Strategy Research Sweden: On the radar

This publication is a summary of interesting market related topics and observations that have been covered and discussed within the Strategy Research group, but not necessarily yet formalized in form of a specific view or trading idea…

Themes in this edition:

- Draghi flirting with QE..?
- Time for Swedish unemployment to drop more than expected..?
- Riksbank vis-à-vis Norges Bank & ECB…
- Bond yields moving away from nominal macro anchors …
- The post-financial crisis currency models still work …
- Pension sector news may affect Swedish yield curve…

25 August 2014

Draghi flirting with QE..?

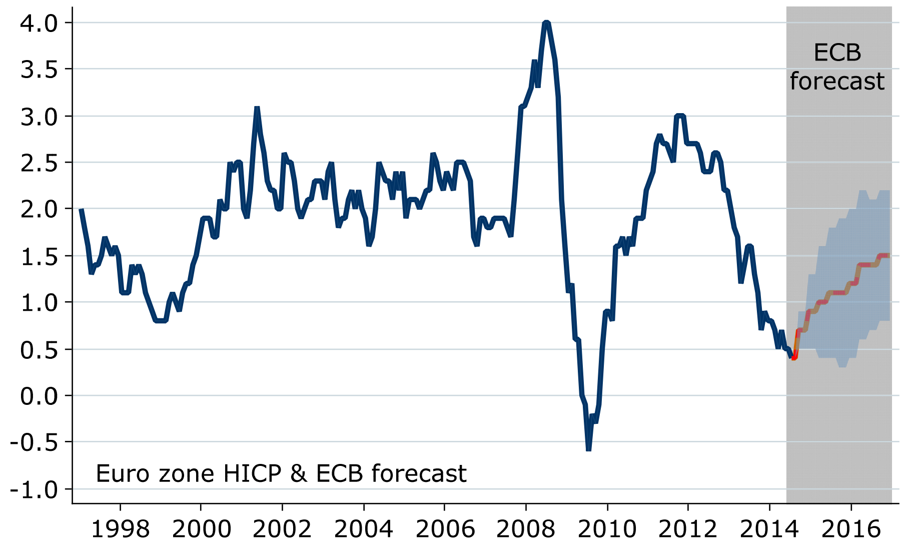
Draghi took another step into the dovish camp on Friday, saying that ***"inflation expectations [in the market] exhibited significant declines at all horizons"***. The decline in 5y5y inflation swaps below 2% was mentioned specifically.

This comes as CPI may reach cyclical lows on Friday at 0.3% (consensus). Considering the ECB´s Q2 forecast at 0.7% (quarterly average), **it once again seems as if the central bank will have to revise lower its inflation forecast**. Considering that the current end-point is 1.5% in December 2016, it cannot be lowered much further before new measures will have to be announced.

We recall Draghi´s comments from April: ***"a worsening of the medium-term outlook for inflation, which would warrant a more broad-based asset purchase program"***.

*"The 5y5y swap rate declined by 15bps, to just below 2% - **this is the metric that we usually use for defining medium term inflation**"* – Draghi, Friday

