



Strategy Research Sweden: On the radar

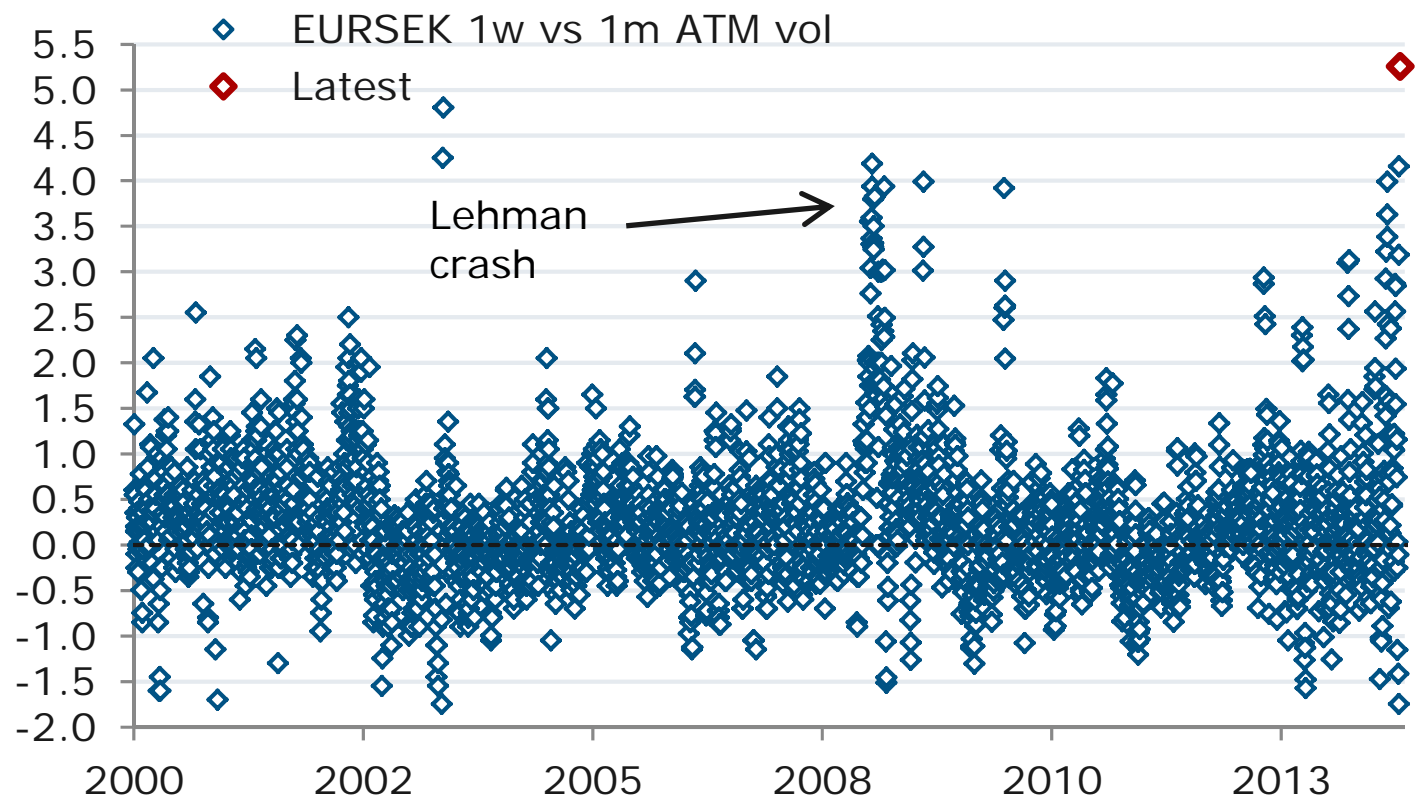
This publication is a summary of interesting market related topics and observations that have been covered and discussed within the Strategy Research Sweden group, but not necessarily yet formalized in form of a specific view or trading idea...

Themes in this edition:

- **Riksbank:** chasing the same old tail
- **Riksbank QE:** could it be more likely than markets think?
- **EUR rates:** is -20bps a "soft" floor for Schatz?
- **FX:** EUR/USD undershooting long-term averages is fair
- **FX:** EUR/SEK vols on the rise ahead of the Riksbank

10 February 2015

Chart of the week: The heat is on ahead of Thursday's Riksbank meeting...



Source: Nordea & Bloomberg

Expectations of Riksbank easing is clearly seen in the rates market and has now also spilled over to FX (see more on page 8)...

