NORDKINN

ASSET MANAGEMENT

# Nordkinn Market Review & Outlook – May 2018

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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

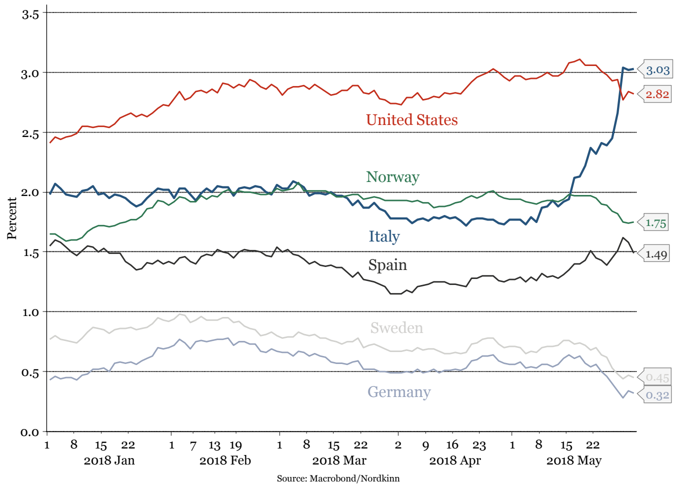
In May, the political crisis in Italy deteriorated dramatically as the two large populist parties struggled to form a new government and promised voters a fiscal stance that is in direct conflict with stable debt dynamics and EU rules. This had dramatic effects on the markets, as investors panicked over the unprecedented level of political uncertainty, which caused volatility to derail. The 10-year Italian government bond yield rose by more than 100 bps reaching 3% during May, see chart. On May 29th, the day when investors capitulated, the yield on Italy's 2-year government bonds rose almost by 200 bps.

While Italy's gross public debt level of more than 130% of GDP is a source of concern amid weak growth and political instability, investors also feared that a possible snap election could be fought over the country's role in the European Union and its membership of the single currency. Consequently, the turmoil in Italy triggered market contagion. Yields on government bonds in Spain and Portugal spiked as investors started to price in euro break-up risks that bore an unpleasant resemblance to the 2011-2012 European sovereign debt crisis.

The crisis in Italy threw a spanner in the works for continued upward momentum in global bond yields as German and U.S. government bonds attracted safe-haven buyers that contributed to push yields significantly lower during the month in review. In particular, German bonds outperformed all of its peers in May, as investors saw a likely delay to the ECB's planned policy tightening owing to current market turbulence, but also reflecting evidence of softer economic growth across the Euro area. The EUR depreciated against the USD down to 1.15 before recovering slightly before the end of the month.

On top of the market stress surrounding Italy, investors were also anxious about the collapse of the Turkish Lira, corruption allegations against the Rajoy's Popular party, international trade tensions and U.S. President Trump's decision to cancel his planned summit with the North-Korean leader Kim Jong-un. On a more positive note, euro area annual CPI inflation rose 0.6%-points to 1.9% in May, which was more than expected. This was partly driven by a rebound in core prices.

**10y Government bond yields**




## Nordic overview

Developments in Europe had a significant impact on the Scandinavian fixed income market, with long-dated government bonds yields tracking broadly the same pattern as those in Germany. That said, Norwegian yields lagged somewhat, which also translated into less pronounced widening of Norwegian asset swap spreads.

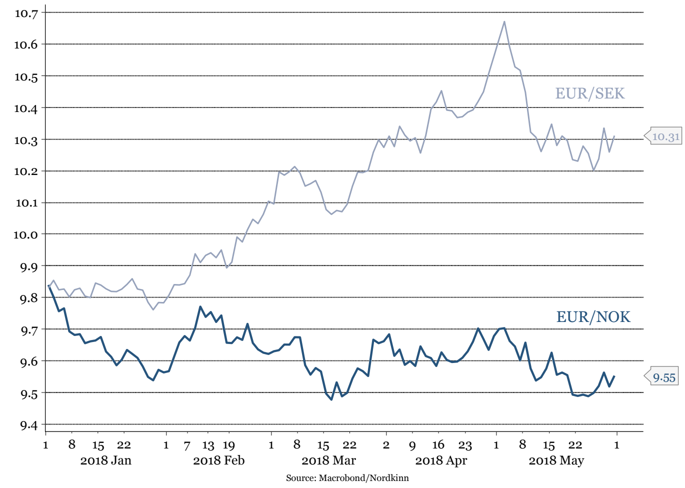
Having sold-off extensively during the winter months, the SEK recovered somewhat against the EUR in May, see chart, whilst remaining stable against the USD. Several factors supported a small rebound in the SEK, including fading dividend pay-out flows and a somewhat more upbeat macro picture with stabilising house prices, and GDP growing at 0.7% in Q1 from the previous quarter. In addition, the April CPIF inflation print matched expectations at 1.9% and a few local bank economists came out with revised CPIF forecasts highlighting upside risks to the Riksbank's prognosis for 2018.

