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 Sweden group, but not necessarily yet formalized in form of a specific view or trading idea…

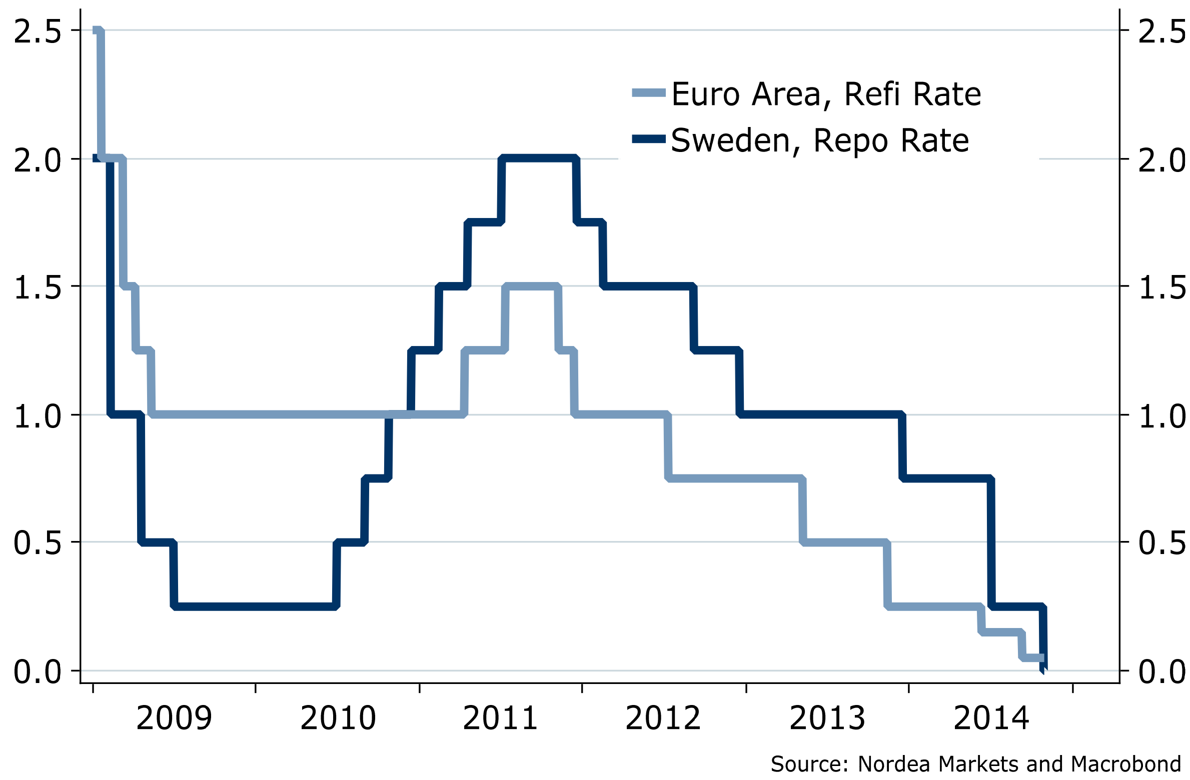
Themes in this edition:

- ***Riksbank:*** *flat-lined for many quarters*
- ***SEK rates:*** *Swedish govies in a cross-market perspective*
- ***Sweden macro:*** *a repeat of 1999?*
- ***FX vol:*** *front-end rate convergence an anchor for FX vol*
- ***ECB:*** *light is shed on the December TLTRO*
- ***EUR macro:*** *is Italy the elephant in the room?*
- ***Central banks:*** *what´s priced in?*

3 November 2014

Markets

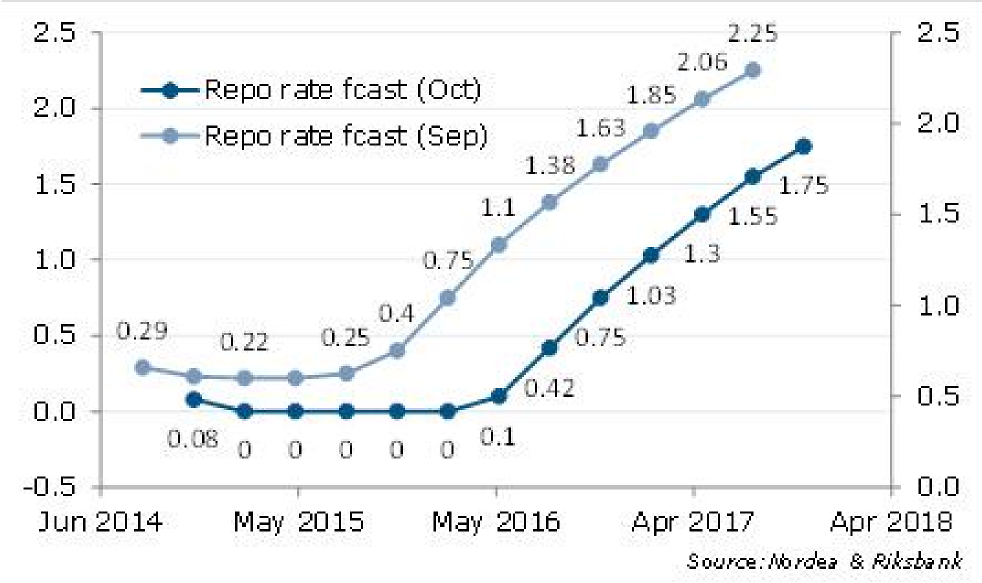
Chart of the week: Ha ha ha! ECB - we beat you to the punch!



