Nordkinn Market Review & Outlook – Sep 2016

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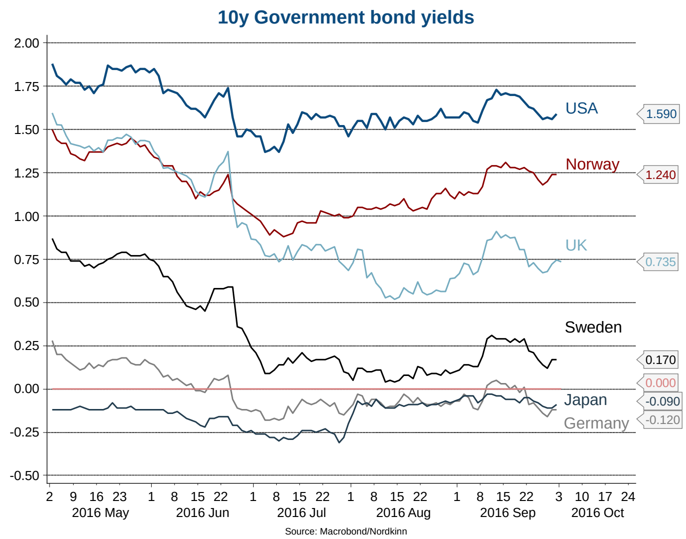
Global overview

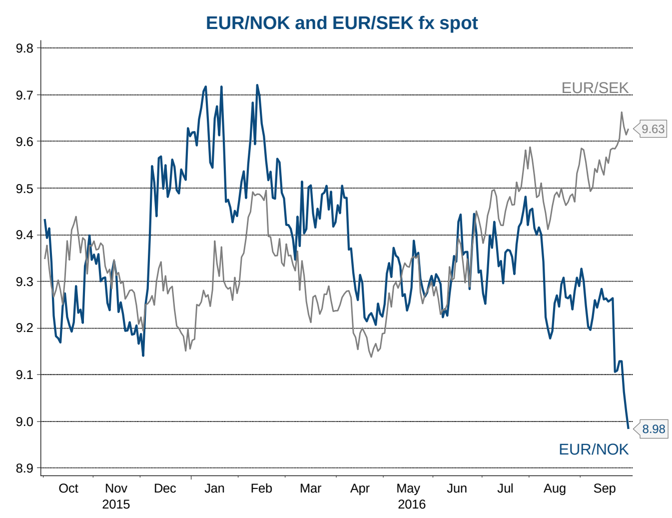
Government bonds sold off at the beginning of September after the ECB had disappointed investors expecting hints about extending the QE program beyond March 2017. Markets reversed later in the month after the Fed yet again downgraded its forecast for rate hikes in 2017 combined with reemerging concerns over Deutsche Bank posing a systemic market risk. The oil price soared towards USD 50 per barrel after the OPEC on September 28th surprised markets with a target to cut production.



ECB president Mario Draghi said on September 8th that the Governing Council did not discuss QE extension, which lead to fears among market participants that the ECB might be less inclined to add further stimulus. At the same time, he emphasised the commitment to run QE until the ECB sees a sustained adjustment in the path of inflation. CPI inflation rose to 0.4%, while core CPI inflation stood at 0.8% in September.On September 21st the Fed decided to leave US interest rates unchanged, while strongly implying that rates will be lifted during Q4 2016. The FOMC said that the case for a rate increase had strengthened as the assessment of near-term risks were upgraded to balanced. Three members even dissented in favour of a hike. Meanwhile, the median projection for rate hikes in 2017 was reduced to two from three in June, which still emphasises a gradual approach towards rate normalisation. Against this backdrop, bond yields fell and the slope of the curve flattened.

Meanwhile, on September 21st the Bank of Japan kept the deposit rate unchanged at -0.10% and its annual bond purchases at JPY 80 trn, but it scrapped the 7-12 year average maturity target and replaced it with a yield target on 10-year bonds around the current level hovering around zero. The quest to thereby avoid negative long-term rates was supportive for financial equities, but had little or no impact on the currency and fixed income markets.

Nordic overview



As we predicted, on September 22nd the Norges Bank maintained its key policy rate unchanged at 0.50% and reduced the probability of further monetary easing. According to our interpretation of the baseline projection for the key policy rate, there is a mere 20% probability of a cut by the end of this year, and 40% by mid-2017. The rate decision was broadly in line with expectations prevailing in the fixed income markets, but more hawkish than the FX market was positioned for. Consequently, the NOK appreciated significantly after the announcement, see chart. Also, the OPEC decision to cut production gave support to the NOK.

