Nordkinn Market Review & Outlook – March 2017

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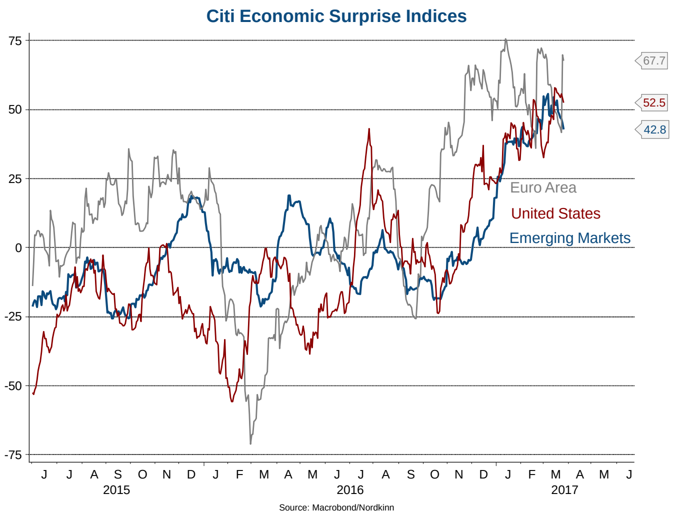
NORDKINN ASSET MANAGEMENT

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

Prinsens gate 22, 6tr
0157 Oslo, Norway
Phone: +47 22 46 63 00
Telefax: +47 94 77 15 16
E-mail: post@nordkinnam.no

Global overview

The global economic upswing remains on track. As illustrated by the Citi surprise indices, economic indicators have generally been better than expected in recent months across major markets. The surprise has been particular for the euro area, see chart, which currently appears to be experiencing the fastest growth rate since 2011. Moreover, political risks in the euro area seem to be declining after Geert Wilders's anti-immigration Party for Freedom failed to live up to supporters' expectations in the Dutch election on March 15th and current polls show Macron would trounce far-right leader Marine Le Pen in France's upcoming presidential election on April 23rd and May 7th. Consequently, in the beginning of March we saw an underperformance of German government bonds.

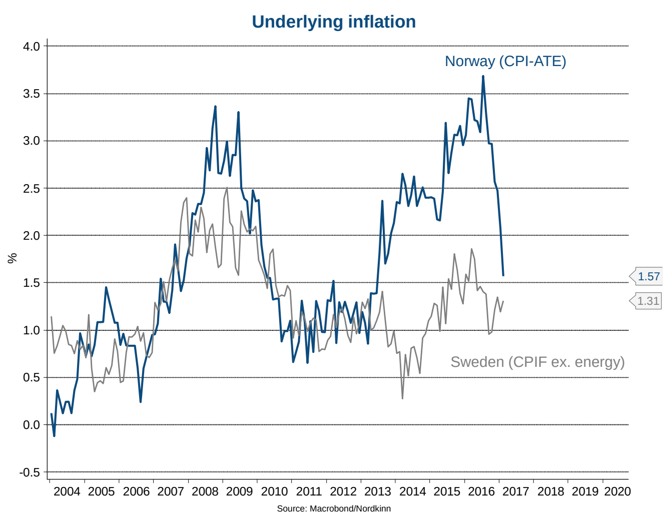


The ECB's meeting on March 9th also underpinned the rise in bond yields, triggered by a more upbeat message by President Draghi who said that the probability of further monetary policy easing had gone down. Gains in yields were however trimmed later on after ECB officials and sources felt induced to clarify that monetary policy will stay loose for a considerable period.

Meanwhile, the Federal Reserve decided to hike its key policy rate by 25 bps at its meeting on March 15th. The decision was widely expected after Fed-chair Yellen in a speech on March 3rd said that such action likely would be appropriate. Interestingly, the USD and US bond yields fell sharply in the aftermath of the decision as the statement and projections were seen as less hawkish than the market had anticipated. The number of FOMC members who expected four rate hikes or more in 2017 did not increase as some had expected.

