NORDKINN
asset management

Nordkinn Market Review & Outlook – July 2015

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.

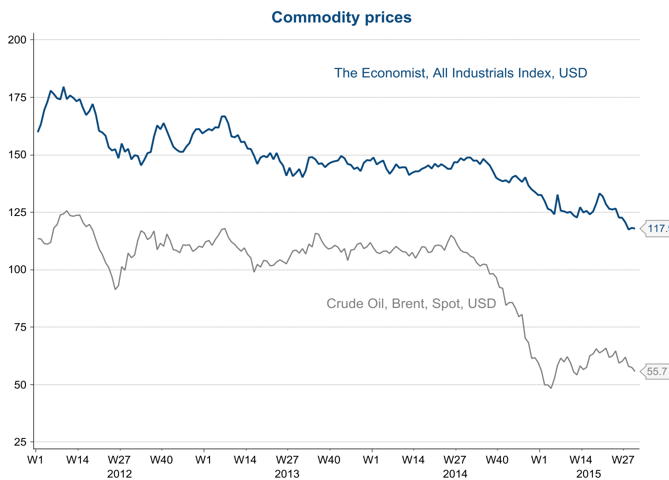
NORDKINN ASSET MANAGEMENT

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

Global overview

Oil prices slid in July due to supply concerns following the historical agreement reached between world powers and Iran for Iran to freeze its nuclear programmes and to open up its market to the world. However, the broad range decline in commodity prices and the stock market crash in China indicates that Iran is not the only story. Various economic indicators, such as the PMI index, point to weaker demand from China. Meanwhile, the Greek drama stabilised after a last-minute compromise between creditors and the previously uncompromising Greek government. In sum, however, the events in July lead to slightly lower bond yields and flatter curves.

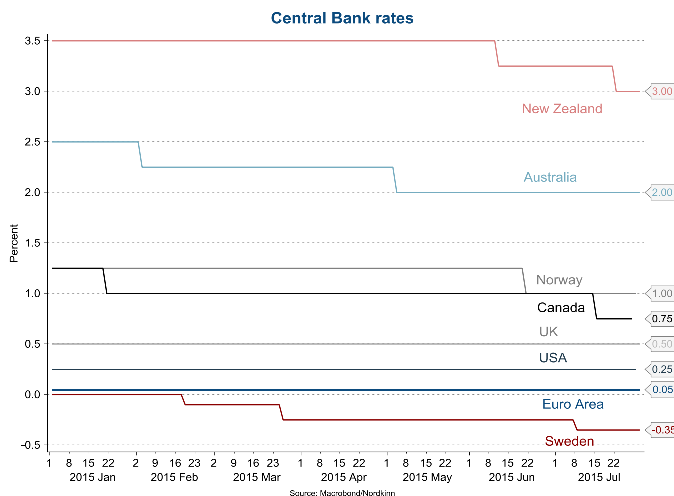


The Federal Reserve left its key policy rate unchanged on July 29th, as we expected. The Committee said that it would be appropriate to raise the federal funds rate when it has seen *some* further improvement in the labour market, therefore the next couple of payroll reports will be critical for the Committee's decision at the policy meeting in September. In a speech on July 15th, Fed Chair Yellen said it would likely be appropriate to start raising rates at some point this year.

Meanwhile, as also expected, there were no news on the monetary policy front at the ECB meeting in July. Draghi repeated the Governing Council's intention to implement the QE programme in full and perhaps even to extend it. The statement stresses the ECB's readiness to do provide more stimulus should it become necessary.

In the UK, the July MPC minutes revealed that more members viewed the decision to keep rates at record low as "finely balanced", sparking speculation of a possible rate hike around the turn of this year. Despite soft readings on core CPI inflation, MPC members see increased upside risks to future inflation, due to a tighter labour market and indications that wage growth is starting to pick up. Elsewhere, both the Bank of Canada and the Reserve Bank of New Zealand cut rates by 25 bps in July.

