# FI & FX Strategy

## *Scandies through the lens of ECB action*

Strategy Research Sweden

# Executive summary

- The risk-on mode, following Draghi´s “whatever it takes speech” in mid-2012, has produced **tremendous returns in fixed income space**, but also sharply **increased the directionality** among assets and the EUR/USD, which suggest that it will be a balancing act for the ECB, to avoid that a weakening of the EUR will not come at the expense of a weaker risk sentiment…
- Scandie “safe haven” allocation was a popular theme in 2011-12, but the alternative cost of doing it, instead of staying in peripheral debt, has been very dear. The unwinding seems complete, though, and the **10yr sector in Sweden and Norway looks attractive**, both versus Germany and in ASW terms…
- Negative deposit rates and an increase in excess liquidity are factors with the capability to drive EUR/USD basis spreads lower and EUR/SEK basis higher. All-else-equal, it means that it will be less attractive for Swedish mortgage issuers to issue in foreign currency, which eventually could put an end to years of light covered issuance in SEK and **pose a widening risk of spreads and lend a steepening pressure on the covered curve**…
- If the ECB succeeds in creating credible expectations that the policy mix eventually will bring inflation back towards target, **long-end rates should move higher**. This is what we have seen in the US after the launch of their QE programmes. Such a scenario is a **risk for credit spreads**, since the sensitivity between spreads and yield levels likely has increased as capital has fled into the sector…
- In the case ECB manages to depreciate the EUR it could be problematic for a small open economy central bank like the Riksbank, particularly with inflation already at a too low level. Although far fetched, but in the case where EUR/SEK would drop back to the 2012 lows, it could **put the bank in the awkward position where they need to target the currency more aggressively**…

# Part 1. Implications of the “Draghi put”

# “Whatever it takes” and asset return implications

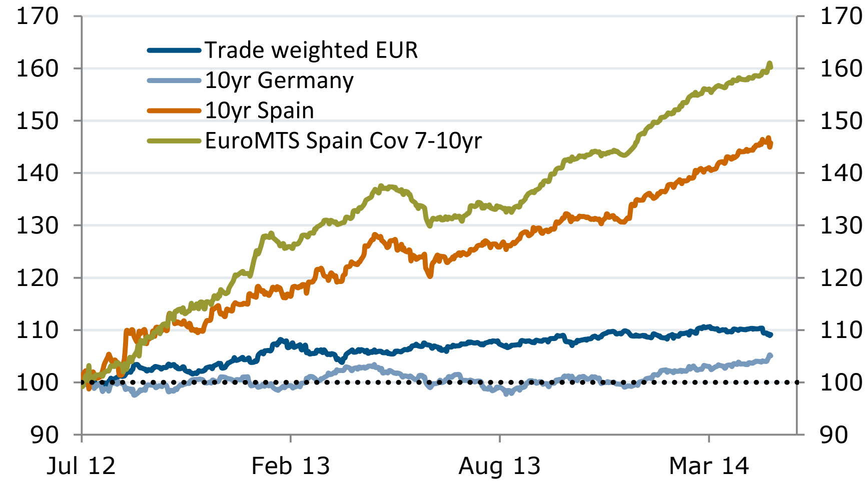
- On July 26, 2012, Mr Draghi delivered what now is a very famous statement: ***“within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough…”***

- Although only verbal, it proved to be an important statement and the starting point for an amazing run of returns in peripheral fixed income (see table and chart below for a few examples). Together with the low-for-long pledge and cheap liquidity, it also spilled-over notably on credit markets and risky assets in general…

- For the ECB, the drawback has been the ~10% appreciation of the EUR (which has helped pushing inflation down to uncomfortable levels), on top of the fact that the transmission in SME lending rates has been weak (particularly in the light of the massive drop in peripheral government yield levels)…

**Asset returns since Draghi´s "Whatever it takes" statement on 26th July 2012**

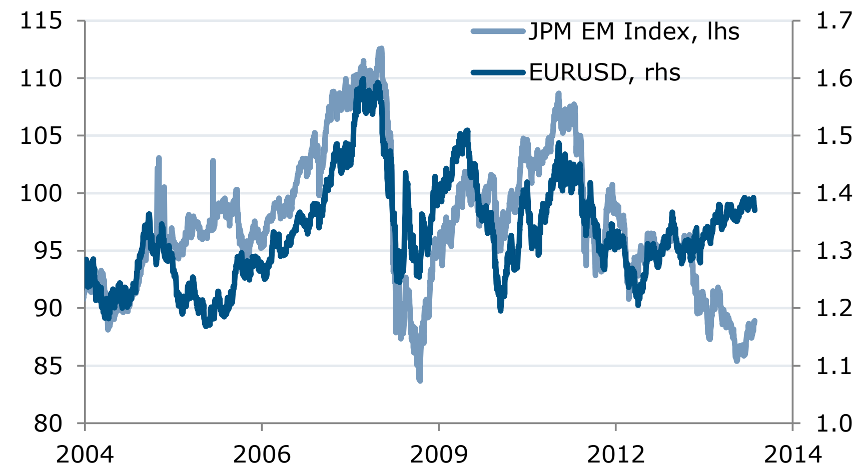
| Asset: | Period % | Vol % | Sharpe-ratio | Monthly drawdown |
|---|---|---|---|---|
| EUR/USD | 11.7% | -- | -- | -- |
| Trade-weighted EUR | 9.2% | -- | -- | -- |
| 10yr Germany | 5.0% | 4.8% | 0.52 | -2.7% |
| 10yr Norway | -1.0% | 4.7% | -0.10 | -4.2% |
| 10yr Spain | 45.2% | 8.5% | 2.64 | -4.8% |
| 10yr Sweden | 1.6% | 4.4% | 0.18 | -3.5% |
| EuroMTS Spain cov 7-10y | 60.0% | 7.23% | 4.15 | -5.1% |
| Itraxx X-over 5y | 37.4% | 6.9% | 2.70 | -6.2% |
| Itraxx Main 5y | 8.0% | 2.1% | 1.89 | -2.0% |
| EuroStoxx-50 | 40.8% | 16.5% | 1.23 | -10.1% |




Source: Nordea, Bloomberg

# “Whatever it takes” and asset directionality

- The “whatever it takes” pledge, and a dovish ECB, created a sweet-spot for European fixed income and particularly for instruments with any yield pick-up to core rates...
- EUR fixed income suddenly looked cheap and attracted capital from abroad, which helped pushing the EUR stronger (e.g. see chart)…
- But, the risk-on mode has not only produced tremendous returns, it has also left most assets increasingly directional to each other. For example, as shown in the table, peripheral spreads, credit spreads and equities have all been strongly directional and correlated with each other, but also to EUR/USD…



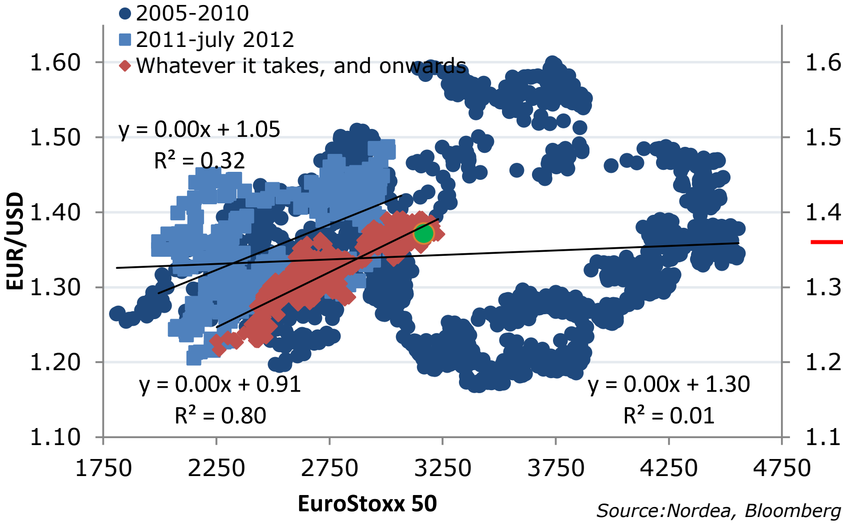
*Source:Nordea & Bloomberg*

| **Squared correlations Levels** | | | |
|---|---|---|---|
| EUR/USD vs. | 1999-2010 | 2011-12 | July 2012 --> |
| 10yr Spain vs Germany | 3.9% | 58.9% | 80.0% |
| 10yr US vs Germany | 2.9% | 10.1% | 60.4% |
| 10yr Spain vs Norway | 44.0% | 54.2% | 81.3% |
| 10yr Spain vs Sweden | 15.5% | 53.9% | 77.3% |
| EuroMTS Spain cov 7-10y | -- | 5.7% | 75.1% |
| *Itraxx X-over 5y* | -- | 35.1% | 81.5% |
| *Itraxx Main 5y* | -- | 30.1% | 81.0% |
| *EuroStoxx-50* | 11.0% | 32.1% | 80.0% |

