NORDKINN
asset management

Nordkinn Market Review & Outlook – June 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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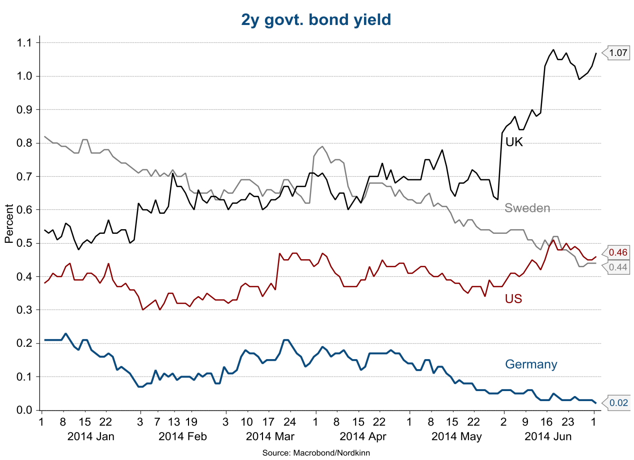
Global overview

Developments in fixed income markets have been highly synchronised across advanced economies in the first five months of the year, but this pattern changed in June. While interest rates in the euro area and Scandinavia continued to fall, they rose in the UK and US (see chart). The spread widening in June was a result of discrepancies in the economic outlook and different signals about the likely path for monetary policy ahead. Meanwhile, volatility in fixed income markets increased slightly in the beginning of June, but fell back to historical lows later in the month.



As we predicted, the ECB announced a comprehensive stimulus package at its meeting in June, including a negative -0.10% interest rate on the ECB's deposit facility and a four-year targeted funding program for banks (TLTRO). The main motivation of ECB easing was to curb the growing risk of deflation in the euro area. Interest rates have continued to drop and the curve has flattened as the market has become even more convinced that ECB monetary policy will remain very loose for years to come. Surprisingly, the value of the euro has been quite stable following the announcement.

By contrast, the UK market expects a tightening of monetary policy already this year. UK interest rates and the GBP rose after Governor Carney on June 12th said that the first interest rate hike *"could happen sooner than the market currently expects".* During February 2015, but this has now been brought forward to Q4 2014.

US interest rates increased moderately in June on the back of better than expected macro data and some tentative evidence of firmer inflation rates. Meanwhile, Fed-Chair Yellen indicated no urgency to step back from highly accommodative monetary policy at the press conference following the June FOMC meeting. Yet, there is no doubt that a tightening of policy is moving closer in the US, as reflected by the FOMC's upward revision of the 2015 and 2016 interest rate forecasts.

Nordic overview

Swedish interest rates fell further in June following the ECB's rate decision and after Swedish CPI inflation dropped in May and remains below the Riksbank's forecast. A repo rate cut to 0.50% at the Board meeting on July 2nd is fully priced in the market (decision will be announced the next day). Meanwhile, economic data continues to paint the picture of an economy that is performing well. Household demand is particularly strong and unemployment appears to be declining, albeit from elevated levels.

In Norway, petroleum investments are losing considerable momentum as a key driving force behind growth in the mainland economy. In response to the weaker outlook for petroleum investments, in combination with a further decline in expected policy rates among Norway's main trading partners, the Norges Bank Board revised its forecast for the key policy rate downwards in the Monetary Policy Report released in June. The revision was larger than the market expected and the new rate path suggests that policy rates will remain at present or lower levels for an extended period. As a result, bond yields fell across the maturity spectrum and the NOK depreciated significantly.

As addressed in our previous report, another development that has contributed to a decline in bond yields is a favourable change in the supply/demand balance of Norwegian government bonds (NGBs). Auction volumes are now smaller than they were at the beginning of the year, and the Government is repurchasing the shortest NGB prior to auctions.

