NORDKINN
ASSET MANAGEMENT

Nordkinn Market Review & Outlook – July 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

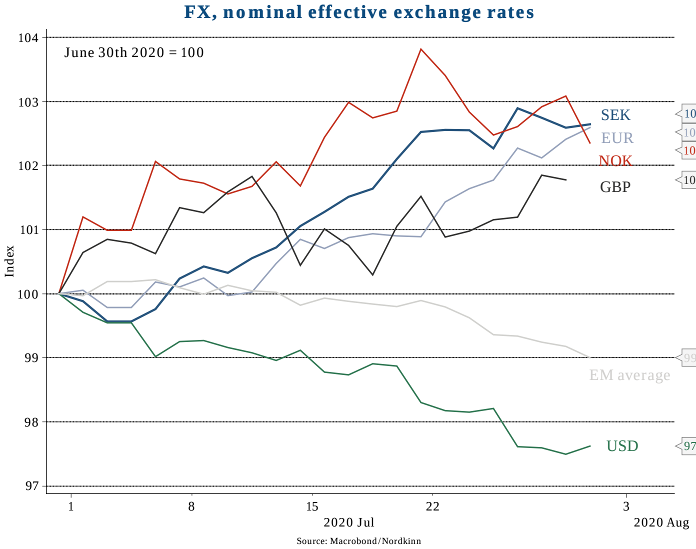
Government bond yields declined across developed economies in July as central banks promise to maintain extraordinary support to alleviate the economic consequences of the Covid-19 pandemic. Meanwhile, in anticipation for economic recovery, corporate bond spreads compressed and equities continued to recover from the troughs reached in March.

Incoming GDP-data confirmed a record steep contraction in the economic activity in the U.S. and euro area in Q2, while higher frequency data suggests a recovery could be building. According to PMI survey data, business activity across the Eurozone rose in July for the first time since February as economies continued to reopen after lockdowns implemented to prevent the spread of Covid-19.

Moreover, on July 21st EU leaders agreed on a ground-breaking plan to jointly borrow EUR 750 bln to respond to the coronavirus pandemic. The recovery fund, to be compromised of EUR 390 bln in grants and 360 bln in loans, is not only a big fiscal stimulus package. It also marks a potential leap into fiscal integration. For the first time ever, the EU has in effect committed to a form of debt union.

At the same time, investors are balancing these positive developments against mounting concerns about the consequences of a second coronavirus wave in places such as the U.S. and Spain. In the U.S., hospitalisation continued to rise and the death toll soared in July, while new infections appear to have peaked. In Spain, growth in new cases rose significantly in July. However, the situation in other European countries appears, for the time being, largely under control.

Against the backdrop of these developments, the EUR and other European currencies appreciated on broad basis in July, whereas the USD sold off, see chart. Consequently, the EUR/USD exchange rate appreciated sharply to 1.19 by the end of July from around 1.12 one month earlier. In June we went long EUR/USD as part of our *"Tactical risk reward trading"* theme, which we later unwound following its 5% appreciation in July.



Nordic overview

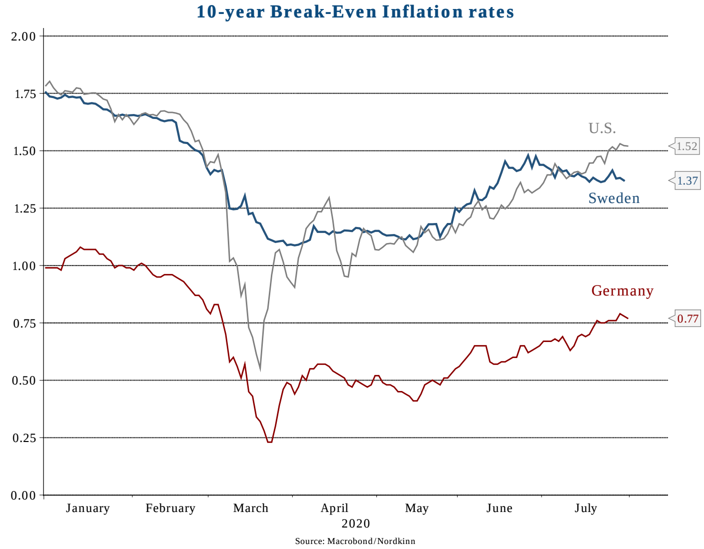
On July 1st the Riksbank announced an extension of asset purchases to SEK 500 bln from SEK 300 bln to help the economy and inflation to recover from the pandemic. It also announced that it will begin purchasing corporate bonds in September. The repo rate was kept unchanged. According to the meeting minutes published on July 10th, members of the Executive Board did not rule out the possibility of a cut in the repo rate, even if such action was not the baseline scenario.

