

Yield Outlook

Market rates and yields set to continue rising

As we wrote in the previous issue of *Yield Outlook*, 17 December 2021, there is increasing concern that high inflation is not just transitory but is proving more persistent, hence requiring far more resolute action by the central banks.

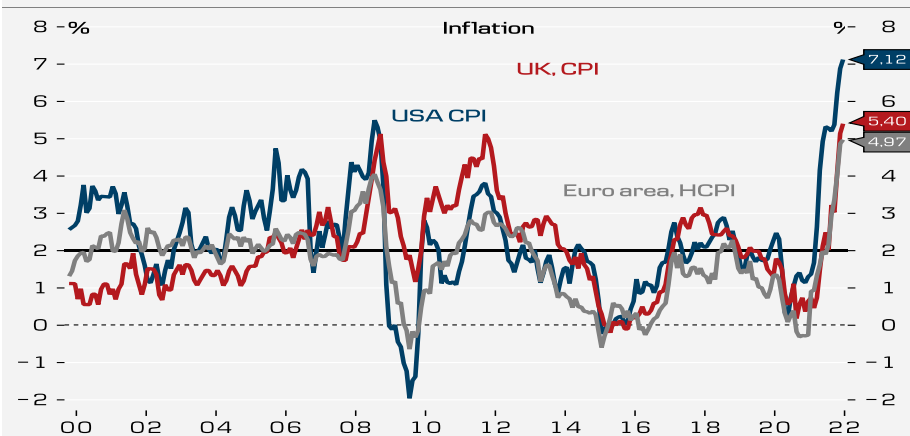
The inflation outlook does not seem to have become less of a concern since then. US CPI headline inflation surged to a 40-year high of 7.1% and German headline inflation hit 5.3% in December. Furthermore, inflation expectations have remained high and labour markets in both the US and Europe continue to tighten. In late 2021, inflation was driven, not least, by rising commodity and input prices but underlying inflation has also edged up everywhere. The central bank nightmare of rising commodity prices and tight labour markets fuelling price and wage pressures is perhaps coming true.

This is the uncomfortable truth that the Fed has already addressed. The ECB will have to do so in 2022, and risks are skewed towards 2023 spelling the end of negative ECB policy rates, in our view.

The market has already started pricing this scenario. 10Y German yields have turned positive for the first time since 2019 and 10Y US yields are moving towards 2%. We expect yields to continue rising through 2022. As we wrote in the November edition of *Yield Outlook*, 16 November 2021, this development is, not least, prompting upward pressure on 3Y-5Y EUR yields, as this part of the yield curve is particularly sensitive to market pricing of the ECB.

While an ECB rate hike in 2022 is not our baseline scenario, we expect markets to increasingly price rate hikes in 2023 and 2024. We expect 10Y US Treasury yields to hit 2.25% in 2022, up from our previous 2.0% forecast. 10Y Bund yields are likely to increase to 0.3% in 2022.

US headline inflation hits 40-year high



Note: Past performance is not a reliable guide to future returns. Source: Macrobond Financial

Links

[Forecast table](#)

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Central bank policy rates

Country	Spot	+3m	+6m	+12m
USD	0.25	0.50	0.75	1.25
EUR	-0.50	-0.50	-0.50	-0.50
GBP	0.25	0.50	0.75	1.00
DKK	-0.60	-0.60	-0.60	-0.60
SEK	0.00	0.00	0.00	0.00
NOK	0.50	0.75	1.00	1.25

10Y government bond yields

Country	Spot	+3m	+6m	+12m
USD	1.87	2.00	2.10	2.25
EUR	-0.02	0.05	0.15	0.30
GBP	1.22	1.10	1.15	1.40
DKK	0.18	0.25	0.35	0.50
SEK	0.38	0.40	0.45	0.60
NOK	1.91	2.00	2.05	2.15

Note: EUR = Germany

10Y swap rates

Country	Spot	+3m	+6m	+12m
USD	1.95	2.05	2.15	2.30
EUR	0.43	0.45	0.55	0.75
GBP	1.47	1.35	1.40	1.65
DKK	0.63	0.65	0.75	0.95
SEK	1.15	1.00	0.95	1.05
NOK	2.14	2.20	2.30	2.40

Source (all three tables): Danske Bank

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Fed increasingly hawkish

In fact, the Fed decided at its FOMC meeting in December to scale back its bond purchasing programme by a further USD15bn a month to USD30bn a month. This means bond purchases are set to cease by March. Fed Chair Powell added that an extended intermission between the phasing out of QE and the first rate hike was unnecessary.

The minutes of the FOMC meeting released in early January revealed that the Fed was in fact even more concerned about inflation than it had initially expressed publicly before Christmas. In a particularly surprising move, the Fed opened up for the possibility of shrinking its balance sheet (quantitative tightening) earlier than it did in the previous tightening cycle, noting that its balance sheet is much larger this time around, both in dollar terms and as a percentage of GDP, and that the economy is in quite good shape.

The Fed conducted QT in the period from 2017 to 2019. Back then, it introduced a cap on how much it could reduce its balance sheet each month (run-off rate). In practice, the Fed will fully or partly refrain from reinvesting the proceeds from maturing bonds, which in return reduces excess liquidity in the market. Last time, the Fed started out cautiously with a monthly cap of USD10bn, which was then gradually adjusted to a monthly USD50bn.

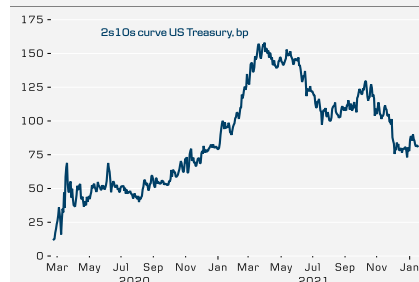
QT measures in 2017-2019 ultimately led to very tight liquidity in the USD market, and the Fed had to buy T-bills in 2019 to increase market liquidity. As the balance sheet is much higher this time around, the risk of tight dollar liquidity ought to be somewhat less severe.

We are not familiar with the details of an upcoming QT programme, but we would expect the Fed to reduce its balance sheet to the tune of USD75-100bn per month. We expect the programme to be officially launched in September.

We now expect four rate hikes in 2022, against previously three, and our forecast is now for lift-off in March already (instead of June), when the QE programme has been fully phased out. In 2017, the QT measures were launched 18 months after the first rate hike, so the Fed is taking more aggressive action this time.

