NORDKINN

ASSET MANAGEMENT

Market Review & Outlook

June 2024

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Market overview

Global overview

Opportunities in rates space continue to be plentiful as interest rate volatility has structurally re-established itself at pre-QE levels. The left-hand chart underscores that the QE-era indeed was an anomaly. June was a good example of the new volatility regime with e.g. U.S. 10-year rates falling in excess of 30 bps, and its Euro area equivalent posting 10-15 bps weekly swings up and down throughout the month.

Both central banks and markets are highly data dependent. A case in point is that rate movements in June kept reflecting data outcomes as the month evolved. June kicked off with a stellar U.S. labour market report where Non-Farm Payrolls rose by 272k vs. 180k expected, thus a relief after a disappointing 165k-print in April. The U.S. May CPI data supported those market participants calling for a soft landing, as Core CPI was a low 0.2% month/month (vs. 0.3% m/m expected). The timing of the CPI release was somewhat unfortunate, as it came in during the Fed's monetary policy meeting. According to Chair Powell, while the print did not affect members' projections, the low reading was encouraging.

Under any circumstances, the FOMC members' economic projections were a far cry from the "Fed-pivot" discussion introduced last November, as merely one cut has now become the median 2024 forecast and the long-term dot (commonly considered the Fed's estimate of the "neutral rate") has also been raised by some 20 bps (to 2.8%).

That said, our general impression is that a September Fed cut remains a distinct possibility should inflation data develop in line with forecasts and, perhaps more importantly, should the tentative signs of a more pronounced labour market slowing, come to fruition.

In the Euro Area the high inflation reading in May was already a thing of the past when June started, and the expected ECB decision to cut on June 6th was proven every bit as complicated as imagined beforehand. With data not speaking clearly in favour of a cut, the more hawkish members on the Governing Council spent the remainder of the month trying to dampen expectations of additional cuts and/or emphasised data dependency, which is a refined way of expressing the possibility of June being a one-and-done cut; or at least a very drawn-out pace of reductions. Admittedly, less hawkish members are simultaneously drumming up confidence in June being the start of a cutting cycle with steady frequency.

The markets' response to the above meant that, on balance, interest rate curves steepened, and not only from the short-end. This was partly captured in our global themes, marginally adding to the June return on a net basis.

