NORDKINN

ASSET MANAGEMENT

Market Review & Outlook

August 2024

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Market overview

Global overview

In his 15-minute opening remarks at the annual Jackson Hole conference, Fed chair Jerome Powell uttered his most recent market enchantment: "The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks." - Needless to say, rates dropped, and stock markets rallied. What, you might ask, had led Powell to this (new) u-turn?

Like beauty, it seems, economic weakness is in the eye of the beholder. During August, U.S. economic data and outcomes have mainly served to strengthen the idea of an economy descending into a soft landing. Labour market data is broadly neutral with the ratio of vacancies to unemployed close to balance, and the levels and trends of unemployment insurance claims and layoffs comforting rather than worrying. Admittedly, and what is probably the main culprit to Powell's angst, July employment growth fell back to 114k vs 179k previously (175k expected) and below short-term labour force trend growth of around 160k, pushing the unemployment rate up to 4.3% (from 4.1% expected and previously).

However, caveats are abound. To start off, it is notoriously difficult to estimate a correct seasonal factor for July, and weather-related disturbances and timing of re-tooling of factories does not make it any easier. According to the Bureau of Labor Statistics, hurricane Beryl had no visible effect on the data, but hurricanes were not the only weather-related disaster striking the U.S. economy in July. Either way, the number of absentees in July due to weather were the highest on record, see chart, reflected also in a high number of temporary layoffs.

While we do not read data quite as bearish as Chair Powell, the market reactions fitted our positioning with lower rates, steeper curves and tighter country spreads and our global theme *"End of U.S. exceptionalism"* has contributed with strong performance also in August. Similarly, the less benign views on U.S. economic (including (real) interest rate) developments vis-à-vis other economies also explains the weaker USD, which provided welcome support to our other global theme: *"FX misalignment"*.

Turning briefly to European developments, the ambiguity to outcomes during August underline the split between hawks and doves on the ECB's governing council. The debate has, nonetheless, become reframed on the balancing of weaker real economic developments rather than on the perceived speed of the (currently non-existent) disinflation process towards the ECB inflation target.

Nordic overview

In Sweden, the July CPI report showed a continued easing of price pressures, although the rate was slightly higher than expected. While private consumption remains weak, consumer confidence appears to be recovering, likely due to widespread expectations of lower mortgage rates soon. Net exports contributed positively to the upward revision of second-quarter GDP data.

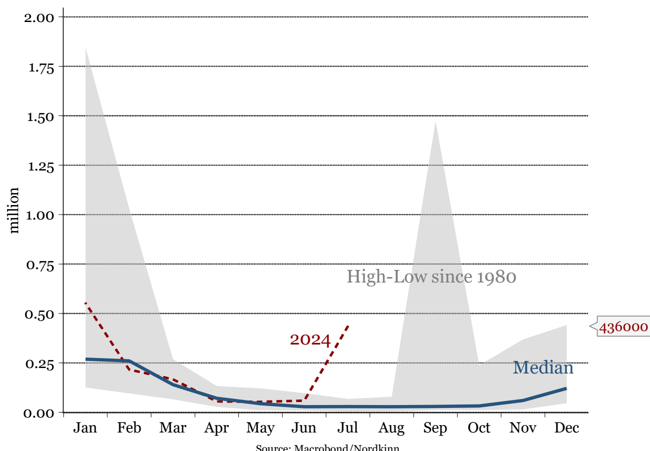
Swedish rates were not immune to the global trend in August, falling and remaining low throughout the month despite better domestic data and rebounding stock indexes. The market is currently pricing in a rapid shift in monetary policy toward a 1.75-2.00% rate by summer 2025, which we consider to be at or possibly even below the neutral level (though the exact level remains uncertain). Market expectations suggest an average reduction of 22 basis points at each of the next eight Riksbank monetary policy meetings.

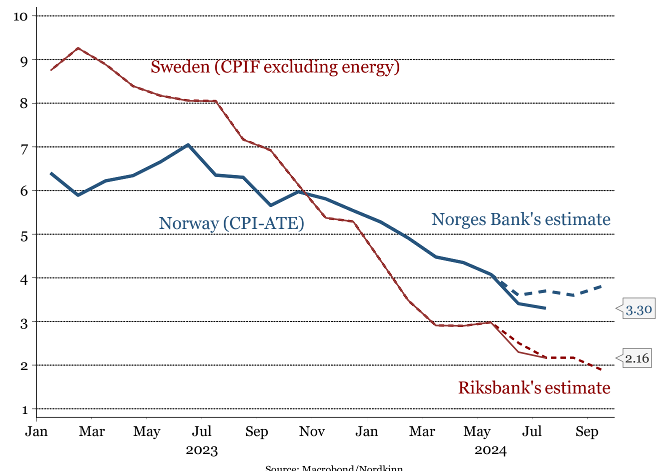
The combination of lower short-term rates, steeper yield curves, and the underperformance of Swedish rates relative to peers led to positive performance for the investment themes *"Sweden: Green light for easing cycle," "Normalising risk premia,"* and the new theme, *"After cuts comes growth"* (explained in more detail in the outlook section).

