NORDKINN

ASSET MANAGEMENT

Market Review & Outlook

May 2024

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Summary of market overview: Global bond yields went off in different directions in May, with European bond yields rising on rebounding inflation and economic indicators. By contrast, U.S. bond yields fell marginally, influenced by softer consumer and labour market data. Swedish short-term rates declined following the Riksbank's decision to cut its policy rate. Despite anticipation of lower rates relative to peers, both the NOK and the SEK appreciated substantially.

Outlook summary: We remain firm on our view that the Riksbank will ease monetary policy further amid lower inflation and softer labour market conditions, while the currency demonstrates resilience. In Norway we anticipate falling inflation to allow the policy rate to be cut once or twice this year. We continue to anticipate at least three ECB cuts this year. In the U.S. we caution severe upside risks to long-term bond yields ahead of the election amid resilient growth and loose fiscal policy

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Market overview

Global overview

The interest rate roller coaster continues. Although U.S. interest rates in May were slightly lower overall compared to the previous month, this masks a drop in the first part of May followed by a rebound later, see chart. Meanwhile, interest rates in the Euro area increased further in May overall, leading to a narrowing of the Transatlantic spread.

May started with a weaker than expected reading of the U.S. labour market. Employment growth (Non-Farm Payroll, NFP) slowed to 175k, from 303k the month before and 240k expected. As other early data also seemed to confirm a view of U.S. labour market stagnation (e.g. lower ISM), recessionary bets increased. As subsequent jobless claims data picked up steam, market participants eventually reevaluated their initial NFP-analysis to something more suited to reality; an NFP change of +175k is not weak, but rather supportive of the view of a soft landing. Especially considering the ~100k deemed necessary to keep the unemployment rate steady in the long-term. Taken in conjunction with hawkish FOMC minutes and many Fed-speakers underlining the still too high inflation, interest rates began a sharp climb that continued into the last few days of May.

In Europe, data for the three criteria for a cut as laid out by e.g. President Lagarde and Chief Economist Lane, have not been clearly conclusive for a rate cut. Both wage growth and inflation are, if anything, a tad high compared to ECB forecasts. As for the ECB upcoming projections, it is probably fair to believe that the ECB policy makers feel that already their current forecasts have erred on the cautious side, forecasting high inflation throughout all of 2024. More important is that the communication from ECB Governing Council members has since long nudged for a June cut.

At this juncture, therefore, market focus is on any hints on the pace of future cuts and the degree of independence vis-à-vis the Fed that the ECB Governing Council seem confident with. For the Fed, markets have already pushed the first cut out to Q4 2024, as confidence to cut is indeed faltering on the back of a still strong economy and high inflation outcomes during the first quarter.

From a Nordkinn perspective it is noticeable that despite having net a long bias of the portfolio throughout May, and global rates little changed overall for the month as a whole, our fund made solid gains. Our performance in May is not merely explained by instrument selection, but our allocation of risk from global themes (performing poorly) to domestic themes (performing strongly).

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Nordic overview

In May, the Swedish Riksbank became the first central bank in a developed economy to cut the policy rate after the Swiss National Bank. This move, which was anticipated by most economists surveyed, demonstrated a small yet significant independence from the Fed and the ECB. Over the past three months, inflation has stabilised just above the 2% target and is projected to fall significantly below this target during the summer months. The most recent data (April) showed CPIF at 2.3% and CPIF excluding energy at 2.9%, both lower than the Riksbank's projection. Meanwhile, price plans in the Economic Tendency Index (ETI) remained below the long-term average for the second consecutive month.

