NORDKINN

ASSET MANAGEMENT

Market Review & Outlook

August 2023

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Market overview

Global overview

The rise in global interest rates during August has mainly been driven by a fundamental reprising of the Fed into a "higher for longer" narrative. With U.S. interest rates exerting an outsized influence on global markets, interest rates have risen almost everywhere, and across almost all maturities. That said, the reprising of Euro Area interest rates has been far less pronounced than in the U.S. Under any circumstances, these developments contributed positively to our theme *"Global: Too soon for dovish pivot"*, but other themes also benefited from steeper yield curves.

Somewhat counterintuitively, data from both the U.S. and Euro Area has been broadly consistent with the idea of a gradual weakening of the business cycle. Not the least are we now starting to see some softness in U.S. labour markets with, e.g., vacancies and employment coming in slightly lower than expected in some instances. Elsewhere, Chinese data has proved to be outright weak. To the Euro Area in particular, heavily exposed to the Chinese growth outlook, this has led to weaker surveys, e.g. Purchasing Managers' Index (PMI) and IFO index, and also to some order and production data coming in on the weak side. This weakening of demand has nonetheless been reflected in cyclically sensitive two-year interest rates demonstrating much smaller raises than shorter and longer rates, see chart below. Fortunately, these developments are exactly in line with what we indicated in the outlook last month, contributing strongly to our steepener positions in Norway and Sweden.

On a less optimistic note, the weaker developments in the Euro Area have not been reflected in market-based inflation expectations, which have held up better than expected. Instead, the weaker European data has led to a decline in European real rates while U.S. real rates have continued their march higher. The relative performance of European real rate resulted in a negative contribution to the overall performance through the theme *"Global: Comparative inflation expectations"*.

Nordic overview

August witnessed yet another month of weakness in the SEK. The currency depreciated by approximately 2% as indicated by the KIX index. The prevailing topic of discussion lately has been the depreciating SEK, with various factors being proposed to explain this trend. While the Consumer Price Index (CPI) for July met expectations, there were noticeable signs of the weaker SEK affecting imported goods and services. This development emphasises one of the largest challenges facing the Riksbank currently.

The second-quarter Swedish GDP reported negative growth, mirroring the indications from both PMI and the surveys conducted by the National Institute of Economic Research (NIER), which suggest further impending weakness. Despite these trends, the real estate market and the service sector appear to be maintaining relative stability. Additionally, retail sales experienced a modest rebound in July, which could be attributed to potential factors like a pick-up in tourism and tourist spending. One plausible explanation for these patterns is the prevailing belief among the public that the recent surge in prices is transient, and inflation, or even outright prices, will eventually subside.

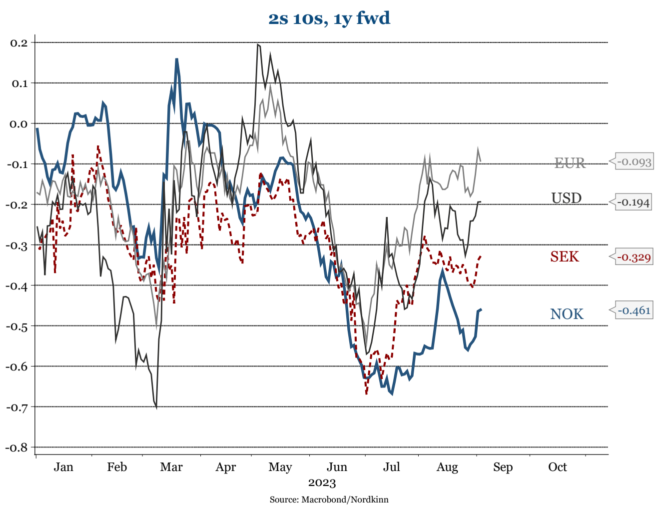
The Swedish fixed income market exhibited minimal net movement during August. However, this apparent stability concealed significant intramonth volatility. Moreover, government bonds underperformed in comparison to both covered bonds and swaps, which gave a positive performance to our theme *"Sweden: From QE to QT."*

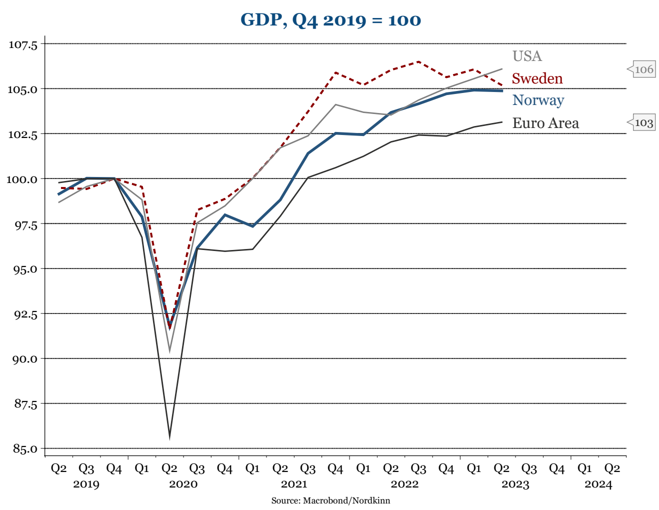
GDP for Mainland Norway stagnated in the second quarter due to a decline in household consumption and investments in real estate. The slowing economy has also become evident in the labour market, with an increase in the number of people applying for unemployment benefits.

