Nordkinn Market Review & Outlook – May 2014

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Based at the Nordkinn peninsula, Slettnes Fyr is the northernmost located mainland lighthouse in the world

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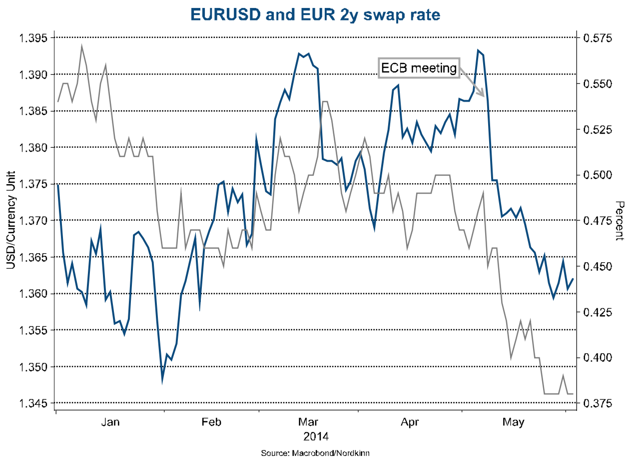
Global overview

A surge in global demand for government bonds in May drove yields to the lowest levels in a year. The global bond rally partly reflects expectations of further monetary policy stimulus by the ECB, which also increased the relative attractiveness of government bonds in the US and in other countries. Moreover, market volatility has fallen towards historical lows at levels not witnessed since Q1 2007. The combination of accommodative monetary policies and low market volatility has been a catalyst for carry trades across asset classes.



The ECB kept its key policy rates unchanged in May, but President Draghi provided market participants with a strong signal of a likely policy response at the Governing Council meeting on June 5th. In particular, he said the strengthening of the currency was a matter of "serious concern" in an environment of low inflation and that the Governing Council was "comfortable" with acting at the next meeting in June. They only waited, he said, to see the staff macroeconomic projections. The euro depreciated immediately after the meeting.

Since then, ECB officials have done little, if anything, to push back on the high market expectations that they will ease monetary policy at their upcoming meeting. As a result, the euro exchange rate and euro area interest rates continued to fall throughout the month, see chart.

Turning to the US, minutes from the FOMC meeting on April 30th, released on May 21st, confirmed that the Committee is sanguine regarding the outlook for solid economic growth with little inflation risk. At the same time, the Committee expressed concerns about the slowdown in the housing market as a source of downside risk to growth, which may have led some market participants to reassess their interest rate forecast downwards.

The very weak GDP report for Q1 (-1.0% annualised quarterly change) may have contributed to the decline in US interest rates as well, even though most economists see the contraction being transitory and weather-related. Furthermore, in recent months there has been much debate in academia and among market participants about the concept of a new lower “normal” for the Fed Funds rate. Finally, the strong bond rally in the euro area, in combination with low market volatility, has probably increased the demand for higher-yielding US bonds and prompted an unwinding of negative-carry trades among many speculative investors.

Nordic overview

Swedish interest rates continued dropping and the SEK depreciated in May as market participants increased bets on a rate cut by the Riksbank on July 2nd (decision to be published on the 3rd). Weaker than expected industrial data and spill over effects from the bond rally in the euro area contributed to the decline in interest rates. Swedish underlying inflation as measured by CPIF (constant interest rate on mortgages) increased to 0.5% in April, marginally above expectations. A temporary surge in airline ticket prices added 0.2 percentage points to inflation, but this effect will likely reverse next month.

The decline in euro area interest rates also pulled down Norwegian long-term interest rates, while the short-end of the curve was largely unchanged. The interest rate spread between Norway and Sweden further increased albeit slightly in May, supported by higher than expected inflation and relatively strong macro data in Norway. This was also reflected in a stronger NOK against EUR and SEK during the month.

Global markets

In our view, the resilience of markets to events such as the Ukraine crisis, combined with a general promise of aggressive monetary policies in major economies for a prolonged period, increases the likelihood that the demand for assets with carry will remain near-term. This means further demand for credit, peripheral spread tightening in Europe, equities and longer-term government bonds in countries where yields are higher on a relative basis.

At the same time, we continue to believe that financial assets – over time – will return to macroeconomic fundamentals. Our quantitative research shows that many assets with carry are already well beyond the point of overvaluation. This includes the value of long-term government bonds in several countries, US equities and the currencies of Australia and New Zealand, see charts. A further strong performance of assets with already excessive valuations makes them vulnerable for a correction, both on a directional as well as relative value basis.

