Northern Lights

The unconventional Vikings

Nordea Research, 17 February 2015

Sweden – Inflation targeting above all

The Riksbank surprised in February and is extremely worried that inflation is too low. The repo rate should be cut to -0.20% in April and the QE program announced will be extended by an additional SEK 10bn. There is a risk of a bond squeeze ahead of the Riksbank's reversed bond auctions. Short term the SEK should remain weak due to the Riksbank's inflation focus.

Norway – Lower wage growth and oil prices

Growth is still rather healthy and the NOK on the weak side, but lower oil prices and wage growth than expected should lead to a 25 bps rate cut in March. We favour inversion trades in the FRA-strip. With other central banks entering unconventional territory, foreign interest in the NOK is returning.

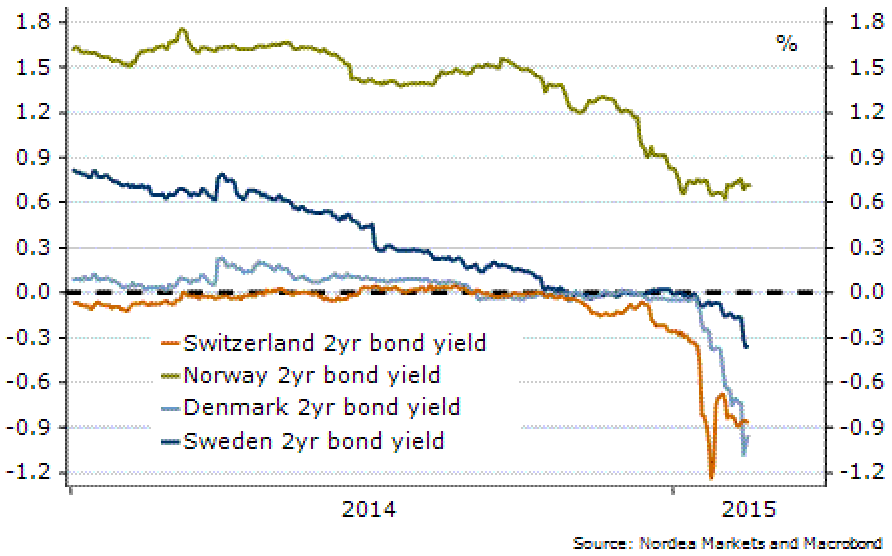
Denmark – Strong defence of the peg

Interventions have continued even after the rate cuts and the suspension of bond issuance, which suggests that the bank has yet to find the CD rate equilibrium that would stop the mounting DKK pressure. The CD rates will therefore be lowered again to -1%. Also, the bank is likely to resort to more unconventional measures, such as possibly mortgage bond purchases.

Finland – Still no recovery

The ECB will launch its sizable sovereign bond purchase programme next month, and we expect these purchases to be very supportive of Finnish bonds vs. closest peers.

Diving into the abyss!



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Sweden –inflation targeting above all

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Sluggish growth in Q4

Weak exports continue to weigh on growth, and the quarterly Q4 GDP growth rate will probably be close to zero.

However, the underlying trend for the domestic economy remains healthy. Household consumption shows decent growth, government consumption is increasing and so is fixed investment.

The domestic economy continue to show good growth

Employment is on a sharp upward trend and labour market indicators are upbeat. Unemployment remains sticky, though, as there is a strong inflow of labour.

Inflation stabilising not enough

The Riksbank changed its footing in February and is increasingly worried that inflation is too low. Measures are thus taken to bring inflation to, or even above, 2% in the not too distant future.

The most important reason for the aggressive monetary policy stance is the concern about inflation expectations getting too low. The distress about price expectations should be seen in light of next year's wage deals.

More action from the Riksbank likely

We therefore believe that the Riksbank will try to stimulate the economy further. We expect the repo rate to be cut from today's level of -0.10% to -0.20% in April, but that this will mark the end of the easing cycle. Moreover, the purchase programme announced in February will be extended to SEK 10bn per quarter until further notice.

