Nordea

FI Strategy

# European FI Strategy

## Blame it on the weather

Nordea Research, 20 February 2014

## Global markets

Weather argument will not work forever: bond markets have limited patience

Risks tilted towards a further fall in rates short term – large short positions leave the market vulnerable to a further drop in yields

## EUR Strategy

Volatility in short EUR swap rates indicative of strongly varying market perception on the ECB. We favour paying 6M3M Eonia.

Peripheral tightening may well continue short term, especially in Spain

## EUR inflation

If EUR rates break fundamentally lower, inflation is a firm candidate as the smoking gun

The sensitivity to the coming inflation prints is large. Downside surprises can put the perception of “firmly anchored” to rest.

## Sweden

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

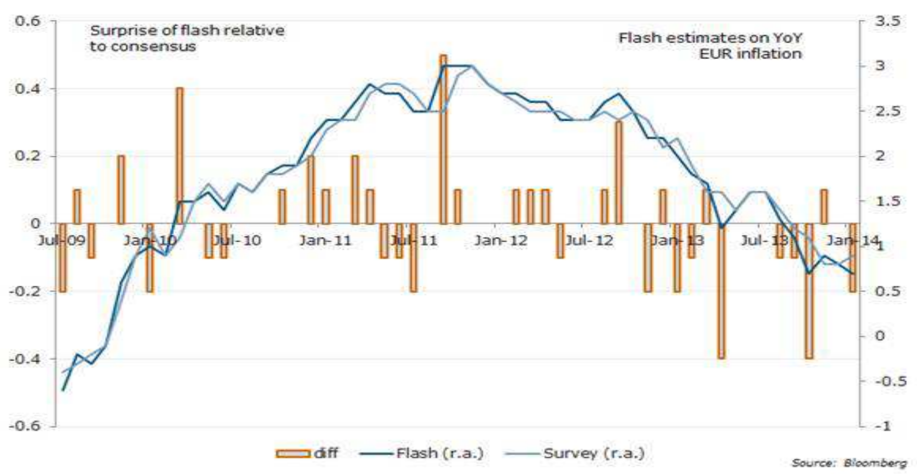
## Norway

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.

## Denmark

The recent weakening of the DKK means that we are close to levels where the central bank has previously reacted

**Chart of the month – EUR inflation numbers for February & March to be big market movers**

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# Global Markets - overview

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**Weak US data not changing our longer-term outlook**

Weak numbers from the US are causing concern about the US recovery losing steam. We think these concerns are misplaced. Growth is slowing a bit from the inventory-juiced pace in H2 2013, but the main drag is likely to be the recent bad weather, which is weighing heavily on activity and new jobs. After all, the economy's strong fundamentals are unchanged: household debt loads are at a 10-year low, business balance sheets are about as strong as ever, credit conditions are improving and overall financial conditions are still very lenient.

*Once the weather clears, we expect a rebound in the data…*

Thus, once the weather clears, we expect payrolls growth to return around 200k per month and the ISM manufacturing index to rebound to around 53-54. If these data improvements do not materialise, we would need to adjust downward our optimistic US GDP growth forecast for 2014.

*…but it might take a while.*

However, with the weather having been just as severe in February, the improvement may not happen until March (reflected in data releases in April). In other words, we might not see significantly stronger US data for still some weeks to come. History suggests that estimating the economic impact of unusually severe weather is particularly uncertain. This time is not different. Still, we believe that spring will bring better times for the US.

*Better times already arrived for the Euro area.*

Better times (in terms of growth) have already arrived for the Euro area. With growth coming back and no major Euro-area country in recession anymore, very low inflation is now clearly the ECB's main concern. In January, consumer prices were just 0.7% higher than one year ago with the core rate hitting an all-time low of 0.8%. ECB president Draghi mentioned a worsening of the medium-term inflation outlook as one of two possible triggers for new policy easing, the other being an unwarranted tightening of money market conditions.

*ECB inflation forecast for 2016 important.*

On 6 March, the ECB will publish its first inflation projection for 2016. We would not be surprised by a projection of 1.6% or 1.7% - i.e. still below the ECB target. However, as we see it, that would not trigger policy action because the ECB has already been expecting a longer period of subdued inflation for quite a while (just as we do). So all in all, while there is risk of further policy easing, our baseline scenario is that the ECB will not take any new easing steps in March (or later). Support for no further action should also come from an unchanged inflation print for February (0.7%).