Outlook

Global markets

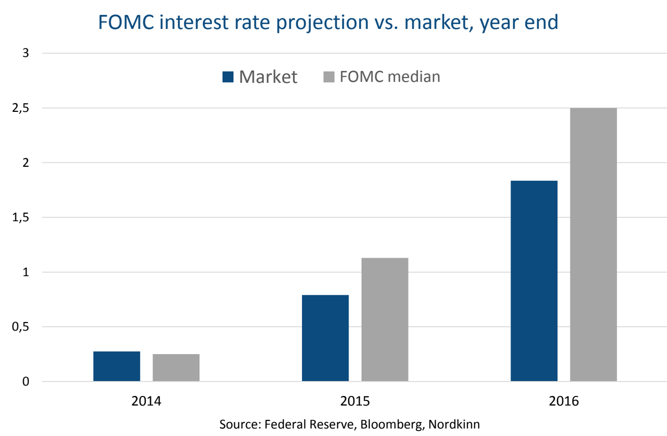
Moving into the summer, we expect the ongoing pro-liquidity stance by the world's major central banks to keep market volatility near record low levels. This fuels the incentive for investors to take on risk, further feeding carry trades and compressing risk premia.

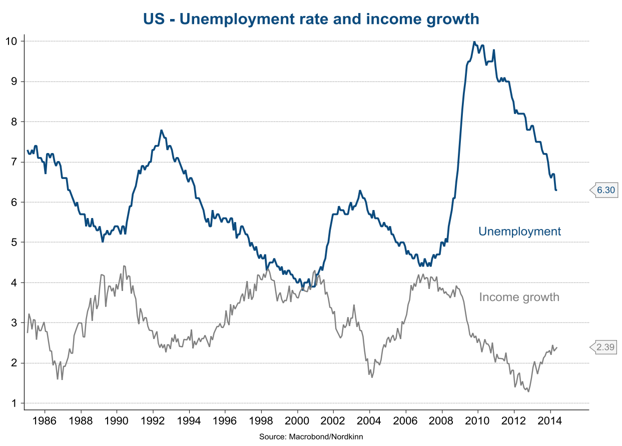
Looking ahead, a tightening of central bank liquidity is likely to be a main source for higher market volatility, but we are not there yet. Rather, after ECB announced its stimulus program consisting of a targeted LTRO and suspension of SMP sterilisation, central bank liquidity will continue to increase. However, as the Fed continues to cut back on security purchases, and will likely end its QE program in Q4, the source of global liquidity is changing. This has already been reflected in the financial markets, notably through wider spreads between long-dated government bond yields in the US and Germany.

By contrast, short-term interest rates have been less volatile across major markets. This is due to the promise by central banks to keep key policy rates very low for a considerable period. We expect the market to increase attention on when, and how fast, Bank of England and the Fed will raise policy rates. As we highlighted in our previous report, this could bring about significant changes in the market environment and volatility levels. We expect Bank of England to be the first major central bank to raise short-term interest rates in Q4 this year, as supported by Governor Carney's speech on June 12th.

Moreover, given the status and outlook for the US economy, it is no longer necessary for the Fed to maintain an extremely accommodative monetary policy stance. In fact, standard monetary policy rules - stipulating how much the central bank should change the nominal interest rate in response to spare capacity and deviation of inflation from target – suggest that the key policy rate should be above the current Fed Funds level of 0 - 0.25%. However, given the severe repercussions that the financial crisis had on the economy, the Fed is probably comfortable being "behind the curve" as an insurance against any possible setback to the recovery, as long as inflation remains below target.