Inflation rising to slowly

Notably, we see CPIF inflation somewhat above the Riksbank's forecast in H1 2015. For instance, there is a good chance that the CPIF inflation will reach 1.0% in March. However, the Riksbank will probably not settle with that and it will not prevent further action from the Riksbank in April.

Minutes and inflation expectations survey on the agenda

As for upcoming events, the minutes will hopefully shed more light on the Riksbank's reaction function (25 Feb). We fear that Q4 GDP will show weak growth (27 Feb). Wednesday 11 March is an important date as February CPI and the Prospera's quarterly inflation expectation survey will be published – as well as Nordea's *Economic Outlook*!

Chart 1. CPIF inflation rising gradually

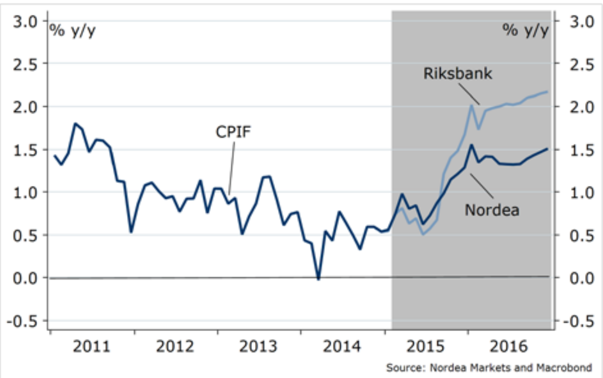

Chart 2. Inflation expectations at historical lows

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Swedish rates: Riksbank made massive fixed income imprint

The reaction after the Riksbank's surprise move to cut the repo rate to -0.1 % and embark on a small QE program in government bonds left a massive market imprint. Government bond yields plunged, especially in the segment the Riksbank said it would seek to buy bonds (1-5y or more specifically SGB 1050, 1051, 1052 and 1047). Swap spreads widened massively, despite the fact that 3m Stibor went negative and the excess liquidity in the system will increase according to the size of the QE program.

It is very hard to suggest a fair-value of Swedish swap spreads.

Apparently, the bond scarcity premium out-weighed the downward pressure on Stibor, which was already fully priced. Until we roll pass the next publication of the quarterly inflation expectation survey (published on the 11th March), it is very hard to suggest a fair-value of Swedish swap spreads. There is a clear risk that a short-term bond squeeze may occur ahead of the Riksbank's reversed auctions (26th Feb, 5th Mar and 12th Mar).

We see some factors that point to a flattening of the bond curve 5-10y relative to the swap curve

Looking ahead we see some factors that point to a flattening of the bond curve 5-10y relative to the swap curve. Firstly, domestic liability managers are most likely to continue to create natural payer flows in the 7-10y segment. Secondly, upcoming issuance from mortgage lending institutions may create receiver interests in segment 4-6y as issuers hedge their interest rate risk. Thirdly, real money investors may start an exodus from segments with negative yields (0-5y) into bond segments with positive yields (5-10y).

We continue to consider the Swedish rate market to be a "swing market"

We continue to consider the Swedish rate market a "swing market" in terms of its potential to overshoot other markets both on the upside and downside in yields. In a continued trend of lower global bond yields, Sweden has the potential to catch up to Eurozone bond yields and the Swedish 5-10y curve to flatten more than other markets. If global activity data pick up, the fact that Swedish macro bears more similarity with US macro than with Eurozone's, implies that the market could start pricing in a probability that Swedish rates could re-couple to US/UK rates and this would mean a massive upside in Swedish bond yields, especially in the 10y sector.

