NORDKINN
ASSET MANAGEMENT

# Market Review & Outlook

September 2023

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# Market overview

## Global overview

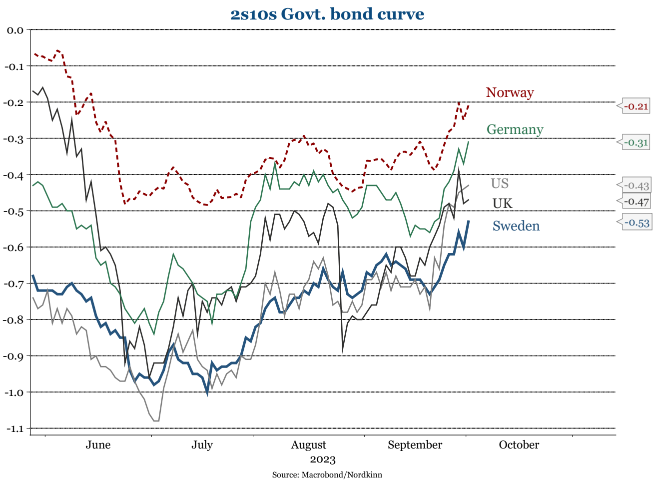
In September, international interest rates relentlessly climbed higher. The robust performance of the U.S. economy prompted the FOMC to raise its interest rate estimates ("the Fed dots") for 2024-2025, by 50 bps. However, the disinflationary trend persisted, with various U.S. core inflation measures in August coming very close to an annualised 2% rate, leading many market pundits to believe that this was the Fed's last hike in this rate cycle.

Nonetheless, a common thread in market commentary during the month has been the normalising of the full interest rate spectra after years of artificially low policy rates, quantitative easing and other substantially rate suppressing monetary policy interventions. As short-term rates are close to peak, this could possibly explain the steepening of the yield curve driven by much higher longer end rates.

In the Eurozone, rates rose in tandem with developments in the U.S., despite the Eurozone's economic performance falling short of that in the in the U.S. and even market expectations. True to form, Euro Area September inflation also came in below expectations, driven by core inflation at 2.3% on a month-over-month annualised basis. Given that Eurozone labour cost growth continues to be very high, not least compared to the U.S., the decline in Euro Area core CPI measures is particularly noticeable. The easing of inflationary pressures is perhaps most obvious in the UK, where a cocktail of very poor economic data and low inflation even caused the Bank of England to leave rates on hold on September 21st, despite expectations to the contrary in the run-up to the meeting.

In summary, major central banks are recognising the earnest onset of the disinflationary process, providing support for most positions in our *"Global: Easing of inflation"* theme. However, these gains were unable to offset for losses stemming from UK rates trading. Additionally, our *"Global: Too soon for a dovish pivot"* faced headwinds from the sell-off in the long-end of the U.S. curve, which offset gains resulting from higher short-term policy rate expectations in the U.S. and Eurozone.

Finally, the theme *"Global: Comparative Inflation Expectations"* positively contributed to performance. The release of lower-than-expected CPI data reduced European Break-Even Inflation (BEI) rates while real interest rates increased. In contrast, Swedish BEIs remained largely unchanged during this period. Towards the end of the month, the Swedish National Debt Office indicated a continuation of indexed-linked issuance, alleviating previous market concerns about a potential halt in issuance of such instruments.




## Nordic overview

In Sweden, CPI inflation data for August came in slightly lower than anticipated, indicating a return to pre-covid seasonal patterns. However, to ensure that inflation continues to fall and stabilise around target in a timely manner, on September 21st the Riksbank decided to raise the policy rate to 4.00%, as expected. The interest rate projection peaked at 4.10% - mere 5 bps adjustment compared with the previous profile. Consequently, the Riksbank's stance closely mirrored that of the ECB, which had made its announcement just a week earlier.

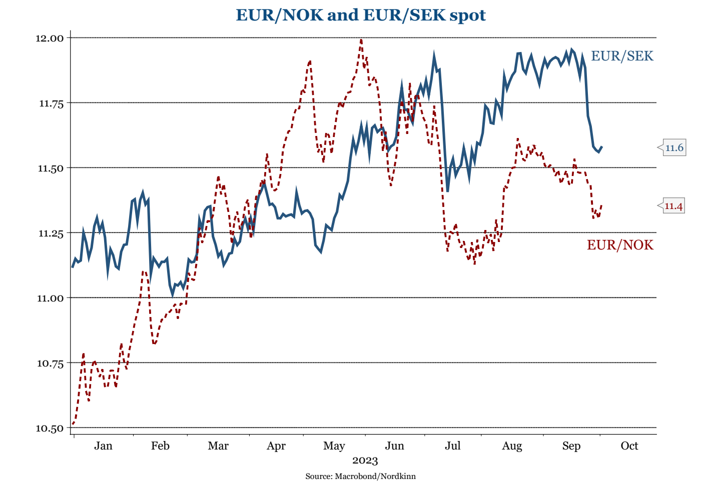
The Riksbank also decided to reduce currency risks in the FX reserves by selling USD and EUR in forward markets. Although this step had been widely debated in advance, the SEK closed the month with an impressive performance after a prolonged period of struggle. We believe that the remarkable late-month rally in the SEK was also supported by expectations that the ECB's policy rates have reached their peak, along with unwinding of speculative short SEK positions. Consequently, our tactically long SEK positions contributed positively to performance in September, which was captured within *"Tactical risk reward trading"*.

