17 June 2019

Yield Outlook

10Y Bund yields stuck in negative territory

In last month's issue of *Yield Outlook* (14 May), we argued that both short-term and long-term yields would stay low into 2020 and that the ECB would not bring deposit rates out of negative territory until in 2022. In other words, we argued that it was difficult to envision any notable climb in long-term yields in 2019 or 2020.

At the same time, we did not anticipate that long-term yields would actually continue their downward path in the weeks that followed, but 10Y Bund yields have now fallen below minus 0.25% from minus 0.10% just a month ago.

Why won't long-term yields stop falling?

First of all, the global uncertainty stirred up by the US-China trade war has continued to set the agenda. There are plans for presidents Trump and Xi to meet at the next G20 summit but we doubt that a new deal will be in the making. Instead, we believe the situation is pointing to a further escalation of the trade war, and the big thing to watch out for is whether the EU can avoid becoming more tangled up than it is already.

Due to trade war fears and other factors, the global business cycle is no longer pointing upwards, but is set for a further slowdown. In our recent quarterly publication *The Big Picture*, 10 June, we lowered our projections for global growth for both 2019 and 2020.

Secondly, we are getting new signals from the ECB. At first glance, the ECB disappointed the markets last week by 'only' extending its forward guidance into H2 20. The market had expected the central bank to move in the direction of new rate cuts or a relaunch of its QE programme. It is important to emphasise, however, that the ECB has by no means precluded the possibility of new monetary policy easing. Governor Draghi specifically mentioned the possibility of rate cuts if prospects were to take a sharp turn for the worse, and markets are in fact pricing the key lending rate to drop by close to 10bp to minus 0.50%. The severe flattening of the 2Y10Y yield curve may also indicate that the market is anticipating new ECB stimuli in the form of a new QE programme.

Market expressing lack of confidence in the ECB

However, the market is not a big believer in the ECB successfully jumpstarting the economy or getting inflation to point upwards. Many market participants are using the 5Y5Y EUR inflation swap (average 5Y inflation rate in five years' time) as an indicator of the rate of confidence that inflation will return to 2%. So, as the market continues to forecast inflation going lower, this is in fact a sign of no confidence in the ECB. The 5Y5Y measure has dropped from 1.6% early this year to currently 1.14%. In other words, the market is saying that it no longer believes the ECB can get inflation back to a level close to 2%. Obviously, low inflation expectations are set to weigh on nominal rates and also constitute another important reason for the continuing drop in long-term yields.

Quick links

Policy rates

Country	Spot	+3m	+6m	+12m
USD	2.50	2.25	1.75	1.75
EUR	-0.40	-0.40	-0.40	-0.40
GBP	0.75	0.75	0.75	0.75
DKK	-0.65	-0.65	-0.65	-0.65
SEK	-0.25	-0.25	-0.25	-0.25
NOK	1.00	1.25	1.50	1.75

10Y government bond yields

Country	Spot	+3m	+6m	+12m
USD	2.11	1.95	1.75	1.90
EUR	-0.24	-0.35	-0.35	-0.25
GBP	0.84	0.80	0.80	1.00
DKK	-0.19	-0.35	-0.35	-0.25
SEK	0.04	-0.05	-0.05	0.00
NOK	1.49	1.65	1.75	1.90

Note: EUR = Germany

10Y swap rates

Country	Spot	+3m	+6m	+12m
USD	2.07	1.95	1.75	1.90
EUR	0.27	0.15	0.15	0.25
GBP	1.04	1.00	1.00	1.20
DKK	0.36	0.20	0.20	0.30
SEK	0.58	0.50	0.50	0.50
NOK	1.86	2.00	2.10	2.25

Source: Danske Bank

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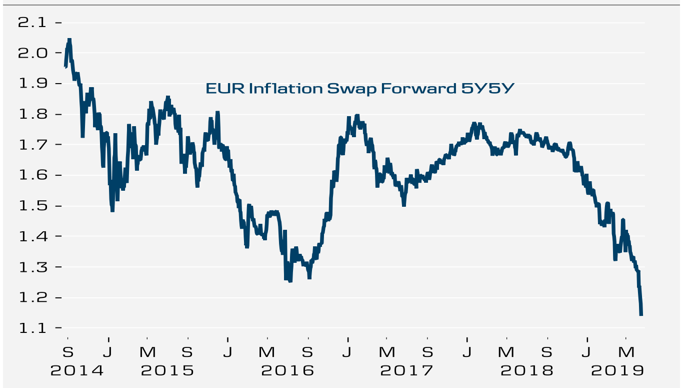
It has also become clear over the past month that rate cuts are underway from the US Federal Reserve. We have also adjusted our forecast and now expect three 25bp Fed rate cuts in H2 19.

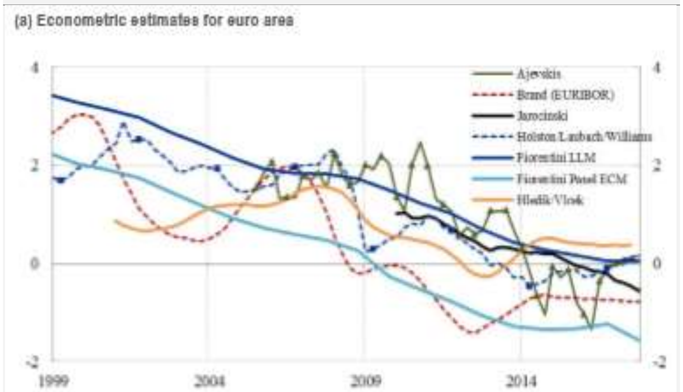
Thirdly, the market continues to focus on the very low neutral rate of interest. As we noted, in our previous issue of *Yield Outlook* we lowered our assumptions for the neutral rate of interest, which plays a key role in market pricing of long-term nominal forward rates. In December 2018, the *ECB* released a comprehensive paper reviewing various estimates for the neutral rate of interest (e*). All of those estimates showed a protracted fall in the neutral rate of interest over the past ten years to the current level of between minus 1.5% and around 0%. We have assumed a neutral rate of interest at the mid-point of this range. We have also assumed that the neutral rate of interest will continue to fall in coming years.

