Nordkinn Market Review & Outlook – April 2015

NORDKINN
asset management

Addressed to Nordkinn's Followers on LinkedIn for informational purposes.

DISCLAIMER

The report does not constitute an offer to sell or the solicitation of any offer to buy. The content of this Report has been prepared by Nordkinn Asset Management AB (the «Company»), registered in Sweden No. 556895-3375. All rights reserved. Information in the Report is made only as at the date of the Report unless otherwise stated, and remain subject to change without notice.

The Content has been prepared in good faith. However, to the maximum extent permitted by law, neither Nordkinn Asset Management AB, nor its related corporations (including Nordkinn Asset Management Oslo Branch, registered in Norway No. 999 136 354), directors, employees or agents, nor any other person, accept any liability, including, without limitation, any liability arising from fault or negligence, for any loss arising from the use of the Report its contents or otherwise in connection with it.

The Report contains forward-looking statements. Although the Company believes the expectations expressed in such forward-looking statements are based on reasonable assumptions, such statements are not guarantees of future performance and actual results. Actual results or developments may differ materially from those projected in forward-looking statements. The Report is only for the use of those persons to whom it is addressed and no part of this report may be reproduced, redistributed or passed on, in any manner, or used other than as intended, without Nordkinn's prior written permission.

NORDKINN ASSET MANAGEMENT

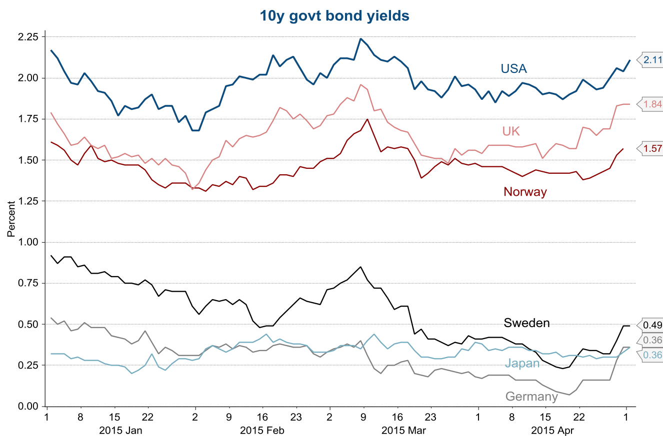
Kungsgatan 33, 6tr
111 56 Stockholm, Sweden
Phone: +46 8 473 40 50
Telefax: +46 8 473 40 51
E-mail: post@nordkinnam.se

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

Market overview

Global overview

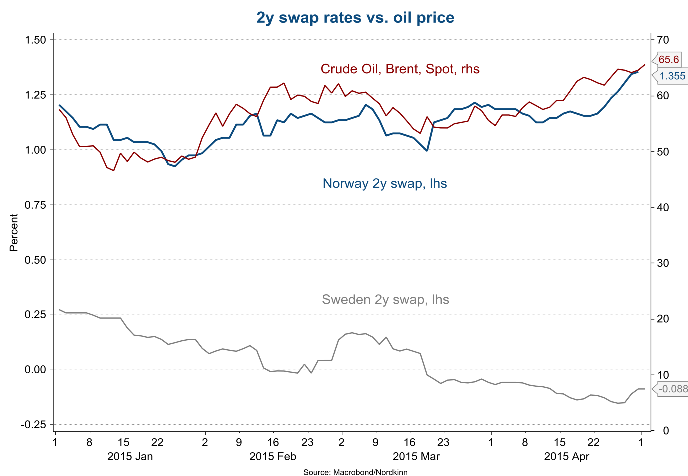
The downward trend in global government bond yields continued in early April, but retreated later in the month lead by Germany. The German Bund yield reached an all-time low of 0.07% on April 20th, before dramatically increasing to above 0.35% by the end of the month. This unexpected move commenced when some multi-billion asset managers indicated that they see little value in holding German bonds. The sell-off in German bonds was further amplified due to relatively thin markets, combined with stop-losses being taken on existing longs as well as some market participants entering new shorts as key technical levels were reached. Further, the increase in energy prices reduced deflation concerns. Meanwhile, the EUR appreciated sharply from an April low around 1.05 against the USD, breaking the important 1.10 level before continuing above 1.12 by month-end.



