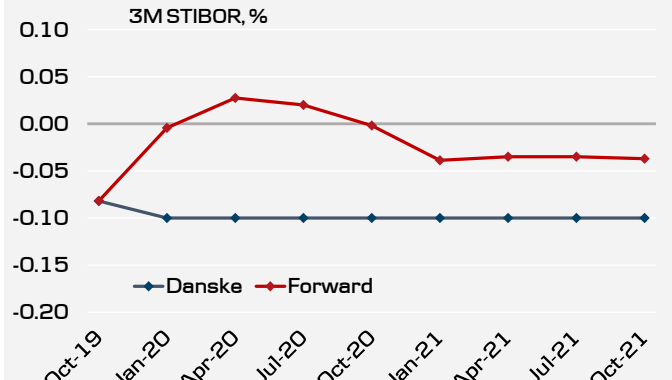
Source: Danske Bank

3M Stibor rate



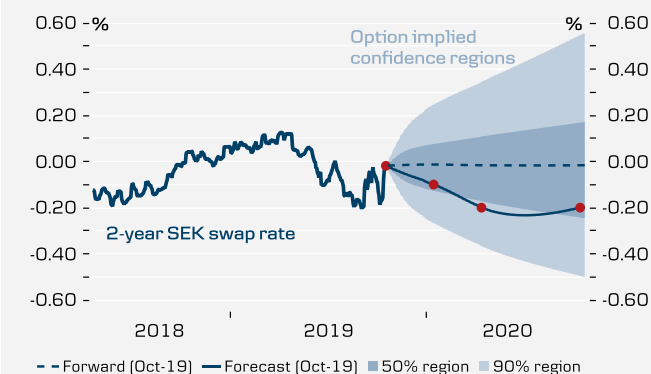
Source: Macrobond Financial, Danske Bank

Danske Bank forecasts and forwards



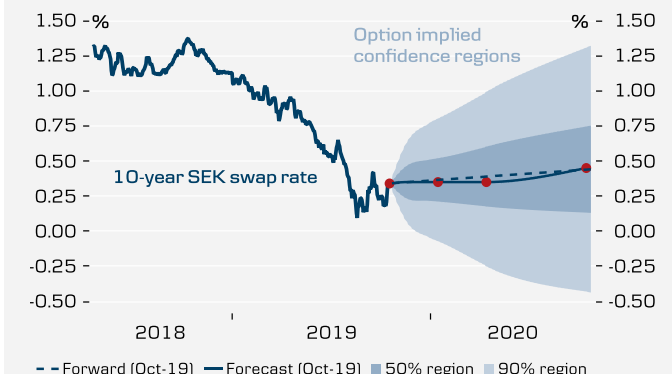
Source: Macrobond Financial, Danske Bank

2Y SEK swap rates



Source: Danske Bank

10Y SEK swap rates



Source: Danske Bank

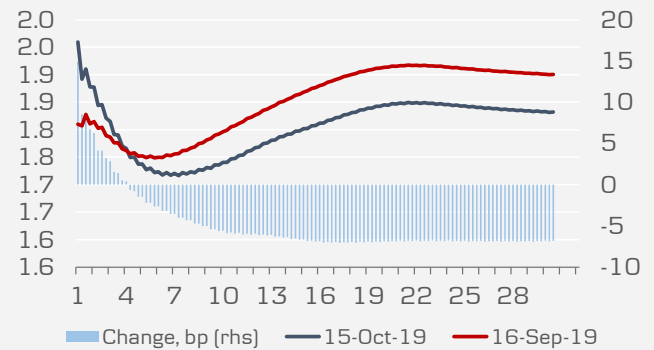
Norway forecasts

NOK forecast summary

15/10/2019	--- Forecast ---				--- Fcst vs Fwd in bp ---		
NOK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
<u>Money market</u>							
Deposit	1.50	1.50	1.75	1.75	-	-	-
3M	1.81	2.00	2.10	2.25	14	31	45
6M	1.93	2.10	2.21	2.33	19	37	52
<u>Government bonds</u>							
2-year	1.16	1.30	1.40	1.45	-	-	-
5-year	1.18	1.20	1.30	1.60	-	-	-
10-year	1.23	1.25	1.30	1.30	-	-	-
<u>Swap rates</u>							
2-year	1.85	1.90	2.00	2.05	8	22	32
5-year	1.73	1.60	1.70	2.00	-11	0	32
10-year	1.75	1.65	1.70	1.70	-9	-4	-4