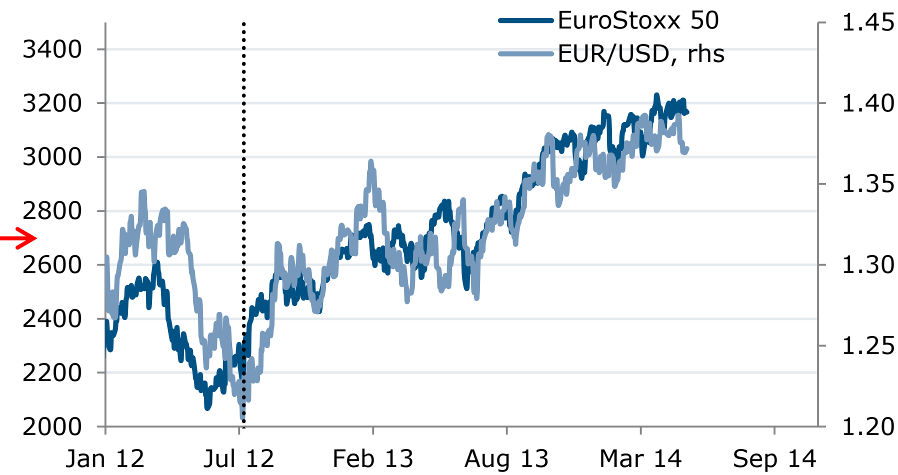
***For more charts, see the next couple of slides…***

# “Whatever it takes” and asset directionality

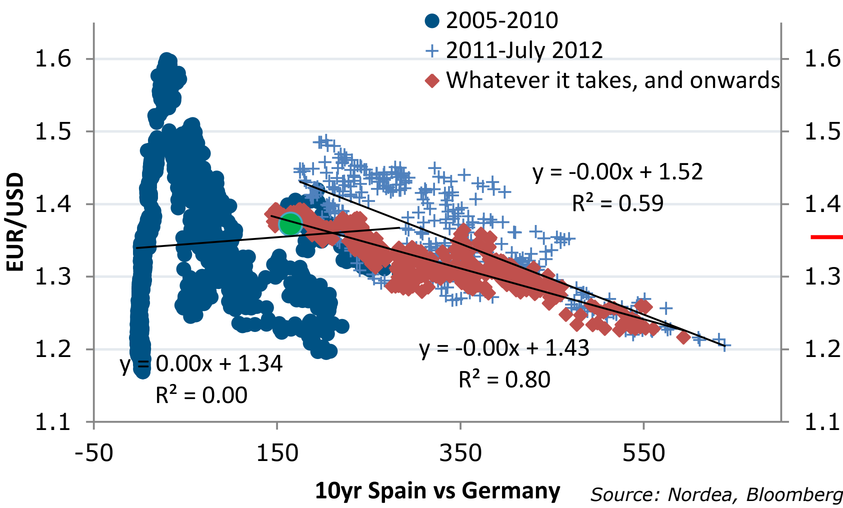
*Short EUR/USD, long the periphery (outright or vs. core) or long equities has been similar trades…*



