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asset management

Nordkinn Market Review & Outlook – May 2017

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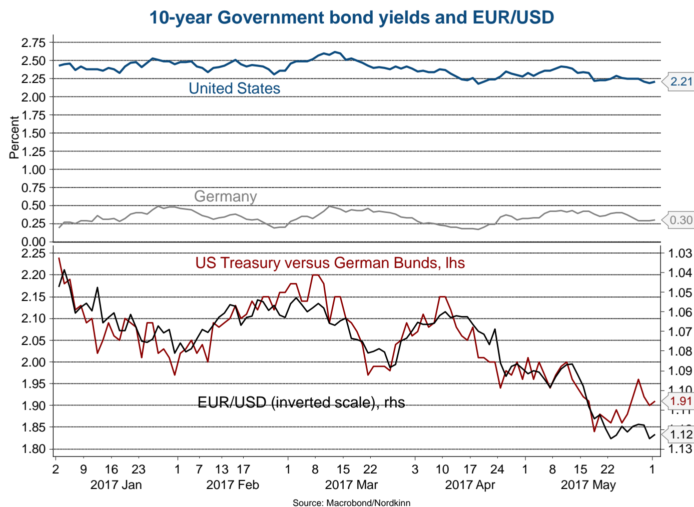
Global overview

Political risks have traversed from Europe back to the US in recent weeks, contributing to a tighter spread between US Treasury and German Bund yields and a higher EUR/USD rate, see chart. On May 17th a sense of panic swept across markets after US President Trump reportedly attempted to halt an FBI investigation into alleged links between his campaign aides and Russian officials. The allegations against the president raised concerns about Trump's ambitious pro-growth policy agenda. Equity indices sold off around 1.5% on the day, the VIX saw a 30% spike and expectations for future Fed interest rate hikes fell sharply. However, market sentiment recovered, for equities in particular, following the appointment of a special counsel to lead the investigation into Russian involvement.

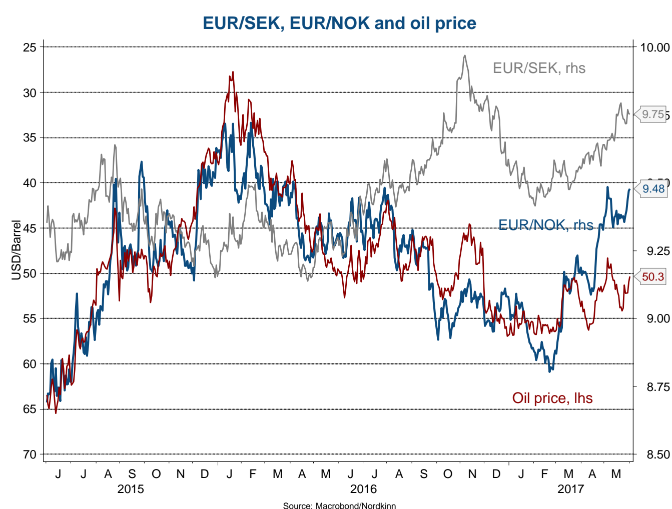


While most US indicators remain at strong levels, the bond and currency markets took notice of a modest decline in US business confidence and inflation indicators over the recent month. Meanwhile in Europe, economic activity showed further signs of improvements and core inflation nudged higher. These economic developments also further fuelled a narrower US/German bond spread and a higher EUR/USD.

Still, according to the minutes from the FOMC meeting on May 3rd, most participants judged that if economic information came in about in line with their expectations, it would soon be appropriate for the Committee to take another step in removing some policy accommodation.

On May 11th the Bank of England's MPC voted 7-1 to maintain the Bank Rate at 0.25%, but stated that monetary policy could need to be tightened to somewhat greater extent over the forecast period than the path implied by the market curve. The market reaction was muted however, as investors are awaiting the upcoming parliamentary election on June 8th and subsequent outcome of the ongoing Brexit negotiations.

Nordic overview



Swedish and Norwegian bonds traded strongly in May, in particular relative to the euro area markets. The soft statement by the Riksbank Board at the end of April hung like a cloud over the Swedish market also in May. The market ignored the stronger than expected rise in the CPIF inflation to 2.0%, as most of the increase was deemed transitory and threrefore considered not to affect the judgement of the Riksbank Board.

Although the rise in GDP of 2.2% in Q1 from a year earlier missed expectations of a much stronger growth rate, the underlying pace of growth is firm and not the reason why the Riksbank maintains a very accommodative monetary policy.

On May 16th the Riksbank proposed to insert CPIF as the new target variable with a +/- 1 % variation band, but stressed that this will not entail any change to the policy being conducted.

