15 August 2013

Yield Forecast Update

Central banks to keep rates low with data improving

Review

- Expectations of the Fed scaling down its asset purchases have been the main theme this summer and interest rates have increased significantly since the beginning of May.
- The recession in the euro area has ended after six consecutive quarters of negative growth. Economic indicators for the eurozone signal a continued improvement and positive growth in H2 '13. In the US macroeconomic indicators are expected to improve as well in H2 '13 and going into '14.
- Central banks will do their utmost to prevent interest rates from increasing too fast and effectively withdraw monetary stimulus prematurely. Hence, both the ECB and the BoE have introduced forward guidance to signal that policy rates will remain low.

International rates

- We have lifted our forecasts as rates generally have stabilised at higher levels. For now we think most of the increase is behind us and we expect rates in EUR and USD to be range-bound in the coming months, before resuming a gradual uptrend on a six to 12-month horizon. The forecasts are close to forwards across tenors and time horizons.
- The ECB has introduced a weak form of forward guidance as it has said that it expects rates to remain at current or lower levels for an extended period of time. Based on our forecast for inflation and the real economy, we expect this period to be two years or more and we forecast the ECB will keep rates at the current level at least until late 2015.
- We believe that the Federal Reserve will begin scaling down its QE programme in September and we believe this is priced with a high likelihood in the US rates markets. We do therefore not expect further major movements on a three-month horizon, before the uptrend continues as data improve.
- With the BoE forward guidance in place in the UK we expect the front end of the GBP curve to be firmly anchored. However, we expect the longer end of the curve to steepen gradually due to a combination of the recovery in the UK materialising and spill-over effects from the projected increases in US and EUR rates.

Scandi rates

- In Denmark we have added one more independent rate hike to our forecast period due to the improving risk picture and our outlook for the EUR money market to grind higher. We expect a 10bp hike from Nationalbanken within six months and another within 12 months. We expect the yield spread to Germany to remain broadly stable.
- A gradual recovery during H2 appears more and more likely in Sweden as suggested by the recent numbers. Thus we have no further rate cuts in our forecast and this is aligned with the pricing in the money market. We expect the longer Swedish rates to be somewhat higher with the belly (5Y) underperforming the most over the next 12 months.

Quick links

Eurozone forecast

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Forecast table

Policy rate outlook

Country	Spot	+3m	+6m	+12m
USD	0.25	0.25	0.25	0.25
EUR	0.50	0.50	0.50	0.50
GBP	0.50	0.50	0.50	0.50
DKK	0.20	0.20	0.30	0.40
SEK	1.00	1.00	1.00	1.00

Source: Danske Bank Markets

10-year bond yield outlook

Country	Spot	+3m	+6m	+12m
USD	2.71	2.70	2.90	3.10
DEM	1.82	1.80	2.00	2.10
GBP	2.65	2.70	2.80	3.00
DKK	1.96	1.95	2.15	2.25
SEK	2.32	2.40	2.45	2.55

Source: Danske Bank Markets

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Eurozone forecast

Growth and inflation

The recession in the euro area has ended after six consecutive quarters of negative growth. Soft indicators signal a continued improvement and composite PMI new orders in July points to positive growth in the euro area. PMI upward revisions from flash to final as well as PMI new orders are pointing towards further improvement in August. We expect the euro area to experience slow but increasing growth on our forecast horizon but the recovery is still challenged by e.g. a continued contraction in bank lending. We estimate average inflation to come down to 1.2% in 2014 from 1.4% in 2013. Hence inflation is expected to remain well below ECB's 2% target throughout the forecast period due to low wage pressure, declining oil prices, slowly increasing agricultural prices and a drop out of previous year's tax hikes.

Monetary policy and money markets

The ECB has introduced a weak form of forward guidance as it has said that it expects rates to remain at current or lower levels for an extended period of time. Based on our forecast for inflation and the real economy, we expect this period to be two years or more and we forecast the ECB will keep rates at current levels at least until late 2015. At the ECB meeting in August Draghi said the Governing Council sees current expectations of rate hikes in money markets as unwarranted, which seemed to be an attempt to talk rates down. Money market rates are expected to increase gradually as the liquidity in the euro system ticks down with the repayment of the LTROs. However, it will be a slow and gradual process where we see 3M EURIBOR increasing 20bp on a 12-month horizon, which is broadly in line with the forward markets.

