NORDKINN

ASSET MANAGEMENT

Market Review & Outlook

July 2024

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Summary of market overview: Incoming data in July largely confirmed slowing demand and cooling inflation in the U.S. economy, which led to meaningfully lower bond yields and steeper yield curves as expectations of rate cuts increased. Meanwhile, in Scandinavia, interest rates fell sharply following surprisingly low inflation data.

Outlook summary: With monetary policy still in restrictive territory while both inflation and economic growth are clearly slowing, rate cuts in the U.S. and Sweden are imminent. Meanwhile, the build-up of market expectations for rate cuts in the Euro Area, and particularly in Norway, appear to have gone too far given the stickier inflation prospects

Global overview

By and large, July proved to be a continuation of developments in June. Money market curves flattened as the prospects of future interest rate cuts increased further, while bond market curves steepened (for much of the same reason).

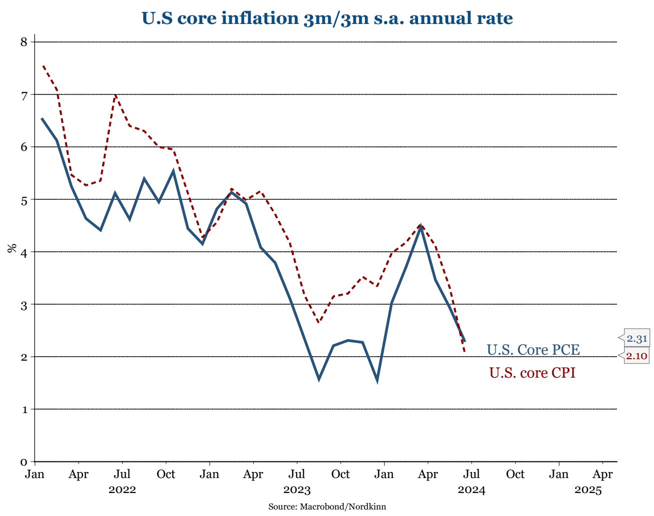
These developments are mainly the result of slowing demand and cooling inflation in the U.S. economy. Both manufacturing and services ISM were a tad weaker, underlined by labour market data also moving into better balance. From an inflation perspective, both the CPI and PCE were slightly lower than expected showing a Q2 inflation well below the high Q1 seasonally adjusted inflation outcomes, see chart. This also holds true for lower labour costs, with e.g. private sector compensation of the ECI dropping a couple of tenths of a percentage point

Against this backdrop, it would be easy to think that the Fed should have lowered rates already at its July meeting, as the monetary policy stance cannot be labelled anything but restrictive. However, and when looking at U.S. data in totality, the softness in demand beyond survey data has the appearance of "normalisation" rather than an outright recession. Retail sales made a welcome jump upwards (after a string of low outcomes) and the various data sets on orders and shipments were broadly consistent with robust growth. The only sector that can be labelled weak also in absolute terms is the housing sector, where prices are still high (higher!), but construction and other housing related activity is bleak even from a historical standpoint.

In all, and considering the bumpy disinflation process thus far, it is not surprising that the Fed wants more "confidence" (i.e. more data pointing in the same direction) before cutting in September. On that note, and even though Chair Powell stated that a cut "could" be on the table in September, a September cut is all but certain.

U.S. developments tend to set the tone also for other developed economies and while slowing activity has also marred the Euro Area, the economic setting was already subdued to begin with, raising warning flags. Interestingly, and importantly, this does not extend to inflation with core inflation still at 2.9% y/y, a notch or two above the ECB's most recent forecasts (at 2.7% y/y) even.

Then, to end along the same lines we started, the continuation of economic and market trends from June has also continued to benefit Nordkinn's global theme *"End of US exceptionalism"*. On the other hand, as clear new trends beneficial to smaller currencies have yet to manifest themselves, our global theme *"FX misalignment"* has not produced similar robust results over the summer.



