Market Review & Outlook

October 2023

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Market overview

Global overview

In October, yield curves continued to steepen, primarily due to increasing of risk premiums associated with holding bonds with longer maturities, known as term premia. This trend was accentuated by robust U.S. economic data: As many Fed officials have expressed their preference for maintaining the current policy rate levels for an extended period, strong U.S. data exerted a significant influence to increase longer-term rates.

During October, our portfolio benefited from steepening yield curves, particularly within our Swedish investment themes. These developments reinforced our long-standing belief in increased divergence of economic fortunes. This divergence is driven by a confluence of factors, including tight monetary policies, contrasting fiscal approaches, and differences in institutional settings such as labour market dynamics in various economies.

In Europe, in contrast to the U.S., short-dated bond yields decreased in response to weak economic data and a gradual disinflation path towards set targets. Consequently, it was the shorter end of the yield curve that triggered tendencies toward curve steepening in Europe.

Notably, at its monetary policy meeting in late October, the ECB's Governing Council decided to maintain its status quo, citing weakening economic activity, rapidly declining inflation, and lingering effects from previous interest rate hikes affecting the real economy. The market interpreted the ECB's communication as a sign that the central bank had passed its peak and that its next move might be a rate cut. This stands in contrast to the Federal Reserve, where there is still a possibility of an interest rate hike in December due to strong economic data.

Looking ahead, the divergences between the U.S. and Eurozone markets have become increasingly interesting. The U.S. market continues to anticipate a "higher for longer" scenario, while European markets do not share this sentiment. Given these dynamics, we have closed our *"Global: Easing of inflation"* theme. To capitalise on emerging divergent market trends, we are introducing the new theme, *"Global: From disinflation to divergence"*. This theme will focus on relative value trades across both fixed income and FX.

Furthermore, as we believe that any rapid disinflation process could challenge central banks' "higher for longer" policies, we are also closing the theme *"Global: Too soon for dovish pivot."* Additionally, because trading positions in the theme *"Global: Comparative inflation expectations"* have gradually become more Sweden-centric, we are renaming it to *"Sweden: Future inflation underpriced"*.

Nordic overview

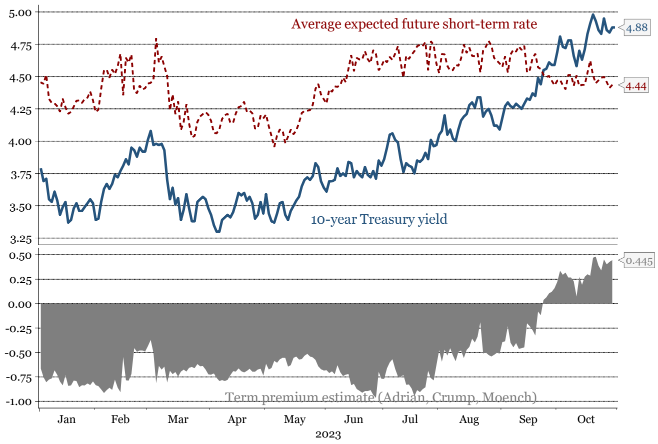
Early in the month, Swedish interest rates mirrored the global upward trend in bond yields, driven primarily by robust U.S. economic data and an increasing supply of U.S. Treasury bonds. In addition, Swedish CPIF excluding energy eased less than expected to 6.9% year-over-year, reinforcing the upward momentum in Swedish bond yields. However, later in the month, the Swedish market shifted its focus to a faster-than-anticipated disinflation process and weaker economic data in Europe. This shift was underscored by the relatively relaxed stance of ECB officials. Consequently, and despite higher-than-expected CPI inflation in Sweden, the Swedish yield curve steepened in line with developments in Europe, with the 5-year segment significantly outperforming the 10-year segment. In the meantime, Swedish government bonds (SGBs) continued to gradually underperform swaps, while the performance of covered bonds relative to SGBs paused in October. Nevertheless, the Swedish themes *"From QE to QT"* and *"Reality bites"* performed well, primarily reflecting the lacklustre performance of SGBs and the steepening of the yield curve.

