NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – May 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

Prospects of economic recovery following substantial fiscal and monetary stimulus combined with gradual re-opening, supported risky assets, commodity prices and the trend for a weaker USD during May. SEK and NOK are among the top currency performers over the past couple of months. Market-based inflation expectations climbed as real interest rates fell, while nominal government bonds were virtually stable on balance. German Bunds and Swedish SGBs underperformed U.S. Treasuries due to higher net supply. Italian and Spanish bonds outperformed on hopes of fresh recovery stimulus.

On May 27th, the European Commission proposed a EUR 500 bln Recovery Fund to be distributed as grants to regions and sectors within the European Union being worst affected by the coronavirus pandemic. On top of these grants, it proposed another EUR 250 bln to fund loans to member states. The EUR appreciated on the news even though the plan met resistance as the Netherlands, Austria, Denmark and Sweden rejected the notion of grants. On the very same day, Japan revealed a JPY 117 tln (USD 1.1 tln) stimulus package that will include a sizable amount of direct spending to cushion the economic downturn.

While the trajectory of new Covid-19 cases is showing signs of stabilisation in the U.S. and a clear downtrend in most of Europe, the outbreak is worsening in emerging markets. Latin America in particular is the new epicentre of the coronavirus pandemic, see chart.

In many advanced economies, governments are gradually easing lockdowns. The scope of the relaxation varies, but several countries are reopening museums and other cultural centres, restaurants and bars. Many countries are even aspiring to allow for international tourism as from mid-June.

Meanwhile, the U.S.-China relationship has worsened dramatically in the past few weeks, as America became one of the countries worst hit by Covid-19, which was first discovered in the Chinese city of Wuhan. Trump appears tough on China as he seemingly needs a "scapegoat" in relation to Covid-19. Moreover, the world's two biggest economies have also clashed on a range of issues from trade to human rights, with Beijing's latest move to tighten its grip on Hong Kong igniting another confrontation between Trump and Xi.

Nordic overview

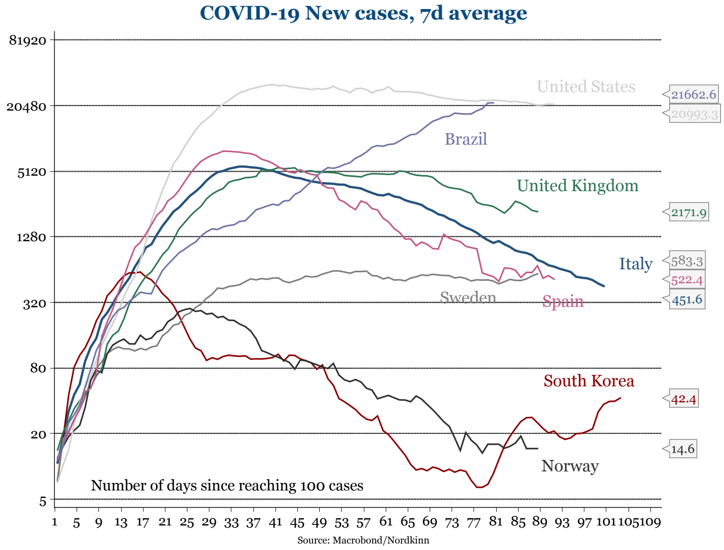
Swedish government bond yields rose around 10 bps amid prospects of rising SGB supply ahead. According to its updated forecast, the National Debt Office expects a budget deficit of SEK -400 bln in 2020, compared with the February forecast of a balanced budget. As a result, borrowing will increase across all debt instruments, although T-bills will account for the lion share of new issuance. The Debt Office will increase volume of bonds only gradually in an attempt to protect the nominal bond market, yet it still needs to attract investors amid negative, or with just a few basis points of positive, yields.

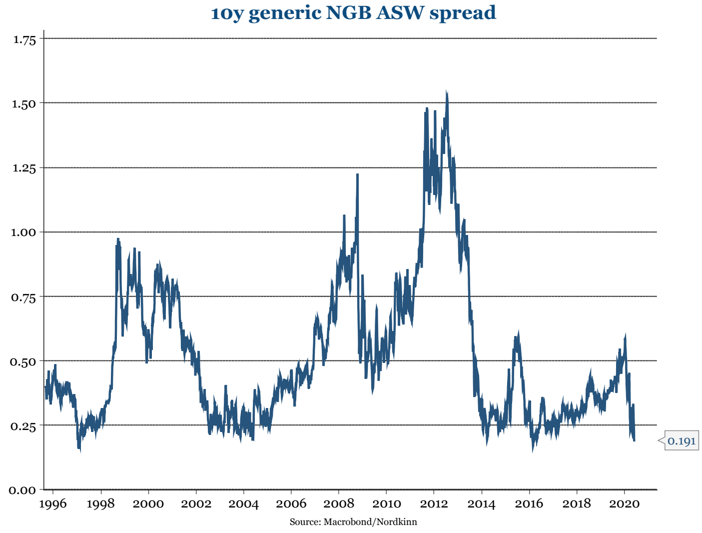
Our anticipation for Swedish bonds to underperform, organised under our theme *"Sweden: Rising bond supply"*, paid off during the month and we expect SGB weakness to continue.