Trades on the radar

Curve – Pay belly in 2s5s10s Curve flattening has led to significantly more curvature in the EZ curve, but only marginally more curvature in Swedish curve. Paying/going short the belly in a 2/5/10s fly should be a good relative value trade for lower rates with a more limited downside on higher rates.

ASW – Wider SGB 1051 ASW Swedish swap spreads look low relative other markets and ECB bond buying and low bond yields in for example Denmark should create support for Swedish bonds. However, SGBs have richened a lot versus RIBA strip and do not look cheap in themselves anymore.

Municipals – Buy KI16 vs swap KI16 looks somewhat cheap vs swaps and given the roll-pattern of previous issues the bond has the potential to roll down to -20 bps below swaps by end of Q3

Inflation – Value in SGBi 3107 & SGBi 3102 Both bonds implies, given the nominal yield curve, an average CPIF of around 0.5% a year over the life time of the bonds. So break-evens are already discounting the Riksbank totally failing the inflation target.

Inflation – go for higher 5y5y real rate Go short a proxy of the forward real rate through buying 3102 and selling any of the bonds SGBi 3108/3109/3104. Forwards price either too low trend growth or too stimulative monetary policy.

Previous edition (2nd February)

Curve – Pay belly in 2s5s10s Curve flattening has led to significantly more curvature in the EZ curve, but only marginally more curvature in Swedish curve. Paying/going short the belly in a 2/5/10s fly should be a good relative value trade for lower rates with a more limited downside on higher rates.

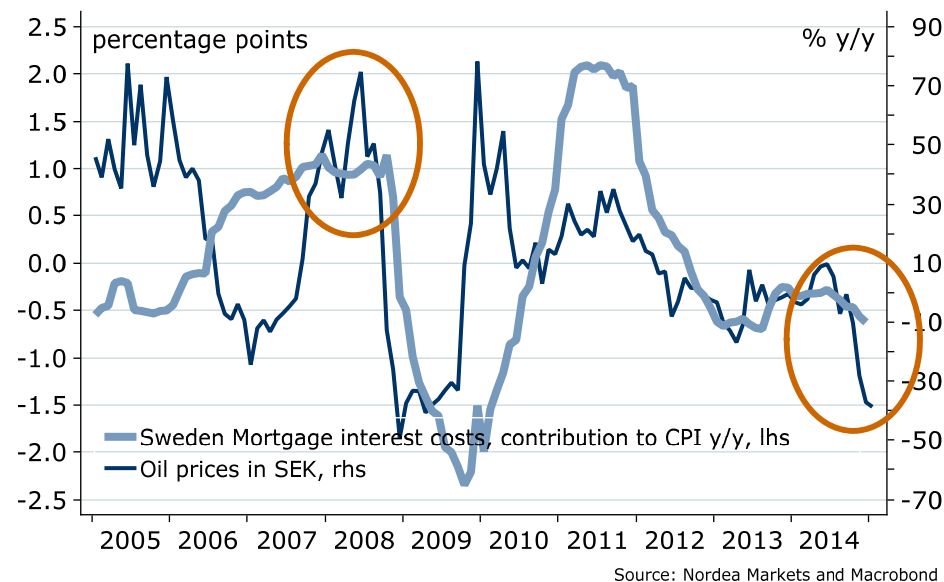
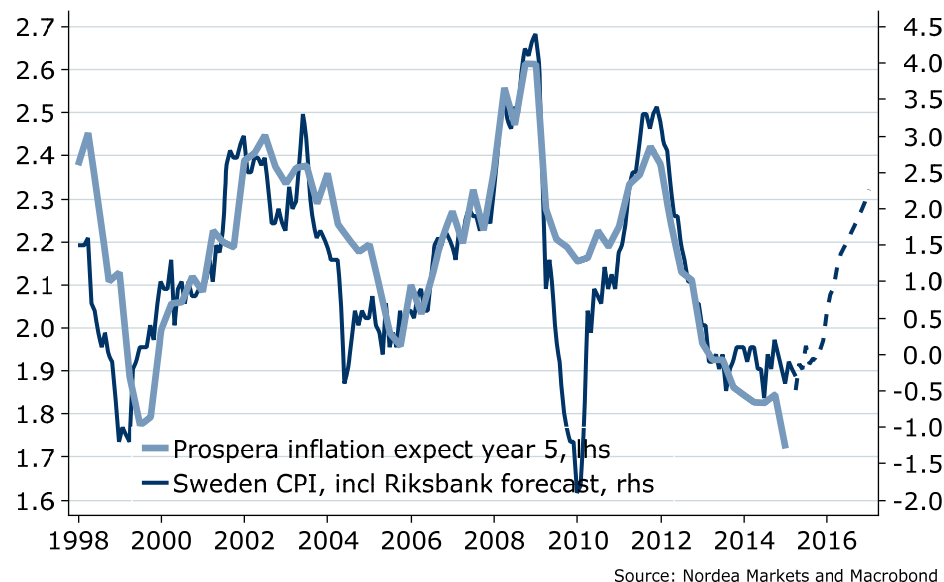
ASW – Wider SGB 1051 ASW A way to pick up value in Swedish short tenor bonds as they trade cheap to the RIBA strip. Stibor and FRA valuation seems stretched. Shrinking universe of AAA bonds especially after ECB QE and Denmark's CB cancelling of auctions make Swedish bonds look attractive.

