Nordkinn Market Review & Outlook – Aug 2016

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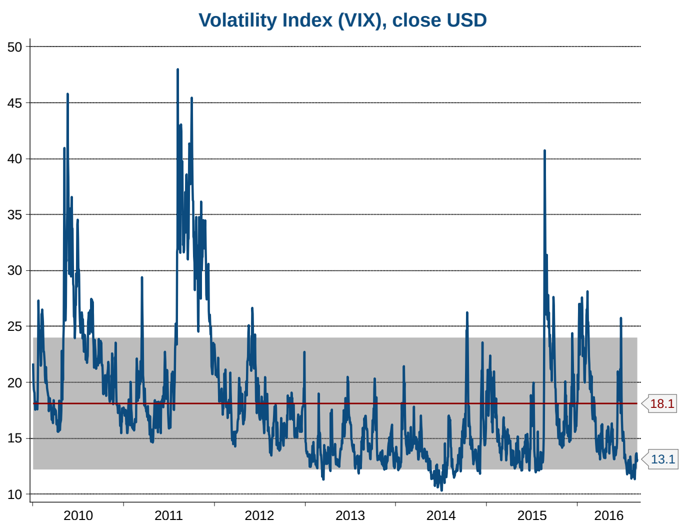
Market overview

Global overview

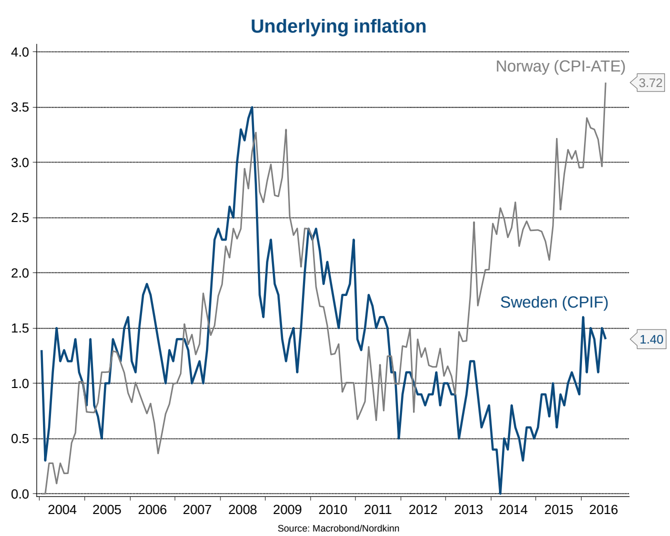
Market volatility has been extraordinarily low this summer despite the UK's surprise vote to leave the EU. Following a temporary spike around the referendum in June, the VIX index has settled at almost record low levels, significantly below average since 2010, see chart. In the UK, business confidence recovered in August and hard data has been mostly positive. There have been no clear signs of contagion to broader Europe yet, in part thanks to central banks' readiness to provide additional liquidity if needed. In this environment, investors have been searching for yield, pushing equities and longer-dated bonds to new highs.



In August, the German 10-year government Bunds yield traded within a very tight range of between -0.0% and -0.10% as investors are awaiting clues from the ECB about amendments to its policy measures, including the duration and size of asset purchases beyond March 2017. Lack of supply in August also contributed to keep bond yields in negative territory across the maturity spectrum.

Meanwhile, US treasuries sold off in August after generally upbeat data releases and hints made by FOMC officials that the second rate hike in this cycle may loom. At Jackson Hole on August 19th, Fed-Chair Yellen said the case for an increase in the federal funds rate has strengthened in receent months. The curve flattened as short-dated bonds sold off, while the long-end remained little changed. In fact, the US 30-year bond ended up rallying in August as investors were chasing yield. The USD erased previous losses after Yellen's speech and remained broadly unchanged in August as a whole.

Nordic overview



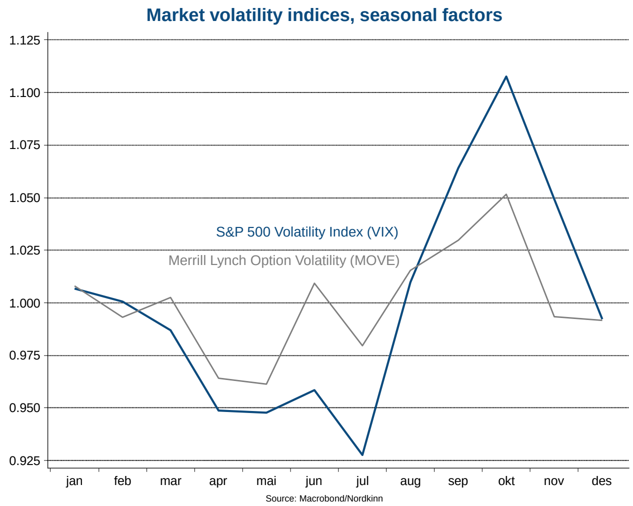
Swedish government bonds were little changed in August, mirroring developments in Germany. They underperformed versus swaps, whereas municipal and covered bonds saw strong demand and thus performed relatively well. Moreover, breakeven inflation spreads widened marginally, supported by the Riksbank's purchases of index-linked bonds. The SEK appreciated at the beginning of the month, erasing losses from July, but depreciated again in late August after a few data releases confirmed a softer economic growth path.

