27 May 2019

Reading the Markets Norway

Norwegian recovery vs stronger international headwinds

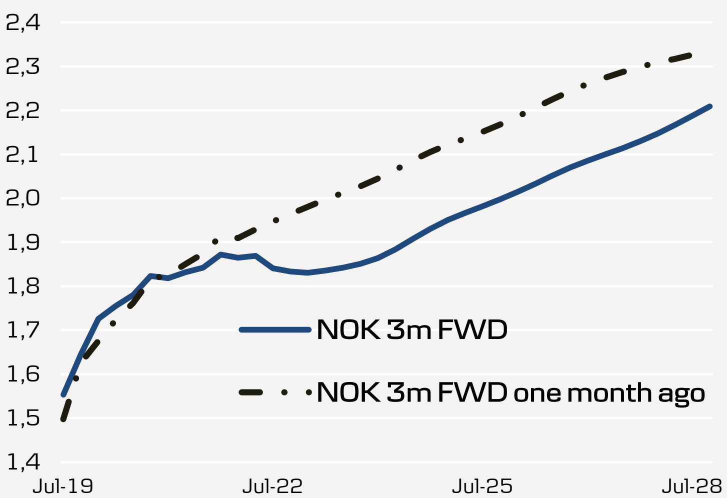
- Macro: **oil investments vital to the recovery going forward**
- Fixed income: **2020 FRA curve too flat**
- NOK FX: **sell AUD/NOK spot outright**
- New trades: **sell NOK FRA 3M DEC19 and buy NOK FRA 3M DEC20, Sell AUD/NOK spot**
- Closed trades: **Steeper FRA curve 2021, Flatter 2Y-10Y swap spread vs Sweden**

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

Relative value				Last update
FX	Add long NOK exposure on dip. Use cheap NOK vol as hedge			10/05/2019
Curve view (NGB)	Flatter curve on three 2019 hikes			01/04/2019
Swap spreads (ASW)	ASW-spread widening vs international peers			20/08/2018
Spread vs peers	Flatter curve on 2019 hikes and excessive long-end spread vs peers			18/03/2019
Short-end (<2y)	Steeper curve as market moving towards Norges Bank's projections			07/01/2019
Norges Bank's policy rate	3m	6m	12m	
	1.25%	1.25%	1.50%	

Source: Danske Bank

Chart 1. Too flat 3m FWD curve for 2020-24



Source: Statistics Norway, Macrobond Financial, Danske Bank

10th issue 2019

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

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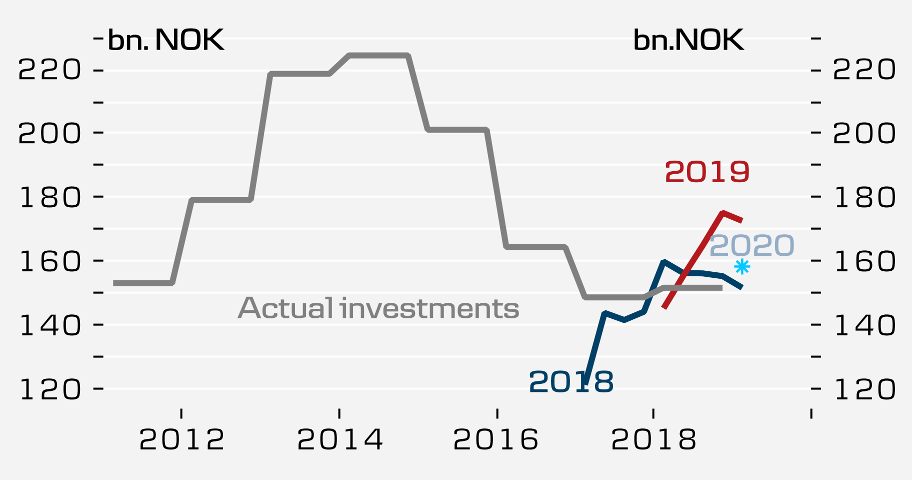
Oil investments vital to our views