Chart 3. Sweden playing catching up to DKK and CHF

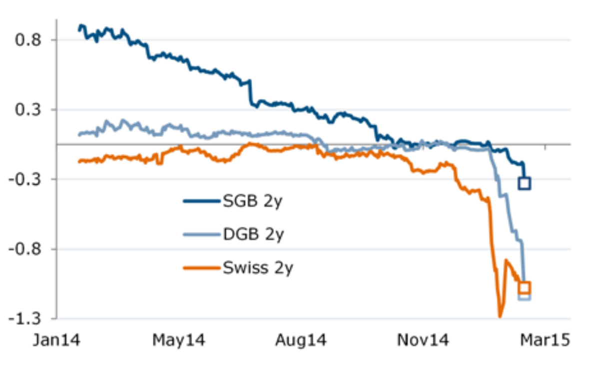
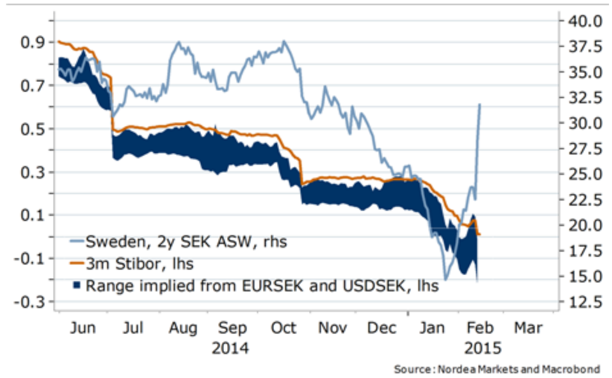


Chart 4. Wider swap spread despite negative 3m Stibor



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SEK: The Riksbank staring into the abyss

The Riksbank opening up the trap-door to the basement of negative rates make it less appetizing to buy the SEK. Both in July and October 2014 the SEK appreciated after the surprisingly large rate cuts, partly as a result of the markets' in retrospect misplaced perceptions that rates had hit rock-bottom. Alas, that was far from the case. Today, the Riksbank's alternative scenario in which inflation expectations ease, and comments from Governor Ingves that it could go "much lower" and that it's far from any "lower threshold" support the notion that the Riksbank could go deeply negative if warranted.

How inflation expectations develop in the next quarterly survey will be key

How inflation expectations develop in the next quarterly survey will be key. The best guess according to our models is that we'll see another decline in March. As long as inflation expectations remain here, or deteriorate, the pressure is on the Riksbank to act further. Continued pressure on the Riksbank is likely in the near term, we think.

While "fair value" of EUR/SEK is around 9.60 based on our view of another rate cut, we could see substantially higher levels if inflation disappoints – prompting larger rate cuts. A Riksbank rate cut to -50bp and some overshooting could prompt a temporary move to as high as 10.

The best SEK-bulls could hope for is a distinct turn-around in the global commodity cycle.

If, however, we start to see surprisingly large currency effects in inflation, or a continued turn-around in global commodity (especially energy) prices, this would reduce the pressure on the Riksbank and hence on the SEK. The best SEK-bulls could hope for would be a distinct turn-around in the global commodity cycle.

In the short term the SEK is likely to remain weak owing to the Riksbank's inflation focus. Further EUR/SEK dip-buying makes sense unless the inflation outlook clearly improves. In the medium term (by summer / autumn), the SEK should appreciate markedly as the Riksbank is implementing monetary policy fit for a deep crisis. Since there is no crisis in Sweden, policies are put into place solely due to disinflation worries.

In short, when the inflation situation improves, a markedly different set of monetary policies will be put in place, all of which would be SEK positive.

Chart 5. Swedish inflation expectations will be crucial

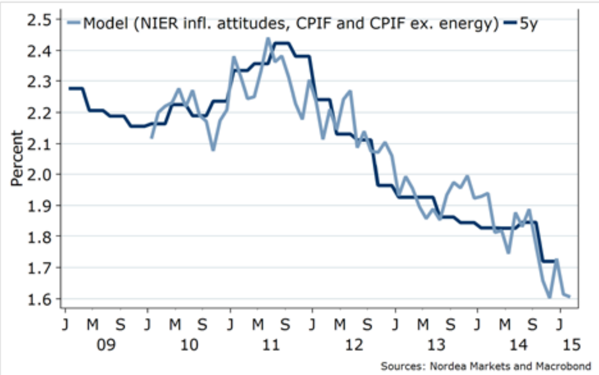
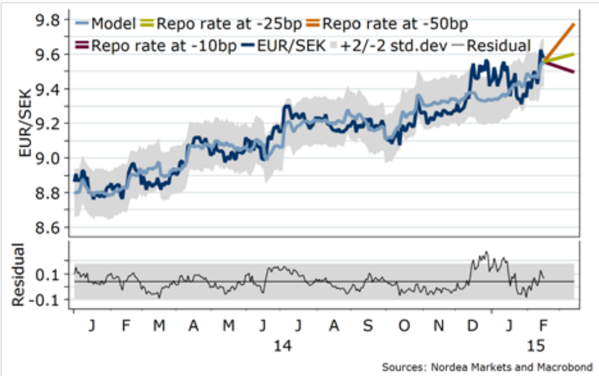


