Nordkinn Market Review & Outlook – February 2016

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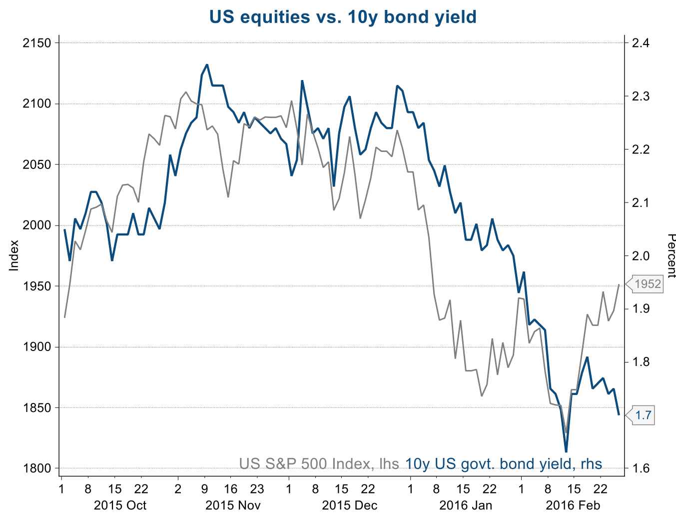
Global overview

The financial market turbulence that surprised investors in January continued into February. Major stock indices fell to levels usually associated with bear markets, as total declines exceeded 20% since spring of last year. The value of the JPY, which correlates highly with global risk sentiment, fell more than 7% against the USD during the first couple of weeks in February. Meanwhile, global government bond yields plunged as markets removed expectations for Fed hikes in 2016 and most of 2017. The market even begun pricing in rate cuts in the UK. The fear of a global recession eased slightly later in the month.



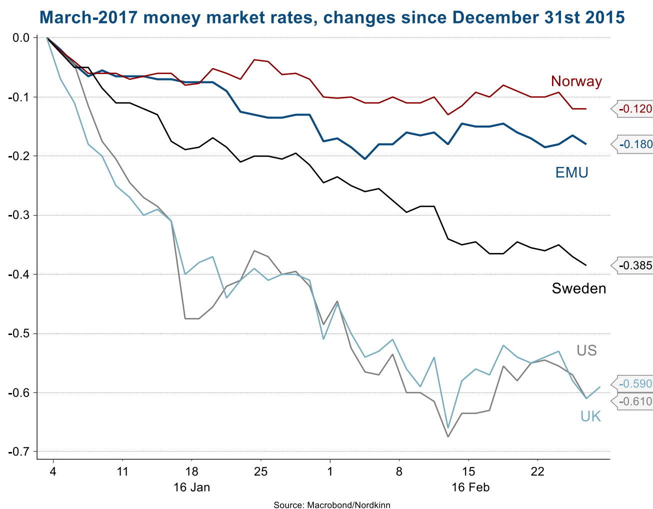
As discussed in the previous monthly report, the market turmoil in the first weeks of 2016 can in our view be attributed to three primary factors (and the interaction between them): China, oil prices and weaker US growth, which in turn are all weighing on the outlook for the world economy. For example, the OECD cut its forecast for global growth to 3.0% from 3.3% previously. Others made larger adjustments.

After signs of improvements across all of the three primary factors, markets stabilised by mid-month: China reassured the markets that it was not planning a big devaluation, the oil price rebounded and incoming data suggested that US GDP growth could bounce in Q1.

Still, markets remained very nervous throughout the remainder of the month regarding the sustainability of these positive trends. Incoming survey data for business and consumer sentiments slipped in both the US and Europe, suggesting that the underlying growth is losing momentum, reigniting fears of a more severe downturn. Consequently, yields on safe government bonds continued to grind lower throughout the month even if the equity markets recovered most of the losses generated during the first half of the month. The yield on 10-year Bunds reached a low of just 0.10%-points on February 29th, a level not seen since April last year.

Meanwhile, the GBP weakened to below 1.39 against the USD for the first time since 2009 after London mayor Boris Johnson on February 21st announced that he will campaign for the UK to exit the EU in the upcoming referendum.

Nordic overview



On February 11th the Riksbank cut the repo rate by 15 bps to -0.50%, which was in line with our own forecast, but a more dovish decision compared with market expectations. Consequently, short-term interest rates fell a few basis points after the decision. The Riksbank emphasised that the cut was motivated by a desire to safeguard the inflation target, attaching little if any considerations to the fact that growth is very strong and unemployment is falling (hence the name of our theme *"Sweden: Credible inflation targeting."*)While the Riksbank highlighted a high level of preparedness to make policy even more expansionary, the market sees only a very low probability of further rate cuts. Doubts about further rate cuts may explain why the SEK, after an initial reaction lower, made a comeback later on and ended the day at a stronger level than before the decision was announced. A few days later, a higher than expected CPI reading gave additional support to the SEK and also gave inflation index-linked bonds a boost.

