The market and the economy in 2014

It is probably true to say that 2014 marked a point at which the Norwegian economy took a turn for the worse. However, it is also true that this only entailed a cautious downward adjustment of the optimistic mood. The question is: how can both statements be correct?

Seen through Norwegian eyes, 2014 turned out to be an eventful year. The oil price fell by more than 50 per cent. Exports of salmon to Russia halted abruptly, as a tit-for-tat for Western sanctions. The Norwegian krone fell so hard that by yearend one US dollar cost 22 per cent more – or almost 34 per cent more if we factor in the fall recorded the year before.

The situation was no less exciting when it came to interest rates. The Swedish central bank cut its key rate to zero per cent. The European Central Bank reduced its deposit rate to minus 0.2 per cent. And German government bonds, traditionally viewed as a safe harbour, rewarded prudent investors with a return of 14 per cent – in euros. For Norwegian krone-based investors, the reward would have been around 23 per cent.

The situation looks less dramatic in the macroeconomic summary: In real terms, global GDP increased by 3.4 per cent, on a par with the two preceding years. Our domestic GDP growth crept upwards to 2.2 per cent overall and 2.3 per cent for the mainland economy.

The stock market's summary of the year, a complex opinion poll in which a large number of operators express their views through the capital they own or dispose, was equally sober. Both globally and in Norway, the average investor in equities received a return of the order of five per cent. Stock market pricing has not changed much over the last year.

This should in no way be taken as a signal that the tension has dissipated.

Norwegian vulnerability

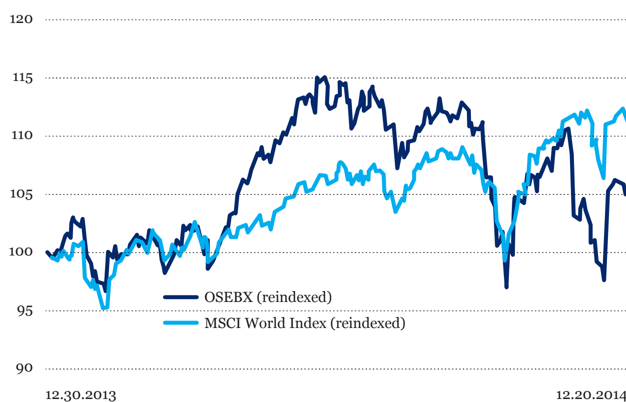
The tumbling oil price is not primarily about the place of oil in the world economy. It is about price sensitivity. In the third quarter of 2014, demand for oil was well over 0.5 per cent higher than in the third quarter of the year before, and by the fourth quarter the gap had increased to 0.9 per cent. The problem was that the supply of oil had increased by 2.3 and 2.9 per cent, respectively, during the same periods.

In the short term, there is rarely any precise correspondence between supply and demand in the oil market. Here, however, expectations also played an important part. In fact, the market had been wrong on both counts. Europe and China both needed less oil than anticipated, and as a consequence of the production boom in the US, the increase in the oil supply outstripped market expectations. In June, just before the oil price began its downward plummeting, almost 20 per cent more oil was being produced in the US than in the same month one year earlier. At this point it became clear that the shale oil revolution was proving to be a far bigger deal than had previously been assumed.

When OPEC subsequently failed to cut production, there was little that could be done to boost the oil price back to the level seen in recent years.

