

Reading the Markets Norway

Norges Bank on track for gradual normalisation

- **Macro: the oil-drive upturn continues**
- **Fixed income: reiterating strategies for steeper FRA curve**
- **NOK FX: resilient to risk-off, we stay short EUR/NOK for now**

New trades: Buy NOK FRA 3m SEP 21 and sell NOK FRA 3m DEC 20

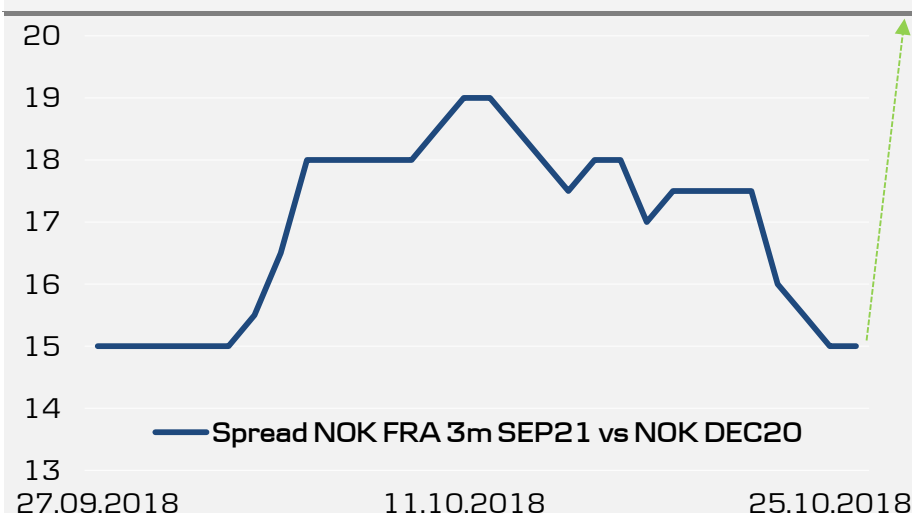
Closed trades: No closed trades

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

Relative value	Last update		
FX	Position for next move higher in NOK		
	23.04.2018		
Curve view (NGB)	Steeper curve on wage inflation		
	23.04.2018		
Swap spreads (ASW)	ASW-spread widening vs international peers		
	20.08.2018		
Spread vs peers	Wider swap spreads vs international peers on wage inflation		
	23.04.2018		
Short-end (<2y)	Market gradually moving towards Norges Bank's projections		
	02.07.2018		
Norges Bank's policy rate	3m	6m	12m
	0.75 %	1.00 %	1.25 %

Source: Danske Bank

Chart 1. Go Green! be positioned for a steeper FRA curve in 2021



Source: Macrobond Financial, Danske Bank

18th issue 2018

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

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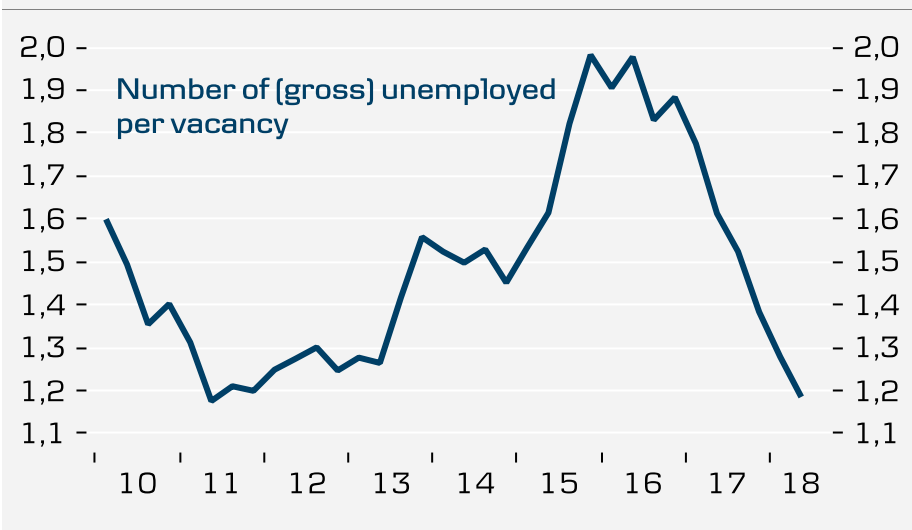
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The oil-drive upturn continues...