Despite clear signs of weakened economic activity, payment flows continued to dominate the NOK interest rate market in early August, continuing the trend observed in July. However, these flows came to an abrupt halt when Statistics Norway announced CPI data for July, revealing that core CPI inflation had eased from 7.0% to 6.4%, coming very close to Norges Bank's June projection. Consequently, this inflation data triggered a relief rally in the NOK interest rate market as market participants quickly abandoned expectations of a possible 50 basis points rate hike at the Norges Bank meeting on August 17th and lowered their expectations of the terminal rate to around 4.35%.

However, this rally proved short-lived. A few days after the Norges Bank delivered the widely expected 25 basis points rate hike to 4.00%, payment flows emerged once again. Mirroring developments in global markets, the Norwegian rates market traded within a relatively narrow range in the second half of August.

The investment team successfully navigated the volatility in NOK rates markets in August, primarily by trading from the long side of the market. We also capitalised on profit opportunities following the release of the CPI data. Consequently, our theme *"Norway: Brake before it breaks"* was a meaningful contributor to our overall performance in August.





Outlook

Global outlook

Global policy rates are probably at, or close to, their peak – close to the "terminal rate" in financial jargon. Indeed, financial market pricing is almost unanimously pointing towards an economic "soft landing". From a U.S. vantage point, this implies that already by the end of 2024, inflation will be close to its target (2%), and both demand and labour markets will stabilise, reflected in a GDP growth around 2% and a monthly employment growth of roughly 100k in terms of NonFarmPayroll-growth. If this plays out, the Fed should eventually be able to gradually reduce the FED Funds Rate towards its neutral stance.

The European economy, while in some respects mirroring the U.S., currently faces additional and significant challenges, making its future trajectory less clear. Economic activity appears to be on the decline, see chart to the left. In particular, the weakness in the manufacturing sector is now seeping into the service sector and there are indications that hiring intentions in both services and manufacturing sectors are falling.

Simultaneously, there are also rays of brighter light, such as rising consumer confidence, driven by consecutively higher wage growth (see chart to the right) and as energy costs have declined. In short order, this should bolster private consumption.

According to a leading ECB Executive Board Member, Isabel Schnabel, this environment presents two pivotal questions for policymakers: The first is "[...] whether the current slowdown will prove sufficiently strong and persistent to reduce underlying price pressures in a way that ensures a timely return of inflation to our target", and the second question facing policymakers is "[...] how fast the slowdown, should it persist, will succeed in reducing underlying price pressures".

The first question relates to the by now somewhat jaded financial market discussion of a hard versus a soft landing. To us, some retracing of labour demand should be expected, after the exuberant developments in the wake of consecutive supply shocks and policy-boosted demand. The key, in our view, is that wage growth is outpacing inflation and real income growth will, for the time being, serve to prop up domestic demand. Further out in time, it is probably more interesting to consider the impacts of wage growth also exceeding productivity by a margin considerably above what is consistent with the inflation target. Our current impression is that with demand continuing a strong note, companies will be able to pass on also increased wage costs, effectively forcing the ECB's hand. Moreover, albeit to a lesser extent, we believe this is also a valid description of the U.S. outlook.

Our answer to the second question relates to the first, but it is more of a fundamental discussion on possible structural changes to the economy. Here, and in all honesty, we have very little additional information to offer. Suffice to say, on some kind of operative time horizon, it is difficult to see how any of the drivers most often discussed would act to lessen inflationary pressures (over the coming 2-4 years):

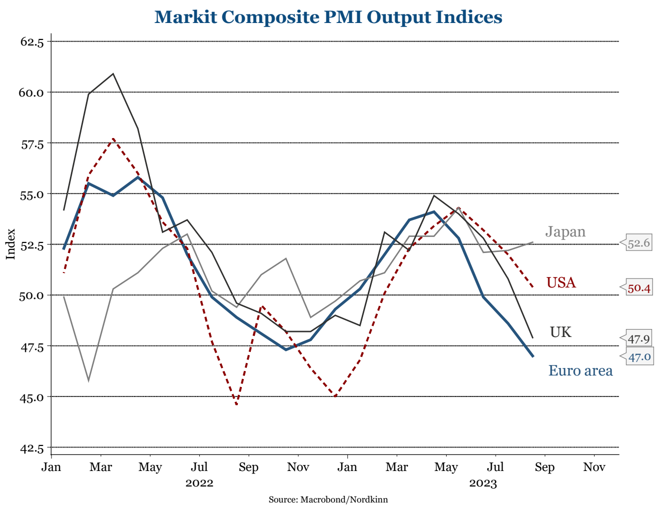
1. Energy prices could, of course, fall for cyclical reasons (but that would also imply we would have given the wrong answer to the first question). However, with the Euro Area aiming for both higher energy independence and cleaner energy generation, we believe this transformation will require strong investments growth over a very long period, serving to prop up demand in general and labour demand in particular. Once in place, nevertheless, the lower marginal cost of renewable energy sources should indeed increase productivity and lower inflation.

