20 April 2017

Yield Outlook

More or less stable yields in 2017 – higher yields a 2018 story

- While we continue to see further upside for 10Y German Bund yields on a 12M horizon, we expect no major changes in 2017. This is also the case for Swedish, Danish and Norwegian yields.
- We do not expect the market to price an ECB tapering premium before 2018, as continued low inflation and a slightly less strong growth outlook are removing the need for tighter ECB monetary policy. We also expect the ECB to prolong its purchase programme into 2018.
- In the US market, not only Fed hikes but also a possible change in the Fed's reinvestment policy will set the direction for yields. We see slightly higher US yields on a six-month horizon but again higher yields are mainly a 2018 story.
- We expect the 10Y Bund yield to rise to 0.80% and a 10Y US Treasury yield of 2.8% on a 12-month horizon.

Yields have fallen again

In the previous issue of *Yield Outlook: Bond sell-off set to pause before resuming in the autumn*, 17 March, we argued that the bond sell-off witnessed in Q4 and gaining momentum in Q1 would pause and that higher yields would mainly be a story on a 6M to 12M horizon.

We argued that the market had got ahead of itself when pricing in ECB rate hikes as early as Q1 18 and that the market in the US had now been priced more or less according to the Fed's rate path. Furthermore, we highlighted the risk of a setback in risk appetite. The market was already positioned for higher bond yields, especially in the US, and expectations of economic data strength were high. We pointed to the high optimism in global equity markets in Q1. We also pointed to the French Presidential election and the risk that the polls would start to move in favour of Marine Le Pen. In respect of the latter, the rising support in the polls for the extreme left-wing candidate Jean-Luc Mélenchon is a new joker. Finally, we highlighted the risk that the global manufacturing cycle, which has been rising for many months, had peaked, which tends to put downward pressure on yields.

We were probably more correct than we thought. We called for a pause in the 'bond sell-off' on the back of these arguments but we actually got a strong global bond rally over the last month. Yields on 10Y German bonds have traded as low as 0.15% and 10Y US Treasury yields have fallen from above 2.60% at the peak in March to 2.20% currently. The market has repriced the outlook for the ECB from an early hike in Q1 18 to a hike late in 2018.

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Policy rate outlook

Country	Spot	+3m	+6m	+12m
USD	1.00	1.00	1.25	1.75
EUR	0.00	0.00	0.00	0.00
GBP	0.25	0.25	0.25	0.25
DKK	0.05	0.05	0.05	0.05
SEK	-0.50	-0.50	-0.50	-0.50
NOK	0.50	0.50	0.50	0.50

Source: Danske Bank Markets

10-year swap rate outlook

Country	Spot	+3m	+6m	+12m
USD	2.18	2.35	2.55	2.80
EUR	0.68	0.75	0.90	1.25
GBP	1.08	1.20	1.35	1.65
DKK	0.92	1.00	1.15	1.50
SEK	1.01	0.95	0.90	1.40
NOK	1.82	1.95	2.15	2.55

Source: Danske Bank Markets

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What next?

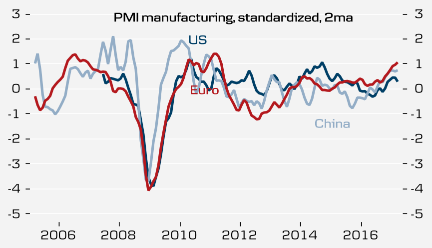
The question now is whether this bond rally will continue over the next three months or whether it was just a temporary correction.

We argue that yields have fallen to a new lower plateau and will stay there for the next three to six months with only small upside potential.

Basically, we see the recent correction lower in yields as fair. In our view, the ECB was never about to start hiking rates as early as December this year and with still muted core inflation the ECB will still be fighting a battle against low inflation throughout 2017. In our opinion, it is likely eurozone inflation peaked in February.

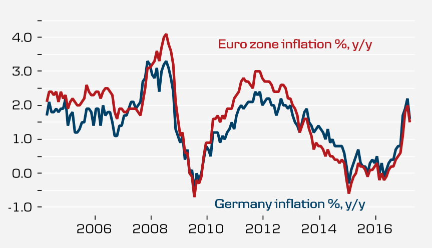
Furthermore, it seems that the global economy is about to slow. Currently, many manufacturing indicators are at, or close to, a record-high level. It is almost inevitable that indicators will now slow somewhat, our economists argue. We rarely see a major fixed income sell-off if growth indicators are easing, even if it is from a high level as the case is now.

Risk of PMIs edging lower



Source: Macrobond Financial

Inflation probably peaked in February



Source: Macrobond Financial

We don't think the fixed income rally will continue...

It also means that 10Y yields in particular could continue lower over the next two quarters. However, this is not our main scenario.