If we're wrong, the most likely steps in our view are a cut of the main refi rate to 0.10% or 0.15% and/or the suspension of the liquidity absorbing operations resulting from the bond purchases under the Securities Markets Programme.

# Overview

**Blame it on the weather, but for how long?**

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Markets have mostly shrugged off the negative data releases coming from the US, as these have mostly been blamed on bad weather. How long can this continue? Bad weather has continued in February in the US, implying also February data, mostly released in March, will be affected. The weather argument can work for only so long, and markets certainly do not have the patience to wait for several months for clarity on where things stand. In fact, we have already seen signs that the sensitivity to bad data is on the increase. It is thus hard to see bond yields facing much upward pressure, before US data picks up again.

*Recent trading ranges to hold.*

That said, we do not expect long yields to fall out of their trading ranges of the past six months or so (2.45% - 3.05% for the US 10-year yield and 1.60% - 2.09% for the German 10-year benchmark), though near-term risks are clearly tilted towards a break lower. After all, rates have fallen already a lot this year, the macro outlook has not changed that much, while Euro-zone data has actually included many positive surprises (e.g. PMIs and Q4 GDP), apart from inflation numbers. In addition, the Fed seems determined to continue its tapering process in measured steps, and the threshold for the central bank to deviate from this path appears to be rather high.

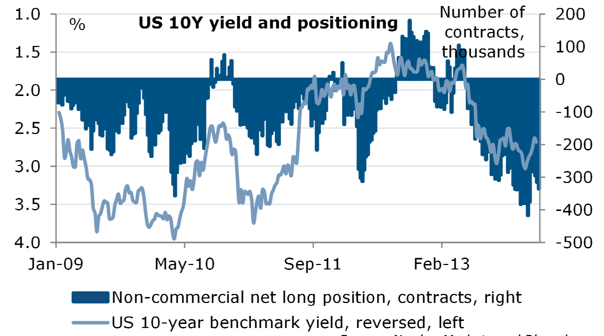
*Downside risks for yields clearly bigger than upside ones in the near term.*

Downside risks currently outweigh upside risks in the near term. Non-commercial short positions in US 10-year Treasury futures continue to look high. If there is a more general loss of confidence towards the US economy, in response to continued data disappointments, we could easily see another move lower in yields, as these positions are unwound. In addition, US equity prices are close to record highs again, leaving the market vulnerable for a correction lower. A correction in equity markets, in turn, most often means support for bonds.

*February inflation and the ECB meeting key events in the Euro zone.*

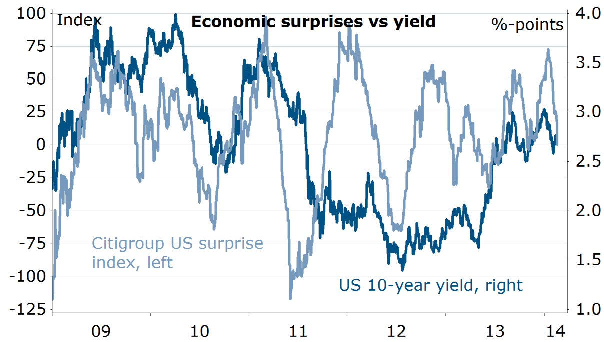
In Europe, risks remain tilted towards further action, and volatility is likely to be large around the February inflation flash estimate on 28 February and the ECB meeting on 6 March. German yields and EUR swap rates remain much closer to the lower end of their trading ranges, so a test of these ranges will not take much bad news. Still, a bond rally driven by further weakness in US data should lead to bigger gains for US Treasuries compared to German bonds.

Chart1. Non-commercial short positions remain high




Source: Nordea Markets and Bloomberg

Chart 2. US data momentum weakened clearly




Source: Nordea Markets and Reuters Ecowin

# ECB uncertainty: Volatile short rates & peripheral tightening

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In January, the ECB was more firm than usual, at least in pinpointing their key indicators important for future policy measures. Inflation expectations (which we look deeper into elsewhere in this publication) and unwarranted short term rates.