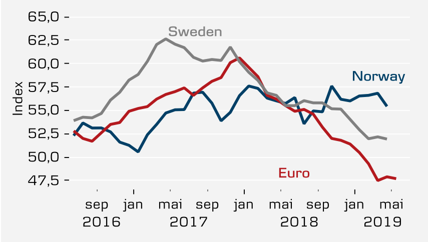
On 28 May, Statistics Norway is due to release estimates for future investments in oil and gas, i.e. the ‘investment survey’. There are several indications that the domestic manufacturing sector, and hence the economy, has succeeded relatively well in the period of global slowdown due to rising activity in oil-related industries. As a result, we view the survey as key for the economic outlook and hence a cornerstone in our views on domestic rates and the NOK throughout 2020. We expect a 2019 level of about the recent survey’s NOK171bn, pointing to around 13% growth this year. The 2020-figure is highly uncertain, but we need to see figures of around NOK165bn to confirm our expectations for higher oil investments in 2020.

Chart 2. Oil investments – solid growth in 2019, what about next year?



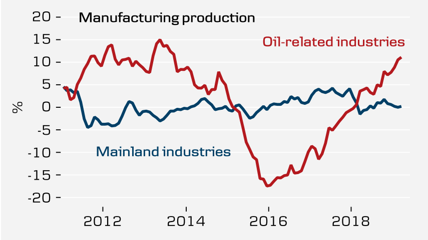
Source: Macrobond Financial, Danske Bank

Chart 3. Manufacturing PMI holding up relatively well…



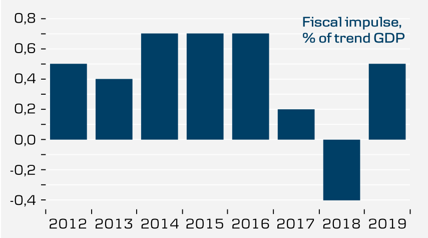
Source: Macrobond Financial, Danske Bank

Chart 4. … supported by oil-related industries



Source: Macrobond Financial, Danske Bank

Chart 5. Fiscal expansion as in the recession



Source: Macrobond Financial, Danske Bank

Fiscal policy remains expansionary

The Norwegian government presented the revised fiscal budget for 2019 on 14 May. The budget was more expansionary than expected as the fiscal stimulus is expected to be 0.5% of GDP this year. Importantly, in the March Monetary policy report Norges Bank assumed a structural, oil-adjusted deficit of 7.4% this year, compared with 7.2% last year, i.e. a budget stimulus of 0.2pp. in 2019. That is, the fiscal plan presented in the revised budget is 0.3pp., or roughly NOK9bn **more expansionary than NB assumed in March**. The effect on interest rates is not straightforward, but we cautiously estimate the isolated effect on the rate path to be roughly 10-15bp. This clearly supports our expectations of a rate hike in June, and obviously increases the likelihood of another rate hike this year, most likely in December.

The budget proposal illustrates the expansionary pressure stemming from a four party government (Conservatives, Progress party, Christian Democrats and Liberals) in an election year, without any real boundaries on fiscal deficits as fresh money can always be raised from the Petroleum fund. The rate path published in the monetary policy report in March is, among other factors, based on an assumption of close to neutral fiscal policy for the next four years. Actually, at 7.7 % of GDP the structural, oil-adjusted deficit is already in 2019 at the level Norges Bank expected for 2022.

