Nordkinn Market Review & Outlook – Dec 2017

Addressed to Nordkinn's Followers on LinkedIn for informational purposes.

DISCLAIMER

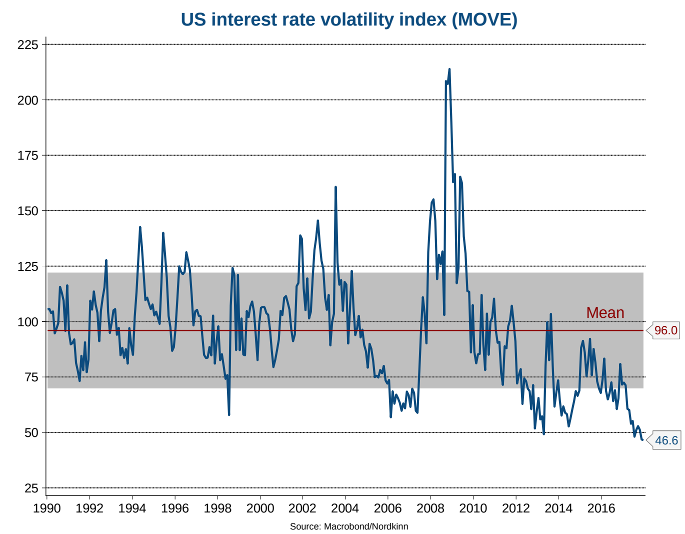
NORDKINN ASSET MANAGEMENT

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

As 2017 came to close, a striking overall reflection is that global government bond yields were remarkably stable in 2017 as a whole. The U.S. 10-year Treasury yield ended the year at 2.41%, which is identical to the yield on November 30th 2017 and merely 2 basis points below December 30th 2016. No wonder the volatility on government bonds, as measured by the MOVE index, fell throughout 2017 to reach an all-time low at 46.6 in December, see chart. Interestingly, the U.K. shows, despite all Brexit uncertainty, the same pattern as yields on 10-year U.K. Gilts ended 2017 exactly where it started. Meanwhile, the yield on 10-year German Bunds rose, albeit from low absolute levels, by 26 bps in 2017 to 0.46%. These yield and volatility developments in 2017 form a testament for investors regarding the importance of remaining active, as history also shows that changes in yield and volality levels are unpredictable and do not necessarily move in tandem.

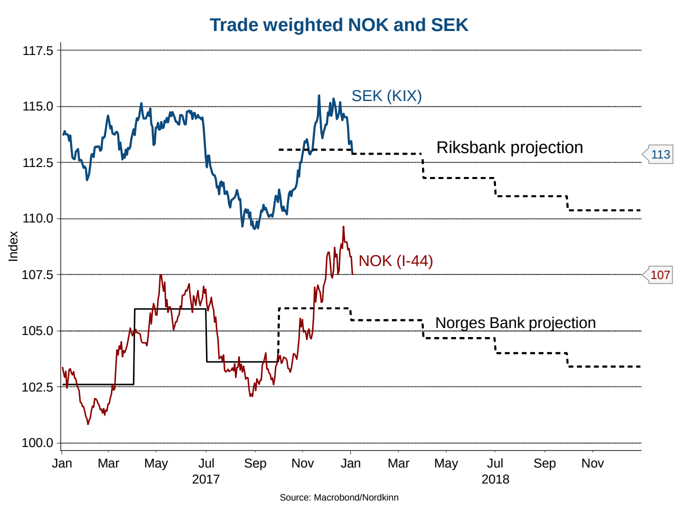


On December 13th the U.S. Federal Reserve raised the target range for the key policy rate by 25 bps to 1.25-1.50% as widely expected by the market. The median expectations of future interest rates remained stable, despite a somewhat stronger GDP forecast due to the upcoming tax cuts in 2018.

The U.S. Senate approved a USD 1,500 bln tax bill, which includes permanent tax breaks for corporations and temporary tax cuts for individuals. Once enacted, this represents the most drastic changes to U.S. taxes since the Reagan administration in the 1980s. Bond yields moved marginally higher after President Trump's first major legislative victory.

