Nordkinn Market Review & Outlook – April 2014

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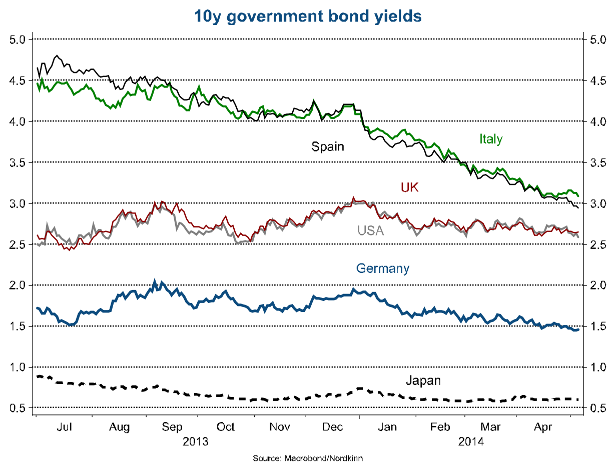
NORDKINN ASSET MANAGEMENT

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

Yields on long-dated US and UK government bonds remained virtually unchanged in April. By contrast, yields continued to decline gradually in Germany and more so in the euro area periphery, see chart. Accordingly, the spread between Germany and periphery bond yields - often seen as an indicator of the risk premium related to the euro - has declined dramatically in 2014.



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.

Meanwhile, yields on long-dated German government bonds have remained low and downward trending, despite improving economic prospects in Germany and in the euro area in general. The low euro area inflation and expectations of additional policy easing by the ECB have increased the appetite for government bonds, specifically in the euro area periphery. In the monetary policy statement in April, the Governing Council said it is *"unanimous in its commitment to using also unconventional instruments within its mandate in order to cope effectively with risks of a too prolonged period of low inflation".* In our view, this reinforces the easing bias in coming months and cements our expectation of a further cut in interest rates.

In Japan, the nation's bond market is surprisingly unaffected by the recent increase in consumer price inflation. The 10-year government bond yield has traded within a very tight range around 0.60% since February, probably because of slightly weaker growth data and uncertainty about the impact of the increase in the sales tax in April.

Nordic overview

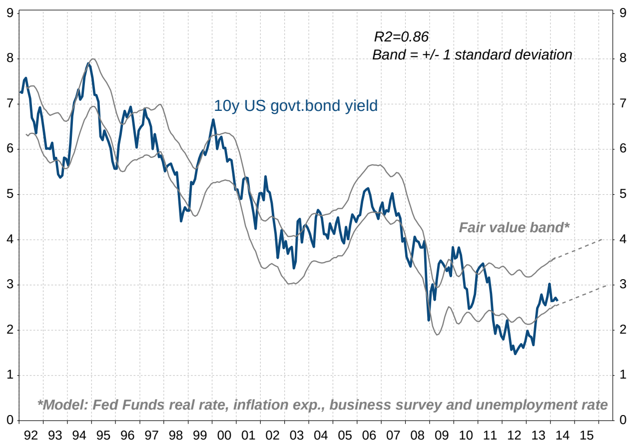
In Sweden, interest rates across the whole maturity spectrum fell in April after yet another soft inflation print. Underlying inflation as measured by the CPIF index fell to 0.0%, well below both consensus expectations and as anticipated by the Riksbank. A few days earlier the Riksbank decided to keep the repo-rate unchanged at 0.75% in April, but the Board also decided to adjust the repo-rate path downwards so that it reflects a greater probability of a cut in the near-term compared to their previous rate path. The minutes from the discussions revealed that even minor revisions to the inflation forecast could trigger a cut. Consequently, the market currently attaches a very high probability to a rate cut in July.

By contrast, in Norway underlying inflation rose to 2.6% in March, which was higher than both consensus and what the Norges Bank had expected. In addition, in a move motivated by market share objectives, most banks cut margins on lending to households and enterprises in April. High margins have been put forward by the central bank as one of the main reasons behind the low level of the key policy rate. This notwithstanding, the market expects unchanged interest rates until the second half of 2015 and, subsequently, a very gradual hiking profile thereafter. In the wake of these developments, the spreads between market interest rates in Norway and Sweden widened in April, in particular for shorter-term maturities.

