15 October 2013

Yield Forecast Update

Long-end EUR rates to move higher on stronger recovery

Review

- The Federal Reserve surprised the markets by deciding not to start scaling down its asset purchases at the September meeting. The decision reflects more mixed data, tighter conditions for house owners and the risk of political gridlock.
- Especially the latter factor has proven relevant since the US government shutdown has materialised and the debt ceiling has still not been lifted.
- The Fed's decision to postpone normalisation brought relief in global bond markets and core rates have in general declined over the past month in response to this.
- In Europe, news flow has been more positive and data continues to improve gradually. For Italy, it is in particular positive that it now appears to be 'game over' for Silvio Berlusconi. This should reduce political uncertainty and add to growth prospects.

International rates

- Given our positive outlook for the global economy going in to 2014, we continue to believe that long-end rates will move higher over the next year. The potential is biggest in Europe, where the very long end is still at low levels in an historical context. In the US, the long end is closer to fair levels and the near-term outlook is more uncertain.
- We have kept forecasts broadly unchanged since the previous update, which implies that they are above forward markets for tenors of 5Y and above on all forecasting horizons.
- We continue to expect the short end of the curve to remain more anchored, as we expect the central banks to keep policy rates low for a prolonged period. In particular, the ECB has enforced its communication on keeping money markets stable as the recovery gradually strengthens. Hence, the forecasts for 2Y segment is broadly in line with the forward markets.

Scandi rates

- We are likely to have to see a further increase in EONIA rates before Danmarks Nationalbank will have to raise interest rates unilaterally and we do not expect that to happen before next spring. Hence, we maintain our current forecast and expect DN to increase interest rates by 10bp once on a 6M horizon and once more on a 12M horizon, which is less than discounted by the markets.
- For Sweden, we stick to our view that the Riksbank is likely to start hiking in September or October 2014, well ahead of both the Fed and the ECB.

Quick links

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	1.25
NOK	1.50	1.50	1.50	1.75

Source: Danske Bank Markets

10-year bond yield outlook

Country	Spot	+3m	+6m	+12m
USD	2.69	2.90	3.10	3.25
DEM	1.89	2.15	2.35	2.55
GBP	2.79	3.00	3.10	3.20
DKK	2.03	2.30	2.50	2.70
SEK	2.53	2.65	2.90	3.10
NOK	3.01	2.95	3.15	3.50

Source: Danske Bank Markets

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Eurozone forecast

Growth and inflation

As a result of better than expected Q2 growth and upward revisions to Q1, we have lifted our official forecast for GDP growth to -0.4% this year. Euro area sentiment data continue to improve, although a setback in some indicators in September underlines the fragility of the recovery. Next year, we expect euro area GDP growth to reach 1.3%. Credit conditions remain tight and this is one of the key risks for the euro area recovery. Sovereign spreads have continued to tighten on the back of a decline in political risk, which is positive for southern Europe. However, Portugal and Greece are both likely to need more financial assistance in 2014 and debt relief for Greece is also likely to become a theme. While this could create some noise, we are confident that solutions will be reached. Inflation has declined to 1.3% and we expect it to remain low for a prolonged period.

Monetary policy and money markets

The ECB continues to have an easing bias. It sees the economy improving in line with expectations but also notes that risks are skewed on the downside. We expect the ECB to react when further declines in excess liquidity push short market rates up. The most likely response seems to be a new three-year LTRO, although its efficiency is questionable. The ECB has other alternatives such as reducing minimum reserve requirements. A new rate cut seems less likely. We expect the ECB to keep rates on hold until the second half of 2015. We expect money market fixings to remain stable throughout the year but believe they could move higher next year – particularly if the liquidity situation tightens.

Yield curve

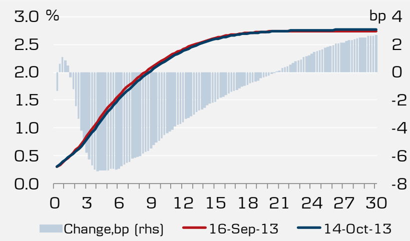
EUR swap rates have moved lower since last forecast update. This has been due mostly to the impact of a correction in US rates. There is now limited downside to the EUR rate and we expect the upward trend to resume as soon as a political solution is reached in the US. We expect the curve to steepen, with long-term growth and inflation expectations recovering on the back of less political risk and a return to positive growth rates. We expect the front end of the EUR curve (i.e. tenor below two years) to remain anchored by the ECB commitment to keep financial conditions supportive. We have not changed our forecast since last month and continue to see a gradual uptrend in rates over the coming year. The forecast for the 5-30Y segment of the curve is above the forward market, while we expect the short-end rates to track market expectations more closely.

