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asset management

Nordkinn Market Review & Outlook – June 2015

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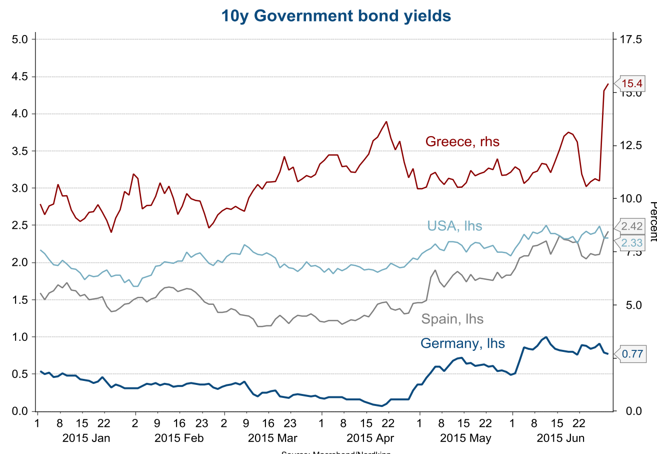
Market overview

Global overview

The sell-off in German government bonds that had commenced in late April and continued all the way into June came to a halt as the potential for a Greek default grew nearer and kept increasing in probability. In light of this, Greek politics had a significant bearish impact on global capital markets in June. Faced by the mounting threat of sovereign default, in a dramatic move to secure domestic support, the Greek government on June 26th broke off the ongoing bailout negotiations with the Troika (EU, IMF and ECB). Instead, prime minster Alexis Tsipras announced that a referendum will be held on July 5th 2015, to approve or reject the bailout terms proposed by the Troika. On June 30th, Greece failed to repay the IMF loan due of roughly EUR 1.5 billion, sending the nation into deeper financial turmoil.



As a result, yields on Greek government bonds spiked in June, which had a significant impact on global market developments. For instance, the spread between Spanish and German bond yields widened in June, and credits and equities declined further.

Elsewhere, the policy committee of the Federal Reserve presented on June 18th a surprisingly dovish interest rate forecast ("dots"). While the median expectation for two hikes this year was unchanged, seven participants now see fewer than two hikes this year, up from only three participants in the March forecast round. We expect some of those participants may include the leadership. Consequently, short-term US interest rates fell in June as the revised forecast did raise questions among market participants about whether September is still the most likely date of lift off after all.

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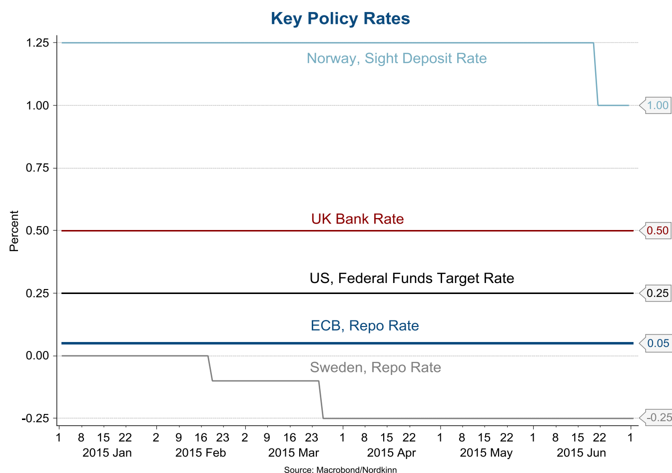
Nordic overview



Swedish bonds underperformed significantly in June for three reasons. Firstly, the sell-off in German Bunds spilled over to Swedish bonds, even those with maturities shorter than three years. Secondly, following the rebound in CPIF inflation to 1.0% y/y in May, which was slightly higher than expected, most economists who had been expecting further monetary policy measures at the July meeting adjusted their view to an unchanged call. Thirdly, the escalation of the Greek crisis lead to wider spreads between AAA covered and government bonds.

Meanwhile, the nominal effective SEK appreciated quite sharply June, in part due to the increase in interest rate expectations.

