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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – July 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 overviev

After remaining virtually stable in the beginning of July, bond yields rebounded across developed markets in the second half of the month. This was in part driven by positive risk sentiment, supported among other factors by receding risks of a full-blown trade war between the U.S. and its allies. On July 26th President Trump and EU Commission President Juncker reached a deal to alleviate trade conflicts.

Meanwhile, trade tensions between the U.S. and China escalated after tariffs of about USD 50 bln on imports from China came into force. China is retaliating to the imposition of tariffs by allowing its currency to depreciate against the USD. A few days ago, President Trump asked the U.S. Trade Representative to consider lifting proposed levies on USD 200 bln in imports to 25% from 10%. The move came just after Washington and Beijing said they are exploring ways to get back to the negotiating table.

On July 31st, the Bank of Japan left its current yield curve target unchanged but announced a few policy tweaks. Most importantly, the central bank said that it intends to maintain both short-term and long-term rates at very low levels for an extended period of time. Also, the Bank will allow greater volatility in longer-dated Government bonds. According to Governor Kuroda, 10-year yields can be allowed to increase to +20 basis points, up from +10 previously. Initially, Government bonds rallied following the dovish forward guidance, but already the next day the market started to push yields towards the upper end of this wider interval.

At its meeting on July 26th, the ECB left its forward guidance on asset purchases and key interest rates unchanged. This was widely expected following the amendments announced at its last meeting in June, namely to wind up its bond-buying program by end 2018 and to keep interest rates unchanged at least through the summer of 2019. President Draghi said that uncertainty over the inflation outlook is receding, although it is too early to declare victory over inflation. The EUR sold off following the announcement.

Nordic overview

The Swedish bond market underperformed vis-à-vis trading partners and the SEK appreciated in first week of the month, supported by what was perceived as a hawkish Riksbank statement on July 3rd. In particular, Deputy Governor Martin Flodén surprisingly entered a reservation against the repo rate path, advocating a path consistent with a 25 basis points hike in the repo rate in September or October.

A few days later, the market sentiment in Sweden turned after June inflation data disappointed expectations. CPIF and CPIF excl. Energy at 2.2% and 1.4% y/y respectively were both 0.2%-points below the Riksbank's projection. The important services inflation component showed further weakness. Moreover, the Riksbank minutes were interpreted slightly dovish, pushing bond yields lower.

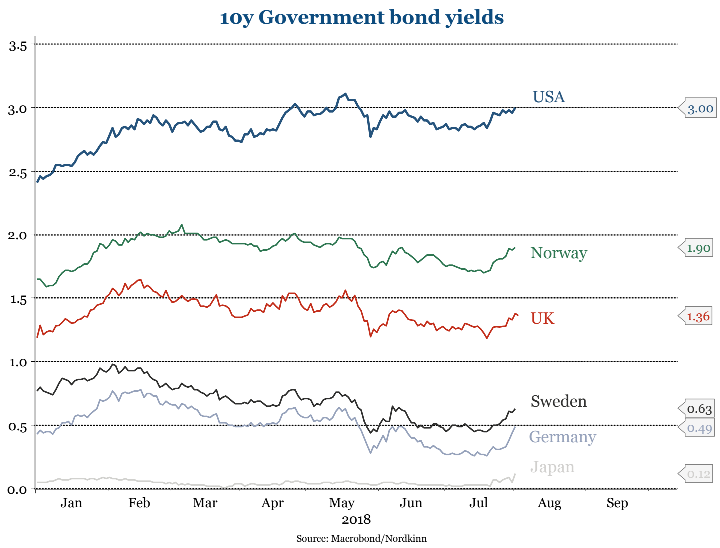
Market sentiment rebounded sharply by the end of the month supported by a strong Q2 GDP report, showing a gain of 1.0% from the previous quarter, twice the pace expected by consensus.

