NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – January 2019

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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

As fears of an imminent global recession caused by policy mistakes receded in January, risk assets trimmed losses from the final months of last year. Federal Reserve officials said on numerous occasions that the central bank can be patient on interest rate moves and on January 30th the FOMC formally dropped the forward guidance on rates from its statement, no longer signalling "some further gradual increases". This boosted confidence among investors that the Fed is on an extended pause and close to a peak in tightening interest rates. This contributed to a weaker USD and JPY, whereas the currencies of Emerging Markets and commodity producers (CAD, AUD and NOK) appreciated, see chart.

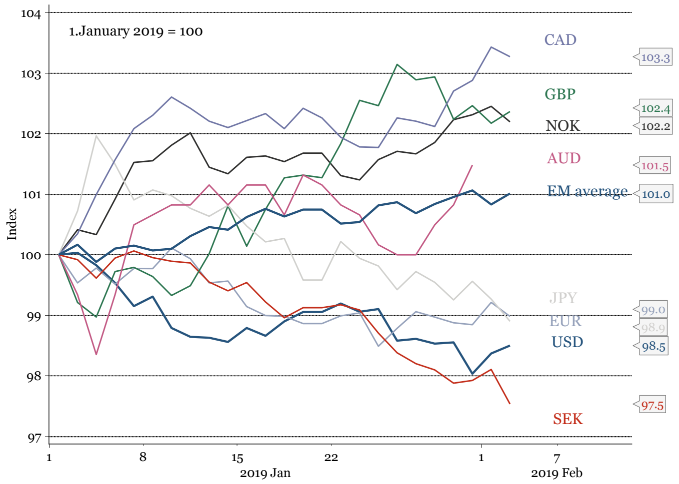
Regarding monetary policy in Europe, the ECB's decision to signal downside risks to growth at its meeting on January 24th was interpreted by investors as a signal of a later lift-off date for key ECB interest rates.

Moreover, trade talks between China and the U.S. resumed in an attempt to pave the way for a deal to end the tariff war before a deadline on March 2nd. Although officials said there had been significant movements in the negotiations, Trump said on January 30th that there will be no final deal until he meets with President Xi. Meanwhile, the Chinese government is ramping up stimulus plans, including tax cuts and infrastructure spending, to stave off economic slowdown and effect of trade war.

Furthermore, the market's perception of the probability that Britain will leave the EU without a deal decreased, triggering a rally in GBP in January, see chart. This move in sentiment occurred in spite of a wider than expected defeat for Prime Minister May at the House of Commons to secure a Brexit deal on January 15th. Further, on January 29th, the Parliament voted in favour of an amendment that called for the backstop to be replaced with "alternative arrangements to avoid a hard border" in Ireland, but EU politicians firmly said they will not renegotiate the deal.

U.S. government bond yields rose slightly in January as markets removed expectations of a cut in interest rates during the next twelve months, while German bond yields ended the month broadly unchanged. Consequently, the 10-year transatlantic bond yield spread widened in January, yet it remains far off its peak from November last year.

FX indices, effective exchange rates since 1.January 2019



Source: Macrobond/Nordkinn

Nordic overview

Four months after its election, Sweden finally got a new government. The government remains being a coalition between the Social Democrats and the Greens, but support parties are now the Centre Party and the Liberals instead of the Left Party. On the margin, the negotiated platform seems to imply an expansionary fiscal policy stance.

On the data front, December inflation was spot on Riksbank's forecasts for CPIF and CPIF excl. Energy at 2.2 % y/y and 1.5 % y/y respectively. House prices climbed around 0.5% in December adjusted for seasonality, continuing their recovery from the late 2017 correction.

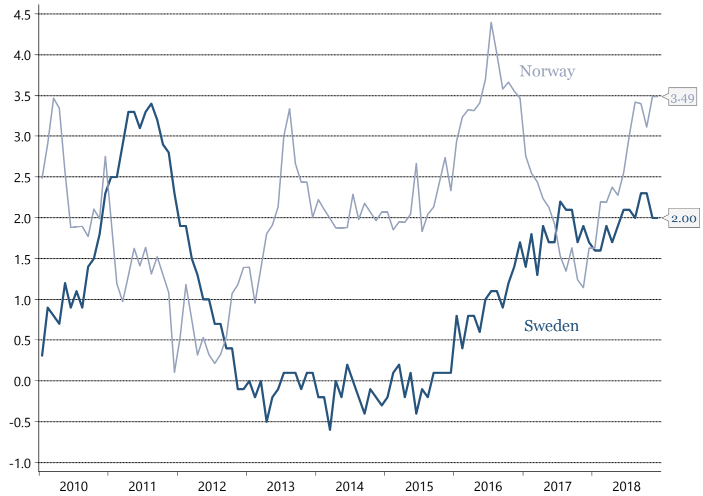
The market reactions to policy and economic data were muted in January. Swedish government bonds underperformed their German peers slightly, but the SEK remained subject to downward pressure as EUR/SEK rallied somewhat and NOK/SEK even more. The rise in the 3m STIBOR fixing continued in the first week of January before coming to a halt mid-month.

