

Reading the Markets Norway

Norges Bank preview: rate hike on strong growth outlook

Macro: most likely a 19 September target rate hike.

Fixed income: higher Red FRAs on Norges Bank – risk related to ECB's two tier system.

FX: tactically stay short EUR/NOK.

New trades: buy Red FRAs on expectations of a Norges Bank hike and improved international sentiment (conditional). Sell NST481 (10-year benchmark) versus swap. Sell EUR/NOK spot outright (from 9 September).

Closed trades: no closed trades.

14th issue 2019

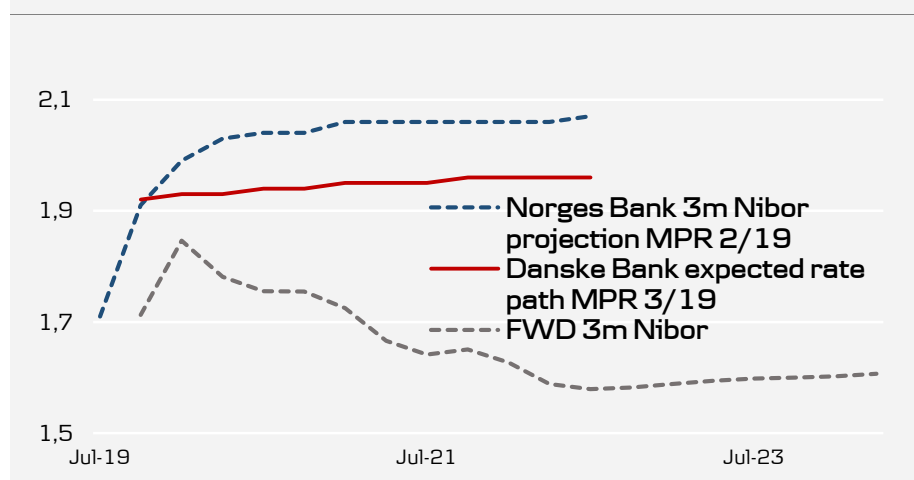
- *Reading the Markets Norway* targets our institutional fixed income and FX clients.
- It is produced biweekly.
- We will update strategy performance in future issues of *Reading the Markets Norway* but strategies may be opened and closed in between reports.

Table 1. Danske Bank's market view in a nutshell

Relative value	Last update		
FX	Stay or add long NOK exposure. Buy NOK FX vol		
Curve view (NGB)	Flatter curve on three 2019 hikes		
Swap spreads (ASW)	ASW-spread widening when international risk appetitt returns		
Spread vs peers	Flatter curve on 2019 hikes and excessive long-end spread vs peers		
Short-end (<2y)	Inversion to be reduced as market moves towards NB		
Norges Bank's policy rate	3m	6m	12m
	1,50 %	1,50 %	1,75 %

Source: Danske Bank

Chart 1. Norges Bank's 3M Nibor projection from the MPR2/19, Danske Banks forecast of the MPR 3/19 projection and the current forward 3M Nibor



Source: Norges Bank, Danske Bank

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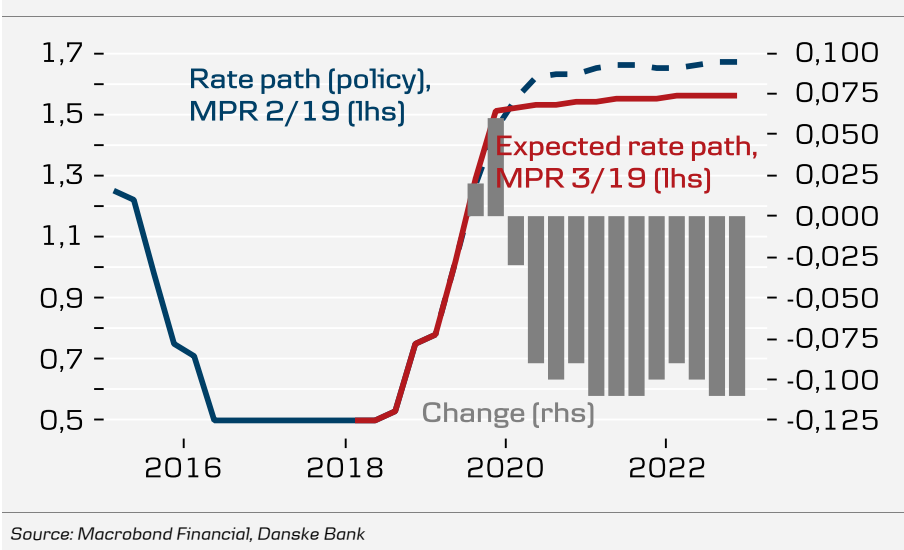
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Domestic growth counteracts global turmoil