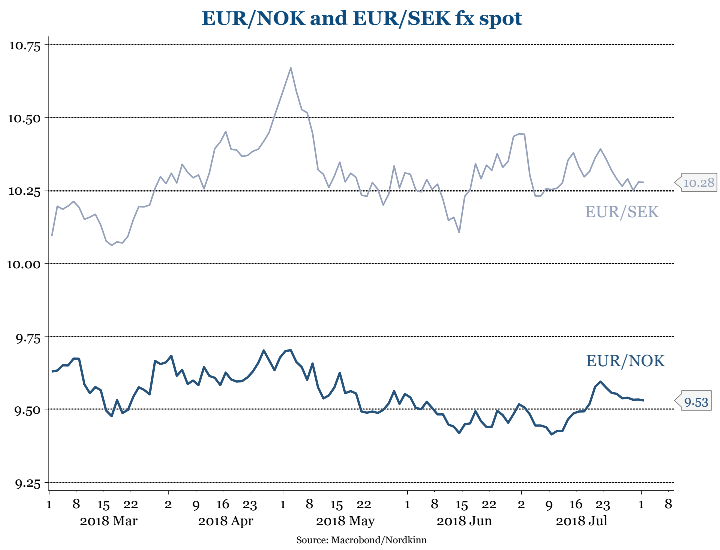
The SEK was tossed between trade war jitters and Riksbank communications, providing an attractive environment for active trading.

The Norwegian fixed income market underperformed peers in the second half of the month. As there were no specific triggers behind the flows, we believe that it was driven by investors adjusting their portfolios in anticipation of a rate hike cycle expected to commence in September.

With the exception of a sharp drop in retail sales in June and PMI in July, both which we suspect were largely influenced by transitory factors, incoming data has overall been in line with the latest projections by Norges Bank.

Despite wider interest rate differentials, the NOK sold off versus the currencies of Norway's main trading partners in July. Global trade tensions and a decline in the oil price seems to have contributed to this development, which was reinforced by thin liquidity during the summer holiday period.





OUTLOOK

Global markets

Albeit the rebound in global bond yields in July, bonds remain broadly overvalued in our view. One reason for this is that the so-called "term premium" currently remains in negative territory, see chart. The term premium is the difference between the yield on a bond and the expected path of short-term rates over the lifetime of that bond. This implies that investors could expect to earn a higher return by rolling over a short-term bill rather than purchasing a bond.

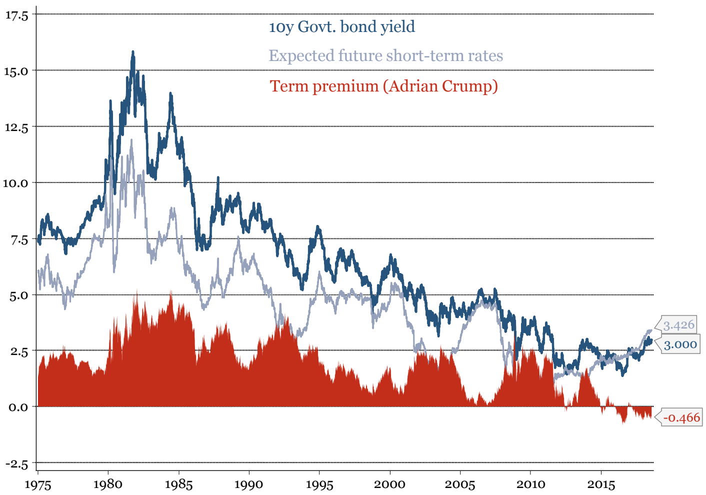
Why has the term premium become negative in recent years? The most important explanation, in our view, is the extraordinary action taken by central banks: Asset purchases have depressed yields. According to a study published by researchers at the Federal Reserve last year, Quantitative Easing had depressed the U.S. 10-year bond yield by 100 basis points.

The situation is now about to change, however. The Federal Reserve is currently letting its balance sheet shrink by USD 40 bln per month, while the ECB intends to wind down asset purchases completely by year-end. 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 severely going forward as higher term premium on bond yields is necessary in order to attract more buyers of bonds from the private sector.