Forecast summary

EUR	Spot	+3m	+6m	+12m
	Money market			
ECB	0.50	0.50	0.50	0.50
3M	0.23	0.25	0.35	0.50
	German government bonds			
2-year	0.19	0.30	0.40	0.50
5-year	0.87	1.10	1.30	1.50
10-year	1.89	2.15	2.35	2.55
	Swaprates			
2-year	0.58	0.70	0.80	0.90
5-year	1.29	1.50	1.70	1.90
10-year	2.16	2.40	2.60	2.80

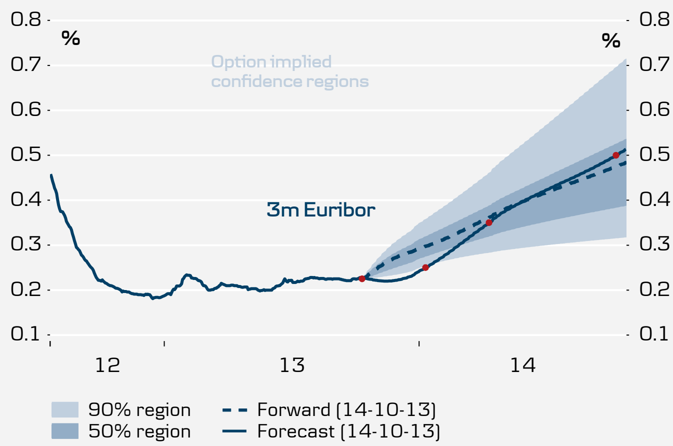
Source: Danske Bank Markets

EUR swap curve



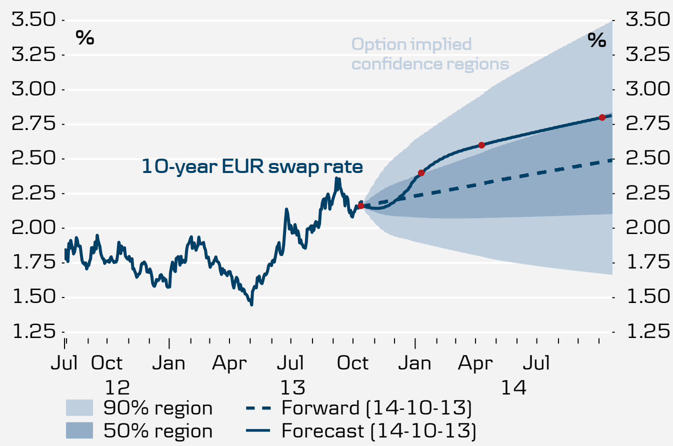
Source: Danske Bank Markets

3M Euribor



Source: Reuters EcoWin, Danske Bank Markets

10-year EUR swap rates



Source: Reuters EcoWin, Danske Bank Markets

US forecast

Growth and inflation

After a period of sluggish growth, both the ISM manufacturing and ISM non-manufacturing suggest better growth ahead. This is in line with our long-held view that the economy will finally be able to reach sustained growth above trend in H2 13. We believe US will raise the debt ceiling in a last minute agreement and fiscal headwinds will ease significantly as we move towards year-end. Fundamentals in the private sector have also improved, the housing market remains a positive factor and business caution last year has left pent-up demand in investments. We expect the slack in the labour market and positive supply factors in oil markets to keep inflation subdued.

Monetary policy and the money market

We expect the Fed to start tapering asset purchases at the December meeting as employment data are expected to improve and consumption and investment growth picks up. We expect the first hike to materialise in the summer of 2015 and the Fed to start a very gradual path of increasing rates thereafter. The market is pricing a first Fed funds hike to 0.5% by August 2015. This is reasonably close to our expectation but leaves some upside to money market rates further out on the curve in a positive growth scenario. Fixing will remain stable throughout the year but is expected to start grinding higher during next year.

