Nordkinn Market Review & Outlook – January 2015

NORDKINN
asset management

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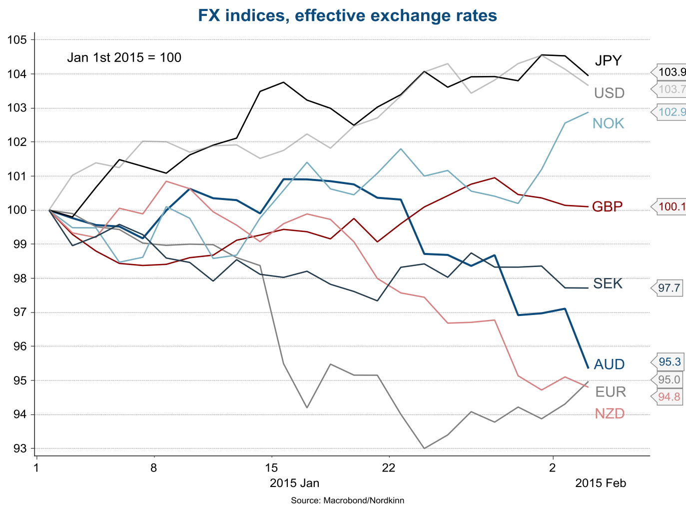
Global overview

To support economic recovery of the euro area and to mitigate the risk of deflation, the ECB announced on January 22nd a large-scale asset purchase program. The scale of the purchase program (EUR 60 bln per month) was larger than the market anticipated. Purchases will be financed through an expansion of the ECB's balance sheet (i.e. quantitative easing (QE)). In addition, the "open-ended" characteristics of the program was a positive surprise: The ECB said that the purchase program will in any case be carried out until the Governing Council sees a sustained adjustment in the path of inflation towards the ECB's inflation objective of below, but close to, 2.00%.



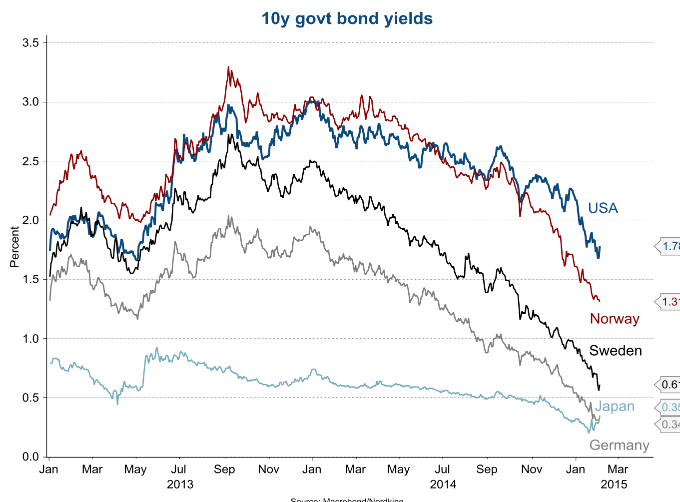
Although there was a strong market consensus that the ECB would launch an expanded QE program, the details impressed markets. As we correctly predicted, the EUR came under additional selling pressure and the European equity markets rallied after the announcement. Government bond prices also rallied, particularly in peripherals such as Italy, Spain and Portugal.

Regarding the actual outcome of the Greek election, the Syriza victory was expected but the anti-austerity coalition partner was not. Still, the market reaction to these news was largely muted. It seems like the ECB's "firewall", announced in 2012, is preventing a significant financial contagion to other peripheral countries.

Elsewhere, the albeit relatively strong macroeconomic performance in the US and the decision by the BoJ not to further expand its monetary stimulus program supported the USD and the JPY respectively. Moreover, the CHF appreciated dramatically after SNB's surprising decision to abandon the floor against the EUR and to lower its LIBOR target rate to -0.75%.

The NZD depreciated following a lower than expected inflation print for December, which probably was one of the reasons why the RBNZ on January 29th announced that inflation is likely to be lower and rise more gradually towards its inflation target than previously anticipated. Consequently, RBNZ replaced its tightening bias with a guidance to keep rates on hold for some time, pushing the NZD even lower.

Nordic overview



The Scandinavian bond markets rallied in January as ECB's ambitious QE announcement increased pressure on the Riksbank and Norges Bank to commit to further policy easing, see chart. Meanwhile, following a higher than expected CPI release, the spread between yields on Swedish nominal and index-linked government bonds (inflation spreads) erased some of the sharp decline from the previous month.

In the FX space, the EUR depreciated against both the SEK and the NOK in January. NOK/SEK gained after a somewhat more pronounced EUR/NOK sell-off in spite of a further drop in the oil price and speculation about a possible 50 bps rate cut by Norges Bank in March. Moreover, DKK is currently under significant pressure as market participants test the Danish National Bank's credibility of its EUR/DKK peg.

Incoming macro data in January were, on balance, slightly positive for both Sweden and Norway, especially interesting as a contrast to the markets' expectations of aggressive monetary policy easing.