Global markets

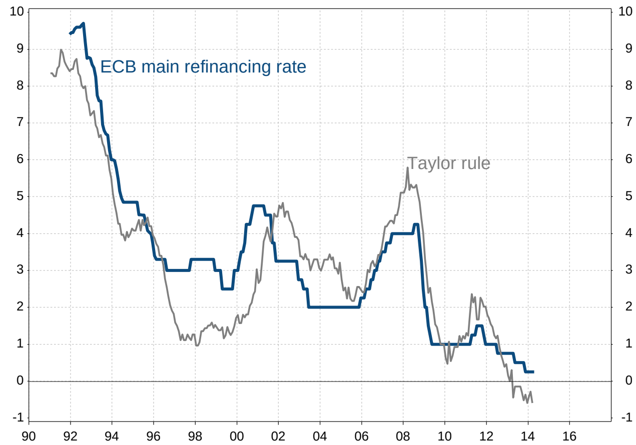
Although incoming data suggests a slight retrenchment in global economic growth in the first quarter of 2014, we expect growth to improve in 2014 -15 amid positive developments in advanced economies. We expect the impulse to come from the US, whose economy will experience a significantly smaller drag from fiscal consolidation. Support will also come from higher household wealth and easier bank lending conditions. Against this background, our medium-term short duration bias in US fixed income remains. Our cyclical fair-value estimates for longer-term US government bonds also suggest there is room for gradually higher yields in the US as the economic recovery unfolds, see chart.

US 10y govt. yield vs. cyclical fair-value model



Source: Nordkinn AM, Reuters EcoWin

Euro area Taylor rule



Source: Nordkinn AM, Reuters EcoWin

In the euro area, by contrast, we expect additional policy easing by the ECB this year. This view is consistent with the interest rate level recommended by the "Taylor rule" (a standard monetary policy rule), see chart. The ECB has identified three potential triggers for more ECB stimulus: 1) An unwarranted tightening of monetary conditions (i.e. higher Eonia rates, a stronger euro exchange rate and/or higher global bond yields); 2) Weak money and credit growth (impairment of the transmission mechanism) as well as; 3) Lower medium-term prospects for inflation. However, these three catalysts require three different responses according to the central bank's reaction function:

1. An unwarranted tightening in monetary conditions is tackled through conventional measures, which comprise a cut in the corridor of rates (i.e. including negative deposit rates), an extension of full-rate-full-allotment regime beyond July 2015, and/or LTROs.
2. Impairment of the transmission mechanism is fixed with targeted LTROs (funding for lending) and ABS buying.
3. Lower medium-term prospects for inflation could require asset purchases (QE – Quantitative Easing) when reaching the zero lower bound for policy rates. Our interpretation is that there is room for one small rate cut before asset purchases will be considered.

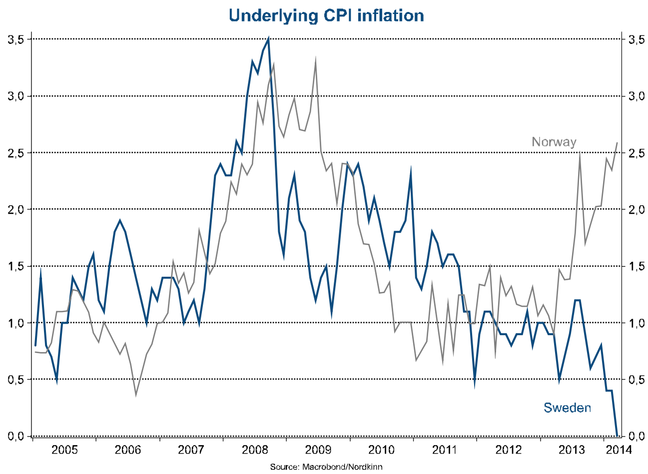
Regarding the former two potential triggers, developments since the meeting in April do not warrant any imminent policy response, even if money and credit growth has been somewhat lower than expected. Regarding the latter, the Governing Council has stressed its commitment – unanimously – to using both unconventional and conventional instruments to deal effectively with the risks of a too prolonged period of low inflation. Although CPI inflation increased slightly in March after the surprisingly low February print, current inflation rates are most likely running a little below ECB's projections. However, given the broad-based improvement in economic data, particularly survey data, we doubt the Governing Council will revise its medium-term outlook for inflation ahead of the meeting on May 8th. Accordingly, the Governing Council will most likely stay put at this meeting, while reiterating and perhaps emphasising its easing bias.