A trade war is currently the main risk to our view that bond yields will rise ahead. A full-blown trade war would lead to higher inflation and weaker economic growth, which have offsetting implications for interest rates. However, since higher inflation would be temporary, on balance, we expect that escalating trade tensions would lead to lower yields on U.S. Treasuries and other safe-haven government bonds.

Just as central banks tend to disregard volatility in commodity prices, we expect them to play down any temporary boost to inflation stemming from a trade war. Instead, central banks will focus on the impact on economic growth, which is likely to be negative.

US 10y Govt. bond yield decomposed



Source: Macrobond/Nordkinn

It is very difficult to quantify how much damage a trade war would do to the global economy. Although the direct impact of higher tariffs is actually quite small, the indirect costs would be meaningful. This is primarily because uncertainty over the magnitude and duration of a trade war could cause companies to postpone new investment spending. Moreover, a trade war would lead to lower equity prices and higher credit spreads, translating into tighter financial conditions.

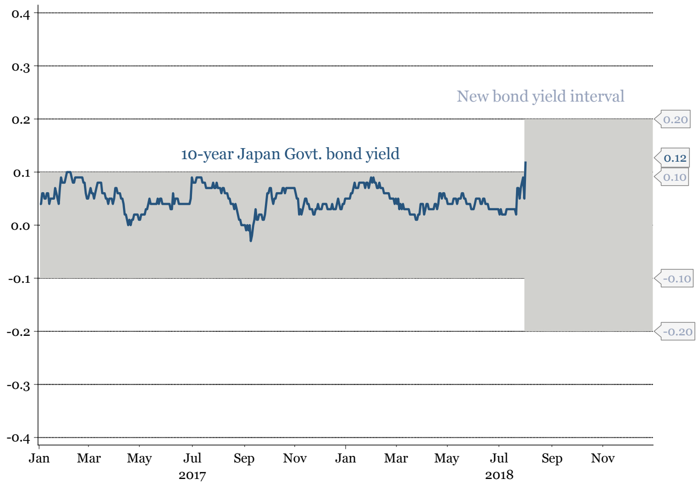
It is too early to assess the impact of trade tensions in economic data, but at least we can conclude that there is no visible signs of slowdown at the moment. U.S. GDP grew 4.1% annualised in the second quarter and business surveys point to a solid growth pace also in the current quarter. Clearly, the significant fiscal stimulus in the U.S. is having an important offsetting positive effect on economic growth.

Turning to Japan, the key takeaway from Bank of Japan's monetary policy meeting on July 31st is the introduction of forward guidance vis-à-vis the current 'Yield Curve Control' (YCC) framework. The essence of this new YCC guidance is that the central bank intends *"to maintain the current extremely low levels of short- and long term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019"*.

Our interpretation is that this is a commitment to maintain the existing monetary policy stimulus in place at least until well after October 2019, most likely until 2020. At the same time, the Bank says 10-year JGB yields *"may move upward and downward to some extent"*. At the press conference, Governor Kuroda clarified that this means yields can now fluctuate by +/-20 basis points around 0%, compared to +/- 10 previously, see chart.

Against this, we expect 10-year JGB yields to fluctuate between 0% and 0.20% depending on economic data and risk sentiment, and we intend to trade this range going forward. Given that yields on August 1st moved towards the higher end of this new range, we decided to close our *"Japan: Yield Convergence"* theme looking for better levels to re-enter.

10-year Japan Govt. bond yield and BoJs interval



Source: Macrobond/Nordkinn

Nordic markets

While growth in Sweden remains robust, the latest inflation data was a disappointment. The increase in CPIF inflation to 2.2% was due to rising energy prices, which most likely are transitory factors that will fade. As the chart shows, the annual increase in CPIF excluding energy fell to 1.4% in June, which was 0.2%-points below the Riksbank's forecast. The main impression we have of the minutes following the monetary policy meeting on July 3rd, is that the discussion is concentrated on the importance of maintaining headline inflation at target going forward when the transitory effects of energy and the weak SEK abate.

