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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – November 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

Hopes of a phase-one trade deal between the U.S. and China along with anticipations of a rebound in the global economy took equities to new all-time highs also in November. Undoubtedly, recent industry data is showing some encouraging signs of late. Manufacturing PMIs from most major countries reached lows during the summer and have rebounded slightly during the fall, see chart.

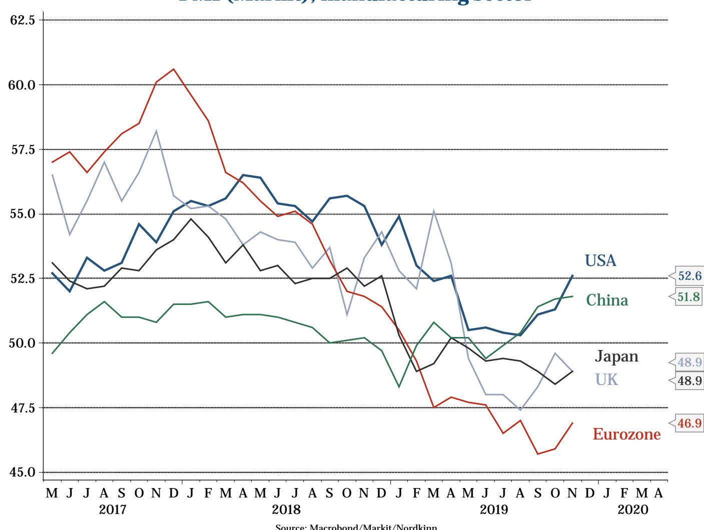
Meanwhile, non-manufacturing data has been less upbeat recently. Service sector PMIs are still on a downward trend and employment growth is generally slowing across the world. Overall, global GDP growth continues to track a sub-par pace in Q4.

The government bond market, which apparently is less constructive with regards the outlook for the global economy, remained virtually unchanged in November as a whole. Behind this overall picture, the market did see some degree of intra-month volatility following higher yields in the first half of November and lower yields in the second half.

The FX market also seems to be more reluctant about the idea that the global economy is switching from slowdown to pick-up. For instance, the USD, which tends to move in the opposite direction of global growth, appreciated against both the EUR and JPY in November.

The signing of a phase-one trade deal between the U.S. and China, which was supposed to happen in November, was delayed until further notice. This created some speculation that the two countries are struggling to come to a final agreement. In particular, the U.S. support for pro-democracy demonstrators in Hong Kong was a complicating factor in the trade talks. However, President Trump did his best to calm financial markets by repeatedly saying negotiations are near completion.

The UK is preparing for a general election on December 12th, which in reality is a Brexit election. According to November polls, the Conservatives are currently leading the race with Prime Minister Boris Johnson promising voters he has an "oven-ready" deal to set in motion as soon as he wins.



Nordic overview

Despite several important data releases, Swedish interest rates traded in a narrow range throughout November. CPI inflation outcome was a tad below the Riksbank's projection, yet close to market expectations. Hence, lead to a subdued market reaction. On November 14th Statistic Sweden presented revised unemployment data for the last year. The revised data painted a brighter picture, with a more gradual deterioration of the labour market than what was reflected by previous reports. Important to note is that the survey sample is now cut by 50%, so this labour market indicator is less reliable.

The first release of GDP data for Q3 was published on November 29th and was, if anything, a small disappointment when looking at the details. Consumption was a bit lower than expected, whereas export was boosted by services exports (R&D), which seems to be a result of a "one-off" effect from a patent or intellectual property.

The SEK appreciated around 2.5% to the EUR in November, see chart. Global markets' talks about "green shoots" have most likely benefitted the SEK together with the expected Riksbank hike in December.

Norwegian interest rates rose in the first half of the month mirroring the trend seen abroad, but the movements were a bit stronger resulting in wider cross-country spreads. Swap rates peaked at 2% across all maturities, before issuance activity and systematic receivers pushed rates and cross-market spreads down in the latter half of November.

