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asset management

Nordkinn Market Review & Outlook – April 2017

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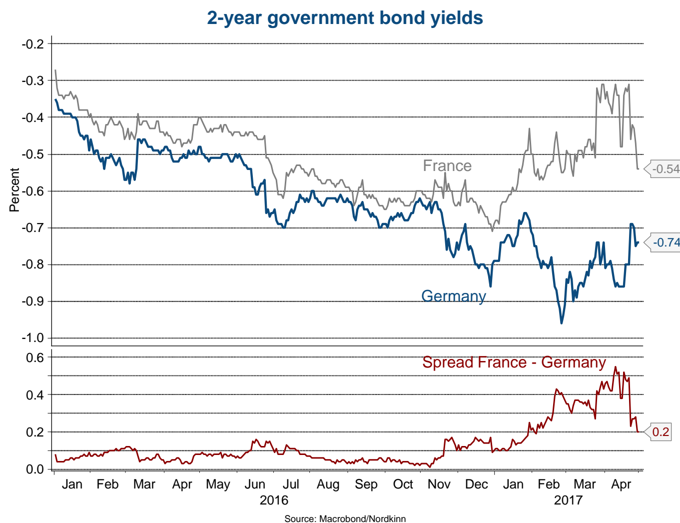
Global overview

Investors were relieved when the pro-Europe reformer Emmanuel Macron won the first round of the French Presidential election on April 23rd. Endorsed by Hamon and Fillon after the first round, Macron is heavily favoured to also win the second round. Investors learned that polls can prove right and that nationalist Marine Le Pen lacks momentum. Hence, worries of a political turn towards the extreme-right in Europe seem to be fading. As a result, the EUR appreciated in late April in sympathy with short-dated German bond yields, while the risk premium on French bond yields plummeted, see chart. Longer-dated German government bonds were however little changed in April, following less political risks in Europe being offset by rising geopolitical risks in the US and Asia-Pacific.

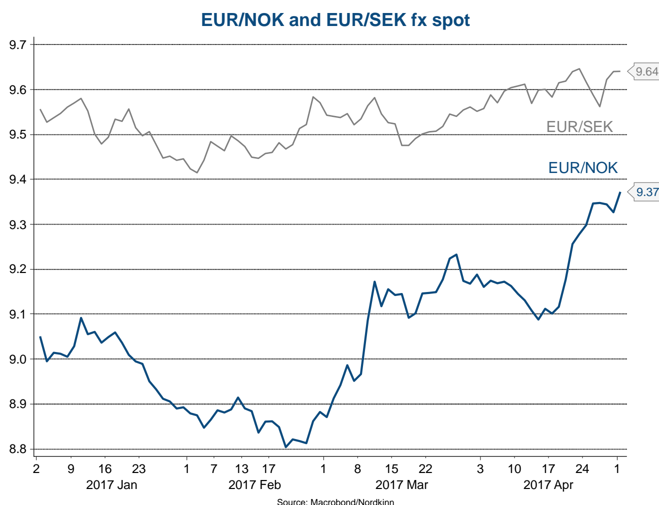


The ECB left both monetary policy and its forward guidance unchanged on April 27th, as most had expected. Interestingly, the Governing Council agreed that the main risk attached to ECB's growth outlook has moved towards a more balanced configuration. However, Mr. Draghi cautioned that underlying inflation pressures have yet to show a convincing upward trend, citing a weaker than expected March CPI reading. He refrained from commenting on any exit strategy.

Interestingly, the preliminary April CPI report released on the following day revealed a sharp rebound in underlying CPI inflation in the Eurozone.

The minutes of the FOMC meeting of March 15th, released on April 5th, showed that a change to the reinvestment policy of both government bonds and agency MBS would likely be appropriate later this year. This notwithstanding, US government bond yields declined in April as a result of softer growth and inflation data combined with fuelled tensions between the US and North-Korea. Consequently, the spread between US and German bond yields tightened, yet remains elevated.

