Nordkinn Market Review & Outlook – August 2015

NORDKINN
asset management

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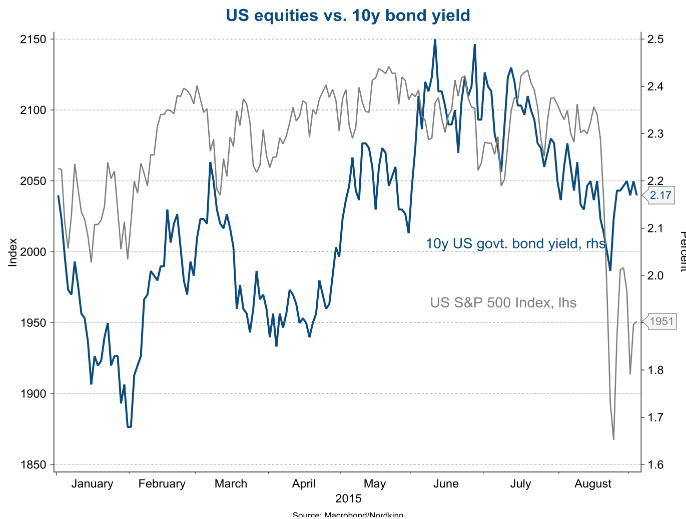
Market overview

Global overview

In August, global stock markets suffered the biggest sell-off in four years. The sell-off was triggered by turmoil in Chinese equities as macro data worsened. The Shanghai composite index dropped by -8.5% on August 24th (named "China's Black Monday") and the effect was felt also beyond stock markets. The VIX volatility index leaped to its highest level since 2011. Prices on oil and a wide range of other commodities fell to six-year lows, and emerging market currencies were hammered. This all lead to demand for safe haven assets, pushing high-rated government bond yields downwards, see chart.

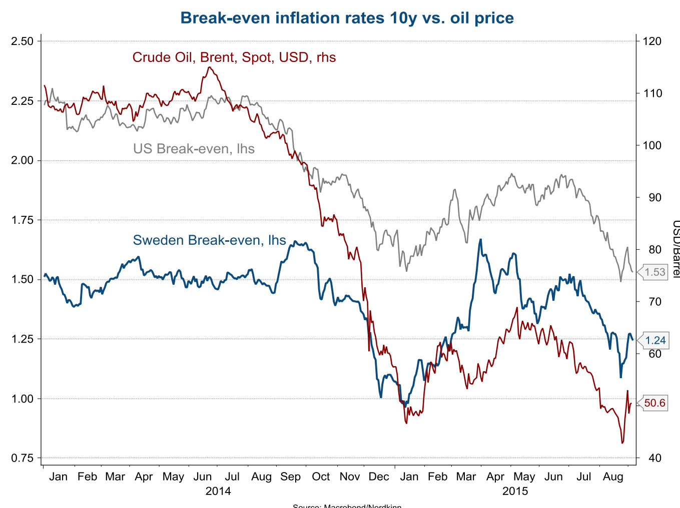


The market turbulence and the decline in commodity prices contributed to a reprising of expected interest rate moves by the FOMC. The market now sees a low probability of a rate hike at the upcoming meeting on September 17th. This was also reinforced by the minutes of the FOMC meeting held in July, which questioned the outlook for higher inflation and did little to support anybody's conviction about a September hike.

As a result of lower US interest rates, the USD depreciated against the EUR and JPY. Meanwhile, the USD appreciated against commodity currencies such as the AUD, CAD and NOK as well as against emerging markets currencies. The move was particularly large against the CNY after the Chinese central bank surprisingly intervened in the currency market.

In the UK, it came as a surprise that only one member of the MPC voted for higher interest rates in August given the July minutes had described the rate decision as "finely balanced" for "a number of members". This dovish surprise from the MPC combined with somewhat weaker than expected indicators of growth and employment contributed to a decline in interest rates, flatter yield curves and a weaker GBP.

Nordic overview



Swedish interest rates fell and the slope of the yield curve became flatter in August as lower commodity prices lead market participants to expect the Riksbank to revise its near-term outlook for inflation and conduct further easing. The unexpected increase in CPI inflation in July was largely interpreted as transitory.

Meanwhile, market-based measures of Swedish inflation expectations (so called break-even spreads) declined in August. The chart shows that this decline was largely a global phenomenon mirroring the drop in energy prices.

The Norwegian fixed income market followed a similar pattern in August, lower yields and flatter curves, although it outperformed Sweden and Europe somewhat given the Norwegian economy's dependence on oil. The NOK sold off sharply against most major currencies. Weak data releases may also have contributed to falling interest rates and a weaker NOK. Survey-based indicators of manufacturing activity slowed to a six-year low and the unemployment rate continued to increase faster than anybody had predicted. This negative sentiment is further fuelled by daily media continuing to report about lay-offs.

