Market Review & Outlook

June 2023

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Market overview

Global overview

Despite some moderation in core CPI inflation in the U.S. and in the Eurozone, inflationary pressures persist at elevated levels, indicating a considerable journey ahead for central banks to reach the 2.00-2.50% targets. This stubborn persistence reflects strong growth in earnings, resilient labour markets and robust demand. As an example, core CPI inflation in the UK has continued to rise and has proven to be surprisingly robust throughout the first half of 2023.

The latest economic indicators reveal regional disparities, with the U.S. demonstrating surprisingly strong economic data such as durable goods orders, consumer confidence and home prices. In contrast however, recent data from the Eurozone, particularly business surveys and credit data, suggest that the foundations of resilience are gradually starting to fade.

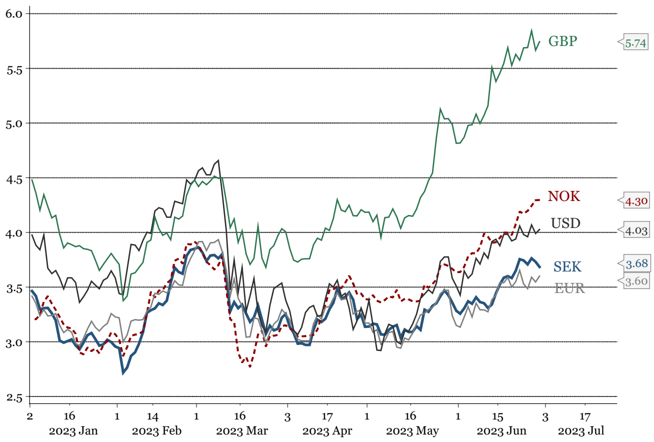
Labour market conditions remain tight in most regions, characterised by healthy monthly job growth and low unemployment rates. Recent data indicate a slight easing of demand in the U.S. labour market, as job vacancies decline. However, overall, demand still appears to exceed the available workforce. Nevertheless, nominal wage growth has shown signs of slowing down, and businesses' compensation plans have decreased. On the other hand, in the UK, annual earnings growth remains remarkably high at around 7.5%.

Consistent with the signals conveyed in speeches leading up to the U.S. Federal Reserve's monetary policy meeting on June 14th, the committee decided to pause hiking by maintaining the target for the Fed Funds rate at 5.00-5.25%. However, the Fed's median projections now forecast two more rate hikes in the second half of 2023, surpassing market expectations prior to the meeting.

In Europe, the ECB decided on June 15th to raise rates by 25 bps to 3.50%, and President Lagarde revealed during the press conference that a further rate hike in July is "very likely." A week later, the Bank of England increased rates by a surprising 50 bps to 5.00% and indicated the possibility of further tightening if there is evidence of more persistent pressures.

In response to these developments, global bond yields continued to rise in June, primarily driven by increasing short-term rates (refer to the left hand chart). Subsequently, yield curves flattened considerably during the month. Our *"Global: Easing of inflation"* theme remained relatively unchanged during the month, while *"Global: Comparative inflation expectations"* experienced modest gains driven by the flattening of European real rate curve.

1y1y fwd rates



Source: Macrobond/Nordkinn

Nordic overview

In June, Swedish market rates followed the hawkish signals from global central banks, resulting in a bearish flattening of the yield curve. This impacted our "*Sweden: Reality bites*" theme negatively. At the same time, profits from our "*Sweden: From QE to QT*" more than compensated for this loss. The supply impact from QT caused government bonds to underperform in comparison to swaps, domestic bonds like covered bonds and German bonds.

Swedish macroeconomic data presented a mixed picture, with lower PMIs but improvements in the broader NIER Economic Tendency Indicator, particularly in consumer confidence. May's inflation data showed a slight increase driven by service prices, particularly in the hospitality sector, indicating sustained demand in those segments. The seemingly endless depreciation of the SEK continued in June, with the EUR/SEK exchange rate reaching yet a new all-time high above 11.80.

