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asset management

Nordkinn Market Review & Outlook – Oct 2017

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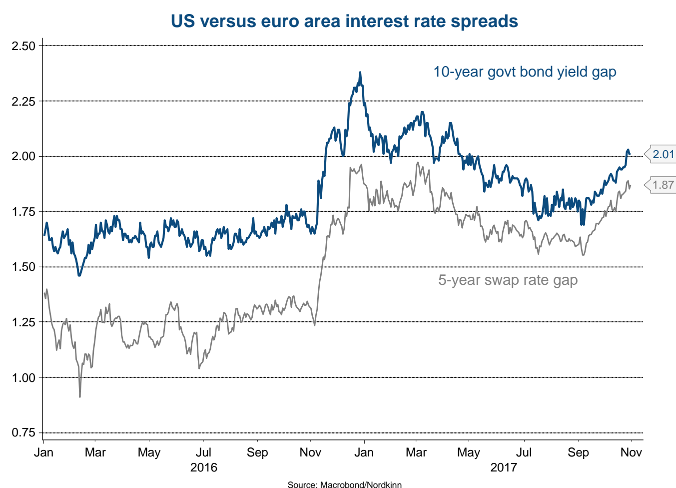
Global overview

Government bond yields in Europe fell and the EUR depreciated following the ECB's decision on October 26th to extend its asset purchase program from January 2018 by 9 months and lowering the monthly pace to EUR 30 bln from 60 bln. After a number of recent leaks of ECB "sources", the decision was the consenus view. However, the overall impression was marginally more dovish as President Draghi said there would be no abrupt stop to the asset purchase program, which lead to speculation of a gradual phasing out from Q4 2018. Moreover, the program remains "open ended" as net purchases are intended to continue until the ECB sees a sustained adjustment in the path of inflation.

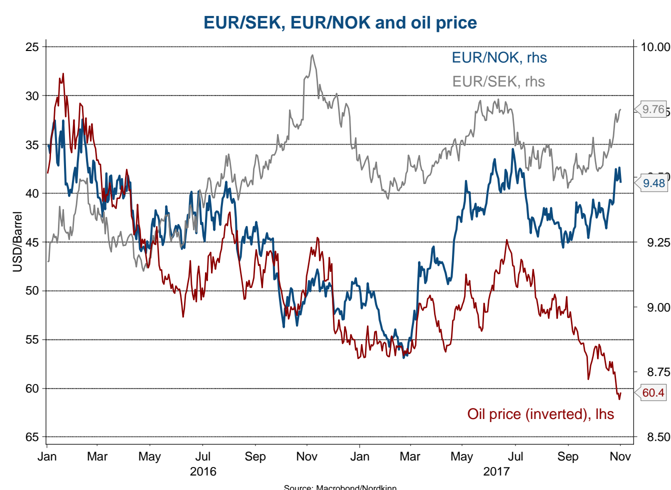


Furthermore, the ECB expects to keep its key interest rates unchanged well past the horizon of its asset purchases. This implies that the first rate hike almost certainly will not occur before 2019. All together, these signals gave markets the impression that euro area bond yields are unlikely to change direction anytime soon.

By contrast, US bond yields rose and the USD appreciated in October as robust economic growth combined with signs of wage inflation boosted expectations of future interest rate hikes by the Fed. As a result, the transatlantic 10 year bond yield spread widened significantly in October, and other spreads such as swaps followed suit, see chart.

The Brent spot oil price rose above USD 60 per barrel in October as expectations of an extension to Opec-led production cuts beyond March 2018 buoyed prices.

Nordic overview



Short-term interest rates fell and the SEK depreciated after Swedish CPIF inflation printed 2.3% in September, which was 0.2%-points below market consensus and 0.1%-points lower than the Riksbank's forecast. As widely expected, on October 26th the Riksbank left its interest rate projection unchanged and will decide in December if QE will come to a halt this year or will be extended into 2018.