The surge in German bond yields spilled over to other major markets, see chart. However, while US government bond yields rose in April, the spread to Germany tightened and the USD depreciated due to weaker than expected economic data. GDP growth was merely 0.2% annualised in Q1 and some indicators of labour market activity slowed. Consequently, the FOMC decided to leave the Fed Funds rate unchanged in April, as widely expected. According to the statement, the FOMC anticipates that it will be appropriate to raise the Fed Funds rate when it has seen further improvement in the labour market and is reasonably confident that inflation will move back to its 2% objective over the medium term.

Elsewhere, UK government bonds underperformed the US market in April, influenced by increased political uncertainty associated with the May 7th election. The election will likely result in a hung parliament, with the winning party having to rule in coalition or in a minority. This will make it difficult to tackle the country's structural issues, including a substantial fiscal deficit. In addition, the Bank of England minutes released on April 22nd, citing stronger survey indicators and a more positive economic outlook in Europe, may also have contributed to the increase in UK bond yields.

Nordic overview



Swedish interest rates declined during almost all trading sessions of the month until the Riksbank on April 29th delivered a message that failed to meet expectations. Instead of delivering a rate cut, which was widely expected, the Riksbank decided to leave the repo rate unchanged at -0.25%. However, as we correctly anticipated, the Riksbank made monetary policy more expansionary by increasing the bond purchase program by SEK 40-50 bln and revised its repo-rate projection downwards. This notwithstanding, market rates rose and the SEK appreciated immediately after the decision.

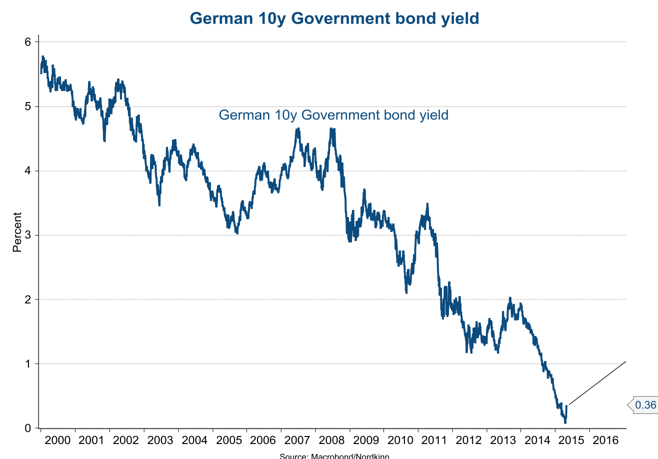
Meanwhile, Governor Ingves again highlighted the importance of the SEK remaining weak in the near term, as a stronger currency would make it virtually impossible to reach the inflation target.

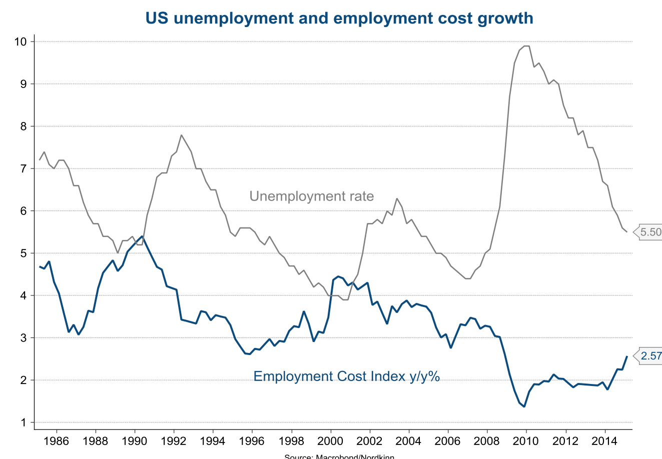
Turning to Norway, interest rates fell early in the month, before rising sharply with Bund yields and oil prices later on, see chart. An increase in commercial paying of fixed interest rates also contributed to higher market rates as asset swap spreads widened substantially during the month. The NOK exchange rate appreciated by more than 3% in April, despite incoming data on balance pointing to weaker economic growth and lower inflationary pressures. Unemployment continues to increase and the rate surpassed 4% for the first time since 2006, while wage growth in 2015 seems to heading below 3% for the first time since 1994.

