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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – February 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.

MARKET OVERVIEW

Global overview

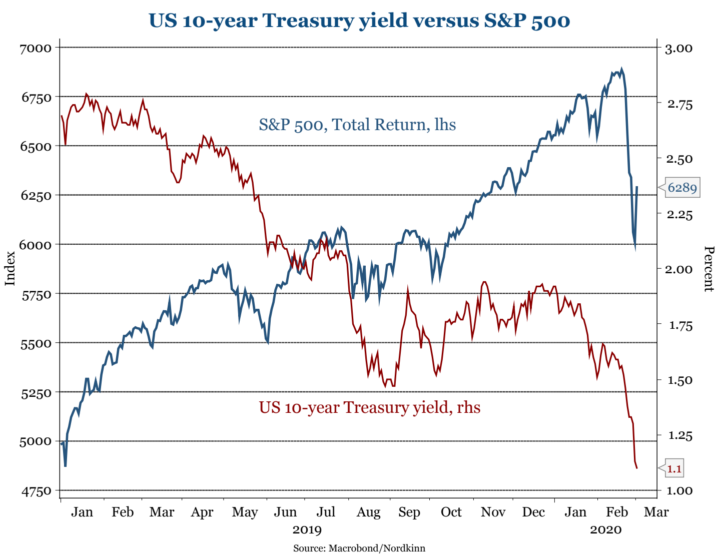
In February the coronavirus shock, named COVID-19, has morphed from being China specific into becoming global, sending global risky assets dramatically lower along with commodities and government bond yields. The trend in bonds and commodities is very much an extension of January, whereas equity investors have reassessed its complacency after the outbreak accelerated outside China and companies warn for substantial impact. Mounting cases across Asia, Middle East, and Europe sparked concern that the outbreak is widening into a pandemic. More than 92,000 cases have been confirmed, including in all provinces of China and more than 70 other countries.

South Korea has seen by far the highest number of coronavirus cases outside of China - within a couple of weeks confirmed cases jumped from a few dozen to almost 6,000. Italy has the third highest infection count with more than 2,500 cases. Fears are growing that we will see a flurry of reports of new cases and deaths around the world over the coming weeks and months. The U.S. has so far reported only 128 cases, but both the Fed and the market is clearing preparing itself for a seemingly inevitable outbreak of virus infection also across the U.S.

As traders ramped up bets that the Federal Reserve will ease policy to support the economy, the 10-year benchmark U.S. Treasury yield sunk to a record low of 1.13% on February 28th. At the time of writing, the yield has fallen another 20 bps after FOMC decided to cut rates by 50 bps at an unscheduled meeting on March 3rd.

While the spread has accelerated outside China recently, stoking fears of a global pandemic, it has abated sharply in China. This suggests that the authorities' forceful measures have achieved success in tamping down the outbreak.

However, for investors in the financial markets, the response from authorities is also worrying. Shutting down large parts of the second largest economy has a knock-on effect on the domestic economy, as demonstrated by the collapsing Chinese PMI data in February. This has also become visible in commodity prices as investors predict there will be less demand for raw materials. Investors fear similar unprecedented measures could be needed in other parts of the world as virus cases steadily climb outside the epicentre in China, increasing the risk of sustained damage on the global economy.



Nordic overview

Swedish interest rates plummeted in February in line with the global move. In addition, lower than expected CPI inflation also contributed to a plunge in Break-Even Inflation rates (BEIs), which benefitted our portfolio. The global spread of the virus triggered demand for safe assets as well as duration, resulting in flatter yield curves. In contrast to the past, the SEK did not depreciate in the risk-off environment.

The CPI inflation print - the biggest downside surprise seen for many years - was broad based and not only confined to low electricity prices: The CPIF ex energy (1.6%) was substantially lower than Riksbank's (1.9%) only one week old projection. Meanwhile, Swedish domestic economic data showed signs of recovery before the coronavirus hit.

