Market Review & Outlook

December 2023

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Market overview

Global overview

The epic November bond rally extended into December, with data by and large supporting a less restrictive monetary policy stance. Labor markets are slowly becoming less tight, and indicators of demand are broadly easing, albeit with some notable exceptions such as Services ISM.

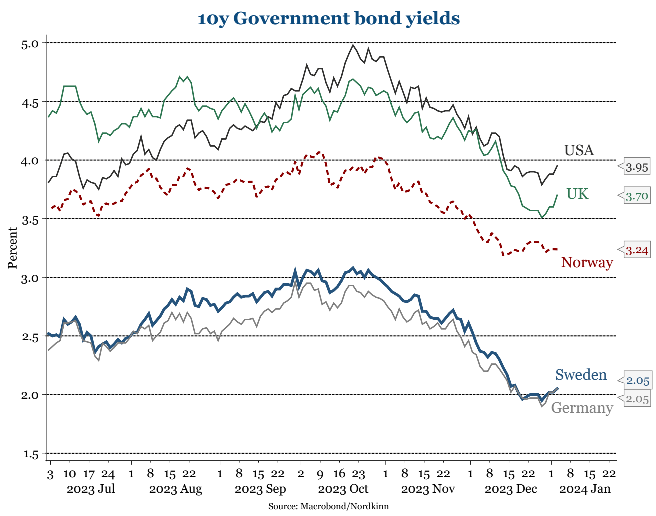
More importantly, the disinflationary trend over the past couple of months is continuing both sides of the Atlantic, with goods inflation leading the way to lower inflation momentum in both the U.S. and the Eurozone. Some of this is probably attributable to the weak developments in China, who is currently exporting (goods) deflation to the rest of the world. Also contributing to the lower overall inflation momentum is probably the direct and indirect effects of lower energy prices.

To be clear, data has not only been in line with central banks' and other forecasts but even a tad lower. Not least is this clear when looking at the underlying, "super-core" measures that have become in vogue with central banks over the past year. That said, wage pressures are still too high to be compatible with inflation targets, but hopes are that wage growth will moderate once labour markets come more into balance.

Understandably, central banks have been pleased to finally receive some good news on the inflation front. And, undoubtedly, the most exciting developments during December are the apparent rifts now opening up between "doves" and "hawks" in the respective monetary policy committees. After Powell channelling his inner Volcker over the past year, we were somewhat surprised by the lack of push back on market pricing coming out of the December 13th meeting, which made rates take another step down, and from which they have not yet recuperated. Admittedly, some other FOMC-members have tried to adjust expectations since, but their impact has been only fleeting.

For the ECB on December 14th, Lagarde in all essence struck a quite hawkish tone but was unable to shift market sentiment after Powell had guided rates lower a day before. Per usual, views within the ECB's Governing Council are aligned to their country of affiliation, but it is also clear that centrists, such as Banque de France Governor de Galhau are becoming less inclined to increase the restrictiveness of monetary policy.

Going into December, our expectations were for some pushback to the strong November rally, either from data or from central banks, who have pushed the higher for longer mantra on the back of experiences of previous high inflation episodes. As neither of these materialised our international theme *"From disinflation to divergence"* suffered, while the FX-misalignment theme received a boost as developments were conducive for currencies in small open economies.



Nordic overview

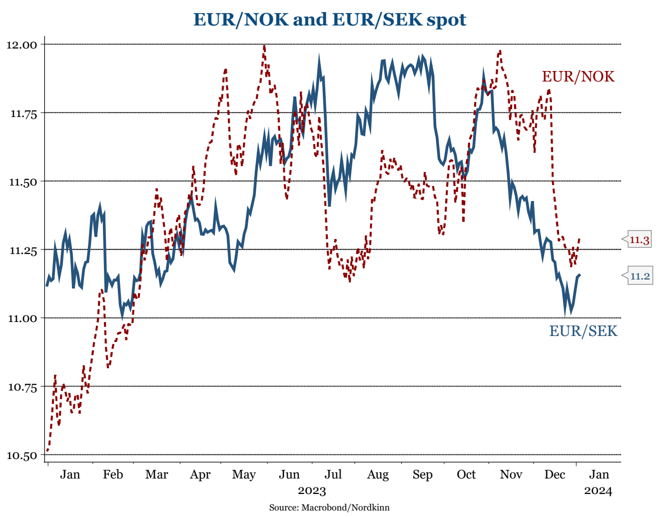
Swedish interest rates experienced a more pronounced decline compared to their European and U.S. counterparts as the market began pricing in early and aggressive rate cuts by the Riksbank in 2024. This flow-driven move was reinforced by lower-than-expected inflation data for November.

