# 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…*

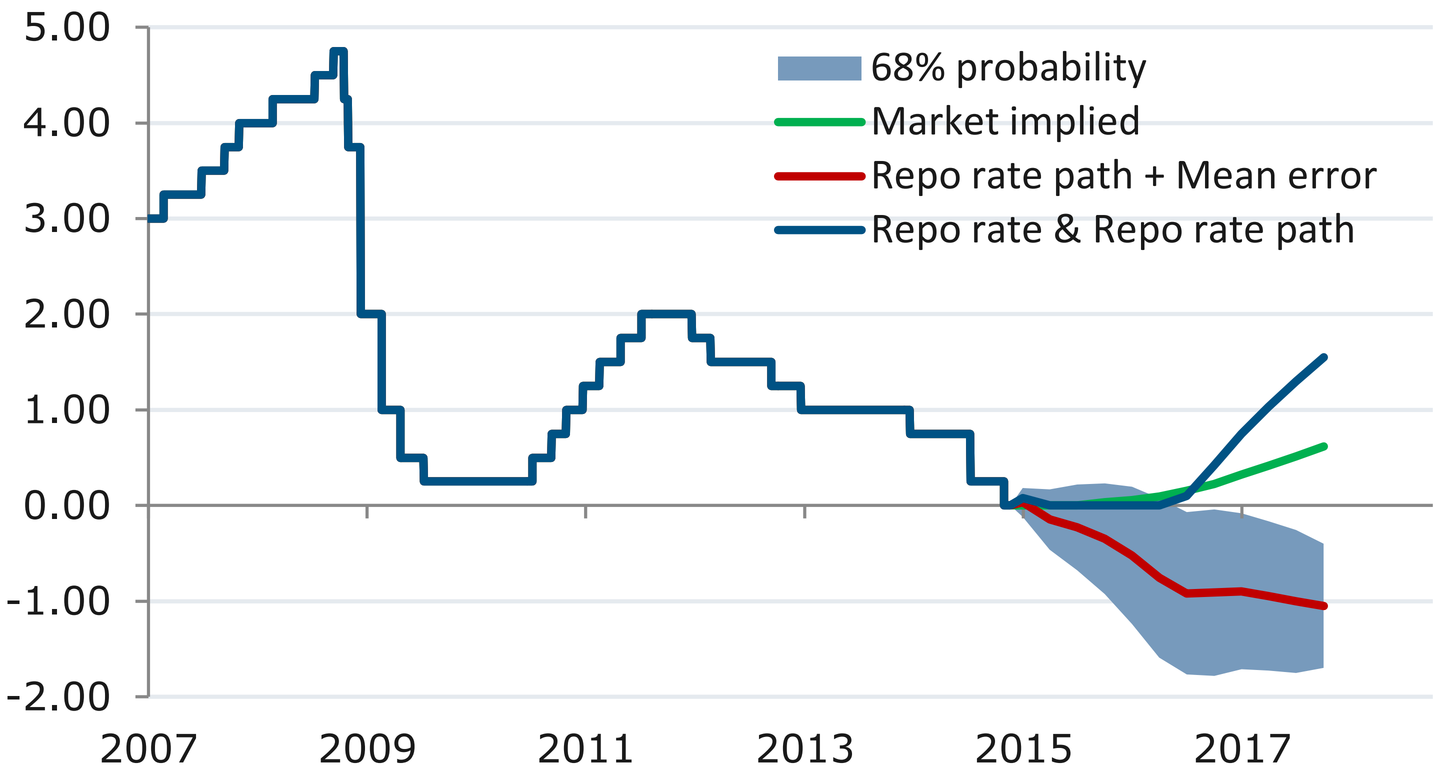
## *Themes in this edition:*

- ***Sweden:*** *Don´t be surprised if GDP surprises*
- ***SEK front-end:*** *Japanized, with no end in sight*
- ***SEK front-end:*** *Covered vs. front-end curve*
- ***Covered bonds:*** *Double the yield in Denmark*
- ***Swedish bond index:*** *Major impact in linkers*
- ***Swedish budget:*** *Revenge is sweet, would drive EUR/SEK higher*
- ***Cross-market:*** *Oil, USD, high yield & asset correlation*

