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ASSET MANAGEMENT

Market Review & Outlook

April 2023

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Market overview

Global overview

Financial markets stabilised somewhat in April 2023 after the turbulence triggered by banking sector drama in March. As stress subsided and macroeconomic data remained robust, central bank officials from both the Fed and the ECB began to express renewed interest in further monetary tightening. However, headline inflation has been decelerating rapidly, prompting central bank communications to suggest that policy rates may be approaching a peak, or at least a saddle point, in the not-too-distant future.

As a result, short-term money market interest rates in the U.S. and Euro Area have rebounded from March lows, driven by expectations of rate hikes and a more limited downside to policy rates in the near term. However, yields on longer money market instruments and short duration bonds have not followed suit, indicating expectations of a business cycle downturn. We read this flattening as another sign of firming expectations of a business cycle downturn, which benefitted the few trades we had in our *"Hiking into recession"* theme in April.

Reflecting these counteracting forces, risky assets posted mixed developments in April, and market volatility measures such as the VIX and MOVE indices remained elevated throughout the month. Combination of risk sentiments helped push the EUR/USD exchange rate higher, supported by a divergence in inflation and monetary policy expectations between the U.S. and the Euro Area. Macroeconomic data from both regions saw a number of negative surprises, as reflected in Citigroup's surprise index approaching zero, see chart. However, both indices remained in positive territory, suggesting a robust economic situation.

March's inflation data showed core CPI inflation in both the U.S. and Euro Area at 5.6% year-over-year, in line with expectations, indicating persistent underlying inflationary pressures in both regions driven by strong labour markets and high wage growth. However, owing to lower energy prices, inflation protection seems to become less attractive, especially in Sweden following a lower-than-expected inflation print in April, which influenced losses to our *"Comparative inflation expectations"* theme. We decreased risk allocated to the theme significantly in April.

In summary, while the rebound after the banking-induced stress in March continued throughout April, softer demand data and disinflationary pressures in headline inflation have made central banks and financial markets see an end to the hiking cycle. Following the developments in the inflation-linked markets, our portfolio generated mixed results in April where trades in our *"Easing of inflation"* theme partly offset losses in *"Comparative inflation expectations".*

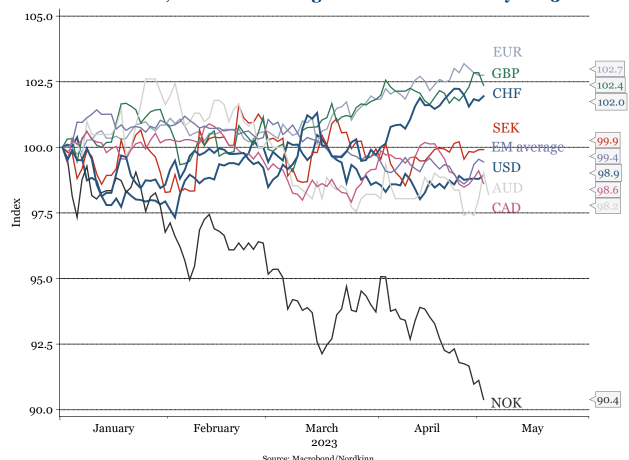
Nordic overview

The Swedish economy avoided a technical recession as Q1 GDP data showed a slight increase in activity. However, April survey data, such as the PMI, indicated a slowdown after a rebound at the beginning of the year. In March, inflation data brought some relief for the Riksbank, as inflation pressure eased a bit. Not only did headline inflation ease due to lower energy prices, but core inflation also surprised on the downside. It seems likely that inflation has peaked for now, and we expect a "cyclical" decline in inflation to occur over the next six to twelve months. The NIER's survey confirmed less price pressure on the supply side in the manufacturing goods production. However, the picture is less clear in the services sector.

At the end of April, the Riksbank delivered a dovish 50 bps rate hike, with three board members in favour of 50 bps and two arguing for 25 bps. The hawkish rhetoric that supported the currency in February was scaled back, and the rate path showed just a 60% likelihood for another 25 bps rate hike. This was visibly below market pricing expectations heading into the meeting. The Riksbank found comfort in the relatively subdued centralised wage deal agreed at the end of March and concluded that the risk of a "wage-price spiral" had receded. The selling of government bonds in the Riksbank's QT began with mixed demand, and long-dated bonds appear less attractive at present. In April, the themes *"Reality bites"* and *"From QE to QT"* contributed positively to performance.

