17 September 2018

Yield Outlook

Italy moving to the background and Fed hikes to continue

The focal point in the European bond markets over the summer has been Italy. This has resulted in downward pressure on, in particular, German yields and in August the 10Y bund yield was as low as 0.30%. Simultaneously, the yield on the 10Y Italian government bond reached 3.25%.

However, over the past couple of weeks, the market has scaled back on its 'Italian fears'. The new government has realised that it would be expensive (higher interest rate costs) to run a significant budget deficit. The latest comment from Finance Minister Giovanni Tria clearly indicates that the Italian budget will not breach the important 3% EU limit and that the budget deficit could be 'just' 2%. We expect the market focus on Italy to be less ahead, as we assume the budget deficit will stay below the 3% limit.

The next focal point for Italy is 27 September, when the Economic and Financial Update is due for release. It contains updated growth, debt and deficit projections. Also pivotal is the 15 October deadline for the submission of the budgetary plan to the EU Commission.

This does not mean Italy's budget troubles are over but merely that Italy is moving down the agenda and that we are moving back to a more normal market in respect of drivers for the fixed income market.

Still no strong drivers for higher EUR rates for the rest of 2018

The outlook for core inflation is still modest for the eurozone and we see little risk of a rate hike before December 2019, when we pencil in a first ECB rate hike of 20bp. Indeed, it seems to us that the European business cycle weakened slightly in the spring and over the summer. Overall, we continue to expect 10Y German yields to range-trade in a narrow 0.3-0.5% range for the rest of 2018.

Modest upward pressure in 2019

We continue to see modest upward pressure on yields and rates in Europe in 2019. The first ECB rate hike is moving closer and the ECB QE programme is widely expected to have ended. The latter has created some concerns that we could see a jump in yields like we saw in the US in 2013, when the Federal Reserve scaled back on bond purchases (tapering).

In 2013, 10Y US yields rose more than 1% over a few months. However, given that the end to ECB QE has been well communicated and that reinvestment of bonds maturing is set to continue in 2019, it is not our main case that the end to QE will have a major impact on EUR rates.

Fed on autopilot until neutral is reached

An important factor for longer dated European rates and yields is long US yields and where they are heading in 2019. Over the past couple of months, we have seen a series of strong US numbers and, importantly, the labour market has continued to tighten. In particular, we note that US wage growth finally seems to be picking up. Closely followed average earnings came in at 2.9% y/y in August. This was the highest level since 2019.

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Forecasts table

Policy rate outlook

Country	Spot	+3m	+6m	+12m
USD	2.00	2.25	2.50	3.00
EUR	-0.40	-0.40	-0.40	-0.40
GBP	0.75	0.75	0.75	1.00
DKK	-0.65	-0.65	-0.65	-0.65
SEK	-0.50	-0.50	-0.25	-0.25
NOK	0.50	0.75	1.00	1.25

Source: Danske Bank

10-year government bond yield outlook

Country	Spot	+3m	+6m	+12m
USD	2.98	3.05	3.20	3.25
GER	0.45	0.50	0.60	0.80
GBP	1.53	1.60	1.70	1.80
DKK	0.37	0.45	0.55	0.80
SEK	0.56	0.60	0.60	0.60
NOK	1.90	2.05	2.15	2.30

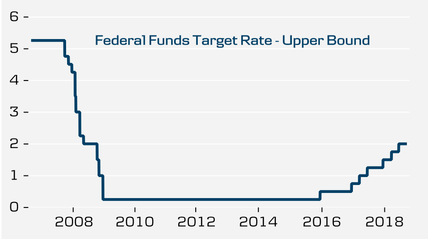
Note: EUR = Germany
Source: Danske Bank

Chief Analyst
Arne Lohmann Rasmussen
+45 4512 8532
arr@danskebank.dk

In particular, the labour market numbers mean the Fed is on autopilot right now and it is quite certain that it will hike both at the meeting later this month and again in December, which would take the Fed funds rate to 2.50% year-end.

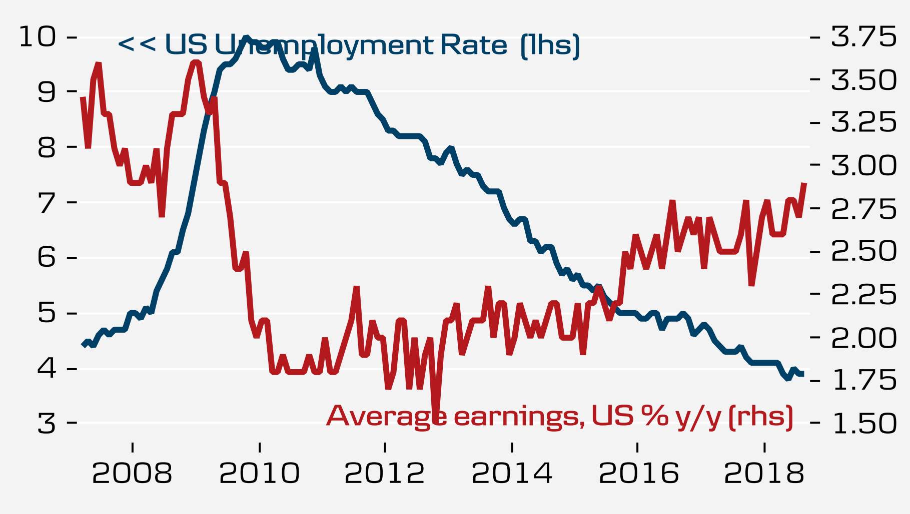
At the press conference following the June meeting, Jerome Powell elaborated on why the Fed removed a lot of its forward guidance from the statement. He hinted that the Fed wants more flexibility, as the Fed funds rate is approaching the neutral rate (the rate where monetary policy is neither expansionary nor contractionary), which most FOMC members estimate is in the 2.75-3.00% range. We believe it will be more 'stop and go' for the Fed when it has reached neutral, which we believe is likely to happen in March 2019.