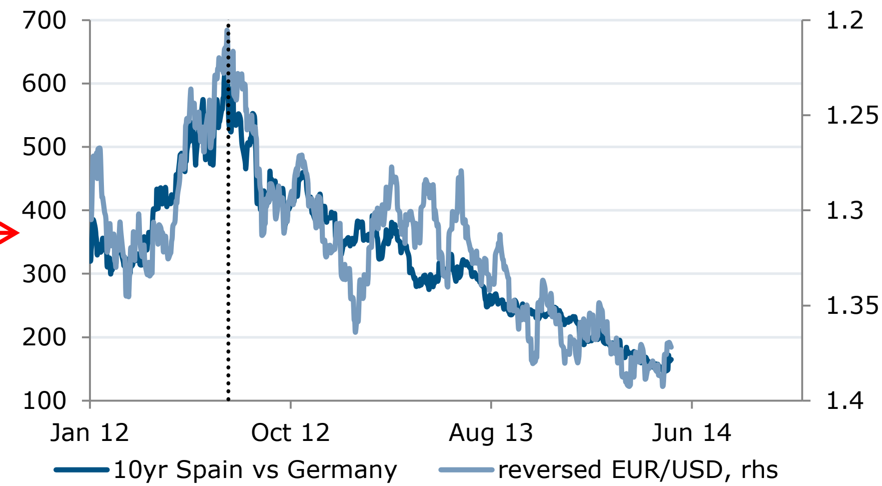

*Source:Nordea, Bloomberg*




*Source: Nordea, Bloomberg*



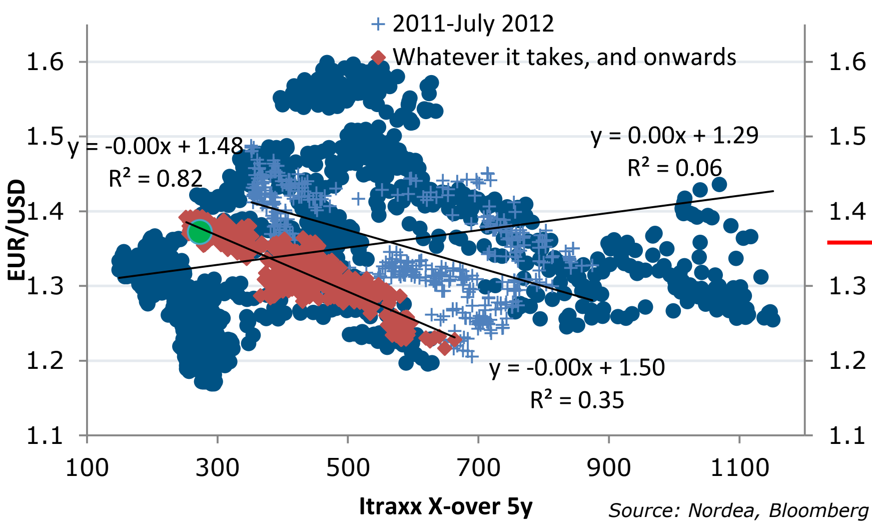

*Source: Nordea, Bloomberg*



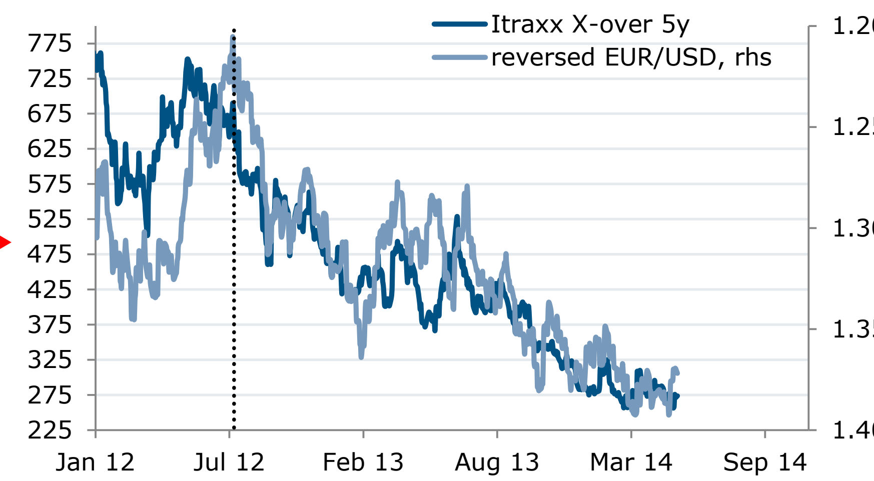

*Source: Nordea, Bloomberg*

# “Whatever it takes” and asset directionality

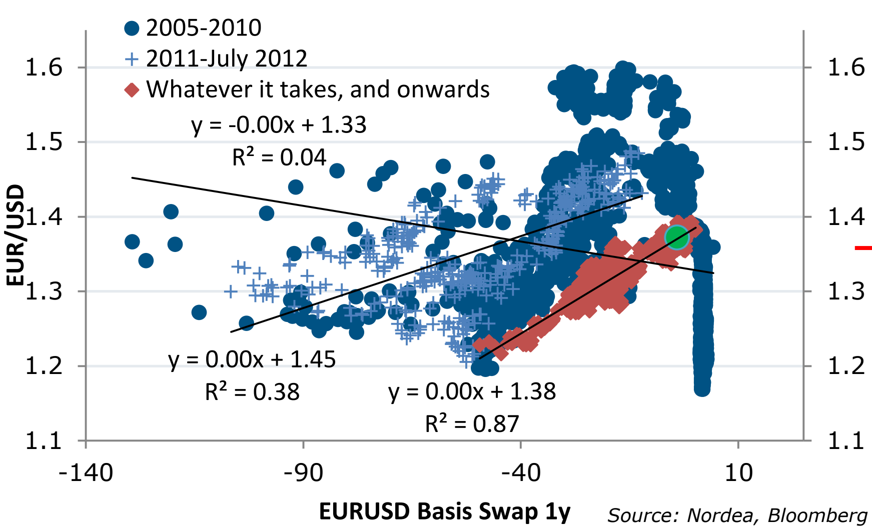
## *Short EUR/USD, long credits (in any form) or short EUR/USD basis has been similar trades…*



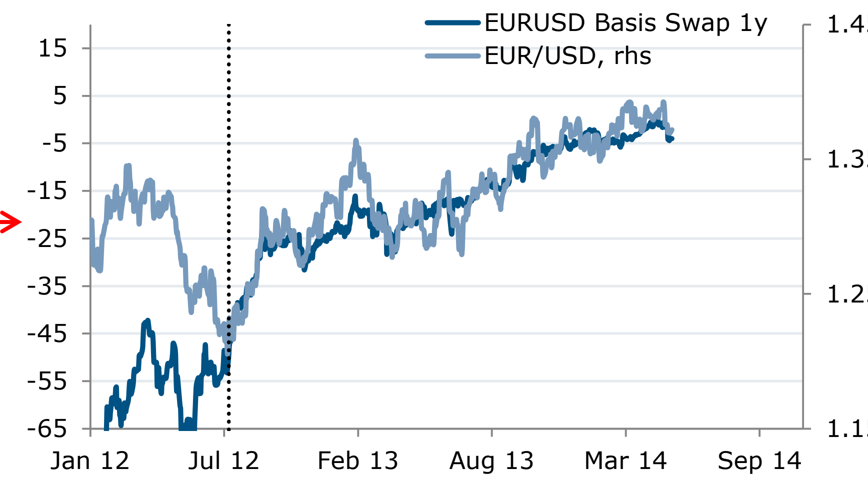
*Source: Nordea, Bloomberg*



*Source: Nordea, Bloomberg*



*Source: Nordea, Bloomberg*



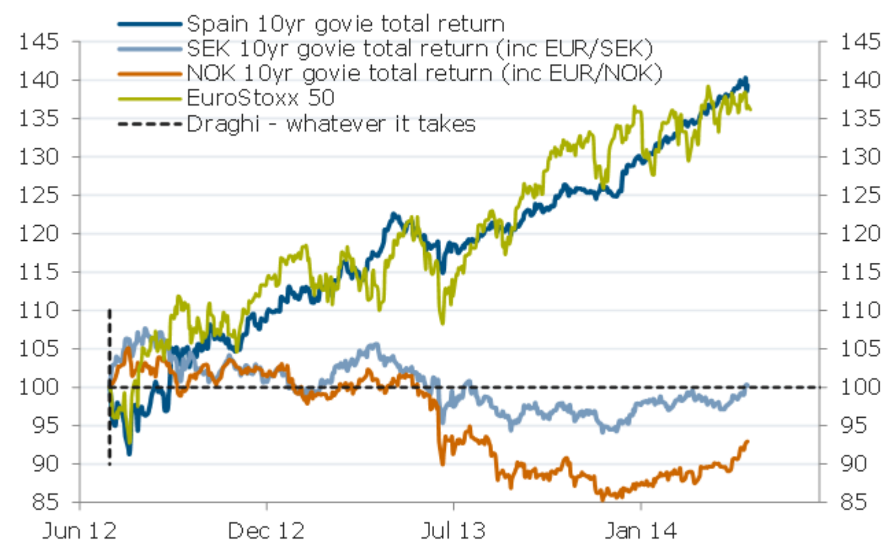
*Source: Nordea, Bloomberg*

# “Whatever it takes” and the Scandie “safe haven” trade

- In 2011 and the first half of 2012, following the sovereign debt crisis, a popular concept was “safe haven” allocation, with an inflow of capital to markets with healthy state finances, such as the Scandies (Sweden, Norway and Denmark)…

- The “whatever it takes” statement, however, also proved to be a key factor and a vital turning-point for this concept and Scandie markets. For example, as shown in the charts below, the difference in performance in 10yr Norway and Spain, since the “Draghi put”, has been remarkable. More specifically, the alternative cost for an unhedged euro investor, who preferred 10yr Norway instead of Spain, would have been 46% since July 2012...


Source: Nordea

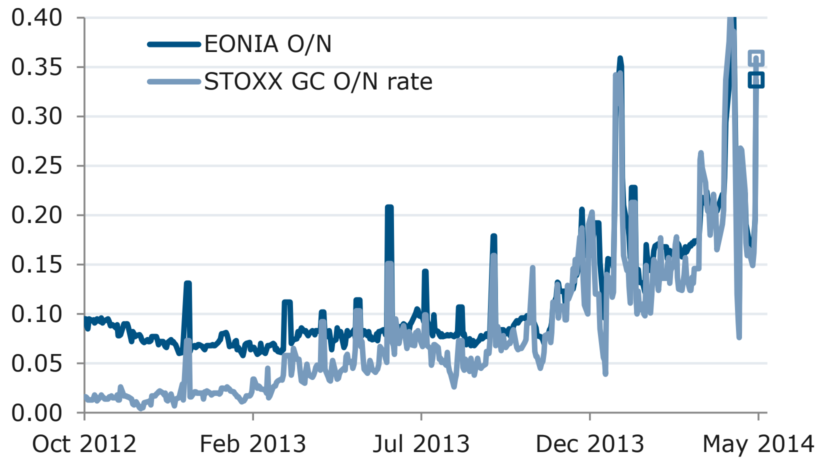



Source:Nordea, Bloomberg

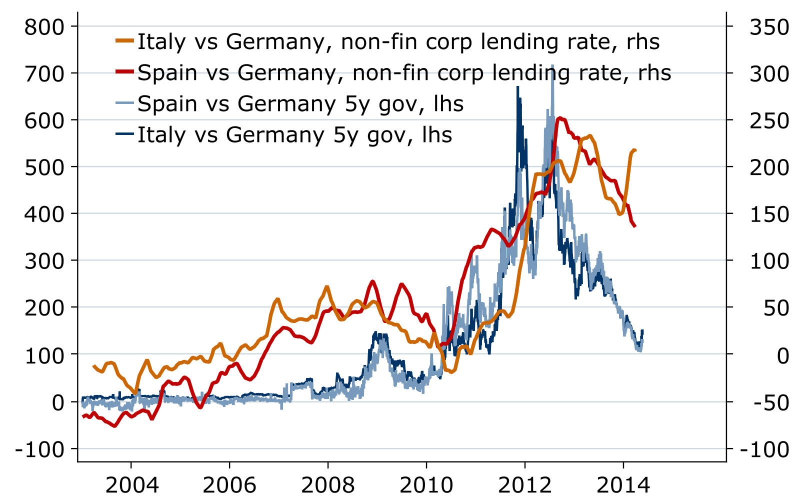
# “Whatever it takes”, the drawbacks from ECB´s perspective

- For the ECB, the drawback in terms of financial asset pricing has been the ~10% appreciation of the EUR, which has helped pushing inflation down to uncomfortable levels…
- In addition, SME lending rates in the periphery hasn´t come down much, despite the massive drop in government yield levels…
- And, that the draining of excess liquidity has translated into higher and more volatile money market rates…

