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:

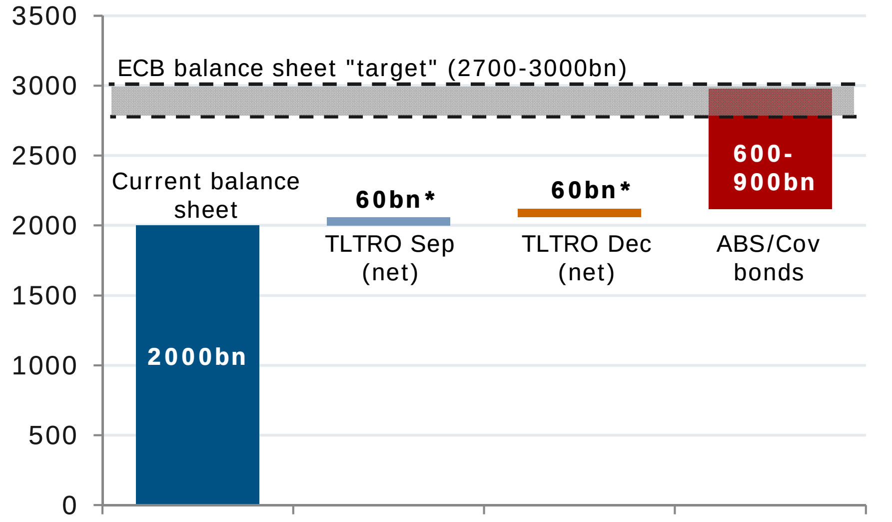
- ***ECB:*** *Draghi backed into a corner*
- ***Fed:*** *Connecting the dots – where is Yellen territory?*
- ***Sweden:*** *Election status, between a rock and a hard place*
- ***Riksbank:*** *A new Riksbank…or maybe not?*
- ***Riksbank:*** *In the light of other central banks…*
- ***SEK front-end:*** *One way of playing a rate cut*
- ***SEK swaptions:*** *Minutes increase value in receiver steepeners*