Yield curve

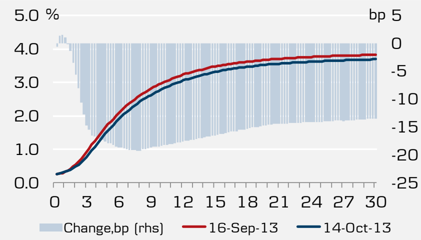
The decision by the Fed to postpone tapering followed by the current gridlock in the US Congress over the debt ceiling have pushed rates lower. We expect this to be temporary and look for a moderate jump in rates when the political situation in Washington is resolved later this month. The long-term trend remains for higher US rates as the Federal Reserve is expected to soon start tapering down asset purchases and rate hikes move closer. That said, the pace of the increase in market rates is likely to be much more gradual during the coming year than seen over the past six months. We have adjusted our three-month forecast across tenors slightly lower to accommodate for the postponement of Fed tapering. However, the longer forecasts are left unchanged from the last update. On tenors of five years or longer, our rate forecast is now above the forward market.

Forecast summary

USD	Spot	+3m	+6m	+12m
		Money market		
FED	0.25	0.25	0.25	0.25
3M	0.25	0.30	0.35	0.50
		Government bonds		
2-year	0.35	0.50	0.75	1.20
5-year	1.42	1.70	2.00	2.30
10-year	2.69	2.90	3.10	3.25
		Swap rates		
2-year	0.48	0.65	0.90	1.35
5-year	1.56	1.85	2.20	2.50
10-year	2.79	3.05	3.30	3.45

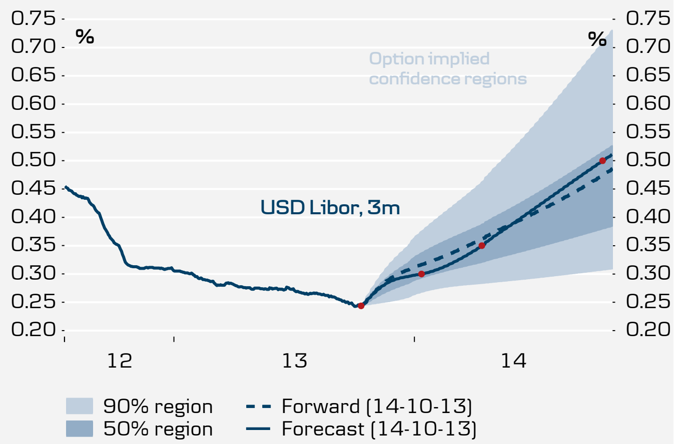
Source: Danske Bank Markets

USD swap curve



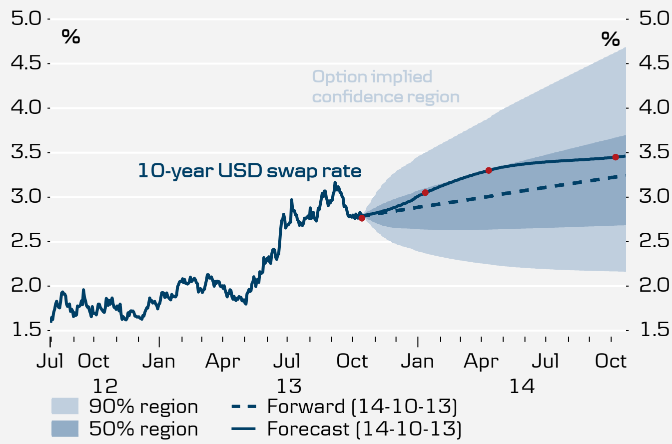
Source: Danske Bank Markets

3M USD Libor rates



Source: Reuters EcoWin, Danske Bank Markets

10-year USD swap rates



Source: Reuters EcoWin, Danske Bank Markets

UK forecasts

Growth and inflation

Confidence is returning to the UK economy. GDP increased by 0.7% q/q in Q2 and the strength of the main survey indicators in August and September suggests accelerating growth in the short term. In light of this we expect GDP to grow 1.3% in 2013 and 2.1% in 2014. This is also confirmed in the newly published IMF World Economic Outlook, where the UK had the highest growth upgrade of any country in the report. The signs of improvement in activity are indeed good news but challenges still persist in the UK economy. Imbalances in the public budget, weak growth in real disposable income posing a substantial headwind for consumer spending and relatively modest prospects for export growth suggest that the UK still has some way to go before reaching 'escape velocity' in the medium term.

CPI inflation is currently 2.8% and Bank of England (BoE) forecasts it to decline gradually towards the 2% target in two years' time.

