Danske Bank
Markets

Norges Bank Preview

Rates unchanged; easing bias reiterated

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Frank Jullum
Chief Analyst
fju@danskebank.dk

Arne Lohmann Rasmussen
Chief Analyst
arr@danskebank.dk

Kristoffer Kjær Lomholt
Analyst
klom@danskebank.dk

www.danskebank.com/research

Main points

- **We expect Norges Bank to leave rates unchanged on Thursday .** There have been few important data releases since the September meeting and most economic figures are close to Norges Bank's September projections with a few important exceptions: 1) The 2016 fiscal budget was more expansionary than expected, 2) global rates are lower as central banks of close trading partners have eased or are expected to ease, 3) private consumption is looking weaker, 4) manufacturing downturn is decelerating and 5) the NOK is weaker than projected.
- We expect Norges Bank to **reiterate its September easing bias but that the statement is otherwise balanced with no clear signals that the bank is planning to cut in December.**
- **Thursday's meeting includes a rate announcement, a statement release and a Q/A session**. Importantly, no new Monetary Policy Report will be released. **The current rate path** from Norges Bank has a 64% implied probability of another 25bp rate cut on a 12M horizon and a less than13% probability of Q4 15 rate cut.
- **Main risk factor.** In our view the largest risk factor is Governor Olsen taking a more hawkish approach to the more expansionary 2016 fiscal budget.
- **Market pricing.** We estimate that markets are pricing in 0bp worth of easing for the November meeting and 29bp cumulative worth of cuts for the coming 12M (the point where most easing is priced). For the December meeting we estimate 6bp worth of cut is priced.
- **FX.** We expect EUR/NOK to remain little changed on the announcement. We do not expect a NOK appreciation trend to materialise until the Norwegian business cycle turns and Norges Bank can signal that there is no longer a need to cut rates further. In our view, this will first be a story for 2016. We target EUR/NOK at 9.30 in 1M, 9.30 in 3M, 9.25 in 6M and 8.80 in 12M.
- **Fixed Income.** If we see a further re-pricing of the Norwegian curve after the Norges Bank meeting we would see that as an opportunity to go long NGBs asset swapped or against Germany. We prefer the 8-10Y segment of the NGB curve.

Unchanged but easing bias reiterated

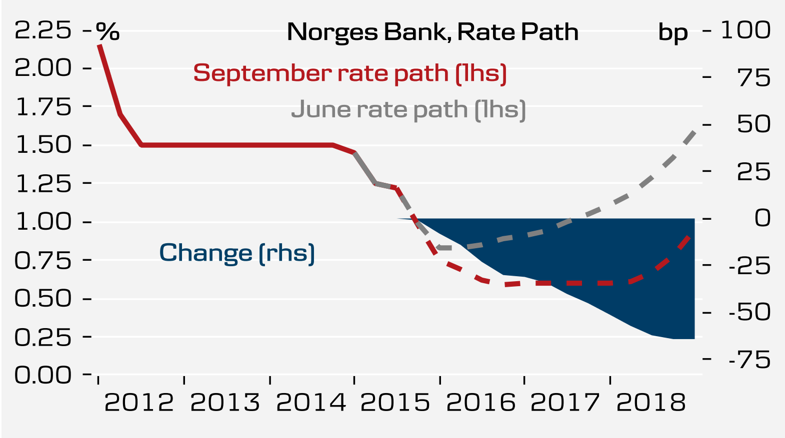
Last meeting: Norges Bank more dovish than expected

- At the last monetary policy meeting in September Norges Bank surprised markets by cutting interest rates by 25bp to 0.75%.
- The monetary policy statement read: '*The krone depreciation has pushed up consumer price inflation. Low wage growth is keeping down cost growth, and inflation will edge down as the effects of the krone depreciation unwind'* and '*The current outlook for the Norwegian economy suggests that the key policy rate may be reduced further in the coming year.'*
- At the same meeting, the revised rate path suggested an implied probability of 64% for another rate cut within 12M and an implied probability of less than13% for a Q4 15 rate cut.

5 November meeting: unchanged but easing bias reiterated

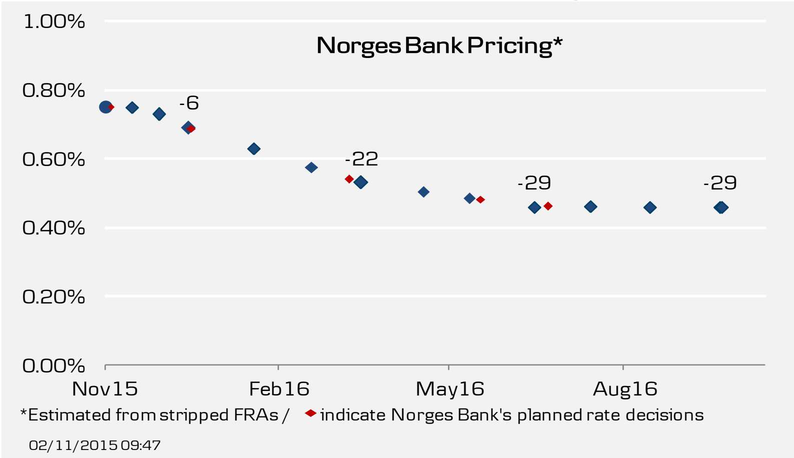
- We do not expect Norges Bank to touch interest rates on Thursday.
- We expect Norges Bank to re-iterate its September easing bias but that Governor Olsen will refrain from giving any clear signals that the bank is planning to cut in December.
- We estimate that markets are pricing in 0bp worth of easing for the November meeting and 29bp cumulative worth of cuts for the coming 12M (the point where most easing is priced). As a result we expect market focus on Thursday to primarily be on comments on how Norges Bank views the more expansionary fiscal policy.

