NORDKINN

ASSET MANAGEMENT

Market Review & Outlook

January 2025

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Market overview

Global overview

The U.S. economy remained strong in 2024, with GDP growth estimated at over 2.5%, increasingly driven by robust consumer spending. While labour market conditions have cooled from their previously "overheated" state, they remain solid: payrolls grew by an average of 170k per month over the past three months, and unemployment has hovered just above 4% since last summer (4.1% in December). This is nearly half a percentage point below what most analysts consider consistent with inflation at target. Wage growth has eased, suggesting reduced inflationary pressure from labour costs. However, we attribute this primarily to strong immigration and unexpectedly high productivity.

Meanwhile, preliminary data suggests Euro Area GDP grew by a meagre 0.7% year-on-year in 2024, with little to no acceleration toward year-end. Despite this, the ECB expects real income to rise and financing conditions to gradually improve, partly due to lower interest rates. However, the central bank also emphasises that past policy tightening continues to filter through credit markets, deliberately keeping borrowing conditions relatively tight.

Turning to inflation, price growth has moved closer to the Fed's 2.0% target, with total PCE inflation at 2.6% and core PCE inflation at 2.8% in December. While this marks progress from a post-pandemic perspective, inflation's decline has stalled somewhat in recent months. As expected, the Fed held the Federal Funds Rate steady at 4.25–4.50% in January, citing "no hurry" to cut rates further. Notably, the Fed has already lowered rates by a full percentage point from their peak, and we view this as a pause to confirm inflation's continued moderation. The path forward will largely depend on the new administration's trade and fiscal policies.

In January, the ECB cut the deposit rate by 25bps to 2.75%, as expected. President Lagarde described the disinflation process as "well on track," with inflation projected to settle around the 2% medium-term target later this year. Most importantly, recent evidence suggests wage growth is moderating, and corporate profits are absorbing inflationary pressures, reinforcing the case for continued disinflation.

These developments meant that while our global theme, *"Geopolitical tensions impacting growth,"* faced a rough start in January, while its end-of-month contribution was only slightly negative as European rates commenced falling relative to the U.S. in particular.

Nordic overview

In Sweden, CPIF excluding energy fell to 2.0% year-on-year, below both the Riksbank's forecast and economists' consensus estimates. As expected by market, the Riksbank responded by cutting its policy rate by 25 bps to 2.25% at the end of the month. However, the central bank maintained that "the forecast for the policy rate made in December essentially holds, but the Executive Board is prepared to act if the outlook for inflation and economic activity changes." This clearly suggests a pause unless conditions worsen.

Recent domestic data has been upbeat, with consumer confidence improving again. The economic tendency survey shows that retail trade, services, and construction have returned to or exceeded historical activity levels. Additionally, December retail sales surprised to the upside, and card payment data points to a strong start for the year.

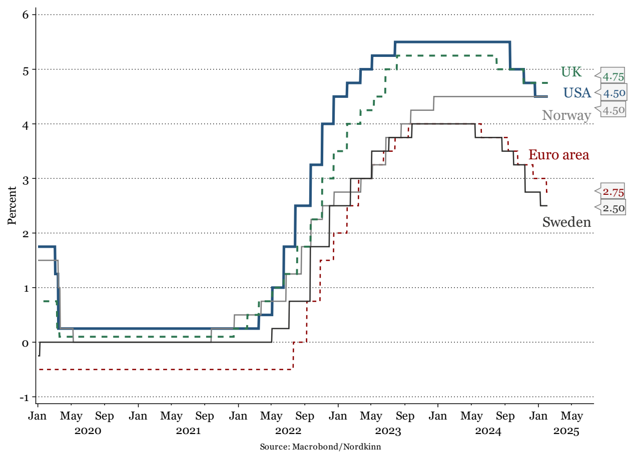
Swedish interest rates declined across the yield curve and outperformed European rates in January, despite the Riksbank's slightly more hawkish stance and resilient economic data. The theme *"Sweden: After cuts comes growth"* struggled in this environment, negatively impacting performance although the government bond curve saw slight steepening. Covered bonds outperformed other bonds and swaps on a relative basis, which worked as catalyst for the theme *"Bond supply set to expand"* to perform well. In foreign exchange markets, the SEK remained broadly unchanged against the Euro.

