Nordkinn Market Review & Outlook – May 2015

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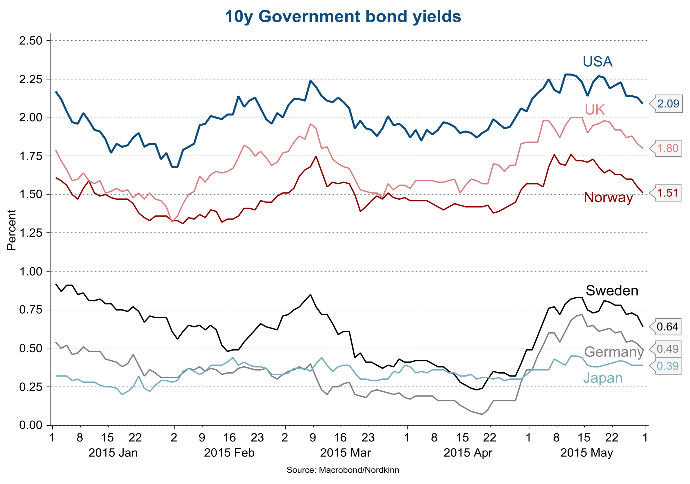
Market overview

Global overview

Government bond yields rose sharply up until mid-May, thereby continuing the trend that had commenced in late April. Given persistent signs of weaker global growth, it is difficult to see a logic connection between incoming lacklustre economic data and the big sell-off in bonds over the past weeks. However, the recovery in energy prices may have motivated investors to reduce their bond holdings on optimism that inflation in major developed economies have bottomed. If anything, the recent sell-off is perhaps a signal that passive bond investing is becoming increasingly challenging.

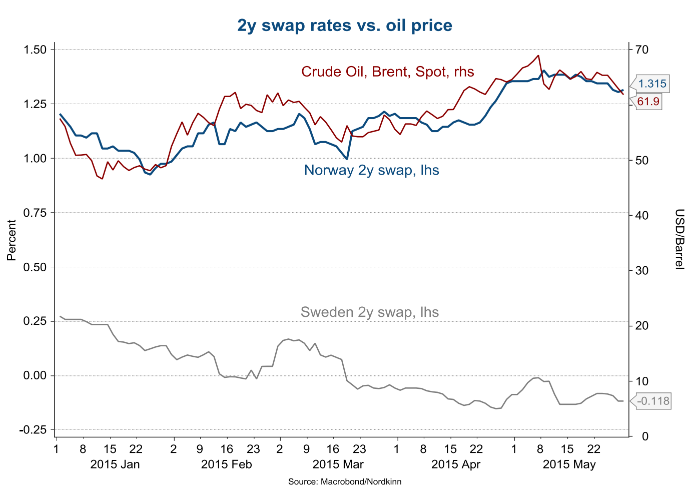


After ECB launched its QE program, long core European bonds became a crowded consensus trade, which drove prices into expensive territory according to our valuation models. As yields rose in May, many traders unwound their bets simultaneously, causing bond prices to fall ever more quickly. Investors were unwilling to enter the market until the sell-off showed signs of stabilising, which further exacerbated the move.

Eventually, yields did stabilise when demand for European government bonds rose after Governor Coeuré on May 18th said that the ECB would increase the pace of bond purchases under the QE program in May and June. Moreover, at the end of the month, a heightened risk of a Greek sovereign default contributed to an appetite for safe haven government bonds combined with a weakening of the EUR.

The GBP became one of the best performing G10 currencies in May after the Conservative party surprisingly won a majority seat in Parliament, defying polls. Financial markets responded positively to the outcome as the Conservatives have said that they will push forward with reforms to tackle the significant UK deficit. The USD appreciated too, while NZD and JPY dropped.

Nordic overview



Swedish short-term interest rates fluctuated in May, ending the month slightly higher compared to April. The slope of the yield curve steepened as longer-term interest rates rose in tandem with German Bund yields. The decision by the Riksbank at the end of April to expand QE did little to hold back sovereign bonds from underperforming, also relative to e.g. Germany and Norway.

A weaker than expected April CPI print increased speculation that the Riksbank would expand its stimulus program further. Although no new measures were announced in May, the Riksbank says it stands ready to act at any time if needed. Deputy Governor Jansson said in a speech that the Riksbank would act if the outcome of the May CPI were to be equally low.

Turning to Norway, the Norges Bank decided to leave the key policy rate unchanged at its meeting on May 7th. We expected a cut, while consensus was almost evenly split between unchanged and a reduction. However, the failure to cut does not change our view that the Norges Bank will act during Q2. Indeed, Governor Olsen said the decision was close and provided a strong statement that, if incoming data develops broadly as expected, the plan is to reduce policy rates in June. Consequently, short-term market rates remained broadly stable in May as the market is reluctant to fully price in a June cut. In addition, tight liquidity in the banking system contributed to relatively high money market rates in May.

