

NORDKINN

— ASSET MANAGEMENT —

Nordkinn Market Review & Outlook – May 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 rallied massively in May, see chart, as investors' risk appetite turned into risk nausea. The 10-year German yield dropped to an all-time low of -0.21%, while 10-year US treasury yields plummeted to 2.12%, a level not seen since September 2017.

Just when markets had the impression that a breakthrough in the trade negotiations was forthcoming, the Trump administration accused China of reneging on its commitments and moved to raise tariffs on USD 200 bln of imports to 25% from 10%. Moreover, Trump set in motion a process to impose levies on all remaining Chinese imports, worth an additional USD 300 bln.

China struck back at those accusations, saying it was Washington that repeatedly tried to change the terms of the negotiations midway through the talks. China quickly retaliated by announcing higher tariffs on imports from the U.S. worth USD 60 bln taking effect from June 1st.

A few days later, tensions escalated even further when the U.S. Commerce Department placed Huawei and a handful of other Chinese tech firms on a trade blacklist. As a result, Google decided to suspend certain software and services to Huawei. China responded by issuing a warning that it may restrict exports of rare earths to the U.S. if needed.

In late May, Trump said he plans to impose a 5% tax on all goods imported from Mexico unless "the illegal migration crisis is alleviated". The news landed like a bombshell in markets already exhausted by the escalated trade tensions with China.

The situation in Europe also took a turn for the worse after a tearful Theresa May on May 24th announced her resignation as Prime Minister for the UK and as Conservative leader, having been defeated by the challenge of delivering Brexit. Her decision heralds the end of a premiership that has been marked by increasingly bitter divisions, raising the risk of a no-deal Brexit. Furthermore, fears over Italy's public debt sparked a sell-off in Italian government bonds.

On top of this increased uncertainty, but also likely because of it, PMI data for several advanced economies came in below expectations, casting doubt about the outlook for the global economy.

10y Government bond yields



Nordic overview

The drop in Swedish global government yields continued uninterrupted in May across the maturity spectrum, while the SEK remained range-bound. As usual, price action in the long-end of the yield curve largely mirrored developments abroad, yet short-dated yields headed lower too, as investors saw a further delay to the Riksbank's process of unwinding unconventional monetary policy. Supported by the Riksbank's decision to continue expanding its balance sheet, prices on government bonds rallied against swaps.

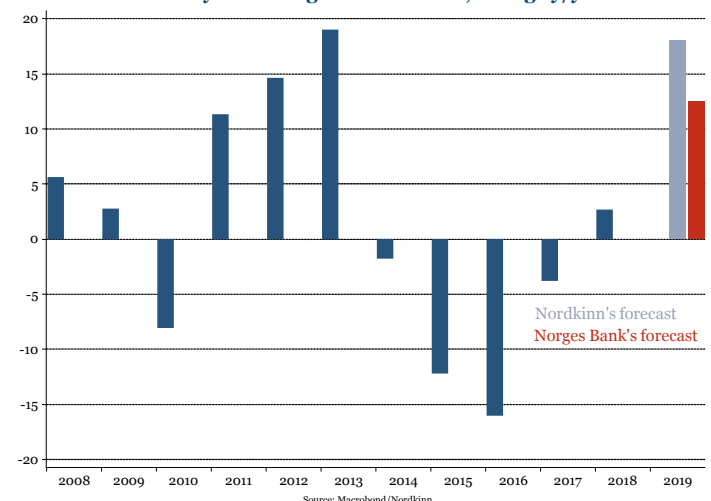
While Swedish GDP expanded by a surprisingly strong +0.6% in Q1 compared with the previous quarter, most survey-data point to a decelerating growth momentum in Q2. CPI inflation rose to 2.0% in April, matching the Riksbank's forecast, but non-energy inflation at 1.5% continues to suggest that inflationary pressures are muted.

In Norway, the global bond yield slump affected mainly the long-end of the curve as shorter dated yields were dominated by strong domestic fundamentals. Underlying CPI inflation in Norway eased 0.1%-points to 2.6% in April, but beat consensus expectations for the third consecutive month and still remains well above Norges Bank's projection from the monetary policy report in March.

