Nordkinn Market Review & Outlook – March 2014

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for informational purposes.

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

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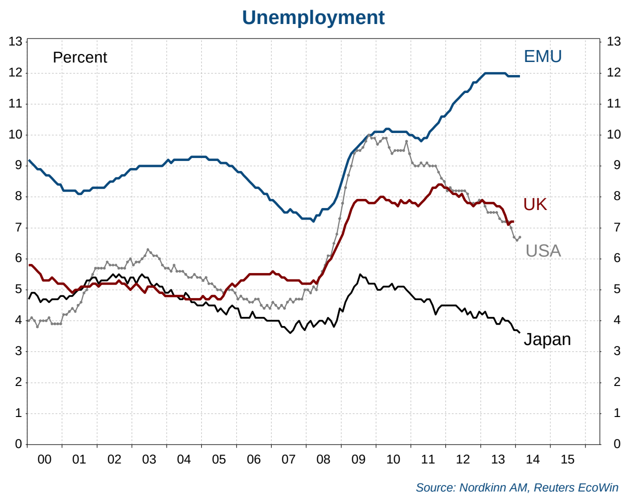
Global overview

Yields on government bonds in major markets increased slightly in March, yet remain below end-2013 levels. The rise in yields in March reflects broad-based improvements in economic data and subsequent expectations of tighter monetary policy ahead. However, developments in the month as a whole masked significant volatility on a daily basis, primarily associated with uncertainty about the outcome of the crisis in Ukraine. While a resolution of the crisis remains uncertain, the markets seem to discount that it should not meaningfully affect the global economic recovery.



In the US, markets have become increasingly confident that the slowdown in growth around the turn of the year was largely due to the adverse weather conditions. Looking beyond volatility, the economic recovery is on track with spare capacity declining, as reflected by the lower unemployment rate, see chart. Against this backdrop, the Federal Reserve decided to reduce asset purchases by yet another USD 10 bn in March.

Moreover, with the unemployment rate nearing the 6.5% threshold, the Federal Reserve updated its forward guidance in March. The new guidance suggests unchanged short-term interest rates for a "considerable time" after ending the asset purchase program, which we expect will happen in Q4 this year. At the press conference, Ms Yellen said "considerable time" probably means something of around six months, which would imply a first hike in Q2 next year. Expected future short-term market rates increased significantly during and after the press conference.

Turning to Europe, yields on long-dated German government bonds remained broadly unchanged in March, while yields on short-dated bonds increased after the ECB decided to keep interest rates on hold. Although the ECB's decision was not a major surprise, the market was split ahead of the meeting and many investors had expected policy easing of some kind. Accordingly, the slope of the German government bond curve flattened and the value of the Euro strengthened.

In the UK, interest rates increased slightly in March, largely in response to the developments in the US. The GBP depreciated against both the USD and the Euro as economic data on the margin come in on the weak side of consensus.

Nordic overview

Swedish government bonds with longer-term maturities remained by on large unchanged in March, whereas expected future money market rates declined as investors raised the probability of a rate cut this year. Consumer price data confirmed that inflationary pressures are diminishing at a faster pace than projected by the Riksbank. Indicators of economic growth painted a mixed picture, but were on balance somewhat weaker than anticipated. The unemployment rate was 8.1% in February, slightly higher than expected and consistent with excess spare capacity in the economy. There were no news from the Riksbank in March. The foreign exchange rate of the SEK was relatively stable.

Long-dated government bonds in Norway sold off in March, partly due to heavy supply, while short-term market rates were stable. Accordingly, the slope of the yield curve steepened. Economic growth is slowing, especially within the construction sector. According to the Regional Network, the underlying growth rate of the economy stood at around 1.5% in Q1. However, house prices have stabilised after the decline last year, suggesting diminishing downside risks for growth in the near term. Underlying consumer price inflation was 2.4% in February.

As expected, the Norges Bank Board left the sight deposit rate unchanged at 1.5% in March. The interest rate projection was little changed from December, but a minor upward revision for 2015 caught markets by surprise. As a result, the NOK exchange rate appreciated after the meeting.

