



Strategy Research Sweden: On the radar

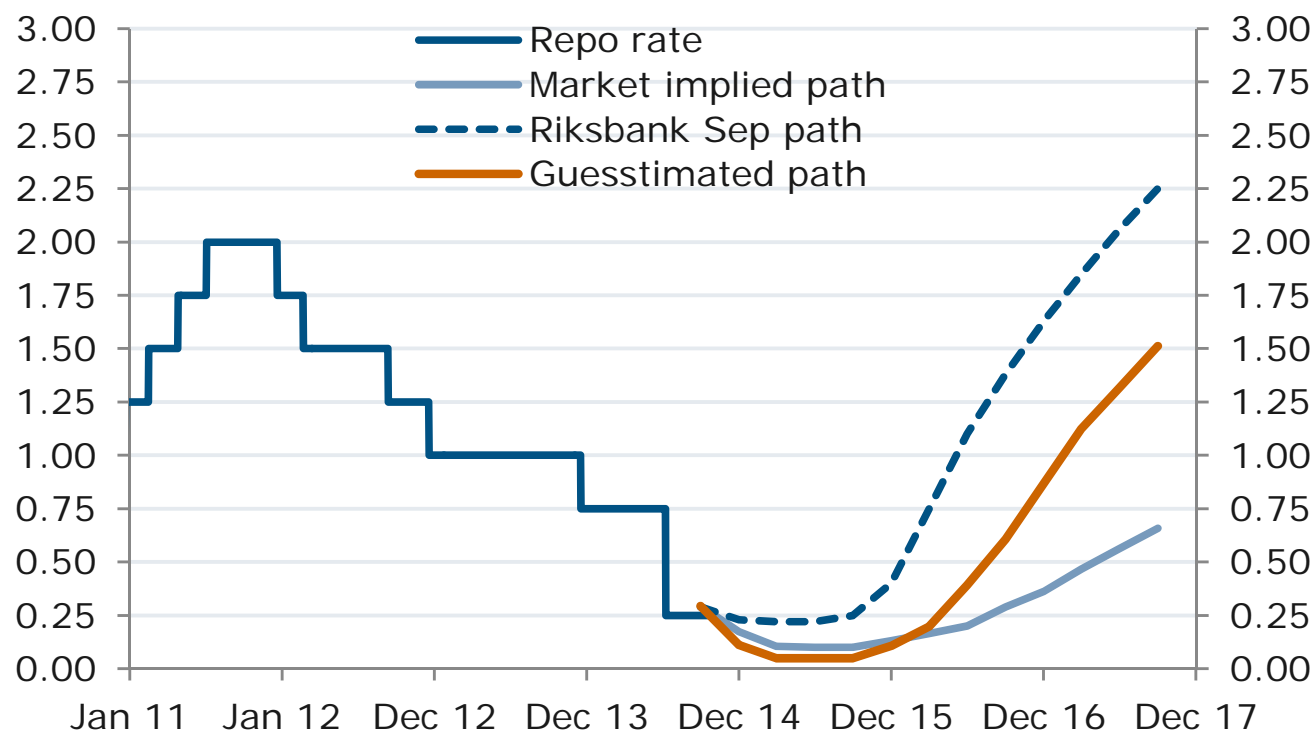
This publication is a summary of interesting market related topics and observations that have been covered and discussed within the Strategy Research group, but not necessarily yet formalized in form of a specific view or trading idea...

Themes in this edition:

- ***Riksbank:*** how will the new rate path look like?
- ***Swedish macro:*** a small open economy. Watch out below!
- ***SEK spread-over:*** perspectives on spreads vis-à-vis the risk sentiment
- ***SEK rates:*** liability hedging less of a driver in SEK long-end
- ***EUR rates:*** Schatz spreads and the AQR/stress tests

20 October 2014

Chart of the week: a cut and large downward revision on the cards for the Riksbank



Source: Riksbank, Nordea, Bloomberg

Following a rate cut down to 0.05-0.10%, our guesstimate is that the rate path will be lowered by around 75bps in 2016 and 2017, leaving the terminal rate at 1.50%. That is still notably less than what markets price in and the risk is skewed towards a larger revision (see more on page 3...)

Riksbank: how will the new rate path look like?

