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asset management

Nordkinn Market Review & Outlook – Aug 2017

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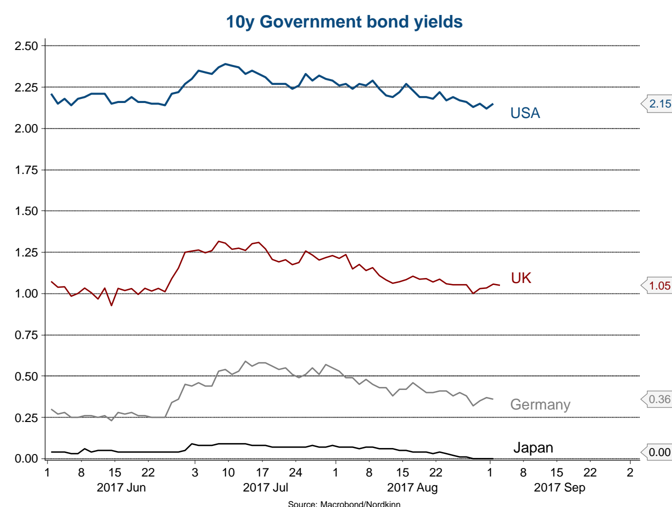
Global overview

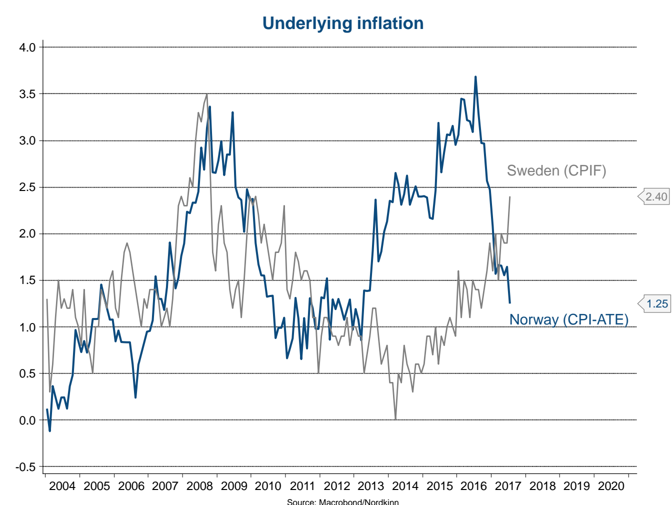
Global bond yields fell in August, see chart, driven primarily by the renewed geopolitical tensions. The US North Korea standoff took a dramatic turn on August 28th when North Korea carried out one of its most provocative tests in recent years by launching a ballistic missile directly over Japan. Tensions continued into September after the regime conducted yet another nuclear test. Meanwhile, the USD made fresh lows being under pressure from various factors, including a fifth consecutive miss on core CPE inflation and spurred pessimism about the ability for US Congress to pass legislation.



By contrast, the EUR made fresh highs in August supported by the ever stronger cyclical recovery and the third consecutive upside surprise in headline inflation. This notwithstanding, German bond yields slipped amid safe haven flows combined with fading anticipation of a policy shift by the ECB. In particular, the market remains uncertain about how the central bank will respond to the stronger EUR. While ECB "sources" suggested in an article that the currency is becoming a problem, Governor Nowotny countered these concerns in a subsequent statement.

The GBP depreciated against all major currencies in August as incoming data points to weaker growth in UK economic activity. Although inflation remains above target and the recent currency move may boost inflation further, expected future interest rates declined on speculation the Bank of England will judge potential inflation overshoot being transitory.

Nordic overview



Swedish interest rates fell only marginally in August as interest rate differentials to Europe widened amid strong domestic macro conditions. CPIF inflation soared to 2.4% in July, yet again higher than the Riksbank's forecast and finally above the 2% inflation target for the first time since 2010. A seasonal spike in prices on travel and transports accounted for a good part of the increase and some of that will likely reverse over the coming months. Yet, some of the uptick in inflation is likely to prove more persistent.

With regards to market implications, break-even inflation spreads widened immediately after the CPI release, but tightened in the latter half of the month influenced by international conditions. Moreover, the SEK appreciated further in August.

In Norway, underlying inflation fell further in July to 1.3%. While being slightly above the Norges Bank's inflation projection, inflation remains significantly below the 2.5% target. Meanwhile, national accounts data confirmed that the economic recovery gained speed in the first half of 2017. Mainland-GDP expanded by 0.7%, slightly above the Norges Bank's forecast. As a consequence, the NOK appreciated somewhat further in August, in particular against the USD. Of note is that the trend for stronger NOK escalated in August in spite of a close to 10% drop in oil prices during the month.

