

European FI Strategy

Not another crisis

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Global markets

Flight-to-quality flows have pushed bond yields lower again, and risks remain tilted towards lower yields, as tensions between Russia and the EU/US over Ukraine / Crimea could easily escalate. On the central bank front, the ECB is struggling with a strong currency.

EUR Strategy

The EUR front end remains flat and the steepness of 5s10s makes the convexity stand out as low. In govie space, hunt for carry is still strong, supporting further spread tightening.

Sweden

Inflation will 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.

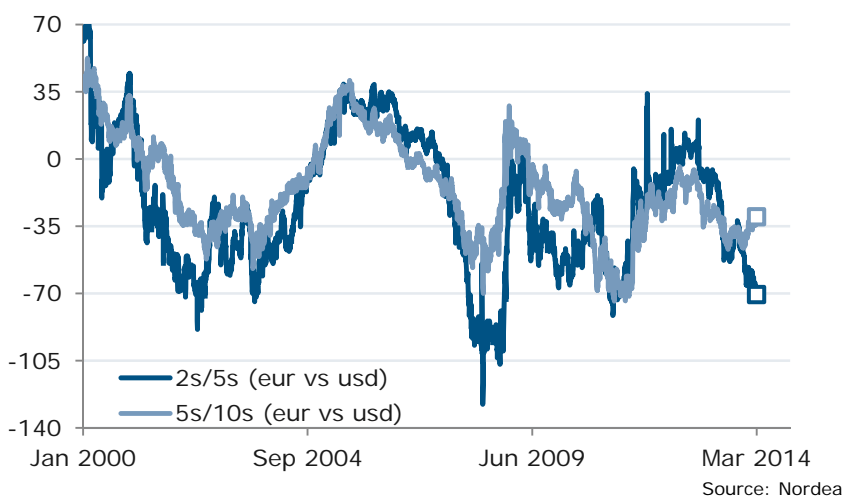
Norway

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 seems high relative to EUR.

Denmark

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 – A tale of two curves



Editors

Jan von Gerich

Chief Analyst – Fixed Income
Global Strategy
+358 9 165 59937
@JanVonGerich
jan.vongerich@nordea.com

Alexander Wojt

Analyst – Fixed Income
Strategy and Research Sweden
+ 46 8 614 73 08
aexander.wojt@nordea.com

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Global Markets - overview

Macro

US: spring is not here yet

Author

Johnny Bo Jakobsen

Chief Analyst

+45 3333 6178

johnny.jakobsen@nordea.com

Holger Sandte

Chief Analyst

+45 3333 1191

holger.sandte@nordea.com

Fed stays the course – it's the weather, stupid

Recent indicators suggest that US real GDP is on track for about a 2% rate of growth in Q1. This is actually not bad considering the weather. We continue to expect activity indicators to snap back once the weather normalises, but it might still take a few more weeks before this is generally reflected in data releases. The 175k rise in payrolls in February, despite a clear drag from the weather, was obviously encouraging and it more or less seals the case for the Fed to continue tapering its monthly bond purchases by USD 10bn, to USD 55bn, at this week's FOMC meeting, which concludes on Wednesday. It is also likely that the Fed will replace its threshold forward guidance with a qualitative approach, referring to a wider range of labour market indicators along the lines of the BoE. A move to qualitative guidance will make the so-called "dot chart" with each FOMC participant's projection of the appropriate funds rate path even more important for the markets. However, we expect no major changes to the dots at this week's meeting.

Euro area: Low inflation remains a worry

Sentiment indicators suggest that in Q1 growth continued to the tune of 0.3% q/q. Retail sales started strongly into the year and industrial production is still on an upward trend in our view, despite the slight fall January. Meanwhile, the euro has reached a 2½-year high against the dollar. On a trade weighted basis, the euro gained 10½% since Mario Draghi's "whatever it takes"-speech in July 2012. We expect headline inflation to bottom in March at 0.6% or 0.7% y/y. However, an even stronger euro could easily lead to even lower inflation rates in the summer half-year. ECB Governing Council members may well stress that they consider deflation risk to be limited. And to some degree, very low inflation rates reflect the unavoidable internal devaluation in troubled euro countries. But still, as long as inflation does not move at least a bit closer to the ECB target, there will be pressure on the ECB to do more. That pressure will increase if we get indications that the strong euro – or other factors like the Ukraine/Russia crisis – take a toll on growth.