Source: Nordea Markets and Macrobond



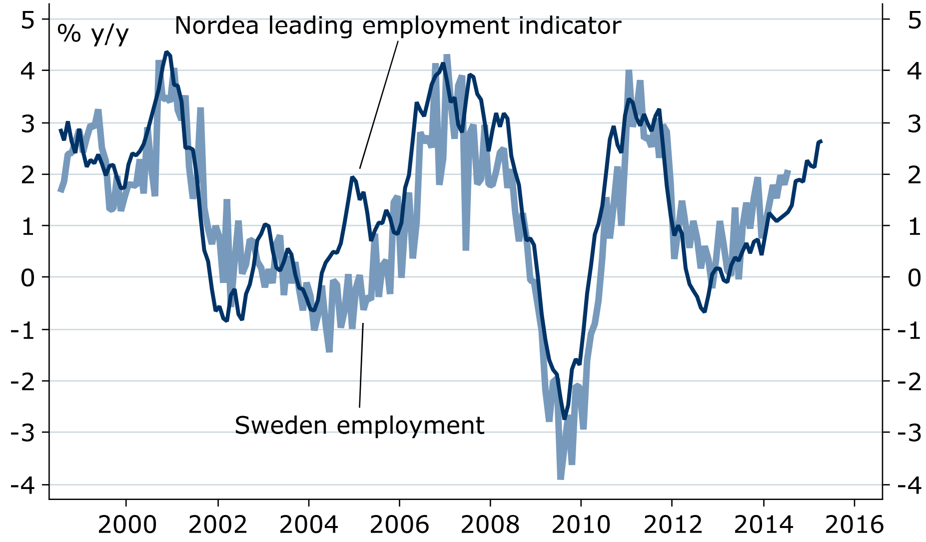
Source: Nordea Markets and Macrobond

Time for unemployment to drop more than expected?

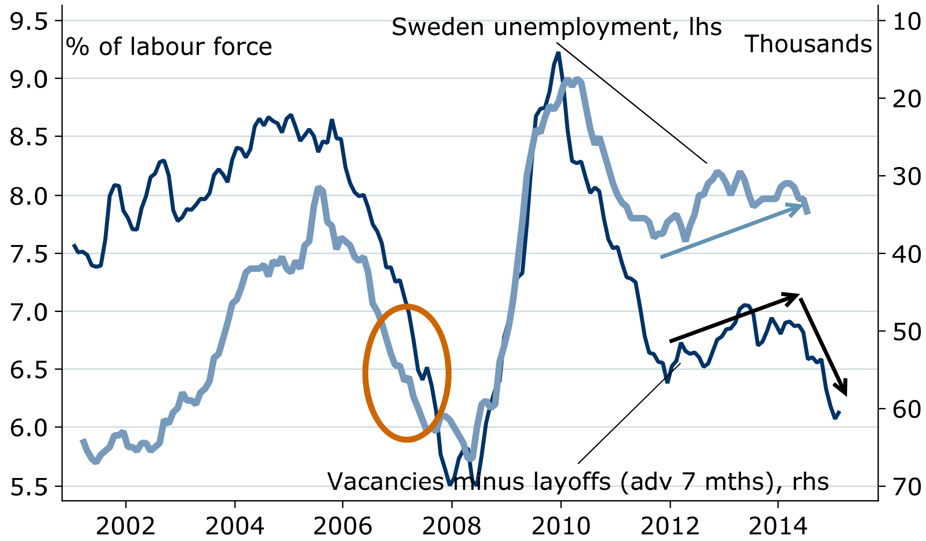
A Swedish success story is employment. **Since end 2009 it has increased 6.5%, while in the Euro Zone, it has fallen 1%**. Unfortunately, however, the more politically and media focused unemployment rate has been stuck around 8% since end 2010. The reason is that the labour force has surged as much as employment.

But it is starting to look like it might be time for unemployment to drop. Our leading indicator points to even stronger employment growth late 2014/early 2015. Also, **a large shift recently in the difference between vacancies and layoffs indicates that the lower than expected 7.7% unemployment number for July could be followed by more positive numbers**. The last time when the difference was at these levels in 2007, unemployment fell a lot faster than expected.

That said, the Riksbank focus is all on inflation and the bank cut rates by a full 50bps in July even though the labour market was in no need of such action. **Falling unemployment is also unlikely to increase inflation markedly, at least until after the next wage round, which sadly isn't due until early 2016**…