22 September 2014

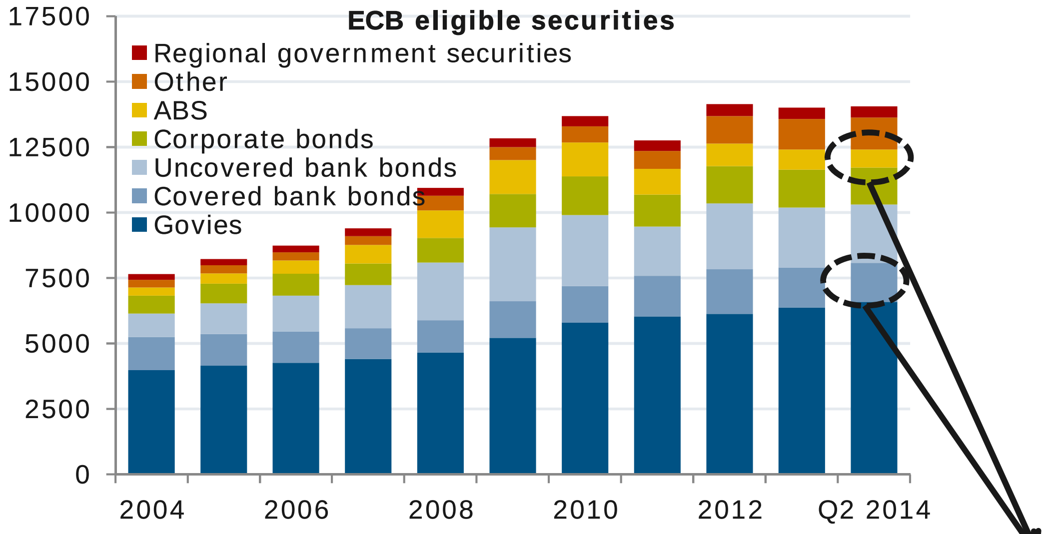
Markets

ECB: Draghi backed into a corner

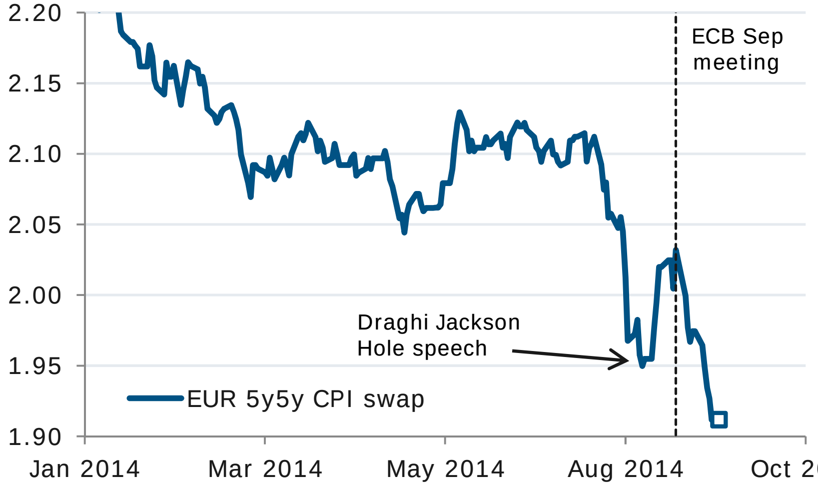
Last week´s first TLTRO operation must have been seen as a disappointment by the ECB. 82.6bn was taken out of a maximum 400bn and a consensus of 130-150bn. Only 255 banks participated, less than half the number that participated in the 3y LTROs. One could have a quality vs quantity approach and argue that the amount was low due to core banks not using the operation or hesitation ahead of the AQR/stress test announcement, but that doesn´t solve the ECB´s balance sheet problem, *"The second aim is to steer, significantly steer, the size of our balance sheet towards the dimensions it used to have at the beginning of 2012"* (Draghi ECB Sep meeting). Add to that the 5y5y CPI swaps below Jackson Hole levels and pressure on the ECB to do a large-scale QE program should have increased. For our economists´ view, see ***"First TLTRO: Considerably less than it takes".***



*Estimates | Source:Nordea



Source:Nordea & Macrobond



Source:Nordea & Bloomberg

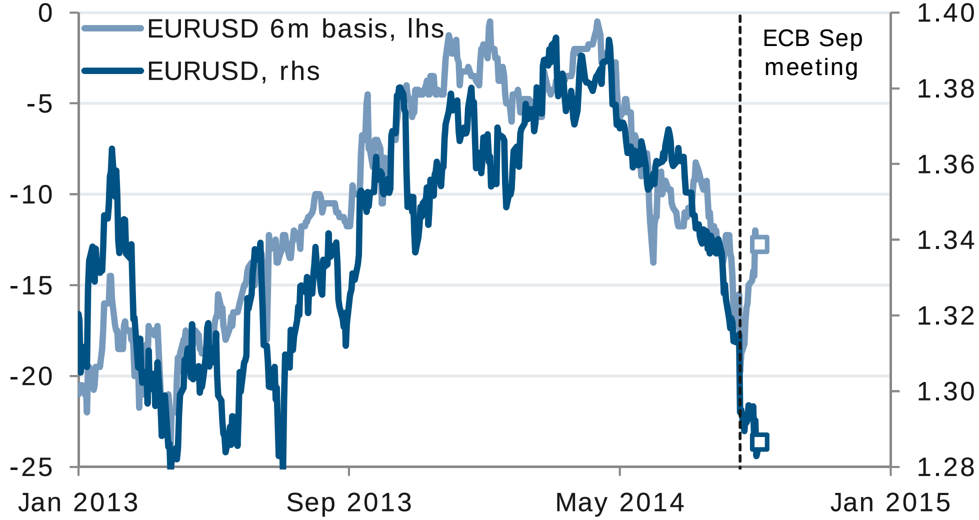
	Cov bonds	ABS
Eligible securities	1500	700
Collateral at ECB	360	300
=	1140	400

ECB: Draghi backed into a corner

Even if one should not be too quick in calling last week´s TLTRO uptake a failure, adding the 5y5y CPI swap move, market expectations for increased ECB easing either through QE or more aggressive ABS/Cov bond programs should pick up…

… Still, short dated EURUSD basis has tightened since the ECB´s Sep meeting, a move that has caught our attention after easing measures were introduced and after last week´s disappointment that could put more pressure on the central bank to act in larger scale.

In addition, considering the deposit cost at the ECB (-20bps) vs Fed´s (+25bps), and including recent basis move, it looks increasingly attractive for euro banks with excess cash to deposit money with the Fed rather than the ECB.



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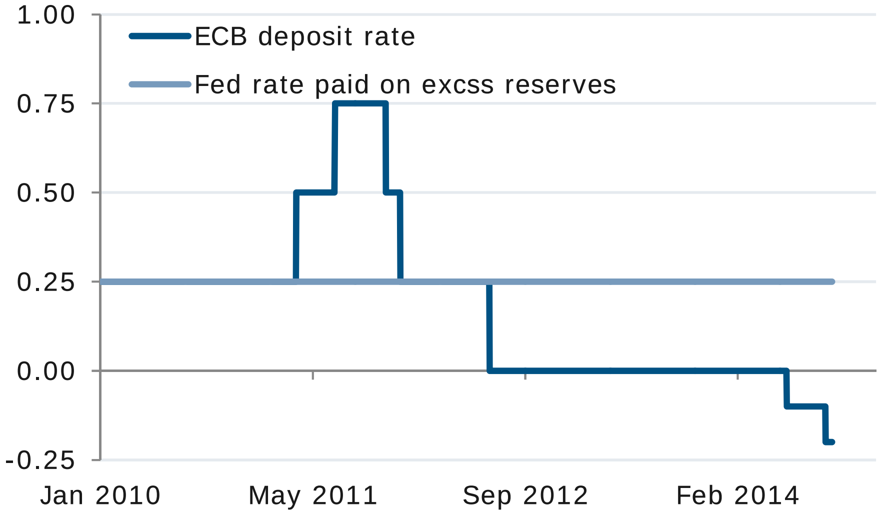

