

NORDKINN

— ASSET MANAGEMENT —

Nordkinn Market Review & Outlook – February 2019

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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

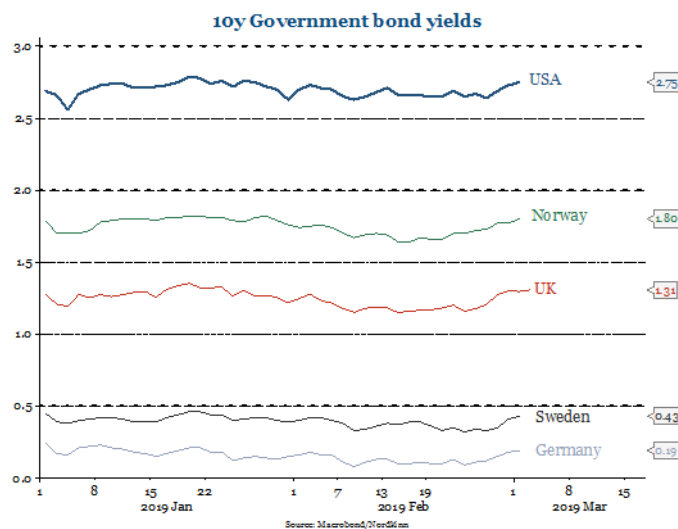
Global overview

Global government bonds moved sideways in February, see chart, as investors digested a more dovish stance of major central banks, weaker growth in the global manufacturing sector and lingering political uncertainties. FX markets were little changed during the month as a whole, with the exception of the GBP that appreciated noticeable on expectations that a no-deal Brexit can be avoided.

The GBP sentiment improved after Labour announced it would support a second referendum. Meanwhile, the government put forward a timetable that would allow for an extension of the deadline in order to prevent a no-deal Brexit, if a new meaningful vote on its withdrawal agreement fails. On February 7th, the MPC of the Bank of England voted unanimously to keep rates unchanged at 0.75%, but cut their growth and inflation forecasts due to risks surrounding Brexit. However, Governor Carney signalled that, once a status quo post-Brexit transition deal is ratified, the MPC maintains its view that tighter monetary policy will be warranted.

The minutes to the January 29-30 FOMC meeting shed more light on the momentous shift in rhetoric regarding the outlook for monetary policy after the turn of the year. The document revealed that several participants argued for raising the Fed Funds target rate later this year if the economy evolved as expected, while several on the contrary said rate increases will prove necessary only if inflation outcomes were to be higher than in their baseline outlook. Interestingly, almost all participants wanted to end balance sheet normalisation later this year.

According to the account of the ECB's January 23-24 monetary policy meeting, the forward guidance on interest rates is working well and officials feel no urgency to adjust it. Meanwhile, they instructed the staff to prepare policy options for future liquidity operations "needed to proceed swiftly", with reference made to the funding cliff in June, when one of the LTRO facilities matures.



Nordic overview

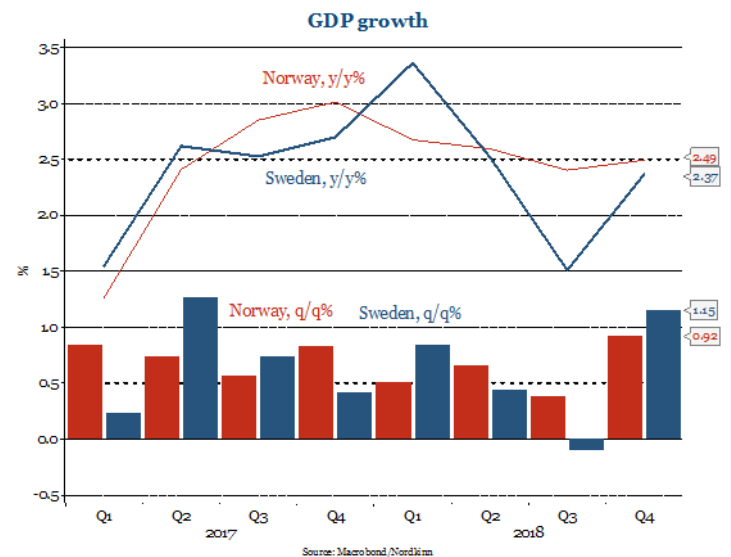
In February, interest rates in Scandinavia declined across the maturity spectrum, broadly mirroring the developments in the euro area. There were a couple of exceptions from this co-movement. Notably, in Sweden the front-end of the yield curve underperformed slightly due to the elevated STIBOR fixing. Meanwhile in Norway, longer-dated bonds and swaps underperformed ahead of the introduction of the new 10-year NGB benchmark, which received strong support with books in excess of NOK 52 bn, around 3.5 times that of the issuance.

