NORDKINN
ASSET MANAGEMENT

Nordkinn Market Review & Outlook – September 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

Government bonds sold off across developed markets as investors shrugged off worries over global trade and politics to rediscover their appetite for risk, see chart. Moreover, escalating earnings growth and rising bond supply contributed to pushing the U.S. 10-year Treasury benchmark yield to 3.11%, before ending just above 3% by month-end. Core European government bonds slipped with Treasuries, while Italian bonds trimmed gains after a proposal to set next year's fiscal deficit target at 2.4% of GDP, causing renewed concerns over Italy.

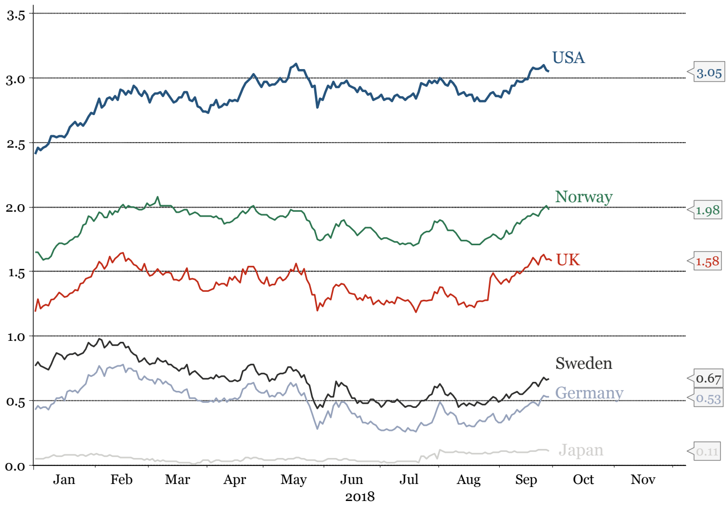
On September 13th the ECB's Governing Council confirmed its intentions to gradually normalise policy, expressing little concern about signs of an economic slowdown. Instead, influenced by recent pick-up in wage growth, the Governing Council has become more confident that core inflation will rise over the medium term. Yet, the forward guidance on rates was unchanged from that of June, stating that interest rates are expected to be on hold "at least through the summer of 2019".

On September 26th the FOMC decided to raise the fed funds target range by 25 bps to 2.0-2.25%. This was universally expected. Interestingly, while the accompanying interest rate projections were left almost entirely unchanged from those in June, the "dot plot" showed that there appears to be a firmer consensus around rates reaching 2.25-2.50% and 3.00-3.25% by the end of 2018 and 2019 respectively.

The line arguing that "policy remains accommodative" was dropped from the FOMC statement, which is simply an acknowledgement of that the fed funds rate is now approaching the short-term neutral rate, and not a signal of future policy changes. Nevertheless, this tweak signals the end of an era of easy monetary policy supporting the economy, sparking a modest rally in government bonds.

At USD 82 a barrel, the Brent spot oil price rose to fresh four-year highs on supply concerns, exacerbated by a steeper decline in Iran's production and bottlenecks in U.S. shale production. In addition, the most recent oil price rally was amplified by OPEC declining to announce an immediate increase in production, despite angry tweets by U.S. President Trump calling for action to raise global supply and bring "prices down now!"

10y Government bond yields



Source: Macrobond/Nordkinn

Nordic overview

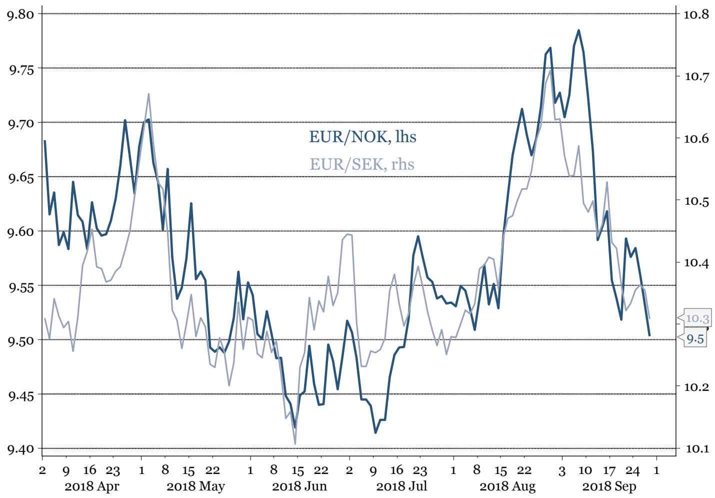
At the Monetary Policy Meeting on September 5th, the Riksbank Board decided to delay the projected timing of repo rate lift-off. Although this message was a tad more dovish than we had expected, the market reaction was contained by a clarification that the Riksbank will not consider raising rates in smaller steps than 25 bps and that it mentioned the December and February meetings more specifically as the most likely occasions for the first hike.