Turning to Norway, underlying CPI inflation eased further in July to 3.3% year-on-year, down from 3.4% in the previous month. This is lower than the Norges Bank's baseline projection of 3.7%. At the same time, Mainland Norway's GDP growth has been somewhat weaker than expected, potentially indicating softer domestic inflationary pressures ahead.

Conversely, while the NOK appreciated during August, it remains weaker than the Norges Bank had projected. At its policy meeting on August 15th, Norges Bank highlighted particular concerns about the NOK's exchange rate developments. However, considering lower inflation and declining international policy rate expectations, the Bank's Monetary Policy Committee adjusted its forward guidance to allow for greater flexibility. Instead of explicitly signalling that the key policy rate would likely remain at 4.50% until the end of the year, the updated guidance suggests that the rate will be maintained at its current level for as long or short as required.

Norwegian interest rate markets were volatile in August but ended the month lower. Our *"Norway: Inflation risks overvalued"* theme contributed positively to performance during the month, largely owing to successful active trading that capitalised on market fluctuations.





Outlook

Global outlook

Over the past few months, our views and positions have been tilted towards lower rates and steeper curves, which has been borne out in both economic data and market interest rates. Recently, however, we have started to ask ourselves if rates may have come down too far, too fast.

While risks to the outlook are apparent, we cannot confidently say that the U.S. nor the world economy are much closer to a recession than a year ago. This is more a testament to the difficulties in accurately and timely calling a recession than a rejection of the hypothesis that a recession is imminent or already unfolding.

Under any circumstances, the Fed now seems set to cut more aggressively than what we deemed likely just a few months ago, mainly due to a weaker demand and labour market outlook, raising "risks to both sides of the Fed's dual mandate". That said, market pricing currently suggest that the Fed will cut near 100 bps at the next three meetings, which in our view requires continued weakness on labour markets.

In short, we believe there is less directional value in U.S. rates as a recession is possible, but by no means a foregone conclusion. We therefore prefer to express our views along the U.S. yield curve, and allocate risk to another long-held idea of ours; steeper bond yield curves. With short-term yields still elevated, this should come with the added benefit of producing returns even in the event of a recession unfolding.

Additionally, as we also see U.S. inflation softening vis-à-vis peers, at least on the margin, we also see interesting opportunities in relative trades across markets.

On that cue, and turning to developments in the Euro Area, there are of course similarities between the U.S. and mainland Europe, such as (still) too high wage growth and elevated services inflation. However, the institutional arrangements on, e.g. labour markets, are quite different between the two, leading us to expect that future inflation and rate developments will also differ.

Financial markets have so far not paid much attention to the possibility of diverging economic and inflation developments across the Atlantic, and the recent U.S. recession scare brought down European rates by almost the same amount as in the U.S. To add insult to injury, the near complete dominance of the Governing Council's doves in financial media during summer did not alleviate market differentiation. Over the past few days some of the hawks have nonetheless returned to center stage and gradual repricing has been initiated.

This is something that we think should have some additional legs as the hard-fought consensus on the Governing Council still seems to be that every other meeting is a reasonable and measured pace. That still leaves some room for repricing as market belief is geared towards cuts at three of the upcoming four meetings.

