

NORDKINN

— ASSET MANAGEMENT —

Market Review & Outlook

October 2024

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Market overview

Global overview

Central bank communication in October has generally been dovish, suggesting further rate cuts over the next few meetings. Notably, the European Central Bank (ECB) appears inclined towards further or potentially larger cuts. The U.S. Federal Reserve (Fed) has indicated that additional cuts remain justified in the near term.

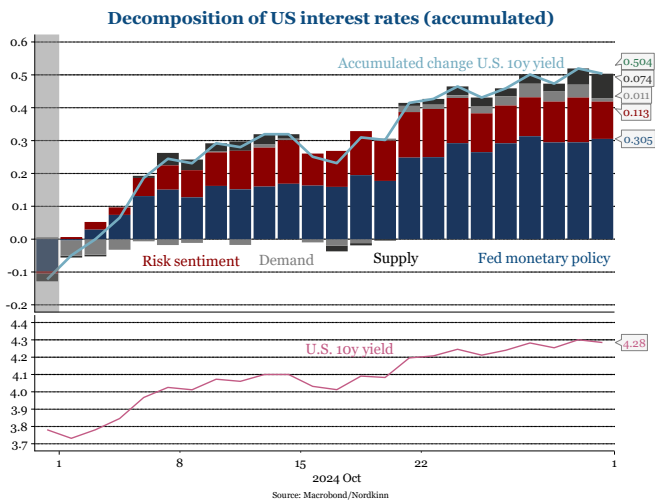
Markets, however, have reacted differently. Economic data has once again demonstrated the strength of the consumer-driven U.S. economy, which contrasts with the relative weakness of the mercantilist, export-oriented, Euro Area economy.

Illustrating this transatlantic divide, the U.S. labour market posted Non-Farm Payroll (NFP) growth of 254k in September surpassing expectations of 150k. Additionally, core PCE-inflation was slightly higher than expected at 0.3% m/m vs 0.2% m/m, which remains well above the Fed's target-compatible rate of 0.165% m/m.

Meanwhile, European data has been persistently disappointing. September's core HICP inflation came in at 2.7% year-on-year, nearly 0.2 percentage points below the ECB's September forecast. The weakness is most evident in survey data, such as PMI, making us cautious about becoming overly negative on the Euro Area, especially as Germany and France—key drivers of this deterioration—are also facing the highest levels of political uncertainty in decades.

Almost a case in point, common knowledge dictates that the political situation has taken the helm on financial markets as "Trump trades" dominate. Still, we are inclined to believe that the financial market commentariat is exaggerating the Trump effects as a decomposition of daily interest rate changes clearly indicate that the repricing is first and foremost driven by the Fed's perceived reaction to stronger than expected data, since the largest movements have come after the strong NFP (released October 10th) and retail sales (released October 17th) reports. If inflationary concerns over a potential "Trump 2.0" effect were at play, we would expect to see this reflected in the "supply" component of rate movements.

Nonetheless, politics in general—and the U.S. election in particular—are widening the distribution of risk, leading us to limit exposure to the more volatile elements of the "Trump trade." Despite our efforts to mitigate election-related risks, our global themes have struggled throughout the month and have contributed negatively to performance in October. Our FX-positions geared towards global growth momentum suffered heavily. In response, we have substantially decreased risk in our two global themes (see page 6) to await better clarity following the U.S. election.



Nordic overview

Swedish economic data in October presented a mixed picture. CPI inflation excluding energy was slightly above expectations, while labour market data—though historically volatile—showed a modest rise in unemployment. Both the GDP indicator and retail sales were disappointing, but consumer confidence remained high, with optimism for the near future. Although the manufacturing sector showed improvement in the first half of the year, it has softened in recent months.