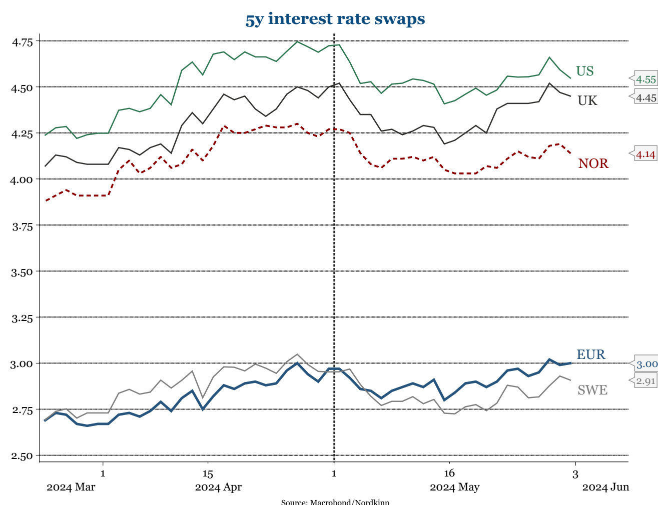
The favourable inflation outlook has bolstered hopes for further rate cuts, leading to a rise in consumer confidence as reflected in the ETI. Additionally, first-quarter GDP was revised significantly higher, with investments being a particularly surprising area of growth.

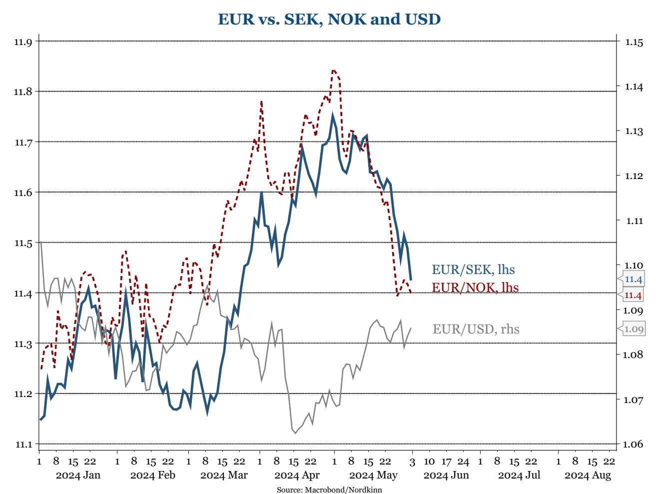
Swedish interest rates declined in May, outperforming European fixed income, particularly in shorter maturities. The yield curve steepened somewhat in the segment up to five years. This provided a positive start for the new theme *"Sweden: Green light for easing cycle,"* which was a meaningful contributor to the fund's performance in May. Despite the rate cut, the SEK appreciated in May, see chart. While this might be temporary noise, it could also be argued that rate cuts will ultimately benefit the economy and, in turn, the currency.

Meanwhile in Norway, during the press conference following the Norges Bank's decision to leave rates on hold on May 3rd, Governor Ida Wolden Bache cautioned that incoming data could suggest a tight monetary policy stance for somewhat longer than envisaged in March. In other words, the most likely timing for initiating a rate cut cycle could be delayed from September to December, or perhaps even further. One reason for this delay, which was signalled despite slightly lower than expected inflation releases, was that the NOK exchange rate had depreciated by about 3% during April and was weaker than assumed.

However, the NOK exchange rate rebounded in May and is currently slightly stronger than the March assumptions. This development has brought the possibility of a rate cut in 2024 back onto the table.

Our **"Norway: Inflation risks overvalued"** theme contributed positively to performance in May. This reflects the performance of Norwegian rates relative to peers and flatter money market curves (2024 vs. 2025 segment).





Outlook

Global outlook

As we are just a few weeks away of the market entering the summer haze, we do believe that the large, data-driven, market swings of winter and spring mostly lay behind us. Looking ahead, most commentators are focusing on the (possibility for) diverging paths of near-term monetary policy of the Fed vs. most other developed markets' central banks.