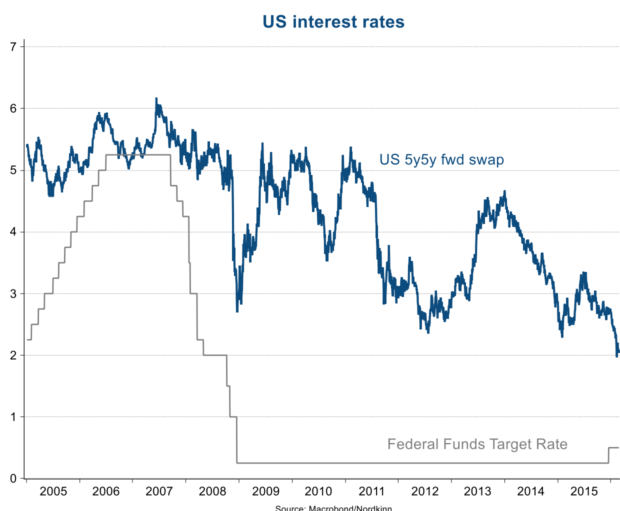
Meanwhile in Norway, as we have been anticipating, data came in on the weak side of market expectations. Revised national accounts data showed Mainland-GDP was on the brink of a recession in the second half of 2015. Moreover, the oil investment survey signalled a larger than expected drop of around -15% for 2016 and consumer confidence slipped further to levels consistent with falling private consumption. Despite, interest rates were little changed in February. This was particularly true for NGBs, which keeps suffering from a lack of demand and therefore has underperformed trading partners significantly in 2016.

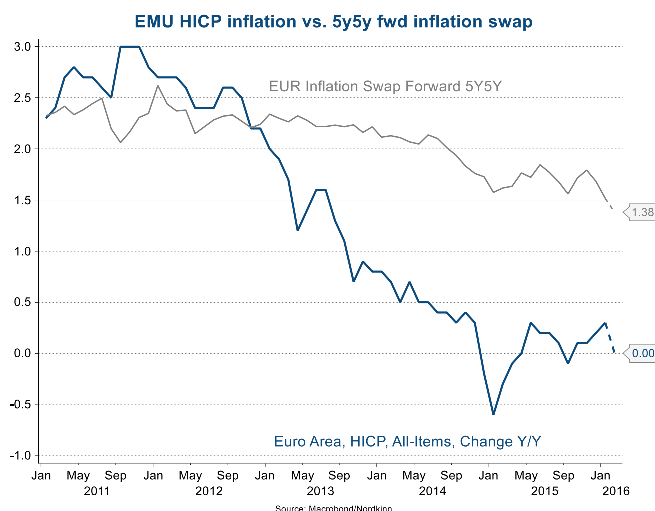
Global markets

The recent deterioration in activity data has prompted widespread downward revisions of forecasts for global growth in 2016, particularly for advanced economies. Beyond the cyclical slowdown that we now are observing, markets are increasingly coming to the realisation that trend growth is decelerating, which likely explains part of the structural decline in interest rates. That said, the fixed income markets have already moved to aggressively factor in lower growth.

In the US, long-term interest rates expectations are at lower levels than during the financial crisis in 2007-2009 and the European debt crisis in 2011-2012, see left hand chart. Such low level is consistent with a very pessimistic long-term outlook for growth and inflation. In the near term, markets currently assign a high probability to unchanged Fed Funds rates in 2016. This contrasts with the FOMCs forward guidance that it will likely raise interest rates gradually, with a median FOMC forecast of four hikes this year. Admittedly, given worse than expected economic and financial developments since these forecasts were made in December, FOMC members will almost certainly revise their rate forecasts downwards when they meet on March 16th.

Indeed, we expect the FOMC to leave interest rates unchanged at the current level at least until June. The cyclical shift in activity data is the main reason why we expect a pause. Our forecast is based on the assumption that the US economy rather is experiencing a soft patch and that growth will bounce back due to positive prospects for domestic demand. Moreover, US inflation has been rising somewhat faster than expected in recent months. Consequently, considering the very low interest rate expectation currently prevailing in the market, we are maintaining exposure to our *"US: Interest rate normalisation"* theme. Under current circumstances however, it is prudent to maintain an active trading approach.





In Europe, incoming data suggests a substantial package of ECB measures is warranted on March 10th: 1) Economic survey indicators have fallen, suggesting that downside risks to growth has increased; 2) inflation remains low and market-derived measures of inflation expectations have fallen sharply, see chart; 3) the drop in commodity prices and the appreciation of the EUR since the December meeting imply further downside risks to future inflation.

