# Northern Lights

## Scandi central banks on hold

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### Sweden – Recovery but very low inflation

Fourth quarter GDP surprised on the upside and we expect continued positive growth numbers.

Inflation will however stay very low during the 1st half of 2014. The Riksbank is expected to be on hold in April and should stick to a rate path that continues to include some probability for a rate cut.

We see EURSEK weakening into the summer due to positive macro momentum and possible flows connected to a Volkswagen/Scania deal.

### Norway – Rates firmly on hold

Housing market data and consumption indicators look poor, while unemployment and GDP figures have surprised a bit on the upside to Norges Banks forecast. All in all we expect an unchanged rate path.

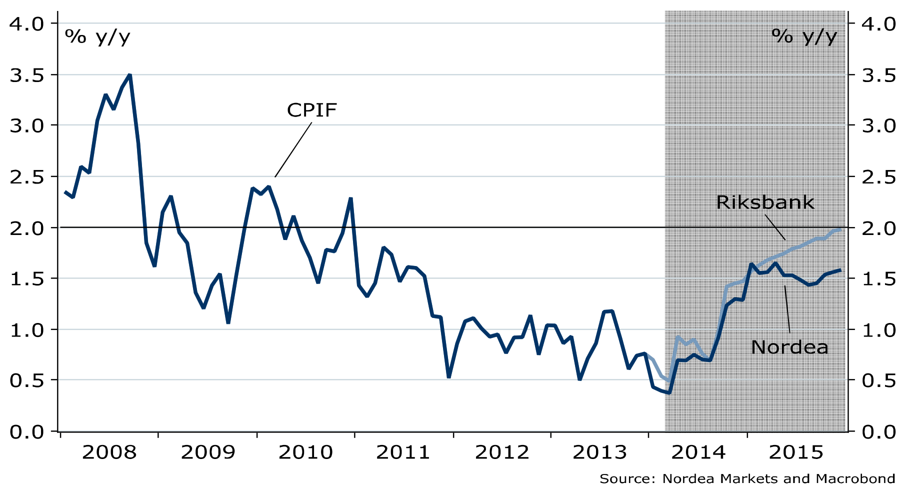
EURNOK strength is not over yet – both a weak Norwegian flow picture, as well as negative surprises to Norges Banks forecasts will weigh on the NOK.

The 5 to 10 year part of the swap curve has moved relative to European rates, while the shorter end takes directions from the EUR curve. The 2s5s10s butterfly in NOK hence seem high relative to EUR.

### Denmark – Great opportunities in Danish govies

The massive spread compression in semi-core countries – and widening of DGB – supports the case for scaling up on the Danish curve. Especially if added focus on European budget (im)balances will be on the agenda again.

**Chart of the month – Swedish inflation will rise later this year**




Source: Nordea Markets and Macrobond

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# Nordic Overview: Cross currents

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Early February NOKSEK was below 1.04 and commentators were looking for parity. Since then the trend has changed and NOKSEK is trading above 1.07. Reasons for the change have been that the economy and house prices in Norway have stabilized and the market sees a vicious house price/falling consumption circle as less likely. At the same time Swedish inflation has surprised on the downside which puts pressure on the Riksbank to stay accommodative for longer. Nordea's economists have also changed their forecasts of Norges Bank (from two cuts 2014 to on hold) and the Riksbank (from hikes Oct & Dec 2014 to one hike in Dec). Both forecast revisions are in a direction that makes NOKSEK parity less probable.

*Short-term risks are tilted towards a weaker NOKSEK*

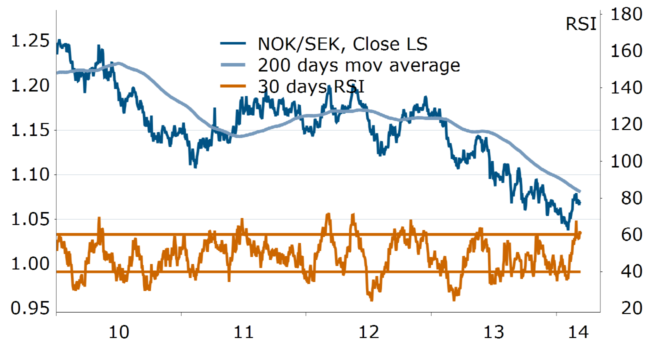
However, in Norway we still think that EURNOK strength isn't over yet. We see a weaker Norwegian economy than Norges Bank and a negative flow picture the coming months. In Sweden, though, we feel that the SEK is range-bound but with risks for a stronger currency. We envisage a period where Swedish macro momentum surprises on the upside. Add a possible Volkswagen acquisition of Scania that could trigger rather substantial SEK purchases, and EURSEK should reach 8.70 by early summer. Combining these views indicate that risks are tilted towards a weaker NOKSEK for now. Of course, should the Ukraine tensions evolve into a situation where risk-off sentiment enters the markets more markedly, then both NOK and SEK would suffer due to liquidity reasons. But that is not our main forecast.

