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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – October 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

Driven by a decline in tail risks for global growth, equities reached all-time highs in October while global government bond yields rose, see chart. The probability of a hard Brexit has diminished while the trade negotiation between the U.S. and China seems to be progressing. Representatives from both the U.S. and China say that they are close to finalising a "phase one" deal that may halt the tariff war, at least for now.

Moreover, recent industry data is showing some signs of stabilisation globally. For the third month in a row global manufacturing PMIs are showing signs of stabilisation, providing markets a hope that the trough in the global slowdown is behind us.

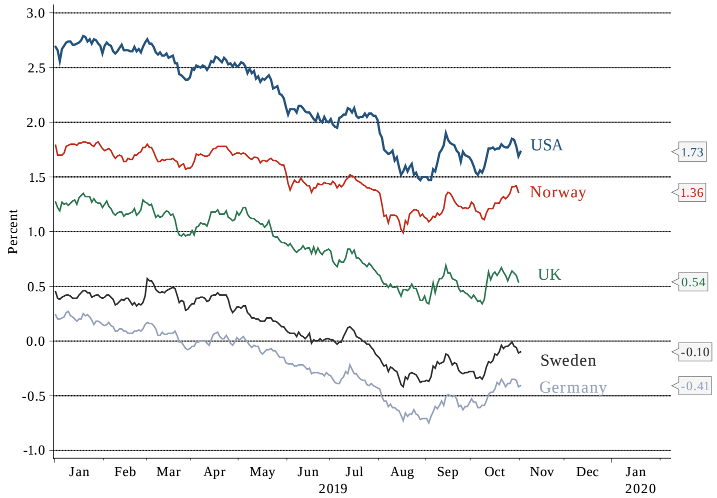
On October 30th the FOMC decided to lower the target range for the U.S. federal funds rate by 25 bps to 1.50-1.75%, citing the impact of global developments on the economic outlook as well as muted inflationary pressures. However, the Fed's previous communication had been interpreted as a bias to ease policy further, but at the press conference Chair Powell said the current stance is *"likely to remain appropriate"* as long as the data is consistent with the FOMC's outlook.

Because interest rate markets had already moved a long way in pricing in a more neutral bias of the FOMC prior to the meeting, the immediate market reaction was relatively muted. The market now prices in only about 20% probability for a cut in December. The next full 25 bps of easing is not priced in before the second half of 2020.

The USD depreciated in October, mainly reflecting a more positive outlook for global growth, following reduced geopolitical risks. The EUR/USD rose from 1.09 on October 1st to almost 1.12.

U.K. Prime Minster Boris Johnson won the first ever majority in the House of Commons for a withdrawal pact. Meanwhile, Parliament voted down Johnson's proposal for an accelerated timetable to get the deal done by October 31st. As required by the so-called Benn Act, the UK Prime Minister formally requested a Brexit extension until January 31st 2020, which was granted by EU states a few days after. The UK is heading for a December general election after Boris Johnson won the backing of the opposition Labour party.

10y Government bond yields



Source: Macrobond/Nordkinn

Nordic overview

On October 24th the Riksbank surprised most market participants by signalling that the interest rate will most likely be raised to 0% in December. The announcement was in line with the September projections, yet markets were taken wrong-footed due to recent macro data pointing to a deterioration in economic conditions. For instance, production plans in NIERs business survey indicate a sharp decline in industrial activity. In addition, labour market indicators, admittedly subject to significant measurement problems, have overall showed a worsening of conditions.

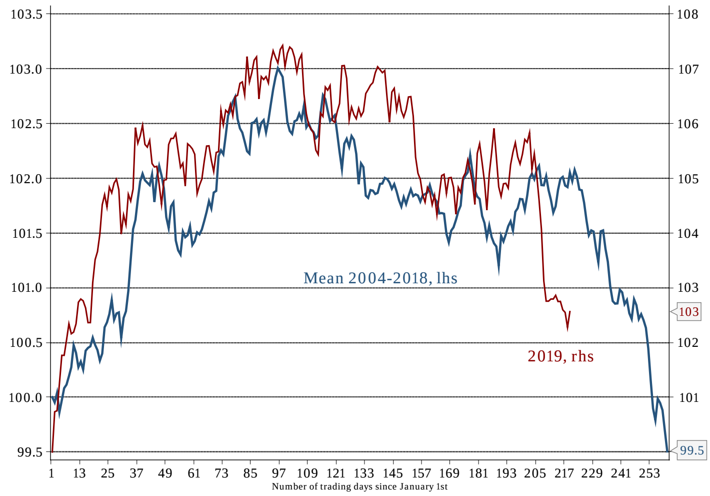
The Riksbank, on their hand, cited overall unchanged inflation prospects as the reason for keeping the near-term interest rate path unchanged. Meanwhile, the interest rate path from 2020 and onwards was revised sharply down due to higher uncertainty and weaker prospects for global growth. The path indicates that the repo rate will remain unchanged at 0% between December 2019 and well into 2022. This prompted a repricing of the interest rate curve, with short-dated rates sharply higher in the aftermath of the announcement. The SEK appreciated immediately after the Riksbank signalled a December hike, but trimmed gains shortly after due to the flattening of the rate path and the uncertain economic outlook.

