Nordkinn Market Review & Outlook – July 2016

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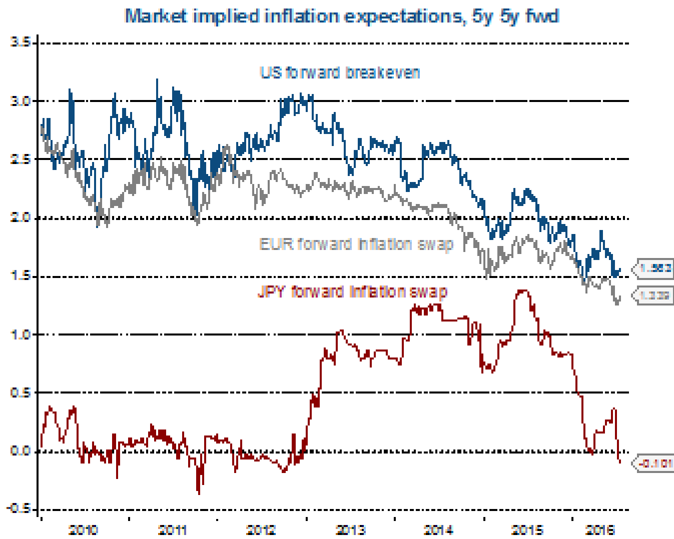
Market overview

Global overview

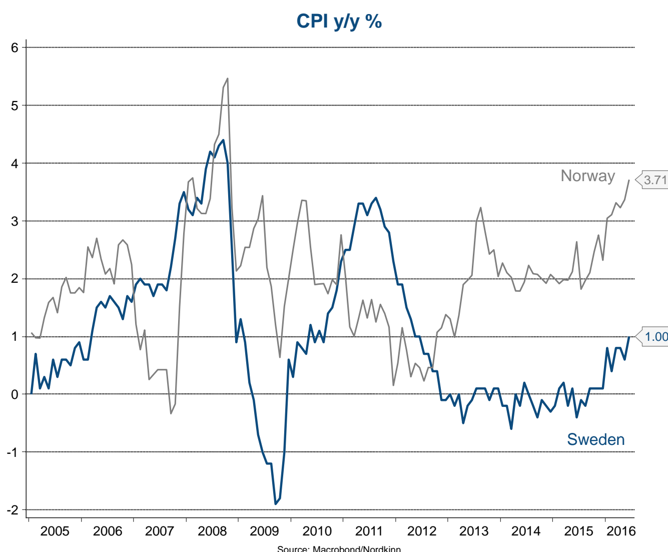
Search for yields and expectations of easy monetary policy were key market themes in July. As a result, global government bond yields reached record lows in July, while risky assets rose. Demand for longer-term bonds were particularly strong, contributing to even flatter yield curves. Meanwhile, a relatively strong US labour market report and a new money market rule in the US lead to somewhat higher short-term USD rates.



After shocking traders by leaving the key policy rate on hold in July, Bank of England signaled that loosening would probably come in August. Survey data suggest the Brexit vote has taken its toll on business confidence. As a result, after having reacted upwards on the interest rate decision, market rates and the GBP subsequently fell.

The JPY weakened in the first half of the month after a strong election result for prime minister Abe's party, which boosted expectations of aggressive policy measures. However, the currency appreciated by a similar amount at the end of the month after the Bank of Japan disappointed many investors by merely expanding purchases of exchange traded funds while leaving its bond-purchase program and negative rate policies unchanged.

Nordic overview



The Nordic government bond markets were characterised by strong demand in July, outperforming German peers. Performance in Swedish government bonds was particularly strong. Thin summer markets in combination with continued, albeit reduced QE kept bonds bid. In July the Swedish Riksbank decided to maintain its monetary policy unchanged as expected. The projected timing of policy tightening was deferred further out in time, also as expected.

In Norway, stronger than expected macro data lead to higher short-term interest rates in July as investors started to doubt the Norges Banks's projection of a cut in September. Moreover, higher USD funding due to upcoming regulatory changes in the US money market contributed to higher Nibor fixings. Meanwhile, longer-term interest rates largely followed developements abroad. Consequently, the slope of the Norwegian yield curve came under heavy flattening pressures in July.