Source: Nordea Markets and Macrobond



*Source:Nordea & Bloomberg*



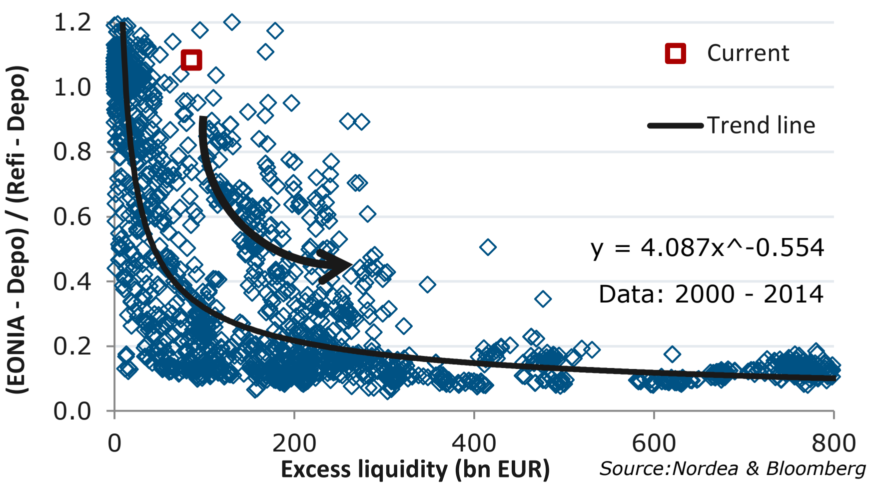
Source: Nordea Markets and Macrobond

# Part 2. What can the ECB do now?

# ECB: *"We are working on a broader range of instruments that might even strike the most fertile imagination of journalists and analysts"*

- The head-line on this slide came from Mersch, but Draghi complemented with an "action matrix" a couple of weeks ago in a speech. He was unusually clear about which responses that could be taken to counter certain risks. The ECB is at the moment pressured to act due to all three scenarios that he highlighted, which supports the "package solution" of multiple measures being taken at once…

- Nordeas base-line scenario *(see https://nexus.nordea.com/#/article/8702)* and likely the consensus, includes a refi/depo rate cut as well as some kind of liquidity easing, possibly in the shape of a suspension of the SMP sterilization. The latter in particular should increase excess liquidity and reduce the level and volatility of the shortest EUR rates, ease the tightening pressure on EURUSD basis swaps and cheapen the funding cost for holding EUR govies/receiving in swaps...



*Source:Nordea & Bloomberg*

| Risk | Possible trigger | Action |
|---|---|---|
| **Inflation outlook worsening** | • Spot inflation declines further<br>• Inflation expectations declines<br>• EUR FX strengthening | • QE |
| **Deteriorating transmission mechanism** | • Further slowdown in lending growth<br>• Worsening conditions for SMEs<br>• ABS market deterioration | • LTRO<br>• Funding for lending<br>• ABS purchase program<br>• Regulatory changes<br>• Change in collateral rules |
| **Tightening of policy stance** | • Money market stress<br>• Rates dragged higher by development in the US<br>• EUR FX strengthening | • Extend fixed-rate full allotment<br>• Liquidity injections<br>• LTRO<br>• Reserve requirement reduction<br>• Repo rate cut<br>• Depo rate cut<br>• SMP sterilization suspension |

# What to keep in mind, following ECB action…

- In our view, the risk that the ECB will disappoint markets in any meaningful way is limited and when a central bank increase the amount of stimulus it´s indeed difficult to end up with the conclusion that it will lead to negative market effects. However, **negative deposit rates, and any other unconventional measures, is uncharted action and can nevertheless produce unintended consequences, flows and chain reactions** - particularly in the light of the past years one-sided action in risky assets and spread-over and strong directionality between these assets…

- **A balancing act** - the strong directionality between assets during the past two years also suggest that if the ECB manages to weaken the EUR it should come at the expense of a weaker risk sentiment, for instance driven by profit taking, with more volatility in credit spreads and possibly a bit of reversal wider. The alternative to this scenario is of course that the ECB will prove capable of keeping the risk-on sentiment while still managing to depreciate the EUR…

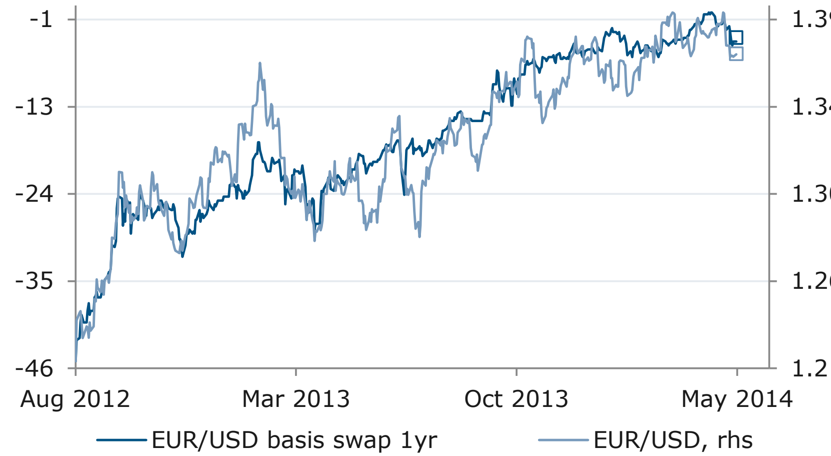
- If the ECB manages to deliver a package that is credible in the sense that it eventually will lead the rate of inflation higher, **longer rates should sell-off and the curve steepen** (which has been the case in the US as QE programs have been implemented). Such a move higher in rates could lead credit spreads wider as the sensitivity between credit spreads and the level of yields likely has increased in the past years (e.g. summer 2013), as allocation into the sector has been high. In addition, a cheapening of EUR liquidity could drive the EUR/USD Xccy basis lower and EUR/SEK higher, which **eventually could lead to more SEK supply of covered bonds**, which also poses a widening risk of spreads…

- If the ECB manages to depreciate the EUR it will likely lead to an appreciation of the SEK and **put the Riksbank in an even more problematic situation** vis-à-vis the current low level of inflation…

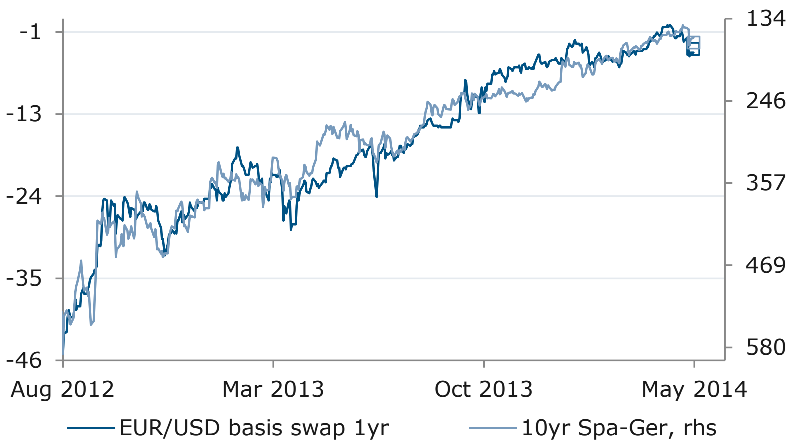
***On the next set of slides we try to outline and address these issues!***

# Observation 1 - Chain reactions or correlation collapse..?

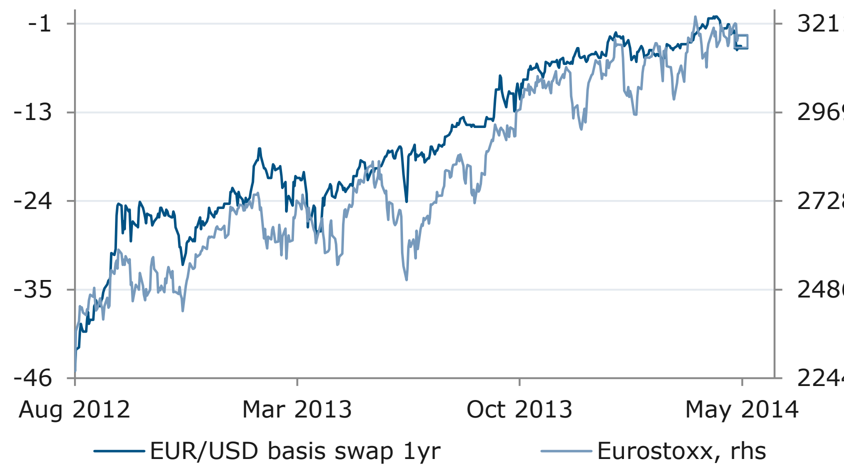
- Previously we learned that most assets have been strongly directional to each other and the EUR in past years. That begs the question, will the ECB manage to weaken the EUR without also weakening the risk sentiment (expressed by spread returns and volatility)? Or, put differently, **can correlations just collapse without any meaningful implications on returns, volatility and the risk sentiment?**
- In our view, one should at least be prepared for that a weaker EUR (e.g. if ECB increases excess liquidity and cuts the deposit rate to negative) could lead to some profit taking, which in turn can create chain reactions and increase volatility, as flows become less one-sided. That´s not the same as risk-off, but in comparison to the past two years, a more challenging time for investors…