The Norges Bank Board left the key policy rate unchanged at 1.50% on October 24th, as expected by everyone. While this was an interim meeting without updated forecasts, Governor Olsen reiterated the Executive Board's forward guidance from September that the policy rate will most likely remain at the present level in the coming period. However, the market took notice of the reference to higher inflation risks ahead due to the weak NOK, sending short-dated market rates higher.

The NIBOR fixed at relatively low levels in most of October, in part reflecting excessive structural bank liquidity, but inched gradually higher towards the end of the month.

The NOK depreciated noticeably during October. We believe the uncertainty about global trade is one factor explaining the weak performance of the NOK in 2019 overall, but in October this has been reinforced by a seasonal headwind for the NOK, even if this began a little earlier than the average historical pattern, see chart.

NOK/SEK between January 1st and December 31st



Source: Macrobond/Nordkinn

OUTLOOK

Global markets

Rising government bond yields and a weaker USD are emerging trends and reflect fading downside tail risks from geopolitics. Investor sentiment thrives on signs of progress on trade talks and about prospects for an orderly Brexit. In addition, monetary policy has contributed to easier financial conditions in recent months. Finally, hopes of an inflection point in global manufacturing arise as global PMI data stabilises.

It would be a mistake to conclude that risks are gone. Although the likelihood of a no-deal Brexit in coming weeks has diminished significantly, the risks may have been simply pushed into next year and depends critically on the outcome of the UK election in December that is designed to break the deadlock over Brexit.

On trade war, the "phase-one" trade deal between the U.S. and China have yet to be signed. And even though the parties may agree on some sort of a deal at a summit in November, this may not be enough to boost business confidence sustainably. Yes, the deal may halt the tariff war, but it does not necessarily mean that the tariffs implemented in May and September will be rolled back. Furthermore, uncertainties may flare up again when the issues of technology and intellectual property are going to be resolved. According to a Bloomberg story released in October 31st, Chinese officials are indeed casting doubts about reaching a more comprehensive long-term trade deal with the U.S.

In our view, the geopolitical uncertainty holding back global investments could keep easier financial conditions from translating into stronger growth. Given the positive mood in markets of late, any signs of set-backs regarding prospects for trade deal or an orderly Brexit would push bond yields down again, as would a further deterioration in global growth data.

Against this background, our inclination is to remain cautious and refrain from pinning hopes on some of the more positive signals of late. This view is expressed through tactical positions for lower bond yields.

Having been inverted and signalling a recession, over the past couple of months the slope of the U.S. 2s 10s yield curve has slowly and gradually steepened up and regained a more normal upward sloping, see chart. This development reflects a combination of Fed easing and rising optimism about economic prospects.

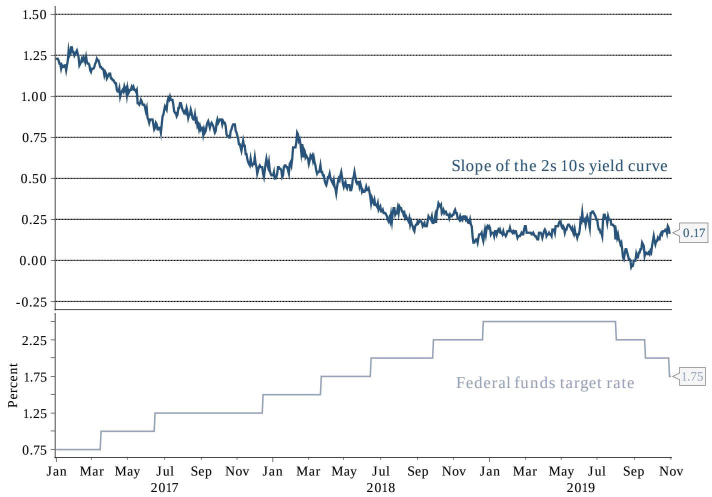
In the short-term we believe the yield curve will struggle to steepen much further because the Fed appears more hesitant to ease policy further and given our view that global uncertainties will return, which may push longer-dated yields lower again. Still, our longer-term view is for steeper curves because we believe the Fed's main focus in 2020 will be to sustain the economic expansion for as long as possible.

