Nordkinn Market Review & Outlook – Sep 2017

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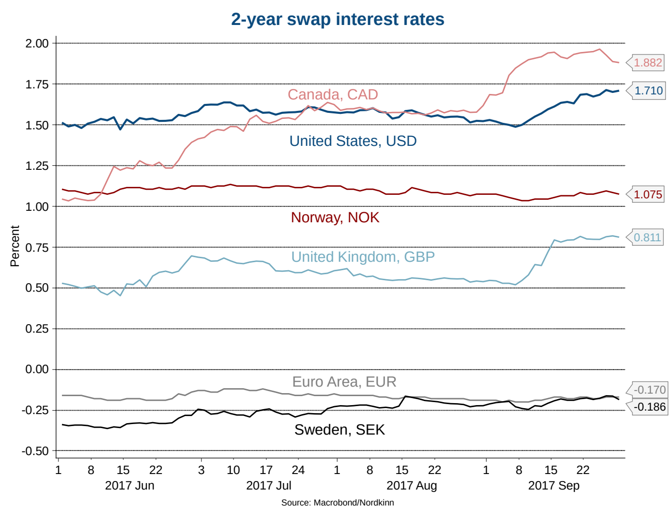
Global overview

Geopolitical tensions between the US and North Korea continues, but the conflict did at least not escalate further in September. In this context, the demand for safe haven bonds eased, allowing yields to push higher. Hawkish comments from central banks being increasingly explicit about their quests to gradually remove stimuli, notably the Federal Reserve and the Bank of England, also contributed to boost bond yields. Carried by declining US oil rigs and declining oil inventories, the Brent spot oil price rose almost 10% in September to 56 USD/barrel, see lower chart.

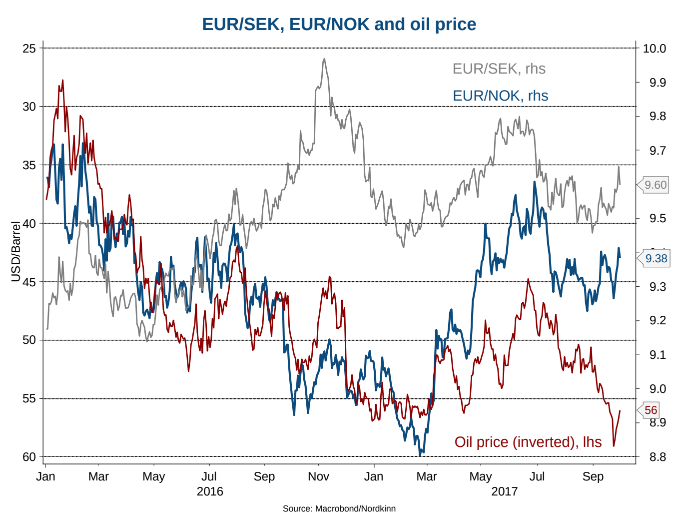


As expected, the FOMC confirmed that it in October will commence to trim the USD 4.5 tln balance sheet it has built up after the financial crisis. At the same time, the committee decided to keep interest rates unchanged, however 12 out of 16 members forecasted another rate hike in December this year, unchanged compared with the forecasts made in June. Moreover, the median projection of another three rate hikes in 2018 was also unchanged. As investors were prepared for more cautious assessment in light of the recent decline in core PCE inflation, expected future interest rates prevailing in the market rose as a result of these forecasts.

The Bank of England voted to keep interest rates unchanged, as expected. But contrary to what the market had expected, the majority of MPC members deemed that some withdrawal of stimulus is likely to be appropriate over the coming months.

As a result, markets reassessed the possibility of a UK hike even before year-end. Subsequently, short-term market interest rates rose substantially, see chart, which also boosted a stronger GBP. Meanwhile, the ECB decided to keep interest rates and asset purchases unchanged, but President Draghi revealed that the ECB indends to make the "bulk" of its decisions regarding the parameters of its QE program at the next meeting in October.