Chart 6. EUR/SEK fair value in different scenarios



Norway - Wage growth and oil prices

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The March Norges Bank meeting is getting closer. After Norges Bank surprise cut and dramatic change in view on the economy and the risk picture in December the uncertainty is high. If we are to believe the rate path Norges Bank themselves presented in December, there is a 50% probability of a cut on the March meeting and then the central bank will be on hold.

Current development as expected

The current development in the economy is very much as expected. Growth is still rather healthy, but as expected. There are some first signs that the labour market is weakening, but not more than forecasted. Inflation is close to target and not significantly different from forecast. Housing prices grow strongly, but not significantly more than forecasted.

NOK is still a bit on the weak side despite the recent strengthening and all else equal argues for unchanged rates in March. We still believe Norges Bank will cut in March and present a rate path which gives a clear probability of another cut. That rates abroad has fallen and the international picture is a bit weaker argues for a cut, but our main argument is that oil prices is lower than forecasted and also clear signs that Norges Bank's forecast for wage growth is too high.

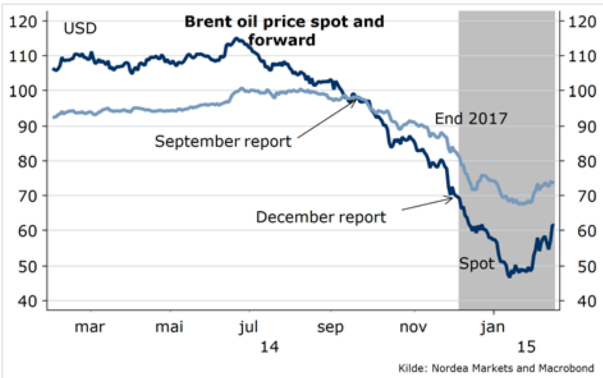
But lower oil prices and wage growth still argues for cut

The drop in oil prices from about USD 100 to USD 70 per barrel was the argument for Norges Bank dramatic change of view in December. Now prices (spot) have fallen another USD 8. The drop is of course smaller, but one could argue that a given drop in oil prices will hurt the economy more the lower the oil price is. On the other hand Norges Bank used the drop in oil prices as an argument for changing its (too) optimistic view on consumption growth. Still, lower oil prices will lower the rate path significantly.

Wage growth in 2014 ended up ¼- ½% lower than Norges Bank's forecast, a clear sign that the wage pressure is less than expected. The signals given before this year wage settlement points to wage growth ending up say at least ½% lower also this year. Lower wage growth means lower inflation forecast and argues for lower rates.

Chart 7. Housing prices as expected

Chart 8. Oil prices even lower



Norwegian Rates: Not so fast, but later?

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Norges Bank cut rates at the last meeting in December and indicated a 50% chance for another cut at the next meeting in March. The question facing the market is how deep and long lived the easing cycle will be.

The answer to this is closely related to the level of oil prices. Since the trough in mid-January Brent has recovered from $45/bbl to just over $60/bbl. In the same period the FRA-strip has come up by about 25bp (see chart 9). This move has been a parallel shift meaning that the market has significantly reduced the cut priced for the March meeting whilst keeping the cuts priced for later meetings largely intact, effectively removing the view that this will be a very front loaded easing cycle.

