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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – November 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

Following the sharp drop in October, global risk assets traded anxiously without any clear direction in November as investors were concerned with indicators signalling a slowdown in global growth combined with lingering political uncertainties. Lead by declines in Europe, the JP Morgan Global manufacturing PMI slipped in October for a sixth consecutive month to 52.0, but remained unchanged in November. This level is consistent with 2% annual growth in global manufacturing production, down from more than 4% earlier this year, see chart.

While U.S. economic growth remains strong, there are some signs that the rise in interest rates is beginning to hurt household's disposable income. US home sales has fallen slightly, along with lesser mortgage applications. On the other hand, home prices are still edging up, though at a slower pace, and indicators of consumer confidence remained close to all-time high in November.

In November, UK Prime Minister Theresa May agreed a Brexit deal with the EU. While the Cabinet approved it, some ministers left in agony. However, chances of the Parliament approving it at the December 11th vote are slim and there is a great deal of uncertainty about what happens next if Parliament rejects the deal. Two official reports released on November 28th said all exit options would leave the UK economy poorer, though a no-deal would clearly be the worst scenario. This lingering uncertainty contributed to the general risk-off sentiment in November.

The deadlock between the EU and Italy persisted in November. There is dialogue between the Italian coalition partners about a possible reduction in the budget deficit target for 2019 in order to meet EU rules, which is keeping the spread between Italian and German bond yields broadly stable.

Signs of weaker global growth, various political uncertainties and Fed chair Powell backpedalling from an earlier comment that the Fed Funds target is "long way from neutral", encouraged investors to cut their expectations for future rate hikes by the Federal Reserve during November. Adversely, the market is now even betting that the end of tightening is growing near. Likewise, in Europe, this intensified speculations about a further delay to rate normalisation.

Global IP growth versus PMI

Nordic overview

Interest rates in Scandinavia fell and the slope of the yield curves flattened in November. This was in part a response to the global sentiment depressing interest rates abroad. Also, country-specific factors also motivated investors to cut their expectations for future interest rate hikes in both Sweden and Norway.

Starting with Sweden, the twelve-month rise in CPIF excluding energy fell to 1.5% in October from 1.6% in the previous month. This was a disappointment for the Riksbank, having forecast an increase to 1.7%. Moreover, GDP fell -0.2% in Q3, clearly below the Riksbank's forecast of a +0.3% gain. However, local bank economists said the GDP miss was not unexpected at all, citing various transitory factors (e.g. new car sales tax and warm weather) that pushed down the Q3 figure.

While local bank economists have kept their forecast for a 25 bps repo rate hike before New Year, investors became more uncertain about the probability of a December 2018 hike, as well as the path for the repo rate coming years.

Despite overall disappointing data releases and lower interest rates, the SEK appreciated slightly against EUR and sharply versus NOK in November.

In Norway, core CPI inflation fell back to 1.6% in October, in line with Norges Bank's forecast, following a lofty 1.9% in the previous month. Mainland-GDP expanded at a weaker-than-expected +0.3% in Q3, though a significant share of the miss reflected the drought harming agriculture production. The oil price fell sharply in November, mainly in response to fear of oversupply ahead of the OPEC meeting on December 6th, see chart. Still, business sentiment remain positive for next year.

The decline in oil price, along with various issuance-related receiver flows, contributed to tighter interest rate differentials between Norway and Europe in November. As a consequence of the combined developments in the oil price, rates differentials, risk sentiment as well as seasonal factors, the NOK depreciated against all major currencies and more than -2.0% on a trade weighted basis.

Oil Brent price in USD and NOK

Global markets

In 2018, the global economy expanded at above-potential GDP along with higher inflation and interest rates. Looking ahead into 2019, we expect that the contribution to global growth from the U.S. economy will slow for three reasons. First, the Federal Reserve has reduced monetary policy accommodation. We predict a neutral stance around summer next year.

