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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – July 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

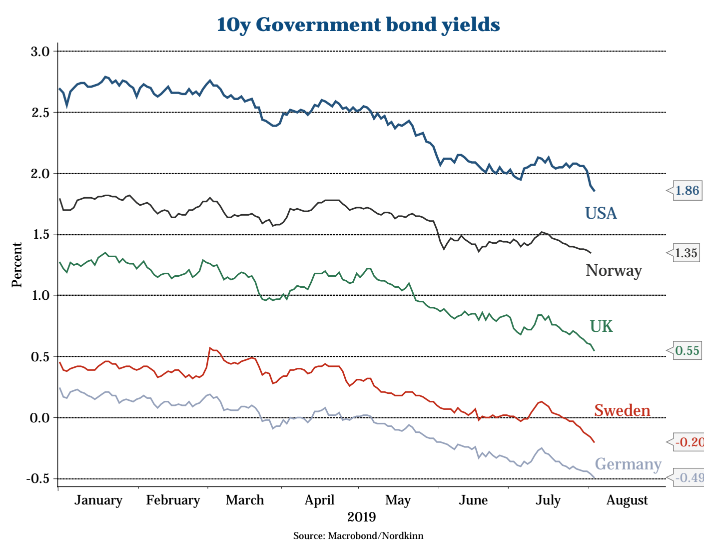
Ahead of anticipated dovish turns in policy from both from the ECB and the Federal Reserve, rates markets were anxiously volatile in July, see chart. In addition, summer markets being characterised by less depth, also contributed to the choppiness. During the first sessions of the month the 10-year German bond yield slumped to a new all-time record low at -0.40%. However, from this trough rates rebounded and pushed the German 10-year bond yield almost 20 bps higher. Later in the month however, the move again reversed and new fresh all-time lows were recorded.

Expectations going into the ECB meeting on July 25th were set very high, and the central bank delivered. The ECB signalled easing later in the year, probably as soon as September, but also announced that the Governing Council had tasked the relevant committees to examine options for a) how to reinforce forward guidance b) how a tiering system could be designed and c) how to size and composition a possible new QE programme. Furthermore, the wording stressed symmetry in their inflation targeting, which might be an indication of another baby step towards an altered inflation target instead of the current "below but close to 2%" (see more in the "outlook" section).

On July 31st the Federal Reserve cut rates by 25 bps and announced an early end to balance sheet normalisation. This was in line with consensus expectations, although several had expected a 50 bps reduction. At the press conference, Chair Powell pushed back somewhat against market pricing of aggressive easing, characterising Fed policy along the lines of an "insurance cut" and mid-cycle adjustment. This contributed to a sell-off in short-dated bonds and a stronger USD.

In the UK, Boris Johnson became new prime minister when he was elected to replace his predecessor Theresa May. Brexit is still dividing the Tory party, while the EU made clear that a renegotiation of the withdrawal agreement is not up for debate.

Amid the ambiguous markets during the month, foreign exchange markets also experienced some hefty moves. The combined action of the ECB and the FED resulted in a lower EUR/USD towards the end of the month.



Nordic overview

The June inflation print published on July 11th was again spot-on Riksbank's CPIF forecast. The inflation gauge ex energy has rebounded from 1.4% at the start of the year to 1.9% in June. The relatively rare situation with both higher service prices and some uptick in the rate of goods inflation, supported by the weak SEK, has resulted in higher underlying inflation.

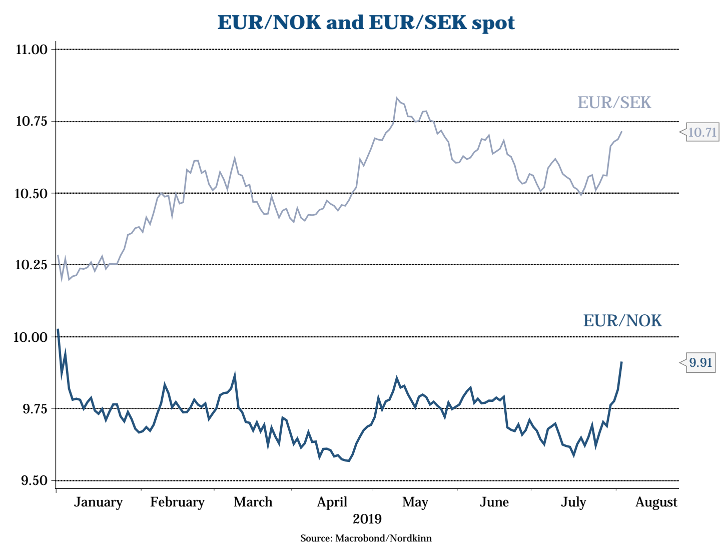
Amid recent inflation data in line with Riksbank's projections, the central bank could afford to relax at the July meeting. On July 3rd the central bank took a wait-and-see stance, still forecasting that a hike is coming late in the year or early next year. The market is however much in doubt as pricing in the money market suggests the next (25 bps) rate hike will not be delivered until summer 2022.

