Nordkinn Market Review & Outlook – November 2014

Addressed to Nordkinn's Followers on LinkedIn
for informational purposes.

DISCLAIMER

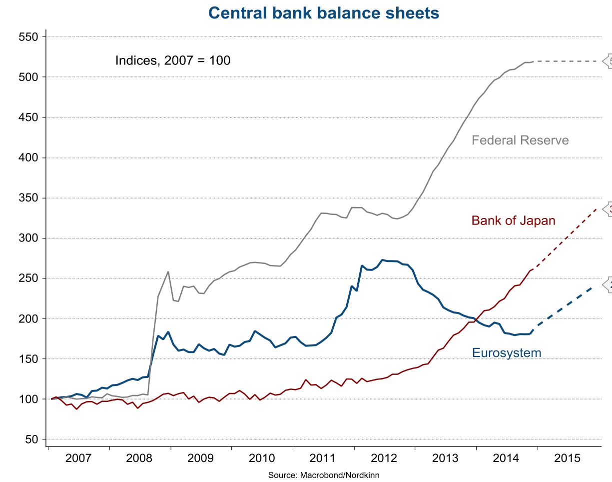
NORDKINN ASSET MANAGEMENT

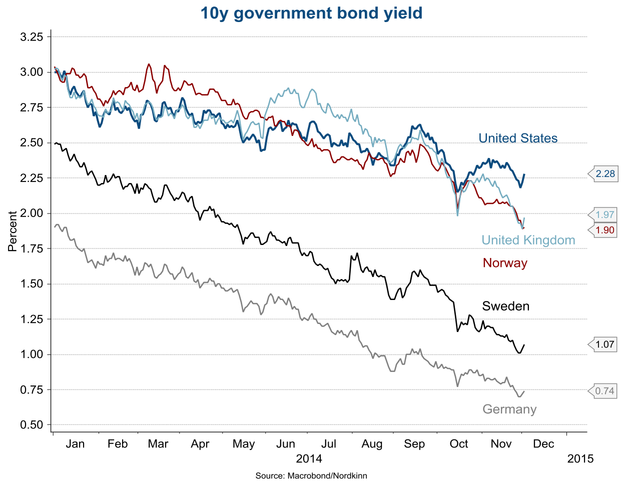
Kungsgatan 33, 6tr
111 56 Stockholm, Sweden
Phone: +46 8 473 40 50
Telefax: +46 8 473 40 51
E-mail: post@nordkinnam.se

Parkveien 57
0256 Oslo, Norway
Phone: +47 22 46 63 00
Telefax: +47 94 77 15 16
E-mail: post@nordkinnam.no

Global overview

In November, global markets continued to digest the decisions undertaken by the Bank of Japan and the ECB to expand their balance sheets and thus maintaining an unprecedented global monetary accommodation while the Federal Reserve terminated its asset purchase program last month, see chart to the left. Global bond yields resumed their downward trends (see chart to the right) and demand for risky assets rose.





Moreover, the drop in commodity prices also contributed to the fixed income rally in November as market participants lowered their forecasts for inflation worldwide. Following the vast growth in US shale oil production over the past few years, excess supply over demand has pushed the oil price sharply lower since June this year. In a move interpreted as a change to the strategy of fine-tuning supply to stabilise prices, the Organization of the Petroleum Exporting Countries (OPEC) unexpectedly decided to maintain the production level unchanged at its meeting on November 27th, which pushed oil prices even lower with e.g. WTI Crude falling to a 5 year historical low to below USD 70/barrel.

The exceptional monetary policy easing by the Bank of Japan weighed on the JPY, which became the worst performing currency in November. Moreover, the AUD and the NOK suffered from plunging commodity prices. Meanwhile, the NZD cut back on earlier losses and was the best performing G10 currency in November (trade weighted), while the USD continued its trend of moving higher on the improving US economic growth prospects.