September MPR indicates a 64% probability of a rate cut



Source: Norges Bank, Danske Bank Markets

Markets expect an additional rate cut from Norges Bank but 0bp is priced for Thursday



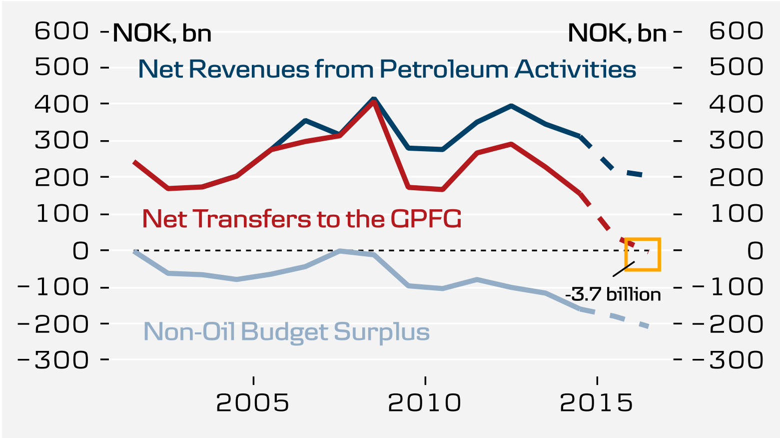
Source: Danske Bank Markets

Unchanged but easing bias reiterated

Main focus on communication regarding the 2016 fiscal budget

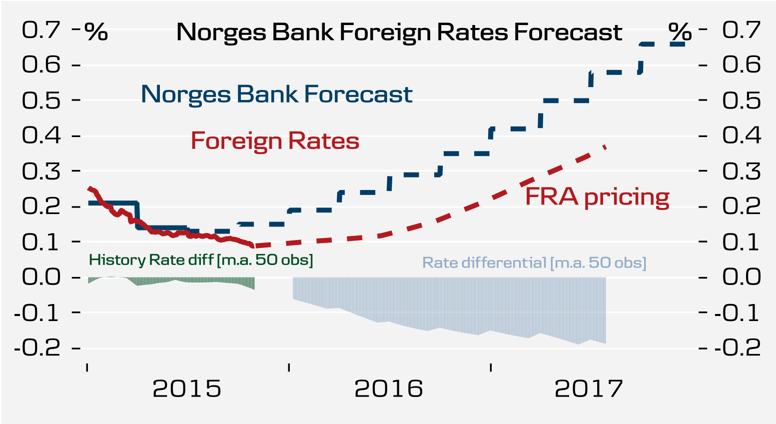
- Although recent data – especially for consumption – have been weaker than anticipated and unemployment has risen, the manufacturing downturn seems to be easing somewhat, with both the PMI and manufacturing confidence now climbing again.
- In our view the deterioration of the growth outlook is probably very close to the expectations from September. In particular, NAV-unemployment (preferred by NB) seems to be exactly in line with September forecast.
- Fiscal policy, however, is set to be roughly NOK12bn more expansionary in 2016 than assumed in the September monetary policy report. Actually, this is the most important news affecting the outlook since the September meeting.
- However, central banks outside Norway are once again headed in an expansionary direction, putting pressure on Norges Bank to follow suit. That said, the rate cut in September was justified as a precautionary move, so one could very well argue that Norges Bank is one step ahead.
- Either way, the NOK is weaker than the bank assumed in September and this is pulling in the other direction.

The 2016 fiscal budget was more expansionary than Norges Bank expected back in September



Source: Norges Bank, Danske Bank Markets

Global rates have dropped below Norges Bank's projections from September



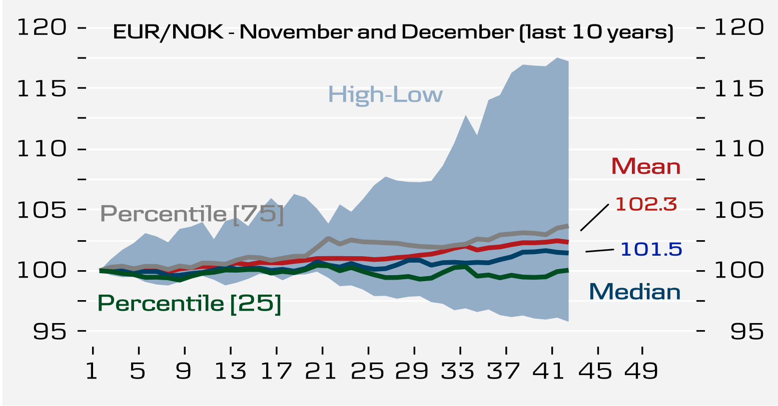
Source: Danske Bank Markets

FX – EUR/NOK to remain little changed

NOK to remain weak until the business cycle turns

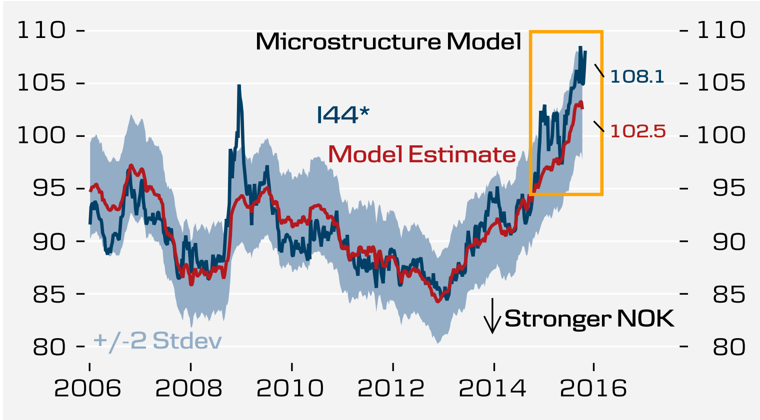
- If we are right in Norges Bank leaving rates unchanged whilst delivering a dovish – yet balanced – statement we think that EUR/NOK will remain little changed on the day. Intraday, risks are skewed towards a stronger NOK, should Olsen's fiscal policy stance be more hawkish than expected.
- Having said this, in our base case we still see some upside risk for EUR/NOK in the months ahead as markets will likely price in a 50% probability of a December rate cut and as the NOK normally is vulnerable at year-end when liquidity tends to worsen. Over the past 10 years, the NOK has on average weakened by 2.2% (1.5% median) in the last two months of the year (see the chart in margin). We see a distinct risk of history repeating itself and that also supports our call that the NOK is not likely to strengthen until in 2016.
- Recent years' severe weakening has driven EUR/NOK to historical highs. From a long-term perspective, the NOK has become fundamentally undervalued and that supports our call for gradual NOK appreciation on a long-term horizon. According to our PPP model, EUR/NOK at 8.25 would seem to be a fair long-term level but judging by historical developments, a move towards this level could take several years, so it should merely be considered a long-term anchor.
- We do not expect a NOK appreciation trend to materialise until the Norwegian business cycle turns and Norges Bank can signal that there is no longer a need to cut rates further. In our view, this will first be a story for 2016. Overall supportive 2016 factors for a stronger NOK are: 1) valuation, 2) Norges Bank re-pricing, 3) speculative short-covering, 4) a higher oil price and 5) higher growth among trading partners.
- **We still forecast EUR/NOK at 9.30 in 1M, 9.30 in 3M, 9.25 in 6M and 8.80 in 12M.**

