NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – April 2019

Addressed to Nordkinn's Followers on LinkedIn for informational purposes

Please note that the content of thetom Nordkinn Market Review & Outlook Report may not be republished without the written consent of Nordkinn Asset Management AB.

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

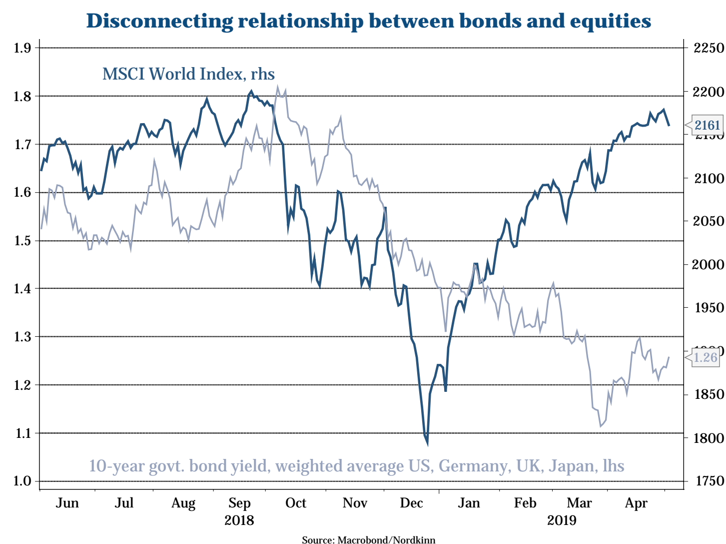
Global government bond yields remained virtually unchanged in April, while equities continued to perform following a string of encouraging indicators across the global economy. Of particular interest, the pickup in China's credit growth provides tangible evidence that stimulus measures are starting to work. Moreover, business sentiment appears to be stabilising or improving in most countries. Furthermore, the perceived risks associated with trade conflicts and other geopolitical minefields have faded, although not entirely.

Recent communication from major central banks seem to be important reasons behind disconnecting bond yields and equities, see chart. At its meeting on April 10th, the ECB's Governing Council noted explicitly in the statement that it will consider whether measures are needed to mitigate possible negative side effects of negative interest rates, fuelling expectations that interest rates will remain in negative territory for an extended period of time, while also opening the door for further cuts.

According to the minutes of the FOMC meeting in March, released on April 10th, a majority of participants expect that the economic outlook would warrant leaving U.S. policy rates unchanged for the rest of the year. Interestingly, several Fed officials noted their views on interest rates "could shift in either direction based on incoming data and other developments". The markets interpreted the "either direction" remark as suggesting that rate cuts are now back on the table.

On April 25th the Bank of Japan clarified its forward guidance, signalling that it intends to maintain the current extremely low levels of short- and long-term interest rates "at least through around spring 2020". The market reaction to this clarification was muted, as this dovish stance was already priced in by the market prior to the announcement.

At a special European Council summit, EU-27 leaders granted the UK an Article 50 extension until October 31st, with a review mechanism at the end of June. The terms of the extension include a break clause such that, if MPs in the House of Commons ratify the withdrawal agreement before May 22nd, the UK is able to leave the EU without participating in elections to the European Parliament.



Nordic overview

Swedish interest rates tumbled and the SEK sold off after the Riksbank on April 25th caused drama by lowering the repo rate path to a greater extent than expected. The Board now assesses that the repo rate will remain stable for a longer period of time than was forecast in February, and future rate hikes to occur at a slower pace. Furthermore, contrary to our expectations, the Riksbank will continue purchasing bonds and thereby increasing its balance sheet until December 2020.

