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asset management

Nordkinn Market Review & Outlook – Nov 2016

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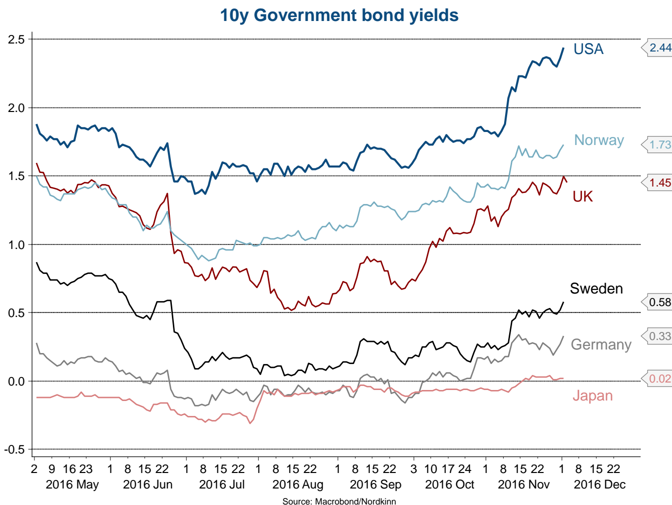
NORDKINN ASSET MANAGEMENT

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

Global overview

In our previous report we highlighted that US government bonds were vulnerable for a sell-off on a Trump victory. Yet, we were admittedly surprised by the extremely quick transition in the market's focus during the election night. As we predicted, the immediate market reaction following the election of Donald Trump was dominated by fear and uncertainty, causing stock markets to tumble, while prices on safe haven assets soared. However, within only a few hours the market was able to overcome the increased uncertainty and moved instead to quickly discount the expected near-term economic effects of Trump's policy. That is, anticipation of massive fiscal stimulation translating into more growth, more debt and more inflation. As a result, US government bond yields rose sharply in the aftermath of the election, see chart.

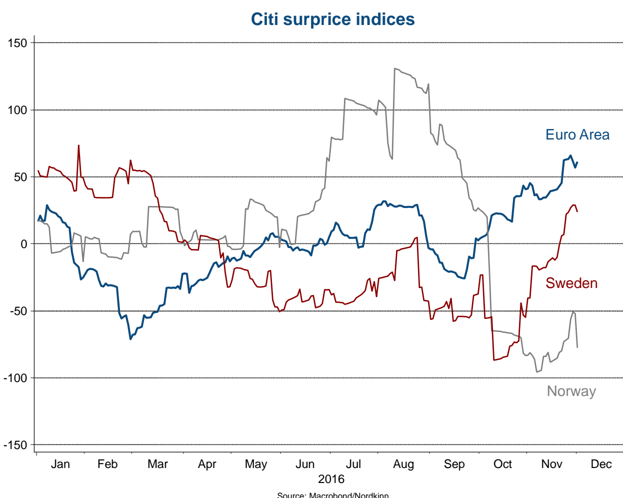


Given the diverse conditions across the Atlantic, the rise in US bond yields had a relatively small impact on European markets. The yield on 10-year German government benchmark climbed merely by 10 bps during November. Consequently, the spread between US and German 10-year government bond yields widened by as much as 45 bps to a 25-year high at 210 bps. Yields on Italian government bonds rose much faster than those of Germany, mainly reflecting a heightened political risk ahead of the Italian referendum on December 4th.

On the back of these developments, the EUR/USD depreciated by 4% in November and the EUR/USD cross currency basis swap spreads widened significantly.

Meanwhile in Japan, the JPY depreciated sharply in November as the central bank put its "Yield-Curve Control" policy into practice. Targeting a 0% yield on 10-year government bonds, on November 17th the central bank offered to buy bonds in unlimited amounts.

Nordic overview



Incoming data confirmed that the Swedish economy is in good shape. GDP rose by 0.5% in Q3 while Q4 also started on a strong note according to survey-based indicators. As we predicted, CPI inflation rebounded in October, yet it remains below the Riksbank's projection. The SEK appreciated in November as Swedish bonds underperformed Bunds, but the currency remains very weak in a historical context.

Swedish break-even inflation spreads widened further in November. This development partly follows a global trend supported by the recovery in commodity prices, and it is partly a consequence of the Riksbank's commitment to bring inflation quickly up to 2%.

Swedish money market rates fell in November, mainly due to supply/demand distortions as banks adjust their books ahead of year-end. 3-month Stibor ended the month at -0.62%.

In Norway, incoming data on balance supports our view that the economy is gradually starting to recover after a long period of zero growth, although most data admittedly were a notch weaker than we and the Norges Bank expected. Mainland GDP increased by only 0.2% in Q3 and new estimates point to a deeper decline in oil investments next year than previously expected. Inflation is relatively high, but is falling slightly faster than Norges Bank had expected. Surprise indices demonstrate the latest disappointment in data. At the same time, the housing market boom seems unstoppable and household debt is accelerating.