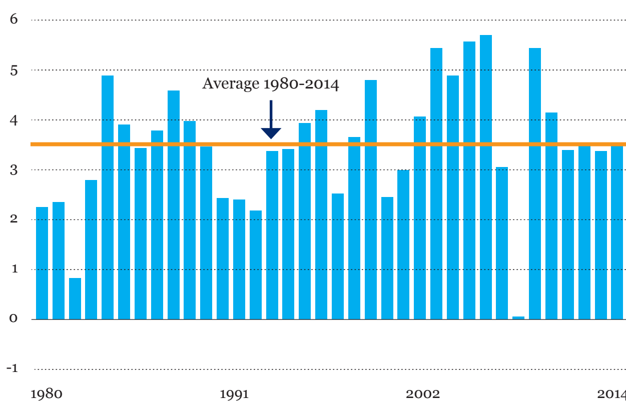
Thus, during the space of a few short months, the framework conditions for the Norwegian economy changed markedly. The foreign exchange market reacted instantaneously. In the last quarter alone the trade-weighted exchange rate index rose (the krone fell) by 9.5 per cent and by yearend Norwegian kroner were worth substantially less in terms of key currencies such as the dollar and the euro. What does this mean for the Norwegian economy?

The road to an average year on the stock market



Source: Oslo Børs, MSCI

Global growth is virtually unchanged



Percentage growth in global GDP. Source: IMF

Prices, margins and models

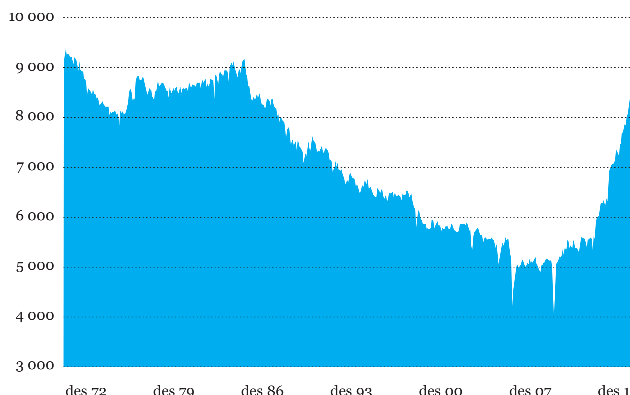
There are no prizes for guessing that oil-related industries will lose out on this, while other industries in the tradable sector will derive some benefit from the stimulation of the world economy. The Economist points out that a 40 dollar reduction in the oil price will give a typical US motorist some 800 extra dollars a year in spending power.

For Norway, however, the first effect will overshadow the second effect. Growth will fall. According to Statistics Norway, the biggest impact will be felt as early as 2015. In their estimates, growth in the mainland economy will be more than halved in 2015, to 1.1 per cent, before doubling again to 2.2 per cent in 2016 and 2.4 per cent in 2017.

The market and the policies pursued will undoubtedly help to alleviate the pain of the necessary transition. The weakening of the Norwegian krone will be good news for industries exposed to international competition. Moreover, large-scale developments on the Norwegian Continental Shelf will help to maintain a great deal of activity in the coming years.

We are not convinced, however, that the underlying model sufficiently reflects the effect of altered price conditions. The high prices and healthy margins enjoyed by a number of suppliers have been an important channel for spreading impulses from the petroleum sector into the mainland economy. Pay levels have consistently been far higher in the oil and gas extraction industry than in all other sectors, although here there are no Chinese walls. Many suppliers have prospered from this industry, recording healthy profits and paying fat wage packets.