Municipals – Buy KI16 vs swap KI16 looks somewhat cheap vs swaps and given the roll-pattern of previous issues the bond has the potential to roll around 20bps over the next three quarters.

Inflation – Value in SGBi 3107 & SGBi 3102 Both bonds implies, given the nominal yield curve, an average CPIF of around 0.5% a year over the life time of the bonds. So break-evens are already discounting the Riksbank totally failing the inflation target.

Inflation – go for higher 5y5y real rate Go short a proxy of the forward real rate through buying any of the bonds SGBi 3107/3110 (new bond)/3102 and selling any of the bonds SGBi 3108/3109/3104. Forwards price either too low trend growth or too stimulative monetary policy.

Riksbank: chasing the same old tail...

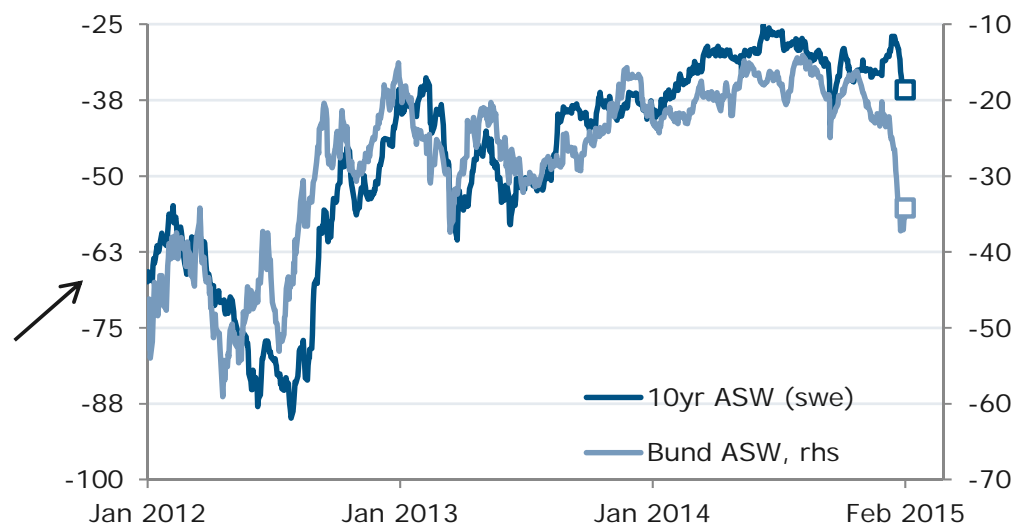


Our Riksbank call for Thursday is that the rate path will be flattened and include some probability for a rate cut in April/July, but that no rate cut or unconventional measures are delivered now. However, the tone will be very soft and the pressure on the Riksbank will return ahead of the April meeting (*strategy comment* & *macro comment*). **The Riksbank is stressed by falling inflation expectations, that follow the trend in spot CPI. It's just like 2008, but in reverse.** CPI can be divided into 3 components: underlying inflation, energy and interest rate costs. In 2008 spot CPI spiked above 4% y/y, making inflation expectations surge, even though underlying inflation was around 2%. Half of the difference was explained by interest rate costs rising on rate hikes and half by energy/oil prices. The Riksbank was chasing its own rate hikes and rising oil prices. Currently CPI is -0.3% y/y. Underlying inflation is 1.1%, mortgage rates are pulling down y/y CPI by 0.8 percentage points and the rest of the difference is energy related. The Riksbank is chasing its own rate cuts and falling oil prices.