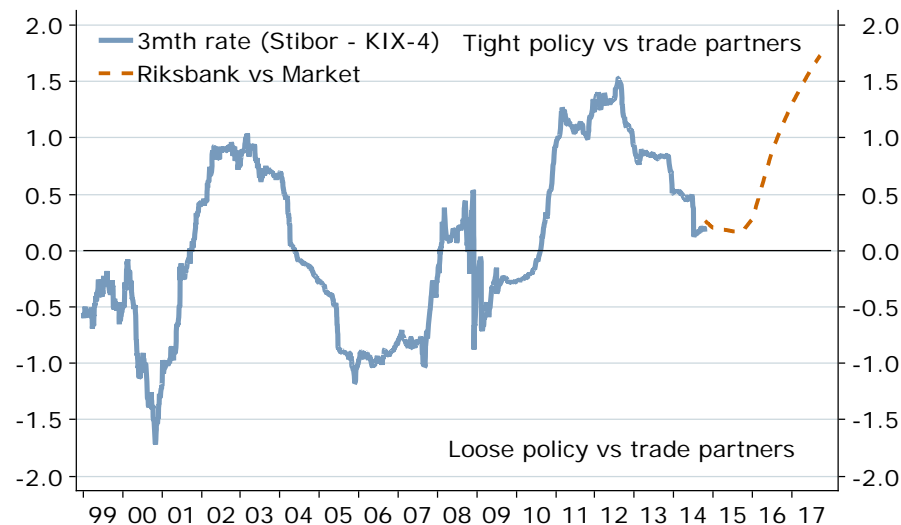
Due to the following factors, the Riksbank is likely to cut rates and sharply revise lower the rate path on 28 Oct:

- *ECB cut to 0.05% and launched a credit easing program*
- *Concerns around the growth story and Riksbank is too optimistic on growth in 2015 (e.g. Swedish at 3.0%)*
- *The recent inflation outcome was yet another shocker and a whopping 0.4% y/y below the forecast*

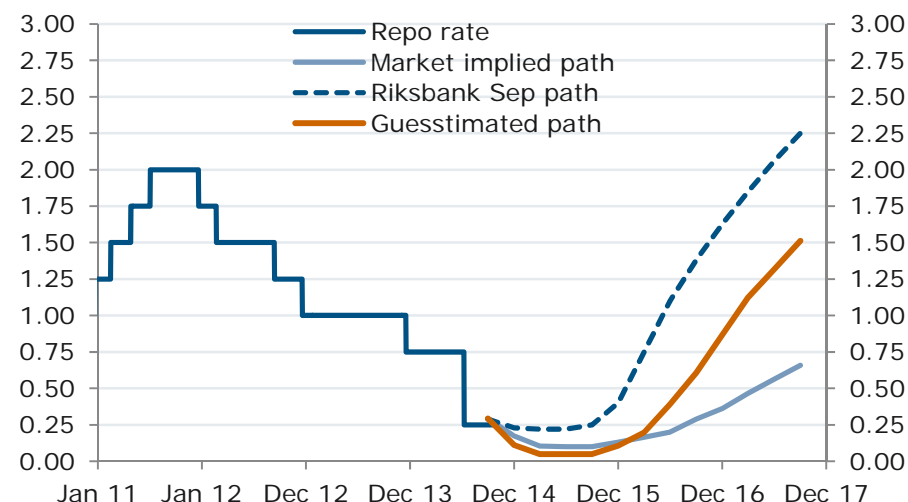
The **rate path looks obsolete** in a comparison with neighbouring central banks and needs yet another sharp adjustment. Following a rate cut down to 0.05 – 0.10%, our guesstimate is that the **rate path will be lowered by around 75bps in 2016 and 2017**, leaving the terminal rate at 1.50%. That is still notably less than what markets price in and the **risk is skewed towards a larger revision, both at this meeting and going forward..!**

Rate path quarterly averages				
Q-average	Market	Sep path	Oct path	Diff
Q4-14	0.18	0.23	0.11	-0.12
Q1-15	0.13	0.22	0.05	-0.17
Q2-15	0.13	0.22	0.05	-0.17
Q3-15	0.13	0.25	0.05	-0.20
Q4-15	0.18	0.40	0.11	-0.29
Q1-16	0.22	0.75	0.20	-0.55
Q2-16	0.28	1.10	0.36	-0.74
Q3-16	0.38	1.38	0.62	-0.76
Q4-16	0.46	1.63	0.86	-0.77
Q1-17	0.55	1.85	1.10	-0.75
Q2-17	0.65	2.06	1.32	-0.74
Q3-17	0.75	2.25	1.51	-0.74

KIX-4 is the composite of EUR, USD, GBP and NOK front-end rates, i.e. what Riksbank refers to as the global policy rate...



