Nordkinn Market Review & Outlook – March 2015

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Based at the Nordkinn peninsula, Slettnes Fyr is the northernmost located mainland lighthouse in the world

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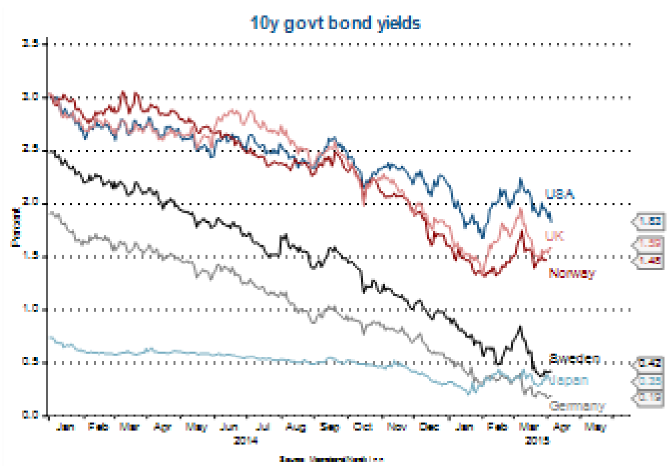
Market overview

Global overview

Global government bonds rallied in March following subsequent central bank actions, which included the ECB commencing with its extended asset purchase program, the Federal Reserve significantly revising its interest rate projections lower and the Bank of England's chief economist signalling that it stands ready to cut interest rates should the risk of deflation intensify. Despite lower nominal rates and further decline in the oil price, market-implied measurements of future inflation expectations rose in March, suggesting that the strong commitment of central banks for accommodative policies is what may bring the end to deflation fears

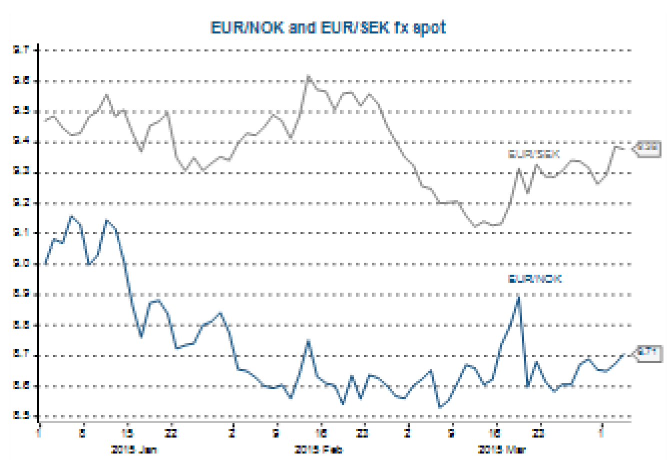


The ECB's launch of its QE program in March had a twist that surprised market participants somewhat. Contrary to expectations of no downward limit on the yield, the ECB announced that the yield floor for purchases is the deposit rate (-20 bps). This contributed to a significant flattening of the government bond curves, accompanied by another leg down in the EUR exchange rate. Moreover, the concern of a scarcity of supply in bonds also added to the downward pressure on bond yields, despite a rise in inflation expectations. European equities outperformed the US market following EUR weakness and signs of improving growth prospects in the euro area.

As we expected, the Federal Reserve dropped "patience" with regards to timing of initiating a normalisation of interest rates. While the actual statement was much as we expected, projections showed that the committee had significantly lowered their forecasts for the Fed Funds rate in 2015 and 2016, primarily as a response to the dollar appreciation. The gap to the market's pricing narrowed significantly and the case for a June lift-off in rates weakened in favour of September.

In addition, Q1 data in the USA has on balance been weaker than expected. Bad weather explains some, but probably not all. Against this background, we have reduced our conviction to the *"US: Economic recovery progressing"* theme.

Nordic overview



Although there are signs that inflation has bottomed and is beginning to increase, the Riksbank Board remains concerned that continued SEK appreciation can reverse this trend. As the ECB actions lead to much stronger SEK, at a non-scheduled policy meeting on March 18th, the Riksbank decided to cut the repo-rate by 15 bps to -0.25% and to purchase additionally SEK 30 bn of government bonds. As Swedish macro remains strong, the Riksbank was arguably cornered by the ECB to react swiftly and firmly.

Swedish government bonds rallied sharply, the curve flattened and the SEK sold off following the decision. Meanwhile, breakeven inflation rates rose. As we wrote in our previous monthly report, we foresaw that the Riksbank could act at short notice and were positioned accordingly.