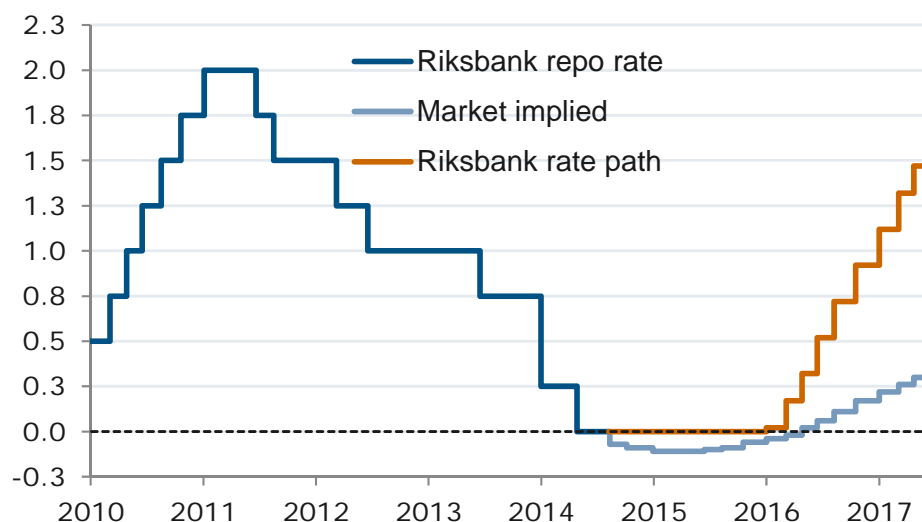
In retrospect, most people feel that the Riksbank hiked too much in 2008. We'll see if the opposite will be true for 2014/15. Anyway, **the focus on inflation expectations will mean that monetary policy towards the end of 2015 will be very dependent on oil prices.** If oil prices gradually fall to 30 USD, CPIF could roughly be around 0.7% y/y end 2015. If oil gradually rises to 90 USD, CPIF could be roughly 1.7% y/y. And inflation expectations should move accordingly...

Riksbank QE: could it be more likely than markets think? (i)

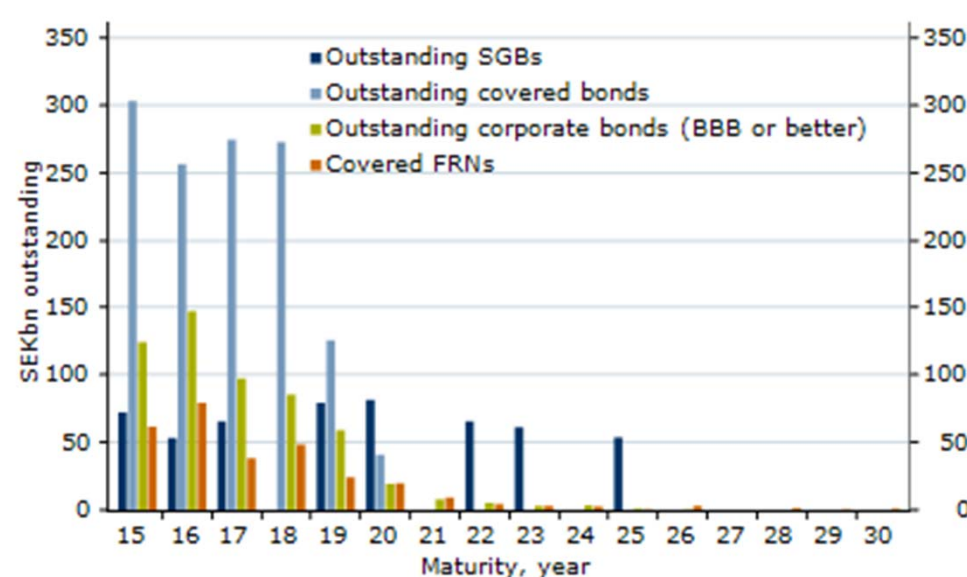
- One of the clearest €-QE trades has been the widening of the Bund spread...
- Yet, even if expectations of unconventional measures by the Riksbank has increased, and the market is pricing in about 30% probability for a cut on Thursday, swap spreads have moved only marginally...
- If the limited bond universe is a problem for the ECB's QE program, it could be an even bigger problem for the Riksbank. The govie stock is limited, covereds are controversial and corporates are from a legal perspective doubtful...
- Thus, while analysts seem split between a QE program and negative rates, why are longer Swedish ASWs only suggesting limited probability for a Riksbank QE program when the RIBAs so clearly are indicating a ~30% probability for a 25bps cut on Thursday?