*Value in Swedish and Norwegian bonds vs Germany*

In fixed income space, both Norwegian and Swedish yield spreads vs Germany look high in a historical context. The front end in Sweden is already pricing in a Riksbank that out-tightens ECB by 50 bps over the coming year. For a period where no hikes are discounted by the Fed or ECB, and with very low Swedish inflation, we see value in receiving Sweden in the 2-year segment. It also makes sense to combine that with break-even-inflation wideners since if spread compression trades are wrong, then current yield and BEI levels in Sweden will prove to be even more wrong.

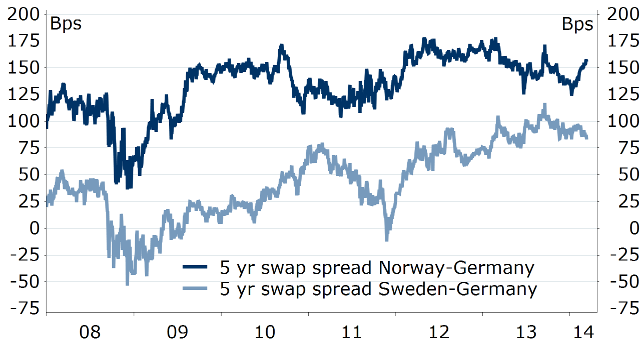
In Norway, there has been a sharp underperformance vs Germany in the 5 to 10 yr sector. The 2s5s10s butterfly thus looks high vs Eurozone. In the current on hold environment in Norway we think 5s should outperform the wings, and the trade has a 20 bps carry per year. Also, receiving Norwegian 2yr2yr fwd vs Eurozone looks interesting.

Chart 1. NOKSEK overbought - should fall again




Source: Nordea Markets and Reuters Ecowin

Chart 2. High spreads vs Germany




Source: Nordea Markets and Reuters Ecowin

# Sweden – Recovery but low inflation

## Growth more broad based

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After a sluggish start to 2013 the Swedish economy began to recover in the latter part of the year. Domestic demand accelerated at a rapid pace whereas exports were subdued also towards year end.

This recovery continues at a good pace this year. Low interest rates and an expansionary fiscal policy line provide stimulus to the economy. Growth is moreover strengthened when global demand and exports regain momentum. With robust growth, the labour market will improve further.

Households are the main growth driver of the economy. Inflation is low, incomes are growing rapidly and household wealth has improved via higher equity and home prices.

## Inflation to rise gradually

*Rate hike before year-end*

As improvements in the labour market take hold, inflationary pressures will increase, albeit slowly. As from H2 2014, CPIF-inflation will start rising from the current low levels. With healthy growth in the economy, the housing market heating up and somewhat higher inflation, we expect the Riksbank to raise rates before year-end 2014.

## Riksbank's rate decision next key event

Inflation is currently the focal point for the Riksbank. In February, CPIF-inflation stood at 0.4% y/y, 0.1% point below the Riksbank's forecast. Notably, CPIF excluding energy was spot on the Riksbank's call at 0.8% y/y.

*Riksbank will keep near term easing bias.*

There are no additional inflation readings ahead of the Riksbank's monetary policy meeting April 8 (announcement April 9). The Riksbank will most likely stay on hold, but. may revise down the near term inflation forecast as electricity prices have fallen. This should in turn mean that they will keep the near term easing bias in the rate path.

As for key figures, the current recovery should be reflected in the data releases in the coming weeks. Sentiment for households as well as companies should remain relatively positive (figures out March 26). We will also monitor closely the trade balance (March 26), household credit growth (March 27) and retail sales (March 28), all for February.