The cornerstone of our view of the Norwegian economy over the next three to four years is an expectation of an oil-driven upswing. With oil prices looking set to be in the USD70-85 range over the next few years, the low cost levels in the Norwegian sector are making a larger proportion of the oil companies' investment portfolio profitable, and making it more tempting to explore for new fields. As yet, we have not seen any real signs of this upswing in hard data, but it has been showing up in the oil investment survey and various panel surveys. The tendency survey for the manufacturing sector showed during last week that this trend is continuing. The overall confidence indicator was unchanged at 8.9, its highest since 2012, and the indices for orders are also up around their best for the past six to seven years.

Chart 2. The labour market is clearly tightening



Source: Macrobond Financial, Danske Bank

...into a tight labour market

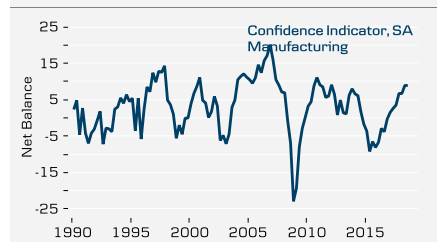
Unemployment has fallen less quickly than expected lately. In principle, this could be a sign that the labour market is deteriorating, as might result if growth were slowing. We do not believe this to be the case, as all growth indicators suggest that growth is holding up.

Instead, higher unemployment seems to be due to stronger growth in the labour supply rather than slower job growth. The quarterly rate of increase in employment is still at 17,000 persons, the highest for more than six years. Meanwhile, the labour supply has really begun to take off, with 22,000 more persons in the labour force in Q3 than in the previous quarter.

What is more, almost all labour market indicators point to demand for labour holding up, or even accelerating. Data from Statistics Norway also show that the number of vacancies in Norway climbed to 68,700 in Q2, up more than 9000 on a year earlier. If we compare this with gross unemployment (which includes job creation schemes), the UV ratio in Norway is now 1.18, which is its lowest since Q2 11 and suggests that the labour market is already relatively tight.

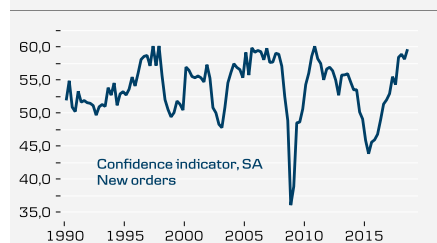
On 8 November, Statistics Norway will publish Q3 figures for the number of vacancies. Another strong reading will, in combination with unchanged or rising unemployment numbers, suggest increasing bottleneck problems in the labour market.

Chart 3. Manufacturing activity is accelerating...



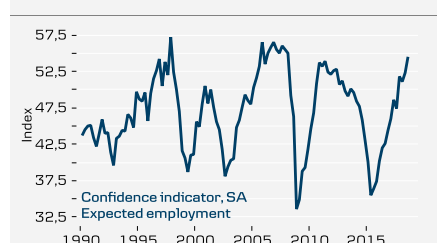
Source: Macrobond Financial, Danske Bank

Chart 4. ...partly driven by strong growth in new orders...