Nordic overview



As we predicted, on April 26th the Riksbank Board decided to postpone the first rate hike until mid-2018 from February and to extend government bond purchases by SEK 15 bln during the second half of 2017, citing weaker than expected cost inflation pressures after the collective wage agreement. Asset purchases will be split 50/50 between nominal and real government bonds. Bond yields and the SEK fell in the aftermath of the decision, which was substantially more dovish than expectations prevailing in the market.

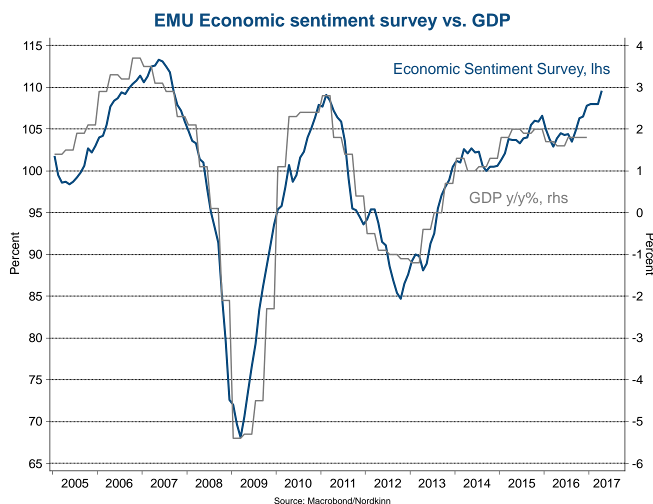
Meanwhile, indicators continuously point to an increasingly strong development in economic activity in Sweden. Business surveys are matching all-time highs and the decline in unemployment rate remains meaningful. However, the impact on monetary policy is so far very limited.

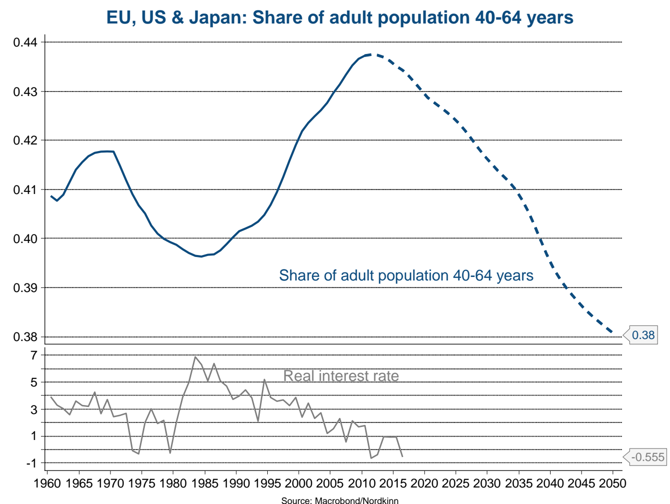
The NOK depreciated significantly against all major currencies in April. The currency lost 2% against both EUR and SEK, following an even larger depreciation in March. The most recent move seems difficult to explain from fundamental factors: The oil price remained stable after gains earlier in April were erased during the second half of the month; growth in the economy continues to show further signs of improvement; global risk sentiment varied during April but showed no strong correlation to the NOK. Rather, we suspect that a combination of commercial flows and short-covering of non-commercial positions contributed to the NOK weakness.

Global markets

On May 7th the second round of the French presidential election will be held. Nothing is over until it is over, but based on current polling, Macron is highly likely to become the next president. Consequently, market focus is gradually returning to the Eurozone's favourable economic fundamentals. Most indicators are consistent with Eurozone growth being well above its potential, including the European Commission's Economic Tendency Survey signalling a sharp rise in GDP growth in 2017, see left hand chart. With political risks abating, we expect economic momentum in the Eurozone to mount strength for the remainder of this year.

