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asset management

Nordkinn Market Review & Outlook – Feb 2018

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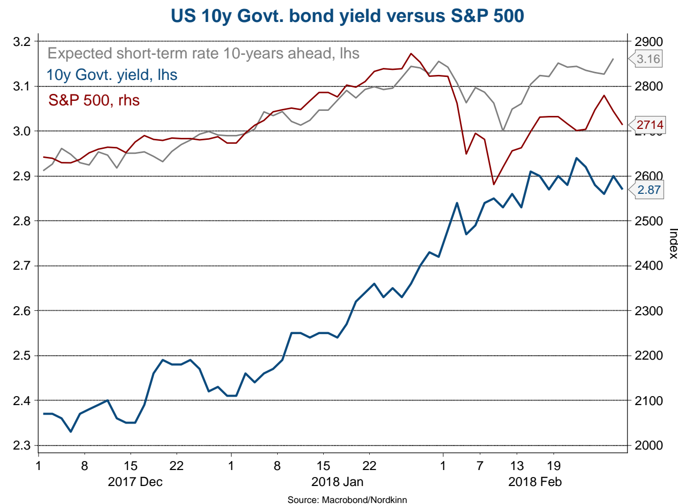
Global overview

Market volatility spiked at the beginning of the month as the release of US payroll and earnings data on February 2nd triggered a significant sell-off in government bonds, followed by a large correction in the equity market, see chart. The equity market correction, in turn, capped the rise in expected future short-term Treasury yields. Still, longer-term US government bond yields ended the month higher, owing to an increase in the term premium. In Europe, by contrast, bond yields edged lower and the slope of the yield curve became slightly flatter in February. As a result, the cross-Atlantic 10-year government bond spread widened by almost 20 bps to 2.20% and the EUR/USD exchange rate depreciated, albeit only slightly.

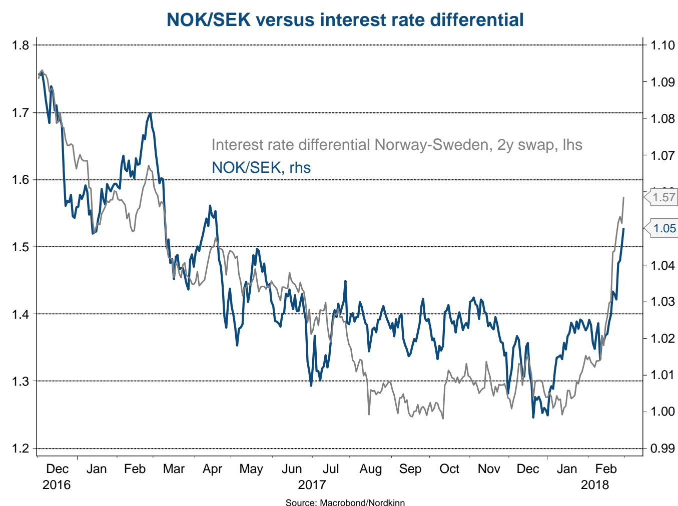


The January FOMC Minutes, released on February 21st, concealed a Committee that is increasingly optimistic regarding the near-term outlook for growth and also more confident in the progress of inflation moving towards the 2% target. This bolstered the market's expectations of a rate hike in March and additional gradual tightening later this year. Indeed, several economists now forecast four rate hikes by the Federal Reserve in 2018, i.e. one more than the median forecast of FOMC members.

The account of the January ECB meeting, released on February 22nd, confirmed the key message delivered by Mario Draghi at January's press conference: The growth outlook had improved. However, with inflation below target and convergence proceeding only gradually, "patience and persistence" in monetary policy remained warranted.

In Japan, the appreciation of the JPY continued in February. As a result, the outlook for Bank of Japan's tapering was pushed forward in the timeline, causing a slight decline in Japanese government bond yields.

