NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – June 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

In the first week of June, the market extended the trends from May as accommodative monetary policy and reopening optimism supported risky assets and steeper bond yield curves. Risky assets also received support from economic data beating expectations across most developed economies. For instance, the Citi Economic Surprise Index for the U.S., which shows how economic data are progressing relative to the consensus forecasts of market economists, rose to an all-time high in June, see chart.

However, later in the month these trends started to reverse following an acceleration of coronavirus infections in the U.S., prompting fears of further tightening of lockdown measures. Indeed, on Friday June 26th a number of states took measures to reverse their reopening plans: In Florida, authorities have ordered ban on bar alcohol consumption and have limited public gatherings to fewer than 100 people. Authorities in Texas took even a more drastic response to the outbreak, shutting all bars completely. Because there are more than a dozen states experiencing a new wave of coronavirus cases, investors fear that other states too will have to reverse reopening decisions.

Consequently, investors began to consider the risk of a setback in the recovery in the world's largest economy over the summer. This lead to more volatile equity markets and somewhat stronger demand for high-quality government bonds in the latter half of June.

Marked-based inflation expectations, as measured by break-even inflation spreads and inflation swaps, rose in both the U.S. and the Euro Area in June. However, the increases in U.S. and euro inflation expectations were unable to offset the losses on our shorts in Swedish break-even inflation rates. Consequently, our *"Global: Comparative inflation expectations"* theme subtracted from performance in June. Other investment themes directed towards the global market had limited impact on our overall performance.

Since the emergence of the pandemic, the investment team has responded proactively to excessive market movements and dislocations under our *"Tactical risk reward trading"* theme. From positions within FX as well as fixed income, this theme - which consist of more shorter-term tactical trades in contrast to our other themes of more strategic nature - contributed positively to performance in June.

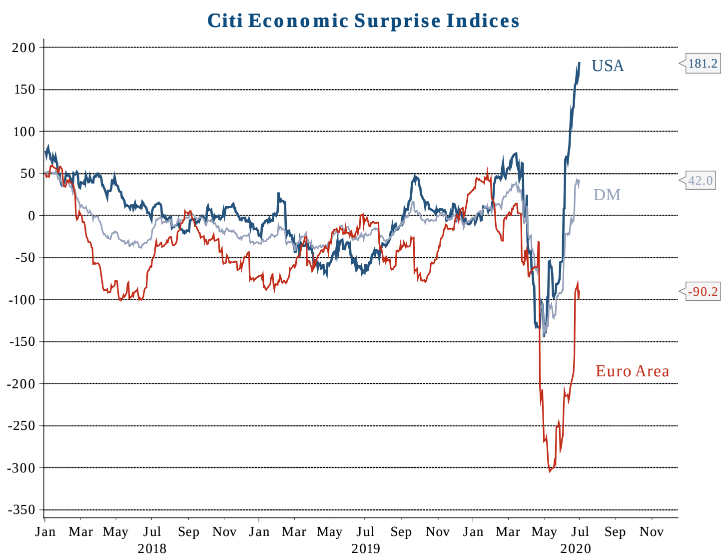
Nordic overview

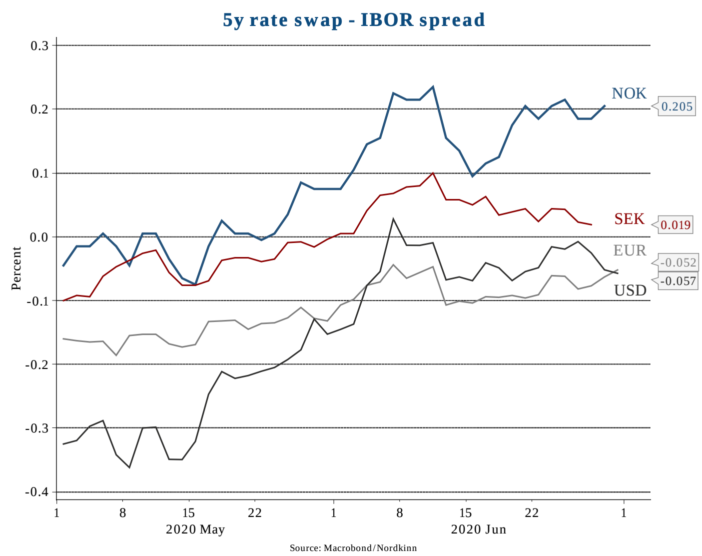
Notwithstanding the bounce in Swedish CPI in May, inflation remains way below Riksbank's projections. However, the surprisingly strong rebound lead to a sharp repricing of Swedish Break-Even Inflation (BEIs), outperforming the increase in the U.S. and European inflation markets. As already mentioned, this resulted in a poor start for our new theme *"Global: Comparative inflation expectations"*, even though the theme rebounded later in the month.