Yield curve

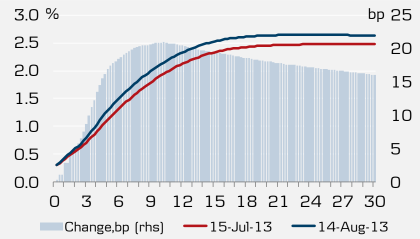
The spread between EUR rates and US rates is historically wide, so given our outlook for US rates we do not see a sharp increase in EUR rates either. We think Draghi would do what he can to anchor the short end of the curve but that the longer end of the curve would gradually increase, but not dramatically.. As this scenario is almost fully priced in the market, our forecast for the swap curve is close to the forward market, but somewhat above for the 30Y segment. We see room for steepening of the 5-30 slope.

Forecast summary

EUR	Spot	+3m	+6m	+12m
	Money market			
ECB	0.50	0.50	0.50	0.50
3M	0.23	0.25	0.30	0.45
	German government bonds			
2-year	0.21	0.20	0.30	0.40
5-year	0.78	0.75	0.90	1.15
10-year	1.82	1.80	2.00	2.10
	Swaprates			
2-year	0.61	0.60	0.70	0.80
5-year	1.29	1.25	1.40	1.65
10-year	2.12	2.10	2.30	2.40

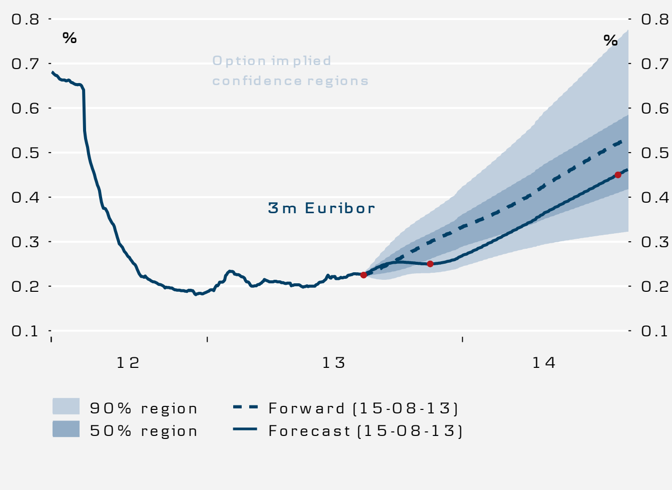
Source: Danske Bank Markets

EUR swap curve



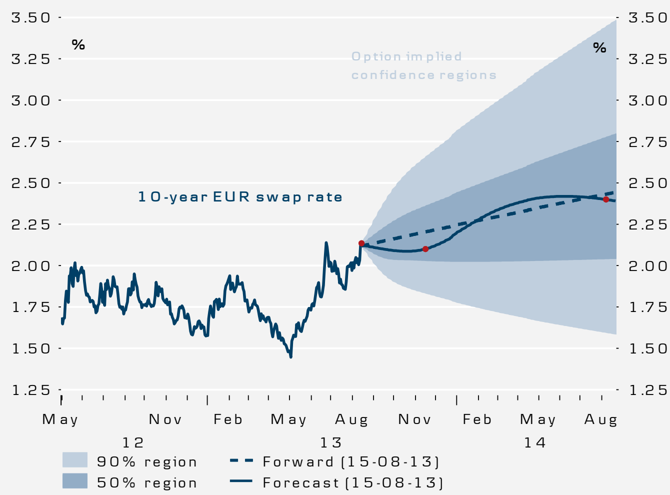
Source: Danske Bank Markets

3M Euribor



Source: Reuters EcoWin, Danske Bank Markets

10-year EUR swap rates



Source: Reuters EcoWin, Danske Bank Markets

US forecast

Growth and inflation

Fiscal tightening is biting on the economy and growth has been moderate in H1 this year. Despite this, the labour market is holding up and sentiment indicators have improved, with both the ISM manufacturing and ISM non-manufacturing suggesting better growth ahead. We expect the H1 weakness to prove temporary and believe the economy will finally be able to reach sustained growth above trend in H2 this year. Fiscal headwinds will ease significantly as we move towards year-end, fundamentals in the private sector have improved, the housing market remains a positive factor and business caution last year has left pent-up demand in investments. We expect the large slack in the labour market and favourable commodity price developments to keep inflation below 2% over the coming years.

