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Nordkinn Market Review & Outlook – January 2020

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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.

Global overview

Moving into 2020 the financial markets had started to discount a rebound or at least a stabilisation of the global manufacturing sector amid encouraging macro data together with the U.S.-China Phase 1 trade deal in late 2019. Later during the month, global equity markets fell and investors piled into safe haven government bonds, amid news that the spread of the new corona virus accelerates, highlighting concerns about the disease's potential impact on the Chinese economy. However, as the virus also commenced spreading around the globe, investors feared it could also provide a set-back for global manufacturing and trade, which had been showing tentative signs of improvement in recent months.

Chinese authorities have made resolute and aggressive steps to limit movement for millions of people living in cities near the centre of the outbreak, Wuhan. The city of 11 million people is in virtual lockdown. Hong Kong is closing 10 of its border crossings with mainland China in a further push to control the outbreak.

The oil price tumbled amid a broad withdrawal from risky assets and fear that the virus will restrain fuel demand as travel is restricted. Consequently, the currencies of commodity producers depreciated sharply against the USD in January.

All major central banks left monetary policy unchanged in January. Ahead of the decision of the Bank of England to keep its key policy rate at 0.75%, markets were pricing in close to a 50% chance of a cut. While it did curb its economic outlook, the Bank's Monetary Policy Committee decided that the improvement in business sentiment since the general election made an immediate cut unnecessary. The GBP climbed after the decision as short-dated money market rates rose.

Nordic overview

Swedish PMI moved a bit higher, which spilled-over to fuel the rebound in the NIERs (National Institute of Economic Research) Economic Tendency Index. On the domestic side of the economy the housing market seems to have boosted the consumer's mood throughout the course of 2019. Retail sales have gradually improved since late 2018, which fits perfectly with when house prices started to move higher again.

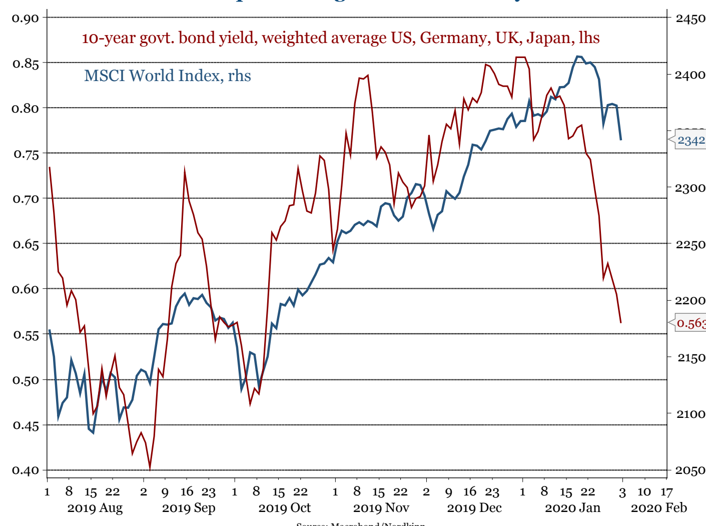
Headline CPI inflation for December was in line with expectations, but if anything it masks elements of weakness in the underlying inflation. Package holiday/airline tickets were a bit higher, hiding some lower inflation in other categories. In addition, the year has started with a very mild winter, combined with windy, wet and snowy (in the northern part of Sweden) weather, which will fill up the important water reservoirs by spring time. Hence, electricity prices in Sweden have slumped at the start of the year, as have the price of oil. As a result, market based inflation expectations (Break-Even Inflation rates) have tightened during the month, while Swedish real yields underperformed international peers.