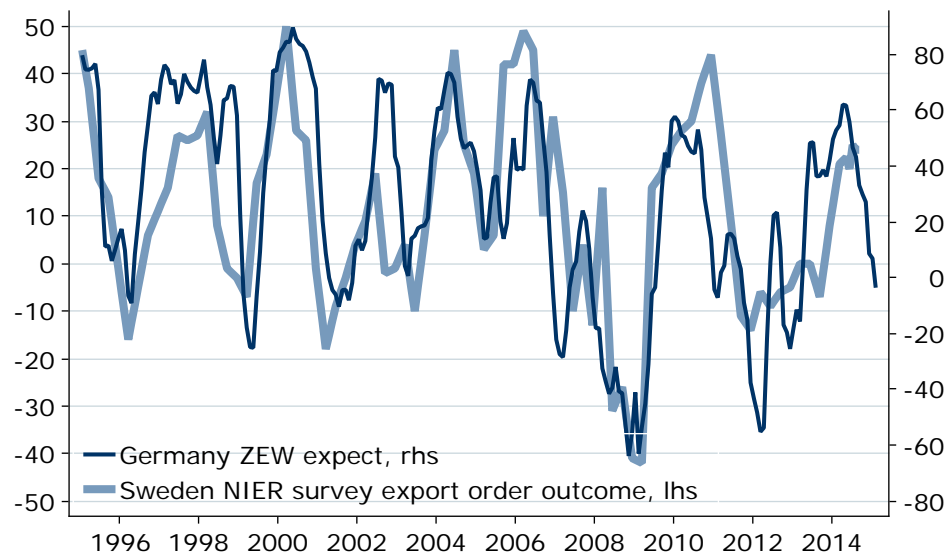
Source: Nordea Markets and Macrobond



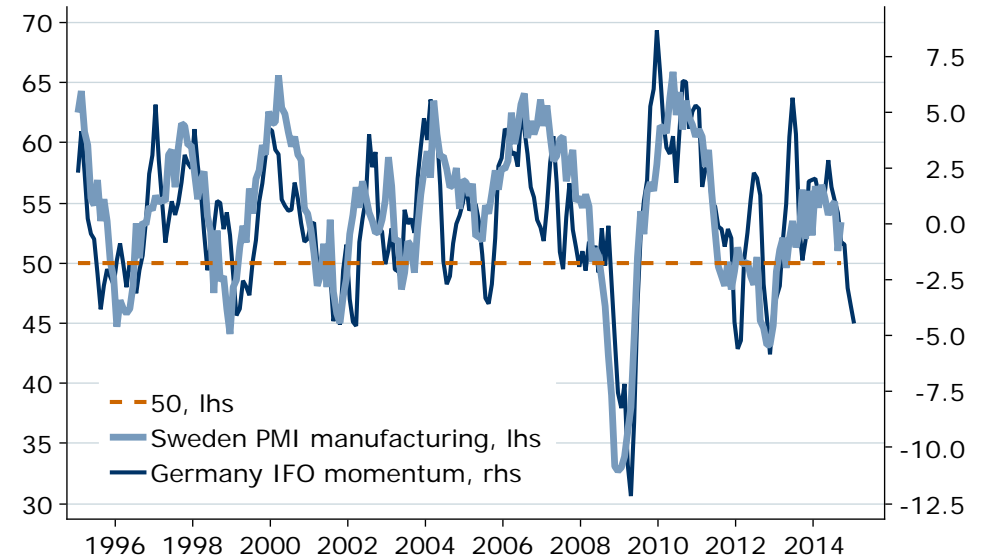
Source: Riksbank, Nordea, Bloomberg

Sweden: A small open economy. Watch out below!

