NORDKINN

ASSET MANAGEMENT

Market Review & Outlook

March 2023

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Market overview

Global overview

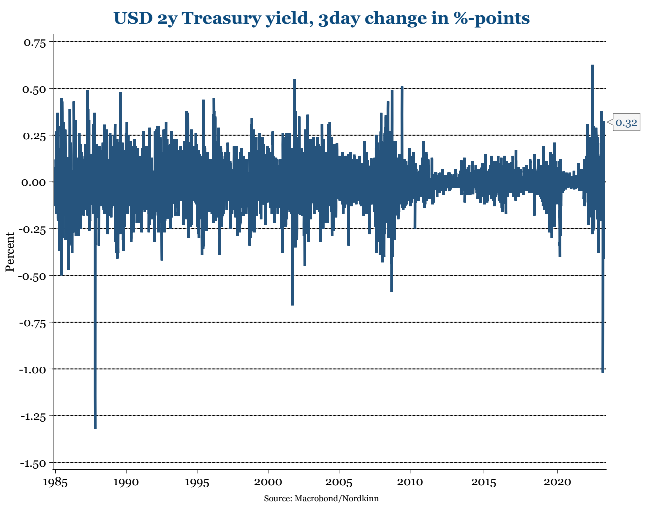
March 2023 proved another tumultuous period for financial markets. Market volatility increased dramatically in the aftermath of a run on deposits at three large regional U.S. banks: Silvergate bank, Signature Bank, and Silicon Valley Bank, which ultimately led to their failure and close by regulators. The banking sector jitters spread across the Atlantic and after a similar flight of deposits from the globally systemic important bank Credit Suisse, regulators effectively merged Credit Suisse with UBS Group in an attempt to stabilise the financial system. As a result, the TED spread, a key indicator of perceived credit risk in the banking sector, widened by as much as 20 basis points.

The broader banking sector also suffered, with bank stocks falling, in particular niche and regional banks. Despite the banking sector being hit and being completely detached from the high volatility on fixed income markets, risky assets performed with Nasdaq even entering a bull market towards month-end.

Interest rates worldwide experienced a spectacular decline, particularly in the 1-2 year segments, as market participants swiftly moved from expecting further tightening to discounting a central bank pivot sometime during the second half of 2023. The 2y U.S. Treasury yield plummeted more than 100 bps over three days in mid-March, the fastest decline since Black Monday in 1987, see chart. However, rates on longer maturities have held up relatively well, hence yield curves, which had previously been deeply inverted, steepened significantly during the month (but remain negative).

The Merrill Lynch Option Volatility Estimate (MOVE) Index, a measure of implied volatility in U.S. Treasury markets, surged from just around 125 by the start of March to close to 200 at the peak of the banking stress, before retreating to near 140 by month-end. These large and erratic movements in volatility underscore the uncertainty surrounding interest rates and the overall economic environment.

As previous large rises of energy are falling out of inflation calculations or even dropping in absolute terms, headline inflation in both the U.S. and Euro Area have begun to recede, while core inflation continues to come in higher than anticipated. In terms of macroeconomic data, the Eurozone faced negative surprises while the U.S. reported figures largely in line with, or even stronger, than expectations have suggested. To combat inflation, the ECB and the Fed both raised policy rates, with the ECB hiking by 50 bps and the Fed opting for a more modest 25 bps increase. The different pace of monetary tightening was reflected in currency developments, with the USD weakening against the Euro.