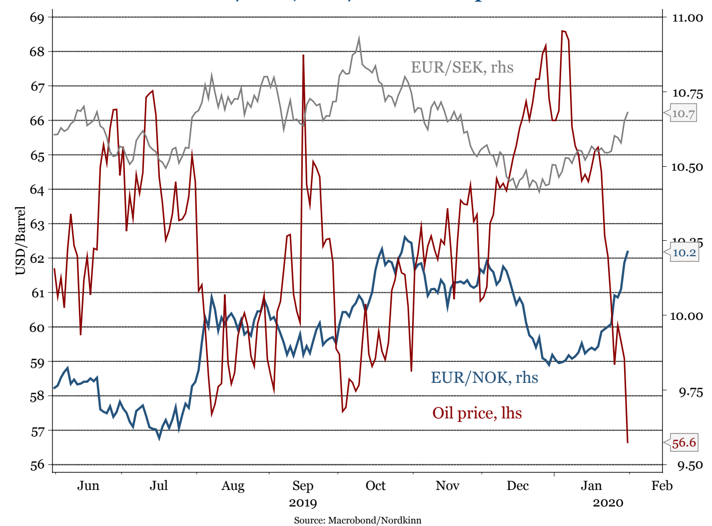
Swedish bond yields declined by up to 20 bps in longer maturities and the slope of the yield curve flattened. Swap rates have declined more than bond yields, compressing the spread between the two assets. The SEK traded in a fairly tight range but started depreciating by the end of the month as markets became more nervous about global growth.

Moving to Norway, incoming data continues to signal a slowdown in the growth rate of the economy. Mainland-GDP is tracking 1.2% annualised, suggesting downside risks to Norges Bank's 1.9% forecast for 2020. Underlying CPI inflation is still running near the inflation target, but eased to 1.8% in December broadly in line with Norges Bank's forecast.

On January 23rd the new monetary policy committee of Norges Bank acknowledged that economic growth was slightly weaker than expected at the end of 2019 and hinted that oil investments in 2020 may be lower than assumed. On the other hand, the committee said that the risk of a sharp slowdown in the global economy had receded. On balance, it reiterated the previous Board's assessment that the policy rate will most likely remain at the present level in the coming period.

The Norwegian fixed income market attracted strong buying following heavy bond issuance activity in January. Moreover, money market spreads fell sharply in line with tighter U.S. Libor-OIS spreads. As a result, the 5-year NOK swap rate tightened around 20 bps against the corresponding rates in EUR and SEK. In the currency market, the NOK depreciated against most major currencies fuelled by a 15% drop in oil prices in combination with deteriorating risk sentiment towards the end of the month, see chart.





Global markets

With the spreading of the coronavirus, uncertainty is increasing for the Chinese economy and thus the global economy and its financial markets. The virus is at an early stage and it is difficult to judge how much it can spread before it gets under control.

Almost all analysis use the SARS epidemic as a benchmark for comparison. The SARS virus continued to spread for 3-4 months in the beginning of 2003 before it got under control. Compared to 2003 the authorities have responded much quicker and taken more drastic measures to stop the spread. That said, the risk of contagion is higher today due to the much wider transportation network in China compared to 2003, and because the virus seems to be more contagious this time. More, a paper published in *The New England Journal of Medicine* article argued that the virus could be transmitted during the incubation but the news has been downplayed due to lack of evidence.

There are too many unknowns at this stage, hence it remains difficult to estimate the potential impact on economy and markets. The virus will certainly have a negative impact on growth, especially in China and in nearby countries. As people will stay at home, the service sector (travel, restaurants, entertainment etc.) is likely to take the main hit. The service sector is a much bigger share of China's economy now than in 2003. Moreover, China accounts for almost 1/3 of global growth today compared with around 1/5 in 2003.

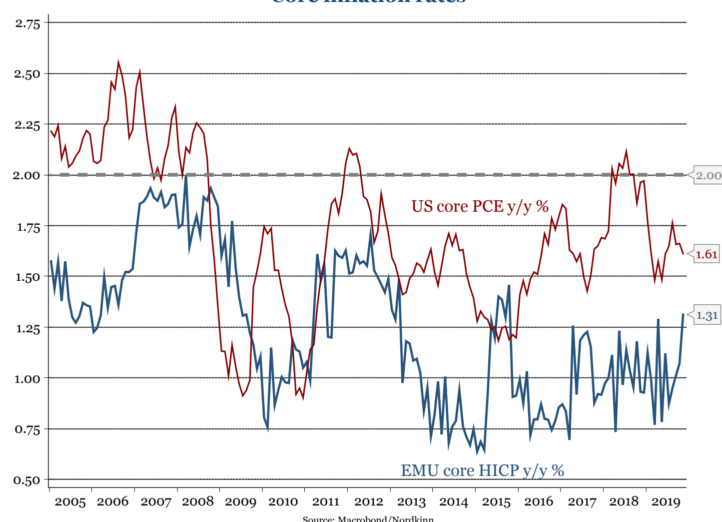
Also of importance, the virus hits economic growth at a time the Chinese economy is already fragile due to lingering effects from the trade war. Moreover, at a global level there is also a risk that the expected recovery in global growth will be delayed. Markets seems ill-prepared for an escalation of the coronavirus epidemic at this juncture. After all, the global equity markets rallied significantly towards the end of last year on receding uncertainties and on expectations growth would recover soon. Market-implied volatility hit an all-time low in early January. Consequently, the virus could trigger, or contribute to, a correction in financial markets that may harm financial conditions and weigh on economic growth.

