

GDP growth in double digits

In December, Statistics Iceland published GDP data for Q3 2016. The YoY GDP growth in Q3 amounted to 10.2%, surpassing our expectations. This high growth in real GDP largely reflects positive contribution from net foreign trade, but exports increased in real terms by 16.4% compared to the same period in 2015. Goods exports grew by 6.1% and service exports by 25.4%, while goods imports grew by 16.9% compared to our forecast of 14%. In the first nine months of 2016 GDP has grown by 6.2%.

Tourists reduce spending amidst appreciating króna

Although Icelanders are using their payment cards like never before, inflation still remains low. Inflation in December grew by 1.9% YoY and remains under the set target by the CBI, just like it had done in the past 35 months. However, the main contributor of the low inflation, the exchange rate of the local currency, the ISK, which has appreciated by more than 16% YTD finally appears to be taking its toll on the domestic consumption of tourists.

Housing prices keep rising

Housing prices have risen markedly over the past year and the countrywide year-over-year increase in November amounted to 14.8%. In the past five months housing prices outside the capital area have especially gained momentum, growing by more than 17% YoY. Rising house prices continue to be the main source of inflation, as the headline CPI has been in a disinflationary phase for six consecutive months when excluding housing prices.

Allowances to foreign investment of pension funds increased

The Central Bank of Iceland recently announced that it decided to grant Icelandic pension funds a permit to invest in foreign financial instruments for 100 b. ISK in 2017, compared to 85 b. ISK in 2016. This increase does not come as a surprise and is a step towards fully lifting capital controls on Icelandic pension funds. As of October 2016 foreign assets of Icelandic pension funds amounted to 5.7 b. EUR or roughly 21% of their total assets.

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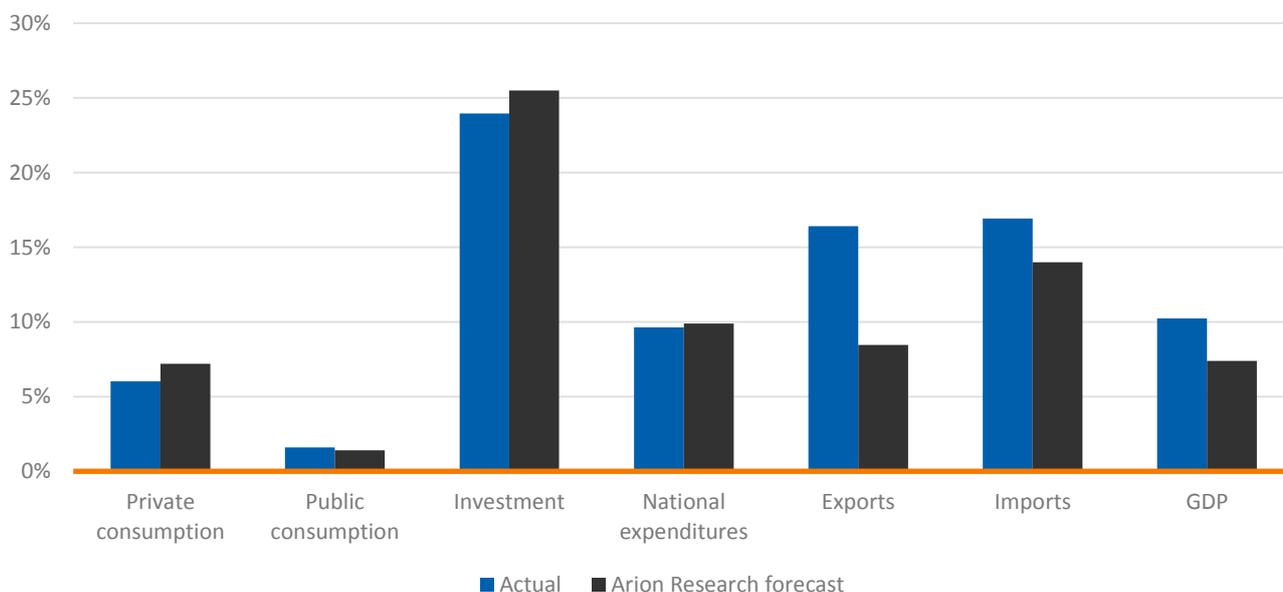
GDP growth in double digits

In December, Statistics Iceland published GDP data for Q3 2016. It is safe to say it exceeded our expectations as real GDP grew by 10.2% in Q3 2016 year-over-year, compared to our forecast of 7.4%. This high growth largely reflects positive contribution from net foreign trade, but exports increased in real terms by 16.4% compared to the same period in 2015. Goods exports grew by 6.1% and service exports by 25.4%, while goods imports grew by 16.9% compared to our forecast of 14%. Seasonally adjusted GDP in the Q3 2016 increased by 4.7% from the previous quarter.

National expenditures growth was broadly in line with our expectations, as private consumption increased by 6%, investment by 24% and public consumption by 1.6%. National expenditure as a whole in Q3 in 2016 grew by 9.6% compared to the third quarter in 2015 (we forecast 9.9% growth).