Norwegian interest rates rose more than peers against the backdrop of higher-than-expected headline CPI inflation outcome and the never-ending depreciation of the NOK adding upward pressures to import prices ahead. Moreover, the parties in the central wage negotiations agreed on a framework to increase wages by 5.2% on average in 2023, ending a four-day general strike. While this estimate is only marginally above Norges Bank's 5.1% projection from March, the relatively high proportion of the deal tied to a generous central outcome for everyone implies upside risks to overall wage growth this year.

The weakening trend in the NOK exchange rate has garnered significant attention from both market participants and local media. The currency depreciated by approximately 3% in April, bringing the total loss so far in 2023 to 10%. Various explanations have been proposed for this movement, including Norges Bank's foreign exchange purchases, lower interest rate differentials, and investor concerns about political risks in Norway. However, no single factor can be pinpointed as the sole cause. Nevertheless, this development could potentially undermine the credibility of the 2% inflation target, increasing the pressure on Norges Bank to react through its monetary policy.



Outlook

Global outlook

According to most forecasters, we are likely in the latter stages of the post-Covid cyclical upswing. As a result, the global economic landscape is marked by high inflation, tight labour markets, strong demand and robust growth, but also low productivity growth and unaddressed structural fiscal deficits. Looking ahead for the remainder of 2023, there are several key factors that will influence inflation and financial market developments:

Due to the current downward pressure on inflation caused by energy prices, it is highly likely that core inflation - which excludes volatile components such as food and energy prices - will outpace headline inflation in the coming months. Although moderation in headline inflation is good news for consumers and central banks, stubbornly high core inflation will persist in the foreseeable future due to supply side issues and historically tight labour markets. Supply-side factors include geopolitical risks, concerns around energy security, deglobalisation, the need for greater supply chain resilience, efforts to mitigate climate change, and aging populations.

Regarding the labour market, high wage growth, particularly in the U.S. and Euro Area, has been a major driver of persistent core inflation. As labour markets remain tight, employers face increasing wage pressures as they compete to attract and retain talent. The high level of competition in the labour market is evidenced by the fact that the number of job openings in almost all developed economies considerably outweighs the number of unemployed individuals. Consequently, this tight labour market will continue to drive wages upwards, which, in turn, will fuel inflationary pressures as businesses pass on the increased labour costs to consumers through higher prices for goods and services. Unfortunately, productivity growth is expected to remain low, which implies that any efficiency gains will not be significant enough to offset the higher labour costs.

Meanwhile, diverging wage trends are becoming apparent in the U.S. and Euro Area, with U.S. wage growth starting to slow down while it continues to rise in the Euro Area, see chart. In part, we believe this discrepancy can be attributed to differences in labour market structures and economic policies between the two regions. In the U.S., a more flexible labour market and swifter monetary policy reactions from the Fed are expected to constrain wage growth.

In contrast, the Euro Area's more rigid labour market and stronger social safety net should contribute to higher and longer-lasting wage inflation. We intend to benefit from these significant differences in the disinflation process with relative fixed income trades and FX positioning, primarily in the *"Easing of Inflation"* theme.

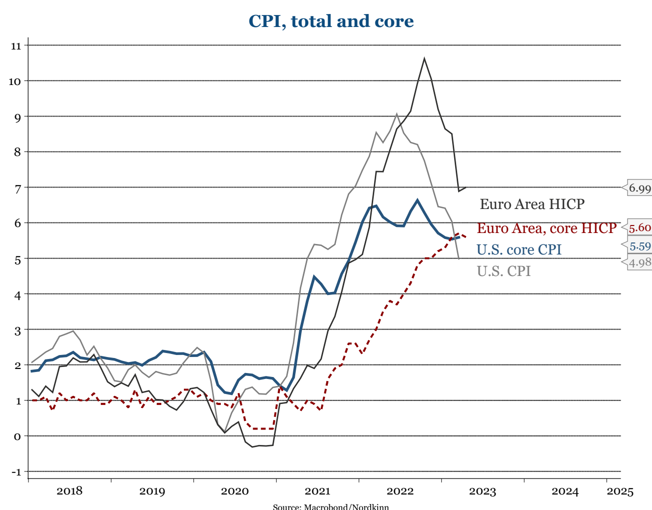
The expansive fiscal policies of the U.S. and Europe are not helping to contain underlying inflation. The U.S. Administration is running cyclically adjusted deficits around 4% of GDP and core Euro Area economies are approaching 3% of GDP. This has enabled companies to sustain and expand their margins. The ability to pass on cost increases to consumers has allowed businesses to manage supply chain issues and rising production costs without compromising profitability, and even improving it. As a result, this dynamic is contributing to high core inflation, as companies' pricing decisions spread throughout the economy.

