Nordkinn Market Review & Outlook – December 2014

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NORDKINN
asset management

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

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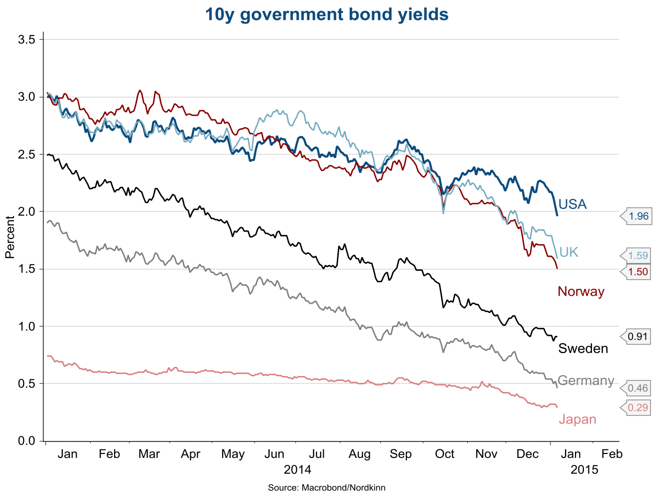
Global overview

December saw a continuation of many 2014 trends: Lower yields on government bonds, a stronger USD, higher equity prices and lower commodity prices. Led by Europe and Japan, the drop in global government bond yields in December reflected a combination of weak economic prospects and (expectations of) aggressive monetary policy easing to combat deflation. By contrast, yields on US government bonds with short-term maturities rose somewhat, and the yield curve flattened, on expectations that the Federal RCCeserve will hike rates in 2015.



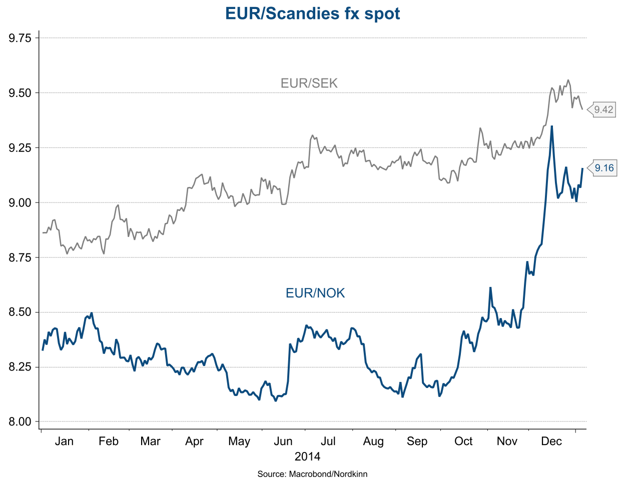
Source: Macrobond/Nordkinn

At its meeting on December 17th, the FOMC decided to alter the guidance on the outlook for monetary policy, as we predicted. The committee rephrased the former guidance of likely maintaining the 0 to ¼ % target range for the federal funds rate for a considerable period of time, by introducing a new guidance that "it can be patient in beginning to normalize the stance of monetary policy". Fed chair Yellen clarified that this means that the FOMC is unlikely to raise interest rates for at least the next couple of meetings (i.e. no hikes in January or March). The Committee also lowered somewhat its expected path for interest rates, which contributed to contain the market impact of the change in guidance. Still, market interest rates rose and the USD appreciated.

The spread between US and European bond yields continued to widen in December, as the weaker economic conditions in Europe is likely to push monetary policy in the opposite direction of that in the US. Yields on government bonds in the euro area (except Greece) dropped and the EUR depreciated as the market saw an increased probability that the ECB will announce a full-scale quantitative easing program in January. The Governing Council of the ECB says it remains unanimous in its commitment to using additional unconventional instruments if needed. The ECB staff is now in technical preparation to "adjust the size, pace and composition" of its measures for early 2015. The "composition" element may involve sovereign bond buying.

