Nordkinn Market Review & Outlook – February 2014

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Based at the Nordkinn peninsula, Slettnes Fyr is the northernmost located mainland lighthouse in the world

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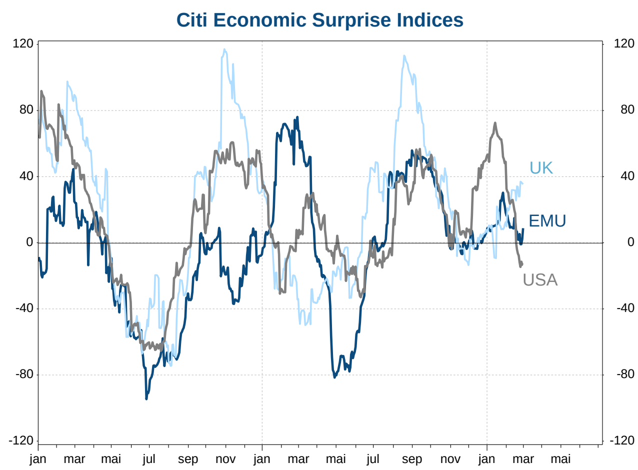
NORDKINN ASSET MANAGEMENT

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

Parkveien 57
0256 Oslo, Norway
Phone: +47 22 46 63 00
Telefax: +47 94 77 15 16
E-mail: post@nordkinnam.no

Global overview

Government bond yields in major economies were broadly speaking unchanged in February as the market weighed a positive economic outlook on the one hand against recent soft US data and expectations of further monetary policy easing by the ECB on the other. While mounting tensions in Ukraine contributed to safe haven demand for government bonds, the Swiss franc and the Yen, the conflict did not develop into a real concern until Russian president Putin got lawmakers to endorse troop deployments at the beginning of March. Meanwhile, the equity markets did not discount any of the risks associated with the unrest in Ukraine as European and US equities gained in February



Considering the extent of the decline in the Citi Economic Surprise Index for the US - which captures how well data is coming in relative to expectations - the fixed income market was remarkably stable in February. A reasonable explanation is that investors are blaming the unusually bad weather for the disappointing US data. Looking beyond volatility, the underlying growth appears quite robust.

The Federal Reserve also seems confident that the US economic recovery is on track. Most FOMC members argue that, in the absence of "an appreciable change in the economic outlook", asset purchases should continue to be reduced at USD 10bn at each meeting, minutes from the January 28-29 meeting show. Participants also noted it would soon be appropriate to change the forward guidance for the federal funds rate given the decline in the unemployment rate.

Turning to Europe, the rally in bunds that started in early January extended through February. Interestingly, bunds have outperformed US treasuries despite Eurozone macro data being more or less in line with expectations, while peripheral bonds have rallied. This combination of market movements, we believe, is a sign that investors have begun to anticipate quantitative easing of some sort.

At the press conference following the decision to leave interest rates unchanged in early February, President Draghi confirmed that the ECB is looking at various tools to address a potential worsening of the inflation outlook and/or a tightening of the short-term money market. The toolbox includes further reduction of ECB interest rates, ending sterilisation of government bond purchases under the Securities Market Programme and a new private sector asset purchase programme.

President Draghi highlighted the need for more information as a key reason for the decision not to act in February. He emphasised the new staff macroeconomic projections scheduled for publication in March, which for the first time will contain forecasts for 2016. This notwithstanding, the majority of economists surveyed expect the ECB to stay put at the policy meeting in March, presumably due to the higher than expected CPI inflation number in February (0.8% vs. 0.7% expected).

Nordic overview

Swedish government bonds rallied across the maturity spectrum in February, supported by lower than expected inflation and soft Riksbank minutes. The inflation rate according to CPIF was only 0.4% in January, 0.3%-points below the Riksbank's projection and significantly below the 2.0% inflation target. A few days prior to the release of the CPI data, the Executive Board of the Riksbank had reaffirmed its easing bias and members expressed concern about the low inflationary pressures in Sweden, minutes from the February 13 monetary policy meeting show. Interestingly, Deputy Governor Per Jansson said he will not vote for a repo-rate increase until CPIF inflation picks up and rises above 1.5%.

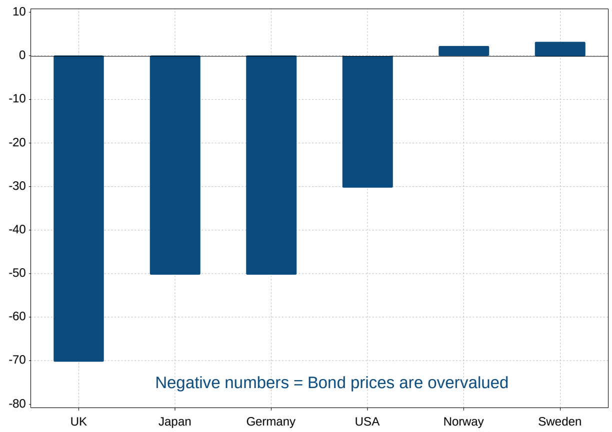
Meanwhile, Norwegian fixed income underperformed Sweden and major markets in February and the Norwegian krone recovered some of its depreciation from previous months. Following stabilisation of house prices, stronger than expected GDP growth in Q4 and higher than expected inflation in January, the market lowered the probability of a Norges Bank rate cut this year. The output gap is almost zero and the underlying inflation rate was only one tenth below the 2.5% inflation target in January, suggesting there is no imminent need to ease monetary policy in the near-term.