At the same time, the lessons from SARS and other epidemics are that the impact on growth and financial markets tend to be temporary. In Hong Kong, which was one of the hardest hit countries during the SARS epidemic, the manufacturing PMI fell from above 50 in February 2003 to 38 in April, before returning to 50 by June. The global economy also took a hit in early 2003, but recovered sharply in the second half of the year, see chart. Based on this experience, long-term investors may therefore try to look through this epidemic as well as softer data over the coming few months.

Regarding implications for markets, the conventional view as we entered 2020 was that monetary policy is going to be unexciting in 2020. However, both the Fed and the ECB are scheduled to present updated reviews of their policies. Our understanding is that it is likely that the central banks will remain committed to bring inflation sustainably higher. The last press conference with Fed chair Powell supported this view. Our investment theme labelled *"Global: Central Banks' inflation commitment"* is broadly based on this notion, i.e. that central banks will continue running accommodating policies, which will be supportive for inflation.

In essence, we believe that the outlook for monetary policy in 2020 and 2021 continues to be asymmetrical. Even if growth and inflation were to rebound, short rates will be kept low and thus allow inflation expectations to rise and yield curves to steepen. Overall, we therefore prefer receiver positions in the short- to medium term segment of the interest rate swap curves, combined with paid medium- to longer term inflation swaps in both the euro area and the U.S.

In addition, we also run a theme called *"Global: Relative Monetary Policy"* designed to take advantage of the difference between markets' expectations and our own views on monetary policy in various currencies. For instance, the sharp decline in NOK interest rates relative to other markets in January was unjustified in our view. See next section for additional comments.



Nordic markets

The small increase in Swedish PMI (in actuality, less negative) is signalling a fragile situation. The improved confidence among manufacturers in the NIER survey was driven by expectations of production increases over the next three months. To us this seems a bit peculiar given the fact that actual orders continued to slump to the lowest level since 2012. Not really a normal pattern, judging by history, and we can not help suspecting that some might have been a bit carried away by the U.S.-China trade deal in December.

Anyway, the outbreak of the coronavirus is clearly jeopardising a swift rebound in global manufacturing. The length of a likely postponement of the recovery will be dependent on how long the virus will pose a threat to the markets and economic outlook in China. While the outlook for the global economy is very uncertain, the domestic economic activity could in contrast pick-up somewhat in 2020, due to the strong housing market. At least as long as the labour market does not deteriorate further.

Regarding inflation, electricity prices have slumped at the start of the year and when the price of oil (as well as other commodity prices) is suppressed by the corona virus it will have a negative impact on Swedish inflation at the start of the year. A few forecasters now expect the headline CPIF to be as low as 0.4% below the current Riksbank forecast for January inflation (due on February 19th). How the Riksbank will react to such data is debated but we don´t regard 0% as a floor for the repo rate.

We expect the Swedish fixed income market to largely mimic those of the global movements, which are in the hands of market´s interpretation of the spreading of the virus and its impact on the global economy. Yields are low and yield curves remain very flat, see chart. The case for steeper curves are building, but the virus is a concern. Hence, we are picky when we assess which curves to steepen and where along the curve. The Swedish government bond curve is one we like to steepen, at least relative to other yield curves. The rationale is that more issuance than currently planned will be needed, driven by outflow from tax account. We question if appetite is sufficient to absorb all risk that will come to the market during the year.

