

# NORDKINN

— ASSET MANAGEMENT —

## Market Review & Outlook

April 2024

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# Market overview

## Global overview

All economies are created equal, but some economies are more equal than others, financial markets seemed to have proclaimed, yet again, in April. Interest rates rose strongly on both sides of the Atlantic during April as U.S. (CPI) inflation posted another strong rise of 0.4% m/m in both headline and core terms. Other price indicators, e.g. ISM prices paid, showed similar strength. In addition, U.S. labour markets again outshone all expectations as Non-Farm Payrolls (NFP) increased by 303k (vs. 214k expected) and retail sales rebounded after a couple of softer (albeit now upwardly revised) months. The U.S. economy is, in short, very robust.

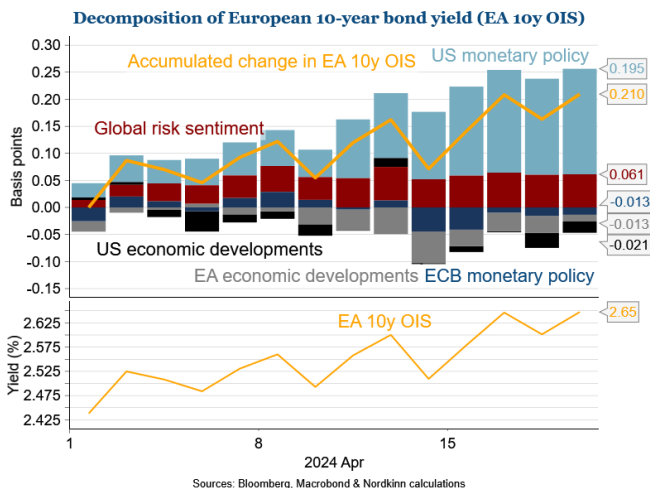
Looking across the pond, there are indeed some green shoots with survey-based indicators such as composite PMI climbing above at 50.3 for the first time in almost a year. European 10-year yields rose up to 30 basis points on the month, despite the ECB chorus apparently finding the pitch for a June cut. Indeed, when looking at our inhouse decomposition of 10-year yields for the U.S. and Euro Area, we can clearly see that developments in the latter are a result of U.S. monetary policy, rather than domestic developments, see left hand chart.

The rather small divergence in macro and interest rate developments between U.S. and Europe nonetheless contributed positively to the theme "From disinflation to divergence" during April.

In Japan, the tremors from last month's policy change are still being felt and the JPY has, intraday, been trading at levels not seen since at least the earliest days of the 1990's versus both USD and EUR. To stem the outflows, Bank of Japan likely intervened to support JPY towards the end of April. Vice Minister of Finance, Masato Kanda, and in charge of currency policies, said that any official statements on interventions will only come by the end of May.

The continued weakness of the JPY, continued strength of the USD, as well as "the kronas" (SEK and NOK) put a dent in our global "FX misalignment" theme, which contributed negatively in April.

Elsewhere, we also note that the long-awaited Bernanke review of Bank of England lent a great deal of support to the Riksbank's practice of disclosing interest rate forecasts, as well as scenario analysis, to help in decision-making and communication. However, Bernanke's review stops short of explaining how inflation shot up the way it did in the first place, and what contribution, if any, unconventional monetary and fiscal stabilisation policies might have had on its trajectory.



## Nordic overview

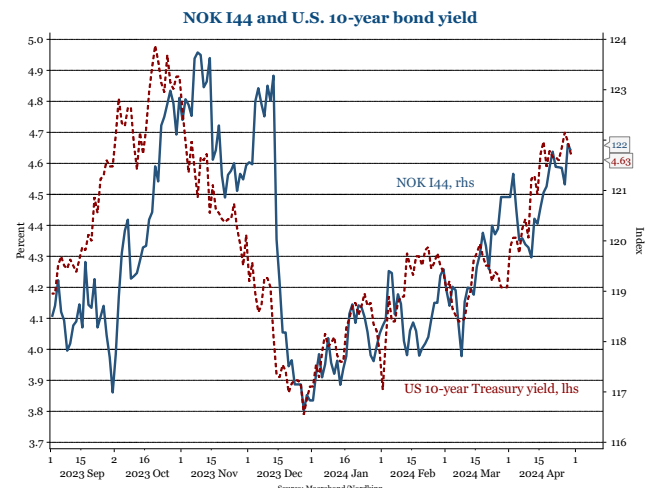
April witnessed further improvement in survey data in Scandinavia. The Swedish NIER (National Institute of Economic Research) survey indicated enhancements across all sectors of the economy, with the most significant contribution coming from the retail sector. However, "hard data" such as the monthly GDP indicator showed less improvement, with GDP contracting by 0.1% q/q in the first quarter.