Market-based inflation expectations in free fall, indicating that markets have lost faith in the ECB



Source: Danske Bank, Bloomberg

Most studies estimate the neutral rate of interest to be negative



Source: ECB Occasional paper No 217, 2018

Low rates for a very long time

On 13 June we published the research note *Global Research: Euro area rates to stay very low for very long*. In this paper we took a closer look at what has driven the neutral real rate of interest lower in Europe and discussed the consequences for long nominal interest rates. We basically conclude that current yields are not particularly low, and as we also argued in the previous edition of *Yield Outlook*, the market is unlikely to speculate in rate hikes from the ECB in coming years.

Low inflation expectations and a negative real interest rate mean that short and long yields are, in reality, not particularly low at the moment. There is, in other words, no longer a gravitational or normalising force that over time would tend to pull yields higher.

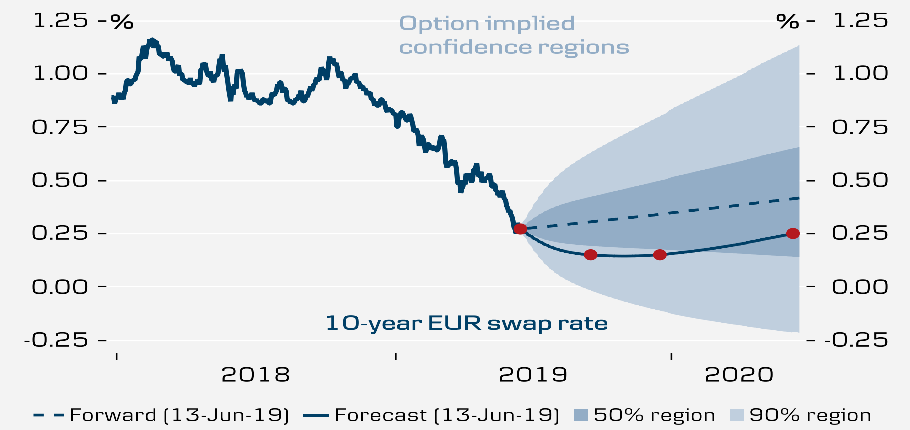
This does not mean that yields cannot rise again. For example, an improving economy would point to higher yields through higher inflation expectations and thus slightly higher long nominal rates. However, there is no longer a trend that would inevitably pull yields higher over time. Also, the economic cycle no longer points to higher yields, but in fact to lower yields.

Finally, it is important to highlight the special market dynamics we are currently seeing. The volume of bonds trading at negative yields in EUR is rising almost daily. This in turn means investors are being pushed further and further out the yield curve – causing the curve to flatten. Investors are also being pushed further out on the credit curve, which could mean investing in Spanish government bonds rather than low-yielding German Bunds.

Negative 10Y government yields now the norm

All in all, this means we expect 10Y German Bunds to trade with a negative yield for the coming 12 months. We also estimate the trend in the next three months will continue to be down. Our 3-month forecast for the 10Y yield in Germany is -0.35% compared to the current level of -0.25%. Risk appetite will be the primary determinant of the level over 12 months. Risk appetite is currently low due to the trade conflict, but we expect it to improve slightly in the coming 12 months and take the German 10Y government yield to 0.25% on a 12-month horizon.

10Y EUR swap rate approaching zero per cent, Danske Bank forecast

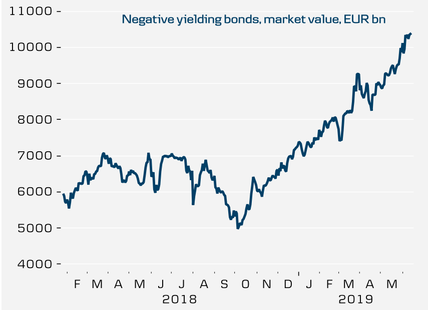


Source: Danske Bank

Our forecast does not contain any further easing from the ECB in the form of additional rate cuts or a new QE programme. We have assumed the market would continue to expect further stimuli and the risk clearly is that the ECB could ease monetary policy further. In principal, this could push yields further down than we expect.

We expect to publish the next issue of *Yield Outlook* in August. We wish our readers a good summer holiday.

Volume of bonds with negative yields is rising and rising. This is pushing investors further out on the yield curve



Source: Bloomberg, Macrobond Financial

Forecasts

Forecasts*

	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	2.50	2.45	1.90	1.86	2.07	1.86	1.85	2.11
	+3m	2.25	1.93	1.80	1.75	1.95	1.75	1.70	1.95
	+6m	1.75	1.75	1.55	1.55	1.75	1.50	1.50	1.75
	+12m	1.75	1.75	1.65	1.65	1.90	1.60	1.60	1.90
EUR	Spot	-0.40	-0.32	-0.31	-0.16	0.27	-0.68	-0.60	-0.24
	+3m	-0.40	-0.31	-0.30	-0.15	0.15	-0.70	-0.60	-0.35
	+6m	-0.40	-0.31	-0.30	-0.15	0.15	-0.70	-0.60	-0.35
	+12m	-0.40	-0.31	-0.30	-0.15	0.25	-0.70	-0.60	-0.25
GBP	Spot	0.75	0.79	0.86	0.91	1.04	0.59	0.63	0.84
	+3m	0.75	0.84	0.90	0.90	1.00	0.60	0.60	0.80
	+6m	0.75	0.84	0.90	0.90	1.00	0.60	0.60	0.80
	+12m	0.75	0.84	0.90	0.90	1.20	0.60	0.60	1.00
DKK	Spot	-0.65	-0.35	-0.24	-0.07	0.36	-0.67	-0.62	-0.19
	+3m	-0.65	-0.33	-0.25	-0.10	0.20	-0.70	-0.60	-0.35
	+6m	-0.65	-0.33	-0.25	-0.10	0.20	-0.70	-0.60	-0.35
	+12m	-0.65	-0.33	-0.25	-0.10	0.30	-0.70	-0.60	-0.25
SEK	Spot	-0.25	-0.02	-0.06	0.12	0.58	-0.62	-0.54	0.04
	+3m	-0.25	-0.10	-0.15	0.05	0.50	-0.70	-0.60	-0.05
	+6m	-0.25	-0.10	-0.15	0.05	0.50	-0.70	-0.60	-0.05
	+12m	-0.25	-0.10	-0.20	0.05	0.50	-0.70	-0.55	0.00
NOK	Spot	1.00	1.65	1.74	1.71	1.86	1.17	1.22	1.49
	+3m	1.25	1.84	1.90	1.95	2.00	1.40	1.45	1.65
	+6m	1.50	2.00	2.10	2.10	2.10	1.60	1.60	1.75
	+12m	1.75	2.15	2.25	2.30	2.25	1.75	1.80	1.90

