Nordkinn Market Review & Outlook – January 2016

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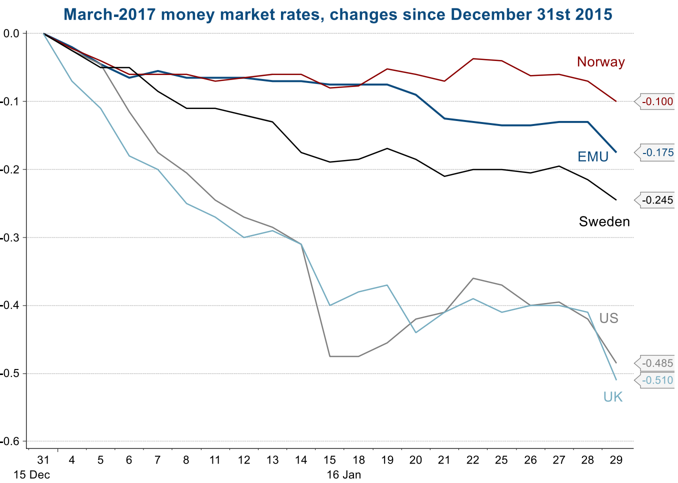
Market overview

Global overview

Markets were in free fall in January. Investors were buffeted by the collapse in oil prices, turmoil around China's currency policy and mixed US activity data, which sent shock waves spreading across global markets. The correlation between oil prices and equities has been unusually high over the past year, suggesting that weakness in global demand is the underlying concern among market participants. These developments have, in turn, contributed to depress inflation expectations. Against this background, virtually all major central banks conveyed dovish statements in January. Consequently, expected money market rates for early 2017 plummeted across the G10 area, see chart.



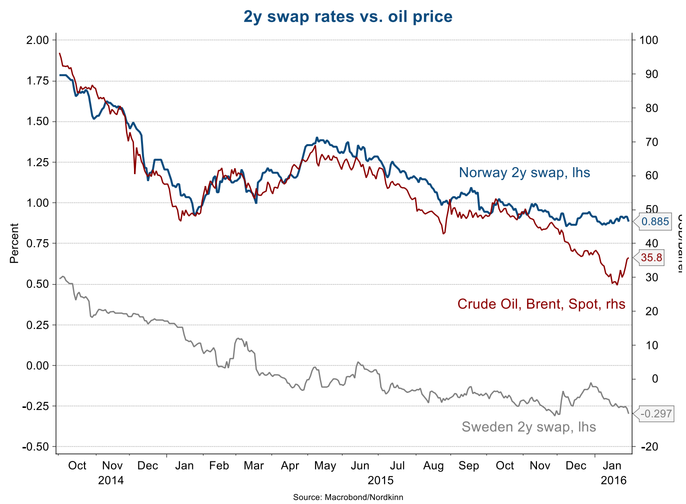
Following an elevated downside risk to global growth combined with the plunge in commodity prices, near-term inflation dynamics are weaker than previously was expected going into 2016. As a consequence, on January 21st the ECB provided a strong signal that it is set to further ease its monetary policy stance at the next meeting in early March.

Having left its key policy rate unchanged for years, the Bank of Japan surprised the market on January 29th, when it announced that it will apply a negative interest rate of -0.10% on accounts held by financial institutions at the Bank. Moreover, the Bank proclaimed a preparedness to cut the interest rate further into negative territory if needed.

Meanwhile in the US, the FOMC kept interest rate unchanged on January 27th, as expected, but raised the concern that it is uncertain about the balance of risks to its projections for economic and financial developments. Market expectations of future interest rate hikes were dramatically reduced in January, which has lead to a repricing of implied market interest rates far below those of FOMC projections.

In the UK, Governor Carney said "now is not yet the time to raise interest rates" in his "the turn of the year" speech on January 19th (renamed "the U-turn of the year" by some market participants). The recent slowdown in economic growth combined with weaker than expected wage and price dynamics are the main reasons behind his dovish message. Interest rates fell sharply across the UK curve in January. Interestingly, the market currently prices in a higher probability of a cut than a hike during 2016.

Nordic overview



Swedish fixed income performed strongly in January, reversing losses from the previous month. The fixed income rally mirrors increased expectations of additional monetary policy stimulus in the light of weaker than expected inflation dynamics as well as the prospects of further easing by the ECB. The SEK depreciated in January after the Riksbank Board on January 4th made a delegation decision regarding currency interventions.

Meanwhile, Swedish longer-term breakeven inflation rates fell in tandem with US and European breakeven rates, reflecting concerns about the impact of lower commodity prices and weaker global growth on future inflation.

In Norway, interest rates and the currency have been remarkably stable and resilient in light of the recent decline in oil prices, see chart.

