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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – December 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

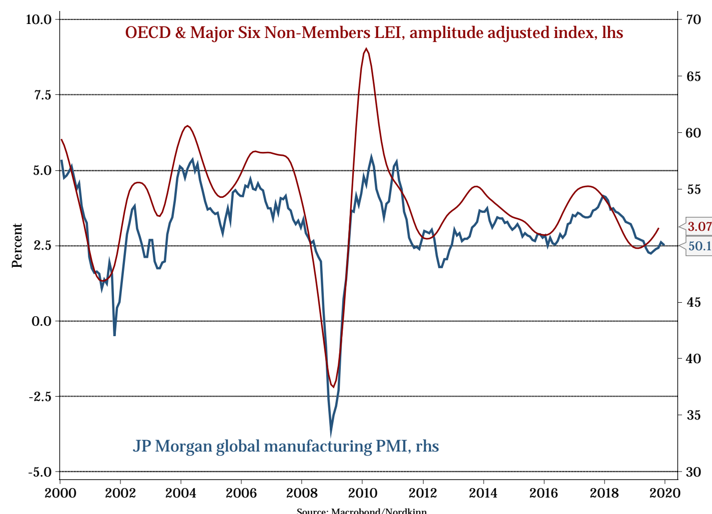
Along with risky assets, government bond yields climbed, as various political developments in December significantly reduced tail-risks. First and foremost, the U.S. - China phase-one deal was reached, which cancels additional duties that were scheduled to go into effect on December 15th and reduces duties on about USD 120 bln of Chinese goods to 7.5% from previous 15%. In return, China pledges to buy another USD 200 bln worth of goods and services from the U.S. and promises to better protect U.S. intellectual property.

At the UK general election on December 12th, voters delivered a decisive message that the country wants to leave the European Union. Boris Johnson's main campaign slogan "Get Brexit Done" led the Conservative party to its biggest majority in more than 50 years. The GBP initially appreciated based on the election result and became the best performing major currency of 2019 as it gave scope to move onto the next chapter in the Brexit saga. However, a few days later the GBP lost all its post-election gains after Boris Johnson moved to change the law to guarantee that the Brexit transition phase is not extended beyond the end of 2020, reviving the threat of a no-deal hard Brexit.

Meanwhile, incoming economic data continued to signal that global growth is bottoming. The OECD's Leading Economic Indicators (LEI) continued upwards in the beginning of Q4 to 3.07 and the global manufacturing PMI is showing a similar trend, even though it retreated slightly to 50.1 in December from 50.3 in the previous month, see chart.

On December 11th, the Fed left its key policy rate in a range of 1.50%-1.75%, signalled unchanged rates also in the period ahead. Chair Powell stressed the need to keep policy accommodative in order to bring up inflation, which practically closes the door for any hikes this year.

In the currency space, the positive developments on trade and global growth data motivated investors to reduce safe-haven positions and look for investment opportunities outside of the U.S. Consequently, the USD depreciated against most currencies and EUR/USD ended the year north of 1.12. Fuelled by rising commodity prices, growth-oriented currencies such as the AUD, NZD, CAD and the NOK also posted significant gains against the greenback in December.



Nordic overview

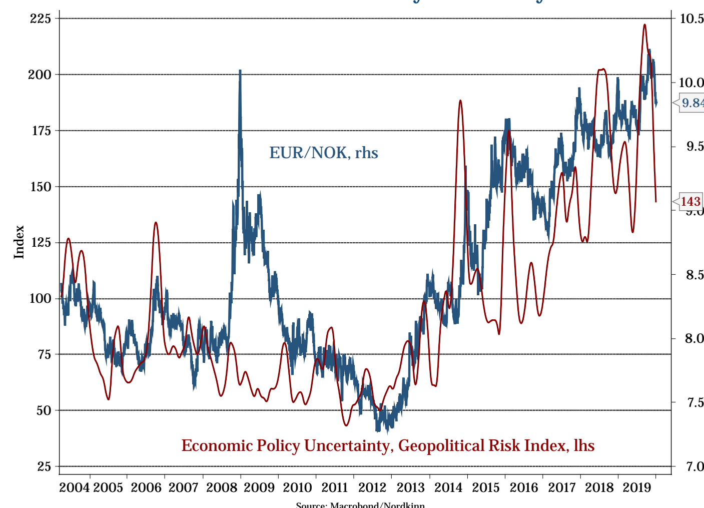
The Swedish fixed income market turned out to offer only marginal moves in December. Swap rates increased, with the 10y spot rate roughly 10 bps higher. Real rates rose a couple of basis points more, resulting in somewhat lower market based inflation expectations (Break Even Inflation rates). Compared to German real rates the Swedish real rates underperformed by approximately 10 bps along the whole yield curve. The SEK appreciated 0.5% versus the KIX index.