Fixed income: 2020 FRA curve too flat

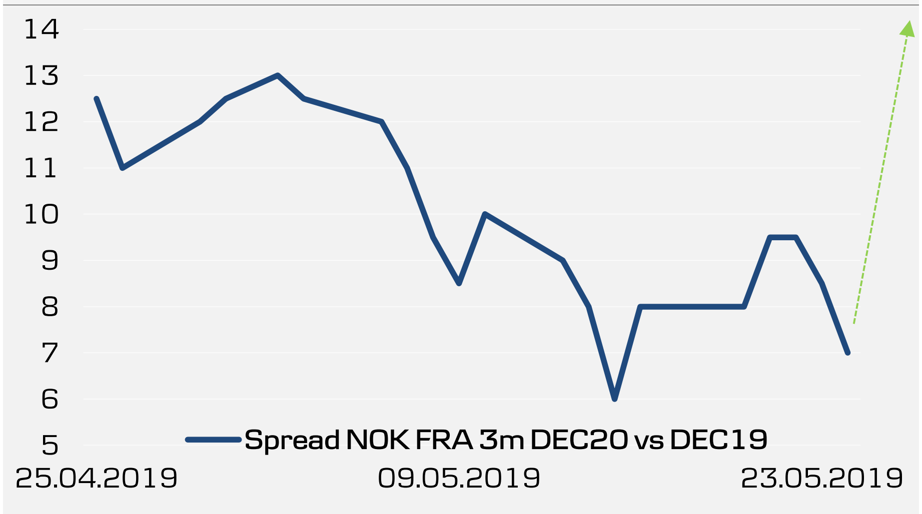
Buy NOK FRA 3M DEC20 and sell NOK FRA DEC19

At the 9 May monetary policy board meeting Norges Bank reiterated the message of the 21 March Monetary Policy Report 1/19, of a gradual normalisation of interest rates. Norges Bank outright said that the sight deposit rate will be hiked at the 20 June meeting, to 1.25% - if conditions are as projected. In the wake of the oil investment and fiscal policy driven recovery, wage growth and inflation pressures are building. Despite the inflation pressure build-up, the market only to a limited degree discounts additional hikes to June.

In addition to almost fully discounting a hike in June, the market discounts less than one hike during the coming two years. At present NOK FRA 3M SEP19 is 1.59% and SEP21 is 1.835%, i.e. a spread of only 24.5bp. The market is discounting that the last hike of the hiking cycle will most likely come at the December meeting this year, i.e. the forward curve for 2020 and 2021 is almost flat. Consequently, the market curve is significantly below the projection of Norges Bank from 21 March. See chart 7. Domestic data since 21 March has confirmed the growth outlook for the Norwegian economy. In addition, the inflation pressure appears to be stronger than projected.

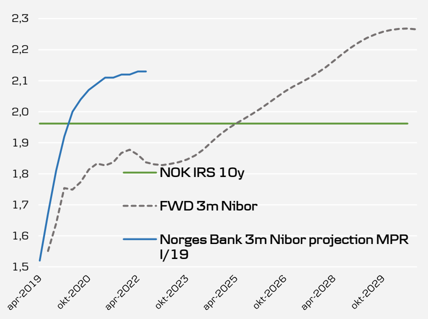
In light of the divergence in the growth and inflation outlook of Norway versus Sweden and the eurozone, and the market expectations of cuts in the Fed Fund interest rate during late 2019 and 2020, the spread in short dated Norwegian interest rates may widen versus international peers going forward. However, it appears that Norges Bank is trying to avoid provoking a strong NOK. In light of the softness of international growth and the high geopolitical risk related to the Brexit process and the China-US trade negotiations, the case for Norges Bank moving only slowly is strong – despite potential wage growth generated inflation. The current domestic outlook, in isolation, could warrant a second hike in September – in addition to a hike in the sight deposit rate to 1.25% in June. Norges Bank will probably refrain from moving in September, and in the 20 June Monetary Policy Report 2/19 it points to the December meeting for the third hike in 2019.