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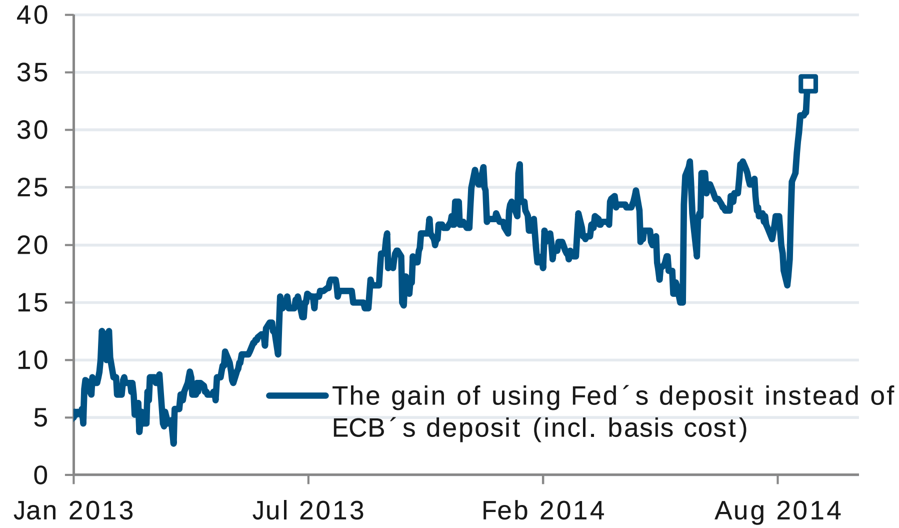


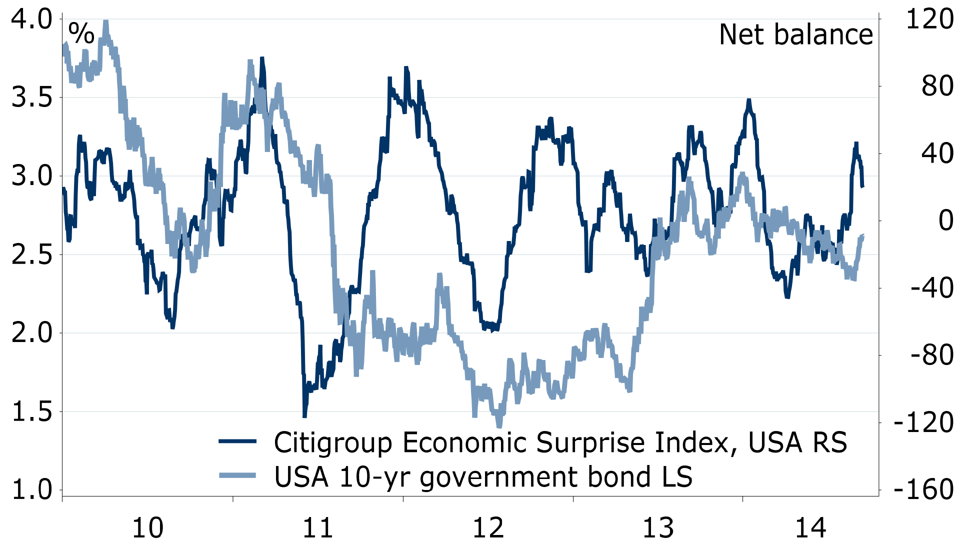
Source:Nordea & Bloomberg

Connecting the dots – where is Yellen territory?