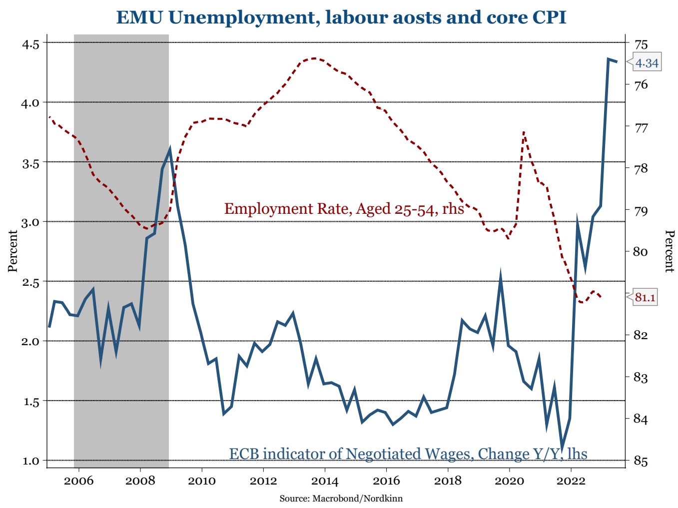
2. Decades of free trade, optimisation of global value chains and generally increased globalisation has helped monetary policymakers keep inflation under wraps. The opposite action, affirmed by geopolitical and security concerns, as well as an increased need for redundancies in value chains should, all equal, produce the opposite result.

3. Unfortunately, climate change has now also entered the realm of stabilisation policy. And it is not simply marginal increases of costs associated with increased regulations. With more and worse extreme weather events ahead of us, food price inflation is set to demonstrate large(r) swings around a higher mean, with effects already noticeable when studying food price trends.

Adherents of full disclosure, we also need to admit that if much of the hype surrounding AI is realised it would, probably, help to deflect some of the less benign developments mentioned above.

In summary, both policymakers and financial market participants seem to, by and large, wrestle the same questions. Getting the answer to the first question right is of higher importance to us at Nordkinn, and while there is a risk of inflation proving transitory after all, we believe that the interplay of high unit labour costs and robust demand growth will indeed produce a situation where rates will need to remain "higher for longer".





Nordic outlook

The challenge of inflation continues to persist for the Riksbank. The momentum observed in service inflation stands out as one of the highest among OECD countries. While some of this can be attributed to the volatility in airfare and package holiday prices, it is noteworthy that service inflation remains elevated even when these factors are excluded. The weak SEK adds to the dilemma faced by the Riksbank. As demonstrated by the chart, the collective surge in prices for imported goods and services over the current year is closely approaching the trajectory seen last year. The Riksbank's latest monetary report presents an alternative scenario that revolves around the notion of the SEK, and while these alternative scenarios serve as illustrative examples, they underscore the concerns that occupy the central bank's considerations.

The resurgence in retail sales could potentially be linked to the weakness of the SEK. There might be an increased expenditure within the country, possibly due to greater domestic tourism and heightened spending by tourists while visiting. Additionally, reports and data suggest a remarkable foreign demand for Swedish assets, including vacation homes, and even consumer goods like cars. If anything, this surge in foreign demand is likely to keep price dynamics sticky. Interestingly, the most recent NIER survey demonstrated an abrupt end in the decline of price plans among retailers.

In September, the Riksbank will resume the sale of government bonds in its QT program. Throughout the autumn, the Riksbank, together with the National Debt Office (Riksgälden), plans to sell approximately SEK 40 bln worth of bonds. This can be compared to a total of SEK 20 bln sold during the whole of 2022. Taken this fact together, first, Riksbank will continue to err on the hawkish side and, second, supply of bond risk will continue to weigh on Swedish fixed income products relative to foreign peers. We explore this in the theme *"Sweden: From QE to QT"*.