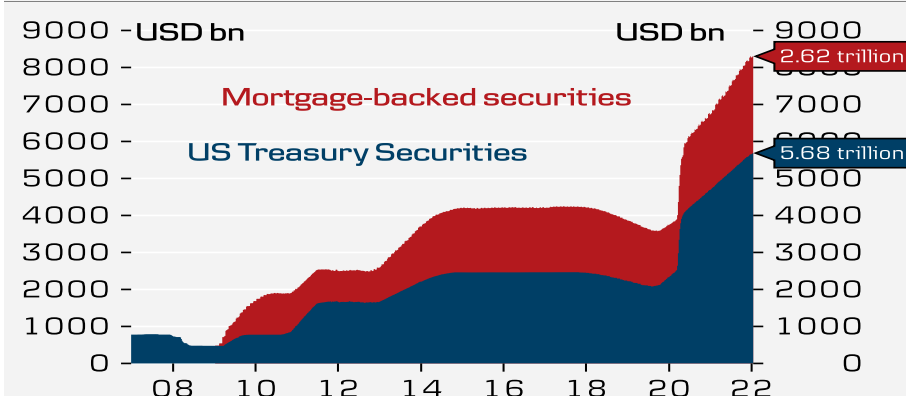
We anticipate that these quarterly rate hikes will continue throughout 2023, which would bring the upper limit of the fed funds rate – after no less than eight rate hikes – to 2.25% by the end of 2023. For more on our new forecast for the Federal Reserve, please see [Fed Research](#), which we released on 18 January.

The 2Y-10Y US yield curve has flattened, bp



Note: Past performance is not a reliable guide to future returns. Source: Macrobond Financial

Fed set to launch QT in 2022



Note: Past performance is not a reliable indicator of current or future results. Sources: Macrobond Financial, Bloomberg, Danske Bank

New Fed forecast and early QT put additional upward pressure on market rates

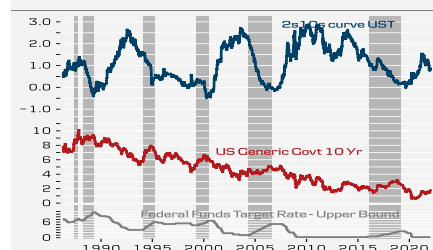
Like our forecast, the market is currently pricing just about four rate hikes of 25bp in 2022. However, the market is only pricing a little over 2½ rate hikes of 25bp in 2023. Hence, we see a potential for further rate hikes to be priced into the yield curve, especially in 2023. The Fed actually beginning to raise interest rates would put upward pressure on 2Y-5Y yields, which are the most sensitive to the expected and actual fed funds rate.

The 2Y-10Y curve flattening prior to and during rate hiking periods is a well-known phenomenon, and this time is hardly likely to be an exception. The chart on the right shows the 2Y-10Y curve, the fed funds rate and the yield on 10Y US Treasuries. The shaded areas are Fed hiking periods, and we can observe two things: The 2Y-10Y curve does indeed flatten, but this happens simultaneously with 10Y yields rising. In other words, yields increase across the curve.

Looking at the market effect of QT, it is worth noting that QT in 2017 initially produced a decent upward movement in long US yields. However, as we moved into 2018/2019, yields began to fall as renewed weakness was perceived in the US economy and the markets began to focus on the Fed hiking cycle coming to an end.

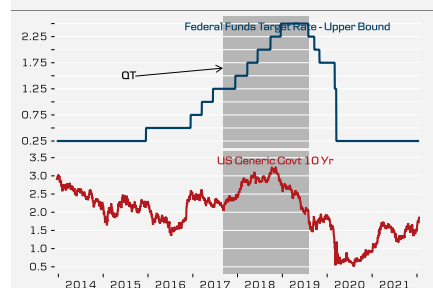
The upward pressure on long yields from QT stems in part from the term premium being pushed higher. The whole idea of QE was to compress the term premium (push long yields down) and so stimulate the economy further. The US economy is rather sensitive to changes in long yields, as many homeowners have fixed-rate loans with the option to remortgage if yields fall. The exact opposite is now happening. The chart below shows the term premium from the New York Fed (ACM) and the 5Y-10Y curve. We expect the term premium to increase in 2022 when the Fed begins to reduce its balance sheet. That would tend to steepen the 5Y-10Y curve – or at least reduce the flattening pressure from rate hikes. Uncertainty on the inflation outlook also tends to increase the term premium.

Higher 10Y UST yields and flatter 2Y-10Y curve when Fed hikes interest rates (shaded ranges: Fed hiking periods)



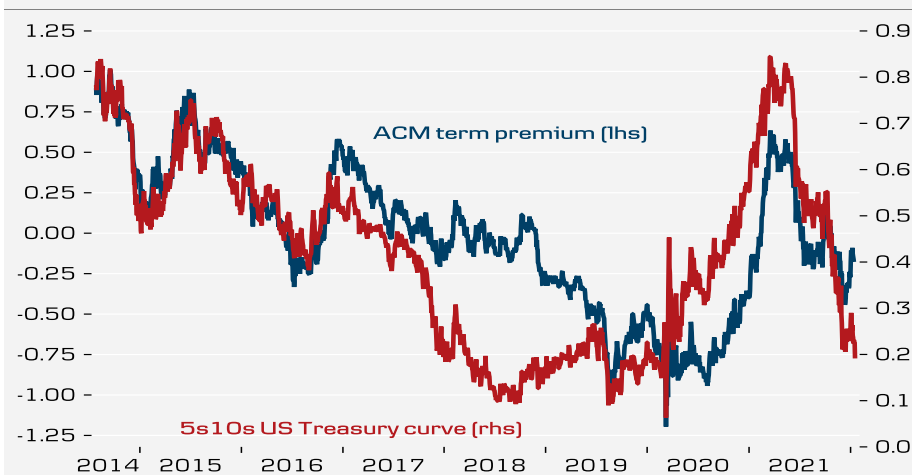
Note: Past performance is not a reliable guide to future returns. Source: Macrobond Financial

Upside to long US yields, especially at the start of QT



Note: Past performance is not a reliable guide to future returns. Source: Macrobond Financial

QT means increased term premium and a steeper 5Y-10Y curve



Note: Past performance is not a reliable guide to future returns. Source: Macrobond Financial

What could be the likely endpoint of the fed funds rate?

Our expectation is that in 2022 the market will be heavily focused on the endpoint of policy rates once the Fed is finished tightening. We assume that a neutral rate would be required, though we certainly cannot rule out the need for a contractionary monetary policy given the high rate of inflation.