In the foreign exchange market, the SEK lost ground against the EUR and the USD after strong performance in the second half of September. Consequently, the FX hedging measures implemented by the Riksbank had limited impact on the SEK during the month. The persistent challenges from SEK weakness raise concerns for the inflation outlook, a matter of significance for the Riksbank. This situation makes the subdued pricing of Swedish inflation, relative to Europe, even more remarkable.

Norway experienced a notable drop in September CPI inflation, with a surprising decrease from 4.8% to 3.3% year-over-year, partly attributed to reduced electricity prices. Additionally, a significant decline in core (CPI-ATE) inflation from 6.3% to 5.7% also played a major role in this downturn. While food prices exhibited a more substantial decline than usual in September, the unexpected decrease was widespread, affecting both core goods and core services, which fell short of expectations.

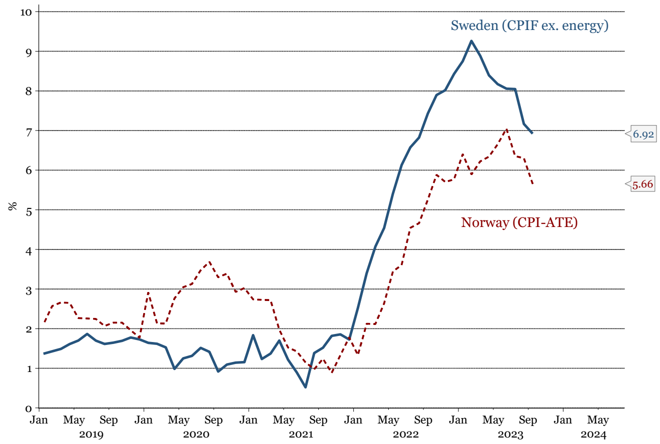
Meanwhile, economic indicators, such as GDP for August and Retail Sales for September, continue to exhibit subdued performance, slightly weaker than the forecasts by the Norges Bank. As a response to the low CPI figures, market interest rates saw a sharp decline, aligning with our *"Norway: Break before it breaks"* theme (now replaced by *"Quick progress towards target"*). The combination of lower NOK rates and a sell-off in global bonds and equity markets led to a considerable depreciation of the NOK during October. Later in the month, concerns arose in the market regarding the potential impact of a weaker NOK on the sustainability of the recent inflation easing, prompting rates to rise again. Notably, they underperformed relative to SEK and EUR rates.

U.S. 10-year bond yield decomposed



Source: Macrobond/Nordkinn

Underlying inflation, Norway and Sweden



Source: Macrobond/Nordkinn

Outlook

Global outlook

Going into October, our impression was that the rise and subsequent easing of inflation, as well as concurrent interest rate moves, have been synchronised throughout all major markets. The rise of the term premia was no exception and we saw little evidence of markets starting to differentiate between disinflation processes or economic developments in response to the massive and swift rise in interest rates across durations and economies with unique institutional settings.

Admittedly, if long term bonds are, in essence, the average of expected future return of short-term yields, it should come as no surprise there is a strong common component in rate developments both over time (curves) and space (countries). That said, underlying this generic central bank view are assumptions of perfect, frictionless markets and, consequently, a very small role for supply and demand imbalances in explaining long-term yields. However, with recurring liquidity blow-outs, QE's, QT's and record-breaking fiscal deficits, we are convinced that the future will show that these assumptions simply will not hold.

For starters, during the past 10-15 years, demand for government bonds reached unprecedented levels on the back of central bank policies and regulations of the Bank and Life & Pensions sectors.