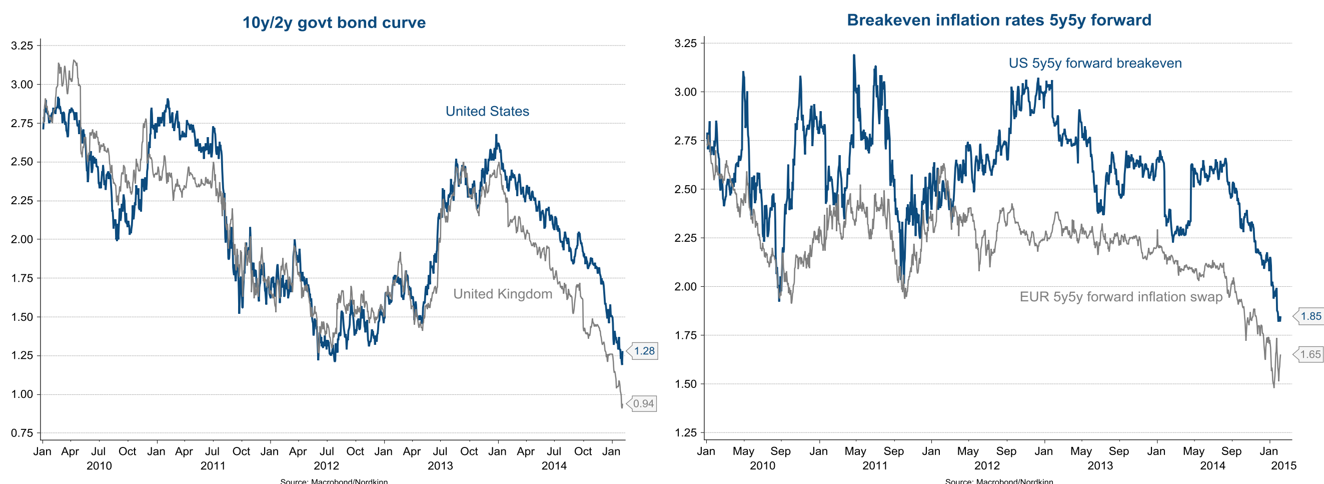
Global markets

We expect that global economic growth will receive a boost from lower oil prices. According to IMF estimates posted in December, a 40% decline in oil prices should boost global growth by between 0.3% and 0.7% in 2015 and between 0.4% and 0.8% in 2016. China, Japan and the US will benefit the most, while oil-exporting countries will suffer from a decrease in revenues. Meanwhile, inflation will fall sharply in 2015, before moving higher again next year as transitory effects of lower inflation dissipates and labour markets improves.

The financial market impact (for oil importing countries) depends on the initial state of the economy and inflation. In the euro area, where the economy is almost at the cliff of deflation and suffers from very high unemployment, the natural response for the central bank is to ease monetary policy to mitigate the risk of deflation becoming entrenched. This is precisely what the ECB has done.

However, if capacity utilisation is approaching normal levels and inflation is well above zero, the central bank should look through what is likely to be a transitory decline in inflation due to falling oil price and instead focus on the medium-term prospects for inflation after base-effects are out of the twelve-month change in CPI. This is what the Federal Reserve seems to be doing. Of course, the near term drop in inflation buys the Federal Reserve more time to assess the state of the economy before pulling the trigger. In other words, we see the probability of a hike in June (which remains our base scenario) as slightly lower than before.

At the same time, given the improved growth prospects for the US economy as described above, a delay in policy tightening now may imply a pent-up demand for tightening at a later stage. If the market agrees, the slope of the US yield curve should steepen. However, the reaction in the market has been the opposite. Short-term interest rates have fallen, essentially pricing out all but one interest rate hike this year, yet longer-term interest rates have fallen even more. As a result, the slope of the yield curve has flattened significantly since the oil price started to drop last autumn, see chart.



Several factors may explain this seemingly counterintuitive reaction on the yield curve: Firstly, the reaction may not be that counterintuitive after all. Given the low inflationary pressures worldwide, including low wage growth, the market may fear that the world economy is at the brink of deflation, which could motivate households and businesses to simply postpone their spending decisions, which in turn would be harmful for future economic growth. Market-based measures of inflation expectations have fallen sharply, see right hand chart. Secondly, even if the US economic outlook is positive, the world economy may be slowing amid lacklustre growth in the euro area, China and Brazil among others. Thirdly, the ambitious QE programs of the ECB and BoJ means global central bank liquidity is set to linger and even increase. When short-term bond yields trade at zero or even negative in some countries, investors in search for yield are forced to buy longer-term bonds.