Zero: The Final Frontier. These are the voyages of the Riksbank Enterprise...
Sometime in a not too distant future young schoolboy Sigismund Wojt will tell his father Alexander Wojt that he has learned in school about something called an interest rate. But he didn't quite understand the idea – to actually pay someone for the right to borrow money. Alexander will tell his son that this was a strange idea of the past, but that he need not worry since it won't come back. Much like the dinosaurs...

Riksbank: flat-lined for many quarters

OK. So it's done. The repo rate has reached 0%. **What will happen now? Not much would be our guess**. The monetary policy report didn't include much grounds for speculation on a negative repo rate nor any QE resembling measures. The alternative risk scenario (lower growth, stronger SEK, lower CPIF) only triggered a move of the first rate hike from mid-2016 until 2017 and no negative repo rate. However, there was one "fact box" on what type of unconventional measures other central banks have used. The conclusion was that the Riksbank technically could use these measures, BUT see the Swedish situation as totally different and thus no need to do it, see below. All in all, the Riksbank is signaling that it will be flat-lined for quite some time. **The rock 'n' roll part of 2014 is over, let's go into hibernation over the winter**…

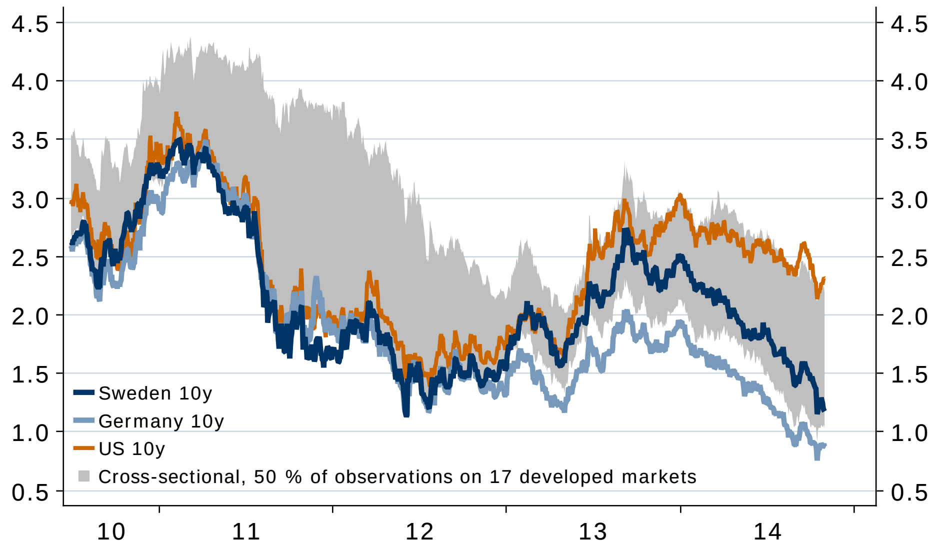


*"**Present conditions in Sweden differ from those in other countries where central banks have adopted complementary monetary policy measures**. The financial markets and financial sector as a whole are functioning relatively well, **lending to households and companies is increasing, interest rates at both short and long maturities are low and the krona is not remarkably strong**. In addition, economic development is relatively strong, **GDP is increasing at a normal rate and employment is rising**. At the same time, inflation is too low. The repo rate has therefore been cut to zero per cent and is expected to remain at this level until inflation has clearly picked up. This highly expansionary monetary policy will stimulate demand and contribute to CPIF inflation rising to 2 per cent in the first half of 2016. **The Riksbank therefore assesses that the situation in the Swedish economy does not require any supplementary monetary policy measures at present**. However, if conditions were to change, the Riksbank has the same possibilities as other central banks to take further measures to increase the monetary policy stimulus"*

