



Market Review & Outlook

January 2024

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Market overview

Global overview

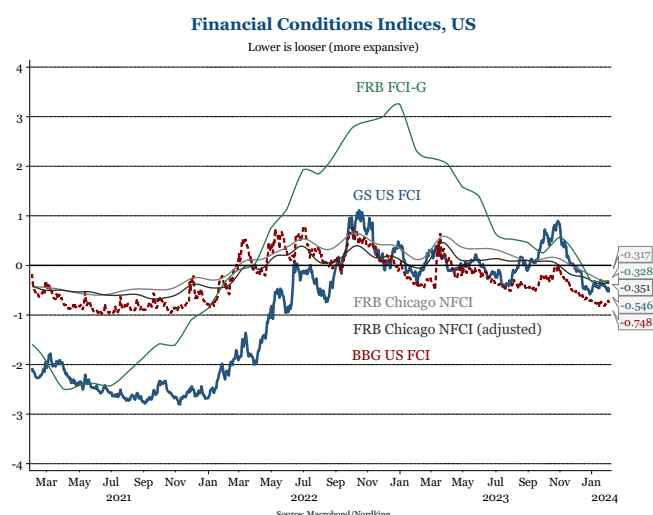
After two months of falling interest rates, developments during January resulted in a rebound with US 10-year rates rising almost 20 bps. Key drivers behind these developments included robust U.S. labour market reports and hawkish comments from key FOMC members, notably Governor Waller, whose previous remarks contributed to the swift rate decline in November. Governor Waller emphasised that disinflation, coupled with a robust U.S. economy, enable the Federal Reserve to proactively instead of reactively lower rates, departing from the reactive approach seen in previous cutting cycles. Consequently, the pace of rate cuts might not be as aggressive as currently priced in by the markets.

Economic indicators since the strong December Non-Farm Payrolls (216k versus a consensus of 175k) have further bolstered expectations of a demand reacceleration in the first months of 2024. Particularly noteworthy is the robust December retail sales reading, where the influential "control group" retail sales surged 0.8% month-on-month, surpassing the expected 0.2% increase. In Europe, data has also begun to hint at bottoming out or even a potential upturn, albeit against a backdrop of very modest expectations.

Regarding inflation, progress has been notable across most economies. While U.S. CPI data slightly exceeded expectations, the pivotal PCE data indicates that progress towards the Fed's 2% target has likely been swifter than anticipated as recently as mid-December. PCE inflation momentum remains at or below the Fed's target across 1-, 3-, or 6-month horizons. Further discussion on this subject will be provided in our outlook section.

In the Euro Area, inflation developments have been similarly benign, see chart. However, Euro Area figures remain heavily influenced by fiscal policy measures and other temporary factors, complicating the analysis. Yet, upstream measures such as PPI and wages are, by most accounts, receding.

While long-term rates saw an uptick in January, expectations for aggressive rate cuts also moderated throughout the month. Long money market rates and short bond rates experienced the smallest increases, leading to flattened money market curves and steepened bond curves during January. However, the rise in market interest rates was even more pronounced in Norway, greatly benefiting our theme: "Global: From disinflation to divergence." Unfortunately, these developments only affected FX markets with a delay, resulting in some setbacks for our global theme: "FX misalignment."



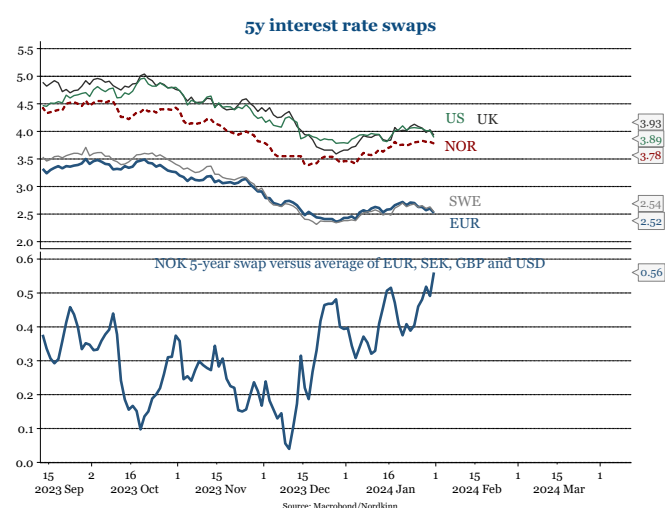
Nordic overview

2024 commenced with domestic data exerting limited influence on the market. Interest rates closely mirrored European rates as they experienced an upward shift. The pricing of Riksbank rate cuts moderated, currently discounting approximately 145 bps of cuts in 2024. After the strong appreciation of SEK late last year the Krona depreciated in January, however, it recovered somewhat at the end of the month. Inflation data surpassed expectations, while other macroeconomic indicators exhibited tentative signs of a recovery in the Swedish economy. PMIs showed less negativity, net exports sustained growth data, and the NIER survey rebounded amid an improvement in consumer confidence (sparked by talks of rate cuts being the next move by the central bank).