According to the minutes of the monetary policy meeting released on September 17th, Board members confirmed that there will soon be scope to slowly reduce the support from monetary policy. The impression is that Board members have become more convinced that the conditions are good for inflationary pressures to rise ahead, allowing them to tolerate some deviation between expected and realised inflation along the way. Consequently, in spite of another downside surprise to underlying inflation in August, several bank economists adjusted their forecast for the first repo rate expecting the first move in December this year. As a result, Swedish interest rates rose and the SEK appreciated in September.

On September 20th the Norges Bank decided to raise its sight deposit rate by 25 bps to 0.75%, as widely expected. As this was the first rate hike since 2011, the Bank stressed that it should evaluate the effects and proceed gradually and cautiously in raising the key policy rate further. Despite having adjusted its forecast for GDP growth and inflation upwards for the coming year, the projection for the key policy rate ahead was revised slightly downwards.

In the days and weeks prior to the decision, Norwegian interest rates had increased and the NOK had appreciated from low levels. The market anticipated a hawkish hike but expectations were failed. Consequently, the immediate market reaction to the downward revision of the rate path was quite substantial. Nevertheless, the interest to pay Norwegian rates and the NOK resumed shortly after. On balance, therefore, expected future interest rates ended the month much higher than they started, and EUR/NOK ended lower, see chart.

EUR/NOK and EUR/SEK fx spot



Source: Macrobond/Nordkinn

Global markets

As we mark the tenth anniversary of the global financial crisis, there have been plenty of post-mortems examining its causes, consequences and whether the necessary lessons have been learnt. At the same time, there are growing concerns that the global economy will soon roll over again. In fact, a U.S. economic recession in 2020 is now a consensus view, and many economists predict it even may happen earlier.

It seems that a relevant question to ask is why the next U.S. recession will occur. The current economic expansion has lasted for a very long time, but expansions do not die of old age. The three main reasons why previous recoveries have ended are 1) Overinvestments; 2) International shocks; 3) Fed tightening.

Presently, we would argue that there are no warning signals flashing from overinvestments. In fact, the current expansion is still relatively "young" in terms of overall investment spending as a percent of GDP. With regards to an international shock, the ever increasing trade frictions will probably result in slower Chinese GDP growth, but the global repercussions may not be of dramatic proportions as long as China, and not Europe, remains President Trump's primary target.

As of September 26th, the target range for the U.S. federal funds rate is 2.00–2.25%, having been hiked by an accumulated 200 bps since December 2015. Moreover, the Federal Reserve began to shrink its balance sheet very gradually by the end of last year. Tapering will reach full pace of USD 50 bln per month as from October 2018. The purpose of tighter monetary policy is to dampen economic growth.

However, as we discussed in the previous monthly report, monetary policy is not having a contractionary impact on the economy as long as the real central bank rate remains below the natural rate of interest (r-star). Most estimates of r-star is above the current real key policy rate, which implies that the monetary policy stance remains expansionary, albeit only slightly so, see chart. Consequently, we think the odds of a U.S. recession to commence within the coming twelve months are low.

Looking ahead, we believe mounting wage pressures will motivate the Federal Reserve to hike its key policy rate into restrictive area. The combination of recent unemployment and earnings trends align with our analysis that the wage Phillips curve has entered the steep part of the curve, see chart. We expect U.S. core CPI inflation to rise quite sharply next year.

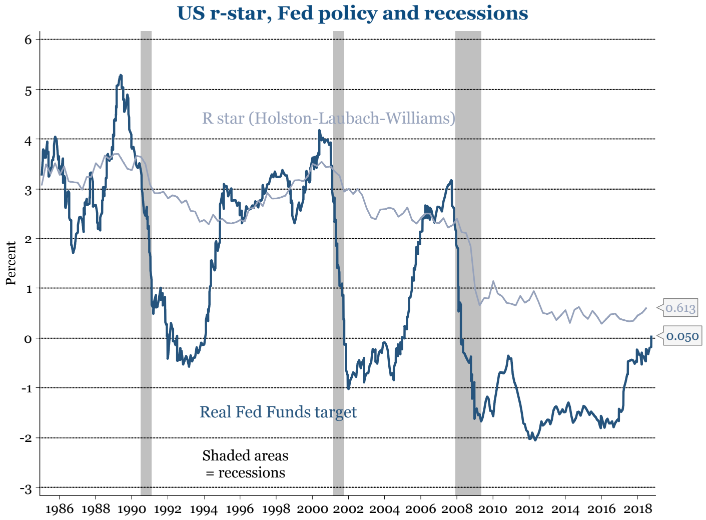
With inflationary pressures building, we therefore subscribe to the FOMC members' own forecasts ("dots") that the fed funds target will be hiked further over the coming year, and more than the market currently expects. Based on these considerations, we actively trade U.S. government bonds and curvature. The trades are organised under the *"US: Interest rate normalisation"* theme.

