Nordkinn asset management

Nordkinn Market Review & Outlook – September 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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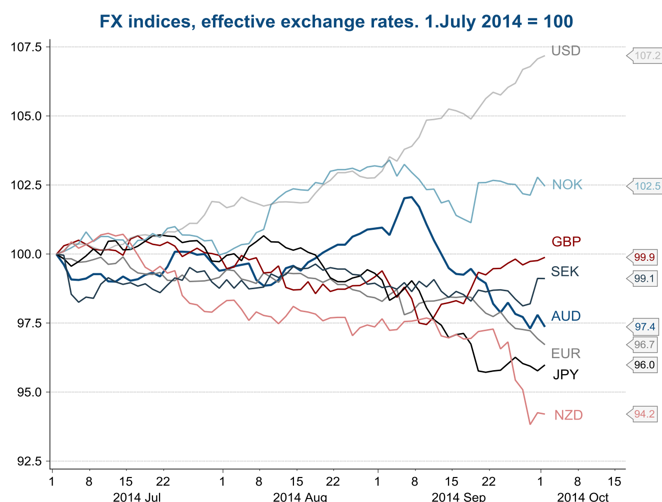
Global overview

September was characterised by significant trends in the FX markets in particular, where USD strength was the key trading theme, see chart. A research paper by two San Francisco Fed economists absorbed markets' attention after concluding that the public expects a more accommodative US monetary policy than the FOMC participants do. As a result, markets pushed expectations for future US interest rates higher. The repricing of interest rate expectations accelerated on September 17th following the release of the FOMC members' revised interest rate projections (dots) for 2015 and 2016, which were noticeably higher, suggesting a more hawkish monetary policy outlook.



At the same time, the FOMC reiterated that the policy stance is likely to remain unchanged for a considerable period after the expected end of asset purchases in October. This was in isolation considered a dovish message, because it implies that the Federal Reserve is yet not ready to start normalising its policy. However, at the press conference Chair Yellen downplayed the importance of the "considerable time" phrase, insisting that policy is data dependent.

The ECB surprised most market participants on September 4th when cutting interest rates by further 10 basis points and announcing a new covered bond purchase program in addition to ABS purchases that both will commence in Q4. Furthermore, President Draghi hinted that the TLTROs and the asset purchase schemes are to increase the size of ECB's balance sheet towards its 2012 level, which would imply a potential increase by 50% from its current level. Consequently, the EUR came under renewed pressure.

In the UK, the Scottish independence vote dominated media and markets in September. The GBP depreciated at the beginning of the month after polls showed an increasing support for the YES (to independence) campaign, but the NO campaign ultimately won with a relatively wide margin. The result was a relief for the market as evidenced by the recovery of the GBP in the latter half of the month, see chart.

The New Zealand dollar (NZD) depreciated more than 4% in September after the central bank signalled a prolonged pause in the tightening cycle, which was further fuelled by a data release at the end of the month showing that the central bank had intervened in the currency market in August.

Nordic overview

The Riksbank decided to maintain the repo rate unchanged at 0.25%. As in the previous forecast, the Board envisages to begin raising the repo rate towards the end of 2015, when inflation is clearly higher. As this assessment was broadly as expected by the market, Swedish interest rates were relatively stable in September. The SEK depreciated ahead of the General Election on September 14th, which resulted in change of government with Social Democratic leader Stefan Löfven as the new prime minister. As Mr. Löfven lacks parliamentary majority and with the extremist nationalist party Sweden Democrats doubling their support by securing 49 out of 349 seats, great complexity is attached to the political landscape. The market does however not discount any major concerns with reference to the relatively weak stance of Mr. Löfven to rule the coming four years.

Norwegian interest rates fell and the NOK depreciated in the first half of the month owing to a weaker than expected oil investment survey, but recovered after the Norges Bank Board decided to remove its easing bias following a sequence of strong macro data and high inflation prints over the summer. According to its new forecast, the Norges Bank Board anticipates that the key policy rate will remain at the present 1.5% level for until 2016 with a gradual hiking profile thereafter.

Related to transfers to the Government Pension Fund Global, the Norges Bank announced on September 30th that it on behalf of the Government will purchase NOK 250 million per day in October. This is the first time Norges Bank buys (instead of sells) NOK. The reason for the decision is that oil revenues (in USD) now exceeds transfers to the Pension Fund, mainly reflecting the upward-trend in the (non-oil) fiscal deficit. The amount was larger than expected and the NOK appreciated immediately after the announcement.