GDP growth in the third quarter of 2016

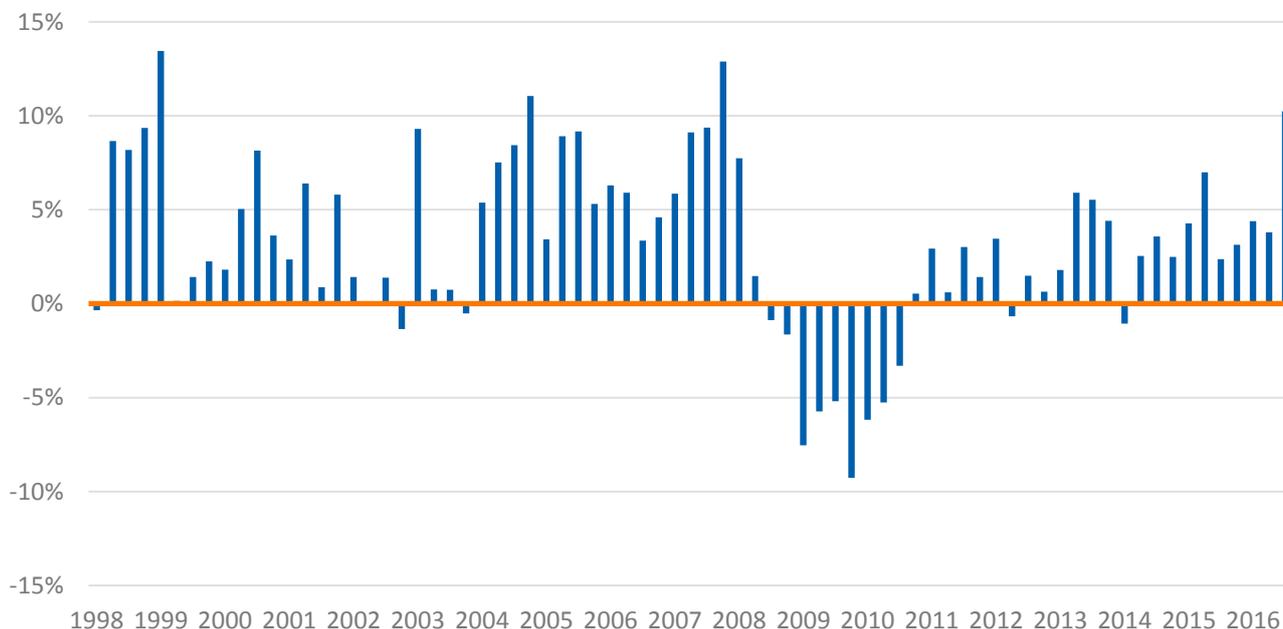
- comparison of forecast and actual results



Sources: Statistics Iceland, Arion Research

As previously mentioned, GDP growth in Q3 amounted to 10.2%, but this is the strongest growth in a single quarter since Q4 2007. In fact this quarter scores high in historical terms, as this is the fourth strongest quarterly growth since 1998.

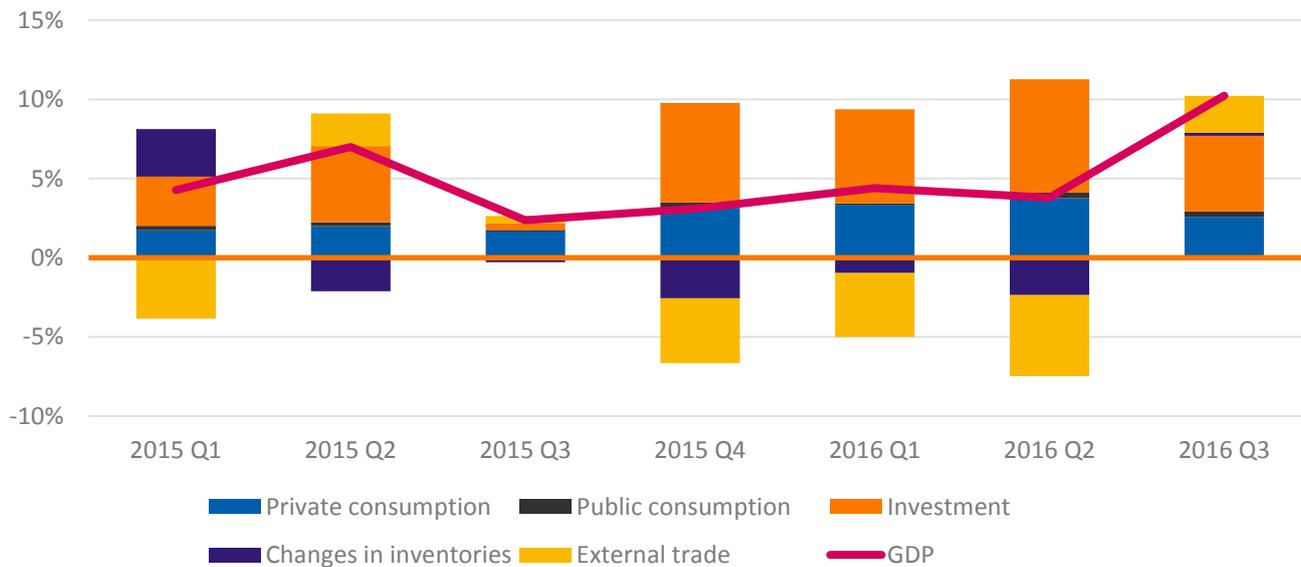
GDP growth



Sources: Statistics Iceland, Arion Research

This time around the growth was driven by foreign trade, private consumption and investment. Parallel to the last three quarters, growth was driven by investment, with business investment leading the way (business investment increased by 28.7%, residential investment by 21.3% and public investment by 5.8%). Due to considerable export growth the contribution of external trade to GDP growth was positive. Moreover, inventories increased primarily due to an increase in inventories of marine products and heavy industry, while inventories of ferrosilicon and oil declined.

