European FI Strategy

The elephant is finally moving

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Global markets

ECB-QE is imminent, and we expect an announcement on the 22nd of January. The culprit or the main one at least, is inflation. The first of likely several negative prints came for December, and on top of that longer-dated expectations have also tanked. We think that the ECB-programme will be credible, and as such will lead to increases in rates, albeit at a moderate pace, at least initially.

EUR Strategy

The Eonia market is now "righter" than it was in the fall, with the low on the forward structure longer out than previously, sensible as excess liquidity will not be maximized on a short horizon. We still see flattening potential and like the risk/reward in paying 6m6m @ -12.5bps (EUR MM rates have tanked today, catching a wind from Switzerland. Be careful on the long end of the curve; 10s30s rebounds seem most certain for increasing rates – user payer swaptions.

Sweden

A negative repo rate is already implied in the Swedish curve, and the SEK curve shows signs of imitating EUR rates. On the SEK curve, we favor paying the belly in the 2s5s10s fly.

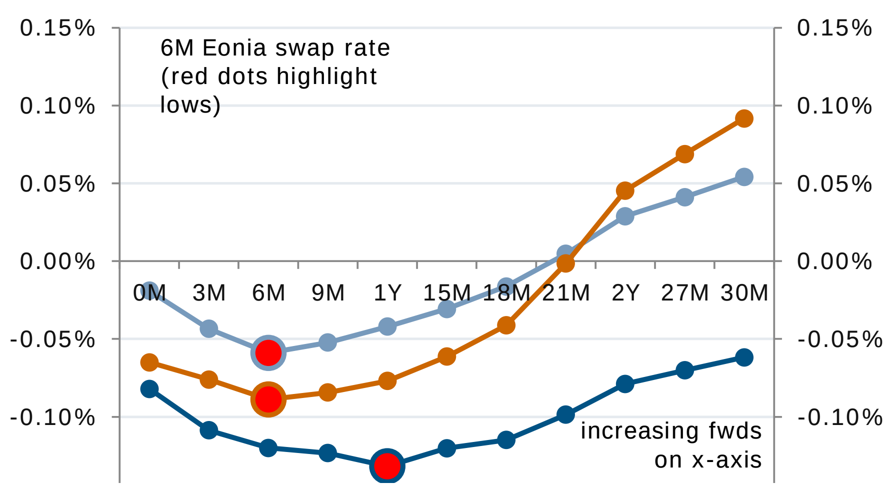
Norway

The NOK FRA strip has inverted sharply and goes as low as 60bp below the current NIBOR. The market implied easing cycle looks too short, and we favor more inversion on the FRAs.

Denmark

A cut is in play in Denmark, and we see it coming within the coming months. Longer out, Danish risk looks cheap, and forward swap spreads against EUR, looks worth receiving; 3y5y in particular.

Chart of the month: QE/liquidity is priced – Eonia's with new lows.



Contents

Global Markets

The big buyer is finally arriving

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Markets have been full of QE speculation in the past months, and it is finally time for the ECB to deliver. Our baseline is an announcement of a broad-based bond purchase programme on 22 January and the first government bonds to be bought before the end of Q1. The central bank is likely to buy bonds along the curve, including inflation-linkers, buy according to the ECB's capital key and include also investment grade corporate and agency bonds.

As the inflation outlook has deteriorated further, a stronger policy response is clearly warranted. In other words, the ECB needs to accumulate bonds at a faster pace towards its intended balance sheet size of more than EUR 3000bn than previously indicated. A purchase pace in all assets of EUR 50 to 70bn a month should amount to a credible programme. In practice, the bulk of buying will be in government bonds. As an illustration, purchases in the current covered bond programme amount to EUR 31bn (started on 20 Oct 2014) and in the ABS programme to EUR 1.8bn (started on 21 Nov 2014).

Credible ECB easing programme to contribute to a rebound in longer yields.

Following initial volatility, a credible programme by the ECB is likely to lead to rebound higher in longer yields and a steeper curve. Establishing short positions ahead of next week's meeting in German 10-year bonds around record-low yields thus have potential.

The risks of the ECB disappointing are considerable, though. Even a disappointment in terms of the programme size or a delayed decision could easily push yields higher, but only for a short while. In such a scenario, expectations that the central bank had to do more later would quickly increase, while more modest QE would do little to combat the deflation risks.

Excluding negative-yielding instruments would add downward pressure on longer German yields.

If the ECB decided to shun negative-yielding instruments altogether, longer German bonds would have more room to rally. After all, more than half of the German bond market is currently composed of bonds trading at negative yields. Excluding such a big part of the market from the programme does not look likely, but if it was done, it would mean much more purchases longer out the curve.

Bonds continued to perform strongly.

In general, the bond market momentum remains strong, also in the US despite rather favourable economic development.