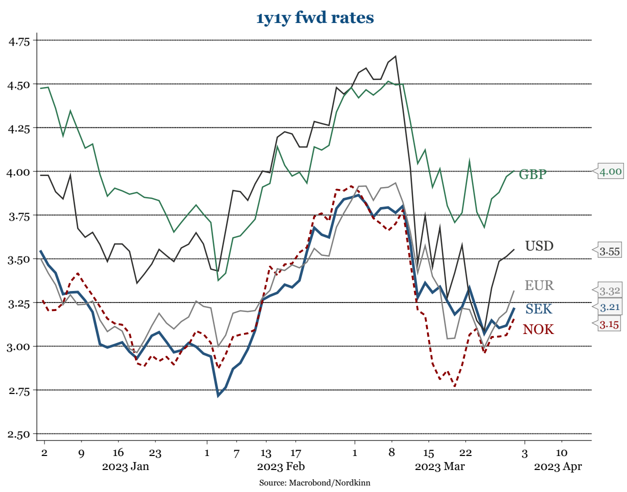
Nordic overview

There were no major events or news in Swedish macro landscape in March. Instead, attention was directed to banking and recession fears where market movements related to these in gyrations. Swedish macro data showed some slight improvements, like service PMI. Retail sales, on the contrary, plunged at a record pace in year-over-year terms. The month also saw another inflation print with super strong core. CPIF excluding energy surprised with a whopping 0.5% from the previous months, taking the year-over-year rate 1.3%-points above Riksbank's February forecast. Needless to say, pressure on the Riksbank did not ease. Nevertheless, for instance, the 2y government bond yield closed the month 30 bps below the level at the start of March. The slump in bond yields despite relatively strong economic and very elevated core inflation data are of course due to the financial woes and mounting recession risks overseas. The yield curve flattened somewhat while e.g. the U.S. curve steepened a lot. The move to safe haven did have a negative impact on our new theme *"Sweden: From QE to QT"*. In addition, the SEK had a tough month given the risk-off related to the financials fear.

The central wage negotiations intensified as the current agreement ran out at the end of the month. The first bid was rejected by the unions a week before the close. However, at the last day of the month the social partners agreed on a two-year deal, where wage increases equal to 4.1% the first year and 3.3% the second year. Although the deal is relatively subdued compared to agreements closed in other economies, it is still the highest on record. While it will not make the Riksbank overly anxious (a two year deal), it will still lift the average underlying inflation compared to the post great financial crisis era.

Norwegian interest rates outperformed peers in the first half of the month, reflecting among other a larger than expected decline in CPI inflation for February, having surprised significantly to the upside in the previous month. The drop in core CPI inflation in February can be attributed to tough competition between the largest grocery chains and is probably short-lived.

NOK interest rates rose and underperformed peers later in the month, following Norges Bank's decision on March 23rd to hike the key policy rate to 3.00% from 2.75% and lift the projection for the policy rate by more than 50 bps. According to the updated projections, the policy rate will peak between 3.50% and 3.75% in the second half of this year. Barring a substantial change to the outlook, the Bank intends to raise the key policy rate again by 25 bps in May. Notwithstanding higher rates towards month-end, expected future short-term rates, such as the 1-year rate starting one-year forward, remained below peers, see chart.



Outlook

Global outlook

While the acute financial stress associated with the collapse of the three U.S. regional banks and a forced high-profile European merger has thankfully receded, recent events are likely to impact tightening of lending conditions for households and corporates that could weigh on growth. To be sure, even prior to the banking turmoil, indicators such as Conference Board's Leading Economic Index have already warned about future recession risks for some time (see left hand chart). Although resilient GDP and labour market data have put these predictions into doubt, the risk of an imminent recession could flare up again unless stability in the banking sector is restored.

Over coming months, however, we will not be surprised if labour markets were to remain strong, with continued low unemployment and robust job growth above or in line with what is long-term sustainable. This strength rests upon the ongoing economic recovery following the pandemic and a resilient demand for goods and to an increasing degree services. History also show that tightening of monetary conditions often affects the economy with considerable lags. However, tight labour markets also lead to increasing wage pressures (see right hand chart for the U.S.), as employers compete to attract and retain talent. We have no doubt that tight labour markets have already contributed strongly to core goods and service price growth above what is compatible with inflation targets.

