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Nordkinn Market Review & Outlook – August 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

Just as investors returned to their desks after the hot summer break, renewed market turbulence swept in like a cold wet blanket. The sentiment deteriorated among several emerging market economies, including Turkey suffering from intense pressures on its currency, and Argentina that was forced to push interest rates to 60%, see chart.

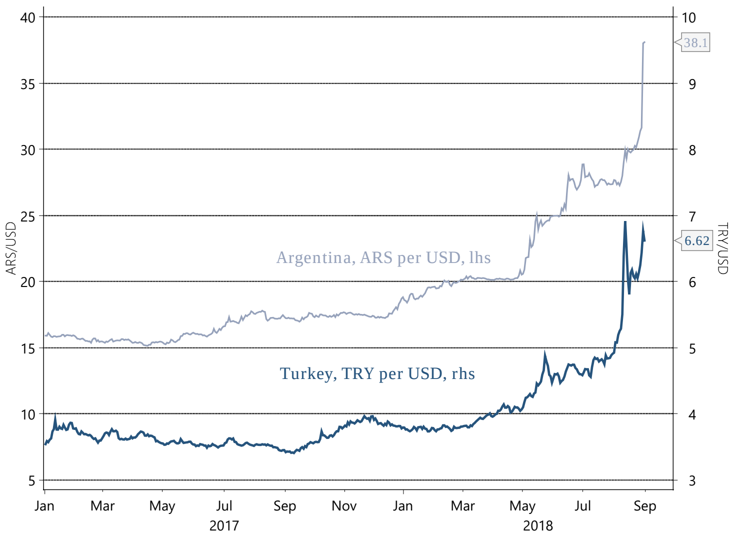
Meanwhile, the trade war yet again escalated after the Trump administration published a list of 279 Chinese goods subject to a 25% tariff as from August 23rd. China responded with tariffs of equal value. As a consequent of these developments, safe haven demand for government bonds offset rising supply, sending global bond yields markedly lower in August.

In his speech at the annual Jackson Hole seminar, Fed chairman Jerome Powell reconfirmed the most recent FOMC projections, signalling further gradual increases in the target range for the federal funds rate. Currently, the market fully prices a rate hike at the FOMC meeting on September 25-26th, but only one more rate hike at subsequent meetings. These expectations remained broadly stable in August, while long-dated yields fell. Consequently, the slope of the yield curve bull flattened.

According to the minutes of the monetary policy meeting at the ECB on July 26th, the Governing council expressed satisfaction that the communication of the June monetary policy decisions had been correctly understood by the financial markets. Its forward guidance on the future path of policy rates had been effective in aligning market views about the future evolution of policy rates with the Governing Council's expectation that the key ECB interest rates will remain at their current levels "at least through the summer of 2019".

The downward trend in the EUR/USD exchange rate intensified in the beginning of August as investors began to fear that the meltdown in the Turkish Lira would ripple throughout Europe. The currency cross rebounded sharply in the latter half of the month after U.S. President Trump reportedly complained about the Federal Reserve's recent interest rate hikes and accused China and the EU of manipulating their currencies.

USD/TRY and USD/ARS



Source: Macrobond/Nordkinn

Nordic overview

Oblivious to fundamentals, bond yields declined in both Sweden and Norway in August. The development in Swedish bonds broadly matched that of Germany when considering the month as a whole, while Norwegian bonds outperformed. In other words, interest rate differences between Norway and Sweden and between Norway and Germany narrowed in August.

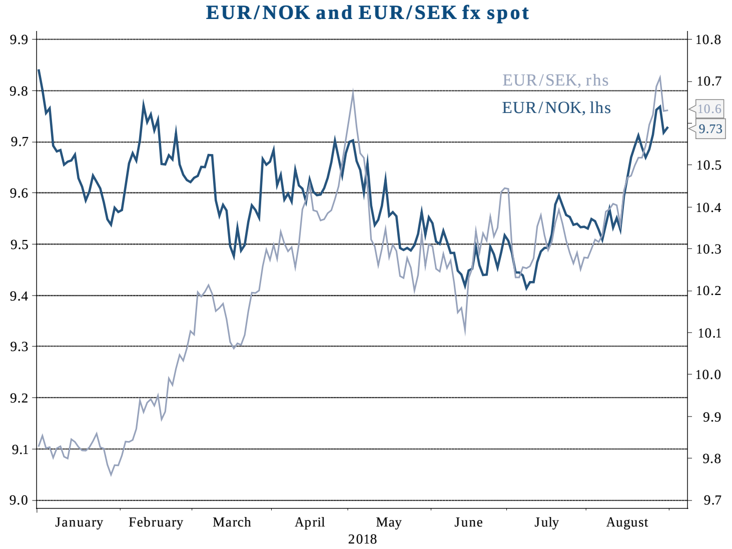
Our interpretation is that issuance-related flows contributed to the decline in Norwegian rates, rather than weaker economic prospects. Quite the opposite, macroeconomic releases were pretty strong, including solid GDP-growth in Q2 and a surprising pick-up in core CPI inflation. Moreover, on August 16th the Norges Bank Board reiterated the Board's intension to raise the key policy rate to 0.75% at the Board meeting on September 20th as the upturn in the Norwegian economy appears to be continuing broadly in line with projections.