Due to strong central government finances, the Swedish National Debt Office (SNDO) significantly cut the estimated borrowing requirement for 2018. The issue volume of nominal bonds is reduced to SEK 40 bln from SEK 50 bln and inflation-linked bonds to SEK 9 bln from SEK 13 bln. T-bill issuance is cut to SEK 20 bln from 60 bln. This puts further pressure on already pronounced supply/demand imbalances.

STIBOR fixings fell in October owing to a wider USD/SEK basis in combination with the resolution fee effect as we approach year-end. This, alongside a rising perceived housing market risk, appear to have reinforced the SEK weakness in October.

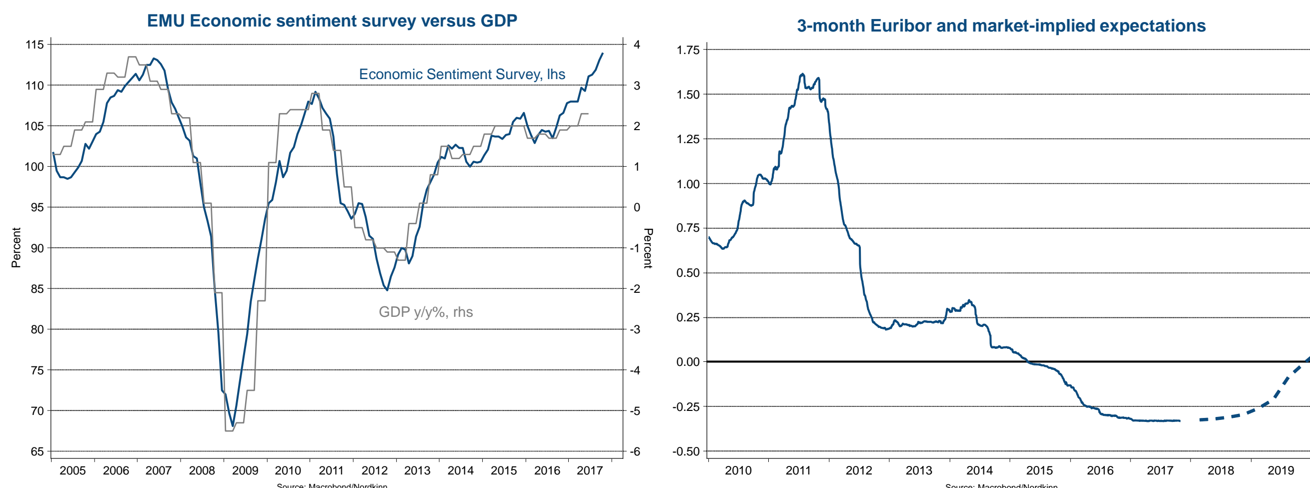
In a month with mixed data, Norwegian interest rates remained broadly unchanged across the maturity spectrum. Consequently, interest rates widened relative to the euro area and Sweden. In addition, government bonds underperformed versus swaps, primarily driven by lacklustre demand for NGBs after summer.

In spite of wider interest rate differentials and a rising oil price, the NOK came under heavy selling pressure in October. Falling house prices in conjunction with weaker than expected CPI and manufacturing PMI indices for September triggered a weakening of the NOK during the first half of the month, reinforced by a generally strong demand for USD in the latter half. Meanwhile, on October 26th the Norges Bank Board unanimously decided to leave rates unchanged. While this was an interim meeting with no new projections being published, the Board concluded that developments so far have broadly been in line with the macroeconomic picture presented in the September Monetary Policy Report.

Global markets

Three years into quantitative easing, the euro area's economy has made significant advances towards full recovery. Growth is outpacing rates seen in the US and the UK this year, and in October the European Commission's Economic Sentiment Indicator surged to its highest level since 2001, see left hand chart. Yet, while the unemployment rate has fallen sharply over the past couple of years, it remains above levels consistent with full capacity utilisation. As a consequence and despite the strong recovery, inflation is expected to continue to fall short of the ECB's inflation target of below but close to 2%, for some time.