CPIF inflation rose to 0.7% June from 0.0% in the previous month, thus above the 0.5% expected by consensus. Non-energy inflation also exceeded expectations, rising to 1.3%. The market reaction to the CPI data was however relatively muted. In fact, Swedish Break-Even Inflation (BEIs) moved sideways in July, whereas the U.S. and Euro inflation expectations rose, see chart. This lead to positive attribution from our *"Global: Comparative inflation expectations"* theme.

In addition, the Riksbank's decision to extend asset purchases contributed positively to our *"Sweden: Hunt for yield"* theme. Furthermore, the underperformance of Swedish government bonds relative to other assets resulted in positive returns from our *"Sweden: Rising bond supply"* theme.

Mainland-Norway GDP rose by +2.4% in May from April. The rebound was weaker than expected (Norges Bank +3.5%), largely reflecting a somewhat disappointing development within business services, in parts within manufacturing and energy extraction services. Meanwhile, household consumption rose by 4.8%, with large contributions from both services and goods. The strong growth in household demand seems to have continued in June, with retail sales surging 5.7% m/m and a blistering 13.9% y/y. Data and anecdotic information about the real estate market indicate exceptionally high activity and strong price growth over the summer.

Lower NIBOR-fixings and receiver flows from international systematic funds dominated the Norwegian fixed income market in July, resulting in tighter cross-country spreads in the 1 to 5 year segment of the curve. Consequently, our *"Global: Relative Monetary Policy"* theme subtracted from performance in July. While NGBs performed slightly versus swaps, the contributions from our *Norway: ASW trading"* theme were marginal.



Global markets

The outlook for the European economy has improved recently and was reinforced by the historical achievement on July 21st. For the first time, as an instrument of macroeconomic crisis management, EU leaders have agreed to allow for direct borrowing by the European Commission under the umbrella of the EU Budget. Brussels will borrow EUR 750 bln from the debt markets to facilitate the recovery in member states.

The recovery fund will remove some of the pressure on the ECB, which has delivered most of the macroeconomic policy response so far. A sound interaction between fiscal and monetary policy – working in the same direction – is a more efficient policy mix than we have seen in the past. Combined, monetary and fiscal policy will directly bolster investor confidence and growth expectations in the region, underpinning the single currency.

In addition, the more indirect effects of the EUR 750 bln fund are perhaps even more important over time. By sharing some fiscal risk, issuing a sizeable amount of joint debt, the EU is sending out a strong signal to the world and financial markets that they are "here to stay".

Furthermore, the euro area and the single currency has received further tailwinds from a successful European reopening process, at least so far. The normalisation process started in Northern Europe in mid-April and has been implemented carefully and gradually in most EU countries, and there have so far been few setbacks. Spain is an exception, which is taking new measures amid fears of a more widespread "second wave".

The reopening across Europe has become visible in survey data. In July, the Euro area composite PMI improved by 6.3pt to 54.8. This was notably above expectations and consistent with a continued positive impulse to economic activity from easier lockdown measures.

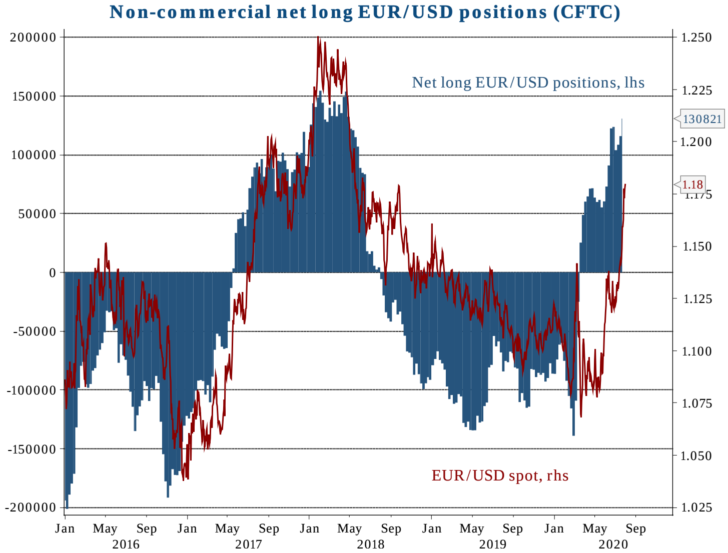
In the short-term, as the Euro has appreciated even more than immediately after the famous "whatever it takes" speech by former ECB-President Draghi in July 2012, we expect more two-way price action in the EUR/USD. Supporting this view, flow data suggests speculative investors have already covered their shorts and have moved to being long the EUR, see left hand chart.

