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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – March 2020

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Nordkinn Asset Management is a Nordic Fixed Income specialist based in Stockholm and Oslo. Nordkinn manages the Nordkinn Fixed Income Macro Fund, which seeks to generate stable absolute returns in all market environments.

MARKET OVERVIEW

Global overview

On March 11th, the WHO declared that Covid-19 is a global pandemic. As of April 1st, over 900.000 cases and 45.000 deaths have been reported worldwide. Measures to contain the diffusion of the virus has left one third of the world's population currently in lockdown. The extreme efforts are driving the global economy into a deep recession.

In fact, the speed and magnitude of the collapse in economic activity appears unprecedented, at least during peacetime. The March PMI data for Europe and the U.S. look eerily similar to the February China data - a plunge that is worse than at the time of the 2008 Financial Crisis.

The sudden breakdown of economic activity caused colossal turbulence in global financial markets, even worse than in 2008 and 1929. After reaching a peak in mid-February, global equities fell around 30% - the fastest crash in history, see chart. Volatility in some markets surged to record highs, and liquidity in key fixed income markets almost disappeared. On top of this, Saudi Arabia and Russia declared oil price war, which triggered a 60% collapse in the oil price.

Quite remarkably, prices on government bonds fell at the same time as equity markets sold off sharply. This odd correlation occurred amid fears over a dollar squeeze as corporates and investors offloaded assets including equities and government bonds. In short, the usual "flight-to-safety" was replaced with panic and a "flight-to-cash", specifically to U.S dollars, which prompted forceful reaction by the Fed.

The Fed cut rates by an accumulated 150 bps to near zero and introduced unlimited asset purchases. The ECB introduced a EUR 750 bln QE program that allows for purchases to exceed issue and issuer limits. Many countries have announced large fiscal stimulus packages.

As the Covid-19 shock hit all countries and markets across the globe with devastating force, country specific factors became of little relevance. Consequently, our theme *"Global: Relative Monetary Policy"* suffered losses after all G10 central banks rushed to their respective zero lower bounds in only a matter of days.

Nordic overview

The combination of a global recession and plunging commodity prices caused inflation expectations to plummet. The 10-year breakeven inflation declined by some 35 bps while the corresponding real rate surged by around 50 bps. This move was beneficial for the theme *"Sweden: slower growth, lower inflation"*.

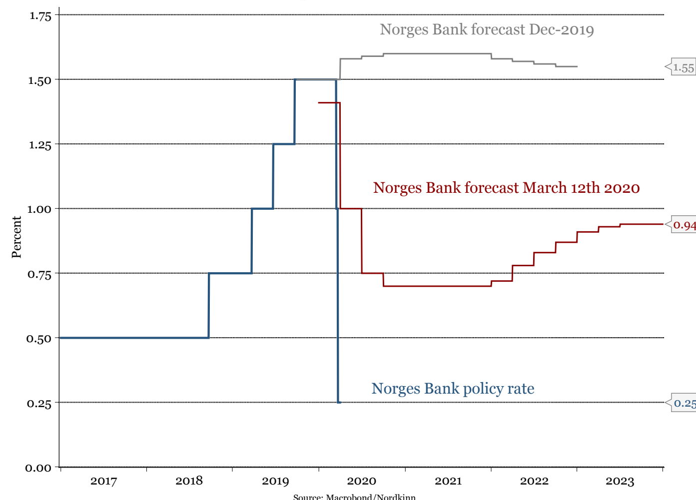
In response to the deteriorating growth outlook, the Riksbank launched a new QE programme, where mortgage bonds, municipal bonds (and later even corporate certificates) were added to its list of purchases, which previously only included government bonds. These actions, along with market discounting potentials for the Riksbank to cut the repo rate, which supported covered and municipality bonds, contributed positively to our *"Sweden: Hunt for yield"* theme.