While growth in GDP for mainland-Norway slowed to 0.3% in Q1, the headline number was affected by a decline in power generation and fishery. The underlying trend is strong. Statistics Norway's estimates for investments in the oil and gas sector were significantly revised upwards for both 2019 and 2020, indicating a much larger increase this year than Norges Bank projected in March, see chart. Furthermore, employment is growing firmly and the labour market continues to tighten.

At the interim meeting on May 9th, the Norges Bank Board said that whilst the economy was growing broadly as projected, inflation was slightly higher than expected. Against this background, the Board explicitly signalled that "the policy rate will most likely be raised in June". Because most market participants anticipated a vaguer statement with regards to the timing of the next hike, short-dated yields rose following the announcement and the slope of the 2s5s and 2s10s yield curves became flatter.

Norway's oil and gas investments, change y/y%



OUTLOOK

Global markets

The dramatic breakdown in U.S.-China trade negotiations on May 5th put a spoke in the wheel for the expected rebound in global growth set to take place after summer.

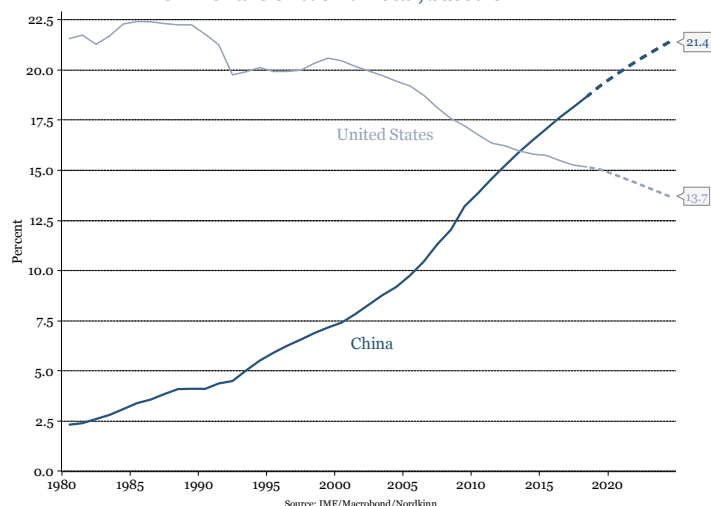
It was common to think that Donald Trump would want to strike a deal with China because a full-blown trade war could jeopardise the health of U.S. economy and the stock market, and thereby his chances of being re-elected on November 3rd 2020. The problem is that Trump's tax cuts and the solid economy did not prevent Republicans from getting hit hard in the 2018 midterm elections. The President struggles to secure funding for his key campaign promise - the wall - and thus faces the risk of irrelevance if he strikes a compromise with China without resolving the longstanding problems in the bilateral trade relationship.

Consequently, the improvement in the U.S. equity markets and tame inflation figures in early 2019 may have encouraged Trump to please the American proponents of a tougher line with China. A hawkish trade policy becomes the clearest path for him to achieve resounding political success and win support ahead of the election.

An underlying issue is probably that the U.S. is no longer the world's economic hegemon, see chart. In light of this, geopolitical tensions are inevitable. Currently, Trump's confrontation with China is specifically focused on China's persistent misappropriation of foreign technology. According to China's vice-premier Liu He, issues related to technology and intellectual property are "matter of principle over which China cannot make concessions". All this would suggest that the probability of a long-lasting grand compromise involving trade and technology at the G20-meeting on June 28-29th is very low.

Having said that, the G20 meeting could be a natural venue for the presidents to agree to resume negotiations, and maybe walk back tensions a little bit. Trump may at some point settle for a deal on trade (excluding technology) to reduce economic risks ahead of the 2020 election, which would imply a short-term improvement for the U.S.-China relationship and promote prospects for a global growth rebound.

GDP Share of World Total, based on PPP



On the other hand, it is also possible that Trump is willing to risk a weaker economy which could lead to another collapse in trade talks at the upcoming G20 meeting in June. This would probably have a further significant negative impact on risk sentiment and a positive effect on safe-haven assets. In our view, it is very difficult to forecast the outcome of any forthcoming negotiations.

Regarding the economic impact of a trade war, the true cost is likely greater than simple economic models would suggest. This is because uncertainty over the magnitude and duration of a trade war could cause companies to postpone new investment spending. At the same time, a significant increase in Chinese economic stimulus, as well as interest rate cuts by the US Federal Reserve, would mitigate those effects.