The market is pricing the endpoint of the fed funds rate at around 1.85%. We expect the market to gradually reprice the endpoint in 2022 as the labour market continues to tighten. However, it remains unclear whether or not the pandemic has shifted the neutral rate of interest (r^*).

Should the market begin to price a higher end rate or neutral real interest rate (r^*), that would tend to push long nominal US yields higher in 2022.

As a consequence of our new forecast predicting four rate hikes from the Federal Reserve in 2022 and with QT likely to be launched in Q3 22, we have decided to raise our forecast for the 10Y US Treasury yield to 2.25% from 2.0% previously.

Steeper money market curve putting upward pressure on 3Y-5Y yields in the eurozone

As we had expected, the ECB announced at its meeting on 16 December that net purchases via its Pandemic Emergency Purchasing Programme (PEPP) would stop by the end of Q1 22, and that the programme would be scaled back during Q1 22. To avoid an unduly sharp reduction in bond purchases in Q2 22, the ECB decided to temporarily ramp up the 'old' APP purchasing programme from EUR20bn to EUR40bn per month in Q2 22 and EUR30bn in Q3 22, before cutting back to the original level of EUR20bn per month. Note that reinvestments stemming from PEPP are set to continue in the coming years – which adds up to a considerable amount given the scale of the programme. Overall, however, the announcement means that, in contrast to both 2020 and 2021, the ECB will probably not buy up the entire net issuance of new bonds in 2022. As the market starts to look ahead to 2023, the volume of bonds the market has to absorb will likely increase further, which could become a theme, particularly in H2 22.

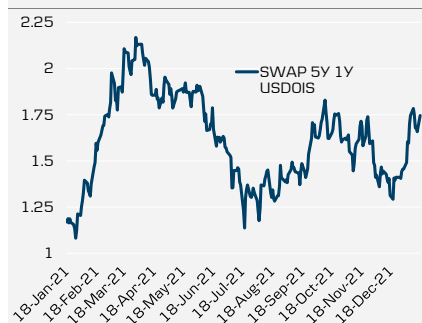
The ECB and President Lagarde used the press conference following the December policy meeting to stress that an increase in policy rates was very unlikely in 2022. And indeed several ECB members have reiterated that this is not the time for rate hikes. That being said, there are definitely ECB members now viewing the high level of inflation with mounting concern.

However, as we wrote in the December edition of *Yield Outlook*, 17 December 2021, the lesson of 2021 is that we need to be a little cautious about basing our own expectations on what the central banks say about the future. Remember that the US Fed was describing inflation as transitory just a few months ago and almost refused to discuss reducing bond buybacks, while not at all discussing rate hikes.

Likewise, the risk is increasing that the ECB could be surprised by inflation in 2022 and alter its rhetoric. Headline inflation in the eurozone was running at 5% in December and we can see core inflation is rising. We are also beginning to perceive an increasing risk of tighter labour markets and high inflation in the eurozone stoking higher wage growth than previously expected.

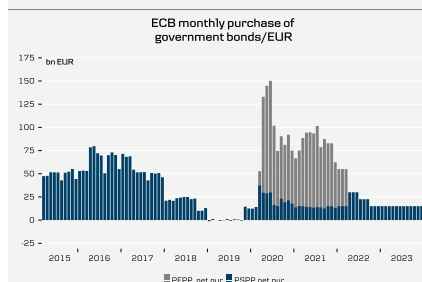
Nevertheless, our overall expectation remains that the ECB will keep policy rates unchanged in 2022, though a rate hike late in the year is no longer unlikely. However, in the past month, the ECB has become much more likely to begin raising interest rates in 2023. Our assumption is that the market will continue to price rate hikes into the curve in

5Y1Y USD OIS rate indicates a Fed funds rate of 1.5% in 5 years



Note: Past performance is not a reliable guide to future returns. Source: Macrobond Financial

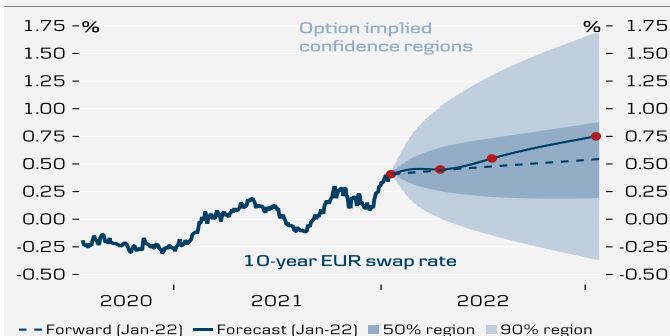
ECB also reducing bond buybacks



Note: Past performance is not a reliable guide to future returns. Source: Macrobond Financial

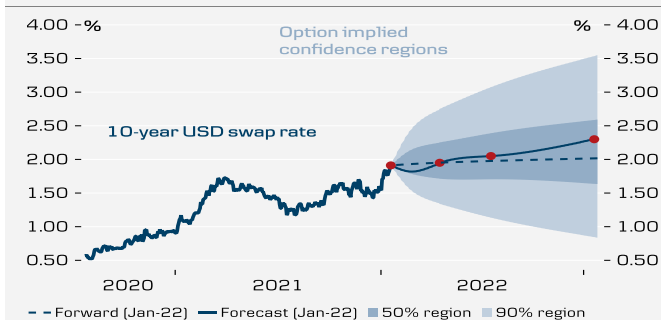
2023 and 2024, putting continued upward pressure on monetary policy-sensitive yields in the 3Y-5Y segment. We now expect the 10Y German government bond yield to increase to 0.3% in 2022 compared to 0.2% earlier.

