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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – October 2018

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Nordkinn Asset Management is a Nordic Fixed Income specialist based in Stockholm and Oslo. Nordkinn manages the Nordkinn Fixed Income Macro Fund, which seeks to generate stable absolute returns in all market environments.

MARKET OVERVIEW

Global overview

In October, as we marked the tenth anniversary of the global financial crisis, global risk assets sold off significantly. European and U.S. stock market indices were down at most around 10% from the recent highs, which is usually known as "correction territory". Interestingly, although many investors did turn to government bonds looking to hedge their equity holdings, the performance of the government bond market was rather muted during the sell-off. In fact, the ten-year U.S. government bond yield ended October at 3.15%, which was 6 bps higher compared with October 1st, i.e. before the equity sell-off began, see chart.

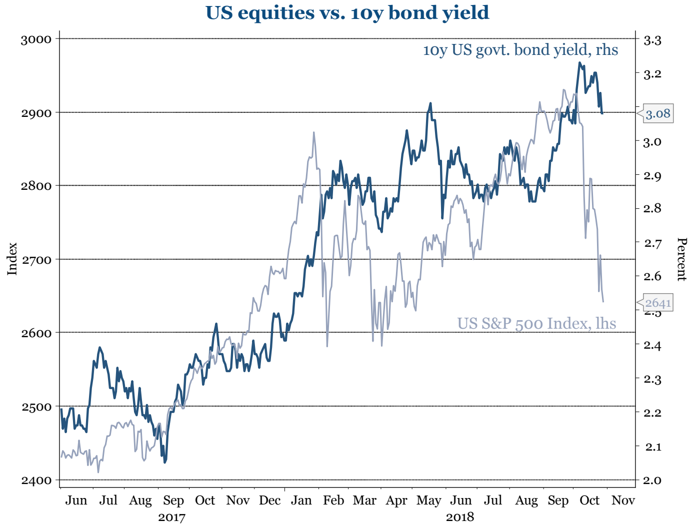
In our view, the stock market sell-off reflects investors' worries about the outlook for global growth. The JP Morgan Global manufacturing PMI index fell in September for a fifth consecutive month to 52.2. Although the level remains consistent with economic expansion, it is still well below the December 2017 peak at 54.5.

While U.S. economic data has been very strong recently, there are signs that investors are starting to focus on the effects on growth from tighter monetary policy further ahead. Bond yields crept higher in September and in the first week of October, which made equity investors nervous. As the stock market sell-off escalated, the rise in bond yields came to a halt and retraced a bit. U.S. President Trump was quick to blame the Fed for the equity market sell-off.

According to the minutes of the September 26th FOMC meeting released on October 17th there appear to be a consensus on continuing to hike the policy rate beyond neutral. The message was interpreted as hawkish and may have contributed to undermine global risk assets.

October saw a further escalation in the standoff between the EU and Italy, with Brussels taking the unprecedented step of rejecting Rome's budget plan for 2019. On October 19th Moody's announced that it downgrades Italy's rating, whereas S&P lowered the outlook on Italy's debt to negative from stable. As a consequence, Italian government bonds and the EUR exchange rate sold-off, while German bonds outperformed sharply in October. The spread between Italian and German 10-year bond yields reached a new multi-year high at 3.25% on October 18th.

US equities vs. 10y bond yield



Source: Macrobond/Nordkinn

Nordic overview

Changes in Swedish and Norwegian government bond prices during October largely mirrored the rollercoaster of global developments: The bond sell-off during the first couple of weeks was largely offset by a rally in the latter half of the month. Indeed, 10-year yields in the Scandinavian countries broadly ended were they started. As such, they underperformed vs. German peers in October, see chart.

On October 24th the Riksbank announced that the repo rate forecast remained completely unchanged, signalling equal probability for a hike in December 2018 or February 2019. Martin Flodén joined Henry Ohlsson as a dissenter, advocating an immediate 25 bps rate hike. According to the Board, an economic development that continues to support the prospects for inflation is a precondition for a hike.

