Nordkinn Market Review & Outlook – June 2016

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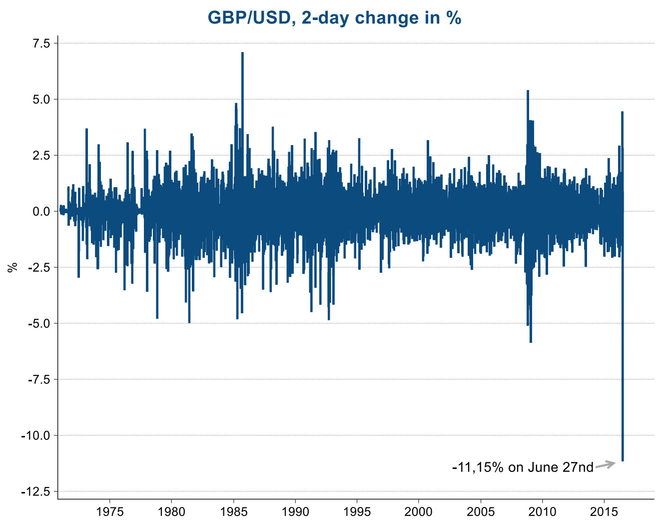
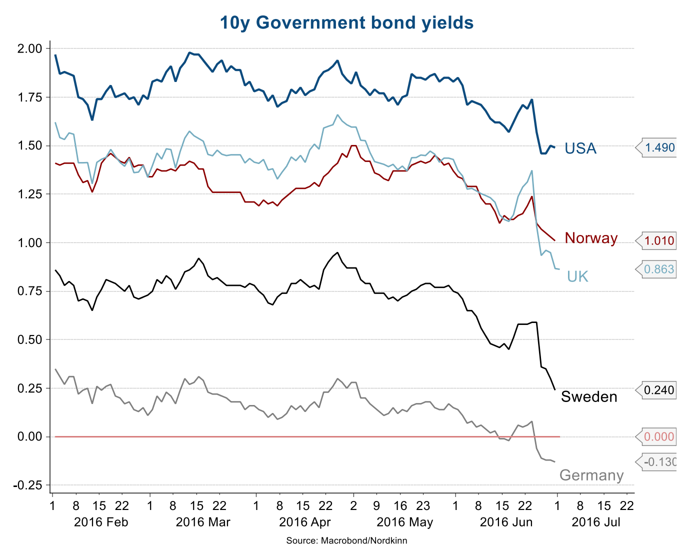
Global overview

Global government bond yields set fresh record lows after the UK's decision to end EU-membership triggered a rush for safety. The 10-year UK gilt yield dropped a spectacular 40 bps during the first two trading sessions after the referendum, falling below 1% for the first time in history. The corresponding reaction in US 10-year treasuries and German 10-year Bunds were -30 bps and -20 bps respectively. Meanwhile, the GBP plunged a stunning 11% against the USD (see chart) reaching its lowest level since 1985. The result wrong-footed investors given high expectations of a "Bremain" outcome, hence the significant reaction.



The financial fallout from the UK's vote intensified after analysts downgraded prospects for global growth and rating agencies said they would cut UK's AAA sovereign rating. UK banks were all hit particularly hard, as an end of EU-membership combined with ever lower interest rates would challenge their business model. At the same time, expectations of easier monetary policy and statements that central banks stand ready to provide additional liquidity, also in foreign currencies, alleviated the impact on risky assets whilst bonds remained supported. This also contributed to a relatively quick normalisation of cross-currency basis swap spreads, having widened significantly when the outcome of the referendum was known. Yet, the political landscape is clouded by uncertainties. While EU officials urged the UK to swiftly clarify its plans to sever from the EU to avoid lasting uncertainty, outgoing prime minister Cameron made it clear that triggering of Article 50, withdrawal of a member state from the EU, would be a matter for his predecessor.

Nordic overview



Financial markets in Scandinavia largely mirrored developments abroad. Having been closed on Friday 24th, the Swedish stock exchange dived 8% on Monday 27th in a move not seen on a single day since 1987. The Swedish 10y government bond rallied more than 20 basis points the same day and the curve bull flattened decidedly. Government bond swap spreads widened. Meanwhile, the SEK sold off moderately as some foreign investors repatriated their capital.

Turning to Norway, on June 23rd, the day of the UK referendum, the Norges Bank published a new interest rate path that was revised upwards for the first time since autumn 2014. The new rate path is consistent with a final rate cut to 0.25% at the meeting in September. However, as Norges Bank removed its bias for additional easing due to the recent increase in energy prices, market interest rates rose a few basis points after the announcement.

