NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – June 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 overviev

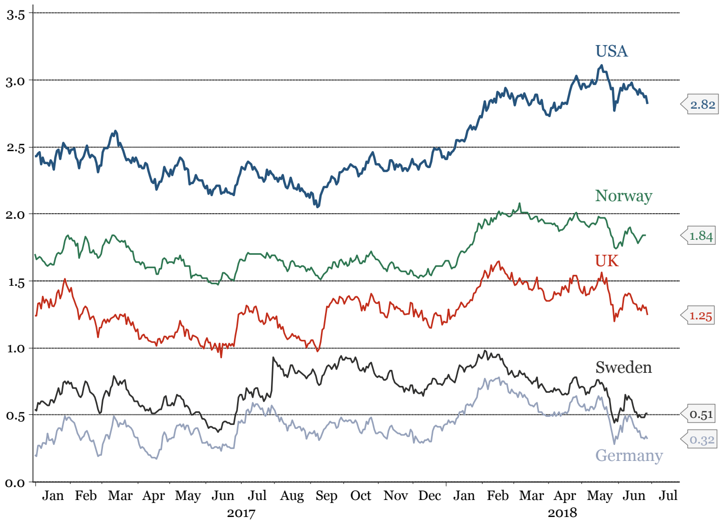
Bond yields rebounded in early June as the market's concern over the political and economic crisis in Italy faded. Later in the month, demand for high-quality government bonds resumed, pushing yields lower (see chart), after U.S. President Trump announced tariffs on about USD 50 bln in imports from China and plans to restrict Chinese investment in U.S. companies. The Chinese government will not turn the other cheek in facing such treatment and has proclaimed to respond in kind.

The ECB's clarification of its forward guidance on interest rates also contributed to lower yields in Europe. On June 14th the ECB said it expects to maintain its key policy rates unchanged at least through the summer of 2019, which essentially means that the first rate hike will not occur before September 2019. Prior to this announcement, the market was pricing in a decent chance of a rate hike in June 2019. The market responded by sending the EUR sharply lower against the USD.

The dovish forward guidance on ECB interest rates was probably a prevention measure against the risk of a Fed-style "taper tantrum" (sharp sell-off across assets) following the announcement of a detailed exit strategy from its extraordinary quantitative easing program introduced in 2015. The exit strategy features a three-month "phase-out" period in Q4 in which monthly net asset purchases will be halved to EUR 15 bln, and a full stop of purchases at year-end 2018. This was broadly in line with market consensus, although some had speculated in a more extended phase-out period of 6 months. However, the timing of the announcement was a bit surprising: Most investors expected the ECB to wait before announcing an end-date.

Just one day earlier, on June 13th, the FOMC increased the target Fed funds range by 25 bps, as expected. The accompanying statement was unquestionably hawkish, with upgrades to economic forecasts and steeper projected interest rate path. The market initially reacted by sending bond yields higher and the USD stronger, but gains were leveled out after President Trump announced tariffs on imports from China.

10y Government bond yields



Source: Macrobond/Nordkinn

Nordic overview

Over the month as a whole, the Swedish fixed income market largely mirrored developments in Europe. Swedish interest rates fell following the ECB's commitment to keeping interest rates unchanged until at least September 2019. In the latter part of June some spread widening versus Germany occurred, which we believe was a response to strong macro numbers and market positioning ahead of the Riksbank meeting July 3.

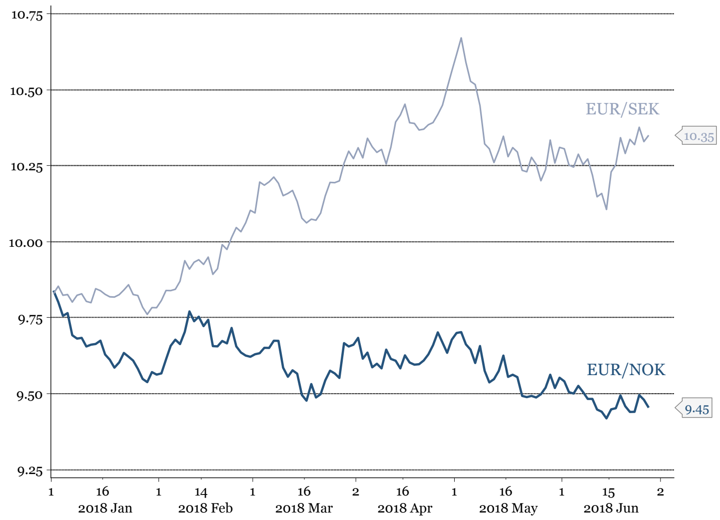
Meanwhile, CPIF inflation came in at 2.1% in May, a tad above the Riksbank's forecast but in line with the consensus among bank economists. However, when stripping out energy, inflation was 1.5% in May, which was below the Riksbank's 1.6% estimate. On balance, the data was interpreted by the market as a slight disappointment vis-à-vis the Riksbank's planned interest rate hike later this year.

