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asset management

Nordkinn Market Review & Outlook - Dec 2016

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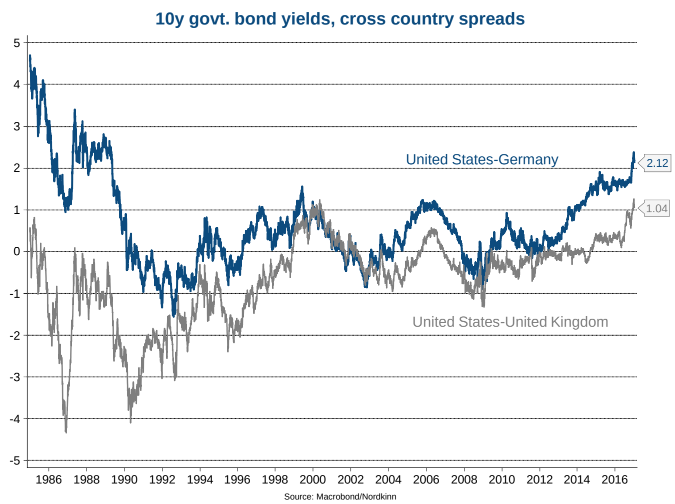
Global overview

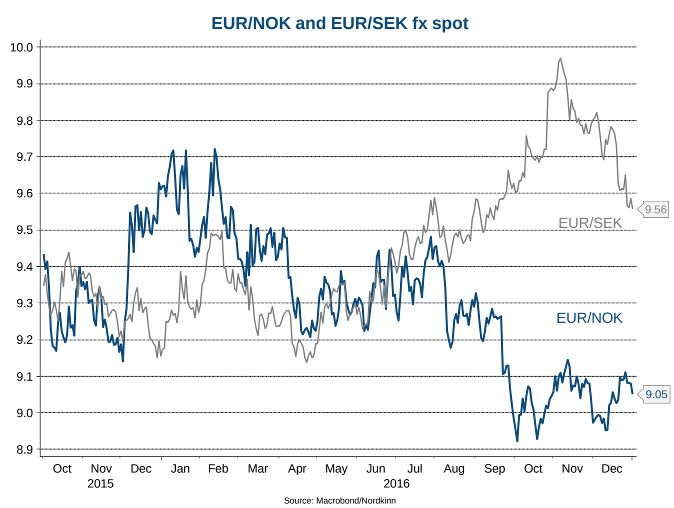
US government bond yields continued higher in December amid expectations for stronger growth, higher inflation and more Fed hikes, but levelled off at the end of the month. Meanwhile, UK and German yields fell in December, partly reflecting various political uncertainties that potentially could undermine economic growth. Consequently, cross-Atlantic interest rate spreads widened significantly to levels not seen since the 1980s, see chart. Rising US bond yields supported the USD also in December, gaining 3% against the JPY and 1.5% versus EUR and GBP.



As universally expected, on December 14th the Fed raised interest rates for the second time in this economic cycle. Unexpectedly however, the new projections showed that Fed officials anticipate three rate hikes in 2017 compared to two previously, after several Fed participants having had incorporated potential fiscal policy shifts into their projections. This was much more hawkish than discounted by the market, which meaningfully boosted US interest rates and the USD.

Turning to Europe, on December 8th, the ECB decided to extend its asset purchase program by nine months, but contrary to what most economists expected the ECB also decided to trim monthly purchases by EUR 20 bn to 60 bn from April 2017. In addition, the ECB decided to allow for more short-dated bond purchases. As a result, the slope of the EGB yield curves steepened somewhat while the EUR remained broadly stable.