Fed hikes to continue



Source: Macrobond Financial

US labour market remains tight and wage growth is picking up



Source: Macrobond Financial, Bloomberg

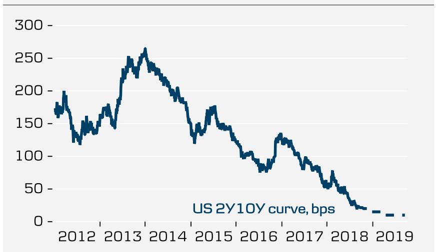
While the US economy is strong with high optimism, strong GDP growth, a low unemployment rate and stronger wage growth, there are also warning signs out there, not least the flattening of the US yield curve, and we think the Fed will adjust accordingly if markets start to send a strong recession signal. It is also easier for the Fed to do this, as every meeting next year is 'live', with Fed Chair Powell starting to host a press conference after each Fed meeting. Our base case remains that the Fed will be able to continue hiking in 2019.

Flatter US curve – will it invert?

Over the past couple of years, we have witnessed a pronounced flattening of the US curve, where 2s10s has moved from 125bp at the beginning of 2017 to around 22bp currently. It is well known in both academia and financial markets that an inversion of the yield curve over the past 50 years has been able to predict a recession in one to two years. Hence, the inversion itself can affect how the market is pricing its Fed funds expectations and in the end affect actual monetary policy as we argue above. If the curve were to invert, the Fed would probably be more reluctant to hike rates.

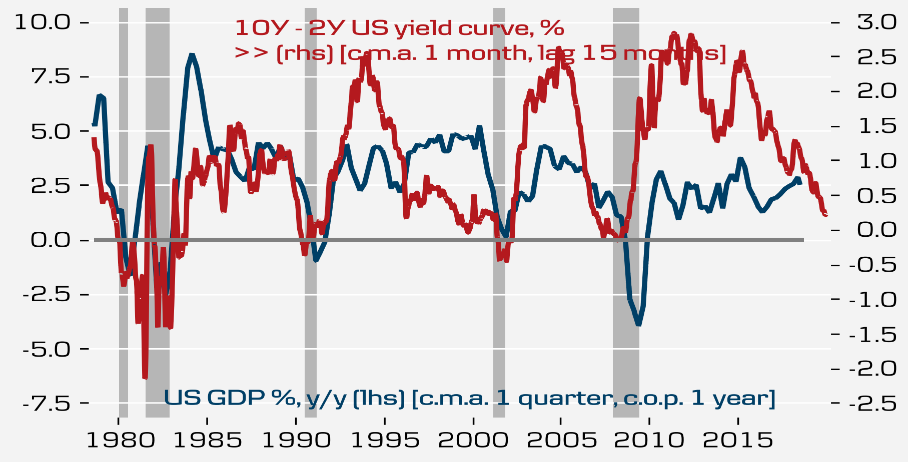
We do not forecast an inversion of the 2Y10Y curve in treasuries on a 12M horizon but, in our view, it will be very close. First, we expect the market to price a very flat to inverted money-market curve, keeping 2Y yields in check after all. In our opinion, the market is unlikely to price the Fed hikes we forecast beyond our 12M forecast horizon.

The US 2Y10Y curve has continued to flatten (includes Danske forecast), bp



Source: Bloomberg

The US yield-curve 2s10s is a famous recession indicator (grey areas are US recessions), curve pushed 15 months forward



Source: Macrobond Financial, Danske Bank

Furthermore, we continue to hold the view that 10Y treasury yields will move above the 3% level in 2019, as the labour market remains tight and the funding need continues to rise due to the expansive US fiscal policy.

However, we expect the 2Y10Y curve to be very flat and believe we should expect a lively discussion about whether this is a signal a new US recession is getting closer. We expect 10Y US Treasury yields to reach 3.25% on a 12M horizon. We expect the curve 2Y10Y to flatten to just 10bp in 2019 and believe temporary inversions throughout 2019 are likely.

The 2Y10Y curve is not the only financial variable that has predictive power in respect of US recessions. Another model is to look solely at the money-market curve. If it inverts and the market starts to price in rate cuts in one to two years, it is a reliable indicator. Others have suggested using the 3M money-market rate instead of the 2Y bond yield. If this is the case, the yield is still some way from inverting.

The point is that both the Fed and the market will look at different indicators to judge whether a recession is underway, not just the 2Y10Y spread.