In Sweden, incoming information suggests that economic growth continues to be robust and CPIF inflation remained above the central bank's 2% target in July. However, excluding energy prices, the rate of increase in CPIF inflation declined to 1.29%, 0.15%-points below the Riksbank's forecast. Against the background of a softer non-energy inflation trend, driven in part by a slower pace of increases in service prices, speculations about another delay in repo rate hikes intensified.

This, in combination with rising political uncertainties ahead of the general election on September 9th, pushed the SEK to a new year-low against the EUR on August 29th, reaching levels not seen since the financial crisis. Consequently, the SEK has been the worst performing G10 currency by far in 2018.

Despite different prospects for monetary policy in Norway, the NOK depreciated sharply against major currencies in August. Indeed, the correlation between EUR/SEK and EUR/NOK has been remarkably strong in recent months, see chart, implying that it is a common driver behind the weakness in the Scandinavian currencies.

EUR/NOK and EUR/SEK fx spot



Source: Macrobond/Nordkinn

Global markets

Although the U.S. economy is in a sustained expansion and many economic indicators show continued strength, concerns have emerged about a possible recession looming. One reason is the narrowing spread between long-term and short-term Treasury yields. A well-established regularity in postwar U.S. economic history is that an inverted yield curve (when long-term rates drop below short-term rates) is generally followed shortly afterwards by an economic recession. The ability of the U.S. Treasury yield curve to predict future recessions has therefore recently received a great deal of public attention.

There has also been a flurry of reports recently explaining why the recent flattening of the yield curve is giving a misleading signal. The principal argument why "this time is different" is that long-term yields, particularly the term premium component, are significantly depressed due to QE programs by central banks around the world and the large balance sheet of the Federal Reserve. If long-term yields are still low because of QE, and if these effects contribute to the yield curve flattening but do not increase recession risk, then flattening may not be worrisome at all.

Leaving this caveat aside for now, let's focus on a recent Fed report (Bauer and Mertens, August 27th 2018). The authors assessed the accuracy of various term spreads in predicting recessions. First, they argue that recession predictions based on the yield curve require an inversion. Second, they find that the ten-year minus three-month spread is the most reliable summary measure of the shape of the yield curve.

In light of this evidence, the recent flattening of the yield curve suggests that recession risks might be rising. However, the flattening yield curve provides no sign of an imminent recession: No matter which term spread is used to measure its shape, the yield curve is not yet inverted. Moreover, the most reliable measure of the shape of the yield curve, the ten-year minus three-month spread, is nearly 1 percentage point away from an inversion, see chart.

Furthermore, when interpreting the yield curve evidence, one should keep in mind what is causing this correlation. In our view, yield curve inversions and recessions have occurred in the past predominately because short-term rates have been hiked to elevated levels, and tight monetary policy is slowing down the economy.

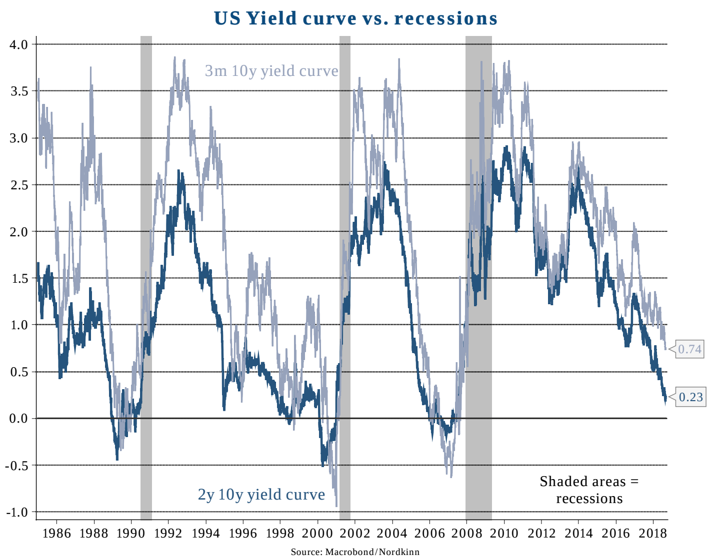
This is why the concept of r-star has been at the center of recent discussion about monetary policy. R-star is what economists call the natural rate of interest; it's the real interest rate that is neither expansionary nor contractionary when the economy is at full employment. While a central bank like the Fed sets short-term interest rates, r-star is a result of longer-term economic factors beyond the influence of central banks and monetary policy.

