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Market Pulse SEK
Govie Bond Issuance and 5y5y as hedge against housing

Themes in this edition:

1. Unsustainable mix of budget surplus & QE … SGBs set for extinction (1 of 2)
2. Unsustainable mix of budget surplus & QE … SGBs set for extinction (2 of 2)
3. "Oh… I'm afraid the QE-program will be quite operational when the SGB 1061 arrives."
4. SGB swap spreads … what's high and what's low
5. High-speed railway: A long-term swing factor for government bonds
6. A glimpse into the SEK 5y5y chamber of horrors

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Unsustainable mix of budget surplus & QE … SGBs set for extinction (1 of 2)

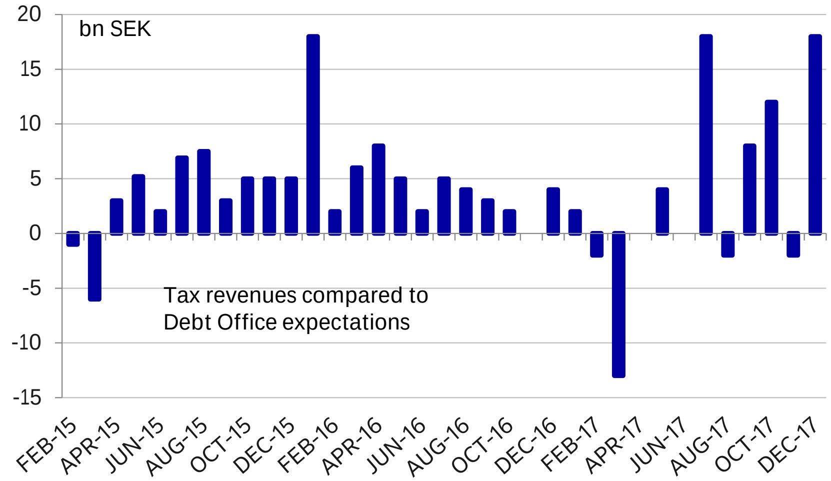
- The government's budget surplus for 2017 turned out to be 61.8bn SEK instead of 28.3bn that was expected by the Debt Office. This means that ***the Debt Office borrowing report from late October may already be obsolete and that a further reduction in bond issuance may be warranted***. The next borrowing report is due 21 February.

- The main driver of the unexpected budget surplus has been higher than expected tax revenues. Figure 1 shows that these surprises has been persistent over several years. Obviously, the Debt Office has been unable to adjust their forecasts adequately given historic errors. The swing in revenues/outlays that stems from the business cycle is notoriously hard to estimate but the consensus perception has for ages been that the swings are "always underestimated". This should have weighed into the Debt Office forecasts from time to time, and ***the business cycle cannot in our view solely explain the long stretch of positive surprises***.

- Another factor at play has been that of large inflows in tax accounts. A high deposit rate relative alternatives has incurred inflows that do not reflect underlying tax revenues. This factor was well known and understood during last year and cannot really explain the recent surprises. ***Perhaps value-added taxes on residential investments is one of the factors that forecasters missed out on*** (including us)? Residential investments have sky-rocketed recent years and more than investments in other sectors, residential investments are liable to final value-added taxes.

