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ASSET MANAGEMENT

Market Review & Outlook

July 2023

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Market overview

Global overview

Entering July, financial market volatility continued along a declining trend as incoming data and central bank communications were broadly consistent with the predominant market narrative of a soft-landing. Preliminary Q2 GDP data were robust on both sides of the Atlantic. However, more recent data on demand, both survey and "hard" data, such as PMIs, industrial production/orders and retail sales, have diverged. The U.S. has continued a strong note, while Eurozone seem to have stalled.

Key to financial market developments throughout July has nonetheless been the moderation of U.S. inflation. Importantly, inflationary pressures eased also on different core metrics highlighted by various members of the Federal Reserve Open Market Committee. US June core CPI came in 0.1576 % m/m (to be precise), which in annualised terms equate to 1.9% m/m AR, i.e. even a notch below the FED's inflation target.

Forward-looking indicators and survey data, such as the prices paid component in the ISM-surveys, point towards further improvement in the inflation outlook. Wage growth seems to be easing.

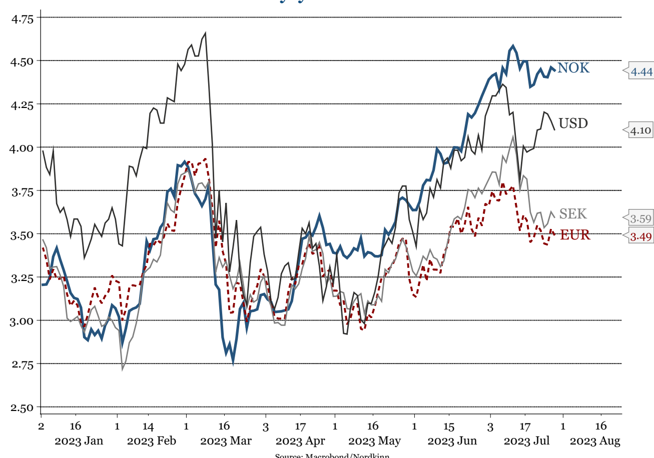
For the Euro Area, June inflation (published by the end of June) demonstrated a high degree of stickiness in core components, aligning with the strong wage growth. Other indicators and input costs, e.g. PPI-data and a stronger EUR, suggest that at least some prices should moderate going forward.

These developments lead to another 25 bps hike (to range of 5.25-5.50%) at the FED's meeting late in July. At the ensuing press conference, Chair Powell cautiously acknowledged the improved outlook for a soft landing, but refrained from even discussing when rates would be lowered.

The ECB-decision to hike rates in July by 25 bps to 3.75% was unanimous. However, opinions on the ECB Governing Council are set to become more and more split as real data is moving from bad to worse while inflation puts monetary policy in a bind, and stagflationary risks are on the rise.

Elsewhere, we also note another step by the Bank of Japan to soften its policy of Yield Curve Control on the back of continued high inflation outcomes. Initial reactions have been muted, nonetheless.

Taken from month-end to month-end, interest rates have moved sideways while the USD has weakened somewhat. However, this masks intermittent shifts that have proved particularly beneficial to our holdings of liquid securities as well as tactical risk reward positions, with performance coming from active management of FX as well as curve positions in both the short- and long end.



Nordic overview

July commenced with an increase in interest rates as Swedish rates followed the global trend. However, the release of softer US inflation data led to a decrease in global rates, which also influenced the Swedish market. Unlike the U.S., Swedish inflation data, a few days later, surprised on the upside, with service inflation contributing to the high reading. As a result, Swedish rates and bond yields underperformed, benefiting the themes "*Sweden: From QE to QT*" and "*Global: Comparative inflation expectations.*" Later in the month, short-term rates declined in line with European peers, causing a curve steepening move and resulting in a positive contribution from the theme "*Sweden: Reality bites.*"

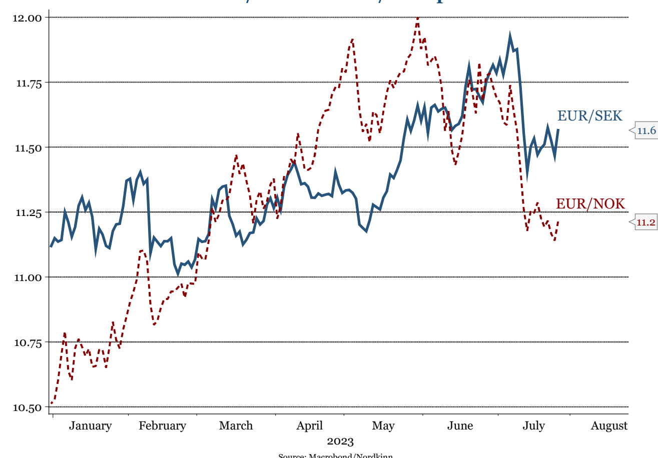
Despite the higher-than-expected domestic service inflation, the pricing of Riksbank eased during the month, and market prices indicate cuts starting (already) next spring. This repricing may be attributed to poor macroeconomic data, with European data playing a significant role when Swedish rates closely tracked the European fixed income market as domestic investor activity was subdued in the month. Nevertheless, Swedish economic data also showed weakness in July, with the NIERs Economic Tendency Index declining and Q2 GDP disappointing. The SEK appreciated at the middle of the month as US interest rates declined due to lower inflation. However, the SEK depreciated again later in the month.

