Nordkinn Market Review & Outlook – Jan 2018

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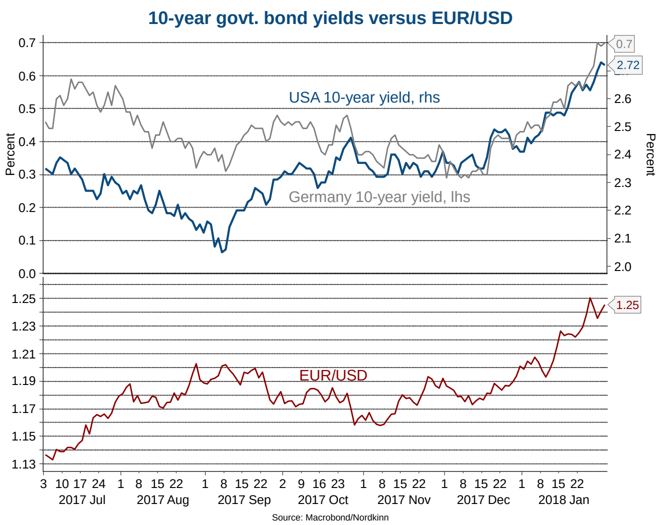
Market overview

Global overview

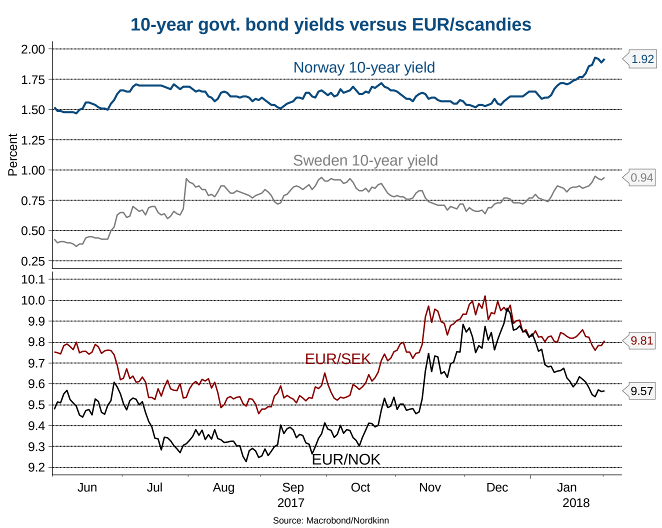
Global government bond yields rose and the USD depreciated significantly in January, see chart, buoyed by strong global growth and mounting expectations that major central banks will follow the Federal Reserve and start normalising monetary policy. Moreover, the Trump administration's decision in January to impose tariffs on e.g. washing machine and solar panel imports raised renewed concerns about U.S. protectionism. This, in combination with U.S. Treasury secretary Mnuchin's comment at World Economic Forum in Davos that a weak dollar benefits American trade, sparked a further USD sell-off.



Meanwhile, the surge in the EUR and European government bond yields continued, following the ECB press conference on January 25th. While President Draghi said that the recent volatility in the foreign exchange market is a source of uncertainty and an element of downside risks to the ECB's growth projections, he also said that the prevailing strong cyclical momentum could lead to further positive growth surprises in the near term. Overall, risks to growth were assessed as broadly balanced, hence investors were left convinced that easy monetary policy in the euro area is indeed gradually set to coming to an end.

U.S. bonds came under additional selling pressure after the FOMC on January 31st delivered a hawkish statement. The Committee highlighted that the economy and labor market are firing on all cylinders. Moreover, they expect inflation to move up this year. Consequently, the Committee's outlook suggests that the current pace of quarterly rate hikes will likely continue. Overall, the statement gave investors the impression that there is even upside risks to the FOMCs current forecast of three rate hikes in 2018.

Nordic overview



The Scandinavian bond markets moved broadly in tandem with the sell-off globally, in particular the 5-year segment of the Norwegian curve. At the beginning of the month, the Norwegian market priced in a shallower path for the key policy rate compared with the Norges Bank's projection, which probably explains, in part, why movements in Norway were more pronounced. Now, interest rates are broadly in line with the central bank's estimate. In Sweden, the market was already better aligned with the Riksbank's projection in early January.

The Norges Bank decided to leave monetary policy and forward guidance unchanged at its meeting on January 25th. The central bank projects a 25 bp rate increase in Q4 this year, while the Riksbank expects lift-off in Q3.

