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asset management

Nordkinn Market Review & Outlook – December 2015

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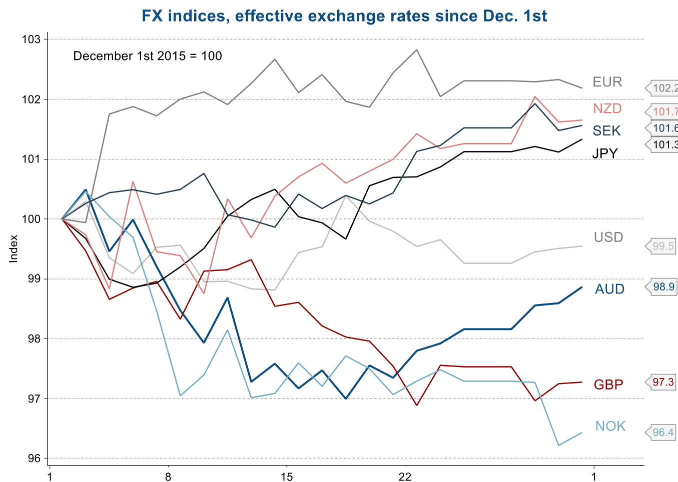
Market overview

Global overview

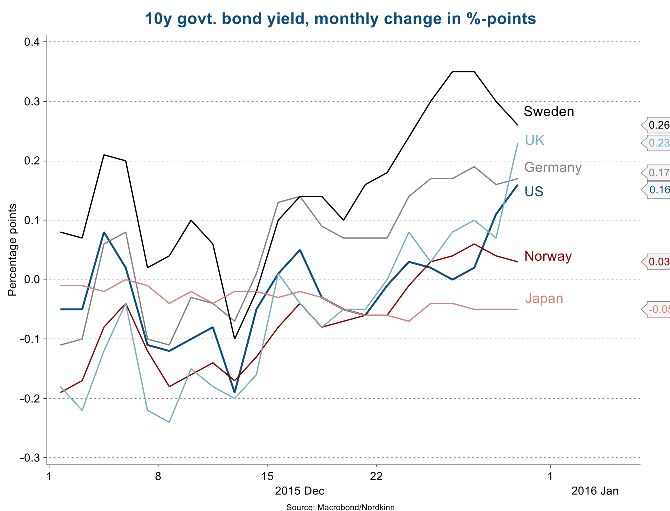
In December the Federal Reserve successfully managed to increase the target range for the Fed Funds rate for the first time in almost a decade without causing significant market volatility. The decision to raise borrowing costs was carefully communicated by Federal Reserve officials in advance and therefore widely expected among market participants, us included. Nevertheless, short-term rates rose slightly as the Federal Reserve indicated a somewhat faster pace of tightening in 2016 than the market had expected, while longer-term rates were largely unchanged. Consequently, the slope of the treasury curve flattened somewhat in December. The USD was relatively stable, see chart.



Meanwhile in Europe, on December 3rd the ECB cut the interest rate on its deposit facility by 10 bps and extended its asset purchase program by six months to March 2017. However, it failed to meet the ramped up market expectations of an expansion of monthly asset purchases. The market was also speculating in a bigger rate cut. Consequently, interest rates rose and the EUR appreciated sharply, see chart.

In the UK, the slope of the money market curve steepened in December on speculation that the Bank of England will be the next in line to raise interest rates. Stronger than expected gains in retail spending and employment contributed to the increase in longer-term market rates, while subdued CPI inflation and a sharp decline in the widely-watched weekly earnings suggest that the Bank of England is in no hurry to act yet. The GBP weakened after the prime minister hinted that a referendum on EU membership could be held already during the summer of 2016.

Nordic overview



Swedish government bonds came under pressure after a number of strong macro figures boosted expectations that the Riksbank will be unwilling to maintain the repo rate in negative territory for a very long time. The underperformance in fixed income supported the SEK.

As we correctly predicted, the Riksbank decided on December 16th to leave monetary policy unchanged due to signs of an upward trend in inflation, while reiterating its readiness to make policy even more expansionary if the positive trend in inflation were to falter again. In a separate press release on December 30th governor Ingves said that the recent SEK appreciation could jeopardise the ongoing upturn in inflation and warned that the Riksbank is highly prepared to intervene on the foreign exchange market.

The Norges Bank decided on December 17th to keep its key policy rate unchanged at 0.75%, but revised its rate projection significantly lower. The new baseline projection signals a rate cut to 0.50% early next year and a 40% probability of a further cut to 0.25% in the second half of the year.

