17 December 2015

Research: Denmark

Danish independent rate hike has moved closer

After the December ECB meeting we have seen a new currency outflow from Denmark, and we now forecast that over the next three months Danmarks Nationalbank (DN) will hike the Certificates of Deposit (CD) rate by a modest 10bp to -0.65%. An independent rate hike could potentially come as early as today.

Our forecast is still well below market pricing. We still believe that the significant Danish current account surplus will ensure that the Danish policy rate can stay well below that of the ECB for the foreseeable future. Our forecast is based on the view that DN favours a currency reserve close to the size at end-2014. If DN is ready to accept a further drop in the reserve, an independent Danish rate hike would not be imminent.

Denmark did not follow the latest ECB rate cut

Danmarks Nationalbank (DN) did not change its policy rates when the ECB lowered the deposit rate by 10bp at the beginning of December and the policy spread between the Danish Certificates of Deposit was narrowed to 45bp from 55bp previously. DN said that the decision not to mirror the ECB reflected, '... the sale of foreign exchange in the market since April 2015'.

The non-move from DN, which indirectly can be seen as an independent Danish 'rate hike', and the November foreign exchange reserve data, which showed that the sale of foreign currency slowed to a modest DKK7.1bn, could indicate that the outflow from Denmark has now come to an end after the strong inflow in Q1. The Danish currency reserve stood at DKK483.9bn by the end of November, which is still some DKK40bn above the level of the FX reserve at end-2014.

Furthermore, Denmark continues to run a significant current account surplus, which was recently estimated by the central bank to be 7.4% of GDP in 2016.

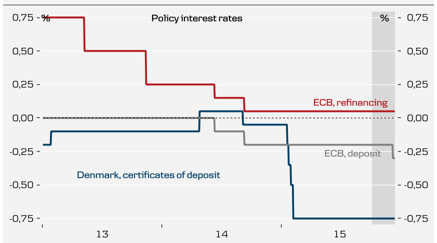
Given the significant current account surplus and the strong balances of the Danish economy, we have so far estimated that the Danish central bank could keep the Certificates of Deposit rates at the record low -0.75% throughout 2016.

Size of currency reserve in focus

However, recent developments seem to indicate that the currency outflow has continued in December after the ECB 'disappointed' the market at the beginning of December.

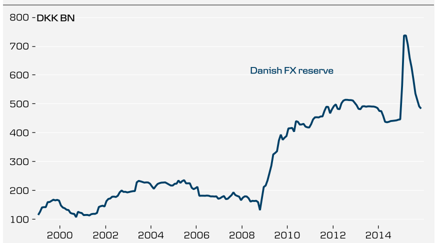
The banks' so-called net position at the central bank has dropped over DKK40bn more than the official liquidity forecast from the central bank would indicate. If this 'rough' estimate for FX intervention so far in December is correct, it would indicate that the Danish FX reserve is now more or less at the level seen at end-2014 before the strong inflow in Q1.

DN did not follow the ECB lower last time



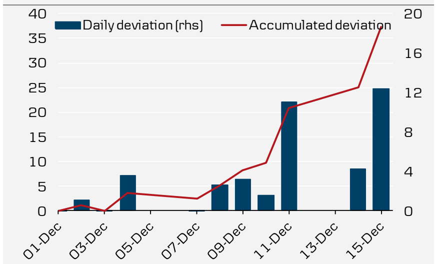
Source: Macrobond Financial

The Danish currency reserve has fallen since April .. but outflow slowed in November



Source: Macrobond Financial

Banks net position and deviation from liquidity forecast, DKKbn



Source: Nationalbanken, Danske Bank Markets

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We have argued for a long time that the central bank would narrow the interest rate spread when the currency reserve reached the level seen at the end of 2014. However, there is certainly a possibility that the central bank is ready to accept a smaller currency reserve today given that the experience in Q1 showed that there is also some risk related to a 'sizeable' currency reserve.

The development over the past couple of years with a significant current account surplus and the fact that Denmark has become a 'creditor nation' could also, all else being equal, speak in favour of DN allowing the currency reserve to drop below the end-2014 level. If this is the case, independent Danish rate hikes are certainly not imminent.

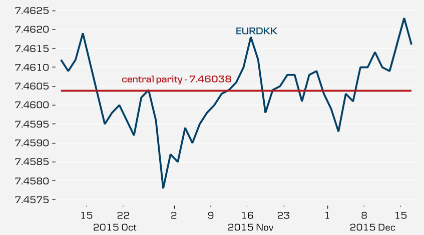
The ECB seems to have been a turning point for EUR/DKK

We also see that EUR/DKK has traded above the central parity since the ECB meeting, which would normally indicate that the central bank is 'in the market'.

It seems that the ECB meeting was a 'turning point' for EUR/DKK. The ECB did not take out the 'big bazooka' and we believe that the meeting marked the 'end of easing' from the ECB. Hence, any fears that potential ECB action could trigger a new strong currency inflow into Denmark as in Q1 now seem much smaller. The latter might be one of the reasons why we currently see a new upward pressure on EUR/DKK.

