Nordkinn Market Review & Outlook – October 2014

NORDKINN
asset management

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

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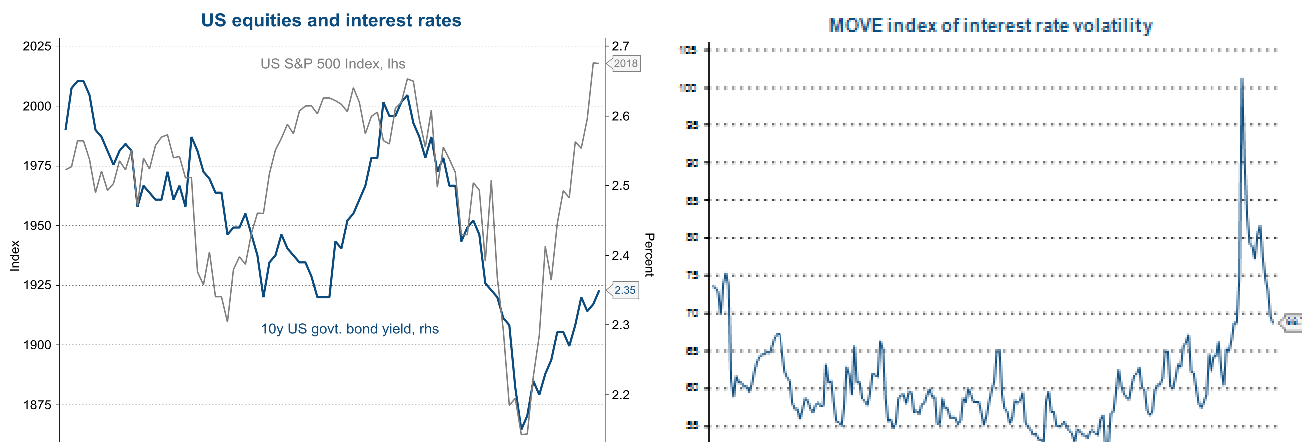
NORDKINN ASSET MANAGEMENT

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

Global fixed income markets rallied sharply in October and the rally was broad based across regions. The yield on the US 10-year note dropped from around 2.5% at end-September to an intra-day level below 2.0% mid-October, before rebounding to 2.3% by month-end close, see chart (note that the chart masks an unusually large intra-day volatility on Wednesday 15th). The plunge, which was accompanied by a correction in equity prices, was the sharpest since the euro area debt crisis reached its peak in mid-2011. However, unlike equities, bond yields did not bounce back to September levels. Meanwhile, volatility in fixed income markets (as measured by the Merrill Lynch MOVE Index), which had remained suppressed since October last year, increased rapidly before falling again at the latter half of the month, see chart.



So, what explains the interest rates volatility in October? The drop seems to have been triggered by a combination of factors: 1) Search for yield after weak Eurozone economic data and IMF warning about elevated risk of another euro area recession; 2) FOMC minutes revealing concerns that weaker foreign economic growth could slow US growth; 3) The 20% reduction in oil price since summer cementing a case for sluggish inflationary pressure (and continued accommodative monetary policies worldwide); 4) The surge in demand for US fixed income in October being a response to the stock market correction; 5) Market positioning, where crowded trades led to lack of liquidity, which amplified the spike in volatility further.

It is however equally important to consider the factors that do not explain the sudden drop in interest rates. Firstly, there are few signs of significant weakness in global economic growth. For instance, the JP Morgan global PMI index, by many considered the single best indicator of world economic activity, has remained relatively stable at elevated levels in recent months. Accordingly, the drop in interest rates is not justified by macro surprises in isolation, even if euro area data admittedly was weaker than expected in October. Secondly, there were no monetary policy surprises in October. Remember that the FOMC minutes, which the market interpreted as marginally dovish, referred to participants actually having revised their forecast for the key policy rate upwards. Added to that, despite increased market volatility, the FOMC decided to terminate its quantitative easing program (QE3) in October due to the “ongoing progress toward maximum employment in the context of price stability”.