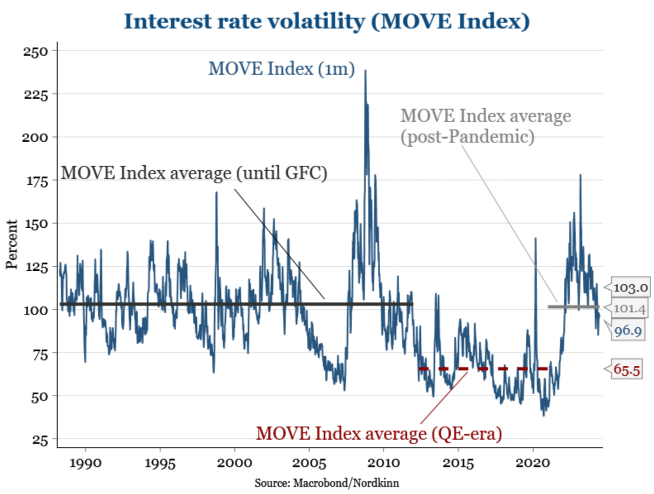
Nordic overview

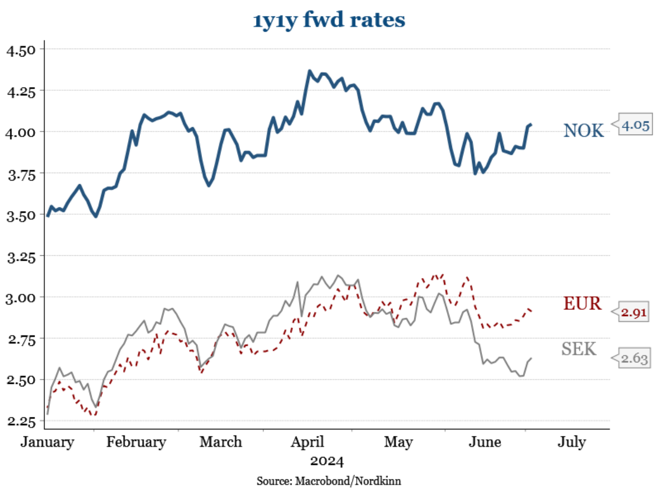
In June, Swedish fixed income continued to perform, and rates outperformed their European peers. These movements originated from the short-end of the yield curve due to re-pricing of future domestic monetary policy over the next few years. As a result, the yield curve steepened by a few basis points, with 2-3 year yields dropping the most. The decline in interest rates occurred despite a somewhat higher-than-expected inflation rate for May, which was released in the middle of the month. Service inflation appears generally sticky and was boosted in May by tourism and events, which likely temporarily lifted inflation. Nevertheless, there appears to still be some pricing power in this sector of the economy, suggesting that services-related inflation may prove stickier than previously thought. The weak SEK will, just like last summer, keep vacationers on home turf while attracting foreign visitors to Sweden.

June ended with the Riksbank's monetary policy meeting. It confirmed the change in policy stance initiated at the May meeting. If inflation behaves as forecasts suggest, the policy rate will be cut 2-3 additional times this year, and if inflation surprises to the downside, i.e. proving that the May surprise was a one-off, interest rates will be cut faster, as hinted in the Riksbank's alternative scenario. Short-end rates declined after the announcement. The drop in interest rates, combined with a slightly steeper yield curve, aligns well with our theme "*Sweden: Green light for easing cycle*" and the positions in it. Consequently, this theme contributed markedly to the performance of the fund throughout June.

Turning to Norway, while the central bank left its policy rate unchanged at 4.50% on June 20th as widely expected, the forward guidance was much more hawkish than anticipated. According to the updated projections, the first likely policy easing is postponed by six months until March 2025, mainly due to higher cost pressures than previously assumed. Consequently, although inflation has been slightly lower than expected recently, the Norges Bank revised its medium-term forecast for inflation upwards due to the prospect of elevated wage growth.

Perhaps somewhat counterintuitively, our "*Norway: Inflation risks overvalued*" theme contributed positively to performance in June. At the beginning of the month, we positioned for lower NOK interest rates relative to peers and flatter money market curves, which performed well. However, as the rally in NOK rates began to stall around mid-month and the Regional Network survey painted a more positive economic outlook, we reversed our positioning. We started to pay NOK rates to protect previous gains and to position for a more hawkish Norges Bank statement, which ultimately proved correct.





Outlook

Global outlook

Currently, political events and developments seem set to steer FX and fixed income markets. UK Prime Minister Rishi Sunak, in late May, decided to hold snap elections on July 4th, which is set to conclude with a clear win for the Labour Party. While pragmatic, the Fiscal Plan announced by the Labour leader Keir Starmer does little to put the UK's debt-to-GDP ratio (currently above 100%) on a sustainable path. Instead, according to e.g. the National Institute of Economic and Social Research (NIESR) Labour's economic policies imply deficits above 4% of GDP.

Only hours after completion of the June 9th EU elections, the not so poor performance by the political centre of the EU parliament was overshadowed by the fact that President Macron immediately dissolved the National Assembly (French parliament) and called for snap elections, due to the strong voter support for the far right (and also for the far left).

After the first round (on June 30th), it stands clear that Rassemblement National (RN) should not be able to achieve absolute majority in the National Assembly, which has provided some comfort to financial markets. The second round is held on July 7th.