For more on the ECB meeting, see *Flash Comment: Draghi disappoints with a 'light menu' – but enough to mark end of easing*, 3 December 2015.

EUR/DKK above the central parity since ECB meeting



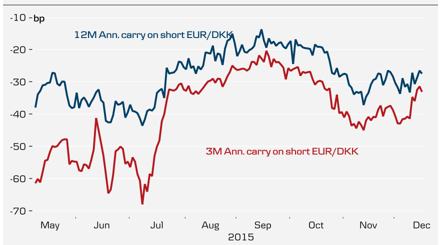
Source: Bloomberg

Still negative carry on long DKK positions in the FX forward market

The negative carry on DKK against EUR in the FX forward market remains elevated despite the slightly narrower deposit rate spread against the ECB. Hence, it is still relatively 'costly' to hedge EUR assets or income in the FX forward market. Currently, the negative carry on an annual basis is around 35bp for a short 3M EUR/DKK position and slightly lower for a short 12M EUR/DKK position (see graph below to the left).

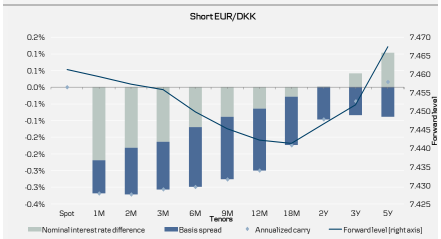
The negative carry is still higher than it was over the summer even though DN did not mirror the ECB rate cut two weeks ago. The negative carry partly reflects the rate differential but also the cross currency basis spread between DKK and EUR, which is illustrated in the graph below to the right. The still elevated negative carry on DKK – even after the narrower policy spread – in the FX forward market could also be contributing to the current outflow. If the basis is seen as more 'permanent' it would also point to a relatively fast interest rate change from DN.

Negative carry on short EUR/DKK positions in the FX forward market higher than it was over the summer



Source: Macrobond Financial, Bloomberg

The cross currency basis spread between DKK and EUR adds to the negative carry on DKK in the FX forward market



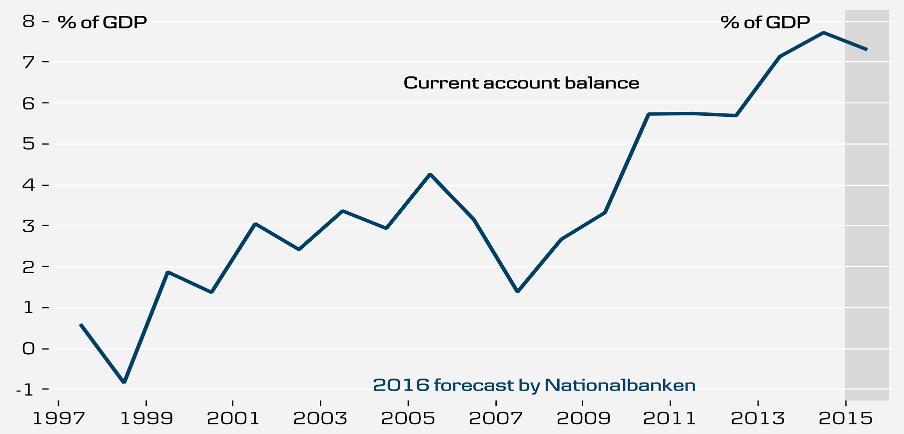
Source: Danske Bank Markets

We now look for an independent Danish rate hike on a 3M horizon

The combination of 1) the ECB having eased for the last time, in our view, 2) the recent indications of continued outflow from Denmark after the ECB meeting, 3) the level of the currency reserve approaching the level seen in 2014, 4) the ECB meeting that probably marked the 'end of ECB easing' and 5) the consistent negative carry on DKK in the FX forward market mean that we now forecast a small Danish independent rate hike of 10bp in Q1 next year. Potentially, it could come as early as today.

We certainly do not think that we are in for a full 'normalisation' of the Danish deposit rate in 2016. In that respect, we still see the significant Danish current account surplus as a factor supporting DKK in 2016.

Significant Danish current account surplus supports DKK also in 2016

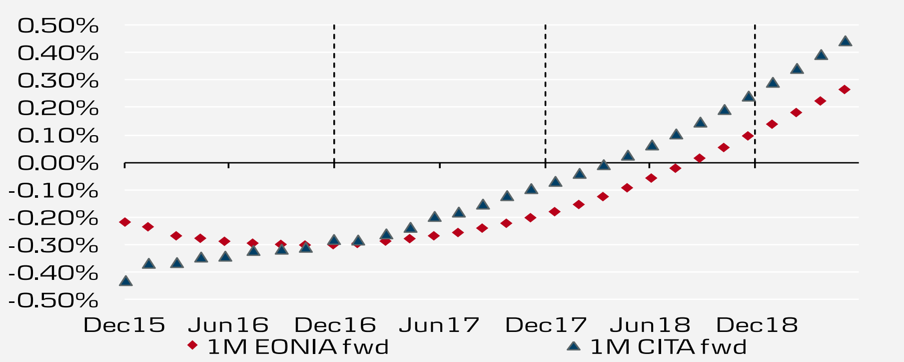


Source: Nationalbanken

The market is ahead of us

The market is already priced for a 'normalisation' of Danish money market rates throughout 2016. Today, the market has priced in that Danish 1M CITA rates will be at par with 1M EONIA rates in Q3 next year and that the spread will turn positive beyond that date. We continue to hold the view that the market is pricing in too steep a Danish money market curve given the Danish current account surplus.