On December 14th the ECB left all policy tools unchanged. While ECB staff projections for GDP growth were strongly revised upwards, President Draghi dismissed the belief that the ECB was under pressure to withdraw stimulus more swiftly. This notwithstanding, EUR/USD appreciated in the latter half of December and ended the year just above 1.20.

Nordic overview



On December 20th the Riksbank Board announced that it will discontinue net asset purchases, but reinvest maturing bonds and coupons, as we expected. The Bank also decided to leave its repo rate projection unchanged, signalling a first rate hike in Q3 2018. While many saw a risk of a more dovish outcome, these policy decisions were broadly in line with expectations among Swedish economists following the unexpectedly strong increase in CPIF inflation to 2.0% in November.

However, by announcing that it will front-load reinvestments of large redemptions set for early 2019 (SEK 45 bln), the Riksbank's holdings of government bonds will temporarily increase in 2018, before falling again. This decision will deliberately soften the impact of net purchases ending as the Riksbank's significant presence in the market is maintained.

In spite of the subsequent upward boost in interest rate expectations, the SEK remained stable after the decision, but appreciated in line with our expectations slightly in the final days of the year, see chart. The slope of the 5-10 yield curve flattened and spreads between bonds and swaps widened marginally.

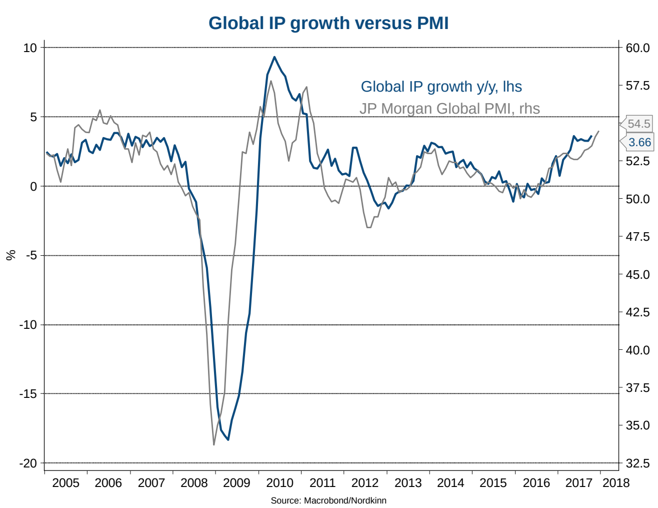
As we predicted, the combination of high capacity utilisation, a higher oil price and a weak NOK motivated an upward revision of the Norges Bank's interest rate projection on December 14th. The Board now expects interest rate hikes to commence in Q4 2018, from Q2 2019 previously. Market expectations of future interest rates spiked on the decision and the NOK appreciated initially. Surprisingly, the effect on the NOK was short-lived. Amplified by thin liquidity, lingering concerns about the Scandinavian housing market in combination with year-end flows took the currency down to a new 2017-low before Christmas Eve.