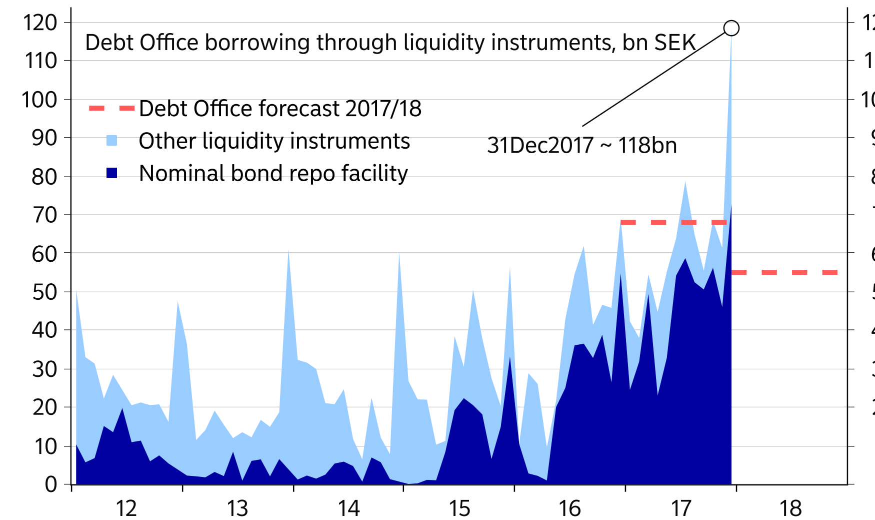
- The shortage of government bonds in the market has increased the amount of bonds that the Debt Office lend to the market through its repo facility. When lending bonds, Debt Office cash balance improves correspondingly. This reduces the borrowing need in other instruments such as bills and bonds. Figure 2 shows that the excess of cash in increasing at the Debt Office and compared to its forecast, ***there is way to much cash in the government's coffers in order to motivate the current plan of issuance in bonds and bills.***

Fig 1. Tax revenues continue to surprise on the upside



Source:Nordea Markets, Debt Office

Fig 2. Excess cash keeps on piling up



Source: Nordea Markets and Macrobond

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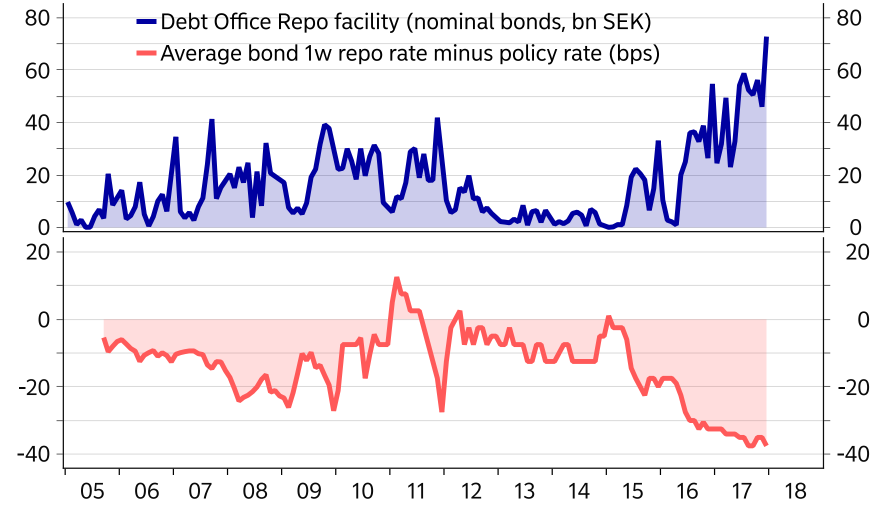
Unsustainable mix of budget surplus & QE … SGBs set for extinction (2 of 2)