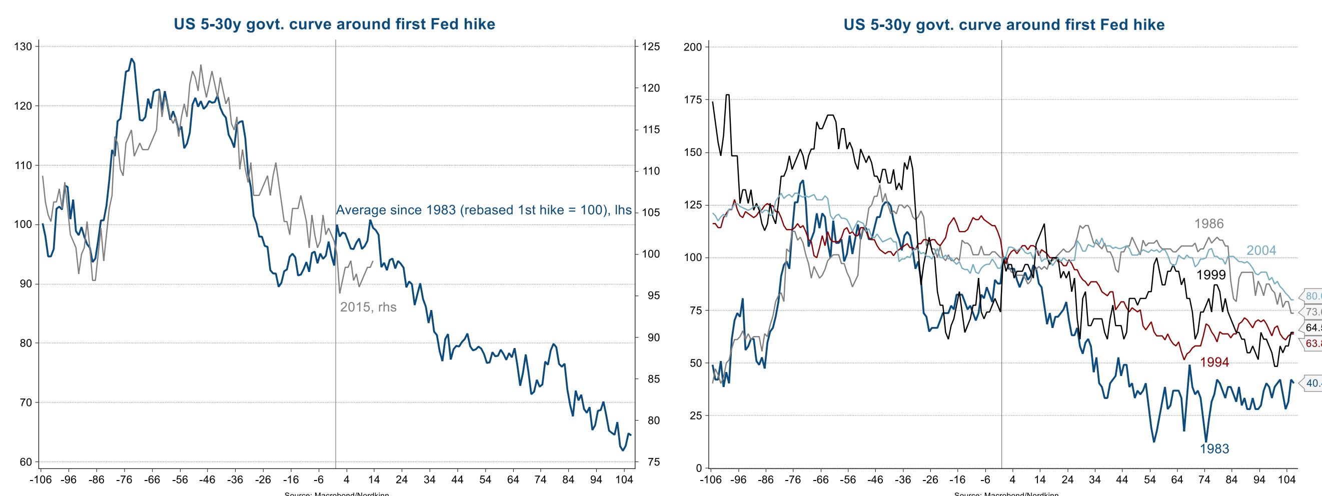
This mix of policy action and forward guidance, which was in line with our forecasts, contributed to higher front-end market rates but a decline in longer-term bond yields in Norway. Accordingly, the slope of the yield curve became appreciably flatter and longer-term bonds outperformed both Sweden and Germany. The NOK was largely unchanged immediately after the announcement, being torn between a hawkish interest rate decision and a dovish forward guidance. Yet, the NOK depreciated throughout December as commodity prices fell, see top chart.

Global markets

The first week of the year brought a negative shock to global markets as Chinese equities melted down by 7% on both January 4th and 7th. While the market plunge seems to exaggerate the weakness in underlying fundamentals, it serves as a reminder that developments in China is a key risk to the global economy and markets in 2016.

Stalling industrial activity in China is dragging overall economic growth downwards. Deceleration is, in our view, a natural and needed by-product of the desired transition to a more modern service-providing economy. That said, economic rebalancing does not always proceed smoothly and there is a risk that growth slows much faster than expected. Credit has expanded sharply over the past few years and becomes a concern when growth slows. Yet, our main scenario is that China will stabilise in 2016.

Supported by the low interest rate environment, we expect ongoing firm growth in domestic demand among advanced economies in 2016. This will likely result in further labour market improvements in the US and Europe, which will lay the ground for more interest rate hikes in the US and for a first rate hike in the UK. The pace of interest rate hikes will be gradual. We currently believe that the next move by the Federal Reserve will occur in March and see an accumulated 100 bp increase in the Fed Funds rate throughout 2016.



The slope of the US 5/30 curve tends to continue flattening several weeks after the first US hike, see chart to the left. Looking at the previous lift-off dates in detail, the slope of the yield curve flattened almost immediately after the first hikes in 1983, 1994 and 1999, whereas in 1986 and 2004 the curve remained virtually flat for a few weeks before flattening began, see chart to the right.

We see two main reasons why history could repeat itself in 2016: 1) Although we expect a very slow pace of tightening in a historical context, the market is pricing a much slower hiking cycle going forward. If we are right, the 5 year segment of the curve should underperform; 2) Global excess of desired savings over desired investments will keep the long-end supported. Curve flattening is one of the strategies that fall under our *“USA: Interest rate normalisation”* theme.

