

# European FI Strategy

## Mad about QE

Nordea Research, 11 April 2014

### Global markets

QE talks are all over the place in the Euro zone, and even though such central bank action is not in any case around the corner, it will very much affect expectations and market pricing. The German 10-year yield has tested an important support several times already, and the odds of a break lower have increased clearly. We thus favour long positions in bonds.

### EUR Strategy

The curve has seen plenty of flattening, but there is more to go. We find more value in 2-5-year curve flatteners. The demand for pick-up continues to be strong, as illustrated e.g. by the fact that demand for the new Greek bond issue amounted to more than EUR 20bn. Spread narrowing will continue, as QE expectations increase.

### Sweden

Riksbanken indicated that the repo rate would rise slower than expected, and then March inflation convinced a majority of the market that Riksbanken will actually cut next time – shorter duration bonds will benefit.

### Norway

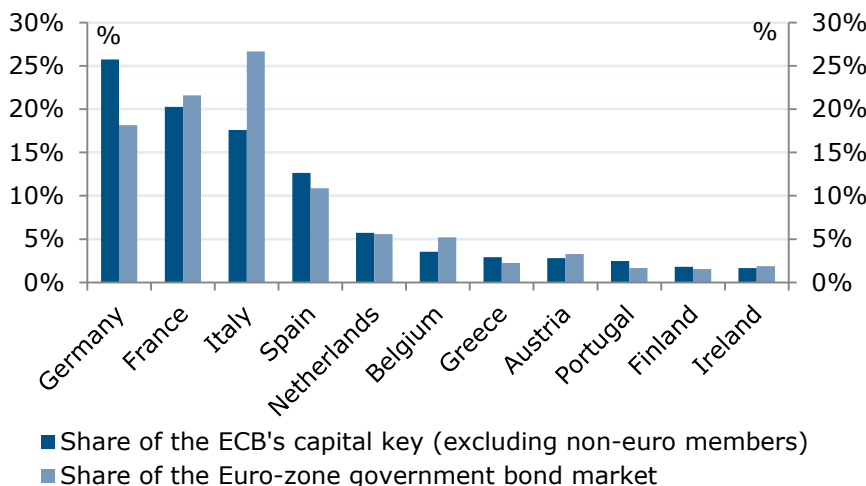
A fall in mortgage rates could somewhat perversely trigger Norges Bank to become more hawkish. Demand for Norwegian government bonds is picking up.

### Denmark & Finland

DK: A possible rate hike is on the horizon, but this is already priced in. Market confidence in DGBs continues to be high.

FI: Finnish recovery is still left to be seen and Ukraine spill-overs risk widening Finnish spreads further. In addition, the recent move by S&P to downgrade the Finnish outlook to negative will pressure spreads.

### Chart of the month – How could ECB QE look like?



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# Global Markets

## Overview

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*QE not about to happen, but it will drive markets.*

*ABS purchases more likely than government bond purchases.*

*German 10-year yield building momentum for a break lower.*

### Q&A on QE

QE (quantitative easing) has become a buzzword in the Euro zone lately, after Mr Draghi assured that *the Governing Council is unanimous in its commitment to using also unconventional instruments within its mandate in order to cope effectively with risks of a too prolonged period of low inflation*, while the topic of QE was explicitly discussed at the April meeting. It would be a mistake to think that the threshold for the ECB to jump into QE would now be low. It would not be a mistake, however, to think that the prospects of more ECB action will be a big driver of markets in the near term.

A QE programme by the ECB could come in many forms, but the most discussed (and best-known) version involves buying government bonds. In the ECB's case the most likely way to go, would be to divide the bonds using the different countries shares in the ECB's capital key, i.e. relative to the size of their economies and population.

A more likely version, however, as pointed out by several Governing Council members, including Mr Draghi himself, would involve buying asset-backed securities (ABSs). Such a programme would have the added benefit of directly boosting lending to the ailing small and mid-sized companies in many parts of the Euro zone, since many banks still struggle with deleveraging and an inadequate capital position. However, the ABS market is currently facing plenty of hurdles, and the ECB itself is unlikely to be ready for such a programme. In any case then, bond purchases are not something for the near future. If the ECB becomes convinced that more action is needed, cutting rates, including a negative deposit rate, looks much more likely in the short term. For more on the topic, please look [here](#).