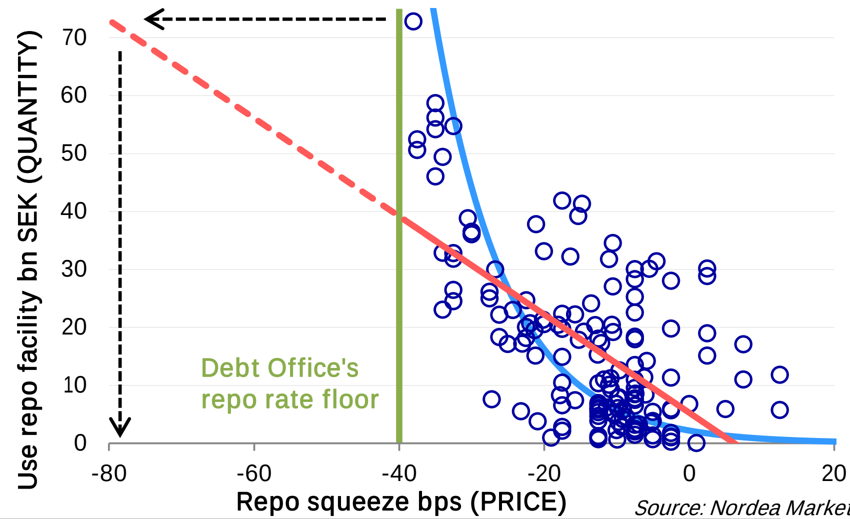
- The December the volumes in the Debt Office's (DO) repo facility reached new highs. This signals a shortage of bonds in the market. With less issuance and continued QE-buying, ***the shortage should have potential to increase further in 2018.***
- **Example** (how the repo facility is used): A pension fund buys 1bn SGB 1054 (5y bond) from a market-maker (a Swedish bank). If the market-maker cannot find another end-investor that want to sell 1bn SGB 1054 at the current yield level, it needs to borrow the bond temporary through the repo market. If this fails, the bond can be borrowed from DO using the repo facility to a rate = [Riksbank's policy rate – 40 bps]. In exchange the DO gets an inflow of cash that equals the present value of 1bn SGB 1054. The cash in placed in short-term AAA instruments (covered bonds with maturity < 1y for example). Through this transaction 1bn new SGB is created by the DO for a short period of time (the repo period). When the market-maker finds an end-investor that wants to sell 1bn SGB 1054, the position is closed and the repo transaction with the DO is ended.
- ***The repo facility*** thus helps the market to handle temporary supply/demand disturbances and it ***improves liquidity in the secondary market significantly***. This reduces the liquidity premium in SGBs and thus reduces the government's borrowing cost.
- Even if the volumes in the repo facility continues to be high over a longer time, it does not mean that there is a problem from the DO's viewpoint. It borrows cash at a lower rate than they deposit it in money-market instruments, so it ***is a source of additional revenues for the tax payers***.
- The problem starts when all bonds trade with repo rate at the floor. If volumes in the facility then starts to build, then this could be a sign that the market does not clear. ***The repo rate floor implicitly creates a floor to bond yields***, and these yields may be too high given the scarcity of bonds. The "high" bond yields attract buyers and the structural short position gets worse. If the repo rate floor was decreased, bond yields would plunge and volumes in the facility would plummet. ***The tax payer would likely save more money on lower bond yields than the reduced "profit" from the repo facility***. On the other hand, the DO needs to take into account the long-term liquidity issues in the market. A change of the repo facility would be a major cataclysm in the bond market and would likely increase yields as a new risk-premium would have to be priced in. All-in-all, ***we believe the DO will stick to the facility with unchanged terms, but it is far from unproblematic***.