Growth contribution of GDP components



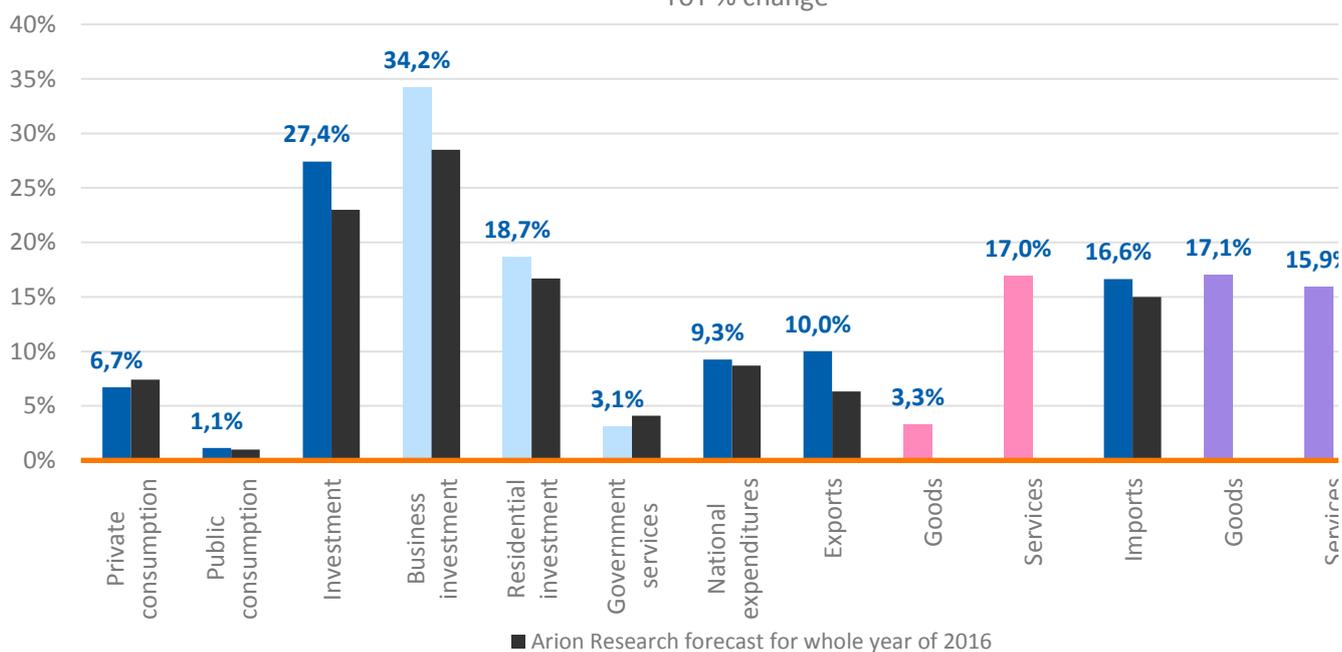
Sources: Statistics Iceland, Arion Research

Various irregular factors, such as changes in inventories and investment in ships and aircraft can have a significant impact on the GDP figures between quarters. Therefore, it may give a clearer picture to decompose GDP in the first nine months of the year.

In the first nine months of 2016 GDP has grown by 6.2%. Our forecast for the year predicts 4.7% growth this year, while analysts on average expected 5% growth. For GDP growth in 2016 to materialize at 5% GDP can only grow by 1.35% in the last quarter of this year (and even less for our forecast to materialize). When put in perspective of the current rhythm of the economy, and the tremendous growth in anticipated tourist arrivals in Q4, we expect that the growth in 2016 will exceed most forecasts.

