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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – April 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

In April, global government bond yields rebounded from last two months' declines as trade war jitters abated and indicators of global growth stabilized. The yield on the 10-year U.S. Treasury note reached 3% for the first time in more than four years, as the rise in core CPI inflation to 2.1% in March combined with oil's move above USD 70 a barrel fueled worries about inflation.

Actually, the five-year segment of U.S. bond yields rose the most as investors become more certain about the prospects of further interest rate hikes going forward. Consequently, the flattening of the 5/10 and 5/30 yield curves continued in April. This move was reinforced by the minutes of the March FOMC meeting published on April 11th, which revealed that a number of participants judged the appropriate path for interest rates over the next few years to be slightly steeper than they had previously expected.

As the meeting of the ECB's Governing Council on April 26th was an interim meeting, no policy changes were expected. Indeed, President Draghi confirmed at the press conference that policy was not even discussed. Rather, the ECB discussed economic data. Mr. Draghi reported that the Governing Council sees the broad-based economic recovery continuing, even if recent data signals some moderation. He gave few concrete hints on the next steps of policy or the timing of any such announcements.

As a consequence of these events, the transatlantic spread between U.S. and German 10-year bond yield rose to new highs in April, which spilled over to the FX market. The EUR/USD exchange rate broke out of the 1.22-1.25 range and ended the month at about 1.20.

On April 27th the Bank of Japan left monetary policy unchanged. The Bank kept its key policy rate at -0.10% and maintained its 10-year JGB yield target at about 0%. As this decision was widely expected, the market reaction was muted.

Nordic overview

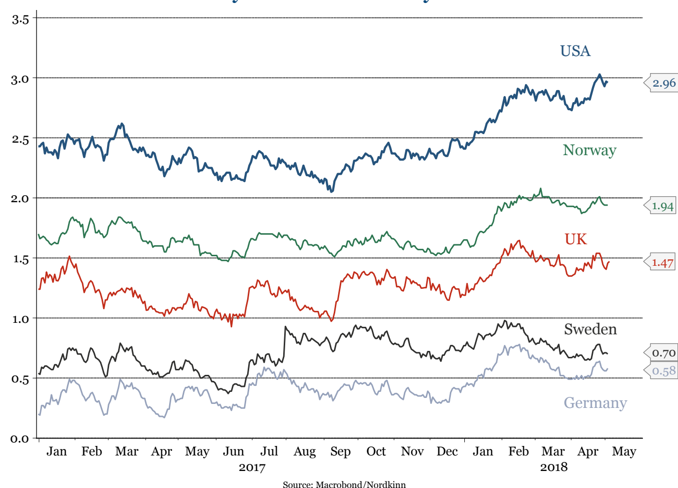
Short-dated Swedish bond yields declined further in April, the main trigger being soft underlying inflation motivating a dovish Riksbank response. Although CPIF came in at 2.0% in March and matched expectations, CPIF excluding energy stood at 1.5%, 0.3%-points below the Riksbank's forecast. According to the Riksbank's monetary policy statement released on April 26th, this *"raises questions about the strength of the development in inflation."* The Riksbank therefore decided that interest rates will begin to be raised somewhat later than previously assessed, projecting a first rate hike in December 2018 compared with Q3 previously.

The SEK depreciated sharply after the release of the March CPI data on April 12th in anticipation of a dovish Riksbank response. The plunge gained speed in thin markets after the Riksbank's Board two weeks later indeed confirmed a more cautious outlook for policy. Making matters worse, the weakening of the SEK in April could potentially also have been influenced by transitory factors, such as the dividend pay-out season.

In spite of soft underlying inflation developments, Swedish break-even inflation spreads widened in April. Rising commodity prices and the Riksbank's unyielding commitment to bring inflation up to target contributed to this development.

In Norway, CPI-ATE rose 1.2% in March compared with the same month last year. As this was 0.3%-points below market consensus, interest rates fell and the NOK depreciated immediately after the release. However, these moves were partly reversed a few days later as market participants became uncertain to what extent this outcome would impact monetary policy. Overall, market interest rates and the NOK were little changed during the month in review, see chart.

On April 19th Norway raised NOK 12 bln in a new 10-year government bond (NGB 480). This was the first time that Norway has issued a bond in NOK by syndication. The bond was well received, attracting an order book in excess of NOK 24 bln from more than 40 investors, including Nordkinn. As a result, NGBs rallied after the syndication and swap-spreads widened.



OUTLOOK

Global markets

During April the Nordkinn investment team became increasingly confident that the decline in bond yields during February and March was a temporary response to data surprises rolling over, reinforced by geopolitical risks and oversold momentum. In this period, we decided to increase risk utilisation and exposure for higher bond yields. The main factors underpinning our conviction are prospects of rising inflation and changing supply/demand dynamics in government bonds.

