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asset management

Nordkinn Market Review & Outlook – Feb 2017

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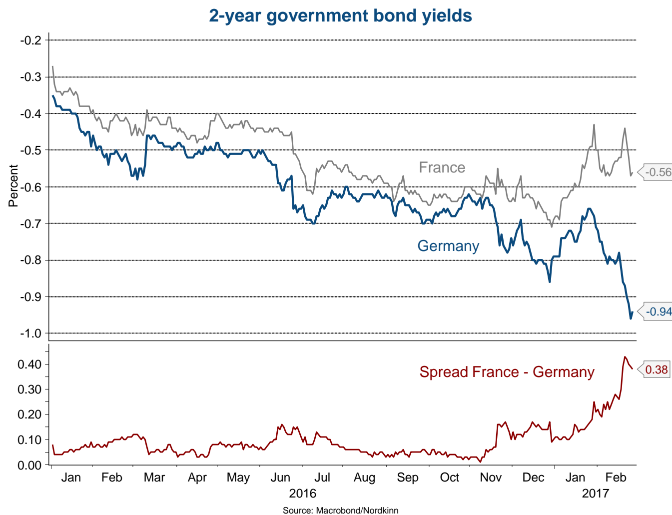
Market overview

Global overview

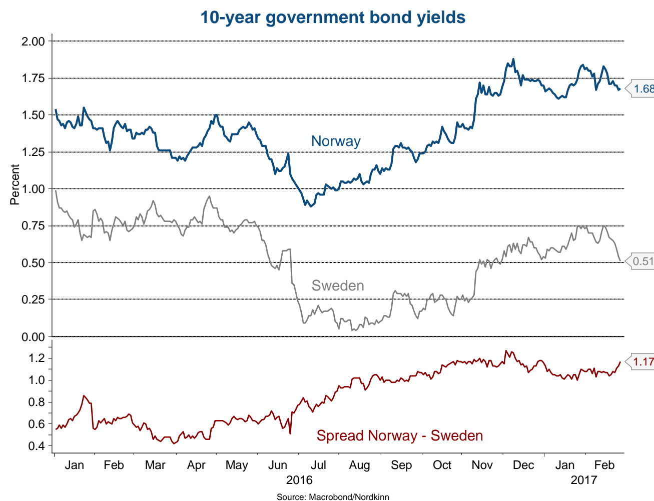
While incoming data in February lent further support to our view that global economic growth is on the rise, fixed income and FX markets put emphasis on renewed political uncertainties, notably French politics. Solid polling support for Marine Le Pen, who has vowed to take France out of the euro area, combined with faltering performance by her opponents, prompted investors to sell French government bonds in favour of the safety of German bonds. The private sector's demand for short-dated German bonds came on top of the purchases made by the ECB: In December the Governing Council decided to purchase German bonds with shorter maturities and below the deposit rate. As a consequence, the two-year German bond yield fell to an all-time low of -0.95% in February, see chart.



The decline in German bond yields impacted US markets as well, in particular through higher demand for longer-dated treasuries. Still, the spread between yields on US and German ten-year government benchmark bonds widened to 215 basis points in February. With the exception of a few days at the end of last year, this spread has not been higher since the early 1980s.

Meanwhile, minutes from the January FOMC meeting revealed a broad support among members to raise the key policy rate again "fairly soon", but the committee did not signal any strong desire to move at the upcoming meeting in March. However, on the final day of the month a couple of Fed officials said they would expect a rate hike to receive serious consideration on March 15th, raising the market-implied probability of a March move to above 70%.

Nordic overview



On February 15th the Riksbank Board announced an unchanged repo rate and it reaffirmed its 6 bp easing bias, as we expected. Moreover, the Board extended the mandate to intervene in the currency market until October this year, which demonstrates how important it is for the Board that the SEK does not appreciate too fast.

Given some speculations in the market that the Board might reduce its easing bias, short-term money market rates and the SEK fell slightly in the aftermath of the announcement. The market now expects the Riksbank to maintain the repo rate at -0.50% until early 2018. The release of the January CPI and Q4 GDP data later in the month did little to change those expectations.

Longer-term Swedish government bond yields fell in February, largely reflecting lower yields abroad, but further fuelled by the Swedish National debt office cutting its estimated borrowing needs for 2017. Asset swap spreads widened due to fear of supply constraints.

In Norway, longer-term government bonds underperformed versus peers in February, see chart. The bulk of this underperformance occurred prior to the new 10-year government bond issue on February 15th, even though this issue was announced well in advanced. The auction size was smaller than expected and saw strong demand, yet long-dated NGBs failed to perform in late February. At the same time, short-dated government bonds performed well, especially versus swaps.

Interestingly, the Norwegian market is looking through the sharp drop in inflation. Core CPI increased by only 2.1% in January from a year earlier, which is no less than 0.8%-points below Norges Bank's projection. Inflation has undershot expectations three times in a row, but without significant market impacts. Rather, the NOK appreciated further in February.