**24 November 2014**

Markets

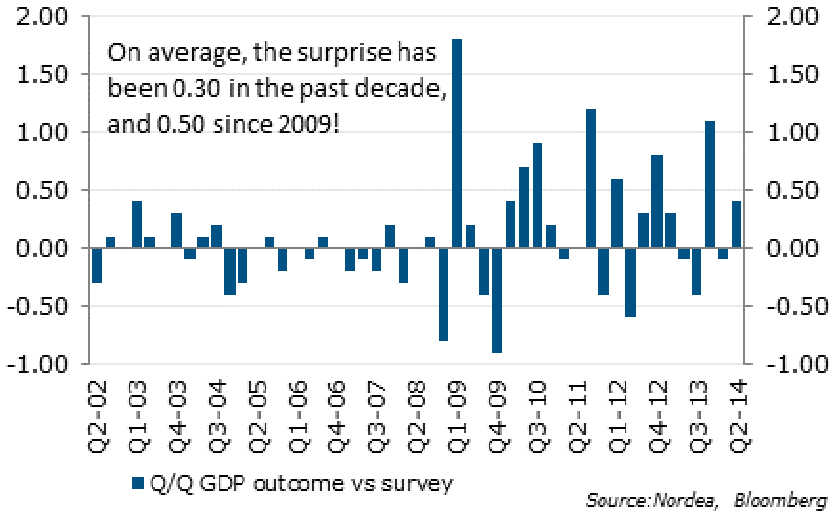
## **Chart of the week:** Riksbank forecast error supports market pricing

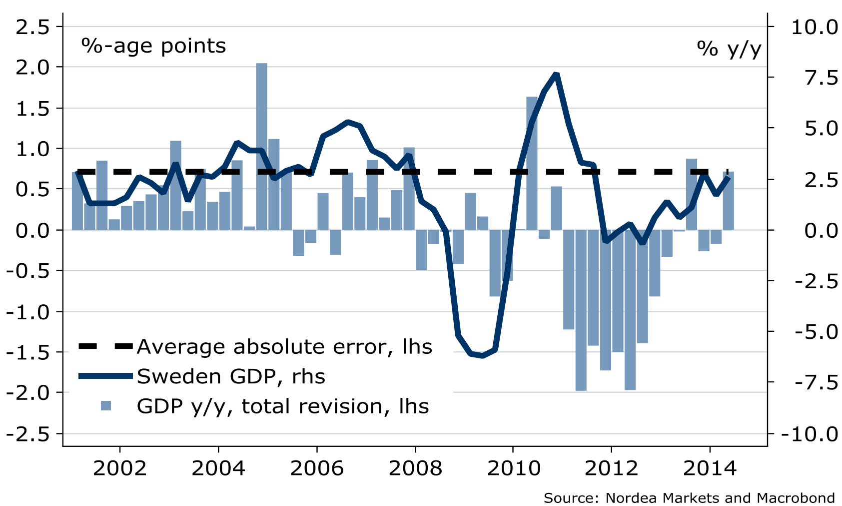



*Source: Nordea & Macrobond*

***SEK front-end rates are japanized, but no end in sight in the near-term (more on page 4) …***

# **Sweden:** Don't be surprised if GDP surprises




The consensus forecast for Swedish Q3 GDP, published November 28, is +0.2% q/q. That forecast is basically worth nothing since the average q/q forecast error since 2009 has been 0.5%, i.e. equaling potential GDP growth. Why care about such a forecast? But the markets will react to the almost certain surprise anyway. The risk is on the downside given weak production growth and somewhat slow personal consumption. Such an outcome has the potential of pushing EURSEK 0.05 if the EURNOK move on stronger Norwegian GDP last week is a guide.

GDP releases should be important for monetary policy and thus markets. However, not only are the surprises very large, it is also the case that the first outcome estimate is a rather lousy indicator of how much GDP actually increased. Revisions to GDP are huge. The average absolute revision since 2001 to GDP y/y has been a staggering 0.7 percentage points. So let's say this week's Q3 GDP number comes in at the consensus 2.3% y/y, then the final outcome after an average revision could be 1.6% or 3.0%. We won't know until a few years from now whether GDP increased more or less than the ~2% potential growth. Thus we won't know if the output gap is increasing or decreasing. In all honesty we won't know much, but markets will act as they know everything. We love markets!