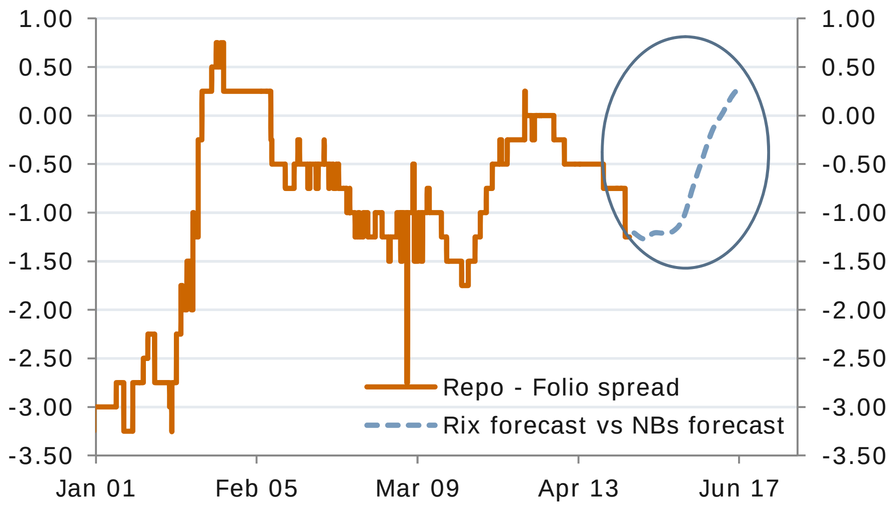


Source: Nordea Markets and Macrobond

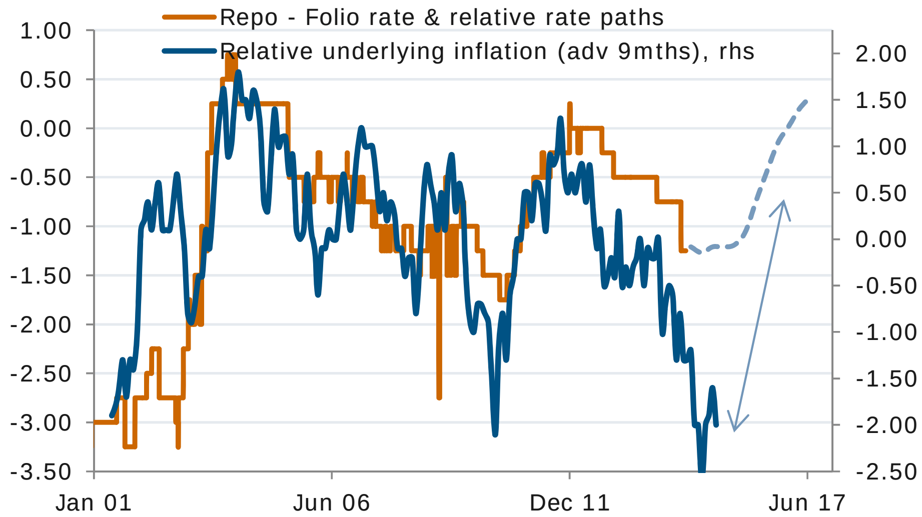


Source: Nordea Markets and Macrobond

Riksbank vis-a-vis Norges Bank



Source:Nordea, Riksbank, Norges Bank



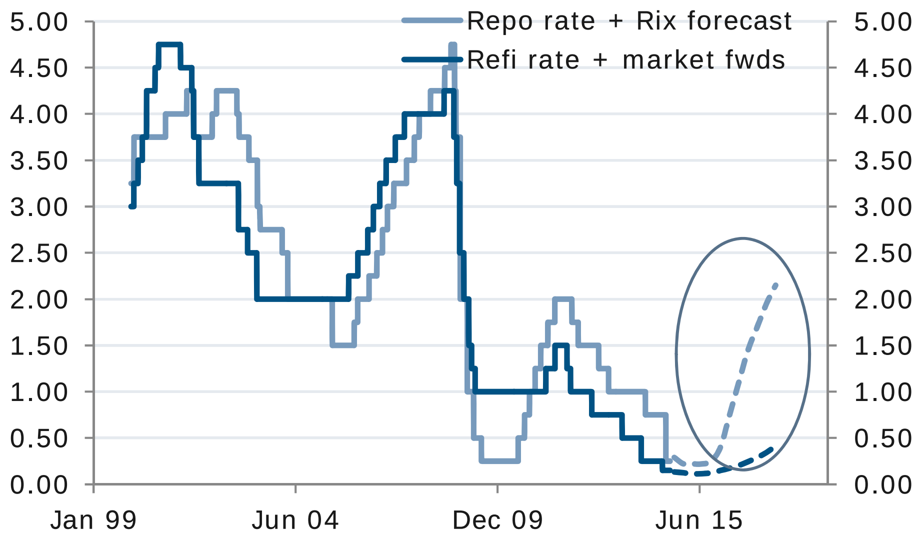
Source:Nordea, Riksbank, Norges Bank

Even considering the huge dovish step in July, the Riksbank is **still forecasting to out-tighten Norges Bank by 1.5% over the next years**, to a policy rate spread level rarely seen before. On a relative basis, that still looks like an unrealistic projection, and not least given relative inflation developments…