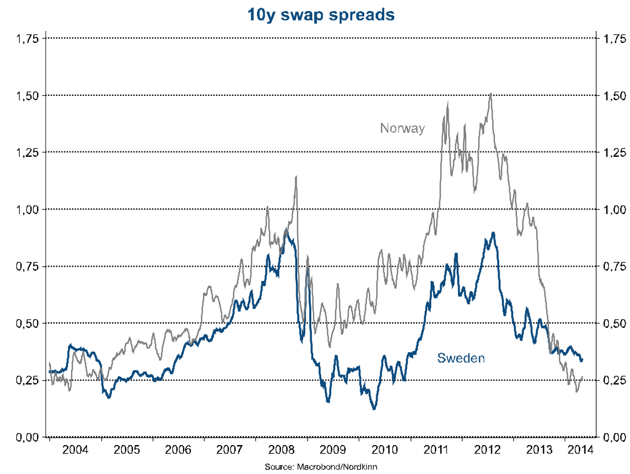
Looking ahead, we continue to expect a lower inflation path than that of the ECB's, and indicators of money and credit growth are likely to remain weak. Consequently, we expect the ECB to cut interest rate(s) in June and indicate that QE could be the next possible step to combat a prolonged period of low inflation. Examples of our trading themes linked to this is to remain long duration in German fixed income against the US as well as being receivers in EUR/USD basis swap.

Nordic markets

In response to the diminishing inflationary pressures in Sweden, we expect the Riksbank to go ahead with another 25 bp repo-rate cut to 0.5% in July. As minutes from the Board meeting in April revealed, the decision to keep interest rate unchanged was very close and the further sharp decline in CPIF inflation to 0.0% in March (see chart) should be sufficient to trigger additional policy stimulus. Although the market is already attaching a high probability for a rate cut, we see some further downside risk for market interest rates in the near-term, especially if inflation were to remain at current very low levels in coming months.

Looking somewhat further ahead, 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 eventually bring inflation higher over the medium term, although probably not as fast as the Riksbank currently anticipates.





Norwegian government bonds (NGBs) with longer-term maturities have cheapened against peers and against swaps in recent months. According to our cyclical valuation framework, NGBs are in line with fundamentals, while in most other countries bond prices are higher in relation to where they would have been if short-term "noise" and policy guidance were not affecting the market. Consequently, holding long-dated NGBs relative to peers is therefore one of our high conviction strategies.

The supply of NGBs has been front-loaded and higher than expected so far this year, and it has been concentrated mainly in the long-end of the curve. During the first four months of the year, the Norges Bank has issued roughly 45% of the estimated annual supply. Consequently, when looking ahead we expect supply to ease somewhat, thus supporting bond prices.

Regarding demand, investors' unwinding of safe haven positions in NGBs was also a factor behind last year's NGB sell-off. This trend seems to have ended. In addition to the more attractive valuation levels, in particular vs. swaps (see chart), domestic demand for NGBs seems to be increasing in the context of new LCR (Liquidity Coverage Ratio) requirements. Furthermore, a NOK 12bn of coupon payments in May and a NOK 32bn swap redemption in June - of which a significant amount is expected to be reinvested into NGBs - will also support demand in the near term.

The short end of the Norwegian interest rate curve is however less attractive in our view. As CPI-ATE inflation is now above the 2.5% inflation target, the Norges Bank is unlikely to cut interest rates this year. Rather on the contrary, the recent improvement in household confidence, in combination with lower bank margins on loans to households and enterprises, could actually motivate an earlier tightening of monetary policy than the market on average expects.