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asset management

Nordkinn Market Review & Outlook – November 2015

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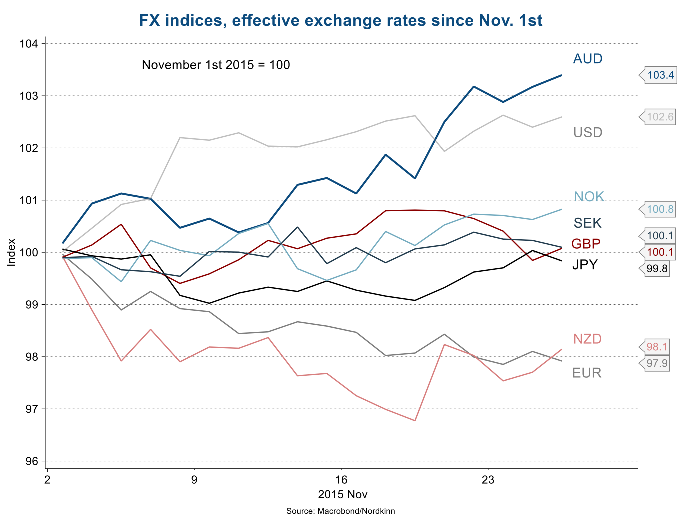
Market overview

Global overview

Upcoming central bank events in December were on financial investors' minds throughout November. The USD appreciated following a stronger than expected payroll report on November 6th, reinforcing expectations that the Federal Reserve will raise rates for the first time in almost ten years. The EUR depreciated during the month, see chart, due to increased expectations of additional ECB monetary policy easing on December 3rd. The spread on interest rates between US and Europe widened across all maturities in November.

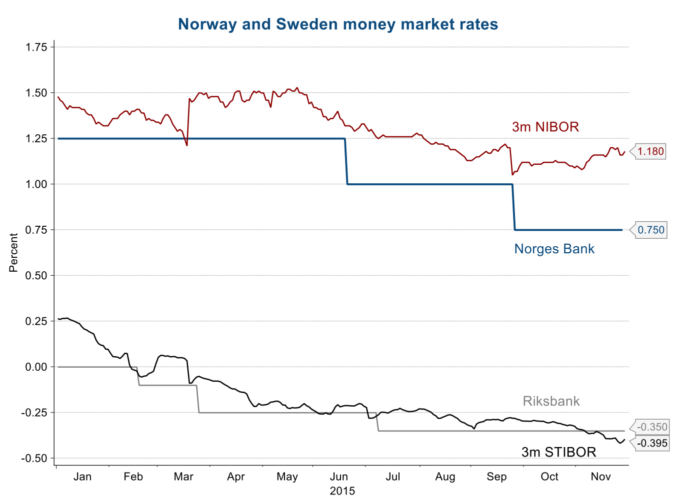


According to the minutes of the October FOMC meeting released on November 18th, the Committee will initiate the process of normalising US interest rates at the meeting on December 16th, provided that unanticipated shocks do not adversely affect the economic outlook. There was some concern that the softness in payrolls would prove more persistent, but this concern was likely dispelled after the stellar payrolls growth in October that was accompanied by a pick-up in wages.

In a speech on November 20th President Draghi reiterated that the ECB was assessing the factors that are slowing the return of inflation towards 2% and was prepared to use all the instruments available to raise inflation as quickly as possible. On December 3rd, ECB did announce a cut, yet smaller than expected, and failed also to meet expectations of an increase in the monthly size of asset purchases. The EUR appreciated and bonds sold off after the announcement.

Meanwhile in Australia, the AUD outperformed broadly in November, boosted by the reduction in rate cut expectations and buoyant risk sentiment, while the NZD reversed gains made in the previous month as inflation expectations fell.

Nordic overview



Swedish and Norwegian money market rates showed opposite trends in November. 3m STIBOR fell by 7 bps in November, whilst NIBOR rose by 9 bps, see chart. We do not think that this divergence mirrors expectations regarding future policy rates in Scandinavia. Rather, the widening of EUR/USD OIS basis has had inverse implications for money market rates in Sweden and Norway due to different funding sources for banks.

Looking at the long-end of the curve, by contrast, Swedish government bonds underperformed vs. Norway and vs. Germany despite Riksbank's decision to extend its asset purchase program. In hindsight, we see several factors explaining the bond sell-off in Sweden; 1) Stronger than expected economic growth; 2) Uncertainty about future bond supply in the wake of the refugee crisis; 3) Riksbank threatening to use currency intervention as an instrument to boosting inflation expectations; 4) Riksbank's hint that any future expansions of the QE program will involve other assets than government bonds.