That said, most forecasters (ourselves included) are expecting somewhat similar developments in both the U.S. and Euro Area, albeit with different starting points. In the U.S., some very fine cracks in an otherwise solid economic structure are emerging. Some interpret this as the advent of a stagnation phase or even a recession. While we have a very hard time identifying recessionary signals in the current economic noise, a stagnation phase would rhyme with a very tight, resource scarce, economy and a monetary policy being restrictive for some time.

The latter observation is, as we have delved upon in many previous editions of the Nordkinn monthly report, still a controversial issue. We believe, however, that the lack of broad-based re-acceleration in both activity and price data does indeed send a message of gradual, policy-induced, slowing. Such developments would also be consistent with a gradual easing of inflationary pressures over the course of the year and a Fed being able to cut a couple of times during H2.

For the Euro Area, a more optimistic image is projected by improving survey data as well as some real data (e.g. orders and production). Simultaneously, inflation is coming down in a prolonged manner after the very strong global supply shocks that has hit the Euro Area particularly hard over the last one to two years. In the Euro Area, also, the consensus among forecasters is for inflation to continue its descent towards the inflation target and, to a more varying degree, for activity to pick up again.

In comparison with our own views, we can conclude that while our outlook for Euro Area growth has been optimistic for some time, our inflation outlook has been based on the belief that companies have been able and willing to pass on any increased costs, including wage costs. Recent national accounts data has challenged that view as profit margins do indeed seem to come down at a faster clip. This has, in turn, pushed our views closer to consensus on the Euro Area inflation outlook of gradually decreasing inflation.

To us, this also implies that Euro Area companies are experiencing a decrease in pricing power, something normally associated with lower demand and/or outlook for demand. We have a hard time grappling this as most activity indicators, if anything, suggest that the Euro Area has turned a corner on activity.

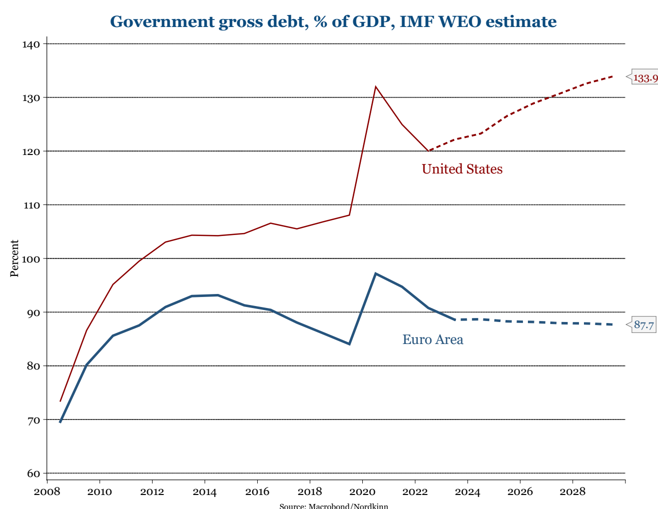
One possible explanation is, nonetheless, that Euro Area fiscal policy has clearly tightened in 2024 compared to 2023 and is set to become even tighter over the next few quarters and years, see left-hand chart. This provides us with a bridge to a discussion of risks to the outlook; or to be more precise, to a discussion of risks beyond financial market ruptures stemming from receding market liquidity during summer months.

