FX & FI Strategy

Northern Lights

Uncharted territory

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Sweden – doing just fine

Healthy GDP growth, surging employment and house prices, and rising trend in core-inflation is hardly an economy in which the Riksbank will implement unconventional measures. Thus, much suggest that the Riksbank will keep monetary policy largely unchanged at the February meeting. We advise using near-term SEK weakness to position for a stronger SEK.

Norway – not so fast

The oil price continues to fall and Norges Bank is likely to cut rates again. However, the market seems confident that easing will be complete during the spring and places too little probability of a more drawn out easing cycle.

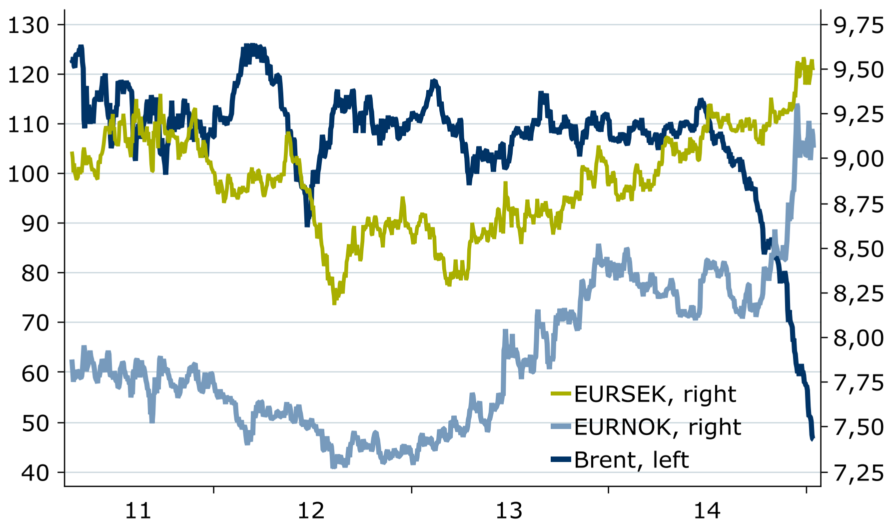
Denmark – a rate cut is approaching

After a minor weakening around year turn the Danish krone is yet again heading stronger versus the euro. Further monetary policy easing by the ECB can relatively quickly drive the krone even stronger, thus triggering further intervention and ultimately an independent rate cut by the Danish central bank.

Finland – welcoming ECB purchases

The ECB is about to announce a large-scale government bond purchase programme next week, and the composition of these purchases should be positive for Finnish government bonds. The Finnish economy continues to exhibit broad-based weakness in all key variables. Currently, it is difficult to imagine that an economic recovery could be sparked by any other factor than stronger external demand.

The NOK has been hurt hard from the falling oil price!



Kilde: Nordea Markets and Macrobond

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Sweden – core inflation rising

Continued growth

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Hard data for Q4 have so far been mixed. However, the underlying trend for the Swedish economy remains favourable. Household consumption is growing swiftly, government consumption is increasing as well as fixed investments. Exports are still lagging, though, and no marked pick up seems to be around the corner.

The domestic economy doing just fine

Employment is on a sharp upward trend and labour market indicators remain upbeat, while unemployment is sticky on the back of a strong inflow of labour. There is a slack in the economy, although the number of available resources in the labour market should not be overestimated.

Higher than expected inflation will keep the Riksbank side lined

CPIF excluding energy 1.1% in December

CPIF inflation was just above the Riksbank's forecast in Q4, despite the sharp fall in oil prices. With energy excluded from the CPIF, inflation was 1.1% y/y in December, a full 0.3% point above the bank's view. An important reason to the uptick in core inflation is the weaker SEK feeding through.

Healthy GDP growth, surging employment and house prices, and rising trend in core-inflation is hardly an economy in which the Riksbank will implement unconventional measures. Thus, much suggest that the Riksbank will keep monetary policy largely unchanged at the February meeting.