Nordic overview

Following another surprisingly low CPI print, the Riksbank cut the key policy rate by 25 bps to a historical low of 0.00%, which was larger than expected. In addition, the interest rate path was revised sharply downwards with a push forward of the first rate hike to mid-2016. Consequently, Swedish interest rates fell sharply and the SEK depreciated.

Fuelled by the developments abroad, Norwegian interest rates also declined in October. The zero interest rate move by the Riksbank had significant spill-over effects on the Norwegian market as investors speculated that the Norges Bank would be the next central bank to cut rates. As a result, the Norwegian fixed income market outperformed the US and Eurozone at the end of the month. The NOK exchange rate sold off against most trading partners, including Sweden, primarily due to a lower oil price and expectations of its subsequent pressure on Norges Bank to ease policy.

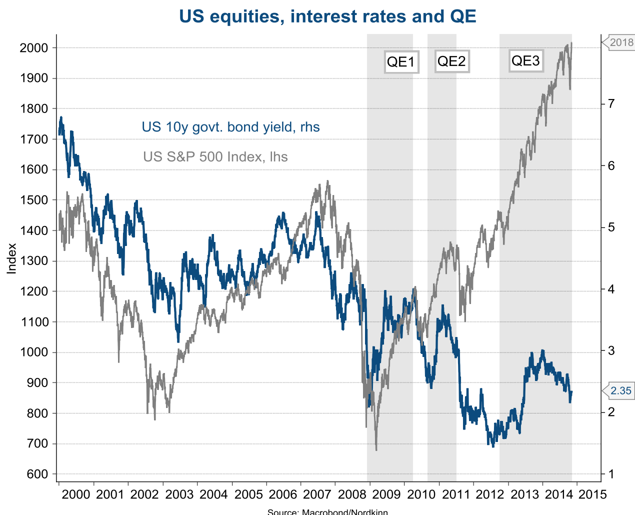
Global markets

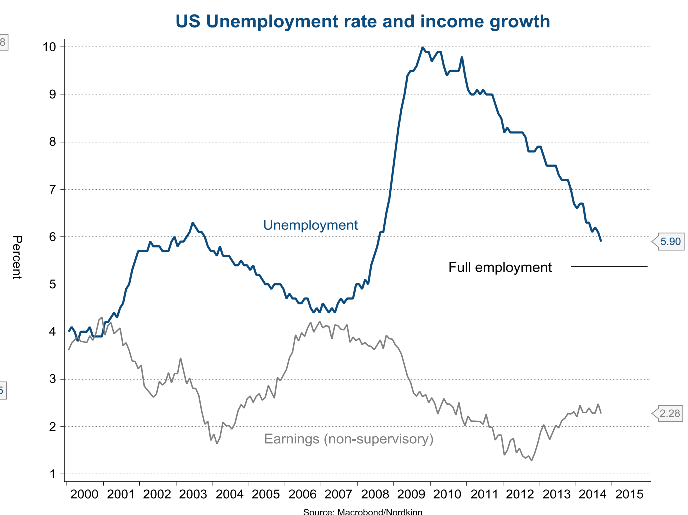
The crucial question for investors is whether the sharp drop in interest rates in October was an overreaction that will prove temporary or that it was induced by a lasting adjustment of fundamentals. The answer resides in the catalysts of the shock.

Long-lasting declines in global interest rates of such magnitude witnessed in October typically occurs when there is evidence of a significant slowdown in global economic activity and/or in the event of an unexpected easing of monetary policy by major central banks. Neither explains the market movements in October. Admittedly, data out of the euro area has been disappointing, but we nevertheless consider the current state and outlook far better compared with 2011 and early 2012, when the euro area was at the brink of breaking up. It is true that the decline in the oil price eases inflationary pressures, but it is also a boost to consumer spending. Besides, the recent FOMC minutes restates that the Committee will look beyond temporary effects from energy prices.

Consequently, the magnitude of the US fixed income rally appears larger than what can be justified by fundamentals, and the sell-off that commenced in the latter half is therefore likely to continue in our view. In other words, our conviction related to our "*USA: Economic recovery progressing*" theme remains firm.

