NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – April 2020

Addressed to Nordkinn's Followers on LinkedIn for informational purposes

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

The trajectory of new Covid-19 cases is showing a stabilisation in the U.S. and a clear downtrend in most of Asia and Europe, see chart. With hospitalisation falling, many European countries have started, or are about to initiate, a measured approach to opening up economies. Even in the U.S., despite a number of states not having an obvious peak nor descent in new coronavirus cases, reopening is starting. The quest to reopen supported a rebound in risk appetite, with most equity indices experiencing a bear market rally from the historical lows in March.

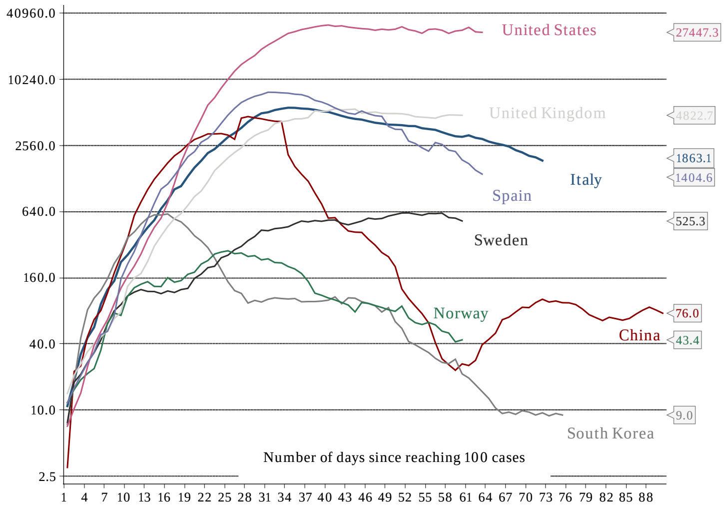
Aggressive central bank policy has also contributed to restoring risk sentiment by limiting strains in the financial system. At the monetary policy meeting on April 29th, the FOMC reiterated that the Federal funds rate will remain close to zero until the committee is confident that the economy has weathered recent events. Furthermore, the central bank emphasised it will continue to support the economy with a wide range of policy tools, including asset purchases in the vast amounts needed.

U.S. nominal government bond yields were little changed in April, while Treasury Inflation Protected Securities (TIPS) performed somewhat. Consequently, market implied inflation expectations inched higher, supporting our *"Global: Central Banks' inflation commitment"* theme.

On April 30th, the ECB made no changes to key policy rates, nor to the Pandemic Emergency Purchase Program (PEPP). However, President Lagarde emphasised that the central bank is ready to increase the size, duration and scope of PEPP if needed. Interestingly, the ECB decided to ease conditions for euro area banks to borrow under the TLTRO-III program, up to 50 bps below the deposit rate. This contributed to a decline in euro area government bond yields at the end of April.

A combination of panic and market reality triggered a collapse in crude oil prices in April. On April 20th traders sent the oil price into negative territory for the first time ever, as they desperately tried to avoid owning oil before the expiry of the May WTI futures contract. The economic reality is a sharp decline in oil demand combined with hesitations among oil producers to reduce supply fast enough. The unwanted oil filled up storage much more quickly than anticipated, particularly in the U.S.

COVID-19 New cases, 7d average



Source: Macrobond/Nordkinn

Nordic overview

April ended with small changes in the Swedish fixed income market compared to last month, with bond yields moving in tight ranges amid a significant decrease in volatility. Unsurprisingly, the Economic Tendency Index and other economic data demonstrated unprecedented declines, especially within the service sector.

