Nordkinn Market Review & Outlook – January 2014

For informational purposes only.

DISCLAIMER

The report does not constitute an offer to sell or the solicitation of any offer to buy. The content of this Report has been prepared by Nordkinn Asset Management AB (the «Company»), registered in Sweden No. 556895-3375. Information in the Report is made only as at the date of the Report unless otherwise stated, and remain subject to change without notice.

The Content has been prepared in good faith. However, to the maximum extent permitted by law, neither Nordkinn Asset Management AB, nor its related corporations (including Nordkinn Asset Management Oslo Branch, registered in Norway No. 999 136 354), directors, employees or agents, nor any other person, accept any liability, including, without limitation, any liability arising from fault or negligence, for any loss arising from the use of the Report its contents or otherwise in connection with it.

The Report contains forward-looking statements. Although the Company believes the expectations expressed in such forward-looking statements are based on reasonable assumptions, such statements are not guarantees of future performance and actual results. Actual results or developments may differ materially from those projected in forward-looking statements. The Report is only for the use of those persons to whom it is addressed and no part of this report may be reproduced, redistributed or passed on, in any manner, or used other than as intended, without Nordkinn's prior written permission.

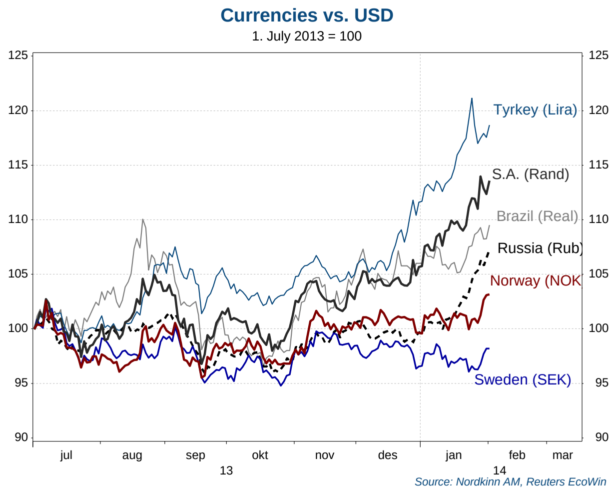
NORDKINN ASSET MANAGEMENT

Kungsgatan 33, 6tr
111 56 Stockholm, Sweden
Phone: +46 8 473 40 50
Telefax: +46 8 473 40 51
E-mail: post@nordkinnam.se

Parkveien 57
0256 Oslo, Norway
Phone: +47 22 46 63 00
Telefax: +47 94 77 15 16
E-mail: post@nordkinnam.no

Global overview

Business surveys indicate that the acceleration in global economic growth witnessed during 2013 stalled in January, reflecting weaker industrial activity in the US and China. Moreover, instability in many emerging market currencies (see chart) have unsettled investors over the past couple of weeks. Overall, these developments contributed to a broad-based market correction in January: Equity returns were negative, bond yields declined and credit spreads widened.



The reasons behind the current nervousness in many emerging economies are complex and to some extent country-specific. However, one common factor is the concern that the low interest rate epoch in the west, which has encouraged capital inflows to emerging markets, is ending. Higher global bond yields means it will be increasingly difficult for countries such as Turkey and Brazil to finance their current account deficits should capital flows reverse. Substantial increases in interest rates in e.g. Turkey and South Africa did little to calm markets.

Turning to advanced economies, growth in the US gained pace in Q4, mainly driven by an acceleration in retail sales growth. However, growth in manufacturing slowed unexpectedly in January 2014 according to the PMI index from ISM. Additionally, the outcome of the non-farm payroll report for December was a major disappointment (74 000 vs. 197 000 expected), although it is reasonable that severe weather conditions had a noticeable impact on these numbers.

As expected, the Federal Reserve decided to continue reducing monthly asset purchases by 10 bn to 65 bn in January. The decision was unanimous. The statement, which did not comment on the emerging market turmoil, indicated that a further measured reduction of asset purchases is likely in the months ahead should the economic and inflation outlooks evolve as projected.

