



## Market Review & Outlook

November 2023

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# Market overview

## Global overview

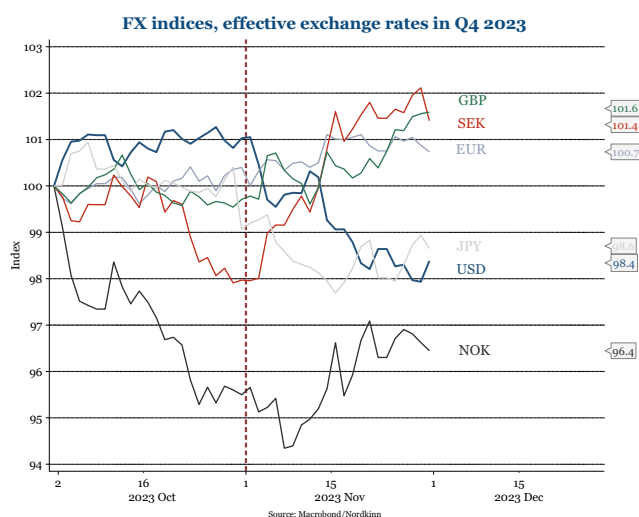
As fate would have it, the Federal Reserve's (Fed) latest two-day policy meeting ended on November 1<sup>st</sup>, which was also the day when the long-expected peak-rate trade took off for real. With record weak bond performance in both 2022 and 2023, we can conclude that November experienced the strongest monthly bond rally for up to 40 years. Clearly, the elevation in bond volatility shows no signs to abate.

These developments become even more impressive considering that Fed communications were little changed compared to the previous meeting, in September. Since, most economic data outcomes have been reasonably firm, broadly in line with expectations overall. Instead, the market moves by and large seem to be due to two of the world's most important data sets coming below expectations: the CPI and the Labor Market Report. Core CPI (CPI excluding food and energy) and the change in non-farm payrolls came in 0.1 percentage points (on a M/M basis) and 30k respectively, below what market consensus expected.

To be sure, there are some caveats to these numbers, but we will return to that discussion in the global outlook section. For now, suffice to state that the somewhat lower inflation and marginally more balanced U.S. labour market are good news for anyone, us included, hoping for a soft landing. And markets have behaved accordingly. Not only have bonds rallied, but stock markets also set off on a magnificent rebound, more than 10% on the month. Cyclically sensitive currencies, including the NOK and even more the SEK, have also performed strongly.

Despite having a macro view consistent with some version of soft landing, we did not expect rates to drop quite as ferociously already by November. In addition, European rates have fallen almost as much as its U.S. counterparts on the back of a similarly low inflation outcome. Consequently, our new global theme *"From disinflation to divergence"* has been off to a rough start. That said, a more sanguine rate outlook has proved every bit as beneficial for our new global FX theme *"FX misalignment"* as we could have hoped for, which more than compensated for the poor initial performance in the Divergence theme.

November was a challenging month for global inflation markets as inflation data continued to surprise on the downside, while oil prices slipped and largely reversed the sharp increase in the days following the start of the Hamas - Israeli conflict. Swedish market-based inflation expectations also fell, but not near as much as European peers, especially when taking inflation compensation into account. In all, movements in the inflation markets helped boost the theme *"Sweden: Future inflation underpriced"*.



## Nordic overview

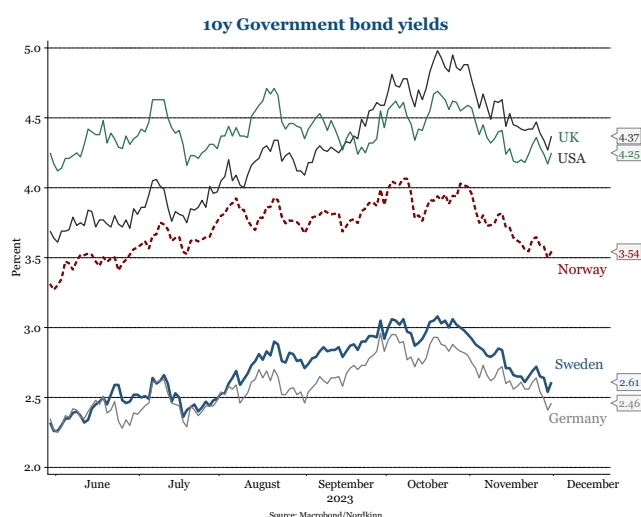
Swedish bond yields declined, and break-even inflation rates decreased throughout November, coinciding with a 3.5% appreciation of the SEK effective exchange rate. Meanwhile, Swedish macroeconomic data, while not robust, did not significantly deviate from expectations. Consequently, these movements in Swedish financial instruments largely mirrored global developments, grounded on a narrative of diminishing inflation. This has prompted central banks to end their tightening measures, boosting hopes for a soft landing. Having struggled with the global inflation shock and the synchronised global monetary tightening, the SEK is now benefitting from global disinflation.