The market now discounts three cuts spread over the March, May and June meetings

The market now discounts two cuts, spread over the March, May and June meetings. This is much more than the half cut in the last rate path, but hard to disagree with since the oil price is $8/bbl lower, wage growth has surprised to the downside and other european central banks have delivered plenty of easing since then.

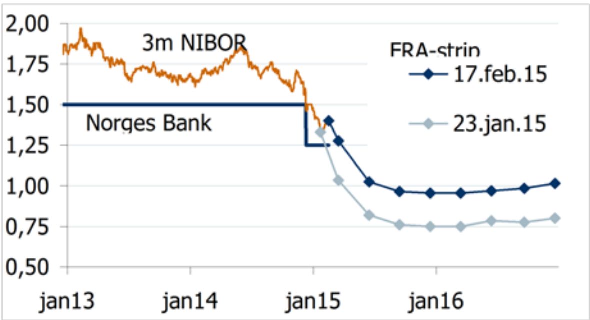
In the last Northern Light we highlighted the possibility for a slower and longer lived easing cycle than what markets priced. This is still a theme we like. The market has removed the front loaded cuts, but has not yet increased the possibility for cuts also after the summer.

The worry is that the fall in oil prices will hurt the demand side of the economy

The economy is to a large extent sheltered from the direct effect of falling oil revenue through the petroleum fund and the worry is that the fall in oil prices will hurt the demand side of the economy through other less direct channels. The most obvious effect is falling oil investments, but the impact from this is likely to be around a 1% drag on 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.

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 a too low chance for cuts beyond the summer. We continue to favour inversion trades in the FRA-strip starting from the June contract.

Chart 9. The FRA-strip is inverted out to June 15



Source: Nordea Markets and Bloomberg

Chart 10. Further inversion between 2nd and 3rd FRA?

Source: Nordea Markets and Bloomberg

EURNOK: the alternatives to NOK are not attractive

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With oil prices rebounding we are seeing foreign interest for the extremely weak NOK again. Another contribution to the idea is the other central banks entering unconventional territory and turning the alternatives to NOK less attractive. Weaker growth will of course create consequences, but at least for now you don't need to pay up for depositing NOK. The same could be said about NZD and AUD. In all these three currencies the main driver has been commodity prices. One should probably expect that to remain the case, but a general rebound in commodity prices could create an even bigger turnaround due to the positive carry.

We expect Norges Bank to cut the target rate in March

We expect Norges Bank to cut the target rate in March and based on history EURNOK normally does not start the falling trend in an environment with falling rates. It makes sense to expect EURNOK to keep on grinding lower slowly and with large corrections. In such an environment, realized volatility should come down and implied volatilities even more taken their level into consideration. Add to this that there still is quite a decent skew for the upside in EURNOK, it should make sense to keep doing what we also wrote about in the last edition of Northern Light: buy puts and sell calls further out of the money at higher volumes.

With spot at 8.58 one can buy 1y puts at 8.45 and sell 1y calls at 8.90 (Zero cost). If EURNOK falls hard and fast this will quite obviously work and there is some protection against the upside until 8.90. If EURNOK falls slowly and implied volatility goes with it (it normally does) the sold calls will decrease quite fast in value and could offset at least some of the time decay in the puts. This strategy will also make timing less of a pressing issue.

Chart 11: Options market heavily skewed for calls

Chart 12: Implied volatilities at extreme levels

Source: Nordea Markets and Bloomberg

Denmark – Strong defence of the peg

A struggle to keep the DKK fixed vs the EUR

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Since mid-January the Danish central bank has put up a brave struggle to keep the Danish krone stable versus the euro. So far, the defense has consisted of independent rate cuts of 70 bp and intervention worth more than DKK 230bn. In addition to these "traditional" instruments, the Danish central bank has announced a suspension of issuance of new government bonds and a de facto stop for issuance of new T-bills. All instruments used in order to keep the DKK stable versus the EUR.