Growth in GDP components in the first nine months of 2016

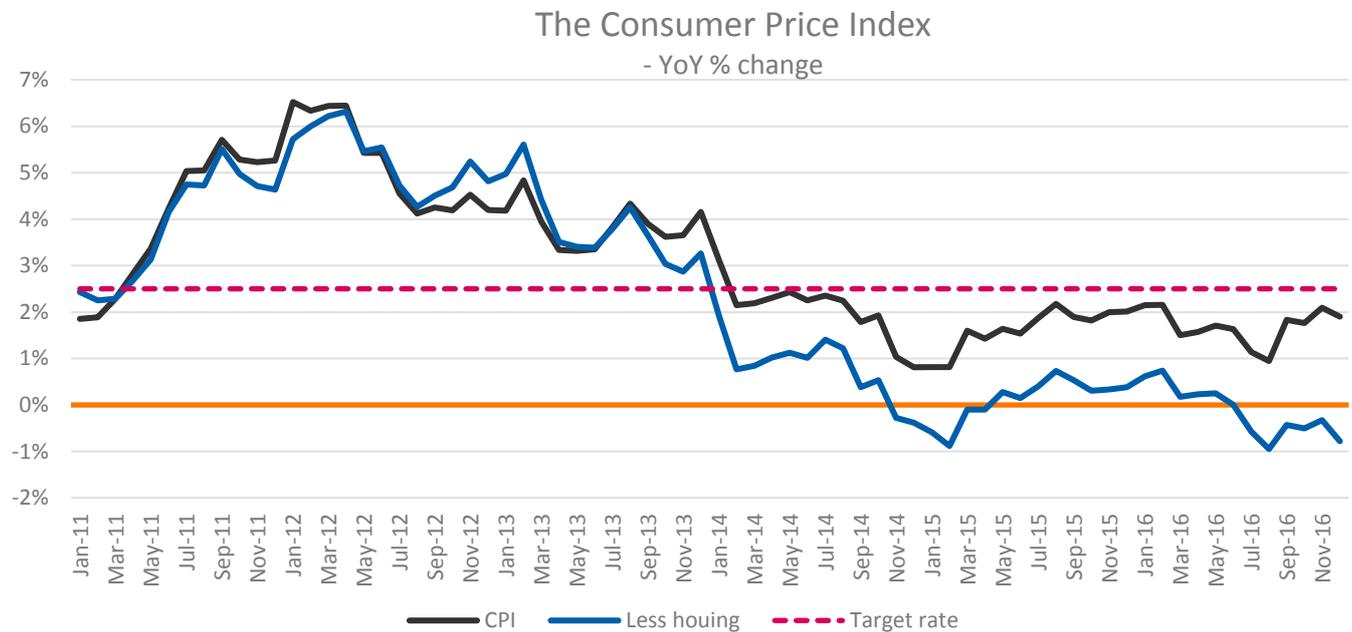
- YoY % change



Sources: Statistics Iceland, Arion Research

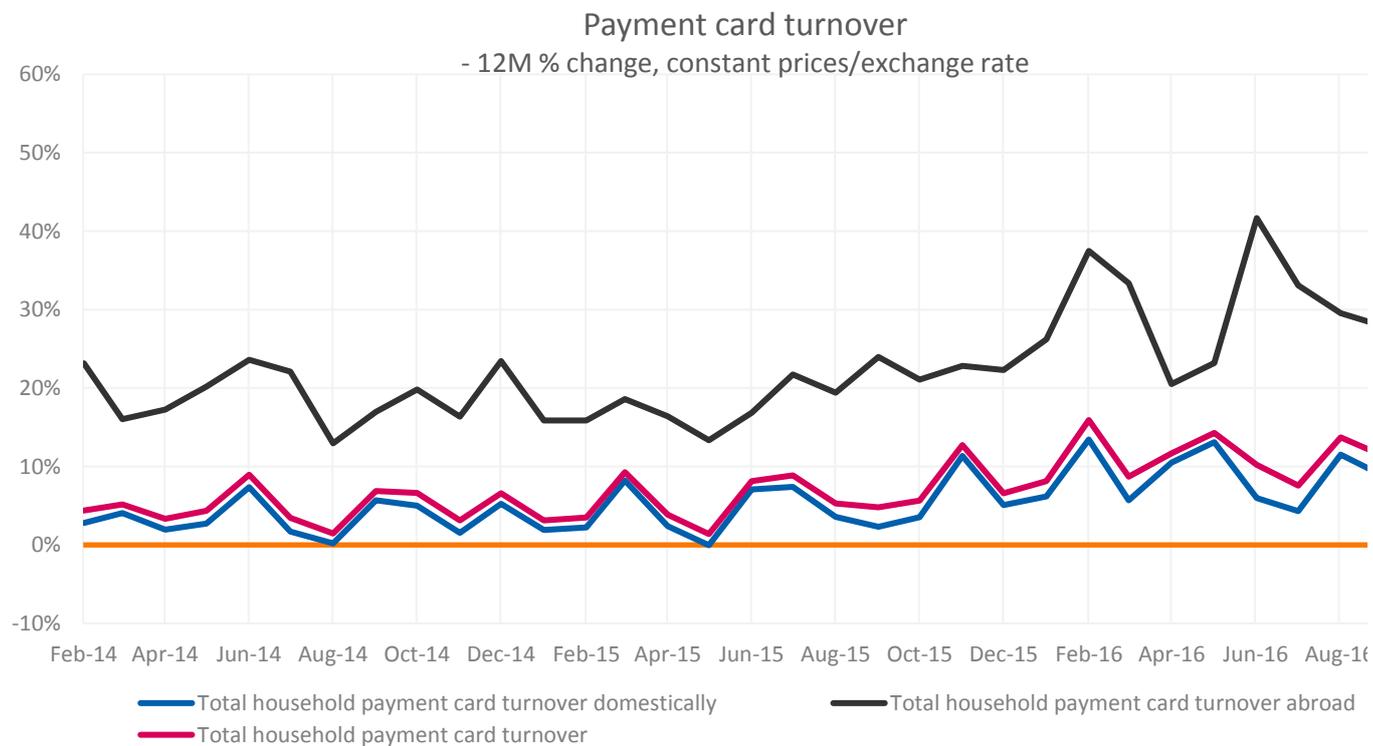
Tourists reduce spending amidst appreciating króna

The headline consumer price index increased by 1.9% year-over-year in December, the 35th consecutive month that inflation remained below the Central Bank's target rate. Considerable appreciation of the króna exchange rate has caused import prices to decline substantially, which in turn has restrained domestic inflationary pressures due to growth in domestic housing prices, positive output gap and wage hikes. The CPI less housing cost now stands at -0.8% YoY and has been in a disinflationary phase for six months in a row.



While inflation remains low, Icelanders' payment card turnover continues to accelerate. At constant exchange rates and constant prices domestic payment card turnover realized around 8.1%, while card turnover abroad increased YoY by no less than 50.8%, the highest increase in a single month recorded. At the same time Icelanders increased their travels abroad by 26% during the month, which explains the high growth of card turnover abroad to some extent. Nevertheless, turnover per Icelandic traveler in November (at constant exchange rates) grew by 19% YoY translating into Christmas shopping abroad comparable to that of December 2007. However this increase per traveler is almost exclusively explained by the significant appreciation of the króna.