The Riksbank Board left its projected future repo rate unchanged on February 13th, still forecasting a repo rate increase during the second half of 2019. While this was expected by most economists, the market saw a risk for a more dovish outcome given slowing growth and more cautious central bank peers. Furthermore, as part of the process of unwinding unconventional policy measures, the Riksbank Board decided not to extend the mandate that enables intervention on the FX market.

Swedish interest rates rose a few basis points and the SEK appreciated after the Riksbank's announcement. However, price action turned sharply on February 19th when the CPI report for January was released, fuelling expectations of a delay to the Riksbank's hiking intentions. CPI inflation eased to 2.0% (1.4% excluding energy), which was 0.3%-points below consensus and 0.4%-points below the Riksbank's forecast.

On the last day of the month market sentiment turned positive again after Swedish GDP rose a staggering 1.2% from the previous quarter, see chart, supported by a positive contribution from net exports.

Following its strong performance in January, the NOK trimmed gains against the EUR and USD in February, while it continued to appreciate against the SEK. Mainland-GDP grew at a brisk 0.9% quarterly rate in Q4 2018, see chart, and survey-based indicators remain consistent with ongoing robust growth at the start of 2019, supported by prospects of a strong increase in oil-related investments.



OUTLOOK

Global markets

The slowdown in global growth combined with consumer price inflation being contained have tilted a number of central banks in a dovish direction recently, led by the Fed. With central banks being more patient, both government bonds and risky assets have been supported so far in 2019, i.e. there has been a positive correlation between the two markets this year, see chart. However, we believe markets are approaching an inflection point where the negative correlation may remerge.

For instance, we believe that any further significant slowdown in global economic growth should continue to support government bonds, but then risky assets might come under renewed selling pressures amid lower expected future earnings. Alternatively, if we were to see signs of stabilisation or a turnaround in the global business cycle, risky assets may continue to perform, but this will also tilt central banks in a more hawkish direction again and put government bonds under renewed selling pressures.

Which of the two outcomes are more likely? We remain of the view that global growth will reach a bottom sometime during the first half of 2019 before moving higher. One important argument for this is that the Chinese economy – the epicentre of global economic weakness – is about to reach a cyclical trough. There are increasing signs that China is abandoning its deleveraging campaign and is deploying monetary and fiscal stimuli measures aimed at stabilising growth. The sharp rise in credit growth in January suggests that policy is working.

Moreover, recent statements by the U.S. and Chinese governments suggest that a deal to end the trade war is in the cards, which would contribute to putting a bottom for global growth. Besides, the U.S. economy still appears to be in good shape, supported by healthy consumer fundamentals.