Nordic overview



On February 14th the Riksbank announced unchanged monetary policy and a forecast for the repo rate that was identical to that of December. Nonetheless, the press release gave the impression that the Riksbank has become slightly more worried about the outlook for inflation, citing weaker service price inflation and slower wage growth than previously expected. Consequently, the inflation forecast was revised downwards slightly and, not dissimilar to the challenges faced by the Federal Reserve in 2016, the Riksbank changed the wording regarding the timing for the first hike to "the second half of this year", from "in the middle of 2018" previously.

On February 20th interest rates fell and the SEK depreciated sharply after CPIF inflation surprisingly fell 0.2%-points to 1.7%, thus reinforcing the Riksbank's concern over muted inflationary pressures.

The NOK, which is more sensitive to global risk sentiment, depreciated in the beginning of February owing to lower oil prices and deteriorating risk appetite among investors fearing higher global inflation would motivate faster monetary tightening among major central banks. Moreover, on February 9th the NOK sell-off gained additional speed after a surprisingly weak inflation print: Core CPI inflation in Norway fell to 1.1% in January, 0.4%-points below market consensus. The NOK rebounded later in the month after risk appetite turned positive with e.g. rising oil prices, which erased previous losses during the month. The NOK/SEK cross gained more than 2% in the latter half of the month in review, see chart.

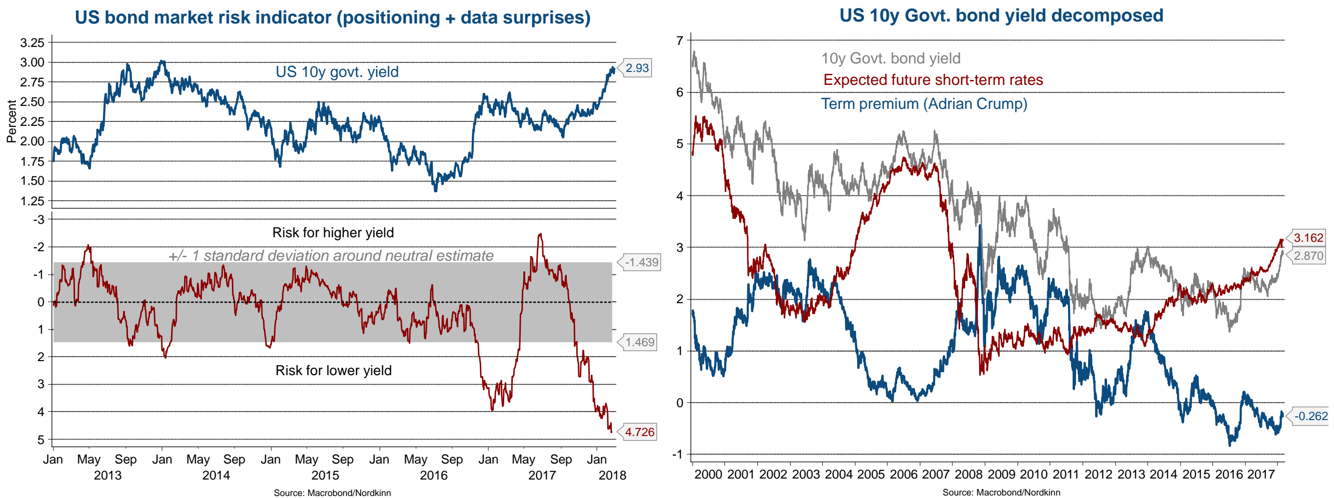
Norwegian interest rates rose in February, in particular in comparison with Swedish rates. Wider US FRA-OIS spreads translated into higher NIBOR fixings, but firmer expectations of a late 2018 rate hike by the Norges Bank contributed to higher interest rates further out the curve as well.

Global markets

Now that US interest rate expectations have almost converged to the median forecast of FOMC members, we continue to believe that the ascent in US government bond yields will flatten out over the coming months. Recent prints aside, actual inflation remains fairly tame. Even if underlying inflationary pressures appears to develop, we do not predict inflation to significantly overshoot the FOMCs forecast; a convergence towards the 2% target this year. Consequently, we continue to expect the Federal Reserve to pursuit the gradual removal of policy accommodation, broadly in line with expectations currently prevailing in the market.