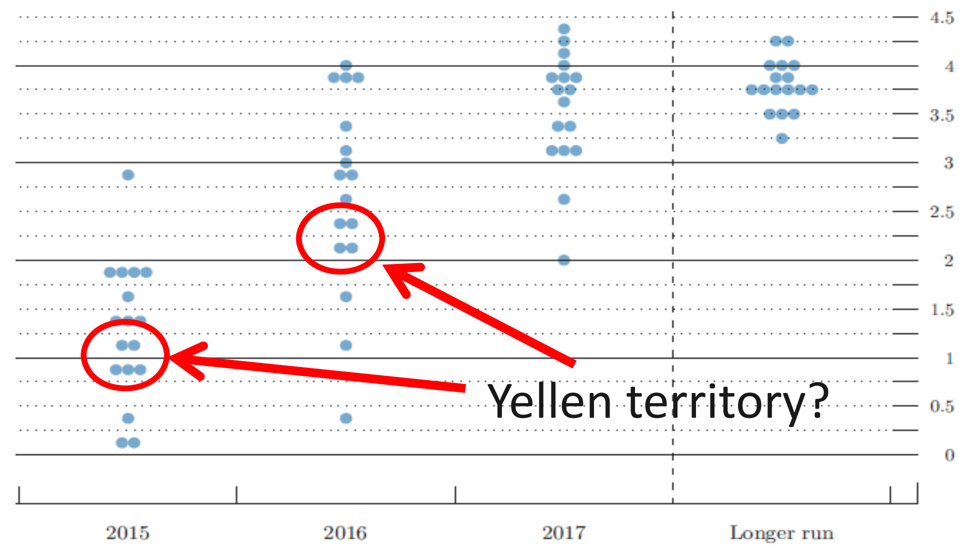
In the 8th of September edition of On the Radar, we **asked ourselves if also US bond yields had stopped caring about the business cycle**, in line with the Euro-zone/Sweden experience. Or, if it simply was an accident waiting to happen? There had been a series of positive data surprises but 10 yr yields were up only 10 bps compared with 40-50 bps in similar situations in the past. We are happy to notice that it seems the latter was true – **the 10 yr yield was up at least 30+ bps from the bottom last week**. **So there is still hope for elderly fixed income strategists…**

This was despite that the Federal Reserve failed to remove "considerable period" from its statement, but helped by them raising the median Fed funds projections. At the same time, it was quite **clear from the press conference that Yellen didn't want markets to view the revised projections as a signal**. She has repeatedly sounded more dovish than the median view, which opens for an interesting question – where is Yellen territory in the Fed's dot chart?

It should be lower than the median, but hardly at the very bottom. So maybe it's around dot #4 to #7? That's not too far away from the fed funds future curve out to 2016. Dec 15 is at 0.78% and Dec 16 at 1.87%. **Yellen territory is maybe slightly higher than the market, but will she care until wages accelerate more clearly?**



Source: Nordea Markets and Reuters Ecowin



Election status: between a rock and a hard place

”Löfven is making a big mistake”, said Left party leader Jonas Sjöstedt when he and the Left party was dismissed under humiliating circumstances as governing material by the Prime Minister to be the day after the election. And the quick reply was that “the Left party is now to be viewed as part of the opposition”.

To gain budget support from the left, the Social Democrats (and most likely the Greens) “will have to make large concessions” was the throw back from Jonas Sjöstedt. He was referring to the stop to profits in parts of the welfare sector, otherwise the party would not cooperate on the budget.

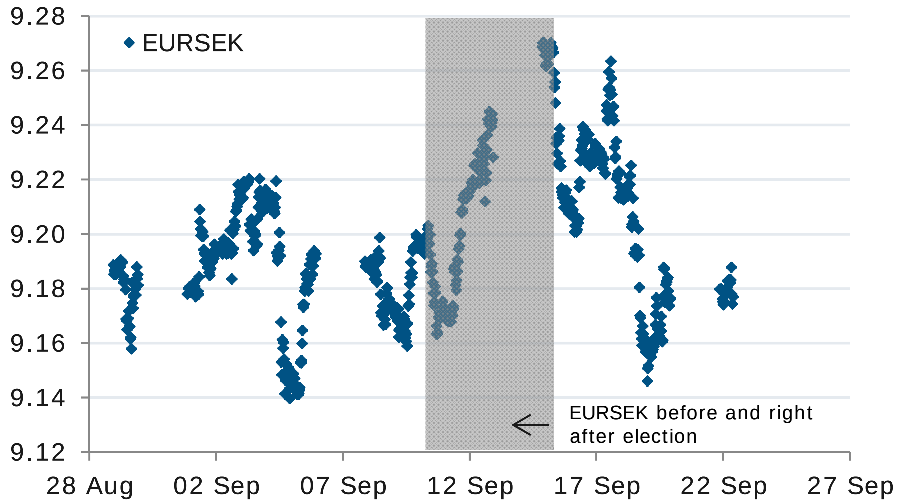
This short term issue needs to be resolved for Löfven in order to move ahead (to be elected Prime Minister and get a budget proposal through Parliament) since there is no bargain to be made with the alliance parties at this point.

The Alliance, on the other hand, will need a guarantee from Löfven that he has a parliamentary majority in order to vote for him as Prime Minister on 2 October. See the Nordea comment – ***“Parliamentary nightmare - what happens now?”***

The political future will be defined by a case by case minority Government rule with myopic vision and short term survival as a strategy.

