Nordkinn Market Review & Outlook – December 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

Global risk assets suffered from a brutal sell-off in December 2018, which became the worst December for U.S. stock market since 1931, in the midst of the Great Depression. The December drama not only ended a bleak year for global stock markets, but also left virtually all asset classes in the red for the year. Notable exceptions include German government bonds.

Meanwhile, oil prices tumbled as fears about weaker oil demand and swelling U.S. shale output more than offset the positive effects of planned production curbs agreed by OPEC in Vienna on December 6-7th.

Indeed, the correlation between global stock prices and oil prices has been very high recently, see chart, driven by a common factor having affected both: Fear of a global economic downturn. The JP Morgan Global manufacturing PMI index fell further to 51.5% in December. Albeit still above 50, which separates growth from contraction, the market seems to price in further decline in 2019.

Worries about the economic outlook also motivated investors to make a substantial reallocation into government bonds in December. As a result, the yield on 10-year U.S Treasuries fell to 2.68% on December 31st from 2.99% a month earlier, yet above the 2.40% level a year earlier. The yield peaked at 3.24% on November 8th.

Despite extensive criticism by President Trump, on December 19th the Federal Reserve raised the key policy rate by 25 bps as we and many with us expected. The vote was unanimous. The FOMC median estimate was adjusted to indicate two rather than three hikes in 2019. The market however, interpreted this as a policy mistake and reacted by not only removing expectation for hikes, but even pricing 1-2 cuts by end 2020.

On December 13th the ECB decided to stop net asset purchases under the QE program at the end of 2018, in line with consensus expectations. Although the ECB tried to retain confidence that the current path for monetary policy remains valid (i.e. on hold at least through the summer), markets paid more attention to the shifting risk picture: President Draghi said risks remain balanced, but are moving to the downside.

Nordic overview

On December 20th the Riksbank hiked the repo rate to -0.25%, as we predicted. Only Deputy Governor Jansson entered a reservation, while the rest of the Board appears convinced that the need for a highly expansionary monetary policy has decreased given that inflation expectations have stabilised around 2%. The market was almost evenly split between expecting a hike and leaving rates unchanged.

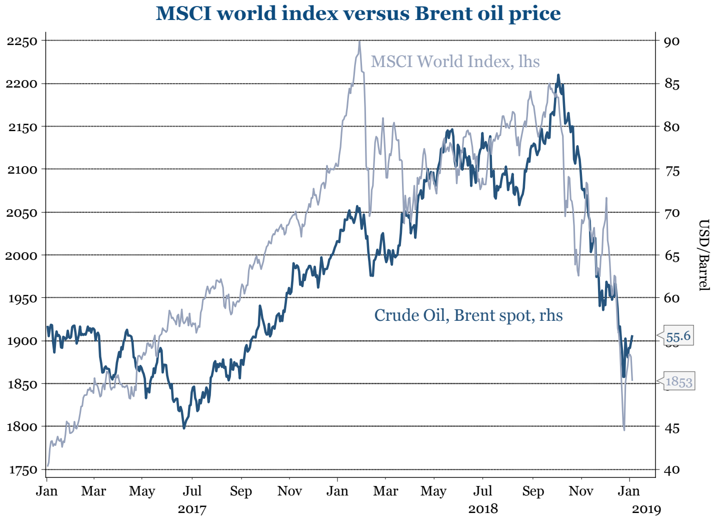
While market interest rates and the SEK rose immediately after the decision to raise rates, the move was muted by the statement accompanying the decision to raise rates. According to the Riksbank, lower than expected inflation outcomes implies that monetary policy needs to proceed cautiously going forward. Consequently, the forecast for the repo rate was adjusted down by -11 bps for Q4 2019 and -25 bps for Q4 2021. The forecast indicates that the next rate rise will probably occur during the second half of 2019.

One week earlier, on December 13th the Norges Bank decided to maintain its key policy rate at +0.75% and explicitly guided March 2019 as the most likely time for the next rate hike. The policy rate forecast was little changed, but as we expected the fall in oil prices and weaker global growth prospects motivated a slightly slower rate rise in 2020 and 2021 than in the previous rate trajectory. After cementing expectations for a hike in March 2019, short-dated market interest rates rose, before falling back as the global market turbulence intensified.

Notwithstanding hawkish central bank actions, the Scandinavian fixed income markets were heavily affected by the bidding frenzy in global bond markets, which also sent local longer-dated yields sharply lower. Swaps and government bond yields moved in tandem, leaving swap spreads broadly unchanged despite the market turmoil.