The release of the April CPI data in Sweden was a major surprise on the downside, with non-energy prices particularly weak. Consequently, Break-Even Inflation (BEI) rates continued to slide in May, resulting in further gains in our *"Sweden: Slower growth, lower inflation"* theme. With BEI rates now being extremely low in a historic context, we have decided to dismantle this theme. However, given the relative high levels compared to other markets, we will continue exploring Swedish BEI rates but in a new theme opened in June, see more in the next section.

At the monetary policy meeting on May 6th, the Norges Bank decided to lower its key policy rate by 25 bps to 0.00% and it forecasts the policy rate to remain at this level over its entire forecast horizon, through 2023. Since the beginning of March, the Bank has slashed the policy rate by an accumulated 150 bps. On top of this, the Bank has taken a range of measures to improve market liquidity, pushing money market premiums down. These measures combined lead to overall strong performance of NOK fixed income both outright and cross-market, benefitting our *"Norway: Weaker growth outlook"* theme.

Meanwhile, long-dated NGBs continued to trade relatively soft compared to other instruments amid temporary heavy supply in May. The market was not prepared for a syndicated NOK 10 bln tap of the August 2030 bond. Asset swap spreads fell sharply to multi-year lows, see chart. This notwithstanding, our *"Norway: ASW trading"* theme had due to active trading a positive contribution to the overall result.





Global markets

The market debate playing out regarding the consequences of Covid-19 is framed by central bank and government support on the one hand, versus a pronounced decline in economic activity on the other. Recently, the pace and range of support for economies and the resumption of economic activity have dominated market sentiment, see chart. If risky assets are correct in that the positive trend in activity can be sustained, and that any second wave of the pandemic can be managed, higher long-term bond yields and a weaker USD will eventually complement the positive risk sentiment, even if central banks are purchasing significant amounts of bonds in the secondary market.

However, much rests on what kind of recovery beckons from here. In particular, it remains to be seen just how long it takes before returning to pre-coronavirus levels. We view the Recovery Fund proposal from the European Commission as positive for the European economy. If it becomes reality, it would be bullish EUR and peripheral government bonds. Indeed, we think there will be increasing optimism about the Recovery Fund heading into the June 18-19th European Council meeting. The stance of the frugal four (the Netherlands, Austria, Denmark and Sweden) is known at this point, and we do not expect incremental opposition to develop in the near-term. If we are right, the EUR/USD could be heading towards 1.15 during June.

At the same time, the pathway for global growth will be slow as restrictions will only be relaxed gradually ahead. As we discussed in our previous monthly report, the baseline scenario from the IMF's April world economic outlook implies that the economy remains below its pre-crisis trend until end of 2023, but they highlighted that there are significant downside risks to this view. The worsening of the coronavirus outbreak in emerging markets accentuates these risks.

Moreover, the deterioration of the U.S.-China relationship is another source of risk that has the potential to further delay the global economic recovery and it will affect financial market sentiment during summer.

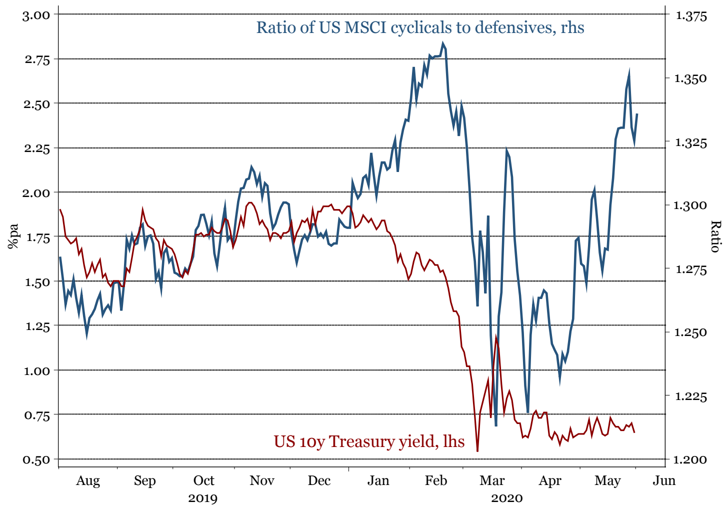
Turning to our investment views, we remain relatively neutral on directional fixed income developments going forward. Instead, we see myriads of interesting opportunities in relative value space. For example, market based inflation expectations appear relatively high in Sweden when comparing wth the US and EUR, see chart.

