FX & FI Strategy

Northern Lights

Divergent scandi outlook

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Sweden – low inflation is here to stay

The Swedish economy is performing well, but inflation is likely to remain below the Riksbank's estimates for the coming months and a cut in July seems like a done deal, possibly with a bias for further easing. The short end has rallied a lot on the turnaround in rate expectations and we now see value in the long end of the curve. We do not expect a significant weakening of the SEK as the positive growth outlook should support the currency, though.

Norway – lacklustre growth despite positive surprises

Economic figures have generally surprised to the upside lately and house prices have started to rise again. However, this is not the beginning of a rebound in growth as activity in the petroleum sector is still levelling out. The macro-economic backdrop will be soft enough to keep hike expectations away so we like steepeners for carry reasons. The good run of data has been positive for NOK lately, but NOK-negative flows should keep pressure on the krona and a rebound in EURNOK seems likely.

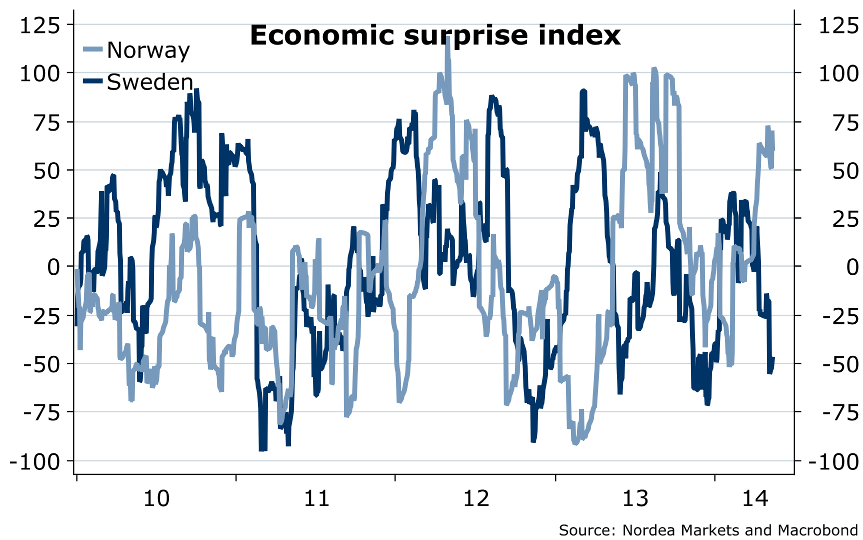
Denmark – central bank supporting the krone

DKK is under pressure and the Danish National Bank is doing its best to support the currency. It is unlikely to follow suit should the ECB cut rates as we expect. In this case the central bank will let the ECB do the work.

Finland – so far just dreadful

The Finnish economy feels the cold wind from the Ukrainian crisis and risks that the economy will not reach positive growth numbers this year are increasing.

Chart of the month – Surprise NOK positive – SEK negative



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Nordic Overview: All about expectations

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Growth may be more important than central banks doing what's already expected. This is the rationale behind our outlook for the scandi currencies.

In Sweden a positive growth outlook should keep SEK supported despite the Riksbank cutting rates as widely expected. Whilst we cannot rule out a rate path with a bias for further easing, we do not expect any more rate cuts below 0.50%.

In Norway data has clearly surprised to the upside lately. In particular the housing market has been of great importance and after three months with solid increases it is fair to conclude that the fear of a sharp correction that many investors entered the year with was overdone. This change in perception has probably been the most important factor behind the recovery for NOK.