Monetary policy and the money market

The big market theme this summer has been when and how Fed is scaling down its asset purchases of currently USD85bn/month. We continue to believe that the Federal Reserve will begin tapering in September and we believe this is priced with a high likelihood in the US rates markets. However, the slightly weaker-than-expected payrolls report for July and the slightly softer FOMC comments lately might provide some room for flexibility in terms of the timing of tapering. In terms of rate hikes, we still have the forward guidance in place. Several Fed comments have tried to guide the market not to price hikes to aggressively, stating that an unemployment rate of 6.5% is not a target but a threshold. We expect the first hike to materialise in the summer of 2015, which will prevent fixings from departing dramatically. We see only a small and gradual increase in USD fixings in the next 12 months.

Yield curve

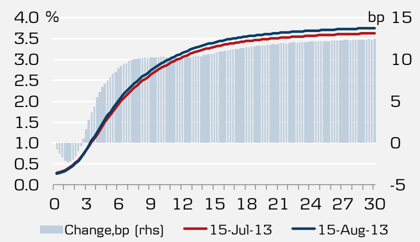
Since May there has been a sharp increase in US rates. As historical evidence suggests that the US bond market is usually relatively stable in the 6-12 months following a +100bp sell-off, we do not expect sharp increases 3-6 months ahead. Indeed, we believe the forward curve is already pricing most of the potential for higher rates and our forecasts are thus not that different. The 2-5 and 2-10 slopes of the swap curve are very steep and we see limited scope for further steepening in these spreads – it will probably require some form of re-pricing of the timing of the first Fed hike and the subsequent rate path.

Forecast summary

USD	Spot	+3m	+6m	+12m
		Money market		
FED	0.25	0.25	0.25	0.25
3M	0.26	0.30	0.35	0.40
		Government bonds		
2-year	0.33	0.35	0.55	0.80
5-year	1.47	1.50	1.75	2.10
10-year	2.71	2.70	2.90	3.10
		Swap rates		
2-year	0.51	0.50	0.70	0.95
5-year	1.64	1.70	1.95	2.30
10-year	2.88	2.90	3.10	3.30

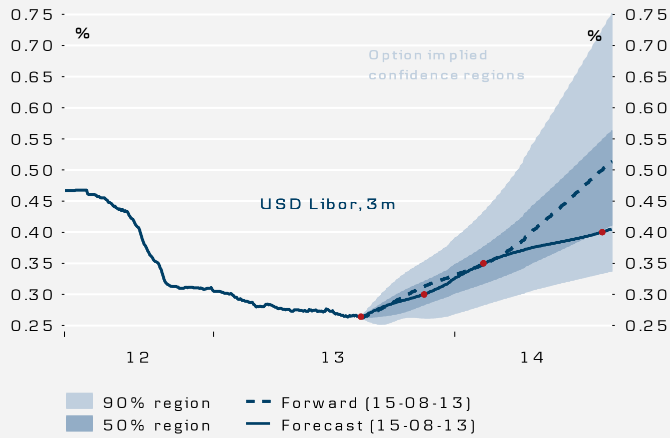
Source: Danske Bank Markets

USD swap curve



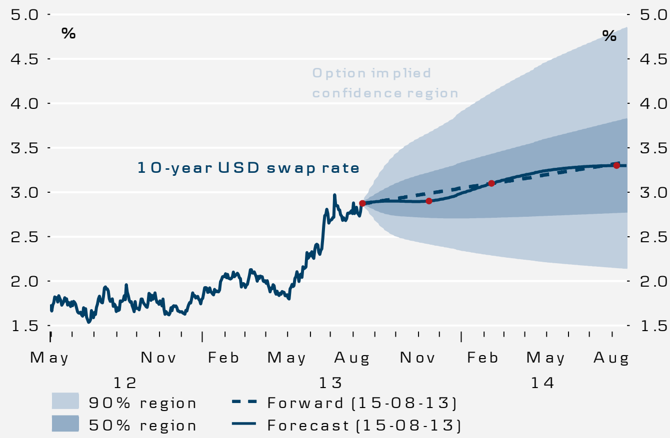
Source: Danske Bank Markets

3M USD Libor rates



Source: Reuters EcoWin, Danske Bank Markets

10-year USD swap rates



Source: Reuters EcoWin, Danske Bank Markets

UK forecast

Growth and inflation

A recovery seems to gain traction in the UK with Q2 GDP printing 0.6% q/q (1.0% y/y). Furthermore, the recent PMIs (Service, Manufacturing and Construction) have continued to improve and the forward-looking elements of the reports are close to the strongest levels seen in many years. Other data releases such as house prices, industrial production, retail sales and consumer confidence add to a recovery materializing, albeit from a low level. In light of this our headline GDP forecast is revised up and we expect GDP to grow 1.1% in 2013 and 2.0% in 2014.