Nordic overview



In a move that took markets and most economists by surprise, on July 2nd the Riksbank announced a cut in the repo rate of 10 bps to -0.35%, see chart. In addition, it also expanded its sovereign QE by SEK 45 bn to 135 bn until the end of the year. Moreover, the Riksbank reemphasised that it stands ready to cut rates further, engage in FX intervention and expand QE into other assets should it be needed. The interest rate forecast for Q3 2015 was set at -0.41%, suggesting a clear easing bias.

Later in the month, Swedish CPIF inflation came in lower than expected, propelling market expectations of further monetary policy easing. As a result of these developments, Swedish bond prices rallied in July.

Norwegian consumer price inflation posted a major upside surprise by jumping markedly in June with an annual increase of 3.2%, the highest in six years. A large proportion of the jump looks to be transitory, but the underlying trend is firmer than expected nonetheless. In particular, the NOK exchange rate seems to have had a more significant impact on imported consumer prices than anticipated. This upside surprise notwithstanding, Norwegian interest rates dropped slightly in July as oil prices fell and foreign interest rates declined.

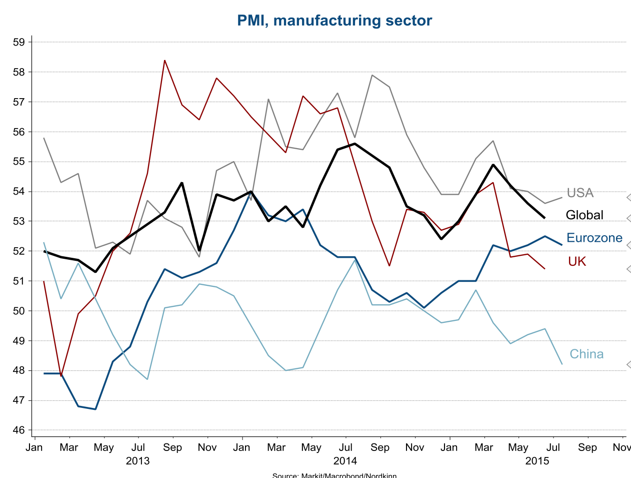
Global markets

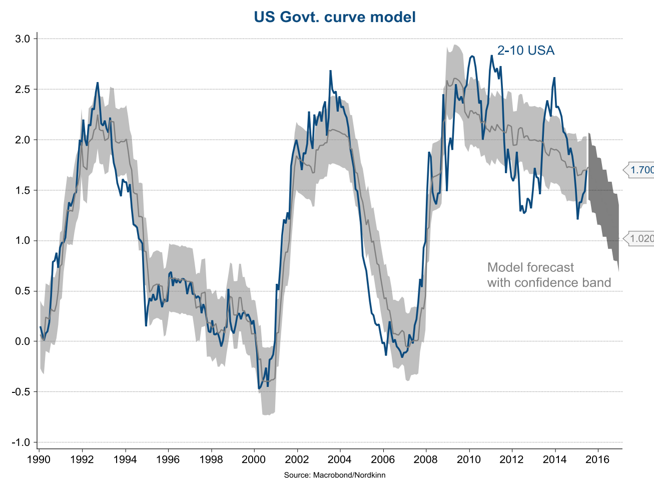
In our view, the Federal Reserve is on track for a first rate hike later this year, most likely in September. Recent communication by FOMC officials supports this view, including Fed Chair Yellen (*"economic conditions likely would make it appropriate at some point this year to raise the federal funds rate target"*) and Bullard (*"probability for a September rate hike is above 50%"*). Of course, no central banker without a hedge: Unexpected adverse economic or financial market developments could make the FOMC act later. Foreign developments, in particular Greece and China, have been put forward as main risks to US growth. While the Greek drama seems to be over for now, signs of weaker growth in China and a volatile Chinese stock market is a concern.