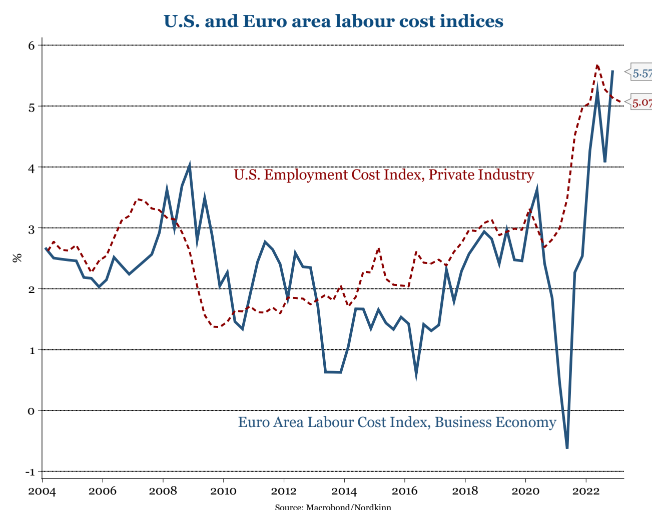
As global monetary policy tightens, demand growth is showing signs of slowing, but labour market tightness is expected to persist in the near term and exert upward pressures on wages and prices. Weak productivity growth exacerbates inflationary pressures, as businesses struggle to offset rising costs with efficiency gains. This is particularly concerning given the structural forces weakening the supply side, which will further limit productivity improvements.

Given these factors, central banks may need to take a more aggressive stance on monetary policy than expected. High core inflation driven by tight labour markets, robust profit growth, and weak productivity may force central banks to maintain higher interest rates for an extended period, and/or even rise them further.

In conclusion, while the inflation process is similar across most countries and driven largely by higher costs on input goods, the disinflation process will depend on institutions such as fiscal and monetary policy interactions, labour market flexibility, social security systems, composition and distribution of wealth, and demographic developments. The U.S. and the Nordics (notably Sweden) are expected to demonstrate less persistence of inflation, while most Euro Area economies and the UK seem set for a long and difficult disinflationary process.

This presents ample relative trade opportunities over both time (curve trades) and space (relative rates and FX). However, it is important to prepare for a bumpy ride and brace for impact, as high and persistent inflation makes this time around different from the last few hiking cycles.





Nordic outlook

The peak in inflation appears to be behind us due to lower energy prices and negative base effects. Additionally, food price increases are expected to slow down, and supply-side price increases are decelerating. These factors suggest a "cyclical" decline in inflation over the next year, which will impact markets and the expected path for monetary policy.

Riksbank's projection for the CPIF excluding energy indicates a rapid deceleration of price increases. As of March, CPIF excluding energy (CPIFxE) increased by 2.5% year-to-date. The Riksbank forecast implies that in the remaining nine months of the year, CPIFxE will increase by another 2.4%, consistent with a clear slowing of increases in core prices. Beyond 2023, Riksbank expects price increases to return to the same pattern as the years prior to the pandemic, see chart.

However, we view this scenario as overly optimistic. Much of it is already factored into market pricing of future interest rates and market-based inflation expectations. The market is discounting that Swedish monetary policy will soon move towards rate cuts. The market discounts a full 25 bps cut already around the turn of the year and around 100 bps up to early 2025, and staying there for several years.

The depth of the economic slowdown or recession will determine if the priced 100 bps rate cuts are sufficient to stabilise the economy. As of now, it is possible to argue that the cuts that are factored in are an expected response to a normalisation of inflation, not a response to a significant economic slowdown on top of inflation being back at the target.

The chart to the right below shows the implied shape of the yield curves in two years, with the Swedish curve expected to remain very flat. Looking ahead, we believe the rate market should contain a greater amount of risk premium (term and inflation risk premium) rather than multi-years of QE purchases by the Riksbank. The selling of bonds has just started with QT, which will continue for several years. Gradually, we believe that more risk premiums will get into the yield curve, as we seek to explore in the theme *"Sweden: From QE to QT."*

Indeed, there is a risk of a deeper recession in the Swedish economy which would require more rate cuts. Combined with room for more risk premiums along the yield curve, this eventually implies a steeper Swedish yield curve. This is what we explore in the theme *"Sweden: Reality bites."* A key factor for a deeper economic contraction is a much softer labour market. So far, there is little evidence of this, but will be central to monitor closely going forward.