Nordic overview

In July, Swedish interest rates slumped and outperformed peer market rates while the yield curve steepened. Monetary policy was reassessed in the market after the low June inflation print released on the July 12th. At the start of the month, cuts of roughly 50 bps in 2024 and 75 bps in 2025 were priced in. By the end of the month, cuts priced in the market amounted to about 85 bps for this year and 100 bps for next year. The 1y1y forward swap rate declined by 50 bps during the month, with the policy rate expected to bottom-out below 2% in late 2026/early 2027. The SEK had a bad month, depreciating by 4% against the EUR at most, before recovering somewhat in the final few days of July.

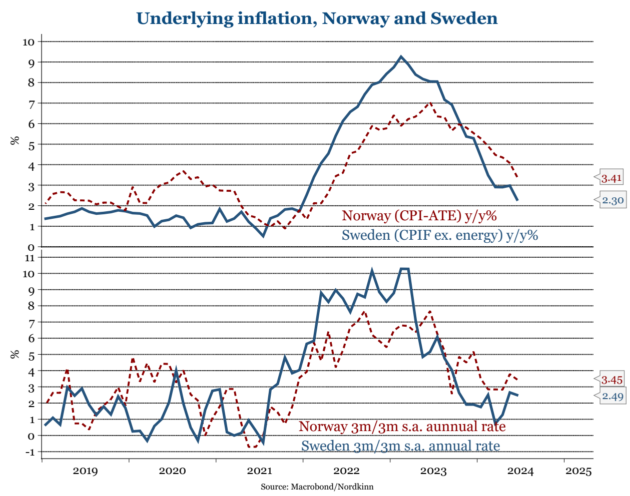
The lower-than-expected inflation in June was partly due to a rebound in the temporary effects in the service and hospitality sectors. The headline CPIF was well below the target at 1.3%, while the core CPIF excluding energy inched closer to the target, recorded at 2.3%. The Riksbank has so far discussed a "gradual" easing of the policy rate, but given the current inflation rate and softer price pressures, the central bank appears to be a bit behind the curve. The market reacted by pricing in more prompt actions by the Riksbank, as the policy rate is still at a restrictive level (now at 3.75%). The decline in inflation has been faster than expected, and a monetary policy that is reacting to data is destined to fall behind the curve. This time, perhaps, it has also been desired.

Considering the developments above, the fund's performance was positively influenced by positions in the Swedish themes *"Green light for easing cycle"* and *"Normalising risk premia"*.

In Norway, underlying CPI inflation eased significantly in June to 3.4% year-on-year from 4.1% in the previous month. While the sharp decline in June was reinforced by base effects from last year's bounce in prices on recreation and culture, notably package holidays, the trend in 2024 has been one of relatively broad-based easing of inflation. However, services remain stickier than goods, and the 3m/3m pace in underlying inflation remains well above the 2.0% inflation target, see chart.

The June inflation print was 0.2 percentage points below both consensus expectations and Norges Bank's projection, igniting a rally in the Norwegian fixed income market and a sell-off in the NOK exchange rate. Low liquidity during the summer holiday period further fuelled the currency weakness, with EUR/NOK moving from below 11.30 in early July to above 12.00 only a couple of weeks later, before settling around 11.80 by month-end.

Overall, our *"Norway: Inflation risks overvalued"* theme contributed positively to performance in July.



Outlook

Global outlook

Political events have continued to be centre stage during July. Admittedly, the UK snap elections did indeed produce an overwhelming majority for the Labor Party, but the second round of French elections did instead produce a surprising show of strength for the newly constructed left-wing coalition Nouveau Front Populaire (NFP), which still left President Macron's Renaissance marginalised (which is not as apparent when eyeing the distribution of government offices, though).

Economically speaking, neither the extreme left nor the extreme right represented an appetising fiscal outlook. And from a market perspective, albeit important, the perhaps only soothing point is that the risks of a more confrontative relationship towards the EU has diminished, at least in the short run, explaining the rather optimistic market reaction to the results.