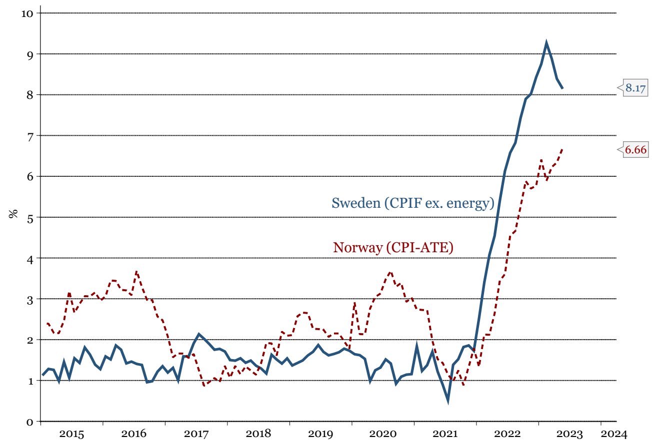
In response to underlying inflationary pressures, the Riksbank decided on June 29th to hike by 25 bps to 3.75% and gave new indication of at least one more hike to come. Additionally, the Riksbank announced an increase of its QT, with monthly sales of government bonds to rise to SEK 5 bln from 3.5 bln. QT aims to reduce the balance sheet while providing support to the SEK, and it will have growing impact on the fixed income market.

In Norway, the most recent data indicate weak growth, reflecting lower private consumption thus far in 2023. Meanwhile, the labour market remains tight, but pressures appear to be easing. Core CPI inflation has not displayed any signs of easing; instead, it reached a new high of 6.7% in May. As we had anticipated, this figure was significantly above Norges Bank's forecast.

Considering this, in the updated Monetary Policy Report released on June 22nd, Norges Bank substantially revised its near-term inflation forecast upward. Higher and more persistent inflation trajectory also incorporated an upward adjustment to wage growth in 2023 and a weaker NOK exchange rate than previously anticipated. Against this backdrop, Norges Bank expedited its tightening campaign by hiking its key policy rate by 50 bps to 3.75%. In its updated forecast, Norges Bank intends to raise rates by 25 bps in both August and September, reaching a peak of 4.25%.

At the end of the month, Norwegian tax authorities presented updated estimates for petroleum taxes in 2023, motivating Norges Bank to cut daily foreign FX purchases in July from NOK 1.3 bln to 1.0 bln. Overall, developments in June contributed to a slightly stronger NOK and higher front-end yields, supporting our "*Norway: Sticky inflation*" theme for the month.

Underlying inflation, Norway and Sweden



Source: Macrobond/Nordkinn

Outlook

Global outlook

As we transition into the second half of 2023, we anticipate an inevitable slowdown in global economic growth due to the drag caused by restrictive monetary policies and tightening credit conditions. With global policy rates having increased by approximately 4 percentage points since early 2022, we expect interest rate-sensitive spending to face challenges. At the same time, recent positive indicators from the U.S. housing market, durable goods orders, and consumer confidence show that the U.S. economy still remains resilient in the face of higher borrowing costs.

The larger prevalence of fixed-rate mortgages, except for Scandinavian economies, implies that households will not experience the full impact of the central bank rate increases for some time. The time lags with which monetary policy affects the economy are illustrated by the accompanying chart. Central banks are certainly aware of these lags, as evidenced by the U.S. Federal Reserve's decision to pause in June.

The complete ramifications of tighter monetary policy on inflation will take even longer to materialise. One reason for this is that, after two years of elevated inflation, households and businesses become accustomed to higher inflation levels and adjust their pricing and wage-setting behaviours accordingly. This complexity is further compounded by structural challenges such as globalisation, demographics, and energy supply, which may have adverse effects on inflation over extended periods.