Global markets

We believe that financial assets – over time – will return to their normal relationships to macroeconomic fundamentals, but at the same time, we recognise the risk of a protracted normalisation process due to various economic and political reasons. When forecasting financial market developments ahead, we therefore distinguish between 1) identifying deviations from the fundamental value of assets and 2) predicting how catalysts such as macroeconomic events, investor positioning and monetary policy are likely to affect the valuation of financial assets in the shorter-term.

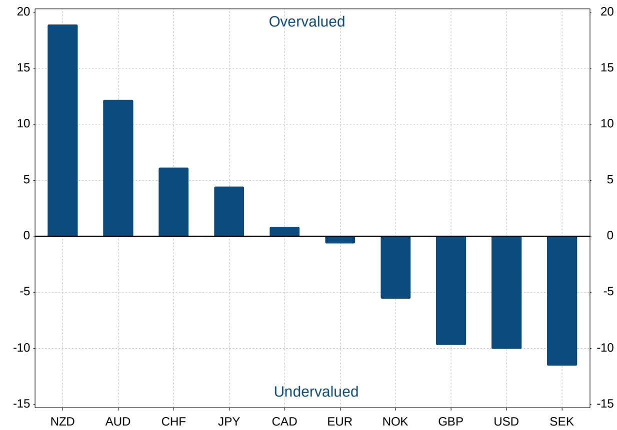
The two charts below display deviations from our estimated fundamental fair values for 10-year government bond yields and foreign exchange rates, respectively: Government bond yields in major economies remain low in relation to where they would have been if short-term "noise" and policy guidance were not affecting the market. UK government bonds are the most overvalued considering the recent sharp improvement in UK fundamentals. In the FX market (chart to the right), we deem the NZ dollar being the most overvalued, while the Swedish krona is the most undervalued amongst the currencies we trade.

10y govt. bond yield, deviation from cyclical fair (basis points)



Source: Nordkinn AM, Reuters EcoWin

Trade weighted real exchange rates, deviation from fair (in %)



Source: Nordkinn AM, Reuters EcoWin

While we expect the UK recovery to proceed in 2014, the wide output gap and a significant pound appreciation will likely keep inflation low, allowing monetary policy to remain accommodative for some time. Our view is quite similar vis-à-vis the US economy, but with the exception that a somewhat narrower output gap combined with upside risks to growth in coming quarters may motivate an earlier Fed tightening than the market currently anticipates. Consequently, while we expect a gradual normalisation process for government bonds on both sides of the Atlantic, we believe US treasuries have the potential to underperform gilts over the next few quarters. In addition, the correction in US economic surprise indices and positioning by non-commercial investors after the turn of the year suggest less resistance for US bond yields to move higher in the short-term.

The British pound and the US dollar are both undervalued according to our fair value estimates. Against the backdrop of positive economic prospects and expected policy firming next year, we expect both currencies to appreciate gradually going forward.

In the euro area, by contrast, we expect low inflationary pressures to motivate additional ECB policy easing, perhaps already in March. Consequently, German government bonds should remain overvalued for quite some time. We consider the current level of the euro exchange rate being "fair" in a longer-term perspective. However, for cyclical and policy reasons we expect the euro to slide to levels well below our estimated fair value in the near-term.

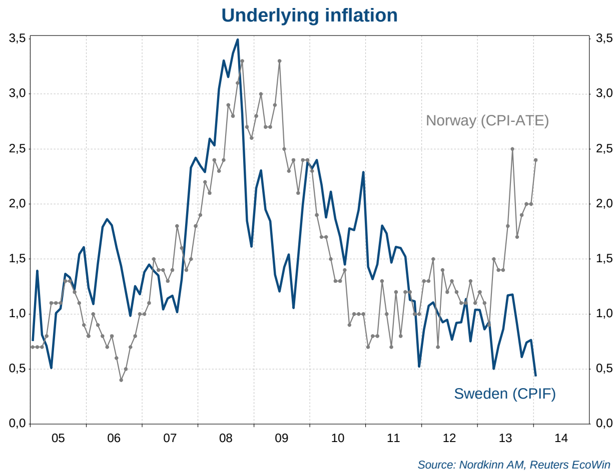
In Japan, we see compelling reasons to expect higher government bond yields ahead. Not only have yields fallen back to the lows from June last year, but they are also trading well below our fundamental fair estimate and are of course exceptionally low in absolute terms. If Abenomics turn out to be a success, interest rates should gradually rise in tandem with a sustained boost to nominal GDP growth, even if the Bank of Japan expands its asset purchase program (experience from the US shows that interest rates actually rose after the Federal Reserve introduced quantitative easing due to a positive impact on confidence).

