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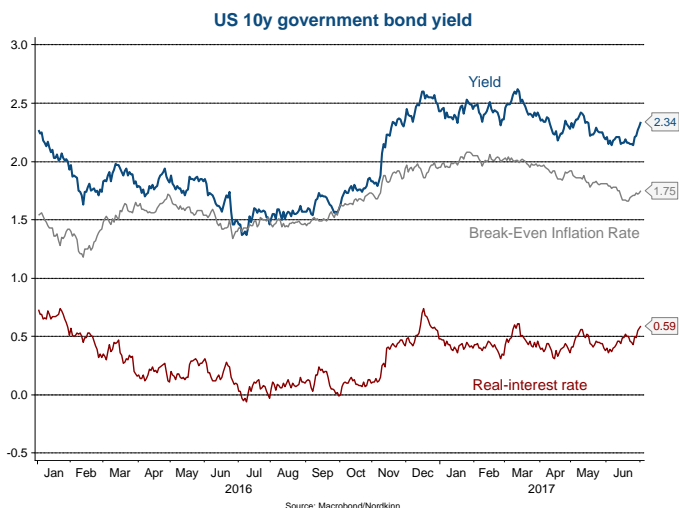
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Global overview

Taking last days of June aside, global bond yields gradually withered in June, hence prolonging the falling trend that commenced in March. As illustrated by the chart, this decline in yields has been rooted in ever falling inflation expectations. Contrary, real interest rates have remained reasonably steady, suggesting that growth worries are not foremost on investors' minds. However, in the last week of June, bond yields spiked, which was led by sell-off in German Bunds after ECB's President Draghi on June 27th described the recent weakness in inflation as merely temporary and that the ECB in fact is confident that its policies will restore and foster inflationary pressures.

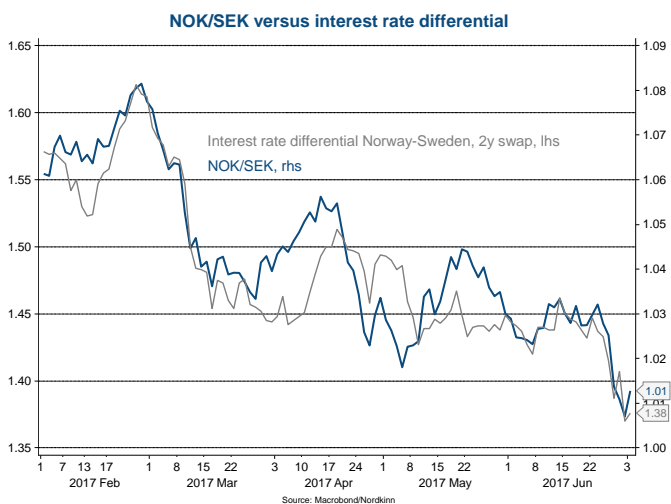


The speech by Mr Draghi was interpreted by many as ECB signalling that adjustments are looming in September regarding the parameters of ECB's stimulus program, in spite of the subdued inflation readings of late. Mr Draghi said deflationary forces have been replaced by reflationary dito, which took the EUR to a one-year high against several FX crosses, including the USD. Government bond yields rose meaningfully and curves steepened.

Earlier in the month, on June 14th the Federal Reserve decided to raise interest rates by 25 bps and kept its outlook for additional policy normalisation broadly unchanged. Similar to Mr Draghi, Fed-chair Yellen said that the recent decline in inflation reflected one-offs and that the progress of economic development will support the return of inflation to target over the medium term.

The Bank of England is seemingly turning more hawkish again. Having left policy unchanged on June 14th, three out of eight members of the MPC dissented and in contrary preferred to increase the key policy rate. Moreover, one of the members voting for unchanged rates, Mr Haldane, later said in an interview that he is seriously considering the case for rate hike. Furthermore, Governor Carney nuanced his dovish stance in a speech on June 28th by saying that "some removal of monetary stimulus is likely to become necessary if the trade-off facing the MPC continues to lessen". As a result, the GBP appreciated in late June.

Nordic overview



The Swedish fixed income market traded strongly in the beginning of June, especially in covered bonds space, but sold-off at the end of the month. The stronger than expected increase in CPI inflation to 1.9% in May fueled speculations that the Riksbank could begin raising rates by next summer. Those speculations were reinforced by the hawkish twist of several other central banks at the end of the month. Yields on short-dated Swedish government bonds rose sharply, which supported the SEK, see chart.

Norwegian interest rates also rose at the end of June, but failed to keep track with the movements of other European countries after the Norges Bank on June 22nd confirmed that monetary policy would likely remain on hold until 2019. The sharp drop in Nibor fixings owing in part to tighter US FRA/OIS spread also contributed to a tighter interest rate differential

between Norway and its trading partners. The Norges Bank removed its easing bias around its interest rate projection as we expected, but the market impact was limited.

