

NORDKINN

— ASSET MANAGEMENT —

Market Review & Outlook

February 2025

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Market overview

Global overview

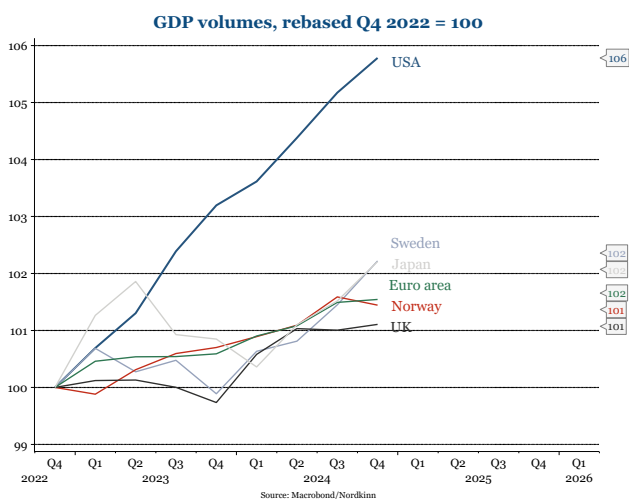
In February, trade policy uncertainty led market participants to recognise the downside risks to future policy rate changes from major central banks. In the U.S., data nonetheless confirm that GDP growth remains robust, see left-hand chart, primarily driven by resilient consumer spending. That said, Personal Consumption Expenditures (as well as prominent consumer surveys) have started to show signs of peaking. Additionally, labour demand seems to be moderating, which may explain why wage pressures have also eased recently. Importantly, PCE inflation continues its gentle downtrend and is now within ½ percentage point from the Fed's 2% target. Yet policymakers continue to speak in a cautious tone, given lingering uncertainties around the global outlook, not least trade policies.

Turning to markets, U.S. bond yields fell across all maturities, see right-hand chart. Money market rates dropped as markets scaled back expectations for more aggressive tightening scenarios, whereas the decline in longer-term yields reflected higher risk of slower growth and a reduced risk of fiscal policy mistakes than previously feared.

Meanwhile in the Euro Area, data revealed only tepid GDP growth and provided additional evidence of abating inflation. Furthermore, wage growth, though still elevated, seems set to normalise over the next few months. Nonetheless, as policy rates are approaching ECB's recently updated estimate of neutral (1.75% to 2.25%), some members of the Governing Council have become increasingly vocal about slowing the pace of rate cuts.

Euro Area yields moved in tandem with U.S. yields, but with short-dated rates falling a tad faster than long-dated equivalents. The EUR strengthened slightly against the USD, driven by expectations that fiscal policy will turn less restrictive and that the oft-heard threats of U.S. tariffs on EU from the new administration will prove to be less pronounced once they come into play.

All told, both in the U.S. and the Euro Area, February's data highlighted a delicate balancing act: Policy makers see encouraging signs on both the growth and inflation front, but with ever-rising geopolitical risks and deep structural challenges materialising, they also need to maintain optionality. For Nordkinn, these developments have produced interesting opportunities mainly in relative value space and resulted in a positive contribution to this month's return from our global theme "Geopolitical tensions impacting growth".



Nordic overview

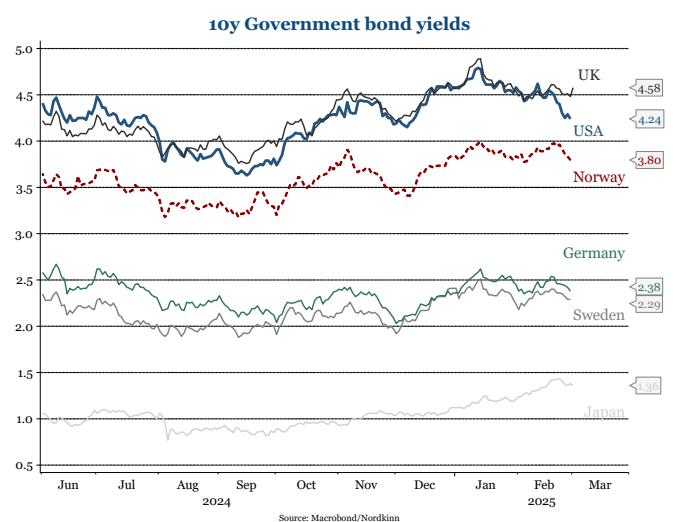
In Sweden, January inflation data came in higher than expected, with CPI excluding energy rising 2.7% compared to the same month last year, notably 0.6 percentage points above consensus. While part of the increase was explained by the reweighting of the CPI basket, price gains were broad-based. Key contributors included higher rents, rising food prices, and increased restaurant service costs. Additionally, subsequent release of PPI data and price plans signalled mounting price pressures, further dampening hopes for a swift disinflation.