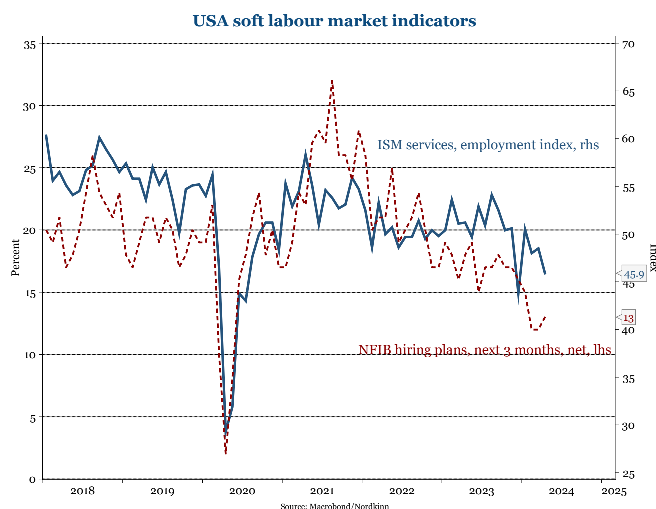
As always, there are number of things that can go wrong. But, focusing on what we believe are the main risks will still paint a picture of risks being biased towards higher rates. Starting off with downside risks, nonetheless, we believe that the U.S. labour market is probably the most important risk. Indeed, the past few outcomes for e.g. non-farm payrolls and claims, have become increasingly volatile, and there are a few soft indicators (Services ISM, NFIB, etc) that also point in the general direction of weakening labour markets, see right hand chart. The weakness in the Euro Area alluded to above could, similarly, provoke stronger disinflationary pressures also on this side of the Atlantic.

Upside risks to interest rates are neither confined to the discussion of higher neutral rates, and hence lower degree of monetary policy restrictiveness, nor to the possibility of compensatory demands from both companies and labour in response to the upward shifts in general cost structures and rising marginal costs.

Instead, we believe upside risks to interest rates are a function of the fiscal policy stance and outlook. We indicated this already in the last Monthly Report's Global Outlook section and since even more information has transpired, not least from the U.S. It is now all but confirmed, from both candidates, that the Trump 2017 tax cuts will be either replaced or extended/expanded, something which is not embedded in, e.g. the Congressional Budget Office's current forecasts. Instead, additional budget strains will emerge, especially if the candidates achieve majorities in both chambers.

The supply of longer-term U.S. government bonds is higher than last year, and issuance is concentrated to H2 of 2024. Importantly, markets are starting to take notice. Looking ahead, and even into 2025, we believe this will gradually come into markets' focus, setting a scene for continued volatility.





Outlook

Nordic outlook

We maintain our view that it is all clear for the Riksbank to continue cutting the policy rate. In fact, we are becoming increasingly firm on this stance. As we expect inflation to stabilise around the Riksbank's inflation target during the summer, a very restrictive monetary policy is no longer justified. Although consumer confidence has rebounded, further rate cuts are needed for this confidence to translate into real spending.

In our view, several factors support the case for the Riksbank to cut rates further, some of which are specific to the Swedish economy. The current inflation rate and outlook are perhaps the most compelling reasons. Additionally, Swedish wage formation has remained stable during the high inflation years, resulting in a favourable outcome in the last wage negotiations. Related to this, inflation expectations have remained well-anchored over the past few years.

If the Riksbank does not continue to cut rates, the real policy rate (policy rate minus CPI inflation) in 2025 will probably be the highest in approximately two decades, see chart. Furthermore, the labour market is showing signs of weakness despite stable employment. Without further rate cuts, the labour market could deteriorate significantly. Taken together, the Swedish economy is well-positioned for rate cuts, more so than many other countries.

In the theme *"Sweden: Green light for easing cycle,"* we are exploring opportunities based on our belief that markets are not only underestimating both the magnitude and speed of rate cuts, but also the potential steepening of the yield curve. We believe current market pricing is more a reflection of the strength of the U.S. economy and the persistence of service inflation in both the U.S. and the Euro Area. The market is struggling to account for an independent Riksbank that will implement monetary policy best suited for the Swedish economy.

At the same time, we see signs of a better performing Swedish economy where the export sector will reap the benefits of more global investments and eventually rate cuts. Consequently, we are getting more optimistic on the currency.