Given that there are already signs of strong internal divisiveness within NFP (e.g. on what detrimental economic measures to prioritise), the longevity of the coalition is an unknown, and another election might not be more than a year away. In such case, with both the left and centre in possible disarray, the options facing the electorate will be few and bad.

In the U.S., President Biden stepped away from the presidential race, endorsing instead Kamala Harris (the current Vice President) for the Democratic ticket. From very few observations, it does seem like Harris have managed to close some of the gap towards former President Trump, both in terms of funding and in terms of polling and in many of the all-important swing states.

In the Middle East, Israel is seen (and has partly admitted) to having eliminated three leading figures in the Iran-supported Hamas-Hezbollah axis, opening the world yet again for deep geopolitical risks. From that perspective, the oil price has not (yet!) reacted as much as could have been expected beforehand but, then again, we have still to see the promised retaliation by the Iranian regime (and its proxies).

As implications of geopolitics on macroeconomics are known unknowns, we seek to avoid positions that are sensitive to flaring geopolitical risks.

In summary, our positioning remains biased towards U.S. achieving a soft landing but with fiscal policy remaining far from sustainable. Admittedly, this opens for the Fed to embark on a protracted interest rate cutting cycle, but cuts will be few and far apart while long term rates will be kept from tumbling all the way down towards pre-pandemic levels (due to the fiscal outlook).

That said, and dwelling on the discussions from past editions of Nordkinn Global Outlook as well as this edition of Overview section (above), the U.S. economy is now at a juncture where renewed weakness in labour markets or private domestic demand could and should be read as a signal of contraction, or even a recession. But that is still not our base-case.

Most indicators that inform Nordkinn's thinking around the U.S. economy, both public and private domain, do indeed point to a continued slowing of demand (less so of labour markets, per se), with inflation plateauing around current levels, over the coming few months. To us, this nonetheless highlights how narrow the Fed's landing runway has become and underlines chair Powell's and the FOMC's recent shift in focus towards "risks to both sides of its dual mandate".

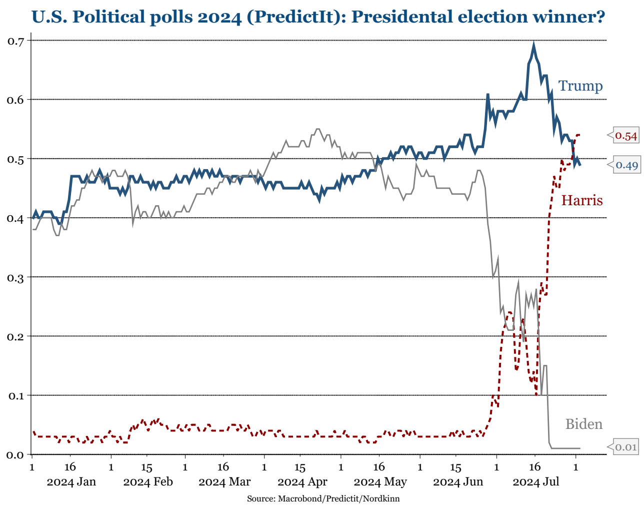
Somewhat surprisingly, financial markets continue to price U.S. and Euro Area developments in broadly similar ways. And while we believe that the Fed's balancing act is well reflected in current market pricing, we feel that the outlook for the Euro Area economy and ECB monetary policy is not at all comparable to developments "across the pond".