Turning to Europe, economic expansions are not as advanced as that of the U.S. Consequently, central banks in Europe now stand at the start of the policy normalisation process. Similar to the U.S. Federal Reserve once it lifted off in late 2015, central banks in Europe are consistently guiding markets toward very gradual adjustments of monetary policy. In the near-term we expect central banks in Europe to remain resistant to signaling material policy adjustments, but we do look for shifts in guidance over the coming couple of years.

The Bank of England's forward guidance is for a shallow path of only 25 bps tightening a year over the coming three years. Assuming a smooth Brexit, we expect that the Bank of England will end up raising rates more rapidly. The ECB has committed not to raise rates before September 2019 at the earliest. We expect the first rate hike to be accompanied by a "dovish" forward guidance. Later on, if the economy follows the expected track for core inflation to rise above 1.5% next year, we believe the ECB's guidance will change in a more "hawkish" direction.

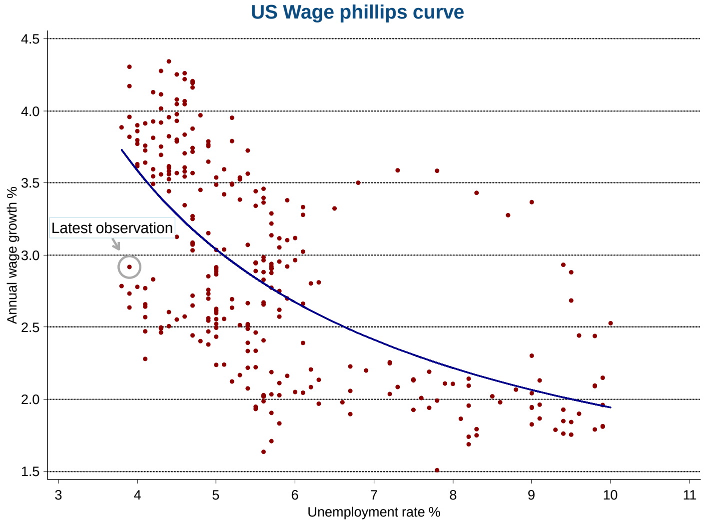
Supported by the upcoming QE tapering process by the ECB, our bias is for European yield curves to steepen gradually in coming months. These trades are organised under our *"EMU: QE tapering"* theme.

US r-star, Fed policy and recessions



Source: Macrobond/Nordkinn

US Wage phillips curve



Source: Macrobond/Nordkinn

Nordic markets

Our main impression of the recent Riksbank communication is that the Board has become more confident that CPIF inflation will remain close to the 2% inflation target over the medium term. A key factor behind this increased confidence is that CPIF inflation has remained close to target for almost two years now. In the same period, both market- and survey based measures of inflation expectations have been stable at around 2% across all horizons, see chart.

As such, the risk that inflation expectations will drift lower has arguably diminished, even if some measures of underlying inflation such as non-energy CPIF has fallen recently. Re-anchoring of inflation expectations allows Board members to be less concerned about the trends in past CPI outcomes and rely more on the underlying drivers of future inflation, such as capacity utilisation. Consequently, with economic activity remaining strong in Sweden and abroad, conditions are good for inflationary pressures to rise. This justifies a rate hike in December or February according to Board members. As an upcoming hike essentially is known, we do not see any strong reasons for the Riksbank to wait for February, which puts us in the camp of a December hike.

As this will be the first rate hike in more than seven years, we believe that the decision to raise rates will be accompanied by a "dovish" statement. Such strategy has been pursued by other central banks that have announced lift off, such as the Federal Reserve in December 2015, Bank of England in November 2017 and Norges Bank in September 2018. In fact, the Riksbank Board will probably be even more wary of the risk of leaving underlying inflation below target if it removes monetary policy accommodation too quickly.