As such, the Riksbank Board is probably dissatisfied with the trend in non-energy inflation in recent months. In particular, the Board seems to be concerned over the present rate of increase in services' prices, which according to some Board members is not sufficiently strong for the Riksbank to be able to stabilise inflation close to the target going forward. Consequently, the latest data is challenging our forecast of an interest rate hike by the end of this year.

That being said and despite, the outlook for inflation is more positive for three reasons. First, producer prices have increased sharply in recent months. It is reasonable to expect some degree of pass-through to the consumer price index. Second, the SEK is more than 6% weaker than a year ago and 3% weaker than the Riksbank's average projection for Q3 2018. Third, the labour market has tightened further in recent months, which should bolster the Riksbank's view that wages will drift higher in the future. Taken together, the risk of inflation expectations becoming anchored at a level too far below the inflation target has therefore receded in our view.

Still, a prerequisite for the Riksbank to start normalising interest rates by the end of this year is that non-energy inflation develops broadly in accordance with its projection. While the probably for a hike in 2018 has fallen with the inflation miss in June, it is still too early to call it off.

Reflecting these considerations, we took advantage of the bond sell-off in July and took profits on some of our short duration trades.

Turning to Norway, we maintain our view that the Norges Bank will hike its key policy rate by 25 bps to 0.75% on September 20th. This is consistent with the remarkably precise forward guidance following the latest monetary policy meeting on June 21st, stating that *"the key policy rate will most likely be raised in September 2018"*.

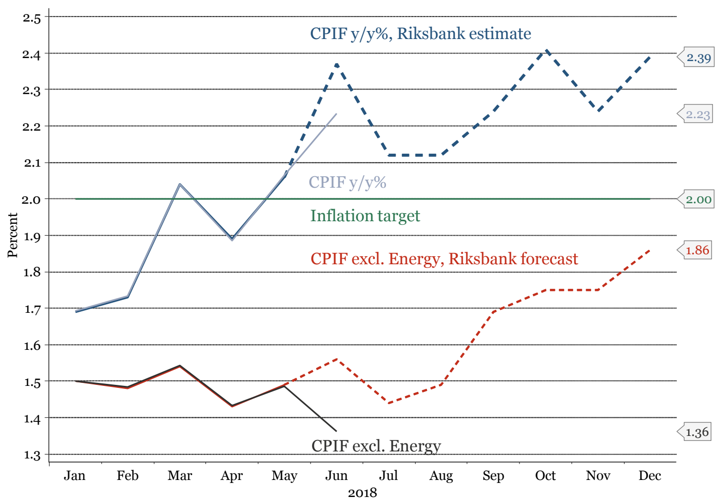
Incoming data since the meeting in June largely confirms the Norges Bank's projection. Admittedly, indicators of growth have been mixed recently, with the PMI falling below 50 in July and Retail Sales slipping by -2.8% in June. However, these data are notoriously volatile, especially during the summer months. Looking at the trends, they continue to point to a robust development in the economy. This view is confirmed by the broader and more reliable Business Tendency Survey, which rose to a seven year high in Q3, see chart.

Moreover, inflation in June was spot on Norges Bank's forecast. We expect inflation to remain well below the 2% target in the foreseeable future, but the Norges Bank has indicated that this is not a concern given that rising capacity utilisation implies higher inflation further out in time.

Furthermore, the NOK is about 1.5% weaker than the Norges Bank's assumption for Q3. Everything else being equal, the Bank's projection is consistent with an average EUR/NOK at about 9.35-9.40 in Q3. The NOK suffered from global trade tensions in combination with thin liquidity during July. In August, while trade tensions could remain a headwind for the NOK in the near-term, we expect the NOK to fade some of its recent losses.

In fixed income space, we continue to favour short exposure in fixed income space, which is organised under the *("Norway: Economic revival")* theme. The September 2018 hike seems to be fully priced, but later on the market is pricing in around 1.5 hike for 2019 and 2020. This is a somewhat slower pace than consistent with the Norges Bank's gradual forecast of 2 hikes, even if the gap admittedly shrunk last month.

Sweden CPIF inflation vs. Riksbank



Source: Macrobond/Nordkinn

Norway industrial confidence vs. GDP

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.

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