Forecast: 10Y EUR swap rates



Note: Past performance is not a reliable guide to future returns.
Source: Danske Bank

Forecast: 10Y USD swap rates



Note: Past performance is not a reliable guide to future returns.
Source: Danske Bank

Forecast*

	Horizon	Policy rate	3m xlbbr	2-yr swap	5-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
USD	Spot	0.25	0.25	1.25	1.76	1.95	1.05	1.66	1.87
	+3m	0.50	0.54	1.35	1.80	2.05	1.15	1.75	2.00
	+6m	0.75	0.80	1.65	1.95	2.15	1.45	1.90	2.10
	+12m	1.25	1.35	2.10	2.15	2.30	1.90	2.10	2.25
EUR*	Spot	-0.50	-0.56	-0.22	0.14	0.43	-0.57	-0.34	-0.02
	+3m	-0.50	-0.54	-0.15	0.20	0.45	-0.50	-0.25	0.05
	+6m	-0.50	-0.54	-0.05	0.35	0.55	-0.40	-0.10	0.15
	+12m	-0.50	-0.46	0.15	0.45	0.75	-0.20	0.00	0.30
GBP	Spot	0.25	0.53	1.44	1.52	1.47	0.87	1.02	1.22
	+3m	0.50	0.69	1.30	1.50	1.35	0.75	1.00	1.10
	+6m	0.75	0.72	1.30	1.60	1.40	0.75	1.10	1.15
	+12m	1.00	1.09	1.55	1.75	1.65	1.00	1.25	1.40
DKK	Spot	-0.60	-0.30	0.04	0.35	0.63	-0.53	-0.10	0.18
	+3m	-0.60	-0.28	0.10	0.45	0.65	-0.40	0.00	0.25
	+6m	-0.60	-0.28	0.20	0.60	0.75	-0.30	0.15	0.35
	+12m	-0.60	-0.28	0.40	0.70	0.95	-0.10	0.25	0.50
SEK	Spot	0.00	-0.05	0.37	0.88	1.15	-0.13	0.22	0.38
	+3m	0.00	-0.03	0.20	0.65	1.00	-0.20	0.10	0.40
	+6m	0.00	-0.03	0.20	0.60	0.95	-0.20	0.15	0.45
	+12m	0.00	-0.03	0.20	0.70	1.05	-0.15	0.25	0.60
NOK	Spot	0.50	1.08	1.80	2.07	2.14	1.53	1.80	1.91
	+3m	0.75	1.24	1.85	2.05	2.20	1.60	1.80	2.00
	+6m	1.00	1.35	2.00	2.20	2.30	1.75	1.90	2.05
	+12m	1.25	1.77	2.15	2.25	2.40	1.90	1.95	2.15

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

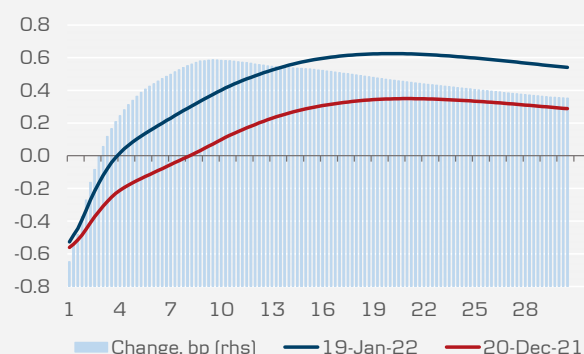
Eurozone forecast

EUR forecast summary

19/01/2022	--- 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	-0.50	-0.50	-0.50	-0.50	-	-	-
	3M	-0.56	-0.54	-0.54	-0.46	-2	-10	-24
	6M	-0.52	-0.52	-0.52	-0.31	-7	-15	-21
	Government Bonds							
	2-year	-0.57	-0.50	-0.40	-0.20	-	-	-
	5-year	-0.34	-0.25	-0.10	0.00	-	-	-
	10-year	-0.02	0.05	0.15	0.30	-	-	-
	Swap rates							
2-year	-0.22	-0.15	-0.05	0.15	-3	-3	-1	
5-year	0.14	0.20	0.35	0.45	1	11	12	
10-year	0.43	0.45	0.55	0.75	-1	5	19	

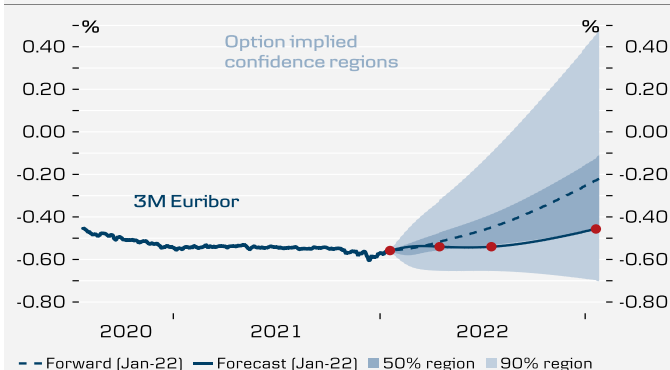
Source: Danske Bank

1M change in EUR swap rates



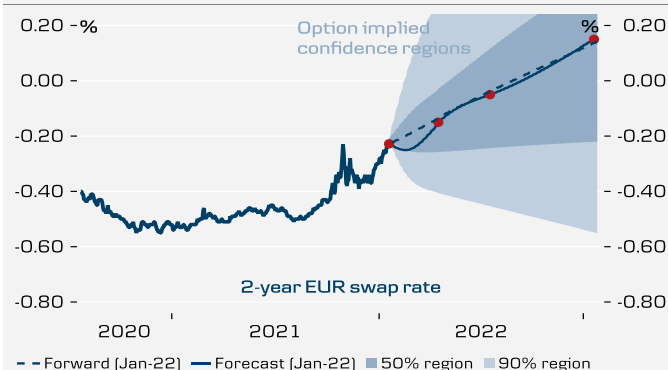
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Euribor rates



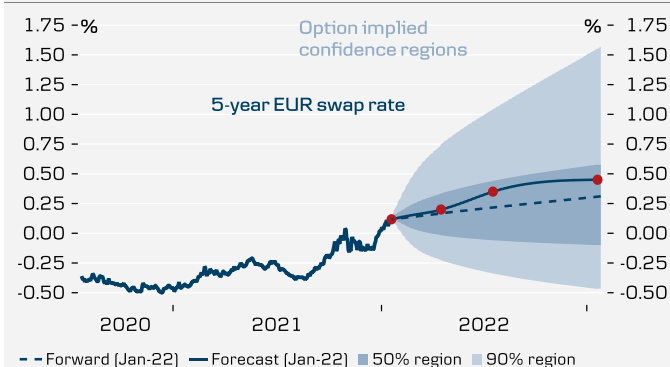
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y EUR swap rates



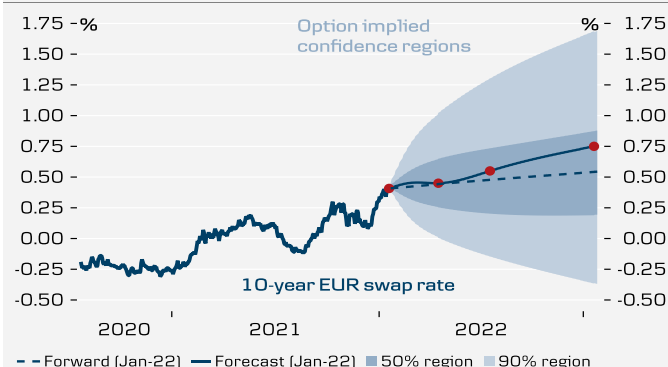
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