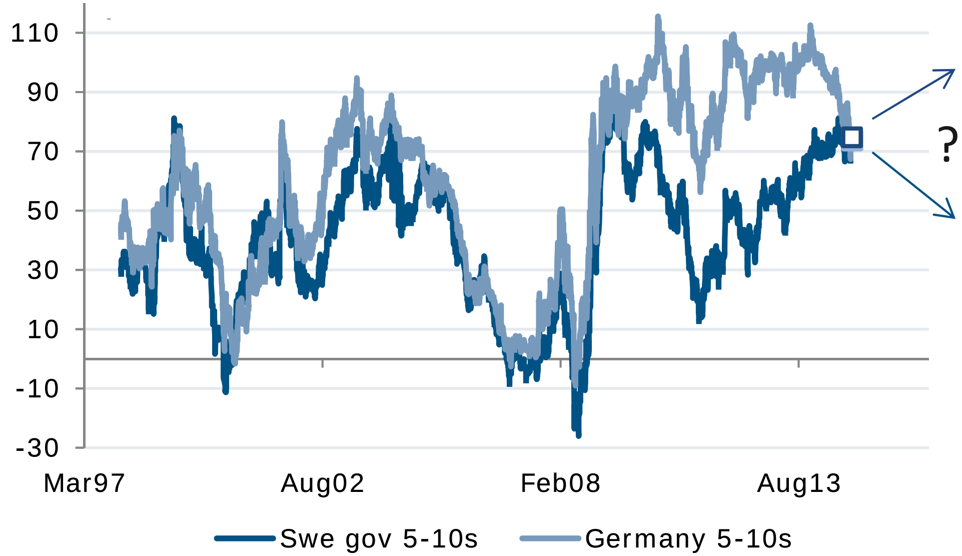
SEK rates: Swedish govies in a cross-market perspective

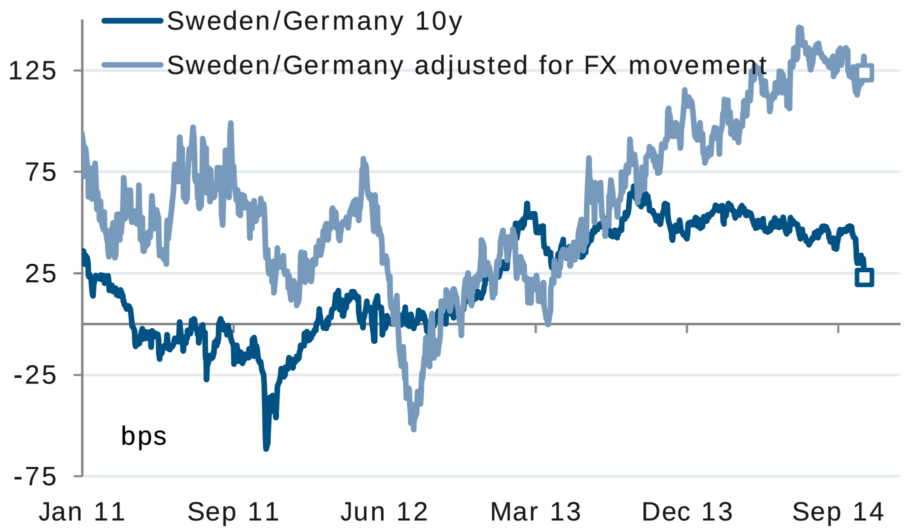
Yield levels starting to look stretched but weak currency provide cushion. Yield curve to stay steep.

- As the Swedish policy rate has converged to ECB, bond yield spreads to Germany have compressed and the SEK curve slope has converged to EUR
- Compared to other developed markets, this has left outright SEK 10y yield levels looking stretched on the downside, as one could argue that not near the same head-wind to growth, as in the Euro zone, would speak for higher yields and a curve that is likely to stay steeper
- However, at the same time, for an unhedged investor, the recent currency weakness provide a cushion for spread widening