CPI inflation is currently 2.9% and the Bank of England's (BoE) forecasts it to decline gradually towards the 2% target in two years' time.

Monetary policy and the money market

Mark Carney has laid out a rule-based forward guidance. It states that the Monetary Policy Committee (MPC) does not intend to raise the Bank Rate from its current level of 0.50% at least until the unemployment rate has fallen to a threshold of 7%, subject to three 'knockouts' based on the outlook for inflation, inflation expectations and financial stability. According to MPC's forecast this threshold would be reached around Q3 16 and consequently it is signalling that a tightening of monetary policy has long prospects. The main reason for the MPC introducing forward guidance today is not to provide additional monetary stimulus but rather an attempt to reduce uncertainty about the future path of monetary policy at a time when the economic recovery is gaining pace.

We believe that the forward guidance as well as the existing policy instruments in place (including the Funding for Lending) should prevent fixings to depart from current levels for several months ahead.

Yield curve

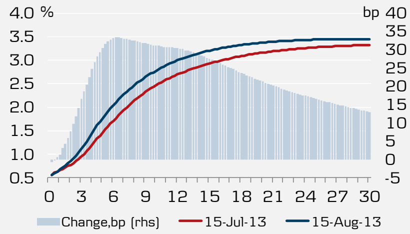
With MPC's forward guidance in place we should expect the front end of the GBP curve to be firmly anchored. However, we expect the longer end of the curve to steepen gradually due to a combination of the recovery in the UK materialising and spill-over effects from the projected increase in US and EUR rates over the forecast period. However, we do not expect a sharp increase in longer-end yields, as we already have seen a 100bp movement since rates troughed in May this year.

Forecast summary

GBP	Spot	+3m	+6m	+12m
		Money market		
Base rate	0.50	0.50	0.50	0.50
3M	0.51	0.50	0.55	0.70
		Government bonds		
2-year	0.45	0.50	0.60	0.70
5-year	1.58	1.70	1.80	2.00
10-year	2.65	2.70	2.80	3.00
		Swap rates		
2-year	0.82	0.85	1.00	1.15
5-year	1.72	1.85	2.00	2.20
10-year	2.75	2.80	2.90	3.10