Monetary policy and the money market

The rule-based forward guidance for conducting monetary policy has clarified the Monetary Policy Committee's (MPC) reaction function. The MPC said it would not consider tightening policy – neither raising the Bank Rate nor unwinding the QE programme – at least until the unemployment rate has fallen to 7% (currently 7.7%), subject to some inflation and financial stability 'knock outs'. Whereas the MPC projects this threshold not to be reached before end 2016, financial markets are pricing in the first hike in summer 2015. Although the strength of the recovery and the prospects for the labour market remain uncertain, we believe that the forward guidance as well as the existing policy instruments in place (including the Funding for Lending Scheme) should prevent fixings to depart from current levels for several months ahead.

Yield curve

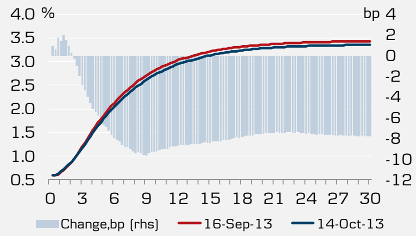
For the past month GBP rates have gone down due to spill-over effects from the US and the postponed Fed tapering and uncertainty surrounding the US budget. With MPC's forward guidance in place we should expect the front end of the GBP curve to be firmly anchored but longer tenors are set to rise further over the coming year. Our forecast is close to forward on shorter tenors and slightly above in the 10Y segment in line with our EUR and USD forecast.

Forecast table

GBP	Spot	+3m	+6m	+12m
		Money market		
Base rate	0.50	0.50	0.50	0.50
3M	0.52	0.55	0.60	0.70
		Government bonds		
2-year	0.50	0.50	0.60	0.90
5-year	1.62	1.70	1.90	2.20
10-year	2.81	3.00	3.10	3.20
		Swap rates		
2-year	0.87	0.90	1.00	1.30
5-year	1.78	1.80	2.00	2.30
10-year	2.73	2.95	3.05	3.15

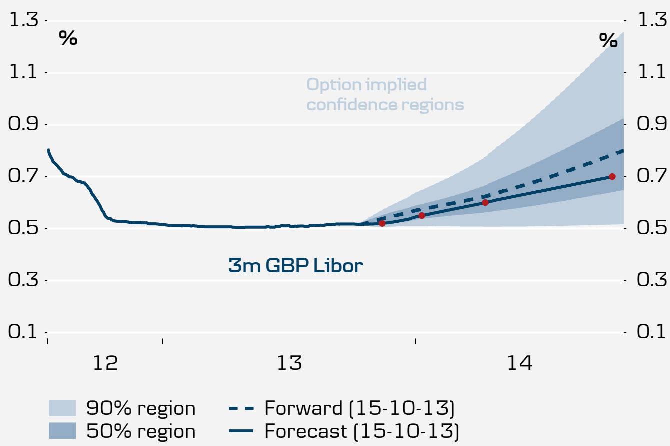
Source: Danske Bank Markets

GBP swap curve



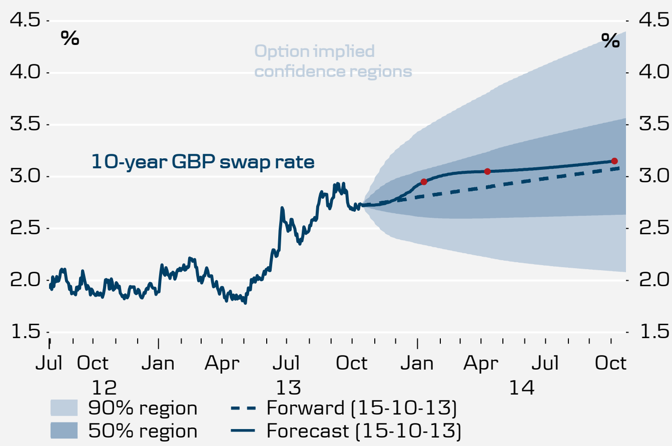
Source: Danske Bank Markets

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 Danish economy looks set to continue the pace of economic expansion seen in the second quarter (0.6% q/q). Consumer confidence remains high, which should translate into higher private consumption over the coming months and exports are currently benefiting from the recent pickup in demand from neighbouring markets Germany, Sweden and the UK. Inflation has likely bottomed out and we expect to see it gradually increasing towards a 1.5-2% y/y level next year. Despite the increasing economic activity the Danish current account (CA) surplus is currently at record high (6% of GDP). We expect the surplus to remain high despite an improving economic outlook.