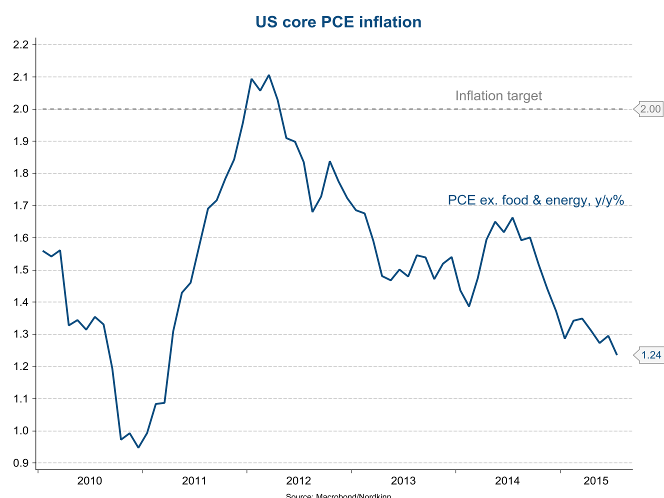
Global markets

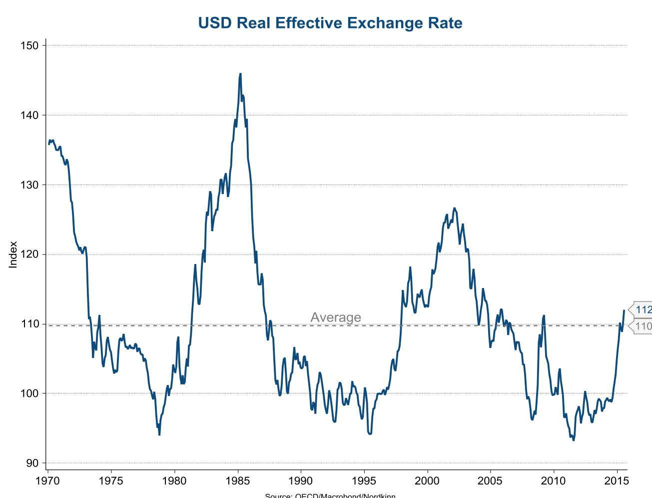
So, is this the end of the cycle? Or, are we just seeing a stock market correction that triggered a temporary safe-haven buying of government bonds? Though the Chinese economy faces problems, we do not think Chinese weakness is serious enough to bring a global recession. China's stock market is small relative to the economy. The property market matters far more. After falling in the beginning of the year, Chinese house prices have now increased for three straight months. Moreover, retail sales remain quite strong. Thus, despite turbulence in the stock market, we do not see sufficient evidence of a hard landing in China the near-term. Accordingly, we think the answer to the question is correction, and not the end of the global business cycle.

If we are right, the safe-haven buying of government bonds should end soon. Given that demand for US government bonds was particularly strong during the period of stock market turbulence, those bonds should underperform relative to other countries when dust settles. However, this does not mean that we expect bond yields to climb very rapidly going forward. The problem for the global economy is that the slowdown in China is coming on top of weakness in many other places around the globe. For instance, PMI data shows growth in global manufacturing activity and trade has slowed so far in 2015. Meanwhile, subdued wage growth and falling commodity prices are likely to keep inflation low for some time.

The two-day FOMC meeting on September 16-17th is one of the key events of the month in global markets. In July, the FOMC said it would be appropriate to raise rates when it has seen "some further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term." The economy added 215,000 jobs in July, close to the trailing 6-month average (211,000). After that number, it seemed that the Federal Reserve had almost all the confirmation it had preconditioned for raising rates.

A couple of weeks later, things started to look different. While the minutes of the FOMC's July meeting said conditions were approaching the point where policy firming would be appropriate, they gave no clues regarding timing. Meanwhile, the sharp drop in commodity prices in July and August combined with weaker than expected growth in employment costs, probably made several FOMC participants feel less confident that inflation will move back to target over the medium term. On top of that, the significant financial market turbulence that emerged in the wake of weaker economic data from China, as well as a further decline in US manufacturing confidence, may question whether economic growth will be sufficiently strong to bring inflation closer towards target over the medium term. Consequently, our conviction for a September rate hike has fallen. The FOMC has the flexibility needed to wait until October or December before the committee delivers its first rate hike since 2006.

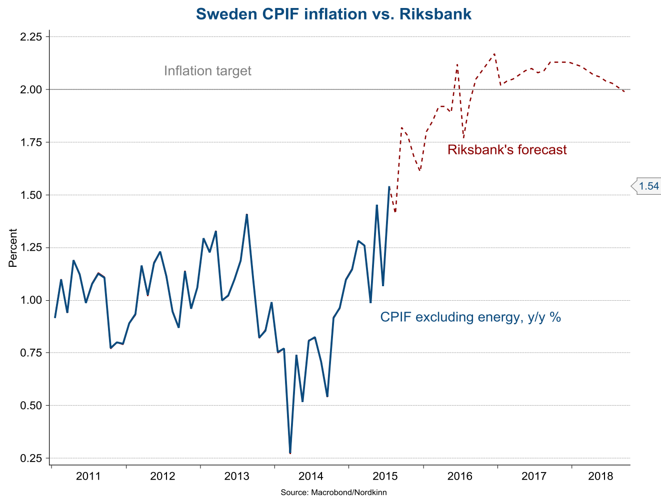




Moreover, regardless if the Federal Reserve moves in September or waits a few months, the pace of hikes in the rate path is likely to be slower than previously assumed. A number of factors drive this view. Firstly, core PCE inflation remains well below the 2% inflation target, see left chart. Secondly, prospects of very accommodative monetary policy in most other countries are pushing the USD higher. The USD has already appreciated 15% in real terms since the summer of last year, which is a more substantial appreciation compared with previous starts of hiking cycles. While the level is not very strong in a historical context (see right chart), the Federal Reserve certainly wants to avoid a further substantial USD appreciation when it begins raising rates

