Nordkinn Market Review & Outlook – October 2015

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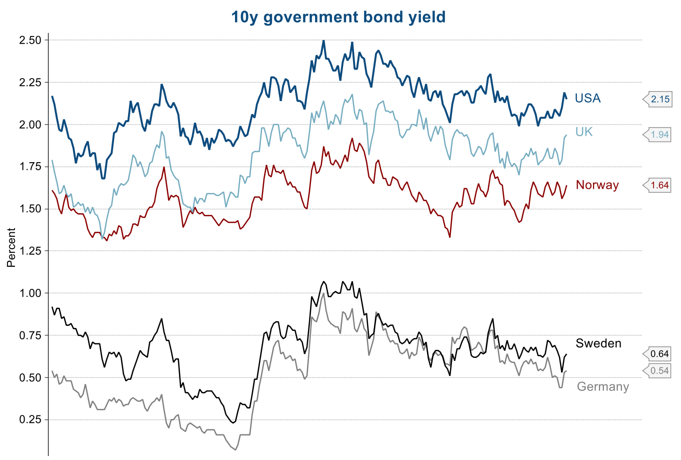
Market overview

Global overview

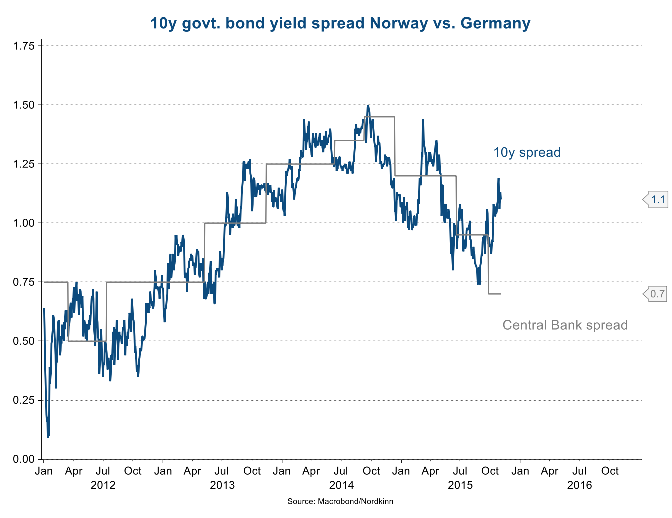
Appetite for risky assets surged in October following tentative signs of stabilisation in global growth combined with further monetary easing by central banks. In particular, concerns for a potential hard landing in China seems to be fading as growth in household demand holds up well whilst Chinese monetary authorities support smooth economic transition by cutting rates. Meanwhile in advanced economies, fixed income markets rallied after the ECB indicated further expansion in December of its monetary easing program, but bonds sold off again a few days later when the FOMC surprised markets when signalling that the prospects for a December hike indeed remain alive. Divergence in expectations regarding monetary policy pushed cross-Atlantic bond spreads wider and the EUR/USD lower.



At the press conference following the ECB meeting on October 22nd, President Draghi provided strong hints about additional monetary easing in December. The ECB motivated its dovish statement with the evident downside risks to projections for growth and inflation in the wake of weakness in emerging markets as well as developments in financial and commodity markets (including previous appreciation of the EUR). The discussion on easing options were described as "rich" and included even a cut in the deposit rate facility.

A few days later, on October 28th, the Federal Reserve almost explicitly said that the Committee will consider raising interest rates at its next meeting, but the decision hinges on progress - both realised and expected - toward its objectives of maximum employment and 2% inflation. The Committee will monitor global and financial developments, but no longer seems to think those factors will meaningfully restrain growth

Nordic overview



In October, the Riksbank decided to maintain its repo rate at -0.35%, but expanded its government bond purchases both in size by 65 bn to 200 bn and in time by six months until mid-2016. The Board also delayed the expected timing of the first rate hike by approximately 6 months and the central projection for the repo rate is now -0.41% throughout all of next year. The slope of the yield curve flattened significantly on the decision. However, the SEK failed to depreciate.

According to the revised projections by the Swedish National Debt Office, government borrowing in 2016 is expected to be largely unchanged despite markedly higher expenditures for migration. As projections revealed, the higher expenditure is compensated by a faster rise in income tax than previous expected combined with an intended decrease in state aid to developing countries.

The combination of stronger than expected demand from the Riksbank and prospects of lower than expected supply contributed to a rally in longer-term government bonds during the final days of the month.

In Norway, government bonds underperformed sharply vs. swaps and vs. German Bunds, see chart. Falling FX reserves globally may have lead end-investors to reduce their holdings, but the sell-off was probably amplified by low liquidity and higher than expected supply of the longest dated bonds. However, the latest government bond auction on October 28th saw strong demand, supported by attractive valuation.

