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asset management

Nordkinn Market Review & Outlook – Nov 2017

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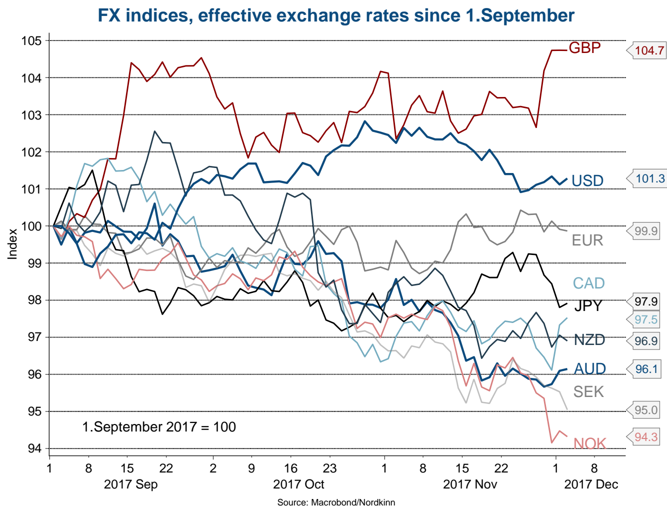
NORDKINN ASSET MANAGEMENT

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

Prinsens gate 22, 6tr
0157 Oslo, Norway
Phone: +47 22 46 63 00
Telefax: +47 94 77 15 16
E-mail: post@nordkinnam.no

Global overview

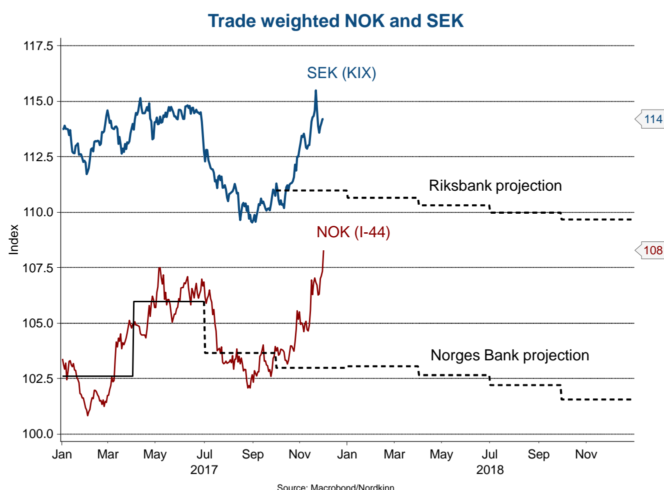
Yields on European government bonds were remarkably stable in November, which must be seen as the market reflection of ECB's decision on October 26th to extend QE until at least September 2018 and its commitment to keeping policy rates unchanged well after the end of QE. By contrast, U.S. government bond yields rose as strong macroeconomic data cemented expectations of a rate hike at the upcoming FOMC meeting on December 13th and lifted expectations for further tightening next year. As the change was less pronounced for longer dated maturities, the slope of the U.S. yield curve flattened substantially.



In the currency space, the USD depreciated against the EUR in spite of a wider interest rate differential in November. Meanwhile, the GBP appreciated at the end of the month after Britain and the EU allegedly are in the midst of reaching an agreement over Brexit divorce bill.

The so called "commodity currencies" (NOK, AUD, CAD and NZD) fell, albeit in various degrees, in November and have generally been out of favour over the past three months, see chart. Their underperformance was very surprising considering the substantial rise in commodity prices in this period, even though oil prices admittedly have been influenced by production cuts. This may suggest that there is a global macro theme in play concerned about the outlook for Chinese and global growth and subsequent reduction in future demand for commodities. Moreover, a common denominator for these currencies is the shared concerns over elevated house prices, which have reduced investors' appetite.

Nordic overview



Seemingly oblivious to firmer macro, Swedish housing bubble concerns sent the SEK into free-fall in November, which inspired foreign investors to abandon the NOK as well. Since September 1st, the trade weighted SEK (KIX index) has lost 5% and is currently 3.5% weaker than the Riksbank's estimate. In the same period, the trade weighted NOK (I-44 index) plummeted 6% and is 5.5% off the Norges Bank's projection.

