Nordkinn Market Review & Outlook – February 2015

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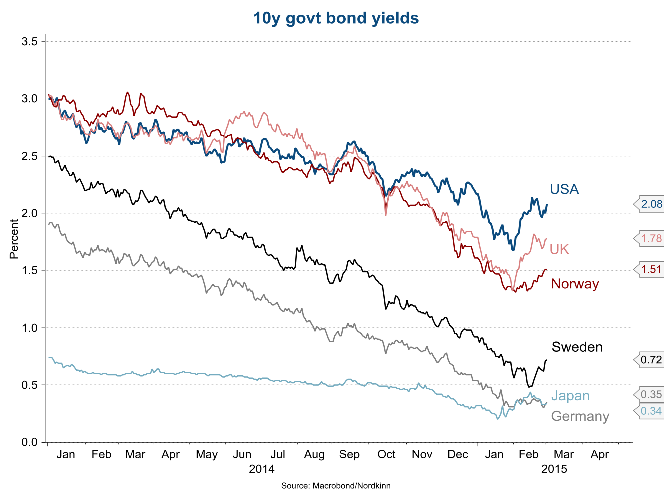
Market overview

Global overview

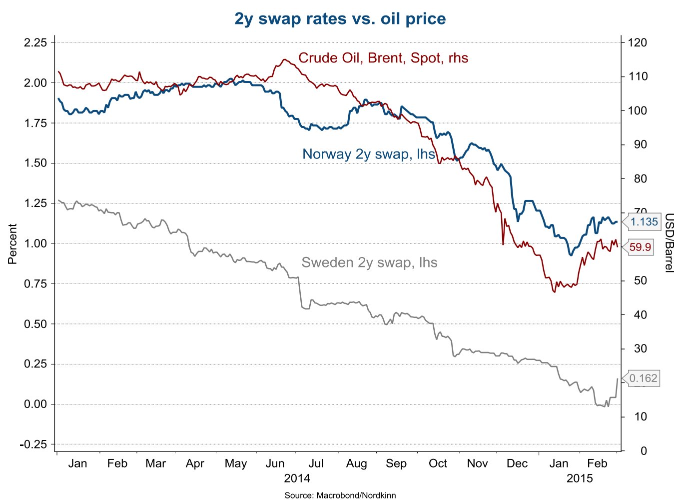
Having rallied strongly in January, global government bonds erased gains in February as rising oil prices, better US labour market data and gradually improving euro area indicators reduced concerns of weak global growth and deflation becoming entrenched, see chart. Meanwhile, various central bank comments suggested that interest rate hikes are not imminent, which in turn kept short-term market rates in check. As a result, the slope of the government yields curves steepened in February, which is consistent with the view we conveyed in our previous monthly report.



At her semi-annual monetary policy testimony on February 24th, Fed Chair Yellen delivered a relatively positive assessment of the economy. She also expanded on the definition of "patience" in the statement to emphasise that the removal of that word does not necessarily mean an imminent rate hike, but rather that the Fed would be looking to have flexibility in responding to the data. She did not provide market participants more clues about the exact timing of the first rate hike, which resulted in some short covering in the government bond market following her statement. Moreover, as in January, heavy month-end extensions also contributed to somewhat lower bond yields and flatter curves in the final week of February.

In Europe, government bond yields traded sideways in February. The spreads between bond yields in Germany and the periphery narrowed slightly after the extension of four months for Greece to negotiate a new bailout. While a Greek exit from the euro area is still a possibility by summer, the markets showed some immediate relief.

Nordic overview



Swedish interest rates fell and the SEK depreciated after the Riksbank surprisingly cut the repo rate by 10 bps to -0.10% and announced a one-off government bond-purchasing program of SEK 10 bn. While the Riksbank Board acknowledged signs that underlying inflation has bottomed out, the aggressive policy response was motivated by the perceived risk that inflation will not rise sufficiently quickly due to various uncertainties such as lower oil price, concerns surrounding Greece and the impact of ECB policy easing.

Moreover, the Riksbank expressed readiness to act even between the ordinary monetary policy meetings should the need arise. This further fuelled the decline in interest rates across the maturity spectrum. Towards the end of the month however, interest rates and the SEK rose markedly due to stronger than expected economic growth.

In Norway, developments in the NOK and market interest rate exhibit a strong correlation for the time being, see chart. The oil price drop last fall was the reason why Norges Bank in December deviated from its central scenario when it cut its key policy rate by 25 bps to 1.25%. Accordingly, the recovery in the oil price during February reduces the probability of a further aggressive monetary policy easing going forward. Moreover, several “hard data” for production, demand, employment and inflation have been relatively stable. On the other hand, business and consumer survey data clearly signals a worsening of economic conditions in coming months.

Supported by the recovery in the oil price and the widening of interest rate differentials, the NOK has been one of the best performing G10 currencies this year. The import-weighted NOK is currently trading very close to Norges Bank’s projection.