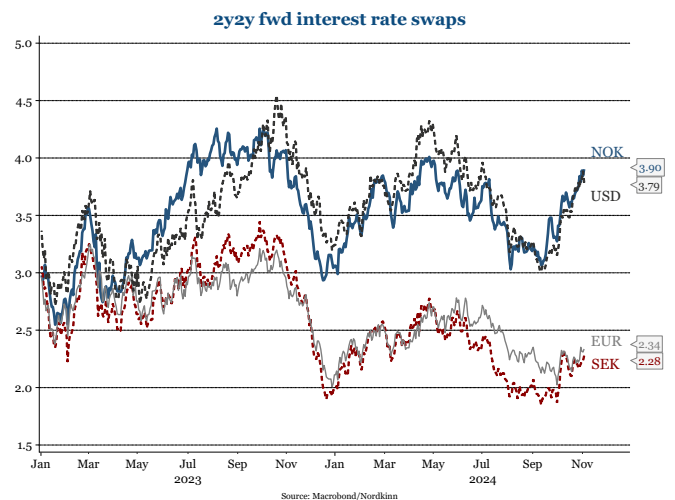
The Riksbank has left the door open for a potential 50 bps rate cut at its upcoming November meeting, though it has not specified the conditions for such a move. Markets are now pricing in a high likelihood of a 50 bps cut, given some weaker October data. This expectation likely underpins the stability of Swedish interest rates against recent global market fluctuations, which were influenced by the Fed repricing and de-risking ahead of the U.S. election. Generally, Swedish rates tend to move in line with global rates; however, aside from early October, they have remained relatively stable despite the high U.S. rate volatility.

Towards the end of the month, the SEK came under pressure, likely due to a combination of risk-off sentiment and potential rate divergence. The weaker SEK weighed on the fund's monthly performance. Nonetheless, the Swedish theme "After cuts comes growth" performed well during the month, driven by a steeper yield curve and relative movements in swap rates against EUR swaps. In contrast, the strong relative performance of Swedish government bonds (SGBs) detracted from the theme "Sweden: From QE to QT."

In Norway, underlying CPI inflation continued to decline in September, reaching 3.1% year-on-year, once again falling short of Norges Bank's forecast. However, the I-44 NOK index is currently around 2% weaker than projected, which broadly offsets the impact of inflation being slightly lower than expected on Norges Bank's rate projection.

Reflecting the rise in U.S. bond yields, Norwegian interest rates increased sharply in October. As shown in the chart below, Norwegian forward rates in recent years have typically demonstrated a high beta to U.S. rates, while Swedish rates more closely follow euro area trends. Consequently, spreads between Norwegian and Swedish forward rates reached historically high levels.

Our "Norway: Inflation risks overvalued" theme detracted from performance in October. Gains from tactical interest rate trades were insufficient to offset losses, mainly due to premature trades aimed at narrowing the Norway-Sweden spread.



Outlook

Global outlook

At the time of writing, the winner of the U.S. election remains undecided. The actions of the incoming administration on January 20th will undoubtedly play a decisive role in shaping financial and economic developments—perhaps more so than at any similar juncture since the Cold War era. This is no exaggeration, given the current severity of fiscal policy, trade tensions, and geopolitical strains, which are all at levels not seen for more than a generation. Further complicating matters, financial, economic, and political dynamics are tightly interconnected; a disruption in one area is almost certain to impact the others.

Analysing financial and economic developments dominated by political uncertainty is challenging. Going into the election, we have throughout October strived to keeping risk exposures both low and liquid. The outcome of the election will dictate the path forward, and in our preparations, we are highlighting what we see as the key components within the following broad scenarios:

Baseline Scenario: Trump Win and “Red Sweep”

Setting aside political perspectives, we believe a Trump victory and a Red Sweep (i.e. Republican control of both houses) is the most plausible outcome based on polls, betting odds, and other indicators, even though the most recent predictions suggest the outcome will be close. This scenario is likely to be the least disruptive for financial markets in the immediate term. However, it also presents dense tail risks and a (distant) chance of market turmoil like the UK’s experience under former Prime Minister Liz Truss in the autumn of 2022.

If Trump is re-elected, primary concerns centre on his tax policies and potential supply-side damage through tariffs and migration restrictions. According to the nonpartisan Committee for a Responsible Federal Budget (CRFB), Trump’s policies could add approximately USD 8 trln (within a range of USD 2–16 trln) to the federal debt beyond current law projections. This would increase the debt-to-GDP ratio to around 143% by 2035, see chart. Deficits are also expected to grow, rising from roughly 6.5% of GDP today to nearly 10% by the mid-2030s.

A slightly less probable scenario would be a Trump win with a divided Congress (i.e. one chamber under Democratic control). In this case, Trump’s tax policies would likely face strong resistance, moving fiscal policy closer to the Congressional Budget Office’s (CBO) “current law” forecast.