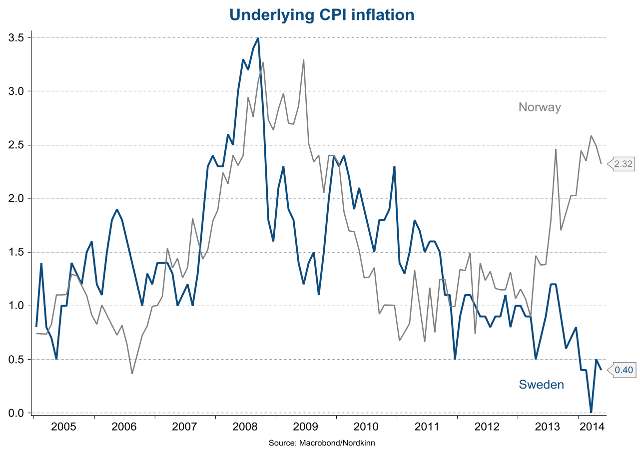
Having said that, at the press conference following the FOMC meeting in June, Fed-Chair Yellen emphasised that the policy stance is data dependent. For instance, the Fed will increase rates earlier and faster if the economy grows and/or inflation rises more than expected. On the other hand, a weaker than expected recovery would warrant a later and a more gradual tightening cycle. Expectations regarding the future Fed Funds rate prevailing in the market remain well below the median forecast by FOMC members (see chart). We think it is more likely that the FOMC will revise its rate forecast upwards than downwards. Consequently, we prefer a short duration exposure in US government bonds.

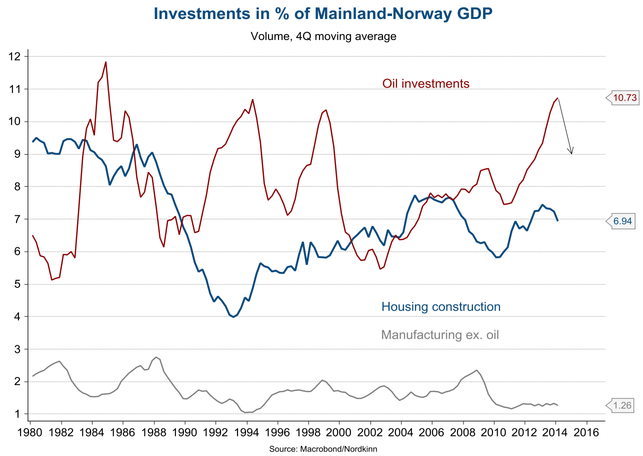




Nordic markets

As highlighted in previous reports, we 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 inflation in Sweden, which remains below both the Riksbank's target and its projected path for inflation. To ensure credibility around the inflation target, the Riksbank board is likely to delay the projected timing of policy firming by several months, and to reiterate an easing bias. Consequently, although the market is already attaching a high probability for a rate cut in Sweden, we do not rule out further downward pressure on Swedish short- to medium term interest rates during the summer.





Looking ahead, 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. Still, we believe that it will take time before stronger economic growth will translate into higher inflationary pressures, especially given the amount of spare capacity that remains in the economy. We expect the Riksbank to be very reluctant to increase interest rates before inflation is considerably closer to the inflation target.

Turning to Norway, most economic indicators have admittedly been somewhat stronger than we predicted when entering into 2014, suggesting relatively healthy GDP growth in the first half of this year. We expected that the high cost level would curb activity in many industries, in particular within the petroleum sector. However, our slowdown scenario got renewed faith in June after Statistics Norway published a gloomy investment survey estimate for oil and gas industries, indicating a sharp decline in petroleum investments next year (see arrow on chart). Although the estimate is associated with a significant amount of uncertainty at this stage, it is nevertheless an indicator for a potential drop in investment activity.

A decline in oil investments of around 15% next year, which the survey implies, would likely reduce Mainland-Norway GDP by between 0.50% and 1.00%. The real impact depends on to what extent lower oil investments will feed through to other sectors of the economy.

A forward-looking central bank should respond to a significant deterioration of growth outlook in advance, and that was exactly what Norges Bank did when it revised its interest rate projection downwards in June. The new path suggests unchanged rates with an easing bias until 2016. If incoming data were to confirm a slowdown of the Norwegian economy - which we predict - Norges Bank may even reduce interest rates before year-end. Meanwhile, we expect downward pressures on Norwegian interest rates across the whole maturity spectrum.