Market Review & Outlook

May 2023

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Market overview

Global overview

The start of the month of May in fixed income markets largely continued the trajectory established in April, featuring relatively minor fluctuations within an overall declining trend in rates. This trend was primarily a response to softer macro data and concurrent depreciation of the USD. However, with the release of data showing elevated inflation expectations and, more notably, a revival of retail sales, a significant revaluation of U.S. interest rates was initiated. This move created a ripple effect, pushing global interest rates upwards, further fuelled by a surprisingly high UK inflation print later in the month.

Additionally, and around the same time, the discourse regarding the potential lifting of the U.S. debt ceiling began to intensify, as time began to run scarce. This development particularly caused shorter-term rates to climb. For the very shortest Treasury bills, the risk premium associated with a possible default was clearly factored into the price. Consequently, U.S. credit default swap (CDS) rates also escalated significantly, at times surpassing even those of frequent defaulters like Greece, Brazil, and Mexico. In a somewhat counterintuitive "flight to quality", the risk of a U.S. default has also resulted in a gradually strengthening of the USD, a development that in turn was further fuelled by the relative strength of U.S. data.

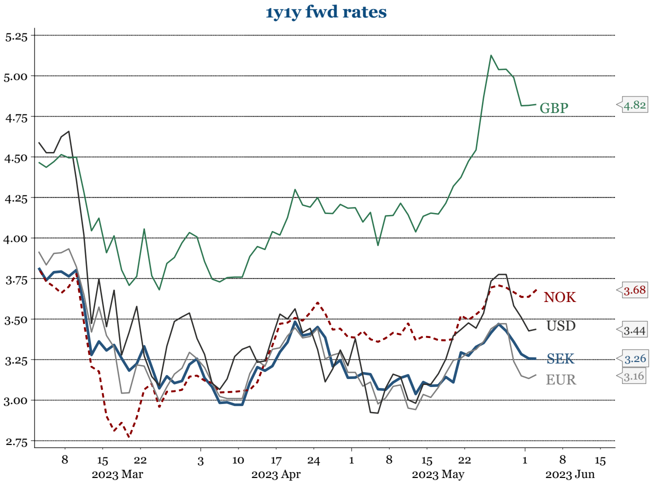
As U.S. data continued to surprise positively, several Fed officials have implied that a June rate hike is a viable possibility, despite chairman Powell's signalling of a pause in June at the press conference following the April FOMC meeting.

The latter part of May experienced both heightened volatility, and rising interest rates on nearly all maturities pushing rates to end the month higher than at the start of it. As the risk of a U.S. recession was pushed to the background, bond market yield curves consequently flattened during the month. Against this background, our *"Global: Easing of inflation"* theme subtracted from performance. However, this was partly offset by gains in *"Global: Comparative inflation expectations"* thanks to higher real rates and favourable inflation carry from CPI linked bonds.

Another crucial turning point occurred on Saturday, May 27th, when the Biden Administration and the Republican-dominated House of Representatives reached an agreement to restrict federal spending and lift the debt limit. This has already counteracted some of the aforementioned trends.

A final observation during in the month in review is the lacklustre performance of the Chinese economy in response to its reopening, raising concerns on its longer-term impact on global growth.