Despite the stronger inflation and, at the very least, a non-deteriorating economic outlook, the price of future inflation continued to decline. The inflation market struggled to attract investors, even with a significantly subdued inflation outlook, much lower than implied by European and U.S. markets. Consequently, the theme "Sweden: Future inflation underpriced" had a negative impact on overall performance. On the other hand, the theme "Sweden: From QE to QT" performed better and contributed positively. Following a robust start to the new year, demand for government bonds diminished as the month progressed. Covered bonds and swaps demonstrated relative strength compared to SGBs in the latter stages of the month.

In Norway, annual core CPI inflation continued its downward trend in December, reaching 5.5%, marginally below the projection set by Norges Bank. Despite this, Norges Bank perceives the inflation rate as uncomfortably high, with elevated inflation risks. Therefore, on January 25th, the central bank announced that the outlook remains largely unchanged since it raised interest rates to 4.50% a month earlier, indicating that this level will be maintained for the foreseeable future. As a result, interest rates experienced a significant increase in January, and spreads versus peers widened.

At the outset of the new year, markets discounted more than 125 basis points of cuts in 2024, an estimate we deemed excessive. To counter this, we strategically built short positions in NOK interest rates relative to other currencies. These positions were structured under the theme of "Global: From disinflation to divergence," which meaningfully contributed to our performance. Meanwhile, notwithstanding wider interest rate differentials, the NOK exchange rate depreciated slightly, resulting in small losses within our "Global: FX misalignment" theme.



Outlook

Global outlook

Towards the very end of January both the ECB (January 25th) and the Fed (January 31st) announced their monetary policy decisions. Initially, ECB communications from the monetary policy meeting seemed little changed. It was only when pressured by journalists, during the Q&A, that impressions clearly turned more dovish as ECB president Lagarde refused to rule out a cut earlier than June. During the WEF Davos meetings a couple of weeks earlier, Lagarde and other prominent ECB members had indicated that summer (i.e., the June meeting) was the earliest possible time for a cut to come in play (and conditional that data would corroborate it). Needless to say, markets have since the ECB-meeting been craving for sooner and more cuts than what was priced before.

On the other hand, at least according to market gyrations surrounding the Fed meeting, chairman Powell did all but rule a cut out on the Fed's March meeting.

Our take is perhaps less digital, but with Powell giving a clear nod to high wage and service price inflation as well as noting "anecdotal signs" that demand is re-accelerating, the bar for a March cut must be considered high. Under any circumstances, and as the tea leaves are settling at the bottom of the cup, the lasting impression is that the Fed is steadily approaching the first cut(s) but that a wider and a more symmetric distribution of risks, which convey a slower pace than what markets are (still) pricing.

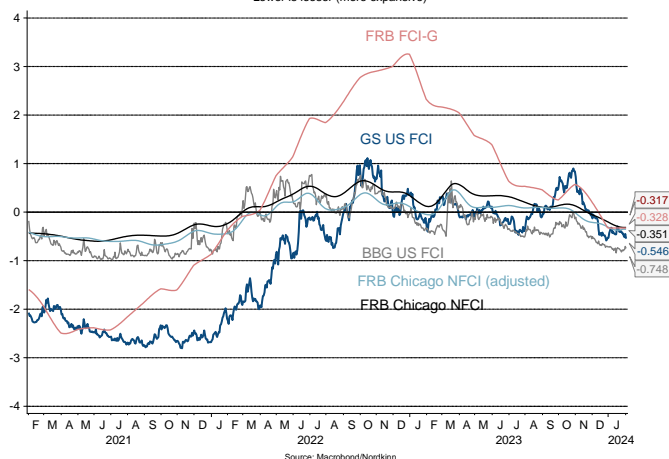
By and large, this lines up nicely with the Nordkinn view of a U.S. economy fundamentally stronger than the Euro Area and that a too swift retracing of previous hikes could spark a reacceleration of demand and inflation.

Interestingly, all commonly used definitions of financial conditions are now firmly in expansionary territory in the U.S., see chart. Even Fed's most recently developed measure, taking monetary policy lags and economic impact into account, suggests that the bulk of tightening is behind us and expansion is imminent. On the margin, at least, softer financial conditions should alleviate some of the stress felt by home builders and buyers alike.