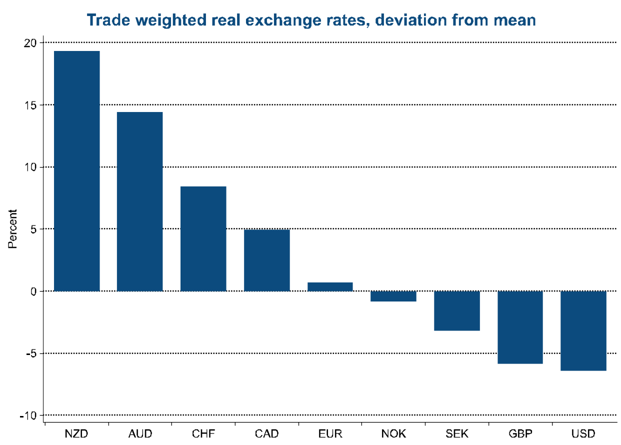
Global markets

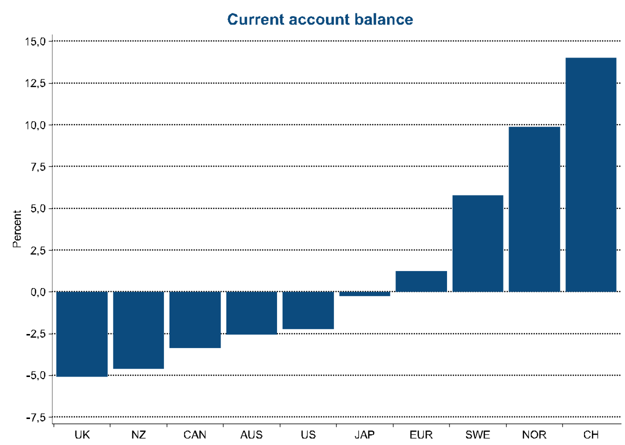
Overall, we expect a continued recovery in the global economy in the months and quarters ahead. Although growth is likely to remain uneven across regions, we expect the overall global economy to grow at a somewhat faster pace in 2014 than in 2013, driven by the advanced economies. We also believe that improving macro fundamentals will prompt financial market instruments to continue normalising. In particular, with spare capacity in some of the major economies shrinking, future interest rates should increase across the maturity spectrum and the slope of the yield curves should become flatter.

However, we believe this normalisation process will remain gradual and with multiple setbacks in the months to come, which will require active portfolio management. Apart from the Reserve Bank of New Zealand, we do not anticipate interest rate hikes from central banks in the G-10 area in 2014, which will keep volatility in the short-end of the curves relatively contained. Also, several risk factors have the potential to absorb the markets' attention going forward. A sharper than expected slowdown in China is one such risk. Another is a further significant worsening of the relationship between Russian and EU/USA after the annexation of Crimea.

Moreover, geographic interest rates differentials are likely to remain wide: Some economies are in very early stages of recovery, with additional policy easing on the table (e.g. Euro area and Japan), while others are gradually approaching "self-sustainable" recoveries (e.g. US and UK) for which a removal of policy accommodation is not far away. Until now, this divergence has given rise to wider cross-country spreads for bonds with long-dated maturities, whereas short-term market rates have been anchored by zero interest rate policies. Looking ahead, we believe speculation about monetary policy tightening will cause higher volatility and wider spreads in the front-end of the curves, such as US vs. Germany in 2yr.

Changes in short-term interest rate spreads between countries are often catalysts in the foreign exchange market. Higher interest rates often attracts buyers, especially in a risk environment where carry trading is favoured. If, in addition, the currency in question is fundamentally undervalued according to our models, it would provide a strong buy signal. When defining whether a currency is under- or overvalued vs. fundamentals, we look at e.g. deviations from historical mean when adjusting for differences in inflation (i.e. the real effective exchange rate), the country's current account balance and terms of trade.





In this context, the outlook for the USD remains positive in our view. Firstly, we expect the Federal Reserve to start tightening the Fed Funds rate next year. Secondly, the real-effective exchange rate of the US dollar is 6-7% weaker than its 20-year average, see chart to the left. Thirdly, while the current account balance remains negative, the deficit has contracted by around 2 percentage points over the past couple of years to below 2.5%, which is less than the deficits in other Anglo-Saxon countries, see chart to the right.

At the other end of the scale, the New Zealand dollar looks fundamentally overvalued. The effective real exchange rate is almost 20% above historical average and the country is running a significant current account deficit, in spite of the positive developments in terms of trade. Regardless, the currency appreciated in March as the Reserve Bank decided to increase the key policy rate by 25 bp and indicated a further 100-125 bp of tightening over the next twelve months, which was more than expected. Such hawkish hiking profile could be difficult for the Bank to top in the next policy report, which is due in June.