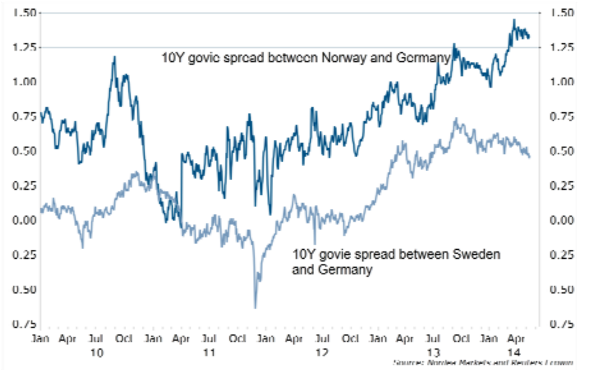
From possibly standing at the edge of a sharp correction in house prices, the economy now seems to be on a much more stable footing. However, the outlook for growth is still lacklustre and the recent positive run of data is likely to prove temporary. We expect data on oil investments due in June to confirm that this hugely important sector has gone from a major growth impulse to becoming a drag on growth. This together with outflow from NOK should keep pressure on the Norwegian currency.

In total we see potential for a correction to the recent rise in NOKSEK in the coming months as the cut we expect from the Riksbank should not come as a surprise.

This also mean that Swedish rates look expensive on an outright basis. After having recommended a long position in front-end rates over EUR we now see better value in the long-end. In Norway we like steepeners as the macro-economic backdrop should be soft enough to keep hikes distant and the pass through from a further fall in long end rates globally should be limited.

Chart 1. NOKSEK on the rise

Chart 2. Spreads are high vs Germany



Sweden – Easing in the pipeline

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Strong economy…

The Swedish economy is performing well. GDP growth picked up in Q3, surged in Q4 and seems to have been strong so far this year. Households are the main growth driver while exports are still lagging. However, much suggest that the export industry will start to recover soon. Construction investments are booming, reflecting the expansionary conditions and the overall strong domestic economy. Employment is rising although unemployment remains sticky due to a strong inflow into the labour force.

…but low inflation and a dovish Riksbank

Inflation to remain low in the coming months

Inflation remains very low. Despite the uptick in April, inflation is still lower than the Riksbank's view. Moreover, our inflation forecast is below the Riksbank's estimates for the coming months. Hence, much indicates that the Riksbank will continue to struggle with very low inflation for some time still.

This supports an already clear picture of a rate cut in July to 0.50%. Moreover, given the low inflation and that further actions from the ECB are in the pipeline, it cannot be ruled out that the rate path will have a bias for further easing. However, we don't expect any more rate cuts below 0.50%.

Q1 GDP important but overshadowed by inflation

GDP probably continued to grow in Q1

The next heavy key figure is Q1 GDP (28 May). We and the Riksbank see GDP growth at 0.2% q/q. This is a decent growth rate as GDP surged in Q4 by a full 1.7% q/q. Inventories (15 May), revised figures for retail sales (26 May) and trade balance (27 May) are important ahead of Q1 GDP.

We also keep an eye on the April Labour Force Survey (19 May) and the NIER's sentiment surveys (23 May). However, all these key figures are currently overshadowed by inflation. It will be a long waiting for May CPI (12 June), by the way the last inflation print ahead of the Riksbank's rate decision in early July.

Chart 3. Inflation below the Riksbank's view

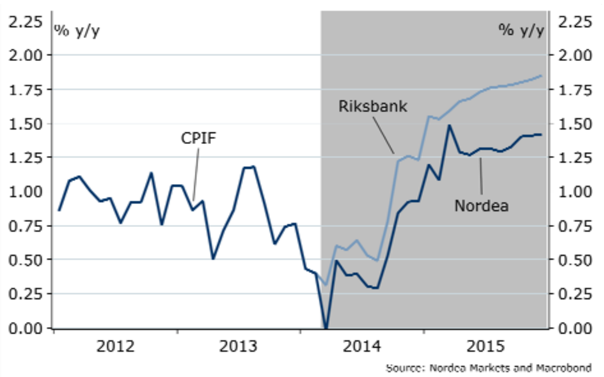
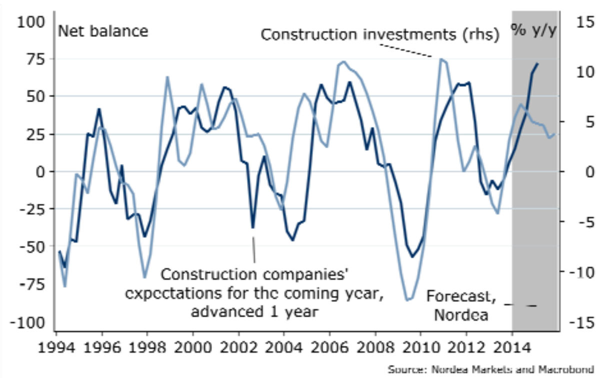