Swedish GDP expanded by 0.8% in Q4 2024 compared to the previous quarter, outpacing analysts' expectations. Growth was primarily fuelled by robust exports, strong business investments, and household spending, marking the strongest quarterly expansion since Q2 2022. Despite this, consumer confidence weakened slightly, likely reflecting concerns over the inflation outlook and interest rates. Labor market data raised some uncertainties, as unemployment rose sharply. While this data is infamous for its volatility and measurement issues, it still raises concerns about the underlying strength of the job market.

Swedish interest rates declined, though to a lesser extent than those in the U.S. and Eurozone. Notably, market-based inflation expectations declined despite stronger-than-expected inflation data. Meanwhile, the Swedish krona (SEK) appreciated by approximately 3% against the EUR. In this environment, the theme "Bond supply set to expand" weighed on performance, while "After cuts come growth" provided marginal support. The overall economic picture remains complex, marked by rising inflationary pressures on one hand, and wavering confidence from lingering labour market concerns on the other.

In Norway, January Core CPI also exceeded expectations, rising 2.8% from January 2024 versus 2.6% expected by consensus and by the Norges Bank. Moreover, while non-energy GDP unexpectedly contracted by 0.4% in Q4 from Q3, most indicators suggest that the economy and the labour market remain in good shape. Indeed, the unemployment rate appears to have stabilised at a low level, while business confidence remains positive overall and consumer confidence is recovering amid real wage growth and expectations of looming rate cuts.

Norwegian interest rates rose sharply following the CPI report and the NOK exchanged appreciated meaningfully, at the start of February but retraced in the latter half of the month. Exploiting these movements both directionally and relative to other markets, the theme "Norway: Path to looser policy" contributed positively to the fund's performance throughout the month.



Outlook

Global outlook

The latest developments in global fixed income markets recognise near-term downside risks to global growth. For instance, in the U.S., yields have retreated from earlier highs, reflecting that the year began on a softer note for economic data, prompting investors to acknowledge two-sided risks regarding the Fed's policy path. Although abrupt, neither the Fed's communication nor forecasters' projections suggest that yields have fallen too far relative to fundamentals. Indeed, while policy expectations have pivoted toward a more dovish stance in the near term, a reasonable probability of further Fed tightening is still reflected in market pricing, given persistent questions about how quickly inflation might return to target. This question, in turn, is strongly tied to U.S. trade and fiscal policies, which already make it reasonably clear that any impact will push prices higher.

A patch of softer activity data, including downgrades to first-quarter growth estimates, underpins the moderation in U.S. yields. Although some of this stems from statistical aberrations—such as trade balance quirks—there is a modest deceleration in consumer spending growth, and a plethora of indicators produces a similar characterisation of labour demand. Barring positive near-term drivers of U.S. growth, our focus shifts to developments in capital formation, where tax incentives and AI-related investments may provide another growth spurt.

Markets have thus taken heed of policy uncertainty (see left-hand chart): New tariffs or other trade-related tensions could undermine growth but reignite inflation, reinforcing the sense that the Fed has ample cause to tread carefully. At the same time, the probability of a recession has risen based on statistical measures, option pricing, and subjective estimates from forecasters. This rebalancing of risks means the bar for a renewed upward push in yields is set somewhat higher.

In historical episodes of "growth scares," risky assets typically stabilise before yields reverse course, and the passage of time—during which new data either confirm or discard existing economic worries—often proves decisive. Consequently, the decline in U.S. bond yields may still have some room to run, especially in the cyclically sensitive 2–5-year segments where terminal rate pricing exerts a strong influence. That said, if economic data pick up steam again, markets will pivot swiftly.

Europe faces contrasting mix of macro drivers compared to the U.S., which should, on balance, drive yields higher over time, while keeping front-end rates pinned lower in the near term. One key development is the prospect of increased defence spending in several European economies, notably Germany, adding at least modest support to growth.

Many estimates suggest a rise in deficits of up to one percentage point of GDP, which should push long-dated yields higher, perhaps noticeably. The market has already started to price in a European fiscal expansion, but further clarity on the scale and timing of defence spending will be pivotal in determining how much further rates could rise.