We therefore expect a combination of a cut in the deposit rate facility of at least 10 bps and an increase in the pace of monthly asset purchases of at least EUR10 bn. The ECB may also consider measures to improve policy transmission via banks, such as standard LTROs.

Given Bund yields at extreme historical lows, market participants are generally probably expecting more than a 10 bps cut and a EUR 10 bln increase in the monthly asset purchases. That said, even if the ECB were to deliver a more substantial easing package than the market is currently pricing in, it is difficult to predict where Bund yields will be one or two months from now. Why? Prior to ECB meetings, the market tends to focus on the flow-effects of expected QE measures. After the decision is announced, the market tends to shift its focus to the likely fundamental outcomes of policy easing.

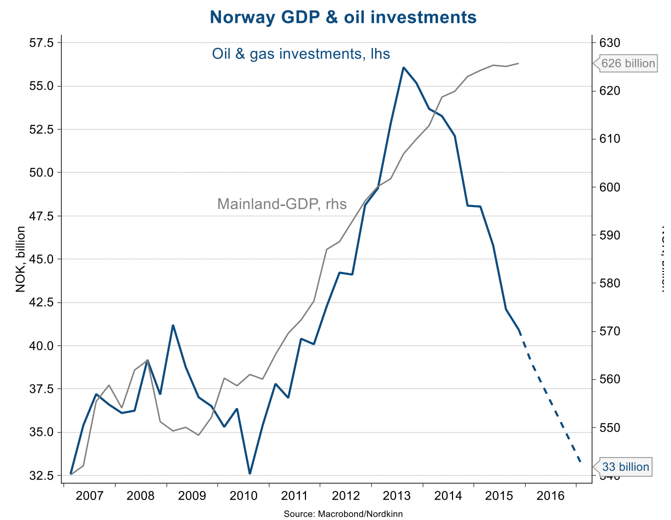
Nordic markets

The Riksbank's arguments for cutting the repo rate by 15 bps to -0.50% on February 11th, we believe provide details for interpretation of what we may expect from monetary policy going forward. In particular, acknowledging the strong growth rate of the Swedish economy, the Riksbank expects CPIF inflation to slightly overshoot its 2% target in the medium-term (2017-2018). Assuming a credible inflation target, the combination of strong growth and an inflation forecast above target one year ahead would in normal times lead to a decision to raise, and not to cut, rates.

The reason why the Riksbank instead decided to cut interest rates was a downward revision of the inflation forecast for 2016, which is due to factors that have very little to do with demand. The Riksbank is certainly aware it can not affect inflation over the coming few months due to significant lags in the transmission mechanism. Rather, the Riksbank hopes it can affect people's confidence in the inflation target. Riksbank members seem to fear that a further weakening of the Riksbank's credibility of reaching its target could become self-fulfilling. This has been at the core of our analysis behind our investment theme *"Sweden: Credible inflation targeting"* that we introduced already in 2014.

The downward revision of the inflation forecast for 2016 was significant. The Riksbank now expects average inflation at 1.3% in 2016, down from 1.7% previously. The monthly CPIF inflation forecast ranges between 0.95% and 1.32% until September this year before it moves higher in Q4, see chart. Since CPIF inflation was 1.6% in January, the probability that inflation will significantly undershoot the Riksbank's forecast this year thus seems small. Consequently, we now expect the Riksbank to keep the repo rate unchanged at -0.50% throughout the year.

However, to prevent an undesired appreciation of the SEK, we do expect the Riksbank to extend its QE program from June to December 2016. This will most likely be announced at the Board meeting in April, we believe. We also expect the Riksbank to include inflation-linked government bonds in the purchase program, and we continue to see municipal bonds as a candidate if the Riksbank would like to broaden its purchases further. We also think the Riksbank could make use of FX interventions, but only if the SEK were to appreciate sharply.



Turning to Norway, the current economic situation is somewhat weaker than the Norges Bank predicted in December after revised national accounts data revealed 0% growth in the second half of 2015. In addition, the outlook is even grimmer after the oil investment survey suggested a further sharp drop in capital spending in 2016, see chart. This comes on top of a weaker global growth outlook recently. We therefore see a relatively high probability of a recession this year. The Norges Bank will almost certainly revise its projection for growth markedly lower in the upcoming Monetary Policy Report. Moreover, as usual the Bank will take into account the recent sharp decline in expected interest rates among trading partners, and it will also take into considerations elevated spreads in the money and credit markets.

The conclusion is unambiguous: To counteract the risk of a severe downturn, the interest rate will be cut to 0.50% on March 17th and the rate projection will be revised downwards. We expect the new rate projection to include another rate cut to 0.25%, possibly as early as in June, and we assign some probability of a further reduction to zero by the end of this year. Consequently, we expect fixed-rate AAA-rated bonds to be well supported and the FRA curve to remain inverted (*"Norway: Weaker growth outlook."*)