At the press conference following the ECB policy meeting in November, Mr. Draghi made further clarifications with regard to the dimensions of its current stimulus program. In particular, the Governing Council agreed that the ECBs balance sheet is “expected to move towards the dimensions it had at the beginning of 2012”. While this is an expectation and not a promise, the Governing council further agreed that the asset purchase program will have a “sizeable” impact on the ECB’s balance sheet - i.e. it fulfils the standard definition of quantitative easing.

Nordic overview

The Swedish interest rate curve flattened as longer-term rates declined in tandem with equivalent rates abroad. Various comments by the Riksbank board members may also have contributed to the flattening of the yield curve, as the next potential measure is likely to be a deferment of the hiking cycle further into the future. Moreover, the market has started to speculate that the Riksbank even could bring the key policy rate into negative territory, should inflation fail to recover towards target.

In Norway, inflation and capacity utilisation is currently fully in line with Norges Bank’s target. Although surveys signal that a slowdown in the oil sector is underway, they currently do not signal a broad-based downturn in the Norwegian economy. This notwithstanding, Norwegian interest rates and the NOK fell sharply in November on expectations that the Norges Bank may follow the ECB and Riksbank to ease monetary policy in December or early next year. In addition, the further sharp drop in the oil price contributed significantly to the downward pressure on rates and especially the NOK in November.

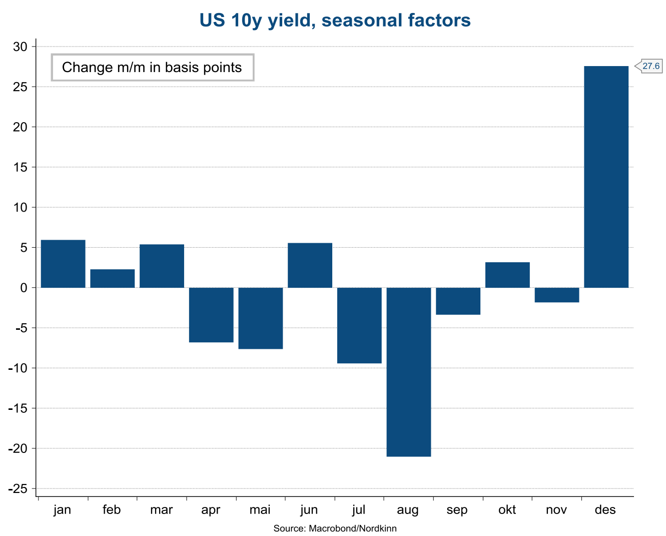
Global markets

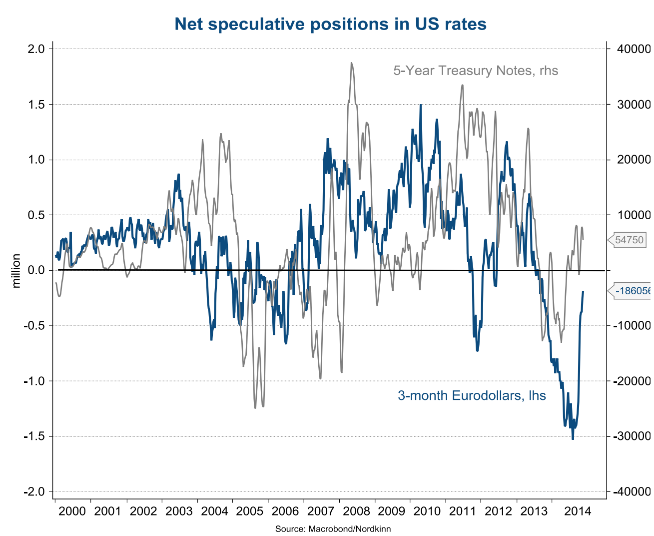
We expect the global economy to grow at a somewhat faster pace in 2015 than in 2014, driven by the advanced economies. We also believe that improving macro fundamentals globally will guide financial assets pricing towards long-term macroeconomic fundamentals. At the same time, the recovery in the global economy is likely to remain uneven across regions, with diverging inflation outlook. As a result, we continue to expect further disparity in interest rates across major economies in 2015.