Interestingly, Swedish 10-year yields rose between February and March. This highlights the effect of the dislocation mid-month when demand for cash triggered a sell-off across asset classes. Moves lower in bond yields were limited to markets where the central banks did cut the policy rate, such as U.S. and Norway.

The Norwegian economy is hit by a double whammy with an oil price war on top of the Covid-19 shock. In response, the Norges Bank not only cut rates twice by 125 bps in aggregate to reach a record low of 0.25%, it also totally redrew its forecasts, see chart. This resulted in a dramatic collapse in short-dated bond yields and a steeper yield curve. While tailspin in the short-end caused losses, our receiver positions and cross-markets spreads further out the curve lead to a positive result on our *"Norway: Weaker growth outlook*" theme.

Norwegian government bonds underperformed massively against swaps, punishing our *"Norway: ASW trading"* theme. Bonds suffered from the flight-to-cash as more collateral was required for FX hedges. Moreover, estimated NGB supply for 2020 rose sharply as the new NOK 50 bln Bond Fund will be financed via issuance of government debt. In contrast to other central banks, the Norges Bank has not yet introduced any purchase program (i.e. quantitative easing) for government bonds.

Having dropped a stunning 30% in 2020, the NOK pared losses month-end, as the Norges Bank said it may intervene with NOK purchases.



OUTLOOK

Global markets

Because the capacity of a country's health system (intensive care units, number of skilled health professionals, etc) is finite in the short run, the aim of public health policy is to flatten the Pandemic curve in order to counter a surge in the fatality rate. The primary countermeasure is to adopt "social distancing".

Extraordinary health policy measures to contain the spread of the virus involves vast economic cost. Global economic activity is falling at an extreme pace and global output will contract in 2020. How deep of a contraction and how fast of a recovery depends on the speed of containment of the pandemic and on the policy response. The longer the lockdown, the bigger the consequences for the sectors that have been hit the hardest, like tourism and restaurants. There will be defaults, bankruptcies and sharp rise in unemployment. Households and business will remain cautious.

Flattening the epidemiological curve means accepting a significant near-term hit to activity. Consequently, the policy response is unable to stimulate activity in Q1 and Q2, because that would be at odds with the need to control the virus. Rather, policymakers are working hard to mitigate the inevitable consequences of what they hope will be a temporary, yet significant loss of income. Governments are working on targeted fiscal support to vulnerable households and to large and small businesses, so they can stay afloat and get back to work as soon as possible. Meanwhile, monetary policymakers have lowered interest rates to zero and introduced extraordinary asset purchase programs to smooth the functioning of markets and the transmission of monetary policy to the economy.

Ultimately, these unprecedented policy responses may eventually lay the grounds for a rebound as measures designed to flatten the coronavirus curve can be relaxed. However, we see a risk for a slower rebound than consensus expects as these measures will probably be relaxed only gradually. Moreover, in the short term the outlook remain extremely uncertain with no peak in new cases in sight yet. Maybe most worryingly, the U.S. has seen an enormous surge in cases and might be facing a severe public health crisis, see chart.

In terms of public health system stress, lockdowns and economic sudden stops, much of Europe and, in particular, the U.S. still seems to have the worst ahead of themselves. This suggests that markets is likely to suffer through more volatility over the coming period.

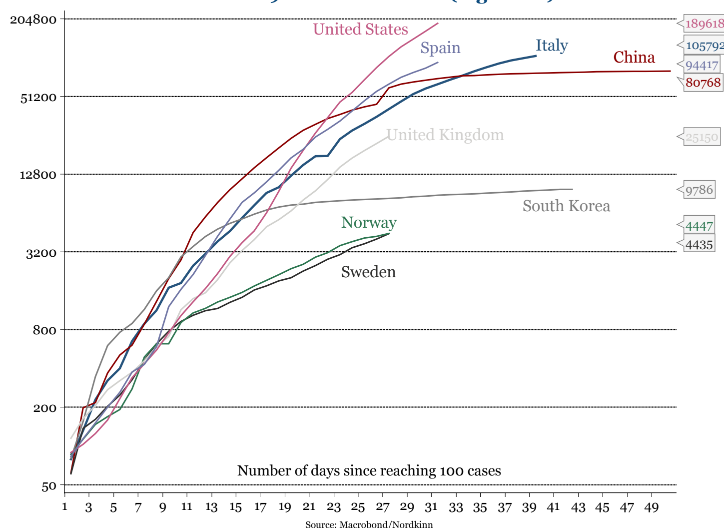
Turning to implications for the fixed income market, we expect very loose monetary policy conditions to remain in place for the foreseeable future. For instance, the Fed's forward guidance explicitly states that interest rates will remain close to zero until the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals. As at current, we do not expect these conditions to be met before the end of 2021 at the earliest.