The international downward trend in interest rates had a substantial impact on the relatively small Swedish bond market. Constrained by a low government debt to GDP ratio, the effect of QT selling and hints of an increased QT pace in 2024 was more than offset by investors searching for yields amid the repricing of expected future policy rates. Consequently, Swedish bond yields tightened relative to German bonds, with the 10-year spread close to flat by the end of the year. Additionally, covered bonds and swaps experienced a pause in their performance relative to SGBs in December. The robust performance of government bonds had a negative impact on the theme *"Sweden: From QE to QT"*.

The outcomes for the two other Swedish-based themes were mixed. Despite a steeper curve, the theme *"Reality bites"* faced challenges due to the swift move in the very short end of the money market curve. The market priced a likelihood of roughly 80% for a rate cut as early as March 2024. On the contrary, the theme *"Sweden: Future inflation underpriced"* contributed positively to the fund in December. This theme is grounded in the idea that market-based inflation expectations in Sweden are unduly low compared to Europe, with the assumption that a stronger SEK and rate cuts are excessively factored into the current pricing.

In Norway, during the policy announcement on December 14th, the central bank opted to increase its key policy rates by 25 bps to 4.50%, aiming to mitigate the risks associated with prolonged high inflation. The announcement caught the markets off guard, as they had factored in only a 20% probability of a rate hike. Notably, the Norges Bank appeared unmoved by the decrease in core CPI inflation to 5.8% in November, slightly below projections, as well as the ongoing disinflationary trend worldwide. The latest projections indicate that the key policy rate is expected to be maintained at 4.50% at least until autumn.

Despite a notable uptick in short-term money market rates, the surprise hike had a limited impact on longer-term rates, with the yield curve experiencing a significant flattening. Initially, the decision led to a negative performance for our theme, *"Norway: Quick progress towards target."* However, this was counterbalanced by positive effects resulting from active trading throughout December, culminating in a modest net gain overall. Furthermore, the rate hike supported our short EUR/NOK exposure, organised under our *"FX misalignment"* investment theme.



Outlook

Global outlook

Much like in November, the global economic outlook is obfuscated by several diverging, even opposing, risks. On the one hand, there is still an ongoing concern that central banks may need to maintain higher interest rates to keep inflation at bay, as the inflation propensity may have risen in the wake of the pandemic. Several factors contribute to this elevated inflation risk:

Firstly, both households and business sectors might demand higher compensation to offset rising costs. There is still an inherent risk for these compensatory demands to create a self-propagating dynamic in the form of a price-wage spiral. At this juncture, those risks seem to be under control, but inflation expectations of business and households, also on longer durations, could shift if, e.g., important central banks are seen as becoming too lenient towards inflation too fast.

Secondly, a series of critical elements, what we in November called "the D's" - Debts, Deficits, Demographics, Decarbonisation, Defense, Derisking/Deglobalisation - are influencing economic conditions. These factors not only necessitate higher investments and rates but also lead to increased redundancies, which should push company cost structures higher.

On the other hand, while such underlying forces should gradually influence the inflation outlook, more immediate, but perhaps also more transient, disinflationary impulses are currently in stronger focus. Recent inflation trends underline the disinflation coming from improving supply chains and energy price-induced disinflation.

But, recent low inflation readings, almost aligning with targets, also mask a quite complex inflation picture as it seems to primarily be driven by lower prices on internationally traded consumer goods every bit as much as lower transport costs or wages. If anything, wage inflation remains quite high, some distance above what is compatible with inflation targets. As the supply and demand balance of labour continues to improve, we nonetheless think it is fair to expect wage growth also aligning with the inflation target (and productivity growth).

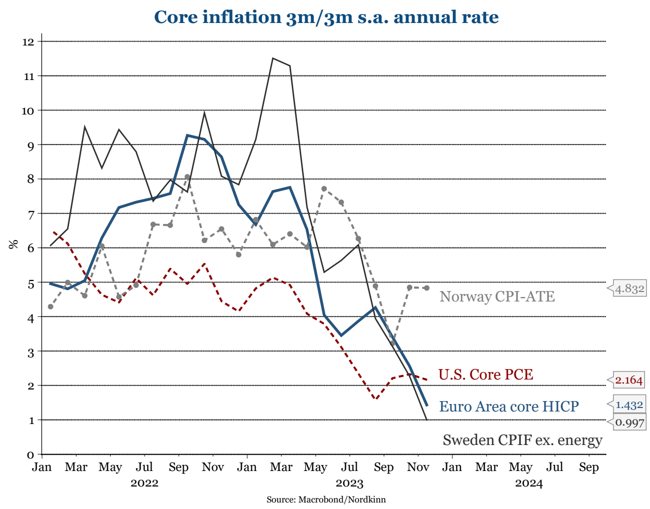
Perhaps most strikingly, and contrary to our expectations, companies seem to be absorbing costs rather than passing them on to consumers, hence accepting lower profit margins. This unexpected development suggests that real interest rates might be excessively high, providing leading central banks with strong arguments to reduce rates towards neutral (at least). Last month, we heard FRB Governor Waller make such arguments, and this month we have heard similar reasoning from many European policymakers.