Fig 3 Debt Office repo facility and the average 1w repo rate



Source: Nordea Markets and Macrobond

Fig 4 The surge in repo quantities suggests a lower "fair-value" for repo rates



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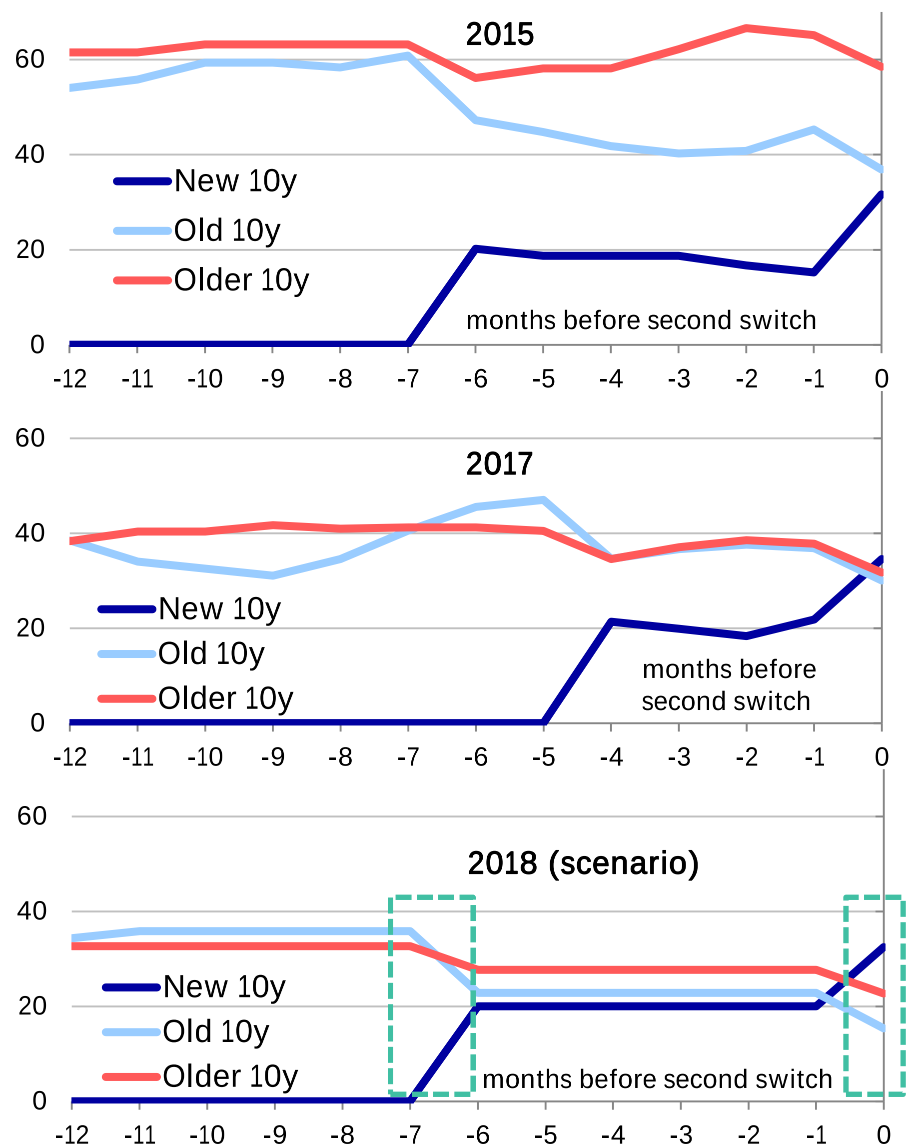
"Oh... I'm afraid the QE-program will be quite operational when the SGB 1061 arrives."

- 30 May, a new 10y government benchmark bond will be launched by the Debt Office (SGB 1061, maturity 12 Nov 2029)
- 31 May-4 June the Debt Office will execute bond switches in order to build volume in the new 10y bond. We expect a second bond switch in November following the historical pattern (see table below).
- The Riksbank is not expected to participate in the switches as it is not allowed to be active in the primary market.
- The QE program has reduced the free-float in the current 10y (SGB 1060) significantly and since this is a major buy-back candidate in the switches, a successful launch of new 10y is far from guaranteed.
- In a scenario where the SGB 1061 is issued with the same amounts as the previous launch, ***the free-float in SGB 1060 may decrease to 15 bn*** (no assumptions made on issuance and QE-buying over period) by year-end. The actual free-float may be higher as Debt Office will likely have to issue the bond in regular auctions.
- The cheapness of SGB 1060, both in the repo market and on the swap spread curve sticks out in this perspective.
- As Debt Office will likely try to issue more 1060s running up the launch of 1061s in May, cheapness may persist for some time. Eventually we expect, SGB 1060 to richen significantly.

