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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – June 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

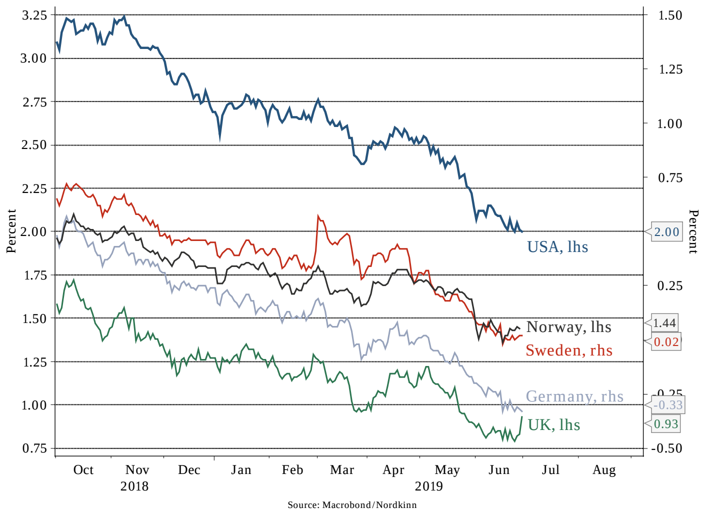
Safe haven government bonds continued rallying in June, see chart, as both the ECB and the Fed introduced easing biases and thereby confirmed market expectations for rate cuts in the second half of 2019. 10-year German yield dropped to a remarkable all-time low of -0.33%, while 10-year US treasury yields plummeted below 2.00%, a level not seen since Donald Trump was elected in 2016.

On June 6th the ECB changed its interest rate forward guidance, signalling that it will keep rates on hold "at least through the first half of 2020" (previously: "end of 2019"). At the press conference, President Draghi said that the ECB stands ready to act and admitted that there had been discussions about the possibility of further policy easing. In a speech given in Sintra on June 18th, Mr. Draghi went further by emphasising that "additional stimulus will be required" in the absence of an improved outlook for growth and inflation. As a consequence, Euribor futures and government bonds rallied as investors grew convinced that the ECB will cut rates in the second half of this year.

The EUR depreciated initially following Draghi's Sintra speech, but the effect was short lived as chairman of the Fed, Jerome Powell, on June 19th hinted about possible rate cuts in the U.S. Although the median projection for fed funds (dot-plots) for 2019 remained unchanged, FOMC participants were almost evenly divided between expecting a cut and expecting a no-change. During the press conference, Powell revealed that a number of those expecting unchanged interest rates in 2019 "agree that the case for additional accommodation has strengthened". As a result, investors became convinced the Fed will cut rates already in July, leading to a rally in U.S. Treasuries and a weaker USD.

The dovish twist among major central banks has in part been motivated by the prolonged slowdown in global economic growth, which in turn seems to have been influenced by escalating trade tensions. As such, the outcome of the G20 meeting in Japan on June 28-29th offered some relief to markets. U.S. and China agreed to restart trade talks after Trump offered concessions including no new tariffs and easing of restrictions against Huawei. China also agreed to make purchases of U.S. farm products and to return to the negotiating table.

10y Government bond yields



Nordic overview

In June Swedish interest rates declined more or less in tandem with euro area rates, keeping the country spread in a relatively tight range, see chart. There are growing expectations among investors that the Swedish Riksbank could be forced to introduce more policy easing if and when the ECB increases its monetary policy accommodation.

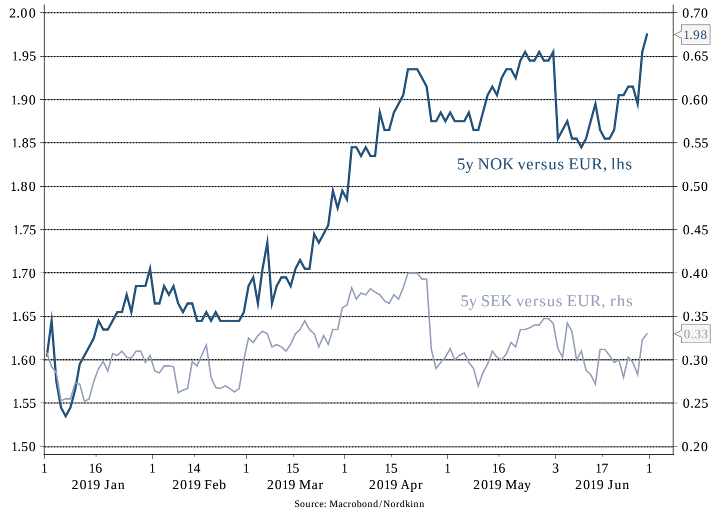
Interestingly, speculation about potential policy easing by the Riksbank took place in spite of higher than expected core inflation readings in June. CPIF increased to 2.1% in the twelve-month period to May 2019, marginally above the 2.0% inflation target and matching the Riksbank's forecast. Furthermore, non-energy inflation increased one tenth of a percent to 1.7%, also in line with the Riksbank's forecast. Consensus forecast was 1.9% and 1.5% respectively. Indicators for the real economy growth were mixed in June, but gives the impression that growth is robust albeit slowing.