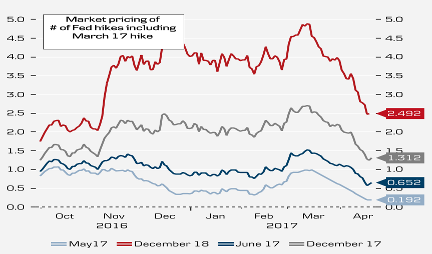
We continue to see two more rate hikes from the Fed in 2017 and on top of this we have the ongoing discussion regarding the Fed changing its reinvestment policy. We expect the latter to work as a tightening of monetary policy and to tend to push longer dated yields higher depending on whether the Fed decides to end reinvestments in mainly mortgage bonds or mainly Treasury bonds. For more, see *Fed's 'Quantitative Tightening': Fixed income implications*, published on 6 April. Compared with a month ago, our forecast of Fed hikes in both 2017 and 2018 is well above the market pricing.

The market is also now priced for a 'soft' ECB with the first rate hike not priced before the end of 2018. One of the factors that has particularly supported German bonds this year has been a strong demand from investors that need German bonds for collateral reasons. It seems that this demand has waned slightly and 2Y German bonds have moved marginally higher.

In *Yield Outlook: Bond sell-off set to pause before resuming in the autumn*, 17 March, we also pointed to positioning. A month ago many investors were positioned for a move higher in US yields in particular. According to positioning data, investors were caught on the wrong foot as yields started to move lower. It probably accelerated to move lower in yields.

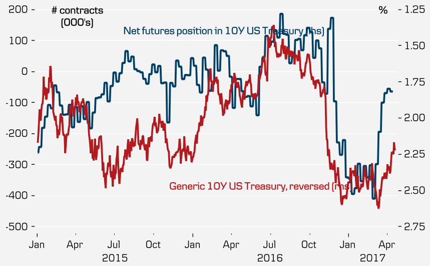
Positioning is now much more neutral. It means it is more difficult to push yields lower once more as 'short covering' will not help. However, there is now room for investors to position for a new move higher in yields.

Fed rate hike expectations have been scaled back in March and April



Source: Macrobond Financial

Market positioning is now more neutral...the market is no longer one-sided positioned for higher yields



Source: Macrobond Financial

...but it's hard to avoid higher yields in in 2018

Even though we are not calling for any significant further rise or drop in yields in 2017 we think the outlook is somewhat different if we look twelve months ahead and into 2018.

It is still our view that the Fed will hike rates two times in the 2nd part of 2017. On top of that a discussion regarding the Fed balance sheet may also start to dominate the agenda in Q1 next year. A stop to the reinvestments, could as mentioned before, be seen as negative for the bond market.

But market attention will certainly also be on the ECB. The market focus will be on whether the ECB will taper (scale down) its bond purchases or cease its purchases altogether. Remember, US Treasury yields rose significantly in 2013 when the Fed announced the tapering of its QE programme. The discussion of the timing of a possible first rate hike will probably also be lively when we look into Q2 2018.

European yield and rates expected higher on a 12M horizon

The pricing of or fear of ECB tapering and higher US yields are two of the reasons we continue to see a steeper 2Y-10Y EUR yield curve in 2018. The ECB still has a tight grip on the short-end of the curve but this is not the case for the 10Y segment. We expect higher 10Y EUR yields to materialise primarily on a 12M horizon, and target EUR swap rates at 1.25% and 10Y German yields at 0.80% on a 12M horizon.

We also still expect US yield movements to feed through into euro yields. We expect the Fed to hike two times more this year (July and December). All in all, our 12 month 10Y US Treasury yield target is 2.8%. In general we also see slightly higher US rates and yields on a 6 month horizon. In Europe it should be underlined higher yields and rates are mainly a 12 months story.

Contents and contributors

Eurozone forecasts

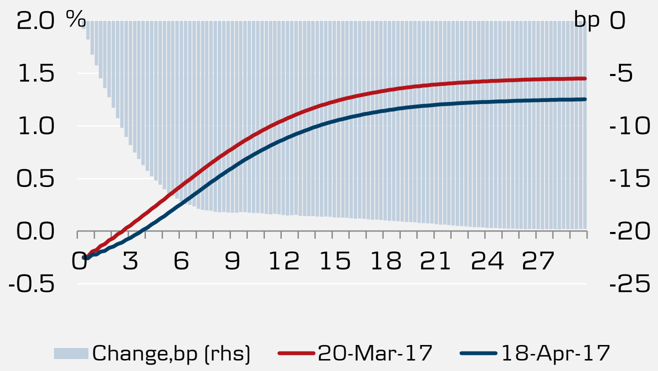
- The ECB has used the past month to quell any speculation that it (1) plans to hike rates before the QE programme has ended or (2) to taper the QE purchases early. Hence, the ECB still plans to continue QE purchases for the rest of 2017. We still think that the QE purchases will continue well into 2018 and after it has ended that any rate hikes will have a long time horizon.
- After the upside surprise in inflation in February, it fell back in March as the effect of higher oil prices fell out of the index and as especially vegetable prices fell back to a normal level. Core inflation still remains very subdued.
- We continue to expect a steeper EUR yield curve for the 2Y10Y in 2017. The ECB still has a tight grip on the short-end of the curve, especially as it is now buying below the depo rate at -0.4%. However, this is not the case for the 10Y segment of the curve, which we expect to be pushed up by higher US yields and a market slowly pricing in a greater probability of the ECB tapering QE purchases in 2018. This is mainly a theme on a 12M horizon.