Historical EUR/NOK distribution for November and December heavily skewed to the upside



Source: Norges Bank, Danske Bank Markets

A higher NOK risk premium remains visible in our Microstructure model



Source: Macrobond Financial, Danske Bank Markets

Fixed income – risk of re-pricing of short end

NGBs have underperformed

- The Norwegian government bond market has underperformed recently both against Germany and against swaps.
- NGBs have especially lost against Germany after the ECB opened the door for further easing at the ECB meeting two weeks ago.
- Higher issuance and continued issuance in the 10Y segment has also weighed on NGBs. The volatile NOK might also have deterred foreign interest from the Norwegian market.
- However, given the significant cheapening of NGBs not least versus swaps we start to see value in the long end of the NGB curve both against Germany and not least against swaps.

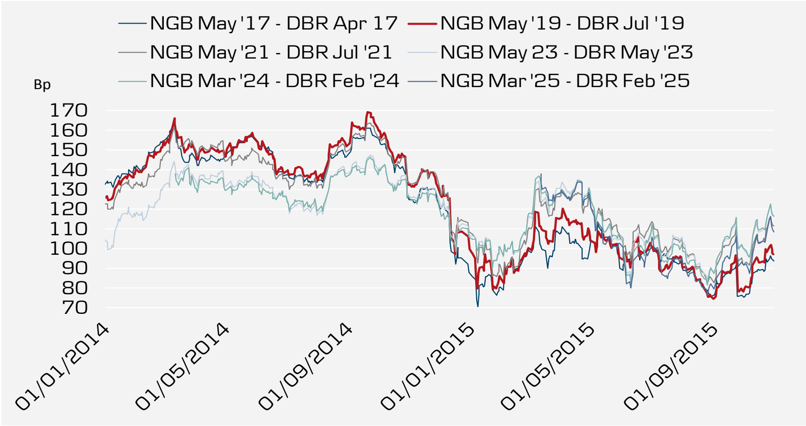
Short-term value in NOK FRAs

- However, importantly, from a risk/reward point of view we see a certain probability that Norges Ban will focus on the more expansive fiscal policy and steepen the FRA curve. Hence, we actually recommend as a short-term trade to buy NOK FRAs (Jun 16 3M FRA) ahead of the meeting. For more see our recommendation here.

Better entry level after meeting for long NGB positions

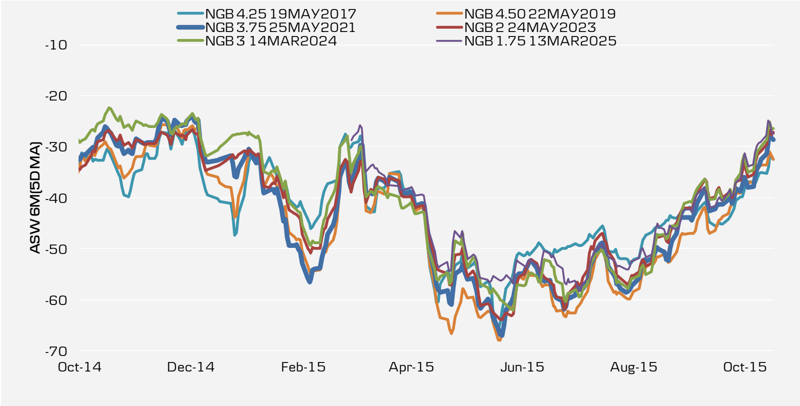
- If we see a further re-pricing of the Norwegian curve after the Norges Bank meeting we would see that as an opportunity to go long NGBs asset swapped or against Germany. We prefer the 8-10Y segment of the NGB curve.

NGBs have underperformed vs Germany...