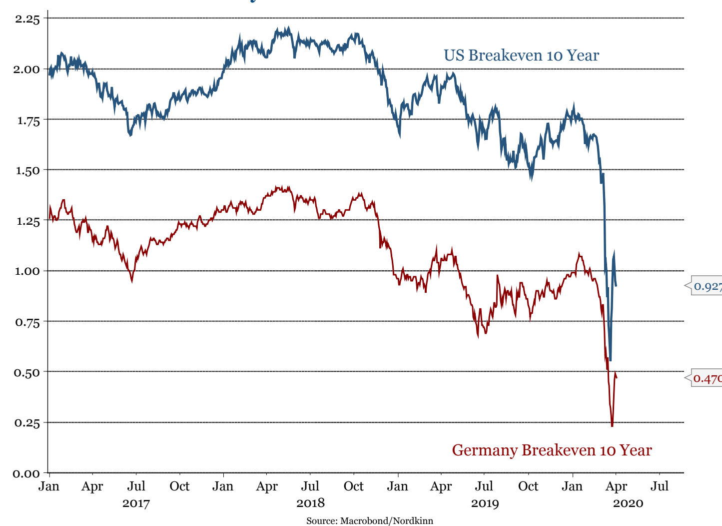
Rather, if the pandemic does not abate in the next few months, policymakers may look at other options to mitigate the recession and accommodate government budget deficits. More central banks may adopt explicit Yield Curve Control, which is equivalent to the practice of Bank of Japan and, more recently, the Reserve Bank of Australia.

In sum, we think risk/reward favours a further relative decline in government bond yields and flatter yield curves.

In particular, we find inflation-linked bonds (real interest rates) attractive for two reasons: Valuation and policy support. Although we acknowledge the imminent downside inflation risks due to lower commodity prices and higher unemployment, the market is pricing in a prolonged period of inflation undershoot. We doubt the spread between nominal and real rates is a clear reflection of inflation expectations. At least to some extent, we believe it is a result of market dislocations, notably a flight-to-cash, experienced in March.

Second, central banks will maintain an accommodative stance for longer to support the economy and inflation expectations, which should benefit inflation-linked bonds in particular. The historical evidence from previous QE announcements have been followed by sharp declines in real bond yields. Given the unparalleled stimulus announced now, we do not see why history will not repeat itself in 2020.





Nordic markets

While we do not foresee the Riksbank to cut rates again, at least not until the picture for the broader economy clears, we can not completely rule it out. Currently, roughly 12.5 bps of rate cuts is priced in the market. Central banks will wait long before increasing policy rates again, and thus the risk being long in shorter (positive yielding) bonds seems relatively safe, with an (inbuilt) option for a rate cut.

The width of the social distancing's impact on the economy remains unclear, but it will be hard to circumvent dire macro data over the next few months. The manufacturing PMI plunged in March to the lowest level since the 2008 Global Financial Crisis, but the service sector will probably take an even bigger hit (data due on April 3rd).

At the same time, a wall of cash will hit the global financial system. This cash will try to find a new home, which also might add to a flattening trend of yield curves. However, the Swedish yield curve is not our preferred choice to flatten from here (rather we favour Norway, see below).