It is likely that certain economic agents in the economy are anticipating rate cuts in Sweden, leading to a more optimistic outlook. Notably, the NIER survey includes an element of expectations. Therefore, an improvement in hard data likely depends on the delivery of anticipated rate cuts, which seem imminent. For more insights on the monetary policy outlook, refer to our Sweden Outlook section on page 4.

In April, movements in Swedish interest rates were affected by U.S. rates, reflecting robust macroeconomic data across the Atlantic. The pass-through from higher rates abroad was more pronounced in the Swedish swap market in comparison to the bond market, the latter being dominated by domestic investors. This division became more pronounced as we approached a significant bond index duration extension, prompting increased appetite for duration in cash bonds among domestic investors. Consequently, the spread between swap rates and government bond yields widened, affecting the "Sweden: From QE to QT" theme negatively. Swedish Break-Even Inflation rates traded higher, and covered bonds outperformed swaps, resulting in gains in the themes "Sweden: Future inflation underpriced" and "Sweden: Normalising risk premia."

Meanwhile in Norway, in April core CPI inflation continued to decline, with year-on-year increases in CPI-ATE dropping to 4.5% from 4.9%, once again falling short of Norges Bank's projections. This reinforces our below-consensus forecast for inflation in 2024, as articulated in our investment theme, "Norway: Inflation risks overvalued."

Despite this, the NOK interest rate markets mirrored the upward trend in USD rates during April, driven in part by a strong correlation between movements in U.S. bond yields and the NOK exchange rate, which depreciated by approximately 2%, see chart. Additionally, concerns about future inflation were heightened by a wage agreement that lifted wages by 5.2% on average in 2024, surpassing Norges Bank's forecast by 0.3 percentage points. Consequently, the investment theme subtracted from performance in April. This was however partly offset by gains from a tactical exposure in Norwegian government bonds relative to swaps.



# Outlook

## Global outlook

Our global theme “From disinflation to divergence” did perform well during April, but as stated already in the review section, we believe that financial markets have not been responsive to the apparent economic differences between the U.S. and Euro Area economies.

Fundamentally, and this also relates to the discussions on “neutral rates” from previous Nordkinn Monthly Report Outlooks, there are reasons to believe that the neutral rate is higher than before the pandemic and Russia’s war on Ukraine. In particular, the fiscal outlook and long-term inflation outlook has dimmed on a global scale.

That said, and according to IMF, the (recently reformed) fiscal rules of the Euro Area necessitates that the cyclically adjusted primary deficits of Europe will all but vanish over the coming five years, while the U.S. primary deficit will exceed 2.5% of GDP, despite quite optimistic assumptions, see left hand chart. Hence, a key explanation to why the massive U.S. monetary policy tightening might not have resulted in a similarly restrictive stance is more or less absent in Euro Area policy discussions.

Furthermore, and perhaps even more pertinent, the cyclical position of the U.S. is considerably stronger than that of the Euro Area. The U.S. economy is back at, or even above, its pre-pandemic GDP-trend while the Euro Area is left wanting, see right hand chart. This is also visible in inflation developments, where inflation momentum has picked up pace in the U.S. whereas it is both low and close to target in the Euro Area. Finally, also from labour market developments, it is clear that employment is fairing considerably better in the U.S. than in the Euro Area, where labour hoarding is still apparent from weak average hours worked and survey data etc.