EUR forecasts summary

18/04/2017	--- 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	-	-	-
3M	-0.33	-0.35	-0.35	-0.35	-3	-5	-10
				Government bonds			
2-year	-0.86	-0.80	-0.70	-0.60	-	-	-
5-year	-0.52	-0.50	-0.40	-0.20	-	-	-
10-year	0.18	0.25	0.40	0.80	-	-	-
				Swap rates			
2-year	-0.16	-0.10	-0.10	0.00	+3	-1	+1
5-year	0.12	0.10	0.20	0.40	-7	-2	+8
10-year	0.68	0.75	0.90	1.25	+2	+13	+38

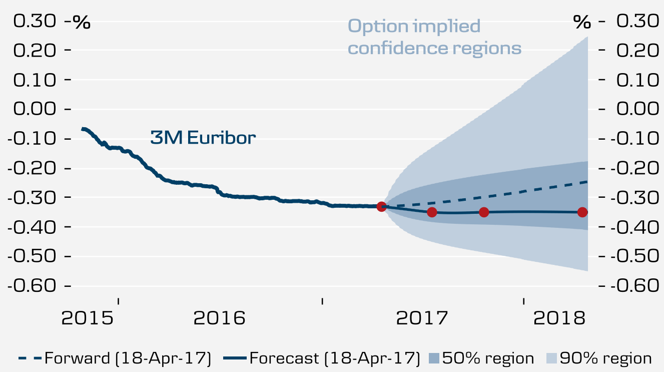
Source: Danske Bank Markets

EUR swap curve – One month change



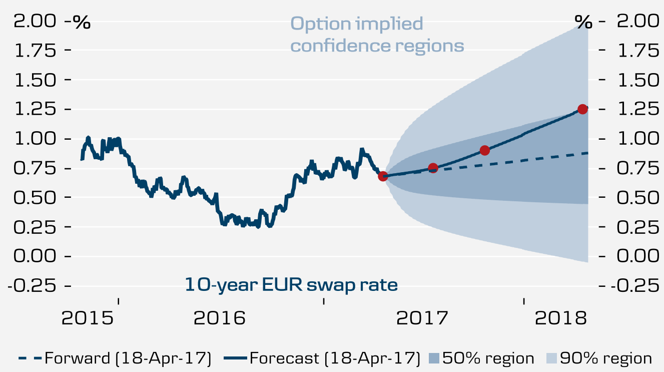
Source: Danske Bank Markets

3M Euribor



Source: Macrobond Financial, Danske Bank Markets

10Y EUR swap rates



Source: Macrobond Financial, Danske Bank Markets

US forecasts

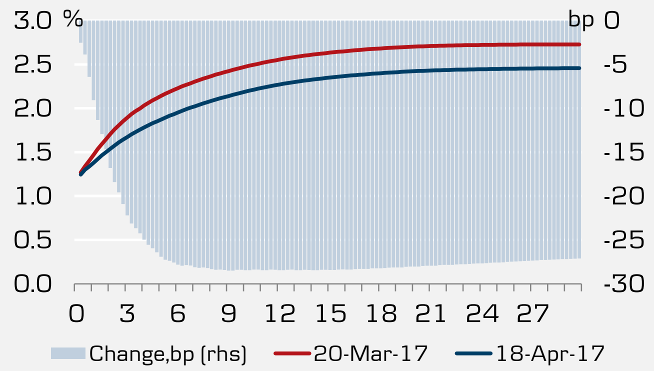
- Following the March hike of the Fed Funds rate to 1%, we expect the Fed to hike twice more this year (July and December) and three to four times next year. We expect the Fed to begin the reduction of its balance sheet in Q1 18. The FOMC is still waiting for more information about ‘Trumponomics’ and the previous FOMC meetings have revealed that ‘almost all’ FOMC members think there is upside risk to growth due to the expectations of more expansionary fiscal policy.
- US yields increased significantly in Q4 16, supported by better economic data and expectations of more expansionary fiscal policy. Recently, however, yields have edged lower again as the ‘Trumpflation’ theme seems to be running out of steam. The market seems to have become a bit impatient waiting to see how Trump will conduct fiscal policy during his term. The market has also started to be concerned about geopolitics and is starting to focus on the risk of key numbers coming out weaker going forward.
- Hence, we forecast that US yields will range-trade more or less for the next three to six months, before moving higher again on a 12-month horizon.