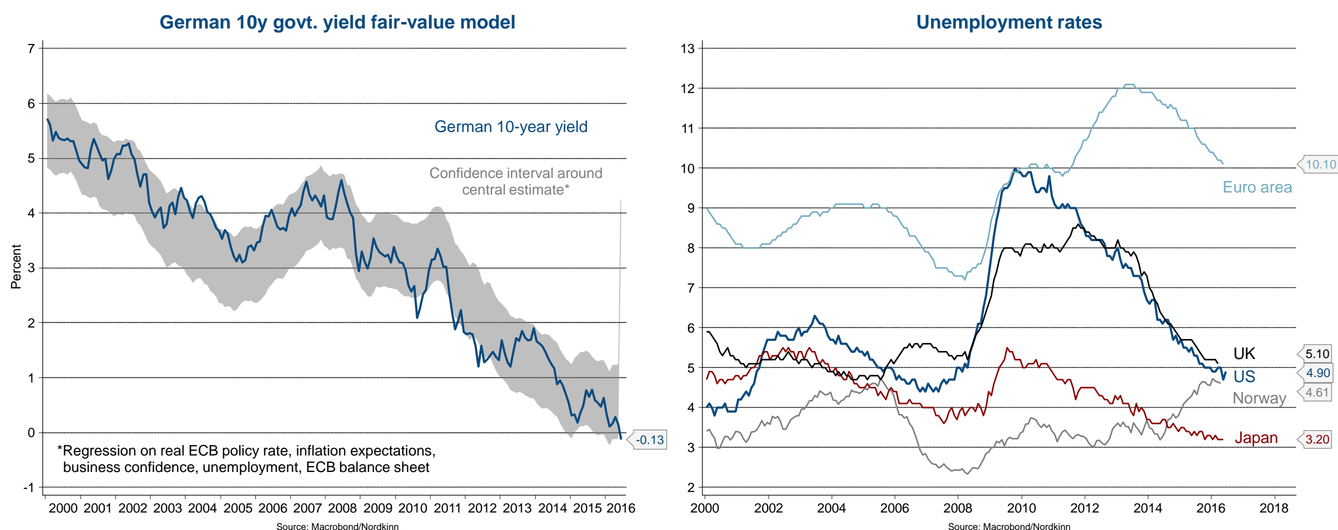
In the FX space, the SEK and NOK depreciated in an environment of thin market liquidity in July. The decline in the oil price also contributed to a weaker NOK.

Global markets

A shortfall in global aggregate demand has been blamed for the sharp drop in global government bond yields to new all-time lows in July. It is true that global growth is weaker than it used to be prior to the Great Recession and it is also true that the economic outlook became more uncertain after the UK voted to leave the EU. Even so, how can this story be consistent with equity indices making fresh all-time highs?

One reason could be that equity investors have a much more positive view on the global economy compared with bond investors. This does not, however, match with the fact that credit premiums have tightened. Another possible explanation is that equity investors have come closer towards bond investors' view regarding the neutral interest rate, i.e. the rate consistent with full employment and stable inflation. The neutral interest rate has fallen significantly because desired saving has risen while desired investments has fallen after the Great Recession. This will keep global bond yields at relatively low levels in the foreseeable future. For equity investors, this means a lower discount rate in their valuation models.

A third reason could be that a massive search-for-yield has pushed up virtually all asset prices. Vast asset purchase programs by central banks in Europe and Japan have pushed bond yields into negative territory across almost all maturities. Negative yields on longer-dated European and Japanese bonds makes long-dated US treasuries look attractive. Meanwhile, with the 30-year US bond yields at just above 2%, the equity market looks even more attractive, even if you do not expect equities to grow at all (because expected dividend yields are higher than expected bond yields).



We do not expect the rally in government bonds to continue. First, government bonds are now very expensive according to our fair value estimates, see left hand chart for the German example. Second, although global economic growth is disappointingly weak, it has so far been strong enough to reduce excess capacity as witnessed by the decline in unemployment rates, see right hand chart. Third, we expect fiscal policy to become more expansionary globally. This means deflationary forces will gradually abate. In fact, in the US core inflation is rising and the Atlanta Fed's Wage Growth Tracker points to an increasingly tight labour market.