Strong euro, low inflation

Chart1. US labour market is basically fine

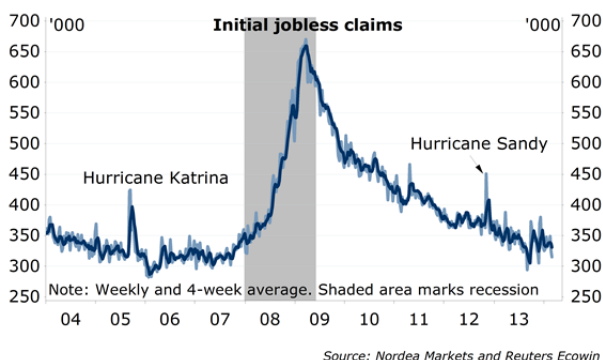


Chart 2. Euro gaining strength



Market overview

Flight-to-quality back

Author

Jan von Gerich

Chief Analyst – Fixed Income
Global Strategy
+358 9 165 59937
@JanVonGerich
jan.vongerich@nordea.com

Risks remain tilted towards lower yields.

ECB trying to talk the currency down.

Search for carry still strong.

Bond markets have exhibited clear swings in the past month. First, the escalating crisis around Ukraine created flight-to-safety demand and sent yields lower. The German 10-year benchmark yield hit its lowest level since last summer, while the corresponding US yield did not quite even reach its year-to-date lows (from early February). Yields then rebounded as US economic data improved and the ECB refrained from further easing. Last week, safe haven demand returned, as in addition to the situation in Ukraine a weak batch of economic data from China coupled with a bond default increased fears towards the second largest economy of the world.

Going forward, the upside for long yields still looks quite limited in the near term, and risks remain tilted to the downside. The Crimean situation is far from resolved, and things could easily heat up. Yesterday's referendum result will only add fuel to the fire, while the pressure for the US and the EU to impose stricter sanctions on Russia increases. Current yield levels still do not appear to illustrate high expectations that the crisis would take another turn for the worse. If flight-to-safety flows picked up again, US Treasuries would likely be the main beneficiaries, though German bonds would rally as well, while curves would see bull-flattening. For more on the Crimean crisis and its market impact, please see [our full analysis](#).

On this side of the Atlantic, a number of ECB speakers have been trying to provide further easing verbally. Vice-President Constâncio complained that while the ECB had made its forward guidance more precise earlier this month, the market had not fully picked up the message. Mr Draghi, in turn, said the euro should weaken going forward, as real interest rates fell with rising inflation. The Governing Council thus appears to be increasingly worried about the rising value of the euro (EUR/USD has hit its highest level in more than two years), and if verbal interventions are not enough to reverse the course, the ECB will have to consider further action.

New bond issues have continued to receive strong demand, and the search for carry in a low-yield environment continues. E.g. Spanish and Italian 10-year benchmark yields have fallen below 3.5%. Any correction higher in intra-Euro-zone spreads due e.g. to tensions in Ukraine should be seen as a buying opportunity.