Second, while fiscal policy will stimulate the U.S. economy in 2019, it will be less than in 2018. Third, trade policy remains a wild card, but given trade deficits the Trump administration seems determined to implement tariffs on USD 259 bln of goods imported from China and has threatened to extend tariffs to all imports from China, which would contribute negatively to growth.

Even though we predict weaker growth, we expect it to remain sufficiently strong for the labour market to tighten somewhat further. In 2018, the decline in the unemployment rate finally became visible in wage growth. Wage cost pressures will rise further in 2019 in our view. Businesses will attempt to pass on some of the cost pressures to consumers, pushing core CPI/PCE inflation upwards.

Given this backdrop, we expect the Federal Reserve to hike the Fed Funds target at the upcoming meeting in December and continue in 2019 with at least two more hikes in 2019. This will bring the key policy rate to 3%, which is consistent with our and the Fed's estimate of neutral. The Federal Reserve may then take a short break to monitor how the economy responds to higher interest rates. If growth holds up well and inflationary pressures keep rising, then the Fed may resume hiking in late 2019 or in 2020 in order to avoid over-heating of the economy.

Against this backdrop, we believe the decline in U.S. government bond yields during November risks being an overreaction. Yields should move higher in 2019 as we anticipate more Federal Reserve hikes than implied by forwards, see chart, and that inflation expectations will rise. We are positioned for this view under our *"USA: Interest rate normalisation"* theme.

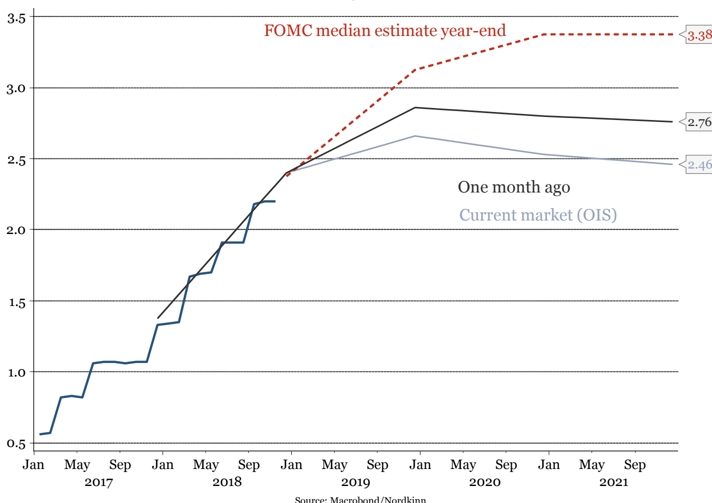
Turning to Europe, economic growth in 2018 slowed more than we expected a year ago, and politics kept providing unfriendly surprises, especially in Italy. This lead to lower European government bond yields than we predicted a year ago.

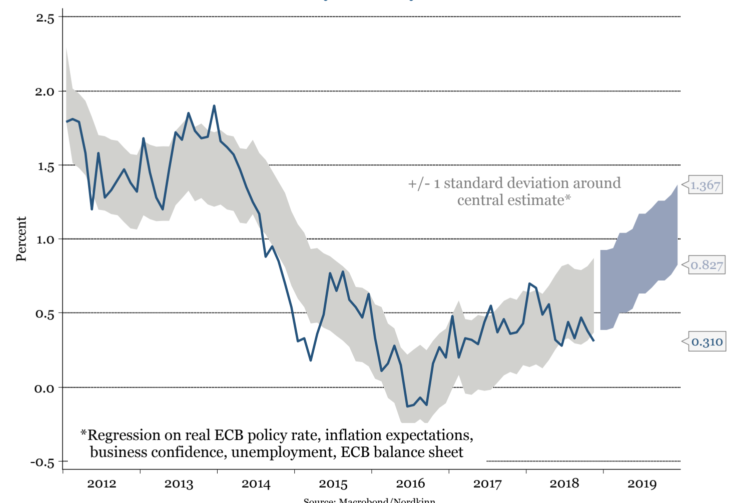
Our outlook for euro area fixed income in 2019 incorporates the expectation that some of the drivers that contributed to lower interest rates in 2018 will take a more positive turn. In particular, we predict a rebound in growth in 2019. This forecast hinges on the critical assumptions that a good part of the Q3 GDP weakness reflected one off factors, such as new mandatory tests for motor vehicle emissions.