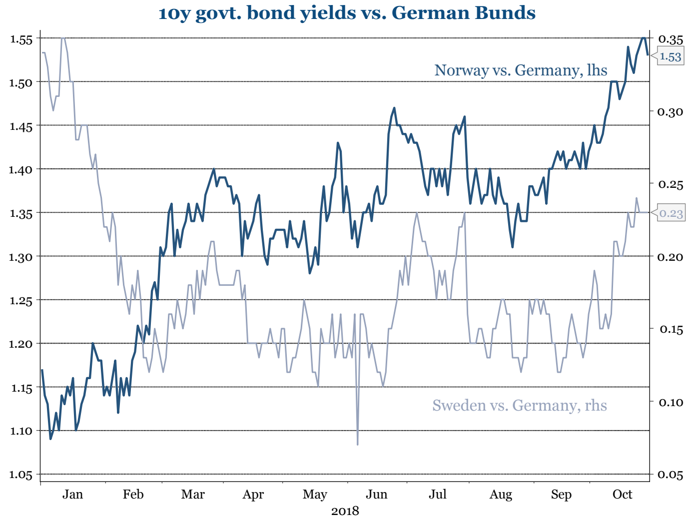
Incoming macro data during October points to robust economic growth in Sweden. Moreover, the inflation rate as measured by CPIF excluding energy jumped to 1.6% in September from 1.2% in the previous month, thus matching the Riksbank's forecast.

Sweden remains in political limbo after Alliance Bloc leader Kristersson and Social Democrats leader Löfven both failed at forming a government. The SEK depreciated in October, but to a very limited extent considering the political standoff, not to mention the deterioration in global risk assets.

Likewise, the depreciation of the NOK against major currencies in October was very contained when taking into consideration the significant risk-off sentiment that dominated global markets as well as the 10% decline in the oil prices.

In Norway, incoming data shows mixed economic developments. While industrial activity and confidence remains at elevated levels, households appear to have become slightly less optimistic. Growth in consumption remains modest and the housing market appears to have cooled down somewhat. Meanwhile, underlying CPI inflation was higher than expected at 1.9% in September.

10y govt. bond yields vs. German Bunds



Source: Macrobond/Nordkinn

OUTLOOK

Global markets

When entering October, several indicators sent warning signals about a pause or a small reversal in the bond sell-off: Bond sentiment was quite bearish and economic growth outside of the U.S. was slowing. In addition, our multi-factor model signalled that a yield above 3.20% is relatively high when measured against macro fundamentals, see chart.

Consequently, in early October we unwound short duration exposure in U.S. government bonds, but kept our steepening bias. In addition, given already quite aggressive pricing of the ECB's hiking profile, we hedged our structurally bond bearish *"EMU: QE tapering"* theme by entering longs in money market futures. These adjustments contributed to contain a slightly positive result despite turbulent markets in October.

Yet, the bigger picture remains intact: The structural as well as the cyclical trends in bond yields are to the upside in our view. Rising capacity utilisation is adding to upward pressures on inflation, which motivates tighter monetary policy and some term premia on bonds. Against this, we remain biased for a steeper U.S. yield curve as part of our *"USA: Interest rate normalisation"* theme, and we have scaled in some outright short exposure again.

The 2018 U.S. midterm elections are held on November 6th. The most likely scenario according to polls is a gridlock where the Republicans loses the House to the Democrats. This could trigger a mild and short-lived safe-haven rally in bonds, but ultimately the cyclical bond bear market will resume. If the Democrats win both chambers, the negative risk sentiment could last somewhat longer. The least expected scenario, namely that the Republicans wins both chambers, will likely lead to much higher bond yields.

In Europe, however, things look different. The ECB intends to maintain the current level of key interest rates at least through the summer of 2019. Yet, the current euro area slowdown, combined with subdued inflationary pressures, not to mention tensions in Italy, makes a delay in the policy normalisation process quite likely. Consequently, we still think it is too early to fade the wide Treasury vs. Bunds spread.

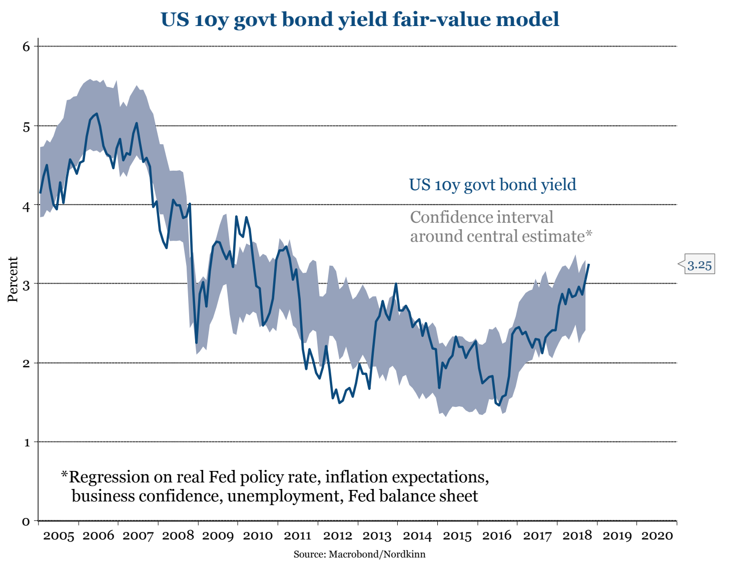
Regarding Italy, the third largest bond market globally, its populist government is on collision course with EU over the fiscal budget, targeting a deficit of 2.4% of GDP in 2019 and a very gradual decline thereafter. According to the Italian government's calculation, this will keep debt-to-GDP stable in 2019 before it starts falling from 2020, see chart.

