NORDKINN

ASSET MANAGEMENT

# Nordkinn Market Review & Outlook – March 2018

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Nordkinn Asset Management is a Nordic Fixed Income specialist based in Stockholm and Oslo. Nordkinn manages the Nordkinn Fixed Income Macro Fund, which seeks to generate stable absolute returns in all market environments.

# MARKET OVERVIEW

## Global overview

Longer term bond yields followed stocks lower in March as investors were deeply troubled by a combination of events calling the sustainability of global growth into question. The events included signs of peaking global growth, fears of trade war and ever more concrete prospects of tighter monetary policy. Trade war concerns were stoked when the Trump administration on March 22nd unveiled plans to impose tariffs on up to USD 60 bln of annual Chinese imports, sending equity markets sharply downwards. China responded already the following day that it has prepared retaliatory tariffs, aiming to respond with countermeasures of equal strength.

Meanwhile, PMI indices have been softer in the past few months, signaling a deceleration in global growth. This contributed to lower government bond yields, especially in Europe. Consequently, the Transatlantic spread on 10-year government bond yields continued to widen further in March, while the EUR/USD remained broadly unchanged.

The Federal Reserve raised its key policy rate by 25 bps to 1.50-1.75% and signalled a steeper path for interest rates over the coming years. The US central bank now projects three hikes in 2019, up from two previously, while it kept the prospects of total three hikes this year.

On March 8th the ECB dropped the so-called QE easing bias as staff projections showed a slightly stronger GDP growth rate for 2018. The market initially reacted by sending the EUR stronger and bond yields higher, but these moves were later reversed as President Draghi, in the press conference, downplayed the forward guidance adjustment, while emphasising a very modest inflation outlook.

## Nordic overview

The depreciation of the SEK continued in the beginning of March, but came to a temporary halt mid-month after Swedish CPIF inflation stabilised at 1.7%, matching expectations, and the unemployment rate dropped to 6.3%, beating expectations by a significant margin. Later on, the sell-off resumed as the SEK suffered from equity dividends pay-out and a general risk-off sentiment in markets.

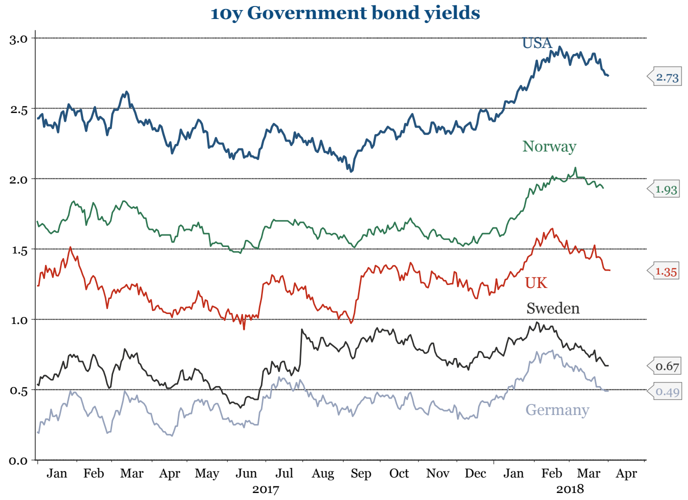
Meanwhile, Swedish government bonds moved broadly in tandem with German yields, while inflation-linked bonds performed significantly.

The Norges Bank left its key policy rate unchanged at 0.50% on March 17th, as widely expected. In response to stronger domestic demand and foreign factors, the interest rate path was raised in the near term by roughly 15 bps to suggest a first rate hike in Q3 2018 first rate hike in Q3 2018, one quarter earlier than implied by the previous projection. Further out, the rate path signals gradual hikes of about 50 bps each year in the coming years.

The decision announced on March 2nd to cut the inflation target to 2.0% from 2.5% contributed to dampen the increase in the rate path from 2019 and beyond. As the first rate hike is approaching somewhat sooner than the market expected, the NOK appreciated after the announcement and the slope of the interest rate curve became flatter. Norwegian interest rates had already adjusted sharply prior to the announcement due to strong domestic data and a spike in NIBOR fixings caused by a wider U.S. LIBOR/OIS spread.

Later in the month, the NOK erased previous gains after the Trump administration's pledge to impose tariffs and signs of peaking global growth triggered a risk-off mood in global markets.