Chart 6. Spread NOK FRA 3M DEC20 – DEC19 at low levels



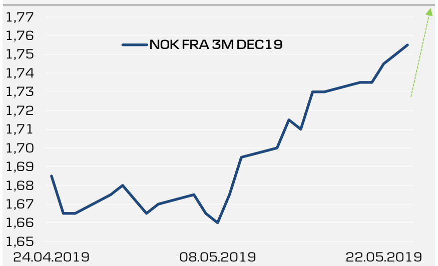
Source: Danske Bank

Chart 7. Market below Norges Bank's 3m Nibor projection



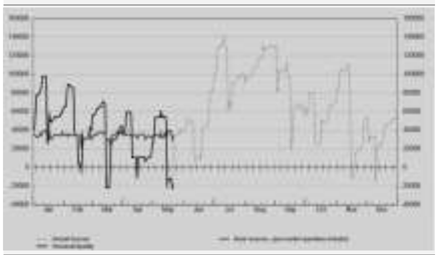
Source: Norges Bank, Danske Bank

Chart 8. NOK FRA 3m DEC19 – still upside potential



Source: Norges Bank

Chart 9. Norwegian cash liquidity forecast (bank reserves)



Source: Danske Bank

The market is partly discounting a December hike. See chart 8. The FRA DEC19 is at present at 1.755%, i.e. 21bp higher than the FRA JUN19. The market is discounting only marginally higher rates from end 2019 and during 2020. The NOK FRA 3m DEC20 is only 7bp higher than DEC19. In light of the Norwegian growth and inflation outlook, and Norges Bank's signal of a gradual normalisation of interest rates, the 2020 FRA spreads appear low. We therefore suggest **selling NOK FRA 3m DEC19 and buying NOK FRA 3m DEC20 at a mid-market spread of 7bp**. We suggest a target of a spread of 30bp and a stop loss of zero. See chart 1 and chart 6.

At present the recent years' high Nibor-sight deposit spreads at year-ends, that partly reflect high US libor-OIS spreads (via Norwegian banks' international short-term funding) and partly domestic structural cash liquidity, affect the pricing of DEC FRAs. The Norwegian government bond NST 472 matured on 22 May – with an outstanding to the market after earlier buy-back auctions of NOK52.29bn. As a consequence of earlier years' issuance policy, only every second year is there a maturity of a Norwegian government bond. Therefore, this year's bond maturity contributes to a more ample cash liquidity in 2019 than last year. There is no NGB that matures in 2020, which in isolation suggests tighter cash liquidity at year-end 2020 than for 2019. This suggests a higher theoretical Nibor-OIS spread end 2020 than end 2019. As the market gradually takes this into consideration, it may widen the spread between NOK FRA 3m DEC20 and DEC19, i.e. supporting the above suggested strategy.

Strategy review: elevated long-end versus peers

Back in *29 October 2018, RtM Norway* we suggested **a steepening of the NOK FRA curve for 2021** as we saw a pickup in Norwegian growth and wage generated inflation. The domestic macro case materialised, but after the drop in international interest rates the trade is close to the stop-loss level. We therefore formally close the strategy at a loss of about 14bp and instead, as discussed above, enter into a new strategy for a steeper curve for 2020.

In the *18 March RtM Norway* report we suggested **receiving NOK IRS 10Y and paying NOK IRS 2Y versus the Swedish equivalent**. We still see some potential for a moderate flattening of the Norwegian curve, but suggest closing the strategy of a relative flattening versus Sweden, as we see a potential for higher short-end Swedish interest rates – partly related to the Stibor-OIS spread.

Long-end Norwegian interest rates are still at elevated levels versus European peers. We, therefore, reiterate our recommendation of **receiving NOK IRS 5Y/5Y and the SEK equivalent**. We opened the strategy in the *29 April RtM Norway report* at a spread of 87bp. The current level is 85bp, i.e. a profit of 2bp. See chart 11. The corresponding spread versus euro also appears attractive as it is far above recent historical levels, despite Norges Bank's inflation target now being close to European peers.

