NORDKINN

ASSET MANAGEMENT

# Market Review & Outlook

February 2024

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# Market overview

## Global overview

Buoyed by strong economic data, global interest rates continued to rise throughout February. In particular, the January U.S. labour market report published early February was very strong; the change in non-farm payrolls came in at 353k vs expected 185k. Further, the December and January data was also revised upwards by another 126k. Needless to say, rates and FX responded in kind. A couple of weeks later, an inflation outcome above expectations (core CPI at 0.4% m/m vs 0.3% m/m expected) amplified the financial market reactions.

In the Euro Area, February started with an inflation outcome (for January) above expectations as core inflation came in at 2.8% y/y versus 2.7% y/y expected. Perhaps more interestingly, tentative inflation data towards the end of the month (for February) strengthened the position of those advancing the idea of "last mile"-disinflation being the hardest. From our perspective, other data was perhaps even more convincing as we received survey data for both the aggregate and individual economies where the economic outlook strengthened, at least on the margin, and input costs and output prices seemed to re-accelerate.

In short, the "immaculate disinflation"-view that has reigned with many important central banks as well as market participants got its first real push-back from data during February, why central bank commentary – and market pricing – have adjusted strongly.

Coming into February, expectations were that the Fed would cut rates by some 150 bps, starting in May (or even March). By the end of the month, pricing instead implies 85 bps cuts starting in June (or even July). For the ECB, the change is almost as dramatic now pricing 90 bps cuts (vs 150 bps at the start of the month). At the time of writing, a June 25 bps cut is almost perfectly priced, but it is nonetheless a full two months later than what was indicated as recently as at the start of the month.

Of course, the economic and financial developments pictured above have not gone unnoticed by policy makers, and as we in March approach decision times and dates, lines in the sand are being drawn by both doves and hawks. That said, we expect that the decisions will ultimately be data-driven, why near-term volatility is set to continuously be high. A volatile environment remains constructive for our strategy, as demonstrated in February by developments in our global interest rate theme: "From disinflation to divergence". The theme captured among other the swift surge in U.S. short-term interest rates versus European equivalents. Our global FX-theme "FX misalignment" simultaneously suffered however, as we mis-timed our entries in primarily long local currency crosses.

## Nordic overview

In Sweden, January CPI data largely met expectations, with CPIF excluding energy (i.e. "core") revealing a notable basket reweighting effect of almost 0.5 percentage points. This significant factor contributed to the in-line reading, suggesting that last year's inflation may have been lower than previously estimated. This was attributed in part to households opting for less expensive products and services, while also masking persistently high price pressures at the start of the new year.

In addition, headline inflation exceeded expectations, making it a positive month for the theme "Sweden: Future inflation underpriced."

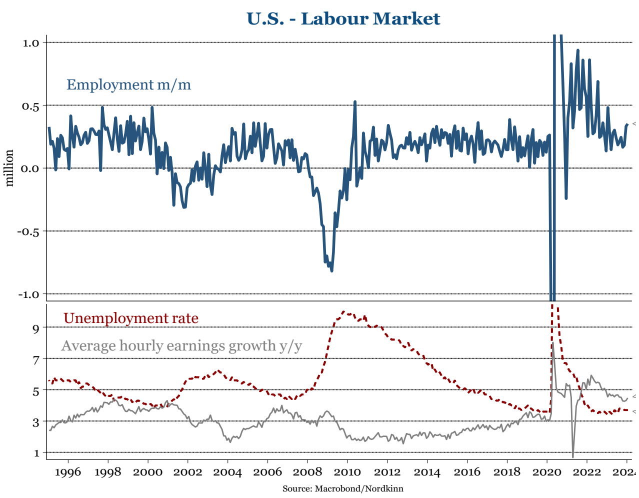
Later in the month, the Swedish National Debt Office released an updated plan for borrowing requirements, notably raising the estimated supply of government bonds in 2024 and 2025. Consequently, the net supply of Swedish government bonds continues to grow, alleviating shortages in the market. Relative value trades, where Swedish government bonds are anticipated to underperform other assets like interest rate swaps and covered bonds, are gradually gaining traction, contributing to the positive performance of the theme "Sweden: From QE to QT" throughout January.