*Source: Nordea and Bloomberg*



*Source: Nordea and Bloomberg*



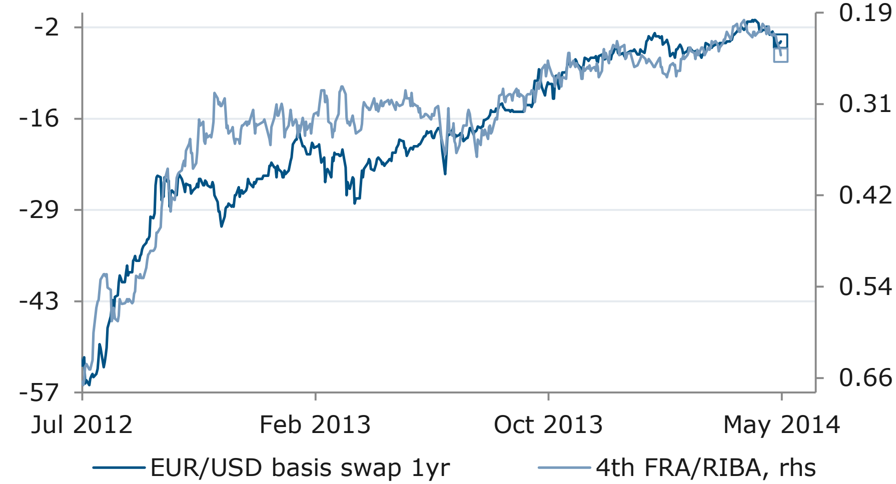
*Source: Nordea and Bloomberg*

# Observation 2 – Implications on asset swap spreads

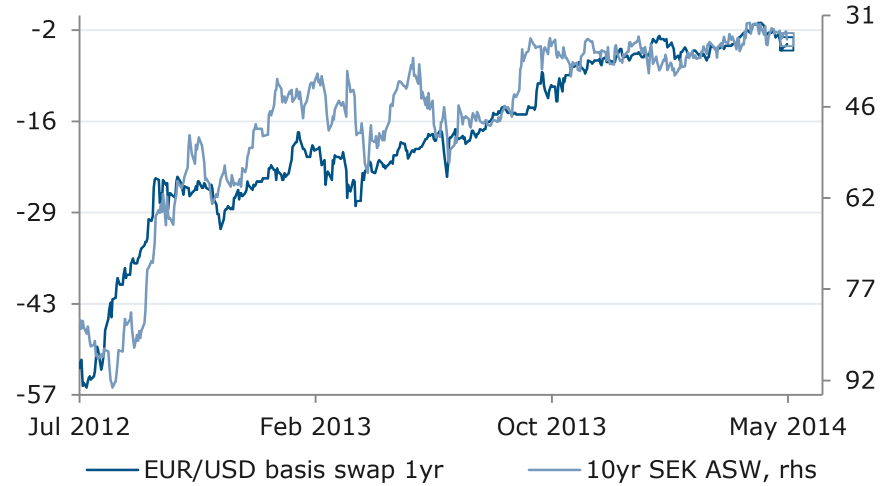
- ASW and FRA/RIBA spreads have compressed notably in the wake of ample liquidity and strong risk appetite. Allocation into spread-over and credits, in exchange of govies, has likely also contributed to the narrowing. So, just like all other assets brought up in this analysis, ASW spreads have been strongly directional to the overall sentiment…

- ASW have also been driven by the trend of tighter 3mth Stibor fixings in relation to the repo rate. In the scenario where the ECB increases excess liquidity again and makes the EUR cheaper, it could impact the EUR/SEK basis (higher). Throughout the crisis, most periods with wider FRA/RIBA and ASW spreads have come when there has been upside pressure on the EUR/SEK basis…

- In our view, though, ASW wideners mostly look like speculation on a weaker risk environment and LCR related buying, and current levels offer a relatively cheap hedge in this perspective…



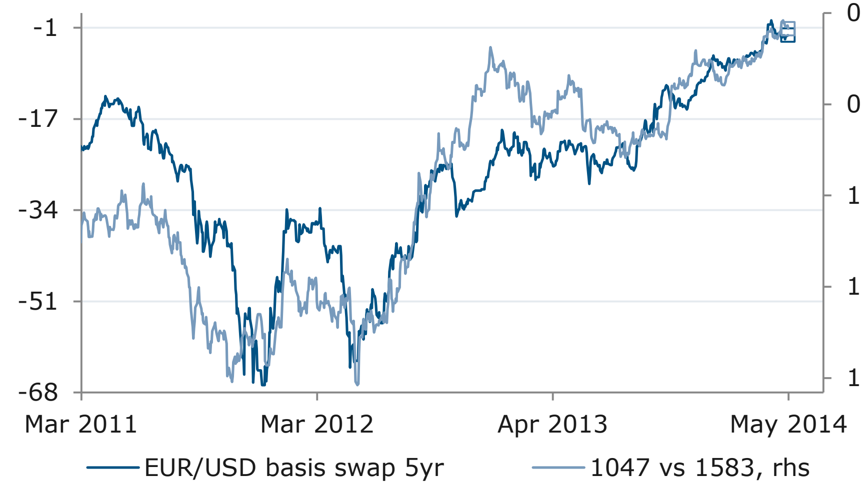

*Source: Nordea and Bloomberg*




*Source: Nordea and Bloomberg*

# Observation 3 – SEK Covered widening if risk sentiment weakens

- Just like for any other spread-over product, the “whatever it takes” statement was very positive also for SEK covered bonds, that have been highly directional to all assets highlighted in this analysis (see charts, where 1047 vs 1583 is a ~6yr covered bond spread)…
- Extra juice has also come from low domestic inflation and the market pricing of a central bank that is gradually moving towards the zero bound…
- So, this simply means that investors should be prepared for a bit of widening if the risk sentiment would deteriorate…




*Source: Nordea and Bloomberg*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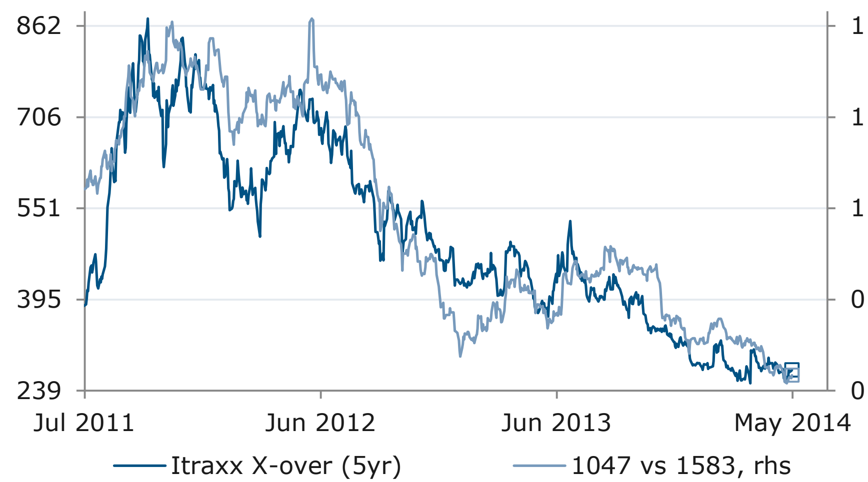
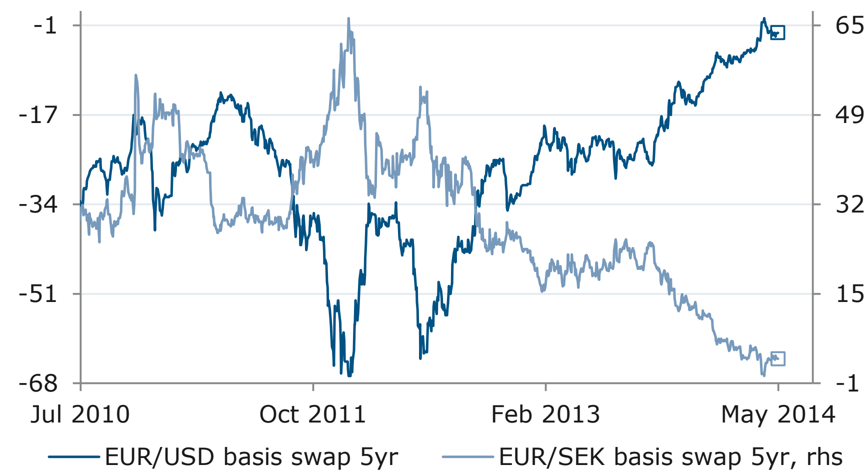