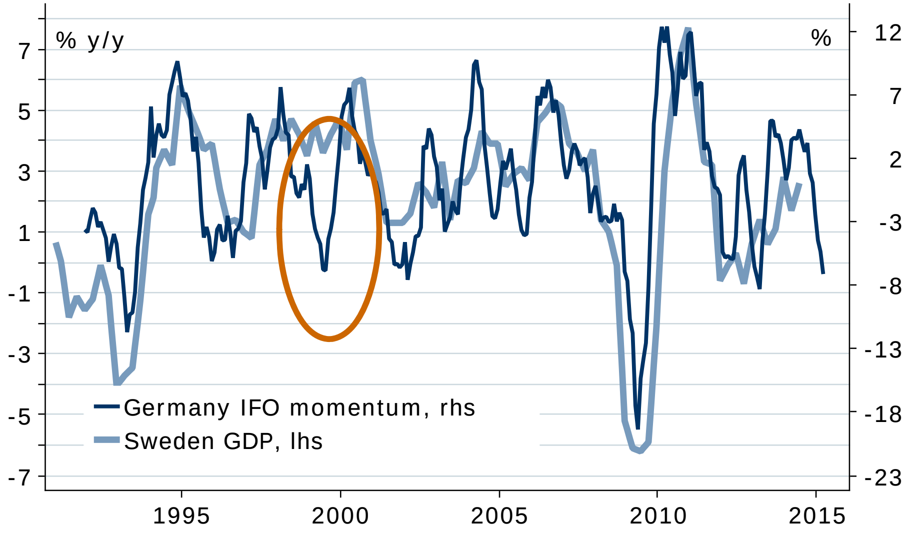
Source: Nordea Markets and Macrobond





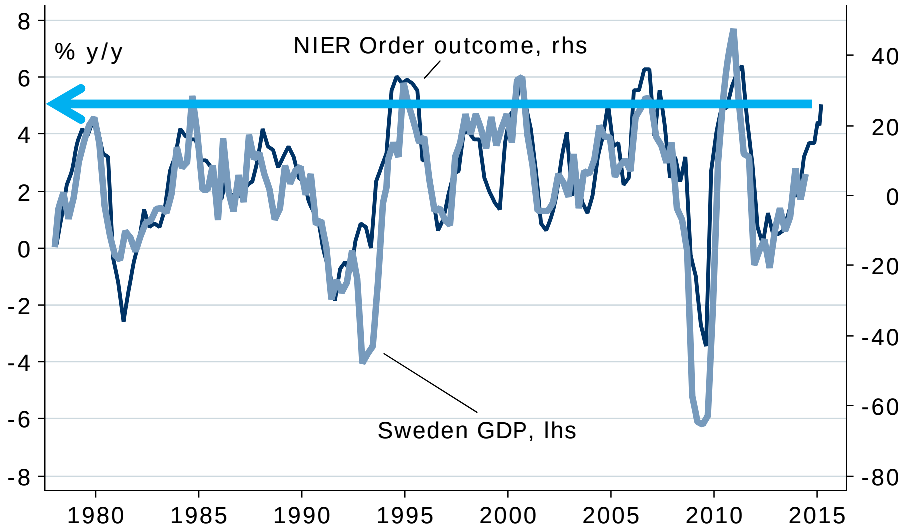
Source:Nordea Markets

Sweden macro: a repeat of 1999?



Source: Nordea Markets and Macrobond

Something fishy is going on in Sweden. Production data indicates weak Q3 GDP. But despite a slowdown in the Euro area, leading indicators hold up well. Actually, they are improving. **Could it be that we are replaying a version of 1999?** Back then, manufacturing indicators dropped (IFO left chart) and everyone started to believe that a small open economy like Sweden would slow down markedly. A strong domestic economy however balanced the global slowdown and GDP instead bounced around 4%. Reliable leading indicators as NIER orders and vacancies point to the same 4% in 2015. So even though survey data should soften short-term**, things are starting to look like 2015 gradually could involve an upside GDP surprise when all is said and done**.



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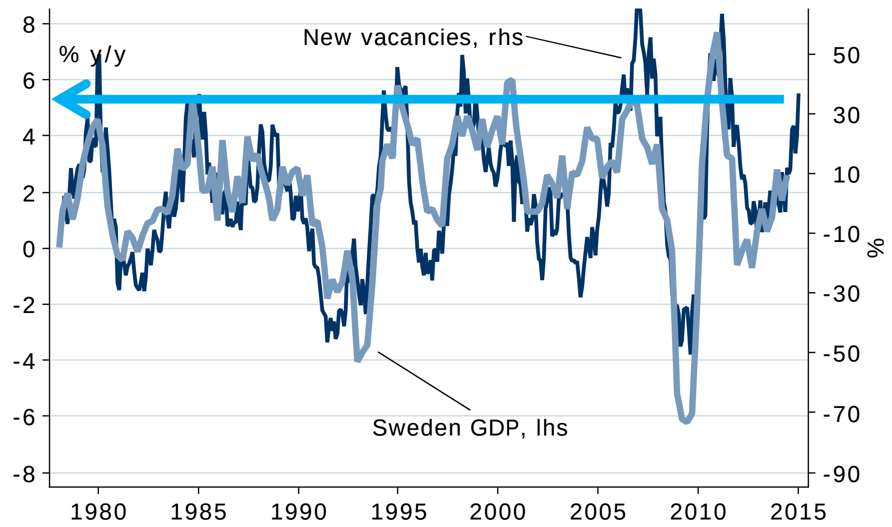
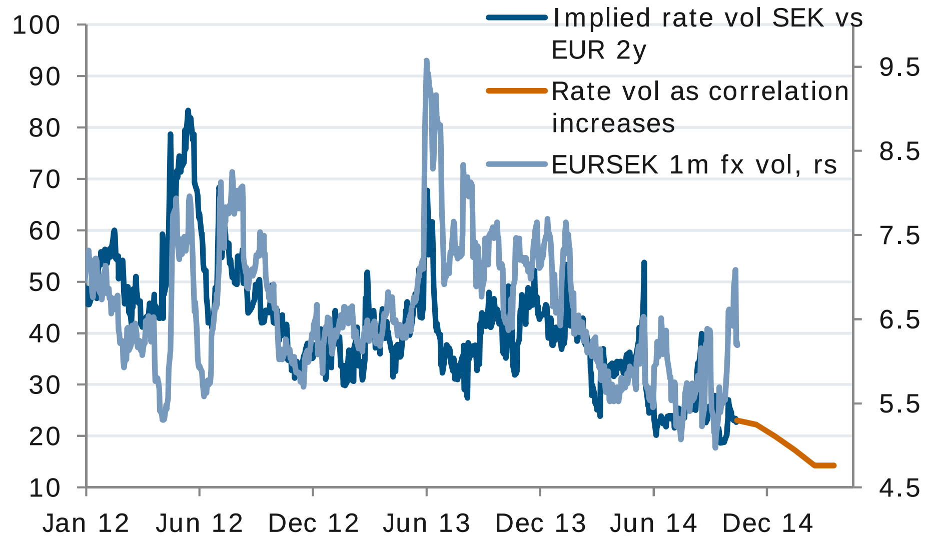