The Danish Central Bank has yet to find the CD rate equilibrium that will be able to neutralize the pressure for a stronger Danish krone

Despite repeated rate cuts and a temporary stop to the issuance of government bonds, the central bank has still not succeeded in stabilizing the krone versus the euro. Our calculations based on the daily net position data show that since its latest official currency reserve data for January, the bank has intervened further to the tune of DKK 125bn. The figures moreover show that since the last rate cut on 5 February the bank has been selling Danish kroner worth around DKK 70bn. This suggests that the bank has yet to find the CD rate equilibrium that will be able to neutralize the pressure for a stronger Danish krone. Therefore, we believe that the central bank will lower rates again in the near future, bringing its CD rate to -1.00%.

In our view, there are neither any formal nor any informal limits as to how far the bank will go in its defense of the Danish fixed exchange rate policy. Continued inflows into the currency will therefore be met with intervention and/or further rate cuts. And the central bank is also likely to resort to more unconventional means, for example mortgage-bond purchases. If this happens, they are likely to focus on the short end of the curve both due to immediate supply, but also due to the fact that shorter rates are the most important ones to press down

The pressure on the krone will ease – eventually

In the near term, we expect Danish yields to decline further

It is difficult to predict how long the downward pressure on Danish market yields will persist. Near term, we expect Danish yields to decline further as the central bank's suspension of government bond issuance takes full effect. At the same time, expectations of more action from the central bank will continue to put heavy downward pressure on the Danish interest rate market.

Slightly longer term, we definitely expect the current pressure on the krone to ease as the central bank manages to stabilize the situation. We expect the central bank to stabilize the situation relatively quickly, as it has a strong interest in doing so to avoid a self-sustaining speculative spiral picking up speed. Against this backdrop, we expect Danish yields to bottom within the coming three months. After this period we look for moderate increases across the entire Danish curve.

What factors could uphold the pressure?

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As mentioned, the Danish central bank has stopped issuing government bonds, and for now apparently also T-bills. The consequence has been that yield spreads on Danish government bonds have plummeted and gone negative relative to German across the curve. And yet in spite hereof we continue to see an inflow into Denmark. Even though we have no way of knowing if the inflow is driven by domestic or foreign entities, we can estimate the attractiveness for non-domestic entities of investing in DKK assets.

The EUR/DKK FX-Forward has gone from around zero and massively into the negative

In this respect a lot can be inferred from the FX-Forward on EUR/DKK. Even as Danish rates have fallen further, and spreads have become negative relative to German, the EUR/DKK FX-Forward has gone from around zero and massively into the negative. This has happened over a relatively short period of time, from mid-January till now. Being negative implies a positive payoff for the non-domestic investor. So from being close to zero the value is now positive from 100-150bp depending on the maturity of the instrument.

The value of FX-Forwards offsets negative yield spreads

Consequently the positive implied value of the FX-Forward offsets the negative yield spreads. The result is that buying short dated Danish government bonds and including the FX-Forward continues to give non-domestic investors a favorable payoff relative to German alternatives. The package payoff is actually at par with French T-bills, and even slightly above at times.

Danish yield spreads differentials being negative to German, might simply not be enough to stem the inflow we are currently seeing

If this situation persists then at least non-domestic investors will have ample reason to increase their holdings of Danish assets. Danish yield spreads differentials being negative to German, might simply not be enough to stem the inflow we are currently seeing. Here it becomes evident why the central bank has acted as it has so far. By halting the issuance of government bonds, these assets simply now are not available anymore.

The alternative is Danish mortgage bonds

Here the Danish mortgage market offers an alternative, and the bonds available are plenty. Already next week we have the February auctions where Danish mortgage bonds with an outstanding amount of DKK 224bn matures. We don't expect the entire amount to be refinanced, but do expect the majority to be so. In any case this will represent an enormous opportunity for non-domestic investors, this could equally represent a challenge as it could speed up the inflow further. (See here).

Finally next month the ECB will start their QE program. How this plays out will also have an impact on Danish rates, and therefore how the Danish central bank can be expected to react.