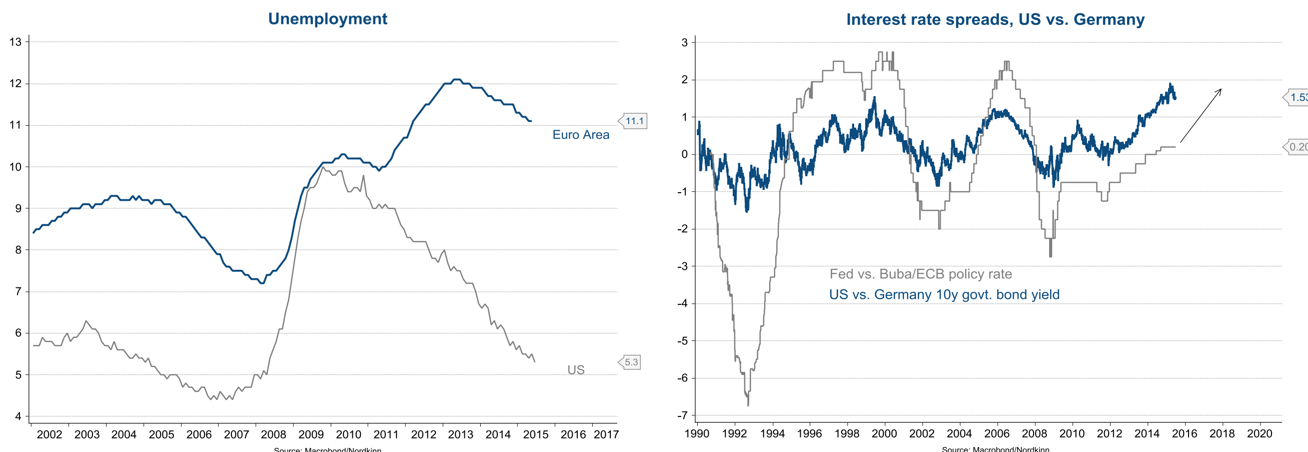
Turning to Norway, as we correctly predicted, the Norges Bank

June 18th, see chart. Moreover, following signs of weaker economic growth and diminishing inflationary pressures, the bank revised its interest rate projection downwards indicating further cut to 0.75% in the second half of the year. Bond yields and the NOK declined after the announcement as the message was somewhat more dovish than the market on average had expected. At the same time, premiums on AAA covered bonds rose due to rising supply and contagion effects from the Greek turmoil.

Later in the month, incoming data for retail sales, unemployment and business confidence all pointed to weak or no growth in the second quarter, although the market's response to this data was rather muted.

Global markets

The spread between yields on 10y government bonds in the US and Germany narrowed from a multi-year high in June. In the long term there is a case for a further compression of this spread based on valuation and an expected gradual normalising of unemployment and inflation rates in the euro area. From a nearer-term perspective, however, we believe the case for wider spread on government bond yields is growing, even if a Greek deal is agreed upon.



Crucially, monetary policy is heading in different directions later this year. In the US, the majority of FOMC members expect at least two interest rate hikes this year according to the latest minutes. Recent reports on consumer spending, housing, industrial orders suggest that GDP is rebounding firmly in Q2 after a temporary dismal Q1, supporting a first hike in September vs. market pricing of a later lift off.

In the euro area, the upside surprise in European inflation outturns has prompted speculation of an early taper by the ECB. However, we believe that the ECB will head for a “full implementation” of the QE program (at least until September 2016) as we see significantly slack in the economy for years to come, see left hand chart. We expect a prolonged divergence in monetary policy, lasting at least until 2018.

The decoupling between Fed tightening and the ECB staying on hold is not new. From June 2004 until December 2005 there was a long period of diverging Fed funds and ECB key policy rates, with the former rising by 300bp while ECB left the rate at 2% for more than eighteen months. These divergent paths saw 10y German government bonds outperform the US by around 100bps, see right hand chart.

Moreover, the net supply situation of euro area bonds radically improves in July, especially compared to May. To put this into perspective, May was the worst month of the year in terms of coupons and redemptions, whilst July is the best.