1y1y fwd rates



Source: Macrobond/Nordkinn

Nordic overview

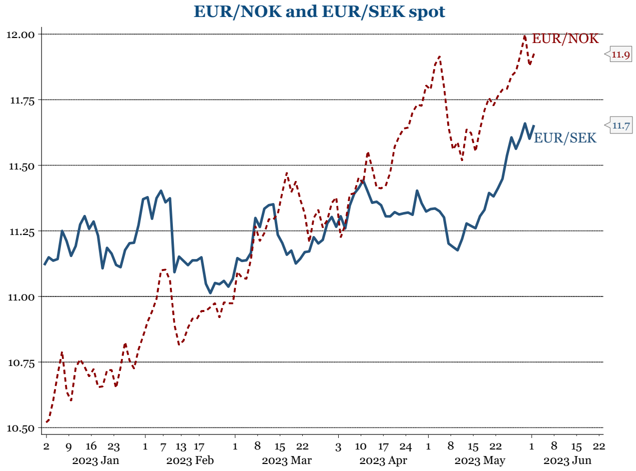
In May, Swedish data releases revealed a combination of weaknesses (PMI) and signs of recovery (retail sales). However, the overall impact was negative, as illustrated by Citi's Surprise Index reaching an all-time low. As regards to the impact on Swedish fixed income market, the primary influential factor was the lower-than-expected inflation data released earlier in the month. This surprise set the tone for the entire month, leading to Swedish government bonds outperforming and the SEK to depreciate. The market's response was in line with the dovish stance expressed during the Riksbank's late April meeting, which likely contributed to the increased demand for SGBs and the record high EUR/SEK in May. Consequently, the fund's performance was adversely affected by the *"Sweden: From QE to QT"* theme, as well as *"Reality Bites"* suffering from flatter yield curve.

Towards the end of the month, the National Debt Office (NDO) released its forecast on future borrowing needs, which indicated an unexpected increase in government bond supply, with a SEK 5 bln increase this year and an additional SEK 10 bln in 2024. While not significant amounts, it signals both higher future borrowing needs and a shift from short-term to longer-term debt. Initially, the market had a limited reaction to this news. However, as Riksbank speeches later in the month expressed concerns about the weak SEK and the possibility of accelerated bond sales in the QT, SGBs gradually reversed some of their earlier gains.

Incoming data for the Norwegian economy continues to reveal fairly strong performance with ongoing moderate growth in GDP and low and stable unemployment. Meanwhile, CPI data posted another upside surprise with core inflation rising to 6.3% in April, with broad-based contribution across items. The weakening of the NOK exchange rate continued in May following a further 2% depreciation measured against a weighted average of trading partners, bringing the total loss so far in 2023 to 13%. This move sticks out in relation to other G10 currencies and has been subject to extraordinary attention by the Norwegian media as well as international investors in recent weeks.

At its meeting on May 3rd, the monetary policy committee of the Norges Bank decided to raise its key policy rate by 25 bps to 3.25% as expected. In the accompanying statement, Governor Wolden Bache said that "a higher policy rate than envisaged earlier may be needed" if the NOK remains weaker than projected or pressures in the economy persists. Consequently, Norwegian interest rates rose a little more than Eurozone and Swedish rates, but broadly matching the move in U.S. rates in May. Our theme *"Norway: Sticky inflation"* resulted in virtually flat performance during the month in review.

EUR/NOK and EUR/SEK spot



Source: Macrobond/Nordkinn

Global outlook

Our long-held view of macroeconomic developments is that the U.S. economy is slowly but surely moving towards a recession. Other large economies are expected to follow suit and, hence, inflation and interest rates are set to ease over the coming year(s). That said, as labour markets keep remaining historically tight, we expect core inflation to demonstrate considerable "stickiness", while headline components, i.e. prices mainly related to food and energy, to come down more swiftly in the near term. To some extent, this should also hold true for cost pressures stemming from covid-related disruptions of supply chains.

As labour market dynamics are very different from economy to economy, the disinflation process (in core measures) should nonetheless be quite different, once the immediate impact of lower food and energy prices has passed. Additionally, long-lasting disinflationary forces such as globalisation (see chart), demographics and energy supply are now going into reverse, both for temporary and enduring reasons, which further complicates the disinflation process.

For all the above reasons, the demand-supply nexus that eventually decides the rate of inflation, has rarely been cloudier. In essence, financial markets participants have settled on three main scenarios, which we can label "hard landing", "soft landing" and "no landing".

