# Nordkinn Market Review & Outlook – August 2014

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NORDKINN
asset management

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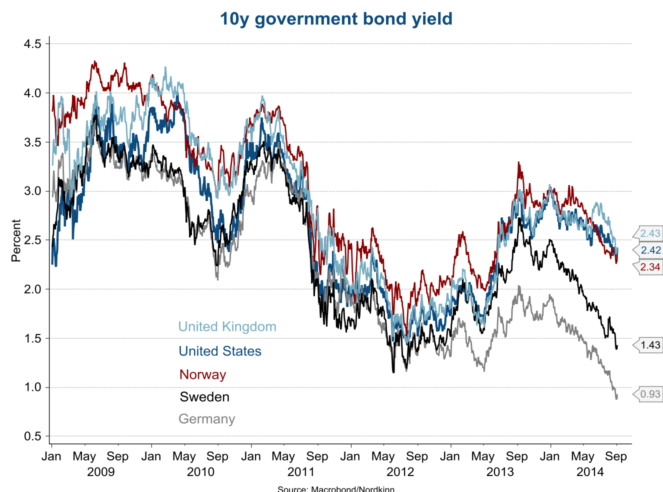
## Global overview

Government bond yields declined across major economies in August and yield curves flattened. Arguably, the unrest in Ukraine may have contributed to investor's appetite for safe haven bonds, but this fails to explain the simultaneous strong demand for equities in August. Instead, the demand for both bonds and equities in August largely mirrors investors' complacency about central banks' monetary policy stances ahead




The rally in German government bonds that brought yields to new all-time lows in August primarily reflects disappointing macro data coming out of the euro area in recent months, while geopolitical factors play a secondary role in our view. An already feeble and faltering European recovery seems to have stumbled, after euro area GDP was flat in the second quarter. Performance was particularly poor in Germany, France and Italy, the three largest economies.

The weak economic performance coupled with already low inflation rates have fuelled speculations that the ECB eventually will take even bolder measures to prevent the euro area from sliding into deflation. These intensified further after President Draghi's speech in Jackson Hole on August 22nd. In particular, the market seemingly attaches a decent probability that the ECB will embark on a large-scale asset purchase program (QE) to support economic growth and to raise inflation expectations.

The spread between US and German government bonds yields reached a fifteen-year high, which motivated investors in search for yields to buy US treasuries in August. Consequently, US bond yields declined. Meanwhile, incoming data showed that the economic recovery in the US is strengthening. Moreover, according to the minutes from the FOMC meeting in July, many participants are in favour of considering an earlier interest rate hike than they currently anticipate if convergence towards the Committee's objectives were to occur sooner than expected. As a result, the USD appreciated further in August.

The market expects that the Bank of England will be the first major central bank to hike interest rates. However, the market pushed expectations for the first hike further out in time after the MPC cut its wage growth forecast in its most recent Inflation Report, which contributed to a slightly weaker GBP. At the same time, minutes of the Committee's August meeting showed a split regarding the Bank rate, as two members wanted to raise it by 25 basis points already on August 7th. The market now expects a first lift-off around the turn of the year and a gradual and limited tightening profile thereafter.

## Nordic overview

Swedish short-term interest rates were remarkably stable in August, as incoming data did little to challenge the Riksbank's base case of an unchanged repo-rate at 0.25% well into 2015. However, due to spill-over effects from the developments in Euro area, longer-term interest rates declined in tandem with German government bond yields. Core CPI inflation, as measured by CPIF, fell in line with consensus expectations to 0.6%, but above the Riksbank's inflation forecast. GDP expanded by a less-than expected 0.2% in Q2 amid weak exports and capital accumulation. Consequently, economic slack in Sweden persists.

In Norway, incoming data for economic growth and inflation have been much stronger than expected over the summer. Core CPI inflation, as measured by CPI-ATE, rose to 2.6% in July, significantly above consensus expectations of a 1.9% print. Mainland-Norway GDP grew by a surprisingly strong 1.2% in Q2. Industrial production has been remarkably firm when considering the weak demand from trading partners. Consequently, short-term interest rates rose as market participants reduced previous expectations of an interest rate cut. In addition, strong data and wider interest rate spreads versus trading partners provided significant support for the NOK, which appreciated by 2.5% in August.

