Nordkinn Market Review & Outlook – Oct 2016

NORDKINN
asset management

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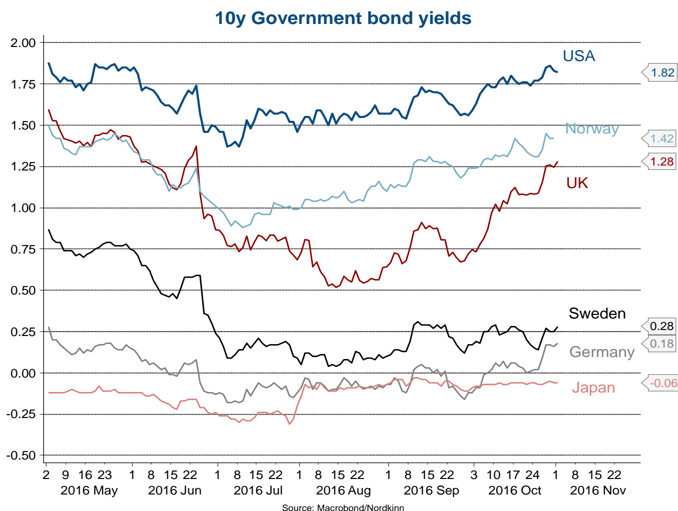
Market overview

Global overview

Global bond yields rose in October. The improvement in global growth prospects, the rebound in inflation expectations and speculation that central banks soon may relax their expansionary monetary policy accommodations contributed to a substantial reprising of longer dated bonds. The reprising was particularly pronounced in the UK due to the sharp drop in the GBP as fears of a hard Brexit intensified. The trade weighted GBP fell by 4% in October and is currently around 16% weaker than at the day of the EU referendum. This depreciation sparked higher inflation expectations and bond yields.

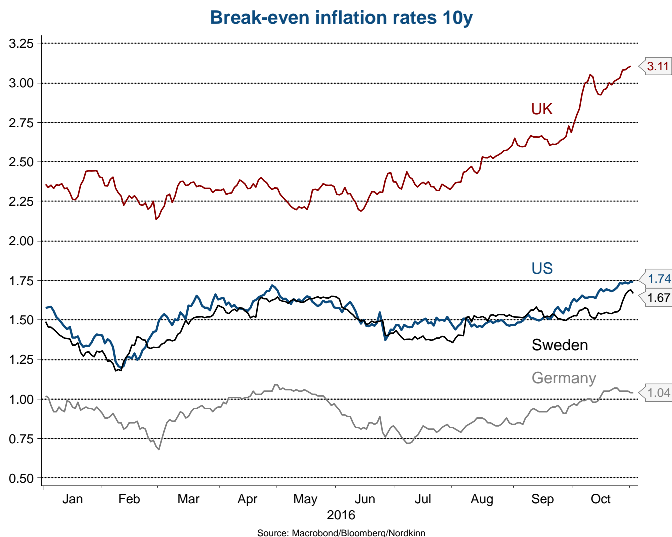


Global economic indicators have been quite encouraging of late, particularly in Europe where there are signs of slightly improving growth and rising headline inflation. After leaving its monetary policy unchanged on October 20th, the ECB said it in December will re-examine its monetary policy stance and the specifics regarding future implementation of its QE program. Although the ECB says it remains committed to preserve accommodation, there is uncertainty in the market about what to expect regarding the size, duration and composition of bond purchases beyond March 2017.

In the US, incoming data confirmed a pick-up in growth in the second half of 2016 and FOMC minutes revealed that the decision to maintain interest rates unchanged in September was a close call. Consequently, expectations for the Federal Reserve to hike before year-end rose in October.

After the US money market reform was formally and smoothly implemented on October 14th, the Libor-OIS spread has tightened marginally but remains elevated.

Nordic overview



The depreciation of the SEK gained speed in October following a surprisingly low CPI print on October 11th, which forced the Riksbank to revise its inflation outlook. At its policy meeting on October 27th, the Riksbank decided to signal an increased probability of a near-term rate cut and a six-month delay to its forecast for a first rate hike. Moreover, the Board said it stands ready to extend bond purchases in December, but will await further information on CPI developments as well as assessing actions from other central banks before making any firm decisions regarding details. Overall, the Riksbank stresses its readiness to act, also between ordinary meetings.