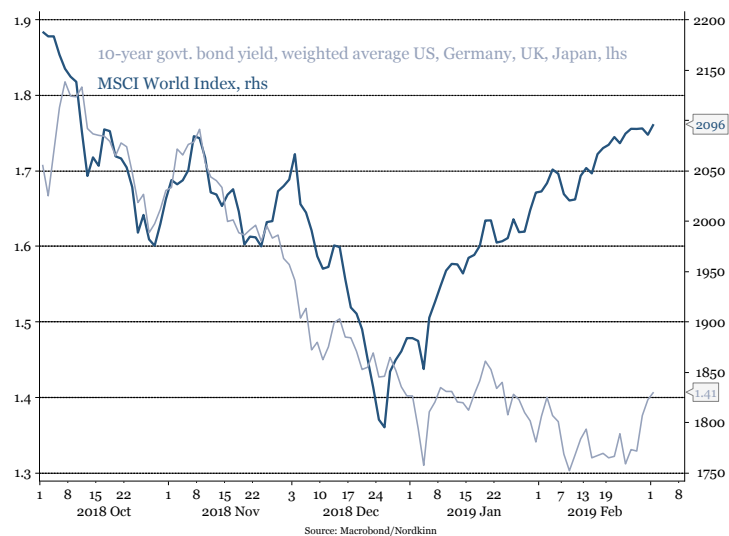
However, it seems far too early to conclude that the positive signals on global growth will persist and form the base for a bottoming in global growth. In fact, indicators of industrial activity suggest manufacturing growth slowed further in Q1. The JP Morgan global manufacturing PMI fell by 0.2 points to 50.6 in February, see chart. This is the lowest since 2016 and align with a near halt in global manufacturing output. Consistent with these signals, economists continue to revise GDP forecasts for 2019 downwards.

With the slowing in industrial activity now intensifying, a broader drag on the global expansion may still be in the offing. In addition, a slowing global economy is vulnerable to new negative shocks and the political calendar points to a number of possible crossroads, notably regarding Brexit and several issues related to U.S. international trade.

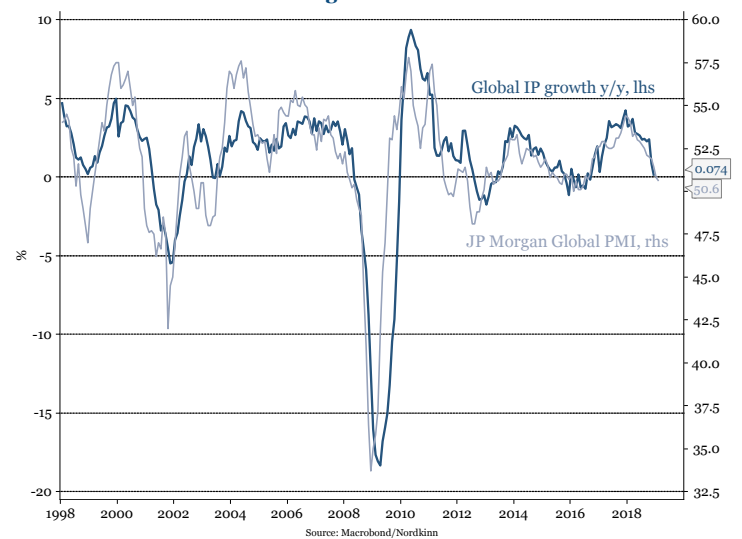
Turning to investment conclusions and considering market pricing and sentiment of late, we currently lack strong views regarding the near-term outlook for global government bond yields. Yields are very low, in particular in Europe, but they could fall even further until we see more convincing signs of a stabilisation in the business cycle.

We continue to expect a rise in the term premium element of long-term bond yields, which remains very depressed. We currently express this view via positions for a steeper US swaps curve, which continues to offer good risk/reward. Firstly, the curve normally stops flattening (and often starts steepening) when the Fed ends its tightening cycle. A protracted Fed pause and bottoming of global growth should lead to a steeper curve. Secondly, if history is any guide, the 2s 10s swaps curve does not invert even in times of an inverted Treasury curve. Thirdly, the position also offer some protection against the risk of a recession, which would motivate investors to price in a series of rate cuts.

MSCI World Index versus Government bond index



Global IP growth versus PMI



Nordic markets

The Swedish Riksbank's decision to not extend the mandate that facilitates FX intervention could be seen as relatively undramatic, but is in our view yet another indication of an aspiration to gradually leave its "crisis" mode. Despite choppy January inflation data, the anchoring of CPIF and inflation expectation close to 2% that we have seen over the past couple of years has allowed the Riksbank to alter focus.