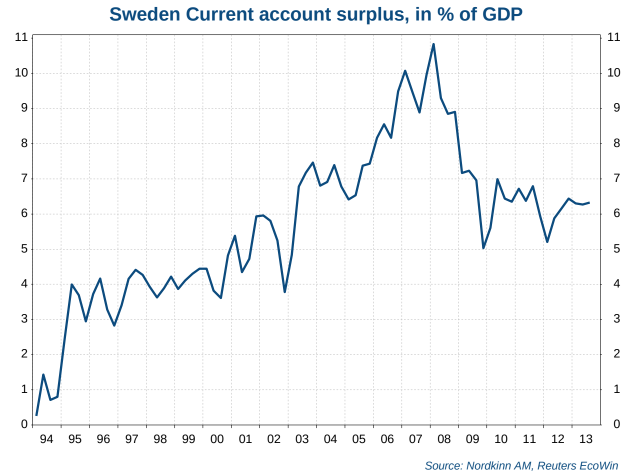
If Abenomics prove not to work, the government debt-to-GDP ratio may become unsustainable and the credit risk premium of holding government bonds would increase. Moreover, while strong domestic demand for JGBs has supported bonds in recent years, the sharp deterioration of the current account surplus towards the end of last year means Japan may also depend on external funding in the future, which should steepen the curve.

There are two main risks to our optimistic view are China and Ukraine. In China, authorities are walking a fine line between the need to restrain credit growth and to maintain growth at acceptable levels. We expect they will succeed, though growth will nevertheless slow somewhat this year. A more abrupt decline in economic activity than we expect would have sizeable effects globally. The outcome of the crisis in Ukraine remains highly uncertain at this stage. It has the potential to have a significant and prolonged impact on global financial markets, but our base scenario is that it will be contained.

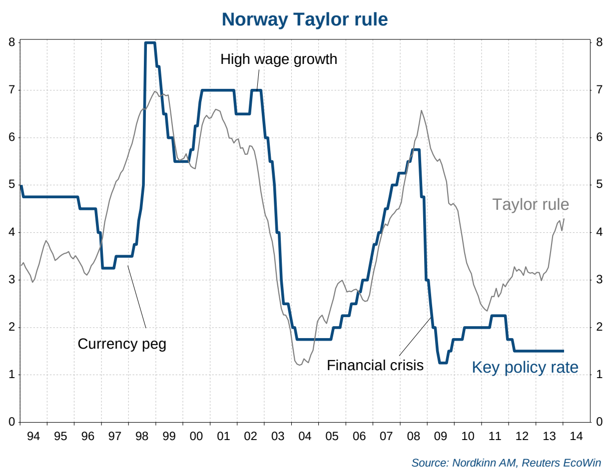
Nordic markets

Unlike the major economies, long-dated government bond yields in Sweden and Norway are broadly in line with our fundamental fair value estimates (see chart on the previous page). On the one hand, bond yields are relatively low when comparing to nominal GDP growth, but on the other high compared to German government bond yields. We do however see a case for a steeper yield curve ahead as both the Riksbank and the Norges Bank keep short-term interest rates low, whereas the longer-term dated bond yields should increase in tandem with higher bond yields abroad.





We judge the Swedish krona being cheap relative to our estimated long-term fair value (see chart on the previous page). Not only is the Swedish real exchange rate below its historical average, but the country is also running a significant current account surplus (see chart to the right). Consequently, we see the krona stronger in the long term, but in the short term it will remain under pressure due to low inflation and the risk of a Riksbank rate cut this year.



In Norway, incoming data since in the Monetary Policy Report in December does not, on balance, deviate much from the Norges Bank's projections. Consequently, we expect the Executive Board to leave the key policy rate at 1.5% on March 27 and signal unchanged rates until mid-2015, which is broadly the message conveyed in the previous statement.

Interestingly, judging from a standard monetary policy (Taylor) rule, the key policy rate in Norway should have been 4%, see chart. This is the level one would expect if the output gap were closed and inflation on target, which is the situation in Norway today.

There are three reasons, we believe, why Norges Bank deviates substantially from this rule; 1) A high interest rate differential between Norway and its trading partners could lead to an excessive appreciation of the krone; 2) The Bank expects a slowdown in economic activity ahead; 3) Interest rate margins on bank loans are high. Our view is nevertheless that the dovish stance will become increasingly difficult to defend if growth remains acceptable and inflation remains close to target.