Hard landing proponents expect a recession to be imminent and more or less unchanged inflation dynamics from the pre-pandemic covid era. This would imply a high risk of swiftly rising unemployment rates, dropping (core) inflation and central bank cuts even before year-end. Currently, as the financial stress from the SVB-fallout in March has subsided, this view has lost a great deal of support and there is now only a slim chance of a Fed rate cut priced before year-end. To us, the very tight labour markets and the structural factors mentioned above have always made this scenario the least convincing.

The soft and no landing scenarios are quite similar in economic terms, implying a more gradual relaxation of labour market tightness and wage and core inflation, or perhaps not at all (if considering the no landing scenario, in extremis). The extreme case is perhaps the least probable, in our book, as a continued historically tight labour market would not allow for wage and cost pressures to subside, but probably re-accelerate instead, as inflation expectations would surely rise in response.

Our main hypothesis, reflected in our overall positioning, is closest to a soft-landing scenario. Fed and other central banks have hiked rates aggressively of the past year and investment plans as well as credit growth have begun to wane among corporates.

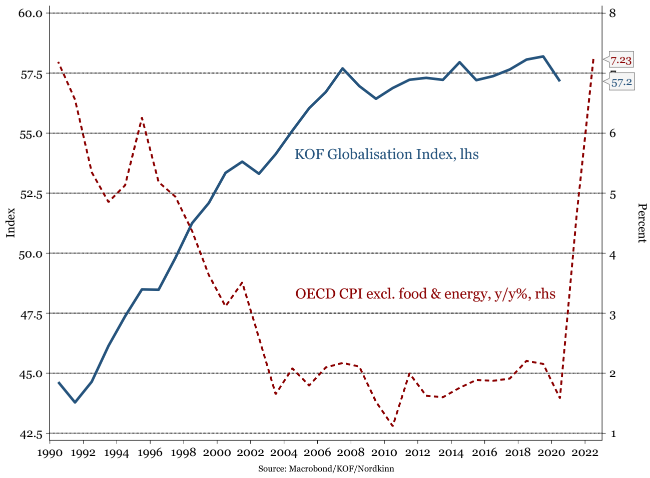
Quitting rates (i.e. persons voluntary quitting a job without necessarily having signed a contract for new job) are trending downwards, and so are job openings and employment growth, see chart. Hence, inflation is indeed expected to drop near-term, but we are less certain that the current monetary policy stance is sufficient to get inflation down all the way to targets in a timely manner. The risk of further policy tightening is high and the idea of a reversal to upcoming policy rate cuts is, to us, premature. Given sticky core inflation, we expect the Fed and other central banks to want continuous confirmation of easing inflation as one of the few monetary policy conclusions we can draw from previous high-inflation eras is the risk of cutting too much, too soon.

Drilling somewhat deeper into global developments, we see some economies as more or less prone to deviate on either side of the general trend described above. Here, national idiosyncrasies will be key to understand regional differences in inflation dynamics.

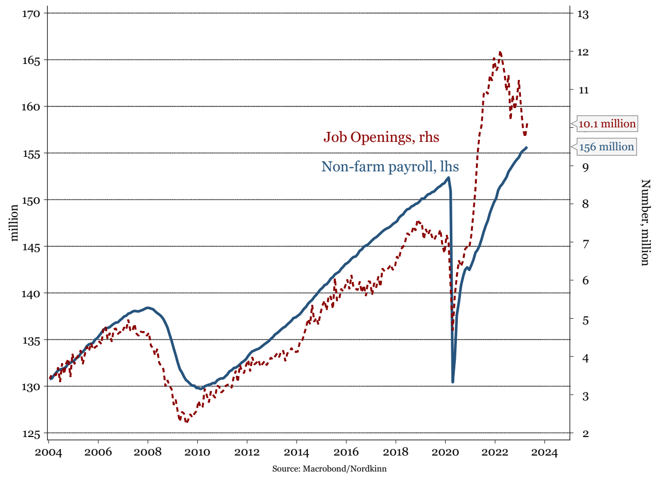
The Euro Area, for example, is considered to have a quite rigid labour market structure. This means that social security nets are strong and response of wage growth to labour market developments is weak, in particular on the downside. This also implies that business cycle swings often are slower and longer than in e.g. Anglo-Saxon countries. In the U.S. and the UK, labour markets are highly flexible, which in the current economic context suggests that when the unemployment rate starts to rise, inflation will also come down quicker than in e.g. mainland Europe. Consequently, the Fed and Bank of England should be able to respond quicker to any weakness in comparison to ECB.