# **SEK front-end:** Japanized, with no change in sight

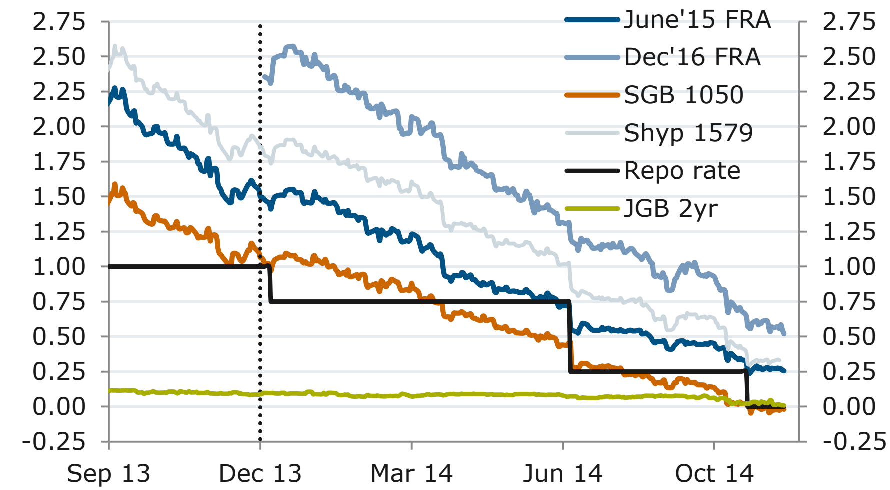
YTD, Swedish front-end rates have rallied a lot, and almost without recoil: June'15 and Dec'16 FRAs are down 130 and 205bps, while font-end govies have rallied 110 and 135bps (SGB 1050 & 1051) with the former at negative yield and below 2yr Japan! Corresponding covered bonds have rallied an extra 20bps

When looking at the pricing of policy, the market buys the concept of no further easing (which likely comes from uncertainties around negative rates), but continues to be much more aggressive than the Riksbank further out (a policy rate that is 1.2% lower by the end of 2007). The first full 25bp hike is not priced until end of 2016 and if markets prove correct, it would be the longest period on record, two years, with no change in the policy rate

True, this pricing is extreme, but an expression of: *(i) inflation unlikely to return to target anytime soon, (ii) ECB low-for-long and to push ahead with further easing, (iii) with limited upside risk on policy, carry/roll strategies dominates*. *In addition*, when looking at Riksbank´s track-record on rate forecasting (excluding the 07-08 episode!), one can hardly blame markets of not trusting the rate path. According to this analysis, the repo rate will, at 68% probability, be negative over coming years (see lower chart)!

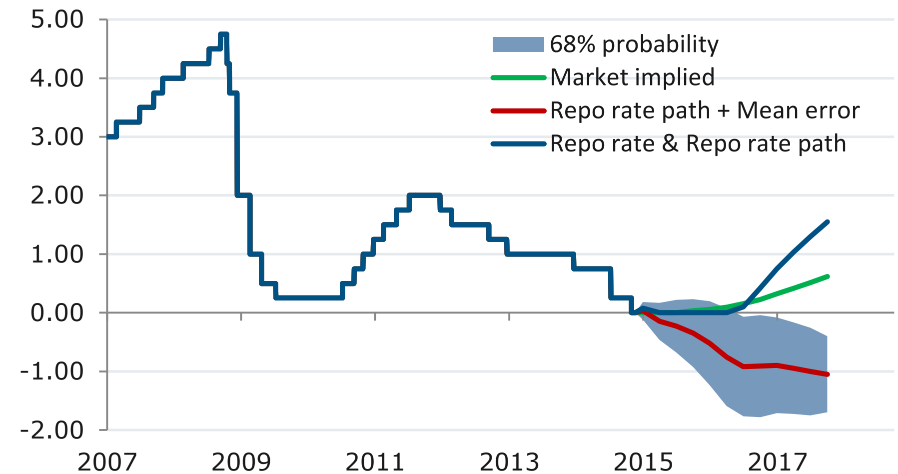
We think there is limited room for the front-end to be re-priced anytime soon and particularly unless there is inflation evidence on the table. Positive or negative macro should therefore influence the long-end instead of leading to premature rate reversal speculations ***(see "Phase 0")***. However, there are still some micro considerations to take into account, which we summarize on the next slide…

