



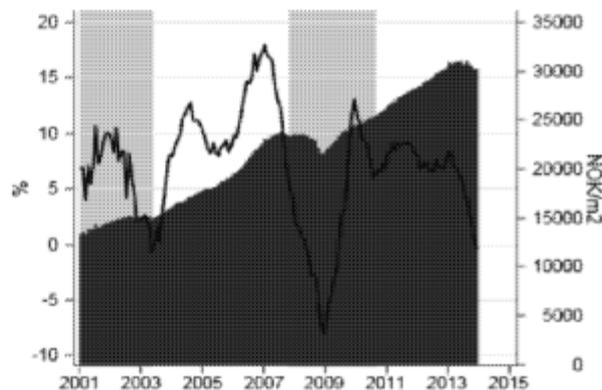
- Norges bank to continue to balance falling house prices vs. sticky CPI.
- NOK cheap, but investors wary of jumping back in unless/until Norges Bank and/or crude provide support supportive.

In Norway, the mainland economy has been growing around 2.0-2.5% YoY for most of the last couple of years, with the recent PMI and manufacturing output suggestive of continuing improvement going forward. Norges Bank's focus is balancing the declining housing market against sticky inflation at the consumer level. With house prices having slowed to largely flat on the year, representing a 3-3.5% drop from the peak in Q3 last year, and headline CPI back in line with the Bank's 2.5% target (from 3.2% YoY in August), Norges Bank is erring on the dovish side, arguing that the rise in [core] inflation is transitory. Indeed, according to the Bank's projections, core inflation is expected to drift back up over the next few months, reaching a peak just above the inflation target of 2.6% in April/May, before dropping down and remaining just below 2% up until the end of 2015. House prices meanwhile, are seen slowing further, to -2.5% to -3.0% YoY in H1 2014, before returning to positive YoY growth in early 2015.

The risk to Norges Banks's finely balanced outlook for inflation and housing is twofold. First is a scenario in which past and current FX weakness feeds through to imported inflation, thus preventing core from moderating in line with Norges forecasts. If the Bank then feels compelled to hike rates at a time when house prices already are declining, that would exacerbate the decline and not be currency supportive. An alternative risk scenario is if the house price falls feeds on themselves. With policy rates already as low as 1.50%, and with core CPI projected at or above target over the next 3-6 months, there would be limited scope for policy to provide a stopgap. While the above scenarios are not our baseline, they will continue to be a key factor in the Norges Bank's decision-making process, with monetary policy likely to be stuck between a fear of adding to the decline in house prices on one hand and sticky inflation on the other. Meanwhile crude is likely to continue to flatline in the relatively tight \$90 to \$110 range of the past few years.

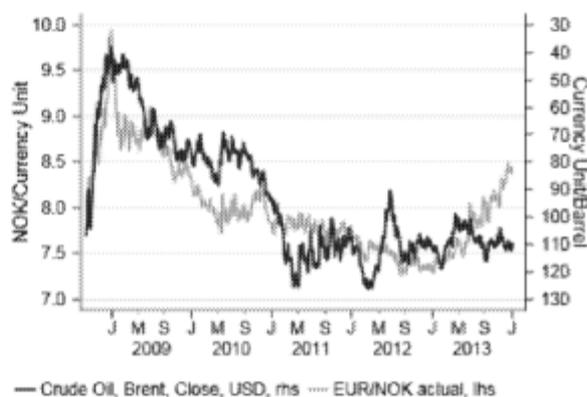
Monetary policy and crude are therefore unlikely to provide much in terms of direction in the NOK. However, given recent depreciation cannot be explained by fundamentals, with the Norwegian unit arguably oversold even when taking into account the market's now very dovish outlook for Norges Bank policy and flat oil prices, we are cautiously constructive. On balance we anticipate very gradual downside in EUR/NOK from current levels. A 3m EUR/NOK put @ 8.25 costs an indicative 76bp. Alternatively, finance it by selling a 3m EUR/NOK 8.65 call.

Figure 4: Norway, Real Estate Prices, All Residential Buildings, Total & YoY



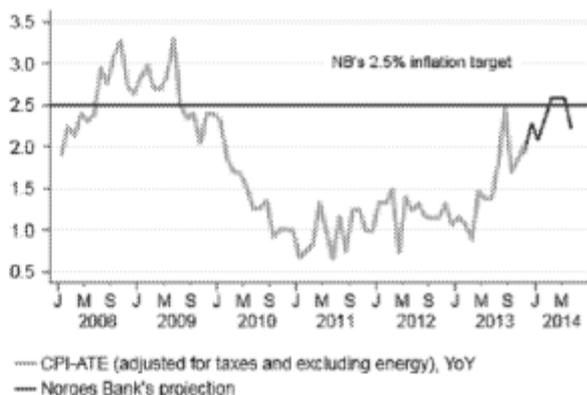
Source: Deutsche Bank, NEF

Figure 5: EUR/NOK and Crude oil



Source: Deutsche Bank, Bloomberg Finance LP

Figure 6: Core inflation - actual and Norges Bank's projection



Source: Deutsche Bank, Bloomberg Finance LP

Henrik Gullberg, London, +44 (0) 20 7545 1947