The USD continued south after President Trump lost on one of his biggest campaign promises; the American Health Care Act. This dented hopes and raised concerns whether the administration will be able to enact the equally ambitious tax reforms, on which the rally in risky assets since the US election to a degree rests upon.

Nordic overview



In March Swedish CPIF inflation reached the Riksbank's 2.0% target for the first time since 2010. While the print marginally exceeded expectations, the market impact was limited as investors focused on the inflation rate when stripping out volatile energy prices, which stood at a mere 1.3%, see chart. Meanwhile, at the end of March unions within the manufacturing industry agreed upon a new three-year wage agreement with a benchmark at 6.5%. Barring an unexpected spike in wage drift, this wage agreement implies total wage growth well below the Riksbank's projections. This troubles an already troubled Riksbank as pertains to inflation targeting.

Short-term bonds rallied at the end of the month as market participants scaled back expectations of a rate hike by the end of this year. These events aside, the Swedish fixed income and FX markets were relatively quiet in March.

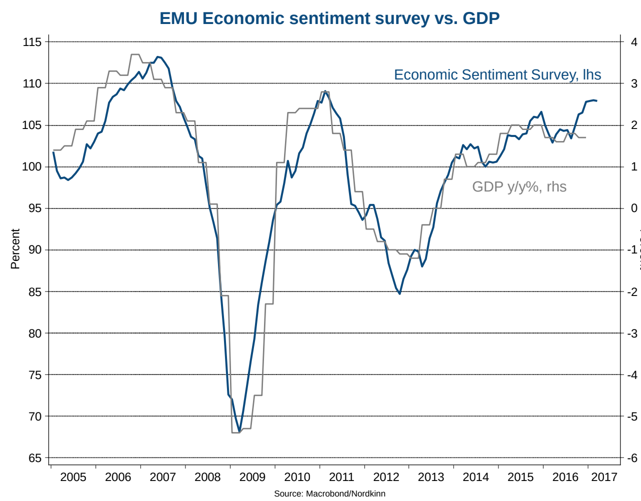
The Norges Bank Board kept its key policy rate unchanged at 0.50% at its meeting on March 16th, as we and the rest of the market had expected. Moreover, in response to the sharp decline in inflation (see chart), the Board maintained its 10 bps easing bias for the near future and decided to delay prospects for future interest rate increases to late 2019. The latter was in line with our view, but more dovish than the market expected. Consequently, Norwegian bonds rallied in the aftermath of the announcement.

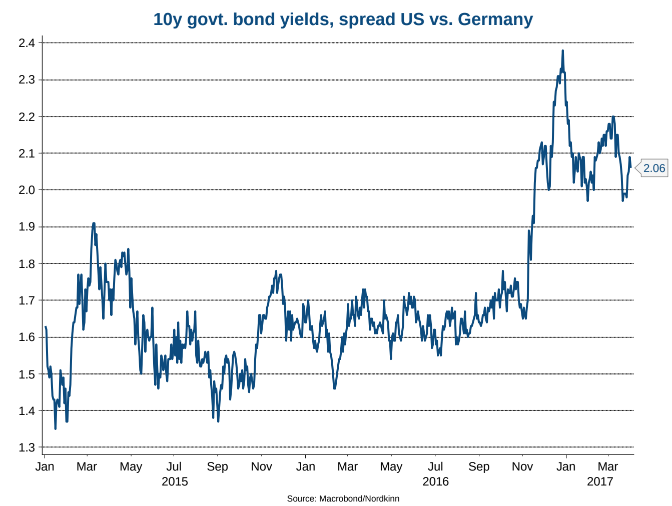
The NOK depreciated against most major currencies in March, mainly as a result of the 10% decline in oil prices in combination with a softer Norges Bank message than expected. Added to that, the Norges Bank's decision to reduce NOK purchases on behalf of the government to NOK 850 mln in March from NOK 1,000 mln in February may have contributed to the weakness.

Global markets

Growth in the euro area economy is gaining speed. According to the European Commission's sentiment survey, GDP growth is currently running at around 2.5%, see left hand chart. This implies that the balance of risk around the ECB's forecast of 1.8% growth in 2017 is tilted to the upside. Consequently, in June we expect the ECB to revise its forecast for growth upwards and unemployment downwards, which indicates that the euro area may reach full employment already by the end of 2018. Wage pressures should begin to rise as a result, contributing in boosting underlying CPI inflation to almost 2% within a couple of years.