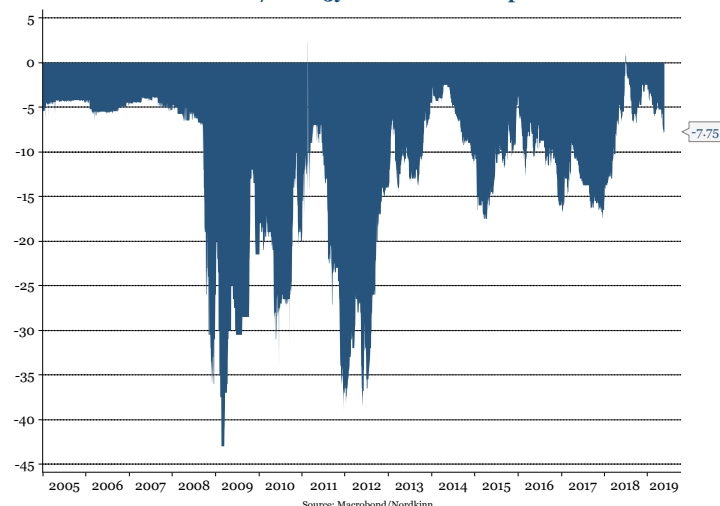
The implication of a trade war on high-quality government bonds should be straight-forward: Yields should fall due to safe-haven allocations combined with expected monetary policy easing. This is what has been going on in May.

Yet, buying German Bunds or U.S. Treasuries outright at current levels may not be the optimal strategy. Firstly, yields are already very depressed, with Germany 10-year Bund yields deeply in negative territory and investors pricing in significant policy easing in the U.S. this year and next. Secondly, the outcome of any forthcoming trade negotiation is very unpredictable. Thirdly, even if it is a low probability outcome, China is threatening to reduce its holding of U.S. Treasuries, which potentially could offset the positive flow-effects of a rise in safe haven demand.

Rather, despite having performed well in recent weeks we like to be paid U.S. Libor under our "Global: Basis Swap Trading" theme. A full-blown trade war would likely lead to increased dollar shortage and a more negative cross-currency basis, see chart.

On balance, we prefer having very little directional risks in global government bonds ahead of the G20 event. We continue to favour relative value over directionality and the Nordic area over global markets.

USD/NOK 5y XCCY basis swap



Nordic markets

The sudden turnaround in trade negotiations has made the global growth outlook murkier. This also poses heightened risks to the Swedish export oriented economy. The latest batch of Swedish macro data (like PMI and NIER economic tendency surveys) has declined in line with the German manufacturing sector, see chart. In addition, Swedish inflation pressure remains subdued despite the weak SEK, hence a hike from the Riksbank seems distant at the moment. As a result, the movements in Swedish interest rates are to a very large extent in the hands of global gyrations. Consequently, we prefer keeping directionality positions in SEK rates to a minimum in the portfolio.

Instead, we are more prone to allocate risk to relative value trades. One such position we are active in, amid the low interest rates volatility in shorter maturities, is where we benefit from positive carry. Another type is where technical factors are expected to influence price action, for instance pulling rates spread temporary tighter or wider. Finally, a third type of relative value trade we are involved in is where two interest rates tend to move together in a broader perspective, but where the underlying fundamentals (in each leg) will be decisive at the end. Hence, a spread with little correlation to the directionality of global yields.

In the portfolio we have positions for tighter spreads in shorter dated covered bonds (in the two year segment) relative to swaps and government bonds. This is an example of a relative value position of the first kind mentioned above.

The 3m STIBOR fixing has been all but stable in the year, which has resulted in plenty of opportunities in the short end of the yield curve. We try to be agile and detect such opportunities as they arise. This is a kind of relative value trade that we associate with the second type above.

Finally, and an example of the third type of relative value position in the portfolio, we see monetary policies in Sweden and Norway moving in different directions, which eventually should result in shorter rates to move further apart.

Speaking about Norway, the Norges Bank will almost certainly follow up the signal given in the press release in connection with the monetary policy meeting in May to raise interest rates at the upcoming meeting on June 20th. Because a June hike is almost fully priced in, the relevant

question for markets is when and to what extent Norges Bank intends to continue normalising interest rates after summer.

