European FI Strategy

Not like, but beyond Japan

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Global markets

With ECB-QE commencing shortly, nothing seems to be able to lift core rates. We remain at or near all-time lows with historically flat curves as well. US spill-over looks impotent for now, and in any case just got put a bit on hold by dovish FOMC minutes. Short term inflation swaps have risen, but longer term levels are not buying the ECB-message, at least not yet. The 5y5y inflation swap is at 1.55% still quite massively below the ECB mandate.

EUR Strategy

The days of casually looking a Japanese rate levels as a soft benchmark of how low we could go are over – we are way beyond in several instances, both in terms of levels and in terms of slope. Term premiums have gone out of fashion on the EUR swap curve – at least temporarily – yet payer positions are not yet a slam dunk. However, in real terms, EUR swap rates are trading at extreme levels, and payer positions there attain strong roll.

Sweden

The Riksbank is easing and the recent surprise 10bp cut in the repo rate has had quite an impact on the curve. On the SEK curve, we see potential in catching up with EUR flatness, and as such a 5s10s SEK flattener looks interesting, either stand-alone or against EUR.

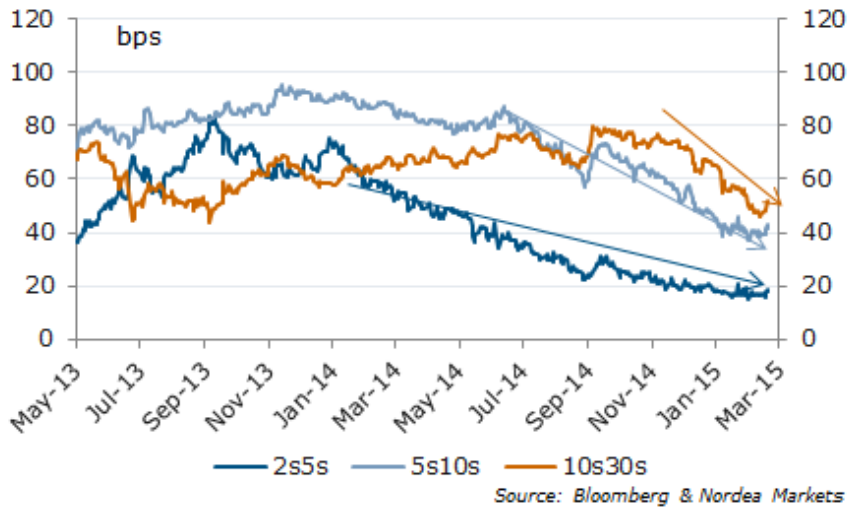
Norway

Two additional cuts are discounted in the market but those are priced to come fast and then the easing will halt. We see the market placing too low a chance of cuts beyond mid-2015 and like inversion trades in the FRA-strip.

Denmark

Four cuts over a three week span, supply side QE and massive interventions, all that and it is not enough. If Nationalbanken goes for real QE, buying short covered bonds is the most logical and effective way to go.

Chart of the month: EUR swap curve: Death of term premiums



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Content

Global Markets

EUR yields resistant to higher US yields

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The ECB has repeatedly pointed out to differences in the monetary policy cycle between the major advanced economies. The bond markets seem to have finally bought this message, though only after the ECB backed it with substantial fire power. While the US 10-year jumped by more than 40bp during the first weeks of February, the German 10-year yield crept up by less than 5bp.

German yields not risen despite considerably higher US yields.

It is naturally worth remembering that the US yields also fell more than German ones in the past month. The drop in the US 10-year yield was more than 50bp between the start of the year and the late January trough, while the German 10-year yield tumbled by only around 25bp during that time. Still, the recent moves are remarkable and a clear indication that higher US yields will put only modest upward pressure on German yields.

Positive Euro-area data flow not managed to lift yields either.

Higher US yields have not been the only factor pointing to also higher EUR yields. Euro-area economic data has broadly been beating expectations, while inflation expectations have at least seen a small rebound. The subdued reaction in bond yields to these developments is a strong testament that it will take a lot to drive German yields much higher from current levels. After all, it seems many central banks are still ramping up further easing measures, as nobody really appears to want a stronger currency. In this kind of an environment, the pressure for even the ECB to keep the door open for more measures is strong, even though the central bank has not even started with the new measures unveiled in January.