Source: Danske Bank Markets

... and versus swaps

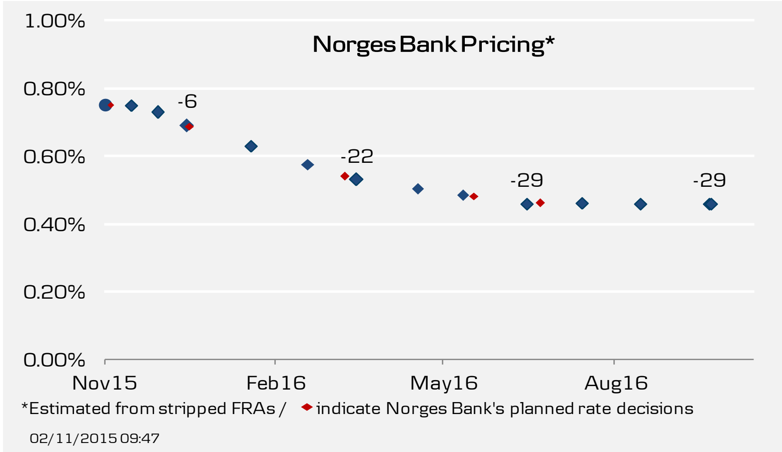


Source: Danske Bank Markets

Market pricing

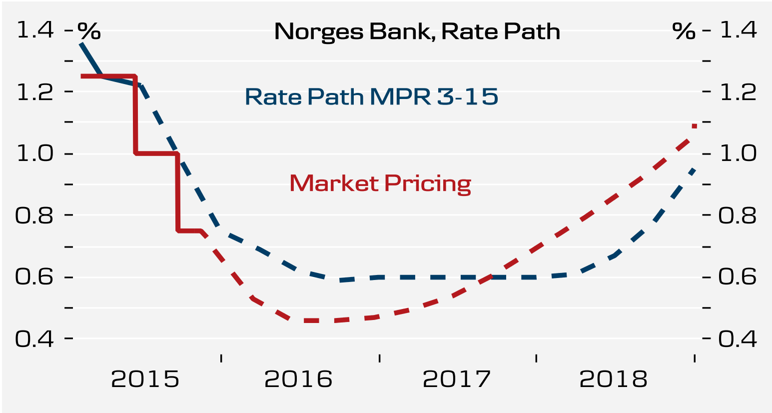
- Since there is no OIS market in Norway it is impossible to estimate what derivatives markets price of Norges Bank monetary policy.
- Best alternative: look at 3M NIBOR forward starting contracts and estimate spread to policy rate.
- NIBOR fixings are vulnerable to money market liquidity and credit risk (i.e. Money market basis).
- USD cash funding has become more expensive/ ECB QE shifts relative liquidity environment which complicates the estimation.
- Look at forward starting Cross Currency Basis swaps (isolate USD/NOK 3M break).
- **Based on this we estimate that**
  - **0bp worth of cuts is priced for Thursday's meeting**
  - **6bp worth of cuts priced for Q4'15 December meeting**
  - **29bp worth of cuts priced on a 8-12M horizon (point where the most easing is priced in)**

Markets expect another rate cut but not on Thursday



Source: Danske Bank Markets

Market pricing vs Norges Bank rate path



Source: Macrobond Financial, Danske Bank Markets

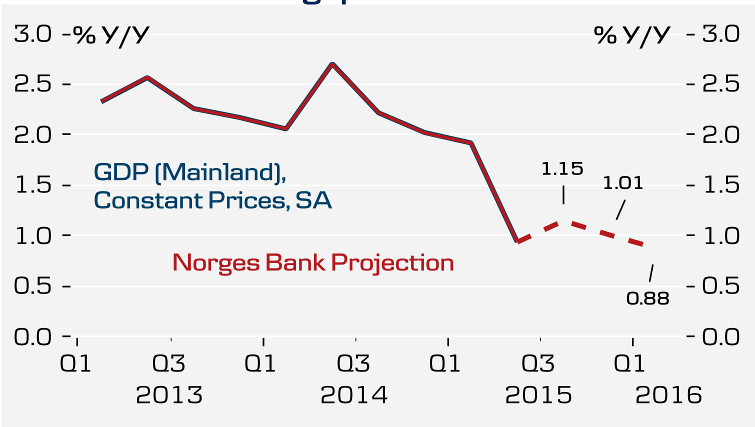
Important dates

- 17 November: Q3 GDP
- 24 November: Oil Investment Survey
- 4 December: Regional Network Survey
- 17 December: Norges Bank meeting

APPENDIX
NORGES BANK'S CHECKLIST

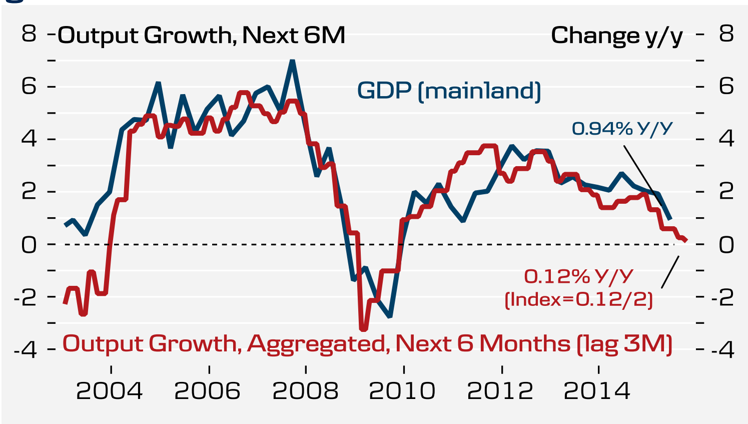
Norges Bank Monetary Policy checklist 1/6 - Growth

Norges Bank expects growth around 1% q/q ann. for the coming quarters



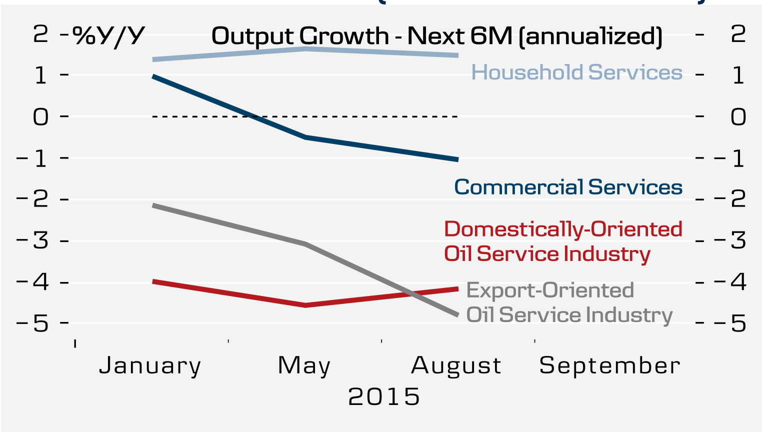
Source: Macrobond Financial, Danske Bank Markets