Given indications from the Prime Minister to be, RN:s Jordan Bardella, fiscal policy will align with the excessive deficit procedures of the European Commission, which implies a yearly reduction of approximately 0.5 percentage points of GDP of the annual primary balance as part of the required seven-year adjustment plan. How such fiscal rigor squares with costly promises to lower the pension age, cut taxes and increase wages, remains to be seen, especially since the proposed financing runs counter to EU regulations (e.g., unilaterally cutting France's EU contribution).

Sadly, the political stage looks no brighter in the U.S., where poor performance by the sitting president in the first (of only two) TV debate has provoked the Democratic establishment into a Johnny-come-late push to replace Biden on the democratic ticket.

Regardless, it is obvious that neither a Trump nor a Biden administration plans to prioritise getting the fiscal house in order. To that extent, it is interesting to note that the Congressional Budget Office has released new forecasts during June, painting an even bleaker picture of the fiscal policy outlook than previously expected, with spending rising from 21.0% of GDP in previous decades to 24.1% of GDP in the next decade.

This implies an overall deficit close to 7% of GDP over the next few years (compared to 3.7% historically). And, beware, this is in a very benign, non-recessionary, economic environment. Also note, net bond issuance is already in 2024 on a record high of USD 200-300 bln per month.

In addition, it should also be noted that CBO fiscal projections do not include an extension of the Tax Cut & Jobs Act that Trump enacted in 2018, and which is almost certain to continue in one form or the other (an extension would add another 1¼ of GDP to the deficit from 2027 onwards).

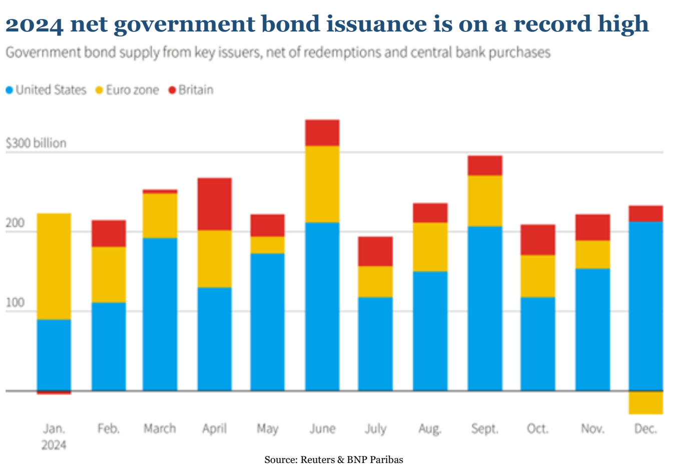
The political backdrop will have a strong bearing of financial market developments, not just over summer but for the foreseeable future. The supply of government bonds is historically high in many developed economies, including the U.S. Ultimately, of course, we should expect to see long rates staying high for many years to come.

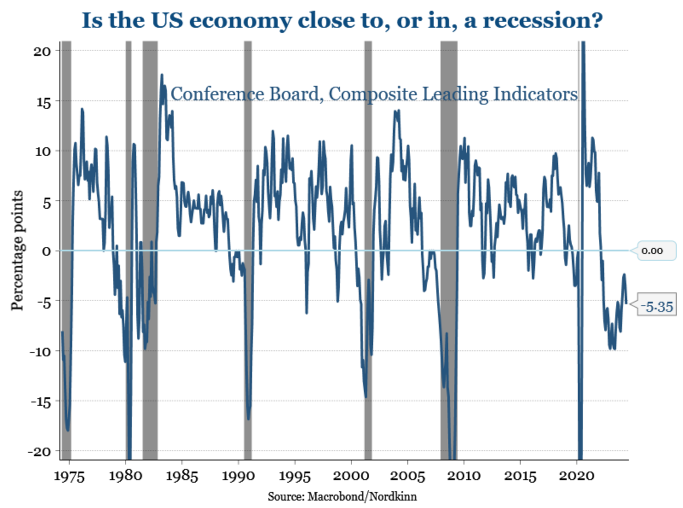
Now, turning to the cyclical side of developments, the gradual weakening of U.S. labour markets we have discussed (above and) in previous editions of the Monthly Report has gathered both strength and attention. E.g., we notice that Chair Powell and other members of the FOMC have generally underlined the "totality of data" in deciding the future path of monetary policy and have, in particular, highlighted that labour markets are close to normal (with the possible exception of wage growth, which is still too high); e.g. vacancies and quit rates etc, are also at or very close to "normal" (i.e. around pre-pandemic levels).