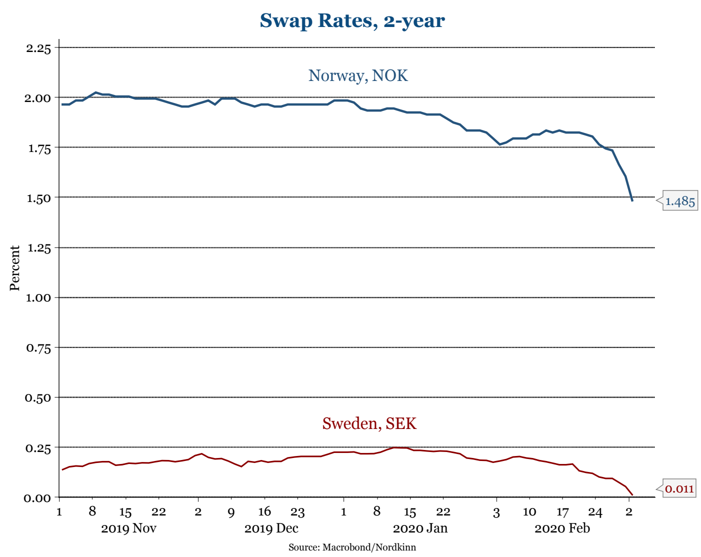
The Riksbank's monetary policy meeting in mid-February offered little guidance about the central bank's stance as it was held prior to the global spread of the coronavirus and also before the low inflation data was released. Reading through the minutes from the policy meeting gives the impression that the Board is justifying the December hike, while at the same time emphasising that 0% is not a floor for the policy rate. To us it is clear that the Riksbank is willing to act if needed.

Moving to Norway, Norwegian bond yields collapsed across the curve as the coronavirus dominated the market moves in February. The long-end fell more or less in tandem with Europe, while short-dated bonds outperformed as speculations about rate cuts grew in response to the gloomier outlook for global growth amid coronavirus spread. As of March 4th, we estimate that the market priced in more than 25 bps of easing at the upcoming monetary policy meeting in March, and an accumulated 45 bps of easing by the end of June.

The NOK plummeted in February reaching new all-time lows as a combination of lower energy prices, general risk aversion and rate cut bets weighed. 10.4330 is the new intraday all-time high for EUR/NOK.

As usual, the spread between NGBs and swaps widened after the syndicated new 10-year benchmark was well received in the market. Later on, the asset swap spreads widened further amid safe haven demand for bonds in combination with corporates hedging in swaps.

Incoming data were mixed in February: Mainland-Norway GDP grew at a weaker than expected 0.2% pace in Q4 2019 from the previous quarter, while core inflation spiked to 2.9% - significantly above expectations.



Global markets

Until late February, the market reaction to the coronavirus outbreak had been mixed. While government bond yields and commodity prices were falling, equities rallied to new highs. This divergence ended when the virus spread accelerated in other parts of the world, including South-Korea, Iran, Japan and Italy. It is becoming clear that the probability of a global pandemic is increasing, see chart. We will most likely see further outbreaks in other countries across the world.

Any estimates of the epidemic's impact on the global economy are largely educated guesses. The economic fallout from the virus outbreak will ultimately depend on the duration of the epidemic: The longer the crisis, the greater the damage. That said, evidence is building for the economic hit to be hard and for lasting over many months, at least.

It appears to be the fear of coronavirus, rather than the virus itself, that hits economies. Because of China's unprecedented measures taken to contain the spread, the damage to the Chinese economy is severe, see PMI chart. As China accounts for almost 1/3 of global growth, the damage to China will spread across the globe as global supply chains are being seriously disrupted. If we see similar shutdowns of economic activity in other big economies such as Japan, South Korea, Italy - and in any other markets to where the disease spreads - the economic damage could be sizeable and a global recession inevitable.

Moreover, the uncertainty itself will spill over to consumer and business confidence, too. Businesses may push back capital spending due to the incentive to wait and see how severe the virus will be. Households will prefer to stay at home instead of going to the cinema or the restaurants, even in countries where contagion so far is limited. Tourism will be hit hard for sure.

For Eurozone, the arrival of the COVID-19 virus comes at a particularly bad time, just as struggling economies were starting to climb out of last year's stagnations and showing signs of recovery.

On a positive note, there are clear signs that China's forceful measures is working. There has been a marked slowdown in officially reported new coronavirus cases from around 4,000 each day in early February to around 200 now, of which almost all are in Hubei, the central province where the virus originated.

With its epidemic slowing, China's officials shift their focus to reviving growth. In areas where the virus is no longer a big danger, companies are trying to resume operations. Many large industrial firms have restarted, yet activity remains depressed by historical standards. If Chinese business activity continues to improve, the positive impact will spread to the rest of the world.

However, China's strategy of resuming operations too soon could backfire. There is certainly a significant risk that new coronavirus cases start to increase again as millions of people try to resume their pre-outbreak lives.