USD forecasts summary

18/04/2017	--- Forecast ---				--- Fcst vs Fwd in bp ---		
USD	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Fed Funds	1.00	1.00	1.25	1.75	-	-	-
3M	1.16	1.53	1.64	2.01	+22	+23	+47
				Government bonds			
2-year	1.18	1.30	1.50	1.90	-	-	-
5-year	1.74	1.90	2.10	2.40	-	-	-
10-year	2.22	2.40	2.60	2.80	-	-	-
				Swap rates			
2-year	1.50	1.60	1.75	2.15	+1	+9	+35
5-year	1.85	2.00	2.20	2.50	+9	+24	+44
10-year	2.18	2.35	2.55	2.80	+13	+29	+48

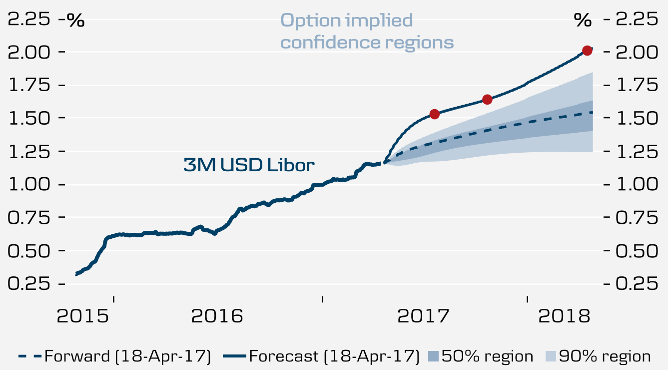
Source: Danske Bank Markets

USD swap curve – One month change



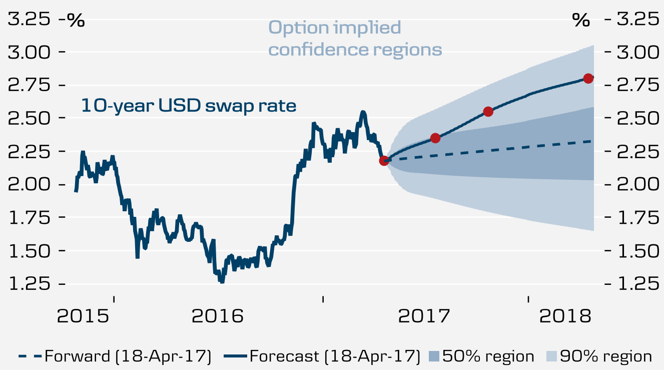
Source: Danske Bank Markets

3M USD Libor rates



Source: Macrobond Financial, Danske Bank Markets

10Y USD swap rates



Source: Macrobond Financial, Danske Bank Markets

UK forecasts

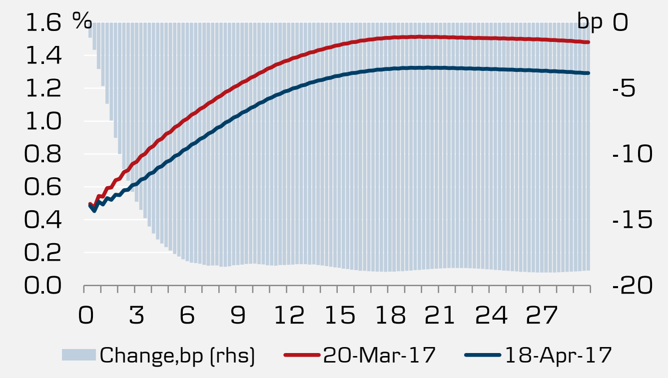
- Since our last update, the UK has finally triggered Article 50, meaning that the Brexit negotiations have finally begun. As the EU leaders are still discussing the EU's negotiation stance and since the real Brexit talks cannot start until after the German election in September anyway, PM Theresa May has called for a snap election on 8 June, see also *Brexit Monitor #28: Snap election increases number of uncertainty factors*, 18 April.
- The Bank of England maintained its neutral stance at the March monetary policy meeting and we still expect it to remain on hold for the next 12 months as (1) we think it is unlikely the BoE will tighten monetary policy at a time of elevated political uncertainty and (2) we think the BoE will continue to prioritise growth over high inflation. On the other hand, we also think we need to see substantially slower growth and/or higher unemployment before easing becomes likely again.
- In line with yields in both Europe and the US, UK gilt yields have moved lower recently, which our new forecasts reflect. We expect UK gilt yields to stay at current levels for now, before eventually moving higher in 6-12M, driven by higher yields in the US and Europe. We expect the 2Y10Y and 5Y10Y yield curves to steepen, as we expect the short end of the curve to stay low.