Monetary policy and money markets

The external surplus adds support to DKK and effectively keeps the bar high for how much outflow is allowed without putting pressure on DKK. On the other hand, there is currently a negative carry on short EUR/DKK positions, which tends to put pressure on DKK and we have seen EUR/DKK move close to the central rate of 7.46038 since the beginning of October. We have not seen any intervention from Danmarks Nationalbank (DN) since January, when it unilaterally increased interest rates, so we do not expect DN to independently increase rates in the near future. We will likely have to see a further increase in EONIA rates before DN will have to raise interest rates unilaterally and we do not expect that to happen before next spring. Hence we maintain our current forecast and expect DN to increase interest rates by 10bp once on a 6M horizon and once more on a 12M horizon, which is less than discounted by the markets. Hence our forecast for the Cibor fixings is below the forward markets.

Yield curve

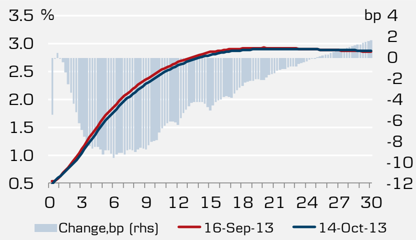
DKK swap rates have moved lower over the past month in line with EUR swap rates. Swap spreads versus EUR are still in the high end compared to the past couple of years, which reflects less demand for safe-haven assets and a higher fixing spread versus EUR in the money market. While we see low risk of further spread widening over the coming quarters, we do not expect a narrowing again given our constructive view on the eurozone. One risk factor though, for spreads to widen further are the upcoming refinancing auctions of adjustable rate mortgages. On an absolute basis we believe there is limited downside to DKK rates and we expect the upward trend to resume, as soon as a political solution in the US has been reached. The forecast for 5-30yr segment of the curve is above the forward market.

Forecast summary

DKK	Spot	+3m	+6m	+12m
		Money market		
REPO	0.20	0.20	0.30	0.40
3M	0.28	0.30	0.45	0.60
		Government bonds		
2-year	0.47	0.60	0.70	0.80
5-year	1.21	1.50	1.70	1.90
10-year	2.03	2.30	2.50	2.70
		Swap rates		
2-year	0.81	0.95	1.05	1.15
5-year	1.56	1.80	2.00	2.20
10-year	2.40	2.65	2.85	3.05

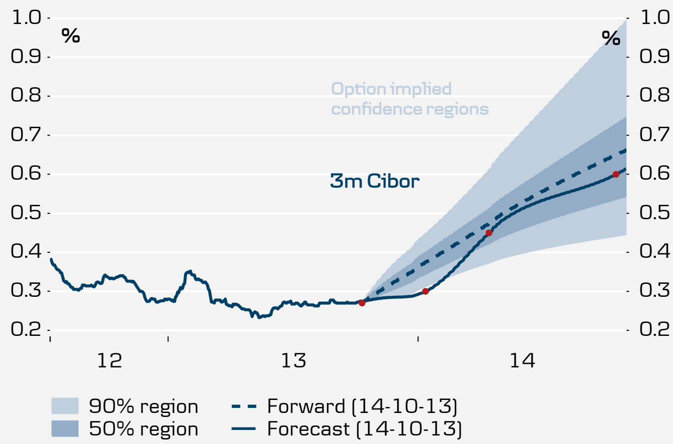
Source: Danske Bank Markets

DKK swap curve



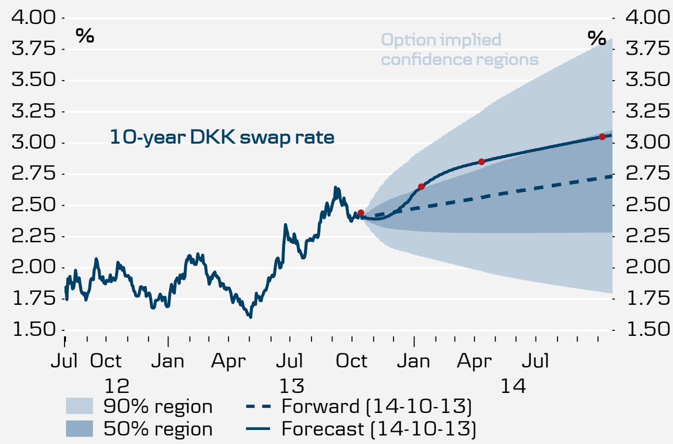
Source: Danske Bank Markets

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

Swedish manufacturing and export data remain mixed. There is a clear improvement in survey data such as PMI, NIER confidence and export managers' expectations but lagging hard data has as yet failed to confirm the 'catch-up' we expect. Short term, we do not rule out a relapse into renewed weakness in confidence due to the US budget debacle. The short-term outlook is simply dimmed by multiple possible outcomes. The longer term outlook, however, is supported by several signs of an improving labour market and a turnaround in the domestic services sector. This should prove favourable for government finances. Inflation is rising but from subdued levels. Household credit growth is slowly accelerating again putting pressure on the debt ratio as well as property prices. Aside from global short-term risks, the Swedish macro outlook is improving, albeit at a very slow pace.