Three factors contributed to the decline in Norwegian bond yields in May. Firstly, money market fixings came under pressure, largely owing to the compression of the US 3m Libor versus OIS (which feeds into NIBOR). Secondly, CPI inflation stood at 1.7%, yet again undershooting both the market's and Norges Bank's expectations. Thirdly, coupon payments and the redemption of NGB472 government bond prompted reinvestments into longer-dated issues.

The currency market mirrored the relative strength of the Scandinavian bond markets: Tighter interest rate differentials led to a weakening of both NOK and SEK against EUR, see chart. Remarkably, over the past couple of months the NOK has sold off more than what normally can be explained by developments in commodity prices and interest rate spreads.

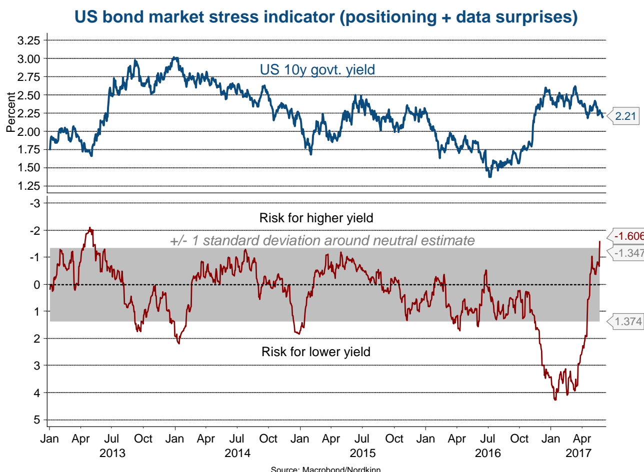
Global markets

We see three reasons why US treasury yields have struggled to gain traction over the past couple of months. First of all, investors see a growing risk that the series of scandals afflicting the Trump administration will disrupt large parts of Trump's market friendly policy agenda. Second, the soft GDP expansion in Q1 combined with the recent modest decline in US manufacturing PMIs have raised concerns about a slowdown in the US economy, and indicators of underlying inflation pressures have eased somewhat. Third, non-commercial positioning has reversed completely, from the largest short bet ever against the US 10-year bond at the start of 2017 to the most net long position since December 2007.

In our view, all these three forces should ebb over the coming months. Donald Trump desperately needs a "win", and cutting taxes is a key priority both for him and Congress. Regardless, as we have communicated before, we do not believe that expectations of tax cuts and increased government spending were the main drivers of the post-election boost in US treasury yields, as the current cyclical upswing in global growth was already underway before Trump's victory.

Moreover, the weak GDP growth rate in the first quarter follows a pattern of sluggish annual starts in recent several years, when momentum has picked up in subsequent quarters. The Fed is well aware of this pattern and will therefore raise rates in June if incoming data matches expectations. In addition, we also expect one rate hike in the second half of 2017 and some additional tightening in 2018, which is more hawkish than the market prices in (*"USA: Interest rate normalisation"*.)

If we are right on the US economy, we expect speculative investors to unwind their net long positions in US treasury futures in coming months, which would push bond yields upwards. We have captured this in our US bond market stress indicator, which combines net long positioning in the treasury market with the City surprise index for the US economy, see left hand chart. In the first quarter of 2017 this indicator warned about a massive risk for lower bond yields, but now it signals the opposite.



Turning to Europe, we see nothing in the euro area data to suggest that the current solid expansion is at risk of meaningfully fading. Given the strong growth rate relative to potential, the unemployment rate will continue to fall steadily. As such, the risks to inflation have become more balanced, casting doubt on the need for monetary policy to remain as accommodative as it is currently. This is why we expect the ECB in September to announce a reduction in asset purchases in 2018 (*"EMU: QE tapering"*).

At the same time, underlying price and wage pressures in the euro area remain subdued, even though some tentative signs have started to emerge. Consistent with the ECB's forward guidance, we expect the Governing Council to maintain key interest rates at current levels until well beyond the horizon of its asset purchases. Consequently, we expect the spread between short-dated US and euro area interest rates to widen going forward, triggered by higher US bond yields.

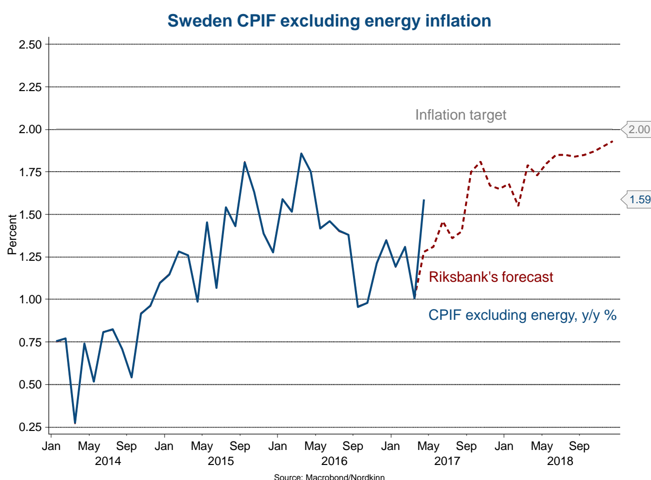
With this in mind, we expect the post French-election rally in the EUR to fade over the summer. The chart to the right illustrates that the market has been busy covering its net short EUR positions during 2017. Now that net long speculative positions in the EUR have risen to a three-year high, we expect the speculative demand to abate and EUR/USD to depreciate over the summer.

