Pareto

The market and the economy in 2012

Taking the long view was by no means easy in 2012 ... but it was profitable.

As in recent years, the financial markets in 2012 were characterised by political risk, marked pessimism and the occasional glint of hope and greed, and the unceasing pursuit of the next macroeconomic key figure and nervous interpretation of ambiguous indicators.

And yet again, much of the information flow could best be described as short-term noise. Most companies carried on as normal, making money and building value for their shareholders, employees and lenders. The upshot was that, taken as a whole, 2012 turned out to be a more than satisfactory year for players in most sections of the financial markets.

Even so, 2012 saw certain structural changes of interest as well as concealing some danger signals that it might be worth bearing in mind. In our assessment, the key features of the 2012 financial year were:

- weak growth in leading Western countries produced lower interest rates.
- Sound growth on the part of our real trade drivers made for good export conditions.
- This combination fuelled an upturn in the stock market and a record year on the bond market.
- The Norwegian economy was solid to the core – but was probably more oil-fuelled than most people realise.

It‘s an ill wind ...

Generally, low interest rates are a bad sign. They normally signal poorer growth prospects, either because they reflect the desire of the authorities to stimulate growth (low short-term interest rates) or the fear of the markets of bad times ahead (low long-term rates).

Both of the above have been true of much of our financial environment. The eurozone countries recorded a total reduction in GDP of 0.5 per cent last year, Sweden lost 0.3 per cent and even UK could only manage a growth of 0.7 per cent, according to IMF.

With economic conditions like this it is not hard to understand that central bank key rates of interest are kept low. The US Federal Reserve has long maintained a target zone of 0-0.25 per cent, whereas the European Central Bank slashed its key rate to 0.75 per cent last year. Similarly it is understandable that market rates of interest should be low. And given our small open economy and free exchange rates, Norway has little choice but to follow suit, at least part of the way.

Thus in 2012 we saw low and falling interest rates at both ends of the yield curve. Last year the Norwegian key policy rate was cut from 1.75 to 1.5 per cent, money market rates fell by over one percentage point to just over 1.8 per cent, and the yield on 10-year government bonds shrank from 2.4 to just over 2.0 per cent. This gave the Norwegian economy a stimulus that it hardly needed.

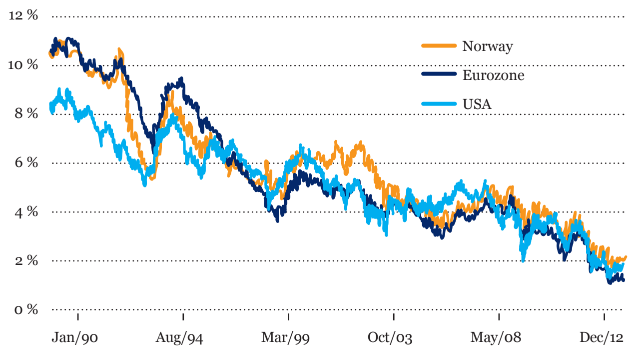
Underlying trading partners?

Macroeconomics tends to focus on Norway‘s trading partners. It is probably more correct to say that the low rates of interest came to us from our financial partners – an overlapping but not entirely identical concept. Furthermore, the truth is that our trading partners do not provide a full picture of the situation for Norwegian exports.

The stock market attempts to understand market risk as exposure to various risk factors, from growth and inflation to oil prices and exchange rates. An equivalent train of thought can be applied to the macroeconomy. If Norway sells oil to Belgium, economic growth in China will be of greater importance in determining the sales price than growth in Belgium.

In this example China represents our underlying exposure. And of course, that‘s an area of healthy growth. In fact, worldwide 2012 was an entirely average year in the context of GDP growth since 1980. Emerging nations compensated for weak or non-existent growth on the part of our traditional trading partners – a situation from which the Norwegian economy has benefited.

Falling and falling – until now



Yield to redemption 10-year government bonds. Source: FactSet

An ideal year for the stock market

OSEBX. Source: Oslo Børs

A good year for equities ...

