Northern Lights

To cut or not to cut

Nordea Research, 19 February 2014

Editors
Steen V. Grøndahl, CFA
Senior Directior
+45 3333 1453
steen.grondahl@nordea.com

Mikael Sarwe
Director
+46 8 614 99 09
mikael.sarwe@nordea.com

Gaute Langeland
Chief Analyst
+47 22 48 53 91
gaute.langeland@nordea.com

Sweden – Inflation surprises again

The low inflation in January makes the February release due 11 March a do-not-miss event.

Our preliminary assessment is that the Riksbank will stay on hold, despite this deviation. But reopened speculation of more easing from the Riksbank will likely weigh on the SEK ahead of the April meeting.

In rates space we continue to see the scope for Swedish bond yields to increase but Swedish bonds should outperform Germany.

Norway – Continued Slowdown

We continue to forecast growth far below Norges Bank's forecast but the weak NOK makes us change our rate call to unchanged this year.

The NOK will stay weak over the coming months, as we will see a rush of maturities in foreign-owned bonds—up to NOK 50bn could leave.

In rates space range trading will be the name of the game, with directions taken from European rates.

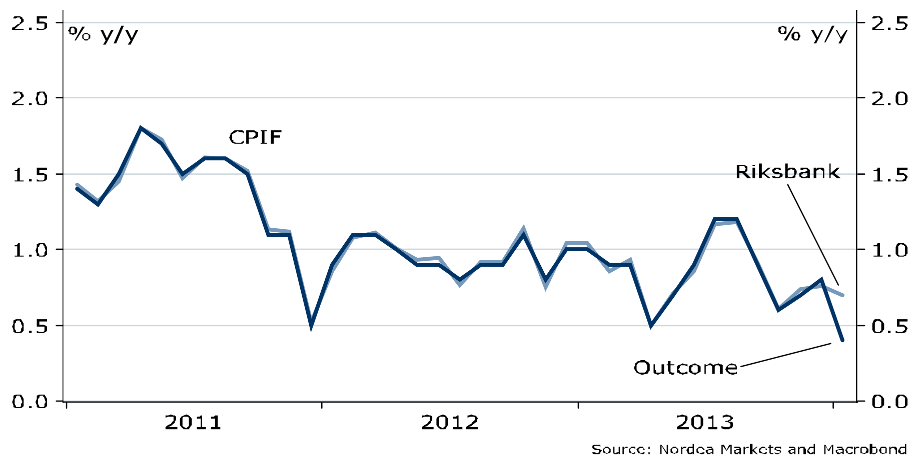
Denmark – Raised state of alert

Households remain upbeat in surveys, but it has yet to spill-over into growing consumer spending.

The recent weakening of the DKK means that we are close to levels where the central bank has previously reacted—but a rake hike is not an option.

In rates space we favour buying the 2-5y Danish govies.

Chart of the month – January CPIF well below the Riksbank's



Contents

Sweden – inflation surprises again

Author

Torbjörn Isaksson
Chief Analyst
Tel +46 8 614 8859
torbjorn.isaksson@nordea.com

Inflation once again surprised on the downside. CPIF-inflation stood at 0.4% y/y in January, thus as much as 0.3% points below the Riksbank's view. There is one additional inflation figure ahead of the Riksbank's April monetary policy meeting (the February reading due 11 March). This will be the most important key figure in the coming weeks. Our preliminary assessment is that the deviation to the Riksbank's forecast will decrease. We still expect the Riksbank to stay on hold, although the surprisingly low inflation means that a rate cut can't be ruled out.

Growth prospects are also important for the Riksbank. If growth fails to recover, the probability of a rate cut increases further. However, much suggest that GDP growth is strengthening. At present, the Riksbank's Q4 forecasts of 0.6% q/q and 1.1% y/y appear to be within reach, and the overall outlook for 2014 is bright.

Labour market fluctuations have been significant recently. Employment growth accelerated in 2013, but employment contracted at the turn of the year. This was further reflected in unemployment, which was as high as 8.2% in January.

We believe the labour market weakening seen in the past two months is temporary. Indeed, GDP growth looks set to recover and labour market indicators have improved. We consequently believe that the labour market will improve going forward.