As a result of Riksbank's reluctance to alter the outlook for its monetary policy, bond and swap yield spreads relative to Germany/Europe widened, especially in shorter maturities. However, soft macro data later in the month resulted in a reversal of this move. Confidence in manufacturing slumped to its lowest reading since 2015, exports slowed significantly and GDP for Q2 disappointed expectations.

Turning to Norway, incoming data in July were broadly in line with expectations, except a disappointing PMI print for July. Boosted by service activities in particular, monthly GDP data up until May point to a clear acceleration in Mainland-Norway in Q3 and that the risk to the Norges Bank's 0.8% forecast for Q3 is tilted to the upside. Meanwhile, core CPI inflation slowed further in June to 2.3%, a tenth of a percent below the Norges Bank's projection.

Norwegian interest rates tracked to a large degree developments abroad during July. In addition, banks reported a growing interest to switch from floating to fixed rates on mortgage loans, which supported medium- to long- dated fixed swaps in particular. Against this, foreign interest in buying Norwegian government bonds at elevated levels against peers gave support to asset swap spreads.

Regarding FX, Scandinavian currencies traded on a relatively strong note in the beginning of the month, before risk-off markets combined with thin summer liquidity took EUR/SEK and EUR/NOK higher.



OUTLOOK

Global markets

At first glance central banks are taking dovish turns foremost in order to safeguard the global business cycle. In the background, however, concerns about inflation and inflation expectations are mounting. Federal Reserve seems puzzled about the still low inflation despite several years of strong growth. ECB appears to be alarmed about the stickiness of low underlying inflation and how that could start to impact inflation expectations. In fact, there are some worrying sings that this is beginning to happen, both in market-based as well as in survey-based expectations.

On top of inflation worries, markets are in the hands of uncertainties about trade negotiations, Brexit and tensions in the Middle East. Moreover, markets need to be on constant alert as just a tweet could alter the outlook.

The changed rhetoric from the Federal Reserve during first half of this year was backed by the issue of low inflation, see chart. In order to lift expectations and to show determination, the central bank, paradoxically, needs to act asymmetrically in order to be regarded as symmetric in their inflation targeting. Several Fed members addressed this notion during the spring and it was also discussed at the Chicago Fed´s symposium in early June. We believe this focus on inflation can have major repercussions for market in the time to come. Exactly how it will unfold time will tell, but it appears that the inflation outlook at some stage may triumph growth in terms of importance.

At the moment, the market is pricing in a lot more than just a mid-cycle adjustment to Federal Reserve policy. Although the U.S. economy seems to be in a relatively healthy state currently, the outlook has changed to the worse after President Trump on August 1st announced a 10% tariff on the USD 300 bln of goods that had not been subject to any tariffs this far (Tranche 4), effective on September 1st. Tranche 4 goods are likely to hit U.S. consumers harder, given the composition of goods.

In response to this announcement, the Chinese Foreign Ministry stated that they would take "necessary countermeasures", strongly condemning the tariff announcement.

From a negotiation perspective, this is likely to harden the Chinese stance further, as one of their core demands is a removal of existing tariffs. Making matters worse, as the prospects of a trade deal between Beijing and Washington again faded, on August 5th the CNY weakened beyond 7 per USD for the first time since the 2008 global financial crisis, breaching a floor that China's central bank has previously defended.