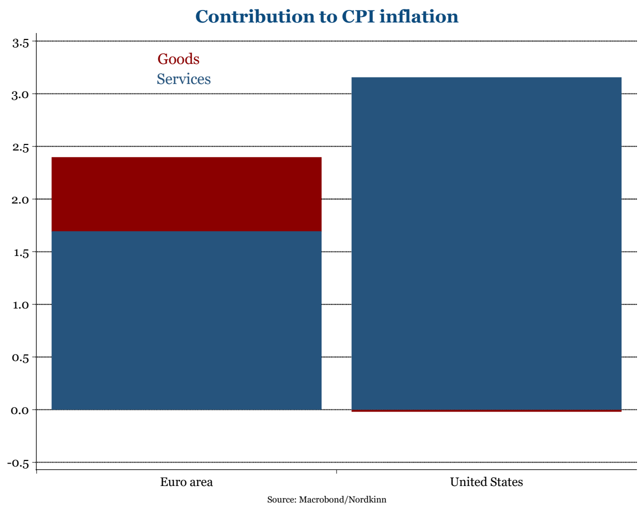
So much for the immediate near-term policy outlook. But even on a somewhat longer horizon, current market pricing is consistent with a soft-landing scenario and an almost immaculate disinflation process towards inflation targets. To us, and for some of the reasons listed above, this seems almost too good to be true. But before taking on more directional bets we would need to see indicators and data pointing more clearly towards either a recession or a reacceleration of inflation, and we cannot exclude neither.

In the near-term, we believe, market pricing will continue to be guided primarily by inflation outcomes and any upward surprise will surely result in a marked bounce in pricing. For rates to come down further, from here, we should probably expect labour market data to weaken and new orders and consumer spending to soften more dramatically.

As we endeavour farther into 2024, we will also face new uncertainties. Most prominently, the U.S. gears up for presidential elections while running subsequent deficits of sizes unknown outside war years. On a more technical note, the massive short-term bill funding of government spending over the past year will be transformed into notes and bonds during 2024, exerting further upward pressures on longer rates for the global reserve currency issuer.

The broad spectrum of risks illustrates the fluidity of both the macroeconomic environment and financial market pricing. Admittedly, the continued bond rally in December caught us off-guard. The Nordkinn portfolio is presently geared towards lower international rates in general, and Euro rates in particular. But overall positioning is very cautious with a slight tilt towards materialising recession risks.





Outlook

Nordic outlook

Being a small open economy, the outlook for Sweden is subject to a range of potential outcomes for the global economy and markets in 2024. At the onset of the year, we identify inflation data as the foremost influence of market pricing, barring unforeseen disruptions to economic activity. The current anticipation of Riksbank cuts will not endure any setback in terms of unexpectedly high inflation. Instead, data is likely required to consistently surprise on the downside to validate the existing pricing, which implies a potential initial cut in March, with a total reduction of approximately 150 bps throughout 2024.

The inflation market appears very optimistic about the inflation outlook. The market-implied average expected CPI inflation rate over the next 15 months is 1.3%, necessitating a sharp drop from the current level of 5.8%. Based on our forecast of a gradual reduction of the key policy rate in 2024, the mortgage component is likely to contribute to approximately 1 percentage point of the CPI reduction in 2024. Consequently, to justify current pricing, the CPIF rate must average close to zero for the next 15 months, a notable deviation from its latest 3.6% print.

The economic outlook, particularly the labor market, will be pivotal if the Riksbank considers further rate cuts beyond current expectations. Market projections indicate a policy rate cut to 2% by mid-2025, approaching a presumed neutral rate. However, for additional cuts to be warranted, we believe that the Swedish economy must experience more adverse effects, and the labour market must worsen significantly, leading to a rise in unemployment. Presently, indications of a rapidly deteriorating labour market are limited, despite increased layoffs and bankruptcies. Surveys also suggest little evidence of a substantial decline in employment plans, and the perceived risk of becoming unemployed remains at low levels. Consequently, we believe it is premature to anticipate market discounting of further cuts, at least until clearer signs of a deteriorating labour market emerge.