Furthermore, renewed speculation about Greece exiting the Eurozone has emerged after the Greek presidential election failed and the parliament was dissolved. Waiting for the new general election, which will take place on January 25th, the anti-austerity Syriza party is currently leading the polls. Although the Eurozone has put in place mechanisms to prevent financial contagion to other periphery countries, the political uncertainty in Greece motivated safe haven buying of German bonds and selling of EUR.

Nordic overview



Source: Macrobond/Nordkinn

Following the drop in commodity prices and poor market liquidity, the spread between yields on Swedish nominal and index-linked government bonds (inflation spreads) dropped sharply in December. To mitigate the risk of long-term inflation expectations falling further, the Riksbank Board announced on December 16th that the repo-rate needs to remain at 0% for longer. The Riksbank also said that it is preparing for further measures, possibly with effect from the next policy meeting. Fuelled by the increased probability that the Riksbank will implement unconventional measures in 2015, nominal bonds rallied and the SEK depreciated in December, see chart.

The Norges Bank board surprisingly decided to act pre-emptively by reducing the key policy rate by 25 bps to 1.25% on December 11th, while at the same time indicating a relatively high probability of another rate cut in early 2015. According to Bloomberg, only 1 out of 16 economist predicted

1 out of 16 economists predicted a cut at that meeting. The NOK, which depreciated sharply prior to the Norges Bank meeting following the oil price drop, continued falling after the policy decision as expected future market interest rates tumbled.

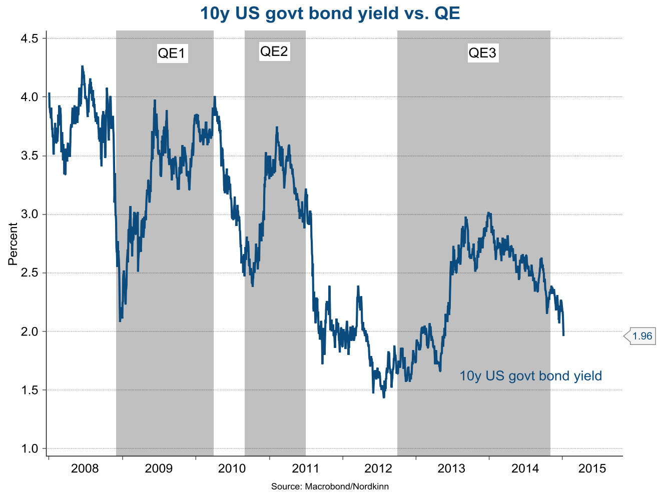
Outlook

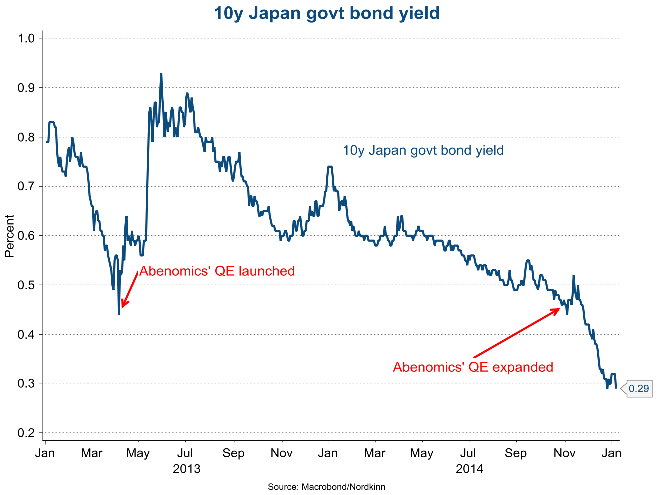
Global markets

We expect 2015 to be the year when monetary policy in Europe and US starts moving in opposite directions. Regarding US, we continue to expect the Federal Reserve to begin normalising its policy rate around mid-2015. We also expect a gradual pace of tightening, yet somewhat quicker than currently implied by market pricing. This view has been implemented under our *"USA: Economic Recovery Progressing"* and *"USA: Curve flattening"* themes.

