

Fixed Income Research

Excessive market volatility in illiquid Norwegian markets: buy NOK FRA 3M SEP19 outright

The decline in Norwegian interest rates this week appears to be a delayed effect of lower international rates, i.e. not related to any domestic news. The volatility and steepness of the fall illustrate the limited risk capacity of market makers at present and the general illiquidity of NOK-related markets. We believe the recent market reaction is exaggerated, as only a major international downturn might make Norges Bank refrain from the strategy of a gradual normalisation of interest rates.

The short-end of the curve now discounts only one hike in 2019 and a flat curve thereafter. Long-end swap and NGB yield spreads have tightened somewhat relative to peers. ASW spreads have widened (see charts overleaf).

The decrease was not triggered by domestic news. As we discussed in *Reading the Markets Norway – Norwegian recovery vs stronger international headwinds*, 27 May, we moved our steepening strategy to the short-end of the FRA curve due to the imminent risk of spillovers from the US curve. The steepness of the fall appears to be linked largely to the illiquidity of the Norwegian markets. The decrease seems to have been triggered by a few major international accounts adjusting their exposure in short-end swaps and FRAs. Somewhat lower oil prices may have motivated the adjustments.

The US forward curve currently appears to be creating a ceiling to the upside for the Norwegian forward curve (see Chart 1). A further inversion of the short-end US curve could put more downward pressure on green NOK FRAs. At present, the FRA curve is perfectly flat. NOK FRA 3M DEC19 is 1.65%, DEC20 is 1.645% and DEC21 is 1.64%. We believe this is excessively flat. Given the risk of further spillover from the US market, we reiterate the recommendation of focusing any steepening strategy to the short end of the curve. Despite a poor performance of these strategies this week, we still recommend **buying NOK FRA 3M DEC20 and selling NOK FRA DEC19**. We also still think **buying NOK FRA 3M DEC19 outright** appears attractive, as we expect Norges Bank to hike the sight deposit rate to 1.25% at the board meeting on 20 June. We believe Norges Bank will stay with the basic strategy of a gradual normalisation of the target rate but that the fall in international interest rates and the changes in the risk environment will affect Norges Bank's 20 June interest rate projections compared with the 8 March *Monetary Policy Report 1/19*.

Purely based on our call of a 20 June hike, we recommend buying NOK FRA 3M SEP19. The current level is 1.535%. We suggest a target of 1.65 and stop-loss of 1.40%.

The decline and volatility in long end rates has been marked. However, the spread is still somewhat high versus international peers. NOK SWAP 5Y/5Y is still above the range of 2018 and Q1 19. Given the current geopolitical risks, we may see renewed interest in Norwegian government bonds, as yields are still high relative to peers. Norway has not enjoyed a safe haven status in recent years, probably due partly to low oil prices and dovish Scandinavian central banks. However, high relative yield levels, high oil investment and somewhat high inflation (suggesting a potential for a stronger NOK) could trigger a Norwegian relative bond rally in the case of an international downturn.

Today's key points

- Due to a public holiday on Monday 10 June and key data releases on 11 June (CPI and Regional Network), we postpone *Reading the Markets Norway* (including the 20 June Norges Bank meeting preview) until Monday 17 June. Because of the postponement, we publish this shorter market update today.
- This week's major decline in interest rates and high volatility appear to be delayed effects of international spillovers and market illiquidity.
- We believe the market move this week is overdone. The short end of the curve discounts only around one hike of 25bp ahead. We expect a hike to be realised at the upcoming Norges Bank meeting on 20 June.
- We reiterate our strategies of steeper FRA curve DEC19 - DEC20. We also recommend buying NOK FRA 3M DEC 19 outright.
- There is downside potential in long-end Norwegian interest rates relative to peers in the case of an international downturn.

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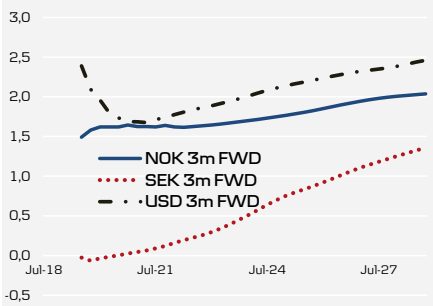
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NOK-FX under renewed pressure

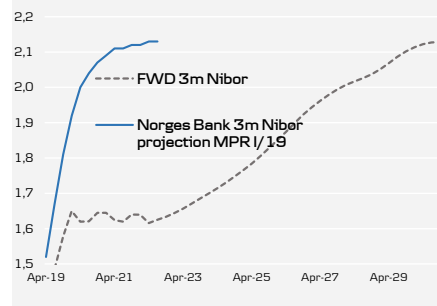
NOK FX has also come under renewed pressure this week from both lower rates and the decline in oil prices. As a result, our NOK/SEK trading recommendation on Wednesday (see *FX Trading Portfolio – Take profit on USD/NOK call and USD/SEK spot*, 5 June) hit our stop-profit level of 1.0825 (PnL +3.1% including carry). In the short-term, the bearish oil sentiment in oil markets is testing our views of both a lower AUD/NOK and lower USD/NOK but, strategically, we still like the trades on both the Norwegian macro case and in an environment where the Fed fully opens up for rate cuts. For a more detailed walk through of our thoughts on NOK FX, see *FX Strategy – Why is the NOK so weak?*, 28 May.