Source: Nordea

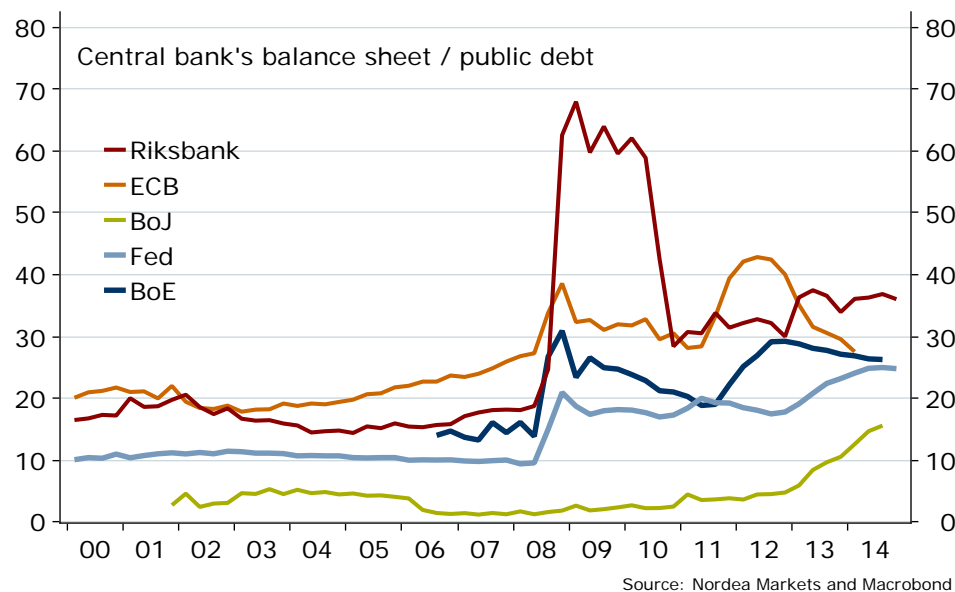


Source: Nordea & Bloomberg

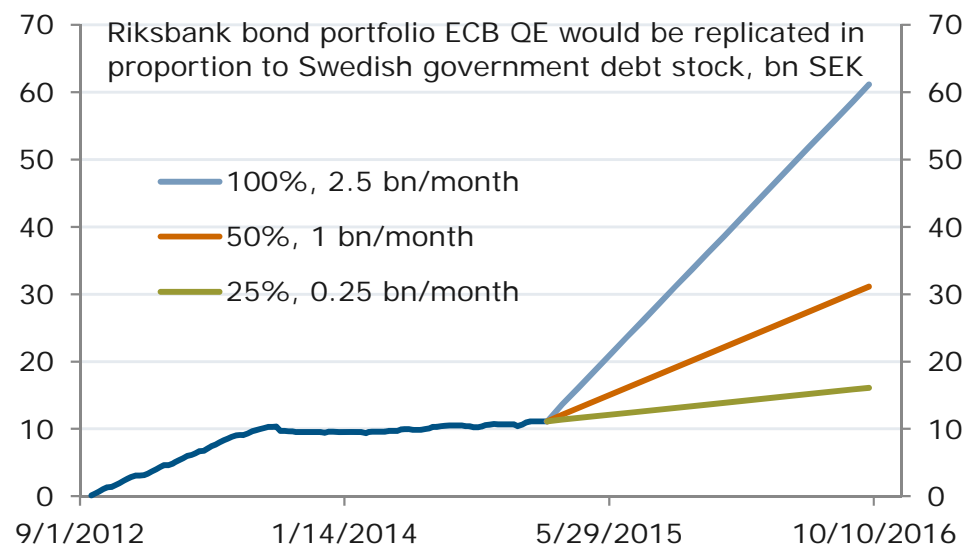
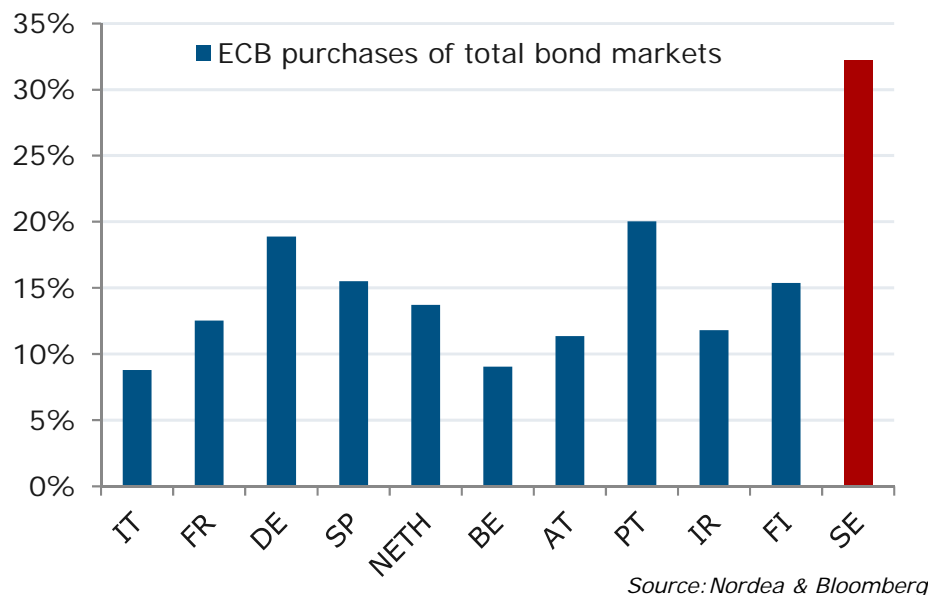