On June 20th the Norges Bank decided to hike its key policy rate to 1.25%, as widely expected. Despite significant global uncertainties and potential rate cuts by major central banks over the summer, Governor Olsen said interest rates will most likely be increased further in the course of 2019. The projection indicates around 80% probability for another rate hike to 1.50% in September. This was a more hawkish message than expected by consensus.

The outlook for further tightening by the Norges Bank must be seen in light of solid domestic growth and a positive outlook for the coming year. According to the Regional Network survey, growth is projected to accelerate over the coming six months supported by the upswing in the oil industry as well as spill-over effects to other sectors. With wage growth on the rise and core CPI inflation already exceeding the 2% target, the Board is determined to bring interest rates up towards a more normal level.

Influenced by the global environment, longer dated Norwegian interest rates fell in June despite rate hike by the Norges Bank. However, Norwegian rates lagged and the spread to trading partners widened in June, see chart. The NOK exchange rate appreciated somewhat.

5y interest swap rate, NOR and SEK versus EUR



Global markets

Going into the second half of 2019, we expect synchronised monetary policy easing involving the Fed and the ECB in particular. Moreover, trade negotiations, Brexit and tensions in the Middle East will remain in the spotlight.

The Fed's dovish turn began early this year as an attempt to bolster credibility for its 2% inflation objective. It indicated a willingness to make up for a persistent inflation undershoot by encouraging inflation to rise above 2% without tightening policy. However, the more recent shift towards an easing bias reflects increased downside risks to economic growth. Fed-Chair Powell gave a clear impression that the Fed is becoming impatient with rising economic uncertainty. The market prices in a 100% probability of rate cut in July, with 80%/20% for a 25/50 bps reduction respectively.

The expected Fed funds rate over the coming 18 months is between 100 and 125 bps below the current level, see blue line in the chart below. This is relatively aggressive compared with previous episodes of easing, only beaten by 2008 when more than 150 bps of cuts were priced over a similar time span.

At the same time, 30 years of history shows that when the U.S. economy falls into recession, the Fed eases more than the market expects in advance. This is illustrated by the red line in the chart. As such, the current pricing looks reasonable if you believe that the U.S. economy is about to enter a recession.

Still, when looking at various indicators for the U.S., most of the data does not signal that recession is an imminent threat. The Conference Board's Leading Economic Index have been trending slightly upwards over the past few_months, the ISM index for the manufacturing sector remains above 50 and jobless claims show no signs of breaking higher, just to mention a few. One notable exception is the difference between the spread between the yields on a 3-month Treasury bill and a 10-year government bond, which has been inverted for some time. However, the interpretation of this indicator is complicated by the significant drop in the term premium on longer-dated bonds.

For now, the slowdown in growth seems more comparable to the mid-cycle slowdown in the 1995 or the Asia crisis in 1998. In both these episodes, the U.S. economy avoided a recession even though the indicators mentioned above signalled a considerably weaker situation in the U.S. than what we witness today. On both occasions the Fed decided to ease monetary policy, but not to a greater extent compared with market pricing in advance, which were by a long way more moderate than what the market expects between now and over the coming 18 months.