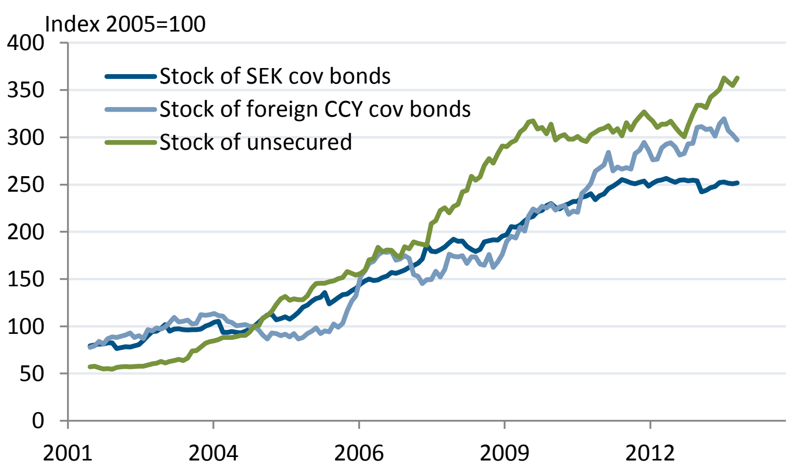

*Source: Nordea and Bloomberg*

# Observation 3 – SEK covereds through the lens of EUR/USD

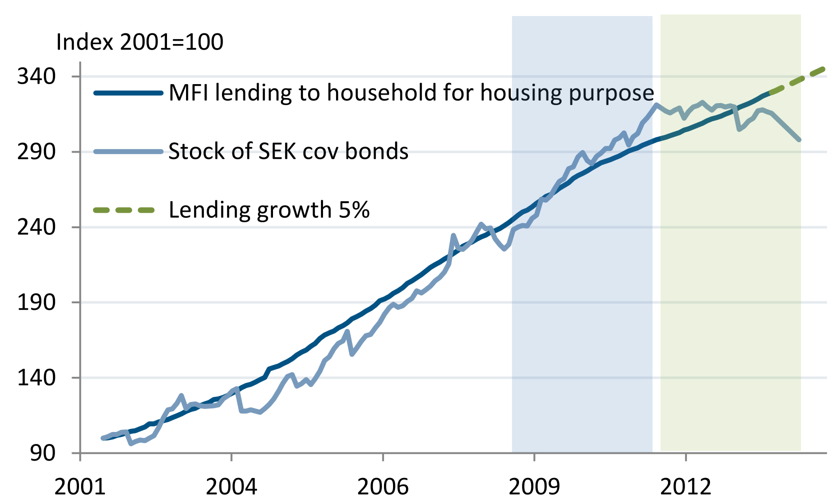
- In addition to the factors on the previous slide, an important driver of SEK covered spreads has been the lack of domestic supply (as issuers have had plenty of cheap funding available abroad). More stimulus from the ECB could improve this situation further, but one should be aware that if it push the EUR/USD basis lower and EUR/SEK higher it would, all-else-equal, make it less attractive for Swedish mortgage issuers to issue in foreign currency…
- Thus, there may be some scope for a heavier SEK supply pipe-line following a long period with very light issuance. Over time, this is a prospective widening risk of spreads and it could lend a steepening pressure on the curve…




*Source: Nordea and Bloomberg*



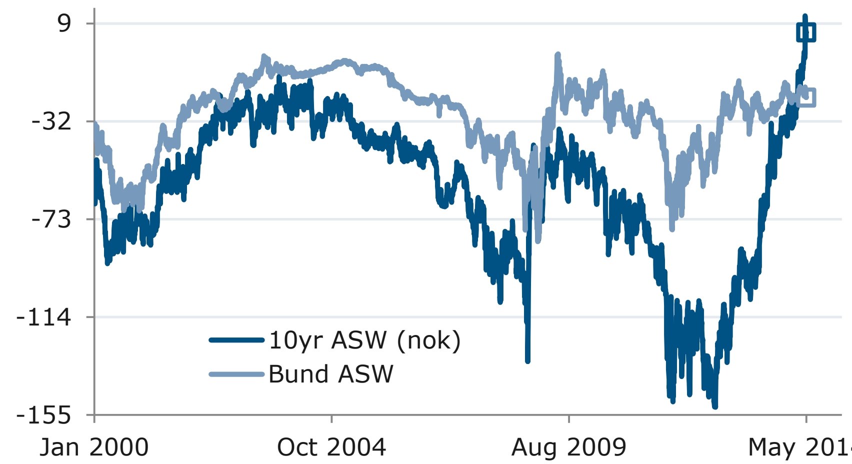

*Source:Nordea Markets, SCB*




*Source:Nordea Markets, SCB*

# Observation 4 – The "safe haven" trade is looking cheap (NOK)

- Sharp underperformance in long-end NGBs, driven mainly by heavy supply and a lacklustre demand from foreigners…
- At the same time, issuance of SSA paper, that have been swapped down, has contributed to a notable tightening of 10yr ASW spreads…
- Recently, NGB auctions have been more successful and already in H2, we expect the NGB supply pressure to abate (with negative net issuance the likely path next year). All-in-all, 10yr sector in Norway begin to look cheap, against Germany and in ASW terms…



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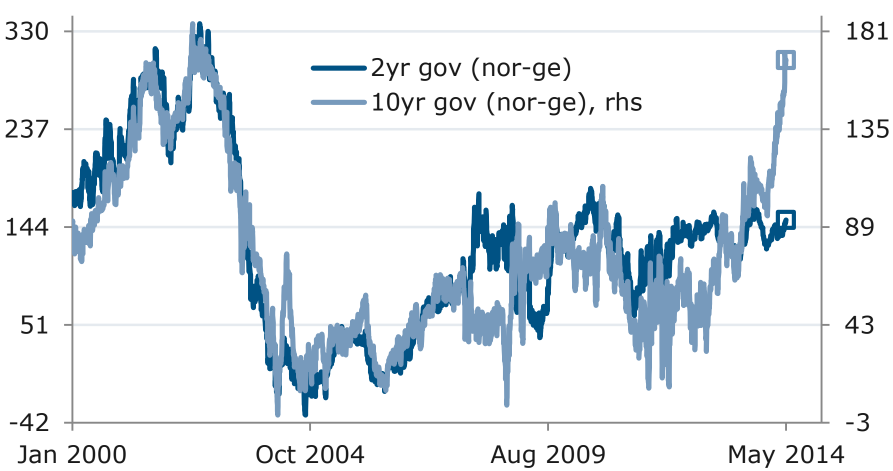