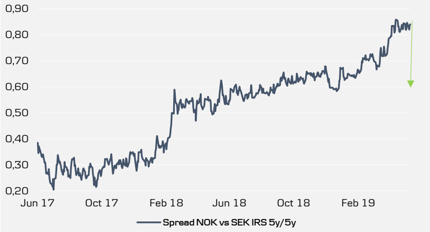
In the *1 April RtM Norway* report we argued that the mid-segment swap curve was too flat, given the signals from Norges Bank of a front-loading of the interest rate hikes and a lower long-run equilibrium interest rate level. We opened the strategy of a **2Y-4Y-6Y barbell**-spread of -2bp. The level is unchanged today. We keep this strategy open, as we still expect a return to a concave Norwegian forward curve.

In the *18 February RtM Norway* report we argued that the Norwegian government bond asset swap spread in the mid-segment was at too wide levels – for NST 476 driven partly by special supply-demand imbalances; see chart 13. After a tightening, the spread is again back to high levels, probably partly due to a short-term effect of cash from the maturity of NST 473 seeking new homes. We keep the strategy open until the NST 473 effect evaporates. We close, however, the strategy of a NGB barbell at approximately no cost.

Chart 10. NOK IRS 10Y-2Y versus SEK equivalent

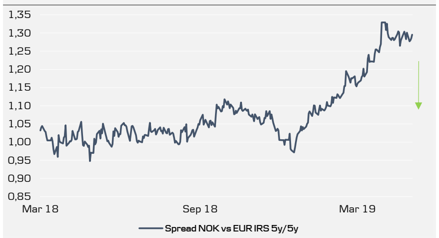
Source: Danske Bank

Chart 11. NOK IRS 5Y/5Y versus Sweden



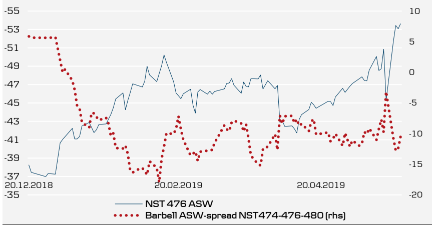
Source: Danske Bank

Chart 12. NOK IRS 5Y/5Y versus euro



Source: Danske Bank

Chart 13. Still high ASW level in mid-segment swaps



Source: Danske Bank

NOK FX – sell AUD/NOK spot

We still think the fundamental case for a stronger trade weighted NOK remains in place but the timing for re-selling EUR/NOK has become tricky in the global environment. As an alternative way of playing a stronger NOK we recommend selling AUD/NOK as a relative bet on commodity prices, global data-policy interplay and relative monetary policy between Norway and Australia. We remain long NOK/SEK spot (live PnL: +4.9%) and maintain our long USD/NOK straddle with expiry on 24 July (+0.1%).

An alternative way of playing a stronger NOK…

We have long argued a bullish strategic view on the NOK from relative growth, rates, oil and fundamental valuation. Recently, that view has been challenged by the escalating trade war, global economic data falling short of expectations and a dovish Riksbank triggering broader-based Scandi weakness.

While we still look for a lower EUR/NOK an alternative way of playing a stronger NOK is via AUD. Essentially this trade is a play on three things:

1) <u>Relative commodity prices in industrial metals versus oil prices</u>. In the coming months, we see downside risk to global (not least, Chinese) PMIs, lack of resolution on the trade war front and by extension also continued downticks in industrial metals as shown on chart 14. On the other hand, global oil supplies should remain tight and with lingering geopolitical concerns in terms of Iran and Saudi Arabia this should keep a hand under oil prices despite disappointing global data releases.

2) <u>The interplay between global data, central banks and the trade war</u>. Both NOK and AUD are heavily exposed to global risk appetite. That said the nature of the recent deterioration in economic data, the escalation in the trade war and G3 central banks reluctant to deliver more easing favours a lower AUD/NOK.