In Europe, by contrast, we expect the ECB soon to announce additional measures given the weak outlook for growth and diminishing inflationary pressures. Indeed, President Draghi confirmed in an interview on January 2nd that the ECB is in technical preparations for altering the size, pace and composition of its policy measures. We anticipate that the ECB alters the composition by adding corporate and sovereign bonds to the list of assets under its purchase scheme at its meeting on January 22nd, which also will increase the scope and the speed of the expected balance sheet expansion in 2015 and 2016.

Rising expectations of a sovereign QE program by the ECB have sent the German 10 year Bund yield to historical lows below 0.50%. But what will happen when sovereign QE is actually launched? The experience from all three rounds of US QE since 2008 shows that bond yields may rise after launching QE, see left hand chart. However, the Japanese experience was different. In April 2013 yields on JGBs jumped at first when Bank of Japan launched its aggressive QE program, but they started to fall steadily only a few months after, see right hand chart. When the Bank of Japan in October 2014 unexpectedly expanded its QE program, the initial sell off in JGBs lasted only two weeks before yields started to drop, reaching a new all-time low less than four weeks after the announcement.





One explanation why bonds initially sells off when a central bank decides to buy them is that investors "buy the rumour and sell the fact". Forward-looking investors buy government bonds in anticipation of a QE program, and then takes profit when the central bank actually announces such program. Another explanation is that QE leads to expectations of stronger economic growth and higher inflation in the future, factors that usually drive bond yields higher. However, the limited size and duration of the movement in JGBs may suggest that the Bank of Japan has failed to convince investors it will succeed in dragging Japan out of deflation.

Turning back to Europe again, we think speculation about a full scale QE will keep the German Bund bid until the next Governing Council meeting on January 22nd. If the ECB decides to add corporate and sovereign bonds to the list of assets under its purchase scheme, based on the experience by other central banks we expect Bund yields to rise immediately after the announcement.

However, unlike the US experience, we think the duration of any sell off in euro government bonds will prove limited. Consistent with what happened in Japan, we do not expect bond purchases in the euro area to meaningfully change economic growth and inflation prospects. Here is a list of our arguments: 1) Yields on government bonds are already very low, especially in Germany; 2) In most of Western Europe, variable-rate mortgages are more common, unlike the fixed-rate mortgage common in the US; 3) European businesses are more reliant on bank funding compared with US firms; 4) Stagnant domestic demand is the real problem in the euro area, as reflected by the positive current account surplus. A weaker EUR will do little to boost domestic demand.

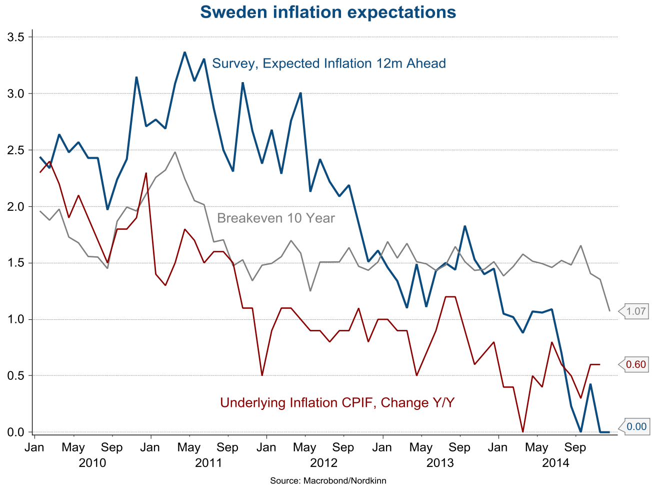
As a result, yields on government bonds may start falling again a few weeks after launching QE when the market realises the stimulus program will not significantly raise growth and inflation. Regarding the effect of QE on the currency, experience from similar programs by the Federal Reserve, Bank of England and Bank of Japan shows that the value of the currency tend to depreciate for a long term after the launch of QE. This means that the EUR/USD fx rate should continue lower in 2015.

