

Flash Comment Norway

Norges Bank might not live up to expectations

Norges Bank is expected to raise its key rate by 25bp to 1.5% at its policy meeting on Wednesday. Stronger domestic growth, reduced risks from the financial crisis and the global economy, and lower credit premiums in the fixed income market all speak in favour of raising interest rates. The probability of a rate hike was further bolstered when the inflation figures for September were released. They showed that underlying inflation jumped to 2.4% in September from 2.1% in August.

The Norwegian government budget for 2010 that was released on 13 October also bolstered the positive growth outlook. It was quite an expansionary budget with an increase in the oil-adjusted deficit of 0.6% relative to 2009. Norges Bank had assumed no increase in the Monetary Policy Report 02/09, so this lends further weight to the case for rate hikes.

On top of that we should not forget that Norges Bank posted a clear pre-warning in September saying that, “The Executive Board considered the alternative of increasing the key policy rate at today’s meeting”. The sentence has a long standing reputation for guiding the market for action on the next meeting, which is reflected in the Bloomberg survey ahead of the announcement: 16 out of 17 forecasters expect Norges Bank to hike rates by 25bp to 1.5%; one dissident looks for a 50bp hike.

Given the almost uniform expectations of 25bp, all focus is on the accompanying monetary policy report and not least the new strategy interval and the new interest rate path.

We expect the growth projections to be revised up relative to the June report, especially for the global economy, reflecting the more upbeat IMF forecast since then. The Norwegian growth forecast is expected to be lifted by 0.25–0.50 percentage points to 2.75–3.00% for mainland GDP in 2010.

There is also room to believe that the clear signs of normalisation in the liquidity situation, the recovery in credit markets and rising asset prices **would indicate that Norges Bank will strike a much more upbeat tone**, arguing that the downside risks from the financial crisis are greatly reduced.

On the other hand, parts of the export industry are still struggling. Norway is one of the few countries where the PMI indicator is still running below the 50-level at 47.4 and 45.5 for the PMI and the orders index, respectively.

The struggling export sector is also in focus in respect of the currency. Since the last monetary policy report in June the import-weighted NOK has strengthened significantly and is current about 7% percent stronger than forecast for Q4 in the latest Monetary Policy Report from June and 4% stronger since the last policy meeting.

Based on Norges Bank’s analysis from the rate-setting meeting December 2008, this will, everything equal, lower the interest rate path by 75bp.