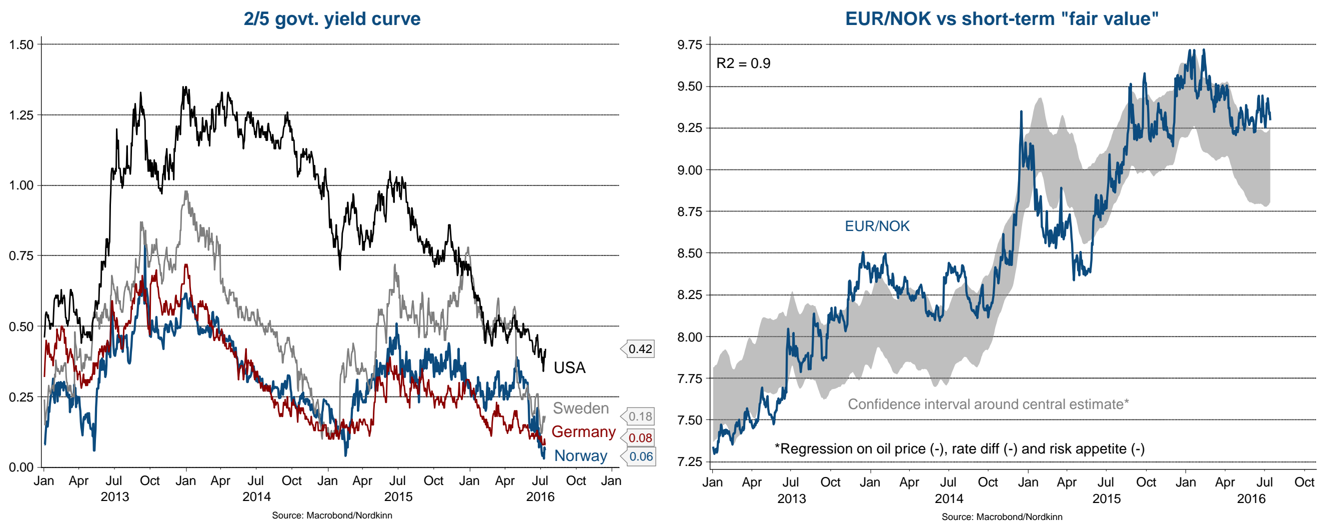
Just because a bond market rally ends does not mean a meaningful bear market trend is imminent. Nevertheless, our inclination is to be somewhat bearish long-dated European bonds, which are the most overpriced according to our valuation models. With that in mind, we remain short German Bunds against US Treasuries and we like curve steepeners in Scandinavia (see next page).

Nordic markets

Economic activity in Sweden continues to strengthen and inflation has shown a rising trend. Even if we expect economic growth to moderate in the second half of the year, we do not expect further interest rate cuts from the Riksbank barring very significant declines in economic activity and inflation. At the same time, we expect the Riksbank to maintain a very accommodative stance for quite some time to ensure that inflation will return to target and remain there. In particular, the Riksbank is unlikely to deviate much from the monetary stance of the ECB in coming months and quarters, as this could lead to a strong upward pressure on the SEK. Consequently, later this year we expect the Riksbank to announce an extention of its asset purchase program to 2017.

However, we expect the Riksbank to make some further adjustments to the composition of its asset purchases. Due to scarcity the Riksbank will probably bring down purchases of nominal government bonds further, and possibly replace some of them with municipal bonds.

In light of this, we remain bullish the short-end of the Swedish bond curve which offers attractive carry and roll, whereas the long-end is less attractive in our view after having performed strongly in recent months. The 5-year segment has become particularly expensive in our view, see left hand chart. We therefore expect the slope of the government bond curve to steepen somewhat ahead, and we like municipal bonds over swaps and covered bonds. Furthermore, we expect index-linked bonds and breakeven inflation to trade strongly.



The Norges Bank's baseline scenario is a final cut to 0.25% in the second half of 2016. In addition to this forward guidance, the Board explicitly said it will react less to news that changes the economic outlook, whether the news pulls in the direction of a lower or higher key policy rate. However, considering the improvement in domestic data, vigorous growth in house prices in most parts of Norway and the weak NOK, we do see a risk that the Norges Bank could decide to leave interest rates unchanged at the meeting in September while awaiting additional information before making a final decision about the need for additional policy easing.

For now, we see roughly 70% probability for a rate cut before year-end. As this is broadly consistent with current market pricing, we remain neutral on the short-end and we are bearish the long-end of the curve. Curve steepeners look particularly attractive in Norway considering the flat shape of the curve in combination with our somewhat negative view towards German government bonds. For instance, the 10-year swap rate in Norway is trading just a few basis points above 6-month NIBOR.

Moreover, we are bullish on the NOK. The recent appreciation of the NOK has in our view been surprisingly modest considering the rebound in energy prices before summer and the resilience in economic data. The NOK therefore appears cheap according to our valuation models, see right hand chart. Consequently, we expect the NOK to strengthen in coming months.