A return to former glory

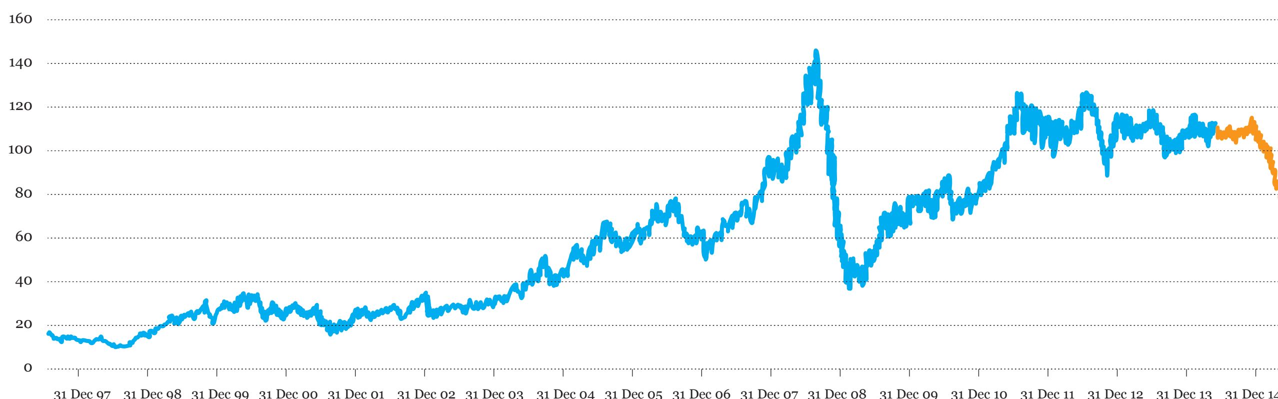


US oil production in thousands of barrels per day. Source: US Energy Information Administration

These suppliers do not form part of any clearly-defined industry, be it in terms of accounting statistics or pay statistics, so that the spread of impulses from the petroleum sector is not that easily read. Moreover, a purely statistical definition is also precluded. After all, what is an oil-related enterprise?

The Pareto group itself is an interesting case in point. The group derives a substantial portion of its revenues from business activities related directly or indirectly to oil extraction, both within and outside Norway. When the activity levels and earnings of these types of company are high, Pareto and the company's employees have more work to do and enjoy higher earnings – with the ripple effects that this in turn produces. Even so, you won't find Pareto in any overview of petroleum-related industries.

A sharp reversal of fortunes



The oil price (Brent Blend in US dollars per barrel). 2014 in orange. Source: Pareto Securities

Ripple effects and pork cycles

In 2014, there was little to suggest any further improvement in the fortunes of petroleum-related industries. As early as the start of the year there had been considerable pressure for costs to be cut and prices to be lowered, and with the oil-price collapse, this pressure has become acute. The impulses from the oil industry are now undoubtedly weaker.

The stock market demonstrated this effect in spades: From its peak at the end of June 2014, the Oslo Energy Index fell by more than a third. And the offshore industry certainly did not get off any lighter than the few oil companies on the list.

More exciting, however, are the long-term ripple effects. In our annual report two years ago, Pareto presented an analysis of the ripple effects that spread from the oil sector to the mainland economy. We described how differences between the growth rates of the Swedish economy and the Norwegian mainland economy were clearly associated with changes in the oil price six quarters earlier. Updated calculations (see graph) show that this link has continued to grow closer.

Given this course of events, the strongest effect will not occur until towards the end of this current year and the beginning of next year. It remains to be seen whether low levels of oil investment – perhaps too low – will contribute to a boom for the oil service companies. Pork cycles are not the sole preserve of livestock markets.

It should be noted that in this calculation, the oil price is measured in Norwegian kroner. A weaker Norwegian krone will dampen the effect. How long the kroner will remain at these levels is another matter. Not only do we no longer have the same “immunisation” of oil revenues now that less is channelled into the Government Pension Fund Global, but the rate of exchange of the krone is also still sensitive to interest rate differences.

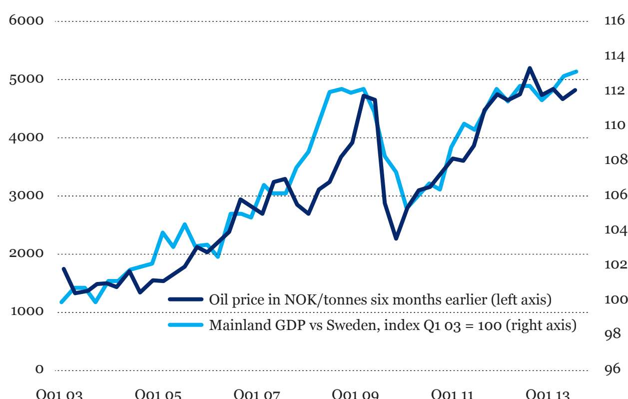
More manipulated interest rates

Short-term and long-term interest rates both fell during 2014. The money market rate (3-month NIBOR) dropped from 1.69 per cent to 1.48 per cent, while the rate on 10-year Norwegian government bonds was reduced from 3.04 per cent to 1.61 per cent. Beyond our borders, the course of events was even more dramatic, with key rates of interest that in several places were creeping below zero.