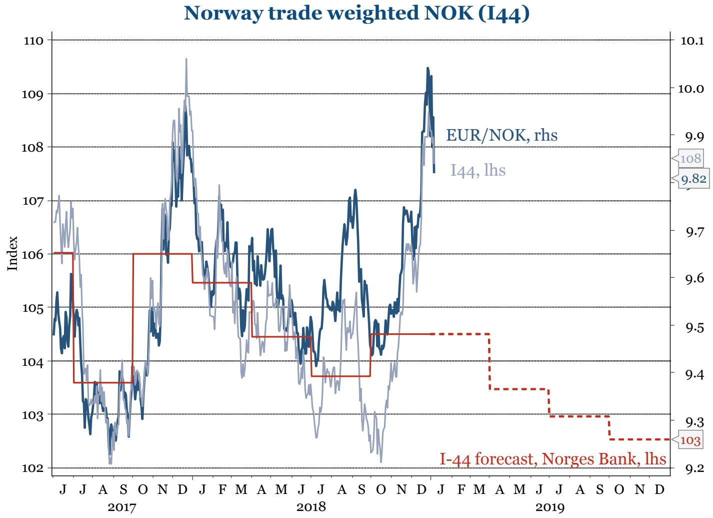
While the SEK remained broadly unchanged in December, the NOK depreciated sharply as thin market liquidity reinforced the impact of a collapse in oil prices and global risk sentiment. EUR/NOK rose to above 10.00 for the first time since the global financial crisis 10 years ago and is currently 3% weaker than the Norges Bank's projection, see chart. NOK/SEK ended the year shy of 1.02, down from 1.06 one month earlier.

MSCI world index versus Brent oil price



Source: Macrobond/Nordkinn

Norway trade weighted NOK (I44)



Source: Macrobond/Nordkinn

OUTLOOK

Global markets

While the pace of global growth evidently slowed during 2018, the U.S. economic environment did not change that much in the weeks leading up to the Q4 2018 sell-off in risky assets, followed by the significant safe haven flows into government bonds. The 5-point drop in the U.S. ISM manufacturing survey in December was indeed disappointing, but this appears to have been a response to the souring market climate rather than the cause of it. As such, we agree with Fed-chair Powell who on January 3rd said that markets had moved "well ahead of the data".

At the same time, almost half of the ISM industry respondents mentioned tariffs as a source of weaker prospects, suggesting that the US-China trade war is affecting both parties now. In our view, this implies that further increase in tariffs is unlikely. The decision by China in December to cut tariffs on imported American cars from 40% to 15% is the first concrete sign of a cooling in the trade war between the world's two largest economies. Moreover, the profit warning from Apple explicitly pointing out weakening demand in China adds pressure for Trump to find a constructive solution to the trade war at this week's meeting, which would reduce the risk of a sharp global slowdown.

The Federal Reserve's decision to raise the Fed Funds target range to 2.25-2.50% in December implies that the key policy rate is now at the lower end of a broad range of estimates of the level that is neutral for the economy – that is, neither speeding up nor slowing down growth. The broad range of estimates for neutral rate is between 2.50% and 3.50%.

Given that U.S. interest rates are now broadly "normal" according to this definition, we have closed our *"USA: Interest rate normalisation"* theme initiated in October 2015, two months prior to the first hike. Even though we do not think that the rate hiking cycle is over yet (as at current we predict two more rate hikes in in this cycle) we do believe that recent developments implies that the Fed will take at least a six month pause before raising rates further. The market however expects almost two rate cuts by year-end 2020, see chart, which we struggle to discount using current fundamentals.

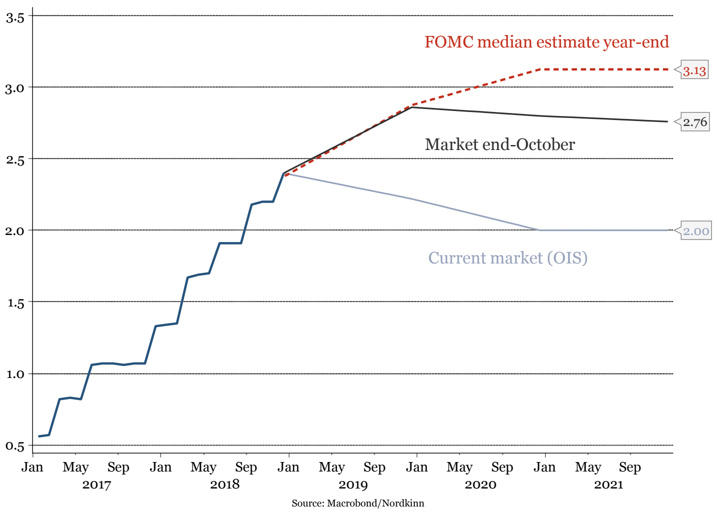
More specifically, we foresee a rise in the term premium element of long-term bond yields. This is the extra compensation (risk premium) investors' demand for the risk associated with holding a long-term bond. We expect the term premium to rise for two reasons. First, the demand/supply balance is about to change as the Federal Reserve is letting its balance sheet shrink and the ECB has ended net asset purchases. All this means that the private sector must absorb the ever rising supply of government bonds in 2019, as the expansionary fiscal policy of the Trump administration is expected to push the budget deficits to about 5% of GDP.

