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ASSET MANAGEMENT

Market Review & Outlook

March 2024

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Market overview

Global overview

In March, and despite large downward revisions to January's employment numbers, the U.S. labour market reports reflected a still very robust employment situation. The three-month average non-farm payroll employment change was stable around 250k while the February number was 275k. This compares to most estimates of the long-term employment growth needed to keep the unemployment rate stable, at and around 100k, although we acknowledge that the neutral employment growth could be higher due to e.g. higher immigration.

Meanwhile, U.S. core consumer prices grew a solid pace also in February, at 0.4% m/m (4.3% Seasonally Adjusted Annual Rate) in CPI-terms and 0.3% m/m (3.2% SAAR) in PCE-terms. At its latest policy meeting the FOMC did on March 20th acknowledge the uncertain inflation outlook by detracting a couple of cuts from the 2025 interest rate forecast in the March Summary of Economic Projections (SEP), but kept a razor-thin majority for three cuts in 2024, which keeps a June cut as an option. Other data during the month also supported a cautious cutting cycle, why U.S. rates ended the month on more or less the same level as they started.

On March 19th, the Bank of Japan raised interest rates for the first time in 17 years, ending also the ultra-loose policies of the Abenomics era, with negative interest rates (NIRP), yield curve control (YCC) and quantitative & qualitative easing (QQE). Our anticipation was that such a strong change of policy direction would entail an end to the perennial weakness of the JPY. But on the news, the JPY instead weakened further, admittedly alongside many other currencies, pushing the USD considerably stronger in trade-weighted terms. Meanwhile, the SEK continued its struggles versus peers, which contributed negatively to our *"Global: FX-misalignment"* theme.

In the Euro Area, the monthly calendar habitually starts with the flash inflation numbers. At 3.1% y/y, February core inflation was again a notch stronger than expected. Nevertheless, there seems to be a consensus building in the ECB's Governing Council for a June cut as even leading hawks like Bundesbank's Nagel and de Nederlandsche Bank's Knot allude to the possibility. Furthermore, ECB President Lagarde pointed to increased confidence in forecasts by highlighting decreasing cost and inflation pressures, which was interpreted as a strong signal of upcoming ECB staff projections to open for a rate cut before summer.

Overall, the U.S. economy continues to outperform most other economies which suited our global trades well, which lead to our theme *"From disinflation to divergence"* contributing positively to our results in March.

Nordic overview

The month displayed further tentative signs that the trough in the Swedish economy has passed. Confidence appears to be rising among households, retailers, and some other businesses, likely as a result of lower inflation and anticipated interest rate cuts. Indeed, in its policy statement on March 27th the Riksbank confirmed its willingness to reduce rates soon, either in May or in June.

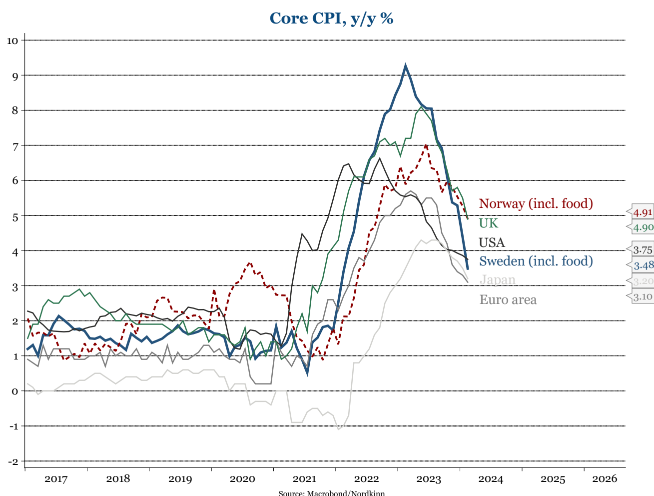
However, to prevent currency depreciation, the central bank advocated for gradual cuts, projecting an accumulated 75 bps of cuts throughout 2024. This aligns relatively closely with market expectations, anticipating approximately a 90 bps reduction. In addition, the central bank still voices concerns regarding service inflation. The February's inflation data release, although slightly below consensus expectations, underscored the stickiness of service inflation, see chart.

