Market Review & Outlook

September 2024

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Market overview

Global overview

September was an extremely eventful month within financial markets after the summer lull. Central banks have now moved into full cutting mode with the ECB lowering its depo rate by 25 bps (which was discounted by markets and expected by analysts), while the Fed delivered a 50 bps cut to its Fed Funds Rate. The latter was largely discounted by markets, though the majority of economists predicted a 25 bps reduction.

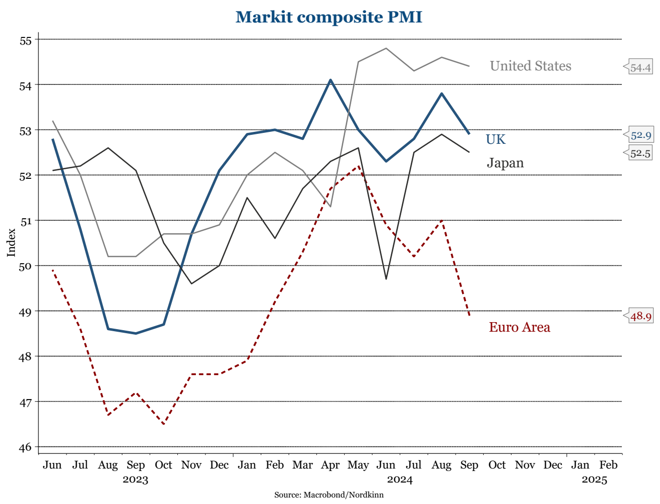
From the perspective of ex ante (i.e. expected) market pricing, the ex-post (i.e. realised) decline in bond interest rates of, first and foremost, shorter durations, were somewhat surprising. However, paired with a string of less convincing data, in particular sentiment and survey-based indicators, the logic strengthens. That said, money market curves are conspicuously flat on the month, but with some steepening appearing in the wake of the Fed decision and its updated summary of projections. The more proactive stance of the Fed vs. the ECB (and other major central banks) has also expedited a weakening of the USD vis-à-vis the EUR and most other currencies.

More specifically, and to highlight some of the most pivotal data outcomes during September; the August U.S. labour market data did indeed post a rebound, with Non-farm Payrolls (NFP) rising a respectable 142k. However, this compares to expectations of 165k and despite receiving a boost from several tailwinds such as seasonality, weather distortions etc (as discussed in our last month's global review).

Together with a waning inflation momentum, the relative weakening of labour markets were undoubtedly the main culprits to Fed's forceful policy action. To be certain, the 50 bps cut was also accompanied by the FOMC announcing a higher "terminal rate" as well as reassuring declarations of the decision being a one-off display of commitment to Fed's maximum employment mandate rather than, say, in preparation of an imminent recession.

In the Euro Area, weak but backward-looking Q2 national accounts data was supplemented by disappointing and more forward-looking survey data, particularly September PMIs, see chart. The data provided the doves within the Governing Council with new ammunition to fire at the hawks, who are seemingly trapped in depleted arguments of lagging and late-cyclical wage developments.

All in all, the above developments, with steeper bond curves and weaker USD as the main traits, lent support to many of Nordkinn's themes, not least those reflected in our global views: *"End of U.S. exceptionalism"* and *"FX misalignment"*, both contributing positively to returns in September.



Nordic overview

Swedish inflation data showed unexpectedly low electricity prices, which pulled annual CPIF inflation well below the Riksbank's target. This contributed to lower market interest rates in September, despite core CPIF (excluding energy) aligning with both market expectations and the Riksbank's forecast.

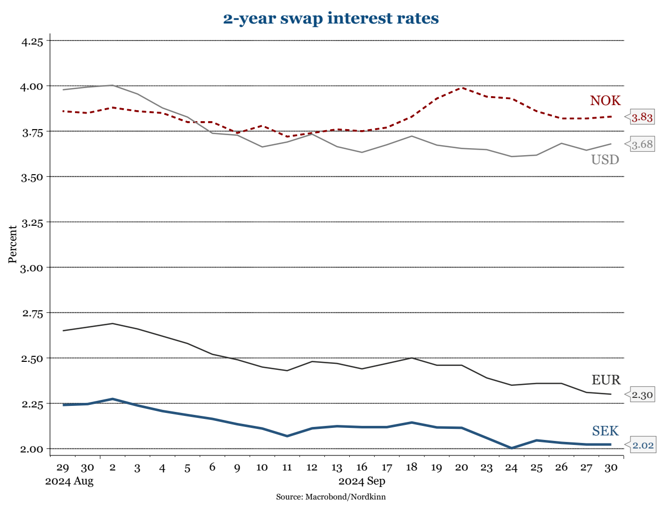
Later in the month, the Swedish National Debt Office (SNDO) recommended reducing the share of inflation-linked debt from 20% to 10%. This implies a cut in the supply of real rate bonds from SEK 177 billion to SEK 80 billion over the next four years. The shift toward issuing fewer inflation-linked bonds and more nominal bonds came as future inflation expectations were already subdued, as reflected by compressed break-even inflation rates along the curve.