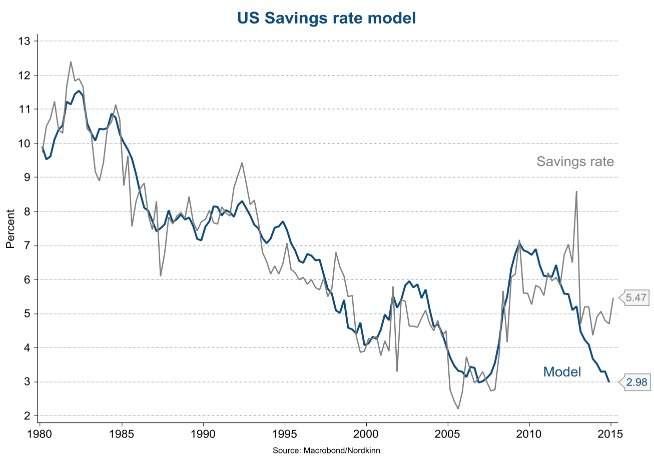
Global markets

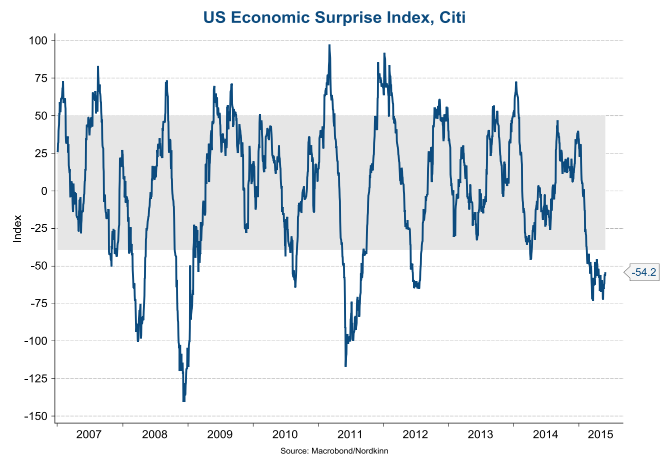
US macro data has been persistently weak in the past few months, pushing expectations of monetary policy lift off further out in time. In fact, a number of macro indicators are close to recessionary levels: GDP contracted in Q1, while growth in retail sales and manufacturing production have stalled. The question we ask: Has the US economic upswing reached the end, or is the slowdown merely transitory?

Our analysis supports the view that the US slowdown so far this year will prove temporary. The unexpected slowdown in manufacturing activity is at the centre of the recent US weakness. The oil price collapse, which now is reversing, has contributed to this weakness, as has cold winter weather and the west coast port strike. The relatively strong USD has contributed too, but to a lesser extent, in our view.

Regarding the oil price, the consensus view is that the long run impact of the oil price collapse is positive, not negative, for growth, as the boost to household consumption should offset the drag from oil-related manufacturing activity. However, this expected boost in household spending has so far not materialised. The share of income being saved by households has instead actually increased, in spite of consumer confidence being at an eight-year high.

The recent increase in the savings rate is also puzzling when considered against the increase in household net worth as a share of income, the low interest rate level and the decline in unemployment. We illustrate this by a simple econometric model, using the above-mentioned fundamental factors that fit the development in the savings rate since 1980, see left hand chart.





The sudden spike in the savings rate in December 2012 was caused by temporary factors, such as expected tax changes in early 2013 and concern over fiscal cliff. The model's failure to explain the upward trend between Q1 2014 and Q1 2015 is of greater concern. The actual savings rate is currently around 2.5%-points higher than the savings rate predicted by the model. What can explain this gap?

It is possible that the model, which has worked well for nearly 35 years, has broken down. However, we think it is more likely that the savings rate will decline going forward or at least stop rising, which should imply stronger private consumption given the rise in income. It is also possible that data revisions will show stronger growth in private spending in recent months than currently indicated. Regarding the latter, research by the Federal Reserve suggests that the first quarter of the year tends to have weaker seasonally adjusted readings on economic growth than do the subsequent quarters. This tendency could imply that the underlying momentum is not as weak as the Q1 data has indicated.

The right hand chart illustrates the extent to which economists have been surprised by the weakness in economic data. The surprise index, which measures the deviation between the actual macro data and the expected outcome, is at the second lowest level since 2009. It is much more difficult to explain the current supressed level compared with the lows in 2011 (when euro area crisis peaked) and in 2008 (when Lehman collapsed). This suggests there is potential for upside surprises in US economic data in coming months.