However, we are not expecting further gap-narrowing action by the Riksbank near-term. Instead, it looks more likely that **part of an adjustment can come from Norges Bank.** In fact, recent economic developments of key variables suggest that NB could revise higher its path of rates already on 18th September;

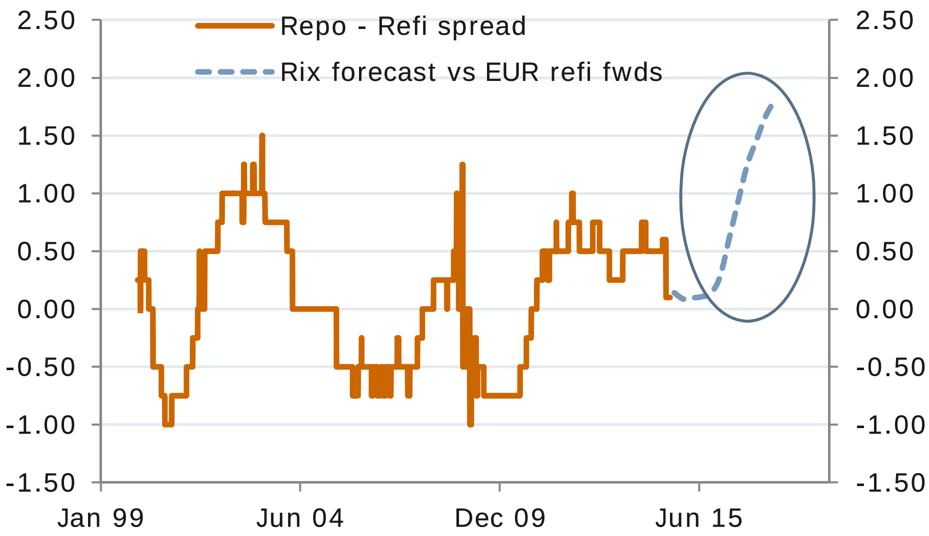
- Q2 mainland growth significantly better, at 1.2% q/q (cf consensus at 0.6%)…
- CPI-ATE surprisingly higher, at 2.6% y/y (cf consensus at 1.9% and NB at 2.2%)…
- Recent figures indicate a tightening in the labour market…
- Currency somewhat weaker than projected (I-44)

Riksbank vis-a-vis ECB

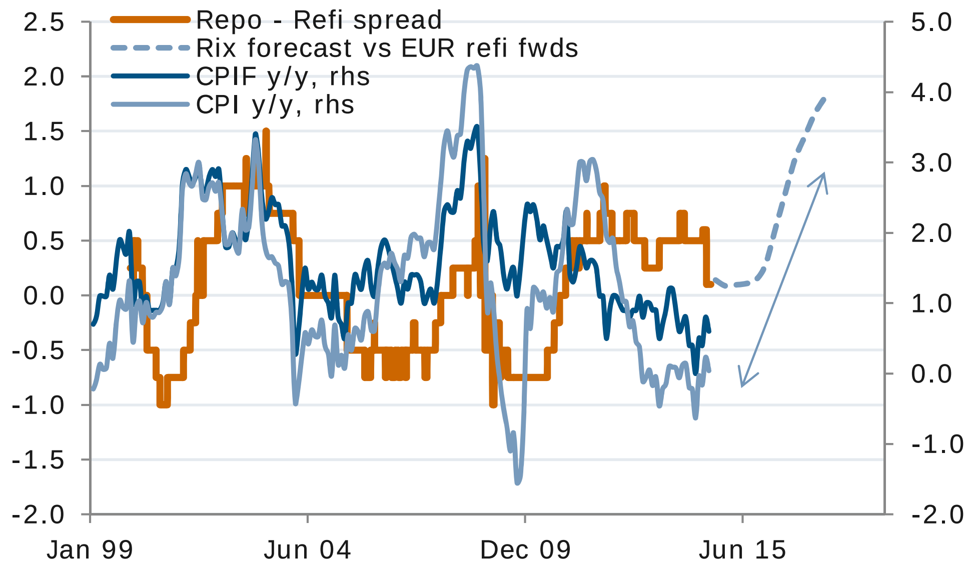


In a similar comparison betweeen Riksbank and ECB (rate path vs market pricing of future ECB policy), we can simply conclude that the Riksbank forecast continues to be **aligned with a scenario of maximum decoupling** (Riksbank to out-tighten ECB by 1.75% by 2017)…