These developments are mainly the result of unconventional monetary policy, where central bank bond purchases were ramped up after the financial crisis to bolster economic and financial market developments, see left hand chart. Demand for primarily government bonds was further bolstered by foreign central banks in their quest to augment foreign exchange reserves and to shelter their economies from reappearing "sudden stops" in external, USD-denominated, financing. Additionally, and because of Basel III reforms, banks' demands for sovereign bonds also increased due to new liquidity regulations.

The unprecedented use of central bank bond purchases has meant that even during large negative shocks, such as the outbreak of the covid-19 pandemic, when public sector deficits skyrocketed, the private sector only had to absorb a small share of the sovereign debt issued.

These developments have also come with adverse effects. The massive, policies-driven, demand has noticeably distorted even major bond markets. For instance, the Bank of Japan now holds over half of the Japanese government bond market and only some 20 to 40 percent of German Bunds remain accessible to private investors. A symptom of this market distortion is the simple observation that, a few years ago, almost a quarter of all government debt traded with a negative yield.

These distortions were not limited to a few important government bond markets only. Fleeting private global bond investors who exploit yield differences across major bond markets have contaminated most bond markets in an unrelenting search for yield. This has, in turn, also affected other capital markets as well.

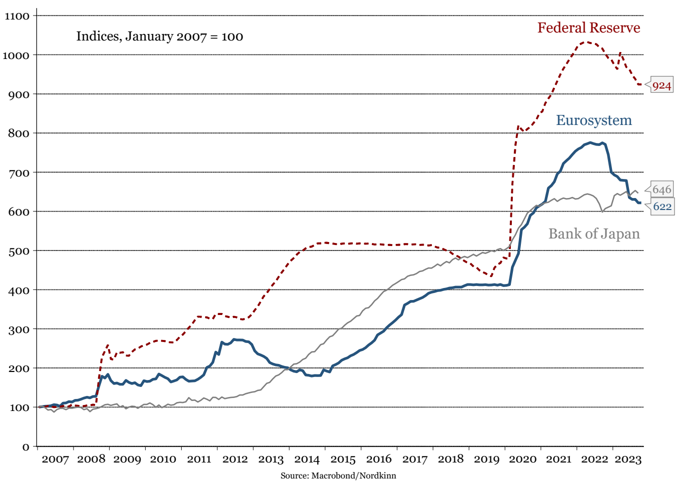
With price-insensitive buyers dominating bond markets, uncertainties regarding future expected yields fell, of course, and caused the term premia to collapse across markets. And with no additional return for bearing interest rate risk over extended durations, how can markets be expected to efficiently price "r square"? i.e. r* as the natural interest rate level that maintains economic equilibria.

Recent developments suggest, nonetheless, that this might finally be about to change, and not only from the fact that central banks have transitioned from buying to selling bonds, or at least not reinvesting maturing bonds. Importantly, major economies are on very different fiscal policy trajectories. The U.S. government is running record deficits and is projected to keep running historically high deficits for many years hence, which may lead to more sticky inflation in the process, see right hand chart. In other economies, public debt levels are instead set to decrease as both primary and overall balances are expected to remain positive, adding to expectations of lower inflation soon.

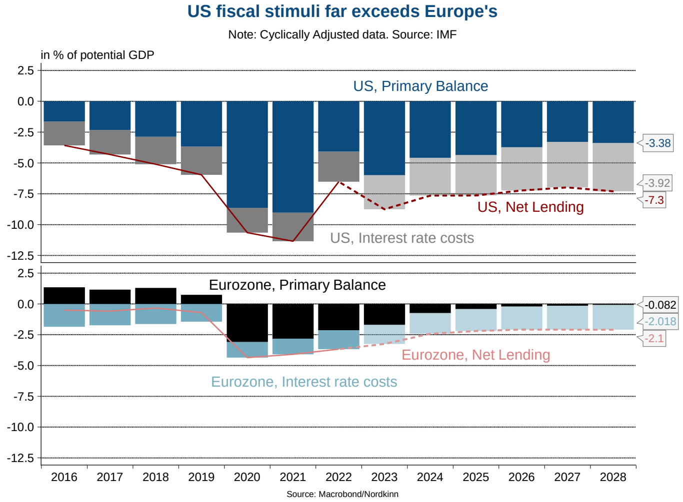
But the crux of the question is what happens now when price-insensitive central banks are no longer active and are replaced by price-sensitive private investors? Standard bond valuation models and most central bank public servants would have us believe the effects are to be small and manageable. We are anything but convinced. Yields are determined by the marginal buyer, and that buyer will now be a price-sensitive private investor with many options to choose from. This should lead to new market dynamics taking hold and we see the continued U.S. steepening, not least relative other economies, as a sign of the times.