New 10y launch cycle		2015	2017	2018 (scenario)
	New 10y	SGB 1059	SGB 1060	SGB 1061
	Old 10y	SGB 1058	SGB 1059	SGB 1060
	Older 10y	SGB 1057	SGB 1058	SGB 1059
	1st switch	May	Jan	May
	2nd switch	Nov	May	Nov
1st switch	New 10y	20	20	20
(bnSEK)	Old 10y	15	15	15
	Older 10y	5	5	5
2nd switch	New 10y	15	12.5	12.5
(bn SEK)	Old 10y	10	7.5	7.5
	Older 10y	5	5	5

Fig 1 Free-float of outstanding amounts, bn SEK



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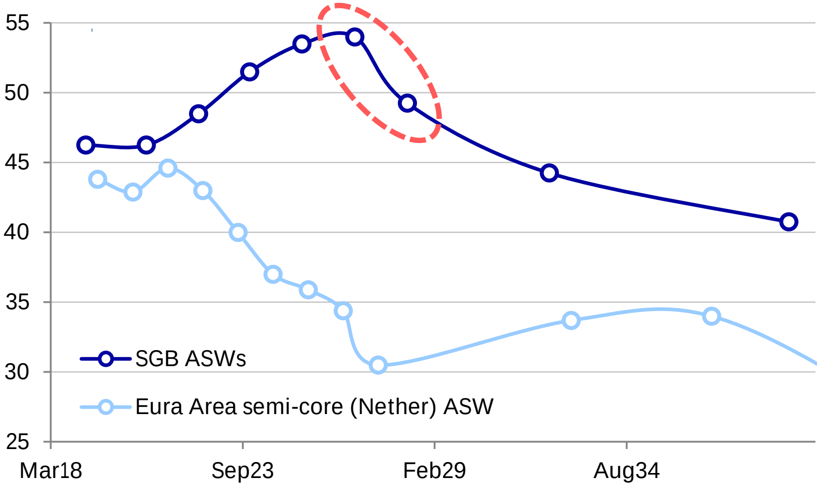
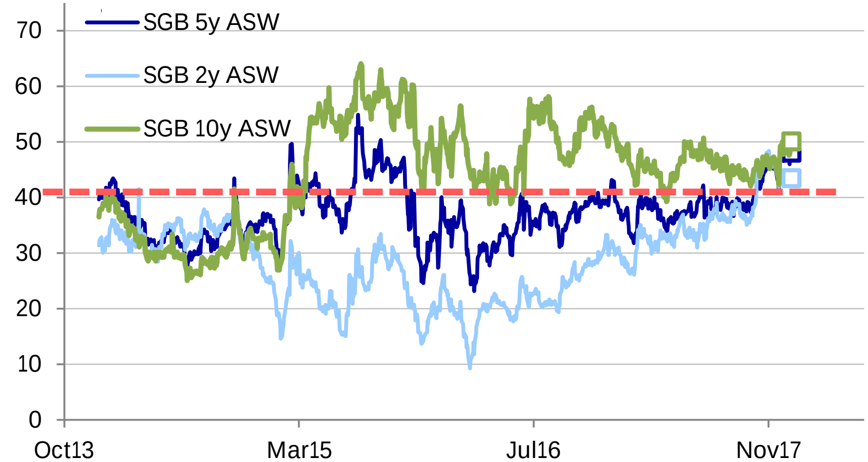
SGB swap spreads … what's high and what's low

Fig 1 Swedish ASWs high and curve steep for good reasons (bond scarcity)



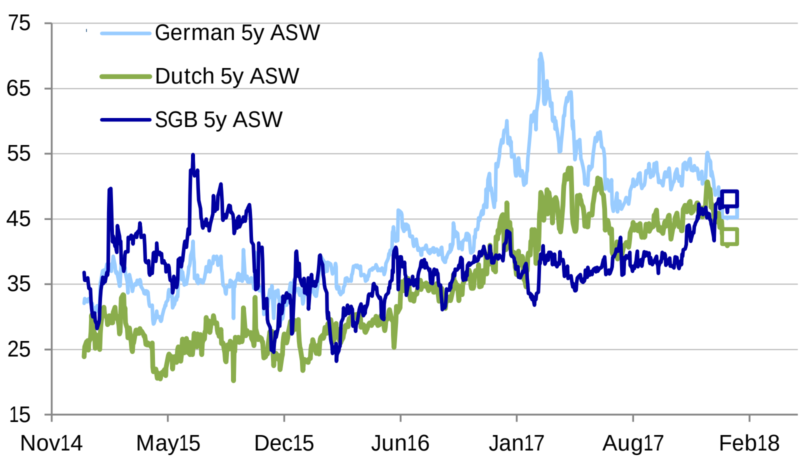
Source: Nordea Markets

Fig 2 Most tenors close to "fair-value" = 40 bps = spread [3m Stibor] - [bond repo]