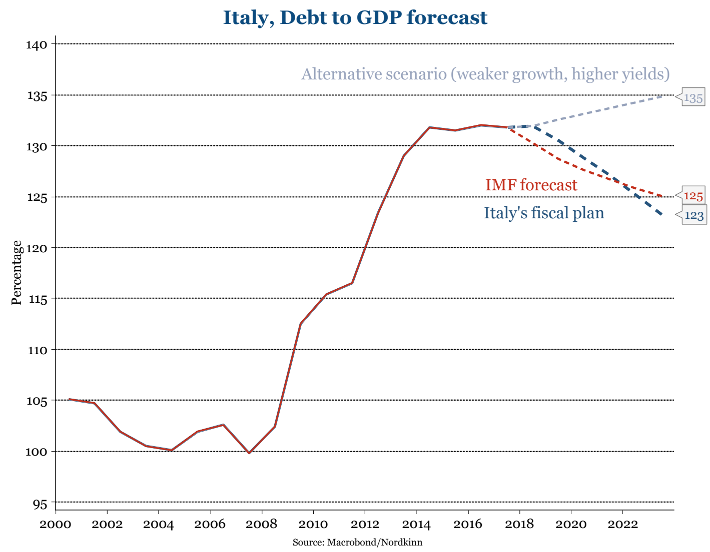
The problem is that the government's growth projections on which the spending plan is based looks wildly optimistic. The government projects GDP growth at 1.6% next year, well above the consensus of institutional forecasts at 1%. The 0.0% growth rate in Q3 2018, which was below expectations, underlines this point. But, the Italian government expects that a loose fiscal policy stance will support growth next year.

However, the economic consequences of a fiscal expansion depend to a large extent on the situation in which the country in question finds itself at the time. In particular, if a rise in the fiscal deficit sparks concerns about the trajectory of the public finances and causes bond yields to rise, the subsequent tightening of financial conditions can more than offset any boost to demand from the fiscal stimulus. This is what we experience in Italy today: The Italian government's budget proposal for 2019 could do more harm than good even to the near-term growth prospects.

Assuming a more realistic growth path of close to 1% GDP growth and a somewhat higher interest rate profile than the Italian government hopes for, the new measures included in the recent budget plan will lead to a deterioration of the fiscal outlook. This is illustrated by the "alternative scenario" in the chart.

Our view is that market tensions are needed in order to exert sufficient pressure on the Italian political system to trigger a change in the policy path and the political rhetoric around it. Surveys suggest that most Italians favour the Euro and trust European institutions more than Italian institutions. Consequently, we expect Rome to back down eventually. But if it doesn't, this has the potential to reignite the Euro-zone crisis.





Nordic markets

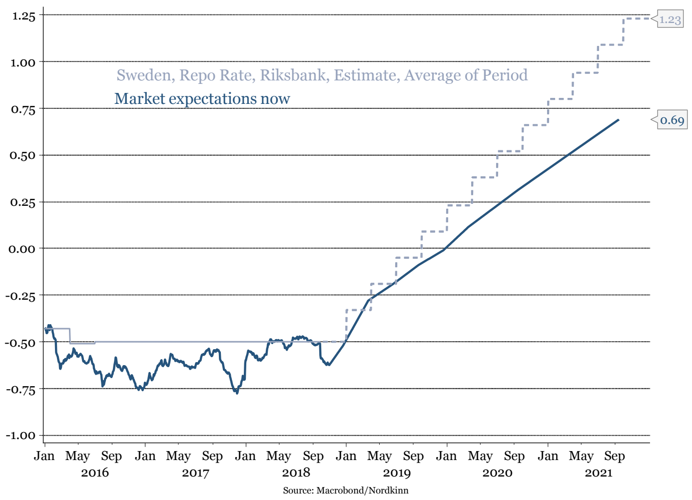
We expect the Riksbank to raise the repo rate by 25 bps to -0.25% on December 20th. The main reason why we expect the Riksbank Board to decide to start raising the extraordinary low repo rate is that the Board is confident that conditions are good for underlying inflation to rise towards 2% ahead. Economic activity remains robust and largely as expected by the Riksbank Board. Importantly, various measures of inflation expectations have been broadly stable around the 2% inflation target for about two years running.