On a medium-term horizon, however, we do think the path of least resistance is up. This does not only relate to the expected positive impact of the historical EU deal. We also agree with the IMF's latest forecast that the U.S. economy will likely underperform global growth ahead. This is usually EUR/USD positive, see right hand chart. Moreover, the rising probability of a Biden victory in the Presidential election will probably be seen as more positive for global growth than for U.S. growth, and thus negative for the USD. Finally, the EUR/USD remains below its long-term historical average, especially in real terms (adjusting for differences in inflation). Consequently, the team will monitor developments carefully and is prepared to re-enter long EUR/USD on dips when appropriate.

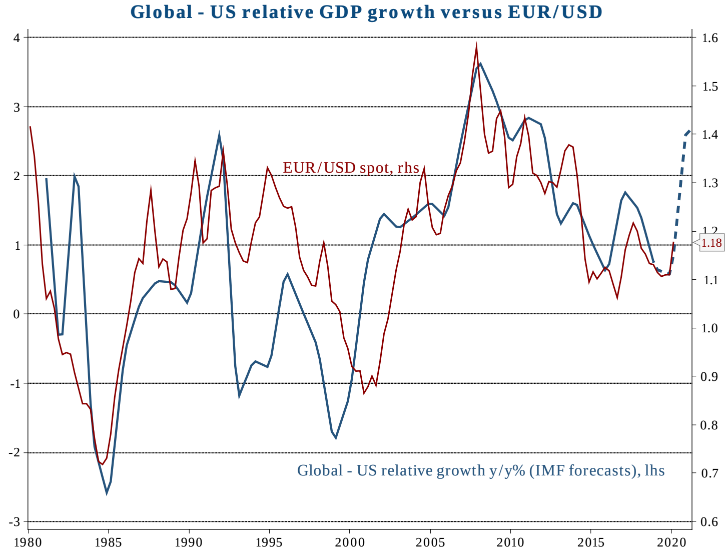
More important for our current positions is that a weaker USD will have ramifications for the relative inflation outlook. History suggests that Swedish inflation will be most impacted from a weaker USD. While inflation expectations in the Eurozone have recovered from the lows in March and April, they are still relatively low. The inflation rate over the next five years is expected to be only +0.7% on average, according to market pricing. For comparison, Swedish inflation expectations are relatively high, even though the difference has tightened somewhat and contributed positive to the fund's performance in July. We see potential for further convergence ahead, and the weaker USD has boosted this confidence. Trades consistent with this view are organised under the *"Global: Comparative inflation expectations"* theme.

The adjustments we made last month to our *"Global: Relative Monetary Policy"* theme did not pay off in July. As of current, the theme is largely seeking to capture a relative underperformance of short dated NOK-rates, and a relative flattening of the NOK curve, versus other currencies. So far, the Norges Bank stands out as the only G10 central bank forecasting tighter monetary policy over its forecast horizon. Because incoming data continues to support this outlook, see the Nordic sections for details, our conviction to this theme is intact.

Non-commercial net long EUR/USD positions (CFTC)



Global - US relative GDP growth versus EUR/USD



Nordic markets

In line with many other countries, economic activity in Sweden appears to have recovered over the past couple of months. Incoming data for growth in July has been broadly in line with the Riksbank's projections published on July 1st and while CPIF inflation was higher than expected it remains signficantly below the 2.0% inflation target.

Looking ahead at indicators of future inflation, such as unemployment rate and the trade-weighted exchange rate (KIX), data suggests inflation to remain well below target also coming years. Having contributed to higher inflation in 2019 after depreciating significantly in previous years, the KIX has appreciated more than 5% so far in 2020. This trend continued in July. Due to time lags in the pass-through from the exchange rate to CPI inflation, we expect downward pressures on inflation to resume in the second half of this year. We believe that the spread between core CPI inflation in Sweden and the euro area not only will remain low, but could even become negative.

This outlook is insufficiently reflected in market-based inflation expectations. As illustraded by the chart below, the long-term inflation expectations are largely influenced by current inflation dynamics. The chart also illustrates that there is now a gap between the spread in long-term inflation expectations between Sweden and Germany on the one hand, and differences in actual core CPI inflation on the other. This gap has grown larger in 2020, but narrowed slightly in July. Based on our forecast that Swedish inflation will remain relatively low ahead, we see scope for further convergence in longer-term inflation pricing, organised under our *"Global: comparative inflation expectations"* theme.

Turning to our *"Sweden: Rising bond supply"*, there is a tug-of-war between the Riksbank's decision to boost QE purchases announced on July 1st and bond issuance. On balance, we see scope for further SGB underperformance relative to other instruments in coming months. On top of the current funding need, the government could implement new measures to boost the recovery after summer when a new fiscal budget is to be decided.

