NORDKINN
asset management

Nordkinn Market Review & Outlook – July 2017

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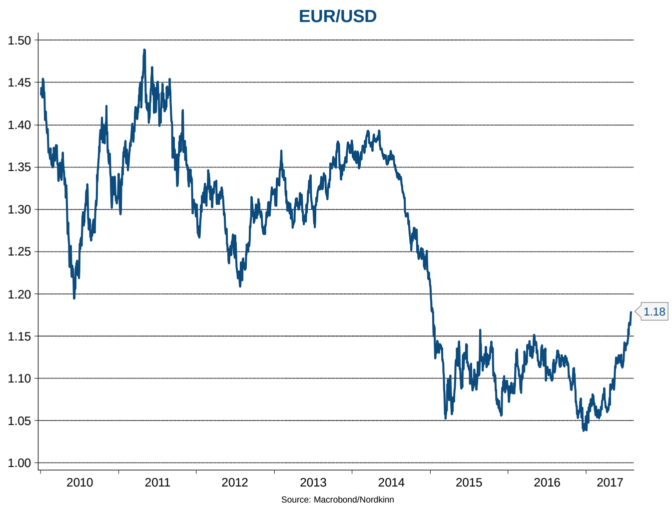
Global overview

The summer lull took grips of markets in July, resulting in modest overall market movements. Global bond yields fell gradually in July, partly offsetting the spike that had followed Mario Draghi's speech at Sintra in late June. Meanwhile, the EUR continued to strengthen on strong European macro data and expectations that the ECB will reduce its asset purchase program next year, see chart. Oil price gained as concerns eased that efforts by OPEC to curb output will be offset by rising output elsewhere.

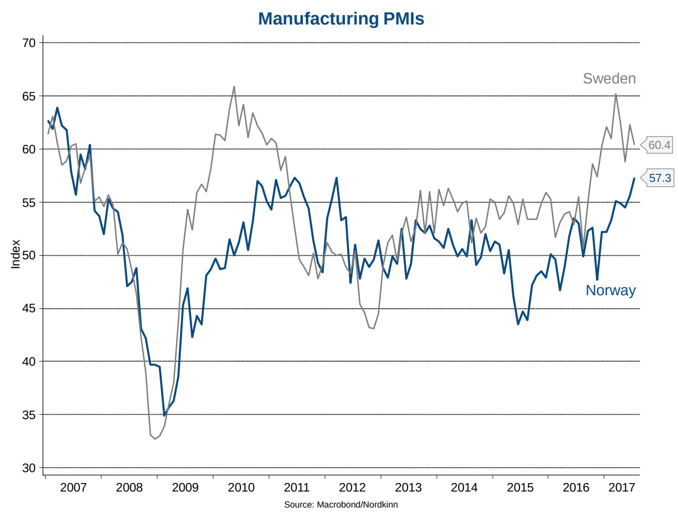


According to the FOMC statement issued on July 26th, the Federal Reserve appears set on announcing the unwinding of QE in September. Moreover, the committee anticipates that economic conditions will evolve in a manner that will warrant gradual increases in interest rates. At the same time, minutes from the FOMC meeting in June revealed that policymakers are divided regarding how they should respond to the recent subdued inflation readings, which lead to declines in both US bond yields and the USD in July.

The ECB's Governing Council kept an easing bias on its asset purchase program at its meeting on July 20th as Mr. Draghi emphasised that there are no convincing signs of a pickup in underlying inflation. While not a major surprise, the statement was interpreted as slightly dovish triggering a small reversal of the recent rise in government bond yields.

Contrary, the Bank of Canada proved decisive on July 12th when raising its key interest rate by 25 bps to 0.75%, responding to strong economic growth and rising capacity utilisation as the economy's adjustment to a lower oil price was deemed largely complete.