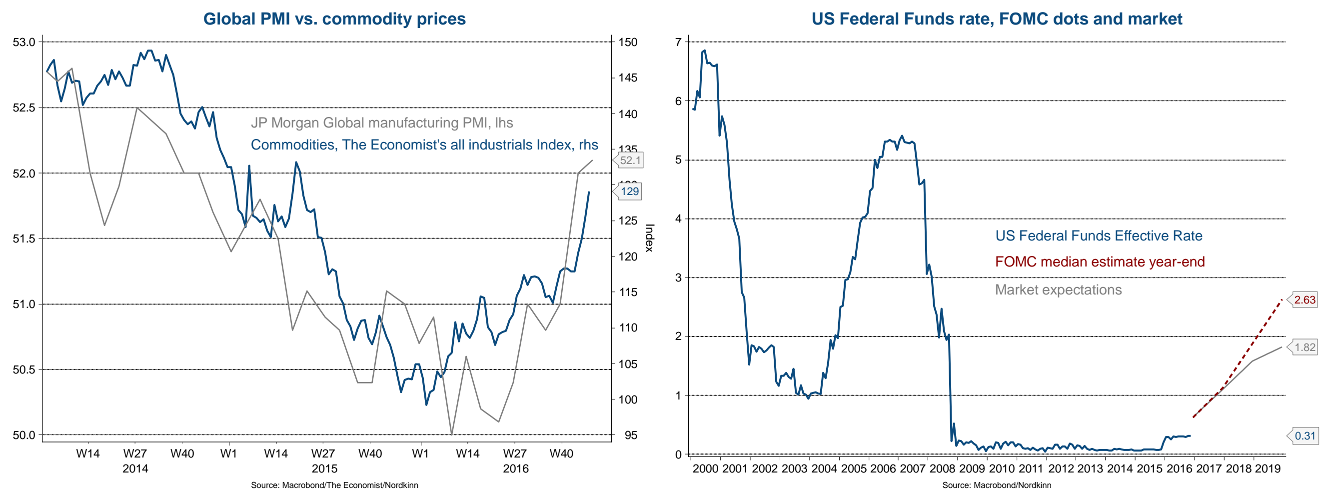
The slope of the Norwegian interest rate curve steepend sharply in November, mainly reflecting developments abroad. In addition, OPEC's agreement on November 30th to cut oil production for the first time since the financial crisis eight years ago provided fuel for higher interest rates and a slightly stronger NOK.

Global markets

As we wrote in the previous monthly report, we see several catalysts for stronger US economic growth ahead, including accelerating income growth, the need for more construction spending and a recovery in oil investments. Importantly, these catalysts have little to do with the outcome of the presidental election. In fact, indicators of growth and inflation in the US were on the way up aleady before the election. This also holds true for the global economy overall. As illustrated by the left hand chart, world manufacturing confidence and commodity prices began recovering several months ago, ending a trend of weaker growth and deflationary pressures witnessed since 2014.

Admittedly, the election of Donald Trump strengthens the confidence in our outlook for stronger US growth coming couple of years, as a looser fiscal policy stance will boost both public and consumer spending. Given that the US economy is already close to full employment, wage growth will accelerate and core CPI inflation will continue to rise. Against this background, we continue to expect the FOMC to raise its key policy rate at the upcoming meeting in December and twice next year.

The market was very quick to price in the estimated impact of a a more expansionary fiscal policy under President-elect Trump. Although we have not dramatically changed our forecast for US growth, we do think that the correction in the US fixed income market was justified. This is because the market discounted a too shallow path for US interest rates prior to the election. Now, the market fully price in three hikes by year-end 2017, in line with our own forecast.



Looking ahead, we expect the sell-off in fixed income markets to lose steam. Outside the US, central banks are still struggling with tepid growth, high unemployment and low inflation. Consequently, in December we expect the ECB to extend its QE program by at least six months, which will essentially cap the potential for higher bond yields in the “core” euro area countries. Meanwhile in Japan, actions taken by the central bank in November demonstrates a firm commitment to its “Yield-Curve Control” policy aimed at keeping long-term interest rates close to 0%.

Given that the market is pricing in almost three Federal Reserve hikes by end-2017, there is little room for yields on US short-dated bonds to rise much further from here, see right hand chart. Market expectations for 2018 and 2019 are still below the FOMC “dots”, but in an environment of extremely accommodative monetary policies elsewhere, there are limits as to how far US longer-dated yields can rise. This is because a wider spread between bond yields in the US and abroad adds pressure on the USD to appreciate. A stronger USD, in turn, implies tighter financial conditions, which could compromise growth in the US as well as in Emerging Markets. Still, we do think the treasury curve could steepen somewhat further in coming months.