Global markets

In the Outlook section of our previous monthly report, we discussed scenarios for German Bund yields, arguing for upward risks over the medium term in a context of improving macroeconomic indicators. Against this backdrop, we decided to launch a new long-term investment theme *"EMU: Economy sprouting seeds"* which we express via short German Bunds against NGBs and US treasuries. The net negative supply of bonds due to QE and search for duration among money managers may dominate pricing action in the short term. However, in April we experienced that there are also sellers in these markets. Indeed, one large global money manager called Bunds "the short of a lifetime" and another said that they were taking an amplified bet against German bonds. These statements were probably the key triggers behind the ca. 30 bps increase in Bund yields at the latter part of April, and the spill-over effects across all major markets was so pronounced given that the absolute level of global interest rates are at such as extreme lows.

While we stick with our view that in the medium term Bund yields are poised to be higher, we think the magnitude of the sell-off ahead could disappoint. In our baseline scenario, we have 10y Bund yield at around 0.6% by year-end and around 1.0% by end-2016, see left hand chart. Given high unemployment, it will take a long time to absorb the very low capacity utilisation even though growth is set to pick up. This, in turn, implies much muted inflationary pressures over the medium term. Consequently, we do not expect any interest rate hike by the ECB before 2018 at the earliest. This should keep interest rates low across the maturity spectrum. Nevertheless, the 5y5y segment is likely to sell off gradually over the coming couple of years as growth picks up and the Federal Reserve starts removing policy accommodation.





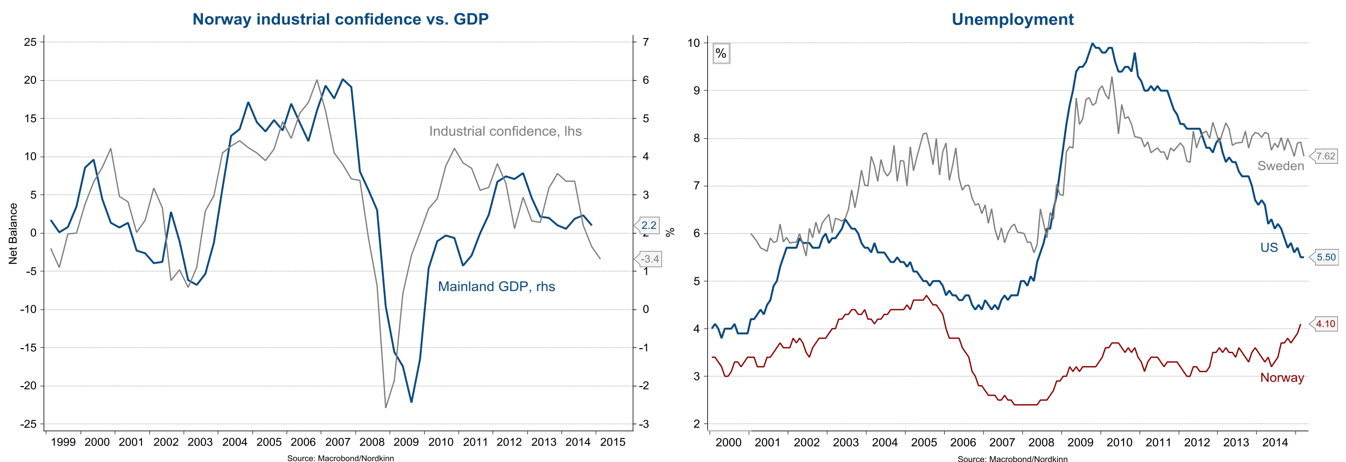
Back in March, the Federal Reserve pledged not to raise interest rates in April. No such promise was extended to June. However, this is in our view not a sign that a hike in June is likely. Our view is instead that the Fed wants the flexibility to be data dependent. If incoming data in May and June comes in significantly stronger than expected, a rate hike in June is a possibility. However, given the slowdown in economic growth in Q1, the overall growth picture must in our view change quite dramatically in coming weeks to make the Federal Reserve confident about raising rates already in June. Rather, we now think September is the most likely meeting for lift off, but even this scenario requires better labour market and growth data compared to what we have seen recently. After all, the FOMC says it needs to see further improvement in labour market conditions before raising rates. This probably means at least two more months with employment growth above 200,000 and a decline in unemployment rates from current levels.