Wider spread between USD and EUR rates

We continue to see a further widening of the two-year spread between USD and EUR rates. We expect the Fed to hike twice more this year and to continue hiking next year. Importantly, we still expect the Fed to raise the Fed funds rate above the longer run dot of 2.83% (the Fed's estimate of the natural rate of interest when the economy is normalised) in coming years. We see a peak at 3.25% in 2020.

Conclusion: higher yields mainly an autumn 2019 story

We keep our 12M forecast for German 10Y yields unchanged at 0.8% and we continue to expect a steeper 2Y10Y German yield curve in 2019. The ECB still maintains a relatively tight grip on the short end of the curve, especially with the first ECB rate hike expected late in 2019.

We plan to publish the next issue of Yield Outlook in mid-October.

Contents and contributors

Eurozone forecasts

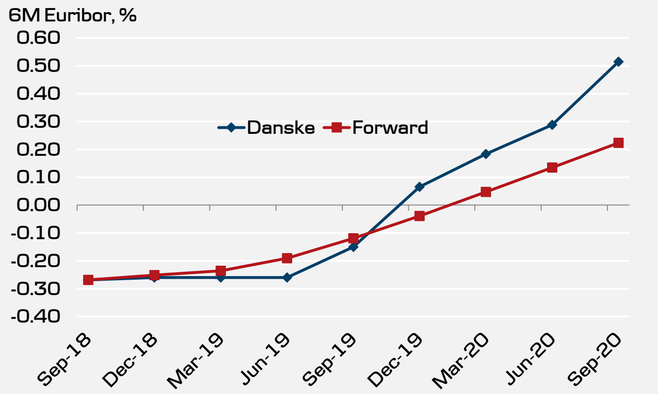
- GDP growth in Q2 was unchanged at 0.4% q/q compared to Q1, as sentiment indicators such as PMI and Ifo have shown signs of stabilising as of late. With the EU-US trade spat put on hold for now, we see scope for business confidence to recover somewhat in H2 and still look for robust growth above potential of 2.0% in 2018 and 1.7% in 2019. Although the ECB has recently become more confident on the inflation outlook on the back of rising wages, we expect core inflation to rise only gradually throughout 2018 and 2019, also in light of the abating economic momentum and lingering downside risks to growth. We expect the first ECB hike of 20bp only in December 2019, while market pricing remains even more dovish (20bp by March 2020).
- We still expect a steeper EUR yield curve on a 12M horizon. The ECB still maintains a relatively 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 pushed higher by rising US yields, the end of ECB QE from the ECB and the pricing of rate hikes in 2019-20. That said, the demand for Germany is expected to stay. Overall, we forecast that 10Y Germany will rise to 0.8%. If the global trade dispute evolves further, it can weigh on risk sentiment and keep yields down.

EUR forecasts summary

13/09/2018	--- 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	-0.33	-0.33	-0.33	-3	-4	-12
				Government bonds			
2-year	-0.55	-0.55	-0.45	-0.30	-	-	-
5-year	-0.15	-0.10	0.00	0.20	-	-	-
10-year	0.42	0.50	0.60	0.80	-	-	-
				Swap rates			
2-year	-0.15	-0.10	0.00	0.15	-1	+2	+2
5-year	0.32	0.35	0.45	0.65	-4	-1	+5
10-year	0.93	0.95	1.05	1.25	-3	+1	+10