At this point, we do not see the potential for a stable parliament in the next four years but the institutional set-up with a balanced budget approach makes no case for four years of financial anarchy.

The political risk premium in the SEK is overshadowed by the positive revision to Q2 GDP as the EURSEK came down in the later part of last week. Although we do believe that the political risk premium will continue to exist under current siren and weigh on the krona in the near future.



Source:Nordea & Bloomberg

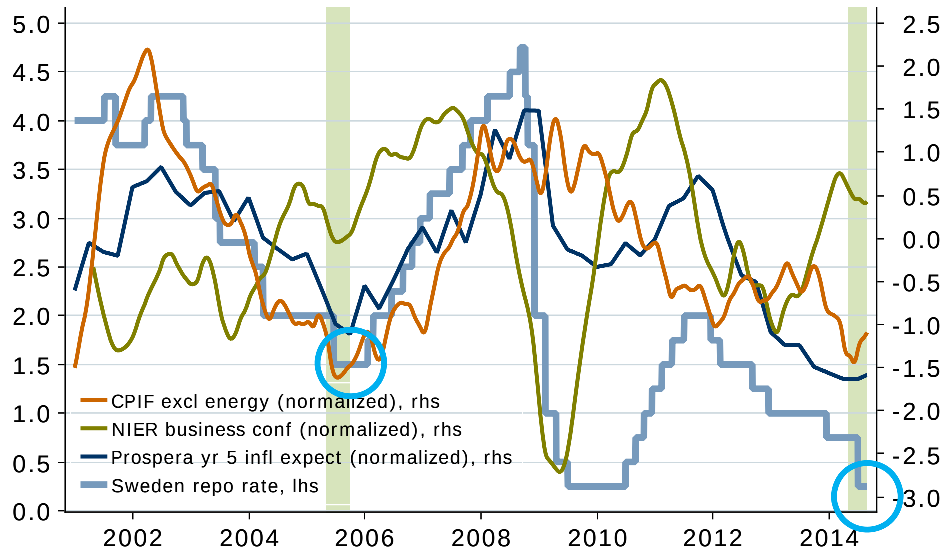
A new Riksbank… or maybe not…

Do we have a new Riksbank? A **case can be made that the "flexible" part of the "flexible inflation target regime" has been ditched and replaced with "strict"**. But in a more mathematical than emotional analysis – is it really true?

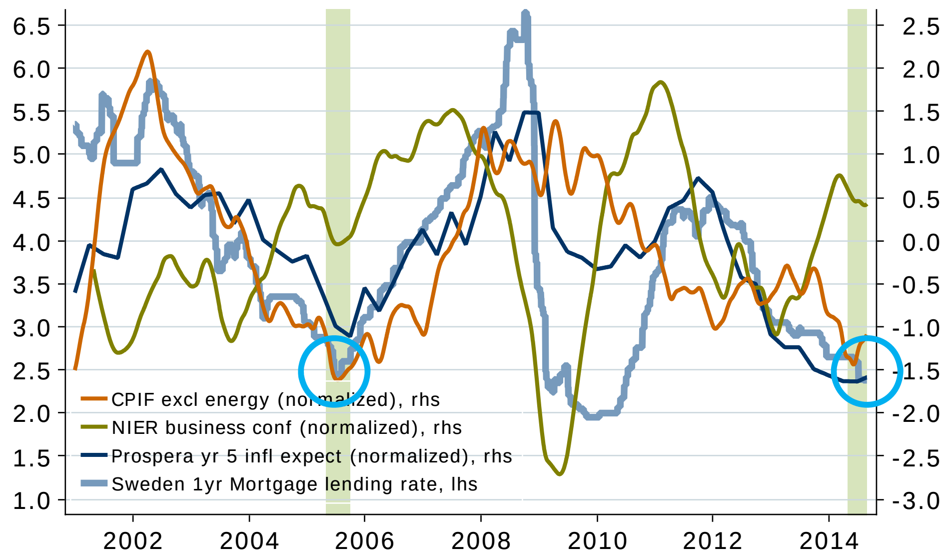
At a first glance it seems so. If we use 3 basic time series for Riksbank analysis - CPIF excl energy, NIER business confidence and Prospera inflation expectations – and **compare them with 2005, Sweden is in a similar situation.** CPIF excl energy looks exactly like then and even bottomed at a lower rate in 2005. Business confidence is slightly higher today while inflation expectations are marginally lower. **However, the repo rate is a staggering 125 bps below 2005 and could even go lower**. Yes! Mathematical proof that we have a new Riksbank! Or…

Let's look at the same chart again but change the repo rate to a 1-year mortgage lending rate. Suddenly we haven't got a new Riksbank. **The lending rate is at the same level as in 2005. Thus, the Riksbank has been forced to lower the repo rate more to reach the same stimulus effect as we had in 2005**. So, we guess we still have the old Riksbank.