These paths for growth and inflation would be consistent with a gradual removal of monetary policy accommodation starting in early 2018. The question is how quickly and in what order such removal will occur. According to the ECB's forward guidance, key policy rates are expected to remain at current or lower levels for an extended period of time and well beyond the horizon of QE. The current EUR 60 bln per month QE program is intended to last until December, or beyond, and in any case until the Governing Council sees a sustained increase in inflation.





Assuming that the ECB abruptly halts the QE program in December and that "well beyond" means at least two meetings after the end of QE, the first rate hike should not be expected before March 2018 at the earliest. This appears early considering Mr. Draghi's comment that he does not expect an abrupt halt to the QE program. We therefore expect a more gradual tapering of asset purchases between December and medio 2018 (reffering to our theme *"EMU: QE tapering".)* Against this background, and given remaining economic slack and low wage pressures, we do not believe that the ECB will be in a hurry to commence the process of raising rates prior to the second half of 2018.

There are currently speculations whether or not the ECB could decide to raise short-term interest rates before starting a tapering of asset purchases, following media reports having indicated that some ECB members have discussed this possibility. The main argument put forward for early rate hikes is that negative rates are having adverse side-effects, such as bank profitability. The removal of negative rates could be viewed as abandoning a non-standard measure, not to be confused with standard monetary tightening.

Yet, our base case is that the ECB leaves its key policy rates unchanged until after the end of QE. First of all, it would be extremely challenging for the ECB to communicate that it is a one-off hike back to zero, then stop. A rate hike too soon could result in an unwanted tightening of financial conditions that could threaten the current economic upturn. Second, bank profitability is also affected by the shape of the yield curve. Rate hikes before the end of QE could lead to a flatter yield curve, which is bad for banks. Last but not least, rate hikes before the end of QE would contradict the ECB's current forward guidance. This could potentially become a very damaging blow for the credibility of the ECB's use of forward guidance many years into the future. We do not believe that the ECB is willing to compromise on its credibility.

Turning to the other side of the Atlantic, the withdrawal of the American Healthcare Act by the House Republicans has damaged the President's authority and lead to some unwinding of the "Trump trade" in financial markets (higher equity prices, bond yields and US dollar). In our view, the global economic upswing, which begun several months before the election of Mr. Trump, will be a much more important factor for markets going forward. The Fed will in our view keep its rate hike plans on track (referring to our theme *"USA: Interest rate normalisation".*) However, the relative underperformance of long-dated US treasuries that occurred after the election of Mr. Trump, see right hand chart, should recede in coming months and quarters.