This somewhat odd combination of circumstances is the logical consequence of a situation in which the authorities in most developed countries are precluded from stimulating their economies by means of fiscal policy, and do their best with – or make the most of – the monetary policy tools at their disposal. This includes a recent innovation known as quantitative easing, whereby central banks purchase government bonds and similar loans on the secondary market on a large scale. As a consequence, the interest rate on these loans – typically longer term papers – falls, while the vendors receive an injection of liquidity and the banking system receives increased reserves in the form of claims on the central banks. If these reserves are used to increase the lending by banks, the supply of money will increase.

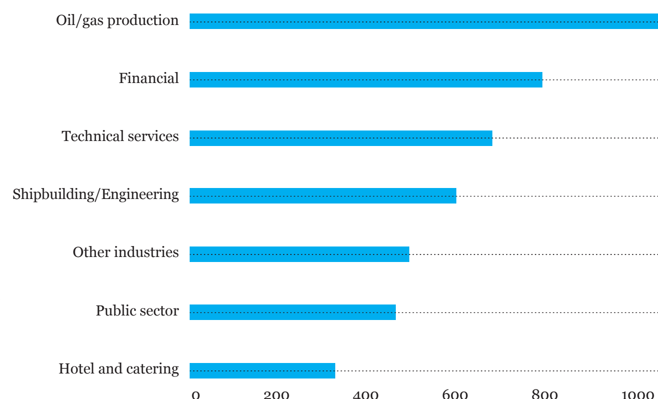
What effect this has is a hotly-debated question, not least as regards the long term, and even in the short term there are a number of

Oil-fired heating on the mainland



Sources: Pareto, SCB, SSB

Widely-differing pay levels



Pay per man-year by industry in NOK ‘000, 2014
Sources: SSB / Norges Bank

paradoxical side effects. For example, the pension burden of very many companies with defined benefit pension schemes has become heavier. The problem is also affecting most Norwegian municipalities, which are already struggling with heavy pension burdens, and, for that matter, many heavily indebted states.

This, however, is because the immediate effect on the interest rate level is the desired effect: the interest rate is forced down, including at the long end. With this, it is time for the general perception of the interest rate market to become more nuanced. Put crudely, the perception has been that the authorities fix the short-term interest rates and the market the long-term rates – which are a function of the price of bonds. And now we find that it is no longer that simple.

There is widespread concern about the outcome of this large-scale experiment, given that we have no historical experiences upon which to draw. An intervention in the market on this massive scale could have consequences that we are not able to foresee.

Two effects, however, should be very obvious.

Rising, invisible interest rate risk

Who would have believed that German government bonds would turn out to be one of 2014's most profitable asset classes? With minimal coupon rates and zero uncertainty about repayment?

The fact is that 10-year government bonds paid a total return in excess of 14 per cent. Not bad for a type of asset that is normally viewed as one of the safest investments around.

Can an investment really be risk-free when it pays such a high return? Of course not.