Source: Macrobond Financial, Danske Bank

Chart 5. ...and higher employment



Source: Macrobond Financial, Danske Bank

Chart 6. Stronger growth in labour supply



Source: Macrobond Financial, Danske Bank

Fixed income: steeper green NOK FRA curve

The market discounts too few hikes during the end of 2020 and 2021

For 2019 and the first part of 2020 the market is basically in line with Norges Bank's 20 September MPR 3/18 projection of close to two hikes per year. Norges Bank sees a 3m nibar on average in Q2 20 at 1.89% (the estimate is formally given as an average of the key policy rate in the present and next quarter plus an estimate of the money market premium). The average of the NOK FRA 3m MAR20 and JUN20 is at present 1.77%. That is, the market is 12bp under the path of Norges Bank. The end-point of Norges Bank's path, i.e. Q3 21, is a money market rate of 2.43%. The average of NOK FRA 3m JUN 21 and SEP 21 is 2.13%, i.e. a spread of 30bp. In other words, the market is behind Norges Bank's projection by one hike approximately by the end of 2021. (Chart 8).

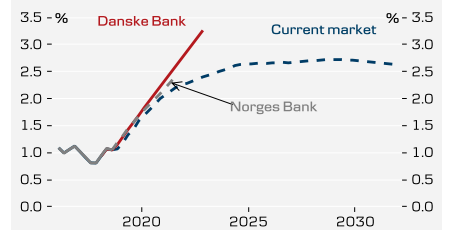
For 2021 the FRA curve is excessively flat both relative to Norges Bank's projection and our positive base case for the Norwegian economy. We therefore suggest being positioned for a steeper 'green' part of the FRA curve, i.e. we suggest buying NOK FRA 3m SEP 21 and selling NOK FRA 3m DEC 20. The spread is at a low 15bp (Chart 1). We suggest a target of 35bp and a stop-loss at zero. Our target corresponds to a case where the market discounts close to two hikes in 2021 – i.e. in line with the expected hiking pace of 2019 and 2020. Note that Norges Bank has recently argued for a neutral real interest rate in Norway close to zero. However, estimates of the neutral real rate of international peers have been adjusted upwards recently and it is reasonable to assume that an upwards revision is on the cards for the Norwegian real rate as well. This, combined with the fact that the output gap for the Norwegian economy is already closed and the economy probably will be running above potential during 2019, make it reasonable to assume higher interest rates than the neutral rate for end 2020 and during 2021. We believe the end-point of the hiking cycle, in money market interest rate terms, is higher than the end-point of the current Norges Bank projection of 2.43%. (Chart 9).

Chart 8. 3M Nibar fwd below Norges Bank's projections – especially 2021



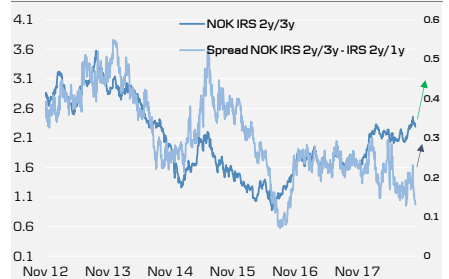
Source: Norges Bank, Macrobond Financial, Danske Bank

Chart 9. We see a higher end-point of the interest rate normalisation process than NB and the market