UK forecasts summary

18/04/2017	--- Forecast ---				--- Fcst vs Fwd in bp ---		
GBP	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Repo	0.25	0.25	0.25	0.25	-	-	-
3M	0.34	0.35	0.35	0.36	-2	-4	-8
				Government bonds			
2-year	0.12	0.15	0.15	0.20	+4	+1	-3
5-year	0.50	0.55	0.60	0.80	+3	+4	+13
10-year	1.04	1.15	1.30	1.60	+5	+16	+35
				Swap rates			
2-year	0.55	0.60	0.60	0.60	+2	-	-6
5-year	0.75	0.85	0.90	1.05	+7	+8	+16
10-year	1.08	1.20	1.35	1.65	+9	+21	+45

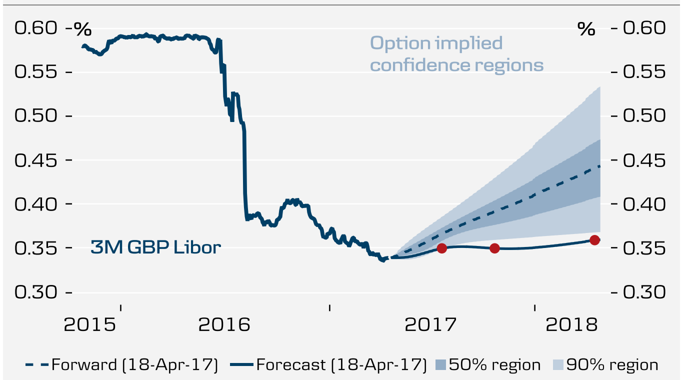
Source: Danske Bank Markets

UK swap curve – One month change



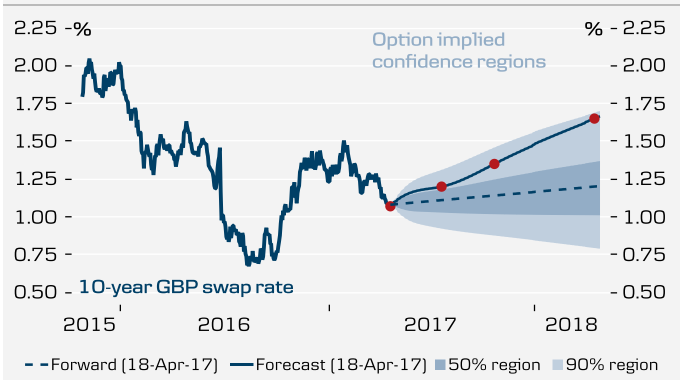
Source: Danske Bank Markets

3M GBP Libor rates



Source: Macrobond Financial, Danske Bank Markets

10Y UK swap rates



Source: Macrobond Financial, Danske Bank Markets

Denmark forecasts

- Danmarks Nationalbank (DN) sold DKK10.3bn in FX intervention in Q1 to keep the krone from appreciating. However, we expect it to keep the rate of interest on certificates of deposit (CD rate) unchanged at -0.65% throughout our forecast horizon. In May and June 2016, DN sold DKK50bn in FX intervention to fend off downward pressure on the DKK ahead of the UK referendum on EU membership, while it refrained from lowering its policy rates. In our view, this was a clear signal that FX intervention selling of DKK is the preferred instrument for DN to cap the EUR/DKK lower bound.

- Given that we expect the ECB to continue with its QE programme throughout 2017 and into 2018, we expect the pressure for the Danish central bank to intervene in the market to intensify in 2018. If political uncertainty escalates in the eurozone, e.g. if Marine le Pen wins the French Presidential election and then calls a French referendum on the euro, we believe it is very likely that we could see a strong inflow into DKK and Danish fixed income assets, leading to a significant tightening of the yield and rates spread to Germany and the EUR swap curve.

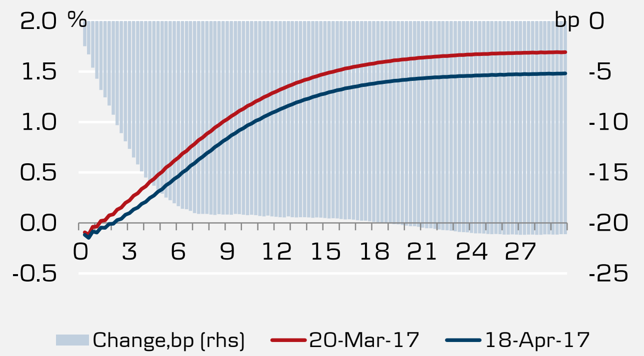
- We expect the bond yield spread to Germany and the DKK-EUR swap spread to stay at the current level or slightly tighter in our base scenario. Supply of Danish government bonds in 2017 might be revised lower by the Debt Management Office.