We expect Norges Bank to raise the key interest rate by 0.25pp to 1.50% at the monetary policy meeting on 19 September. This was strongly signalled by Norges Bank in the monetary policy report in June. However, the escalation of the US/China trade war and the gridlock in the Brexit negotiations have increased downside risks from the global economy. However, as (i) the domestic economy still seems insulated from the global slowdown and (ii) the NOK is unaffected by the rising spreads versus global rates, we expect Norges Bank to hike rates as planned.

Chart 2. Expected new rate path (policy): marginal downward revision



In June, the rate path indicated around 70-75% probability that interest rates would rise again in September. Since then, global forward rates have fallen significantly and global growth prospects have weakened. This will push the rate path downwards but especially from end-2020. However, the NOK has been weakened on global risks, even though the oil price has been more or less in line with expectations. The net effect on the rate path **from financial factors** (rates, FX, oil price) is actually positive in the short end, indicating two hikes within March and then lower from mid-2021 and indicating a rate cut in 2022.

Domestic growth appears to have been roughly as expected and the Regional Network survey points to an annualised growth around 2.7% for the next six months. However, core inflation has been weaker than expected, which in isolation will pull the rate path downwards marginally.

As financial factors point to two rate hikes and domestic growth has been as expected, it takes a **significant downward revision** of the global outlook for Norges Bank to signal 'on hold' for the entire period. We expect Norges Bank to make downward revisions to the global outlook but any expectations of Norges Bank calling a global recession at this point seems highly premature. We acknowledge Norges Bank could change the risk assessment and stay on the sidelines due to increasing downside risks. However, as the policy rate still is well below the neutral rate, we find it hard to believe that it will stay on hold for almost a year awaiting a possible global recession. As a result, we expect Norges Bank to stick to its plan and hike rates and believe that the new rate path will indicate a small probability of another rate hike (around 25 %) in the first half of 2020 and then flatten. Importantly, this would signal a higher probability of a rate hike than a rate cut going forward.

Chart 3. Domestic growth in line with expectations

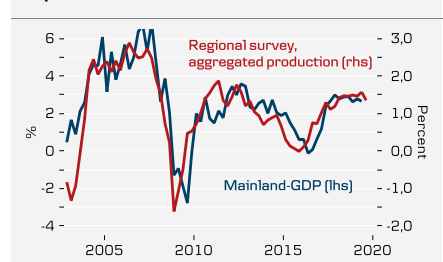


Chart 4. Weaker NOK counteracts fall in global rates

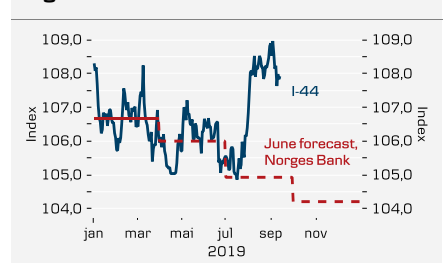


Chart 5. Oil price is USD2/bbl lower

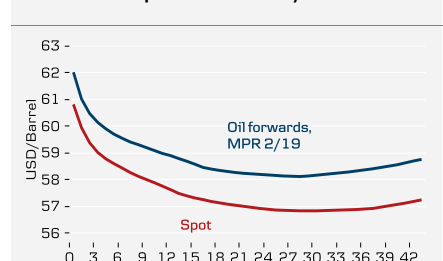
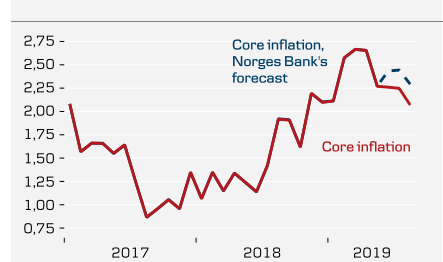