In Norway, wage growth is on the rise and the ongoing depreciation of the NOK exchange rate is increasing the risk of inflation in the coming months and quarters. We believe that the 5.2% framework agreed between the labour parties in the manufacturing industry should be considered as a minimum rather than an average estimate for wage growth in 2023. This was highlighted when the parties in the wage settlement in Oslo municipality agreed on 5.4% wage growth, which exceeded that of the manufacturing sector, and the Norges Bank's projection of 5.1% average wage growth in 2023.

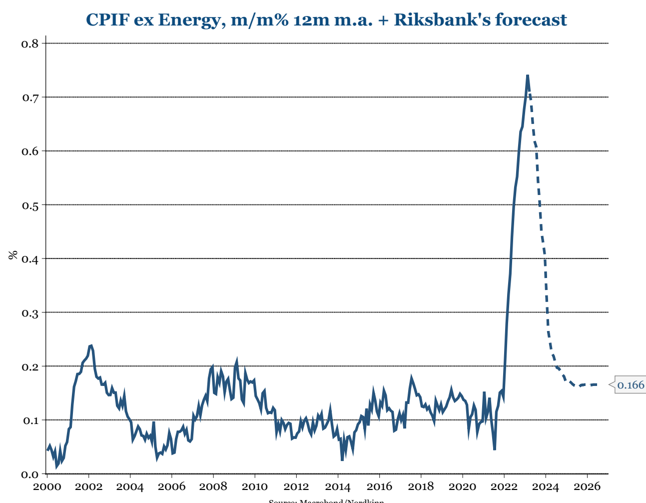
Regarding the NOK exchange rate, while the current level of the I-44 index being three percent weaker than Norges Bank's forecast for Q2 is not a major concern, the longer-term trend is indeed worrying. The NOK has depreciated by 16% since a year ago, which in magnitude can be compared with developments during the Financial Crisis in 2008-2009, and the oil price collapse in 2014-2015. This trend severely undermines the Norges Bank's efforts to bring inflation back to 2% in a timely manner.

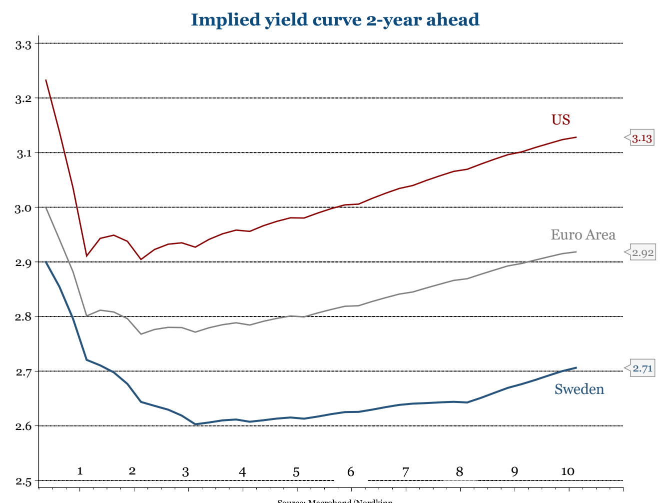
There are likely several reasons behind the NOK depreciation, with sharply lower expected interest rates relative to trading partners being a significant factor. The ECB and the Riksbank have been more aggressive than the Norges Bank in raising interest rates over the past six months or so.

Another factor is probably the relatively large FX purchases related to saving of petroleum revenues in the Government Pension Fund Global, which are carried out by the Norges Bank. However, the Ministry of Finance, not the central bank, is responsible for procedures related to the petroleum fund mechanism.

The deteriorating outlook for future inflation in Norway is putting pressure on the Norges Bank to continue hiking interest rates. As a result, we anticipate upside risks to short-term money market rates and a flatter (more inverted) yield curve going forward. A more hawkish monetary policy stance could act as a trigger for the NOK exchange rate to turn stronger, especially if there is a larger decline in FX purchases for June (to be announced at the end of May) as well.

Our trades are consistent with these views and are organised under our *"Norway: Sticky inflation"* theme.





About Nordkinn

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Our focus is to generate stable absolute returns that exhibit low correlation to other assets. Our Nordkinn Fixed Income Macro Fund was launched in 2013.

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