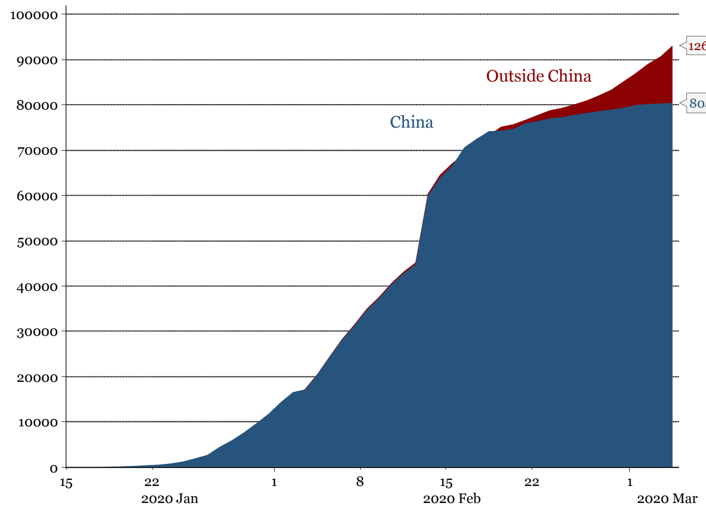
From an investment point of view, we are monitoring the situation closely, and it is dangerous to be dogmatic. As of now, there are no signs of moderation in the international spread of the virus. We therefore believe that global markets are correct in pricing in much weaker economic growth in 2020 compared to expectations prior to the outbreak, even though we do expect that the crisis ultimately is a transitory shock.

Central banks and governments recognise the coronavirus as a threat to economic growth. Although monetary policy is less effective when it comes to solving supply-chain issues, lower interest rates could certainly alleviate the effect of the coronavirus shock on economic activity. However, the Fed's 50 bps rate cut at an unscheduled meeting on March 3rd did not seem to bring much calm to the financial markets.

As the coronavirus poses evolving risks to the U.S. economy through a variety of channels, including financial conditions, we expect the Fed to cut rates further at the upcoming meeting on March 18th. Meanwhile in Europe, we expect the ECB to announce target measures at the meeting on March 12th, including cheap loans to banks (TLTROs), and we expect the Bank of England to cut rates by 25 bps on March 26th.

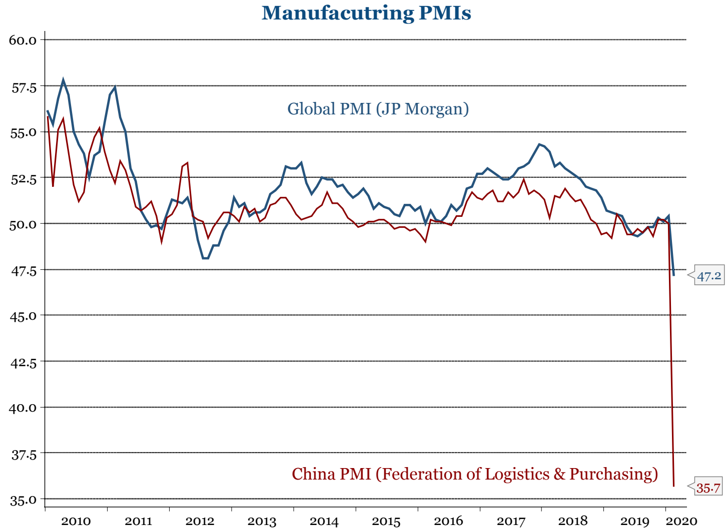
Furthermore, we expect growing willingness among governments to deploy fiscal policy as a tool to counter downside risks to growth and inflation.

Coronavirus, COVID-19, confirmed cases



Source: Macrobond/Nordkinn

Manufacutring PMIs



Source: Macrobond/Nordkinn

Nordic markets

As we noted in the overview, economic data improved somewhat in February, in particularly from the manufacturing sector. The question, however, is what it is worth when we know that the impact from the virus is yet to show up in the data.

The picture related to inflation is much clearer in our view. Commodity prices have plunged as an outcome of the virus hit to the Chinese economy. As the virus now has gone global, travelling will take a major hit. This will impact the demand for oil (jet fuel) among other things. This is interesting given the fact that the "Transport" sub-category in the Swedish CPI contributed with 50% to the overall headline CPI (0.65% of the total 1.3%) in January. The Transport component consists of various sub-components where we find "Purchase of vehicles" (here we will have a major negative base effect since the weak SEK pushed prices higher last year), "Petrol" (the decline in oil price will be a big drag) and "Airplane tickets" (shrinking demand for travelling will not push prices higher from here). All these sub-components could be close to a peak. In fact, the tumbling commodity prices could cause the contribution from the "Transport" component to become much less or even negative in a few months. Hence, the headline inflation could potentially move closer to 0.5% or even 0% by mid- or early autumn in 2020.