Thus many investors had their cake and ate it too, with excellent corporate earnings, low capital costs and rising valuations. A good recipe for stock market appreciation. And when the mood on Wall Street shifts from scepticism to cautious optimism it is hardly surprising that Oslo Børs should want to tag along.

The word mood has been chosen with care. For the last 2-3 years the stock market has been characterised by mood swings lasting for six months to a year. In industry jargon the market has been sentiment-driven.

The sentiment changed about halfway through 2012. After bottoming out at around the six-month mark, all the signs pointed upwards. On the stock market the upward trend didn't stop until the Oslo Børs benchmark index had paid a return of 15.4 per cent, not far off the figure recorded by the S&P 500 in the US. For the long-term investor this is an almost ideal state of affairs. A sound reward for risk, not least when compared to interest rates, but not so hefty as to herald its own reversal.

... for some, at least

Nevertheless, the willingness to invest did not keep pace. Firstly, last year's Norwegian stock market was characterised by low liquidity. Although the establishment of new marketplaces means that Oslo Børs is no longer synonymous with the Norwegian equities market, it is striking that trading in equities on Oslo Børs fell by over a third last year.

Secondly, the fall was not equal for all shares. Trading was concentrated around the most liquid shares, which also meant a less rewarding share price development for many less liquid shares – and represented a greater challenge for investors who in the past would have been able to harvest an excess return on shares of precisely this nature. In 2012, this strategy produced a negative excess return.

Thirdly, interest in investing in equities was still modest. It seems likely that low supply rather than high demand was behind the price gains. Figures published by the Norwegian Fund and Asset Management Association show that in 2012 net subscription for equities funds by Norwegian private customers was just NOK 232 million. Net subscriptions by Norwegian institutional customers were only about 10 times as high, of which half in December alone. Small amounts, in this context.

So where did the money go?

A record year on the bond market

Answer: it went to the bond market. And the bond market had a record year, in more ways than one.

During the course of 2012 corporate bonds were issued to a value of over NOK 96 billion, which was over twice the volume issued in the preceding year. More than half of this was high yield bonds, i.e. loan notes with a higher risk and, accordingly, a higher expected return.

In terms of industry, shipping and oil-related industries accounted for approximately half. However, other sectors increased their share of the pie.

This growth is an indirect after-effect of the financial crisis. The banks are subject to increasingly stricter capital adequacy requirements, meaning that they are obliged to restrict the growth in their lending. In Norway, this has primarily impacted on corporate customers, while lending for housing purposes has continued as normal. The upshot has been that a demand for alternative forms of corporate funding has emerged.

In institutional terms the bond market has been well equipped to face the challenges. In Norway we have developed efficient arrangements, with extensive documentation and a well functioning trustee scheme. Incidentally, Pareto Securities has recently been involved in setting up a similar trustee scheme in Sweden.

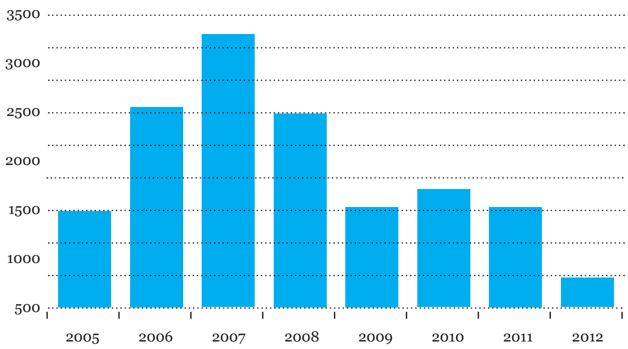
Hence, from this perspective there are sound grounds for interpreting the growth in the bond market as structural. That being said, this growth was well aided by cyclical factors in 2012.

High high-yield

Although government bond yields are low, corporate bonds paid a very handsome return last year. Risk premia, expressed as the increment on a risk-free rate of return, remain at an all-time high – not least as a proportion of total interest yield.