Source: Nordea Markets and Macrobond

FX vol: front-end rate convergence an anchor for FX vol

- Simplistic fair-value models (based on rate differentials) suggest that EURSEK should be somewhere around 9.30-ish
- Since both front-end SEK and EUR rates are more or less nailed to the floor, the rate differential will be more or less constant
- So, it is reasonable to expect that EURSEK will oscillate with less and less vol around the fair-value. Chart to the right shows relationship between implied rate spread vol and fx vol and impact from increase in rate correlation on rate spread vol
- Since the Riksbank has more or less closed the door on unconventional tools (near-term) at the same time as it has fired its last ”conventional rate bullet”, risk scenarios on EURSEK are starting pile on up the downside:
    - ECB delivers broad-based QE => EURSEK down
    - Macro improves, no ECB QE, Swedish export benefits => EURSEK down
    - Macro worsens, ECB do not deliver QE => Euro break-up speculations, EURSEK down
- Value in selling OTM EURSEK calls on 1m-3m option tenors if spot around 9.30
- Have a look at using the premium from the sold FX option to buy ATMF SEK swaption receivers, for example 3m5y or 1y5y



Source:Nordea Markets

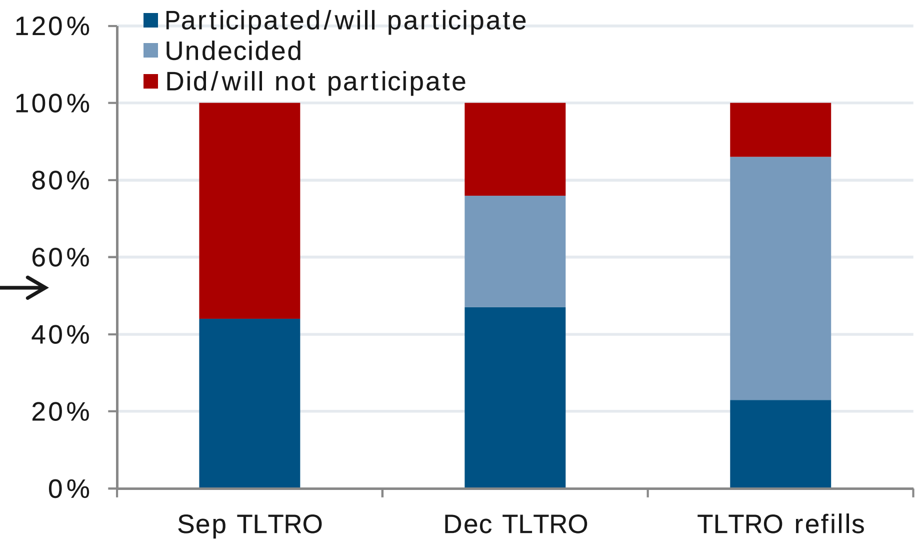
Source: Nordea

ECB: light is shed on the December TLTRO

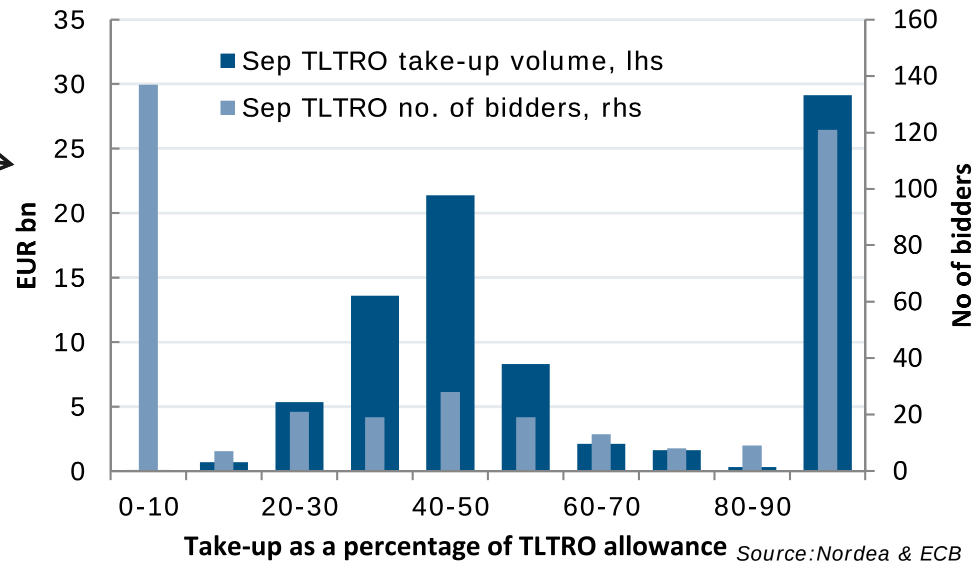
Last week´s Bank Lending Survey from the ECB included a number of ad-hoc questions on the usage of the TLTRO. Adding together what has been communicated in recent monthly bulletins, we notice a couple of things