Chart1. ECB QE would not affect all markets equally

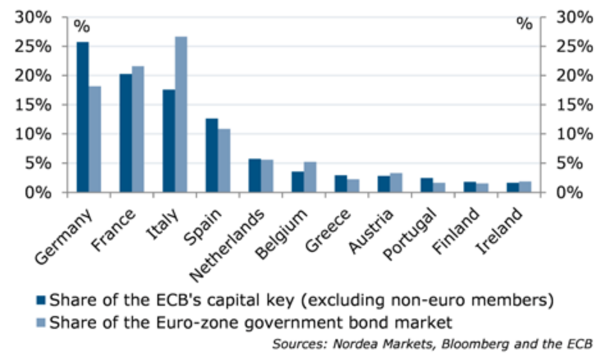

Chart 2. Bonds with more performance lately

EUR Strategy

Semi-core spreads to rebound – Finnish bonds with potential

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While the volatility in peripheral intra-Euro-area spreads has increased, semi-core spreads have narrowed vehemently lately. While the upcoming ECB bond purchase programme will limit the widening potential in spreads, some profit taking in the semi-core looks likely following the ECB's announcement. After all, spreads already look low, while the bulk of the purchases will be in German bonds at a time, when net bond issuance is set to be negative.

Rebound ahead in semi-core spreads, but Finnish bonds to perform vs the Netherlands and Austria.

A closer look at the semi-core space reveals Finland has the smallest government bond market relative to GDP, while 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, assuming the ECB conducts its purchases relative to the capital key, the amount of purchases targeting Finnish bonds will be larger relative to the size of the bond market compared to Austria and the Netherlands. 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.

Long end of curve with extreme volatility

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The long end of the EUR swap curve has been under continuous pressure so far in 2015 and last week's -8bps day-to-day move was just below the largest over the past 5 years, see chart 4 below, and as such an extreme move.

The culprits here depend on who you ask. We have heard, lack of duration, CVA desks hedging, Danish pension low-level guarantees getting near the money, Dutch pension funds receiving due to underweight in hedges, and even the occasional interpretation of persistent deflation setting in.

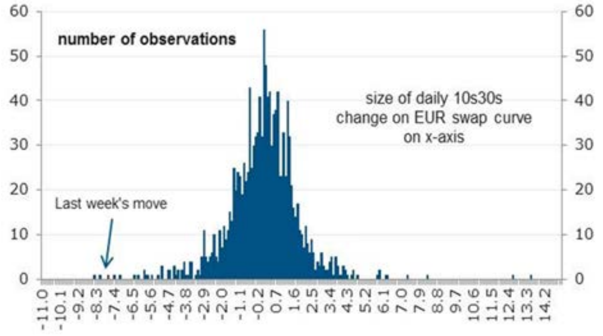
It could actually easily be a combination of many or all of the above. What's clear is that the market (1) trades at long stretches essentially one-sided, with payers on 30Y simply not there and (2) displays clear feedback mechanisms at times, where drops fuel renewed drops.

10s30s rebounds: Do them contingent on rising rates (i.e. in payer swaptions).

To us, a sizeable rebound in 10s30s on a tactical horizon, say for the next 3 to 4 months, is extremely likely to be directional, contingent on increasing rates. Payer swaptions therefore to us, right now is the tool to use.

Chart3. Semi-core spreads look too tight already

Chart4: 10s30s daily moves – last five years.



EUR short rates – more sensible now, but opportunities remain.

Excess liquidity will increase, but not surge on the short horizon

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Excess liquidity in the Eurozone is currently at around €200bn, and started the year just above €260bn. More interestingly is how excess liquidity will increase from here, and at what pace. The market focus regarding ECB-QE has shifted from *if* to *how will it will look.* The deterioration in inflation, prints and expectations, has been especially stark since late November in large part fuelled by falling oil prices.

ECB-QE now a matter how will it look rather if it will come

In the fall we recommended Eonia flatteners at more than one occasion (here, here and here). That has performed, but we still see more potential here. However, the market is shape-wise more aligned with the "right liquidity path" now than it was a couple of months ago. At those times, the low on the Eonia forward curve was 6m6m, which we argued was counter-intuitive because excess liquidity is unlikely to be maximized until at least 2016. The market has complied and the trough on the Eonia forward curve has moved outwards, cf. chart 5 below.

The trough on Eonia swaps is now for a "righter" forward than previously

The current structure looks more reasonable to us, though we'd argue that risk-reward still favours a flatter curve and paying 6m6m even though it's no longer the low-point on the curve. If the ECB delivers QE, there's even a chance that they will do so in relatively large size, but the program is likely to expand for two years (or more), equivalent to the CBPP3 and ABSPP programmes which will last for at least two years according to Draghi on December 4th. Additionally, our projection on the maximal take-up on March's TLTRO is €200bn whereas the redemptions of the old 3Y LTRO's are deterministic at €64.5bn and 145.5bn respectively, i.e. a net drain in total.

March's TLTRO unlikely to be higher than €200bn

Curve still flat with flattening potential and e.g. 6m6m looks too low

Flatteners remain the choice, but we also like paying 6m6m Eonia outright near -12.5bps.