**Front-end SGBs lower on yield than front-end JGBs..!**




*Source:Nordea*

**Given historical forecast errors, the market pricing makes sense**

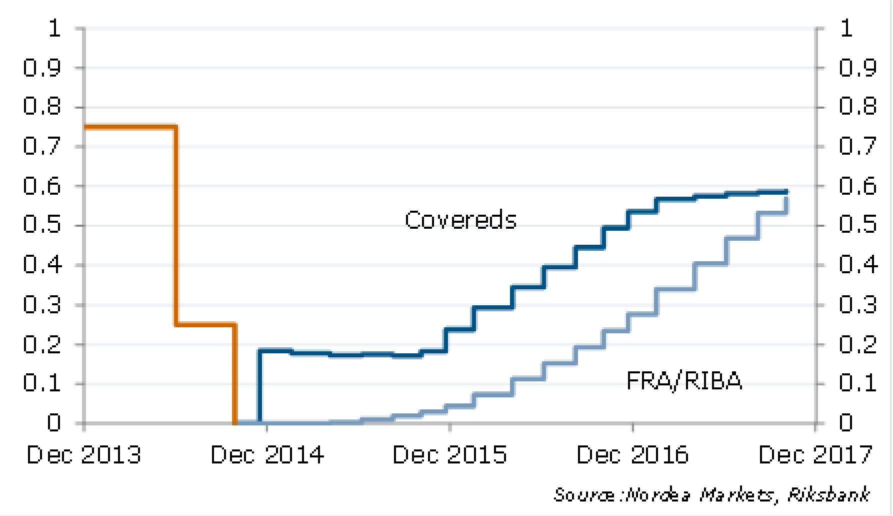


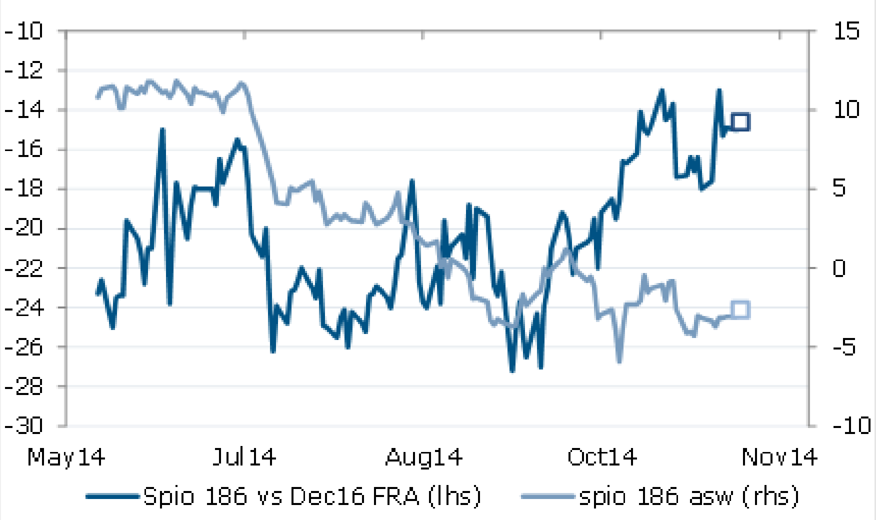

*Source: Nordea & Macrobond*

# **SEK front-end:** Covereds vs front-end curve

***Consider adding front-end steepeners to longs in 2-3yr covereds***

- In a historical context, 2-3y SEK covereds seem to trade rich relative to swaps. Still, weekly repo financing rates in covereds are well below 3-mth Stibor, so in a carry perspective, covereds still look cheap
- At the same time, the front-end of the yield curve has flattened notably and long-term bond yields are at all-time lows. This makes it interesting to look at combinations of trades, where one would stay/enter long 2-3y covered positions and hedge it by steepeners in swaps/FRAs (our choice to pay Dec'16 FRA or steepen 1yr1yr vs 3yr1yr fwds)
- Such combination can be made carry/roll neutral (or even positive) while still benefitting of a steeper curve or higher yields. An alternative, consider Denmark (see next slide)…