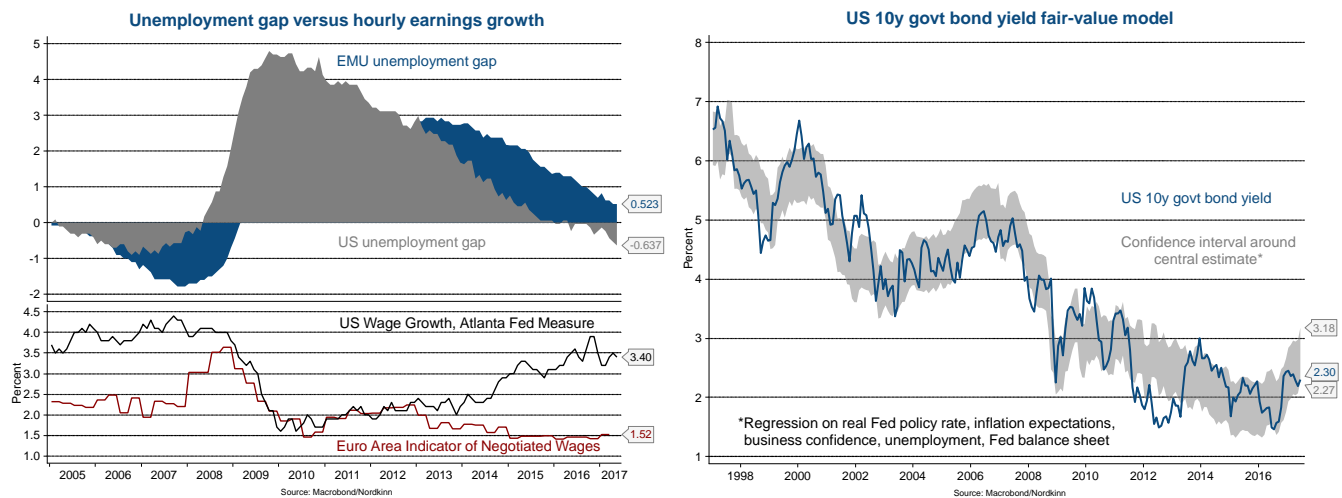
The NOK depreciated in June, primarily due to a tighter interest rate differential in combination with a fall in energy prices. The sharp sell-off at the end of the month may have been reinforced by thin liquidity in connection with the start of the holiday season.

Global markets

The weaker than expected rise in consumer prices in recent months has given investors more confidence that the Fed will not need to raise rates aggressively and that the ECB may extend its asset purchase program into 2018. This has pushed bond yields downwards and has fuelled a rally in stock prices. However, sentiment among investors are now about to flip after recent comments from central banks downplaying the decline in inflation of late, which have been caused by “one-offs” (Ms Yellen) and “supply factors, which a central bank can typically look through” (Mr Draghi).

Even if inflation may remain below both central banks’ objective, the threat of deflation is considered gone and reflationary forces are at play. This is particularly evident in the US, where wage pressures started to build gradually when the unemployment gap (the difference between actual unemployment and the NAIRU) closed and eventually turned negative, see left hand chart. The rise in wage growth is particularly pronounced in wage measures that controls for a changing composition of the work force, such as the Atlanta Fed wage tracker.

Meanwhile, the euro area indicators of negotiated wages do remain very low. This is partly because the unemployment gap is still positive, broadly matching the level of slack that was apparent in the US economy back in early 2014, when the first signs of rising inflation started to emerge. Besides, a prolonged period of low inflation is always likely to be exacerbated as wage indexation is backward looking, which influences future wage and price formation.



Interestingly, in his Sintra speech on June 27th Mr Draghi described these factors weighing on inflation as temporary, as long as they do not affect inflation expectations. Looking ahead, the unemployment gap in the euro area should close already in 2018 if growth in the economy holds up as we forecast. Consequently, we should expect to see some upward pressures on wage and price growth next year. Inflation will however most likely remain muted for the remainder of this year.

Even if inflation remains low in coming months, the ECB appears more confident that the factors weighing on inflation are temporary and that reflationary forces have started to get foothold. As the economy continues to recover, a constant policy stance will become more accommodative according to Mr Draghi. It sounds like a contradiction, but consider the real interest rate: Zero inflation combined with a zero nominal interest rate implies a zero real interest rate, whereas a gradual increase in inflation means the real interest rate is falling if policy remains unchanged.

This is why Mr Draghi told the market that the central bank can “accompany the recovery by adjusting its policy instruments, not in order to tighten the policy stance, but to keep it broadly unchanged.” For us, this message strengthens our view that the ECB will wind down its asset purchase program and begin adjusting interest rates next year, underpinning our “EMU: ECB QE tapering” theme.

In the US, the market is currently pricing mere 25 bps of tightening over the next 12 months, which to us seems far too low. Most indicators point to further economic expansion and rising inflationary pressures in coming months, which will be accompanied by continued gradual rate hikes. The yields of US government bonds are currently too low according to our proprietary indicators, including the fair-value estimate in the right hand chart. Therefore, we remain short US government bonds and money market futures as part of our “USA: Interest rate normalisation” theme.