3) <u>Relative monetary policy</u>. Central banks are on a divergent path. The RBA is moving towards cutting rates as the Australian economy remains weak and faces major headwinds from the lack of traditional Chinese easing through the industrial cycle. With the recovery in global petroleum industries, a weak NOK and large infrastructure investments, the Norwegian mainland economy will remain shielded against weaker global impulses. On NOK rates pricing, we expect both a June and a December hike. In comparison markets price 16bp for June but only 45bp accumulated for end 2020. Aussie rates price 50bp cuts on 6M but we see scope for more inversion of the curve.

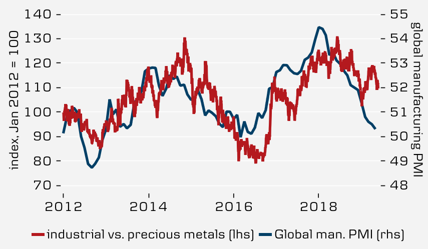
On 21 May we entered this trade with spot entry of 6.0375, see *FX Trading Portfolio*. The primary risks of this trade recommendation are 1) sudden massive easing from Chinese authorities 2) easing of global oil supply conditions 3) an unexpected pickup in global PMIs and/or 4) a negative repricing of NB if we are wrong on the Norwegian macro story.

Overall, however, we like the balance of risk and with carry virtually neutral (albeit marginally negative) we like to play a spot move down towards the 5.80-5.90 range which serves as our soft target. We consider the trade to be a 3-4 week trade.

Fundamentally, our pre-disposition remains to re-sell EUR/NOK but we prefer more clarity on the global environment before re-entering this trade. We leave on our long NOK/SEK spot trade (live PnL: +4.9%) as a continued bet on Scandi growth and inflation divergence.

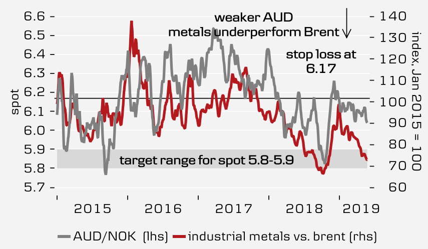
For now we also leave on our positional hedge trade of a long USD/NOK straddle with expiry on 24 July. Implied volatility has come down slightly lower after the initial spike but given the spot move higher the trade is in a modest positive 0.1%. We will look to sell the call leg to also play an eventual move lower in USD/NOK spot.

Chart 14. Industrial metal prices somewhat elevated relative to global fundamentals (whereas oil holds up via supply). Suggests AUDNOK downside risk.



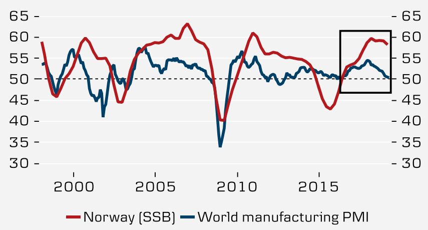
Source: Macrobond Financial, Danske Bank

Chart 15. AUD/NOK has been lagging in recent weeks, likely a EUR/NOK effect



Source: Macrobond Financial, Danske Bank

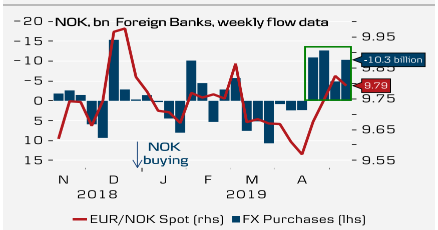
Chart 16. Norwegian economy running at full speed ahead versus. global macro



Based on weighted score of various volatility valuation metrics.