On September 25th, the Riksbank announced yet another 25 bps rate cut to 3.25%. The accompanying statement suggested a notably faster pace of rate cuts in the coming months. However, since markets had already priced in a trough near 1.50% before the announcement, the market impact was muted. Consequently, Swedish interest rates declined less sharply than European rates in September, which aligned with our *"Sweden: After cuts comes growth"* theme. A steeper yield curve and strong performance of covered bonds on relative basis also contributed positively to performance.

In Norway, underlying CPI inflation continued to ease in August, reaching 3.2% year-on-year, down from 3.3% in July. While this figure was below the Norges Bank's forecast, the progress on inflation is still insufficient for the central bank to adjust its current monetary policy stance. The gap from the 2% target remains significant, and the inflation outlook remains clouded by substantial upside risks, according to the Bank.

Following its expected decision on September 19th to maintain the key policy rate at 4.50%, Governor Ida Wolden Bache indicated that rates will likely remain at this level through the end of the year, with gradual reductions not anticipated until in the first quarter of next year.

Norwegian interest rates, which had fallen in line with global rates during the first half of the month, saw a sharp reversal following the hawkish statement from the Norges Bank, see chart. To protect our long-term view expressed in the theme *"Norway: Inflation risks overvalued"* from such market reactions, we tactically positioned ourselves by paying NOK rates ahead of the decision, unwinding shortly after. This strategy contributed positively to performance. Toward the end of the month, the relative performance of Norwegian bonds compared to Swedish bonds also added to the fund's positive results.



Outlook

Global outlook

Inflation and global rates have fallen swiftly over the past few months, and the directional views and positions we entered early in Q2 have gradually transformed into relative trades in time and space towards the end of Q3. And with inflation now allowing the Fed to show its true colours by being pro-active and pro-growth, we believe the risk of a major policy error, with global repercussions, has diminished considerably.

Fittingly, and with the Fed paving the way, "ECB sources" recently divined that an October cut (albeit contested) was on the table, which gently pushed ECB pricing towards favouring a cut also in October. Likewise, only a few days ago, another seldom discussed (in this forum, at least) global behemoth, China, enacted the most comprehensive (predominantly monetary) policy stimulus package in many years. And a broadly similar policy intent can be detected across central banks in developed markets, notwithstanding at different degrees.

It is obvious that risks to the economic outlook remain plentiful. Not only are labour markets sending ambiguous signals which could easily tilt towards less benign equilibria, but worrying fiscal policy indicators and historically high equity valuations suggest additional and substantial downside risks. To be sure, there are many other candidates.

That said, the plethora of economic risks and a massive shift in global monetary policy stance seem well reflected in market pricing. Based on prices on interest rate markets alone, the regional Fed banks in Cleveland and New York estimate that the risk of a recession is far above 50%, see right-hand chart.

Evidently, fixed income market expectations are for the global economy to remain weak or even be pushed into recession, and potentially soon. Undoubtedly, with inflation at or close to targets and a weakening labour market situation, central banks are set to comply with market pricing in the near term, for both risk management purposes and a need to recalibrate a monetary policy stance perceived as excessively restrictive.

Despite the high interest rates over the past two years, private sector balance sheets have strengthened. Households' savings rates have been restored to pre-pandemic averages in most economies, including the U.S. (after recent revisions to data), and wage earners in most countries are enjoying strong real income growth on the back of both lower inflation and continued high nominal wage growth. In addition, companies are not expressing a need to cut labour costs in order to protect margins/profits, making labour market conditions appear less dangerous than what the financial market discourse would have you believe.

For instance, long term U.S. population growth projections suggests that anything above 80k-100k employment growth serves to strengthen labour market conditions and U.S. NFP is currently averaging a still respectable 116k (over the past three months). Admittedly, participation rates and – importantly – high immigration has probably pushed the equilibrium level of employment growth somewhat higher, which might explain the recent upticks in the unemployment rate.

Now, as interesting as the back and forth above may be, what are really the investment conclusions?

We are not seeking to build near-term investment themes and positions on neither accelerating U.S. or global demand growth nor reappearing inflation. We simply believe that the balance of risks is not so universally skewed towards recessionary outcomes as market pricing suggests.