Chart 6. Core inflation is marginally lower



Fixed income: September hike and flat forward guidance suggest buying Red FRAs

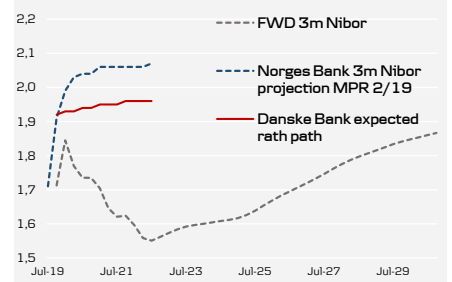
Consider buying NOK Red FRAs ahead of Norges Bank on 19 September but await the market turmoil after ECB to subside

The market discounts a 25bp hike in the sight deposit rate on 19 September to only a moderate degree. The domestic economy is strong and running slightly above potential growth, as confirmed by the recent Regional Network report. Inflation is close to the inflation target. On 20 June, Norges Bank guided a September hike. On 15 August, it acknowledged the increased geopolitical risks but reiterated its main guidance. We believe Norges Bank will deliver a September hike and present a flat to marginally upward sloping interest rate path (see Chart 8).

We suggest buying Red NOK FRAs outright on our Norges Bank call. However, we suggest waiting for the turmoil following the latest ECB meeting to subside before entering into this trade. A flat or slightly upward Norges Bank interest rate projection for 2020-23 would be significantly above the current market, which discounts cuts from 2020 onward (see Chart 8). Geopolitical risks and dovish international central banks have contributed to the low NOK FRAs at present (see Chart 9). Any good news from the Brexit process or the China-US trade negotiations at the end of September and in October could push the level of Norwegian Red FRAs significantly upward.

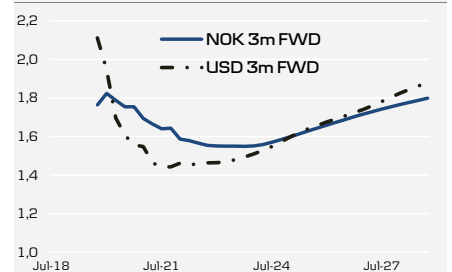
The ECB's introduction of the two-tier system on banks' current account holdings pushed Red FRAs upward late last week. NOK FRA 3M JUN21 jumped from 1.55% to 1.65% on the news. The impact of the two-tier system on short-end NOK interest rates appears exaggerated. **Thus, we suggest a conditional strategy of buying NOK FRA 3M JUN21 if the current ECB turmoil subsides early this week. Profit target 2.00%. (Consider entering around 1.60%).**

Chart 8. Market expectations still far below Norges Bank's June projection



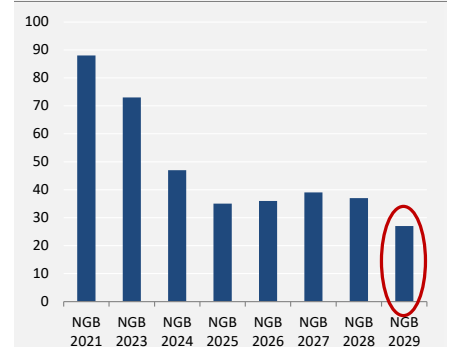
Source: Danske Bank

Chart 9. Shape of the Norwegian 3M Nibor forward curve strongly affected by the US curve