The German 10-year yield has tested the important support at 1.50% several times already, but has been unable to break lower. The odds of a break lower have improved, however. Apart from increased QE talks, the situation in Ukraine appears to be heating up, with the potential to create more flight-to-safety demand. In addition, the Q1 earnings season that just started could easily trigger an overdue correction lower in equity prices – helpful for bonds. Finally, even though the latest US employment numbers were quite okay, they were not good enough to open more upside potential for US yields. We thus continue to favour long positions in bonds.

Chart1. How could ECB QE look like?

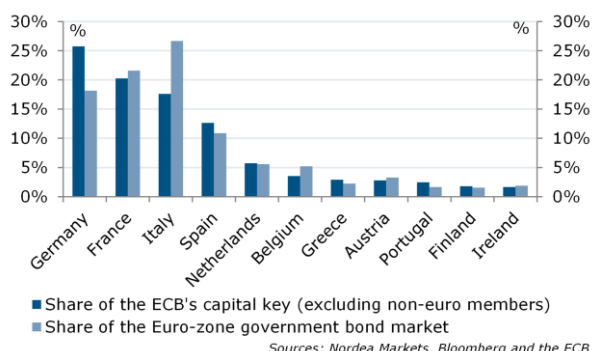


Chart 2. German 10-year yield near key levels



## EUR Strategy

### Not a pancake yet – more flattening ahead

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*Increasing QE expectations should contribute to a flatter curve in the short end of the curve.*

The curve has seen plenty of flattening this year, especially in the 2-5-year sector. Still, we are nowhere near exceptional levels yet. The 2-5-year EUR curve is almost 15bp steeper compared to the lows seen last spring, and at around 50bp is of course nowhere near the negative levels seen in 2008. Flat starting levels should thus be no obstacle for further flattening.

The effect increasing ECB QE expectations would have on the curve is not straightforward, since unlike e.g. the Fed, the ECB might have a stronger preference to target its purchases to shorter maturities. However, at least in the shorter end of the curve the effect should be a flatter curve.

We find value remaining in 2-5-year curve flatteners, which also offer positive carry/roll. A 2-5-year EUR curve flattener with a 6-month forward start offers positive roll of some 6bp.

### Spread narrowing has not run its course

*Demand for pick-up still huge.*

The demand for pick-up continues to be strong. Just take a look at the Italian and Spanish 10-year yields, which are approaching 3% and the Italian one recently hit a new record-low. Another illustration is the fact that Greece was able to return to the market with a 5-year bond, yielding below 5% and gathering more than EUR 20bn of demand, following a debt restructuring just two years ago.

*Government bond purchases by the ECB would not affect all spreads equally.*

Going forward, the prospect of government bond purchases by the ECB should boost risk appetite, and the higher the spread, the more narrowing potential it has. However, the size of the bond market relative to the purchases matters as well (see the graph on the previous page), and should have a bigger role between countries with rather similar spread levels. In other words, e.g. Spanish bonds should perform vs. Italy, as the Spanish bond market is much smaller compared to the Italian one relative to the likely bond purchases by the ECB (the Italian bond market is more than a fourth of the Euro-zone market, while it would likely see only some 18% of the total purchases; Spain, in turn, accounts for around 11% of the Euro-zone bond market, while close to 13% of the purchases should target Spanish bonds).

Chart 3. Curve with more flattening potential



Chart 4. Italian bond yields been in a free-fall



## Scandi Corner

### Swedish rates

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The message from the Riksbank's policy meeting this week was dovish, with a lower repo rate path (down 40bps in late 2015) and an almost doubled probability (to just shy of 40 %) of a rate cut in July. This was softer than the market expected and consequently, front-end rates were down and the currency weakened. Like we have been arguing, it was lower inflation aggregates that pushed the Riksbank into this territory and SEK receiver positions against EUR have been favourable into the announcement. Despite the spread re-pricing, we continue to see value in red and green SEK receivers vs EUR, with the attractive roll-down along the spread curve being an additional factor.

Interesting to note is also that on the same day as the Riksbank delivered its rate decision, a 10y SEK government auctions failed for the first time since 2010. The more likely a near-term rate cut becomes, the more credible a future rate hike is. So in a way, the soft stance from the Riksbank might very well be negative for longer dated bonds in a relative sense and an environment that nurtures a steep curve is more in place now.