With the gap between core CPI inflation and Riksbank's forecasts narrowing in October, and as labour market data softened, the Riksbank maintained its key policy rate stable at 4.0% on November 23<sup>rd</sup>. The market was split ahead of the decision, with a slight majority expecting a hike. Although the Riksbank left the door open for future hikes, the market made complete reversal by month-end, forecasting a full cut by June 2024 and 100 basis points of cuts throughout 2024. As yield curves flattened, short-end interest rates slumped and mortgage bonds outperformed government bonds, the theme *"Sweden: Reality bites"* contributed negatively while *"Sweden: From QE to QT"* gained during the month.

In Norway, the central bank maintained its key policy rate unchanged at 4.25% during its policy meeting on November 2<sup>nd</sup>, aligning with expectations. While Governor Wolden Bache reiterated the forward guidance from the September meeting, signalling a likely rate hike in December, a new phrase in the press release introduced an element of balance to the decision: *"If the Committee becomes more assured that underlying inflation is on the decline, the policy may be kept on hold."*

Although CPI-ATE inflation rebounded in October, aligning with the Norges Bank's September projection, other indicators of underlying inflation, such as the trimmed mean and weighted median, have experienced a more noticeable decline since the summer. Additionally, while indicators of wage cost growth were elevated in Q3, surveys forecasting wage growth for both 2023 and 2024 witnessed a decline. Furthermore, growth in Mainland-Norway GDP and employment fell below expectations in Q3. Finally, surveys including the Regional Network point to weaker growth in coming months.

On balance, incoming data supported a decline in Norwegian interest rates in November, benefitting our theme of *"Norway: Quick progress towards target."*



# Outlook

## Global outlook

Rarely in history has the range of potential macroeconomic outcomes been as wide as for the years ahead.

First, our base case remains that inflation propensity will be elevated in the coming years compared to the pre-pandemic period, i.e. to keep inflation at targets, central banks will be forced, on average, to keep rates at a higher level than in the pre-pandemic era.

The main arguments include competing compensation demands for increased costs from households as well as from business. And a whole lot of D's: Debts, Deficits, Demographics, Decarbonisation, Defense, Derisking/deglobalisation, etc. Adding complexity to the mix is the growth of AI, which could push for lower inflation.

That said, those are predominantly underlying forces, who will only rather gently raise and affect the longer-term inflation outlook. In the near term, much stronger, but also more short-lived, both inflationary and disinflationary impulses will be decisive.

A short summary of global reviews and outlooks during the past year would read something like: As the lagged inflation impulses from supply chain disruptions and energy price shocks peter out, headline inflation comes back down. Thereafter, which is about now, inflation is instead the result of core, wage driven, inflation. And here we are.

With merely a couple of very low inflation readings behind us – almost in line with targets even (see chart) – we cannot avoid getting a bit jittery. Wage inflation is indeed too high to be compatible with inflation at target. However, for that to also transpire into inflation, we have assumed that retailers and other companies peddling goods and services to households would (at least!) keep their profit margins intact. Instead, what the latest numbers suggest is that companies are accepting lower margins why inflation, regardless of if we look at headline or core, has rapidly approached inflation targets. If these circumstances prevail, real interest rates are much too high and central banks can soon start cutting rates. Federal Reserve Board Governor Waller and – importantly – a bellwether participant at the FOMC (Federal Reserve Open Market Committee) and a few other members have recently indicated as much.