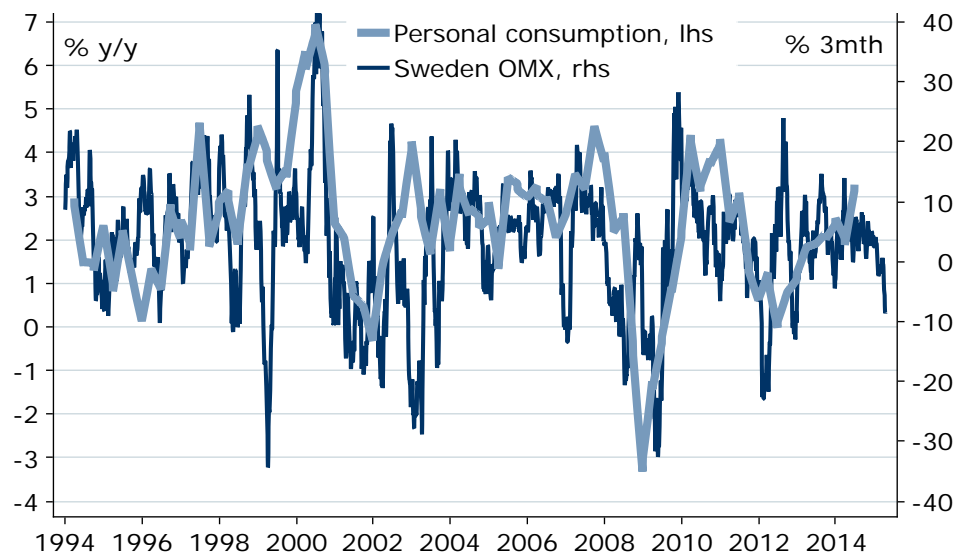
Given recent developments in Germany soft indicators will turn down (PMI below 50). Stock market jitters will translate to lower consumer confidence and risk hurting house prices.