Since December 2013, volatility in the very front end of the EUR curve has been abnormally high. The backdrop for this is sieving excess liquidity and its impact on Eonia fixings and swaps in particular. Chart 1 below shows the history since November 2013. Since then we have experienced squeeze like scenarios around year turn and then - in particular - in January.

Currently the front end of the Eonia curve remains rather strongly inverted. The 3M swap got as high as 20bps on January 21st, but is now down to around 13.5bps. 6M forward the swap is at 9bps however. We think that policy easing as soon as March is unlikely, so paying the bottom of the Eonia curve makes a lot of sense on an immediate horizon. *We in particular like 6M3M at 9bps.*

Further out on the curve we still see the 5Y point as the most overbought, and although 5s10s has steepened over the past two weeks, we see more potential. Such trades should be made in forward starting swaps.

### Peripheral bond spreads continuing to narrow

Bonds from the peripheral Euro-zone countries have continued to perform well. E.g. the Spanish 10-year benchmark bond yield has fallen to around 3.5% already, the lowest level since early 2006. The market has been very receptive to new issuance, the latest example being the Portuguese EUR 3bn 10-year syndicated tap last week.

*General spread narrowing intact, but risks on the horizon.*

As long as there are hopes of more action from the ECB, the general spread narrowing trend will likely remain intact. However, considering the magnitude of the narrowing seen lately without a clear correction, a central bank unwilling to deliver more easing is a clear potential trigger for a temporary move higher in spreads.

*Spanish outlook better than Italian.*

We see more potential for spread narrowing especially in Spain, as the economy there has picked up momentum. For Italy, the short-term risks are

Chart 3. Semi-core spreads actually widened some

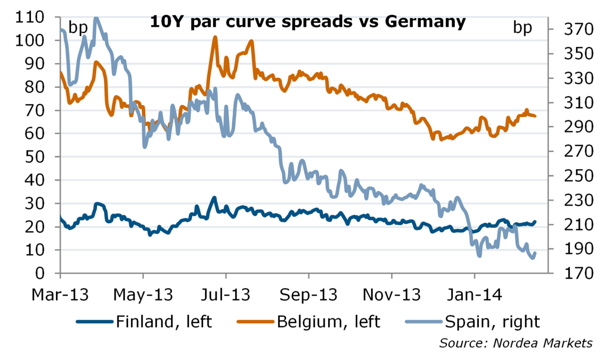
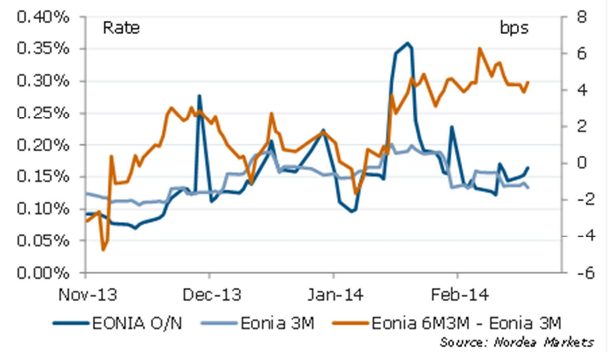



Chart 4: Volatile times for short EUR rates



larger, as the market seems to be pricing in a smooth change of government. However, there are certainly risks out there, as it is Italian politics we are talking about. In addition, the list of reforms awaiting the new Italian government is daunting.

**Semi-core performance more mixed**

The performance of Euro-zone government bonds in the semi-core countries has been more mixed, and spreads vs Germany have actually widened somewhat lately.

*Austrian bonds to feel pressure in the near future.*

We identify several risk factors ahead for a number of the semi-core countries. Austria has been under pressure lately due to the fate of the nationalized Hypo Alpe-Adria-Bank. The government's plans to create a bad bank to absorb assets from Hypo could significantly boost government debt and put pressure on the Austrian ratings and thus Austrian bonds. Fitch will review its AAA rating with a stable outlook tomorrow, while Moody's (currently Aaa with a negative outlook) will have its turn next week.