Chart 3. Inflation to rise later this year

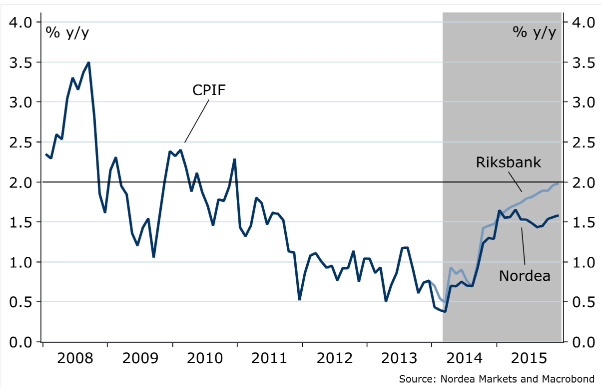
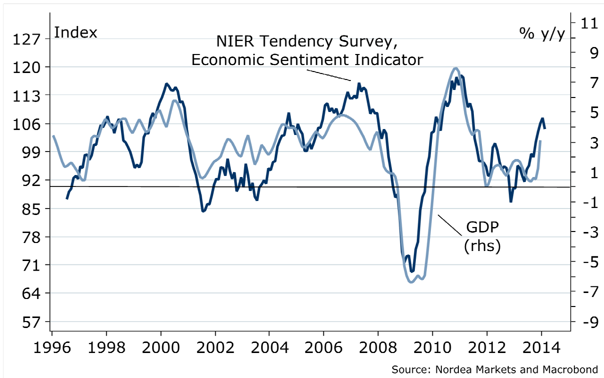



Chart 4. Improved sentiment point to higher growth



## Swedish rates: thoughts on inflation and spreads

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Even though Nordea's official forecast is a rate hike in December 2014, we don't think the market will agree with this view the coming months. When studying the SEK market in isolation, one can conclude that 2yr rates are around all-time lows and that the curve is looking flat in relation to the level of front-end yields. However, when studying the SEK market through the EUR market, the opposite holds - here we find that SEK rates look cheap and the curve steep in relation to front-end spreads. SEK rates and curves have correlated more strongly with the US lately, but by the end of the day, the development in the Eurozone, and ECB policy, will prove more important. The EUR currency has an outstanding importance for Swedish trade (partly represented by the 47% weight in the KIX currency basket). Moreover, the ECB got an even higher weighting (72%) in the all-important KIX-4 measure. This measure is a stripped version of the KIX basket that the Riksbank uses to calculate the so called global policy rate, which in turn is an important ingredient in the rate forecast.

*Swedish BEI wideners are a perfect complement to SEK vs EUR spread compression trades*

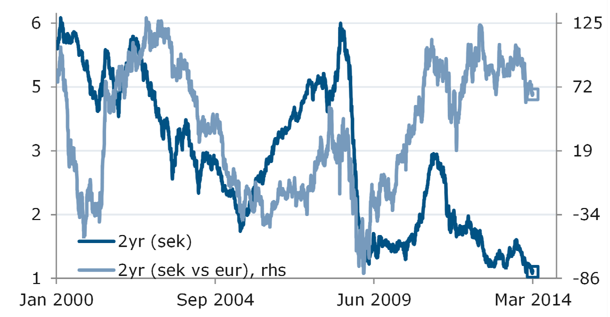
Front-end spreads between SEK and EUR already discount the Riksbank to out-tighten the ECB by an additional +50bps over the coming year and the Riksbank rate path is projecting an even more pronounced decoupling. In our view, such scenarios would only be reasonable if Swedish inflation picks up meaningfully and approaches levels near the 2% target. Thus, if spread compression trades in the front-end will prove wrong, current yield and BEI levels in Sweden will most certainly prove to be even more wrong.

Therefore, conceptually, and in order to exploit the double faced conclusions addressed above, it looks attractive to enter Swedish BEI wideners as a complement to SEK vs EUR spread compression trades. The segment we prefer to receive in is the 2-3 year part of the swap curve (or alternatiely green FRA vs Euribor spreads, with the Euribor curve arguably very flat). Break-even wideners are in our view best implemented in SGBi 3107 or 3102 (3y and 6y index-linked).