DKK forecasts summary

18/04/2017	--- 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	-0.27	-0.25	-0.25	-0.25	+1	-1	-9
6M	-0.12	-0.10	-0.10	-0.10	-1	-5	-13
				Government bonds			
2-year	-0.60	-0.55	-0.45	-0.35	-	-	-
5-year	-0.35	-0.30	-0.20	0.00	-	-	-
10-year	0.49	0.50	0.65	1.05	-	-	-
				Swap rates			
2-year	-0.01	0.05	0.05	0.15	+3	-2	-1
5-year	0.31	0.30	0.40	0.60	-6	-2	+6
10-year	0.92	1.00	1.15	1.50	+3	+13	+38

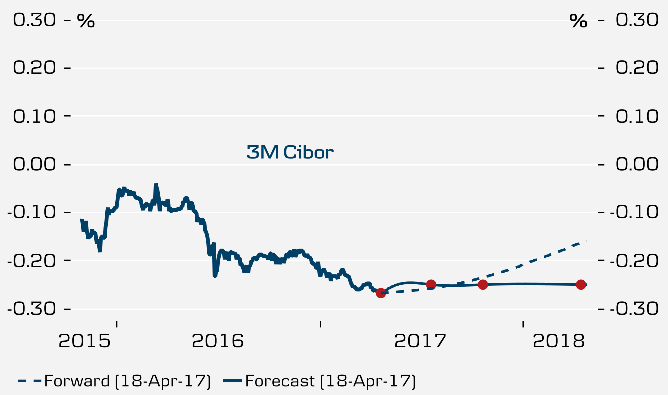
Source: Danske Bank Markets

DKK swap curve – One month change



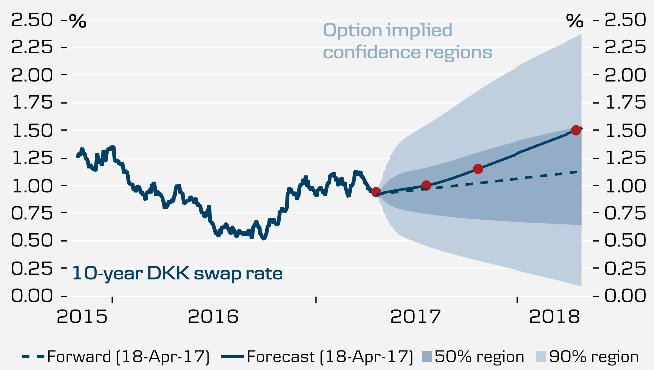
Source: Danske Bank Markets

3M Cibor rate



Source: Macrobond Financial, Danske Bank Markets

10Y DKK swap rates



Source: Macrobond Financial, Danske Bank Markets

Sweden forecasts

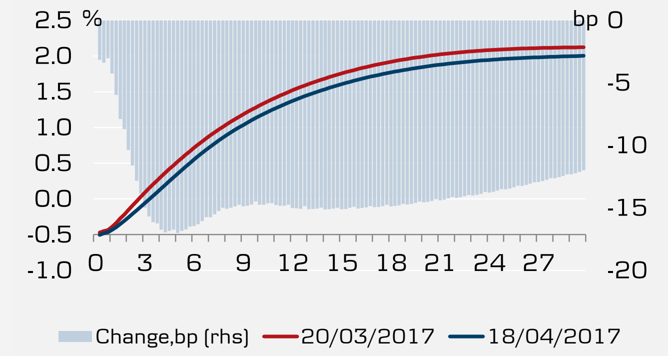
- Against the backdrop of the low 3Y wage deals, March inflation coming in well below forecasts and with worsening bond liquidity, we expect the Riksbank to quit QE while flattening the repo path to balance the risk of a too strong appreciation of the SEK.
- In addition to our view on the Riksbank, there are a few other factors ahead of us that are normally positive for Swedish bond yields: primarily, positive cash flow to investors and bond index duration extension. Over the past two years, amid Riksbank QE purchases, we have seen a seasonality in how Swedish bonds trade relative to Europe (Germany). For instance, the 10Y spread tightened by 20bp and 50bp in 2015 and 2016, respectively, between mid-May and mid-August.
- Current pricing in combination with our Riksbank's view and positive flows suggest that Swedish 5-10Y bond yields will outperform over the next few months.