**10y Government bond yields**




Source: Macrobond/Nordkinn

**EUR/NOK and EUR/SEK fx spot**


Source: Macrobond/Nordkinn

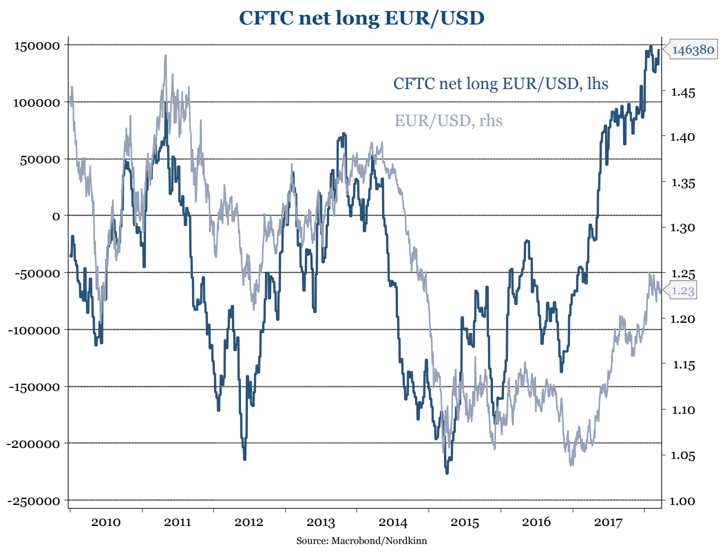
## Global markets

In March, global government bonds consolidated following three months with rising yields. In our view, this consolidation is a temporary response to data surprises rolling over, reinforced by oversold momentum and very short market positioning in U.S. bonds in particular. Moreover, market pricing had already converged with central bank projections.

One of the triggers behind this consolidation in bond yields was a growing fear or trade war. In March, U.S. President Trump stepped up his protectionist measures aimed at China, which announced retaliation shortly afterwards. Protectionism is popular with the American public. Trump made a promise to his voters and is trying to keep it. Consequently, trade frictions will probably continue.

At the same time, Trump is also used to taking credit for a rising equity market, which contrary to the American public dislikes protectionism. If stocks were to struggle even more than it currently does, the President may think twice about pushing for more trade barriers. He will have to strike a fine balance. In our view, worries about a plunging stock market will constrain Trump from acting too aggressively.

This implies that the implications for economic growth and inflation should be relatively contained. If anything, rising trade tensions will reinforce a tendency that we believe is already underway: Peaking global growth and rising inflation. The JP Morgan global PMI has been softer the past few months. While the absolute level of the index suggests that the global economy is growing at an above-trend pace, it also signals a slight deceleration in the pace of growth, see left hand chart. A further escalation of trade tensions would be negative for global growth, even if it may initially boost the U.S. economy.


Meanwhile, shrinking output gaps in the global economy will fuel inflation eventually. This trend would extend if globalisation, which historically has been a highly deflationary force, is on the back foot.

Regarding the implication for fixed income markets, this depends crucially on whatever happens to growth and inflation. Given that we predict global growth and inflation heading in opposite directions, the impact is ambiguous. Nonetheless, we believe that any slowdown in global growth will be modest as monetary policies remain accommodative and, in some countries, fiscal policy is simulative as well. On the other hand, any rebound in inflation would accelerate the process of monetary policy normalisation. On balance, after a temporary consolidation, we think bond yields will continue higher. We are biased for higher European bond yields via our *"EMU: QE tapering"* theme.

As far as the implication for currency markets is concerned, the USD will probably gain in a scenario where global growth slows and if the composition of global growth shifts in the direction of America. Such a scenario is the opposite of what happened in 2017: Global growth outperformed the U.S., which triggered a broad-based depreciation of the USD. Last year, investors were expecting a stronger USD and were caught on the wrong foot. That could happen again this year: Positions for further USD weakness against the EUR is crowded, see right hand chart, which we conversely see as yet another attractive feature that fits our forecast. Consequently, we re-entered the *"USA: Dollar bull market to resume"* theme in March.

# Nordic markets

At the upcoming monetary policy meeting on April 25th, we expect the Riksbank to shift the repo rate path by postponing the first rate hike from Q3 to Q4. The reason is lower than expected CPIF inflation, see left hand chart. Already at its previous meeting held on February 13th, the Riksbank Board members expressed concerns over the outlook for inflation, in particular the declining rate of increase in service prices. After lowering its forecast for inflation, without adjusting the interest rate path, several participants indicated that the Board should be prepared to postpone rate hikes if the downside risk to inflation were to materialise, according to the minutes of the February Board meeting.

Notwithstanding expected headwinds from the Riksbank's monetary policy, we think the SEK is due for a rebound (*"Sweden: SEK FX recovery"*). Firstly, the market already expects a later lift-off date compared with the projections made in February. Secondly, we predict a temporary rebound in the March CPIF data, due on April 12th, as cold winter and early Easter are expected to exert upward pressures on electricity and travel prices respectively. Thirdly, the bulk of Swedish equity dividends, which has contributed to a weaker SEK in March, should be paid-out by mid-April. Finally, Swedish house prices appear to be close to a bottom, which should finally free the SEK from its wet blanket of housing risk premia.