In Norway, underlying CPI inflation eased to 2.7% year-on-year in January, aligning with Norges Bank's forecast. However, headline inflation fell to 2.2%, well below the central bank's projection, primarily due to lower energy prices. While Norges Bank typically disregards energy price fluctuations, they may hold greater relevance this time given upcoming wage negotiations, where purchasing power improvements are key for labour unions' demands.

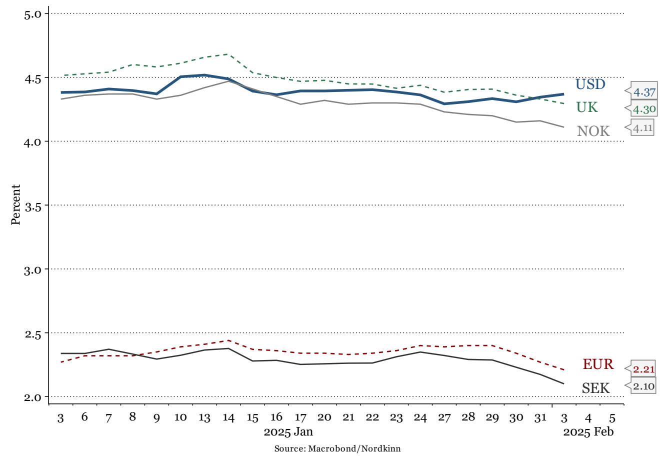
On January 23rd, Norges Bank left its policy rate unchanged at 4.50%, as expected, while reiterating that a rate cut in March is "very likely".

Norwegian interest rates rose sharply at the start of the year, clearly influenced by the rise in global bond yields, before reversing lower in the latter half of January. The theme *"Norway: Path to looser policy"* contributed positively to the fund's performance throughout the month.

Central Bank interest rates



2-year interest rate swaps



Outlook

Global outlook

With the glaring exception of the Bank of Japan, major central banks share a similar outlook of lower inflation and easing rates. However, while the Fed, ECB, and others see encouraging signs - such as moderating inflation and, in the Fed's case, a more balanced labour market - significant risks and uncertainties remain. Chief among them is the formulation of trade and fiscal policies by the incoming U.S. administration and the inevitable retaliatory actions, which pose major threats to the outlook.

At the January press conference, Fed Chair Powell emphasised that future policy moves are not on a "preset course." He stressed that strong economic performance means the FOMC is in "no hurry" to cut rates and must remain vigilant. If inflation stagnates above 2% or economic growth accelerates in a way that renews price pressures, the Fed may even tighten policy again. Conversely, if labour market conditions deteriorate sharply or inflation falls faster than expected, rate cuts are almost certain to follow. Powell was particularly clear that the FOMC does "not seek or think necessary any further deterioration in labour market conditions".

While inflation remains above target, progress has been significant. Total PCE inflation has fallen from over 5% in 2022 to 2.6% year-on-year in December 2024, with core PCE inflation at 2.8%. This decline largely reflects the unwinding of pandemic-era supply disruptions, the normalisation of goods demand, and the impact of previous rate hikes in curbing excessive spending.

That said, Fed officials have recently flagged several potential risks, including a resurgence in energy prices, global supply chain realignments, and geopolitical tensions - all of which could reignite inflation. The latest example is the sweeping 25% tariffs imposed on Canadian and Mexican imports by executive order on February 1st. At the same time, Trump announced a 10% tariff on Chinese goods and signalled that EU tariffs will follow.

Across the Atlantic, the ECB's Governing Council lowered its key interest rates by 25 basis points just days ago, bringing the deposit facility rate to 2.75%. The move aims to support the ongoing disinflation process, which ECB is confident remains the fact. The ECB's latest projections suggest euro area inflation could converge toward 2.0% over the medium term - potentially within this year - barring unforeseen global shocks, such as the direct and indirect effects of U.S. tariffs.

That said, in the ECB's policy assessment, domestic factors remain pivotal. Services inflation is expected to stay elevated due to lagged wage adjustments following past inflation surges and sector-specific price pressures. However, wage growth is already moderating, which should ease upward pressure on consumer prices soon. Additionally, corporate profits are absorbing most cost increases, limiting their pass-through to consumers. In our view, this signals that monetary policy remains restrictive, and demand is sufficiently subdued to justify further rate cuts in the spring.