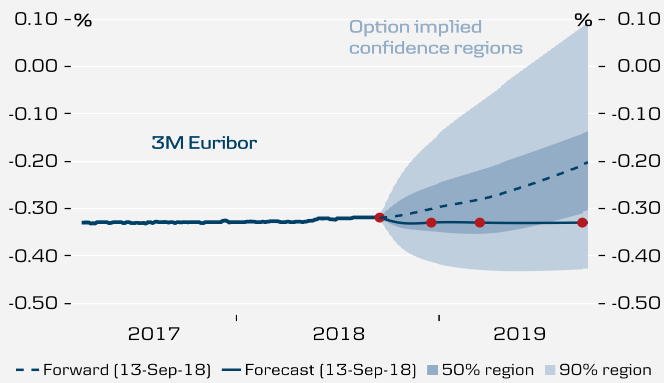
Source: Danske Bank

Danske Bank forecast and forwards



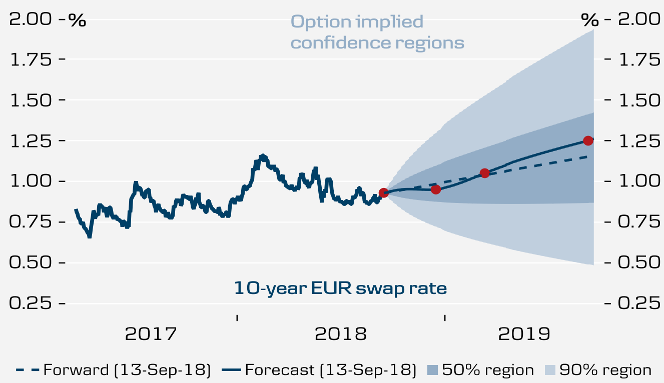
Source: Danske Bank

3M Euribor



Source: Macrobond Financial, Danske Bank

10Y EUR swap rates



Source: Macrobond Financial, Danske Bank

US forecasts

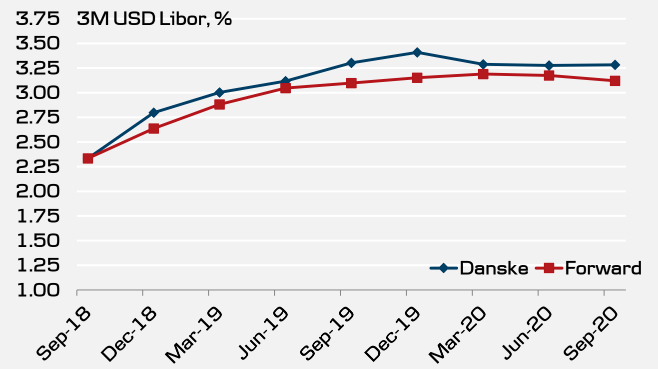
- The Fed seems on track to deliver two more hikes this year (in September and December), which is also a consensus among analysts and priced by markets. Growth is strong, optimism is high, the unemployment rate is low, wage growth is increasing (although at a gradual pace) and core inflation is running near the 2% target. We also expect the Fed to continue hiking next year, as the expansion seems to continue but the committee is monitoring the yield curve, as many FOMC members are concerned about an inversion, which is considered a good recession indicator.
- We still see a case for both higher 2Y and 10Y yields. The short end is pushed higher as our Fed rate path is not priced in the money market curve. In respect of the long end, a modest repricing of the US term premium is expected. We also assume an effect on the yield level from the more expansive US fiscal policy, which has boosted US bond supply. However, we do not forecast an inversion of the 2Y10Y curve in treasuries on a 12M horizon, as we expect the market to price a very flat to inverted money market curve keeping 2Y yields in check after all. However, the curve is set to be very flat and we should expect a lively discussion whether this is a signal of a new US recession getting closer.

USD forecasts summary

14/09/2018	--- Forecast ---				--- Fcst vs Fwd in bp ---		
USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Fed Funds	2.00	2.25	2.50	3.00	-	-	-
3M	2.33	2.80	3.00	3.30	+16	+12	+20
				Government bonds			
2-year	2.76	2.90	3.10	3.15	-	-	-
5-year	2.88	2.95	3.10	3.15	-	-	-
10-year	2.98	3.05	3.20	3.25	-	-	-
				Swap rates			
2-year	2.95	3.10	3.30	3.35	+5	+20	+21
5-year	3.02	3.05	3.20	3.25	-	+13	+17
10-year	3.05	3.10	3.25	3.30	+3	+16	+20

