

GDP growth 4.5% in first nine months of 2015

GDP growth numbers for Q3 2015 were a bit below our expectations, although growth in the first nine months of 2015 has been quite strong overall at 4.5%. According to Arion Research's most recent economic forecast growth in 2015 was expected to be 5.4%. With disappointing numbers for housing investment in Q3, that is unlikely to materialize.

The CBI keeps key rate unchanged

The Central Bank's Monetary Policy Committee decided to keep rates unchanged in December due to an improved near-term inflation outlook. The MPC's tone has become slightly more dovish even though the CBI claims the medium- to long-term inflation outlook remains roughly the same. Setting external factors aside, the State budget for 2016 and labor market conditions will most likely be determining factors for the inflation outcome in the coming year.

The Housing Market – In Search of Equilibrium

In December, Arion Research published a report on the Housing Market. We are currently forecasting a 30% increase in nominal house prices until year-end 2018. House prices have risen by 8% in real terms over the past 12 months and we believe demand will continue to be strong going forward. Whether price increases will be restrained by an increase in housing investment, or whether housing starts will continue to disappoint, will be the main uncertainty in the housing market over the coming quarters.

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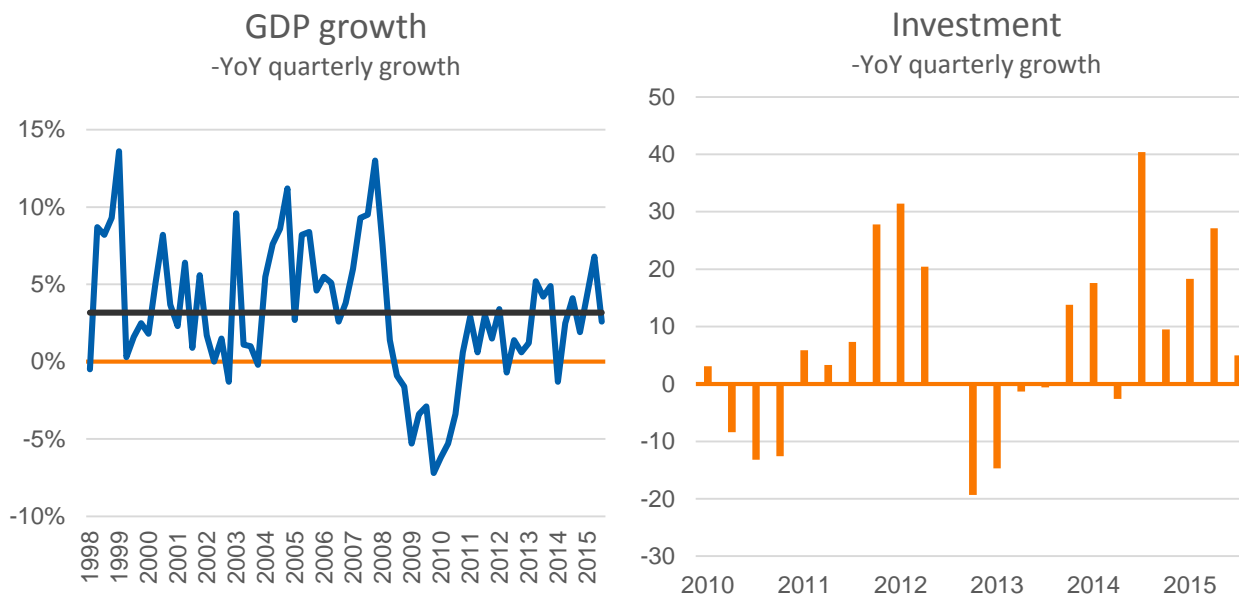
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Provisional release:

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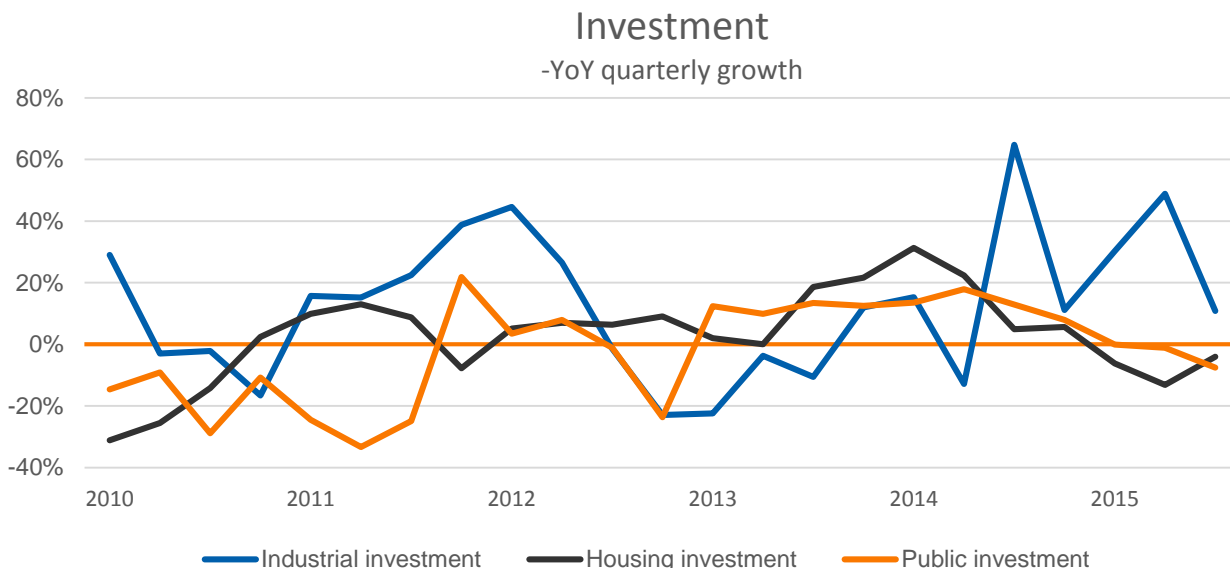
GDP growth 4.5% in first nine months of 2015

GDP growth in Q3 2015 was below our expectations, at 2.6% compared to the same quarter of last year. Growth continues to be driven by private consumption and investment. Nonetheless, investment growth was particularly disappointing at 5% in Q3 (investment growth in the first nine months this year has been 15.8%).



Source: Statistics Iceland

Housing investment continues to surprise to the downside (-4.0%) while industrial investment shows robust growth (10.8%), with hotel construction, silicon plants and investments in ships and aircraft. According to most estimates there is pent-up demand for housing, especially in the capital area, so a contraction in housing investment this year has been somewhat disconcerting. Despite considerable price increases in the housing market in recent quarters (an 8-9% annual increase), housing investment has been very sluggish – possibly due to competition from the hotel industry as well as the recent implementation of more stringent regulations regarding housing. Additionally, construction cost has risen almost as fast as housing prices, hampering the incentive to build.



Source: Statistics Iceland

Private consumption growth was in line with our expectations at 4.3% year-on-year growth. We believe consumption might pick up in the coming quarters due to a rapid increase in purchasing power, resulting from high wage increases and low inflation. Exports grew 3.7%, almost exclusively as a result of hefty growth in service exports (10.9%). Imports also grew quite rapidly (4.9%) making the contribution of trade to GDP growth negative.

Arion Research had predicted stronger growth in Q3 and our latest estimate assumes 5.4% growth for 2015 as a whole. Although this has been the strongest year in economic terms since 2007, Q4 will have to be quite strong for our forecast to materialize.

