Nordkinn Market Review & Outlook – July 2014

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Based at the Nordkinn peninsula, Slettnes Fyr is the northernmost located mainland lighthouse in the world

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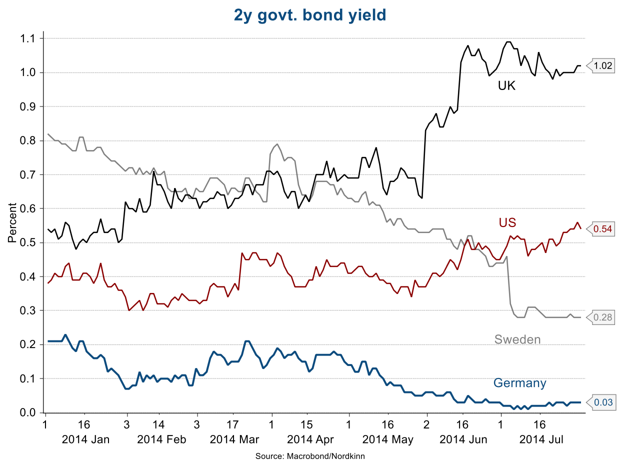
Global overview

Induced by renewed geopolitical risks, government bond yields with longer-dated maturities declined across most major economies in July, except for the US, where strong growth offset the geopolitical concerns and kept yields broadly stable overall. Meanwhile, shorter-term interest rates increased slightly in the US, but were relatively stable or declined elsewhere (see chart). Consequently, the slopes of the advanced economies' government bond curves became somewhat flatter in July. Market volatility was seemingly unaffected by the increase in geopolitical risk and remains close to the historical low levels witnessed in Q1 2007.



The 10y German bund yield reached a new all-time low of 1.12% in July. Ultra-easy monetary policy, weaker than expected macro data and geopolitical tensions were the main triggers in July behind the ever-decreasing bund yields. However, the low yield is also indicative of a lack of confidence among market participants regarding the likely economic effects of ECB's new policy measures. Some argue that the new TLTRO is less "targeted" than the name suggests, while other sense that a large asset-purchase program is the only way to kick-start the economy and raise inflation expectations.

In the US, incoming data showed that the economic recovery is on track. Q2 GDP rebounded strongly after contracting in Q1 and indicators of inflation have increased in recent months. As a result, market expectations regarding the future level of the Fed Funds Rate rose in July. However, yields on long-dated US government bonds were broadly stable, as geopolitical tensions and talk about a "new lower neutral" for short-term interest rates (refer to the "Outlook" section for our reflections on this concept) offset the effect of stronger US growth and firmer inflation rates.

Nordic overview

Short-term interest rates in Sweden fell significantly along with the SEK after the Riksbank surprisingly cut the repo-rate by 50 bps in July. None of the 17 economists surveyed by Bloomberg predicted a 50 bps cut. Although the decision exceeded our expectations too, it supported our investment theme "*Sweden: Credible inflation targeting*" detailed in our previous monthly report. It was not an alarming macro-economic outlook that was behind the large interest rate cut. Instead, the Riksbank had reached the conclusion that a much different monetary policy is required with lower rates for a longer period in order to get inflation back to target, and to prevent inflation expectations from drifting too far away from 2%. In short, the Riksbank Board wanted to restore credibility for its inflation target.

Interestingly, CPIF inflation rose to 0.8% in June (from 0.4%). The figure, released a few days after the Board meeting, was much higher than expected. One may wonder if the Riksbank would have been content with a smaller rate cut if this inflation print was known prior to the decision.

Incoming data in July painted a mixed picture for economic activity in Sweden. Survey-based indicators continue to suggest economic activity is strengthening. However, realised growth in manufacturing production remains weak and the preliminary estimate of growth in Q2 GDP were lower than expected.