Core CPI inflation in Norway surged to 7.0% in June, surpassing Norges Bank's projected 6.6% forecast. The increase was broad-based, with a significant contribution from the delayed impact of elevated global food prices, along with increases in recreation and culture costs. Notably, this marked the fourth consecutive month with core CPI rising more than 0.5% m/m (seasonally adjusted), heightening market expectations of impending interest rate hikes.

The surge in inflation led to Norwegian fixed income markets underperforming their counterparts, as investors re-evaluated the appropriate Norges Bank terminal rate necessary to control inflation.

In the foreign exchange market, the NOK experienced remarkable gains in July, appreciating over 5% against the EUR and showing further strength against the USD. This robust performance was attributed to a combination of factors, including wider interest rate differentials, higher energy prices, and the Norges Bank's decision to reduce its daily foreign FX purchases in July from NOK 1.3 bln to 1.0 bln.

All in all, developments in July affirmed our newly introduced theme, *"Norway: Brake before it breaks,"* which underscores the delicate balance of curbing inflation without inflicting undue harm on the real economy.



Outlook

Global outlook

Gazing into the final part of 2023 financial markets seem to have converged on "soft landing" as the main scenario for global economic and financial developments. From the perspective of the U.S. economy, a soft landing encompasses most views where inflation during the coming 12 months recedes towards the inflation target, while demand and labour markets align with potential, i.e. GDP-growth around 2% and employment growth of some 100k in monthly NFP terms. Eventually, the story goes, FED can ease on the breaks and lower the FED Funds Rate towards its neutral level.

The European economy is a world apart (almost literally) and is currently experiencing severe headwinds. The landing trajectory has therefore become highly uncertain, but it is still seen as broadly aligning with the U.S.

In most economies, headline inflation is now rising more slowly than wages, giving rise to improved purchasing power and higher real wages for households and is an important factor behind the perceived success of stabilisation policy. However, we believe the market discussion on a soft landing (at least as we read it) lacks nuance and simply seems to assume that the economy will continue along the same tangent indefinitely, which almost automatically will produce the desired soft landing. While this is a possibility, advocating for a soft landing must come with several important clarifications and caveats.

Firstly, receding headline inflation during 2023 has mainly been due to the resolution of supply problems in energy and food markets in the wake of Russia's invasion of Ukraine. Already by September, these base effects will have petered out and provide no further impetus to the real economy. To the contrary, both energy and food prices are now turning higher again, as oil supplies are tightened and the weather phenomenon El Niño wreaks havoc on harvests, and Russia failed to renew the Black Sea Grain Initiative.

Secondly, executing a soft landing will arguably require a different trajectory of productivity and wages. Currently, wages are rising considerably faster than productivity, resulting in higher unit labour costs for companies. Arithmetically, this implies higher prices (or lower margins). Hence, to keep a soft-landing a possibility, either productivity growth must accelerate, or wage growth decelerate. Tight labour markets contradicts both decelerating wage growth and hopes of stronger productivity (AI, cheap green energy, etc, are nonetheless possible routes to higher productivity).

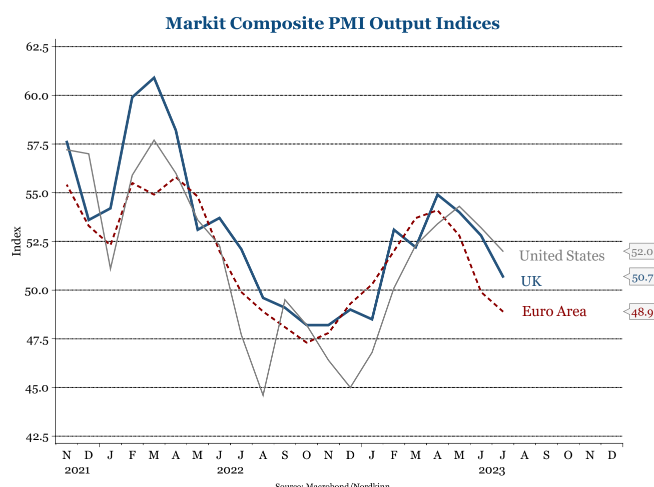
Ultimately, but relatedly, inflation expectations with both households and companies will decide the type of landing we eventually experience. Anchored inflation expectations imply that households and companies should be able to resist the urge to push for compensatory wage increases and to desist from price hikes to defend profit margins. This would let domestic relative price changes and allocation of productivity gains handle any real adjustment and, eventually, facilitate a soft landing.