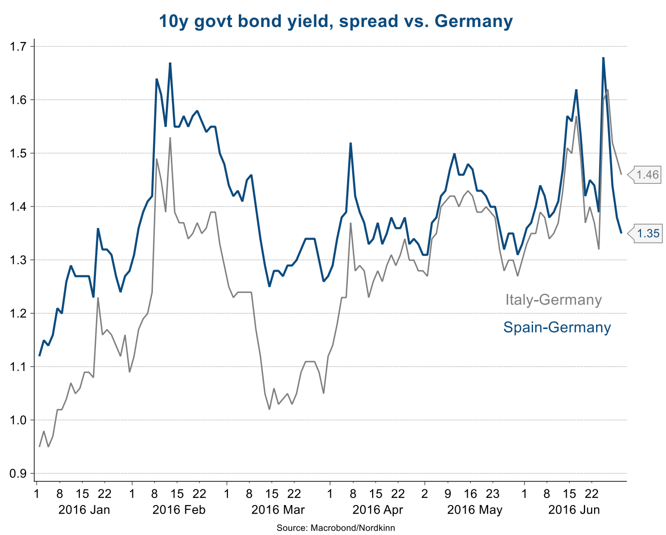
Moreover, the decline in Norwegian interest rates after the UK referendum was relatively muted, particularly in money market space. This reflects a combination of higher NIBOR fixings and the Norges Bank's reluctance to cut beyond the 0.25% level. Longer-term rates, however, moved broadly in tandem with Europe, hence the slope of the yield curve flattened. The NOK was sold immediately after the referendum as speculative positions were unwound, but appreciated later on as risk appetite improved and oil prices remained steady.

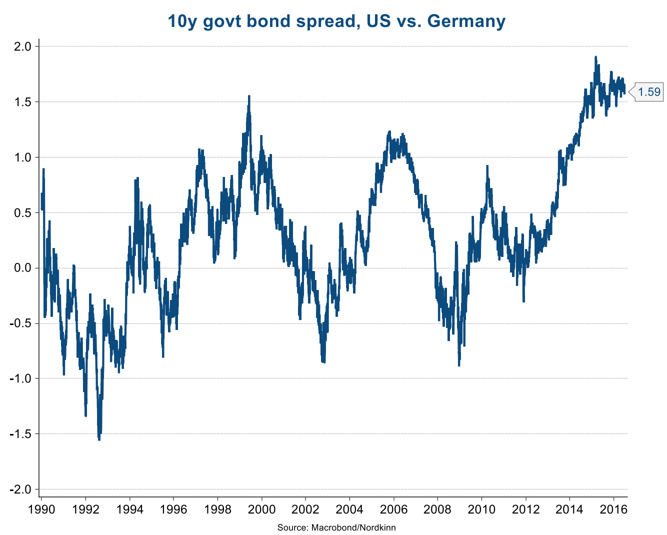
Global markets

The result of the EU referendum was a major break in 70 years of European integration. For the UK the immediate consequence is a rise in uncertainty and a further deceleration in growth, especially as the future of trading relationships between the UK and the EU is expected to remain unclear for some time. We expect the Bank of England to look through the likely surge in imported inflation, to rather focusing on the growth outlook. Consequently, we expect a rate cut in August. Further, easier monetary policy and a likely sharp drop in inflows into the UK from overseas will in our view add to further downward pressure on the GBP.

Whilst the referendum only has an “advisory” status, we expect the UK government to respect its outcome. This has repeatedly been made clear during the public debate. Moreover, although technically possible, we believe a second referendum in the UK is highly unlikely. Claims that the public did not really know what they voted for is difficult to validate given the long period of public debate.

The bigger problem is continental Europe. Mounting fears that “others are next to leave the EU” is impacting capital markets as new exits could impair European and global growth. For instance, poll data reveals that EU scepticism has increased in Italy in recent years. Investors may therefore demand higher yields on Italian government bonds, see left hand chart. That said, we believe no other country will vote to leave the EU. Besides, the ECB stands ready to increase purchases of peripheral bonds if necessary. This will in our view limit the global economic and financial fallout of Brexit, even so there will be uncertainty and volatility in the near-term.





The ECB will likely revise its forecast for economic growth and inflation downwards as a result of UK’s vote. President Draghi has already indicated that Brexit could shave GDP by a cumulative 0.5% over the coming three years. Against this background, the likelihood of a more dovish monetary policy stance has increased, although we believe this would only happen in the event of a more significant decline in economic activity. Extending QE beyond March 2017 is very likely, but we expect the ECB to wait until Q4 before providing any clear guidance about whether the ECB will proceed as before or commence tapering asset purchases. Regarding US monetary policy, the Federal Reserve will likely need time to assess the economic and financial impact of Brexit before making any adjustments in interest rates. Consequently, a rate increase in Q3 now appears very unlikely. A rate hike in December is possible if consequences are limited, but our conviction is rather low. Consequently, we closed our *“US: Interest rate normalisation”* theme at the end of June.

Prior to the UK referendum, we initiated a long exposure in US 10y Treasuries against short German 10y Bunds as part of our *“EMU: Cyclcal upswing”* theme, see right hand chart. The main motivation behind this trade was that the spread is elevated in a historical context and looks likely to narrow over time as the economic momentum in Europe gradually improved. According to our valuation models, the cyclical fair-value should be around 1.35%. However, we also noted that this trade could work well in a scenario where risk appetite recedes due to the larger downside for US bond yields.