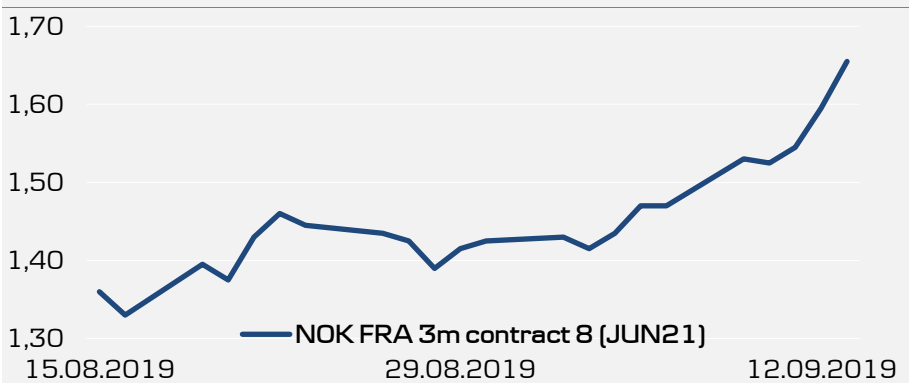
Source: Danske Bank

Chart 10. NGBs to the market and held by the government by issue



Source: Norges Bank

Chart 7. Still low Red FRAs, but significantly up on ECB: NOK FRA 3M JUN21



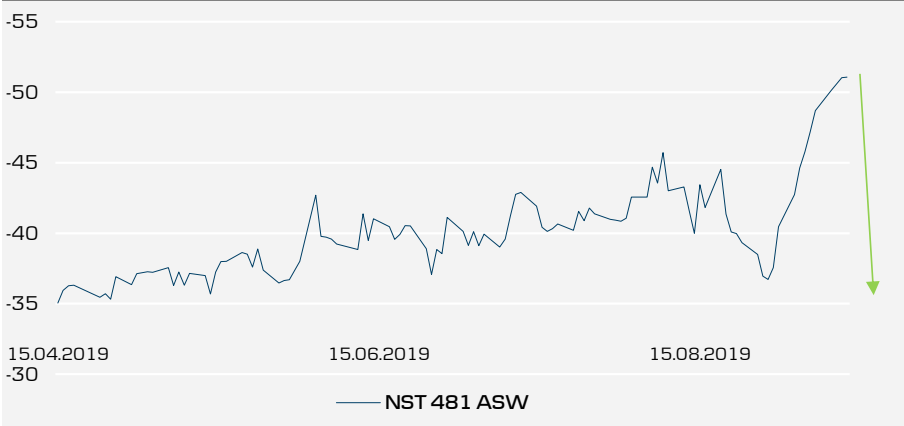
Source: Macrobond Financial, Danske Bank

Sell NGB NST481 vs swap on more balanced flow and forthcoming taps

The long-end Norwegian government bond asset swap spread has widened significantly recently, following a rather narrow spread in August (see Chart 11). The volatility in the ASW spread is partly related to flows. Total outstanding in NST 481 – the new 10-year benchmark bond – is still somewhat limited. The bond was introduced by syndication on 6 March. Four taps later NOK23bn is outstanding to the market (see Chart 10). One-sided flow in NST481 largely explain the volatility in the ASW spread in recent months.

In our view, it is reasonable to assume that flows will be more balanced ahead. In addition, the current high relative price of NST481 will probably increase the probability that Norges Bank will tap NST 481 at the upcoming bond auctions. The next auction is 25 September. Note that Norges Bank tapped NST481 at the recent auction on 28 August. This could be seen as an argument against a second in a row NST481 tap on 25 September but Norges Bank does not traditionally refrain from tapping the same bond twice in a row if market conditions are right. **We suggest selling NGB NST481 versus swap at a spread of 51bp. We suggest a target of 35bp and a stop-loss of 60bp.**

Chart 11. NGB NST481 ASW – high level on flows



Source: Danske Bank

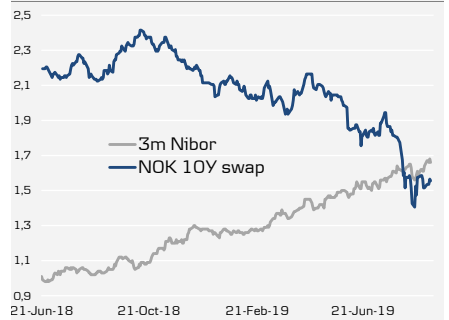
Strategy review: keeping open strategy for tighter NOK IRS 5Y/5Y vs EUR

The long-end swap spread versus international peers is elevated (see Chart 13). The high spread may be explained partly by the relative growth outperformance of the Norwegian economy versus peers. However, the high spread can also to some degree be attributed to flows. Recently, the spread between the 10Y NOK IRS and the 3M Nibor has become negative (see Chart 12). A higher floating than long-end fixed interest rate has triggered somewhat increased payer interests from domestic corporates, municipalities and households. In the current risk-off NOK environment, long-end NOK issuance activity appears to be low. The inversion of the swap curve and the limited receiver interest largely explains the current high long-end swap spread versus peers. We opened the strategy of **receiving NOK IRS 5Y/5Y and paying EUR IRS 5Y/5Y** on 2 September. The spread has been volatile and after initial gains the spread is now back to a moderate profit. We believe there is still potential in this strategy, especially in an international moderate risk-on environment.