... despite the Regional Survey pointing to zero growth in the next 6M



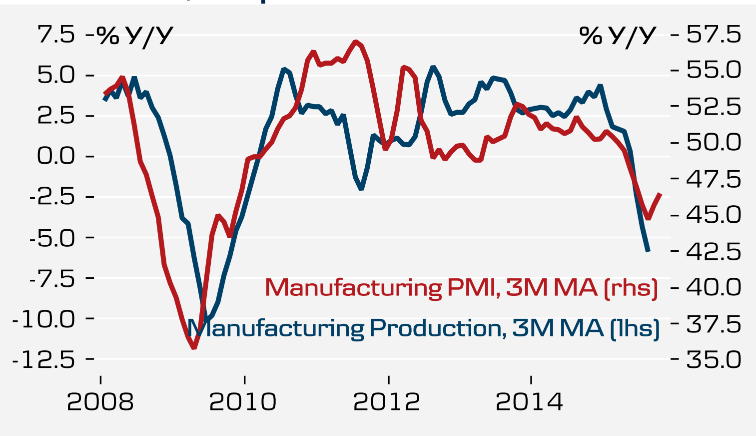
Source: Macrobond Financial, Danske Bank Markets

Norges Bank is worried about the deteriorating outlook in the service sectors (both oil and non-oil)



Source: Macrobond Financial, Danske Bank Markets

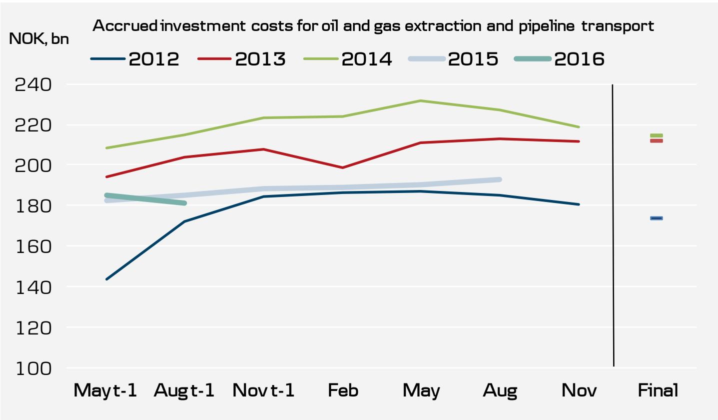
... as the manufacturing sector remains a weak link, despite the recent PMI stabilisation



Source: Macrobond Financial, Danske Bank Markets

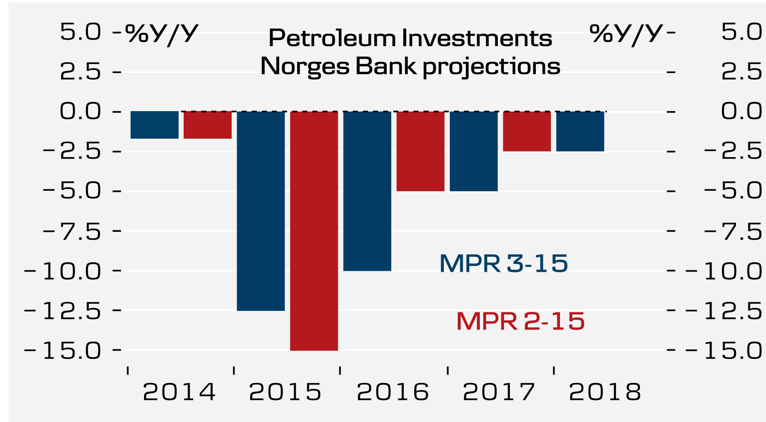
Norges Bank Monetary Policy checklist 2/6 : Investments

Oil investment outlook better than feared but does not reflect the summer's re-collapse in the oil price



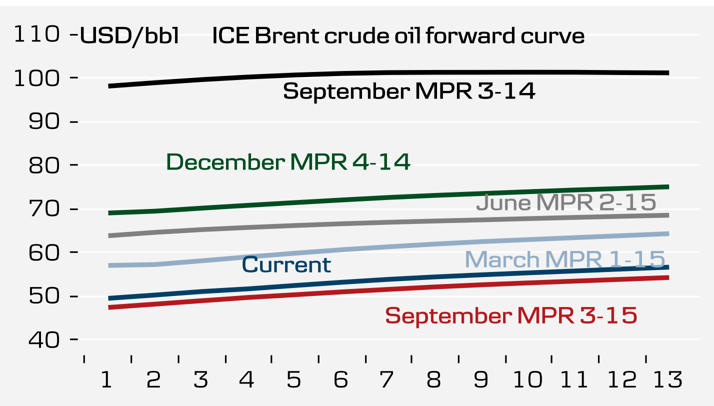
Source: Macrobond Financial, Danske Bank Markets

… and is still expected to remain a drag on growth



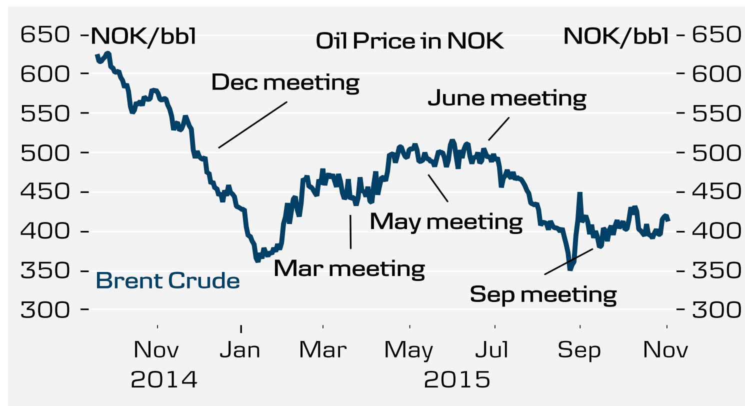
Source: Macrobond Financial, Danske Bank Markets