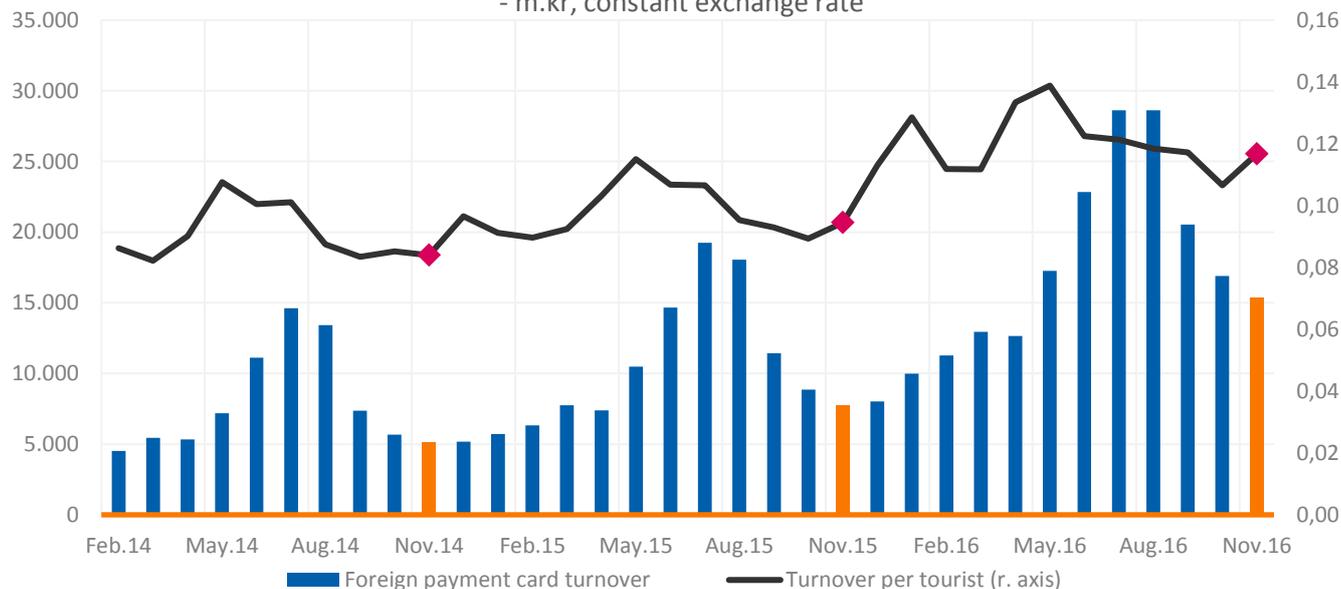
In total, household card turnover grew by 13.7% in November, fairly in line with the trend this year.



Along with increased turnover by Icelanders domestically and abroad, foreign payment card turnover in Iceland continued to increase sharply in November. With the number of foreign tourists growing by 61.4% YoY, foreign card turnover increased by 68% in nominal terms, or 99% at constant exchange rates. Consequently, foreign card turnover per tourist increased by 23% at constant exchange rates.

Foreign payment card turnover

- m.kr, constant exchange rate

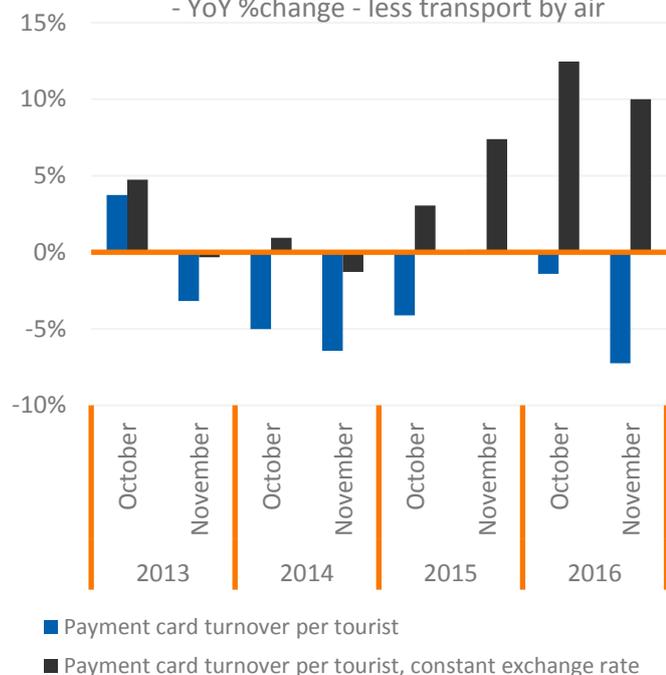


Sources: Central Bank of Iceland, Arion Research

However, when overlooking expenditure on transport by air, which has multiplied recently, the sharp increase in the exchange rate of the króna appears to have decreased tourist spending. Payment card turnover per foreign tourist declined by 7.2%, while increasing by 10% at constant exchange rate. The decrease as measured in ISK was less in October, but a contributing factor could be that the YoY appreciation in October was less than in November, or 12% and 16% respectively.