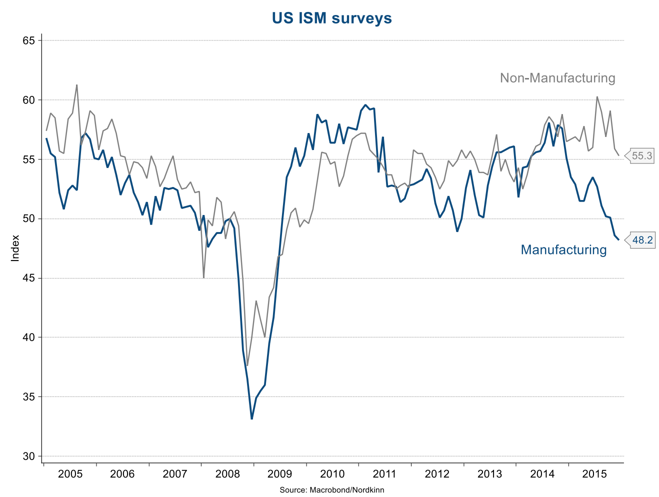
Expected money market rates for March 2017 fell only by 10 bps in January, compared with close to 50 bps drops in both the UK and the US, as the correlation between short-term rates and oil prices broke down, see charts. Some, but not all, can be explained by the persistently high spread between NIBOR and the Norges Bank key policy rate. However, even longer-term bonds have underperformed significantly versus trading partners, as the appetite for Norwegian government bonds have been rather muted in January. For the same reason, asset swap spreads became considerably tighter.

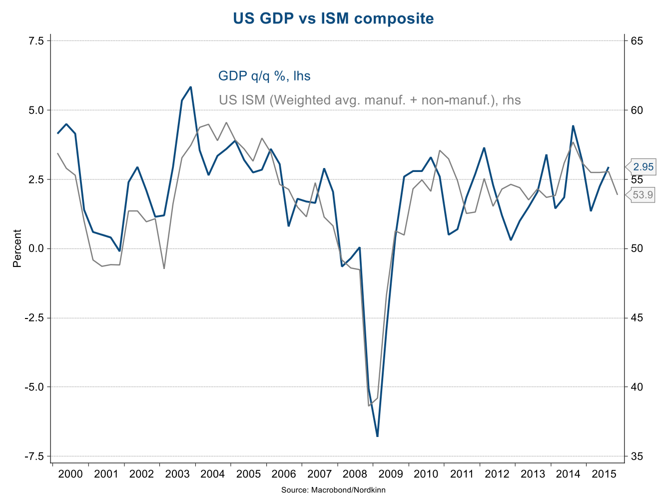
Global markets

The latest tumble in the price of oil has contributed to a decline in equities and bond yields globally, presumably due to an expected negative impact on growth and inflation. While the negative impact on inflation in the short term is unambiguous, the impact on growth is more complicated to assess. Indeed, analysing the signal from oil price moves requires a deeper understanding of the cause. If it owes entirely to weaker demand, then the oil price decline is an alarming signal of recessionary magnitudes. However, if it reflects continued increases in supply, the positive impact on consumers will likely outweigh the negative consequences for oil producers.

Given that increased supply is arguably an important, if not the main, cause behind the drop in the oil price, we believe that the financial markets are currently neglecting the potential positive effects. The reason could be related to time lags; oil-related industrial activity has been under pressure for some time already, whereas it takes time before the presumed positive effects is visable in spending data. In fact, global consumer spending has so far not expanded as much as an oil supply shock would have suggested.

Partly as a result of this time lag effect, many market participants have become increasingly worried about the US economy and fear that it may be heading towards recession. Growth in US industrial production has stalled and will turn slightly negative soon, according to the ISM survey. The decline in oil prices are negatively impacting oil exploration activities, but in addition the strong dollar is having a negative impact on external demand. Meanwhile, non-manufacturing, which accounts for around 80% of GDP, is holding up well according to the ISM survey, although the most recent trend is admittedly a concern, see left hand chart. On balance, however, the trend in the composite ISM index is consistent with growth at around 2.5% (see right hand chart), suggesting that the weak Q4 GDP release reflects temporary factors.