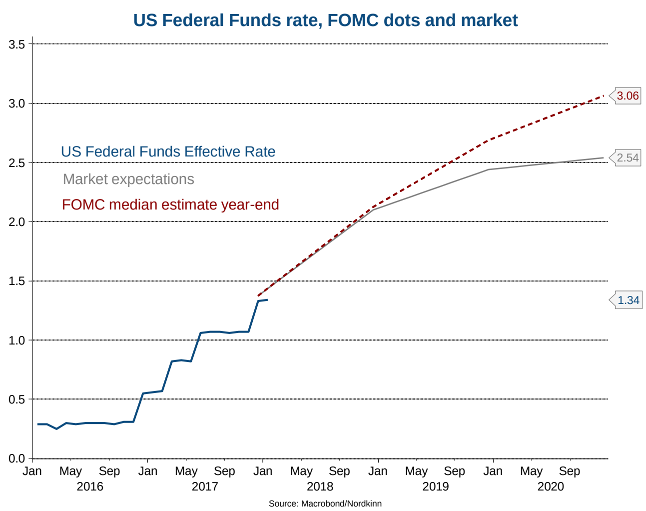
The SEK and, above all, the NOK appreciated in January, see chart. Fading housing risk premiums, in combination with improving liquidity conditions after the turn of the year, contributed to the Scandinavian currencies' performance. In addition, a higher oil price and the underperformance of the Norwegian bond market supported the NOK last month.

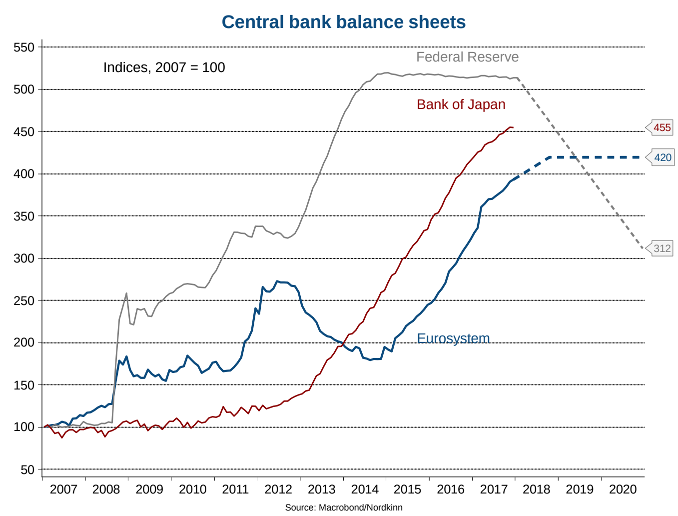
Global markets

We expect global growth to remain solidly above-trend in 2018 as we think the global economy will maintain its strong momentum experienced in 2017, at least in the near-term. Meanwhile, we expect the composition of global growth to shift back in favour of the U.S., supported by easy financial conditions and the expected macroeconomic impact of the tax reform. Alongside strong growth and higher capacity utilisation, we predict that global inflation will rise and monetary policy normalisation will gather strength. The Federal Reserve will probably hike its key policy rate at least three times this year while continuing to normalising its balance sheet.

However, the FOMC's median projection for the Fed Funds rate in 2018 is already discounted by the market, while market's forward pricing for interest rates in 2019 and 2020 remain somewhat below the FOMCs median estimates, see left hand chart. To be sure, FOMC members may well revise their interest rate forecast upwards and end up hiking 100 bps this year, but we think it is too early to fully price four 2018 rate hikes already now. After all, inflation remains below target and has yet to respond to tighter capacity utilisation.

Moreover, although near-term risks to the global economy appear balanced, we see downside risks over the medium-term. In particular, financial markets have seen a sustained run-up in asset prices and very low volatility, seemingly undisturbed by policy or political uncertainty in recent months. A significant correction cannot be ruled out during 2018. Furthermore, the recent adoption of protectionist policies pose downside risks to global trade. Against the backdrop of uncertainty associated with the outlook combined with less attractive valuation, we have temporarily removed exposure to our *"USA: Interest rate normalisation"* theme, but stand ready to re-allocate risk when/if deemed appropriate.





Turning to Europe, given that the ECB will run QE until at least September 2018 and has committed to maintain the current level of key policy rates "well past" that date, there will not be any ECB rate hikes this year and probably not until Q2 2019. Provided that economic growth remains above trend and inflation moves somewhat closer to the ECB's target, we envisage two, maximum three, hikes in 2019. However, that is already more or less priced in. Consequently, we took profit on our short positions in Euribor futures and will even consider scaling in net long holdings if the market sell-off continues in this segment of the curve.

Further ahead, longer-term government bond yields in Europe are poised to rise further towards the end of this year as we expect the ECB to cease net asset purchases next year, see right hand chart. In other words, we manage our *"EMU: QE Tapering"* theme actively and with patience.