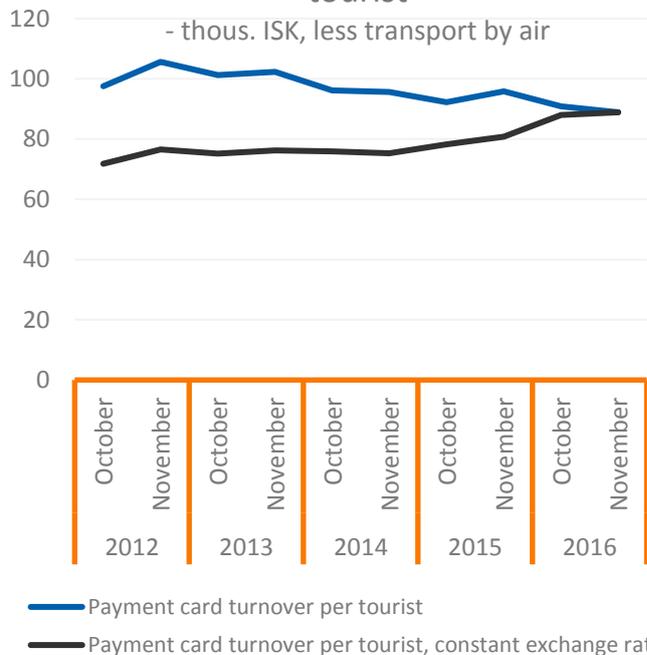
Card turnover per tourist

- YoY %change - less transport by air



Payment card turnover per tourist

- thous. ISK, less transport by air

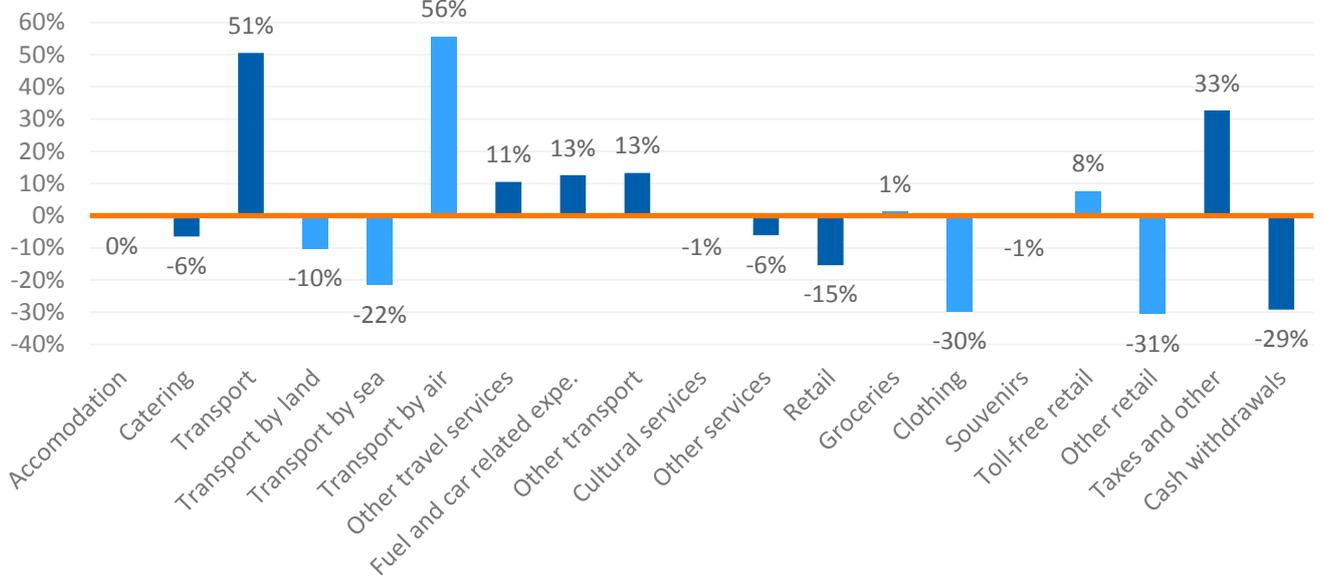


Sources: RSV (Centre for Retail Studies), Arion Research

The largest contraction was in cash withdrawals (-31%), followed by retail related expenditures (-15%). Moreover, there was a 6% contraction in both food and beverage expenditures and other services. However, travelers spent more on fuel and other travel services. Other transport expenditures also increased by 11%, but that category contains some organized trips and entertainment.