Nordic overview



Even though the Riksbank policy announcement on December 21st were in line with market expectations, the SEK appreciated sharply in December on speculation that the Riksbank's aggressive easing policy is reaching the end of the road. The Riksbank extended its asset purchase program by six months, but lowered the amount of nominal bond purchases to SEK 15 bn (from 30 bn in H2 2016) while keeping index-linked bond purchases unchanged at SEK 15 bn. Crucially, three of the six board members proclaimed reservations against the decision, which for the first time since 2008, forced governor Ingves to use his casting vote in favour of the more aggressive easing. Interestingly, both the repo rate and the Riksbank's projection for the repo rate were left unchanged, which implies a 60% easing bias in 2017.

In the fixed income space, breakeven inflation spreads rose sharply in December supported by both the Riksbank's purchases of real rate bonds and global inflation trends.

On December 15th the Norges Bank maintained its key policy rate at 0.50% and left its interest rate projection broadly unchanged, as we predicted. The central bank cut its forecast for both growth and inflation in 2017, but the monetary policy implications of those changes were offset by the risk of a further rapid rise in house prices and household debt. The new interest rate projection implies a 40% probability for a cut by summer 2017.

Overall, the market reaction to the new interest rate projection was muted. Interestingly, as the market pricing discounts for unchanged rates in 2017 it ignores the easing bias implied by the Norges Bank's interest rate projection. Consistent with its seasonal pattern, the NOK depreciated slightly in December, presumably due to commercial NOK flows as the Norges Bank halted daily NOK buying on behalf of the State Pension Fund between December 16th and New Year.

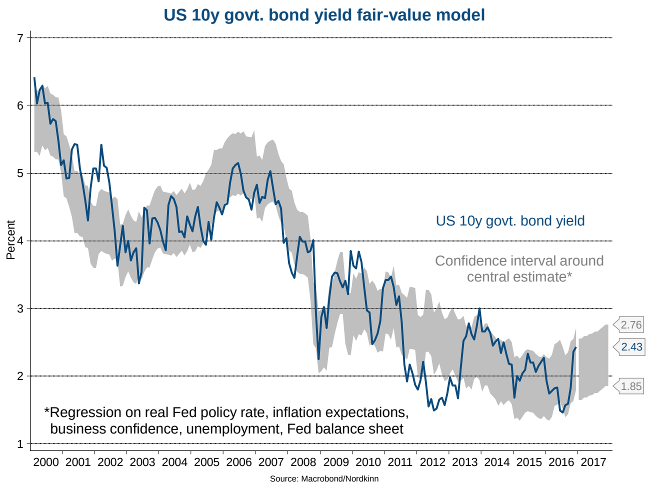
Global markets

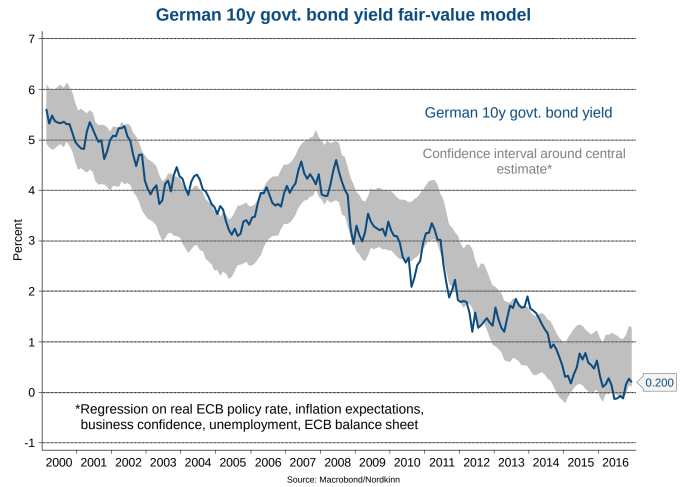
Ever since the US election, the anticipation for fiscal easing has helped raise growth and inflation expectations, which in turn has lifted bond US yields and contributed to the USD rally. Are these trends set to continue in 2017?

