18 January 2018

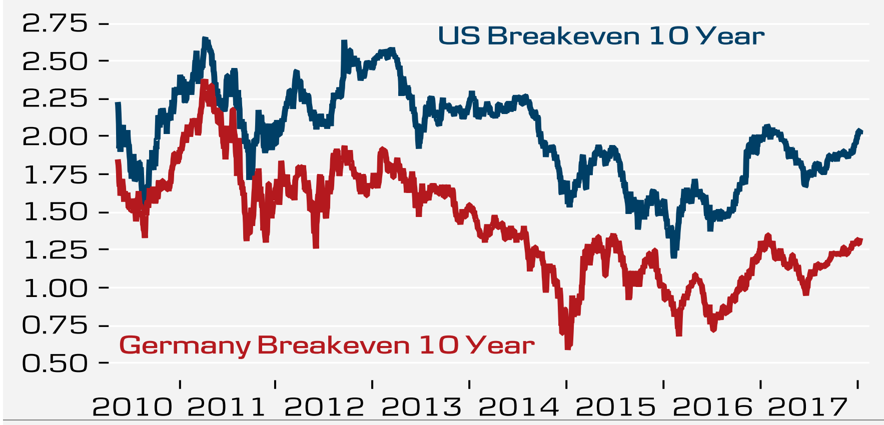
Strategy

The big EUR curve flattening has started

It has been a rocky past month for both the US and the European fixed income market, as 10Y Bund yields have moved 25bp higher and are close to the highest level since the brief spike in yields in July last year. Also, 10Y US treasury yields have moved higher. We have to go back to 2014 to see a similar level, if we disregard the two spikes in yields a year ago.

In our *Yield outlook,* published last week, we looked at some of the factors behind the recent bond sell-off. We highlighted the global recovery that has recently gained momentum and pushed commodities such as oil and, importantly, inflation expectations higher. The move in break-evens over the past couple of months is quite remarkable.

Breakeven rates are moving higher reflecting a renewed focus on reflation



Source: Bloomberg, Macrobond Financial

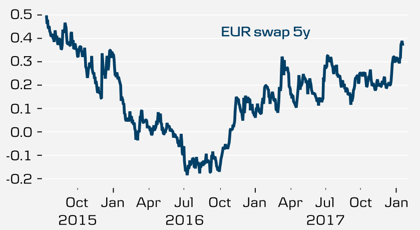
We also pointed to the re-pricing of ECB and Fed expectations that we have seen recently. The market is now priced for an ECB rate hike in Q1 19 and the March Fed hike is now priced by almost 90%. The repricing of ECB expectations has especially occurred after the recent ECB minutes mentioned that the 'forward guidance' could be revisited early in the coming year.

We revised higher both our EUR and USD yield and rates forecast, but mainly on a 12M horizon. We have now pencilled in somewhat higher 10Y EUR and USD rates and yields (Germany) on a 12M horizon. We now expect the 10Y EUR swap rate to rise to 1.45% from earlier 1.20% on a 12M horizon. The 10Y USD swap rate is forecast to rise to 2.90% from previously 2.70%. 10Y Bund yields (Germany) and 10Y US Treasury yields are forecast at 1.0% and 2.90% on a 12M horizon, respectively. Short term, the market might have run ahead a bit ahead of the curve and short term we could see some reversal of the recent moves. But we argue that we will have a bearish FI market in 2018.

Key points

- The 5Y point is the pivotal point on the EUR curve. This is right after the textbook and the normal pattern we see when monetary policy is about to change in either direction.
- It has resulted in a steepening of the 2y5y curve and a simultaneous flattening of the 5y10y curve. The 'butterfly' 2y5y10y has flattened.
- The curve has also flattened 10y30y, reflecting that long rates are already trading close to what is considered the 'neutral rate' in the eurozone. A curve dynamic close to the curve dynamics seen in the US since 2013.
- During 2018, we continue to see an extension of the recent flattening of the EUR curve. Both the 5y10y and 1030y curve are expected to continue flattening.

5Y EUR rates are seeing an upward pressure



Source: DG ECFIN, Macrobond Financial

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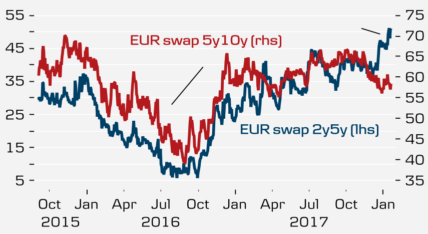
Curve dynamics – 5Y the focal point in 2018 and flatter 10y30y

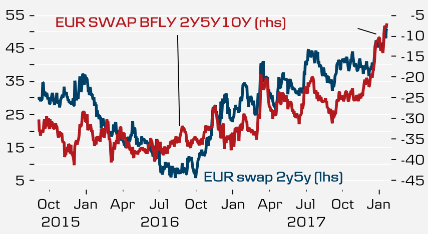
We have also seen moves in the European curves over the past couple of months that to a certain degree reflect what we have seen over the past couple of years in the US. First of all, the 5Y point has become the pivotal point on the curve. This is right after the textbook and the normal pattern we see when monetary policy is about to change. On the EUR swap curve, we have seen that the 2y5y curve has steepened and noteworthy that the 5y10y curve has flattened. It is rarely seen that the 2y5y and the 5y10y move in different directions. The result has been that the 2y5y10y 'butterfly' has moved higher over the past month.