We expect persistent inflation to keep exerting pressure on central banks to continue tightening their monetary policy stances a bit further this summer, maintaining them restrictive for an extended period, even if economic growth decelerates. While the global economy has exhibited surprising resilience thus far in response to the rapid and substantial tightening of monetary policies, we attribute this phenomenon to the aforementioned time lags associated with the transmission of monetary policy effects on the economy.

Due to these time lags, the central banks' strong commitment to restoring price stability in a timely manner does not align well with a soft-landing scenario. Instead, it is likely that the firm commitment to achieving price stability, particularly when inflation is persistent, may require an end to the economic expansion - i.e. a recession - before inflation is effectively controlled.

Although the recent data do not dismiss the possibility of a recession in the upcoming year, they provide reasons to believe that a downturn is not imminent, for now.

Regarding the upcoming monetary policy decisions, the incoming data strongly supports another rate hike from both the ECB and the Fed during their respective July meetings. Furthermore, the data suggest that policymakers will keep the option open for further tightening later in the year, if necessary, in accordance with the forward guidance provided in their June meetings.

Simultaneously, we anticipate that both the Fed and the ECB will indicate higher levels of uncertainty and data dependency regarding additional rate hikes beyond July. As we predict a moderation in economic growth, labour market conditions, and inflation in the coming months, we expect them both to consider a pause after the hikes in July. However, given the resilience demonstrated by the current data, this decision will be finely balanced.

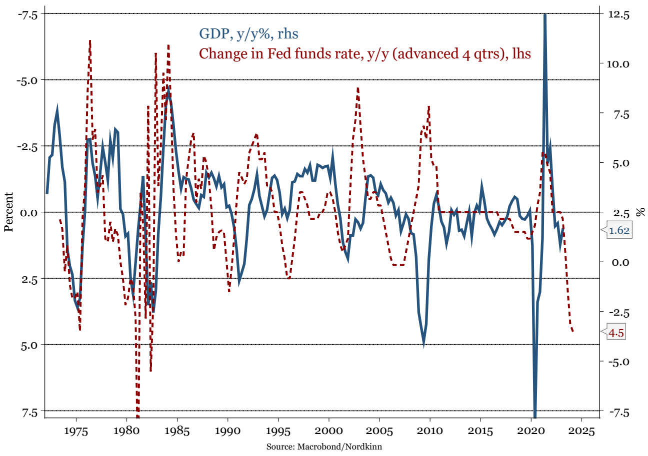
Historically, global yields have declined, and yield curves have steepened in the months following the conclusion of a tightening cycle. This supports a more optimistic medium-term outlook for government bonds.

Nevertheless, there are several factors that will limit the extent of any government bond rally in the second half of 2023. Persistently high inflation poses a challenge as central banks will strongly resist expectations of near-term rate cuts. Additionally, the expanding implementation of Quantitative Tightening policies by central banks going forward, will act as a headwinds to lower bond yields.

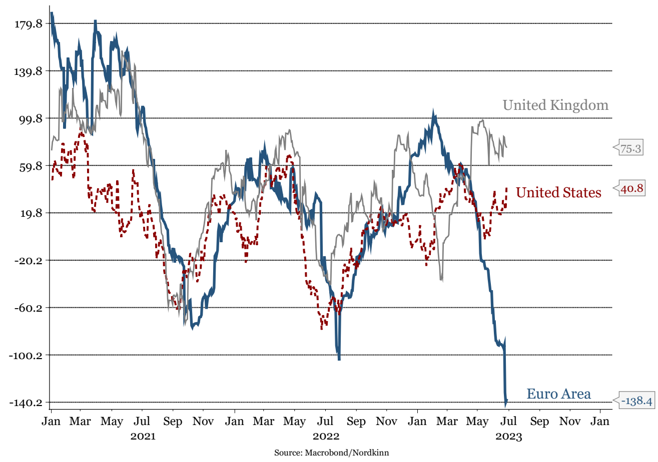
However, considering the recent repricing of bond yields and our outlook for the second half of the year, a cautious and selective bullish stance on medium-term bond duration in the U.S. seems warranted. As markets are currently pricing in only one more Fed rate hike this year, we prefer maintaining curve flattening strategies. Flatter European real interest rate curve also appears appealing, given the combination of lower headline CPI inflation and hawkish central bank rhetoric, which would support higher real interest rates in the short end of the yield curve, while recession risks bolster the case for duration.