Actually, we don't know. When and how fast they raise the repo rate will be the deciding votes in this never-ending story. And 2015 looks like a very interesting chapter…

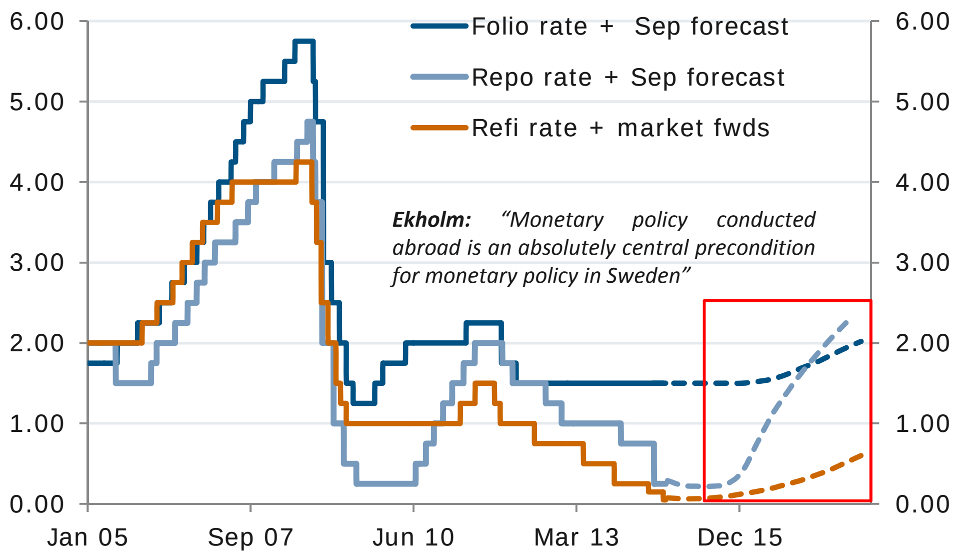


Source: Nordea Markets and Macrobond



Source: Nordea Markets and Macrobond

Riksbank, in the light of other central banks



Source:Riksbank, ECB, Norges Bank, Ecowin

Since the previous rate meeting on 4th of Sep, both ECB and Norges Bank have come out with new information. While the former surprisingly decided to cut the refi rate down to 0.05%, and launch a credit easing program, the latter found reasons to be somewhat more optimistic on the domestic economy (following strong data in the summer), which resulted in a deletion of the near-term easing bias. This was less dovish, but at the same time, the rate path was revised lower further out and the first rate hike pushed out to Q1-17.

As the chart on this page very clearly illustrates, the Riksbank continues to have a rate forecast that very much looks like an upside risk scenario rather than a base-line one. This systematically built-in decoupling assumption is also something that clearly begins to bother several Riksbank board members, which we learned from the Minutes. So, what ECB and Norges Bank did just highlight the urgency to revise lower its path of rates, if credibility is prioritized.

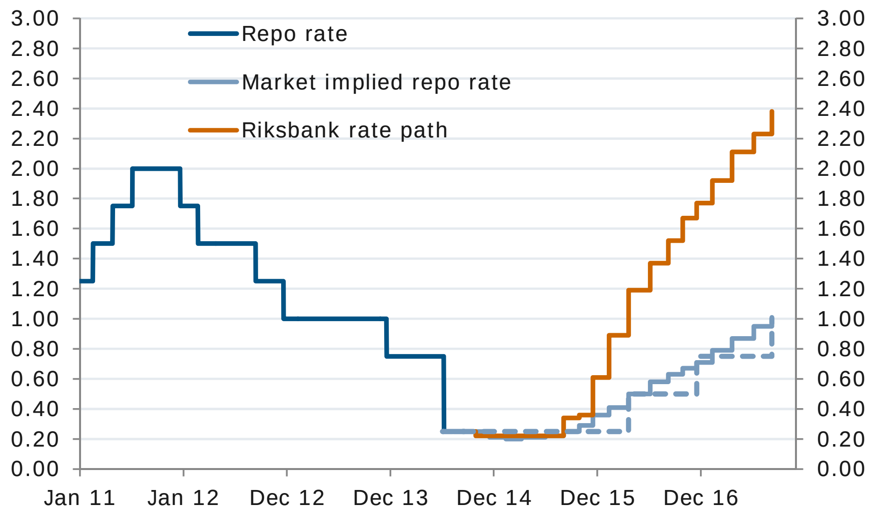
Since the inaugural path in Feb 2007, the path has been revised lower (>10bps) 13 times, of which 10 has also come with a rate cut and in the remaining 3 the repo rate has been cut at the next meeting…

