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asset management

Nordkinn Market Review & Outlook - Jan 2017

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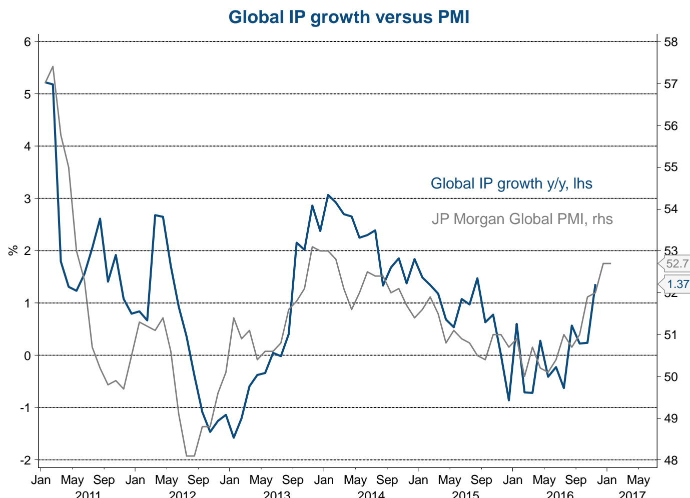
Global overview

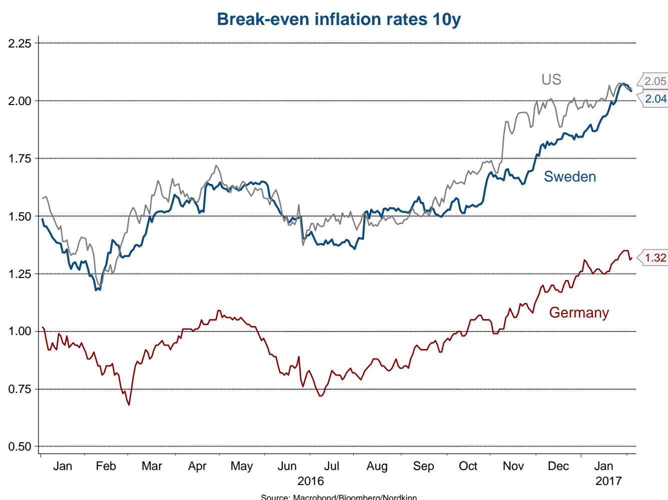
Bonds selling-off pushed global bond yields higher in the first month of 2017, lead by a catch-up in European government bond yields. A combination of heavy bond supply, rising CPI inflation and uplifting economic indicators contributed to the increase in German yields. Meanwhile in the US, yields range traded as investors continued to digest the potential consequences of the Trump administration's policy. In the wake of this, the spread between US treasuries and German Bunds tightened somewhat but remains elevated at historical highs. The FX markets reflected this development by EUR/USD appreciating.



Whilst various political events and risks continue to cloud news flow, we are witnessing a positive and accelerating shift in the global economic momentum. As illustrated by the chart, this turning point occurred around the summer of 2016, which counter the often used argument of pure Trump effect as this commenced several months before the election. Moreover, the recovery is broadbased across regions and has contributed to a sustained rise in both commodity prices and breakeven inflation spreads.

Notwithstanding improvements in the outlook for growth and inflation, on January 19th the ECB's Governing Council firmly reiterated its intention to purchase assets at a monthly pace of EUR 60 bn between April and December. The Governing Council will carefully monitor the extent to which commodity prices are feeding into prices of non-energy goods and services. As long as there are no convincing signs of higher underlying inflation the ECB is set to hold its ground.

Nordic overview



Developments in Sweden and Norway largely mirrored developments abroad: Bond yields rose and the slope of the yield curve steepened. However, the surge in Swedish break-even inflation rates in January was much more pronounced than in other major economies, see chart. A combination of higher than expected CPIF inflation (1.9% in December) and the Riksbank purchasing significant amounts of index-linked bonds as part of their QE program, contributed to this outperformance.

Meanwhile, the appreciation of the SEK continued uninterruptedly in January, among other things supported by the release of the Riksbank minutes on January 12th, highlighting a pronounced split between hawks and doves in the Board. The minutes revealed that the three (out of six) Board members dissenting on the asset purchase decision also argued for a reduced easing bias, a signal which pushed short-term interest rates and SEK higher.

The NOK appreciated too, supported by a positive trend for commodities and risk appetite as global growth gains momentum. Micro data shows that demand for NOK from foreign accounts has been particularly strong, in spite of the softer than expected indicators for growth and inflation in Norway over the past couple of months. Core CPI inflation fell unexpectedly to 2.5% in December, after averaging 3.0% the previous six months.

The drop in inflation initially triggered a rise in demand for longer-term government bonds in Norway and consequently a flatter yield curve, but later in the month this was offset by commercial accounts paying significant amounts of interest rate swaps. Consequently, the spread between swap rates and government bond yields widened slightly in January.