Some improvement is already visible, not least in the demand for construction workers and in financing costs. That said, housing starts have not yet noticeably responded, but at least some measures of housing construction permits seem to be bottoming out. Looser financial conditions and higher real wage growth are also having effect on retail sales, resulting among other in higher demand for workers also in this labour-intensive subsector.

Financial Conditions Indices, US

Lower is looser (more expansive)



With U.S. labour markets still tight, and employment growth far above the 100k/month that is deemed compatible with balanced labour markets, a re-acceleration of demand must be considered an apparent risk of not only stronger demand growth, but also inflation.

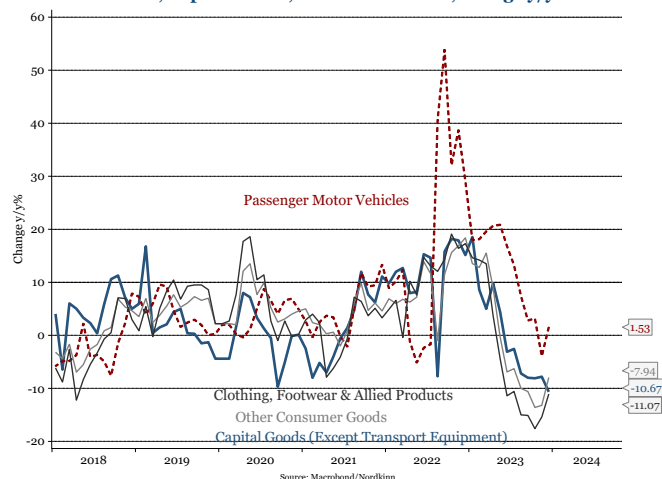
Now, turning to inflation, goods inflation has undeniably come down swiftly during the autumn/winter 2023 and we believe this primarily is the result of supply shocks falling out of companies' price setting. However, we also notice that China, still the world's sweatshop, is now posting falling export prices to an extent not seen since the early 2010's, see chart. Furthermore, it is apparent that many of the falling prices on Chinese goods are related not only to a weak CNY, weak domestic developments or direct measures to increase Chinese exports, but are to a large extent a residual of industrial support to important sectors such as batteries and electric vehicles which are also important export sectors.

Taken together, then, it is quite easy to see how goods inflation has fallen globally and even become strongly negative in some instances, pushing overall inflation measures down, both in terms of headline and excluding (e.g.) food and energy. The main threats are more geopolitical and, importantly, some time away; the near closing of the Suez Canal, the concerns surrounding the Hormuz Strait in conjunction with the very low capacity of the Panama Canal (due mainly to droughts) have the capacity to push transportation costs and goods inflation on an upwards trajectory again.

Services inflation, on the other hand, is demonstrating a much "stickier" behaviour, which is probably due to a strong link to labour markets and wages, which are holding up well in most developed economies. Admittedly, both wages and services inflation are now trending downwards, and we expect this trend to continue, albeit more slowly. Our main argument is that wage growth is still much too high, and without an outright recession it is hard to see how wage and services inflation could come down to levels compatible with 2% inflation any time soon.

Services inflation and labour markets will therefore hold the key to developments. Considering that markets are expecting cuts from both the Fed and ECB at virtually every meeting from summer and thenceforth, we aim to explore what we feel are too aggressive expectations, not least in relative terms. The strong U.S. economy warrants a much more cautious approach to rate cuts than the weaker Euro Area.

China, Export Prices, Consumer Goods, change y/y%



Outlook

Nordic outlook

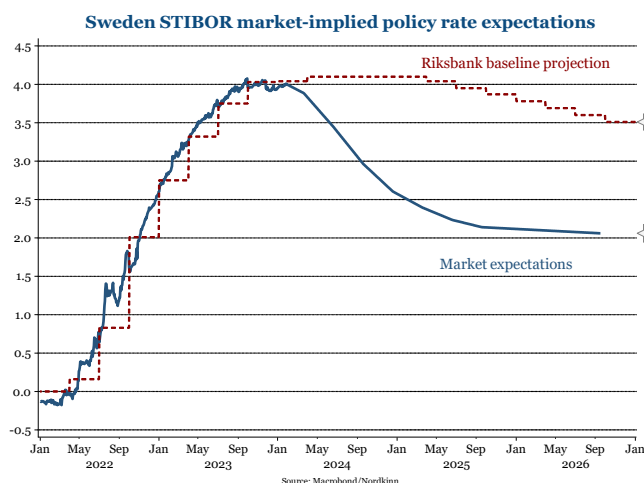
February kicked off with Riksbank's monetary policy decision and update. The central bank concluded that the policy rate can probably be cut sooner than was indicated in their November projections (see chart), even hinting at the possibility of a cut in the first half of the year if inflation data remains favourable. We believe this is contingent on the SEK not depreciating again.