*SEK covered bonds have lagged the performance of Pfandbriefe*

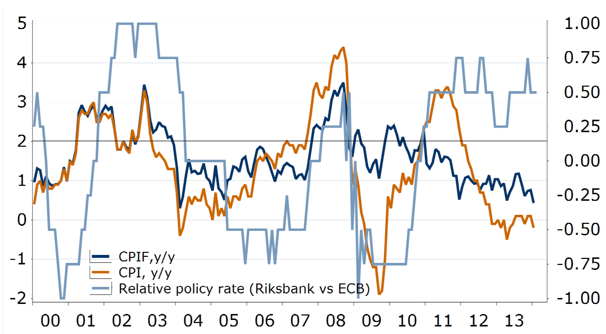
SEK covered bond spreads are lagging the compression in credits and other mortgage bond markets such as Pfandbriefe. In a cross-market comparison, Swedish covereds seem to be on the cheap side. The recent index-extension has especially cheapened up the 2y segment versus swaps.

Chart 5. Outright levels low, country spreads wide




Source: Nordea

Chart 6. Inflation and relative policy rate




Source: Nordea and Ecowin

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## EURSEK – Scania to support the SEK?

Short-term we see a range-bound EURSEK, 8.80 – 9.00. We find arguments supportive of a slightly stronger SEK and see no obvious reason why the spot should cross 9.00 again. The macro momentum is still in favor of the krona and the surprise index has not reached its cycle high just yet. Although therein lies a small problem: It seems as if the FX market currently is more sensitive to favorable Swedish data than the interest rate market. An appreciation of the SEK would be more reliable if the macro momentum set its mark on short rates. Buyers of USDSEK at present low levels could also serve as a trigger for a slightly higher EURSEK short term.

*The potential sale of the national champion Scania is an option worth considering*

But the potential sale of the national champion Scania is an option worth considering. Volkswagen's offer to buy the remaining stake in Scania at 200 SEK/share, or 6.7 billion EUR in total, opens next week and will expire April 25. The question is how much will go through the market. According to Volkswagen, around five billion euro will be raised through issuance of preferred shares and hybrid capital and two billion euro will be drawn from Volkswagen's ample cash reserves. Even if the latter consists of some SEK, the issuance of new securities suggests that exchanges are to be made. As for Scania's approximately one billion euro cash reserve, these are likely to contain some SEK as well. Unless Volkswagen gets 90% of the shares, the deal will not be finalised. However, with the share trading above SEK 195, a high probability is given for the deal to go through, even if some minority share owners have declared that they will not participate. All in all, news of the Volkswagen/Scania deal going through will likely support SEK in the coming month.

*A sharp move lower in stocks would naturally be pushing the krona away from our forecasts*

The last couple of weeks have also been overshadowed by another theme, the tension in Ukraine. This has raised the question; what would happen to the SEK in case of sudden bursts of risk aversion and sharp equity sell-offs? Historically, these periods have been associated with a weaker krona. However, in calmer periods the currency correlates only weakly with equities. Thus, a sharp move lower in stocks would naturally be pushing the krona away from our forecasts. But a more gradual softness would not necessarily mean EURSEK should move higher. During the past year EURSEK has in fact been surprisingly weak, considering the strong equity rally.

Chart 7. EURSEK and stock market correlation

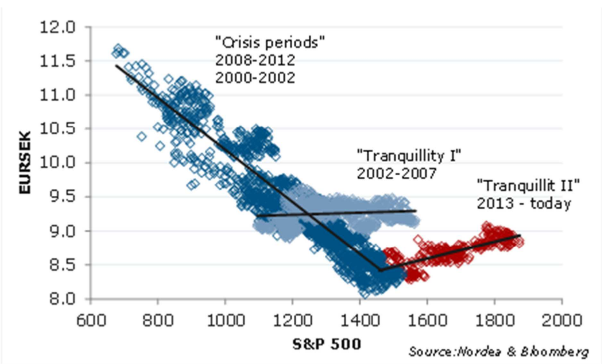
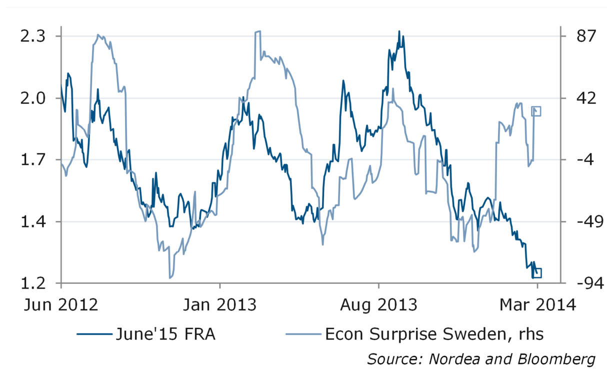



Chart 8. Macro data leaves no print in interest rates



# Norway – Rates firmly on hold

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Norges Bank publishes their new interest rate forecast on March 27. Developments since the December report do not point to any major revisions.