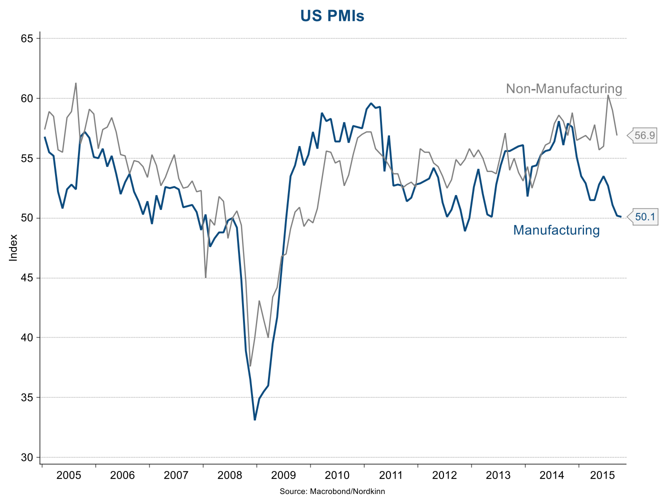
Macro wise, incoming data confirmed a slowing economic landscape in Norway. Goods consumption contracted in Q3, both business and consumer confidence remains muted, and the rise in unemployment has gained further speed.

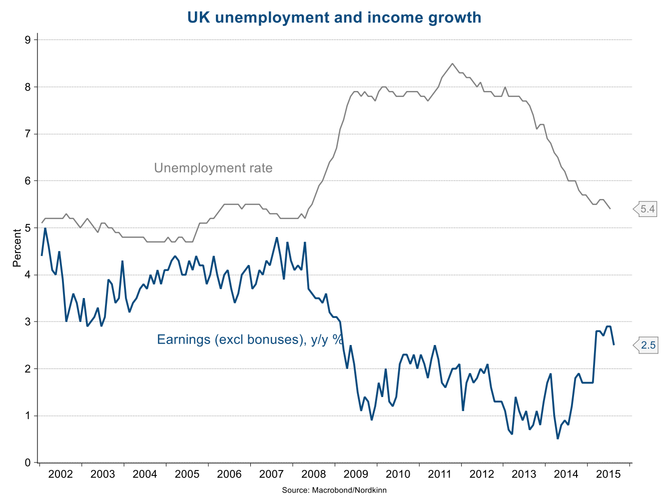
Global markets

Incoming information continue to support our view that economic activity in China is stabilising, thanks to improvements in the property market and public infrastructure investments. Moreover, the recent monetary easing in China should also support a smooth transition to a more consumer-driven economy, although it will not fully offset a moderation in economic growth, which is inevitable.

The drag on G10 growth from the emerging markets slowdown has been offset by growth in domestic demand, largely driven by further improvements in the labour and housing markets in the US, UK, euro area and Japan. The macro economic differences are mirrored by divergence in manufacturing vs. non-manufacturing PMIs in some countries, see left hand chart for the US case. In turn, firm domestic demand should help stabilising exports from emerging markets. Accordingly, if we are right on our assessment that China indeed is stabilising, we expect global growth to gain some speed next year.

The FOMC seems to share our view that the US economy may withstand weaker growth in emerging markets. Our interpretation of the most recent policy statement is that a rate hike in December remains the base case for the Committee, albeit the decision will crucially depend on economic and financial developments in coming weeks. The hurdle to delay rate hikes is probably quite low should the outlook for growth and inflation deteriorate. Nevertheless, a rate hike in December remains our main scenario.





Meanwhile in Europe, President Draghi said in October that the ECB is in a "work and assess" mode to examine the pros and cons of different instruments, and he even used the phrase "vigilance" alluding to the code word former President Trichet used to signal a policy change at the next meeting. Consequently, in our view, the question is not whether the ECB will announce more stimulus in December, but rather specifically which instruments will be used.

As accounted for in our previous monthly report, we are capitalising on the divergence in monetary policy outlook between these two major central banks by shorting US treasuries against German Bunds. In addition, we expect the US money market curve to become steeper up until the first FOMC hike is delivered. After the first hike, long dated US government bonds should outperform short dated bonds, particularly if the USD continues to appreciate. From November 1st these trades are organised under the theme *"USA: Interest rate normalisation"*, which replaces our previous theme *"USA: Economic recovery progressing."*

If we are right on Fed, a policy change at the Bank of England may also occur somewhat earlier than the market currently anticipates. The main hurdle against a rate hike in UK is inflation being below target, and the likelihood that some spare capacity remains in the economy. However, there is increasing evidence of capacity pressure in some segments of the economy, and shortages in labour skill in particular. Wage growth in the private sector has risen, see right hand chart. This could bring upward pressure on inflation in the medium term (refer to our theme *"UK: Longer-term inflation prospects.")* We exploit this view using a combination of curve steepeners and being long GBP.

In New Zealand, following the decision to maintain the policy rate at 2.75%, Governor Wheeler said some further reduction seems likely. Interestingly, he said the recent sharp appreciation of the NZD, if sustained, would require a lower interest rate path than would otherwise be the case. As a result, we see attractive risk/reward being short NZD at current levels.