Perhaps more importantly, the Riksbank comments from the hearing in the Parliament on May 3rd suggested that some members were uncomfortable with the sharp SEK depreciation post the latest Riksbank monetary policy announcement on April 26th.

The NOK appreciated against the EUR in May, but it depreciated against the SEK and the USD. Incoming macro data was mostly strong in May, with Mainland-GDP growing at 0.6% in Q1, beating consensus expectations. Moreover, retail sales and house prices rose at a faster than expected pace in April, confirming elevated consumer confidence readings. On the other hand, core CPI rose by 1.3% from the same month the year before. This was 0.1% below expectations among market economists and 0.3%-points below Norges Bank's inflation projection, putting prospects of a September rate hike into speculation.

Meanwhile, the 3-month NIBOR fell by 11 basis points to 1.00% in May, reflecting tighter U.S. LIBOR-OIS spreads. The 2-year NOK swap rate fell a little more as the market reprised the path of Norges Bank interest rate hike over the coming couple of years.

**EUR/NOK and EUR/SEK fx spot**



## Global markets

The political parties in Italy struggling to form a government, the anti-establishment Five Star Movement and the anti-immigration La League, have proposed generous tax cuts and spending plans. The plans include a universal minimum income, repeal of the pension reform passed in 2011 and a commitment to keep VAT tax rates unchanged.

If implemented as stated and under assumption that no other government budget item is changed, these policies would boost the government deficit to approximately 6.5% of GDP in 2019 compared to circa 1.5% in 2018. However, even if implemented on a smaller scale, these measures would have a sizable impact on the Italian government deficit and would likely again place public debt as a mounting concern.

Assuming a 3%-points sustained increase in the fiscal deficit in 2019, we see debt to GDP embarking on an unsustainable upward path in coming years, see chart. Our estimate also incorporates that the markets would likely demand more risk premium for holding Italian government bonds, so that borrowing costs rises from 2% to 3%. Moreover, the forecast assumes that the fiscal expansion would boost GDP-growth in 2019 and 2020, but this is in our view not enough to stop debt to GDP from rising.

An unsustainable path for debt dynamics is only part of the story here. The projected fiscal stance is inconsistent with EU's fiscal rules and therefore has the potential to create tensions between Italy and the European institutions. This could reinforce concerns over the future of Italy's membership of the EU and participation in the currency area.

However, a euro area exit is not on the table in our view. Although the share of Italians supporting membership in the euro area has fallen and is well below euro area average, it is still around 60%. Moreover, the anti-establishment parties seemed to have performed well in this year's election precisely because of this strategic decision to abandon their skeptic rhetoric on the currency union.

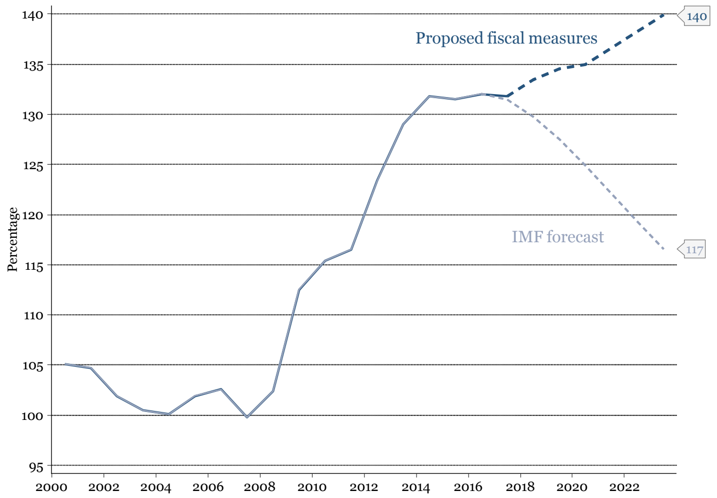
At the same time, we currently regard Italy as the largest geopolitical risk across the developed world and we would not rule out the scenario where Italy will try to test the markets with a euro area exit attempt over the next decade or so. However, such an event is far more likely to occur following a recession than it is today.