In the *Reading the Markets Norway – Excessive long-end spread vs peers due to payer flow*, 2 September, we suggested **buying NOK FRA 3M DEC19 on a sight deposit hike 19 September**. We reiterate this recommendation. We opened the strategy at 1.815%. The current level is 1.87%, i.e. a moderate profit of 5.5bp. The profit so far is probably related mainly to expectations of tight Norwegian structural liquidity towards year-end, spillover from US money markets and the ECB two-tier system. That is, in the case of a 19 September hike and tight liquidity the DEC19 could get close to 2.0%.

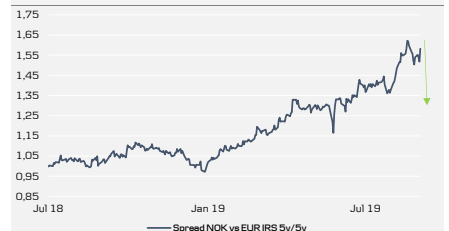
We also keep open the **NOK 2Y-5Y-10Y barbell** strategy (receiving 5Y versus wings). The barbell has been relatively stable recently but should perform in the event that the market starts to discount fewer interest rate cuts over 2020-23. A somewhat hawkish interest rate projection in the upcoming Monetary Policy Report is a key to this strategy, together with an improved international risk sentiment.

Chart 12. High relative payer flow as NOK IRS levels go below 3M Nibor



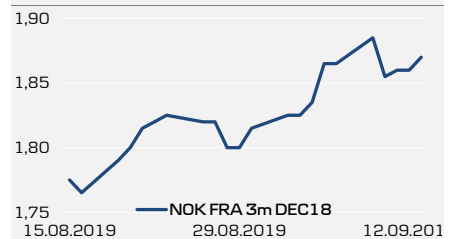
Source: Macrobond Financial

Chart 13. NOK IRS 5Y/5Y vs EUR eq at high levels due to flows



Source: Danske Bank

Chart 14. Somewhat higher NOK FRA3M DEC recently



Source: Danske Bank

Chart 14. Too low mid segment IRS: NOK IRS 2Y-5Y-10Y barbell



Source: Danske Bank

NOK FX – tactically stay short EUR/NOK

We have recommended a short EUR/NOK position as a tactical trade. We still like this position especially as a play on Norges Bank delivering a rate hike, as we think markets underappreciate Norges Bank’s communication and front-loaded rate path on strong domestics and a weak NOK. EUR/NOK has fallen in 14 of the past 15 ‘big’ meetings. We think this will become 15 from 16. We will look to take profit fairly soon after the meeting, as we still pencil in a global environment that is unlikely to yield much NOK support.

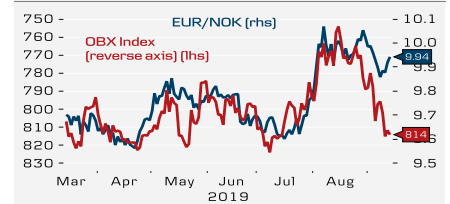
We expect Norges Bank to give NOK support (again)

In *FX Trading Portfolio – Sell EUR/NOK spot outright as tactical trade*, 9 September, we argued for a tactical move lower in EUR/NOK on (1) relative growth, (2) relative rates, (3) positioning, (4) global environment and (5) technicals. Since then domestic data – not least the Regional Network Survey (see *charts*) – have confirmed our expectations of a rate hike from Norges Bank next week and trade worries have diminished further on more negotiations-friendly news from both the US and China. As such we think the building blocks for the trade recommendation remain intact even though the oil price has moved somewhat lower since inception on stories that Donald Trump might ease sanctions on Iran.

Meanwhile, importantly for the short-term price action, the EUR has turned bid on last week’s ECB meeting. Historically, we have seen post ECB EUR momentum (in either direction) have a driving – but temporary – impact on EUR/NOK. As we still like the tactical case, we wanted to make sure we are not stopped-out on temporary price action ahead of the Norges Bank meeting. In addition, the underlying rise in inflation expectations on the back of the open-ended ECB QE programme is positive for the inflation-heavy nature of the Norwegian assets, stock market and hence NOK FX. As a result, we have raised the stop-loss to 10.1000 (see *FX Trading Portfolio – Lift stop-loss on EUR/NOK to 10.1000*, 13 September).