The SEK appreciated in the beginning of June, but gains were erased in the latter half of the month (see chart) as expectations of future Riksbank rate hikes faded and global trade tensions escalated.

The Norges Bank maintained its key policy rate at 0.50% in June, while reinforcing its intention to raise rates in September this year. Lower than expected inflation in recent months had a relatively small impact on the Bank's interest rate projection as the Board is confident that solid growth implies an increase in wage and price inflation further out. Indeed, the Board expects that capacity utilisation will rise faster than previously expected, reflecting in part higher than expected oil prices. On balance, incoming information since the previous monetary policy report in March motivated a slightly steeper interest rate path.

The Norges Bank's conditional interest rate projection is consistent with 50 bps of tightening each year (March and September). Prior to the meeting, the market priced in only 30 bps of tightening per year, as the market saw a risk of a more cautious statement given the persistent undershoot in inflation in 2018. Consequently, market rates rose and the NOK appreciated following the revised projections, but momentum reversed as trade tensions escalated towards the end of the month.

EUR/NOK and EUR/SEK fx spot



Source: Macrobond/Nordkinn

Global markets

The rapid coordinated acceleration in global growth seen in 2017 has clearly peaked, with several signs of softening momentum. The JP Morgan manufacturing PMI index has slowed from 54.5 in December 2017 to 53.1 in May 2018.

However, the U.S. economy exhibits an impressive resilience to this slowdown. Expansionary fiscal policy, in particular lower corporate tax rates and the temporary allowance for full expensing of investment, is an important factor contributing to solid U.S. growth and an upbeat outlook also for 2019. According to estimates by the IMF, U.S. real GDP will be 1.2 percent higher by 2020 than in a projection without the tax policy changes. In addition, higher public spending following the February 2018 bipartisan budget agreement further adds to growth.

The projected increase in the U.S. fiscal deficit occurs in a situation with the unemployment rate already at historical low levels. As the chart demonstrate, the combination of low and falling unemployment and rising fiscal deficits is not normal. Consequently, we expect growth to remain above potential, prompting further tightening of the labour market, thus lifting core inflation to and above the Federal Reserve's target. This will motivate further rate hikes this year and next.

With the market not fully priced to the Federal Reserve's interest rate "dots", we expect Treasury yields to remain susceptible to upward pressure going forward. This view is organised under *our "USA: Interest rate normalisation"* theme.

In Europe, the ECB's decision to end net asset purchases in December this year marks another step towards the end of extraordinary monetary stimulus across the advanced economies. Yet, the ECB was able to avoid a Fed-style "taper tantrum" by conveying a dovish signal on the timing and pace of rate hikes after bond purchases stop.

The market is now pricing in 10 bps rate increase by September 2019, but with a full 25 bps of increases not discounted until spring of 2020, see right-hand chart.

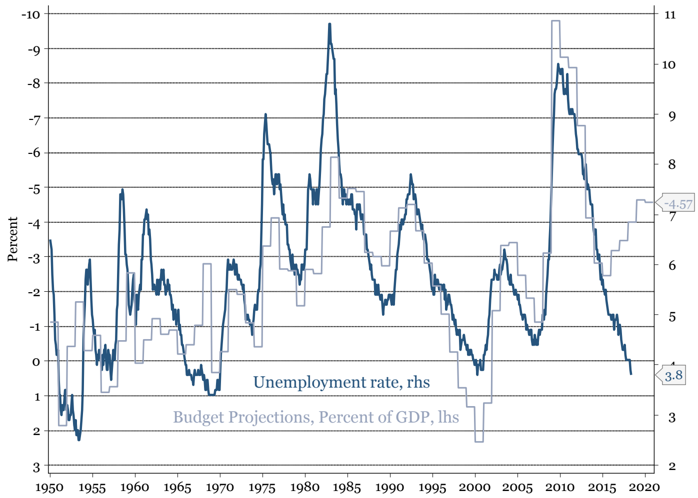
In a speech at the ECB's annual Sintra conference on June 19th, President Draghi signaled that markets had interpreted its message correctly, saying: *"The path of very short-term interest rates that is implicit in the term structure of today's money market interest rates broadly reflects these principles."*