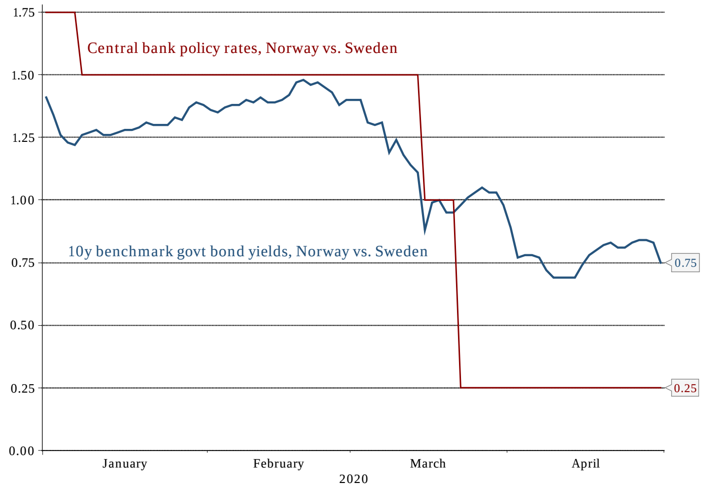
In response to evidence of a stalling economy, the Swedish government signalled further measures in order to keep businesses afloat through the crisis, and funding these measures requires a substantial increase in the net borrowing requirement from virtually zero to roughly SEK 300 bln. On top of that, lower income from taxes combined with costs for rising unemployment will add further strain on the government's budget deficit. The focus on potential bond supply amid the fiscal measures lead to downward pressure on SGBs relative to other assets, including swaps, municipality bonds and NGBs. The underperformance of SGBs benefitted our *"Sweden: Rising bond supply"* theme.

Moreover, while the CPI release was not as dire as the most bearish forecast suggested, the theme *"Sweden: Slower growth and lower inflation"* continued to benefit from lower inflation expectations (Break-Even Inflation Rates) in shorter maturities, which were further compressed by the plummeting oil price. On April 28th, the Riksbank kept its policy rate and its QE purchases unchanged, yet the market continues to discount rate cuts later in the year.

According to estimates from Statistics Norway, economic activity in Mainland-Norway was 14% lower at the end of March than at the beginning of the month. The government lifted some of its Covid-19 restrictions in April, including ban on visiting holiday properties, and reopening of kindergartens, schools for primary years 1-4 and services with one-to-one contact (such as hairdressers and psychologists). The unemployment rate fell to 9.6% in April from 10.7% in March following the easing of some containment measures.

After a dramatic rollercoaster in March, the NOK exhibited less volatility in April and appreciated slightly during the month in spite of the dramatic collapse in oil prices. Interest rates declined somewhat both in absolute terms and relative to peers, in part driven by a significant plunge in short-term money market rates and the relative appealing valuations of NGBs.

Interest rate spreads, Norway vs. Sweden



Source: Macrobond/Nordkinn

Global markets

The key and pressing theme for investors in financial markets is the process of lifting containment measures, which is starting to unfold across the world thanks to a reduction in the number of hospitalisations and critical care requirements. As governments across the world are moving to reopen economies, most analysts are predicting economies to bounce back coming months.

The speed at which economies can rebound from here is extremely hard to predict as it depends on numerous uncertain factors, including the pathway of the pandemic. The IMF's baseline scenario outlined in the April World Economic Outlook is a contraction of Advanced Economies' GDP by -6.1% in 2020, an outcome far worse than during the 2009 financial crisis, followed by a rebound of +4.5% in 2021.

It is worth noting that this trajectory depends critically on the pandemic fading in 2020, allowing containment efforts to be gradually scaled back. Interestingly, in spite of this relatively optimistic assumption of a fading pandemic this year, the baseline scenario implies that the economy remains below its pre-crisis trend until end of 2023, see chart. It takes time to restore consumer and investor confidence, and for production to ramp up, after the shock.

Moreover, as containment efforts are lifted, there is a risk that the virus could again start spreading more rapidly. The IMF therefore discusses three alternative scenarios where the pandemic could prove more persistent. The first scenario assumes that the pandemic, and necessary containment measures remaining in place, lingers for about 50% longer than in the baseline scenario. The second assumes a second milder outbreak wave in 2021. The third features a combination of these two scenarios. As illustrated by the chart, these alternative scenarios imply weaker trajectories for the economy over coming years compared with the baseline scenario.

One upside risk dismissed in this scenario analysis is if a therapy or a vaccine is found earlier than expected, allowing for a quicker removal of social distancing measures and a faster economic rebound than expected. Scientists are examining dozens of drugs as possible treatments for Covid-19.