In the euro area, most indicators suggest that the weak economic recovery is improving, presumably reflecting the strengthening of global demand. Nevertheless, the pace of growth is still not strong enough to reduce the very high unemployment rate. Against this background, CPI inflation remains low and eased further in January.

Also as expected, in January the ECB decided to keep interest rates unchanged at very low levels. In response to the risk of tighter short-term money markets and expected subdued inflation over the medium term, the ECB strongly emphasised that it will maintain an accommodative monetary policy stance and remains determined to take further action if required. As a result, yields on government bonds in Germany declined in January.

Nordic overview

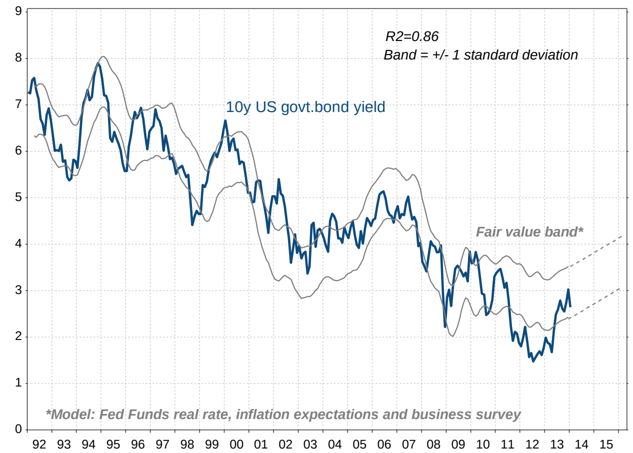
Following several months of weak growth rates in the Swedish economy, industrial production increased sharply towards the end of last year and thereby narrowed the gap to the more elevated business survey indices. Business surveys continued to advance in January and levels are consistent with robust realised growth at the beginning of the year. Yet, retail sales declined in December and was weaker than expected, but a firm underlying trend for consumption is still intact. Consumer price inflation was higher than expected in December, but remains low.

In Norway, recent data has challenged our bearish view held on the Norwegian economy. Confidence in the manufacturing sector unexpectedly increased towards the end of last year according to a survey conducted by Statistics Norway, and the decline in house prices that got foot-hold after summer last year came to a halt around the turn of the year. Inflation was lower than expected in December, but at 2% it is close to the Norges Bank’s target of 2.5%.

The general “risk off” sentiment in the wake of weaker global macro data coupled with the unrest in emerging markets had a direct impact also on Scandinavia. Interest rates declined across the maturity spectrum, while NOK and SEK depreciated against USD in the latter half of January.