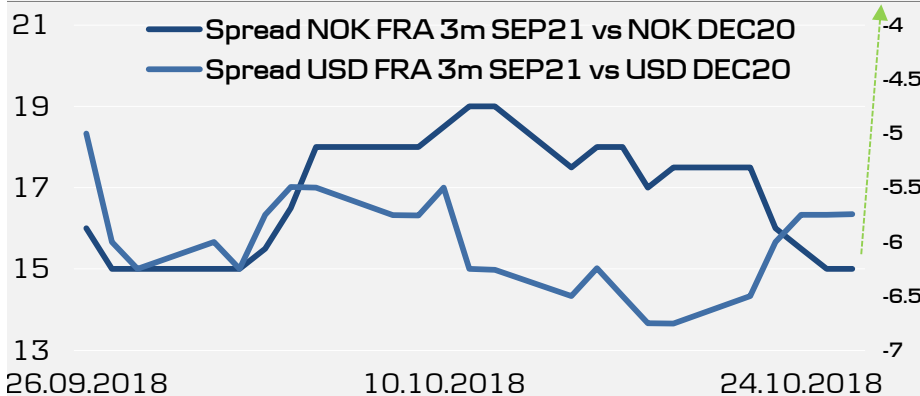
Source: Norges Bank, Danske Bank

Chart 10. Strategy for outright higher interest rates NOK IRS 2Y/3Y



Source: Danske Bank

Chart 7. Spread NOK 3m FRA MAR21 vs. DEC20 and the US equivalent



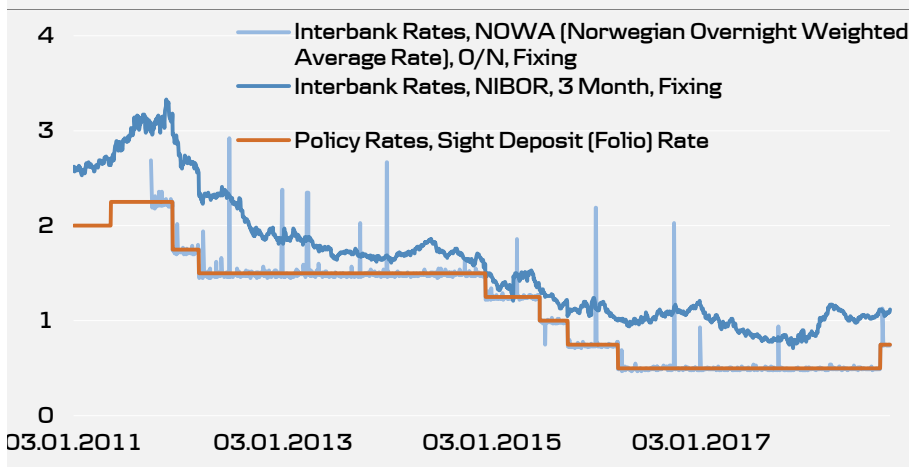
Source: Danske Bank

The current flatness of the Norwegian 2021 FRA curve is probably to some extent affected by the corresponding US curve flatness. The spread USD FRA 3m SEP 21 and USD FRA 3m DEC 20 is negative at -6bp (Chart 7). This illustrates that we cannot rule out a downward sloping green part of the FRA curve even in an economy growing above potential. However, Norway is still very early in the hiking cycle, which should reduce the risk of an inversion of the curve short-term.

The reference rate reform process: interim report from the working group released

On 23 October the working group on alternative reference rates released an interim consultation report. The group seems to favour an ‘extended’ Nowa as the most likely alternative to Nibor. The current Nowa (Norwegian Overnight Weighted Average) is the rate on unsecured overnight interbank lending in NOK. Nowa is to a large extent based on actual trades – which is a key criterion for being a viable alternative as a reference rate under the current regulative regime. Nowa is, however, volatile close to quarterly and year-end turns. Nowa is occasionally based on estimates close to turns. To circumvent this imperfection the group favours the introduction of an extended Nowa, which will also include overnight transactions between banks and non-bank market participants. Norges Bank has taken the initiative to introduce daily reporting of money market transaction data. These data will be collected from the end of Q1 next year. The next step in the reform process is an open meeting on 20 November. Central Bank Governor Øystein Olsen will give an introductory statement at this event. The 23 October report is available on [Norges Bank’s webpage](#).

Chart 11. The Nowa interest rate, the sight deposit rate and 3m Nibor



Source: Danske Bank

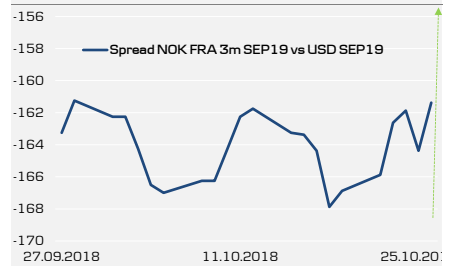
Strategy review – we keep existing strategies open

For late 2019 and beyond market rates at present are below Norges Bank’s projection. We therefore reiterate our strategy of outright higher interest rates NOK IRS 2Y/3Y. We opened the strategy on 1 October at an interest rate of 2.30%. For a while this strategy showed a substantial profit but in line with lower interest rates among international peers the strategy is now below start levels. The current level is 2,26%, i.e. a loss of 4bp. See Chart 10.