The current recovery should be reflected in the data releases in the coming weeks. Sentiment should stay relatively optimistic, although household and corporate optimism may fade somewhat the past month (figures out 21 February). We will also monitor closely the GDP figures (28 Feb.) and the Labour Force Survey (13 March). But as already mentioned the most important key figure is February inflation figures due 11 March.

Chart 1. Inflation well below the Riksbank's in January

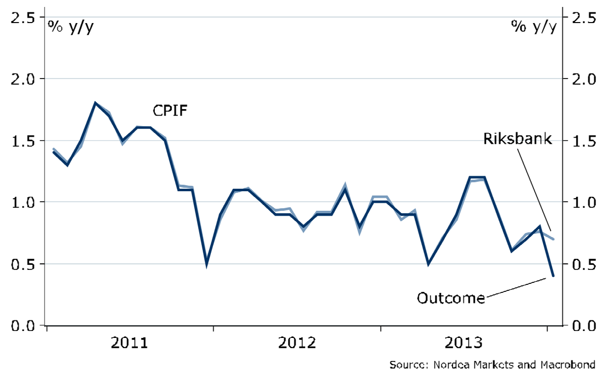
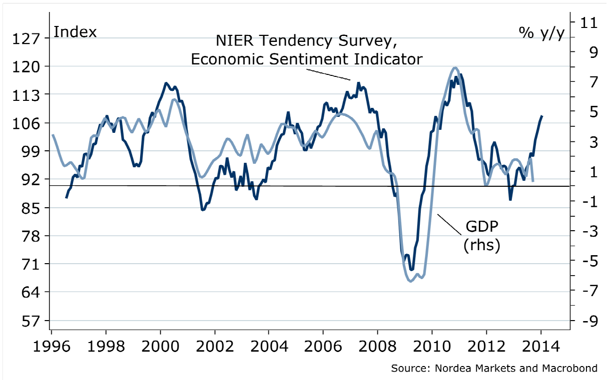


Chart 2. Growth prospects improving



Authors

Mats Hydén
Chief Analyst
+46-8-6149602
mats.hyden@nordea.com

Fredrik Floric
Chief Analyst
+46-8-6148215
fredrik.floric@nordea.com

Swedish rates: Time to outperform Eurozone

At the start of this year, we had the view that momentum in Swedish macro should pick up in the first half of 2014, which would open up for rates moving back up in the range again, with a steeper curve relative to other markets, as an effect. We also viewed wider break-evens as an attractive trade for higher bond yields in general. So far, the domestic macro story has played out pretty much as we had envisaged and the Swedish curve has steepened on a relative basis in the wake of an underperforming 5-10y sector versus core Eurozone. At the same time, global bond yields are down for well-known reasons (weak US data, EM turbulence) and Swedish inflation numbers have disappointed and brought rate cut ideas back on the agenda. While our bond bearish bias was well timed initially, the development so far in 2014 has more than reversed the move in December.

The Riksbank has shown that it is in no way immune to CPI downside surprises, leaving the probability for a rate cut far greater than the probability of a hike. In this perspective, it is worth noting that the Swedish front-end looks steep relative to the Eurozone and that the 5y5y spread is at cyclical highs.

This leaves our strategic considerations in a bit of a dilemma. On the one hand we continue to see the scope for global bond yields (and Swedish as well) to increase on the back of a decent looking macro picture. Trades with a bias for higher rates that we like are: out-right shorts in 3-5y segment (SGB 1051 or 1052 in particular), wider BEI (SGB 3102 vs 1047) and out-of-the-money SEK gamma payers (25 delta 9m x 10y).

On the other hand, the recent low inflation prints might very well push the Riksbank into another rate cut, despite that Swedish activity data seems to be picking up. Even though we think that the odds are in favour of the Riksbank keeping rates unchanged, markets will probably price in a decent chance of yet another rate cut following the December cut. Trades with a receiver bias in SEK rates that we like are: receiver SEK 5y5y or 2y2y versus EUR in swaps, receiving green FRAs vs Euribor and going long 1-2y covered bonds versus swaps.