In the Eurozone, we favour forward starting steepening structures as we believe the recent weakness in data (refer to the right hand chart) indicate that the ECB all equal is approaching the end of its tightening cycle faster than the Fed.

US GDP vs. Fed Funds rate, y/y



Citi Economic Surprise Indices



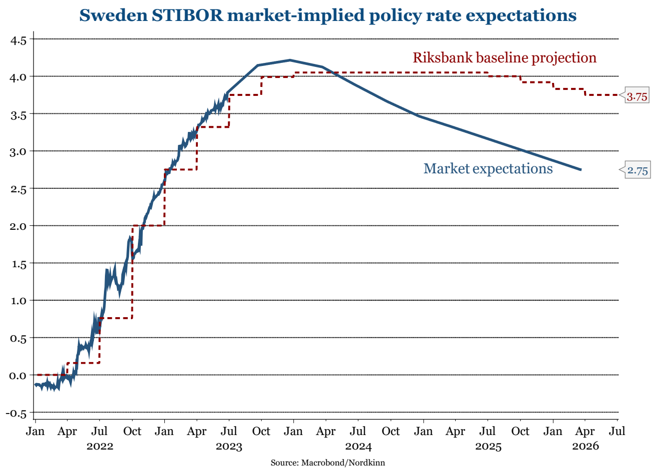
Nordic outlook

The Riksbank's June meeting revealed a clearly hawkish stance compared to the April meeting. This shift in tone can be attributed to higher-than-expected inflation and the stronger economy observed in the first half of the year. The Riksbank is concerned about persistent inflation caused by robust demand for hospitality services. Also, the all-time record weakness of the SEK adds uncertainty to the inflation outlook. Although the Riksbank stated that its investigation to commence selling currencies to hedge the FX reserve would not serve monetary policy purposes, it was still decided upon and announced during the monetary meeting, suggesting a potential stealth intervention. This would be a tailwind for the SEK to appreciate longer-term.

Overall, we anticipate the Riksbank to align with the camp of higher-for-longer interest rates. Our base case scenario suggests another 25 bps rate hike in September, with the possibility of an additional hike at the final meeting of the year. Firm domestic demand, combined with the continued depreciation of the SEK, could provoke this additional hike. In fact, the Riksbank has presented an alternative rate path where the currency struggles, resulting in a policy rate peak of 4.50%, i.e. 50 bps above its base scenario. Despite the SEK's record weakness against the EUR, there are few factors favouring the SEK, particularly if the global economy falters in the second half of the year and risky assets face challenges. Therefore, it is not unlikely that market pricing of the Riksbank's policy rate path will align with the alternative scenario.

At the same time, the monthly NIER Economic Tendency survey provides some comfort and hope for the Riksbank. The decline in price plans observed in the industry has spread into the retail sector, indicating a potential decline in goods inflation in the coming months. The survey's outlook for durable goods prices is positive for the Riksbank. On the contrary, consumer confidence is rising, and optimistic expectations could stimulate increased spending on services. The weak SEK could also play a significant role in service inflation, as it is supportive for tourism, attracting more tourists and boosting spending within the country.

While the Swedish economy has shown resilience in the first half of the year, we anticipate challenges in the second half. As more households face higher interest rates and the global economic outlook deteriorates, the Swedish economy may encounter difficulties. Higher interest rates could lead to reduced household spending and diminished pricing power among retailers and service providers. This risk has increased with the prospect of more Riksbank rate hikes, although the peak is likely within reach. Adding QT to the equation, we maintain our belief that government bonds will underperform, and yield curves to eventually steepen.