SEK forecasts summary

18/04/2017		--- Forecast ---			--- Fcst vs Fwd in bp ---		
SEK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
			Money market				
Repo	-0.50	-0.50	-0.50	-0.50	-	-	-
3M	-0.47	-0.48	-0.48	-0.48	-1	-2	-18
			Government bonds				
2-year	-0.67	-0.72	-0.70	-0.65	-	-	-
5-year	-0.12	-0.22	-0.10	0.20	-	-	-
10-year	0.54	0.40	0.45	1.00	-	-	-
			Swap rates				
2-year	-0.32	-0.47	-0.45	-0.45	-22	-28	-47
5-year	0.23	0.18	0.25	0.55	-14	-16	-5
10-year	1.01	0.95	0.90	1.40	-13	-25	+11

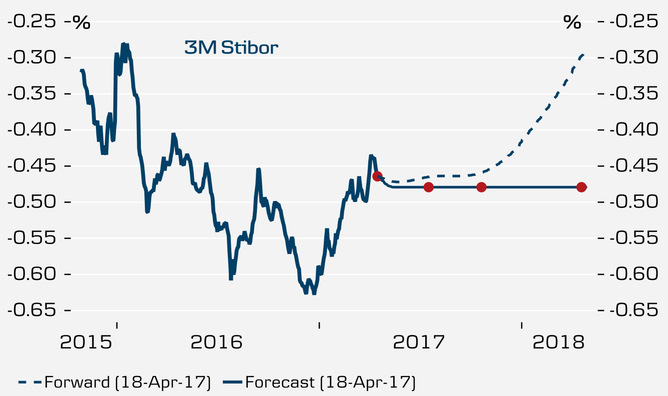
Source: Danske Bank Markets

SEK swap curve – One month change



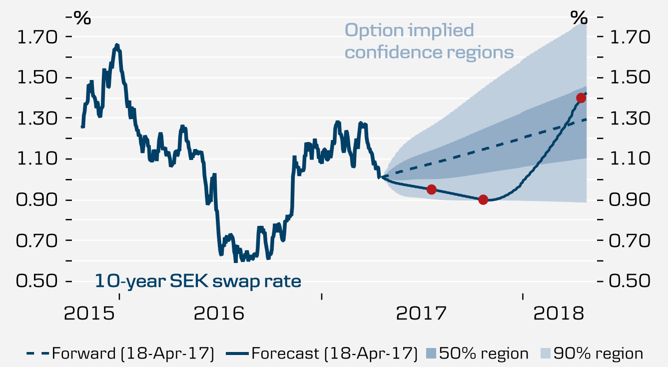
Source: Danske Bank Markets

3M Stibor rate



Source: Macrobond Financial, Danske Bank Markets

10Y SEK swap rates



Source: Macrobond Financial, Danske Bank Markets

Norway forecasts

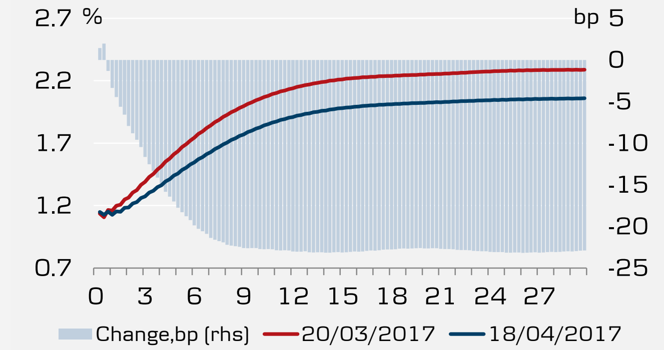
- At the recent policy meeting on 16 March, Norges Bank signalled no change in the target rate in 2017 from the present 0.50%. However, the bank's economic projections suggest a non-negligible probability of a cut, reflecting mainly the significant fall seen in core inflation over the past couple of months.
- The strong housing market, especially in the Oslo region, and the risk to long-term financial stability in the case of a bursting of a potential housing bubble, is the main reason for Norges Bank refraining from cutting the target rate. Recently introduced mortgage market regulations seem to be cooling the housing market somewhat already. We forecast unchanged central bank rates on a 12M horizon.
- There is an ongoing public and academic debate on the need for a revision of the current inflation target. Market effects of a potential reform will probably be muted by the fact that the market seems to be discounting moderate inflation already.
- We expect 5Y and 10Y yields to be stable versus peers in 2017, as the Norwegian economy is improving slowly but is still not out of the woods following the oil investment downturn. The positive outlook could trigger some inflows into the Norwegian government bond market and tighten the spread to Germany more than we forecast.