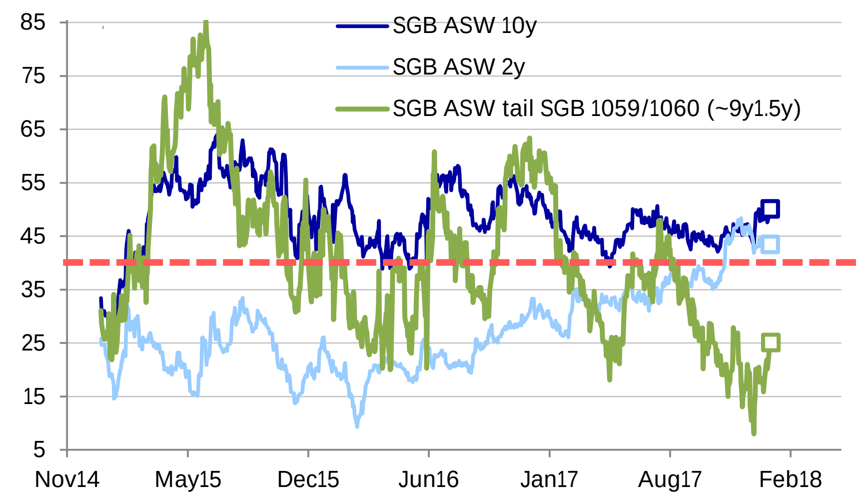
Source: Nordea Markets

Fig 3 Recent widening totally out-of-sync with Eurozone, and domestic bond issuance story behind it



Source: Nordea Markets

Fig 4 SGB 1060 sticks out as cheap and extension from SGB 1059s to 1060s make sense



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High-speed railway: A long-term swing factor for government bonds

- In the summer of 2014, the investigating team called “Sverigeförhandlingen” (in English: the National Negotiation on Housing and Infrastructure) started to explore the prospect of building a high-speed railway between Sweden’s three major cities (Stockholm, Gothenburg, Malmö).

- Since then several reports and proposals have been published by the investigation. Read a comment from us from 2016: “What a high-speed railway could mean for yields”.

- 20 December 2017, the investigation delivered their final report to the government. The main points can be summarized:
- A new railway system between Stockholm and Gothenburg & Malmö is proposed making train speed of ~320 km/h possible
- The aim is to finish it by year 2035
- Estimated cost: 230 bn in 2015 SEK (actual cost about 20% higher when adjusted for inflation)
- Funding: Exclusively through the Debt Office, i.e. through bond issuance

- The political parties are split in their stance towards the building the railway. The negative socio-economic consequences presented in the final report do not help. The investigation argues that making socio-economic cost/benefit calculations are notoriously difficult and the estimated negative consequences are no worse than for other comparable projects.

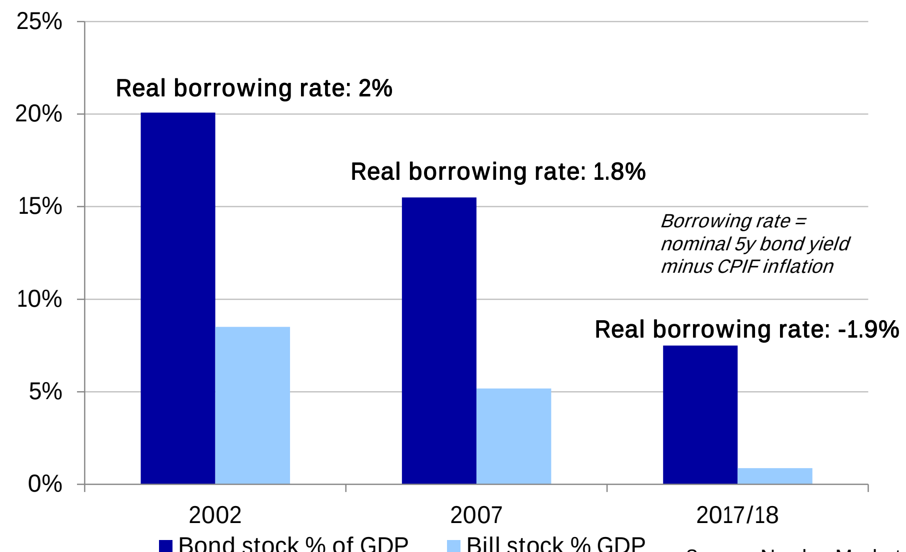
- Although we see no reason to believe that a decision on the project will be made this election year, there are a number of factors that speak for the railway becoming a reality.