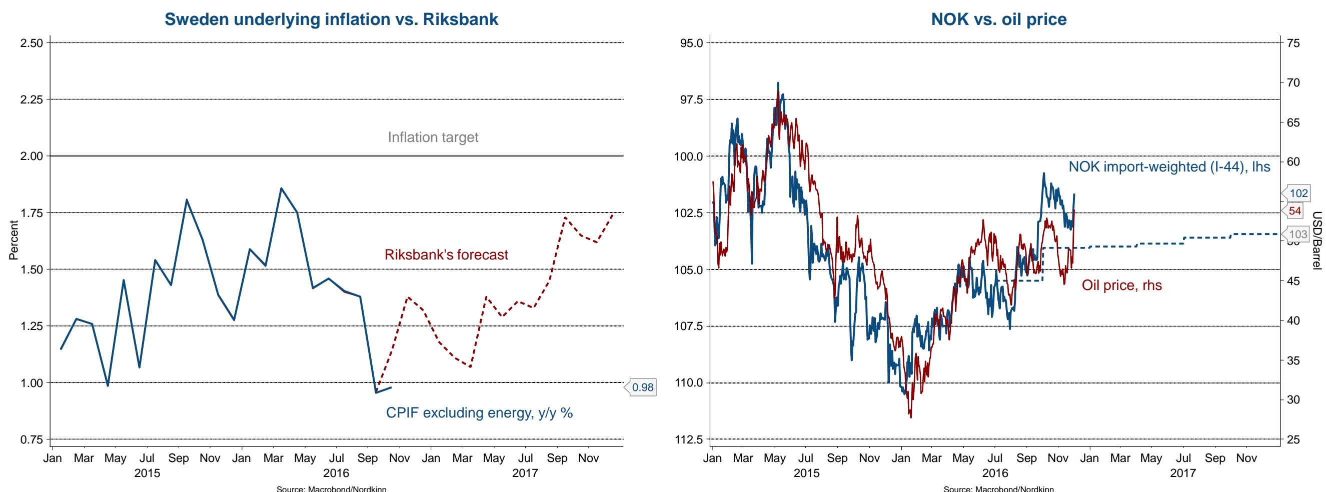
Nordic markets

Although Riksbank Board members still expect inflation to rise going forward, they have obviously become more uncertain regarding how quickly inflation will rise following the weak inflation data in recent months. Consequently, on October 26th the Board lowered its projections for both inflation and the repo rate. The new rate path signals, according to our interpretation, a 60% probability for a 10 bps rate cut to -0.60%. If our interpretation is correct, we believe that the Riksbank will cut should data come in line with projections or worse.

At 1.0% y/y, CPIF inflation excluding energy was 0.15%-points below Riksbank's projection in October, see left hand chart. Admittedly, this deviation is very small, but remember who has the burden of proof: The significant easing bias means incoming data must be better than expected to prevent a rate cut.

Meanwhile, incoming information about future inflation has been mixed. Commodity prices are rising and the weak SEK, if sustained, should put upward pressure on prices for imported goods next year. At the same time, a precondition for a weak SEK is that monetary policy remains accommodative. Another possible catalyst for higher future inflation is the rise in resource utilisation amid firm economic growth. Yet, there is so far no convicing evidence of rising wage growth, and unions' confidence in the inflation target as a nominal anchor remains fragile.

To sum up, we expect the Riksbank to continue to put emphasis on running CPI numbers when deciding upon its monetary policy stance. If we are correct, the outcome of the upcoming CPI report on December 13th will be instrumental for shaping Board members view ahead of the Board meeting on December 21st. As things stands now, we judge the probability for a cut to be above 50%, which is significantly more dovish than expectations prevailing in the market. Given this non-consensus view, receiving short-dated Swedish interest rates is attractive from a risk/reward perspective. Moreover, we also expect the Riksbank to extend its asset purchase program by another six months, possibly including municipal bonds.



In Norway, we expect the Norges Bank to maintain its key policy rate at 0.50% at the upcoming meeting on December 15th. Based on a technical summary of incoming data since the September monetary policy report, one could actually argue that there is a case for a rate cut. Both growth and inflation have been weaker than expected, the NOK is stronger than expected and banks have increased the interest rates on mortgages. However, we doubt the Norges Bank Board will vote for a rate cut now for a number of reasons. First of all, the low interest rate level has fuelled a boom in house prices and consumer debt. Second, the recent appreciation of the NOK relates in part to the recovery in energy prices, which in turn is positive for the growth outlook further ahead, see right hand chart. Third, the rise in global bond yields reduces the pressure on the Norges Bank to cut interest rates in order to keep the NOK weak.

On balance, we expect that the new interest rate profile will look broadly similar to the one from the September report, signalling a stable interest rate in 2017 and 2018 and a gradual increase starting early in 2019. Given the mixed growth indicators, we expect the Norges Bank to maintain an easing bias. The risk is that the Norges Bank put more emphasis on house prices and debt than we currently anticipate, which could lead to a slightly higher rate path.

Against this background, we continue to like curve steepeners between 2018 and 2019. Even if our main scenario is that the Norges Bank maintains an easing bias, we think the NOK has room to appreciate somewhat further conditional that the elevation in energy prices lingers.