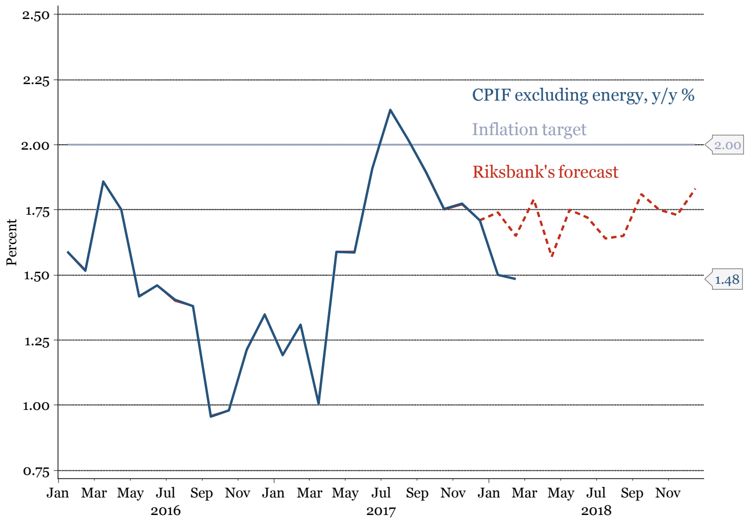
Moreover, we think the flattening of the Swedish yield curve has gone too far. We fade this move by a combination of longs in short-dated bonds and an increased short exposure in the 10-year segment of curve. These trades are organised under the *"Sweden: Government relative value"* theme.

Turning to Norway, we expect the Norges Bank to begin raising interest rates in Q3 this year, most likely at the Board meeting in September. This is in line with the projections made in the most recent Monetary Policy Report. Contrary to Sweden, slightly lower inflation is unlikely to affect the timing of the first rate hike in Norway, but weaker economic growth could. However, given that our composite leading indicator points to stronger GDP growth ahead, see right hand chart, the probability attached to a Q3 rate hike should be relatively high.

An expected rebound in oil investment is the most important factor underpinning the rise in Mainland-Norway GDP growth in 2018. We also anticipate a positive contribution from private consumption, even if goods consumption started the year on a weaker note than expected. We expect a negative contribution from housing investments in 2018, but the ongoing stabilisation in house prices, and the large number of dwellings still under construction, will curb the decline in investment.

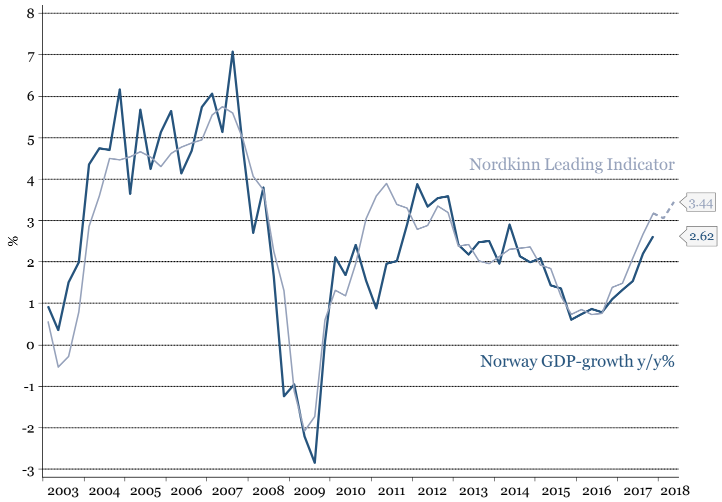
The interest rate curve already discounts a tighter monetary policy stance over the coming couple of years. Rather, we prefer positioning for stronger growth and higher interest rates in the foreign exchange market (*"Norway: NOK FX recovery"*). In addition, we expect a steeper interest rate curve as part of our *"Norway: Economic revival"* theme, which suffered from lower foreign bond yields in March and a reprising of Norges Bank interest rate expectations. Moreover, we predict a decline in NIBOR fixing ahead based on our forecast of a tighter US LIBOR-OIS spread.

**Sweden CPIF excluding energy inflation**




Source: Macrobond/Nordkinn

**Norway GDP versus Leading Indicator**




Source: Macrobond/Nordkinn

# ABOUT NORDKINN

Nordkinn Asset Management aims to create and preserve wealth by consistently providing investors with stable risk-adjusted absolute return through its unique team and local expertise. Operating from Stockholm and Oslo, the team of ten capitalises on their specific fixed income and absolute return backgrounds. Nordkinn aspires to be the leading hedge fund in the Nordic region as measured by risk-adjusted performance, operational excellence and investor appreciation.



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