Outlook

Global markets

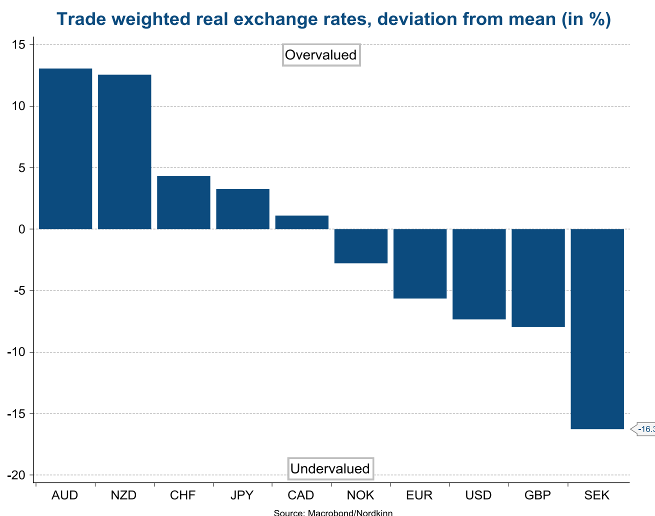
In the US, our long-held view continues to be that the market is underestimating the timing and pace of interest rate hikes. We have expressed this view through our *“US: Economic Recovery Progressing”* theme, with exposure for higher short-term interest rates and a stronger USD. In our view, the decision by the FOMC to keep the “considerable time” phrase in the September statement does not necessarily mean that the Committee will wait until the second quarter next year before lifting interest rates (which seems to be a consensus view). This phrase is data dependent; if employment and inflation were to converge faster than anticipated, our expectation is that the Federal Reserve will increase interest rates sooner.

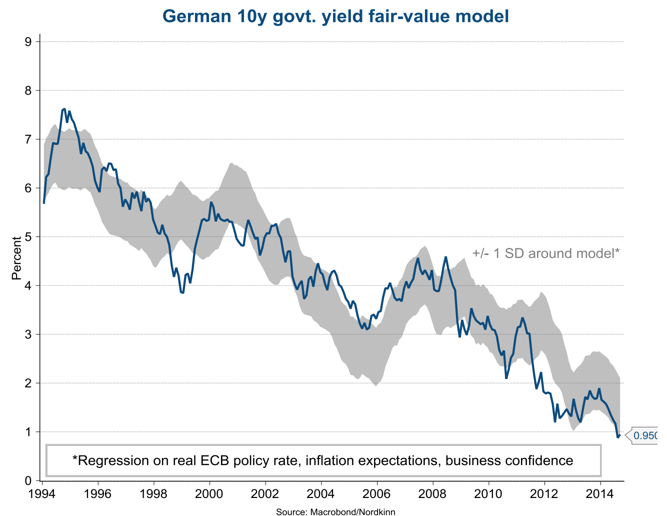
In the euro area, by contrast, we stick to our *“EMU: ECB policy easing”* theme, which, we expect, will contribute to a widening of EUR/USD cross currency basis swaps across the maturity spectrum. In October, the ECB will start purchasing two types of financial instruments underpinned by bank loans: covered bonds and asset-backed securities (ABS). Although the main purpose of this program is “credit easing”, it is also a form of quantitative easing (QE) since the ECB will create money to pay for the purchases and thereby expand the ECB’s balance sheet back to 2012 level. However, it will be small in scale compared to a full-scale QE involving purchases of sovereign debt.

The question is whether this will be enough to reboot the euro area economy, which is struggling with near zero growth and a lingering risk for deflation. We expect the impact to be rather small, yet positive. Although the euro area economy will continue to face several headwinds, we believe there is scope for at least a very gradual recovery in coming quarters. Our opinion is that even a modest improvement in the economic outlook is far better than what the market currently discounts. Yields on government bonds are not only historically low, they are fully discounting a “Japan lost decade” scenario, see chart to the right. This is too pessimistic in our view.

Economic growth in the US and Euroland decoupled this summer as growth slowed in the euro area, whilst gaining speed in the US. Looking ahead, we see a case for a gradual convergence of economic growth between the two economies. This is reflected by a new theme deployed in September: Our *“US/EMU: Growth convergence”* theme is positioned to capitalise on an expected tightening of the yields on long-dated government bonds in the US vs. Germany and an outperformance of euro area risky assets vs. US.

Regarding implications for the FX market, a compression of yield spreads between US and German government bonds would in isolation underpin the EUR vis-à-vis USD. However, we believe that the FX market is more sensitive to expectations about monetary policy, which is set for divergent paths in the short-term. In the past couple of months, we have witnessed an appreciation of the USD against most major currencies, and we expect this trend to continue as Fed tightening looms. Moreover, the real effective level of the USD, which remains somewhat undervalued when measuring against its historic mean (see chart to the left), also suggests that the USD has potential to appreciate further should the economic recovery unfold as we currently expect.