However, executive powers over international policy mean that tariffs could become an even more central, and possibly disruptive, aspect of U.S. policy, particularly impacting international, and especially European, markets.

Alternative Scenarios

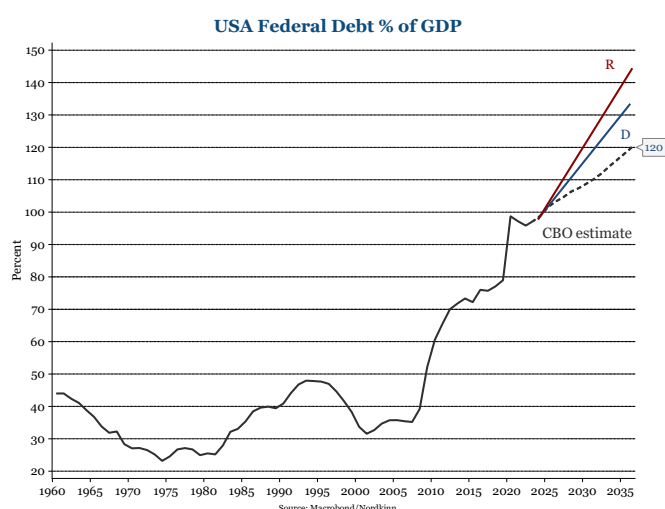
The CRFB also estimates that a Harris win and a Blue Sweep would lead to increased fiscal strains, albeit to a lesser extent. The unfavourable U.S. fiscal outlook largely reflects the poor starting point, or “current law” projections, calculated semi-annually by the CBO.

Despite earlier troubling CBO projections, neither candidate (nor other leading politicians) has shown much concern for the impact of escalating fiscal pressures. However, there are meaningful differences between a Red and a Blue Sweep, including dynamic effects (not included in the CRFB analysis) from Kamala Harris’s relatively less disruptive policy proposals. Thus, while some tail risks and potential market turbulence would still exist, they would likely be lower under Harris’s policy framework.

One of the main alternative scenarios is a Harris win paired with a divided government (with Democratic losses in both the Senate and House). Put simply, this scenario could prove chaotic. For instance, the federal debt ceiling will be reinstated already on January 2nd 2025, requiring the new administration to race against time to prevent a default, secure key appointments (e.g., Treasury Secretary), and prepare for the next budget bill by early autumn. All of this would unfold with a newly elected Congress and an incoming administration.

The potential upside in this scenario is that it may limit excessive fiscal stimulus, staying closer to the CBO’s current law projections, and might avoid severe disruptions to international trade relations.

Needless to say, each scenario does present its own set of macro challenges and opportunities, where meaningful market impacts are set to follow.



Outlook

Nordic outlook

The near-term outlook for fixed-income markets, including Sweden's, will largely depend on the U.S. election outcome. It's not only the results that matter but also the relief from ending a prolonged period of uncertainty, which could help stabilise markets. We have in recent month observed a risk-off sentiment that has led to unusual market moves, potentially opening opportunities in the weeks or months ahead. For instance, in the review above, we highlighted the resilience of Swedish interest rates amid heightened global rates and volatility, see chart. This de-risking ahead of the election may have led to the closing of short positions in SEK rates. As markets stabilise post-election, some of these pre-election movements may start to reverse. We await the results to respond in line with our analysis of the outcome.

There is also anticipation that the Swedish economy could be affected by potential tariffs. While much analysis has focused on the U.S. and European economies, less attention has been given to Sweden. According to a simulation by the National Board of Trade Sweden, Swedish exports to the U.S. could decline by 16%, although the overall impact may be limited as increased exports to other EU countries might offset this decrease.

Assuming only moderate effects on the export sector (with a global recession posing a greater risk), we believe Sweden's economy will most likely improve significantly in 2025. Consumer confidence is on the rise, plans for durable goods purchases are increasing, and unemployment risks appear to be diminishing. Additionally, recent media reports indicate a potential easing of amortisation and loan-to-value regulations, which would support spending and the housing market. Recent data also show that more households are choosing fixed mortgage rates over variable, reflecting a shift in sentiment. Altogether, we still view the Swedish yield curve as overly flat, lacking any risk premiums for an improved economic outlook or higher inflation.