In Europe, we expect a cyclical economic upswing in 2016 consistent with lower unemployment rates. However, we do not expect any major consequences for ECB policy. Low resource utilisation will persist throughout the year, which allows the ECB to focus entirely on the current low inflation rate. The loose monetary policy stance should keep bonds well supported. At the same time, we do see a case for a gradually steeper German government bond curve as the impact of loose monetary policy bears fruit.

In the UK, we expect a steady tightening of the labour market, a reacceleration in pay growth and somewhat higher CPI inflation to prompt the Bank of England to begin raising rates in 2016. With a 2016 referendum on the UK’s position within the EU looking very likely, the timing of the vote could have implications for the timing of the first rate hike and for markets. Until the uncertainty related to the outcome of the referendum abates, the market will remain careful in pricing in hikes.

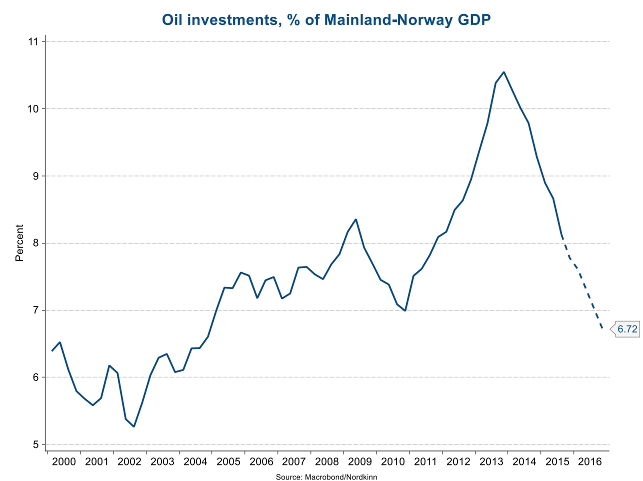
Nordic markets

When entering 2016, the Swedish economy is growing at around twice the speed versus G10 average. If this pace holds up, the economy will reach maximum sustainable capacity utilisation this year according to our estimates. Reaching capacity limit means inflationary pressures will start building. However, it normally takes time before rising capacity utilisation translates into higher domestic CPI readings. Moreover, we expect the impact of the weaker SEK on imported inflation to fade next year. Consequently, while base effects will lift CPIF inflation, non-energy inflation may slow in 2016, before rising again in 2017.

The Riksbank is facing a trade-off between subdued inflation and strong growth. How the Riksbank balances this trade-off will guide markets this year. In the near term, we expect the Riksbank to put more emphasis on inflation. The preference for higher inflation was illustrated by the monetary policy statement in December 16th which emphasised that the consequences of strong GDP growth for monetary policy in the coming period will be minor. Moreover, Governor Ingves published a comment on December 30th expressing deep concerns about the impact of the recent appreciation of the SEK (see chart to the left) on inflation and warned that the Riksbank is prepared to intervene on the exchange rate market. On January 4th the Riksbank Board made a delegation decision regarding currency interventions and reiterated preparedness to also take other monetary policy measures.

Consequently, we expect the Riksbank to remain dovish in the first half of the year, supporting government, municipal and covered bonds. The Riksbank could make monetary policy even more expansionary in February or April if inflation were to disappoint, and we would not rule out currency interventions if the recent SEK appreciation continues. These are currently the key ingredients of our *"Sweden: Credible inflation targeting"* theme.

At the same time, there is an increasing risk of a policy shift occurring in the second half of this year amid strong growth and rising headline CPIF inflation, consistent with further increases in inflation expectations and steepening pressures on the Swedish interest rate curve. This outlook is covered by our "S*weden: Inflation expectations bottoming"* theme. In December we reduced our exposure towards this theme somewhat.



In Norway, we continue to look for further monetary policy easing in 2016 to mitigate consequences of a likely further significant drop in oil investments, see chart to the right. We are confident that the Norges Bank will cut its key policy rate by 25 bp to 0.50% at the next meeting in March, and we expect a further reduction to 0.25% during 2016. Consequently, we expect fixed-rate AAA-rated bonds to be well supported. In addition, we believe that the recent underperformance of highly rated Norwegian bonds versus swaps will gradually fade in 2016.

The outlook for the NOK currency is less obvious in our view, as it depends heavily on developments in the commodity market. At 30-35 USD per barrel, we do see more upside than downside potential for the oil price throughout 2016, although we do not see any catalysts for an increase in the oil price near-term given the current excess supply. Furthermore, further easing by the Norges Bank will in isolation contribute to NOK weakness. In sum, we expect the NOK to remain weak in early 2016, but could appreciate later in the year if excess oil supply diminishes.