Chart 4. Record optimism in the construction sector



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Swedish rates: Riksbank easing expectations push rates

The run of low inflation and the return of easing expectations have pushed front-end rates to new all-time lows, even though the growth outlook has improved markedly. Since September, the "red" part of the FRA curve has rallied 110bps on only 25bps of Riksbank easing and the belly of the curve (5yrs) looks expensive, both against the wings (2s and 10s), but also in relation to longer tenors (steep 5s/10s).

Swedish rates have experienced a higher correlation with USD than EUR in the past years, but at the end of the day the development in the Euro-zone (and ECB policy) will prove more important. In particular, it will be very difficult to decouple further without inflation returning towards target. Even though Swedish rates look expensive on an outright basis, they still look cheap vs Euro-zone, especially in the scenario of further Riksbank easing. However, after having recommended a long position in front-end rates over EUR we now see better value in the long-end. For unhedged cash investors, the weakening of SEK has also left SGBs much more attractive to DBRs (chart 6).

Stagnation of SEK covered stock and a dovish Riksbank will be important themes going forward

As for SEK covered bonds, the longer term story of an increase in lending, leading to more issuance of bonds, is still valid. But for coming months, other factors are more important. The stagnation of the SEK covered stock as a result of more issuance in foreign currency is still one of the most important themes. The increase of the probability of a rate cut by the Riksbank in July is another. The June redemptions are large and close enough in time to make it hard for issuers to balance them with new bonds. Consequently, the covered stock might decrease once again as the market rolls past June IMM.

There are few arguments why covereds should trade above swaps in the long-term, and currently most factors seem aligned for continued spread contraction. Strong global credit markets, record low rate levels, low volatility, low xCCY basis swap spreads and a decent index-extension in June. If ASW in covereds were to take another step toward zero, the environment could hardly be much better.

Chart 5. Swedish yield levels look stretched

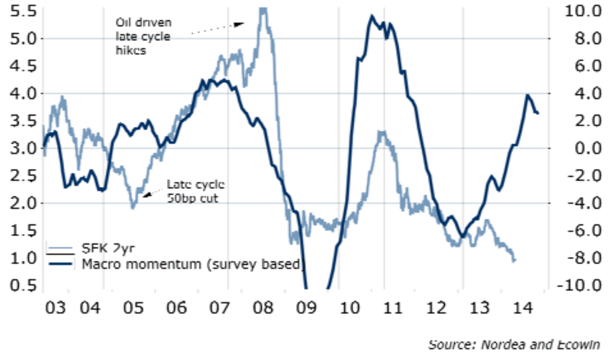
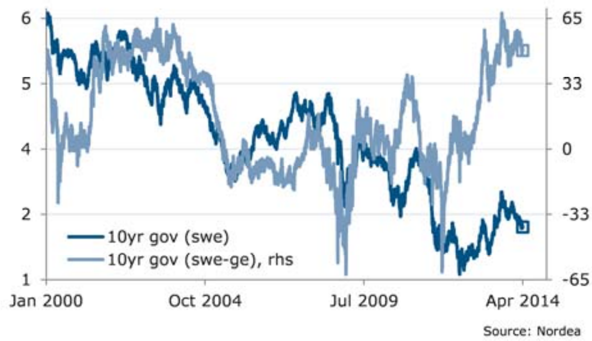


Chart 6. Spreads to EUR still high given yield levels



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EURSEK: Inflation darkness in the Riksbank tunnel

It would seem that the asymmetrical monetary response to overly low inflation and subpar growth between the Riksbank and the ECB is over. The ECB now has an easing bias going into the June meeting and it gave the EURSEK a gentle push downwards toward 9 as rate spreads widened. Our 3m forecast is that the EURSEK will trade around 9 due to a longer period of low inflation and the Riksbank having shifted its policy response towards low inflation alone. The downward pressure on shorter maturities will continue as the 3m Stibor drifts downwards going into the July meeting. The de-anchoring of our inflation forecast compared to the Riksbanks forecast does suggest that the July meeting could potentially see an inflation revision and hence it is rational to expect a slight bias towards a further cut in September. That would mean leaving the EURSEK above or marginally below 9 throughout the summer.