In addition, the ECB will continue to reinvest the principal payments from maturing bonds in its portfolio, estimated at around EUR 15 bln per month in 2019. Combined with a delay in the expected timing of future ECB interest rate hikes, this will keep a lid on longer-dated European bond yields. As outlined in the previous monthly report, we have reduced exposure to our *"EMU: QE Tapering"* theme in favor of our *"USA: Interest rate normalisation"* theme.

The recent escalation of trade tensions between the U.S. and China represent the premier risk to our bearish view on U.S. government bonds. President Trump was elected with the mandate of changing the trajectory of American power and getting the country back on a "winning" path. However, his protectionist actions could cause the rest of the world to react in unpredictable ways. A full blown trade war might be underway. How far it escalates remains unclear, but initial responses do not suggest an easy way of defusing the conflict.

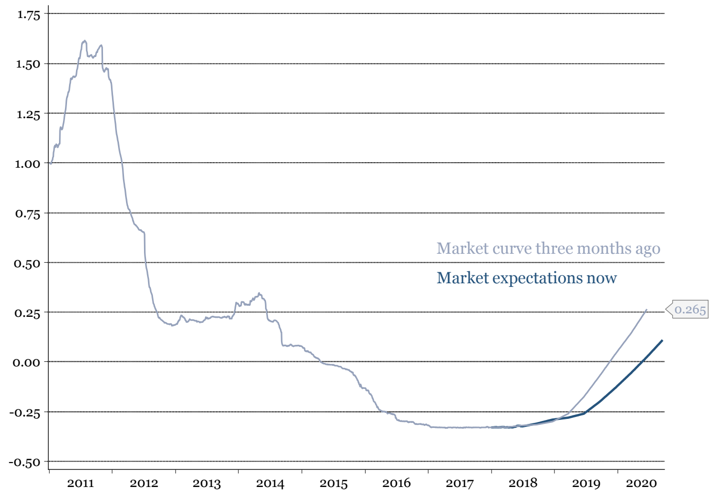
One conclusion based on the latest information is however clear. The decision to impose these tariffs will raise prices for American consumers. The impact on growth would be very similar to that of a tax increase. However, the impact on China and the rest of the world would also be significant. Ultimately, the U.S. nor China want a trade war, but both seem willing to push the boundaries of one in order to get their messages across. The negative implications of such action would be widespread on financial markets, but it could also provide investors with plenty of opportunities. The Nordkinn investment team is prepared for a volatile summer.

U.S. Budget balance and unemployment



Source: Macrobond/Nordkinn

3-month Euribor and market-implied expectations



Source: Macrobond/Nordkinn

Nordic markets

Incoming data for Sweden has been broadly in line with what the Riksbank has expected. Economic growth remains solid and CPIF inflation is in line with the 2% inflation target. The 0.1%-points miss on non-energy CPIF is in our view not enough to alter the Riksbank's projection for a repo rate hike in Q4 this year. Indeed, if anything the Riksbank may have become more confident regarding the prospects for higher inflation and less concerned over the risk of inflation expectations becoming anchored at a level too far below the inflation target.

In our view, three developments should strengthen the Riksbank's confidence that inflation will stabilise around its target in a sustained manner: The producer price index increased by 6.3% y/y in May, partly under the influence of a weak SEK. It is reasonable to expect some degree of pass-through to the consumer price index. The Riksbank has assumed that the SEK will appreciate, but so far the opposite has kept happening. At the time of writing, the SEK is almost 5% weaker than the Riksbank's average projection for Q3 2018. The labour market has tightened further in recent months, which should bolster the Riksbank's view that wages will drift higher in the future.

In our view, 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 continue to expect the first hike to occur in December 2018.

When looking into 2019, when the effect of the weaker SEK on import price most likely fades, inflation may fall again and limit the Riksbank's ability to raise rates as much as it currently envisage 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.

Market expectations of future interest rate hikes have fallen significantly in recent months, see chart. We have used the bond rally to position ourselves for a Riksbank hike coming at the end of this year, through long SEK and short exposure in bonds. In addition, we have positioned ourselves, on relative terms, for higher inflation.