With this in mind, we expect Swedish fixed income to underperform prior to the December Board meeting. Money market curves will probably remain under pressure to steepen and the SEK to appreciate as the market discounts a series of rate hikes going forward. After rate lift off, we expect however that the Riksbank will take its time to evaluate the effects. In addition, we see a risk that base effects from energy prices will push CPIF inflation downwards early next year, which could motivate a prolonged pause before the second rate hike. We are trading Swedish interest rate risks actively under the *"Sweden: Credible Inflation Targeting"* theme. In addition, we hold several relative value trades that are organised under the *"Sweden: Government relative value"* theme.

After hiking the key policy rate by 25 bps to 0.75% on September 20th, the Norges Bank reassured markets that it will pursue a cautious approach, raising interest rates very gradually in the years ahead. While the outlook for growth and inflation would normally warrant a faster pace of tightening, the high household debt implies that interest rate increases now will dampen consumption and housing demand more than previously. The Board seems to have become more concerned since June about the risks of raising rates too rapidly ahead, citing for instance low house price inflation in recent months.

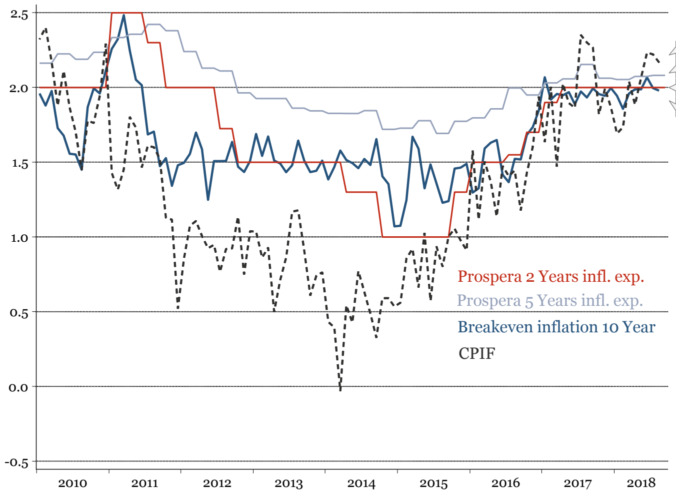
In addition, despite strong growth and higher core CPI inflation in recent months, the Board has cut its wage growth projections and therefore anticipates lower inflation further out. The change to the wage projections seems unjustified in our view.

That said, in the near term we think incoming information about household demand will accentuate the Board's anxieties of raising rates too quickly. In particular, we expect to see further evidence of cooling housing market in coming months. Meanwhile, we will not receive significant new information about wage developments until the centralised wage negotiations commences next year. Consequently, in the near term we expect that the Norges Bank will resist signaling a faster pace of tightening.

Later on, we believe that the Norges Bank will become more confident about the robustness of the current economic upswing and that inflationary pressures will keep rising. This will in our view warrant a gradual shift towards a more hawkish stance over the coming year.

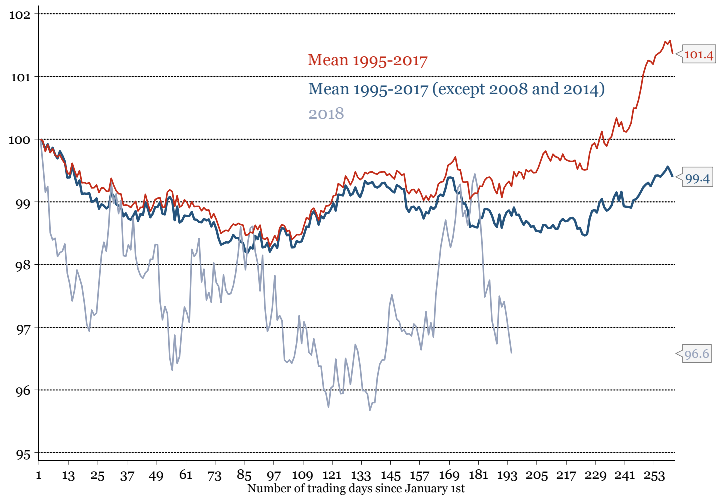
As the market is almost fully pricing in the Norges Bank's interest rate projection until the middle of 2020, we have decided to meaningfully reduce our short exposure in fixed income space, which is organised under the *"Norway: Economic revival"* theme. Lower conviction on near-term developments in interest rates also affects our *"Norway: NOK recovery"* theme. In addition, we approach a season which historically has been a headwind for NOK, see chart. Closing of books ahead of year-end combined with thin liquidity could amplify the price impact of any negative news. Still, we remain long NOK via option structures and we stand ready to add risk if valuation becomes even more attractive.

Sweden inflation expectations



Source: Macrobond/Nordkinn

EUR/NOK between 1.January and 31.December



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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