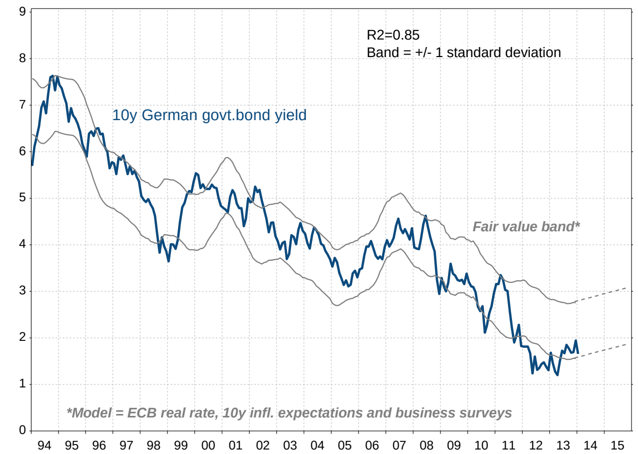
Global markets

US 10y govt. yield fair-value model



Source: Nordkinn AM, Reuters EcoWin

German 10y govt. yield fair-value model



Source: Nordkinn AM, Reuters EcoWin

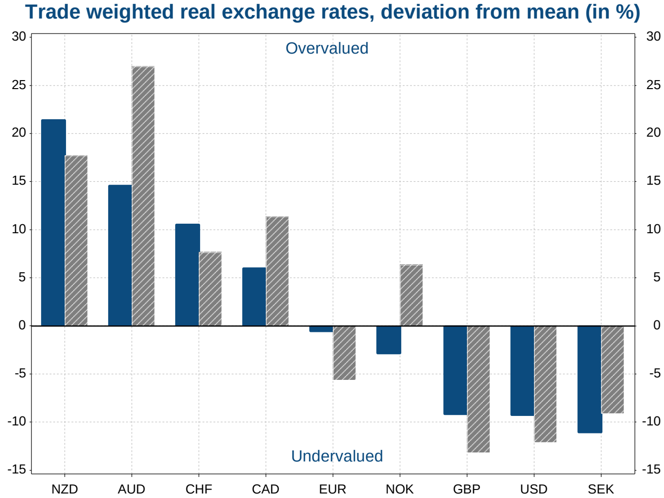
Weaker growth in the US and China, further fuelled by the unrest in emerging markets, supported government bonds in major markets in January. As a result, prices on long-dated government bonds are now looking quite expensive, see charts above. German government bonds (chart to the right) look particularly expensive, largely reflecting market expectations of very accommodative monetary policy by the ECB for an extended period.

Looking ahead, our main scenario is that the dust associated with the emerging market sell-off will settle. We do not think that the reversal of capital flows will initiate a major crisis for emerging economies due to relatively low external debt burden. This said, if the emerging market crisis were to involve a sharp economic slowdown in China, the impact on the global economy would be meaningful. Moreover, regardless if China were to slow or not, a worsening of the emerging market instability could have significant market impact in the short term.

Elsewhere, we continue to expect growth in the US to strengthen this year underpinned by rising domestic demand. In our view, the distribution of risk is skewed towards a stronger GDP outcome than expected by consensus. As a result, US bond yields should continue to move gradually higher over coming months. In addition, the correction in economic surprise indices and positioning by non-commercial investors in January suggest less resistance for bond yields to move higher in the short-term.

We also expect the euro area economy to gain pace, yet growth will remain relatively muted as tight lending conditions weigh on economic activity. As such, we expect the low levels of German bond yields to persist for quite some time. Additionally, given the very low inflation rate, we expect the ECB to go ahead with additional policy easing, perhaps as soon as in the current quarter.

Trade weighted real exchange rates, deviation from mean (in %)



Source: Nordkinn AM, Reuters EcoWin

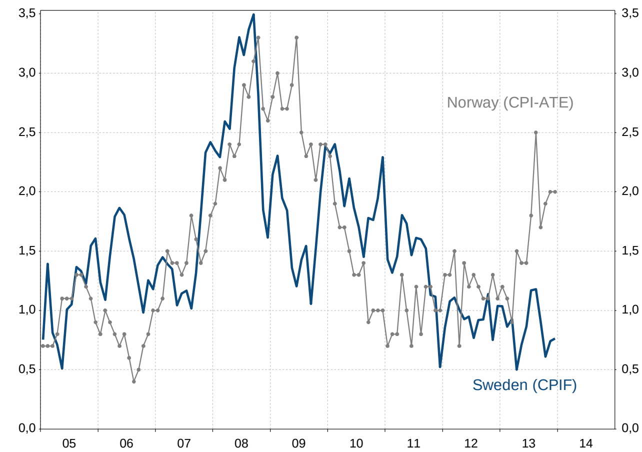
Looking at valuations across the FX market, most currencies have reverted towards historical mean during over the past twelve months, see chart. The NZD is one exception, and has now overtaken AUD as the most overvalued currency according to our models. At the other end of the scale, we consider the SEK, USD and GBP to be largely undervalued.

Based on our optimistic outlook for the US, we continue to see a potential for the normalisation of the USD to proceed in coming months. Moreover, the narrowing of the US current account deficit, which to some extent reflects higher US energy production, is also underpinning the value of the dollar on its own merits.