The tepid market movements were a response to inflation data that came in line with expectations and a highly anticipated Riksbank hike to 0.00%. Still, the economic data continued to indicate a weak trend with manufacturers in the doldrums, while confidence in the service sector hit a, close to, seven years low according to the NIER business survey. Hence, GDP for Q4 2019 is at risk of being close to zero, or even negative, on a quarter-to-quarter basis. The report is due on February 20th.

The Norges Bank left its key policy rate unchanged at 1.50%, as expected. According to the Executive Board's forward guidance, "the key policy rate will most likely remain at the current level in the coming period", which is also unchanged from the previous two meetings. The new rate path was virtually identical to the previous one, which also was broadly aligned with expectations, although some market participants looked for a slight downward adjustment to the 2020 path. As before, the rate path peaks at 1.60% in late 2020, which is meant to signal that the probability of another hike is greater than the probability of a cut.

The Norges Bank revised its forecast for Mainland-Norway GDP growth down to 2.5% from 2.7% previously, reflecting a somewhat lower than expected growth path in in the second half of 2019. The forecast for 2020 was left unchanged at 1.9%. Meanwhile, the Bank lifted its forecast for core CPI inflation in 2020 to 2.2% from 2.1% previously, reflecting the expected impact of past NOK depreciation on imported goods and services prices.

Norwegian interest rates rose in December and the slope of the yield curve steepened somewhat in tandem with developments abroad. Contrary to what has been the tradition in recent years, the NOK rebounded quite sharply in the second half of December. The NOK appreciation appears to have been influenced by a reduction in geopolitical uncertainties, especially related to trade policy, see chart.



Global markets

The short-term implications of recent political events look favourable, but the medium-term outlook has not changed much in our view.

Starting with the short-term, the announcement of a U.S. - China phase-one deal will be helpful for confidence, especially once the tariff relief actually kicks in. The deal does not only remove the threat of further tariffs in coming months, but it also removes the threat of an escalation of the conflict into other areas and regions in coming months. Similarly, the political developments in the UK mean that the Brexit uncertainty should recede in the next couple of months, with potentially positive implications for European macro data.

Looking beyond the next few of months, however, the medium-term economic outlook remains fragile as plenty of uncertainties loom. The U.S. – China trade deal is very narrow and does not address the more fundamental objections that both Republicans and Democrats have about Chinese trade practice and other issues such as technology theft. This begs the question whether the Trump administration opted for a short-term agreement given the risk of a slowing economy in the run-up to this year's upcoming election.

China's interest in a deal lies in gaining time for allowing a smooth transition from exports to consumption as its main driver for growth.

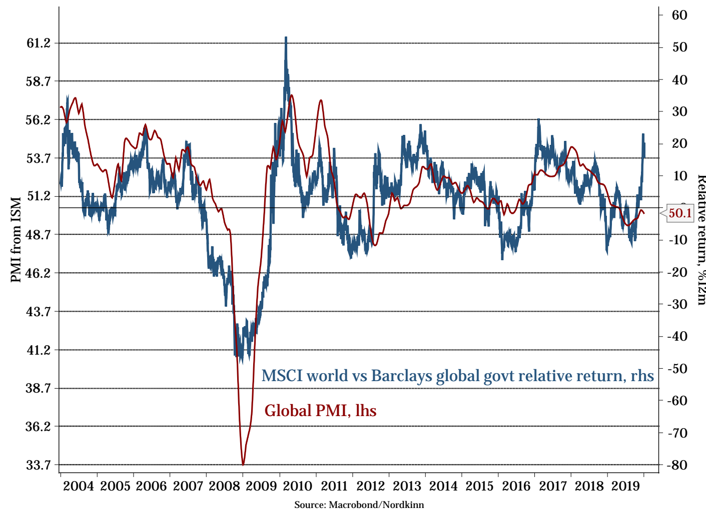
Judging from the price moves in Q4 2019, the fixed income and currency markets seem to have interpreted the deal as moderately positive, yet insufficient to properly address the fragile medium-term outlook for global growth. The equity market, on the other hand, seems to have interpreted the trade deal as constituting a meaningful de-escalation of trade tensions, promoting prosperity and driving several equity indices to new record highs. The year-over-year performance in equity returns over bond returns was relatively large in 2019, which seems to reflect equity market's expectation of a robust rebound in global growth ahead, see chart.