Against this background, we entered a short position in German Bund yields in May. Parts of this exposure were implemented as a spread versus US treasuries. Our valuation framework estimates the current fair value at around 1.35% compared with the current spread of around 1.70%, see right hand chart. The Bunds-Treasury trade could also work well in a scenario where risk appetite recedes due to the larger downside for US bond yields.

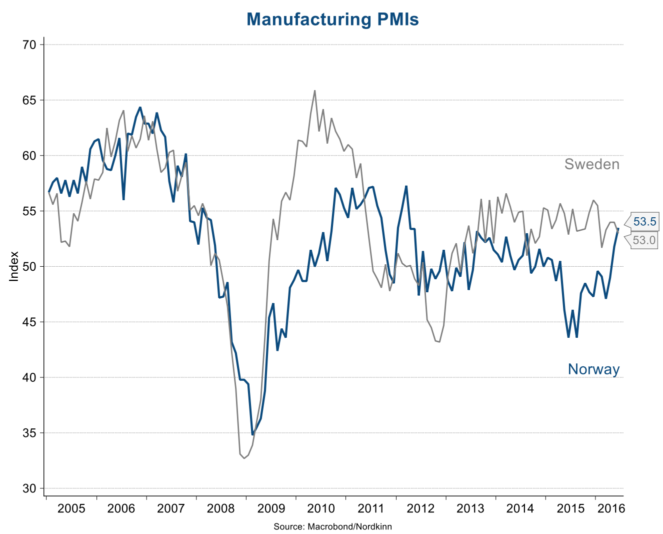
One of the risks associated with this trade is fear of bond scarcity in the euro area in the context of the ECB’s extended asset purchase program. Another risk is a near-term rate hike in the US, although we doubt longer-dated treasury yields would be much affected.

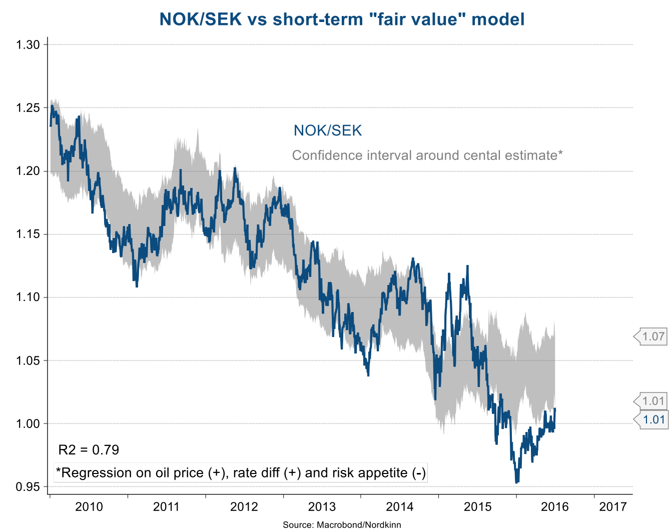
Nordic markets

Recent news reassures that economic growth is holding up well in Sweden. While we do expect some moderation in growth in coming quarters, the economic momentum per se is unlikely to require further easing from the Riksbank. We believe this would only happen in the event of a more significant decline in economic activity or a sharp appreciation of the SEK, which hardly can be imminent concerns for the Riksbank even if uncertainty has risen after the Brexit vote.

With Swedish growth remaining strong and unemployment falling, we expect that the Riksbank will remain confident that inflation will return to target eventually. However, after a long period where inflation has been undershooting target, we expect the Riksbank to maintain a very accommodative stance to ensure that inflation will return to target and remain there. A premature tightening of monetary conditions could weaken inflation prospects and thus jeopardise the confidence in the inflation target for which the Riksbank has been working so hard.

In light of this, we remain bullish on the short-end of the Swedish bond curve which offers attractive carry and roll. The long-end is less attractive after having performed sharply in June, although we think bonds can outperform swaps due to a significantly negative net supply over summer. We also like the index-linked bonds that are eligible for the Riksbank's asset purchase program relative to the index-linked bonds that currently are out of Riksbank's scope (i.e. longer-dated maturities).





The baseline scenario in the latest Norges Bank's monetary policy report is a 25 bps rate cut to 0.25% at the meeting in September. The press release was less detailed regarding the timing: *"There are still prospects that the key policy rate may be reduced in the course of the year"*. Nonetheless, our conviction for a move in September is very high, especially considering the surprise outcome of the UK referendum.

Compared with the previous monetary policy report, the trough in the Norges Bank's interest rate projection was revised marginally upwards, to 0.25% from 0.20%. The Norges Bank reiterated that the uncertainty surrounding the effects of monetary policy increases when interest rates approaches a lower bound. The Board will therefore *"react somewhat less to news that changes the economic outlook, whether the news pulls in the direction of a lower or higher key policy rate"*.

Considering that domestic data is showing signs of stabilisation, we now believe that the Norges Bank will keep the key policy rate unchanged at 0.25% (after cutting in September) for a considerable period of time. As this is broadly consistent with current market pricing, we decided to close our *"Norway: Weaker growth outlook"* theme in June. Nonetheless, we remain bullish on Norwegian covered bonds as we expect a reduction in money market and credit spreads. We also expect the slope of the yield curve to steepen and the NOK to appreciate from current levels.