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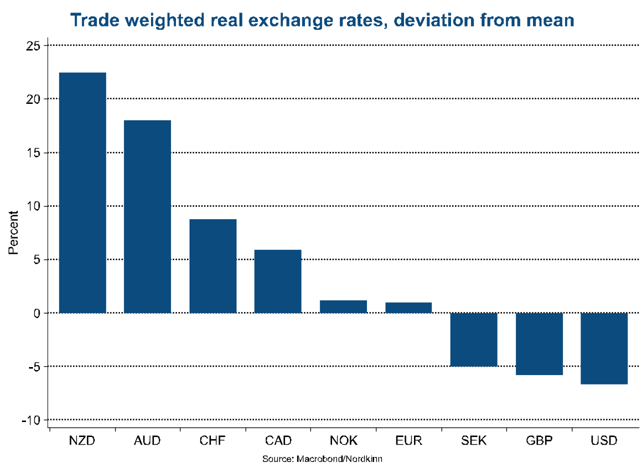

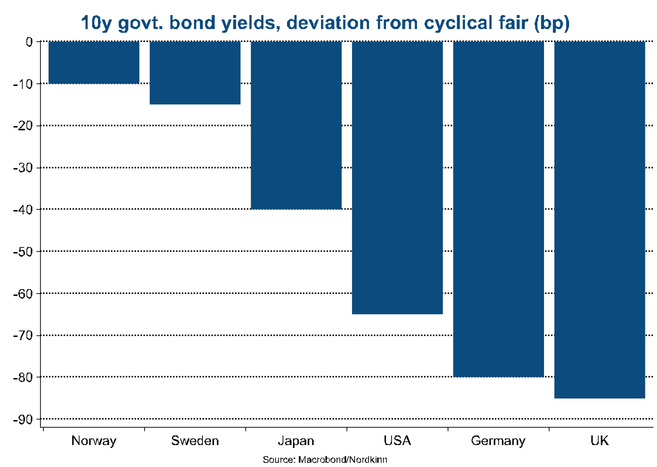

A normalisation of market volatility from the current very low levels is a potential catalyst for the unwinding of carry trades that could bring asset prices closer towards fundamental fair values. There are different known and unknown sources of higher market volatility, but higher central bank interest rates is one possible channel.

Yet, we do not expect monetary policy to tighten in the near-term. We expect major central banks to keep policy rates unchanged throughout the year, with the exception of the ECB and the Riksbank, which we anticipate will take steps for lower rates. Having said that, speculation about a possible interest rate hike by the Federal Reserve or the Bank of England beforethe middle of 2015 could lead to changes in the market environment and volatility levels.According to its forward guidance, the Federal Reserve will likely maintain the key policy rate at the current low level for a considerable period.Moreover when tightening begins, the Federal Reserve predicts a measured pace of tightening. The median forecast for the Fed Funds rate byu the end of 2015 and 2016 is 1 % and 2.25% respectively. Note that the market, as measured by Eurodollar futures, expects an even more gradual increase in interest rates, see chart. We expect the first hike by the Federal Reserve around mid 2015, in line with markets expectations. However, when the Fed begins to tighten, se predict a slightly faster pace of tightening than the market currently anticipates.

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Regarding the ECB, we continue to expect a small cut in all three key policy rates in June. This will bring the deposit rate into negative territory. The main motivation for a cut is to weaken the euro, but a fall in the EURUSD cross currency basis swap is a potential side effect of such decision. Moreover, Mr Draghi will probably underline that the Governing Council is ready to act with quantitative easing later this year if needed, which, in isolation, would contain longer-term interest rates. Having said that, if the ECB also decides upon measures to increase the availability of credit, which we predict, longer-term interest rates should start moving slightly higher from the current very depressed levels. Accordingly, the yield curve should steepen.

Nordic markets

We continue to expect the Riksbank to reduce the repo-rate by 25 bps to 0.50% at its meeting on July 2nd. The decision will primarily be a response to diminishing inflationary pressures in Sweden. Inflation is well below target and there is no clear evidence of a substantial reduction is spare capacity as indicated by the stubbornly high unemployment rate. In addition to a rate cut, the Riksbank board may keep the door open for another interest rate cut to 0.25% in the autumn should inflation continue lower. Moreover, we expect the Riksbank to delay its expected timing of policy firming by several months. Consequently, although the market is already attaching a high probability for a rate cut in Sweden, we see some further downside risk for market interest rates in coming months.