Oil price curve close to the September projection



Source: Macrobond Financial, Danske Bank Markets

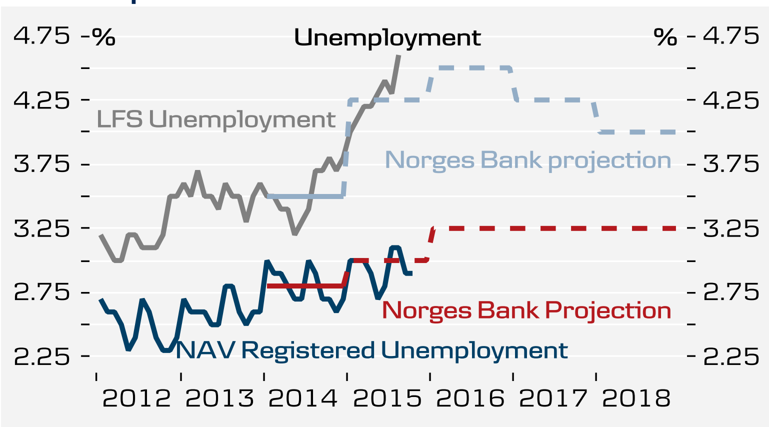
… also when measured in NOK



Source: Macrobond Financial, Danske Bank Markets

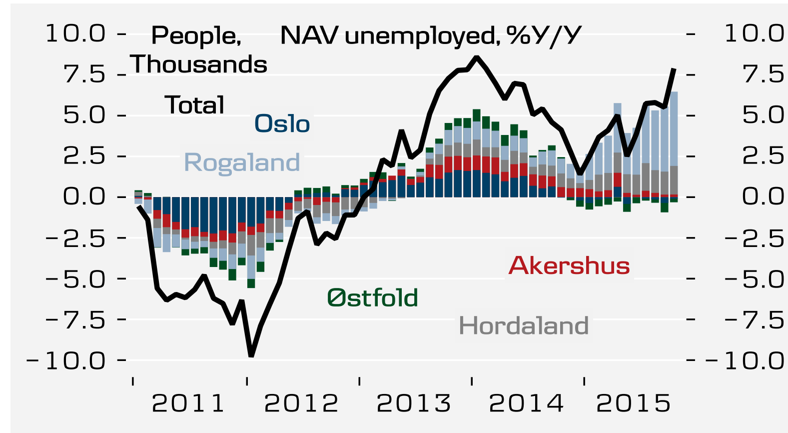
Norges Bank Monetary Policy checklist 3/6: Labour market

Higher unemployment is a threat to private consumption



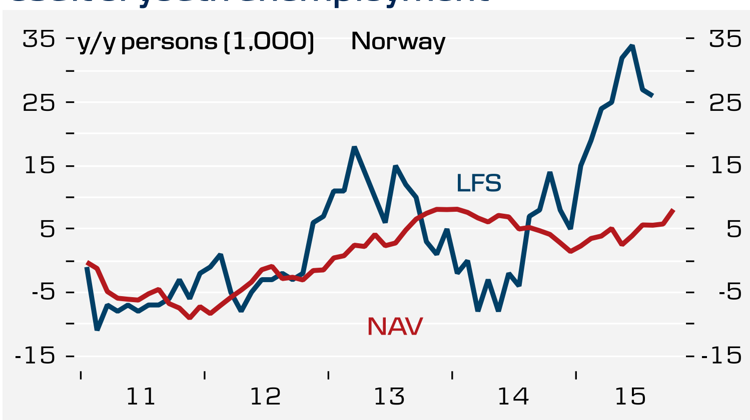
Source: Macrobond Financial, Danske Bank Markets

... but huge regional differences



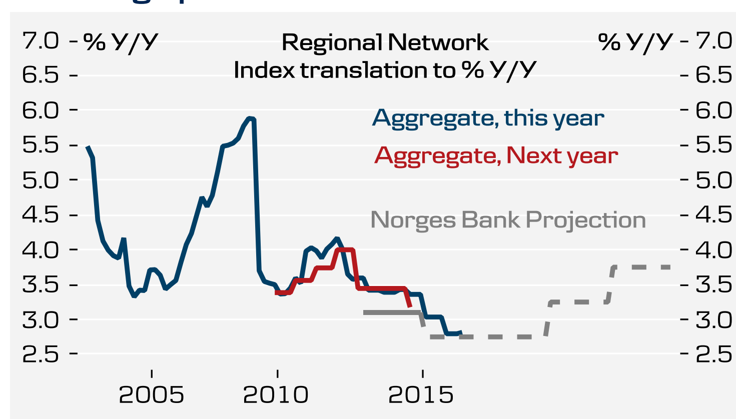
Source: Macrobond Financial, Danske Bank Markets

Unemployment measures have diverged – primarily a result of youth unemployment



Source: Macrobond Financial, Danske Bank Markets

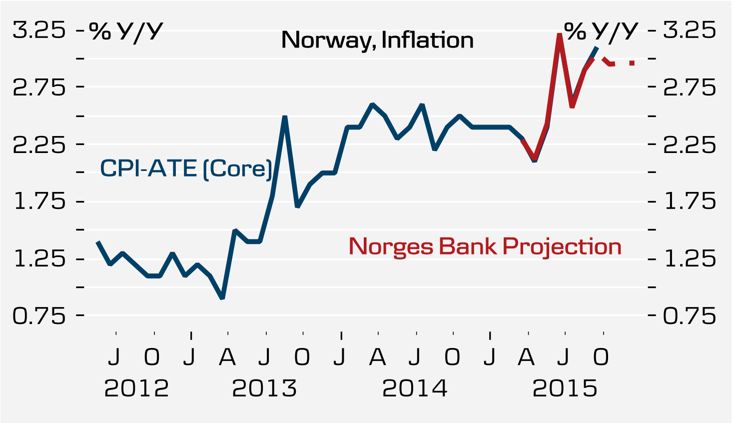
Low wage pressure



Source: Macrobond Financial, Danske Bank Markets

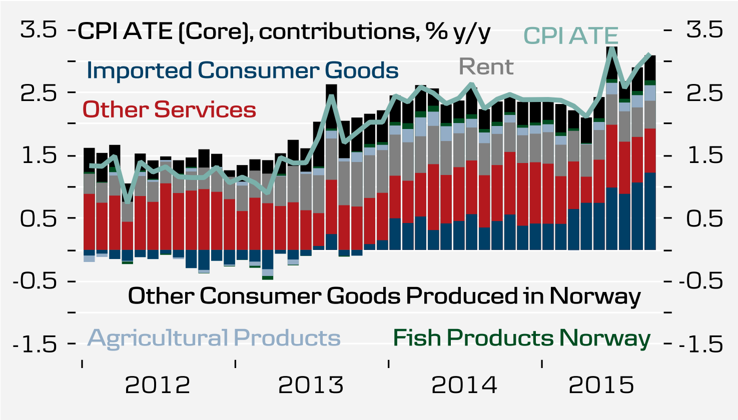
Norges Bank Monetary Policy checklist 4/6 : Inflation

Core inflation sharply higher ...