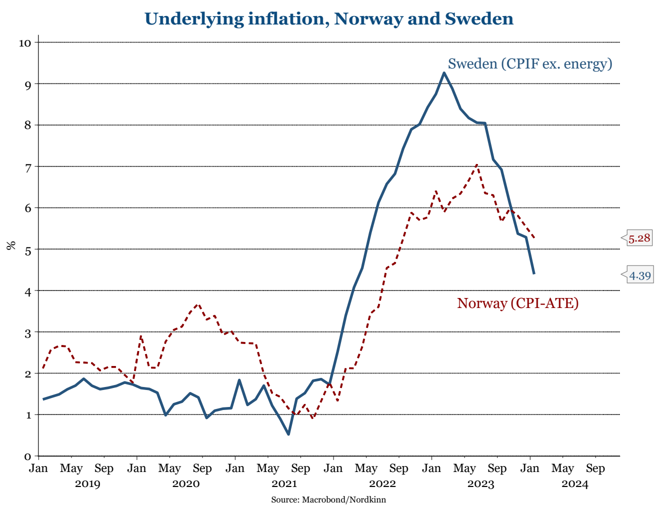
Swedish interest rates largely mirrored the upward trend in global rates during the month but traded weaker than German counterparts. Expectations regarding Riksbank rate cuts in 2024 decreased by more than 40 bps, to roughly 75 bps of accumulated cuts.

In Norway, annual CPI-ATE (i.e. "core") inflation continued its downward trend in January to 5.3% from 5.5% in December, remaining marginally below the projection set by Norges Bank. However, the disinflation process is too slow for the central bank to advance the timeline for its first rate cut, estimated in autumn 2024 according to its projections.

Moreover, given the Norges Bank's sensitivity to the development of the NOK, the lower probability of imminent rate cuts from other central banks practically eliminated any hopes for interest rate cuts before the second half of the year in Norway. This was also reflected in the market. The market now discounts some accumulated 40 bps of cuts in 2024.

On February 1st, we introduced a new investment theme: "Norway: Inflation risks overvalued", aiming to capitalise on the deviation between our forecast for a swifter decline in inflation compared to Norges Bank's projections. The theme faced headwinds in February, mainly because the removal of rate cut expectations internationally transmitted to Norway and led to much flatter 2/10 yield curves. Also relevant, the decline in January CPI inflation was not sufficiently large to have an impact on Norges Bank's thinking about future monetary policy.



# Outlook

## Global outlook

As mentioned in last month's global outlook, summertime seems to equal decision time for the main central banks. However, data outcomes during February have clearly obscured the crystal ball and all the while summer is fast approaching. Volatile data raises the temperature also in the monetary policy board rooms. While cuts are the communicated (and priced) baselines, "hot" data (e.g. higher inflation, tighter labour markets, stronger demand) will be the hardest to cope with.

At Nordkinn, we feel there is a need to separate the global outlook as the U.S. and the European economies are quite out of synch, see chart, which is why we towards the end of last year introduced the investment theme "From disinflation to divergence" in the first place. The U.S. economy is demonstrating few weaknesses and despite the tight labour markets, it is even managing to eke out decent productivity growth rates which to some extent balances the high wage growth. The conditions for a re-acceleration of inflation are therefore better in the U.S. than elsewhere. On the current economic trajectory, we believe a no-cut in 2024 is a distinct possibility and we even see a risk, albeit at this stage slim, that the Fed eventually could be forced to hike again(!)

This is not our main scenario, but the fact that the U.S. economy is powering on despite the high, supposedly restrictive, interest rates is a signal that something has happened to the neutral rate (a.k.a. "r*" or "r-star"). Most commentators, including the Fed itself, estimates that r* is low, below 1%. Adding inflation target of 2% would imply a neutral nominal rate of ca 3%. However, all endeavours to calculate r*s come with major caveats, with confidence intervals in the magnitude of percentage points. An r* close to 3% is by no means impossible. Fact is that when using ideas and methods developed by the Fed to capture short term variations in r* we can easily motivate current levels of interest rates, even when refraining from considering the current high inflation and tight labour markets.

The Euro Area is in a very different situation. For all intents and purposes, Euro Area developments are akin to those of the stagflation period of the 1970's and early 1980's. The new but few bright spots alluded to in the review-section is something we take notice of, as a rebound would be a big surprise to markets. That said, data must firm substantially if the Euro Area is to keep up with its transatlantic neighbour and shift the monetary policy outlook more fundamentally. Hence, we continue to see ample opportunities in relative space between our core markets and major economies as well as between major economies themselves.

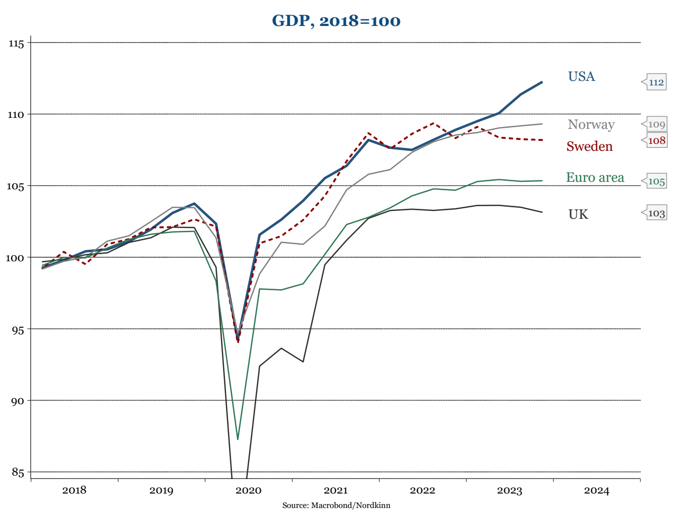
Our baseline above is, of course, subject to several risks. On the downside, we are probably more worried about labour market developments, as a general weakening would imply that a recession has been long in the making, after all. That said, and thus far, most of the indicators we are watching seem to suggest some kind of normalisation of very tight – extremely tight even – labour markets, rather than outright weakness. In this context, it is of course also important to note that labour markets are, often, a lagging rather than leading indicator. However, demand indicators are, in general, strong with Q1 GDP-growth expected to exceed 2% according to Atlanta Fed's well performing GDPnow-calculations.

