Nordkinn Market Review & Outlook – April 2016

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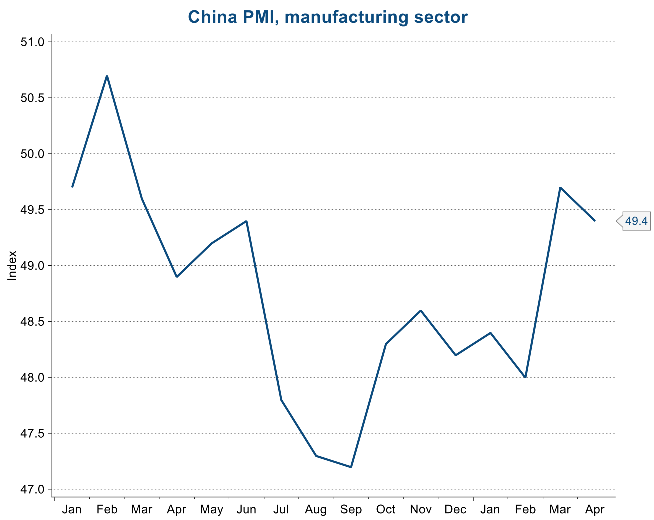
Market overview

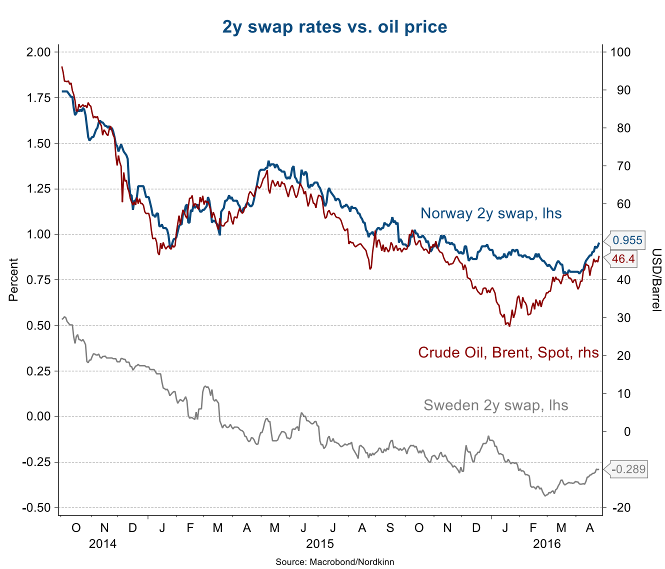
Global overview

Global government bonds sold off in April, driven by rebounds in indicators of global economic growth. A revival of the Chinese manufacturing sector appears to be the root cause of the upturn in global growth, which in turn can be attributed to the impact of fiscal and monetary stimulus. This revival lead to a gradual reflation in commodities, equities and credit. Meanwhile, the Federal Reserve's shift to a more dovish stance in March has essentially capped short-term interest rates, which contributed to a weaker USD, a positive risk sentiment and steeper bond yield curves in April.



Moreover, at its meeting on April 27th the Federal Reserve did not signal an impending rate increase, as it did in the October statement prior to the hike in December. Domestic US growth of recent has been weaker than expected, hence the Federal Reserve probably needs more time to assess the trend for consumption and investments. At the same time, the previous statement that *"global economic and financial developments continue to pose risks"* was deleted, presumably reflecting the recent improvement in external conditions. However, this change did little to alter the market implied probability for a June hike, which remained unchanged at around 20%.In spite of lacklustre growth and falling inflation expectations, on April 28th the Bank of Japan surprised the market by maintaining its monetary policy stance on hold. At his post-meeting press conference, Governor Kuroda said Bank of Japan will give negative rates adopted in March more time to work. The JPY appreciated sharply after the announcement, as the market are speculating that the monetary policy aiming for weaker JPY is at the brink running out of ammunition.