Norwegian government bonds continued to perform in July in light of the Norges Bank's easing bias coupled with reduced auction volumes. Moreover, following the surprise decision by the Riksbank, Norwegian short-term market rates fell as the market sees a relatively high probability of a rate cut in Norway in Q4 or Q1. Contrary, incoming data during July did not suggest that a rate cut is imminent. Core CPI inflation rose to 2.4%, as expected, while unemployment unexpectedly fell to 3.2% (previously 3.4%) according to the Labour Force Survey.

Global markets

We see two different scenarios for fixed income markets ahead. On the one hand, the current pro-liquidity stance by major central banks is set to keep market volatility low and to support asset prices. On the other hand, the market's complacency about the outlook for interest rates could gradually fade in the wake of stronger economic growth and firmer inflation rates.

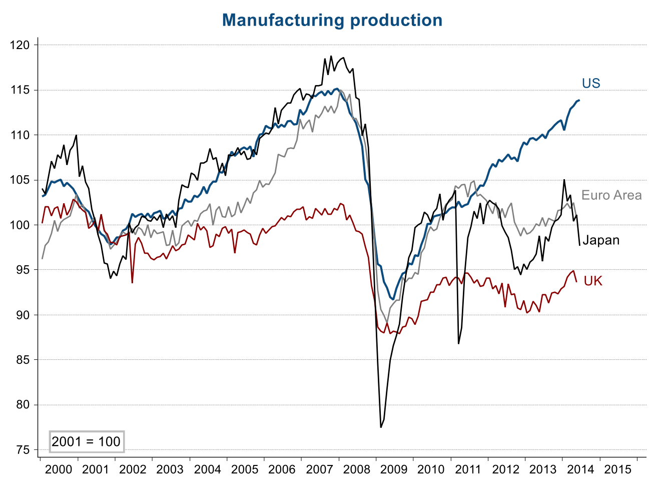
The first scenario represents a continuation of the market environment witnessed in the first half of this year. Although we expect that the Fed will end its asset purchase program in October, it will keep key policy rates unchanged for a considerable period after ending QE, in line with its forward guidance. Moreover, the new ECB measures will contribute to boost global liquidity, fostering asset price support and search for yield.

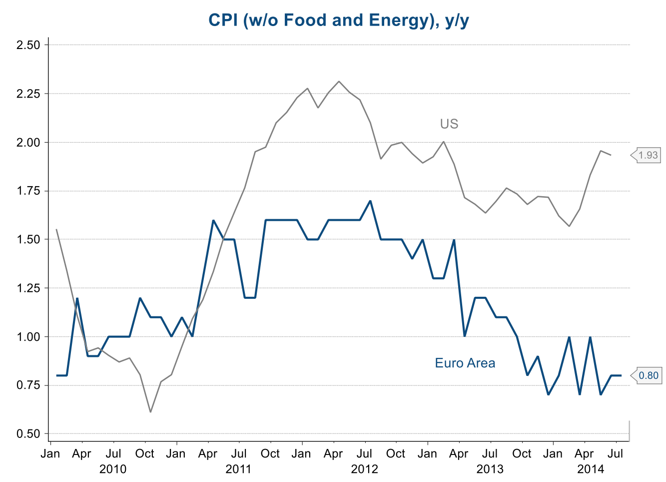
Furthermore, the concept of the "neutral" level for short-term interest rates – i.e. the rate consistent with full sustainable employment (i.e. no spare capacity) and inflation on target – has received more attention in recent months. A hypothesis currently prevailing among many market participants is that the neutral interest rate level has fallen from around 4% to around 2% in the US, reflecting debt overhangs and lower potential output growth. The hypothesis of this "new lower neutral" rate has two important implications: Firstly, the price of long-dated government bonds are less overvalued than presumed, and secondly, asset returns are likely to be subdued ahead.

If the second scenario – fading complacency about the rate outlook – plays out, trades comprising a negative "carry" will likely outperform search-for-yield trades, and volatility levels should increase. As we illustrated in the previous monthly report, market expectations regarding the future Fed Funds Rate are still below the median forecast by FOMC members, although the deviation has narrowed after short-term interest rates rose in July. If the current trend of stronger growth and firmer inflation rates continues (see charts), the FOMC will continue to revise its rate forecast gradually upwards.