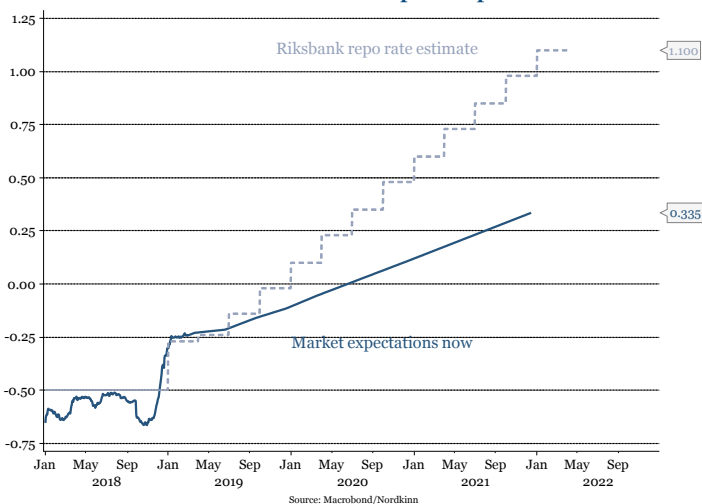
In fact, recent communications suggest that most Board members are downplaying the importance of the latest inflation numbers and instead focus attention to the medium-term outlook for inflation. The minutes from the Board meeting on February 13th reinforced this view, with all board members highlighting that conditions for inflation in line with target going forward are all good.

According to the minutes, two Board members (Skingsley and Ohlsson) explicitly said that monetary policy will not be guided by the most recent inflation data. Moreover, after the big CPI miss last month Governor Ingves said that inflation for January is complicated due to e.g. changes to weights, which calls for closer look at the details of the report (before drawing conclusion about underlying inflationary pressures).

Furthermore, labour market data and the blistering Q4 GDP numbers are both evidence of robust underlying economic conditions, which should lend support to the outlook for inflation over a policy-relevant horizon. Consequently, we expect the Riksbank to continue its strategy of abandoning unconventional policy measures, including negative rates.

Against this background, we now see a better chance that the Riksbank will decide to stop reinvesting bond redemptions by the summer. Hints about how the Riksbank is reasoning on this matter are few, but Skingsley mentioned last year that "the Riksbank's repo rate needs to rise above zero before we start dismantling the portfolio". The next SGB redemption is in December 2020 and, thus, ending reinvestments by summer will not mean that policy is tightened (shrinking balance sheet) until end of 2020. Continuing reinvestments would in practice result in an increase of the balance sheet for another 18 months until the next bond matures. Such a move would be hard to justify. In our view, a decision to stop reinvesting redemptions therefore make sense.

Sweden STIBOR market-implied expectations



The Norges Bank will almost certainly raise its key policy rate by 25 bps to 1.00% on March 21st. This hike is more than 80% priced according to our estimate. However, further out on the curve the spread between market expectations and Norges Bank's projection from December has become rather large, see chart. Will the Norges Bank signal a much shallower path for future interest rate hikes as the market seems to expect?

We expect the overall strategy to remain in place: The Norges Bank intends to gradually remove policy accommodation going forward, because 1) Underlying inflation is slightly above target and wage pressures are building; 2) Measures of resource utilisation are above normal levels and remains strong regardless uncertainty about the global outlook. The upbeat outlook for Norway in 2019 is supported by a strong rise in oil investments in 2019, and there are evidence of positive spill-over effects to the non-oil sector.

In short, the outlook for inflation and demand in Norway is little changed from December, which in isolation implies no changes to the interest rate projection. However, a softer growth outlook abroad and expectations of delayed hiking prospects among central bank peers are arguments for a downward revision of the interest rate path. On the other hand, the NOK exchange rate is somewhat weaker than projected as developments in the currency continue to deviate from changes in interest rate differentials and the oil price.

On balance, we expect that the Norges Bank will make no major adjustments to the near-term outlook for monetary policy. The Bank will probably continue to signal one more hike before year-end 2019, while the estimated rate path for 2020 and 2021 will likely be lowered slightly as a result of international conditions. Yet, the rate path should remain well above expectations currently prevailing in the market.

Against this backdrop, the medium-term outlook is for the NOK to appreciate somewhat further. In rates, we continue to be outright paid front-end NOK-rates, and we anticipate a relative flattening of the NOK versus the USD interest rates as interest rate normalisation unfolds. Finally, we also expect government bonds to perform versus swaps.

Norway NIBOR market-implied expectations



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

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