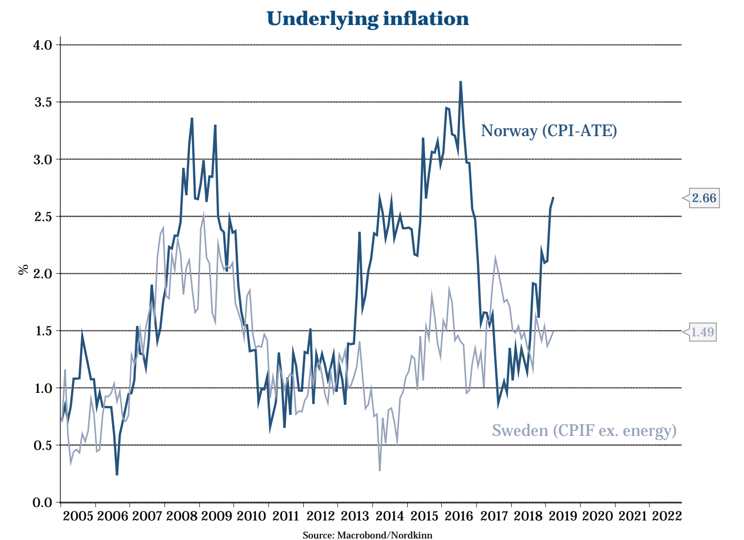
Behind this dovish stance, the Riksbank highlighted softer CPI readings in recent months which suggested that inflationary pressures are slightly weaker than expected. Interestingly, and seemingly counter-intuitively, the Riksbank painted a relatively optimistic picture of future inflationary pressures, citing high economic activity, unexpectedly rapid growth in Q4 and sound prospects ahead despite slowing growth.

In our view, lower than expected inflation at the start of the year, which to a certain extent seems to have been affected by new methodology for estimating prices of foreign travel, seems unlikely to be the only explanation behind the dovish stance. The ECB announcement just a few weeks earlier probably influenced as well. In addition, the small decline in inflation expectations might also have been a factor for the decision.

Conversely, underlying CPI inflation in Norway rose more than expected for the second consecutive month to 2.7% in March, see chart, reinforcing speculations that the Norges Bank could raise rates in June for the second time this year. Economic indicators during April have, overall, been broadly in line with expectations, with weaker consumption data offset by a strong oil sector and firm labour market indicators.

Supported by strong growth and inflation dynamics, combined with a relatively hawkish central bank rhetoric, Norwegian government bond yields rose in both absolute terms and relative to trading partners, Sweden in particular. Spreads between bonds and swap rates fluctuated but remained broadly unchanged over the month as a whole.

The NOK appreciated in the beginning of the month on rising oil prices and wider interest rate differentials, but pared gains in the second half of the month, partly reflecting spill-over effects from the SEK sell-off.



OUTLOOK

Global markets

A tailwind from global financial conditions is starting to build, thanks to the combination of a monetary policy pause among major central banks and rising Chinese credit growth. Moreover, hints of strength in the manufacturing sector may signal that the slowdown that began for more than a year ago has broken and global growth is poised to accelerate.

In particular, the firming in activity indicators such as PMIs in several countries point to stronger manufacturing growth in Q2. Together with easier financial conditions, these green shoots bolster our conviction for a synchronised recovery in global growth getting foothold later this year.

While this would normally motivate a move towards a more bearish stance on government bonds, we see at least four reasons why this time could be different:

First, major central banks are unlikely to tighten monetary policy in 2019. A majority of U.S. Federal Reserve officials expect the key policy rate to be left unchanged for the remainder of the year, as the current level is seen as close to their estimates of longer-run neutral level and they foresee economic growth continuing near its longer-run trend rate ahead. The ECB expects key policy rates to remain at their present levels at least through the end of 2019, while the Bank of Japan says it expects to keep interest rates extremely low well into 2020.

Second, the Federal Reserve announced in November 2018 that it would conduct a broad review of the strategy, tools, and communication practices it uses to pursue monetary policy. The first question of this review is to consider "makeup" strategies that aim to reverse past misses of the inflation target. This include strategies aimed at keeping average inflation over a multi-year period constant and price-level targeting. If Fed officials are about to tilt the conduct of monetary policy towards such "makeup" strategies, which we believe they are, this would imply a more patient response to rising inflation ahead. In other words, interest rates would be kept lower for longer than what would be the case under the present monetary policy framework.

Third, underlying consumer price inflation is not rising, but remains broadly stable or even slowing in some countries including the U.S. This has happened in spite of tighter labour market conditions transmitting into rising wage growth.

Fourth, while the case for this turnaround is building on the back of fading geopolitical risks and easier financial conditions, it will likely take time to turn the tide on business sentiment.