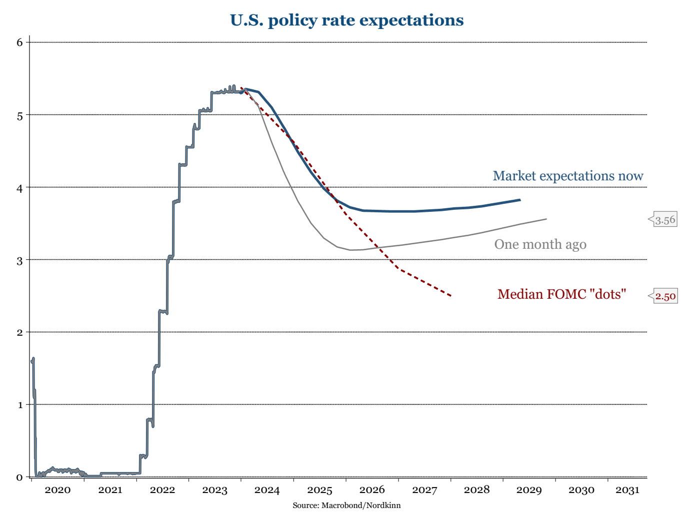
Which brings us to upside risks. As stated initially, market expectations and our baseline are for the Fed and ECB cuts towards summer and the second half of this year. At current, no one expects the Fed nor ECB to hike again. But the absolute premise is that inflation will come down further, towards targets, and stabilise. With major economies in decent shape, not least labour markets, inflation outcomes will continue to be all-important. Any signs of levelling off or even re-acceleration of inflationary pressures is sure to be met with violent swings in market pricing.

The key remains, as we have touched upon in many previous editions of the monthly report, corporate pricing. Over the past few months and quarters, companies on both sides of the Atlantic have seemingly accepted ever-lower margins, which is why it is interesting to see that survey data on price plans (also on both sides of the Atlantic), has bottomed out and in some cases even has risen.

Should this, de facto, translate into higher inflation, we could have a very different market discussion in just a few months. Maybe central banks were not done hiking, after all?

As markets remain impatient in frequently over- or undershooting expectations, market volatility is set to linger, which allow for continuous repositioning. At the time of writing, our duration exposure is broadly neutral overall, but we remain wary of upside surprises to inflation as we believe downside risks are limited, near-term.



## Nordic outlook

The Swedish economy appears to have passed its recent trough. With inflation easing and the anticipated peak in mortgage rates approaching, households' real spending power is poised to increase, likely contributing to the more optimistic consumer confidence being observed. Consequently, we made the decision to shut down the theme "Sweden: Reality bites" during February. We believe the worst of the economic outlook challenges for Swedish households are now behind us, also offering potential optimism for the currency moving forward.

Although the inflation outlook remains complex, we maintain the view that underlying inflation will be persistent. This perspective was also, in our view, supported by the January data. Notably, a discrepancy emerged in analysing service inflation excluding housing, compared to the same measure excluding foreign airfares, highlighting substantial differences in results, see chart.

However, it is essential to recognise that perceptions can change rapidly based on the apparent increase in volatility of inflation data over the past few quarters. Nonetheless, market pricing demonstrates expectations of a swift return to inflation below the 2% target, with the 5-year Break-Even Inflation (BEI) rate at 1.45% and the 10-year BEI rate close to 1.60%. In fact, the entire forward BEI curve remains well below the 2% Riksbank inflation target. This aberration contrasts considerably with other inflation markets, where BEIs exceed Swedish rates and forwards even surpass the 2% target. While we remain cautious and adaptable in our views and trading positions, we maintain our exposure for higher Swedish inflation, as addressed in the theme "Sweden: Future inflation underpriced."