Monetary policy and the money market

The Riksbank's recent policy announcement (September) did not bring about any changes of relevance compared with the July announcement. The repo rate is seen on hold until late 2014. Lately, money market rates have been trading lower again. Initially, sentiment about Riksbank rate hikes was affected by the Fed's decision not to start tapering in September and ECB Governor Mario Draghi's comment that the rise in Euribor rates was unwarranted. Later, the Riksbank's Per Jansson (considered hawkish) suggested too much was priced into the short end of the Swedish curve relative to the Riksbank's forecast. We stick to our view that the Riksbank is likely to start hiking in September or October 2014, well ahead of both the Fed and the ECB.

Yield curve

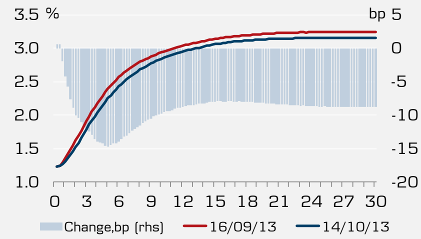
The spreads between Swedish and German 5- and 10-year bonds are at the highest level in 10 years, around 100bp and 65bp respectively. Foreign ownership of SGBs has fallen slightly from a peak of 58% in mid-2012 to 53% currently. As Swedish government finances are in excellent shape, there is an increased probability of a revival of moderate 'safe haven' flows into Swedish government bonds if the US budget debacle lingers on, there is great uncertainty about the state of the US economic recovery and depending on the Fed's response in terms of QE tapering.

Forecast summary

SEK	Spot	+3m	+6m	+12m
		Money market		
Repo	1.00	1.00	1.00	1.25
3M	1.21	1.25	1.30	1.55
		Government bonds		
2-year	1.09	1.15	1.40	1.70
5-year	1.87	1.90	2.30	2.50
10-year	2.53	2.65	2.90	3.10
		Swap rates		
2-year	1.52	1.55	1.80	2.10
5-year	2.25	2.30	2.70	2.90
10-year	2.84	3.00	3.20	3.40