If we see a surprisingly sharp improvement in economic conditions over the coming few months that motivates market participants to remove their expectations of interest rate cuts, global yields could rise somewhat. The chart on the left below shows a forecast for the 10-year U.S. Treasury yield using a macro model assuming that the Federal Reserve remains on hold this year and next. The current yield is some 30-40 bps below "fair value", because the market is currently pricing in rate cuts over the coming 12 months.

Taken together, we judge the upside potential for global bond yields in 2019 being limited. Overall, we therefore continue to favour relative value over directionality and the Nordic area over global markets.

Regarding currency markets, the USD is a countercyclical currency, meaning that it tends to move in the opposite direction of global growth, see chart. As global growth has been decelerating since early 2018, the USD has appreciated in this period.

Looking ahead, if our expectation of a synchronised recovery in global growth proves correct, the USD is set to weaken. A revival in Chinese growth will typically affect Europe with a few months lag, consistent with a recovery starting around summertime. If euro area growth recovers, the market will probably price in a bit of tightening from the ECB starting late next year, leading to a stronger EUR.

Nordic markets

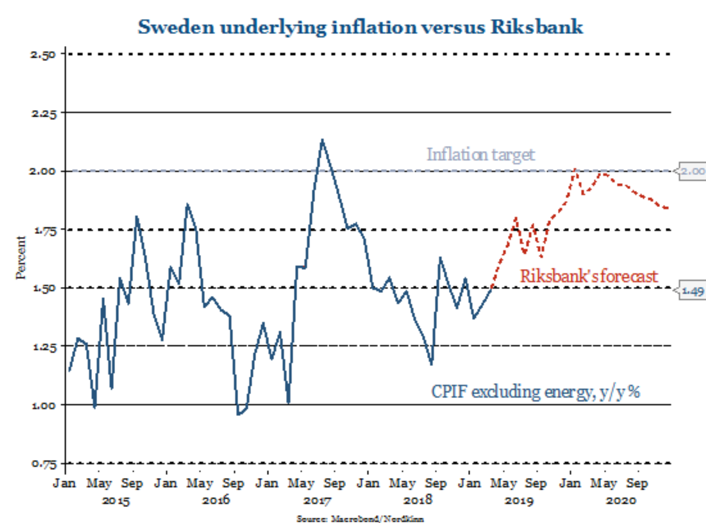
Going into April, our assessment was that the Riksbank Board's confidence in the inflation target had strengthened, allowing for greater tolerance of near-term inflation misses and a shift to a more forward-looking policy strategy. As the statement published on April 25th explicitly referred to "recent outcomes" of CPI as suggesting that "inflationary pressures are slightly weaker than expected", we were wrong. By being incorrect on our assumption of a more flexible inflation targeting approach, we were subsequently wrong on our call for the Riksbank to soon abandon unconventional policy, including the negative repo rate and the ever increasing balance sheet.

According to the updated forward guidance, the repo rate could be raised again in December. However, after the dovish twist last month, markets will likely doubt the prospects for further Riksbank tightening in this cycle. Any signs of a renewed de-anchoring of inflation expectations would lead to speculation of a return to the asymmetric, near-term inflation focused Riksbank reaction function of recent years, as the Bank does what it deems necessary to defend the credibility of its objective.

It surely does not help that the Riksbank's forecast of inflation looks relatively optimistic. The Riksbank expects underlying inflation to rise quite rapidly towards the 2.0% target, see chart. We see the balance of risk being tilted to the downside.

In the aftermath of Riksbank's announcement, massive repricing and subsequent dislocations followed. While this prompted a re-assessment of our positions, it did not incur a total reshuffling of the portfolio. Risks related to the event were contained and some positions remain intact. Market is currently pricing very little rate increases in 2019. Hence, positions for higher rates at the very short end of the money market curve do have characteristic of cheap options of either a hefty rebound in inflation and/or higher STIBOR fixings.

Positons in ASW spreads are also retained. We continue to be long SGBs with shorter maturities against matching swaps where Riksbank holds a decent size of the issued stock (some 60-65%). Meanwhile, we are prone to be short longer-dated bonds that the Debt Office concentrate tap issuance to. Moreover, as only some 50% of the redemption of the next maturing bond will be reinvested, the net supply in nominal bonds will be positive over next 20 months. This will be the first in years.