Meanwhile, our theme *"Sweden: Reality bites"* enjoyed the transmission of higher long term global bond yields into steeper Swedish yield curves as shorter rates remained broadly unchanged. Moreover, covered bonds outperformed government bonds initially, but as the month progressed, demand for government bonds improved significantly, such that *"Sweden: From QE to QT"* subtracted slightly from the fund's overall performance.

In Norway, core CPI inflation dipped to 6.3% from 6.4%, one tenth of a percentage point below Norges Bank's estimate. Despite the favourable recent inflation trends, Norges Bank surprised the market by revising its 2024 inflation forecast upwards in the Monetary Policy Report released alongside the decision to raise the key policy rate to 4.25% on September 21st. The Bank attributed this adjustment to expectations of increased wage growth in 2024, driven by high resource utilisation in the economy and prospects of improved profitability in oil-related manufacturing.

In anticipation of persistent inflationary pressures, Norges Bank revised its interest rate outlook beyond market expectations, signalling a likely additional policy hike to 4.50%, most probably in December. This contrasted with the prevailing market sentiment, which had expected the Bank to signal a period of unchanged rates ahead. Consequently, market interest rates increased following the announcement.

Despite the uptick in interest rates in September, our theme *"Norway: Brake before it breaks"* contributed positively to the fund's performance, as Norwegian rates increased less on a relative basis to peers.



# Outlook

## Global outlook

Macroeconomic developments have rarely been as exciting as they are now. Over the past few years, we have witnessed an unrivalled stabilisation policy response to a pandemic and experienced the economic consequences in the form of a globally synchronised inflation shock. This shock is now giving way to a disinflationary aftermath testing the different institutional frameworks of individual economies, not least the hard-fought and -won establishment of (still) credible inflation targeting regimes, separating this experience from the inflation shocks of the 1970's and 1980's.

Diligent readers know that we have been siding with the soft-landing narrative as baseline, but with a nod towards "higher for longer" trades. At length, we have also discussed what we believe has become the main threat to our baseline; the "Immaculate disinflation", i.e. disinflation moving in a straight line back to target. While we still attach low probability to this scenario, developments and outcomes over the past few weeks have admittedly increased the chances of an immaculate disinflation process. This would defend the views held of "Team Transitory", albeit with a lag. If this were to happen, the chances of central banks cutting rates sooner rather than later increases.

But, in the current situation, how would this play out? Central banks are sure to find comfort in sequential inflation rates approaching 2% (in annualised terms), as it suggests that the monetary policy stance is indeed restrictive. As, or rather, when, core inflation stabilises around 2% it also opens up for the possibility of central banks lowering rates towards estimates of neutral.

However, in a context of still strong demand and tight to very tight labour markets, expectations of swift and deep accommodation are overdone. Should, instead, labour markets tank and demand fall off a cliff, the current hope of straight line disinflation only proved a precursor to a hard landing of the global economy, a recession even. Herein, probably, lies the key to why the Band of England's swift turnaround has given reason for us to pause; in an environment of receding inflation, what is really the degree of stagnation necessary before changing pace?

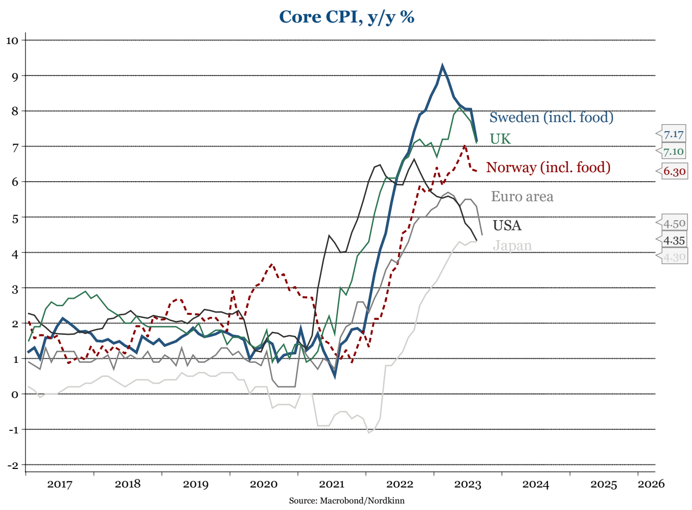
There is also more for us to consider. An important prerequisite for straight line disinflation and decreased policy rates sooner rather than later is low and stable inflation expectations. And measured inflation expectations (surveyed as well as market based) are indeed both stable and close to inflation targets.