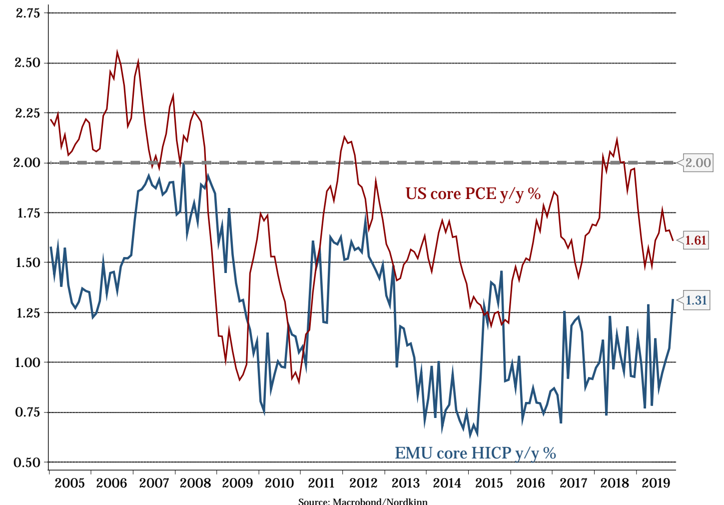
While the downside risks to growth seem to have diminished in the near-term, political risks are likely to rise again well before the end of 2020. To be sure, 2020 had barely started before the U.S. assassinated Iranian commander Soleimani, which rattled markets. Crude oil rose above USD 70 per barrel, while stock prices and bond yields dropped. Moreover, the risk of a hard Brexit is not gone after all. Boris Johnson and the Conservative government seem very keen to depart from the EU by the end of 2020, deal or no deal. Furthermore, the U.S. election in November 2020 could be a pivotal risk for investors.

Regarding investment implications for fixed income, yields on short-dated bonds have limited room to rise in 2020 as central banks are communicating a strong commitment to bring inflation sustainably higher. At the press conference following the FOMC meeting on December 11th, Chair Powell said he would prefer to let inflation rise and linger above the central bank's target before considering future interest rate hikes. This is further evidence that the central bank is discussing the adoption of some form of "average" inflation targeting, i.e. to aim for inflation somewhat above 2% in coming years after sustained periods of inflation below 2% in the aftermath of the 2008-2009 financial crisis, see chart.

Moreover, the ECB's commitment to raise inflation is explicit in its forward guidance: "The Governing Council expects the key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics".

As a result, we prefer to fade any expectations of interest rate hikes priced into bond markets in the near term. Against this, we like to pay medium- to longer-term inflation swaps. Moreover, we keep some tactical exposure for higher longer-term US bond yields relative to German Bunds. In the currency space, we prefer to remain short the USD as a near-term positive growth scenario will undermine the greenback against most major currencies.





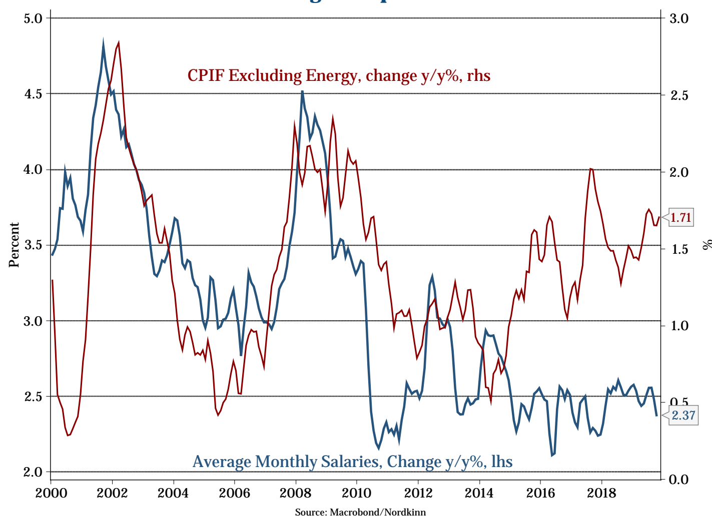
Nordic markets

The Riksbank hike paves the way for higher Swedish real rates, in our view. There has only been modest moves in traded real rates after the two hikes in December 2018 and 2019. Traded inflation expectations (Break Even Inflation rates) have moved higher, offsetting some of the rate hikes. This move has been supported by a bit higher than projected inflation in the year due to the weakness of the currency. However, we believe that the brunt of the weaker SEK effect on inflation is behind us.