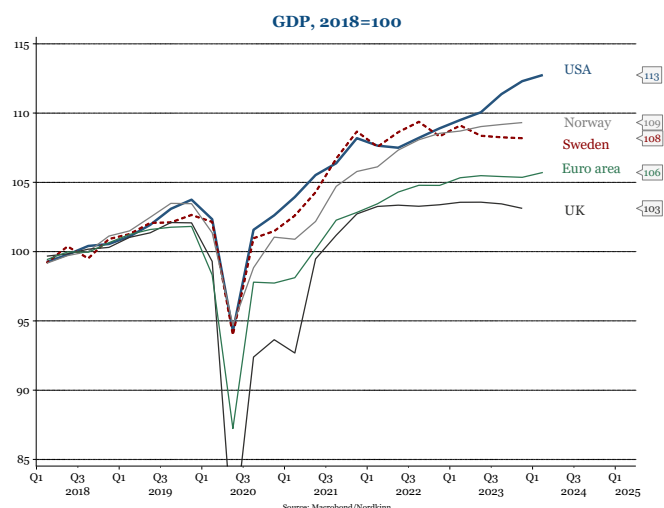
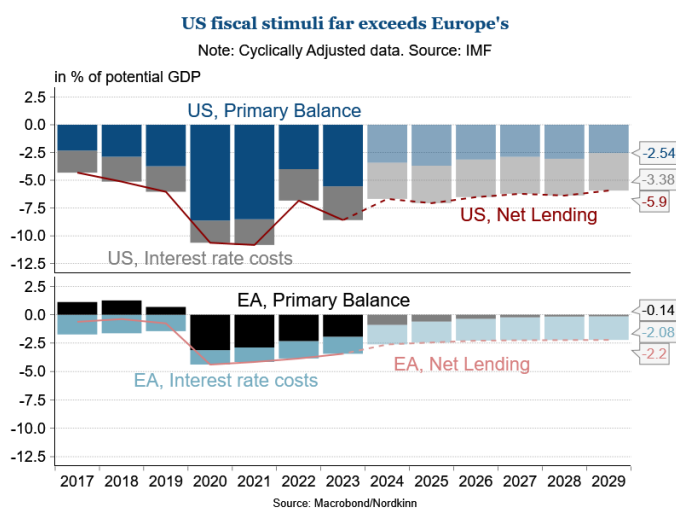
These developments have not gone unnoticed by neither the Fed nor the ECB. From the monetary communication during April and in the communication from the May 1<sup>st</sup> monetary policy decision, attaining the level of confidence in inflation sustainably approaching the 2.0% target is taking longer than expected for the FOMC. On top of that, the U.S. is heading into general elections implying a very opaque fiscal policy outlook which, in sum, could mean that there is also a risk of no cuts, or even hikes as the next step, even though Powell at the press conference said the latter was unlikely. Our modal forecast, nevertheless, is indeed for the Fed to cut one or two times this year (barring any swans of course, black or otherwise).

As for the ECB, interest rate expectations implied by markets are almost perfectly aligned to three cuts this year. And make no mistake, not cutting in June would constitute a major surprise as inflation is largely in line with ECB forecasts and wage growth seems to be heading towards levels compatible with the inflation target. The most important development, in our opinion, is nonetheless that our fears of a bumpy last-mile inflation seems to have been somewhat laid at rest as corporates are apparently willing to accommodate at least some wage increases in their profit margins, paving the way for a continued disinflationary process.

Admittedly, and as the latest PMI-reading confirmed, the worst is probably behind in the Euro Area and a recovery is imminent. That said, in the Euro Area, there also appears to be considerable economic slack to pick up before resource utilisation becomes inflationary, confer, the latest reading on capacity utilisation, and the pace of growth risks being less than vigorous.

Studying the Euro Area in isolation, thus, suggests that ECB should want to balance the lower inflation and, hence, higher real interest rates quite rapidly. We therefore believe that current market pricing risks erring on the cautious side, especially in the near term, and that three cuts this year is probably a minimum. This means there could be outright opportunities to explore in the Euro Area.

However, the ECB will also take some notice of Fed and the U.S. economy, not least because some of the structural arguments above should have bearing also on the Euro Area economy, making entering any divergence positions much of a timing issue. In addition, many of the highlighted developments lend support to already existing relative value positions in the theme “From disinflation to divergence” why we will continue to explore similar trades, but also in relation to Sweden (see Sweden outlook below) as some of the differences pointed out above seem starker yet.



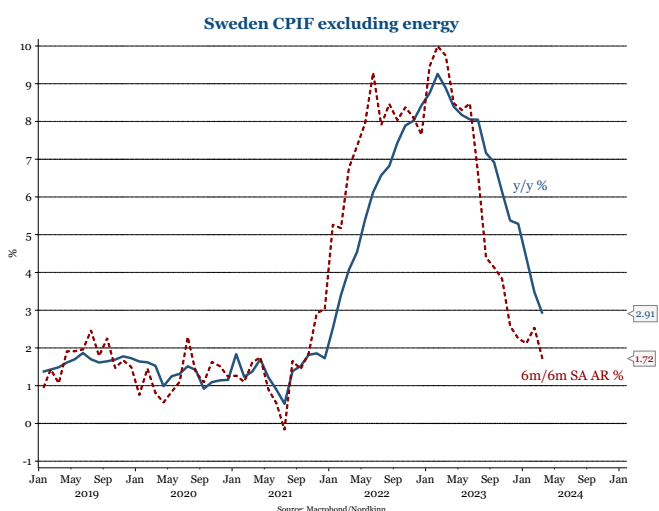
# Outlook

## Nordic outlook

As noted in the Review section, anticipated improvements in the economy depend on the delivery of rate cuts. We believe rate cuts by the Riksbank are indeed becoming more imminent. Two significant developments in April, in our perspective, have significantly increased the likelihood of the first rate cut in May. Firstly, inflation for March came in lower than expected, exhibiting a broad-based decline in momentum. Towards the end of the month, the Riksbank published an Economic Commentary wherein they evaluated various time frames for measuring inflation and their respective insights. The authors concluded that shorter time frames are too volatile but can offer insights during periods of high inflation. They also argued that the six-month timeframe is the most suitable for monitoring inflation. Related to this we noted that in March, the 6m/6m SA AR stood at 1.72% for CPIF excluding energy, see chart. Thus, it appears evident that y/y% inflation is soon to dip below the 2.0% target, a prediction shared by forecasters.