Let's sum up our outlook by discussing some of the main economic risks to our views and positions, which concurs with the soft landing scenario. Both a soft and hard landing scenario should imply a steepening of interest rate curves, why our portfolio undeniably is most vulnerable to a no landing scenario. Admittedly, and as recent data underline, a no-landing scenario is a non-negligible risk. However, the real key is how inflation expectations would respond to such a scenario. Our belief is that inflation expectations and wage growth will rise in such a scenario, necessitating a strong monetary policy response, leading to an eventual recession. However, developments in measured inflation expectations, be it for households, companies or markets, have remained very well-anchored throughout this period of high-inflation. This remains a key issue to closely monitor. By e.g. pushing our steepeners out the curve and into forward space, we dynamically seek to protect the portfolio against a no-landing scenario.

Globalisation index and CPI inflation



USA Job openings versus non-farm payroll



Outlook

Nordic outlook

The weakening of the SEK has gained attention in the market and domestic media. During the February monetary policy meeting, the Riksbank stressed the importance of preventing rapid depreciation of the currency. However, the rhetoric at the April meeting seemed to downplay the currency's impact on inflation once again. It is evident that the Riksbank's monetary policy lacks symmetry. Even a slight deviation below the inflation target was met with a negative policy rate and substantial bond purchases. However, with underlying inflation now more than four times the target (8.4%), the policy is being implemented with greater caution, particularly regarding Quantitative Tightening (QT).

In recent Riksbank speeches, board members have discussed the possibility of addressing the weakening SEK by increasing QT volumes. The current volume is SEK 3.5 bln per month. The rationale is that higher interest rates and term premia could attract capital inflows and improve the functioning of the fixed income market, which in our view is also crucial for foreign involvement in the Swedish bond market. While this completely differs from the previous Riksbank approach, an increase in QT volumes is entirely plausible.

The weak SEK presents challenges for the central bank. Further rate hikes risk derailing the domestic economy, while a dovish stance risks further depreciation of the currency, amid a high core inflation. A potential compromise could involve pausing the hiking cycle, gathering more information, and increasing QT volumes. Unlike rate hikes, longer-term interest rates have a limited direct impact on households due to the vast use of flexible interest rates on mortgages.

Moreover, despite the weak SEK, PMI data suggests limited support for the export sector as new orders remain pessimistic. The NIER's Economic Tendency Index shows less negativity, making it uncertain where the export sector is heading. But if the manufacturing sector weakens significantly due to slower global growth, few sectors in the economy will contribute positively. This could prompt the Riksbank to cut rates earlier than other central banks. The labour market also here remains a key factor to monitor.

We anticipate the yield curve will eventually steepen as lower short-term rates are factored in, while increased bond supply due to higher borrowing requirements and QT could keep longer-term interest rates slightly higher than expected. The themes *"From QE to QT"* and *"Reality Bites"* seek to capitalise on these domestic outlooks.

In Norway, the relentless, consistent decline in the NOK exchange rate has also attracted significant attention in the Norwegian population, from households and politicians, to businesses and financial market participants. Some consider the depreciation a conundrum, while others propose explanations that seem to correlate with their political point of views. For instance, those voting for political parties on the centre-right economic axes criticise the government for pursuing an industry hostile policy involving unexpected tax increases for many businesses, while voters on the Green party seem to believe that Norway's oil and gas policy is to blame. This only illustrates the significant uncertainties associated with the factors behind the NOK weakness in 2023.