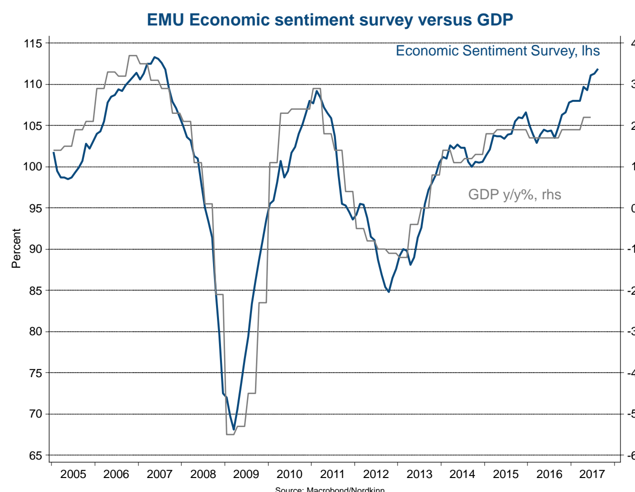
Global markets

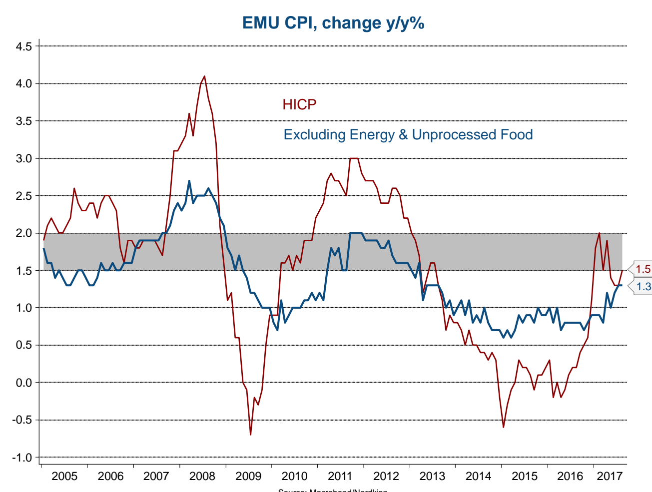
The upcoming monetary policy meetings of the ECB on September 7th and of the Federal Reserve on September 20th may include major announcements that will be decisive for the direction of fixed income and FX markets in coming months. By then, both central banks' assessments of the future path for interest rates and balance sheets will benefit from updated macroeconomic projections. Still, consensus in the market seems to be that the Governing Council of the ECB will wait until the next meeting in October or even the following in December before announcing its QE plan for 2018.

Most indicators of euro area economic activity continue pointing upwards and EMU headline inflation has surprised positively three months in a row, see charts. This notwithstanding, we expect the ECB staff macroeconomic projections presented in the upcoming meeting of the ECB's Governing council on September 7th to foresee a lower inflation profile than in June. This is because the EUR appreciated by over 5% in trade-weighted terms between the cut-off dates for June and September ECB projections.

Regardless of whether the decision on QE will come in September, October or December, we expect the ECB to announce asset purchases in 2018 at a slower rate of EUR 40 bln per month, which is in line with consensus. While the debate in the market is whether it will be a six month or nine month extension, we see a risk of an "open-ended" and data dependent decision in order to allow for more flexibility. Such flexibility would ease the speculative attacks on the EUR, but would also add unwanted uncertainties for the likes of the Riksbank being heavily influenced by the actions of the ECB.

If we are right, the ECB's communication this month would be interpreted as relatively dovish, thereby limiting further upside for the EUR. However, Bunds rallied about 25 basis points to 0.35% between early July and late August, which to us suggests that the fixed income market is already discounting a relatively dovish message.





On September 20th we expect the U.S. Federal Reserve to announce a program to reducing its USD 4.5 tln balance sheet set to commence as from October. As we explained in our previous monthly report, we estimate that this program will bring about an increase in the 10-year government bond yield of approximately 70 basis points by 2021 compared to an alternative scenario where the balance sheet remains stable. Note that the short-term impact of this policy change would depend on whether it would negatively impact risk sentiment or not.

Failure to raise the debt ceiling or extend federal spending beyond the current budget window could spoil the benefits from lower tax rates. Fortunately, the risks of such an outcome have receded. Hurricane Harvey is a tragic event, but it may bring some market-positive outcomes to U.S. politics. The need for disaster relief reduces the probability to hit the debt ceiling or end up with government shutdown. Moreover, Americans suffering in a state that voted for President Trump could be the catalyst that Republicans need to put their intra-party differences aside and start working with vigour on legislation, including tax reform.