We see little reason to expect this trend to change in the near-term, but rather expect the weakness to become more broad-based and affect both employment growth and unemployment rates negatively going forward. One of the most reliable near-term indicators is the unemployment claims data, where we see a small but notable deterioration of outcomes (i.e. claims are rising). Other macroeconomic indicators are also worsening, and we think it is noteworthy how weak household consumption growth has become, despite a perkier real income growth.

Fact is, we feel that the "totality of data" is now weak enough to question the U.S. economic "exceptionalism" we have experienced over the past few years and are thus introducing a new theme "*End of U.S. exceptionalism*", while closing down the old global theme "*From disinflation to divergence*". We expect to allocate more risk into this theme over time and as the cyclical deterioration becomes clearer.

Admittedly, cyclical developments on this side of the Atlantic have not been all good either. The optimism heralded by rising household and business confidence data is concentrated on expectations rather than the current situation and industrial data, at large, seem to linger on the weak side of things. Thankfully, rapidly improving household real incomes should provide some near-term support to growth and make the Euro Area great again, at least on a relative basis.





Outlook

Nordic outlook

The next few months of inflation data will be very interesting. Last summer, service inflation was underpinned by 'staycation', as the weak currency kept Swedes at home. Additionally, the SEK also attracted foreigners to spend their time and money in Sweden. How much of this effect we will see this summer is difficult to assess, but some effect is reasonable to expect. While the annual inflation rate is likely to decline, momentum measures on service inflation (such as the seasonally adjusted 3m/3m annual rate) will probably remain sticky or even rise over the summer. Still, if CPIF declines as most forecasters, including the Riksbank, expect, next time the policy rate will be cut will be in August, or September, at the latest.

Looking at the Swedish fixed income market, pricing currently suggests that the Riksbank will cut the rate to roughly 2.25%, but the rate will not bottom-out until mid-2026, see left-hand chart. This would translate into a very protracted cutting cycle without a rebound in inflation or growth, implying that the Riksbank may not cut enough to trigger significant growth or inflation. This is puzzling given the highly interest rate-sensitive economy, considering both indebted households and the fact that lower global interest rates should be positive for a small open economy.

Moreover, while the policy rate on one hand is expected to bottom-out at 2.25% in two years, the policy rate is on the other hand, eight years later, expected to only have been lifted to 2.75% and with inflation constantly running below the target. The implied 5y/5y Break Even Inflation rate is at 1.7% compared to 2.3% for the Euro Area and 2.6% for the U.S. This is particularly odd since inflation is very much a global phenomenon. It is difficult to find a sensible and intuitive scenario supporting this kind of pricing, but perhaps one should not read too much into it. There is still a lack of domestic supply of interest rate risk, at least in a cutting cycle where inflation is dropping fast, which creates demand for bonds. We believe that eventually the fixed income market, which in our view is distorted, will start to reflect a more probable scenario.

Hence, we are on a journey, and the market has taken baby steps to steepen the yield curve, but so far, this has solely been a story of lower front rates outperforming. Lower implied front (policy) rates will eventually lift anticipations of a stronger economy and a stabilising, or higher, inflation, which should send longer-dated yields higher. Still, we are in the first phase, and we expect this to prevail for some time yet. Hence, we stick to our themes "*Sweden: Green light for easier policy*" and "*Sweden: Normalising risk premia*".