Swayed by the Norges Bank's determination at the meetings in both March and May to signal another rate hike coming sooner rather than later, market participants now seem to embrace the idea of a relative hawkish forward guidance that includes another rate hike later this year. In fact, some analysts are even open to the thought that the next hike could come ahead in September.

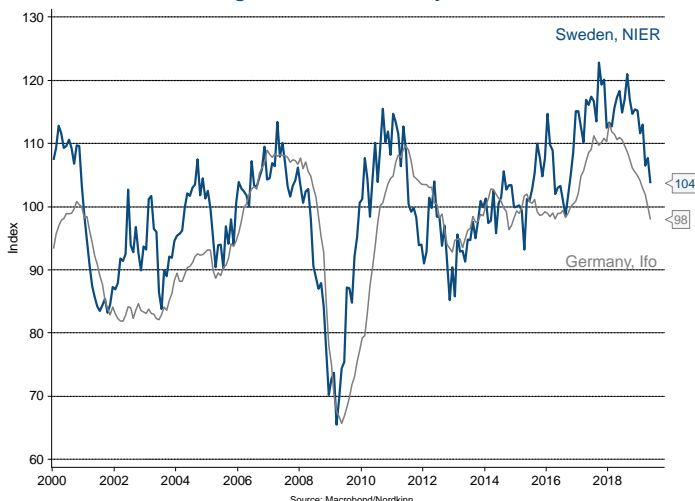
To be sure, if you disregard global factors and focus exclusively on incoming information about the near-term prospects for growth and inflation in Norway, the September meeting would certainly be in play. Capital spending in the oil and gas sector is rising faster than expected and it turns out that the fiscal policy stance this year is more expansionary than the Norges Bank assumed back in March. Core CPI inflation remains above target and has been slightly higher than projected, and with NOK weaker than expected and labour market indicators tightening further, the Norges Bank will be forced to revise its near-term forecast for inflation upwards.

At the same time, the Norges Bank will most likely take into account that the global economic momentum is slowing more than it expected in March and that downside risks to growth have increased, largely owing to the escalation of trade tensions between the U.S. and China. This calls for carefulness. The following quote from Norges Bank in March seems even more relevant now: "The uncertainty surrounding global developments and the effects of monetary policy suggests a cautious approach to interest rate setting".

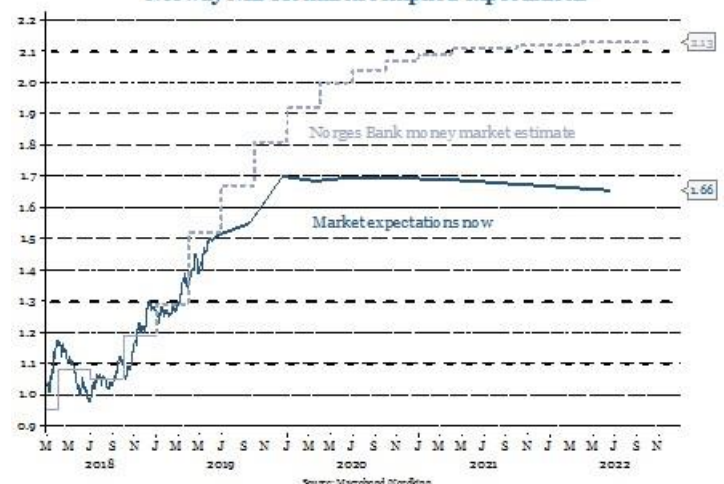
On balance, we expect an interest rate projection that looks quite similar to the one published in March. The interest rate will be raised in June, and provided that the outlook for economic growth remains favourable, it will most likely be raised again in the second half of this year. We expect the projection to indicate a peak at around 1.75% in late 2020.

Regarding investment implications, our forecast of a June hike followed by a clear signal of more to come should bring NOK FRAs closer to Norges Bank's projected money market curve, see chart. We are also biased towards a stronger NOK exchange rate, although global risk factors seem less favourable in the short-term.

Manufacturing confidence; Germany versus Sweden



Norway NIBOR market-implied expectations



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