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asset management

Nordkinn Market Review & Outlook – September 2015

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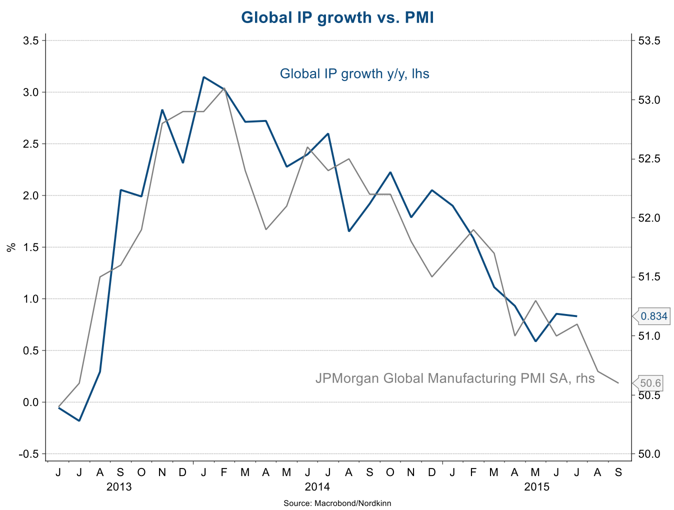
Global overview

In September, prices on high quality government bonds rallied while credit and equities tumbled due to escalating worries about a slowdown in global growth lead by China. Statistics and surveys all point to very slow growth in global industrial production this autumn, see chart. Weaker global demand has in turn contributed to further softness in commodity prices, which is fuelling downward pressure on both near-term and longer-term inflation expectations. In these circumstances, central banks in advanced economies are keeping monetary policy exceptionally loose while monitoring developments in Emerging Markets.

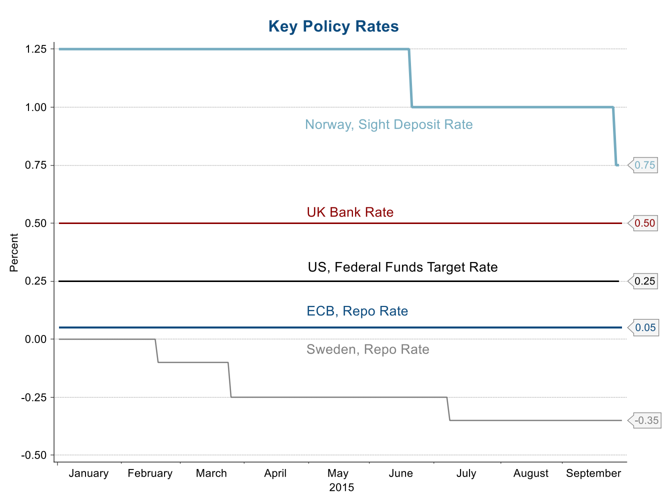


The Federal Reserve decided in September to hold off from beginning its long-awaited hiking cycle. Almost 50% of economists surveyed expected a rate increase at that meeting, though they generally recognised that it indeed was a close call. While the decision to stay put was not very surprising, the statement and the tone at the post-meeting press conference were softer than most had expected. Consequently, market interest rates and the USD declined, although the USD sell-off was short lived.

The ECB said that the economic recovery was weaker and the increase in inflation was slower compared to earlier projections. Consequently, the ECB staff revised its forecast for growth and inflation downwards and President Draghi expressed further downside risks to these forecast, taking into account the recent developments in commodity prices and exchange rates. Thus, the ECB retains a very dovish stance

Bank of England Chief Economist Andrew Haldane said in a speech that *"the balance of risks […] is skewed squarely and significantly to the downside"* and *"there could be a need to loosen rather than tighten the monetary reins as a next step."* These comments helped pushing interest rates and the GBP lower. However, Mr. Haldane's views are not always representative of the rest of the committee. Other MPC members express upside risks to inflation following a relatively clear increase in wage growth in recent months. Meanwhile, Governor Carney reiterated that a decision on forthcoming rate increases is likely to come into sharper relief around the turn of the year.

Nordic overview



Swedish short-term interest rates rose after the Riksbank decided to refrain from further monetary policy easing in September, as we correctly anticipated. Strengthening economic activity, a clear upward trend in inflation and a broadly unchanged outlook since summer were the main reasons behind the decision. The SEK appreciated following the decision, but sold off later in the month on mixed data releases, rebalancing flows and risk-off market sentiment.

The Norges Bank decided to cut its key policy rate by 25 bps, as we expected. The decision came as a surprise to most economists and market participants, as illustrated by the sharp depreciation of the NOK after the announcement. Moreover, the Bank revised its interest rate projection quite significantly downwards. The Board said it anticipates

We have seen a drastic spread widening in the Norwegian covered and municipal bond market in recent weeks. Several factors have been at work, including Kommunalbanken's pullback to meet new capital requirements as well as greater capital discipline at the trading desks suffering from losses on corporate bonds. Investor worries about the Norwegian economy may also have contributed.