Registered unemployment has moved sideways the last two months, thus being somewhat on the strong side to Norges Bank's forecast. In addition the Q4 GDP figures were stronger than expected and together the figures point to somewhat stronger capacity utilization than Norges Bank forecasted in the December Monetary Policy Report.

*Demand seems to be weaker than Norges Bank expected in the December report. The big question is how it will affect the new rate path.*

The big question this time will be how Norges Bank weighs this against signs of weakness in demand and the latest Regional network report. Consumption of goods covers about 50% of private consumption and year on year growth now points to lower growth in private consumption than Norges Bank expects (Chart 9). In contrast to registered unemployment and the Q4 GDP figures, the Regional network report indicates lower capacity utilization and lower GDP growth in Q1 compared to Norges Bank's forecast.

House prices have moved sideways the last three months, but recent housing market data could still cause worries for Norges Bank. Housing starts fell almost 40% in January (SA). The figures are in line with other figures and the stories we hear from builders – the sales of new houses have plummeted.

Other factors are about neutral to the rate path. The NOK has strengthened and is now in line with Norges Bank's forecast. The same holds for rates abroad and Norwegian market rates. Inflation was below Norges Bank's forecast in December while it was above in January. With the February figure being more or less in line with forecast we think Norges Bank in sum will judge inflation as expected.

*The new rate path probably much the same as the December path.*

All in all we think Norges Bank will judge the development since December more or less as expected. The Network report does however increase risks on the downside, but still no major revision. The interest rate path presented at the end of March will therefore indicate rates firmly on hold well into 2015.

We stick to our view of weaker growth than Norges Bank forecasts due to weakness in housing market and oil investments. This will however need time to materialize, but when it does we think Norges Bank will have to keep rates on hold beyond 2015.

Chart 9. Consumption of goods point to weakness…

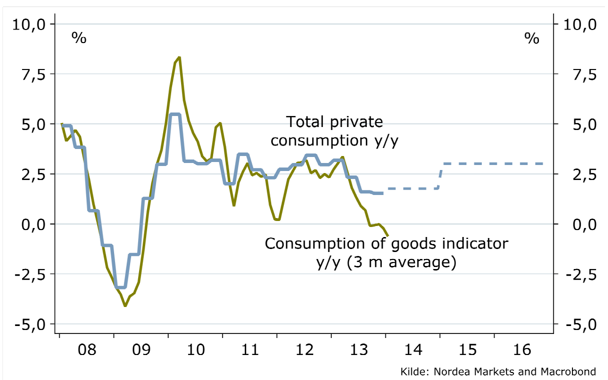
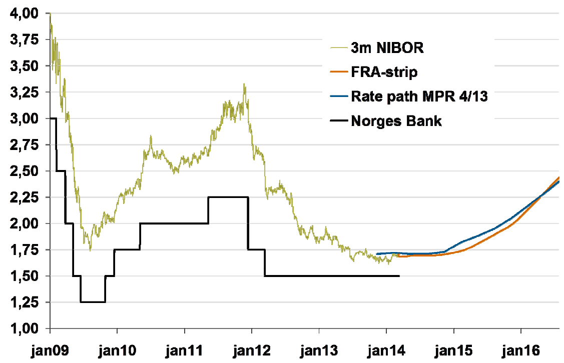



Chart 10. The market does not expect major changes




Source: Nordea Markets and Bloomberg

### Norwegian rates: Receive Norway vs Eurozone in 2yr2yr forwards

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We expect Norges Bank to confirm its on hold stance at the upcoming meeting. Recent developments do not justify major revisions to the rate path and the new path is likely to continue to indicate unchanged rates well into 2015. We see no reason to disagree with the central bank's rate forecast despite our soft outlook for the economy. We expect the krona to take the hit and the economy to get enough stimuli from a weaker currency to make rate cuts unwarranted.