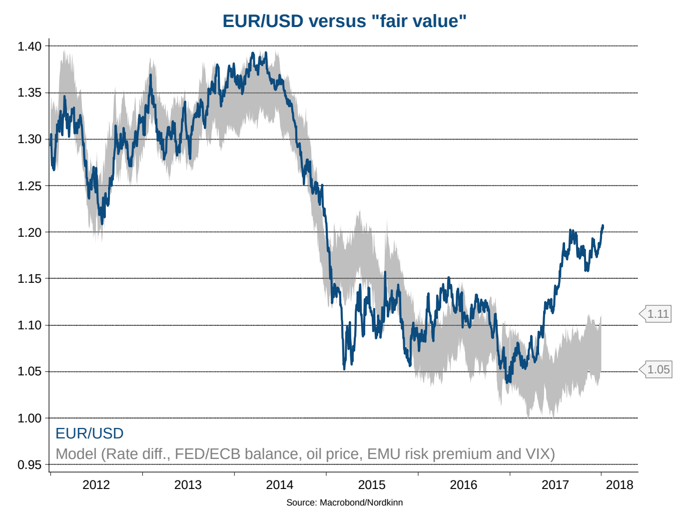
Global markets

The JP Morgan Global PMI rose to 54.5 in December from 54.1 the previous month, consistent with accelerating global growth towards the end of last year, see left hand chart. The current pace of global growth is the strongest since the beginning of 2011. We estimate Global GDP growth at 3.8% (PPP weighted) for 2017, up from 3.2% in 2016. Looking ahead, conditions remain in place for a broadly similar growth rate in 2018, although one should not be surprised if the pace of growth moderates a bit later this year. Alongside strong growth and higher capacity utilisation, we predict that global inflation will rise and monetary policy normalisation will gather strength.

We expect U.S. monetary policy to be a catalyst for rising global interest rates in the first half of 2018. The Federal Reserve will probably hike its key policy rate in both March and June while continuing to normalising its balance sheet. However, we expect the rise in global interest rates in 2018 to be contained due to a lingering depressed natural rate of interest combined with expectations that central banks elsewhere are yet not ready to follow the Fed. Against this backdrop, we are managing our *"USA: Interest rate normalisation"* theme actively. Exposure is modest at the moment, but will be increased when deemed appropriate.

Indeed, having extended QE until September 2018 and having guided that policy rates will stay on hold until "well past" that date, we do not foresee any ECB rate hikes until Q2 2019. If we are right, euro area bond yields and volatility will remain relatively low also in coming months, even though heavy supply could lead to a temporary spike in Q1. Further ahead, longer-term government bond yields in Europe are poised to rise towards the end of this year as we expect the ECB to cease net asset purchases next year. Consequently, we manage our *"EMU: QE Tapering"* theme actively and with patience.





Following a broad-based USD decline in 2017 driven by mounting global economic growth, we expect the macro environment to become more USD positive in the first half of 2018. The weakening of the dollar in 2017 should boost U.S. net exports, while dwindling spare capacity and faster wage growth should spur business investment and consumer spending. Meanwhile, euro area growth is likely to tick lower, as the impact of a stronger euro and a softer Chinese growth begins to take its tolls on exports. Moreover, data shows that the average speculative investor is long the EUR and short the USD, which explains why EUR/USD has appreciated beyond what can be accounted according to our model consisting of monetary policy differences, oil price, EMU break-up risks and the VIX, see right hand chart. We remain long the USD under our *"USA: Dollar bull market to resume"* theme.

The biggest question mark currently over global growth surrounds China. Various indicators of economic activity have slowed during 2017 as monetary conditions have tightened. So far, there is no reason to panic. Growth has weakened, but from an above-trend pace. Some cooling in the economy was both inevitable and desirable. The Chinese government is unlikely to take measures that allow growth to fall significantly below trend, yet a more ominous economic slowdown cannot be ruled out.

Nordic markets

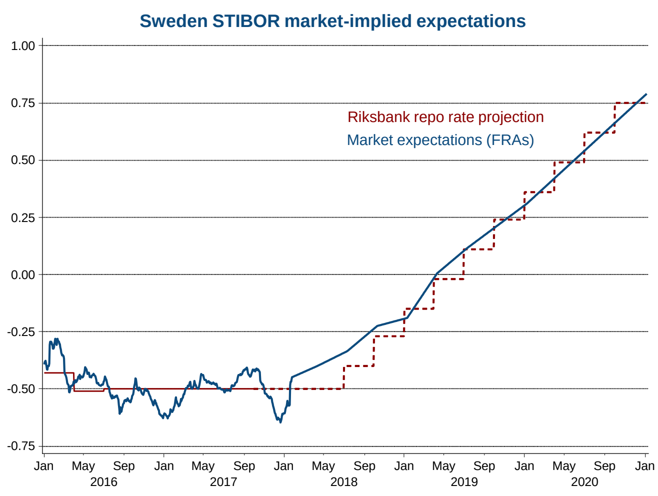
A rapid upturn in housing construction and a recovery on Swedish export markets have contributed to several years of high GDP growth in Sweden. Rising capacity utilisation has, in combination with a weak SEK, contributed to a positive trend for inflation in recent years, with CPIF inflation actually reaching the Riksbank's target of 2.0%. Looking ahead however, we see downside risks for both growth and inflation.