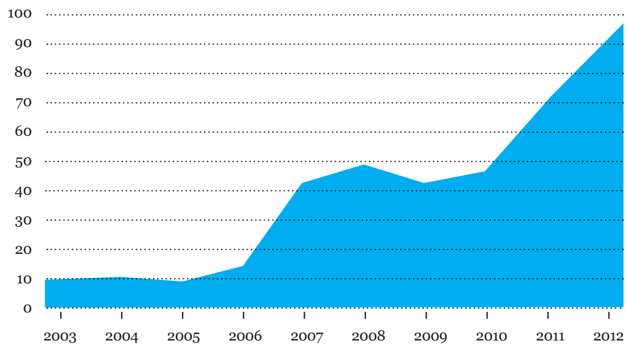
The outcome has been that rates of return have also been historically high. According to Pareto Securities, BB-rated bonds issued in Norwegian kroner generated an average return of 9.1 per cent, while B-rating paid investors 13.8 per cent and CCC rating no less than 21.8 per cent.

Stock market less liquid



Turnover on Oslo Børs in NOK billion. Source: Oslo Børs

Interest, nothing but interest



Accumulated difference in NOK billion between net subscriptions for fixed-income funds and net subscriptions for equities funds, Norwegian institutional clients. Source: VFF

Bonds denominated in Norwegian kroner generally have a floating rate, meaning that the rate is adjusted in line with changes in the market rate. In such cases, the high return for investors reflects the high cost of debt capital for the issuing companies. Why do they nevertheless opt to seek funding in the bond market? One reason is undoubtedly that equity capital remains expensive, in the sense that pricing in the equities market is still relatively low.

Many Norwegian companies, typically those deriving their revenues in dollars, issue bonds denominated in dollars. These are normally fixed-rate. In 2012, this offered investors wonderful rewards, because of the downturn in both the risk-free rate and credit premiums: the average return on dollar-denominated bonds in the Norwegian market was over 20 per cent, and in the CCC-rated category the return was 40 per cent and more!

Nevertheless, it must be borne in mind that record-level returns are a function of higher risk.

Oil-fuelled mainland economy

A more fundamental form of risk applies to the Norwegian economy, which in 2012 was both lively and robust. Over the longer term, this situation can not be taken for granted. Pareto's analyses indicate that the Norwegian economy has been even more oil- fuelled than is generally appreciated.

Traditional GDP figures do not pick up oil price changes, so it may be useful to start with revenue figures. According to the Norwegian Government's latest report on long-term perspectives for the Norwegian economy, increases in the price of oil and natural gas contributed 2.0 percentage points to the average annual growth of 3.3 per cent in real disposable income in Norway in the period 2004-2011. A high proportion? In our assessment, this is more likely to be an underestimate. Static calculations have been applied in determining the contribution made by oil. The missing factor is the way in which high oil prices stimulate the mainland economy.

One essential figure is missing when Statistics Norway publishes key figures for mainland Norway: our biggest export market. According to Pareto's estimates, last year the mainland economy "exported" goods and services to the petroleum industry to a value of over NOK 215 billion, more than three times as much as the entire Nordic region combined – and more than three times as much as in 2001.

Measured as a proportion of mainland GDP this corresponds to almost 10 per cent. Why is the figure so high?

Oil – a mainland business

Clearly, higher oil prices will result in higher levels of activity in the North Sea and, as a consequence, higher levels of activity on the part of onshore contractors. But this does not tell the entire story. Just as important is the fact that the cost of producing the oil has increased. Mature oil fields and complicated geology have provided the ingredients for a bonanza for mainland Norway.

The development in Statoil's costs provides a useful illustration. Whereas in 2001 operating costs and depreciation amounted to less than seven dollars a barrel, by last year the corresponding items had increased to a total of almost 20 dollars a barrel. And here's the key: much of the difference has ended up in mainland Norway.

So it is not the case that high oil prices and hefty profits in the North Sea have spilled over into the mainland economy. Rather, the opposite applies: the mainland has benefited from the fact that the oil industry has not earned as much as might be suggested by the rise in price. Far more of each petroleum krone ends up in the mainland economy than was the case just a few years ago. And that is how the economy of mainland Norway has also come to be oil-fuelled.