In our view, three key factors explain the unprecedented depreciation seen this year, although there are most likely other forces at play, too. Firstly, relative monetary policy seems to matter. The chart illustrates that currencies (EUR and GBP) where interest rates have risen more than U.S. rates during the past 12 months have performed well, while interest rate laggards (AUD and in particular NOK) have depreciated the most.

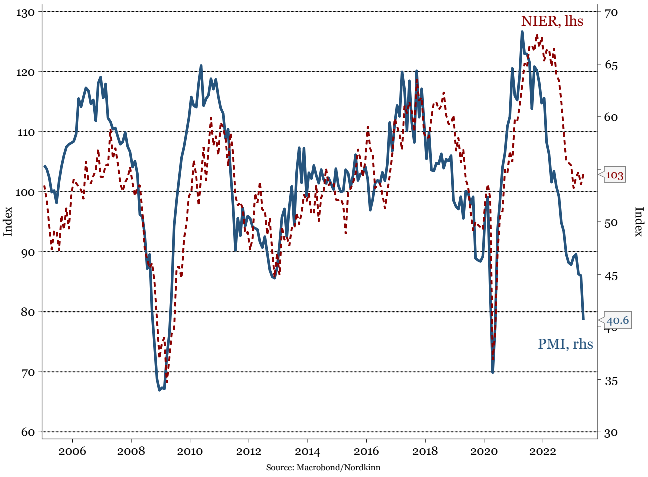
Secondly, the consistent, daily foreign exchange transactions conducted by the Norges Bank on behalf of the government may have reinforced the NOK weakness in an environment of thin liquidity, even though these flows should be more than offset by energy companies' NOK purchases over longer horizons. Thirdly, gas prices have dropped significantly during 2023, reducing energy companies' tax payments in NOK.

Looking ahead, we expect some of the NOK headwinds to turn into tailwinds. The risk to inflation remains very skewed to the upside in our view, reflecting lagging rental and food prices, higher wage growth and the weak NOK. As a response, we look for several more hikes by the Norges Bank at a time when other central banks are slowing down.

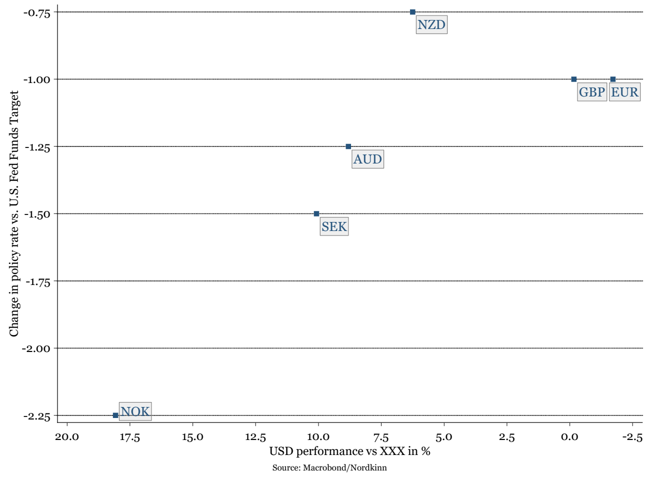
Secondly, the Norges Bank is cutting their daily FX purchases and will continue to do so over the summer, bringing energy-related FX transactions into better balance. Finally, the IEA has warned that energy markets are tightening, reflecting higher than expected demand and supply cuts by OPEC+, which could support energy prices ahead.

Taken together, we have scaled into long NOK positions in currency space and remain exposed to money market curve flattening trades under our *"Norway: Sticky inflation"* theme.

Sweden business surveys, PMI versus NIER



12-months FX and policy rate performance vs USD



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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