The KIX index has returned to levels seen last summer when the Riksbank was more concerned about the SEK. Now, however, the Riksbank may prioritise the domestic disinflation process. Nonetheless, the current situation highlights the risk of maintaining a looser monetary policy than neighbouring economies. We believe that the recent resilience and outperformance of Swedish rates may soon come to an end.

In Norway, we expect disinflation to continue, though likely at a slower pace than seen thus far in 2024. Specifically, we forecast core CPI inflation to ease down to, or near, the 2.0% inflation target by spring or summer of next year. In contrast, Norges Bank projects core inflation to remain stable around 3% through mid-2025 and to stay above the 2.0% target across its forecast horizon, which extends to 2027.

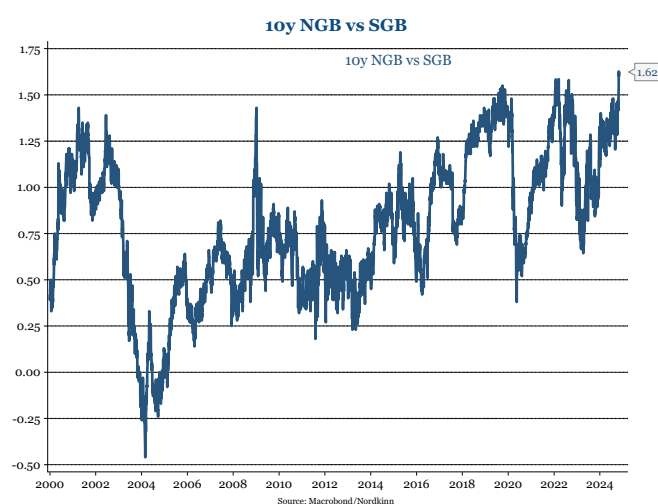
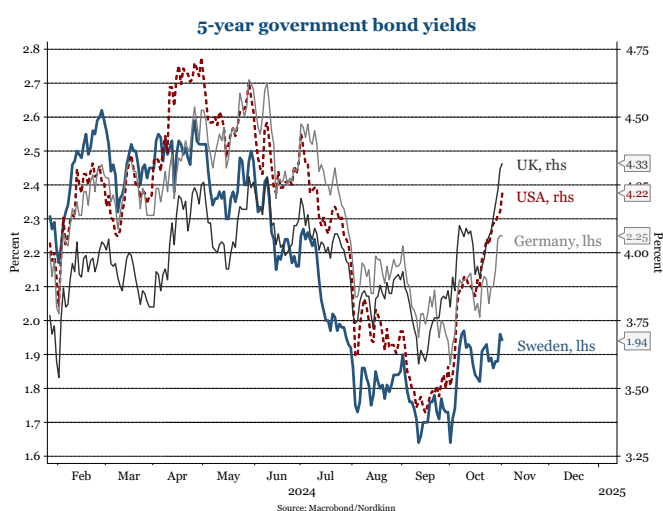
Despite this forecast of persistently high inflation, Norges Bank's interest rate projection aligns with a gradual reduction of 25 bps at the end of each quarter (i.e., at each policy meeting) to reach 3.50% by the end of 2025. A more gradual reduction is anticipated toward a neutral rate of around 2.75% by 2027. The interest rate path reflects a balancing act between bringing inflation back to target and supporting a robust labour market.

Since the latest projection was published on September 19th, new data has had minimal impact on the interest rate outlook. While inflation has declined slightly faster than anticipated, this effect has largely been offset by a weaker-than-expected NOK exchange rate.

International developments have been roughly neutral for Norway's monetary policy outlook; higher expected U.S. interest rates are balanced by more aggressive easing from the ECB and Riksbank. However, the international landscape could shift significantly following the U.S. elections.

At the upcoming monetary policy meeting on November 7th, we expect Norges Bank to hold the key policy rate steady at 4.50%. The committee will likely reiterate its guidance to keep the policy rate unchanged through the end of 2024, while signalling that rate cuts are approaching. In our view, a rate cut is most likely in March, though January remains a possibility.

Looking further ahead, if inflation declines faster toward target in 2025 as we anticipate, Norges Bank may opt for a more front-loaded approach to rate cuts next year. In this scenario, we find cross-market spreads against Swedish and Eurozone rates particularly compelling, see chart. Additionally, the yield curve's inversion across almost all maturities presents an attractive fade opportunity. These factors are reflected in our 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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