Following the Riksbank's announcement at the end of January regarding the further increase in QT volumes, we received updated projections in February from the National Debt Office indicating additional bond issuance to the market. Issuance of Swedish Government Bonds (SGBs) over the next two years was raised by a total of SEK 33 bln. When combined with the QT selling by the central bank, the net issuance will be the highest seen in decades. So far, demand has comfortably absorbed the bonds. The relative pricing of SGBs (compared to swaps and covered bonds) has evidently "normalised," while the spread to Germany has seen minimal movement. We anticipate that, eventually, absorbing all bonds will require further repricing of SGBs compared to other bonds/assets, including the German government bond curve, to keep demand aligned to the supply of Swedish bonds. We retain the themes "Sweden: From QE to QT" and "Sweden: Normalising risk premia," as we believe the relative demand for covered bonds will remain resilient.

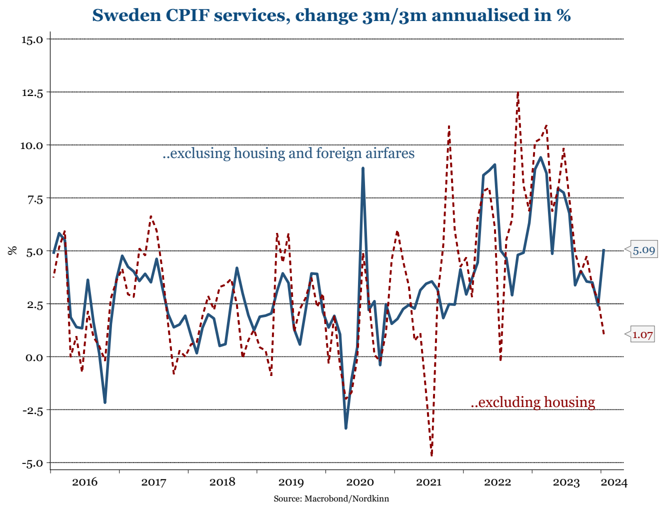
In Norway, the disinflation process remains broadly consistent, if not slightly faster, than that projected by the Norges Bank in its most recent monetary policy report. Despite positive risk sentiment, higher oil prices, and wider interest rate differentials between Norway and its trading partners, the NOK exchange rate continues to be stubbornly weak. In addition, wage pressures remain strong.

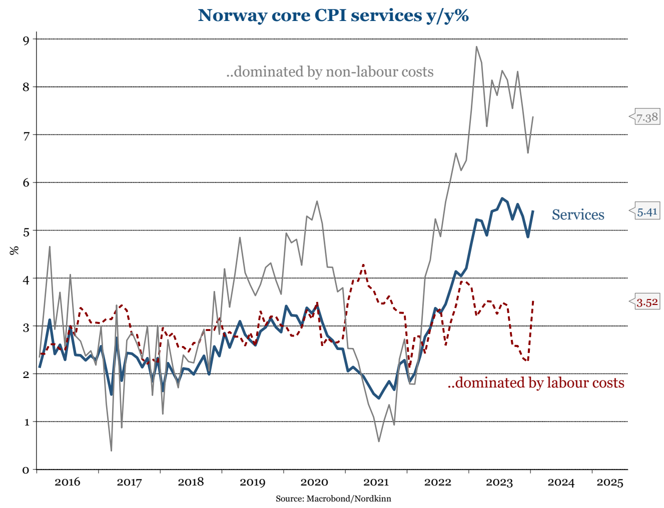
Taken all together, inflation remains elevated, and the pace of improvement is insufficient for Norges Bank to confidently anticipate a stabilisation towards the 2% target soon. The central bank forecasts that core CPI inflation will persist stubbornly above 4% throughout 2024, allowing for only one or two rate cuts in the autumn, according to their current projections.

Looking ahead, however, we see the risk surrounding Norges Bank's inflation projections clearly skewed to the downside. As detailed in our previous monthly report, goods price inflation in Norway has been notably higher compared to other nations. This disparity can be partly attributed to a weaker NOK exchange rate, which has kept prices on imported goods elevated. Additionally, sluggish adjustments to lower producer price inflation in domestically produced goods prices, particularly within the food sector, have also contributed. Anecdotal evidence points to much softer price developments for goods such as food, furniture, and household equipment.

Furthermore, while wage pressures in Norway remain strong, service price inflation appears to be roughly in line with international trends. Consequently, the argument that the robust Norwegian labour market is responsible for inflation outpacing other countries is not entirely convincing. Services where labour input dominates rose "merely" by 3.5% from a year earlier, while those dominated by other input costs (such as electricity and rents) rose by 7.4% in the same period, see chart.

In summary, our forecast suggests that Norwegian core CPI inflation has the potential to decline more rapidly during 2024 than expected by both consensus and the Norges Bank. We seek to capitalise on this view in our investment theme: "Norway: Inflation risks overvalued." Specifically, if our inflation analysis proves correct, 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. We also anticipate a steeper yield curve, primarily driven by lower rates in the medium-term segment, but also supported by the sharp increase in bond supply for 2024.



# 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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