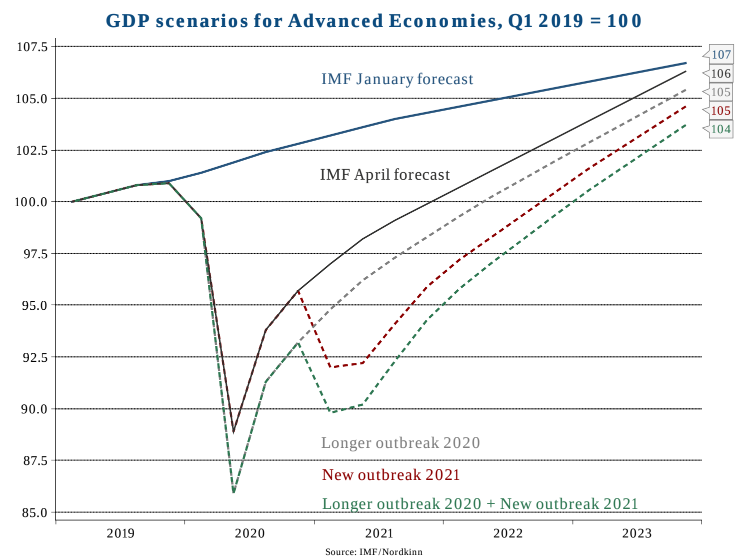
Early results from a drug obtained by Gilead, a biotechnology company, showed it might help patients recover somewhat quicker. However, the effect on the death rate was not statistically significant, which means limited ability to quickly get back to "normal".

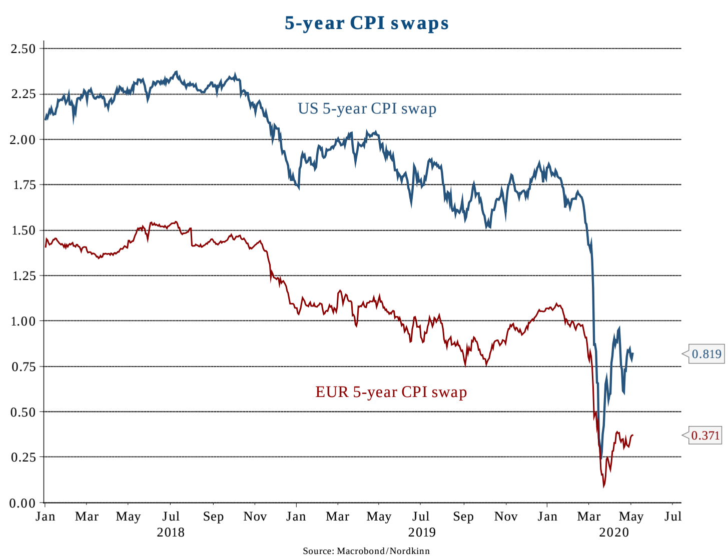
On balance, a common feature for these scenarios is that the recovery will unfold gradually. Lingering uncertainties about the pathway of the pandemic is likely to result in precautionary savings and low investments. This means that economic activity will remain below its long-term potential for quite some time and that unemployment will remain relatively high and decline only gradually in coming years.

With the meaningful output gap being expected, it is hard to see a strong wage push on the horizon. Moreover, commodity prices have fallen, oil prices have collapsed, putting downward pressure on inflation. In short, it is also hard to see strong push for higher consumer price inflation in the coming year or so. Consequently, we expect central banks will be stuck at the zero effective lower bound for a very long time.

Looking beyond the short term, the large fiscal and monetary programmes could indeed lead to a return of inflation and, eventually, a rise in interest rates. Interestingly, despite a small rebound in April, inflation expectations implied by markets are extremely low. In the U.S., the inflation rate over the next year is expected to be -1.0% and over the next five years an average of 0.82%, see chart. Expectations on Euro area inflation rate is even lower, where the five-year average is expected to be 0.37% according to the market. Next year will of course be challenging, but further out in time we doubt that current pricing is a reflection of actual expectations.

In March, demand for USD cash amid the market crash in March lead to a substantial liquidity premium on U.S. real interest rates, which moved considerably higher. Since then, we have seen a thaw of the financial markets as central banks have injected huge amounts of liquidity into the system. As central banks are determined to normalise markets and pressing real rates lower, we have increased positions for lower U.S. real rates and higher mid-term inflation expectations. In effect, we expect a normalisation of the liquidity risk premia in this asset.