Very steep CITA forward curve relative to the EONIA curve



Source: Danske Bank Markets

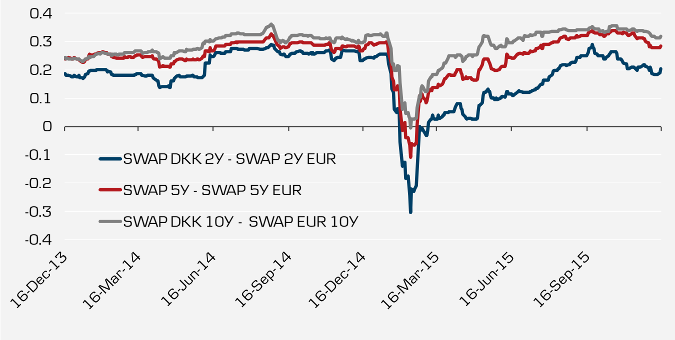
Market implications: rates

We only forecast a very modest tightening of Danish monetary policy. Hence, the impact is mainly expected to be visible in the very short end of the curve; not least as the market is already priced for a '2016 normalisation' of Danish monetary policy and as longer bond and swaps are already trading with a spread at or above the spread that prevailed before the currency inflow in Q1.

From a hedging perspective, we continue to see upside for 5Y and10Y rates in 2016, but that has more to do with our long-held view that higher US long rates will tend to push long European rates higher in 2016.

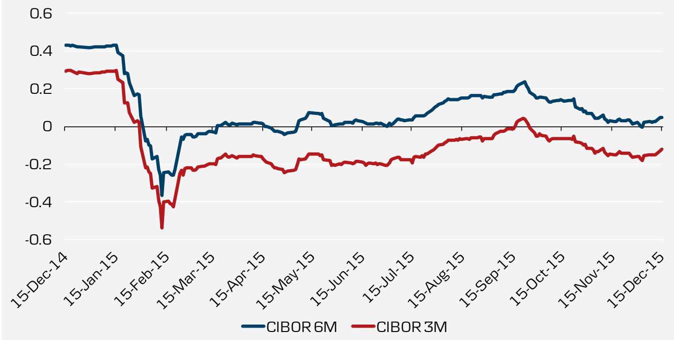
An independent Danish rate hike will also tend to move 3M and 6M Cibor rates slightly higher. But the effect will not be one-to-one, as market rates are trading well above the CD rate and as the market has started to price in a probability of a Danish rate hike in the short term.

5Y and 10Y swap spreads to EUR are at 'normal' levels, %



Source: Danske Bank Markets

3M and 6M CIBOR have edged marginally higher



Source: Danske Bank Markets

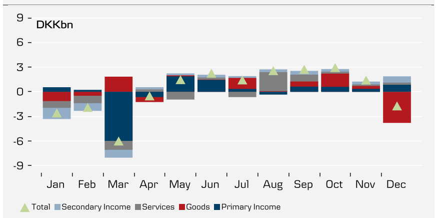
Market implications: FX

We expect EUR/DKK to stay elevated in the range of 7.4600-7.4620 in the coming one to three months as the outflow from Denmark might continue. Fundamental flows are usually DKK negative during the winter and should continue to support EUR/DKK in Q1 16. Longer term, we expect EUR/DKK to edge lower to the range of 7.4550-7.4600 on the back of a unilateral rate hike by DN.

As mentioned earlier, the forward market is currently pricing in the gap between CITA and EONIA to close in Q3 next year and grow positively after that. Given the solid outlook for Denmark's external position, which, in our view, still warrants a negative carry on EUR/DKK, the normalisation is too steeply priced. Hence, we still recommend Danish pension funds with a hedging mandate and EUR exposure to hedge EUR exposure in longer-dated EUR/DKK FX forwards. From 5Y and beyond, FX forwards offer a positive carry in short EUR/DKK and we prefer to use 5Y-10Y FX forwards due to the positive carry and because we forecast the largest tightening of the DKK-EUR interest rate spread in the long end of the curve. However, we also see some value in 2Y-3Y FX forwards due to a possible roll-down of the steep FX forward curve.

Danish importers with EUR payables should hedge EUR payables on a 1-6M horizon via FX forwards and thereby take advantage of the negative carry.

Fundamental flow DKK negative during the winter



Source: Macrobond Financial, Danske Bank Markets

Disclosure

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, Head of Fixed Income Research and Morten Thrane Helt, Senior Analyst.

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