Second, the negative correlation between bonds and equities should weaken if our prediction of rising inflation and inflation expectations proves right. Investors would then be less willing to buy bonds as a hedge against stock price declines. Following the correction at the end of 2018, the 10-year government bond yield is now at the lower end of our model fair-value range, see chart. Against this backdrop, in December we launched a new investment theme named *"USA: Return of term premium"* that benefits from enlarged term premium and a steeper yield curve, replacing *"USA: Interest rate normalisation"*.

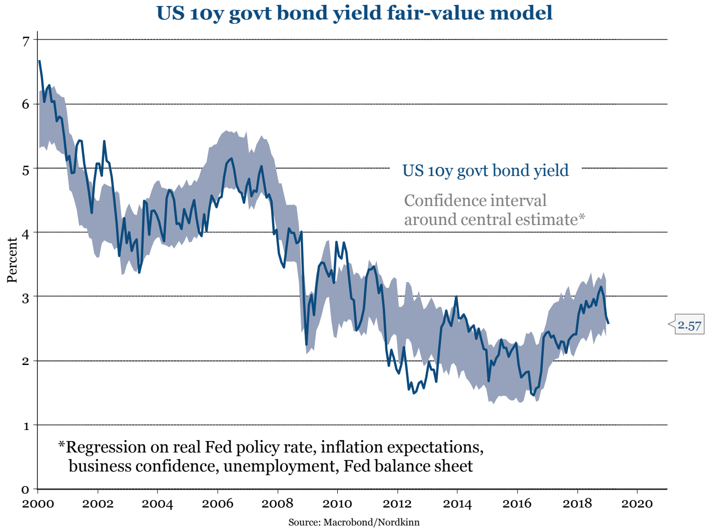
Turning to Europe, the ECB's decision to end net asset purchases in December put an end to our long-held *"EMU: QE tapering"* theme. The market impact of ending QE during Q4 2018 turned out to be muted, for two reasons. First, the ECB successfully introduced a forward guidance that pushed back expectations of future rate hikes, offsetting the prospected change in the bond demand/supply balance. Second, euro area economic growth slowed more than expected in 2018.

Looking ahead, 2019 will be another year of considerable political uncertainty across several dimension, including the UK's planned departure from the EU and the upcoming European Parliamentary election in May. Against this background, in December we launched a new investment theme named *"EMU: Political uncertainty"*, which organises our euro-related fixed income trades. The theme mainly consists of strategies that are exposed to changes in market volatility.

US Federal Funds rate, FOMC dots and market



US 10y govt bond yield fair-value model



Nordic markets

Despite the significant market turbulence and a lower than expected increase in CPIF excluding energy, the Riksbank decided to hike rates by 25 bps in late December occurred. In fact, even though the market was almost evenly split between expecting a hike and leaving the repo rate unchanged, Governor Ingves said at the press conference that the decision was not "all that hard".

This lends support to our view that the Riksbank's inflation targeting strategy is shifting to a more flexible approach, which is more in line with the strategies conducted by most other central banks. Instead of giving a very large weight to the difference between historical inflation and the 2% target, our interpretation is that the Riksbank is now about to give greater weight to achieving a reasonable trade-off between the path for inflation and the path for the real economy, even though low and stable inflation over time is of course the main objective of monetary policy.

The key reason why we believe the Riksbank is moving away from a rather strict inflation targeting policy is that both survey and market based measures of inflation expectations have stabilised around 2% for two years running, see chart. Thus, the very expansionary monetary policy since 2015 has successfully contributed to restore credibility to the 2% inflation target. Credibility is a crucial precondition for flexibility.

Looking ahead, we agree with most economists warning that the Riksbank's expected path for inflation looks somewhat optimistic, albeit less so for 2019. As inflation expectations are likely to remain around 2%, the Riksbank is enabled to discontinue its unconventional policy measures including negative rates and QE. Thus, this could even allow for a hike back 0% in September or October. Trades consistent with this view is now organised under a new theme: *"Sweden: Unwinding unconventional policy"*, which replaces *"Sweden: Credible inflation targeting"*.