Looking somewhat further ahead however, we are quite optimistic concerning growth prospects in Sweden. In particular, the high level of consumer confidence should motivate households to reduce the elevated savings ratio to boost spending. Yet again, it will likely take time before stronger economic growth will translate into higher inflationary pressures.

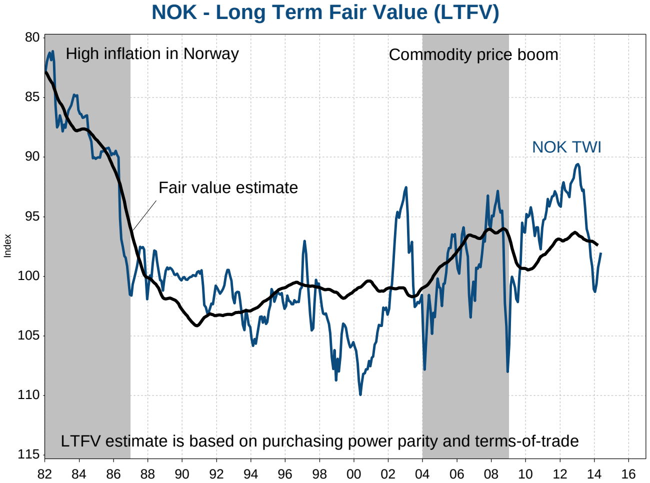
In the FX space, we are moderately positive on the short-term outlook for the SEK. The depreciation of the SEK in May was partly due to what we believe is transitory weakness in some key macro data, such as industrial production, the unemployment rate and GDP. With Swedish economic surprise indices at very low levels, there is potential for positive surprises going forward. Having said that, a dovish Riksbank is likely to cap any appreciation of the SEK.

The Norges Bank is facing a different environment. Inflation is on target and slightly above the Norges Bank's projection. There is little, if any, spare capacity in the economy at present. Moreover, indicators of consumer spending have picked up recently and suggest upside risks to the Bank's forecasts for private consumption and GDP. Developments in the housing market since the turn of the year has been stronger, too. At the same time, indicators of business investments have been weaker than expected.

On balance, the domestic situation in Norway would in isolation call for a higher key policy rate than 1.50%. This notwithstanding, we do see several factors that even could trigger a decline in interest rates in coming months. Firstly, being a small open economy, interest rates in Norway are very sensitive to developments in interest rates abroad, particularly in the euro area and Sweden. Secondly, the NOK exchange rate has appreciated more than Norges Bank projected in its previous Monetary Policy Report. Thirdly, despite relatively high capacity utilisation, we forecast inflation to drop faster in coming months than expected by the Norges Bank and consensus. This is partly due to the recent appreciation of the NOK exchange rate, but also due to base effects from the change in the statistical measurement that pushed up housing rents in the CPI last summer.

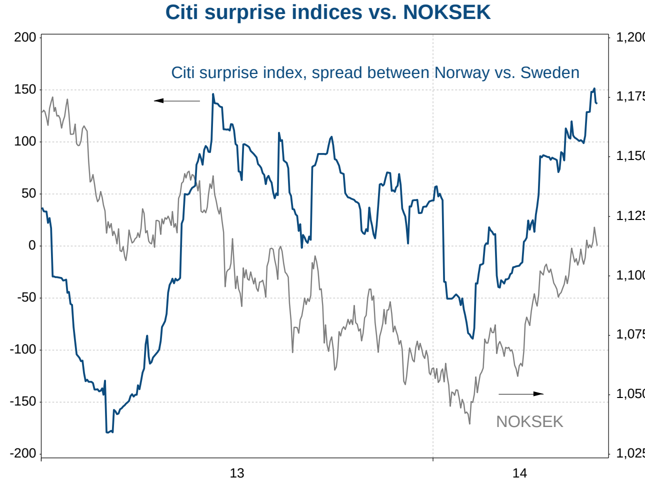
Having appreciated since January, the trade weighted NOK exchange rate is now almost back to fair according to our fundamental model, see chart. Still, assuming that the demand for assets with carry continues, the relatively strong macro developments and relatively high interest rates in Norway should favour the NOK in the short term. Short-term trading models, which take into account FX effects of interest rate spreads, commodity prices and risk appetite, also suggest more upside for the NOK ahead. One cautionary note, however, is the elevated level of economic surprise indices for Norway, in contrast to Sweden (see chart).

NOK - Long Term Fair Value (LTFV)



Source: Nordkinn AM, Reuters EcoWin

Citi surprise indices vs. NOKSEK



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