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asset management

Nordkinn Market Review & Outlook – May 2016

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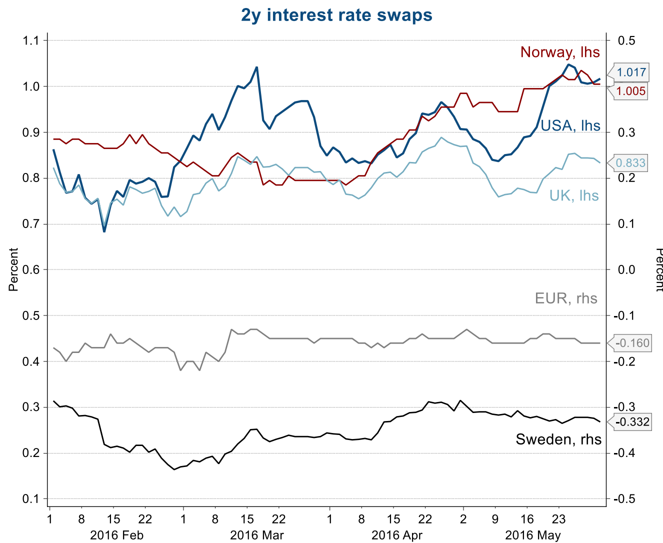
Market overview

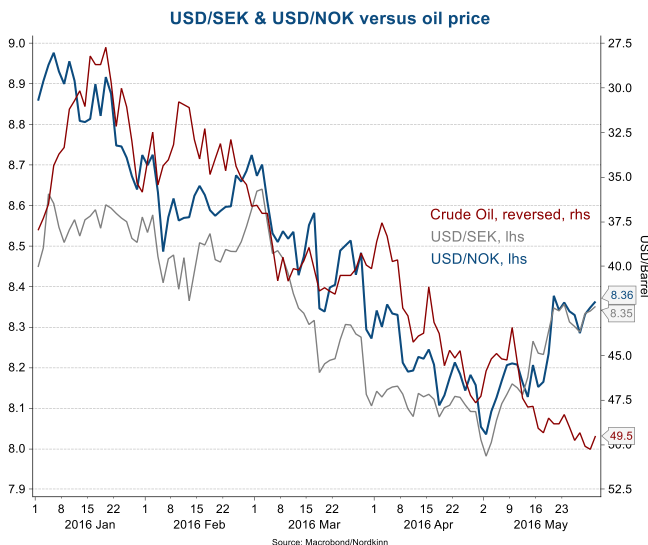
Global overview

Risk appetite reemerged in May which supported global equities and credit, despite increased expectations of a mid-year hike by the Federal Reserve. While short term US interest rates rose as markets reassessed their view on the Federal Reserve, longer-term interest rates were little changed globally. Commodity prices were mixed: Metals fell, whereas energy continued to edge higher, influenced by a combination of both stronger demand and supply disruptions in Canada and Nigeria.



The minutes of the FOMC meeting in April revealed that most members saw a rate increase in June as likely if economic growth picked up in Q2, labour market continued to strengthen and inflation made progress towards 2%. In addition, several FOMC members came out delivering hawkish speeches. Consequently, as we also cautioned in our previous monthly report, markets significantly adjusted their expectations of a rate hike this summer, albeit from very low probabilities. The USD appreciated as the interest rate spread versus the rest of the world widened.In the euro area, despite economic data signalling decent growth, core government bonds rallied in May, presumably reflecting easier supply conditions. Meanwhile, periphery bonds benefitted from the debt deal between Greece and its creditors. The risk of Britain leaving the EU receded early in the month after a couple of polls gave a solid lead for “remain”, but flared up again at the end of the month after a poll showed an opposite result. The referendum will be held on June 23rd.

Nordic overview



Swedish GDP growth continued at a brisk pace in Q1, supporting the Riksbank’s latest decision to reduce asset purchases in the second half of the year. Interest rates were little changed during the month as a whole, but government bonds underperformed swaps somewhat. Breakeven inflation rates rose prior to the implementation of the Riksbank’s index-linked bond purchase program in June. Meanwhile, the SEK depreciated in May, in particular against USD for the reason mentioned above.