Moreover, the announcement included an increase in the volume of bonds offered monthly in the Quantitative Tightening (QT) auctions. Consequently, the supply of government bonds (SGBs) is set to rise. Specifically, the net supply (adjusted for Riksbank buying and selling) of SGBs will expand compared to the last 10-15 years, affecting the relative pricing of bonds in the Swedish fixed income market. This is explored in our theme *"Sweden: From QE to QT."*

We anticipate the Riksbank to lower the policy rate following the ECB's initial cut, viewing this as an effort to prevent currency depreciation. The impact on inflation has been more significant than in previous years when inflation surged.

Another crucial factor in the rate-setting puzzle will be the aftermath of the January inflation report, scheduled for release on February 19th. The January inflation figure is notoriously challenging to predict, especially this year, with some items/services in the CPI basket sensitive to capital-intensive segments of the economy typically resetting at the beginning of the year. Rents, semi-CPI-linked fees, and infrastructure, such as public transport, could combine to result in a slight backlash at the onset of the inflation year 2024.

In the new theme *"Sweden: Normalising risk premia,"* we address opportunities that we observe such as in covered bonds on a relative basis to other instruments. In particular, while credit risk has performed well, Swedish covered bonds have lagged this performance. Consequently, the risk premia in covered bonds appear attractive to pick up in a world where positive carry and a positive roll along the negatively sloping yield curve are challenging to find.



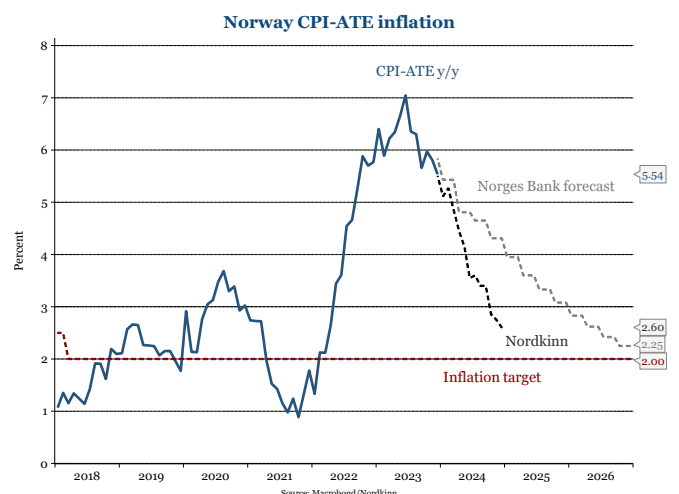
In Norway, the prevailing consensus among Norwegian economists suggests that sustained high wage growth and the weakened NOK exchange rate are likely to impede disinflation in the country, aligning with Norges Bank's assessment. Indeed, the central bank forecasts core CPI inflation to persist stubbornly above 4% throughout 2024, allowing for only a potential rate cut by year-end, as per their current projections.

However, delving deeper into the various components of the CPI index and conducting a comprehensive analysis of recent price trends reveals intriguing insights. Firstly, it is evident that goods prices continue to drive inflation in Norway, with an annualised 3m/3m rate of increase exceeding 6%. This contrasts sharply with the disinflationary patterns observed in other nations, reflecting not only the impact of the weakened NOK exchange rate on import prices, but also the relatively sluggish adjustments in domestically produced goods prices, notably within the food sector. Nevertheless, reports suggest that the softer trend in goods prices has now begun in Norway, propelled by fierce competition in the grocery industry.

Secondly, service price inflation appears to be roughly in line with international trends, increasing at an annualised 3m/3m pace of around 3.5%. Contrary to conventional wisdom, the rise in service prices is not primarily driven by higher wage costs; rather, other input costs such as electricity play a more significant role. Services where labour input dominates are experiencing only a modest annualised 2% pace of increase.

In summary, our analysis is that Norwegian core CPI inflation has the potential to decline rapidly during 2024, a perspective at odds with the consensus view. In light of this, effective February 1st, we introduced a new investment theme: *"Norway: Inflation risks overvalued."* This theme aims to capitalise on the deviation between our forecast for a swifter decline in inflation compared to Norges Bank's projections and the consensus among economists. Specifically, while we anticipate Norges Bank to reach a similar conclusion gradually, we believe the market's reaction to lower realised CPI data will drive NOK rates lower relative to peers, particularly in the 2025 segment of the curve. Lower 2-year rates should consequently contribute to a steeper yield curve, further supported by the planned increase in bond supply for 2024.

That being said, we anticipate that Norges Bank will implement rate cuts later than its counterparts, which should help mitigate any headwinds to the NOK exchange rate.



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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