Turning to Norway, the forward guidance in the press release following the Norges Bank's policy meeting on June 21st was crystal clear: *"The Executive Board's current assessment of the outlook and balance of risks suggests that the key policy rate will most likely be raised in September 2018"*. With less than three months left, we reckon incoming information needs to be extraordinary weak for Norges Bank not to hike rates by 25 bps to 0.75% on September 20th. Let's take a closer look at various circumstances that may or may not alter the Bank's course:

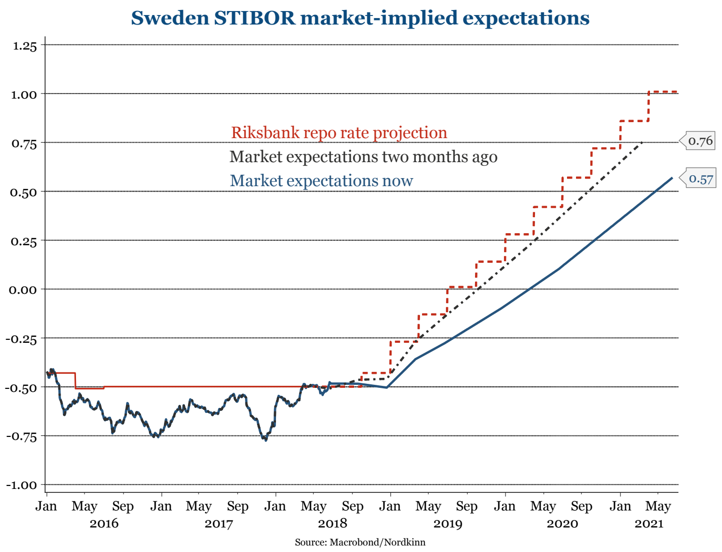
1) Domestic demand is very strong. Given the volatility of data, we find it extremely unlikely that the Norges Bank will attach weight to monthly releases ahead of the September meeting. The most important publication will be the Regional Network report on September 11th, but unless a dramatic collapse is coming the Norges Bank's confidence in domestic condition will not be seriously questioned;

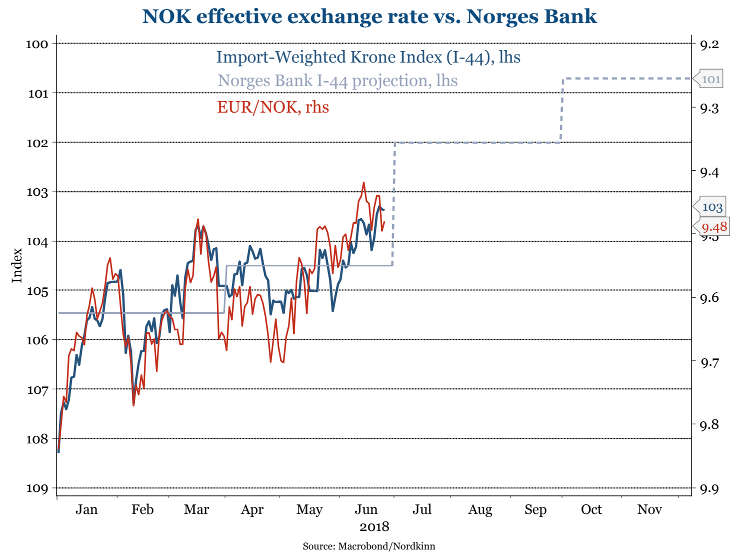
2) Inflation is low, but that is not a concern for Norges Bank as long as rising capacity utilisation implies higher inflation further out in time. Interestingly, the Norges Bank expects core inflation at 1.1% in June and 1.2% in July, which is well below consensus forecast;

3) A sharp appreciation of the NOK could become a concern for the Norges Bank. However, this risk appears low at the moment. At the time of writing, the NOK is about 1.5% weaker than the Norges Bank's projection. Everything else being equal, the projection is consistent with an average EUR/NOK at about 9.35 in Q3, see chart. However, we believe the FX cross would need to drop well below 9.20 over the summer before the Bank begins to reconsider the timing and pace of interest rate hikes.

4) International conditions are the main risk to the Norges Bank's hiking intensions in our view. A global stock market crash, or a collapse in the oil price, would almost certainly lead the Norges Bank to reconsider its interest rate trajectory.

On balance, we continue to favour short exposure in fixed income space (*"Norway: Economic revival"*) in combination with long NOK exposure (*Norway: NOK FX recovery"*).





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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