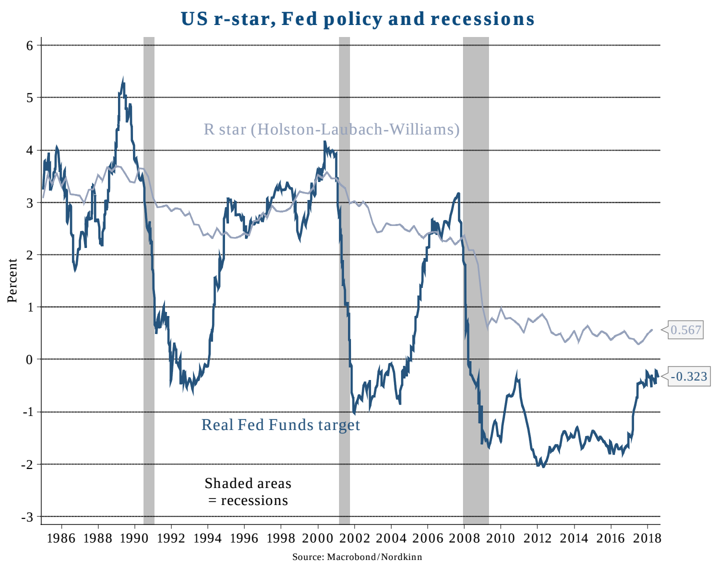
If the central bank sets the base rate above r-star then policy is restrictive – the further above r-star the more restrictive. Hence understanding and estimating r-star is essential for the formulation of monetary policy, and for forecasting future recessions.

The most well-known estimate of r-star is the one made by Holston, Laubach and Williams. In the chart below we compare this estimate of r-star with the Fed Funds target rate adjusted for CPI inflation. As illustrated by the chart, periods where the real Fed Funds rate is well above r-star has often (but not always) predicted a recession.

Now, the real Fed Funds target rate is around 80 basis points below r-star. At current inflation rates, the Fed Funds target can be hiked three times (25 basis points each) before coming to neutral. This is more than what is currently priced in by the market.

With inflationary pressures building, we subscribe to the FOMC members' own forecasts ("dots") that the Fed Funds target will be hiked into restrictive territory by the end of 2019, which is significantly more than the market currently expects. Based on these considerations, we actively trade U.S. government bonds and curvature. The trades are organised under the *"US: Interest rate normalisation"* theme.





Nordic markets

At the Monetary Policy meeting on July 2nd, the Riksbank Board projected a first rate hike in October or December this year. Since then, while CPIF inflation has remained close to the 2% target, it has been held up by rising energy prices. Most board members of the Riksbank think it is reasonable to see through such temporary effects from higher energy prices in their monetary policy deliberations, and instead focus on measures of underlying inflation. Yet, the increase in CPIF excluding energy has shown a falling trend over the last couple of months.

Given that non-energy CPIF was 0.15%-points below the Riksbank's forecast in July and that this deviation is caused by a lower increase in service prices, a majority of bank economists expect a slightly lower forecast for the repo rate path when the Riksbank presents its updated projections on September 6th. This also appears to be the market's view: The money market curve prices in a later start and a slower pace of rate hikes compared with the Riksbank's own latest forecasts.

However, we are not convinced that the Riksbank will lower its forecast for inflation, nor the repo rate path. The SEK is currently around 2.5% and 4.5% weaker than the Riksbank's Q3 and Q4 forecasts respectively. The notoriously weak SEK trend in 2018 is starting to have an impact on import and producer prices, but has yet to have any clear effects on consumer prices. However, this could take several months. Indeed, the chart below illustrates that CPIF excluding energy lags the rate of increase in consumer goods PPI by around 6 months, suggesting that underlying inflation will turn upwards again later this year. With April 2018 in mind, a further postponement of interest rate hikes could in fact trigger an unwelcome currency collapse.