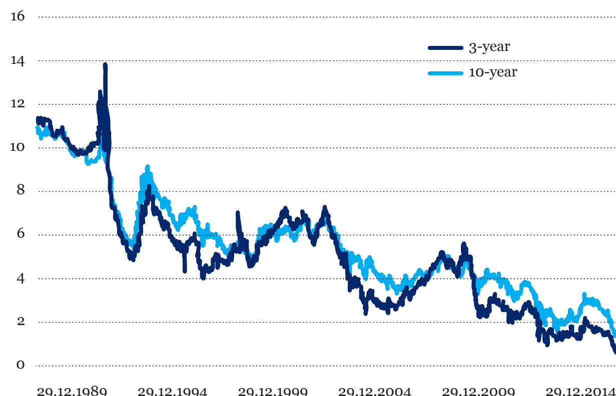
It is not possible to protect oneself against interest rate risk with long-term government bonds. The substantial return can largely be attributed to a falling rate of interest; the price rose by well over 12 per cent. Common sense dictates that these papers could rapidly fall by 12 per cent instead, and here, common sense is backed up by science – as is often the case. Were the interest rate level to rise instead, there is, sadly, every reason to expect a corresponding drop in the price.

Not only that. The fact of the matter is that the interest rate risk has risen in recent years. In 2007, for example, it was possible to buy 10-year German government bonds with an interest-rate sensitivity of approximately eight per cent. Put more simply, this meant that an interest rate rise of one per cent would have reduced the value of the bonds by eight per cent, or, more precisely, 8.07 per cent.

By August of 2010, the corresponding ratio had risen to 8.89, and immediately after the end of 2014 it had almost reached 9.76. In other words, a corresponding interest-rate increase would now trigger a price reduction of almost 10 per cent. Likewise, the interest rate risk has increased for all our financial neighbours. Measured over a longer period of time, and for longer maturities, the increase has been even greater.

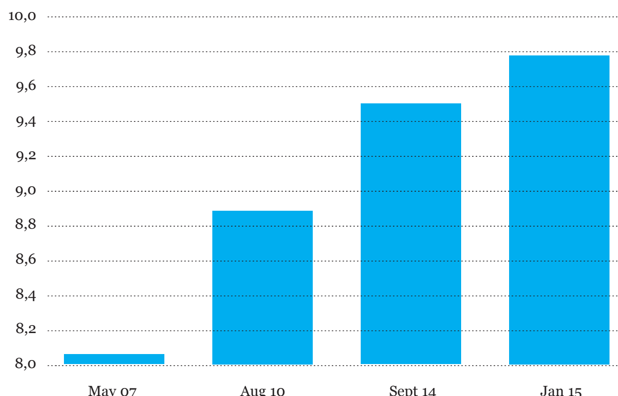
Thus here, too, we see paradoxical side effects of government intervention: the more the authorities attempt to force down the level of interest rates, the more they increase the interest rate risk.

Just one long ... upward rise?



Yield to redemption Norwegian government bonds, for two different maturities.
Source: Norges Bank

Rising interest-rate risk



Modified duration, 10-year German government bonds
Source: Pareto Securities

Debt championship

An equally foreseeable effect of low interest rates is that borrowing increases. Indebted states have less need to curb their borrowing through tighter budgets, and consumers the world over react in exactly the way we might expect. Eleven months into last year, The Wall Street Journal reported that almost four out of ten loans granted for motor vehicle purchases, credit cards and personal consumption in the United States were to subprime customers. A word that will be familiar to anyone for whom the financial crisis is more than just a faint memory.

Here at home there are clear signs that house buyers have taken advantage of lower interest rates to increase their borrowing without increasing their debt servicing burden. Viewed over the course of several years, the P/E of the housing market, i.e. the ratio between house prices and rental prices, has increased substantially. Many buyers quite simply borrow to the hilt and when lower interest rates come along, they borrow even more. And that's another way that risk is built.

Perhaps the authorities themselves will unleash this risk in the long-expected and awaited reform of the tax system? Here, prudence may turn out to be self-defeating: the longer they delay the reform, the harder the fall they risk creating.

Sensible risk?

A classic effect of low interest rates is an increase in appetite for higher-risk assets, through lower opportunity cost and lower rates for discounting future cash flows. This should stimulate more financial saving, more sensible risk taking.