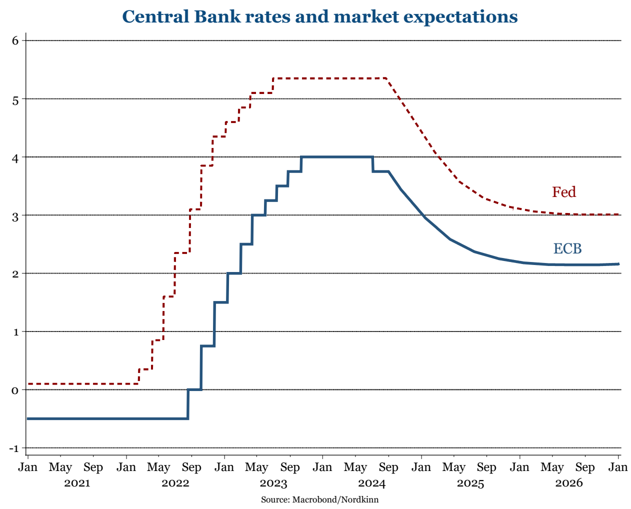
With inflation within striking distance of the inflation target and demand and labour markets obviously cooling, there is nothing short of a reacceleration of inflation that could stop the Fed from cutting rates, especially as the monetary policy stance is obviously restrictive. In the Euro Area, still all-too-high wage inflation and weak business sector productivity hamper profits and make companies' unwilling to lower prices, at least if demand is not outright contracting.

Here, it is probably wise to also remind ourselves of the institutional differences between the two central banks, with ECB pursuing a single (stable inflation) mandate whereas the Fed has a dual mandate also supporting labour markets ("maximum employment").

Hence, for ECB, the fragile European recovery should be more of a feature than a bug as inflation is still considerably above the inflation target and, importantly, also above what the ECB considers a plausible path towards the inflation target. Therefore, we reject the market hypothesis of near-term ECB policy actions being a carbon copy of the Fed.

Under any circumstances, we believe the above differences are worth exploring when implementing new themes and positions with global exposure, even as fiscal and geopolitical risks are building. Now, perhaps more than ever, timing is everything





Outlook

Nordic outlook

The decline in inflation has been steadfast and we saw a substantial repricing of Swedish monetary policy outlook in July. At the time of writing, the policy rate is expected to trough somewhat below 2%, which seems relatively fair to us, see chart. Perhaps more interesting to ponder is *when* the policy rate will bottom-out. We are inclined to think it will happen sooner than what market pricing suggests. Despite the recent steepening of the curve, it is still flat with little or no risk/term premia.

Historically, Swedish inflation has been tightly linked to European inflation, at least after adjusting for FX-movements. In our global outlook section, we make the case for sticky European inflation, which we believe will have the normal spillover-effects on the Swedish economy.

One important caveat is the fact that Swedish wage formation has been very benign when compared to the Euro Area, which could of course reduce the impact from high European inflation. That said, one often overlooked reason for the strong covariation in inflation is the complete lack of Swedish domestic fiscal impulses to demand and, hence, inflation.

Now, looking ahead, the fiscal policy stance will probably diverge quite strongly as the Euro Area needs to strengthen public finances, not least because of the binding fiscal frameworks. In Sweden, public finances are very strong and there is ample space for stimulating the economy. Indeed, even without any of the openly discussed changes to the rather strict Swedish fiscal framework, the National Institute for Economic Research (NIER/Konjunkturinstitutet), estimates that there is a budget space of (at least) SEK 50-80 bln in the near term (c. 1% of GDP). On top of that, there are also a number of structural issues (Defence, Infrastructure, Climate/Energy etc) where there is broad political consensus for increasing investments.

This suggests that trough/terminal policy rates are probably higher than in the most recent rate cycles and in particular that the long-end of the Swedish yield curve could and should rise both in relative and absolute terms. A more assertive fiscal policy stance should also serve to support the SEK, mainly through stronger growth but perhaps also through reducing SEK-negative FX flows.

Hence, we end up repeating the main message from the past few Monthly Reports: The steepening of the Swedish yield curve has just begun and the SEK (and NOK) should strengthen. Also and but, as the Chinese proverb states, "a journey of a thousand miles begins with a single step".

Turning to Norway, we continue to anticipate that the Norges Bank will remain patient regarding the timing of initiating rate cuts. This stance contrasts with most other central banks across developed markets, where cuts are already underway or imminent.