Source: Nordea Markets and Macrobond

Riksbank QE: could it be more likely than markets think? (ii)



An important reason why markets discount a very small probability for QE in Sweden is the combination of a small government bond stock and a guess that the Riksbank doesn't want to buy covered bonds (household debt worries). Indeed, the Riksbank balance sheet as a share of public debt is already larger than the major central banks. Also, if we toy with the idea that Sweden was a member of EMU then ECB should have bought a massive 32% of all outstanding government bonds. But what if we twist the comparison a bit. **What if we instead view the ECB QE program as a share of outstanding government bonds and do something similar in Sweden?** A replica would mean that the Riksbank would buy ~2.5 bn government bonds per month out of a gross issuance of ~7 bn. Or half the size buy 1+ bn. Suddenly it seems possible...



EUR rates: is -20bps a “soft” floor for Schatz?

Will ECB shun away from bonds trading below the deposit rate floor as this may be seen as the de facto break-even yield for purchases?

Thoughts of short-end DE govies

Investors to avoid bonds trading below -20bps...?

ECB's depo floor could partly be a “soft” floor for German bonds. If bonds trade below this level, investors may be better off putting the money with the ECB at -20bps (depo floor) instead.

... as will the ECB?

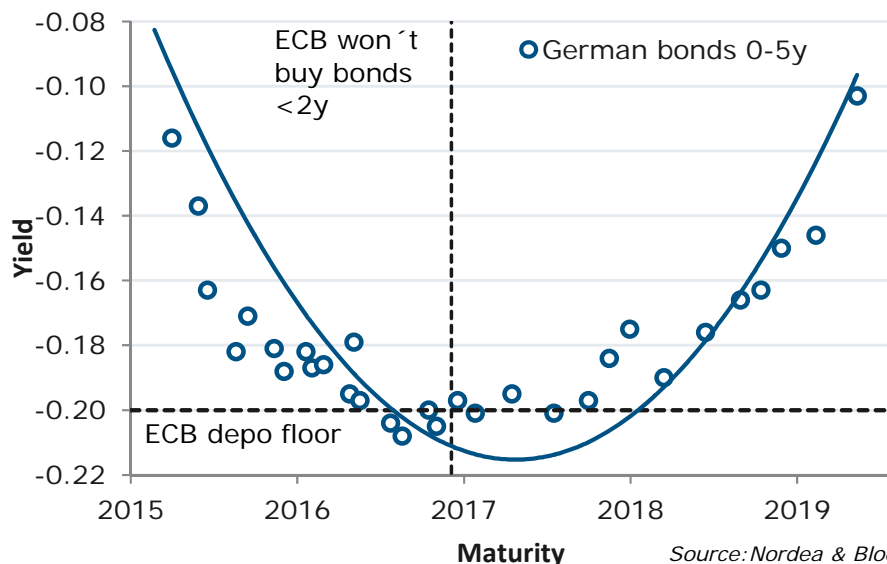
The excess liquidity that the ECB creates when buying bonds will be “punished” at -20bps. Thus, the ECB's break-even is not necessarily bonds yielding zero but rather -20bps. The central bank may be unwilling to buy bonds below this level.