Nordic overview



The Riksbank Board decided at its meeting on July 3rd to remove the easing bias in its interest rate projection, signaling to markets that further cuts are unlikely in the near term. The Riksbank citied higher than expected inflation as one of the reasons behind this change, although we suspect that the ECB's move to a neutral bias in June largely influenced the decision. Apart from this, the interest rate projection was identical to the previous one, indicating that the first hike will come around summer of 2018.

CPIF inflation stood at 1.9% in June, which was higher than the Riksbank expected and almost at par with the inflation target. Meanwhile, GDP rose by a staggering 4.0% in Q2 from a year earlier. The strong data triggered speculations about the possibility of an earlier start date for the removal of monetary policy accommodation. Consequently, the SEK has appreciated substantially and interest rates have risen.

After weak performance in June, the NOK rebounded in July, in part supported by rising energy prices. A slow-down in market activity induced by summer holidays characterised in particular the Norwegian bond market in July, as even a limited demand for bonds contributed to push yields lower both in absolute terms and relative to Germany as well as versus swaps. The slope of the NOK FRA curve steepened, largely owing to a decline in short-term interest rates.

Incoming data continues on balance to paint a picture of a relatively robust economic recovery in Norway, even if the housing market is slowing in Oslo. The manufacturing PMI is lagging that of Sweden's, but the gap is narrowing as Norwegian business optimism is rising, see chart. CPI-ATE inflation rose to 1.6%, slightly above Norges Bank's forecast. On balance, economic developments appear somewhat stronger than the Norges Bank expected in its Monetary Policy Report.

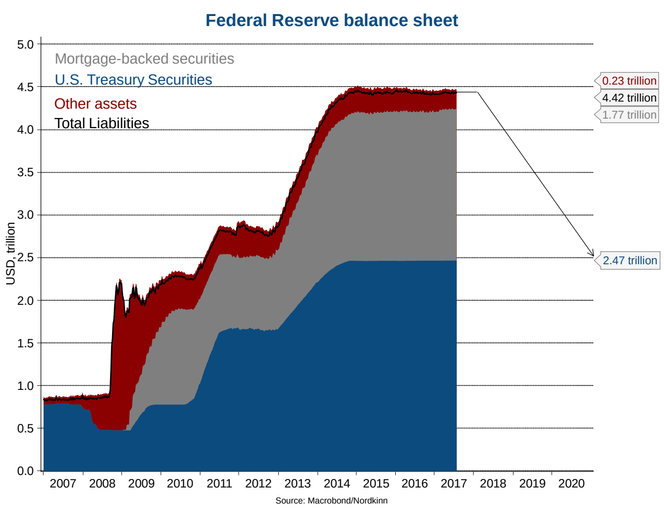
Global markets

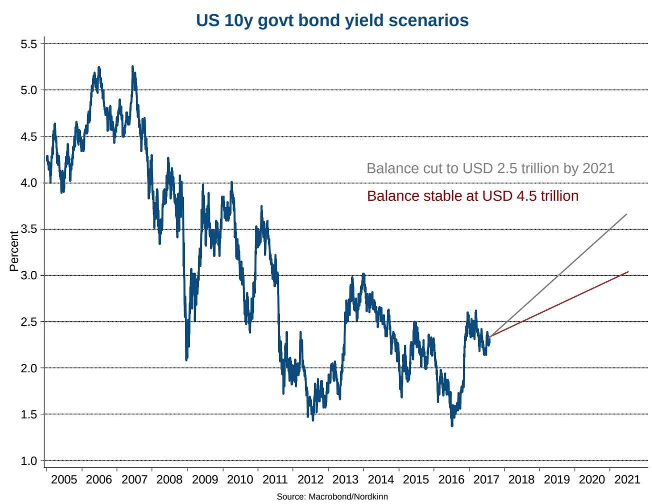
In determining the pace of interest rate normalisation, central banks are currently trying to strike a tricky balance. On the one hand, hiking interest rates too early and too quickly could derail a fragile economic recovery, especially in the event of a stormy reaction in the financial markets which have grown accustomed to ultra-low interest rates. On the other hand, if central banks keep interest rates too low for too long, they would fall behind the curve and may at some point need to tighten more abruptly to keep the economy from overheating.