We also keep open the strategies for higher NOK FRA mid-segment contracts versus international peers. That is, we suggest a spread widening between NOK FRA 3m SEP 19 versus the US equivalent and between NOK FRA 3m SEP20 versus the SEK equivalent. So far the spreads have been fairly stable, but we see substantial spread widening if we are right about a pick-up in oil investment activity during the autumn. See Charts 12 and 13.

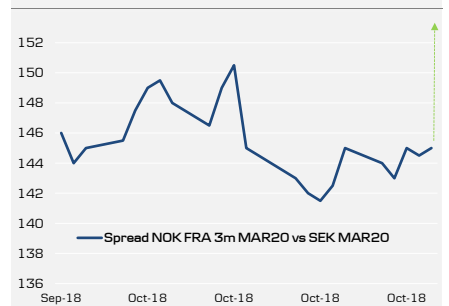
In 15 October’s *RtM Norway* we argued for a wider asset swap spread – absolute and in a box versus Germany. The Norwegian asset swap spreads have recently been slightly affected by the Italian turmoil. This is not surprising in light of the NGB market being characterised by low liquidity compared to peers. In light of the relative quality of state finances the spill-over from the Italian to the Norwegian market is somewhat absurd. We therefore reiterate the strategy of being positioned for an AWS-spread widening in the 10-year benchmark NGB NST480. The spread is at present 35bp versus 34bp two weeks ago.

Chart 12. Spread 3M NOK FRA MAR19 vs USD eq.



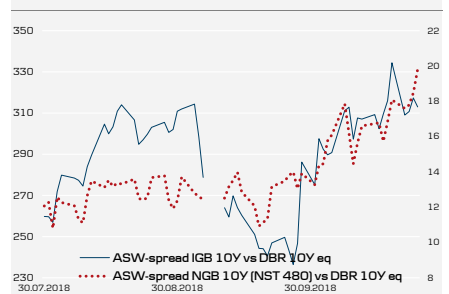
Source: Danske Bank

Chart 13. Spread 3M NOK FRA MAR20 vs SEK eq.



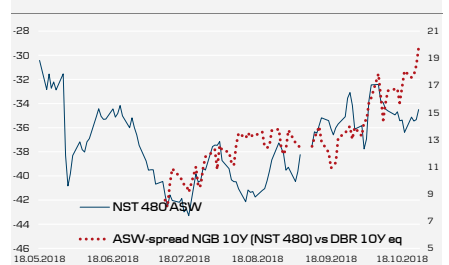
Source: Danske Bank

Chart 14. Long-end NGB AWS-spread vs Germany and the Italian eq.



Source: Danske Bank

Chart 15. ASW spread NST480



Source: Danske Bank

FX – resilient to risk off, stay long NOK

We remain short EUR/NOK spot outright, live PnL +2.5% (target 9.20, revised stop-loss of 9.6425). Little has changed since the last edition and we are still contemplating taking profit on year-end seasonality, lack of near-term triggers and SEK risk should the December Riksbank hike get re-priced. That said NOK has been remarkable stable recently despite a sell-off in equities and oil. Hence, for now we stay short EUR/NOK on carry and on the strategic attractiveness of the NOK.