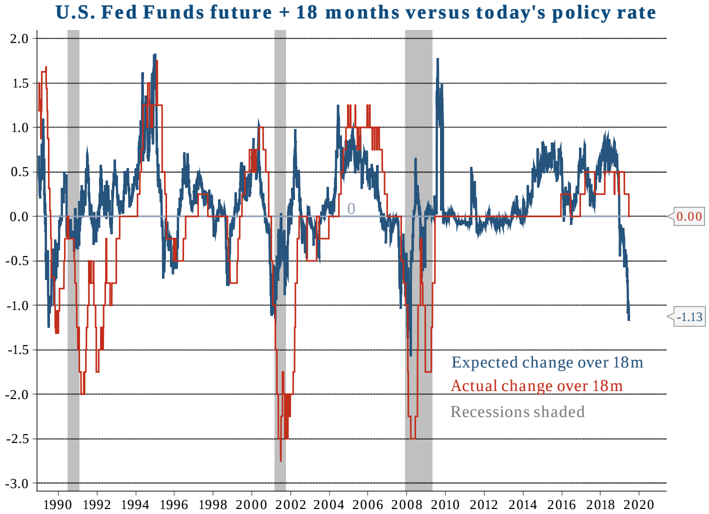
In short, the domestic data on economic activity in the U.S. do not come close to explaining the expected path for the Fed Funds rate ahead implied by market rates. Rather, the story is about global growth – which means trade – and possible ramifications for the U.S. economy ahead.

The G20 summit in Japan on June 28-29th did not resolve the trade tensions chasing the global economy, but nor did it exacerbate them as some progress was made: The less restrictive sales to Huawei should be a modest net positive for both China and the US. Despite that optimism, a final deal is far from accomplished. The two sides have substantive issues to overcome and uncertainty will likely persist as talks could fail quickly and without prior warning.

The major test will be whether the G20 outcome will improve global trade and manufacturing sentiment in the second half of the year following a steep decline in the first half, see chart. However, in our view the uncertainty over the ultimate outcome of talks may remain a small net drag on global growth in the near term.

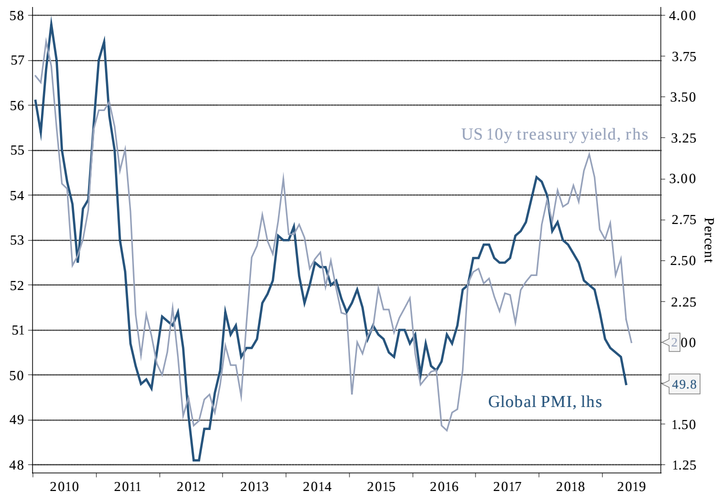
Consequently, the Fed will probably soon agree on a precautionary easing of monetary policy in order to sustain the economic expansion. However, barring a more significant deterioration in U.S. economic activity than what appear to be the consensus view, we doubt the Fed will ease more than what the market is currently pricing in over the coming 18 months. This notwithstanding, as illustrated by the chart below, Treasury yields are unlikely to rise in a pronounced fashion until there is evidence of a sustained improvement in global economic growth.

U.S. Fed Funds future + 18 months versus today's policy rate



Source: Macrobond/Nordkinn

Global PMI versus US 10y govt. bond yield



Source: Macrobond/Nordkinn

Nordic markets

Inflation data over the past months have been in line with the trajectory presented by the Riksbank in April. This fact suggests an unexciting Riksbank policy meeting in July. However, the world outside the domestic economy overlooked by the Riksbank has been all but undramatic. Lacklustre global economic data, uncertainties about global trade, a big step towards rate cuts in the US and in the euro area, which have prompted core rates to take another nosedive. Such a move normally triggers the alarm to blast off at the Riksbank.

As a result, expectations of Riksbank's policy moves have shifted and a few basis points of rate cuts is now priced in the money market curve. It is pretty uncontroversial to expect the back-end of the repo rate path to be adjusted downwards by the bank at the July meeting (market pricing will still be far below the RB path) but we are less convinced that the first hike will be pushed further out in time already at this meeting. Riksbank will have time to adjust the front end of the curve at the September meeting when there is more information available. Having said this, we would not be surprised if the first hike was postponed by a quarter or so given global uncertainties and dovish peers. Needless to say, due to our own ambiguity, we refrain from allocating risk to positions that are highly dependent on the outcome of the actual meeting.

In addition, we have stayed away from the SEK for some time now. Instead, various relative value trades remain our favoured positions in SEK rates. Market pricing is stretched at this junction since Riksbank will think twice before cutting rates again. However, a slowing Swedish economy, lower inflation and perhaps, as a result, also sliding inflation expectations in the second half of the year would be an obstacle for significantly higher rates in Sweden. Such economic outlook is in stark contrast to how we assess the Norwegian domestic economy. Hence, we like to play the relative pricing of the two Nordic economies.