Taken together, while the economic impact from the coronavirus remains uncertain, the repercussions for Swedish inflation will undoubtedly be negative. Consequently, the Riksbank's projections are too optimistic. If our forecast of falling inflation over the next few months proves correct, we anticipate the survey based inflation expectation to follow suite. At the same time, markets have reacted accordingly and have sent BEIs lower and discounting more than 10 bps of cuts from the Swedish central bank.

In our last monthly report we argued that the outlook for steeper curves had started to build. However, we also raised the virus as a concern, which proved correct. Moreover, the Swedish National Debt Office kept issuance unchanged when the borrowing requirement forecast was updated in February. Altogether the supply of SGBs in the year has become less of an issue amid rising demand for safe haven assets. We stay very picky when looking at curves to steepen as well as which specific segments along the yield curve.

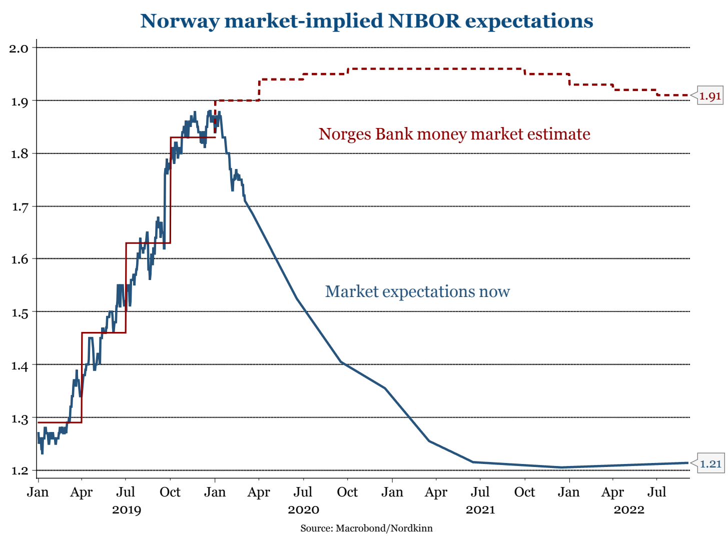
The international spread of the coronavirus, and its implications for global growth and commodity prices, accentuated a discussion about the need for monetary policy stimulus everywhere, including in Norway. With a relatively high interest rate level in Norway in an international context, the Norges Bank has plenty of room to adjust monetary policy if needed.

In general, it could make sense for central banks to alleviate some of the economic damage caused by dramatic measures to contain the spread of the coronavirus, even though monetary policy has its limitations when it comes to dealing with a coronavirus shock. However, in Norway this trade-off is perhaps even more challenging than for many other central banks at the moment. The reasons is that the NOK exchange rate has depreciated sharply on the virus outbreak, putting upward pressure on an inflation rate already well above target.

Looking at Norges Bank's latest forecast for 3m NIBOR and market expectations as reflected by FRA rates, there is a significant gap, see chart. The market expects that the Norges Bank unwinds last year's monetary policy tightening by mid-2021. Our interpretation is that the market is pricing in a rising tail risk probability: A global recession.

Given that the Norges Bank, in contrast to the Fed, does not respond to equity market crashes, we see no reasons for the Bank to act before the meeting scheduled on March 19th. In an interview after the Fed's decision to cut rates on March 3rd, the Norges Bank governor Olsen confirmed that the coronavirus outbreak will in isolation pull down the interest rate outlook, but added that: *"There's a lot of other information: The krone rate is weak, and other things on the upside as well"*.

In any case, given the evolving risks to the economy, the Norges Bank will obviously remove the hiking bias indicated in its previous forecasts and move to an easing bias. To be sure, a high spot inflation rate is no obstacle for a Norges Bank rate cut, and we do see a significant risk of a 25 bps rate cut at the upcoming meeting on March 19th even if that is not our base case. However, a rate cut by June now looks increasingly likely. We prefer curve steepening trades in combination with cross-market tightening in the long end. We also see risk of higher NIBOR fixings should the uncertainty prevail.



ABOUT NORDKINN

Nordkinn Asset Management aims to create and preserve wealth by consistently providing investors with stable risk-adjusted absolute return through its unique team and local expertise. Operating from Stockholm and Oslo, the team of ten capitalises on their specific fixed income and absolute return backgrounds. Nordkinn aspires to be the leading hedge fund in the Nordic region as measured by risk-adjusted performance, operational excellence and investor appreciation.

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