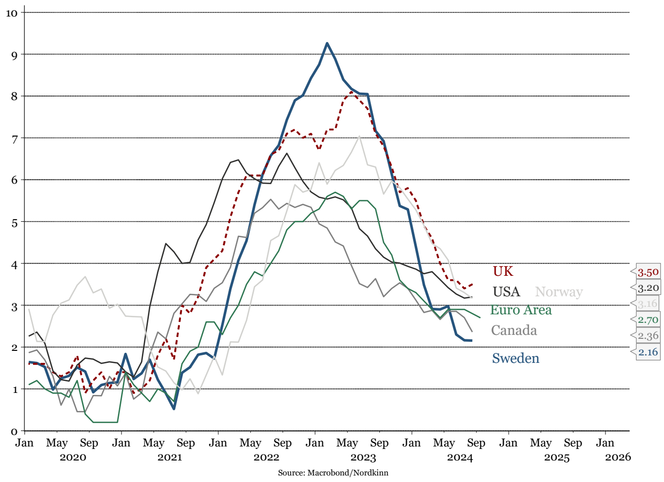
The Fed is priced to cut rates by more than 25bps at almost all meetings up until next summer, and to continue cutting at some pace thenceforth. The ECB is analogously priced for 25bps cut at each policy meeting until next summer, despite alluding to being gradual and remaining cognisant of flaring inflation from still much-too-high labour cost growth (further aggravated by very weak productivity growth).

From our perspective, an unfolding recession is the only way to warrant an aggressive monetary policy expansion on a scale proportional to current market pricing.

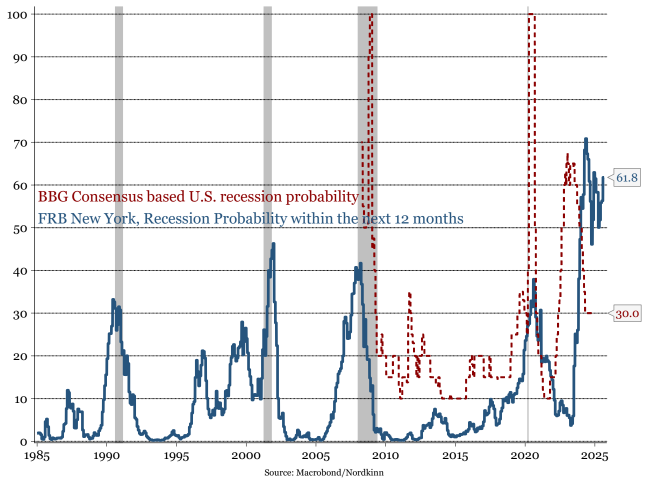
In the right-hand chart, we have also added recession probabilities estimated from analysts and consensus expectations. Analysts' expectations are evidently still set on something like a soft-landing and the risk of a recession (within the next 12 months) is calculated to be around 30%. To be sure, this is still elevated compared to the probability of an unconditional forecast of a recession unfolding every 5 to 10 years, i.e., a 10-20% risk (based on post-WWII economic history). This, we believe, is a more sensible description of recession risks for economies in a robust economic standing and who are facing swift and deep monetary policy expansion.

Taken together, we are attentive to the scenario that monetary policy, and in some instances also fiscal policy, will act to shore-up demand as counter to market perceptions of an imminent recession.

Core CPI inflation, y/y %



U.S. recession probabilities, markets versus analysts



Nordic outlook

The developments in September reinforce our view that the Swedish economy will rebound in 2025 and 2026. The policy rate is approaching the neutral level at a relatively fast pace, and fiscal stimulus via lower taxes and increased investments will soon take effect. However, most forecasters expect a gradual recovery with modest growth in 2025. While rate cuts have yet to significantly boost private consumption, we expect consumer spending to begin picking up in 2025, potentially by the second quarter, as lower interest payments gradually improve disposable income.

Currently, nearly 70% of Swedish mortgages are on floating rates (3 months), a near-record high. This indicates that monetary policy changes will have an immediate effect on households. Consumer sentiment is already responding, as shown by the National Institute of Economic Research's Economic Tendency Indicator (ETI), which reported an all-time high in household confidence in future personal finances in September. Furthermore, plans to purchase capital goods and cars have risen notably in recent months. With savings and savings rates now back to pre-pandemic levels, this should further bolster future consumer spending.

If our forecast of a robust rebound in 2025 proves correct, it will likely prompt a repricing of Swedish fixed income and the SEK. We expect Swedish yields to rise relative to European rates, a further steepening of the yield curve, a stronger SEK, and an increase in inflation risks (at the very least, avoiding negative territory). These trends will be reinforced by a reduced supply of real interest rate bonds in the coming years. Despite some steepening since early summer, the Swedish yield curve remains relatively flat. Currently, 10-year government bond yields are only about 30 bps above the market's expected bottom for the Riksbank's policy rate by the end of 2025 or early 2026, leaving limited room for term premia.