The left hand chart illustrates our attempt to quantify the potential impact of fiscal easing on the 10-year US government bond yield using an estimated fair value model covering 20 years of data. Assuming that fiscal easing translates into lower unemployment and higher inflation (respectively 4.3% and 1.9% by end-2017), this exercise produced a 10-year range between 1.8% and 2.8% at the end of 2017. Notwithstanding the uncertainties associated with the policy of the new administration, the market has quickly moved to the higher end of this range. During this transition, speculative accounts have become excessively short duration in the US and are therefore vulnerable to a correction.

In addition, given the already high expectations for economic growth and monetary policy tightening in 2017, we see potential for disappointments on both fronts. While we agree with the consensus view that US growth will pick up in 2017, we see downside risks stemming from a stronger USD as well as structural forces such as weak productivity growth and adverse demographics.

In short, given that the market has already corrected to a substantial extent, the risk-reward is increasingly favouring exposures of duration in long-dated US government bonds. We have expressed this view under the *"USA: Interest rate normalisation"* theme.





Meanwhile in Europe, sluggish growth and high unemployment will continue to keep a lid on underlying inflation dynamics and the ECB will therefore maintain key policy interest rates low for at least a couple of years. Moreover, the ECB announced on December 8th that it will continue purchasing bonds at least throughout 2017, which will keep longer-term bonds supported.

That being said, barring an abrupt change to the economic outlook, we expect the ECB to announce explicit tapering later this year as the central bank needs to respond to capacity constraints. The ECB has already decided to reduce monthly purchases by EUR 20 bn from April. In upcoming policy deliberations, we expect ECB hawks to put emphasis on the upward trend in headline inflation and longer-term inflation expectations in combination with a modest improvement in business surveys and falling unemployment as arguments for expecting higher underlying inflation over the medium term.

Given that valuation in 10y German Bunds is very stretched (see our fair value estimate in the right hand chart), Bunds are highly vulnerable to explicit changes in policy. In our view, this favours short exposure in German government bonds relative to US and Norwegian government bonds. Moreover, the ECB's decision to remove the self-imposed floor for bond purchases below the deposit rate in combination with heavy supply of long-dated EGB bonds in Q1, favours curve steepener in the euro area, which we express in our *"EMU: ECB low for longer"* theme.

Finally, in the UK the economic outlook is associated with unusually high uncertainties following the Brexit vote. While incoming economic data has proven resilient, it seems inevitable that there will be a hit on growth over the next couple of years. The weak GBP will lead to a rise in inflation, but we believe that the Bank of England will look through any transitory effects on inflation and keep interest rates low for a considerable period of time.