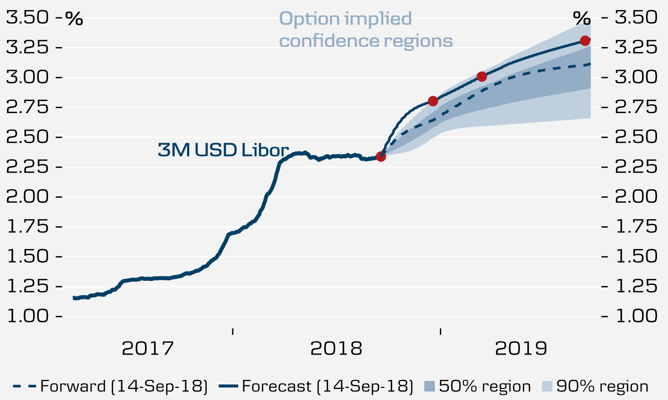
Source: Danske Bank

Danske Bank forecast and forwards



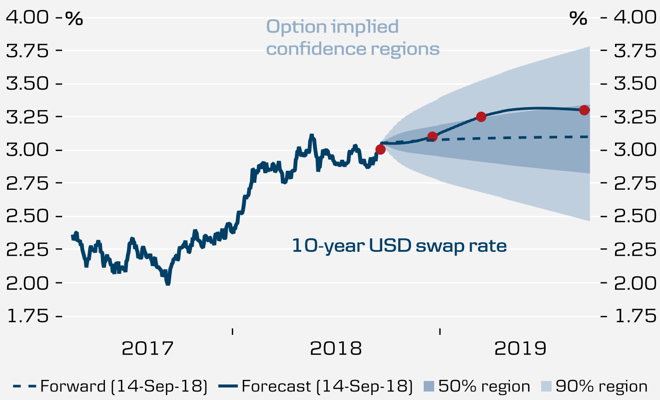
Source: Danske Bank

3M USD Libor rates



Source: Macrobond Financial, Danske Bank

10Y USD swap rates



Source: Macrobond Financial, Danske Bank

UK forecasts

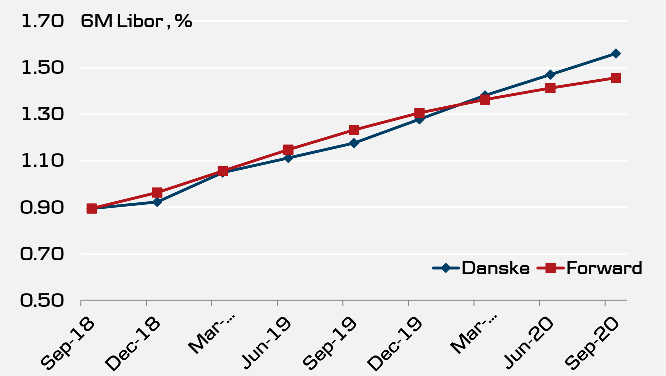
- Activity in the UK economy has rebounded after a weak Q1 and GDP expanded at the fastest pace in almost a year with an increase in GDP of 0.6% in the three months from May to July. Especially a rebound in construction output and retail sales has boosted activity over the summer. CPI inflation inched higher to 2.5% y/y in July. We still expect the downward pressure on CPI inflation to continue this year due to the fading impact of the previous depreciation of the GBP.
- As expected, the Bank of England (BoE) voted unanimously to keep the Bank Rate at 0.75% in September. We expect the BoE to hike around once a year and our base case is that the next hike will arrive in May 2019.
- The UK money market curve is relatively flat, with the next BoE rate hike priced to arrive in November 2019. While this is slightly dovish compared to our expectations, we think market pricing is fair for now – especially given the uncertainty related to Brexit. Over the medium term, we generally forecast higher yields across the curve. With the BoE expected to continue to lift the front end in coming years, we look for a gradual flattening of the 2Y10Y and 5Y10Y yield curves.

UK forecasts summary

14/09/2018	--- Forecast ---				--- Fcst vs Fwd in bp ---		
GBP	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Repo	0.75	0.75	0.75	1.00	-	-	-
3M	0.80	0.82	0.93	1.07	-3	-2	-6
				Government bonds			
2-year	0.82	1.00	1.10	1.30	+14	+19	+29
5-year	1.13	1.25	1.40	1.60	+8	+19	+32
10-year	1.53	1.60	1.70	1.80	+5	+11	+14
				Swap rates			
2-year	1.14	1.30	1.40	1.60	+9	+13	+20
5-year	1.41	1.55	1.70	1.90	+10	+21	+34
10-year	1.62	1.70	1.80	1.95	+6	+13	+24

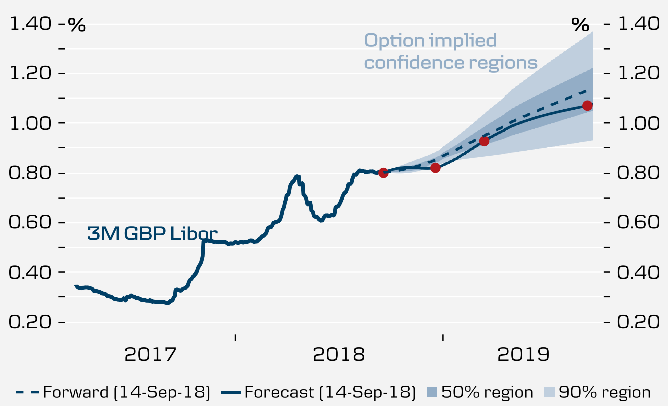
Source: Danske Bank

Danske Bank forecast and forwards



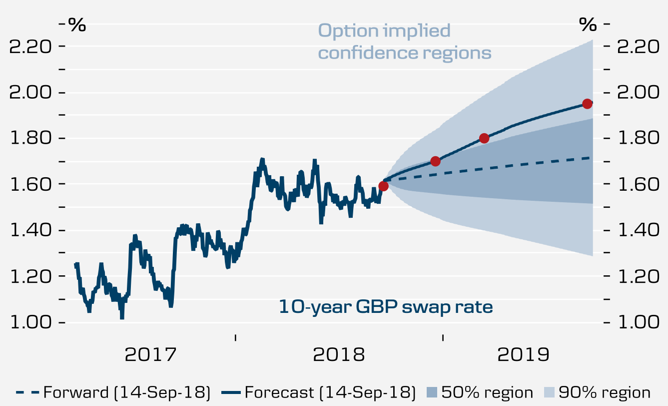
Source: Danske Bank

3M GBP Libor rates



Source: Macrobond Financial, Danske Bank

10Y UK swap rates



Source: Macrobond Financial, Danske Bank

Denmark forecasts

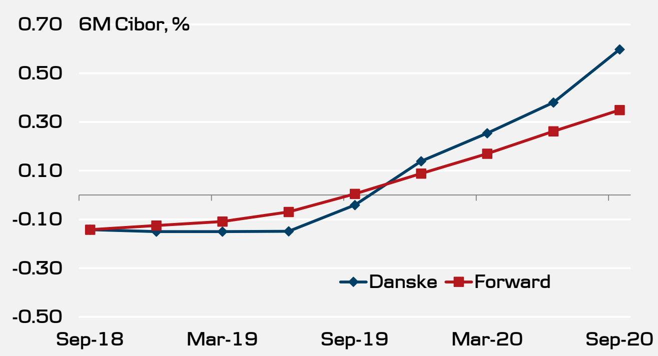
- We do not expect Danmarks Nationalbank to adjust interest rates over the next year. Denmark's sizeable current account surplus continues to support a stronger DKK, though the forward discount in EUR/DKK has increased, thus pulling in the opposite direction.
- The 2019 budget shows the Ministry of Finance plans to buy back more than DKK50bn worth of the new government-guaranteed mortgage bonds that are set to finance social housing. This is to be funded by a major draw down on the government account in 2019 rather than increasing the supply of government bonds. Hence, a substantial volume of liquid funds is likely to enter the Danish market, which will push Danish yields lower.
- We therefore still expect the 10Y DKK-German yield spread to hit zero. The spread is being reduced by foreign demand for Danish bonds, the expected larger surplus liquid funds and the 'large' forward discount in EUR/DKK, which makes short-term Danish securities attractive to foreign investors.
- We expect Danmarks Nationalbank to shadow the ECB in 2019, i.e. raise the certificates of deposit rate by 20bp in December 2019 to mirror the expected ECB action.