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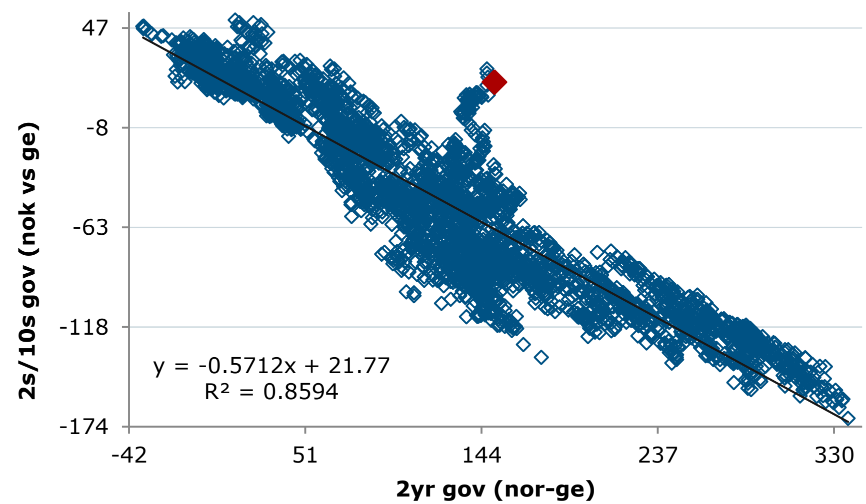
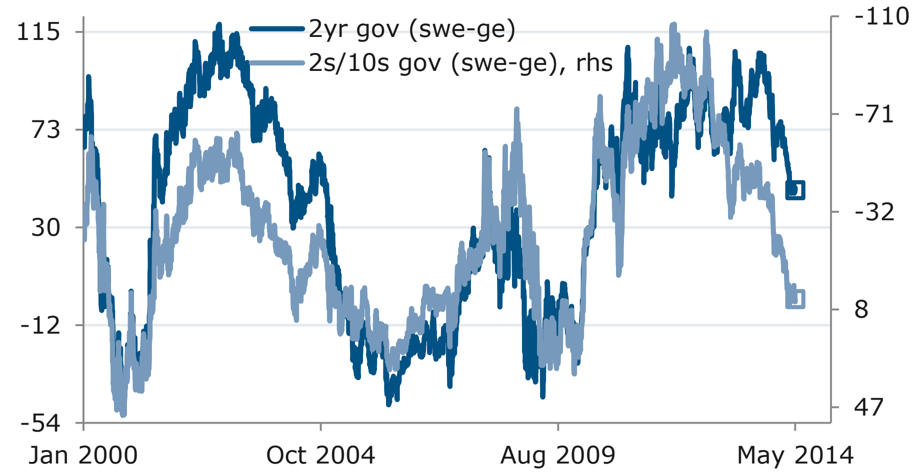


# Observation 4 – The "safe haven" trade is looking cheap (SEK)

- In the wake of falling inflation and the re-emergence of Riksbank easing expectations, front-end SEK rates have performed against Germany (EUR). However, the curve has steepened much more on a relative basis than what can be explained by the front-end performance (i.e. 2s/10s and 5s/10s look steep in relation to the German/EUR curve)…
- Spread levels also look high given yield levels…
- Unhedged foreign investors should find it more attractive now, to buy into the strong credit of Sweden, than in a long while and particularly 10yrs…

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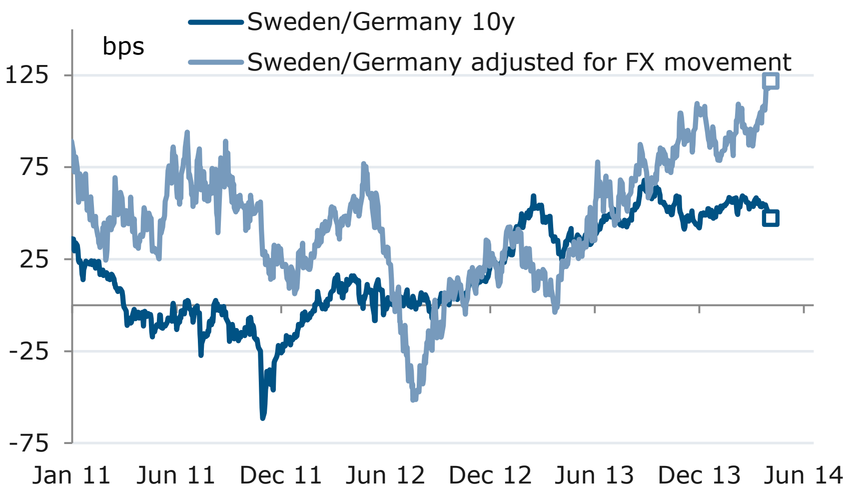
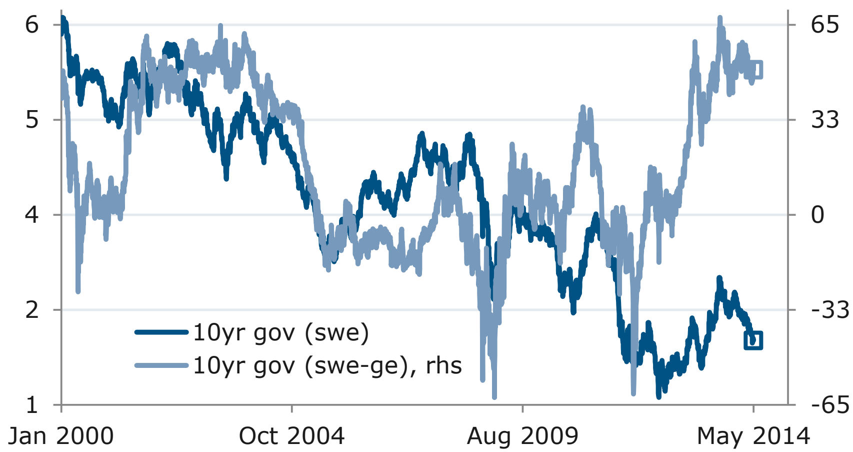


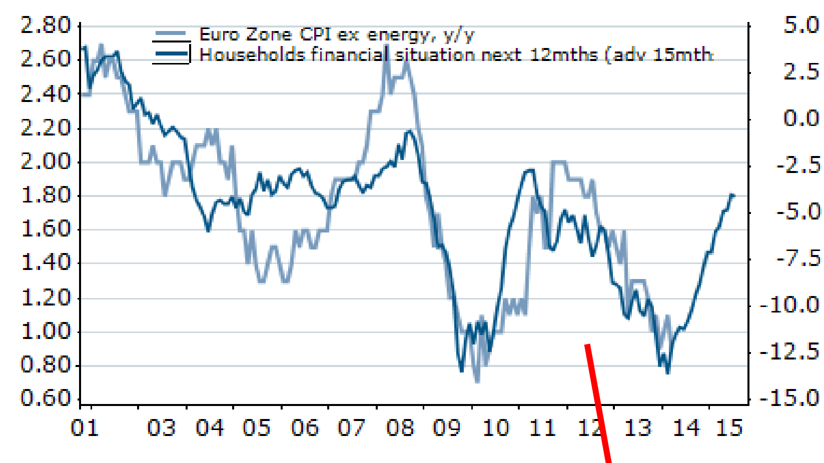

*Source:Nordea Markets*



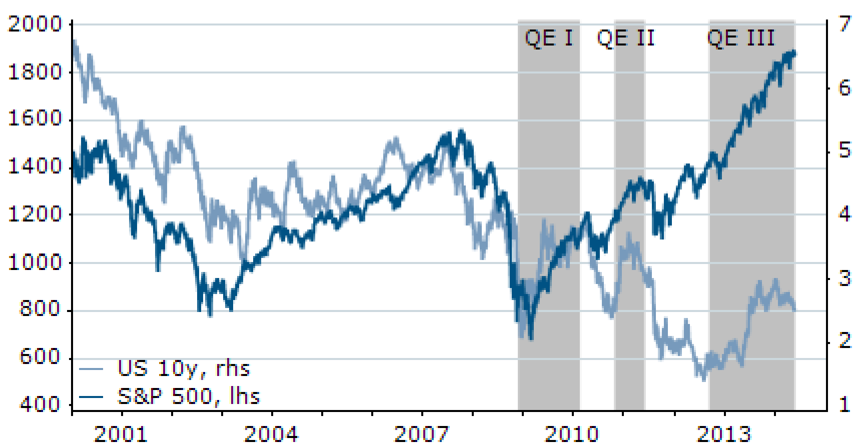

Source: Nordea

# Observation 5 - What if the ECB succeeds?

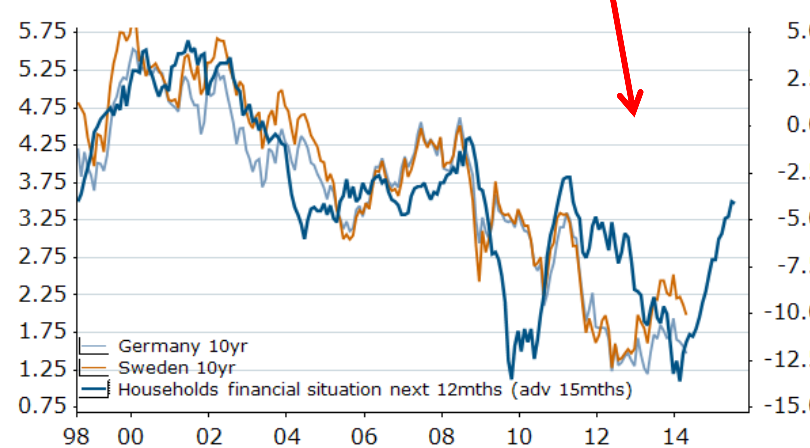
- Falling and low euro-zone inflation has been a magnet for bond yields and with unemployment around 12%, it's a long way until there are reasons to expect wage driven inflation…
- At the same time, consumer surveys have re-bounded notably since the lows and suggest the economy is at a turning-point…
- If the ECB succeeds to create credible expectations that the policy mix will be able to bring inflation back towards target, long-end rates should start to move higher. This is what we have seen in the US after the launch of their QE programmes…