Further, we see little scope for inflation to run hot due to other factors in the next couple of years. Annually wage growth is expected to remain close to current pace at roughly 2.5%, see chart. This is too low in order to put underlying domestic inflation in the favourable place of being close to the inflation target. Together with a slowing economy and a fierce competition among retailers, we believe that both inflation and inflation expectations will slide towards the long term average of 1.4-1.5%. As a result we keep positions for lower market based inflation expectations and higher real rates both outright and relative to Germany.

The slowing of the economy has so far been mostly felt by manufacturers, but now confidence in the service sector is also taking a severe hit. However, as long as the lower activity is confined to private businesses and do not spread more significantly to the labour market, and thus private consumption, it is unlikely that public finances will deteriorate meaningfully. Still, the Riksbank hike could trigger outflows from the tax account, creating a higher borrowing requirement in 2020/2021 than previously thought.

To be sure, 2020 will be the first year since 2014 when net-supply of SGBs will be positive, i.e. greater than Riksbank's QE purchases. The supply will not be massive but given the very low bond yields we are not convinced domestic investors will pick up the extra supply so easily, and foreign investors will probably require a decent pick-up relative to, for instance, German Bunds before they pile in. In addition, if the labour market weakens more markedly in 2020, resulting in more cautious households, or if money flows out of the tax account, the borrowing requirement could rise further, pushing bond supply even higher.

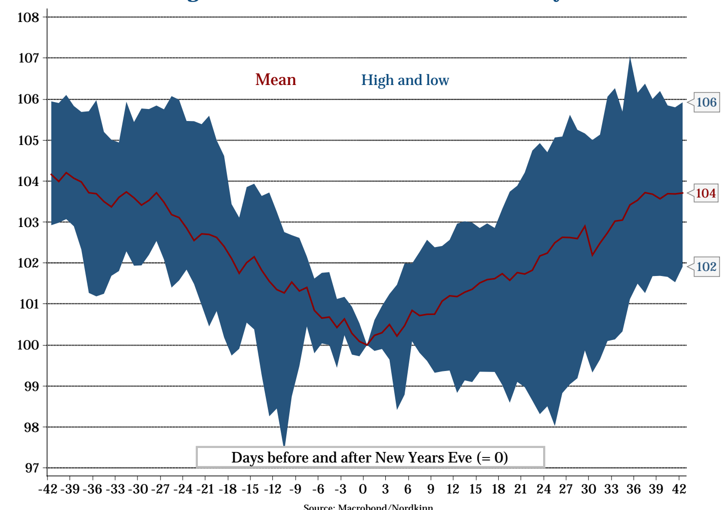


In Norway, while the Norges Bank's interest rate path continues to imply a hiking bias, we believe the Executive Board is satisfactied with the current monetary policy stance. The real interest rate, i.e. the three-month money market interest rate adjusted for inflation, is currently just shy of 0%, which according to Norges Bank's own estimate describes a neutral monetary policy stance. With inflation at the 2.0% target combined with evidence of slowing GDP growth, we do not see any compelling case for additional monetary policy tightening in 2020. In our view, the slight hiking bias in the interest rate path is rather intended to signal to markets that rate cuts remain distant.

We continue to see the risk to economic growth as tilted to the downside in 2020, which constitutes the fundament of our *"Norway: Weaker growth outlook"* investment theme. After a strong rise in 2019, oil investments will barely grow this year and are likely to decline from next year. We also expect weaker growth in other business investments, and in public spending. Against this backdrop, over the coming couple of years we believe the probability of rate cuts overshadows rate hikes. In contrast, the market prices in a symmetrical probability distribution. Consequently, we favour being received rates in the 1 to 5-year area against payed positions in the sub 1-year area as well as in the long-end.

Despite our somewhat bearish view on the Norwegian economy, our view on the NOK currency is positive. GDP-growth and monetary policy were not crucial for NOK developments in 2019, nor will they in 2020 in our view. Rather, the NOK suffered from geopolitical headwinds in 2019 that in late 2019 turned into tailwinds, temporarily at least. Barring any renewed geopolitical tensions in 2020, we expect the NOK at current levels to continue performing against most major currencies.

Apart from the geopolitical tailwind, we also observe that the NOK tends to appreciate in the beginning of the year. The chart illustrates the seasonality in NOK/SEK, which often bottoms on New Years eve and rises thoughtout the first three-four months of the year. The seasonal effect is also statistically signifcant when controlling for macro fundamentals and risk sentiment.



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