Due to the arithmetic effects of decelerating energy price growth when calculating overall inflation, it is all but certain that headline inflation will moderate over the coming few months. While financial market participants seem torn on what measure to focus on, central bank policy makers point squarely on elevated core inflation (and -expectations). The persistently high core inflation is driven by the strong labour markets mentioned above, as well as second round effects of global supply chain disruptions and rising production costs. As core inflation remains stubbornly high, central banks may be compelled to take a more aggressive stance on monetary policy than what financial markets currently expect, leading to additional policy rate hikes and for rates to remain on higher levels for a longer period of time.

This, of course, contrasts with the recent sharp drop in rates on short duration bonds. However, we attribute this move to the banking stress and subsequent recession fears. Given stronger regulatory oversight since the financial crisis (especially in Europe), we believe central banks can confidently address both inflation with higher interest rates and flaring liquidity stress with targeted measures, without returning to broad interest rate cuts. That said, risks are elevated and a number of overlapping developments will need to unfold:

1) Stabilisation of the banking sector:

Financial institutions need to regain stability and bolster market confidence. Blunt force intervention, such as the disputed merger between Credit Suisse and UBS in March, actually may not help in this regard. Instead, more nimble regulatory steps are preferable and increase transparency on the root causes of the banking sector stress, e.g., banks' exposure to liquidity and interest rate risks.

2) Easing recession fears and continued credit expansion:

A swift deterioration of sentiment indicators or demand and supply of credit will imply that weaker economic developments are imminent. In addition, robust macroeconomic data, such as decent GDP growth rates, continued strong labour markets and improving sentiment, will be needed to lower recession fears.

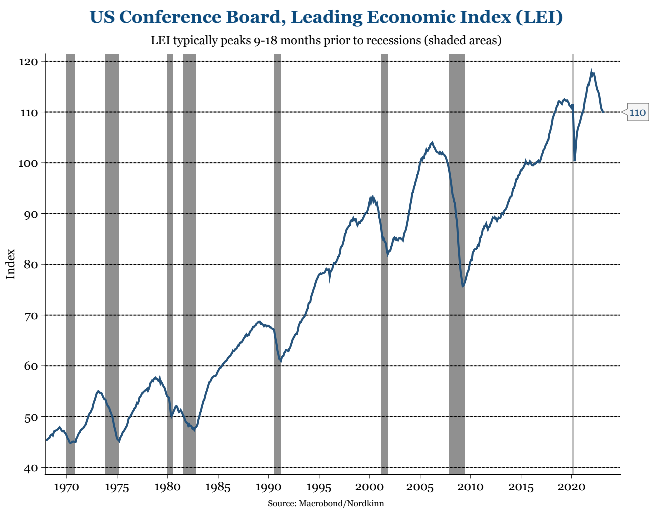
3) Affirming central bank communications:

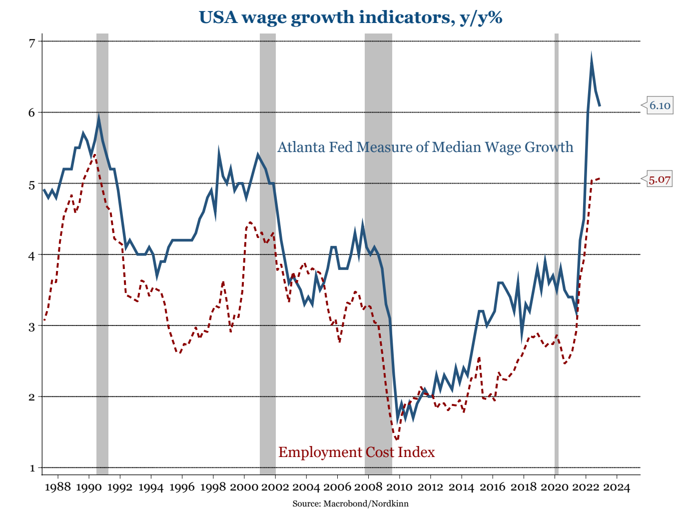
Unfortunately, central banks have been unwilling to maintain a clear and confident forward guidance in the current turmoil. Assuming the banking sector stress continues to decline, the communication from central banks regarding their policy intentions and commitment to addressing inflation should firm, which is essential for shaping financial market expectations. If central banks are seen to successfully balance between fighting inflation and avoiding a recessionary outcome, interest rate variance is set to narrow.