Currently, the low inflation rates and muted wage growth across most developed markets are supporting a very gradual approach towards rate normalisation. In spite of subdued inflation, many central banks have turned more hawkish in their communication lately and the Bank of Canada even took action by deciding to hike in July.

By contrast, the recent unexpected drop in US inflation has lead to a decline in expected future interest rates. The market is now pricing in less than 25 bps of Fed tightening between now and next summer. Of note is that this is meaningfully slower than the median forecast of the FOMC members, which project another 25 bps of tightening this year alone and a further 75 bps in 2018.

We concur with the Federal Reserve's view that the recent weakness in inflation as largely transitory. Methodological changes and lagged effects of the 2014-2015 USD appreciation are among factors that have contributed to lower inflation. Looking beyond temporary factors, reflationary forces are at play, supported by high capacity utilisation and rising import prices as the impact of the USD appreciation is now fading. Indeed, as inflation is lagging the business cycle, we see a risk that inflation could even rise faster over the coming two years than the Federal Reserve is currently expecting.





The Federal Reserve is preparing markets for a program set to commence reducing its USD 4.5 tln balance sheet. The plan is to begin tapering by letting USD 10 bln a month in maturing securities to run off, which will slowly increase over the subsequent months until reaching USD 50 bln per month. This pace will take the balance sheet down towards USD 2.5 tln in 2021, see left hand chart.

We have used a regression model to estimate the impact on US 10-year government bond yield of changes in the balance sheet. In the baseline scenario, we assume that FOMC continues to raise rates at a gradual pace as inflation makes further progress towards the 2.0% goal. We also assume that the Fed's balance sheet deflates to about USD 2.5 tln in 2021. In this scenario the US 10-year government bond yield rises to 3.7% in 2021. In an alternative scenario where the Federal Reserve keeps its balance sheet stable, the 10-year yield rises to only 3.0%. This is in our view a sizable impact.

We expect the balance sheet reduction program to be implemented at the next FOMC meeting in September. The Federal Reserve will most likely maintain rates unchanged then in order to avoid too much tightening of financial conditions. Given that the committee has been transparent about its thinking around the balance sheet, we expect the implementation to proceed relatively smoothly in the near term, even if we expect that the longer term impact on rates will be sizable. In that case, barring further unexpected weakness in underlying inflation, we believe that the FOMC will hike rates at the meeting in December.

Taken together, this analysis supports our *"USA: Interest rate normalisation"* theme expressed through combinations of short positions in US treasuries and curve steepeners. Moreover, as we discussed in detail in our previous monthly report, we remain committed to our *"EMU: QE tapering"* theme.