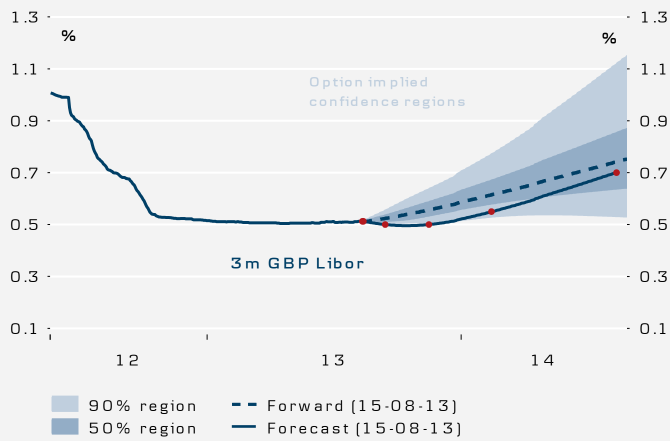
Source: Danske Bank Markets

GBP swap curve



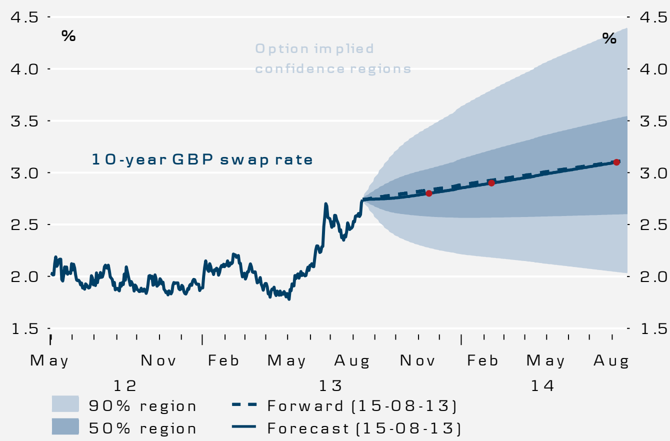
Source: Danske Bank Markets

3M GBP Libor rates



Source: Reuters EcoWin, Danske Bank Markets

10Y UK swap rates



Source: Reuters EcoWin, Danske Bank Markets

Denmark forecast

Growth and inflation

The economy is beginning to show signs of recovery. Over the summer, consumer activity has increased along with a marked rise in consumer sentiment and a turnaround in the housing market. Q2 data is likely to have been dragged down by a teacher labour dispute but the second half of 2013 might see a return to more normal GDP growth, especially as the main export markets in Europe are also looking better. However, we will probably have to wait until 2014 before employment starts to pick up. Inflation fell to 0.6% y/y in July, as taxes on soft drinks and beer were cut. The y/y inflation rate is weighed down by this and other tax cuts, lower fuel prices and other technical factors. As these effects fade, we expect a return to more normal inflation rates of 1.5-2.0% y/y in 2014. However, before this, we might see even lower rates and 2013 is on course to have the lowest inflation measured in 60 years.

Forecast summary

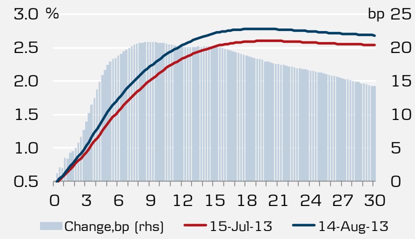
DKK	Spot	+3m	+6m	+12m
		Money market		
REPO	0.20	0.20	0.30	0.40
3M	0.27	0.30	0.40	0.55
		Government bonds		
2-year	0.49	0.50	0.60	0.70
5-year	1.20	1.15	1.30	1.55
10-year	1.96	1.95	2.15	2.25
		Swap rates		
2-year	0.82	0.80	0.90	1.00
5-year	1.54	1.50	1.65	1.90
10-year	2.35	2.30	2.50	2.60

Source: Danske Bank Markets

Monetary policy and money markets

EUR/DKK has been relatively stable around 7.455-7.460 over the course of the summer, just below the central rate. Danmarks Nationalbank (DN) has not needed to intervene in the FX markets to support DKK; hence, an independent Danish rate hike in the near term is not that likely. However, as the risk picture is improving and as we expect EUR money markets rates to grind higher eventually, we expect this to trigger a couple of independent Danish rate hikes over the next 6-12 months. Hence, we have added one more independent rate hike to our forecast since our previous forecast update (see *FX Forecast Update: Forward guidance to weigh on EUR, GBP*, 15 July). If ECB decides to cut the refinancing rate by a further 25bp later in the year, we expect DN to go along and cut the lending rate by 10bp to 0.10%. We expect Cibor fixings to inch higher over time and we expect the spread to Euribor to remain broadly stable. Our forecasts are slightly below the forward markets for tenors up to five years but slightly above for the very long tenors.