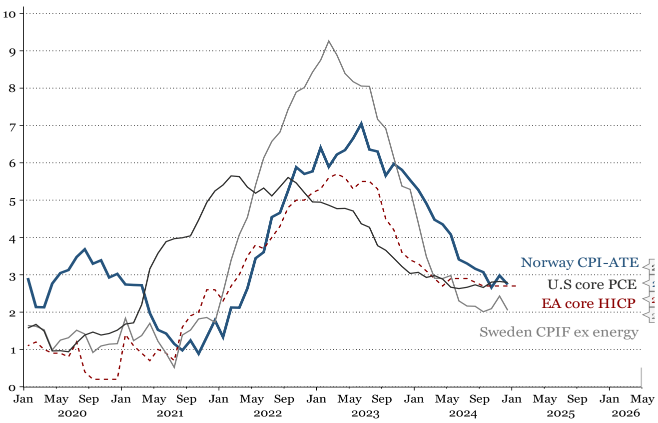
Euro Area growth may also be nearing an inflection point. Rising real incomes and the ECB's cumulative 125 bps of rate cuts to date, should soon outweigh previous policy tightening, increasing the likelihood of a "soft landing."

However, geopolitical uncertainties and trade frictions pose significant risks. These could reignite cost pressures or weaken global demand, depending on how events unfold. Climate-related disruptions to agriculture and infrastructure also present inflationary risks in the short and medium term, as seen in supply disruptions at the Panama Canal and shortages of key internationally traded oils and food.

In sum, monetary policy has reached a critical juncture where past tightening has meaningfully reduced inflation, but the task remains unfinished. The next phase requires careful balancing between price stability, sustainable growth, and mounting geopolitical, fiscal, and trade uncertainties. While central banks and financial markets see rate hikes as unlikely, the economic impact of rising tariffs and political risks could be recessionary, stagflationary, or outright inflationary.

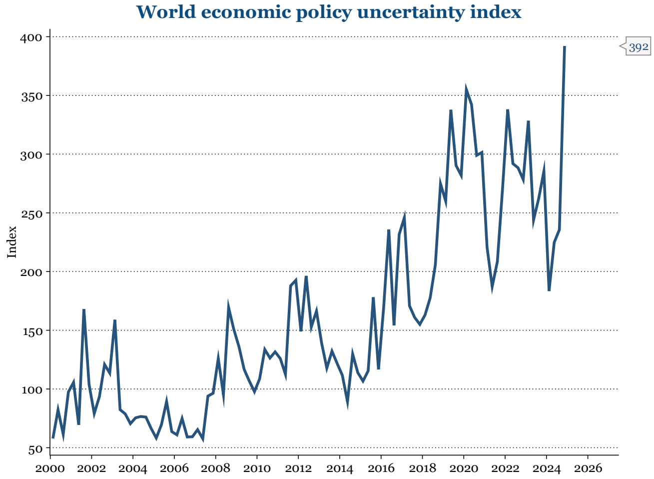
From a Nordkinn perspective, the current environment - while full of opportunities - is often primarily driven by political rather than economic factors, posing near-binary risks to our positions. To counter the increased set of possible outcomes, we continue to focus on relative value trades across maturities, geography and instruments.

Core inflation, y/y %



Source: Macrobond/Nordkinn

World economic policy uncertainty index



Source: Macrobond/Nordkinn

Nordic outlook

Swedish core inflation appears to have stabilised near the Riksbank's 2.0% target. If this trend continues, economic data will become the key driver of monetary policy, along with the direction of U.S. trade policy under the new administration. If private consumption and overall economic activity weaken further, additional rate cuts remain possible. However, after 175 bps of easing in just nine months, a pause seems warranted to assess how households and businesses are responding, especially as not all previous cuts have fully filtered through to the economy.

Ahead of the March policy meeting, the first major data release will be January inflation, which is notoriously difficult to predict. However, this year's basket effect is expected to be less pronounced as Statistics Sweden reverts to pre-pandemic methodology, using consumption patterns from two years ago. That said, annual price hikes at the start of the year have been larger in recent years - a trend that may persist, though to a lesser extent.

Looking at December's PPI data and the NIER survey, we remain unconvinced that inflation alone will push the Riksbank toward further easing. While profitability remains weak, demand is picking up, some upstream costs - such as food and energy - are rising. A scenario in which consumer prices trend higher into the summer is not difficult to imagine.

Household consumption and retail sales will be critical in assessing whether recent rate cuts are sufficient to stimulate growth. Labor market data will also be key: If unemployment and employment fail to stabilise early in the year, the Riksbank may face pressure to ease further. However, under Thedéen's leadership, the central bank seems less reactive to short-term inflation fluctuations than previous management. There may be a greater reluctance to cut rates in response to minor, temporary inflation misses and a stronger emphasis on curbing excessive lending while relying more on fiscal policy.