*Finland facing several short-term risk factors.*

Finnish bonds, in turn, face the risk of some underperformance due to weak economic performance. Finnish GDP contracted by 0.8% q/q in the last quarter of last year, according to the flash estimate – only Cyprus did worse among the Euro-zone countries. January export data is set to show double-digit falls in y/y terms (largely due to base effects, but will lead to ugly headlines nonetheless). Finland is thus likely to lag most Euro-zone countries in its recovery. In addition, the Finnish government will most likely spread the EUR 3bn of extra budgetary measures needed to stabilize debt-to-GDP over several years and beyond its term in power instead of implementing them at one go. The Finnish debt-to-GDP will thus continue to rise for now.

*Dutch economy seeing some light, while we remain positive on Belgian bonds.*

The risks still facing the French economy were illustrated again by the weak PMI numbers released earlier today, a potential risk factor for French bonds, while the Dutch economy has actually seen some light for a change with a rather strong 0.7% q/q expansion in the last quarter of 2013. Finally, we remain positive on Belgian bonds, not least because this year's benchmark bond issuance is set to be the lowest since 2007.

# EUR Inflation – a troublesome child

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That inflation is a key decision variable for the ECB is almost per definition not news given the mandate of the central bank. Still, over the last several ECB meetings, inflation – both short term, medium term, and for the longer term – has been absolutely key in the discussion and communication.

Coming up at the March meeting, the ECB will for the first time include projections on inflation for 2016. It seems reasonable to assume that these projections will be largely in line with the recent ECB survey of professional forecasters who called for 1.7% in 2016. Here, we dig a bit deeper into what we see as growing disagreement between the ECB and market pricing.

**ECB and market inflation expectations – each end of the spectrum**

*2016 ECB staff inflation forecast looks to be a full 50bp over inflation swap levels*

There are two very interesting aspects regarding the potential of the ECB using their own projections for 2016, and likely land around 1.7%. Firstly, this reduces the chance of short-term easing and can a bit cynically perhaps be seen as a potential self-serving logic, as it – per design - allows the conclusion of *firmly anchored* as usual. Secondly however, the divergence to swap levels (cf. chart 1) is significant and a 2016 call of 1.7% should be held against the 2y1y inflation swap at 1.22%, i.e. almost a 50bp difference.

*5y5y inflation swap levels just barely indicative of ECB still being in control*

The 3Y inflation swap currently is in 1.05% against the potential forecasters 2014-16 call for 1.4%. 5y5y stabilizing around the level of the November 2013 stabilization is however indicative of the ECB still having credibility in terms of longer end pricing on the inflation market. Still, at a level around 2.14%, 5y5y is at its lowest since mid-2012 and before that 2010-2011.

**Cyclical lows in inflation prints = trouble ahead?**

Partly due to pure mechanical effects of the placement of Easter in 2013 (March) and 2014 (April), a cyclical low in inflation prints is likely for March. Chart 2, shows the recent levels of and divergence between consensus and flash inflation. The most recent big negative surprise was for October 2013, which exerted a big re-pricing of the inflation market. The market looks strongly susceptible to any downside risk on the coming prints.

To investigate to what extent the latest downside surprises have been comparable to the noise in 2010-11, we collect inflation swap data back to mid-2009 (we want to exclude the extremity of 2008), infer the correlation

Chart 5 6Mhistory on EUR inflation swaps: 3Y, 5Y, 5Y5Y

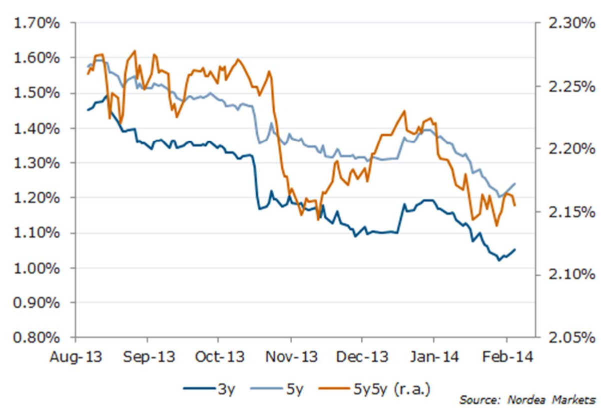
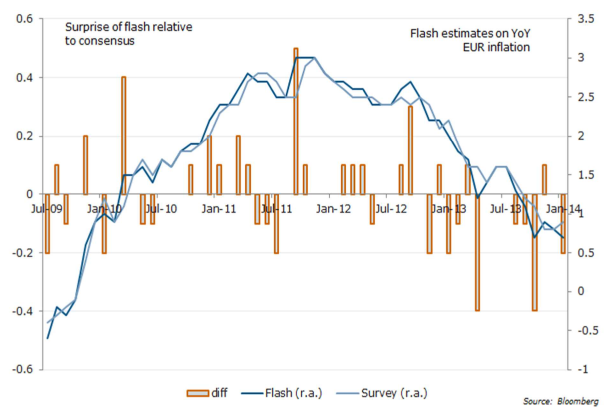