DKK swap curve

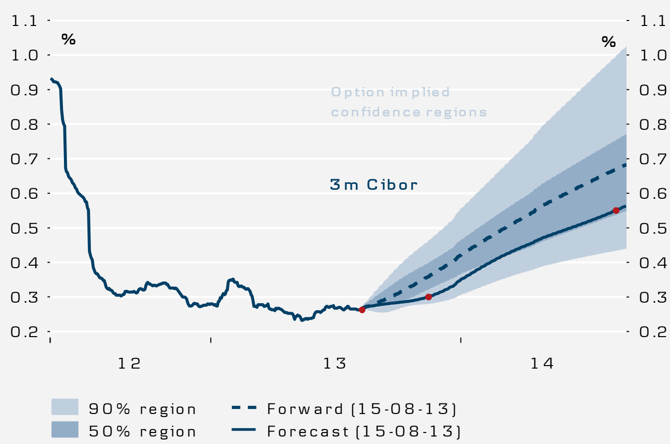


Source: Danske Bank Markets

Yield curve

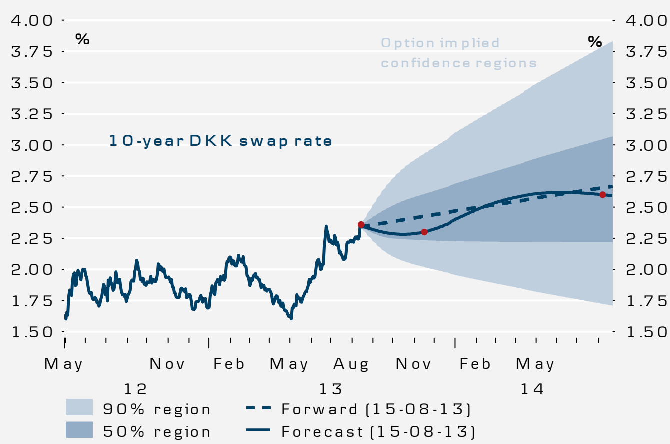
The spread between DKK and EUR swaps has been relatively stable over the past few months. Going forward, we expect Danish rates to track European rates.

3M Cibor rates



Source: Reuters EcoWin, Danske Bank Markets

10-year DKK swap rates



Source: Reuters EcoWin, Danske Bank Markets

Sweden forecast

Growth and inflation

Advanced estimates of Q2 GDP (-0.1% q/q, 0.6% y/y) were relatively soft. Export industries remain troubled by underperforming demand from European markets and in the meantime enterprises hold back on investments partially as a way to shelter earnings. Swedish manufacturing has performed more poorly recently compared with several European pears – not least Germany. This is unusual and a gradual recovery during H2 appears likely. Inflation troughed in April and we expect a further normalisation of inflation moving forward. The government is currently discussing the 2014 budget. More details will be available later this month but it is already apparent that additional tax cuts and other forms of fiscal stimulus are in the pipeline.

Monetary policy and the money market

Not much new can be said about monetary policy other than that the Riksbank's minutes seem to be about 10 pages shorter since former deputy governor Lars Svensson left. The latest (July) minutes basically reveal that a) had it not been for the concern about excessive household debt, the current inflation and unemployment outlook would in principal be arguments for lower rates but that b) house prices and household lending are both rising again and this is worrying. The gap between so-called doves and hawks seems somewhat narrower than before. Pricing in the money market has corrected. No further rate cuts are forecast. From December, the market (Stina swaps) has priced in a small but positive premium for tighter policy.

Yield curve

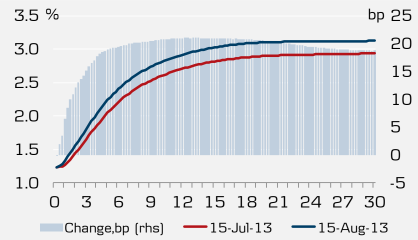
Since the (US-driven) early summer sell-off, Swedish rates have moved fairly much sideways with a *slight* tendency of a 2/10 year steepening. As mentioned, Swedish macro has been mixed recently and looking at surprise indices, Sweden is lagging behind both Euroland and the US. We do not think this will persist (Sweden should catch up) and we consequently expect somewhat higher rates with the belly (5Y) underperforming.

Forecast summary

SEK	Spot	+3m	+6m	+12m
		Money market		
Repo	1.00	1.00	1.00	1.00
3M	1.20	1.25	1.30	1.50
		Government bonds		
2-year	1.17	1.20	1.30	1.45
5-year	1.77	1.90	2.00	2.05
10-year	2.33	2.40	2.45	2.55
		Swap rates		
2-year	1.55	1.60	1.70	1.85
5-year	2.23	2.30	2.37	2.40
10-year	2.80	2.80	2.80	2.90