Recent events highlighted our long held idea of central banks *"Hiking into recession"*, a theme we have managed to benefit from in the short time period following the flaring banking stress. This theme will benefit from central banks stubbornly bringing down inflation via weaker labour markets.

Towards the end of March we reallocated risk to our "*Easing of inflation*" theme, which among other things seek to profit on the idea that receding inflation pressures will come in many forms and shape as we, e.g. expect the rigid labour market in the Euro Area to result in inflation being much more persistent than in the U.S. This theme is also interesting from the perspective that it complements our portfolio with an economic hedge against many of our other themes and positions.

Finally, with financial markets stress gradually decreasing and inflation likely to remain sticky, we expect Break Even Inflation rates to recover from losses in March and support our global theme *"Comparative inflation expectations"*.





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In early April, the Riksbank will start selling government bonds as part of their QT program. It will mark the final step in central bank's turnaround of monetary policy that begun in 2022. Swedish government bonds (SGBs) remain expensive relative to other sovereign bonds, especially when comparing with Norwegian NGBs, see chart.

After several years of QE the Riksbank holds a large share, roughly 50%, of nominal government bonds. This has resulted in a scarcity of 'risk free' bonds. Hence, there will be some holes of lacking government bonds to fill but, in our view, the significant shift in issuance will gradually result in cheaper bonds and steeper curves. At least relative to other markets. The market seems however a bit complacent, being used to a price-unsensitive buyer that has absorbed, more or less, all interest rate risk that has been issued in the Swedish fixed income markets over the last years. Note that when covered bonds, municipal bonds etc are issued the risk is usually swapped to floating, which means no net issuance of interest rate. The Swedish fixed income market will enter a new phase with a lot more interest rate risk to be digested by investors. Time will tell how it will impact bond pricing, but we are certain that it will. Our belief that QT will grow critical for the Swedish fixed income market, is addressed in our theme *"Sweden: From QE to QT"*.

Riksbank will also hold its second monetary meeting this month. Going into this there is no doubt that the central bank's core inflation projection from February will be revised up. A lot. The February CPIF ex Energy data was 1.3 percentage points above the Riksbank's forecast and the gap will most likely widen further when March data is released by mid-April. On the same note, the industry wage agreement, which is the (bench-)mark for the rest of the labour market, gives the Riksbank some breathing room since it is a two-year deal. Yet, it is the highest central agreement on record (after 1997) and will lift the underlying domestic inflation pressure. The Riksbank's projections for wage growth will be lifted. The era after the Great Financial Crisis when core inflation averaged 1.4-1.5% will most likely not return. At least not in the next few years. On the positive side, goods inflation seems to have peaked globally and there are also tentative signs that food prices are getting closer to peak, judging by agriculture commodity prices and signals from the industry.

In all, we believe that the Riksbank will resume hiking at the April meeting. The size, 25 bps or 50 bps, will be decided by the inflation data released by mid-April.

In Norway, the drop in year-over-year headline and core inflation to 6.3% and 5.8% respectively was a positive surprise but is in our view unlikely to mark the beginning of a sustained disinflationary trend.