Finally, rebouding economic activity in a context of large-scale asset purchases by both the Riksbank and other central banks remain a very positive environment for our *"Sweden: Hunt for yield"* theme. Further, the theme should maintain tailwind as the last announcement by the Riksbank showed a determination to retain covered bonds as the preferred asset in the extended QE purchase programme.

When the Norges Bank's monetary policy committee (MPC) revised its interest rate outlook upwards on June 18th, it cited a stronger economic rebound than projected in its previous assessment, particularly for household demand. The experience with Norges Bank's policy in past years is that domestic factors are very important for the rate outlook even in times of international uncertainty.

As mentioned in the Review section, incoming data since the June 18th meeting suggests a very strong rebound in household demand in Q2. True, the sharp rise in retail sales largely reflects a change in the shopping pattern from services to goods amid restrictions on travel. Nevertheless, an assessment of all indicators combined suggest an impressive bounce in household demand also when comparing to other countries undertaking similar Covid-19 restrictions.

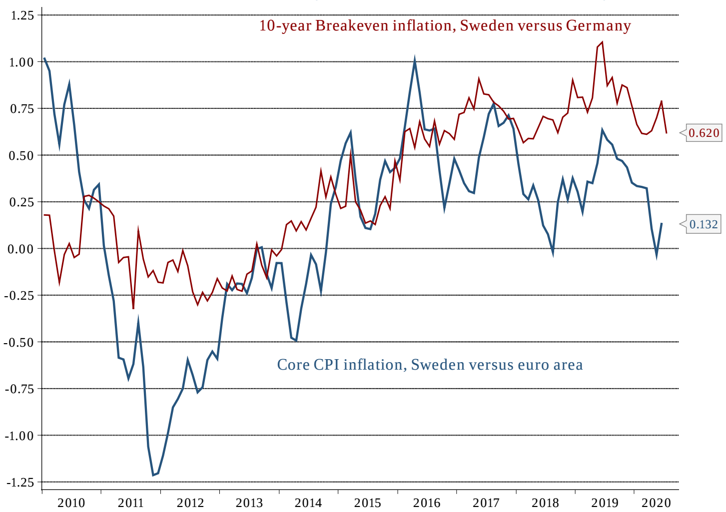
Developments in the Norwegian real estate market support this assessment. Existing home prices continued upwards in June and brokers report that there was an exceptionally strong development in July (data to be released on August 5th). The MPC's concern in June that a "long period of low interest rates could increase the risk of a build-up of financial imbalances" has become even more valid.

Despite lingering uncertainties related to Covid-19 and global growth, we anticipate that the MPC of the Norges Bank will assign particular weight to incoming strong data on domestic demand when it is set to update its interest rate oulook on September 24th. We will also carefully read the press statement following the upcoming MPC meeting on August 20th for any hints in this direction. However, because this is scheduled to be an interim meeting without a press conference, the committee will probably wait and see until the September meeting before formally presenting a revised interest rate projection.

In our view, the market understates the risk of Norges Bank rate hikes in 2021 and 2022. Looking ahead, we anticipate the 1 to 5 year segment of the NOK curve to underperform other G10 rates. We also expect the NOK curve to flatten relative to G10 curves. Trades consistent with this view are organised under our *"Global: Relative Monetary Policy"* theme.

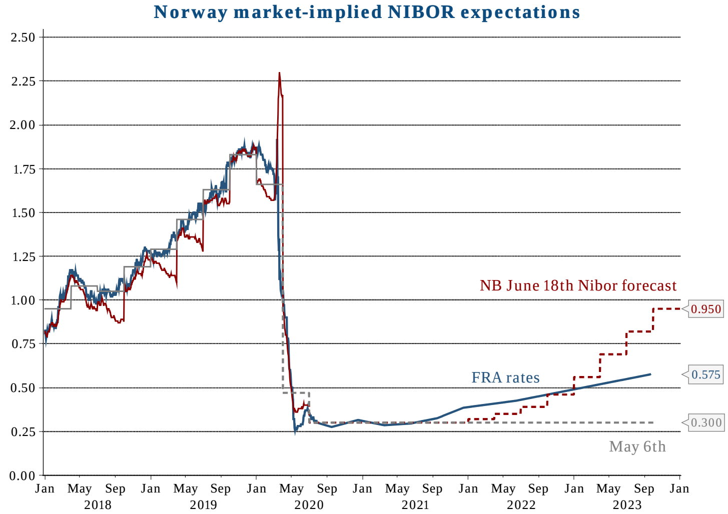
Meanwhile, given the cheap FX hedging cost, relatively low valuations and prospects of much lower supply ahead, we expect the long-end of the NGB curve to attract increased demand from global investors and perform relative to swaps, all part of our *"Norway: ASW trading"* theme.

Core inflation and 10y BEI, Sweden versus Germany



Source: Macrobond/Nordkinn

Norway market-implied NIBOR expectations



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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