Card turnover per tourist in October and November 2016

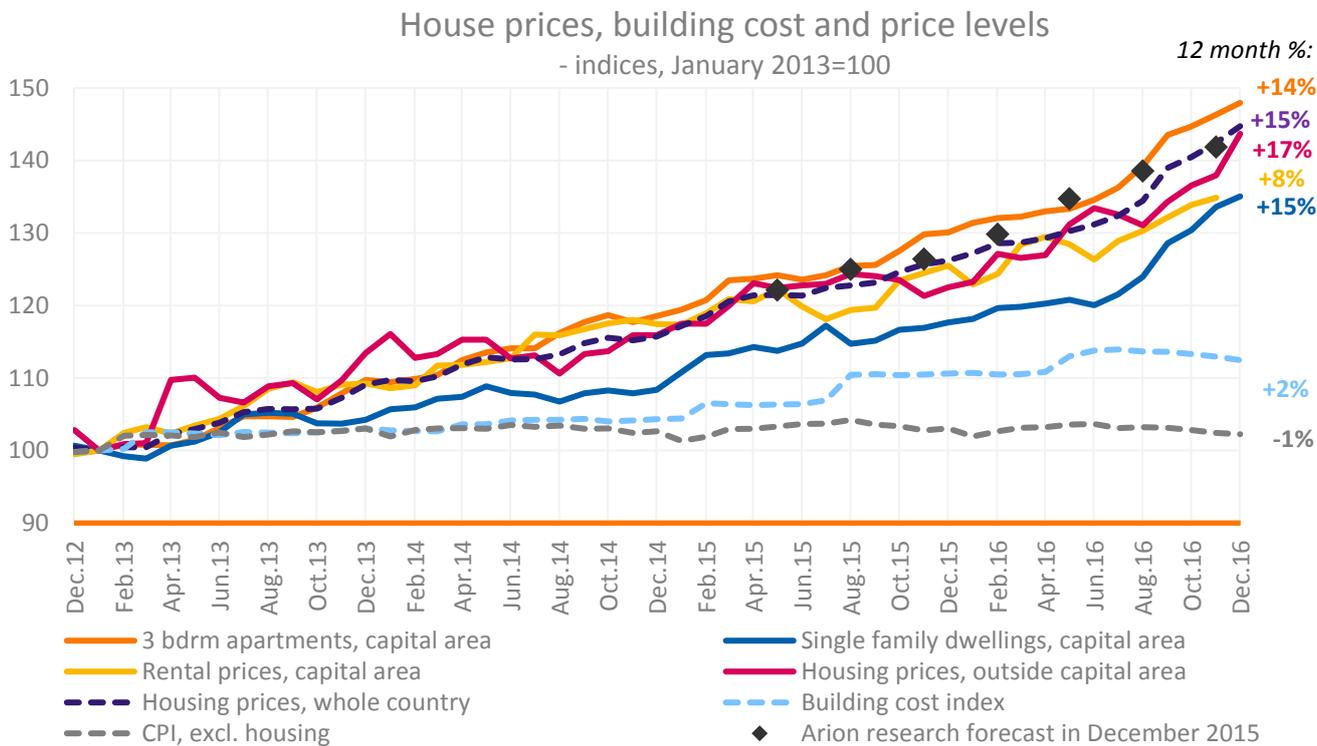
- YoY% change, prices in ISK



Sources: RSV (Centre for Retail Studies), Arion Research

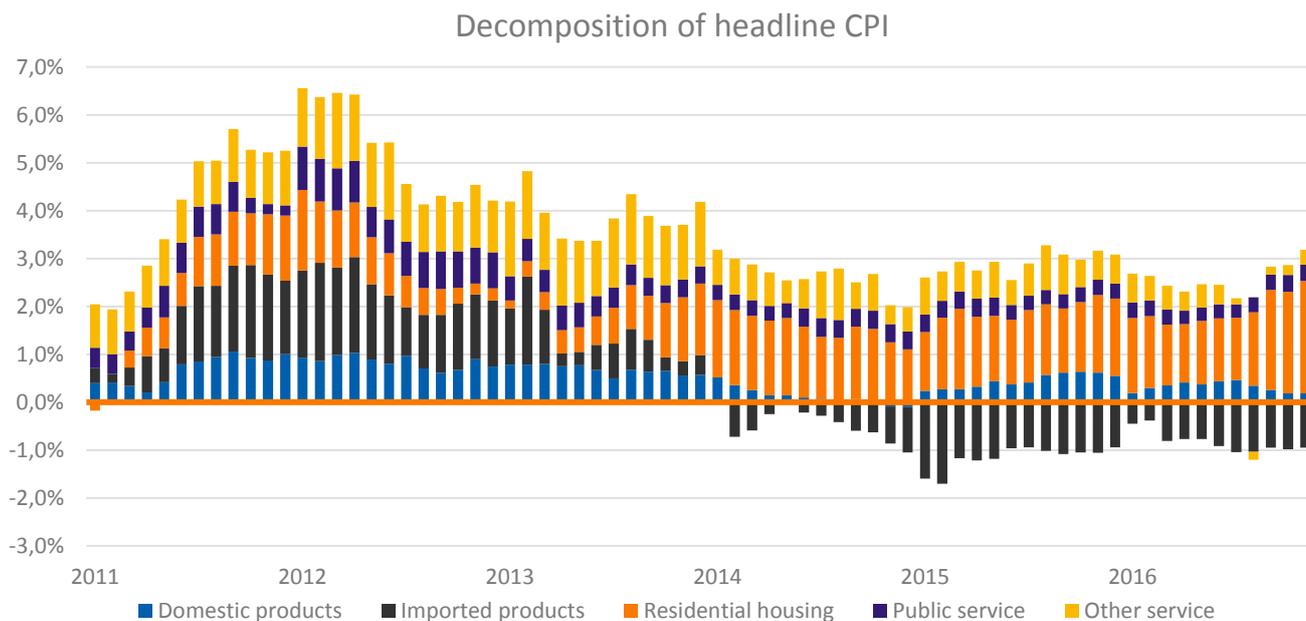
Housing prices keep rising

Arion Research recently published a summary covering the Icelandic housing market, but over the past two years housing prices have risen markedly. Over the last 12 months (November YoY) housing prices in the country as a whole have risen by roughly 15% compared to a 12% increase in July YoY. A noticeable difference from when we [covered the market in August](#) is that housing prices outside the capital and single family dwelling prices have gained considerable momentum as of late, rising by 15% and 17% respectively.



Sources: Statistics Iceland, Registers Iceland, Arion Research

As mentioned above, inflation has remained below the set target rate of the Central Bank for 35 consecutive months. However, the headline CPI in Iceland includes housing prices which has been the main cause of inflation over the past two years. When discounted for housing price, the headline CPI has been in a disinflationary phase for six months in a row.