- The survey suggests that the number of participants in the Dec tranche will likely be larger than in Sep
- The stigma effect seems to be limited. No bank highlights it as an issue not to participate in the coming operations
- Only very few banks suggest that the purpose of the uptake is to buy bonds or other assets
- A majority of banks said they would use the funds for lending, which is positive
- Roughly half of the participants in the Sep TLTRO took the full amount allowed for Sep + Dec. The others took on average close to 50% of max allowance
- A fairly large number of banks suggested they would use the TLTRO to substitute for other ECB operations

All in all, this result is probably what the ECB has hoped for, and together with the AQR/stress test results being released could argue for the higher uptake in December that our economists have highlighted previously. For more on the lending survey, see ***"Good and bad news in the Bank Lending Survey".***



Source:Nordea & ECB (BLS)

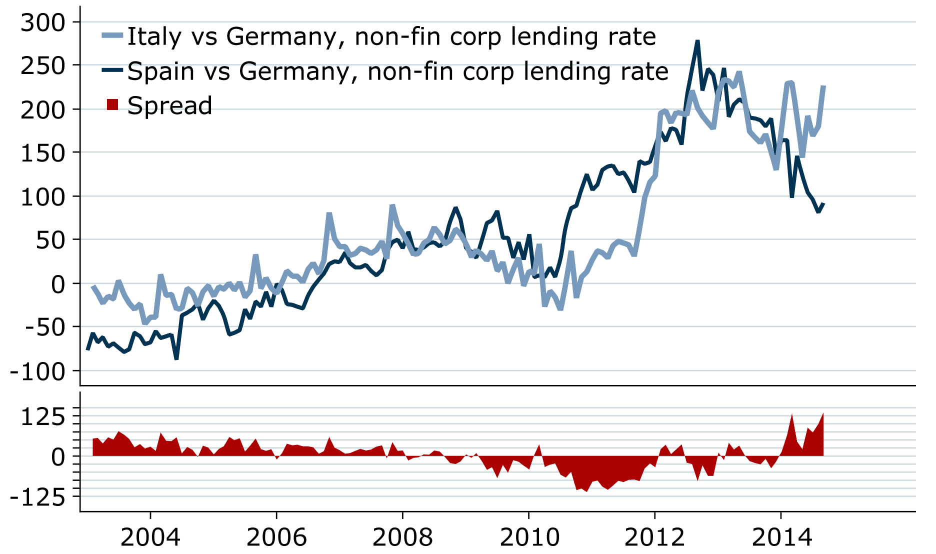


Source:Nordea & ECB

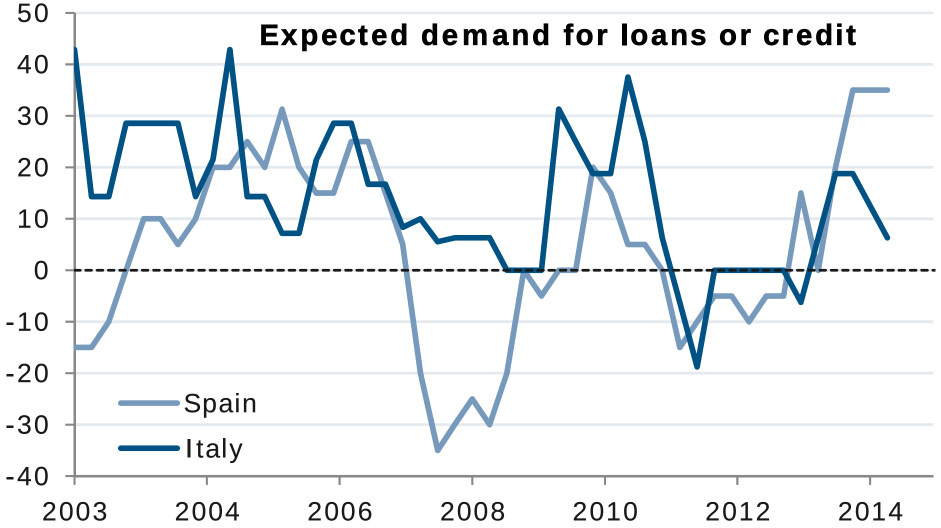
Euro macro: is Italy the elephant in the room?