The de-anchoring of our inflation forecast does suggest that the July meeting could potentially see an inflation revision

We don´t expect a significant weakening of the SEK because a sustained supportive growth outlook will keep the upside in EURSEK contained as it implies a risk premium to the counter cyclical monetary policy currently conducted by the Riksbank.

It certainly takes two to tango and Draghi’s pre-warning of softening monetary policy in June could weigh on the euro. The counter intuitive take (which post crises, has become a rational one) is that the EUR will remain strong because a slight improvement in growth, together with an easing central bank bias, supports risky assets. EUR exposure might turn out to be the sweet spot. On the other hand: If one considers Draghi’s rhetoric i.e. that “the strengthening of the exchange rate in the context of low inflation is a cause for serious concern” one could easily entertain the notion of the conventional toolbox being empty.

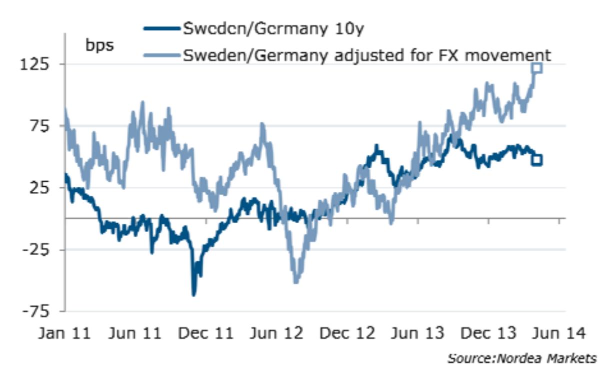
We would consider a new short term range of 8,95 - 9,10 in EURSEK for the next month or two

We would consider a new short term range of 8.95 – 9.10 in EURSEK for the next month or two. For unhedged cash investors, the weakening of the SEK has left SGBs much more attractive to DBRs (see chart 8.). But we would also, perhaps a little too early, like to highlight the September election as a possible SEK negative event. The process of forming a government could take time in a situation with a hung parliament.

Chart 7. Elections in September – a SEK risk

	Red	Blue
Majority	• The combination of S, V and MP is a historically constellation that has worked • *SEK neutral*	• *SEK neutral/positive*
No majority	• *SEK negative*	• The Alliance doesn´t gain majority but with active/passive support from SD the form government • *SEK negative*

Chart 8. Sweden/Germany adjusted for FX movement



Norway – Rates firmly on hold

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The petroleum investments decide

The Norwegian economy slowed down during last year, and we expect the mediocre growth to continue. This winter we have seen a rebound in some demand indicators like retail sales, and house prices have picked up again. We do not think this is the beginning of a rebound as the main growth engine in the Norwegian economy, the activity in the petroleum sector, is levelling out and the sector's investments probably will decline somewhat in 2015.

In 2000 Norway experienced a gain from higher oil and gas prices

The terms of trade gain, mainly from higher oil and gas prices, Norway has experienced since early 2000, has had strong simulative effect on the economy. The investments on the continental shelf have doubled in volume over the last decade and now correspond to about 9 percent of GDP. About 60 percent of the petroleum investments are value added by mainland-Norway, the rest is import. The expansion in petroleum investments therefore led to strong demand for engineers, geologist and workers to produce platforms, specialized ships etc. The oil companies' cost consciousness was poor because of the steady increase in the oil prices and because expenditure is deductible from a marginal tax rate of about 80 percent. Wages and the general costs for producing equipment and services to the petroleum sector increased strongly. This affected wages also in other sectors. The inflation was at the same time low as China's expansion caused prices on imported goods to fall, and most consumer goods are imported to Norway. High wage increases and low inflation gave high annual increases in households' real disposable income, contributing to strong growth in private consumption, house prices and residential investments.