As pointed out multiple times, that **looks like an unlikely scenario,** especially if not domestic inflation returns to, or exceed, the 2% target level…

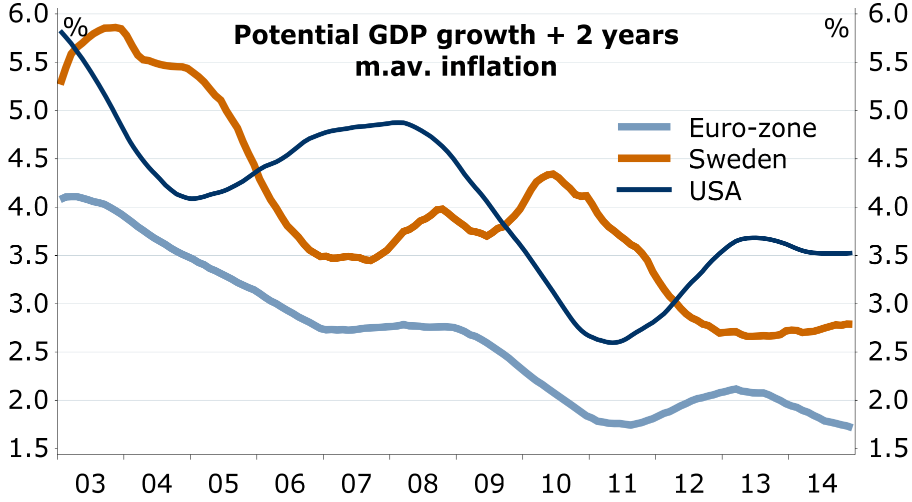


Source:Nordea, Ecowin

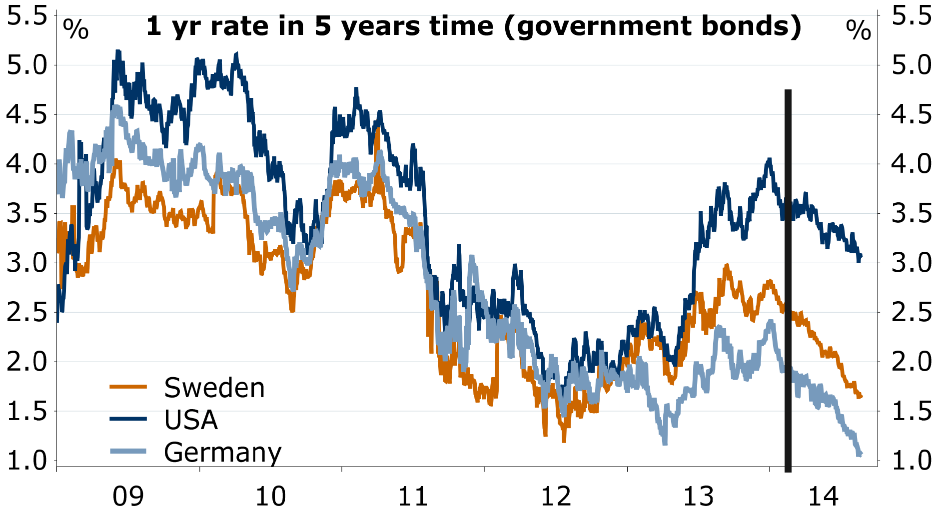


Source:Nordea, Ecowin

Bond yields moving away from nominal macro anchors

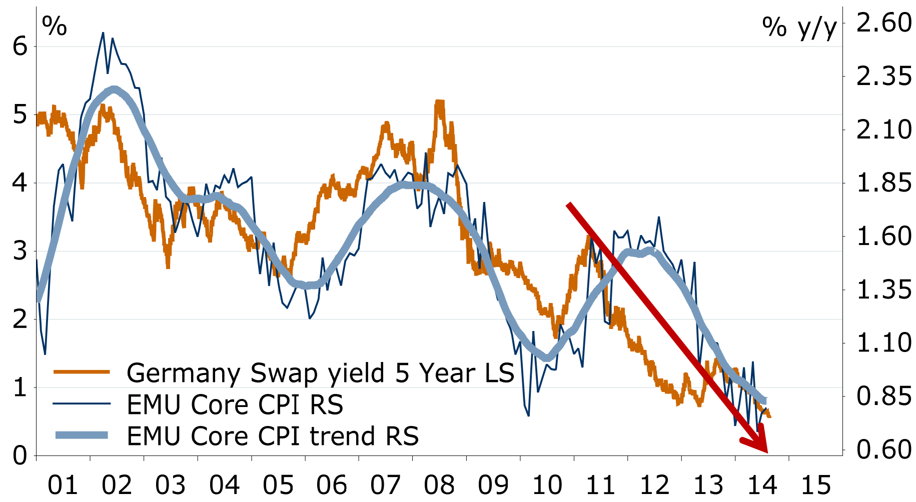


Source: Nordea Markets, CBO, NIER, EU Commission and Reuters Ecowin



Source: Nordea Markets and Reuters Ecowin

The simplest way to look at an interest rate is to split it into a real part (linked to potential growth) and an inflation part. If we look at these macro variables – what interest levels make sense? Add potential growth, USA 1.7%, Sweden 1.9% & EMU a horrendous 0.7% (according to public sources), to the inflation trend. Then we get **"nominal anchors" of 3.5% for USA, 1.8% for EMU and 2.7% for Sweden. Bond markets agreed to these numbers early 2014** according to the policy rate levels discounted in 5 years' time, **but don't