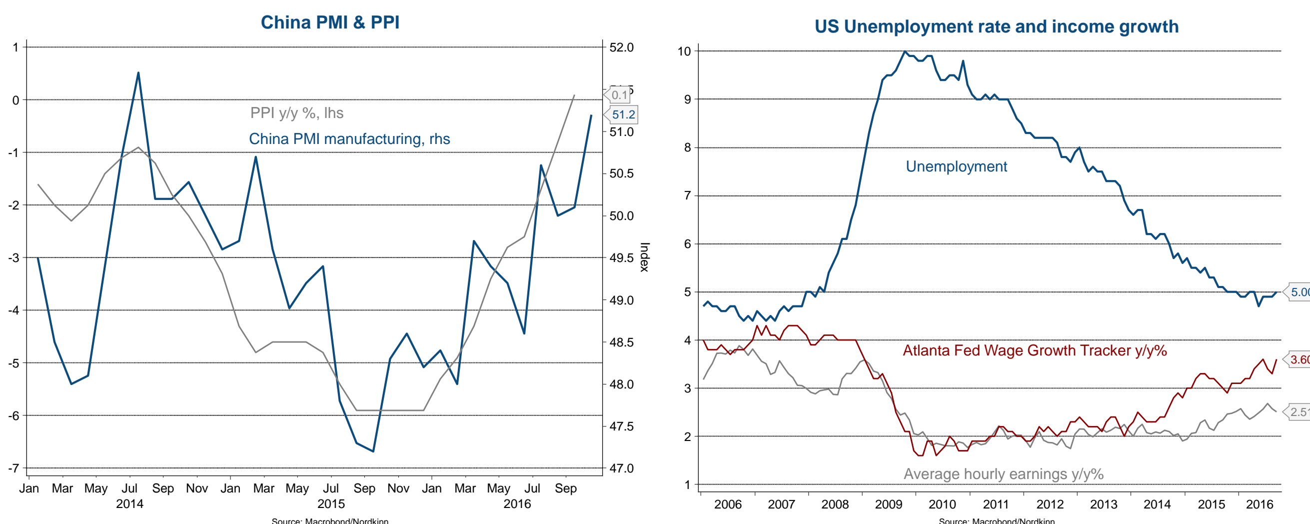
The subsequent sharp sell-off in SEK sparked a surge in demand for inflation-linked bonds, pushing break-even inflation spreads markedly wider, see chart. Meanwhile, the spread tightened between Swedish and German 10-year government bonds.

The NOK remained broadly unchanged in October; merely weakening slightly versus the EUR whilst appreciating significantly versus the SEK. The trade weighted NOK is currently 2-3% stronger than the Norges Bank assumed in its latest monetary policy report from September 22nd. However, in terms of monetary policy implications, the impact of a stronger NOK is partly offset by somewhat higher oil prices than assumed. Added to that, house prices and household debt have risen more than the Norges Bank projected. Overall, as confirmed by Norges Bank on October 27th, developments since the September meeting are on balance broadly in line with its expectations and therefore neutral for monetary policy.

While short-term NOK interest rates remained virtually unchanged, longer-term rates rose more or less in tandem with euro area rates. Consequently, the slope of the Norwegian yield curve steepened in October.

Global markets

In 2015, China experienced a slowdown and downward pressures on inflation, dampening the outlook for growth and inflation in developing economies as well. This was probably an important factor behind the financial market turbulence and government bond rally last fall and earlier this year. Now, we believe a rebound in global economic growth is in the making. This is confirmed by the recent bounce back in business sentiment in both emerging and developing economies. For instance, China manufacturing PMI rose to a two-year high in October. The rebound has been accompanied by an increase in producer price inflation, see left hand chart. This development is quite different compared with only one year ago.



The recovery in emerging market growth is important because it will probably have a positive impact on developing economies and markets. In addition to this tailwind, we see in particular three other catalysts for stronger US growth ahead. First, the 70% decline in US oil investments is now coming to an end. Second, and more importantly, we expect a further acceleration in wage growth as any remaining slack in the US labour market will soon be absorbed, see right hand chart. Higher wage growth will boost household income and spending. Third, an increase in income combined with a low level of housing inventories should lift construction activity. Non-residential investments may also benefit from higher consumer spending.

In an environment of stronger growth and rising inflationary pressures, the Federal Reserve will probably want to raise the Fed Funds rate a couple of times in 2017 in addition to the widely expected rate hike in December 2016. The market, on the other hand, expects a recap of 2015 and 2016, anticipating merely one hike in 2017. The market may be proven right also next year if growth in the economy is slowing and/or inflationary pressures remain subdued, but current data implies the opposite. As discussed above, we instead see evidence of pick-up in both growth and inflation occurring right now.

If we are right about our US outlook, the USD has the potential to appreciate a bit further as short-term interest rates will rise. Meanwhile, the slope of the treasury yield curve will likely flatten as the increase in short-term yields outpace longer-term yields. Our calls for a stronger USD and a flatter US treasury yield curve should also benefit from other major central banks keeping interest rates low for longer, as they are struggling with more economic slack and domestic downward pressures on inflation.

The US presidential election poses a near-term risk to financial markets. We believe a Trump victory will hit risky assets immediately and trigger a rally in government bonds, although the effect should be short-lived and relatively contained when comparing to the Brexit vote. The checks and balances built into the US system make radical changes unlikely, no matter who wins, even though no thing is certain.