Source: Nordea and Ecowin



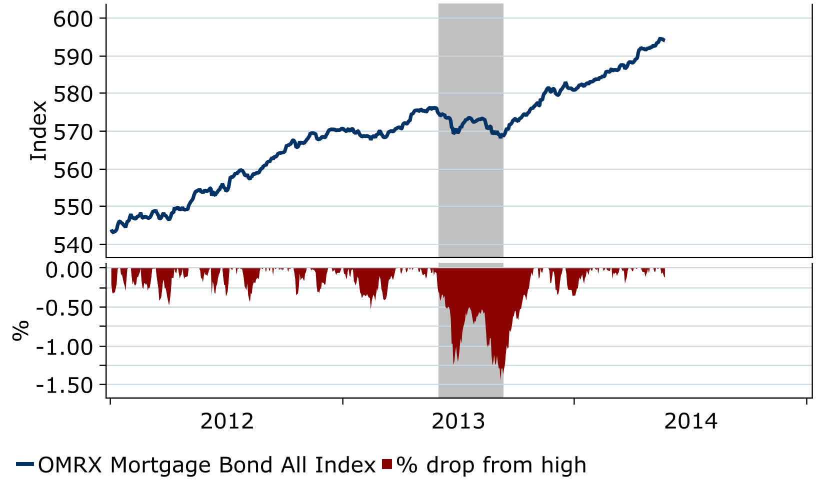

Source: Nordea Markets and Reuters Ecowin



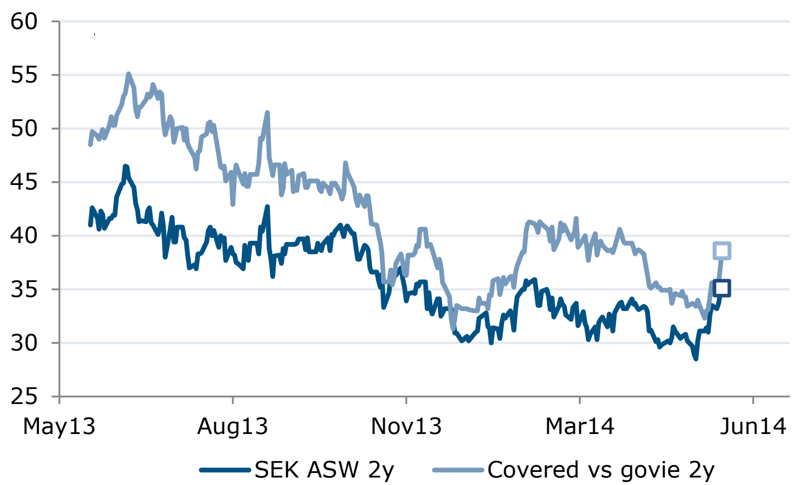

Source: Nordea and Ecowin

# Observation 6 – Spread-over to get hurt if rates sell-off

- Credits and Swedish covered indices have performed almost without a set-back for a year now, but as we roll past the June index extension, investors may need fewer arguments to reduce duration. The scenario described on the previous slide also poses a risk for credit spreads, since the sensitivity between spreads and the yield levels likely has increased as capital has fled into this sector. In addition, the experience from last summer should leave investors a bit more cautious…
- The covered bond 2s/5s curve has flattened substantially while yields have dropped. This leave positions for higher forward yields (i.e cash neutral steepeners) an attractive way to reduce exposure.
- In terms of spread positions, it feels safer to be long covereds vs swaps than vs govies. Covereds may perform vs swaps since negative deposit rate at ECB might increase demand for liquid assets in general, while it leads to a widening of govie ASWs…




Source: Nordea Markets and Macrobond

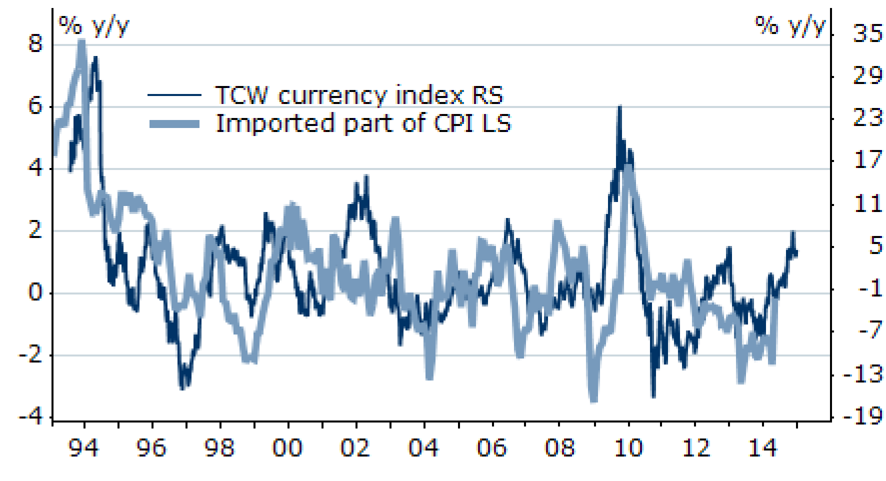



# Observation 7 – Riksbank implications of a strong SEK

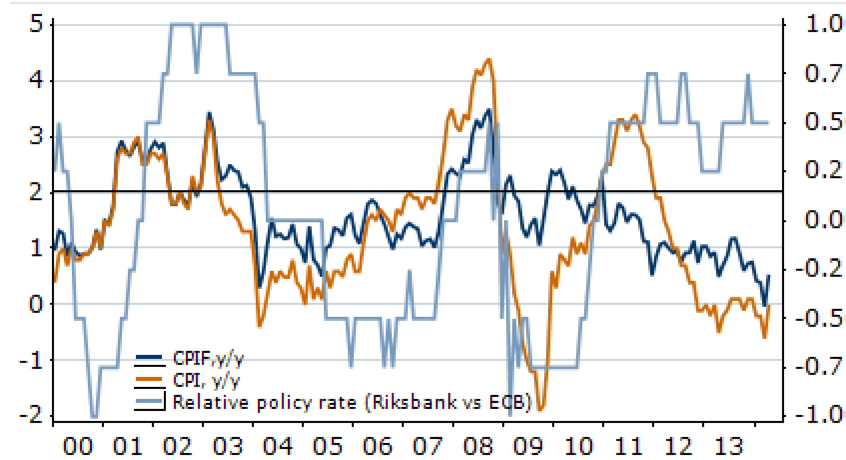
- For a small open economy like Sweden, with a high dependency on the euro-area, there is indeed a scenario where a successful EUR depreciation tactic by the ECB will create problems, and particularly if the starting point is a very low level of inflation already. At this juncture, it looks like the imported part of CPI will be leading CPI a bit higher and it would certainly not be ideal if another run lower is on the cards instead (top chart)…

- A scenario where EUR/SEK moves back towards the 2012 lows again (8.20-50 area), it would not be unnoticed and likely force the Riksbank down to the zero bound, since relative monetary policy will look too tight and more in line with a situation where Swedish inflation is above the 2% target (lower chart)…

- Although premature and wild in its nature, such a scenario could potentially even put the bank in a position where they would consider unconventional measures to affect the currency, such as interventions or introducing a SEK floor (like the SNB)…



Source: Nordea Markets and Reuters Ecowin



Source: Nordea and Ecowin

# Thank You!

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