NORDKINN
ASSET MANAGEMENT

Market Review & Outlook

December 2024

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Market overview

Global overview

As political discussions intensified and U.S. data emerged in December, U.S. interest rates once again surged. Key drivers included robust labour market data, with Non-Farm Payrolls rising by 227k (vs. 220k expected) alongside positive revisions to prior months, and hotter-than-expected inflation data (CPI and PPI). The Summary of Economic Projections, released during the Federal Reserve's December 18th meeting, further fuelled rate increases. Despite market anticipation of a less aggressive rate-cutting cycle, the FOMC struck a distinctly hawkish tone, revising the 2025 rate path upward by 50 basis points (bps) and the long-run dot by 12.5 bps.

These developments significantly elevated market expectations for the Fed policy rates. At the time of writing, fewer than two rate cuts are priced in for the entirety of 2025.

In contrast, Europe faces a less optimistic outlook amid persistent economic weakness in its largest economies and ongoing political challenges across the bloc. The European Central Bank (ECB) played a pivotal role in moderating interest rate movements, softening its policy language during its December 12th meeting. Notably, the ECB removed the key phrase, "[The Governing Council] will keep policy rates sufficiently restrictive for as long as necessary." This shift in narrative, combined with signals from traditionally hawkish council members, suggests a forward-looking approach, with several rate cuts anticipated during the ECB's early 2025 meetings. Current market pricing indicates that the ECB may cut rates at all four meetings in the first half of 2025, with rates stabilising thereafter.

Our global investment theme, *"Geopolitical tensions impacting growth"* contributed on a net basis modestly to the Fund's performance in December. This theme aims to capture relative changes in the economic outlook driven by anticipated policies under the Trump administration, particularly in areas such as trade and migration. The theme predominantly comprises select curve and FX trades.

In December, we decided to close the global theme *"FX misalignment"*. It was designed to exploit deviations in real exchange rates following the global inflation shock and as both real rates and inflation have normalised on relative basis since, the theme has lost its relevance.

Nordic overview

The Swedish Riksbank cut its policy rate by 25 bps in December, bringing the accumulative rate cuts in 2024 since May to 150 bps, and signalled that a pause in easing is approaching. This move was broadly in line with expectations.

November CPI matched forecasts, though core inflation (excluding energy) remained slightly above the Riksbank's September projection. While private consumption has yet to gather momentum, indicators such as the manufacturing PMI and the NIER's Economic Tendency Indicator (ETI) both point to signs of economic recovery. Labor market changes remain muted, but activity in the housing market is picking up, accompanied by growth in household lending.

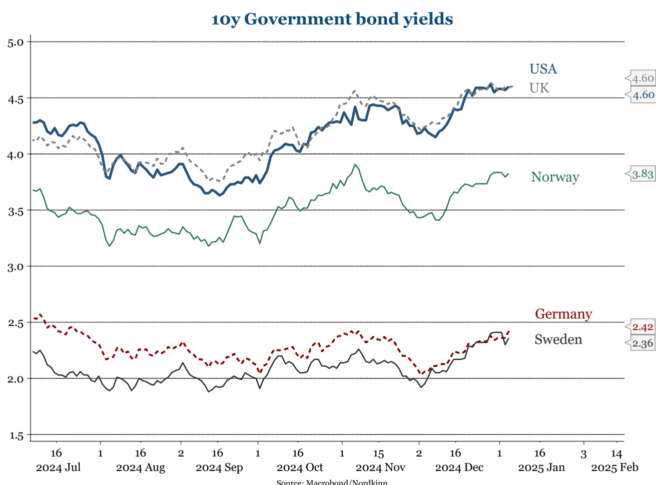
Swedish rates edged higher in December, primarily as response to global developments rather than domestic catalysts. Swedish swap rates and bond yields underperformed their European counterparts. This underperformance likely represents a delayed reaction to Sweden's relatively upbeat economic data compared to Europe, which has yet to significantly impact rate spreads—a dynamic we highlighted already in the November outlook.