Norwegian interest rates rose further in May as the reflation in energy prices continued with crude oil approaching 50 USD per barrel. In addition, the revised 2016 fiscal budget, which was more expansionary than expected, added to speculations that the Norges Bank will back-track on its forecast to cut again in September. Influenced by weaker household spending and employment data, the rise in interest rates came

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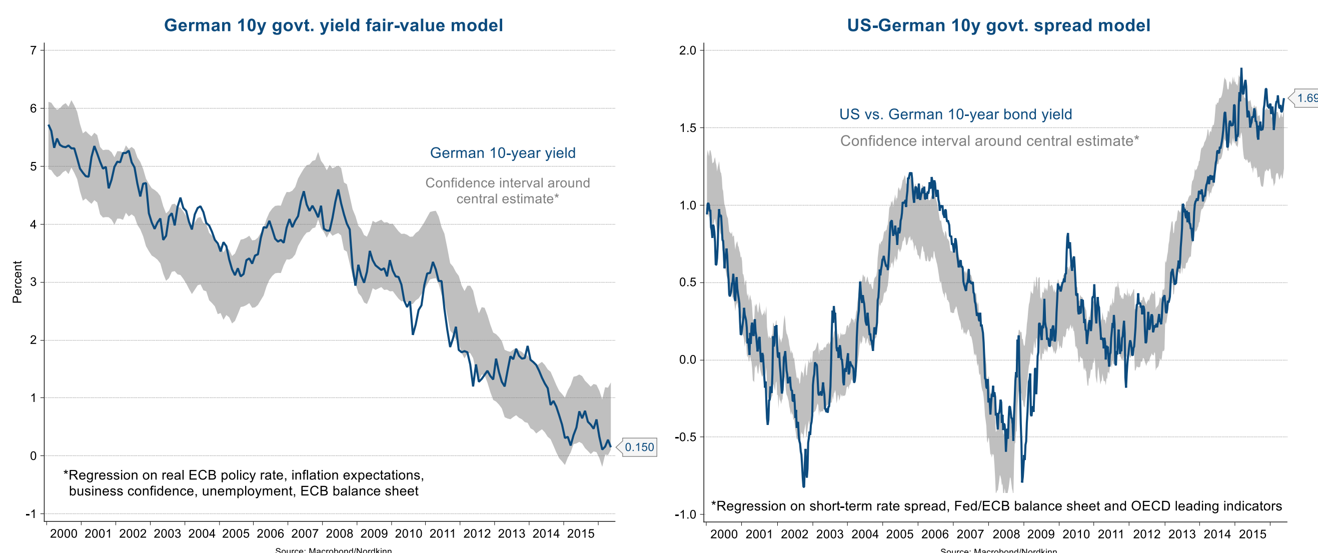
to a halt at the end of the month when markets discounted only about 25% probability for a cut after summer. Notwithstanding the higher oil price and widening interest rate spread versus trading partners, the NOK sold off in May, see chart.

Global markets

Despite FOMC members' warning of a mid-year rate hike, the market attaches only about 25% probability for a move at the meeting on June 15th. One reason why the market is reluctant to price in an even higher probability for a rate hike in coming months is that the FOMC has attached three important preconditions. Namely, data must be consistent with growth picking up in Q2, the labour market must continue to strengthen and inflation must make progress towards the 2% objective.

Regarding the first precondition, US growth appears to be picking up after the meagre 0.8% pace, as for instance suggested by the Atlanta Fed Q2 estimate that currently stands at 2.5%. That said, the most recent news on growth is mixed. For instance, fixed investments appear to be contracting and the latest readings on business confidence are consistent with only modest growth. There is a risk that the slide in business confidence will translate into reduced hiring, which then could jeopardise the second precondition; a stronger labour market. Third, core PCE inflation remains below target and the FOMC is uncertain about whether the increase around the turn of the year was due to transitory factors or not.

Against this background, and given the recent reprising of rate hike expectations in the market, we have temporarily reduced our exposure to our *"US: Interest rate normalisation"* theme, which performed well in the month in review.



While there are good reasons why euro area bond yields are lower than in the previous cycle, they are currently on the low side according to our valuation framework. The chart to the left illustrates our macro fundamental model for 10-year German Bund yield that also takes into account the current extremely loose monetary policy (QE and a negative deposit rate). The estimated fair value is currently around 60 bps with a confidence interval ranging between zero and 120 bps, as compared with actual yields at 15 bps at the end of May.

With euro area recovery proceeding relatively smoothly and headline CPI inflation likely to edge higher in coming months, we see upside risks to bond yields over summer. In addition, a "remain" outcome in the UK referendum on June 23rd could lead to some unwinding of safe-haven longs in German government bonds.

Against this background, we entered a short position in German Bund yields in May. Parts of this exposure were implemented as a spread versus US treasuries. Our valuation framework estimates the current fair value at around 1.35% compared with the current spread of around 1.70%, see right hand chart. The Bunds-Treasury trade could also work well in a scenario where risk appetite recedes due to the larger downside for US bond yields.