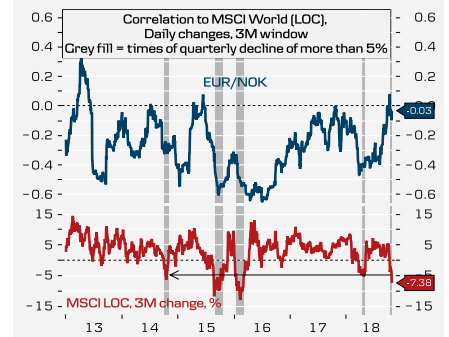
Strategic attractiveness limits selling pressures amid risk-off

Generally speaking, the NOK FX case is little changed since the previous issue: strategically we see a strong case for a lower EUR/NOK but the near-term tactical case remains tricky. The cross has for some time been rangy within 9.40-9.60 and given investor focus on historical year-end NOK vulnerability it still seems difficult to see a break below 9.40 on this side of New Year without a re-pricing of NB monetary policy. However, with inflation losing momentum on lower imported inflation and domestic food prices, with NB’s conservative NOK projection for Q4 and with NB essentially having to trigger the repricing themselves (given its September communication) this is unlikely to happen in the coming weeks.

That said, the NOK has also been remarkably resilient to the latest risk-off environment. Over the past few years the NOK has sold off heavily versus both the EUR and the USD in risk-off environments resembling the current one (Chart 16). Meanwhile this time EUR/NOK moves towards the top end of the range have triggered selling interests suggesting that investors are more comfortable being long NOK now on the back of the strong strategic case. Hence, for now we will continue to enjoy positive carry on our short position but we follow global risk and SEK price action closely. Also, while long NOK/SEK positioning seems crowded (anecdote based) we are not worried about aggregate NOK positioning due to the weekly NB flow data (Chart 19).

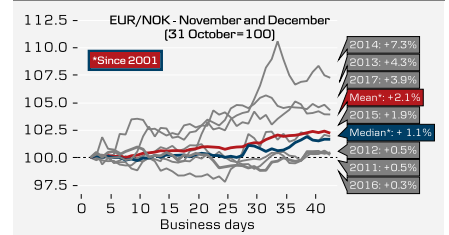
Note: for investors worried about NOK seasonality we have back-tested the strategy of buying 2M at-the-money-forward call options on 31 October since 2001 (inflation target change). This strategy has yielded right skewed returns throughout the period with an average and median return of 1.0% and 0.1%, respectively. Performance over the past 5 years has been even better.

Chart 16. The NOK has been remarkably resilient to recent risk-off



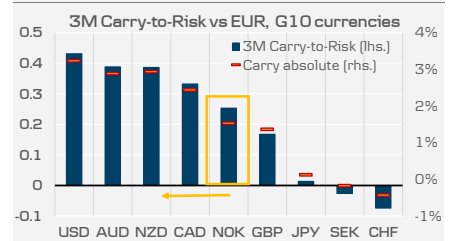
Source: Macrobond Financial, Danske Bank

Chart 17. Seasonality vulnerability fresh in investors' memory



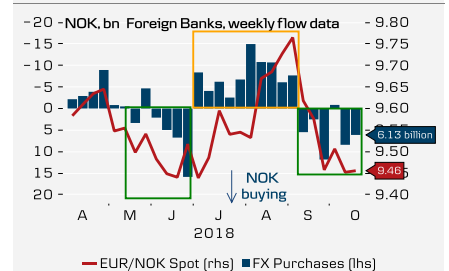
Source: Macrobond Financial, Danske Bank

Chart 18. G10 carry comparison



Source: Macrobond Financial, Danske Bank

Chart 19. Aggregate NOK positioning not stretched even if long NOK/SEK position is crowded



Source: Danske Bank

Historically, EUR/NOK call options have yielded right skewed returns for year-end