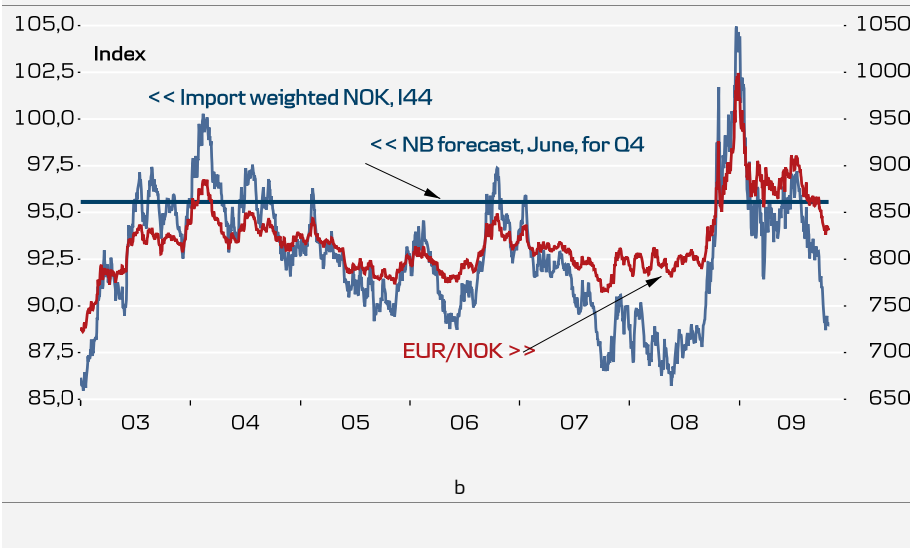
Key points

- We believe Norges Bank, in line with expectations, will hike rates by 25bp to 1.50% on Wednesday
- However, the monetary policy report might disappoint the market somewhat by not living up to market pricing in the fixed income market
- We forecast that Norges Bank will signal a more cautious approach in the new Strategy Interval signalling that a rate hike in December is not a done deal
- Market is long the NOK and risk is on the upside for EUR/NOK if Norges Bank tries to verbally intervene after the significant appreciation of the NOK lately
- We will use a possibly set-back in the NOK to position for a stronger NOK on a 3M horizon.
- We believe the market is pricing a too high probability of a rate hike in December

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Significantly stronger NOK worries Norges Bank



Source: Ecowin

Therefore, it certainly cannot be ruled out that **Norges Bank will try, like the Canadians last week, to verbally weaken the currency.** We do not think they will succeed on a longer horizon, but we might see some upside pressure on Wednesday on EUR/NOK.

Furthermore, it should be noted that the weekly flow data from Norges Bank together with anecdotal information underline that foreign banks, which we use as a proxy for “speculators”, are quite long, adding to the risk of a higher EUR/NOK if the market is disappointed.

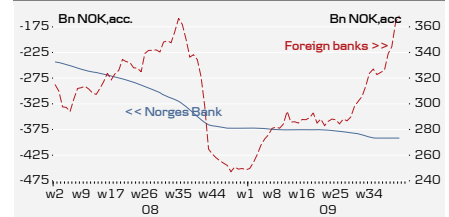
But that said, we still think the trend for a lower EUR/NOK will still be firmly in place also after the meeting. Hence, we would see a move higher in EUR/NOK above 840 as an excellent entry level for long NOK positions. If we see no “verbal” intervention from Norges Bank, it will most likely be seen as a broad acceptance of a stronger NOK and we would certainly recommend to go along for a significant drop in EUR/NOK. **All in all we doubt the policy meeting will impact our 3M and 12M forecast for EUR/NOK, where we expect the cross to fall to 820 and 800, respectively.** See the latest issue of *FX forecast Update* for more on our currency forecast for EUR/NOK.

The trade-off between a strong domestic economy and a relative strong trade-weighted NOK will probably have an impact on the new interest rate path. **We therefore expect Norges Bank to have problems living up to the market’s interest rate expectations.** Although we expect the bank to be forced to raise rates relatively quickly during H2 10 and we have an end of 2010 forecast of 3.25%, we do not expect this to be signalled by Norges Bank.

We expect the central bank to put forward a new strategy-interval from 1.25% to 2.25%. This would imply two rate hikes of 25bp at the October, December or February meeting next year. In other words if we presume an October hike of 25bp, this is a clear signal to the market that rates will not be hiked in either December this year or February next year. We believe we will see no rate hikes in December. If we see such indications, it would be a disappointment to the fixed income market that fully prices two consecutive hikes of 25bp in October and December.

Regarding the interest rate path, we believe it will be pushed forward and revised higher. We forecast that Norges bank will point to an end 2010 interest rate of 2.75% 50bp below our own forecast. The DEC09 FRA 3M is currently trading at 3.70% implying a policy rate close to our forecast of 3.25%. The old interest rate path indicated a policy rate of 2% end 2010.

The market is long the NOK



Source: Ecowin

Note: Accumulated amount since 2005.

Regarding the fixed income market, we continue to recommend positioning for a steeper FRA curve. As elaborated above we forecast that Norges Bank will indicate less tightening than priced in the market, pushing the front-end of the curve lower. However, we believe Norges Bank will be more aggressive during H2 of 2010. See the latest issue of *Reading the Markets* for more on our fixed income trading strategies.

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