2014 in a nutshell

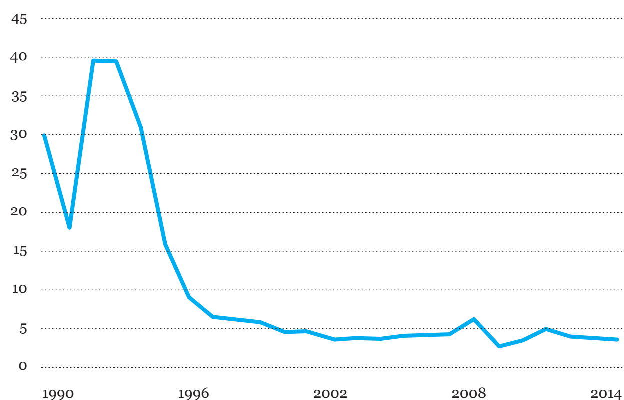
• OSEBX	+5.0%
• S&P 500 return	+13.7%
• MSCI World net (USD)	+4.9%
• 3-month NIBOR	from 1.69% to 1.48%
• 10 year Norwegian Treasury	from 3.04% to 1.61%
• Share turnover Oslo Børs (value)	+32.4%
• Brent Blend	from USD 110.80 to USD 57.33
• USD/NOK	from 6.08 to 7.43
• EUR/NOK	from 8.38 to 9.04
• GDP growth, global	3.4%
• GDP growth, Norway	2.2%
• GDP growth, Mainland Norway	2.3%

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

The shares of Chinese Internet giant Alibaba are perhaps not the best example of sensible risk, but the market gave the record-level IPO a warm welcome in September 2014. When the company's shares were listed, its market cap nudged 230 million dollars.

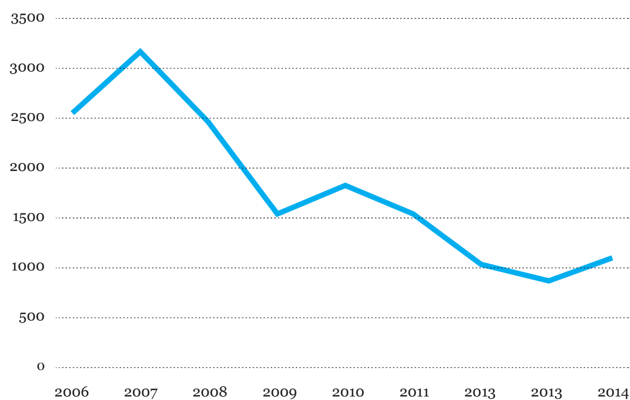
In the case of the Norwegian market, the following example provides an interesting illustration: Over the course of 11 years, private individuals in Norway have increased their total holdings in equity funds by almost NOK 100 billion, including pension schemes with mutual fund options. Before you read on: how do you think this increase breaks down into returns on investment and net subscriptions?

Once upon a time ...



Global inflation expressed as percentages.
Source: IMF

The drought continues



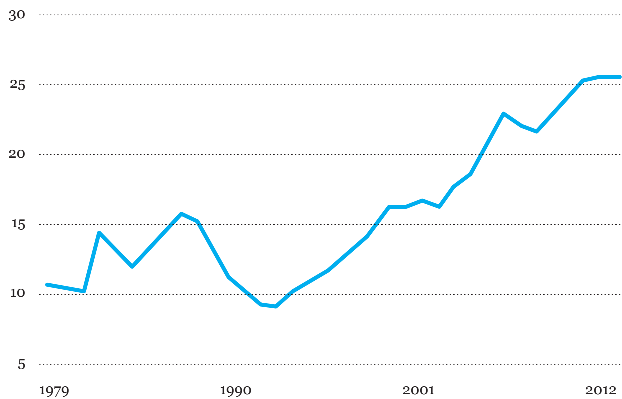
Total turnover of shares, equity certificates and ETFs on Oslo Børs in NOK billion.
Source: Oslo Børs

Well: Everything, absolutely everything and then some, is return on investment. Accumulated net subscriptions are negative. We should add that, during the same period, the gross debt of Norwegian households increased by over NOK 1,600 billion. Thus there has been no lack of willingness to invest, but everything has gone into houses, not into industry ownership.