Option strategy backtest: buy 2M ATMF EUR/NOK call on 31 October (MF)										
Year	Entry	+1M	Expiry	Entry	Strike	Price	B/E maturity	PnL after 1M	Spot Expiry	PnL at maturity
2017	31-Oct	30-Nov	29-Dec	9.522	9.540	0.09	9.63	3.0%	9.8432	2.2%
2016	31-Oct	30-Nov	30-Dec	9.064	9.090	0.11	9.20	-0.5%	9.0874	-1.2%
2015	02-Nov	02-Dec	04-Jan	9.354	9.373	0.16	9.53	-1.3%	9.6313	1.1%
2014	31-Oct	28-Nov	31-Dec	8.456	8.477	0.08	8.56	3.0%	9.0607	5.9%
2013	31-Oct	29-Nov	31-Dec	8.084	8.103	0.09	8.20	1.5%	8.3588	2.0%
2012	31-Oct	30-Nov	31-Dec	7.396	7.417	0.06	7.48	-0.7%	7.3359	-0.9%
2011	31-Oct	30-Nov	30-Dec	7.695	7.715	0.10	7.81	0.0%	7.7423	-0.9%
2010	01-Nov	01-Dec	03-Jan	8.154	8.173	0.12	8.29	-0.9%	7.7909	-1.4%
2009	02-Nov	02-Dec	04-Jan	8.508	8.525	0.13	8.66	-0.9%	8.2294	-1.5%
2008	31-Oct	28-Nov	31-Dec	8.528	8.553	0.22	8.78	0.5%	9.7201	11.0%
2007	31-Oct	30-Nov	31-Dec	7.788	7.802	0.08	7.88	4.2%	7.9335	0.7%
2006	31-Oct	30-Nov	29-Dec	8.345	8.344	0.08	8.42	-0.9%	8.2354	-1.0%
2005	31-Oct	30-Nov	30-Dec	7.786	7.789	0.06	7.85	1.3%	7.9854	1.7%
2004	01-Nov	01-Dec	03-Jan	8.153	8.150	0.08	8.23	-0.3%	8.2389	0.1%
2003	31-Oct	28-Nov	31-Dec	8.252	8.262	0.09	8.35	-0.7%	8.3979	0.6%
2002	31-Oct	29-Nov	31-Dec	7.382	7.429	0.07	7.50	-0.9%	7.2721	-1.0%
2001	31-Oct	30-Nov	31-Dec	8.008	8.053	0.07	8.12	-0.3%	7.9883	-0.9%

Source: Danske Bank Markets

EUR/NOK strategy: stay short EUR/NOK for now

Forecast. 9.40 (1M), 9.40 (3M), 9.20 (6M), 9.10 (12M).

Leveraged funds. We recommend staying short EUR/NOK for now.

Bond investors should seek to lower hedge ratios on NOK exposure (3-6M horizon).

Real-money funds. We recommend rolling EUR hedges short (3M) while extending USD hedges further out on the curve (1Y).

Table 2. Open strategies and trades with recent status change

Type	Trade	Idea	Target & P/L	Status
Money Market	Buy NOK FRA 3m SEP21 and sell NOK FRA 3m DEC20	Steeper NOK green FRA curve as market buys into the NB normalisation process	Opened 29-Oct-2018 Start 15 Target/stop 35/0 Now 15 P/L 0	New
Money Market	Wider ASW-spread 10Y benchmark	Increased ASW-spread NST480 relative to German equivalent: "Risk on", strong-Nok-trend generated demand for NGB and increased payer interests in swaps	Opened 15-Oct-2018 Start -34 Target/stop -43/-29 Now -35 P/L 1	Hold
Fixed income	Buy NGB NST 480 26 Apr 2028 in an ASW-box vs Germany	Increased ASW-spread NST480 relative to German equivalent: "Risk on", strong-Nok-trend generated demand for NGB and increased payer interests in swaps - relative to international peers	Opened 15-Oct-2018 Start 15 Target/stop 0/22 Now 20 P/L -5	Hold
Money Market	Pay NOK IRS 2Y3Y outright	Market still significantly below NB guiding and NB may upward revise the real interest rate estimate	Opened 1-Oct-2018 Start 2.3 Target/stop 2.65/2.15 Now 2.26 P/L -4	Hold
Money Market	Buy NOK 3m FRA SEP 19 and sell USD 3m FRA SEP19	Norway at the start of the hiking cycle and the US cycle start to mature - too flat Norwegian curve first half of 2019 vs US- urve	Opened 17-Sep-2018 Start -157.5 Target/stop -130/-172 Now -162 P/L -4.5	Hold
FX	Sell EUR/NOK FX spot outright	Sell EUR/NOK spot outright as a strategic 3M trade on valuation, Norges Bank, positioning and fading NOK headwinds	Opened 11-Sep-2018 Start 9.7125 Target/stop 9.22 Now 9.571 P/L 2.50 %	Hold
Fixed income	Buy NGB 2.0% May-23 (NST 475) in an ASW box vs Germany	Increased ASW-spread NST475 relative to German equivalent: "Risk on" and NB hike: Strong-Nok-trend generated demand for NGB and increased payer interests in swaps - relative to international peers	Opened 20-Aug-2018 Start 15 Target/stop 0/25 Now 7 P/L 8	Take profit
FX	Sell 2W straddle	Play rangy spot and lower volatility by selling short-dated straddle	Opened 16-Jul-2018 Start 9.4852 Target/stop NA Now P/L 0.5	Take profit