Chart 3. German 10-year yield hit 6-month lows

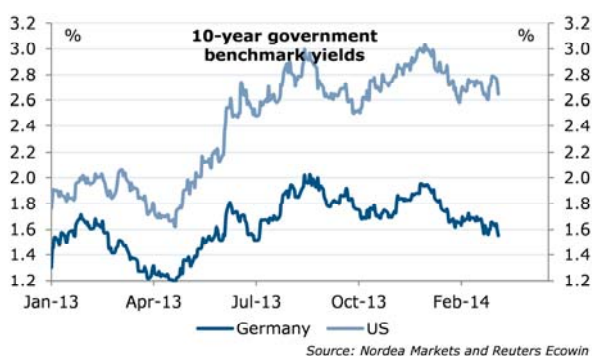
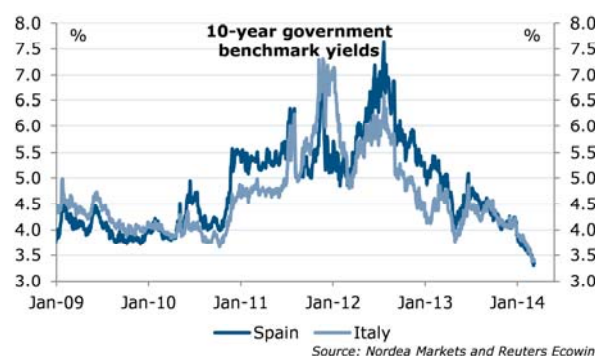


Chart 4. Rally in Spanish and Italian bonds continued



EUR Strategy

The curve is dead, long live the curve!

Authors

Jan von Gerich

Chief Strategist
+358 9 165 59937
jan.vongerich@nordea.com

Alexander Wojt

Analyst – Fixed Income
+46 8 614 7308
alexander.wojt@nordea.com

*2s5s10s curvature standing
out as low*

While the March ECB meeting was interpreted as somewhat positive by the market the slightly inverted front-end still suggests that expectations are for some kind of action by the ECB in the coming months. However, with the liquidity draining progressing and data gradually improving we find current flat levels in the front-end looking stretched. Any measure by the ECB in the shape of rate cuts or suspension of SMP sterilization may also pull only the shortest rates lower and have a steepening effect on the curve. Steepening the front thus looks interesting and this could also be done vs the USD curve where roll is attractive (Chart 5). Alternatively, for investors with steepening exposure in other markets we would consider switching some exposure into EUR.

Looking slightly further out on the curve the story is quite different. While 5s10s has flattened somewhat during past months this part of the curve is not far from all time steep levels. That makes the 2s5s10s curvature stand out in a historical context as low and close to the widest level in a decade vs USD (Chart 6). Among developed markets the convexity levels in EUR are not far from what can be seen on the Swiss and Japanese curves. Consequently, we like to pay the belly vs the wings as a trade with good risk reward but at the same time notice that this is starting to evolve into a consensus bet on the EUR curve.

Any widening in spreads a buying opportunity

*Spreads still with
narrowing potential*

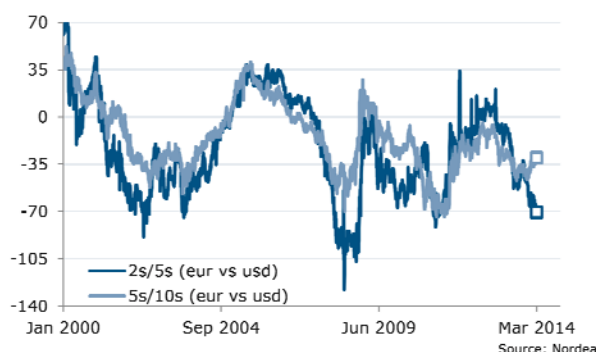
The trend of narrowing spreads has continued outside the semi-core lately. Even though the absolute yield levels already look low for countries like Spain and Italy (10-year yields below 3.5%), spreads to Germany do not look that low. In a world of low interest rates and adamant search for carry, spread narrowing can continue. We would thus see any correction higher in spreads due to tensions related to Ukraine a buying opportunity.

In the semi-core space, we have heard several pieces of positive rating news. Moody's lifted its outlook on Germany, Austria, Belgium, the Netherlands and Luxembourg from negative to stable, while Standard & Poor's did the same for its outlook on Belgium. The pressure on the ratings thus appears to have eased for most semi-core countries.

Chart 5. Short end remains flat in EUR



Chart 6. Diverging curves in EUR vs USD



Scandi Corner

Sweden – Recovery but low inflation

Author

Torbjörn Isaksson

Chief Analyst

+46 8 614 8859

torbjorn.isaksson@nordea.com

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

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.

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.