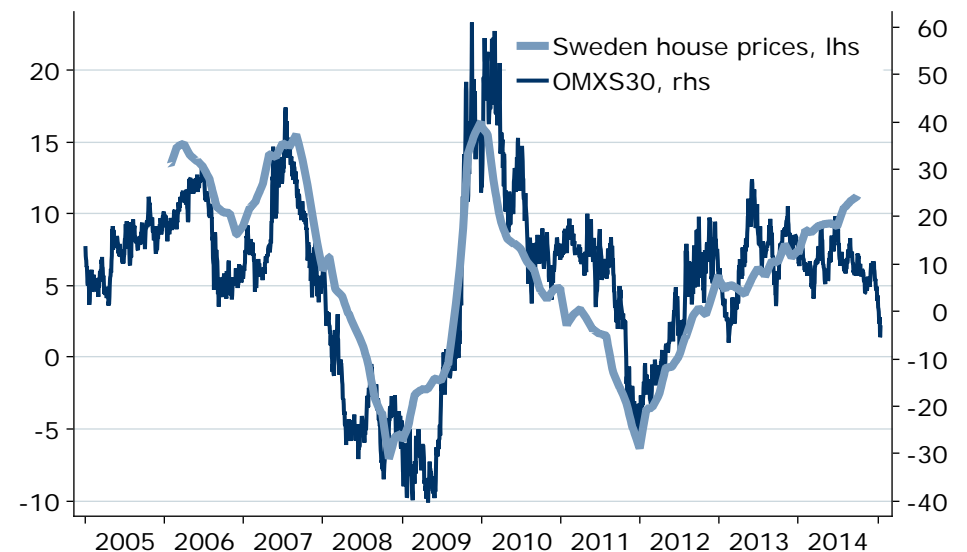
Source: Nordea Markets and Macrobond



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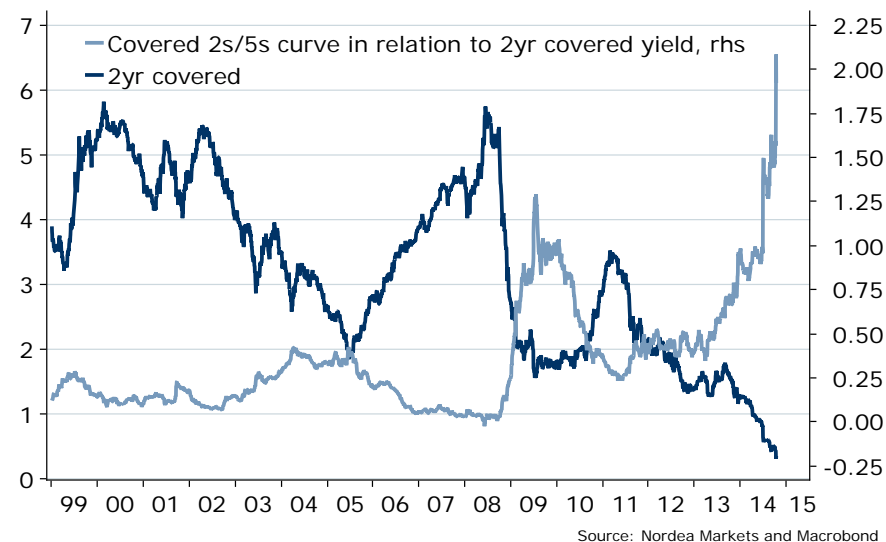
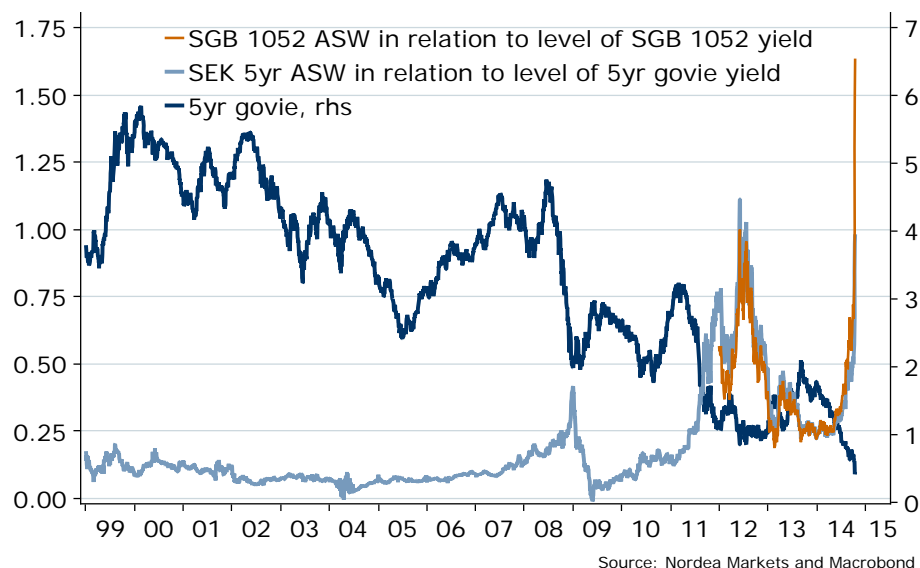
SEK spread-over: perspectives on spreads vis-à-vis the risk sentiment



The risk-off sentiment experienced recently has, as typical, led to wider ASW and covered spreads, which may have more legs if the situation intensifies.

However, the potential may be capped. When relating spreads to the level of govie yields it suggests that SGBs are expensive and for spreads to widen much further we need to see negative yields or fixing problems.