As for index-linked bonds, the negative carry month of March has passed, with linkers actually outperforming the negative carry contributions. The next big theme is the relative play between the high March Euro zone HICPxt and a low Swedish March CPI. Swedish short-end linkers need to outperform by as much as 32 bps (SGBi 3107) compared to their German peers to break even during the month of May. We are therefore no longer bullish on Swedish linkers for this tactical reason.

The SEK covered bond market is still dominated by the ebbs and floods of index-extensions, buy-backs, and new issuance. Right now, the June index-extension should start to leave its imprints on June 2015 bonds as they should stay cheap or chepen up even more against swaps. At the same time, duration extensions are supportive of 5y covereds and there are currently few signs that issuers are about to increase the SEK market as a funding source, since appetite among foreigners for unsecured debt is high and liquidity continues to be abundant in the Euro zone. We think that 3-5y SEK covered bonds will continue to perform decently relative to swaps.

Chart 5. Relative govie curve with failed auction marked

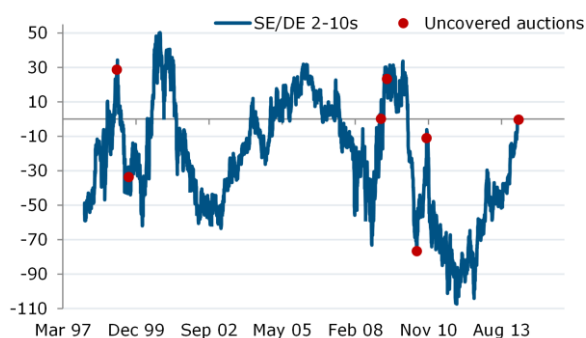


Chart 6. SEK covereds lagging credit spread tightening



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*Banks cutting lending rates might trigger opposite move by Norges Bank.*

*Interest in NGBs is picking up*

### Norwegian rates: Increasing demand

Norges Bank confirmed it's on hold stance at the last meeting. There were only small adjustments to the rate path and the message is unchanged: you will have to wait until well into 2015 for the next hike.

We see a couple of recent developments that pose near term upside risks to this outlook. House price developments have turned out stronger than expected. After falling towards the end of the year, they levelled out early this year and showed a 0.7% rise in March. The last rise is close to 10% on an annual basis and would give reason to worry should the pace continue.

Add to this that Norwegian banks have cut mortgage rates by approx. 20bps over the last weeks. Falling lending rates is a factor that has the potential to affect Norges Bank's rate setting in the near term (see [Norges Bank will take lower mortgages rates into consideration](#)). The cuts so far are not large enough to trigger a hike on their own, but more could be in the pipeline as margins on mortgages are still high by historical standards.

Buying one of the front FRA contracts seems like a cheap option on a one-off hike should these developments continue. Risk reward is good since the FRA strip is flat out to December and a cut seems a remote possibility.

We have seen a lot of interest in government bonds lately and we think the trend of underperformance has come to an end. Demand for the new NGB2024 (#476) has been very strong.

Domestic investors were on the side line over the past two years as they considered NGBs too expensive, but this is definitely not the case anymore. Ownership data shows that they have been net buyers of 18bn since the start of the year. This is a substantial amount given that only 23bn has been auctioned in period.

We see this as a response to cheap levels vs swaps and a swap spread curve that finally shows a pick up to investors along the entire term structure. Given the response we are seeing from investors, we think the trend of underperformance is likely to stop here. Add to this that the currency is showing signs that the unwind of the safe haven trade is nearing completion and that we are likely to see lighter issuance in the second half of this year and the stage may actually be set for some NGB outperformance soon. Being long NGBs is also an attractive risk-off trade.