As highlighted in ***"European FI Strategy: Volatility back for good"***, Italian bonds are set to feel more pressure (vs Spain) in the near term. Our concern has increased during past weeks, partly due to

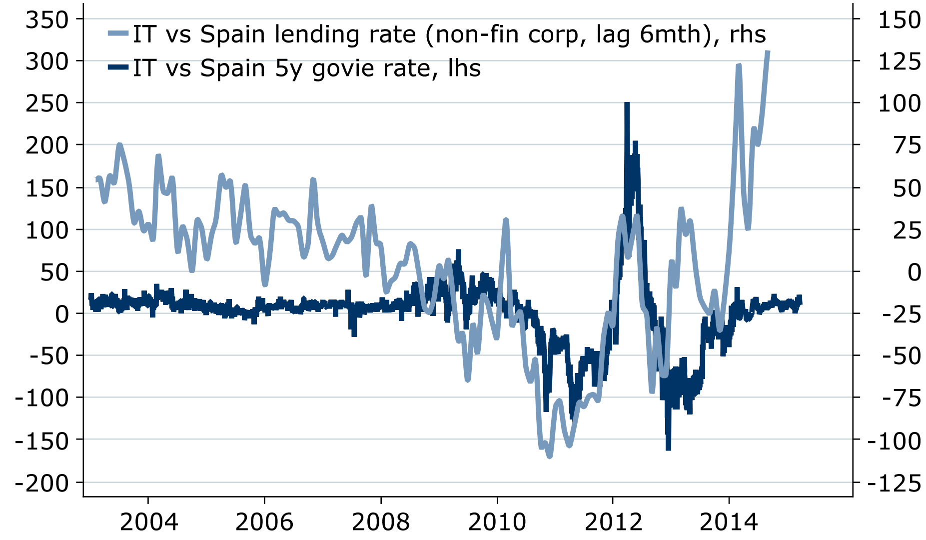
- Lending rates having increased and are now on widest levels on record vs Spain
- Bank Lending Survey showed a slight decline in demand for credit for SMEs
- AQR and stress tests were somewhat on the weak side for Italian banks (see ***"Stress tests behind, not the stress"***).
- Italian banks were the largest takers of the TLTRO