Turning to implications for ECB's monetary policy, the Italian situation has to be put in the context of the outlook for the euro area as a whole. Indicators of euro area growth has fallen four months in a row, see chart, suggesting there is more than temporary factors behind the slowdown. When the Italian impasse comes on top of this, we find it likely that the ECB will remain cautious and use very dovish language in coming months, especially with reference to interest rate hikes. But we do not expect it to change course completely nor postpone the end of QE. Such a choice could be erroneously thought of as giving Italy a helping hand.

In this context, we remain of the view that supply/demand dynamics for government bonds will change significantly going forward, as described in the previous monthly report. The ECB will end QE in 2018 and the Fed balance sheet run-off will pick up in coming months. Against this, bond supply in the U.S. is set to rise significantly. Higher yields are therefore necessary in order to attract more buyers from the private sector.

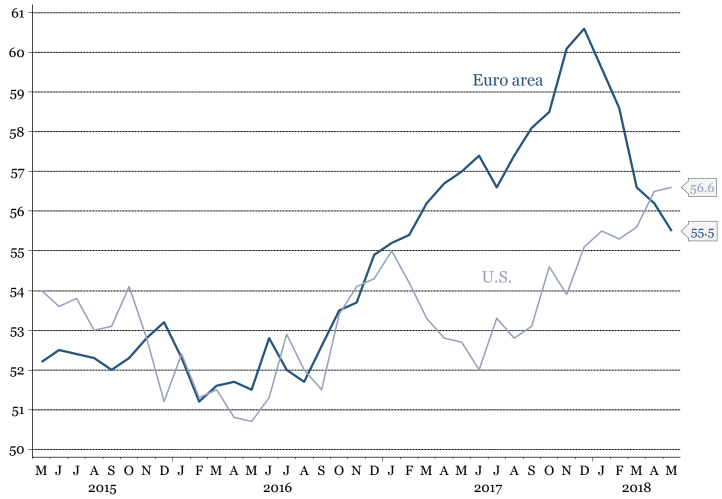
Still, considering the increased uncertainty, the Nordkinn investment team made some changes to its portfolio in May. Firstly, we reduced our exposure to our *"EMU: QE Tapering"* theme. Not because we expect the ECB to extend QE, but rather that we think that recent developments could last over the summer to keep German government bonds yields low. Secondly, we have re-entered our "short-duration" exposure to the U.S., where business surveys point to strong economic growth and further upward pressures on inflation going forward. This means the prospects of further U.S. interest rate hikes remain intact.

**Italy, Debt to GDP forecast**




Source: Macrobond/Nordkinn

**Manufacturing PMIs**




Source: Macrobond/Nordkinn

# Nordic markets

In recent years the Riksbank has almost exclusively given weight to developments in CPI inflation and inflation expectations when considering the path for interest rates. Overall, we reckon that the Board has become less concerned about the risk that inflation expectations could become entrenched at a level too far below the Riksbank's target. CPIF inflation has hovered around 2% over the past year, see chart, and the Riksbank's inflation forecast for the remainder of 2018 does not look overly optimistic. Rather, the combination of rising energy prices and the weaker SEK imply upside risks to CPIF inflation in coming months and quarters. This opens the window for the Riksbank to start normalising interest rates by the end of this year, in accordance with its projection in April. We expect the first hike to occur in December 2018.

When looking into 2019, we expect that the effect of the weaker SEK on import price most likely will fade such that inflation will fall again. In our view, wage growth will remain muted next year, hence the Riksbank's forecast for inflation in 2019 onwards looks somewhat too optimistic.

In addition, with signs of euro area growth slowing and uncertainty over sovereign debt in the currency area flaring up, there is a risk that the ECB will delay its first rate hike. Riksbank officials have repeatedly stated that monetary policy is unlikely to deviate extensively from that of the euro area.

If we are right on inflation and the ECB, the Riksbank Board will have a hard time raising rates as much as it currently envisages next year. Consequently, a scenario that we deem plausible is that the Riksbank delivers a couple of hikes in late 2018/early 2019, followed by an extended pause.