The CBI keeps key rate unchanged

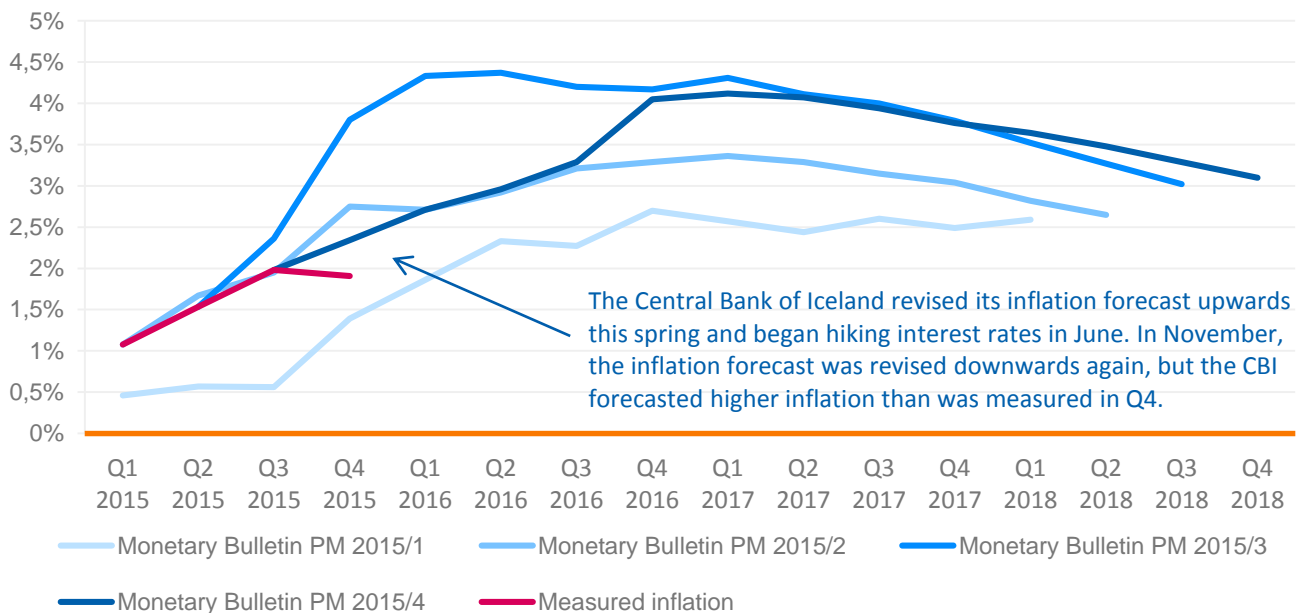
The Central Bank of Iceland's Monetary Policy Committee kept its key rate unchanged at 5.75% in December. Main analysts had expected as much due to an improved inflation outlooks since the CBI published its Monetary Bulletin in November. The MPC has demonstrated a very hawkish tone since last spring when it looked like wage negotiations would get out of hand, but inflation has yet to materialize following high wage increases which took effect for a large part of the Icelandic labor force mid-year. The MPC's tone was noticeably softer in December:

“A stronger króna and more favourable global price developments have provided the scope to raise interest rates more slowly than was previously considered necessary. However, this does not change the fact that, according to the Bank's November forecast, a tighter monetary stance will probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened will depend on future developments.”

Analysts noted that the word “probably” had been added to an otherwise rather repetitive statement, indicating a more dovish stance than in previous MPC statements.

Since last spring the Central Bank has revised its inflation forecast upwards - until November, when it was revised downwards again (at least for the coming 12 months). Since then, measured inflation has been well below the CBI's forecast.

CBI's inflation forecasts and measured inflation



Sources: The Central Bank of Iceland, Statistics Iceland, Arion Research

After having raised the reserve requirement from 2% to 4% in October, the MPC lowered it again to 2.5% already in December. The reserve requirement was raised in order to protect the banks' liquidity position through the winding-up procedures of the old banks' estates and in relation to the pending offshore ISK auction. Additionally, this change was supposed to strengthen the Central Bank's liquidity management in relation to its FX purchases. Even though the auction terms and date have yet to be announced the MPC deemed the change to 4% as having been adequately successful and as the composition agreements of the failed banks' estates have already been approved by Icelandic courts (in advance of their March 15 deadline) the MPC decided to lower the reserve requirements again so soon.