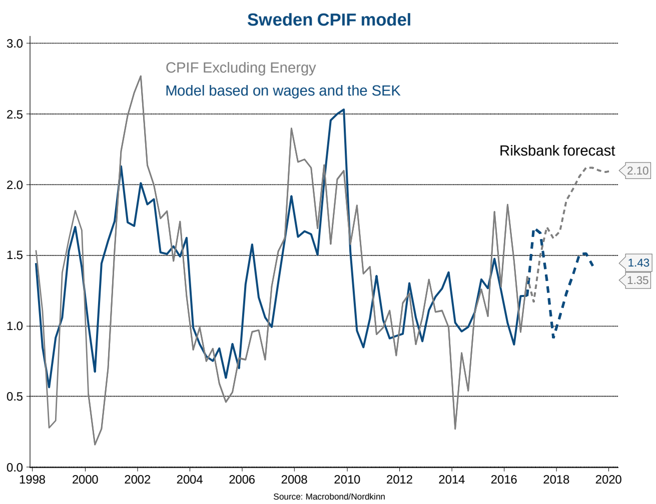
Nordic markets

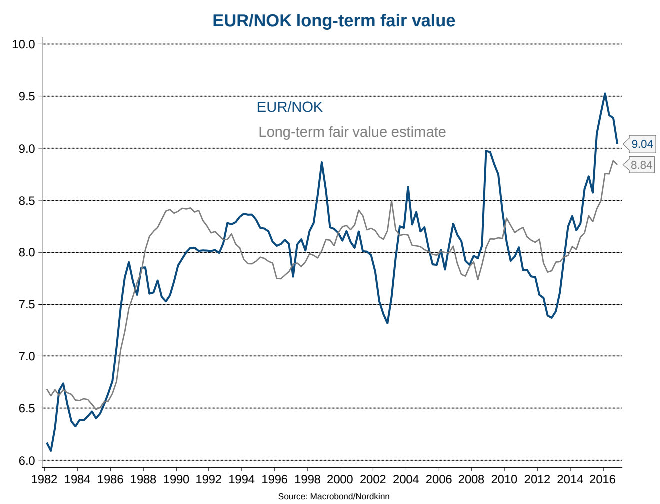
The Swedish economy remains strong and companies and households are optimistic about the outlook. The relatively strong pick-up in euro area economic activity in combination with a weak SEK bodes well for the Swedish exports sector. And with CPIF inflation finally back to the Riksbank's 2.0% target in March, it is tempting to draw the conclusion that the Riksbank soon will begin hiking rates.

Yet, we think that the Riksbank will be patient when it comes to eventually removing policy accommodation. As we have emphasised repeatedly over the past years, the Riksbank's ultimate aim is to secure the long-term credibility of its inflation target. The recent rise in CPIF inflation has been driven by energy prices. Base effects will soon abate and bring inflation back to the 1.0-1.5% range again.

For underlying inflation to rise sustainably back to 2%, wage growth must pick up. The Riksbank is hopeful that the combination of a strong economy and tight labour market will translate into a higher wage settlements, which can help push underlying inflation higher. But despite the strength of the domestic economy, focus among unions remains on protecting the competitiveness of the industry. Given the muted outcome of the 2017 wage negotiations, we see significant downside risks to the Riksbank's 2017 and 2018 wage growth forecasts of 3.3% and 3.6% respectively.

Assuming wage growth slightly below 3% this year and next, we expect CPIF excluding energy to remain in a 1.0-1.5% range over the next couple of years, see left hand chart. With underlying inflationary pressures likely to remain weak, we expect that the Riksbank stays sensitive to the currency and will therefore not deviate too much from the ECB's monetary policy stance. Moreover, following the disappointing outcome of the recent wage negotiations, on April 27th we see a risk that the Riksbank postpones future rate hikes (referring to our theme *"Sweden: Credible inflation targeting")* and extends its purchases of index-linked bonds in the second half of this year (the latter is captured in our *"Sweden: Government relative value"* theme.)





The appreciation of the NOK since the beginning of last year has contributed to push CPI-ATE inflation sharply lower over the past few months to 1.6% in February. Looking ahead, we expect underlying inflation to drop further towards 1%, dragged lower by economic slack, subdued wage growth and the gradual yet volatile NOK recovery. Although the Norges Bank has aimed for its 2.5% inflation target with great flexibility in recent years, the pace of the decline in inflation is clearly a concern for the Board.

While the near-term economic outlook looks positive in Norway, we expect growth to peter out next year as the contribution from housing investments and public demand should diminish. Taken together, we expect the Norges Bank to maintain the key policy rate unchanged in both 2017 and 2018. This will support Norwegian bonds (referring to our theme *"Norway: Inflation convergence".*)

In the previous monthly report we highlighted the risk of a NOK correction, but the weakness in March admittedly exceeded our expectations. The NOK sell-off in March looks somewhat exaggerated according to our models and we expect a partial recovery before summer (referring to our theme *"Norway: FX recovery".*) However, the potential for a significant appreciation in the NOK in 2017 is overstated in our view. We expect oil prices to increase merely gradually going forward to levels well below previous peaks. This implies a much higher long-term fair value for EUR/NOK than just a simple long-term average infers, see right hand chart. Added to that, our views on growth, inflation and monetary policy support our forecast that the NOK will remain relatively weak in a historical context for a considerable period.