Nordic overview



CPIF came in at 2.3% in August, beating the Riksbank's forecast yet again. Notwithstanding higher inflation outcomes recently, the Board does not believe that confidence in the inflation target has been completely restored after such long period of low inflation. Consequently, according to the minutes of the policy meeting held on September 6th the Board agreed that it was too early to bring forward interest rate hikes. However, some members envisage that the first repo rate hike could occur slightly earlier than current forecast, if future CPI numbers were to indicate a persistent upturn in inflation.

On September 29th the General Council of the Riksbank decided to extend Stefan Ingves' mandate as Governor of the Riksbank by five years, and First Deputy Governor Kerstin af Jochnick's mandate by six years. This triggered an initial decline in expected future market rates and the SEK.

On September 21st the Norges Bank surprised markets slightly when revising its interest rate projection upwards by 15 basis points for 2019 and 2020. We interpret the new rate projection being consistent with about 50% probability for a hike in December 2018, which is earlier compared with the previous forecast. Norwegian interest rates rose and the NOK appreciated somewhat after the publication of the monetary policy report. However, the NOK erased all gains in the final week of the month and is trading on a weak note in relation to the oil price, see chart.

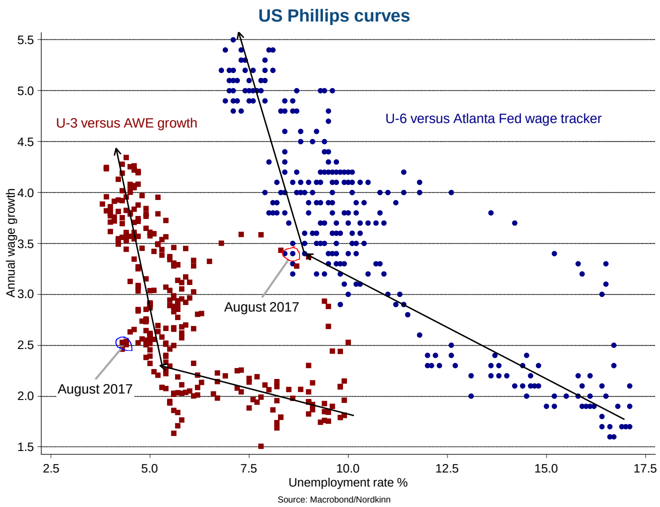
The Board appears quite relaxed about core CPI inflation, which was labelled "broadly as projected" after falling to 0.9% in September. The Board expects inflation to remain well below its 2.5% target for the entire forecast horizon, but in contrast to the Riksbank, the Norges Bank Board says inflation expectations are firmly anchored.

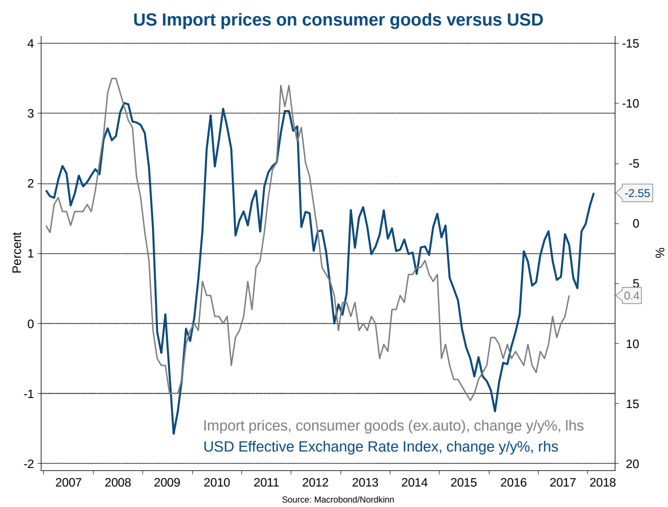
Global markets

The failure of inflation to accelerate in response to diminished slack has prompted numerous commentators to question whether the so-called Phillips curve has broken down. This has in turn fuelled doubts about the prospects of further interest rate hikes in the US. In our view, the Phillips curve is far from dead. Rather, we believe that the US economy is just about to enter the steep part of the curve.