In line with the normal seasonal pattern, the NOK appreciated significantly in January following the severe December sell-off. The seasonal effect was reinforced by the combined stabilisation in risk assets and recovery in oil prices.

Furthermore, the Norges Bank's monetary policy statement also lends its support to the NOK. While the Norges Bank decided to maintain its key policy rate at 0.75% on January 24th, the Board confirmed its intention to raise rates at the next meeting on March 21st. According to the Board's assessment, new information since the projections made in December were mixed, but indicated on balance little changes to the outlook for the policy rate in the coming period.

On the data front, measures of industrial confidence have been very strong recently in Norway, in spite of weaker readings among trading partners. The main explanation for this is that oil investments are boosting activity. Meanwhile, we caution that private consumption is being restrained by the energy-driven rise in CPI-inflation to 3.5% in December, see chart.

CPI, change y/y %



Source: Macrobond/Nordkinn

Global markets

The slowdown in global economic growth is in our view not as dramatic in nature as investors fear. Starting with the U.S., the pace of annualised GDP growth in Q2 and Q3 at 4.2% and 3.4% respectively, could never be sustained. In Q4, growth slowed to around 2.7% according to the Atlanta Fed's Nowcast model, and will probably slow somewhat further in Q1 2019. As we see it, growth is merely approaching the Fed's long-term estimate of potential growth of 1.9%. This is natural when capacity utilisation is high and the economy receives less support from fiscal and monetary stimulus. While the government shutdown poses a near-term risk to the U.S. economy, the effect on growth is likely to be completely reversed once the shutdown ends.

Based on our judgement, the probability of a U.S. recession in 2019 remains low. This is because there are no clear signs of overheating in labour nor goods markets, having heralded some recessions in the past, nor overspending or credit excesses, having preceded others.

Recent communication by Fed officials suggests that the central bank will be patient and stay on hold for the next few FOMC meetings. The lower than expected inflation readings recently strengthens this view.

Looking outside the U.S., the slowdown has been deeper. China's economy grew by 6.6% in 2018, the slowest annual rate since 1990, as the U.S. trade war and, perhaps more importantly, policy decisions to deleverage the economy have taken a toll on sentiment and spending. However, in January, China's central bank responded to the slowdown by cutting the bank's required reserve ratio. Looking ahead, we expect China's economy to be muddling through: Slowing, but not realising the worst fears of downside risks to the global outlook.

The euro area is being hit by weakness in China, but domestic demand continues to underpin the economic expansion. Moreover, the drag on growth caused by the introduction of new emission standards on cars should turn into a tailwind in 2019 as production resumes. Furthermore, the resolution of the conflict between EU and Italy over its 2019 fiscal budget is reducing downside risks to growth.

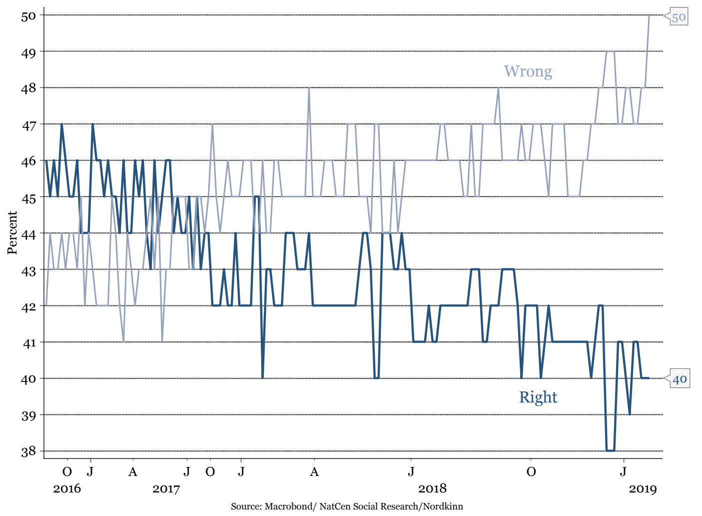
After the Drama in January, the Brexit process remains very complex. That said, the probability of a hard Brexit seems low, as few MPs in the House of Commons favour a hard Brexit, and any course of action that the U.K. takes must have the support of the British parliament. In our view, Brexit will have to be delayed due to the lack of time now available to agree on a deal and to seek approval from the EU member states. We expect the final outcome to either be a "soft Brexit" or "no Brexit", both which would be market friendly.