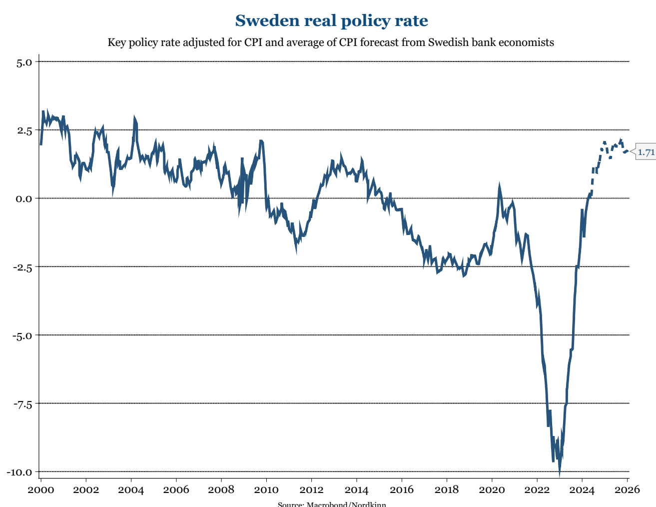
In Norway, consumer price inflation continues to moderate but remains markedly above target. Headline and core CPI inflation were 3.6% and 4.4%, respectively, in April, higher than inflation rates in most other European countries. Despite inflation being slightly lower than the Norges Bank projected in March, Governor Wolden Bache hinted on May 3rd that the initial rate cut, originally projected for September, may be postponed until December 2024 or even later.

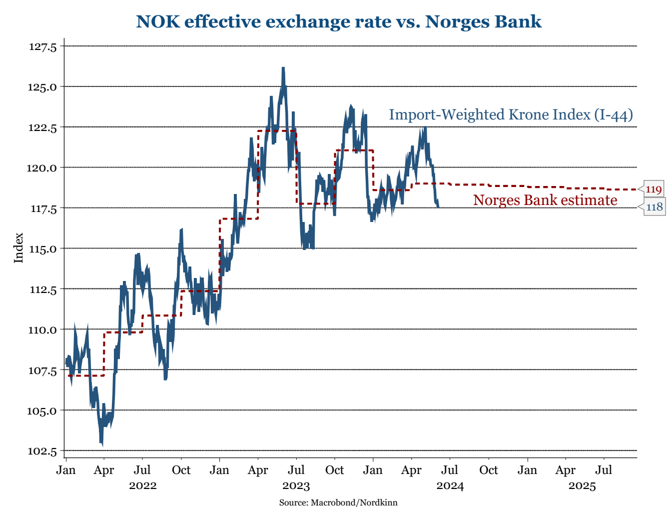
Four developments were cited as reasons for the potentially extended policy stance. Firstly, economic activity had been slightly higher than expected. Secondly, the outcome of centralised wage negotiations suggested upside risks to wage growth in 2024. Thirdly, interest rate expectations abroad had increased. Lastly, the NOK exchange rate was somewhat weaker than assumed.

Interestingly, since these comments were made in early May, the case for delaying rate cuts has weakened somewhat. According to updated national accounts data, economic activity at the end of Q1 was broadly in line with Norges Bank's projection from March, rather than higher. More importantly, since the last policy meeting the NOK exchange rate has appreciated more than 3% in trade weighted terms and is currently slightly stronger than Norges Bank assumed, see chart.

Admittedly, the appreciation of the NOK exchange rate in May would probably have been less pronounced if the Norges Bank's comments on May 3rd had been less hawkish; hence, this development does not put a September cut firmly on the table again. Besides, international rate expectations are still higher, and upside risks to Norges Bank's wage growth forecast remain.

Taken together, we nevertheless expect Norges Bank to cut the key policy rate by the end of this year, as our forecast for inflation remains well below that of Norges Bank. Additionally, we believe the NOK exchange rate should benefit from policy easing by the Riksbank and the ECB over the summer. Our view remains that the anticipated cumulative rate cuts discounted by the end of 2025 are insufficient compared to other nations. We aim to capitalise on this outlook through various trades structured around our investment theme *"Norway: inflation risks overvalued."*





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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