Admittedly, the decline in euro area PMIs in October and November are concerning and point to downside risks to our expectations of a growth rebound next year. Moreover, several political event risks have the potential to become a headwind to euro area growth in 2019, including the conflict between the populist government in Italy and the European Commission about the Italian deficit, the UK's planned departure from the EU and the upcoming European Parliamentary election in May.

Despite the weaker-than-expected euro area data, we expect that the ECB discontinues its net asset purchases at the end of 2018. Given the evidence that employment compensation has started to respond to a tighter labour market, see chart, we believe the ECB has become more confident that core CPI inflation will move upwards over the medium term. If our forecast of a growth rebound in 2019 materialises, we expect that the ECB begins raising rates towards the end of 2019. But, if growth continues to slow into next year, the ECB will probably delay rate hikes until 2020.

Based on our central scenario on growth and ECB policy, we predict German government bond yields to rise in 2019, as illustrated by our fundamental bond valuation model, see chart. At current yield levels, long-dated German government bonds looks very attractive to trade from the short side. We express our bias towards higher long-term European bond yields under our *"EMU: QE tapering"* theme.





Nordic markets

We have since November 2017 held the view that the Riksbank most likely will raise its policy rate in Q4 2018, and since April we have been highlighting the December 2018 meeting specifically as the most likely time for lift-off.

Although the October CPI data was disappointing, we commit to our forecast that the Riksbank will raise the repo rate by 25 bps to -0.25% at the upcoming Board meeting on December 20th. We expect the November CPI report to come closer to the Riksbank's projection. But even if the distance between the Riksbank's forecast and realised CPIF inflation were to persist, we expect that the Board motivates a rate hike based on its forecast that inflation will stabilise at 2% over the medium term.

The Riksbank's confidence in reaching its inflation mandate going forward has likely been reinforced by the fact that both survey- and market based indicators of inflation expectations have been broadly stable around the 2% inflation target for about two years running. Moreover, we expect that the Riksbank remains confident that underlying economic growth remains robust despite the Q3 GDP miss, which largely reflected transitory factors.

Admittedly, the Riksbank's forward guidance implies, in theory, that there is a 50-50 split between December and February. Given recent developments in inflation, GDP and market sentiment, we cannot rule out that the Riksbank Board decides to buy itself some more time before pushing the button. The problem with such wait and see strategy is that the market would immediately speculate that a rate hike may not come at all. In other words, if the Riksbank skips December, we expect market rates to fall and the SEK to depreciate sharply. We believe that the Riksbank is aware of this problem and wants to avoid it.

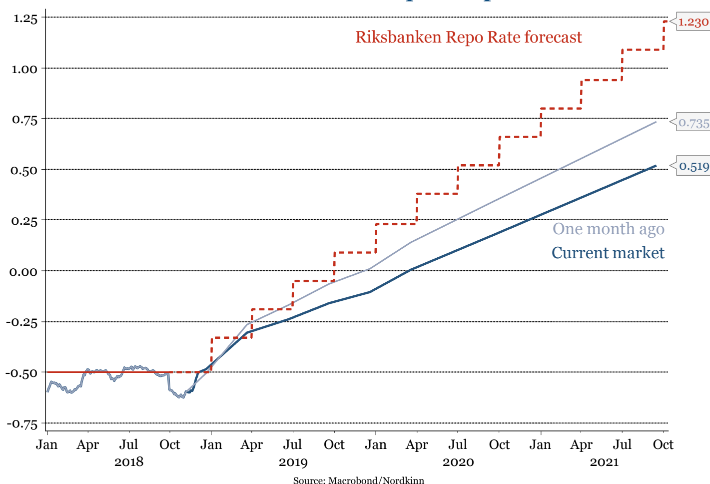
The market is discounting a very cautious hiking approach by the Riksbank, see chart. We expect Swedish bond yields to rise ahead led by the 5-year segment. In FX space, the outlook is for SEK to outperform the euro as monetary policies between the Riksbank diverge from the ECB. We are trading Swedish interest rate risks actively under the *"Sweden: Credible Inflation Targeting"* theme and remain net 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.