Nordic markets

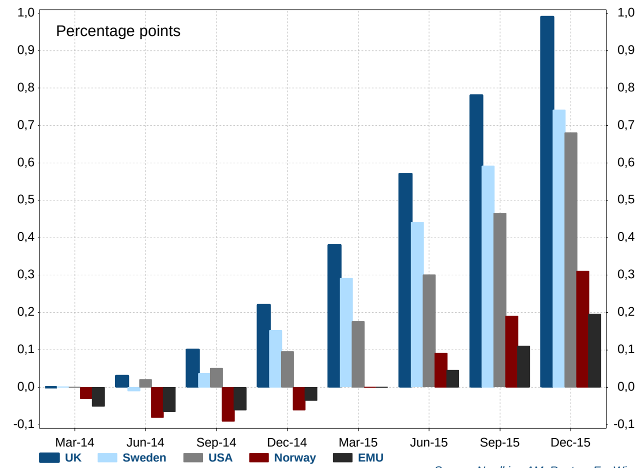
As the outlook for growth in major advanced economies is gradually improving, demand for Swedish exports is likely to increase going forward. The more optimistic household sector, as witnessed by stronger retail sales and higher consumer confidence, should also support growth in Sweden this year. As a counterbalance, the unemployment rate is likely to fall only gradually from current high levels, which in turn should keep inflationary pressures low.

Underlying inflation



Source: Nordkinn AM, Reuters EcoWin

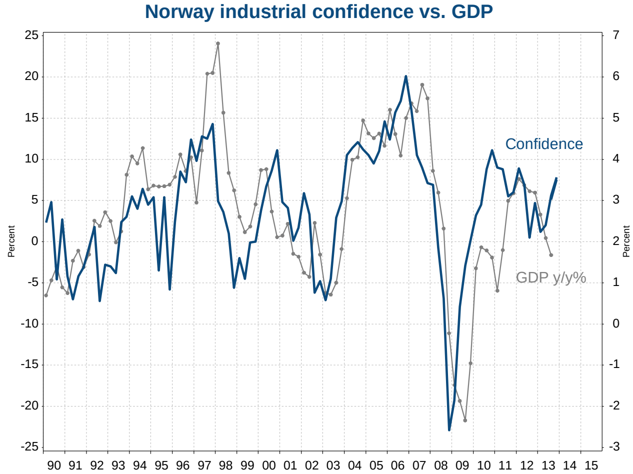
Expected change in 3m market rates



Source: Nordkinn AM, Reuters EcoWin

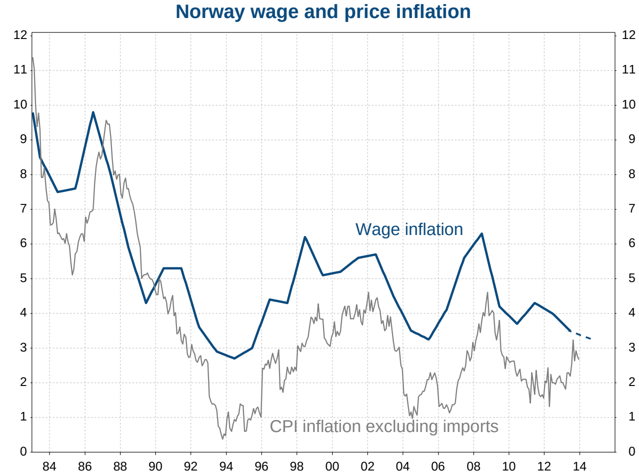
Reflecting the low inflation rate (see chart to the left) and soft indicators of future inflation, we expect the Riksbank to keep interest rates unchanged throughout 2014. We anticipate a gradual tightening of monetary policy in 2015, but this view is already reflected by the relatively steep money market curve (chart to the right).

Norway industrial confidence vs. GDP



Source: Nordkinn AM, Reuters EcoWin

Norway wage and price inflation



Source: Nordkinn AM, Reuters EcoWin

Positive data for industrial confidence in Q4 (see chart to the left) and signs of a stabilisation in the housing market around the turn of the year are challenging our negative view on the Norwegian economy. The decline in house prices in the second half of 2013 appears to have attracted buyers, while stronger global growth and a 10% cheaper NOK exchange rate are benefitting non-energy exports. Still, we continue to see downside risks for growth ahead in Norway as we anticipate the positive contribution from oil investments to fade, and we expect subdued wage growth in 2014 (see chart to the right).

Incoming information since the Monetary Policy Report in December suggest the Norges Bank will stick to its plan of keeping interest rates unchanged at Board meeting in late March. Looking further ahead, we have become less confident in our call for a rate cut by Norges Bank later this year due to the slightly better macro data in January.