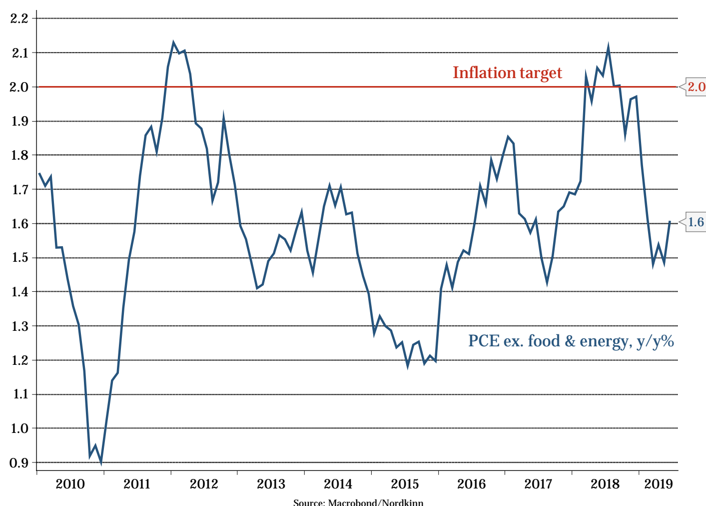
Overall, this set-up makes things even more unpredictable than before, in terms of timing and next steps, but it is hard to see a positive path from here, at least for the next few months.

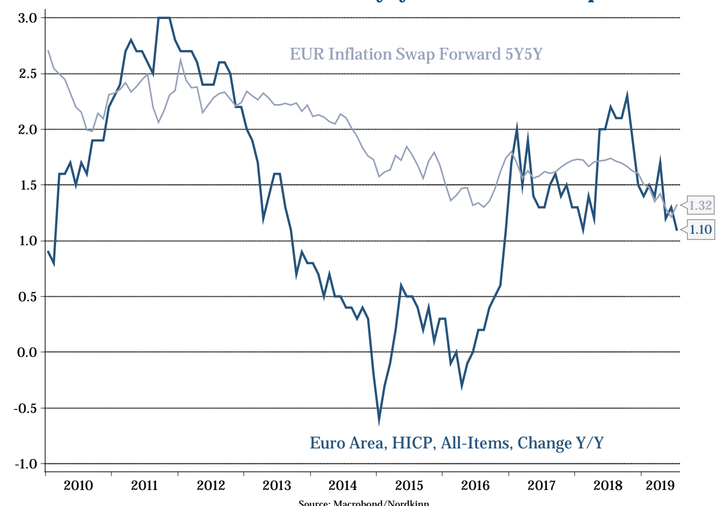
ECB is not in a better place than the Federal Reserve when it comes to inflation and expectations. Compared to the U.S., growth in the Euro Area has already started to decline. Draghi mentioned, however, that recession risk is still low in Europe.

Given Fed's discussion about inflation expectations, and the symmetry of inflation targeting earlier in the year, it did not come as a surprise that ECB minutes showed similar discussion at the June meeting. A potential refocus within ECB, towards a more symmetric targeting, will have big impact on markets.

We do not find it unlikely that such a shift of policy could happen over the medium-term. However, such a change will be preceded by a lot of discussions and markets will gradually adapt accordingly. We believe this debate will continue in the second half of the year and might spur some moves in the long-term market based inflation expectations as these are set very low for the Euro Area.

To conclude, if major central banks cut rates in order to boost inflation expectations, this should in theory result in steeper yield curves. However, in real life and as seen over the last few years, the yield grabbing forces are relentless. Hence, curve steepening might not be so obvious, at least not in the near term.





Nordic markets

In Sweden, the relatively hawkish Riksbank at the July meeting can be ascribed to recent inflation prints matching the central banks forecast. In the same way as low inflation in 2015-2017 was an obstacle for the Riksbank to hike rates despite strong economic growth, the lower growth outlook today is neutralised by the fact that inflation has risen and is currently at target.

The market will most likely continue to doubt Riksbank's current stance and expect the central bank to eventually respond to the slower economy. There are more and more signs that the decline in German manufacturing is gradually taken its toll on the Swedish industry sector. The NIERs confidence index (KI Konjunkturbarometer) for the manufacturing sector was at a four-year-low in July and the PMI for the service sector plunged below 50. More worrisome are the indications that the labour market is slowing. The data over the summer months are notoriously uncertain, but it is clear that employment growth has stalled.

This notwithstanding, we believe that the Riksbank will continue to be hawkish relative to market pricing, at least in the short term. During the second half of the year we expect inflation to gradually slow again. In more detail, we note that the sub-category for input prices in the service PMI has showed a significant drop over the last year. This does not bode well for the important service inflation, and yet there are no signs of higher wage growth.

Although we think it will take longer time for Riksbank to shift, we see a very low likelihood that Riksbank will lift the policy rate in the coming winter in the way that their current rate path suggests, see chart.