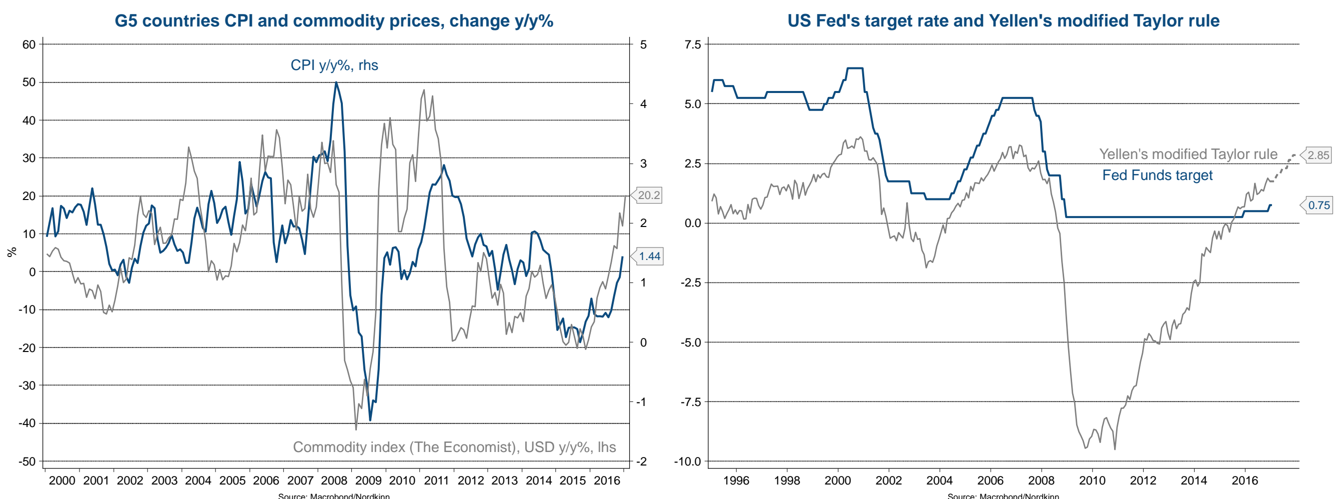
Global markets

The global economy is growing at a faster pace. The market has taken notice, as reflected by higher earnings growth expectations, commodity prices and bond yields. Market-based inflation expectations have risen in particular and commodity prices are already feeding into consumer price inflation, see left hand chart. In our view, these trends are likely to continue in coming months, among other things supported by a more expansionary US fiscal policy.

However, herein also lies meaningful risks to markets in the near-term. Owing to high expectations, investors may end up being disappointed by the extent to which President Trump delivers on his key campaign promises; increasing infrastructure spending and cutting taxes. European politics pose even larger risks to markets in 2017. Elections in France, Germany and the Netherlands are minefields that could ignite growing political discontent and unrest across the continent. In addition, Greece's debt crisis is flaring up again as reflected by the recent spike in Greek government bond yields.

In our assessment, these political risks imply that the path for markets in 2017 will be a rocky one, with plenty of set-backs along the way. Nevertheless, when looking through and beyond this inevitable volatility, bond yields will continue upwards, in particular owing to fading deflation concerns.

As we discussed in our previous monthly report, the Fed is likely to raise rates at least twice this year, which should keep the USD bull market intact in the near-term. The chart to the right shows Fed-chair Janet Yellen's modified Taylor rule, a simple rule she proclaims to be using as a rough guidepost for policy. According to this simple rule, the Fed should continue to withdraw policy accommodation to avoid falling behind the curve. We are expressing these considerations in our *"USA: Interest rate normalisation"* theme.



Meanwhile, we believe that the ECB will maintain its key policy rates unchanged in both 2017 and 2018 (ref. our *"EMU: ECB low for longer"* theme), mainly reflecting excess capacity and subdued underlying inflationary pressures. At the same time, later this year we expect the ECB to announce explicit tapering of asset purchases in 2018. The reasons are both cyclical (stronger growth, falling unemployment, higher realised as well as expected inflation) and technical (capacity constrains). This policy mix will be a strong force for steeper yield curves in Europe.

The ECB is in no rush to signal any policy change on QE before summer, which will keep the EUR bear market intact for a little longer. However, barring any significant negative shocks from upcoming European elections, in June or September this year the ECB will start preparing markets for a gradual slowdown in the pace of asset purchases next year. Bunds are highly vulnerable to explicit changes in policy, which favours short exposure in German government bonds relative to US and Norwegian government bonds.