Added to that, it is possible that the market is starting to become too optimistic (or perhaps pessimistic is a better word) about the concept of a "new lower neutral" rate for monetary policy, and what it means for asset prices. We think the magnitude of the decline in this (unobservable) rate is something in the order of 0.5%-points, not 2%-points as some argues. If we are right, this means that the neutral level of the Fed Funds Rate is around 3.5%. This is below the "old" 4%, but clearly above 2%. The implication for fixed income markets of a lower neutral rate is that the cyclical peak in long-dated government bond yields will be lower than in the past. For equity markets the implication is not straight forward: Lower bond yields is in isolation positive for equities, whereas the reason behind the lower neutral rate – which is a decline in growth potential – is not.

We believe that the second scenario - fading complacency about the rate outlook – will gain traction in the months ahead, which we seek to capture in e.g. our investment theme *"USA: Economic recovery progressing".*





Nordic markets

According to the new monetary policy report and the minutes following the surprisingly large interest rate cut in July, the Riksbank Board is vigilant with respect to further downward surprises to consumer prices and stated that the door is not closed for even a further reduction in the repo rate in the near term. At the same time, the minutes suggests there is room for a positive surprise on inflation without an opposite policy reaction in the near-term. Given that the market is pricing in a rate hike in the second half of 2015, we expect further downward pressure on Swedish FRA-rates maturing next year. Consequently, although our *"Sweden: Credible inflation targeting"* theme performed well in July, we still think short-term money market rates will grind lower.

Meanwhile, we remain quite optimistic concerning economic growth prospects for Sweden. In particular, the high level of confidence, combined with an even lower interest rate level, should motivate households and businesses to boost spending. Moreover, the unexpected sharp increase in consumer price inflation in June significantly reduced the downside risk to inflation ahead. Given the considerable decline in yields across the maturity spectrum, and the Riksbank's commitment to keep interest rates low for an extended period, we have started to build positions for a steeper money market yield curve going forward.

Turning to Norway, we continue to expect growth to slow significantly next year, primarily based on our anticipation of a sharp drop in oil investments, which would feed through to other sectors in the economy. The quarterly survey of future oil investments released in June suggests a drop in investments in the order of 15% next year. We are mindful that this outcome was a preliminary estimate subject to revisions, thus we will monitor the next survey closely, which is due in mid-September.

If upcoming surveys were to confirm this gloomy investment outlook, the Norges Bank should try to dampen the negative economic impacts by lowering the key policy rate, which currently stands at 1.5% - well above the levels of its trading partners. Market participants already discount a relatively high probability of a rate cut by the end of this year.

So far, with the exception of the oil investment survey, incoming economic data do not indicate that a sharp slowdown is currently underway. GDP is growing at a healthy pace, the unemployment remains low and core CPI inflation remains close to the 2.5% inflation target. Consequently, and given current market pricing, we have lowered our exposure to our investment theme labelled "*Norway: Weaker growth outlook"* which is expressed through long positions in the Norwegian fixed income market, and which contributed significantly to the positive results in June and July.

Against this backdrop, we introduced a new investment theme in July: *"Norway: NOK recovery"* as a response to the sharp NOK depreciation following the dovish Norges Bank statement in June. One motivation for the theme is that the NOK appears undervalued judged by our short-term trading models, which among other factors takes into considerations the differences between short-term interest rates between Norway and its trading partners. Accordingly, we judge that an interest rate cut by Norges Bank is a necessary condition for a further significant depreciation of the NOK from current levels - a scenario which already is addressed by our *"Norway: Weaker growth outlook"* theme. Therefore, the introduction of the "*Norway: NOK recovery"* theme may have contributed to reduce rather than increase the overall portfolio risk in July.