These moves have taken most local investors and economists by surprise, which have had a hard time explaining them with traditional factors such as interest rate differentials, commodity prices and indicators of economic growth. As discussed above, it is not obvious what has been the main driver behind reduced apetite for "commodity producers", including the NOK, but a softer housing market is likely part of a larger picture.

The SEK was hammered in November following weak Swedish housing market data. According to the Nasdaq OMX Valueguard index, Swedish home prices fell on average by -3% in October following -1.5% in September. Seasonality can only explain a fraction of this decline. Although average house prices in Norway surprisingly rose by 0.4% in October following six consecutive months of price declines, a general "Scandie" concern sparked a sell-off in the NOK as well, amplified by thin liquidity.

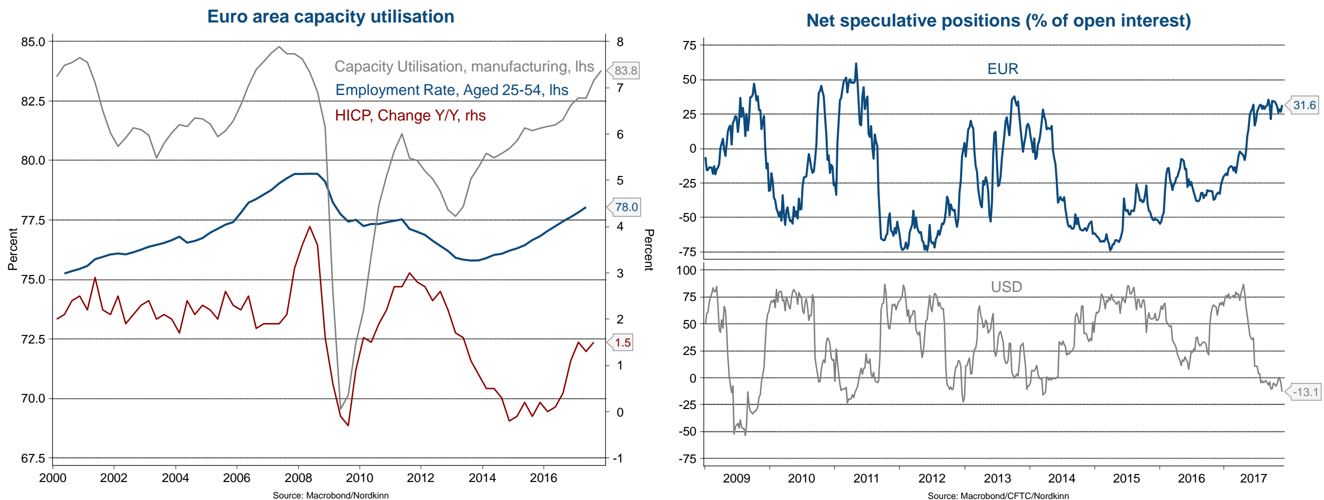
Interest rates fell across the maturity spectrum in both Norway and Sweden during November, as a dovish forward guidance by the ECB combined with concerns over housing market developments weighed on the expected future path of monetary policy in Scandinavia.

Further, money market fixings fell in both countries. While the STIBOR decline, in line with our expectations, has been influenced by the resolution fee, the NIBOR drop has surprised us. Put simply, the positive impact of a wider EUR/USD basis swap on NIBOR has been overshadowed by ample domestic liquidity being fostered through Norges Bank's provision of unlimited F-loans over Year-End. The launch of these F-loans in November was a major surprise. The decline in expected future Norwegian market rates during November to some extent reflects expectations that liquidity will remain generous also at the beginning of next year.

Global markets

Indicators of global economic growth point to a strong end to 2017. The JP Morgan global PMI index rose to 53.5 in October, which is the highest level since winter 2011. Consistent with this signal, growth in world GDP rebounded in 2017 and we estimate a running annual rate of 4% in the second half of this year, the strongest pace since early 2011. Against this backdrop, many economist are now revising their growth forecast for 2018 upwards.