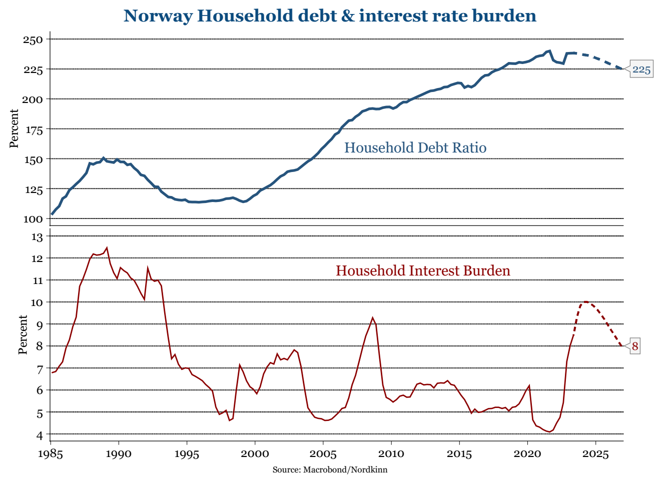
In Norway, we anticipate a further slowdown in economic growth during the second half of this year as the impacts of restrictive monetary policy begin to materialise. Following the Norges Bank's decision on June 22nd to raise its key policy rate by 50 bps to 3.75% and signal an additional increase to 4.25% by the end of Q3, Norwegian households are projected to allocate approximately 10% of their income towards interest rate payments by the end of 2023 (refer to the chart). This would represent the highest interest burden in any year since the 1988-1992 Norwegian banking crisis, which stands as one of the most significant financial crises in Europe since the end of World War II.

Floating-rate loans account for more than 90% of outstanding residential mortgage loans in Norway. These rates can be changed after a six-week notice period, exposing households to changes in policy interest rates. When a substantial portion of their income is dedicated to interest rate payments, households are forced to reduce their private consumption. Consequently, we believe the risk to economic growth is tilted towards the downside.

Regarding inflation, core CPI has aligned closely with our *"Norway: Sticky inflation"* theme this year, driven, among other factors, by rising prices in housing rentals and food. According to our forecast, core inflation is expected to reach its peak in June and commence a decline from July onwards. Importantly, the risks around Norges Bank's inflation forecast are now more evenly balanced. The primary reason behind our projection of peak inflation in Norway is attributed to base effects, as month-over month increases in core CPI experienced a sharp rise in the second half of 2022. Notably, the 7.5% m/m rise in food prices recorded in July 2022 will not repeat itself this year, as one of the major grocery chains has decided to adjust prices more frequently instead of the biannual (February and July) practice that has been customary until now.

Considering the weak economic growth, we believe the Norges Bank's forecast of a peak rate of 4.25% is sufficiently high. In fact, if our predictions for GDP, inflation, and the monetary policies of peer central banks materialise, we perceive a higher likelihood of the Norges Bank pausing at 4.00% in August rather than continuing to 4.50% in Q4. This outlook is more dovish than the current market expectations.

Based on the aforementioned factors, we closed our *"Norway: Sticky inflation"* theme and opened the new theme *"Norway: Brake before it breaks*" which seeks to capture Norges Bank's balancing act to hike rates without breaking the economy. As we are more dovish than Norges Bank for the coming quarter, we have adjusted our interest rate exposure accordingly.



About Nordkinn

Nordkinn Asset Management is a fixed income specialist based in Stockholm and Oslo. We invest in the global fixed income and currency markets – with a particular focus on our home markets Norway and Sweden.

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.

Hamngatan 11, 3rd floor
111 47 Stockholm, Sweden
Phone: +46 8 473 40 50
E-mail: post@nordkinnam.se

Prinsens gate 22, 6th floor
0157 Oslo, Norway
Phone: +47 22 46 63 00
E-mail: post@nordkinnam.no