- The need to catch up in infrastructure investments is a consensus view in the public opinion. It is difficult to quickly find large infrastructure projects and the railway investigation has the timing perfect.

- Interest rates are at record-lows and even negative when adjusting for inflation. The government thus “gets paid” in real terms when borrowing for investments. The debt are at record-low level, even so that low that it risks influencing negatively on bond market liquidity and thus on government borrowing cost. The Riksbank has bought close to 300bn SEK in QE and in a way the Riksbank has already pre-paid for the railway.

- The railway is suggested to be funded through issuance of government bonds. Over several years, up to 200bn in SEK nominal bonds may have to be issued to fund the railway and the duration of borrowing should be expected to be long. This makes the railway the single biggest “swing factor” for the government bond stock together with a potential housing crash.

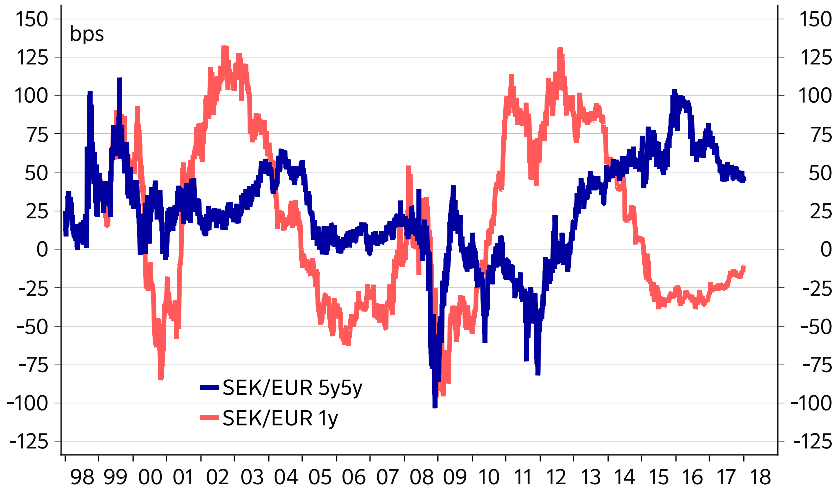
Fig 1 Outstanding amounts of bonds and bills (minus what the Riksbank has bought) compared to some earlier years



Source: Nordea Markets

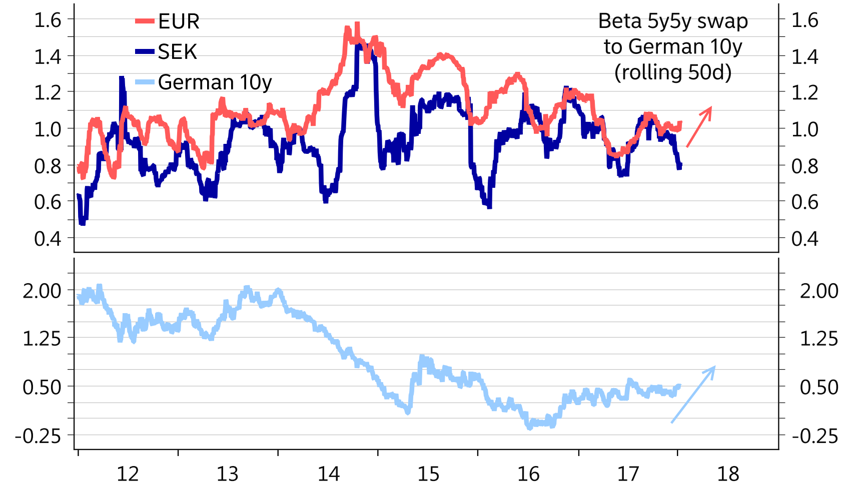
A glimpse into the SEK 5y5y chamber of horrors