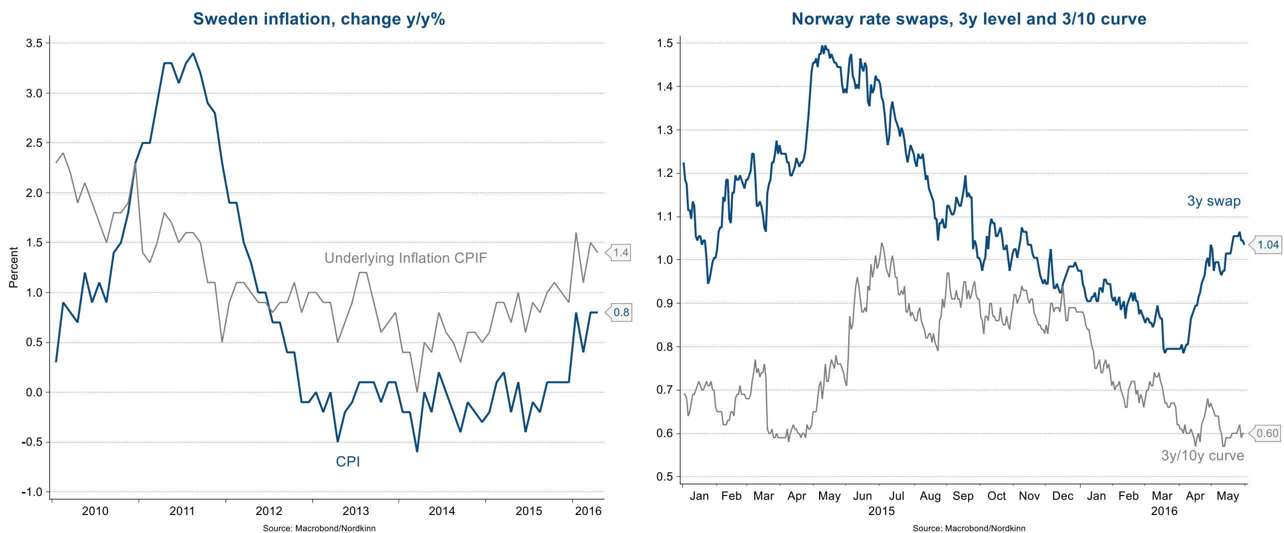
One of the risks associated with this trade is fear of bond scarcity in the euro area in the context of the ECB's extended asset purchase program. Another risk is a near-term rate hike in the US, although we doubt longer-dated treasury yields would be much affected.

Nordic markets

The latest news showing strong GDP growth on average in Q4 and Q1 combined with underlying inflation trending higher supports the Riksbank's latest statement that further monetary policy stimulation is less likely to be needed in the period ahead. However, this does not mean that the Riksbank is unlikely to ease again if negative surprises weaken inflation prospects, and it certainly does not mean that a rate hike is looming anytime soon. On the contrary, Riksbank officials have repeatedly stressed the readiness to act if needed.

Although the Riksbank has succeeded in bringing inflation closer to target and boosting inflation expectations, the job is only halfway done. After a long period where inflation has been undershooting target, the Riksbank will probably ensure that inflation remains at the target for a while, see left hand chart. A premature tightening of monetary conditions could weaken inflation prospects and thus jeopardise the confidence in the inflation target that the Riksbank has been working so hard for.

Against this background, we like exploiting the steepness in the short-end of the Swedish covered bond curve which offers attractive carry and roll. We also see scope for tightening of covered bond credit spreads in both Sweden and Norway, which are lagging recent developments in the euro area credit market. Moreover, we like to fade the recent underperformance of Swedish government bonds vs. swaps as net supply will turn significantly negative over summer. At the same time, given that the SEK is weaker than the Riksbank's projection, monetary policy should not stand in the way of some SEK appreciation going forward.



Turning to Norway, we expect the Norges Bank to maintain its key policy rate unchanged at its meeting on June 23rd. In its latest monetary policy report, the Norges Bank Executive Board's assessment of the outlook suggested that the key policy rate may be reduced further during the course of the year. The baseline interest rate projection indicated a 25 bp rate cut in September and some 20% probability of a rate cut to 0% in December.

In our view, developments have not, on the whole, deviated sufficiently from the Norges Bank's projection to bring the planned rate cut in September into question. Although energy prices have increased, oil companies plan to cut investments by around 15% this year and a further 8% next year. This is, if anything, slightly weaker than expected. Recent disappointing data for household spending suggests there might be some spill-over effects from the oil sector to the broader economy. At the same time, the rise in energy prices may reduce uncertainty among households and businesses. Indeed, recent readings suggest confidence is picking up from low levels, which might contribute to somewhat higher growth in the economy ahead.

On balance, our conviction for a rate cut to 0.25% in September remains high, and we expect the market to come to the same conclusion after the Norges Bank meeting on June 23rd. If the Norges Bank were to back-track on the outlook for a September hike, the NOK could appreciate substantially. While our confidence for another cut to zero has receded somewhat, we expect monetary policy to remain very accommodative for a long time ahead, supporting the bond market. Moreover, the spread between the 3m NIBOR and the key policy rate could narrow somewhat after summer as liquidity in the banking sector improves.

Given the rebound in energy prices, we prefer a combination of outright longs in the short-end of the curve and curve steepening in 3-year versus 10-year swaps. The curve flattened in May (see right hand chart) due to a combination of higher short-term rates and issuance-led receiving at the long-end.