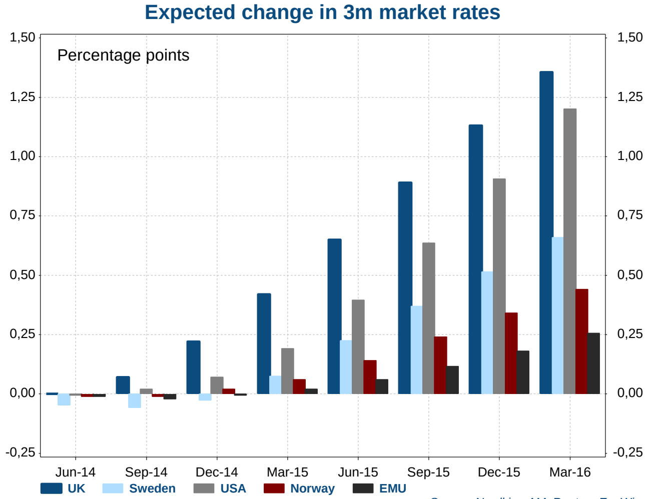
Nordic markets

Despite somewhat softer business survey data in March, we are quite optimistic concerning growth prospects in Sweden. Confidence among Swedish companies has risen to levels better than normal and demand for Swedish exports is likely to increase in sync with improving demand amongst its trading partners. The high level of consumer confidence should motivate households to reduce the elevated savings ratio to boost spending. This will in turn be positive for employment.

The SEK is likely to be supported by stronger growth prospects and a substantial current account surplus. In real effective terms, the SEK is currently around 3% weaker than historical mean, see chart on previous page.

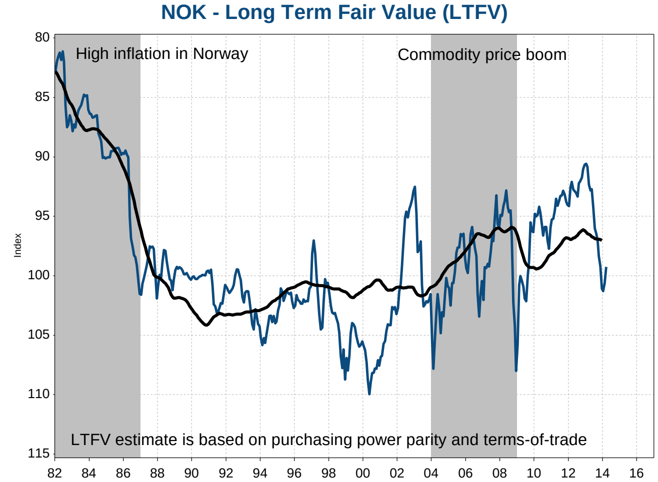
Despite better growth, a significant amount of spare capacity in the economy is likely to persist for another year or so. This will keep inflationary pressures subdued. In the near term, we expect inflation to remain below the Riksbank's projection from the inflation report, which could motivate another rate cut this year. We expect the Riksbank to keep interest rates unchanged in April, but the Bank is likely to keep a dovish bias in the press statement.

Expected change in 3m market rates



Source: Nordkinn AM, Reuters EcoWin

NOK - Long Term Fair Value (LTFV)



Source: Nordkinn AM, Reuters EcoWin

In Norway, we expect economic growth to slow in 2014, driven in particular by fading growth stimulus from petroleum investments and a decline in housing investments. In contrast to Sweden and most other countries, the economic slowdown in Norway takes capacity utilisation from a little above normal to slightly below. Therefore, inflation is likely to remain close to the 2.5% inflation target also going forward. Furthermore, downside risk to growth has diminished due to better than expected activity in the existing housing market since the turn of the year.

With little spare capacity and inflation close to target, a Norges Bank policy rate of 1.5% is quite low. There are two main motivations behind this low policy rate: 1) Interest rates among trading partners are even lower; 2) There is a considerable spread between the key policy rate and the interest rates facing households and enterprises. On the former, we expect major central banks to keep short-term interest rates on hold this year, but some will likely increase them next year. Regarding the latter, some banks have recently decreased interest rates on mortgages and we expect other banks to follow suit. Consequently, the Norges Bank may well increase interest rates next year. The market however expects very small changes to short-term market rates next year, see chart to the left.

Our outlook for the NOK has become more positive recently, after it depreciated by around 10% last year, see chart to the right below. We highlight three factors behind this view: 1) Economic growth in Norway has been slightly better than expected recently and downside risks to growth has decreased; 2) The Norges Bank has signalled an increase in the key policy rate towards the summer of next year, but is monitoring the developments in mortgage rates carefully and stands ready to increase the policy rate earlier should private banks reduce interest rate margins; 3) There will be no need for the Norges Bank to purchase foreign currencies for the State Pension Fund going forward. On the contrary, the central bank may have to start selling foreign currencies (i.e. purchase NOK) if the government's foreign currency revenues from the petroleum sector exceeds the transfers to the State Pension Fund.