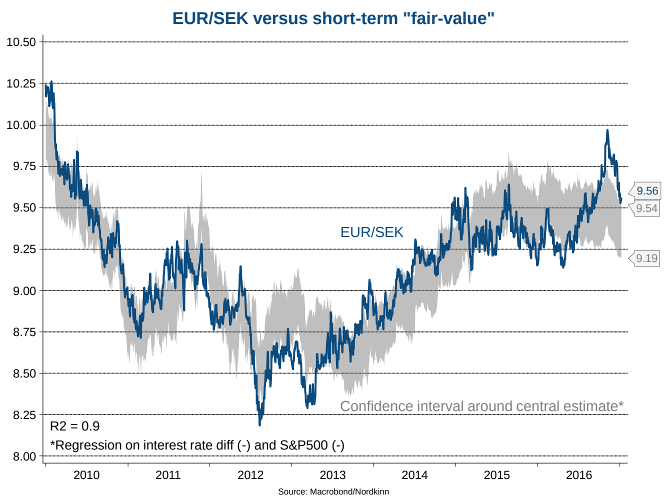
Nordic markets

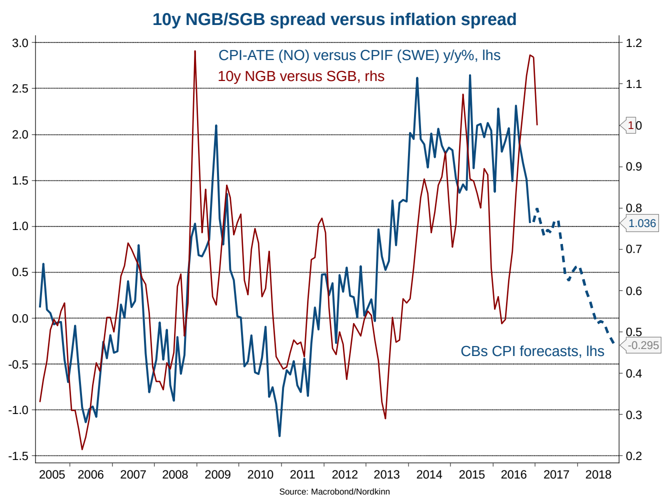
We forecast that Swedish CPI inflation ended 2016 below but close to the Riksbank's 2% inflation target. Given that the December print will be the only CPI release prior to the monetary policy meeting in February, we expect the Riksbank to remain firmly on hold on that meeting. The sharp improvement in various business surveys also suggests that the Riksbank Board is unlikely to act on its easing bias in the near-term, even though the Board has not attached much importance to economic performance over the past couple of years.

Moreover, the 3-3 tie in the Riksbank Board at the previous Board meeting suggests that the end of the road for quantitative easing is approaching. Mr. Flodén wanted only to extend index-linked bonds, while Ms. Skingsley and Mr. Ohlson wanted no extension at all. Against this background, we have become more bearish on longer-term Swedish nominal bonds. For the same reasons, we have become more bullish on the SEK (*"Sweden: SEK recovery"*), which despite a strong performance lately still trades weaker than our model-implied fair value, see left hand chart.

At the same time, it is too early for the Riksbank to declare victory on inflation as underlying inflationary pressures (i.e. wage growth) remain subdued. The Riksbank will surely avoid tightening monetary policy too early and thereby put the confidence in the inflation target at risk again. Consequently, we expect the Riksbank to maintain the repo rate at -0.50% throughout 2017, which favours long/receiver positions in the front-end of the curve (*"Sweden: Credible inflation targeting"*).

Moreover, given the lasting Riksbank support for higher inflation in combination with global inflation trends, we remain bullish on breakeven inflation spreads *("Sweden: Government relative value"*).





We launched a new investment theme in December, *"Norway: Inflation convergence",* which expresses our bearish outlook for Norwegian inflation and its expected effects on bond prices. Having remained well above the Norges Bank's 2.5% inflation target since mid-2015, core CPI inflation will soon undershoot as the effect of the weak NOK fades. The NOK has appreciated by around 7% since the trough in January 2016 and we expect the stronger NOK trend to continue due to higher commodity prices in combination with the Norges Bank's focus on financial stability (*"Norway: NOK recovery").*

Longer-dated Norwegian government bonds have been relatively unpopular over the past couple of years, influenced by the regime shift in supply in 2012 and relatively high inflation since 2013 among other factors. As a result, Norwegian government bonds appear cheap versus similar bonds in for example Sweden and Germany, and asset swap spreads are tight in the long-end. Given that we expect Norwegian inflation to drop sharply in an environment where global inflation is picking up, we expect Norwegian government bonds to perform going forward. The right hand chart illustrates the correlation between the bond yield spreads in Norway and Sweden on the one hand and inflation differences on the other. The chart includes the Norges Bank's and the Riksbank's forecasts for inflation. If those forecasts prove correct, we expect NGB versus SGB yields to tighten.

In addition, there will be a negative net supply of government bonds in 2017 as NGB 472 matures. History shows that bond demand usually increases in years of bond redemptions as investors roll their holdings to longer-dated bonds, and asset swap spreads tend to widen in the months prior to maturity date. We therefore remain long NGBs versus swaps (*"Norway: ASW trading"*).