Greek developments contributed to volatility.

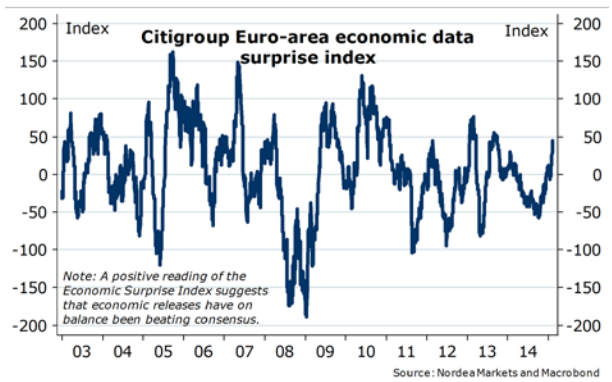
Greek developments have been capturing a lot of headlines lately, and in fact contributed to some market volatility also outside Greece. Unless the situation escalates considerably, it is hard to see it becoming a bigger market driver, but more of a source of short-lived volatility, whenever there are new developments on the issue. That said, the Greek uncertainty has been one factor contributing to low core bond yields, one that arguably has more significance for German than US yields.

Some near-term upside potential for yields.

Despite the recent resilience of German bonds, yields still have *some* upside potential in the near term, as the positive Euro-area data flow probably has some more to run. Rising Grexit fears pose a real risk to this outlook, though.

Chart1. German yields not followed the US higher

Chart2. Euro-area economic data surprised positively



EUR Strategy

Too early to position for a renewed narrowing of spreads

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Intra-Euro-area bond spreads have edged wider from January lows, but in the bigger picture the moves have been rather limited. Spill-over effects from Greece have put some widening pressure on spreads, while the recent moves also reflect profit taking. With the situation regarding Greece still characterized by plenty of uncertainty, it would be too early to position for a renewed narrowing in spreads, even though ECB purchases are looming.

Spanish bonds suffered more than Italian bonds, and this could continue in the short term.

Spanish bonds have taken a bigger beating compared to Italian ones lately, as Spain is seen as more vulnerable to spill-over effects from Greece due to the looming Spanish elections and the rise of the anti-establishment Podemos party. Spanish bonds now actually offer some pick-up vs their Italian counterparts in some maturities. We see better value in Spanish bonds longer out, but in the short term the underperformance of Spain vs Italy could easily continue.

In the semi-core space we continue to prefer Finnish bonds vs Austrian and Dutch bonds, as we estimate that the ECB's upcoming bond purchases will be more supportive of Finnish bonds in a relative perspective.

Short end: Eonia is getting it better than previously

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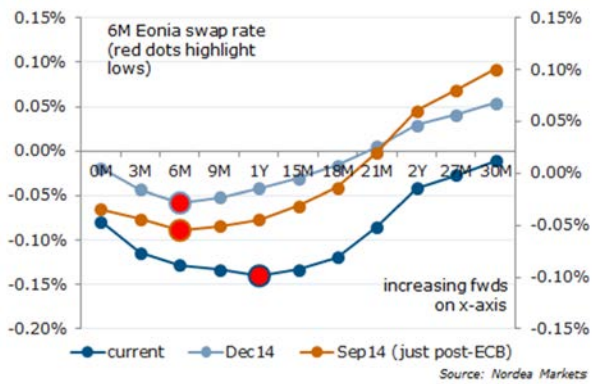
We tackle the longer end of the EUR swap curve on the next page, but regarding the front, in particular the Eonia curve, we see it as being more correct/logical than previously. With this we mean that though e.g. 6M6M looks a little too low still, the shape of the curve is spot on with it being minimized around the period where ECB-QE so far is scheduled to end, see chart 4 below.

Several indications that point towards Eonia's not getting as close to the depo as previously.

Data over recent months, in a period where excess liquidity went from below €100bn to over €250bn, indicates that the relation between the Eonia-Depo spread and liquidity has changed towards Eonia trading higher than previously. This has to do with (1) banks seeing an outright penalty (-20bps) on their excess reserves unlike e.g. 2012 where the depo rate was still positive, (2) short rates being unattractive with e.g. Schatz even trading through the depo, and (3) the longer carry game being close to exhausted (e.g. Italian 5y yields trading at below 0.75%). Against these things, 6M6M Eonia at -13bps looks a couple of basis points too low for us.