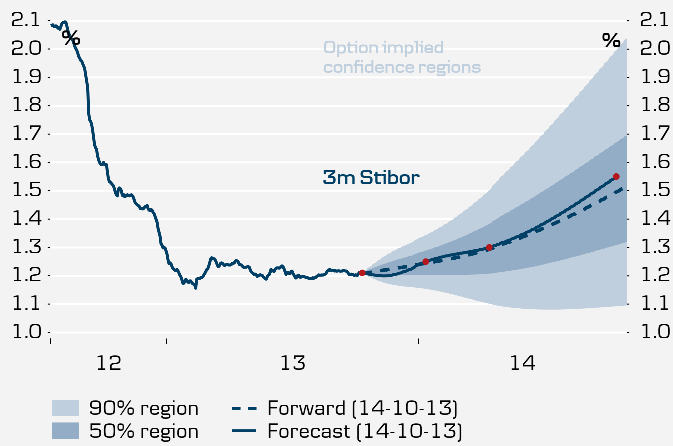
Source: Danske Bank Markets

SEK swap curve



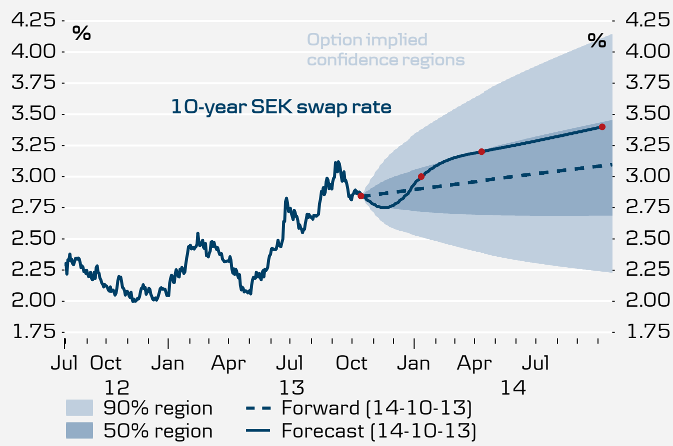
Source: Danske Bank Markets

3M Stibor rates



Source: Reuters EcoWin, Danske Bank Markets

10-year SEK swap rates



Source: Reuters EcoWin, Danske Bank Markets

Norway forecast

Growth and inflation

The growth outlook for Norway has become gradually more subdued over the past half year. The official growth rate for the Norwegian mainland economy came in at a moderate 0.2% for Q2 (q/q growth, seasonally adjusted), which was significantly below expectations of 0.7%. Unemployment appears to have stabilised at a benign level; the survey numbers were slightly higher at 3.6% for July, whereas the official unemployment figure for September was 2.6% – slightly lower than the previous reading.

Inflation has been a big topic in the Norwegian economy this year after it increased from 1.4% in early summer to 2.5% in August. The September figure surprised on the downside at 1.7%. The fluctuations appear to be influenced by a weaker krone (which leads to imported inflation) and seasonal variations. Even accounting for this, it appears that inflation is picking up slightly. This observation is slightly at odds with the softer economic data we observe.

Forecast summary

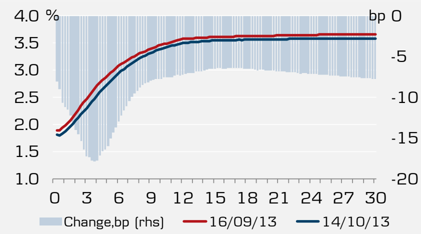
NOK	Spot	+3m	+6m	+12m
		Money market		
ON DEP	1.50	1.50	1.50	1.75
3M	1.69	1.85	1.90	2.05
		Government bonds		
2-year	1.71	1.70	1.85	2.20
5-year	2.22	2.30	2.45	2.90
10-year	3.01	2.95	3.15	3.50
		Swap rates		
2-year	2.07	2.25	2.40	2.75
5-year	2.76	2.95	3.10	3.40
10-year	3.40	3.60	3.70	4.00

Source: Danske Bank Markets

Monetary policy and the money market

In the latest Monetary Policy Report (MPR.3.13) published on 19 June, Norges Bank decided on an upward revision of the rate path from 1.38% to 1.5% for Q4 13 and pushed forward the expected time for a rate hike to the summer of 2014. This was, however, less hawkish than the market expected and rates and the krone sold off as a consequence. Compared with the assumptions put forward in MPR.3.13, the exchange rate is considerably weaker and inflation came considerably lower than Norges Bank anticipated. These two factors have an opposite effect on the rate and we consider them to be a wash. Hence, we see no reason to expect a revised rate path, which is again broadly in line with market pricing.