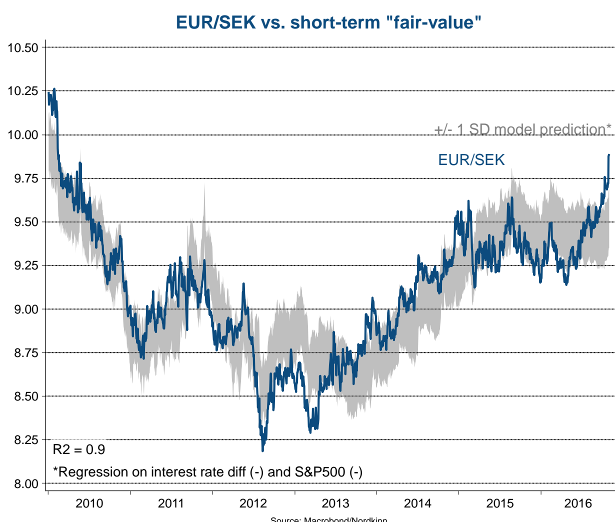
In the medium-term, US government bonds may eventually suffer if Trump wins, reflecting a looser fiscal policy stance. Moreover, any reversing of trade liberalisation, which has supported growth and contained inflation, could result in a higher inflation premia on government bonds.

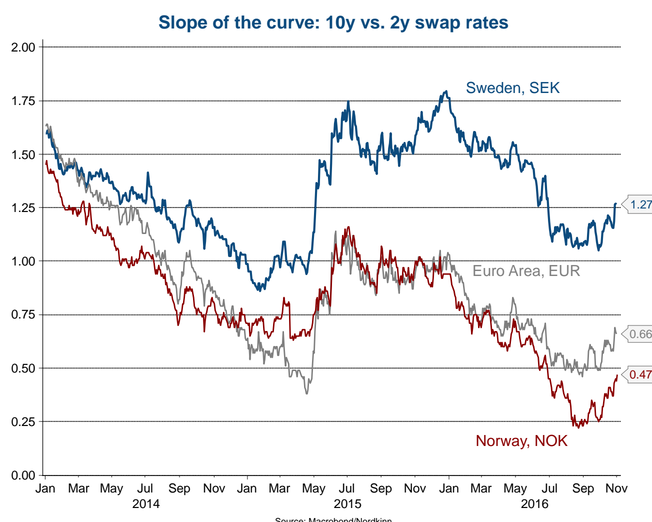
Nordic markets

The shockingly low September CPI print at 0.9% y/y was a game changer for the Riksbank. It forced the Riksbank to delay the prospects for inflation to reach 2%, which in turn requires a low repo rate for longer. Interestingly, the slowing trend in CPI inflation occurred at the same time as business surveys signal a rebound in economic growth. In our view, therefore, the only trigger for a rate cut is another surprisingly low CPI release due on November 15th. That may well happen, but in the near term we see a greater probability of a bounce, as some temporary factors behind the meagre September print subsides.

Regarding non-standard measures, we are confident that the Riksbank will extend its asset purchase program in December. By then, the Riksbank has not only had time to evaluate another CPI report, but also has had the opportunity to respond to actions taken by other central banks, especially the ECB. In its statement on October 27th, the Riksbank said it stands ready to extend government bond purchases, which for us suggests that non-government bonds are not under considerations yet. However, it is possible that the Riksbank in December will highlight a possible change in the composition of future bond purchases if needed, such as opening up for the possibility to purchase municipal bonds next year.

Market wise, we remain positive on break-even inflation spreads. Inflation is on the rise globally and the Riksbank is conducting an extremely accommodative policy to support a rising trend in inflation. Policy includes the purchase of a significant amount of outstanding index-linked bonds. Added to that, given evidence of a rebound in economic growth, we see some scope for the SEK to recover some of the losses it suffered in recent months. The EUR/SEK cross appears significantly overvalued according to market-based fair value models, see left hand chart.





Turning to Norway, we believe curve steepening is an attractive way to express a bearish bias towards the global government bonds market. The slope of the yield curve is relatively flat, see right hand chart. This implies low costs and good risk/reward in holding this trade. Another rate cut in Norway can not be ruled out in the near term, but it is not priced. This means there is some protection in the short-end in Norway if a black swan were to appear. However, the curve could also steepen if the strong trend in house prices and debt were to continue, as the market might start questioning the Norges Bank's projection of stable rates until 2019.

Regarding the Norwegian government bonds market, total supply will be cut by around 10% in 2017 from 2016 according to the government's budget proposal. In addition, as the NGB 472 bond matures in May 2017, there will be a negative net supply of government bonds next year. History shows that bond demand usually increases in years of bond redemptions as investors rolls their holdings to longer-dated bonds. Consequently, asset swap spreads tend to widen in the months prior to maturity date. Considering the attractive carry and roll profile of Norwegian asset spreads, we have therefore increased our conviction for wider swap spreads in the Norwegian government bond market.