The situation is quite different now with levelling prices

The situation is now very different when the oil prices have levelled out and declined somewhat. The oil companies cost level increased so much that the companies' profitability is back to where it was when the oil price was at USD 20-30 per barrel. Cost cutting and more careful selection of investment project is now the companies' main focus. The labor market is less tight, net immigration has come down somewhat and the wage increases seems to slow. We expect the petroleum investment survey to be published by Statistics Norway in the first part of June to indicate a decline in petroleum investments next year of about 10 %. This will be after an increase of 18 % last year, slowing to some 2-3 % this year. The swing from a growth in the petroleum investments of close to 20 % in 2013 to a decline of 10 % in 2015 will have a negative impact on growth in Mainland-GDP by some 1½ percentage points over the two years. In addition, there will be negative indirect effects via more moderate growth in private consumption and decline in residential investments.

So despite the fact that we the last months have seen some stronger than expected numbers, we consider the underlying growth rate to be between 1 ½ and 2%. Stronger than expected indicators a few months do not change the underlying situation that the oil sector in the coming years will not be the growth engine it has been the last decade.

We stick to our view of weaker growth expectations compared to Norges Bank

We stick to our view of weaker growth than Norges Bank forecasts due to weakness in housing market and oil investments. This will however need time to materialize, but when it does we think Norges Bank will have to keep rates on hold beyond 2015.

Norwegian rates: To lag global fall in rates

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Norwegian rates have been broadly stable since late last year, but two developments are worth highlighting. (1) The NIBOR fixing has moved higher and pulled the first part of the FRA strip with it and (2) the curve is bull flattening as long dated forwards are following global rates lower.

The move higher in the fixing is primarily due to a tightening in structural liquidity for the banking system (see chart 9.). We will see the low in liquidity in late May and early June. From then on it will improve again. The high in the fixing are likely to be seen in the coming weeks.

Long end bull flattening driven by global long end fall

The bull flattening in the long end of the curve is driven by the fall in global long end rates. NOK rates have so far moved in line with this move, but as chart 10 shows, the NOK long end is less volatile to the downside compared with its global peers. This is because the pension sector in the NOK markets manages a significant proportion of their assets on a hold to maturity basis and buying in the long end of the curve is to a large extent based on the need for a high coupon rather than duration. This means that this group of investors is less inclined to chase yields lower than in the markets around us.

Cross market spreads to move higher

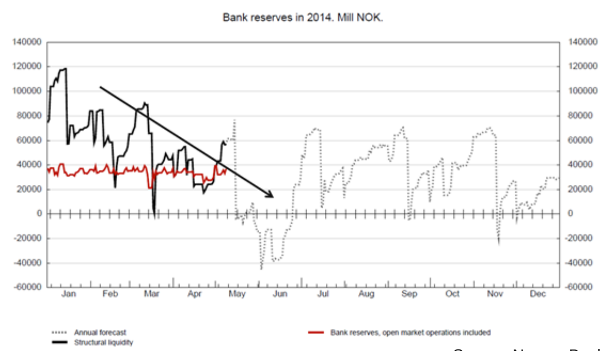
As such we think NOK rates should lag a further fall in global rates. This has two implications. (1) cross market spreads is likely to move higher in an environment with lower rates and (2) there is only limited flattening potential left in the NOK curve. Steepeners in the long end make sense for carry reasons since we think the macro economic backdrop will be soft enough to keep hike expectations away.

Large domestic investor attention to NGBs

Swap spreads have come out again in the long end of the NGB curve. NGBs finally became cheap enough to trigger demand from domestic investors. We have seen buying from domestic banks and money managers in a scale not seen for years. In a market traditionally dominated by international investors, domestic investors bought 24bn of the 31bn that has been auctioned this year.