Having raised rates twice so far this year and signalling that there is more to come, the Norges Bank is seemingly on a very different pathway than that of major central banks. What can possible justify the courage to defy global trends? There are two answers to this questions as we see it, both which relate to the response function of monetary policy.

First, whereas most central banks struggle with inflation undershooting target almost consistently since the Global Recession, underlying inflation in Norway has remained above the 2% inflation target for seven months running. Behind the elevated inflation rate is a strong contribution from prices on domestically produced goods and services, indicating that the inflationary pressures relate to the economic situation in Norway.

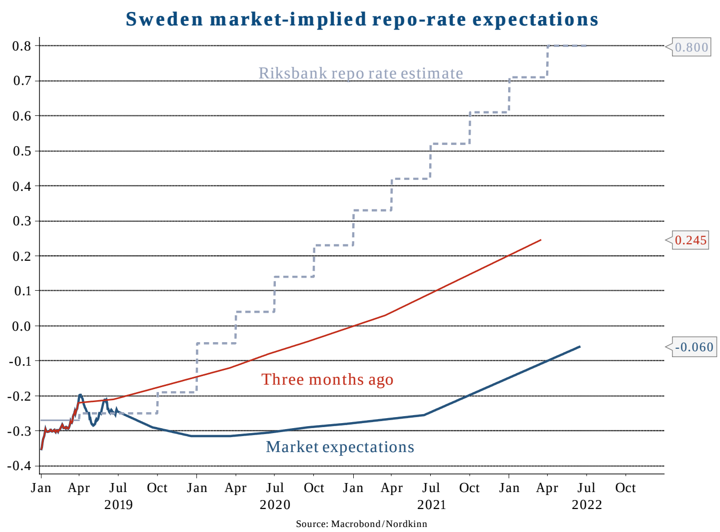
Second, whilst economic growth is slowing in almost all developed countries, the latest news point to accelerating economic growth in Norway in 2019 supported by rising oil investments and spill-over to other sectors. This is happening when almost all measures of capacity utilisation already is above levels consistent with non-accelerating inflation.

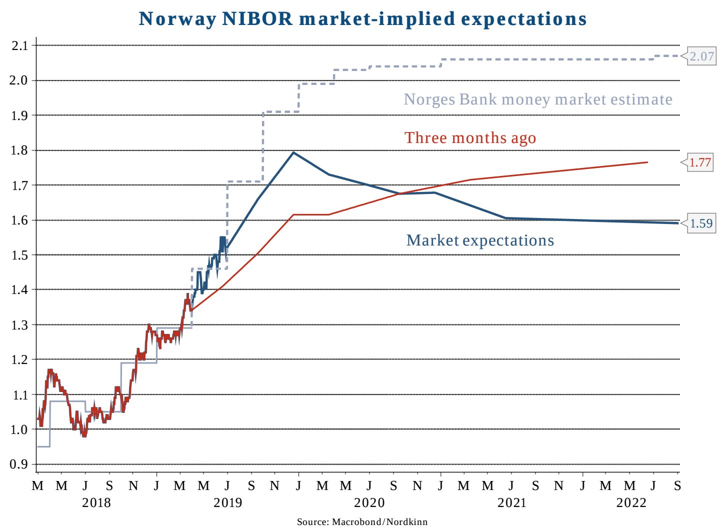
In sum, with both capacity utilisation and inflation above normal levels, the Norges Bank Board does not feel confident about maintaining an accomodative monetary policy stance.

Of course, the Norges Bank is aware of global risk factors that may weigh on domestic growth and inflation ahead. We expect the bank to swiftly adjust its rate outlook if signs emerge that this downside risk to domestic growth materialises. The drop in the PMI to 51.9 in June from 54.1 is the first sign of weakness so far, but this indicator is notorously volatile and contrasts with the message of broader economic indices.

With less than three months left, one of the following two criterias must in our view be met before the Norges Bank decides to drop the planned rate hike in September: 1) A more pronouced deterioration in global growth prospects, possibly combined with a sharp correction in stock markets; 2) a sharp, unsustainable appreciation of the NOK.

In this context, the outcome of the G20 meeting in Japan was important because it reduced the risk of a dramatic worsening of the global environment over the summer. Consequently, we still see some further upside potential for short-dated NOK rates and the NOK exchange rate ahead.





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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