Chart 3. SEK long-end looks cheap to EUR

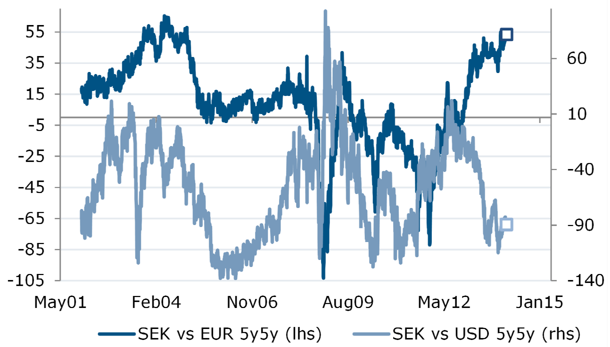
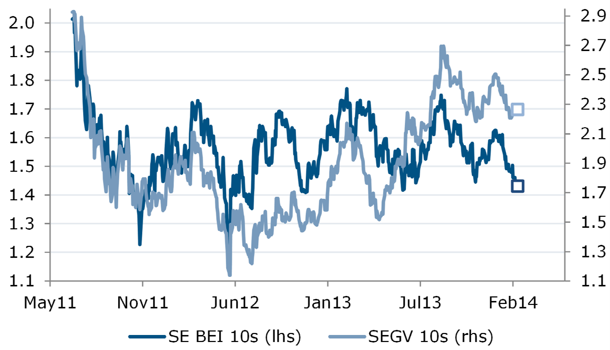


Chart 4. BEI versus level of 10y rate



Authors

Henrik Unell
Chief Strategist
+46 8 534 910 97
henrik.unell@nordea.com

Mikael Sarwe
Director
+46 8 614 99 09
mikael.sarwe@nordea.com

SEK: Weaker on rate cut speculation

Rate cut speculation should mean SEK prone for weakness short-term

You could argue that the transition towards more normal markets suggest that EURSEK should trade in its historically normal range of 9.00 – 9.40. We do agree that history should be a guide for the future but we disagree on the EURSEK range for that normality. We do suggest that the medium-term outlook for the SEK is one of pro-cyclicality where Sweden is leaving a soft patch and the EURSEK should eventually go lower as activity picks up. But the low inflation print for January tilts the view in the short-term towards markets hunting for a rate cut in April. There is scope for Swedish bond yields to outperform German. During the similar run up to the December rate cut EURSEK touched 9.10 – this could happen again. That said a rate cut in April is far from the "done deal" that December turned into due to stronger underlying economic data which makes us favor an on hold decision. But the December cut was still an indication that the Riksbank for now has abandoned the financial stability "lean hawkish" rhetoric in favor of more traditional inflation targeting. So markets should speculate in a rate cut or a repo rate path from the Riksbank that pushes the first hike even further out in time than the February 2015 date from the latest monetary policy report.

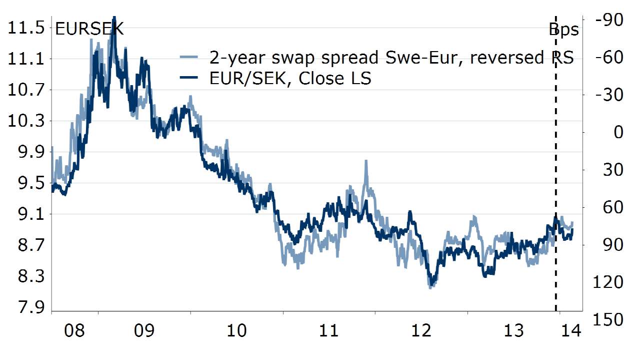
Also, movements in EURSEK and USDSEK and NOKSEK have for the past year been more of a USD, EUR and NOK story rather than a pure SEK story. Whether ECB delivers something or not in March, the US weather story and developments of Norwegian house prices and growth will be of importance.

Strong Swedish macro momentum should strengthen SEK towards the summer

Looking past the April rate decision, we still feel that the growth outlook for Sweden is more positive than for Eurozone. During the first half of 2014 growth should improve markedly and our economists believe that inflation will start to gradually trend up. EURSEK continues to be heavily influenced by relative monetary policy expectations, i.e. the 2-yr spread between Sweden and Eurozone, and data surprises. The Riksbank is considered to be one of the first central banks able, at some distant point in time, to hike the policy rate which should benefit the SEK later on this year.