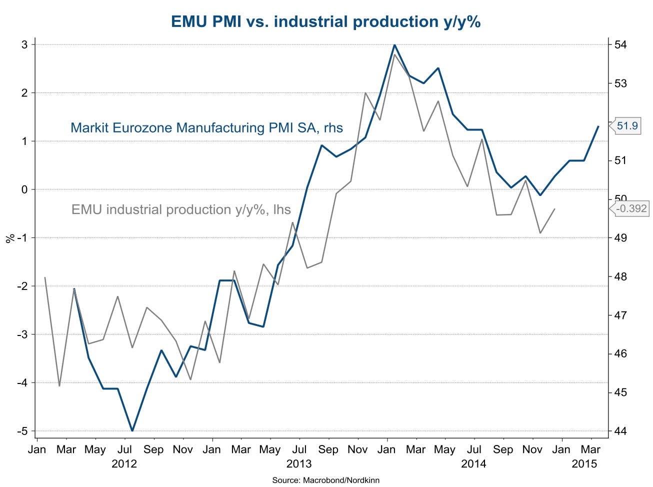
Norges Bank caught market participants and us by big surprise when leaving its key policy rate unchanged at 1.25% on March 19th. In December, the Bank had signalled a 50% probability for a cut, but despite a further softening of the growth and inflation outlook in the context of falling oil prices and low wage growth, the Norges Bank decided to stay put. Signs of rapid house price growth and building household debt made the board cautious. However, the board gave a very strong signal that if developments ahead are broadly in line with projections, rates will be cut by 25 bps in Q2 and the rate path even implies a 20% probability for a second cut later this year. While market interest rates increased sharply and the NOK rose after the decision, longer-term bond yields fell (i.e. the curve flattened) as the Bank revised its projection for interest rates in 2017 meaningfully lower.

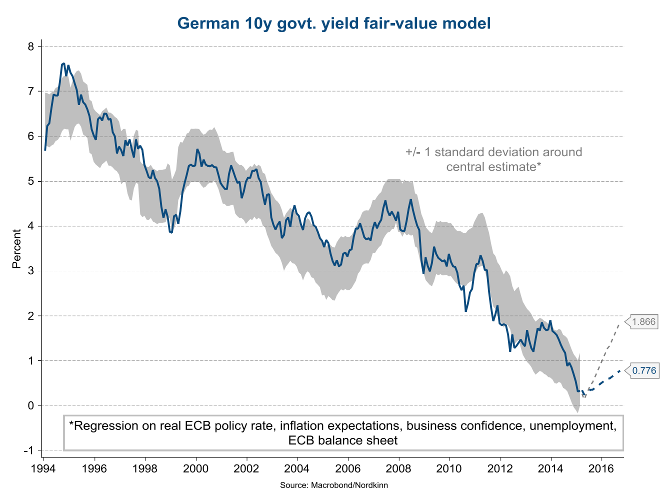
Global markets

In this global market outlook, we discuss how ECB's asset purchase program could affect the financial markets over the medium term. In retrospect, there is no doubt that the program has already had a significant impact on government bond yields. Since autumn last year, expectations of a QE program by the ECB had gradually started to build and those expectations grew firmer in the weeks prior to the announcement on January 22nd. These expectations accounted by far for most of the fall in government bond yields since autumn last year. In addition, the announcement of the program itself in January led to a further fall in sovereign yields, as the program was more ambitious than anticipated. Furthermore, the implementation of the program in the beginning of March also contributed to another leg down in yields after the ECB announced the -20 bps yield floor.

Now that all details regarding the terms on purchases (e.g. set range of maturities, 25% cap per issue and yield floor at -20 bps) are well known, should we expect a further decline in the German 10-year government bond yield from the lows in March (+0.17%)? In the near term, the answer is probably "yes"; there is a risk that the German Bund yield continues to fall near term. The QE program is fuelling a search for duration and low fiscal deficits imply a net negative supply of bonds. Consequently, fears of a scarcity of bonds could materialise in shortage, which would push yields even lower.

At the same time, if ECBs measures were to work their way into the real economy, there are good reasons to expect upward pressure on nominal yields over the medium term. For instance, the reduction in sovereign yields is already passing through to corporate bonds, to equities as well as to the exchange rate. This, in turn, seems to have contributed to recent signs of a better than expected macroeconomic development. Businesses and consumer confidence has increased in recent months (see left hand chart) as corporate banks report easing credit standards and the unemployment rate is moving downwards.





Turning to the right hand chart, we use our proprietary macroeconomic model to forecast the developments in the 10y Bund yield over the next couple of years. The model, which incorporates the impact of ECB monetary policy, inflation expectations and cyclical economic indicators, successfully captures the broader trend in the yield over the past 20 years. We present two different forecasts for the Bund yield in 2015 and 2016. Both forecasts assume a continued albeit very gradual decline in the unemployment rate and a gradual rebound in inflation expectations. One model takes into account the ECBs extended asset purchase program, the other does not.

Under these assumptions, both models predict a floor in the 10y Bund yield at around 0.20% in April 2015, followed by a gradual increase in the yield. Without the ECB's QE program, the model predicts an increase in the 10y Bund yield to 1.9% by end-2016 (grey dotted line). In the more relevant model where ECB's QE policy is included (blue dotted line), the model predicts a much more gradual increase in the Bund yield. The key take away is that the 10y Bund yield is set to increase over the next couple of years as monetary policy is working its way through the real economy.