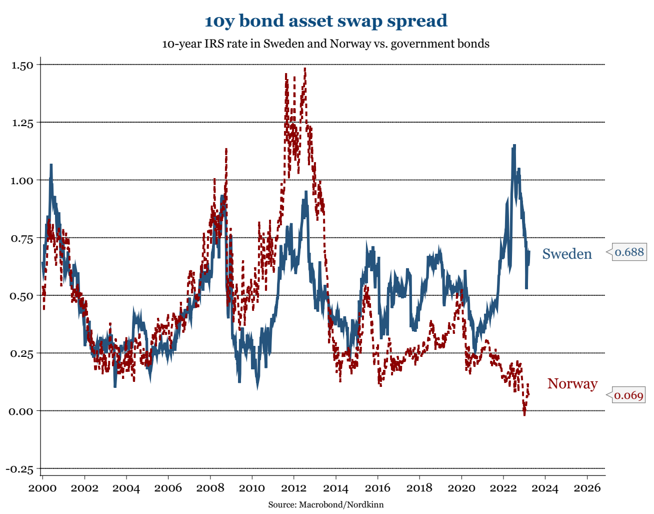
First, the bulk of the surprise decline in February CPI can be attributed to tough food competition, as Kiwi – one of the three largest discount chains – surprisingly chose not to raise prices in February with the aim of increasing its market share, forcing the other large chains to follow suit. This appears unsustainable. Food prices in the CPI basket have increased by only around 15% since early 2021, while producer prices are up a whopping 30%. Consequently, we expect grocery chains to raise prices significantly in July instead. Supermarkets in Norway raise prices twice a year, in February and July.

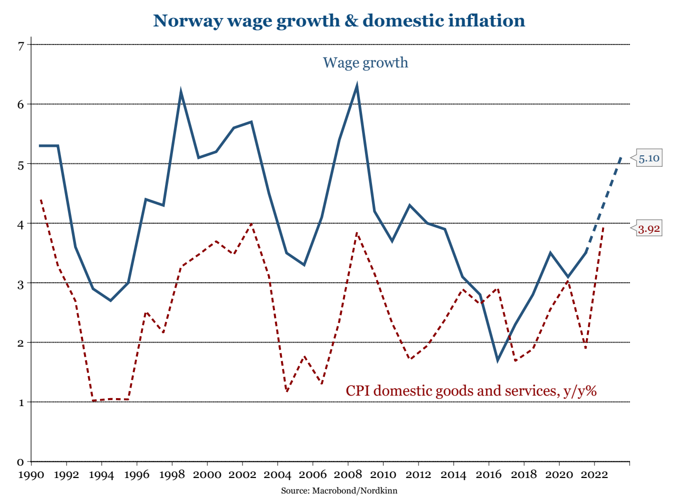
Rental prices are another laggard, accounting for more than 20% of the CPI basket. These prices tend to lag total CPI by about a year on average, which is naturally given that property-owners are allowed to adjust rental prices with CPI once a year. In February, the 12-month rise in rental prices was 3.4%, merely half the increase in total CPI. Consequently, we anticipate a faster increase in rental prices in coming months.

Furthermore, the 15% depreciation of the import-weighted NOK exchange rate since a year ago, most of which has occurred in 2023, implies upward risk to prices on imported goods and services going forward. There are probably multiple reasons behind the NOK depreciation, but lower expected interest rates relative to trading partners is certainly one of them.

Finally, wage growth turned out higher than expected in 2022 and will most likely surpass 5% in 2023 as labour unions demand improvement in purchasing power, and it will be difficult not to meet those requirements given tight labour market conditions and disappointing real wage growth in 2022. This will contribute to sustain higher price growth on goods and services produced domestically, see chart.

Taken together, the outlook for future inflation has deteriorated in Norway and there is an increasing risk that inflation will become entrenched. The investment implication is that we expect Norges Bank to pursue a more hawkish, inflation-focused monetary policy stance ahead than it over the past several months. Against this background, with effect from early March we decided to open a new Norwegian investment theme *"Sticky inflation"*. We simultaneously decided to terminate the theme *"Weaker growth dampens policy rate"* that has served the fund well since it was introduced in September last year.





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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