The recent rout in commodity prices is another source of uncertainty as regards the timing of the first hike. Commodity indices fell to multi-year lows in July, probably influenced in part by weaker global demand as illustrated by weaker PMI readings, see left hand chart. US consumers are likely to benefit from lower energy prices, but on the other hand, it means a further delay in prospects for the Federal Reserve to reach its 2% inflation target. In addition, wage growth has been subdued.

Having said that, core CPI inflation has drifted higher (up by 0.193% month-over-month on average over the past three months) because of firmer core services inflation, in particular housing costs. Moreover, employment growth has been solid in recent months and the unemployment rate fell to a new cycle-low of 5.3% in June. Consequently, looking beyond the near-term negative impact on energy prices, the FOMC may still be reasonably confident that inflation will move back to the 2% target over the medium term.

Elsewhere, Greece's capitulation to the Troika's demands may help buy the country some time, but it is not the final chapter in the ongoing crisis. According to the IMF, Greece's debt is too high and can only be made sustainable through debt relief measures that go far beyond what Europe has been willing to consider so far. This uncertainty may therefore continue to weigh on euro area growth also going forward. Nevertheless, even if euro area growth recovers more quickly than we expect, we believe that the ECB will head for a "full implementation" of the QE program (at least until September 2016) and a key policy rate close to zero (now 0.05%) at least until 2018 due to the significant amount of slack persisting in the economy.





Looking at investment implications, we think curve flattening trades have become more attractive after term premia was rebuilt in G10 curves during Q2 2015. The short end in the US and UK remain vulnerable to hawkish shocks given limited hikes being priced in. Meanwhile, the ECB and several other central banks will continue with an accommodative monetary policy stance for several years, limiting the pace of tightening in US and UK and keeping the long-end supported. Furthermore, we see a risk that the slowdown in China may weigh on forthcoming leading indicators in G10. Finally, given renewed downward pressures on commodity prices, we do not expect any form of reflationary shock driving expectations of long-term inflation significantly higher in coming months.

A simple curve model, approximating the historical impact of various financial and macroeconomic variables on the slope of the US government bond curve, suggests there is scope for the US sovereign bond curve to flatten going forward, see right hand chart. The forecast in the chart is based on the assumption that growth improves to around 3%, core PCE inflation moves gradually towards the 2% target and that the FOMC commences a very gradual hiking cycle in September 2015.

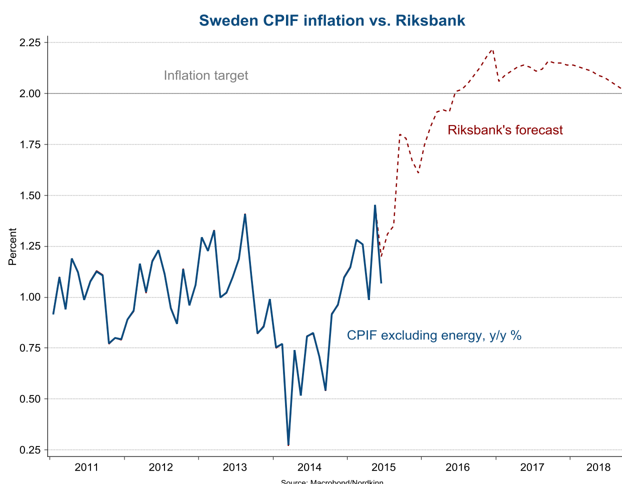
In sum, we will consider entering curve flattening trades in the US market ahead of the September FOMC meeting.