5Y EUR swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y EUR swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

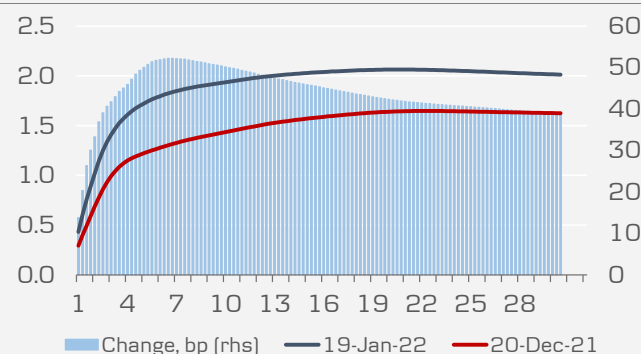
US forecast

USD forecast summary

19/01/2022	--- Forecast ---				--- Fcst vs Fwd in bp ---		
USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
	<u>Money Market</u>						
Fed Funds	0.25	0.50	0.75	1.25	-	-	-
3M	0.25	0.54	0.80	1.35	-7	-14	-10
	<u>Government Bonds</u>						
2-year	1.05	1.15	1.45	1.90	-	-	-
5-year	1.66	1.75	1.90	2.10	-	-	-
10-year	1.87	2.00	2.10	2.25	-	-	-
	<u>Swap rates</u>						
2-year	1.25	1.35	1.65	2.10	-13	-1	18
5-year	1.76	1.80	1.95	2.15	-6	1	10
10-year	1.95	2.05	2.15	2.30	5	11	19

Source: Danske Bank

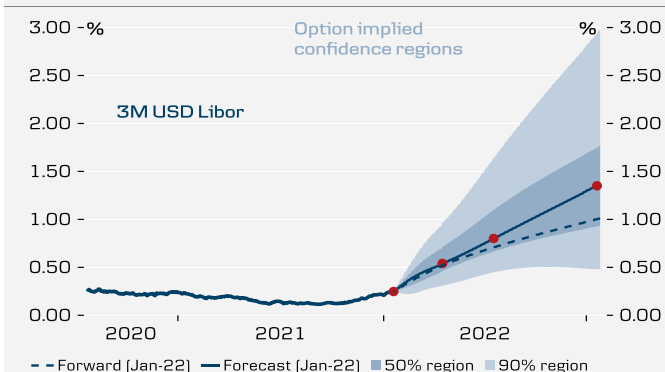
1M change in USD swap (3M) rates



Note: Past performance is not a reliable guide to future returns

Source: Danske Bank

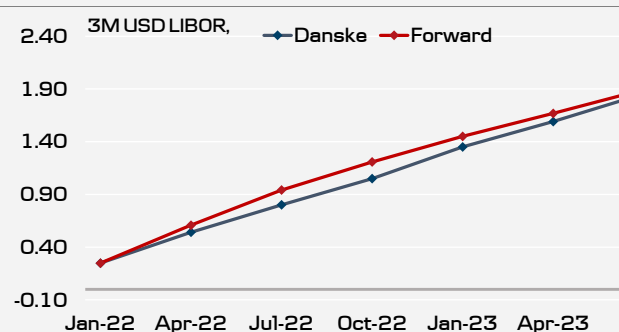
3M USD Libor rates



Note: Past performance is not a reliable guide to future returns

Source: Danske Bank

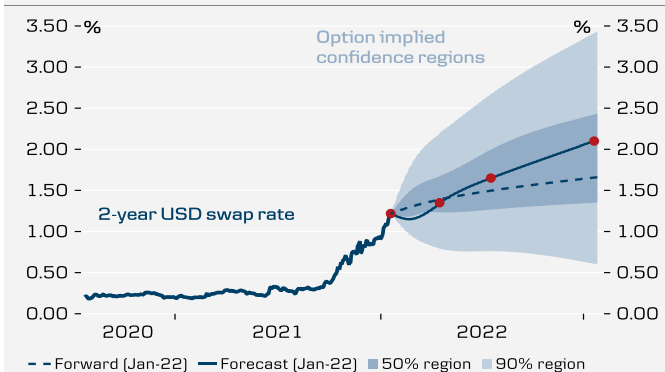
Danske Bank forecast and forwards



Note: Past performance is not a reliable guide to future returns

Source: Danske Bank

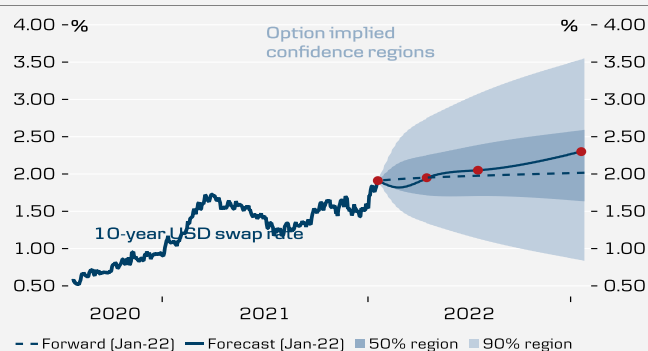
2Y USD swap rates



Note: Past performance is not a reliable guide to future returns

Source: Danske Bank.

10Y USD swap rates



Note: Past performance is not a reliable guide to future returns

Source: Danske Bank.