No case for unconventionals

For unconventional measures to be on the agenda, inflation must undershoot the Riksbank's forecast. Our forecast for the CPIF is somewhat below the Riksbank's in H1 2015, but probably not sufficient for extraordinary stimulus to become relevant.

Riksbank's rate decision next main event

In the coming month, we monitor the NIER quarterly Tendency Survey (29 Jan.). The December LFS should show continued employment growth (22 Jan.), while there is less hope for exports rising in December (27 Jan.). Christmas retail sales should reach a new record level (December figures are due 29 Jan.). These are second tier data for the Riksbank, as inflation is the main focus, and there are no more inflation readings ahead of the Riksbank's monetary policy meeting 11 February (announcement 12 Feb.)

Chart 1. Core inflation rising

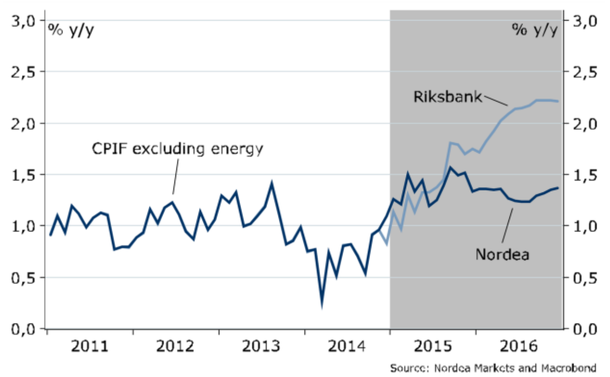
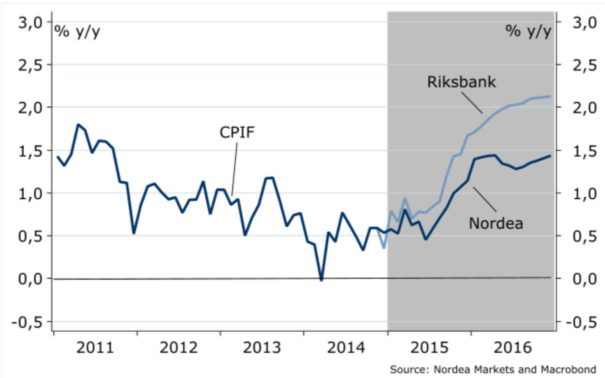


Chart 2. Riksbank's CPIF forecast a tad too high in Q1



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Swedish rates

A negative repo rate is already discounted in the Swedish yield curve as the money market is pricing roughly 20 percent probability for a 25 bps rate cut over the coming six months. As yield levels have plummeted, the pattern of correlations between tenors on the Swedish yield curve has started to imitate the pattern that has been present in the Eurozone for some time, with an increasing directionality in the 5-10s curve and a tendency for the belly of the curve in 2/5/10s flies to underperform on lower rates. ***We consider paying the belly in SEK to be a good risk-reward trade for lower rates.***

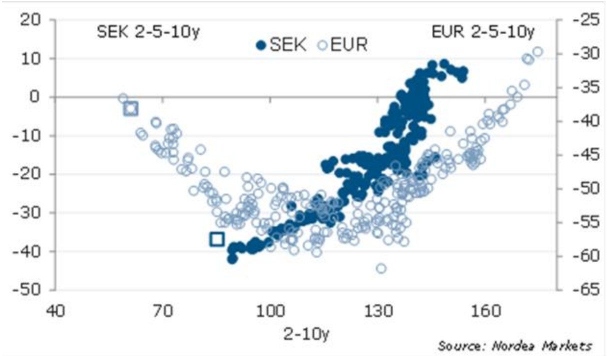
Government bonds on short tenors have displayed a tendency to start trading cheap

Government bonds on short tenors, such as SGB 1050 (1.5y) and SGB 1051 (2.5y), have displayed a tendency to start trading cheap on the curve as negative repo rate expectations have been established. For example, SGB 1050s trade about 5 bps cheap to the RIBA strip in cash bonds despite that the bond trade below the Riksbank's repo rate in the repo market. Some sort of behavioral barrier in short-end government bonds seems to be present, making it hard for them to trade on negative yields (technical issues in terms of support systems might still play into it as well). ***We consider going for wider ASWs in SGB 1050 and 1051 to be good value trades.***