In addition, the Federal Reserve needs to be confident that inflation is likely to pick up towards its 2% target over the coming couple of years before raising rates. This does not necessarily mean that price and wage inflation must increase before raising rates, although that would certainly strengthen the case. According to Yellen, labour utilisation is the most important indicator of future inflationary pressures. Interestingly, the recent increase in the employment cost index, which we believe is the Federal Reserves most preferred measures of wage pressures, could be a sign that wage growth is already starting to pick up from low levels, see right hand chart.

Nordic markets

In April the Riksbank continued to ease monetary policy with a view to bring inflation rapidly up to target and to remove downside risks to inflation, although the measures fell somewhat short of the elevated market expectations. In the near-term, the key source of downside risk to inflation in Sweden is the currency. With wages growing at a very slow pace, a stronger SEK will make it hard, if not impossible, for the Riksbank to achieve the inflation target within the next couple of years. This was also emphasised by Governor Ingves at the press conference following the interest rate announcement. Consequently, there are limits as to how much the SEK can appreciate in the near term before the Riksbank decides to ease further. In our view, a EUR/SEK below 9.00 would be a trigger, and the Riksbank would in that case act before the next scheduled policy meeting in July.

Meanwhile, the decision to expand government bond purchases by SEK 40-50 bln should be a strong force for curve flattening. Moreover, even though Governor Ingves indicated that the Riksbank is not comfortable with the idea to purchase mortgage bonds, we nevertheless expect covered bonds to be supported via the so-called portfolio-balance channels, whereby purchases of government bonds push investors into holding higher-yielding assets. Overall, therefore, our conviction to the *"Sweden: Credible inflation targeting"* theme remains high.



Turning to Norway, we expect the Norges Bank to cut its key policy rate by 25 bps to 1.00% at the upcoming Board meeting on May 7th. According to a Bloomberg survey, 6 out of 10 economists expect the Norges Bank to leave rates unchanged. Governor Olsen said at the Board meeting in April and in subsequent speeches that if developments in the economy ahead prove to be broadly as expected, there are prospects that the key policy rate will be lowered either in May or June.

There are several reasons why we expect the Norges Bank to move already in May instead of waiting until June. Confidence indicators have dipped further (left hand chart), the unemployment rate has increased quite sharply (right hand chart) and the outcome of wage settlements suggests lower wage growth in 2015 than projected by Norges Bank. Moreover, expected interest rates among trading partners have fallen further and the NOK exchange rate has appreciated. A failure to cut now would push the NOK even higher.

The best argument against our call for a cut is that the Norges Bank may want to await and assess additional information. For instance, the next quarterly oil investment survey and the next full report from the Norges Bank's regional network are due after the May meeting. Added to that, the Norges Bank said in March that rising house prices was a concern and the Board may want to see more house price data before taking a final decision. Furthermore, oil prices have increased since March, although they remain low. On balance, however, we believe incoming data since March has made the Board sufficiently confident that a cut is warranted already this week, but the call is close.

Looking further ahead, we expect more signs of weaker economic growth and lower CPI inflation over the summer, which in our view should trigger further policy easing in the second half of this year. In contrast, the market prices only one cut this year, and the cut is not fully priced before the September meeting. This means that the market is not 100% sure that the Norges Bank will cut in Q2. As we are more pessimistic on growth and inflation than consensus, we expect market interest rates to drop and the yield curve to flatten going forward. We also predict a weaker NOK in coming months. This is the essence of our *"Norway: Weaker economic outlook"* theme.