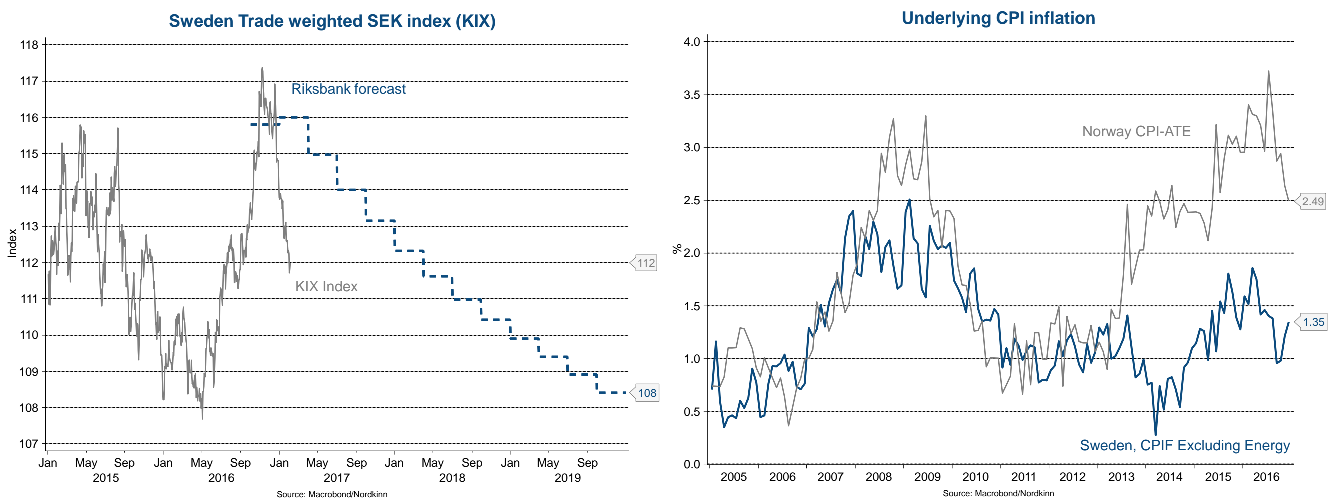
Finally, the Bank of England faces a difficult job given the unusually high uncertainty around the prospects for growth and inflation over the medium term. On the one hand incoming economic data has proven resilient, on the other it seems inevitable that there will be a hit on growth over the next couple of years due to the Brexit vote. 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

The Swedish economy is growing at a brisk pace and inflation is going up. Consequently, the Riksbank Board is now split between two camps of equal size. In December, Mr. Ingves, Mr. Jansson and Ms. af Jochnick voted for a SEK 30 bn asset purchase program until mid-2017 and a significant easing bias for the repo rate. Contrary, the other camp (Mr. Flodén, Ms. Skingsley and Mr. Ohlson) wanted a less stimulative monetary policy stance. As we wrote in our previous monthly report, the end of the road for QE is approaching, which implies that the path of least resistance for nominal bond yields is to the upside. This view is at the core of our *"Sweden: Government relative value"* theme.

However, this does not mean that the end of the road for a negative repo rate is approaching anytime soon. In line with our *"Sweden: SEK recovery"* theme, the SEK has appreciated sharply in recent months and is now 4% stronger than the Riksbank's forecast, see left hand chart. A further significant appreciation of the SEK could undermine the credibility of the inflation target, which the Riksbank has been working so hard for. Indeed, excluding volatile energy prices, the lingering headache for the Riksbank is that underlying inflationary pressures remain well below the Riksbank's target, see right hand chart.

The stronger SEK has two implications for our portfolio. First, we are taking profits on our long SEK exposure, due to our belief that the currency is firming too quickly for the Riksbank. Second, 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. This is reflected in our *"Sweden: Credible inflation targeting"* theme.



In contrast to Sweden, growth in the Norwegian economy is modest and inflation is on its way downwards, albeit from high levels. Thanks to stronger global growth, higher commodity prices and Norges Bank's focus on financial stability, the NOK has appreciated by almost 10% since the trough in January 2016. We have captured this move in our *"Norway: NOK recovery"* theme, but owing to the currency's solid performance since last summer we are now scaling down this position.

Nevertheless, the lagged impact of a stronger NOK over the past twelve months will push inflation significantly lower in 2017 (*"Norway: Inflation convergence".*) Lower inflation should make Norwegian nominal bonds more attractive again as the real compensation of holding these bonds increases. In addition, with plenty of excess capacity in the economy, the Norges Bank will be in absolutely no hurry to raise interest rates given that inflation at the same time undershoots its 2.5% target.

Furthermore, there will be a negative net supply of government bonds in 2017 as NGB 472 matures. History shows that asset swap spreads tend to widen in the months prior to maturity date. In our view, the combination of lower net supply and higher expected demand bode well for long NGBs relative to Swedish and German bonds, but also versus swaps due to higher demand for fixed-rate loans (*"Norway: ASW trading".*) Finally, swap spreads serve as protection against a flare-up euro break-up risks.