NIBOR rates rose in September, largely reflecting a wider US LIBOR-OIS and EUR/USD cross currency basis swap spreads. FRA rates discount a decline in NIBOR after the implementation of the new US money market reform becoming fully effective as from October 14th.

Turning to Sweden, on September 7th the Riksbank decided to maintain its monetary policy stance and outlook unchanged, as we expected. Covered and municipal bonds performed well. The three-month STIBOR rose and ended the month close to the repo rate, due to higher SEK FX forwards and large Swedish T-bill maturities.

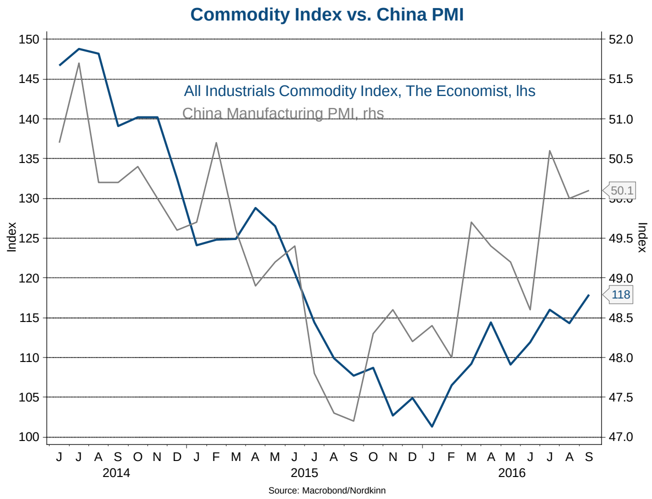
The SEK depreciated against most currencies, continuing a trend that commenced before summer. We believe that the trend in part can be explained by increasing fears that economic growth is slowing. The currency lost around 5 percent against the NOK in September. In trade weighted terms, the SEK vs. the KIX index ended the month at the weakest level so far in 2016.

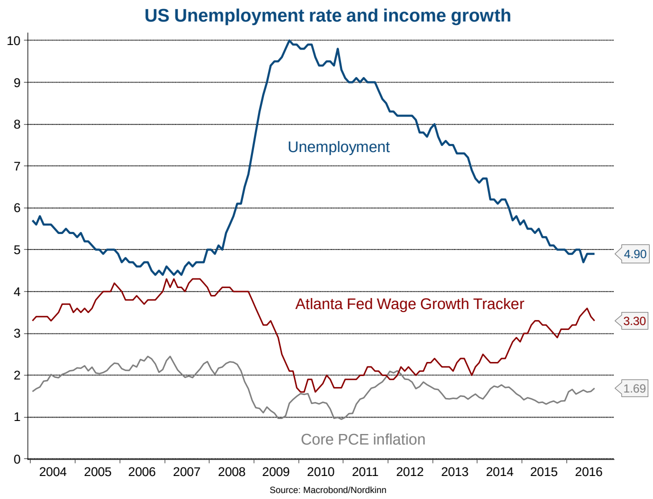
Global markets

In recent years, market volatility has been limited thanks to very accommodative monetary policies worldwide. Looking ahead, however, central banks may unintentionally become the catalysts for volatility as the global economy continues to expand, inflation creeps up and the long-term negative effects of extremely low interest rates on the financial sector are becoming ever more apparent.

Starting with the global economy, we believe that growth is picking up, supported by both developed (DM) and emerging economies (EM). Activity in China appears to be recovering, giving a boost to commodity prices, see left hand chart. This is a very different situation compared with only six months ago when a slowdown in China was the biggest risk to global growth. Moreover, the economic fallout from Brexit looks contained, as demonstrated by the surprising improvement in UK data. Furthermore, despite slow growth by historical standards, growth in DMs has been sufficiently strong to reduce unemployment. After all, it is the labour market and inflation that matter for monetary policy, not growth.

Speaking about inflation, the latest reading on core PCE inflation at 1.7% in the US illustrates how close the Fed is in reaching also this part of its dual mandate, see right hand chart. We expect the upward trend in inflation to continue as the labour market strengthens further and wage pressures continues to build, which should put the Fed on track for a December rate hike. In Europe, core CPI inflation is still contained at only 0.8% given remaining slack in the economy, while headline inflation is rising due to the increase in commodity prices compared with one year earlier. We believe some of the year-over-year rise in commodity prices will feed through to core prices as well.





Evidence is mounting that distortions caused by the very low level of interest rates are growing and conversely that the benefits are diminishing. Pension and insurance companies struggle to find yield on their investments and honour future promises, while banks struggle to make money when rates are flat or negative. These negative effects lead the Bank of Japan to scrap its average maturity target and to introduce a yield target at around zero for the 10-year government bond. In our view, this decision by the Bank of Japan illustrates that even unconventional monetary policy is about to reach a limit.