The 2014 statistics for investments in securities funds show no signs of reversal of this trend. Net redemptions of Norwegian-registered equity funds totalled almost NOK 15 billion, while well over NOK 102 billion found its way into fixed income funds. However, two months into 2015, the Norwegian Fund and Asset Management Association reported that net subscriptions by Norwegians in equity funds and combined funds have not been higher since 2006.

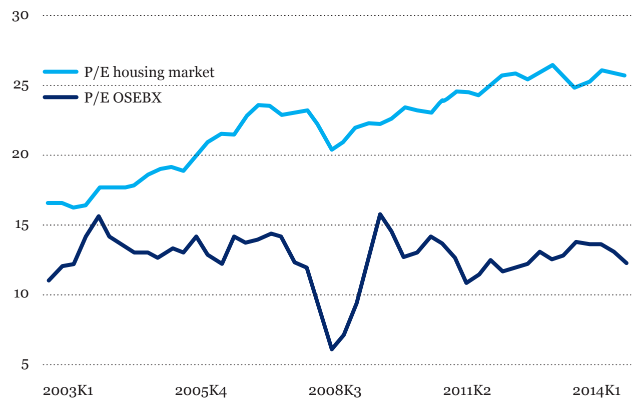
All that remains is for them to show their willingness to stay the course should the road ahead prove to be a rockier one.

Housing P/E continues to rise



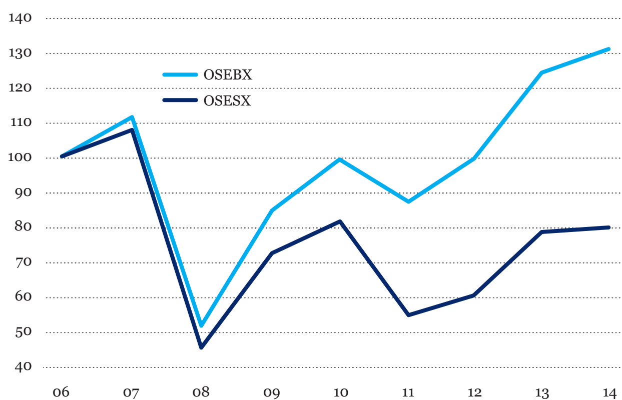
Source: Pareto, Norges Bank, Statistics Norway

Costlier housing, cheaper stocks



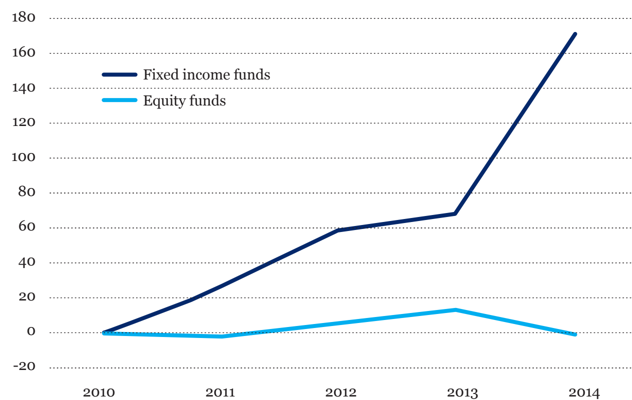
Source: Pareto, Norges Bank, Statistics Norway, FactSet

A tale of two markets



Small cap stocks have lost even more ground. Reindexed, 2006 = 100
Source: Oslo Børs/Pareto

Two fund markets



Accumulated net subscriptions in NOK billion in the Norwegian securities fund market.
Source: VFF