Swedish interest rates demonstrated relative strength compared to European peers in December. We anticipate a rebound following the completion of the year's initial round of macro data and the first Riksbank meeting. Increased focus on bond supply and hopes for rate cuts may result in steeper yield curves and renewed underperformance of government bonds. Furthermore, we maintain the view that Swedish inflation is undervalued relative to European inflation. These perspectives are elaborated in various forms within our Swedish themes: *"Reality bites," "From QE to QT,"* and *"Future inflation underpriced."*

In Norway, at a time when lower global inflation had prompted central banks worldwide to shift their focus from contemplating further rate hikes to discussing conditions for policy easing, the Norges Bank diverged from the prevailing trend by opting to raise rates to 4.50% in December. Within the Committee, a growing impatience surfaced regarding the persistent inflation rate, coupled with concerns that a weakened NOK exchange rate might jeopardise the timely return of inflation to the target range.

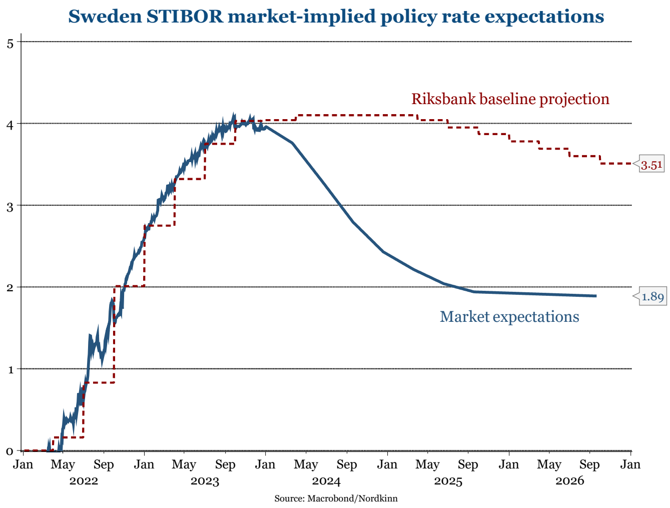
Regardless of the circumstances, this unexpected decision should be interpreted as a resolute commitment to advancing the disinflation process, and this determination appears unlikely to waver in the near future. Firstly, there are immediate challenges to the argument for significantly lower inflation in Norway, including the persistence of house rental prices, which, by design, lag behind the headline Consumer Price Index with a prolonged time lag. Additionally, the weak NOK exchange rate is anticipated to prolong the decline in imported goods prices.

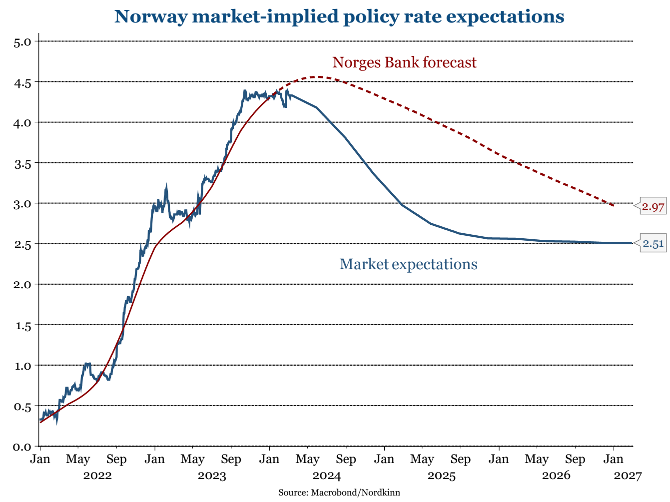
Secondly, even if inflation were to decelerate more rapidly than anticipated, it would naturally take time to persuade the central bank that the downward trajectory is sufficiently sustainable to justify the kind of disinflationary cuts under consideration by policymakers at some other major central banks.

Considering these factors collectively, it becomes challenging to rationalise market expectations of a cumulative 150 bps of rate cuts by year-end in Norway. It seems reasonable to anticipate that the most recent rate increase by the Norges Bank positions it to lag behind other central banks in the journey back to a neutral stance.

Given this context, we have chosen to temporarily pause our Norway theme, titled *"Quick progress towards target."* Instead, we currently prefer to engage in trading Norwegian interest rates from a different perspective, notably one that questions the excessive number of rate cuts discounted in the market for 2024. Positions reflecting this view are now organised under the global theme "*From disinflation to divergence.*"

Moreover, we identify favourable conditions for maintaining a long position in the NOK exchange rate throughout 2024, anticipating the continuation of global disinflation and expecting that the Norges Bank will implement rate cuts later than its counterparts. Long NOK positions are categorised under the theme *"Global: FX imbalances."*





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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