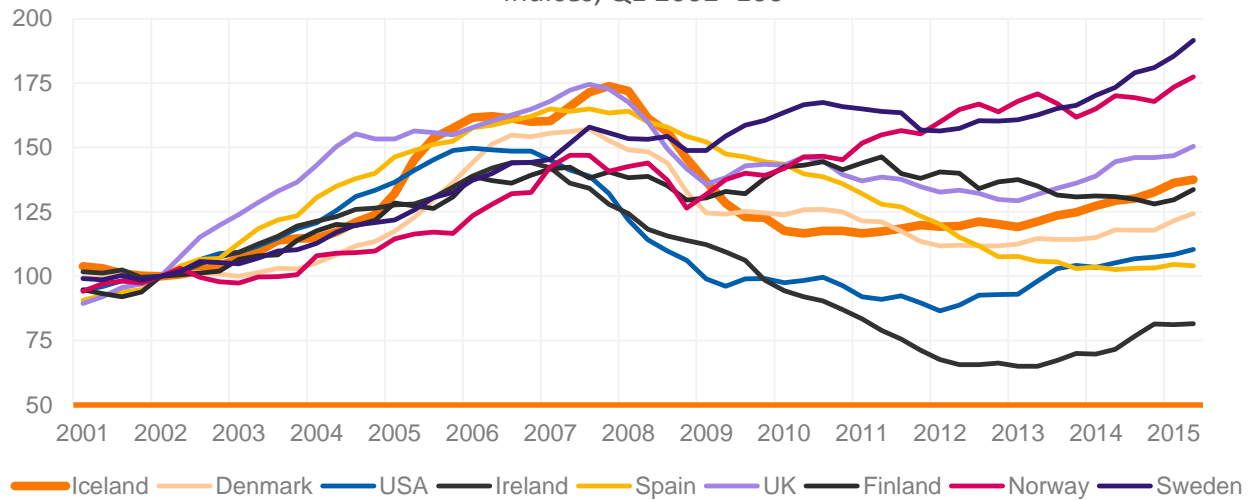
In addition to uncertainty still lingering in the labor market (some wage negotiations might be reopened in February) the Central Bank has voiced concerns over government finances, which will most likely include more tax austerity measures than previously suggested. Inflation pressure might very well be in the cards next year as the CBI predicts. Setting external factors aside, the State budget for 2016 and labor market conditions will be most likely determining factors for the inflation outcome in the coming year.

The Housing Market – In Search of Equilibrium

In December, Arion Research published a report on the Icelandic housing market. In an international comparison real house prices have not risen unusually in Iceland since the housing bubble burst in 2008.