Rate hike before year-end

Riksbank will keep near term easing bias.

Chart 7. Inflation to rise later this year

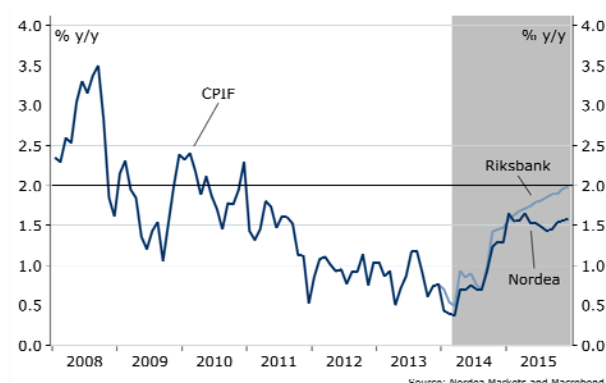
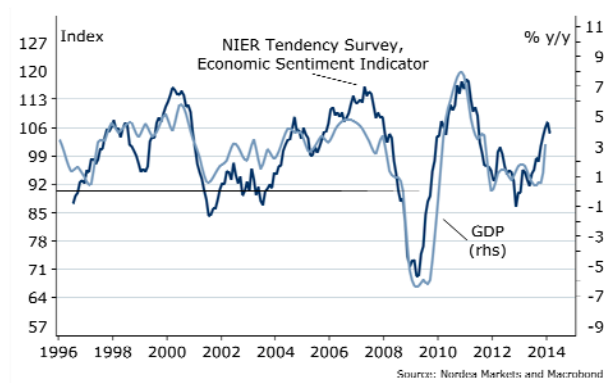


Chart 8. Improved sentiment point to higher growth



Swedish rates: thoughts on inflation and spreads

Authors

Mats Hydén

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

Fredrik Floric

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

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

SEK covered bonds have lagged the performance of Pfandbriefe

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.

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 widenings 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 widenings are in our view best implemented in SGBi 3107 or 3102 (3y and 6y index-linked).

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 9. Outright levels low, country spreads wide

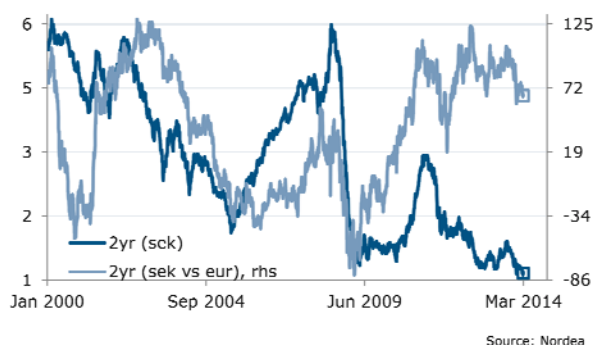
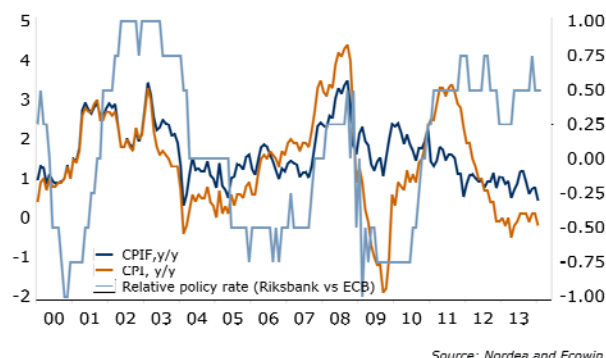


Chart 10. Inflation and relative policy rate



Norway – Rates firmly on hold

Author

Joachim Bernhardsen

Analyst

+47 2248 7913

joachim.bernhardsen@nordea.com

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

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.

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.

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 11. Consumption of goods point to weakness...