Furthermore, the parameters of the Greek bailout proposal appear sufficiently weak that it seems unlikely to lead to a significant improvement on market appraisal of long-term Greek fundamentals.

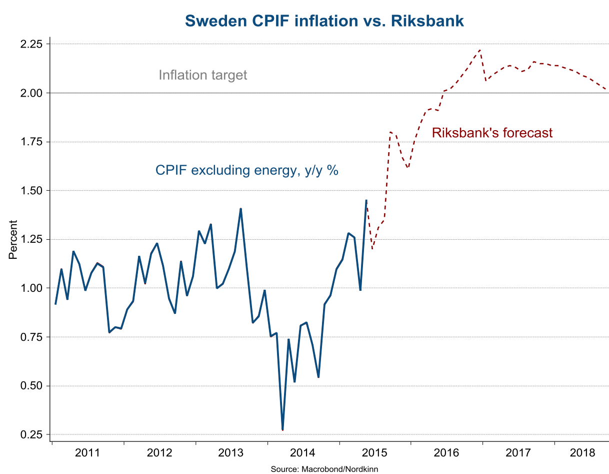
The bottom line is that the supply/demand backdrop should become more favourable for euro area core debt vs. US debt in the coming weeks. This points to wider yield spreads, downward pressure on the EUR/USD fx rate and associated spill-over to risky assets, e.g. euro stocks outperforming US stocks.

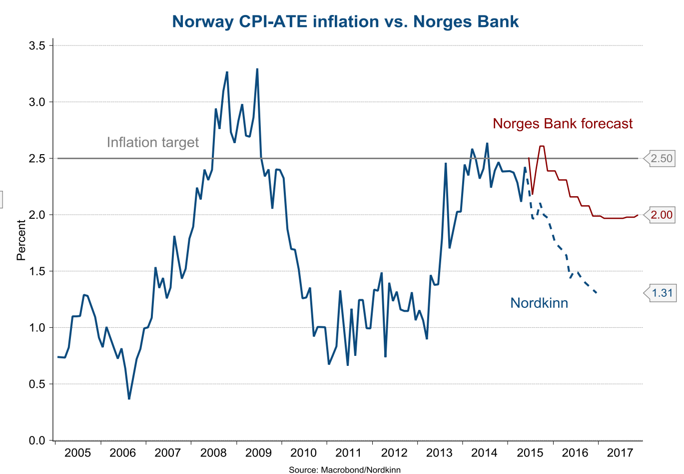
Nordic markets

The Riksbank's major concern is that Sweden is one of the strongest growing economies in Europe, while it must also manage the inherent risk of high household debt and a potential housing bubble - all arguments for higher interest rates.

On the other hand, policy makers are worried that after years when inflation has undershot the Riksbank's 2% target, employers will ignore it in wage negotiations. If unions assume inflation will continue to run well below the 2% target, they may accept a rather low nominal wage growth given that a decent real wage growth is what matters. This would in turn make it even harder for the Riksbank to reach the 2% inflation target, perpetuating a vicious cycle. A further complication is that the SEK appreciation in June and spike in global and Swedish bond yields in the last few weeks could diminish the impact of monetary policy on inflation.

As important wage negotiations are approaching, we maintain a high conviction level to our *"Sweden: Credible inflation targeting"* theme, even though the Riksbank has already put in effect extreme policy measures including negative rates and a quantitative easing program. This view is predominantly expressed by a combination of long interest rate risk and short interest rate volatility. In addition, we remain long break-even inflation rates as we expect the aggressive measures by the Riksbank to raise market-implied inflation expectations.





Turning to Norway, incoming macro data continues to support our long-held *"Norway: Weaker economic outlook"* theme, mainly being expressed via long interest rate risk and curve flattening trades. Looking ahead, we believe that the slowdown in growth will lead to a prolonged period of low inflation. 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 gradually 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. As a result, we expect core CPI inflation to fall more rapidly than implied by Norges Bank's recent forecast, 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.