Nordic overview

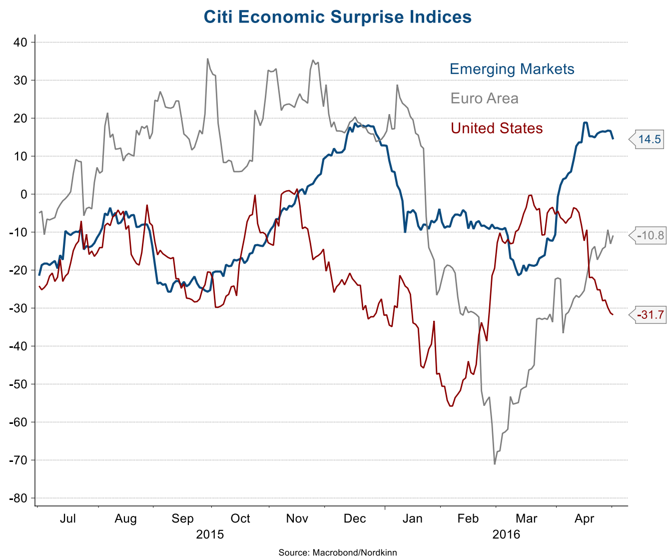


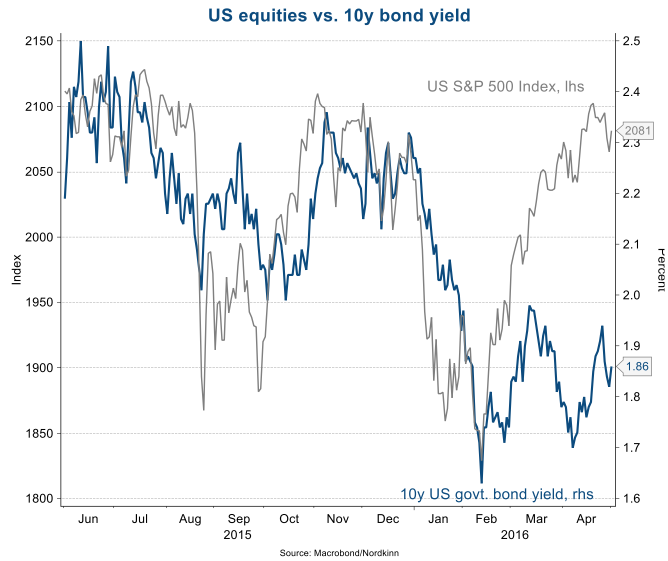
As we had anticipated, on April 21st the Riksbank decided to leave its key policy rate unchanged, extend its asset purchases into the second half of the year and also include index-linked bonds to its purchase program. However, the amount of purchases will be reduced, from SEK 65 bln of nominal bonds in H1 to only SEK 30 bln in H2, plus SEK 15 bln real bonds. This tapering sparked off a substantial sell-off in nominal government bonds shortly after the announcement. Consequently, Swedish nominal bonds underperformed versus trading partners whilst break-even spreads widened. Yet, the SEK remained broadly unchanged after the announcement, having appreciated prior to the meeting.

Norwegian interest rates rose across the maturity spectrum and the FRA curve steepened substantially. Norwegian government bonds underperformed German Bunds, contrary to the normal pattern when Bund yields rise. The Norwegian underperformance can primarily be explained by the rebound in oil prices (see chart) as the market commenced speculating if not the Norges Bank would be encouraged to back-track its forecast to not cut rates further. Better than expected unemployment data at the end of the month reinforced these speculations, even though other economic indicators painted a more mixed picture. Furthermore, the NIBOR spread remained surprisingly high throughout the month, reflecting expensive USD funding and a tight structural liquidity situation in the banking system. Against this background, the NOK appreciated during April.

Global markets

The Federal Reserve has been citing uncertainties regarding “global economic and financial developments” as the main justification for the postponement of further interest rate hikes, directly tying the path of US rates to external developments. However, the risks associated to these developments were toned down in the most recent statement, probably because emerging markets, notably China, and the euro area have been catalysts for global growth to rebound, see left hand chart. In addition, the weakening of the USD and the rally in global equities and credit markets have contributed to ease financial conditions and to reduce downside risks to growth. Therefore, despite US economic indicators having disappointed lately, the improvement in the external environment could justify a more hawkish Federal Reserve policy already this summer.





As we continue to expect employment and inflation to show further progress towards its dual mandate, the Federal Reserve should push ahead with another 25 bps rate hike in not too long. The precise timing will depend on incoming data. A move at the next meeting in June is possible, but that requires evidence of a pick-up in GDP growth after the dismal Q1 print. Therefore, a move in July or September looks more likely. As the US treasury curve has steepened in March and April due to dovish Federal Reserve policy combined with increased optimism regarding global growth, we expect the curve to “bear” flatten and the USD to appreciate once the Federal Reserve start preparing the market for a rate hike.

Looking further ahead, we expect the rebound in emerging markets growth to peter out later this year causing a “bull” flattening of the government bond curves once the effects of stimulus measures from China, with a weaker currency and looser fiscal policy, run their course. In addition, financial conditions may worsen again once the Federal Reserve delivers another rate hike, causing the Federal Reserve to back-track on its plans for future rate hikes again.

In Europe, surprisingly heavy long issuance in April seemingly contributed to steeper European government bond curves and tighter spreads between US and German government bond yields. As we expect supply to ease in May, we see this as an opportunity to fade the recent underperformance of German Bunds.

In Japan, hopes that Abenomics would lift Japan out of deflation are being crushed by the stronger JPY. What began as a typical JPY rally following a spike in market volatility developed into a vicious cycle being fuelled by speculation that the Bank of Japan is running out of policy tools. In our view, policy needs to become much more aggressive to break this vicious circle, and we do not think policymakers are out of tools. Rather, we expect them to launch a major stimulus package consisting of massive fiscal and monetary policy measures aiming at raising inflation and inflation expectations.