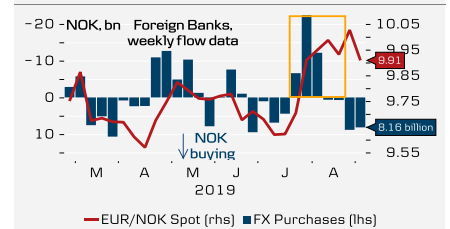
The biggest risk factors to our position are a sudden re-escalation of the trade war, a very hawkish Fed weighing on equities and inflation expectations on Wednesday or Norges Bank not hiking rates next Thursday (still priced at less than 50% probability).

Chart 16. NOK has not yet fully reacted to improved risk appetite



* Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Chart 17. After significant selling foreign banks have returned as net buyers



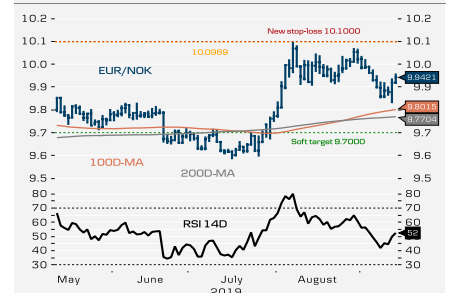
Source: Macrobond Financial, Danske Bank

Chart 18. Globals have – temporarily – turned more friendly for commodity and inflation sensitive currencies



* Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Chart 19. Trade target and stop-loss



* Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Chart 15: Daily change on days with MPR-meetings incl. percentile rank since 2013

Date of meeting	EUR/NOK		2Y Swap spread (NOK-EUR)			
	Change, %	Percentile*	Change, bp	Percentile*		
14/03/2013	1.3%	99	-11	0	Tendency to surprise dovishly	
20/06/2013	3.5%	100	-15	0		
19/09/2013	0.0%	54	0	41		
05/12/2013	0.5%	86	-6	1		
27/03/2014	-1.1%	1	3	97		
19/06/2014	1.9%	100	-9	0		
18/09/2014	-1.6%	0	8	100		
11/12/2014	1.1%	98	-13	0		
19/03/2015	-3.1%	0	13	100		
18/06/2015	1.9%	100	-8	0		
24/09/2015	2.8%	100	-12	0		
17/12/2015	-0.9%	3	6	99		Tendency to surprise hawkishly
17/03/2016	-0.9%	2	-4	3		
23/06/2016	-0.7%	5	3	95		
22/09/2016	-1.6%	0	4	98		
15/12/2016	-0.1%	38	2	87		
16/03/2017	-0.2%	29	-2	8		
22/06/2017	-0.6%	8	1	75		
21/09/2017	-0.4%	18	1	80		
14/12/2017	-0.8%	3	3	95		
15/03/2018	-0.6%	7	3	95		
21/06/2018	-0.2%	28	3	97		
20/09/2018	0.6%	91	-3	4		
13/12/2018	-0.1%	38	0	46		
21/03/2019	-0.8%	3	7	100		
20/06/2019	-1.2%	1	7	100		