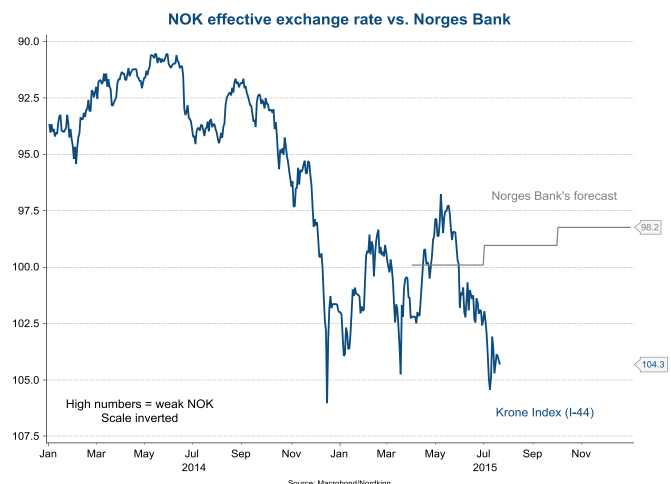
Nordic markets

As incoming inflation data up to May showed inflation was on a rising trend, at the policy meeting on July 2nd the Riksbank hastily concluded that monetary policy is working. The positive trend notwithstanding, the Riksbank announced further easing by cutting rates by 10 bp to -0.35% and expanding QE by SEK 45 bn, against markets' expectations that the Board would leave policy unchanged for now. The surprise decision underlines the Riksbank's aim to safeguard the credibility of the inflation target and its role as a nominal anchor before upcoming wage negotiations.

Since then, we have seen a set-back for inflation. The year-over-year increase in CPIF excluding energy slowed from 1.45% in May to 1.07% in June, see left hand chart. Although this was only a tenth below the Riksbank's forecast, the print may weaken Board members' confidence about the inflation outlook. If inflation remains below Riksbank's forecast in July, the Riksbank could cut interest rates further at the Board meeting on September 3rd, consistent with the easing bias inherent in its repo rate forecast.

Looking a little further ahead, the Riksbank expects a sharp increase in inflation towards its 2% target already around the turn of this year. Given economic slack and subdued wage growth, this forecast is unlikely to materialise in our view. Consequently, we expect additional easing of monetary policy and a continued dovish communications by Board members to support short-dated bond prices and keep EUR/SEK within a 9.20-9.50 range going forward.





In Norway, the trend in inflation has been quite the opposite of that in Sweden and the June print was an extreme example of this divergence. Core CPI inflation come in at 3.2%, 0.7%-points above Norges Bank's projection and its inflation target. A good part of the surprise is a result of temporary factors which will likely reverse next month. However, the increase in inflation can also in part be explained by a stronger than expected pass-through of past NOK weakness to prices on imported goods.

Norges Bank normally looks through monthly volatility in consumer prices and concentrates instead on determinants of future inflation. In particular, a much weaker growth outlook in combination with wage growth at a 20-year low should bring inflation sharply lower in coming quarters. Moreover, the impact of past depreciation of the NOK on year-on-year inflation rates will soon fade. Yet, the current inflation rate, a strong housing market in some parts of the country and a weaker than projected NOK exchange rate (see right hand chart) do not suggest that the Norges Bank is in a hurry to cut the key policy rate from the current 1% level, even though the oil price has fallen somewhat recently.

As a result, we expect the Norges Bank to consider leaving the monetary policy stance unchanged in September, while still signalling an easing bias. We expect one cut to 0.75% by year-end, but we see the probability of a no change being somewhat greater than the probability of two cuts over this period. Looking further ahead, we expect sluggish growth and, eventually, lower inflation to trigger a further easing of policy next year, supporting bond prices and a flattening of the FRA curve.

Regarding the NOK, we expect the relatively strong correlation with commodity prices to continue going forward. Even if we expect additional policy easing next year, we see scope for some NOK appreciation if oil prices were to rebound later this year as we expect. Added to that, the recent depreciation of the NOK exchange rate has been more pronounced than interest rates and energy prices normally imply, i.e. the NOK appears undervalued at current levels. Our long-term positive view on the NOK is captured by our *"Norway: NOK recovery"* theme.