Norwegian government bonds saw strong demand during the first three weeks of the month driven by what seems to have been foreign real-money investors. Demand was particularly strong for NGBs with shorter-term maturities, likely reflecting an increased appetite for NOK FX exposure and a relatively lower appetite for duration. This contributed to wider NGB asset swap spreads in the beginning of the month. However, demand for NGBs faded before the end of the month.

The NOK appreciated slightly to EUR in November following some improvement in global manufacturing data, slightly higher commodity prices and a reduction in geopolitical tail-risks.

OUTLOOK

Global markets

As 2019 draws to a close the market is pricing in a global economic recovery. However, with U.S. equities hitting new highs and longer-term government bond yields well above the recent lows across major economies, bond investors appear less optimistic than equity investors. This optimism reflects in part positive news regarding trade negotiations between the U.S. and China, and in part the sharp reduction in the likelihood that the UK will leave the EU without any deal.

These positive trends have also become visible in manufacturing and trade data. After falling sharply for much of 2018 and 2019, the global manufacturing PMI index has inched higher over the past few months. True, the level remains low and it is too early to call it a trend, yet the notion that a turning point in the global business cycle might be underway has also been identified by other data such as the OCEDs leading indicators, see chart. For financial markets that pride themselves on being forward-looking, price developments around turning points in the global business cycle can be quite significant.

Still, the idea that the global economy is about to rebound has not yet found its way into forecasts. Rather, on November 21st the OECD trimmed its global 2020 growth forecasts owing to "persistent policy uncertainty and weak trade and investment flows", projecting world GDP to grow by 2.9% next year. The previous forecast was 3.4%, see chart.

Where we go from here depends largely on the U.S.-China trade dispute and on whether things escalate, de-escalate or just move sideways. The U.S. is scheduled to levy 15% tariffs on about USD 156 bln of Chinese products on December 15th. If these tariffs are indeed implemented, we expect further global weakness over the next few quarters and further easing of monetary policy worldwide.

On the other hand, there are speculations that the fate of these tariffs would be considered as part of the final negotiation over the phase-one trade deal. Even a removal of the tariffs implemented on September 1st is being considered according to news stories. In such a trade war de-escalation scenario, we expect business confidence to recover.

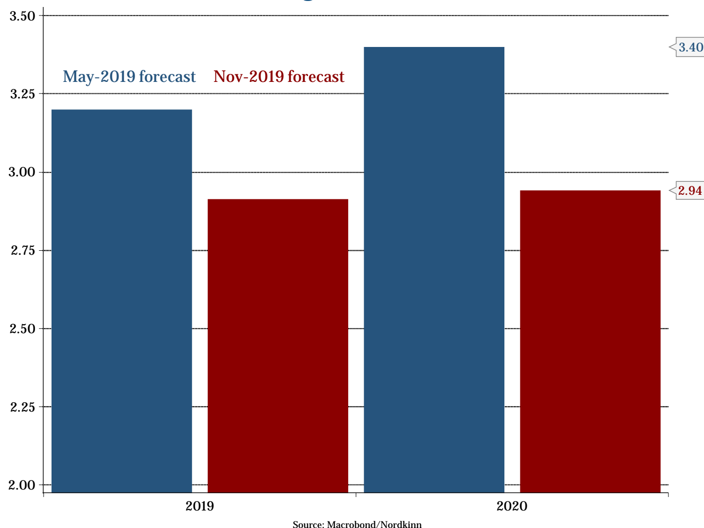
Nonetheless, uncertainty will linger even if a first-stage deal is agreed upon. The November 2020 U.S. presidential election and the difficulties in getting the phase-one deal done are dimming hopes for anything more ambitious in the near future. Consequently, we do not see a strong bounce in global growth.