NOK swap curve

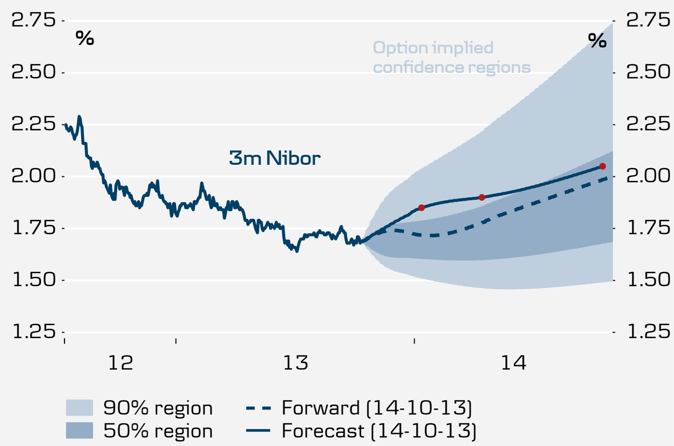


Source: Danske Bank Markets

Yield curve

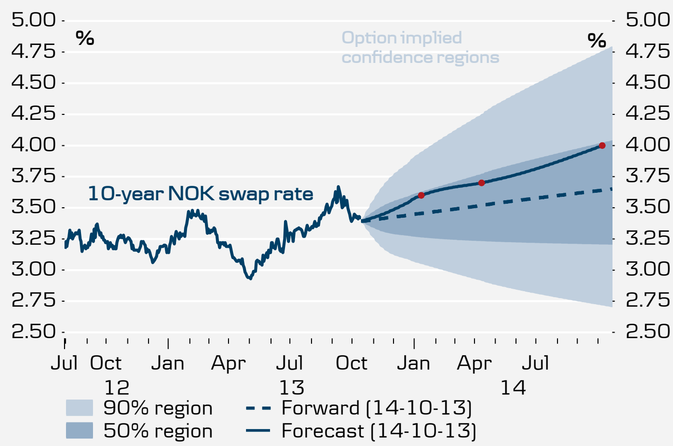
After a considerable rally in equity markets and rates throughout the year and into late summer 2013, markets have sold off a bit in the autumn. We believe the ongoing discussions about the budget and the debt ceiling in the US are likely to be solved eventually, but volatility is likely to ensue in the process. Therefore, we expect an increase in yields towards the end of the year. We believe such movements are likely to be subdued for terms of less than two years. Moreover, we see particularly good value in terms beyond 10 years, due to an inverted yield curve (in forward terms) for longer durations.

3M Nibor rates



Source: Reuters EcoWin, Danske Bank Markets

10-year NOK swap rates



Source: Reuters EcoWin, Danske Bank Markets

Forecast table

Forecast table

	Horizon	Policy rate	3m xIbor	2-yr swap	5-yr swap	10-yr swap	2-yr gov	5-yr gov	10-yr gov
USD	Spot	0.25	0.25	0.48	1.56	2.79	0.35	1.42	2.69
	+3m	0.25	0.30	0.65	1.85	3.05	0.50	1.70	2.90
	+6m	0.25	0.35	0.90	2.20	3.30	0.75	2.00	3.10
	+12m	0.25	0.50	1.35	2.50	3.45	1.20	2.30	3.25
EUR*	Spot	0.50	0.23	0.58	1.29	2.16	0.19	0.87	1.89
	+3m	0.50	0.25	0.70	1.50	2.40	0.30	1.10	2.15
	+6m	0.50	0.35	0.80	1.70	2.60	0.40	1.30	2.35
	+12m	0.50	0.50	0.90	1.90	2.80	0.50	1.50	2.55
GBP	Spot	0.50	0.52	0.87	1.78	2.73	0.48	1.60	2.79
	+3m	0.50	0.55	0.90	1.80	2.95	0.50	1.70	3.00
	+6m	0.50	0.60	1.00	2.00	3.05	0.60	1.90	3.10
	+12m	0.50	0.70	1.30	2.30	3.15	0.90	2.20	3.20
JPY	Spot	0.10	0.14	0.22	0.38	0.82	0.10	0.24	0.67
	+3m	0.10	0.15	0.25	0.45	0.90	0.10	0.30	0.75
	+6m	0.10	0.20	0.30	0.45	0.95	0.15	0.30	0.80
	+12m	0.10	0.20	0.30	0.55	1.05	0.15	0.40	0.90
CHF	Spot	0.00	0.02	0.14	0.69	1.53	-0.06	0.19	1.06
	+3m	0.00	0.05	0.30	0.85	1.65	0.00	0.30	1.15
	+6m	0.00	0.05	0.30	0.95	1.75	0.00	0.40	1.20
	+12m	0.00	0.10	0.45	1.15	1.85	0.15	0.60	1.30
DKK	Spot	0.20	0.28	0.81	1.56	2.40	0.47	1.21	2.03
	+3m	0.20	0.30	0.95	1.80	2.65	0.60	1.50	2.30
	+6m	0.30	0.45	1.05	2.00	2.85	0.70	1.70	2.50
	+12m	0.40	0.60	1.15	2.20	3.05	0.80	1.90	2.70
SEK	Spot	1.00	1.21	1.52	2.25	2.84	1.09	1.87	2.53
	+3m	1.00	1.25	1.55	2.30	3.00	1.15	1.90	2.65
	+6m	1.00	1.30	1.80	2.70	3.20	1.40	2.30	2.90
	+12m	1.25	1.55	2.10	2.90	3.40	1.70	2.50	3.10
NOK	Spot	1.50	1.69	2.07	2.76	3.40	1.71	2.22	3.01
	+3m	1.50	1.85	2.25	2.95	3.60	1.70	2.30	2.95
	+6m	1.50	1.90	2.40	3.10	3.70	1.85	2.45	3.15
	+12m	1.75	2.05	2.75	3.40	4.00	2.20	2.90	3.50

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

Source: Danske Bank Markets

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