Given that there are signs, albeit admittedly tentative, of improvements in underlying economic activity, we expect pockets of green shoots to appear in the European real economy. Nordkinn therefore in March launched the new long-term investment theme *"EMU: Economy sprouting seeds"* that will benefit from improvements in the real economy. Currently, one such strategy is a gradual compression in yield spreads between Germany and trading partners outside the euro area.

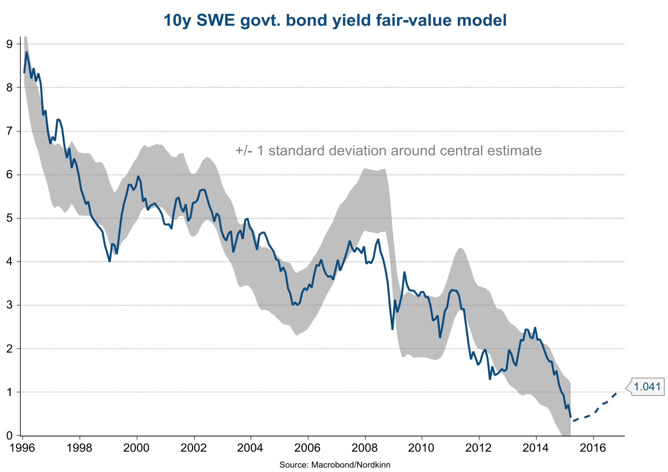
Nordic markets

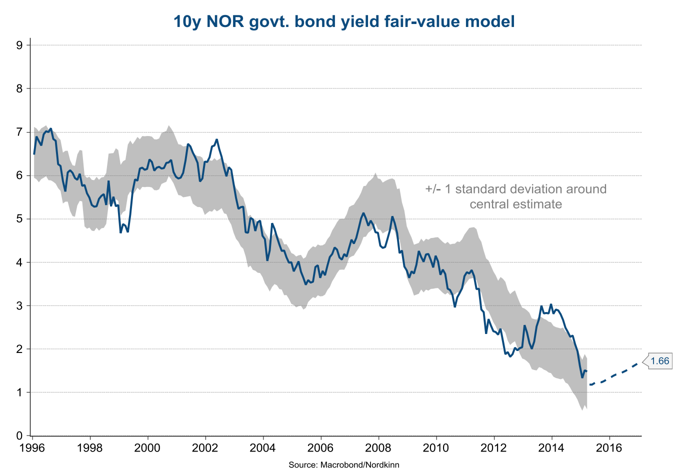
We continue to expect additional monetary policy easing by both the Riksbank and the Norges Bank, but for different reasons. Despite a more positive outlook for growth in Sweden, the Riksbank will continue to pursue an extremely accommodative monetary policy stance with a view to bring inflation rapidly up to target and to remove downside risks to inflation. In Norway, where inflation is close to the 2.5% target, the Norges Bank will respond to a weaker growth outlook and signs of easing medium-term inflationary pressures.

The key source of downside risk to inflation in Sweden is the currency. With wages growing at a very slow pace, a stronger SEK will make it hard, if not impossible, for the Riksbank to achieve the inflation target within the next couple of years. Indeed, comments from board members confirms that the risk of a stronger SEK was a main reason behind intermediate cut to -0.25% and the expansion of government bond purchases by 30 bn SEK, which surprised most market participants.

Contrary to the policy action in March, the market now expects additional stimulus at the Board meeting in April. As such, a failure to add monetary stimulus would likely cause the SEK to strengthen again, which is why we expect the Riksbank to undertake further action in April, primarily via extended bond purchases. Although the exact market impact will depend on the size of the stimulus added, we expect the government bond curve to remain flat, covered bonds to be supported and the SEK to be subject to downward pressure.

Based on our assumption of additional Riksbank action, our bond model predicts a further 10-12 bps drop in the Swedish 10y government bond yield to slightly below 0.3% in coming months and to remain low throughout the year, see left hand chart. Next year, we expect Swedish government bonds to underperform Germany as growth momentum and inflation pick up.





Turning to Norway, the Norges Bank provided in March a forward guidance stating that, “if developments in the economy ahead prove to be broadly as projected, there are prospects that the key policy rate will be lowered.” The central projection in the monetary policy report indicates a rate cut by summer, either in May or in June. This means a cut is very likely, but not a done deal. The forward guidance gives the Bank the flexibility to await incoming data on house prices and demand before taking a final decision.

Incoming data confirms in our view a weakening trend for growth and inflationary pressures in Norway. In line with Norges Bank’s forward guidance, we expect a rate cut in Q2. The very modest outcome of this year’s wage negotiations clearly favours May instead of June in our opinion. Looking further ahead, we expect more signs of weaker economic growth over the summer, which would trigger further policy easing in September and December.

Our bond model predicts a 35-40 bps downside for the 10y Norwegian government bond yield this year, before rising gradually in tandem with Bunds yields next year, see right hand chart. We also predict a weaker NOK in coming months, before recovering with higher oil prices in the fourth quarter of this year and into 2016. Overall, our conviction to the *“Norway: Weaker economic outlook*” theme remains high.