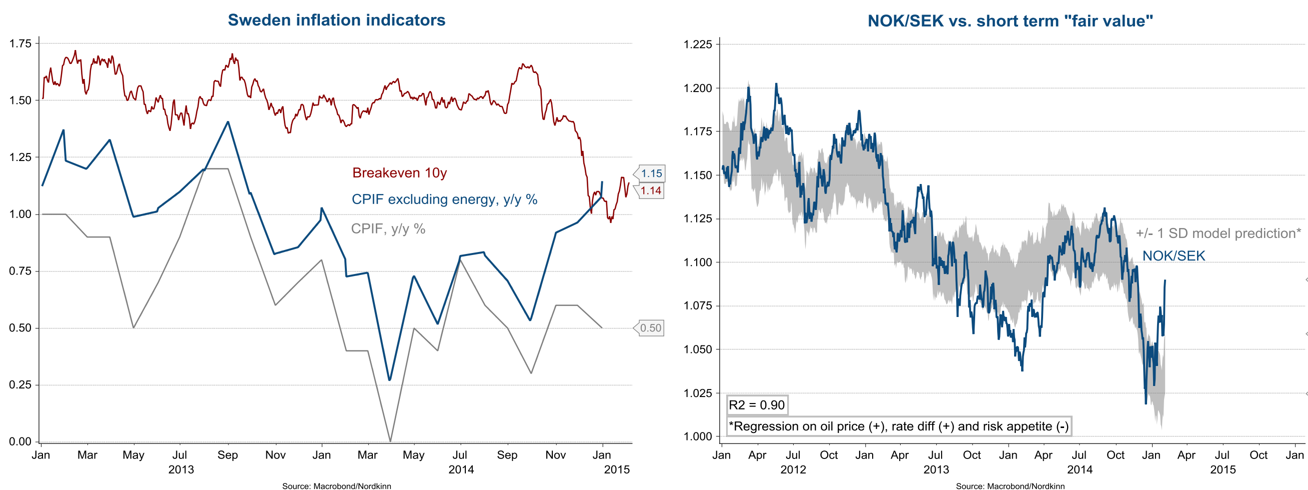
Having these caveats in mind, we nevertheless see a significant risk for bond yields to increase and yield curves to steepen before summer, partly reflecting our expectation for a 25 bps hike in the Fed Funds rate in June. According to our bond valuation models, which takes into account cyclical factors such as capacity utilisation and growth, UK and US government bonds are the most overvalued in our investment universe (even if German and Japanese bond yields are substantially lower).

Nordic markets

As we stated in the previous monthly report, a further drop in inflation and inflation expectations is the main preconditions for the Riksbank to undertake unconventional measures in its monetary policy. Incoming data during January confirms that inflation and inflation expectations in Sweden remain at very subdued levels. However, there are signs that the downward trend may have come to a halt. Excluding energy, the inflation rate has in fact increased quite markedly since the trough in April last year, see chart. Inflation in December was actually slightly above Riksbank's projection.

This may give the Riksbank Board time to await new information, which in our view favours a no-change at the Board meeting on February 12th. At the same time, the Riksbank will provide more details on unconventional measures that could be implemented if needed. Consequently, we expect the market to continue speculating that the Riksbank eventually will follow in the ECB's footstep and launch a QE program designed to boost inflation expectations, which will support covered and government bonds. However, those investors expecting the Riksbank to launch such a program already on February 12th may be disappointed.

In our view, the stabilisation in petroleum prices and the ECB's large-scale asset purchase program should contribute to lift inflation expectations in the euro area and Sweden in the months ahead. Still, we expect actual CPI prints to remain low for quite some time. The effects of the depreciation of the SEK on CPI is associated with significant lags and, despite improving labour market conditions, there are no indications of upward pressures on wages. Consequently, in particular short-term indicators of inflation expectation are still vulnerable for any setbacks in CPI.



Since the Norges Bank Board meeting on December 11th the oil price has continued to drop sharply and is now some USD 15-20 per barrel below the Norges Bank's projections. This will translate into a weaker outlook for economic growth in Norway, lower wage growth and a subdued medium-term outlook for underlying inflation. As a result, the Norges Bank Board is likely to revise its forecast for economic growth even lower on March 19th. In response to that, the Board will probably cut the key policy rate by a further 25 bps to 1.00% and keep the rate path open for additional easing later this year.

Interestingly, the NOK exchange rate appreciated by a couple of percentage points in January. While the ECB's policy decision can account for parts of this appreciation, the NOK also gained vis-à-vis the SEK in spite of several better than expected macro data coming out of Sweden. The right-hand chart above shows that the increase in the NOK/SEK FX-rate does not reflect movements in the oil price, interest rate differentials nor risk appetite. According to this model, short-term fair value is between 1.02 and 1.06 at the time of writing; hence the current level of 1.09 looks somewhat overvalued. Against this background, and given our expectations that the Riksbank will remain on hold in February, we see downside risks for NOK/SEK in coming weeks.

While we expect Norges Bank to cut the key policy rate by 25 bps on March 19th, there is a risk that the Norges Bank will be somewhat more patient in monetary policy than the market currently expects. The market is fully pricing a 25 bps cut in March, another 25 bps of easing in May and a 50% probability of a third cut by the end of September. So far however, incoming macro data does not point to a major crisis in Norway, especially not in the household sector, which seems to benefit from a very low real interest rate. The Norwegian government has a substantial buffer and can continue to run an expansionary fiscal policy stance almost indefinitely. If the Norwegian economy in coming months withstands the negative consequences of past declines in the oil price, current market pricing looks too aggressive in our view.