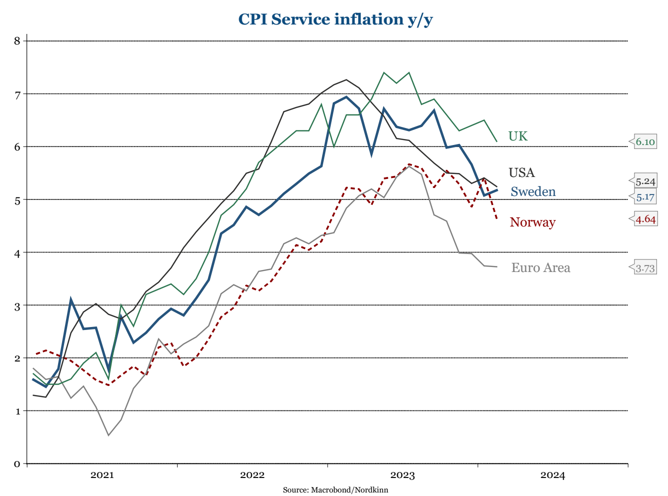
The Swedish fixed income market has increasingly aligned with the European. The yield curve experienced a marginal steepening in March, with government bonds underperforming, and longer-term inflation expectations rising slightly. This bolstered the Swedish themes *"From QE to QT,"* "*Future inflation underpriced*," and *"Normalising risk premia,"* which all profited in March.

In Norway, the annual CPI-ATE (core) inflation continued its downward trend in February, dropping to 4.9% from 5.3% in January and 5.5% in December. The decline exceeded market consensus expectations, with the latest figures falling short of the Norges Bank's projection by as much as 0.6 percentage points. Reflecting the more favourable CPI data, the Norges Bank, in its monetary policy report published on March 21st, revised its projection for core CPI downward by 0.7 and 0.3 percentage points for 2024 and 2025 respectively.

Despite the lower inflation forecast, the interest rate projection remained largely unchanged, with a slight increase of a few basis points anticipated for 2025 and 2026. This seemingly contradictory response in interest rates reflects an upward revision to economic activity, which contributed to a more resilient inflation projection from 2026 onwards.

Following the CPI data, Norwegian interest rates initially rallied, but this rally was short-lived as the Norges Bank appears hesitant to ease monetary policy until it gains more confidence that inflation is moving towards a sustained decrease, likely not until September according to its latest projection. Our investment theme *"Norway: Inflation risks overvalued"* contributed positively to performance in March.





Outlook

Global outlook

Major central banks are approaching decision time for the long awaited cuts. However, data is only partially playing along in that narrative, with indicators of input costs and wage growth remaining some distance above what has historically been compatible with inflation at target. In addition, activity remains robust in the U.S., and there are even some signs of sprouting seeds in depressed Euro area economies. Importantly, and on both sides of the Atlantic, labour markets can only be described as tight from a historical perspective.

At the same time, the disinflationary processes are continuing across advanced economies (with, arguably, the exception of Japan) and central bankers are constantly dwelling on the optimal degree of tightness of monetary policy. That debate is far from clear-cut though and requires a strong belief in estimates of the neutral monetary policy rate, i* (r* plus the inflation targets). While neutral rate has proven to be a complex concept even in more normal times, many central bankers are likewise demonstrating curiosity and an explorative approach to it.

Meanwhile, financial markets are gradually preparing for how a cutting cycle will pan out, which not only include the timing of first cuts, but also the frequency of cuts and where the terminal rate is located.

With so many uncertainties surrounding the interest rate outlook, it is no wonder that volatility in rates markets continues to be very high, which remains a constructive environment for active portfolio management. That said, it is also an environment where it is hard to hold strong directional convictions, especially over time, why we still focus more on relative trades, both in time and space.

At the time of writing, markets are well aligned with our view of few and slow cuts and a still high terminal rate in the U.S., see chart. However, markets are very sensitive to data pointing to a weaker economy or lower inflation and are eager to price in a swifter and deeper cutting cycle than what we currently believe will transpire. This is probably due to the simple fact that rates have not been this high since before the Global Financial Crisis of 2007-08 and that many of the latest cutting cycles have indeed been both swift and deep.

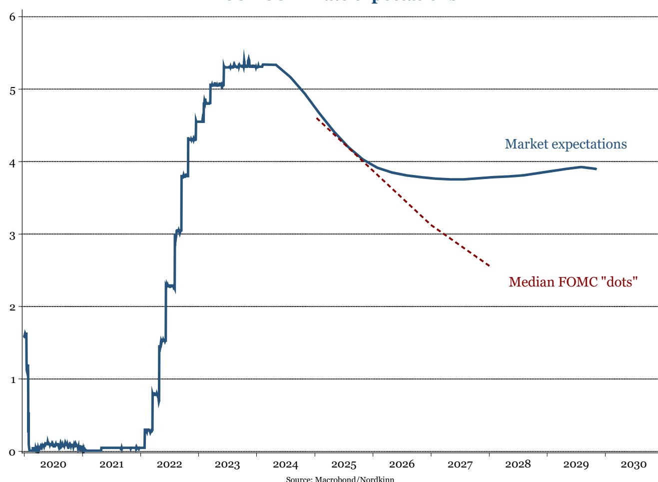
But this time is different, we feel. Demand and labour markets seem robust and apart from very high valuations of a handful of companies, asset valuations (even including real estate) are at least not becoming more stretched.