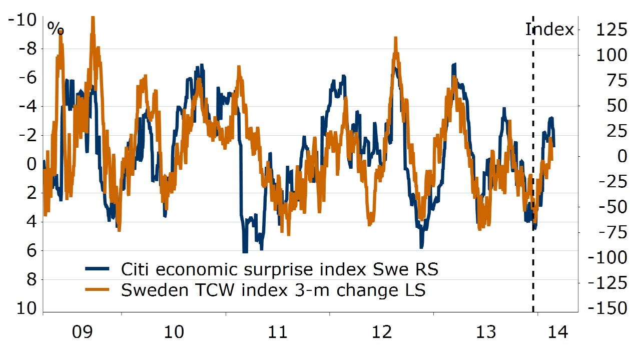
The view is thus schizophrenic. Markets love a good story and will be inclined to try to play a rate cut theme that should make the SEK prone to weakness the coming month. In time, however, Swedish macro data will show quite strong momentum and strengthen the SEK towards the summer.

Chart 5. Rate spread still main driver of EURSEK…



Source: Nordea Markets and Reuters Ecowin

Chart 6. …combined with Swedish data surprises



Source: Nordea Markets and Reuters Ecowin

Norway – Continued Slowdown

Author

Erik Bruce
Chief Analyst
Tel: +47 2248 4449
erik.bruce@nordea.com

We see no reason to change our view of a continued slowdown in the Norwegian economy. Mainland GDP grew 0.6% in Q4 which was more than expected, but we would not give too much weight to that as inventory growth was high in Q2 and Q3 and mainland demand was unchanged through H2 2013. Add to this that the levelling out of oil investments is now on its way with nearly unchanged investments in the second part of 2013. Housing investment is still growing due to past growth in housing start, but builders are reporting that it is very hard to sell new projects. Housing starts will most likely fall soon and with some lag building of new houses.

Lower growth and capacity utilization argues for lower rates.

We continue to forecast growth far below Norges Bank's forecast both this year and next. With slow growth in production, growth in demand for labour will also slow. But so will supply and that is why our forecast for unemployment is not that much higher than Norges Bank forecast.

We think a weaker NOK will counteract the real economy for Norges Bank. Currently trade weighted NOK is only marginally weaker than Norges Bank`s forecast but they forecast NOK to strengthen throughout the year while we forecast the opposite. Furthermore, we believe a general stronger SEK, GBP and USD will keep the trade weighted NOK weak.

Late March we will receive a new interest rate forecast from Norges Bank based on a more optimistic view on the economy than ours. Their view on price and wage growth could also be somewhat higher. If we are right that the 0.3% point higher core inflation in January compared to Norges Bank's forecast was temporary then inflation should be no argument for higher rates.

However, this year's wage negotiations could be tougher than previously believed. The negotiations will be based on an inflation forecast of 2 ½% which at least at the margin argue for higher nominal wage growth. Higher educated employees in manufacturing got significantly more than the average wage growth last year which will raise demand for the same groups in other parts of the economy this year.

In conclusion, we could see a moderately higher rate path in the March report with a somewhat earlier first hike (say early 2015) than in the Dec report. But the main message will still be that rates are on hold for now.

Chart 7. Downside risk to Norges Bank`s forecasts

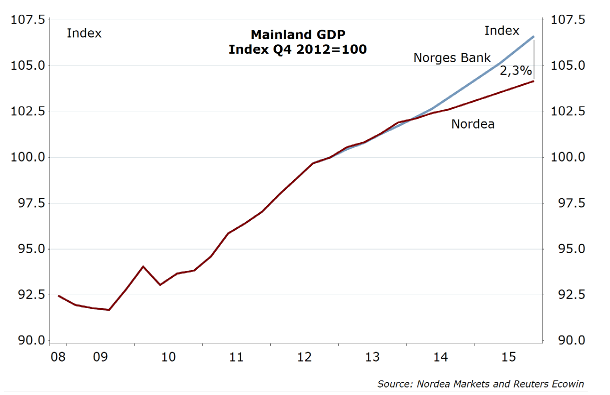
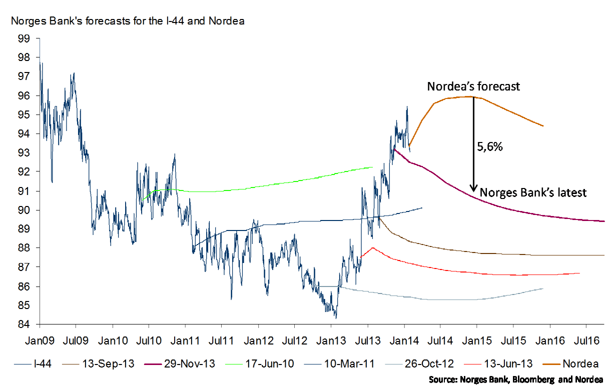