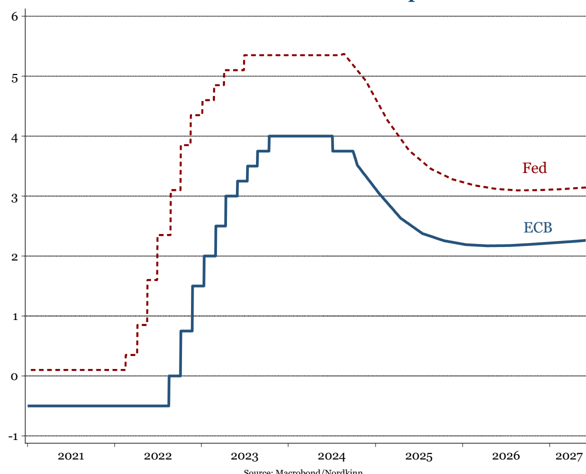
More importantly, and looking even further ahead, we believe that the European disinflation process could suffer setbacks, forcing the ECB to prolonging its cutting cycle further. In particular, and as implied above, the degree of wage coordination is much lower in the U.S. where wage setting is largely determined in a local agreement whereas in Europe, collective bargaining is the main form of determining wages. This, together with more generous and broad-based welfare systems means that wage formation is a much more slow-moving process in Europe, while wages quickly respond to changed economic conditions in the U.S.

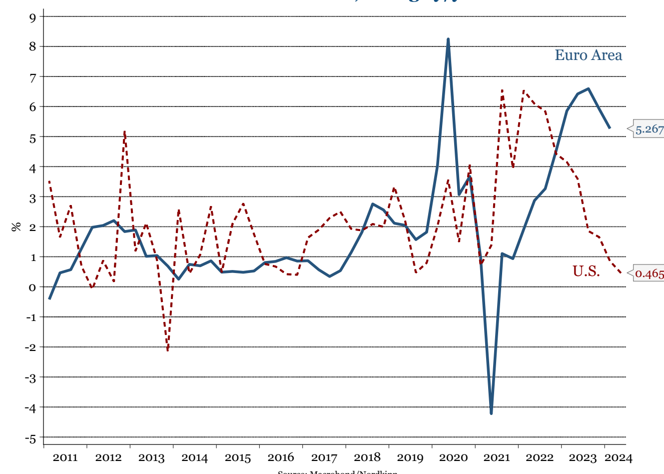
Another circumstance affecting the lags and leads of wage inflation in Europe versus the U.S., and which has risen in prominence since the pandemic, is "labour hoarding". Labor hoarding is a practice which entails keeping labour on the payroll for longer, often in situations when re-hiring is seen as both difficult and expensive. This is predominantly a cyclical phenomenon, but there is surely also a structural element as demographic challenges are abound in the Euro Area. This should extend the lags in Euro Area labour market rebalancing even further, and for an extended period.

As labour demand and supply is currently near or in balance in the U.S., we believe that US wage growth will not become an obstacle to Fed cuts, also because productivity growth is nothing less than impressive for such a late stage of the business cycle. Admittedly, labour demand does seem to be cooling and companies do express less interest in keeping payrolls bloated also in Europe. However, wage growth is still much too high, and productivity growth has been negative since early 2022. In sum, productivity adjusted wages; unit labour costs, are moving in almost direct opposite directions in the U.S. and the Euro Area.

While U.S. Unit Labor Costs (ULC) growth is rapidly approaching zero, Euro Area ULC-growth is close to 4.5% and showing few signs of dropping. For companies, of course, this means that prices need to be adjusted upwards to similar extent to avoid a drop in margins and profits.

The question, then, should be if Euro Area demand is so weak that companies are void of any pricing power? Our view is that it is not, and that European inflation will remain an obstacle to swift and deep ECB rate cuts.





Outlook

Nordic outlook

The Swedish yield curve has steepened more sharply than those of its peers, partly due to the Riksbank's early rate cuts in May and August. Additionally, a rapid decline in inflation has led to very dovish expectations for the remainder of the rate-cutting cycle. While we do recognise that the Riksbank has room to quickly reduce its policy's restrictiveness, the neutral rate level remains uncertain after the pandemic and the prolonged inflationary period that followed. Consequently, we expect the central bank to proceed cautiously in 2025 as the policy rate approaches lower levels, opting for gradual cuts to assess the economy's response. This cautious approach is not reflected in current market pricing.

This leads to another observation: Current market pricing suggests expectations for a subdued recovery in economic growth and low inflationary pressures over the coming years. Despite the recent steepening of the yield curve, it remains relatively flat, with long-term rates and bond yields at historically low levels. The 10-year government bond is trading only about 30 bps above the expected trough of the Riksbank's policy rate in the current cycle. The policy rate is anticipated to stay low, with Break-Even Inflation rates indicating that inflation will be below target for at least a decade. Consequently, investors moving further out on the yield curve currently find little to no risk premiums.

Contrary to the market's implied outlook for the Swedish economy and future inflation, we believe that rate cuts, combined with anticipated fiscal stimulus and lower costs, will promote a significant rebound in the Swedish economy in 2025-26. Such developments will support a steeper yield curve and a stronger SEK.