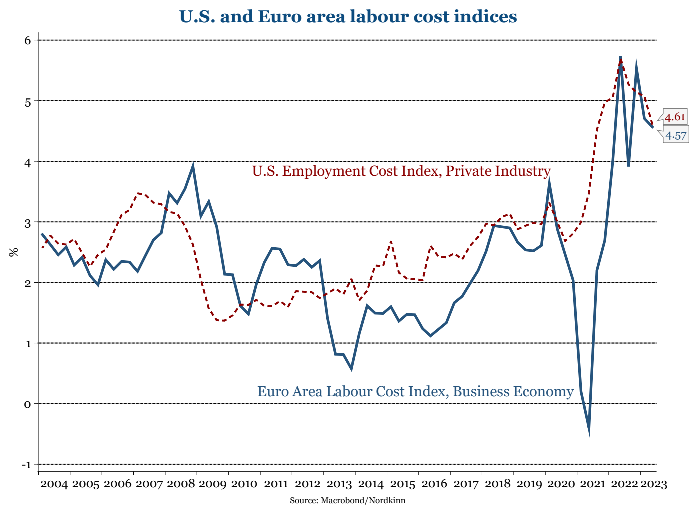
But in studies and surveys of corporate pricing behaviour, the main driver of price adjustments are changes to (marginal) costs. If this is true, which we believe it is, the current disinflation is arguably an effect of energy prices normalising after last year's dramatic rises. Looking ahead, and long term, it is rather labour costs – wages – that are responsible for changes of companies' costs. Thus, for company pricing decisions and "fundamental" inflation expectations to remain close to inflation targets, companies' labour costs should develop in line with the inflation target adjusted for any productivity gains the companies can eek out of their employees. Labour costs adjusted for productivity is labelled Unit Labor Costs (ULC) and if ULC grows faster than inflation, profit margins are suffering. In the Euro Area as well as the UK and the U.S., ULC-growth is currently, albeit by varying degrees, outstripping inflation.

With historically tight labour markets, wages should continue to increase at a swift pace. Tight labour markets also imply that the quality of labour is deteriorating, making it harder for companies to count on productivity gains to alleviate cost pressures. But it also suggests that demand is robust, which should make it easier for companies to hike prices, i.e., increase inflation going forward.

This latter line of reasoning still underpins our thinking and our positioning on financial markets. As the cyclical and institutional settings differ from economy to economy, the type of disinflationary process we experience is nonetheless set to diverge markedly between countries. And this is probably what has now started to play out on financial markets and something we will explore in future themes and positions.

With even more dimensions to consider, the potential influence of macroeconomic developments on markets is gradually growing more relevant and more pronounced.



# Outlook

## Nordic outlook

The September Riksbank monetary policy meeting indicated a reluctance to move too far from the ECB's stance. There was only a minor upward adjustment in the rate path, leaving the probability of another rate hike below 50%. Our interpretation is that unless there is a continued depreciation of the SEK, the Riksbank will be reluctant to proceed with further rate hikes. However, as there is a reasonable chance that both the ECB and the Fed have concluded their rate hikes, the risk of a significant depreciation of the SEK has likely diminished substantially.

Nonetheless, recent inflation data indicates that service inflation momentum remains relatively high. Additionally, the belief that rate hikes have concluded and rate cuts are imminent could hinder the expected slowdown in private service consumption. Moreover, if the labour market continues to display resilience and strength, it may challenge the Riksbank's convictions, or optimism, regarding the disinflation process. The combination of reluctance to hike rates further and the risk of a slower disinflation process suggest that market pricing will continue to be highly volatile. However, given the ECB's status quo and an anticipated appreciation of the SEK, we believe that Swedish interest rates are likely to outperform in the short term, albeit with a continued bias towards a steeper yield curve. The initial phase is expected to be a stronger, or at least a stable, SEK.

The disinflation phase in Sweden remains precarious due to persistent domestic service inflation. Curiously, this is not fully reflected in future inflation pricing, which suggests risks appear to be skewed to the downside. On the growth front, Swedish manufacturers are not reaping the benefits of the global soft-landing, as the soft-landing largely relies on robust private consumption abroad, not strong manufacturing. Furthermore, the pain from rate hikes on the domestic economy has not yet reached its zenith. Consequently, the economy carries downside risks while inflation risks are skewed to the upside, particularly when compared to Europe. Short-term interest rates in Sweden are slightly higher than those of European peers, while inflation risks are notably lower. Considering these factors, we advocate a preference for holding long positions in short-term rates and inflation relative to Europe.