DKK forecasts summary

14/09/2018	--- 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	-0.31	-0.30	-0.30	-0.29	-3	-3	-10
6M	-0.14	-0.15	-0.15	-0.04	-3	-4	-5
			Government bonds				
2-year	-0.53	-0.55	-0.45	-0.30	-	-	-
5-year	-0.12	-0.05	0.05	0.25	-	-	-
10-year	0.37	0.45	0.55	0.80	-	-	-
			Swap rates				
2-year	-0.02	0.00	0.10	0.25	-4	-	-1
5-year	0.45	0.45	0.55	0.75	-7	-4	+1
10-year	1.07	1.10	1.20	1.40	-2	+2	+11

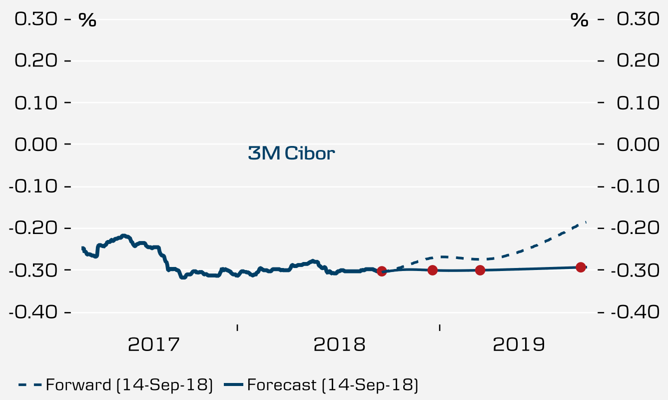
Source: Danske Bank

Danske Bank forecast and forwards



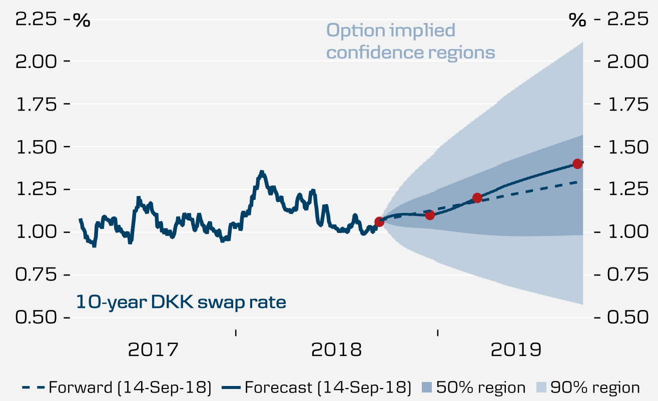
Source: Danske Bank

3M Cibor rate



Source: Macrobond Financial, Danske Bank

10Y DKK swap rates



Source: Macrobond Financial, Danske Bank

Sweden forecasts

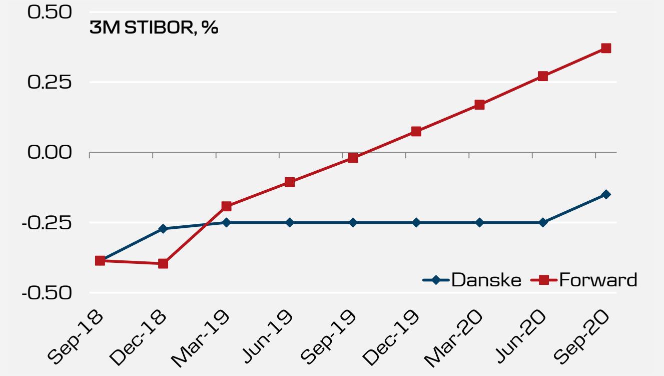
- Since last month's Yield Forecast, the Swedish Riksbank has provided more information about its plans for monetary policy. Earlier it has indicated that the first rate hike might come in Q4 (i.e. at the October or December meeting) but it has become more specific now, saying that it intends to hike either in December or in February (i.e. a small delay). It also clarified that it intends to raise the repo rate in steps of 25bp. Furthermore, the rate path in 2019-21 is intact, implying two hikes per year.
- Up to next spring/early summer, our inflation forecast is similar to the Riksbank's, which is why we see a December hike as probable. After that, the Riksbank's inflation forecast still looks too optimistic, in our view, and we are less convinced that it will actually hike again next summer. Nevertheless, market pricing is reasonably well aligned with the Riksbank's rate path one year out. Pricing two to three years out remains below the Riksbank. Therefore, as we approach the first hike in more than seven years, we would say that the front-end (two to three years) yields are more exposed to the change in monetary policy than longer-term yields. In fact we believe that rates in the 7-10 year segment (and longer) can be relatively immune to a near term repo rate hike. In summary, curve flattening.