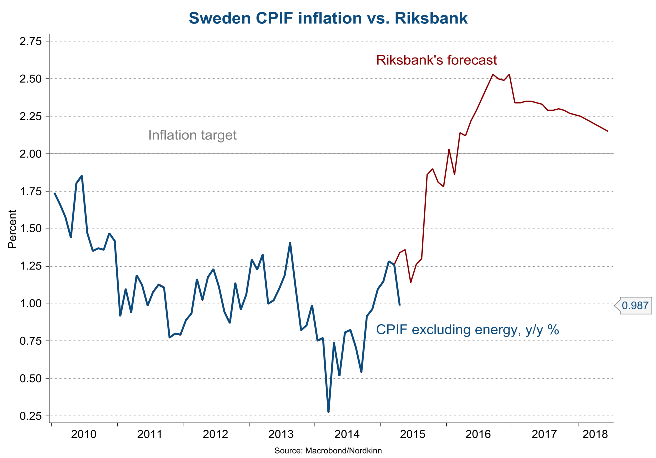
We scaled down the exposure to our *"US: Economic recovery progressing"* theme a couple of months ago given the weakness in data and the performance of the USD. However, based on the analysis above, we have decided to increase exposure to this theme again. In particular, we expect 10yr government bonds in the US to underperform those of Germany, Norway and Sweden.

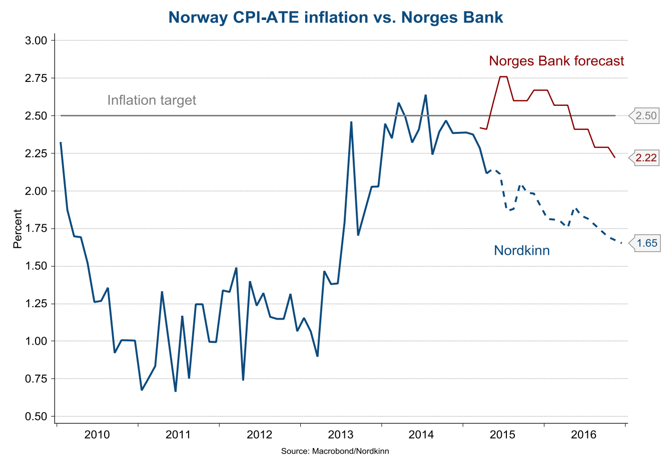
Nordic markets

The Swedish Riksbank continues to struggle with persistent low inflation, which is potentially damaging the long-run credibility for the 2% inflation target. In order to preserve the credibility of its mandate, the Riksbank has initiated an extraordinary stimulus package including negative deposit rate and outright purchases of government bonds. This should be a strong force for curve flattening.

Moreover, we continue to expect further action by the Riksbank this year. According to its projection, CPIF (the consumer price index with a fixed interest rate) inflation will reach 2% as early as at the end of 2015 and overshoot target next year. Barring a sharp increase in commodity prices or wage costs (we expect neither), the inflation projection looks overly optimistic, see left hand chart. The probability that inflation will undershoot its projection is therefore quite high. Given its commitment to bring inflation higher, the Riksbank must act should inflation disappoint. In a recent speech after Statistics Sweden in April published a surprisingly low CPI, Deputy Governor Jansson left no doubt in that the Riksbank would announce further stimulus if CPI inflation were to remain equally depressed in May. Added to that, a sharp appreciation of the SEK, given its impact on imported inflation, is also a potential trigger for additional measures.

On balance, we maintain a high conviction level to our *"Sweden: Credible inflation targeting"* theme, predominantly expressed by a combination of long interest rate risk and short interest rate volatility. Moreover, following the decline in break-even inflation rates in May, we increased our exposure to *"Sweden: Inflation expectations bottoming"*.





Although we have been wrong on the timing of Norges Bank's policy response, we maintain a high conviction to our *"Norway: Weaker growth outlook"* theme. We express the theme through a mix of long interest rate risk, country spreads and curve flattening strategies. Admittedly, recent strong indicators of household demand have made us somewhat less convinced of a cut by Norges Bank in June, yet we still think a 25 bps cut is the most likely outcome. At the press conference following the monetary policy meeting on May 7th, Governor Olsen clearly said the base case is to lower policy rates in June. We doubt one strong retail sales report will change the Norges Bank's plan when forward looking indicators, such as business and consumer surveys, all point to weaker growth. We believe that it is just a matter of time before the economic weakness becomes evident in "hard" data.

Wage and price growth have surprised on the low side vs. Norges Bank's projection, supporting our call for a cut in June. Overall wages in 2015 looks likely to grow at the slowest pace since the banking crisis in the early 1990s. Looking ahead, slow wage growth will continue to spill over to lower consumer prices. Moreover, our analysis suggests that the impact of NOK weakening on import price growth will fade significantly in coming months. Our forecast for May CPI (due on June 10th) is significantly below Norges Bank's projection. In contrast to Norges Bank (and consensus), we expect core CPI inflation to drift further away from the 2.5% inflation target during the remainder of this year and into next, see right hand chart. Consequently, to support stronger growth and inflation returning to target in the medium-term, we expect the Norges Bank to run an accommodative monetary policy stance for quite some time.