Nordic markets

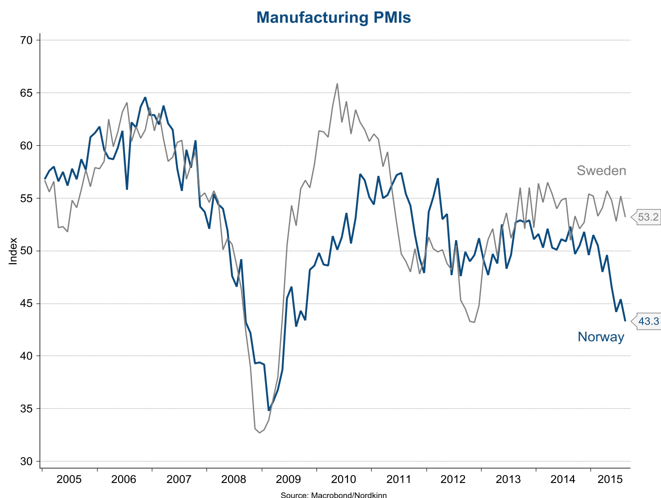
The Riksbank decided to keep the monetary policy stance unchanged on September 2nd on the back of strengthening economic activity and a "clear upward trend" in inflation. Meanwhile, the Riksbank kept the downside bias in the repo rate path signalling a possible rate cut at the October meeting. Moreover, the Board repeats the message that it is prepared to do more, also in-between regular monetary policy meetings.

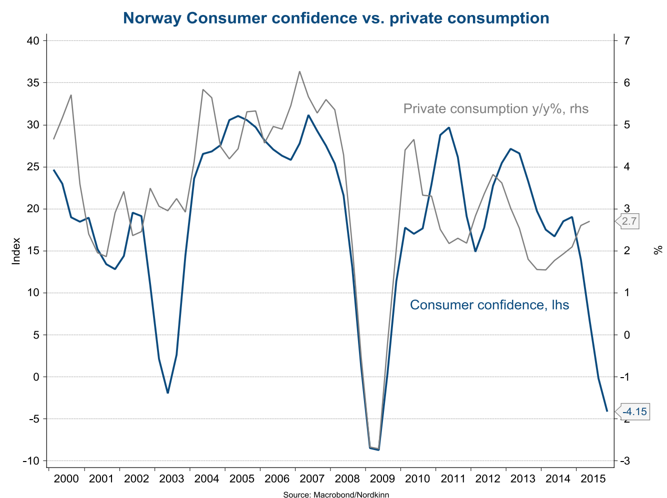


The Riksbank expects a sharp increase in inflation towards its 2% target over the coming few months. Given economic slack and subdued wage growth, we think this forecast is unlikely to materialise. Given the Riksbank's low hurdle for disappointing CPI releases, we expect additional easing of monetary policy in Q4. This includes another rate cut and more asset purchases. Continued expansionary policy should support short-dated bond prices and longer-term inflation expectations.

Turning to Norway, in June the Norges Bank said that the key policy rate is more likely to be cut further to 0.75% before Christmas if conditions evolve broadly as expected. Looking at Norges Bank's projections with regards to the probability of a move already at the next meeting on September 24th, we interpret a 50-50 chance.

In our previous monthly report, we said that we expected the Norges Bank to remain on hold in September and cut in November or December. However, based on recent incoming information and our outlook, we expect a cut on September 24th.





Since the publication of the June Monetary Policy Report, global economic developments have softened and been somewhat weaker than projected. News from China, an important demand source for commodities, has been particularly worrying. Market expectations concerning foreign policy rates in the coming period have fallen somewhat. Oil prices have fallen quite sharply to levels considered among Norwegian oil suppliers as critical. Oil futures prices have fallen, too.

New information on activity in the Norwegian economy indicates that growth has been a little weaker than projected and that the prospects ahead have weakened somewhat. For instance, the drop in the PMI index has continued (left hand chart), so has consumer confidence (right hand chart). Moreover, according to the Labour Force Survey the unemployment rate has risen to 4.5%, a higher level than Norges Bank projected. The unemployment rate for those entitled to unemployment benefits has increased to a lesser extent, and was in line with expectations.

On the other hand, the NOK is around 4% weaker than expected and core CPI inflation was 0.4% percentage points higher than expected in July. Again, on balance we believe the mix of news since June is tilted to the downside for Norges Bank.