In Europe, the market prices in nearly two rate hikes in the second half of 2019, which is consistent with the ECB's current forward guidance. The central bank expects to maintain key policy rates at present levels well past the horizon of the net asset purchases. Given that asset purchases are intended to run at a pace of EUR 30 bln until September 2018, or beyond, the ECB will for sure not hike rates before 2019. Moreover, several participants of the ECB's Governing Council seem to prefer tapering of purchases during Q4. Against this background, we expect the ECB to maintain key policy rates at current levels until mid-2019 and see a maximum 50 bps of tightening during the second half of 2019.

The convergence of market pricing to the central bank's interest rate prospects raises the odds that the rise in bond yields will level off soon. Indeed, our bond market risk indicator, which combines net long positioning in the treasury market with the Citi surprise index for the US economy, signal an increased risk of lower bond yields in coming months, see left hand chart. Potential triggers could be that inflation continue to lag or financial conditions tighten, forcing speculative investors to unwind their net short positions in US treasury futures.



While we anticipate a pause in rising bond yields near-term, we firmly believe the long-term trend remains to the upside due to a combination of cyclical and structural forces. Starting with cyclicals, the global economy is growing firmly and causing output gaps to shrink, fuelling expectations of higher inflation in the future. As a consequence, central banks will gradually raise short-term interest rates and, eventually, reduce the stock of assets purchased under QE. Fading central bank demand for government bonds, in combination with higher supply to finance growing fiscal deficits in some countries, will spark an increase in the term-premium on longer-term government bonds. The term premium on 10-year US Treasuries has risen by almost 25 bps so far in 2018 according to the Adrian Crump estimate, but remains very low by historical standards, see right hand chart.

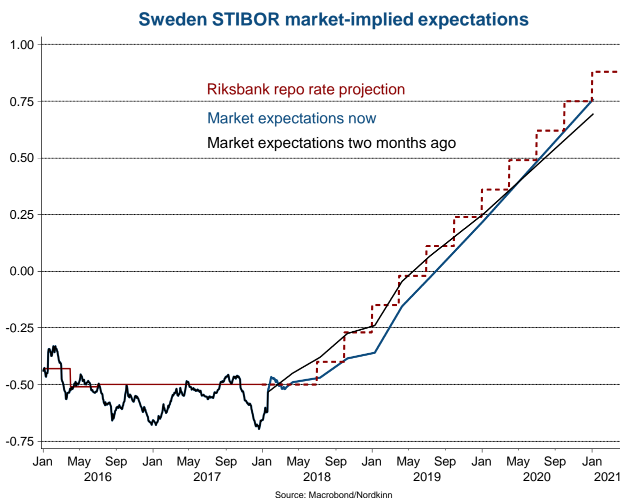
Structurally, one of the secular drivers of global bond yields over the past 35 years has been the age structure in major advanced economies in which the baby boom generation has added to the global savings pool. The share of adult population between 40 and 64 years, usually associated with a high propensity to save, rose sharply between 1985 and 2017. Now, we have reached a tipping point where aggregate savings will come under downward pressures over the coming 20 years as the baby boomers shift into retirement. A reduction in aggregate savings suggests upward pressures on global bond yields in the long-run.