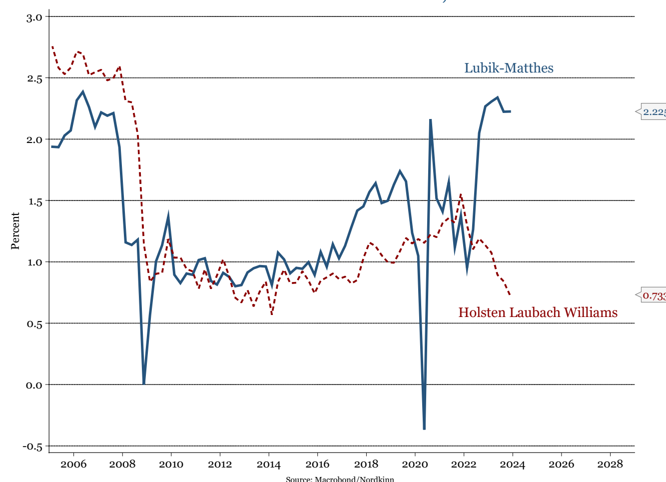
And if this benign narrative dominates, central banks should be in no rush to push monetary policy deep into expansionary territory. Rather, and given the uncertainty surrounding r*-estimates (see chart) central banks can afford to take an explorative approach when guiding monetary policy towards neutral. When these facts change, we will of course change our minds accordingly.

We are attentive of short-term U.S. labour market developments as a deterioration would signal that monetary policy has undeniably become overly restrictive and recession risks have been underestimated. On the upside, we have already begun to detect signals of the Euro area economy being well past its lows, and a resurrection of the Euro area economy would certainly come as a surprise to financial markets. Importantly, and as we believe the global economy will escape a near-term recession, we believe medium term risks should be of equal interest.

Looking into the second half of 2024, we expect financial market's focus could shift towards the sustainability of public finances and another apparent divergence between major economies. Whereas the U.S. is set to continue running large deficits for the foreseeable future, the Euro area, for all its shortcomings, has at least nominally started to exert some degree of fiscal stringency. However, this is only one of the possible perspectives financial markets can choose to take on public finances. Within the Euro area, there are notorious differences in the sustainability of public finances, and without a fundamental resolution in place, odds are low that the situation in weaker economies will again come into focus. Here, cyclical developments will be instrumental in deciding how an increased public finance focus will play out. In both scenarios, however, longer-end yields should remain high or perhaps become even higher in the economies at risk, which we try to explore in several different trades.

All in all, there are reasons to remain confident that both volatility and opportunities will remain. The gradual albeit foundational change across financial markets now underway is that interest rates are again and increasingly decided by normal market price mechanism rather than disruptive central bank interference.





Outlook

Nordic outlook

The Riksbank appears eager to lower the policy rate, aiming to alleviate households' interest rate expenditures and possibly to repay for the previous concessions made by labourers and unions during recent wage negotiations. However, uncertainties persist as the currency situation and persistent service inflation continue to cloud the outlook.

The SEK closed the month at its weakest level against the USD since November of the previous year. Clearly, the Riksbank is concerned about the weakened currency and its potential to disrupt the disinflation process. Goods inflation began declining in the second half of 2023. Should the USD continue to appreciate (there is a risk that the Fed needs to maintain a more hawkish stance than currently assumed), goods disinflation may encounter obstacles in the latter half of this year.

Service inflation remains elevated; aggregated price changes in the service category up to February were slightly lower than in 2023 but significantly above the pre-pandemic average (2015-2019). In fact, aggregated service inflation up to February was only marginally lower than the average annual aggregated service inflation during the pre-pandemic years (see chart). Therefore, we understand the Riksbank's concerns regarding sticky service inflation.

While it could be argued that this is primarily driven by "administratively" set prices rather than demand, the risk is that it leads to compensation demands. It is worth noting that most of these price hikes pertain to services that are difficult to avoid. Additionally, while wage growth may be lower than in continental Europe, it remains the highest seen in over twenty years in absolute terms. We find it unlikely that it will have no effect; rather, we believe it partially explains the high service prices.