The idea that the Phillips curve steepens at low levels of unemployment is highly intuitive: If unemployment is high at the early start of recovery, which was the case in 2010, a modest decline will still leave many workers unoccupied. In such environment, wage growth is unlikely to rise even if growth is fairly strong. However, once the unemployment rate approaches its so-called "natural" rate, i.e. the level of unemployment arising from structural or non-cyclical forces, any further decline will cause bottlenecks to emerge, pushing wages and prices higher.

It is true that the combination of the official unemployment rate ("U-3") and average weekly earnings ("AWE") is about to enter unchartered territory, see left hand chart (red "dots"). However, it is in our view too early to conclude that the Phillips curve has become permanently flatter. Looking at a broader measure that includes discouraged workers ("U-6"), the unemployment rate has still some way to go before reaching previous lows. In addition, average wage growth has been depressed by the inflow of low-wage workers into the labour market. In contrast, the Atlanta Fed wage tracker, which measures wage growth of the same workers over 12 months (i.e. adjusting for composition effects), shows faster wage growth. The combination of the U-6 rate and Atlanta Fed wage growth (blue "dots") has entered the point where the curve bends.





Moreover, the appreciation of the USD in 2015 and 2016 has contributed to depress prices on imported goods, see right hand chart. Although import prices has started to rise, it may still take some time before those goods enter the shops and feed through to the Personal Consumption Expenditure (PCE) index. Additionally and partly owing to the USD weakness in 2017, we therefore expect rising core PCE inflation in coming months.

To conclude, we expect the Federal Reserve to stick to its plan of slowly reducing the balance sheet and hiking rates going forward, at a faster pace than currently discounted in the market. This said, the bond sell-off in September reached levels that we deemed motivated for profit taking in our *"US: Interest rate normalisation"* theme towards the end of the month, but we stand ready to add again depending on the evolution of risk/reward according to our judgement.

Finally, the Federal Reserve faces staff turnover over the coming months, which adds uncertainty over future monetary policy. Stanley Fischer has already resigned and Janet Yellen's term as Chair ends in January 2018. It remains far from clear that she will be offered another term or would even choose to stay if given the chance. The President will probably consider other candiates, and among those are former Fed Governor Kevin Warsh who has made a number of public interventions in support of Mr. Trump's policies and has been critical of current dovish Fed strategy. Media reports suggest that the previous front-runner, Gary Cohn, is out of consideration following his criticism of President Trump's response to the Charlottesville incident.

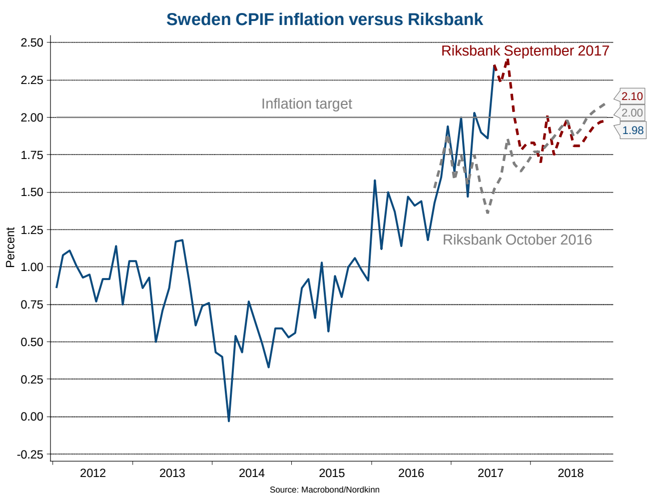
In our view, we think Fed policy to a large extent will be guided by the economic environment regardless of who is the Chair. If we are right that the US economy will remain solid and that inflation is about to turn higher again, the Federal Reserve will hike rates in December 2017 and continue with gradual rate hikes next year.