Nordic markets

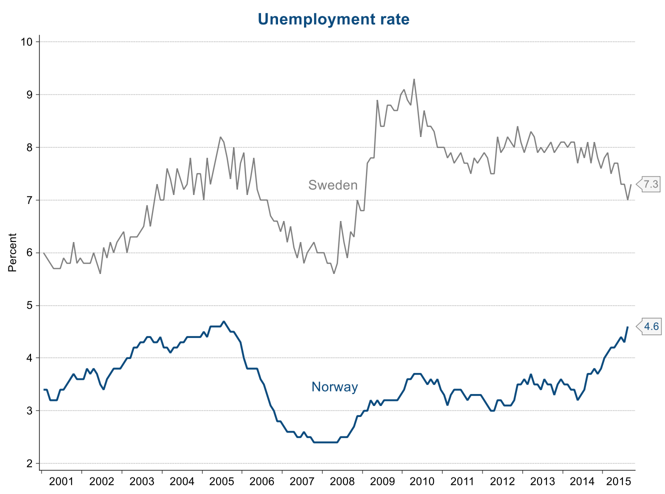
Following the decision to adjust the size and duration of its government bond purchase program, the Riksbank said there is still a high level of preparedness to quickly make monetary policy even more expansionary if inflation prospects were to deteriorate. The list of means include further repo rate cut and purchases of more "securities" beyond government bonds.

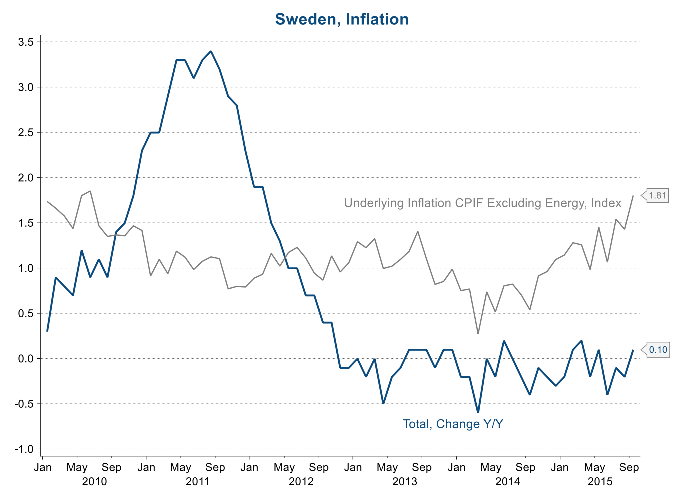
Regarding the latter, we note that the Riksbank previously used "purchase more government bonds" as an option. Realising that the share of foreign ownership has fallen to levels that might give a reason for concern, the change in language may indicate that the Riksbank is about to reach a limit to how much government bonds it can purchase without disturbing the long-term reputation of the market. Consequently, any further expansion of the QE program may include municipal, covered and/or index linked bonds.

That being said, we are not entirely convinced the Riksbank will need to make monetary policy even more expansionary. First, the repo rate is already very low at -0.35% and the current asset purchase program will continue until mid-2016. Second, while changes in the monetary policy stance of the ECB is very important for the Riksbank, the Riksbank's decision on October 28th to extend QE was in part a preemtive response to expectations that the ECB will extend its asset purchase program in December. Third, economic growth has picked up and unemployment is falling, see left hand chart. Fourth, the increase in house prices and household indebtness remains a concern. Finally, yet most importantly, inflation is indeed rising. CPIF excluding energy is 1.8% (see right hand chart), just 0.2% shy of the inflation target and the negative impact of last year's plunge in energy prices on total inflation will soon disappear.

At the same time, the hurdle for additional policy easing seems low if the ECB announces a larger than expected policy stimulus or if the SEK appreciates too quickly.

Regarding market implications, we expect prices on government bonds to rally vs. German Bunds and vs. swaps going forward. Given that the current QE program focuses on government bonds, the share of purchases of outstanding bonds will become quite large. Added to that, the Swedish National Debt Office estimates supply to remain relatively contained next year (see comment on page 2). Trades benefiting from a strong government bond performance is now organised under a new theme named *"Sweden: Sovereign QE expansion."*





In Norway, we believe that prospects for further interest rate cuts have been brought forward in time due to a combination of weaker than expected macro data and our forecast that the ECB will announce additional monetary policy easing in December. We now expect a 25 bp rate reduction to 0.5% by March 2016 (previously "by mid-2016"), and we no longer rule out December 2015 as an occasion to execute this cut if data keeps coming in on the weak side. Regardless, we expect the Norges Bank to revise its interest rate projection further downwards in December.

Moreover, we now expect an accumulated 50 bp cut to 0.25% by mid-2016 (as opposed to 2H 2016 previously). If we are right, market interest rates should continue lower across the whole maturity spectrum over the coming months and quarters.

Regarding the upcoming meeting on November 5th, we are almost certain that the Norges Bank will maintain the key policy rate unchanged at 0.75% as the Board will need more time and data to assess whether developments on balance are deviating or not from the projections laid out in the September Monetary Policy Report. We expect the statement to reiterate that the key policy rate may be reduced further in the coming year.