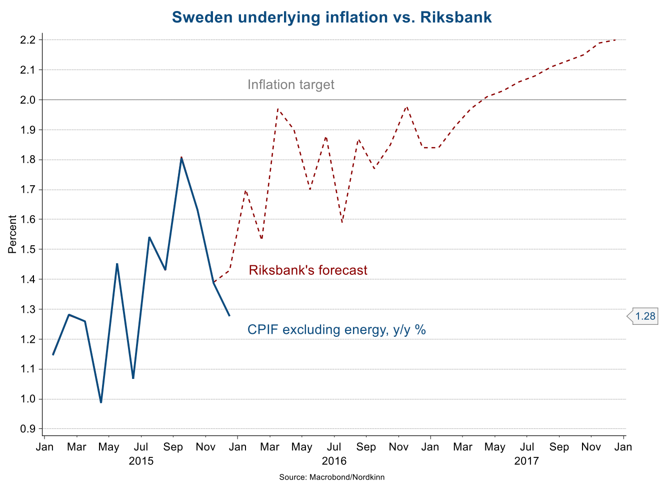
At the same time, there are reasons to temper this optimistic view. Our main concern is that the fall in oil prices is putting extreme pressure on energy producers and perhaps some of their creditors. Fears about a possible credit event, related to the drop in commodity prices or the rise in the USD and its negative feedback to the broad economy, are contributing to uncertainty and undermining the prices of risky assets and bond yields. Moreover, the outlook for China and other emerging market economies remains uncertain. These various forces may dampen G10 demand.

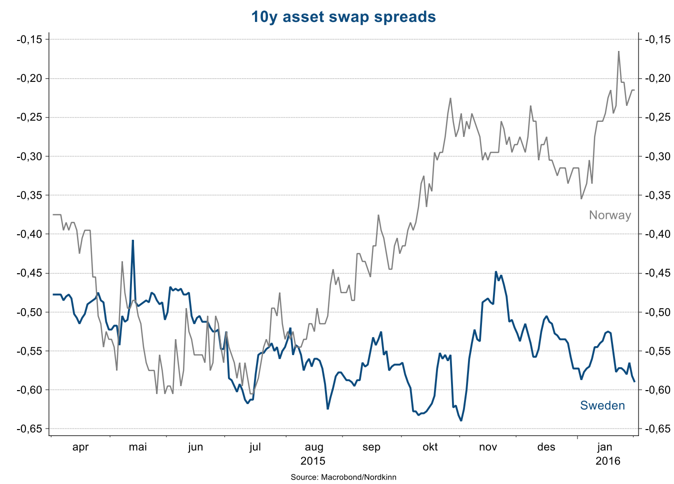
Consequently, it is in our view understandable that FOMC members are uncertain about global economic and financial developments and need time to assess their implications for the US growth and inflation outlook, including the balance of risks. The probability of a rate hike in March has therefore fallen in our view. We would probably need to see firm data releases and a more positive financial market sentiment before the FOMC raises interest rates again. March could simply be too early. Still, we maintain our constructive view on US household consumption for 2016 and therefore forecast more hikes than currently discounted in the markets.

Nordic markets

At its upcoming Board meeting on February 11th, we expect the Riksbank to ease monetary policy further. There are two main reasons behind this view. First and foremost, the Riksbank will have to revise its 2016 inflation forecast downwards, reflecting weaker than expected inflation dynamics in the past couple of months (see chart), the oil price collapse and a slightly stronger than expected SEK. Second, the statement by the ECB that its monetary policy stance will be "reviewed and possibly reconsidered" in March is an argument for the Riksbank to act pre-emptively in order to combat further SEK appreciation.

We regard a rate cut in the magnitude of 10-15 bps as the most likely outcome at the upcoming Board meeting. The Board may also consider additional asset purchases as either a substitute for, or a complement to, a rate cut. If the Riksbank decides to expand its asset purchase program, we expect the program to encompass non-government bonds such as municipal bonds, e.g. Kommuninvest. Covered bonds may also be considered, even though Governor Ingves has indicated strong scepticism given the housing market upturn. Furthermore, despite both the IMF and the Riksbank review by Mervin King and Charles Goodhart advising against it, we also see currency intervention as a tool the Riksbank will use if the SEK appreciates too quickly. It is all related to the credibility at stake (refer to our theme *"Sweden: Credible inflation targeting"*).





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 and contagion to other sectors. We are confident that the Norges Bank will cut its key policy rate by 25 bps to 0.50% at the next meeting in March, and we anticipate strong signals that further policy easing is likely during 2016. We expect that the Norges Bank eventually brings its key policy rate down to zero, but the Bank will most likely a gradual approach given the stimulus which comes from the weak NOK. Consequently, we expect fixed-rate AAA-rated bonds to be well supported and the FRA curve to remain inverted.

The right-hand chart illustrates the scale of the tightening in the 10-year Norwegian government bond asset swap spread since summer last year. While higher than expected supply may justify some tightening, in our view Norwegian government bonds look significantly oversold against both swaps and versus other government bond markets. Consequently, we like to fade this underperformance.

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. Moreover, on behalf of the government the Norges Bank will buy NOK 900 million per day in February 2016 to cover the non-oil budget deficit. This is a larger amount than previously expected. At the same time, the Norges Bank will respond to any unwarranted appreciation pressure by easing its monetary policy stance further.