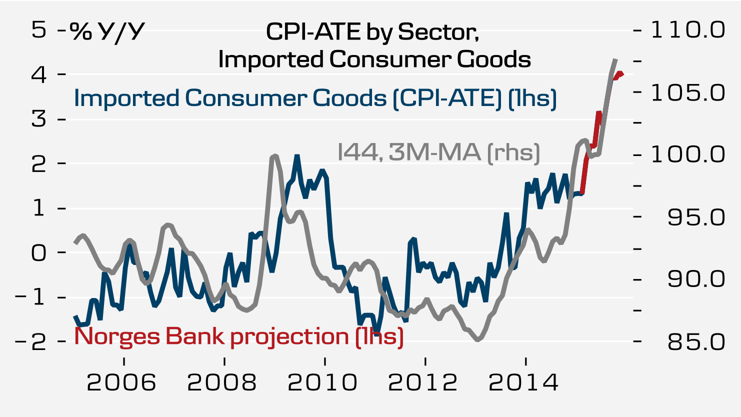
Source: Macrobond Financial, Danske Bank Markets

... driven by the significant rise in imported inflation



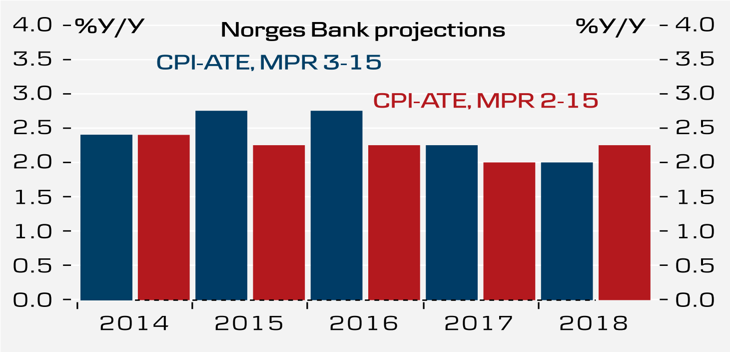
Source: Macrobond Financial, Danske Bank Markets

... which in turn is a result of a faster-than-expected transmission from the weaker NOK



Source: Macrobond Financial, Danske Bank Markets

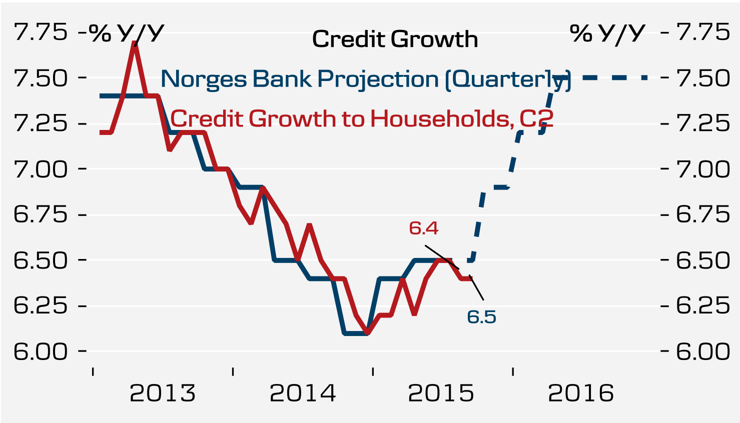
Cost-push and demand pull pressures, however, will drag inflation down in the coming years ➔ Norges Bank is not worried about inflation temporarily overshooting



Source: Macrobond Financial, Danske Bank Markets

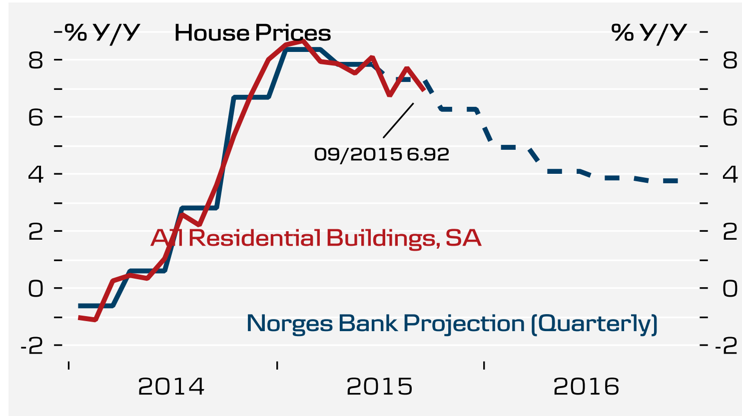
Norges Bank Monetary Policy checklist 5/6: Credit growth

Credit growth slightly below NB's projection



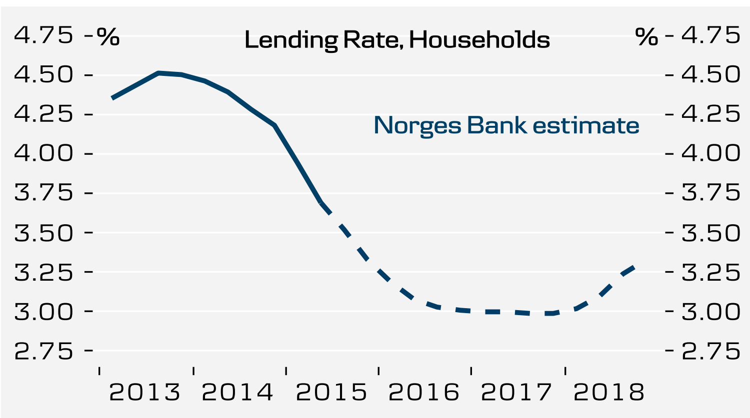
Source: Macrobond Financial, Danske Bank Markets