Chart3. Latest spread widening modest in the big picture

Chart4. Eonia curve looks "essentially correct" now



EUR rates – Death of term premiums?

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Historical flatness of core yield curves – why?

Core EUR curves, here taken as the EUR swap curve, are currently near their all-time lows, at least when filtering out periods where rate cuts were being priced in and then delivered (e.g. in 2008). This has not transpired all of a sudden on the back of QE; indeed, the overall flattening trend has been intact for well over a year, cf. chart 5 below.

Historical flatness has its origins in at least 3 sources

Reasons for this flattening are plentiful. First and foremost the violent moves down in core rates were (dis)-inflation driven and then exacerbated by ECB QE first becoming a consensus expectation and then actually coming. Secondly, other curves (e.g. the US curve) have also flattened especially for the latter part of 2014. Thirdly, carry-chasers have systematically gone longer and longer out on the curve looking for pick-up. That flow is not much more complicated than simply starting with 2s5s moving to 5s10s and then to 10s30s moving onwards each time the carry/roll gets "too small".

All these motivations will tend to compress the risk premium on the term structure and as chart 5 shows that has certainly happened.

In a broad context, paying e.g. 2s10s or even 10y outright on the EUR curve looks interesting, but the mechanics of QE (large in size and length and with much perceived impact on the 10y segment) and the risk-generator of Greece will be difficult to overcome.

Real rates display the most startling levels

Short real rates mean implicit tightening whereas long rates are historically low.

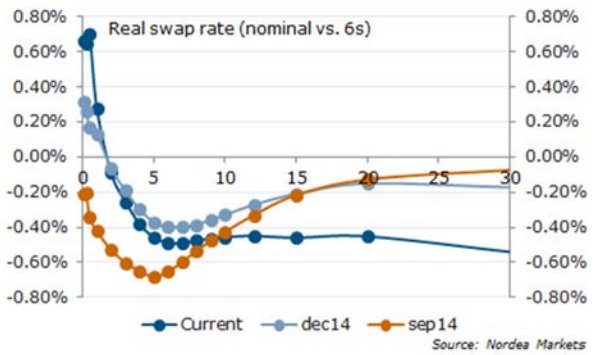
It also remains the case that paying in EUR swaps is a negative carry/roll proposition though that has of course diminished greatly with the flatter curves. As there's a sizeable chance that we could see a prolonged period of steady low rates, ideally we'd flip for a position that rolls in our favour.

Forward starting real payer swap positions offer great roll.

That leads us to real swap rates where much of the curve is significantly negative, cf. chart 6 below. First off, what an unfortunate scenario for the ECB: Easing hand over first, but by being on the lower bound, dropping inflation causes real rate tightening. Second, long real swap rates below -0.5%, there's no precedence here in Japan nor did the US ever get this low (30y real reached -40bps in late 2012). Finally, for roll in the payer position, real rate forwards such as 1y2y offers plenty with over 40bps for 12 months.

Chart5. Flatness induces more flatness

Chart6. Real swaps: Tightening in the front, low long end



Scandi Corner

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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.

Chart7. Sweden playing catching up to DKK and CHF

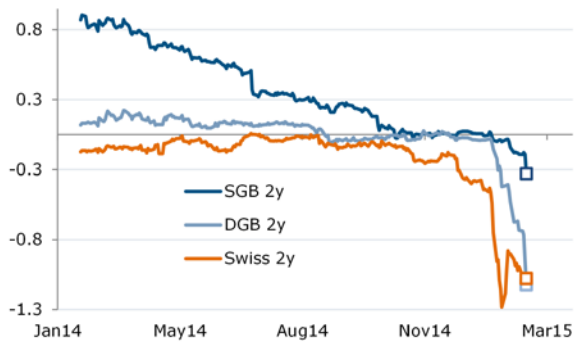
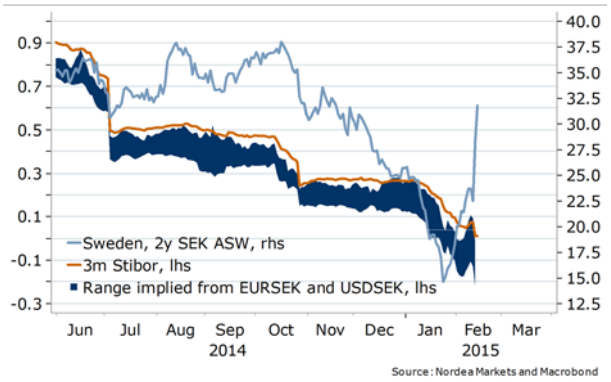


Chart8. Wider swap spread despite negative 3m Stibor



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Norwegian Rates: Not so fast, but later?