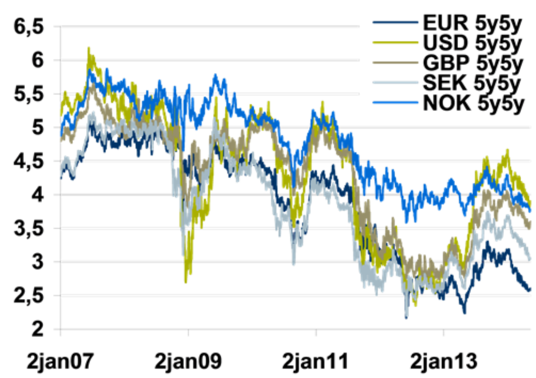
Question is how much further spreads can widen. Domestic investors have proved themselves very price sensitive and are unlikely drive spreads much wider. News that covered bonds is likely to be allowed in LCR beyond the 40% cap on level 2 assets (less demand for government bonds) and that the regional savings banks are not defined as systemically import (later deadline to meet LCR) is negative in this respect.

Chart 9. Liquidity is reaching its low in May/June



Source: Norges Bank

Chart 10. Long dated forwards. Will history repeat itself?



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EURNOK: Strong NOK-buying to turn?

Surprise in the real estate markets supports NOK

Surprisingly good news from the macro picture of Norway is the obvious motivation for the NOK-buying we have seen lately. Perhaps the most important turnaround is in the real estate market which by, especially foreigners, was seen as the biggest risk last year. The thinking was probably that falling real estate prices has been able to destroy quite some economies the last couple of years so here goes Norway down the same drain. Right now this scenario does not look too likely, even if it might be premature to conclude.

The elevated Nibor (see "Rates") has most likely also contributed to the stronger NOK. With a rate cut from ECB this differential could go further and push EURNOK even further down.

We will likely see negative flows in May

However, in the last half of May we are likely to see NOK-negative flows from several sources. We will see redemptions in EURNOK-bonds of NOK 13bln, dividend payments to foreign owners of large Norwegian corporates of NOK 12bln and NOK 7bln in coupons from Norwegian government bonds to foreign owners. As always it is hard to estimate how much of it that will be reinvested in NOK. A rebound of the drop from 8.34 to 8.12 seems quite likely.

Chart 11. Foreign investors re-entering NOK position

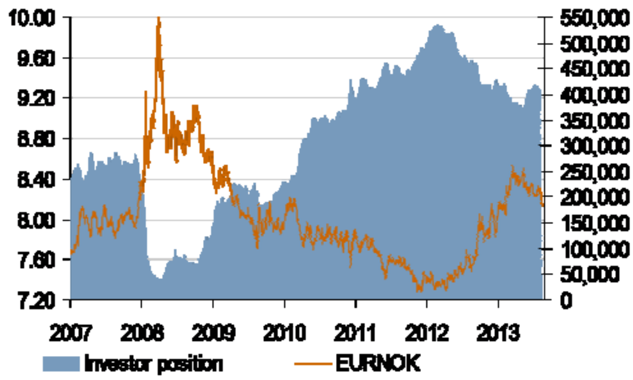

Chart 12. Macro picture, but also elevated Nibor

Denmark - A unique period has ended

An independent rate hike from the Central Bank surprised

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On 24 April the Danish central bank surprised the market by hiking the CD rate by 15bp to 0.05%. The independent hike came after a long period of DKK weakening, bringing it to the lowest level against the EUR in seven years. Data from the currency reserves later revealed that prior to the rate hike the bank had intervened to the tune of just over DKK 20bn in an effort to prevent the DKK from weakening against the EUR.

The Central Bank is on its way to normalizing monetary policy

By hiking the CD rate, the central bank ended a unique period of almost two years with negative interest rates in Denmark. At the same time the bank reduced the ceiling it puts on the current account for monetary counterparties to place their funds from DKK 67.4bn to DKK 38.5bn. By doing this, the bank took yet another step in the long process of normalizing monetary policy. The initial reaction on the FX market was a minor strengthening of the DKK, bringing it down to 7.464 versus the EUR.