The Riksbank was again active in June and QE purchases were concentrated to longer dated bonds. As an effect, a lot of interest rate risk were drained from the market despite a pick-up in bond issuance from the Debt Office. In addition, the Debt Office presented a surplus of SEK 10 bln in government payments for May, which was significantly below expectations and thus sparked a hope that the funding need might not be as substantial as previously thought. Taken together, this resulted in a solid performance of SGBs in June, contributing to losses on our *"Sweden: Rising bond supply"* theme. In the short-end of the curve, STIBOR fixings continued to slip throughout the month, supporting our short-end receiver swaps.

In Norway, incoming data point to a clear rebound in economic activity. The upturn mainly reflects easing of containment measures amid declining infection rates, but is also a result of forceful measures to dampen the economic fallout of Covid-19. This includes financial support measures to households and businesses, including a change in petroleum taxation. Moreover, the 150 bps interest rate cut has bolstered household's confidence as reflected by a sharp rebound in retail sales and the housing market. The 1.5% increase in existing home prices in May offset the entire decline during the month of March. As the economic rebound has been stronger than the Norges Bank had projected, on June 18th the Board presented a revised interest rate forecast, signalling rate hikes in 2022 and 2023.

Considering lingering uncertainties regarding the pathway for Covid-19 as well as global growth, the revised monetary policy outlook took the market by surprise. Consequently, NOK rates underperformed across the maturity spectrum, see chart. Meanwhile, NGBs attracted significant demand towards the end of the month after the Norwegian Debt Office revised its funding needs for 2020. This resulted in positive contribution for our *"Norway: ASW trading"* theme.





Global markets

According to the June IMF World Economic Update, the 2020 downturn in the global economy will be deeper and the recovery will be more gradual than projected in April. The inflation outlook has been revised downwards and remains muted, reflecting expectations of persistently weak aggregate demand. However, in contrast to the April projections, the risk assessment around the June economic projections appears more symmetrical.

The economic recovery after reopening in China has so far been stronger than anticipated. Other areas that have reopened could also experience a faster normalisation of activity. Moreover, medical breakthroughs with development of an effective vaccine would lift sentiment. Meanwhile in the U.S., the one-day increase in coronavirus cases is accelerating again and hit new highs in June, see chart. A couple of U.S. states are therefore reversing their reopening plans. This raises the risk that the country's economic rebound could be short-lived. Financial conditions may again tighten.

Taken together, there is still a higher-than-usual degree of uncertainty around the economic outlook, warranting vigilance and discipline in the consumption of risk. In particular, we prefer consuming risk that has a low level of directionality and thereby lesser correlated with risky assets, while we favour relative value trades where we continue to see a breadth of interesting opportunities.

For example, the skewness in the balance of risks around the outlook for monetary policy differs from one economy to another. This partly reflects variances in the economic outlook, but also in differences in central banks' reaction functions. Even before Covid-19 the Fed was coping with muted inflationary pressures, and it will take a very long time before the economy has weathered Covid-19 and is on track to achieve its maximum employment and stability goals. Consequently, the Fed is not even "thinking about thinking about raising rates". Rather, we believe the Fed is seriously considering implementing yield curve control, i.e. interest rate caps on Treasury yields, an approach similar to what Bank of Japan has implemented since 2016.

Other central banks may also consider easing monetary policy further in order to support the economy and inflation over the medium term, including such of the ECB, the Bank of England and the Riksbank. In contrast, the Norges Bank stands out as the only G10 central bank forecasting tighter monetary policy over its forecast horizon. As a consequece, we added new risk to our *"Global: Relative Monetary Policy"* theme, see next section on the Nordic Outlook for details.

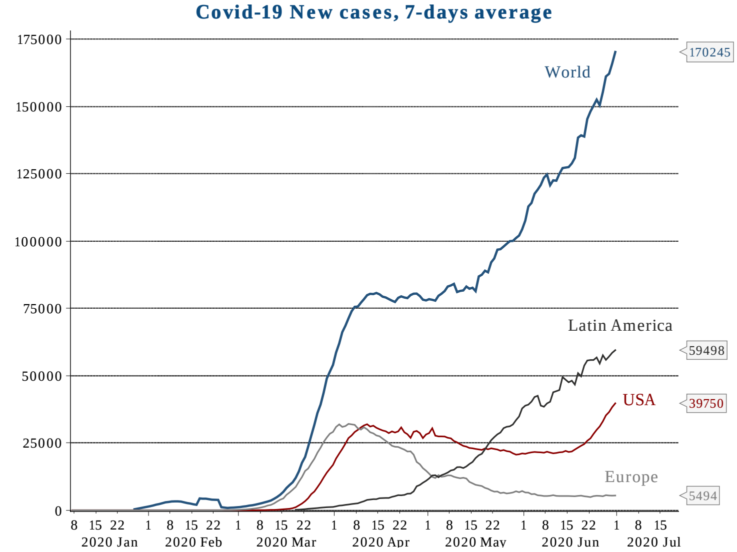
Another example of relative value in the current environment is differences in market-implied inflation expectations between countries. The global recession is undoubtly deflationary for the next few quarters, but looking beyond the short term we expect more volatile inflation ahead. However, in Germany and the U.S. the markets have so far priced only the deflationary impact, as witnessed by the relative performance and valuations of 5y and 10y break-even inflation rates (BEI), for instance. For comparison, Swedish BEIs are still relatively elevated, even though they have dropped significantly this year.