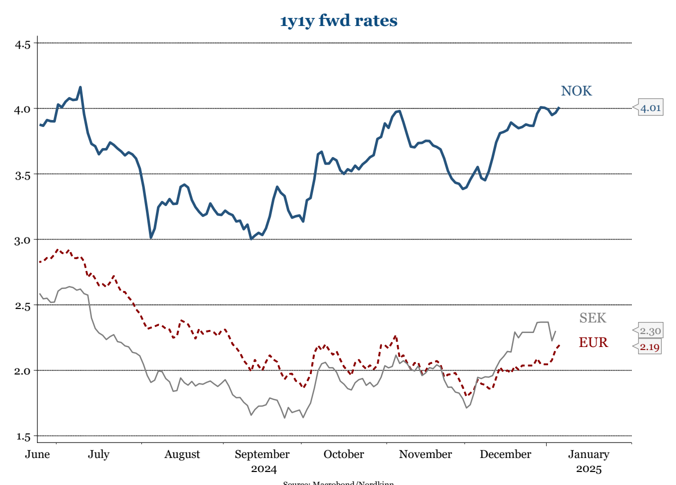
The relative underperformance of Swedish versus Eurozone interest rates positively affected the theme *"Sweden: After cuts comes growth,"* contributing to December's performance. Similarly, the theme *"Normalising risk premia"* also performed, while the new 2025 theme, *"Sweden: Bond supply set to expand"* detracted from returns.

In Norway, underlying CPI inflation rose to 3.0% Year-On-Year in November, surpassing consensus expectations and aligning with Norges Bank's forecast. This upside surprise, the first and only in 2024, diminished the likelihood of earlier or more aggressive policy easing than Norges Bank's baseline projections. As a result, market interest rates rose sharply. Expectations for rate cuts were further tempered by stronger-than-expected growth in the Norwegian economy and external factors, such as higher rate expectations among trading partners, particularly in the U.S.

On December 19th, Norges Bank confirmed this view by slightly raising its interest rate projection. While this adjustment was largely anticipated, Norwegian interest rates continued to climb into year-end amid positioning flows.

Overall, Norwegian interest rates underperformed those of major trading partners. Consequently, our new theme, *"Norway: Path to looser policy"* detracted from December's performance.





Outlook

Global outlook

True to recent trends, fixed income markets remain highly reactive to macroeconomic developments. Interest rate movements that we expect to unfold over several months are often compressed into weeks—only to reverse course soon after. Our recently introduced global theme, *"Geopolitical tensions impacting growth"* is already starting to exemplify this dynamic. The inflation risks perceived to stem from Trump's economic policies have quickly been incorporated into Fed market pricing, arguably without adequately accounting for potential downside risks to the broader economy.

From a fundamental perspective, particularly regarding labour market developments, there are reasons to believe that the U.S. inflation outlook may be less concerning in the near term (3–9 months). U.S. unemployment, albeit gradually, is trending upwards, and other labour utilisation indicators, such as the quits rate and the NFIB's difficulty in filling positions, are declining. Simultaneously, wage cost pressures are easing, with various wage indicators—including the Employment Cost Index (ECI)—falling to levels consistent with the Fed's inflation target (see chart). This assumes a continuation of 2% annual productivity growth, which has held steady in recent quarters.

While there is a risk that Trump's proposed migration policies—such as reducing immigration or deporting existing immigrants—could disrupt these trends, any impact on inflation would likely materialise closer to 2026 rather than in the near term.

On tariffs, we remain firm in our view that they are likely to have a short-term positive effect on inflation, potentially a significant one. However, tariffs represent a one-off supply-side distortion. A forward-looking monetary policymaker should allow such effects to dissipate rather than overreact. The key question with tariffs—and other Trump policy proposals—is whether and how they influence inflation expectations. Despite any reservations we may hold about the measurement of inflation expectations, the stability of both business and household expectations is evident. This supports the notion that the Fed may look through a temporary tariff-induced boost to inflation.

Our takeaway is that markets may be overestimating the immediacy and magnitude of Trump's policies on U.S. inflation and monetary policy. Furthermore, the lack of discussion around downside risks to the growth outlook is notable. Dynamics such as historically high equity valuations, low corporate risk premia, and rising inflation and term risk premia could evolve in ways that are currently unforeseen.

According to the description of our investment theme, *"Geopolitical tensions impacting growth"* near-term developments in the Euro Area are likely to remain weak. Of particular concern is the inflation outlook, despite a rebound in December inflation data. As discussed in the review section, market pricing for the ECB has shifted toward anticipating a series of rate cuts during the first half of 2025, which aligns with our expectations.