SEK forecasts summary

14/09/2018	--- Forecast ---				--- Fcst vs Fwd in bp ---		
SEK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Repo	-0.50	-0.50	-0.25	-0.25	-	-	-
3M	-0.39	-0.25	-0.10	-0.10	+15	+9	-8
				Government bonds			
2-year	-0.47	-0.30	-0.30	-0.25	-	-	-
5-year	0.02	0.10	0.10	0.15	-	-	-
10-year	0.56	0.60	0.60	0.60	-	-	-
				Swap rates			
2-year	-0.07	0.20	0.10	0.15	+18	-3	-18
5-year	0.50	0.55	0.55	0.60	-4	-14	-26
10-year	1.19	1.20	1.15	1.10	-5	-17	-35

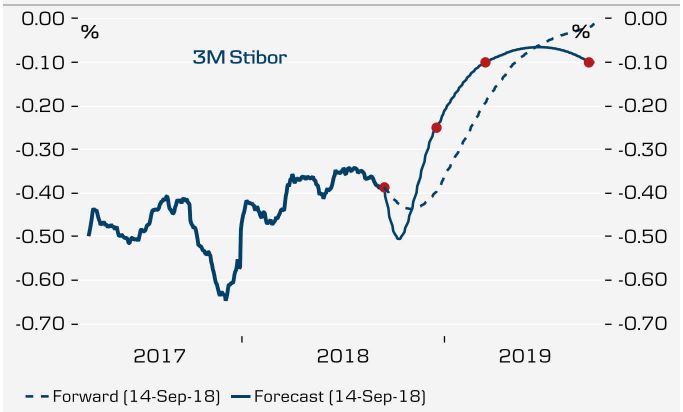
Source: Danske Bank

Danske Bank forecast and forwards



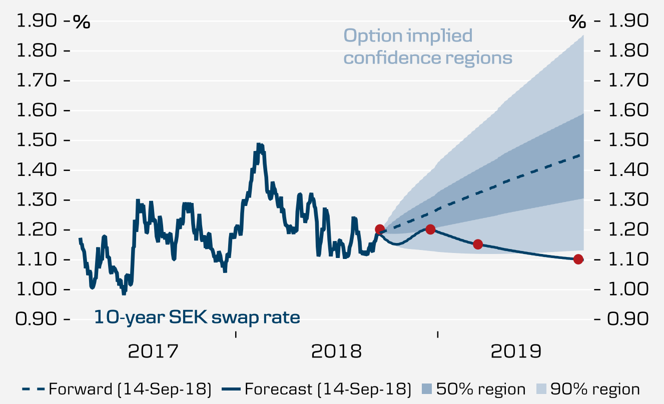
Source: Danske Bank

3M Stibor rate



Source: Macrobond Financial, Danske Bank

10Y SEK swap rates



Source: Macrobond Financial, Danske Bank

Norway forecasts

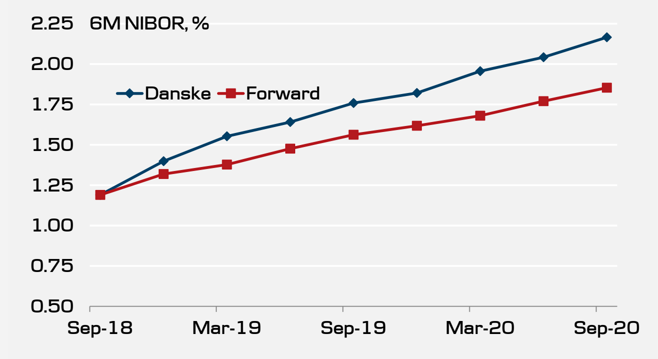
- In the Monetary Policy Report 2/18, on 21 June, Norges Bank expressed that ‘the key policy rate will most likely be raised in September 2018’. Since June, almost all factors affecting the rate decision and the corresponding rate path have been on the positive side.
- Global forward rates are a bit lower than assumed in the June report, which will have a marginally negative impact from the second half of 2020 and onwards, but core inflation has been higher, the oil price is a bit higher and the money market spread a bit lower than expected. Domestic growth has been in line with expectations but the oil investment survey clearly points to an upside risk to the oil investment forecast and hence the GDP-forecast for 2019. The main contribution comes from the weaker NOK.
- We expect Norges Bank to hike the policy rate by 25bp to 0.75% on 20 September and to adjust the rate path upwards, signalling a more than 50% probability of another rate hike in December, two and a half hikes in 2019, two hikes in 2020 and one and a half hike in 2021.
- We expect 5Y and 10Y yields to widen further versus peers in 2018-19, as the Norwegian economy is improving and as Norge Bank hikes rates, whereas the ECB will stay on hold.