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

Money Market	Buy NOK FRA 3M MAR20 and sell SEK FRA 3M MAR20	Steeper NOK FRA curve for 2019-20 on stronger relative Norwegian economy vs Sweden	Opened Start Target/stop Now P/L	26-Jun-2018 146 170/135 145 -1	Hold
Fixed Income	Reduced asset swap spread NST 476	Tighter mid segment ASW spread on less concave IRS and reduced international political risk	Opened Start Target/stop Now P/L	13-Jun-2018 -42.5 -27/-48 -45 -2.5	Closed 20 Aug
FX	Enter 3M bearish EUR/NOK ratioed seagull	Position for next leg lower in EUR/NOK as Norges Bank hiking cycle constitutes important fundamental trigger.	Opened Start Target/stop Now P/L	11-Jun-2018 9.515 NA 9.515 0.00 %	Expired
Money Market	Sell NOK FRA 3M DEC18 and buy NOK FRA 3M DEC 19	Market interest rates for 2019 to move towards Norges Bank's projection	Opened Start Target/stop Now P/L	28-May-2018 31 45/24 40 9	Take profit
FX	Sell NOK/SEK spot outright	Sell NOK/SEK on tactical basis as a way of positioning for modest NOK setback and continued near-term SEK support.	Opened Start Target/stop Now P/L	13-Jun-2018 1.0755 1.060/1.086 1.0739 0.13 %	Take profit
Money Market	Pay NOK IRS 4Y and SEK IRS 2Y and receive NOK IRS 2Y and SEK IRS 4Y	Relative inflation and growth outlook and lower Nibor going fwd	Opened Start Target/stop Now P/L	15-Mar-2018 -18 0/-30 -9 9	Take profit
Money Market	Pay NOK IRS 2Y/8y and SEK IRS 2Y/3Y and receive NOK IRS 2Y/3Y and SEK IRS 2Y/8Y		Opened Start Target/stop Now P/L	23-Apr-2018 -34 -15/-45 -35 1	Closed (neg profit incl spread)
FX	Sell EUR/NOK spot outright.	Downside potential on relative growth, valuation, positioning, relative rates and global outlook	Opened Start Target/stop Now P/L	5-Mar-2018 9.6541 9.25/9.84 9.495 1.69 %	Take profit 16 Mar
Money Market	Sell NOK FRA 3m JUN18 and DEC18 and buy NOK FRA 3m SEP18	Increased probability of September hike relative to December and normalisation of cash liquidity	Opened Start Target/stop Now P/L	12-Mar-2018 7.5 -10/15 -1.5 9	Take profit 12 Jun

Note: indications generally based on mid-market prices some hours ahead of the publishing of the report

Source: Danske Bank

Disclosures

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Date of first publication

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