Chart 13. Deposit rates

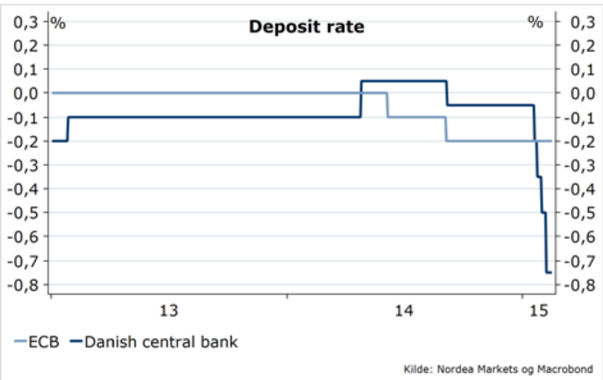
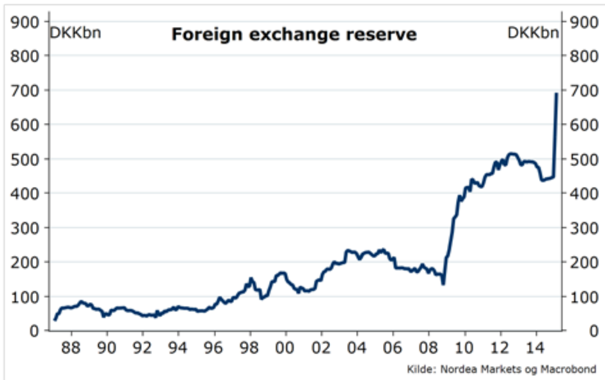


Chart 14. FX reserve



Finland – Still no recovery

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Finnish bonds among the main beneficiaries of ECB purchases

Finnish bonds to perform vs Austria and the Netherlands on the back of the ECB's purchases.

The ECB will launch its sizable sovereign bond purchase programme next month, and we expect these purchases to be very supportive of Finnish bonds vs. closest peers. No matter whether one compares the upcoming purchases to this year's gross bond issuance or the size of the bond market, the purchases should support Finnish bonds more than e.g. Austrian or Dutch bonds. Also, the ownership structure of the Finnish bond market should mean Finnish bonds will be well-supported by the ECB's purchases (see more here).

The effect of the ECB's purchases will dwarf the uncertainty stemming from the still cloudy economic outlook and the upcoming elections. We are thus generally positive on Finnish bonds.

We find most value in Finnish bonds offering a pick-up over Dutch and Austrian bonds. Especially RFGB 2021 continues to look attractive, also offering value vs the Belgian bonds in that maturity area. RFGB 2022 looks good as well.

Reforms stalled long before the elections

Structural reform process stalled.

The rather promising structural reform programme unveiled in 2013 has imploded almost totally. One by one, the suggested reforms have either been abandoned, amended or the implementation has been postponed. In short then, no real reforms should be expected ahead of the parliamentary elections due in April. The pension reform has been about the only real step of progress, and also there the government was not the main stakeholder.

Finnish economy still in poor shape.

The weak reform willingness is a pity, since the Finnish economy continues to exhibit broad-based weakness in all key variables, and would thus be in dire need of reforms. Q4/2014 flash GDP showed a contraction again following two quarters of modest expansion, while the actual GDP drop was likely much steeper compared to the flash estimate. As a whole, the economy probably contracted for the third year in a row in 2014.

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, which still remains somewhat elusive.

Chart 15. Finnish bonds to be boosted a lot by ECB QE

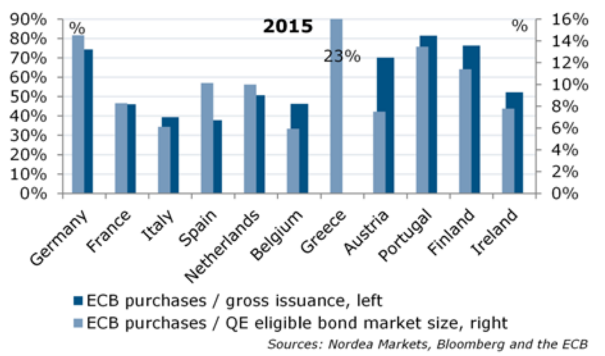

Chart 16. Finland seriously lagging in the recovery