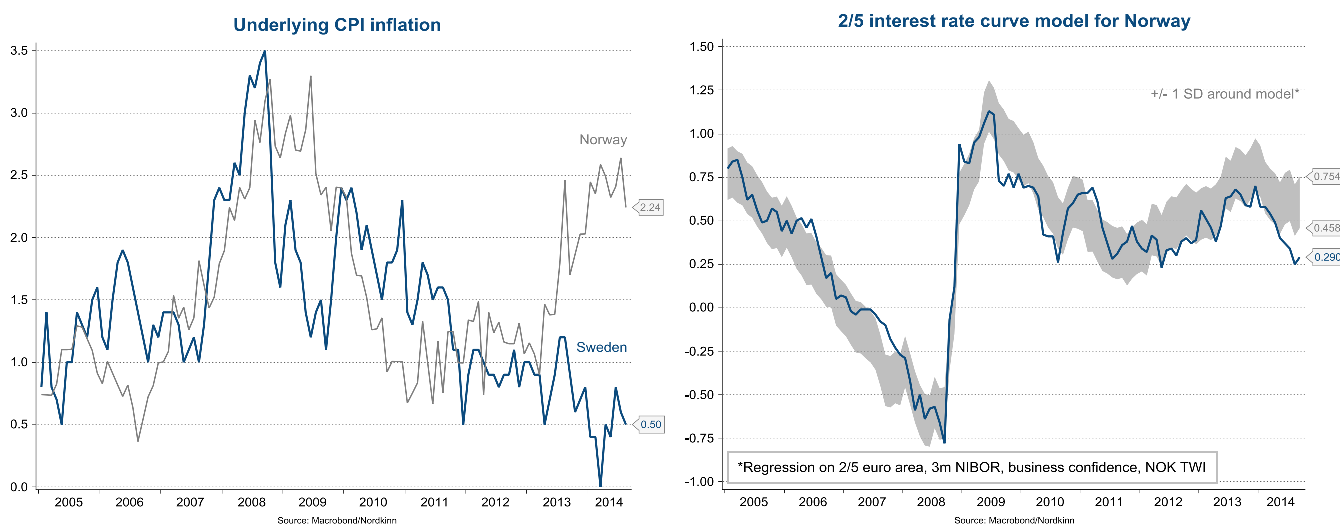
Nordic markets

After relatively weak growth so far this year, we expect a gradually stronger pace of economic expansion in Sweden coming quarters. The household demand, specifically such as consumption and housing investments, are still expected to be important for growth. During next year, we anticipate exports and business investments to drive growth as international economic activity will strengthen according to our forecast. Having said that, the recent disappointing performance of the euro area economy poses downside risks to this scenario.

While labour market conditions in Sweden have improved, there is significant underutilisation of resources as illustrated by the elevated unemployment rate. In this context, cost pressures are likely to remain subdued in the near term, but may gradually increase next year as capacity utilisation picks up. As a result, consumer price inflation, which is currently negative, will likely remain very low in coming several months and rise only gradually next year.

Indicators of inflationary pressures are key for the Swedish Riksbank, which struggles to defend its credibility towards the 2% inflation target. Consequently, we expect the central bank to maintain the repo rate at the present low level until data shows a sustained increase in inflation towards the inflation target. This is unlikely to occur before the end of 2015.

Although the trade-weighted level of the SEK is lower than what we consider a reasonable estimate of long-term equilibrium (see chart on previous page), it will likely remain undervalued until money market interest rates – and thus inflation – have started to increase. In the meantime, longer-term Swedish interest rates are likely to move largely in tandem with Eurozone rates coming months.



Interestingly, developments in Norway so far in 2014 have been virtually the opposite those of Sweden and the euro area. Mainland GDP growth has picked up somewhat, as has the inflation rate, see chart to the left. Looking ahead, we continue to foresee a slowdown in economic growth caused by a fall in oil investments next year in the order of 10-15%. Moreover, we expect a decline in inflation as cost pressures are likely to remain subdued and the effect of a weaker NOK will gradually fade.

Contrary to Sweden, where CPI announcements is having a significant impact on monetary policy, the Norges Bank is likely to focus more on the outlook for growth. In the event of a fall in oil investments that are considerably deeper than we currently expect, the Norges Bank will reduce the key policy rate to mitigate the negative impact on growth and inflation. At the same time, the strong trend in household demand could continue and exports might pick up more than we expect, which would motivate an earlier tightening of monetary policy. On balance, the probability of a Norges Bank hike before summer next year appears very small. As such, we see downside risks for money market rates in the near-term.

Looking at longer-dated market rates, though, the balance of risk is different. We expect longer-term interest rates in Norway to move higher in line with our bond yield forecasts for trading partners. Accordingly, we envisage a steepening of the yield curve from the present flat levels, see chart to the right.