The Danish central bank will let the ECB do the work

In our baseline scenario we expect the ECB to cut both the refi and the deposit rate by 10bp on 5 June. If implemented, we do not expect the Danish central bank to follow the ECB lower – thereby implicitly causing a widening of the spread to the Euro zone. The reason for this unchanged call primarily is that the DKK is still trading above its central parity of 7.4604. This leaves plenty of room for the Danish central bank to accept a further widening of the spread of money market rates between Denmark and the Euro zone. Currently EUR/DKK is trading around 7.464.

We do not expect the Danish Central Bank to follow ECB lower

On a longer horizon, we expect the Danish central bank to continue its gradual normalisation of monetary policy. This implies that the lending rate will be around 25bp above the ECB refi rate.

The most challenging scenario for the Danish central bank would be if the ECB decides to take bolder action against the strong EUR, e.g. by cutting the deposit rate by 25bp. If this takes place, we assume that the Danish central bank will be forced to follow the ECB lower. Therefore, this could give rise to an unwelcome return of negative deposit rates in Denmark.

Chart 13. EUR/DKK and Danish CB intervention

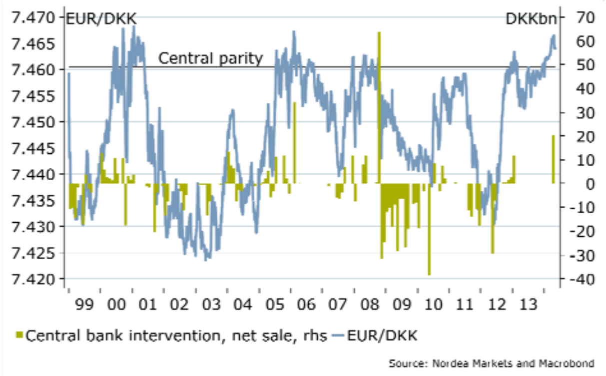
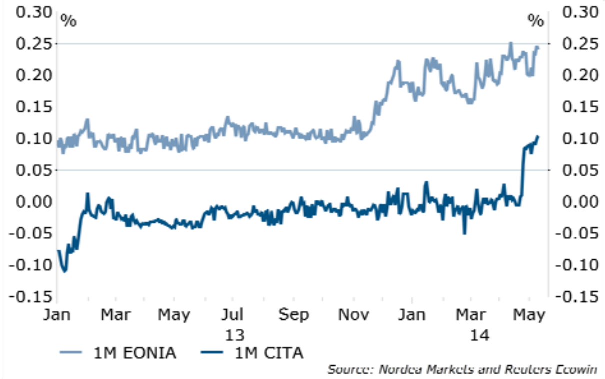


Chart 14. 1M CITA and EONIA



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Danish rates: Breakthrough to covered bonds as level 1 equates performance

Two Danish ministries Friday 5 May in a joint press release stated that the EU Commission has published a draft that will make covered bonds eligible for level 1 inclusion in LCR holdings, albeit with a limit of 70%, and a haircut of 7%. This is a major breakthrough for the segment in light of the European Banking Authority (EBA) previously having recommended a 40% limit and a hair-cut of 15% to the Commission.

The draft (and not the final rules) from here on has to be adopted by the Commission before 30 June this year. After this the Council (qualified majority) and Parliament (by majority) can then REJECT it.

The odds of making covered bonds eligible for level 1 inclusion is greatly improved

In our opinion this greatly improves the odds of it being approved.

Market sentiment had actually previously shifted from expecting a level 1 classification into expecting a level 2 classification on the back of the recommendation from EBA, which disregarded its own findings which showed that covered bonds in many instances were as liquid as government bonds.

We asses that this is the reason why we recently have seen Danish ARMs underperforming, and in our view Danish ARMs, now in light of the recent development, look cheap relative to EUR covered bond comparables.

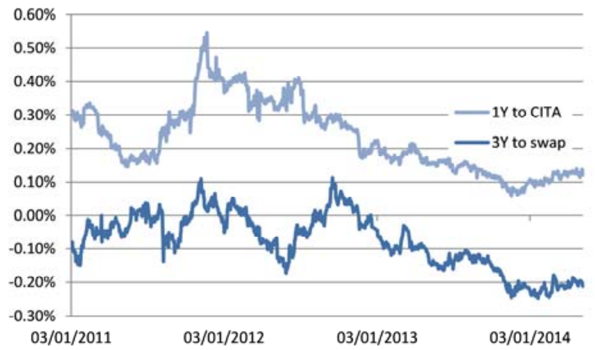
We expect performance on the back of this in Danish ARMs.