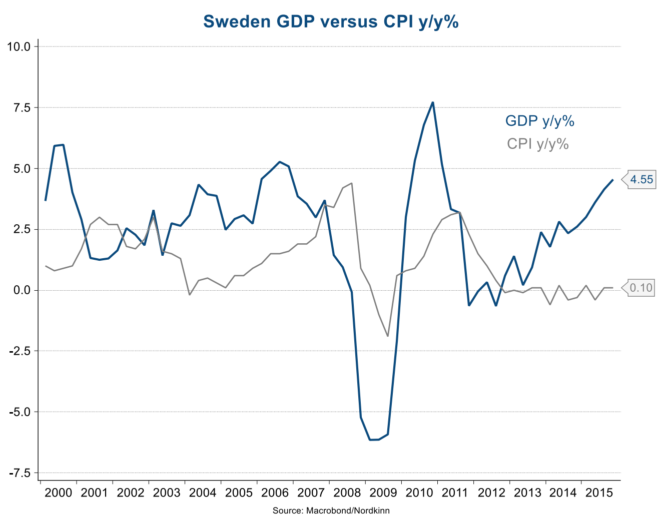
Nordic markets

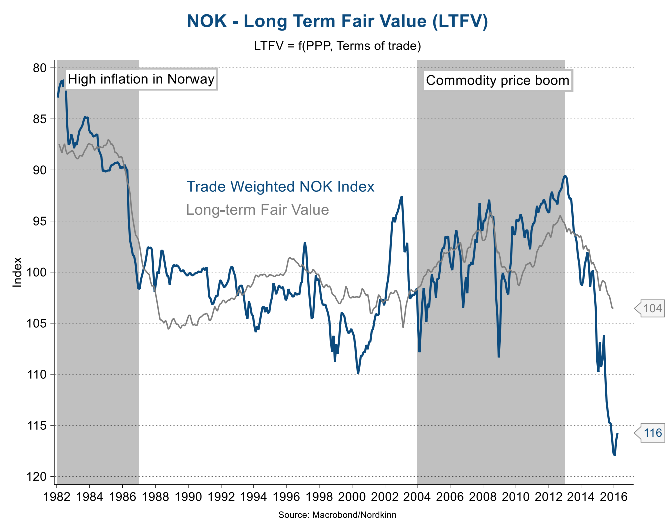
The combination of strong Swedish GDP growth and low inflation has created a classic trade-off problem for the Riksbank, see left hand chart. Provided inflation expectations are anchored, central banks facing such trade-off would when setting rates normally take both the real economy and inflation into consideration. In the case of the Riksbank, it is our understanding that so far economic growth has practically been left out of the response function to instead solely look at short-term inflation trends.

There are now some indications that the Riksbank is reviewing its strategy. In particular, Mrs Skingsley told a Swedish newspaper that she would start focusing less on monthly CPI data and instead take a more long-term view on inflation targeting. One interpretation is that the Riksbank in its monetary policy deliberations may start putting more emphasis on the real economy, which is often seen as a good indicator of future inflationary pressures.

Against this backdrop, we continue to believe that the Riksbank will refrain from cutting rates further. Still, we expect the Riksbank to extend its QE program from June to December 2016. This decision, which we think will be announced in April, should keep monetary policy closely linked to that of the ECB's for the remainder of the year in hopes to prevent an undesired appreciation of the SEK. We also expect the Riksbank to include inflation-linked government bonds in the purchase program. Should the SEK appreciate sharply in spite of this expected policy easing, we think the Riksbank could make use of FX interventions.

Regarding investment implications, we expect yields on Swedish bonds to remain broadly stable in coming months. The SEK will appreciate gradually over time, but at current levels the risk/reward of buying SEK is rather poor due to the Riksbank's low tolerance to a stronger SEK.





In Norway, we have not changed our view that growth is likely to remain weak for a long time and the unemployment rate will continue to climb. This notwithstanding, we expect the Norges Bank to proceed with greater caution in interest rate setting as the key policy rate approaches a lower bound. This was also clarified in its most recent monetary policy guidance, where the Board decided to bring down its forecast for interest rates in 2018 significantly instead of signalling more aggressive cuts in the short term.

This cautious strategy by the Norges Bank creates some interesting market implications. We can no longer make use of the Norges Bank's traditional response function when predicting future changes to the key policy rate and the rate path, because the link between incoming data and monetary policy will from now on be much weaker than it used to be. Consequently, we need to see significant deviations from projections before the central bank changes its mind about keeping rates unchanged in Q2. We therefore expect the next cut in September. Such outlook for monetary policy, combined with tight liquidity in the banking system and high USD funding costs for banks, should keep the 3m NIBOR at relatively elevated levels until summer.

This prudent interest rate strategy should in our view favour the NOK, which looks cheap against most fair-value models, see right hand chart. Ironically, this could in turn force the central bank to abandon its cautiousness. If the NOK were to appreciate too fast, the economy could slide into a deeper recession and trigger a more aggressive monetary policy response. For this reason, we think the Norges Bank will be forced by cut rates by an accumulated 50 bps in the second half of 2016 to 0.00%, while keeping the door widely open to negative interest rates if further accommodation is needed. Consequently, a long (currency unhedged) exposure to medium- to longer-term Norwegian bonds is highly attractive in our view.