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

Eurozone forecasts

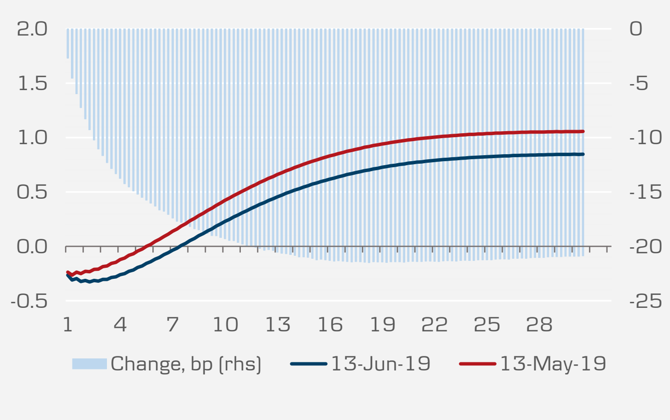
- The eurozone economy currently looks weak. We still expect the economy to pick up slightly over the course of 2019, though the US-China trade war has taken uncertainty to exceptional highs.
- We expect no ECB rate hikes in 2019 or 2020. 10Y Bund yields are set to trade well into negative territory for the next 12 months. Risk is skewed to the downside on a three-month horizon.

EUR forecast summary

13/06/2019		--- Forecast ---			--- Fcst vs Fwd in bp ---		
EUR	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money Market				
Refi	0.00	0.00	0.00	0.00	-	-	-
Deposit	-0.40	-0.40	-0.40	-0.40	-	-	-
3M	-0.32	-0.31	-0.31	-0.31	5	9	11
6M	-0.26	-0.24	-0.24	-0.24	6	9	10
			Government Bonds				
2-year	-0.68	-0.70	-0.70	-0.70	-	-	-
5-year	-0.60	-0.60	-0.60	-0.60	-	-	-
10-year	-0.24	-0.35	-0.35	-0.25	-	-	-
			Swap rates				
2-year	-0.31	-0.30	-0.30	-0.30	2	1	-2
5-year	-0.16	-0.15	-0.15	-0.15	-2	-5	-12
10-year	0.27	0.15	0.15	0.25	-15	-19	-16

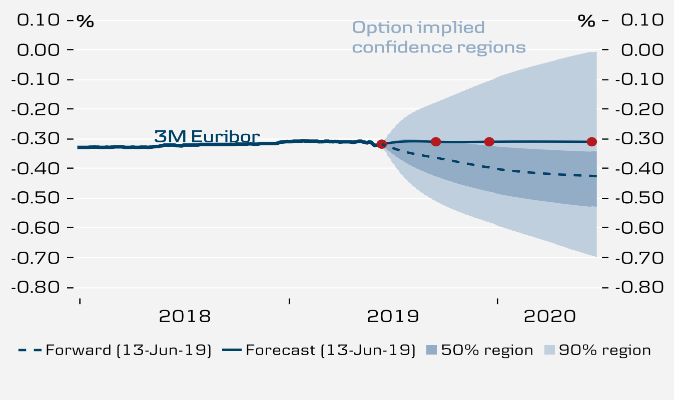
Source: Danske Bank

1M change in 6M Euribor



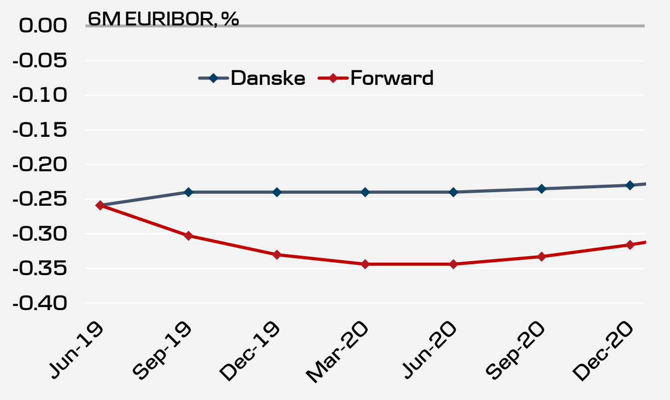
Source: Danske Bank

3M Euribor



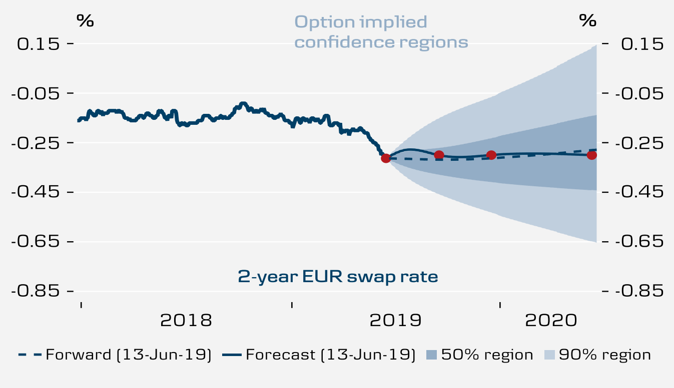
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