The second crucial piece of information received in April was the price plans outlined in the NIER's survey. According to this survey, price hike plans have reverted to a level below the long-term average. This reinforces the view of forecasters that the annual inflation rate will soon fall below the inflation target. We anticipate the Riksbank to respond to this by cutting rates in May and continuing with further cuts in 2024. The Riksbank will likely be among the first to cut rates and will have more leeway to do so given the inflation and economic outlook. While the unemployment rate has increased, we approach this data with caution as employment remains relatively stable. However, without rate cuts, the labour market could face a more pronounced deterioration. The currency is often seen as a possible "showstopper", but we believe this argument is less relevant when inflation is at, or below, the inflation target. After all, the Riksbank is targeting inflation, not the currency.

In fact, we anticipate that the Swedish economy and the Riksbank will not only act as early "cutters" but will also appear more aggressive in their monetary policy outlook, due to their published rate path. We believe this is currently underappreciated in the market and not adequately reflected in pricing. Therefore, in May, we introduced a new theme titled "Sweden: Green light for easing cycle". In this theme, we explore opportunities to capitalise on interest rate spreads to other countries as well as curve dynamics in the market.

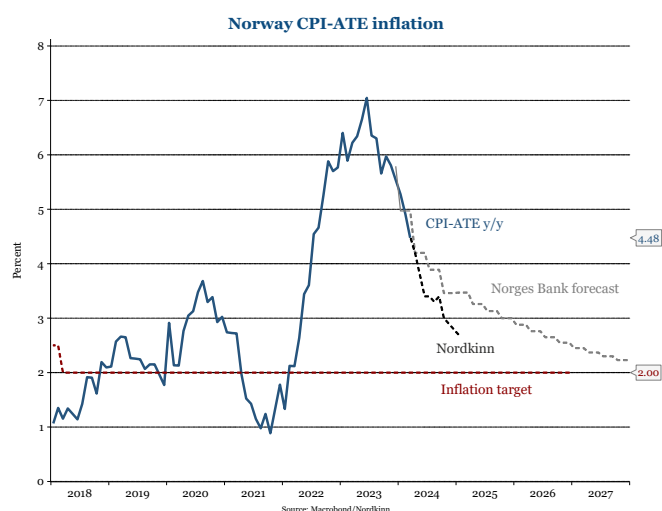


In Norway, our primary macroeconomic forecast for 2024 has been a faster-than-expected disinflation, diverging from the consensus held by the market and the Norges Bank interest rate setting committee. Thus far this year, incoming data has consistently validated our perspective, prompting the central bank to significantly revise down its inflation projection for 2024 in March. However, our analysis continues to highlight downside risks to inflation, with our expectation that core CPI inflation will dip below 3% by year-end, in contrast to Norges Bank's forecast of reaching this level by end-2025. We aim to capitalise on this outlook through various trades structured around our investment theme, "Norway: Inflation risks overvalued."

While actual inflation figures have been supportive for our call, the market impact has been offset by unfavourable conditions originating from the U.S. Persistent inflationary trends in the U.S. during the first quarter have driven Treasury bond yields higher, contributing to the recent depreciation of the NOK exchange rate. One of the mechanisms at play is the requirement for Norwegian life insurers and pension funds to rebalance their FX hedges amidst foreign bond sell-offs. The Norges Bank is apprehensive that a weaker NOK could prolong elevated inflation levels beyond their projections. Without an appreciation or at least stabilisation of the NOK exchange rate, the central bank finds it difficult to be sufficiently assured that inflation will converge towards the 2.0% target within a reasonable timeframe. Consequently, the outlook for Fed's monetary policy will exert a significant influence on the Norges Bank's decisions.

Additionally, the wage agreement between labour unions and employer organisations, set at 5.2%, exceeded Norges Bank's forecast by 0.3 percentage points, potentially exacerbating inflation concerns.

Given these factors, there is a distinct possibility that the Norges Bank's initial rate cut, initially projected for September, may be postponed until December 2024, or even later. However, these inflation concerns could dissipate if actual inflation continues to undershoot the central bank's forecasts in the coming months. Overall, while we acknowledge the market consensus of only a 25 basis points easing by the end of this year, with risks tilted towards no rate cuts, we believe that the anticipated cumulative rate cuts discounted by the end of 2025 are insufficient compared to other nations. Therefore, we advocate for money market flatteners in rates, steepening of forward starting swap rate curves, and tighter forward starting spreads between Norway and its peer countries.



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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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