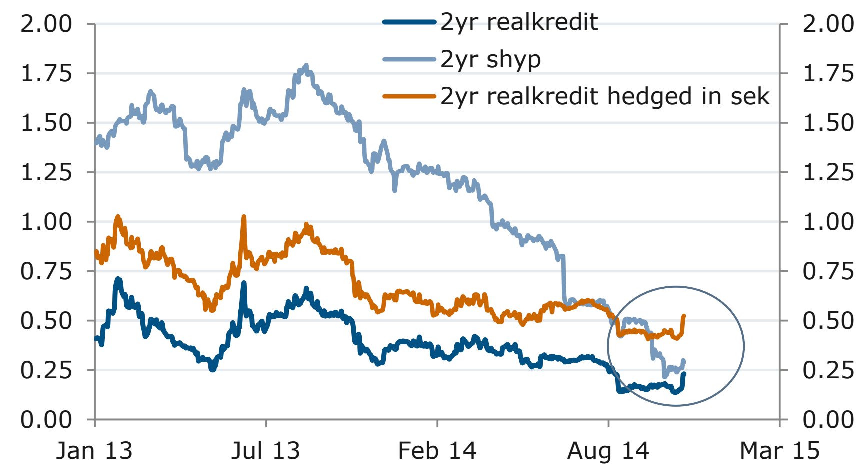




# **Covered bonds:** Double the yield in Denmark

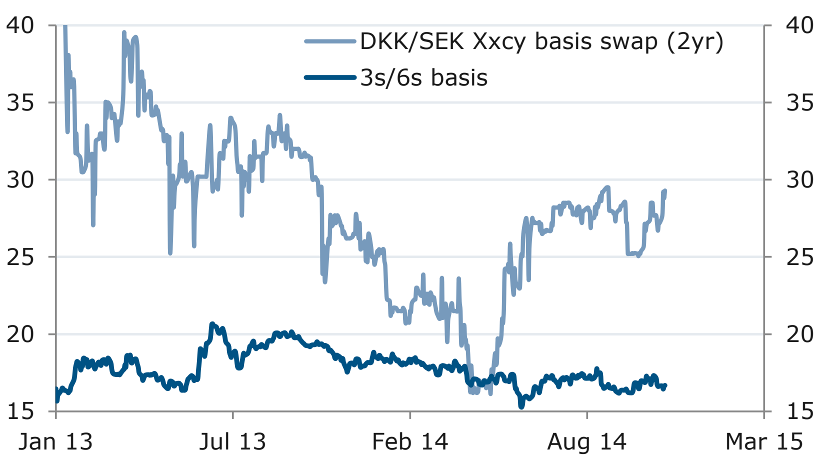
After a stunning rally in 2014, yield levels in Swedish 2yr covered bonds are now around parity with Danish comparators, and SEK ones have also performed in ASW terms. At the same time, the 2yr DKK/SEK cross currency basis swap has widened by almost 15bps since the spring lows (see bottom left chart)…

Thus, a Swedish investor, with a natural interest in front-end covered bonds, and indifferent between an investment in Sweden or Denmark (they are both AAA and have the same hair-cut in LCR), are now able to pick up around 25bps by selecting Realkredit instead of Statshypotek, and swap it back into SEK (see charts to the right). The corresponding pick up in the 3-5yr segments are 3 – 6 bps higher…

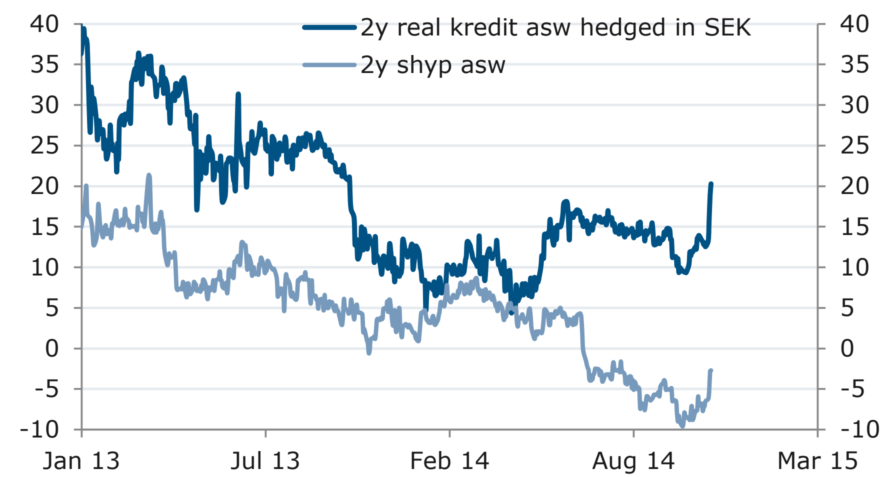
This pick-up is almost as high as the yield level on 2yr Statshypotek (like Shyp 1578), which certainly is not a negligible amount in the current zero bound monetary policy environment!