With the short end likely to continue to be anchored the market should take direction from European rates. Recently we have seen a sharp divergence where the 5 to 10 year sector of the NOK swap curve has risen vs European rates whilst the 2 yesr spread has been stable. This means that the 2s5s10s butterfly in NOK now seems high relative to EUR. The current on hold environment would typically keep the fly in negative territory and receiving the belly has positive carry of more than 20bps/yr. We like the trade.

Because of this relative decoupling the 2yr2yr spread vs EUR now stands out as high. We like receiving 2yr2yr fwd vs EUR as a good way to go against the recent spread widening. Carry here is 12 bps/yr.

There is plenty of action in the government debt market at the moment. The long end of the bond curve has cheapened so much vs swaps that the 6bn introductory auction of NGB2024 (#476) was much stronger than expected. Domestic banks have become the largest buyers by far lately. New buyers being drawn into the market means that the trend of tighter swap spreads is likely to stop.

The short end of the bond curve is getting pricier as the bills market is getting squeezed. This is a result of a dramatic fall in the volume of bills (see "The impact from disappearing bills"). During the financial crisis the government let banks swap covered bonds for bills for up to 5 years. The last of these swaps are maturing at March and June IMM this year and the bill volume will halve over this period. Investors will have to reallocate into alternative assets as there simply will not be enough bills for current holders. We saw signs of this in December when 11bn of these swaps matured. In March 46bn mature and in June 32bn mature. Being long short end government debt over these dates has the potential to pay off well as the situation is likely to get more extreme.

Chart 11. 5 year sector in NOK is high relative to EUR

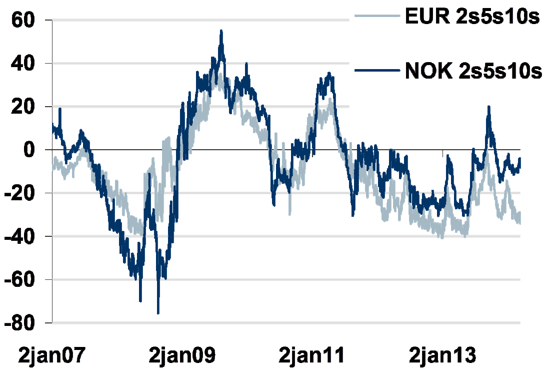
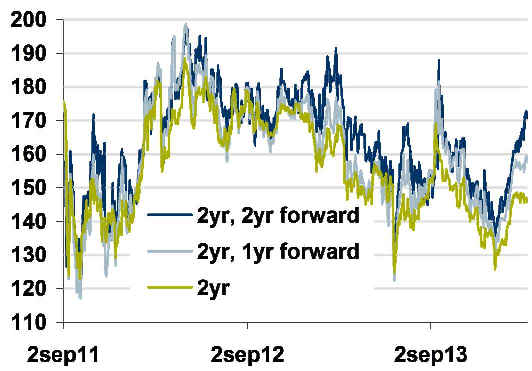



Chart 12 Spreads to EUR: 2yr,2yr forward



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**NOK: Investments leaving the (not so) safe haven**

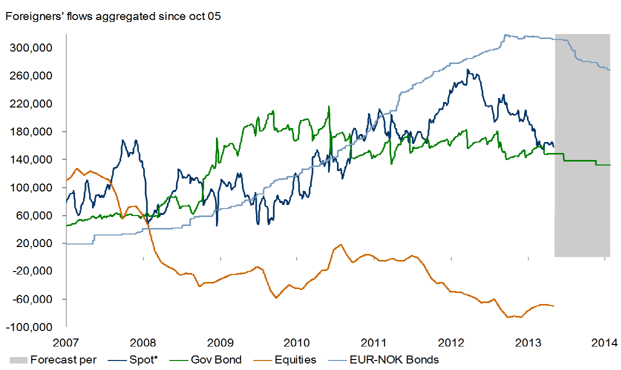
NOK weakened along with Emerging Markets in the beginning of the year. With improved risk sentiment and key figures on the strong side EURNOK came down from the 4.5 year high around 8.54. In addition to low liquidity, the picture of decreasing oil investments makes the case for a comparison with countries like Russia, South Africa and Brazil. Like stated earlier, our main reason for believing in a weak NOK is our forecast for a weaker Norwegian economy than Norges Bank.

The flow picture in NOK for the coming months could also become a negative contribution. The perception of NOK as the safe haven made EURNOK-bonds quite attractive during the European debt crisis. 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 the 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 on March 22 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 amount maturing might of course be reinvested, but with our take on the Norwegian economy such an outcome is not obvious, and we find it hard to believe in a stronger NOK for the coming months.