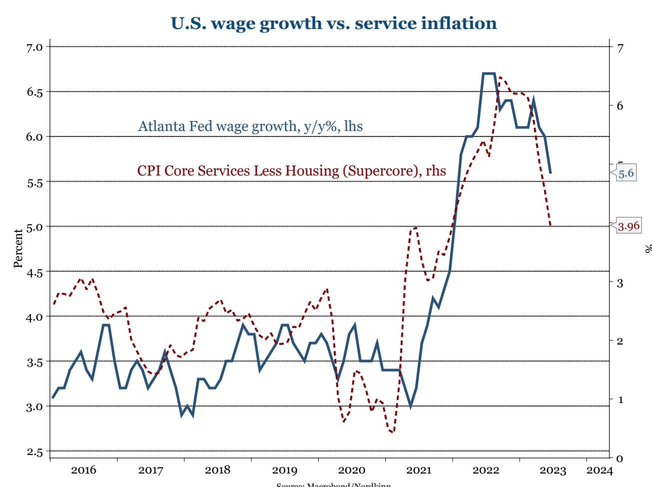
Admittedly, these are high hurdles to clear. But as mentioned above, the market narrative of a soft landing is also possible. A growing number of (mainly academic) commentators claim that the surge in inflation over the past 12-24 months was solely the result of transitory supply side problems. This would suggest that international and domestic relative prices are now simply realigning back to the pre-pandemic situation. Admittedly, this is not the basis for our current thinking and positioning, but it is indeed a possibility.

Before turning to positioning, let us summarise our global macroeconomic views: The U.S., less affected by the supply side challenges emerging over the past few years, is expected to demonstrate a smoother disinflationary process than other developed economies, not least due to a more flexible labour market. The FEDs July hike was possibly the last, but the FED will rather err on the side of caution, not to risk flaring inflation and inflation expectations. Hence, the first FED cut is probably not going to take place before year-end.

In the Euro Area, stagflationary risks are building. Inflation is proving stickier than expected and demand is weakening. In the absence of an outright and deep recession, we believe the ECB will have no choice but to keep rates (even) higher for longer for sure.

Taking stock of our macroeconomic analysis above, it seems we are at, or close to, peak policy rate levels. However, high and sticky inflation suggest that a pronounced cutting phase is not imminent. We are therefore a bit hesitant to take on strong directional bets, as central banks are expected to only belatedly acknowledge any need for cutting rates. Consequently, the very shortest yields should be fixated over the coming months. Nonetheless, short end bond yields could be expected to demonstrate a higher sensitivity to economic news, while a slight reversal higher of term premia on the back of, e.g. quantitative tightening by central banks suggest that yields on medium to longer dated bonds could stay relatively high. Hence, we will try to explore an expected increase in volatility in short term bond yields, pivoting between short end flatteners and steepeners, to more traditional 2 – 10 year steepeners and similar constructions in forward space.





Outlook

Nordic outlook

Market pricing suggests that we may have reached or are very close to the peak in policy rates. While this seems reasonable, we are not entirely convinced. Real rates, defined as the running core inflation (CPIF excluding Energy) relative to the policy rate, remain deep in the negative territory, at -4.3% in Sweden (and -2% in Europe). Core/service inflation remains elevated and stubbornly sticky, particularly in the Euro Area. Consequently, it will be up to the central banks to strike a balance between combating high and sticky core inflation while acknowledging the softer economic data, primarily in the manufacturing sector.

In the case of the Riksbank, the outcome might be one or possibly two additional rate hikes, but more importantly, an extended wait for rate cuts to be delivered. The current market pricing, projecting rate cuts starting by spring next year, seems a bit premature considering the available data. We expect pricing to continue adjusting to the latest economic information as the Riksbank finds itself in a challenging situation as macroeconomic data indicates signs of deterioration. The softer economic data is weakening the currency and risks prolonging the period of elevated inflation.

Our theme "Sweden: Reality bites" remains increasingly relevant, as we anticipate rate cuts in due course while expecting longer interest rates and bond yields to remain elevated or even higher due to QT (Quantitative Tightening). The first half of the year was surprisingly resilient in terms of growth. The second half possibly will be prove more challenging as households will face higher mortgage costs (yet again) and there are more signals of deteriorating demand in the manufacturing sector. Consequently, we foresee a gradual steepening of the Swedish yield curve, especially in forward starting structures.