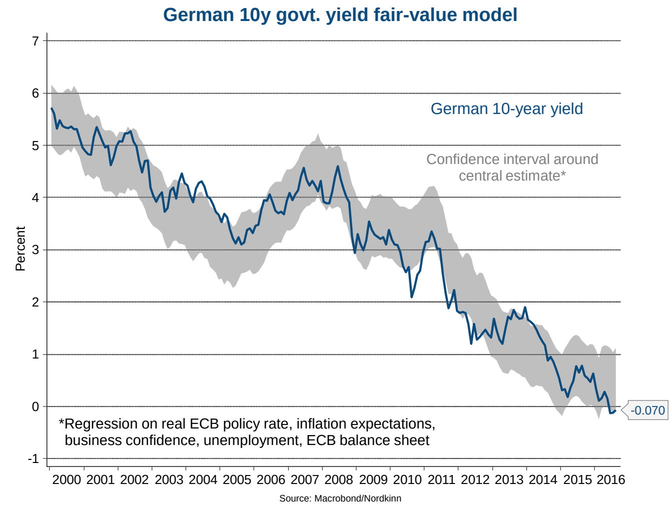
Meanwhile, CPI inflation rose to 1.1%, the highest rate since 2012, while the Riksbank's preferred measure of underlying inflation, CPIF, slowed to 1.4%, see chart. On balance, inflation has shown a rising trend. In Norway, most data confirmed an improvement in economic momentum over the summer and a stabilisation in unemployment. House prices have risen sharply. Moreover, underlying inflation as measured by the CPI-ATE index rose sharply in August to 3.7%, almost 0.9%-points above Norges Bank's projection from June. All this contributed to a further increase in short-term interest rates and even flatter curves, as longer-term rates were held in check by developments abroad. Meanwhile, issuance related receiving in swaps contributed to tighter swap spreads in the long-end, despite wider money market spreads.

Stronger data and higher interest rate expectations supported the NOK in August, even if the currency erased gains in the latter half of the month influenced by a decline in energy prices.

Global markets

A number of events are likely to drive financial markets over the coming weeks, including political developments, central bank policies and the increase in bond issuance after a quiet summer holiday. This comes on top of important data inflow, including the trajectory of inflation. In fact, the agenda this autumn is rather busy and we note that markets have entered into a season where volatility often picks up. The left hand chart illustrates this pattern, displaying estimated seasonal factors of volatility in fixed income (MOVE Index as grey line) and equity markets (VIX Index as blue line) in the US.





Starting with Europe, we expect the ECB to extend its asset purchase program beyond March 2017, to be announced before year-end. In our view, a decision to prolong QE will be accompanied by amendments to the QE program, which may increase the eligible pool of German bonds that can be bought. That could result in a somewhat steeper government bond curve. However, given encouraging developments in economic indicators and financial markets since the surprise UK vote to leave EU, we do not think the ECB is in a hurry to take a decision already at the upcoming meeting on September 8th. Rather, we think the ECB is more likely to use the freedom to wait until December 8th before taking any new decision on the duration (and size) of its QE program. As regards key ECB rates, we do not think a rate cut is on the agenda now.

Given stretched valuation of German long-term bonds combined with a seasonal increase in euro area sovereign debt supply in coming weeks, a no-change in monetary policy on September 8th could in our view suppress bond prices somewhat even if we expect President Draghi to strike a dovish tone overall. Moreover, our inclination remains bearish vis-a-vis global government bonds in general, but especially German bonds which are the most overpriced according to our models, see right hand chart.