Judging by history, we disagree with this relative pricing. In the 2000s, Swedish CPI has been lower than in Euro Area and the U.S. most of the time. Even when taking rate cuts into account, which affect headline CPI, but are dismissed from the CPIF index. The few years (four out of six) when inflation has been highest, the SEK has been on a weakening path. As we doubt that the SEK is set on another prolonged course of depreciating, it is in our view very unlikely that inflation will unfold in manner in line with relative market pricing.

We see no reason why Swedish inflation will be much higher than European and American in the next few years to come. If anything, the pandemic has shown that service prices, so far sheltered, will be subject to even more global competition (the new phase of globalisation and telemigration, i.e. machine translation / white collar robots etc.), giving rise to interesting opportunities in these inflation spreads going forward.

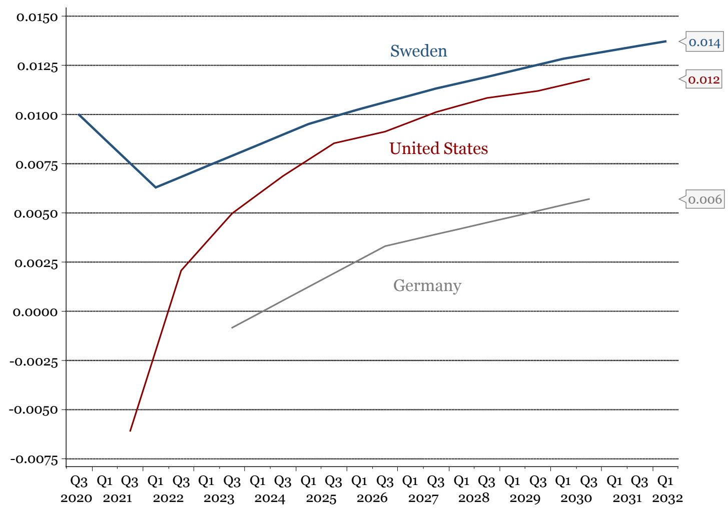
Consequently, we have in June opened a new theme *"Global: comparative inflation expectations"* where we exploit the fact that various markets are pricing different paths for inflation over the next decade. This new theme replaces *"Global: Central Bank's inflation commitment"* and *"Sweden: Slower growth, lower inflation"*. In addition, real rate spreads in these markets will be scrutinised and we see attractive risk/reward opportunities in these spreads going forward.

Bond and Equity markets disagree on the economic outlook



Source: Macrobond/Nordkinn

Breakeven inflation rates



Source: Macrobond/Nordkinn

Nordic markets

In Sweden we except the outlook for rising bond supply, and its market reprecussions, to remain on radar at least throughout this year. Yield curves are extremely flat, combined with issuance of bonds along the entire curve surging, they will most likely cease to be "squeezed" in the (repo) market. This will move bond repo rates (funding of bond positions) closer to the Riksbank's policy rate (less negative). As a result, holding these bonds will become a costly affair, unless yields were to move higher.

Some market pundits expect Riksbank's QE purchases to be an obstacle for bond yields to rise. While we acknowledge that purchases by the central bank will be a force in holding back yields, buying will be done in the secondary market. This means that other investors need to acquire the bonds before selling them to the Riksbank at a later stage. Admittedly, there will be a tug-of-war between issuance and QE purchases, but given the current shape of the yield curve, we foresee volatility picking-up and yield levels to slowly grinding higher. As bond yields increase, not only in Sweden, the outlook for active bond trading looks more favorable the next few years compared to the past five years or so.

The negative surprise in Swedish core inflation (see review section above) does suggest that underlying inflationary pressures are moderating in line with our forecast, see chart. Forward looking indicators point to weaker price pressures ahead. For instance, the NEIR´s monthly report shows expected selling prices in the service sector at an all-time low. In additon, this happens as the currency is on a stronger path.

In line with our long-held view, market based inflation expectations have finally come down to more appropriate levels. Admittedly, they are now very low, which lead us in May to unwind our directional positions for lower break-even inflation.