Turning to FX, the USD entered October at its highest level since mid-2017. Renewed optimism about the prospect for global growth, largely emanating from outside the U.S., have driven the USD weaker. Was this the start of a downward trend in the USD or just another false start?

Our answer to this question is that the USD is mainly a countercyclical currency, meaning that it tends to move in the opposite direction of global growth. Because we are tactically inclined to fade the more positive signals of late regarding global growth, we would be cautious in chasing widespread USD weakness at the moment. Furthermore, the USD still sees the highest carry in the G10 and the Fed has recently said it needs to see *"material changes"* to the outlook before it resumes policy easing.

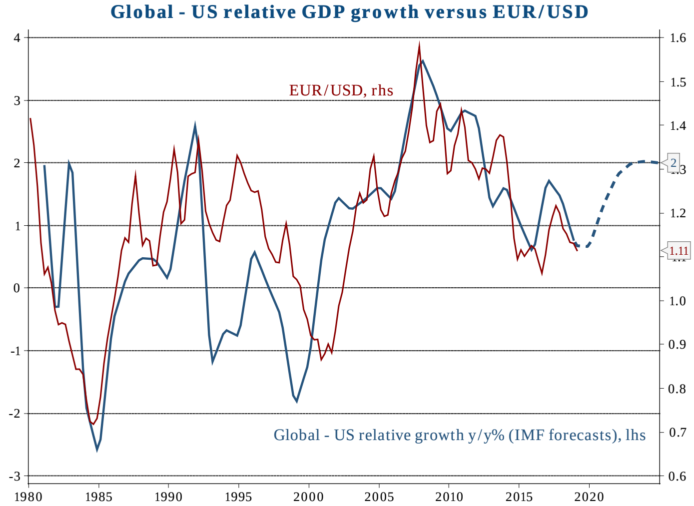
The most pressing downside risks for the USD is if U.S. growth were to significantly underperform global growth in the way the IMF expects, see chart. Such a scenario would likely be accompanied with expectations of more Fed easing next year and tighter interest rate spreads between the U.S and offshore markets.

United States 10 Year-2 Year



Source: Macrobond/Nordkinn

Global - US relative GDP growth versus EUR/USD



Source: Macrobond/Nordkinn/IMF

Nordic markets

The soft confidence data over the last few months confirms our view that Swedish hard data will struggle in the near- to medium-term. Industrial production is set to decline as we near the end of the year. Moreover, households have a dire outlook when it comes to the macro economy as the labour market deteriorates. Added to that, the plausable rate hike in December is on the margin bad news for confidence, the housing market and the overall economy. We see the theme coined "*Sweden: Slower growth, lower inflation*" as vivid as ever. Below we dig deeper into the "lower inflation" part of this theme.

Headline inflation will probably rise a bit in the next couple of months but the medium-term outlook is, in our view, not promising. Over the past few years there have been various contributors to the inflation rate. In general, "Housing" (i.e. fuel, mortgage costs, water etc.) has been the biggest factor behind the swing in inflation, from being low in the years 2012-2015 to a move higher in the years 2016-2019. When inflation troughed, the sub-component "Housing" had a negative contribution to CPI equal to 0.9%, while it has been adding up to 1.1% to the headline inflation over the past few years.

In 2016, "Clothing" was a big contributor on the back of the SEK depreciation of roughly 35% over the course of a year, see chart. In 2017 there were big moves in food prices and recreation/restaurants costs that drove up inflation. The latter, we suspect, was to a large extent an effect of a booming housing market and the related "feel good factor". In 2018, the biggest contributor was "Housing'"and in 2019 "Food" and imported goods like furniture have been major contributors.

If the brunt of the SEK depreciation to USD (50% over the past years) is behind us and if the housing market is moving sideways – what will drive Swedish inflation going forward? Given weaker labour market conditions, we doubt that the 2020 wage negotiation will be sufficient to lift the inflation rate in a sustainable manner. Global factors such as Chinese PPI, will not be of any help over the next year either. Hence, in order to reach the 2%-target, a further weakening of the SEK will probably be required. It can not be ruled out completely but, at least in the near term, the Riksbank will not be the main driver behind such a move. Instead, if the SEK at some point should start to appreciate, the inflation could decline substantially.