Swedish market-based inflation expectations still implies that Swedish inflation will undershoot both European inflation as well as the Riksbank's inflation rate target for years. In our view, such a scenario is very unlikely and should eventually adjust, either in the market or in the form of higher inflation compensation from the Swedish CPI linked bonds. The discrepancy of inflation pricing when comparing Sweden and, for instance, Germany, we judge, is neither warranted nor anchored in a clear-cut macro view, rather it reflects an 'illiquidity premia' in the CPI linked- bonds that we estimate to be around 75 bps. We anticipate that real money investors eventually will start appreciating this 'illiquidity premia', while at the same time be shielded for unpleasant inflation surprises that may erode the value of nominal bonds.

In Norway, we anticipate a resurgence in CPI-ATE in August-September, propelling core inflation a few tenths above the projections made by the Norges Bank in June. Our view is influenced, in part, by persistent pressures on housing rental prices, which, due to their nature, trail behind the headline CPI by approximately a year. Moreover, the potential for upside risks is further accentuated by the delayed transmission of effects from the weaker NOK to the prices of imported goods and services. This delay is exemplified by clothing stores, where the new autumn collections carry price tags established during the spring, a period when the NOK was at its lowest valuation.

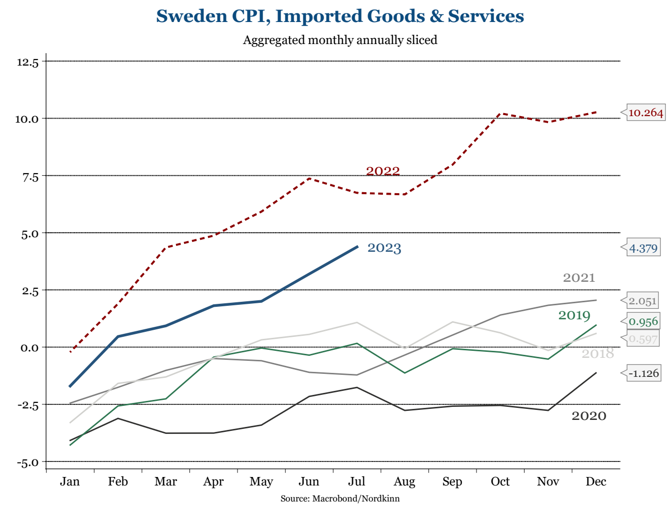
Isolated from other factors, the heightened inflation rate is likely to sustain market expectations of additional rate hikes by the Norges Bank in the fourth quarter. Currently, the market is factoring in a 25 bps tightening in September, along with almost a full 25 bps adjustment around the turn of the year, as depicted in the chart.

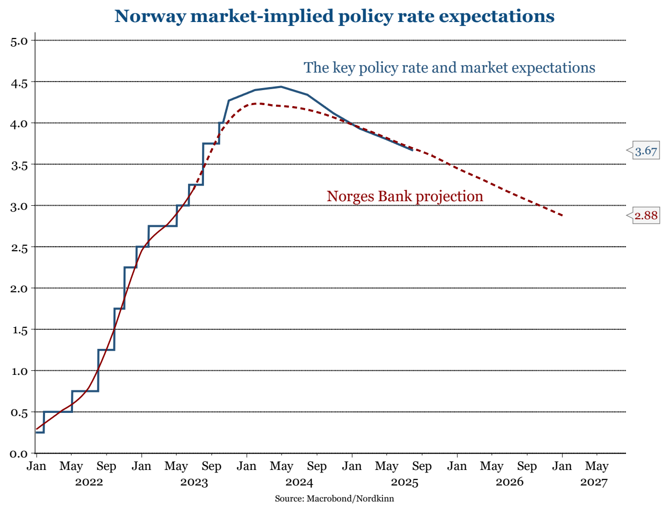
Looking further ahead, however, there is compelling rationale for anticipating a downward trajectory in core inflation. This perspective is partly influenced by favourable base effects, with prices of numerous goods and services experiencing sharp escalations toward the close of 2022. Additionally, with the NOK exchange rate demonstrating greater stability in recent months, the pressures on prices of imported goods and services are likely to alleviate by the fourth quarter.

Furthermore, the combination of stagnant economic growth and indications of diminishing labour market strains are expected to contribute to the containment of both price and wage inflation. Additionally, the decline in electricity prices is dragging down headline CPI inflation, thereby lowering input costs for production and subsequently aiding in tempering wage demands.

The Norges Bank endeavours curbing inflation without imposing undue strain on the real economy, which we seek to exploit in our theme *"Norway: Brake before it breaks."* At current we predict a final rate hike by the Norges Bank to 4.25% in September, which is below existing market expectations, see chart.

This said, we acknowledge that core inflation could rebound in August-September. Moreover, if other central banks persist with their rate hikes, the pressure on the Norges Bank to undertake further actions may endure. Nonetheless, we perceive this potential upside risk to be already incorporated in market prices. Additionally, as we foresee downside risks in the FRA/OIS spreads, we find NOK interest rates attractive to receive relative to some peers.





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.

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