Source: Bloomberg, , Danske Bank

Chart 17. Foreign banks have heavily net sold NOK over the last month



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 DEC20 and sell NOK FRA DEC19	Too flat fwd curve for 2020	Opened	'27 may-2019	New
			Start	7,0	
			Target/stop	'30/0	
			Now	7,0	
			P/L	0	
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	'21 may-2019	Hold
			Start	6,0375	
			Target/stop		
			Now		
			P/L		
Fixed income	Buy NOK FRA 3m DEC19 outright	Market discounts too low probability of a total of three hikes during 2019	Opened	13-May-2019	Hold
			Start	1,685	
			Target/stop	1.85/1.59	
			Now	1,755	
			P/L	7	
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	'29 April-2019	Hold
			Start	87	
			Target/stop	'60/100	
			Now	85	
			P/L	2	
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	24/04/2019	Hold
			Start	8,5756	
			Target/stop	N/A	
			Now	8,6680	
			P/L	0,3	
Fixed income	NOK IRS BARBELL 2Y-4Y-6Y	Too flat mid-segment swap curve	Opened	1-Apr-2019	Hold
			Start	-2	
			Target/stop	-15/+5	
			Now	-2	
			P/L	0	
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	12.mar.19	Expired
			Start	9,735	
			Target/stop	N/A	
			Now	9,8025	
			P/L	0,00 %	
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	18-Mar-2019	Take profit
			Start	-45	
			Target/stop	-70/-30	
			Now	-49	
			P/L	4	
Fixed income	Receive NOK IRS 10Y and pay NOK IRS 2Y vs US equivalent	Norges Bank to continue the normalisation of the sight deposit rate. The long-end of the curve is excessively high relative to peers	Opened	18-Mar-2019	Take profit
			Start	32	
			Target/stop	-20/70	
			Now	23	
			P/L	9	

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

FX	Sell EUR/NOK spot outright		Opened Start Target/stop Now P/L	18-Feb-2019 9,7434 9.500/9.845 9,845 -1,00 %	Stop-loss
Fixed income	Reveive NOK IRS 5Y/5Y and pay EUR IRS 5Y/5Y	High spread vs recent range and likely 'dovish hike' 21 March	Opened Start Target/stop Now P/L	4-Mar-2019 112 95/120 120 -8	Stop loss 2 April
Fixed income	Sell NGB NST 476 (14 MAR 2024) vs swap	Elevated ASW-spread driven by demand ahead of long-end syndication and limited outstanding in this new 5Y benchmark bond	Opened Start Target/stop Now P/L	18-Feb-2019 -52 '-35/-60 -54 -2	Hold
Fixed income	Buy NOK NGB NST 480 (24 APR 2028), NST474 (25 MAY 2021) and Sell NOK NGB NST 476 (14 MAR 2024) X2 vs swap	Exaggerated ASW-spread in the mid-segment vs wings (ref strategy opened 15 Oct)	Opened Start Target/stop Now P/L	18-Feb-2019 -12 -3/-25 -10 2	Closed no cost
Fixed Income	Buy NOK payer SWAPTION 3M/5Y ATM - 1.89%	Potential for higher Norwegian interest rate, if geopolitical risk subsides and international downside outcomes do not materialise	Opened Start Target/stop Now P/L	4-Feb-2019 0,475 Hold 0 -0,475	Loss taken 4 May ATM 1.88%
Money Market	Buy NOK FRA 3m SEP19 sell SEK FRA 3m SEP19	Too little hikes discounted for the NOK curve and too much for the SEK curve for 2019	Opened Start Target/stop Now P/L	21-Jan-2019 140 160/130 153,5 13,5	Take profit
Fixed Income	Pay NOK IRS 5Y/5Y and receive EUR IRS 5Y/5Y	Norwegian growth outperformance and increased wage growth	Opened Start Target/stop Now P/L	21-Jan-2018 96,5 120/85 110 13,5	Take profit
Money Market	Buy NOK FRA 3m JUN19 sell NOK FRA 3m MAR19	The market discounts a too low probability of a hike during the summer of 2019	Opened Start Target/stop Now P/L	10-Dec-2018 2,5 15/-5 1 -1,5	Closed
Money market	Buy NOK FRA 3m JUN19 outright	The market discounts a too low probability of a hike during the summer of 2019	Opened Start Target/stop Now P/L	10-Dec-2018 1,32 1,5/1,25 1,415 9,5	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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