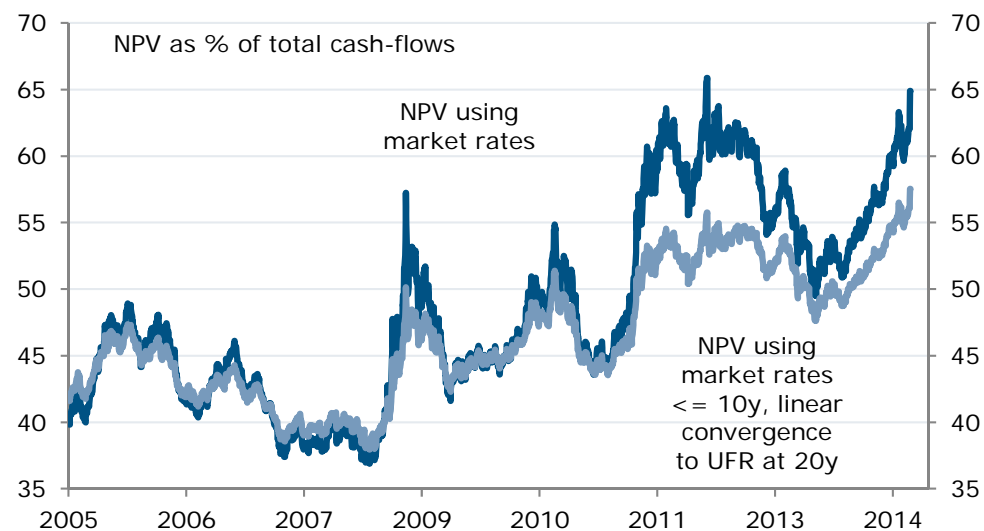
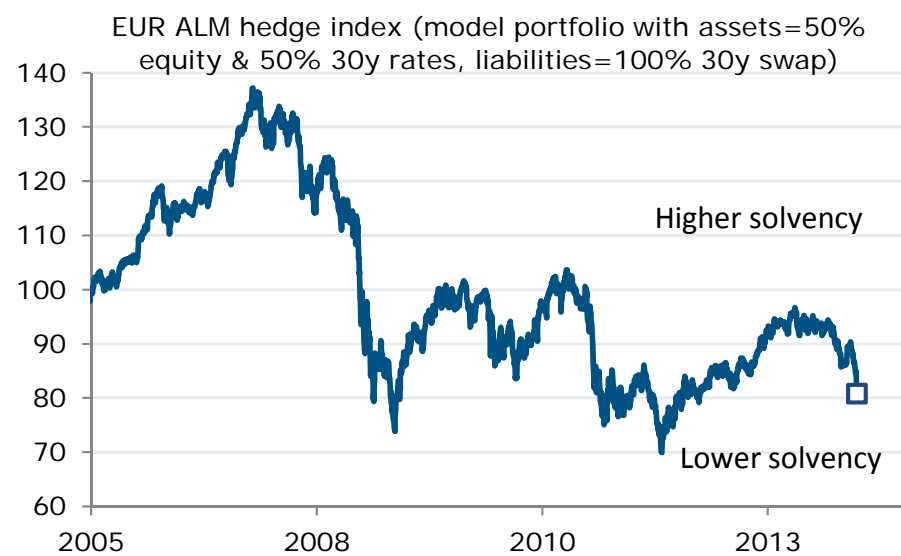
With covered bonds the situation is partly different, since the asset class is less liquid and a credit proxy, i.e. problems in the credit market can therefore have a negative spill-over effect on these bonds. But also here, on a relative return perspective, they continue to look cheap for an investor that selects between covered and govies.



SEK rates: liability hedging less of a driver in SEK long-end

One simplified way of tracking the solvency situation in the pension sector is to construct an index of the NPV of a model pension portfolio with 50 % equities and 50 % 30y bonds on the asset side and with liabilities discounted with a 30y swap rate. In the upper chart, such an index for the Eurozone shows that solvency has indeed been dented.

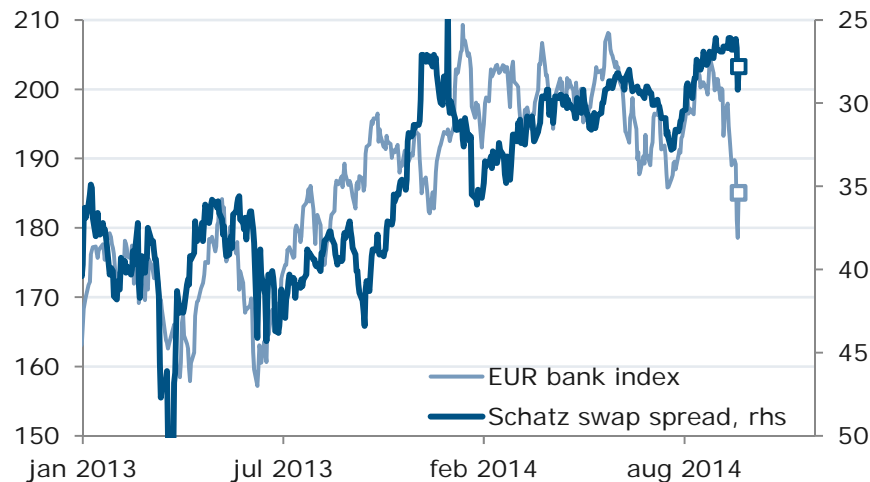
In Sweden however, important regulatory changes have been implemented. As of January 1st 2013, Swedish pension sector uses a quasi-Solvency II framework for discounting their liabilities (a fixed UFR at 4.2 % is set at maturities 20y+). Using a typical Swedish liability profile one is able to compare the net present value of a debt discounted in the old framework (only market rates) to the NPV in the new framework (quasi-Solvency II). This shows that the current regulatory "discount" in terms of lower NPV of liabilities are slightly above 15 % of the NPV at market rates. With total pension sector assets around 2900 bn SEK where around 70 % are affected by the discounting rules, this equals more than 300 bn SEK in improved solvency. The Swedish long-end of the yield curve will thus likely be much less driven by ALM related flows triggered by low yield levels. Even in a scenario where asset prices continue to slide globally, the "cyclical" part of the yield curve (~0-5y) should be more of a driver of SEK 10y+ rates than supply/demand factors. In this perspective, the historically steep yield curve in SEK compared to EUR seems to be motivated as long as yields stay low. Also, EUR vega receiver volatility should have a larger potential to rise compared to similar SEK volatility as the demand for convexity hedging has been reduced in SEK relative EUR.