Source: Bloomberg, Danske Bank

Table 2. Open strategies and trades with recent status change

Type	Trade	Idea	Target & P/L		Status
Fixed income	Buy NOK FRA 3M JUN21 outright	Market moving towards a new NB projection that is above the current fwd-curve. Await entering to the effect of the ECB two-tier system subsidies	Opened Start (cond.) Target/stop Now P/L	'16 Sep-2019 1,60 2.00/1.30 1,65 NA	New (cond.)
Fixed income	Sell NGB NST 481 vs swap	Reduced ASW-spread on more balanced flow and future taps in NST 481	Opened Start Target/stop Now P/L	'16 Sep-2019 51 '35/60 51 0	New
FX	Sell EUR/NOK spot outright	Sell EUR/NOK on relative growth, rates, positioning, global environment and technicals.	Opened Start Target/stop Now P/L	'9 Sep-2019 9,8850 9,700/10,100 9,9350 0,5%	New
Fixed income	Buy NOK FRA 3M DEC19	Outright buying the DEC FRA contract as too low probability of a September hike is discounted by the market	Opened Start Target/stop Now P/L	'2 Sep-2019 1,815 2.00/1.75 1,855 4	Hold
Fixed income	Receive NOK IRS 5Y/5Y and pay EUR IRS 5Y/5Y	The long-end swap spread vs international peers is elevated due to short-term imbalances in flow	Opened Start Target/stop Now P/L	'2 Sep-2019 159 '130/175 156 3	Hold
Fixed income	Pay NOK IRS 5yr and receive NOK IRS 2yr and 10yr	Too low mid-segment NOK IRS in light of Norges Bank's projection of a gradual normalisation of interest rates	Opened Start Target/stop Now P/L	'1 July-2019 14 0/25 13 1	Hold
Fixed income	Sell NOK FRA 3m DEC19 and buy NOK FRA 3m JUN22	Excessive inversion of the NOK FRA curve	Opened Start Target/stop Now P/L	'1 July-2019 -20 '0/-30 -30 -10	Stop loss 5 Aug
Fixed income	Sell NOK FRA 3m DEC20 and USD FRA 3m JUN22 and buy NOK FRA 3m JUN22 and USD FRA 3m DEC20	Too flat NOK long-end FRA curve relative to the US equivalent	Opened Start Target/stop Now P/L	'1 July-2019 -21 0/-30 -11 10	Take profit
Fixed income	Buy NGB NST481 and sell NGB NST475	Flatter NOK yield curve on hawkish Norges Bank relative to current market expectations	Opened Start Target/stop Now P/L	'17 June-2019 27,5 '10/35 10,0 18	Target hit 1 Aug

Note: Indications generally based on mid-market prices some hours ahead of the publishing of the report

Source: Danske Bank

Table 3. Open strategies and trades with recent status change

Fixed income	Buy NOK FRA 3m SEP19 outright	20 June hike not totally discounted by the market	Opened Start Target/stop Now P/L	'7 june-2019 1,535 1.65/1.40 1,650 11,5	Target hit 20 June
Fixed income	Buy NOK FRA 3M DEC20 and sell NOK FRA DEC19	Too flat fwd curve for 2020	Opened Start Target/stop Now P/L	'27 May-2019 7,0 '30/-10 -10,0 -17	Stop loss 20 June
FX	Sell AUD/NOK spot outright	An alternative way of playing a stronger NOK via a play on relative commodities, global environment and central bank divergence.	Opened Start Target/stop Now P/L	'21 may-2019 6,0375 5,98 5,98	Target hit
Fixed income	Buy NOK FRA 3m DEC19 outright	Market discounts too low probability of a total of three hikes during 2019	Opened Start Target/stop Now P/L	13-May-2019 1,685 1.85/1.59 1,825 14	Take profit
Fixed income	Receiving NOK IRS 5Y/5Y and paying SEK IRS 5Y/5Y	Long-end spreads vs peers elevated - partly driven by mid-segment payer flows	Opened Start Target/stop Now P/L	'29 April-2019 87 '60/100 98 -13	Stop loss 28 Aug
FX	Buy 3M USD/NOK ATMF straddle	3M USD/NOK volatility stands out as outright "cheap" going into decisive months for the spot drivers. Trade also serves as partial hedge to directional NOK views.	Opened Start Target/stop Now P/L	24/04/2019 8,5756 N/A 9,0800 0,9	Expired
Fixed income	NOK IRS BARBELL 2Y-4Y-6Y	Too flat mid-segment swap curve	Opened Start Target/stop Now P/L	1-Apr-2019 -2 -15/+5 5 -7	Stop loss 20 June
FX	Sell 2M bearish EUR/NOK risk reversal	Norges Bank to trigger renewed NOK interest supported by relative growth, tighter structural liquidity and an improved global environment.	Opened Start Target/stop Now P/L	12.mar.19 9,735 N/A 9,8025 0,00 %	Expired
Fixed income	Receive NOK IRS 10Y and pay NOK IRS 2Y vs SEK equivalent	Norges Bank to hike twice in 2019 vs Riksbanken will probably be on hold	Opened Start Target/stop Now P/L	18-Mar-2019 -45 -70/-30 -49 4	Take profit

Note: Indications generally based on mid-market prices some hours ahead of the publishing of the report

Source: Danske Bank

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