We anticipate that the SNDO will need to continue increasing its borrowing requirements and raising capital through nominal bonds. This, coupled with a recovering economy and minimal term and inflation risk premia, suggests the balance of risk is skewed towards higher bond yields and a steeper curve ahead. However, the real test of bond demand will likely come as the policy rate nears its lowest point, when the Riksbank signals the end of its rate-cutting cycle. We explore these themes further in *"Sweden: After cuts comes growth."*

Since launching our theme *"Norway: Inflation risks overvalued"* earlier this year, inflation has fallen more quickly than the Norges Bank anticipated. Despite this, the central bank has remained cautious about lowering interest rates prematurely, emphasising the importance of fully returning inflation to its target in a timely manner.

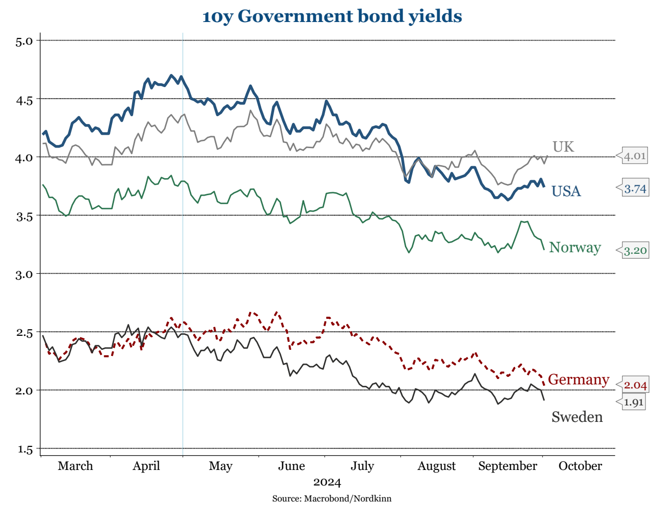
"We are approaching the time to lower interest rates," said Norges Bank Governor Ida Wolden Bache in her statement on September 19th. According to the Bank's central projection, the key policy rate will stay at 4.50% until the end of the year, followed by a 25 bps reduction each quarter next year, with the risks skewed toward a slightly more gradual easing cycle.

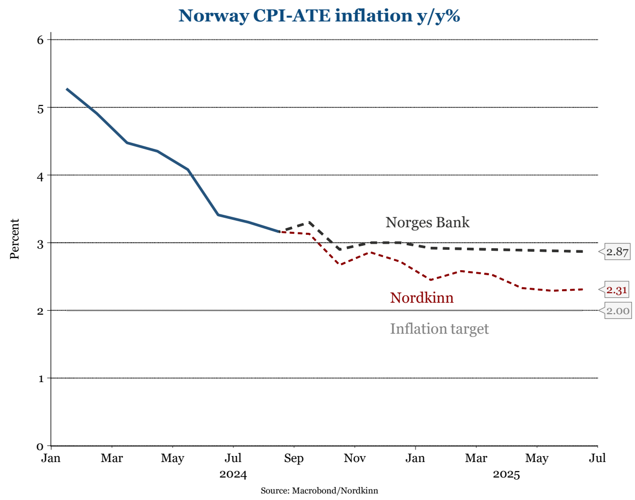
While this projection carries significant uncertainty and is likely to be adjusted at each quarterly review, the bar for revising the forecast for the current three-month period until December is typically high. Our near-term inflation forecast is slightly lower than that of Norges Bank, but not by enough to justify a rate cut in December. Therefore, we expect the key policy rate to remain at 4.50% through year-end.

Looking further ahead, while we agree with the Norges Bank that the pace of disinflation will slow, we continue to expect underlying inflation to make some further progress in coming quarters. If correct, the inflation target should be within reach by the first half of 2025, contrasting with Norges Bank's expectation of a more persistent inflation profile over the next year, see chart.

Additionally, if the economy continues to grow at a slow pace in the coming months, as we anticipate, the trade-offs in monetary policy could shift. Norges Bank may become less concerned about inflation risks and more focused on the potential downside of maintaining high interest rates for too long, which could unnecessarily contract the economy.

In summary, our theme *"Norway: Inflation risks overvalued"* remains central to our investment strategy for Norwegian interest rates. As always, our trading strategy will align this outlook with prevailing market expectations and central bank communications. While we see potential for significant spread compression between Norwegian rates and their peers over the longer term, we acknowledge the possibility of further near-term upward adjustments to Norwegian interest rates.





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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