2y point is trough on DE curve

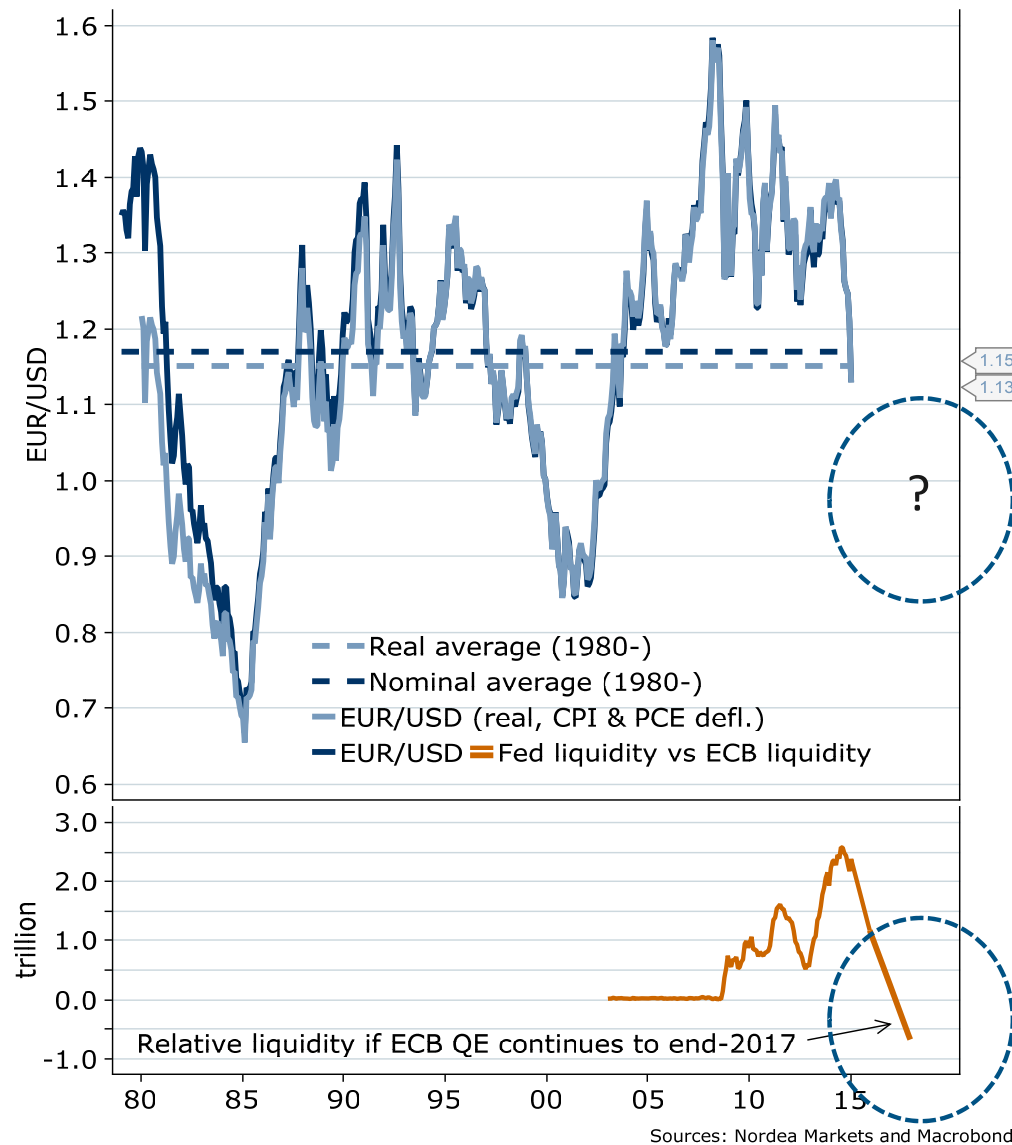
... and the ECB will not buy bonds shorter than 2y.

Roll-down slightly positive (for Schatz sellers)

ECB's QE decision has made the govie curve slightly inverted between 0-2y, as the shortest bonds have cheapened somewhat.



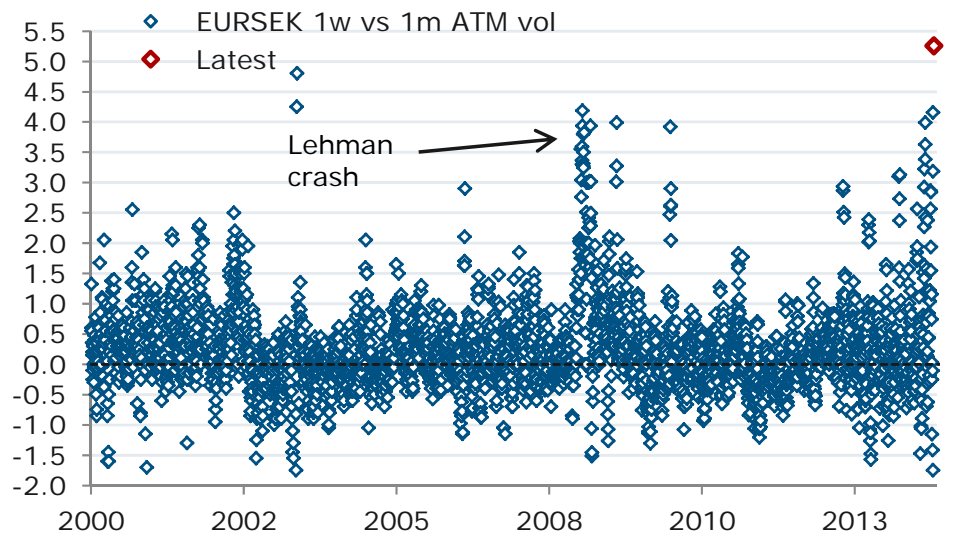
FX: EUR/USD undershooting long-term averages is fair



- The average of EUR/USD since 1980 is 1.17
 - The real average is 1.15
 - The US in a nutshell: strong growth, unemployment gap closing, well-functioning financial system, solid demographics, no obvious structural impediments
 - The Euro Area in a nutshell: weak growth, unemployment gap open for many years, financial system in disarray, weak demographics, plenty of structural issues
- ⇒ It makes sense for the EUR to be weaker than usual. This has only started to be priced-in.