International comparison of real house prices

- Indices, Q1 2002=100

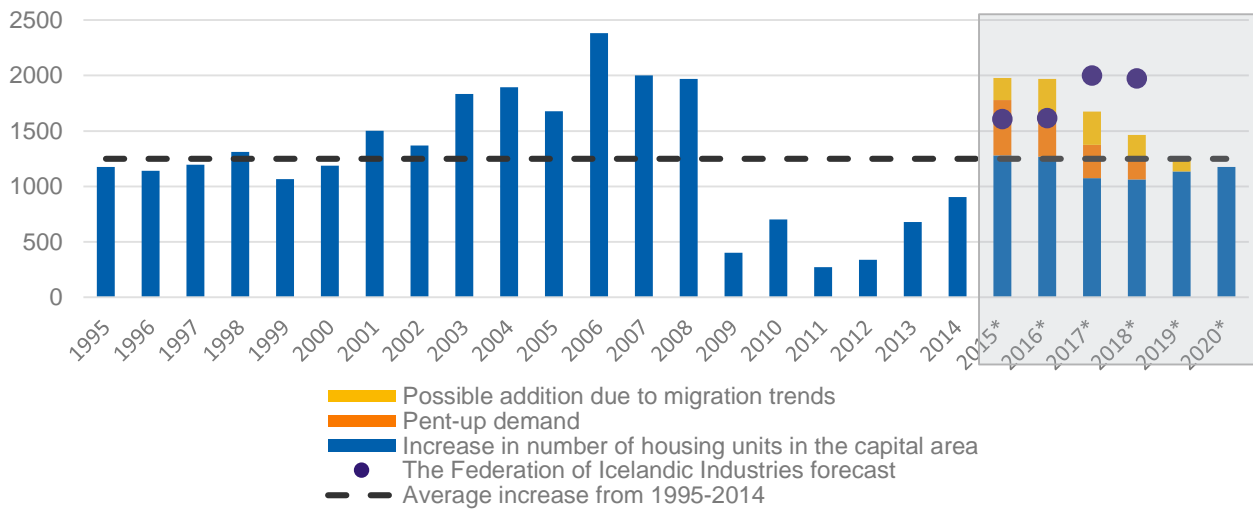


Sources: Central Bank of Iceland, Statistics Iceland, Registers Iceland, Arion Research

We are currently forecasting a 30% increase in nominal house prices until year-end 2018. Disposable income is expected to grow considerably and household debt has declined, facilitating the continued migration from the rental market to homeownership. Disappointing numbers for housing investment this year further support our forecast for price increases as supply is not likely to meet pent-up demand until 2018, at least not in the capital area.

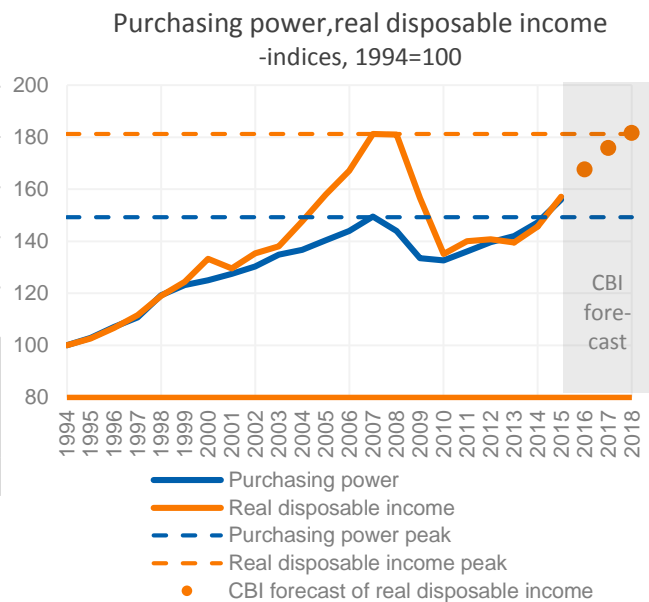
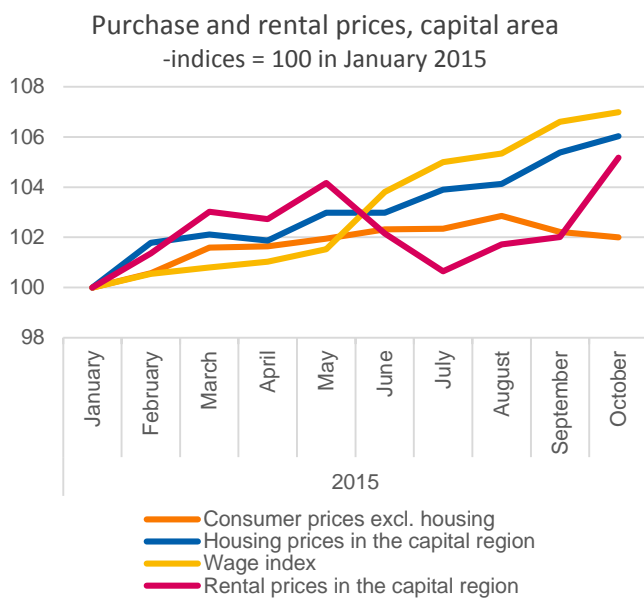
Increase in number of housing units in the capital area