NOK forecasts summary

14/09/2018		--- Forecast ---				--- Fcst vs Fwd in bp ---	
NOK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Deposit	0.50	0.75	1.00	1.25	-	-	-
3M	1.07	1.24	1.39	1.64	+4	+7	+14
				Government bonds			
2-year	0.80	0.95	1.25	1.50	-	-	-
5-year	1.61	1.60	1.80	2.10	-	-	-
10-year	1.90	2.05	2.15	2.30	-	-	-
				Swap rates			
2-year	1.53	1.65	1.95	2.20	+2	+22	+30
5-year	1.95	1.95	2.15	2.45	-7	+7	+26
10-year	2.27	2.40	2.50	2.65	+9	+15	+23

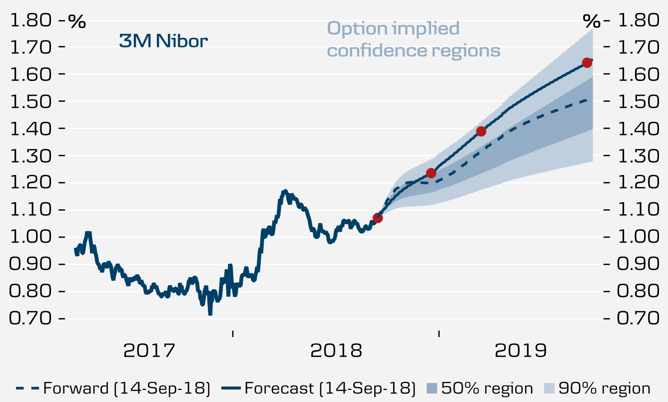
Source: Danske Bank

Danske Bank forecast and forwards



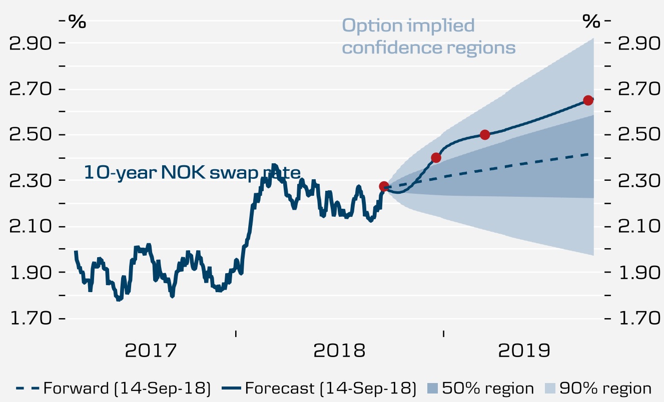
Source: Danske Bank

3M Nibor rate



Source: Macrobond Financial, Danske Bank

10Y NOK swap rates



Source: Macrobond Financial, Danske Bank

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	**2.00**	**2.33**	**2.95**	**3.02**	**3.05**	**2.76**	**2.88**	**2.98**
	+3m	2.25	2.80	3.10	3.05	3.10	2.90	2.95	3.05
	+6m	2.50	3.00	3.30	3.20	3.25	3.10	3.10	3.20
	+12m	3.00	3.30	3.35	3.25	3.30	3.15	3.15	3.25
EUR*	Spot	**-0.40**	**-0.32**	**-0.14**	**0.33**	**0.94**	**-0.54**	**-0.13**	**0.45**
	+3m	-0.40	-0.33	-0.10	0.35	0.95	-0.55	-0.10	0.50
	+6m	-0.40	-0.33	0.00	0.45	1.05	-0.45	0.00	0.60
	+12m	-0.40	-0.33	0.15	0.65	1.25	-0.30	0.20	0.80
GBP	Spot	**0.75**	**0.80**	**1.14**	**1.41**	**1.62**	**0.82**	**1.13**	**1.53**
	+3m	0.75	0.82	1.30	1.55	1.70	1.00	1.25	1.60
	+6m	0.75	0.93	1.40	1.70	1.80	1.10	1.40	1.70
	+12m	1.00	1.07	1.60	1.90	1.95	1.30	1.60	1.80
DKK	Spot	**-0.65**	**-0.31**	**-0.02**	**0.45**	**1.07**	**-0.53**	**-0.12**	**0.37**
	+3m	-0.65	-0.30	0.00	0.45	1.10	-0.55	-0.05	0.45
	+6m	-0.65	-0.30	0.10	0.55	1.20	-0.45	0.05	0.55
	+12m	-0.65	-0.29	0.25	0.75	1.40	-0.30	0.25	0.80
SEK	Spot	**-0.50**	**-0.39**	**-0.07**	**0.50**	**1.19**	**-0.47**	**0.02**	**0.56**
	+3m	-0.50	-0.25	0.20	0.55	1.20	-0.30	0.10	0.60
	+6m	-0.25	-0.10	0.10	0.55	1.15	-0.30	0.10	0.60
	+12m	-0.25	-0.10	0.15	0.60	1.10	-0.25	0.15	0.60
NOK	Spot	**0.50**	**1.07**	**1.53**	**1.95**	**2.27**	**0.80**	**1.61**	**1.90**
	+3m	0.75	1.24	1.65	1.95	2.40	0.95	1.60	2.05
	+6m	1.00	1.39	1.95	2.15	2.50	1.25	1.80	2.15
	+12m	1.25	1.64	2.20	2.45	2.65	1.50	2.10	2.30

** German government bonds are used, EUR swap rates are used*
Source: Danske Bank

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Date of first publication

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Report completed: 17 September 2018, 12:41 CEST

Report first disseminated: 17 September 2018, 16:20 CEST