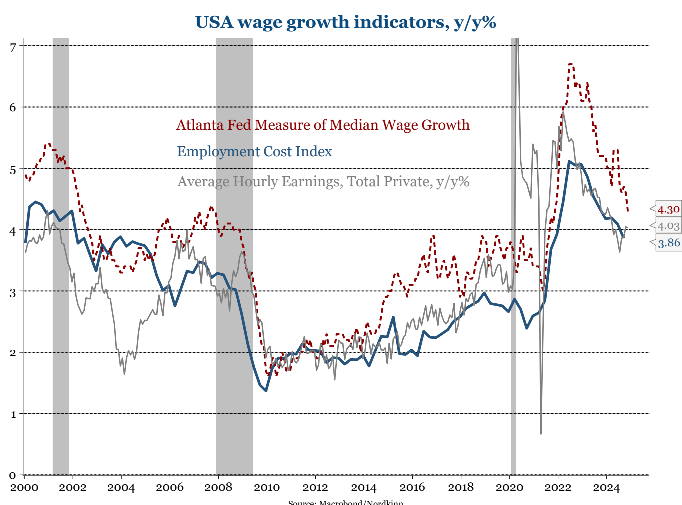
That said, we see little justification for the ECB to halt its rate-cutting cycle as early as the summer of 2025, as current market pricing suggests (see chart). While labour markets have remained resilient, with unemployment at a historical low of 6.3%, signs of softening are beginning to emerge. Both survey-based indicators and hard data, such as job vacancies, point to weakening conditions. Labour markets, like inflation, tend to lag the broader economic cycle, and elsewhere, the outlook remains bleak.

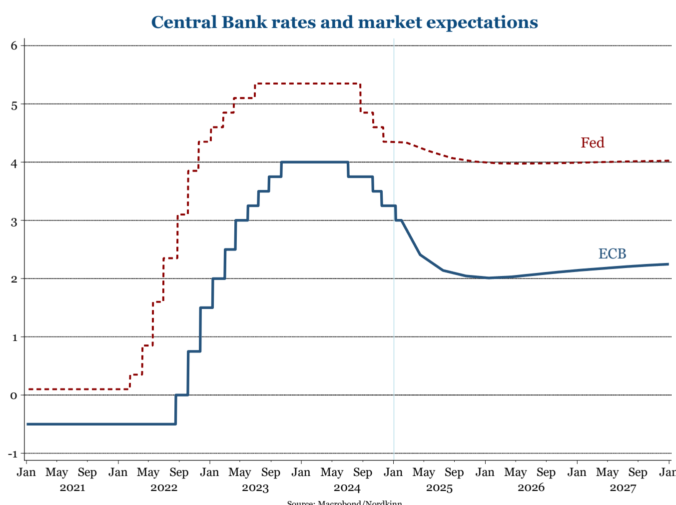
The Euro Area faces a confluence of challenges, including a potential trade war with the U.S. and structural disadvantages against U.S. and Chinese competition in critical sectors such as battery electric vehicles. Core Euro Area economies are grappling with both cyclical and structural headwinds.

Exacerbating these issues is the rigidity of fiscal rules and frameworks, which suggest fiscal tightening at a time when stabilisation policy would call for expansion, at least at the aggregate level. This tension is further intensified by the financial burden of Russia's war of attrition in Ukraine, which is increasingly falling on Europe's shoulders.

Amid these challenges, Europe finds itself in yet another political crisis—this time with Germany and France at the centre of the discord. The political response has been underwhelming, leaving the ECB as the sole institution actively addressing the situation. In these dire times, we expect the ECB to continue playing its critical role and to act decisively.

On January 20th the inauguration of Trump to become U.S. president for a second term will bring the world into a new era. While many of the current uncertainties finally will be brought to certainty, certainly new series of uncertainties are set to emerge.





Outlook

Nordic outlook

While our forecast for a stronger rebound in private consumption has yet to materialise, we remain optimistic about the Swedish economy's outlook in 2025. Consumer confidence dipped from elevated levels in the latest survey, which we attribute mainly to the November spike in electricity prices. This development, widely reported in local media, likely reminded households of the harsh winter two years ago. However, electricity prices stabilised in December, and we do not view this dip in confidence as a structural shift.

Encouragingly, the latest NIER survey shows that the outlook for purchases of capital goods, durable goods, and home renovations over the next 12 months has reached its highest level since 2022. Simultaneously, savings intentions have dropped significantly. These trends suggest that households may increase consumption in 2025, supported by lower mortgage costs and tax reductions.

A rebound in private consumption, along with increased public spending on defence and infrastructure, positions the Swedish economy to outperform continental Europe. The primary downside risk is a weaker export outlook to Europe. However, Sweden's recent export gains have been concentrated in services, particularly cultural and recreational services, which may offset some of the potential weakness in goods exports.

We do not expect inflation to decline further and stabilise well below the 2% target. Therefore, we anticipate that the Riksbank will cut rates by another 25 bps in January or March before pausing to assess the effects. If this forecast holds, the Swedish fixed income market is unlikely to experience the same strong tailwind in 2025 as it did in the previous year.