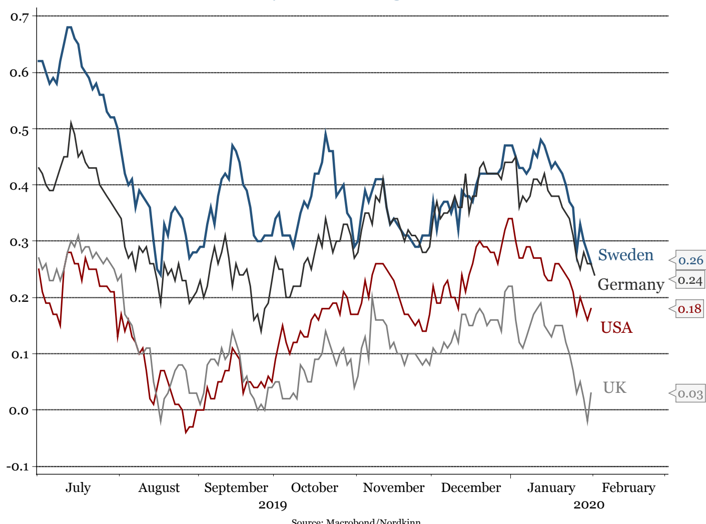
In Norway, incoming data confirms our long-held view that the risk to economic growth in 2020 is tilted to the downside, which constitutes the fundament of our *"Norway: Weaker growth outlook"* investment theme. After a strong rise in 2019, oil investments will barely grow this year and are likely to decline from next year. If sustained, the recent drop in oil prices could add to downside pressure on oil investments. Moreover, non-oil business sentiment is falling as the sector is feeling the pain from the global slowdown. Against this backdrop, we continue to believe that the Norges Bank will remove its hiking bias in 2020, and we expect a first step in this direction at the next MPC meeting on March 19th.

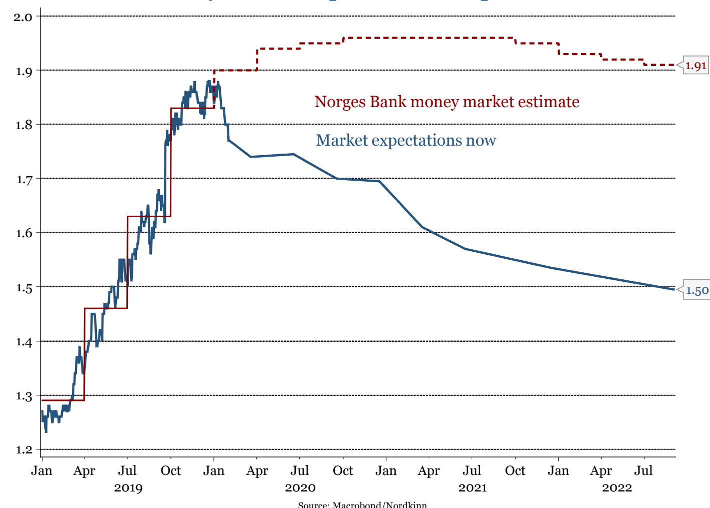
Having said that, we do not see a strong need for the Norges Bank to alter its monetary policy outlook dramatically and start cutting rates for the following reasons. First, capacity utilisation in Norway remains high and is most likely above a normal level, which implies upward pressure on wage and price inflation. Second, the slowdown in Norwegain growth is not unexpected at all, even if the pace of the slowdown probably exceeds Norges Bank's projections.

Third, underlying inflation is close to the 2.0% target and broadly in line with Norges Bank's forecast. Looking ahead, the Norges Bank's inflation forecast looks reasonable in our view. Fourth, the spread between money market rates and the key policy rate is tighter than assumed, which implies lower bank lending rates than projected. Finally, the NOK is currently at a much weaker level than expected.

Comparing Norges Bank's forecast for money market rates with market expectations, a significant gap is now growing, see chart. While this gap is partly owing to a lower NIBOR premium than expected, the market is also pricing in rate cuts at the end of 2020 or early 2021. The latest market move is exaggregated in our view.

We prefer to fade the recent decline in Norwegian rates by using relative value strategies and cross markets spreads in particular.





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