A new referendum is a possible end-game of this saga. Polling trends suggest that if another referendum were held, the "Bremain"-side would probably win, see chart. However, the support for a second referendum is currently poor among MPs and will need to gain significantly more support in order to become realistic.

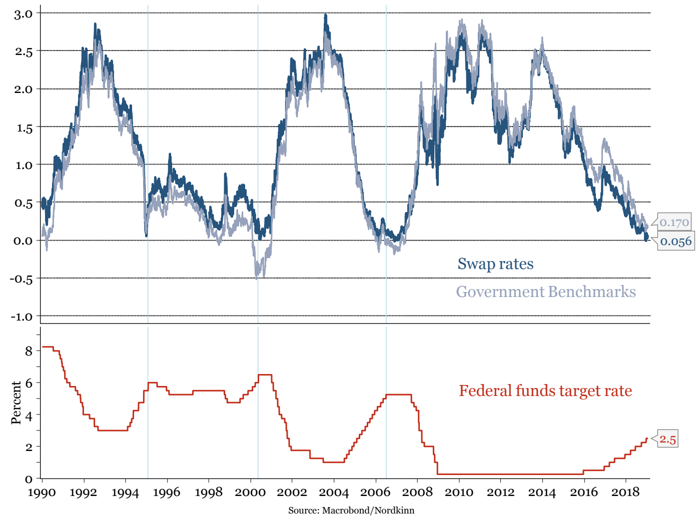
Turning to investment conclusions, the low probability of a no-deal Brexit and the European Commission's truce with Italy over Rome's spending plan implies that the risk of policy mistakes hampering growth in Europe has fallen, at least in the short-term. Consequently, we commenced building long EUR exposure against USD, organized under our *"EMU: Political uncertainty"* theme. The main reason for being constructive on e.g. the EUR/USD cross is that a further slowdown in China could hurt Europe more than the U.S.

In the fixed income space, we continue to expect a rise in the term premium element of long-term bond yields, which is very depressed at the moment. Moreover, we are positioned for a steeper US swaps curve. If history is any guide, the 2s 10s swaps curve never inverts even when the treasury curve does, see chart. Furthermore, the yield curve normally stops flattening (and often starts steepening) as soon as the Fed ends its tightening cycle. While we expect a protracted pause, we are contrary to market consensus not convinced that the Fed is permanently done hiking. Consequently, we hedge this trade with active trading U.S. money market futures.

In hindsight, was Britain right or wrong to vote to leave the EU?



United States 10 Year-2 Year



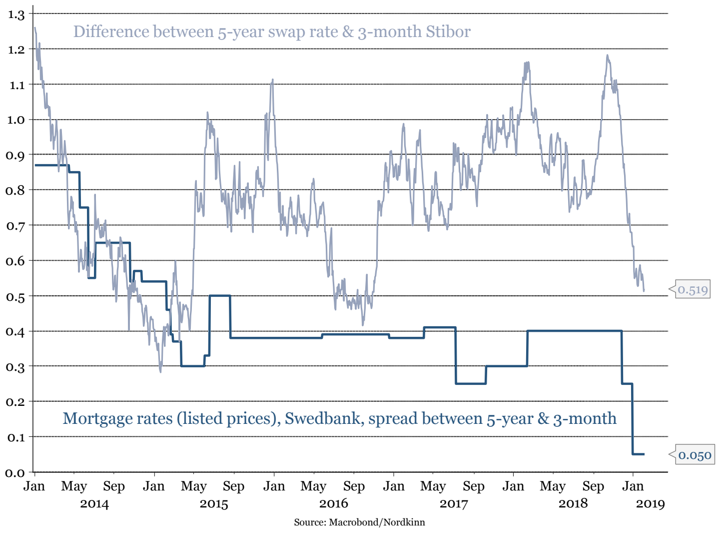
Nordic markets

We expect the Riksbank Board to maintain the path for the repo rate unchanged at its meeting on February 13th. The rate path will indicate a first rate hike in the second half of this year, most likely in September or October. Given tighter labour market conditions and the re-anchoring of inflation expectations, we expect the Board to remain confident that underlying inflation (CPIF excluding energy) will return to target, allowing patience towards monthly deviations from its inflation forecast. Meanwhile, the Board will express concerns over the global economic outlook, yet not enough to alter its forecast for economic growth meaningfully. Note that the Riksbank is already forecasting a slowdown in Swedish GDP growth to 1.5% in 2019, from 2.3% in 2018.