Chart 8. A weaker NOK will be the result



Norwegian rates: Range trading the name of the game

Author

Gaute Langeland
Chief Analyst
+47 22 48 53 91
gaute.langeland@nordea.com

Norges Bank have signalled that they are firmly on hold and despite our soft outlook for the domestic economy we see no reason to disagree with the central bank's stance: the krona is taking the hit and the economy is getting its required dose of stimuli from the weakening of the currency instead.

The FRA strip has risen about 10bp from the lows and no longer discounts a meaningful probability of a rate cut for the coming year. Some of this rise has been driven by a higher NIBOR fix. This is partially a result of a fall in the EURUSD basis swap, but a more important factor has been tighter liquidity in the NOK interbank market. This is set to improve in the coming month and we expect NIBOR to decline as this happens.

Over the past six months, the market has gone from pricing significant chances for hikes to pricing significant chances for cuts to now pricing Norges Bank firmly on hold. This means that the market is in the middle of its recent range, outright levels do not stand out against their own history.

With the short end firmly anchored, range trading is likely to be the name of the game in the coming months and carry should become an important driver of performance. The lack of volatility in the short end means that the market should take direction from European rates.

In this context investors should look for cases where NOK rates decouple from global movements as this is unlikely to represent a lasting trend. Positions like this with decent carry should offer decent risk/reward.

Low level of long end forwards in the NOK market.

What stands out currently is the low level of long end forwards in the NOK market. 5y5y forward at 3.95% is just 35bp above its all-time low. The global rise in long end rates during the second half of last year has had a limited spill over to the NOK market. Relatively low forwards have resulted in a decoupling where the NOK 5s10s curve seems flat. A 5s10s steepener carries 10bp/year.

Chart 9. Lack of spillover from global rise in long rates…

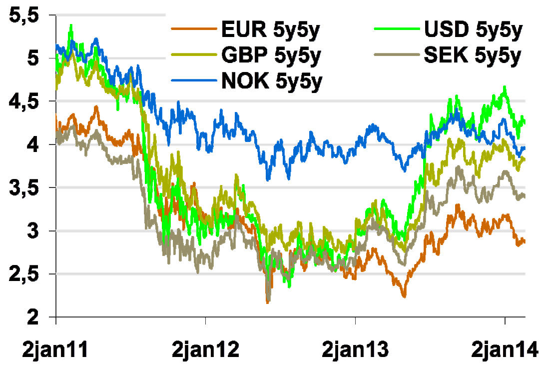
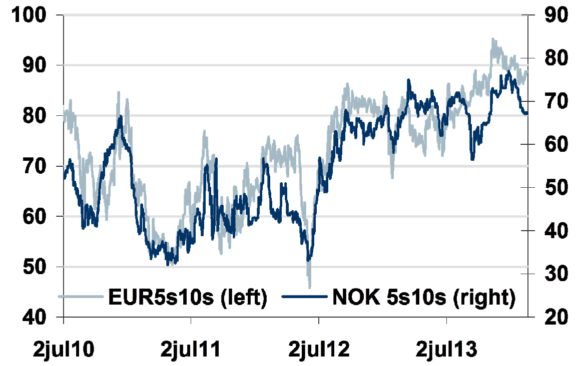