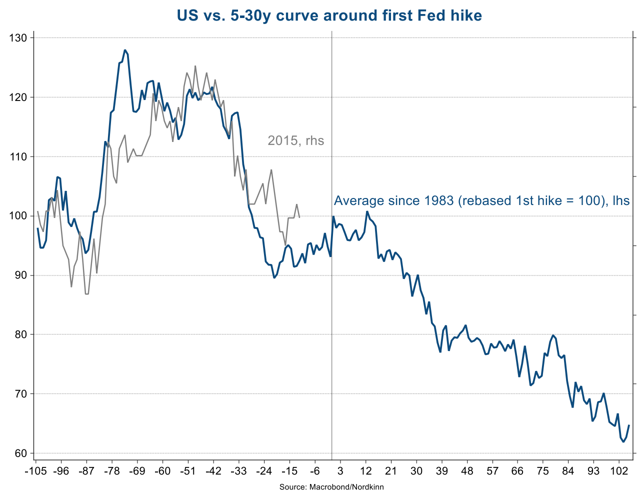
In Norway, with exception of the front end, interest rates fell across all maturities both outright and relative to trading partners due to weak economic outlook. The slope of the yield curve flattened. The NOK and the SEK were both broadly stable.

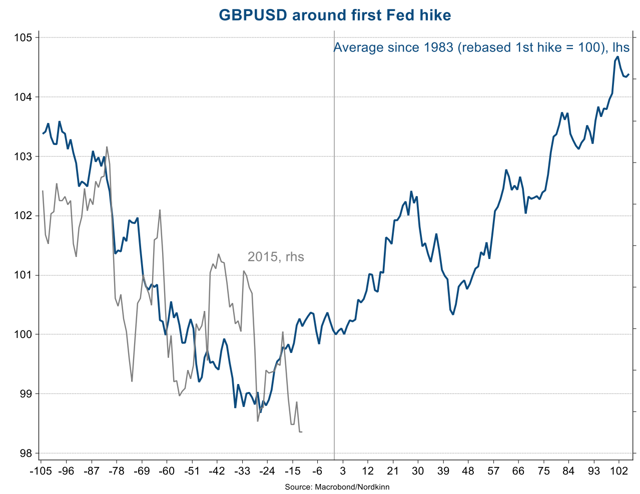
Global markets

In December 2015 two of the most influent central banks in the world, the Federal Reserve and the ECB, are likely to bring their monetary policy stances in opposite directions for the first time since the ECB was established in 1998. The Greek crisis that hit the euro area economy in 2011 and 2012 is crucial to understanding this deviating outlook because it created a substantially longer lag between the US and the euro area business cycles than the historical pattern would suggest.

That said, the euro area economy is already on path to recovery. A motivation behind the ECB stimulus is to help the recovery gaining speed, which is bullish for the long-term outlook of the euro area economy. The implication for longer-term bond yields is however ambiguous: Central bank purchases will normally support bond prices and contribute to a flatter yield curve. However, if the central bank's action contributes to improve market participants perception on the economic outlook and raise inflation expectaionts, longer-dated bonds might actually sell off. Following the recent ECB announcement, we do see a case for a steeper German government bond curve in 2016 as the impact of the most recent as well as past ECB easing bear fruit, which is expressed through our new theme *"EMU: Cyclical upswing"* (replacing *"EMU: Economy sprouting seeds"*).

Turning to the US, we expect the Federal Reserve to increase interest rates on December 16th for the first time since 2006. We have looked at the financial market developments in the days before and after the previous five lift-off dates (1983, 1986, 1994, 1999 and 2004). A couple of observations stand out. Firstly, the slope of the US yield curve tend to begin flattening around 1-2 months prior to lift-off, see chart to the left. Compared with previous hiking cycles, this time the markets price in a very slow pace of tightening. Consequently, we favour 5-30 flattening over 2-10 and especially over 2-5.





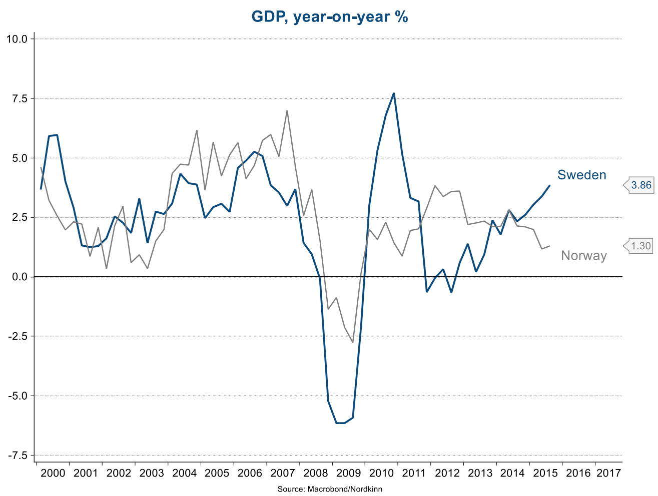
Secondly, the USD tends to appreciate several months before lift-off, but often depreciates once the hiking cycle has commenced. One explanation is that investors "buy the rumour and sell the fact". Forward-looking investors buy the USD in anticipation of higher rates, and then takes profit when the Fed actually announces the decision. Another explanation is that the financial markets ask "who is next" and buy the currency where interest rates are likely to be increased next. As the current lag between the US and euro area business cycle stands out in a historical context, it is in our view too early to position for a stronger EUR. Rather, we expect the Bank of England to begin raising rates in 2016 and therefore expect GBP/USD to appreciate in line with the historical pattern, see chart to the right. At the same time, we will carefully monitor any political risks associated with the UK's EU membership next year. These cases are expressed through our theme ("*UK: Longer-term inflation prospects"*).