Source: Nordea, Bloomberg




Source:Nordea, Bloomberg



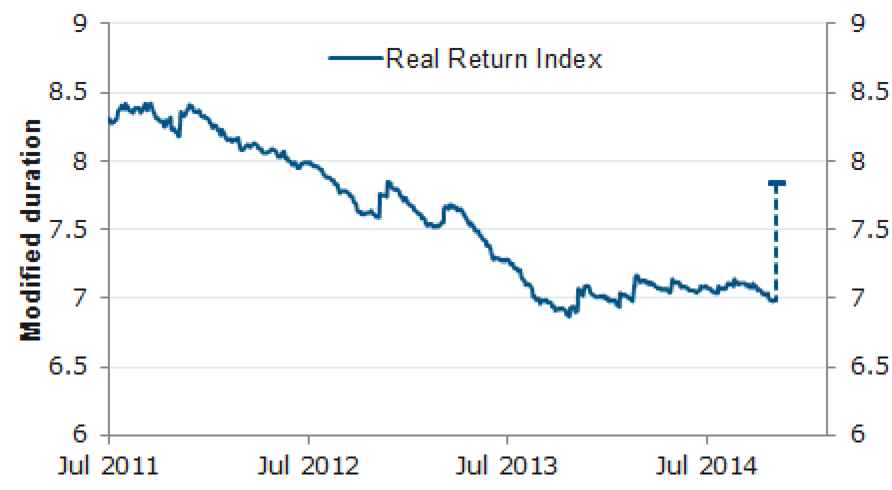

Source: Nordea, Bloomberg

# **Swedish bond index**: Major impact in linkers

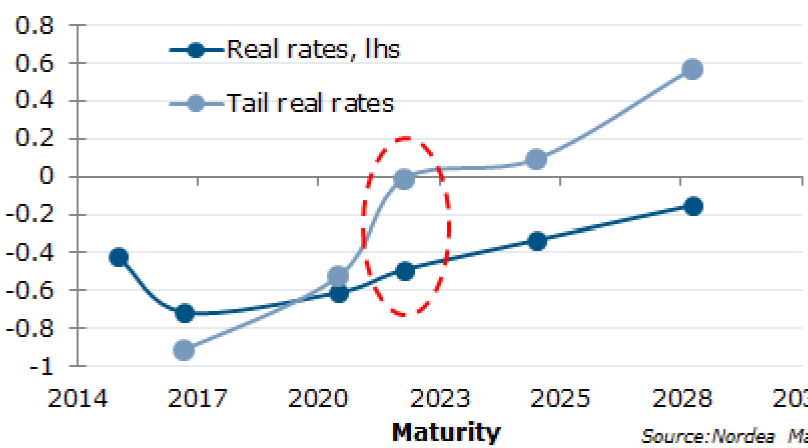
On November 28 (market open), SGBi 3105 will be excluded from OMRX Real Return Index. This will have a major impact on the index for which the duration is expected to be extended by 0.9 years. For more information on the re-balancing see:

**SEK Rates: OMRX Index re-balancing - SGBi 3105**

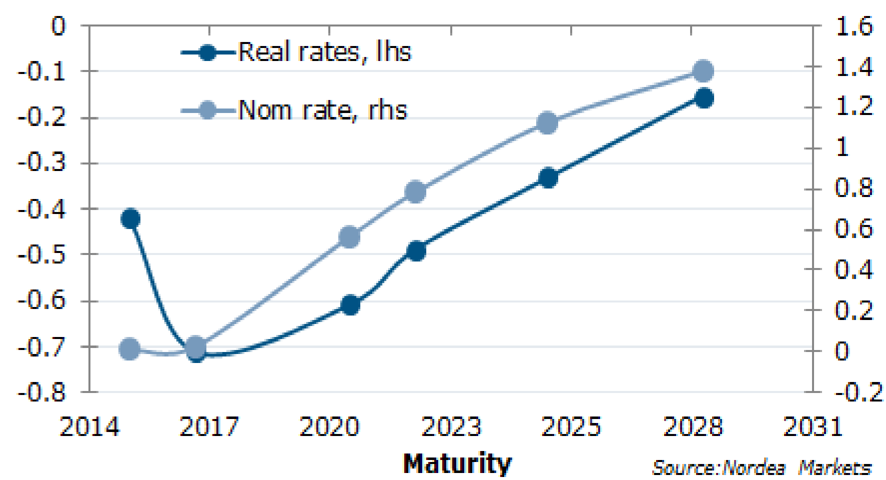
SGBi 3104 will absorb most of the weight in the index. We see best value in extending to SGBi 3108. Despite seasonal effects, 3108 looks somewhat cheap when considering the forwards between the bonds. SGBi 3109 and 3102, on the other hand, looks rich. One possible explanation behind the richness in 3109 is the duration pick-up investors get when extending towards it