Starting with inflation, the most recent developments in U.S. inflation rates largely confirm that the weakness in inflation in 2017 was related to transitory factors, notably a sharp decline in prices of wireless telephone. As last year's unusual weakness of this price category dissipated, U.S. inflation bounced back in March 2018, see chart.

Looking ahead, business surveys point to a further rise in U.S. price pressures in coming months. According to the Federal Reserve's own economic survey, the Beige Book, several companies report that they are successfully passing through price increases to customers. On top of that, the moderate wage growth we are seeing at the moment may well begin to break higher as labour market conditions across the U.S. remains tight.

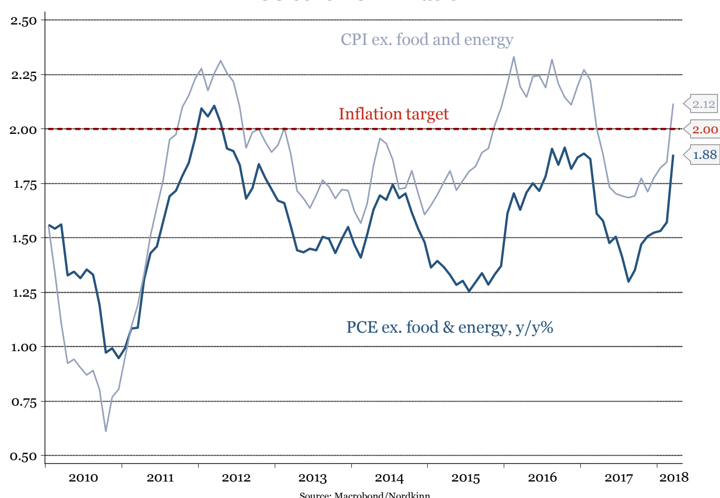
Consequently, it is reasonable to expect some upward pressure on CPI inflation ahead. In response to that, the Federal Reserve will likely continue raising its key policy rate at a gradual pace over the coming year. The median projection of FOMC members is a total of three hikes in 2018, but the probability of four has certainly increased.

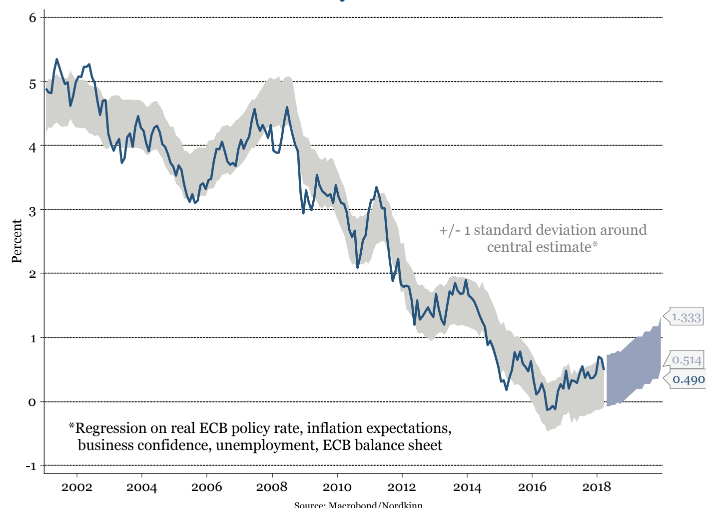
Turning to supply/demand dynamics, the pace of Fed balance sheet run-off will pick up in coming months. At the end of last year the run-off was about USD 30 bln per quarter. In Q1 it was closer to USD 70 billion and after summer it will be nearly double that pace. Against this, government bond supply is set to rise significantly. The U.S. Congressional Budget Office (CBO) projects a sharp rise in the government budget deficit in both 2018 and 2019. Consequently, the supply/demand ratio will deteriorate sharply going forward. In our view, higher bond yields are therefore necessary in order to attract more buyers from the private sector.

Elsewhere, we anticipate slowing demand for government bonds from the ECB and Bank of Japan as well later this year. We continue to forecast the ECB to cease net asset purchases at the end of 2018, and we expect the Bank of Japan to adjust its Yield Curve Control policy in 2018 targeting a somewhat higher yield.

We expect the ECB to remain patient and wait until July before announcing a three month tapering of bond purchases between September and December. Moreover, we expect its forward guidance to evolve towards linking the future rate path more directly to inflation developments. For now, we expect the ECB to begin raising its deposit rate by mid-2019.

Our short duration trades are concentrated in Europe, based on the view that Europe will catch up with the U.S. eventually. Also, our bond forecasting models suggest European yields will rise going forward, see chart.





Nordic markets

The new Riksbank interest rate projection (see chart) suggests rate hikes will begin *"towards the end of year"*, which we interpret as the December meeting. In our view, the risk is very asymmetrical and skewed towards an even later lift off date. There are four reasons for this. First of all, the Riksbank's current reaction function gives a remarkably high weight on stabilising inflation around its target (which comes at the expense of output stabilisation).