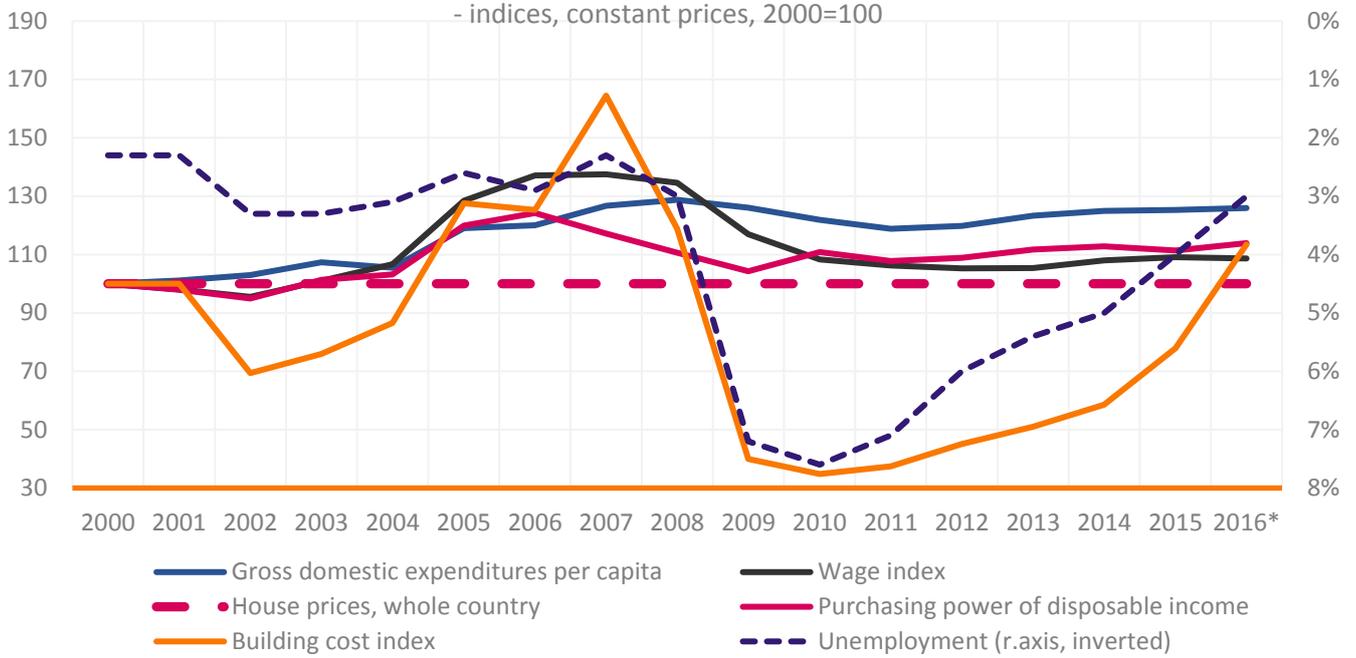


Sources: Statistics Iceland, Arion Research

When inspected in relation with underlying factors such as unemployment (decreasing), building cost and purchasing power of disposable income, it can be seen that housing prices still closely follow the aforementioned variables. The considerable increase in purchasing power as of late, due to wage hikes and low inflation, has especially followed housing prices closely.

Housing prices in relation with underlying factors

- indices, constant prices, 2000=100



Sources: Statistics Iceland, Registers Iceland, Arion Research *Arion Research forecast **Residential property market price index from 2001, imputed rentals for housing before that

Allowances to foreign investment of pension funds increased

The Central Bank has decided to grant pension funds a permit to invest in foreign financial instruments for 100 b. ISK in 2017, compared to 85 b. ISK in 2016. This increase does not come as a surprise and is a step towards fully lifting capital controls on Icelandic pension funds. As of October 2016 foreign assets of Icelandic pension funds amounted to 5.7 b. EUR or roughly 21% of their total assets. This is much lower than we believe to be adequate in the long run given Iceland's dependency on imports. We thus expect that in the long term Icelandic pension funds should set their aim on having 30-40% of their assets abroad.

Foreign assets of Icelandic pension funds*
- % of total assets



Sources: Central Bank of Iceland, Arion Research *as of October 31, 2016

Total assets of Icelandic pension funds amounted to 3,300 b. ISK in October 2016 or just above 140% of GDP. We assume that net premiums amounted to 46 b. ISK in 2016 and financial income will amount to around 70 b. ISK. In 2016 the lion's share of new investment of Icelandic pension funds have been directed towards foreign investment and mortgage loans to fund members and to a lesser extent into Icelandic security markets. Domestic pension funds are by far the largest holders of Icelandic securities so their asset allocation is of great importance to the development of domestic asset markets. In its statement the Central bank takes that into account as it claims "the authorization for 2017 is based on granting the funds maximum scope for foreign investment, but without selling domestic assets or pulling out of the domestic bond market to a disruptive degree."

The Icelandic króna has appreciated close to 17% in 2016 due to strong current account surplus and to some extent to investment inflows. We think it is important to lift restrictions on domestic investment abroad in the short run to curb the negative effects of strong króna and in the long run from asset allocation and balance of payments perspective.

The Central bank grants this authorization with the proviso "that amounts could change if the scope for foreign exchange purchases proves considerably less than is envisaged at present; for instance, if the balance of payments should develop unfavorably or other circumstances should change. If foreign currency inflows continue to be strong in 2017, however, it may be possible to increase the pension funds' authorizations for foreign investment."