NOK forecasts summary

18/04/2017	--- Forecast ---				--- Fcst vs Fwd in bp ---		
NOK	Spot	+3m	+6m	+12m	+3m	+6m	+12m
				Money market			
Deposit	0.50	0.50	0.50	0.50	-	-	-
3M	1.02	0.90	0.90	0.90	-13	-18	-13
				Government bonds			
2-year	0.65	0.65	0.75	0.80	-	-	-
5-year	1.04	1.05	1.15	1.35	-	-	-
10-year	1.56	1.65	1.85	2.25	-	-	-
				Swap rates			
2-year	1.18	1.20	1.30	1.35	-	+7	+3
5-year	1.44	1.45	1.55	1.75	-3	+3	+14
10-year	1.82	1.95	2.15	2.55	+10	+27	+61

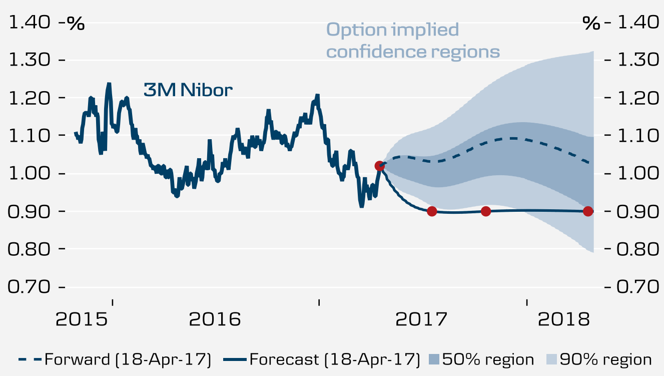
Source: Danske Bank Markets

NOK swap curve – One month change



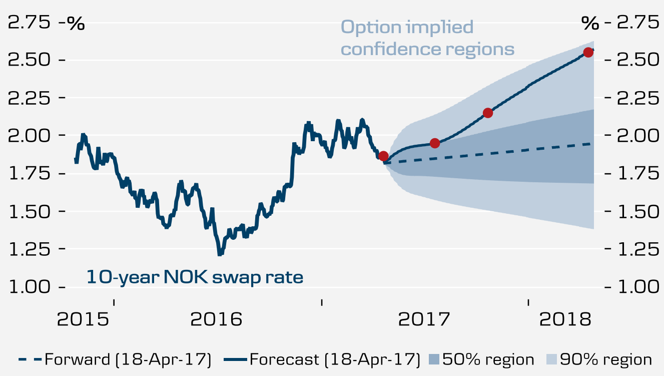
Source: Danske Bank Markets

3M Nibor rate



Source: Macrobond Financial, Danske Bank Markets

10Y NOK swap rates



Source: Macrobond Financial, Danske Bank Markets

Forecasts table

Forecast table

	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	1.00	1.16	1.50	1.85	2.18	1.18	1.74	2.22
	+3m	1.00	1.53	1.60	2.00	2.35	1.30	1.90	2.40
	+6m	1.25	1.64	1.75	2.20	2.55	1.50	2.10	2.60
	+12m	1.75	2.01	2.15	2.50	2.80	1.90	2.40	2.80
EUR*	Spot	0.00	-0.33	-0.16	0.12	0.68	-0.86	-0.52	0.18
	+3m	0.00	-0.35	-0.10	0.10	0.75	-0.80	-0.50	0.25
	+6m	0.00	-0.35	-0.10	0.20	0.90	-0.70	-0.40	0.40
	+12m	0.00	-0.35	0.00	0.40	1.25	-0.60	-0.20	0.80
GBP	Spot	0.25	0.34	0.55	0.75	1.08	0.12	0.50	1.04
	+3m	0.25	0.35	0.60	0.85	1.20	0.15	0.55	1.15
	+6m	0.25	0.35	0.60	0.90	1.35	0.15	0.60	1.30
	+12m	0.25	0.36	0.60	1.05	1.65	0.20	0.80	1.60
DKK	Spot	0.05	-0.27	-0.01	0.31	0.92	-0.60	-0.35	0.49
	+3m	0.05	-0.25	0.05	0.30	1.00	-0.55	-0.30	0.50
	+6m	0.05	-0.25	0.05	0.40	1.15	-0.45	-0.20	0.65
	+12m	0.05	-0.25	0.15	0.60	1.50	-0.35	0.00	1.05
SEK	Spot	-0.50	-0.47	-0.32	0.23	1.01	-0.67	-0.12	0.54
	+3m	-0.50	-0.48	-0.47	0.18	0.95	-0.72	-0.22	0.40
	+6m	-0.50	-0.48	-0.45	0.25	0.90	-0.70	-0.10	0.45
	+12m	-0.50	-0.48	-0.45	0.55	1.40	-0.65	0.20	1.00
NOK	Spot	0.50	1.02	1.18	1.44	1.82	0.65	1.04	1.56
	+3m	0.50	0.90	1.20	1.45	1.95	0.65	1.05	1.65
	+6m	0.50	0.90	1.30	1.55	2.15	0.75	1.15	1.85
	+12m	0.50	0.90	1.35	1.75	2.55	0.80	1.35	2.25

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

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This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The authors of the research report are Arne Lohmann Rasmussen, Chief Analyst, and Nina T. B. Andersen (Assistant Analyst).

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None

Date of first publication

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