

NORDKINN

— ASSET MANAGEMENT —

Nordkinn Market Review & Outlook – Mar 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

Global government bond yields fell sharply in March, see chart, as repeated evidence of weaker industrial activity among developed economies prompted monetary policy responses by major central banks. Lead by a sharp fall in Germany, the euro area manufacturing PMI index fell for the eight consecutive month to 47.5 in March, signalling a deeper contraction in activity. Meanwhile, the official Chinese PMI index jumped more than two points to 50.8, suggesting that the cyclical downturn may finally have found a bottom.

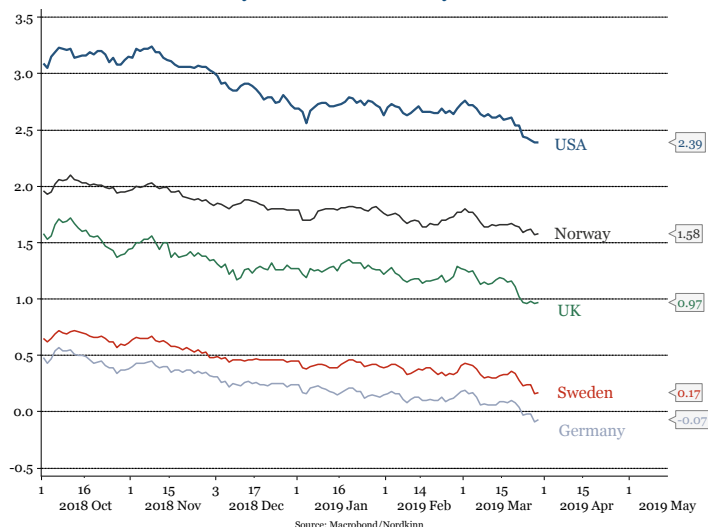
As a response to the weaker euro area data, on March 7th the ECB presented a significant downward revision to the ECB's GDP forecast for 2019 to 1.1%, from 1.7% previously, and with downside risks prevailing. Inflation forecasts were also lowered, in particular for 2019.

Reflecting these updated forecasts, the ECB changed its forward guidance for monetary policy ahead, to indicate that rates will stay at their current levels at least through "the end of 2019", compared with "summer of 2019" in the previous statement. The ECB also announced a new series of seven quarterly TLTRO auctions, taking place between September 2019 and March 2021. The change in the ECB's forward guidance already at this meeting was a surprise, hence the EUR depreciated and government bond yields declined across all maturities following the announcement.

After leaving the Fed Funds target rate at 2.25% to 2.50%, the FOMC participants slashed their forecast ("dot plot") for future rates to indicate zero hikes in 2019 compared to two hikes at the December meeting. Moreover, the committee presented a plan for tapering the balance sheet roll-off from May to end it in September. The adjustments were more dovish than expected. At the Press conference, Fed-chair Jerome Powell said "our overarching goal is to sustain the expansion".

The Brexit drama continued in March without any obvious solutions. On March 12th and on March 31st the House of Commons rejected the Withdrawal agreement for a second and a third time respectively. By April 12th, Theresa May is now left to decide whether the UK should leave the EU without an agreement or demand a much longer extension.

10y Government bond yields



Nordic overview

Swedish inflation fell again short of expectations, with CPIF easing to 1.9% and CPI excluding energy at 1.4% in February. The outcome was 0.4 and 0.3 percentage points below the Riksbank's forecast, respectively. Moreover, confidence indicators for the Swedish manufacturing sector edged lower, indicating that there is some spill-over effects from weakness in the euro area to Sweden. The soft data fuelled expectations of a delay to the Riksbank's hiking intentions.

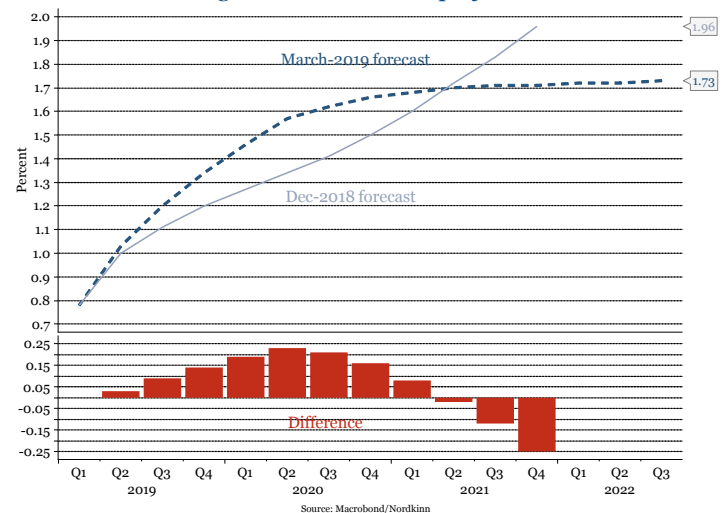
At the same time, speeches by Riksbank officials did not suggest that the recent inflation data would change the path for monetary policy significantly. Skingsley ("median" voter) emphasised that confidence in the target has strengthened and was "not really" worried about the latest CPI outcome, whereas Ohlsson ("hawk" voter) said he does not currently see anything that speaks against the Riksbank's forecast of another hike this year.