Nordic markets

The message from the Riksbank's monetary policy update published on December 16th was clear: The Board commits to maintain a "zero repo rate until inflation is close to 2 per cent". Given the very low wage growth and continued underutilisation of labour resources, there is little inflationary pressures in sight. In our view, unless the SEK depreciates significantly further, which in our view will happen only if the Riksbank embarks on unconventional measures, inflation is likely to remain well below 2% until at least the end of next year.

Moreover, if monetary policy needs to become even more expansionary, this would primarily entail continuing to postpone a first hike in the repo-rate. The Riksbank is also preparing further measures that can be used to make monetary policy more expansionary. Such measures, which may include bond purchases or exchange rate interventions, could be presented at the next monetary policy meeting on February 12th.

A further drop in inflation and inflation expectations are the main preconditions for the Riksbank to undertake unconventional measures in monetary policy. An asset purchase program, which primarily would aim to weaken the SEK, is the most likely measure in our view. Since the Board meeting in December, market-implied inflation expectations have continued to slide from already low levels. Against this background, we expect the market to speculate about a possible Swedish QE program in early 2015, especially if the ECB acts on January 22nd.



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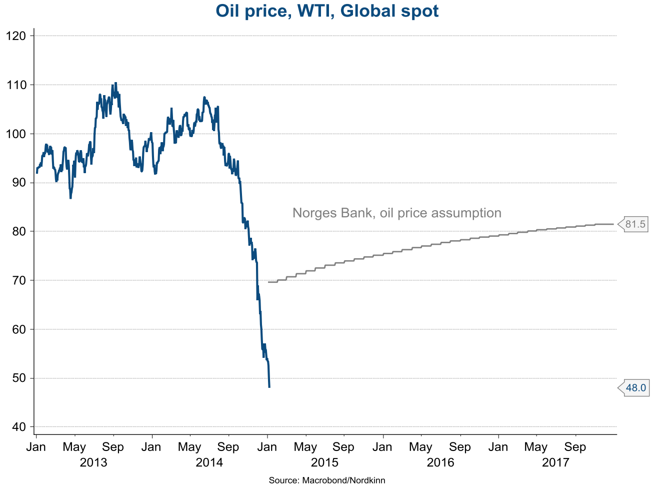

Source: Macrobond/Nordkinn

In Norway, by contrast, indicators of inflation are unlikely to influence monetary policy in coming months. Despite a forecast of inflation which overshoots the 2.5% target in 2015, the Norges Bank cut the key policy rate in December and has signalled an easing bias for the March 19th Board meeting. Rather than looking at current inflation, the Norges Bank will be assessing medium-term inflationary pressures through indicators of the real economy and the oil price.

Since the Board meeting on December 11th the oil price has continued to drop sharply and is now some USD 20 per barrel below the Norges Bank's projections. This will translate into a weaker outlook for economic growth in Norway, lower wage growth and a subdued medium-term outlook for underlying inflation. A 5-6% weaker NOK exchange compared with Norges Bank's projection will mitigate some of the negative consequences, but the net impact is still negative. This means that, assuming the oil price stabilises at around 50 USD per barrel, the Norges Bank Board is likely to revise its forecast for economic growth even lower. In response to that, the Board will probably cut the key policy rate by a further 25 bps to 1% on March 19th and keep the rate path open for additional easing later this year.

However, if the oil price recovers prior to the Board meeting in March, and if the Norwegian economy withstands the negative consequences of past declines in the oil price, there is a risk that the Norges Bank will be more patient in monetary policy than the market currently expects. Market expectations of a 3m NIBOR at around 1.15% from mid-March to mid-June is consistent with a 25 bps rate cut on March 19th and a further 25 bps cut on May 7th. While we agree with the market that a 50 bps of additional easing may well occur this year, we think the Norges Bank may pause at the Board meeting in May in order to evaluate the effects of past policy easing. If we are right, the money market yield curve should remain inverted.