Interestingly, Swedish BEIs price in an increase in inflation relative to peers in coming years, even though the recent appreciation of the SEK exchange rate (among other factors) suggest the opposite, see chart.

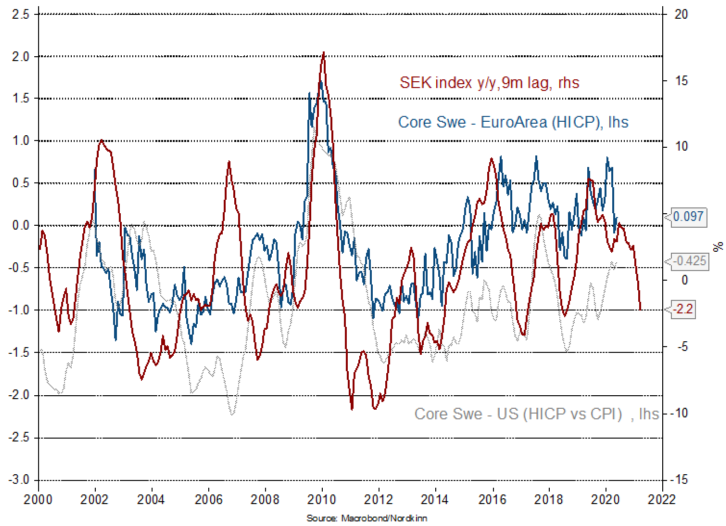
Given that the world is still very globalised, we believe common global forces will decide the main drivers of long-run inflation in the developed world. In the short-run, country-specific deviations between countries do happen, but over time there tend to be small variations in inflation across markets. This insight is at odds with how markets are pricing Swedish inflation compared to European and U.S. inflation over the next few years.

At the start of June, we launched a new theme, *"Global: Comparative inflation expectations"*. The idea behind the theme is that over time expectations will gradually converge between the countries. Partly, this theme is an extension of our previous theme *"Sweden: Slower growth, lower inflation"* (closed end of May), which focused on, in our view at the time, the too high expectations about future Swedish inflation.

Covid-19 New cases, 7-days average



Relative Swedish inflation and SEK index



Nordic markets

Riksbank´s purchases of bonds in June kept bond yields stable and the summer will most likely be relatively quiet as both issuance and QE slows. The Riksbank's decision to boost QE purchases announced at July 1st will act as an obstacle for bond yields to move significantly higher. However, while QE has the upper hand for the moment, it may not be the case after summer when a new fiscal budget is to be discussed. On top of the current funding need, the government could address new measures to boost the recovery. We expect the pending tug-of-war between issuance and QE purchases to continue and opportunities to trade bonds and bond spreads will arise. We organise these opportuninities within our *"Sweden: Rising bond supply"* theme.

In the new theme *"Global: comparative inflation expectations"* we address the relative pricing of future inflation in Sweden compared to other markets. Admittedly, we do not have a strong view on what absolute BEI level is the most accurate. Will the pandemic be solely deflationary or eventually inflationary? The jury is still out. Instead, we focus on how Swedish BEI and real rates trade relative to peers. History shows that Swedish inflation moves fairly close to European and the U.S., albeit now characterised by large disconnects.

The current market pricing suggests that Swedish inflation on average will be 1 percentagepoint above European inflation over the next five years. One factor, that tend to move the Swedish inflation relative to European/the U.S., is the currency. The chart on the previous page shows how the difference in core inflation (Sweden vs Euro Area core HICP and U.S. core CPI) do move with the Swedish Krona Index (KIX). Clearly, market pricing is stretched at current levels.

Another factor that in theory could drift Swedish inflation higher relative to peers is Riksbank rate hikes that would increase mortage costs in the CPI basket. However, like in the U.S. and Euro Area not much is discounted in terms of rate hikes: Only 50 bps between 2025-2030, see chart below. Meanwhile, the pricing of inflation during the same period is very close to the inflation target, with 5y5y BEI at 1.8%. Hence, despite expectations that inflation will run close to target over the five year period, markets expect more or less no action by the Riksbank. This signals an inconsistency, but also results in very low real yields. Swedish 10y real yields are among the lowest in the developed world. As long as this is the situation, we believe Riksbank are more or less the only "end investor" of SGBs. Domestic investors tries to find alternative assets with some positive yield. We expect markets to continue to compress spreads to SGBs.