Chart 10. … gives a relatively flat 5s10s curve



NOK: Investments leaving the (not so) safe haven

Author

Ole Håkon Eek-Nielsen
Chief Analyst
+47 2248 7869
ohen@nordea.com

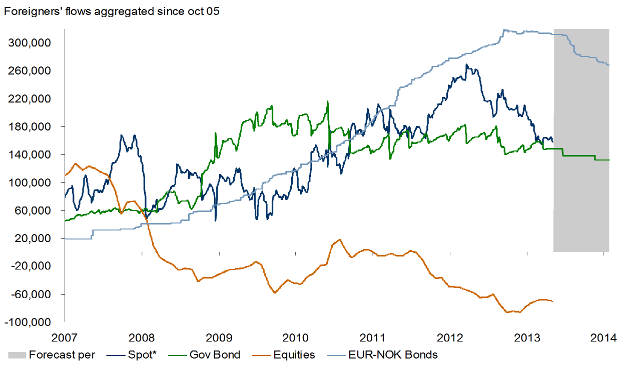
With improved risk sentiment and better than expected Norwegian key figures, EURNOK came down from the 4 ½ years high around 8.54. It seems quite clear that NOK is behaving like an emerging market asset. Low liquidity is one factor contributing, but the picture of decreasing oil investments might also make the case for comparison with countries like Russia, South Africa and Brazil. Weak Norwegian macro figures (and weaker than Norges Bank expects) and flows argues for a rather high EURNOK the coming months.

We might look at more than NOK 50bn on its way out of the country

The flow picture in NOK for the coming months could also become a negative contribution. Foreign investors piled into the NOK-trade in several channels after the financial crisis. The perception of NOK as the safe haven made EURNOK-bonds quite attractive. These are bonds issued by foreign companies with high credit rating in NOK mostly attracting investors with a positive NOK-view. The issuance activity came to a halt in second half of last year, and this spring we will see a rush of maturities. The combined volume is around NOK 30bn during April and May. In addition to this we will see redemption of Norwegian T-bills in March of which foreigners own NOK 9bn. Add the dividend payments in May of around NOK 13bn and we might look at more than NOK 50bn on its way out of the country.

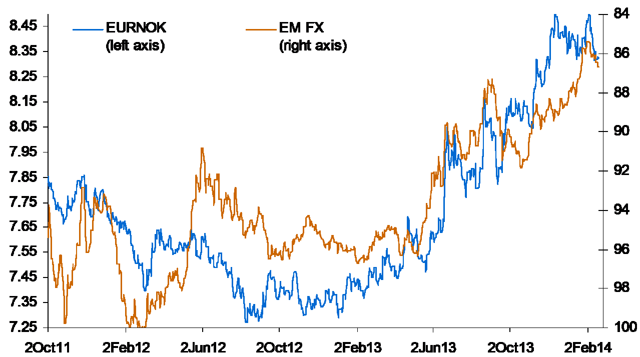
The positions in NOK have already been reduced quite a lot, in our estimates close to NOK 170bn, but the coming reduction could add to the already weak NOK. That will of course depend on the themes in the market. If our forecast for a weak economy fails then these amounts might get reinvested, but it seems hard to see NOK strengthen in the environment we forecast.

Chart 11. Foreigners on their way out of NOK



Source: Norges Bank, VPS, Bloomberg and Nordea

Chart 12. NOK; part of (not so) emerging market



Denmark – raised state of alert

Author

Jan Størup Nielsen
Senior analyst
+45 3333 3171
jan.storup.nielsen@nordea.com

Optimistic households, cautious consumers

Household consumption is a drag on the economy

The latest macroeconomic data has painted a mixed picture of the development in the Danish economy. According to confidence indicators, households are still upbeat. However, the growing optimism has yet to show through in actual consumer spending, which grew by a mere 0.4% in the first three quarters of 2013. Especially the retail sector has been hard hit as volumes in retail sales have declined to a 10-year low. We expect consumer spending growth to gradually gain momentum going forward. The reasons are higher disposable incomes thanks to tax cuts and positive real wage growth. Coupled with a positive trend in household wealth, this indicates that consumer spending once again could become the main driver of economic growth.

Inflation ticks higher

Inflation at highest level since the start of 2013

Danish CPI-inflation rose by 1.0% y/y in January vs. 0.8% in December. This was the highest reading since the beginning of 2013. Looking further into 2014 we expect inflation to edge gradually higher, mainly driven by base effects related to energy prices and the fading effect of the indirect tax on fat and sugar. On average we expect Danish inflation of 1.4% in 2014, rising to 1.6% in 2015.