Source: Nordea Markets and Macrobond

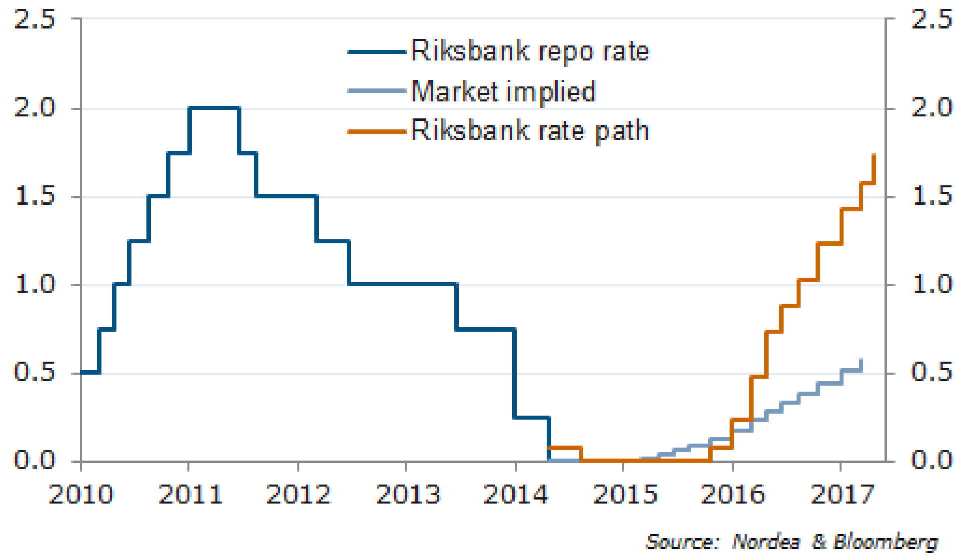


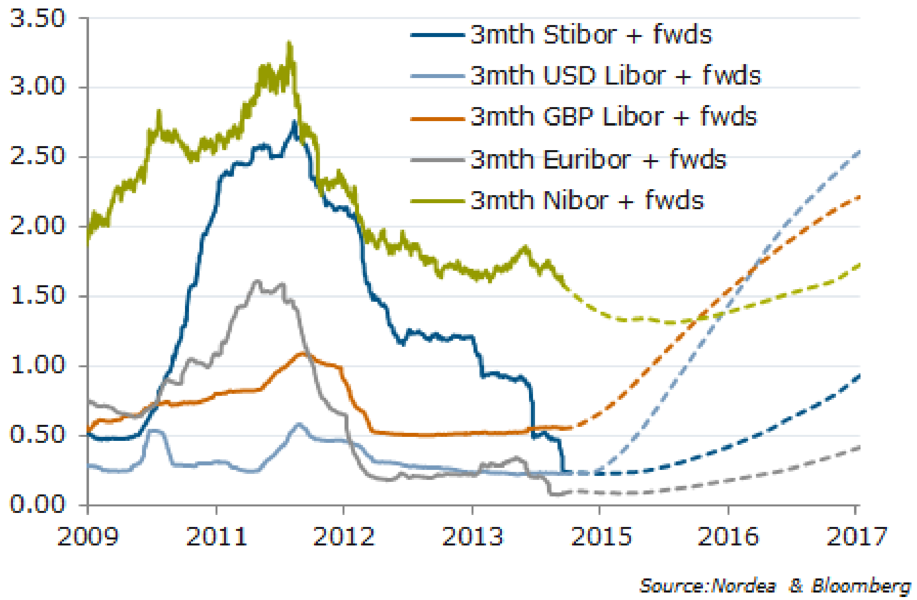
Source:Nordea & ECB Bank Lending Survey



Source: Nordea Markets and Macrobond

Central Banks: what's priced in?





Market discounting of future 3mth rates and implicit central bank action

		2014	2015				2016				2017	2018	2019	2020
USD (Fed)	Current	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Dec	Dec	Dec	Dec
3m USD Libor	0.23	0.23	0.25	0.38	0.58	0.82	1.06	1.30	1.55	1.80	2.52	2.93	3.19	3.40
Accumulated Δ		0.00	0.02	0.15	0.35	0.59	0.83	1.07	1.32	1.57	2.29	2.70	2.96	3.17
No of 25bp hikes			**0.1**	**0.6**	**1.4**	**2.3**	**3.3**	**4.3**	**5.3**	**6.3**	**9.2**	**10.8**	**11.8**	**12.7**

		2014	2015				2016				2017	2018	2019	2020
EUR (ECB)	Current	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Dec	Dec	Dec	Dec
3m Euribor	0.09	0.11	0.09	0.09	0.09	0.11	0.13	0.16	0.19	0.22	0.41	0.67	0.98	1.32
Accumulated Δ		0.02	0.01	0.00	0.01	0.03	0.05	0.08	0.11	0.14	0.32	0.58	0.89	1.23
No of 25bp hikes			**0.0**	**0.0**	**0.0**	**0.1**	**0.2**	**0.3**	**0.4**	**0.5**	**1.3**	**2.3**	**3.6**	**4.9**

		2014	2015				2016				2017	2018	2019	2020
GBP (BoE)	Current	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Dec	Dec	Dec	Dec
3m GBP Libor	0.56	0.57	0.66	0.79	0.96	1.13	1.30	1.46	1.62	1.76	2.21	2.45	2.66	2.69
Accumulated Δ		0.01	0.10	0.23	0.40	0.57	0.74	0.90	1.06	1.20	1.65	1.89	2.10	2.13
No of 25bp hikes			**0.4**	**0.9**	**1.6**	**2.3**	**3.0**	**3.6**	**4.3**	**4.8**	**6.6**	**7.6**	**8.4**	**8.5**

		2014	2015				2016				2017	2018	2019	2020
SEK (Riksbank)	Current	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Dec	Dec	Dec	Dec
3m Stibor	0.24	0.24	0.23	0.24	0.25	0.29	0.34	0.39	0.46	0.53	0.91	1.38	1.74	2.04
Accumulated Δ		0.00	-0.01	-0.01	0.01	0.04	0.09	0.15	0.21	0.28	0.67	1.14	1.50	1.79
No of 25bp hikes			**-0.1**	**0.0**	**0.0**	**0.2**	**0.4**	**0.6**	**0.8**	**1.1**	**2.7**	**4.6**	**6.0**	**7.2**

		2014	2015				2016				2017	2018	2019	2020
NOK (Norges Bank)	Current	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Dec	Dec	Dec	Dec
3m Nibor	1.59	1.51	1.39	1.34	1.35	1.32	1.34	1.37	1.42	1.47	1.72	2.08	2.34	2.61
Accumulated Δ		-0.09	-0.20	-0.26	-0.25	-0.28	-0.26	-0.23	-0.18	-0.13	0.13	0.49	0.75	1.02
No of 25bp hikes			**-0.8**	**-1.0**	**-1.0**	**-1.1**	**-1.0**	**-0.9**	**-0.7**	**-0.5**	**0.5**	**2.0**	**3.0**	**4.1**

Thank You!

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Kristofer Eriksson
kristofer.eriksson@nordea.com

Fredrik Floric
fredrik.floric@nordea.com

Mats Hydén
mats.hyden@nordea.com

Mikael Sarwe
mikael.sarwe@nordea.com

Henrik Unell
henrik.unell@nordea.com

Alexander Wojt
alexander.wojt@nordea.com