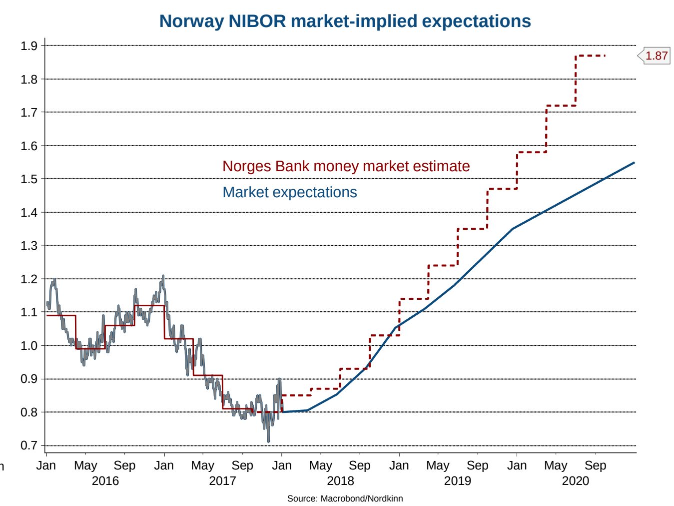
In particular, developments in the housing market is a major source of uncertainty as regards the outlook for growth. Although a slowdown in Swedish GDP growth is inevitable as housing construction has peaked, we cannot rule out a more gloomy development if the drop in house prices were to become more significant than we expect. We also note that the Riksbank assumes that the cooling housing market is a short-term blip.

In addition, we think the Riksbank's inflation longer-term forecast is overly optimistic. While inflation may remain close to current levels in coming months, which motivates a late 2018 rate hike broadly consistent with the Riksbank's repo rate path, we see a risk further out in time that low wage growth and a stronger SEK will send CPI inflation below the central bank's prediction.

To sum up, we expect a hawkish communication by Riksbank officials in coming months to culminate in a late 2018 repo rate hike, but we are sceptical that the rate hiking cycle will extend into 2019 such as currently priced by the market, which is more or less spot on the Riksbank's repo rate path, see left hand chart.

We use a variety of trade strategies to exploit this view, most of which are organised under the *"Sweden: Government relative value"* theme. We are short government and covered bonds with maturity of 3-5 years, while receiving shorter-dated FRAs and buying longer-dated government bonds. The latter is also motivated by the Riksbank's decision to front-load reinvestment of the SGB1052 redemption (March 2019), which implies that the Riksbank's holding of bonds is set to continue to rise by another SEK 45 bln until March 2019.





Turning to Norway, we are optimistic regarding the growth outlook for 2018, fuelled by an expected rebound in oil investments of between 5 and 10%, which will offset the expected decline in housing investments. This will push capacity utilisation higher and erode any slack left in the economy this year. This notwithstanding, we expect modest wage growth in 2018. The NOK weakening during 2017 will translate into temporarily higher CPI inflation this year, yet weak domestic cost pressures will keep core CPI inflation below the Norges Bank's 2.5% target for an extended period of time.

The Norges Bank forecasts that the key policy rate will remain unchanged in the period to Q4 this year followed by a gradual increase. This is broadly in line with our own assessment, although we think the risk is skewed towards a slight delay of the first hike until early 2019. The market shares this view, but from 2019 and onwards the market expects a shallower path for the key policy rate than both we and the Norges Bank projects, see right hand chart. Consequently, we prefer NOK rate steepener trades in combination with NOK versus EUR spread widening in the 5-year segment.

Added to that, we remain of the view that the NOK is undervalued. Stronger economic growth, a higher oil price and a more hawkish Norges Bank communication are main triggers for an expected appreciation this year. Consequently, we decided to re-enter long NOK positions in late December as part of our *"Norway: NOK FX recovery"* theme.