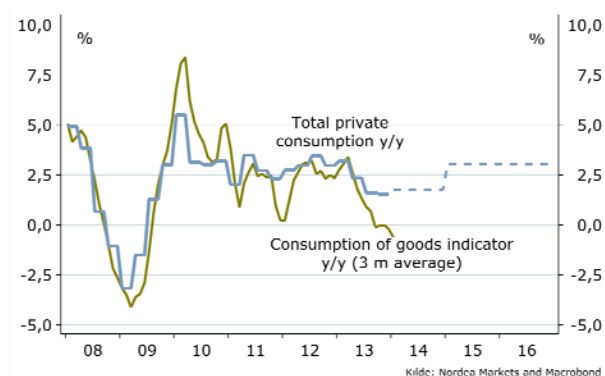
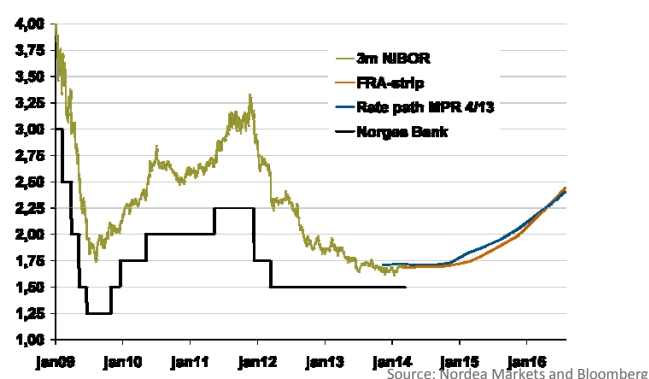


Chart 12. The market does not expect major changes



Author

Gaute Langeland

Chief Analyst

+47 22 48 53 91

gaute.langeland@nordea.com

Norwegian rates: Receive Norway vs Eurozone in 2yr2yr forwards

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 year 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.

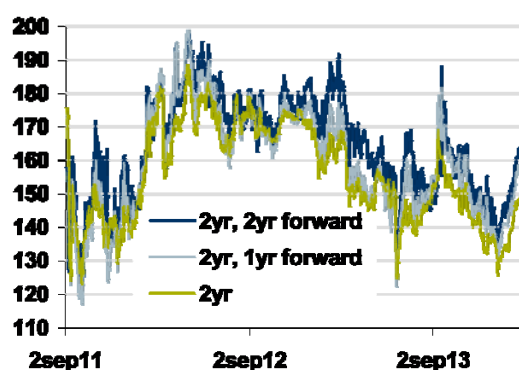
There is plenty of action in the government debt market at the moment. The long end of the bond curve has cheapened so much vs swaps that the 6bn introductory auction of NGB2024 (#476) was much stronger than expected. Domestic banks have become the largest buyers by far lately. New buyers being drawn 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 13. 5 year sector in NOK is high relative to EUR



Chart 14. Spreads to EUR: 2yr,2yr forward



Denmark

New possibilities in Danish government bonds

Author

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

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

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.

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

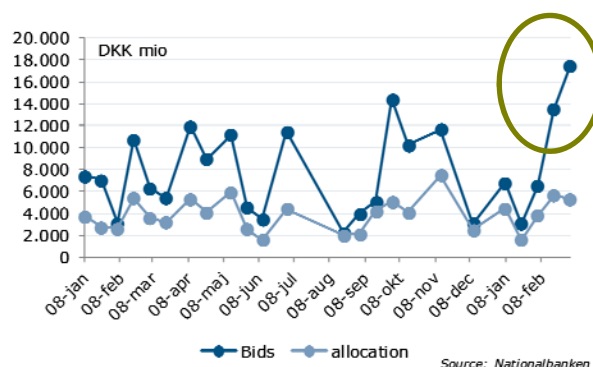
During the last couple of auctions we have seen a very good interest from investors. This has been most pronounced in the DGB16, which now has an outstanding amount of DKK 46.99 bn. The next auction will be on Tuesday March 18. The massive spread compression in semi-core countries – and widening of DGB – 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.

$$* \Delta(\text{DGB-DBR}) = \Delta(\text{EUR IRS} - \text{DBR}) \Rightarrow \Delta(\text{EUR IRS} - \text{DGB}) = 0$$

Chart 15. DGB re-pricing early 2014



Chart 16. Good auction interest



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