House prices also slightly below projections



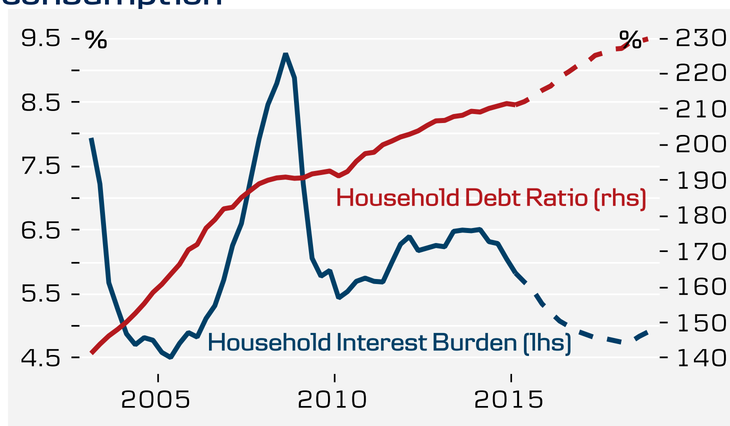
Source: Macrobond Financial, Danske Bank Markets

Lower lending rates support credit growth



Source: Macrobond Financial, Danske Bank Markets

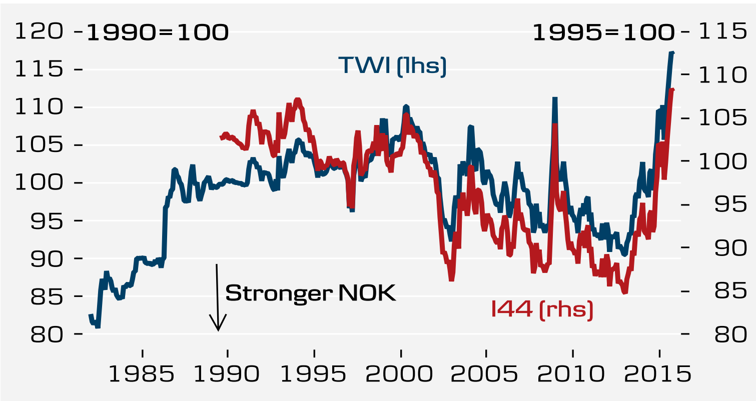
Lower interest rate burden to support private consumption



Source: Macrobond Financial, Danske Bank Markets

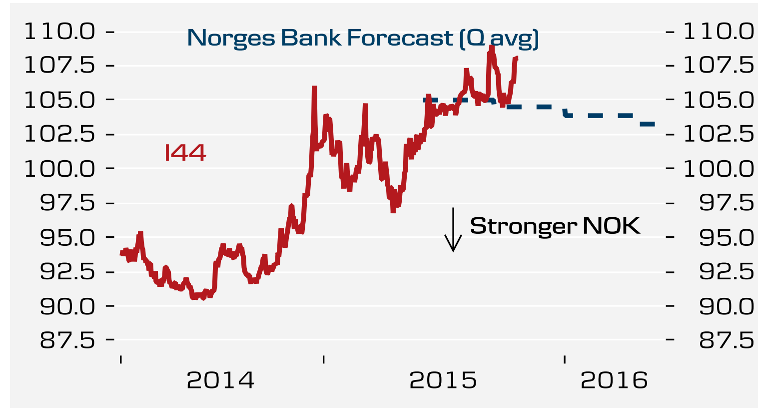
Norges Bank Monetary Policy checklist 6/6: FX and rates

The NOK reaching record-weak levels



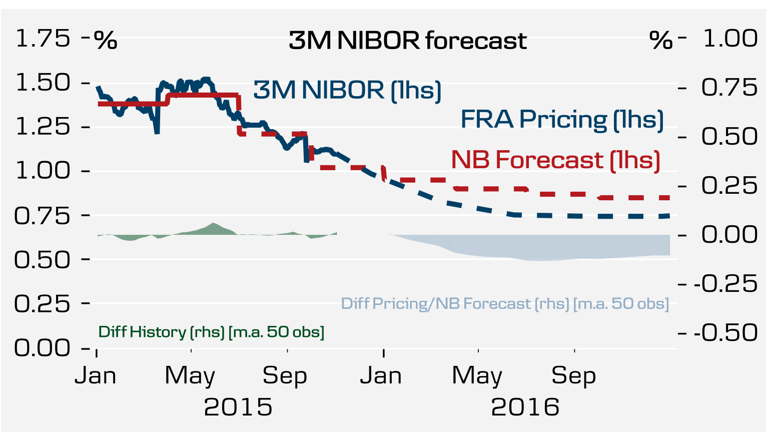
Source: Macrobond Financial, Danske Bank Markets

... and is now weaker than projected in September



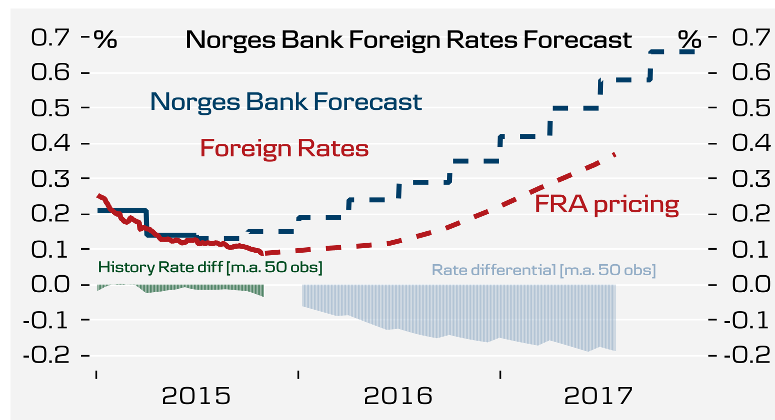
Source: Macrobond Financial, Danske Bank Markets

Markets price in lower 3M NIBOR rates



Source: Macrobond Financial, Danske Bank Markets

Foreign rates below projections



Source: Macrobond Financial, Danske Bank Markets

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