We maintain our Swedish themes, expecting economic improvements to spill over into the fixed-income market *("After cuts comes growth")*. Additionally, we anticipate a gradual process where QT and increased bond issuance will eventually fill portfolio gaps left by nearly a decade of QE. As a result, investors will increasingly demand elements of term premia along the yield curve, which we actively explore in *"Bond supply set to expand"*.

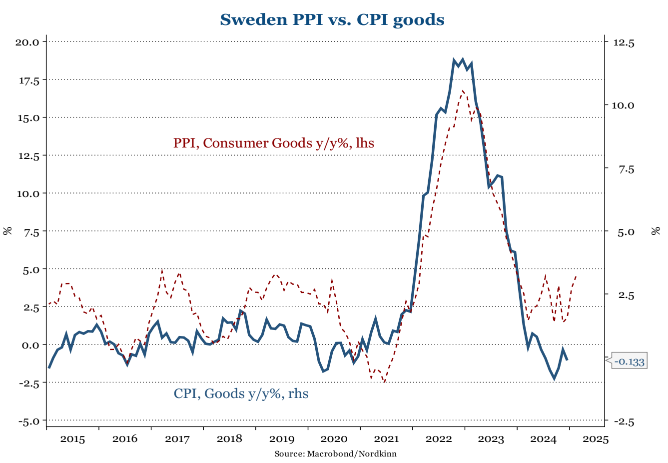
In Norway, with the central bank reaffirming its plan to cut the policy rate at its March meeting, the threshold for not following through appears high. The sharp decline in inflation throughout 2024 has reassured the monetary policy committee that it will soon be appropriate to begin easing monetary restrictions.

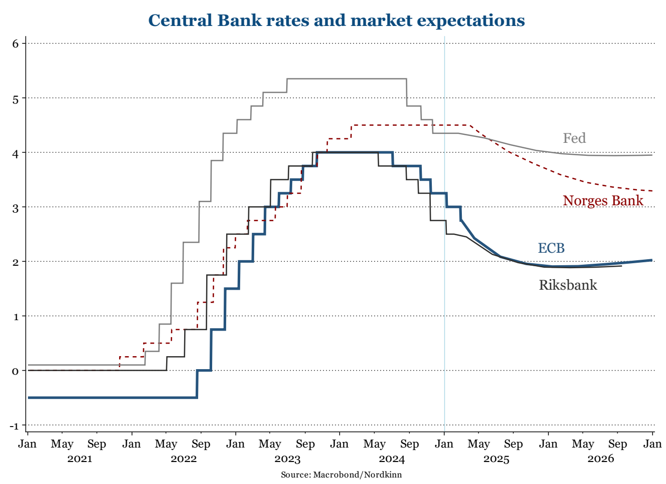
That said, Norges Bank expects inflation to remain above its 2% target through the forecast horizon (end-2027), warranting a continued restrictive stance. Moreover, with the economy and labour market in relatively good shape, the central bank sees no urgency to cut rates neither early nor aggressively. Instead, its motivation for easing appears to stem from concerns that maintaining restrictive policy for too long could create downside risks over time - risks that are unnecessary given the progress on inflation.

Norges Bank also appears convinced that the neutral rate is well below the current policy rate, as evidenced by sluggish performance in interest-rate-sensitive sectors such as housing investment and household spending. The economy has received a boost from petroleum investments as companies took advantage of pandemic-era tax breaks to fast-track projects. Looking ahead, petroleum investments are expected to plateau in 2025 and decline in 2026, weighing on growth. Interest-rate-sensitive sectors can counterbalance this trend, but only if interest rates come down.

Even if upcoming data confirms persistent inflation and resilient growth, we expect Norges Bank to cut rates at least twice in 2025, in March and June. However, if our forecast is correct and core inflation drops to 2.0–2.5% by summer - below Norges Bank's projections - then the central bank is likely to continue cutting at a quarterly pace, reaching 3.50% by year-end, even if the economy remains strong. Of course, if economic conditions were to weaken, rate cuts could be more aggressive, though that is currently not our base case.

Following the bond rally in January, we are tactically broadly neutral on Norwegian fixed-income duration. We see value in curve steepeners, and cross-market rate spreads. We express these views through our *"Norway: Path to looser policy"* theme.





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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