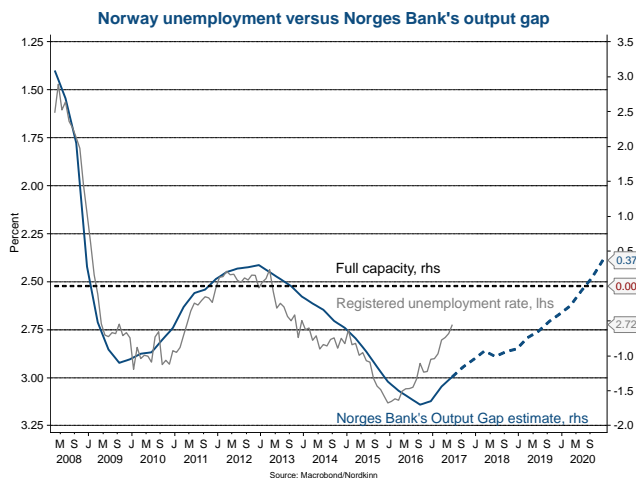
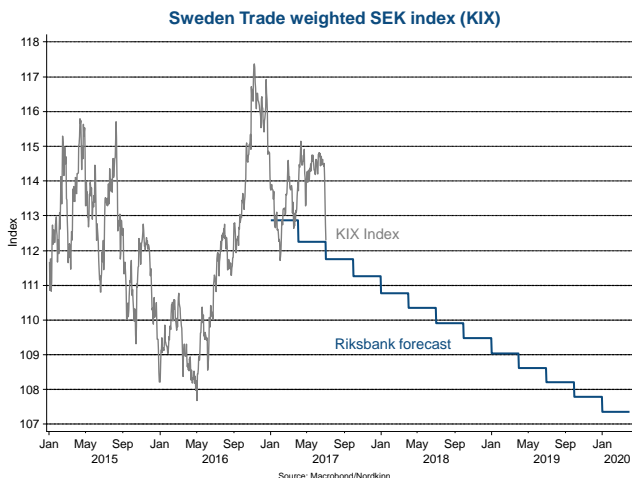
Nordic markets

Following the recent events at the end of June, several central banks around the developed world have seemingly turned more hawkish. While we do not subscribe to the conspiracy theory that central banks are coordinating a hawkish assault on markets, we do think that central banks, like investors, can be prone to group-think behaviour when they meet at various gatherings such as last week's ECB forum in Sintra. This may have influenced the thinking of the Riksbank Board as well, leading up to the announcement on July 4th to remove their easing bias.

The sensitivity of the SEK towards varying interest rate differentials implies that the Riksbank's monetary policy decisions are indeed highly influenced by the action of other central banks. The limits as to how far monetary policy can deviate from the policy of other central banks were further emphasised by the Riksbank Board in the monetary policy statement released in July. Given that both the ECB and the Norges Bank removed their easing biases in their forward guidance at the meetings in June, it was not a surprise to us that the Riksbank followed suit. Indeed, bond yields have increased and the SEK has appreciated somewhat recently on speculation that the Riksbank is turning more hawkish, see left hand chart.

At the same time, even if the risk around the near-term path for interest rates have become more balanced, we expect key policy interest rates to remain steady at present levels until medio 2018. After many years of low inflation, the Riksbank Board is determined to restore the confidence in the 2% inflation target. Besides, as the ECB will keep interest rates at present levels for a considerable period of time, any speculation about upcoming rate hikes in Sweden would boost the SEK and thereby reduce imported consumer prices, undermining the credibility of the inflation target.

Regarding investment implications, we significantly reduced exposure towards our "Sweden: Credible inflation targeting" theme during June. Our portfolio now consists of more pro-reflationary trades ("Sweden: Government relative value"), including shorts in long-dated nominal government bonds and longs in breakeven inflation spreads.



In Norway, economic growth has been stronger than the Norges Bank has expected in recent months, which motivated an upward revision of its growth forecast in the most recent Monetary Policy Report. This was accompanied by a removal of the Norges Bank's easing bias, but prospects of the first rate hike was left unchanged (2019) because interest rate expectations abroad had fallen. The latter may be about to change in our view, which in isolation would lead the Norges Bank to signal a higher interest rate path at the meeting in September.

More importantly, we believe that the Norges Bank is underestimating the level of capacity utilisation in Norway at the moment (i.e. overestimating the amount of slack). The right hand chart shows the Norges Bank's estimate of the output gap, which suggests that the current level of economic activity in relation to potential is lower when comparing to the 2009 recession. Most indicators, including the registered unemployment rate in the chart, suggest that the output gap is closing faster. In fact, we think capacity utilisation will return to normal levels already in late 2018, while the Norges Bank's estimate for this to occur is not until 2020.

As a result of the more hawkish tone among major central banks and the firming economic developments in Norway, we have removed all outright exposure for lower bond yields in Norway, but remain long NGBs in spread terms versus German Bunds as a part of our "Norway: Inflation convergence" theme. We expect the slope of the FRA-curve to steepen further as the Norges Bank gradually will bring forward the first rate hike in its projection. All this should meaningfully support the NOK which is currently trading at very weak levels.