One source of downside risk is manufacturing weakness spreading to non-manufacturing activity. Indeed, the most recent PMI data suggests non-manufacturing growth is slowing. Fortunately, the historical track record for the manufacturing sector to pull all the other sectors down is not that strong, though it depends on the depth and endurance of the manufacturing recession. If the tariff disruption does not dissipate and manufacturing remains under stress, there is an increasing probability of the rest of the sectors getting pulled into recession.

Taking all together, in the near-term we judge that the probability of a global recession has decreased for two reasons. First, we do see some evidence of uptick in manufacturing confidence. Second, monetary policy have acted precautionary and financial conditions have eased, see chart.

In this environment, what is the investment implications for bonds and currencies? We expect monetary policy to remain accommodative throughout 2020, supporting bonds with short- to medium term maturities. At the same time, signs of a turning point in manufacturing and trade should lead to somewhat higher yields on longer-term bonds, i.e. a steeper yield curve. Moreover, a more positive outlook for trade and global growth will lead to a weaker USD against most currencies, but perhaps particularly against the currencies of small open economies such as the NOK, SEK, AUD and NZD.

Having said that, we do recognise that there are plenty of macro risk factors in December, including trade talks and the UK election. Moreover, following the strong performance of risky assets in 2019, it is possible investors just want to hedge risk with less than one month left to year-end. Taken together, we have low conviction on directionality in the global market, focusing primarily on relative value opportunities.



Nordic markets

The year is expected to end in the same fashion as last year, i.e. a Riksbank hike. Perhaps, also as a resemble to last year, it is not totally in line with what domestic macro data implies. The market has re-priced accordingly and, in fact, the market implied repo rate path is above the Riksbank's own trajectory. Although it is just a few basis points, it was a long time ago market pricing was above the Riksbank's projection. Amid the repricing of the Riksbank, the Swedish yield curve has flattened a lot relative to other curves during the autumn. After this move, we now expect other forces to play a more important role going forward.

In October the Swedish National Debt Office (SNDO) forecasted that borrowing requirements will increase in 2020 and 2021, prompting more bond issuance starting January 2020. The SNDO will continue to prioritise the 10-year segment. Hence, 2020 will be the first time in years the SGB market will have a clear positive net supply (after adjusting for the Riksbank purchases). Admittedly, the net supply will not be huge, but the question is who will buy more bonds at current yield levels? More, the supply could increase further if companies cease or reverse flows to the Tax Account after the anticipated Riksbank rate hike.

Over the course of the first half of 2020 we expect bond supply to gradually push Swedish SGB bond yields higher relative to swap rates and relative to yields in shorter maturities and compared to cross-market yields. The theme *"Sweden: Rising bond supply"* consists of positions benefitting from such market moves. In combination with the other theme, *"Sweden. Slower growth, lower inflation"*, it is evident that real rates should be the main driver for higher interest rates in Sweden in 2020. It is striking that Swedish real rates (in the 5y segment) are still trading some 25 bps below where they were before the Riksbank hike a year ago. Hence, despite 50 bps higher nominal policy rate (after the expected hike in December) real rates are stuck at lower levels.

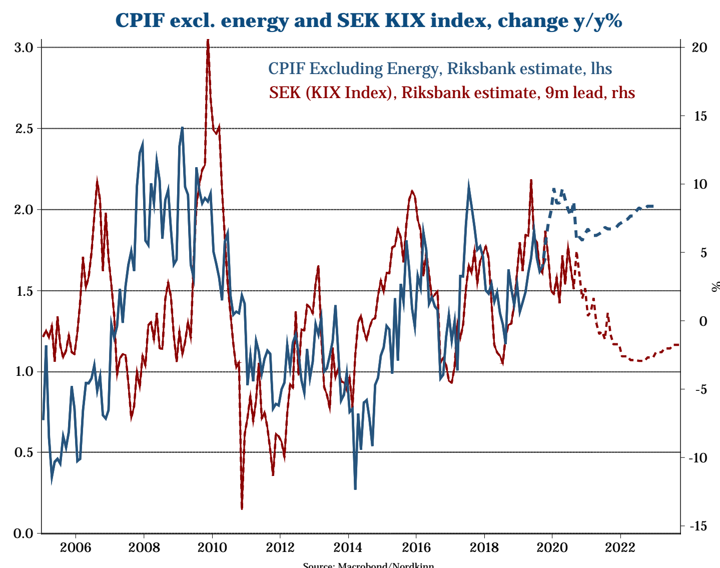
We see it as very unlikely that a higher average inflation of about 0.5% over the next five years or so will offset the higher nominal policy rate. Particularly as the inflation has been boosted by a very weak currency over the last five years, see chart. We see it as implausible that it will repeat itself over the next five years. Instead most indicators point towards a decline of Swedish inflation in 2020.