Within the advanced economies, the biggest upside surprise is the euro area economy, which appears to be in the boom phase of the business cycle. The strong growth rate is reflected in rising capacity utilisation. In the manufacturing sector, capacity utilisation is almost 84%, which is just shy of its 2008 peak. This is also reflected in the labour market, with the "core" employment rate (aged 25-54) at 78%. This compares with the 2008 peak of 79.4%, see left hand chart. To us, these data demonstrate that there is less slack in the euro area economy than suggested by the high unemployment rate of 8.9%.



Price inflation, e.g. as measured by the HICP index (see chart), has so far remained contained in the euro area, but given the high and rising level of capacity utilisation it would be reasonable to expect some evidence of inflation build-up in 2018. Consequently, we expect QE to come to a complete end during next year and we anticipate the first ECB interest rate hike in Q2 2019, followed by gradual rate increases thereafter. Our forecast remains somewhat more hawkish compared to expectations currently prevailing in the markets. Consequently, we are currently positioned for steeper euro area bond curves as part of our *"EMU: QE tapering"* theme.

That being said, the ECB's commitment to QE until September 2018 and keeping rates unchanged until well beyond the end of QE implies that euro area bond yields may trade in a range until at least summer of next year before moving higher. Reflecting this, an active trading approach makes sense in our view.

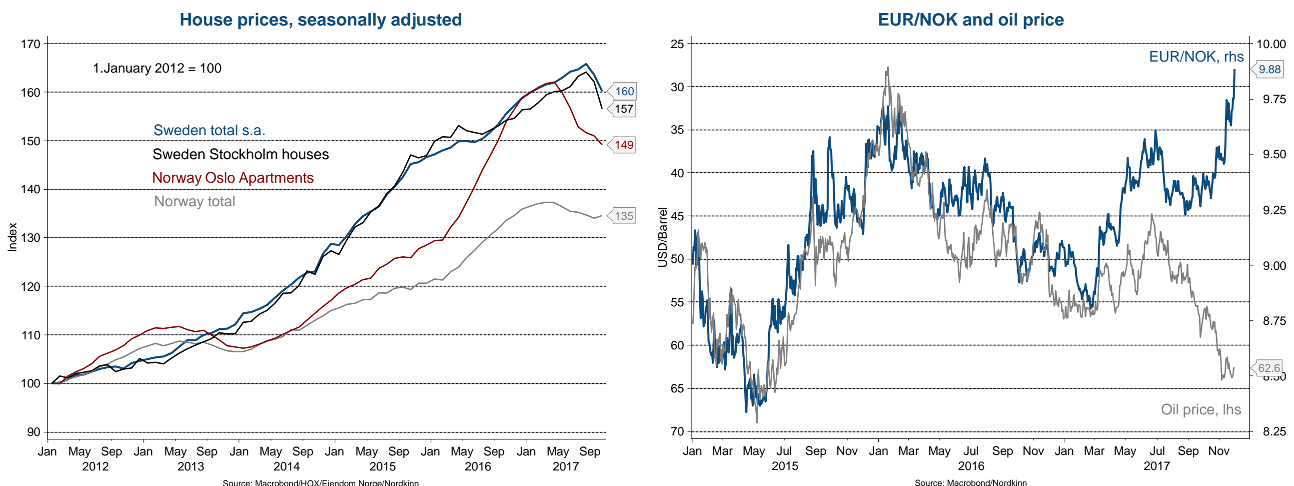
The surprisingly strong growth rate in the euro area, and in the world economy as a whole for that matter, was a key factor behind the declining USD in 2017. We expect macro conditions to become more USD favourable next year. First of all, the U.S. economic outlook is very bright in our view and we think both growth and inflation will surprise positively in 2018. Secondly, the high expectations for Europe's economy and the rest of the world is vulnerable for downside surprises, not to mention various geopolitical uncertainties that could re-emerge outside of the U.S. Third, data shows that investors are generally long the EUR and short the USD, see right hand chart. This implies that, for the EUR/USD to appreciate further, the euro area may need an increase in the pace of positive surprises relative to the U.S. over the coming months, the opposite of what we expect. In light of this, we introduced *"USA: Dollar bull market to resume"* in late November as a new investment theme.