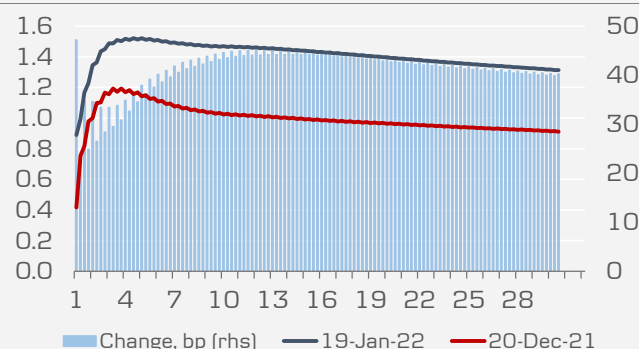
UK forecast

GBP forecast summary

19/01/2022	Spot	+3m	+6m	+12m	Forecast	Forecast	Forecast
GBP					+3m	+6m	+12m
Money Market							
Repo	0.25	0.5	0.75	1	-	-	-
3M	0.53	0.69	0.72	1.09	-22	-48	-40
Government Bonds							
2-year	0.87	0.75	0.75	1.00	-22	-31	-3
5-year	1.024	1	1.1	1.25	-5	3	14
10-year	1.22	1.10	1.15	1.40	-19	-18	4
Swap rates							
2-year	1.44	1.30	1.30	1.55	-26	-34	-13
5-year	1.52	1.50	1.60	1.75	-5	3	25
10-year	1.47	1.35	1.40	1.65	-14	-10	15

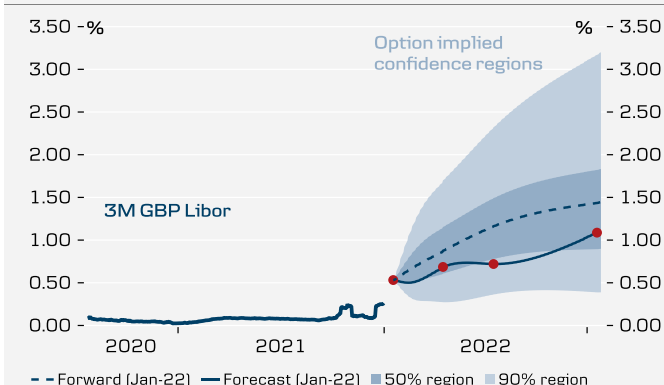
Source: Danske Bank

1M change in GBP swap (6M) rates



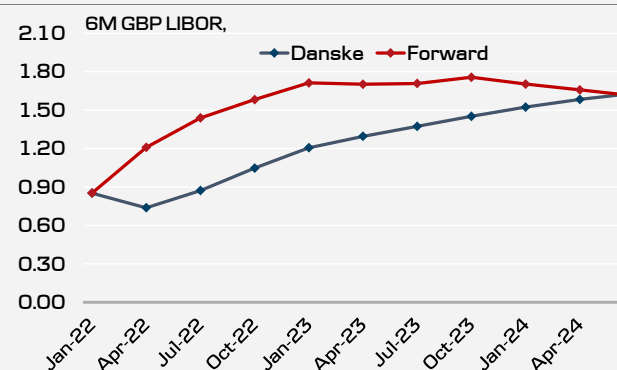
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M GBP Libor rates



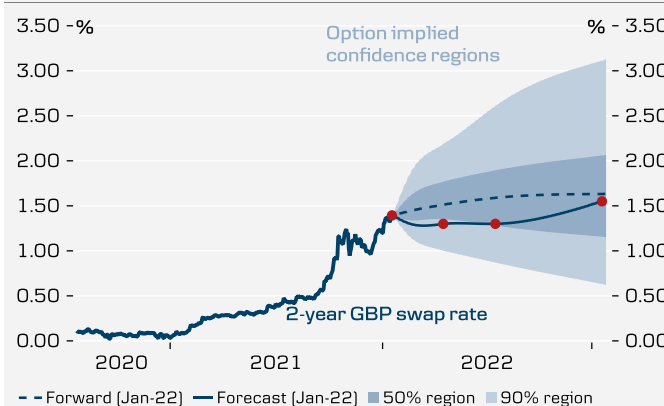
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

Danske Bank forecast and forwards



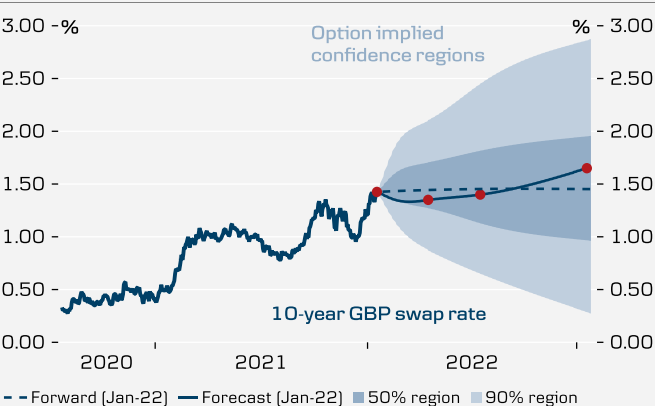
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y UK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y UK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

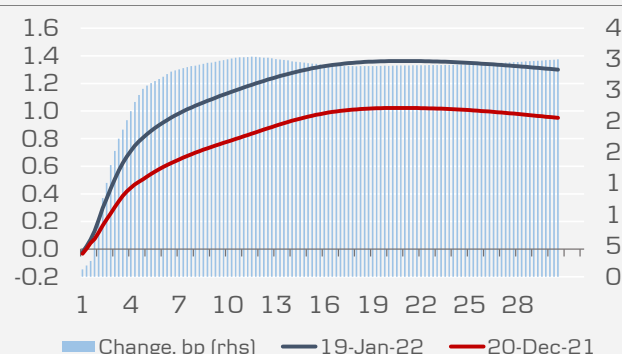
Sweden forecast

SEK forecast summary

19/01/2022		--- Forecast ---			--- Fcst vs Fwd in bp ---		
SEK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
Money market							
Repo	0.00	0.00	0.00	0.00	-	-	-
3M	-0.05	-0.03	-0.03	-0.03	-5	-14	-42
Government bonds							
2-year	-0.13	-0.20	-0.20	-0.15	-	-	-
5-year	0.22	0.10	0.15	0.25	-	-	-
10-year	0.38	0.40	0.45	0.60	-	-	-
Swap rates							
2-year	0.37	0.20	0.20	0.20	-30	-44	-71
5-year	0.88	0.65	0.60	0.70	-30	-41	-44
10-year	1.15	1.00	0.95	1.05	-19	-28	-26