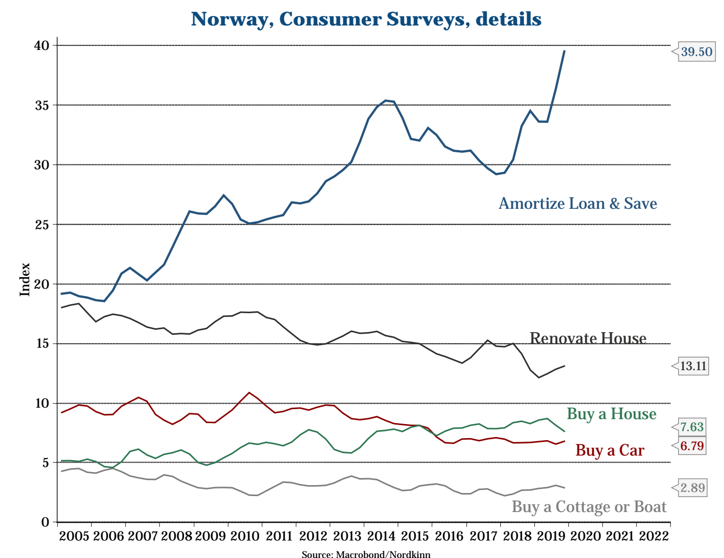
In Norway, the rate of growth is loosing momentum as oil investments are peaking after stellar growth in 2019. Growth in non-oil manufacturing has already been tepid for a while. Given our view that any rebound in global demand will be moderate by historical standards we expect overall growth in manufacturing activity to slow sharply in 2020. Business confidence has already started to roll over, so has consumer confidence. In fact, the share of households claiming that they will amortise or save rose to an all-time high in Q4, see chart. On balance, we see risks to GDP-growth in 2020 predominantly on the downside, supporting our *"Norway: Weaker growth outlook"* theme.

Following the depreciation of the NOK exchange rate since Norges Bank raised its key policy rate to 1.50% in September, there is growing speculation that the Norges Bank is mulling over the need to tighten monetary policy further early next year. The argument put forward for such a response is that the current interest rate projection implies around 40% probability for a hike in March 2020. Given that the NOK is currently around 3% weaker than Norges Bank's assumption, the weak NOK will in isolation contribute to a higher interest rate path.

We disagree with this view. First of all, we belive that the Board's forward guidance is the more important tool for signalling the monetary policy outlook for the period ahead. For the first time in more than a year, the Norges Bank Board shifted from a hiking bias to a neutral stance in September by saying that *"the policy rate will most likely remain at this level in the coming period*". Second, we expect the Norges Bank to follow the recent OECD economic outlook and cut its forecast for global growth in 2020. This will, at least in part, offset the impact of a weaker NOK. Third, the Norges Bank is well aware of the seasonal NOK weakness this time of the year, and when staff meets to discuss new forecasts, 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.

We continue to believe that the key policy rate will remain unchanged at current levels at least until summer 2020. We prefer being received the belly of the curve, partly hedged by paying position in wings. We expect the NOK exchange rate to rally in the first half of 2020, but look for a temporary depreciation against the SEK in December due to seasonality and monetary policy convergence.





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