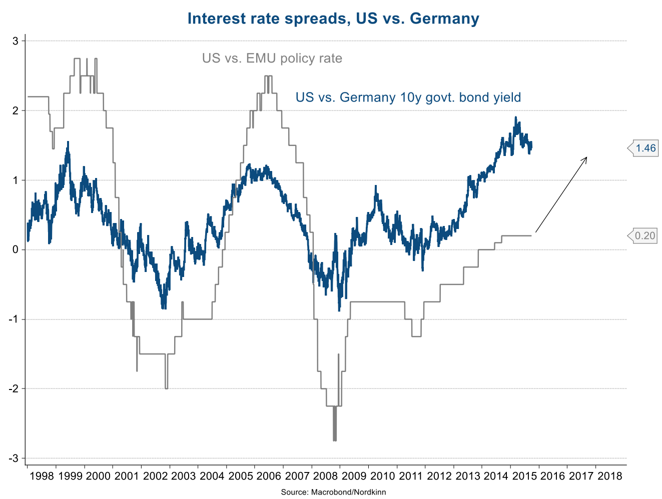
Global markets

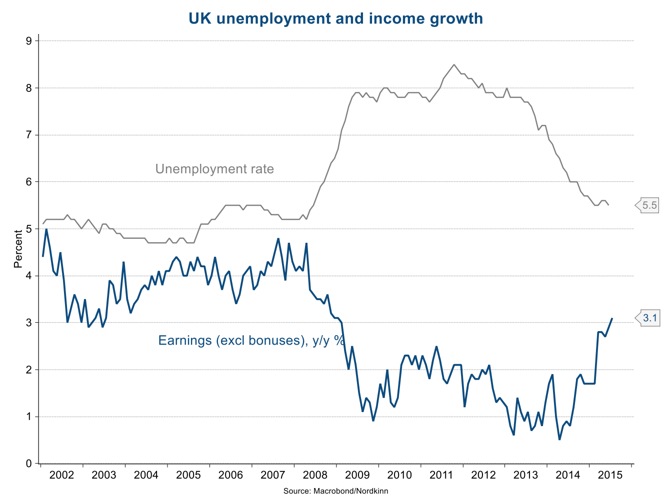
Weaker industrial growth in China and the rest of the emerging world appears to be the main reason behind the recent decline in equity indices and widening of corporate bond spreads globally. Weaker growth has also contributed to the renewed softness in commodity prices that lies like a wet blanket over the low longer-term inflation expectations, although we would argue that the main story here is actually increased energy supply. Whether China is heading for a hard or soft landing is the key question for global financial markets in the final quarter of 2015.

We are in the soft-landing camp. Growth in China is edging lower as rebalancing continues towards a higher consumption share and we therefore expect investments to drag and consumption growth to remain stable. That said, rebalancing does not always proceed smoothly and without volatility. There is a risk that growth slows much faster than expected. In such event, we expect stimulus efforts by the Chinese government to put a floor for growth in coming quarters, creating the possibility for upside surprises relative to very downbeat expectations.

If we are right on our global economic view, the rally in US government bonds should end soon. FOMC chair Janet Yellen said in a speech on September 24th that the Committee is monitoring developments in Emerging Markets, but do not *"anticipate that the effects of these recent developments on the U.S. economy will prove to be large enough to have a significant effect on the path for policy."* She concluded the speech by highlighting that most FOMC participants, including herself, anticipate that conditions will likely entail a rate hike later this year. At the same time, the Committee is data dependent. If the recent weakness in the trend of payroll growth continues in October and November, the Committe will not hesitate to delay the first rate hike further.

As markets digest the imminence of the first tightening cycle in nine years, yields are liable to climb in our view. Later on, once the first hike has occurred, long dated US government bonds should outperform short dated bonds, particularly if the USD continues to appreciate. Cross-market, we expect US to underperform German bonds before and after the first Fed rate hike. Although the spread between 10-year Treasury and Bund yields are already wide in a historical context, it tend to trend wider when monetary policy departs, see chart the left.





The main risk against this cross-market view is any Emerging Market downside surprise, which normally triggers significant Treasury buying. Having said that, Europe is probably more vulnerable to contagion from Emerging Markets than the US. Moreover, the ECB has already become much more dovish recently due to developments abroad and stands ready to take necessary measures. We see a high probability that the ECB will announce an adjustment of the size, pace and/or duration of its asset purchase programme in coming months. This would support the bond market, intra EMU spreads, breakeven inflation and risky assets.

