Nordkinn Market Review & Outlook – March 2016

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NORDKINN ASSET MANAGEMENT

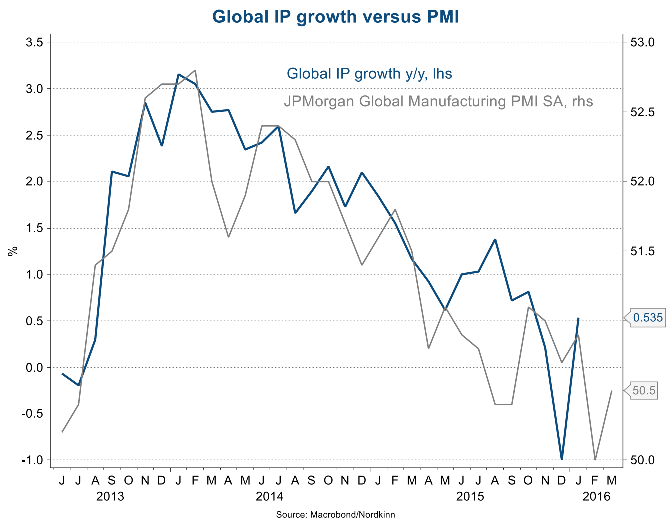
Kungsgatan 33, 6tr
111 56 Stockholm, Sweden
Phone: +46 8 473 40 50
Telefax: +46 8 473 40 51
E-mail: post@nordkinnam.se

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

Market overview

Global overview

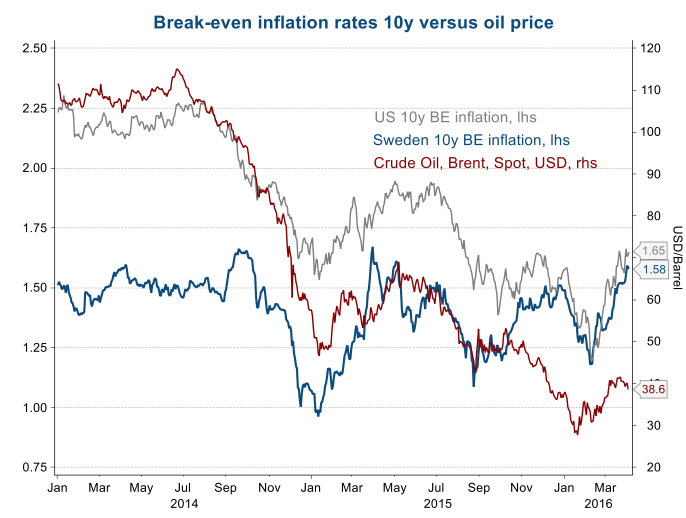
Global government bonds sold off at the beginning of March driven by rebounds in commodity prices and risky assets, but rose in the latter half of the month supported by dovish central banks. Weaker global growth (see chart), tighter financial conditions and declines in longer-term inflation expectations have yet again forced central banks to signal a more protracted period of stimulus compared with the outlook prevailing three months ago. Commodity currencies rallied, while the USD declined in March.



Reflecting the ever ongoing risks to US economic outlook being posed by the fragile global economic and financial developments at the beginning of this year, the Federal Reserve decided on March 16th to leave interest rates unchanged. The median rate projections for the end of 2016 and 2017 by the FOMC participants were both cut by 50 bps, broadly as we expected. Interest rates and the USD fell after the announcement.

Meanwhile in Europe, on March 10th the ECB delivered as anticipated a comprehensive package of policy easing, including cuts in all three key ECB rates, four TLTROs at very easy conditions, an increase in the monthly asset purchase program by EUR 20 bln to EUR 80 bln and adding non-financial investment grade corporate bonds to the program. Despite these measures, the ECB disappointed the markets regarding the forward-looking signals of rates; basically, further interest rate cuts are limited due to the potential negative effects it could have on the banking system. Consequently, short-term interest rates rose and the EUR appreciated slightly in March.

Nordic overview



Swedish break-even inflation spreads widened significantly in March. We believe the widening reflects both international developments (see chart) and domestic factors, notably expectations that the Riksbank may add index-linked bonds to its asset purchase program in April.

Moreover, Swedish covered and municipal bonds performed versus interest rate swaps in March. Demand for bonds was boosted by the risk-on sentiment in the wake of dovish central banks worldwide, while money market and swap rates rose as expectations of a multi-tier deposit rate facility faded.

The SEK appreciated slightly in March as data continued to reveal strong economic growth and a rising underlying trend for inflation. At the same time, the SEK strength is held back by negative interest rates and intervention threats.

Turning to Norway, as we correctly predicted the Norges Bank decided to cut its key policy rate by 25 bps to 0.50% and lowered its interest rate projection quite significantly. However, instead of forecasting further aggressive easing in the near term, the bank decided to substantially reduce its interest rate projection for 2017 and 2018, signalling that rates will remain low for long. According to its projections, the Norges Bank will likely maintain its policy rates unchanged in May and June, before reducing it to 0.25% in September. Moreover, the projection implies some 20% probability of a further cut to 0.00% by year-end.