Moreover, September's rebound in non-energy CPIF inflation to 1.6% was certainly reassuring for the Riksbank. That said, even if upcoming inflation prints were to lag the Riksbank's forecast, we still attach a relatively high probability to a rate hike. Our impression is that years of strong economic growth and re-anchoring of inflation expectations has made Riksbank Board members confident that inflation will remain at 2% in coming years. This allows Board members to be less concerned about monthly volatility in CPI outcomes, while focusing more on the underlying drivers of future inflation.

As this will be the first rate hike in more than seven years, we believe that the decision to raise rates will be accompanied by a "dovish" statement, highlighting the desire to move gradually and cautiously. Such strategy has been pursued by other central banks that have announced lift off, such as the Federal Reserve in December 2015, Bank of England in November 2017 and Norges Bank in September 2018.

However, the market is already discounting a cautious hiking approach by the Riksbank. In fact, expected future interest rates remain well below the Riksbank's repo rate forecast, see chart. Consequently, barring an economic of financial shock that would alter the prospects of future inflation, we see limited downside for Swedish interest rates in the near term. Rather, we expect the slope of the yield curve to steepen and the SEK to appreciate ahead. We are trading Swedish interest rate risks actively under the *"Sweden: Credible Inflation Targeting"* theme and remain long the SEK under *"Sweden: SEK FX recovery"*. In addition, we hold several relative value trades that are organised under the *"Sweden: Government relative value"* theme.

Sweden STIBOR market-implied expectations



Source: Macrobond/Nordkinn

The Norges Bank has embarked on a very cautious hiking cycle, planning to raise interest rates in 25 bps steps only twice a year. High household debt is cited as the primary reason behind this gradual strategy, which we believe makes sense. Interest rate increases now will dampen consumption and housing demand more than previously.

In the near term we think incoming information will accentuate the Board's anxiety of raising rates too quickly. In particular, indicators of private consumption and the housing market remain soft. Moreover, subdued wage growth implies that the outlook for inflation over the medium term has not changed despite the recent unexpected rise in underlying CPI inflation. On this basis, we do not expect that the Norges Bank will signal a faster pace of tightening anytime soon.

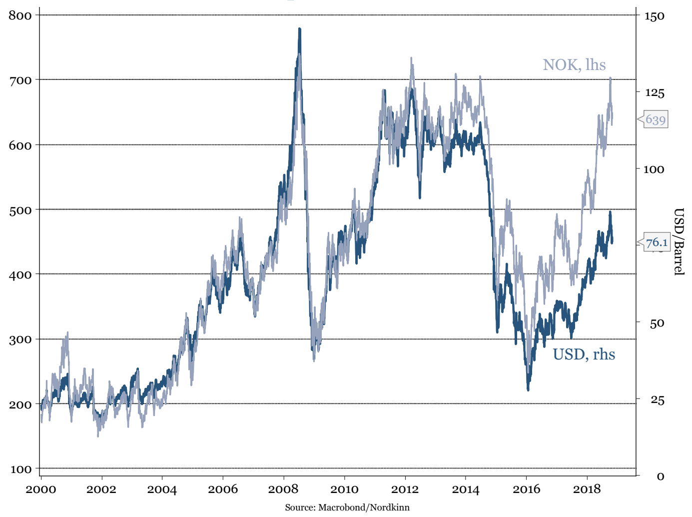
However, if wage pressures begin to build, the Norges Bank will adjust its inflation forecast. In our view, the Norges Bank underestimates the extent to which a booming oil sector activity ahead will push wage growth. While the oil price has corrected down somewhat recently, it remains close to all-time high when measured in NOK, see chart.

If we are right, monetary policy will shift towards a more hawkish stance over the coming years. We will monitor incoming data about wage developments, including the Regional Network reports. As the next major event is the centralised wage negotiations next year, we expect no major changes from the Norges Bank until summer next year.

In late September and early October we meaningfully reduced our short exposure in Norwegian fixed income instruments organised under the *"Norway: Economic revival"* theme. Lower conviction on interest rates was a consequence of the market's reprising to the Norges Bank's interest rate projection. However, after rates corrected lower in late October, we have decided to add exposure to this theme again.

Meanwhile, acknowledging that we now are in a season which historically has been a headwind for NOK, our NOK exposure is limited for the time being. We will remain patient and look for opportunity to re-enter long NOK exposure when we deem appropriate.

Oil Brent price in USD and NOK



Source: Macrobond/Nordkinn

ABOUT NORDKINN

Nordkinn Asset Management aims to create and preserve wealth by consistently providing investors with stable risk-adjusted absolute return through its unique team and local expertise. Operating from Stockholm and Oslo, the team of ten capitalises on their specific fixed income and absolute return backgrounds. Nordkinn aspires to be the leading hedge fund in the Nordic region as measured by risk-adjusted performance, operational excellence and investor appreciation.

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