We anticipate the Riksbank to wait a few months before sending any new signals on how it will handle maturing bonds and coupons from the QE program when the current program expires in June this year. But before the current program expires, we expect the Riksbank to announce that it will continue reinvesting redemptions and coupon payments on maturing government bonds after summer this year. The incentive for the Riksbank is to retain presence on the market and attain smooth asset purchases going forward. If we are right on this view, Swedish government bonds should remain bid for the remainder of this year.

Meanwhile, the significant flows from variable interest rate mortgages to fixed rates seen recently should, if continued, put some upward pressure on interest rate swaps ahead. We see two reasons why this trend will continue. Firstly, years of rate hike talks have finally become a reality. Secondly, the relative price of a fixed loan to a variable one has collapsed, see chart.

Regarding implications for investments, our own forecast for the repo rate is aligned with the Riksbank's; that negative rates will be abandoned in the second half of this year. This is more hawkish than expectations currently prevailing in the market. Trades with exposure for higher rates are organised under *"Sweden: Unwinding unconventional policy"*. Our view on swaps versus bonds are organised under *Sweden: Government relative value"*.



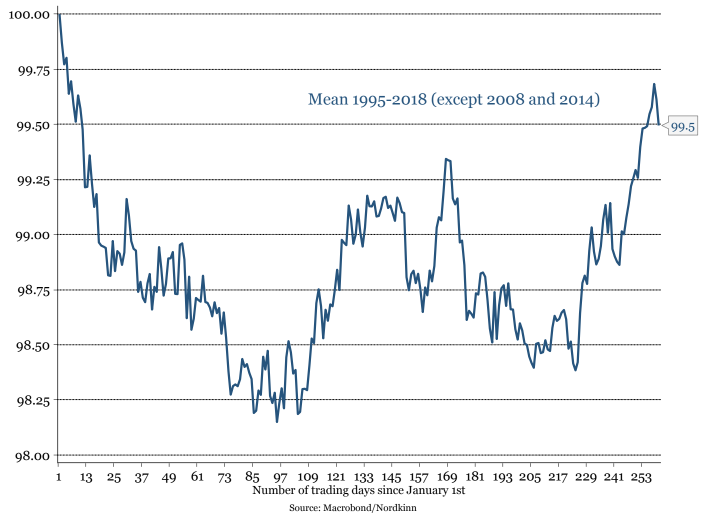
The Norges Bank will almost certainly raise its key policy rate by 25 bps to 1.00% on March 21st. Given that the board is explicitly guiding the March meeting as the "most likely" occasion for raising the key policy rate further, it would take a sharp deterioration of the growth outlook to prevent a hike at that meeting. However, following the adjustments in market rates during January, this hike is almost fully priced. Accordingly, the outlook for interest rates beyond March is the only thing that matters for markets now.

While the pace of future moves will depend on incoming data, the Norges Bank will stick to its strategy of gradually removing policy accommodation going forward. There are three reasons behind this. Firstly, the latest data shows that underlying inflation is slightly above target. Secondly, measures of resource utilisation are above normal levels, which usually means inflationary pressures are building. Thirdly, the growth outlook for 2019 remains strong regardless uncertainty about the global outlook.

Oil investments, which are set to rise by at least 10% in 2019, is the key factor behind the relatively upbeat outlook for the Norwegian economy. This implies significant spill-over effects to other sectors of the economy, which will cushion any negative impact of weaker global growth. In addition, the negative impact of lower housing investments will fade.

Given the relatively strong macro outlook combined with prospects for tighter monetary policy in Norway, the medium-term outlook is for the NOK to appreciate somewhat further. Contrary to the situation in Q4, short-term factors such as seasonality and risk sentiment are also NOK-supportive for the time being, and we see this tailwind lasting for at least another couple of months. We remain constructive on the NOK under our *"Norway: NOK FX recovery"* theme.

In rates, we continue to be outright short NOK-rates, but only in the front end of the curve given its relatively larger sensitivity to the forward guidance of the Norges Bank. Considering the early stages of the tightening cycle in Norway, we expect a relative flattening of the NOK versus the USD interest rate curve and we expect NOK rates to underperform EUR in absolute terms. These trades are organised under *"Norway: Interest rate normalisation"*



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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