The Norges Bank raised its key policy rate by 25 bps to 1.00% at its meeting on March 21st, as widely expected. However, following an upward revision to the forecast for GDP growth and inflation for both this year and next, the near-term rate path was revised materially higher to signal the possibility of three rate hikes in 2019 compared with two previously.

Interestingly, the revised rate path attaches a relatively high probability to another rate increase already in June. This was more hawkish than what was implied by market pricing, which had been dampened in recent months by concerns around weaker global growth and more dovish policy abroad. The rate path was lowered somewhat further out, indicating a peak at 1.75% compared with 2.00% previously, see chart.

Consequently, the slope of the Norwegian yield curve flattened sharply, driven by both higher expected rates in 2019 and 2020, and lower forward rates from 2021 and beyond. The NOK appreciated against all major currencies immediately after the publication of the Monetary Policy report, but the currency trimmed gains the following days as global risk sentiment deteriorated.

Norges Bank interest rate projections



OUTLOOK

Global markets

The yield on 10-year U.S. government bonds fell below the three-month Treasury bills' yield in March, prompting warnings that the U.S. is heading for recession later this year or in early 2020, see chart. In our view, the signal of an inverted curve conflicts with a rather constructive economic outlook for the U.S. economy, and the relatively tight spreads in the credit markets.

The main reason behind the misalliance between the inverted yield curve and what we believe is a rather benign economic outlook, is that the sharp fall in the German 10-year yield to negative territory is putting downward pressure on longer-dated U.S. yields as well. Moreover, the Fed's announcement that it will taper its balance sheet reduction starting already in May, which was earlier than expected, may also have added to the downward pressure on longer-dated yields. For these reasons, we believe that the U.S. yield curve inversion overstates the probability of a U.S. economic recessions over the coming year.

While incoming data keeps pointing to weaker global growth in Q1 2019, especially in Europe, we continue to expect that global growth will reach a bottom sometime during 2019 before moving higher. Our expectation of stabilisation in growth hinges on what happens to China, which has been the epicentre of the recent global economic weakness.

In China, there are some encouraging developments ongoing. Firstly, while it is too early to signal the "all-clear!" regarding a trade deal with the U.S., the news of late has been uplifting. Secondly, there are signs that China is abandoning its deleveraging campaign and is deploying monetary and fiscal stimuli measures aimed at stabilising growth. Thirdly, the jump in manufacturing PMI for March indicates a sharp rebound in industrial production, see chart.

If the Chinese business cycle is about to turn positive again, European exporters will benefit. In addition, domestic demand in the euro area will also gain from easier monetary and financial conditions, as well as from winding down of some supply constraints related to the German automobile production and the "yellow vest" protests in France.

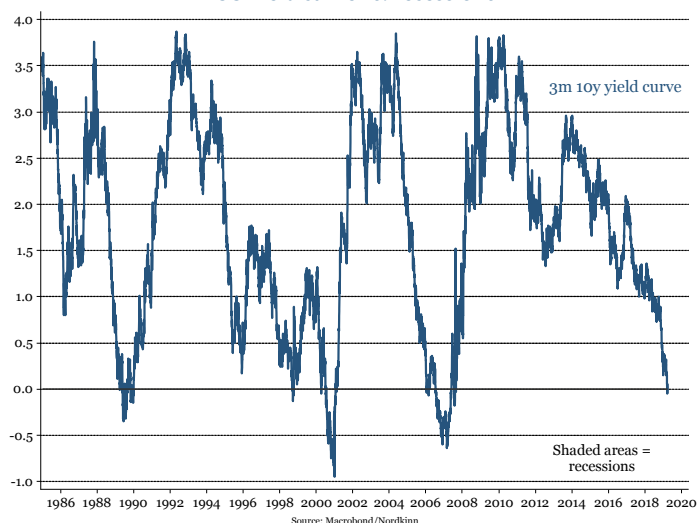
However, even if we are right that global growth will reaccelerate, we expect government bond yields to lag. This is mainly because major central banks have removed all projected interest rate increases for 2019.