Nordic markets

One of the Covid-19 crisis more profound impacts on the Swedish economy is the total change in fiscal policy. The government's response to the crisis has been to announce and release several costly measures. So far, these measures have been directed to keep business alive through the severe crisis. When the economy eventually opens up again, the government has declared that new fiscal support will be directed to stimulate spending. In all, the measures so far amount to roughly SEK 300 bln, but more will most likely be needed later and they could prove more costly than estimated. For instance, applications for support to layoffs were first expected to amount to just over 100k, but current applications counts to more than 400k. On top of this, there will inevitably be a significant loss of tax revenues.

Taken together, the Debt Office's last forecast for borrowing requirements (February) is obsolete. Forecasters estimate borrowing needs to range between SEK 300-600 bln more than what the Debt Office estimated in February. This has to be financed. We expect issuance in T-bills and bonds to have an impact on the market despite Riksbank QE purchases. We see room for both swaps and covered bonds (and some foreign government securities) to outperform Swedish government bonds. SGB bond yields are negative amid a close to record flat yield curve. Hence, investors are dependent on a continuation of declining interest rates in order to make money. We expect investors to see better opportunities in other bonds (and assets).

One important theme in our portfolio since last summer has been *"Sweden: slower growth, lower inflation"*. This theme has gradually benefitted since start and when the crisis hit, with the economy at halt, and commodity price plummeting, market based inflation expectations plunged to lows. However, these inflation expectations are elevated relative to what we see in, for instance, Europe and the U.S. As a result, the portfolio is being more focused on relative pricing of future inflation in Sweden compared to Euro and U.S.

Riksbank kept its repo rate unchanged at the monetary policy meeting on April 28th, as any additional stimuli to spur spending will have to wait until people are not told to stay at home. In light of this, we do not expect any rate cuts at the July meeting. However, the Riksbank Board does not rule out rate cuts post Covid-19 to support the recovery of economic activity and inflation. Consequently, the market should price-in the chance for a cut, also as a rate hike indeed seems very distant.

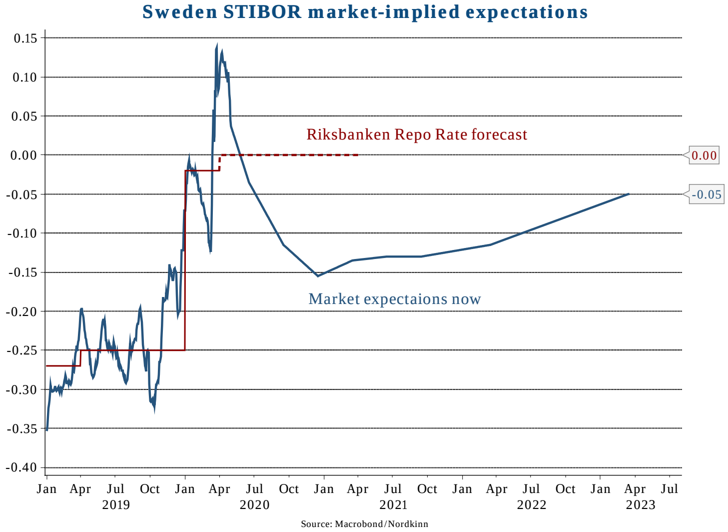
After an abrupt standstill in the Norwegian economy, the government's decision to lift some Covid-19 containment measures in April will lay the ground for a rebound in economic activity. Yet, the rebound will be very gradual for a number of reasons, which we also discussed in the global outlook section. Many restrictions still remain in place and the process of lifting them will be inert in order to avoid new outbreaks. Lingering uncertainties will restrain consumer and business confidence for some time.