Given the aforementioned factors, we maintain our belief that future inflation in Sweden is underestimated by the market. We argue that Break-Even Inflation (BEI) rates are too conservative and that the market's pricing of the pace of Riksbank's rate cuts is overly aggressive in the near term. The risk, of course, is that if rate cuts are slow or postponed, it could significantly impact the economy and labour market, necessitating more aggressive action by the Riksbank later on but for other reasons.

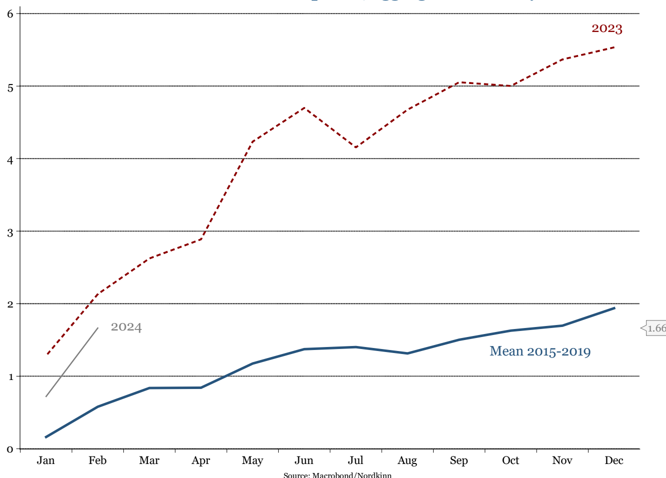
In Norway, inflation has fallen more rapidly than anticipated by both market consensus and the Norges Bank, but it aligns closely with our forecast as outlined in previous monthly reports and summarised by our investment theme, *"Inflation risks overvalued."* However, the significant decline in inflation failed to sway the Norges Bank, which left its interest rate projection largely unchanged due to concerns that inflation may persist above target in the medium term.

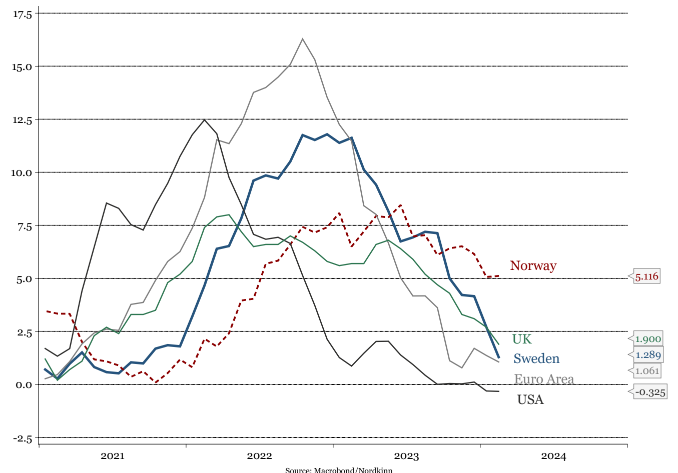
The Norges Bank's hawkish response to the lower CPI data reflects, in our opinion, two primary concerns: Firstly, despite the appreciation of the NOK exchange rate since the Norges Bank's decision to hike rates in December 2023, the bank remains vigilant about the risk of renewed currency weakness, which could complicate efforts to bring inflation back to target promptly. This suggests that the Norges Bank may prefer to await other central banks to ease monetary policy before taking action. Secondly, the Norges Bank evidently wishes to await the outcome of centralised spring wage negotiations before gaining confidence in the sustainability of the decline in inflation.

Although the updated inflation forecast for 2024 is more aligned with our own view, we still perceive the risk surrounding the Norges Bank's inflation projections to be skewed to the downside. Goods price inflation remains relatively elevated in Norway and is expected, in our assessment, to converge towards the rates observed in other economies. Service inflation may prove to be more persistent, given the high wage growth. However, our analysis indicates that the surge in service inflation last year was influenced by factors beyond just wage growth, including energy costs, rents, and higher margins. Therefore, we anticipate disinflation within services, and the February CPI outcome largely confirmed our hypothesis.

Unless there is an unexpected upside surprise in wage negotiations, we anticipate the Norges Bank expressing greater confidence in the inflation trajectory in its next monetary policy report in June. By then, we expect to have observed several more benign CPI figures and gained further clarity on wage developments. Additionally, we will have more insight into the trajectory of interest rates in other countries, which we believe will significantly impact the NOK exchange rate.

We maintain long positioning towards the NOK exchange rate and favour money market flatteners in rates, a steeper forwarding staring swap rate curve, and tighter spreads across country spreads.





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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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