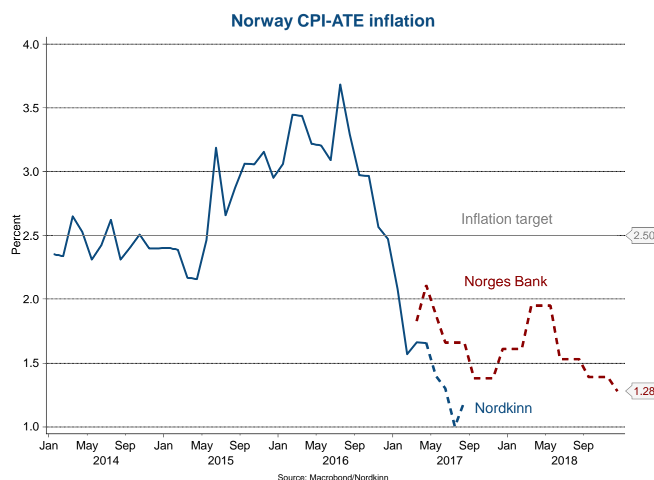
Nordic markets

According to the Riksbank, the proposal to replace CPI with CPIF as the new target variable and introducing a "variation band" will not affect how monetary policy is conducted. So why bother making these changes? The Riksbank stresses that the CPIF (CPI with a fixed interest rate) has de facto served as the intermediate target variable to steer clear off the direct effects of interest rate changes on inflation. We agree that this part of the proposal is a technicality that will not change monetary policy but facilitate communication.

Given the Riksbank's commitment to protect the credibility of its 2% inflation target, we fully understand why the Riksbank stresses that the +/- 1% variation band will only serve as a tool of communicating that the development of inflation is associated with uncertainty. We trust that this will not affect the judgement of monetary policy in the near term, which is why our long-held investment theme *"Sweden: Credible inflation targeting"* is alive and well. Despite a healthy economy, according to the Riksbank the current expansionary monetary policy is needed to stabilise inflation at 2%, because inflation has been below target for long. The rise in underlying inflation in April, see left hand chart, was largely due to transitory factors that will fade away soon.

That said, in a longer-term horizon the introduction of a +/- 1% variation band could, in our view, signal a small change towards a more flexible conduct of monetary policy. Once the Riksbank can declare victory in the battle for a credible inflation target, monetary policy will likely become less sensitive to small deviations from target and play a bigger role in stabilising the real economy. We anticipate that this, over time, will support a rebound in longer-term bond yields and the SEK, although in the very near-term we struggle to identify the domestic triggers for a major turnaround in either monetary policy or market sentiment.





In Norway, the near-term economic outlook looks positive, supported by expansionary impulses coming from both fiscal and monetary policies. Incoming data suggest slight upside risk to the Norges Bank's forecast of 1.6% growth in 2017. However, because growth has picked up even more among several of Norway's trading partners, including Sweden and the euro area, the relative performance of the Norwegian economy is not supporting the NOK at the moment. Nor does the development in the commodity markets. Given the lack of domestic and international triggers for a turnaround, the NOK could remain weak for longer than previously expected.

Meanwhile, the drop in core CPI inflation over the past six months to 1.7% in April from 3.0% in November last year was significantly larger than predicted by any economist, including those at the Norges Bank Board. Although the Norges Bank is relatively tolerant when it comes to volatility in inflation, there is a limit to that. Looking ahead, we predict a further decline in core CPI inflation over the summer, also relative to the Norges Bank's projections, see right hand chart.

Still, as development in demand and employment remain healthy, we expect the majority of the Norges Bank Board to vote for unchanged rates at the upcoming Board meeting on June 22nd. However, we would not rule out dissenting votes from members who care more about stability in inflation. Interestingly, at this meeting the Norges Bank will for the first time in history publish voting records from the Board. We remain long Norwegian bonds as part of our *"Norway: Inflation convergence"* theme.

The Ministry of Finance is currently working on "a modernisation of the monetary policy regulation". It is possible, in our view, that a change in the inflation target to 2.0% from 2.5% is under consideration. If the Ministry of Finance decides to change the inflation target, the announcement could come about the same time as the upcoming Monetary Policy Report is published on June 22nd. We do not expect such change to affect the current conduct of monetary policy, which should limit the immediate market impact. In the longer-term, a lower inflation target should in our view be supportive for longer-term government bonds.