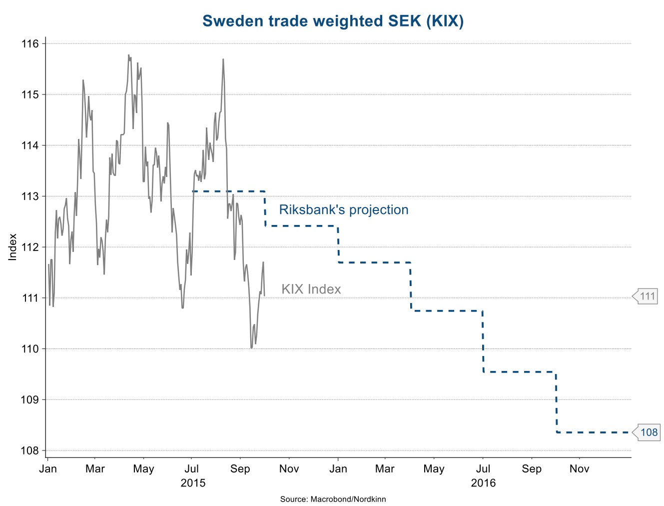
In the UK, as we move into the final quarter of the year we expect stable growth and ongoing labour market tightening. The tightening of the labour market since 2013 has already resulted in higher wage growth and thereby higher inflation prospects, see chart to the right. Markets have pushed back the start of MPC tightening with the first full 25bp hike now being priced for early 2017, which looks too late in our view. As a result, we expect UK bond yields to rise, the short-sterling curve to steepen and the GBP to strengthen, in particular vs. the EUR in coming months.

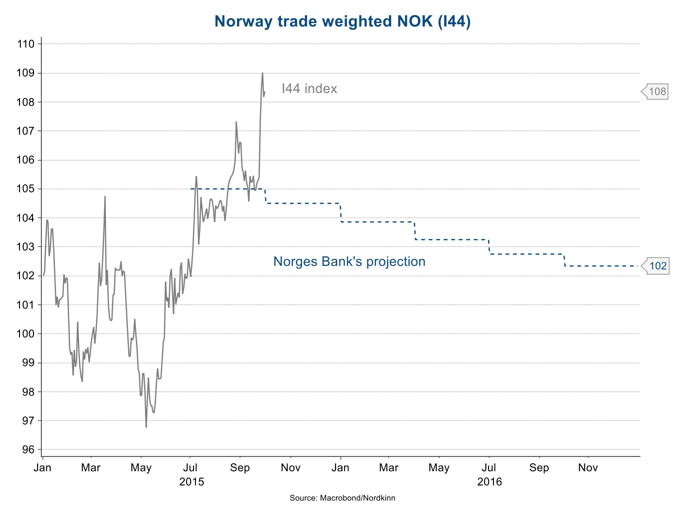
Nordic markets

The Riksbank is already pursuing an extremely accommodative monetary policy aimed to safeguard the credibility of the 2% inflation target. However, the Riksbank has on several occasions emphasised that the development of the SEK and international conditions, including the monetary policy stance of trading partner's central banks, are very important conditions for the near term inflation outlook. Given the uncertainty surrounding international developments, the Board agreed unanimously in September that the Riksbank needs to maintain a high level of preparedness to make monetary policy even more expansionary, even between ordinary monetary policy meetings, should the inflation outlook deteriorate. The current asset purchase program that commenced in February is set to end at the turn of the new-year.

Against this backdrop, developments since the Board meeting in early September have in our view increased the probability that the Riksbank will undertake additional monetary policy measures as early as at the meeting on October 28th (the next policy meeting scheduled on December 15th will be too close to the new-year). Many parameters combined add to our conviction: Firstly, with the Federal Reserve remaining on hold on September 17th, the Norges Bank cutting on September 24th and the ECB apparently considering additional monetary policy easing, pressures on the Riksbank to do more have increased. Secondly, the trade weighted SEK is somewhat stronger than the Riksbank has projected, see chart to the left. Thirdly, uncertainty regarding international developments prevails and the decline in the oil price may put downward pressure on the near term inflation outlook.

Specifically, we expect the Riksbank to expand its asset purchase program until the end of Q1 2016 or beyond. In addition, we expect a more ECB type QE program that includes both index linked and municipal bonds. Additional QE and sqeeze in the repo market will keep Swedish bonds supported and the spread to Germany tight.





In Norway, the Norges Bank clearly demonstrated in September that, unsurprisingly, developments in the oil price are very important for the economic outlook and thus for monetary policy. The Norges Bank decided to take pre-emptive action against the worsening growth outlook by cutting rates last month.

Contrary to what some other analysts seem to think, we believe the pre-emptive rate cut in September reduces the probability of further rate cuts this year. Firstly, the Norges Bank's interest rate projection for Q4 is 0.75%, meaning the base scenario is to keep rates unchanged until next year (although, admittedly, the Q1 forecast implies that there may be approximately 20% chance of a rate cut already in December this year). Secondly, the main trigger for a pre-emptive cut is a further significant decline in the oil price, which is not our base scenario. Thirdly, the trade weighted NOK exchange rate is already some 4% weaker than the Norges Bank's projection, see chart to the right.

Overall, we therefore expect the Norges Bank to save ammunition until next year. We do not only anticipate a rate cut to 0.50% by summer next year, we also expect another reduction in the second half of 2016.

Such action should put some upward pressure on front FRAs and keep the FRA curve inverted. We also expect longer-dated Norwegian government bonds to perform well against German and US government bonds over the coming months. The NOK exchange rate may appreciate somewhat in the near term if Norges Bank keeps its policy stance on hold in Q4 as we expect, but will remain at relatively weak levels for a considerable period.

Regarding covered and municipal bonds, we believe that spreads have overshot as liquidity deteriorated due to transitory factors and that the current market offers attractive risk/reward for shorter dated covered and municipal bonds.