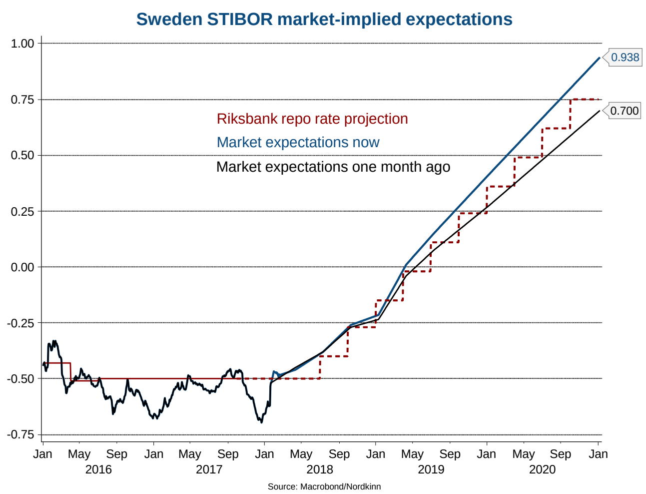
Our expectation that the USD would retrieve some of last year's losses has not worked out so far *("USA: Dollar bull market to resume"*). The dollar tends to suffer when global growth accelerates and when the composition of growth shifts away from the U.S., which happened in 2017. Although we expect 2018 to be different, with U.S. contributing relatively more to global growth as discussed above, it may take time before this view is confirmed by data. For now, the trend is for the USD to weaken further. As a consequence, we decided to temporary terminate our long USD currency holdings in January, as we await more information supporting our view.

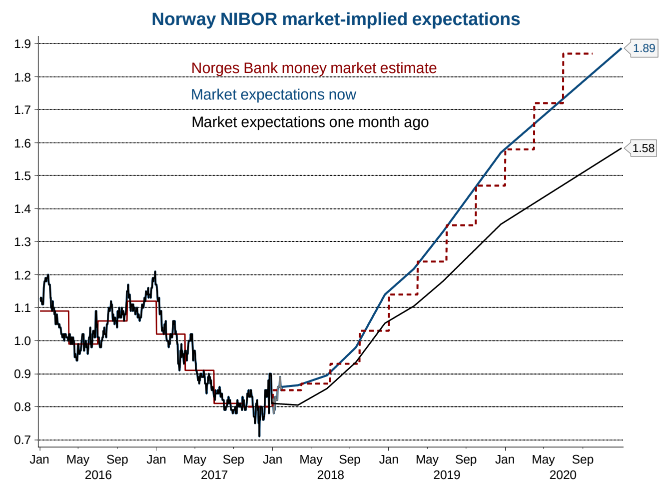
Nordic markets

Swedish GDP growth will probably decelerate in 2018 and 2019 due to weaker housing construction. We expect a broadly stable contribution from housing to GDP this year, before turning negative next year. Residential investments accounts for almost 6% of GDP, having increased from 3.5% in 2012. Considering a positive outlook to net exports from strong growth among trading partners, the overall impact of weaker housing on the broader economy will be manageable. Moreover, anecdotal information signals decent activity in the housing market at the beginning of January. Nevertheless, the Swedish housing market remains a source of uncertainty going forward.

What ultimately matters for the Riksbank is whether inflation will stabilise around 2% or not. The Riksbank expects it will, while we see significant downside risk to this projection. Fundamentally, both wage growth and the SEK suggest weak inflationary pressures ahead. In addition, the leap in inflation in 2017 reflects to some extent factors we deem temporary, such as the new methodology of measuring charter holidays introduced in April last year.

The Riksbank's repo rate projection for 2018-2020 is now fully priced by the market, see left hand chart. Given downside risks to inflation and lingering housing market uncertainty, we see a very low probability that the Riksbank will commence its hiking cycle before September 2018 and proceed more aggressively than the market is currently pricing in. On the contrary, a later start-off date and a more gradual approach would not be surprising to us. Consequently, we have taken profit on outright short bonds and added exposure to longs in the front end of the curve. These trades are organised under the *"Sweden: Government relative value"* theme.





In Norway, we expect that the strengthening of economic growth that began in 2017 will continue in 2018, supported by a rebound in oil investments following three consecutive years of decline. Needless to say, the sharp increase in oil prices of late have strengthened our confidence in our *"Norway: Economic revival"* theme. Moreover, updated information on the housing market reveals that the decline in existing home prices halted last autumn, challenging what appears to be the consensus view of a continued decline in home prices for most of 2018.

This notwithstanding, following a significant sell off in January lead by offshore paying mid-segment NOK swaps, we took profit on many fixed income trades during the month in review and, at the end of the month, we temporarily flipped to a net long exposure. The main trigger was a catch up with Norges Bank's interest rate path; the market now prices in the projected profile for the sight deposit rate ahead, see right hand chart. Secondly, while we expect higher CPI inflation in coming months due to lagged effects of the weak NOK last autumn, weak domestic cost pressures will keep core CPI inflation below the Norges Bank's 2.5% target for an extended period of time. Overall, we think risk/reward favours positive carry/roll trades in the short-end of the curve.

On balance, the current macroeconomic environment should be positive for the NOK, which remains undervalued in our view. We remain long NOK as part of our *"Norway: NOK FX recovery"* theme.