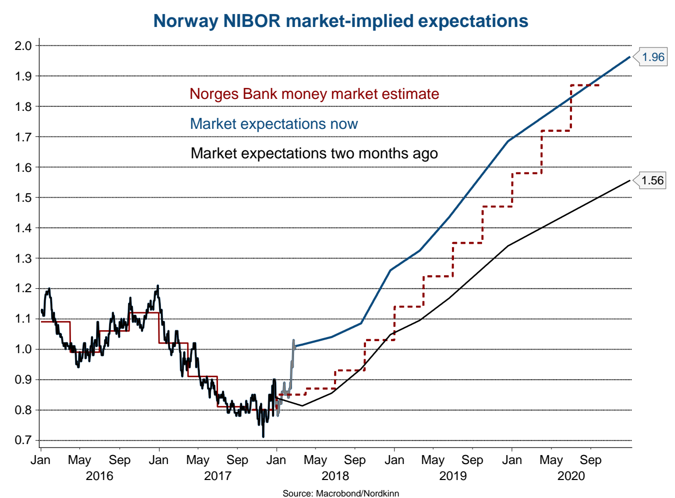
Nordic markets

The lower than expected CPI inflation print for January significantly raises the odds that the Riksbank will be shifting the repo rate path by postponing rate hikes at the monetary policy meeting on April 25th. This is consistent with the message conveyed in the minutes of the Riksbank meeting held on February 13th, when Board members expressed concern over the outlook for inflation, in part due to a declining rate of increase in service prices. Against this background, several participants said the Board should be prepared to push the repo-rate path forward if this should be necessary to meet the inflation target in the long run.

The downside risk to inflation, precisely that of what the Riksbank governors worry, has already begun to materialise. Therefore, we predict unchanged rate hikes until at least Q4 2018, with the balance of risk skewed towards lift off in 2019. This has to some extent been discounted in the market, as short-term rates are currently some 10 bps lower than at the beginning of the month, see left hand chart. Nevertheless, we continue to favour long fixed income trades, particularly in the 2-year segment of the Swedish curve. Trades benefitting from a later Riksbank lift-off date are organised under the *"Sweden: Government relative value"* theme.

Turning to FX, the weaker SEK had mixed effects on the overall portfolio as we were both short EUR/SEK and long NOK/SEK. Our EUR/SEK trade reached predefined stop-loss levels and were terminated in the second week of February, prior to the surprisingly low CPI data that took the cross even higher later in the month. Athough the SEK appears fundamentally undervalued at current levels, the near-term outlook hinges on the evolution of Riksbank's monetary policy. Given our bias towards a later lift-off date for the repo rate, we are reluctant to go against the weaker SEK trend at the moment.





Turning to Norway specifically, the central bank attaches a much lower weight on running CPI numbers in its monetary policy deliberations compared with the Riksbank. In his Annual Address on February 15th, Governor Olsen said *"we would be less worried about low inflation than if real economic prospects were also weak. We can then choose to bring inflation up to target over a longer horizon, particularly if interest rates are already low and there are signs that financial imbalances are building up"*. The situation now is that real economic prospects are strong and household credit growth remains high. Consequently, even though January inflation were 0.4%-points below the Norges Bank's projection, we do not expect a dovish Norges Bank statement at the upcoming Board meeting on March 15th.

Rather, we expect the Norges Bank to lift its forecast for the key policy rate upwards at the upcoming meeting, owing to a rebound in petroleum investments, signs of improvement in the housing market, an increase in the oil price, tighter than expected labour market conditions and higher interest rates abroad. Shorter term however, given current low inflation combined with elevated NIBOR-spreads, the Norges Banks should be in no hurry to raise rates soon. Added to that, expected future interest rates among Norway's trading partners are, overall, little changed for 2018: They have increased somewhat in the US, remained steady in the euro area and fallen in Sweden. The change has occurred in 2019 and beyond. Consequently, we expect no major changes to the Norges Bank's rate forecast for 2018, but a slightly steeper rate path for 2019 and 2020. The Governor will repeat that a rate hike in late 2018 seems appropriate.

In our view, the change in the inflation target that was announced on March 2nd (to 2.0% in Norway from 2.5% previously) should not impact the actual conduct of monetary policy in the near term. In fact, the new inflation target of 2% matches average inflation over the past 20 year and is in reality what the Norges Bank has aimed for in recent years.

If anything, the new inflation target should contribute to a tighter spread on longer-term interest rates between Norway and trading partners. We fade the recent move higher in bond yields, but favour long NOK in the FX space.