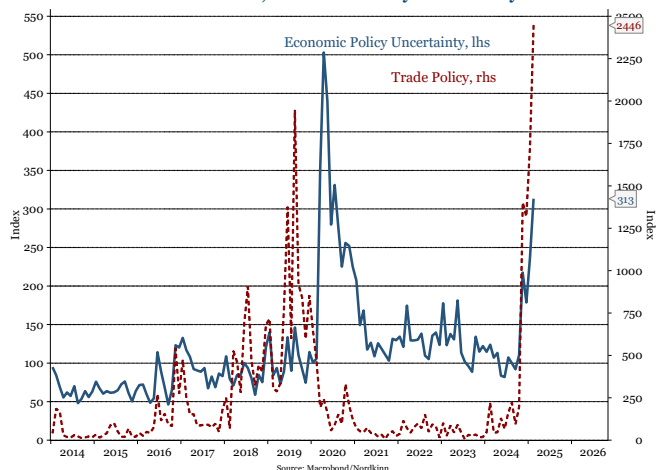
Admittedly, there are some tentative signs of growth momentum building in certain sectors, particularly consumption and parts of the struggling manufacturing industry. However, there should be ample room for growth before demand levels become inflationary. In addition, Europe is confronting significant tariff risks and lingering geopolitical concerns, which should weigh on growth. The disinflation process remains intact, and notably, even the persistently high services inflation has started to ease as wage growth embedded in labour agreements (both finalised and under discussion) normalises.

ECB officials apparently want to avoid forward guidance beyond the upcoming meeting, and monetary policy is explicitly contingent on evolving inflation dynamics and economic performance. Given weak demand, softening labour markets (albeit from strained levels), and continued progress on inflation, we nonetheless see the front end of the euro curve as biased toward further declines. The longer end, on the other hand, may start to reflect the implications of eventual fiscal expansions—especially if an improved geopolitical picture or an actual increase in government defence spending materialises. This tension produces a bias for a steeper yield curve: while the ECB pursues additional cuts, the prospect of higher deficits exerts upward pressure on longer-dated yields, see right-hand chart.

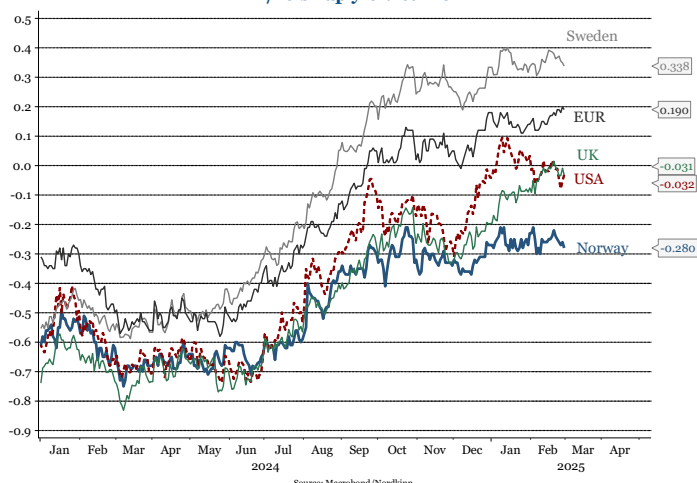
Overall and again, the range of possible outcomes is unusually wide, both in terms of growth and inflation. Similarly, investors are neither embracing a sustained bond rally nor anticipating a rapid rise in yields. Instead, markets are balancing softer growth indicators against residual inflation risk, as well as new fiscal and geopolitical realities.

From a Nordkinn perspective, this highlights the importance of being able to position selectively in rates and FX, rather than being restricted to directional bets. Relative value opportunities persist, and at the time of writing, for example, our long-held idea of steepening curves is especially relevant in Europe. We aim to profit from several such opportunities in our theme, "Geopolitical Tensions Impacting Growth." At the same time, we remain cognisant that the risks of sudden macro shocks—be they political, geopolitical, or environmental—demand prudent risk management.

United States, Economic Policy Uncertainty



2/10 swap yield curve



Outlook

Nordic outlook

The Swedish economy is finally and indeed showing stronger signs of recovery, with foreign trade, investments, and household consumption all driving a pickup in activity. Rate and tax cuts are expected to provide continued support as 2025 progresses. However, risks to the outlook remain. Foreign trade could be hit by rising tariffs, while higher household savings could limit the recovery.

The inflation outlook remains complex, making it challenging for the Riksbank to implement further rate cuts—at least in the near term. Later in the year, as the recovery gains further momentum, economic strength itself could become a barrier to additional easing.

Meanwhile, fixed income markets reflect low expectations for a rebound in growth and inflation. Yield curves remain flat, and market-based inflation expectations continue to suggest a rapid return to the low-inflation environment of the 2010s. We believe structural changes will trigger investors to, at some point, demand higher risk premia given the significant changes in the global economic landscape. For instance, protectionism is gaining traction, with nearshoring, supply chain redundancies, and trade tariffs driving production costs higher.

Furthermore, wage growth is roughly 50% higher than in the 2010s, further reinforcing underlying inflationary pressures in Sweden. The green transition is proving costly, as evidenced by sharp increases in producer fees for packaging recycling (Matpriskollen)—costs ultimately passed on to consumers. Climate change is another factor driving up costs. The continuous rise in insurance premiums reflect heightened climate risks, while poor harvests are already affecting food prices.