As a result, short-term market rates remained broadly unchanged after the announcement, while longer-term interest rates fell both outright and vis-à-vis trading partners. The NOK remained virtually unchanged in March, as a rebound in energy prices and risk sentiment balanced the effects of a dovish Norges Bank.

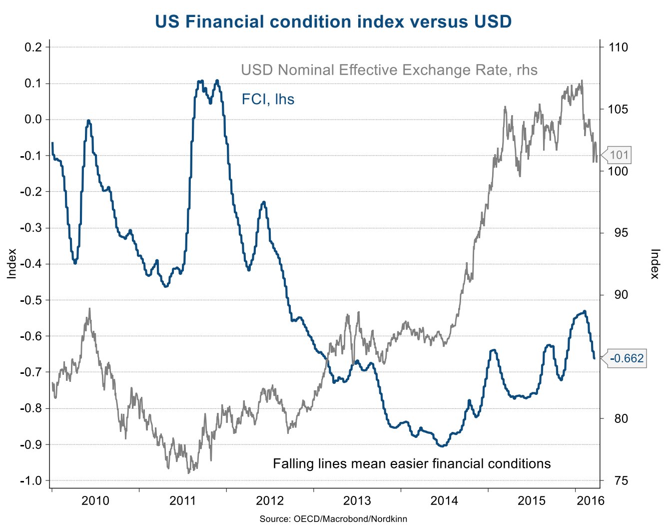
Global markets

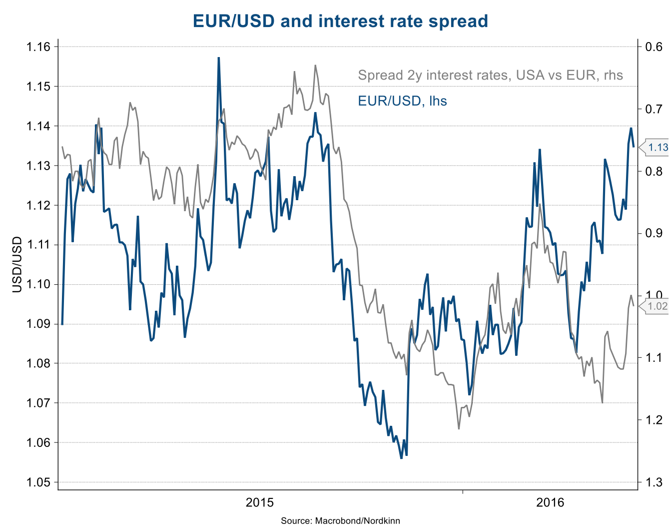
Notwithstanding the recent calmer tone in markets, the outlook for global economic growth in 2016 remains fragile. The slowdown witnessed in Q4 2015 and Q1 2016 may well continue in Q2, reinforced by the significant, though temporary, tightening in global financial conditions in January and February. This outlook is importantly influenced by the developments in China, but there are also potential sources of political risks that could hamper global growth. These risks include the US presidential election, the refugee crisis, not to mention the Brexit risk.

That said, we do not expect the global economy to enter a recession in the near-term. Although we agree that the economic expansion that commenced in 2009 is aging, it is important to remember that expansions do not die of old age, they are usually ended by a combination of severe imbalances (e.g. over-investments) and significant central bank tightening. In the developed world, none of the typical recession signals are flashing right now.

However, developments in China continue to pose risks to the global economy, which we believe was one of the main reasons why FOMC members on March 16th cut their interest rate forecast this year from four down to two. Further, the FOMC is struggling with the challenge of a too large divergence in monetary policy between major economies, which becomes apparent with excessive U.S. dollar strength that hurt the US export sector. Thus, rate cuts in Japan and Europe in Q1 do delay the tightening process in the US.

This is why we continue to expect only a very gradual increase in US interest rates going forward. On the back of the recent easing in financial conditions, including a weaker USD (see left hand chart), we think that the Federal Reserve will try to raise rates in June, before pausing another six months until December. At the same time, we also caution our conviction that the Federal Reserve will not hesitate to delay rate hikes again should global economic and financial conditions worsen.





If the Federal Reserve seriously considers a rate hike in June, we may get such hint already in the April FOMC statement. In October last year, when the statement made an explicit reference to the December meeting as an occasion where a rate hike would be discussed, market interest rates rose and the USD appreciated. Given the low probability currently priced in for a June hike, a similar hint in the April statement could push short-term interest rates higher and the USD stronger in the near term. At the same time, we also believe a rate hike could trigger another round of tighter financial conditions over the summer, which would reduce expectations for more rate hikes further out in time.

Two investment conclusions occur from this view. A Federal Reserve hike combined with a limited extent of policy divergence over time should favour US rate curve flattening trades. Regarding currencies, we look to range trade the EUR/USD as even a very gradual widening of US versus EUR policy rates should limit how far the EUR/USD can rally in the near term. If the EUR/USD were to revisit the low end of the range (see right hand chart), we would expect the Federal Reserve to turn more dovish again.