Chart 7. The FRA strip and Norges Bank's NIBOR-path

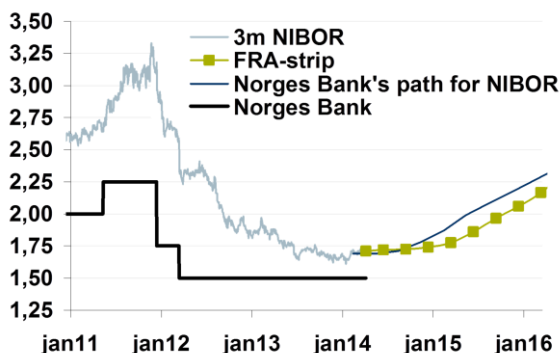
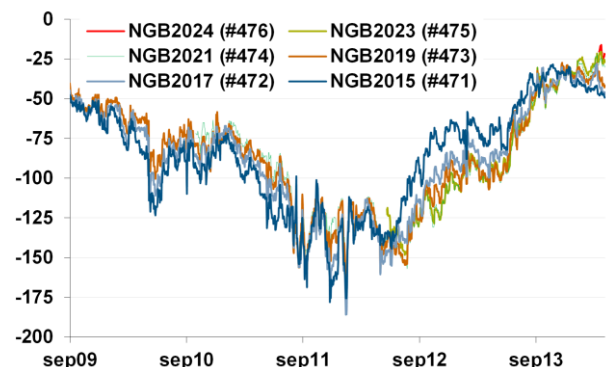


Chart 8. NGB asset swaps



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### Danish rates: We remain confident in DGBs

The gradual currency weakening and a possible rate hike on the horizon, speculation around the directionality of DGBs arises, this is not warranted. We are of the opinion that the hike to a large degree has already been priced into the market. This is evident when looking at OIS forward curves between Denmark and the Euro zone. Hence, we estimate that a 10bp hike has been priced in when looking at 2 months forward.

Taking a look at the historical development of DGBs (ASW mm) it's clear that the shorter end of the DGB curve (2-5Y) has cheapened in sync with EURDKK, whereas the 7-9Y have been more stable. In breakeven terms vs. Germany the DGB16 can take a hit of 2bp relative to the existing curve over a six month horizon.

Market confidence in DGBs therefore continues to be high, not least exemplified by the latest auction 1 April, where the DGB16 was oversubscribed more than four times (bid 15.8bn/offer 3.7). Indeed, even in the light of the gradual DKK currency weakening in April, we have continued to see performance in DGBs vs. Germany.

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### Finnish rates: Ukraine spill-overs risk widening Finnish spreads

The long awaited Finnish recovery is still left to be seen. Furthermore, the risk of a more severe Russian economic slowdown is considerable and escalation of the crisis would postpone recovery and put upward pressure on Finnish spreads.

In the same time the government is shaking and finding credible solutions to the long term problems, such as the considerable loss of competitiveness and the aging population, is getting harder and harder.

Credit rating agency S&P already reacted to this by downgrading the outlook of the Finnish AAA rating to negative. S&P cited subpar growth and risk to policy implementation. If the government fails to address the long term problems, Finland will be downgraded within the next two years. For more on S&P's recent move please see [here](#).

Chart 9. Historical development (asw mm)

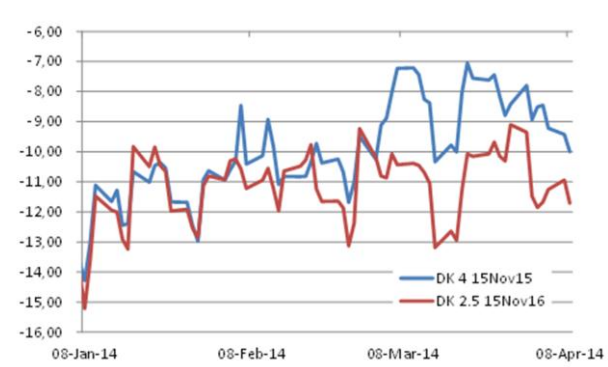
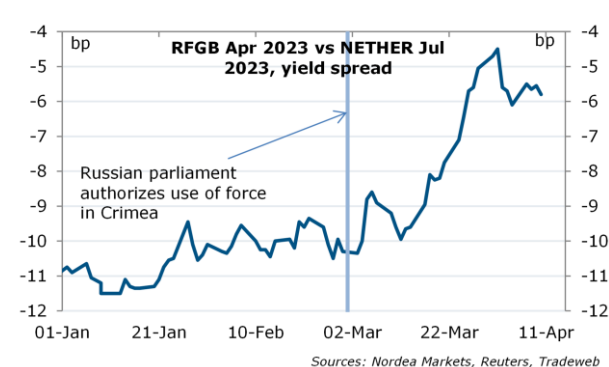


Chart 10. Uncertainties reflected in the spreads





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