Secondly, the Riksbank's approach to assessing underlying inflationary pressures is a combination of A) backward-looking analysis of trends in CPIF excluding energy and B) wage growth, which represents the forward-looking element. The trend in the latter will almost certainly not change much during this year, whereas the former is associated with near-term downside risks.

Third, in its Monetary Policy report the Riksbank largely dismissed the inflationary impact of the weakening of the SEK, citing several temporary forces at play that may persuade companies to allow profit margins to decline going forward before considering to implement price changes. This suggests that the weaker SEK will have less impact on monetary policy than we previously thought.

Finally, if inflation were to rise faster than expected contrary to our expectations, the Riksbank will most likely want to see evidence that this development is persistent and not succeeded by falling inflation only a few months after.

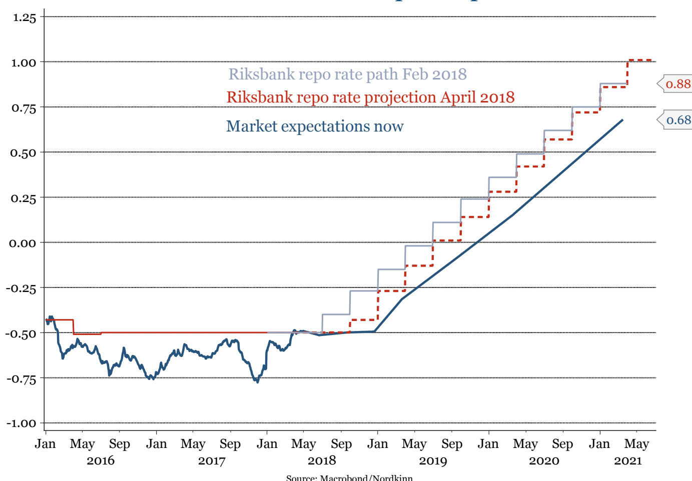
Against this backdrop, we closed our *Sweden: SEK FX recovery"* theme after the Riksbank's announcement and reopened *"Sweden: Credible inflation targeting"*, expecting lower short-dated bond yields. At the same time, we have kept our short-duration exposure in long-dated bonds looking for a steeper yield curve.

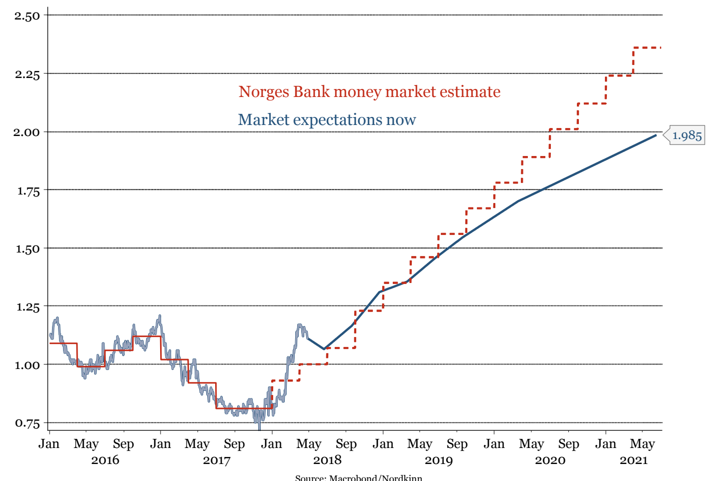
Turning to Norway, incoming data over the past few months has been mixed. Retail sales have moved sideways and the decline in registered unemployment has abated. On the other hand, employment growth is robust and business confidence high. On balance, we remain confident that the outlook for growth this year is healthy. Supported by a rebound in oil investments, our leading indicator suggests annual GDP-growth surpassing 3% in the second half of the year. Given the Norges Bank Board's relatively high weight on output stabilisation, the positive outlook supports our forecast that Norges Bank will begin to raise interest rates in September this year.

One of the risk factors that could delay the normalisation process is if the inflation trend becomes significantly weaker than expected. Indeed, the low core CPI print for March is raising questions about the underlying trend in inflation. Having said that, Statistics Norway argues that the March data was significantly affected by Easter offerings on food products. Moreover, according to our estimates the weak NOK will soon begin to feed into higher prices on imported goods. Consequently, we expect inflation to rise somewhat faster again over the coming months.

In light of this, our view remains that the Norges Bank will begin raising rates in September. This is not fully discounted by the market, reflecting in particular the uncertainty that emerged after the March CPI release. For that reason, we expect market interest rates to rise and the NOK to appreciate when the date for the first rate hike is coming closer.

Judging by the difference between market-implied expectations and the Norges Bank's projection, the 2-5 year segment of the bond curve is due for a correction going forward.





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