The hefty decline in breakeven inflation rates has left them at historically low levels. On the other hand, we have never seen such degree of shutdown in modern time, with subsequent substantial spike in unemployment. What will this mean in terms of underlying inflation? Uncertainty is massive and while Swedish breakeven inflation rates are trading low in a historical context, international peers are trading well below the Swedish. Hence, a general rebound in inflation expectations should move EUR and USD breakeven inflation rates higher relative to Sweden. In addition, Swedish real rates appear expensive compared to, for instance, German linkers and US TIPS.

How protracted the lockdown of the economy will be will also be decisive in terms of the government borrowing requirements. So far, the prevailing view is that the economy will rebound relatively quickly and that lay-offs could easily be reversed. Nevertheless, if lockdowns are prolonged and their effects are greater than currently thought, the labour market will suffer more long term. This, in our view, would make the National Debt Office to focus more on bond issuance instead of T-bills. The labour market is probably the most important factor for long-term borrowing requirements and will be very important to monitor going forward.

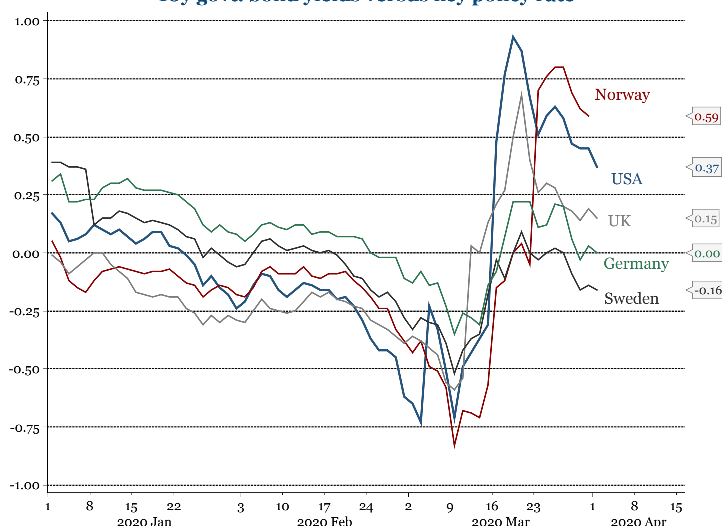
The implications of the coronavirus outbreak on the Norwegian economy became much more severe than we expected only a month ago. The main scenario now is a deep economic contraction in 2020, with GDP falling no less than -3%, and probably more. The depth of the recession will among other factors depend on how long the government's measures to flatten the coronavirus curve will remain in place.

However, relaxing government measures is not the only necessary condition to boost the Norwegian economy back to pre-corona levels. Norwegian businesses will struggle with weak global demand for a long time and many companies are now cutting back on capital spending. With Brent oil price hovering around USD 25 per barrel, the lowest level since 2003 (see chart), petroleum investments will fall sharply and cause significant ripple effects on the non-energy sector as well.

At the same time, the Norwegian economy has a strong fiscal position with plenty of room to manoeuvre on policy support. The government has already introduced a large number of compensation schemes that will keep businesses afloat and extended unemployment benefits to mitigate income losses. Moreover, the weak NOK and a 125 bps slash of the key policy rate will also bring valuable support to the economy.

In our view, monetary policy will have to remain very accommodative for an extended period. Low-for-longer should support bond prices and contribute to flatter yield curves in coming months. The curve is relatively steep by international comparison, as the Norges Bank has loosened monetary policy by cutting the key policy rate without introducing QE. Consequently, as soon as market liquidity gradually improves, the long-end of the Norwegian bond curve appears relatively attractive for global investors hunting for yield.

Following a significant cheapening relative to NOK interest rate swaps in March, NGBs offer attractive yields in particular. Yet, because supply in Q2 will become significantly higher than originally planned, NGBs may well cheapen somewhat further in the near term. However, in the second half of 2020 we expect supply to moderate and at current levels the risk/reward is in favour of going long NGBs both relative to swaps and cross market, versus Sweden in particular.



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