With regards our *"USA: Interest rate normalisation"* theme, bond yields have reached levels we deem motivated for profit taking. The market currently expects two rate hikes in 2018, admittedly one rate hike less than suggested by the median estimate of the FOMC. However, history demonstrates that the market tends to be reluctant to fully price in the FOMCs interest rate projection well in advance, reflecting various risks that could emerge and potentially delay further tightening. Moreover, some FOMC members also appear concerned that the recent downward trend in inflation may continue for longer than the committee currently envisages. Against this background, and considering the ever rising spread between U.S. and European bond yields, we prefer U.S. government bonds over German bonds. Rather, long USD is in our view the optimal way to position for a relatively stronger U.S. economy ahead.

Nordic markets

Swedish and Norwegian house prices have fallen in recent months, following massive gains in recent years and even decades. In Sweden, prices fell by an accumulated 3.5% in September and October (seasonally adjusted), led by Stockholm houses, see left hand chart. In Norway, average house prices have fallen by mere 2% since the peak during the winter of 2017 and recorded in October the first increase in six months. Meanwhile, Oslo apartments slid further in October and are down by 13% since April. These developments have sparked concerns that a major housing correction is on the cards in Scandinavia, with alarming spill-over effects to the broader economy.

While we believe that the concerns about the Scandinavian housing market are exaggerated, there are important nuances. Both economies are performing well and there are few signs of demand-side issues. In our view, prices are falling because stricter regulations have coincided with large increases in supply, rather than a structural dent in demand. This said, amortisation requirements have hurt Swedish buyers' potential budgets, whereas Norwegian buyers are restricted by tighter maximum loan-to-value and debt-to-income ratios. Yet, turnover is relatively high in both countries, except for new houses where asking prices are more rigid. With the market for holiday homes remaining unabated, demand is seemlingly not an underlying problem.



Consequently, the latest data already signals a stabilisation in Norwegian house prices. In Sweden, by contrast, we expect house prices to further edge downwards in the coming months, but to stabilise by the end of next year. As at current, we do not envisage a significant impact on household consumption in either country. However, housing investments are probably peaking now and are likely to become a drag on growth in 2018 and 2019. We anticipate an accumulated 10% decline in 2018 and 2019 in Norway and somewhat more in Sweden where investments have risen very fast in recent years. In the case of Norway, we anticipate that the decline in housing investments will largely be offset by a recovery in oil investments. Overall, therefore, we expect Norwegian GDP growth to remain relatively stable going forward.

A slowdown in Swedish GDP growth is inevitable after a couple of years of very strong activity, but we do not anticipate a severe slowdown. However, we are monitoring the housing market and possible spill-over effects closely.

Turning to implications for monetary policy and markets, neither the Riksbank nor the Norges Bank are in a hurry to hike interest rates anytime soon. When the Riksbank Board meets on December 20th, we expect a decision to end QE but at the same time to slightly delay the first projected rate hike to Q4 2018, from Q3 previously. This should motivate some steepening pressures on the Swedish yield curve in our view.

Against the backdrop of higher energy prices combined with a weaker NOK (see right hand chart), the Norges Bank Board could end up revising its interest rate projection upwards on December 14th. Developments in GDP, inflation and house prices have matched the Bank's expectations and should therefore not contribute to change the outlook for monetary policy, while the labour market has been stronger than expected. The Bank may cut its forecast for housing investments and consumption, but not enough to fully offset for the positive contributions to the interest rate path.

In light of this, the recent sharp depreciation of the SEK and, in particular, the NOK is unjustified in our view. Losses on our NOK and SEK recovery themes were significant yet contained in November as stops were taken in accordance with our game plan. While thin liquidity and year-end flows may contribute to further weakness in December, we consider re-entering positions ahead of New Year as our conviction for a better alignment with fundamentals remains high.