

# Euro Rates Outlook

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## Bond yields past their lows

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- **We expect 10y Treasury yields to increase as the Fed will hike rates due to the sizeable impact of fiscal policy initiatives by President-elect Trump...**
- **... but the eurozone economy will muddle through while core inflation will remain weak until the turn of 2017/2018**
- **The ECB is expected to announce an QE extension by 6 months and to remove the floor for its purchases, while it will taper its QE programme in early 2018**
- **German 10y bond yields will move higher especially in the latter part of 2017**
- **Eurozone country spreads will drift wider due to a cocktail of diminishing impact of QE, taper speculation and political risks**

### US bond markets will pave the way for higher bond yields

In the past few days, we have updated our global scenario for the economy and financial markets and extended it through 2018 (see [here](#) for full publication). For the direction of global bond markets, the impact of the expected sizeable fiscal stimulus by President-elect Trump on the US economy and inflation outlook will be key.

For the US economy in particular, we have upgraded our GDP growth to 2.4% in 2017 (up from 1.9% previously) and 2.8% in 2018. With unemployment already low, this will lead to an acceleration in inflation. In response to this, we expect a faster pace of Fed rate hikes. We expect three hikes in 2017 and two hikes in 2018. Given this is not yet fully priced in financial markets, we expect the yield of 10y Treasuries to reach 2.9% in 2017 and to fall back to 2.6% in 2018.

### Eurozone economy will muddle through and ECB sticks to accommodative policy

Our forecast for eurozone growth (see [here](#) for a detailed publication on the eurozone outlook) is broadly remained unchanged for next year at 1.4%, though we do expect a lower euro to contribute to stronger growth in 2018 (1.8%). Eurozone headline inflation is expected to edge higher, mostly resulting from base effects and rising energy prices. However, we continue to expect that inflation to remain below the ECB's target of just under 2% during 2017 and 2018. Crucially, core inflation will likely to remain very low with no uptrend until the turn of 2017-2018.

We therefore assume the ECB to continue its accommodative policy and that it will announce an extension of its QE programme at the current pace by 6 months at its upcoming December

GC meeting. We think the ECB will also remove the deposit rate floor for its purchases, which will bull steepen the eurozone core bond curve. In addition, we expect the ECB to relax the criteria to conduct so called substitute purchases for high scarcity bond markets. This will mean that the ECB will be able to temporarily move away from purchases based solely on its capital key. Furthermore, we expect the ECB to continue with its QE programme at its current pace through to March 2018 after which the European Central Bank will start to taper its asset purchases by EUR 20bn a month.

### Eurozone bond yields past their lows, tapering speculation to start in 2017Q4

German sovereign bond yields will remain supported in the near term by the extension of the ECB's QE programme and by weak underlying inflation. However, in the latter part of 2017 we expect a more significant rise of 10y Bunds to 0.8% (previously 0.10%) as markets will start to price in a tapering of asset purchases in early 2018. During this period we expect asset swap spreads to tighten to 30bps. We see the 10y Treasury-Bund spread peaking at 220bps in 2017Q3. After the announcement of tapering, we expect 10y Bund yields to gradually rise to 1.2% to the end of 2018.

### Eurozone country spreads remain susceptible to political risks

Eurozone bond spreads will benefit from the QE extension although we expect that the effect will be modest and temporary. As the year 2017 progresses, we expect that spreads will drift wider. We think that political risks could give rise to underperformance of specific countries. As idiosyncratic political risks rises, Bunds will benefit somewhat. We think that yield spreads of countries which will have elections and in which anti-Europe political parties are on the rise, will mainly be affected. In the short term, Italian and Austrian sovereign bonds could underperform with Italian bonds putting a lid on the potential performance of other peripheral spreads. Next year, we signal potential political risks for most notably the Netherlands and France. In the latter part of 2017, we expect eurozone country spreads to move wider because of increased taper speculation.

#### Interest Rate Forecasts

\*denotes forecasts

Euro Interest Rate Forecasts	Now	2016Q4*	2017Q1*	2017Q2*	2017Q3*	2017Q4*	2018Q1*	2018Q2*	2018Q3*	2018Q4*
Deposit facility	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Marginal lending	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Eonia	-0.35	-0.38	-0.38	-0.38	-0.38	-0.38	-0.38	-0.38	-0.38	-0.38
3m Euribor	-0.31	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35
2y Germany	-0.74	-0.85	-0.85	-0.85	-0.85	-0.85	-0.50	-0.50	-0.50	-0.50
5y Germany	-0.43	-0.55	-0.55	-0.55	-0.45	-0.25	-0.10	-0.10	-0.10	-0.10
10y Germany	0.24	0.20	0.30	0.50	0.60	0.80	1.10	1.10	1.10	1.20
30y Germany	0.90	0.90	1.00	1.20	1.30	1.50	1.90	1.90	1.90	2.00
2y IRS	-0.15	-0.20	-0.20	-0.20	-0.20	-0.10	-0.10	0.00	0.00	0.00
5y IRS	0.08	0.10	0.10	0.10	0.10	0.20	0.20	0.20	0.20	0.20
10y IRS	0.65	0.65	0.75	0.90	1.00	1.10	1.40	1.40	1.40	1.50
30y IRS	1.19	1.20	1.30	1.50	1.60	1.70	2.10	2.10	2.10	2.20
US and UK Interest Rate Forecasts	Now	2016Q4*	2017Q1*	2017Q2*	2017Q3*	2017Q4*	2018Q1*	2018Q2*	2018Q3*	2018Q4*
Federal funds rate	0.41	0.75	0.75	1.00	1.25	1.50	1.50	1.75	2.00	2.00
3 month US dollar Libor	0.87	0.90	1.00	1.20	1.40	1.60	1.70	2.00	2.20	2.20
10y Treasury	2.38	2.30	2.40	2.60	2.80	2.90	2.90	2.80	2.70	2.60
10y Gilt	1.42	1.40	1.50	1.80	2.00	2.10	2.10	2.00	2.00	1.90
Curve Spreads	Now	2016Q4*	2017Q1*	2017Q2*	2017Q3*	2017Q4*	2018Q1*	2018Q2*	2018Q3*	2018Q4*
Germany 2s5s	31	30	30	30	40	40	40	40	40	40
Germany 5s10s	68	75	85	105	105	105	120	120	120	130
Germany 10s30s	66	70	70	70	70	70	80	80	80	80
10y Bond Swap Spread	44	45	45	40	40	30	30	30	30	30
IRS 2s5s	24	30	30	30	30	30	30	20	20	20
IRS 5s10s	56	55	65	80	90	90	120	120	120	130
IRS 10s30s	54	55	55	60	60	60	70	70	70	70
10y Government Bond Yield Spreads	Now	2016Q4*	2017Q1*	2017Q2*	2017Q3*	2017Q4*	2018Q1*	2018Q2*	2018Q3*	2018Q4*
Finland	19	20	20	20	20	25	25	25	25	25
Netherlands	16	15	20	20	20	25	25	25	25	25
Austria	30	25	25	30	30	35	35	35	35	35
Belgium	42	35	35	35	35	40	40	40	40	40
France	54	45	45	45	45	50	50	50	50	50
Ireland	69	50	60	60	60	70	70	70	70	70
Italy	189	150	150	150	160	160	160	160	160	160
Spain	134	100	100	100	110	110	110	110	110	110
Portugal	339	300	300	300	325	325	325	325	325	325
Greece	662	700	700	700	750	750	750	750	750	750
United States	214	210	210	210	220	210	180	170	160	140
United Kingdom	118	120	120	130	140	130	100	90	90	70

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