While these factors will fluctuate over time, ignoring these structural changes and assuming inflation will simply return to 2010s levels seems overly optimistic—especially without accounting for a potential surge in defence and infrastructure spending, which could further impact growth and inflation. Instead, we see a higher likelihood of structurally elevated inflation and/or interest rates. Given this backdrop, we maintain our Sweden themes “*Bond supply set to expand*” and “*After cuts comes growth*.” Positions in these themes stand to benefit from this scenario and/or from a shift where investors begin to demand higher risk premia in line with these structural changes.

Turning to Norway, we expect Norges Bank to reduce its key policy rate by 25 bps to 4.25% at the upcoming policy meeting on March 27th, in line with the forward guidance introduced in December and reaffirmed at the January interim meeting. Some monetary easing appears appropriate given the sharp decline in inflation throughout 2024, coupled with lower policy rates abroad. However, with inflation unlikely to stabilise sustainably at the 2% target anytime soon and challenging wage negotiations approaching, the key question is how many additional cuts, if any, we should expect this year.

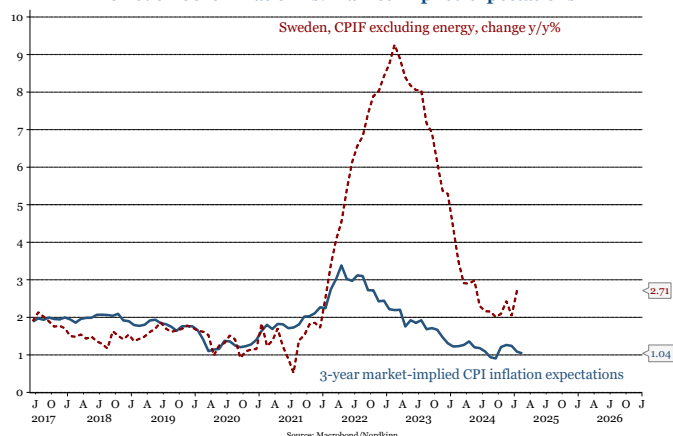
In the December monetary policy report, the central projection indicated 75 bps of easing to 3.75% by the end of 2025, with a higher probability assigned to 100 bps rather than 50 bps of cuts. Since then, January CPI inflation came in slightly above expectations, the unemployment rate has been lower than expected and wage growth in 2024 exceeded forecasts. All this suggest inflationary pressures could persist, see chart. As a result, the outcome of the 2025 centralised spring wage negotiations will be crucial in determining whether Norges Bank remains confident that inflation will return to the 2% target in a timely manner. However, these negotiations will conclude only after the March policy meeting.

Given this backdrop, at the monetary policy meeting in March, we expect Norges Bank to raise its projection for the key policy rate, signalling a total of 50–75 bps of cuts in 2025, compared to the 75–100 bps projected in the December report. We do not anticipate the central bank committing to a second rate cut until there is greater clarity on wage developments, resulting in more cautious forward guidance on further policy easing.

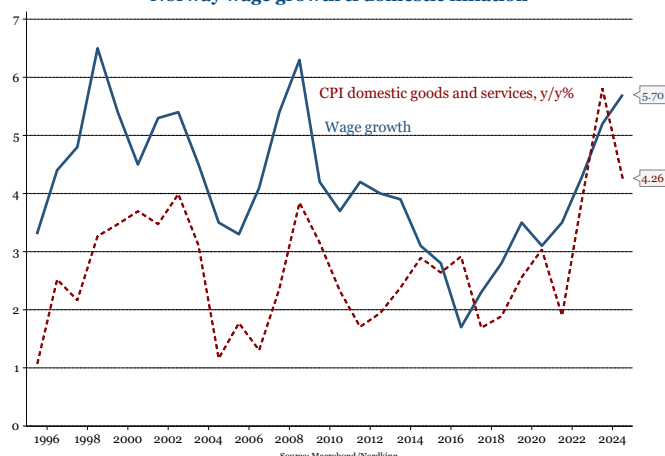
As always, external developments will influence the trajectory of NOK rates. Should global growth concerns intensify, and global rates continue to decline, Norges Bank is likely to accelerate rate cuts.

Overall, while uncertainties admittedly have risen, we remain reasonably confident in our near-term forecast that inflation will ease further through summer, justifying at least one additional 25 bps rate cut beyond March. Our preferred NOK rates trading range is between 50 and 100 bps of cuts this year, and our money market strategy is to fade movements toward the top and bottom of this range. Elsewhere, we continue to see value in forward-starting curve steepeners and cross-market rate spreads. We express these views through our “*Norway: Path to looser policy*” theme.

Sweden Core inflation vs. market-implied expectations



Norway wage growth & domestic inflation



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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