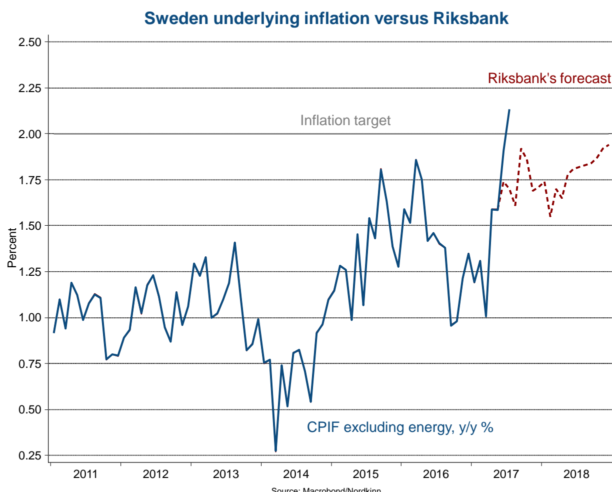
Under the assumption that the debt ceiling will be raised, the U.S. Treasury Borrowing Advisory Committee is projecting USD 501 bln of issuance in Q4. That is more than has been issued during the past four quarters alone. Combined with a reduction of the Fed's balance sheet, a sharp increase in issuance activity should in our view lead to a widening of the EUR/USD basis swap spread before year-end. This will in turn spill over to the Scandinavian money market, with downward pressures on STIBOR and upward pressures on NIBOR. In August we decided to formalise these ideas into a new investment theme; *"Scandies: Basis effects from US debt ceiling"*, which is centred around the ripples from the U.S. debt ceiling and the subsequent issuance activity.

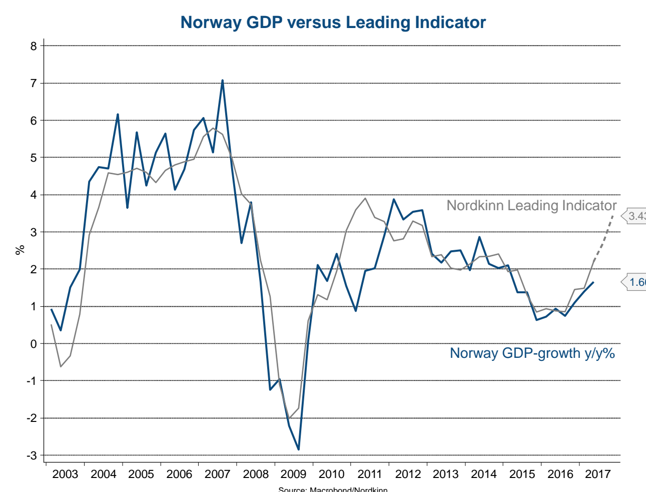
Nordic markets

Strong growth, rising capacity utilisation and, finally, the return of inflation to the 2% target all suggest that the extraordinary loose monetary policy stance in Sweden will soon come to an end. However, the Riksbank Board has so far rejected any possibility for an early rate hike, emphasising that an overshoot in the inflation rate is not a problem. As we have highlighted in previous reports, the Riksbank wants to ensure that inflation stabilises around 2% for some time in its quest to restore the credibility of the inflation target. In particular, it seems important for the Riksbank Board that the SEK does not strengthen too quickly. The trade weighted SEK (KIX index) is around 3.0% stronger than the Riksbank's projection.

In our view, this implies that the probability for a near term rate hike continues to be rather low. However, given the recent strong Swedish data it is difficult not to come to the conclusion that the probability for a rate hike early next year has increased. Against this backdrop, we have closed our *"Sweden: Credible inflation targeting"* theme entirely. Although we see some further downside for Swedish money market rates before year-end, that has more to do with an expected widening of the USD/SEK basis spread combined with the usual year-end impact of the resolution fees. This view is organized under our new theme *"Scandies: Basis effects from US debt ceiling"*, see global markets outlook on page 3.

With regards to the upcoming Board meeting on September 7th, we expect the Riksbank to announce an unchanged policy stance, holding the repo rate at -0.50% and continuing its purchases of nominal and inflation-linked government bonds until year-end, as decided in April. We continue to expect the first Riksbank hike medio next year, although the risk around that forecast is skewed towards an earlier move. In this context, we remain bearish Swedish government and covered bonds and we are bullish break-even inflation spreads as part of our *"Sweden: Government relative value"* theme.





In Norway, the near-term economic prospects look encouraging according to our proprietary leading indicator, see right hand chart. The indicator, which combines information from consumer and business surveys as well as lagged effects of the NOK, point to a solid increase in year-on-year growth in the second half of this year. If "hard" data follows suit, the Norges Bank would have to revise its forecast for economic growth and capacity utilisation.

Indeed, following solid growth and an improving labour market, we expect that the Norges Bank amends its output gap estimate already at the upcoming Board meeting on September 21st, admitting a smaller amount of slack compared with previous assessments. Considering the somewhat higher than expected inflation rates recently, an upward revision to capacity utilisation should also lead to an upward revision of the interest rate projection. This does however not mean that the Norges Bank is on the verge of hiking rates. The June Monetary Policy Report projected a first hike in the second half of 2019, and we expect the new estimate to be only a few months earlier. Nevertheless, such a change should support our NOK FRA curve steepener.

The Ministry of Finance is working on a modernisation of the monetary policy regulation. We think that the market underestimates the probability of a change in the inflation target to 2.0% from 2.5%. Such change could lead to a flatter yield curve and a stronger NOK as the market would eye the possibility of a faster return to target. In the longer-term, a lower target should in our view be supportive for longer-term bonds as investors should accept a lower compensation for future inflation.

Despite stabile monetary policy, we expect the 3m NIBOR to increase ahead of New Year mainly as a result of an expected widening of the 3m EUR/USD basis swap spread.