The obstacles faced have almost evaporated

We have previously done calculations that in our worst case scenario (40% and hair-cut of 15%) show that the six largest Danish Monetary Financial Institutions (MFI) could need around DKK 130bn of additional level 1 assets.

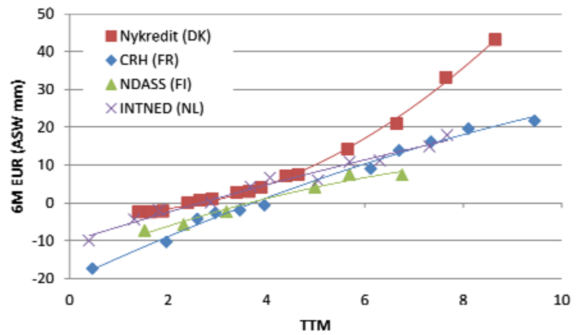
With a limit on the inclusion of covered bonds set at 70% the additional requirement of level 1 assets drops dramatically to just above DKK 20bn. In our best case scenario the need falls to DKK 1bn, if the limit is set at 70%.

Chart 15. Historical development



Source: Nordea

Chart 16. Curves



Finland – So Far Just Dreadful

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Finnish spreads widening

The Finnish bonds have taken a hit recently. In addition to a still worsening economic outlook the political risks have continued to increase.

Of the credit rating agencies S&P already downgraded the outlook for Finnish AAA rating to negative. Next in line are DBRS at 16th of May and Moody's at 6th of June. Risks are tilted to a negative surprise. If the outlook is reaffirmed, it would not clear the risk of a subsequent action later on.

Pressure on the Finnish government to finish structural reforms is growing, but ability to implement planned measures is shrinking.

Finnish economy still to shrink this year?

The Finnish economy feels the cold wind from the Ukrainian crisis. March was one of the worst export months for Finland during the last 3 years. The value of goods exports fell by 3.2% y/y while our expectation was an increase in the range of 1-4%. We expect that net exports did not boost economic growth in Q1.

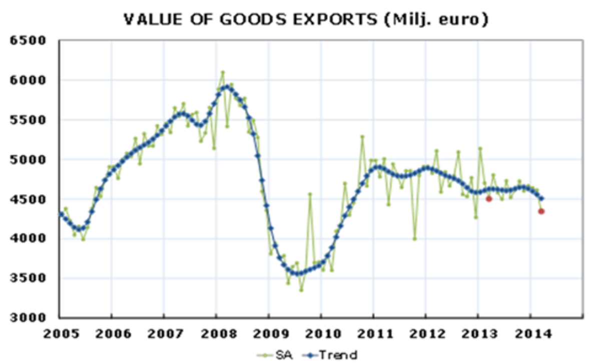
As our expectation of a Finnish recovery is based on a pick-up in exports, the numbers do not come out encouraging. Most likely the decline in Finnish GDP actually continued in Q1. Our forecast of economic growth of a sheer 0.3 % this year is suddenly looking too optimistic. Risks that the economy will not reach positive growth numbers this year are increasing.

Political risks - the sugar on top

The Finnish Social Democratic Party ousted its leader and also the finance minister, Jutta Urpilainen. The new party leader Antti Rinne is well known to be more to the left in his thinking and has criticized the policies adopted by the government. This could make it even harder to get the structural reforms to the target and bring the debt-to-GDP-ratio to a declining trend.

The government shake-up continues later in the summer as the Finnish prime minister will step down. Uncertainty on Finnish political direction together with lousy incoming economic data is likely to continue to put pressure on Finnish bonds and widen spreads.

Chart 17. March export data weak



(source: Finnish Customs, Statistics Finland and Nordea)

Chart 18. Finnish spreads have started widening and there is more room to go