Chart 6. It hurts to be wrong



matrix, and perform PCA on it. We find that 82% of the variation can be attributed to a common factor while a slope factor accounts for 13%. Along with the delivered prints, these series are given below in chart 4.

*Current inflation swap levels at post 2008 lows*

Note that the level component – i.e. in essence the inflation swap market in level terms – is at a post 2008 low. The slope factor is nearing its low, and as this factor increases in 1Y and decreases in e.g. 30Y, this is indicative of longer swap levels holding up *just barely*, just enough for "no need to panic". Further bull steepening of the inflation swap curve will push this metric to a post-Lehman low. This is quite remarkable really given the fact that other stress indicators such as gamma vol and xCcy basis' are near pre-2008 levels.

*The perception of firmly anchored is close to cracking*

In sum, longer-term inflation expectation is walking a tight-rope, and the divergence between the ECB and the market is heading for a clash.

**What can the ECB do (if it goes wrong)?**

The continued stream of low prints and in particular downside surprises may eventually force the ECBs hand. Along with liquidity concerns and noise in the short rates, the first tool is likely to be a refi-cut.

*If expectations plummet, what will be required from the ECB: Something radical.*

The efficacy of a refi-cut onto longer inflation expectations is however quite weak (cf. chart 3). For the ECB to tackle a real and prolonged decrease in e.g. 5y5y inflation swaps, something more radical would be required – e.g. renewed long dated liquidity or outright asset purchases, and even in that case, the results are not clear cut. For instance, while the Fed looks at 5y5y inflation swap levels around 2.80% percent, this level is not yet replicated in prints ticking up and actually lie in the lower part of the range from 2.6%-3.4% seen since early 2009. This is despite massive QE which has doubled the Fed's balance sheet from 2000bn mid-2009 4120bn currently.

Chart 7. 5Y5Y inflation swap levels in November 2013

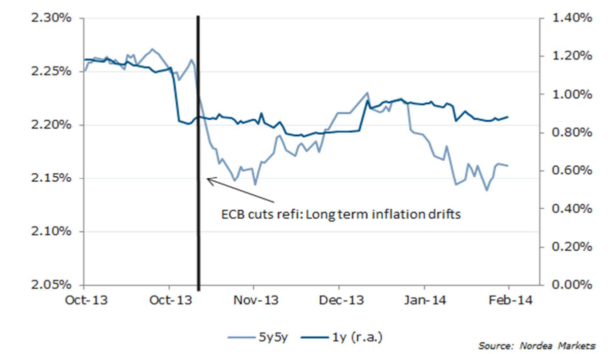
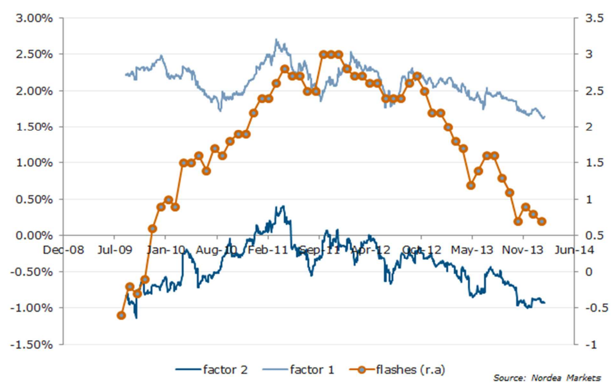



Chart 8. Quantifying inflation surprises/shocks



# Scandi Corner

## Sweden – inflation surprises again

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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 9. Inflation well below the Riksbank's in January