-estimated need for 2015-2020



Sources: Statistics Iceland, The Federation of Icelandic Industries, Arion Research

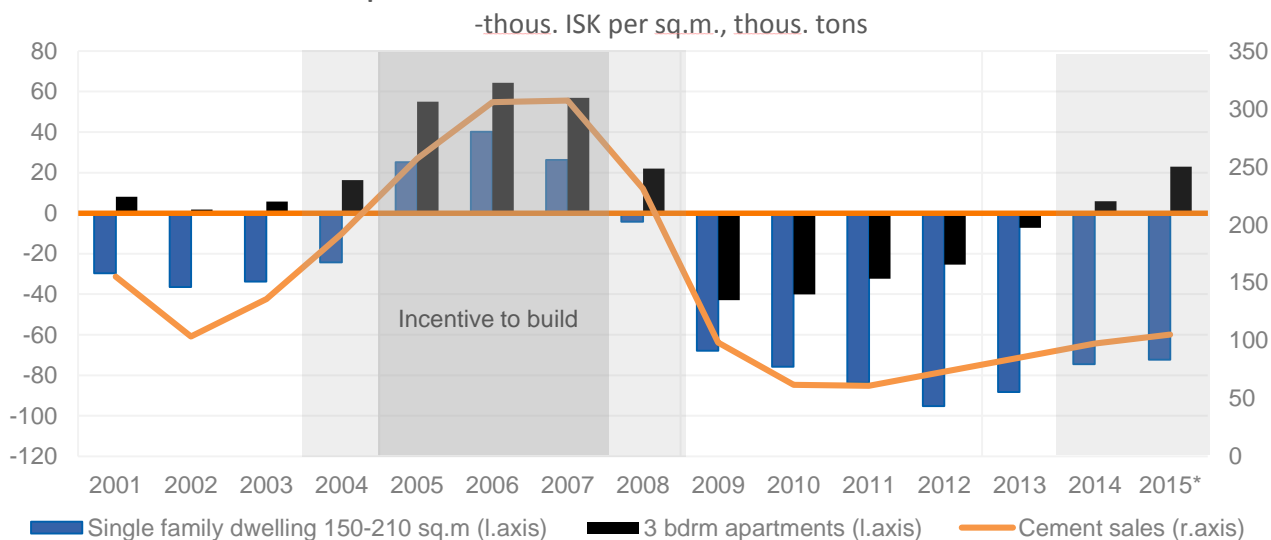
We are already seeing signs of further pressure on prices in the housing market; price increases in the rental market are slowing down relative to the housing market, the proportion of households in the rental market is decreasing, real disposable income is increasing rapidly and surveyed renters are still expressing a desire to move into their own homes.



Sources: Central Bank of Iceland, Statistics Iceland, Registers Iceland, Arion Research

Despite hefty price increases in the housing market over the past quarters, and predicted further increases in the years ahead, we do not yet see signs of a housing bubble. Recent price increases have not sufficed to create adequate financial incentive to build, especially not for single family dwellings, as construction costs have more or less kept up with price increases in the housing market. Many blame a recent expansion in housing regulation, which require home builders to fulfil expensive size and quality requirements, which some deem excessive. In response to criticism, housing regulations are currently being reviewed.

House prices less construction cost, cement sales



Sources: Central Bank of Iceland, Registers Iceland, Hannarr ehf. Arion Research

In real terms, house prices have risen by 8% this year, a reflection of strong growth in domestic demand, an increase in real disposable income and an improvement in households' balance sheets as well as a lack of adequate increase in supply. We believe demand will continue to be strong in the coming quarters due to favorable economic conditions and expected net migration to Iceland. Whether price increases will be restrained by an increase in housing investment, or whether housing starts will continue to disappoint, will be the main uncertainty in the housing market over the coming quarters.