Fig 1 The spread SEK vs EUR 5y5y is a horror trade, near impossible to have view on. It develops seemingly arbitrarily, independent on monetary policy



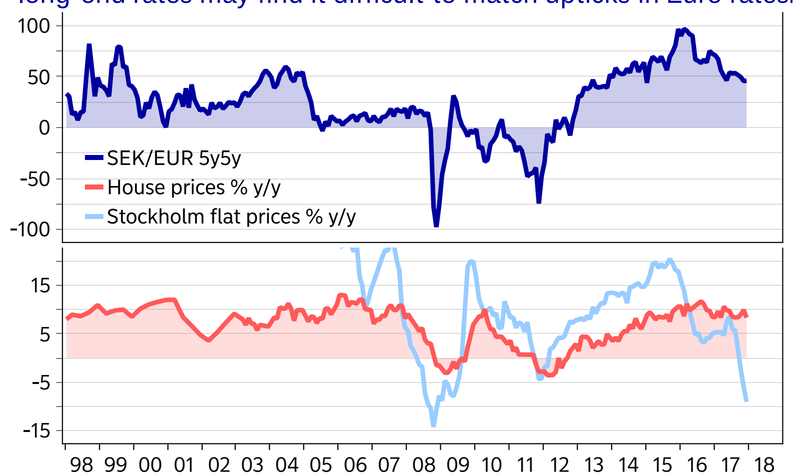
Source: Nordea Markets and Macrobond

Fig 2 EUR 5y5y has a higher beta to bunds than SEK. If global bon yields break on the upside, the higher beta should push EUR 5y5y more than SEK



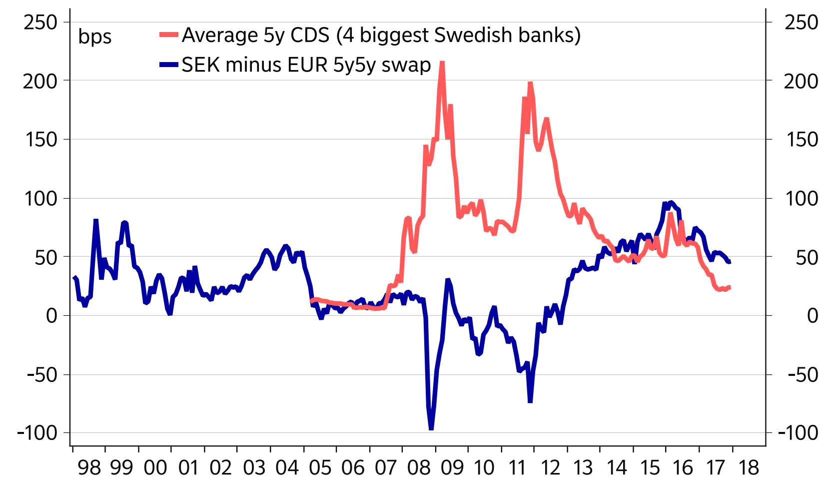
Source: Nordea Markets and Macrobond

Fig 3 Swedish housing market has been a driver of growth, but may going forward be a drag. If global macro momentum continues Swedish long-end rates may find it difficult to match upticks in Euro rates.



Source: Nordea Markets and Macrobond

Fig 4 If risk scenario in housing market materialize, credit concerns regarding banking system may emerge. Historically, spikes in credit premium have coincided with lower SEK 5y5y for obvious reasons



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