Chart 1. NOK 3M Nibor forward curve vs the US and SEK equivalent



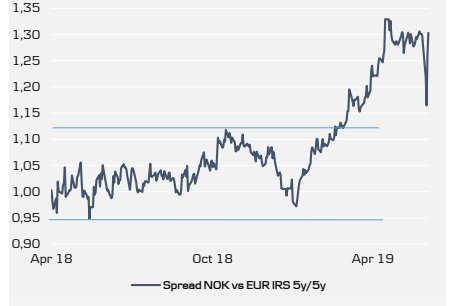
Source: Danske Bank

Chart 2. Norges Bank's MPR 1/19 3M Nibor projection vs 3M forward Nibor



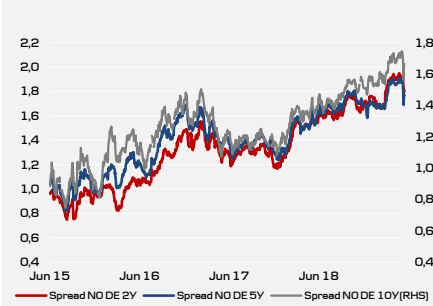
Source: Norges Bank, Danske Bank

Chart 3. NOK SWAP 5Y/5Y spread vs EUR



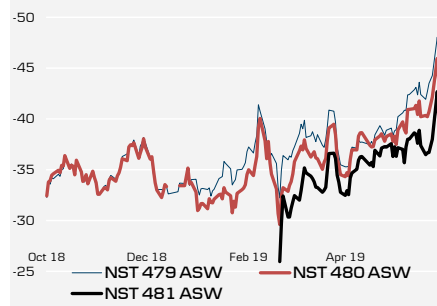
Source: Norges Bank

Chart 4. NGB spreads vs German peers



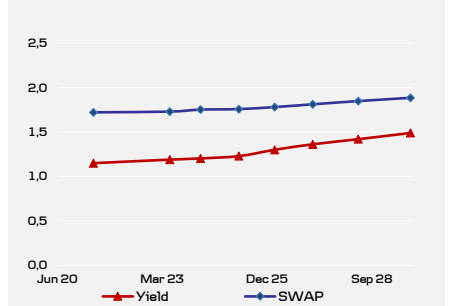
Source: Danske Bank

Chart 5. NGB long-end ASW spreads



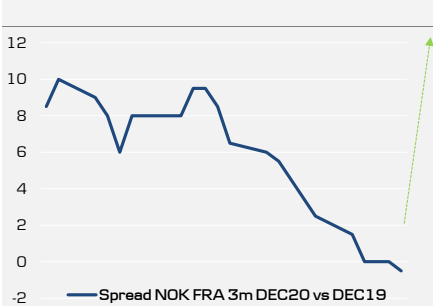
Source: Danske Bank

Chart 6. NGB and NOK swap curve



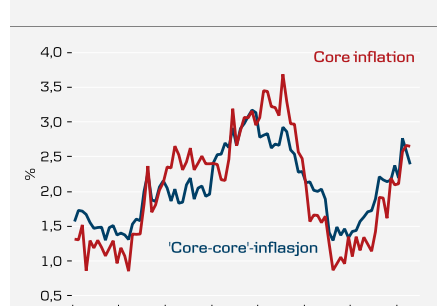
Source: Danske Bank

Chart 7. NOK FRA 3M DEC 20 - DEC 19



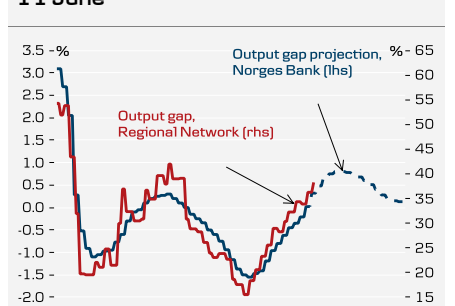
Source: Danske Bank

Chart 8. Norwegian core CPI above 2% target, May CPI due 11 June



Source: Macrobond Financial, Danske Bank

Chart 9. Regional Network report confirms growth above potential - due 11 June



Source: Macrobond, Norges Bank, SSB

Disclosures

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Ad hoc.

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