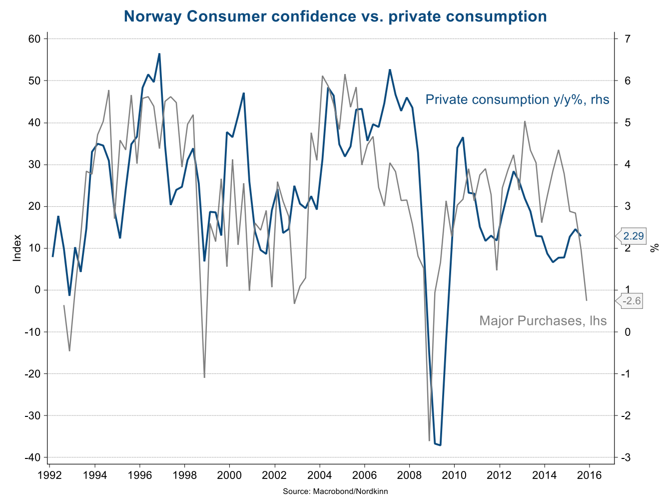
Meanwhile in Australia, the AUD outperformance (see chart on previous page) has come about despite declines in the prices of Australia's key commodity exports such as iron ore. We expect lower commodity prices to reinforce concerns about weakness in income and the risks that still exist in the economic transition from the mining industry. Against this backdrop, we re-entered an AUD bearish trade in late November ("*Australia: Transition from mining"*).

Nordic markets

In the near future, the Riksbank will remain under pressure due to uncomfortably low inflation expectations and the ECB's expansionary policies, even though the ECB disappointed elevated market expectations. Consequently, we expect the Riksbank to reiterate at the December meeting that it is prepared to take further steps to making policy even more expansionary if needed. However, given that the asset purchase program recently was extended until June-2016 in anticipation of ECB easing on December 3rd, we think the Riksbank will deem it too early to make any adjustments to this program at the upcoming meeting. The Riksbank might consider a small cut in the repo rate, but given the smaller than expected rate cut by the ECB, combined with strong macro data in Sweden recently, we think the Riksbank will stay put. However, if the SEK were to appreciate sharply around the turn of the year, the Riksbank could move at the February 2016 meeting.

At the same time, we see an increasing risk of a policy shift during 2016. Strong economic growth (see chart to the left), rising capacity utilisation and a booming housing market is not compatible with a prolonged period of negative interest rates and quantitative easing. As opposed to the ECB, the Riksbank does not need to help the economy to grow faster. Moreover, with measures of non-energy core inflation already close to target, headline inflation is set to make significant progress towards the 2% inflation target in early 2016. As inflation starts rising, it is also likely that inflation expectations will gradually begin to climb ("*Sweden: Inflation expectations bottoming"*).





In Norway, we continue to expect further monetary policy easing as a response to a deteriorating growth outlook. Recent estimates for oil investments show a further sharp decline, which we think will have negative ripple effects across the economy. Consumer confidence is plummeting to the degree that households say they are delaying plans of major purchases, see chart to the right. The Norges Bank will continue to look through current elevated CPI readings, which almost exclusively can be explained by lagged effects of the NOK depreciation, and instead focus on the medium term outlook for inflation. Our forecast remains that the Norges Bank cuts the key policy rate by an accumulated 0.5%-points to 0.25% by mid-2016, which is more dovish than currently discounted by markets.

Regarding the upcoming Board meeting on December 17th, we expect the Norges Bank to remain on hold consistent with Norges Bank's base case from the September Monetary Policy Report. While we do think incoming information on balance is on the downside vs. Norges Bank's projections, we don't judge the data to be weak enough for the Norges Bank to pull the trigger just yet. The import-weighted NOK exchange rate is weaker than projected. On the other hand, the oil price is slightly lower and money market premiums and credit spreads are much wider than anticipated.

Regardless, we expect a downward revision of the interest rate projection. If the Norges Bank keeps rates on hold at the upcoming meeting, we expect a clear hint that the key policy rate may be reduced at the Board meeting in March if data evolves broadly as expected. The overall message will likely be bullish for longer-dated covered and government bonds ("*Norway: Weaker growth outlook"*).