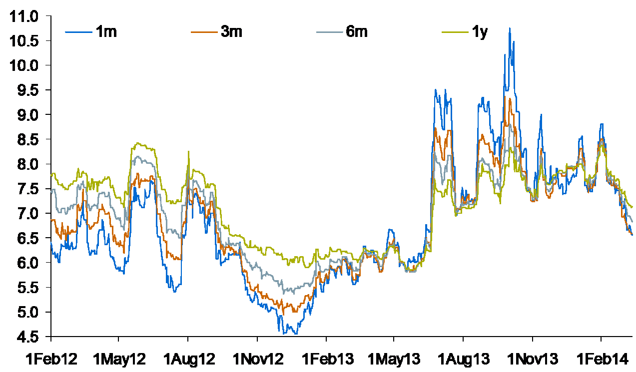
Going into the Norges Bank's meeting on March 27; buying volatility for the upside seems interesting. In general, we have been realizing more volatility than implied through these meetings, in particular the last year. Add the flow picture to this and it seems like the drop of more than two percentage points in implied volatility the last couple of weeks make for a decent buying opportunity.

Chart 13. Foreigners on their way out of NOK




Source: Norges Bank, VPS, Bloomberg and Nordea

Chart 14. NOK; implied volatility coming back down



# Denmark

## New possibilities in Danish government bonds

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After a period of massive performance in Danish government bonds to Germany in November last year we have seen a re-pricing in early 2014 (Chart 15). Does that mean that Danish govies are again an attractive buy?

In the current environment the same liquidity and risk premiums that enter into the Bund-spread also feeds into the DGB-DBR spreads in the 10y segment of the curve. This basically means that DGB trade 1:1 with EUR IRS*. In the following, we will focus on the benchmark DGB23, but comparable maturities have the same properties.

*DGB as an alternative to rec. EUR IRS has an interesting asymmetric risk reward profile over different risk scenarios*

If the current regime prevails, DGB hedged in EUR IRS will be a quite stable trade with at 6m carry/roll of some 2bps running. In a risk-off scenario, DGB might initially underperform Germany as will EUR IRS – but at some point DGB will most likely re-emerge as a safe-haven placement, as we saw during the PIIGS crisis, and thus perform to EUR IRS. Instead of actually trading the "cross-country" ASW, DGBs could also be seen as alternative to EUR receiver-positions in ALM hedging. Note that EUR based investors get an additional pick-up of some 30bps by rolling 1m EURDKK fx swaps.

During the past couple of years the structural demand for receiving DKK IRS in the long end has been lower, due to the discontinuation of interest guaranteed products in the l/p industry. Also, the demand for paying DKK IRS in the medium segment is structurally higher due to more covered bond hedge activity. Because of the cheap DKK IRS, we don't favour buying DGB vs DKK IRS.

## Good demand for DGBs at the last auctions

*Good demand for DGB at the bi-weekly auctions lately*

During the last couple of auctions we have seen a very good interest from investors. This has been most pronounced in the DGB16, which now has an outstanding amount of DKK 46.99 bn. The next acution will be on Tuesday March 18. The massive spread compression in semi-core countries – and widening of DGB – supports the case for scaling up on the Danish curve, especially if added focus on European budget (im)balances will be on the agenda again.

* Δ(DGB-DBR) = Δ (EUR IRS – DBR) => Δ (EUR IRS – DGB) = 0

Chart 15. DGB re-pricing early 2014

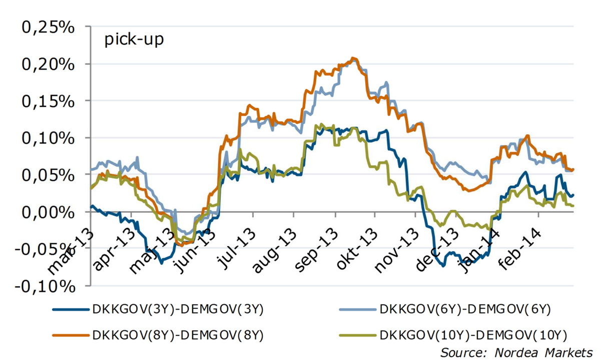


Chart 16. Good auction interest