For now, we remain long the short-end of the Swedish fixed income curve as part of our *"Sweden: Credible inflation targeting"* theme, while we have kept our short-duration exposure in long-dated bonds in anticipation for a steeper yield curve.

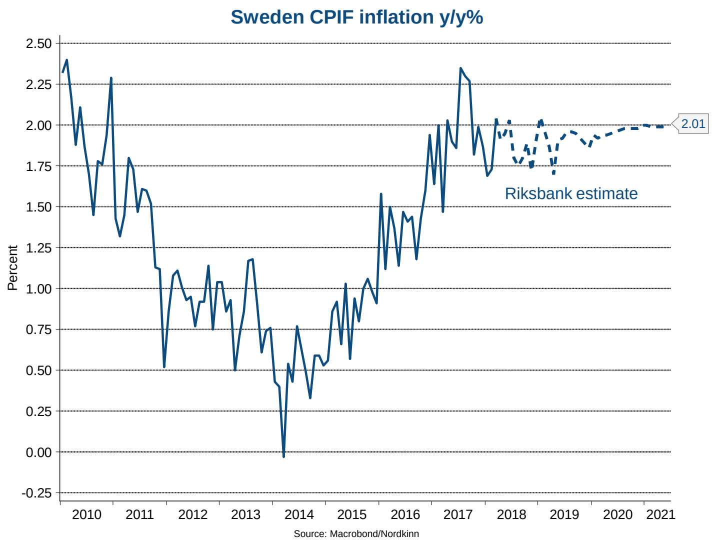
The Norges Bank also takes into account developments in the euro area to the extent that it affects economic growth and inflation. However, due to the relatively large petroleum sector in Norway, which is booming again, the sensitivity to the euro area is somewhat lower compared to Sweden.

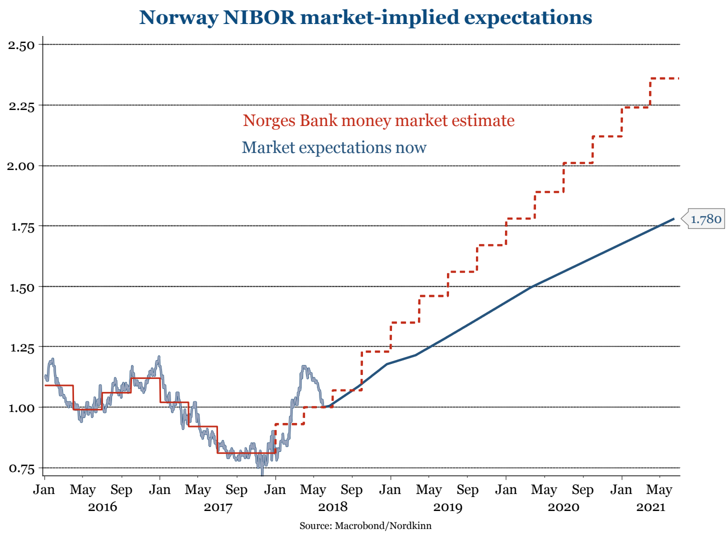
That was also the experience during the 2011-2012 European sovereign debt crisis; the Norwegian economy was relatively robust and outperformed the rest of Europe. But eventually, this outperformance contributed to a significantly stronger NOK against the EUR, hampering non-energy trade and inflation. As a result, the Norges Bank was then eventually forced to ease monetary policy.

This scenario may well happen again, which is why we prefer a combination of long NOK and short fixed income exposure in Norway. Incoming macro data in May confirmed our view that the Norwegian economy is growing at a robust pace this year. Moreover, the petroleum investment survey point to a strong investment outlook also for 2019. Against this backdrop, we think the Norges Bank intends to raise its key policy rate in September this year and continue to removing accommodation in Q1 next year.

The main downside risks to this hawkish view is a sudden sharp appreciation of the NOK, which would suit our portfolio well, and a further decline in core CPI inflation. Regarding the latter, inflation is already 0.3%-points below the Norges Bank's projection, and additional disappointments could raise questions about its underlying trend.

However, this deviation is largely driven by weak prices on imported goods, which we think is temporary. As long as this weakness in import prices can not be attributed to a strong NOK, we think the Norges Bank will look through this weakness and focus more on the underlying drivers of inflation ahead, such as the output gap and wage formation. Moreover, our estimates suggest that the weak NOK will soon begin to feed into higher prices on imported goods over the coming months.



# 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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