Source: Nordea, Macrobond & Bloomberg



Source:Nordea Markets



Source:Nordea Markets

# **Swedish budget:** Revenge is sweet - would drive EUR/SEK higher!

Balanced budgets are still in vogue but whose will it be: the alliance or the government proposal (red and green)? **Our main scenario is for the government proposal to go through but a non negligible risk points to a crises.**

The situation is such that the Sweden Democrats will hold the balance of power, i.e. they will have the casting vote on the 3rd of December. **If the SD decides to make a political statement, then the political risk premium in the SEK is back**. The party has said on repeated occasions that they will vote for the budget alternative that they regard as being the lesser of two evils, excluding immigration and integration policy. **It would, in our world, of course be unusual if the party did not attempt to achieve as much of its policies as possible in other areas.** Whether or not the party will decide to do this in connection with the budget vote in December, or plans to target the mandate period as a whole is as yet an unknown.

If a vote for the Alliance budget sparks a government crisis, which in turn means the government will need to be reformed this may also be an objective for the Sweden Democrats. Such a reformation of the government is entirely possible without a new election.

It has, however, been suggested that the Sweden Democrats have an interest in following standard practice and abstaining so the government's budget goes through.

**What often seems to be neglected in this discussion is that the treatment of the Sweden Democrats hardly follows standard practice** as they have been more or less excluded from chairman appointments in parliamentary committees despite them being the third largest party. We do not know what will happen if the government fails to get its budget approved. There are no rules preventing the government from administrating the opposition's budget, but this option is unlikely. The following scenarios are, however, possible.

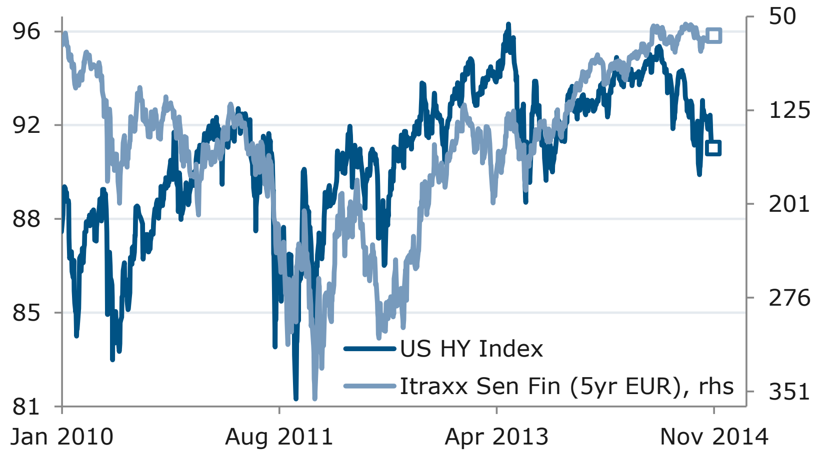
- The Prime Minister chooses to step down and the government is dissolved.

- A vote of no confidence is declared against the Prime Minister. The entire government then resigns.

If the government resigns and no new election is announced, the speaker undertakes a new round of discussions with the party leaders. **The likelihood of another election is currently very low.** It is more likely that there will be a change to the composition of the government within the framework of September's general election result. Since a budget defeat would be an expression of the Soc Dem+Green government's failure, the new government would probably have a different party composition to the current one. Whether it is then just the Soc Dems, the Soc Dems together with one or more Alliance parties, and possibly the Greens, or even a new coalition government is impossible to tell.