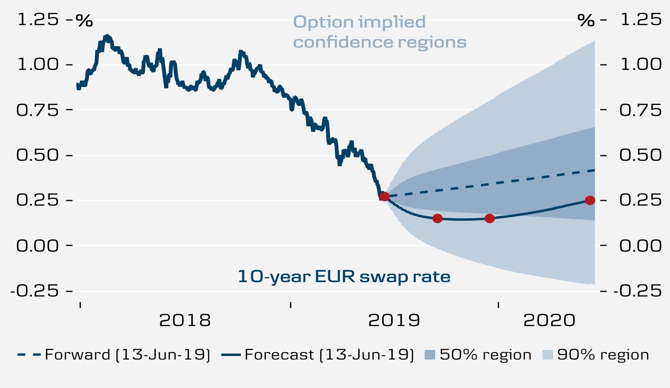
Source: Macrobond Financial, Danske Bank

2Y EUR swap rates



Source: Danske Bank

10Y EUR swap rates



Source: Danske Bank

US forecasts

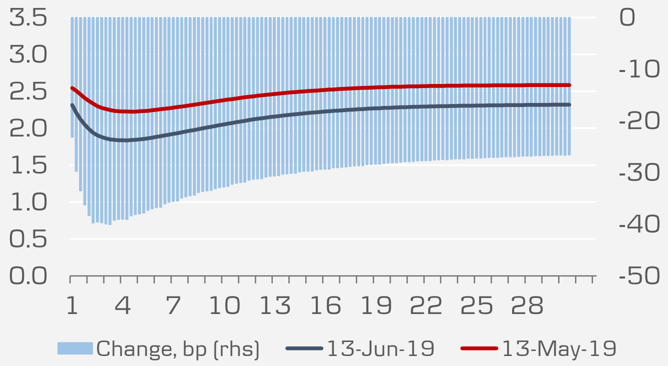
- We have recently changed our Fed call and now expect the Fed to deliver a total of 75bp cuts in H2 19 (most likely in July, September and December). We still have a constructive US macro outlook but think the risks are greater by not easing at all than easing too much or too early. For more details see *FOMC preview: Cutting like it is the 90s*, 11 June.
- We expect the Fed cuts to should push US treasury yields a new leg lower. The pivotal point on the curve will be the 5Y segment, which is normally the most sensitive to changes in monetary policy.

USD forecast summary

13/06/2019		--- Forecast ---			--- Fcst vs Fwd in bp ---		
USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money Market				
Fed Funds	2.50	2.25	1.75	1.75	-	-	-
3M	2.45	1.93	1.75	1.75	-20	-25	0
			Government Bonds				
2-year	1.86	1.75	1.50	1.60	-	-	-
5-year	1.85	1.70	1.50	1.60	-	-	-
10-year	2.11	1.95	1.75	1.90	-	-	-
			Swap rates				
2-year	1.90	1.80	1.55	1.65	0	-20	-5
5-year	1.86	1.75	1.55	1.65	-9	-29	-21
10-year	2.07	1.95	1.75	1.90	-12	-33	-21

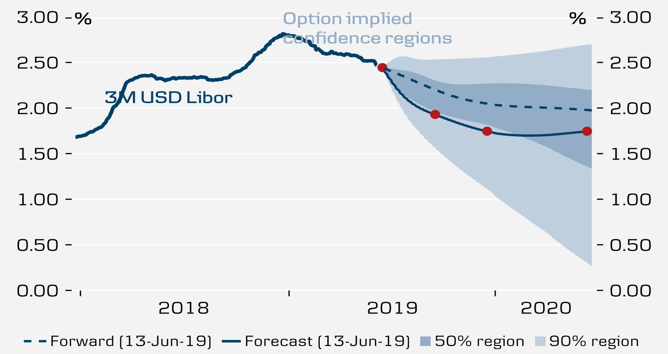
Source: Danske Bank

1M change in 3M USD Libor



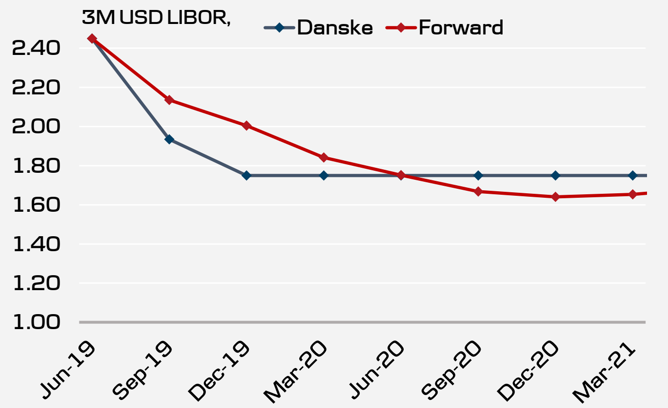
Source: Danske Bank

3M USD Libor rates



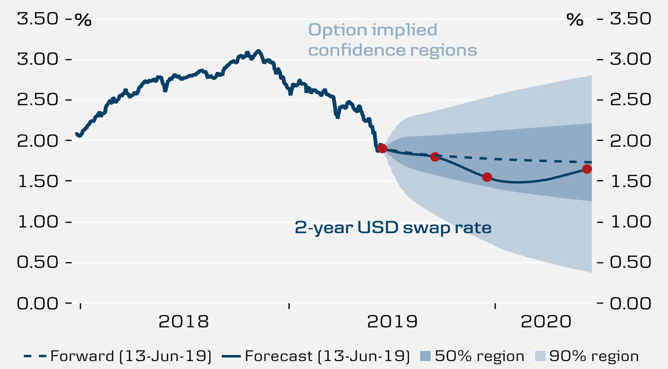
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



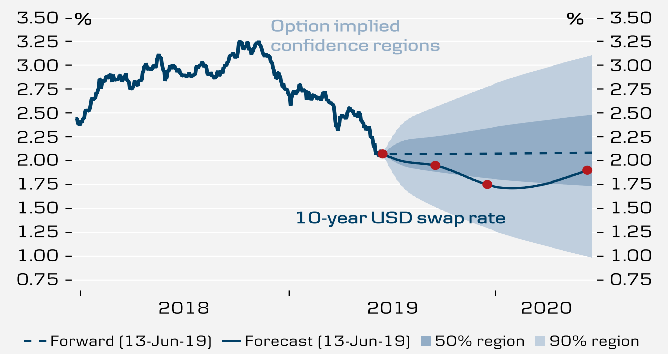
Source: Macrobond Financial, Danske Bank