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.

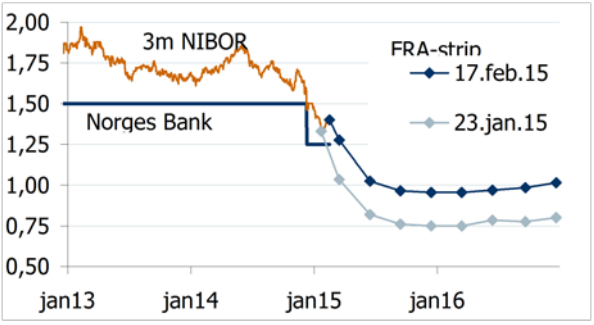
In the last Northern Light we highlighted the possibility for a slower and longer lived easing cycle than what markets priced. This is still a theme we like. The market has removed the front loaded cuts, but has not yet increased the possibility for cuts also after the summer.

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.

Chart9. The FRA-strip is inverted out to June 15



Source: Nordea Markets and Bloomberg

Chart10. Further inversion between 2nd and 3rd FRA?

Source: Nordea Markets and Bloomberg

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Danish rates: Extreme measures, but still not enough

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

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 stopped the supply. The next step of taking away Danish risk is likely to focus on 1Y ARMs, see details here.

Chart11. Deposit rates

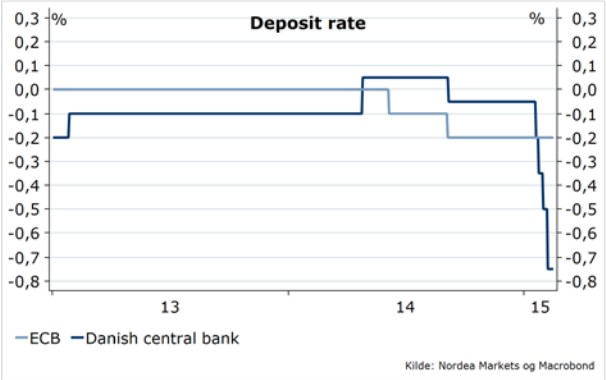
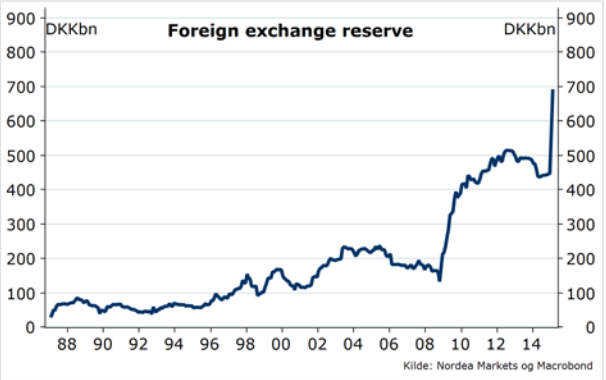


Chart12. FX reserve



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Finnish Rates: Among the main beneficiaries of ECB 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).

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

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.

Chart13. Finnish bonds to be boosted a lot by ECB QE

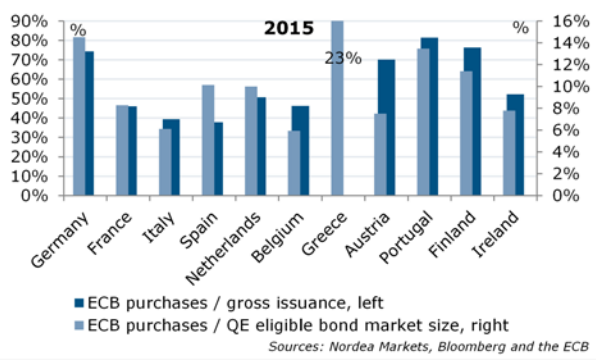

Chart14. Finland seriously lagging in the recovery