What the Norwegian Government Pension Fund could have become

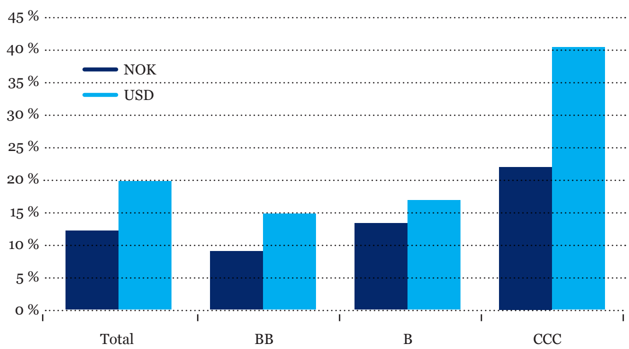
For the Norwegian economy this is far more important than the income effect of the oil price. It is also far more difficult to apportion than the more marginal part of the oil revenues that the politicians discuss.

The Norwegian Government Pension Fund Global was worth over NOK 3,800 billion at year-end. Almost half, nearly NOK 1,760 billion, can be attributed to higher oil prices than those projected when the pension fund was started.

However, the Government Pension Fund Global is not NOK 1,760 billion larger than was projected at the time. It is "only" just under NOK 500 billion larger, according to our estimates.

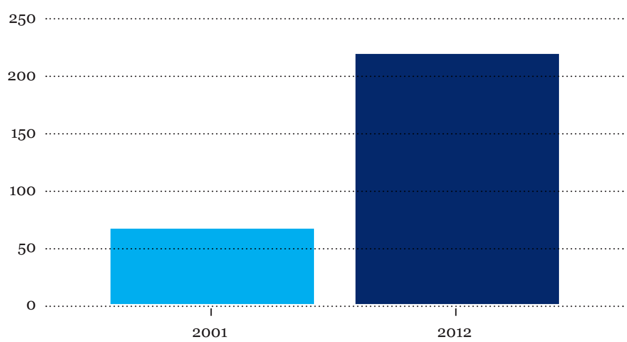
Lower real returns than the expected four per cent account for well over half of the difference. The rest – by coincidence, this too

Interest-rate bonanza



Average returns in 2012 for bonds on the Norwegian market by currency and rating category. Source: Pareto Securities

Almost 10 per cent of mainland GDP



Demand by the oil industry directed at the Norwegian mainland economy in billions of NOK. Pareto's estimates amounts to almost NOK 500 billion – can largely be attributed to the fact that more of the oil revenues have leaked out in the form of higher costs. And these costs have largely represented revenues for mainland companies.

The real stimulus

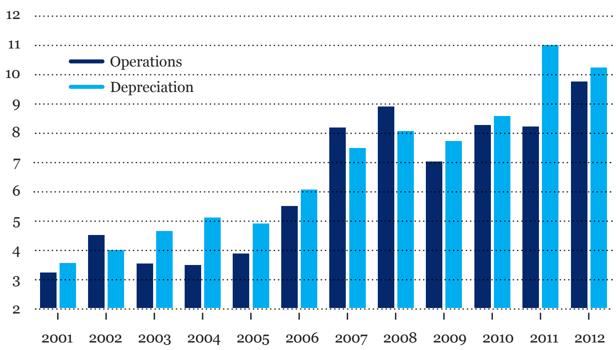
Scope is not an insignificant factor here. The Government has made an issue of the fact that less oil revenue is being spent now than is indicated under the "budgetary rule" governing the use of capital gains generated by the Government Pension Fund Global. Since the Fund was established this "underconsumption" has amounted to a total of 42 billion 2012-kroner.

In reality, more money has probably been spent than was intended, since the budgetary rule automatically indicates higher expenditure when the Pension Fund grows. Now that the Fund has grown almost NOK 500 billion bigger than anticipated, this provides scope for using roughly NOK 20 billion more a year without breaching the budgetary rule.

However, this effect is of far greater importance and, moreover, underestimated: increasing or decreasing the national budget by a few million kroner will be a drop in the ocean when compared with the almost NOK 500 billion that has leaked out and stimulated the mainland economy. Furthermore, in this calculation we have not included a single krone in knock-on effects (multiplier effects).