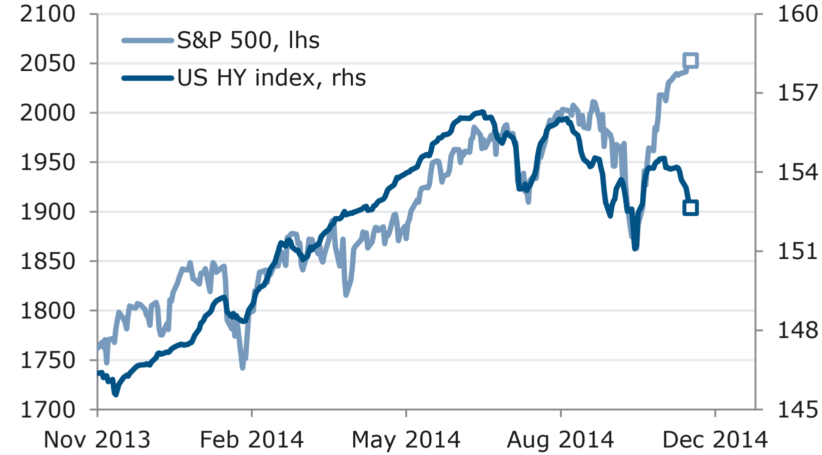
# **Cross-market:** Oil, USD, high yield & asset correlation

*The oil price decline has had an impact on some markets…*



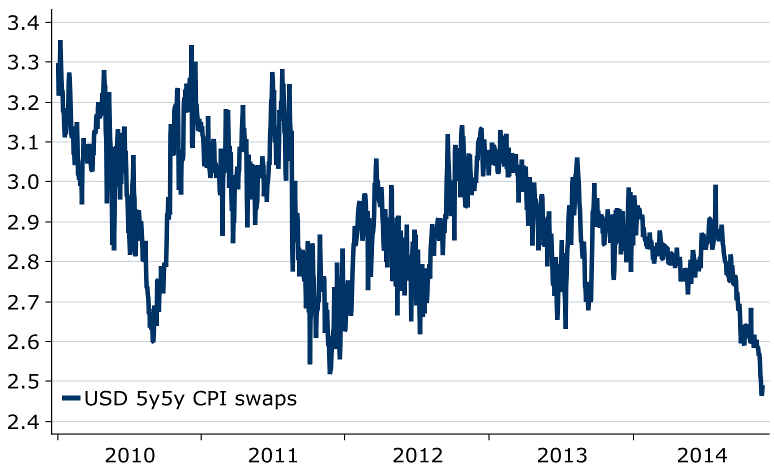

*Source:Nordea & Bloomberg*

*… equities are back on all time highs while US high yield have suffered from weak oil prices*



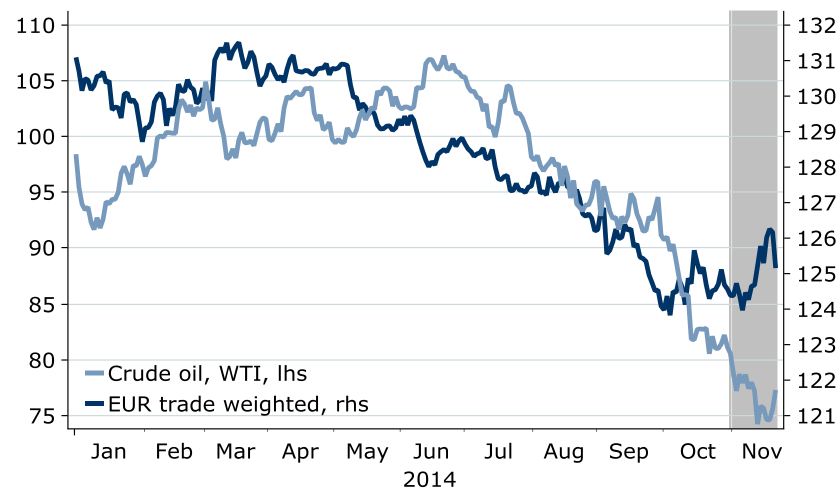

*Source:Nordea & Bloomberg*

*Short-term, it could weigh on the inflation outlook, but medium term it has a stimulating effect on the economy…*




Source: Nordea Markets and Macrobond

*The Fed seems more relaxed about it but the ECB is running out of time…*




Source: Nordea Markets and Macrobond

# Thank You!

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