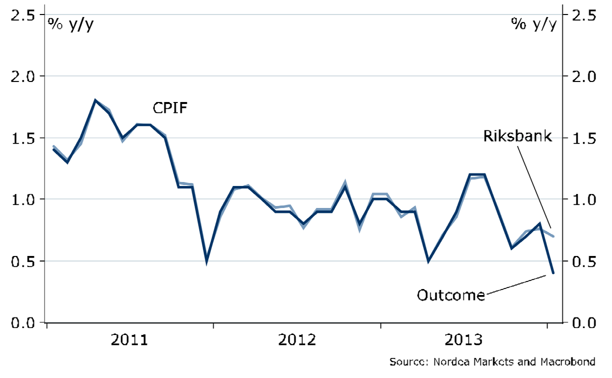
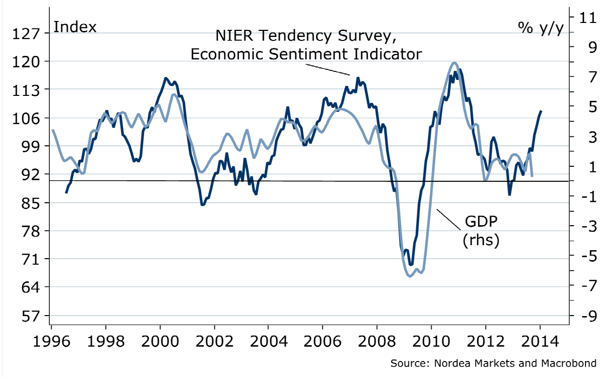



Chart 10. Growth prospects improving



# Swedish rates - Time to outperform Eurozone

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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 11. SEK long-end looks cheap to EUR

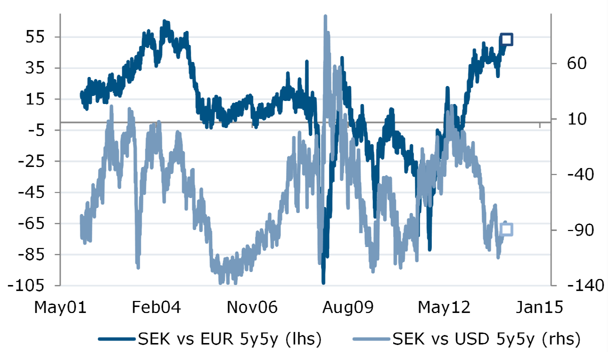


Chart 12. BEI versus level of 10y rate

# Norway – Continued Slowdown


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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 13. Downside risk to Norges Bank`s forecasts

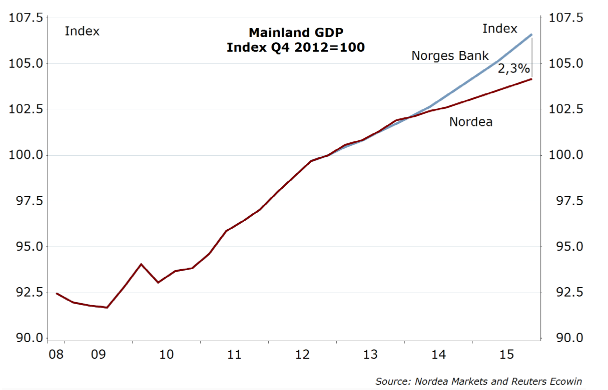
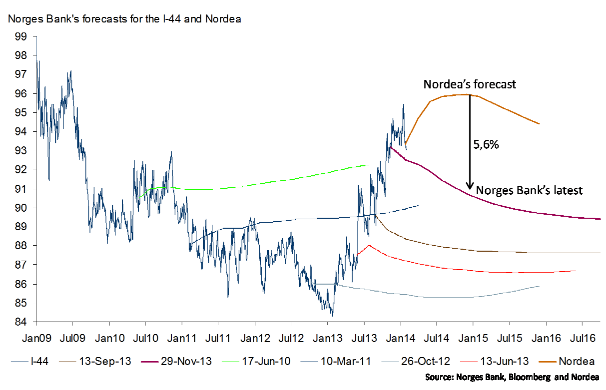



Chart 14. A weaker NOK will be the result



# Norwegian rates - Range trading the name of the game

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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 15. Lack of spillover from global rise in long rates