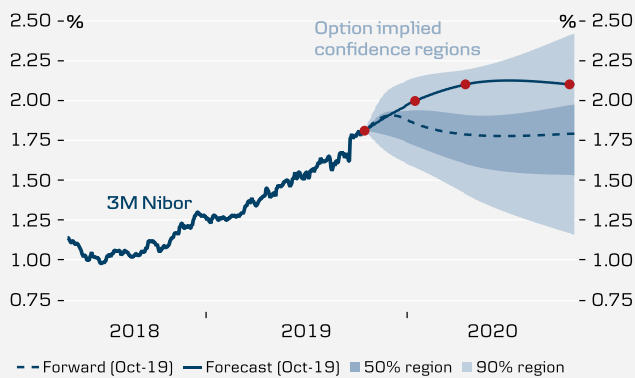
Source: Danske Bank

1M change in 6M Nibor



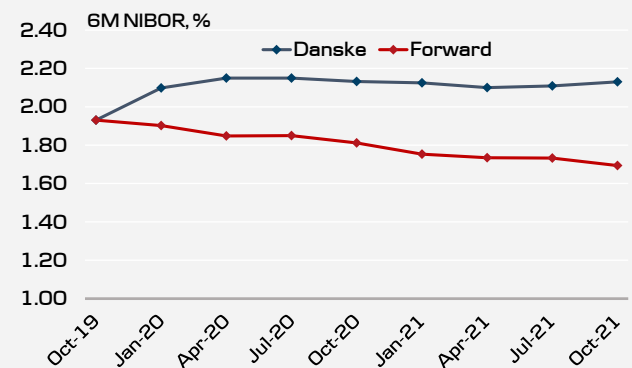
Source: Danske Bank

3M Nibor



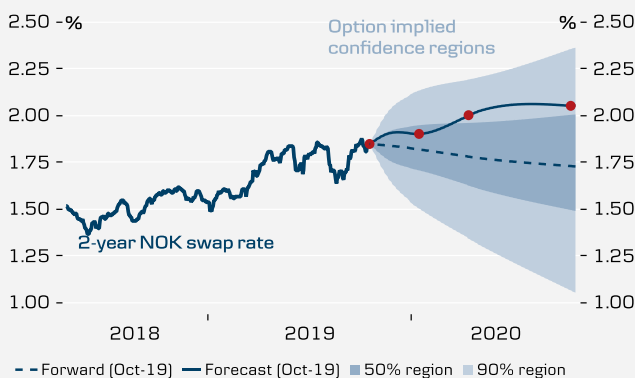
Source: Danske Bank

Danske Bank forecasts and forwards



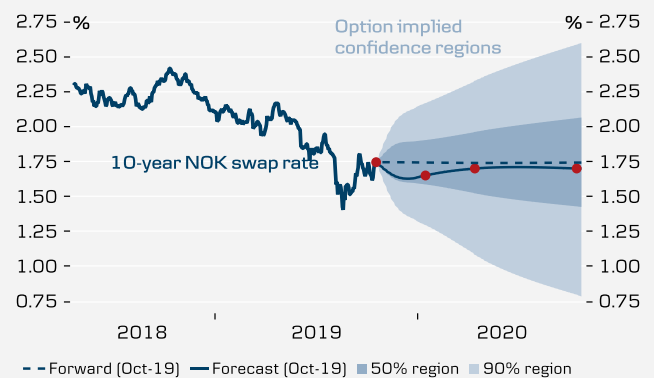
Source: Danske Bank

2Y NOK swap rate



Source: Danske Bank

10Y NOK swap rate



Source: Danske Bank

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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, Chief Analyst.

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