Meanwhile, the Riksbank continues to sell Swedish government bonds (SGB). In the latter half of September, SGBs exhibited relative strength as demand picked-up. Only time will tell if this trend is sustained but given the persistent selling by the Riksbank and the debt office's issuance, we remain confident that SGBs will gradually reprice to levels resembling a pre-QE era. The Swedish yield curve is susceptible to steepening in the future. This is explored in *"Sweden: From QE to QT"*.

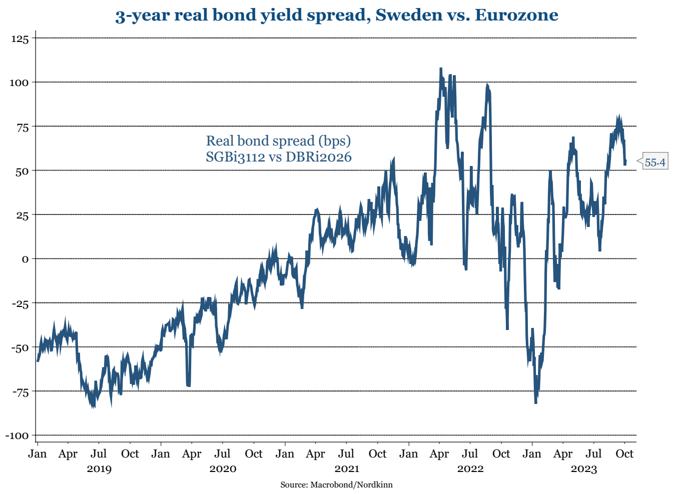
In Norway, our expectations continue to revolve around core CPI inflation closely mirroring inflation trends observed in other markets, albeit with a time delay. This temporal lag, in part, stems from country-specific disparities in the inflation dynamics of certain key items. For example, in Norway, housing rental prices typically follow the headline CPI by approximately a year due to legal provisions permitting property owners to adjust rental prices in alignment with the CPI only once annually. Consequently, housing rental inflation, which constitute a significant portion of the consumer basket, are expected to remain high and relatively stable over the next year or so.

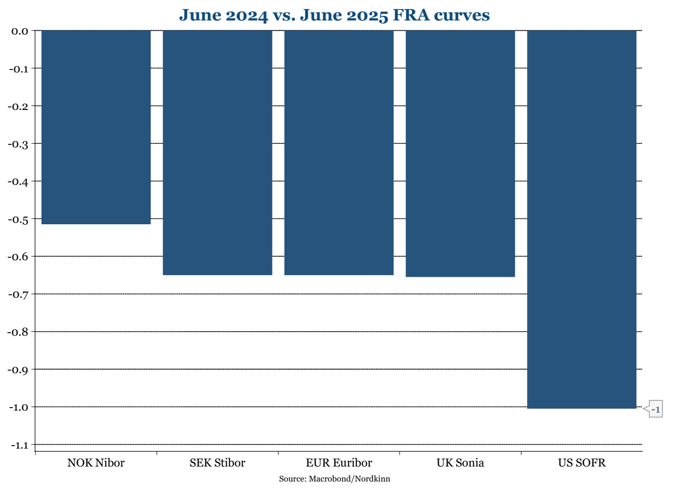
Furthermore, the depreciation of the NOK exchange rate during the first half of 2023 is also manifesting itself in the CPI, albeit with a lag of roughly six months. This factor contributes to near-term upward risks. However, with the NOK exchange rate appreciating in Q3, pressures on imported goods' prices are likely to diminish in the not-so-distant future.

Nevertheless, as numerous goods and services experienced sharp price increases toward the end of 2022, a downward trajectory in year-over-year inflation appears likely in Q4 2023. Additionally, the combination of sluggish economic growth and indications of reduced labour market tightness (with the oil industry being a notable exception) is expected to help contain inflationary pressures, even though wage dynamics are likely to remain sticky for some time.

In the short term, we anticipate the market to assign a relatively high probability to another rate hike by the Norges Bank by year-end, aligning with the central bank's forward guidance following the Board meeting in September. However, it's worth noting that if other central banks opt to maintain their rates at current levels in the future, and with the NOK exchange rate moving in a favourable direction, we see less urgency for the Norges Bank to raise rates again. Economic growth is evidently slowing, and we firmly believe that the Norges Bank aims to curb inflation without exerting undue strain on the real economy.

Given this context, we maintain our commitment to our theme *"Norway: Brake before it breaks,"* with a preference for receiving NOK rates relative to other markets. In addition, considering the relatively few cuts discounted in the NOK curve compared to other markets (see chart), we also adopt positions for flatter money market curves.



# 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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