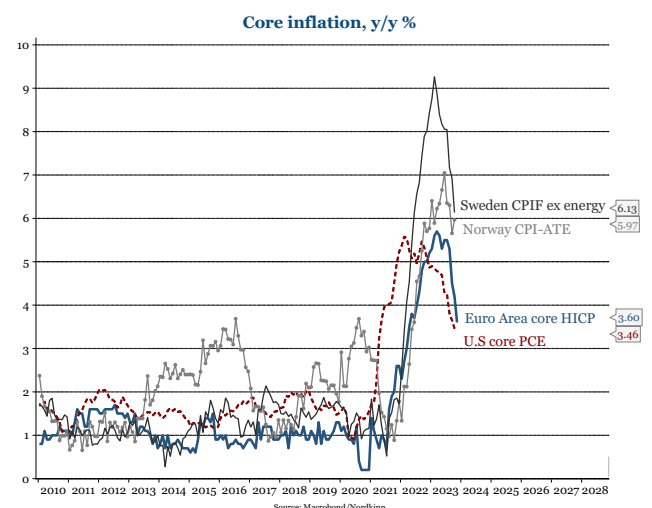
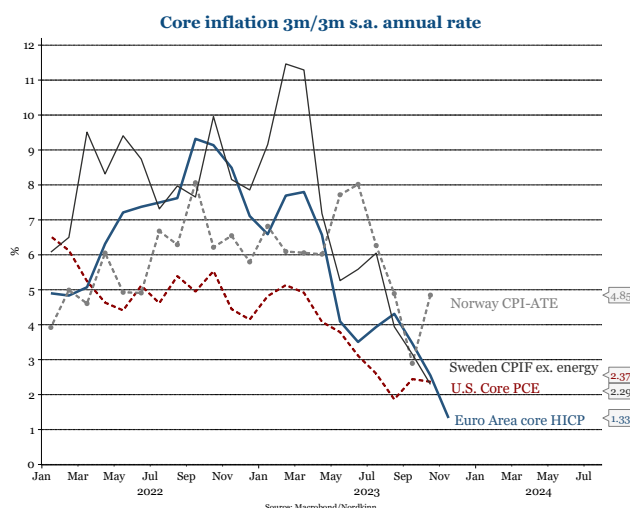
This is also where it gets interesting. If we iron out out several plausible near-term scenarios we have: (1) the soft-landing, immaculate disinflation scenario where the central bank will be able to cut rates to neutral within a few months as inflation targets are well anchored and wages (etc) will soon settle at levels consistent with inflation targets. This seems to be what markets, and not least risky assets, are going for. But there is also; (2) the “prelude to a recession” scenario. In this scenario, demand is slowing to a degree that makes it impossible for companies to pass on higher rates why they will be forced to cut staff and we will enter a recession in a not-too-distant future. This is compatible with the observed inversion of the yield curve, slight rise in unemployment rates and stalling margin developments (not to mention that almost all previous recessions have been preceded by a soft-landing narrative). In this scenario, rate cuts will be considerably deeper but risky assets will also suffer.

In addition, we have (3) the “inflation head fake” scenario where the recent lower inflation readings are either a turn of the compensation cycle, statistical delusion, or compositional changes. This scenario lends support from falling prices on input goods (not least energy), the incredibly distorted seasonal adjustment readings and the surprisingly and continuously high demand for goods rather than services. There are of course other possible (combinations and) scenarios, like an AI-driven productivity boom, but these three scenarios should cover the different main strands of thought.

From the perspective of the November Nordkinn portfolio, the third scenario (inflation head fake) would probably suit the best, but it is getting increasing difficult to fight off the impression that we are moving towards something like either scenario ‘1’ or ‘2’. That said, recession risks are and have been latent in our portfolio risk allocation for over a year, and we are therefore a bit frustrated with not having caught the recent falling knife of peak rate trades as well as we intended.

If nothing else, the above discussion shows how wide the distribution of risks currently is and how fluid the macro environment and financial markets are. Such environment we believe constructively fit the Nordkinn set up, and getting the broad strokes right is paramount if we are to be able to trade markets correctly.

In this context, Nordkinn is monitoring data and financial market developments very closely and is constantly evaluating our trading positions and investment themes to capitalise on the ever-changing macroeconomic and market trends.



# Outlook

## Nordic outlook

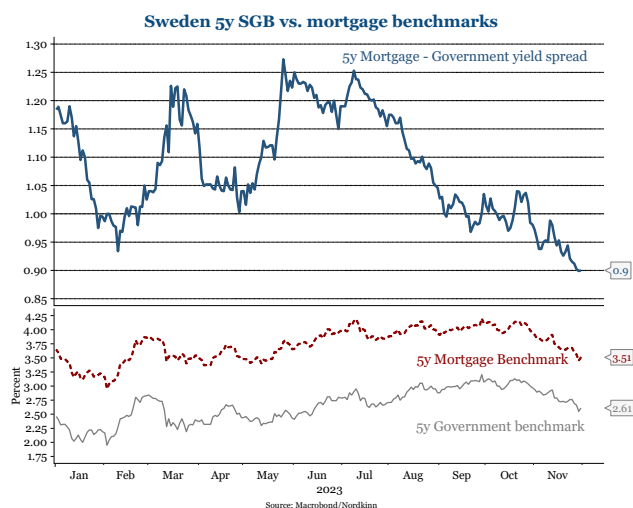
The repricing of central banks in November unfolded relentlessly. Once again, the market demonstrates a keen eagerness to factor in the anticipation of the first rate cut. Admittedly, this time certain central banks appear to be inching closer to a potential pivot, even though the likelihood of a Riksbank rate cut as early as May next year, as currently discounted by markets, seems overly optimistic.