The 10year German Bund yield now hovers close to an all-time low. Theoretically, there is no reason why the Bund yield could not be parked in negative territory for an extended period. Yet, we believe this requires market not only to price out any prospects for policy normalisation from the ECB, but also to price in deposit rate cuts deeper into the negative rate abyss. All doubts aside, we stick to our belief that the hurdle for the ECB to move deeper into negative rates remains reluctant and high.

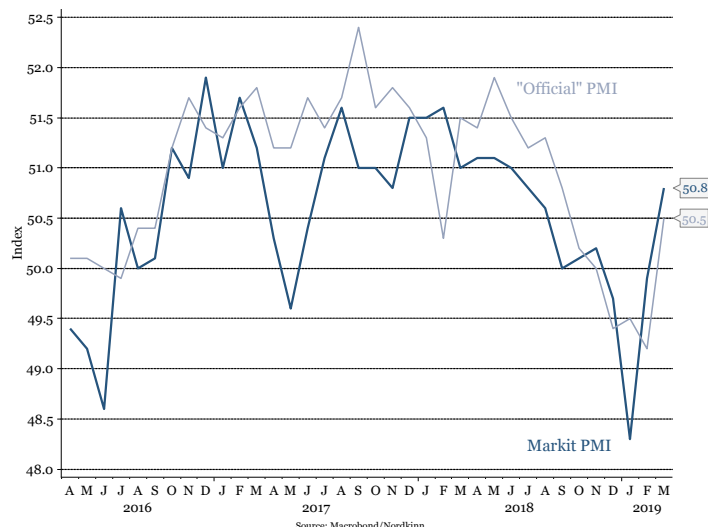
Consequently, barring a major improvement in economic conditions over the coming few months, we judge the upside potential for global bond yields in 2019 being somewhat limited. For this reason, we have reduced our exposure associated with the expected rise in the term premium element of long-term U.S. bond yields.

Considering the negative cost of carry associated with short duration trades, it is in our view appropriate to wait for a better timing to strategically go short government bonds in major developed markets. Overall, a low share of risk allocated to global relative to Nordic markets remains appropriate in our view.

US Yield curve vs. recessions



China PMI



Nordic markets

Incoming data for Sweden points to a slowdown in GDP growth following a blistering Q4 report. This is already expected by the Riksbank, forecasting only 1.3% GDP growth in 2019. However, given weakness in euro area economic activity, the balance of risk is skewed towards a weaker economic outcome than the Riksbank currently predicts. On top of that, the latest inflation data has been weaker than expected.

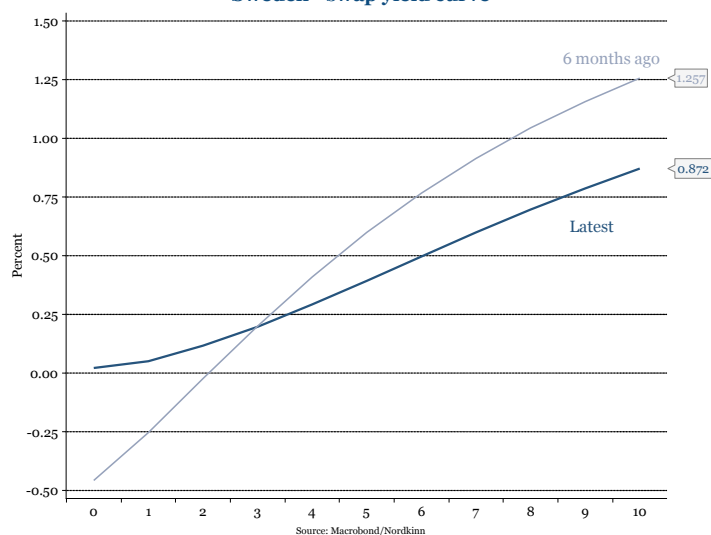
This notwithstanding, we still expect the Riksbank Board to signal a rate hike in 2019 when it presents updated forecasts on April 25th. The main reason is that the Riksbank believes confidence in the inflation target has strengthened, allowing for more tolerance for inflation misses now compared with a couple of years ago. Inspired by this confidence, the Bank seems motivated to gradually abandon unconventional policy, including the negative repo rate and the ever increasing balance sheet.