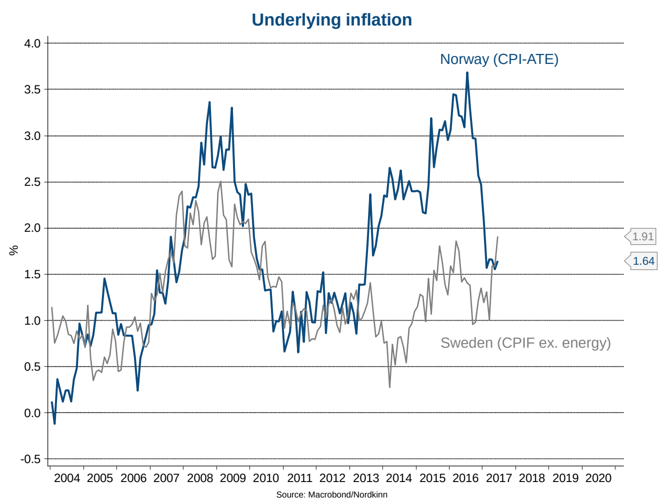
Nordic markets

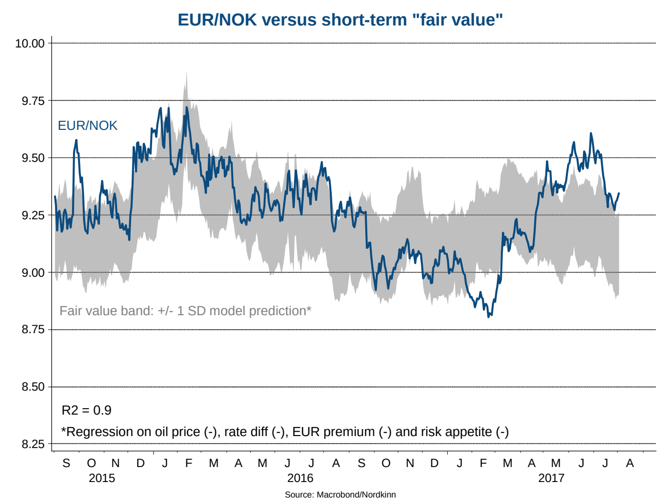
Swedish economic activity is developing strongly and confidence indicators point to continued optimism among households and companies. Resource utilisation is high and, according to our assessment, higher than what is normal. Moreover, underlying inflation has been higher than expected recently and very close to the Riksbank's 2% inflation target, see left hand chart.

Still, the Riksbank does not appear to be on the verge to hike the repo rate from the current unprecedented -0.50% level. The aim of the expansionary monetary policy is to stabilise inflation around 2% and to keep inflation expectations in line with the target. Given that inflation has been below target for a long time, the Riksbank remains extremely sensitive to the risk of downside surprises. In particular, it seems important for the Riksbank Board that the SEK does not strengthen too quickly. That would surely happen if the Riksbank's monetary policy were to deviate from that of other economies, the euro area in particular. The trade weighted SEK (KIX index) is currently 2.5% stronger than the one-month old projection from the Riksbank.

Given our view that the ECB will not raise rates before the end of 2018, our main scenario is that the Riksbank remains patient and waits until medio 2018 before raising rates. Admittedly, the recent developments in inflation and growth imply a risk that the Riksbank begins its tightening process earlier. This risk could materialise if inflation and growth continues to surprise on the upside in coming months.

Against this backdrop, we have modified our Swedish risk during the summer. In particular, we have taken profit on our covered bond holdings, which accounted for a good part of our *"Sweden: Credible inflation targeting"* theme. Now, our portfolio consists of increased pro-reflationary exposure including trades for wider breakeven inflation spreads (*"Sweden: Government relative value"*) and a stronger SEK (*"Sweden: SEK FX recovery".*) Moreover, given our bearish view on global bonds, we think longer-term Swedish nominal bond yields could rise further.





The recovery of the Norwegian economy appears to be gaining speed as the adjustment to a lower oil price is complete. The unemployment rate, which historically has been an important indicator for the Norges Bank's assessment of slack, is falling much faster than both we and the Norges Bank have expected. As we explained in our previous monthly report, we see capacity utilisation returning to normal levels already by the end of 2018, which is almost two years ahead of the Norges Bank's estimate.

As a result of firming economic conditions in Norway combined with an increase in interest rate expectations abroad, we expect the Norges Bank to revise its interest rate projection upwards when the Board meets in September. This should continue to support a steeper FRA-curve (*"Norway: Curve steepener"*) and a stronger NOK (*"Norway: NOK FX recovery".*) The EUR/NOK is in our view trading too high in relation to the oil price and interest rate differentials among other factors, see right hand chart.

Moreover, we have removed all outright exposure for lower bond yields in Norway, but remain long NGBs in spread terms versus German Bunds as a part of our *"Norway: Inflation convergence"* theme.