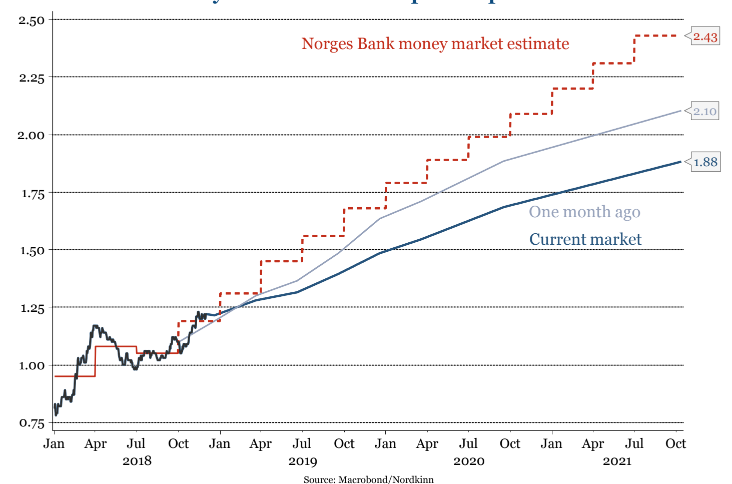
The Norges Bank will maintain its key policy rate at 0.75% in December. The market will focus on the Bank's forward guidance and its interest rate projection. According to the most recent forward guidance, the key policy rate will most likely be increased further in Q1 2019. We expect the new forward guidance to replace Q1 2019 with March 2019, effectively ruling out a rate hike in January.

Regarding the Norges Bank's new interest rate projection, we recognise that incoming information has been mixed. On the downside, indicators of economic growth after summer have been somewhat weaker than expected. While Mainland-Norway GDP were affected by some transitory factors, the underlying trend in household consumption has been weaker than expected. Moreover, growth among Norway's trading partners is somewhat weaker than expected. Last, but not least, the oil price has tumbled around 25% since the peak in October, and is some 15% below the level of cut-off when the Bank prepared its September Monetary Policy report.

Usually, such a fall in the oil price would motivate a downward revision to economic growth in Norway. This time, we expect the effect to be somewhat smaller, in particular for 2019. According to the investment survey released by Statistics Norway on November 22nd, the risk around Norges Bank's latest oil investment forecast for 2019 is actually tilted to the upside. Moreover, the sharp swing from fear of a tight oil market in October to speculation about oversupply in November reflects to some extent political uncertainty, including U.S. President Trump's pressure on Saudi Arabia. We do not expect the Norges Bank to read too much into the volatility in oil in recent months.

On balance, we expect that the new rate projection will be adjusted down marginally given the more uncertain growth outlook in Norway and abroad, though we expect the Board to hold on to March-2019 as most likely for the next move. We expect two rate hikes in 2019, and look for three hikes in 2020. The latter is one more hike than the Norges Bank predicts, which reflects our view that wage growth pressures will start to build next year. Anyway, both our and Norges Bank's interest rate forecasts are well above expectations currently prevailing in the market, see chart. We have increased short duration risk in Norwegian fixed income under our *"Norway: Economic revival"* theme and we intend to exploit seasonal NOK weakness by building long net NOK exposure.





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