The arguments supporting a Riksbank pivot next year include the possibility of inflation surprising to the downside due to diminished cost pressures, a stable or stronger SEK, and diminishing pricing power. Moreover, signs of softening in the labour market and the prospect of an early ECB cut are considered factors that could set the stage for a Riksbank move.

While we maintain a humble stance at this juncture, it remains our perspective that a Riksbank rate cut before the autumn of next year might still be optimistic. There is a plausible scenario in which central banks, including the Riksbank, express discomfort with the sustained decline in interest rates and the corresponding ease in financial conditions. If this trend persists, it runs the risk of pre-emptively initiating a shift towards easier monetary policy. Consequently, we anticipate potential push back from central bankers if rates continue to decline.

The January inflation print is anticipated to play a key role in shaping monetary policy decisions. Larger increases in fees related to water/sewage, central heating, waste, etc. (similar to the previous year) could sustain inflation at levels higher than expected. Conversely, a significant negative basket effect may provide support for a more accommodative policy stance by the Riksbank.

The Riksbank has signalled a readiness to intensify the QT (Quantitative Tightening) program by implementing larger monthly volumes. This commitment appears robust, and unless there are setbacks in QT auctions towards the end of the year, it seems probable that the central bank will increase QT auction volumes at the outset of the next year. Thus far, the dismantling of the balance sheet, through auctions of SGBs have proceeded smoothly. However, in comparison to swaps and mortgage bonds, SGBs have shown poor performance, see chart. Against this backdrop, we maintain our position on the theme “Sweden: From QE to QT,” anticipating a continued normalisation in the pricing of SGBs.



In Norway, as well as internationally, short-term interest rates are most likely at peak levels. In its latest Monetary Policy Report released in September, the Norges Bank outlined baseline projections indicating a 75% probability of a 25 basis points interest rate hike to 4.50% at the upcoming policy meeting on December 14<sup>th</sup>. However, since the publication of this report, new information, though mixed, has significantly altered the likelihood of further rate hikes in Norway.

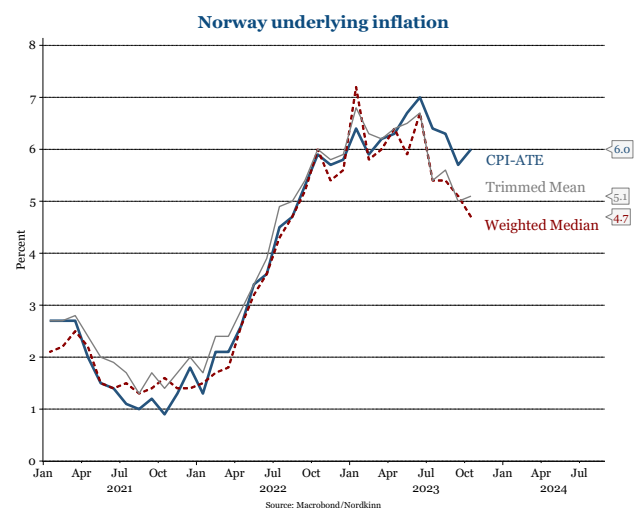
Notably, realised inflation have been somewhat lower than anticipated since the September projections. While market participants typically focus predominantly on CPI-ATE inflation, which rebounded in October after three consecutive months of decline, the Norges Bank prefers to analyse a broader array of measures, including trimmed mean and weighted median. Taken together, these measures confirm that underlying inflation has decreased since reaching its peak in June (refer to the chart).

Secondly, underlying CPI inflation among Norway's trading partners has declined remarkably in recent months. Also relevant, oil spot prices have fallen approximately 20% since the September report, and freight rates and non-energy commodity prices have declined as well. All pointing to lower international inflationary pressures.

Thirdly, reflecting the decline in global inflationary pressures, central banks among Norway's trading partners have maintained unchanged policy rates since September, and expected future policy rates have decreased significantly as markets are now discounting rate cuts already in the first half of next year. This certainly diminishes the risk of further weakening of the NOK.

Fourthly, economic activity and employment growth are weaker than the Norges Bank has projected, and surveys indicate contraction ahead. This implies lower resource utilisation and, consequently, weaker domestic inflationary pressures. Finally, although data for wage cost growth were surprisingly high in Q3, expectations for price and wage growth in 2024 have seen a decline. This suggests that the Norges Bank is likely to lower its price and wage growth forecast for 2024.

On the flip side, the NOK exchange rate is weaker than expected. Nevertheless, considering all incoming data since September, our analysis leads us to believe that the Norges Bank will maintain its key policy rate at 4.25% in December and begin reducing the policy rate after summer next year.





# About Nordkinn

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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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