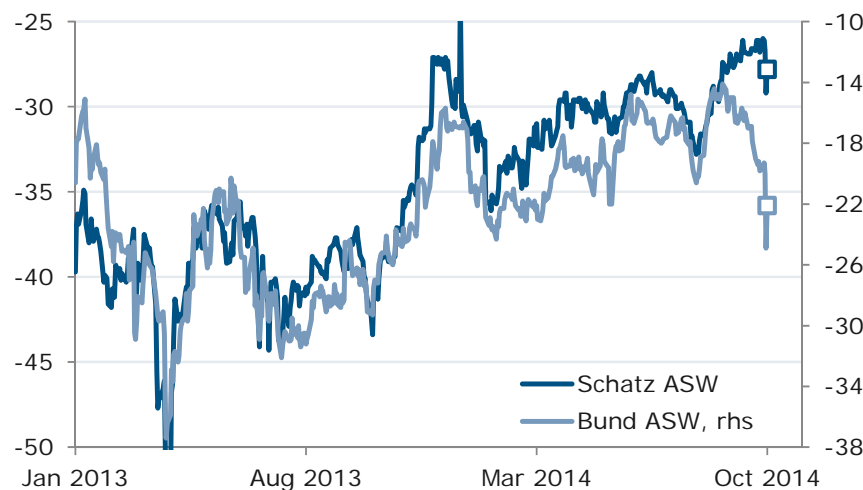
Source: Nordea Markets

Read more in *"SEK rates: liability hedging less of a driver"*

EUR rates: Schatz spreads and the AQR



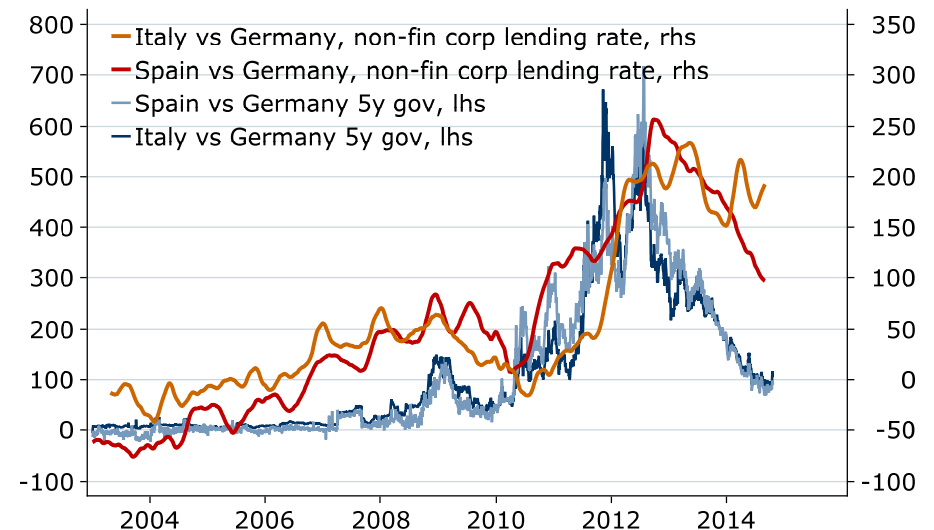
Source: Nordea & Bloomberg



Source: Nordea

The results of the AQR and stress tests are only a week away (published on Sunday at CET 12.00). The results of the tests could be interpreted somewhat asymmetric. Few banks failing may cast doubts over the usefulness of the tests while a large number of banks failing could increase concern about the health of the Euro area banking system.

As such, we like wider Schatz spreads as a trade going into the publication of the results, a trade that could also work as a hedge if last week's wobbly markets would continue. For more on this, see [*"EUR rates: Schatz spreads and the AQR/stress tests"*](#).



Source: Nordea Markets and Macrobond

Thank You!

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