Other observations also support our view for US bond yields to gradually moving higher. For instance, the stock market decline in October was based on the expectation that the FOMC would end QE3 at its meeting in late October (which it did). We saw similar reactions after the end of QE1 and QE2, see chart to the left. It should be noted that QE3 differed from the first two rounds of QE since QE3 was "open-ended" i.e. subject to stronger fundamentals (see chart to the right) and not a fixed schedule. Interestingly, equities seem to discount a far better long-term outlook for nominal growth compared to bonds, as evidenced by equities reaching new all-time high in late October.





Furthermore, market participants cited positioning (e.g. crowded trades) and lack of market liquidity as factors exaggerating the drop in US interest rates in October. Data collected by the US Commodity Futures Trading Commission (CFTC) confirms a significant reduction in short positions in government bonds being washed out in October, which suggests that the market should be less vulnerable to negative market news ahead.

The economic outlook for other developed economies remains less benign, however. The euro area and Japan suffer from slow progress towards the respective central banks' (implicit) inflation targets, which explains the Bank of Japan's decision to boost its bond purchase program in late October and supports our conviction that the ECB will continue to ease policy further in December or early next year. As a result, we expect bond yields to remain low in Japan and Europe coming months, while interest rate spreads versus the US should widen.

Nordic markets

Economic activity in Sweden remains well below its potential, mainly due to lacklustre economic activity among trading partners. The trend in industrial production has been disappointingly weak, see chart. High unemployment and low inflation lingers and the recent slowdown combined with weak growth in the euro area suggest longer time before Sweden returns to full capacity.

While the low repo rate will bring continued support to household consumption, which has been growing firmly this year (see chart), downside risks have increased due to prospects of tighter fiscal policy and talks of new mortgage repayment schedules. Given the amount of spare capacity that is expected to persist coming quarters, inflation is likely to remain well below the target for quite some time. Base effects and a weaker SEK may contribute to a slightly higher inflation rate going into 2015, yet downside risks have increased due to declining energy prices.

Regarding monetary policy, the Riksbank is more than ever committed to pursue a monetary policy aimed at lifting inflation. This has been the essence of our *"Sweden: Credible inflation targeting"* theme that we reintroduced in October following the surprisingly low inflation print. If low inflation were to persist, the Riksbank may even take unconventional measures to boost the expansiveness of its monetary policy.

If needed, we expect the Riksbank to take somewhat different measures than the ECB and Fed have done in the past. The main reason is that Sweden's problem does not involve transmission mechanisms. Yields are already low on all types of fixed income securities and they benefit households and businesses. Instead, we expect the Riksbank to consider using the exchange rate to stimulate the economy. In a small open economy, the exchange rate is important for inflation and a weak SEK would provide relief for the struggling export industry. Subsequently, at current levels in the Swedish fixed income market, we seek to explore our *"Sweden: Credible inflation targeting*" theme via the foreign exchange market when opportunities present themselves.

Turning to Norway, the drop in the oil price in October, if sustained, strengthens our case for a weaker medium-term growth outlook. Even long before the drop in the oil price, oil investments were set to decline by around 15% next year. The drop in the oil price (brent) from USD 110 in June to below USD 85 in October increases risks for an even larger reduction in capital spending.

At the board meeting on October 23rd, Norges Bank emphasised that the uncertainty regarding the outlook for the Norwegian economy had increased due to weaker developments in the euro area and the fall in the oil price. The Governor promised to present more analysis related to these increased "uncertainties" in the Monetary Policy Report in December. We expect a downward adjustment to the growth outlook that, in combination with lower interest rates among trading partners, could justify a 50-60 bps lowering of the interest rate path.

However, this calculation does not take into account the effects of the weaker NOK and the reduction in commercial banks' lending margins, which almost nets out the impact on the interest rate path. As a result, our current view is that the Norges Bank will maintain its key policy rate at 1.5%, while at the same time highlighting an easing bias should growth falter.

In this context, we do however believe that the reduction in short-term market interest rates during October was somewhat exaggerated, as the market is currently pricing in a 50% probability of a December cut and a further reduction in interest rates next year. That said, taking a longer-term perspective, the risk is that economic data next year will disappoint and that Norwegian fixed income will continue to perform well against trading partners.