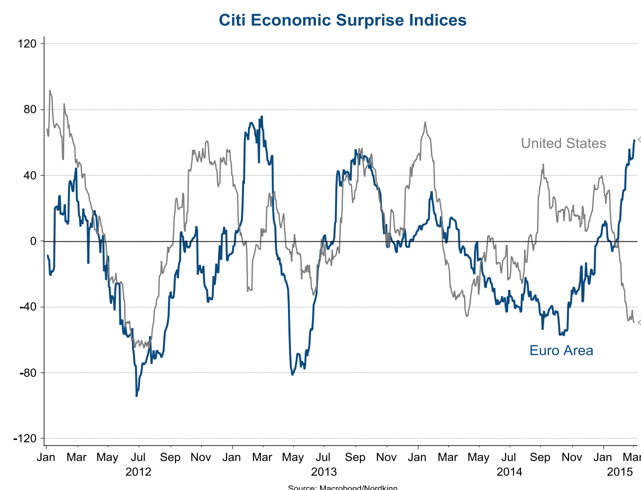
Global markets

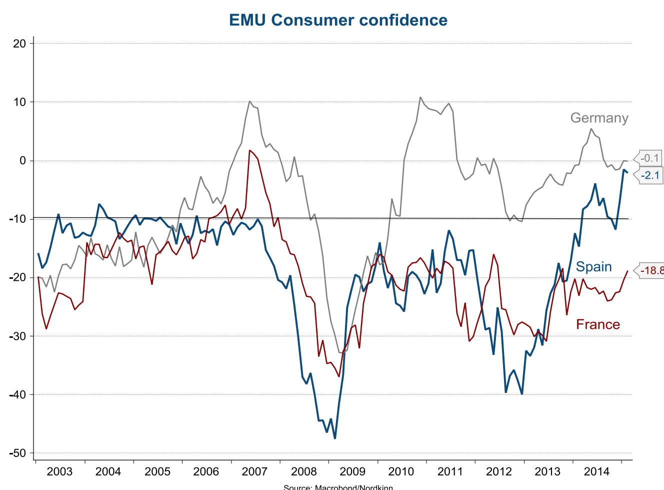
We interpret Fed Chair Yellen's semi-annual testimony on February 24th as laying the groundwork for removal of "patience" in the March FOMC statement. Otherwise, she would probably not spend so much emphasis on elaborating upon the definition of this expression, including how a removal of "patience" should (and should not) be interpreted. Yellen's message was that removing "patience" does not guarantee a mid-year hike. The purpose of this emphasis is probably to avoid excessive market reactions when FOMC removes "patience" from the statement. In essence, incoming data is key to determining whether lift off will occur in June or later. Given our relatively positive view on US economic prospects combined with the recent slightly upbeat indicators for global growth in general, we are still holding onto our June call.

As our Fed view is more hawkish than expectations currently prevailing in the market, we remain biased towards higher US bond yields coming months. Our proprietary quantitative toolbox, including medium-term trading indicators as well as longer-term fundamental models, supports this view.

In February, we launched a new investment theme in our portfolio; "*UK: Longer-term inflation prospects*". We believe that the market is overly focused on the near-term inflation outlook, whereas we believe the Bank of England sees the current drop in inflation as being transitory. Recent comments from Bank of England officials supports this view. In the medium-term, which is the relevant horizon for monetary policy, the drop in commodity prices provides further support for economic growth and employment in the UK. As labour market conditions improve, inflationary pressures should gradually feed into wage and price data coming quarters.

This does not mean that we predict the Bank of England will raise rates soon. The market currently expects Bank of England to keep interest rates unchanged well into 2016. Given our call for a mid-year hike by the Fed and a positive outlook for the UK economy, we believe that market participants will adjust their expectations for Bank Rate lift off to 2015. We obtain exposure to the theme by selling short-sterling futures (note that the fund portfolio on balance has a more neutral duration given our long bias in Scandinavian fixed income, see next page).





Meanwhile, recent incoming data for the euro area have made us question if not the euro area could become a positive surprise relative to expectations in 2015. There are signs, albeit admittedly tentative, of improvements in underlying economic activity. For instance, business and consumer confidence are rising across the euro area, credit demand picks up and banks report easing credit conditions as financial fragmentation improves, see charts. In addition, German wage growth appears to be picking up and the February CPI release suggests inflation is about to bottom across the euro area as commodity prices stabilises.

Regarding investment implications, we have to bear in mind that the euro area recovery has a very long way to go before capacity utilisation approaches normal, and the ECB's Governing Council remains committed to continue its large-scale asset purchase program at least through September next year. Having said that, the unexpected weakness of euro area growth and inflation in 2014 contributed to: 1) a global bond rally; 2) lower demand for oil; 3) plummeting break-even inflation rates and 4) a significant depreciation of the EUR. If, and it is still a big if, the euro area economy were to surpass expectations in 2015, one could easily imagine a reversal of these trends. In particular, the German Bund should come under pressure sometime this year if this scenario plays out.