Instead, we expect a substantial increase in bond supply, driven by the simultaneous unchanged quantitative tightening (QT) volumes by the Riksbank and higher issuance by the Debt Office. Household lending is also beginning to rise, while liquidity in the financial system is tightening, which may reduce inflows to bank deposits. This dynamic could lead to an increase in covered bond issuance in 2025, alongside greater expected issuance from municipalities (Kommuninvest). We organise these ideas on our new theme *"Sweden: Bond supply set to expand,"* which replaces *"Sweden: Normalising risk premia."*

Additionally, a Riksbank pause may encourage more households to lock in fixed mortgage rates. This, in turn, would likely result in increased rate locking in swaps by mortgage institutions, adding interest rate risk to the market. Taken together, we foresee upward pressure on interest rates and a steeper yield curve emerging in 2025.

Throughout most of 2024, our macro view for Norway has been that inflation would decline more quickly toward target than projected by both Norges Bank and consensus. This view has been expressed in our investment theme, *"Norway: Inflation risks overvalued."* In December, we transitioned to a new theme, *"Norway: Path to looser policy"* reflecting our belief that conditions are aligning for interest rates to soon begin normalising.

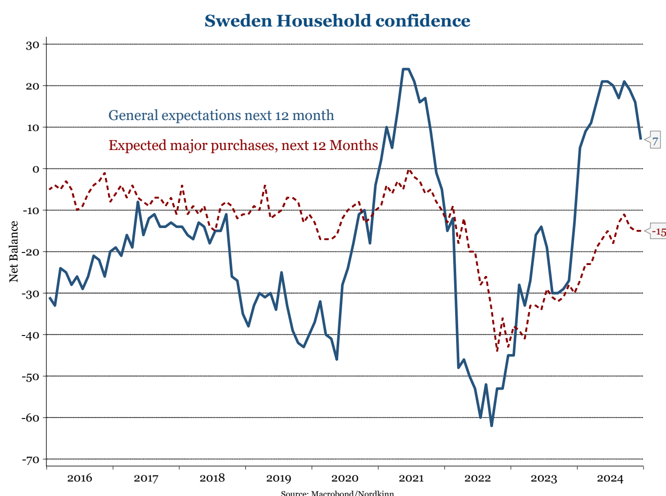
According to the updated interest rate projections, Norges Bank is likely to start reducing the policy rate in March by 25 bps to 4.25%, with an additional reduction to 3.75% expected by the end of 2025. This outlook aligns broadly with current market expectations. However, for 2026 and 2027, market expectations for rate levels remain significantly above Norges Bank's projections.

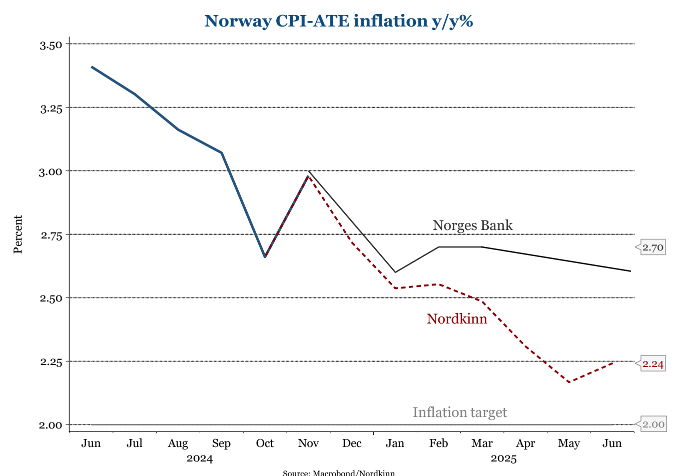
When evaluating the balance of risks around Norges Bank's projections and the market-implied rate path, we see greater risks of more aggressive easing than of further delays. Given Norges Bank's December communication, the threshold for not cutting rates in March seems high. With rates at restrictive levels, a March rate cut followed by another reduction in June would not be viewed as a policy misstep, even if incoming data surprises on the upside in early 2025.

Conversely, if data surprises on the downside—such as inflation falling faster than expected or unemployment rising more than anticipated—the likelihood of accelerating the easing cycle increases. This scenario would resemble the policy shifts seen in Sweden and the Euro Area in 2024, where central banks moved quickly.

While the growth outlook appears reasonably positive if Norges Bank begins lowering rates in March, uncertainty remains elevated. For instance, higher global tariffs could dampen global growth, indirectly affecting Norway.

We continue to expect inflation to decline to a range of 2.0–2.5% by summer, slightly below Norges Bank's projection (see chart). Key components of the CPI, such as housing rents and food prices—which together account for nearly one-third of the index—remain elevated, with year-over-year increases exceeding 4% as of November. However, forward-looking indicators suggest these sub-indices could see significantly slower growth in 2025.





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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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