The key question is then how the bank would tackle it? A large revision over 1 or 2 meetings together with another rate cut, or small revisions in gradual steps without changing rates? Historically, the bank has preferred to cut rates in conjunction with much smaller revisions than what looks necessary today (see table below)…

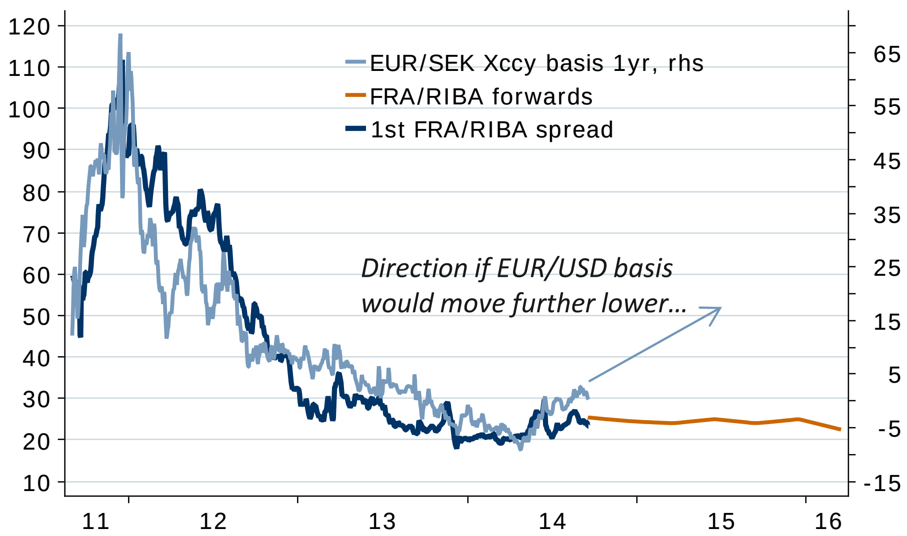
Historical downward revisions of the Riksbank rate path (since the inaugural path in Feb 2007)

	23 Oct 08	04 Dec 08	11 Feb 09	21 Apr 09	07 Sep 11	20 Dec 11	16 Feb 12	06 Sep 12	25 Oct 12	18 Dec 12	17 Apr 13	17 Dec 13	03 Jul 14
Repo rate	-0.50	-1.75	-1.00	-0.50	0.00	-0.25	-0.25	-0.25	0.00	-0.25	0.00	-0.25	-0.50
2nd q-avg	-1.31	-1.44	-1.14	-0.41	-0.25	-0.31	-0.22	-0.17	-0.07	-0.20	-0.02	-0.22	-0.44
6th q-avg	-1.26	-1.14	-1.27	-0.38	-0.49	-0.65	-0.27	-0.23	-0.08	-0.21	-0.39	-0.55	-0.80
10th q-avg	-0.82	-0.81	-0.62	-0.22	-0.38	-0.45	-0.23	-0.23	-0.24	-0.10	-0.13	-0.35	-0.70

One way of playing a rate cut



Source:Riksbank, Nordea, Bloomberg



Source: Nordea Markets and Macrobond

So clearly, from the previous page we learned that another large downward revision is on the cards, something **which markets already discount** to a large extent (125bps lower end-point). However, in relation to this, rate action at the October or December meetings is something **the market price in to a lesser extent**.

If they would cut again, it would mean cutting the repo rate to an unprecedented level. An exact number is a pure guessing game in this perspective, but our best guess would be to target an alignment to the ECB level at 0.05%...

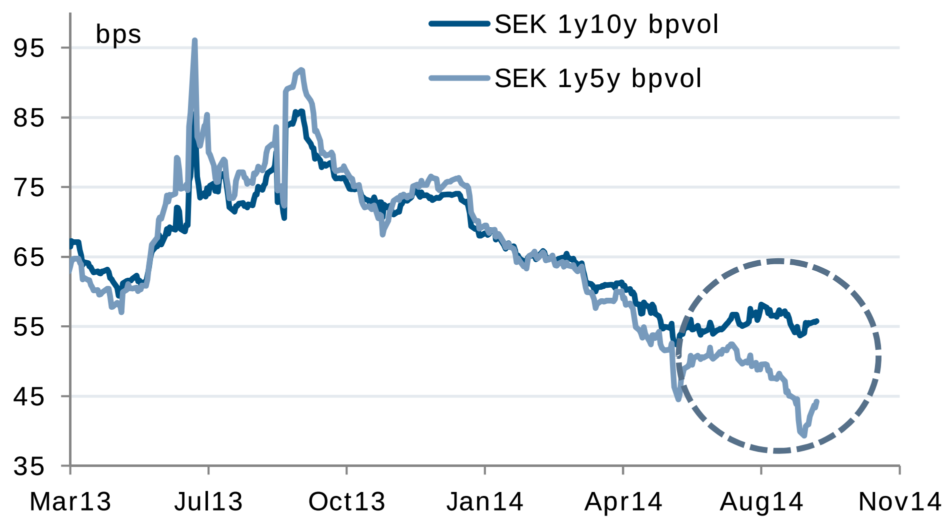
In such an event, on either the October or December meeting, the downside in Mar'15 RIBA is some 15bps. At the same time, we see less potential in 3m Stibor to come down. Fixings have been a bit more sticky recently (following moves in EUR/USD and EUR/SEK Xccy bases) and turn-of-the year effects and further regulatory initiatives could create pockets of tension.