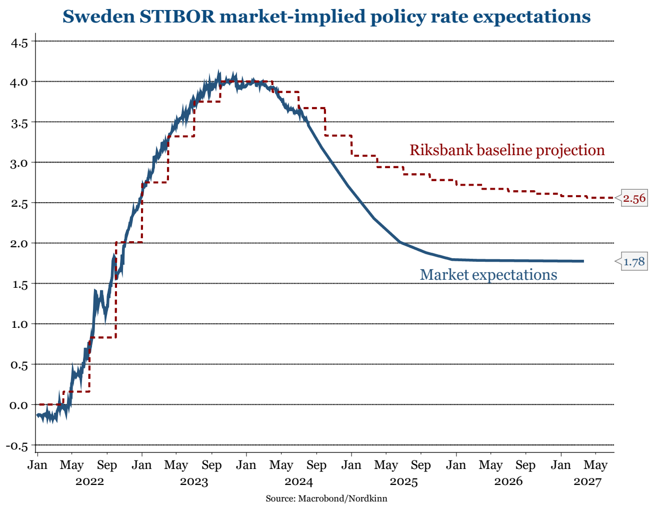
There are two key reasons for this view. Firstly, following a sharp sell-off in July, the import-weighted NOK effective exchange rate is currently about 4% weaker than the Norges Bank projected in its June report (see chart). The NOK depreciation from 2022 to 2023, and its implications for price inflation and wage formation, was fundamental to the Norges Bank's shift to a relatively hawkish stance last summer. Since then, the Norges Bank has demonstrated a strong commitment to bringing inflation down to target within a reasonable time horizon.

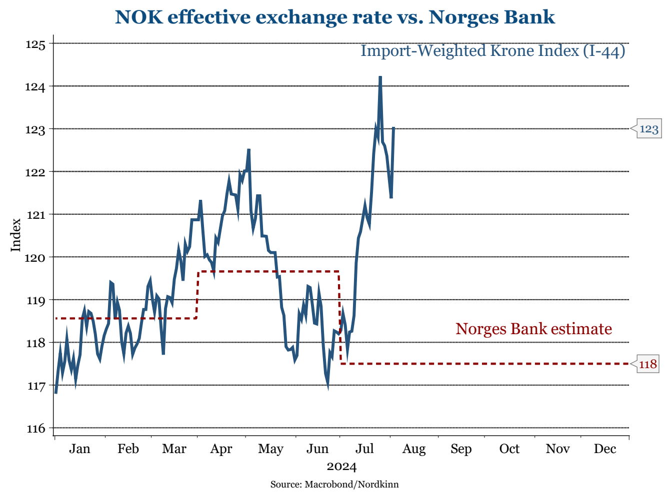
Secondly, the higher-than-expected outcome of spring wage negotiations was concerning for the central bank, which responded by raising its 2025 and 2026 inflation forecasts despite improvements in actual inflation data so far this year. Since then, labour market data has evolved broadly in line with the central bank's forecast.

To be sure, based on incoming data during the summer, our models predict a relatively high risk of a rate hike in the near term, largely due to the weaker-than-expected NOK exchange rate. However, given the significant progress made on inflation in recent months both in Norway and abroad, we believe the bar for a rate hike is high. Additionally, it is possible, even likely, that thin summer liquidity in the exchange rate market has contributed to the excessive depreciation of the Norwegian krone. As investors return to their offices after the summer break, we could see a recovery in the NOK exchange rate.

At the upcoming monetary policy meeting on August 15th, we expect the Norges Bank to keep interest rates unchanged and signal that they will likely remain at current levels throughout this year. Looking further ahead, given our expectation that inflation will slow faster than the Norges Bank's forecast in the coming months, we believe a rate cut will be on the table at the December meeting.

Regarding market implications, a rate cut this year is already priced-in, and almost 100 bps by summer next year. Consequently, we prefer paying front-end interest rates, and receive longer-end bonds relative to other markets, notably Sweden. We capitalise on this outlook through various trades structured around our investment theme *"Norway: Inflation risks overvalued."*





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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