Late in August the Riksbank will resume their selling of Swedish Government Bonds (SGBs) as part of the QT program, with the monthly size of QT increased as announced in the June policy meeting. Additionally, the Swedish National Debt Office will slightly increase auction sizes in issuance after the summer break. There will be a significant step-up in net-issuance of bonds relative to previous years. This summer SGBs have traded less impressive compared to previous summers when issuance have been on hold. So far this summer, swaps and other bonds have outperformed SGBs. We anticipate a gradual increase of the term premia along the Swedish bond yield curve. In line with our view, we expect SGBs to underperform relative to other bonds and fixed income products, and we will continue exploiting this in our theme "*Sweden: From QE to QT.*"

In Norway, we maintain our expectation that core CPI inflation peaked in June this year at 7.0% and will start to decline as we receive July data on August 10th. The reason for this is straightforward.

In the second half of 2022, month-over-month increases in Norwegian core CPI experienced a sharp surge. Notably, food prices rose by a record 7.5% m/m in July of the previous year, as major grocery chains adjusted their prices biannually (February and July) to catch up with the worldwide spike in food prices following the Russian invasion of Ukraine. Consequently, Norwegian inflation lagged behind other countries during its upward trajectory, as shown in the chart.

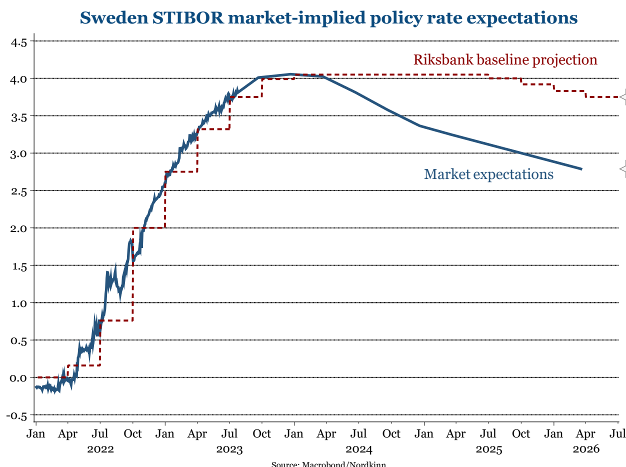
However, this biannual price adjustment behaviour in the food market is set to change this year. The major grocery chains have opted to adjust prices more frequently instead of the customary biannual practice. Consequently, while they significantly contributed to higher year-over-year inflation in June 2023, we anticipate a substantial negative contribution in July 2023.

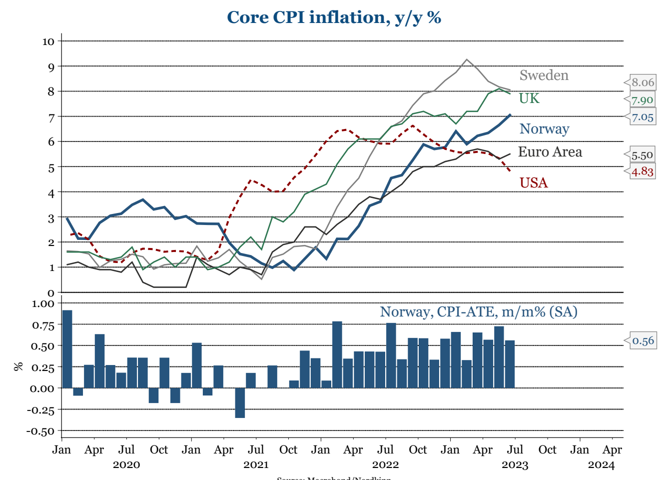
Furthermore, we expect the contribution from housing rentals to CPI inflation to slow down, also driven by base effects. Meanwhile, there are upside risks to prices on imported goods due to the delayed effects of the NOK depreciation during winter and spring, despite the NOK making an impressive comeback in July.

Regarding the NOK, the currency is now approximately 3% stronger than the Norges Bank's June projection, which in isolation would allow the Norges Bank to make only a 25 bps interest rate adjustment when the Monetary Policy Committee announces its next decision on August 17th. Assuming we are correct about peak inflation, we believe the Norges Bank's forecast of a peak rate of 4.25% is adequately high.

While Norwegian inflation lags behind other countries, we have reasons to expect a faster pass-through from interest rates to economic growth in Norway. This is attributed to the combination of a high debt burden among households and over 90% of mortgage loans being tied to floating rates.

Considering all these factors, our theme *"Norway: Brake before it breaks"* seeks to capture the Norges Bank's delicate balancing act of slowing inflation without causing unnecessary amounts of harm to the economy. As our stance is more dovish than the prevailing interest rate expectations in the market, we favour a combination of money market flatteners, forward starting steepeners in the swaps curve, and cross-market spread tighteners.





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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