Meanwhile, underlying price and wage pressures in the Eurozone remain subdued, even though some tentative signs have started to emerge. With unemployment rates falling steadily, the risks to inflation have nevertheless become more balanced, casting doubt on the need for monetary policy to remain as accommodative as it is currently. In September, we therefore expect the ECB to present a plan for tapering asset purchases with full completion by medio 2018, but the rhetoric's of the ECB will become progressively more hawkish already at the next meeting in June. Against this backdrop, we remain underweight German government bonds in accordance with our *"EMU: QE tapering"* theme. Moreover, consistent with the ECB's forward guidance, we expect the Governing Council to maintain key interest rates at current levels until well beyond the horizon of its asset purchases, i.e. no hikes before 2018.





Turning to the other side of the Atlantic, we expect the rally in US Treasuries and money market futures in particular to fade in coming weeks and months. Slower US growth in the first quarter of the year, softer inflation readings and various political uncertainties have all contributed to the rally. In our view, the lacklustre "hard data" on US economic growth is probably lagging the perky survey data, hence growth will show a clear improvement in the second quarter. With capacity utilisation and inflation readings more or less in line with the FOMC's dual mandate, we continue to expect at least two additional interest rate hikes in 2017 (*"USA: Interest rate normalisation"*.) This view is more hawkish than the market currently prices in.

Any escalation of the currently tense political stand-off between the US and North-Korea has the potential to rattle markets in coming months, but we believe that President Trump is preparing for negotiations in order to give diplomacy a chance.

Overall, the cyclical factors that have suppressed global interest rates over the past 10 years, including the US financial crisis in 2007-2009, the Eurozone's debt crisis in 2011-2012 and the deflation fears associated with collapsing commodity prices in 2014-2016, have weakened and are in our view set to fade.

In addition, we also see a convincing case that many structural factors behind the decline in bond yields could begin to unwind or even reverse over the coming years. One of the secular drivers of global bond yields over the past 35 years has been the age structure in major advanced economies in which the baby boom generation has added to the global savings pool. As the right hand chart illustrates, the share of adult population between 40 and 64 years, usually associated with a high propensity to save, rose sharply between 1985 and 2015. The chart also demonstrates that we have reached a tipping point where aggregate savings will come under downward pressures over the coming 20 years as the baby boomers shift into retirement. A reduction in aggregate savings suggests upward pressures on global bond yields.

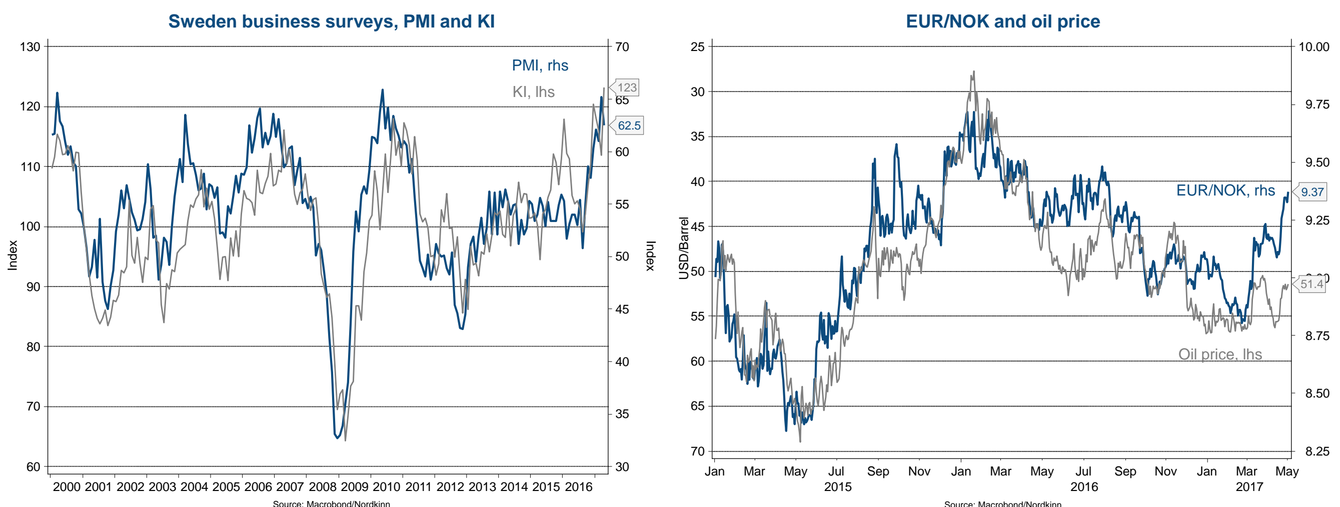
Admittedly, it will take time for bond-bullish structural forces to unwind. Moreover, these forces are seldom relevant for our investment horizon. Nevertheless, from a longer term perspective, aging adds to the cyclical factors suggesting that a 35 year period of bond rally has indeed come to an end.