anymore**. Why? Geopolitical risks. But also signals that the Riksbank (and ECB) **"only" care about the inflation side of the policy rate. So bye, bye nominal anchors until the inflation trend changes in EMU**.



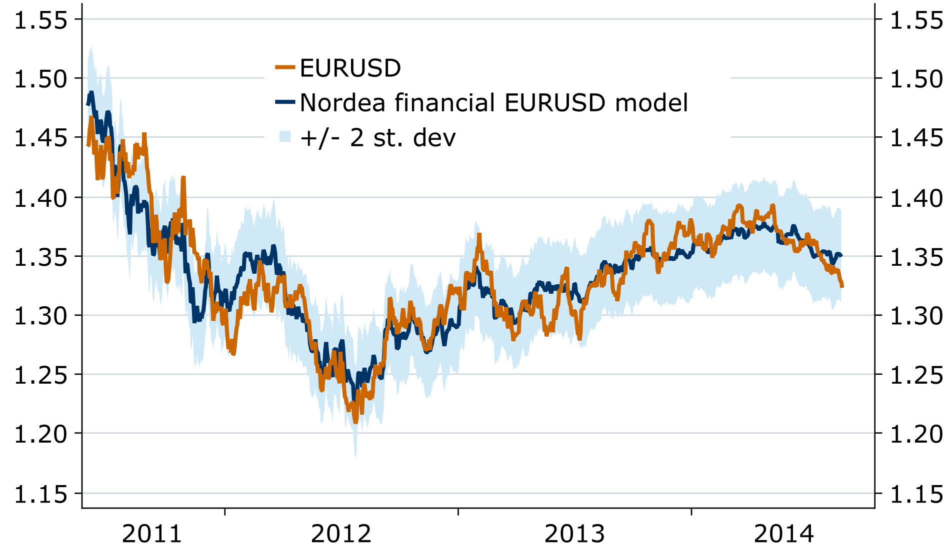
Source: Nordea Markets and Reuters Ecowin

The post-financial crisis currency models still work

At a glance, it seems like the FX market listens and acts according to ECB-chief Draghi's wishes. His classic "whatever it takes" speech turned the euro trend in 2012. And this spring's Draghi statements, that the euro was too strong, marked yet another trend change. Oh mighty Draghi…

Another way of seeing it, however, is that the same factors that explained the euro level before the Draghi-speeches still works perfectly well today. Our EURUSD-model is based on peripheral spreads, stock market volatility, relative monetary policy expectations and economic surprises. The EURUSD move since this spring is here explained mostly by the changed relative monetary policy expectations by the market.