The easy monetary policy stance worldwide is also great news for carry trades. Accordingly, we keep positions for spread compression in medium term covered bonds relative to swaps with matching maturities. In addition, we anticipate SEK swap rates in certain maturities to move closer EUR peers, i.e. some tightening from current spreads.

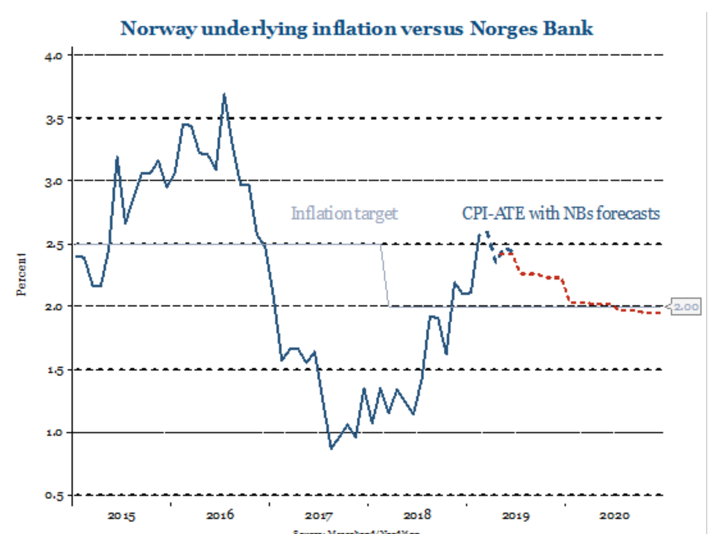
After the Riksbank joined the club of more dovish central banks across the globe, the Norges Bank clearly appears as the last hawk standing. As Norway's central bank is alone in the G10 area having tightened monetary policy this year, markets are wondering whether it can diverge again in not too long.

At the press conference following the decision to raise rates on March 21st, Governor Olsen said the "current assessment of the outlook and balance of risks suggests that the policy rate most likely will be increased further in the course of the next half-year". There are four meetings in this period (May, June, August and September), but May and August are interim meetings and almost certainty not in play. The interest rate projection favours June over September.

Make no mistake, changes in monetary policy among trading partners do affect the outlook for interest rates in Norway, but the impact is greater further out the forecast horizon. In our view, near-term prospects of a hike will not be deferred unless incoming domestic data comes in much weaker than expected, or if the central bank has reasons to believe international factors will significantly affect the domestic situation over the coming quarters.

Overall, incoming domestic data since the publication of the monetary policy report in March has been broadly in line with expectations. The NOK exchange rate is weaker than expected despite wider interest rate differentials and higher energy prices. We do not see any reasons to question the Norges Bank's forecast of an increase in GDP growth to 2.7% in 2019, which stands out relative to trading partners. Meanwhile, we think the balance of risk around the Bank's forecast for inflation to fall in 2019 is tilted to the upside.

Consequently, on May 9th we expect that the Norges Bank sends a strong signal that it intends to hike the policy rate to 1.25% in June. We see further value in positions for higher NOK rates and flatter curves.



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.

DISCLAIMER

The content of this Report has been prepared by Nordkinn Asset Management AB (the «Company»), registered in Sweden No. 556895-3375. All rights reserved. Information in the Report is made only as at the date of the Report unless otherwise stated, and remain subject to change without notice. The Content has been prepared in good faith. However, to the maximum extent permitted by law, neither Nordkinn Asset Management AB, nor its related corporations (including Nordkinn Asset Management Oslo Branch, registered in Norway No. 999 136 354), directors, employees or agents, nor any other person, accept any liability, including, without limitation, any liability arising from fault or negligence, for any loss arising from the use of the Report its contents or otherwise in connection with it.

The Report contains forward-looking statements. Although the Company believes the expectations expressed in such forward-looking statements are based on reasonable assumptions, such statements are not guarantees of future performance and actual results. Actual results or developments may differ materially from those projected in forward-looking statements. Past performance is no guarantee of future returns. The value of investments and the income from them may fall as well as rise and is not guaranteed. Changes in rates of exchange may cause the value of investments to fluctuate. The Report is confidential information, only for the use of those persons to whom it is addressed and no part of this report may be reproduced, redistributed or passed on, in any manner, or used other than as intended, without Nordkinn's prior written permission. The report does not constitute an offer to sell or the solicitation of any offer to buy

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