The trend of lower global bond yields and flatter curves together with a Riksbank that seems to be on a path for yet more stimulus, are all arguments that speak for flat covered curve and a continued search for carry. Still, a lot of bond positive news is already discounted as nominal yield levels in general look stretched on the downside while momentum in inflation surprises seems to have tilted to the upside as illustrated by the recent higher-than-expected CPI print. In a relative value perspective, 0-2y covereds look cheap compared to 4-6y at the same time as the adjustment of the mortgage factor in Nasdaq OMX bond indices will shorten duration by 0.2 years. All-in-all, ***we are biased to favor covered bond steepeners over flatteners at this juncture.***

Chart 3. Swedish and German 2/5/10-flies in govies

Chart 4.Correlation 2/5/10s versus curve slope



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SEK: The Riksbank vs valuation

The Swedish krona was affected by the Norwegian flu at the end of 2014, which triggered SEK weakness far beyond fair values as indicated by the central bank outlook.

The Riksbank is sounding very much like the ECB

However, the market is rife with speculation that the Riksbank may need to launch unconventional measures, potentially at the February 12 or April 29 meetings. The Riksbank is after all sounding very much like the ECB, stating that "further measures (…) could be presented with the effect from the next monetary policy meeting".

So, while the Riksbank may launch further measures to boost the economy, given the unconventional nature of most such measures this leaves the near-term future of the krona somewhat harder than usual to determine. For instance, while the effect on EURSEK from the Riksbank cutting the repo rate into negative territory easily point in the direction of krona weakness (potentially above 9.60); a launch of e.g. funding for lending-styled LTROs could actually point in the direction of a stronger krona as the market may then need to reduce the perceived probability of negative rates.

In the short term, the risk of further Riksbank stimulus is likely to hold the SEK back until it is clear that the Riksbank has done enough.

The trade-weighted krona has weakened by 12% since early 2013

In the slightly longer term, the Swedish economy is in a much better shape than the Euro Area economy. Sweden should also see an earlier and more impactful effect on inflation from a weaker currency than should the Euro Area. After all, the trade-weighted krona has weakened by 12% since early 2013, with the EURSEK 15% higher, USDSEK 25% and GBPSEK a whopping 28% higher. Somewhere down the road this should show up in inflation as well.

As for ECB QE which may be launched already on January 22, suffice to say that EURSEK has actually been little affected by events south of the border ever since the European debt crisis ended. This is phenomenon possibly reflecting a market convinced that the Riksbank will have little tolerance for a stronger krona and will tend to respond in kind, or reflecting doubts regarding the details or effectiveness of ECB QE. A large negative effect on EURSEK from ECB QE is not what we predict, but is admittedly a risk.

For now, we advise using near-term SEK weakness to position for a stronger SEK later in 2015.

Chart 5. What if the Riksbank lowers the repo rate?

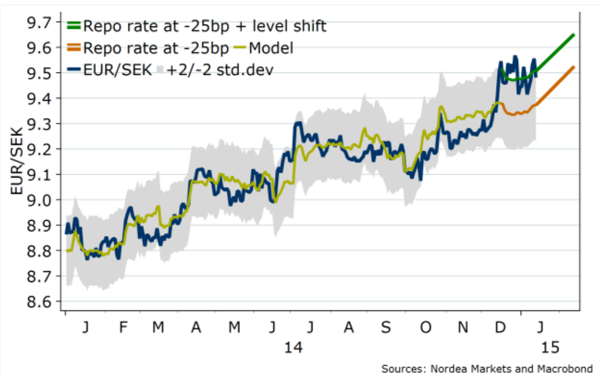
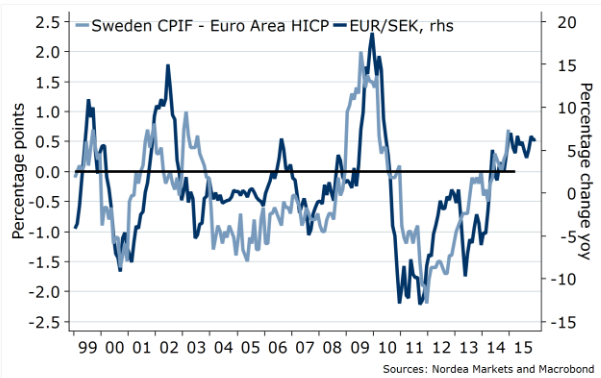