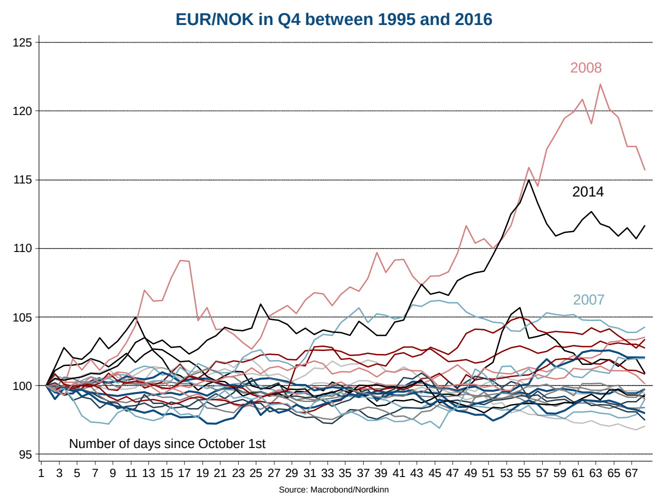
Nordic markets

The decision of the General Council of the Riksbank to extend the mandates for Stefan Ingves and Kerstin af Jochnick does not change our view that interest rates will remain unchanged until medio 2018 before moving higher. The probability for a 2017 rate hike has fallen from already very low, to zero. A move in February 2018 is unlikely, but the meeting in April 2018 could be in play if inflation were to prove stickier above 2% than we, and the Riksbank Board, currently expect. For now, our base case scenario remains that the Riksbank moves in July next year, in line with the Riksbank's own forecast.

The Riksbank has successfully supported the return of inflation back to 2%, see left hand chart. However, according to Board members the Riksbank has yet to achive full confidence in its inflation target. The current very expansionary monetary policy will continue to support economic growth and lead to higher inflation expectations in our view. Eventually, inflation expectations will become anchored and monetary policy will be more flexible as a result. In this context, we remain bullish break-even inflation spreads and bearish longer-dated nominal bonds. These views are core under our *"Sweden: Government relative value"* theme.

However, we see some further downside for Swedish short-dated money market rates. Firstly, we expect downward pressures on STIBOR in Q4 because we anticipate a wider 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"* as discussed in our previous monthly report. Secondly, we see a risk that investors will fade the current high probability of a Riksbank hike during the first half of 2018 following the extention of Mr. Ingves' mandate. Consequently, we hedge our pro-reflationary trades in Sweden with receiver positions in short-dated interest rates.





Turning to Norway, the central bank believes there is confidence in the inflation target and does not appear too concerned about core inflation being 1.6%-points below target according to the latest reading. Indeed, the rise in capacity utilisation motivated a slightly steeper interest rate projection in the most recent monetary policy report, although a rate hike is still far away.

As we described in the previous report, the near-term economic prospects look encouraging and inflation will most likely edge higher in coming months due to lagged effects of the NOK depreciation that began in March. Consequently, we decided to unwind our *"Norway: Inflation convergence"* theme in September as we see a risk that the Norges Bank will make further upward adjustments to its interest rate projection in the future. Furthermore, we decided to launch a new theme *"Norway: Economic revival"* that replaces *"Norway: Curve steepener"* as it contains more elements than only steepening trades. Finally, we manage our *"Norway: FX recovery"* theme actively and have increased exposure during the NOK sell-off at the end of the month.

We read many comments that the NOK could face seasonal headwinds in the final quarter of the year, although there are few attempts to explain why. We have investigated this and find that EUR/NOK on average has risen by 1.2% in Q4 since 2007, which may suggest there is such a pattern. However, we argue that this pattern is almost entirely due to a few outliers; 2008 and 2014 in particular, see right hand chart. The Lehman collapse in late 2008 had a dramatic impact on financial markets, including commodity prices. The oil price dropped from about 150 USD/barrel in July 2008 to 40 USD/barrel in December 2008. Regarding 2014, the oil price fell from 110 USD/barrel in July to sub USD 40 in late December. Excluding 2008 and 2014, we find no statistical significant seasonal pattern in EUR/NOK over the past 20 years.