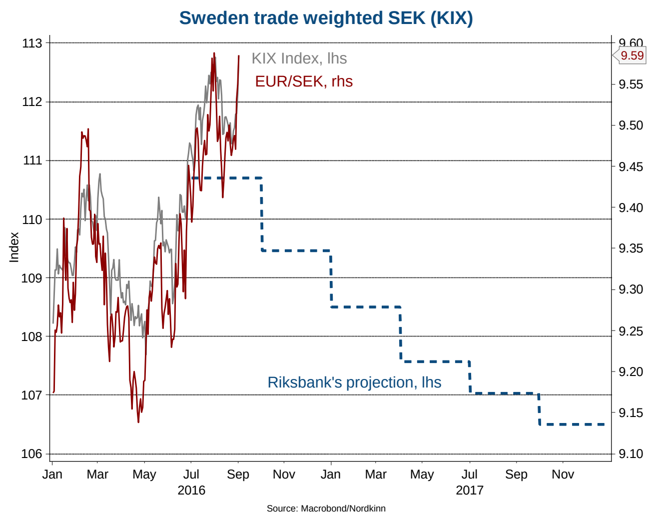
Turning to the US, we expect short-term rates to grind higher in coming months as the Fed becomes more vocal and explicit about the prospects of policy tightening. Recent economic data has been reasonably strong and we believe the Fed is reasonably convinced that inflation will rise gradually going forward. We expect a move in December, but would not rule out the possibility for a September hike. Furthermore, we envisage a couple of hikes in 2017, which is more hawkish than current market pricing. This could lead to a slightly stronger USD. While we do not expect the long-end of the treasury curve to respond much to a rate hike in isolation, positioning in long bonds (30-year segment) looks crowded and a correction towards a steeper curve is looming.

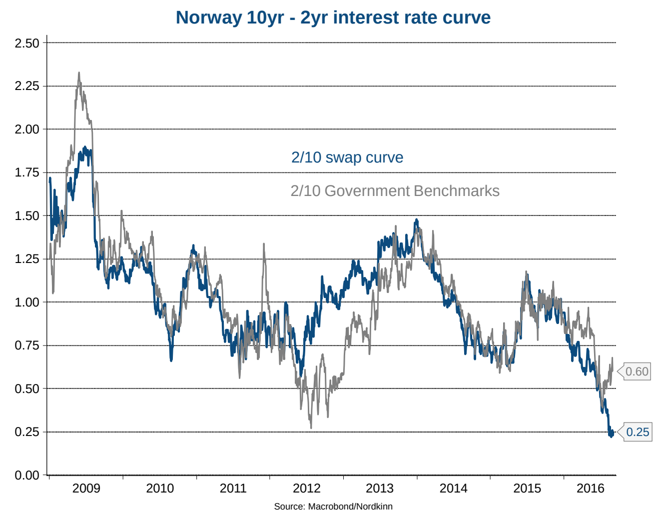
Regarding upcoming political events, the markets are likely to pay close attention to the developments of opinion polling ahead of the Italian constitutional referendum due later this year. Prime Minister Renzi says he will resign if the people votes “no”, which could herald a new phase of high political uncertainty and add to the headwinds for the euro. Likewise the market will also pay close attention to the upcoming US presidential election.

Nordic markets

Growth in Sweden has slowed, yet the economy remains solid. Inflation continues to make progress towards the 2% target, supported by rising capacity utilisation and a weak SEK. While the Riksbank's strive for a credible inflation target will keep monetary policy very expansionary for a significant period of time, we do not expect the Riksbank to announce further monetary policy easing on September 7th, just one day before to the next ECB meeting. We think the Riksbank is monitoring developments in the SEK very carefully, which is why Riksbank Board members have emphasised that the need to take further measures will be affected by how other central banks choose to act. Given the current weak level of the SEK (see left hand chart), the Riksbank should be in no hurry to announce further action before Board members know the outcome of the upcoming ECB meeting.

In light of this and given the strong rally in nominal government bond prices over the summer, we have closed our *"Sweden: Sovereign QE expansion*" theme which was designed to benefit from the direct market effects of the Riksbank's asset purchase program. At the same time, we have opened a new theme *"Sweden: Government relative value"* to reflect our bearish inclination towards nominal government bonds compared with other types of bonds as well as swaps.





Turning to Norway, the central bank's baseline scenario from June was a final cut to 0.25% in the second half of 2016. While the numbers behind the interest rate projection was consistent with a high probability of a cut at the upcoming meeting on September 22nd, the Executive Board's guidance was less precise as regards the timing *("…the key policy rate may be reduced in the course of the year".).*

Reflecting the improvement in domestic data, vigorous growth in house prices in most parts of Norway, surprisingly high inflation and the weak NOK, we expect the Norges Bank to maintain its key policy rate at 0.5% in September and revise its interest rate projection upwards. We expect the trough in the rate projection to be lifted to 0.38% from previous 0.25%, consistent with a 50/50 chance of rate cut around the turn of the year. We also expect that the projected timing of policy tightening will be brought forward, yet remain distant.

Given the sharp increase in short-term market rates in August, we see better risk/reward in being long short-dated bonds (or received FRAs) at current levels as we do not rule out the case for another cut in December or March. However, we prefer to express this view via curve steepeners in swaps, given the very flat shape of the swap curve, see right hand chart. Moreover, we see value in longer-term Norwegian government bonds versus paid swaps.

Finally, one of our top convictions is long NOK. The appreciation of the NOK this year has in our view been remarkably modest considering signs of rebound in economic momentum, stabilisation in energy prices and rising interest rate expectations for the coming year.