The US economy has made significant progress towards meeting the Federal Reserve's mandate of 2.0% medium-term inflation and full sustainable employment. Core personal consumption expenditure (PCE) inflation rose to 1.6% y/y in October, its highest since December 2012, while the unemployment rate fell to 5.8%, just marginally above the Federal Reserve's 5.25-5.5% long-term equilibrium estimate. Consequently, we expect the Federal Reserve to begin normalising its policy rate around mid-2015. Although we anticipate that the hiking cycle to be gradual, we predict a faster pace of tightening than currently implied by the market. This is at the centre of our "*USA: Economic Recovery Progressing*" theme.

Assuming that the drop in the oil price will stabilise at current levels, it will have a lasting impact on the consumer price level, but the impact on inflation is only transitory. Consequently, we expect the FOMC to look through volatility in CPI caused by the decline in the oil price and instead focus on the positive impact cheaper energy brings for economic growth prospects. The drop in the oil price should in isolation lead to steeper yield curves.

Regarding communication, we expect the FOMC to adjust its forward guidance at its meeting on December 17th, replacing the "considerable time" phrase with a stance to showing "patience" before hiking. This is likely to mean a hike in June 2015, which compares to a market-implied timing of September/October 2015 at the time of writing.





Looking at prospects for global rates in the near term, historical data shows an interesting seasonal pattern for government bonds; yields often falls in August and rises in December, see chart to the left. The relationship is however not stable, and we would only attach very modest importance to such pattern, but on the margin, it supports our short conviction in the US bond market going into December. Also in support of this view, data collected by the US Commodity Futures Trading Commission (CFTC) shows a significant reduction in speculative short positions in Eurodollar futures over the past couple of months, see chart to the right.

Turning to Europe, we expect the Bank of England to hike its key policy rate around the middle of 2015, which is around half a year ahead of market-implied expectations. However, we admit there is a risk that the Bank of England will delay its tightening process until later next year given recent softening in growth and inflation data.

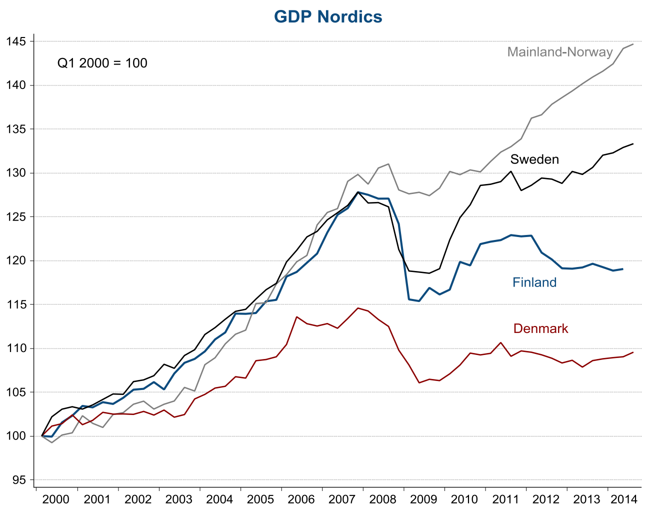
At the press conference in November, Mr. Draghi outlined two contingencies that would trigger more stimulus: 1) The current measures are not enough to expand its balance sheet towards 2012 levels; 2) A worsening of the medium-term outlook for inflation expectations. In our view, the current measures (TLTROs and purchases of covered bonds and asset back securities) are not enough to expand the balance sheet significantly. Secondly, the drop in inflation expectations seems to continue, although not rapidly. In sum, we expect the ECB to stay put at the December meeting, evaluating the TLTRO uptake and the effects of the other measures already in place, before taking additional steps in monetary policy. This is at the centre of our "*EMU: ECB policy easing*" theme.