2Y USD swap rates



Source: Danske Bank

10Y USD swap rates



Source: Danske Bank

UK forecasts

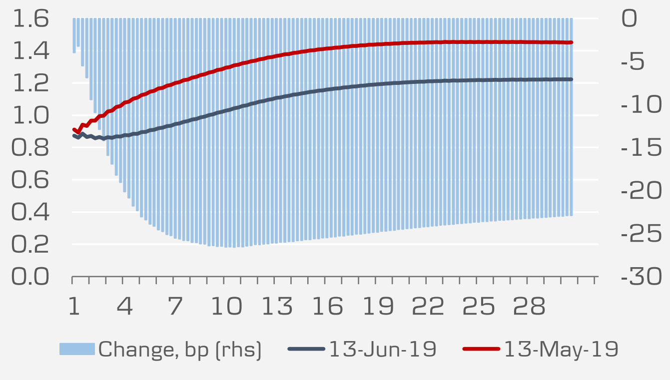
- With the rest of the global central banks moving in a more dovish direction, we expect the Bank of England to stay on hold despite its tightening bias.
- Long Gilt yields likely to track German yields closely.

UK forecast summary

13/06/2019		--- 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	0.79	0.84	0.84	0.84	2	-1	6
			Government Bonds				
2-year	0.59	0.60	0.60	0.60	4	6	8
5-year	0.627	0.6	0.6	0.6	-5	-4	-5
10-year	0.84	0.80	0.80	1.00	-13	-15	0
			Swap rates				
2-year	0.86	0.90	0.90	0.90	4	4	4
5-year	0.91	0.90	0.90	0.90	-2	-2	-19
10-year	1.04	1.00	1.00	1.20	-5	-7	11

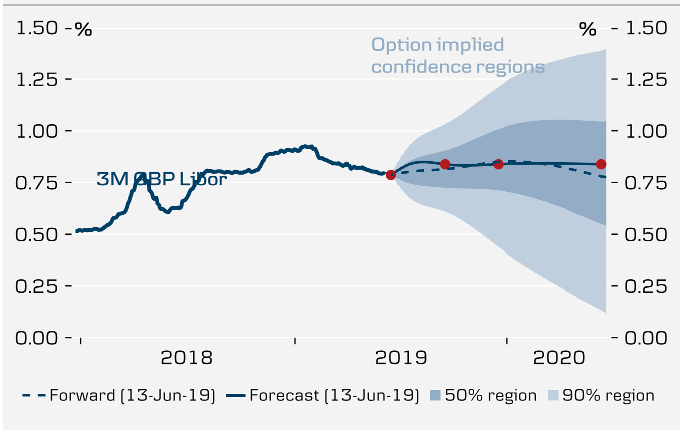
Source: Danske Bank

1M change in 6M GBP Libor



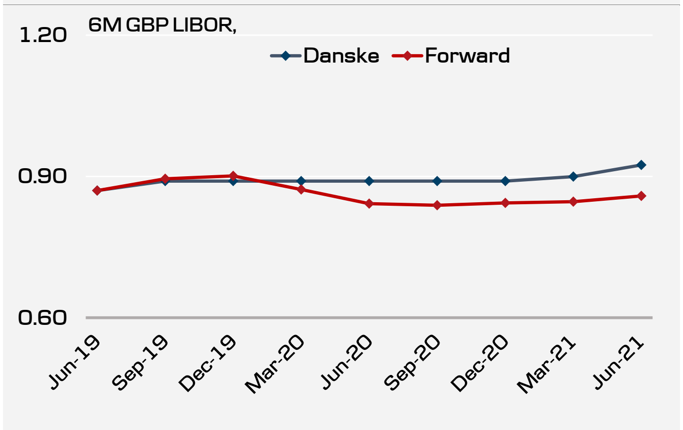
Source: Danske Bank

3M GBP Libor rates



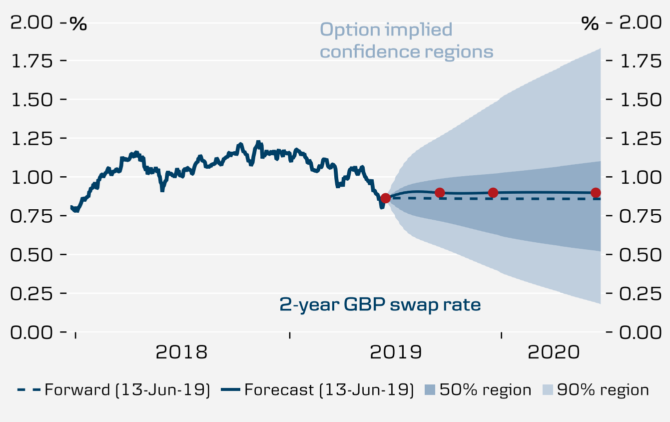
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



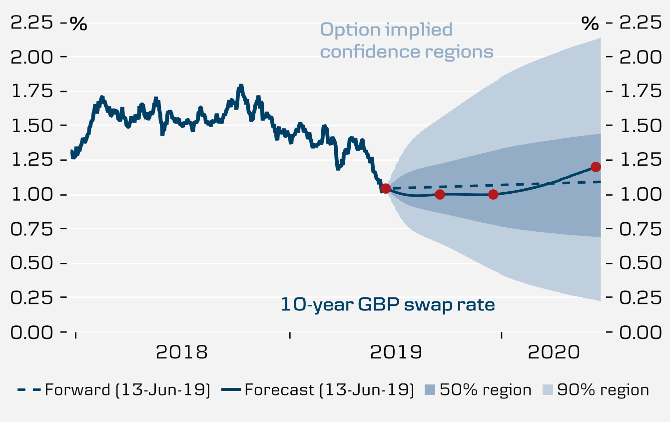
Source: Macrobond Financial, Danske Bank