Chart 6. SEK weakness starting to show up in CPIF



Norway: Lower oil price vs lower rates

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Much lower oil prices means weaker growth

Oil price have fallen sharply lately and is well below Norges Bank's forecast. At least in the longer term this means significant lower spending, especially investment, by the oil companies. Oil investment is close to 10% of mainland GDP, but has a rather high import share at close to 50%. The oil company's investments plans from the autumn 2014 indicated a drop in oil investment in 2015 by 10-15%. Much of the planned activity in 2015 is already started and will be followed through even given today's much lower oil prices. But exploration and investments in fields already in operation could be cut further bringing the overall drop in investment to say 20%.

The key question is however how mainland spending and especially private consumption will be affected. Consumption is about 50% of mainland GDP and has an import share of just 20%. The effect from lower oil investment on consumption through lower employment should be rather modest. However oil related industries have pushed up wage growth in the whole economy due to shortages of labour and high profitability. Now wage growth slow. Add to this that lower oil prices and fear of a sharp downturn probably will hurt sentiment and lead to higher saving.

But lower rates and weaker NOK will dampen the impact

However lower mortgages rates will soften the impact on consumption. With two more rate cuts from Norges Bank, mortgage rates this spring could be about 1% points lower than early 2014. Add to this that banks seem much more willing to give loans. Lower rates will increase household income, housing prices and sentiment. Housing prices is already increasing strongly.

The sharp weakening of NOK will also soften the impact on the mainland economy from lower oil prices. How the end result will be is hard to forecast. Short term at least the impact of lower rates might counteract the effect of lower oil prices and current development might not be much weaker than expected by Norges Bank. Still we believe Norges Bank will cut two more times during the spring. Low oil prices and the risk of a coming sharp downturn will be the main argument.

Remember that it will take time before the full effect of the oil price drop will work its way through the economy. Norges Bank could cut further later especially if oil price remains at the current level for long

Chart 7. Stronger growth in housing prices

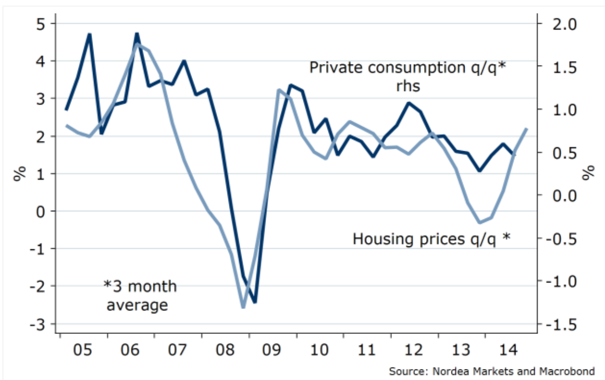

Chart 8. NOK won the currency war

Norwegian rates: Not so fast

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Norges Bank cut rates at the December meeting and indicated a 50% chance for another cut at the next meeting in March. Since then, Brent has fallen from around $65/barrel to $45/barrel, so the market obviously takes a more dovish stance than this.

The FRA strip has inverted sharply and price the trough in rates 60bp below the current NIBOR fixing. When we break this down on individual meetings we find that 25bp is priced for both the March and May meeting, whilst just 5bp is priced at the June and September meeting. Essentially the market takes the view that this will be a fast and short-lived easing cycle.