The Norges Bank is the only G10 central bank projecting interest rate normalisation on its forecast horizon. According to its updated interest rate projection, the Monetary Policy Committee (MPC) envisages a 25 bps rate hike in the second half of 2022 and an accumulated 75 bps of tightening by the end of 2023. This was a major change from the May 7th monetary policy statement, where the committee cited unusually high uncertainty and the risk of a prolonged downturn, thus forcasting the interest rate to remain at its effective lower bound across the entire forecast horizon.

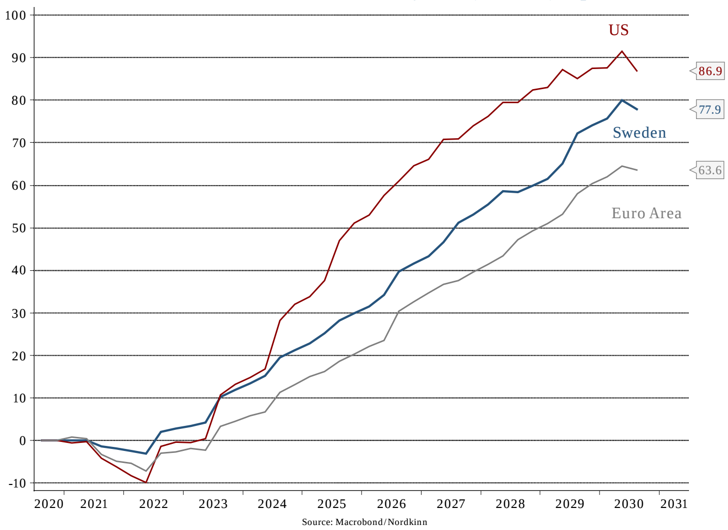
The change in in tone between May and June was surprising given that there is still very high uncertainty regarding the pathway for Covid-19 and for the the economic recovery ahead. That said, a limited number of data points regarding household demand may suggest that there has been a sharper rebound in household sentiment than the committe expected (and feared) when it slashed rates by 150 bps to 0% in May. The sharp rebound in household demand, combined with the risk of a build-up of financial imbalances when rates are low, seem to have encouraged the committee to revise its interest rate path upwards.

Incoming data since the June 18th statement confirms a pick-up in household demand. Retail Sales increased by +2.8% in May following a strong +4.8% in the previous month and real estate brokers report further strong development in the housing market in June. We see this trend most likely continuing in coming months. Against this backdrop, we have decided to close our *"Norway: Weaker growth outlook"* theme.

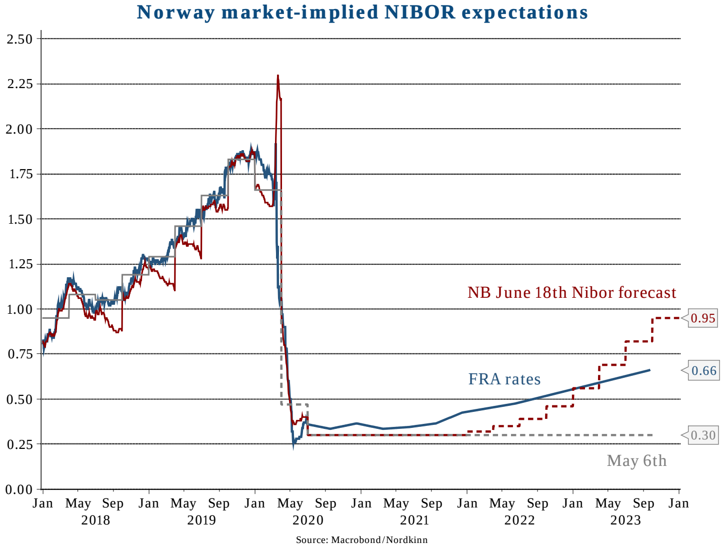
If we are right that rebound in household demand continues over the summer, and barring another sharp and uncontrolled virus outbreak, the MPC may very well revise its interest rate projection upwards again in Q3. The probability of that happening is not sufficienty discounted in the NOK interest rate curve in our view, see chart. The spread between 5y NOK swap and 6m Nibor has not steepened a lot when comparing to the rate curves of other economies. Consequently, in June we brought our *"Global: Relative Monetary Policy"* theme back to life, anticipating the 3-5 year segment of the NOK curve to underperform relative to other G10 rates.

Meanwhile, given the cheap FX hedging cost, relatively low valuations and prospects of much lower supply ahead, we expect the long-end of the NGB curve to attract increased demand from global investors.

Priced rate hikes over next 10 years (3m fwd), bps



Norway market-implied NIBOR expectations



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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