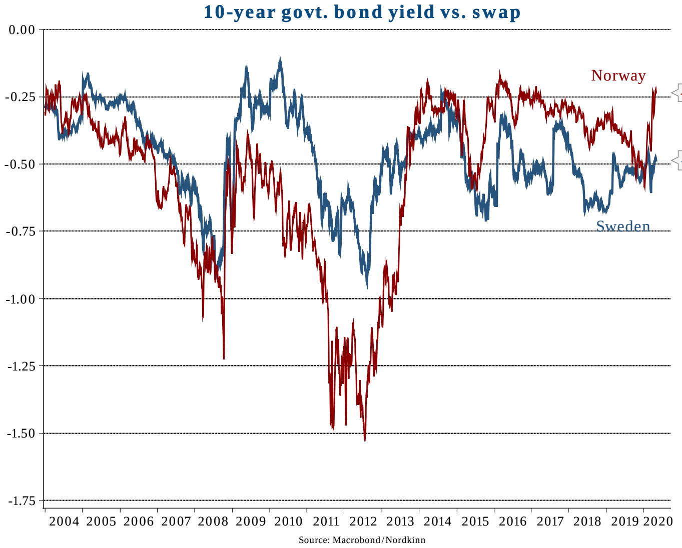
Moreover, Norwegian businesses will struggle with weak global demand and are now cutting back on capital spending. With Brent oil price below USD 20 per barrel, petroleum investments will fall sharply and cause significant ripple effects on the non-energy sector as well.

In spite of this gloomy outlook, we do expect Norwegian economy to tackle the downturn relatively well. Norway 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 mitigate income losses. Moreover, the 125 bps reduction in borrowing costs combined with a weaker NOK will give a push to the economy when Covid-19 restrictions are lifted. Banks have more capital and liquidity than in the past, allowing them to support economic activity even when facing credit losses, preventing the emergence of adverse macro-financial feedback loops.

Still, monetary policy will have to remain very accommodative for an extended period of time. We expect the key policy rate to remain at the effective zero lower bound until at least 2022, but most likely longer. This should keep a flattening pressure on the yield curve in coming months. In our view, the long-end of the Norwegian government bond curve appears relatively attractive relative to both peers and swaps. Note that the budget deficit in Norway will be financed by a transfer from the Government Pension Fund Global, not an increase in supply.

While weak in a historical context, the NOK exchange rate does appear broadly fair in our view, particularly when considering the sharp decline in interest rate differentials to other currencies as well as the very low level of oil prices. Moreover, the risk-on sentiment in equity markets seems to have provided support to the NOK, but sentiment could easily go sour again should virus containment fail. Consequently, our short-term view on the NOK is neutral or slightly bearish.





ABOUT NORDKINN

Nordkinn Asset Management aims to create and preserve wealth by consistently providing investors with stable risk-adjusted absolute return through its unique team and local expertise. Operating from Stockholm and Oslo, the team of ten capitalises on their specific fixed income and absolute return backgrounds. Nordkinn aspires to be the leading hedge fund in the Nordic region as measured by risk-adjusted performance, operational excellence and investor appreciation.

DISCLAIMER

The content of this Report has been prepared by Nordkinn Asset Management AB (the «Company»), registered in Sweden No. 556895-3375. Information in the Report is made only as at the date of the Report unless otherwise stated, and remain subject to change without notice. The Content has been prepared in good faith. However, to the maximum extent permitted by law, neither Nordkinn Asset Management AB, nor its related corporations (including Nordkinn Asset Management Oslo Branch, registered in Norway No. 999 136 354), directors, employees or agents, nor any other person, accept any liability, including, without limitation, any liability arising from fault or negligence, for any loss arising from the use of the Report its contents or otherwise in connection with it.

The Report contains forward-looking statements. Although the Company believes the expectations expressed in such forward-looking statements are based on reasonable assumptions, such statements are not guarantees of future performance and actual results. Actual results or developments may differ materially from those projected in forward-looking statements. Past performance is no guarantee of future returns. The value of investments and the income from them may fall as well as rise and is not guaranteed. Changes in rates of exchange may cause the value of investments to fluctuate. The Report is confidential information, only for the use of those persons to whom it is addressed and no part of this report may be reproduced, redistributed or passed on, in any manner, or used other than as intended, without Nordkinn´s prior written permission. The report does not constitute an offer to sell or the solicitation of any offer to buy

Kungsgatan 33, 6th floor
111 56 Stockholm, Sweden
Phone: +46 8 473 40 50
Telefax: +46 8 473 40 51
E-mail: post@nordkinnam.se

Prinsens gate 22, 6th floor
0157 Oslo, Norway
Phone: +47 22 46 63 00
Telefax: +47 94 77 15 16
E-mail: post@nordkinnam.no