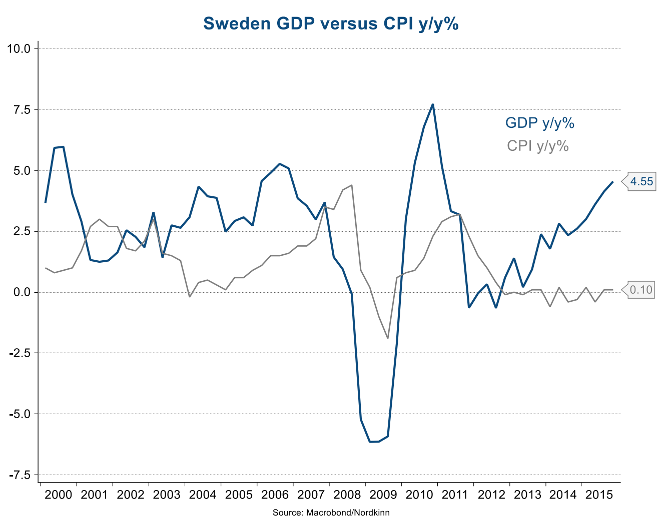
Nordic markets

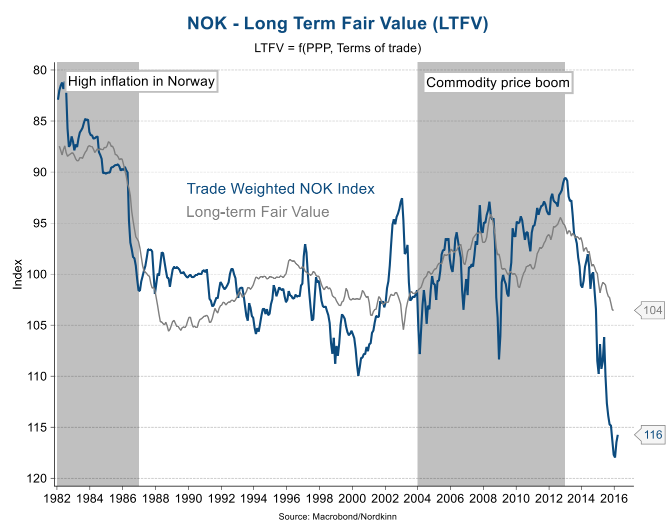
The combination of strong Swedish GDP growth and low inflation has created a classic trade-off problem for the Riksbank, see left hand chart. Provided inflation expectations are anchored, central banks facing such trade-off would when setting rates normally take both the real economy and inflation into consideration. In the case of the Riksbank, it is our understanding that so far economic growth has practically been left out of the response function to instead solely look at short-term inflation trends.

There are now some indications that the Riksbank is reviewing its strategy. In particular, Mrs Skingsley told a Swedish newspaper that she would start focusing less on monthly CPI data and instead take a more long-term view on inflation targeting. One interpretation is that the Riksbank in its monetary policy deliberations may start putting more emphasis on the real economy, which is often seen as a good indicator of future inflationary pressures.

Against this backdrop, we continue to believe that the Riksbank will refrain from cutting rates further. Still, we expect the Riksbank to extend its QE program from June to December 2016. This decision, which we think will be announced in April, should keep monetary policy closely linked to that of the ECB's for the remainder of the year in hopes to prevent an undesired appreciation of the SEK. We also expect the Riksbank to include inflation-linked government bonds in the purchase program. Should the SEK appreciate sharply in spite of this expected policy easing, we think the Riksbank could make use of FX interventions.

Regarding investment implications, we expect yields on Swedish bonds to remain broadly stable in coming months. The SEK will appreciate gradually over time, but at current levels the risk/reward of buying SEK is rather poor due to the Riksbank's low tolerance to a stronger SEK.





In Norway, we have not changed our view that growth is likely to remain weak for a long time and the unemployment rate will continue to climb. This notwithstanding, we expect the Norges Bank to proceed with greater caution in interest rate setting as the key policy rate approaches a lower bound. This was also clarified in its most recent monetary policy guidance, where the Board decided to bring down its forecast for interest rates in 2018 significantly instead of signalling more aggressive cuts in the short term.

This cautious strategy by the Norges Bank creates some interesting market implications. We can no longer make use of the Norges Bank's traditional response function when predicting future changes to the key policy rate and the rate path, because the link between incoming data and monetary policy will from now on be much weaker than it used to be. Consequently, we need to see significant deviations from projections before the central bank changes its mind about keeping rates unchanged in Q2. We therefore expect the next cut in September. Such outlook for monetary policy, combined with tight liquidity in the banking system and high USD funding costs for banks, should keep the 3m NIBOR at relatively elevated levels until summer.

This prudent interest rate strategy should in our view favour the NOK, which looks cheap against most fair-value models, see right hand chart. Ironically, this could in turn force the central bank to abandon its cautiousness. If the NOK were to appreciate too fast, the economy could slide into a deeper recession and trigger a more aggressive monetary policy response. For this reason, we think the Norges Bank will be forced by cut rates by an accumulated 50 bps in the second half of 2016 to 0.00%, while keeping the door widely open to negative interest rates if further accommodation is needed. Consequently, a long (currency unhedged) exposure to medium- to longer-term Norwegian bonds is highly attractive in our view.