Nordic markets

The Riksbank's decision on April 26th to further delay planned interest rate hikes and extend QE until December this year yet again confirms our *"Sweden: Credible inflation targeting"* investment theme. While recognised by the Riksbank, the increasingly strong economic activity in Sweden (see left hand chart) is deemed irrelevant for monetary policy unless it contributes to higher inflation. Instead, the Riksbank's main focus has been on the low collective wage agreement, which likely implies a more muted development in cost pressures and CPI inflation than previously expected.

For investors it is important to understand that the Riksbank conducts a stricter inflation targeting regime compared with other central banks. Most central banks conducts what the literature describes as "flexible inflation targeting", whereby the objective of the central bank is not only to achieve the inflation target, but also to stabilise real economic variables such as GDP and the labour market. However, flexible inflation targeting requires that households, business leaders and labour unions are confident that the central bank will be able to bring inflation to target. In Sweden, the Riksbank Board sees a risk that inflation expectations have, or are about to, become unanchored after inflation has been running too low for too long. This is why the Riksbank Board currently attaches a very low weight on the stabilising output and employment. Although the Riksbank is being criticised for putting too much weight on inflation, regaining credibility remains priority number one for the Riksbank.

The investment implication is that the Riksbank Board will keep monetary policy extraordinarily loose until it sees a sustained increase in inflation towards its target. To prevent that a rapid appreciation of the SEK pushes inflation even lower, the Riksbank will in our view not deviate too much from the ECB's monetary policy stance. We like being long short-dated bonds, while long-dated bonds will largely mirror developments in Germany. Furthermore, we expect break-even inflation spreads to widen as a response to the Riksbank's commitment to inflation targeting. Finally, risk/reward favours buying the SEK at current levels.



Turning to Norway, the magnitude of the NOK depreciation during March and April caught us by surprise. Interestingly, the sell-off occurred in an environment of positive data surprises as illustrated by the surge in the citi surprise index for Norway. Moreover, as illustrated by the right hand chart, the oil price decline explains only a fraction of the NOK sell-off (oil price on inverted scale). We believe active positioning has become more neutral during this sell-off, laying the grounds for a gradual recovery of the NOK in coming weeks and months.

The recent weakening of the NOK should dampen the Norges Bank's concern that inflation will continue to undershoot its inflation projections. The trade weighted NOK exchange rate is currently 3.5% weaker than projected, reducing the risk of a dovish monetary policy surprise in May and June. Instead, the recent encouraging data on economic development may convince the Board that a reduction in the easing bias is appropriate. We do not expect any further delays in the prospects of future interest rate hikes in the next monetary policy report.

Regarding investment implications, the NOK is currently our top conviction in the Norwegian market *("Norway: FX recovery".)* Meanwhile in fixed income space, we continue to see value in fixed-rate bonds relative to Europe as we expect Norwegian inflation dynamics to remain relatively weak going forward *("Norway: Inflation convergence")*. However, in the near-term we expect higher global yields to be the main driver of interest rate spread compression and therefore hedge our outright long positions with curve steepeners.