Consequently, we expect that the Riksbank will maintain its projection for the repo rate more or less unchanged, which is consistent with a rate hike in December. Given current market pricing, we think risk/reward favours short duration trades in fixed income organised under the *"Sweden: Credible Inflation Targeting"* theme. The SEK may also meaningfully benefit should the Riksbank leave its repo rate forecast broadly unchanged.

Turning to Norway, the Norges Bank will almost certainly hike its key policy rate by 25 bps to 0.75% on September 20th. While underlying inflation is below target, the most recent figure was two tenths of a percent above the Norges Bank's inflation forecast. More importantly, the Bank appears convinced that rising capacity utilisation implies an increase in price and wage inflation further out in time. Interestingly, the Norges Bank's models for short-term forecasting (SAM) were updated on August 15th, signalling a somewhat faster rise in inflation ahead compared with the previous projections made in June.

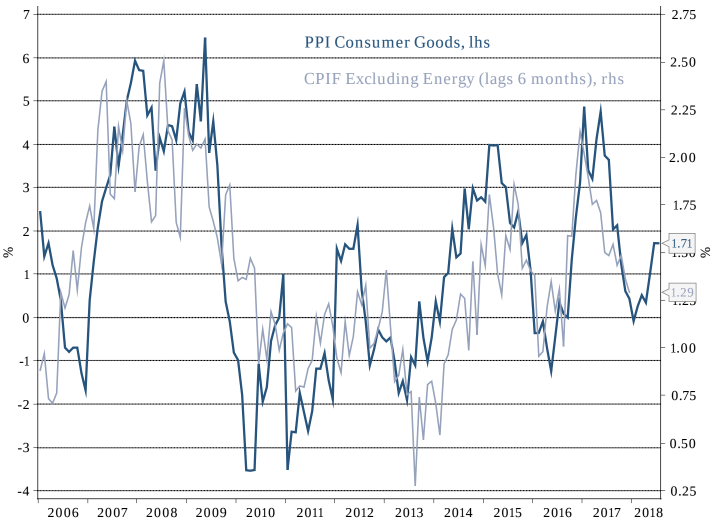
Incoming data on economic growth largely confirms the Norges Bank's June projections. A temporary drop in electricity production due to the dry summer resulted in slightly weaker growth in Mainland-Norway GDP than the Bank expected, but the underlying trend remains strong. Moreover, the quarterly oil investment survey published on August 23rd signals strong growth in 2019.

Regarding financial markets, the NOK is almost 3% and 4% weaker than the Norges Bank's assumption for Q3 and Q4 respectively, and money market premiums are some 10 bps lower than expected. This will in isolation contribute positively to the next interest rate projection.

On balance, we expect the Norges Bank Board to revise its interest rate projection slightly upwards. The previous rate path is consistent with two hikes in 2019, and in the updated report we expect to see an increased likelihood of three hikes next year. For comparison, the market prices in only about one hike next year.

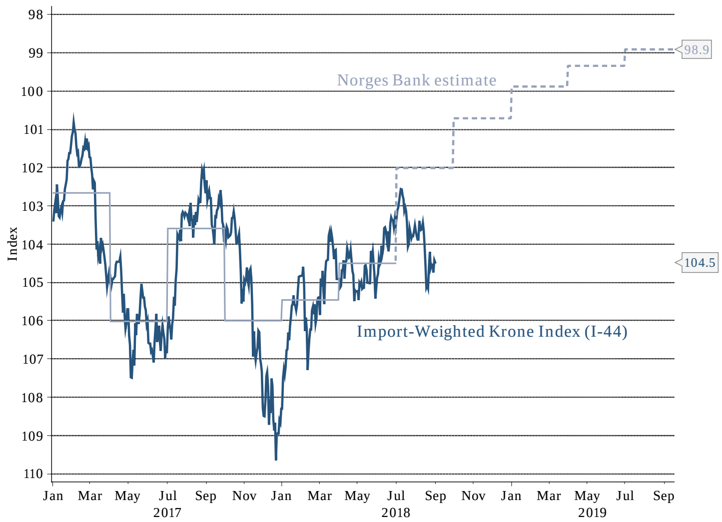
Consequently, we continue to favour short exposure in fixed income space, which is organised under the *"Norway: Economic revival"* theme. Moreover, we continue to see fundamentals supportive for the NOK going forward, in particular as we expect the Norges Bank to hike in September 2018 accompanied by a hawkish message indicating a faster pace of tightening next year.

Sweden PPI vs. CPIF



Source: Macrobond/Nordkinn

NOK effective exchange rate vs. Norges Bank



Source: Macrobond/Nordkinn

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