To support the return of inflation towards target, the ECB is committed to keep monetary policy exceptionally loose for an extended period of time. The ECB's decision on October 26th to extend QE at least until September 2018, and Mr. Draghi's hint that there would be no sudden stop thereafter, sent strong signals to the market that a rate hike is not on the table until Q2 2019 at the earliest. The motivation is clear: To lock in interest rate expectations at extremely low levels in order to avoid a "taper tantrum". The ECB certainly does not want to make the same mistake it did in 2008, and again in 2011, when it prematurely raised interest rates, only to find itself having to reverse course.



The ECB's decision to cut net asset purchases in half from January 2018 confirms the rationale behind our *"EMU: QE tapering"* theme. Nonetheless, the soft communication with regards to expected future interest rates may imply that euro area bond yields will remain in limbo for several months before changing direction. Given the robust momentum of the euro area economy, we expect QE to come to a complete end during next year and we anticipate the first ECB interest rate hike in Q2 2019, followed by gradual rate increases thereafter. By the end of 2019, we expect money market rates to return to 2013 levels, i.e. before the ECB decided to conduct non-standard measures. This forecast is somewhat more hawkish compared to expectations currently prevailing in the markets, see right hand chart.

As a result of monetary policy divergence, the gap between US and euro area longer-term interest rates have risen over the past couple of months. For example, the 5-year swap rate in the US was 2.10% at the end of October, 190 basis points above the corresponding euro area interest rate. For comparison, in September the spread was 160 basis points. This spread will certainly narrow over the coming years, but that is largely already priced in as the 5-year spread 5 year forward is only 110 basis points. Given the divergent outlook for monetary policy ahead, we do not see a compelling case for entering spread narrowing trades at present, but have the idea on our watch list.

In October, we further cut exposure towards our *"US: Interest rate normalisation"* theme, as bond yields reached levels we deemed motivated for profit taking. Although we remain optimistic on the outlook for the US economy and inflation, there are several risks that could propel demand for safe-haven assets and trigger renewed USD-selling. We continue to monitor market developments with a view to add exposure again when the risk/reward ratio improves.

Donald Trump is poised to announce the next Federal Reserve chair on November 2nd. According to news agencies, Trump is leaning towards appointing Governor Jarome Powell. In our view, no matter who eventually is selected, the direction for monetary policy will not change radically next year, unless the economic outlook changes radically. The organisational structure of the Federal Reserve makes it impossible for the chair to run over other FOMC members.