2y5y and 5y10y in different directions



Source: Danske Bank

The 5y point push the 2y5y10y butterfly higher



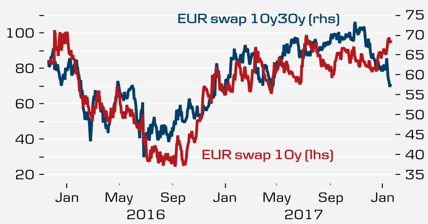
Source: Danske Bank

Secondly, we have seen a pronounced flattening of the curve 10y30 in EUR, despite the outright move higher in 10Y EUR rates and the higher inflation expectations reflected in break-even rates. Again, this is different from the pattern seen over the past couple of years.

The flattening of the 10y30y curve is very similar to the pattern we have seen in the US in the past couple of years. In the US, we have since the tapering announcement in 2013 seen a flattening of the USD swap curve 10y30y of 90bp and the curve is now very close to inverting. In our view, the same curve forces are now at play in Europe. It reflects that the 30Y rate of 1.50% in EUR and 2.75% in USD is close to the 'neutral rate over the cycle' so the long rates are 'in place'. Hence, the main curve moves are primarily found in the policy sensitive 5y segment and the more inflation expectation sensitive 10Y point.

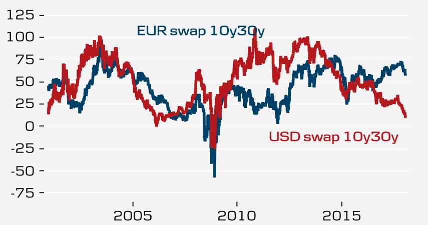
We believe that looking 6M to 12M ahead that both 5Y and 10Y EUR rates will be somewhat higher. But little is expected to happen in the 30Y segment. Hence, during 2018 we continue to see an extension of the recent flattening of the EUR curve. Both the 5y10y and especially the 10y30y curve are expected to continue the flattening tendency.

The EUR 10y30 curve has flattened despite the move higher in 10Y rates



Source: Danske Bank

The flattening of the curve is reminiscent of the USD curve since 2013



Source: Danske Bank

Financial views

Asset class	Main factors
Equities	
Positive on 3-12 month horizon.	Strong business cycle and near double digit earnings growth in most major regions. Low rates and bond yields drive demand for risk assets.
Bond market	
German/Scandi yields – set to stay in recent range for now, higher on 12M horizon	Inflation set to stay subdued despite decent growth. Stronger euro keeps euro inflation outlook down. ECB to normalise gradually only, due to lack of wage pressure and stronger euro. ECB on hold for a long time.
EU curve – 5Y10Y and 10y30 curve set to flatten in 2018. Flattening of US 2Y10Y curve to continue	The ECB keeps a tight leash on the short end of the curve. But the 5y point has become the pivotal point now.
US-euro spread - set to widen marginally	The Fed's QT programme (balance sheet reduction) is set to happen at a very gradual pace and the effect on the Treasury market should be benign. Yet, market pricing for Fed hikes is still dovish for 2019 and yields should edge higher on a 12M horizon.
Peripheral spreads – tightening but still some factors to watch	We expect economic recovery, ECB stimuli, better fundamentals, particularly in Portugal and Spain, an improved political picture and rating upgrades to lead to further tightening despite the recent strong moves. Italy is the big risk factor but it is very expensive to be short Italian bonds.
FX	
EUR/USD – sensitive to ECB and upside risks dominating	Any dip in EUR/USD near term set to prove shallow and shortlived; cross supported longer term by valuation and debt-flow reversal.
EUR/GBP – in range near term but GBP to strengthen eventually	We still see EUR/GBP within 0.8650-0.90 in coming months as the Brexit risk premium is likely to persist near term. Longer term, GBP should strengthen.
USD/JPY – gradually higher longer term but challenged near te	Focus on BoJ's quiet tapering and personnel changes to weigh on USD/JPY near term. Still supported by global recovery, suppressed risk premiums and Fed-BoJ divergence longer term.
EUR/SEK – risk to the topside on housing market, RB pricing	Housing market risk premium to keep SEK under pressure alongside too aggressive Riksbank market pricing. Eventually lower but not a H1 story.
EUR/NOK – set to move lower	NOK headwinds towards year fading - we expect the NOK to rebound on valuation, growth and real-rate differentials.
Commodities	
Oil price – starting to correct lower again	June review weakens impact of extension of OPEC+ output cuts. Geopolitical tensions around Saudi Arabia and Iran looming.

Source: Danske Bank views

Disclosure

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, Head of Fixed Income Research.

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Date of first publication

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Report completed: 18 January 2018, 17:00 CET

Report first disseminated: 18 January 2018, 20:30 CET