Given the volatility in oil 1prices it is extremely hard to take a firm stance on how many cuts eventually will be needed

Given the volatility in oil prices, it is extremely hard to take a firm stance on how many cuts eventually will be needed. What complicates the matter is that the economy to a large extent is sheltered from the direct effect of falling oil revenue through the petroleum fund. The question becomes what effects the fall in oil prices will have on the demand side of the economy. The most obvious effect is falling oil investments, but the impact from this is unlikely to be much more than a 1% drag on growth. I.e. the effect is only enough to give the economy a period of sub trend growth.

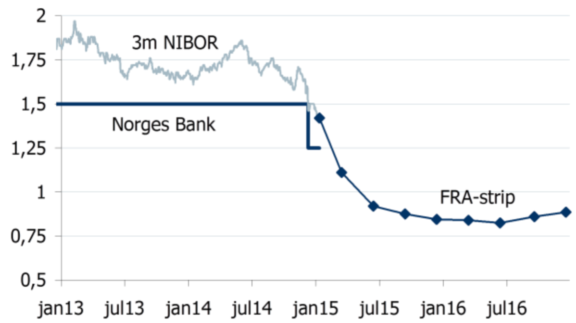
Anything more serous requires second order effects such as increased household savings, falling mainland investments or a setback for the housing market. This again is driven by confidence and is extremely hard to forecast.

Norges Bank's cut in December was not justified by its outlook for the economy, but the risks to the outlook

As such it is no surprise that Norges Bank's cut in December was not justified by its outlook for the economy, but the downside risk to the outlook: "There is a risk that developments will be considerably weaker than currently envisaged. An early reduction in the key policy rate could reduce the level of uncertainty and counteract the risk of a pronounced downturn in the Norwegian economy. This robustness consideration suggests a lower key policy rate at the beginning of the forecast period …"

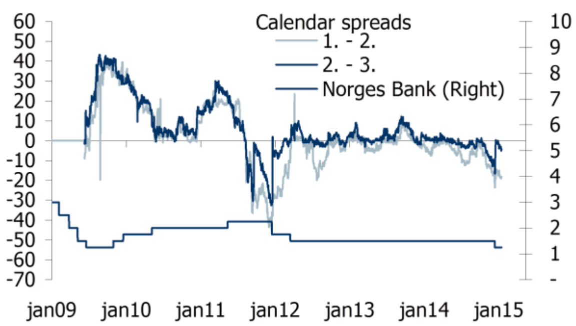
Given that the forces that drive the need for rate cuts are indirect, vague and uncertain we think the market is too confident in a short lived easing cycle. It could be that Norges Bank takes a slower approach to easing rates with cuts taking more time to materialise. Or it could be that more than two cuts are needed. Either way the market places too low chance for cuts taking place beyond May. We favour inversion trades in the FRA-strip starting from the June contract.

Chart 9: The FRA-strip is inverted out to June15



Source: Nordea Markets and Bloomberg

Chart 10: Inversion between the 2nd and 3rd contract?



Source: Nordea Markets and Bloomberg

NOK: The downside, but not before the oil price stops falling

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As long as oil price and interest rates are falling it is hard for the NOK to appreciate even if the levels are on the extreme side of history. With our view of two more rate cuts to come in the coming months it could even make sense thinking EURNOK should move higher from today's levels short term. Interest rate differentials will fall even if such cuts are currently expected in the market. Slightly higher is also our forecast. Last time we had EURNOK at these levels was in 2008/2009. Back then EURNOK ended up being quite volatile, but moving sideways first half of 2009 while the target rate was cut from 3% to 1.25%. Like today most of these cuts where expected. 2009 ended up 100bp lower than the starting point. This could happen again, the big question then becomes timing and level in which to start the short EURNOK position.