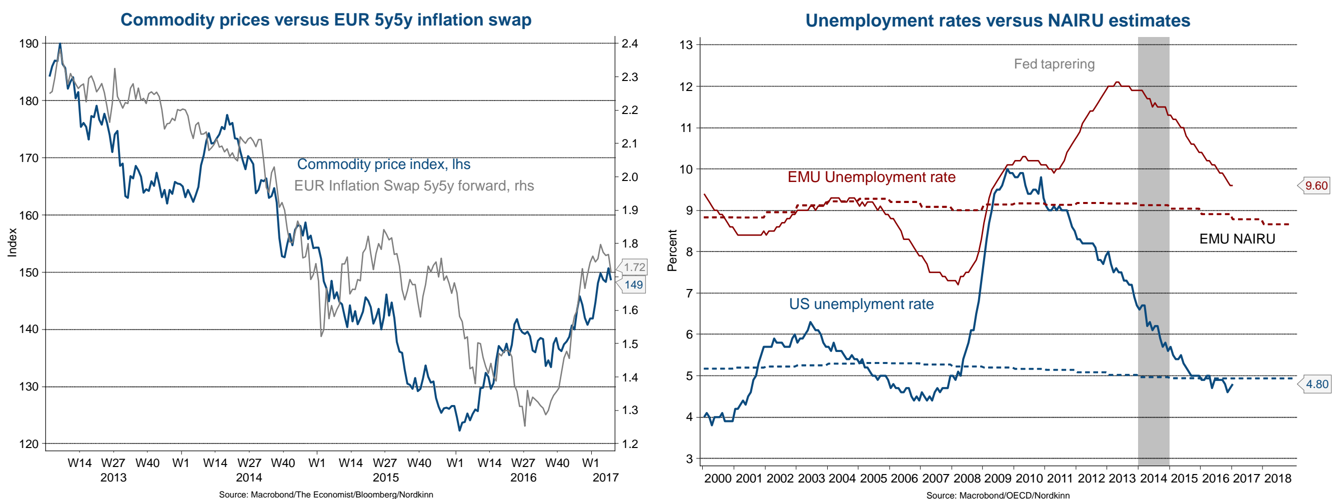
Global markets

We continue to expect the path for markets in 2017 to be a rocky one, among other factors due to European politics. Upcoming elections in the Netherlands and particularly France could stir up meaningful political unrest across the euro area. With Brexit and President Trump's victory fresh in everyone's consciousness, it is unsurprising that investors are nervous ahead of the elections. It is therefore only logical that bond markets consolidates after the pronounced sell-off between November and January.

In Netherlands the Eurosceptic PVV party of Geert Wilders will become the largest of any party in the general election on March 15th according to polls, but not enough to form a majority. Coalitions usually take a long time to form in the Netherlands. However, we do not think that PVV can form an anti-euro government. The Dutch support for the euro is very high according to polls. This is also true for France, where more than 2/3 say they are in favour of the euro. Moreover, Le Pen trails both Macron and Fillon by around 20%-points in second-round polls (election date is May 7th). For comparison, Trump never trailed Clinton by more than 8%-points with less than three months to go.

Meanwhile, global growth has accelerated and most leading indicators suggest that the expansion will endure for the remainder of 2017. Moreover, easier fiscal policy could provide an additional tailwind. Given the lack of slack in the global economy, the current cyclical upswing will lift inflation. This view is reinforced by the recovery of commodities from the deflationary 2014-2015 bust. Against this backdrop, we expect the next significant move in bond yields to be upwards.

Following recent hawkish comments by FOMC officials combined with strong macro indicators, the market has repriced the probability of a rate hike at the upcoming meeting on March 15th to above 70%. The hurdle for actually moving in March should then be quite low in our view (ref. theme *"USA: interest rate normalisation."*). We expect the new FOMC "dots" to be consistent with a cumulative 75 bps of tightening this year. That said, a move in March would in our view open up the possibility for four rate hikes of 25 bps each in 2017, although three remains our base case.



The ECB is in absolutely no hurry to increase policy rates anytime soon, given economic slack and subdued underlying inflation. Still, the arguments for extending QE are diminishing. Market-based expectations of future inflation have increased as the deflationary impact of the commodity bust is fading, see left hand chart. Moreover, economic growth has accelerated meaningfully over the past year. The unemployment rate is now at 9.6%, about 2%-points below the rate when QE was launched.

Interestingly, the unemployment rate is now less than 1%-points above the OECD's estimate of the Non-Accelerating Inflation Rate of Unemployment (NAIRU), i.e. the level of unemployment that does not cause inflation to rise up. For comparison, in the US the difference between the unemployment rate and the OCED's NAIRU estimate was around 2%-points when former Fed-chair Bernanke announced QE tapering, see right hand chart.