# Outlook

## Global markets

Our top-level assessment regarding the global market outlook remains largely unchanged from the message conveyed in our monthly reports for June and July: The pro-liquidity stance by the world's major central banks keeps market volatility near record lows and fuels demand for both bonds and equities. We expect that this will dominate market sentiment in the short-term. When looking beyond the short-term, the market's complacency about the outlook for interest rates could gradually fade in the wake of stronger economic growth and firmer inflation rates, which could become a source for higher market volatility.

However, in light of the disappointing macro data out of the euro area in August, speculation that the ECB will announce another bold stimulus package, a large-scale asset purchase program (Quantitative Easing - QE), has intensified. Not only is growth evaporating; inflation is also extraordinary low, which induce fears of deflation.

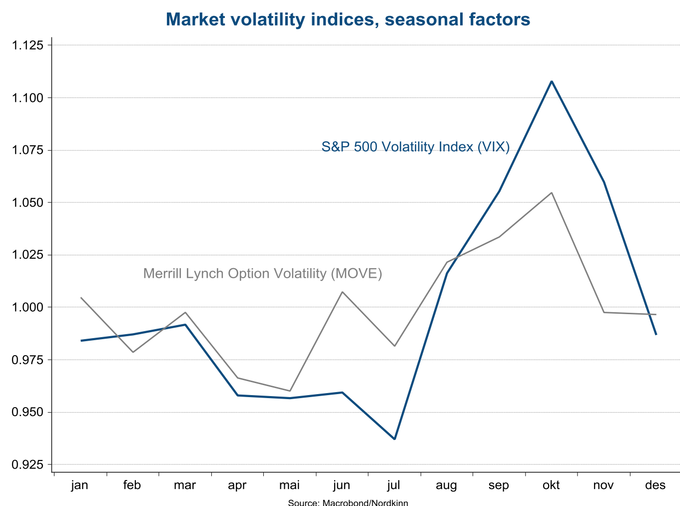
Although the ECB has confirmed that QE is an option if deemed necessary, there are a few obstacles. Some ECB members oppose the idea because many of the region's biggest problems are structural and have less to do with monetary policy. Additional monetary easing could take the pressure off euro area countries to enact structural reforms.

In our view, the probability of the ECB having to deploy QE in order to rescue its price stability mandate is directly proportional to the risk of deflation and a de-anchoring of medium-term inflation expectations. Indeed, there is at least one worrying sign that confidence in its inflation target is eroding: Market expectations of inflation over the next five years have tumbled and this should frighten the ECB. Once entrenched, inflation expectations are hard to dislodge. Low inflation or deflation pushes real interest rates upwards and forces businesses, households and governments to slash spending in order to avoid a growing debt burden.

Consequently, if realised inflation and inflation expectations were to fall further, or if the euro area economy were to slide back into recession, we expect the ECB to act firmly. However, ECB members would probably wish to evaluate the effects of the first TLTRO (to be initiated in September) before they consider QE. Hence, we see the December 2014 meeting as the earliest occasion for such decision.

In the meantime, QE speculation in the market will probably linger as long as euro area data remains weak. We see two triggers for higher bond yields in Germany: 1) Better macro data, including higher inflation; 2) A QE program that boosts confidence and sends the Euro sharply lower. None of these triggers are however likely to materialise in the next couple of months.

On the other side of the Atlantic, the situation is markedly different. Economic growth continues to improve and inflation has firmed. The Federal Reserve will likely terminate its asset purchase program in October and start hiking the Fed Fund's rate next year. Consequently, spreads between the US and euro area bond yields could remain at historically wide levels for some time. Moreover, different expectations regarding the paths for monetary policy should push the EURUSD spot rate lower and cross currency basis swaps wider.




Finally, we note that markets have entered into a season where volatility often picks up. The chart illustrates this pattern, displaying estimated seasonal factors of volatility in fixed income (MOVE Index as grey line) and equity markets (VIX Index as blue line) in the US. Important events in September are the FOMC meeting, which may include adjustments to the committee's forward guidance, and the first TLTRO by the ECB. In addition, markets remain sensitive to geopolitical risks such as the developments in Ukraine.