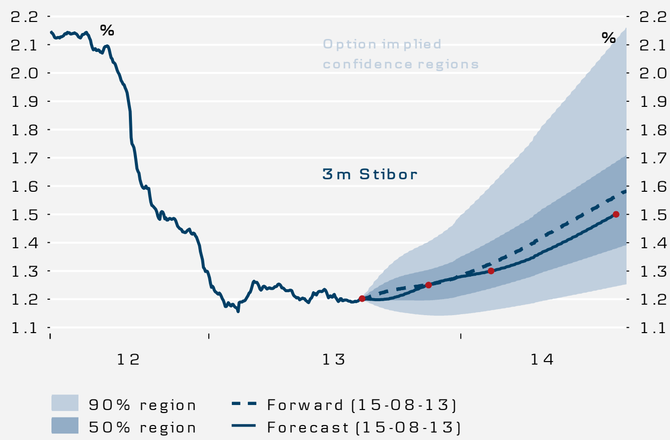
Source: Danske Bank Markets

SEK swap curve



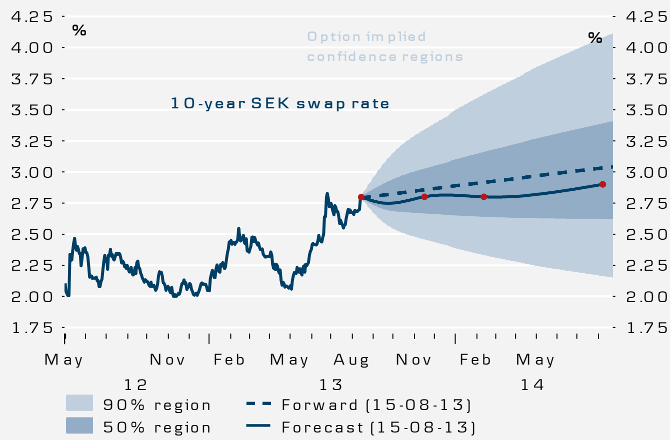
Source: Danske Bank Markets

3M Stibor rates



Source: Reuters EcoWin, Danske Bank Markets

10-year SEK swap rates



Source: Reuters EcoWin, Danske Bank Markets

Forecast 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	**0.25**	**0.26**	**0.51**	**1.64**	**2.88**	**0.33**	**1.47**	**2.71**
	+3m	0.25	0.30	0.50	1.70	2.90	0.35	1.50	2.70
	+6m	0.25	0.35	0.70	1.95	3.10	0.55	1.75	2.90
	+12m	0.25	0.40	0.95	2.30	3.30	0.80	2.10	3.10
EUR*	Spot	**0.50**	**0.23**	**0.61**	**1.29**	**2.12**	**0.21**	**0.78**	**1.82**
	+3m	0.50	0.25	0.60	1.25	2.10	0.20	0.75	1.80
	+6m	0.50	0.30	0.70	1.40	2.30	0.30	0.90	2.00
	+12m	0.50	0.45	0.80	1.65	2.40	0.40	1.15	2.10
GBP	Spot	**0.50**	**0.51**	**0.82**	**1.72**	**2.75**	**0.45**	**1.58**	**2.65**
	+3m	0.50	0.50	0.85	1.85	2.80	0.50	1.70	2.70
	+6m	0.50	0.55	1.00	2.00	2.90	0.60	1.80	2.80
	+12m	0.50	0.70	1.15	2.20	3.10	0.70	2.00	3.00
JPY	Spot	**0.10**	**0.16**	**0.26**	**0.43**	**0.93**	**0.11**	**0.28**	**0.75**
	+3m	0.10	0.20	0.25	0.45	0.95	0.10	0.30	0.80
	+6m	0.10	0.20	0.35	0.55	0.95	0.20	0.40	0.80
	+12m	0.10	0.20	0.45	0.65	1.05	0.30	0.50	0.90
CHF	Spot	**0.00**	**0.02**	**0.23**	**0.77**	**1.56**	**0.02**	**0.26**	**1.01**
	+3m	0.00	0.05	0.30	0.80	1.60	0.00	0.30	1.00
	+6m	0.00	0.05	0.30	0.85	1.60	0.00	0.35	1.00
	+12m	0.00	0.05	0.45	1.00	1.75	0.15	0.50	1.15
DKK	Spot	**0.20**	**0.27**	**0.82**	**1.54**	**2.35**	**0.49**	**1.20**	**1.96**
	+3m	0.20	0.30	0.80	1.50	2.30	0.50	1.15	1.95
	+6m	0.30	0.40	0.90	1.65	2.50	0.60	1.30	2.15
	+12m	0.40	0.55	1.00	1.90	2.60	0.70	1.55	2.25
SEK	Spot	**1.00**	**1.20**	**1.55**	**2.23**	**2.80**	**1.17**	**1.77**	**2.32**
	+3m	1.00	1.25	1.60	2.30	2.80	1.20	1.90	2.40
	+6m	1.00	1.30	1.70	2.37	2.80	1.30	2.00	2.45
	+12m	1.00	1.50	1.85	2.40	2.90	1.45	2.05	2.55

Note: * German government bonds are used, EUR swap rates are used

Source: Danske Bank Markets

Disclosures

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 Peter Possing Andersen (Senior Analyst), Lars Tranberg Rasmussen (Senior Analyst) and Anders Vestergård Fischer (Analyst).

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