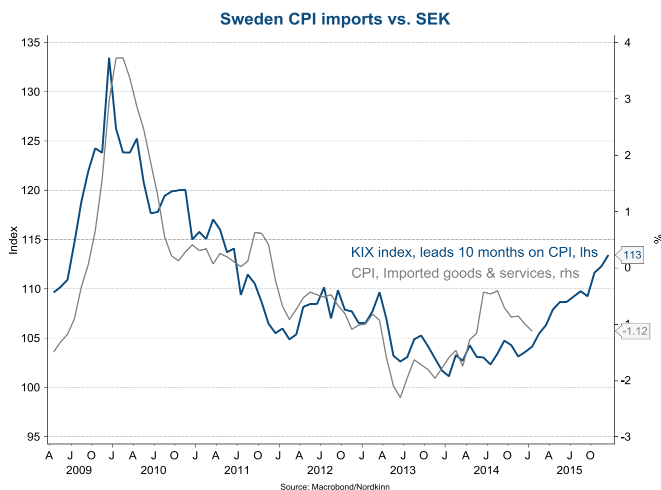
Nordic markets

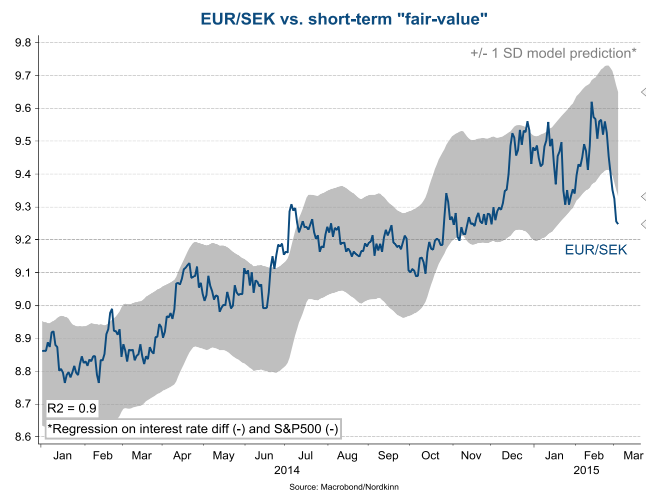
The decision to cut the repo rate to -0.10% and to purchase government bonds demonstrates how far the Riksbank is willing to go to safeguard the credibility of the inflation target as a nominal anchor for price setting and wage formation (refer to our investment theme "*Sweden: Credible inflation targeting*"). Although there are signs that underlying inflation has bottomed out, the minutes of the meeting on February 11th reveals that the Riksbank Board is strongly committed to do whatever needed to combat any downside risks to inflation and to support "inflation rising towards the target sufficiently quickly".

Looking ahead, we expect the global economic recovery to reinforce economic activity in Sweden and the labour market will continue to improve. However, we expect resource utilisation to remain below normal levels until at least 2016. This, in combination with a drop in inflation expectations, will contribute to a very slow rate of wage increases this year and next. Consequently, we agree with the Riksbank that domestic inflationary pressures appears very soft.

Moreover, the Riksbank Board expressed concerns that international developments, including the low oil price and the foreign exchange market, will contribute to a slow rate of increase in prices on imported goods and services. In particular, considering the aggressive monetary policy stance in the euro area, there is a risk of a stronger SEK, and thus continued slow price growth on imported goods and services (see left hand chart). Since the monetary policy meeting in February, the SEK has appreciated by almost 4% against the EUR. In our view, this has increased the probability that the Riksbank will undertake additional monetary policy measures at the Board meeting in April (or potentially even earlier at a non-scheduled monetary policy meeting).

To sum up, we expect that our "*Sweden: Credible inflation targeting*" theme will continue to perform going forward. We express this theme through long positions in fixed-rate covered bonds and in curve flatteners. Moreover, convinced by short-term trading signals (see right hand chart) and our Riksbank call, in the beginning of March we also started to build short positions in SEK.





Turning to Norway, growth and inflation since December has broadly been in line with Norges Bank's projections. Moreover, having recovered since the turn of the year, the import-weighted NOK is currently in line with Norges Bank's projections. Notwithstanding these developments, our conviction for a dovish message by the Norges Bank on March 19th is very high for the following three reasons:

1) The oil price is currently around 10 USD below the Norges Bank's projection from December. This will contribute to a further downward revision of growth and inflation prospects. 2) Incoming data points to a significantly lower wage growth in 2015 than the Norges Bank projected in December. The Bank is thus set to cut its forecast for 2015 wage growth by as much as ½ %-points. 3) The Norges Bank will take into account the aggressive monetary policy easing undertaken by other central banks, in particular the ECB and Riksbank, since the last meeting in December.

Following the surprise decision to cut rates in December, the Norges Bank communicated to the market that the probability of a further 25 bps cut in March is around 50%. The three arguments above will almost certainly tip the balance in favour of a 25 bps cut on March 19th. Moreover, we expect the Norges Bank to signal readiness to do more in 2015 should the outlook for growth and inflation deteriorate further. We express our theme "*Norway: Weaker growth prospects*" though long positions in fixed-rate covered bonds, curve flattening and short NOK.