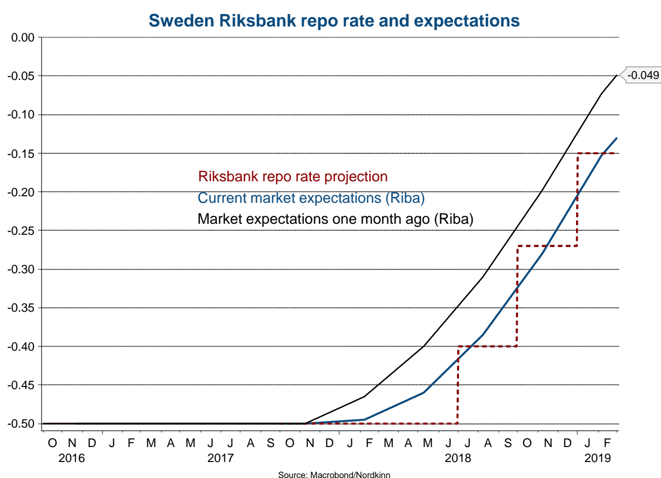
Nordic markets

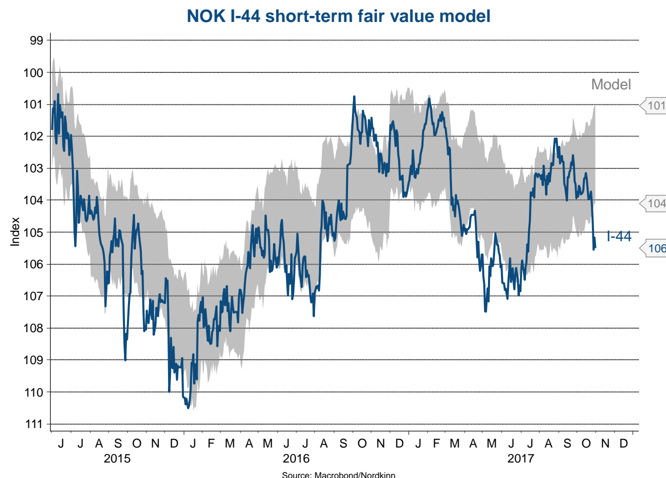
In the previous report we highlighted the risk that the market may fade the high probability of a Riksbank hike during the first half of 2018. Now, interest rate expectations prevailing in the market are more aligned with the Riksbank's own projection, see left hand chart. The lower than expected inflation print combined with dovish communication by both the Riksbank and the ECB were the key catalysts for the readjustment of interest rate expectations in October.

The current very expansionary monetary policy will continue to support economic growth and lead to higher inflation expectations in our view. The SEK is almost 4% weaker than the Riksbank's estimate, which should provide meaningful support to price growth on imported goods ahead. Consequently, our base case scenario remains that the Riksbank moves in July next year.

That said, we see some risks that could further delay the projected removal of monetary policy accommodation in Sweden: CPI inflation may have peaked; ECB interest rate hikes in 2018 are off table; the cooling of the housing market could become more severe than we currently expect. In this context, we continue to hedge our pro-reflationary trades, organised under the *"Sweden: Government relative value"* theme, with receiver positions in short-dated FRAs.

Moreover, as part of our *"Scandies: Basis effects from US debt ceiling"* theme, we anticipate some further downward pressure on STIBOR in Q4 as we look for a wider USD/SEK basis spread combined with the usual year-end impact of the resolution fees. Finally, the SNDO's reduction in estimated SGB issuance in 2018 creates an interesting supply/demand imbalance that will support Swedish bonds, in particular government bonds. Consequently, we expect additional widening pressures on asset-swap spreads and we continue to favour longer-dated SGBs over covered bonds.





In Norway, incoming macro data has been somewhat weaker than expected this autumn. The second consecutive drop in monthly retail sales in September implies that the trend in consumption growth is far less impressive now than it was over the summer. In addition, the fall in house prices has been slightly steeper and more wide-spread geographically than we had expected. This is challenging for our *"Norway: Economic revival"* theme. However, retail sales data is very volatile and the elevated levels of consumer confidence, in combination with a strengthening labour market and low CPI inflation, does not signal any imminent slowdown in household spending. Consequently, while we monitor developments carefully, we still expect a firming of economic growth in the coming two quarters, which is consistent with the signals from our leading economic indicators.

At the same time, with core inflation substantially below the inflation target, the Norges Bank is in no rush to hike interest rates anytime soon. Given recent developments in Norway and abroad, the probability of a late 2018 rate hike has fallen in our view. We expect the first rate hike to occur in spring 2019. For this reason, the yield curve has room to steepen further in our view.

The NOK sell-off in October looks exaggerated according to our fair-value models. The oil price has increased by almost 10% over the past month and the spread between interest rates in Norway and trading partners have widened. Taken together, these developments would normally signal a stronger trend for the trade-weighted NOK, see right hand chart. Conversely however, the NOK has shown a contrasting trend. Therefore, we find the current levels of the NOK very attractive and have added exposure to our *"Norway: FX recovery"* theme in October.