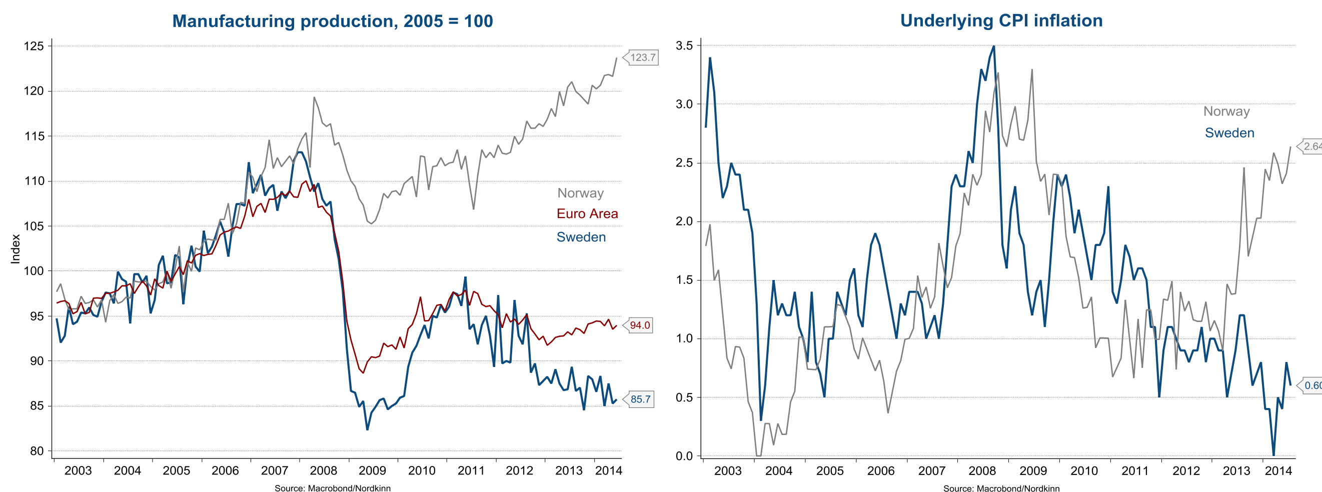
The investment team has undertaken pre-emptive measures to address a possible spike in market volatility.

## Nordic markets

Indicators of inflationary pressures are key for the Swedish Riksbank, which struggles to defend its credibility towards the 2% inflation target. Although CPIF inflation has been somewhat higher than the Riksbank's forecasts in recent months, the Board is clearly vigilant with respect to further downward surprises and has stated that the door is not closed for even a further reduction in the repo rate in the near term. Given modest cost pressure in Sweden, as indicated by the elevated unemployment rate and weak GDP growth, we envisage inflation to remain subdued going forward. Even if we forecast a pick-up in economic growth ahead, we expect the Riksbank to maintain a very accommodative monetary policy stance going forward.

With the policy rate already down at 0.25% and future rate hikes seemingly remote, global macro developments are likely to influence the Swedish fixed income market. In particular, we expect Swedish rates to move largely in tandem with Eurozone rate in coming months. As such, speculation about additional monetary easing by the ECB will likely be a key driver for the Swedish market as well.

The election for the Swedish parliament is taking place on September 14th. We see a risk that the outcome of the election could evolve into a political chaos that might influence markets. Current polls suggest that Prime Minster Reinfeldt and his coalition parties are heading towards a defeat, but that there is no clear majority government alternative. Any minority governments could risk being ousted before it got started in earnest. In August, we introduced a *"Sweden: Election risk"* theme which will benefit from an increase in EURSEK volatility and wider asset swap spreads.




As we wrote in our previous monthly report, in July we decreased our exposure to the investment theme labelled *"Norway: Weaker growth outlook"* due to strong performance (interest rates fell in June and July) and, consequently, lower conviction for future performance. Since then, we have witnessed a sequence of strong macro data that caught us by surprise, which lead us to further reduce the exposure to this theme in August.

In response to the stronger than expected macro data, we have adjusted our assessment of the current situation. We believe capacity utilisation in Norway is higher than previously thought, as witnessed by the low unemployment rate and, in particular, the high and upward-trending core CPI inflation rate. We think the Norges Bank Board will reach the same conclusion when they meet in September.

At the same time, oil investments are set to decline by 15-20% in 2015 according to the latest survey conducted by Statistics Norway. This is a larger drop than the Norges Bank projected in June. In addition, interest rates among Norway's trading partners are lower than they were in June. On balance, therefore, we expect the Norges Bank to maintain an easing bias in the Monetary Policy Report to be published on September 18th, which could lead to a renewed weakening of the NOK.