Our forecast is for an end to the reinvestments of redemptions by summer this year, which in practice would mean no further build-up of the balance sheet, as was the case when the central bank started to pre-reinvest the last bond redemption 15 months in advance. Furthermore, we also expect the repo rate to be hiked to zero during Q3. The Riksbank's forecast for the repo rate in 2020 and 2021 could be revised down somewhat in response to the weaker outlook for growth and inflation over the medium-term.

Turning to investment implications, the Swedish yield curve has reached a very flat shape up to the 5-year segment, see chart, hence a further downward pressure on global bond yields would put most pressure on longer-dated rates and resulting in a greater curvature in the relationship between two, five and ten-year yields. Directional positions, but still with a relatively muted co-movement with global rates moves, are concentrated to the very short end of the yield curve where activities are more associated with domestic factors, like Riksbank decisions.

In addition, the monetary policy changes we expect should give rise to some gradual shifts of the Swedish government bond curve relative to the swap curve (ASW-spreads). We assess such relative value positions closely and foresee spreads to stay wide in shorter maturities while longer spreads could tighten in accordance with less of, or a complete stop to, bond purchases by the Riksbank.

Sweden - swap yield curve



The weakness of the Swedish krona is in our view a natural consequence of negative Swedish rates and its status as a financing currency by non-domestic investors in particular. This does not look likely to change anytime soon. Moreover, in the coming couple of months the SEK will also face another headwind, namely a seasonal SEK weakness that seems to be driven by Swedish companies distributing a significant amount of SEK to their shareholders of which roughly 40% are domiciled outside of Sweden. Consequently, we do not expect the SEK to benefit much short-term.

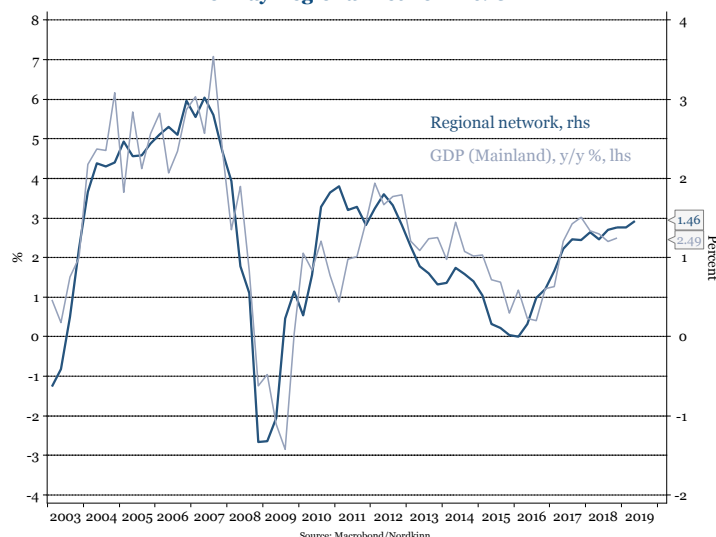
In Norway, the economic outlook for 2019 and 2020 deviates from most other countries as a rebound in oil investments will support a relatively strong growth rate in spite of weakness abroad. According to its updated growth forecasts in the Monetary Policy Report published on March 21st, the Norges Bank now expects growth to continue the coming quarters. Previously, it had expected growth to loose pace.

Although we believe that the international outlook implies downside risks to these updated forecasts for 2020 and beyond, we share Norges Bank's new and more optimistic view about growth coming quarters as they are aligned with various expectations surveys, including the Regional Network, see chart.

We also subscribe to the updated forecasts for core inflation to remain above the inflation target in coming months. Moreover, after several years of moderate wage negotiation outcomes and lower purchasing power than expected due to higher than expected inflation, labour unions clearly have more aggressive demands now.

Consequently, barring a much weaker international environment in coming months, the odds of a June hike is rather high in our view. The Norges Bank will probably give a more precise signal regarding June in the press release following the interim meeting in May. Given that a June hike is not priced, we expect short-dated NOK rates to increase ahead of the summer, which in turn should bear-flatten the slope of the yield curve. The NOK exchange rate should in our view benefit from the expected front-loading of Norges Bank hikes, which deviates significantly from the interest rate prospects abroad.

Norway Regional Network vs. GDP



ABOUT NORDKINN

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Kungsgatan 33, 6th floor
111 56 Stockholm, Sweden
Phone: +46 8 473 40 50
Telefax: +46 8 473 40 51
E-mail: post@nordkinnam.se

Prinsens gate 22, 6th floor
0157 Oslo, Norway
Phone: +47 22 46 63 00
Telefax: +47 94 77 15 16
E-mail: post@nordkinnam.no