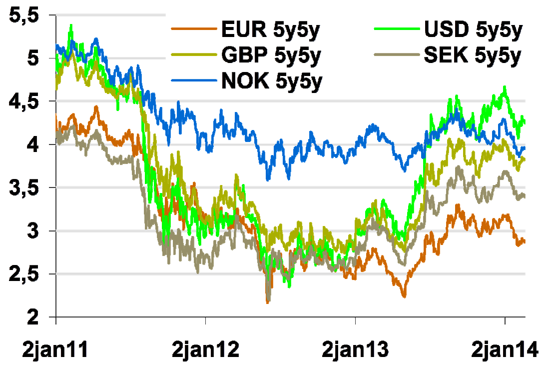
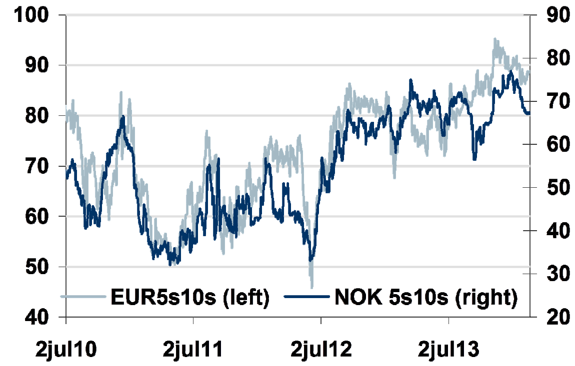



Chart 16. … gives a relatively flat 5s10s curve



# Denmark – raised state of alert

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### 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 17. Consumer confidence and retail sales

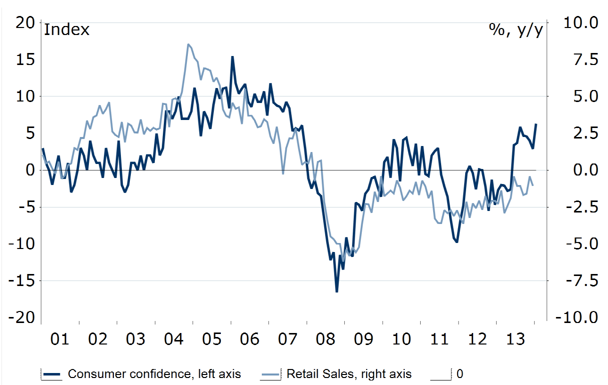
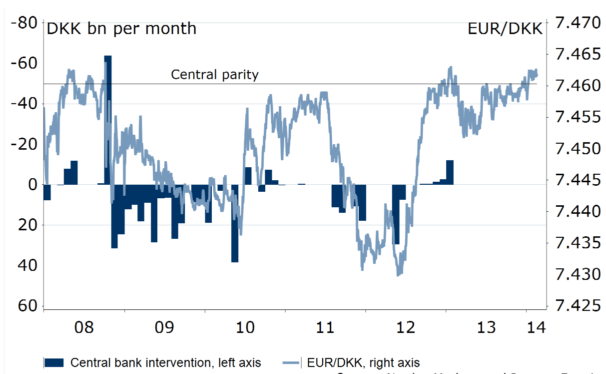



Chart 18. DKK and central bank intervention




Source: Nordea Markets and Reuters Ecowin

# Danish rates: 2-5y government bonds look interesting

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### 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 19. Break even spread widening 3y covered

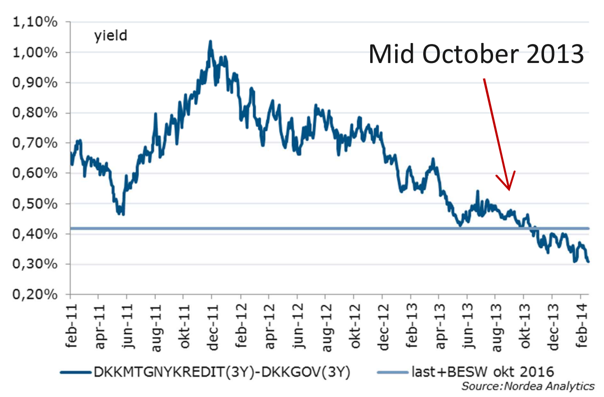


Chart 20. IRS, real and nominal DBG pickup