2Y UK swap rates



Source: Danske Bank

10Y UK swap rates



Source: Danske Bank

Denmark forecasts

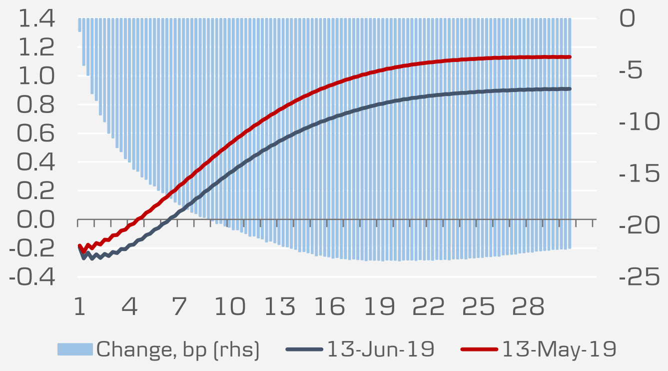
- No rate hikes or cuts for the next 12 months, as we expect Danmark's Nationalbank to shadow the ECB 100%.
- Banks' net balances set to be significantly higher in the second part of 2019, putting downward pressure on short rates, including CIBOR. 10Y DKK yields set to follow Bunds; potential for modest spread narrowing. 10Y government spread to Germany to hit zero.

DKK forecast summary

13/06/2019		--- Forecast ---			--- Fcst vs Fwd in bp ---		
DKK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money Market				
CD	-0.65	-0.65	-0.65	-0.65	-	-	-
Repo	0.05	0.05	0.05	0.05	-	-	-
3M	-0.35	-0.33	-0.33	-0.33	5	6	8
6M	-0.20	-0.18	-0.18	-0.21	6	8	5
			Government bonds				
2-year	-0.67	-0.70	-0.70	-0.70	-	-	-
5-year	-0.62	-0.60	-0.60	-0.60	-	-	-
10-year	-0.19	-0.35	-0.35	-0.25	-	-	-
			Swap rates				
2-year	-0.24	-0.25	-0.25	-0.25	-1	-2	-6
5-year	-0.07	-0.10	-0.10	-0.10	-5	-9	-16
10-year	0.36	0.20	0.20	0.30	-20	-23	-21

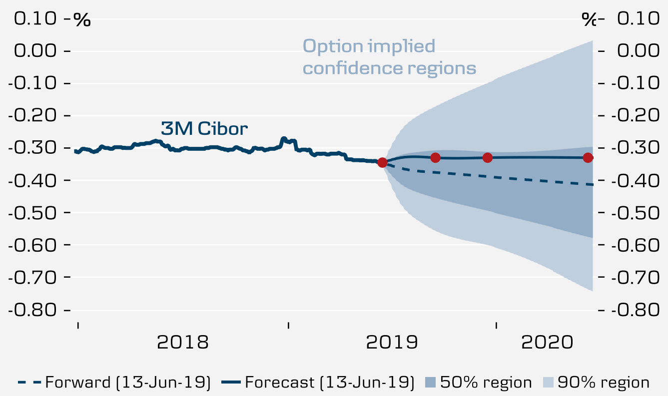
Source: Danske Bank

1M change in 6M Cibor



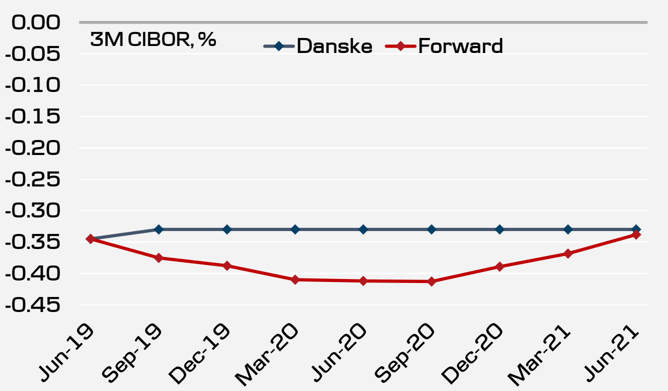
Source: Danske Bank

3M Cibor



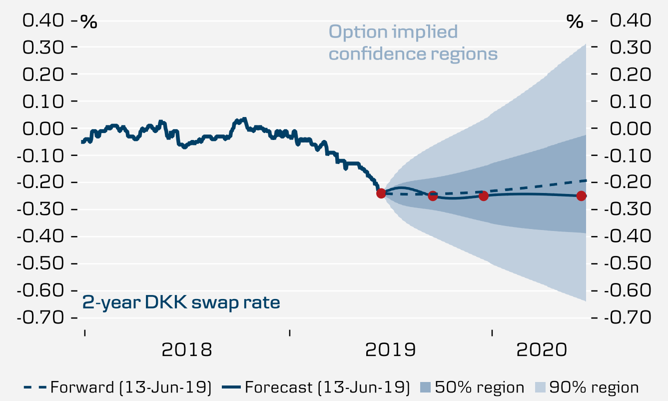
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



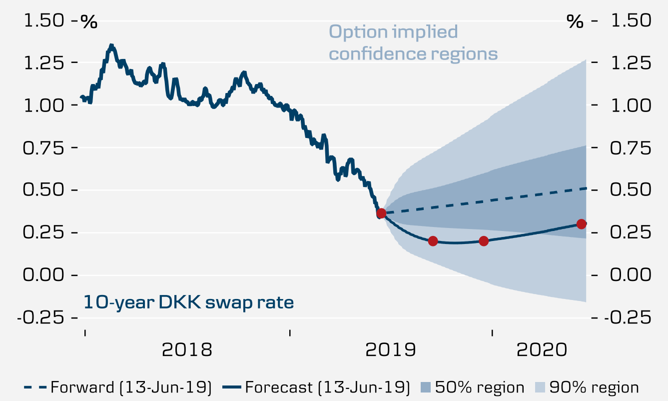
Source: Macrobond Financial, Danske Bank