To sum up: We believe that the fiscal policy outlook and private investor demand for sovereign risk are the most important factors behind the recent resurgence of the term premia, per se, but also in driving the divergence in (especially long term) interest rates between economies and also in currency exchange rates. As expressed in the review section, our confidence in this view leads us to replace the former global themes with the new theme: *"From disinflation to divergence"* in November.

Central bank balance sheets



US fiscal stimuli far exceeds Europe's



Nordic outlook

Market-implied inflation expectations in Sweden suggest that inflation is expected to swiftly return to levels below target and remain there. Moreover, the market discounts that the Riksbank will closely mirror the ECB's actions, reducing the policy rate to 3.00% and maintaining it at that level. As such, the market does not foresee a severe nor prolonged economic downturn, and it expects the depreciation of the SEK to subside. This is overly optimistic in our view.

We anticipate that persistence in service inflation combined with a weaker SEK will keep the Riksbank vigilant. If not implementing a rate hike in November, we expect the central bank to keep rates elevated until underlying inflation is reasonably close to the target. In the meantime, households and businesses will continue to feel the strain of escalating mortgage costs, rents, and wage expenses. It is likely that, at some point, consumers will need to curtail their spending, while companies will have to cut costs. The latter may occur first as the rising risk of unemployment prompts consumers to reduce their expenditures.

For a considerable period, the manufacturing sector benefited from a substantial backlog of orders. However, order books have dwindled, and new orders appear to have slowed significantly, see chart. Moreover, surveys reveal that profitability is weak in many domestic service-related sectors such as restaurants, hotels, and retail. Consequently, either consumer prices must increase, or costs must be reduced. Given the declining demand, achieving the former is likely to be challenging. Hence, we are watching closely for signs of labour market weakness.

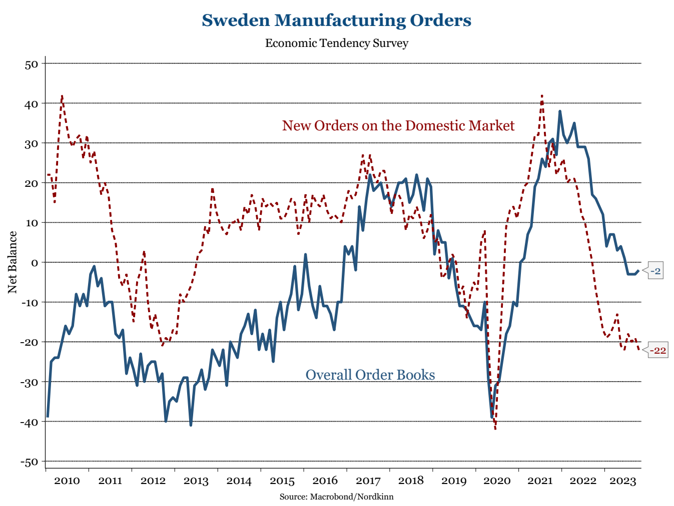
In light of these circumstances, we maintain our themes related to the Swedish economy; *"Reality bites"* and *"From QE to QT."* In our perspective, households and businesses are yet to confront the reality described above, which will ultimately exert pressure on the Swedish economy. When inflation is under control, the Riksbank may have the capacity to reduce rates by more than 100 bps, which is currently discounted by the market. The era of QE is now a distant memory, and gradually, we anticipate risk premiums, such as the term premia, to resurface along the yield curve, pushing for a steeper curve. Moreover, a probable global economic slowdown is rarely favourable for the SEK, so it may take some time before the currency embarks on a sustainably appreciating trend, although the most challenging headwinds are likely behind us. The (cyclical) disinflation process has started but it seems unlikely Swedish inflation will be stuck way below European inflation for years to come. The new theme *"Sweden: Future inflation underpriced"* is set to explore this inconsistency, specifically that inflation will be below the 2% target for years, yet the policy rate will be stuck around 3.00%.