The option market also offers a heavy skew for calls

One could obviously just wait for the oil price to stop falling, but telling the difference between the bottom and a correction in the great trend could be difficult. This market offers other possibilities for this problem. Realized volatility is definitely high, but has not been as high as the implied volatility in the market. The option market also offers a heavy skew for calls. With a spot at 9.13 one can buy 1y puts at 9.00 financed by selling 1.5 times the size of 1y calls at 9.80 (zero cost).

If spot where to stay the same, say for 6 months, then the time decay in the calls will increase the value of the structure. If EURNOK starts dropping the need to know if the movement is the start of a large trend or just a correction becomes less pressing, participation starts at 9.00 and loss at maturity only occurs above 9.80.

Chart 11: Options market heavily skewed for calls

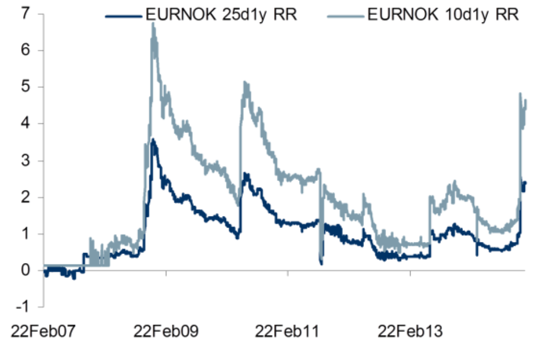

Chart 12: Implied volatilities at extreme levels

Source: Nordea Markets and Bloomberg

Denmark – a rate cut is approaching

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After a minor weakening around year turn the Danish krone is yet again heading stronger versus the euro

DKK is staying strong

After a minor weakening around year turn the Danish krone is yet again heading stronger versus the euro. Over the past four months this appreciation has triggered total krone sales of DKK 6.9bn by the central bank. With the past months' intervention the central bank follows the normal reaction pattern where an undesired movement in EUR/DKK is initially countered by currency market intervention. If that is not enough, the next step for the central bank will be to sanction an isolated Danish rate cut.

Further monetary policy easing by the ECB can relatively quickly drive the krone even stronger, thus triggering further intervention and ultimately an independent rate cut by the Danish central bank. Initially we expect the bank to cut rates by 0.10% point, applicable to both the lending rate and the rate on certificates of deposit, to 0.10% and -0.15%, respectively. The current account rate is set to remain unchanged at 0.00%.

Market says cut in play, but longer spreads are near historical wides

There are two separate mechanisms currently that both can trigger a rate cut from Nationalbanken. The first pertains to further ECB easing (QE, most likely) which will pressure EUR MM rates downwards and pressure EURDKK. The second is a re-boot of the flows seen during the sovereign debt crisis which prompted a lot of safe haven flows in Danish assets. Such a re-boot could be triggered by the ongoing exit possibility for Greece.

The overnight swap market is currently clearly indicating a large chance of a cut with the 3M3M Cita swap 5bps below the current spot value. If the ECB delivers QE in large size and speed, Cita swaps could easily move in excess of that.

Regarding the safe haven flows, these are not here, at least not yet. The 5Y DKK-EUR swap spread traded as low as -18bps in early 2012 and currently lies almost 50bps higher at just under 30bps. Despite the fact that historically this is a wide spread, and the real risk of deflation and political risks in the Eurozone, this is priced to expand further

As the DKK swap curve is lagging the EUR curve in terms of flattening, the 3y5y swap spread trades at a spread of 35bps (cf. chart 14 below), a level we like receiving given the risk picture.