Furthermore, we expect the SEK to outperform the Euro as monetary policies between the Riksbank diverge from the ECB (*"Sweden: SEK FX recovery"*) and we hold several relative value trades that are organised under the *"Sweden: Government relative value"* theme.

Even though global growth has softened, the condition for ongoing robust growth in Norway remains in place for 2019. Notwithstanding the recent drop in oil prices, petroleum investments are set to rise by around 10%, which implies significant spill-over effects to other sectors as well.

Given that the Board mentions March 2019 as the "most likely" meeting for raising the key policy rate further, it would take a sharp deterioration of the growth outlook to prevent a hike at that meeting. Based on recent survey data and prospects of a significant boost from the petroleum sector, we find it hard to see why growth in Norway will slow dramatically near-term despite increased uncertainty about the global environment.

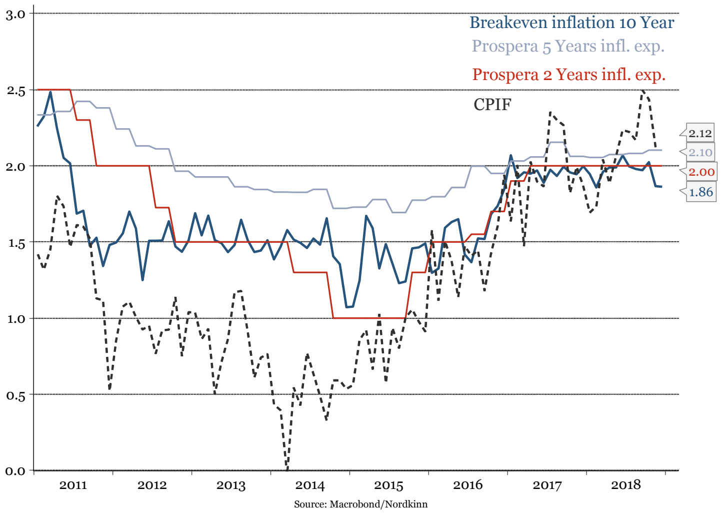
Regardless, the market currently prices in less than 40% chance of a March 2019 hike according to our estimates. The full 25 bps hike is priced by year-end 2019. For comparison and as at current, we predict 50 bps of tightening in 2019 and an additional 75 bps in 2020. This would bring the key policy rate to 2.00% by end-2020, which is almost 1.00% above expectations currently prevailing in the market, see chart.

While slower growth abroad and a much lower oil price could pull down growth further out in time, we do not expect the Norges Bank to change its strategy of gradually removing policy accommodation unless domestic data shows signs of weakness. This is unlikely to occur before the March meeting in our view. And if history is any guide, the Norges Bank does not refrain from raising rates months after the U.S. economy enters a recession, which in our view will not occur before 2020 at the earliest.

Regarding investments, we remain short Norwegian fixed income, but has decided to organise the trades under a new investment theme named *"Norway: Interest rate normalisation"*, which replaces *"Norway: Economic revival"*. The name change reflects the fact that the strong economic revival that begun in 2016 has eroded all economic slack, which implies that policy accommodation is no longer needed even if growth were to slow to a more normal pace in coming years.

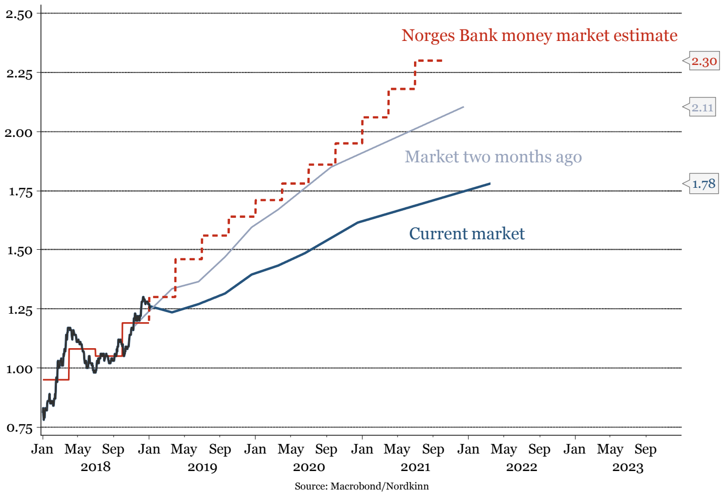
We deliberately scaled in long NOK exposure during the sharp seasonal-related sell-off in December. Looking ahead, we expect the NOK to appreciate and come closer to Norges Bank's forecast during 2019.

Sweden inflation expectations



Source: Macrobond/Nordkinn

Norway NIBOR market-implied expectations



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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