Subsequently, we prefer curve flatteners and hold only marginal outright positions in SEK rates. We will likely, however, refrain from holding curve flatteners when we approach next Riksbank meeting. Given pricing and a Riksbank slow to respond, the risk for disappointment is imminent. We still believe Swedish short end rates to move strongly relative to Norway.

In Norway, incoming data confirms that the oil-related economic upswing has broadened to the services sector. At the same time, there are signs emerging that the non-oil manufacturing exports industry is being hurt by the global slowdown. On balance, we expect growth to keep up in the second half of this year before slowing faster than the Norges Bank has projected in 2020.

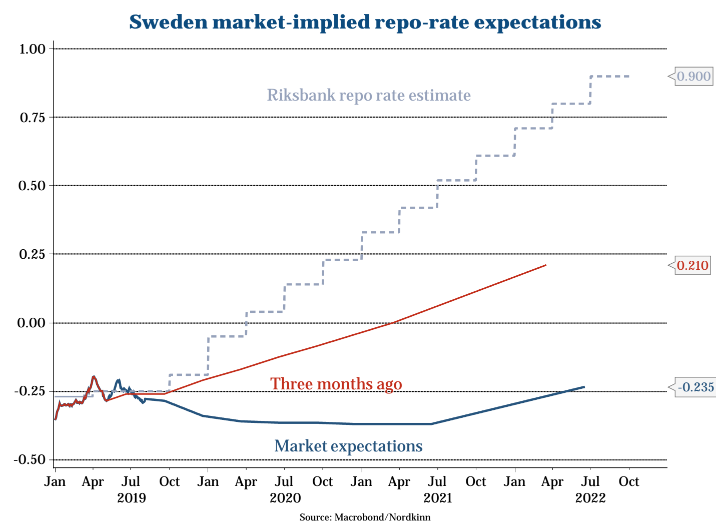
The labour market is tight and capacity utilisation is estimated to be above normal levels. This has lead to a rise in wage growth, which will continue to support domestic inflationary pressures. Meanwhile, the appreciation of the NOK will soon begin to put downward pressures on import prices. On balance, we expect underlying consumer price inflation (excluding taxes and energy) to remain between 2% and 2.5% in the second half of this year.

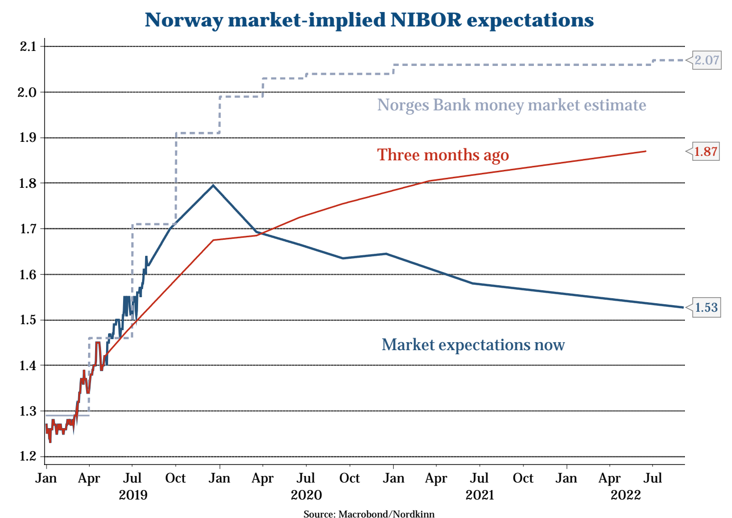
Considering the domestic situation in isloation, a key policy rate at 1.25% is too accomodative. At the same time, the slowdown abroad, in combination with a stronger NOK exchange rate, likely reduces the need for a tight monetary policy in Norway. Taking everything into account, at its meeting on August 15th the Norges Bank will most likely signal that it indends to raise rates for the third time this year to 1.50% in September, thus bringing the rate closer to netural.

If we are right about our call for a September hike, we expect that the Norges Bank Board will find it appropriate to signal an unchanged key policy rate for the foreseeable future, while assessing the effect of past tightening as well as mounting global uncertaities.

Turning to investment implications, we still see some further upside potential for short-dated NOK rates in the second half of the year. Further out the curve, we have unwound almost all directional positions as we focus almost exclusively on relative value trades against Sweden and the Euro area.

We have added to positions for a stronger NOK exchange rate on relative macro performance as well as more attractive carry, even though global risk factors are less favourable in the short-term.





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