2Y DKK swap rates



Source: Danske Bank

10Y DKK swap rates



Source: Danske Bank

Sweden forecasts

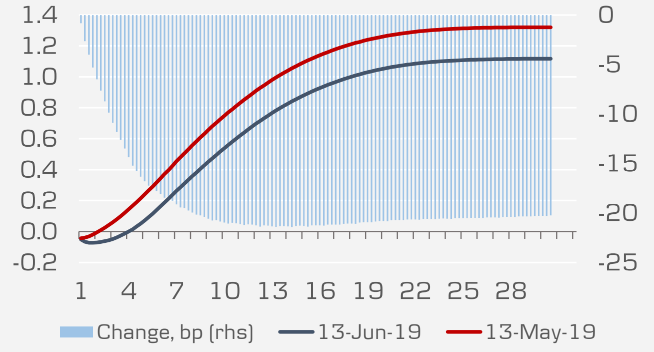
- At the April meeting, the Riksbank postponed the next projected hike to late 2019 or early 2020, flattened the repo rate path and decided to reinvest parts of its bond holdings (SEK45bn by December 2020). Despite the dovish message, we still expect inflation and growth to undershoot the Riksbank's forecast and we expect the repo rate to remain unchanged for the next 12 months.
- The market is currently pricing just 4bp of hikes up to the September 2020 meeting. By December 2019 pricing is now on the verge of signalling rate cuts. We expect no rate changes this year and in our view it is most likely that there will be none next year either. The longer end is set to follow international yields, with limited upside potential.

SEK forecast summary

13/06/2019		--- Forecast ---			--- Fcst vs Fwd in bp ---		
SEK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Repo	-0.25	-0.25	-0.25	-0.25	-	-	-
3M	-0.02	-0.10	-0.10	-0.10	-2	0	-3
				Government bonds			
2-year	-0.62	-0.70	-0.70	-0.70	-	-	-
5-year	-0.54	-0.60	-0.60	-0.55	-	-	-
10-year	0.04	-0.05	-0.05	0.00	-	-	-
				Swap rates			
2-year	-0.06	-0.15	-0.15	-0.20	-9	-10	-20
5-year	0.12	0.05	0.05	0.05	-10	-13	-22
10-year	0.58	0.50	0.50	0.50	-12	-15	-23

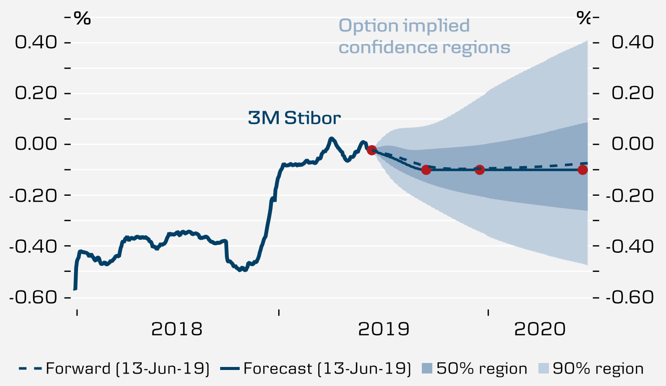
Source: Danske Bank

1M change in 3M Stibor



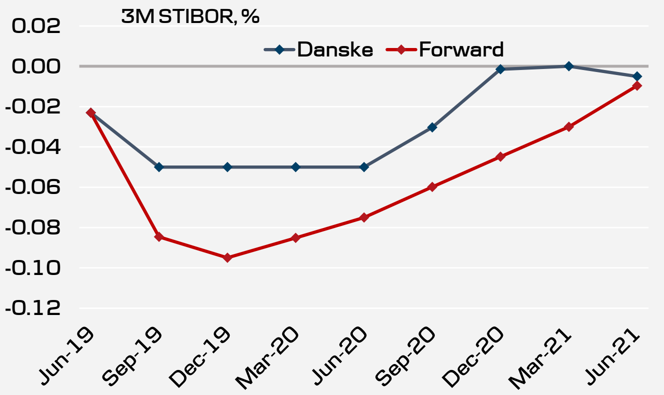
Source: Danske Bank

3M Stibor rate



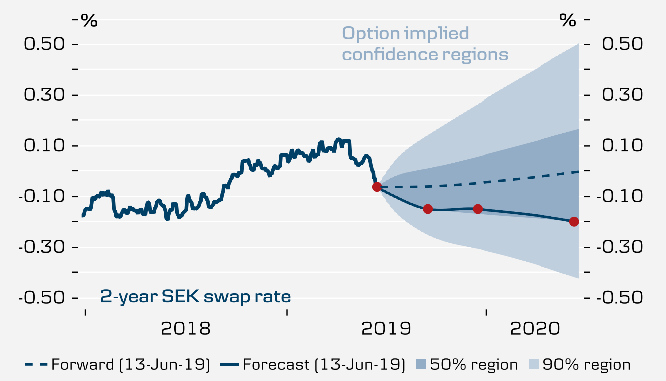
Source: Macrobond Financial, Danske Bank

Danske Bank forecast and forwards



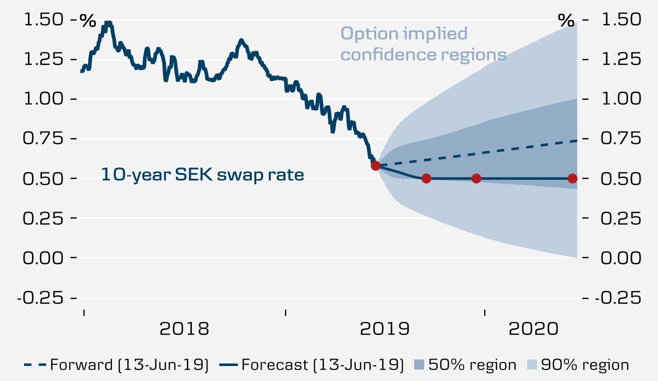
Source: Macrobond Financial, Danske Bank