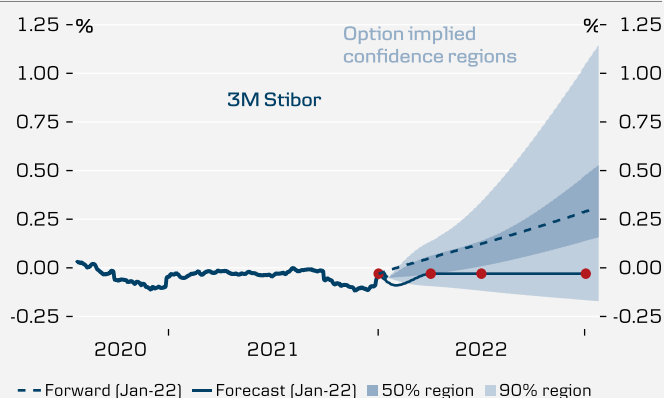
Source: Danske Bank

1M change in SEK swap (3M) rates



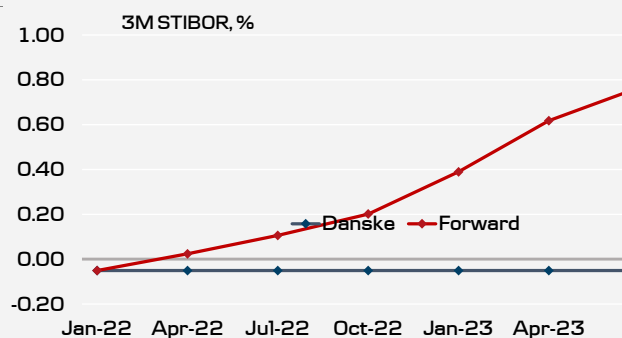
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Stibor rates



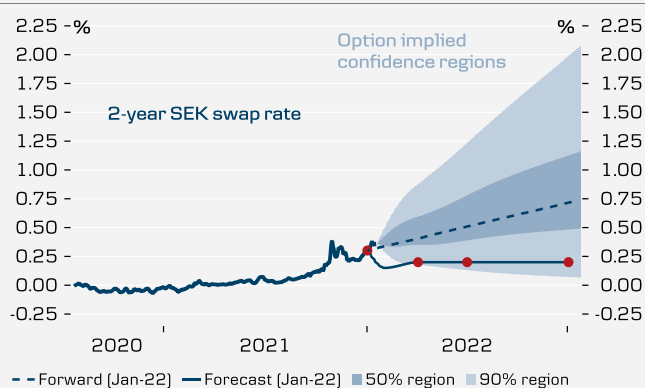
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

Danske Bank forecast and forwards



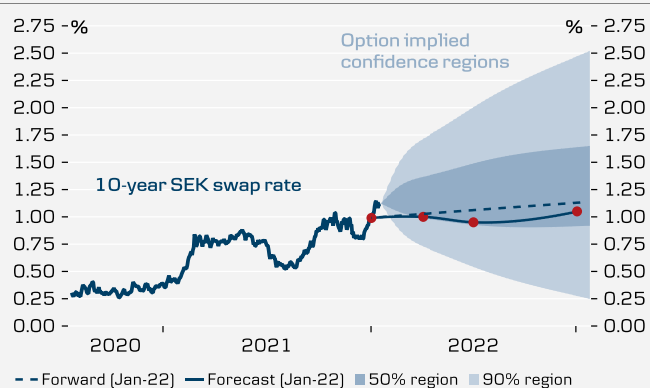
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y SEK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y SEK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

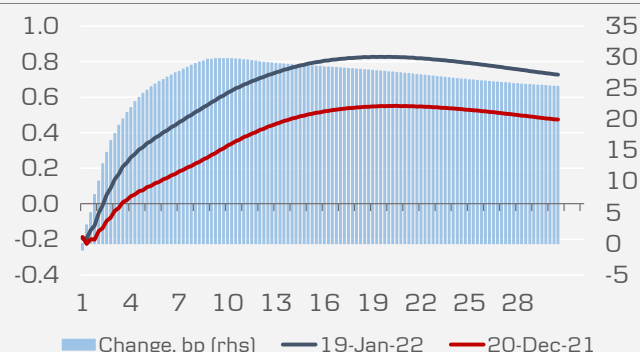
Denmark forecast

DKK forecast summary

19/01/2022	--- Forecast ---				--- Fcst vs Fwd in bp ---		
DKK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
	<u>Money Market</u>						
CD	-0.60	-0.60	-0.60	-0.60	-	-	-
Repo	-0.45	-0.45	-0.45	-0.45	-	-	-
3M	-0.30	-0.28	-0.28	-0.28	-1	-4	-26
6M	-0.20	-0.18	-0.18	-0.18	-3	-7	-31
	<u>Government bonds</u>						
2-year	-0.53	-0.40	-0.30	-0.10	-	-	-
5-year	-0.10	0.00	0.15	0.25	-	-	-
10-year	0.18	0.25	0.35	0.50	-	-	-
	<u>Swap rates</u>						
2-year	0.04	0.10	0.20	0.40	-2	0	4
5-year	0.35	0.45	0.60	0.70	5	16	17
10-year	0.63	0.65	0.75	0.95	-1	6	20
30-year	0.71	0.75	0.80	0.85	3	8	12

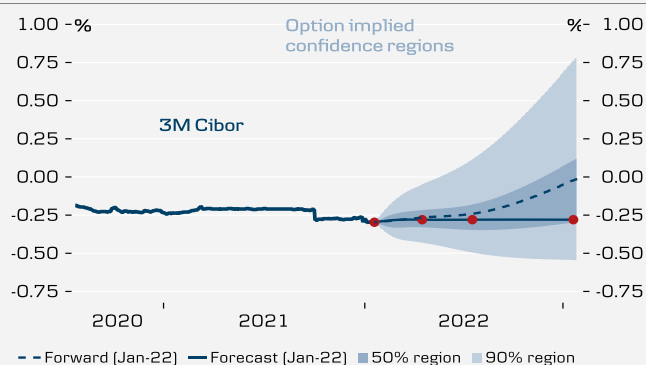
Source: Danske Bank

1M change in DKK swap (6M) rates



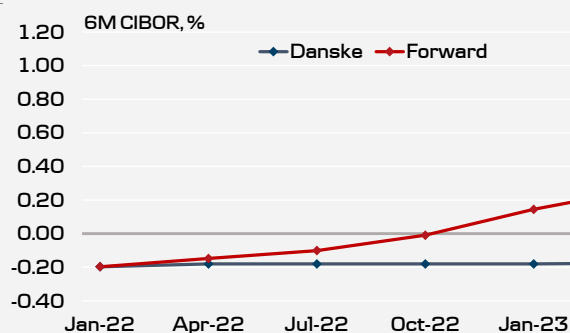
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Cibor rates