FX: EUR/SEK vols on the rise ahead of the Riksbank

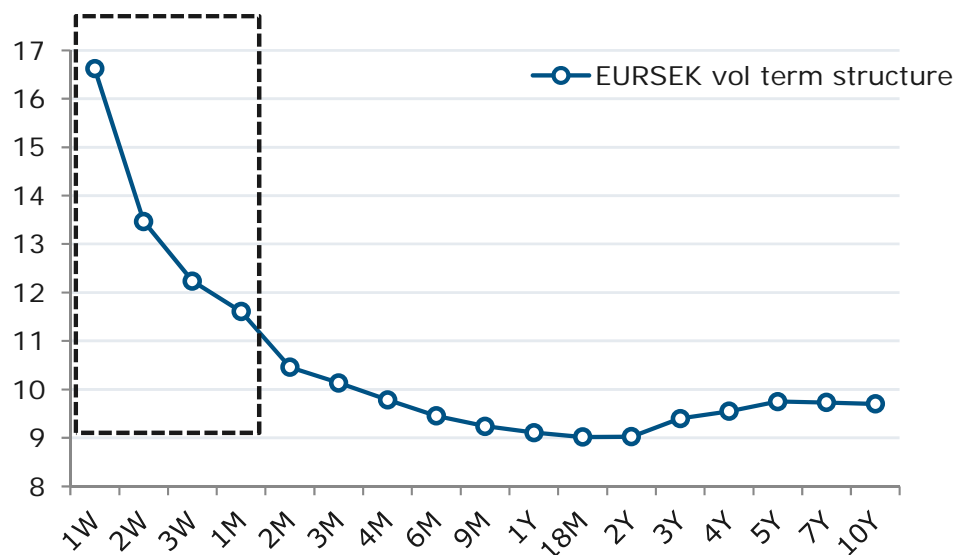
Expectations of Riksbank easing is clearly seen in the rates market but lately EURSEK vol has climbed increasingly higher and the currency has decoupled from its oil-driven peer, the NOK...



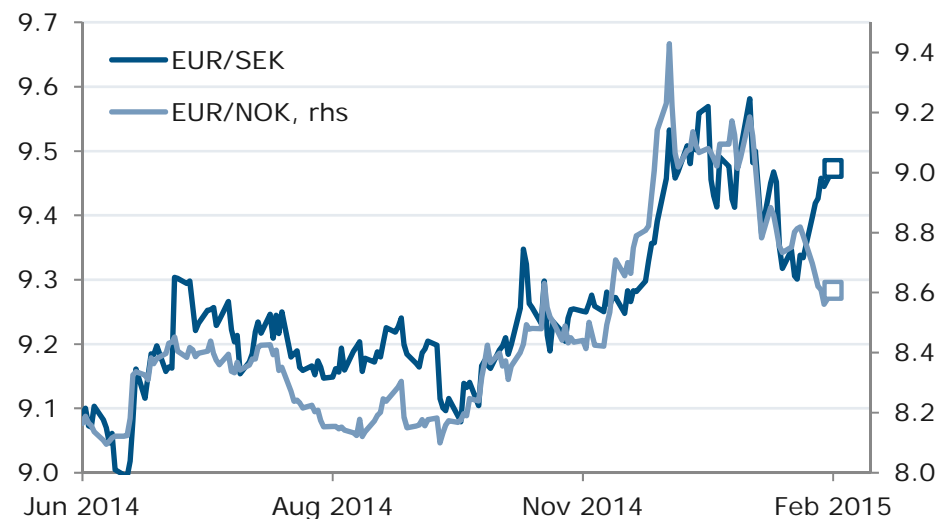
Source: Nordea & Bloomberg



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Thank You!

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Kristofer Eriksson
kristofer.eriksson@nordea.com

Martin Enlund
martin.enlund@nordea.com

Mats Hydén
mats.hyden@nordea.com

Mikael Sarwe
mikael.sarwe@nordea.com

Henrik Unell
henrik.unell@nordea.com

Alexander Wojt
alexander.wojt@nordea.com