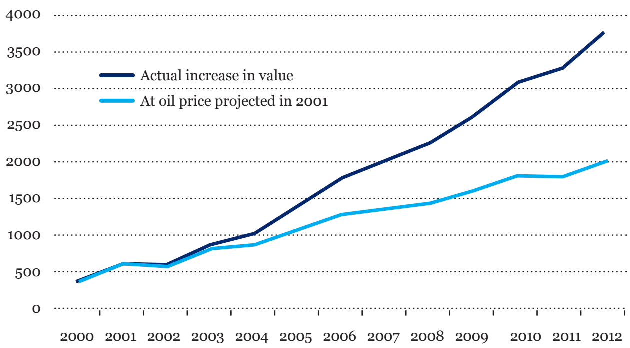
The outcome: the mainland economy too fluctuates in line with the oil price.

Statoil's costs keep rising



US dollars per barrel. Source: Pareto

Enormous oil price bonus



Figures in NOK billion. Source: NBIM, Pareto

Just look at (see figure) the way in which the difference between GDP growth in mainland Norway and in Sweden follows the oil price, albeit with a lag.

Obviously, the fact that the oil revenues have benefited a larger portion of Norwegian business and industry is a good thing. This has generated fresh business activity, high levels of employment and a sound return for the shareholders.

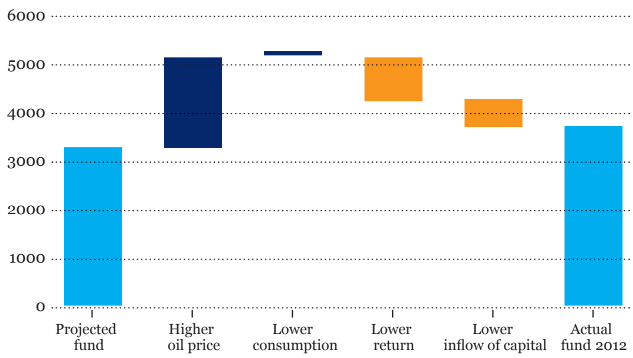
But it must be noted that this return is not risk-free. It is unlikely that the Norwegian economy is as immune to economic downturn as many appear to believe.

2012 in a nutshell

OSEBX	+15.4%
S&P 500 return	+16.0%
MSCI World net	+15.8%
3-month NIBOR	from 2.89% to 1.83%
10 year Norwegian Treasury	from 2.41% to 2.04%
Share turnover Oslo Børs (value)	-35.2%
Brent Blend	from USD 106.87 to USD 109.89
USD/NOK	from 5.99 to 5.57
EUR/NOK	from 7.75 to 7.34
GDP growth global	3.4%
GDP growth Norway	2,7%
GDP growth Mainland Norway	3.8%

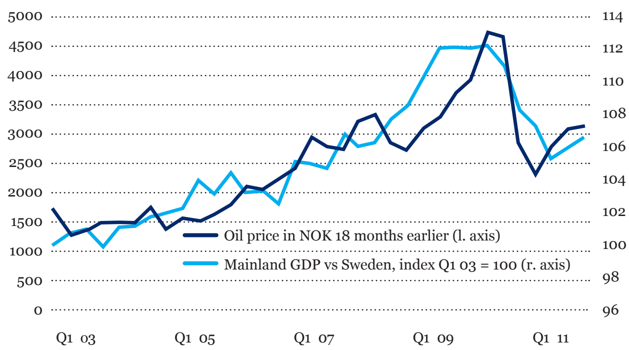
Sources: *Oslo Børs, S&P Dow Jones Indices, MSCI, Norges Bank, FactSet, IMF, Statistics Norway, Pareto. GDP growth is updated with revised estimates after the respective Pareto annual reports were published.*

Factors underlying the growth of the Norwegian Government Pension Fund Global



Milliarder 2012-kroner. Kilde: Pareto

Oil lubricates the mainland economy



Source: Pareto, SCB, SSB