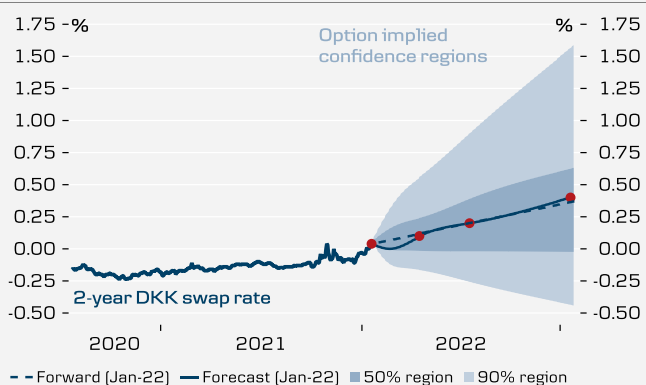
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

Danske Bank forecast and forwards



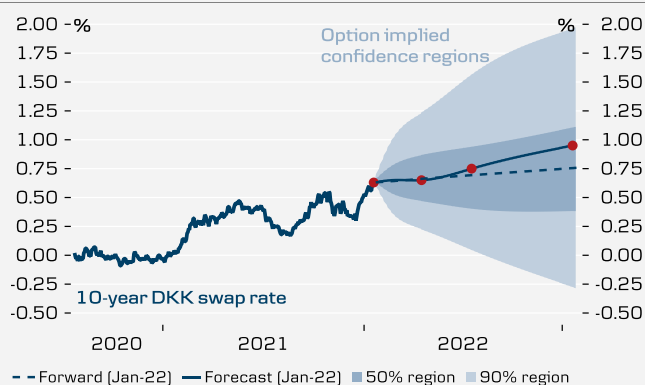
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y DKK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y DKK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

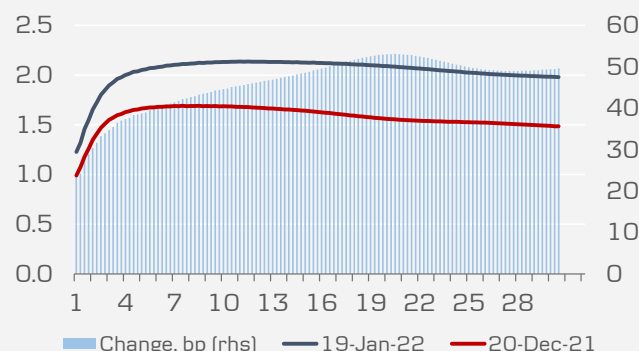
Norway forecast

NOK forecast summary

19/01/2022	Spot	+3m	+6m	+12m	Forecast	Forecast	Forecast
NOK					+3m	+6m	+12m
Money market							
Deposit	0.50	0.75	1.00	1.25	-	-	-
3M	1.08	1.24	1.35	1.77	-2	-15	-16
6M	1.22	1.37	1.46	1.90	-7	-22	-15
Government bonds							
2-year	1.53	1.60	1.75	1.90	-	-	-
5-year	1.80	1.80	1.90	1.95	-	-	-
10-year	1.91	2.00	2.05	2.15	-	-	-
Swap rates							
2-year	1.80	1.85	2.00	2.15	-10	-7	-7
5-year	2.07	2.05	2.20	2.25	-7	3	2
10-year	2.14	2.20	2.30	2.40	4	11	19

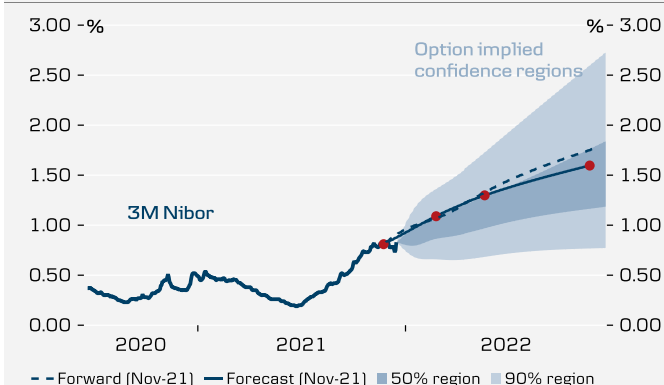
Source: Danske Bank

1M change in NOK swap (6M) rates



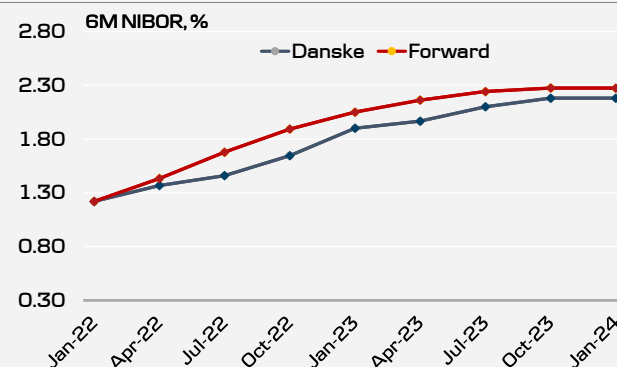
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

3M Nibor rates



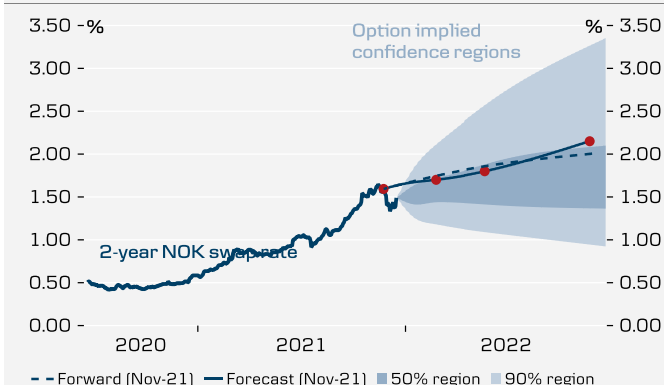
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

Danske Bank forecast and forwards



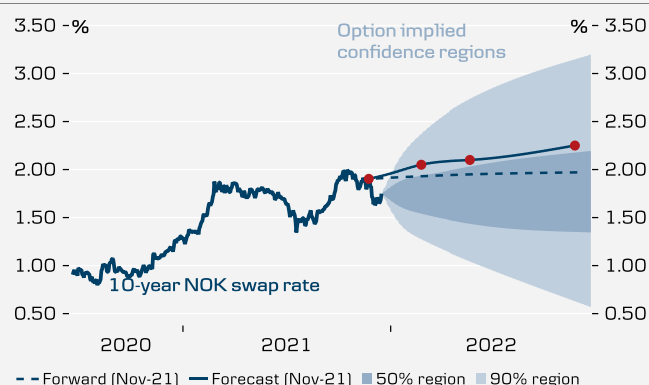
Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

2Y NOK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

10Y NOK swap rates



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

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