Chart 13. EUR/DKK and central bank intervention

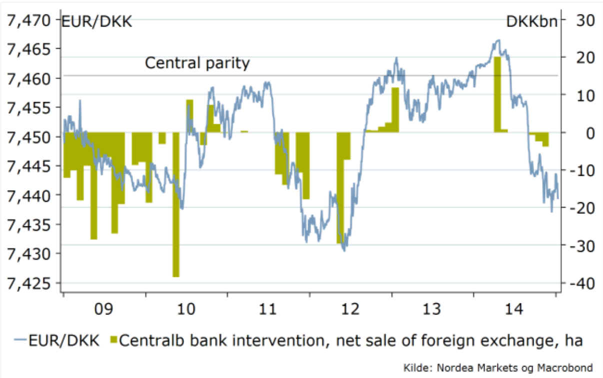
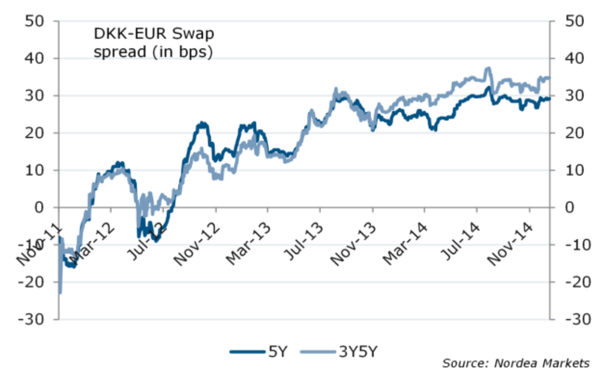


Chart 14: DKK-EUR spreads – close to historical wides



Finland – Welcoming ECB purchases

Finnish bonds to benefit from ECB QE

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The ECB is about to announce a large-scale government bond purchase programme next week, and the composition of these purchases should be positive for Finnish government bonds. We expect the central bank to conduct the purchases based on the ECB's capital key. In the semi-core space, Finland has the smallest government bond market relative to GDP, and the share of the Finnish bond market relative to the Euro area as a whole is smaller than the Finnish share of the capital key. In other words, the amount of purchases targeting Finnish bonds will be larger relative to the size of the bond market compared to Austria and the Netherlands.

Finnish bonds to benefit from ECB purchases more than Dutch and Austrian ones.

We thus find value in Finnish bonds vs their Austrian and Dutch comparables, especially at parts of the curve, where Finnish bonds can be bought with pick-up. Especially RFGB 2021 looks attractive on the Finnish curve. This bond is actually trading close to the Belgian curve, and thus has performance potential also vs the Belgian bonds in the maturity area.

What happened to the weak economic outlook?

ECB purchases a much bigger market driver than the weak economy in the near term.

The Finnish economic outlook has not really improved, while political uncertainty is high due to the parliamentary elections due in April. However, in the near term at least, the ECB bond purchases will be a much more important driver of the Finnish bond market than the economic or political outlook. After all, the ECB purchases would likely amount to a size equivalent to a lion's share of this year's Finnish bond issuance.

The Finnish economy continues to exhibit broad-based weakness in all key variables. Currently, it is difficult to imagine that an economic recovery could be sparked by any other factor than stronger external demand and a resulting pick-up in exports. Despite a weaker euro, a major improvement in exports is not expected before H2 2015, as sanctions on Russia are a major drag on both demand and confidence.

Structural reform process stalled.

On the political front, the current government is not expected to do much to address the structural issues burdening the Finnish economy. Parliamentary elections will be held in April, and the reform process will hopefully pick up after the summer. Luckily, the need for reforms seems to be generally accepted at this point, but the next government will have its hands full.

Chart 15. Finland to benefit from ECB sovereign QE

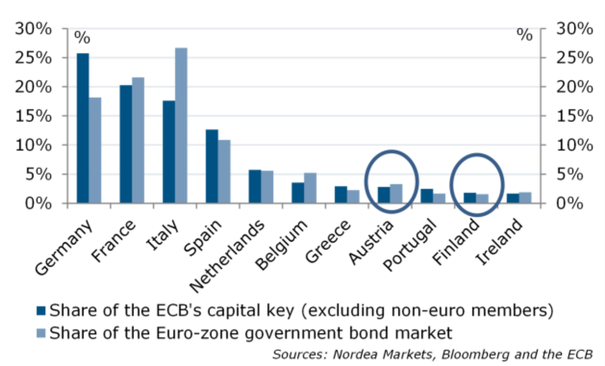

Chart 16. RFGB 2021 looking attractive on the curve