Given this view, we found it prudent to close the theme *"Sweden: Green light for easing cycle."* Having been introduced in May, we argued then that the market was grossly underestimating the upcoming rate-cutting cycle, as Swedish short-term interest rates were heavily influenced by U.S. trends. After substantial repricing over the summer, the market has moved closer to our perspective and even excessively so.

Therefore, in August, we replaced this with a new theme: *"After cuts comes growth."* This theme aims to capitalise on the current low and flat Swedish yield curve and the expected market impact of improving economic prospects domestically and future inflationary pressures.

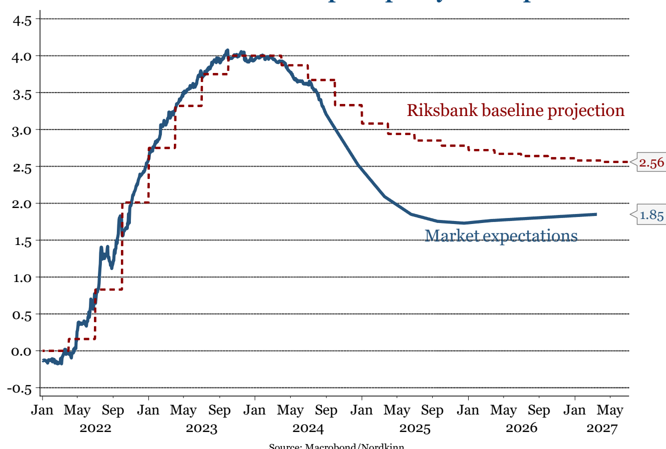
In Norway, while inflation made notable progress toward Norges Bank's 2% target over the summer, we continue to anticipate a cautious approach regarding both the timing and pace of interest rate cuts. This sentiment was clearly conveyed by Governor Wolden Bache in her August 15th speech, where she explicitly indicated that the key policy rate is likely to remain at its current level for some time. This stance diverges from that of most other central banks in developed markets, where rate cuts are either underway or imminent.

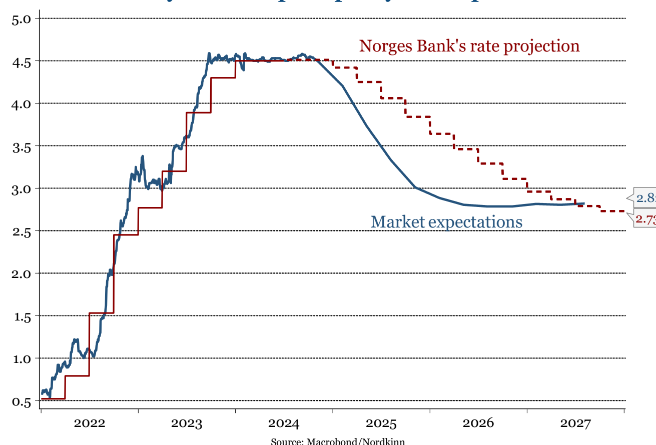
However, unlike in June, the Governor stopped short of committing to an unchanged key policy rate until the end of the year. This may reflect heightened uncertainties and a preference for greater flexibility. Notably, international policy rate expectations have declined since June due to signs of weaker global growth prospects. Additionally, Norway's unemployment rate exceeded Norges Bank's projection in July, potentially indicating a cooling labour market. Since the Governor's speech, updated GDP data has shown weaker-than-expected growth, though the unemployment rate aligned with the Bank's forecast by ticking lower in August. Meanwhile, the NOK appreciated in August but remains weaker than Norges Bank's projection.

Crucially, the underlying inflation rate, while lower than projected by the central bank, remains elevated at 3.3%. Consequently, Norges Bank can afford to wait a few more months before deciding when to begin easing monetary policy.

We continue to expect inflation to decline further and fall below 3% later this year, which could prompt the central bank to consider a rate cut at its December meeting. However, in our view, the risk remains skewed toward a later start to the cutting cycle.

Regarding investment implications, our longer-term outlook suggests that receiving longer-end bonds relative to other markets offers good value. Additionally, we see further potential for steepening in the Norwegian yield curve in the coming months and quarters. However, with markets pricing in over 30 bps of cuts in 2024 and 75 bps by March, we favour paying front-end interest rates at current levels as a tactical short-term trade ahead of the upcoming Norges Bank meeting on September 19th. We seek to capitalise on this outlook through various trades structured around our investment theme: *"Norway: Inflation risks overvalued."*





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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