Central bank in raised state of alert

DKK has weakened against the EUR

The DKK has weakened versus the EUR as a result of short money market rates in the Euro area rising relatively sharply, widening the spread to corresponding interest rates in Denmark. The weakening of the DKK means that EUR/DKK is currently close to the levels where the Danish central bank has previously reacted.

We believe that the central bank will try to ease the current pressure on the DKK through minor open market operations. On the other hand, we believe that an actual isolated Danish rate hike is still some way off. The central bank will probably be relatively cautious about hiking rates in the current situation where there is still significant uncertainty about the ECB's future monetary policy line. Against this background we do not think the central bank will implement the first isolated Danish rate hike until sometime during the autumn.

Chart 13. Consumer confidence and retail sales

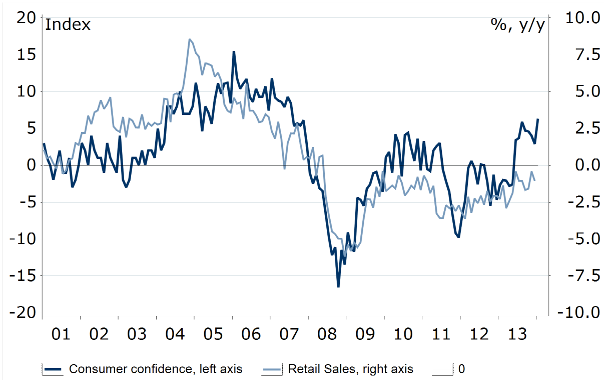
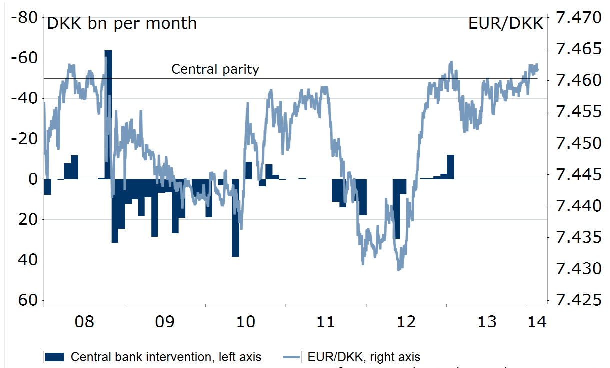


Chart 14. DKK and central bank intervention



Source: Nordea Markets and Reuters Ecowin

Danish rates: 2-5y government bonds look interesting

Author

Niels Blixenkrone
Chief Analyst
tel +45 3333 1457
niels.blixenkrone@nordea.com

Regulatory risk to Danish covered bond might have widespread effects

The European Commission must make the final decision on how covered bonds should be classified no later than 1 July. According to EBA's final recommendations covered bonds should be classified as level two assets. A level two classification is manageable, but the 40% limit as proposed by Basel must be revised up. The effects will take effect long before the implementation roadmap below.

Danish Act on Refinancing

In the event of a rate increase in excess of 500bp over the last year 1y and 2y, covered bonds will be extended by 1y at the "rate-one-year-ago" +500bps. For a sequence of failures this first knock-in rate will prevail until there is a market again. All covered bonds where there is a mismatch between underlying loans and the bond will in case of a failed auction have the multiple extensions as well. In our view many foreign investors will be reluctant to buy bonds with multiple extensions.

Financial supervisory diamond

The Danish FSA is responsible for implementing a supervisory diamond with the aim of setting limit values in order to counteract excessive risk-taking. Deadline is 1 July. It will include restrictions on interest-only loans, interest rate risk, sum of large exposures and lending growth. We expect that the main focus will be on the reduction of interest-only loans. Banks have already addressed this aspect and the outstanding will decline automatically over the coming years. The risk is that a too harsh implementation will have a destabilizing impact on the housing market

Recommendation

Balancing the drivers and pricing of adjacent markets we now favour buying the 2-5y Danish government bonds in cash space. The overall top pick for being long Danish risk is still receiver positions in DKK IRS 5-10y due to a wide IRS spreads EUR compared to real and nominal cash bond spreads to Germany.

Chart 15. Break even spread widening 3y covered

Chart 16. IRS, real and nominal DBG pickup