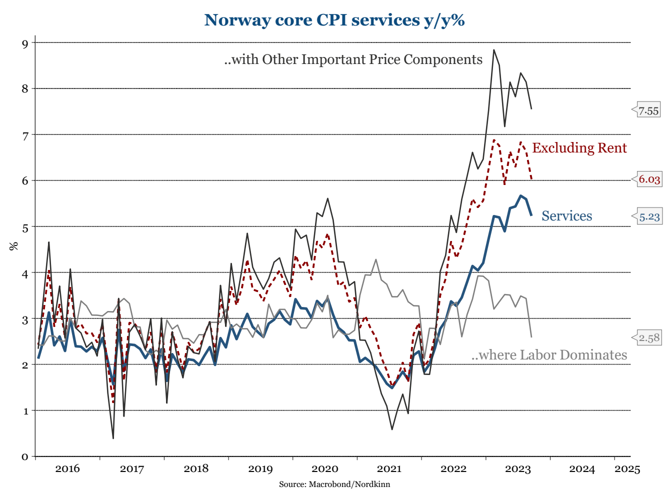
In Norway, the data received in October continues to support our perspective that inflation is poised to decrease in the forthcoming months. However, it also underscores the risk that this downward trajectory may occur more rapidly and pronounced than we initially anticipated. Notably, even though Norwegian wage growth is currently running above levels consistent with the inflation target, this fact does not fully mitigate the risk of lower inflation.

A closer examination of goods and services within various delivery sectors reveals some intriguing insights. Prices for services heavily reliant on labour, such as juridical and accountant counselling, funeral services, haircut and styling, dental treatment, etc., only rose by 2.6% in September compared to the previous year. This suggests that Norwegian wage growth does not account for much of the ongoing elevated core CPI inflation rate. Instead, services with significant cost components other than labour, such as car rental, transportation services, hotel and restaurant charges, TV streaming, amusement park fees, fitness centres, insurance, etc., experienced a substantial year-over-year increase of 7.6%. The robust price growth in these services primarily stems from delayed effects of high demand following the covid-19 reopening, as well as pass-through effects from energy and food costs.

Looking ahead, a combination of subdued household demand and declining commodity prices, with the exception of energy, may lead to a more pronounced reduction in service price inflation than previously anticipated. Additionally, Norwegian goods prices are still rising rapidly when measured on a year-on-year basis, in contrast to many other countries where goods price growth is beginning to slow down. This can be attributed largely to the lagged effects of a weaker NOK exchange rate. However, during Q3, we observed a significant appreciation of the NOK, which should help alleviate price pressures on imported goods. Even though the NOK lost most of these gains in October, its current level, if maintained, should lead to lower year-on-year growth in imported goods prices in the coming months.

Given these factors and the mounting evidence of an economic weakness in Norway, we have decided to rename our theme from *"Norway: Brake before it breaks"* to *"Norway: Quick progress towards target."* While our trading strategies remain largely unchanged, we believe that this new name better describes our outlook for the Norwegian markets. In summary, lower inflation is expected to keep the Norges Bank's interest rates steady for the remainder of the year, with the market likely bringing forward expectations of interest rate cuts.





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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