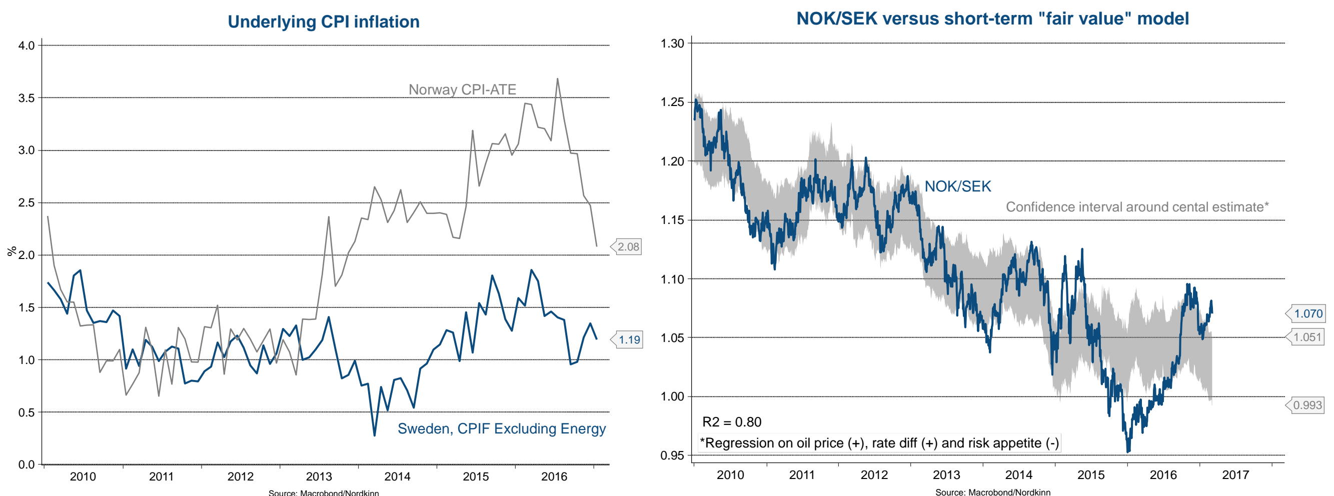
Economic factors supporting the end of QE aside, the ECB is also constrained by a shrinking pool of eligible German bonds to purchase. There are ways for the ECB to overcome this challenge, including a break from the self-imposed "capital key" restriction. However, such a controversial step for the ECB does not appear likely unless it is absolutely necessary. Against these economic and technical considerations, later this year we expect the ECB to announce explicit tapering of asset purchases. This will trigger another move upward whip in German bond yields, and asset swap spreads will tighten from current elevated levels. Trades associated with higher German bond yields are all part of our new *"EMU: QE tapering"* theme.

Nordic markets

The Riksbank repo rate path indicates that there is still a greater probability that the rate will be cut than raised in the near future, underlying the Riksbank's aim to safeguard the inflation target. Against this background, and given the still low rate of inflation excluding volatile energy prices, (see left hand chart), we do not expect any Riksbank hikes in 2017. A commitment to a low repo rate for a considerable period will lend further support to short-dated bonds for most of this year in our view.

At the same time, various indicators suggest that confidence in the inflation target has increased, thanks to rising economic growth and inflation combined with a commitment to ultra-easy monetary policy. This increase in confidence motivated the Riksbank to trim asset purchases in 2H 2016 and further in 1H 2017. Barring any significant downward surprises to the path for inflation, we expect the Riksbank to announce that asset purchases will come to a halt later this year. This would in all likelihood push long-dated bond yields to the upside. Moreover, we think that the increase in breakeven inflation spreads have more to go. In the near term, however, fears of supply constraints should keep asset swap spreads elevated. These considerations are captured in our *"Sweden: Government relative value"* theme.

Although it is important for the Riksbank Board that the SEK does not appreciate too fast, it cannot avoid a measured strengthening if the economy remains strong, inflation remains on a rising path and the Riksbank ends its asset purchase program. We trimmed exposure to this theme in late January, but following the depreciation of the SEK in February we have yet again increased exposure to our *"Sweden: FX recovery"* theme.



Turning to Norway, the lagged impact of a 10% stronger NOK since January last year is having a major impact on inflation, see left hand chart. After hovering above 3% for much of 2016, underlying inflation fell to 2.1% in January, 0.4%-points below the Norges Bank's inflation target. More importantly, the inflation print was 0.8%-points below the central bank's projection. Although a lower path for inflation was to be expected, the pace of decline is a concern. Most indicators point to a further rapid decline in inflation later this year.

Although the economy is showing some signs of improvement, growth is moderate and there is still significant slack to absorb. Consequently, for monetary policy there is currently no trade-off between bringing inflation back up to target and reducing economic slack. These considerations require a very accommodative monetary policy stance. On the other hand, the booming house market implies a hurdle to reducing interest rates further.

At its upcoming Board meeting on March 16th, we expect the Norges Bank to balance these considerations by leaving interest rates unchanged, while signalling a significant easing bias for the near future. We also expect the downward revision of the inflation path to be accompanied by a further delay in the prospects for future monetary policy tightening.

Regarding implications for markets, the weaker inflation outlook and Norges Bank's likely response favour holding NGBs in our view, at least on a relative basis against SGBs and German Bunds (*"Norway: Inflation convergence".*) We also see room for wider asset swap spreads.

While the longer-term trend for the NOK may be tilted towards the upside, the recent appreciation appears somewhat exaggerated according to our models, as illustrated by the NOK/SEK chart to the right. Given our view on monetary policy, we look for a correction in the near term.