The post-financial crisis EURSEK model also still seems to work just fine. The main weakening SEK-force since mid-2012 has been the Riksbank's increasingly loose policy stance. **The EURSEK-model is currently just north of 9.00. Our short-term view, however, is that the SEK should stay weaker than the model implies** on the back of continued Riksbank dovishness and an unclear election outcome (see our *Riksbank preview*).



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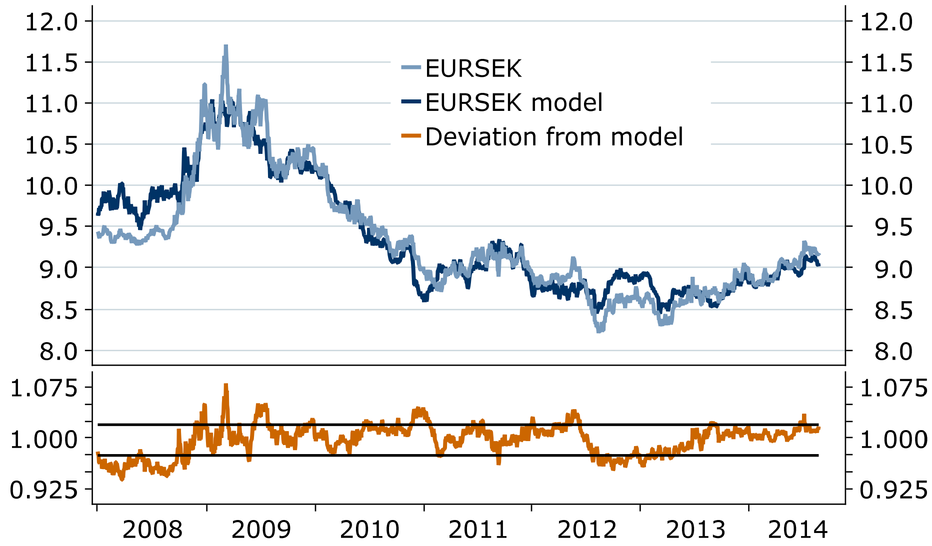

Source: Nordea Markets and Macrobond

Pension sector news may affect the Swedish yield curve

On 27 August, new information that concerns the Swedish pension sector arrives. This could potentially be a factor for higher long-end rates and a steeper yield curve.

In March 2013, the government started a commission into the legislative framework around Swedish IORPs (**I**nstitutions for **O**ccupational **R**etirement **P**rovision). After many delays, the result will finally be presented on 27 August. Among the things that the commission was set to investigate was the rules concerning solvency and **how existing life insurance companies would be able to put some of their existing liabilities into IORPs, thus being subject to less restrictive solvency and liability matching legislation**.

According to European law, life insurance companies and IORPs should have different solvency rules, but Sweden has so far chosen to let both type of pension companies be subject to more or less the same conditions. The reason for this has been that the Swedish FSA has put a higher priority of levelling the playing field between Swedish pension companies rather than levelling the field between Swedish IORPs and European IORPs. As a consequence, **Swedish IORPs have had stricter regulation than European peers**.

The legislative environment for Swedish IORPs has been incomplete for several years; for example new IORPs have not been able to start up. **As the commission presents it´s work, it might very well suggest that Swedish IORPs should follow European standards (and there are good arguments for this) and thus less liability matching might be the case**. The commission might very well open up for existing life insurance companies in the future, to be able to offer their customers better return through letting part of their liabilities to be run by an IORP instead of a life insurance company.

There are many additional steps to take before any concrete change of regulation is at hand, and the whole solvency issue in the pension sector is much less stressed now, as equity markets are rallying. Nevertheless, it is well worth keeping the 27 August date in mind. **If anything, the risk is skewed for a watering down of pension legislation and thus for higher bond yields and a steeper curve.**

Thank You!

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