We still favour flatteners such as 6m6m vs. 6m2y or 6m6m vs. 18m6m. *Further, 6m6m at -12.5bps (target -6bps, stop -17bps) looks ripe for paying outright*. It rolls well, liquidity will not be maximised in H2 2015, no fixing has been near that yet, and the empirical evidence (chart 6) so far suggests that Eonia for a given excess liquidity number won't go as close to the depo as it did when banks weren't outright penalized for depo-placements.

Chart 5. Eonia's now projected to bottom out later

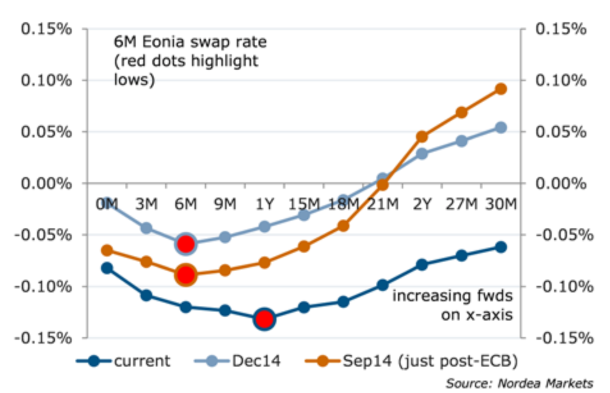
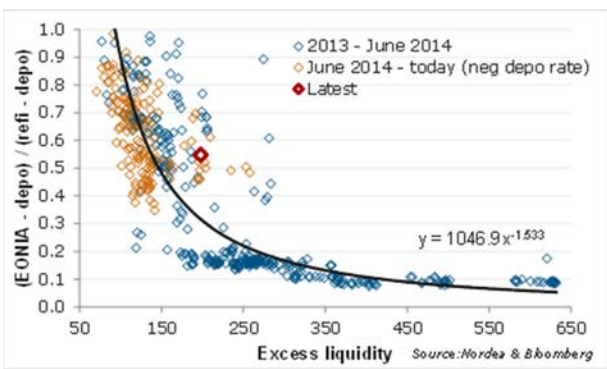


Chart 6. Negative depo = changed dynamics?



Scandi Corner

Swedish Rates

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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.*

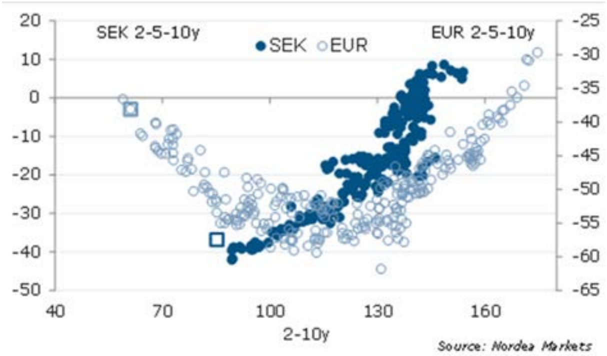
Government bonds on short tenors have displayed a tendency to start trading cheap

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

Chart 8. Correlation 2/5/10s versus curve slope



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

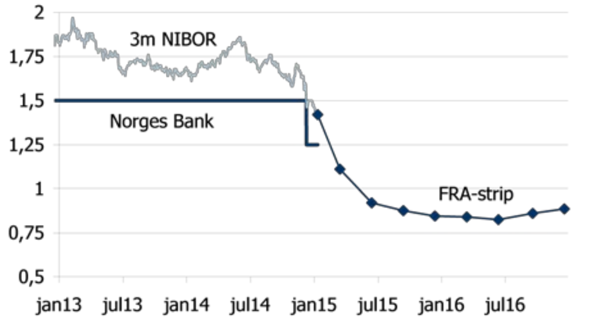
Anything more serous requires second order effects such as increased household savings, falling mainland investments or a setback for the housing market. This again is driven by confidence and is extremely hard to forecast.

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 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

Danish rates: Market says cut in play, but longer spreads are near historical wide

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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 12 below), a level we like receiving given the risk picture.

Chart 11. EUR/DKK and central bank intervention

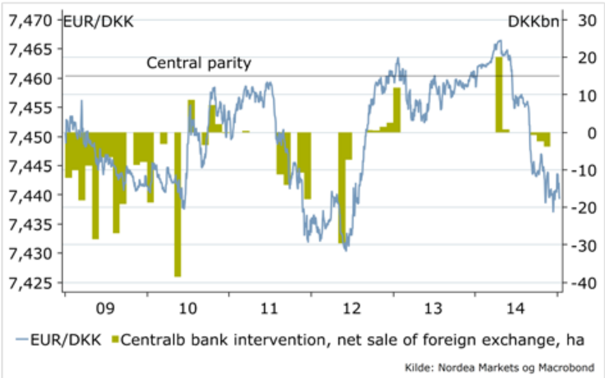

Chart 12: : DKK-EUR spreads – close to historical wides