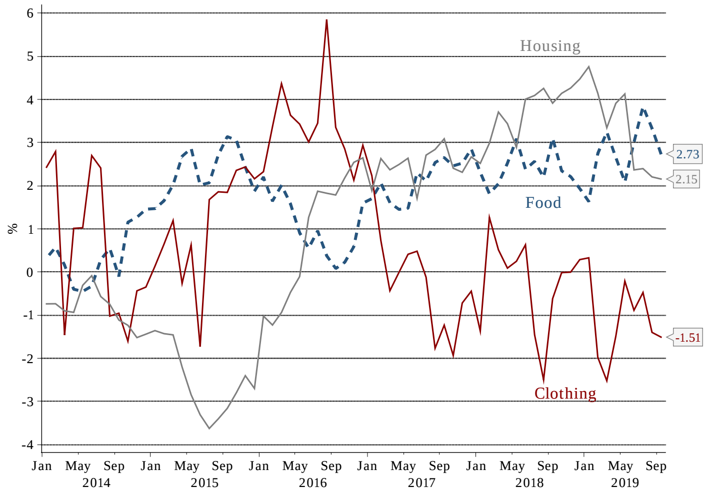
In Norway, while activity is at a high level, the rate of growth is loosing momentum. Business confidence for the manufacturing sector has started to roll over, indicating that business are starting to feel the pain from global weakness. Morevoer, while oil investments are at a very high level, activity is peaking and is unlikely to support the rate of economic growth next year. Considering the dim outlook for the global economy, we see risks to Mainland-Norway GDP-growth predominantly on the downside in the period ahead.

Following the relentless depreciation of the NOK in October, there is growing speculation about whether the Norges Bank may be forced to hike rates further to defend its currency. We do not expect such response. Granted, looking at the Bank's reaction function a weaker NOK forecast will in isolation lead to an upward revision of the rate path, which already sees a higher probability of a hike than a cut. However, the Norges Bank is well aware of the seasonal NOK weakness this time of the year, and when staff meets to discuss new forecats, it will almost certaintly forecast a recovery of the NOK in the first half of 2020. This will dampen the impact of the current weak NOK on the rate path.

In addition, the overall impact on the interest rate outlook depends crucially on the reason behind the weak NOK. According to the Exectutive Board's assessment following the rate decision on October 24th, growth among Norway's trading partners is weaker than assumed in September and the weak NOK may reflect persistent uncertainty about global developments. We largely agree with this view, which has seen other currencies of small open economies depreciate against the USD, see chart. Anyway, global weakness and geopolitical uncertainties are not conditions that argues in favour of further hikes beyond the 100 bps of tightening already delivered. In other words, we expect that the isolated impact of a weaker NOK on the rate path will be partly or fully offset by weakness abroad.

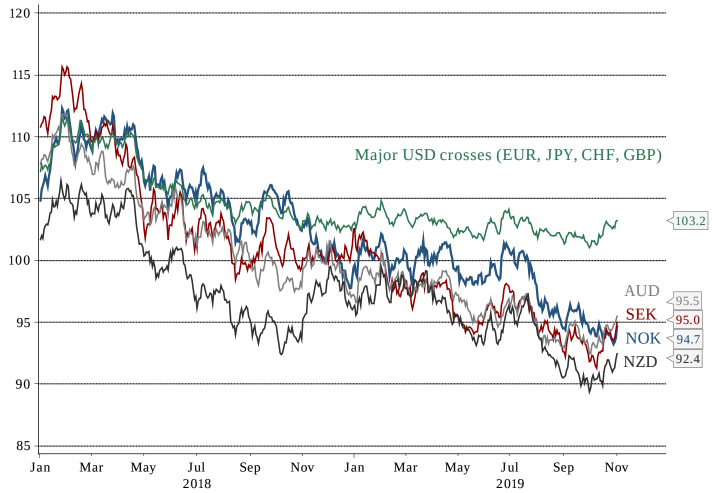
We continue to believe that the next move in the key policy rate will be a cut, but our forecast for the coming quarters is for rates to remain unchanged at current levels. The recent steepening of the yield curve has reinforced our preference for being paid the front-end and received further out the curve. We expect the NOK exchange rate to rally in the first half of 2020, but seasonality, combined with our inclination to fade global optimism in the near-term, warrants patience.

Sweden CPI inflation, selected sub-indices



Source: Macrobond/Nordkinn

USD crosses since June 1st 2017



Source: Macrobond/Nordkinn

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