In Norway, the central bank has demonstrated a strong commitment to bringing inflation down to target within a reasonable time horizon by ruling out the possibility of a rate cut this year in its baseline projection. Interestingly, the decision to revise its key policy rate projection to signal no rate cuts until spring 2025 was made despite slightly lower-than-expected recent CPI outcomes. This hawkish message is largely due to higher wage growth forecasts for 2024 and 2025, which are expected to keep inflation elevated longer than previously anticipated.

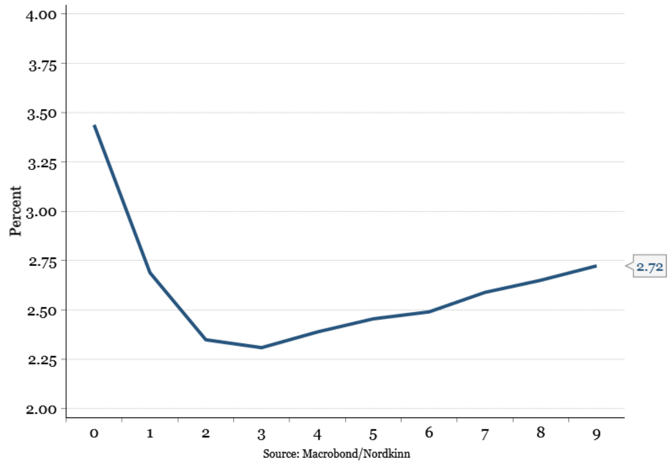
We agree with the Norges Bank that there is no rush to cut rates. The economy is performing well, and inflation remains well above target. Additionally, maintaining elevated rates longer than other central banks should help buoy the NOK exchange rate, accelerating the pace of disinflation towards the target.

At the same time, we see no compelling reasons for the Norges Bank to raise rates further. Significant progress has been made on the inflation front recently, allowing the Norges Bank to be patient to avoid a hard landing. Moreover, we expect inflation to slow much faster than the Norges Bank's forecast over the coming year, largely due to lower price growth in goods consumption, with service price inflation likely to ease more gradually amid prospects of weaker demand.

Regarding market implications, with current pricing (see right-hand chart) of no chance of policy easing in Q3 and only a slight possibility in Q4, the balance of risk appears asymmetric, which is a pattern we recognise from several occasions in Norway the past year. While the risk of a hike is very low, several scenarios could motivate a faster easing cycle than currently expected by the market. One such scenario involves the potential (and rather long) lags with which monetary policy operates, in turn resulting in a stronger impact on growth in the coming quarters, weighing further on inflation prospects.

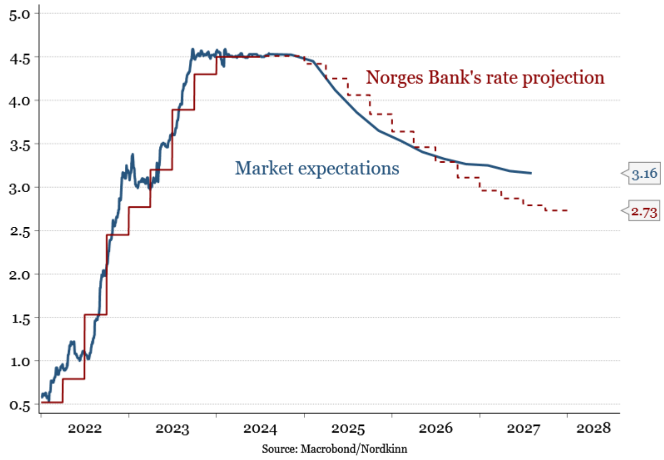
We aim to capitalise on this outlook through various trades structured around our investment theme *"Norway: inflation risks overvalued"*. Benefitting from the structural elevation in market volatility, we manage all themes and trades actively and continuously adjust positions as necessary if incoming information challenges our view or if market pricing over- or undershoots.

Sweden: Term structure of 3-month forwards



Source: Macrobond/Nordkinn

Norway market-implied policy rate expectations



Source: Macrobond/Nordkinn

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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