However, compared to the major peer markets, the U.S: and Euro Area, inflation expectations still remain relatively optimistic in Sweden. This is currently the key ingredient of our new theme *"Global: comparative inflation expectations"*, see the previous section for a more detailed analysis.

Norway has been severely hit by the Covid-19 shock, but the recovery has begun thanks to gradual easing of lockdowns and massive policy stimulus. The 150 bps reduction in interest rates is having powerful impact on household sentiment, as reflected by a growing demand for goods and exising homes.

Nevertheless, it will likely take time for economic activity to return to the levels before the pandemic. As a consequence, we expect the Norges Bank to maintain its zero interest rate policy for years. This said, we deem zero to be the effective lower bound in Norway and do not anticipate further cuts into negative territory.

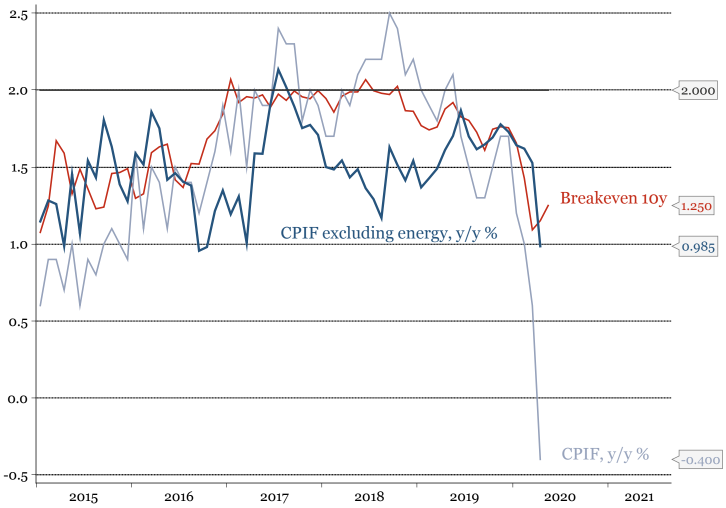
Regarding investment opportunities, we like NGBs with longer maturities and have increased our exposure in May for a number of reasons. First, from a global bond allocator's perspective, NGBs with longer maturities currently offer a very attractive pick-up compared to other AAA bonds both outright and when hedged into EUR or USD using a three-month currency hedge.

Second, the spread between the 10-year yield and the central bank's key policy rate is considerably steeper than in other currencies, see chart. Third, NGBs are currently trading at multi-year cheap relative to interest rate swaps, as illustrated on the previous page.

Finally, the supply story in NGBs differs considerably from that of other countries. In Norway, the NGB supply has been frontloaded to Q2 2020 due to the establishment of the "Government Bond Fund 2020", which temporarily provide capital to the corporate bond market and is funded by the issuance of NGBs. Meanwhile, the increased government budget deficit is financed via transfers from the State Pension Fund and not via increased NGB supply. With most of this year's NGB issuance behind us, supply will ease considerably in the second half of 2020 and in 2021.

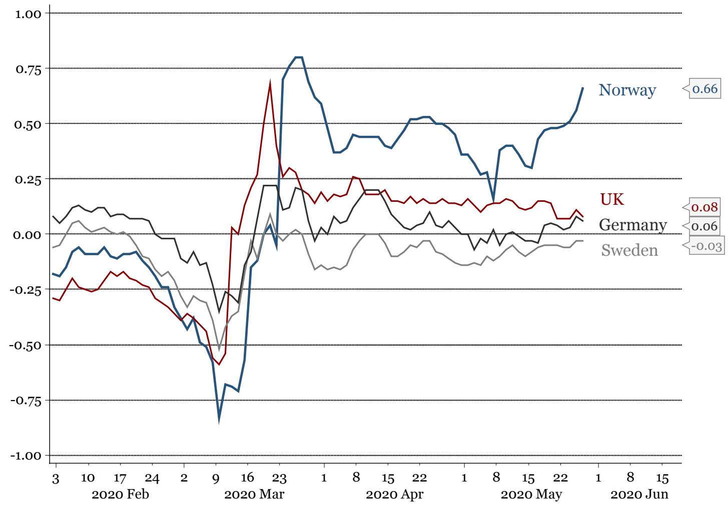
At the short-end, we see risk of higher money market premiums as we anticipate excess liquidity in the Norwegian banking system to shrink over the summer. Consequently, we favour payer positions in the short-end of the Norwegan swaps curve.

Sweden inflation indicators



Source: Macrobond/Nordkinn

10y govt. bond yields versus key policy rate



Source: Macrobond/Nordkinn

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.

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