As such, we see value in receiving Mar'15 RIBA against paying Mar'15 FRA at current tight levels, which would be one way of capturing another possible rate cut by the Riksbank and a position that is unlikely to suffer if that never happens.

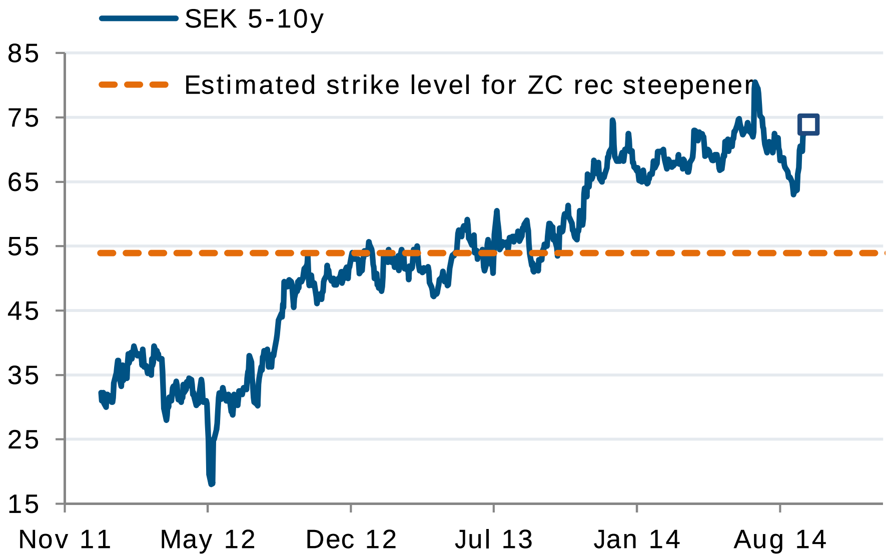
For those looking to capture the combination of higher global rates and a late cycle Riksbank rate cut, consider receiving Mar'15 RIBA against paying a later FRA (such as Mar'17)

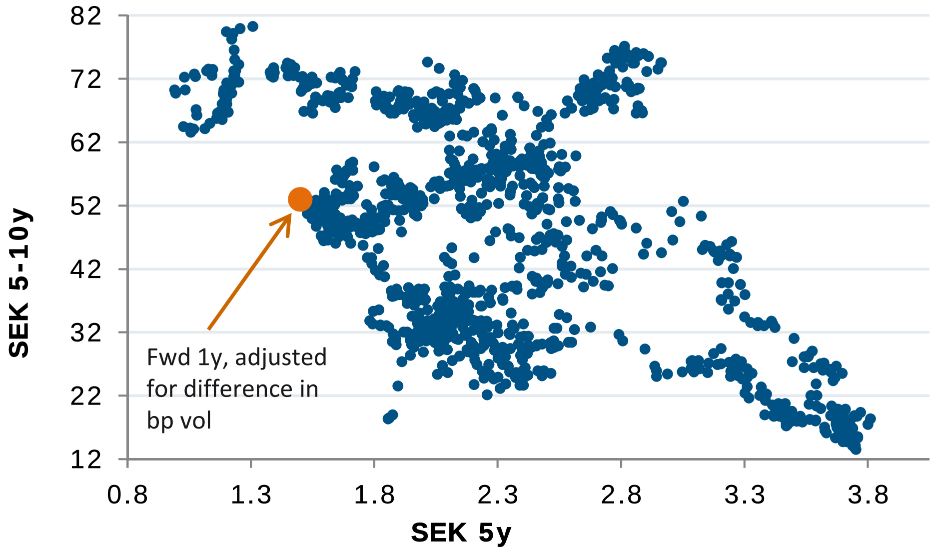
Riksbank minutes increase value in receiver steepeners

SEK 5-10y curve more than 10 bps flatter 1y fwd than spot, bpvol in 1y10y around 10 bps higher than in 1y5y. We like buying an atmf 1y5y SEK receiver vs selling an atmf-10 bps SEK receiver at close to zero-cost…



Source:Nordea Markets





Thank You!

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