2Y SEK swap rates



Source: Danske Bank

10Y SEK swap rates



Source: Danske Bank

Norway forecasts

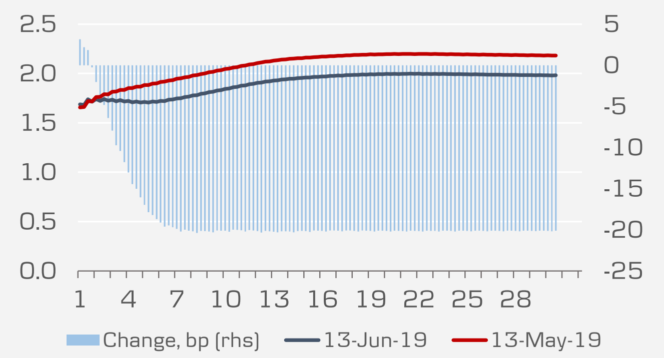
- The Norwegian economy continues to grow above potential driven by higher oil, construction and public investment. Core inflation was down slightly in April but, at 2.6%, it is still running above the 2% target. A weak NOK and higher wage growth are now feeding through.
- We expect another two rate hikes from Norges Bank in 2019 (June and December). At its May meeting, Norges Bank again signalled a June rate cut. We expect long NOK yields to edge slightly further up versus Bunds but the 2Y-10Y curve looks likely to flatten.

NOK forecast summary

13/06/2019		--- Forecast ---			--- Fcst vs Fwd in bp ---		
NOK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money market				
Deposit	1.00	1.25	1.50	1.75	-	-	-
3M	1.51	1.67	1.84	2.04	6	13	36
6M	1.65	1.84	2.00	2.15	10	23	41
			Government bonds				
2-year	1.17	1.40	1.60	1.75	-	-	-
5-year	1.22	1.45	1.60	1.80	-	-	-
10-year	1.49	1.65	1.75	1.90	-	-	-
			Swap rates				
2-year	1.74	1.90	2.10	2.25	15	35	52
5-year	1.71	1.95	2.10	2.30	23	37	57
10-year	1.86	2.00	2.10	2.25	13	21	34

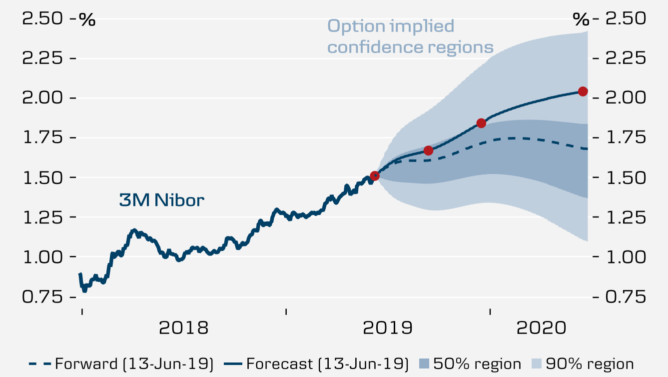
Source: Danske Bank

1M change in 6M Nibor



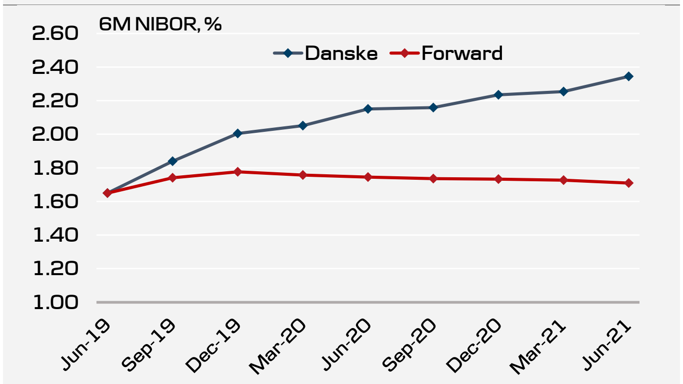
Source: Danske Bank

3M Nibor



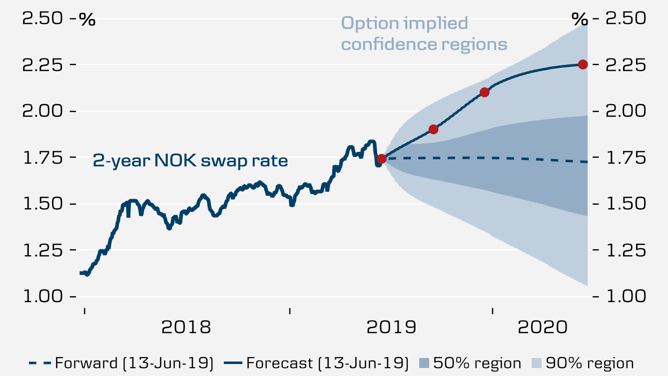
Source: Danske Bank

Danske Bank forecast and forwards



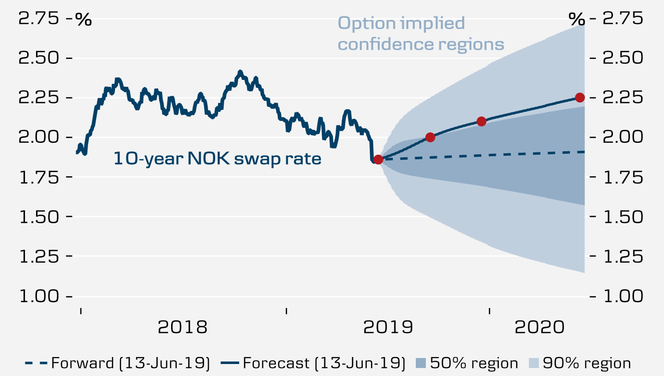
Source: Danske Bank

2Y NOK swap rate



Source: Danske Bank

10Y NOK swap rate



Source: Danske Bank

Contents and contributors

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Date of first publication

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Report completed: 17 June 2019, 16:13 CEST

Report first disseminated: 17 June 2019, 18:25 CEST