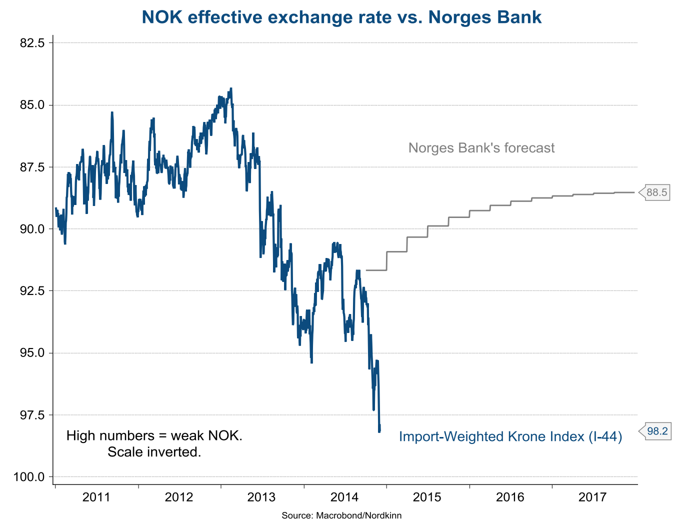
Nordic markets

After the Riksbank lowered its policy rate to zero in October, the market is speculating what the next move could be. In its October Monetary Policy Report, the Riksbank presented a list of possible additional measures, including forward guidance, bond purchases and exchange rate interventions. The conclusion was that the Riksbank has the same possibilities as other central banks to take further measures to increase monetary policy stimulus. This list of measures does not exclude a negative repo rate. However, according to the latest minutes of the monetary policy meeting in October, there is currently in essence no ambition to reducing the repo rate from the current levels. Rather, if needed, the next potential measure looks likely to be a postponement of the repo-rate increase, although the effectiveness of such decision is questionable given the already low bond yields across virtually all maturities.

Interestingly, the Riksbank also presented a list of appealing arguments of why the situation in Sweden looks better than of those countries where central banks have adopted complementary measures. For instance, the financial markets and financial sector as a whole are functioning relatively well, reflected by an increase in lending to households and companies that, somewhat ironically, appears to be a major concern for many Riksbank Board members. Moreover, economic development is relatively strong, with GDP increasing at a normal rate and employment rising significantly. Finally, the Riksbank points out that the SEK is not remarkably strong (as opposed to the CHF when the SNB implemented the EUR/CHF floor).

To sum up, aside from forward guidance on the repo rate, the hurdle for the Riksbank to undertake additional action seems high as at current. We therefore expect the Riksbank to stay put in the near future.





In Norway, a key policy rate at 1.5% is well above the zero bound, which allows for meaningful cuts. Indeed, with the outlook for the oil sector deteriorating sharply due to falling oil investments and a plunging oil price, we expect Norges Bank to cut interest rates at least twice next year. However, we think market expectations of a possible cut already at the upcoming meeting in December is overdone. Against this background, we launched a "*Norway: Norges Bank event risk*" theme last month that will benefit from unchanged rates by Norges Bank in December.

Incoming data on growth and inflation since September are, on balance, almost neutral for Norges Bank. Inflation is on target and GDP growth has been quite firm so far this year, see chart to the left. However, surveys indicate that growth is slowing in the current quarter, but there are no signs of a sharp contraction in activity, with exception of the oil industry.

The most significant news since the previous monetary policy report is the sharp drop in the oil price, which may fuel a further decline in prospects for oil investments in 2016 and 2017. However, the impact over the forecasting horizon is uncertain for two reasons: 1) Oil price developments largely reflects a supply shock, which should be accommodative for Norway's main export partners; 2) The biggest investment project for 2016-2019 (a.k.a. Johan Sverdrup) will not be postponed.

Finally, the NOK (I-44) is now 6-7 per cent weaker than the Norges Bank projected in September, see chart. This will support the non-oil export sector. A rate cut now would push the NOK even lower. In sum, we therefore expect the Norges Bank to keep rates unchanged at the Board meeting later this month, while at the same time signal an easing bias for next year.