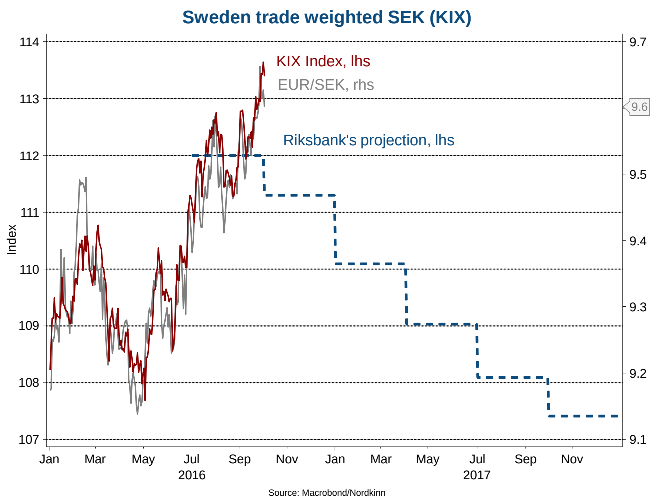
Against this backdrop, our inclination remains slightly bearish vis-a-vis global government bonds, especially in Europe where they are most overpriced according to our valuation models. To be clear, we do not expect central banks to make a U-turn anytime soon. Rather, monetary policy will remain accommodative and we expect the ECB to reach a decision to extend its QE program beyond March 2017. However, this is already expected by the market and the risk is that central banks are becoming less willing to add further stimulus than markets hope for. In addition, we expect a US rate hike in Q4. Eternal support for markets can no longer be taken for granted. This implies that the markets are in for a bumpy ride in the months ahead.

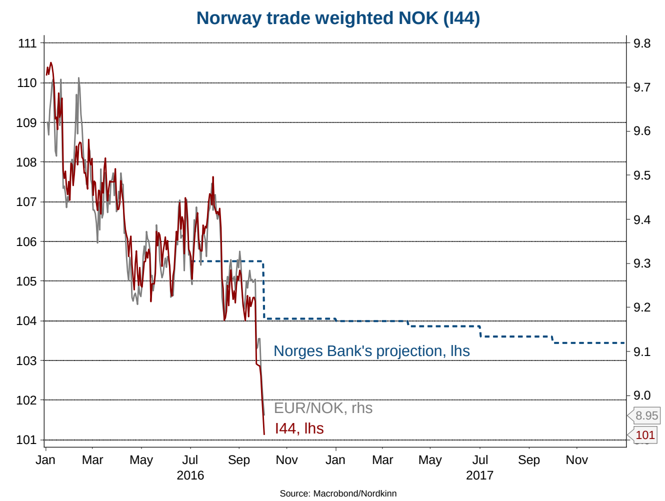
Nordic markets

The Swedish economy is developing strongly despite the recent inevitable slowdown in growth. Inflation continues to make progress towards the 2% target, supported by a very accommodative monetary policy. We expect the Riksbank to maintain an expansionary monetary policy to support a rising trend in inflation going forward. This implies an extension of its asset purchase program into mid-2017. This view is based on our assumption that the ECB decides to extend its QE program beyond March 2017.

At the same time, we expect the Riksbank to reduce asset purchases compared with the SEK 45 bln pace in the second half of 2016. Further, we also expect that the Riksbank will announce changes with regards to the composition of assets and the actual types of instruments to be purchased.

In light of this, we remain positive towards short-dated investment grade bonds and breakeven spreads, while we have a bearish stance towards nominal government bonds, especially those with longer-dated maturities. In the FX space, we like to fade the recent underperformance of the SEK, currently trading more than 2% weaker than the Riksbank's projection, see left hand chart.





Norwegian short-term interest have increased significantly in recent few months as markets have repriced the outlook for Norges Bank's monetary policy. This was confirmed at the latest monetary policy decision and outlook, where the Norges Bank left rates on hold and it signalled only around 20% probability to a cut by end-2016 and 40% by mid-2017. Since then, the market has moved even further, now discounting only a tiny chance of further easing according to our assessment. The exact market pricing is complicated, as it combines a link between USD funding, which has become more expensive recently, and NIBOR. The market expect USD funding to cheapen after the introduction of the US money market reform in mid-October, which explains why NOK FRAs currently trade below NIBOR.

Long NOK has been one of our top conviction trades since summer. However, after the sharp appreciation in September we have reduced exposure to our *"Norway: NOK FX recovery."* theme. The NOK is currently trading 3% stronger than the Norges Bank's projection, see right hand chart. If the appreciation where to continue, the Norges Bank may be forced to act on its easing bias after all, in particular if macro data turns softer again.